BIM Barrantagh Review

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ECONOMIC & GEO-POLITICAL BACKDROP | SOFT LANDING EXPECTED FOR GLOBAL GROWTH

Economic growth in Canada is improving after a significant slowdown in the final quarter of 2018. Growth was a solid 2% in Q3, before oil prices declined in Q4 and growth decelerated to 0.4%. The economy has picked up in 2019 with reported January GDP growth surprising to the upside despite oil production curtailments in Alberta. A big boost came from the manufacturing and construction sectors. Q1 GDP growth is tracking around 1.2%, not nearly as strong as Q2 and Q3 2018, but an improvement from Q4 and only a bit below long-term growth potential. Oil prices rebounded in Q1 by US$20 per barrel for WCS (Western Canadian Select) and US$15 for WTI (West Texas Intermediate). Going forward, stable or improving oil prices will be important for 2019 as residential housing activity in Toronto and Vancouver remains subdued.

Job growth in Canada has been resilient, with first quarter figures showing that companies continue to hire and the unemployment rate remains at a record low. Wage growth has improved in 2019, after declining at the end of 2018, and is supporting consumer spending. **In January, retail sales, excluding volatile auto and gasoline sales, reported the first monthly gain in six months.** Consumer household debt remains a concern, but lower interest rates are providing more breathing room.

The economic slowdown in Q4 2018 caused enough of a concern for the Bank of Canada to shift its attention from worrying about inflation surpassing 2% to supporting the economy. So far, core inflation has remained around 1.9%, but could decline given the backdrop of modest economic growth. The BoC appears unlikely to raise interest rates for the foreseeable future.

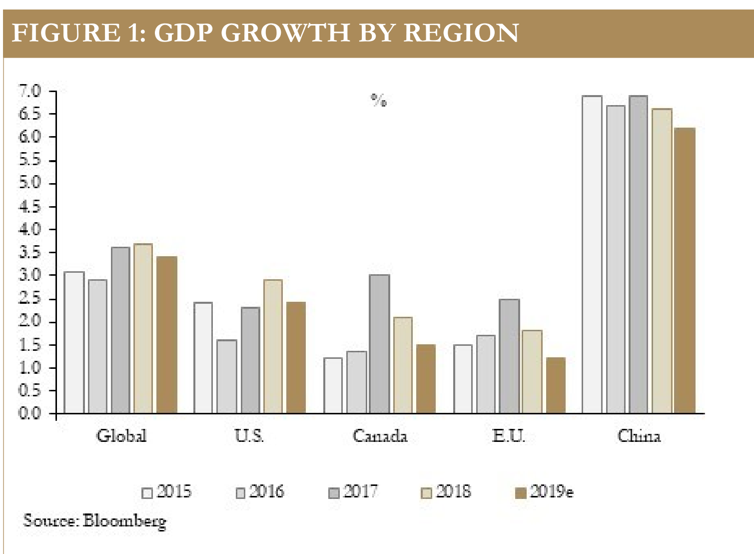
Canada is attracting and admitting a large number of immigrants, with the influx creating new supply for the workforce and demand for housing and consumer spending. Meanwhile, Canadian productivity and global competitiveness remains a challenge, particularly in the energy sector.

U.S. ECONOMY

The U.S. economy continued to slow in the first quarter of 2019 and is on pace to expand by 1.5%. Looking back, U.S. economic growth peaked in Q2 2018 at 4.2%, with the unsustainably high growth in part due to the 2018 tax cuts, and has been normalizing ever since. With the stimulus from the tax cuts now fading, economic growth will again depend on population growth and productivity improvements. Data for March is looking better and it appears that growth will reaccelerate. The GDP forecast for all of 2019 is a sustainable 2.4% and Q2 should make up for lackluster growth in the first quarter. **We are watching economic data closely to gain confidence that the U.S. economy is turning the corner from decelerating to sustained growth.**

After an employment hiring boom in January, February was very poor, but the two months average out to a respectable job gain. The unemployment rate has continued its downward trend and more people are entering the workforce. Year-over-year wage growth in February reached 3.4%, the highest since 2009, and continues to trend upwards. **The job market is the backbone of the U.S. economy and as long as people remain employed, the economy will keep growing.** Auto sales peaked several years ago, but we are monitoring home sales closely, which have room for improvement. U.S. existing home sales slid through most of 2018 as interest rates climbed, but since November mortgage rates have fallen quickly, which should support the housing market.

FIGURE 1: GDP GROWTH BY REGION



Source: Bloomberg

With its mostly closed economy and strong employment, the U.S. should continue to grow and perform well (Figure 1). An eventual trade deal with China should help U.S. exports and the global economy. Lower interest rates instigated by the Federal Reserve communicating that it will pause its rate hiking cycle will help businesses and consumers. There do not appear to be any large disruptive bubbles in the economy that could cause major challenges. Political interference could remain an overhang, particularly with regards to the fiscal spending and the budget deficit.

EUROPE & CHINA

Economic growth in the Eurozone has slowed. Q4 was reported at 1.1%, slightly below earlier forecasts. Thus far, it does not appear that growth will improve as 2019 GDP growth is forecasted at 1.2%, and relies on better growth in the second half of the year. Italy's economy contracted in both Q3 and Q4 2018 and is in a technical recession. Germany has not faired much better, with GDP growth of -0.2% in Q3 2018, followed by 0% growth in Q4. Germany should return to positive growth in Q1 and 2019, but the country relies heavily on exports, and in particular demand from China. Brexit uncertainty continues to remain a challenge for Europe. However, European employment and wage growth remain strong, with core inflation still around 1%.

Officially reported economic growth in China has continued to moderate, but leading indicators are beginning to perk up. The Chinese government has taken several steps to boost economic growth and is actively negotiating a trade deal with the United States that will eliminate tariffs on Chinese exports to the U.S. The interest rate pause from the U.S. Federal Reserve will have a positive flow through effect on the Chinese economy and the strong Shanghai stock market should bolster consumer sentiment.

EQUITY MARKETS | SENTIMENT REBOUNDS, FUNDAMENTALS TO FOLLOW

Equity benchmark returns were exceptional in the first quarter, with Canadian and Global indices returning +13.3% and +10.5% (+12.7% in USD terms), respectively. Strength was broad-based across sectors.

In our prior BIM Review, we opined that any one of concrete progress on the U.S.-China trade file, a lack of further yield curve flattening, or a less fractious political environment could serve to unlock the fundamental value in equities. A resolution of the U.S. government shutdown, constructive commentary on trade negotiations and the dovish pivot from global central banks were positive developments in the quarter.

The recent inversion of the U.S. yield curve requires close monitoring given it has been one of the most accurate leading indicators of previous recessions, although not prescriptive on timing. **When considering past instances of yield curve inversion, we recall the oft quoted market axiom that "Bull markets don't die of old age, but of excess" and note that the '08 and '01 recessions were preceded by inversions, but also more importantly by bubbles in U.S. housing and technology stocks, respectively. From our analysis of the current financial landscape, we don't see any material excesses in asset classes of importance.** Additionally, U.S. inflation remains well below the levels experienced during prior instances of yield curve inversion (Figure 2), which should allow the U.S. Federal Reserve to remain accommodative. It is possible that the low level of absolute rates in non-U.S. developed markets, and perceptions of further monetary policy easing, are playing an outsized role in shaping the U.S. yield curve.

While 2019 consensus EPS (earnings per share) estimates for the bellwether S&P 500 index have moderated, echoing the recent deceleration of economic data, full-year earnings growth of 4% is expected. The first quarter corporate reporting season should represent a trough in earnings growth, but we concur with the view that fundamentals should improve over the rest of the year (Figure 3). Furthermore, we believe a concrete resolution of the U.S.-China trade dispute would de-risk earnings estimates given the conservatism embedded in corporate outlooks impacted by the issue.

GLOBAL MARKETS

Global equities staged a remarkable recovery, from one of the worst fourth quarters on record, but with notable divergences. Yield sensitive sectors such as real estate and utilities outperformed in the fourth quarter selloff, but also performed very well during the first quarter rebound as interest rates plunged. These rate-sensitive sectors now trade at elevated valuations. On the other hand, many economically sensitive sectors, such as industrials, materials and financials, have not fully recovered from the declines suffered in the fourth quarter of last year and trade at more attractive valuations.

From a geographic perspective, markets in China and Australia were particularly strong in the first quarter, while European exporting countries, along with Japan, lagged. Given structurally lower growth in the domestic economies of Western Europe and Japan, these economies were more impacted by the trade dispute and emerging markets slowdown. As the U.S.–China trade discussions become more amicable, equity markets in these lagging regions could benefit the most, particularly as valuations are relatively attractive.

CANADIAN MARKET

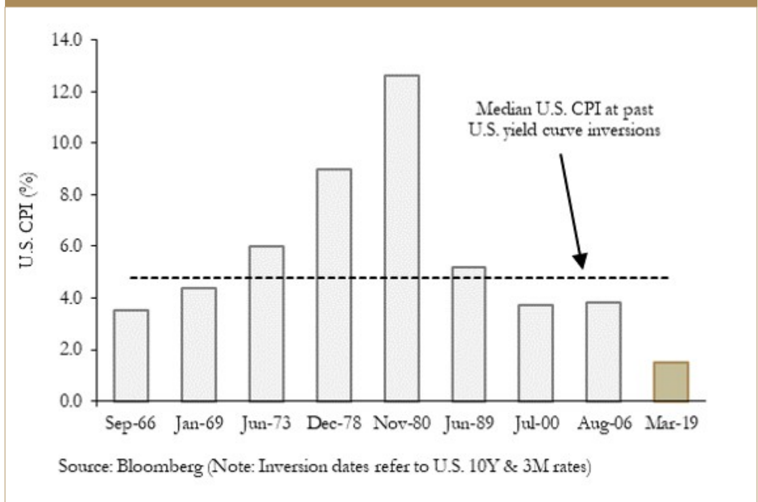
Capital markets pay closer attention to politics during a federal election year, though the provincial election in Alberta is also likely to warrant scrutiny given the energy infrastructure challenges the region is facing (recently compounded by a further extension of the expected in service date for the Enbridge line 3 replacement project). While all have expressed frustration, the current opposition United Conservative Party seems prepared to pursue confrontational policies, such as the pursuit of a referendum on equalization payments in 2021, should a coastal oil pipeline not be built.

More relevant to the upcoming federal election was the recent announcement of a CRTC (Canadian Radio-television and Telecommunications Commission) review of mobile wireless service, with a preliminary suggestion that wholesale resellers should be mandated access to the networks of the national carriers. While lower wireless prices clearly benefit consumers, businesses will only spend capital when forecasting adequate returns, which make the findings puzzling when considering the large levels of expected capital deployment in advance of a future 5G rollout. For now, we view the announcement largely as noise, given certain caveats in the proposal and the interesting timing ahead of the election.

PORTFOLIO INSIGHTS

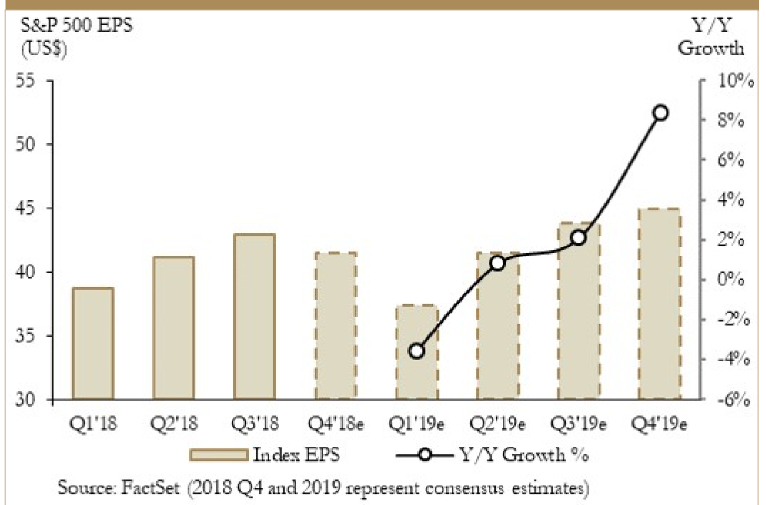
In Canadian portfolios, we took advantage of market volatility in the quarter to initiate a position in Toromont Industries, one of the world's largest Caterpillar heavy-equipment dealers with operations mainly located in Eastern Canada. The company's valuation became attractive due to a combination of a relatively weak

FIGURE 2: U.S. INFLATION AT PRIOR INVERSIONS



Source: Bloomberg (Note: Inversion dates refer to U.S. 10Y & 3M rates)

FIGURE 3: EPS GROWTH IS BACK HALF WEIGHTED



Source: FactSet (2018 Q4 and 2019 represent consensus estimates)

third quarter earnings report (which we judged as mostly due to transient factors) and generally poor market sentiment early in the first quarter. Toromont is in the process of improving the operations of the recently acquired Hewitt Group (an acquisition that materially expanded its presence in Quebec and Atlantic Canada), with the initiatives likely resulting in strong cash flow growth. Furthermore, the company should benefit from infrastructure investment programs gathering momentum across its footprint.

In Global portfolios, we continue to own Total System Services (TSYS), a credit card processor and merchant acquirer that benefits from growing credit card usage trends (driven by a healthy consumer and a transition towards electronic payments and e-commerce penetration). The company's technology is used to get card transactions on-and-off the Visa and MasterCard networks. TSYS is a leader in each of its three operating segments: credit card processing for financial institutions and merchants; assisting merchants to accept credit cards in-store; and providing prepaid/direct deposit cards to consumers and small businesses. Additionally, TSYS provides value-added solutions such as fraud prevention, data analytics, omni channel acceptance and card-holder loyalty programs. Lastly, the importance of scale has resulted in significant industry consolidation in the past several years, which has allowed TSYS to expand into faster growing services and new verticals.

FIXED INCOME MARKETS | CENTRAL BANKS TALK INTEREST RATES EVEN LOWER

Economic data reported during the first quarter led the bond market and central banks to become increasingly concerned about the sustainability of the economic cycle. Interest rates were generally steady through the first half of the quarter, but fell quickly in March. The U.S. Federal Reserve perpetuated this decline at its March meeting where it changed its forecast to no interest rate hikes in 2019 and only one in 2020. This was a big reversal from December when the U.S. Fed dismissed financial market deterioration as normal volatility. The Bank of Canada (BoC) remains data dependent and is increasingly concerned about international trade and business investment. Later in March, economic data began to improve.

After falling 35bps in Q4, Canadian interest rates decreased another 30bps in Q1 as the market went from pricing further interest hikes from central banks, to pricing in rate cuts (Figure 4). Short-term Canadian rates reached as low as 30bps below the BoC overnight rate of 1.75%, implying slightly more than one rate cut from the central bank.

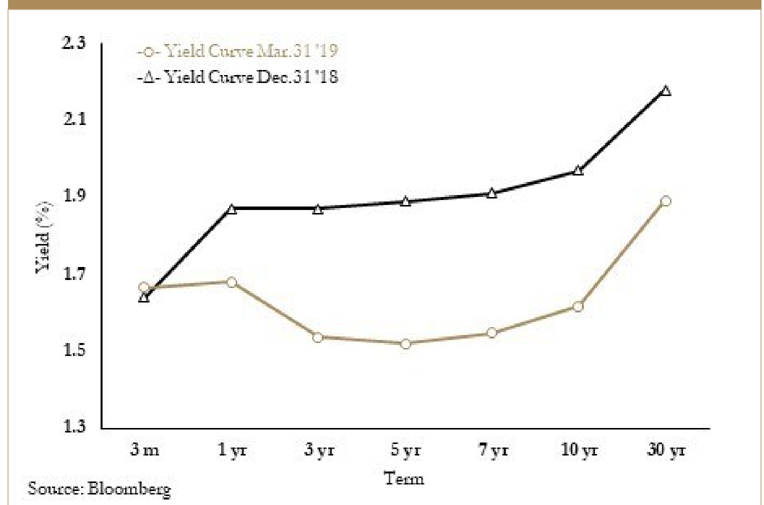
The 10-year interest rate was also affected by the prospect of a potential peak in the interest rate hiking cycle and declined to below the BoC overnight rate, and even below the 3-month rate, flattening that part of the yield curve to below zero. This has negative connotations for the economy and will be watched closely to see if it persists. The U.S. 3-month to 10-year yield curve, which is more liquid than the Canadian counter part, also went negative in the last five days of the quarter. With improving economic data, this part of the yield curve is expected to return to a positive slope.

So far in 2019, credit spreads have reflected an optimistic view on the economy. After widening out about 30bps in Q4, spreads rallied to finish the first quarter 20bps tighter, mirroring the positive sentiment experienced in equity markets. While credit spreads are not back to the tighter levels of 2018, the fixed income credit market has taken the view that central bank actions should be enough to sustain the economic cycle. In our view, there is no evidence to suggest that North America is likely to experience a 2008 or 2001 type of recession.

PORTFOLIO INSIGHTS

Declining interest rates and tightening credit spreads are the ideal scenario for the fixed income market. The best performing holdings are those with long maturities, and therefore the most sensitivity to changes in interest rates, and BBB credit ratings. North West Redwater Partnership with a 2039 maturity was the standout performer in the quarter. Other long dated A-rated corporate names also performed very well, followed by long Provincial holdings. Short-dated bonds achieved a positive return, but underperformed due to limited sensitivity to interest rates and credit spreads.

FIGURE 4: CANADIAN YIELD CURVE (%)



Fixed income portfolios entered 2019 with slightly lower duration (interest rate sensitivity) than usual after the rally in rates in the fourth quarter of 2018. The pivot in the first quarter from central banks to a more neutral stance helped credit spreads, but interest rates did little in January and February. After the lack of reaction from interest rates, and a surprisingly poor U.S. February jobs report, we added to the holding of Canada 3.5% 2045 and purchased Canada Housing Trust 2.9% 2024, mostly from cash. This increased portfolio duration to just above where it was for most of 2018.

In the first week of March, when credit spreads were tightest so far this year, we took advantage of the improved pricing to sell the long Telus 4.4% 2043 holding and replaced it with more Canada 3.5% 2045. Later in March, once the U.S. Fed made clear that it was nearly finished raising interest rates, we added more duration with a purchase of Canada 1.5% 2026 and Canada 2.25% 2029. To fund those purchases, we sold floating rate notes (FRNs) and two bonds that were due to mature in June of this year (Pembina and Ford).

Should the BoC decide it is necessary to cut the overnight rate, the middle portion of the interest rate curve offers the best return potential since it is sensitive to central bank actions and has a higher duration than shorter maturities, resulting in more interest rate sensitivity. Now that the rate hiking cycle is likely finished, we feel confident increasing portfolio duration higher than in past years. However, duration remains slightly below the benchmark.

Barrantagh

Investment Management

Barrantagh {manx gaelic} trustworthy *adj.*, dependable *adj.*

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