BIM Barrantagh Review

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ECONOMIC & GEO-POLITICAL BACKDROP | MODEST GROWTH LIKELY AHEAD

After two quarters of weaker economic growth, the Canadian economy is back on track with 2% growth expected in Q2. The Canadian consumer remains strong, backed by solid employment, and international trade is poised to be a positive contributor to growth after being a big detractor in Q1. Inventory building helped the Canadian economy expand in the previous two quarters, but this is likely to be worked off in Q2.

Canadian job growth has been solid, with the unemployment rate near all-time lows at 5.4%. Wage growth of 2.8% year-over-year is modestly above the 10-year average and has strengthened versus the second half of 2018. Consumers have made a significant contribution to growth, with strong retail sales in March followed by more solid data in April. This provides a good hand-off to Q2 growth.

While inflation is cooling across most of the developed world, Canadian core inflation has yet to show signs of slowing. The most recent May data shows measures on either side of the 2% target, with some data reaching near-term highs. The Bank of Canada (BoC) is listening carefully to business leaders about the current environment and the recent Business Outlook Survey showed confidence in the Canadian economy. If it were not for cooling business confidence outside of Canada, there would be a good case for the BoC to be raising rates again. There is usually a lag before current conditions are reflected in inflation measures.

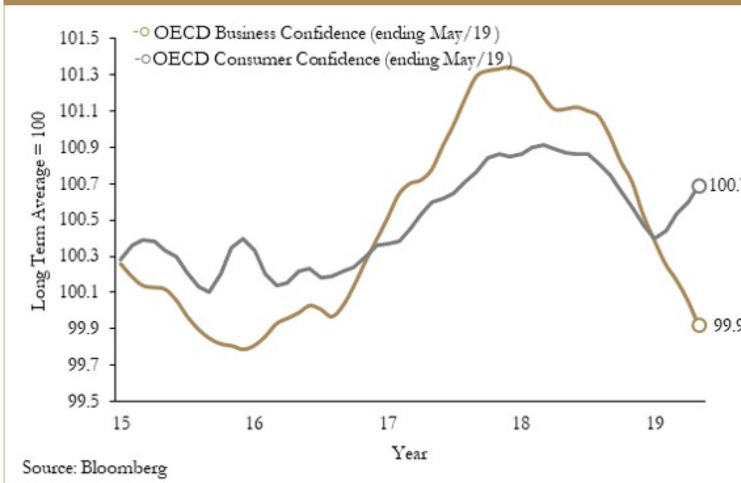
Several central banks have become increasingly dovish and accommodative to support economic growth. The Bank of Australia cut its administered rate to 1.25% in May, with further reductions expected. The European Central Bank (ECB) indicated that its Deposit Facility rate would fall from -0.40% absent an improvement in economic conditions and it will potentially revisit quantitative easing. The Bank of Canada will next update markets on July 10th and is likely keeping a close eye on the recent strength of the Canadian dollar (CAD) versus the U.S. dollar (USD). Support of export growth has been a focus of Governor Poloz' tenure, with a strong CAD a constraint in this regard.

U.S. ECONOMY

U.S. economic growth surprised to the upside in Q1, with annualized quarterly growth of 3.1%. Inventory build-up, declining imports, and higher government spending led to the surprise. Consumer spending slowed in Q1 partially due to temporary factors such as weather and the government shutdown, which should reverse in Q2 and support the 1.8% growth forecast.

U.S. job growth appears to be slowing so far in 2019. This is most likely due to the country nearing full employment, with the unemployment rate remaining at a 50-year low of 3.6% in May. Nonfarm payroll job gains have averaged +164k per month so far in 2019, down from the monthly average of +223k in 2018, but only slightly below the average of +179k in 2017. Weekly jobless claim have been trending sideways this year. Hourly earnings growth appears to have peaked in February at 3.4% year-over-year, but is still strong at 3.1% currently. Retail sales have grown in Q2, although not at the same rapid pace experienced in 2018.

FIGURE 1: BUSINESS AND CONSUMER CONFIDENCE



Source: Bloomberg

Consumer confidence in the U.S. and other developed economies has held up relatively better than business confidence in 2019 (Figure 1). As consumers in the U.S. and abroad are the backbone of the economy, elevated confidence bodes well for prospective growth. While both consumer and business confidence declined in the second half of 2018, mostly from concerns about international trade and China's slowing economic growth, a notable divergence has emerged since the beginning of the year. International trade issues are mostly self-inflicted and could be resolved swiftly, which would quickly change corporate confidence.

Communication from the U.S. Federal Reserve (Fed) about a prospective interest rate cut in July has pushed market interest rates lower and depreciated the U.S. dollar, which is supportive of U.S. economic growth. **With U.S. inflation well below the 2% target, the Fed has ample room to reduce interest rates to help businesses and consumers, and extend the economic cycle.**

EUROPE & CHINA

European growth is still inching along at 1.1% year-over-year, with inflation around 1%. Germany's economy is expanding again, with Q1 quarterly growth of 0.4% after flirting with a technical recession in the second half of 2018, and Q2 is estimated at 0.2%. France is in a similar position to Germany, while Italy is barely growing at 0.1% quarter-over-quarter. The ECB's recent dovish pivot is likely to help growth in the region.

Official Chinese GDP numbers have the economy growing at a steady annual rate of 6.4%. However, multiple data points suggest the economy is going through a rough patch. Purchasing manager indices sit around 50, sometimes in contraction territory, below 50, depending on the month and surveyor. Car sales are currently declining around 15% year-over-year. Imports are shrinking by about 4% on an annualized basis and export growth has slowed from double to mid-single digits. The Chinese currency has depreciated sharply versus the USD to closely watched levels. The central government is regularly enacting policy to stimulate growth, while an improvement in U.S. relations would help both the national and global economy.

EQUITY MARKETS | GROWTH HARDER TO FIND, BUT SITUATION SHOULD IMPROVE

Equities posted positive returns in the second quarter despite ongoing trade tensions, with Canadian and Global indices returning +2.6% and +2.0% (+4.2% in USD terms), respectively. Info tech continued to shine, and industrials and financials contributed solid performance, while energy finished in the red. Geographically, Europe and North America modestly outperformed, with Japan lagging and China posting a negative return.

The deceleration in global growth that started in the middle of last year continues to linger in part due to ongoing trade-related concerns. This has kept corporate confidence tempered and held back corporate spending in many companies we follow. At the same time, employment remains strong and interest rates have declined meaningfully, which is supportive for consumer confidence and spending behaviour. **Given the current backdrop of uncertainty, many companies are finding it harder to grow, while equity markets continue to favour those that can.** Companies that have been able to maintain growth rates, benefiting from secular tailwinds or limited exposure to the trade dispute, have generally seen valuation multiples expand. In contrast, companies with greater cyclical exposure have mostly underperformed the broader markets as investors worry about future earnings.

Equity markets have recently benefitted from growing expectations of interest rate cuts from the U.S. Federal Reserve. In fact, the Fed has indicated that potential rate cuts may be appropriate in this environment since "an ounce of prevention is worth a pound of cure". Over the past twenty-five years, we have seen four instances of Fed cuts within a broader tightening cycle and noted strong equity markets in half of the cases. **In our view, the present situation most closely resembles the 1995 episode when the Fed's proactive "insurance" rate cut amid benign financial conditions (Figure 2) protected against a potentially weakening economy and helped re-accelerate growth, which consequently drove equity markets higher.** The current low inflationary environment coupled with healthy financial conditions signals little recessionary risk at this time, though global trade developments bear close scrutiny notwithstanding the resumption of talks between the U.S. and China.

Equity valuations, in particular relative to bonds, remain attractive, with the earnings yield spread remaining well above the long-term average (Figure 3).

GLOBAL MARKETS

Both stock selection and diversification are important during periods of uncertainty. We continue to find attractive investment opportunities in underappreciated companies with high visibility of growth, often resulting from exposure to favourable secular trends. Examples would include IT services companies, given the shift towards the cloud and ecommerce, and healthcare companies that benefit from an aging population.

We are also finding opportunities in well managed companies, particularly in the industrials sector, that are facing some short-term cyclical pressures, yet trade at meaningful discounts. These companies have seen investor concern grow due to the ongoing trade conflict and moderating growth rates. We are also noticing a few special situations where companies have suffered a temporary growth set back or have been impacted by an operational issue that we expect to be overcome. These stocks in particular have become attractively priced since the market tends to place significant attention on short-term dynamics.

CANADIAN MARKET

Within Canada, we continue to see good value in telco stocks amid an evolving industry backdrop. The recent introduction of unlimited data wireless plans (or more appropriately no overage) in tandem with the CRTC review of wireless service (discussed in the previous BIM review) has resulted in relative underperformance versus other defensive sectors. Subdued subscriber loading in the (seasonally weak) first quarter also added to concerns of underlying demand weakness. However, telco stocks have exposure to several positive trends including continued healthy Canadian immigration, increasing smartphone penetration rates and the potential for multi-year tailwinds from 5G implementation.

Strategically, it seems logical for the telcos to stimulate worry-free data usage in advance of a 5G rollout, whose initial success will be dependent upon consumers embracing the benefits of enhanced mobile broadband (e.g. applications such as Ultra-HD video streaming that require faster data speed and capacity). While the actions of the incumbents could introduce noise in near-term results, we see the medium-term rationale for the decision to pivot to unlimited data plans and do not fear a race to the bottom in pricing.

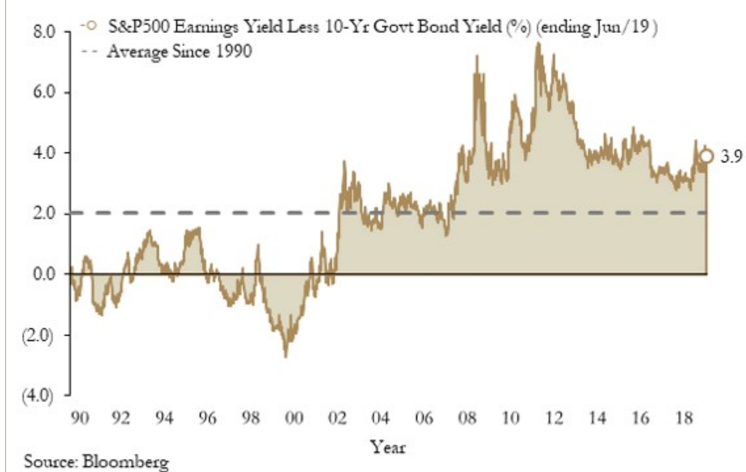
PORTFOLIO INSIGHTS

In Canadian portfolios, we recently initiated a position in Brookfield Business Partners (BBU), an entity that co-invests in mainly private companies alongside Brookfield Asset Man-

FIGURE 2: FINANCIAL CONDITIONS HEALTHY

Source: Bloomberg

FIGURE 3: EARNINGS YIELD SPREAD



Source: Bloomberg

agement's private equity funds. The investments are focused on attractively valued companies in the business services and industrial sectors that benefit from high barriers to entry and/or low production costs. We believe BBU's share price is cheap considering the cash flow generation of its current portfolio of investments, with upside as performance improvement initiatives take hold and as new investments are made (coffers are full after a recent equity raise). Brookfield's global reach, scale, long-term track record and contrarian approach to private equity investing should result in significant value creation for BBU unitholders, particularly as complex transactions and economic environments emerge.

In Global portfolios, we continue to own Leidos, the largest pure-play government IT services company in the U.S. The company's offerings include digital modernization, integration of mission critical software, cyber security, data analytics, and electronic health records. Leidos has significant exposure to defense and civil government expenditures, with its customers including many key government departments such as the army, navy, air force, homeland security, and veterans affairs. The company is currently benefiting from a major refresh cycle of old government IT systems that are digitizing, shifting towards the cloud and improving cyber security capabilities. In addition, after years of IT underinvestment in military budgets under the Obama administration, the U.S. defense and civil budgets may now be on an upswing.

FIXED INCOME MARKETS | INTEREST RATES CONTINUE TO FALL

Interest rates continued to decline in Q2 falling 16 bps, for a collective 90 bps drop in the past three quarters. In combination with tightening credit spreads, fixed income returns have been remarkable given the nature of the asset class. Returns are led by long-term bonds, with higher duration and thus interest rate sensitivity. The Long Index is up over 12% in 2019, with the corporate bonds outperforming.

The 30-year interest rate in Canada declined the most of any term in Q2 at 20 bps, ending June at 1.70% or 5 bps below the Bank of Canada (BoC) overnight rate of 1.75% (Figure 4). This has occurred only three times since 1990; briefly in 1998, 2000/01, and 2006/07. So far this year the 30-year rate has only been below the overnight rate for the month of June. **Similarly, the U.S. 3-month to 10-year yield curve is watched as an indicator for forecasting economic difficulty and has been negative for six weeks. This indicator may be distorted due to quantitative easing (QE) by a number of central banks, whereby bonds are bought with the express intention of suppressing long-term interest rates.** Therefore, the low long interest rates of today may not be a true reflection of economic conditions and the yield curve would otherwise be steeper.

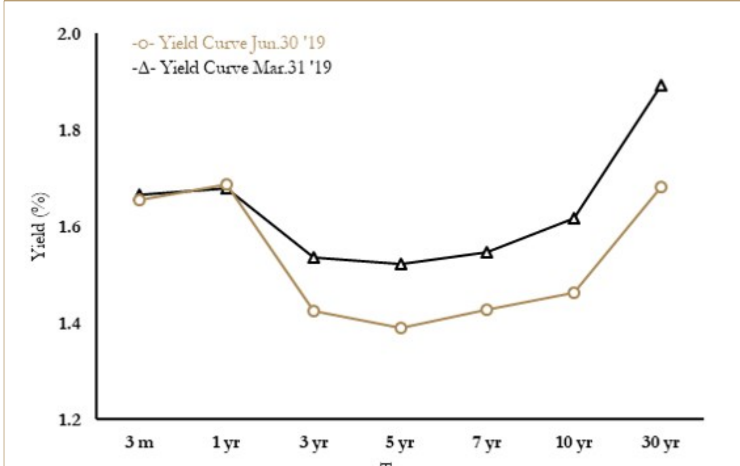
The decline in 30-year Canadian interest rates has not left much room for further performance. The 30-year rate bottomed in July 2016 at 1.55% and only stayed below 1.60% for four business days. For the rest of Q3 2016, the rate stayed just above 1.60% before rocketing up to 2.30% by the end of the year after President Trump was elected. Today there is only about 10 bps for the 30-year rate to decline to match the all-time lows and should struggle to decline beyond 1.60%.

Duration in the fixed income market increased remarkably in the second quarter, with duration for the main benchmark now just above 8 years for the first time ever. This is a result of declining interest rates and entities choosing to issue longer dated bonds. Client portfolios remain underweight duration, with the large majority of this underweight coming in the long end.

Credit spreads tightened about 9 bps in the second quarter, mostly on the idea that central bank easing will be successful in prolonging the economic cycle. More volatile corporate BBB rated bonds outperformed as spreads have come in from the wide levels at the beginning of the year. Should global economic data improve, there is room for further performance in credit spreads.

The Bank of Canada remains on pause from its rate hiking cycle as first communicated in January. Canadian economic data has been surprisingly strong, as well as core inflation, allowing the Bank to remain on the sidelines, unlike its counter parts in the U.S., Europe, and Australia.

FIGURE 4: CANADIAN YIELD CURVE (%)



Source: Bloomberg

Governor Poloz will likely be closely watching the Canadian dollar exchange rate to ensure that currency appreciation doesn't derail the economy.

PORTFOLIO INSIGHTS

As noted previously, long-term bonds were the standout performers in fixed income portfolios again this quarter. This can be explained by a chase for yield and a flight to safety. With credit spreads tightening corporate bonds performed the best, led by Highway 407 ETR 2041. Shorter maturity bonds, with lower duration, underperformed though still made a positive return.

In May, we sold Royal Bank of Canada debt that was due to be called in July this year and bought Federal-Agency Canada Housing Trust 2022, reinvesting the proceeds of a bond that was about to mature at a good interest rate further out the curve.

There were a few changes to long dated holdings during the quarter. We sold North West Redwater 2039 as the project completion was delayed again and will cost an undetermined amount to have it fully online. Management hopes to be at full capacity by the end of the year. We increased our holding in Highway 407 ETR 2041 at the start of the quarter and bought Telus 2046 in June, both at attractive spreads. We offset these changes with long maturity Canada bonds to manage the duration risk. Switching from long Canada bonds into corporate bonds adds some protection should long-term interest rates increase.

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

We are dedicated to preserving our clients' capital while generating growth through consistent application of our value-based fundamental investment philosophy

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