BIM Barrantagh Review

Volume 24 | Edition 3 | September 2019

ECONOMIC & GEO-POLITICAL BACKDROP | SOFT LANDING REMAINS IN PROGRESS

The Canadian economy continues to be one of the strongest in the developed world. Second quarter growth of 3.7% was aided by thriving exports and fewer imports. Domestic demand was a bit soft, but this was expected after a strong first quarter. So far, the third quarter has shown no signs of concern, with growth estimated at 1.5%.

The Canadian job market is better than ever, with the unemployment rate, at 5.7%, hovering near its all-time low. Job growth has been strong, along with healthy wage increases. At the provincial level, Quebec has the lowest unemployment rate in Canada and its economy has outperformed. Alberta and Saskatchewan have been soft given high exposure to resources.

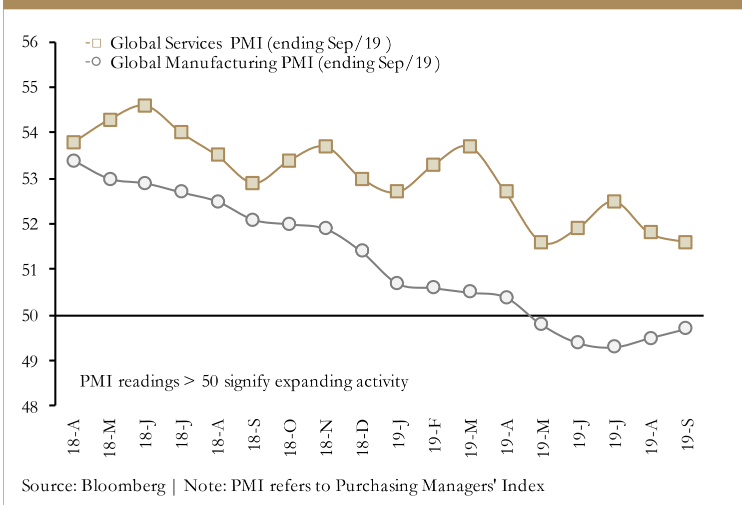
Consumer spending has been adequate, but not exceptional considering the strength in the job market. High levels of debt partially explains the limited capacity for additional spending. Fortunately, the housing market, particularly in Vancouver and Toronto, has experienced a soft landing and become balanced, while Montreal's market is strong.

The main inflation gauge remains around 2%, with Canada one of only a few countries that has met its target. In other countries, persistently low inflation is an issue as it reflects an economy growing below potential and this could harm confidence.

In October, Canadians will elect a new Federal government. It's likely to be a close contest and financial markets will likely wait for clarity before pricing in potential outcomes.

With the housing market seemingly under control and energy industry fortunes somewhat improved, the Canadian economy is in a good place. The risks to the domestic economy mostly come from abroad. As global trade volumes decrease amid volatility in trade relations, measures such as Manufacturing PMIs (purchasing managers' indices) are softening (See Figure 1), while Service sector PMIs remain relatively resilient. Business leaders take fewer risks during uncertain times, which can lead to slower economic growth, and worst case, decreased employment. Thus far, Canada has fared very well, but a spill over from the slow down in manufacturing or a further decline in confidence could tip the scales in an undesirable direction.

FIGURE 1: SERVICE PMIs REMAIN HEALTHY



Source: Bloomberg | Note: PMI refers to Purchasing Managers' Index

U.S. ECONOMY

The U.S. economy is in a similar position to Canada, with the domestic economy in good shape, but concerns persist about how struggles abroad will ultimately impact local businesses and consumers. The U.S. faces additional scrutiny from investors as it is the world's largest economy and the source of much of the recent political turmoil.

U.S. economic growth in the second quarter was reported at 2%, with a pickup in consumer and government spending offset by weakness in business investment and slowing exports. So far, third quarter growth remains on stable footing and is estimated at a healthy 1.9%.

The unemployment rate has remained steady around 3.7%, near the lowest since the 1960s. Increases in employment remain solid, but have not been as robust as last year. This is likely due to the economy starting the year closer to full employment, but could be a more ominous sign. However, weekly jobless claims are stable, neither increasing nor decreasing, and wage growth continues to be strong, supporting the view of a benign economic backdrop.

The U.S. consumer remains one of the bright spots in the global economy, with consumer spending remaining robust amid low unemployment and high wage growth. The current solid footing of the U.S. consumer is a vote of confidence for investors and the U.S. Federal Reserve.

The main inflation measure for the U.S. central bank remains comfortably below 2% and has remained below this target for most of the past decade. This disappointing inflation data, coupled with ebbing concerns about business confidence, led the U.S. Federal Reserve to make two "insurance" interest rate cuts in the third quarter. Lower rates should help the domestic economy maintain its momentum amid the export oriented challenges emanating from abroad.

EUROPE

In the second quarter, economic growth in the Eurozone slowed to 1.2% and is expected to moderate further. **The biggest concern is Germany, the stalwart of the zone, where the economy contracted in the second quarter with limited visibility for improvement.** As a manufacturing and export powerhouse, Germany is significantly more exposed to trade tensions than most countries. While employment numbers have yet to deteriorate, these figures are often slow to react. However, it remains feasible that Germany can avoid a broader downturn.

The European Central Bank (ECB) reduced its administered rate further below zero in the third quarter and will resume quantitative easing. The ECB also highlighted that new government fiscal spending would go a long way in helping the economy. The German government has balanced its budget almost every year since 2012 and is reluctant to begin deficit spending. However, pressure is building to act. Should the German government decide to increase spending, it could lead to a change in attitude from austerity across the continent. If the global economy slows further, government fiscal spending is likely to become a bigger focus.

EQUITY MARKETS | SELECTIVITY REMAINS KEY IN CHOPPY MARKETS

Strength in equities continued with Canadian (+2.5%) and Global (+1.8% or +0.7% in USD terms) benchmarks posting positive returns for a third successive quarter. Defensive sectors including, utilities and real estate, posted solid gains, while cyclical sectors trailed behind. Geographically, the U.S. and Japan outperformed, with Europe and emerging markets declining.

As discussed, the dichotomy between the consumer and the industrial economy persisted in the quarter as evidenced by a number of indicators. Service PMIs (purchasing managers' indices) remain healthy, while manufacturing PMIs (Figure 1) show that corporate confidence within pockets of the industrial sector most exposed to global trade remains weak. The feud between the U.S. and China continues to weigh on corporate sentiment. A similar dynamic is apparent in consensus sub-sector earnings forecasts, whereby select companies that are either consumer driven or benefiting from structural tailwinds have seen upward revisions to estimates, versus declines for certain heavy industry, logistics and financial services businesses (Figure 2). While there is not much evidence to support a strong industrial rebound at this time, we note that sentiment in this regard is tightly correlated to news flow on the U.S./China trade file, which did turn more positive during September following a very disruptive August (Figure 3). The countries have set a 13th round of trade talks for October. It remains difficult to envision a significant breakthrough at this juncture, as the protagonists seem to continue to place greater importance on political considerations rather than economic pragmatism.

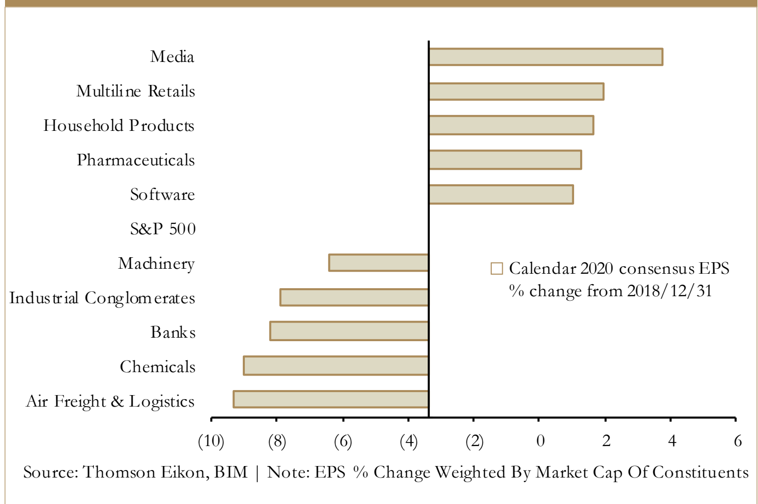
Many companies more exposed to economic growth or global trade have seen earnings growth slow, resulting in weak share price performance. Though in some instances these companies appear more attractively valued, we remain patient as we gain more confidence in earnings outlooks. On the other hand, many companies with more resilient business models have seen valuations reach levels at or above the high-end of historical ranges, and have become less appealing to us. As such, when managing equity portfolios we include exposure to companies that have either misunderstood risk profiles or underappreciated long-term growth potential, as highlighted in the Portfolio Insights section. **Although equity markets will likely remain volatile, accommodative monetary policy and the option value of a potential trade détente continue to point to a favourable risk reward proposition for equities.**

GLOBAL MARKETS

As noted previously, the trade tensions continue to reduce visibility into near-term corporate profitability. This is particularly true of companies exposed to globally traded goods, namely multinational corporations. A good example of this would be the air freight industry. Being highly exposed to global trade, some companies in this industry have seen meaningful downward revisions to earnings estimates and lagging share prices. Although attractively valued, we have little confidence in industry earnings growth given the trade dispute and a lower global growth environment. We continue to follow this industry closely, however, we remain patient.

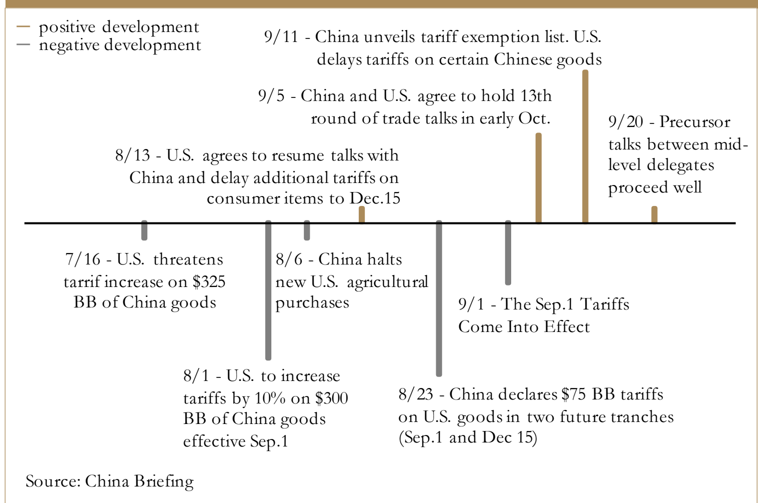
While management teams have become increasingly cautious in future growth plans, most companies are not yet contemplating drastic cost cutting actions given strong balance sheets and healthy profit margins. **Furthermore, reducing employees in a tight labour market is particularly risky should growth prospects re-accelerate, as it will be more difficult to hire employees back.** As such, we remain confident that companies can successfully navigate this short-term deceleration without negatively impacting employment levels, which is very important to consumer confidence.

FIGURE 2: EARNINGS REVISION BIFURCATION



Source: Thomson Eikon, BIM | Note: EPS % Change Weighted By Market Cap Of Constituents

FIGURE 3: Q3 TRADE NOISE TIMELINE



Source: China Briefing

CANADIAN MARKET

While the energy sector remains out of favour, it was in bright focus in September when oil prices briefly spiked almost 20% following news of attacks on Saudi Arabian processing facilities, which knocked out nearly 6% of global supply. However, a combination of de-escalating regional tensions, Saudi Arabian assurances of deliveries to its customers and the communication of much quicker-than-expected guidelines for facility repairs resulted in oil retracing its gains. While the event highlighted the vulnerability of Middle Eastern supply, our energy producer exposure remains weighted towards more resilient companies with strong free cash flow generation capabilities at current oil prices.

Energy infrastructure equities have fared well year-to-date, without climbing to the high-end of historic valuation ranges that some defensive peers have experienced. Part of the strong performance has been driven by private or foreign capital pursuing either discrete assets or corporate entities, as highlighted by the unsolicited bid rejected by Inter Pipeline. We continue to focus our energy infrastructure investments on self-funding companies with strong future project inventories.

PORTFOLIO INSIGHTS

In Canadian portfolios, we

continue to own Brookfield Asset Management (BAM), a leading global manager and investor in alternative assets, including infrastructure, real estate, renewables and related business services. The company has experience strong growth over the last several years due to solid investment performance and continued growth in investor allocations to alternative investments. We expect these two trends to continue, with fundraising inflows potentially accelerating as investors adapt to a low-rate environment. Additionally, the recently closed acquisition of Oaktree Capital, a long-standing global credit investment manager with a focus on distressed debt, should provide another lever for BAM to grow fee-bearing capital and enhance client returns.

In Global portfolios, we continue to own Dollar General (DG), a leading value-focused retailer in the U.S. The company has 16,000 stores, with significant exposure to rural regions. DG sells everyday-low-price consumables and general merchandise in an efficient small-box format. Catering to lower income earners with less disposable income, DG is often used as a fill-in trip offering convenience, but at prices comparable to mass merchants. Further, DG's highly efficient and convenient small stores still have a significant runway of footprint expansion. In the current uncertain environment of the U.S./China trade dispute, DG has been able to navigate the escalation in tariffs on Chinese imports with minimal impact to its earnings, highlighting the resiliency of the business model.

FIXED INCOME MARKETS | A TALE OF TWO MATURITIES

A strong Canadian economy has given the Bank of Canada (BoC) confidence to keep its interest rate policy unchanged, while observing incoming economic data. By the end of the third quarter, Canadian short-term interest rates were slightly higher as the idea that the BoC will soon reduce its overnight rate diminished. The Canadian job market remains solid and inflation continues to be at the 2% target. Any decrease in business confidence or slowdown in manufacturing has yet to factor into the health of the overall economy.

Longer-term interest rates, however, have been influenced by the slowdown in international trade stemming from U.S. and China trade tensions. While July was relatively quiet, President Trump's announcement on August 1st to increase tariffs on Chinese imports rapidly sent interest rates lower, increasing bond prices. The escalation in trade policy decreased the chances of a near-term deal and heightened the possibility of slower economic growth. The Canadian 30-year interest rate briefly set a historic record low at 1.30%, falling 40bps in two weeks. Subsequently, as President Trump softened the timing and size of tariff increases, interest rates reclaimed half of that decline.

The dichotomy of a strong domestic Canadian economy and the weakness in other countries, such as Germany and Australia, resulted in an unusual change in the Canadian yield curve this quarter. Instead of interest rates moving in the same direction across the curve, short-term interest rates increased and long-term rates declined (see Figure 4). **In mid-September, Canada 30-year bonds began offering a lower interest rate than 2-year bonds, an unusual situation that often precedes economic difficulty. However, this was unique to Canada as every other developed market still has a positive slope.**

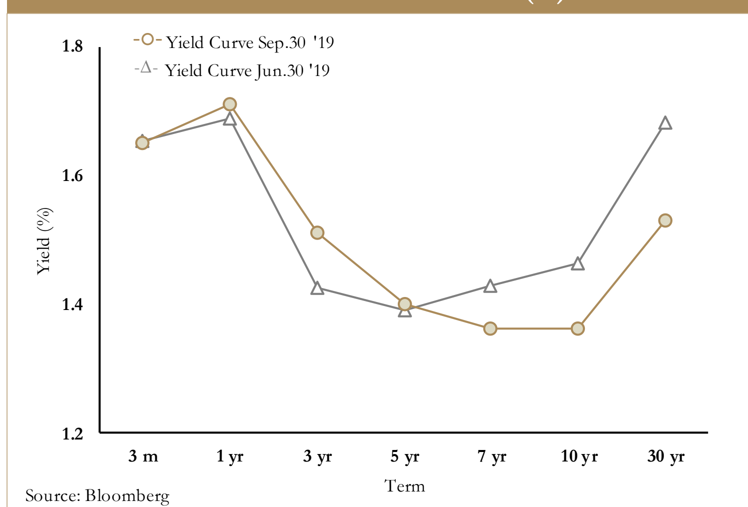
In the third quarter, the U.S. Federal Reserve (Fed) reduced its administered interest rate twice to 2%. In contrast, the BoC has not taken any action since October 2018, leaving its rate accommodative at 1.75%. It's not certain what direction monetary policy will move in the coming months. In the U.S., the market is anticipating that the Fed will reduce its rate again in 2019 as its decision impacts the global economy. Meanwhile, the BoC can likely focus more on the domestic economy.

Changes in credit spreads were mixed for the quarter. Short-term provincial and government agency spreads tightened and performed the best, offering an attractive all-in yield amid rising short-term Canada rates. Long-term corporate BBB spreads widened and under-performed.

PORTFOLIO INSIGHTS

Long-term bonds were once again the standout performers in fixed income portfolios this quarter. Interest rates declined the most in the long-end, with long bonds also the most sensitive to changes in interest rates.

FIGURE 4: CANADIAN YIELD CURVE (%)



Source: Bloomberg

What was different this quarter was the wider credit spreads on long provincial and corporate bonds resulting in Canada bonds outperforming in that term. Short-term bonds underperformed with underlying interest rates increasing modestly, but still had a positive return due to tighter credit spreads and interest income.

During the quarter, we continued to sell bonds near maturity to opportunistically reinvested in longer-term debt. In early July, we sold Bank of Montreal bonds callable in September 2019 and Nissan bonds that will mature in October 2019, and purchased Federal Agency, Canada Housing Trust, due in March 2023.

In August, we sold Enercare Solutions with a February 2020 maturity and H&R REIT March 2020 maturity, and purchased Canada 2030 bonds.

In September, we trimmed the Canada 2026 holding and topped up the existing Canada 2045 holding to manage duration and interest rate risk. We also purchased bonds from Gibson Energy. The company has improved its credit profile in recent years and issued investment grade rated debt for the first time. To make room, we sold the holding in Suncor Energy.

After the portfolio changes during the quarter, fixed income portfolio duration finished at 8.2 years, slightly longer than the main benchmark at 8.1 years. On the credit side, portfolios are underweight long-term provincial credit risk as current prices are unattractive.

Barrantagh

Investment Management

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

Barrantagh Investment Management Inc. provides disciplined portfolio management to institutional and individual investors. The firm is committed to a high level of client service provided directly by its experienced partners. We are dedicated to preserving our clients' capital while generating growth through consistent application of our value-based fundamental investment philosophy. We manage portfolios on a segregated basis to meet our clients' investment objectives. Because the firm is owned by our professional staff we maintain a completely independent and objective perspective.

For more information contact: Barrantagh Investment Management Inc. (416) 868-6295

Copyright 2019 Barrantagh Investment Management Inc. All rights reserved. Reproduction of portions of this Commentary is permitted provided the source is noted. Please notify us at info@barrantagh.com of any reproductions.