TRIASIMA

Economic and Financial Markets Commentary

Second Quarter 2016

Stable Economic Landscape

As in the first quarter, world economic growth has been relatively stable in the second quarter, sputtering along at a somewhat lower than historical pace. The International Monetary Fund is predicting growth of 3.2% for 2016, having recently adjusted downward its forecast from 3.4%.

The United States rebounded from a pocket of weakness early in the year, the Eurozone gently accelerated from a low base, and in Asia, from Japan to China to India, growth remained below historical averages but was otherwise steady.

Most broader themes were also unchanged: overly leveraged financial and real estate sectors in China, weak final demand in the Eurozone, improving conditions for American households but low expectations in the industrial sector, and, above all, continuation of the aggressive monetary easing theme by central bankers throughout advanced countries.

In the United States, the economy has rebounded from its slow start. First quarter GDP was revised up to 1.1% from a lower than expected annualized growth of 0.5%. Similarly, retail sales pulled back during the first months of 2016 only to rebound during the second quarter. Despite this, second quarter GDP came in below expectations, illustrating the intractable nature of the weakness permeating the economies of the advanced countries.

Although recent weakness was seen, the labor situation is good with steady job creation, rising household income, and a low unemployment rate.

Japan is more than ever in a conundrum. The economy remains weak and inflation expectations continue to decline leading to more stimulus. Brexit has complicated matters as investors sought out the Yen as a safe haven currency and countered the Bank of Japan's Quantitative Easing policy.

In Canada, the economy was surprisingly resilient in the face of global economic uncertainty and lower oil prices with GDP rising at an annualized pace of 2.4% during the first quarter of 2016. This good outcome was driven by consumption and residential investment. Exports also rose compared to imports due to the weak Canadian dollar.

The second quarter was another story altogether with a very weak -1.6% GDP. This was caused by wildfires in Alberta and diminished oil and gas activity. Fortunately, such weakness will probably be transitory.

Brexit

Late in June, the United Kingdom voted to leave the European Union. The Brexit vote was unexpected. It surprised financial markets and the value of risk assets came off sharply. Uncertainty rose and the vote triggered a rush to safe havens such as the American dollar, the Japanese yen, and gold. Worldwide, equity and bond markets quickly recovered, but not in the UK. Actually, British residents are being hit by the triple whammy of a lower currency, lower equity prices, and softer housing values.

The long-term ramifications of the Brexit vote are not clear, and may even turn out to be positive since the current arrangement for the UK and the management of the Eurozone can certainly stand improvements.

Meanwhile, a tangible risk is contagion whereby fringe right wing parties in some European countries may find their questioning of the validity of a European Union further validated.

Interest Rates: Lower and Lower We Go

Already at record lows at the onset of the second quarter, interest rates slid further down to new historical levels over the ensuing months. A key reason is inflation expectations that keep being revised down.

A second reason is the Brexit vote which triggered a flight to safe heavens such as Canadian and American federal bonds. The fall in rates was widespread and led to a flattening of the yield curve.

The yield-to-maturity of the FTSE TMX Universe Index thus fell once again, from 1.95% to a new record low of 1.77% by the end of June. For the first time, the yield-to-maturity of Federal bonds, as a group, stands below 1%, having ended the second quarter at 0.97%. As for the yield-to-maturity of the long term bond, it is only 2.73% (versus over 3% three months ago). All these very low levels predict benign inflation ahead for years to come.

Falling interest rates pushed up the price of bonds and improved performance. The FTSE TMX Universe Index was up 2.6%, and first half 2016 return is 4.1%. These are attractive

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returns for this conservative asset class against the prevailing inflation. Unfortunately, returns such as these become harder to repeat as the yield-to-maturity slide further down.

Falling rates caused the Index duration to lengthen because the discount factor applied to future cash flows decreases as well. The Index duration thus jumped over the past months, to reach 7.7 years at quarter-end. Also a record!

Portfolio managers are currently afraid of building bond portfolios with durations anywhere near that of the Index, fearing a rebound in rates. Prognosticators have been expecting for the last six years that rates would climb "six months hence"…

At Triasima, we have held a contrarian view for several years now from the consensus. Consequently, we have maintained relatively high duration levels in our clients' bond portfolios. This has been beneficial. We are currently targeting an 8.2-year duration, which is above that of the Index.

With falling interest rates alongside a strong performance from bonds, the S&P/TSX Preferred Share Index moved up 2.9% over the second quarter. Despite this move, this small asset class still appears attractively valued.

Searching for Income and Value

World equity markets had a rather pedestrian quarter with the MSCI ACWI Index advancing a slight 1%. The Index had dipped into negative territory early on due to concerns over the Brexit vote, but it bounced back during the last days of the quarter.

At the sector level, an odd mix of defensive and cyclical stocks outperformed with the Energy sector leading with a 10% gain. Utilities and Consumer Staples also outperformed, up 4% each. Cyclical stocks continued their rally from the first quarter while the search for yield and stability buoyed the more defensive names.

On the other side of the ledger, Consumer Discretionary and Financials were down 4% and 1.5% respectively. Financial stocks, banks especially, are hurt by the compression in net interest margins stemming from continued quantitative easing in Japan and by the European Central Bank, and the prospect of lower interest rates by the Bank of England in response to the Brexit vote. In addition, the lack of action by the American Federal Reserve to further increase the discount rate so far in 2016 has lowered expectations for higher rates across the yield curve and, thus, also lowered the interest rates margins forecast for banks.

Meanwhile, in Canada…

The S&P/TSX Composite Index posted a 5.1% gain. The regime change from expensive growth to depressed value that had manifested itself during the first quarter has solidified during the second quarter. The Materials (27%) and Energy (10%) sectors outperformed while the hunt for yield continues with Utilities (7%) and Telecommunications (3%) also doing well.

Looking deeper into the behavior of the Index, sectors performance was fairly dispersed as usual with Materials leading and the small Health Care sector coming last with a 15% drop. This was primarily due to Valeant Pharmaceuticals which keeps running up into new issues and collapsed a further 23%. Next worst was Information Technology, down 6%, as investors move away from this growth oriented sector. The top performing industries within Materials were the silver (52%) and gold miners (40%). Global political and economic uncertainty and low interest rates have pushed precious metals higher with gold up 7%, and silver up 21%.

…in the United States…

In the United States, the S&P 500 Index returned 2.8% (2.5% USD). Like in Canada, investor preference towards value and against growth names that begun early this year continued throughout the second quarter. Persistently low interest rates have also sparked a chase for yield and defensive sectors have outperformed again.

As such, cyclical sectors such as Energy (12%) and Materials (4%) outperformed, while defensive sectors such as telecommunications (7%) and Utilities (7%) rose nicely as well.

At the other end of the spectrum, the Information Technology sector declined 3% while the Consumer Discretionary sector drifted down 1%. Expensive information technology stocks were once again out of favor while concerns over the future of the retailing industry in the United States weighed on the Consumer Discretionary sector. Heightened competition in the apparel and retailing sector as well as the continued shift towards online shopping weigh on the sector with Department Stores one of the worst performing industries, down 24%. In contrast, Amazon was up 21%.

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...and Internationally

Internationally, equity markets had another mediocre quarter with the MSCI EAFE Index retreating 1.2%; down 10.2% after six months.

The Index was on pace to chalk up a positive return, but the Brexit vote decimated investor confidence in June and it slipped back into negative territory. As in Canada and the United States, cyclical stocks continued their rally from the first quarter while the search for yield and stability buoyed the more defensive names.

Emerging markets were nearly unchanged at 1% over the quarter, slightly outperforming the EAFE Index. Latin America continued its impressive climb with a 6% gain; it is now up 11% year-to-date. Latin America is quite levered to the price of commodities.

Conclusion

The first quarter witnessed little economic news of significance, but this had not been the case for the equity market. An upturn in prices of both oil and other basic commodities, combined with a weaker American dollar and lower expectations for interest rates, triggered a regime change from expensive growth to depressed value stocks.

The second quarter was comparatively calmer. The new markets regime established itself further while, on the economic front, the first quarter pattern carried on with its combination of hot and cold news resulting in overall sub-par growth.

New themes are coming to the fore to explain the stickiness of slow growth the world is going through. Some of the most interesting reasons in our view revolve around advanced country economies that are increasingly service oriented, which may result in less capital spending, an important source of growth, and aging demographics, which implies different spending patterns of households. Excessive fiscal discipline of federal governments, which depress final demand, is also invoked, especially since budgetary deficits have shrunk, borrowing costs are low, and the physical stock deteriorates.

Equity markets appear to be more correlated than ever. We see as probable reasons increased globalization, instant international communications, a freer movement of capital, and the ever rising propensity of investors to invest beyond their national borders. The rising correlations of local equity markets performance has been an ongoing trend for a few decades now. We see no reason for this phenomenon to stop.

Interest rates remain at very low levels in the absence of inflation and with excess capacity in most industries and locales. At this time, the only visible path to higher inflation, and consequently higher interest rates, would be rising labour costs in the United States where full employment has taken hold.

Recently, in mid-February, we changed our preference back to Canadian equities, from American equities previously. This was due to the stock market regime change, relative Canadian versus American valuations, profits trends, and the stage of the economic cycle. We continue to expect Canadian equities to outperform in 2016.

A concern with regards to American equities has been topping revenues and profits for the corporations making up the S&P 500 Index. Roughly half have substantial operations abroad and earnings from these foreign operations have been under pressure due to US dollar strength. This is a significant headwind for the American equity market. We have been expecting weakness there since late in 2015. This is still our view.

Unless otherwise specified, financial information here presented is in Canadian dollars

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