TRIASIMA

Economic and Financial Markets Commentary

Third Quarter 2016

Stable and Unexciting Economic Landscape

World economic growth remained relatively stable and below average in the third quarter, staying with the trend of the first half. Despite soft investments and a strong dollar, the United States economy is set to accelerate, supported by household spending, buoyant consumer confidence and solid employment. Albeit weak, the Eurozone recovery appears firmly on track helped by loose monetary policies and an improving labor market.

In Japan, where exports are being hit by the strong yen, the Government unveiled the largest fiscal stimulus package since 2009, 269 billion US$, in an attempt to boost the economy. China is showing signs of stabilization helped by a rebound in fixed-asset and property investment, as well as an improvement in industrial production and a slight recovery in global demand for Chinese exports.

More specifically, in the United States, the economy kept improving from its slow start to 2016. First quarter annualized Gross Domestic Product (GDP) growth was low at 0.8%, the second quarter was better with a 1.4% growth rate and this quarter was higher still with 2.9%. The Fed continues to build a strong case for a rate hike in December after the November 8 presidential election. Although capital spending is weak and the dollar strong, consumer confidence and labor market conditions are at their best since the last recession, which in turn stimulates consumption growth.

Four months ago the Brexit vote surprised the markets, but, so far, there is no major sign of economic shock to the Eurozone. The same cannot be said for the United Kingdom economy which is witnessing widespread capital spending curtailments and a weak currency. Following the vote, the Bank of England cut interest rates and expanded monetary easing, which helped UK equities to recover for a while. However, consumer confidence is low and the aftermath of the vote is unclear.

Meanwhile, in Europe, many are now questioning whether the ultra-loose monetary policy has reached its limits and whether negative interest rates may do more harm than good to the already fragile banking sector. Also posing a threat is the growing instability in Turkey, which is struggling with weak economic growth and terrorism. Germany and France among others are scheduled for elections in 2017, where the rise of populist anti-immigrant parties could undermine the political status quo in Europe.

Japan is more than ever in a conundrum. The economy is forever weak and inflation expectations continue to decline, leading to more monetary 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.

Canada recovered from a difficult second quarter when the economy contracted, with the recent rebound helped by increases in exports and consumption. GDP contracted at an annualized pace of 1.6% during the second quarter as a result of the wildfires in Alberta that disrupted oil production and caused a massive decline in energy exports. A rebound was at hand for the third quarter with GDP growth clocking in at 3.3%. The housing sector remains a pillar of strength with continued firmness in prices. However, like in the United States, economic growth is hindered by soft private sector capital spending while public infrastructure spending is picking up.

Interest Rates: An Abundance of Savings

Already at record lows, interest rates slid further down in Canada to new historical lows over the last three months. The key reasons are the lukewarm Canadian economy, inflation expectations that kept being revised down and the ongoing postponement of a second, after December 2015's, Federal Reserve rate hike in the United States.

Ample sources of savings are swamping financing requirements at a time when corporations are flush with cash, governments exercise fiscal austerity and households, outside Canada, are prudent with borrowings. This savings glut is particularly obvious in emerging countries where investment alternatives are fewer and capital markets immature. Over the past months, the drop in rates was widespread across all credits and maturities and led to a flattening of the yield curve.

The yield-to-maturity of the FTSE TMX Overall Universe Index thus fell once again, from 1.77% to a new record low of 1.71% at the end of September 2016. The yield-to-maturity of the long-term bond component of the Index is now only 2.63%. All these very low interest rates predict benign inflation for years to come.

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As an aside, with this backdrop of low inflation, the Bank of Canada is caught between trying to stimulate a slow economy and rein in escalating home prices in Toronto and Vancouver.

Falling interest rates push up the price of bonds and improve performance. The FTSE TMX Overall Universe Index was up 1.7% over the quarter. The return is 5.3% after nine months. Such attractive returns will become increasingly hard to repeat while the yield-to-maturity slides further down. The Index duration held steady at record levels, over the past months, near 7.7 years.

In the United States, the benchmark 10-year Treasury bond yield rose from 1.47% at the end of June 2016 to 1.59%. A smattering of better economic data and an improving employment situation prompted investors to believe a September rate hike was possible. However, this was not the case as the Federal Open Market Committee chose once again to leave its federal funds rate unchanged. Although the pace of economic activity has picked up, the FOMC decided to wait for further evidence of continued economic progress before raising rates.

In Japan, the focus shifted from monetary stimulus to controlling the yield curve. This will help the Bank of Japan mitigate the impact low interests rates have on Japanese banks.

Central Bankers Overstaying Their Welcome

We have noticed this past year a rising debate over the role of central banks, a group we believe is often too slow to put into motion new policies when the economy cycles from expansion to recession and vice-versa. Less charitably, we could add that Central bankers easily find justifications to widen their scope of responsibilities.

Quantitative easing has been going on for long in advanced countries. Interest rates have been pushed down to unheard levels, and monetary aggregates have exploded while the velocity of money has plummeted.

Strong action was certainly needed in the aftermath of the Great Recession with the American GDP falling 4.2% over an 18-month period ending in 2009's first quarter. However, worldwide demand immediately improved afterwards with world GDP growth of 5.4% in 2010, and of 3.1% in the United States from mid-2009 to mid-2010.

Similarly, it did not take long to get back to the pre-recession levels. World economic activity established a new record in 2010 while the United States took a little longer with a new high occurring in 2011's second quarter.

World GDP grew between 4.8% and 5.7% per year for the four-year period from 2004 to 2007, the fastest pace known over such a time span. Memories of these heady times are still fresh in the minds of investors, but it is quite unrealistic to expect a repeat during the next expansion.

Investors are thus not satisfied with the pace of growth since the Great Recession. Yet, world GDP has grown at an annualized pace of 3.8% since then and the world economy is now 25% larger than the 2007 peak. This is not recognized. In the case of the United States, annual growth has been 2.1% over more than seven years, an acceptable level, and its economy now stands 11% above the pre-recession peak.

With decent growth in the United States, accommodative policies have gone on for too long. This is important since the Fed, by virtue of the size of the American economy, influences all other central bankers.

Besides initially spurring growth, an effect of lingering ultra-easy monetary policies has probably been to encourage competitive currency devaluations. Moreover Interest rates are not 'supposed' to go negative. This has perverse and largely unpredictable implications.

Fiscal Policies To The Rescue… Maybe

Despite record economic activity thus, the global recession mood never really lifted since 2008. A reason may be that advanced countries have been facing for some time a mix of lower growth than in the previous expansion and of deflationary tendencies, a problematic mix.

To spur growth, there is a growing call for governments in advanced countries to embrace looser fiscal regimes, mainly through stepped up infrastructure spending. Canada and the United States appear to be moving rapidly in that direction, with budgetary deficits lifting as a consequence.

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Low Interest Rates, The New Normal?

Interestingly, there is another interpretation of the current ultra-low interest rates phenomenon. Conventional wisdom dictates that records low rates are the results of years of expansionary monetary policies.

Maybe it is the other way around. Expansionary monetary policies have become de rigueur because long-term natural interest rates, and inflation, are low and declining. Reasons often mentioned are demographic trends (i.e. aging populations and lower fertility rates), lower productivity growth, and the growing share of the service sector in the economy (which has lower capital requirements).

Whichever thesis is accurate, rates are low because of central bankers' actions or central bankers have merely acted the way they have because of secular deflationary trends, it is a story to be followed with keen interest!

Equities Do Well In Canada...

The S&P/TSX Composite Index posted another solid gain, at 5.5%, similar to the second quarter's 5.1%. Sector performances were all positive, except for Materials (-1%) and were less dispersed than usual with six sectors within 3% of the Index return. Of special note this quarter is the creation of an eleventh sector, Real Estate, which has been split off from the large Financials sector.

The new market regime in place since February, favoring cyclical value over growth, weakened over the quarter. The cyclical Materials sector paused after climbing 52% over 2016's first half. Gold producers were hit especially hard, dropping 17% in August when the Federal Reserve hinted at the chance of an interest rate hike in September. After this correction, the sector reverted to its previous uptrend.

Technology names recovered after falling out of favor along with other growth stocks earlier this year. The Health Care sector was up 9%, a performance mainly attributable to Valeant Pharmaceuticals which rebounded 27%.

...And In The United States

The S&P 500 Index also had a good quarter, up 4.7%. Information Technology was in vogue again and the best sector, up 14%, erasing the drop incurred over the first half of the year. The big names Apple, Google, Intel, and Microsoft all posted double digit returns over the third quarter.

The Financials sector also fared well, rising 6%. The Utilities and Telecommunications sectors were down 5%. The common theme between these defensive sectors, a favorite place to search for income, is the unwinding of the interest rate trade. As bond yields rise, these high yielding sectors become less interesting. Also they had become quite expensive, with their price/earnings multiple trading above that of the S&P 500, an anomaly. This correction followed mid-teens gains in the first half of the year. The interest rate trade is also visible in the financials space where banks, positively impacted by higher rates, rose 9%, while the high yielding Real Estate sector fell 2%.

Positivism Returns Internationally

The International equity market did an about face in the quarter with a large 7.3% jump, on the heels of a large 9.1% first quarter drop and of a smaller 1.2% second quarter pullback.

The cyclical and value oriented theme from the previous two quarters remained in force. The Materials, Industrials and Financials sectors were up 12% on average while other sectors lagged. High dividends defensive sectors that had previously performed well went sideways, over worries from rising interest rates in the United States. Of note is the large 16% jump by the Technology sector, erasing its 2016 first half 12% drop.

Optimism returned to the stock markets with Japan (up 10%) outperforming both Europe (6%) and the London market (6%). Similarly, emerging markets performed strongly, rising 10%. Latin America is levered to the price of commodities and stocks carried on with their impressive first half performance and rose 6% in the quarter, bringing the 2016 year-to-date performance to 26%.

Conclusion

Economic activity reaccelerated to normal levels in many regions and countries over the past several months: Canada, the United States, Latin America, China, and India. The Eurozone economy also improved somewhat.

Stock markets recognized this and performed very well while interest rates went sideways. Actually, we may have

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witnessed late in the third quarter and early in the fourth what could be the beginning of the end of the interest rate/search for yield trade. Gold stocks, REITs, and Utilities all sold off on the prospect of higher interest rates.

Triasima has been below consensus since 2009 with regards to the evolution of interest rates. Prognosticators have been consistently forecasting for six years that rates would begin to rise in six months. This has never happened. Meanwhile, our bond portfolios maintained a much higher duration than the peers.

Although our expectations remain lower than consensus, we now believe we have advanced enough through the economic cycle post-Great Recession that rates could rise.

The key reason is full employment in the United States, the world's economic locomotive. The prospect of inflation increasing by way of wage growth, a cost push phenomenon, seems realistic.

Looking back, and limiting our choice to the Canadian and American equity markets, we have preferred Canada in 2009, 2010, and 2011. The Canadian market outperformed each of those three years. From 2012 to 2015, our first choice was the United States, and the American stock market outperformed Canada each of those four years.

More recently, in mid-February 2016, we went back to Canada as the market of choice. Reasons centered around the ongoing market regime change from growth to value leading to a revival of the value sectors and industries that weigh heavily in the S&P/TSX Composite Index; such as the Energy and Materials sectors or the banking industry. Relative Canadian versus American valuations, profits trends, and the stage of the economic cycle were factors as well.

Additionally, our long-term Trend pillar assessment of the American equity market has been poor since the second quarter of 2015. Our current rating highlights the strong possibility of a long-term top materializing. The Canadian market looks comparatively healthier.

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

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