TRIASIMA

Economic and Financial Markets Commentary

Fourth Quarter 2016

Accelerating World Growth

The year 2016 had its share of unexpected socio-political events, with large potential economic repercussions. The United States voted for a non-establishment candidate, Donald Trump, as president of the United States. Great Britain voted to leave the Eurozone trading block in the historic "Brexit" vote. OPEC agreed to cut production in an agreement that was negotiated over many months.

In Italy, Matteo Renzi resigned as prime minister after his constitutional referendum dealing with parliamentary and Senate reforms, but interpreted as an endorsement of the pan-European status quo, was soundly rejected. And finally, in Asia, Prime Minister Narendra Modi of India decided to void 86% of the country's cash in an attempt to crack down on tax evasion and so-called "black money".

Despite all this, the year was no more eventful than average. In fact, studies show that we now live in the safest and most peaceful times in the history of mankind. Naturally, geopolitical risk always lurks, but it was not higher than usual last year.

The world economic situation improved in the fourth quarter. Growth remains below the average of the last few decades, but picked up gradually over the last months of the year. Advanced countries showed higher industrial production and obtained strong survey results from purchasing managers, especially in Europe.

In the **United States,** the economy kept improving from its slow start in 2016. The Gross Domestic Product rose at the brisk pace of 3.5% in the third quarter while the labor market steadily improved and unemployment fell towards 4.5%. Residential construction spending is firm and consumer confidence is high. The current recovery and expansion period is starting to get long in the tooth at over 90 months on a combined basis as the economy approaches full employment. Inflationary pressure of a cost push nature from wage increases is set to grow in 2017.

The Federal Reserve recognized the economic strength and raised the Fed fund rate 0.25% in December, signaling a faster pace of increases in 2017. The election of Donald Trump does not change the current economic situation, but it has important ramifications going forward. Trump's pro-growth policies include tax cuts, less regulation, and increased infrastructure spending. They undeniably are business and stock market friendly.

However, stimulating an economy already near capacity and with a tight labor market should lead to inflationary pressures and higher interest rates. In a sense, overheating in the near tem will bring it is bringing the next recession closer in time.

The **Eurozone** economy has been muddling for years, but is now showing renewed vigor. The easy monetary policy of the European Central bank is finally bearing some results with inflation lifting in Europe in the past quarter, reaching 1.1% on an annualized basis. The ECB has recently decided to extend it quantitative easing program for another nine months while scaling back its bond purchases from 80 billion euros per month to 60 billion euros.

The Eurozone political landscape is however more uncertain than usual with France, Germany, and the Netherlands heading for elections in 2017. Notwithstanding, we expect the economic ramifications from these elections to be underwhelming.

Renewed vigor is occurring in **Japan** as well where a weaker yen and a Chinese and South-East Asian growth have bolstered exports. To counter strong, but unacknowledged, deflationary demographic forces, the Bank of Japan has been trying to manufacture inflation for the past 20 years, to little avail so far. The Bank continues to cap the 10-year Federal bond yield at around zero in an effort to move towards an elusive 2% inflation target. Although inflation is still near 0%, it may, coincidentally for cyclical reasons, finally be in the process of ramping up. This would help consumers and corporations confidence alike.

Meanwhile, **China** and many other emerging countries generate growth well above those of the advanced countries. The impact of China at the world scale continues to grow due to its sheer size. This country was helped recently by a slight recovery in global demand for its exports. It also carries on with its delicate long-term transition from an export driven economy relying on industrial production growth to a consumer led economy hinging on middle-class spending and interior demand.

In the short term, Chinese authorities have to contend with an indebted corporate sector, a falling currency relative to the American dollar, and capital flight as many Chinese citizens try

1555 Peel Street, Suite 1200
Montreal (Quebec) H3A 3L8
T 514 906-0667

to get their money out of the country. To counter the weakness of the renminbi, Chinese authorities have been using up their foreign exchange reserves to defend the currency on foreign exchange markets. They have also recently imposed individuals a foreign exchange quota of US$50,000 a year on foreign exchange transfers

Adding to the uncertainty, President Donald Trump has threatened to impose a 45% tariff on imports from China and to label China a currency manipulator. We doubt any of this will happen for fear it would directly hurt the American economy or out of concerns over tit-for-tat retaliation.

We are not overly concerned about **Trump**'s anti-trade rhetoric. We see this as a populist stance directed at his electoral base and which targets countries such as China and Mexico that have substantial trade surpluses with the United States and enjoy a labor cost advantage. Erecting trade barriers such as a 'border tax' will raise inflation in the United States and likely hurt more Trump's electoral base in the end.

England is no outlier in the economic landscape. The June 2016 Brexit vote has indeed heightened uncertainty levels for trade and commerce and resulted in a weak currency. However, its impact has so far only been felt in certain sectors, such as high-end London real estate, while the economy at large continues to do well.

Canada Tagging Along

The Canadian Gross Domestic Product improved at a 3.5% annualized pace in the third quarter of 2016, versus a 1.6% contraction in the second quarter, the later largely because of the Alberta wildfires at the time. Conspicuously absent was Prime Minister Trudeau's promised infrastructure spending stimulus as government expenditures fell 1.2%. This is normal, however, as infrastructure programs need time to ramp-up and impact the economy at large. This is probably for late 2017 at the earliest.

Expectations are for a strong fourth quarter GDP reading as well. Thereafter in 2017, the Bank of Canada forecasts a 2% GDP growth. We think the risk to this forecast is on the upside. Our optimism is reflected in the latest Bank of Canada meeting as governor Poloz decided to leave rates unchanged and adopt a wait-and-see approach.

Generally, the Canadian economy follows the American's, but with a lag. The two economies are quite interlinked; a key reason is that 70% of Canadian exports are to the United States.

We currently like the American situation. That country has a full employment and rising household income. Inflation remains benign and does not represent an impediment to growth. Although interest rates have moved up late in 2016, the increases are not large enough to slow the economy. Finally, President Donald Trump has pro-growth policies that should be beneficial, at least initially in 2017, to corporations and labour alike.

Within this broad context, the election of Justin Trudeau and of a Liberal government is not that significant, provided personal or corporate taxes are not hiked too much as this would dampen growth. But so far, Trudeau has proven to be more pragmatic than left leaning in economic matters.

Canada's economy is open to outside influences, and we expect steady or accelerating growth in 2017. Strength in the price of oil in 2016 is expected to carry on in 2017 while the prices of other commodities, that generally troughed in the first quarter of 2016, should follow the cyclical rebound.

The record indebtedness of Canadians is a negative factor. This, in isolation, reduces potential growth; however, two caveats exist. First, this indebtedness is largely the result of a record mortgage load, a more stable form of borrowings that is beneficial for the economy because of the concurrent construction activity it generates (although many mortgages are for second-hand dwellings that have few spillover economic benefits).

Secondly, it is debt servicing requirements that really matters and these are within historical norms thanks to low interest rates (debt servicing is the sum of the total payments relating to all mortgage and non-mortgage loans outstanding divided by total household disposable income.)

Like other advanced countries, a substantial increase in interest rates would be detrimental to growth since the Canadian consumer is sensitive to such a happening due to his debt load. However, in view of the current accommodative Bank of Canada policy, low inflation, and lukewarm growth, we do not foresee this in 2017.

1555 Peel Street, Suite 1200
Montreal (Quebec) H3A 3L8
T 514 906-0667

Are 35 Years of Falling Interest Rates Over?

Interest rates on 10-year Government of Canada and U.S. Treasury bonds hit all-time lows in 2016. This took place early-July in the United States and late in September in Canada, and rates have been rising since.

The main reason for the increase is the election of Donald Trump as his pro-growth agenda is considered to be inflationary. Economic growth also rebounded in North-America beginning mid-year 2016 and it has contributed to firming up interest rates. Inflation expectations were already rising before Trump's election as the U.S. labor situation continues to tighten, thus putting upward pressure on wages, on inflation, and ultimately on interest rates.

The yield-to-maturity of the FTSE TMX Canada Universe Bond Index, on a quarter-end basis, thus reached an historical low of 1.71% in September 2016. It was subsequently pushed back up to 2.14% by the end of the year. This is a large increase.

The yield-to-maturity of the long-term bond component of the Index is now 3.21%, well above the level of 2.63% three months prior. This is again a large increase. Canadian bond yields have risen in sympathy with their American counterparts as any improvement to the U.S. economy is beneficial to Canada.

Rising interest rates push down the price of bonds and depress performance. The FTSE TMX Canada Universe Bond Index was thus down 3.4% over the fourth quarter. Its return is only 1.7% for all of 2016. This is the lowest annual performance for the Index since the 1990s.

In response to the jump in rates, the Index duration slipped from 7.7 years to 7.4 years; still a very high number.

Fixed income investors must now fear the end of the long bull market for bonds whereby interest rates have generally been on a downtrend since 1982, an incredible 35 years! If rates indeed established an historical bottom early in the third quarter of 2016 and are set to increase both on a short-term cyclical basis and for long-term macro-economic reasons, it will be very detrimental to bond investors.

At this time, we believe rates will be firm for a while for cyclical reasons, until the next recession. However, we are not ready to call an end to the long-term downtrend in interest rates that began in 1982.

In the United States, the benchmark 10-year Treasury bond yield rose from 1.59% at the end of September 2016 to 2.44% at year-end. Relatively speaking, this is a huge 50% increase. Rates rose as high as 2.60% as optimism over Trump's election overwhelmed the markets. As the pace of the economic activity picked up, the Federal Reserve raised rates by 0.25% at its last meeting in December.

In Europe, where economies are weaker and inflation lower, interest rates did not bounce anything like in North-America. The European Central Bank's low interest rate policies have kept bond yields near its recent historical lows. For example, the German 10-year bond yield ended the quarter at 0.20%. Eurozone inflation is nonetheless picking up a little and this should put upward pressure on European bond yields. The era of negative yields may end soon.

The focus of the Bank of Japan has shifted to controlling the yield curve. As such, the 10-year Japanese Government bond yield is firmly anchored at 0%. This is supposed to help the Bank of Japan mitigate the impact low interests rates have on Japanese banks.

Preferred Shares and Income Trusts

The S&P/TSX Preferred Share Index was up 5.3% in the fourth quarter, a performance in sharp contrast to bonds.

Preferred shares dividend yields high relative to bond yields, and it looks like investors shifted into this asset class in reaction to rising interest rates and falling bond prices. This follows on the heels of a 7.6% return the previous six months due to dropping interest rates and the appeal of the high current income generated by preferred shares.

This illiquid asset class is in favor right now. It is used at Triasima in the management of Balanced Income mandates. These are more conservative than the Balanced mandates, and have a high emphasis on the protection of capital and the generation of an attractive current income.

Income trusts acted opposite to preferred shares and more in line with bonds. The rising rates of the last few months diminished their appeal, and the S&P/TSX Canadian Income Trust Index went sideways with a 0.2% return. Most income trusts making up the Index belong to the real estate category

1555 Peel Street, Suite 1200
Montreal (Quebec) H3A 3L8
T 514 906-0667

and this sector has been under pressure from the lukewarm economy, a perceived overbuilding situation, and rising capitalization rates.

Inflation Expectations on the Rise

The current economic cycle began in the second quarter of 2009 and is elongated. At this stage, inflation typically begins to build up from a combination of heretofore easy monetary policy and cost-push pressures stemming from the rising cost of labour and raw materials.

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 prospect of inflation increasing by way of wage growth, a cost-push phenomenon, seems realistic.

We thus expect inflation to gently lift up in 2017 relative to 2016, initially gaining in the United States with a spillover effect in Canada. Any increase in inflation will take longer to take hold in the Eurozone and Japan.

A Regime Change and a Reflation Trade

The Equity markets moved away in 2016 from companies either of a growth nature or with above average dividend yield and whose stocks react well to low or declining interest rates. Instead, investors turned their attention towards industries of a more cyclical nature and related to natural resources or the industrial sector. This regime change gained considerable strength with the election of Donald Trump, and the moniker 'reflation trade' was adopted to identify what was occurring in the closing months of 2016.

With investors shrugging off concerns over their feasibility and timeline, his pro-growth policies spurred a reflation trade whereby companies of a cyclical nature were bid higher and outperformed defensive or high dividend-paying stocks.

A key risk for portfolios positioned to profit from this emerging theme is that the underlying fundamentals supporting the reflation trade falters down the road. To manage this risk, one needs to keep a degree of prudence when building up the cyclical component of equity portfolios.

Another risk to the equity market in 2017 is that US dollar strength stifles profitability growth for large American corporations, removing a key support to the progression of the equity market.

A Stellar Year for Canadian Equities

The S&P/TSX Composite Index posted another solid gain for the fourth quarter, up 4.5%. The market regime change favoring value over growth substantially gained in prominence. The Financials and Energy sectors did well due to the reflation trade and contributed the bulk of the up-move by the S&P/TSX Composite due to their large weights in the Canadian index.

The best performing sector was Financials, rising 12%. Donald trump's pro-growth and fiscally loose policies are inflationary in nature and interest rates rose as a result. One of the big beneficiaries of higher interest rates are banks, which capture higher margins on loans as interest rates increase, and rose 13%. Another beneficiary are life insurance companies, whereby their cash flows are reinvested at higher rates, and were up 21%.

The Energy sector rose 7% as OPEC agreed to cut production by 1.3 million barrels per day effective January 1, 2017, a decision that is working so far this year. It spurred a rally in the oil price and oil related equities. The Materials sector retreated 6% due to a 16% drop by gold producers caused by higher interest rates and a strong US dollar. In the same sector, the cyclical diversified miners rose 16% on the back of the reflation trade.

The worst performing sector was Health Care, down 29% due to the continued fall by drug producer Valeant Pharmaceuticals (-40%).

The fourth quarter capped off a phenomenal year for the S&P/TSX Composite Index, up 21% for 2016. The Index was up strongly each quarter and all sectors were positive with the exception of Health Care due to the poor performance of Valeant Pharmaceuticals (−86%).

An Average Year for American Stocks

Just like its Canadian counterpart, the S&P 500 Index had a good quarter, up 6.3%. Sector performance tracked Canada's.

Financials were the best performer, up 24%, and within this sector, banks rallied 34%. Banks look to benefit from Donald

1555 Peel Street, Suite 1200
Montreal (Quebec) H3A 3L8
T 514 906-0667

Trump's election as looser regulation will free up capital and higher interest rates will drive profitability for the group.

Energy and Industrials were both up 10%. The OPEC agreement also spurred a rally in the oil price and oil related equities. As for Industrials, this cyclical sector was buoyed by Donald Trump's pro-growth agenda.

The only negative sectors were Health Care and Real Estate at -2% each. These defensive sectors were shunned as the attention turned towards more cyclical sectors.

The S&P 500 Index is up 9% for the year, a fine outcome. Eight out of the eleven sectors had a positive return with the exceptions of Health Care (-6%) and the newly formed Real Estate sector (-2%).

Internationally Equities: Not So Much

The MSCI EAFE Index posted a small 1.6% gain over the quarter. Conversely, performance is negative for the year with a 2.0% pullback.

The first quarter of 2016 had been especially troublesome for international equities with poor economic growth in Europe and Asia and a strengthening Canadian dollar which depressed returns from foreign bourses.

Similarly to Canada and the United States, the past quarter witnessed a strong reflation trade whereby cyclical and value oriented securities outperformed relative to stable or growth oriented names. Hence, the MSCI EAFE Value Index was up 6.7% while the MSCI EAFE Growth Index was down 3.3%. The 10% differential between the two styles is far above norm. Again, the reflation trade favored the Energy, Materials, and Financials sectors.

As a whole, European stock markets did well. The Italian and Swiss markets rose 12% and 9% respectively and the export-heavy German market went up 5%.

In emerging countries, Brazil stands out despite its struggling economy. It was up 6% over the quarter while the full year performance is an impressive 64%. In Japan, the Nikkei rose 3% due to the falling yen and improved investor sentiment, a weak yen being positive for exporters.

Conclusion

More often than not, the United States is the world's locomotive and the global economy should benefit from an accelerating growth in this country As we enter 2017, Europe and Japan are showing renewed vigour while China and most other emerging countries generate growth well above those of the advanced countries.

The impact of China at the world scale continues to grow due to its sheer size. This country is now embarked on a delicate transition from an economy relying on industrial production and supported by borrowings to an economy pushed along by household spending and with the service sector dominating the economy.

We see a slight acceleration for global real Gross Domestic Product growth driven by the United States, the Eurozone, Japan, and some key emerging countries, such as Russia. European economic activity, especially, seems to be finally accelerating years after the Great Recession.

As of the close of the fourth quarter of 2016, Triasima's investment methodology is geared towards value stocks and away from growth or defensive ones. As a general rule, our quantitative, fundamental and trend assessments are more favorable towards resources and cyclical stocks. This has led to portfolio structures with a higher value orientation than usual, although portfolios must nonetheless maintain growth parameters that are superior to those of benchmark indices.

Looking back, and limiting our choice to the Canadian and American equity markets, we have preferred Canada in 2009, 2010, and 2011. From 2012 to 2015, our first choice was the United States. We have been right each of those seven years.

More recently, in mid-February 2016, we went back to Canada as our market of choice. Once again, our call was correct as Canadian equities outperformed American equities in 2016. As we enter 2017, we continue to prefer Canada over the United States. The reasons are largely the same as one year ago: relative Canadian versus American valuations and profits trends, the stage of the economic cycle, and the market's preference for value over growth, which is advantageous to a Canadian equity index heavily weighted to cyclical industries.

Equity valuations are somewhat high in Canada, in the United States, and globally. These valuations can, however, be justified by two factors. Firstly, the discount factor, which is

1555 Peel Street, Suite 1200
Montreal (Quebec) H3A 3L8
T 514 906-0667

linked to long-term interest rates and used to value future cash flows, remains historically low, yielding a higher present value for stocks and thus higher equity valuations.

Secondly, globally, earnings estimates are being revised upward, already a rare occurrence, and at the strongest pace of the last six years. It indicates that the underlying fundamentals are in the process of catching up to current valuations.

For 2017, we are not concerned with increases in interest rates that would lead to a higher discount factor for future cash flows that would lower equity valuations. On the contrary, at this stage of the economic cycle, rising interest rates are a sign of economic strength that pushes up earnings expectations for corporations. Moreover, inflation remains low in advanced countries and we do not think interest rates will increase much in the short term following their jump in the closing months of 2016.

In closing, our trend assessments of the Canadian, American, and International equity markets are positive at this time, all three recording our best +2 score. The only caveat is the Canadian market with the S&P/TSX Composite Index possibly lingering at 15 500.

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

1555 Peel Street, Suite 1200
Montreal (Quebec) H3A 3L8
T 514 906-0667