TRIASIMA

Economic and Financial Markets Commentary

First Quarter 2017

World Growth Accelerating Further

After improving in the second half of last year, the world economy gained further strength in the first quarter of 2017, in advanced and emerging countries alike. Corporate profits have also been rising in parallel. Meanwhile, inflation is showing some signs of awakening, eight years after the end of the Great Recession. All of this is in sharp contrast to the situation one year earlier.

In the **United States,** Donald J. Trump was sworn in as the 45th president. He inherits an economy close to full employment, with high expectations as reflected by increasing small business and consumer confidence.

It remains to be seen if his administration can push through his pro-business policies. This also begs the question as to whether aggressive fiscal stimulus is indeed necessary in a full employment situation as it may hasten the onset of the next recession by soaking up the supply side of the economy. Already, unemployment is sitting at a low 4.5% while growth is strong at an annualized 2.8% pace for the second half of 2016, and with a consensus forecast of 2.3% for 2017.

The **Eurozone** seems to be finally coming out of the doldrums. Political risk has abated somewhat, with the Dutch voting in Mark Rutte's centre-right People's Party for Freedom. Germany and France are still set to head to the polls during the year. Germany is a model of political stability but the outcome is more uncertain in France.

The changing political landscape is masking underlying strength within the Eurozone. Inflation is picking up and German and French manufacturing indices are at 6-year highs. As such, economists have been making upward revisions to their GDP growth forecasts for 2017. It now stands at 1.6%, up from 1.2% in August 2016.

The **United Kingdom** has initiated the negotiating process to exit the European Union, following the historic June 2016 Brexit vote. Estimated at two years in length, this process will heighten uncertainty levels for trade and commerce and depress the British pound.

China and many other emerging countries generate growth well above those of the advanced countries. China is targeting 6.5% GDP growth in 2017. A short-term concern for this country is the state of its immature financial industry. Non-performing loans need to be reduced, mainly in the real estate and industrial production sectors.

Emerging countries in general seem on sounder footing as Russia and Brazil emerge from deep recessions. Inflation in these countries has been dropping while growth is already high or accelerating. In India, the negative impact of demonetization, whereby most paper currency was eliminated to combat the underground economy, has been weaker than feared. GDP numbers for the fourth quarter of 2016 came in at 7.0%, ahead of the 6.1% expected.

Canada is doing well. GDP improved at a 2.6% annualized pace in the fourth quarter of 2016, as exports rose while imports fell. Second and third quarter GDP figures were also revised upward. The strong showing is not a surprise given the strength of the United States, our largest trading partner. As for newly elected Prime Minister Justin Trudeau, he is proving more pragmatic and adaptable than expected.

Interest Rates Upward Move Terminates

Ten-year Treasury bond rates in Canada and the United States hit all-time lows in the third quarter of 2016. Both countries next experienced a sharp run up in yields in the closing months of 2016 as inflation expectations troughed due to an accelerating economy and a strong labor situation. The run-up also coincided with the Trump election.

This yield run-up ran out of steam this past quarter. The yield-to-maturity of the FTSE TMX Canada Universe Bond Index edged down to 2.06% from 2.14 % three months earlier. It had been much lower at 1.71% in September 2016. This index had a decent 1.2% return over the past quarter.

The synchronized global economic strength is reflected in the actions of central Banks. The American Federal Reserve, after raising its benchmark short-term rate by 25 basis points in December 2016, increased it again in March by another 25 basis points, to 0.75%. After its second move, the Fed signaled a slower pace of increases than anticipated going forward. Long-term rates fell on this news.

As for the European Central Bank, it stepped back from its "whatever it takes" policy as it prepares to eventually reduce its bond-buying program. Something, however, it is not ready to do just yet. Eurozone inflation came in at 1.5% recently, well above the levels of recent years and also near the ECB's

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2% target. Years of deflation in Europe and the era of negative yields seem to be coming to an end.

A Risk-Off Quarter for Equities

The value style was in favour in 2016, with cyclical names from the natural resources, industrials, and financials sectors outperforming. Growth stocks were cast aside as well as securities from the interest sensitive and defensive industries. However, this risk-on reflation trade, quite profitable last year, cooled off in the first quarter. One reason is that markets shifted from hope that the Trump administration would enact pro-business policies to actual action and policies. Backtracking over the Obamacare Repeal and Replace action has undermined confidence in future tax cuts and a cash repatriation holiday.

The reflation trade faltered, but other sectors left behind in 2016 took over and equity indices garnered further gains. The S&P/TSX Composite Index advanced 2.4%, the S&P 500 Index was up 5.3% and the MSCI EAFE Index posted an impressive 6.4% return.

The best performing sectors across these indices were those left behind in 2016 by the new cyclical oriented regime, such as Consumer Discretionary (+6%), Technology (+10%), and Utilities (+7%). Conversely, the Energy (-5%) and Financials (+4%) sectors, both cyclical and with strong performance in 2016, lagged.

One outlier to this trade away from cyclical value names was the Materials sector in Canada where base metal, gold, and precious metals producers rose nicely for most of the quarter; an average of 12% for these three industries. Stable interest rates and strong economies are the reasons why.

Energy was weak over renewed concerns of oversupply from U.S. shale oil producers and a lack of demand growth for oil as the world becomes increasingly more energy efficient. Conversely, in the Technology sector, semiconductors, software, and internet companies are growing rapidly and earnings are climbing.

Internationally, Europe had an impressive first quarter with investors shrugging off political concerns and focusing on the improved economic situation. Spanish and Italian markets were particularly strong, up 12% and 8%, respectively. In Japan, the Nikkei rose 3%.

Latin American equities had an outstanding quarter with Brazil up 11%, while the Argentinian and Mexican markets jumped 22% and 17%, respectively. Argentina’s new pro-business government continues to enact economically positive measures while Mexico has bounced back from concerns over Trump’s tough stance on Mexican imports.

Conclusion

Our macro-economic view remains positive. Demand for labor is firm yet wages gains are low. Inflation is subdued and interest rates are stable following last year’s step-up. We see no immediate threat to this goldilocks scenario.

Relatively elevated equity valuations, the result of strong equity markets over the past several months, have become justified given the catch up in profits. The more so since inflation and interest rates remain low, suggesting low discount factors. Moreover, globally, earnings estimates are being revised upward, a rare occurrence.

Under a late cycle scenario, high beta countries, such as Canada, outperform the United States, and so do laggards, such as Europe. We have preferred the Canadian equity market over the American market since the beginning of 2016, and continue to do so.

We think interest rates will be firm, but we do not fear large and sustained increases that would derail the equity bull market. The supply of savings is just too large for that against a lukewarm demand for capital. Moreover, at this stage of the cycle, rising interest rates are a sign of economic strength that pushes up earnings expectations for corporations.

Insights from our Three Pillar Approach

From a top down vantage point, **fundamental** scores are enhanced by the current robust economic data. Many companies from diverse industries are faring very well for both top-down and bottom-up reasons. We can think of Canadian National Railway and Honeywell in the Industrials sector, Kinaxis and Microsoft in Technology, Salvatore Ferragamo in the luxury Consumer discretionary space or Saputo in Consumer Staples, and, globally, Financials, such as Royal Bank in Canada or Banco Macro in Argentina. All these companies are held in Triasima portfolios.

Our **trend** assessments of the Canadian, American, and International equity markets are positive at this time,

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recording either +1 or +2 scores. The only caveat is that the S&P/TSX Composite Index may linger at its current 15,700 level for a while. From a sector perspective, Industrials, Financials, and Technology have many names with top scores. Energy stands out as being weak.

On the **quantitative** side, top performing equities over the past quarter typically have higher financial and balanced sheet risk and are more volatile than their respective equity benchmark. Furthermore, they are more indebted and have higher profit stream variability. These are the hallmarks of value names from cyclical industries.

However, these same securities have rapidly growing revenues and profits, and their profit expectations are being revised upward. These quantitative parameters indicate they have the capacity to keep outperforming; implying the current value oriented cyclical regime is still alive as we end the first quarter.

We also noticed a comeback in growth names. These companies may also be more expensive and share the same elevated volatility and financial risk characteristics as cyclical companies from the resources industry. It is therefore not a coincidence that they are less out of favour as of late, especially in the Consumer Discretionary and Technology sectors.

In view of the above fundamental, trend, and quantitative considerations, our Three Pillar methodology is still favoring value equities over defensive and interest sensitive ones. However, portfolio evolution must now also take into account that growth is making a comeback. This recent development further justifies maintaining portfolios with superior growth parameters than those of equity indices while it is less crucial that value and risk metrics be better than those indices for now.

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

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