TRIASIMA

Economic and Financial Markets Commentary

Second Quarter 2017

World Economy: Steady As You Go

Following nine months of improving growth, the second quarter can be characterised as steady from an economic standpoint. The sociopolitical background was quiet as well, with the exception of England where Theresa May lost her majority in a snap election, weakening her position as Brexit negotiations get underway. France elected Emmanuel Macron, a centrist President.

Economic data in the **United States** proved rather tepid as first quarter GDP increased at a 1.4% annualized pace, the lowest level since the 2016 second quarter slowdown. Higher consumer spending was a key contributor to growth. Forward looking, sentiment indicators such as the Purchasing Managers Index dipped from a high level but remain in expansionary territory. Similarly, the GDP advanced indicators have eased to 3.5% as at the end of May versus 5.9% in February. In essence, growth in the USA is fine, but indicators have pulled back from higher levels and investors have focused on the recent downward trend. In contrast, the employment situation remains quite strong. As the economy approaches full employment, wage inflation is starting to tick up. This is typical late-cycle behaviour where wealth is transferred from corporations to individuals.

A slew of positive data came out of the **Eurozone** during the quarter. Eurozone GDP growth forecasts for 2017 have been revised upwards while inflation expectations are moving higher. This has led ECB President, Mario Draghi, to signal a (future) curtailment of monetary easing. France elected Emmanuel Macron who plans to enact pro-business reforms to stimulate the economy. The political uncertainty that hung like a cloud over the second largest Eurozone economy has lifted and should lead to an increase in consumer confidence and business investment.

The **Chinese** economy grew by 6.9% in the first quarter of 2017, a strong outcome. Nonetheless, concerns about its growth have resurfaced over attempts by policymakers to drain liquidity from China's immature financial system. Rules for property purchases were tightened to slowdown the overheated market. The financial system is also being addressed through regulation aimed at the shadow banking system and opaque high-yield wealth management products targeted to retail and institutional investors.

The economic situation in other **Emerging countries** has improved due to the resurgence of global economic activity. These countries are generally much better suited now to withstand interest rates increases radiating from the United States than in 2013 during the "Taper Tantrum". Current account deficits are manageable and central banks hold larger foreign exchange reserves. However, political risk remains present as witnessed by the recent corruption scandal in Brazil. Numerous reforms to be implemented remain in limbo as the investigation into bribery claims against President Temer unfold.

The **Canadian** economy contracted in the second quarter of 2016, but it has since been on an expansionary path for the last twelve months. Commodity prices were firm in 2016, but weak so far in 2017. The Canadian economy, however, has been resilient, achieving 3.7% annualized GDP growth in the first quarter, with expectations at 2.2% for the second quarter. It is spurred along by sharp gains in domestic demand. Labor markets are strong, notably in the private sector. This has led the Bank of Canada to consider whether the monetary stimulus in place is still justified.

Yield Curves Flatten

For the first time since the Great Recession, there seems to be a concerted worldwide effort within advanced countries to reduce monetary stimulus. The Federal Reserve, after raising its benchmark short-term rate by 25 basis points in March 2017, increased it again in June by another 25 basis points, to 1.0%. Late in the quarter, European, British, and Canadian central bankers, acknowledging the strong economies and improving labor markets, asked whether monetary stimulus should be tapered. As a result, the Bank of Canada raised its overnight rate for the first time in seven years last July, from 0.50% to 0.75%.

Talks of tapering in Canada and in the United States have pushed up short-term rates over the quarter while long-term rates dipped due to the underwhelming economic news and benign inflation data. This caused Canadian and American yield curves to flatten.

In Canada, the yield-to-maturity of the FTSE TMX Canada Universe Bond Index edged up to 2.17% from 2.06% three months earlier. It had been much lower at 1.71% in September 2016, a record low.

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Equities Pull Back from Recent Highs

The second quarter of 2017 was marked by the continued unwinding of the so-called "reflation trade", with commodities-related equities underperforming. Overall, Growth beat Value as an investment style, with cyclical names from resources sectors taking the brunt.

As such, the resource heavy S&P/TSX Index retreated 1.6% while the S&P 500 advanced 0.5%. Non-North American markets fared better with the MSCI EAFE posting a 3.5% return. The recent European economic revival is the main reason for this.

Overall, for all three indices, the best performing sectors were a mixture of cyclical and growth, such as Health Care (+8%), Industrials (+4%), and Information Technology (+4%). Conversely, cyclical Materials (-2%) and Energy (-7%) lagged, faltering alongside the reflation trade.

Internationally, Europe had a decent quarter with the MSCI European Monetary Union rising 6%. The Portuguese and Irish markets were the standouts, up 8% and 7% respectively. These countries were deeply affected by the European recession and the fact that they are coming back strong is a sign of improved confidence in the Eurozone.

Latin American equities fared rather poorly with Brazil retreating 11% and Argentina, 3%. Brazil was hit by yet another scandal, this time ensnaring the current President, Michel Temer, in a bribery scandal. Argentina fell on the news that MSCI did not upgrade the country from "frontier" to "emerging". This does not change the fact that the country is improving with its new pro-business government continuing to enact economically positive measures.

Insights from our Three-Pillar Approach

Worldwide, economies of significance to a Canadian investor are faring well or are improving: Canada, the United States, China, and the Eurozone. Just like three months ago, and from a top-down vantage point, **fundamental** scores for companies are enhanced by robust economic data.

Important exceptions are entities falling within the Energy and Materials sectors where the pricing environment deteriorate over the last months. Most Energy names and approximately half of the Materials names held in Triasima's portfolios were downgraded an average of 0.5 point within our -2 to +2 scoring system.

An important change has taken place in our **trend** assessment of the Canadian equity market, which went from +1 to 0. It was rated +1 three months ago while struggling to surpass the September 2014 all-time closing high of 15,658. We did not expect this to happen soon and wrote that '*the S&P/TSX Composite Index may linger at its current 15,700 level for a while.*'

The trend behavior of the Canadian market is in sharp contrast with that of the American and International markets. These two have stayed the course and remain on their uptrends, a steady one for the United States and a steep one abroad. Both markets are still rated +2.

From a sector perspective, Industrials, Financials, and Technology have many names with top trend scores.

On the **quantitative** side, recently top performing Canadian and American equities typically showed higher financial and balance sheet risk, higher historical profit volatility, and lower earnings growth than average. However, especially in Canada, these companies already are as profitable as their peers while enjoying superior expectations revisions.

These quantitative parameters indicate that, over the second quarter, the market rewarded companies more speculative than the average, but are transitioning to a higher quality level. It is likely these companies will keep outperforming.

Not all top performers come from the value-oriented resources or cyclical industries, some are turnarounds or expensive growth entities. Examples of both include Air Canada and Blackberry in Canada, and Nvidia and Intuitive Surgical in the United States.

In view of the above **fundamental, trend,** and **quantitative** considerations, our Three-pillar methodology has moved away from a value versus growth paradigm. With weakness in the resources sectors and growth and with consumer-focused and interest sensitive sectors having made a comeback or rebounded from depressed levels (we pointed out three months ago that growth was making a comeback), we seem to be in a period where no specific style dominates. With lower stock returns correlations than in the past few years, we may be in a stock picker's market.

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Conclusion

Little has changed over the past three months. Our macro-economic view remains positive with steady growth and wealth creation in advanced countries, with the Eurozone improving while the United States slows down. The labor market is strong in North America and rebounding in Europe. Labor costs are not accelerating significantly, inflation remains subdued, and long-term interest rates are stable. We continue to see no immediate threat to this goldilocks scenario.

Equity valuations have become a little stretched, the result of strong markets over the past months. Profits are increasing, but further catching up is required, especially in Europe where overall corporate profitability is still low. Meanwhile, globally, earnings estimates are being revised upward, a rare occurrence.

We expect interest rates to be firm, but we do not fear large and sustained increases that would derail the bull market. The supply of savings is just too large 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.

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

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