TRIASIMA

Economic and Financial Markets Commentary

Fourth Quarter 2017

Synchronized Growth Worldwide

The confluence of low inflation and low interest rates combined with rising profits provided a near-perfect, "Goldilocks" environment for investing in 2017. Global bourses climbed with little volatility around the world while commodity prices firmed late in the year. The equity markets shrugged off a number of political worries, including the rise of populism in Europe and tensions with North Korea. To wit, it has been 380 days and counting since the S&P 500 corrected by 5% or more, the longest stretch since 1960!

We have long mentioned this Goldilocks scenario. The question is whether it will be sustained in 2018, while central bankers taper off their quantitative easing (QE). Inflation and interest rates should rise, but nonetheless remain below central banks targets of 2%-2.5%, as wage inflation remains benign.

In the current period of global synchronous growth, not all countries or regions are at the same stage of the economic cycle. The United States is in the late stage of the cycle, as is probably China. The Eurozone is in the middle stages while Emerging markets, such as Brazil, are still in an earlier phase. This dispersion between regions is crucial to prevent global growth from overheating or a global recession.

Economic growth in the **United States** has been stronger than expected in 2017, especially in the second half of the year. Consumer confidence has risen to levels not seen since 2000, with the labour market in very good condition. Meanwhile, consumer credit flows freely. This should translate into more buying power for the consumer and a strong economy in 2018. Corporate profit margins have peaked, and we are now in the full employment phase of the economic cycle, when a larger portion of the economic wealth created shifts away from corporations and goes to the household sector, leaving consumers with more disposable income.

Another reason for optimistic growth prospects is that capital expenditures should pick up in 2018 (this is typical of late cycle behavior) under Trump's current tax plan, which will encourage business investments. Other measures such as cutting the corporate tax rate from 35% to 20% and offering a repatriation tax holiday to multinational companies will further fuel GDP growth. In light of this, the Federal Reserve is now expected to raise the discount rate three times in 2018.

The European Central Bank (ECB) raised their forecast for GDP growth in the **Eurozone** for 2018 from 1.8% to 2.3%. This region is benefiting from strong global growth abroad and steady growth at home.

Conversely, the ECB inflation forecast for 2018 remains subdued at 1.4%, below the 2% target rate. This low level means that quantitative accommodations will remain in 2018 to some degree. As such, the ECB plan to purchase 30 billion euros of bonds monthly between January and September of 2018, half the recent pace of 60 billion euros a month.

Politics could once again come to the forefront in 2018. Europe managed to sidestep election worries in 2017 including in Germany, the Netherlands, and France, but risks remain with Italian elections in May and the ongoing Catalan dispute in Spain.

The 19th National Congress of the Communist Party of **China** was held in October. No specific growth targets were set, and "quality of growth over quantity" was emphasized. This represents a strong departure from the past. Announced capacity cuts in some industries are congruent with President Xi's goal of reducing pollution over the next three years. Policymakers also further strengthened efforts to cool down the housing market by tightening the regulation of mortgages.

Given this emphasis on balanced development, and because of the sheer size of the country, GDP growth will drift lower from the 6-7% range to a 4-5% range over the next five years, until the 20th National Congress.

In **Japan**, the world's third largest economy, Prime Minister Shinzo Abe retained his super majority in the October 22 election. This gives him the liberty to continue implementing Abenomics for the foreseeable future. Unemployment rate is at 2.8%, the lowest in 23 years, and the labor market is tight. Deflationary forces have abated because of this and rising wages are in the cards. A remarkable contrast with the situation prevailing since the early 1990s. Like in the Eurozone, the country is not late enough in the cycle for the Bank of Japan to pull back on its accommodative policy as it pledges to continue buying assets at a rate of 80 trillion yen per year.

Canadian GDP came in at 1.7% for the third quarter, a decent outcome given the second quarter's 4.5% print. The Canadian economy is on track to grow 3% in 2017, the strongest showing in six years. This is reflected in the labor market

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where a spectacular 423,000 jobs were created. Because of this, the unemployment rate fell to 5.7%, the lowest level since 1976 (comparable data does not go further back).

Domestic concerns by market participants continue to center on the high level of indebtedness of Canadians and elevated residential prices in Vancouver and Toronto, and on the outcome of negotiations with the United States and Mexico over NAFTA.

Socio-Political Developments

Negotiations are ongoing between London and Brussels over the terms of Brexit, the departure of the United Kingdom from the European Union. A key milestone was reached recently over the amount to be paid by the UK for items such as pension payments to European Union bureaucrats and the share of the common debt.

A positive development was the announcement by Chinese authorities that the country would set up a massive national carbon-trading system for emitters of greenhouse gases. Extreme pollution in large cities is a major challenge in China as the country advances from emerging to advanced, with a huge middle class being created. China is the world's worst polluter now, ahead of the United States or Europe (although Americans, European, and Canadians pollute more per capita). The announcement is good news for planet Earth.

Also of note is the decision on November 26 by 41 Muslim countries to ban together to combat terrorism. The Islamic Military Counter Terrorism Coalition is an unprecedented global, multi-disciplinary strategy.

Finally, we must mention the cultural changes taking place in Saudi Arabia. This conservative country has been led since 1932 by King Idn Saud or one of his descendants (he is thought to have had 45 sons). The actual ruler, King Salman bin Abdulaziz, holds the position since January 2015. However, Crown Prince Mohammed bin Salman, aged 32 and grandson of King Idn Saud, has risen to prominence as of late and appears to be spearheading changes of all kinds. From allowing women to drive, to blockading Yemeni ports, to standing up to Iran, the recent assertiveness of this country is a dramatic departure from the past. Most noteworthy of all is the anti-graft purge that begun November 5 of over 200 royals, ministers, and businessmen on allegations of systematic corruption.

Benign Upward Pressure on Rates

The low volatility environment of the equity markets was also present in the bond market in 2017, as measured by the Merrill Lynch Option Volatility Estimate, trickled down all year to record lows (since 1988).

After raising its benchmark rate twice during the third quarter, the Bank of Canada (BoC) left it unchanged at 1% during the fourth. Despite the slew of positive economic data in Canada, the BoC mentioned that "The global outlook remains subject to considerable uncertainty, notably about geopolitical developments and trade policies." One must wonder if the BoC is looking for any excuse to maintain a weak Canadian dollar to stimulate exports and in turn the manufacturing sector.

Key interest and market rates where thus fairly stable in the quarter. Three-month Treasury bills rates remained stuck at 1% while the long end of the yield curve, beyond 10 years, shifted downwards. The flat yield curve that results from this points to lowered inflation expectations over the long term. The yield-to-maturity of the FTSE TMX Canada Universe Bond Index was nearly unchanged, ending 2017 at 2.47%. The Index's return was 2% for the quarter. It is a meagre 2.5% for 2017, due to the lift off of the yield curve in the second and third quarters.

The situation is different in the United States where the yield curve jumped about 0.25% on average, on account of the strong economy. The Federal Reserve has reacted by increasing its overnight rate by 0.25% over the quarter, and by 0.75% for 2017. Short-term rates followed suit and rose 1% for the year. These increases were all anticipated by market participants.

Reflecting the low volatility and supportive economic and financial backdrop, credit spreads eased down further to low levels in Canada and the United States.

In Europe, the yield curve rose 20 basis points on average in the first semester due to better economic prospects. After that, rates were stable at low historical levels.

A Banner Year for Equities

The fourth quarter capped off a great year for global bourses. 2017 will be remembered as a near-perfect year for equities when markets focused on the synchronized global growth,

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rising profits from corporations, and well behaved interest rates.

The S&P/TSX Composite Index gained 4.5%, the S&P 500 Index went up 6.6% (US$), and the MSCI EAFE, 4.2% (US$). For the full year 2017, the returns were 9.1% (US$), 21.8% (US$), and 25% (US$) respectively.

These superior returns were accompanied by record low stock price volatility in the United States (with the record going back to 1996). A very appealing combination.

When reported in the Canadian currency, the performance of the American and International markets drops to 13.8% and 16.8% respectively due to the loonie's mid-year rebound.

The best performing sectors for the quarter varied across markets. For the year, however, cyclical sectors dominated with the Materials, Industrial, and Consumer Discretionary sectors performing best.

Consumer Discretionary, a hodgepodge of automaker, homebuilder, and consumer retail stocks, was one of the best sector. It is benefitting from a more confident consumer in the United States and Europe, with ample supplies of credit available to the free-spending Americans.

Notwithstanding this cyclical theme, the best sector of all was Information Technology. Tech stocks, from small ones to mega cap companies, enjoyed a tremendous run, rising a phenomenal 39% (US$) in the United States and 48% (US$) internationally. We live in a world of rapid technological advancements and these companies, from software to semiconductors, are among the main beneficiaries.

Japan was one of the strongest markets during the quarter, rising 9%. Given Prime Minister Shinzo Abe's recent landslide election victory, expansionary monetary and fiscal policies will likely continue. This puts downward pressure on the Yen, which is good for many export-driven large Japanese companies.

Emerging markets also had a stellar quarter and year, up 29% in 2017. India and Argentina were leaders (the Argentinian Merval Index was up 42%). Argentina elected a pro economic laissez-faire government, while in India the economic reforms implemented by Prime Minister Modi have been well received. From a demographic standpoint, India boasts a young and educated population and an expanding middle class, ideal conditions for the future path of corporate earnings.

Given their different demographics, it is only a question of time before India supplant China as the largest economic influence amongst emerging countries.

Insights from our Three-Pillar Approach

From the **Fundamental** pillar vintage, scores had generally improved over the second and third quarters of 2017. This was due to the broad based economic growth, with many companies faring better for both top-down and bottom-up reasons. This was especially true for large European based companies and those of the financial sector located in Europe or Latin America.

The synchronized economic expansion carried on over the fourth quarter and fundamental scores were stable. The exception was selective improvements in Materials names, especially in Canada. Scores for that sector troughed in the second quarter and have since been rebounding due to effective cost management and better commodity pricing, leading to higher profitability. The increasing maturity of the economic cycle is a positive contributor here.

As for the **Trend** pillar, not much has changed relative to the two previous quarterly commentaries. The trending aspect of the equity market is a hallmark of the time with the momentum factor on a tear. As such, the American and International markets are staying the course and remaining on their remarkably steady uptrends. The S&P 500 Index has been uninterruptedly rated +2 since November 2016, while the MSCI EAFE Index has had a +2 rating since February 2017 (with the sole exception of August 2017 at +1).

The story for the Canadian market is very different. Cyclical resources-based sectors occupy a much larger weighting within the S&P/TSX Composite Index and these sectors, along with the also heavily weighted banks, have shown weakness from March to August 2017, pushing the Canadian Index down into a consolidation pattern. It recently emerged from it and the Index has now been rated +2 like its American and International counterparts for two months.

The Canadian equity market is likely to maintain a strong Trend rating because we see a shift within our **Quantitative** pillar, with Value style beginning to be rewarded by the market. This change is very propitious to Canada given that

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Energy and Materials sectors and bank stocks are all of that style. Value leads Growth when economic growth is high, like now.

As for the American and International equity markets, no quantitative indications are casting doubts on the legitimacy of the current market uptrend. As for Size, it is still a factor leading to outperformance.

One key change from several months ago is that stock movements have become poorly correlated, relative to historical norms. This makes it possible for our quantitative tool to discriminate between good and bad stocks.

Our Three-Pillar methodology moved away from the Value versus Growth paradigm six months ago since no specific style was dominating. We called it a 'stock picker market' at the time. This is no longer the case: Value metrics now correlate with outperformance as we begin a new year.

Conclusion

The fourth quarter was a smooth continuation from the third from an economic vantage point. The newly fanged expansion remained in place in the Eurozone and Japan, while the United States stayed the course. The stability and breadth of the expansion combined with low interest rates continue to support earnings growth worldwide and points to a still long lifespan for the bull market.

Many are of the view that the stock market uptrend is long in the tooth and that valuation multiples are expensive. We do share some of this assessment. However, when one looks at the return of the MSCI All Country World Equity (ACWI) Index for 2017, 65% of the return was driven by earnings growth. This is even more pronounced for emerging markets at 75%. This shows that the climb by equity markets is largely justified, being supported by strong underlying fundamentals.

Although we see upward pressure on rates and inflation in 2018, we are far less pessimistic than the consensus on this, as we have been since 2010, which has been the correct view. Discount factors to apply against future corporate cash flow should not rise enough in the near term to derail the equity markets. At the near end of the yield curve, we can count on central bankers to be behind the ball, rising rates too little too late at this stage of the cycle.

Central banks have pumped a tremendous amount of monetary capital over the last decade which has indiscriminately lifted asset prices. As liquidity is withdrawn from the economic system, which we are beginning to see, valuations and individual company dynamics matter more once again. The drop in stock prices correlations adds fuel to the fire, clearly favouring active managers.

We hear repeatedly that Canadian are too highly indebted and that housing prices are too high. Fears over the outcome of the NAFTA negotiations are also voiced. Generally, Triasima does not share these concerns.

Equity earnings yields are well above bond yields, a powerful indicator that equities are not overpriced relative to bonds.

By factoring in the rapid pace of technological advances, we can only conclude that these are exciting times to be an equity investor.

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

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