TRIASIMA

Economic and Financial Markets Commentary

Third Quarter 2017

A Great Time for the World Economy

Nine months into the year, the global economy remains healthy with strength in developed and emerging countries alike. In the developed world, not a single OECD country is in contraction, a situation that has not occurred since 2007. As for the emerging countries, they are benefitting from an increase in global economic activity and looser monetary policies. This sustains wealth creation for their citizens. Inflation is either declining or remaining subdued nearly everywhere despite the strong economic backdrop.

Synchronized growth and contained costs are leading to corporate margin expansion and increased capital investment. The overall situation has created a “Goldilocks” scenario for the equity markets, with low inflation and interest rates, rising profits, and steady growth.

The political discourse has been dominated by the fracas between the United States and North Korea over that country’s effort to develop an atomic deterrent to the purported threat of an American invasion. Financial markets are assuming a diplomatic resolution to this dispute.

Economic activity picked up in the **United States** as second quarter Gross Domestic Product rose at a 3.1% annualized pace and with solid expectations for the rest of the year. Household consumption was once again a key contributor to growth. Higher business investment and trade also chipped in, offsetting the drag from lower government spending. Recent hurricanes Harvey and Irma will lead to a small and temporary drag on growth, counterbalanced later by the ensuing reconstruction effort.

On the political front, President Trump provided a framework that aims to reduce the corporate tax rate to 20% from 35%; for individuals, it means cuts to the number of tax brackets from seven to three. Criticisms of this initiative center on the larger budgetary deficits that will immediately follow.

The **Eurozone** continues to roll with second quarter real GDP accelerating to 2.3%. Growth in this region of the world is becoming more broad-based as the sovereign debt crisis recedes in the background. The European Central Bank revised up its GDP growth forecasts to the highest level in over ten years. At the corporate level, earnings growth has inflected in the majority of industries. Instances of negative real rates are rarer.

The **Chinese** economy purportedly grew at 6.9% in the second quarter of 2017, a strong outcome. The emerging middle class supports solid consumption metrics while fixed asset investment continues to grow. This marks two quarters in a row of reported 6.9% growth, providing an important measure of stability before China’s communist party congress in October as the country leaders pursue aggressive growth targets to 2020.

A key long term issue, however, is the dangerous level of debt, both in the financial and non-financial sectors. With an immature financial system, this issue will not likely be self-correcting and come from within, but rather be externally triggered and ‘disruptive’.

Japan is witnessing a resurgence. A weak Yen is supporting exports while the domestic economy in uncharacteristically strong. Overall conditions are approaching those of the mid-2000s. The jobs-to-applicants ratio, a measure of labor market tightness, is at its highest level since 1990. Hopes are that this will result in some rise in unit labour costs since Japan has been battling deflationary demographic forces for some time. For now, the trailing twelve-month inflation rate is very low at 0.7%, far from the Bank of Japan’s 2% target.

Canada is on tear with second quarter GDP growth coming in at a blistering 4.5% annualized rate. Consumption spending contributed 2.6% to that growth as consumer credit rose at the fastest pace in seven years. Labor markets are strong, with 186,000 jobs created in the first half of the year, a level not seen since 2010.

Domestic concerns center on the high level of indebtedness by Canadians and elevated residential prices in Vancouver and Toronto. A proposed tax reform has also emerged as a contentious point with the potential to slow down the economy.

Yield Curves Shift Upwards

Worldwide, there is a divergence between advanced and emerging markets monetary policy. In advanced countries, there is a general consensus to reduce monetary stimulus for the first time since the Great Recession as respective economies pick up steam. Some central bankers have already begun to tighten their monetary policy.

Meanwhile, emerging countries are loosening theirs. Stable current account balances allow policymakers to focus on economic fundamentals rather than compete for capital

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flows. Declining inflation in these countries also gives them more room to remain accommodative.

Canada saw its central bank raise its overnight lending rate twice by 0.25% to reach 1% during the quarter as the economy accelerated. Following the increases, Bank of Canada governor, Stephen Poloz, mentioned that they would move cautiously towards policy normalization. This is code speak for measured and gradual future rate increases.

With short term rates pushed up by the Bank of Canada and with strong economies here and abroad, a sizeable interest rate readjustment occurred. The yield-to-maturity of the FTSE TMX Canada Universe Bond Index shot up 34 basis points from three months ago, to reach 2.51%. The all-time low of 1.71% took place one year ago in September 2016 and the current level is the highest since December 2013's 2.75%. All maturities were impacted, resulting in a large parallel upwards shift by the entire yield curve of approximately 35 basis points.

As for the Federal Reserve, its last increase was in June, also to 1.0%. The Fed has stood pat since, befuddled over the lack of inflationary acceleration.

With a background of economic and financial conditions remaining supportive, business credit continued to rise in Canada while credit spreads contracted, a mark of confidence, by an average of 0.27% for ten year corporate bonds so far this year.

Equities: Firing On All Cylinders

Bourses rose worldwide in the third quarter, reflecting the global economic strength. The S&P/TSX Composite Index gained 3.7%, the S&P 500 Index went up 4.5% in US $, and the MSCI EAFE by 5.4% (US $).

Overall, for all three indices, the best performing sectors were a mixture of cyclical and growth. On the cyclical side, the third quarter could be defined as 'risk-on' as the natural resources based sectors outperformed while the defensive sectors lagged. As such, the Energy sector was best across all three indices, rising 6% on average, followed by Materials at 4%. The oil price moved higher due to a growing demand forecast while supply remains curtailed by OPEC. Meanwhile, base metals prices were firm.

The growth oriented Technology sector did well too, spurred on by the global economy and tremendous innovation oriented historical period we live in.

On the flip side, the defensive Consumer Staples, Utilities and Real Estate sectors underperformed. The last two sectors have large dividend or distribution yields and firmer interest rates diminished their appeal.

The Canadian dollar gained in value over the recent months and this strength deflates the returns from the S&P 500 Index and the MSCI EAFE Index to 0.5% and 1.4% respectively.

Europe performed nicely with Italy being the standout (+8%) among the European developed countries. Italian banks are reducing their bad debt levels as the economy improves. Second quarter Italian GDP came in at 1.5%, still a low absolute number but a strong improvement from the norm since 2008.

Emerging markets outperformed the broad MSCI EAFE index with Latin American achieving a stellar quarter, up 11%, and a sharp reversal from the 4% drop the previous quarter. With inflation falling in both countries, Brazilian and Argentinian led once again, climbing 19% and 10% respectively. Brazil's central bank is lowering interest rates, which stimulates the economy, while in Argentina, Mauricio Macri's economic reforms are well received.

Insights from our Three-Pillar Approach

Fundamental scores have generally improved over the last six months, alongside the broad based growth. Many companies from diverse industries are faring better for both top-down and bottom-up reasons. This is particularly true for large European based companies and for those of the financial sector located in Europe or Latin America. Overall, the fundamental scores went up about 0.2 point over the past three months, within our -2 to +2 scoring system, for American and International names commingled.

In Canada, many Energy and Materials sectors names had been downgraded 0.5 point on average from last February to last June. This pattern troughed over the summer due to effective production costs management by corporations and a better pricing environment for oil and other commodities.

The **trend**ing aspect of the equity market is a hallmark of the time with the momentum factor on a tear. Our comment

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of three months ago still holds: *'the American and International markets 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.'* They actually have been almost uninterruptedly rated +2 for quite sometimes now: for 11 out of the last 15 months for the United States (the other 4 months were +1) and 8 months in a row for the International market.

From a sector perspective, the Health Care and Technology sectors stand out as having a high proportion of their constituents demonstrating superior trends.

The domestic story is different. The pullback in Energy, Materials and banks that began in March had pushed down by mid-June the trend assessment of the full Canadian equity market from +1 to 0. This rating of zero is still in effect: the third quarter rebound has not proven sufficient to bring about an upward revision.

The S&P/TSX Composite Index was struggling six months ago, while at 15 600, to surpass its September 2014 high of 15 658. We wrote then that '*we did not expect this to happen soon and … that the S&P/TSX Composite Index may linger at its current level for a while.*' Six months later, the equity market is at 15 635.

We thinks the odds are higher that the Canadian equity market will continue meandering sideways than that it will imitate the American and International markets and resolutely embark on a steady uptrend.

Triasima's **quantitative** tool does not currently work very well outside Canada. The American and International markets are so uniformly strong that this analytical method is unable to discriminate efficiently between outperformers and underperformers. To some extent, we are in a period whereby a 'rising tide lifts all boats'.

More specifically, the current equity markets, outside of Canada, are not rewarding value metrics such as the price/earnings ratio or return on equity. Those parameters are actually associated with underperforming names. The best performing stocks are a hodgepodge of value and growth names that are somewhat more volatile than the market. What they have in common, however, is the ability to surprise financial analysts who have to revise their expectations up.

Canada is not that different. The best performing names are more volatile as well and value and profitability metrics are also not rewarded. The difference is that the best names simply have better growth parameters, rather than better expectations parameters. This nuance renders the quant tool easier to use for Canada since growth parameters are more stable over time than expectations ones.

Our Three-pillar methodology moved away from the value versus growth paradigm three months ago as we seem to be in a period when no specific style dominates. Stock return correlations have been below average for some time now, and still falling. As we stated, also three months ago, all this points to a stock picker's market.

Conclusion

The third quarter was a smooth transition from the second in terms of economic data with a steady recovery in the Eurozone while the United States stay the course. The economic stability and breadth of the expansion combined with low inflation and interest rates supports earnings growth worldwide and points to a still long lifespan for the bull market.

With this background environment, the equity market narrative has swung massively bullish. By the end of the third quarter, the S&P 500 Index has gone 316 days without a correction of 5% or more. Such a long stretch of steady advance by this market has not been seen since 1960. This shows how powerful the current Goldilocks environment is.

As far as equity valuations are concerned, we can only repeat what we wrote three months ago: '*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 can add that the equity earnings yield is well above the bond yield, a powerful indicator that equities, at least, are not overpriced relative to bonds. Many prognosticators would argue, however, that both markets are in bubble territory.

We disagree. Our advice is not to worry too much for now and to simply enjoy this powerful bull phase for stocks.

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

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