# Investment Commentary

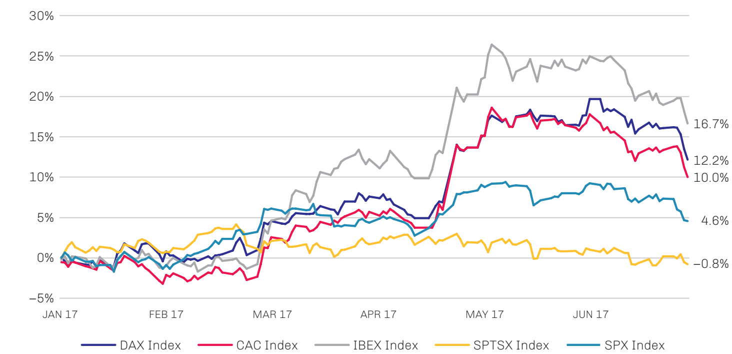
EQUIUM CAPITAL

Second Quarter 2017

## Europe's Second Act?

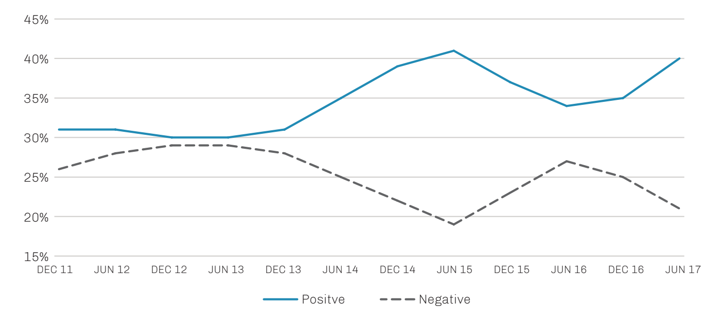
We have been bullish on Europe since the beginning of the year as both qualitative and quantitative factors turned positive against a backdrop of negativity and low valuations, a situation which typically provides fertile ground for positive risk-adjusted returns. True to form, French, German and Spanish equity indices are all up significantly year-to-date against the S&P/TSX Composite and the S&P 500 Index (Chart 1). Now that investor opinion of Europe has started to come around to our view, it's a fair question to ask whether there is still more to the story.

**Chart 1 | Europe vs. North America Total Return YTD (CAD)**
source: Bloomberg, Equium Capital




Positively, Europe remains technical leadership among global equities and economic indicators, such as Purchasing Manager Indices (PMIs), loan growth and credit spreads, continue to point to a healthy recovery. Corporate earnings growth is expected to be in the mid-teens this year and valuations remain discounted versus other global markets. Consequently, the short-term cyclical recovery appears firmly in place and we continue to find European equities attractive at current levels.

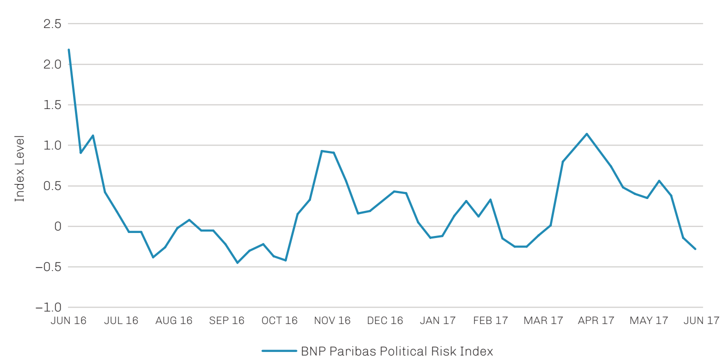
**Chart 2 | European Attitude Towards the EU**
source: Eurobarometer, Equium Capital




Thinking longer-term, we have historically worried about major structural issues in Europe, notably weakening demographics, competing political agendas and the disconnect between a single Euro monetary policy and many national fiscal policies. It always seemed more likely than not these challenges would derail any shift to sustainable growth and any effort at necessary reform would be opposed by significant protests.

That being said, numerous indicators now show significant progress and we are considering whether past perspectives may be too pessimistic. The election of Emmanuel Macron, along with his landslide parliamentary victory, placed an unabashedly pro-Euro reformer at the head of France. EU cornerstone, Angela Merkel, looks set to be re-elected in Germany in September. On the other side of the political spectrum, anti-Euro parties, such as the Five Star Movement and Alternative fuer Deutschland, have suffered significant regional defeats and waning poll support. Most positively, survey results show European views regarding the EU project have rebounded materially since the Greek crisis (Chart 2).

**Chart 3 | European Political Risk Index**
source: BNP Paribas, Bloomberg, Equium Capital




For the most part, the market has treated these political developments as simply reducing tail risk of a Euro breakup (Chart 3). While true, this view misses the more important benefit of helping lay the foundation upon which necessary structural reforms can take place. The Achilles heel of the Euro has always been a shared currency without shared fiscal responsibility. Already we are seeing signs of convergence with both Macron and Merkel openly supporting the idea of a single European finance minister as well as the potential creation of a common budget. For context, these ideas could have lost entire elections only a couple of years ago.

There is also tangible progress being made to clean up the European banking system, which is another necessary step before greater integration can be achieved. In June we saw Spanish regulators wind down Banco Popular, the 6th largest Spanish lender, and combine Bankia and BMN, creating the 4th largest bank by assets. Meanwhile, Italy forced the resolution of two struggling mid-sized Venetian banks and approved a €5B recapitalization of the oldest and 4th largest Italian lender, Monte dei Paschi. Given the lack of contagion, and in some cases positive market response to these workouts, we expect more progress to be made, which in turn should support a further recovery in loan growth and improve prospects for reform.

While we remain cautious in our long-term expectations, we cannot help but note the stark contrast between broad investor pessimism on Europe (Chart 5) and the significant headway being made. Should we see continued follow through with reform, it could result in a multi-year run of structural outperformance for the region. For now, the investment process remains significantly overweight European equities and our fundamental research team continues to carefully monitor progress of reforms and the cyclical rebound in the region.

## Biotech Bounce Back

So far this year, U.S. Health Care has been decidedly mixed in our work, with several sub-sectors challenged by the constant stream of reform efforts and drug pricing threats that clouded the fundamental outlook. However, over the last several weeks there has been greater policy clarity on multiple fronts and our process has moved to overweight the sector.

On the technical front, the relative strength of Health Care broke out versus the S&P 500 (Chart 6) and is one of only two sectors currently demonstrating clear positive momentum. As a reminder, we use top-down technical analysis to highlight areas of strength within the market that we then confirm with thorough fundamental research in an effort to maximize risk-adjusted returns and protect capital in downturns.

From a bottom-up perspective, we've seen several storms pass through Washington DC that we now believe leave clearer skies ahead for the group. Namely, the tabling of the Affordable Care Act (ACA) repeal effort as well as the White House draft policy statement on drug pricing. Although both efforts will likely see

**Chart 4 | Non-Performing Loans, by Region**
source: Moody's, Financial Times, Equium Capital

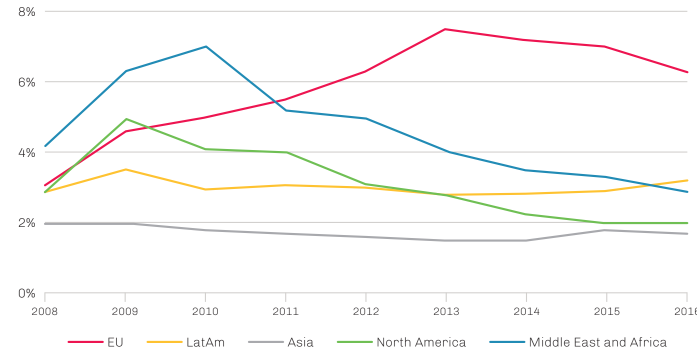



**Chart 5 | Global Investor Fund Flows, by Region**
source: EPFR Global, Equium Capital

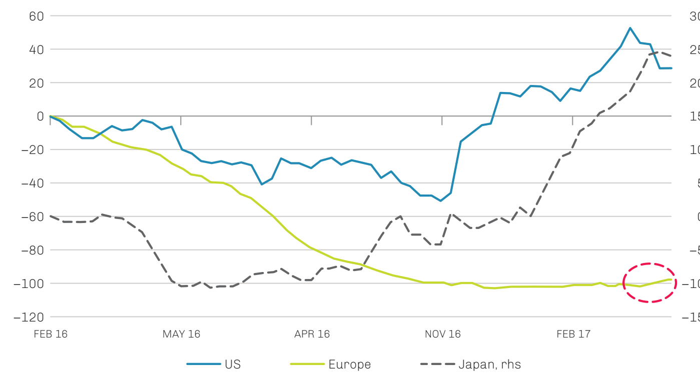
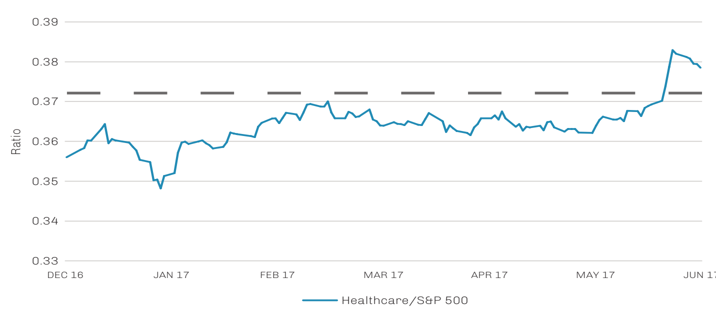



**Chart 6 | Health Care Relative Performance to S&P500**
source: Bloomberg, Equium Capital



further changes they appear largely benign for Health Care stocks overall.

Within the sector, we continue to favour certain industries over others given significantly disparate long-term structural drivers and headwinds among them. We added exposure to the Medical Equipment sub-sector in April given the group's strong technicals, high quality of earnings, multiple growth levers and minimal policy risk. Positively, the position is up +11% vs. the S&P 500 up +4% since purchase. Other groups, such as Pharmaceuticals and Services, remain negative in our work as they continue to struggle with a poor growth outlook and modest return on capital metrics (Chart 7).

Biotech is an industry where we have recently moved from negative to positive. After the darling run of +249% from 2012-2015, a confluence of election politics and drug price scandals caused Biotech to underperform the S&P 500 by more than -30% from the 2015 peak to the end of May (Chart 8). This period served to reset frothy expectations and drive valuations back to 10 year lows making for the current favourable entry point.

As is our process, valuation on its own is not a sufficient reason to buy any particular asset. To be overweighted in portfolios, an attractively valued investment needs to be accompanied by strong fundamentals and confirmed by a positive technical outlook. In the case of Biotech, the group experienced a relative performance break out mid-June after the New York Times leaked the White House's draft order on drug prices. The news alleviated one of the industry's biggest concerns, that enhanced regulations could restrain pricing growth, and cleared the way for new investment flows.

Stepping back, Biotech's fundamentals are very favourable relative to the market, with return on capital more than double the S&P 500, higher revenue and earnings growth and far better balance sheets. This confluence of positive fundamental factors strikes us as very inconsistent with the industry's current -20% valuation discount. Also, the introduction of biosimilars, which are generic versions of biotech drugs, has been much slower than expected, with only 5 approved since 2015 vs. 800 conventional pharmaceutical generics in 2016 alone. Moreover, no biosimilars have been approved as interchangeable, meaning that they will require extra layers of approval to be prescribed. Lastly, the Supreme Court's decision to review the Inter Partes Review process (IPR), which assesses drug patent validity, could lead to a further slowing of generic competition. All in, Biotech looks set to recover from its lengthy period of underperformance as headline risk dissipates and fundamentals drive significant earnings growth.

**Chart 7 | Medical Devices Outperformance YTD**
source: Bloomberg, Equium Capital

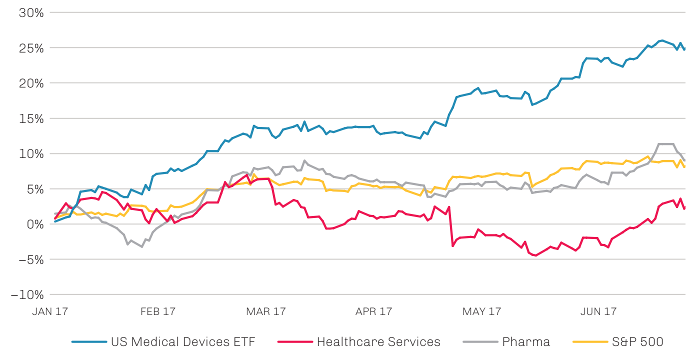
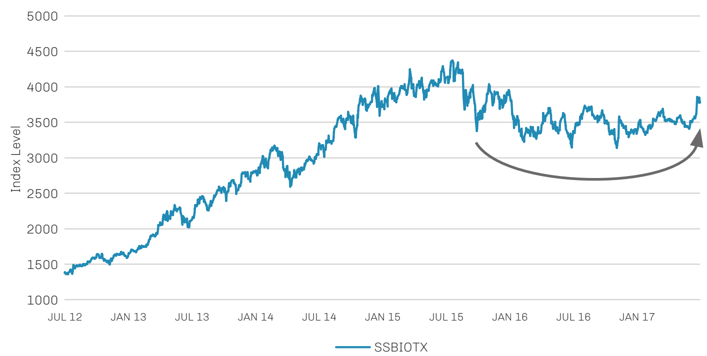



**Chart 8 | US Biotechnology 5 year Performance**
source: Bloomberg, Equium Capital

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# Q2 Review & Outlook

As we reach the end of the second quarter, we note our Global Tactical Allocation strategy was ostensibly flat over the last three months. During a period of dramatic shifts in monetary policy punctuated with bouts of currency volatility and unpredictable U.S. policy headlines, we are comfortable with the strategy's ability to protect capital and not suffer any significant drawdowns. If we've learned anything from 1H17 it's that fundamentals thankfully matter more than Twitter.

At the asset level, the continued portfolio tilt toward equities over bonds has been a tailwind for returns with the MSCI All-Country World equity index clearly outperforming both U.S. and Canadian bond markets (Chart 9). Moreover, we suspect that tightening Central Banks and positive economic growth will drive further outperformance of equities in the back half of the year.

Regionally, our significant overweight in Europe was a key beneficiary of the economic recovery and a dampening of political and financial risks in the region. As outlined above, we see Europe and our specific investments in Germany, France and Spain as benefiting from both cyclical and reform tailwinds through the second half of the year. Our underweight in Canadian equities also added value as weakness in the dominant Energy and Financials sectors more than offset other areas of strength. Given the weak technical outlook for both Energy and the TSX generally, we expect the process to remain underexposed near-term.

On a sector basis, our entry into Health Care and specifically Medical Equipment paid off with the IHI up +7.5% (CAD) in the quarter. As discussed, confirming technical trends support our positive fundamental view of the sector. The strategy is also overweight Industrials, which consolidated over the quarter after significant earlier gains (Chart 10). Just recently, our process began selectively engaging Financials again, although yield-sensitive banks remain negative in our work.

On the other hand, we continue to avoid areas of weakness such as Energy, Telecom and the defensive yield sectors, such as Real Estate, as both the top-down and bottom-up outlooks remain unappealing. During the quarter, the overweight in Technology, a sector that performed very well for the first 5 months of the year, turned negative in our work. In order to protect capital and lock in gains, we repositioned portfolios to a modest underweight in June when the technical trends broke down against a backdrop of stretched valuations. This reflects a key aspect of our risk-first investment process, wherein capital and profits should be better protected by combining unemotional technical analysis with bottom-up fundamental research.

**Chart 9 | Equity vs Fixed Income Performance YTD**

source: Bloomberg, Equium Capital

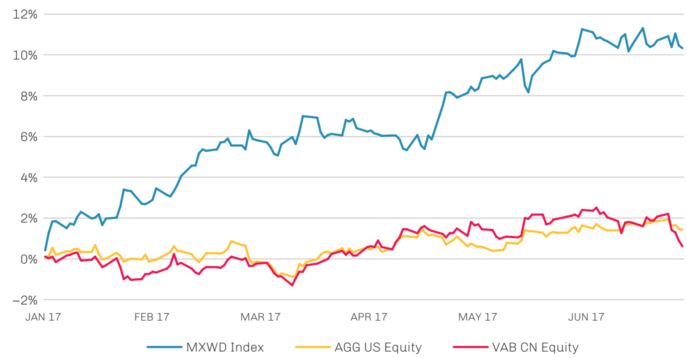
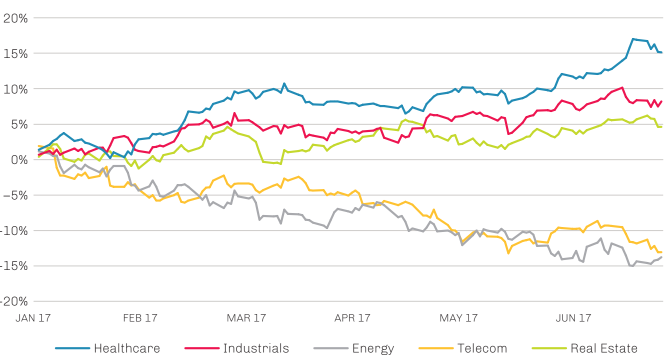



**Chart 10 | S&P500 Sector Performance YTD**

source: Bloomberg, Equium Capital



At the halfway point of 2017, we continue to believe in the global economic recovery. Although our inflation expectations have been pared back by the larger-than-expected selloff in oil and the still nascent recovery in wages, corporate earnings growth is clearly benefitting from positive economic trends and still loose monetary policy.

On a more cautious note, we see the seemingly co-ordinated Central Bank push to normalize monetary policy in the face of soft inflation data as having the potential to create significant volatility in the months ahead. These developments warrant close monitoring and on-going evaluation owing to their material implications for investment returns, a key aspect of our daily process at Equium Capital. For now, our indicators and process continue to favour risk assets globally on the back of supportive technicals, very strong credit and corporate earnings trends, and continued low odds of a recession.

Table 1 | Investment Recommendation Snapshot
source: Equium Capital

| | Sector | Region |
|---|---|---|
| Overweight | Equities<br>Health Care<br>Industrials<br>Financial Services | Germany<br>France<br>Spain<br>U.S.<br>Japan |
| Underweight | Fixed Income<br>Energy<br>Real Estate<br>Staples<br>Utilities | Australia<br>Canada<br>China<br>United Kingdom |



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