Investment Commentary

EQUIUM CAPITAL

August 2017

Well, That Escalated Quickly

Back in early June we discussed the increasing likelihood of a rally in the Canadian Dollar given that extremely negative trader positioning coupled with the best GDP growth in the G7 laid the groundwork for a rebound from oversold levels. Since then the CAD has risen almost +10% against the USD and is threatening to break out to multi-year highs (Chart 1).

As a global investor based in Canada, we need to proactively manage currency risk in order to effectively protect client capital in local Canadian Dollar terms. Our foreign exchange positioning is therefore an outcome of our disciplined investment process, which combines both top-down and bottom-up perspectives. Technically, Canadian equities continue to perform poorly on both an absolute and relative basis driven by weakness in the three largest sector weights: Energy, Financials and Materials. Until the TSX begins to exhibit positive momentum our unemotional top-down lens is likely to maintain the current underweight bias.

Fundamentally, the data offers a more positive perspective, with GDP figures continuing to exceed expectations (May +4.6% vs +4.2% expected) and the Bank of Canada signalling further rate hikes as a result (Chart 2). Although the data has been strong, we do not view the trend as sustainable and point to consensus forecasts of a slowdown to only +2% GDP growth in 2018. Our caution revolves around our neutral view of commodities along with weak consumer balance sheets and record high home price-to-income ratios, which are susceptible to further rate increases.

Additionally, the recent spike in CAD/USD creates a headwind for the domestic manufacturing recovery as well as reduces inflation that was already well below the Bank of Canada's +2% target (Chart 3). Throw in uncertain NAFTA negotiations and oil price risk from a teetering OPEC agreement and we see a decent probability that the currency has seen its short-term highs.

Won't You Buy me a Mercedes Benz

We at Equium Capital have been bullish on Europe for some time as we see the strengthening cyclical upturn along with the clearing of bad debts from the banking system as material positive drivers of improved earnings and returns. As the cycle matures, however, the focus is beginning to shift away from a broad EU recovery to a more nuanced domestic growth story.

Chart 1 | CAD/USD Exchange Rate

source: Bloomberg, Equium Capital

Chart 2 | Bank of Canada December Rate Hike Expectations

source: Bloomberg, Equium Capital

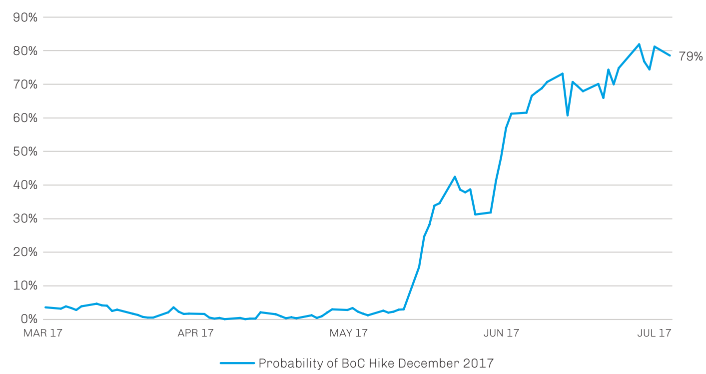
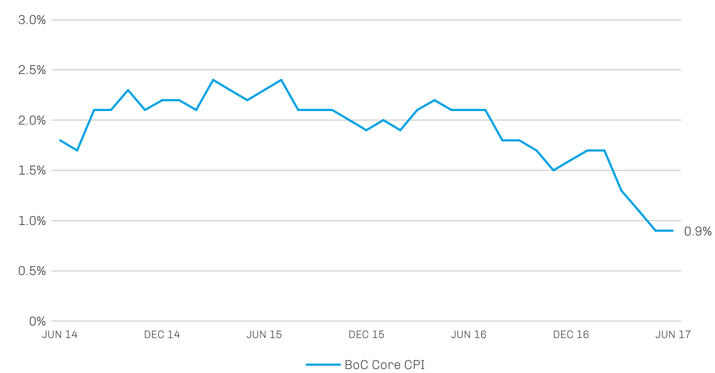


Chart 3 | Canadian Core Consumer Price Index

source: Bloomberg, Equium Capital



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This is made especially true by the recent rise of the Euro. As the economic recovery takes hold and inflation picks up, the extraordinarily loose monetary policy of the ECB is likely to tighten. In turn, tighter policy will likely drive the currency higher making exports less competitive but at the same time increasing the purchasing power of European consumers. This is already beginning to manifest in the relative performance of small capitalization stocks over large as the higher domestic exposure of smaller firms disproportionately benefits from the rally of the currency (Chart 4).

In addition, regional equity indices have begun to diverge as export-heavy markets, such as Germany, are now underperforming more domestically driven European peers, such as Spain and Italy (Chart 5). The German market's significant auto exposure has also weighed heavily on recent overall performance. The price fixing investigation along with a barrage of Trumpian import threats impair the outlook of the market's largest industry. These have combined to cause a significant breakdown in the relative price trend of the DAX. As is our process, once the technical picture deteriorated our unemotional lens prompted us to lock in our gains and exit the position. Fundamentally, we prefer to maintain our European overweight through Spain and France, where the technical and fundamental perspectives are well aligned.

Portfolio Update

In addition to the exit of Germany, we have made several other adjustments to more precisely reflect our global view for positive, yet moderate growth and subdued inflationary trends. Although we assume some benefit from U.S. tax reform in 2018, we no longer expect a sustained cyclical uplift as growth slows and liquidity conditions tighten. This updated view of slower global trade and tempered U.S. expectations contradicts our rationale for owning hedged Japanese equities, which we have transitioned to more structural global growth economies, such as India. We have also further refined our Industrials exposure into the Aerospace & Defense sub-sector and expanded our position in U.S. Capital Markets & Asset Managers, which are not dependent on a steeper bond yield curve.

Currency volatility, the inflection of Central Bank policy, slower sequential global growth and elevated valuations have combined to lower our conviction level in risk assets over the month. As our investment process caused the sale of two notable geographic exposures, our Investment Committee deemed the proceeds most prudently maintained in cash for the time being. That said, credit spreads remain well-behaved, we see limited risk of recession in the near-term and corporate earnings continue to be strong, so the strategy remains overweight equities versus bonds with a significant tilt toward global equities.

Chart 4 | European Small Capitalization Stocks vs Large
source: Bloomberg, Equium Capital

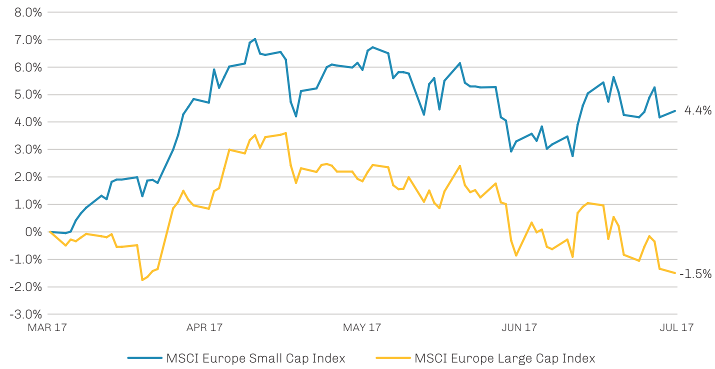

Chart 5 | Spain, Germany & Italy YTD Performance (CAD)
source: Bloomberg, Equium Capital

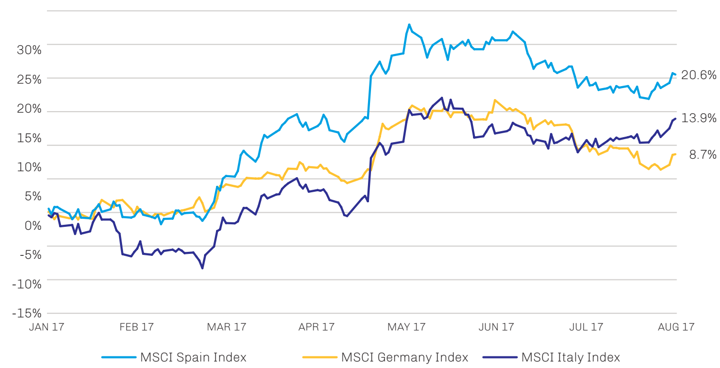

Table 1 | Investment Recommendation Snapshot
source: Equium Capital

	Sector	Region
Overweight	Equities Health Care Industrials Financial Services	U.S. France Spain India
Underweight	Fixed Income Energy Real Estate Staples Utilities	Australia Canada United Kingdom

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