SSQ Financial Group
Values in the right place

2017 ECONOMIC PERSPECTIVES

TRIASIMA

Interview with Triasima

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What are your expectations for real Canadian GDP growth in 2017 considering the election of Justin Trudeau in November 2015 and Canadian consumers who are among the most indebted in the world?

Generally speaking, the Canadian economy follows where the American economy goes. However, this happens with a lag. The two economies are actually quite interlinked; a key reason is that 70% of Canadian exports are to the United States. We currently like what is happening in the United States. That country has a full employment situation and rising household income. Inflation remains benign and does not represent an impediment to growth. Although interest rates have moved up somewhat late in 2016, rate increases are not large enough to slow the economy. Finally, President-elect Donald Trump has pro-growth policies that should be beneficial, at least initially in 2017, to corporations and labour alike.

Within this broad context, the election of Justin Trudeau and of a Liberal government is not that significant; provided personal or corporate taxes are not hiked as this would dampen growth. Canada's economy is open to outside influences and we expect steady or accelerating growth in 2017. Strength in the price of oil in 2016 is expected to carry on in 2017 while the prices of other commodities, that generally troughed in the first quarter of 2016, should continue with the cyclical rebound.

The record indebtedness of Canadians is indeed a negative influence. This, in isolation, reduces potential growth. However, two caveats exist. First, this indebtedness is largely the result of a record mortgage load, a more stable form of borrowings that while being incurred has very beneficial repercussions on the overall economy because of the concurrent construction activity it generates (although many mortgages are for second-hand dwellings that have few spillover economic benefits). Secondly, although debt levels are indeed high, it is debt servicing requirements that really matters and these are within historical norms thanks to low interest rates. Debt servicing can be defined by the sum of the total payments relating to all mortgage and non-mortgage loans outstanding divided by total household disposable income.

A sudden increase in interest rates would be detrimental to growth in Canada since the Canadian consumer remains sensitive to such an event. However, we do not expect this to occur to a significant degree, at least in the first half of 2017, in view of the current accommodative Bank of Canada policy, low inflation and lukewarm growth.

What is your global real GDP growth perspective for 2017?

The world economy should benefit from a steady or accelerating American economy. More often than not, the United States is the locomotive that pulls along the rest of the world. Europe and Japan are both showing renewed vigour as we enter 2017 while China and most other emerging countries generate growth well above those of the advanced countries. The impact of China at the world scale continues to grow due to its sheer size. This country is now embarked on a delicate transition from an economy relying on industrial production supported by borrowings to an economy supported by household spending and where the service sector dominates economic activity.

We thus see a slight acceleration for the global real Gross Domestic Product growth driven by the United States, the Eurozone, Japan and some key emerging countries, such as Russia. European economic activity, especially, seems to be finally accelerating years after the Great Recession.

What is your outlook for commodities in 2017?

Commodities should continue to rebound from the trough of 2016. Coal has benefitted from a slowdown in Chinese production due to concerns over air pollution and the cost of maintaining inefficient mining operations. Oil bottomed in early 2016 and has been rising ever since. An oil price below US$50 is not sustainable for most producers. The Organization of the Petroleum Exporting Countries (OPEC) deal reached in November 2016 should support the price further going into 2017.

Finally, base metals and fertilizer prices have rallied since the Trump election victory on the hope of infrastructure spending and renewed economic vigour.

What about the year-end exchange rate for the Canadian/U.S. dollar?

The evolution of the value of the Canadian dollar relative to the Greenback is primarily driven by the levels and trends of a few factors that relate to two theories that explain relative currency levels between countries: purchasing power parity and interest rate parity.

These factors are the relative rate of growth of the Canadian and American economies, and the levels and relative changes in inflation and interest rates. In addition, the price of commodities, especially oil, is important for the value of the Canadian currency.

Apart from the price of oil, which is in an uptrend, most input factors are currently more negative than positive for Canada, and could remain so for the first half of 2017. However, we expect Canadian growth and interest rates to gradually catch-up to the US later in 2017. This implies some future strength in the Canadian dollar. As such, we see the Canadian Dollar troughing at the current level of around 75 cents and making up some ground later. A year-end value nearer 80 cents should be expected.

What are the greatest risks threatening investors in 2017 and what investment strategy do you recommend to minimize the impact?

Fixed income investors must fear the end of the long bull market for bonds whereby interest rates have generally been on a downtrend since 1982, a period of time spanning an incredible 35 years! If rates indeed established an historical bottom early in 2016 and are set to increase both on a cyclical and secular basis, this will be very detrimental to bond investors.

Our view is that rates may show some cyclical firmness in 2017 but we are not yet ready to call an end to the secular decline in long term interest rates, in part due to demographic reasons.

On the equity side, the markets moved away in 2016 from companies of a growth nature or with above average dividend yield whose stocks react well to low or declining interest rates. Instead, equity investors turned towards industries of a more cyclical nature and related to natural resources or the industrial sector of the economy. This regime change gained considerable strength with the Trump election in November 2016, and the moniker 'reflation trade' was adopted to identify what was occurring in the closing months of 2016. Reflation trade is based on the premise that some of Donald Trump's promises, notably tax reductions, budgetary deficit expectations, and investment in infrastructure, will result in a broad increase in the prices of goods and services, and thus, in company earnings.

A key risk for portfolios positioned to profit from this emerging theme is that the underlying fundamentals supporting the reflation trade falters down the road. To manage this risk, one needs to keep a degree of prudence when building up the cyclical component of equity portfolios.

Another risk to the equity market in 2017 is that U.S. Dollar strength stifles profitability growth for large American corporations, removing a key support to the progression of the equity market.

In general, what will be the impacts of Trump's election on the Canadian economy and how will you position your portfolio considering this?

The election of Donald Trump as President of the United States of America is positive for Canada as most of his policies are pro-growth. We are not overly concerned about his anti-trade rhetoric. We think this is a populist stance aimed at his electoral base and targeting emerging countries such as Mexico and China that have trade surpluses with the United States and enjoy a labour cost advantage. Many American states have large trade relationships with Canada and would lose wealth if tariffs were imposed or anti-trade policies enacted. Trade agreements are not something you just tear up.

We forecast attractive returns from equities in 2017 and would favour having an overweight in quality cyclical companies.

What are inflation expectations for Canada?

The current economic cycle began in the second quarter of 2009 and is now quite elongated. At this stage, inflation typically begins to build up from a combination of heretofore easy monetary policy and cost push pressures stemming from the rising cost of labour and commodities. We expect inflation to gently lift up in 2017 relative to 2016, gaining more in the United States than in Canada and with a spillover impact as well on the Canadian situation.

Do you think that another rate cut by the Bank of Canada is possible in 2017? Why?

We do not think a rate cut by the Bank of Canada will occur in 2017. At the most recent Bank of Canada meeting, Governor Poloz did not act and adopted a wait-and-see approach. We believe what the Bank of Canada will see is that economic growth, inflation, interest rates and the value of the Canadian dollar (relative to the American currency) are all at trough or low levels and that they are set to increase in 2017. This will remove any underpinnings for a rate increase.

Considering your real GDP growth perspectives, what are your views on the S&P/TSX and global valuations?

Equity valuations are somewhat high in Canada, the United States and globally. These valuations can, however, be justified by two factors. First off, the discount factor, that is based on interest rates and used to value future cash flow, remains historically low, yielding a higher present value for stocks and, thus higher equity valuations. Secondly, globally, earnings revisions are currently being revised upward, already a rare occurrence, and this is occurring at the strongest pace of the last six years. This indicates the underlying fundamental situation for stocks is in the process of catching up to current valuations.

For 2017, we are not concerned by increases in interest rates that would lead to a higher discount factor for future cash flows and lower valuations. On the contrary, at this state of the economic cycle, rising interest rates are a sign of economic strength that pushes up future earnings expectations for corporations.

What sectors, based on GICS, do you favor in 2017 for Canadian equities?

Given the positive outlook for growth and earnings, and the ongoing reflation trade, we would be overweight resources, cyclicals and industrial oriented companies. This would include banks which we consider 'soft' cyclicals but would exclude gold and precious metals producers, whose valuations are overly impacted by interest rates trends and levels.

Conversely, we would be underweight interest sensitive sectors such as REITs, Telecommunications and Utilities, and defensive stocks such as Consumer Staples.

Considering you simultaneously maintain growth and value styles, do you have a preference in style for Canadian equities?

At this time, the Triasima investment methodology guides us towards value stocks, instead of growth stocks or defensive stocks. As a general rule, our quantitative, fundamental and trend assessments are better or are improving for resources and cyclical stocks. This leads to portfolio structures with a higher value orientation than usual, although portfolios must nonetheless maintain growth parameters that are superior to those of benchmark indices.

In the SSQ Triasima Canadian Equity GIF, you're allowed to invest in up to 10% in foreign equities: do you favor foreign equities for 2017?

Looking back, and limiting our choice to the Canadian and US equity markets, we have preferred Canada in 2009, 2010 and 2011; and the Canadian market outperformed each of those three years. From 2012 to 2015, our first choice was the United States, and the American market outperformed Canada each of those four years.

More recently, in mid-February 2016, we went back to Canada as our market of choice. One of the reasons were the ongoing market regime change from growth to value, leading to a revival of the cyclical value sectors and industries that weigh heavily in the S&P/TSX Composite Index, such as the Energy and Materials sectors or the banking industry. Relative Canadian versus US valuations, profit trends and the stage of the economic cycle are all factors favoring Canada. As we enter 2017, we still prefer Canadian equities over US equities.

Notwithstanding our preference at any given time, we generally always fully use the 10% foreign equity allocation. It is a rather small percentage in the end and there are always attractive companies to include in the portfolio from the large universe of eligible securities, especially for sectors and industries poorly represented in the Canadian index. Apart from potentially lifting performance, such names bring diversification benefits to the portfolio.

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