Investment Commentary

EQUIUM CAPITAL

April 2018

Q1'18: What Was That About?

Our view has been, and continues to be, that we are experiencing a gross-down of risk exposure after bullish investor sentiment and positioning became overly extended in January. The U.S. wage report helped stoke fears of faster than expected Fed tightening which in turn caused the initial round of volatility. Compounding problems, aggressive U.S. trade actions with Facebook and Amazon headlines followed closely behind and finally proved too much for investors to ignore. Throughout this period, consensus expectations for economic growth and earnings estimates have risen (Chart 1) while other asset classes such as gold, currencies and fixed income demonstrated materially lower levels of volatility. In other words, at the core, not much has changed.

At the margin, however, several warning flags have appeared and bear watching. One is the deterioration of financial conditions, driven by inter-bank interest rates (LIBOR) rising, Central Banks reducing liquidity and corporate credit spreads widening (Chart 2). We would stress these moves, although directionally negative, continue to be modest within the overall context of positive trends.

Secondly, the rate of economic expansion has slowed across several key markets, such as Europe and China, and recent data has materially surprised to the downside in some regions (Chart 3). Assuming our base case thesis is correct in that U.S. tax reform stimulus and closing output gaps will drive a capital investment cycle and possibly one last leg of growth for the global economy, we expect these revisions to mean-revert higher over the coming months. In this scenario, we view the risk of imminent recession as minimal.

Lastly, although our base case remains that the vast majority of aggressive trade rhetoric can be dismissed as noise, the tail risks are clearly getting fatter. Even though recent tariff announcements represent a de minimis amount of economic activity and we could even see a surprise NAFTA agreement further reduce trade risks, the market will likely remain focused on the current negative loop of China-Trump brinkmanship. From our perspective, we are concerned that face-saving exit options are declining with every salvo and that President Trump may be further emboldened by his rising approval ratings, which have improved to their highest in a year. We fear this encouragement will lead to an increase in aggressiveness, contrary to what many investors are expecting or hoping, and could sustainably impair multiples, if not earnings themselves, due to increased uncertainty and risk.

Chart 1 | S&P 500 Forward 12-Month Estimates

source: Bloomberg, Equium Capital

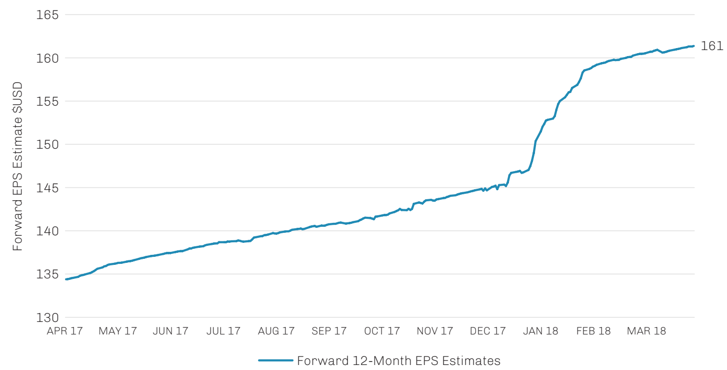


Chart 2 | U.S. Financial Conditions (5 year)

source: Bloomberg, Equium Capital

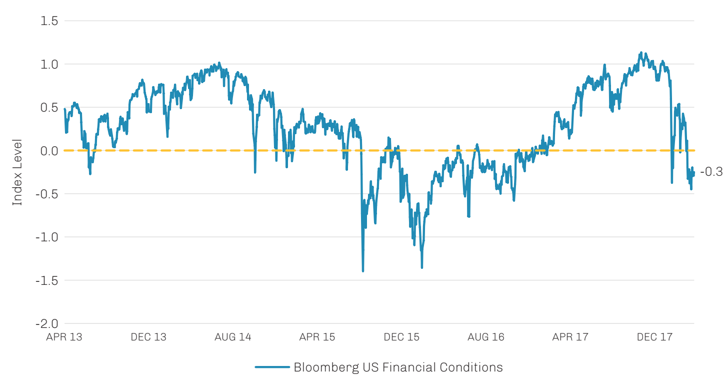
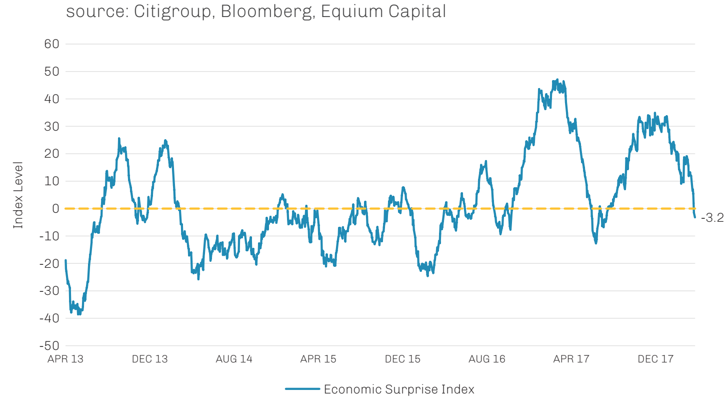


Chart 3 | Global Citi Economic Surprise Index (5 year)

source: Citigroup, Bloomberg, Equium Capital



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Process At Work

During the quarter, our technical risk controls were hard at work helping the fund to outperform even as markets whipsawed from euphoria to fear. Our process began flashing warning signs in mid-January and so the portfolio was already above 10% cash when markets started to decline in early February. Throughout February and March, cash peaked above 20% owing to our investment process exiting faltering positions and adding fixed income to further reduce risk. Importantly, fundamental indicators kept many core positions in the portfolio throughout the period of weakness, namely Aerospace & Defence and Medical Devices. In every case, positions maintained throughout the pullback made higher highs on the market bounce followed by higher lows when the broad market retreated back to prior lows in March. This is a key technical pattern demonstrating leadership and confirming our strong fundamental research view of these investments.

Although our process is not yet signaling "All Clear" several necessary conditions have been met. Namely, overly bullish investor sentiment has normalized (Chart 4) and positioning in several long-standing consensus trades such as short volatility and FANG (Facebook, Amazon, Netflix & Google) have been meaningfully tested. We also find encouraging the fairly neutral relative performance of "Risk Off" sectors, such as Staples and Real Estate, as well as our breadth and volume indicators, which are signalling seller fatigue and firmer technical underpinnings, both required for a sustained rally from current levels.

At quarter end, we returned to a modest overweight of equities and to short duration in bonds as we expect interest rates to rise and a strong Q1 earnings season to drive risk assets higher. We remain positive on Emerging Markets, which held up well during this period of volatility, and added weight in late March. We also added to U.S. Consumer Discretionary early in April as rising wages and tax reform support earnings and the pullback in valuations provides a compelling entry point. Additionally, our long-held underweight of Canada was closed after a significant period of relative underperformance (Chart 5); both the fundamental and technical pictures have improved, and prospects of a NAFTA deal appear brighter, making a tactical rebound increasingly likely.

Going forward, we expect a solid earnings season to refocus attention on the strong fundamental underpinnings of equity markets. Economic data revisions should begin to revert higher as the effects of tax reform stimulus are felt not just in the U.S. but in Canada and globally. Trade could be a risk to multiples, but our focus remains on liquidity conditions and the sustainability of economic momentum in 2H'18 for signs that our late cycle optimism needs to shift more defensively.

Chart 4 | U.S. Investor Sentiment Bullish Index
source: The American Assoc. of Individuals Investors, Bloomberg, Equium Capital

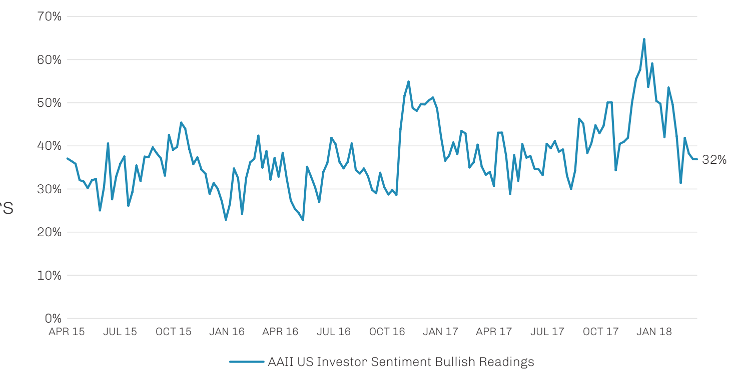

Chart 5 | Canada vs. World Equities Relative Price Performance
source: Bloomberg, Equium Capital

Table 1 | Investment Recommendation Snapshot
source: Equium Capital

	Sector	Region
Overweight	Equities Discretionary Industrials Financial Services Health Care	U.S. France Emerging Markets
Underweight	Fixed Income Real Estate Staples Utilities	Australia Japan United Kingdom

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