Investment Commentary

EQUIUM CAPITAL

June 2018

Exit Stage Left

One of the bigger shifts in the portfolio over the last several weeks has been the move to smaller capitalization companies and away from a previous favourite, Emerging Markets. At the beginning of the year our fundamental expectation was that strong global growth and a pick up in inflation would lift equities over bonds as well as contain real interest rates at low levels, which in turn would keep liquidity conditions favourable.

This view proved largely correct in Q1 as global GDP estimates were revised higher, inflation surprised to the upside and the U.S. Dollar hit its lowest level in over three years. As a result, Emerging Markets relatively outperformed (Chart 1). However with President's Trump announcement of $60B of retaliatory tariffs against China on March 22nd, this relative outperformance peaked and then reversed. Given that prior threats had been dismissed by markets, why was this time so different?

Beyond trade concerns, slower than expected European growth, the collapse of the Iran nuclear deal and 10-year U.S. interest rates breaking above the key 3% level were all incremental negatives. What these issues have in common is that they all reduce global liquidity conditions (Chart 2), either through a stronger U.S. Dollar or higher energy prices. In addition (and not coincidentally), we have seen the breakdown of several marginal sovereign credits, namely Turkey and Argentina, which have been forced to engage in desperate monetary measures and seek IMF bailouts.

Unsurprisingly, our technical process aligned with this view as the relative price performance for the Emerging Markets group fell towards trend in mid-April triggering a review of the position (Chart 3). The research team determined that trade risks were likely to prolong and liquidity conditions to further deteriorate, meaning the fundamental thesis for owning Emerging Markets was no longer valid, which in turn motivated an exit of the position.

Smaller is Better

One of the key advantages of Equium Capital's global multi-asset approach is our ability to move from strength to strength as cycles evolve and conditions change. We are never held captive by restrictive traditional fund mandates, which allows us to focus solely on reducing risk and maximizing return for our clients.

In this case, as much as Emerging Markets are hurt by the conditions outlined in the first section, small caps are likely to

Chart 1 | Emerging Markets vs. U.S. & Canadian Equities YTD
source: Factset, Equium Capital

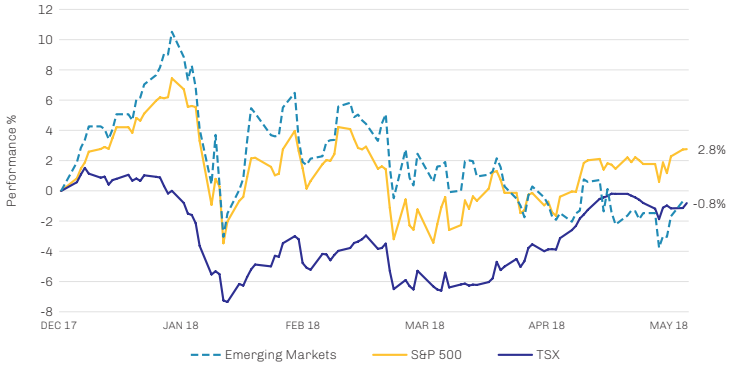

Chart 2 | Asia ex-Japan Financial Conditions
source: Bloomberg, Equium Capital

Chart 3 | Emerging Markets relative to Global Equities 1 Yr
source: Bloomberg, Equium Capital

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benefit. Given small caps' greater domestic orientation compared to large caps, they are likely to benefit more from U.S. tax reform (37% average tax rate vs. large caps at 26%), are less impacted by trade wars and are advantaged by a stronger U.S. dollar. We also prefer the more cyclical sector make up of small caps with higher weights in leadership sectors like Financials and Discretionary and lower weights in defensives such as Staples and Telecom (Chart 4).

These benefits are now proving themselves out in estimate revisions with Russell 2000 expected earnings growth now higher than the S&P 500 year-to-date (Chart 5). We would also expect the M&A boom to disproportionately favour the group as cash builds, growth remains subdued and interest rates are still low. Supporting this view, Q1'18 saw $118B worth of transactions, the fastest start to a year since the financial crisis.

Our technical process has had a mixed view on small caps ever since the post-U.S. election pop, an interesting divergence given the significant outperformance of high beta over this period. However, as mentioned above, the relative price trend reversed at the end of March and broke out sharply mid-April leading to our review and eventual entry into the group.

Going forward, the impact of cost inflation and interest expense on the forecasts for margins and earnings will be closely monitored in combination with the technical outlook. A significant breakdown in small caps will likely serve as a broader indicator for the overall market and economic cycle.

These Aren't the Euros You're Looking For

A quick word on Europe. The situation remains far too fluid for intelligent, long-term comment; however, we want to ensure our clients are focused on the key issues, as opposed to media headlines that misdirect attention from what matters most. The Spanish vote of no-confidence is not concerning given the new government is pro-EU and center-left with a tenuous minority limiting its ability to enact major changes. Italy is more difficult to gauge, but here too we are generally more sanguine than consensus. While the formation of a populist government is concerning, the fact that there have been 64 Italian governments since 1945 makes it difficult to see how a combination of extreme left and extreme right would be the alliance that breaks the trend.

Turkey is what really matters. If the Turkish situation does not stabilize there could be significant knock-on effects to European Financials, particularly given the size of their direct exposure and much weaker capital positions. Watch the performance of EU Financials, already weak, for clues that contagion is taking hold. This would argue for reduced European exposure and greater defensiveness overall.

Chart 4 | Sector Weights Small Caps vs. S&P500
source: Bloomberg, Equium Capital

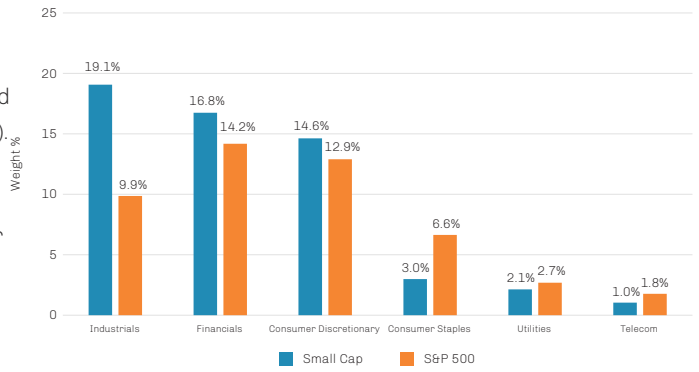

Chart 5 | Russell 2000 vs. S&P500 Earnings Estimates YTD
source: Bloomberg, Equium Capital

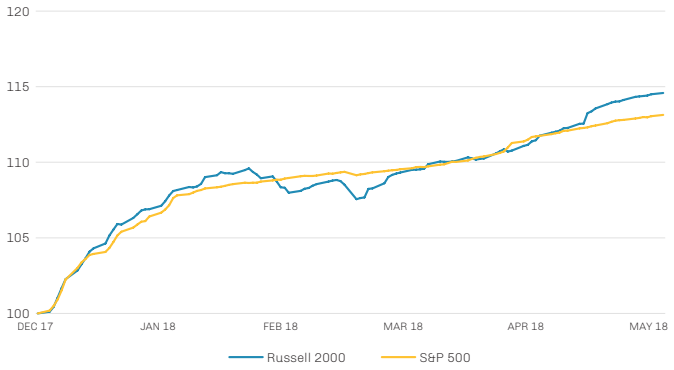

Table 1 | Investment Recommendation Snapshot
source: Equium Capital

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

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