Market Commentary
Fourth Quarter 2016

TETREM CAPITAL MANAGEMENT

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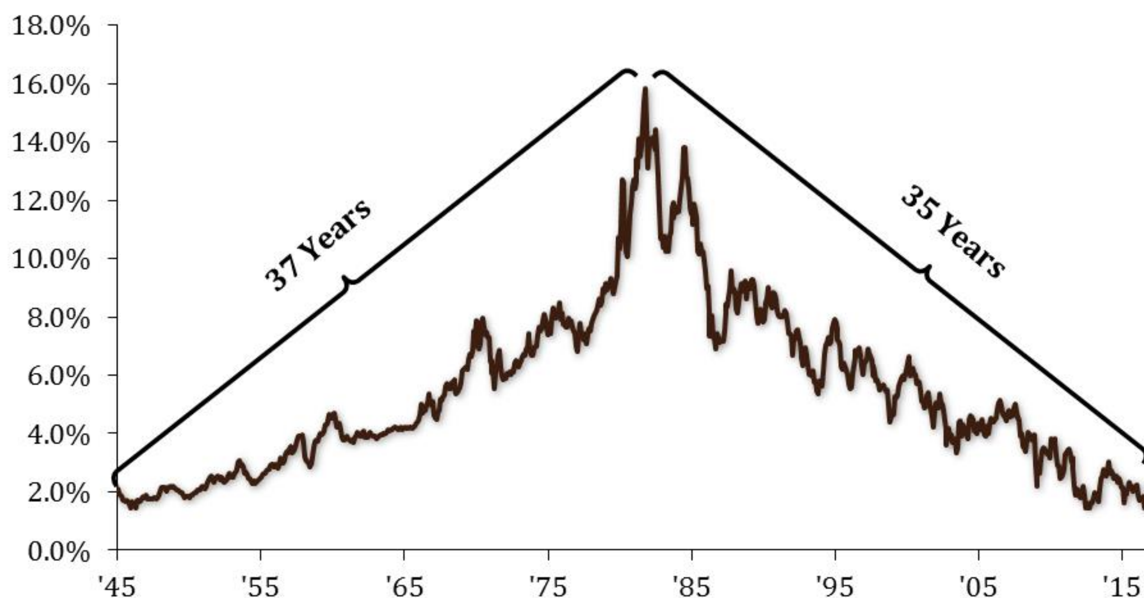
"Tremendous" shift in the market

After starting the year on rocky footing, 2016 turned out to be a good year for North American equity investors. Both the S&P 500 Index and the S&P/TSX Composite Index posted double digit total returns of 12% and 21%, respectively.

Since the onset of the financial crisis, the subtext of the market narrative has been the ongoing tug-of-war between reflation and deflation. Over the past few years, deflation has dominated and, in the aftermath of the Brexit vote in the summer of 2016, markets priced deflationary risks to an extreme level. Negative interest rates, particularly given the magnitude of $13 trillion of negative yielding sovereign debt, were simply not sustainable. However, since the summer of 2016, equity markets have taken on reflationary characteristics, with the U.S. presidential election acting as an accelerant. This shift looks like it is going to extend well into 2017, fuelled by fiscal stimulus and stronger economic growth. The shift is bad for bonds and good for the stock market, particularly companies that benefit from an improving economic outlook. Rather than pricing assets on simple yield, earnings are back in vogue, favouring active management and fundamental stock picking in particular.

That said, many market observers believe the equity bull market is getting long in the tooth. We are approaching the eight-year mark of the 2009 trough in equity prices and investors are wondering where we go from here. Early in the bull market, equities rallied in anticipation of an earnings recovery, but over the past few years the upward trajectory of equity prices has increasingly been driven by the thirst for yield. We've often used the U.S. 10-year Treasury bond to illustrate both the duration and magnitude of the fall in global interest rates (Figure 1). This time, we've extended the chart back to 1945 so as to capture the period of rising rates coming out of World War II. The last secular rise in long-term interest rates lasted 37 years. The subsequent secular drop in interest rates has lasted 35 years and there are indications that yields hit secular lows this past summer. Since bottoming at 1.32% in July of 2016, the yield on the 10-year Treasury has risen 113 basis points to 2.44%, handing significant losses to bond investors. During this time, the S&P 500 rallied 6.6% to new all-time highs. It appears that the bull market is intact but its character is now changing to one that is earnings driven, a situation that will bring on new market leadership, as we started to see in the second half of 2016.

Figure 1: U.S. 10-year Treasury yield



Source: Strategas Research Partners

One of the many problems with negative interest rates is that they distort the pricing mechanism in asset markets. How does an investor value a cash flow stream when the benchmark risk-free rate is negative? The answer is "with great difficulty and caution." Declining rates have pushed up the valuation that investors have been willing to pay for pretty much any asset that offers a steady and persistent cash flow. This dynamic is now at risk with the rise in rates. Instead of investing with the "greater fool theory" that accepts expanding overvaluation on the expectation that another investor will pay a higher price, investors need to look for earnings growth and rising profitability as drivers of capital appreciation. Fortunately, it appears that, as we enter 2017, earnings are set to expand in a number of important sectors.

Since Donald Trump was elected President of the United States, energy and financials have been market leaders after having been market laggards for much of the eight-year bull market. Despite what he may think, Mr. Trump doesn't get all of the credit. Both areas were doing well coming out of the summer, benefitting from a pick-up in global growth and rising interest rates. Energy stocks received a post-election boost from OPEC when it announced plans to limit production, with Russia joining in. The Trump Administration appears to be pro-domestic energy production, to the benefit of all industry participants, particularly energy service and infrastructure companies in both the

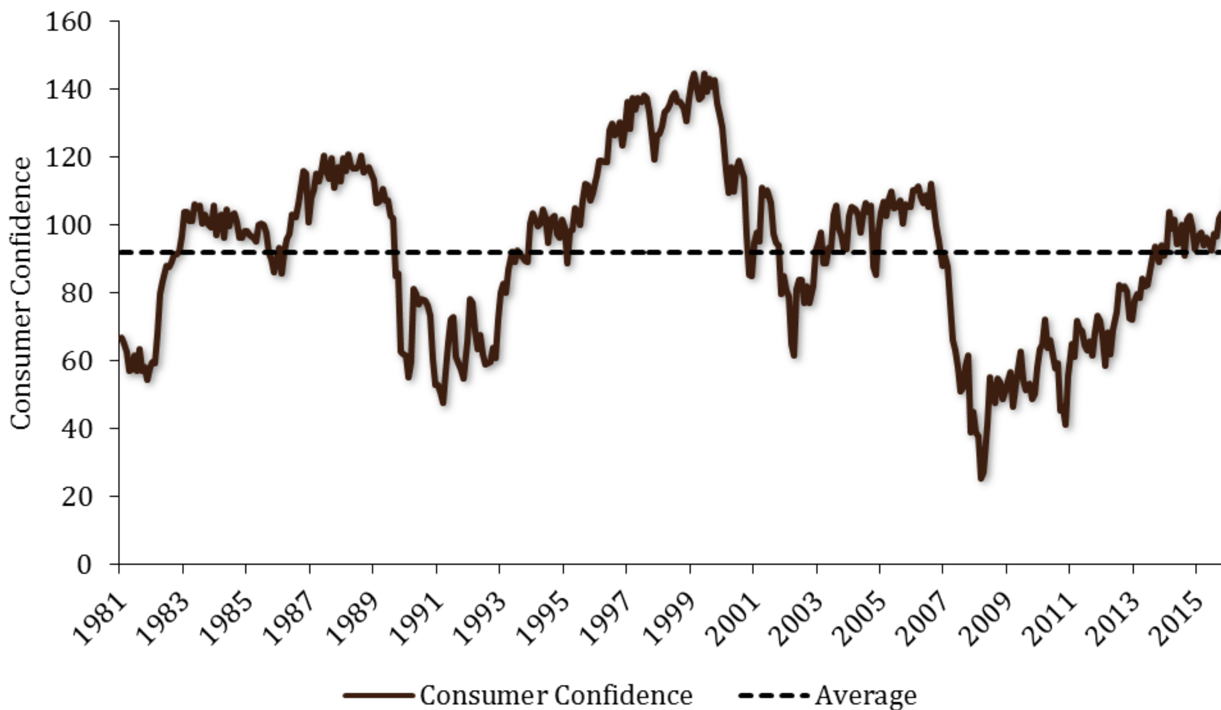
U.S. and Canada. We have written in the past about the deep undervaluation of our portfolios' energy services companies, such as Precision Drilling. Service stocks performed strongly in the fourth quarter and yet remain historically cheap on book value, which suggests there is upside as profits normalize, thanks to a friendlier oil drilling environment.

Without question, financial service companies, and in particular banks, appear to be the big winners from the Republican sweep. The list of reasons is quite long. Pre-election, few investors cared about American banks. They were dramatically under-owned after years of lagging the market with low valuations that matched investor apathy. Like everyone else, investors expected a Clinton Presidency and a continuation of Obama's policies of bureaucratic bank oversight. After November 8th, this changed and banks simply had to rally as they were cheap and under-owned. The liftoff in bank shares was further fuelled as news came into the market of reduced regulatory burden, lower taxes and pro-growth economic policies. Most importantly, banks benefit from a rise in interest rates. There is a huge latency of earnings power within the sector to higher interest rates and a steeper yield curve, both of which are occurring. This was beneficial to both our U.S. and Canadian portfolios, where bank holdings such as JP Morgan and TD Bank were up 23% and 9%, respectively, from the election to year end.

Yes, there are reasons for caution. Everyone seems focused on an errant presidential tweet but thus far, the market (and voters) has largely ignored them, so this may not be the obvious area of risk. Valuations are not particularly cheap and expectations are high. Therefore, if earnings growth does not deliver, equity markets will have to correct. A longer-term risk is that pro-growth policies come with debt, something that all former over-leveraged casino owners, such as Donald Trump, are aware of. Sentiment has picked up but it is a long way from being frothy. Even with the rally in equity prices, investors continued to sell in the aggregate – hardly a sign of excessive enthusiasm. Protectionist trade policies will be a clear negative if they are enacted, but there is a difference between pro-domestic growth policies and anti-trade policies, something that the market is sniffing out thanks in part to trade-oriented cabinet appointees.

What we haven't seen since the financial crisis is the activation of "animal spirits" that ultimately are required for an economy to achieve escape velocity and grow without the artificial stimulation of central bank money printing. Even though The Donald was elected President without a majority of the popular vote, his election has not had a dampening effect on consumer or business confidence – in fact, the opposite has occurred. The December reading for consumer confidence increased 6.6 points, adding on to November's massive jump of 8.5 points and pushing the survey to a level not seen since the 1990s (Figure 2). Business confidence indicators are moving up in a similar fashion. The spirits are starting to stir. We think that 2017 is setting up to be a "terrific" year for value investing.

Figure 2: Conference Board Consumer Confidence



Source: Bloomberg

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