HAJ Quarterly Commentary

June 2017

Market Review

The strength in global equity markets that started at the beginning of the year continued into the second quarter (Q2 – the first three months ending June 30, 2017), driven by optimism over the global economy as well as positive sentiment towards President Trump's pro-growth policies including corporate tax cuts, increased infrastructure spending, de-regulation and repatriation.

Although U.S. political news flow continued to dominate the headlines, both positive and negative for the current administration, the markets' reaction has been relatively muted in terms of volatility. Although the U.S. Federal Reserve raised rates 25 bps during the second quarter, yields on the 10-year treasury retreated to 2.31%, slightly lower than the start of the quarter. Volatility remained at low levels during the quarter and high-quality/low-volatility strategies tended to underperform in this environment.

The S&P 500 Index climbed to new highs during the Q2, but finished the quarter slightly off the highs. This was the second quarter in a row that the S&P 500 Index posted new highs. The U.S. market continued to shrug off any negative political news flow and has maintained its focus on president Trump's calls for decreased regulation, tax reforms and increased fiscal spending, which creates an environment that benefits strong EPS growth and margin expansion. In terms of factors that worked well in the U.S. during the quarter, the equity style standouts were Price Momentum and Large Cap. By sector, Health Care, Industrials, Financials and Information Technology were the best-performing sectors in the S&P 500 Index during the quarter.

Telecommunication Services and Energy were the largest laggards in the S&P 500 Index during the quarter. With the U.S. labour market strengthening, business investment continuing to expand and household spending picking up, the Federal Reserve took the opportunity to tighten, raising its benchmark interest rate from 1.00% to 1.25%. Although inflation has declined recently and is running just below 2%, the committee will be closely monitoring economic indicators to determine the timing of future interest rate increases, although interest rates are expected to remain below expected long-term averages.

Since the Brexit vote, the Bank of England has been proactively communicating to the markets that it will maintain confidence in the UK's economy and financial markets. Similarly, the European Central Bank has been assuring markets that it is ready to provide additional stimulus, if needed. The triggering of Article 50 in March was just the beginning of a two-year effort which will see Britain leave in March 2019. Britain and the EU need to agree on a number of issues including immigration, trade and borders. Although the election of Emmanuel Macron in France has taken some of the political uncertainty out of the Eurozone, there is still uncertainty surrounding the Eurozone and its relation to Brexit. The Eurozone still needs to deal with a number of issues which may threaten the status quo on both social and economic issues although the French elections have removed some of the worries of more protectionism in Europe.

Canadian equities gave up some of their gains from the beginning of the year with the S&P/TSX Index declining about 1.5% during Q2. Canada continues to benefit from a strong U.S. dollar which is driving demand for goods and services from U.S. consumers. The Energy, Materials and Financials sectors were the only sectors to post negative returns during the quarter.

The Bank of Japan has maintained its Quantitative and Qualitative Monetary Easing stimulus framework which includes a focus on the yield curve, pledging to keep the nominal ten-year government bond yield around 0%, while keeping the key policy rate at -0.1%. Japan's annual GDP growth in the first quarter came in at 1.3%, slightly below the previous quarter. Exports have continued to pick up in Japan especially for IT-related and capital goods items due to improvements in global manufacturing. Although employment and income have improved in Japan, which has kept personal consumption resilient, CPI has remained at about 0.0%.

In China, positive momentum continued with retail sales and industrial production growing 10.7% and 6.5% respectively. The Chinese Central Bank (PBOC) left interest rates for open market operations unchanged despite the Federal Reserve's decision to raise rates. During the first quarter, the unemployment rate in China dropped by a couple of basis points while the annual GDP growth rate rose slightly.

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Portfolio Review

MSCI Emerging Markets Index (the "Index") was up 3.60% in Canadian dollars in Q2. The Horizons Active Emerging Markets Dividend ETF ("HAJ", the "Portfolio") lagged the Index, underperforming by 254 bps.

The defensive nature of the Portfolio led to underperformance in Information Technology, Telecommunication Services and Utilities. Industrials and Financials were the largest contributors to relative positive performance.

The Industrials sector was the largest contributor to relative performance due to positive stock selection. Outperformance in the Industrials sector was driven by Grupo Aeroportuario Del Sureste, Grupo Aeroportuario Del Pacifico and Grupo Aeroportuario Del Centro Norte. All three holdings in the Industrials sector posted double digit returns during the second quarter.

Stock selection as well as an underweight position to the Financials sector also contributed to relative performance. Indian banks, HDFC Bank and ICICI Bank posted strong gains which contributed to positive relative performance.

The Information Technology sector was the largest detractor from relative performance due to underweight position in the sector as well as stock selection. The largest detractors from performance were Siliconware Precision Industries, Advanced Semiconductor Engineering and Taiwan Semiconductor Manufacturing.

The Telecommunication Services sector was the second largest detractor from relative performance driven primarily by an overweight to the sector. Relative underperformance in the sector was driven by Telefonica Brasil, China Mobile, KT and SK Telecom.

The Utilities sector also detracted from relative performance primarily due to stock selection and an overweight position to the sector. The largest detractor was Companhia Paranaense De Energia which declined over 25% during the quarter.

Portfolio Activity:

In Q2, the Portfolio did not initiate any new positions or eliminate any positons.

Positioning:

Based on the economic backdrop and outlook on economies and valuations, our core view on uses of cash investment recommendations are to own stocks that deploy cash in a shareholder friendly way that reflects the current late stage of the economic cycle of rising interest rates, de-regulation, increased capex and marginal expansion. We look to position-in stocks with low price to book values, high cash/assets, strategic M&A/assets ratio, sustainable net buyback yields, and growing dividend yields. As well, we continue to emphasize higher yielding names that have the lowest probability of a dividend cut.

The Portfolio has an overweight in the yield friendly, defensive sectors, Telecommunication Services (+16.5%), Consumer Staples (+16.4%) and Utilities (+2.7%). Underweight sectors are Information Technology (-16.1%), Consumer Discretionary (-9.4%) and Financials (-8.1%).

The dividend yield of the Portfolio is 2.70%.

The current market environment requires continued immunization to rising interest rates on a relative basis to our peer group. We continue to increase diversification, finding yield outside of the traditionally defensive sectors favoured by our peer group.

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Outlook:

On the whole, most global leading indicators and broad measures of economic activity suggest that global growth should remain on solid footing through the second half of the year. Global growth continued to recover with supportive trends seen in the Global Purchasing Managers Index (PMIs) and confidence data. Furthermore, a reasonable decline in the USD Trade Weighted Index since the start of the year strengthens the case for an earnings surprise, especially for Multinationals. Additionally, the ramp-up in U.S. consumption is seeing a rise in top-line sales growth at a time when U.S. capacity utilization rate is still low (75% vs. > 80% prior cycle). Furthermore, wage growth, while rising, remains persistently below 3%. The convergence of these factors should bode well for an overall Global economy that is trying to remove its Federal Bank Induced "cheap money shackles".

While valuation indicators such Purchasing Power Parity suggest the pound is one of the cheapest currencies relative to the dollar, the Euro (amidst a backdrop of recovering economic indicators) looks most likely to rise. Rising economic activity should continue to see government bond yields rise on both sides of the Atlantic, as comments from the European Central Bank (ECB) and the Bank of England (BOE) indicated that they may join the U.S. Federal Reserve Bank in tightening monetary conditions sooner than expected. The recent bond market volatility was triggered by ECB President Mario Draghi when he expressed his confidence that the Bank's policies were working by strengthening economic recovery and restoring inflationary pressures in the Eurozone (deja vu to 2013 comments by the then U.S. federal Reserve Chairman Ben Bernanke). His remarks have fueled expectations that the Central Bank might start tapering asset purchases as early as September this year.

The 10-year German Bund and British Gilt benchmark yields gained on average 20 bps, a significant jump based upon the absolute levels. The equivalent-maturity U.S. Treasury was also dragged higher and ended up a further 15 bps higher. As a result, our long-held strategic shift since 2014 to lower interest rate sensitivity in yield based strategies while relying on earnings growth (GARP) and related dividend growth (Growth Payout Sustainability or GPS) is based on the outlook that earnings will regain a larger role in merging the funding gap for companies vs. cheap borrowing as in the past years post sub-prime market events.

Our internal analysis does show greater visibility in overall cash flow generation amidst greater confidence in extending the length of the duration (duration defined as the summation of both the next 10 years visible cash flow plus the long term assumptions of future cash flow) of stocks. At the industry level, the strongest revenue growth going forward continues to be from Global Semiconductor stocks predicated on solid non-PC computing/data center demand and ongoing stabilization in PC market driven by corporates. Diversified Financials including U.S.-based Global Banks are expected to show strong earnings momentum supported by higher net interest margins and stronger Investment banking activity. The weakest growth is expected from Telecom due to intense price competition.

As for full-year 2017, we expect some delay in investment activities, given uncertainties around tax reform, fiscal policy and geopolitics. While a lack of cash flow in recent quarters has been largely funded by debt issuances, the rising cost of capital should gradually dampen the balance sheet expansion trend. Our broad-based constructive view is however punctuated by the fact that we currently are more than eight years into the second-longest bull market in history, and we see classic late-cycle signs everywhere. For example, there are elevated market valuations, a flattening yield curve with the short end rising more than the long end, levered balance sheets and an increasingly hawkish Fed in the U.S. and now in Europe. We feel that maintaining a longer equity duration (supported by earnings growth and greater cash flow visibility) with a strong dividend growth outlook (quality with a fair payout) would outperform a yield-chasing strategy. Consequently, we continue to buy the dips for our dividend growth strategies while we maintain a disciplined rebalancing approach towards any pockets of earnings growth for our GARP strategies.

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