HAJ Quarterly Commentary

Sept. 2017

Market Review

The first half of the year saw historically muted moves in global stock markets (to either the upside or downside). Actual market volatility continued to plummet to record lows over the last three months (Q3 - the first three months ending September 30, 2017) as we have seen just eight days with +/-1% moves so far this year (the lowest to this point of the year since 1972). Additionally, the S&P 500 set 15 new record highs.

The risk of a destabilizing shock to the system of a ballistic nature has loomed large over the summer, but recent months have seen other risks continue to ebb and the backdrop is looking increasingly optimistic across most of the globe. The powers that be in Washington managed to reach a short-term agreement to avoid a U.S. government shutdown and potential debt default this month (though, these issues were simply delayed rather than outright resolved).

And while the onslaught of hurricanes has wreaked havoc on Texas and Florida, "broken window economics" proved to be positive from an economic growth standpoint. The net result is that the outlook calls for more of the same: effectively steady underlying growth that will continue to underpin a tightening job market that is already operating at full employment by many metrics, though still not generating much in terms of cost-push inflation.

Europe, which a year ago was the viewed as being on the verge of economic collapse against the rising wave of "Euroscepticism", continues to see its political backdrop mellow. Indeed, it appears that the events of the first half of this year (most notably, the strong mandate won by France's Emmanuel Macron, but also the defeats of nationalist parties in other elections including wins in the Netherlands and Italy) have sowed the seeds for greater cohesion among the members of the European Union. Germany's Angela Merkel, the de facto leader of the bloc, won her fourth term as Chancellor in her country's federal election on September 24, adding to the increasing political stability in the region.

The Japanese economy is on a run of sustained growth unlike anything the country has seen in two decades – a run that forecasts expect to continue. The concurrent boost in approval ratings for the reigning Liberal Democratic Party underpinned a decision by Prime Minister Shinzō Abe to call a snap election for October 22 designed to strengthen his mandate for reforms (he also announced $18 billion in added macroeconomic stimulus as part of his platform).

In the Emerging Market space, China has worked to show itself as a bastion of stability and strength ahead of the upcoming National Congress of the Communist Party of China starting October 18 (where President Xi Jinping is expected to strengthen his hold on power within the Party's ranks in this five-yearly changing of the guard within the Politburo). The Brazilian central bank is doing its part to support the economy by continuing to its campaign of aggressive easing policy — the Banco Central do Brazil has slashed its policy rates by 200 bps over the last three months. In India, the Modi government continues to make progress on important economic reforms and has seen some renewed verve in its economy following a moderation in growth over the past year.

Portfolio Review

During Q3, the MSCI Emerging Markets Index (the "Index") returned 3.97% in Canadian dollars on a total return basis. The Horizons Active Emerging Markets Dividend ETF ("HAJ", the "Portfolio") underperformed the Index by 261 bps.

The Portfolio outperformed in 5 of the 11 sectors led by Materials, Financials, Utilities and Health Care. Telecommunication Services, Information Technology, Industrials and Real Estate were the largest detractors from relative performance.

Materials was the largest contributor to relative performance during the quarter primarily as a result of positive stock selection. The Portfolio's holdings in Sociedad Quimica Y Minera De Chile, Braskem, Fibria Celulose and Vale drove the majority of the outperformance in the Materials sector. Within the sector, Sasol was a slight detractor from relative performance.

The Financials sector was the second largest contributor to relative performance due to positive stock selection. Outperformance in the Financials sector was driven by double-digit gains for South American banks, Banco Bradesco and Banco De Chile. HDFC

Bank in India also contributed to performance.

Stock selection within the Utilities sector rounds out the top three contributors to relative performance. Companhia Paranaense De Energia and Enel Generacion Chile were the largest contributors to relative return within the sector and both posted strong double digit returns.

The Telecommunication Services sector was the largest detractor from relative performance due to stock selection as well as an overweight to the sector. KT Corp, SK Telecom and PLDT were the largest detractors from performance. On the positive side, Telefonica Brasil contributed to performance during the quarter.

The Information Technology sector was the second-largest detractor from relative performance driven primarily by stock selection while an underweight to the sector also impacted performance negatively. All the Information Technology stocks in the Portfolio detracted from performance as the sector strength during the quarter was dominated by non-dividend paying stocks. AU Optronics, Sliconware Precision Industries and Netease were among the largest detractors from relative performance.

The Industrials sector also detracted from relative performance due to stock selection and a slight overweight position in the sector. The Portfolio's exposure in the sector is in Mexican airport operators and developers which pulled back substantially from their YTD highs set this summer.

Portfolio Activity:
There were no new positions initiated or complete eliminations during the third quarter of 2017.

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: Consumer Staples (+16.9%), Telecommunication Services (+15.3%) and Utilities (3.1%). Underweight sectors are Information Technology (-15.6%) and Financials (-7.1%). The dividend yield at the end of quarter was 2.61% and the Portfolio has a large-cap, high-quality bias.

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. We have slightly increased exposure to European growth over the past quarter.

Outlook:
The macro backdrop is generally improving across the board. Accordingly, the International Monetary Fund (IMF) got out its eraser over the summer and again revised its estimates of world economic growth — and in contrast to what we have seen over much of the last decade, the revisions were to the high side. As it currently stands, global real GDP growth is expected to accelerate in 2017 — the first uptick in the rate of expansion of the world economy this cycle since the initial snapback in 2010 — and the momentum is projected to be sustained into 2018.

A big reason for this upward trajectory is the fact that just as this economic expansion finishes celebrating its eight birthday, more countries are joining the party. All 45 major economies tracked by the Organization for Economic Co-operation and Development (OECD) are projected to grow in 2017, the first time there has been such a degree of synchronized growth in a decade.

Moreover, of the 191 economies tracked by the IMF, 179 are projected to expand this year, also the highest share in a decade — and that tally is expected to continue to increase next year.

Expansions are stronger when they are broadly-based because such an environment can help create a "virtuous cycle" of growth — rising demand in one economy creates rising demand for another country's exports, which in turn supports domestic demand there and further supports more exports. And it is no coincidence that this breadth of synchronized economic improvement comes at a time when growth in global trade flows are accelerating.

The major advanced economies are at a stage of industrialization where productivity gains are less dramatic than those earlier in their development and overall economic growth converges with that of the labour force — and on that last point, the underlying demographics of aging populations in these economies enforces a low speed limit. So, what we are seeing is a general convergence among growth rates across the world, and the underlying trends are generally shifting lower — albeit, with expectations being for a further modest uptick among Emerging Market economies thanks simply to more countries expanding.

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. 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.