HAJ Quarterly Commentary

Dec. 2017

Market Review

The U.S. ended 2017 on a high note with the slow first half giving way to a material acceleration through the second half as both businesses and consumers increasingly translated their buoyant sentiment into increased spending. That solid momentum is carrying into 2018 and being further compounded by the passing of a business-friendly tax plan by the U.S. Congress.

The Eurozone put in its best performance of the cycle with the aggregated region expanding at its fastest rate in a decade. Expectations are for 2018 to largely be a repeat, with all 19 members of the currency union posting gains in the context of firming business and consumer spending with an added boost from governments in the region continuing to scale fiscal restraint.

In the Emerging Markets, it is really an improved version of last year's story.

While China faces domestic issues regarding debt and demographic problems, the government (which has seen Xi Jinping's power consolidating following October's Communist Party Congress) has the capacity to weather the storm and growth is expected to maintain an above-trend once (though that trend is seeing a downshift).

India continues to see Prime Minister Narendra Modi's economic reforms gain traction (and the recent wins by the ruling Bharatiya Janata Party in two state elections provide an indication that Modi's mandate will be re-upped in the 2019 elections) and growth there is slated to tick up, which helps spin the dial for the global add-up thanks to the world's sixth-largest economy is increasing heft.

While Mexico has been a target of the Trump administration, America's neighbour to the south has seen its economy performed solidly in recent years but runs into heightened uncertainty in 2018 against the tumultuous NAFTA negotiations and impending presidential and congressional elections.

Russia will likely continue to struggle but should see the upbeat sentiment swing that comes with hosting the FIFA World Cup (forecasts point to modest growth for the second straight year in 2018). There is a Russian presidential election in March, but with Vladimir Putin overwhelmingly expected to win his second straight term (and fourth overall), there is no expectation for anything but the status quo from a policy perspective.

Venezuela remains a hot mess and is all but assured at this point to experience the first major debt default since Argentina in 2007 in the coming year. Importantly, this will be an idiosyncratic event, with limited spillover outside the country's borders.

The Middle East remains a hotbed of tensions with the "purge" by Saudi Arabia's Crown Prince Mohammed bin Salman against power-players in the region, combined with the renewed flare up of long-unsettled issues between Israel and Palestine. That said, the continued agreement on production curbs by the Organization of the Petroleum Exporting Countries (OPEC) and OPEC-adjacent oil producers (namely Russia) does provide for a somewhat rosier fiscal picture for those economies that have seen their financial position deteriorate significantly over the last three years as oil prices collapse against substantial supply/demand imbalances.

The big story in Emerging Markets this year will be the two largest economies in South America. Brazil, despite the best efforts of its government, is on track to expand – shifting the on-again-off-again oscillation from expansion and recession back into growth mode (albeit modestly). After years of malaise, Argentina's economy is finally showing some verve as the will for change has been met with the willingness of Mauricio Marci's government.

Portfolio Review

During Q4, the MSCI Emerging Markets Index (the "Index") returned 7.45% in Canadian dollars on a total return basis. The Horizons Active Emerging Markets Dividend ETF ("HAJ", the "Portfolio") underperformed the Index by 402 bps.

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The Portfolio underperformed in 8 of the 11 sectors led by Consumer Staples, Telecommunication Services and Utilities. Materials, Real Estate and Information Technology were the only contributors to relative performance.

The Materials sector was the largest contributor to relative performance due to positive stock selection. Outperformance in the Materials sector was driven by the Portfolio's exposure to Sasol, Vale and Posco.

Information Technology also contributed to relative performance during the quarter due to an underweight position in the sector as well as positive stock selection. Netease rose over 31.0% during the quarter contributing to the sectors positive relative performance.

The Consumer Staples sector was the largest detractor from relative performance due to stock selection. Industrias Bachoco, Coca-Cola Femsa, Ambev and Fomento Economico Mexicano were the largest detractors from relative performance.

The Telecommunication Services sector was the second-largest detractor from relative performance driven primarily by stock s election while an overweight to the sector also impacted performance negatively. Telefonica Brasil, Telekomunikasi Indonesia PLDT which is a telecommunications provider in the Philippines were the largest detractors from relative performance.

The Utilities sector also detracted from relative performance due to stock selection and an overweight position in the sector. CPFL Energia and Companhia Paranaense de Energia were the largest detractors from performance.

Portfolio Activity:
In Q4, the Portfolio did not initiate any new positions and did not eliminate any positions.

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 capital expenditures 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 (+16.1%), Telecommunication Services (+15.6%) and Utilities (+2.86%). Underweight sectors are Information Technology (-15.0%) and Financials (-6.8%). The dividend yield at the end of quarter was 2.46% 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.

Outlook:
As the calendar rolls over into 2018, the world is in a situation that it has not experienced since the financial crisis and the subsequent Great Recession which took hold a decade ago.

The ensuing synchronized global growth as represented by the highest earnings momentum in six years across U.S, Europe, Asia and Emerging markets is occurring amidst a favorable macro backdrop of weaker the U.S. dollar, higher commodity prices and moderate inflation. An accommodative monetary policy should remain largely supportive in 2018. When skepticism over Trump's policy initiatives turned to reality in the form of lower corporate taxes and a reduction in regulatory burden, it should be a significant source of upside for equities and drive further rotation across global markets. Shareholder yield friendly activities like buybacks, dividends, M&A, and capital expenditures should increase driven by rising profits, cash repatriation, and declining policy uncertainty. Corporate strategy on the margin could shift to capital structure optimization via lower cash balances and higher ROE, leading to greater cash flow visibility across multiple sectors.

Guardian Capital's global outlook calls for a positive tilt towards reflation sensitive and mid- to late-cycle sectors. While higher rates might continue to weigh on the bond proxy sectors like utilities, real estate and telecommunication services, the confluence of sustained cash flow and growth factors should allow strategies based upon dividend growth with a sustainable yield to outperform their respective style peers.