PORTFOLIO MANAGERS

SHARE INSIGHTS ON MARKET DIRECTION FOR 2017

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2016 was a period of significant change in capital markets.

What started off as a very difficult year for equity investors, reversed course quite dramatically over the summer. Going into 2017, we find ourselves in very different market conditions. Equity valuations are at record highs and interest rates are rising rapidly – leading to a potential global bond sell-off. The world finds itself in a very new political environment with a wave of populism sweeping the western world, culminating in the election of Donald Trump as President of the United States.

What can we expect in 2017? Horizons ETFs reached out to four portfolio managers who oversee some of our most popular ETF mandates. They discussed what they expect to happen in markets over the next 12 months.

THE PORTFOLIO MANAGERS ARE:

HANS ALBRECHT

Vice-President, Portfolio Manager and Options Strategist with Horizons ETFs Management (Canada) Inc. Mr. Albrecht co-manages a number of products in Horizons ETFs' growing global line-up of covered call ETFs and managed risk ETFs. He also oversees all day-to-day options activities of Horizons ETFs.

SRI IYER

Managing Director and Head of Systematic Strategies at Guardian Capital L.P. Mr. Iyer leads the development and implementation of Guardian Capital's proprietary systematic equity portfolio management strategy. Mr. Iyer and his team sub-advise all of Horizons ETFs' actively managed dividend ETFs.

TYLER MORDY

President and CIO of Forstrong Global. Since joining the firm in 2003, Tyler has become a recognized innovator in the design and application of "global macro" ETF portfolios. He is widely quoted and interviewed by the financial media for his views on global investment strategy and ETF trends. Forstrong Global is the sub-advisor of the Horizons Global Managed Opportunities ETF.

NICOLAS NORMANDEAU

Vice-President and Portfolio Manager, Fixed Income for Fiera Capital. Mr. Normandeau is a member of the Integrated Fixed Income team and is a portfolio manager for the Integrated Fixed Income strategies, including the team's preferred shares portfolios. Fiera Capital is the sub-advisor of Horizons ETFs active fixed income ETFs.

What was the biggest investment-related surprise of 2016 and what do you foresee happening in 2017?

Hans Albrecht:
It's been an interesting couple of years given that there have been real extremes in volatility. Either all hell has been breaking loose or we've had periods of very low volatility.

It was quite amazing how many things the markets got wrong in 2016. The Brexit vote and Trump winning were the two biggest events that come to mind. Few market forecasters predicted these developments based on polling. I think we all learned something about relying on polling to make investment decisions. As a result of this, we saw drastic changes in investment outlooks based on very sudden and unexpected events.

The question is: Are we going to see more of these political surprises next year? Well, a Trump presidency is definitely unpredictable. Things likely won't be as crazy as last year, but there's the potential for anything to happen. I think that's going to make things interesting from my perspective because I trade markets that very much build-in emotion and expectation, and I look for ways to take advantage of that through options trading. I think generally we're going to see very stable markets. U.S. equities will probably push higher. I see why the markets have reacted positively to Trump (who will be actively engaging in fiscal stimulus).

Sri Iyer:
One of the biggest bubbles happening in the market right now in my opinion is a systemic, passive bubble that is in part being driven by derivative investments. I don't think the market has perceived that risk yet.

Mathematically, you can see that the probability of an 'event risk' has exponentially gone up over the past three to six months. I think there are positive things that will happen in the equity space, particularly in the United States. But in a global context, I think you're going to see a lot of dispersion in markets (i.e. a market of big winners and big losers; not everything will go in the same direction).

I don't have a set prediction for 2017 because I'm not a proactive manager; I'm an adaptive manager, but in the context of the market, let me use a musical chairs analogy: make sure you have a chair to sit on when the music stops – or at least start looking at the exits.

Whether it's the fragile geopolitical scene in Europe or the degradation of Asian corporate structures and capital finance, there are a lot of global market risks that could play a bigger role in 2017. I'm not necessarily a pessimist, but clearly we are seeing where things could go wrong in 2017 and one of our main focuses will be addressing that risk in our equity portfolios.

Tyler Mordy:
The biggest surprise for me in 2016 was the level of pessimism earlier in the year. At every investment conference I attended, all of the experts were very bearish on what was happening. The price of WTI oil was $28 a barrel and everybody predicted that the price decline in oil was foreshadowing a global recession. When you look at macro-economic history, the price of oil has never correctly predicted a global recession. In fact, it's quite the opposite: every American recession for the past 50 years has been preceded by a spike in the price of oil. Every period of rapid global economic growth has been preceded by a decline in oil prices. For me, that was kind of the big surprise – that market forecasters were so negative. I continue to think there's a lot of upside opportunity n the market.

Nicolas Normandeau: What surprised Fiera's fixed income team the most in 2016, like many people, was the election of Donald Trump. Not necessarily the actual election of Trump, but the reaction of the markets to his victory.

"Perhaps the next move for the Bank of Canada is actually a cut if these conditions persist, not a hike. That could be a big surprise in 2017." — **Nicolas Normandeau**

All of a sudden, the markets were predicting that rates would go higher, and that we'll see huge GDP growth in the U.S. – close to 3 or 4%. We'll see a higher U.S. dollar, higher stock prices and higher corporate spreads. It really surprised me how fast the market reacted and accepted this new narrative.

In reality, we've seen nothing to support these themes, and we really have no clue what the market is going to do over the next 12 months. It's very possible that by next June we might see that this growth is still below 2% and there's no inflation at all. Everywhere else in the world, in Europe, Japan and England they all want inflation, but it doesn't exist.

This applies to Canada as well. If you listen to our Bank of Canada Governor, he has been very dovish (hesitant to raise rates). From his most recent public comments, nothing has changed from an economic perspective. The economy in Canada is still weak, crude oil is at $50 (which is not historically high) and exports for energy companies are still weak. There's very little economic investment from corporate Canada. Perhaps the next move for the Bank of Canada is actually a cut if these conditions persist, not a hike. That could be a big surprise in 2017.

What does a Trump victory mean for investors in the U.S. and globally?

Tyler: Before the election, we had a binary scenario: The market was saying if Hillary Clinton gets elected, it's status quo - volatility will decline and markets will love that. The other view was that if Trump is elected, markets will tank – the markets would hate it.

When you look at those scenarios, you also have to consider what else could happen. These are not certainties, and that's where our investment committee starts brainstorming. For example, what if Trump wins and the markets actually rally?

After Brexit, it took about three days to erase the losses, then we had the election of Trump and it took about three hours to erase the losses. We had the Italian referendum and it took about three minutes to erase the losses. One of the defining features of the post-2008 landscape is that investors continue to expect another financial crisis. That's behavioral psychology 101.

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> — **Hans Albrecht**

Going forward, I think what we said prior to the election is going to remain true. Hillary and Donald are very different in terms of their political values, but they are very unified in their endorsement of fiscal expansion. Debt-to-GDP has stabilized since 2011, the deficit has actually come in dramatically under the Obama administration. Lobby groups like The American Society of Civil Engineers saying that if you don't spend money on the infrastructure, you could then lose about $4 trillion between now and 2020.

Political regimes are moving away from austerity and embracing government spending, and this trend will spread globally. This is bullish for global growth. I don't make comments on whether I think those are the right policies, but it should be good for growth and it should be good for global stock markets.

Hans: What have you seen in terms of changes in volatility – before and after the U.S. election?

Hans: We actually haven't had a lot of realized movement in volatility (that is actual volatile movement in markets), but we've generally had higher levels of option pricing. There have been high levels of worry in the options world and we can take advantage of that.

Whether it's selling covered calls or selling puts, it has been a very interesting year-and-a-half. We've had two stretches of four or five months that have been the lowest range in the market in the history of the S&P 500. That's quite incredible.

I speak to advisors all the time who are very cautious about markets. That's a good scenario for markets to go up because people are not as invested as they should or could be. Things are looking okay – there is good physical stimulus, oil prices are low and Trump is likely going to bring in a much less burdensome regulatory environment for financial institutions. Regardless of whether that's good or bad, I think people are fearful of missing the boat on some of these sector rallies, like the one we are seeing in financials. That could make things positive in the near-term.

Regardless of interest rates, most fixed income portfolio managers at Fiera have held the belief that interest rates in both the U.S. and eventually in Canada are poised to rise. What kind of rate environment do you think Canadians can realistically expect over the next 6-18 months?

Nicolas: Up until recently with our bond funds, we were going longer duration (buying bonds with longer maturities). That was a tactical decision based on the fact the central banks, especially the Federal Reserve and the European Central Bank, have been dovish or to even say when they're planning to hike rates.

Perhaps a year from now, rates could be slightly higher than they are now [*as at December 7, 2016*]. I think the FED will hike soon. [*They did on December 14, 2016.*]

As for a Canadian rate hike – it is a real possibility, but I personally think they will do nothing in 2017 and perhaps in 2018 start thinking and providing some guidance about a rate hike. In my view, that that would be late in 2018.

Even though rates have been rising, the reason why we have bought longer duration bonds is to attain a higher weight to

corporate credit – we like corporate bonds, particularly BBB-rated issues – we think the pricing of corporate spreads are getting are fair. Not cheap, but fair.

With the fiscal stimulus we will see in the U.S., this is a perfect environment for corporate credit. There's probably not going to be a recession in 2017, so there is no real concern about corporate balance sheets. The search for yield will continue. Even though we're late in the credit cycle, we can play this (corporate spread) trade for at least another year if not more.

Where do you think you'll get yield in 2017?

Nicolas: As I said, in corporate credit. I think you'll get the most upside from Canadian preferred shares. Canadian preferred shares got crushed last year (2015) because of declining interest rates, weaker credit conditions and thus no one wanted to buy preferred shares as a result, driving demand down. This year is going to be much better for pref investors. The asset class is only up 3% or so on year-to-date basis. On many of the preferred shares, you are earning a yield about above 5%, so I think this is where you can get the best yield for the risk you're taking.

With record-high equity prices, are you concerned about current valuations on large-cap stocks going into 2017?

Sri: We're not concerned – all of our analytics tell us assets are currently priced at fair value. We're not looking at the market through the same lens as we've looked at it in past years. Technology has allowed asset management firms like us to bring very sophisticated approaches to extracting market information into a common parlance in investing.

> "We've become country agnostic, style-agnostic, size-agnostic and just focused on buying the best of breed companies around the world in each economic sector." — **Sri Iyer**

Ten years ago, a multi-factor process, where you had multiple variables of growth, value and other factors, which were ranked and used to come up with a stock ranking system, was something we did and we got some alpha out of it. That type of asset management approach has now been commoditized into something called Smart Beta – where index strategies can just do some ranking systems and provide information on what stocks to own. We're using technology to evolve beyond this. For example, we now use intrinsic-based market analytics that create 10-year cash flow projections for stocks as well as intrinsic value analysis. We come up with unique ways to measure equity duration (interest sensitivity) and we are extracting the intrinsic cash flow of companies to figure out what their true duration is.

We're also using technology to assess market impact data. We're reading all kinds of data, including Twitter feeds, Facebook posts, and Dow Jones data, to scan everybody who talks about everything in the market. This data is read by machines and we can see what sentiment of on any particular asset class is.

All of this use of technology only represents about 10-20% of what we do now on top of all the fundamental and quantitative research we do on the stocks we own.

Sri, you've argued one of the true sources of diversification within a portfolio is its sectors. Can you elaborate?

SI: In the 1990s, much of the alpha in the equity industry came from tactical asset allocation. Stock selection at that time was not that important. For example, it really didn't matter what stock you bought in Japan or France – you just needed to get Japan and France correctly. So you go long-France/short-Japan. As the European Union formed in the 1990s, and as bond and equity markets converged, a lot of the bottom-up stock-picking skills evaporated because the market converged. You need dispersion in markets to create alpha. What we discovered was that the dispersion is not coming from country or region, or style or size. Much of the dispersion in markets were coming within sectors, particularly by industry.

We've become country agnostic, style-agnostic, size-agnostic and just focused on buying the best of breed companies around the world in each economic sector

What's your opinion on gold and gold miners, which despite a big sell-off recently will probably finish the year as the strongest performing asset class?

Tyler: I wrote a piece called: "Cold Gold – It's Complicated". All the things that propelled the gold market from 2002 to 2012 were the declining U.S. dollar and inflation. People got the inflation trade really wrong in the post-crisis period, so the bloom came off the rose in the gold market. I think there's going to be very good capital opportunities potentially in gold and gold stocks, but I'm struggling to come up with a macro-story to support it right now. We're currently agnostic on the issue.

Hans: I really like writing calls on gold miners. In some cases, I might reduce my exposure to 30% in terms of how much I would be writing on them, but if you write 30% of the portfolio for out-of-the-money calls, you're not really going to receive

much in premium. So what I do is bring in the strikes a little bit closer to the money and get that overall premium take-up. If something crazy happens, at least you've got 70% uncovered to get exposure to any run in the gold miner market.

Nick, can you elaborate on the rise of institutional buyers in the preferred share market?

Nicolas: We're seeing more and more institutional buyers for Canadian preferred shares. In the past, a good deal would have about 30% institutional interest. More recently, about 60% of new issuances are being sold to institutional buyers. A recent Bank of Montreal deal had 70% allocated to institutional investors.

Generally speaking, institutional interest is a positive – there's better liquidity for preferred shares. In preferred shares over the next 12 months, we expect to make between 7% and 10%, total return. That's not bad for fixed income.

What do you see from an issuance perspective in 2017?

Nicolas: This year, new issuance on preferred shares has been around $10 billion, and we expect close to $7 billion next year.

What outlook do you see for Canadian banks?

Tyler: Canadians love their big banks. I've seen some shocking statistics over the last few years that the average Canadian investor holds about 27% of their entire portfolio in just Canadian bank stocks. Yes, the Canadian banking sector is solid, but there are headwinds, notably the decline in commodity prices and credit is now starting to roll over.

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I think there are far more interesting places to put your money in the world than Canadian banks. The U.S. banking sector looks quite good for the simple reason that credit is finally re-leveraging and the European banks are going to become the very interesting at some point. You look at Deutsche Bank as an individual stock and it has a pretty mouth-watering valuation these days. To me, Canadian banks are an uninteresting play.

Is there an investment factor out there that investors should tilt toward in 2017, and is there one you think they should avoid?

Nicloas: For fixed income, I think active management is the way to go. Active management in the ETF structure is not as expensive compared to mutual funds.

Tyler: The first factor I would avoid is the interest rate risk factor. If you think about interest rate risk, consider things like dividend-paying equities – really anything that has interest rate sensitivity.

There are times to embrace some momentum in the market and I think this fiscal expansion with Trump is for real and will bleed over into next year and engineer higher bond yields.

The factor that I would dramatically overweight is the Emerging Markets. Consider the consensus views out there. Trump has been elected and suddenly the markets love U.S. equities. I think these equities are set to outperform and the U.S. dollar is going to soar. Back in 2009, the U.S. dollar was cheap, the Fed was the most accommodative central banker in the world and valuations in the stock market were cheap. What conditions do we have today?

Today, the U.S. dollar is an expensive currency. We have an expensive stock market, and we no longer have an accommodative Fed. Trump's protectionist policies may backfire. In potentially closing off the United States to the rest of the world, it will enlarge the economic ecosystem with which other countries operate, and I'm thinking primarily of Asia. China was rooting for a Trump win so they could enlarge their economic footprint in Asia. Emerging Markets have underperformed for five years now. It's had a dramatic slowdown, so the currencies are really cheap, boosting competitiveness.

If you look at any value measure on Emerging Markets versus the United States, it's at levels not seen since 2003. So I think heading into 2017 we're facing a new emerging market boom, and that's not on anyone's radar right now.

Sri: I think anything to do with earnings growth coupled with strong positive cash flow growth will perform really well. Other traditional factors might not do as well. Dividend yields did really well the last couple of years but anything with (interest rate sensitivity) risk might underperform and anything with strong cash flow growth and earnings growth will do really well.

For further information please contact **Horizons ETFs** toll free at **1-866-299-7929** or visit **HorizonsETFs.com**.

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