HAZ Quarterly Commentary

March 2019

Global Markets Review

Despite the more tumultuous performance of the stock market at the end of last year, corporate fundamentals remained constructive — the increase in volatility was very much sentiment-driven as investor psychology took over and pessimism swung to an extreme. But while markets can decouple from fundamentals for a period of time, they typically do not remain detached forever with the more extreme the dislocation often followed by sharp reversals — such as was recorded through Q1 (the first three months ending March 31, 2019), which marked the best quarter for global equities in 8½ years.

For starters, one of the larger headwinds from 2018 has largely subsided and is not expected to present the same degree of head-winds in the near future. Global interest rates had been largely grinding higher since touching lows in the aftermath of the Brexit vote in June 2016, with the upward move picking up through 2018 against the increasingly hawkish tone from global central bankers. Indeed, it was the early jump in rates and concurrent firming of the U.S. dollar last year that brought vulnerabilities to the forefront in the Emerging Market economies most exposed to changes in the external conditions through their reliance on foreign funding — namely, Argentina and Turkey — and spurred on concerns that the stress could spread through the region.

As inflationary pressures remained benign and concerns rose over the health of the global economy amid increased financial market volatility at the end of the year, major monetary policymakers made a material shift in their approach that led to a dramatic repricing of interest rates. In particular, the adoption of a dovish tilt by the US Federal Reserve last November followed by the more overt move to cut its projected path for interest rates in March and the announcement that it would stop allowing maturing securities to roll off its balance sheet in the Fall was key in spurring on the global bond rally that brought yields down to lows last seen two years ago. While it appears as though market interest rates overshot to the downside, the room for significant upward adjustments remains fairly limited given central bankers appear committed to erring on the side of caution and keeping rates lower for longer. Accordingly, this suggests that the type of aggressive monetary tightening that can choke off credit and trigger a global recession that was a growing concern last year is looking increasingly unlikely near-term.

Another major issue that clouded the outlook over the last year is also showing signs of abating as well. The trade tensions that began in earnest at this point last year (with the U.S. administration introducing tariffs on Chinese produced washing machines and solar panels) and escalated thereafter have come off the boil as the latest threatened tariff increases were delayed again, this time indefinitely. Given the inherent unpredictability associated with the policy direction of the current White House, the developments on this file remain fluid, however, there are signs of continued progress on a trade deal that could result in an agreement sooner rather than later. This would provide more clarity over the prospects for trade, which has become an increasingly integral cog in the global economic machine.

The potential for a boost to trade flows would be a more than welcome development for many of the world's export-oriented economies. Chief among them, China which is continuing to deal with the secular downshift in its pace of expansion from the unsustainably high rates that prevailed over the prior decade as it faces the growth limits of a maturing economy. For their part, policymakers in Beijing have turned on the stimulus spigot to help the world's second largest economy avoid a "hard landing". Monetary authorities have reversed course on their efforts toward tightening financial conditions to rein in escalating debt burdens via multiple cuts of the re-quired reserve ratio and large-scale injections of liquidity into the domestic financial system. On top of that, the Chinese government has announced fiscal policy stimulus measures totaling RMB¥4 trillion ($600 billion) of which half is tax cuts and the other half is funding for local infrastructure projects.

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Germany is seemingly in need of a jumpstart that improvements on the trade front and a resurgence of Chinese demand could provide. The Eurozone's growth engine stalled in the second half of 2018 in part due to the one-off hit associated with a large-scale shutdown in the country's important auto sector, but has struggled to get back on track against muted demand from Asia for its output. More generally, Europe has been largely stuck in neutral and growth momentum has shown only nascent signs of bottoming out. The political backdrop is not doing any favours for the region's economies, with Italy's populist government impeding economic and political stability, the ongoing unrest in France and the Brexit saga in the UK that still is not offering much by a way of a clear end point.

Performance Attribution Q4 2018

The HAZ portfolio underperformed the index in Q1.

The portfolio outperformed in six of the 11 sectors led by Consumer Staples, Information Technology, Materials and Industrials. Health Care, Consumer Discretionary, Energy and Communication Services were the largest detractors from relative performance.

The Consumer Staples sector was the largest contributor to relative performance due to positive stock selection. Outperformance in the Consumer Staples sector was driven by strong performance from Nestle and Costco during the quarter.

Information Technology was the second largest contributor to relative performance during the quarter due to stock selection. The portfolio's holdings in Accenture, Mastercard and Microsoft drove the majority of the outperformance in the sector.

The Materials sector also contributed to relative performance due to positive stock selection. Air Products & Chemicals was the largest contributor to relative performance in the sector.

The Health Care sector was the largest detractor from relative performance driven by stock selection. Amgen and UnitedHealth Group were the largest detractors from relative performance.

The Consumer Discretionary sector was the second largest detractor from relative performance driven by stock selection and an overweight to the sector. Six Flags Entertainment was the largest detractor from relative performance.

The Energy sector also detracted from relative performance due to stock selection as well as an overweight position in the sector.

Portfolio Activity:

In Q4, the Portfolio purchased Sanofi and Procter & Gamble which is a defensive company with strong earnings and low-volatility, yielding a higher dividend compared to peers and backed by a low probability of a dividend cut.

In Q4, the Portfolio sold Analog Devices, Broadcom and Texas Instruments to reduce the weight of Information Technology. Chevron was sold as it de-rated based on declining revenue growth and price multiple expansion. Health Care stocks, Fresenius Medical and Novo Nordisk stocks experienced a de-rating as Fresenius Medical came under scrutiny from regulators, endangering operating margins, and Novo Nordisk experienced pressure from an increase in competition from generic brands. BASF's cyclicality and exposure to China was a risk we wanted to eliminate from the Portfolio. Targa Resources and ENI were sold during the quarter as well.

Positioning:

The Turbulence in the market (cross correlation of assets) fell back at the start of the year, which also marked a mean reversion cycle – seeing cyclical stocks and those that had fallen most in Q3 and Q4 rise back up. The only factor which worked in January was Mean Reversion as Value, Growth, Quality and Dividend Yield factors all underperformed. The market was on a rebound, unsupported by the underlying macro data. Towards the end of February and into March, Quality and Growth factors started to perform better. Momentum and Quality have been the leading factors in March. YTD the Mean Reversion factor was rewarded the most as people bought the stocks that fell the quarter before.

Turnover was minimal in the portfolio as we maintained our lower market sensitivity and consolidated in names we already own adding to our conviction. The few names we exited are related to lack of visibility of future growth which jeopardizes profitability and sustainability in the business.

Based on aggregate levels, we are seeing that Consumer Staples has lower forecast dividend growth and that has materialized in the increase in volatility seen in some names from this traditionally defensive sector. We are seeing lower forecast dividend growth across all sectors in the US, which may be a sign that the market needs additional visibility on growth prospects before projecting significantly higher dividend growth.

As a result of the economic backdrop and our 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. We continue to emphasize higher yielding names that have the lowest probability of a dividend cut. Our decision to increase exposure to the Dividend Growth factor over Dividend Yield over the past few years— which has served well to keep up with the growth market while maintaining reasonable cash flows — has proven beneficial to our performance. The enhancements in our process that have coincided with this period have led to the implementation of our machine learning model for Dividend Growth Forecasting and Dividend Cut Prediction. This has helped us position the portfolio in strong dividend growers and avoid the damaging dividend cutters. In addition to our new machine learning model, we continued to enhance our relative model.

The portfolio has an overweight in the Utilities (+5.1%), Consumer Staples (+4.6%) and Health Care (+2.2%) sectors. Underweight sectors are Financials (-8.3%), Consumer Discretionary (-2.2%) and Materials (-1.2%).

Geographically, the portfolio is overweight North America (+14.8%) and underweight Asia & Pacific Basin (-11.0%) and Europe (-3.5%). The portfolio does not have a weight in Emerging Markets at this time. The dividend yield at the end of quarter was 3.05% and the portfolio has a large cap, high-quality bias.

Outlook:

For its part, the US has shown the most economic resiliency and offers up the most clarity on the near-term outlook. That said, the expectation that last year's tax cut-induced acceleration was a one-off that will see its positive effects fade means that growth is expected to decelerate to more the trend-like rates consistent with an economy running up capacity constraints associated with full employment.

Of course, the question is whether the market got ahead of itself, setting up for consolidation ahead. While there are plenty of risks remaining that could cause a change in course, for the here and now there appears to be reason to be cautiously optimistic about the prospects for the global economy over the coming months.

Dividend stocks typically outperform the market in periods of heightened volatility in part due to their cash flow cushion muting the downside — when volatility has been above-average over the last two decades, global equities with higher dividend yields materially beat the broad index. Similarly, stocks that are classified as "quality" also provide a haven against volatility, supporting a preference for tilting exposure to these typically stronger and more stable companies with better earnings visibility.

In conclusion, we have an unwavering discipline when it comes to choosing stocks, and it is based upon model fundamentals that cover all three facets of investing, namely, relative opportunities, intrinsic conviction and objective non-human analysis through Machine Learning methods. We believe fundamentals continue to prevail as companies continue to deliver double-digit earnings growth, buybacks and divided increases on the backs of a US tax catalyst and low interest rates in and outside the Unites States. Yield for yield sake is not the right approach and we feel that stocks exhibiting consistent earnings strength, or those that signal shareholder friendly activities like dividend increases or buybacks with respect to cash flow usage should allow for the best opportunities to buy.

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