RAZORBILL ADVISORS INC
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January 2018

Razorbill Advisors Research

Economic and Market Outlook for 2018

Investment Context:

In the last few years investors incorporated in their market expectations a generous investment context built on low inflation, loose monetary policies, synchronized global growth and the formation of new corporate giants. As those factors are now maturing, many financial asset prices appear stretched and volatility is at generational lows. We think investors should be cautious about general valuation (beta mandates, total returns / indexed mandates) and focus their attention on niche opportunities (alpha mandates, absolute returns mandates).

Economic Outlook:

Canada had surprisingly strong real GDP growth in 2017 (3.0%) generated by a strong energy sector a housing wealth effect. Helped by a late-cycle commodity upswing and positive fiscal policy (+0.6% contribution), the economy should keep some momentum in 2018 (2.2%). However, with an output gap almost closed (Unemployment 5.9%) and inflation trending up (Core CPI Trim 1.8%), the Bank of Canada could move its short term benchmark rate up 3 times this year along with the Federal Reserve. It will be important to monitor how the overheated housing market and the indebted Canadian consumers react to those hikes. Even though Canada is rapidly opening new trade routes we also see NAFTA renegotiation as a key risk for Canada. Should the negotiation fail all parties concerned would see their GDP being impacted.

In the United States, following a 2.2% reading in 2017, real GDP is expected to grow at 2.5% in 2018 as wage increases should support consumer spending, high business confidence should reinforce CAPEX. However, given an economy already running over potential (Unemployment 4.1%), a lower US dollar, higher energy prices and no sign of productivity improvement, the Federal Reserve could deliver up to three 3 more rate hikes this year. It will be interesting to see if the Federal Reserve will start targeting stretched financial asset valuation more directly. Undoubtedly, the political landscape will remain a wild card in terms of geopolitical and economic risks.

Boosted by exports and peripheral fiscal loosening, Europe’s 2017 real GDP growth was better than initially expected (2.3% VS 1.7%) and the 2018 consensus is at 2.1%. Since Germany is approaching full capacity (unemployment 5.5%, inflation 1.8%), the ECB has already drawn a plan to terminate its quantitative easing next September and could soon rethink the adequacy of its negative overnight rate (-0.4%). This could reignite tensions within peripheral economies (Italy, Portugal, Spain), however at this point, despite Italian election coming in March, Eurozone integrity risk seems to have diminished, as extremist parties have shifted from an anti-European rhetoric toward an anti-immigration rhetoric.

Japan benefited from its export engine in 2017 to outstrip real GDP growth expectations (1.7% vs 0.6%) and the consensus is optimistic for 2018 (1.3%). However, structural problems are obvious and well documented. Inflation hovers stubbornly low (0.5%) despite a ‘’job offers to applicants’’ ratio at 1.5x, the government has to handle rapidly increasing expenditures related to aging population coupled with a significant debt level framework and with labor mobility reforms that are yet to be implemented. As the Bank of Japan is heading toward 50% ownership of governmental bonds and market (including equity markets) ETFs, monetization is still in the cards over the medium term. It will be interesting to observe how this rich country manages this wealth redistribution process.

In China, 2017 GDP real growth came over expectations (6.8% vs 6.5%), even if good progress has been made to counter the excesses in heavy industry, housing inventory and financial leverage. China's heavy industry overcapacity was reduced, which translated to higher PPI, better profitability and therefore improved corporate credit quality. Its housing inventories were kept reasonable vastly reduced from their 2015 peak. On the financial side, both leverage and shadow banking stopped growing after years of intense ramp up. Moreover, FX reserves and the Yuan value both extended their trend upward. For 2018, 6.5% real GDP growth is expected as China continue its secular catch-up with the rest of the developed world. However, President Xi recently strengthened its leadership position. Although, over the long term, its reforms (State Owned Entities mixed-ownership, market-oriented approach, environmental measure, anti-corruption provision) are favorable, in the short term working out surplus could be negative hampering its promise to deliver growth of higher quality.

Market Outlook:

We think that North American yields should generally continue their march upward (10 Yr US 3.00%, CAD 2.75%), as reflation comes back on investors' radar led by US inflation revival signs (Atlanta Fed Wage 3.2%, NY Fed Underlying Inflation 2.95%). In terms of curve shape, we were surprised by the recent curve flattening in 2017 (US 30-2 Yrs -102 bps to 86bps) given central bank emphasis on gradualism and their willingness to light up inflation. Moreover, we see the beginning of a reversal of the Fed quantitative easing, particularly the Fed's balance sheet reduction of 400B in 2018, and potentially larger budget deficits, as potentially bringing back term premium in positive territory and steepen curves.

We believe that Investment grade corporate spreads are not the most expensive asset class out there and can still generate a carry of quality in the yield chasing environment we are currently experiencing. However, we see the corporate market as expensive (treasury yield +94bps for the 7yrs U.S. corp cash) when compared to their historical range, given equity elevated valuation and the current high debt level. This is even truer considering index quality deterioration, questionable ETFs liquidity and a transformative technological landscape. We are particularly cautious of the high yield market, which is already experiencing stress in many sectors (retailers, auto rental and hospital).

The story for equity markets did not change much in 2017. In the U.S., stocks are expensive (Forward P/E 18.6) and earnings growth forecasts are aggressive (2018/19 10% yearly). In the short term, profits will be boosted by a lower tax rate but over the medium term, interest rates and wages should go up pressuring margins. Moreover, interest rate trending up will have the currently attractive risk premium scrutinized more closely. European and Canadian equities represent better value to us with their lower P/E ratios and an accommodative central banks.

We see Oil (WTI) as continuing to trade in a tight range between $50 and $65. The OPEC agreement seems to be working and temporary disruptions are possible, but the price ceiling imposed by more and more producers, particularly in the shale segment, will be hard to break through.

For currencies, we see the weakness of the USD in 2017 (DXY -10% to 92.1) as driven mainly by a reversal of technical factors, as investors were all bull USD to begin the year, particularly large speculators (if we are to use COT as a gauge). At this point, the market seems more balanced and the divergence in monetary policies should help the DXY gain back ground toward 100 however we have to weigh in the impact of the current administration protectionist agenda as a potential further disruptor for the USD. For the CAD, given oil prices and interest rate differential (Cad vs US), we view 1.20-1.30 range as fair.

In the medium term, the high debt burden globally should have to get reduced to avoid social inequality tension, improved productivity and accelerate growth. This reduction should be done through a balanced combination of austerity, inflation, defaults and tax on wealth. The latest seems to have been underused up to now as the wealthy political influencers have preferred to lend money to governments and having them indebted instead of getting taxed and no one has stood up to them.

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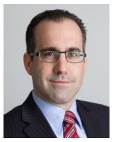

HUGUES SAUVE holds a M.Sc Finance from HEC Montreal and is a CFA charter holder. In addition to his extensive experience acquired at UBS Global Asset Management (1999-2004) and at National Bank of Canada (2004-2013), Hugues has developed a thorough expertise in fundamental analysis and relative value trading within various parts of the credit markets. He joined Razorbill Advisors in 2015, as Chief Investment Officer.

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