Quarterly commentary

International Core Equity

2017 third quarter

Market review

Equity markets extended their rally in the third quarter pushing year-to-date (YTD) returns well into double-digits for most regions led by international markets in general, and emerging markets, in particular. Rising global growth prospects became more apparent as we saw an upswing in more synchronized global expansion and further weakness in the U.S. dollar propelled commodity prices higher, particularly industrial metals, all supportive of further strength in the emerging markets. While emerging markets continues to top regional return tables, breadth in market returns remains apparent worldwide. After a prolonged period of returns being driven by multiple rerating, 2017 has been defined more by an improvement in earnings growth and the third quarter was no different. Corporate profits are returning to health with further extension of cost controls driving earnings and margin expansion. The quarter was centered around a more risk-on sentiment with sectoral leadership having a commodity/cyclical tilt.

Energy and materials sectors topped returns in the quarter led by strength in their underlying commodity prices. West Texas Intermediate (WTI) and Brent Crude saw their prices surge higher by 12% and 20%, respectively, driven by a better supply/demand rebalance outlook and in turn left for investors to venture into companies within the previously downtrodden energy sector. Materials caught a bid as copper prices rallied 9% amid tightening supply and positive economic data from China. Technology shares continued to rally as investors appear to like the growth in that sector in the current low rate environment. Conversely, defensive-oriented sectors such as utilities, telecommunications, and real estate were out of favor amid investor appetite for risk. Consumer-oriented sectors were also relatively weak as investors fear the loss of sales by the brick and mortar stores to growing on line trade, whilst Amazon's acquisition of Whole Foods in August sent further deflationary concerns across the food & staples retail industry

Despite an ongoing flurry of geopolitical news and events, market volatility remained at or near historic lows across most regions. The continuing solid market performance in the U.S. was outshone by several key international markets. Returns were particularly robust in the commodity-rich Canadian market, amid relative valuation opportunities and a troughing in commodity prices.

In Europe, its early cycle growth kept investors interest as well as the winding down of the heavy election year acted as catalysts to its positive total returns. However, the German elections concluding with the far-right party performing better than expected, and taking votes both from Chancellor Angela Merkel's ruling Christian Democrats, and from the opposition SPD. Merkel's position is thus weakened as she will need to make more compromises as she finds new coalition partners, and we are already hearing a toning down of the pro further European Union integration rhetoric there.

Central banks across the globe have remained a topic of discussion as previously divergent monetary policies are beginning to move in a more synchronized hawkish fashion. The Federal Reserve hiked rates by 25 basis points (bps) during the quarter while also approving the commencement of reversing its bond-buying program in October while the Bank of Canada implemented two separate rate hikes of 25 bps in the quarter. The Bank of England has remained hawkish, while the European Central Bank seems to be on a rather wait-and-see path. The sentiment amongst central banks helped to turn global yields higher through the later part of the quarter, after rather depressed levels for much of 2017. While volatility was apparent as the U.S.10-year Treasury yield started the quarter at 2.3% it touched as low as 2.0% in early September to only move higher and end the quarter at 2.3%.

Investor sentiment seemed to be shifting at the end of the quarter in accordance with rising reflation expectations as evidenced by abrupt moves higher in Treasury yields and the U.S. dollar. While global yields moved in a rather mixed fashion overall for the quarter, most made sudden moves higher in the last couple weeks of September, led by the United States, United Kingdom, and Canada. The appreciation in yields was helped by shifting sentiment on the prospects for higher inflation in the near-term led by rising growth and commodity prices. The U.S. dollar seemingly moved in the same fashion higher at the end of the quarter, particularly against emerging baskets and the Japanese yen. For the quarter, the dollar fell against most currency baskets highlighted by a 2%-5% depreciation against the Chinese yuan, euro and Brazilian real. Conversely, it remained relatively flat against the Japanese yen.

International markets broadly outperformed in part due to the weaker U.S. dollar and valuation opportunities. The MSCI EAFE index return posted a 5.5% return for the quarter, 20.5% YTD, while the MSCI Emerging Markets index notched another sharp advance of 8.0%, and 28.1% YTD. Smaller capitalization shares partially reversed their previous lagging performance against its large-cap brethren across the globe, except for emerging markets, led by the cyclically-oriented industrials.

Strategy review

The strategy outperformed the index for the quarter.

Top contributors

Dollarama Inc. is Canada's largest dollar store in Canada, with almost 1,000 stores across the country. They have five times the stores of their nearest competitor. Their multi-price strategy has just started to offer products in the $3.50 and $4 price range. During the month, the company reported earnings per share ahead of consensus expectations while EBITDA beat by 10%. Dollarama opened 17 stores in the quarter which is ahead of what is needed to meet the full year guidance.

Ulvac, Inc. is Japan's largest supplier of flat panel display production equipment, it is also a leading supplier of physical vapor deposition equipment with 70%-80% market share and a major vendor of plasma enhanced chemical vapor deposition tools with 20%-30% share. Ulvac should continue to benefit from growth in OLED screens.

Lonza Group AG. is based in Switzerland and is one of the world's leading custom contract manufacturers of biotech drugs, as well as a leading provider of chemical ingredients for antimicrobial, agrochemical, sanitation, nutrition and personal care products. After years of overinvestment leading to lackluster returns, Lonza's CEO is addressing the issues by creating a leaner, more market-driven organizational structure.

Ubisoft Entertainment SA engages in the production, publication, and distribution of multimedia, audio-visual, and information technology products. Management maintained their guidance driven by continued healthy digital mix and reiterated its 2018-2019 goals of improving their digital gaming mix, which is driving margin growth ahead of expectations.

Sumitomo Heavy Industries, Ltd. is a Japanese machinery company. The FY3/16 operating profit mix was 9% construction, 38% precision machinery, 18% machinery components, 21% industrial machinery, 2% shipbuilding, and 12% environment & plant. The geographic sales mix was 47% Japan, 19% NA, 7% China and 27% rest-of-the-world. Order momentum continues to pick up and guidance is likely to be raised, reflecting stronger earnings and the AMEC Foster Wheeler's CFB boiler acquisition.

Top detractors

Glencore plc, which we did not hold, is a diversified mining company based in Switzerland. The rebound in underlying commodity prices has benefited the company. Results from the first half of the year were in line with expectations and the company recently announced two new acquisitions with Chevron South Africa and Botswana, highlighting the company's unique capital allocation strategy. We have since added the stock to the strategy.

Aena SME SA is a Spanish based company engaged in airport operations. They operate 46 airports, plus two heliports in Spain. During the quarter, the company reported solid results as expected with EBITDA beating by 1%, however no guidance was provided and commentary was conservative on the potential to improve retail spending or operating expenses.

Orion Oyj. is a European Specialty Pharma company based in Finland that develops, manufactures, and markets human and veterinary pharmaceuticals, active pharmaceutical ingredients, and diagnostic tests. The company's leading franchise is in Parkinson's disease, which has been off patent since fourth quarter 2013. The second quarter was a disappointment versus consensus, but management indicated sales and operating profit for the first half have progressed according to plan.

Royal Dutch Sell Plc, which we do not own, is an integrated oil company operating with three main business segments: upstream, integrated gas, and downstream. The upstream segment includes conventional and deep-water exploration and production, shale, and oils sands. The integrated gas segment includes liquefied natural gas and gas-to-liquids. The downstream segment includes marketing, refining & trading, and chemicals. The rebound in underlying commodity prices benefited the company as they revamp their operating costs, integrate BG Group, and execute on their divestment strategy.

Nippon Telegraph and Telephone Corporation (NTT) is the incumbent telecommunications operator in Japan, which derives all of its revenues and profits domestically. It has a 66.7% stake in the number-one mobile carrier NTT DoCoMo and a 54.2% stake in NTT Data, both of which are listed separately. While the telecommunication sector underperformed during the quarter, the company announced a share buyback plan of 1.5% shares outstanding. We continue to hold the stock in the strategy.

Outlook & strategy

With improving economic data in most regions of the world, the backdrop for earnings from the cyclical sectors of the market remains good. Industrials, technology, and financials continue to see earnings forecasts move higher as growth prospects improve in the United States, Europe, and Asia. Energy and materials are also seeing earnings forecasts revised higher, however, commodity prices in many cases have begun to weaken (crude oil, natural gas, coking coal) resulting in lower share prices for companies.

As we expected, Brexit related earnings forecasts are beginning to normalize. Sharp cuts post Brexit are giving way to earnings upgrades for many domestic United Kingdom companies. We see opportunities in these companies along with some of the multi-nationals that will additionally benefit from the weaker British pound.

Regardless of the region, sector, or general market conditions, our bottom-up focus on sustainable earnings trends and valuations relative to expectations remains a constant across the strategy, and helps rise above the fray of short-term "risk on/risk off" tendencies of many investors during bouts of volatility. As always, our analysts' search for underappreciated fundamental change at attractive valuations continues and, despite the macro noise, is highlighting profitable investment opportunities across sectors and regions.

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