Perspectives on Global Equities

Summary:

- While Brexit remains a concern, there are still exciting opportunities for Ireland and Europe.
- Overall, from a growth point of view, Europe is still projected to have a couple of strong years of growth ahead of it.
- In terms of emerging markets, China remains the most dynamic market, as well as the biggest. As such, you can look at what's happening with China and the countries that.
- When evaluating alternative investments, consider something where there's the discipline, you can afford to take longer-term view of things, and it's in a legal structure like a closed-end fund that really allows you to do that.

CEFA is joined by Noel O'Halloran, Chief Investment Officer with KBI Global Investors and Portfolio Manager of The New Ireland Fund, and Jonathan Morgan, President and CEO of Canadian General Investments Limited.

The following Q&A is from a discussion that originally took place as part of a podcast series on July 25, 2018.


Noel O'Halloran


Jonathan Morgan


Libby Hastert

Announcer: **Welcome and thanks for joining the Closed-End Fund Association for another discussion. Today we will hear from industry experts who share insight on a timely issue affecting the closed-end fund space.**

LH: **Good afternoon. Today is Monday, July 25th. And returning to the CEFA podcast series are Noel O'Halloran, Chief Investment Officer with KBI Global Investors and Portfolio Manager of The New Ireland Fund, and Jonathan Morgan, President and CEO of Canadian General Investments Limited. With a focus on global equity, we're going to hear from the New Ireland Fund about its single-country fund approach and the overall outlook for Ireland and Europe. From there, we'll pivot to Canada for a look at its investment landscape, as well as Jonathan's views on the emerging market sector.**

To frame things up I'd like to remind listeners that today's discussion comes at an interesting time, given the very public international trade dialogue, Italy's volatile political situation, Brexit's impending consequences, and the Fed continuing to hike US interest rates. The global equity markets have captured investors' attention.

Without further ado, I'll turn things over to Noel. When we spoke last October you felt that Ireland had a very strong macroeconomy. How is the Irish economy positioned at this point? Where are you seeing opportunities in Irish equities, Noel?

NOH: Yeah, as we were last October, the Irish economy continues to perform extremely well. So at this point in time, we recorded GDP growth of over 7% in 2017 and the Irish Central Bank is forecasting GDP growth of close to 5% again for 2018 and indeed expect something similar for 2019. So the economy remains very robust and strong.

From my perspective, and we see ourselves now having been through a restructuring phase in the economy, we are now very much in a growth phase. Trade has helped that as one component, so many of our trading partners in both North America and Europe being strong has helped the very open Irish economy, but from my perspective probably more excitement in terms of the strength in the domestic economy.

So the Irish domestic economy is very strong at the moment and so whether we look at consumer confidence or if I look at the unemployment rate, we are now sub 6%, against a European average of eight and a half percent and indeed the unemployment market itself we now have employment levels back to where we were at pre-bubble back in 2008. So, other indicators such as the real estate market remain very strong so the consumer overall was a heavy market where there's commercial rents.

We've seen some very strong growth, and another good indicator that I look at, particularly from the Bank's perspective is credit growth, and we're seeing some strong credit growth. So overall, the Irish economy is as well positioned today as it was six months ago with the obvious sort of caveat of Brexit, which no doubt, we'll discuss later.

In terms of opportunities for Irish equities, I remain very optimistic on the portfolio. I think that growth phase, in particular, helps a number of sectors, some I'm interested in, so in particular, I suppose I'm looking more towards the cyclical sectors because of where we are in the cycle. Within that I'd point to some of the construction and building-related stocks such as CRF which remains the largest holding in the portfolio. Kingspan, another specialty building materials stock is another strong holding in the portfolio. I also like the transportation sector and continue to have a large position in Ryanair, which remain the favorite domestic consumer plays. The banks have been of increasing interest to me, and particularly with the lending growth that I have already alluded to, and also some sort of specialist consumer stocks within the Irish economy such as hotels operator Dalata or a gas station operator, Applegreen. They've, again, been the kind of things we like within the market but overall, very optimistic still on the outlook. I just like the overall earnings growth profile of the portfolio with a very attractive valuation still in place.

LH: **Noel, last time we spoke, you also mentioned how Ireland will likely have some negative impact from Brexit, but nothing dramatic; however, there still seems to be a lot of unanswered questions around Britain's exit from the EU. How is this likely to be resolved and how do you see this impacting Ireland as well as the broader European Union? Noel?**

NOH: Well that's a great question. In six months' on, I think the only known unknown we still have is that a deal has to be agreed by, and for implementation on, the 31st of March, 2019. So we're now nine months away and the rest remain from my perspective kind of unknown unknowns. It literally could be any sort of a deal and anything I might say now could look very stupid and be changed tomorrow. So, the nature of the deal that will come we still don't know. Our working assumption at KBI is that a deal will be done. Our working assumption is based on the fact that no deal, which is a possibility, would be absolutely disastrous and therefore inconceivable for the UK and probably for the broader European Union, but specifically for the UK.

So an assumption that we will get some sort of a soft Brexit from our perspective, you know, that should knock something like half a percent off of Irish GDP on an ongoing basis, that's half a percent off the strong figures I've already commented on. So not a major impact but obviously an impact and certainly from the industry perspective it would hit sectors such as the food sector which have very strong export links with the UK. So at an overall level, probably a negative from the Irish economy perspective.

From an Irish portfolio point of view and from an Irish economy point of view, it's all negative. So in particular, as we discussed last October, financial services, professional services, and sectors such as real estate would definitely be beneficiaries of a Brexit move as we've already been seeing firms from the UK relocating operations or teams to Dublin that will only accelerate as those unknowns become more known. So, from a portfolio view that is why I still like sectors such as the REITs which are beneficiaries of those kinds of moves.

LH: And Noel, more broadly, what are your thoughts on the outlook for Europe and European equities? Are there areas that seem particularly attractive, and is there anything that you would avoid?

NOH: I think Europe, as a whole, is a bit like Ireland. We're in a recovery phase. The big difference in Europe as a whole - recovery in Europe - is excitement can be two and a half percent growth, whereas Ireland can be five, six, seven, as I've already talked about. But Europe has had five or six quarters of above-trend growth. People got a little bit concerned in the first quarter of this year, that we did see slower growth again, but that was predominantly down to the weather. We had an extremely difficult winter, lots of snow. And certainly, all of the recent indicators are pointing to the European economy picking up again.

So overall, we still think from a growth point of view, Europe has a couple of strong years of growth ahead of it. Inflation is of particular concern, so therefore, the ECB will continue to be supportive of that growth. Politics has always remained something to watch, so we have political issues in Germany, we always seem to have political issues in Italy. So for us based in Europe, we don't get too phased by these issues. They're kind of perennial issues.

But from a stock market point of view, I think Europe's similar to Ireland - is in a good recovery phase, we're seeing strong earnings growth in 2017, probably a slightly slower pace of earnings growth for 2018, but nonetheless positive again. The strength in the Euro versus the dollar over the last twelve months has dented somewhat earnings growth, that as we move into 2019, I think again we'll see some strong earnings growth out of Europe. So overall, constructive on Europe. We probably think over recent months, Europe itself has underperformed, probably for the wrong reasons from the global investors' point of view, so possibly an opportunity there.

In terms of areas we like, again similar to the Irish portfolio, we would be more constructive on the cyclical sectors of the market. We would tend to be, and particularly as we take a twelve to eighteen-month view, a little bit cautious on the interest rate sensitive sectors, particularly bond- type proxies, because undoubtedly, German ten-year bonds at the current level we think are too low. So we do see a rise in the European core bond yields, so traditional sectors such as telecom or utilities and maybe some of the staples sectors might be vulnerable to those rate rises. So, we would be much more favorable toward the cyclical sectors. Europe doesn't have a great tech sector, so tech has dominated things in particular markets, such as the US, and emerging markets. Europe is devoid of those types of stocks, and possibly looking at trend valuations, maybe that's not a bad thing going forward from a European perspective.

LH: Thanks for sharing that, Noel. I think that Ireland illustrates how single-country investing can be effectively positioned in a portfolio. And when we discussed challenges Brexit brings to the European trading block, the recent events that have created uncertainty in the North American trading block. Jonathan, I'm hoping that you can share your perspective on the likely outcome from the current trade disagreements, as well as your outlooks for the Canadian market. Jonathan?

JM: Yeah, well I think the likely outcome is that, given enough time, some sort of economic rationality will come to the forefront once again. You have to remember, not only are Canada and the United States close friends and trading partners, but Canada is actually your number one trading partner and the number one export market for thirty-two individual states. So it's not nothing, it is important.

We do periodically have these recurring trade disputes. That was why we created NAFTA in the first place. Two of the trade disputes that keep on coming up are softwood lumber and dairy, and in fact, those were left out of NAFTA because we just never did agree on them, and it was intentionally left out. We have periodically revisited the softwood lumber agreement, and we just sort of agreed to go our separate ways on dairy.

NAFTA itself was probably due for an updating, but I think what's going on right now is, in the long run, counterproductive for both sides. That said, if NAFTA were to go away, then you would end up seeing, probably over a five-year period, the best estimate I've seen is about a one percent reduction in Canadian GDP, because we would still have the WTO rules. However, given some of the recent moves that you've seen, it doesn't look like the current US administration is terribly interested in following the niceties and going by the traditional way of applying these sorts of things. So, it could end up being worse.

I think the area where you really have to worry about it is the auto parts sector, which is a major component of the Central Canadian economy. But, it's one of those things where you quickly find that it hurts in both directions because the average auto part crosses either the Canadian or Mexican border, I think it's eleven times before a car is made. So you know, it's a fully integrated supply chain. So you'd end up causing a lot of pain in the United States as well. I don't expect we'll end up getting that far, but you never know. So, I think that the outcome will eventually be some sort of updated system. It might even be some change on dairy, which wouldn't be a terrible thing, frankly. It only exists for political reasons as opposed to making any sort of economic sense.

That said, I think that we've been able to position the portfolio quite well to avoid the sectors that are worst affected by that, by the current trade imbalance, not a trade imbalance, but a trade dispute. The trade is actually reasonably in balance. So, you tend to focus on things that aren't so directly exposed to the US market, and at the same time, we are getting back into a sort of a tit for tat thing, so you're basically trying to avoid that. And remember, the Canadian stock market and Canadian economy look rather different because the Toronto Stock Exchange is the premier stock exchange for junior oil and gas - and mining, as well. So we've got actually quite a lot of companies that are headquartered here because they're listed here, but actually have operations elsewhere in the world. We've got quite an exposure to companies that do that sort of thing.

On top of that, despite the dispute, the Canadian economy has continued to be very robust and is one of the leading economies in the G7 in terms of GDP, and it has been since before the crisis, remembering we didn't really have a financial crisis here. So it remains robust, and you're also able to pick your spots, certain markets like Toronto and Vancouver, people are probably aware of the real estate that's going on here. But also, one of the reasons that real estate is so high, is that we're seeing large inflows of people and talent and capital into these markets. In part driven by the harder line that's being taken in the US, where, for example, tech talent is actually opting instead to come to Toronto and Vancouver.

LH: Thanks for that overview, Jonathan. And if we could look beyond North America, we've seen a lot of investors looking to emerging markets for higher growth rates. But with political risks in countries like Argentina, Venezuela, Turkey, and South America, in combination with rising US rates impact some of the emerging market currencies, what does your outlook look like for the emerging market equities?

JM: Well, emerging markets is one of those things where it's such a broad basket, you really have to pick your spots. The main thing, I think to focus on, is what's China doing. China remains the most dynamic market, as well as the biggest, and so you can look at what's happening with China and the countries that it trades with, and then those companies that are profiting from that. So, I especially like, for example, Chinese companies that are serving the domestic demand. So they aren't really exposed in the same way to trade disputes, and then satellite countries that are feeding into that.

One of the ideas behind the TPP was actually to try and achieve some of these things that the US government is now trying to put pressure on China about, and it seems an odd time to pick a fight with all your friends when you want them to help you exert pressure on China. I should also mention, just going back to the previous topic that Canada is actually a member of the TPP as well. It did end up joining.

So I think you're looking at China. I think India probably looks pretty good, too. They're fairly isolated from a lot of these trade disputes. They are subject to increasing energy costs, and the monsoon this year is a little bit late and it's not as good as they'd hoped, so that's bad for the Ag sector, which is I think, about half of their economy.

But that said, I think that you're probably going to have a bit of a bumpy time before it calms down again for emerging markets. They're a little bit undervalued, especially as compared to the US market. The US economy still looks very strong, and I think you're going to see a stronger US dollar, whereas everywhere else I think you're going to see an accommodative monetary policy. So, it ends up being a bit of a wash because that helps their companies, but then you sort of lose it on the currency a little bit, depending on what currency you're priced in.

LH: And if we could discuss this just a little further, I'd like to hear about CGI's bottom-up investment strategy for the emerging market investments. How does Active Management play a role here, and what are the advantages of being selective?

JM: Well, first of all, it's not Canadian General itself, Canadian General is a Canada Fund, but in-house we do have emerging markets portfolios, and we employ very much the same sort of strategy. One of the reasons you want to be bottom-up is you get the big whipsaws on the big macro trends. Things that are exposed to big swings in ETFs, and even Mutual Funds, because that's where you can get a lot of hot money flowing in and out, and if you're actually investing in companies and investing, not just trading, then you really want to get exposure to the individual companies themselves.

Having a closed structure like a closed-end fund really helps because, again, with the hot money flowing in and out, you can afford to take a longer-term view of things. And you can do things like get a local settlement, so you're not only exposed to members of the index or companies that are listed as ADRs or GDRs in New York or London. So that helps a lot, and then you also don't have to just always go with the headline stocks. So once you've started to do that, then you can really look at the quality of the company, where they're serving, the quality of the management, and then over time, that's what will actually drive your returns.

LH: Thanks. And with this being a CEFA podcast, I want to circle back to something you just brought up, which was, of course, closed-end funds. I'd like to hear from both of you about why you think the structure works well for global equity investments. Noel, could we turn things over to you for a moment?

NOH: I think as a portfolio manager, one of the great advantages of managing a closed-end fund is that you can take a longer-term perspective, particularly for the long-term investor. So, I'm not worried about the daily retail or mutual fund flows in and out of the portfolio. So, I can then buy some more attractive, less liquid, maybe idiosyncratic-type names that I can invest in for the longer term that, quite frankly, much bigger funds couldn't look at. So I'm not an index hugger. I can take a longer-term view.

The other thing that I like about closed-end funds is I think you've got a good governance structure in place, with a board that's overseeing and appointing the managers. Both are well separated, but kind of work well hand in glove. And I think for the investor, they can buy, and unfortunately one of the persistent challenges to closed-end funds is discounts to their NAV. But for investors that provides an opportunity to buy very attractive portfolios at a discount to the underlying net asset value, and hopefully as growth and returns come through, in turn, those discounts narrow, so I think there are lots of advantages to closed-end funds.

And the final thing I'd say is many closed-end funds, including the New Ireland Fund that we manage, pay very attractive income distributions to underlying investors as well, which is sort of a constant source of returns for clients. So to me, these are the kind of advantages that accrue from investing in closed-end funds.

LH: And Jonathan is there anything you'd like to add?

JM: Well, I agree with everything that Noel just said. I think the one thing to also think about is if you are going outside of, say, S&P 500 or the FTSE, and you're in an open structure from an ETF, you really have to think about that, because especially with an ETF, they have to buy on the way up, and they have to sell on the way down. So you end up really exacerbating the moves. I think once you get to something that's a little more illiquid, or there's a little more geopolitical risk or anything like that, that's really the wrong structure. You want to be in something where there's the discipline, where you can afford to take a longer-term view of things, and it's in a legal structure like a closed-end fund that really allows you to do that. For example, we're able to get local settlement in a number of countries that you just simply wouldn't be able to do with an open-ended structure.

LH: Jonathan and Noel, thank you for making time for today's discussion. I think you raised a lot of important considerations, and we look forward to seeing how things pan out.

Announcer: Thank you for joining us. We hope will stop by again for news on this ever changing space. Until next time, connect with us on Twitter at @CEFAssociation or by searching for the Closed End Fund Association on LinkedIn or YouTube.