SPROTT ENHANCED EQUITY STRATEGY

March 2017 Commentary

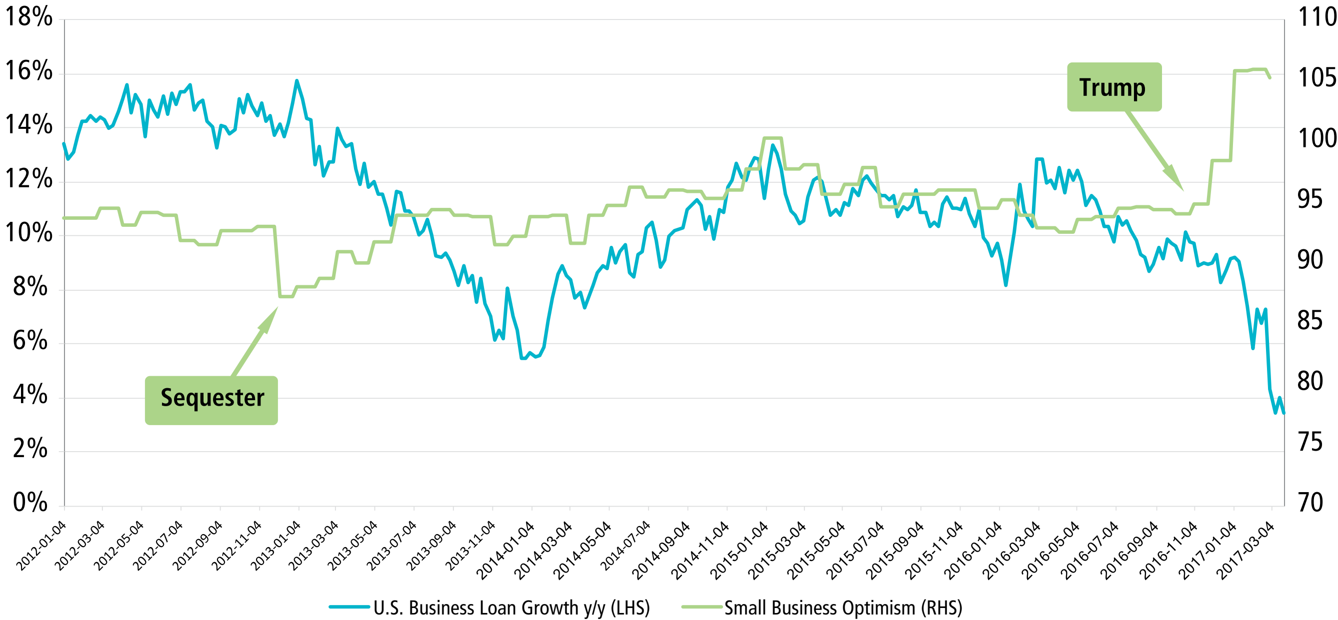
The "Trump Reflation Trade" has run headlong into the messy reality of actually crafting legislation that can pass Congress (the difference between campaigning and governing!), and the result has not been pretty. While equity markets remain close to recent highs, wobbly recent action suggest growing fears around two of the key assumptions underpinning the post-election rally:

- Deregulation and tax reform will not happen as fast nor will be as pronounced as promised by Trump during the campaign.
- Expectations around global economic momentum have gone too far too fast.

In fact, right now in the U.S. it appears as though the Trump effect is having a perverse effect on the economy. Figure 1 below shows the year-over-year growth rate in loans to businesses along with the small business optimism index. While the positive "Trump Effect" is obvious for small business optimism, the opposite is happening with loan growth: it has been decelerating steadily since the election. While this might at first seem counterintuitive, it actually makes a lot of sense when placed into proper context.

Political uncertainty is high, and the recent Obamacare Repeal and Replace impasse is a stark reminder that there are a lot of different views, even within the Republican Party. While we might eventually have deregulation and/or tax reform, businesses do not currently know what form, if any, those will take. Why would a decision maker acquire a new business, purchase a new plant or meaningfully invest in an expansion plan without any visibility on what the tax code will be, particularly when they have been promised wholesale changes (CAPEX expensing, interest deductibility, border adjustment, etc.). It just makes sense that businesses would defer important decisions until they have more clarity.

Figure 1: Business Loan Growth and Small Business Optimism Tell a Different Story



Source: Bloomberg. Federal Reserve Board.

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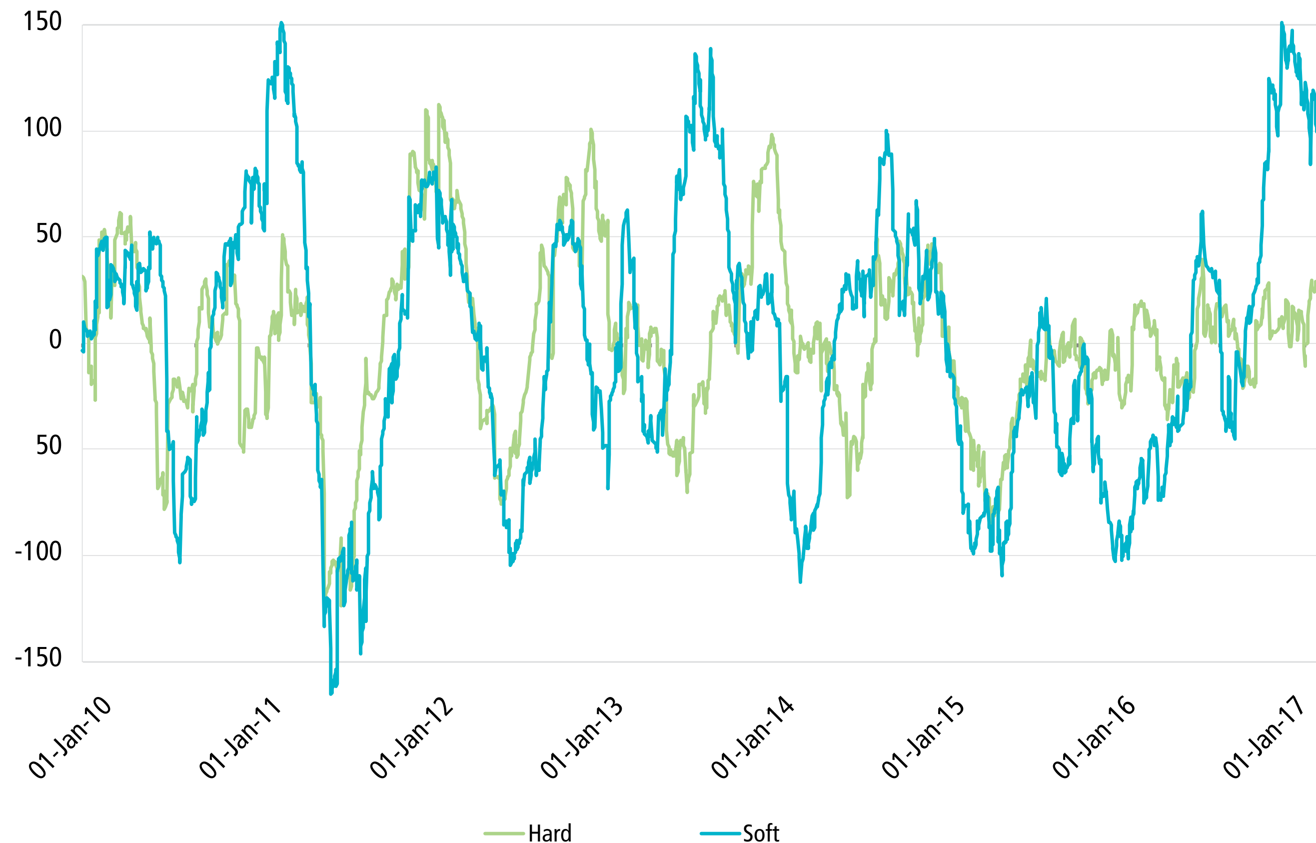
Actually, recent conversations with several U.S. regional bank CEOs confirm our thesis. They believe that their clients are particularly bullish on their prospects and the economy, but that they are very reluctant to "pull the trigger" on any of those plans, given the political uncertainty.

This situation is strangely reminiscent of late 2012, when the U.S. government was going into shut down and the so-called Sequester because the GOP was refusing to lift the government debt ceiling. We have highlighted this episode in Figure 1. Small business optimism took an immediate hit, which coincided with a significant deceleration in business loan growth as businesses deferred important decisions until they had more clarity on government policy, the main difference today being that optimism is as high as it has been this cycle.

Indeed, the market has rallied over the past few months on the back of accelerating optimism, hoping that this would translate in better growth. Figure 2 below shows the Citi Economic Surprise Index for the U.S., broken down into 2 of its main components, "hard" and "soft" data. Hard data is defined as measures of true economic activity such as production, GDP, etc., whereas "soft" data relates to surveys such as optimism, PMI, etc. Today, the main risk to this "Reflation Rally" is that the unabated optimism we have seen from both consumers and businesses, reflected in the soft surprise index making new highs, does not translate into positive outcomes in the real economy. Figure 2 shows that so far, the "hard" data has been rather unimpressive.

Figure 2: Citi Economic Surprise Index – U.S.

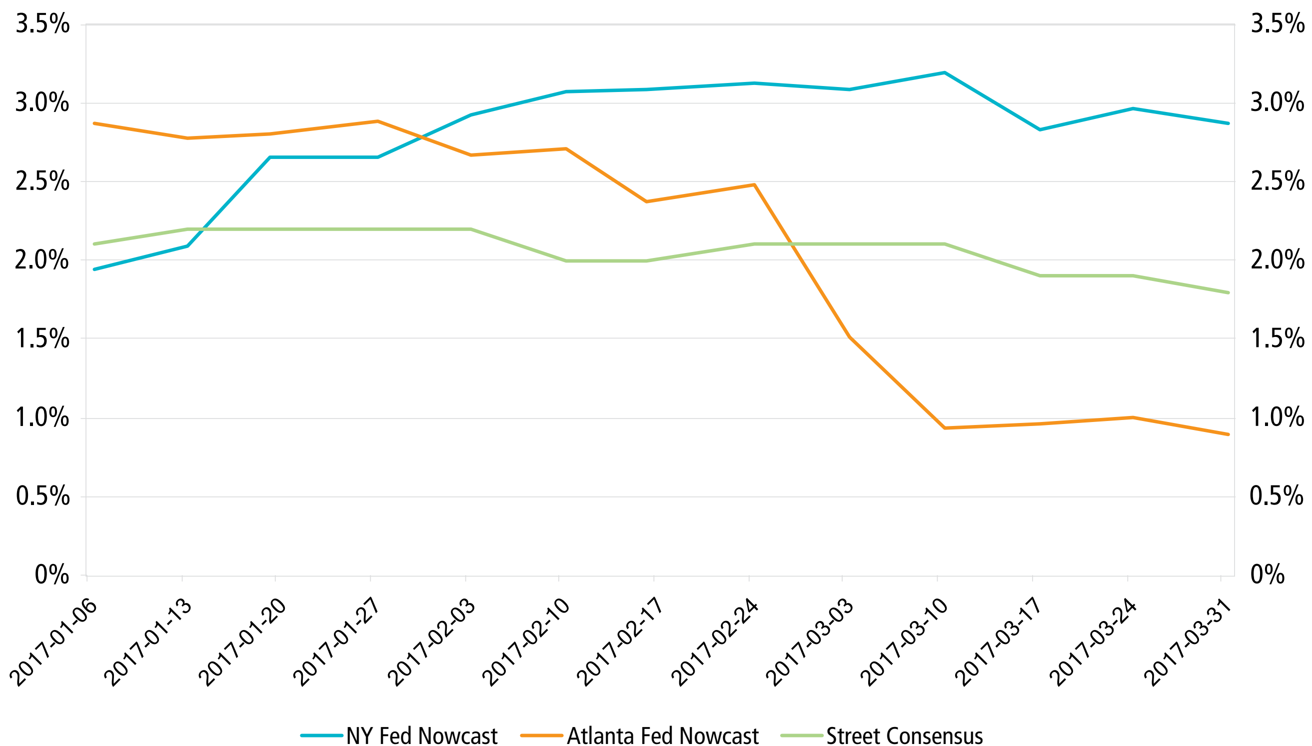


Source: Citi Global Markets.

However, because hard data typically comes with a lag (it take more time to measure real activity than to take a survey), so far the market seems to be willing to wait. But, given the discussion above, we believe that in the coming weeks, incoming "hard" macro data has the potential to disappoint.

To make a final point on the extent of the divergence between "hard" and "soft" data, Figure 3 shows three estimates for 2017Q1 U.S. GDP: street consensus, the NY Fed Nowcast (which includes soft and hard data) and the Altanta Fed Nowcast (which includes only hard data). The difference is about 200bps of GDP growth.

Figure 3: Estimates of U.S. GDP Growth for 2017Q1



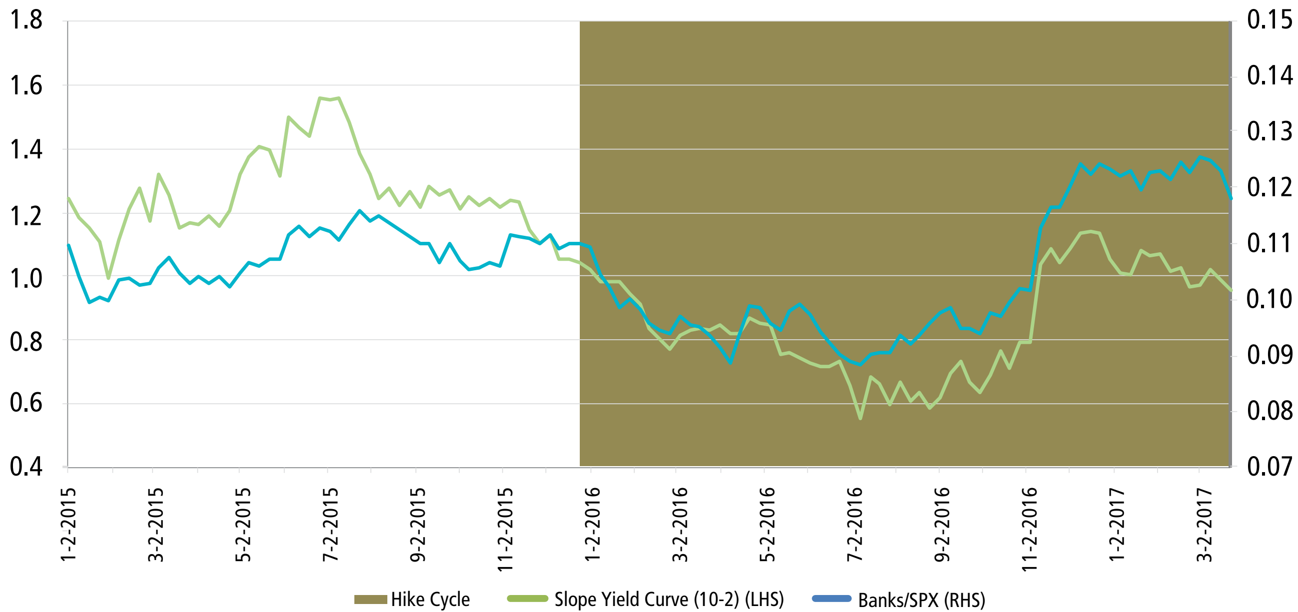
Source: Bloomberg.

Softer macro data increases the risk of a sell-off and reversal of the "Reflation Rally": lower long term bond yields and a flatter yield curve would put downward pressure on financials, industrials, materials, value stocks, small caps, high beta stocks, the U.S. dollar and commodity prices. As a corollary, it is positive for defensives, low beta, large cap and bond proxies.

In our funds, we are tactically positioned to benefit in this environment. On the long side, our portfolio is tilted towards stocks exhibiting defensive qualities, such as utilities, consumer staples, REITs, high revenue visibility companies and those with low betas to the overall market. Additionally, we have taken advantage of the historically low cost of market insurance to add to our S&P 500 put option portfolio, while selling put spreads on some of those defensive, high dividend sectors to capture their dividends and help finance it.

In a scenario where a market selloff is triggered by macroeconomic data coming-in short of expectations, sparking a continuation of the rally in long term bonds and associated flattening of the yield curve, we believe that U.S. financials, which have been the primary beneficiaries for the "Reflation Rally", would significantly underperform on the downside. The relationship between bank's relative performance and the slope of the yield curve is well established (Figure 4).

Figure 4: 2015 Rate Hike Cycle



Source: Bloomberg. Sprott Calculations.

Furthermore, as the Federal Reserve continues to progressively increase the Fed Funds Rate, our expectation is that the yield curve will continue to flatten, as it has done during the past four rate hike cycles. As such, in addition to our S&P 500 hedges, we have enhanced our hedge book with a combination of XLF put options. This hedge is designed to cost very little, but benefit mostly from violent moves to the downside accompanied with an increase in implied volatility. In the event that we are wrong, the cost of this hedge will be immaterial to the funds. However, if we are right, given the extreme positioning in banks and the currently low level of implied volatility, we expect this position to do very well.

Finally, we are comfortable with the level of hedging in the portfolio and remain well positioned to take advantage of a market pull back. We have a good amount of dry powder ready to put to work.

Until next month,

The Enhanced Strategy Team:
John, Colin and Etienne

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COMPOUNDED RETURNS (%) AS AT MARCH 31, 2017*

	1 MTH	YTD	3 MTH	6 MTH	1 YR	3 YR	5 YR	10 YR	ANNUALIZED INCEPTION
SPROTT ENHANCED BALANCED FUND, SERIES A	0.0	0.6	0.6	2.1	5.1	1.5	-	-	4.0
BLENDED INDEX[1]	0.8	2.9	2.9	5.6	13.8	8.9	-	-	10.7
SPROTT ENHANCED BALANCED CLASS, SERIES A	0.1	0.8	0.8	2.5	5.2	1.2	-	-	2.3
BLENDED INDEX[1]	0.8	2.9	2.9	5.6	13.8	8.9	-	-	11.3
SPROTT ENHANCED EQUITY CLASS, SERIES A	-0.1	0.0	0.0	2.1	5.3	1.3	-	-	4.9
TSX/S&P 500 BLENDED INDEX[2]	0.8	3.8	3.8	9.4	19.5	11.7	-	-	14.5
SPROTT ENHANCED LONG-SHORT EQUITY FUND L.P., CLASS A	0.5	0.9	0.9	0.0	0.8	-1.5	1.9	2.6	8.6
TSX/S&P 500 BLENDED INDEX[2]	0.8	3.8	3.8	9.4	19.5	11.7	13.9	7.0	8.0
SPROTT ENHANCED LONG-SHORT EQUITY RSP FUND, CLASS A	0.4	0.7	0.7	-0.4	0.1	-1.9	1.5	2.3	3.9
TSX/S&P 500 BLENDED INDEX[2]	0.8	3.8	3.8	9.4	19.5	11.7	13.9	7.0	8.0
SPROTT ENHANCED U.S. EQUITY CLASS, SERIES A	0.7	1.6	1.6	3.2	3.2	-	-	-	-2.5
S&P 500 TRI (CAD)[3]	0.1	6.1	6.1	10.1	17.2	-	-	-	9.5

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* All returns and fund details are a) based on Class/Series A shares/units; b) net of fees; c) annualized if period is greater than one year; d) as at March 31, 2017; e) inception date for Sprott Enhanced Equity Class is 04/16/12; f) inception date for Sprott Enhanced Balanced Class is 09/13/13; g) inception date for Sprott Enhanced Balanced Fund is 04/16/12; h) inception date for Sprott Enhanced Long-Short Equity Fund L.P. is 04/07/04; i) inception date for Sprott Enhanced Long-Short Equity RSP Fund is 09/30/05; j) inception date for Sprott Enhanced U.S. Equity Class is July 22, 2015.

[1] 40% S&P/TSX Composite TRI; 30% S&P 500 TRI CAD; 30% FTSE TMX Canada Universe Bond Index™ and is computed by Sprott Asset Management LP based on available index information.

[2] 50% of S&P/TSX Composite TRI; 50% of S&P 500 TRI CAD and is computed by Sprott Asset Management LP based on available index information.

[3] Indices are computed by Sprott Asset Management based on publically available index information.

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