SPROTT FOCUSED STRATEGY

Global Market Update April 2017

Market Update

Geopolitical events remain the number one risk in 2017, and Q1 featured some major risks of this nature. We began with the inauguration of a new US President in January, followed by elections in the Netherlands, a rate hike from the Federal Reserve Bank, the formal triggering of Brexit, a surprise call for UK elections, and finally French Presidential elections. Each of these events had the potential to derail market momentum however, each one broke favourably and took markets higher.

A growing divergence between "hard" (sales, lending, jobs) and "soft" (surveys on hiring and sentiment) data has begun to worry investors. While optimism is up and businesses are ready to invest in people and productive capacity, they have yet to actually do so. It is unlikely that corporations are going to invest in their Chinese or Mexican supply chains if they believe that the government is poised to materially reduce the utility of that supply chain. Business owners in the US have witnessed political gridlock for six years and are loath to invest based on the promise of tax cuts, deregulation and additional fiscal stimulus. The initial Obamacare repeal setback only reinforces the idea that Washington is "broken". Soft data tends to be more volatile (opinions change more and faster than capital allocation) so it's likely that the currently bullish soft data will moderate and come back to the more sober hard data.

Fund flows have continued their long-established trends in Q1. Globally, equities have taken in $118B YTD with International Funds ($45.8B) leading the way. US and Japanese funds continue to attract assets but it is the European funds that have experienced an acceleration in flows subsequent to recent election results. We would expect this trend to continue and drive returns as well.

Dennis Mitchell
Senior Vice-President,
Senior Portfolio Manager

"A growing divergence between 'hard' and 'soft' data has begun to worry investors."

Portfolio Update

Since the start of the year, the Sprott Focused Global Dividend Class has reduced its exposure to Canadian and US equities and increased its exposure to European equities. Europe has been a value trap for four years as the promised EPS growth has not been delivered. We see the capital recovery in the financial system as the catalyst for greater lending, hiring and consumption in the Eurozone. This upcycle should see EPS growth finally materialize and drive multiple expansion and returns.

> "We see the capital recovery in the financial system as the catalyst for greater lending, hiring and consumption in the Eurozone."

The Sprott Focused Global Dividend Class has initiated new positions in Affiliated Managers Group, American Tower, Ameriprise Financial, Carrefour, Credit Agricole, Crown Castle, Western Digital and Xylem. Against this, the portfolio has exited positions in Bank of America, Cisco, Discover Financial Services, Safran, Starbucks, US Bancorp and Waste Management. Top contributors to the fund YTD include Cineworld Group (up 33.0%), Alphabet (up 19.4%) and Dufry (up 33.5%) while top detractors include Ameriprise Financial (up 1.4%), Safran (up 1.9%) and Discover Financial Services (down 8.2%).

Cineworld is the largest owner/operator of cinemas in the UK with a footprint in Eastern Europe. Operations have benefited from a recent acquisition and a strong 2017 film slate, while the 2018 film slate is even stronger. Alphabet continues to see paid click growth in excess of cost per click decline. The firm continues to see margin expansion as proprietary Google sites generate more revenue and traffic acquisition costs as a percentage of revenue appear to have plateaued. Finally, Dufry is the largest duty-free travel retailer in the world with a 24% market share. They have fully integrated World Duty Free and have seen a recovery in organic growth and passenger volumes. China's HNA Group has also offered Temasek and GIC a significant premium to purchase their combined 16.8% holdings in Dufry.

We exited Discover Financial Services at a material gain as we reduced our Financials exposure in light of the growing soft/hard data discrepancy. US financial services companies have appreciated dramatically since the US Presidential election on the promise of deregulation, NIM expansion and loan growth. Against this we observed Discover's strong loan growth but increasing provisions (for bad loans) and decided to exit this position.

> "We exited Discover Financial Services at a material gain as we reduced our Financials exposure in light of the growing soft/hard data discrepancy."

The Sprott Focused US Dividend Class has initiated new positions in Affiliated Managers Group, Ameriprise Financial, Western Digital and Xylem. Against this, the portfolio has exited positions in Bank of America, Cisco, Discover Financial Services, Nike, Starbucks, US Bancorp and Waste Management. Top contributors to the fund include Alphabet (up 19.4%), Allergan (up 18.6%) and Visa (up 19.1%) while top detractors include Ameriprise Financial (up 1.3%), Berkshire Hathaway (up 3.1%) and Discover Financial Services (down 7.9%).

Allergan is a growth pharma company that was hurt by the Treasury Department's crackdown on serial inversion companies last year. The stock has recovered dramatically as they have completed the divestiture of their generic business and made several high growth acquisitions. Hilary Clinton's loss also means the Treasury Department is less likely to pursue its inversion crackdown. Visa has completed the integration of Visa Europe and global payments volumes continue to grow at 12%, fueling high teens EPS growth.

In general, we exited US banks at material gains as the stocks had performed very well since the US Presidential election. They have gone from trading at 10x 2018 EPS and 1x TBV to current levels of 13x and 1.3x respectively. Again, on the promise of things to come (tax cuts, deregulation, NIM expansion and loan growth) instead of actual operational performance. We agree with the reduction in risk premium across the sector, but now see valuations reflective of normalized earnings and so have reduced our exposure.

At the start of the year, we saw value in Canadian Energy names and added some exposure in both the Focused Global and Focused US Dividend Classes. However, the breakdown in oil prices motivated us to sell these positions at a loss and redeploy capital. Of the six Energy names we owned during the year, the average weight in the portfolio was between 9bps and 71bps. So while their contribution to returns was more negative than some of the other detractors we highlighted, the non-core nature of the allocation and short duration of the investment leads us to highlight other detractors with higher average weights.

Portfolio Outlook

We expect that the soft data will moderate and come back to meet the hard data, which supports US GDP growth of 2.5% and global GDP growth of approximately 3.0%. Both are decent numbers in recent times and should support current equity market valuations. Corporate earnings growth has been particularly strong this quarter and we would expect value equities to benefit in the US, and European equities to benefit globally. We expect the Federal Reserve Bank to raise rates twice more this year, likely at the June and December meetings, with the potential for a September rate hike if tax reform is delivered by August for 2018 implementation.

Finally, the political calendar looks favourable for the rest of the year. The Conservatives should trounce Labour in the UK elections and Merkel and the Christian Democrats should prevail over Schulz and the Social Democrats, though I'm not sure anyone outside of Germany can tell the difference between the parties. The biggest portfolio adjustment is likely to be our continued rotation into European equities as Eurozone earnings recover and valuations justify increased allocations.

"The biggest portfolio adjustment is likely to be our continued rotation into European equities as Eurozone earnings recover and valuations justify increased allocations."

Thanks and **stay focused**,

Dennis Mitchell
Senior Vice-President,
Senior Portfolio Manager

www.sprott.com

Sprott Asset Management LP: Toll Free: 1.866.299.9906. DEALER SERVICES: RBC Investor & Treasury Services: Tel: 416.955.5885; Toll Free: 1.877.874.0899.

0517253 05/17_SAM_WP_DM_E