THE MACKIE WEALTH GROUP

THIRD QUARTER 2015 MARKET UPDATE
OCTOBER 2015

3RD QUARTER NOTE: MANAGING THROUGH VOLATILITY

INDEX RETURNS (LOCAL CURRENCY)	3rd QUARTER	YTD 2015	3 YR. ANNUALIZED
S&P/TSX	-8.6%	-9.1%	2.6%
S&P/TSX Venture (small cap)	-21.9%	-24.6%	-26.7%
S&P/TSX Materials	-24.9%	-25.1%	-23.7%
S&P/TSX Capped Energy (XEG)	-18.0%	-23.8%	-14.3%
S&P/TSX REIT	-4.0%	-6.0%	9.1%
S&P/TSX Financials	-8.6%	-9.1%	2.6%
S&P 500	-6.9%	-6.7%	10.0%
Euro Stoxx 50	-9.5%	-1.5%	8.1%
England (FTSE)	-7.0%	-7.7%	1.8%
MSCI Emerging Markets	-18.5%	-17.2%	-7.6%
TMX Universe Bond	0.1%	2.5%	3.4%

COMMODITIES	3rd QUARTER	YTD 2015	PRICE USD
Natural Gas (NYMEX)	-14.9%	-16.9%	$2.52
WTI Crude	-25.4%	-22.4%	$45.09
Gold	-5.0%	-6.0%	$1,115
Silver	-7.2%	-7.7%	$14.52

CURRENT YIELDS	CURRENT	ONE YEAR AGO
2-yr Gov Cda	0.52%	1.12%
5-yr Gov Cda	0.80%	1.63%
10-yr Gov Cda	1.43%	2.15%
2-yr Treasury US	0.63%	0.57%
5-yr Treasury US	1.36%	1.76%
10-yr Treasury US	2.04%	2.49%
US/CAD spot	**1.34**	**1.11**

Source: Richardson GMP, spindices.com, Thomson

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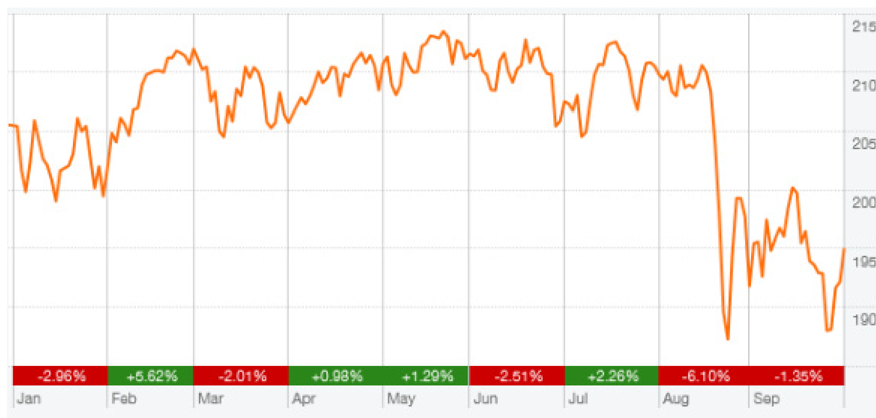
Volatility is back

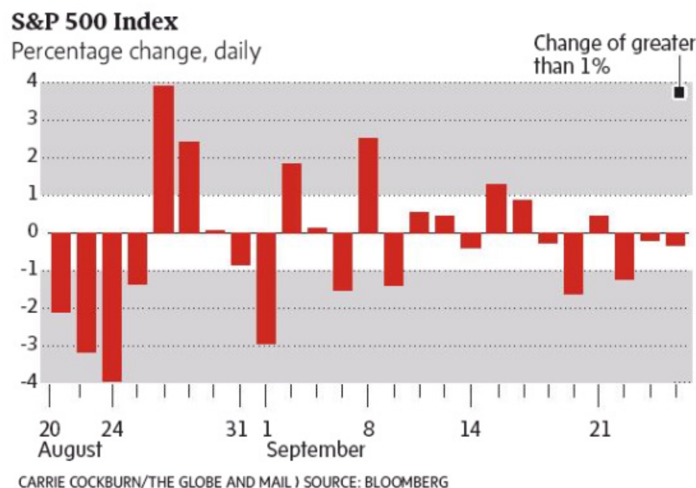
We hit multi-year highs in the U.S. markets in July, and the TSX peaked out in May, around the time when oil was touching $60 per barrel. This was followed by a choppy summer, which concluded with one of the most dramatically volatile days ever in stock markets on August 24. After a plunge in Chinese markets overnight Sunday August 23 our time, the markets in Europe then North America crashed at their openings when massive “sell at market at open” orders built up. This day was the largest drop for the Dow Jones in its history in such a short time frame: 1,100 points down in 6 minutes, a 6.6% loss in value. Today, more than 50% of U.S. stocks are trading at 20% below their July peaks. Canada is similarly dragging, with our core sectors of energy and mining down generally over 30% from May peaks. Even the banking sector is down 10% from its spring peaks. Yields on 10 year U.S. treasuries are today at 1.99%. Several European sovereign 10 year debts are trading much lower, and in some cases, at negative yields. Even select European new issue corporate bonds are raising money with zero coupons. Investment grade corporations and governments are effectively able to borrow for free. This abnormality is reflecting the current investment sentiment that, for now, protecting capital overrides achieving acceptable rates of returns on capital. Investors in longer term investment grade corporates and sovereigns are locking in certain negative returns after taxes and inflation.

S&P 500 (SPDR S&P 500 ETF Trust) 2015 year to October 2



Source: Globeandmail.com

If you feel like the market seems more volatile than usual, you’re right. More than half the days between August 24 (flash crash day) and September 24 had S&P 500 moves of 1% or greater. For the same period last year only one day had such a move:



Volatility is back for a number of reasons, the main ones being:

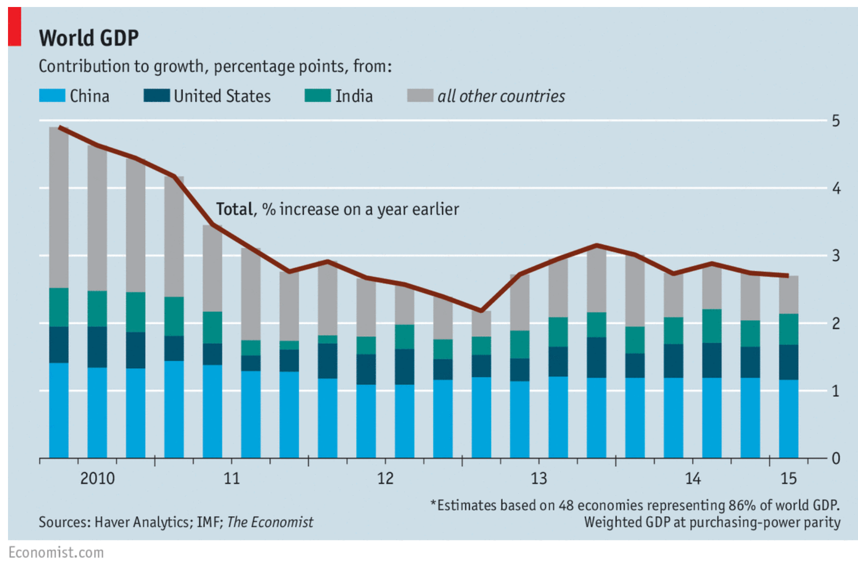
- Concerns around China's slowing rate of growth
- Emerging market weakness: much lower currencies and high rates of inflation in some, and U.S. dollar denominated debt a burden. There are emerging markets to be avoided, but some are benefitting from low energy inputs.
- Extremely low, even negative interest rates combined with uncertainty over equities and bonds.
- The Fed's intention around interest rate hikes and what effect that will have on markets
- Divergence of monetary policy. The Fed against everyone else. The Fed is tightening while other regions still need to stimulate weaker economies with looser monetary policy.
- The very strong U.S. dollar against almost all currencies is broadly affecting the profits of large U.S. internationally diversified companies.
- Increasing role that computer based trading plays in volumes and market direction, making it very difficult for traditional investors to understand true value and demand for stocks. Program trading is thought to make up most of the daily trading volume in equity and commodity markets now. The trading is tied to the proliferation of passive index and ETF strategies in recent years. There are $2.1 trillion in ETFs on U.S. markets now, up from $826 billion five years ago.
- Incidents like the major commodity trader Glencore plunging in value these past weeks, leading to fears around solvency and contagion – Glencore has been working to assure markets they are solvent. Large and heavily indebted commodity businesses (and countries, think Brazil) are generally vulnerable.
- Record margin debt to borrow stocks was recorded in April (NYSE statistic), borrowing levels have come down somewhat with the pullback in markets, but high margin debt makes markets more sensitive to changes in sentiment; bond and equity funds saw markedly higher outflows in the last week of September, pulling $8.4 billion out of bond funds and $6.3 billion out of stock funds.

We think much of the instability will smooth and will improve in the sectors in which we are invested over the coming year, particularly once the market has certainty of a rate hike by the Federal Reserve. In the near term, the market should continue to be challenging, as the above concerns are digested by market participants. However, we still believe stock markets provide appropriate long term return rewards for taking the risk of investment. Valuations are more in-line now and many stocks at current prices provide opportunity when considering long term earnings growth potential. We are also maintaining or adding to top of class externally managed funds that can short sell, pair-trade, use options strategies that are aimed at taking advantage of stock market volatility and create portfolio stability even in otherwise turbulent times. We are continuously monitoring these funds and looking for new opportunities to ensure we are sourcing managers that provide superior risk-adjusted returns. We also plan to hold on to investments that give us exposure to the U.S. dollar as a source of return for Canadian investors, particularly into the October election.

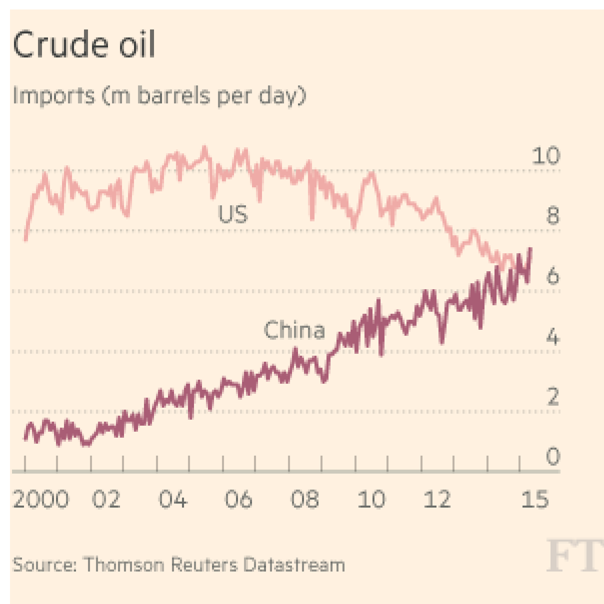
China: why it matters to some, not as much to others

- China is the second largest economy in the world, driving about a third of global growth, far larger than a decade ago.
- It is the world's second biggest importer (after the U.S.), driving demand for commodities. They are also a large driver of specific manufactured products like aircraft, luxury vehicles and goods.
- The published rate of growth has slowed from double digits to 4-6%, and markets are digesting what impact that will have globally.
- Much of the emerging market angst was led by China this summer, after its domestic stock market plunged 40% from its peak values this summer, creating ripple effects across equity and bond markets as margin calls created a ripple effect of broad forced selling.

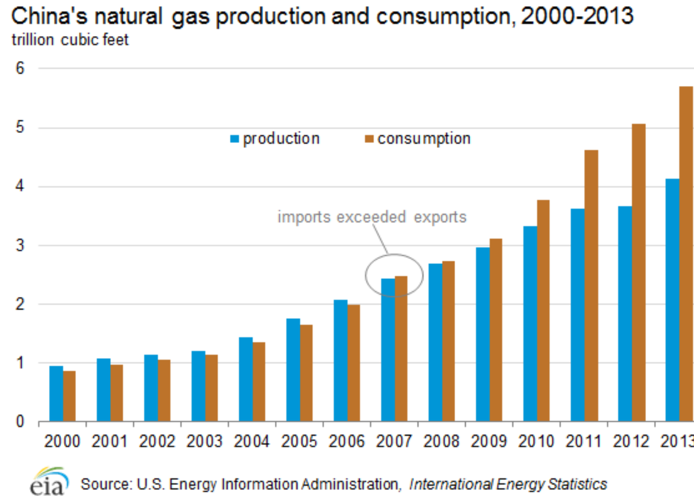
- China is devaluing the yuan, to protect their export market, and the concern is they will also be exporting deflation to the world. They are also loosening the tie to the USD, with the goal of becoming a recognized reserve currency within a couple of years.
- China is loosening monetary policy to stimulate domestic consumer and property markets – there are early signs this is working. By example, interest rates were lowered, purchase taxes on small vehicles cut, and first time home buyers required deposit was cut from 30% to 25%. Consumers are the most confident that they have been in over a year (ft.com, Westpac-MNI monthly survey).
- China mainly imports goods that are used in the manufacturing process- they are turned around and re-exported. Commodity export nations are most affected by a slowdown in demand: Canada, Australia, Russia, and Brazil. Geographically close Asian trading partners are affected; but Europe and the U.S. have limited direct exposure.



- A much larger economy growing GDP at 4-5% is still significant for global demand, versus the catastrophic interpretation from the panic sellers in August. For example, as of last year, China became the world's largest net importer of petroleum and other liquid fuels:

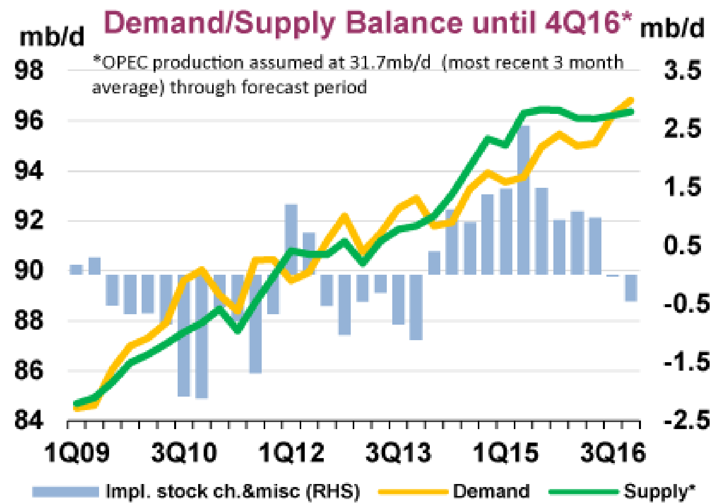


Other energy consumption continues to grow as the economy expands:

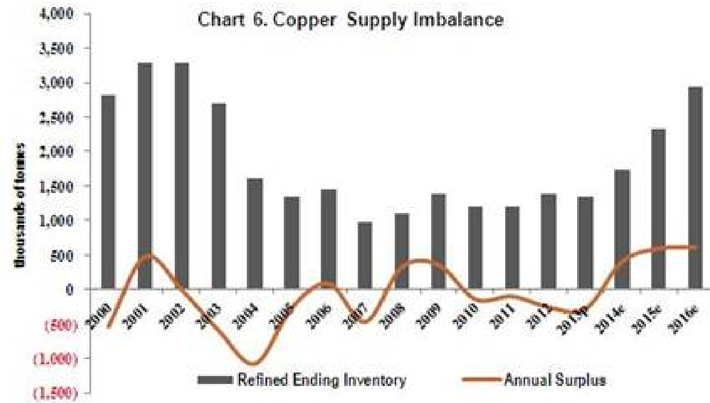


Commodities: it's mostly a supply issue, not a demand issue

- The commodity super-cycle is over, not because the world is using fewer commodities, but because they broadly are being overproduced owing to dramatic changes in technology (oil and gas), and access to very cheap capital as a result of aggressive quantitative easing programs and near zero interest rate policies. Over the last several years, capital was drawn to ever riskier investments, trying to achieve above average investment returns. As a result, in the commodity space, many more mines and resources were allowed to be developed than the market could bear from a demand perspective. In some cases, production looks like it may be peaking and rolling over, but now in the face of potentially big increases in efficiency of use, particularly in transportation, with new electric and plug in hybrid cars showing efficiency gains of as much as 75% over pure internal combustion.

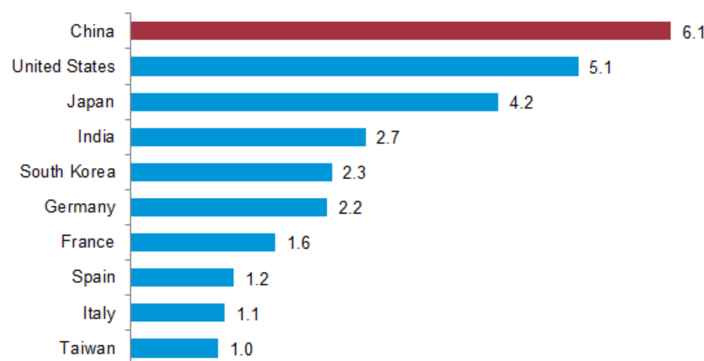


Source: IEA.org



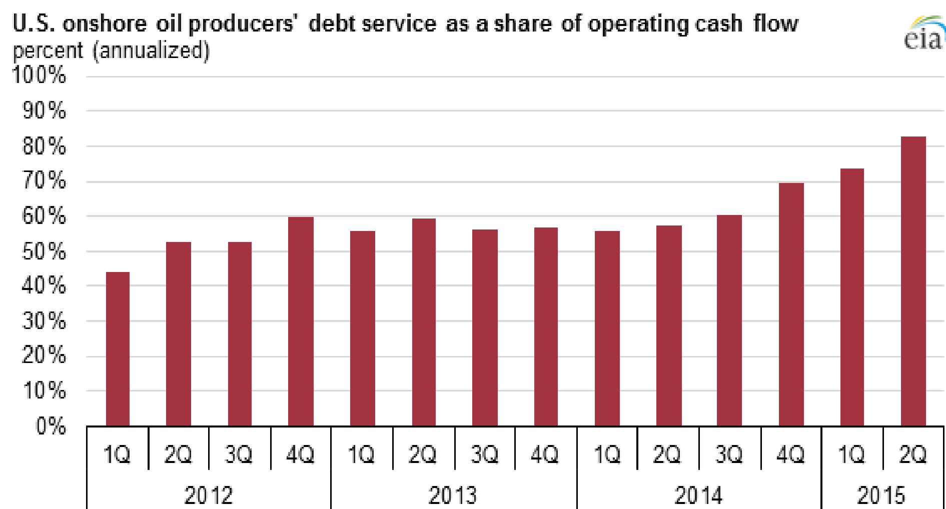
Source: Kitco, ICSG

- Commodity prices peaked in 2011, and billions of investment dollars went into mining through 2012 to expand output.
- We are now working through the destructive process of rooting out misallocation of capital and driving weak projects out of business, which will reduce supply over time and re-balance markets.
- Note that oil and gas development has structurally changed: reserves are accessible at ever cheaper development costs, and new exploitable reserves still being discovered, and many of them much closer to large markets than historical basins. Mexico is starting to explore in its portion of the Eagle Ford shale this year; China is just shale gas exploration, and has huge potential reserves. It is on track to produce 600mmcf/d of shale gas by the end of 2015; other countries are exploring shale gas and tight oil possibilities.
- US. commodity consumption peaked in around 2005, but emerging market growth is still creating overall growth in demand, just at a lower rate than how fast supply is coming on.
- China overtook the U.S. to become the world's largest importer of oil this April, hitting a new high of 7.4 mm barrels a day. Note that cheaper oil prices are a huge stimulative benefit for a commodity importing and manufacturing nation like China. China saves $2.1 billion annually for each $1 drop in the price of oil. (economist.com)
- Globally, many economies benefit from cheap energy. In fact, large run ups in the oil price almost always precipitate a global recession, and pullbacks generally precede general growth. When oil was priced at $115 per barrel, the yearly trade in oil was $3.8 trillion; at $50, it is $1.6 trillion. Oil importers benefit from that transfer of $1.6 trillion. Nations like Canada lose out on that transfer of wealth and profit. Top importers below:



Given structural impediments to the oil and gas industry in North America, we remain generally cautious and select on investments here:

- Oil and gas supply can keep growing as technology improves and costs of production continue to fall.
- The cost structure of the industry will change in Canada to remain competitive with the U.S.: i.e., fewer jobs, lower paying jobs, higher cost projects shut in, better and better technology changing the business. For example, Suncor predicts that it will replace all of its drivers of large mining trucks with robots within five years, affecting potentially 800 heavy-haul truck operators earning an average of $200,000 per year (Financial Post, June 8, 2015).
- Large resources are unavailable for foreign buyers now in Canada; eliminating much of the potential for companies being taken out at premium prices, slowing the traditional progression of recycling investment into new development projects – the business cycle and companies who can develop resources now has changed for oil and gas.
- Canada has limited its ability to access foreign markets to buy our product because of the systematic blocking of oil pipelines and export terminal projects at the same time that our only buyer is producing more and more of its own hydrocarbon and using less of them; we limit profitability potential because of this.
- Changes in political leadership also make domestic and foreign investors nervous about future profitability – access to development capital will be more challenging.
- It is possible that oil markets may become balanced by the end of 2016, as analysts are now predicting. Access to capital and overly stretched balanced sheets may cause companies to shut in production. Still, the oil price will likely be capped around U.S. $60 per barrel for the foreseeable future as the cost of production has come down enough to incent more volumes to come on or idle wells to be tied in at that price.



Investment themes

Investments in Canadian equities will focus on those with growth outside of Canadian markets, as we believe that domestic consumption should be low or slowing, and any business directly or indirectly dependent on commodity prices will still have headwinds or low rates of growth.

The U.S. still the strongest economy: valuations are not cheap, but pulled back significantly over the summer. We look for equities that are in areas of growth and innovation; benefit from cheap energy; and a strong domestic consumer.

Lower expectations on bond returns. Bond prices were bid up as investors chased yield and stopped properly pricing risk. High yield bond indices are down about 8% year to date (see HYG- U.S. for an example), negating the returns that investors will receive from the income. From here, junk bonds will continue to be volatile in a market that swings between risk on/ risk off. High quality long term bonds now have too low yields, and their prices will be extremely volatile when interest rates increase. We are focusing on shorter duration, higher quality, and active managers that can trade to provide returns.

Holding cash as a large portion of an investment portfolio is untenable for the long term. At 0.5% annualized risk-free interest rates in Canada, savers are, with certainty, losing the value of their money over time. On both a pre- and after-tax basis, the return is far below the rate of inflation.

Several different types of strategies are required to make portfolios move ahead and protect them in an environment of continued volatility and overall lower expected returns from equities and bonds. Some diversification away from long-only trading in the basket should continue to be a benefit.

Sincerely,

Tricia Leadbeater
Director, Wealth Management
The Mackie Wealth Group

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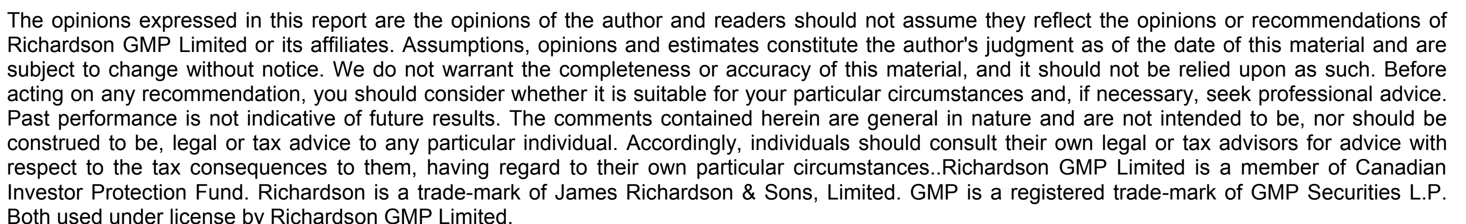

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