RICHARDSON GMP

Panic with the Herd or Invest for the Long-Term

Over the last twenty years there have been too many bubbles and too many crises in financial markets. Investors have been trained to sell quickly and heavily when anything sounds like it might be bad. In the last three weeks, investors have exhibited this learned behaviour of panic selling. But what is the current crisis? Two common suggestions are China, and the low price of oil.

China

Things are changing in China. It has grown from an economy with GDP expenditure of U$1.3 trillion in 2000 to the second largest economy in the world at U$11.3 trillion last year. The recent headline for China is growth of 6.9% year-over-year for 2015. Then the comment, "the slowest growth rate in 25 years". Well of course it is. And the percentage gain will keep getting smaller as the economy gets bigger. Fifteen years ago in China, a U$250-$400 billion increase in GDP in a year translated into a 10-12% growth rate after removing inflation (real growth). Last year, the Chinese economy grew by a trillion dollars! But because the economy is eight times bigger than fifteen years ago, and the growth rate is stated net of inflation, it seems that things aren't so good. They grow over half the size of the entire Canadian economy every year! With that kind of growth there are issues with real estate, changes in commodity demand, and monetary policy. But whatever little piece of financial data you want to wrap the 1.4 billion people of China in, the bottom line is that the Chinese economy is large and growing. The Chinese economy had GDP that was 6% of the size of the U.S. economy in 1990. It now has GDP 60% of the size of the U.S. economy.

One key change in China is the movement from the yuan being a pegged currency to the U.S. dollar, to more of a floating one. The yuan was recently included in an IMF currency trading basket, putting the yuan in the same league as the dollar, yen and sterling. China has large U.S. dollar reserves and its currency has traded at an estimated 30% above purchasing power parity relative to the U.S. for a long time. The Chinese authorities have a significant influence in the value of the currency by being a buyer and seller of their currency in the open market. They have signaled the intention to depreciate their currency relative to the U.S., just like nearly every other country in the world is doing.

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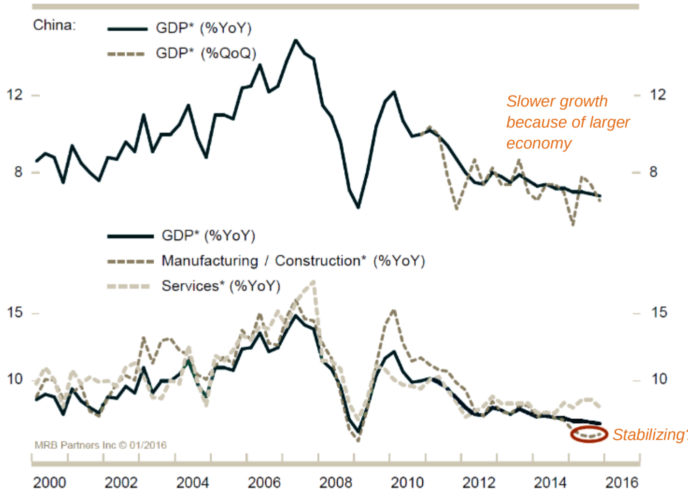
The depreciation of the yuan is suggesting to some that the export economy in China must need significant stimulation in order to remain competitive. Cynics suggest the devaluation as evidence that China's economy must be weaker than we think.

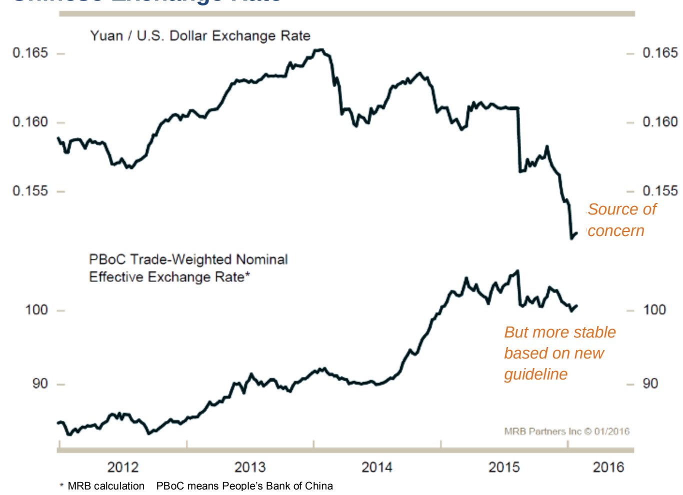
Since speculators and currency traders believe that the yuan will devalue, they have been selling it, enhancing the speed of the currency's adjustment. Movements are quicker and deeper in the yuan than the government wants. So it has been entering the market heavily by buying yuan. There is a struggle between the authorities wanting a slow and orderly decline and traders wanting to profit on a potential longer-term trend quickly.

To my thinking, the devaluation of the yuan is a long-term inevitable thing. It is too expensive. And as I discussed previously, the growth rate in China will likely never return to the double-digit pace because the overall economy is too large. The Chinese don't even have a goal of double-digit growth. They are simply trying to become a significant economic power and build their own domestic consumption. A striking change in China has been the movement from close to half the economy involved in mining and resources in 2000 to over half the Chinese economy today involved in services, while dependence on resources as a percentage of the economy continues to fall.

Chinese GDP Growth



Chinese Exchange Rate

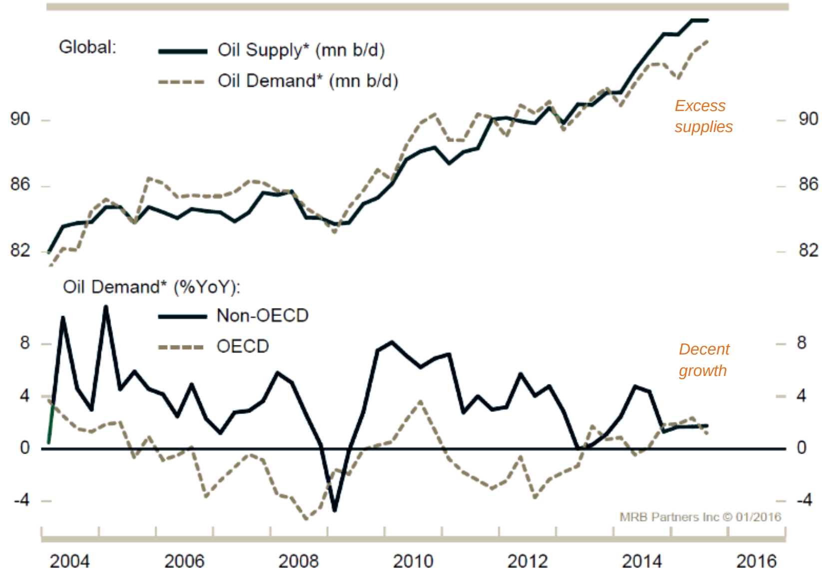


Oil

Oil prices are very low. Falling from over U$100/bbl twenty months ago to below U$30/bbl today was completely unexpected. Oil moving from a U$20/bbl average for previous decades to a U$95 average between 2008 and 2014 caused massive investment in the energy sector, particularly in North America. Projects which were historically uneconomic such as shale oil and oil sands became highly economic, and billions of dollars were spent on their development. Some thought the U.S. might become oil self-sufficient before 2020. The problem was that with oil at an expensive $95/bbl, demand growth didn't keep pace with the significant supply growth as more and more large and significant production projects started to produce. This was enhanced by unrest in the Middle East, where Saudi Arabia was facing an eroding market share in oil as new high-cost producers were brought into the fold. Higher production in Iraq and other Middle Eastern states also occurred to fund war and rebuilding efforts. This year, Iranian production is expected to increase.

All this new production has caused record levels of crude inventories, while at the same time a significant gap in supply above demand persists. Production decisions in North America are done at the individual company level; they don't behave like OPEC or sovereign states who historically made production decisions that would influence the commodity price itself. Drilling activity subsided in North America over the last year, capital commitments to energy products has significantly reduced, and natural production declines from existing reserves has taken place. But it has not represented a material enough reduction in supply as of yet.

Global Oil Supply and Demand



* Source: U.S. Energy Information Administration (EIA)

The good news for energy producers is that low crude prices is producing a predictable effect – demand is rising. In time, possibly even in one to three years, demand could be much closer to supply levels and possibly exceed it. At that point, energy prices could be volatile to the upside.

In the shorter term, the problem is that the cost of production exceeds the revenues. For some companies, money is lost for every barrel produced and sold, particularly for newer and high cost wells. The longer oil prices stay below the cost of production, the more companies will be forced into bankruptcy. Well capitalized energy companies will pick over the bones of those without the capital to last through low prices. Strong companies that acquire new production too early may face eventual bankruptcy themselves if they acquire high cost production while commodity prices persist for too long at low levels. It will be a challenge acquiring assets at the right time - both for energy companies and for investors.

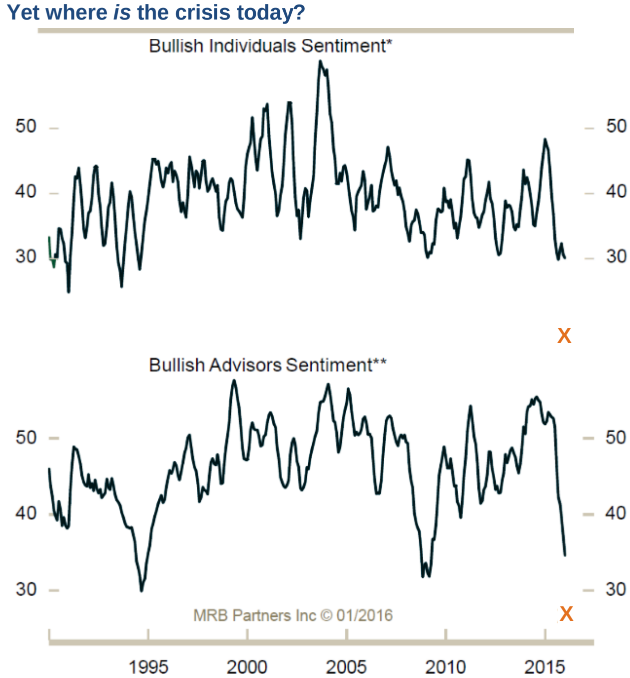
Normally, oil being low is a stimulus. It's like a tax cut. It helps energy consuming nations like Europe and the U.S. while hurting commodity producing nations like Canada, Australia, South America and Russia. It helps consumers buy more products from companies and it helps companies manufacture and sell products for less. However, oil prices have dropped so far, so fast, that investors are confused. Is the weakness in oil prices evidence of how weak global economies must be? I think that question is answered by seeing how strong demand growth is for oil. Low oil prices are a supply problem and not a demand problem. Caution, and maybe some confusion is warranted, but it doesn't make any sense to say that low oil prices are hurting the global economy. Canada, yes. Globally, low prices are a stimulus.

Portfolio Strategy

I enjoyed the Christmas and New Year's holidays. Recently I've been signing letters to clients accompanying their Annual Reviews, with returns often between 2-4% for 2015. It was a result lower than I hoped after being well over 5% and over 10% for growth-oriented portfolios by mid-year last year. The China-led drop in August (2015), led me to protective actions during September. The resulting heavy cash composition caused me to miss much of the nearly 10% jump in the U.S. markets in October. I seem to remember a lot of people telling me October is always a bad month. And I was fearful of what might happen in the Canadian election. Last year January, February, and October experienced significant returns – and my results were reduced by having too little in equity to share in the strength of the U.S. in October. **Missing that one month's returns was one reason that moved returns from a great year to only a mediocre one.**

After feeling pretty good for having a positive return for clients in 2015 by owning securities in the U.S. and avoiding energy, my smile faded at the start of 2016. It has been the worst start to North American stock markets in history. I had thought that the Federal Reserve's decision to increase interest rates in the U.S. in December (one month ago) was an endorsement of the strength of the U.S. economy. In October, there were 307,000 new jobs created and 257,000 in November in the U.S., which is the higher end of job growth, and well over the expected numbers. Unemployment claims today are at thirty-year lows. I can't remember one significant company that had trouble with earnings so far related to last quarter, and there were no memorable pre-announcements of earnings problems in December. Why doesn't the media talk about the underlying corporate earnings in the U.S.? Because is it positive. It doesn't fit with trying to explain why panic selling is going on. Things are great in the U.S. so the media focuses on oil being low and perpetuating confusion on what is going on in China because they seem bad, and seem to explain why things are falling. As I've discussed, they don't.

Investors' Panic at Worst Level in 25 Years
Yet where *is* the crisis today?



* Smoothed; source: American Association of Individual Investors
** Smoothed; source: Investors Intelligence
Note: X represents the latest data points

During the fall last year, equity was strategically reduced in portfolios while investment in hedge funds that have less volatility than the market and have no correlation to it was increased. This decision was implemented because the overall uncertainties in global markets had increased, and the hedging strategies in portfolios were producing reasonable returns. Due to the underlying strength of the U.S. economy, I deployed much of the remaining cash in U.S. stock at the end of the year.

Equity values in managed portfolios have dropped in 2016 along with the markets, but this drop has been partially offset by currency gains in holding U.S. securities. The greatest risk to the bull market seems to be sentiment.

I have not sold securities into this correction. Global uncertainty is perpetual, but in my opinion I don't see the crisis in this round of panic selling. For example, Disney is one of the larger equity holdings in the portfolio. The stock was around U$115 when Star Wars debuted. The success level of the movie, measured by sales, set records in many categories. Yet four weeks later, the stock is down close to U$90 – a U$25 loss based nearly solely on market fears despite the greatest entertainment success the world has experienced. I'm not going to give up my Disney stock while the company continues to post record earnings. A similar story of strong underlying earnings yet share price weakness exists for many of the U.S. stocks and sectors held (which are mainly in the technology and consumer sectors).

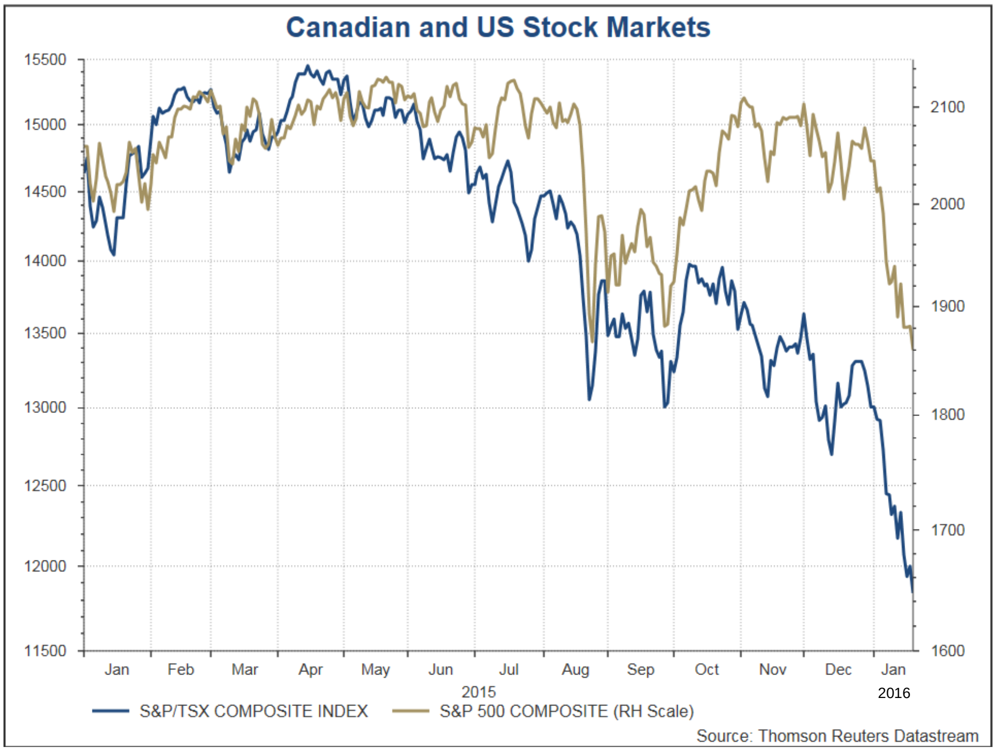
In Canada, managed portfolios are down to nine stocks. They are mainly defensive with a third of them being food companies. A utility, a telco, a bank, a toy company spun off from Toys R Us, and a global software company are all clients own in Canada. **I expect Canada to enter an energy-led recession this year.**

The U.S. is currently the fastest growing developed nation. I anticipate the historically strong election year of 2016 to be a good year to invest in American companies, and in the American currency. Seasonally, the most strength in the markets is typically after the Republican and Democratic final candidate is selected in April/May and the three or four subsequent months. Often investors start reducing equity positions a couple months before the November election.

My strategy has been to ensure fixed income positions are of high quality in the corporate bond space, and to have approximately 1/6 of portfolios in hedge strategies. **I intend to continue focusing on owning U.S. securities through the late summer for the growth portion of portfolios.** My resolve is currently being tested by emotional selling in financial markets. I will sell any security that shows a sign that its underlying earnings are weak. Decisions in accounts are driven by market events, and so I can't yet say whether we will continue to hold or if securities might eventually be sold. **My mandate is to meet the long-term income and investment goals of the clients I manage. I don't have to be right every day to achieve this – I just have to keep trying.**

Registered Accounts

With the start of 2016, new contribution room for registered accounts such as RSPs (Registered Retirement Savings Plans), RESPs (Registered Education Savings Plans), and TFSAs (Tax Free Savings Accounts) is now available. The federal Liberal budget has not been released yet, but the intention of the new government is to allow $5,500 of new contribution room for 2016. Cumulative contributions for TFSAs for adult taxpayers now stands at $46,500. This is a significant sum, especially between couples and can save meaningful amount of taxes over the long term.



We are proactive with managing investments for clients, but the transfer of funds between accounts for tax purposes requires client input. Let us know your intentions with your registered accounts each year including the sources of funding.

Please call if you would like to discuss the markets further. We have been meeting with clients for their Annual Reviews as well.

Regards,

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