RICHARDSON GMP

QUARTERLY OUTLOOK

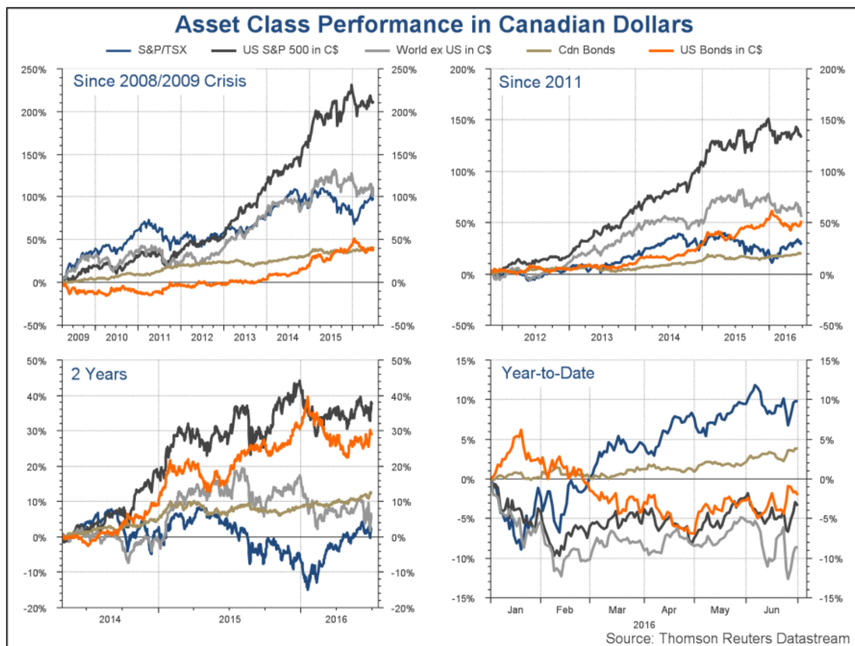
Second Quarter 2016

Best To Worst. Worst To Best.

Writing an investment manual for buying stocks and stock markets at the beginning of 2016 would have been simple:

1. Find out the long-term performance for securities.
2. Sell the best performers and buy the worst.

It's been a year for contrarians. This mantra works best around peaks and turnarounds, both in markets and individual securities.



The fundamental question is one of leadership. Has the leadership of U.S. and world stock markets ended? Has longer-term leadership of the Canadian markets begun? Is the return to energy and gold stocks (particularly the most speculative ones) a marker of investor foresight into economic strength? Why has U.S. consumer, health, and technology leadership stalled? What effect will low interest rates have going forward?

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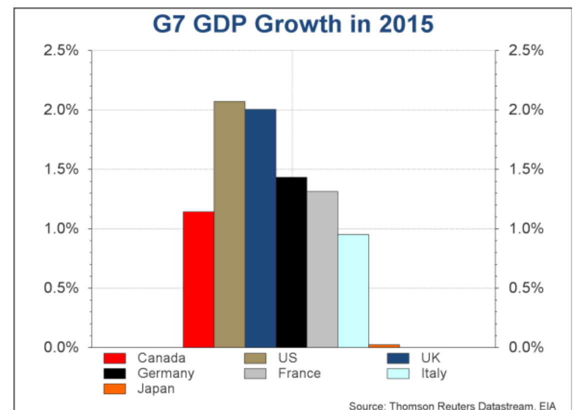
North American Setup for 2016

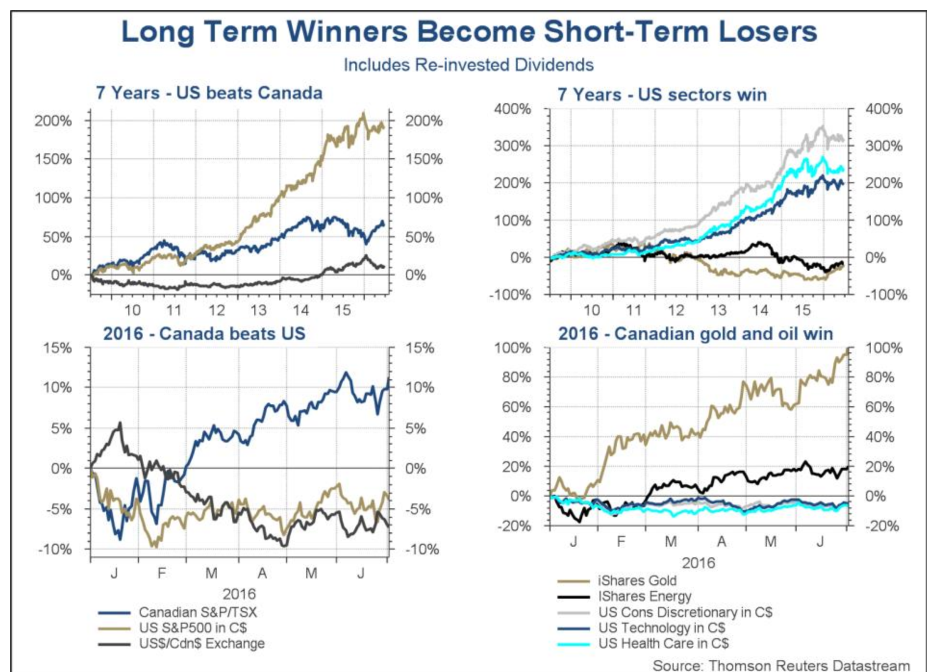


At the end of 2015, I was cautiously optimistic about equities in the United States. Both the United States and the United Kingdom had economies strong enough that central banks in those countries were expected to raise interest rates to slow the rate of growth and reduce the chance of future inflation.

Growth potential in the U.S. was so convincing that four rate hikes were anticipated in 2016 to slow it down. Moving interest rates up causes currency to rise as well, which would give Canadian investors additional profits from holding U.S. dollar-denominated investments. U.S. unemployment was at four-year lows, leading indicators were positive (although only barely so), earnings growth was expected to be better than 8% in 2016, and the housing industry continued to be strong. Historically an election year combined a strong U.S. economy has provided better than average stock market returns.

By contrast, at the end of 2015, the two-year 70% drop in oil prices to test $30/bbl level threatened to throw Alberta and all of Canada into a recession. It was uncertain whether global investors would applaud the newly elected Liberal government's decision to borrow money to invest in infrastructure, potentially increasing national debt by more than $100 billion over the next five years. Financial losses in the energy sector led to lay-offs for possibly one in every six persons directly employed by energy in Alberta.

2016 YTD Results



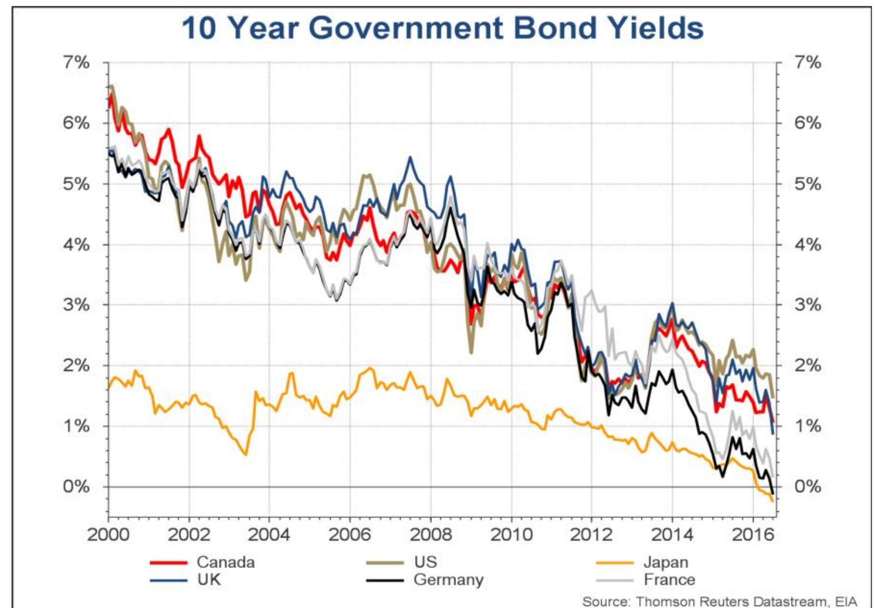
The U.S. dollar dropped 7% relative to the Canadian dollar, providing Canadians investing in the broad U.S. stock market with a 4% half-year loss. At the same time, the Canadian market rose 10%, propelled by investment in gold and energy. **This is not what I expected.**

Chinese authorities devalued their yuan unexpectedly the first week of the year, U.S. earnings were slightly weaker than forecast, and the U.S. Fed's position changed to no longer be likely to raise rates at all in 2016. Gold stabilized, then rose. There was fear of global recession, punctuated by fear of global growth being so severe that 10-year U.S. Treasuries fell to multi-decade lows of around 1½%.

After dropping 68% from the beginning of 2012 to the end of 2015, **gold stocks doubled** in 2016, providing more than half of the gains in the Canadian stock market average this year. From the end of June, 2014 to the end of December, 2015, the **energy index dropped 49%.** But it gained 19% in the first six months of 2016 to provide most of the rest of the overall year-to-date gains in the Canadian average. The advances in these two sectors are so large that the scaling on the chart above makes the **5-6% loss in each of the previously top performing sectors** hard to even notice.

Investment Expectations

Global interest rates stay very low. The Brexit vote highlights political uncertainty and the willingness to make significant economic changes. Altering terms of trade between the U.K. and the E.U. is expected to reduce the economy in the U.K. and make imports more expensive. The Bank of England has signaled it expects to decrease interest rates in the short-term to deal with uncertainty, but is likely to have to deal with rising inflation from higher import prices from the drop in the pound. The U.S. central bank as well as other global banks are likely to remain cautious because of the uncertainties around Brexit.



Uncertainty keeps valuations low. When investors are less sure about growth, they assign a lower valuation to investments. Low interest rates are stimulative, but this is offset somewhat by the reason they are low – lack of confidence in future growth. Continuous uncertainty reduces how much investors will pay for earnings. Consumer, technology, and health care stocks likely fell in price during 2016 because their valuations were above average from doing well for so long.

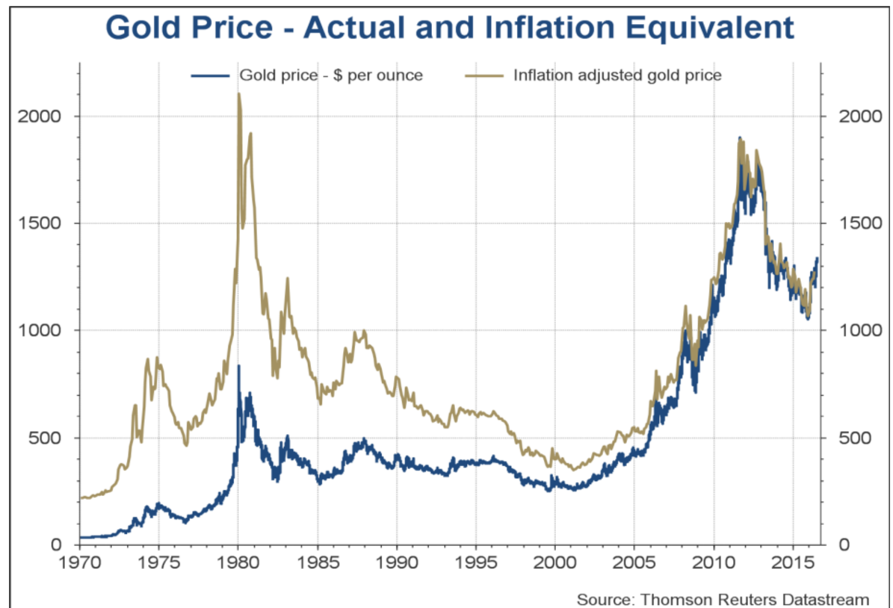
Value outperforms growth. Investors are not confident in future global growth. They have greater conviction in owning companies that have a lower, but more consistent growth rate, and are particularly attracted by a strong dividend policy. Price to earnings ratio is a good starting point for valuation. Energy companies are more commonly valued by looking at the net present value of existing and potential reserves at longer-term average commodity prices. By this measure, some energy companies are looking attractive.

Defensive sectors outperform. Utilities, telecommunications companies, and food stocks have several things going for them. Uncertainty and low global growth moves investors to companies that have more predictable and consistent earnings, even if those earnings are growing that much. High dividends paid to shareholders in these industries are extremely attractive in a low interest rate environment. Defensive sectors have been showing outperformance overall for two years, but in particular have been strong the second half of 2015 and in May and June of 2016.

Real estate provides income. Canadian real estate continues to benefit from low interest rates, immigration from Asia, Eastern Europe, and the Middle East. Western Canadian provinces attracted nearly 3 million people over the last 6-7 years from eastern Canada to fill jobs in the energy sector. But over the last year-and-a-half the trend has reversed. The contraction of the western energy industry and the potential for eastern manufacturing and exporting jobs in a lower Canadian dollar environment has made property and jobs in eastern Canada more attractive.

Real estate stocks are evaluated by the value of their underlying properties, their vacancy rate, their capitalization rate, and their ability to add value to properties acquired at lower values. Mortgage investment companies are also in this category. Canadian and U.S. banks who are facing greater regulation and a more pronounced aversion to risk have left a void in providing mortgages and financing to property developers. Private and public entities in this area are attractive because of their relatively high distributions and dividends, reasonably stable income, and underlying collateral.

Gold continues to rise. I have a hard time picking gold because of the lack of long-term profitability of gold companies. Gold reacts more to political, inflationary, and currency issues than it does to underlying supply and demand fundamentals. The cost of gold production is well below current levels, suggesting gold could move hundreds of dollars lower. But with global uncertainty so high, gold found a bottom after four years of decline and has been rising since January, 2016. Brexit highlights political uncertainty and divisive issues to be debated all over the world, relevant in many other countries.



Canada and Infrastructure. The Liberal government plans to spend money on Canadian infrastructure. This may benefit engineering, construction, and transportation companies, and possibly help utility and pipeline businesses as well. The U.S. dollar is likely the best short-term beneficiary of uncertainty in Europe. But as the U.S. election nears, Canada's relative political stability and lower overall market valuation may continue to fuel outperformance. Commodities also may be an attractive "fear trade" because of their lower valuation and the surprising resistance to the U.S. dollar climbing too much further.

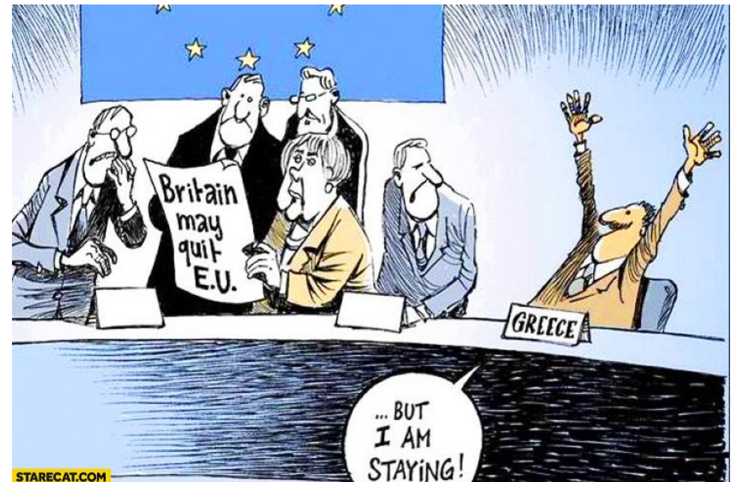
Hedge funds reduce the need to predict markets. The performance of hedge funds is based on their ability to identify outperforming securities and hedge those investments by shorting a similar security with far less or negative prospects. They make money by being right about the spread changing between two investments. It no longer matters to them which way markets go. My job is to evaluate a hedge fund for its ability to deliver results independent of market direction. This lack of correlation to markets as well as the risk reduction strategies hedge funds have allows portfolios to improve their consistency and reduce overall variability.

Three of the core five hedge funds owned across managed portfolios have been performing well. The two most conservative ones, both market-neutral have recently struggled. After a barely positive performance last year (which was okay given the close to double-digit loss in the Canadian stock market last year as comparison, but not great), one of them has lost 6% or so year-to-date and so has now been sold for lack of performance. The other, less held market-neutral hedge fund had strong performance last year, but is down 3% or so year-to-date in 2016. Hedge funds are an important aspect to portfolios but must be continually evaluated and changed to ensure performance and risk-reduction.

Importance of Cash. A major long-term potential trend change from U.S. outperformance in consumer, technology, and health care stocks to early outperformance in commodity sectors such as gold and energy may be occurring. Some cash needs to be held back while it is determined whether the trend change is real and whether it will stick or not. The occurrence of three shocks to the U.S. stock market prices in the last twelve months also argues to have cash available to take advantage of shock opportunities and to participate less in them when they occur. I was pleased to have a high cash balance during the Brexit crisis. But the market drop ended too quickly. There still may be some weakness in the markets related to Brexit fears to come. Earnings season begins in July and that can also lead to a few surprises.

Cash currently held is primarily American, which does have the potential to appreciate if investors become more cautious on investing in the euro or British pound in the short-term.

Musings on Brexit



People are upset. There is a growing divide between wealthy and poor. Technology continues to revolutionize industries and replace labour. Immigration, religious, racial, gender, sexual orientation, and many other issues lead to emotionally charted conflicts with entrenched viewpoints. People are globally exploring the values of equality versus tradition, individual choice versus group economies of scale, free trade versus protectionism, and so on. People are upset about being forced to change, or conversely upset about others not embracing change, or upset about not understanding the costs associated with various increasingly complex choices.

People are divided. Many issues have close to the same number of supporters on either side of the issue. Decisions aren't easy. This feeds into uncertainty continuing into the future as less and less people agree on anything. To statisticians, future outcomes are less likely to follow a normal bell curve. This means that "average" or "expected" results may become less common. Surprises outside of normal expectations may become more frequent. This can be positive or negative. For example, gold dropping 68% over four years, then doubling in six months illustrates how extremes both ways have occurred more often than an average result and that in some cases it was bad and in others it was extremely good. **This highlights the need to have investments that have low correlation to each other, to weather changes in the world more smoothly. It also highlights to become more comfortable with a higher frequency of unexpected results. Cash and active management can help deal with more market surprises.**

People want change. Changes means both uncertainty and opportunity. Uncertainty leads to lower valuation. Opportunity means the potential for above average results if the right trends are followed, but also below average results if markets change but a status quo portfolio is still owned.

Global population is on the move. A global economy has produced better communication, more knowledge, enhanced interactions between people, and facilitated easier geographic movement. People are moving from areas of relative hardship to wealthier places of opportunity, at an increasing rate. They seek more rights, more benefits, more privileges, more security, more control over their own destiny, and a better life. This includes a significant movement of people from eastern, lesser economies to western, more prosperous economies. This can displace individuals in areas considered globally affluent but who themselves are not particularly well-off. Individuals previously resident to areas hosting immigration can face greater competition for employment, strains on existing infrastructure and higher costs for developing new infrastructure. **This issue is likely to keep "people upset".**

Free trade has come under global scrutiny. Economics 101 teaches total global production is greatest when individual countries produce goods that are cheapest and most efficient for them to make. They export them in return for importing goods and services that are less expensive to create elsewhere. Eliminating globally higher cost production and jobs looks good on paper. But if you are one of the families affected by someone globally producing what you make better or cheaper, you will be out of a job. Tariffs, subsidies, and laws protect workers in globally less efficient industries, who are not willing to move for cultural, political, lifestyle, family, citizenship, and a host of many other reasons. It has always been challenging to find a balance between producing the most and cheapest goods versus maximizing personal lifestyle for people who are in reality far less mobile, or able to re-educate and change jobs than economic models suggest. **Reducing free trade should diminish global GDP. It often leads to higher costs for goods and services. A significant benefit might be *local* job stability.** Whether free trade agreements are renegotiated is yet to be seen.

What's Happening in Managed Portfolios?

It was a year of transition. Companies showing leadership for 4-7 years broke down. Currencies moved dramatically. Commodities that had been out of favour for years leaped ahead.

Cash was high by the end of June, 2016 – as much as half the funds allotted to equity in some accounts. This was mainly the result of selling now underperforming U.S. securities in April and May. U.S. cash positions are currently particularly high. This high cash position is expected to be reduced as discussed below, but some cash will be retained for taking advantage of shocks. The Brexit shock was too short to take advantage of in North America – so far anyway.

Fixed income continued to be a base of stability for investors. The strategy continues to favour Canadian corporate bonds. By mixing investment grade and high yield securities, a yield of 4-5% is expected. There was a reduction in some of the higher yield bonds owned in favour of longer-term government bonds for some clients. This move reduces credit risk and benefits from rates lower for longer. Two professionally managed global bond managers were added.

Hedge funds continue to provide stability and consistency. They have been reduced from close to 15% of portfolios closer to 10% because of the underperformance of one of them. In this broader category of Alternative Investments, companies that privately invest in or lend to real estate and real estate development are being considered to replace the sold hedge manager. Consistent results, income, and strong collateral and asset base are important.

Equity was positioned primarily in U.S. consumer, technology, and health care to a lesser extent at the end of 2015. This led to underperformance primarily due to the U.S. dollar falling. Selling of underperforming securities occurred as it became increasingly possible that a trend change had occurred. Canadian utilities, telco, and food companies are still owned. Additions in defensive sectors, yield-focused, and value stocks is slowly occurring. A reduction of U.S. dollar exposure is expected over the next few months in favour of Canadian equities. It's too early to speculate on entering Europe, although valuations are very low and attractive. I expect U.S. exposure including U.S. cash to end up around 35% to 40% of the equity part of portfolios, and some of these positions may become hedged to the Canadian dollar.

Regards,

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