RICHARDSON GMP

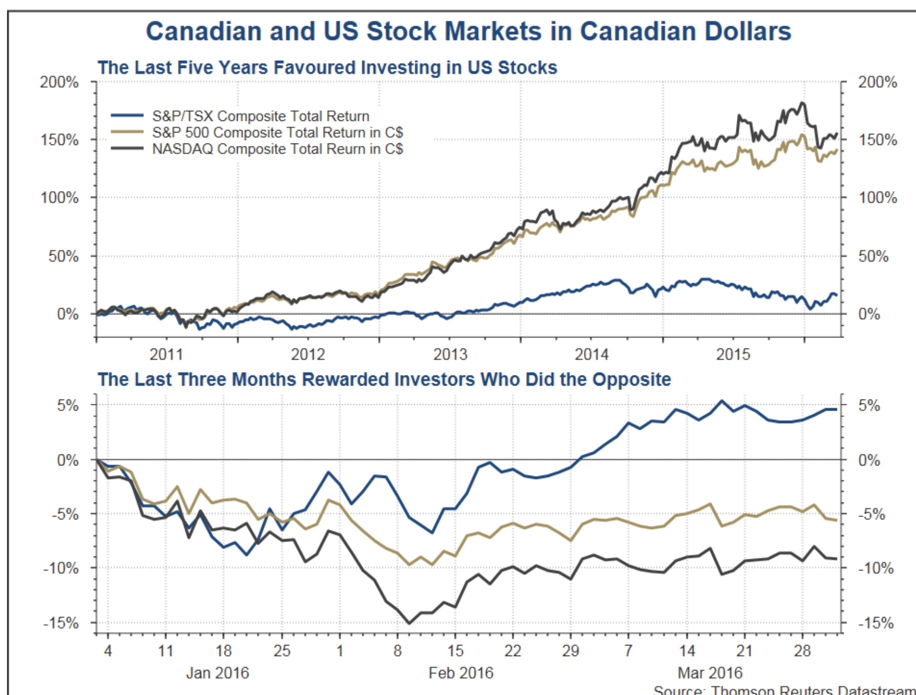
# QUARTERLY OUTLOOK

FIRST QUARTER 2016

## Currency Drives Performance

**The big winner was gold in the first quarter of 2016.** Canadian gold stocks were up 36%. More accurately they gained 45% in three weeks from late January to mid-February and lost value the rest of the time. The Canadian mining sector was the strongest performer, while Canadian defensive sectors like utilities, telecom, and staples also had sizeable gains. Canadian energy stocks averaged a 9% gain in the quarter.

**The U.S. dollar fell, intensifying losses on American stocks by an extra 3.2%.** Telecom and utility sectors in the U.S. were able to grow around 5%, after absorbing this currency loss. Nearly every other U.S. sector lost 5-10% of its value in Canadian dollar terms. Health care and financial stocks did the worst, losing 15% on average in Canadian dollars.

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## Making Sense of the First Quarter – A Story of Currency

**North American markets lost more than 10% of their value in the first three weeks of 2016. Half of it in the first week.** China devalued their yuan again while releasing softer economic data, and the race for the exits was on. It was eerily similar to the 2015 late summer panic shown by investors. The Federal Open Market Committee (FOMC) had cited economic growth and inflation pressures in the U.S. to be strong enough to raise interest rates at the end of last year. But investors disregarded the FOMC's positive outlook, and sentiment collapsed to its lowest level in decades. **Investors wanted a crisis.** The problem was, they couldn't find one.

**Three weeks into January, Canadian Bank of Canada governor Poloz made a pivotal decision** to keep the Canadian bank rate unchanged when it was widely expected that he would decrease it. He explained how decreasing interest rates would continue to push down the Canadian dollar further. The central bank was already seeing a stimulative effect on some components of the Canadian economy because the dollar was already low enough.

**The Canadian dollar reversed from touching as low as U$0.68 after Poloz's announcement**. It averaged U$0.73 within a week. It was then the U.S. FOMC's turn to make an announcement in February. The FOMC's prior December 2015 actions and comments suggested that interest rates in the U.S. were likely to move up as many as four times over 2016. FOMC chairwoman Janet Yellen expressed caution at this meeting. She suggested U.S. rates may only be increased two times during the year, and likely not in the shorter term. This extended the descent in the U.S. dollar, moving it to the U$0.75 mark relative to the Canadian currency. Doubts for any rate increase at all persist today.

**The final strength in the Canadian dollar came in the delivery of the Canadian budget, which revealed a significant amount of deficit spending.** It may seem that running a $30 billion deficit in 2016 and 2017 while committing to spend $120 billion on infrastructure over the next ten years might seem worrisome. But Canada still enjoys one of the best Debt to GDP ratios and Deficit to GDP ratios compared to other G8 nations. Moreover the spending on the economy seems welcome compared to many countries moving towards budgetary austerity. Canadian economic data had also been recently surprising to the upside.

**The significant rally in gold was sparked by a continuation of fears of a slowing economy and the FOMC decision to delay raising interest rates.** These factors caused the U.S. dollar to weaken, which gold moves inversely to. Normally investors buy U.S. dollars when they are fearful. Panicked investors had to buy gold and gold stocks instead because the U.S. dollar was already falling. After losing half its value in five years, some suggest that gold prices were due to bounce. But the price of gold is still well above the cost of gold production.

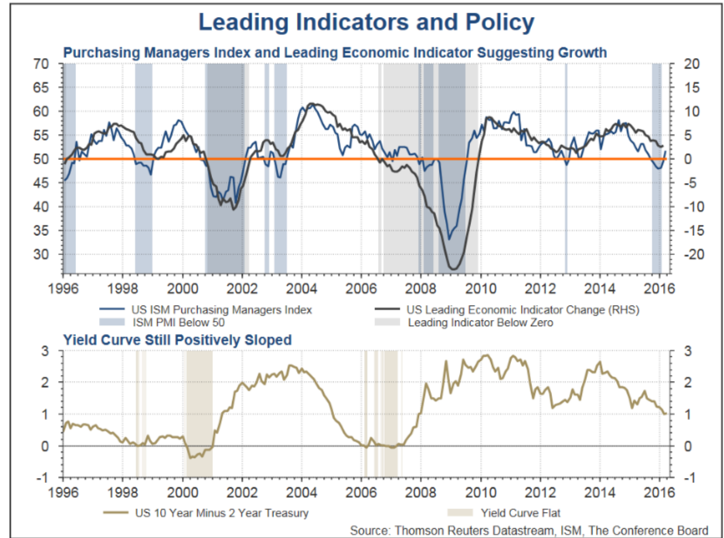
**The U.S. electoral process also seems to be having a negative effect on the U.S. markets as well.** This election seems to be characterized by uncertainty, extremism, and polarized views. Each candidate seems to pose real challenges to having voters accept them. Tensions appear greater than typical. There is a possibility uncertainty will diminish as it historically does when the Democratic and Republican presidential nominees are finally established in June. The U.S. stock market often historically then outperforms in election years.

**Fourth Quarter earnings reported during the quarter were generally on track.** They often met or exceeded reduced levels of expectations. There is no crisis in earnings. But future growth expectations for many companies are lackluster and are often trimmed down. This furthers uncertainty. On a positive note, there have been very few earnings warnings ahead of upcoming first quarter earnings to be announced in April and May.

**Why did commodity stocks pop upward 20-30%?** No real demand growth or economic strength reason. Perhaps the best explanation is a technical bounce - the value had just been pushed down too low, too fast, and for too long. Investors may need to look to the direction of currencies to help determine what is next.

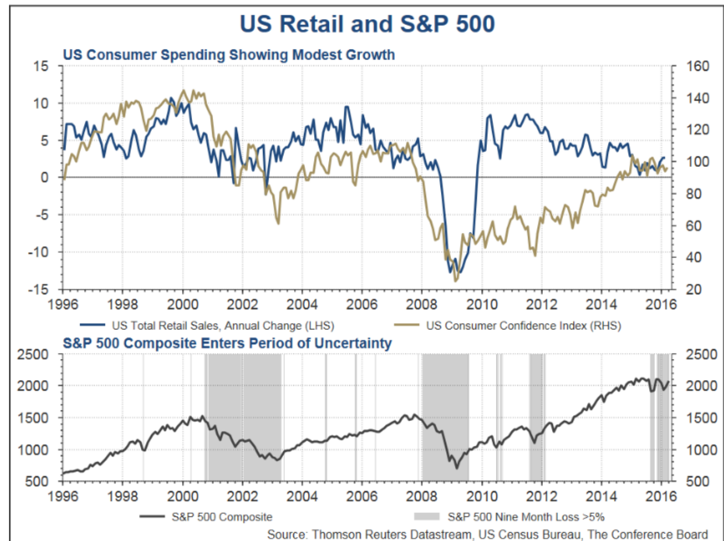
## The U.S. Economy is Doing Fine … But Not Fantastic

**Leading economic indicators shown to the right are providing expansionary readings,** although the ISM Purchasing Managers Index had dipped briefly below 50. Investors should be encouraged that both readings support expansion and that the ISM indicator has turned upward. They should also be cautious because the expansion level is close to neutral. <u>What investors shouldn't be, is either wildly optimistic or pessimistic</u>.



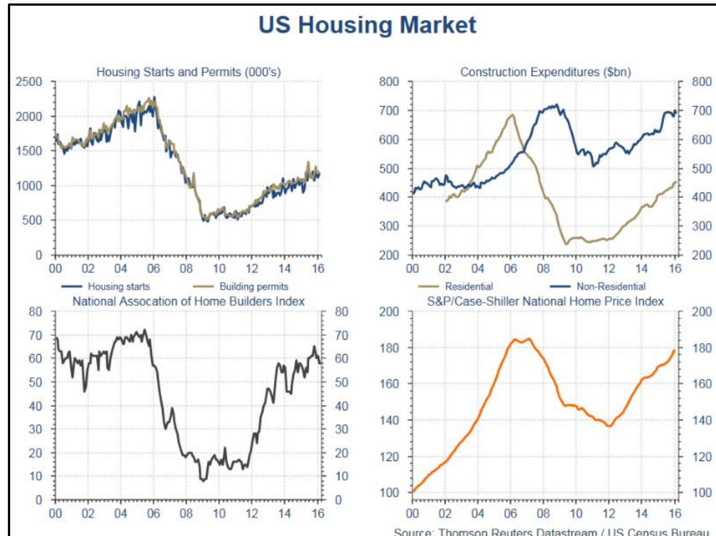

**Central bank interest rate policy is accommodative.** Recessions have been preceded by short-term interest rates moving up to yield the same as long-term rates, called a flat yield curve. The U.S. yield curve has been flattening, but is still positively sloped and stimulative.

**There is still growth in retail spending, and consumer confidence is still high.** But growth is slower than it has been in several years and confidence is fading.

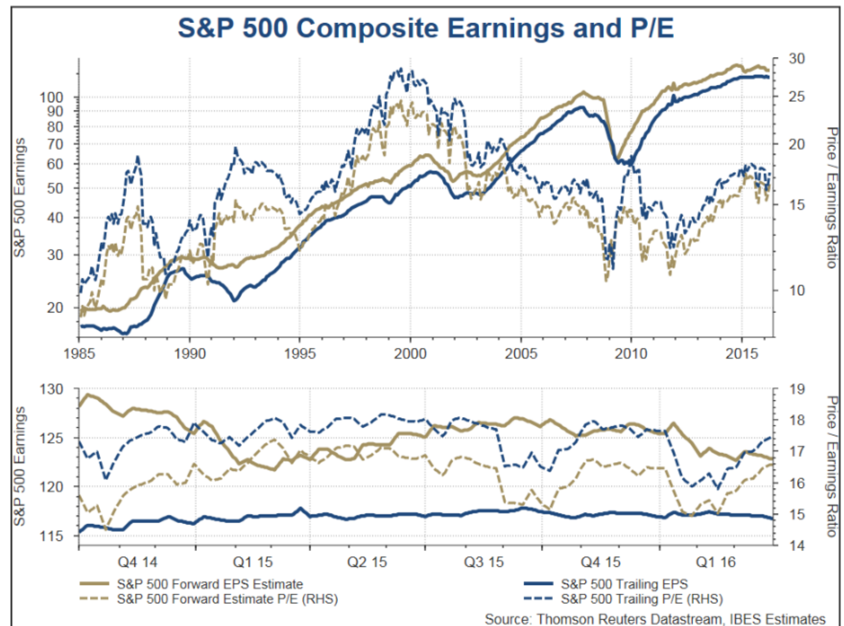



**The U.S. housing market has been growing for several years now** and continues to show strength in many ways: housing starts, permits, price appreciation, and construction spending. The construction industry is a significant employer, especially in the 20-30 year-old demographic.

**Employment levels themselves continue to be very strong.** Multi-decade low initial claims are being made for unemployment. Non-Farm Payrolls are growing (jobs added). Wage are growing despite low inflation.



## Own U.S. Stock. Own Some Cash




**Stocks move up for two reasons:**

- the company is growing its earnings, and/or
- investors pay more for those earnings. (Increase in P/E ratio)

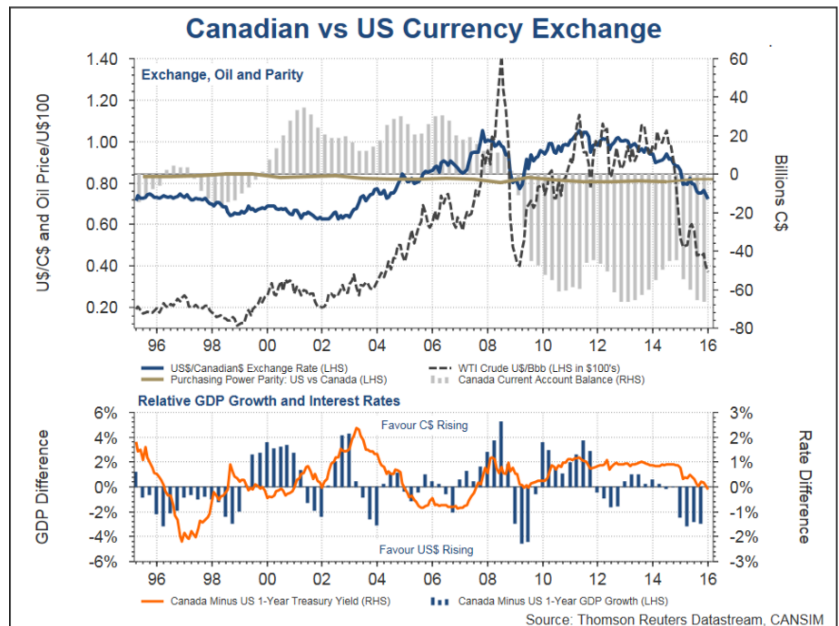
**Actual trailing S&P 500 earnings have been flat for over a year**. The estimate is still for a modest increase. But the amount of earnings growth expected over this year has been slipping since the start of the year.

**The amount investors are willing to pay for earnings is about average** – 16.5x next year's earnings and 17.5x trailing earnings. There doesn't appear to be any real trend in the P/E for the last few quarters. It has been oscillating between a pessimistic 15x forward earnings multiple when investors have been panicky and 17.5x trailing earnings when there has been a little more optimism.

**This tells me:**

- **Keep invested** - it's an average market. There is no crisis.
- **Hold back some cash** - there is little growth. What expectations there are of growth are (slowly) falling.

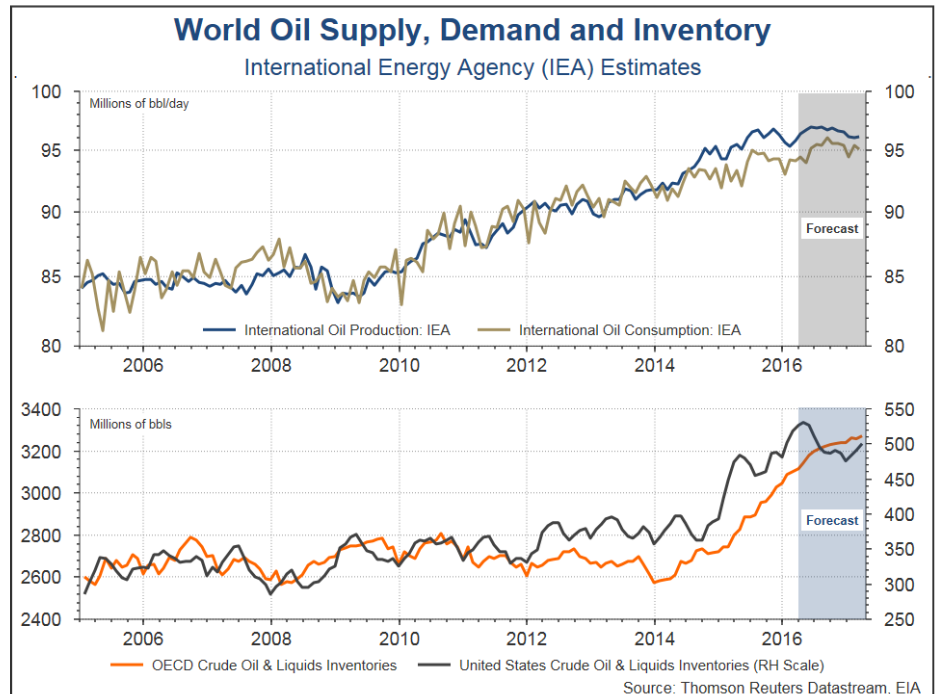
## Hold U.S. Cash




**I expect the Canadian dollar to fall below U$0.70 again because:**

- **Interest rates are still expected to rise** in the U.S. and stay flat or fall in Canada.
- **GDP is growing 1-2% faster in the U.S.,** although there is risk of this fading.
- **There is more than a $60 billion Annual Current Account deficit in Canada.** This means Canada is importing far more than it exports. Canadians are selling dollars to buy the currency of their foreign imports, which should move the Canadian dollar down. The low price of oil contributes to the value of exports being low.
- **Investors may think that if oil rises the Canadian dollar will rise.** But oil dropped 60% from 2014 while the Canadian dollar dropped only 25%. **The potential for oil to rise seems limited as supply of oil currently exceeds demand, and inventories are already at record highs.** Oil is effectively just part of the Balance of Payments for Canada, already reflected in the Current Account discussed above.
- **The Canadian dollar is undervalued, but only slightly so.** Extremes of 15-20% from parity are common.

## Oil Inventories Build. But A Falling U.S. Dollar Pushed Crude Prices Higher




**Crude oil prices have recovered remarkably in the first quarter**. West Texas Intermediate crude is now trading just under $40/bbl, rising from a low of $26/bbl in mid-January. Investors are encouraged by oil producers reducing output, supply disruptions, consistent oil demand, and the recent weakness of the U.S. dollar.

**Later in April, oil producers are expected to meet to discuss a possible output freeze.** It is unlikely that an agreement will substantially change the supply/demand balance in the first half of 2016, but there are hopes of particularly Russia and Saudi Arabia making concessions. Supply disruptions in Iraq, Nigeria, and UAE have already reduced global production. Iran's production increased by only around half of what was expected. Increases in Iranian production is still expected but the ramp up appears gradual.

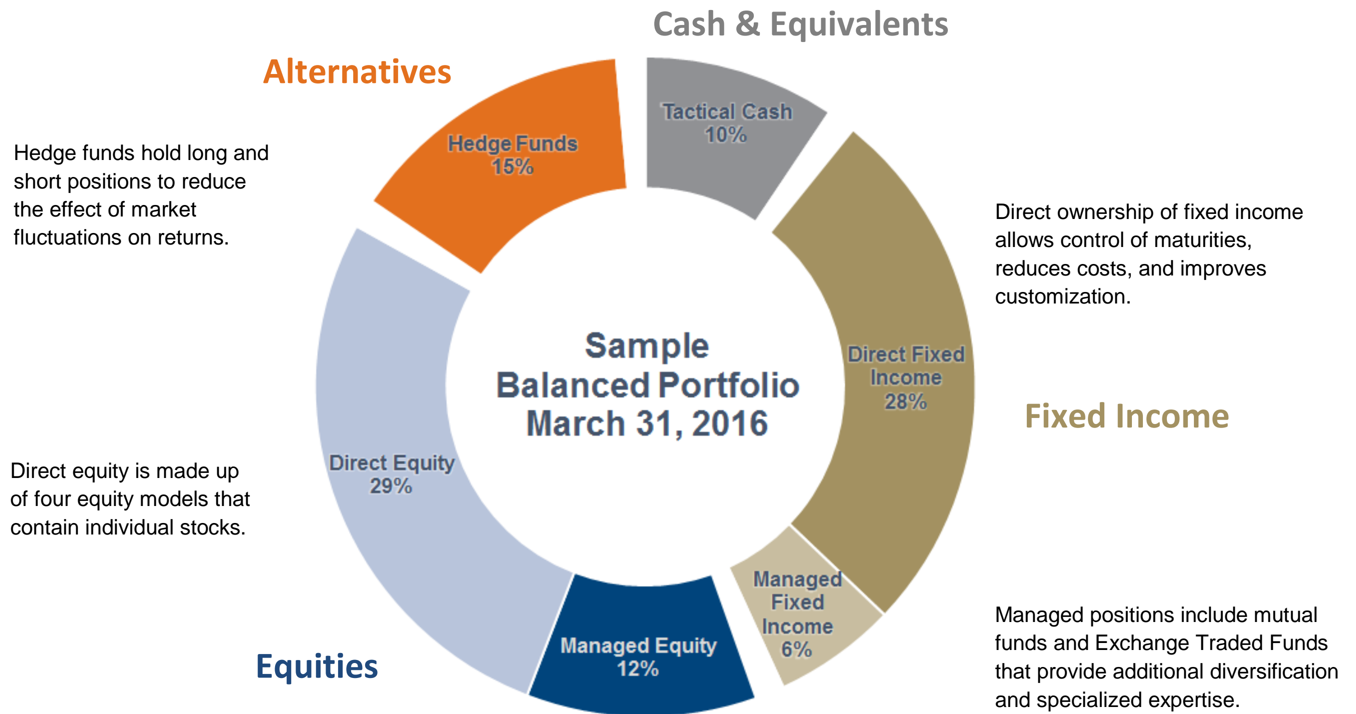
**The real challenge is to reduce high cost output, while experiencing demand growth**. There are signs of production decline in the U.S., where output is forecast to be possibly half a million bbl/d less over the next year. Other countries like Brazil and Colombia may also face production declines. Global oil demand is expected to grow by around 1.2 million bbl/d according to MRB Partners. MRB cautions that there are still significant risks that oil demand may disappoint and fall below estimates because of slow overall global economic growth.

**The International Energy Agency forecast suggests that oil supply will continue to exceed demand for at least another year.** Inventories in the U.S. are expected to retreat from all-time record highs, but remain elevated at 50% above historic averages. Non-OPEC inventories are also at record levels and are forecast to continue rising. It is hard to understand how oil prices could strengthen significantly in the near term in light of the massive oil global inventories that continue to build.

**The impact of the falling value of the U.S. dollar on oil markets has been a driving force in the recent price recovery.** The weakness in the U.S. dollar has nudged fearful investors to add to currently inexpensive commodities. The price of commodities naturally rises as the U.S. dollar falls, since they are priced in U.S. dollars.

Changes in government spending have always been a tool for smoothing out economic productivity in a nation. Increasing and decreasing interest rates became a more popular tool for central banks. With many global interest rates close to zero, **I suspect authorities are going to put more emphasis on managing currency and foreign exchange**. This may cause greater than historical turbulence in currencies, and in particular have a significant impact on commodities. The era of currency wars is going to make investing in specific companies harder. Global flows of money because of currency changes may matter more compared to the financial statements and management of individual companies.

## Sample of Current Managed Account Strategy




**Cash is currently held in a higher proportion than the long-term objective.** Hold between 15-20% of the equity portion of a portfolio in cash to mitigate risks in the financial markets related to a slow rate of earnings growth, average trading prices that are generally at fair values, and the willingness of investors to spontaneously panic to extremes with very little reason. This cash should be deployed into the market on dips, provided that earnings growth and leading indicators still suggest expansion. U.S. cash is preferred due to currency gain potential.

**Fixed Income is held slightly below long-term target levels based on individual investor goals**. The low level of yield for government bonds (that effectively loses purchasing power after inflation, taxes, and fees) provides very little buffer against the risk that rates increase causing government bond prices to fall in the short-term. Corporate bonds are favoured for their higher yield. Managed bonds allow global fixed income investment that include a currency strategy, and more specialized disciplines in purchasing corporate bonds.

**Equities are also held slightly underweight. The intention is for U.S. cash to be deployed into equity during weakness,** or possibly converted to Canadian in the U$0.65 to U$0.70 range. U.S. equities are currently favoured, particularly in the consumer discretionary and technology sectors. Commodities and financials are significantly underweight. Consumer staples is the largest industry held currently in Canada. Overweighting U.S. equity hurt portfolio performance in the first quarter. The strength in the Canadian dollar currently provides an opportunity to move more investments to the U.S. and global investments – as either equity or cash.

**Alternatives provide diversification by providing returns not correlated to equity or fixed income markets.** They attempt to add consistency to performance and reduce overall volatility in the portfolio.

**The actual asset mix used in each portfolio is dependent on the unique goals and circumstances of each client**.

## Integrate Wealth Planning With Wealth Management

**Join me over a lunch seminar where I'll help you understand the building blocks of a portfolio and how to actively move them based on financial markets and your individual situation. I'll also discuss trends in the financial markets and the most effective securities and ways to participate in them.**

Topics of discussion will include:

- Determining your financial needs – importance of a wealth plan
- Market outlook – understanding the current economic environment
- Understanding asset classes – the building blocks of a portfolio
- Combining your strategic wealth plan with active asset management.

Date: **Thursday, May 12th, 2016**

Time: **11:45am – 1:00pm**

Location: **Richardson GMP (Main Boardroom)**
**47th Floor, 525 - 8th Avenue SW**

RSVP: **Rita Penno by telephone 403.355.6034 or**
Rita.Penno@RichardsonGMP.com

**Lunch and refreshments will be provided.**

**I hope you have to opportunity to join us. Please pass this invitation to anyone who may benefit from attending.**

Regards,

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