Jerk

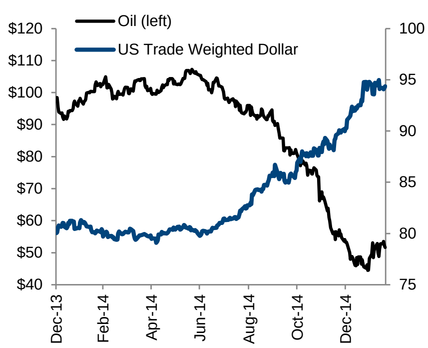
February 25, 2015

In case you missed it, there have been some big, heavy forces moving about in the global economy and capital markets. While none are solely negative, the implications of these big moves will likely reverberate through the markets for some time and may pose some unforeseen risks and opportunities for portfolios. We don't believe any of these big movers are necessarily market cycle ending and we continue to consider the market in the early stages of the late bullish phase- during which there is usually greater volatility and greater return potential, and it also tends to last some time (see Market Outlook Quarterly). But these moves are powerful enough to raise the risk of a real correction. Here are the biggies:

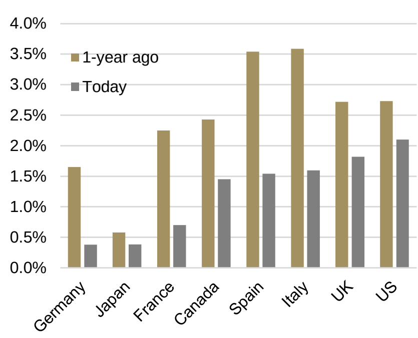
- **Oil has dropped from \$100 to \$50 over the past six months**
- **Global bond yields took another step lower, then rebounded**
- **The U.S. dollar has risen over 20% or more against most currencies in the past six months**

These are interrelated moves in some cases but the magnitude of the move and the size of the market affected are worth a deeper analysis. Oil is a multi-trillion dollar global industry that just saw prices cut in half. The U.S. dollar is the dominant currency for international trade. The global government bond market is massive.

Oil's plunge and rise of the U.S. dollar



10-year Bond yields a year ago vs. today



Source: Richardson GMP Asset Management, Bloomberg

Connected Wealth Market Ethos posts are market thought pieces from the Richardson GMP Asset Management team. As part of our philosophy for managing money, we believe in providing quality objective advice and services with greater transparency. These reports are designed to provide a deeper look into our current thinking.

Market Ethos - Ethos is defined as the character or disposition of a group. In this case it's the disposition of the market itself.

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So you are likely wondering about the title. Of the big moves in the market that we have highlighted, we are not overly concerned about the direct or even the 2nd derivative consequences, it is the less obvious or hidden consequences and impacts which are of concern. What is the next impact or derivative? In physics, the 1st derivative is Speed, the 2nd is Acceleration and the 3rd is Jerk, which is the rate of change of acceleration. For a market example, the drop in oil prices has direct negative consequences for oil patch companies and positive consequences for fuel consumers, such as retail or airlines. We are calling these 1st derivative consequences, pretty easy to see. We are not even overly concerned about the 2nd derivative impacts, like on capex spending. Our concern is the 3rd derivative impacts. Often difficult to see, they can really take the markets by surprise. And the markets don't like to get jerked.

Oil

The decline in the price of oil from nearly $100 to the $50s/barrel has both been dramatic in magnitude and speed. Clearly the gradual and relentless production growth led by the U.S. has finally overcome demand growth in a material enough way that prices plummeted. OPEC not cutting production certainly exacerbated this shock. Given the size of the energy market, the implications of this move are far reaching. The world consumes about 90 million barrels of oil every day, with a $50/barrel drop, that is a $4.5 billion dollar relocation of capital on a daily basis or $1.6 trillion over a year. This is capital that is not flowing to energy producers, capital that is not being spent on gas. Ok, not everyone pays the WTI quoted price, but the point remains this drop has materially altered a considerable amount of global money flows with many winners and some losers.

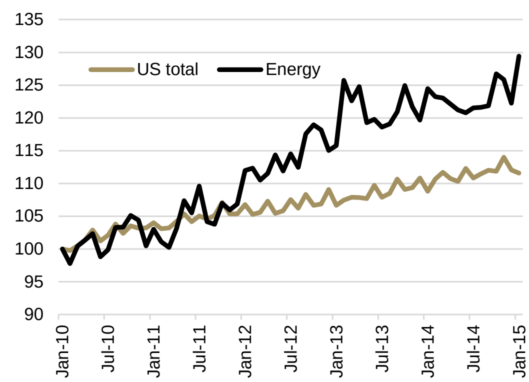
The direct impacts are clear, and in some cases painful. These would include more money for consumers thanks to lower fuel bills, reduced costs for the transportation industry in general. The 2nd derivative impacts are pretty evident as well. This includes a clearly negative impact on commodity exporting countries, like Canada, and carries both a currency and an economic toll. Alberta and Texas real estate is taking a hit, along with employment in those regions. It is destabilizing for some emerging markets but aids others, those that are net importers of energy. So what could the 3rd derivatives be?

Potential Oil Jerks

- Given how ubiquitous energy is within the global economy, this is driving lower inflationary pressures and clearly is helping push bond yields lower. Lower inflation or disinflation is good and bad. Where previously there was inflation, it is good. The door has been opened for many developing economies to cut interest rates as their inflation pressure wanes. China, Singapore, Indonesia, Chile, India have all cut rates during the past few months, thanks to lower oil. This is a very positive development for the global economy. Unfortunately, where there was no inflation previously, it raises fear of deflation. Europe comes to mind. **But we would say the real jerk could potentially be the drop in oil, feeding lower inflation that triggers the market to become concerned about a global economic growth scare, or slowdown.** We don't think it would materialize but there certainly could be a brief growth scare.

- The Fed – we still expect the U.S. Federal Reserve to raise rates this year and that is clearly the consensus. That being said, **there may be a case for the Fed to wait longer**. U.S. wages rose last month by 0.5%, bringing the year-on-year number over 2%. We are starting to see wage pressures, which would elicit faster Fed action on rate hikes, but this wage pressure may be fleeting. The energy sector had been pushing wages higher to attract workers, which also pushed up wages in construction and other industries tapping the same labour pools. But now with the energy industry shedding jobs and folks driving their F150 from the wellheads to the home construction sights, you can believe the wage pressures for both industries will dissipate. Lower wage pressures (or lack of pressure), does soften the argument for the Fed to begin raising rates. Add the strong U.S. dollar, which makes the prices of imports lower, and there is going to be even much less inflationary pressures in the U.S. economy in the coming months.

Upwards wage pressure from the energy patch may prove fleeting in the coming months



Source: Richardson GMP Asset Management, Bloomberg

- **Destabilization** – Most economies, including ours, can weather lower oil prices. However there are some that are put at risk due to oil at $50/barrel. It raises financial strains on economies heavily reliant on exporting oil, and this could quickly transmit to geopolitical risk. Some are fine, given the build-up of reserves over the past decade, but many others are not so flush. **This could raise geopolitical stress in the coming quarters.**

Global Bond Yields – one more step lower

Global bond yields plummeted in January with the U.S. 10-year getting down to 1.65%, albeit briefly as the yield is now back over 2.0%. However, yields around the globe dropped in January. Pick your culprit - lower oil prices, lower CPI, more quantitative easing from the ECB, higher volatility driving capital into safe haven assets, or maybe just some performance chasing given bonds were top performers in 2014. In Canada, this equalled a 4%+ move in the Canadian bond ETF in one month, a move that is relatively unheard of. We had to go back to 2003 before finding a month with a higher return. The January move may be a bit short sighted. Looking back to the beginning of 2014 shows bond yields compressing for pretty much the last year.

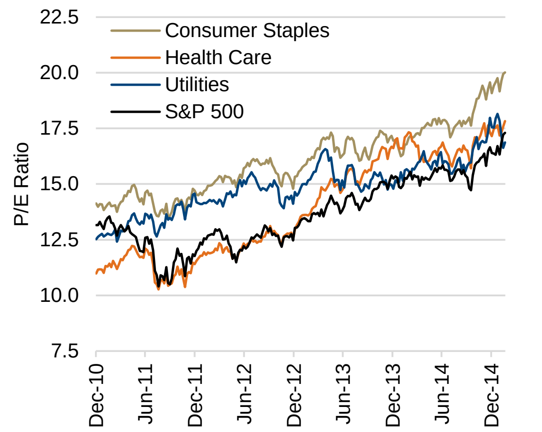
Direct impact of this drop in yields has been a big positive for bonds and a big positive for interest rate sensitive investments. Yield proxy sectors such as Utilities, Consumer Staples, Health Care and REITs have really enjoyed the declining yield environment. Some of this is being undone so far in February.

Potential Global Bond Yield Jerks

- **The drop in global bond yields may exacerbate any impact of rising rates in the U.S.** The U.S. economy continues to build on solid momentum, which may auger for higher bond yields and the Fed to begin tightening. Neither will be big moves in our opinion but the bond market is a relative business. When we experienced the Taper Tantrum in 2013, U.S. 10-year yields rose from about where they are now to 3.0%. But German yields were 1.5%, today they are 0.4%. Japan yields were 0.7%, today they are 0.4%. Lower global yields will limit how high U.S. yields can climb, but may increase the impact on capital. Meaning more money flows to the U.S., lifting the dollar, lifting capital markets in America. This may cause another exodus of capital from emerging markets, which saw a 15% decline during the 2013 tantrum.

- De-risking trades have become much more problematic largely thanks to the drop in yields. If an investor wanted to de-risk, usually the path would be to reduce beta and increase weights in more defensive sectors or asset classes. Obviously with bond yields lower, the bond option is an expensive one that would have the investor trading market risk for interest rate risk, noting the bond markets now have a very elevated duration. Or within equities, to reduce beta sectors including Health Care, Consumer Staples and Utilities are top of the list. But these are also sensitive to yields and are certainly trading at expensive levels. **Lower bond yields have made de-risking a portfolio much more difficult**.

Defensive options are not cheap



Source: Richardson GMP Asset Management, Bloomberg

The rise of the U.S. dollar

The U.S. dollar has risen 19% against its trade weighted partners during the past six months, a big move for the biggest currency in the world. Better economic growth prospects, relative bond yields and the view that the Fed will begin tightening rates this year while other central banks (ECB, BOJ) are pouring on quantitative stimulus. We continue to have a positive view on the U.S. dollar but acknowledge that this move was very fast and could be due for some consolidation. The direct impacts have been felt, U.S. investments have flown. The S&P 500 is up 10.6% since the end of July, but in Canadian dollar terms it's up 28%. The strong greenback has been good for exporters to the U.S., it has been good for U.S. consumers. Digging down to the 2nd derivative, commodity prices are under added pressure with a higher dollar as just about every commodity is priced in U.S. dollars. A higher dollar will supress inflationary pressure in the U.S. given imports are cheaper, down 7% since July. This is more support for the Fed to potentially either wait longer to raise rates or move slower.

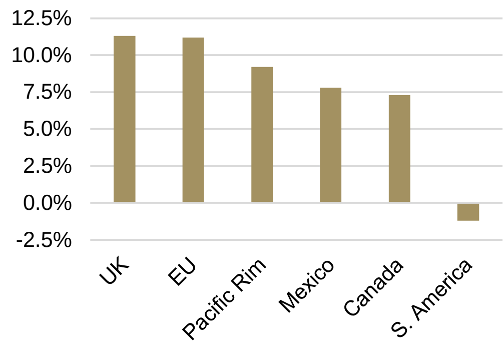
The higher U.S. dollar is having a big impact on earnings. Translation of foreign results back to U.S. is weighing on many multinationals. We put some validity to this but not that much. If results are better overseas, that is much more important than if there was a currency translation impact. The move is positive for any company importing such as retailers. The benefit for Canadian companies that have U.S. operations or report in U.S. dollars has been stellar (stellarly positive that is).

These are the more apparent impacts of this rapid move in the dollar. Here are the potential hidden impacts:

Potential Dollar Jerks

- **A strong U.S. dollar will help lift global growth.** This is a very positive potential jerk as a strong dollar makes for a strong consumer that has the size and capacity to help foster growth in foreign economies. European goods are now materially cheaper than just a year ago and much more competitive. Will it be a Barolo tonight or a California Cab Sauvignon…the price difference is not what it used to be. This helps Europe, Japan and just about every country, except China that pegs its currency to the U.S. dollar. In the end, a strong dollar helps translate more of the economic growth in the U.S. economy to other countries.

Year-over-year change in U.S. imports from key trading partners



Source: Richardson GMP Asset Management, Bloomberg

Conclusion

This report was triggered by the question – what are we worried about, that was raised at a recent client event. Given this starting point, we do apologize that the report focused primarily on negatives and was not very balanced. But we hope it provided some insight into a few of the risks out there in the market.

From a more balanced perspective, the current bull market is about to celebrate its 6th birthday in March. The good news is given the last recession was credit driven, followed by a deleveraging period (in the U.S., not so much here at home), this should make the cycle a longer one. Typically following a credit driven recession the recovery is flatter or slower and longer. This is supported by our models and indicators that have the current market cycle just entering the "late bull" phase. It is still a bullish phase for risk assets including equities and often is one of the longer phases. But, with the late bull phase typically comes higher volatility. The low volatility period of 2H 2012 to 2H 2014 couldn't last forever, and now we have to adjust our strategies to better handle the bigger market swings.

We believe this bull market has a ways to go and potentially some very healthy returns. That being said, after six years upward markets we are likely closer to the top than the bottom, and 2015 should be a year that investors begin adding more defensive strategies and/or increasing diversification.