The BIM REVIEW

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- The first real test of Janet Yellen's mettle came in a press conference in March following the FOMC meeting. She was asked the question on everyone's lips: When will you start to raise rates? She was finally trapped into saying that the appropriate timing was six months following the end of tapering. That works out to mean that the Fed would start tightening sometime around April 2015 which is earlier than the market had expected. She has since stressed that the move to a tightening stance would be slow and well announced.

- For the U.S., some economic measures, such as the PCE (personal consumption expenditure), long a favourite of Yellen's predecessor, appear to be slowing. Other indicators, particularly around confidence levels are at odds to this slowing. It will take a couple months to properly identify which is right as many observers attribute the slackening to the unusually long and difficult winter, which if correct, should be a temporary lull.

- In southern Europe, economic indicators are gradually improving, with better purchasing manager readings providing support to forecasts. Unemployment in these same economies has stabilized. Of more concern is the low rate of inflation. This has created nervousness, with participants worrying that the EU will fall behind and not stimulate the economy sufficiently to avoid falling victim to deflation.

- The other concern for investors remains China. The Purchasing Managers Index (a leading economic indicator) is signaling slower growth putting the 7.5% GDP target in jeopardy. This is raising expectations that the Chinese government will be compelled to do more to loosen credit conditions and stimulate manufacturing while increasing spending on infrastructure. All of this should contribute to continued global growth.

- As the year began equity markets struggled due to a number of factors including economic numbers which came through softer than anticipated, the development of the Ukrainian crisis and some disappointment in corporate earnings numbers. However, as the quarter progressed, investors soon discounted many of the initial concerns. Markets are now anticipating a peaceful outcome for the Ukraine situation despite no clear resolution while soft economic numbers and earnings misses have been blamed on the extended polar vortex.

- Markets outside of North America remain below historical valuation levels and would have to increase 30% to achieve their previous peaks, something the U.S. and Canada have already accomplished. Despite this, concerns remain around the current length of the business cycle as it approaches 20 quarters in duration since the bottom. Looking to previous cycles the average length of postwar recoveries is just over 20 quarters but readers should realize that business cycles do not end because of old age.

- Corporate bond spreads are continuing to squeeze tighter and our clients continue to hold corporate debt that offers the potential for capital preservation and growth together with ready liquidity.

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Economic Backdrop – Inflation Welcome

The 31st of January witnessed the official passing of the baton from Ben Bernanke to Janet Yellen as the new chair of the Federal Reserve Board. The first real test of her mettle came in the press conference in March following the FOMC meeting. She was asked the question on everyone's lips: When will you start to raise rates? The room became more aggressive in the questioning and she was finally trapped into saying that the appropriate timing was six months following the end of tapering. That works out to mean that the Fed would start tightening sometime around April 2015. This was a much more hawkish Yellen than the market had expected and brought significant turmoil to both bond and equity markets. Since that meeting Yellen has tried to mend fences and indicate that qualitative easing (the new QE) would dictate the start of tightening and the markets should not view this pronouncement as gospel.

In her latest speech, delivered at the end of the quarter, she turned back from a perceived hawk to a dove. She stressed that the move to a tightening stance would be slow and well announced. She also focused on the lack of job creation, reiterating that the declining labour participation rate was not a consequence of people retiring or returning to school, but rather because companies were not creating sufficient jobs to absorb the unemployed. In the last year we have seen less than 170,000 jobs per month created, well below the 250,000 required. This keeps the NAIRU (Non-accelerating inflation rate of unemployment) elusive. Inflation is unlikely to be a worry in the near term and remains stable both at the core measure and at the headline rate.

Many observers attribute the slackening to the unusually long and difficult winter.

Meanwhile, other measures, such as the PCE (personal consumption expenditure), long a favourite of Yellen's predecessor, appear to be slowing. It will take a couple months to properly identify the cause of this slowing. Many observers attribute the slackening to the unusually long and difficult winter. The weather has definitely slowed residential and commercial construction. The various measures of the real estate market, at the resale level or new home sales, have clearly demonstrated a slow down but that can rebound quickly, and the home builders are still generating strong confidence measures. The trend in U.S. manufacturing is also picking up, so the overall expectation for the economy is looking stronger as the year develops.

Not all of the excitement in the first quarter of 2014 has come from the U.S. The western supported overthrow of the President of the Ukraine led to the well organized and successful occupation and absorption of the Crimea Region by Russia. Putin rode his new found popularity in Russia and Eastern Europe following the completion of the successful Winter Olympics in Sochi to "adjust" the postwar political boundaries. Given the lack of response to his invasion of Georgia, he had expected that the West would not intervene. Russia, while economically dependent on the west, is also the supplier of natural gas to most of the European countries. This has made it more difficult for the EU to impose sanctions. To date the sanctions that have been announced have been largely symbolic, targeting individual businessmen and government infrastructure figures.

In southern Europe, economic indicators are gradually improving, with better purchasing manager readings providing support. Unemployment in these same economies has stabilized. Of more concern is the low rate of inflation in the EU. The head of the European Central Bank, Mario Draghi, has continued to resist lowering interest rates despite failing to meet its established inflation target. He points out that inflation's decline in the EU has come from a reduction in energy prices, overwhelming the other upward price pressures. This attitude has created nervousness, with participants worrying that Draghi will fall behind and not stimulate the economy sufficiently to avoid falling victim to deflation.

The other concern for investors remains China. In the course of the first quarter China experienced its first corporate bond default. The corporate bond market in China has grown steadily over the past five years at a compound growth rate of 41 percent with nearly 40 percent of domestic corporate bonds outstanding held by banks. This raises a concern about diversification and brings into question the inherent risk in the banking system. However, it must be borne in mind that China's heavy load of debt has come from financing investment, particularly in infrastructure and not from consumption. This lessens the potential impact of the debt. Even after the weak borrowers are shaken out, the economy gets the benefit of the new infrastructure, rather than the experience in the west where the borrowing was largely for consumption and there was little of value left afterwards. The Purchasing Managers Index (a leading economic indicator) is signaling slower growth putting the 7.5% GDP target in jeopardy. This is raising expectations that the Chinese government will be compelled to do more to loosen credit conditions and stimulate manufacturing which should continue to support global growth.

Equity Markets – Grinding Higher

January proved to be an interesting start to the year. Global equity markets struggled due to several factors including softer than anticipated economic numbers, the development of the Ukrainian crisis, and some disappointment in corporate earnings numbers. However, as the quarter progressed, investors soon discounted many of the initial concerns.

Many investors are looking to the second quarter to provide a clearer picture for the direction of equity markets.

Markets are now anticipating a peaceful outcome for the Ukraine situation despite no clear resolution. Soft economic numbers and earnings misses have been blamed on the extended polar vortex. The net result was a good quarter for investors with the Canadian market up 6.1% and global markets up 5.3% in Canadian dollar terms with much of the global performance due to the weakening Canadian dollar. Many investors are looking to the second quarter to provide a clearer picture for the direction of equity markets and as mentioned in our yearend report, we continue to remain constructive on the markets for the year despite many opinions to the contrary.

As readers already know, differing opinions make a market and also generate opportunity. However, as it relates to the equity markets we are constantly looking for evidence to develop our investment view. For instance, some interpret a negative January performance in the markets as foreshadowing a negative year. We have looked at the U.S. market going back 30 years and found 12 years with a negative starting month and only 5 of those had a negative return for the year. All of those coincided with a recession. In fact, during years without a recession, the returns for the remaining 11 months were very rewarding. As revealed in the economic write up, we do not foresee a recession at this point. Investors often worry that because 2013 was such a good year for returns, the following year will be negative. Again, if you study the evidence this statement does not hold any merit. Going back 50 years shows that years, which follow a previous calendar return of 25% or more, are generally positive with the average return being in excess of 10%. As stated previously, we think last year's great return for equity markets can be followed by a very good year. A more difficult concern to dispel is the polar vortex affect or at least the size of the affect on economic and business activity. We can all agree that there was some drag as three solid months with below average temperatures caused shoppers to hibernate while companies struggled with everything from shipping to heating. To gauge the polar vortex affect we looked at retailers reported earnings on two fronts; hard goods and soft goods. The results of this analysis reveal that there was definitely a large weather related drag. Soft goods retailers such as clothiers reported disappointing numbers while hard goods retailers selling shovels and salt reported numbers better than expected. Therefore, the end of last year and the first quarter of this year may not be indicative of the full year 2014.

Previously we have mentioned that market valuations are in line with historical averages and this holds on both forward looking and trailing methodologies. In fact, markets outside of North America remain below historical valuation levels and would have to increase 30% to achieve their previous peaks, something the U.S. and Canada have already accomplished. Despite this, concerns remain around the current length of the business cycle as it approaches 20 quarters in duration since the bottom. Looking to previous cycles the average length of recoveries (postwar) is just over 20 quarters but readers should realize that business cycles do not end because of old age. Usually one of three factors will cause the demise; overcapacity, speculative excess or demand driven inflation causing interest rates to rise. In reviewing these possibilities today, companies have been extremely disciplined with respect to capital investment to the point that business investment is only now reaching previous peaks. This is much slower than any of the previous four cycles suggesting overcapacity is not a concern. Similarly, there does not seem to be any speculative excesses from a valuation point of view as we have seen with the tech bubble or the housing bubble. Finally, inflation is certainly not a concern. In fact governments are doing everything they can to stoke inflation as they wish to avoid the tyranny of deflation. For these reasons and more the business cycle has legs and we continue to find securities that meet our stringent guidelines.

Autocanada, one the largest and the only publically listed automotive dealerships in Canada, is a great example of the many opportunities we have uncovered for our clients. Exposure to OEM's (original equipment manufacturers) that have generally been growing faster than the market as well as abundant acquisition opportunities due to the lack of succession planning continues to sustain growth into the future. Auto dealerships tend to be cash cows as geographic exclusivity is guaranteed and incentives along with inventory support are granted by the OEM's. As well, recurring revenue streams from the warranty and service side of the business tend to be counter-cyclical and cover a majority of the fixed costs. Valuation continues to be favorable given the growth profile and along with the growing dividend, Autocanada is just one example that supports our view that this market continues to hold investment potential.

Fixed Income Markets – Regulatory Indigestion

This year has witnessed a shortage of new investment grade debt allowing corporate issuers to sense an opportunity and issue debt at ever tighter spreads relative to government bonds. The pricing has been so tightly aligned to secondary market levels that there has been little in the way of opportunity for investors. In many cases participants in new issues are finding that they are holding fully valued bonds.

The decline in new issue volume in the Canadian market in the first quarter of this year is almost wholly a consequence of the Basel committee (which sets international capital adequacy rules for banks). In its attempt to create a methodology to avoid the need for the massive infusion of capital from central banks needed during the last financial crisis, the Basel committee has frustrated many of the entities it oversees. As one can imagine it is a complicated process to rescue failing and potentially undercapitalized banks while still trying to protect the senior debt holders in any financial crisis.

Canadian banks are still awaiting implementation of the recently released Basel III capital adequacy rules and are therefore hesitant to issue new debt. Also, OSFI (the regulator which directly oversees financial institutions in Canada) has not yet announced whether outstanding deposit notes will be swept up in the requirement that all senior and subordinated bank issued bonds be structured with a "Bail-in" feature or whether existing senior debt will be grandfathered. The bail-in feature is a key part of the "Non Viable Contingent Convertible" (NVCC) methodology developed to transfer default risk to the bond holders from the government in the event of a bailout.

The Bail-in feature is a mechanism whereby in the event a bank's regulatory capital falls below a certain pre-established level such that the bank would no longer be viable, the junior and senior debt issued by that bank would be converted to common equity at a predetermined rate, thus eliminating the current benefits of seniority and rank of the bond holder and ensuring that the bond holder is subject to the same risk as the equity holder. As of the time of writing it is not clear how this will all be structured. There have been a couple of preferred share issues that are NVCC compliant, but no NVCC debt has yet been issued in Canada. We are carefully studying this new structure, and the risk it may generate, in order to be prepared for the first issuance. Of course the big issue is pricing. Market participants are trying to develop a practical methodology to be able to value these instruments when they come to market.

In the meantime, the reduction in bank debt issuance in the first quarter has seen new issue volumes this year decline by nearly $6 billion (or 25%) from last year, demonstrating just how important the Canadian banks really are to the Canadian bond market and investors.

As in previous cycles, while the market worries about rising inflation, the curve steepens, and then when the central bank is seen to take an aggressive stance against inflation the curve flattens.

The yield curve responded to Janet Yellen's initial hawkish stance by flattening nearly 30 basis points. The curve has now returned to a steepening mode with the later dovish clarification. As in previous cycles, while the market worries about rising inflation, the curve steepens, and then when the central bank is seen to take an aggressive stance against inflation the curve flattens. We will take the appropriate steps to participate in this shift when needed. Meanwhile there is less pressure on Canadian interest rates. There is little evidence of inflationary pressures and the earlier concerns about the impact of rising house prices expressed by Carney and Flaherty has faded under Poloz and the arrival of Joe Oliver as the new Finance Minister.

At this point it appears that monetary policy tightening will come to the U.S. before Canada. Therefore, we are currently keeping duration relatively short, and will continue to do so until we get an indication of policy change from the central banks.

Meanwhile, corporate credit spreads are continuing to squeeze tighter across the yield curve. We are continuing our core strategy of careful credit analysis to ensure that we hold corporate debt that offers the potential for capital preservation and growth in the current environment together with ready liquidity.

Barrantagh Investment Management Inc. provides disciplined portfolio management to institutional and individual investors. The firm is committed to a high level of client service provided directly by its experienced partners. We are dedicated to preserving our clients' capital while generating growth through consistent application of our value-based fundamental investment philosophy. We manage portfolios on a segregated basis to meet our clients' investment objectives. Because the firm is owned by our professional staff we maintain a completely independent and objective perspective.

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