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- The Fed has persisted with tapering; lowering the amount of U.S. government bonds to be purchased by $10 billion each month. The reduction in bond purchases was expected to push longer rates higher and to slow the housing market. In fact long rates have hardly moved and housing starts as well as pending sales have picked up quite nicely.
- Quantitative Easing (QE) is still adding liquidity, at least until later this year when the tapering comes to an end. However, the lingering effects of QE did not help the overall economy in the first quarter with revised U.S. GDP growth coming in at negative 2.9%. This is the weakest GDP growth measure outside of a recession in many years which led analysts to expect a sharp positive pick-up in the second quarter.
- The market has nervously watched inflation pick-up at both the Producer Price Index (PPI) and Consumer Price Index (CPI) levels suggesting that analysts may eventually be right about continuing economic improvement and the first quarter may have been an aberration.
- The unexpected rise in inflation in Canada places the Bank of Canada in an awkward position. If they respond by raising rates, the traditional response to inflation, it will undoubtedly strengthen the Canadian dollar, and eat into the country's exports. This would in turn slow the manufacturing sector, even to the extent of accelerating the loss of jobs and output. In addition, higher rates would raise the cost of the consumer debt load, which is already at levels that cause significant concern in Ottawa.
- On the international scene, Japan is still struggling to stimulate their economy, but may have finally achieved the momentum they need in Q2. Europe's economy continues to slowly improve, albeit from very low levels with the news dominated by the Ukraine where there is still no final resolution to the ongoing turmoil.
- Clients have been enjoying the positive return in the equity markets; however, we speculate that part of the enjoyment is not only due to the great returns but to something that is missing... volatility. For the past 18 months the largest market pull back has been about 6%, which probably went undetected by most casual observers.
- If market forecasters are correct, then industries that benefit from rising rates and have been avoided to some degree by investors, as they defaulted to yield plays, will benefit. Cyclical industries such as railways, insurance and autos will gain as they have pricing power in an inflationary environment, allowing earnings to increase and ultimately valuation multiples to expand.
- As we worked through the first quarter, the general expectation in the bond market was that as the tapering of bond purchases under QE gained momentum, the long end of the U.S. treasury curve would rise, and the bond market would decline. Events proved otherwise, and the bond market has remained relatively well supported by cash flows.
- While there is still room for further tightening in the corporate bond market, we are vigilantly anticipating that any small upward movement in government rates, perhaps responding to the growing evidence of inflation, may limit any gains from yield spreads.

Barrantagh
Investment Management

Economic Backdrop – Choppy Growth

As we entered the second quarter there was broad market consensus on a range of items. Some came to be, others did not. The Fed has persisted with tapering; lowering the amount of U.S. government bonds to be purchased each month by $10 billion. The reduction in bond purchases was expected to push longer rates higher and to slow the housing market. In fact long rates have hardly moved and housing starts as well as pending sales picked up quite nicely.

It is important to remember that QE (Quantitative Easing) is still adding liquidity, at least until later this year when the tapering comes to an end. However, the lingering effects of QE did not help the overall economy in the first quarter with revised GDP growth coming in at negative 2.9%. This is the weakest GDP growth measure outside of a recession in many years which led analysts to expect a sharp positive pick-up in the second quarter. This has not necessarily been the case as consumer spending remains soft. In both April and May consumer expenditure declined, indicating continued potential downside in forecasting the second quarter GDP final numbers. On the other hand, after hearing reassuring words from Janet Yellen about the transitory nature of the reported inflation measures, the market has nervously watched inflation pick-up at both the PPI and CPI levels suggesting that analysts may eventually be right about continuing economic improvement and the first quarter may have been an aberration. In the past the Fed has indicated that the most significant measure of price trends that they follow is the PCE (Personal Consumption Expenditures) price deflator. While the deflator is still below 2%, it is 1.5% higher than a year ago. This has been largely driven by food and energy but those are not the only positive contributors suggesting the trend is not only up, but also broad in nature.

In both markets, there is a growing concern that the central banks are going to find themselves behind the curve.

In Canada the rise in inflation has been more substantial, with the core CPI measure having risen from 1.3% to 1.7% in two months. The headline number is now at 2.3%, clearly over the Bank of Canada's target of 2%. Again this rise has been driven in particular by food, energy and shelter. The unexpected rise in inflation in Canada places the Bank of Canada in an awkward position. If they respond by raising rates, the traditional response to inflation, it will undoubtedly strengthen the Canadian dollar, and eat into the country's exports. This would in turn slow the manufacturing sector, even to the extent of accelerating the loss of jobs and output. In addition, higher rates would raise the cost of the consumer debt load, which is already at levels that cause significant concern in Ottawa. In both markets, there is a growing concern that the central banks are going to find themselves behind the curve. That of course would lead to more aggressive responses from the regulators. Therefore nothing has changed, Canada needs a stronger growing economy south of the border, which should allow for a weaker Canadian dollar and increased demand for our products, whether raw materials or manufactured.

On the international scene, Japan is still struggling to stimulate their economy, but may have finally achieved the momentum they need in Q2. In the second quarter retail sales picked up, exceeding expectations, while household spending still failed to meet target. Meanwhile, core inflation has hit 2.8%, in line with expectations and perhaps more importantly, jobs available now exceed job applicants to an extent not seen since 1992, indicating economic growth is on track to pick up as we move through the coming quarter.

Europe's economy continues to slowly improve, albeit from very low levels with the news dominated by the Ukraine where there is still no final resolution to the ongoing turmoil. However it appears that Putin is pulling back from the brink, and has instructed the military to stand down. Unfortunately, just as one conflict subsides another erupts with Iraq the latest victim. The outcome is uncertain but it will continue to impact the western financial markets, especially energy, as we move through the balance of 2014.

Finally, China appears to have engineered a soft landing as indicated by PMI (Purchasing Managers Index) measures. However, recovery and growth will come slowly as they face the dual headwinds of financial risk and a tepid real estate market.

Overall, the global economy continues to grow at a choppy rate. However, the numbers do suggest that each economic block is acting as expected. The U.S. is gaining momentum into the second half, Europe is healing and China has hit the targeted plateau.

Equity Markets – Muted Volatility

Global equity markets continued to grind higher in the second quarter as the MSCI Index was up 1.5% in Canadian dollar terms. In U.S. dollar terms it was up 5.1% revealing the strengthening Canadian dollar. In part, the Canadian dollar strength is due to increasing energy prices as the Iraq confrontation helped the Canadian stock exchange lead the way in the second quarter with a return of 6.4%, bringing the year-to-date performance in at 12.9%.

Clients have been enjoying the positive return in the equity markets; however, we speculate that part of the enjoyment is due to something that is missing… volatility. For the past 12 to 24 months, volatility has been below historic averages.

Our conjecture is that quantitative easing, along with the current tapering, has led to this period of almost artificially induced low volatility.

Looking back at the S&P 500 over more than 30 years, despite the very positive yearly returns (26 of the last 34 have been positive) intra-year declines have averaged in excess of 14%. This means that at some point during any calendar year we can expect the market to pull back on average over 14% even though the return for that calendar year may be hugely positive. For the past 18 months the largest market pull back has been about 6%, which probably went undetected by most casual observers.

So why has the recent volatility been more muted? Our conjecture is that quantitative easing, along with the current tapering, has led to this period of almost artificially induced low volatility. This has occurred in a period in which inflation was low and central banks achieved what they were hoping for... price stability. Volatility will return to the market place when investors opinions on valuations for individual securities and asset classes start to broaden. Although we do not see volatility picking up in the immediate future, it will rise when central banks start to increase posted interest rates, inflation starts to accelerate or valuations in the market place achieve frothy levels. Any of these conditions does not mean an end to the current bull market but does create the fertile stage for a differing of views and therefore a return to "normalized" market volatility.

Which of the three factors; market valuations, posted interest rates or inflation will jeopardize the muted volatility in the equity markets? As discussed in recent *BIM REVIEWS* our work on several levels suggests that markets are not expensive. With respect to interest rates, we believe central banks will remain "behind the curve" until global growth is self-sustaining and inflation is moving up. Inflation, which is inherently tied to interest rates, seems to be the key for volatility watchers. Employment figures, inventories and capital investment suggest that there is very little slack left in the economic system. As global growth continues, the result will be increased pressure on inflation as the business sector starts to have a larger impact on the economic expansion, ultimately driving confidence and eventually allowing or maybe even forcing the central banks to increase rates. If we are correct, then industries that benefit from rising rates and have been avoided to some degree by investors, as they defaulted to yield plays, will benefit. Cyclical industries such as railways (CNR), insurance (MetLife) and autos (Penske) will gain as they have pricing power in an inflationary environment allowing earnings to increase and valuation multiples to expand.

Over the last several years, with below normal volatility, companies have become very disciplined in the deployment of excess capital. They have looked to share buybacks, dividend increases, debt repayment and merger and acquisition activity to increase their return on equity (ROE). Since 2008 companies have been loath to take on excessive debt and balance sheets remain pristine. Share buybacks and increasing dividends have been the preferred use of capital which has enhanced value in a time of rising equity prices. Going forth, as markets continue to rise and rates remain low, we expect the mechanism by which companies will drive ROE gains will, on balance, switch from financial engineering to a focus on operations, including mergers and acquisitions and capital expenditures on machinery. As mentioned, railways should benefit in this environment. Canadian National and Union Pacific rank one and two respectively in the rail business when looking at operating ratios (think margins) and will continue to benefit from rising rail traffic as the need for goods increases with an improving economy. Earnings should be sustained and enhanced as both companies look to deploy excess capital to improve ROE's. Therefore, even if volatility does return to more normal levels in the equity markets it does not mean that the upward trend in the markets is broken. It only suggests that investor's views with respect to valuations are broadening and some industries that have been ignored may now be adored!

Fixed Income Markets – Corporates Dominate

As we worked through the first quarter following Janet Yellen's inaugural misstep during the March FOMC press conference, the general expectation in the bond market was that, as the tapering of bond purchases under Quantitative Easing gained momentum, the long end of the U.S. treasury curve would rise, and the bond market would decline. Events proved otherwise, and the bond market has remained relatively well supported by cash flows.

***Even economic growth was expected to trigger a further sell-off in the bond market, and instead the weaker expansion has been supportive of low yields*.**

Janet Yellen's comment that the Fed would begin raising interest rates six months after the end of tapering, later disavowed, has morphed into suggestions that it will be 2015 or even 2016 before the Fed starts tightening. The exact timing remains uncertain but even then the Fed's balance sheet remains bloated and it will only be once the Fed starts to reduce excess reserves in the system that monetary policy will begin to tighten.

Even economic growth was expected to trigger a further sell-off in the bond market, and instead the weaker expansion has been supportive of low yields. Bonds have also been supported by another sensitive area for the U.S. economy - job creation. The U.S. economy has not yet achieved the level of new job creation to sustain strong growth. The 8.7 million jobs lost during the recession have been replaced, but only just.

Inflation, a foe of bonds, does not yet appear to be a big concern in the U.S., but is a more significant worry in Canada. Whether measured at the headline level or at the core (i.e. ex-food and energy), inflation is picking up. A recent survey conducted by the New York Fed concluded that market participants see inflation as more deeply entrenched than the current numbers suggest. This means that policy will have to be that much more rigorous to demonstrate control.

Overall the Canadian yield curve flattened slightly in the second quarter, but showed signs of steepening as the quarter came to an end. Most of the movement came in the belly of the curve, 7 to 9 year maturities. Of more interest was the continued tightening of corporate credit spreads relative to government of Canada bonds. Corporate credit spreads have generally continued to scrape tighter, giving opportunities to enhance returns. New issue volumes have continued to rise, with the current pace pointing towards a $100+ billion new issue level for the year. Of some concern to the corporate debt market is the fact that much of the funds being raised are used to finance share buy backs, acquisitions, and generally to increase leverage at the borrower level. While there is still room for further tightening, and there remains strong demand for new issues, we are vigilantly anticipating that any small upward movement in government rates, perhaps responding to the growing evidence of inflation, may limit any gains from yield spreads. Therefore, we have the portfolios positioned to be defensive, with duration well short of the bond index. We remain overweight investment grade corporate bonds, taking advantage of the yield pick-up over instruments of similar maturity.