The BIM REVIEW

Volume 19 | Edition 3 | September 2014

In This Issue

Economic Backdrop – The U.S. Leads

Equity Markets – WOW

Fixed Income Markets – Low New Issuance

- The third quarter of the year has brought us a mixed bag of economic data, culminating in strong U.S. personal spending and personal income numbers. The U.S. consumer appears to have finally gained the confidence to spend.
- Market participants are still trying to get a better understanding of Janet Yellen's (the Federal Reserve Chairperson) policy direction and sensitivities. She remains steadfastly focused on the notion that the move to normalize monetary policy remains data dependent but we have crossed the various target levels for job creation and unemployment without a reaction or deep concern from the Fed (U.S. Federal Reserve).
- The Fed continued their lower for longer rate policy, keeping administered rates unchanged. The Fed has at least a temporary reprieve, with the inflation rate holding at or below their target. Even more remarkable was the fact that for the first time since October 2010, core prices did not rise.
- Although jobless claims numbers continue to trend in the right direction, there has not been sufficient growth in incomes and jobs to maintain the earlier upward trend in housing starts and sales. Starts, building permits and sales have all flattened out but the market is confidently expecting third quarter economic growth of 3% or higher.
- In Europe, economic growth continues to lag, with the overhanging threat of deflation. The President of the ECB (European Central Bank), Mario Draghi, surprised the market with a further 10 basis point cut in administered rates, and has announced a plan to purchase MBS (mortgage backed securities) debt together with covered bonds. The ultimate goal of course is to kick start the GDP stagnation that seems to have enveloped even the stronger EU nations.
- In China, fixed asset investment is up 16.5% year over year and retail sales expanded 11.9% year over year. However, a weak Chinese August industrial production number of 6.9% gave a negative tone to risk assets prompting some anxiety in the market.
- A key concern for investors as we head into autumn is the ever more evident economic growth disparity between the U.S. and much of the rest of the world. It is not difficult to have concerns but we remain of the mind that China will be able to stabilize, Europe will continue to move into positive growth territory and U.S. growth may surprise to the upside.
- In equity markets, it would seem that normal volatility has returned and although it may not be the only reason, it seems strangely coincidental with Janet Yellen's view that rates may rise sooner than markets expect but they will keep rates low if required. Her statements helped prevailing market views to broaden, resulting in the market turbulence witnessed during the quarter.
- Equity markets have been climbing the proverbial "wall of worry" (WOW) for the entire year. Despite the Ukraine and Iraq confrontations, China slowing below the targeted 7.5% GDP growth, the European Central Bank's procrastinated response and the deadly Ebola virus, just to mention a few, global markets have increased 10% year-to-date to the end of September in Canadian dollar terms. We believe markets will continue to climb in the fourth quarter.
- Economic doubt and ongoing tension in both the Ukraine and the Middle East have been unsettling for the bond market. However, with the general expectation that the U.S. will begin raising rates in 2015, there has not been a capital flight to safety seen in previous times of uncertainty.

Economic Backdrop – The U.S. Leads

The third quarter of the year has brought us a mixed bag of economic data, culminating in strong U.S. personal spending and personal income numbers. The U.S. consumer appears to have finally gained the confidence to spend. However, market participants are still trying to get a better understanding of Janet Yellen's policy direction and sensitivities. She remains steadfastly focused on the notion that the move to normalize monetary policy remains data dependent but we have crossed the various target levels for job creation and unemployment without a reaction or deep concern from the Fed (U.S. Federal Reserve). The conclusion must be that the target for unemployment, is viewed as flexible, and could be adjusted up or down as the economy requires.

U.S. Quantitative Easing (QE) will come to a halt in October, bringing to an end the stimulative impact of the Fed purchases in the open market.

The Fed is consistent in its view on inflation. Higher inflation values may be tolerated, but the Fed will not act to stimulate inflation. Aiding them in this task is the fact that the latest CPI (consumer price index) data is showing stability, particularly with a sharp drop in energy prices. This has let the Fed continue their lower for longer rate policy, keeping administered rates unchanged. The Fed has at least a temporary reprieve, with the inflation rate holding at or below their target. Even more remarkable was the fact that for the first time since October 2010, core prices did not rise. More important from a policy standpoint, the PCE (personal consumption expenditure) measure which is closely watched by the Fed should now stabilize at, or below, their 2% target. U.S. Quantitative Easing (QE) will come to a halt in October, bringing to an end the stimulative impact of the Fed purchases in the open market. Logically this should lead to some upward pressure on yields in the Treasury market.

While the new jobless claims number remains volatile, it does appear to be trending in the right direction. So far in the current year the U.S. economy has created on average more than 200,000 jobs per month. While there is some debate as to the quality of many of those new jobs, the trend is undeniable. Unfortunately, there has not been sufficient growth in incomes and jobs to maintain the earlier upward trend in housing starts and sales. Starts, building permits and sales have all flattened out but the market is confidently expecting third quarter economic growth of 3% or higher.

In Europe, economic growth continues to lag, with the overhanging threat of deflation. The President of the ECB (European Central Bank), Mario Draghi, surprised the market with a further 10 basis point cut in administered rates, and has announced a plan to purchase MBS (mortgage backed securities) debt together with covered bonds. This has triggered further dispute within the EU, with Germany maintaining that the ECB does not have the necessary authority to launch such a program, contradicting Draghi's statement and making more public the depth of disagreement at the political and policy level. An additional problem is that Europe does not have a well developed MBS market, and it may prove difficult to achieve the volume of transactions needed. The ECB also launched its first TLTRO (Targeted Long Term Refinancing Operation) which is designed to put cheap funds in banks. It is targeted at increasing consumer and small company lending by the banks. The results of the first of eight TLTRO allotments was disappointing, with roughly 80 Billion Euros allotted against a forecast of 130 Billion. The ultimate goal of course is to kick start the GDP stagnation that seems to have enveloped even the stronger EU nations. All of this is reminiscent of the EU's dealing with its debt crisis. They have the model which the U.S. used to stimulate its economy, but their process is painfully slow.

In China, fixed asset investment is up 16.5% year over year and retail sales expanded 11.9% year over year. However, a weak Chinese August industrial production number of 6.9% gave a negative tone to risk assets prompting some anxiety in the market. In response to this weakening economic indicator, the PBoC (Peoples Bank of China) injected roughly $90 billion into the system by way of three month loans to the five largest banks. China is clearly concerned about its worsening domestic credit conditions, and we expect further measures to be introduced in the coming months. As measured by the PMI (purchasing managers index), economic growth is slowing as they have targeted, but efforts so far to stabilize and inflate have fallen short of the mark.

A key concern for investors as we head into autumn is the ever more evident economic growth disparity between the U.S. and much of the rest of the world. China is using more targeted policies in an attempt to stabilize growth in the 7 to 7.5% range and Europe continues in its attempts to stimulate growth and avoid slipping back into recessionary territory. It is not difficult to have concerns but we remain of the mind that China will be able to stabilize, Europe will continue to move into positive growth territory and U.S. growth may surprise to the upside.

Equity Markets – WOW

There is an old saying, "be careful what you wish for", and that has certainly come true during the third quarter. In the second quarter BIM Review, we highlighted that the positive performance of equity markets had occurred during a time of lower than normal volatility. We postulated that markets would return to more normal volatility once the outlook for rates changed causing market participants to have varying views on the opportunities in the equity markets and therefore valuations of, not only asset classes, but the individual securities within the asset classes. It would seem that normal volatility has returned to the markets and although it may not be the only reason, it seems strangely coincidental with Janet Yellen's view that rates may rise sooner than markets expect but they will keep rates low if required. Her statements helped prevailing market views to broaden, resulting in the market turbulence witnessed during the quarter with the Canadian equity exchange off 0.6% and world markets off 2%. Interestingly, in Canadian dollar terms, world markets are actually up 3% due to Canadian dollar weakness driven by a slowing China and lower energy prices, which is the opposite of what happened during the second quarter when energy prices reacted positively to world confrontations in the Ukraine and Iraq.

Despite the concern in the market, we believe that this turmoil cannot be avoided as the support for equity markets changes from a guaranteed low rate environment to one in which the outlook for rates changes. As most strategists would suggest, it is healthy to have consolidation in the market as investors reset their views, asset valuations are realigned and the markets climb higher. Many investors sense that a rising rate environment is negative for the market. However, studies reveal that is not necessarily the case. For instance, in the U.S., when ten year treasury bonds are yielding below 5% (today around 2.5%) and rates begin to rise, there is a very positive correlation with equity markets. Conversely, investors are correct to worry about the negative effect that rising rates will have on the equity markets when ten year treasuries are yielding above 5%.

Equity markets have been climbing the proverbial "wall of worry" (WOW). Despite the Ukraine and Iraq confrontations, China slowing below the targeted 7.5% GDP growth, the European Central Bank's procrastinated response and the deadly Ebola virus, just to mention a few, global markets have increased 10% year-to-date to the end of September in Canadian dollar terms. It is worth pointing out, that for almost the last 100 years, the month of September has proven to be the weakest month for equity markets, up less than 50% of the time. Meanwhile, the last quarter of the year has been positive 4 out of 5 times when markets have been positive to the end of September.

Looking forward we expect the relative valuations between individual securities in any given industry to widen.

To be sure, there have been many confusing signs in the markets. Government bond yields have continued to decline around the globe while high yield bonds (junk bonds) have sold off, suggesting an increased risk for the onset of a recession. Small capitalization stocks have pulled back after outperforming their large capitalization peers by a large margin and currency markets have been more turbulent as countries try to gain an economic advantage or lift through increased exports. Notwithstanding these opposing views, we remain constructive on the outlook and boldly suggest that the equity markets will continue to ascend the WOW. Looking forward we expect the relative valuations between individual securities in any given industry to widen. During the extended period of artificially low rates, the valuation spread between securities in any given industry has been tighter than we have witnessed historically making the marginal difference between opposing valuation views somewhat immaterial. If investor's views on the price of securities start to diverge then we may see some biases form in the market. For instance, investors may start to prefer dividend growth opportunities over dividend yield situations which investors have enjoyed for some time. There may be preference for insurance companies over banks or companies with pricing power over others. In all of these instances we continue to seek out the companies with the best potential overall dividend and capital return combination and we are still finding value in the market.

For instance, we recently purchased Philips (PHG), a leader in healthcare, lighting and consumer products. Under new management since mid 2011, PHG is undergoing a sizable restructuring program in order to improve efficiency (the program has resulted in over 3% of margin improvement to date). More recently, PHG announced it will separate its healthcare and lighting segments to realize shareholder value. Overall, management is confident it can achieve 4-6% revenue growth, margins in the 11-12% range and is targeting a return on invested capital in excess of 14% which should drive 10%+ EPS growth over the next several years. As always, we will let our fundamental research tell us if there is value in the market. While we are still able to find great examples such as PHG, we believe this market will continue to move higher despite the WOW!

Fixed Income Markets – Low New Issuance

Generally speaking, the third quarter continued the trend set in the previous quarters of this year. Total new issuance has been low. This has largely been the case because of a decline in issuance by the banks and insurance companies who have been holding back in anticipation of clarification of the Basel III capital adequacy rules. While still leaving some questions unanswered, OSFI (Office of the Superintendant of Financial Institutions, Canada's bank and insurance company regulator) has provided enough detail to allow bank analysts to better assess the risk characteristics of Canadian bank deposit notes and subordinated debt.

On a projected basis against last year, full year total issuance in Canada will have fallen by approximately $22 billion. While there has been a small increase in corporate issuance the decline in bank issuance completely overwhelms the corporate market showing its dominance. Now that OSFI has, in their briefing papers and requests for comment, broadly confirmed that the outstanding deposit notes and subordinated debt will be "grandfathered" and therefore not vulnerable to conversion to equity in the event of a liquidity event, the path should be cleared for more bank issuance in the fourth quarter. The market participants are now developing a greater comfort with the NVCC (non-viability contingent capital) subordinated debt structure. The Royal Bank (RBC) has already tested the waters by issuing a NVCC bond in July which went very well. This was followed by a successful issue from The Bank of Montreal as well as a second 12 year issue from the RBC as we rolled into the new quarter. Simply put, the concept is to force the common shareholders and debt holders to absorb the cost of a bank failure. The NVCC structure converts the subordinated debt to common equity at a preset multiple, so the original common and preferred share holders are effectively wiped out. If the equity value of the troubled bank continues to fall, then it is those former NVCC bondholders that take any further loss.

Companies may look to pre-fund at least some of those issues given the current low cost of funds and the probability that rates will begin to rise in the next year.

One factor that may bring additional new issuance in the final quarter is the possibility that, with substantial maturities in the first half of 2015, companies may look to pre-fund at least some of those issues given the current low cost of funds and the probability that rates will begin to rise in the next year.

The corporate credit curve moved downwards until the middle of September, when some issues, as much in response to event risk, began to reverse and widen. For instance, the unexpected bid to acquire Tim Hortons by Burger King triggered a sharp and permanent drop in the value of the outstanding Tim Hortons bonds. Tim Hortons is rated BBB (investment grade) and Burger King is below investment grade at B or lower. This has also triggered a debate about the value of change of control clauses in underwritings. The current practice is a price at which the bond must be bought back by the issuer, typically $101. When there has been as large a rally in spreads as we have seen in the past few years, it is not unusual for the market price to be well above the change of control price. Consequently the bond holder is not protected for the often substantial spread in value between the market and the buyback prices.

The ongoing tension in both the Ukraine and the Middle East has been another unsettling factor for the bond market. However, with the general expectation in the bond markets that the U.S. Federal Reserve will begin tightening in the first half of 2015, there was not the same degree of capital flight to safety seen in previous flare-ups in the Middle East. It is worth noting that the markets have not sold off either.

We continue to believe that a careful balance between curve positioning and credit analysis will serve our clients well in this market environment. There will be some rotation out of industries or sectors that have done well so far this year, and into some of the new opportunities, such as NVCC bank capital debt.

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.

For more information contact:Barrantagh Investment Management Inc.(416) 868-6295

Copyright 2014 Barrantagh Investment Management Inc. All rights reserved. Reproduction of portions of this Commentary is permitted provided the source is noted. Please notify us at info@barrantagh.com of any reproductions.