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In This Issue

Economic Backdrop –Forecast Dilemma

Equity Markets – The Saudi Effect

Fixed Income Markets – Event Risk

- The final quarter of the year was a tough environment for economic forecasting. GDP (Gross Domestic Product) in the U.S. came in much stronger than expected, CPI (inflation) was lower than the market survey, existing home sales were softer than forecast, and construction spending turned negative month over month. Meanwhile, jobless claims have trended lower, personal income has risen steadily, retail sales in the U.S. have generally expanded as growth in the services sector remained positive and improving, while manufacturing remained solid.
- Given all of the above mentioned conflicting economic indicators, readers will not be surprised that the Fed continues to debate the timing of the shift to a tightening bias in monetary policy. It is becoming more difficult to identify the trigger that will usher in a new policy of increasing interest rates. Inflation has lessened throughout the fourth quarter freeing the Federal Reserve to continue to follow an expansionary policy.
- The U.S. appears to be in a bit of a utopia from the Feds point of view, with strong economic growth, low unemployment, and controlled positive inflation.
- Japan continues with what has been dubbed the three arrows to characterize Abe's policy - massive fiscal stimulus, more aggressive monetary easing, and structural reforms to boost Japan's competitiveness. However, in the past quarter the national rate of inflation rose to almost 3% before declining again to 2.4% and GDP growth remains elusive. Much of this may be due to the imposition of the consumption tax which discouraged consumers and pushed down retail sales.
- Economic growth in China continues to be a concern for the global economy. In the past three months the Chinese government has taken steps to reduce leverage and risk in the financial sector.
- Europe remains mired in weak economic condition and seems to be caught in the drift towards deflation. The ECB (European Central Bank) has done little to stimulate the EU economies so the market has been eagerly awaiting a clear statement of its intent to initiate QE, and has so far remained disappointed.
- In the fourth quarter, the overriding macro event was the steep decline in oil which started in the summer months and has contributed to equity market volatility. Oil's decline will probably be an overhanging topic for the next several quarters, as we enter 2015, due to the large shadow it casts, especially as it relates to Canada. What is dire for Canada is good for the global economies and stocks. For consuming countries, declining oil prices should modify consumer spending as disposable income shifts from gas purchases (currently about 15% of disposable spending) to other goods, thereby supporting global GDP.
- Energy's decline creates a catalyst for many other industries and the markets in general. Retailers such as Wal-Mart benefit as consumers have more disposable income for non-energy needs. Energy is a large part of operating costs for companies in the transportation industry creating an instant savings and increased bottom line. Inflation will remain subdued allowing cost advantages for companies while consumers spend more.
- The second half of 2014 brought the threat of event risk to the Canadian fixed income market with the takeover of Tim Horton's by Burger King and Enbridge's restructuring.
- As long as the Bank of Canada holds the Bank Rate steady at 1%, the yield curve will continue to trade in the same range we saw through the end of the year. The market consensus remains that Canadian administered rates will follow the U.S. with a few months lag.

Economic Backdrop – Forecast Dilemma

The final quarter of the year was a tough environment for economic forecasting. GDP (Gross Domestic Product) in the U.S. came in much stronger than expected at 5% versus forecasts of 4.3%. Good GDP numbers are usually accompanied with higher inflation. However, CPI (Consumer Price Index) was lower than the market survey for November at 1.3% versus 1.4% expectations. Meanwhile, notoriously volatile month to month housing statistics, did create some concern as existing home sales were softer than forecast (Nov. 4.93M vs forecasts of 5.20M), and housing starts lost some thrust (Nov. 1,028k, Oct. 1,045k). Construction spending turned negative month over month which seems to support the housing trend. On the other hand initial jobless claims have trended lower, leading forecasters to expect stronger job creation results for December as non-farm payroll growth and the overall employment rate exceeded expectations throughout the quarter. Retail sales in the U.S. have generally expanded, and are expected to make a significant contribution to Q4 GDP. Retail sales have been supported by personal spending, and will likely continue to benefit as most industrialized consumer nations gain from the decline in the price of oil. Similarly, personal income rose steadily through the year. Most indicators suggest that the consumer, accounting for some 70 percent of GDP, is still on track. The benefits from that should become more apparent as we move into 2015 and undoubtedly this will attract more attention from the Federal Reserve (Fed). In contrast to the improving employment and consumer spending news, capital goods orders remained soft through the quarter, although the decline in the cost of energy may boost this value going forth. Meanwhile, growth in the services sector as measured by the non-manufacturing ISM (Institute for Supply Management) has remained positive and improving (Nov. 59.3, Oct. 57.1, Sept. 58.6). Similarly the manufacturing ISM has remained solid but its growth rate is slipping with the December value (55.5) now at a six month low.

The U.S. situation seems to be in contrast to the rest of the world.

Given all of the above mentioned conflicting economic indicators, readers will not be surprised that the Fed continues to debate the timing of the shift to a tightening bias in monetary policy. It is becoming more difficult to identify the trigger that will usher in a new policy of increasing interest rates. It is clearly no longer the unemployment rate, as that has fallen to 5.8%, well below the 6.5% target Janet Yellen first offered as a data point. Inflation does not present any threat at this point, nor does capacity utilization (stable near 80%). Price pressures as measured by the PCE (Personal Consumption Expenditure) deflator, often referenced by both Bernanke and Yellen as a more reliable indicator of inflation, has lessened throughout the fourth quarter (Nov. 1.2%, Oct. 1.4%, Sept. 1.4%), freeing the Fed to continue to follow an expansionary policy. The U.S. appears to be in a bit of a utopia from the Feds point of view, with strong economic growth, low unemployment, and controlled positive inflation.

The U.S. situation seems to be in contrast to the rest of the world. In Japan, Abe called a snap election and had his mandate decisively renewed. This has freed him to continue with what he has dubbed the three arrows to characterize his policy (a massive fiscal stimulus, more aggressive monetary easing, and structural reforms to boost Japan's competitiveness). In the past quarter the national rate of inflation rose to almost 3% before declining again to 2.4% and GDP growth remains elusive (Q3 growth was -0.5%). Much of this may be due to the imposition of the consumption tax which discouraged consumers and pushed down retail sales, in turn compelling Abe to seek popular endorsement directly with the election.

Economic growth in China continues to be a concern for the global economy. In the past three months the Chinese government has taken steps to reduce leverage and risk in the financial sector. The availability of credit has decreased as well as expectations for economic growth which now stands at 7% for 2015.

Europe remains mired in weak economic condition with Q3 GDP growth of just 1.15%, and seems to be caught in the drift towards deflation amid a November inflation rate of just 0.3%. The ECB (European Central Bank) has done little to stimulate the EU economies. The market has been eagerly awaiting a clear statement of intent to initiate QE, and has so far remained disappointed. Meanwhile Greece has managed to stir things up again, with further budget problems and the collapse of the coalition government. The one serious issue that is likely holding back the start of QE in the EU is the structure of the EU monetary authorities. If QE is started, then the ECB will be required to buy issues of the member states in various weights, including those of Greece, Portugal and so on. This carries the risk of building a flawed picture of market support for the issues of marginal EU member states, and would likely push deficit management off into the future, potentially creating a new crisis again in a few years time.

The final analysis continues to suggest a low interest rate environment, with low, but positive growth for the global economy.

Equity Markets – The Saudi Effect

In the fourth quarter, the overriding macro event was the steep decline in oil and will probably be an overhanging topic for the next several quarters, as we enter 2015, due to the large shadow it casts, especially as it relates to Canada. With over 27% of the Canadian stock market weighted to the oil sector when it was trading at $100 per barrel, it would be very difficult for the market to perform well as oil slid below $60 per barrel and energy names fell sharply. The oil sector is off 25% from its peak in June with its weight declining to 20% in the S&P/TSX. Despite the drag from energy resulting in a negative fourth quarter (down 1.5%) for Canada, the net result for the year was a very positive 10.5%. Global markets fared better with a fourth quarter return of 4.8% driving the overall yearly return to 15.5% in Canadian dollar terms. For those travelling outside our borders at this time of year, it's interesting to note that two thirds of the world equity, yearly performance, is partially due to the negative effect on the Canadian dollar from oils decline.

Energy's decline creates a catalyst for many other industries and the markets in general.

As these performance numbers demonstrate, what has been dire for Canada is good for the global economies and stocks. While energy makes up a large portion of Canada's GDP (10%), for consuming countries, declining oil prices should modify consumer spending as disposable income shifts from gas purchases (currently about 15% of disposable spending) to other goods, thereby supporting global GDP. In recent memory, Saudi Arabia has been the swing producer to manage supply. However, it is different this time. Saudi Arabia (30% of OPEC's production) has openly "drawn a line in the sand", refusing to curtail production and in fact discounting prices to protect their market share. They wish non-OPEC nations and high cost production (i.e. North Sea, U.S. shale, Canadian Oil Sands) to feel the pain and therefore reduce supply, which should allow prices to move higher. Much of this thinking revolves around economic needs for OPEC, but there are many conspiracy theories, around lower oil prices, that seem to hold some credence around a political realm. For instance, lower oil prices make it tough for Russia who needs the exports for its economy. ISIS, the militant terrorist group, is funded by oil money. The conspiracy theorists believe the U.S. may be supporting the Saudi's in an effort to spur its domestic growth and advance its global agenda.

Given the wide shadow that energy casts and the stance of the Saudi's, we have been very proactive in the portfolios. Since it is a commodity, we reviewed production costs for key areas to determine a reasonable range for long term oil prices. This analysis concluded that oil will range between $70 and $90, with a longer term average of $80. We then stress tested companies to weed out high cost, high debt and high dividend paying energy names that may have issues in a lower oil environment. Our analysis then led us to review energy companies that can perform well during a full cycle. All of this analysis led to a reduction in the energy names in client's portfolios and ultimately preserved capital for clients. As a result of the lower energy weight, cash has increased and the weighting towards Canada was reduced in portfolios. Heading into the New Year, we fully expect to reinvest the cash. Ironically, one area of opportunity is the energy space. Names such as Whitecap and Tourmaline have sold off to a point where they are discounting oil prices below our projected long term price. To initiate positions we will have to become more comfortable that natural gas prices can hold up reasonably well during a mild winter (not the case in 2012) and that oil will revert back to a reasonable long term average. We are monitoring well permits, drilling rigs, and capital spending along with many other variables to determine a reasonable moment to re-enter energy names.

Meanwhile, energy's decline creates a catalyst for many other industries and the markets in general. Retailers such as Wal-Mart benefit as consumers have more disposable income for non-energy needs. Energy is a large part of operating costs for companies in the transportation industry creating an instant savings and increased bottom line. Inflation will remain subdued allowing cost advantages for companies while consumers spend more. As well, interest rates should stay lower for longer, continuing to catalyze spending. This has allowed us to identify companies that display great long term value, such as Adidas. Adidas is a well known brand name in sports shoes and apparel and a leader in golf equipment (Taylor Made). Adidas sold off recently due to softness in golf equipment and concerns around Eastern Europe (Russia). As well, the stock always seems to sell off after the World Cup of Soccer as investors assume sales have peaked, creating a buying opportunity. In golf, Adidas has been increasing margins by cleaning out inventory and changing to longer, new equipment release cycles. Meanwhile, it may take some time but we have faith that Eastern Europe will revert to normalcy at some point. Trading at a 20% discount to competitors, we believe it is a great long term value opportunity.

As we move into 2015, we continue to see value in the market place and will maintain our fundamental, value oriented, research focus. It is this focus which has preserved capital for clients while finding investment opportunities, not unlike what we have witnessed with the Saudi effect.

Fixed Income Markets – Event Risk

As noted in previous commentaries, new corporate issuance has been well short of the high reached in 2012. The culprit in this decline has been the big six banks. We noted that the Royal Bank of Canada (RBC), had issued the first domestic Canadian NVCC (non-viability contingent convertible) bond in the third quarter, and followed up with another issue. Bank of Montreal and CIBC followed the RBC deals, but the trickle did not turn into a torrent. However, in the coming year the bank maturity schedule is more than double that of 2014, so the banks will be compelled to resume issuance of debt. That rise in volume is likely to be at least somewhat offset by a decline in other corporate issuance.

The second half of 2014 brought event risk to the Canadian fixed income market. The first blow fell with the acquisition of Tim Horton's by Burger King. Tim Horton's bonds were downgraded from BBB to B to match ratings with those of the acquirer. The next incident came with the pressure applied by a hedge fund on TransCanada, which pushed their credit spreads out. Sandell Asset Management made public their desire to break up TransCanada, believing that this would unlock value, and allow a significantly higher dividend. This situation in turn encouraged Enbridge to restructure before one or more hedge funds upped the ante and came after them. This was accomplished in an equity friendly, negative for bonds, manner. Enbridge transferred ownership of Enbridge Pipeline to Enbridge Income Fund, and at the same time they increased the dividend payout from 60%-70% to 75%-85%. The sharp outward swing in spreads on previously stable Enbridge issues indicates that the market expects these changes will likely trigger a credit rating downgrade.

In light of the fact that Enbridge had just recently been to the fixed income market and the sheer volume of new capital required for their planned projects, it is expected that Enbridge will offer to exchange at least some of its existing Enbridge Pipeline Inc debt for Income Fund debt. This could be done in the same manner as the exchange that followed the takeover of Bell Alliant by BCE. That entailed the straightforward exchange of existing Bell Alliant bonds for the same terms and conditions in newly issued BCE bonds. The net result is to lessen the impact of the new structure on the bond holders, and to bring bondholders back closer to the assets that support the credit. This would be a positive for the holders of Enbridge Income Fund debt.

The bond market may be impacted by the anticipated tightening of monetary policy.

Government of Canada (GOC) yields dropped significantly in the last three months, declining almost 30 bps (basis points) in the 10 year and 25 bps in the 30 year. This is about 18 bps off the all time low set in July 2012 in 30 year bonds and 25 bps off the all time lows in 10 year bonds. As long as the Bank of Canada holds the Bank Rate steady at 1%, the yield curve will continue to trade in the same range we saw through the end of the year. Consensus remains that Canadian rates will follow the U.S. with a few months lag. This would have the Bank of Canada initiating a slow tightening program in Q3 or Q4 of 2015.

REITs (Real Estate Investment Trusts) continued to be strong performers in the first part of the fourth quarter. With oil and gas issues starting to underperform and their spreads over the GOC curve widening, energy spreads pushed wider than telcos and industrials, which is not the historical norm, nor sustainable. Lesser rated REIT spreads relative to government bonds had to widen out to maintain their structural position relative to the stronger energy credits. This widening meant that REITs gave back some of the strong yearly performance.

The fall in energy prices is a boon for Ontario and Quebec, which were being held back by the high cost of energy and the consequent slowing in manufacturing. Over the past few years, as fuel costs rose, the U.S. car makers were shifting production of larger, inefficient vehicles to Canada. Now Canadian factories are producing the vehicles the ever fickle car buyer wants, so between a weaker dollar, falling fuel costs, and rising production, Ontario and Quebec should see a reprieve in credit quality.

As we move through 2015 we expect that the bond market may be impacted by the anticipated tightening of monetary policy and will position the portfolios accordingly to maximize performance for our clients.

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