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- Market participants headed into the first quarter of 2015, with the hope that the growth pattern of the U.S. economy and hence monetary policy would begin to be clearer, however, little emerged as a trend. Given the mandate of the Federal Reserve, to ensure maximum employment, stable prices and moderate long-term interest rates, policy remains unpredictable as the Fed struggles to reconcile the disparate data items.
- One of the major drags on the U.S. economy in 2014 was the second half slowdown in housing. In Q1 this has started to reverse itself. New and existing home sales have picked up nicely. Pending home sales (representing home sales that have not yet closed) are up sharply, and the S&P Case Schiller home price measure is rising steadily.
- Having abandoned QE (quantitative easing) in 2014, the Fed has turned its attention to the timing of raising interest rates. Initially the FOMC used language indicating that they would act slowly and deliberately and would be data driven. Then, after much speculation at the March FOMC meeting they removed the word "patient". Market participants have returned to the old practice of Fed watching, parsing every word or phrase to get a hint of a start date for tightening.
- Western Europe has finally started to show signs of life. Germany's unemployment rate has fallen to a recent low, at 6.4%. The Euro has declined to USD 1.05 before settling at USD 1.07, and that has helped the Eurozone recover. Domestic consumption is also picking up, with growth in new car sales and reported retail sales volumes. Construction in Western Europe is expanding as well.
- In the first quarter the ECB (European Central Bank) finally launched its version of quantitative easing (QE). The start of this program has driven many 10 year government bond yields below zero and it does appear that the ECB is managing to open up the monetary policy transmission channels.
- The first quarter of 2015 started on a positive note for global equities but not all areas or industries have been treated equally. It would seem that the volatility that we have referred to in several BIM Reviews has become contagious with notable volatility in currencies and commodities creating winners and losers within the markets.
- Although the markets in general do not seem overvalued, we are noticing in our research that we need to sort through more ideas today to find potential investment candidates, than we had to a year ago. The volatility in the various asset classes, the onset of QE Europe, China slowing, mixed economic numbers and interest rate uncertainty, have all contributed to valuation movements that may or may not be justified.
- The seven month slide in oil to $46 from $98 in June caused enough concern at the Bank of Canada that they decided to surprise the market and cut rates by 25bps to "take out an insurance policy". Not only is the overnight rate now set at 0.75%, the market also expected a second, or even a third rate cut, potentially putting the overnight rate back to 0.25%, last seen in mid-2010.
- Throughout the quarter, communication from the BoC became less dovish making the bond market less sure of any future rate cuts. Uncertainty in the market for the first quarter and increasing company event risk has driven bond investors to buy lower risk debt, specifically highly rated infrastructure and utility companies.

Barrantagh
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Economic Backdrop – Growth Not Synchronized

Market participants headed into the first quarter of 2015, with the hope that the growth pattern of the U.S. economy and hence monetary policy would begin to be clearer, however, little emerged as a trend. Given the mandate of the Federal Reserve, to ensure maximum employment, stable prices and moderate long-term interest rates, policy remains unpredictable as the Fed struggles to reconcile the disparate data items. On the one hand job creation continues to be successful. The unemployment rate has fallen over the first quarter settling at 5.5% and non-farm payrolls have risen steadily, averaging roughly 250,000 new jobs each month. However, other economic indicators have proven less cheering.

Personal income has expanded fairly steadily, while personal spending has slowed (actually falling 1.2% annualized in the three month period of Q1). In our December letter we had expressed the hope that the then rise in consumer spending would persist and contribute to economic growth. This was not to be! It is likely that the long, snowy and cold winter kept shoppers at home, and the final arrival of spring will bring more retail activity. Similarly inflation has stubbornly resisted efforts to increase. This has of course been helped by the continued low price of oil. Durable goods orders declined substantially in the first quarter, falling 5.4% annualized in the three months. New orders for non-defense capital goods ex-aircraft, which is often used as a proxy for future business spending, declined in February marking the sixth decrease in a row, raising further concerns about the state of the U.S. economy.

Meanwhile, one of the major drags on the U.S. economy in 2014 was the second half slowdown in housing. In Q1 this has started to reverse itself. New and existing home sales have picked up nicely. Pending home sales (representing home sales that have not yet closed) are up sharply, and the S&P Case Schiller home price measure is rising steadily, up 4.6% YoY. Housing starts, a strong source of new jobs, are also gaining momentum. Most forecasters had expected the harsh winter weather to have suppressed the home sales numbers, but clearly, buyers have cash and the desire to spend it on housing. Mixed economic signals, has made it very difficult for the Fed to determine the most appropriate course of action. Having abandoned QE (quantitative easing) in 2014, the Fed has turned its attention to the timing of increasing interest rates. Initially the FOMC used language indicating that they would act slowly and deliberately and would be data driven. Then, after much speculation at the March FOMC meeting they removed the word "patient". Market participants have returned to the old practice of Fed watching, parsing every word or phrase to get a hint of a start date for tightening.

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The Fed also needs to balance the impact of the rising dollar. Any rate increase in the U.S. will further strengthen the currency, impacting export growth. It is easy to understand why Yellen continues to vacillate, facing such a mix of contradictory economic measures.

Western Europe has finally started to show signs of life. Germany's unemployment rate has fallen to a recent low, at 6.4%. The Euro has declined to USD 1.05 before settling at USD 1.07, and that has helped the Eurozone recover. Domestic consumption is picking up, with growth in new car sales and reported retail sales volumes. Construction is expanding as well. In the first quarter the ECB (European Central Bank) finally launched its version of quantitative easing (QE) entailing the purchase of €1.1 trillion worth of government bonds. Under the asset purchasing scheme the ECB will not hold more than 33% of any issuer's debt and will not buy more than 25% of any issue. The start of this program has driven many 10 year government bond yields below zero. However, it does appear that the ECB is managing to open up the monetary policy transmission channels. The ECB has also managed to increase the availability of bank credit for companies and individuals. This should contribute to economic expansion in the Eurozone. The greatest hurdle for the Eurozone is Greece. Greece will not be eligible for the new bond purchases until July, under existing rules, and would have to continue with its austerity program to qualify. The election of the Syriza party in Greece has led to a series of tortuous negotiations that are not going very well. Greece has to make a repayment in April, which they are currently unable to meet.

In Japan, the news is also less positive. Core CPI has stalled in its upward trend and slipped back slightly. GDP growth is anemic, whether measured at the private consumption level or business spending. New car production has dropped significantly in the quarter, despite the depreciation of the Yen. The verdict on Abenomics is not in yet, but Abe is clearly on the defensive. The one bright light for the Japanese economy is the rapid growth in Asian tourists coming to Japan. Once a very expensive destination, the exchange rate drop has made it cheap. Tourism has risen 30% or more in the past few months. Globally, regions continue to be in different states of the economic cycle, but growth continues to be positive.

Equity Markets – Not All Treated Equally

The first quarter of 2015 started on a positive note for global equities but not all areas or industries have been treated equally. It would seem that the volatility that we have referred to in several BIM Reviews has become contagious with notable volatility in currencies and commodities creating winners and losers within the markets. For instance, the Saudi effect from last year has continued the energy related volatility as lower oil prices have not deterred production to-date. As well, energy related currencies such as the Canadian dollar have not done well which is highlighted by the performance numbers. In Canadian dollar terms the Canadian market was up 2.6% for the quarter and world markets, led by Europe and the start of its QE (quantitative easing) program, were up 11.8% suggesting a wide discrepancy. However, in U.S. dollar terms the global markets were up 2.5% underlining the currency volatility with more than a 9% drop in the Canadian dollar, versus the U.S. dollar, making up the difference.

Many would suggest that the Canadian dollar decline is due to oils decline and in part that would be true. However, one would also be right to point to many other longer term factors at play which also weigh on the Canadian dollar. Canada's incessantly lagging productivity levels versus other countries or our employment trends (part time versus full time) or the personal debt load to name a few. All of these factors are well known by potential foreign investors and in fact were emphasized by the IMF (International Monetary Fund) during the month of March as things that Canada needs to address. Therefore, the decline in the Canadian dollar is in part due to these factors as well and emphasizes the need to filter investment opportunities both domestic and foreign.

Although the markets in general are not overvalued, we are noticing in our research that we need to sort through more ideas today to find potential investment candidates, than we had to a year ago. The volatility in the various asset classes, the onset of QE Europe, China slowing, mixed economic numbers and interest rate uncertainty, as mentioned in the Economic Backdrop, have all contributed to valuation movements that may or may not be justified.

High quality stocks, in this environment, seem to carry a premium valuation over historical spreads.

For instance, social media stocks such as Facebook Inc. trade at very high multiples, whereas "old school" technology stocks trade at reasonable multiples, have good growth and free cash flow, but their performance lags. Similarly, high quality stocks, in this environment, seem to carry a premium valuation over historical spreads making it difficult to justify valuation in some cases. Many are trading at valuation multiples which are 4 or 5 times higher than their historical norms as investors seek certainty in an uncertain environment. Despite the irregularities, we have been able to find securities which hold long term value.

For instance, Gildan Activewear is a leading North American provider of basic family apparel that has made significant investments in large-scale textile manufacturing to drive profitable growth. The company enjoys a dominant position in print wear (shirts sold to screen printers), and continues to build out a branded apparel offering (recent success in underwear). We expect Gildan will continue to leverage its quality and cost leadership derived from its vertically integrated manufacturing footprint to drive continued volume growth in print wear and branded apparel.

Globally, Priceline, the world's largest ecommerce travel company, was added for its leading European market position, disciplined cost structure, and ability to generate strong cash flow. We expect Priceline to continue to gain market share versus peers, specifically in North America under its Booking.com brand. Online travel agencies have disrupted the conventional means of booking travel and revolutionized the booking experience for consumers to become one of the largest sales channels for travel suppliers. Throughout 2014 Priceline faced foreign exchange pressure and slowing growth expectations from the maturation of the industry. Priceline's premium valuation disappeared creating an entry point. Through its strong portfolio of brands we expect Priceline to grow bookings at greater than 20% for a number of years translating into further cash generation and shareholder value.

We added Jarden ("JAH") below 18x earnings, a 15% discount to home and personal care (HPC) peers. JAH is a high-quality company with over 120 well known brands for everyday life (Coleman, Sunbeam, etc.). The Company has a consistent track record of above average organic growth (6% higher than peers last quarter) and margin expansion (up 1% last quarter) driven by its diversified and innovative portfolio of brands. Additionally, Jarden has a long history of successful M&A which it uses to supplement organic growth and add to its product portfolio. We believe the valuation gap with peers will contract over time. Longer-term, management has committed to a 2018 earnings per share target of $4.00 (from $2.65 in F2014) indicating their confidence in JAH's ability to grow 10% + over the next several years.

These examples suggest that the imbalance in the markets continues to let us find great long term value opportunities for our clients.

Fixed Income Markets – Rate Cut Surprise

January continued the trends of 2014 with lower oil prices and lower interest rates. The seven month slide in oil to $46 from $98 in June caused enough concern at the Bank of Canada that they decided to surprise the market and cut rates by 25bps to "take out an insurance policy". Not only was the overnight rate now set at 0.75%, the market also expected a second, or even a third rate cut, potentially putting the overnight rate back to 0.25%, last seen in mid-2010.

Since the end of January oil and interest rates have remained range bound.

As the economic data continued to come in, and the market analyzed the BoC (Bank of Canada) comments, the 1 year rate slid through January and into late February. By Feb 23rd the Canada 1 year rate was yielding 0.41%, down from 0.93% at the surprise date. Canadian interest rates for other maturities followed suit, and the 30 year rate went from 2.33% at the start of 2015 to 1.83% at the beginning of February. Since the end of January oil and interest rates have remained range bound. The 1 year rate moved back to a high of 0.65% in March, while the long end of the curve increased to 2.23%, but still below the December 31st high of 2.33%.

Throughout the quarter, communication from the BoC became less dovish making the bond market less sure of any future rate cuts. Uncertainty in the market for the first quarter and increasing company event risk has driven bond investors to buy lower risk debt, specifically highly rated infrastructure and utility companies. Hydro One, the credit quality leader of the corporate market, has seen its 30 year credit spread drop 17 basis points (bps) from the end of Jan to the end of March. Our investors have benefitted from this gain through two holdings of Hydro One, and similar positions in GTAA, Nav Canada, 407 ETR, and Toronto Hydro. However, even in this typically safe part of the Canadian corporate debt market, concerns abound. It is budget season and while some provinces are meeting their targets, here in Ontario, privatization remains a steady topic of discussion.

As regulators clarify rulings on non-viable contingent capital (NVCC), and its impact on older subordinated debt and senior debt, the banks have issued in the five and seven year terms. Bank senior debt also benefitted from the move into quality credit, seeing its spread decline from a high of 99bps in mid-January. While we did not participate in any of the new deals, our existing positions benefited from the flight to quality.

One of the corporate sectors in the debt market that is gaining a stronger fundamental business footing is the grocers. Store square footage growth is moderating in 2015, and grocers are also benefitting from the pickup in inflation, as it is able to pass on higher prices to its customers. In addition, most national chains have shown that their recent acquisitions and expansions are being successfully integrated. As a result we feel confident in our holding of five year Loblaw debt. Future performance in the sector may be influenced by relative value relationships with other sectors. Historically, Enbridge represented the floor of quality pipeline and energy names and its credit spread was much lower than companies like Loblaws. However, after Enbridge's restructuring and payout announcement in early December its relationship with other sectors has changed. Today, the perceived credit quality of Enbridge, and historical precedence, may be providing resistance for companies like Loblaws to move tighter. As the next quarter unfolds the market will find out more about Enbridge's restructuring plan and that could have considerable impact on this part of the corporate debt market. We continue to monitor this situation closely and its impact on our single holding of Enbridge debt.

The telecommunications sector has underperformed so far in 2015. In March, Telus was a big player in a wireless spectrum auction, which was expected as it had not been successful in previous events. The company spent $1.5bln dollars, and funded this with three bond issues for a total of $1.75bln. As a result of the supply, Telus 10 year spreads have widened. We avoided the underperformance of Telus and continue to hold seven year debt of Bell and Rogers.

We continue to follow the market very closely to identify opportunities to benefit from improving credit quality and to reduce the susceptibility to event risk. We have maintained our duration at current, lower than market levels, to position ourselves against the risk of higher interest rates as the year progresses.

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