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- The majority of forecasters had concluded that the Fed would commence liftoff and begin tightening in September. The September FOMC meeting came and went with no rate change, and while the FOMC press release made reference to other countries' weakness, which is not specifically identified in the Fed's mandate, little new was put forward.
- Yellen has now indicated that a majority of the FOMC voters are in favour of increasing interest rates by year end. However, little has changed in the economic picture since the September meeting, leading to the inevitable question of what has changed to justify a rate hike in October or December.
- Meanwhile the U.S. economy is picking up some speed. Personal spending has been growing steadily from month to month, and the new housing market has been accelerating as well. The search for building sites has been a greater challenge than finding buyers. Consumer confidence is gaining momentum and job creation is holding steady around the 200,000 level each month.
- China's economy experienced significant weakness throughout the third quarter. Profits earned by Chinese industrial companies in August fell by over 8.8 percent year over year. Companies were reportedly hurt by rising costs, falling prices, and the recent stock market slump, which pushed down investment returns. China's economic slowdown is affecting global growth, especially in the emerging markets.
- European concerns have shifted from the slow but ongoing resolution of the various eastern European sovereignty issues to dealing with the sudden flood of migrants coming from Libya, Syria, Iraq and countless other centres.
- However, in Europe the biggest surprise came in the form of Volkswagen and their manipulation of the anti pollution controls in their diesel engines, involving over 11 million cars and light trucks. Ironically the preparation of mechanical and software fixes will likely keep assembly lines running and create job opportunities in Germany and eastern European countries, helping to maintain predictions of moderate global GDP growth.
- In Canada, we have had a technical recession, consisting of two quarters of negative economic growth. However, much of the Canadian situation has been compounded by the Saudi's determination to remove high cost, non-OPEC oil production from the market as they drove prices to levels which has deterred capital investment and should affect supply.
- Despite concerns, at this point we do not believe the equity market pullback is a precursor to a global recession, but rather an adjustment to continued moderate global growth. Our confidence is supported by the lack of any recessionary predictors along with reasonable stock valuations. Our analysis has given us the confidence to add to positions or buy new names as the opportunities unfolded.
- In July, the Bank of Canada (BoC), cut the overnight lending rate by an additional 25bps to 0.50%. We do not expect the Bank of Canada to change rates as they wait to see when the U.S. Fed will enter a rate hiking cycle. It is worth noting that Canada has never consistently cut rates when the Fed is hiking. Right now, the market has priced in no rate changes for the next two years, which may err on the conservative side.

Barrantagh
Investment Management

Economic Backdrop – The China Effect

Another quarter has passed with market participants failing to receive a clear signal from the Fed Open Market Committee (FOMC). The majority of forecasters had concluded that the Fed would commence liftoff and begin tightening in September. The September FOMC meeting came and went with no rate change, and while the FOMC press release made reference to other countries' weakness, which is not specifically identified in the Fed's mandate, little new was put forward.

The continued insistence by Janet Yellen that the Fed's policy moves are data driven has kept the U.S. stock and bond markets off balance.

In the subsequent press conference Chair Yellen made it clear that economic difficulties in major foreign markets would not be sufficient to deter the Fed from acting. The foreign reference was interpreted as pointing to a rapidly weakening Chinese and soft European economies. The FOMC press release also indicated that inflation would slowly move upwards to meet the Fed target of 2 percent. This was evidently intended to ease concerns that deflation would impede the Central Bank's policy implementation. As long as the price of oil remains low, inflation has little opportunity to gain a foothold in the world economies. Yellen has now indicated that a majority of the FOMC voters are in favour of increasing interest rates by year end. However, little has changed in the economic picture since the September meeting, leading to the inevitable question of what has changed to justify a rate hike in October or December.

The continued insistence by Janet Yellen that the Fed's policy moves are data driven has kept the U.S. stock and bond markets off balance. Hawkish statements from board members are followed closely by dovish action. The Fed needs to get a better sense of the economy's strengths and weaknesses before they act, but the insistence on action before the end of 2015 puts this off balance. Meanwhile, the economy is picking up some speed. Personal spending has been growing steadily from month to month, and the new housing market has been accelerating as well. Concurrently, consumer confidence is picking up and job creation is holding steady around the 200,000 level each month.

China's economy experienced significant weakness throughout the third quarter. This was first interpreted as the result of the Chinese government being slow to add liquidity, but then emerged as the consequence of the collapse of the real estate lending bubble, particularly in the major centres, and a general economic slowdown. Profits earned by Chinese industrial companies in August fell by over 8.8 percent year over year, the largest annual decline since China began collecting this data in 2011. Over the first eight months of 2015, profits were down 1.9 percent compared to the same period last year. Companies were reportedly hurt by rising costs, falling prices, and the recent stock market slump, which pushed down investment returns. China's economic slowdown is affecting global growth especially in the emerging markets.

The arrival in Syria of a major military force backed by Russian troops has now further served to complicate the already highly confused picture in the Middle East. Russian President Putin's intentions are not clear, and the West is trying to determine if this represents an escalation of the fighting, which would inevitably bring Western alliance forces into a military confrontation, or the introduction of a negotiating position. By the end of September the Russians had begun executing a broad swath of air strikes against both ISIS and Syrian rebel forces.

In Europe, the European Central Bank has had a difficult time trying to add liquidity to the European markets. This is partly because of a lack of demand for corporate and consumer loans. European concerns have also shifted from the slow but ongoing resolution of the various eastern European sovereignty issues to dealing with the sudden flood of migrants coming from Libya, Syria, Iraq and countless other centres. The sheer volume of people seeking to enter Europe in search of refuge has overwhelmed the humanitarian resources of the various countries along the way. Efforts led by Germany to coordinate an EU aid response have been stymied by regional self interest or a lack of willingness of many countries to take on a share of the burden or the risks. To further complicate matters, the voters in Catalonia did not give a sufficiently substantial mandate to their regional government to begin negotiating separation from Spain, hopefully removing one more EU concern.

The biggest surprise in Europe came in the form of Volkswagen and their manipulation of the anti-pollution controls in their diesel engines, involving over 11 million cars and light trucks. This issue has cast a blemish on the sterling reputation of German companies. The scandal is spreading as more information emerges, and fresh allegations are made. While VW has made provisions, the potential cost both in terms of penalties and loss of sales will likely soar higher. Ironically the preparation of mechanical and software fixes will likely keep assembly lines running and create job opportunities in Germany and eastern European countries helping to maintain predictions of moderate global GDP growth.

Equity Markets – Nervous Consolidation

During the past year we foreshadowed the inevitable increase in volatility for the equity markets, suggesting that it was well overdue and should be considered "normal". Of course the timing of the volatility and the extent is almost impossible to predict. However, what we should have reminded readers and ourselves is that any downward volatility in the markets never feels good no matter how much it is anticipated. The markets reminded us of that in the third quarter as they consolidated from their peaks. The Canadian markets pulled back 7.8% and global markets followed suit dropping 8.3% which translated to negative 1.6% in Cdn dollar terms. At this point, questions abound about whether this is a pull back or a bear market that is predicting a recession.

Clearly in Canada, we have had a technical recession, consisting of two quarters of negative economic growth. However, much of the Canadian situation has been compounded by the Saudi's determination to remove high cost, non-OPEC oil production from the market as they drove prices to levels which has deterred capital investment and should affect supply.

As a better picture unfolds for Canada, many other names which are oversold will benefit…

In fact, oil service activity and production declines suggest this is already occurring and there should be a more favourable energy outlook by year end. This is not only supported by the fundamentals but also by the rhetoric emanating from more knowledgeable sources. For instance, over the course of the last month Saudi Arabia continues to do debt issues and is seeking a consultant to help with their budgeting process, suggesting that they are not immune to the effects of lower energy prices. The Saudis also proposed that OPEC may need to meet to discuss "fairer" prices for energy which follows the Norwegian Oil Minister's statement…"Nobody is making money at these levels". A more favourable outlook for energy will continue to support the current rebound in the Canadian economy and sustain our view that over the next 12 months energy related securities such as Badger Daylighting, Black Diamond, Raging River and Flowserve will be some of the better performers in our client's portfolios. As a better picture unfolds for Canada, many other names which are oversold will benefit as foreigners rush back to take advantage of low valuations, an improving economy and a strengthening currency. The Canadian banks, having just reported numbers that beat expectations while raising their dividends, should perform well as they trade at only 10 times earnings and support dividend yields over 4%.

Meanwhile, the global economy is feeling the effects of the slowdown in China, especially in countries most dependent on exports to China such as Japan and many emerging market (EM) countries. China's slowdown has also weakened commodity prices, affecting developed markets such as Canada and Australia. Despite these concerns, at this point we don't believe the market pullback is a precursor to a global recession but rather an adjustment to continued moderate global growth. Our confidence is supported by the lack of any recessionary predictors. For instance, the yield curve continues to be positive with long rates higher than short rates. In fact the spread between long and short rates suggests the probability of a recession is less than 20%. Inventories are low, employment continues to improve, consumer confidence is high, corporate balance sheets are in great shape and stock valuations give no indication of valuation bubbles. Most importantly, interest rates are low, and inflation is currently benign. It is also worth noting the slowdown scares that occurred in the U.S. and Europe over the last few years, causing market pull backs, but no recession.

In taking the longer term view, our analysis has given us the confidence to add to positions or buy new names as the opportunities unfolded. We added Bayer at less than 15x F2016 earnings per share which is a 10% discount to the sector and 15% from its peak. Bayer has higher than average earnings growth of 15% over the next couple years vs. peers at closer to 10%. Bayer is highly diversified with a focus on Pharmaceuticals, Consumer Health and Crop Science. Bayer's largest segment, Pharmaceuticals (roughly 45% of revenue) is expected to continue to grow at greater than 6%, driven by its strong franchise of current drugs and key product launches. Additionally, with the planned initial public offering of its Material Science segment, the Company is becoming more focused on the faster growing Healthcare segment.

We also added CCL Industries, a global leader in the label and specialty packaging markets with an excellent track record of shareholder value creation. The company's global leadership in labels (printed for customers mainly in the consumer staple, healthcare, and food & beverage markets) should continue to drive strong organic growth, margin stability and the opportunity to consolidate a fragmented market. We expect CCL to leverage its leadership position to drive profitable growth, utilizing its strong free-cash-flow and pristine balance sheet. These purchases are excellent examples of the long term, value opportunities that the current market retreat has exposed.

Fixed Income Markets – Rates on Hold

In July, the governor of the Bank of Canada (BoC), Stephen Poloz, followed through on his communication from earlier this year and cut the overnight lending rate by an additional 25bps to 0.50%. This move effectively reversed two of the three hikes in 2010 under the previous governor Mark Carney. The decision to cut rates was mostly a result of the drop in commodity prices and its effect on the Canadian economy. As the former head of the Export Development Bank of Canada, it seems that Governor Poloz has continued to focus on supporting non-energy industries. A lower interest rate diminishes the value of the Canadian dollar, which should make Canadian exports more competitive internationally.

The recent economic data out of Canada has stabilized, and third quarter GDP growth is projected to be around 2.5%, ending two quarters of negative growth. In the current environment the focus is no longer on cutting rates. With the U.S. Fed poised to raise rates in the near term, there is no need to cut in Canada. While there is a chance the BoC will cut again in the next 12 months, the market is pricing in only a very small probability.

In the U.S., the focus is less on when the Fed will hike, and more on the pace of raising rates.

The Canadian yield curve remains relatively flat through to 2020. Investing in a Canada bond that matures in one month or three years will have almost identical yields. As such, we have limited the exposure in that date range to the short end. During the quarter we sold half the 2019 exposure. Funds were reinvested in near term 2016 & 2017 holdings as well as 2021, 2022, with some 2045 maturities. This balanced approach helped manage duration risk by offsetting the new longer term holdings with shorter dated ones. To date, this strategy has worked well as the 2018 and 2019 maturity dates have been the worst performing part of the curve during the quarter. The yield curve is exhibiting a flattening trend as the 2 year part of the curve is locked near 0.50%, while rates in the 10 and 30 year parts continue to move down.

When adding holdings with near term maturities we looked to the corporate market to add more yield. We added Ford 2.634% Nov 2016 and Cominar 4.274% Jun 2017, which yield 1.85% and 2.60%, respectively. A great pick up from Canada bonds at 0.50%.

We do not expect the Bank of Canada to change rates as they wait to see when the U.S. Fed will enter a rate hiking cycle. It is worth noting that Canada has never consistently cut rates when the Fed is hiking. Right now, the market has priced in no rate changes for the next two years, which may err on the conservative side.

In the U.S., the focus is less on when the Fed will hike, and more on the pace of raising rates. The Fed's own forecast suggests the Fed Funds rate will rise considerably faster than what is priced into the market, and that point may be widely debated for some time. In Canada, the five year bond, with a yield of 0.78% implies only one full hike in the next five years as the overnight rate is currently 0.50%. Again, we see this as overly conservative and we will continue to look for opportunities to lighten up on five year maturities.

Provincial spreads moved significantly wider in August and September. The credit spread on the Ontario 3.5% Jun 2024 bond rose from 72bps at the beginning of August to 95bps at the end of September. Ten year Ontario spreads have not been this wide since 2012, during the height of the European debt crisis. Part of this widening is a result of underlying credit weakness, but a significant amount comes from the current risk-off tone in the markets. We do not hold any Ontario bonds.

Corporate spreads also moved wider in July and August. Looking at spreads as a percentage of the overall yield, this measure is comparable to levels seen during the financial crisis. Contrary to the market, we believe in U.S. economic growth, and that Canada has brighter days ahead. Should interest rates begin to rise modestly, spreads are poised to tighten. Even if rates maintain their current level, the higher yield in corporate bonds will add to strong returns. Corporate bonds are in a great position to outperform for the foreseeable future and we remain overweight.

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