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- The economic data has not changed significantly and continues to indicate a slow, non-inflationary recovery for the U.S. economy. To date the statistical measures that have been key to the Fed's policy are quiet. The sharp decline in all commodity prices will also contribute to the ongoing suppression of inflationary pressure.

- Throughout the year, contrary to the U.S. experience, other nation's central banks were shifting to a softer bias. The price of oil collapsed, abruptly forcing the Bank of Canada into an accommodative monetary policy. China's economy unexpectedly began to slow more than expected forcing an administered rate reduction while the ECB continued to try and design the most appropriate response to Europe's lack of growth through its own form of Quantitative Easing (QE).

- The terrorist attacks in France, together with the already contentious influx of refugees to the EU, have highlighted the starkly different attitudes of many of the EU member states. Germany needs younger workers that can apprentice to operate the German manufacturing sector. Many of the other EU members remain strongly opposed to taking in a proportionate number of refugees.

- Consumption in China, which has been the focus for domestic economic policy and had appeared to be strong earlier in the year, now appears to be on a steady decline. Meanwhile, China is attempting to raise the Yuan's status internationally.

- At the close of 2015 Saudi Arabia released a budget making it clear that they have little intention of reducing oil supply and will continue to pressure higher cost producers. They are now running a deficit over $100 billion and are planning to reduce this through a program of tax increases and spending cuts, reduction in subsidies and a privatization program. Further pressure on oil prices may come as Iran resumes exporting oil following the lifting of international sanctions.

- Equity markets started 2015 on an upward trend, but by the middle of the year, a negative bias took hold. In fact, the always anticipated Santa Rally in the markets was nowhere to be seen as December's performance was the weakest on record in over 10 years.

- Driven, in large part, by the slowdown in Chinese demand, commodities sold off. Fortunately, our under exposure to the commodity area helped the relative outperformance that our clients experienced in equities this year. The positive impact of our fundamental analysis on individual stocks is also apparent.

- Looking forward to 2016, we remain constructive on equity markets but returns for the markets as a whole, although likely positive on an absolute basis and relative to other asset classes, will probably be lower than experienced in the years prior to 2015. Also, we continue to think that volatility will become more prevalent which should benefit management styles that stress fundamental stock selection.

- We believe that the Bank of Canada will remain on the sideline through the coming quarter and maybe the year. The chances of a change in rates are very oil price dependent.

Economic Backdrop – Political Drag

In the fourth quarter financial markets were rewarded for their patience as the Federal Reserve finally moved to a tightening mode. At the December meeting the FOMC voted to increase the Fed Funds target range from 0.0% - 0.25% to 0.25% - 0.5%. This was the first tightening move by the Fed since the June 2006 meeting.

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We are now entering a bold new world of more restrictive monetary policy, in the U.S. and so far it has had little impact on the markets. For example, two year Treasury's have risen 15 basis points since the Fed move and have remained basically untouched at the long end. The commentary that accompanied the decision to begin "lift off" implies a strong probability that there will be more rate hikes in 2016. The economic data has not changed significantly and continues to indicate a slow, non-inflationary recovery for the U.S. economy. The sharp decline in all commodity prices will also contribute to the ongoing suppression of inflationary pressure. To date, the statistical measures that have been key to the Fed's policy are quiet. Labour availability and cost measures remain stable. Average hourly earnings growth is holding at or below the rate of inflation, while the creation of non-farm payroll jobs has been consistently higher than the 200,000 mark, creating a healthy backdrop.

2015 has been a tumultuous year for the world economies. Throughout the year, contrary to the U.S. experience, central banks were shifting to a softer bias. The price of oil collapsed, abruptly forcing the Bank of Canada into an accommodative monetary policy. China's economy unexpectedly began to slow more than expected forcing an administered rate reduction while the ECB continued to try and design the most appropriate response to the lack of growth through its own form of Quantitative Easing (QE). Germany and France, the strongest members of the EU, are facing presidential and other key elections in 2016, and early analysis suggests that there will be a continuing shift to the right. The terrorist attacks in France, together with the already contentious influx of refugees to the EU, have contributed to this shift and highlight the starkly different attitudes of many of the EU member states. Germany needs younger workers that can apprentice to operate the German manufacturing sector. Many of the other EU members are strongly opposed to taking in a proportionate number of refugees, fearing job losses, increased social benefit costs and are concerned about giving legal entry to terrorists. With the threat of a vote on a UK exit from the EU by the end of 2016, the Conservative government in London is wary of committing to any changes beyond their current efforts in the Middle East. Meanwhile, the aggressive entry of Russia into the civil war in Syria has added further complication to the political scene. While remaining economically weak and running with a significant level of sovereign debt, President Putin appears to be counting on a recovery in the price of oil to bail them out. In the meantime, Russia's presence in the Middle East has the effect of compelling the U.S. to slow their tactics in an attempt to achieve consensus on their plans for Syria and Iraq.

Consumption in China, which has been the focus for domestic economic policy and had appeared to be strong earlier in the year, now appears to be on a steady decline. China is attempting to raise the Yuan's status internationally. The entry of the Yuan into the SDR, while legitimizing it as a reserve currency, has had little if any impact so far. The small number of Yuan bond issues has in fact been taken up by central banks or sovereign wealth funds. Meanwhile, both as a means to stimulate the domestic manufacturing sector, and to boost China's global stance, they are producing warships of various specification to allow the Chinese navy to be more aggressive away from their shores. They are currently claiming territorial rights to a number of small islands in the South China Sea. This is bringing them into conflict with other countries in the area, notably Vietnam, the Philippines, Japan and ultimately the United States.

At the close of 2015, Saudi Arabia released a budget that made it clear that they have little intention of reducing oil supply and will continue to pressure the higher cost oil producers. They are now running a deficit over $100 billion and are planning to reduce this through a program of tax increases and spending cuts, reduction in energy subsidies and a privatization program. Further pressure on the price of oil may come as Iran resumes exporting oil following the lifting of international sanctions. Canada's economic decline, triggered by the fall in the price of oil, may make some of newly elected Justin Trudeau's plans less straightforward to implement. Trudeau has committed to significantly leverage Canada's economy to create jobs through the issuance of debt and a significant increase in the personal tax rate for the top one percent of income earners. Already, budget deficit projections are increasing.

As you can sense, we expect 2016 is likely to be a disparate year for global economies. However, pressure is building globally to force continued economic recovery as the year progresses.

Equity Markets – No Santa Rally

Equity markets started 2015 on an upward trend, but by the middle of the year, a negative bias took hold. Global markets showed positive performance for the fourth quarter (US 5.6% and CDN 9.0%) but were flat in U.S. dollar terms for the year. Canada was down 1.4% for the quarter and down over 8% for the year. In fact, the always anticipated Santa Rally in the markets was nowhere to be seen as December's performance was the weakest on record in over 10 years.

Driven, in large part, by the slowdown in Chinese demand, the Canadian market, due to its heavy bias to commodities, felt much of the brunt from the commodity sell off. Materials and energy led the negative charge, down over 15% and 20% respectively for the year, bringing commodity prices in-line with long term averages suggesting the commodity bubble has finally burst. Fortunately, our clients have not been overly exposed to commodities during this correction. However, with commodity prices reflecting normalized industry fundamentals, and global growth increasing demand, the current valuations in these areas are becoming a focus for our investment team. Commodity related industries were not the only areas to see weakness for the year. Of the 10 industry groups that comprise the stock markets, only 4 showed positive performance for the year. The under exposure to the commodity area helped the relative outperformance that our clients experienced in equities this year, but the evidence of our fundamental analysis on individual stocks is also apparent in other ways. When reviewing performance attribution analysis, it reveals that over 70% of the companies that our clients owned outperformed their respective industry, which is a very high percentage. This is a strong testament to our investment team and the bottom-up research we endorse.

Many times it is what you do not own that can highlight an investment philosophy. For instance, Valeant Pharmaceuticals, a company which develops and distributes drugs, played a large part in the Toronto Stock Exchange performance. Its stock price ended the year down about 15%, but during the year was up over 100% as well as down almost 50% relative to its starting price. Many clients ask why we did not own Valeant. The easy answer is that our analysis of the industry and the company generated contradictions. We could not answer critical questions such as why the revenue and earnings were growing far beyond expectations given our knowledge of the company and the industry. This made it difficult for us to justify the valuation. Throughout the year, it became apparent that this growth was in part driven by aggressive and questionable business practices related to the company's specialty pharmacy network. After all this was revealed, management changed their practices, and we look forward to updating our research to decide on the company's investment worthiness.

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Looking forward to 2016, we remain very constructive on equity markets and believe that with the selloff in commodities, hopefully behind us, Canada may not lag as it did in 2015. Despite being positive on equity markets looking forward we would like to highlight two developing themes. First, returns for the markets as a whole, although positive on an absolute basis and relative to other asset classes, will probably be lower than experienced in the years prior to 2015. We justify this view with our outlook on inflation, dividends, growth and current valuations. Secondly, we continue to believe that volatility will become more prevalent. The Federal Reserve has basically warned us that the direction of interest rates will be more of a guessing game for investors each meeting with less pre-guidance from the Fed. This suggests that investor's views on the markets will broaden and add to volatility, but also opportunity.

Opportunities such as CVS and Algonquin Power are good examples. CVS Health Corporation is an integrated health provider including a chain of pharmacies. Pharmacies continue to play a greater role in total patient care in the U.S. CVS is leveraging their traditional pharmacy retail network to expand into areas such as specialty drug administration, pharmacy benefit plans, in store clinics and e-commerce services, all of which have much higher growth prospects. Trading at an attractive valuaton, CVS is uniquely positioned with a low cost base, which is expected to drive market share gains and higher margins in the medium term. Algonquin Power & Utilities has interests in a portfolio of renewable power generation and utility infrastructure assets, such as water distribution, across North America. The company offers a highly transparent multi-year growth outlook back stopped by a robust development pipeline of commercially secured projects which support a 10% per year dividend growth target. We also like the relatively low operational risk of the business driven by the long term nature of power pricing agreements, the largely regulated nature of the utilities segment, and management's strong track record of execution.

Our outlook suggests we will have to work harder for our clients but we remain confident that our bottom-up analysis will continue to find great opportunities.

Fixed Income Markets – U.S. Rate Increase

After a long period of data watching, the U.S. Federal Reserve finally made the leap and increased the Fed funds rate to 0.25% to 0.5%. This increase was signaled well ahead of time and the market reaction was limited. The market appears to be gaining more confidence in the U.S. economy and the idea that the U.S. Fed will increase rates steadily. As evidence, the U.S. 2 year rate went from 0.63% at the beginning of the quarter to 1.05% as of December 31st, an increase of 42bps. This is a substantial move to levels untouched since April 2010.

During the quarter long bonds performed the best, with lower rates and credit spreads marginally wider.

Comparatively, the U.S. 30 year started the quarter at 2.85% and finished the year at 3.02%, rising just 17bps. The U.S. curve flattened from 222 bps (difference between short and long rates) to 196 bps, and is approaching 177 bps which was reached briefly in late January 2015. In a rate-hiking cycle the yield curve typically flattens and we expect this trend to continue in 2016. However, there is a long way to go before the yield curve completely flattens out to nearly a straight line as it did in 2006 and early 2007. The U.S. Fed meets on January 27th and again on March 16th, with expectations for no change in rates in January, and a 50% chance of a hike in March.

Meanwhile, in Canada, the 2 year rate did rise to 0.67% in early November as a result of higher U.S. rates, but lower oil prices caused it to decrease back to 0.48% by the end of the year, leaving it 4 bps lower for the quarter. This pushed the differential between Canada and the U.S. to 57 bps at year end, up from 11 bps at the beginning of the quarter. The Canada-U.S. 2 year differential has not been this wide since April 2007. This corresponds to a strong U.S. economy and expectations for higher interest rates, which has increased the value of the U.S. dollar substantially. Of course, Canadian competitiveness benefits from a weaker currency. With this in mind, we will keep a close eye out for the time that international investors begin to sell their Canadian holdings on the belief that the Canadian economy will begin to pick up and the Bank of Canada will increase their rates. When that time comes, U.S. and Canadian rates could converge quickly. The first step in that process will be stabilization in the price of oil, if not a sustainable increase, both of which remain elusive.

We believe the Bank of Canada will remain on the sideline through the coming quarter. They will meet on January 20th and March 9th, and the market is expecting about a 20% chance of a cut from either meeting. As mentioned, the chances of a change in rates are very oil dependent.

During the quarter long bonds performed the best, with lower rates and credit spreads only marginally wider. Communication companies such as Telus, Bell, and Rogers outperformed other BBB rated corporate bonds. We took advantage of the strength in Bell and sold Bell 3.35% Mar 2023 after the earnings release on Nov 5th, and fortunately before Shaw announced its acquisition of Wind Mobile causing a sell-off of the Big 3 communication names.

We also sold Goldman Sachs 3.55% Feb 2021 after reviewing their earnings results, the S&P downgrade to BBB+ from A-, and attending a company presentation. We decided that while Goldman is a strong company with good credit prospects, the ongoing changes in U.S. banking regulation are not worth the risk.

In anticipation of potentially higher rates in the long end, we exited two more positions. We sold a small holding of Canadian Utilities 4.085% Sept 2044 after seeing some strength in the name compared to its peers, and we also sold BC Ferry 6.25% October 2034. BC Ferry has seen significant strength and improvement in its business during the time we have owned it. The company has benefitted from renewed support from the Province of British Columbia, operational reviews, and an increase in traffic due to the decline in the CAD/USD exchange rate. While it is a strong name with a solid A rating, it is not very liquid and can be extremely difficult to sell in a bad environment. Both of these sales were done to improve the portfolios position should rates go higher. If long Canada rates were to rise significantly, we are now well positioned to entirely exit that part of the curve easily and quickly.

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.

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