Barrantagh

Investment Management

CAPITAL MARKETS REVIEW
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- By several indicators the global economy is better positioned for expansion than a year ago. In the U.S. key fundamentals, such as housing, business investment and exports are more supportive of growth. Europe remains mired in recession but its leaders are slowly orchestrating necessary reforms. China is poised for renewed growth under its new leadership.
- Unfortunately the broad longer term challenges constraining growth have not materially changed – unresolved revenue / spending gap in the U.S., excessive sovereign and private debt, punitive austerity programs, high unemployment in the developed world and a slowdown in emerging economies. Accordingly, global growth may improve only marginally in 2013 from the present 3% rate.
- On balance, growth in the developed economies will be too low to allow any exogenous shock to be absorbed without severe repercussions. Central bankers recognize this and will continue to do whatever they can to stimulate growth and head off the possibility of an economic slowdown.
- The macro shocks witnessed during the last three years seem to be dissipating or at least fading in the eyes of the markets. Having survived the so called fiscal cliff at year end, U.S. lawmakers will be mired in a potentially more difficult debate as they try to negotiate spending cuts under the March 1st debt ceiling deadline. Everyone realizes the debt ceiling will have to be raised given the yearly deficit and a solution will have to be found. However, will the politicians be able to agree on the tough choices to lower the fiscal deficit dramatically, or will it once again be “kicked down the road”? Rating agencies, along with all market participants will be watching carefully.
- The backdrop for the equity market seems encouraging and we believe further positive performance on the back of 2012 will be delivered in 2013 based on several constructive indicators. Rates are low, valuations are cheap, balance sheets are in great shape and global growth continues to look positive for 2013. After years of macro issue domination, there seems to be a shift to micro fundamentals that usually drive security prices. Should this trend continue, fundamental research will allow solid performance with lower volatility than experienced over the last three or four years.
- Income securities have done well over the last couple of years as investors turned to these names in search of yield and risk aversion. Although income securities are not overvalued, investors may not default to these names as the year unfolds. However, equity yields are still attractive relative to credit security yields and would support equities outperforming credit securities over the next year.
- Even with Mark Carney’s move to the Bank of England, we believe the course for Canadian interest rates has been set. Rates are most likely at the bottom and will look to move gradually higher over the course of the next couple of years in anticipation of a central bank move. Economic growth, QE “infinity” and inflationary pressures are all strong forces ultimately winning the day and moving rates higher. Corporate bonds will continue to be favoured in client’s accounts in anticipation of spreads tightening.

Economic Backdrop – Growth Trajectory Moving Higher

As we have discussed in previous reviews, the global economy faced daunting challenges in 2012 as the U.S. economy closed the year with an anemic fourth-quarter growth rate of about 1.2% (down from 2.7% in the third quarter), most of Europe slipped into recession, as did Japan, and the slowdown in emerging market economies continued unabated. Nevertheless, by some indicators, the global economy appears to be better situated relative to this time last year. In the U.S., some of the underlying fundamentals are more positive. Banks have strengthened their balance sheets, many households have pared their debt back to 2003 levels (through frugality and default, although excessive mortgage debt still burdens lower income families), the housing market has bottomed, consumer spending is gradually rising and there is pent up demand for construction and industrial activity. Growth is also expected to be supported by business spending and exports, two earlier drivers of the three-year expansion. These should supplement slowly improving employment and a stronger housing market. A further important underpinning to the improved outlook in the U.S. is the recent decision by the Federal Reserve to increase its monetary policy accommodation (after Operation Twist ends) with $45 billion/month of outright treasury purchases complementing the current $40 billion/month of mortgage-backed security purchases. Admittedly, large scale asset purchase programs have diminishing benefits but $1 trillion dollars is probably significant enough to have some stimulative impact. Furthermore, the U.S. Federal Reserve plans to maintain the current low level of interest rates at least as long as unemployment remains above 6.5% and inflation below 2.5%. The U.S. economy is forecast to expand at a relatively modest 2%. According to a Bloomberg survey of economists, this falls short of the 3% average over ten years through 2007, but is sufficient to produce meaningful progress in the healing process.

It is troublesome that Europe remains mired in recession, but European leaders are orchestrating reforms which should facilitate a transition to improving economies. Although risks remain tilted to the downside in the early part of the year, the Euro area is likely to stabilize by mid-year, reflecting a positive contribution from net trade. For the year as a whole, the domestic demand components of the Euro area will remain constrained and therefore overall Euro zone growth will be negligible but a meaningful improvement relative to the negative 0.4% outcome expected in 2012. As well, China is poised for a turnaround from a period of slowing economic activity as its new leaders address the reforms needed to rebalance from an export led economy to a more consumer driven growth path.

Overall global growth may show some improvement throughout the year but only relative to the weak output of the past year. Specifically, global growth may exceed 3% in 2013, a nominal increase from 2.9% in 2012. It will be uneven with only about 1.3% coming from G7 countries and the main contribution coming from emerging economies. Unfortunately, the broad challenges constraining growth have not materially changed. Relative to the past two decades there remains no obvious catalyst to a faster pace of economic output. In this cycle there is an absence of sustained gains from transformative new technologies or industrial breakthroughs that launched and sustained earlier recoveries. From 1960 to the present, computers, mobile phones and the internet were transformative but such stimulative breakthroughs are not visible in developed economies today. From a fiscal perspective, excessive debt (sovereign and private) within much of the developed world continues to weigh heavily on economic growth, particularly since many countries are attempting to implement austerity measures. The fact that mature economies have to save more in a period of insufficient income growth presents a unique challenge. On the other hand, emerging economies need to identify new sources of growth.

Regardless of the bold initiatives taken by central banks and painful adjustments made in the private sector, the world is still fundamentally out of balance. It is apparent the global economy will continue to struggle through various transitions for some time. For example, in the U.S., investment remains insufficient and downward wage pressures continue. Meanwhile in China, wage pressures are rising and investment in some areas is excessive. The fiscal cliff negotiations in the U.S. have demonstrated that the structural gap between federal spending and federal revenue has yet to be resolved. In Europe, risks will continue to percolate and in China and emerging markets the implications of slower growth is still being felt. On balance, growth rates in the developed world are too low for comfort (i.e. there is insufficient margin to absorb any significant exogenous shock). Accordingly, while the growth trajectory for 2013 may turn higher, the capital markets will remain highly sensitive to even minor shifts in economic activity around the world.

Equity Markets – Macro Takes a Back Seat

In our third quarter commentary we alluded to the fact that micro economic factors, such as the fundamentals in any industry or a particular securities performance relative to its peers, seem to be impacting the markets more than we had witnessed during the previous couple of years. The effects of macro factors, including the European debt situation and U.S. politics, which have been dominating the volatility in the markets during the past two or three years, has been fading. Readers may not realize that historically, market performance has not been dominated by macro factors but rather industry and stock specific factors suggesting that market performance may now be driven by fundamentals. The markets' refocus on micro versus macro factors seems to have been solidified with the anticipation of the year end U.S. fiscal cliff and its subsequent passing, as equity markets delivered very good returns in 2012. The S&P/TSX was up 7.2% for the year and world markets were up 14.1% as represented by the MSCI in Canadian dollar terms.

Our prediction at the start of the year that equities would do better than credit based securities, despite the possibility of continued volatility has played out over the course of the year. As we enter 2013, we continue to believe that equity securities will do better than fixed income securities based on the continual healing in several areas that we witnessed as the past year unfolded. First, as mentioned, many of the macro factors have been fading. The Euro crisis solutions have been taking their natural course and markets seem to be accepting the longer term resolutions that are being enforced. Although the Euro area entered a recession in the latter half of 2012, the worst may be behind them. The re-election of Merkel in Germany seems assured given her leadership in the Euro crisis throughout the ordeal and current popularity. Persistent healing in European country bond yields such as Spain and Italy may foreshadow positive surprises to the upside in 2013 for growth and debt resolution as the year progresses. In the U.S., a portion of the fiscal cliff was resolved with agreement on taxes, but agreement on spending still looms and will need to be decided by the end of February as the U.S. debt ceiling of $16.4 trillion was reached at year end. The fiscal cliff negotiations were tough but we believe agreement on spending cuts, coinciding with the debt ceiling limit will be even more difficult and may create market uncertainty. Ultimately however, a solution will be found. A second factor that continues to favour equities is the valuation of the equity markets versus the credit markets. Analyzing equity valuations versus historical norms, leads one to conclude that there is anywhere between 15-20% upside should market multiples revert to normal levels. As well, dividend yields and earnings yield for stocks relative to bonds, heavily favours the equity asset class. Furthermore, the quantitative easing delivered by QE1, QE2 and now QE3 although started by the U.S., seems to have caught on in other parts of the globe. Maintaining low interest rates will support the IMF's (International Monetary Fund) predicted 3% plus, global growth for 2013. From this point it would seem that equities have more to gain from continued low rates promoting economic growth than any other asset class, especially if the embers of inflation start to reignite.

Within the equity market, we suggested that investors would default to dividend paying stocks during 2012 given the uncertainties with-respect-to economic growth and large macro factors. We advocated that dividend paying stocks would be a means for controlling volatility. We also suggested that small cap securities would have a difficult time due to a lack of growth and abating inflation. These predictions unfolded as expected. Income bearing stocks have not become overvalued, but going forth we do not believe investors will default to dividend bearing stocks and small cap stocks may do better as growth becomes more certain.

In the environment described throughout this quarterly review, we believe fundamentals will allow us to source high quality names for clients. For instance, fiscal 2012 was largely a recovery year for Toyota after the tsunami in 2011 disrupted its operations. Toyota has repaired its supply chain, ramped up production and regained much of its market share resulting in year-to-date revenue growth of greater than 30%. Another material benefit to Toyota's bottom line has been the significant margin recovery. Toyota has been able to increase its margins to over 5%, from 2% last year due to production increases, cost cuts and a weaker currency. In addition, despite the relationship challenges between China and Japan, Toyota was able to raise its full year forecast last quarter due to higher volumes in other countries and streamlining its Asian operations. We continue to expect improvement in all aspects of Toyota's business as it returns to its historic leadership position. Toyota is trading at roughly 6.5 times cash flow. This is a discount to its historical valuation multiples. Looking at examples such as Toyota, we welcome a reversion to normal market influences, where micro factors drive performance, and fundamental research can continue to add value for clients.

Fixed Income Markets – Rates Seem to Have Bottomed

Canadian rates appear to have made a bottom. Government yields fell gently through the last quarter and then started to back up in November. The Canadian inflation measure for December reinforced the market's comfort with slow economic growth, without inflationary factors disturbing the rate structure. The Bank of Canada continues to put up a tightening front, reiterating the eventual need to start draining liquidity from our markets. Undermining this position, economic growth in Canada remains stubbornly slower than the base case for policy implementation as forecast by the central bank.

As we pointed out in our third quarter commentary, Canadian corporate treasurers and governments at all levels have become comfortable with the level of nominal borrowing rates, resulting in over $89 billion in new issues being launched in 2012. Many of the new issues were targeted at the retail investor, and have seen steady spread tightening as demand for the bonds grew. The Canadian banks were ready borrowers in the deposit note and subordinated debt markets, particularly after they emerged from the October 31 year end. Retail interest is also driving the growth in the high yield (junk bond) sector, with a growing number of below investment grade issuers coming to market. The retail market is less sensitive to credit ratings, typically focusing on familiarity with the borrower name. These issues can provide greater than 6.5% yields, and of course a significantly higher probability of default in exchange for that seemingly generous yield. How quickly we forget that not long ago AA corporate issuers carried those yields!

The bond market has gained significant comfort with the European situation. Mario Draghi's oft quoted statement that the ECB would do "whatever it takes", announcing an unlimited bond-buying program to save the Euro market, marked a turning point in confidence. That the ECB took as long as it did to announce a policy package was nothing to crow about, but at least a corner has been turned. The market is still easily unbalanced by news from Greece, Spain or Italy, but the hurdle of approval of the disbursement of the latest funding package for Greece was successfully crossed. Some of the bonds issued in the depth of the crisis are now providing substantial gains for the hedge funds holding them. Financial profits and Greece do not regularly turn up in the same sentence, but it is evidence of the new set of circumstances.

In the U.S., the "fiscal cliff" continues to dominate the thinking in the bond market. Long a feature of the market interpretation of the European crisis, the U.S. domestic market now also ricochets between risk-on and risk-off attitudes. The slightest hint that the budget negotiations have broken down drives down treasury yields and forces a selloff in the equity market. We have long maintained that U.S. lawmakers are reasonable individuals with a clear understanding of the consequences of no resolution, and we have expected, and continue to expect, a solution that does not impose $600 Billion or more of expenditure cuts and increased taxes, forcing the already stumbling U.S. economy into a recession that benefits no one. As of the writing of this letter, some progress is being made, but much of the problem is being "kicked down the road".

In Canada, rates are now relatively stable, but credit spreads are continuing to scrape tighter. There is still a long way to go before spreads reach the level they achieved before the financial crisis. We continue to add corporate exposure where we are permitted by the applicable investment policies, and are overweight corporates across the board. For the past three years we have confidently described Canadian rates as too low, and predicted that the central bank would take steps to tighten monetary policy. Of course this has not come to pass, and rates are at a level that is close to an historical bottom. It is likely that mid 2013 will finally produce the change in direction. However, we do not expect a sharp rise in interest rates until 2014 or even beyond. Any change in the yield curve is likely to be gradual and well telegraphed in advance by the central bank.

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