By **Daniel Theriault**, CFA, MBA,
Chief Investment Strategist

Market Commentary

Looking for Canaries in the Coal Mine

"Every now and then the canary in the coal mine does indeed die — it would be kind of foolish to blithely wave away this particular dead bird just because it might signify a freak avian heart attack."

Jobs Report: Blip or Bummer

Salon.com

Andrew Leonard, April 2012

Into the early part of the 20th century, work in a coal mine was particularly hard and dangerous. The technology to extract coal was still pretty basic. Miners used picks and shovels to go at the coal face. Pit ponies or children hauled the pieces to the surface.

Hazards were everywhere. Mines flooded, shafts caved in. Methane, a poisonous and highly combustible gas, was naturally found with coal. Explosives could make coal extraction easier, but igniting the blasts added a distinctly greater risk to the miners. Mitigating this risk fell to the shotfirer, who was responsible for setting the charges and securing the blast area. Caged canaries were enlisted as sentinels to warn the shotfirer of the presence of harmful and explosive gases. The birds' small size and higher metabolisms made them more vulnerable to low levels of toxic gases. When a canary stopped singing or toppled from its perch, it was time to head for the surface. While today gas monitors have replaced canaries, we still use the metaphor of a "canary in the coal mine" to mean an early harbinger of impending disaster.

Not surprisingly, that expression has cropped up a lot lately as market watchers try to predict which economic signals might be the portent of a much greater concern.

U.S. Economy – No Turkey

The U.S. Federal Reserve's decision at the September meeting to stand pat on interest rates has economists and investors revising their view, once again, on when and by how much U.S. interest rates will head higher. Fed watchers are a little confounded that the discount rate remains at emergency low levels, given that there isn't much apparent need for such aggressive support of the U.S. economy. A clue to the foot dragging came from Fed Chair Janet Yellen. She expressed a persistent concern about importing deflation: "Recent global economic and financial developments may restrain economic activity somewhat and are likely to put further downward pressure on

inflation in the near term." Markets slumped on the news. Within days, Ms. Yellen was back in front of a microphone trying to ease investors' fears.

Expectations about how far rates can ultimately rise should likely be tempered. GDP growth remains low, mostly due to an aging population and relatively weaker productivity growth. Credit spreads will probably remain a bit wider as a result of the increased cost of financial intermediation (basically, the process banks perform when taking in funds from a depositor and then lending them out to a borrower). Higher credit spreads suggest that policy rates need to be lower. While U.S. households have taken great strides in repairing their balance sheets, it's doubtful that they will return to pre-crisis debt levels. Finally, savings rates in a number of economies, particularly China's, remain high. That puts further downward pressure on interest rates globally.

The U.S. consumer must factor prominently in any discussion of the U.S. economy. A string of encouraging data recently provided upbeat news: real disposable personal income was up 3.2% year-over-year in August; the Conference Board Consumer Confidence index rose in September, despite all the uncertainty globally; and support for the housing market came from an annual improvement of more than 20% in mortgage applications. By the time you add in lower oil prices and a powerful dollar, it's clear that the U.S. consumer is in pretty good shape. There is a caution though – non-farm payroll employment increased by a lacklustre 142,000 for September and the results for the previous two months were revised downward.

Europe – More Nests

Greece's September 20th election did little to change the European political landscape. The left-wing Syriza party was returned to power on low voter turnout. This likely reflected Greek voters' sober realization that it is impossible for Prime Minister Alexis Tsipras to deliver on obviously incompatible promises: end austerity, set the economy on a path to recovery and keep Greece in the euro. The new bailout program will likely spell further economic contraction for Greece. That's on top of the 29% reduction in Greek GDP since 2009.

The first review of the proposed bailout will occur before year end. If the review is successful, new European money will help recapitalize the frail Greek banking system. Debt relief is actually the key to a truly successful outcome for the Greeks, however. On that point, the IMF has refused to participate in the bailout unless creditors make some accommodation on Greek debt. Expect Mr. Tsipras to push assertively for this, plus a reduction in austerity measures. Expect certain parts of Europe, notably Germany, to push back.

Housing is staging a modest rebound in Europe. The European Central Bank's recent bank-lending survey revealed an increase in the number of households looking for a mortgage. This validates recent upbeat consumer surveys indicating respondents intend to buy a home soon. Lower

borrowing rates in periphery countries are also fueling a recovery in mortgage approvals, housing starts and property turnover. Even Spain is again showing some promise, albeit modest, after working through about half of its inventory of more than one million unsold homes. Italy may also join the housing party. The Italian government is pursuing an ambitious reform agenda that could reduce some of the huge impediments to buying Italian property. Unlike Spain, Italy has no glut of unsold homes. Fine weather and superb food should add to that market's appeal compared to some of the more northern parts of the eurozone.

China – Economy Likely in Flight Next Year

China continues to be a major focus of investor attention as its quest for greater liberalization of its financial systems reshapes global markets. (Economic liberalization is the loosening of government regulations and restrictions in an economy in exchange for greater participation by private entities.) That process is building momentum. China has just begun to report its currency reserves to the International Monetary Fund. Making key components of its economy more transparent represents a major milestone for the Middle Kingdom. It's all part of China's move to have the yuan included in the IMF's basket of reserve currencies to aid debt-distressed countries. While the initial reporting will only include a "representative portfolio on a partial basis," full disclosure is scheduled to occur within a quick two to three years.

Investors have been concerned about slowing GDP growth in China. Recent data on manufacturing, exports and other economic activity raised concerns that the Chinese economy was slowing much more quickly than official reports indicated. The downdraft in Chinese equity markets reignited selling pressure on commodities, especially energy. To top it all off, the introduction of greater flexibility in exchange rates fueled fears that large devaluations of the renminbi were imminent.

There are reasons to be optimistic that China's growth rate will pick up in the next year or so. First, while some economic numbers have been weaker, this suggests that the economy is slowing – not collapsing. Despite official published figures, China's economy is difficult to measure. Yet some numbers indicate that growth has stabilized since the beginning of the year. Second, the Chinese equity market has very little impact on the broader economy: few Chinese companies rely on the equity markets to raise funds. Third, policy makers have lots of latitude for further policy stimulus, which is not the case in many other economies. Interest rates and required reserve ratios have both been cut recently. Plenty of room remains to make further moves. Finally, concerns about China's financial sector are likely overblown. China's public sector balance sheet is resilient enough to absorb substantial losses if necessary. Our overall expectation for Chinese GDP growth over the next year is still a very respectable 5% to 6%.

Canada – Cheap Oil Still a Drag

The July GDP month-over-month increase of 0.3% was better than consensus expectations; it supported the Bank of Canada's view that the economy will likely bounce back in the second half of the year. A rebound in oil and gas extraction caused July's positive readings (and June's). The rebound came after production resumed at some oil sands facilities that had been shut down due to maintenance and fires. If some other area of the economy had sparked this growth, the reaction might have been more optimistic. All the same, the result is encouraging.

Manufacturing also rose by a healthy 0.6% over the previous month, primarily on the strength of the auto sector. The U.S. auto sector also had strong July results, but slipped back in August. The Canadian industry will likely follow suit.

Not surprisingly, activity in the construction industry contracted modestly. This no doubt reflects the ongoing slowdown in the oil and gas sector. Oil continues to hover in the mid-forty-dollar range. That price is too low to stimulate new Canadian energy projects. As long as this depressed price persists, construction will likely remain a drag on economic growth. The negative impact will also spill over into residential housing in markets like Alberta.

The Canadian story is little changed over the quarter. We won't get more robust economic activity until oil prices firm up.

Our Strategy

September was just as volatile for equity markets as August, with most major stock exchange indices delivering negative returns. This is not extraordinary; in fact, expansions are typically punctuated with periods of retraction. We continue to believe that we are in a market correction and that a full-blown bear market remains distant. Our cautious posture has helped portfolios through this period of market weakness.

We have modestly enhanced yield for the fixed income portion of most portfolios by adding a structured, tax-advantaged note to our holdings. A second note that was closer to maturity and lower in yield was sold to partly fund this purchase.

We continue to maintain our relative overweight to equities over bonds. The current generous monetary policy in Canada and the U.S. is strongly influencing that decision because it has a double impact on investment assets. Interest rates are currently suppressed on bonds, making them less attractive, while risk assets like equities are supported. Our relative emphasis on U.S. equities remains unchanged – the U.S. will most likely be the catalyst for a global recovery.

The Last Word

Using canaries to detect gas in coal mines is unambiguous. If that canary wobbles, get out quickly, gas is present. It's not quite so easy to be that definitive in forecasting economic direction or growth - there are simply too many variables at play. The same is true of assessing how capital markets will interpret news.

It appears that we have just witnessed yet another strong and adverse seasonal effect on equity markets. If history repeats itself, we can expect a meaningful recovery between now and Christmas. That would clearly be welcome. Even so, we must accept that corrections create negative sentiments. The markets take time to recover. Patience is required. In the meantime, our focus remains on carefully watching and assessing economic and market events with an eye to spotting opportunities to enhance portfolio returns.

Information contained in this publication is based on sources such as issuer reports, statistical services and industry communications, which we believe are reliable but are not represented as accurate or complete. Opinions expressed in this publication are current opinions only and are subject to change. BMO Private Investment Counsel Inc. accepts no liability whatsoever for any loss arising from any use of this commentary or its contents. The information, opinions, estimates, projections and other materials contained herein are not to be construed as an offer to sell, a solicitation for or an offer to buy, any products or services referenced herein (including, without limitation, any commodities, securities or other financial instruments), nor shall such information, opinions, estimates, projections and other materials be considered as investment advice, a recommendation to enter into any transaction or an assurance or guarantee as to the expected results of any transaction.

® "BMO (M-bar roundel symbol) Private Banking" is a registered trademark of Bank of Montreal, used under license. Investment management services are offered through BMO Private Investment Counsel Inc., an indirect subsidiary of Bank of Montreal.