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Market Commentary

Changing Times

*"Come writers and critics
Who prophesize with your pen
And keep your eyes wide
The chance won't come again
And don't speak too soon
For the wheel's still in spin
And there's no tellin' who
That it's namin'.
For the loser now
Will be later to win
For the times they are a-changin'."*

The Times They Are A Changin'

Bob Dylan, 1964

When Bob Dylan penned this tune just over 50 years ago, the U.S. was in the midst of tumultuous change. As the Vietnam War was ramping up, college campuses became the focal point of social protest. It was also the year that Cassius Marcellus Clay Jr. defeated Sonny Liston to become world heavyweight champion; shortly after, Clay would join the Nation of Islam and change his name to Mohammed Ali.

The civil rights movement was also gathering momentum. Dr. Martin Luther King Jr. won the Nobel Peace Prize in 1964 for his commitment to non-violent resistance against racial prejudice in America, while Malcolm X advocated a somewhat different approach. Ed Sullivan welcomed The Beatles to New York City and the Ford Mustang rolled off Michigan assembly lines. For the earliest cohort of baby boomers, it was time to finish high school, start college or, for increasingly more young men, get drafted into the military. Boomers were just beginning to understand the tremendous influence they would assert over the coming decades.

In the fifth century BC, the Greek philosopher Heraclitus wrote "change is the only constant." That statement was accurate in 1964 and remains accurate today. We might well ask this question right now: are some of our economic paradigms, particularly those for commodities and interest rates, undergoing a sea change?

U.S. – A Change Could Do You Good

The odds of the Federal Reserve raising interest rates in December improved substantially following the most recent jobs report. The headline number was spectacular: 271,000 new jobs, plus an upward revision for a number of earlier months. The U.S. unemployment rate is down to 5.0%, wages are up 2.5% year-over-year and number of hours worked is up as well. How much better does it have to be before the Fed makes a move? (A pessimist might focus on the 62.4% labour-force participation rate, the lowest in 38 years, but that would be a stretch given the record number of retiring boomers.) The first few interest rate increases could actually boost economic activity: an increase often motivates consumers and corporate investors to take their hands out of their pockets and make planned expenditures.

Significantly, consumer spending remains resilient and earnings growth is solid. October's auto sales put 2015 on pace for the best year ever in that sector. Services and construction are on fire. Consumer confidence could well challenge pre-recession highs. The cheerful mood is justified. U.S. households have made great strides in repairing their balance sheets. Household debt in the U.S. is now lower than household debt in the median OECD country. Consumers are well positioned to provide support for further economic expansion.

A stronger dollar is hitting manufacturers hard, however. Factoring in the energy production slump, the outlook for growth in equipment investment will likely remain subdued. Corporations are choosing share buybacks or dividends over capital investment. Consequently, business investment is expected to increase by a modest 3.2% in the coming year.

To Canada's disappointment, President Barack Obama announced his decision to reject the Keystone XL pipeline project.

Europe – Time for Economic Climate Change

The European Central Bank has sent a clear message that it will announce additional monetary stimulus. We can probably expect another deposit rate cut and expansion of the quantitative easing program. This seems like a reasonable response given the stubbornly low inflation expectations. All in all, good news for investors.

A number of peripheral European economies have improved their fiscal balance sheets, which is a welcome change. While this news is positive, it hasn't been enough to materially improve their debt ratios yet. That is the ultimate goal. Naturally, Greece stands out as the exception: its headline deficit went up from 1.3% of GDP to 2.5%.

Speaking of Greece, the results from the recent ECB stress tests on the Greek banks were better than the consensus estimates. The total capital shortfall was about €4 billion less than expected, although it was still shy of the ECB's ultimate requirement. Greek banks face obvious challenges: they lack access to cheap funding and deposits are depressed. Access to cheaper capital is likely if Greece clears the first hurdle in its bailout review. That is contingent on some fairly controversial reforms that the government has yet to pass, however. Repairing bank capital is one thing; improving liquidity and depositor confidence is quite another. Only time will tell how this will play out.

China – Transition to a Consumer-led Economy

Data out of China in recent weeks is decidedly mixed. Business surveys and credit data suggest that China's economy may actually be gaining momentum. The industrial sector, however, shows weakness in mining, manufacturing and construction. Most companies in these sectors are state-owned, making it likely that their outstanding loans will be supported by fresh corporate credit to prevent the original loan from becoming impaired – while at the same time not creating any increase in capital or operating expenditure. A surge in non-performing loans or shutting down productive capacity does not appear to be in the works. Marginal producers outside China are more likely to be at risk. It's generally expected that, over the medium term, China will continue to rebalance its economy toward services and private consumption.

This transition will have a fairly predictable spillover effect on other economies. The first, and perhaps most meaningful consequence, is that commodity prices will remain low. This isn't just a problem of weak Chinese demand: excess supply is also a major factor in depressing prices. Commodity-producing countries expanded capacity because they anticipated continued, accelerating urbanization and industrialization in China. Many of those countries now face falling export revenues and the broader consequence of slowing economic activity that supports commodity production.

Falling commodity prices have a domino effect – lower commodity prices mean weaker global capital expenditures. The resource sector is very capital intensive, particularly in the early stages of bringing production on-stream. There's a timing issue as well. Resource companies can quickly cancel new projects and capital spending. On the flip side, when lower commodity prices increase profit margins for some companies, they are slower to make enough capital investments to offset the downturn in the commodity sectors.

Canada – Sweeping Political Change

Justin Trudeau and the Liberals won a decisive victory in the October election, gaining seats across all regions of the country. The party campaigned on a platform of change; expect it to be incremental rather than wholesale. The Liberals promised to lower mid-bracket tax rates by 7%, which works out to about a \$33-billion tax cut. Those earning more than \$200,000 (the top 1%) will see their tax bill

go up by \$4,000 for each additional \$100,000 they make. We'll likely see this new tax legislation introduced before the Christmas parliamentary recess.

Other promised tax measures include a rollback in the TFSA contribution limit and a repeal of the income-splitting provision. Pension reform is on the docket, one area where change may have more impact. Prime Minister Trudeau promised to run a deficit for the first three years of the new Liberal mandate to fund a \$60-billion spend on infrastructure. These amounts are modest in the context of the total Canadian federal budget and are unlikely to impair Canada's fiscal strength. In fact, this move could potentially boost economic growth. Given some recent economic signals, that would be welcome news.

The new smaller and more diverse cabinet enjoyed a warm reception; Bay Street in particular was pleased with the choice of one of its own, Bill Morneau, for finance minister. We can expect a honeymoon period for the new government, but the challenges to economic growth may shorten that just a bit.

The month did deliver some upbeat figures on the economic front. Canada added 44,000 jobs in October, a much higher number than the consensus estimate. This number seems to indicate that the country is withstanding low oil prices better than previously thought. Hiring gains came in both the public and private sectors. Self-employed numbers contracted by 27,300. Part-time workers accounted for most of the private sector jobs; full-time worker numbers increased much more modestly. While the overall report is not quite as strong as the headline number may suggest, it's likely enough to keep the Bank of Canada from cutting interest rates.

Our Strategy

October witnessed a decent recovery in a number of the world's equity exchanges, although volatility remained relatively higher. Japan, the U.S., Europe and Asia led the recovery. The Canadian S&P/TSX index, while positive, lagged along with markets of other commodity producers.

Yields on fixed income investments nudged up in October on the expectation that the U.S. Federal Reserve would hike interest rates. We remain defensively positioned in fixed income, anticipating a further, albeit modest, rate increase. We are shopping for opportunities to enhance current yield on this component of portfolios.

Our tactical perspective continues to favour equities over fixed income. We watch equity valuations, though, to ensure that this overweight position is still justified. Ultimately, earnings and interest rates determine returns on equities. We are maintaining our relative overweight to equities over bonds. While we continue to place geographic emphasis on the U.S., we are also looking for

opportunities for a more assertive allocation into European and possibly Japanese equities. We are patient in that regard and prefer to wait for the right entry point.

The Last Word

The lyrics of *The Times They Are A Changin'* were a pointed reply to the struggles of the U.S. civil rights movement. They heralded a massive generational change. Young boomers who first asserted themselves so profoundly in the 1960s are now retiring at record rates. Not surprisingly, their influence continues to dominate the direction of capital markets. Central bank intervention designed to sustain economic growth is thwarting their need for income. The resulting low interest rates, both nominal and real, will probably stick around for some time. While the Fed is expected to begin the process of "normalizing" or raising interest rates in December, it's highly unlikely that rates will return to pre-recession levels any time soon.

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