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Market Commentary

Are We Paddling Upstream?

Cyrus Higbee:
"I'm not sure Canada's far enough to send you!"
Rawhide Buttram:
"You gotta admit it's a step in the right direction."
From the movie *Blue Canadian Rockies* starring Gene Autry, 1952

Maligne Lake in Jasper National Park is the largest natural lake in the Canadian Rockies. Meltwater from Replica Peak runs into the Maligne River, which feeds the lake with a heavy, silt-laden flow that turns the water a striking turquoise colour. Parks Canada operates two lakeside campsites, which are only accessible by canoe or kayak. The most distant is at Coronet Creek; it takes six or seven hours to paddle the 22 kilometres if the weather cooperates.

That's a pretty big "if." Parks Canada warns: "The wind is funnelled by the mountains and can change direction and intensity very quickly. You can expect the wind to come from different directions, or change directions throughout your trip. Sudden storms, cold temperatures and occasionally snow can be expected throughout the whole summer." With appropriate precaution, a prudent paddler can enjoy the majestic, serene beauty of this remote campsite.

What is appropriate precaution for the Canadian investor? Domestic headwinds seem to be intensifying and swirling from different directions. With a pending federal election, Liberal and NDP candidates have lately become a bit cavalier in tossing around the "R" word. Yes, energy and commodity prices remain stubbornly low and the loonie is trading down around 76 cents against the U.S. greenback. Even so, solid improvement in non-energy exports may well be the catalyst for a solid second half of the year for Canada.

U.S. Navigating the Locks

Consensus seems to be building that the U.S. Federal Reserve will hike rates in September. The most recent jobs report is certainly supportive of this type of action. In July, 215,000 non-farm jobs were added and, almost as important, results for earlier months were revised upward by more than 14,000. There was even a modest bump in hourly earnings, which rose a little over 0.2% on a

month-over-month basis. This left the unemployment rate at 5.3%, its lowest level since April 2008. While the participation rate stubbornly remains at a 38-year low of 62.6%, the broadest metric of labour market utilization dropped to 10.4%.

What does that mean? Those who are working part-time as they wait for full-time jobs saw their numbers shrink by 180,000. When combined with an increase in average number of hours worked, it's likely that the Fed will see this as a further reduction in labour market slack. While there is one more employment report before the Federal Open Market Committee meeting September 17, nothing in this month's results should dissuade the Fed from initiating a rate hike. The Fed could postpone tightening until the December meeting, however. The decision will depend on the performance of other factors. A delay could occur if the dollar continues to strengthen, the manufacturing Purchasing Managers Index dips, home sales drop, or consumer confidence weakens.

How will the market react to a rate hike? For a lot of investors, this is unfamiliar territory: the Fed hasn't lifted rates in more than a decade. The last three times that the Fed started tightening rates – in 1994, 1999 and 2004 – the market responded poorly. Generally, bull markets end when inflation starts to rise and the Fed must tighten aggressively; or when a policy mistake occurs; or when an exogenous shock disrupts the global economy. While the third event is unpredictable, the first two situations seem unlikely. This suggests that we are some distance yet from the start of a bear market.

Europe Trapped Between Scylla and Charybdis

Despite all the posturing, Greece and its creditors came to an agreement at the eleventh hour. The terms are tough for Greece. A debt write-off is absolutely essential if the Greek economy is to have any chance of making a full recovery. Yet, no debt relief is contemplated until Greece at least passes the first review of the bailout. Part of that review includes passing tests on budget targets. Current budgetary assumptions forecast a contraction of the economy by 3.3%, even though the Greek economy is currently contracting by about 7.0% annually. Without a pretty decent bounce back in the rest of the year, this target seems out of reach. If Greece undershoots on its growth assumptions, then more austerity will be needed in order to hit the target of a primary budget surplus. So far, the agreement seems to have bought the Greeks time; however, a more permanent and achievable solution remains elusive. We will most likely revisit this issue within the next year or so.

If ever a country was well positioned economically, it would be Germany. A weaker euro, highly accommodative monetary policy and falling oil prices should make Germany the winner of the economic trifecta. But GDP growth has stalled at rates ranging from 1.0% to 2.0%. Past periods of robust recovery point to export growth; that is not the case right now. Export growth is weak – surprising, given Germany's substantial exposure to trade outside the eurozone. It's a simple issue of demand weakness. Germany still sends nearly half of its exports to other eurozone countries. Those

countries' failure to meaningfully recover continues to restrain German export growth. Germany has not lost its competitive edge. The country's economic performance will be healthy this year, but likely not healthy enough to transform the outlook for the rest of Europe.

China: a Scary Plunge

China's total import bill fell by 8.1% year-over-year in July after declining 6.1% in June on a comparable basis. Lower commodity prices explain most of this drop; import volumes led by iron ore and soybeans actually increased in the month. This is likely evidence that government stimulus is starting to make its way into the real economy. Import volumes are expected to remain robust for the balance of the year. Part of the surge in volume was opportunistic buying – there is both official and commercial stockpiling of oil thanks to renewed weakness in the price of oil.

Concern about Chinese equity markets is well founded. Since the broader market peaks of June 12, the Shanghai, Shenzhen, and Hang Seng markets retreated by 26.7%, 30.0% and 9.8%, respectively. It's important to note, however, that on a year-over-year basis the Shanghai market is up 73.6%, the Shenzhen market is up 91.9% and the Hang Seng is flat. The impact on the vast majority of Chinese households is minimal. Most household wealth is held in the form of bank deposits and real estate. To put this in context, less than 10% of Chinese household assets are in the form of stock holdings. That number is much closer to 31% for U.S. households. Also important to know is that China's economy is much more reliant on bank lending than on capital markets. All the same, policy makers in China did intervene aggressively to stem losses in stock prices. Interest rates were cut, short selling was banned, as were sales by large shareholders. Brokerages were pushed to buy back stocks and, at times, trading was suspended. Policy makers also suggested that the government's direct equity purchases and public policy pronouncements could be used as additional tools to alleviate the plunge in prices.

Canada: Shooting the Rapids

Recent economic data for the Canadian economy is encouraging. June trade results were much better than the consensus expectation, with exports surging 6.3%. A slight dip in imports helped reduce the trade deficit to $476 million, which is the smallest shortfall in the last seven months and a huge rebound from the largest three-month deficit on record. Bank of Canada Governor Stephen Poloz is likely impressed and relieved that the growth in non-energy exports improved by 6.2%. He did call the weakness in the first half of this year in that sector "puzzling." Let's hope it's a harbinger of what the rest of the year will bring.

July's employment numbers were lacklustre yet still positive, with a job increase of 6,600. That leaves the jobless rate flat at 6.8%. Average hourly wages did improve by 3.4% in July on a year-over-year basis; that should help bolster the Canadian consumer.

The upcoming release of key manufacturing numbers will likely give us some insight into June's GDP results. Continued strong auto sales and the trade results indicate that the numbers should be good. The signs are there for an improved third quarter.

The Canadian dollar has a lot working against it right now. Oil prices have again weakened and the U.S. dollar is up dramatically compared to a broad range of currencies, not just the loonie. While further softness is possible, renewed strength in the domestic economy is supportive. We continue to watch for more improvement in non-energy sectors of the economy.

Our Strategy

What global equity markets gave up in June, they recovered in July – with Europe and, more specifically, the European Monetary Union leading the way. The notable exception to this was emerging markets, which backed off about 6.8% in the month. Canada's TSX Composite was down a modest 0.32% in July, bringing the total return for the year to -2.85%. Not surprisingly, the materials and energy sectors are holding back overall returns.

Despite some recent increases in equity market volatility, our investment strategy continues to favour equities in most portfolios. This is a continued acknowledgement of relatively low yields for fixed income. The divergence in interest rate policy between Canada and the U.S. is becoming more pronounced. We continue to be defensively positioned in our fixed income portfolios although we will opportunistically look to improve overall yield as circumstances and markets allow.

The Last Word

It took 13 and a half hours of vigorous paddling over a couple of days to complete the 44-kilometre round trip of glacial Maligne Lake. Experiencing Canada's vast, timeless and silent wilderness, away from technology and market noise, can put things into proper perspective. Investors should stick with sound investment fundamentals: stay well diversified both domestically and internationally; remain steadfast and unafraid in the face of cyclical volatility; and be prepared to seize opportunity when it comes knocking. Portfolios are well positioned.

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