July 2014

Market Commentary

All In One Rhythm

Rio's classic Bossa Nova rhythms have been the summer's theme song as the world tunes into the FIFA World Cup games in Brazil. "All in one rhythm" is the official slogan of this truly international event. Football, or soccer as North Americans call it, is the world's most popular game by a wide margin.

While football is dominating the sports headlines, the state of the world's economies is still front-page news. Six months into the year, let's take stock of what's happened so far in terms of capital market performance in a number of key geographies. Are they moving ahead in step, or marching to the beat of their own drummers?

If we're keeping score – and we are – the U.S. economy has defied expectations and largely failed to lead the global recovery. In fact, after a couple of downward revisions, U.S. first quarter GDP actually shrank by 2.9%. The rebound in the second quarter looks like it could be just enough to offset the contraction in the first quarter. The result is net zero growth to date this year. It will be close, as the U.S. consumer appears to be economizing.

The U.S. Slow Dance

Consumption is the true driver of U.S. GDP success, and there hasn't been consistent growth. U.S. consumer spending dropped from 3.3% in Q4 of 2013 to 1.0% in Q1 of 2014. Massive winter storms and an unusually cold winter were partially to blame for this slowdown, but surprisingly low spending on healthcare also contributed. With the introduction of the Affordable Care Act and legions of newly insured enrollees, Americans were expected to ramp up healthcare spending by 10.0%. Instead, spending contracted by 1.4%. It's likely that the one million people who recently lost their extended jobless benefits, and must pay higher prices for gasoline, food and rent, are keeping their hands in their pockets, adversely impacting reported consumer results. Overall, there are many positive signals to encourage consumption: monthly non-farm job growth has been consistently in the 200,000 range, wealth has been rising as key assets like housing and stocks rebound, and the Thomson Reuters/University of Michigan Consumer Sentiment survey clocked in at an improved 82.5%, nicely ahead of expectations. Americans are particularly positive on current conditions and are not worried about inflation in the near term.

To be clear, the U.S. is not showing any indications that it is heading into a recession. Despite the consumer GDP numbers, housing and auto sales have been brisk. A continued bright spot in the U.S. recovery is industrial production, which enjoyed a 4.5% increase in Q1.

The U.S. Federal Reserve (the Fed) doesn't appear to be overly concerned about the GDP results and hasn't altered its tapering policy, trimming another $10 billion off of its bond-buying purchases in June. It has kept short-term rates near zero since December 2008, consistent with the Fed's guidance that eventual rate hikes will lag behind improving growth conditions. On the other hand, even a conservative view of the future Fed funds rate calls for higher bond yields as early as the latter half of this year.

Despite an unspectacular start, the U.S. will likely modestly outpace most other developed economies in 2014. The odds favour a U.S. comeback – bet on that before wagering on American dominance in the World Cup.

Europe Out of Step

In World Cup matches, great soccer nations like Spain, Italy, England and Portugal all went down to early defeat. With the exception of England, their performance on the pitch was matched by poor economic numbers.

While June business surveys suggest that global manufacturing activity is expanding, the eurozone alone appears to be riding the bench. Composite and manufacturing PMIs both fell to six-month lows and are on par with past surveys that suggest growth in the area of 0.3% to 0.4%, quarter over quarter.

The European Central Bank (the ECB) has lagged most other central banks around the world in taking action to get its economy moving again. After repeated ECB signaling, President Mario Draghi introduced new measures early in June. Interest rates were lowered by 10 basis points; deposit rates are now negative – the intention is to get banks to lend rather than hoard cash. Although the ECB continues to balk at the notion of a quantitative easing program (the central bank would buy government bonds in the open market), it has introduced a plan to buy bonds made up of loans to small businesses. This measure is unlikely to have much impact; however, it's a start. President Draghi must convince investors that he still has more means at his disposal should conditions in Europe worsen. With the eurozone economy barely growing and deflation running perilously low, further measures will likely be necessary. Interest rates are an ongoing challenge, but the big problem is Europe's banks don't have much confidence in each other. They are currently undergoing stress tests to measure their financial resilience. If the results are generally okay as expected, this may be the catalyst that unlocks credit markets again. The euro has fallen a bit, yet not enough to substantially help European exporters.

China in Step

Although the Asian Conference didn't produce a single soccer team to advance to the round of 16, the Asian model for economic growth does produce winners.

China's economic development closely follows the Asian model – it's driven by exports and led by investments. The Asian model has a well-documented downside characterized by heavy state intervention, over-investment, asset bubbles, financial crises and ultimately growth stagnation. The biggest problem with the Asian model is whether it's efficiently and optimally allocating its resources. Perhaps a better question might be how quickly can the model raise the standard of living? By this measure, it's very successful. Per capita GDP in China has grown in a mere 30 years to levels that it took Japan 60 years to achieve and the U.S.120 years. A substantial part of the credit belongs to the Chinese ethic of saving and investing; at the peak, the investment rate touched 45%, almost 10% higher than that achieved by Japan in the 1990s. What happened in both Korea and Japan could foreshadow what's next for China. Both experienced drops in their long-term growth rates as a result of diminishing returns, plus lower growth percentage as a result of calculating growth compared to a much larger GDP base. Even so, we expect China to follow a somewhat different path – its urbanization rate is still well back of where Japan was in its growth heyday. Continued labour migration from rural to urban China should be the catalyst for strong GDP expansion for years to come.

The Chinese government continues to support growth and, despite what is now becoming a pronounced weakness in housing, GDP growth appears to have stabilized in Q2. The weakness in housing prices seems to be boosting affordability. According to anecdotal evidence, many prospective buyers are now waiting for signs that prices are stabilizing before stepping onto the property ladder.

Rising Middle East tensions could cause the price of oil to spike. Like many emerging market countries, China runs a substantial energy deficit, making it particularly vulnerable. Unlike many emerging market countries, China has the benefit of running a substantial current account surplus; this helps offset the destabilizing impact of higher oil prices.

Canada Waltzes Along

Canada's World Cup aspirations were dashed way back in the qualifying round in October of 2012. This isn't surprising for a wintry country. On the other hand, Canada's equity markets at the half-year mark have delivered a trophy performance, with a total return of 12.88%, among the best of global returns.

Merger and acquisition activity in Canada's energy sector in the first half of 2014 has already surpassed last year's total. Two major deals were the Canadian Natural Resources purchase of Devon Energy Corp's natural gas properties and Encana's sale of exploration land to private equity.

The Canadian dollar has also rebounded nicely, moving back to 94.01 cents. This isn't likely to last, given the closing differential in bond yields between Canada and the United States.

If Canada has a weak flank, it's household debt. The recent Financial Stability Report from the Bank of Canada (BoC) highlighted two vulnerabilities. First, the bank cited "imbalances in the housing market," both stretched values and overbuilding. Second, it singled out "elevated levels of indebtedness among households." An interest-rate hike would have dire effects on some borrowers. This probably means that BoC Governor Stephen Poloz will let the U.S. Fed move rates higher before following suit (perhaps waiting for some time).

Our Strategy

Our strategy of overweighting equities has paid off over the last 10 quarters or so. This month, the S&P/TSX eclipsed its all-time high on renewed strength in energy and materials. We continue to watch valuations very carefully as markets advance: corporate earnings will have to justify appreciating share values. Federal bond prices, both north and south of the border, continue to defy gravity, although they must ultimately give way to higher yields. Economic growth may be slow, but each passing month of positive numbers brings us closer to interest-rate hikes. We defensively favour shorter maturities and higher coupons in the fixed income portion of portfolios as a result.

The Last Word

By the end of the month, one country will own the World Cup. The winner is assured glory at the podium, yet will pay a steep price. While the victorious nation's economy historically outperforms the world economy by 3.5% in the month after the World Cup, it underperforms by 4% on average in the full year following the win. Victorious or not, host country Brazil must face the long-term impact of the record-setting $11 billion tourney cost and unrest about how the event was handled. Brazilians are rightly concerned about increasing their country's endebtedness. The massive global debt overhang has held back world economic growth for more than half a decade.

Just as FIFA World Cup soccer demands the highest level of skill, global policy makers must execute brilliantly to propel the world's economies beyond the last vestiges of the Great Recession. They will have to share the goal of moving forward "All in one rhythm." Meanwhile, we continue to think defensively.