April 2013

Market Commentary

Aphrodite Not So Mighty

As the warm weather returns, many of us think about packing our bags and roaming off to exotic locales for a summer holiday. Tripadvisor.com, the free travel guide and research website, is a good place to find a recommended destination. Here's what the popular site has to say about Cyprus:

Travellers' Choice® 2013 Winners

Cyprus

The legendary birthplace of the goddess Aphrodite, Cyprus has been coveted and fought over by a succession of admirers: Mycenaeans, Egyptians, Assyrians and Persians, to name a few. The former British colony was most recently fought over by the Turks and the Greeks. A result of this turbulent past is an impressive range of cultural treasures, from Crusader castles to the tomb of Mohammed's aunt. The island's geography – plentiful coastline with a mountainous centre – ensures plenty of activity all year round.

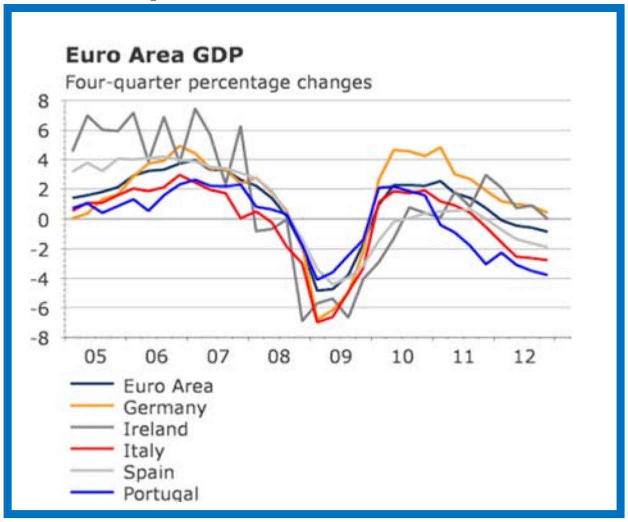
Certainly in recent weeks there has been plenty of activity in Cyprus – but not the kind that attracts holiday makers. The island country captured the lion's share of headlines this quarter because of its banking crisis. Although that was temporarily solved with 10 billion euros from an international rescue package, the terms were onerous. In a novel and concerning twist, the troika (the European Central Bank, the European Commission, and the International Monetary Fund) imposed conditions on the bailout: depositors would be forced to forfeit a substantial amount of their savings. As it became more likely that Cyprus would request a bailout, Northern European states grew decidedly uncomfortable that their taxpayers' money would be used to salvage Cypriot banks and protect assets of questionable pedigree, especially money of Russian origin. Depositors with more than 100,000 euros in the Bank of Cyprus could lose up to 60% of their money. Cypriots reacted with justifiable anger. So did the Russians.

How did this happen? Cyprus underwent an economic transformation as it joined the European Union. Its economy moved away from agriculture and light manufacturing, becoming a money centre with banks modelled on elite institutions in Luxembourg and Switzerland. Cyprus positioned itself as the hub to Europe, Asia and the Middle East, offering an attractive destination, multilingual service and very lax bank regulation. Initially, the impact of joining the EU was widespread prosperity. Construction boomed. Accounting and legal firms flourished as they supported and were fuelled by the banking industry. The financial sector accounted for about half the country's economic activity.

Everything changed in 2010 when the debt crisis peaked. Cypriot banks were burdened by non-performing loans, many of them Greek, and quickly cut off new lending. The economy came to a standstill. Bank mismanagement made things worse. While other financial institutions were unloading Greek debt, the banks in Cyprus doubled down, believing that the Greek debt would be largely backstopped. A bailout request became inevitable. In a bid to attract more tourist dollars, Cyprus now hopes to lift a ban on casinos.

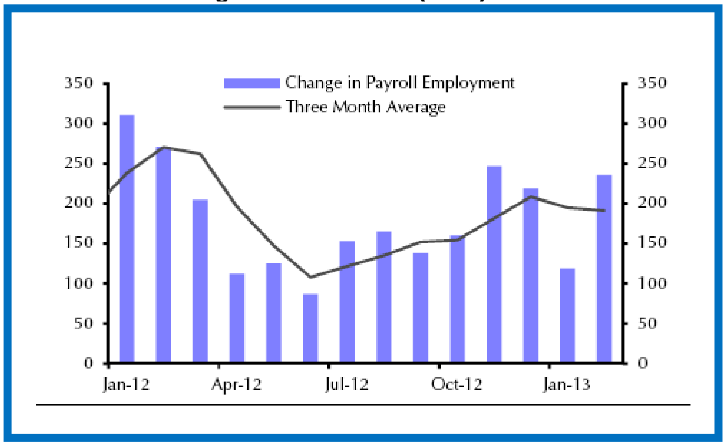
Elsewhere in Europe, challenges remain. In a number of countries, most notably Spain and Greece, unemployment numbers remain stubbornly high. For young people under 25 in Spain, the jobless rate tops 55% and in Italy it's more than 58%. Many eurozone economies are still in recession. At the end of the quarter, Italy was still struggling with political deadlock after the February election that gave no party a majority. Squabbling continued over how to form a coalition government, the only way to avoid another election and allow the country to get on with addressing debt and stimulating economic growth.

Chart 1: Many euro zone countries remain in recession



Source: Thomson Reuters Datastream/Fathom Consulting

Chart 2: U.S. Change in Job Growth (000s)



Source: Thomson Reuters Datastream/Fathom Consulting

The Cyprus situation offers two lessons: the eurozone has not resolved its structural problems; and, significantly, policy makers can stumble spectacularly. We continue to underweight investment in the eurozone and watch as this story unfolds.

The United States Brings More Good News

U.S. stock markets continued their torrid upward climb in March. The S&P 500 advanced 3.75% (U.S.) for the month and finished the quarter up an impressive 10.61% (U.S.). All sectors performed well; leading the way were Healthcare, Consumer Staples, Utilities and Consumer Discretionary. Economic fundamentals that are showing consistent, albeit modest, improvement are supporting the market rally. The ISM Manufacturing Index ticked up, industrial production improved and retail sales also showed strong gains through the quarter. The big news came in February with the change in non-farm payrolls – 236,000 jobs were added in the month and unemployment improved to 7.7%. In March, the economy added 88,000 new jobs, which was below expectations. Despite these March numbers, employment figures are encouraging because they so directly impact consumer spending. Federal Reserve Chairman Ben Bernanke has set a target rate of 6.5% unemployment as the benchmark that will trigger an increase in interest rates. We can anticipate that the Fed will stay the course with its accommodative money policy for some time yet (keeping interest rates low and making money easier to borrow).

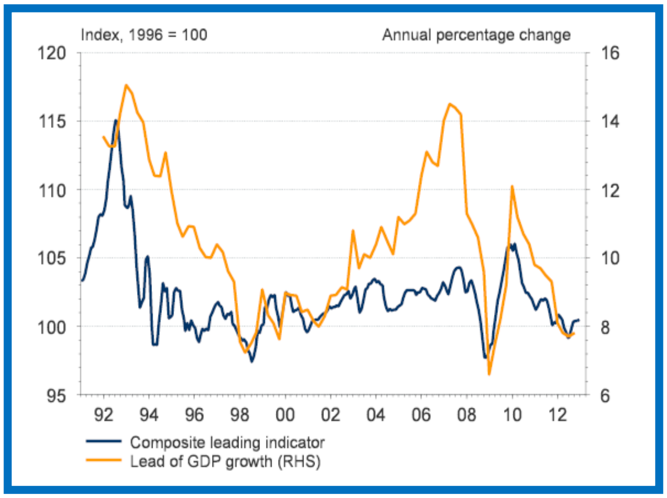
There were plenty of bright spots in the U.S. housing picture. Existing and new home sales are up, prices are up, the inventory levels of distressed properties are down and sales of building products are rebounding nicely.

A deeper look reveals that there's more than just sound economics behind the equity market rallies. Investors are looking at stocks from a "TINA" perspective – (There Is No Alternative). Why? Inflation is running about 2% annually in the U.S., yet money market instruments only pay .02%. This is an inevitable outcome of the Treasury's purchase of 60% of all new bonds issued. The real rate of interest paid to savers is negative, which chips away at the purchasing power of their capital. The happy outcome for the U.S. government is that it repays its debts with cheaper dollars. The outcome for investors is that they are corralled back into risk assets after retreating from them for five years. This isn't necessarily a bad thing. Corporate earnings are steadily improving, dividends are attractive and balance sheets have been shored up substantially for many publicly listed companies. All of these factors point to the potential for an equity rally that will last much longer than cynical investors might expect.

China's Slower Growth Means Stalled Commodity Prices

The Chinese economy continues to recover at a more tepid pace compared to its previous strong pace. Gross Domestic Product (GDP) for 2012 was 7.8%. Fourth-quarter GDP expanded at an annualized rate of 7.9%. Although the increase in economic growth is impressive in absolute terms, the point of comparison is last year's GDP growth, which was the slowest in more than a decade. Two-thirds of the slowdown was due to the weakness in the property market following tightening government policy controls. Resilient demand from overseas markets, including Europe, boosted China's trade balance surplus this past quarter, although domestic demand remains weak. Industrial production has been disappointing and retail sales figures have dropped considerably from a few months ago. New leadership is intent on pursuing anti-corruption initiatives, which may place more questionable investment projects in jeopardy. For Canada, the overall implication of slower Chinese economic growth is that commodity sales remain stalled.

Chart 3: China comp. leading indicator and GDP growth



Source: Thomson Reuters Datastream/Fathom Consulting

Canada after the Quiet Budget

Finance Minister James Flaherty introduced the government's 2013-2014 budget in March. At first glance it appeared to be a bit of a yawner. After all, it didn't pack much punch in the areas of fiscal stimulus and tax revenue. The goal of balancing the budget by 2015 still seems within reach if the economy cooperates – just in time for the next federal election. A balanced budget was a central promise of the Conservative election platform. The big winners included the construction industry, which will benefit from $47 billion in new infrastructure spending, and manufacturers, who received a combination of tax-break extensions and new spending ($1.4 billion in tax relief for new equipment purchases, $1 billion to southern Ontario's auto sector, and $1 billion to the aerospace industry over the next five years). The unemployed and underemployed also came out ahead; $500 million per year will be set aside for skills training matched to employer needs. Parents and sports enthusiasts had reason to celebrate over the removal of import tariffs on baby clothes and sports gear, which should make those goods more affordable.

While there are more tax breaks for generating clean energy, the incentives fell short of what some environmental lobbists expected. The question remains - will this help boost support for the proposed XL Pipeline project? Although tax reform was modest, Ottawa intends to get tough on tax cheats by offering a new whistleblower reward. The budget also closed a number of tax loopholes, further signalling the government's intent to go after tax evaders. Projections of increased tax recovery may be somewhat optimistic, however. It's also a tough time to be a public servant in Canada. Pension plans, severance policies, travel expenses and direct program expenses all came under the knife and are projected to drop by $4 billion this year and another $2.5 billion next year. The public sector continues to shrink.

Our Strategy

An overweight to equities was rewarded in the first quarter of the year and continues to represent good value. We are maintaining our overweight position in both Canadian and U.S. stocks.

We continue to remain underweight in fixed income instruments across most portfolios. Bond valuations remain high and interest rates are likely to remain low for the foreseeable future, given the posture of the U.S. Federal Reserve.

The Last Word

While Aphrodite may be famous for being the goddess of love, it's hard to believe that her fellow Cypriots are feeling the love right now. Perhaps they see her in another of her guises: the goddess of death-in-life. Their sudden reversal of fortune may feel just that bleak. The quarter ended with a question mark: will other struggling eurozone countries follow Cyprus's lead and rewrite the bailout rules? Bank customers in Greece, Italy, Spain and Portugal have very good reasons to be nervous. Once again, uncertainty in Europe is rattling global markets. International and Canadian policy makers have closely watched the events unfolding in Cyprus and the good news is that the Canadian banking system is in very decent shape.