Market Commentary

June 2013

Pinball Wizards Wanted

"He's a pinball wizard
There has to be a twist.
A pinball wizard,
S'got such a supple wrist.

How do you think he does it?
I don't know!"

-- *Pinball Wizard by Pete Townsend, from the rock opera Tommy*

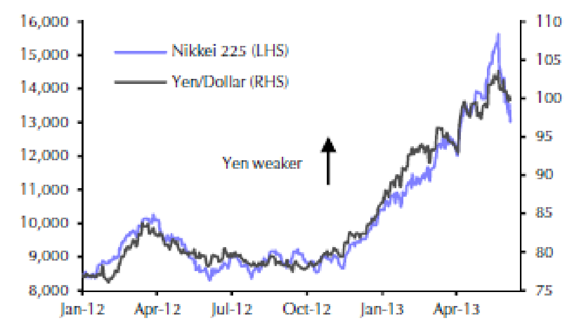
The agitated, acoustic strumming that opens The Who song Pinball Wizard introduces us to the extraordinary talent of Tommy. The power chords of the chorus quoted above are the backdrop for the story of a genius with a light and deft touch at a noisy arcade game.

Pinball Wizard would make a great theme song for Japanese Prime Minister Shinzo Abe. The world's attention is riveted on his bold economic experiment dubbed "Abenomics." This portmanteau word (named after a French suitcase with two compartments) describes Mr. Abe's approach to lifting Japan out of its decade-long deflationary funk. The "three arrows" of Abenomics are wide-ranging fiscal, monetary and structural reform measures that are being deployed assertively and broadly across Japan's economy, the world's third-largest. Government spending will increase to 2% of GDP and will have the likely and obvious consequence of raising the fiscal deficit; some estimates put it at 11.5% of GDP by the end of the year. Step-by-step increases in the consumption tax are designed to offset the big fiscal spend; the tax will increase from the current 5% to 8% in 2014, and will increase yet again to 10% in 2015. This attempt to help balance the national budget will surely will put a damper on domestic spending, just as a consumption-tax increase drove the country deeper into deflation in the late 1990s.

The move in the exchange rate is even more dramatic. In 2012, the yen was mired at a rate of 80 yen to the U.S. dollar; last month, a greenback would buy 102 yen. That's a currency depreciation of 28%.
The Japanese stock market has responded with appreciative gusto as well. It has advanced by 63.7% (JPY) over the last year, although it did give up .62% (JPY) of those gains in May. Volatility is sharply up. Should pension funds in Japan be directed to increase their equity allocation from 15% to 25%, the Nikkei index will most likely move even higher. The challenge for non-Japanese investors is to gauge whether the equity gains will withstand any further deterioration in the currency. There is a clear winner in this, however; Japanese exporters are enjoying invigorated revenue growth on the back of the currency weakness.

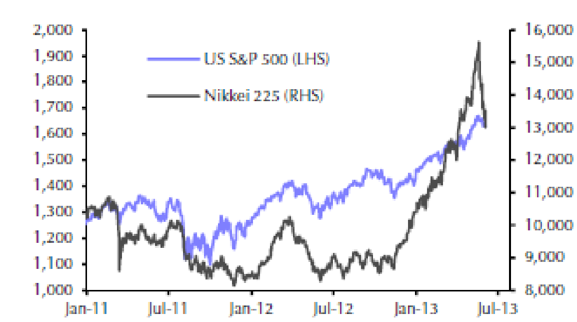
Like almost all stimulus policies, Abenomics has its detractors. European Central Bank policymakers have expressed concern about the danger of a currency war; the very real possibility looms that other countries may follow suit with a strategy to devalue their currency as well. Japanese workers are concerned too that the inflation targeting may result in a drop in real wages. The bigger concern is that all this stimulus spending may eventually face a day of reckoning.

Chart 1: Nikkei & Yen/Dollar



Source – Thomson Datastream

Chart 2: US & Japan Equity Indices



Source – Thomson Datastream

U.S. May Scale Back QE3

While we're on the subject of pinball, the U.S. Federal Reserve is starting to send weak signals that it intends to scale back its bond purchases somewhat sooner than expected. The Fed's program of bond buying, or quantitative easing, is now in its third stage. These massive purchases are meant to boost the economy, although it's unclear whether QE 3 will produce the desired effect. The Fed's goal is to make sure the game does not go "tilt." The key question is this: can the Fed orchestrate an orderly unwinding of its quantitative easing program and, equally important, is the underlying economy strong enough to stand on its own?

The big story in May was the surge in yield for 10-year Treasury bonds. At the beginning of the month, 10-year notes paid 1.66% (USD); at month end, they yielded 2.12% (USD). Increases in yield like this erode capital. Other than being in cash (which currently has a negative real return), the best strategy for protecting capital is to hold shorter maturities and higher coupons, which allows investors to take advantage of attractive reinvestment opportunities as they become available.

China Struggles with Momentum

Four months of disappointing numbers have led many economists to pare back their forecasts for growth in China, the world's second-largest economy. The year started out with high expectations for a rebound that would take levels close to 8% in 2013; however, softness in demand and manufacturing appears to have spread to the service sector. Growth will likely come in at 7.6% – or perhaps even lower. Several factors have contributed to the depressed numbers: contracting factory output; government policies to cut spending; controls on the unofficial banking sector; and Beijing's general tolerance for lower growth rates as the economy gradually restructures in the direction of a stronger domestic consumer base.

BoC Under New Management

At the end of May, Mark Carney stepped down as Governor of the Bank of Canada and will take over the helm at the Bank of England on July 1. We can expect new Bank of Canada boss Stephen Poloz to put his stamp on the position, although he will likely extend the policy of low interest rates for a while; under Mr. Carney, the benchmark rate has remained at 1% for 32 consecutive months. We'll stay tuned for further developments.

Canadian equity markets had a better, albeit modest, month in May, with the S&P/TSX providing a total return of 1.77% for the month. Commodities remain the concern for the Canadian market if growth in China continues to slow. The slower growth anticipated for China is impacting commodity prices, which is a likely catalyst for softness in the Canadian dollar.

Our Strategy

For some time now, we have been overweight equities relative to bonds; we continue to favour that allocation. The average bond maturity has been shortened quite deliberately in our portfolios over the last few quarters and will tighten up even further. Our focus is squarely on the actions of all central banks, but we are particularly watching the U.S. Federal Reserve.

The Last Word

Unwinding the fiscal and monetary stimulus programs known as quantitative easing was always going to be tricky; central bankers understood that from the outset. If the stimulus lasts too long or is too much, inflation could return with a vengeance. Cut stimulus measures off too soon, and economies risk slipping back into recession. To complicate this, financial markets have been nervously reacting to even the slightest hint that the unwinding will be anything but later, gradual and orderly.

Like the brilliant pinball player from *Tommy*, central bankers must display a gifted – almost flawless – dexterity in unwinding their programs aimed at supporting the economy. While we expect short rates to remain low for a number of quarters yet, later this year the Fed will likely begin to gradually ease out of some strategies such as bond purchases. Unlike a performance of *Tommy*, which is best enjoyed LOUD, let's hope these pecuniary pinball wizards accomplish their goals against a background score that plays out at more subdued, chamber-music volumes.