November 2014

Market Commentary

A Whale of a Month

"With the landless gull, that at sunset folds her wings and is rocked to sleep between billows; so at nightfall, the Nantucketer, out of sight of land, furls his sails, and lays him to his rest, while under his very pillow rush herds of walruses and whales."

\- **Herman Melville, Moby-Dick**

In 19th century America, capitalism was raging – for good and bad. Fortunes were won, lost and won again. Business boomed, fueling a staggering level of wealth creation. The population was expanding at an explosive rate. Eager for diversion, Americans devoured epic romances about the frontier. Tall ships and tall tales electrified a nation that could vicariously see paradise by a whale-oil light.

Herman Melville's Moby-Dick tells the story of Ahab, captain of the Nantucket whaler Pequod, and his obsessive pursuit of a giant white whale. The vendetta is personal: the leviathan had cost him both his son and his leg. Back then whaling was more than just a high-risk, heroic adventure – it could be very lucrative for captain, crew and investors. While the entire animal was harvested profitably, oil drove the economics of whaling. At its peak, whaling was the fifth-largest sector of the U.S. economy. This is impressive considering that U.S. GDP growth averaged 4.5% every year in the three decades before the Civil War (1861-1865). Yet by 1860, the whale fishery accounted for just a small fraction of the illuminants and lubricants supply. Although the fishery was about the same size, the market had expanded immensely. Coal oil was a fierce competitor. It was plentiful, cheap, and could be piped – unlike whale oil, which won't burn if it's piped any distance. The death knell came with the discovery of enormous reserves of petroleum in Pennsylvania; the price of both coal oil and whale oil ultimately tumbled.

Today, energy prices are just as volatile. With a barrel of oil now below $80, the impact of cheaper energy is mixed. For high-cost producers like the Canadian oil sands, price declines of more than 25% are not good: no amount of volume can ever make up for this. Consumers are the winners here. It's also a boon to countries that run an energy deficit, including most of Asia, central Europe, large parts of South America, Turkey and South Africa.

U.S. — Fine After Fishtailing

At month-end, the S&P 500 was up by a respectable 2.44% (U.S.) on a total-return basis over September's close. It was not a smooth ascent, however. Eleven of 24 trading sessions saw day-over-day moves of more than 1%. Although investors had been expecting a market correction, the speed, breadth and severity of the drops were alarming. The first taste of indiscriminate selling in more than five years stirred bad memories of the financial crisis. Fortunately, the scare was short lived and buyers prevailed.

The U.S. Federal Reserve wound up its Quantitative Easing program (QE3) as planned, but not without a hint of hesitation as markets dove and rose again like a harpooned Moby-Dick. The Fed changed the tone of its message, no longer calling the degree of labour underutilization "significant." Instead, it said underutilization of labour resources is now "gradually diminishing." A more hawkish tone from the Fed seemed to reassure the markets that the U.S. economy is ready to stand on its own.

In fact, the U.S. economy grew faster than expected in the third quarter, supported by a surge in defense spending. Real GDP growth came in at 3.5%; consumer and manufacturing confidence continue to strengthen.

Personal income is up slightly and sales are also showing modest growth. New home prices have slowed a bit, which is good news for first-time home buyers.

The mid-term elections brought few surprises. Republicans gained control of Congress on the back of the President's low approval ratings. This is actually good news, given that the historical average return for equities favours the combination of a Democratic president and a Republican-controlled Congress. It's not scientific (nor investable) data, but the 22.3% average annual historical return under these conditions widely outpaces the other three possible combinations. Although gridlock for the balance of the President's term is possible, we're more likely to see some real compromise on key issues like the Keystone Pipeline, tax reform and the Trans-Pacific Partnership trade deal. Some parts of the Affordable Care Act may be revised.

Europe — Still Sinking Like the Pequod

The recovery in the eurozone continues to deteriorate. Special factors like the crisis in Ukraine are having a negative impact. Germany has been hardest hit, with exports to Russia down sharply at a time when its exports to other trading partners are up solidly. Yet trade with Russia is only 1.2% of total German GDP; the crisis in Ukraine is not the big reason for the eurozone's pervasive economic malaise. More fundamental forces are at play here, including the previous strength of the euro, ongoing austerity programs, sluggish wage growth and a weak banking sector. On October 26, policymakers published the results of the Asset Quality Review and the stress tests of eurozone banks. The results were generally encouraging. Even so, 13 banks – largely in the eurozone's weakest economies – need to raise more capital. Credit is unlikely to expand much in the countries where it is most needed.

Rumours abound that the European Central Bank (ECB) is considering a program of corporate bond purchases. To meaningfully expand its balance sheet, however, the ECB should include sovereign bonds as well. If Europe wants to avoid a Japanese-style bout of deflation, both the ECB and national governments must act fast and be bolder and broader in their support.

China — Tackling a Slowing Economy

Reforms identified a year ago at the Third Plenum meeting of the Chinese Communist Party are likely to gain momentum in 2015. Implementation has been slow thanks to softer economic data. Reform is really contingent on a cyclical rebound in the housing market and sustained expansion in exports. That economic strength should provide China's policy makers with the support they need to push through reforms that would allow the market to determine factor inputs such as capital, labour and land. These changes are designed to address some of the economic imbalances that have emerged over the last decade or so.

Equally important are fiscal and governance policy changes that are designed to decrease concerns about debt sustainability in local governments and state-owned enterprises. Newly released numbers show more weakness in home prices, which could prove to be a fly in the ointment. Interestingly, the monthly drops have now translated into a yearly decline spread across cities of all sizes and locations. The financial system is wary since housing represents collateral that backs a major portion of China's financial system.

Other indicators also suggest further slowing of the Chinese economy. Lack of demand is the problem; the likely cause is the government's policy of curtailing credit expansion in an effort to bring down the credit-to-GDP ratio. The evidence is in ex-factory prices (the cost of goods at the factory, before taxes and delivery charges are added), which have been falling for 35 months in a row. This tight policy is odd because it's normally used to fight economic overheating and inflation. Falling prices should be a signal to relax credit. It's starting to look more like a question of when, rather than if, we see another round of aggressive monetary easing.

Canada — Oil is the Story

October was an eventful month for this country. Sadly, attacks likely inspired by Islamic extremism resulted in the death of a Canadian soldier in Saint-Jean-sur-Richelieu, Que., and another in Ottawa. While the nation mourned, negative market reaction was brief.

On the economic front, arguably the single most important event is the steep drop in oil prices since the

summer. Oil peaked in June at more than $107 (U.S.) and currently trades below $80 (U.S.). The impact on Canadian GDP will likely be modest, trimming about 0.2% off of the overall figure (2015 estimates have been revised lower to 2.4%). The greatest impact is in capital expenditures for the energy sector, which accounts for 22% of all non-housing capital spending in the country. If prices stay low, it could be a significant blow. For consumers, it's a different story. Lower oil prices have already made their way to the gas pumps. The effect is like an immediate tax cut, which should support the consumer-dependent sectors of the economy. Canada's manufacturing sector enjoys a double bonus: not only is the input cost of energy lower, the Canadian petro dollar has also softened in tandem with oil prices. Canadian exporters enjoy a pricing advantage when they sell to the U.S., our biggest trading partner.

In October, Canadian equity markets did not fare quite as well as their American counterparts. Volatility was a bit higher, with triple-digit declines in many consecutive sessions. Those down days were also busier. Important for Canadian investors, the S&P/TSX composite index regained some lost ground, closing lower by 2.32%, but not before climbing back 744 points over its October 15 low.

Our Strategy

October's mini-correction caught no one by surprise. It came after three years of largely uninterrupted equity-market advances and a Fed that has been clearly signaling a course change. We realized some profits back in July and at the same time took some risk off of the table. We were well positioned to deal with both the volatility and the somewhat exaggerated negative sentiment of the markets. Our strategy was to maintain discipline in the face of volatile markets and avoid selling into weakness.

It appears that the U.S.-led recovery is gaining strength, pointing to a gradual increase in the Fed's overnight interest rate. Asset allocations in our portfolios continue to favour equities over fixed income. We are also maintaining our geographic bias to U.S. stocks. Our fixed income remains defensively positioned ahead of early-stage increases in interest rates.

The Last Word

We don't have a modern equivalent of Melville's celebration of the whaler's life. We can look forward to an epic novel based on an all-Canadian saga of conflict, survival and redemption, perhaps based on the life of a roughneck toiling on a "triple" that's fracturing its way to economic glory. While times have changed since Moby-Dick was published, the U.S. oil and gas industry is a major catalyst for current U.S. economic strength, just like whaling in the 1800s. On a number of economic fronts, the industry is making a substantial contribution, including very robust employment growth.

Oil prices are both a problem and an opportunity for Canada. The challenge to our high-cost producers – and the provinces that tax those industries – is lower revenues. On the flipside, the manufacturing sector in central Canada suffered hugely after energy exports drove the Canadian dollar skyward. Governments and entrepreneurs should quickly seize the chance to rebuild. Balance in our economy is crucial.

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