January 2015

Market Commentary

A Glimpse into the Future

"There was of course no way of knowing whether you were being watched at any given moment. How often, or on what system, the Thought Police plugged in on any individual wire was guesswork. It was even conceivable that they watched everybody all the time."

- George Orwell, Nineteen Eighty-Four

George Orwell's *Nineteen Eighty-Four* hit book shelves in1949, just as the chill of the Cold War was settling over most of Europe. The novel is set in a dismal world divided into three powerful states after a global nuclear conflict. Oceania, one of those three states, is a bleak, joyless place. Its citizens are beaten down by perpetual war, constant government surveillance, public manipulation and relentless propaganda. Futurists like Orwell used the dystopian state – a place or time in which one or more characteristics of society are highly undesirable – to illustrate the disastrous consequences of failing to address current, real-world issues.

The concerns Orwell expressed would eventually consume much of Europe, especially the growing power and influence of communism and totalitarianism. Orwell had presciently sketched out the main theme of his book five years earlier, shortly after the Tehran Conference in 1944. There, Stalin, Roosevelt and Churchill met to strategize an end to the war in Europe. One consequence of the meeting particularly worried Orwell: the three leaders had essentially divvied the world up into "zones of influence," described in *Nineteen Eighty-Four*. The Yalta and Potsdam Conferences of the following year sealed the division of Europe and the post-war order.

Redefining and defending those "zones of influence" continues to be an ongoing theme in both global politics and economics. We shouldn't be too surprised to hear Russian leader Vladimir Putin using such language to justify his foray into Ukraine, particularly when it comes to Ukraine's potential NATO membership. In March 2014, Russia forcibly annexed the Crimean Peninsula and the city of Sevastopol. Eastern Ukraine was next to fall. Western retaliatory economic sanctions and a precipitous drop in the price of oil have left Russia facing the rather bleak prospect of an imminent and perhaps severe recession.

Throughout the balance of 2014 little was resolved and Ukraine is not in a position to force a resolution on its own. Some recent, albeit modest, progress can be noted with Russia's agreement to provide Ukraine with power and coal. This is a tough test for Western diplomats – Putin seems to take a step farther away from rationality with each new twist in this story. A fully satisfactory resolution appears unlikely in the near term, so perhaps the best we can hope for is no further escalation of this standoff.

U.S. — the Future Looks Bright

We aren't going out on a limb in predicting that the U.S. will enjoy the strongest growth of all the major developed economies in 2015. Despite a very vibrant domestic-energy sector, the U.S. is still a significant oil importer; lower input prices for energy are a definite tailwind. Overall GDP growth will likely rise to a 3% pace. The U.S. economy has momentum on a number of key fronts: weekly jobless claims; the November Leading Economic Indicators; and industrial production. Housing isn't quite as robust, taking two steps forward and one back. In fact, it may turn out to be one of the reasons the Fed doesn't aggressively raise interest rates in 2015.

U.S. shale producers have been a game changer for global oil production. It's easy to understand why. First, the geologic risk is lower for new shale-formation wells, especially compared to deep-water exploration. Second, the new technologies of horizontal drilling and fracturing have greatly boosted the yield from shale plays. The break-even point for oil prices from an incremental new well in some U.S. shale fields is as low as $70 per barrel.

Cash operating costs for existing wells are much lower; shutting-in or capping that production would not likely occur until oil dropped below $45 per barrel.

Depressed oil prices will probably have the greatest impact on capital spending for new exploration and production. The last time we witnessed an oil-price decline of this magnitude was in 2008 when oil dropped from $145 to $35 per barrel. Although that price drop was relatively short lived, new capital expenditure dropped 15% globally and 35% in the U.S.

The decline in oil prices has been good news for U.S. President Barrack Obama. His approval rating has gone up as gasoline pump prices have gone down.

It's pretty safe to predict that the Fed will gradually increase interest rates during the year ahead. That's the consensus, but it has been wrong for quite a while now. Slowing productivity could undermine that prediction yet again.

Europe — Time to Design Its Own Future

The focus in Europe is on the European Central Bank (ECB). Expectations that the ECB will introduce an effective quantitative easing program have been steadily and persistently increasing as economic growth in Europe continues to languish. It is clearly time for the ECB to act.

Greece is in the spotlight again. Under Greek law, parliament has only three opportunities to elect a president. In the third and last attempt, Stavros Dimas – Prime Minister Samaras's presidential candidate – only garnered 168 of the 180 votes needed to become president. This triggered a call for a snap general election that will likely be held January 25. Europe is concerned that Syriza, the front-running party, is looking to roll back some of the austerity measures that went along with Greece's bailout. Greek 10-year bond yields dangerously touched 9.8%. The primary concern is the risk of contagion to other states like Italy and Spain. Euro watchers are again focused on the potential for Greece to exit the eurozone. For the time being, bond markets in Italy and Spain are showing restraint.

Lithuania has chosen to move from one zone of influence to another as it joined the eurozone on January 1. Lithuania will adopt the euro and must meet fairly stringent criteria: the country's budget deficit must not exceed 3% of GDP; its national debt must not exceed 60% of GDP; and the inflation rate can be no more than 1.5% higher than similar inflation rates in three EU member states with the lowest inflation. Lithuania is concerned for obvious reasons – it is surrendering the ability to debase its currency in order to regain international competiveness. On the other hand, Lithuania's currency, the litas, has been tied to the euro for more than a dozen years. This move to formally join the eurozone gives Lithuania a seat at the table in setting monetary policy.

China — Who Controls the Past Controls the Future

The world's second largest net importer of oil (roughly 5.5 million barrels per day), China stands to substantially benefit from lower oil prices. Data for November suggested that China's export growth has slowed somewhat. That's likely to be short lived. As the price of oil drops, China's exports should outpace imports by a widening margin.

Expectations for GDP growth in China continue to favour the view that it is gradually losing steam. This makes sense, given China's slower trajectory for the last few years as it repurposes its economy to a more domestic orientation.

Bank lending has been closely watched in China. Further evidence of overall credit-growth slowing is welcome news for the People's Bank of China (PBOC), whose objective is to reduce risk in the financial sector and property market.

It's been a challenge to get Chinese investors interested in their own stock market over the last number of years. That has certainly changed in the last couple of months, with a very sharp momentum move currently playing out. The number of recently opened new investment accounts shows an equally unbridled enthusiasm for domestic stocks. Is this a harbinger of a PBOC quantitative easing program?

Canada — The Future Revisited

The recent sharp decline in oil prices is a clear reminder to investors that oil prices can be very volatile, despite the relative stability of the last few years. While lower oil prices do not portend a great year for Canada in the short run, the good news is that oil markets are self-correcting in the long run. Lower prices inevitably lead to declining supply. For Canada, and in particular the oil sands, being a high-priced producer will hurt. The energy industry in Canada is smart, however, and has been through situations like this before. We are already seeing evidence of appropriate capital discipline, along with lower projected spending and drilling activity.

Canadian housing defied the critics again in 2014. Instead of collapsing or retracting, home prices rose again, besting U.S. housing-price gains. Of the 26 Canadian cities measured, Toronto prices posted the largest annual increase at 8%. New condo starts have fallen off; vacancies have dropped to 1.3%. Not surprisingly, rents have inched up and a correction does not seem to be looming on the lakeshore skyline any time soon. The lower price of oil will probably slow Alberta real estate.

In 2015, provincial economic leadership is likely to shift away from the energy-producing provinces of Alberta, Saskatchewan and Newfoundland. Expect British Columbia, Ontario and Quebec to deliver relatively better results.

Our Strategy

Going into 2015, there has been no real shift in asset-class leadership. We continue to prefer equities over bonds, given the low absolute levels of rates on fixed-income investments and the very likely scenario of rates rising this year. Valuations for equities, while not cheap, are not overly expensive either. Despite the potential for an interest-rate rise in the U.S. this year, both the Fed and the Bank of Canada have been clear that they will remain accommodative for some time yet. This should reassure both consumers and investors for now. We continue to favour the U.S., although it's a time to be cautious – which means being selective. We don't expect much of the total return to come from a general multiple expansion (multiple expansion occurs when the market values go up, but earning don't keep pace), so we will watch earnings very carefully.

The strength of the U.S. economy can't help but pull Canada along. While we anticipate that Canada's economy will lag in the shorter term, we will benefit from the growing economic strength of our neighbour to the south.

The Last Word

Mercifully, 30 years after 1984, the future is nowhere near as bleak as Orwell painted it. So far, at least. Still, there are several discomforting, eerie similarities between Orwell's dystopia and some aspects of our society, particularly the surrendering of personal freedoms and privacy.

This bull market, while maturing, is showing few signs of being exhausted. (It seems silly six years in to still call it a rally or a recovery.) The odds are good that this next leg will be a slower march; however, all the signs are in place for continued economic expansion. In 2014, we did not travel too far down the road to *Nineteen Eighty-Four.* As Orwell comfortingly wrote, "Freedom is the freedom to say that two plus two make four. If that is granted, all else follows."

Very best wishes for a happy and prosperous 2015!