September 2014

Market Commentary

Jackson Hole

The early history of Jackson Hole, Wyoming, is typical of many regions in the American West. Before the Euro-Americans arrived, the valley was home to the Bannock, a First Nations people. They lived off the land, hunting elk, bison and other animals. But the Bannock way of life changed dramatically with the arrival of white settlers and the rapid expansion of their trade-based economy. Conflicts were inevitable. For the Bannock people, it came down to a single issue – how to ensure their livelihood as they became increasingly dependent on settlers for food and work.

For most of the year now, Jackson Hole is like any small community: nothing much happens. Local news recently reported that wet weather had caused the Budge Drive landslide to move another couple of centimetres, though no disastrous release is expected. Partial funding was approved via a state loan for winterization of water and sewer lines, as well as a rebuild of the pump house near the slide site. Decidedly sleepy stuff. Then comes August, when many of the world's most powerful financial players arrive to talk in an informal setting about the global economy. Jackson Hole steps into the international spotlight. This year, investors were looking for signals that could herald an important change in monetary policy. The theme of this year's symposium was labour market dynamics. It was all about jobs.

U.S. Charges Ahead

U.S. Federal Reserve Chair Janet Yellen began her symposium address by pointing out the considerable progress in U.S. job creation since the end of the Great Recession, which she called "the largest and most sustained loss of employment since the Great Depression." The economy added an average of 230,000 jobs a month this year, outpacing by 40,000 the monthly rate of the previous two years and making this the best year of the recovery so far. Optimism among market watchers was dampened, however, by the unexpectedly low job numbers in August – just 142,000. The Fed's dual mandate is to "foster maximum employment and price stability." Monetary policy needed to be unambiguously easy and supportive of boosting economic activity when unemployment was over 8.0%. Recent jobless numbers hover around the targeted 6.2%. The Fed is now having difficulty setting policy and providing guidance because it's not clear how close the economy is to achieving maximum employment.

Structural changes in the U.S. labour force are complicating that analysis: demographic shifts (the aging workforce), a declining participation rate and the reduction of middle-skill jobs are three examples. Ms. Yellen doesn't think the economy has achieved full employment yet; she believes that a number of cyclical and structural changes might be reversed with additional monetary accommodation. She commented that "the labour market has improved significantly over the past year, but ... the decline in the unemployment rate over this period somewhat overstates the improvement in overall labour market conditions." The Fed signal was clear: monetary policy will remain easy for the time being. As expected, the Fed reduced its asset purchases by another $10 billion this month and is on track to wind up its quantitative easing program in October as planned.

Until recently, capital spending has been missing from the U.S. economic recovery. In late 2013, there were vague hints that activity was picking up speed, but a dismal and wintry 2014 first quarter blurred recovery signs. Pent-up demand seems to be roaring back in the second half of the year, however, judging by August's PMI (Purchasing Managers Index) surge in new orders. Other indicators point to considerable strength across the U.S. economy: an impressive combo of improvements in manufacturers' shipments of durable goods, new job openings, housing starts and consumer confidence.

Europe – a Day Late, a Dollar Short?

Europe is in a very different stage of its recovery than the U.S., particularly in job creation. European Central Bank President Mario Draghi does not have a mandate to tackle the employment issue – it is not an ECB policy target. Even so, Mr. Draghi has been adept at incrementally broadening the central bank's platform; this is where he may have upstaged his American counterpart at the symposium. Despite the complexity of Europe's jobless issue, his argument was simple. He said Europe's unemployment is cyclical (caused by the recession) rather than structural (caused by fundamental shifts in the economy).

Cyclical unemployment contributes significantly to lack of demand because the jobless don't spend as much. Therefore, the output gap is wider than previously estimated and further stimulus is required to achieve full GDP potential. In essence, his message was that unemployment was deflationary and therefore a monetary issue. Analysts have been calling for this type of action for months and safely predicted that the ECB would make further accommodation to its policy stance. The ECB lowered rates on September 4, pushing returns on deposits deeper into negative territory at -0.20%.

Europe will not solve its economic problems through monetary policy alone. Mr. Draghi correctly points out that fiscal policy must turn pro-growth across a number of countries. (He was likely thinking of both France and Italy.) The crisis in Ukraine caused some of the weakness in recent weeks, but a fall in exports, a sharp slide in the composite PMI and yet another drop in consumer confidence are evidence of a wider issue. Trade with Ukraine and Russia simply isn't that material. Even Germany's trade with Russia only amounts to roughly 1.2% of its GDP.

China and Emerging Markets

China seems to be moving in fits and starts. After a strong finish in Q2 economic activity, evidence of slowing returned yet again. Freight volumes are down from both a month ago and last year. The taper in trade volume through its seaports also persisted throughout July.

Data on new housing starts indicate a revival in property development. Government policy is likely the cause, given the stock of unsold inventory developers are holding. Interestingly, policy responses across other sectors of the economy appear to be muted and may indicate that Chinese policy makers will tolerate a gradual growth slowdown.

Aggregate GDP growth in emerging markets has been about 4.5% for most of this year. Aggregation doesn't tell the real story. Softening commodity prices have adversely impacted Latin America. Emerging Europe is experiencing slower growth as a result of weakened demand from the eurozone. Russia in particular has been weaker due to capacity constraints and economic sanctions imposed because of its interference in Ukraine. Emerging Asia continues to improve on the strength of its export growth. The inflation outlook is mixed across emerging market countries. Inflation is a concern for Venezuela, Turkey, India, Russia, Brazil and South Africa. Inflation is low and stable in emerging Asia and the Middle East.

In emerging markets, economies that are commodity users currently have a distinct prosperity advantage over commodity producers.

Canada – A Burger with that Double-Double?

The Canadian message at Jackson Hole was quite simple in its guidance. Bank of Canada Governor Stephen Poloz indicated that Canadian monetary policy will not necessarily move in lock step with U.S. monetary policy. Bay Street and Wall Street should take notice. Investors expected BoC interest rate policy would move in the same direction as the Fed's policy, with a lag of perhaps one or two months. Governor Poloz suggested otherwise. His reasoning is sound. The key Canadian interest rate has a head start at 1%, unchanged since 2010. The U.S. Fed has kept short-term interest rates near zero since 2008. More to the point, there is a real difference in the strength of the two economies. While the U.S. has some forward momentum, Canada is still waiting for better numbers in exports and business investment. Encouragingly, retail sales were up 1.1% in June and consumer prices were firmer, up 2.1% on a July year-over-year basis.

BoC news was completely eclipsed by the sale of Tim Hortons to Burger King. This iconic Canadian brand was sold in a complex deal to Brazilian investors looking to replicate the cost-cutting strategy they used at Burger

King and capitalize on the lower Canadian corporate tax rate.

Our Strategy

Despite some profit taking last month on a number of positions held in portfolios, we remain overweight equities. This reflects our view that stocks will continue to outperform bonds. Yields on interest-bearing vehicles remain low, held down by events in Europe and foreign buying of U.S. treasuries. Our fixed income strategy remains defensive in anticipation of a reversal in interest rates, despite an apparent reluctance of bond yields to back up any time soon. The growing strength of the U.S. economy makes this rise inevitable, however. The consensus view is that the Fed will likely start increasing its discount rate sometime in mid-2015.

Equity markets have tremendous support from the amount of liquidity in the financial system and momentum is certainly a tailwind. Valuations are still increasing faster than earnings, though. As they advance, our strategy is to continue taking profits, keeping our overall risk exposure relatively constant. We continue to emphasize U.S. equities for our overweight position in stocks, given the relative strength of the U.S. economy. To date, we have not found the right entry point for adding to European equity. We continue to carefully monitor events there, paying particular attention to issues that could have broader international implications.

The Last Word

Plus ça change, plus c'est la même chose. On the Western frontier in1895, the conflict ultimately came down to jobs in a rapidly changing world. In the symposium halls at Jackson Hole, central bankers from across the globe focused on the same theme. Despite major progress since the end of the Great Recession, there is still a lot to do to ensure a solid economic future. One haunting symposium message demands the serious attention of governments and educators everywhere: the growing skills gap between job seekers and employers. Central bank policy has been the primary driver of this recovery; we continue to pay close attention to the guidance of global central bankers.