November 2013

Market Commentary

Quiet Improvements Mark the Month

If you have ever wondered why Wall Street gets things so wrong and Warren Buffett gets them so right, the answer might lie in a book called *Quiet,* which explains "The Power of Introverts in a World That Can't Stop Talking." Author Susan Cain says that reward-sensitive people are highly motivated to seek rewards - a promotion, a stock-market win, social status or a casino hand. But reward sensitivity often triggers outsized risk taking that ignores obvious signs of impending danger. The predominance of personalities chasing wealth and fame contributed to the bank meltdown of 2008. Introverts are more likely to heed warning signals. Warren Buffett, a self-professed introvert, foresaw the dot-com bubble collapse and advised investors to take cover.

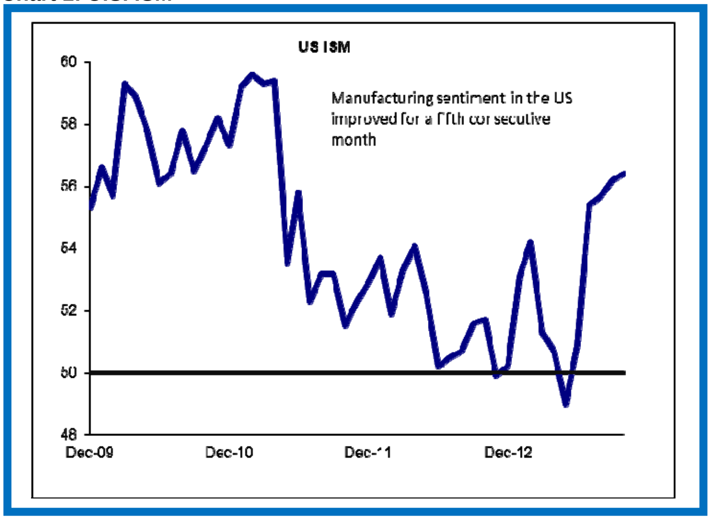
Where were the introverts in the U.S. debt-ceiling debate? A number of clearly extroverted Tea Party Republicans ignored the warnings of their more moderate colleagues and barreled ahead with their plan to defund The Affordable Health Care Act (Obamacare). They threatened to drive the U.S. into default as though that were a credible and reasonable tactic. They didn't succeed, but the risk taking was staggering and a little pointless: the U.S. had already made great strides in bringing down the budget deficit. Sequestration - the automatic government budget cut had chopped government spending; further curtailments to expenditures are just around the corner. A rebounding economy is also fattening tax coffers. While the U.S. deficit and debt levels deserve attention, the situation did not warrant the political brinksmanship we just witnessed. Early in 2014, those same fiscal debates will begin again.

The U.S. Delays Tapering

No one was surprised when the Federal Reserve decided at its October meeting to stand pat on interest rates. The economy is creating new jobs, but at a very slow rate. High unemployment (7.2%) and the looming conflict in the House and Senate probably mean the Fed will stay with its monthly $85-billion bond purchase until the end of the year.

The recent 16-day government shutdown cost the U.S. economy as much as $24 billion (USD) in lost economic output. The American economy is resilient, however, and there are some very positive signs. First, the budget deficit is the lowest since 2008 and more government budget cuts are scheduled to kick in early next year as part of sequestration. Second, some economic indicators are encouraging. Core retail sales were up 0.50% in September. The Manufacturing Purchasing Managers' Index was up 0.20% and Industrial Production up 0.60%. Initial job loss claims were down and producer prices ticked down slightly. Gasoline prices dropped, providing consumers with some relief at the pumps.

Chart 1: U.S. ISM



Source: Bloomberg

Financial Reform in China

China watchers are eagerly awaiting the outcome of the Third Plenary Session of the 18th Central Committee of the Communist Party of China. Prior to this meeting of the top Communist Party brass, the committee issued a list of suggested goals for economic and social reforms in three broad areas: improve the market system; change the role of government; and adjust corporate structures. We will find out after the conference what the Chinese have chosen as near-term priorities. Premier Li Keqiang has been promising financial reform since he assumed office last March, including convertibility of the renminbi (the official currency of the People's Republic of China). To be a truly global currency, the renminbi must become fully convertible, meaning it can be bought or sold without government restrictions. A move in this direction would certainly herald financial liberalization as a key reform strategy. Lending-rate liberalization is also on the table. Savers in China anxiously anticipate improved mechanisms for setting deposit rates as well as deposit insurance. The upcoming Plenum slightly overshadowed some good economic news. In the third quarter, China posted its best growth of the year, with GDP swelling at a healthy 7.80% year-over-year pace. Although trade results were a bit sluggish, improvements in industrial production and retail sales made up for the lag.

European Recovery Slows

While the eurozone outlook continues to improve, the recovery is fragile and slow. Unemployment is still shockingly high, particularly in the peripheral countries. Youth jobless numbers are troubling: in Spain and Greece they top 50%, in Italy they stand at 40%. Growth momentum is being hampered by double-digit unemployment, austerity programs designed to decrease budget deficits and sovereign debt. The 17-country eurozone is expected to expand by just over 1.0% next year. The Markit Eurozone Composite Purchasing Managers' Index of activity in the services and manufacturing sectors slipped to 51.9 in October from 52.2 in September. That was an improvement on an initial estimate 51.5 from two weeks ago, however.

Canadian Markets Perform

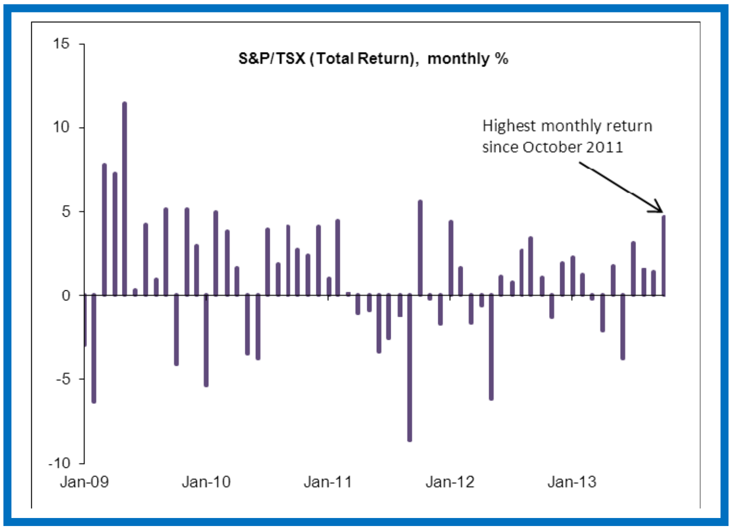
Prime Minister Stephen Harper praised the newly announced Canada-European Union trade agreement as “the biggest deal our country has ever made,” calling it a “historic win for Canada.” Although we lack details, the agreement seems to touch almost every aspect of the Canadian economy. Canadian consumers will gain when tariffs on thousands of items imported from Europe are reduced or abolished. Canadian companies and farmers, in turn, will be able to sell hundreds of products tariff-free in Europe. With new access to the $17-trillion European economy, the Canadian GDP and job creation are in line to benefit. Ratification will likely take a couple of years. Expect vigorous lobbying from some participants in economic sectors that are considered vulnerable.

Until this month, the Bank of Canada (BoC) said its next move on interest rates would be an increase; however, stubbornly low inflation and a gloomier economic outlook prompted a change in tone. In its October policy statement, the Canadian central bank dropped its so-called tightening bias, a strategy designed to restrict the money supply by raising interest rates. The BoC is mandated to keep inflation between 1% and 3%. Both headline and core Consumer Price Index rates (the CPI indicates changes in the general level of consumer prices or the rate of inflation) have been below 2% for more than a year and have come close to falling under 1%. The slack in the economy will likely persist for the next couple of years. With no real sign of inflation on the horizon, the BoC will probably keep the overnight rate at 1%. Bank of Canada Governor Stephen Poloz will be watching for worsening household debt or a hot housing market.

Weakness in the manufacturing sector is creating some of the slack. While the broader economy is likely to add a modest number of jobs this quarter, the manufacturing sector has been shedding jobs at more than 4% annually. The recent softening in the Canadian dollar may help reverse this trend.

Equity market performance in Canada was strong in October, with the S&P/TSX Total Return Index delivering a solid 4.72% (CAD), one of its best monthly performances since the 2009 market rebound. Bond returns were also positive across most maturities and sectors.

Chart 2: S&P TSX (Total Return) Monthly %



Source: Bloomberg

Our Strategy

We continue to favour equities over bonds. That view is supported by slow but steady improvement in economic indicators globally. We don’t expect interest rates to rise quickly, but they will inevitably move higher as economies strengthen and central banks receive clearer indications that it’s time to withdraw stimulus programs. Any potential and persistent weakness in commodities would ultimately be a serious headwind for Canada. This factor continues to influence our tilt in favour of U.S. equities.

The Last Word

Introverts are responsible for an impressive list of accomplishments, including the theory of relativity, Chopin's Nocturnes, Google and Harry Potter. *Quiet* offers a lesson for policy makers and investors alike: pay attention to the quiet ones who can spot the canary in the coal mine. We hope for a more reasoned debate in Washington next year, but we shouldn't expect it.