February 2015

Market Commentary

Alberta Bound

"Turner Valley boomed...into a very busy place. Thousands of people flocked to the valley, swelling its population to over 7,000. Hundreds of drilling rigs, pipeline crews, truckers, and workmen invaded the foothills oilfield after crude oil greeted the drill at the south end. The gas discoveries in 1914 and 1924 were just teasers compared to the excitement that followed the crude oil discovery in the summer of 1936."

David Finch, Hell's Half Acre: Early Days in the Great Alberta Oil Patch

Decades before the famous strike at Leduc in 1947, Alberta oil first gushed from the wooden derrick of a well named Dingman No.1. The find occurred at Sheep's Creek in the Turner Valley of Alberta's western foothills – ranching country. Gas samples from a nearby coal mine hinted at the vast treasure hidden below. It was a modest well by today's standards, yet people went "oil crazy" overnight and more than 500 new companies sprung up to get a piece of the action. The boom of 1914 was short lived compared to a second, much longer boom following a 1924 oil strike. A massive gusher announced the discovery, spewing a spectacular tower of fire that took 21 days to extinguish and could be seen for many miles.

Challenges facing the industry in the early 1900s still echo today. That second find produced deadly sour gas, which contained significant amounts of hydrogen sulfide. The fuel had to be processed prior to sale and consumption. Yet, like the oil sands deposit, it was valuable. Technology used to scrub the gas dissipated the chemical into the surrounding air. Waste was rampant mainly because there was no funding for pipelines that could safely move gas to nearby markets. Instead, it was "flared off" to get at the more valuable oil. Outside interests like Rockefeller's Standard Oil sought to own the resource outright and influence governments in order to control it.

Thanks to Alberta's resources, today Canada holds an enviable place in the energy world. Our recoverable reserves rank in the global top three, behind only Saudi Arabia and Venezuela. There's a catch, however. Most of Canada's reserves are in the oil sand deposits and are only profitable when crude fetches a relatively high price.

U.S. — it's a Technology Story

Ten years ago, the story of oil was about China's voracious appetite for the energy it needed to build its massive infrastructure and new housing. Today, the story has shifted to the supply side and the U.S., which has made impressive marginal production gains through the advanced technologies of horizontal drilling and fracturing. Since 2008, only Saudi Arabia has been able to improve its marginal production more than the U.S.

The strong greenback is having an impact at home. U.S. consumers benefit when they shop outside their borders. Yet, the continued strength of the currency has a significant negative offset. The S&P 500 index is predominantly made up of large capitalization companies that earn a substantial portion of their revenues abroad. Recent reports indicate that this is likely somewhere in the range of 30% to 40% of their total revenue. With further divergence in central bank policy globally, these revenues will be vulnerable to continued currency swings. (Last year 22 central banks lowered interest rates and 16 raised rates.)

American consumers are in good shape. They have pruned their debt-service ratios impressively since the financial crisis and household net worth is now above 2007 levels.

Housing in the U.S. has slowed just a bit. While prices have firmed somewhat over recent years, buyers still have lots of incentive to establish new households. A recent snapshot suggests that for many renting is a viable and attractive alternative to home ownership.

Europe — News Erupts

The European Central Bank has finally made a decisive move aimed at shaking Europe out of its economic funk. The ECB announced plans to purchase €60 billion in assets per month, which should spur sluggish credit growth. European equity markets responded immediately and favourably. The European STOXX 600, a broad index, was up 7.3% month over month. U.S. equity markets advanced nicely after each of the U.S. Fed's three rounds of quantitative easing, which may prove to be a useful guidepost for European equity investors.

Greece again captured front pages after the leftist party Syriza scored a minority win on promises it would end or reduce austerity measures. Just how far can those fiscal restraints be loosened? Germany and others are very reluctant to renegotiate the terms of Greece's bailout – the fear of contagion is real and pressing. Support for Spain's Podemos party has soared over concerns of austerity and even higher unemployment. A Spanish election later this year merits watching, particularly since Podemos considers the eurozone the "euro trap." France's far-right Front National party also opposes austerity and wants a eurozone exit. Its popularity is growing as France teeters on the verge of another recession. President François Hollande is provoking widespread dissatisfaction over his reluctance – or inability – to deliver on election promises and cut austerity measures.

Even the Swiss got in on the action this month with a surprising reversal in policy. Markets panicked when the Swiss National Bank stopped pegging its currency to the euro.

China — Growing but Slowing

Policy makers in China announced their GDP target for 2015 is 7.0%. China continues to repurpose its economy away from manufacturing and investment and toward services and private consumption. With negligible growth in electricity and steel production, plus shrinking industrial profitability and a softening housing market, the typical activity proxies for gauging China's growth suggest that the economy is struggling. The services sector now appears to be China's primary growth driver. National statistics indicate that household incomes are growing and that private consumption should hold up well in the face of a slowdown in investment.

China's trade surplus continued to swell in December. In fact, it was just shy of the record set in November. This trade surplus will likely expand even further, given the softness in a broad basket of commodity prices, most notably energy.

The People's Bank of China cut the required reserve ratio by 50 basis points. Banks can now hold fewer reserves against the deposits they take in from savers. The move should stimulate bank credit activity. This accommodation follows on the heels of November's rate cut. While we will probably see additional policy loosening from the PBOC, it will be curtailed by concerns about the overall growth of credit as a share of GDP. That number is now estimated at greater than 200%.

Canada — Winners and Losers

The Bank of Canada's decision to drop the overnight lending rate by 25 basis points was a jaw dropper for both investors and economists. The message is clear: the BoC stands ready to provide unambiguous support for the Canadian economy and appears willing to reflate asset prices (e.g., bonds, equities and housing) through an easy-money policy. Fixed income and equity markets rallied on the announcement. Yields on Government of Canada 10-year bonds hit all-time lows. The federal government can now borrow money for 10 years at an annual rate below 1.3%.

A careful read of the BoC's *Monetary Policy Report January 2015* reveals some potentially deeper concerns. It states that GDP growth could dip as low as 1.5% in the first half of 2015 and then rebound in the second half. Forecasts for 2016 call for economic growth in the range of 2.3% to 2.6%.

Canadian manufacturing lags its U.S. counterparts in competitiveness. The sharp decline in the loonie should at least partially offset this disadvantage. Capital expenditures outside the energy sector are expected to strengthen and the *Monetary Report* optimistically states that, "the pickup in non-energy exports is increasingly perceived as sustainable." There are caveats, however. We don't know how long it will take to rebuild and retool capacity, nor do we know if oil prices will stay low long enough to support this investment. The recent improvement in the non-energy trade deficit shows early evidence of a lower Canadian dollar's impact. Non-energy exports spiked almost 5% while imports increased by a much lower 1.7%. Back in July, we witnessed a similar type of improvement that was quickly reversed. We will watch closely to see if the Canadian economy can sustain this essential trend.

Our Strategy

Our strategy continues to focus on the relative attractiveness of equities over fixed income. We continue to assess valuations for equities carefully and scrutinize earning reports. We anticipate further divergence between Bank of Canada policies and U.S. Federal Reserve policies. It has become increasingly unlikely that Canada's central bank will raise interest rates even if the Fed does so later this year. We also look for opportunities to take profit in asset classes that have benefited from the BoC's recent "largesse." The ongoing support of the world's central banks remains a positive for the major asset classes of equities, bonds and housing. We continue to favour the U.S. and are invested up to allowable limits for most accounts. While further allocation of new funds to the U.S. remains attractive, recent Canadian currency declines suggest caution.

The abiding strength of the U.S. economy will be positive for Canada, which will again likely ride on the strength of our southern neighbour's coattails.

The Last Word

From the outset, Canada's oil exploration and development industry has been prone to the boom-and-bust cycle. It's inherent to the commodity. High prices encourage additional exploration; additional supply ultimately drives down prices. Oil prices do tend to be self-correcting, though. There are two compelling reasons for that. First, it costs more than the current price of oil to bring new production onstream, which predictably creates upward price pressure down the line. Second, many OPEC countries – including Saudi Arabia – cannot balance their fiscal budgets with oil prices at these levels. Countries like Nigeria, Iraq, Iran, Russia and Venezuela are vying for market share, but in the intermediate-to-longer term they need steeper oil prices just as much as high-cost producers like Canada.