Market Commentary

Politics and the Pipeline

"What's astonishing about the oil sands, when you begin to seriously consider its potential, is how much prosperity is sitting there waiting, if we have the will, to be tapped...there is still billions more in economic benefit to come to millions of people."

Ezra Levant, *Ethical Oil: The Case for Canada's Oil Sands*

The proposed $8-billion Keystone XL pipeline is an ambitious project designed to transport 830,000 barrels of oil per day to refineries in the American Midwest and along the U.S. Gulf Coast. The 1,897-kilometre pipeline would snake strategically through Alberta, Saskatchewan, Montana, South Dakota and Nebraska to move U.S. shale oil as well as Alberta crude. Many Americans consider it a vital infrastructure component for energy security.

Stakes are high, given the enormity of the economic benefits. Resistance from environmentalists is fierce and opponents of the pipeline appear to have President Obama's ear. For only the third time in his presidency he used his executive power, vetoing a bill to immediately approve the pipeline – as promised. This pushback is mainly due to concern about what he called the environmental profile of Alberta's oil sands. Is this concern justified?

Perhaps – but only in part. Environmentalists bolster opposition to the oil sands development by focusing on the unsightly open-pit operations. Yet that constitutes a very small aspect of extracting the resource. In his book *Ethical Oil*, Ezra Levant champions the Alberta oil industry for its responsible approach to oil-sands development and aims to dispel many of the myths about that deposit. He supports his argument by citing technological improvements in extraction and processing. He further attempts to reframe the evaluation of America's energy choices beyond a monolithic measure of carbon emissions. His analysis includes a more comprehensive examination of the total social impact of other oil-producing competitors. His conclusion: the environmental case against the Canadian oil sands is vastly overstated. In his view, we should evaluate the development of the oil sands in the context of broader social criteria. Should carbon emissions carry more weight than human-rights violations in oil-exporting countries like Saudi Arabia, Russia and Sudan? Canada's oil sands come out ahead compared to many of the world's energy producers.

U.S. — More Jobs, More Money to Spend

The U.S. economy appears to be catching fire. A strong labour market and lower energy prices are boosting consumption. Business investment is likely to be more mixed, though. While mining and energy exploration may exhibit some weakness, this is being offset by persistent attractive borrowing costs and more favourable input costs for energy.

Cheap gas is having a pronounced effect on consumers. Prior to the recent crude-oil price drop, Americans were paying $380 billion a year for gasoline. That has plummeted to a rate of $240 billion per year, which can potentially increase consumption on other items by a full 1.0%. The savings would be even greater were it not for the strike at 35 of the nation's refineries.

At the same time, we're also seeing consumer behaviour that raises red flags: easy financing has triggered a major auto boom (great for vehicle manufacturers), but increased rates of loan delinquencies suggest that more and more consumers can't keep up with their debt. Overdue student loan payments are showing a similar and more pronounced trend.

Changes in U.S. non-farm payrolls also tell a compelling story, with new job growth at nearly 300,000 this month. Baby boomers are also retiring in droves, further shrinking the slack in the overall labour market. Even so, growth in average hourly earnings has been sluggish. We can expect wage increases later this year, however, given the rapidly improving trend in the unemployment rate. Surveys of pay intentions for small firms support this notion.

The U.S. Federal Reserve (the Fed) may be close to a decision on moving rates upward. Low productivity means that any pay raises will be quickly passed on to the consumer through price increases. The Fed's focus is likely on where it sees inflation in two years' time and not on the current rate. Given the shrinking slack in the real economy, inflation above the core target of 2.0% by next year seems probable. The Fed's year-end predictions for its overnight rate are just over 1.0% for 2015 and 2.5% for 2016. This perspective on inflation makes sense – the Fed has been aggressively stimulating price growth for the last six years or more. The central bank's actions seem to be bearing fruit at last. Inflation tends to appear later in the economic cycle as capacity for both equipment and labour is absorbed.

Europe — Tragedy or Farce?

The pending quantitative easing program in Europe demonstrates that it's all about investor psychology. While the details of the implementation will not be worked out until the ECB meeting on March 5, the markets have been busy anticipating the effect. The mere announcement of the QE program produced two early successes: yields have been steadily dropping and inflation expectations are bottoming.

The intensely strained negotiations over the temporary rollover of Greek debt indicate the difficulty of creating a more permanent solution for Greece. How do you put together a satisfactory resolution that will endure? The challenge is daunting: Greece's debt exceeds its ability to repay in the intermediate term. A restructuring of some sort is inevitable. Most observers calculate that the price of a Greek exit (or "Grexit") from the eurozone will be greater than the cost of any concession to Greece from its European creditors. The European Union might want to adjust Greece's debt downward to affordable but still tight levels, yet that would create a moral hazard: Greece could choose to avoid or water down reform, inviting other nations to copy this bad example.

From a Greek perspective, the option of leaving must be tempting. A debt default would be almost immediate. A reversion to the drachma and the impending devaluation would put Greece on the path to producing goods that could again be competitive against their eurozone rivals. The slack in the Greek economy will take years to erase and shedding its deflationary impulse perhaps even longer. A Greek exit would certainly make three things clear to policy makers: eurozone membership is revocable; punishing levels of austerity have repercussions; and high-debt countries really are a vulnerability.

China — Slower Growth Ahead

The People's Bank of China (the PBOC) cut benchmark rates to alleviate a rise in the real cost of borrowing, which was caused by falling inflation. The PBOC still appears to want some tightness in lending though, so the rate cut will likely provide limited impetus for credit and economic growth. Deposit rates were also trimmed by a similar 25 basis points; however, the ceiling on the maximum amount payable on deposits was also raised. The PBOC believes that lowering the benchmark rate while raising the ceiling encourages more market-based pricing for interest rates. Many view this as an important intermediate step toward greater liberalization of rates.

February also saw stronger PMI (Purchasing Managers Index) readings in China, suggesting that a pickup in domestic demand is fuelling a slight improvement in momentum. Downward pressure on inflation also appears to be easing, with price components of both indices recovering after many months of declines. This should be supportive of GDP growth for the quarter. Concern about China's shrinking need for industrial metals has recently driven down prices. These stronger readings suggest that industrial metal prices may go higher in coming months.

The annual meeting of China's parliament, the National People's Congress, is taking place this month. Attention will focus on GDP growth targets, which may be reined in to give the government some flexibility in the face of ebbing economic momentum. Consumer price inflation targets may be reduced as well. It's worth noting that actual inflation is running a lot beneath policy targets.

Canada — Pat on Rates for Now

Just when economists were convinced they had the Bank of Canada (the BoC) all figured out and that a second or even a third rate cut were basically in the bag, Bank Governor Stephen Poloz decided to stand pat, suggesting that the bank had done enough for now. Subsequent comments hint that the central bank believes that overall financial conditions – a sharply lower dollar, stingy bond yields and balanced inflation risks – justify a wait-and-see approach.

The central bank 'promises' not to be shocked by any downward surprises in first quarter GDP growth. Keeping the key rate steady gives the BoC room to chop rates again if circumstances warrant. Inflation seems to be stuck above the bank's 2.0% target, household debt is creeping up again and there is strength in Toronto and Vancouver home prices – all factors that support Mr. Poloz's decision to sit tight.

Layoffs in Alberta's oil sector are predictably triggering softness in that province's real estate sector. Home sales in Calgary were down more than 30% year over year in February and prices are off about 4.0%. The story in Edmonton is much the same; notably, new listings are up sharply. Albertans were saddled with elevated levels of household debt before oil prices tanked. Layoffs and softer home prices certainly don't help.

Our Strategy

A structured note was added to the fixed income portion of many portfolios to boost both the current yield and the after-tax return (the note has a favourable tax feature). We funded the note purchase by capturing some profits in mid-term bonds. This move is consistent with our fixed income strategy of maintaining a short duration, a strong tilt to investment-grade corporate credit and a high current yield.

We continue to emphasize equities over fixed income with an equity blend that pushes our U.S. allocation up to the allowable limits in most accounts.

The investment environment is supported by accommodative central banks here in North America and around the globe. Any short-term rebound in the Canadian dollar, especially when combined with a bounce in Canadian equities, would warrant another look at increasing exposure to U.S. equities.

Corporate earnings remain a key focal point in determining the overall attractiveness of our continued overweight to stocks over bonds and cash.

The Last Word

Energy prices stabilized somewhat in February, with the price for Brent crude oil (the global standard) actually rebounding nicely despite further supply increases. That price likely reflects a decline in the number of rigs drilling in the U.S., although output hasn't slowed yet. (So far, the Saudis and OPEC haven't blinked and are not cutting oil production.)

Firmer stock prices for service companies and refiners pushed the S&P/TSX energy sector to a modest gain for the month, which is constructive. While lower prices for oil are certainly conceivable, the intermediate-to-longer-term pressure is upward. Meanwhile, the energy industry and Alberta are hunkering down until this slump is over.

The bottom line for oil, and the Canadian oil sands in particular, is simple: the world needs reliable, responsible sources of energy. Canada's oil industry fits the bill.

Given the greater social cost of other sources of oil and the much higher risk of moving crude by rail, perhaps President Obama should have been content with just two vetoes during his time in office.

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