THE MACKIE WEALTH GROUP

FIRST HALF 2014 REVIEW
JULY 2014

WELCOME TO THE EVERYTHING BOOM?

INDEX RETURNS (LOCAL CURRENCY)	1H 2014	3 YR. ANNUALIZED
S&P/TSX (price)	11.20%	4.40%
S&P/TSX small cap index	10.30%	-18.60%
S&P/TSX Materials	15.50%	-13.28%
S&P/TSX Energy	19.20%	2.44%
S&P/TSX REIT	6.30%	3.07%
S&P/TSX Financials	6.60%	10.12%
S&P 500	6.10%	14.10%
Euro Stoxx 50	3.80%	4.30%
England (FTSE)	-0.10%	4.30%
MSCI Emerging Markets	4.80%	-2.90%
DEX Bond Universe	4.80%	4.80%
SAMPLE BENCHMARKS		
30% S&P 500, 70% TSX	9.67%	7.31%
20% S&P 500, 50% TSX, 30% DEX bonds	8.26%	6.46%
Natural Gas (NYMEX)	7.60%	
WTI Crude	9.20%	
Gold	9.80%	
CURRENT YIELDS		ONE YEAR AGO
2-yr Gov Cda	1.11%	1.22%
5-yr Gov Cda	1.53%	1.80%
10-yr Gov Cda	2.24%	2.44%
2-yr Treasury US	0.46%	0.36%
5-yr Treasury US	1.63%	1.39%
10-yr Treasury US	2.53%	2.49%
CAD spot	**1.067**	**1.052**

Source: Richardson GMP, spindices.com

THE MACKIE WEALTH GROUP

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RICHARDSON GMP

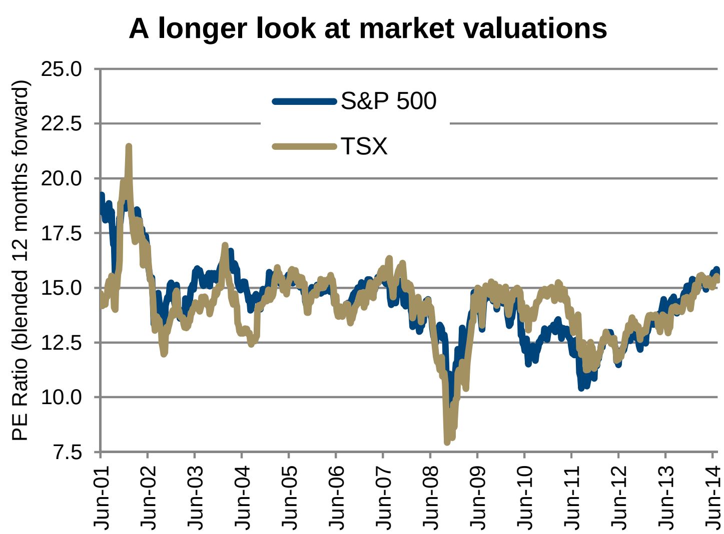
Mackie Wealth Group

To cop the title of a recent New York Times article, something unusual has happened in the markets this year. Perhaps for the first time, stocks, bonds, commodities, and real estate were all up in the first half. Each sector of the stock market has performed well, with all ten of the S&P 500 sectors up this year. Interesting to note, this is the first time in five years that the Canadian market (as measured by the TSX) has been in positive territory in the first half of the year. With commodities prices so strong, even gold is bucking bearish predictions and moved up 10% in the first half. The TSX also outperformed the S&P 500 by a meaningful margin, which we haven't seen in years either. In our portfolios, the hedge position in gold bullion or stocks performed extremely well; pipeline companies continued to hit new highs and were among best performers; oil and gas producers ran up; pipelines made new highs; and banks and insurance companies continued to track upwards too.

The key debate now: are we due for a correction, and how big? What segments of the market are most vulnerable? Are stocks overvalued? Or is there real earnings growth on the horizon, and markets still have room for appreciation from here? (www.NYTimes.com/2014/07/08/upshot/welcome-to-the-everything-boom-or-maybe-the-everything-bubble.html)

The state of the markets midyear 2014:

- **Global stocks are at new multi-year highs**: not one of the ten S&P 500 sectors are down year to date (Consumer Discretionary up a modest 0.8%). Valuations by all measures, are not cheap, but not necessarily in danger territory.



Source: Richardson GMP

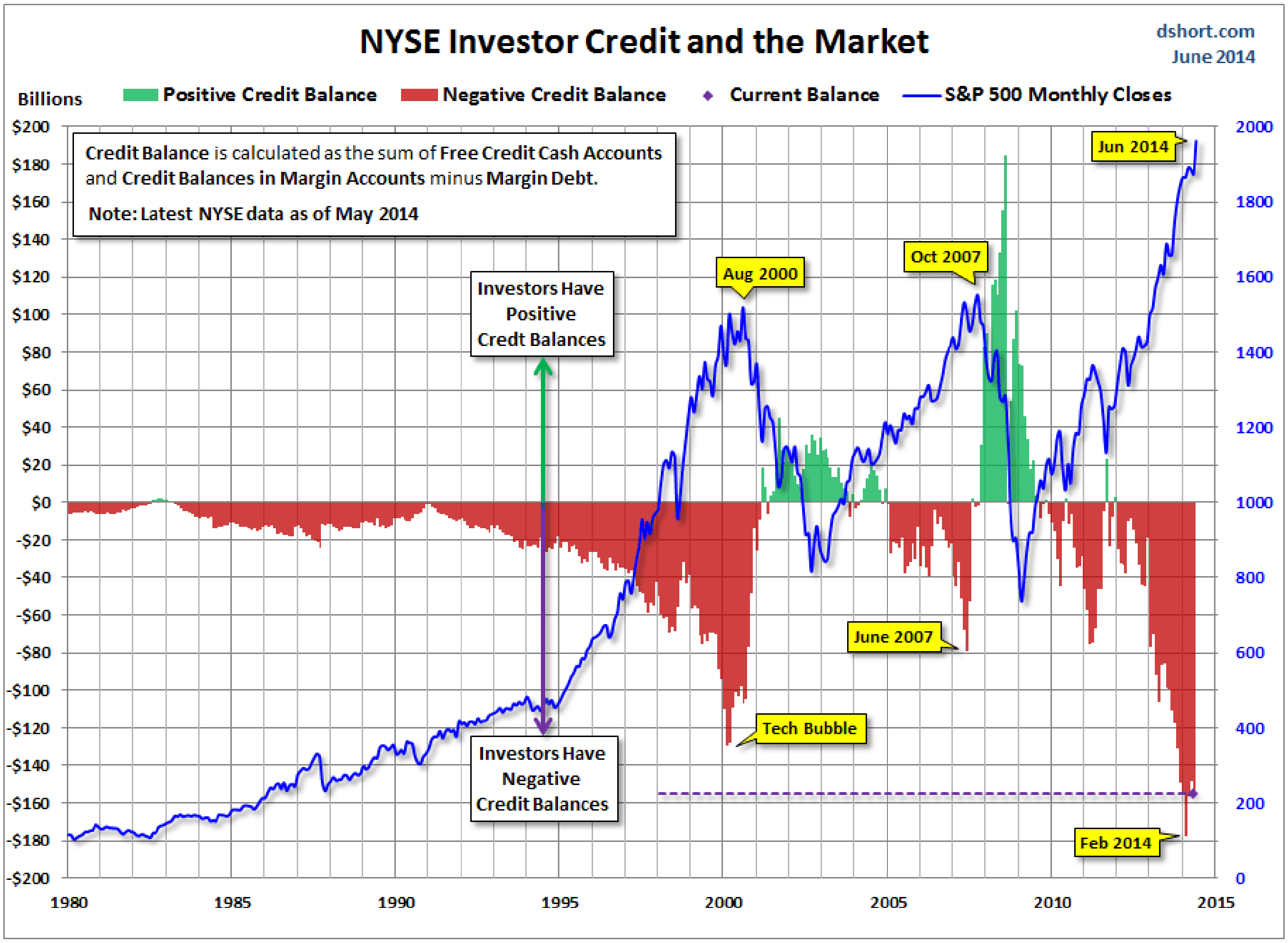
- **Bond markets surprised almost everyone by rallying, and interest rates moved down further**: DEX bond index of Canadian bonds is up 4.8% year to date. At the beginning of the year the U.S. 10 year was yielding 3% and universally expected to go higher, but prices instead moved up, and pushed yields below 2.5%, back to where they were a year ago. Junk bonds have rallied as well, about 5.5% year to date, meaning investors are reaching further into risky assets to meet income objectives. High yield bond indices yield about 5.5%, down from 6.5% this time last year. Investment grade bonds in Europe yield 1.5%, and only slightly higher in North America. Corporations are taking advantage of cheap debt mainly to finance share buybacks, or buyouts of other companies. This is not productive for the long term. Capital has been borrowed to make companies the biggest buyers of shares over the last few years, versus investment in plant equipment or labour. The long awaited "capital investment" has still not happened. Ironically, this is one of the unintentional consequences of a low interest rate policy. It is cheaper and quicker to issue debt and buy back shares to increase profitability.

- **Gauges indicating upcoming market volatility for currencies, equities, bonds, oil, have all plummeted to multi-year lows.** The markets at the end of the quarter seem to be complacent about future risks. The chart of the CBOE volatility index below illustrates this. The so called "VIX" is a measure of market expectations of near term volatility as conveyed by stock index option prices. Below is the 5 year % change vs. the S&P 500 Index. As the market has gone up, investors have become more confident that it will keep going up without disruption:

Source: www.CBOE.com

- There is a **consensus view that official interest rates will remain exceptionally low** for a long time, and so support the continued rally in equities and high-yield bonds. We are worried about this level of conviction, as the Fed has stated they are concerned about valuations in the high-yield market, among other sectors – they want to see yields rise and prices fall, so that the risks of owning high yield debt is priced more appropriately to the underlying risk of the credit quality of those issuers. Corporate defaults have been very low of late at these interest rates, giving investors increasing confidence. Caution in high yield debt selection is needed at this point in the cycle.

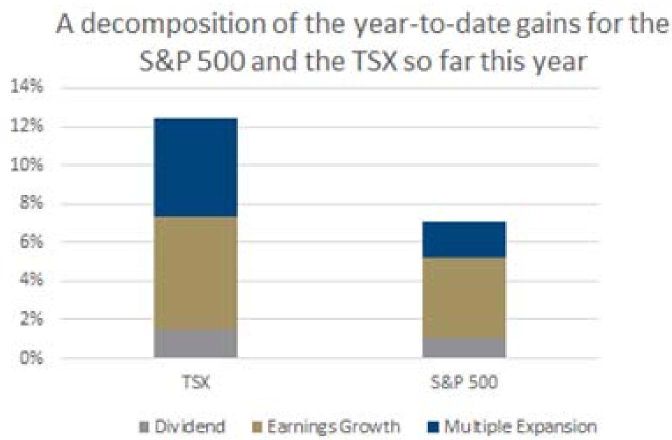
- **Use of leverage in U.S. stock market back to record levels**. US investors are borrowing aggressively to invest. Historically high levels of margin are thought by some to be a leading indicator of stock market corrections. To quote the often referenced economist Hyman Minsky: "stability breeds instability." A little counter-intuitive perhaps, but the idea is that is the more stable the stock/bond/real estate market is, the more tempting it is to pile on more leverage to be in the game. We can see the confidence in future stock market rises in the VIX chart above, and the levels of increasing margin debt below. The point to be aware of is that increasing leverage in the system makes the whole system more unstable as time goes on, so when the unpredictable trigger happens to change investor sentiment or confidence, we can have an extreme destabilizing event on the downside. Margin debt has nearly doubled in the last four years (nyxdata.com).



Source: Doug Short, Advisorperspectives.com, June 27, 2014

- **Structured product issuance is back:** issuance of structured products with embedded leverage, like collateralized loan obligations, reached $82 billion globally last year, 15% below its peak in 2006. This year is on track to match or surpass the peaks of 2006. Sales have clearly been driven by the relentless quest to get reasonable yield on investments. Credit risk premiums in the bond market is very low and quality of bond issuance falling – as investors reach for yield by going into structured products, they are underpricing risk. Global leveraged loan issuance for leveraged buyouts also was at record volumes last year, rising 55% since 2012, as private equity firms are buying out companies at record highs ("Bundled debt demand reaching levels of height of crisis," *Financial Times*, May 18, 2014).

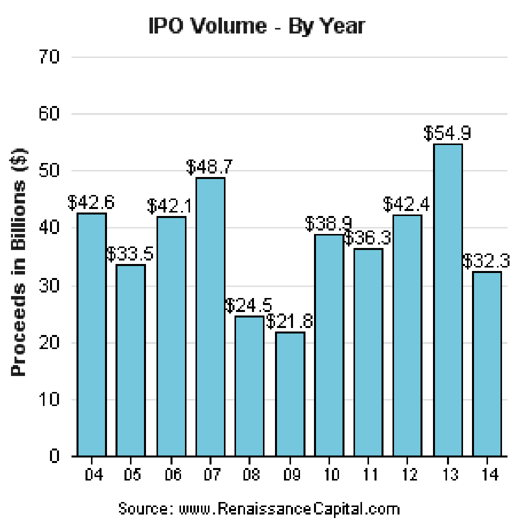
- **Market returns this year driven by earnings growth, and partly by multiple expansion**. An interesting Richardson GMP chart on the decomposition of share price growth so far this year:



Source: Richardson GMP

- In 2013 it was actually multiple expansion and moderate or no earnings growth behind the rise in stock prices. Last year, as investors projected a stronger economy ahead, they jumped broadly into stocks, chasing especially yield oriented stocks. 2014 to date, earnings are so far growing modestly in the US and so arguably supporting current P/E levels. This fact is actually a positive support for stock market valuations, so long as we keep seeing that earnings trend stay intact. If the earnings surprise to the negative, then stocks are vulnerable given the moves they had this year.

- **Social media and tech valuations are a concern:** the above statement notwithstanding, some social media stocks are valued like the frothiest of the tech bubble of 2000. LinkedIn, while hugely popular and having a broad and established network of users, still trades at 100x earnings. We have seen a proliferation of tech stock IPOs that recalls 1999. The well-publicized GoPro IPO last month (a wearable camera developer) ended up 69% higher from its IPO price, currently trading at 150x earnings. According to Renaissance Capital, total proceeds from IPOs in the US this year are $32.3 billion, up 47% from last year. But not all have worked out – check out CYNK. Cynk, a social media company that had its IPO earlier this year reached a $6 billion market capitalization before being de-listed by the SEC. Cynk has no revenue and one employee. The SEC is currently investigating for “potentially manipulative transactions” that may have taken place before trading was shut down.



- **The mega-merger is back:** some of the takeovers announced in the last three months: Reynolds and Lorillard announced a $27.4 billion merger, followed by Imperial Tobacco's $7bn takeover of the Lorillard brands Kool and Salem, and e-cigarette maker blu; AbbVie's proposed $54bn takeover of Shire (partly motivated by a desire to move the company offshore from US tax jurisdiction, as was US based Pfizer's failed proposal to buy AstraZeneca for $118bn in May); Mylan was successful in their transaction (also intended to take the company offshore) when it bought Abbott Lab's drug business outside the US for over $5bn. Medtronic bought medical device maker Covidien PLC for $42.9 billion last month. Covidien is domiciled in Ireland. In April Swiss cement firm Holcim bought Lafarge to become the world's largest cement maker, with combined sales of $43bn. The trend has been capped with the recently announced $80 billion bid for Time Warner by 21st Century Fox. Note these are highly leveraged takeovers as well – AbbVie plans to borrow $23bn from JP Morgan to close the transaction, and later issue bonds. If the takeover trend continues there will be $1.9tn of deals in the US 2014, passing the peaks of $1.6tn in 2007. It is important to note that the basis for many of these transactions is to achieve a so-called "tax inversion." Many US companies have the majority of their revenue base outside America, and are shopping to be domiciled in more tax favourable jurisdictions. This could be a serious loss of tax revenue for the US at a time when they are running deficits. Congress is at the moment trying to reform policy to curb these "tax inversions."

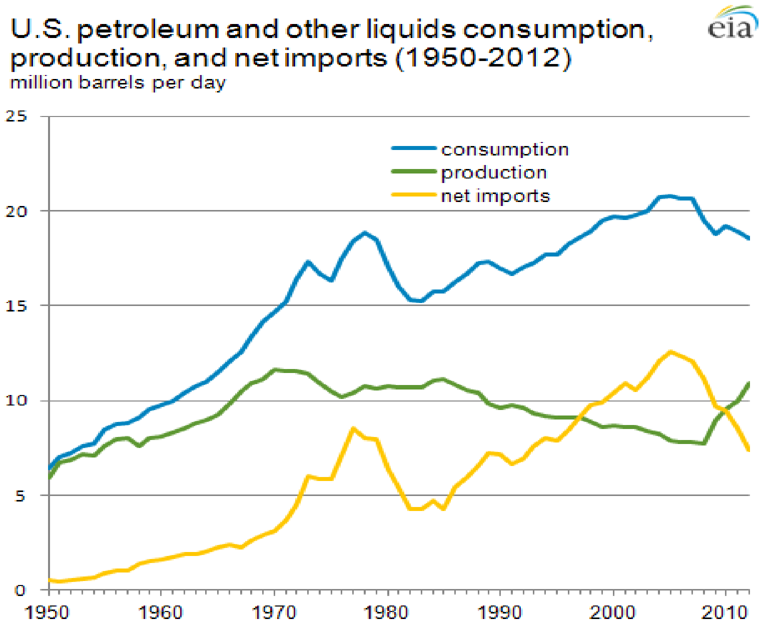
Oil and Gas, pipelines and infrastructure among biggest contributor to portfolios year to date

After being depressed for several years, the oil and gas sector had its day in the first half of 2014, driven by a meaningful change in commodity prices. We saw capital coming back in to our Canadian energy stocks from both Wall Street and Bay Street in the spring. This opened up the window to finance transactions that had been largely closed for the last two years, making Canada an exciting place to invest again. Companies have been issuing equity to fuel acquisitions and drilling programs at a rate not seen for three years. As we have noted before, most of the deals this year have been homegrown Canadian transactions, versus the last few years where foreign buyers were driving large asset purchases. The window for large scale purchases of Canadian resources seems closed, both from government intervention and through sober assessment of the actual returns achievable from the high-priced purchases made by sovereign wealth or National Oil Companies over the last several years. M&A transactions this year have been focused on relatively small companies, or asset purchases from the former royalty trusts by smaller companies.

New issue activity has been busy. The Canadian oil and gas sector has already seen 60 deals worth $22 billion year to date, compared with $6 billion in the same period in 2013. (FP Infomart Data, Financial Post, June 25, 2014). And, the industry has already seen seven deals worth more than $1 billion each.

Natural gas prices settled solidly above $4 per mcf after languishing between $2 and $3 for over two years. At sub $3.50, almost all Canadian gas producers cannot operate profitably, nor afford to explore, or attract investor interest. There are a couple of US basins, with manufacturing style development that are profitable at sub $3.50 gas. Notwithstanding the summer dip we are having, natural gas futures today show traders expect gas to stay at $4 for the next two years, which is mildly supportive for the Canadian oil and gas sector, but not indicative of stellar profits. WTI Oil prices hit USD $100 in February, and remain near that level. We have been surprised to see oil prices so strong with the abundance of mainly US supply coming on, but with supply disruptions a concern in the last quarter (Iraq, Libya, and Ukraine/Russia), the $100+ price was supported. For now, the huge supply additions in the US have just been offsetting global disruptions (or perception of disruption) to supply. However, the increase in US production may not be dire for global prices going forward: the Paris based IEA predicts that global demand for oil will increase by 1.4MM barrels a day (up from 1.2MM barrels in 2013). This will help to offset the 1.2 mmb/d in non-OECD supply growth to come mainly out of the US next year.

In 2014, the U.S. became the world's biggest producer of oil, and as of 2010, the world's largest natural gas producer, and is still growing on both fronts. However, given that Canada relies on the US to consume our own increasing oil and gas production, the global demand growth doesn't help Canada unless we access global markets through pipelines to the west coast. And, the US will certainly be exporting LNG before Canada. To compound our issues, that the US is actively changing policy so that oil product can be exported internationally.



Source: U.S. Energy Information Administration, *Monthly Energy Review*, Table 3.1 (April 2013), preliminary 2012 data, and *Annual Energy Review*, Table 5.1b (August 2012).

Over the last two years, the U.S. government has started to allow exports of some refined crude products like condensate and ethane, ending a multi-decade ban on exports. Chemicals companies like Nova Chemicals based in Calgary, have started buying cheaper feedstock like ethane from producers in the US North Dakota (Huffington Post, Jul 15, 2014). There is speculation that bans on exporting crude will continue to be relaxed. The US has already increased its exports to Canada by six fold since 2012 year hitting 268,000 barrels per day in April. Crude is allowed to cross into Canada, and is now hitting refineries on the Canada's East Coast, replacing more expensive Brent. Overall, Canada's exports to the US are still much larger, at 2.7 million barrels per day. But still, this is emblematic of Canada's inability to protect and develop its own interests. While pipeline reversals are being delayed to deliver Canadian heavy crude to the East Coast, the US has taken advantage of this gap and is happily selling to our own refineries out East. It is expected that 400,000 barrels per day may be delivered to Canada's East via the US by year end.

Our conclusion is that Canadian producers may still struggle from here, given uncertainty on what prices for oil and gas we can actually realize, as price takers from the U.S. However, with the abundance of energy supply still steadily increasing from new and revitalized old basins, we see real growth in oil and gas infrastructure and pipeline companies. We are cautious about entering new positions at the moment, but look for stock market weakness to add to the several high-growth, well managed, well financed companies that are based here. We also are investors in some US companies in the space, and at lower valuations than Canada's comparable names.

Thoughts on the second half of 2014 and beyond

Europe

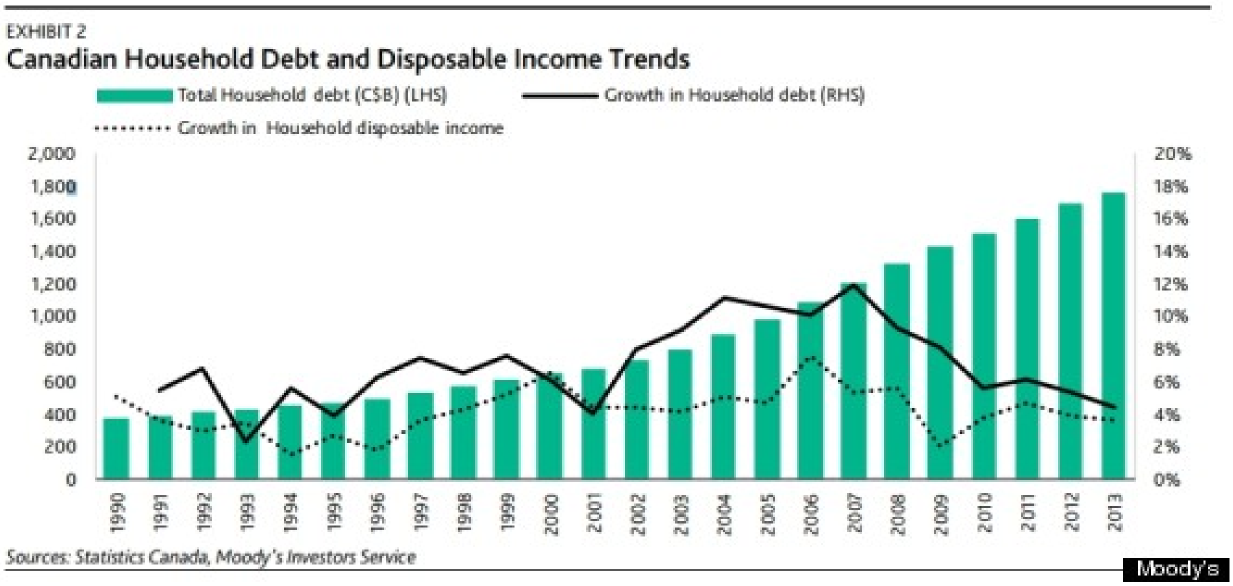
At the beginning of June, the European Central Bank acted decisively to support its slow growth economy and low inflation rate: it lowered short term interest rates, bringing them back in line with US rates. It also increased liquidity by adding about 150 billion euros to the money supply through changes to its securities purchase program, and promises to add more in coming months through an asset backed security purchase program. In addition, a new plan was announced to deliver 400 billion euros in loans to non-financial companies. Short term rates are effectively zero, and in some cases large depositors have to pay to hold cash deposits. All these measures are intended to incentivize banks sitting with large cash deposits to get out and start lending again. These moves mean more financial repression for savers, but positive for markets, as investors will continue to seek out yield and risk investments.

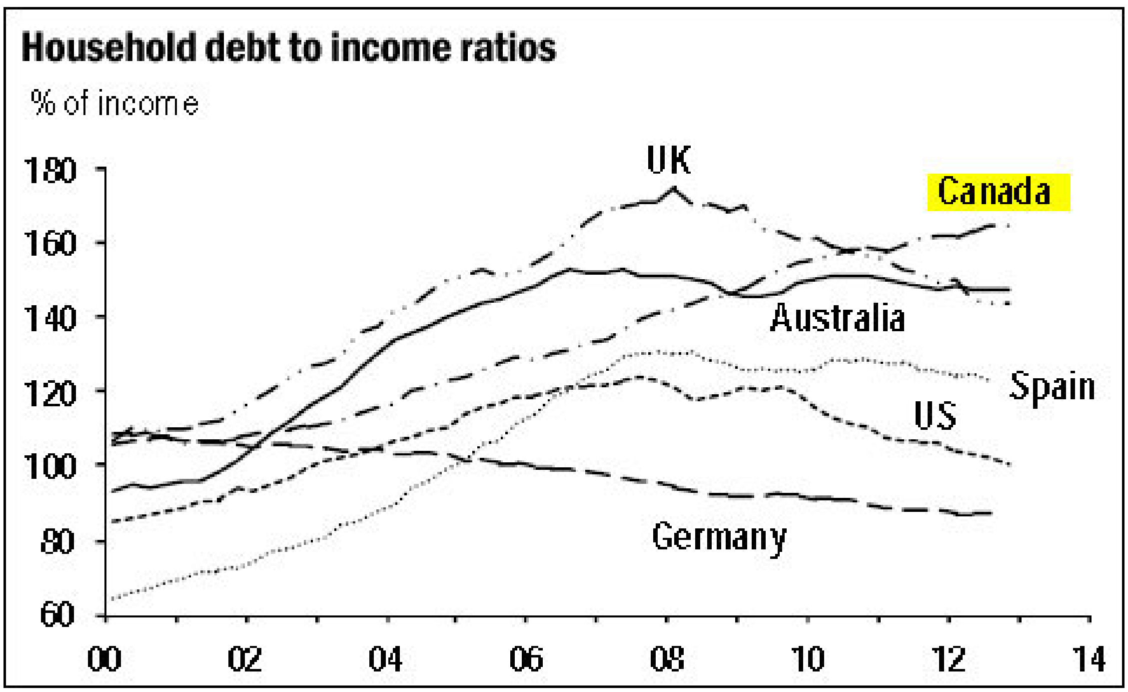
Canada

Economic data out of Canada shows broadly weak to uninspiring growth. Thus we will continue to hold a meaningful portion of the portfolios in USD directly and US listed international growth companies. As mentioned above, we are also interested in developed Europe, with its accommodative policies, weakening euro, strong economies in the UK and Germany. With the US economy ticking along at a moderate or slow grow pace, Canada is likely to be able to muddle through on the back of demand from this important trading partner (the US took 81% of our total exports in 2010), but Canada has several headwinds that will limit us to low growth over the next few years (barring an unlikely resolution to get LNG and oil moving out of Canada to international buyers in the near term). In the Bank of Canada's most recent report of July 16, it now projects 2.2% annual real GDP growth through 2016. The B of C acknowledges that a pickup in exports and business investment is required to get Canada back on track to real growth, and we are still waiting for that pickup to take hold. From a portfolio investment perspective, we are not banking on this growth in the near term.

One thing is clear, is that the Canadian consumer is not going to be driving growth from here. Unlike the cautious private sector that has been generally sitting on cash and deleveraging since the Great Recession, Canadian consumers ramped up their personal balance sheets over the last five years, well over what we historically used to be comfortable with. It is the combination of extremely low mortgage rates and steadily rising house prices that have encouraged consumers to borrow more. The Bank of Canada's goal in imposing artificially low interest rates was to turn cheap cash into productive capital – that small businesses would be created, and existing businesses would buy equipment, develop new products, and hire more staff. But in fact, the cheap cash was borrowed by consumers for non-productive assets. Cheap money was used to buy condos, houses, cars, travel, and the consumer must be nearly maxed out. These are non-productive in the sense that they do not generate a cash flow stream by which the debt could be paid off. A positive trend is that statistics are showing that revolving credit is growing at a much lower pace now than in the previous few years. But consumers are still vulnerable to interest rate rises on existing debt payments.

The construction industry has certainly benefitted from this borrowing, but we wonder whether the building boom must be nearing its end (Calgary may be an exception to this). A vicious circle has formed, where household net worth has actually increased meaningfully for Canadians over the last 10 years, but this has been mainly tied to the increase in housing prices, as a family's primary residence remains the most valuable asset in households. So, the vulnerability lies in the fact that debt loads have been increased based on the wealth creation and confidence gained on increasing house prices, but house prices have been increasing because of historically low mortgage rates allowing buyers to stretch into more expensive properties. More importantly, growth in income remains modest, and so does our capacity to actually service that debt. Which is what puts the Bank in a bind around raising interest rates. If interest rates move upwards, the ability to service debt could become compromised or impossible for many. House prices would likely fall, along with ability to access credit, such as home equity lines of credit (HELOC). Debt to disposable income sits today at 164%, up from 85% in 2009. Debt-to-asset level is perhaps what gives Canadian borrowers comfort, for now, as that ratio is still comfortable.





Source: www.HuffingtonPost.ca

Job creation over the last year has been just 0.4% in Canada, the slowest in four years, and the unemployment rate has inched to 7.1%. The good news is that all job gains in the last year have been in the private sector, and that more full time, versus part time jobs are being created. Ontario likely feels the biggest brunt of weakness, with factory employment now at its lowest levels on record, dating back to 1976. For those of us based in Alberta, this is contrary to what we see: employment growth in Alberta was 3.5% year over year, well above the national rate. But if Alberta were stripped out of the statistics, there would have been no job growth at all over the last year in Canada. Alberta also had the highest net gain in interprovincial migration in 2013, with 43,100 people moving to the province. The overall provincial population grew by 3.3% in 2013. Calgary itself grew its population year over year to July 2013 by 4.2%. Given Calgary has the best paid workforce among Canada's major cities and a lower cost of living than either Toronto or Vancouver, and Alberta has the lowest taxes in the country, this trend looks set to continue for now. (Statistics Canada, cbc.ca, Mar 21, 2014).

It has been well commented and documented, that Canada's housing market is priced well above historic norms. Concerns are particularly focused on the condo market in Toronto, but other areas of Canada's market look frothy as well. The mortgage debt that consumers have taken on have been a source of concern expressed by both the Bank of Canada and the Government over the last three years. Cautionary statements haven't slowed down housing prices or purchases, but the CMHC is acting to impose limits on speculation and debt in the housing market. CMHC has said it will stop insuring second mortgages, is placing limitations on mortgage insurance for self-employed people, and will stop insuring mortgages over $1MM, among other changes. Given all of the above, consumer spending is probably peaking now in Canada.

Source: www.IMF.org

So, this is how we can conclude that real economic growth needs to come from exports. However, given the slower demand for materials from China and the fragile state of their economy, to our inability to develop export infrastructure for oil and gas to other international markets, combined with our expensive labour force keeping manufacturing growth down, and the fact that we continue to be laggards in innovation - we are not optimistic we are going to see meaningful growth rates in Canada over the next several years.

U.S.

Large cap U.S. stocks will continue to form a core foundation for portfolios, much more so than in the mid-2000s when Canada was one of the highest growth developed global economies with a rising currency – this was back when China was demanding all the resources we could provide. The switch to holding increasing amounts in U.S. companies and increasing USD exposure continues to be warranted given the headwinds facing Canada. And, in holding large cap U.S. stocks, we gain exposure to global growth – in fact it is estimated that now 50% of earnings of the S&P come from outside the US. (McDonald's by example, has 69% of sales coming from outside the US, International sales at GE make up 53% of the top line).

In the U.S., we are actually seeing year to date highly profitable companies continue their earnings momentum. It is this momentum that we can argue justifies current stock valuations. At writing, analysts are expecting that S&P 500 profits will expand 4.6% in Q2 compared with the same period last year (FactSet, ft.com), and to rise by as much as 10% over the second half. Of course, with the steady rise in the market so far this year, we are vulnerable to a correction should the earnings not materialize.

A reason to be cautious and wait for buying opportunities, is there is uncertainty on how quickly the Fed will withdraw its support underpinning the market. While the Fed and ECB and other banks look to be supportive to corporate investment, and so stock prices, we do know that the Fed is trying to ease out of their aggressive quantitative easing program by the end of 2014. This may cause some bumps and volatility as the market adjusts to lesser amounts of liquidity hitting the market monthly, and potentially higher interest rates. Bond yields could fluctuate, which would cause volatility both in bond and stock markets.

We have been looking to raise cash by trimming back positions that have done well, and owning a meaningful position in certain non-market correlated alternative strategy funds that should keep moving forward if the volatility comes. While we are due for some instability, perhaps even a painful correction, the fundamentals underpinning the market look solid, so we don’t see a crash like 2008 on the horizon.

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