THE MACKIE WEALTH GROUP

THIRD QUARTER 2014 REVIEW
OCTOBER 2014

2014 3RD QUARTER REVIEW

INDEX RETURNS (LOCAL CURRENCY)	YTD	3 YR. ANNUALIZED
S&P/TSX (price)	9.80%	8.80%
S&P/TSX small cap index	-2.40%	-14.70%
S&P/TSX Materials	3.40%	-15.75%
S&P/TSX Energy	10.50%	4.25%
S&P/TSX REIT	3.92%	3.99%
S&P/TSX Financials	8.70%	13.81%
S&P 500	6.70%	20.40%
Euro Stoxx 50	3.80%	14.00%
England (FTSE)	-1.90%	8.90%
MSCI Emerging Markets	0.30%	4.50%
TMX Universe Bond	5.90%	3.40%
SAMPLE BENCHMARKS		
30% S&P 500, 70% TSX	8.87%	12.28%
20% S&P 500, 50% TSX, 30% DEX bonds	8.01%	5.54%
Natural Gas (NYMEX)	-1.00%	$4.12 USD
WTI Crude	-3.00%	$91.16 USD
Gold	0.50%	$1,212
Silver	-12.60%	$17.06
CURRENT YIELDS		ONE YEAR AGO
2-yr Gov Cda	1.12%	1.19%
5-yr Gov Cda	1.63%	1.86%
10-yr Gov Cda	2.15%	2.54%
2-yr Treasury US	0.57%	0.32%
5-yr Treasury US	1.76%	1.38%
10-yr Treasury US	2.49%	2.61%
CAD spot	**1.1198**	**1.03**

Source: Richardson GMP, spindices.com

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The markets hit all-time highs and turn to dramatic volatility in a matter of weeks

For months, markets brushed off mounting geopolitical tensions in Iraq/Syria and Russia/Ukraine, and how the U.S. would get involved, and then the possible disturbance of Scotland separating from the UK, Ebola fears, and pushed through to multi year highs in early September. How quickly sentiment can change. The long predicted return to volatility and overdue market correction is now upon us, starting in the last two weeks of September, and into this writing at mid-October. September and October 2014 are certainly living out their bad reputation for being the year's most volatile months. Some of this seasonality can be attributed to the fact that the mutual and hedge fund industry, as well as banks, have their year ends in September and October, and reposition portfolios in these months to be holding and adding to their stars and dumping dogs from the final balance sheet that investors see. This year the effect has been exacerbated by several events: the unexpectedly large run up in the U.S. dollar in September (the USD index running from 80 in July to 86 last week, or over 7 percent in the last three months); worries around when the Federal Reserve will increase borrowing rates; data coming in that tells us Europe's growth is faltering; worries growing around the spread of Ebola and the negative economic impact that can happen (the market still remembers the impact of SARS on travel and other economic activity). In some years, markets turn to positive sentiment in late October and November when quarterly earnings season has been digested. This may happen this year, depending on how earnings growth tallies up for the year to date and management projections of the important fourth quarter and year ahead. We are looking to see whether corporate America will start investing in capital projects to drive growth, as earnings in the last three years has largely been driven by share buybacks and dividend increases. Real capital investment is needed to carry the economy into the next stage of sustainable earnings momentum. Earnings season can provide clarity and confidence to markets and kick-start the so-called "Santa Claus Rally" that can lift markets in to year end (sometimes).

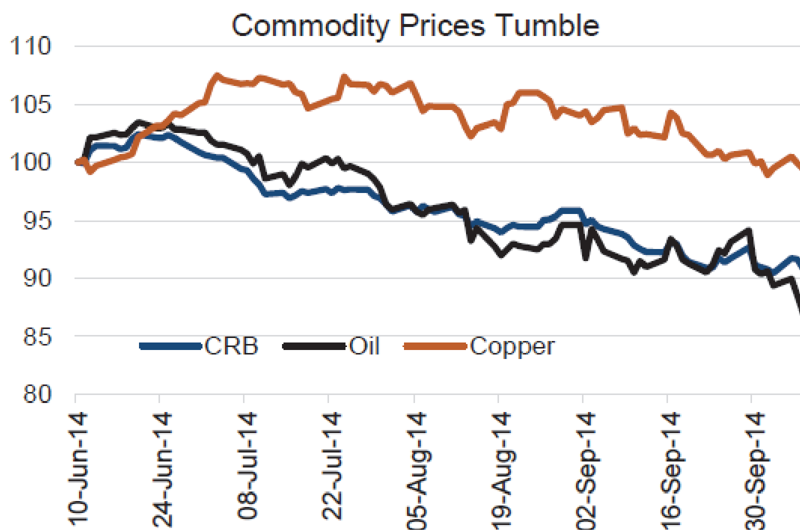
One year chart TSX:

Globeandmail.com

One year chart S&P 500:

Globeandmail.com

At writing, the market is preoccupied with whether or not we are in a period of stable global growth, or if other factors will pull us backwards, such as China's growth rate slowing further, and further impacting commodity prices, or regions of the Eurozone sliding into recession. Worries about global growth directly affects commodity markets, as you can see by the chart below. And, as a third of the TSX is directly exposed to commodity prices, we certainly saw the effects in our stock market this past month. Note however, that commodities are inversely related to the USD, and so the 7% move upwards in the USD over the same period explains some of the depression in commodity pricing – and also that we are due for a settling out and perhaps upwards move in commodity prices, as it is likely the USD is due for a correction back from such a rapid run. Furthermore, U.S. policy makers will be looking for a weaker USD.



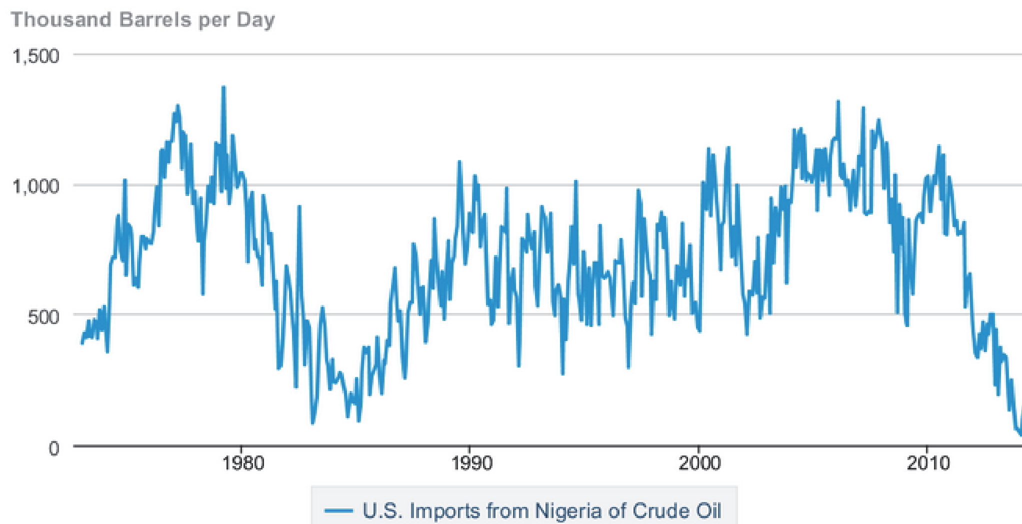
Richardson GMP

At the beginning of 2014, it seemed that Europe was on the cusp of growth and was catching up to the U.S. The quantitative easing programs the ECB had implemented were assumed to be enough to carry Europe into real growth; the UK was already booming. But since summer, fears of deflation and low growth overshadowed the optimism. And as the West imposed sanctions on Russia, further economic pressures were put on Germany and France, among other European trading partners. In Russia, the sanctions caused the ruble to hit an all-time low last week. There are concerns that Russia will impose capital controls to stem the flow of money out of the country, and further depress the ruble. Perhaps most pressing, it seems that quantitative easing measures in Europe are not having the desired impact, and in fact the Eurozone is fighting to keep the economy out of a deflationary spiral. The question now is whether policy can pull the Eurozone out of its malaise, or whether it is stuck in a no growth zone for the foreseeable future. Settling the Ukraine/ Russian standoff would be a positive for Europe, as meaningful trade could resume. (As well as normalize gas deliveries into the upcoming winter).

Oil Trends: Non-OPEC supply growth is far exceeding global oil demand growth, for now.

The U.S. shale boom finally bore weight on oil prices in September and October, with oil prices dropping by more than 20% since hitting a multi-year peak in June, and hitting $81 a barrel WTI in mid-October, down from $103 in June. Non-OPEC supply growth is far exceeding the rate of global oil demand growth, by as much as 1 million barrels a day, according to Credit Suisse analysts (Credit Suisse presentation, September 30, 2014). Meanwhile, consumption in the U.S. is expected to continue to shrink back to 2012 levels next year – as drivers are putting fewer miles on their vehicles and driving more fuel efficient cars. The structural decline in U.S. consumption while at the same time the country is creating the massive increase in supply, has led to a global shift in oil markets in the last few months. U.S. fields will add 1.1MM bbls/day of production this year, and another 1MM expected in 2015, an increase of 12%, which brings U.S. production back to 1970 era levels, and ever closer to North American energy independence.

Over the last few months, global oil producers have seen their exports to the U.S. drop meaningfully. In July, Nigeria completely stopped exporting crude to the U.S. This was the first time since 1973 that Nigeria did not make a U.S. delivery. This is quite significant – four years ago it was among the top five suppliers to the U.S. Currently Nigeria is working to create new customers in Asia to make up for the dramatic shortfall in U.S. demand (Financial Times, October 6, 2014).



Financial Times, October 6, 2014

Other nations have been affected as well. In the year to July, Colombia's crude oil exports into the U.S. have dropped by a third to 200,000 b/d from the same period of 2013, according to the EIA. Colombia's sales into China have more than doubled since 2013 to 130,000 b/d (Financial Times). "Latin American arrivals into China over the last six to eight weeks were off the charts. That's because Venezuelan cargoes and Colombian cargoes had no place to go in the U.S.," says Abudi Zein, chief operating officer of Clipper Data, which tracks tanker records. Canada's Enbridge is in discussions with Ecopetrol SA, Colombia's state-controlled oil producer and other Colombian producers to build a $6 billion pipeline to the Pacific Coast, in order to allow crude to be easily exported to markets in Asia, in the face of uncertain future US demand. (Market Business News, Sep 30, 2014).

It has been reported in the first weeks of October that Saudi Arabia and Iran are cutting official selling prices of crude to buyers in Asia for November deliveries, and that Iranian and Iraqi oil shipments to China reached records in April (Bloomberg, Oct 3, 2014). About half of Nigeria's planned November exports remain unsold, and Angola has secured sales for only 85% of its oil for next month (Bloomberg, October 10, 2014).

It is thought that OPEC may cut production in November to get oil back to the cartel's price targets. However, if they don't, and if if WTI prices were to stay below $90, the global production dynamic could change again. It is not clear the U.S. would continue on their production growth trajectory at sub $90 oil, as many shale oil producers aren't profitable enough there. After a time, new shale oil projects would be deferred, and production curtailed. Shale oil is far more costly to produce than middle east oil – some plays need more than $90 oil to make a reasonable return, compared to the $10-$25 per barrel cost to produce from the Middle East (IEA, Bloomberg).

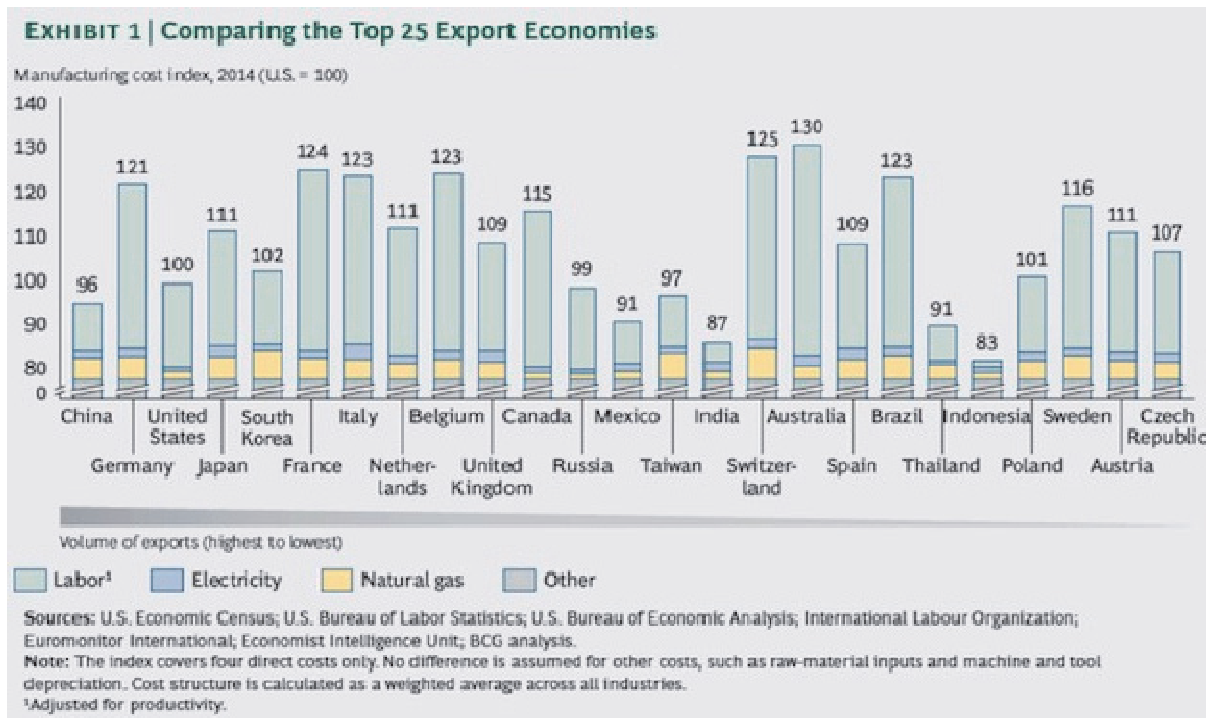
Where does this leave Canada?

Interestingly, Canada has not seen any decline in oil deliveries to the U.S. We've gone from exporting 1.9MM barrels a day in 2010, to just over 3MM barrels a day as of October 2014 (EIA). However, Canada has not seen the expected full financial boon of this massive increase in oil exports, as we remain price takers to the U.S., and the U.S. pays a big discount to global prices. They can command this of us, as we have very little infrastructure at the moment to sell to competitive buyers. There has been much handwringing over this by producers and pipeline builders, but not from the general public, and so Canada remains at a standstill, in ongoing negotiations with aboriginal and other public groups who don't want to see pipeline infrastructure built, or want to extract some form of a toll or tax. Estimates are that producers lose $50 Million to $100 MM a day selling at a discount to the U.S. (depending on how big the WTI to Brent spread is), compared to selling at global (Brent benchmark) prices. Or, as one oil executive put it to us recently, it is like Canada gives up the building of a new hospital, or multiple schools, every few weeks for accepting this discount, as it's not just producers and shareholders that lose – it's the Alberta government in royalties and the Federal government in additional taxes (and so the rest of Canada). While Canada is mired in hearings and discussions, other global players are already developing routes to export oil to global markets, including the U.S. We wonder whether by the time we build pipelines to get oil to Asia, will we still have customers who want the product?

The Bank of Canada and the Federal government are relying on the general growth of the U.S. economy to lift Canada's economy, as it traditionally happens. We are cautious about Canada's growth prospects this time however, as we may not be able to simply rely on America's growth to pull us along. The growth in Canada's energy sector, not manufacturing, has been by far the biggest driver of employment growth.

Our concerns are as follows: **first**, we now have a very expensive labour force. Automobiles and other products of manufacturing have moved to the U.S. or Mexico since the great recession. But we acknowledge the lower Canadian dollar does help to make the manufacturing sectors and commodities producers more competitive. And low energy prices can act as a stimulus for other industries.

See the chart below courtesy of Boston Consulting Group outlining cost of manufacturing by country. You will see both the U.S. and Mexico are most cost efficient over Canada:



Second, is the above mentioned discount we receive for one of our most important exports, oil. We are also price takers for our gas, which will suffer same fate if we can't get it into an international market. **Third**, our consumer is highly indebted. We sit at a ratio of credit debt to disposable income of 163%, an historical high in an era of historically low borrowing rates. On a positive note, Canadian's net worth is at its highest level as well, driven by the rise in house prices. Another positive is that the rate of debt growth is slowing, and debt service ratios – the level of interest payments relative to disposable income- is at its lowest level in 24 years, at 6.9%. Jobs growth has been on a steady, if moderate, rate of growth, now at 6.8% unemployment level, which has not seen since 2008. Still, we can imagine that debt servicing will take place at the expense of future domestic consumption. Note that despite the widespread antagonism towards pipeline, and especially oil sands development, Alberta was responsible for all of Canada's net employment growth over the previous year. The unemployment rate in Alberta sat at 4.9% in June (Bloomberg News, National Post, July 23, 2014). The nut is that caution is required going forward as investors in Canada, given our slow pace at developing global markets for our products. There is a large divergence between what will do well and what will struggle to show growth going forward.

The big themes:

Strong U.S. dollar has global implications:

A weak CAD is positive for the Canadian oil and gas and manufacturing sectors, but is causing market dislocations elsewhere. We've had a global carry trade predicated on borrowing cheap U.S. money and putting it in U.S. stocks – which presumably is being unwound by some on the backs of margin calls and the trades becoming unprofitable, causing some of the recent volatility (both because of the fall in stock prices and the rise in borrowing costs of USD). Since the recession, the USD has been bought in times of uncertainty, and U.S. Treasuries, even with their extremely low interest rates, are still providing a superior return to similar credit quality Euro debt. But a strong USD and rising rates in the U.S. will be a headwind for emerging markets and therefore global growth. Much emerging market debt is priced in USD, and at a spread to U.S. interest rates, making debt burdens more difficult to manage. Central bankers are certainly aware of the interdependent relationship, which will likely cause delays in raising U.S. rates. Bankers have a vested interest in keeping global growth moving forward. A high U.S. dollar is also harmful to the U.S. export sector - the country has been attracting investment back into its manufacturing sector since the great recession, but a strong USD will hurt that growth. For U.S. consumers however, the combination of cheap gasoline and a strong USD will be a boon to spending.

Commodity price trend:

China's growth rate is slowing resulting in less demand for materials exports from Canada. With other markets slowing down as well, China is setting prices on materials, such as coal and potash, which hurts economies and stock markets in Canada and Australia, who are so heavily weighted to mining and materials. Other economies impacted are Brazil, Russia, Argentina, and South Africa. We expect the U.S. to have a bit of a correction from this run, which should positively impact commodity prices. But a long term turn around requires global growth.

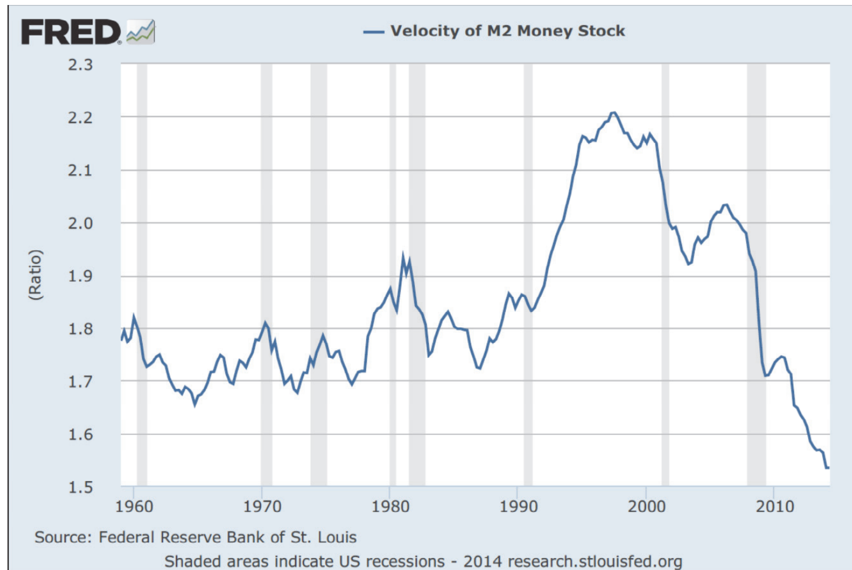
What are the central banks going to do?

The artificially low interest rates of the last 5 years have arguably caused a mispricing of some assets – negative real interest rates have caused investors to flood into high yield and equities. The question is how much accommodative monetary policy and quantitative easing measures are left? Given the strength in the USD, we think interest rate hikes will be slow to come from the Fed, but their asset purchase program is set to end this year, which has been providing liquidity to the markets. Liquidity leads to momentum, withdrawal of liquidity slows momentum. It is assumed that the European Central Bank will pick up the task of injecting liquidity into the markets as they increase quantitative easing programs, but there are worries on whether they will come in with enough support.

Where is the growth?

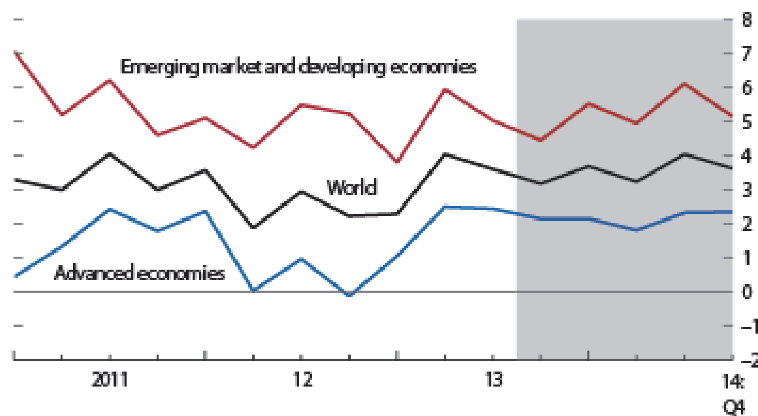
The chart below of money velocity graphically represents how slow the economy is moving right now – well below long term trends (The M2 money supply is money in cash, savings accounts, money markets, etc.). Since the Fed began is QE program, it has increased the money supply by 46%, but the GDP of the economy has only been growing at 2-3% annually. The economy would have to accelerate at Chinese – like growth to deploy the money that has been created in the last 4 years, so it is not surprising it is moving at a slow rate, but this rate is well below trend. A different way of looking

at the situation is to say, billions of dollars are hitting the economy, but instead of encouraging consumers to buy goods and services, and corporations to increase payrolls and equipment, money is stopping and sitting in bank accounts. We have seen that the American consumer has generally been reducing debt loads over the last 5 years, and that corporations have been hesitant to hire new staff or invest in their business. Money velocity typically slows down in early stages of recovery, while consumers aim to get in better shape. A turnaround on this indicator will suggest inflation is back as money starts to chase goods, and create scarcity, and then growth. We are currently well below the trend line.



We continue to focus on the U.S. as best market for equity exposure for the future. The domestic economy is strengthening and it cannot be overstated what a tailwind is provided by their cheap energy supply. Still, the U.S. is heading for moderate 3% growth this year and next. Hardly banner years, but certainly better than Europe's 1% this year and 1.4% in 2015 (expectations recently downgraded by the IMF). It's the "cleanest dirty shirt in the closet," as Bill Gross has said. Canada is expected to ring in 2.2% this year and 2.4% in 2015 (IMF).

oWhile big picture global growth is improving from the years of the recession, but slowly and in spurts. The IMF expects 3.8% global growth in 2015, up from 3.3% in 2014. We can expect to see moderate returns from stocks in such a world going forward:



Conclusion:

Bonds are kept short term (under 5 years, and generally under 3), portfolio weightings vary based on individual risk tolerance and investment horizon. This is the lower volatility/ lower reward portion of the portfolio that lessens portfolio volatility. High yield (also known as “junk” debt) has been chased to generally overvalued prices in the last several years, leaving this sector vulnerable to corrections. We do not have widespread exposure to high yield.

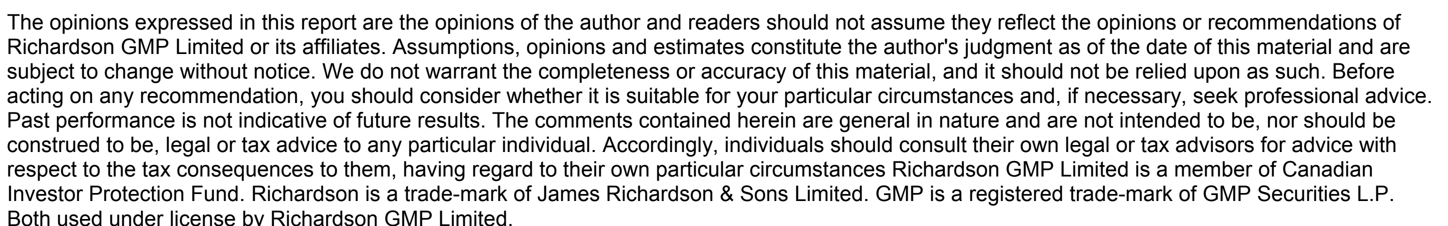
We have cash on hand for the opportunities to buy good companies that market volatility will provide.

Equities: keep a focus on the U.S. growth story and international corporations that have global growth. We have spent the last year adding to U.S. dollar denominated positions, and portfolios are benefitting from this. Within Canada: keep oil and gas producers and service companies small – however some energy infrastructure has growth. We are expecting low growth from the banks over the next year. In all our equity positions, we are weighted to dividend payers, as we think that is where the demand will remain given the low interest rate alternatives to cash. Stock selection is getting ever more important, as we are transitioning from a low volatility phase in the market, where generally all sectors and all stocks were lifted, to more conscientious differentiation of company prospects. Growth themes can be found in capital spending activities in technology; companies that benefit from lower fuel prices, like UPS (who also benefits from U.S. online shoppers and generally healthier U.S. economy); the requirement for increasing energy infrastructure in North America, and healthcare.

Alternative strategies: these are funds that should be low or no correlation to the market. They can short sell, having an advantage in profiting from volatile or falling markets. Portfolios have 10-20% weighting in alternative strategies to balance long only equity exposure. These include Picton Mahoney market neutral strategies, Ross Smith funds, or Altairis long/short funds.

Best regards,

Tricia Leadbeater
Mackie Wealth Group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