THE MACKIE WEALTH GROUP

FIRST QUARTER 2015 REVIEW
APRIL 2015

2015 FIRST QUARTER REVIEW

To date, 2015 has been a lot like 2014, wherein the first quarter stock markets were volatile day-to-day, and overall range bound. The U.S. markets were up 0.4%, flirting with negative first quarter returns most of March. Yet with the USD up another 7% against its major trading partners, U.S. dollar denominated assets still looked great in portfolios for Canadians, and nearly any other investor based outside of the U.S.A.

2015 year to date

January 1 – March 31 2015 index returns: TSX (in blue) up 1.8%; vs. S&P 500 (red line) up 0.4%.

Source: Yahoo.com

15 months return

January 2014 – March 31, 2015 Index Returns

Source: Yahoo.com

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INDEX RETURNS (LOCAL CURRENCY)	1st QUARTER	YTD IN CAD	2014	3 YR. ANNUALIZED
S&P/TSX	1.8%		7.4%	6.3%
S&P/TSX Venture (small cap)	-2.2%		-25.4%	-24.3%
S&P/TSX Materials	-2.0%		-4.5%	-13.3%
S&P/TSX Capped Energy (XEG)	-24.0%		-18.2%	-5.9%
S&P/TSX REIT			10.0%	2.2%
S&P/TSX Financials	-1.1%		9.8%	9.4%
S&P 500	0.4%	9.6%	11.4%	13.7%
Euro Stoxx 50	17.5%	13.8%	1.2%	14.3%
England (FTSE)	3.2%	6.0%	-2.7%	5.5%
MSCI Emerging Markets	1.9%	11.2%	-4.6%	-2.2%
TMX Universe Bond	4.2%		8.8%	5.1%

COMMODITIES	1ST QUARTER PRICE	MAR. 31 PRICE
Natural Gas (NYMEX)	-9.1%	$2.64
WTI Crude	-13.4%	$47.60
Gold	-0.2%	$1,183
Silver	6.2%	$16.60

CURRENT YIELDS	CURRENT	ONE YEAR AGO
2-yr Gov Cda	0.51%	1.07%
5-yr Gov Cda	0.76%	1.71%
10-yr Gov Cda	1.36%	2.46%
2-yr Treasury US	0.56%	0.42%
5-yr Treasury US	1.37%	1.72%
10-yr Treasury US	1.92%	2.72%
CAD spot	**0.778**	**0.905**

Source: Richardson GMP, spindices.com

A surprise rate cut in Canada in January and continued weakness in oil and other commodity prices pushed the loonie down further, from 86 cents to 79 cents, a drop of 8% against the U.S. dollar this quarter. Year over year, the Canadian dollar is down 13%, versus the USD.

It wasn't only Canada that felt large currency shocks. The U.S. dollar marched higher against nearly all of its major trading partners. Currency volatility globally meant wider than normal swings in real returns on various indexes, depending on your local perspective. For example, while Europe was among the best performing markets in local currency terms, up 17.5% in euros this quarter, in USD terms, the European market was up only 4.76% after factoring in the drop in the euro versus the U.S. dollar:

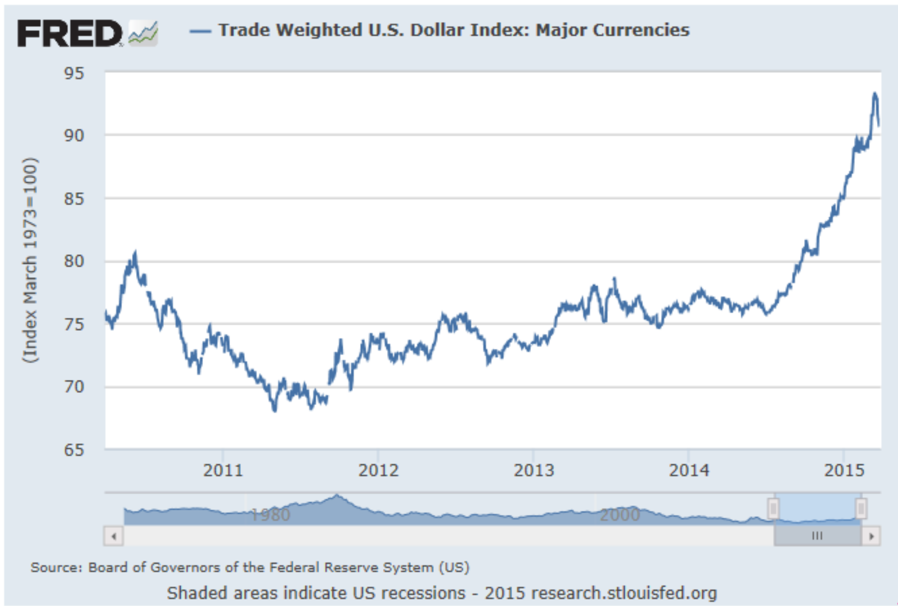
EURO STOXX 50 **PRICED IN EUROS** **UP 19.5% to April 7, 2015**

EURO STOXX 50: **PRICED IN USD** **UP 7.5% to April 7, 2015**

Source: www.stoxx.com

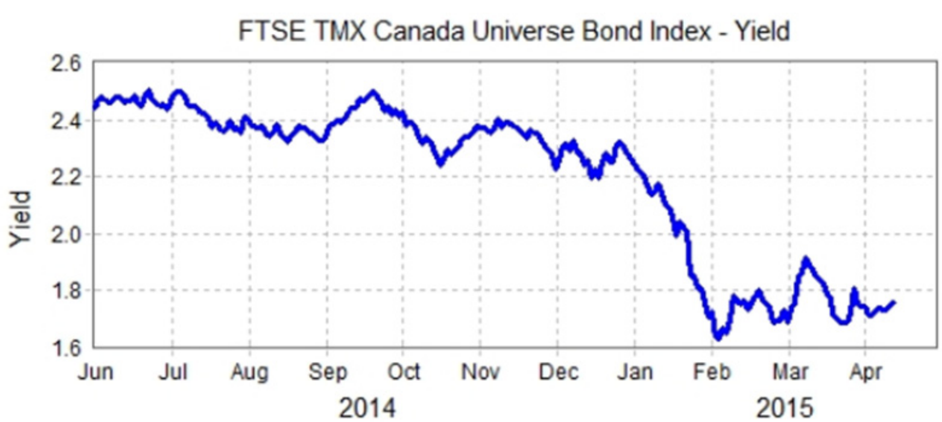
Canada's TSX performed similarly [delete:looks similar] in local versus Dollar terms. While our stock market had a nice jump upward following the January rate cut, the returns are negative if you invested U.S. dollars in January into the TSX. Looking ahead, the strong U.S. dollar is projected to impact corporate earnings negatively on multi-national U.S. companies. We will see the effect of this as first quarter earnings start to roll in in the first weeks of April. Close to 50% of the earnings of S&P 500 companies come from outside the U.S., so when those global sales are translated back into USD from weaker currencies, with few exceptions such as the Swiss Franc and Chinese Yuan, we will see a negative impact on net profits.

The chart below shows how dramatically the USD has moved against its trading partners:



The USD could still move higher, given it remains the reserve currency of the world in a time of diverging monetary policies, especially compared to Europe; other major currencies continue to weaken, such as the Yen and the Euro, attracting large investors to the U.S.; U.S. Treasuries have higher yields than comparable German, British, Swiss, French, Japanese bonds; the local growth rate is stronger than many other developed nations; and the prospect of future interest rate hikes also keep the currency strong.

The Bank of Canada dropped interest rates by 0.25% in January, which caused an immediate spike up in bond prices, and a decline in the loonie. 10 year Government of Canada bonds now yield 1.36% (down from 2.4% this time last year).



Source: www.FTSE.com

Very low yields in the bond world usually signal low future expected economic growth and inflation rates, and therefore low expected future investment returns. Low government yields persist across Canada, the U.S., Europe and Japan, suggesting we should anticipate low expected low growth rates, and lower than historic investment returns globally over the next few years, from bonds and perhaps stocks as well.

As corporate bonds are priced off the "risk free" price of Government issues, lower rates have made coupon clipping for savers even more difficult, but for borrowers, cheap credit has been extended a little further. Mortgage rates and other consumer borrowing costs keep creeping downward in Canada. But the continued marginal yields forces savers and those living off portfolios to either accept lower cash flow streams (now maybe not even keeping up with the effects of inflation) or invest in riskier assets in the stock market. For example, an investment grade 5 year corporate bond such as the Enbridge 03/03/2020 yields 1.815% annually to maturity. Canadian banks are lower, with 1.25% yields on 5 year issues. Yet Enbridge shares have a dividend yield of 3%. The problem is that Enbridge trades at a higher than historical forward earnings multiple of 27X P/E, partly because of the desirable dividend, and so the conservative investor needs to hope that the valuation remains at least stable, or that the company grows over the long run so the risk of reaching for the higher dividend pays off.

Looking Ahead:

We expect Canada to be a struggling economy, and see few exciting growth investments here at reasonable valuations:

- In an interview with the Financial Times at the end of March, Stephen Poloz said "the first quarter of 2015 will look atrocious, because the oil shock is a big deal for us," and added that capital expenditure could fall by 10 percent in Canada as a result of energy companies cutting back on investment. "When the oil shock came, it was clear we would no longer be able to close the output gap by 2016… since we had some firepower, we took some insurance and cut rates." (Financial Times, March 30, 2015)

- The Bank of Canada hopes that a lower Canadian dollar and strong U.S. economy will lift the export sector – but this will take time. And it is uncertain that we can recover significant manufacturing – labour costs in Canada are still much higher than other manufacturing countries, such as Mexico, a direct competitor in NAFTA, and parts of the U.S., where much of our auto industry went following 2008.

- In fact, February economic data just out in Canada shows that both imports and exports were down, suggesting weak demand within Canada and weak demand outside of it for our products. Volume of overall exports was down 3.3%. Energy export volumes were down 2.3% (yet the value was up 15% from January, owing to some price recovery on oil compared to January). Manufacturing exports were down 2.3% in February, the biggest hit being to motor vehicles and parts, down 15% in value in the month.

- The Canadian consumer continues to leverage up: IIROC reports that margin borrowing in brokerage accounts surpassed the 2008 peak last year, and is now at the highest level since 2000, fuelling a 37 percent surge in mutual fund assets and 41 percent rise in ETFs in the last two years. In January Canadians borrowed $19.2 billion against their brokerage accounts. Higher than usual leverage means stock markets can be more vulnerable to funds being quickly pulled back out.

- Household debt to disposable income rose to a record 163.3% in the fourth quarter, but it could be argued this statistic isn't as negative as it appears, because the value of financial assets also rose. Household net worth in Canada is now at $233,000, up 7.5% from a year before.

- Don't rule out another rate cut – and a weaker dollar.

- Investment theme: Canadian companies that have growth outside Canada; receive income in stronger USD; and avoid industries that have strong headwinds, like oil and gas producers. Oil and gas stocks have had a significant rebound from December lows, and now are trading at valuations that largely reflect much higher energy prices. Stick with strongest balance sheets and large capitalization in energy investments, and vertical integration, especially refining.

The state of the oil patch today:

- New share issuance (secondary markets) in the oil patch was strong (U.S. and Canada), with the market absorbing $11 billion in stock this quarter, 10 times more than the same quarter last year (Bloomberg). Oil companies mainly issued stock to shore up weakening balance sheets and protect dividend payments. A more modest amount went to support M&A transactions. We expect to see more acquisition and divesting activity this summer, as low oil and gas prices continue to strain corporate balance sheets. Banks tend to re-assess lines of credit and debt based on updated commodity pricing and reserve valuations at this time of year, so also expect to see more pressure put on the sector by banks looking to protect their books – banks are not in the business of lending to distressed borrowers. Further, we may see more failures on high yield debt held outside of banks in the oil patch. Southern Pacific, Connacher, and Laracina Energy were among some of the local oil patch players that failed or defaulted on debt this past quarter, and are in or near bankruptcy protection.

- The fundamentals of North American oil and gas supply point to prices where most Canadian companies cannot make money or support any new investment. New oil sands projects for example, are widely believed to need at $80 oil prices to earn a marginal return, and oil prices continue to stay well below that level. Oil and gas producing companies will be aiming to drive costs as low as they can, through exploring improved technology, reducing headcount, and putting pressure on suppliers. We are still in retrenchment mode.

- At this writing, oil supply is still growing in North America. We are not yet seeing reductions in supply from other global players. Further, there is the real possibility that a large source of currently constrained oil supply could come on to global markets if sanctions are lifted with Iran. Exports are currently 1.1mmb/d, about half of their pre-sanctions level, and up to 30 mm barrels of crude are being stored that could make their way on to the market (Financial Times, April 6, 2015)

- Of note, energy and resource stocks have diminished in importance to now be a much smaller part of the Canadian index. Energy stocks were 26% of the index in July, and now make up 21% of the overall index. Four years ago, Materials and Energy represented 52% of the TSX index; today they represent 32.5% (Globe and Mail, March 28, 2015). The drop in the index weighting reflects how poorly the resource sector overall has performed over this extended period, and how much less meaningful it is to portfolios.

- One can appreciate the headwinds against resource focused investments when looking at the five year Thomson Reuters commodity futures price index that tracks global commodity prices. From the peak of May 2011, the index has fallen over 40%, reflecting increasing supply in a period of weakening demand, especially from China, who was the major contributor to the “commodity super cycle” of the early to mid-2000s.

5 year chart: Thomson Reuters Core Commodity CRB index

Source:Bloomberg.com

With respect to investment themes, we are looking for the industries that have tailwinds behind them – such as those that benefit from the drop in commodity prices, and where consumers and corporations are growing stronger.

The U.S. is still a haven for investments, but we are cautious on entering new positions:

- US. equities are at richer valuations versus this time last year, and it is unclear whether earnings can still rise significantly from here to support even higher stock prices, given we are now seeing upward wage and salary pressures, and a reduction in offshore revenues due to the higher dollar. Stock picking will be more difficult, and more dependent on timing.
- We are looking for companies focused on domestic markets and low or no headwinds from U.S. dollar currency translation, and that benefit from the supply of cheap and abundant energy sources: Walgreen's, Trinity Industries, Royal Caribbean Cruises, and Alaska Air are examples of where we can see real future earnings growth, and attractive multiples for considering investment. We have also found investments in industries that have high rates of investment going into them, such as NXP Semiconductors, spun out from the Dutch company Phillips, that is a le ader in chip technology that goes into credit cards, ID cards, as well as "smart – car" technology.

Global markets: there is growth in markets that are consumers of oil or are exporters to the U.S., such as NXP Semiconductors, exposure to German and other manufacturers of goods in the automobile and consumer staples space.

We expect continued sideways but volatile markets this year:

- Generally fully valued markets usually signals future volatility
- Uncertainty on timing and speed of U.S. interest rate hikes (later this year is likely)
- Some uncertainty on how strong the U.S. economy really is; real employment numbers are not that strong in terms of quality of jobs added; student loan debt is still a large burden
- Quantitative easing underway in Europe – which is generally supportive of local asset prices, but divergence in global monetary policies likely to cause disturbances to markets
- Geopolitical uncertainty still high in Middle East
- China demand and growth continues to slow – lessening demand for raw commodities
- Expecting continued weak oil and natural gas prices in North America, among other commodities

Outside of our direct investments, we advocate and have invested in a basket of alternative strategies or hedge funds that incorporate long/short trades; arbitrage trades; options based insurance strategies, and global exposure to reduce portfolio volatility and provide growth if markets do have a muddle through 2015.

Best regards,

Tricia Leadbeater
Mackie Wealth Group