MACKIE WEALTH GROUP

2013 REVIEW AND YEAR AHEAD
JANUARY 2014

2013 REVIEW AND YEAR AHEAD

2013 was in many ways, a market that was a repeat of 2012: the US markets performed exceptionally well; while Canadian markets were nothing to be excited about – until the final two months of the year. The TSX was down in fact most of the year, but a year-end rally pulled the TSX to close up 9.6% in 2013. We note the returns on the Canadian market were very divergent as a whole, with a large part of our index performing poorly overall. Materials were down dramatically; REITS lackluster at best; but Financials and Consumer Staples (following notable drugstore and supermarket buyouts) had extremely positive returns. In our portfolios, US dollars and US stocks were certainly the main source of performance. Canadian banks and insurers, pipelines and energy infrastructure were also among the best performing stocks. The main source of drag in our portfolios were some oil and gas producers, materials holdings, mainly Potash Corp, and especially gold and gold stocks.

One Year TSX:

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Comparables:

INDEX RETURNS (LOCAL CURRENCY)	2013	3 YR. ANNUALIZED
S&P/TSX (price)	9.60%	0.40%
S&P/TSX small cap index	3.63%	-6.79%
S&P/TSX Materials	-30.60%	-20.08%
S&P/TSX Energy	7.16%	-5.93%
S&P/TSX REIT	-8.72%	4.66%
S&P/TSX Financials	19.10%	7.96%
S&P 500	29.60%	13.70%
Euro Stoxx 50	17.90%	3.60%
England (FTSE)	14.40%	4.60%
MSCI Emerging Markets	-5.00%	-4.50%
DEX Bond Universe	-1.19%	3.94%
Natural Gas (NYMEX)	4.50%	
WTI Crude	5.80%	
Gold	-29.00%	

CURRENT YIELDS		ONE YEAR AGO
2-yr Gov Cda	1.14%	1.14%
5-yr Gov Cda	1.94%	1.38%
10-yr Gov Cda	2.76%	1.80%
2-yr Treasury US	0.38%	0.25%
5-yr Treasury US	1.74%	0.72%
10-yr Treasury US	**3.03%**	**1.76%**
CAD spot	**1.0623**	**0.9921**

Source: Richardson GMP, spindices.com

Gold

We hold gold in our portfolios for several reasons. One is as a hedge or alternative to having paper currency. That is, to benefit from possibly increasing inflation coming out of this unprecedented monetary global stimulus, and to protect ourselves against government manipulation of paper currencies. We also hold gold for traditional investment objectives: we can identify the steadily increasing global demand for it physically: by investors, national banks, and meaningful retail buying from especially China. At the same time, it is becoming harder and harder to find meaningful economic deposits, in good jurisdictions, to bring new supply on stream. There has been no disruptive technology which has opened the door to new extraction possibilities as has occurred in the oil and gas industry. Increasing demand and shrinking supply is a good start to an investment theme. But this year our hedge was a serious drag that we did not anticipate fully. The price of gold fell 30%, from USD $1680 to USD $1200. Gold miners fared worse. Gold mining companies were hit by two major headwinds: rising costs of operations, and the falling gold price. The gold price fell off dramatically starting in the summer months as some very large hedge funds and Gold-backed ETF investors gave up on the need to protect against inflation (this occurred in tandem with the “taper tantrum” in May and June which prompted dramatic reversals of fund flows through many asset classes). Those investors likely flowed those funds into rising US equity markets. Next, Indian demand went nearly to zero instantly this past summer as a buyer of physical gold. The Indian government unexpectedly imposed severe restrictions on gold imports to protect the rupee, and demand in India plummeted. This is important to note, as emerging market buyers have a large influence on gold prices. In a GMO study (a US fund manager), cited by the Financial Times, between 2000 and 2010, emerging market consumers accounted for 79 percent of total demand for gold (John Plender, Financial Times, January 12, 2014). According to the World Gold Council, Indian and Chinese consumer demand accounted for 37% of total gold demand in 2012. Our view on gold today, priced at $1220, is to continue to hold positions. We think that gold companies are oversold, operating costs are improving, large future mine projects have been shut in, and it is unlikely that many new projects will be planned at this price. Reducing supply will eventually move the price of the commodity up. The timing of that change in price, and corresponding change in investor interest is uncertain, but we feel that this is not the time to be sellers of gold. Note, just this week, Goldcorp put out a hostile bid to buy Canadian miner Osisko for $2.6 billion, a 20% premium from the previous day’s closing price. Even at that premium, the shares are trading down 60% from their peak of 2011, and are trading at a significant premium to the offer, suggesting the Goldcorp will have to pay up to acquire their target. We think the Goldcorp offer is a positive signal by a sophisticated gold player that companies are undervalued here, and acquisitions will be accretive. A premium priced acquisition will allow investors to upwardly re-price gold stocks.

Bonds & Yield

Interest rates, while still low, moved dramatically up over the summer months and then again into the final weeks of 2013. The shape of yield curve is now much steeper and more normalized, but expect to see the 10 year yield to increase again in 2014. Expectations are that it could move to 3.5 – 4%, from 3% at the end of 2013 (up from 1.7% a year ago, almost doubling). The drama in fixed income was started by the Fed’s first mention of their intention to “taper” their unprecedented monetary stimulus program in May. Bond yields shot up, bond prices crashed, and stock markets were instantly volatile (see the TSX chart above). The 10 Year US Treasury bond dropped from a peak price of 103 to 92 over the May/June period, a loss of nearly 11%. Note the 10 year is widely used as the “risk free” asset. Correspondingly, the volatility on below investment grade bonds was even greater.

Markets were shortly afterwards soothed when the Fed backed away from tapering, pushing that course out until the end of the year. It then broadcast further guidance that it is not on a predetermined program and will act and adjust to tapering only as it sees the economic, inflation and employment environment can bear it. The resultant effect of the increase in longer term interest rates, and the perception that the taper is coming, is that bond markets and yield stocks, especially utilities and REITS, were volatile and had poor performance overall in 2013. At the beginning of 2014, the Fed has started to ease in some modest tapering, by reducing monthly bond purchases from $85bn per month to $75bn per month. This time the market took the news in stride. In fact, many stock markets ended December 31 on multi-year or new all-time highs. In conjunction with starting the easing program more modestly than previously predicted, the Fed maintained that they will keep borrowing costs at extremely low rates until unemployment falls solidly below 6.5%, and that we see a reasonable rate of inflation (versus potential deflation that the Fed fears now).

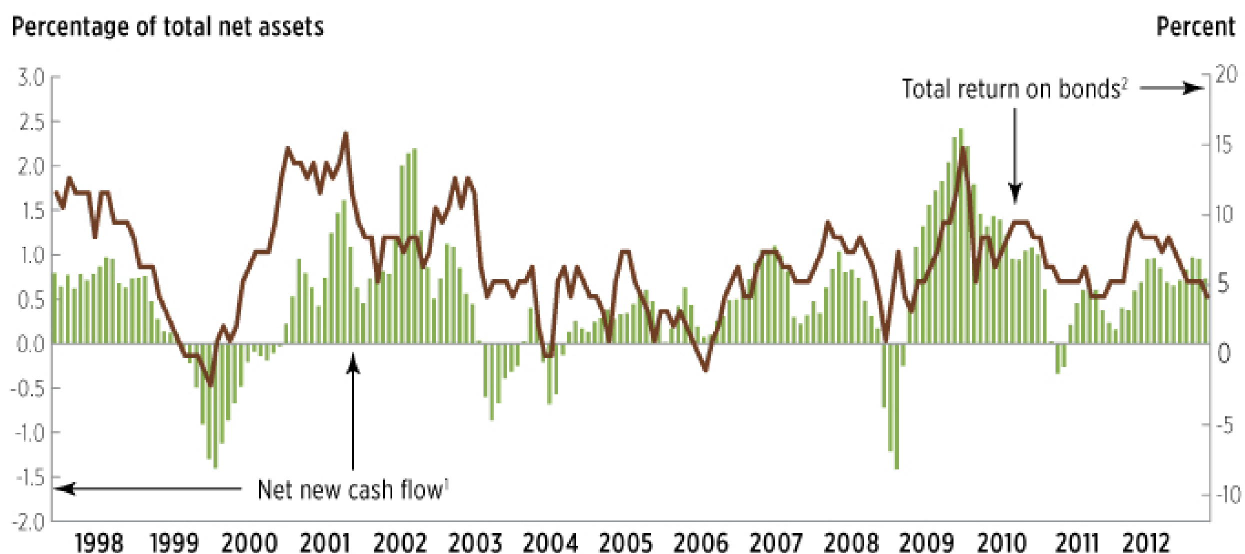
The reality for conservative savers is that they face the same dilemma in 2014 as they have in the past 4 to 5 years: how to grow assets for the future without taking undue risk? Interest rates have improved, but 2 year investment grade corporate bonds still yield under 2%. You will still have to reach to a 5 year maturity to get a close to a 3% yield on an investment grade corporate bond in Canada. By example, a CIBC bond maturing in March 2018 yields an annual 2.32% to maturity today. In a taxable account, you are still maybe just keeping your money on pace with inflation. And you would want to be prepared to lock in that money to maturity or risk taking a capital loss to reinvest in other opportunities in the coming years as interest rates rise.

We think an important, structural investment theme is to consider that the “baby boomer” segment of the investing market is looking to save and create income streams as conservatively as possible to fund retirements. We are in an era of declining defined benefit plans, and increasing defined contribution and do-it-yourself savings plans for retirement. This fact will determine where investment dollars will go, and how income generating investments will be valued for the long term. In the US, individual retirement savings accounts hold $5.3 of the $13.1 trillion in mutual fund assets (at 2012), and will probably continue to grow. The first part of the “Baby Boomers” are entering early stages of retirement, and requiring investment savings to stretch out potentially several decades beyond what their parents required, given much longer assumed life expectancy. Baby boomers born at the peak of the “boom” are between 50 and 54 years old today, and are still in the phase of accumulating assets for retirement, but certainly sensitive to perceived risk, given the two major market busts of the 2000s. In this vein, following the last bust, retail investors en masse sought out the perceived security of bonds. For 6 consecutive years, with the trend just starting to turn in 2013, investors bought bond funds or went to cash and redeemed their equity funds. We think this very large investor group will continue to seek out income generating investments. But some of those investors learned (painfully) this past year with their negative returns that bond investments are not risk free. (ICI.org, and Sandy McIntyre of Sentry Investments).

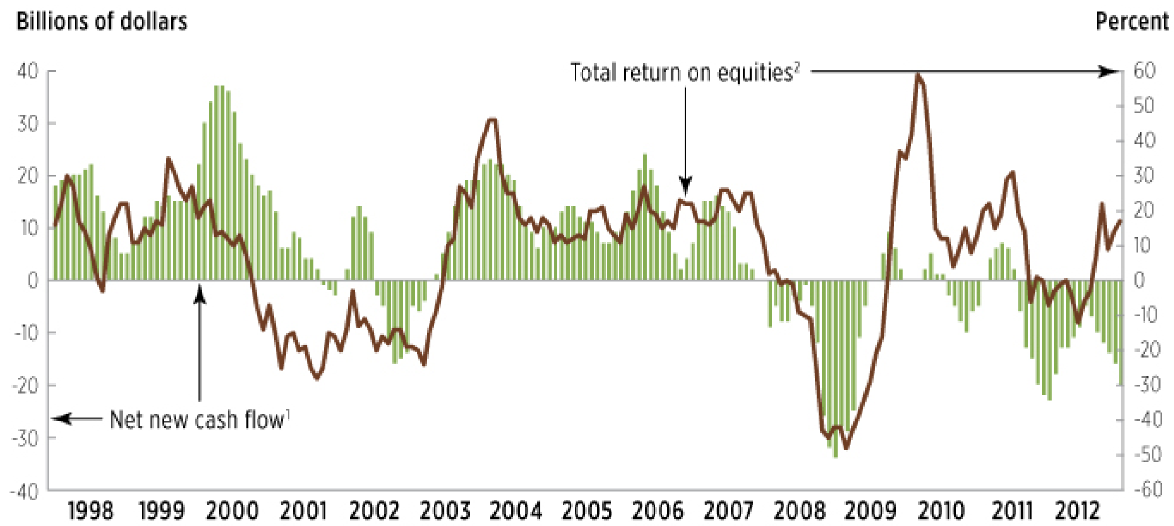
Retail investment flows tend to lag a turnaround in the stock market, so we would expect to see continued inflows into equities in 2014. We continue to maintain that stocks, with a weighting to dividend paying stocks, and companies generating growing free cash flow, with the potential to raise dividends, are the means to getting inflation beating returns, even though they require taking market risk. The capital gains returns from dividend payers we expect to be muted this year, as many dividend payers are getting close to fully valued in terms of their future earnings growth. But the dividends form an important part of long term portfolio return.

Some charts, courtesy of Investment Company Institute, are below. They lead us to believe a reallocation of capital from bonds and the sidelines of the market into equities will continue through 2014.

Net New Cash Flow to Bond Funds Is Related to Bond Returns. Monthly, 1998–2012



Net New Cash Flow to Equity Funds Is Related to Global Stock Price Performance. Monthly, 1998–2012



US Markets

The US again had the strongest performing market globally. Even with below long term trend growth, US markets ended December on all-time highs, and that was after the Dow had already made 52 all-time new closing highs, and the S&P 500 made 45 new all-time closing highs in 2013.

Even with the recession firmly in the past, the price move in US stocks is at a disconnect from the growth of the economy and of top line growth in corporate earnings, which is still quite anemic. An analysis of earnings growth on the S&P 500 is very revealing:

In Q3 2013, S&P 500 earnings were up 4.9% from the same quarter a year earlier. But note, revenues for these companies were up only 3%, meaning that companies are maximizing "operating leverage," versus experiencing high rates of demand for their products. Profit margins hit multi-year highs this past year on the back of modest revenue growth (at around 9.5%). This has been the result of labour and other cost cutting measures, along with cheaper energy supply and more efficient energy usage. Large scale share buyback programs have also been increasing earnings per share over the last two years. The trend has been for corporations to hoard cash or return some of it to shareholders, versus risking it in acquisitions or capital investments. But that trend could reverse somewhat in 2014. It is time for technology and equipment to be upgraded. Investment like this is required to create real growth.

The majority of the price move in stocks then, is the result of investors gaining confidence in the turnaround of the US market, and revaluing forward earnings. P/E valuations have expanded from 12x to around 15x by the end of the year for the S&P 500. It is this change in multiples, versus extraordinary growth in earnings, which explains most of the move in the price of stocks last year.

Given that US markets are at multi-year highs, and valuations getting somewhat stretched in some sectors, we are cautious about the US market. Yet, we also think the prevailing positive trends give us a reason to still be investors in US markets. We warn to expect a return of volatility in 2014 as some profit taking is overdue.

Risks to growth include: a disorderly exit from quantitative easing; investors fearing a disorderly exit and panic selling the markets; government gridlock disrupting markets when the next debt ceiling approaches in February; unemployment growth and consumer confidence and spending trending down; or some unpredictable event that triggers widespread profit taking.

Headwinds that could provide another positive year of returns:

- Strongest economic fundamentals compared to other developed countries
- Banking sector well recovered from the financial crisis, ahead of European banks
- Energy advantage leading to “reshoring” of manufacturing to US
- Labour advantage; demographics in Japan and Europe less favorable
- The US market represents 48% of total global market capitalization
- Strong corporate balance sheets – and corporate investment in technology and capital is overdue
- The budget deficit is half of what it was in 2010
- Housing market continues to strengthen; auto market also strong
- The Dollar’s status as safe haven currency is intact
- The Fed has indicated its intentions to provide ongoing support

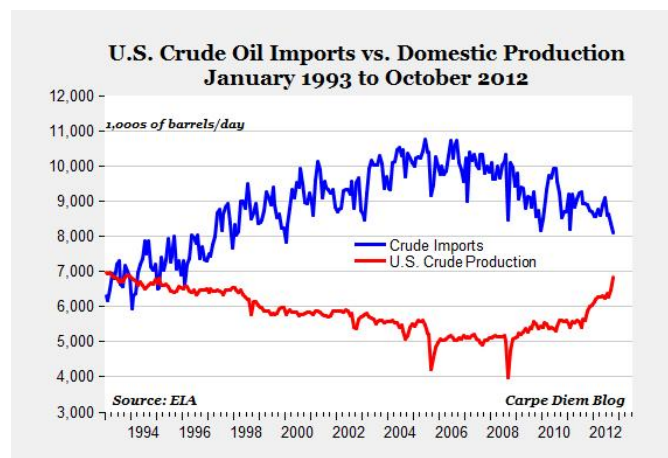
The US economy has the strongest and most persistent, (if modest), growth globally, and we see this continuing for 2014. The banking sector post financial crisis has recovered ahead of European banks; the US has a more efficient and dynamic labour pool than Europe or Japan; and perhaps most importantly, as a result of the explosive growth in oil and gas production over the last 4 years, has the cheapest energy supply in the world. GDP growth in 2013 will probably come in upwards of 2.6%, and the general projections expect over 3% GDP growth in 2014 (the IMF said they will raise their forecast for 2014 US growth in mid-January).

A comment on how cheap energy is changing America’s competitiveness, job market, and overall economy:

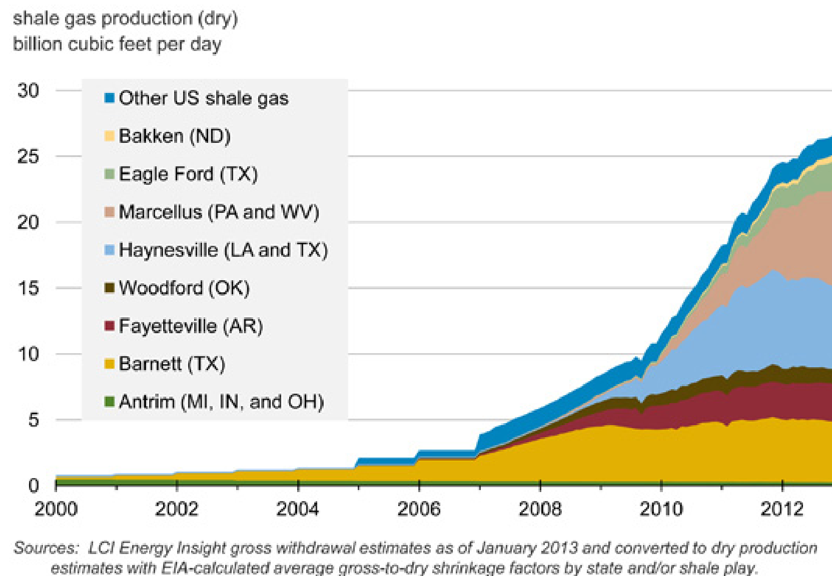
In a survey of American manufacturing companies by the Boston Consulting Group in 2012, 37% of companies with sales over $1 Billion were planning or actively considering moving production back to the US from China. It is not only companies like Whirlpool, Corning and Coleman that have already moved production back to the US from China, but investment is being drawn from other parts of the world as America becomes a more cost effective country to produce goods.

Dow Chemicals is spending $4 billion to build factories in Texas and Louisiana; Methanex has moved two of its plants in Chile to Louisiana; Exxon, Chevron and Sasol also plan to spend $100 Billion to build or expand chemical plants in the US (Bloomberg Business Week, July 25, 2013). French company Michelin and Goodyear are moving tire making facilities from France to the Southern US as well.

The changing energy supply in the US. Light oil production still on the increase:



Gas production is increasing at a rate much quicker than growth in US demand, allowing for exports to Canada and Mexico:



Sources: LCI Energy Insight gross withdrawal estimates as of January 2013 and converted to dry production estimates with EIA-calculated average gross-to-dry shrinkage factors by state and/or shale play.

Investment Themes of 2014

Mixed Canadian markets:

- The cheap and growing energy supply the US is enjoying means we should expect weak demand and low prices for Canada's oil and gas, until overseas export capacity grows or gets approval.
- Getting approval of pipelines and facilities, then the expedient building of overseas markets remains a major risk. Even with some liquefied natural gas (LNG) projects in early stages of approval, it is uncertain they will be built in time to capture market demand at attractive price margins. We will be price takers at best if we rely exclusively on the US for our exports.
- Emerging markets, the main driver of robust Canadian stock market returns in the mid 2000's will likely show anemic growth or even recession in some areas.
- Consumers remain highly leveraged in Canada. And the two largest provinces in Canada, Ontario and Quebec are massively overleveraged with weak growth prospects.
- However-
- A strong US market is generally a benefit to Canada and exporting companies especially.
- A continued weak CAD is generally very positive for energy producers and manufacturers.
- Our economy overall is muddling through – not growing strongly, but not recessionary.

US markets will be volatile due to current valuations, and the process of unwinding Quantitative Easing will probably be bumpy, but the US is still the strongest economy in the world, and continues to provide opportunities for equity investment. The large dividend payers, with free cash flow growth remain a focus.

European markets have the potential to be strong again this year: markets have still not caught up to 2007 peaks, valuations in many cases not as high as US companies. Risks include European debt issues flaring up. We will look to have an allocation to European markets this year.

Emerging markets require caution in a rising interest rate environment. Shocks to their borrowing costs are a risk. Brazil, India, China will not recover their strong growth of the early 2000's this year.

Fixed Income: we remain cautious and will stay short term in duration. Expect another poor year in bond returns as the debt markets normalize. Bond prices still have further to fall, which affects the total return.

Alternative Strategies: we advocate having select long/short strategies to lower portfolio volatility, and for moderate growth.

We appreciate your ongoing trust and support, and look forward to connecting in the new year.

Tricia Leadbeater
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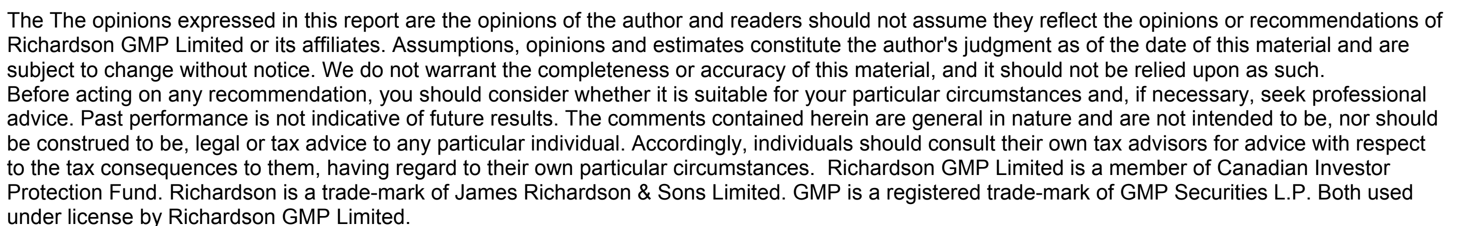

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