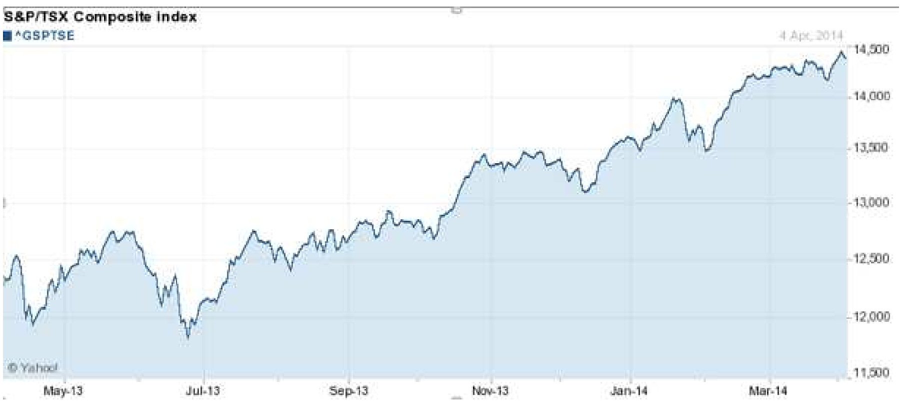
THE MACKIE WEALTH GROUP

2014 FIRST QUARTER REVIEW
APRIL 2014

Q1 2014 REVIEW

For the first time in many years, our Canadian markets were something to be excited about. Nominally, the TSX was one of the best performing developed economy markets. In the month of March, the TSX made new 52 week highs almost daily, and at writing is finally back to its level of 3 years ago. We are now about 550 points or another 4% rise from the all-time peak of June 2008. This 1st quarter run wasn't without shakiness however; markets dropped sharply by about 6% at the end of January over 10 days, then turned around and recovered more than the drop in the next 10 days and onward to new highs. While the market has shrugged off this volatility into distant memory already, we would like to highlight this bumpiness as likely foreshadowing of more to come in 2014.

One Year Chart TSX



In regards to the TSX, once you factor the 4% pullback the Canadian dollar (CAD) has had since the start of the year, and the total 10% fall against the USD since last summer, you understand the basis of our market's strength. A falling CAD materially helps our crucial resource export sectors. Commodity producers sell their end product in USD, and costs are priced in CAD. The weak CAD helps to offset Canada's relatively higher labour and production costs compared with other developed countries. The performance of TSX sub-indexes show what the market is anticipating and should see better margins for resources producers, especially in oil and gas and gold. We do think that the falling CAD is attracting foreign investment to our resource oriented stock market again as we are seeing Calgary oil and gas and our mining stocks making sizable upward moves on good volume for the first time in several years. This is also driven by a stabilization and broad improvement in commodity pricing (with the exception of copper, which has been volatile this last quarter). Most analysts are calling for an 85 cent Canadian dollar before we bottom. This is leverage that supports earnings, and will probably continue to drive buyers of Canadian resource companies.

Statistics Canada reports that cumulative foreign purchases of Canadian stocks in the last four months of 2013 totaled $22.6 billion, **the best inflow into stocks in 10 years**.

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Comparables:

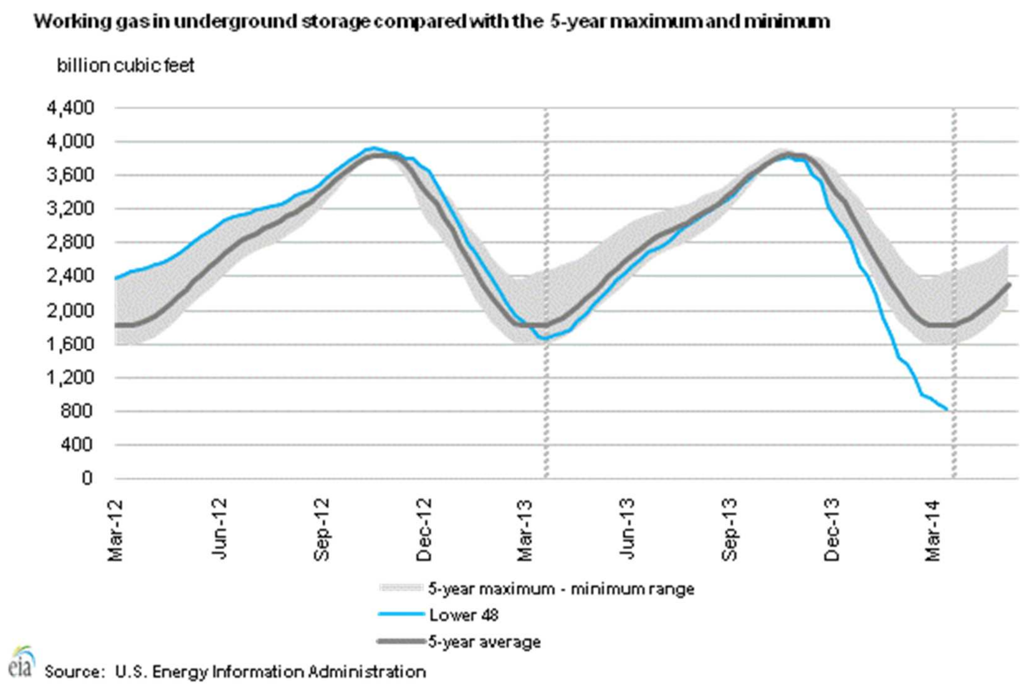
INDEX RETURNS (LOCAL CURRENCY)	Q1 2014	3 YR. ANNUALIZED
S&P/TSX (price)	5.20%	0.50%
S&P/TSX small cap index	6.70%	-24.30%
S&P/TSX Materials	9.20%	-18.00%
S&P/TSX Energy	8.70%	-5.57%
S&P/TSX REIT	3.50%	2.32%
S&P/TSX Financials	1.90%	5.61%
S&P 500	1.30%	12.20%
Euro Stoxx 50	1.70%	2.80%
England (FTSE)	-2.20%	3.70%
MSCI Emerging Markets	-0.80%	-5.30%
DEX Bond Universe	2.76%	5.00%
SAMPLE BENCHMARKS		
30% S&P 500, 70% TSX	4.00%	4.00%
20% S&P 500, 50% TSX, 30% DEX bonds	3.70%	3.80%
Natural Gas (NYMEX)	6.70%	
WTI Crude	3.70%	
Gold	6.70%	
CURRENT YIELDS		ONE YEAR AGO
2-yr Gov Cda	1.07%	1.00%
5-yr Gov Cda	1.71%	1.30%
10-yr Gov Cda	2.46%	1.87%
2-yr Treasury US	0.42%	0.24%
5-yr Treasury US	1.72%	0.76%
10-yr Treasury US	2.72%	1.85%
CAD spot	**1.105**	**1.0174**

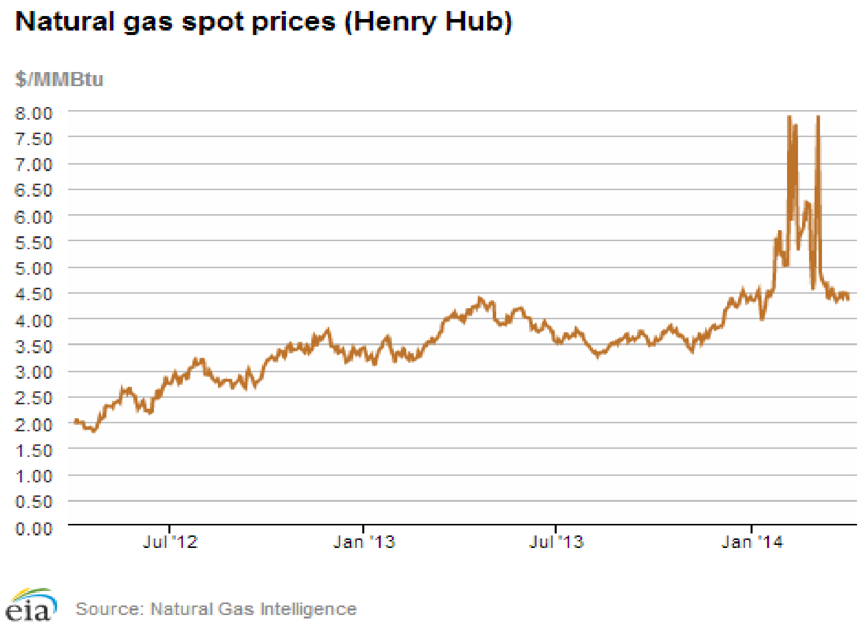
Source: Richardson GMP, spindices.com

Oil and gas

The upward valuation of Canadian oil and gas equities has also been driven by the dramatic increase in M&A activity in the last month of 2013 and first quarter of 2014. This has been very encouraging to investors. Interestingly, the bulk of the activity has been driven by domestic Canadian buyers, contrary to recent year's trends of foreign state owned companies driving acquisitions. Foreign buyers have been precluded from participating in large asset purchases in Canada, owing to changes on federal policy toward State Owned Enterprises (SOEs), after CNOOC's $15 billion acquisition of Nexen closed last year. Key examples include the $3.1 billion purchase of Devon's Canadian assets by CNRL; Baytex Energy's $2.6 billion purchase of Aurora Oil and gas that involved a $1.3 billion bought deal offering, one of the biggest equity bought deal offerings in the Canadian oil and gas sector ever; Vermilion Energy's purchase of a private Saskatchewan company for $400 million; Whitecap's purchase of assets from Imperial Oil for $855 million. Cardinal Energy was quick through the gate with a $250 million IPO in December, one of the biggest IPOs in Canada in 2013. Canadian buyers are benefitting from the change in rules that now limit foreign SOEs from buying certain resource assets – competition is less fierce.

Natural gas producers are gaining particularly on the continued strength of natural gas prices, following one of the coldest winters on record that has drawn gas storage levels far below seasonal averages. The EIA reports that inventories in the U.S. are at their lowest levels in 11 years:





The increase in activity and availability of capital for this sector could bode well for Canadian oil and gas stocks for the rest of the year. Analysts are beginning to move up target prices on increased confidence in oil and gas prices, smaller discounts for Canadian heavy oil compared to last year, and slowly improving access to markets because of the increase in transportation by rail. Some companies, like Crescent Point are beginning to export some of their oil from West Coast U.S. in order to get access directly to global markets, and much higher prices. This diversion of Canadian oil to U.S. ports circumvents the issues around Canadian pipeline delays, and takes advantage of available space in U.S. ports, as they cannot export U.S. crude, but can export Canadian crude. The forces of economics and capitalism are more powerful than regulatory/ political constraints!

Note, while gas price strength and a weaker CAD is helpful for Canadian producers, still only the most efficient, resource style plays with higher priced liquids are making money today. The EIA now projects an average Henry Hub gas price of $4.44/mcf in 2014 (average price in 2013: $3.73).This price still doesn't make breakeven for Canadian dry gas projects, but can support the lower cost, liquids oriented resource plays. Canada will require a dramatic change in the supply/demand picture to make dry gas projects economic. Factors that will influence the future demand for Canadian producers over the long term: continued cheap supply growth from Marcellus shale; increasing ability for the U.S. to rely on their own domestic production; Canada's ability to get LNG projects approved and built economically and expediently (Canada still has among the highest labour costs in the world, see "Oilpatch Salaries average $130, 000," *Calgary Herald*, April 20, 2014); and the largest short term influence on prices: weather. Weather was our friend this past winter, one of the coldest in decades in many parts of North America. The potential for natural gas liquids drilling to remain strong, and the potential that LNG projects get approved leads us to remain invested in infrastructure names that stand to benefit, particularly: Altagas, Keyera, Gibson Energy, Interpipeline, and Plains All American (although we have taken some profit at the margin on some positions). We will also invest in oil and gas producers that have reliable access to capital and to markets.

Gold

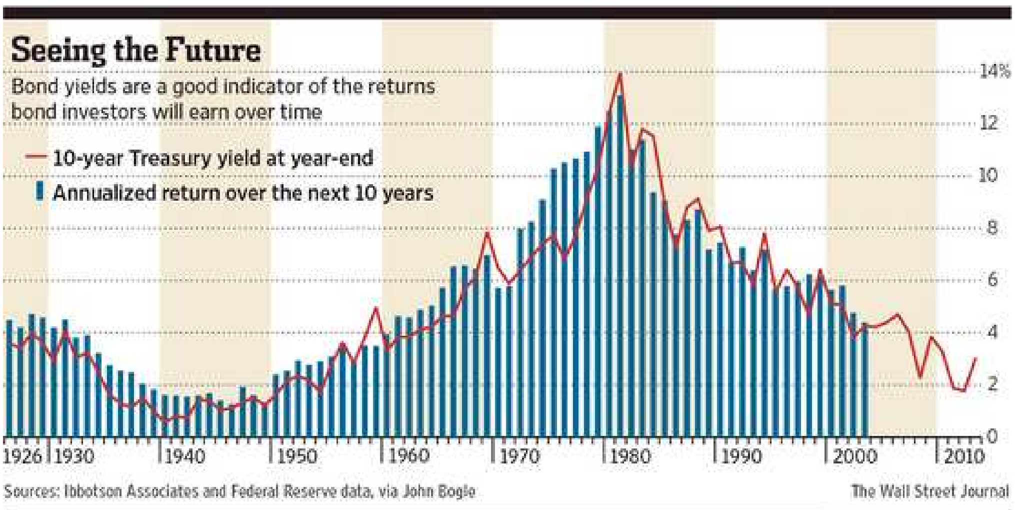
This has been an interesting period for the gold price and gold stocks, in which we retain a position across accounts. We hold gold as a hedge against future inflation; for protection against currency weakness given the back drop of global currency devaluation policies; as a safe haven in times of geopolitical turbulence. Now we think gold companies which have been so dramatically revalued over the last two years stand to benefit from a stabilization of the gold price. Investor sentiment suddenly changed toward gold equities this quarter. Dramatic moves up in some names were driven partly because they were so oversold at year end (when tax loss sales peak). Before a pullback in late March, the spot gold price moved up 15% from the start of the year, and is still up 9% at writing. For the first time since December 2012, a net inflow of funds went into GLD, the largest gold-backed exchange traded fund. Hedge funds increased bets in gold this quarter as a safe haven play, at the same time that emerging market equities increased in volatility around concerns on the Ukraine/ Russian standoff. Interestingly, private equity also seems to be making a play for precious metals: a large Canadian private equity player just announced that they have raised more than $1 billion for investing in precious metals companies (Financial Post, Monday April 7, 2014). The gold sector is also benefitting from increased M&A activity this year, amid confidence that company valuations have troughed. By example, Sentry's Precious Metals Growth fund is up 27% year to date; Goldcorp up 17%; Silver Wheaton up 14%. And, like the oil and gas stocks, a 10% decrease in the CAD means a significant drop in operating costs for some, alongside a gold price that is over $100 per ounce higher than at year end 2013.

Fixed income

Higher pace of growth is what is needed for equity markets to keep moving up, and growth seems to be the consensus view right now. But, a stronger pace of growth will in the future result in higher inflation and interest rates, a prospect the bond market is starting to anticipate. ETFs that track short dated treasuries have experienced large redemptions this past month, according to ETF.com, meaning investors think rates will soon start moving up on short dated maturities. Investors pulled a record $7 billion out of U.S. Treasuries funds in the week ending March 5, the biggest outflows since Lipper began records in 1992; taxable bond funds posted $4.9 billion in outflows. Funds that specialize in U.S. stocks attracted $8.9 billion in the same week. Currently, the market is pricing in interest rate hikes starting in 2H 2014.

A recent article in the Wall Street Journal helps to illustrate what you can expect from bonds going forward for the next few years. Rather than annualizing the last 10 years to create an expectation of what the next 10 will look like, you should look at today's coupon to determine future expected returns.

The chart below comes via the WSJ and John Bogle, the legendary investor who founded Vanguard. Simply, "current yield is the best indicator of how much you'll earn over time from fixed-income holdings." (Wall Street Journal, March 3, 2014). The 10 year Treasury yield has been hovering around 2.75%, down from 3% at year end. Consensus estimate on 10 year yields for 2014 range between 2.5% - 3.5%, the variance depending on economic growth data. Stronger growth leads to higher yields. So, you can project that bond investors will earn perhaps 3% annually going forward for up to the next 10 years. This sounds realistic as many bond investors faced losses last year and could experience more in the coming two years as interest rates start to move upward. A sample bond index we track, the DEX Bond Universe, has returned 5.1% annualized over the last 7 years; but only 2.7% over the last 2 years.



online.wsj.com/news/articles/SB10001424052702304558804579376930382873584

Forward view: care & attention required

There are a number of factors at play that continue to support stock markets, but also some that give us reason to have some focus on risk avoidance:

- Janet Yellen, the new head of the Federal Reserve looks to maintain the accommodative position to equity markets of her predecessor. She clarified her stance in recent weeks that the Fed will remain accommodative on interest rates.
- Zero Interest Rate Policy is supportive of stocks – investors are seeking out risk assets to get acceptable returns, and will continue to do so.
- The ECB is still maintaining a very accommodative stance to ward off deflation
- Federal level government policy gridlock is much diminished compared to last year
- Merger and Acquisition activity is broad based and picking up steam
- Financing costs for corporations remain historically low
- Corporations broadly are in strong balance sheet positions, even hoarding cash
- Renewed capital investment spending could be positive for many sectors like IT, banking, infrastructure
- Housing construction looks to still be on the growth track after a slowdown in winter months due to abnormally cold weather
- Thanks to rise in U.S. equity and housing prices, net worth of households is now close to 2007 peak. U.S. households have never been wealthier according to Barclays, in USD and adjusted for inflation (Bloomberg)
- The number of U.S. millionaires hit a new high in March 2014, surpassing the 2007 peak. 9.6MM new millionaires, the last peak in 2007 was 9.2MM.
- money.cnn.com/2014/03/14/news/economy/us-millionaires-households/index.html?section=money_topstories

IPOs year to date are surging:

- 46 companies at March 10 have conducted IPOs, raising $8.6 billion
- Average one month return this year so far is 37%
- Rate of IPOs matches 2007, and the rapid pace of listings matches that of the start of 2000: 56 firms filed to list on U.S. exchanges in the first two months of this year, the highest number since 2000.
- Biotech is one of the main sources of IPOs. (Dealogic)

It is early yet to declare that this IPO rally is an echo of the frothiness year 2000, or a sign that growth and business confidence are still on the rise.

Vigilance needed

While the U.S. economy looks strong, and Europe is stabilizing, and Canada may just muddle through, we are cautious because of where stock market valuations currently sit: S&P 500 P/E: 17.7x; TSX 17x. As we noted in previous comments, much of the stock market gain over the last year and a half is owing to investors' willingness to pay higher valuations for stocks, even though they have shown modest or little real earnings or top line revenue growth on the whole. Investors have been encouraged to take on increasingly risky investments in order to meet return objectives, and so they are looking to stocks to get those returns. As the years of "financial repression" drag on, savers feel increasing pressure to move out of negative real rate of return investments in government bonds and money markets, and into much riskier stock market investments. For many investors, large capitalization dividend paying stocks need to serve as a bond proxy, even though the risk to reward ratio is much more skewed to risk of capital loss. That is, a 2 year Bank of Nova Scotia bond will yield 1.4% with little risk of loss, but BNS shares will provide a 4% dividend yield, but you must accept volatility in the value of your capital. For our dollar, we are more interested in the possibility of equity growth and dividends in stocks, than accepting low or negative returns on bonds.

For stock markets to move up from current valuations, we need either the continued faith that the Fed will support equity markets through quantitative easing and low interest rates, and a smooth withdrawal of quantitative easing, or, corporate revenues have to start moving up, and economic fundamentals need to continue to improve. Investors may continue to support or drive up valuations as the so-called “great rotation” out of bonds and into stocks continues. But we do know that the Fed is reducing its monthly purchases of bonds, with the bond buying program on target to end this year. Reducing the rate of funds going into the market is expected to create bouts of volatility as the market digests changes in the flow of funds. Currently, the Fed is spending $55 billion per month on bonds, down from $85 billion last year. If earnings growth doesn’t meet heightened expectations, we could also see periods of selling if investors become disappointed with lack of growth. And we feel this market is increasingly populated by weaker holders of stocks, i.e., buyers who have jumped in late, perhaps using margin, and so volatility could be exacerbated by their selling.

As we expect markets to get increasingly bumpy, we recommend portfolio hedges in the form of Alternative Strategies; for some, short term bond exposure; and modest gold exposure. Investments in the Ross Smith and Picton Mahoney market neutral funds, have the ability to “go short,” and even profit from volatility. But, as we can observe developed world economies growing modestly, and their fundamental underpinnings far stronger than they were in 2007, we still want exposure to the stock market. Themes that will still have multiyear growth potential include: U.S. housing, oil and gas infrastructure; America’s cheap energy supply benefitting some industries and manufacturers; lower cost oil and gas resource style plays; cyclical industrial investments such as Kansas City Southern Rail and General Electric. We strive to be patient and have our watch list in hand to be buyers at times when we have abrupt bumps in equity markets.

We appreciate your continued trust and support,

Tricia Leadbeater
Mackie Wealth Group