MARKET OUTLOOK QUARTERLY

Q2 2015 MARKET OUTLOOK QUARTERLY

The U.S. zigs, Canada zags

With the U.S. Federal Reserve zigging while the rest of the worlds' central banks zag, we are witnessing some more volatility in the markets, consistent with the later stages of a bull market. The Bank of Canada surprised everyone in January and put Canada in line with the world, as opposed to the USA, onto easier monetary policy.

We are watching markets perform well, and yields drop precipitously in most countries, but are sticking with our outlook from the beginning of the year, as we expect the results of these easy policies will start to show themselves in Q2 and Q3 of this year.

Key themes

- **Re-estimating Canadian economic growth** – The surprise cut from the Bank of Canada and downward revisions of GDP growth estimates are weighing on loonies and bond yields. Certain sectors could still face further re-rating.
- **U.S. momentum** – The U.S. dollar remains strong, and U.S. stock market performance is continuing to impress.
- **Volatility** – The big swings in the U.S. dollar, drops in global interest rates, and huge swings in energy prices will not and have not gone unnoticed.
- **Market leadership** – Well into this bull market, we are seeing signs of sector and sub-sector leadership. While the race isn't won, this is typical for the later stages of a bull market. Unfortunately for Canada, those sectors leading are poorly represented.

Recommended portfolio adjustments for Q2

- Shorten duration on fixed income. The huge returns in bonds in Q1 have taken yields to low levels.
- Stick with U.S. dollar exposure. The Federal Reserve will still be the first central bank to hike interest rates, even if it doesn't happen until much later this year.
- Energy may present an opportunity, but we aren't there yet.

RICHARDSON GMP

Contributors

Craig Basinger, CFA
Chief Investment Officer

James Price, CFA
Director, Capital Markets Products

Gareth Watson, CFA
Director, Investment Management Group

Derek Benedet, CMT
Research Analyst

Chris Kerlow, CFA
Research Analyst

Joey Mack, CFA
Director, Fixed Income
GMP Securities L.P.

www.ConnectedWealth.com

Q

Before we look ahead, how have your investment themes for 2015 held up in the first quarter?

A

Our key theme for 2015 was for a year of divergence amongst central banks, leading to an increase in volatility as markets digested monetary policy changes. This theme developed nicely in Q1 as the Federal Reserve hinted that interest rate hikes may come in 2015, while the European Central Bank (ECB) finally plunged into a larger than expected quantitative easing (QE - bond purchasing) program about six years after the first round of QE started in the U.S. With lower energy prices and inflation levels, we also saw a number of other central banks cut interest rates. Canada was not immune to this trend as we'll explain later, and we eased monetary policy as well. We didn't see that one coming, though. While volatility settled as the quarter progressed, the VIX volatility index still remains higher than levels seen last summer, matching our theme of expecting choppier markets.

We thought that the U.S. equity markets and dollar were still attractive entering 2015 and Q1 supports this thesis. U.S. equities easily outperformed the S&P/TSX Index in Canadian dollar terms thanks mostly to a strengthening greenback, which continues its run. We also thought Europe was worth another look and thanks to a winning combination of cheap credit, a lower Euro, and fewer calls for austerity, Eurozone benchmarks had a remarkable Q1.

We predicted that U.S. bond yields would finish the year marginally higher thanks to higher growth expectations and, while wrong for now, we remain committed to that outlook. This one is on track to be a miss, but we stick with the original call as the deflationary fears should ebb as QE starts to take effect.

On energy, we predicted the oil glut would be around for a while. WTI crude oil price performance thus far supports that call, although Q1 has seen stabilizing oil prices. We reiterate that there will likely be an opportunity for investors in the energy space sometime this year.

Q

The Bank of Canada surprised the markets in January. What was the rationale behind the rate cut and can we expect further cuts this year?

A

To address this question, let's first take a look at the mandate of the Bank of Canada (BoC). Without getting too technical, interest rate policy in Canada focuses on two main factors: 1) keeping inflation within a targeted band of 1% to 3% and 2) maintaining a flexible exchange rate (otherwise known as a floating dollar). We can also provide a generalization that when the economy is very strong the central bank is more likely to raise rates; whereas a struggling economy is stimulated by rate cuts.

Now let's review what happened on January 21st as the BoC announced that it was cutting the overnight lending rate from 1.0% to 0.75%. While energy sector weakness was acknowledged as one of the main reasons for the cut, the BoC also noted "outside the energy sector, we are beginning to see the anticipated sequence of increased foreign demand, stronger exports, improved business confidence and investment, and employment growth". So the central bank highlighted that the Canadian economy was doing well excluding the energy sector, but had been taken off its trajectory thanks to oil and natural gas weakness and that stimulus was required to get that trajectory back on target.

Knowing what happened and what influences BoC decisions, let's take a closer look at those two factors starting with inflation. The most recent reading of the Consumer Price Index (CPI) in Canada showed a 1.0% increase in prices year-over-year, right at the lower end of the targeted band after being firmly at 2.0%+ for most of 2014 having last exceeded the upper 3.0% band back in 2011. One of the reasons for the recent decline has been weakness in oil and gas prices. Prior to January's rate cut the year-over-year CPI stood at 2.0%. But only two days after interest rates fell, monthly inflation data was released showing that the rate had fallen to 1.5%. So with CPI falling and close to the lower end of the targeted band, it is possible that the BoC moved to protect the lower bound of its inflation target.

When we take a look at the currency, the Canadian dollar closed at U.S. $0.825 the night before the rate cut after reaching a high in 2014 of U.S. $0.941. Following the rate cut the loonie continued to decline as economists, who once expected no interest rate cuts this year, are now expecting as many as three in 2015 resulting in the Canadian dollar falling to a recent low of U.S.$0.782. While the BoC does not target a specific exchange rate with the U.S. dollar, a lower loonie can stimulate foreign investment in the Canadian economy by making our exports less expensive and more attractive to foreign buyers. In other words, a good reason to cut interest rates. After all, many Canadians will remember how strong our export and manufacturing sectors were back at the beginning of the millennium when the loonie traded as low as U.S. $0.62.

Canadian inflation well under control

Source: Bloomberg

A horrible time to be a loonie

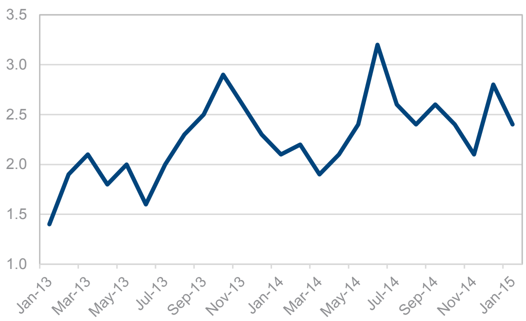
Source: Bloomberg

So why did the Bank of Canada cut interest rates in January? Because rapid cutbacks in energy sector expenditures lowered estimates of economic growth and the central bank decided that with inflation falling it was in a position to help stimulate the economy more by pushing the Canadian dollar lower. So now the question remains, can we expect more interest rate cuts before the end of the year?

Q So what about economic forecasts? What factors likely influenced the BoC to downgrade its outlook?

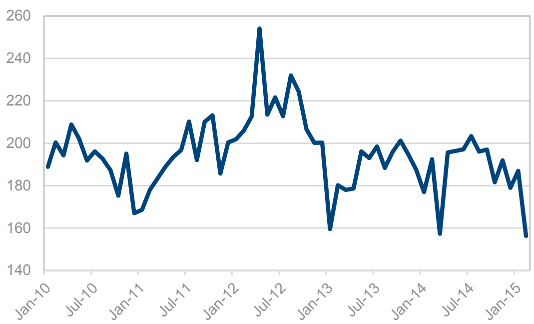
A To be blunt, economist forecasts have been all over the map, and mostly wrong. First, no cuts were foreseen at the beginning of the year. However, following January's announcement another cut was expected in March which did not materialize and economists adjusted their views yet again. Instead of looking to economists for guidance we'd prefer to look at the bond market which is currently indicating, at the time of writing, that there is a 60% chance for another 25 basis point interest rate cut before the end of the year, and a 20% chance of two cuts. Is such movement in rates justified at this time? We must remember that monetary policy tends to be forward looking and if we view current data we can observe:

Future Canadian GDP to disappoint?



Source: Bloomberg

Canadian housing starts material decline

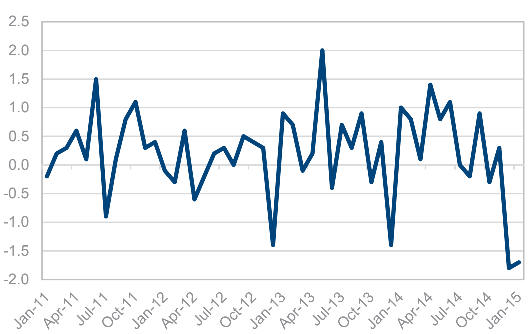


Source: Bloomberg

1. GDP growth was reasonably strong at 2.8% in the fourth quarter, but the BoC is suggesting that the first quarter is not looking good. In fact, there is some speculation the economy might contract in Q1, as the first look of January's growth revealed, but rebound somewhat in Q2 thus avoiding a technical recession. Therefore, the near term outlook for the Canadian economy is not particularly robust.

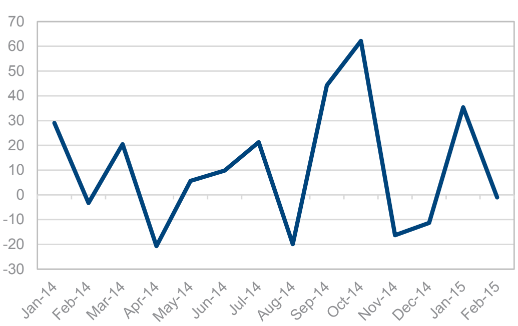
2. Housing starts have recently started to trend lower and there are concerns that weakness in the oil and gas sector are impacting housing prices in Alberta and Saskatchewan in particular. However, those concerns are currently being offset by record low mortgage rates (we've seen 2.69% on a fixed 5-year). While sales volumes may be lower in certain markets, prices are holding up reasonably well thanks to the lower borrowing costs.

Canadian retail sales
Recent trends are not constructive



Source: Bloomberg

Will the energy sector materially hurt employment?



Source: Bloomberg

3. Retail sales have declined month-over-month in four of the past six months. The U.S. consumer has de-levered, but it would appear the indebted Canadian consumer is not in a position to step up discretionary spending.

4. Offsetting these negative trends are the fact that full time employment has been positive over the past six months; however, the Canadian Association of Petroleum Producers (CAPP) recently estimated that the oil and gas sector employed approximately 550,000 people directly and indirectly in Canada, so employment levels could fall as investment in the oil and gas industry is reduced. With this data in mind, there is reason for concern in the near term for Canada. So yes, future interest rate cuts are possible.

Q

Back to rate cuts – can we expect them to have the same effect as we get closer to zero?

A

With rates already at record lows, how meaningful further cuts are in stimulating economic activity is a big question. The U.S. experience would suggest that going to zero – and then further through quantitative easing – actually works. Europe and Japan are experimenting now, so the jury is out even though Japan has failed with zero between 2000 and 2014. We also have to remember that the impact of a rate cut is not felt immediately and can take a number of quarters to finally filter through the economy and influence economic activity.

What's equally important is a recognition that interest rates are not going to increase any time soon. This is in direct contrast to what we're witnessing across the border in the United States and explains why our loonie has struggled against its American counterpart. This is true for pretty much every currency in the world, as central banks globally ease while the U.S. threatens to tighten.

Many strategists are having a hard time finding reasons to love our country; however, one saving grace is that the U.S. economy has been remarkably strong for the past year. Considering our high sensitivity to U.S. economic activity, Canada has not suffered to the extent of other commodity based economies. It has been pretty rare for the U.S. economy to power forward without dragging us along for the ride.

Even with what appears will be a dip in growth in the first half of 2015, what could help turn the Canadian economy around in the coming year?

- A falling loonie, if expected to persist, could stimulate exports and attract multinational firms to invest in Canada.
- Continued growth in the U.S. and a faster than expected economic recovery in Europe could increase demand for resources sooner than expected, pushing commodity prices higher.
- We would also mention China as a catalyst; however, the consensus outlook for 2015 is relatively neutral, so we doubt we'll see any material pick-up in economic growth this year.

Q

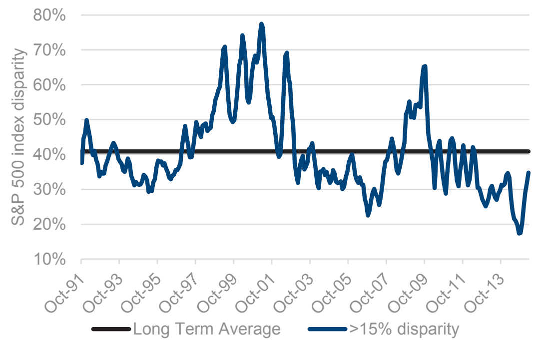
We are well into a bull market, with many agreeing the end is likely closer than the beginning. So are we starting to see leadership develop as we have in past bull markets?

A

Let's put it into perspective. From 1995 to 2000, the S&P 500 Technology sector grew in market capitalization from $354 billion to $4 trillion. That is over 11 times in more than five years. Then it came to an abrupt end and shrank to less than $1 trillion over the next two years (aka down 75%). While not as impressive in magnitude to the tech boom/bust, there were clear leaders in the 2003-08 bull market as well. Energy was almost a 3 bagger, rising from $474 billion to over $1.8 trillion. Utilities, which comprise a number of energy related companies, doubled as did Materials. Relative performance should also be considered. During the tech driven boom, the S&P rose 179% during the last five years. Ending in 2008, the S&P appreciated at much more modest 27%.

Bull markets have leaders and those leaders tend to become easily identifiable as the bull market matures. So with the current bull market in its seventh year, the leaders should be apparent. And if you believe this cycle is longer than most and has room to run, these leaders should still be embraced. If anything though, this cycle is a tricky one.

Disparity of stock performance still low but rising

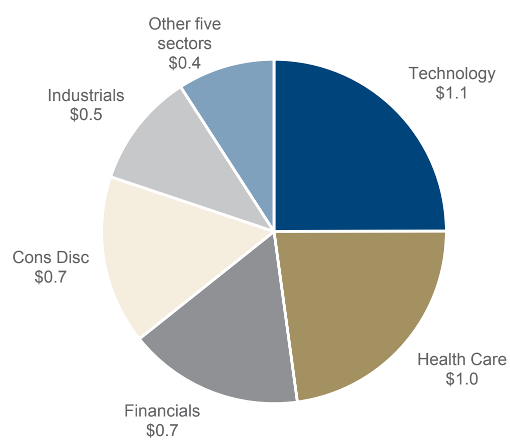


Source: Bloomberg

A number of factors have contributed to make this recovery a very homogeneous or leaderless recovery. The rise of ETFs have created blanket buying or selling, likely contributing to the lack of disparity among individual company performance. Central bankers, with all that easy money and quantitative easing have certainly contributed as this kind of stimulus lifts all boats (or sinks all boats if poorly implemented /communicated). This homogenous market, where stocks tend to move in unison, is apparent when looking at the disparity of 6-month individual stock performance of the S&P 500. From 2012-2014, the average disparity was very low by historical standards and has only recently started to move back towards the long term average, albeit still below.

This of course begs the question, who are the apparent leaders? The S&P 500 has increased in market capitalization by about $4.5 trillion over the past couple years, from $14.4 to $18.9. Let's start with who is not leading the market. Leaders have to not only be increasing in value well above the market pace but also have the size to lift the overall market. Materials, Utilities and Telcos have had a very small contribution to increased market size over the past few years and comprise very small weights, clearly not looking like market leaders. Energy has the size, but has been a laggard instead. The biggest lift to the market has come from Technology (+$1.1 trillion in value) and Health Care (+$1 trillion). Other notables include Financials (+$740 billion) and Consumer Discretionary (+$714 billion).

Tech & Health Care have done a lot of the lifting for the S&P 500



Source: Bloomberg

It is safe to say at this point in the cycle market leadership sits with Technology, Health Care, Financials and Consumer Discretionary. But given the gains, there isn't a clear leader at this point to the extent we have seen in past cycles, unless we consider sub-industries of the 10 sector groupings may be masking true leadership. Sidebar – worth noting that Technology, Health Care and Consumer Discretionary are very under represented sectors within the TSX. If you needed another reason to increase non-Canadian diversification, this would be it.

We dug into the individual sector sub groups and found some key areas that are showing some leadership. Within Consumer Discretionary the autos and auto parts have been strong performers and contributors. Within Health Care, biotechs and health care providers have been leading. The banks in Financials have lifted the most. For technology, internet software and services led the group.

As the current market cycle matures, we would expect leadership to narrow. At this point the jury is still out, but we certainly see some front runners.

Looking for more?
Check out our Market Ethos Blog on www.ConnectedWealth.com