January 18, 2013

Fiscal Cliff to Fiscal Drift

Bottom Line:

We come into 2013 feeling more optimistic than we did coming into 2012. Whereas we can't say we are bullish, we are not bearish either. Many of the short-term economic and political risks we discussed in 2012 have either been dealt with or at least set aside for the time being. We feel the slowly improving economic backdrop and the upward momentum of equity markets since November should carry forward into a positive first quarter this year. Although we are optimistic in the shorter term, we are still very aware of the tail risks that linger and we are closely watching leading indicators to be as proactive and tactical as possible.

Economic Overview:

The calendar year 2012 was a pivotal year on many fronts – economically and politically. Our cautious stance was mostly predicated on uncertainty in Europe and the effects Europe might have on the rest of the world. As Europe was sliding into a mild recession, they were also dealing with certain countries struggling with unmanageable debt levels.

Most of those problems have been put off for now. Greece did technically default on their national debt, at least partially; however, it didn't hit the headlines the way one would have thought. And so life goes on in Europe – until the next round of debt problems hits in Greece, Spain or Italy. The problems have certainly not gone away, but they have been successfully 'dealt with' for the moment.

In the US, Obama being re-elected may or may not lead to more stability going forward. The positive argument is that with all the campaigning over, perhaps the government can get back to work solving some of the country's ongoing fiscal and structural issues. Also, this being Obama's second term, he seems to be a bit more determined to push policies through – not having to worry about whether or not he will keep his job. This too could be a positive to relieving some of the backlog in much needed policy change.

One of the most discussed terms of 2012 was probably 'fiscal cliff'. We originally mentioned this in our July 2012 market commentary and as the year went on, it commanded more and more of the media's attention. In the end, the outcome was somewhat positive in our view. The US government did something, but not too much. We are all in favor of the US getting its fiscal house in order by reducing its annual budget deficit which currently stands around 7% of GDP. However, trying to tackle too much of the deficit at one time would simply push the already fragile economy back into a recession (which in turn would make the deficit actually increase). So we are happy to see that the government did enact some deficit reduction strategies, without choking off the economy. In theory, if the US can simply reduce its deficit by about 1% of GDP per year, in about five years they would be in a similar position as Canada (albeit with a much larger debt load by then).

Canada certainly has a leg up on many other countries in the world. Our economy is not growing at a great pace (about 1.9% last year), but we have some distinct advantages. First off, we have a federal debt level of roughly 35% of GDP and roughly 60% of GDP when you include all provincial government debt. Secondly, our budget deficit is roughly 1 – 2% of GDP. We know finance minister Flaherty would love to get us back to a balanced budget and even running surpluses (wouldn't we all), but running a budget deficit that is smaller than the rate the economy is growing is not a bad balance to have. Thirdly, our banking system was rock solid throughout the banking crisis of 2008 – 2009 and remains so today. And finally, our unemployment rate of 7.1% is quite reasonable, being at roughly 6% before the Great Recession began in 2008.

Any economy has its risks and for quite some time, the Bank of Canada governor Mark Carney has warned that our level of household debt is our number one risk. We have mentioned this in previous newsletters, but it is worth updating that information. In the third quarter of 2012, Canadian household debt-to-income ratio reached a fresh record high of 164.6%. This level is actually well above the level at which the US peaked out before their housing prices began to decline precipitously. However, we have read reports that this could be somewhat misleading due to the fact that Canadians pay for their health care through their taxes. This means that our disposable income is distorted relative to the US. In any event, it is very much worth watching closely.

Of course, debt (like everything else) isn't a problem until it's a problem. So what would make it a problem for Canada, our economy and even perhaps our solid banking system? The answer is most likely a precipitous decline in our own housing prices. We wrote a section on the Canadian housing market in our last commentary which you can read on our website. The Economist magazine recently ranked Canada once again as one of the most over-valued real estate markets in the world. That doesn't necessarily predict a decline, but it is something to be aware of. As it looks so far, the Canadian housing market appears to be slowing slightly and hopefully we have a 'soft landing'. This would still have an effect on our economy in the form of a drag in construction spending and jobs, but would not have the much more severe impact of affecting our banks or banking system.

The Markets & Our Strategy:

Below is the price performance summary of global equity and North American bond markets up to December 31st, 2012:

Equity Markets

Canada	Level	2012	2012 C$
S&P/TSX Composite	12434	4.0%	4.0%
S&P/TSX 60	714	4.8%	4.8%
S&P/TSX Small Cap	585	-4.9%	-4.9%
US	**Level**	**2012**	**2012 C$**
Dow Jones	13104	7.3%	4.2%
S&P 500	1426	13.4%	10.2%
Nasdaq	3020	15.9%	12.6%
Russell 2000	849	14.6%	11.4%
International	**Level**	**2012**	**2012 C$**
DAX	7612	29.1%	27.6%
FTSE 100	5898	5.8%	7.5%
Nikkei	10395	22.9%	3.3%
MSCI EAFE	1604	13.6%	10.3%
MSCI World	1339	13.2%	10.0%
MSCI EM	1055	15.1%	11.9%

Fixed Income

Indices / Rates	Level	2012	
DEX Universe Bond	894	3.6%	
DEX Real Return Bond	540	2.9%	
Mer Lynch US High Yield Master II	952	15.6%	
LIBOR 3-month	0.3060%	-47.3%	
Government Bond Yields	**3-mo T-bill**	**10-yr Bond**	**30-yr Bond**
Canada	0.92	1.798	2.365
US	0.06	1.758	2.95
Spread	0.86	0.04	-0.585

Source: TD Asset Management

After a very strong third quarter, the fourth quarter of 2012 proved to be mostly flat. We essentially alternated quarters last year with the first and third quarters being stronger and the second and fourth quarters being weaker. In the end, it was a moderately positive year for equity markets, and a below average year for government bond markets. Our S&P/TSX Composite finished up 4% on the year. For the second year in a row, we have seen the US equity markets drastically outperform our own. The S&P 500 price index is up 13.4% (in US dollars) over the last two years, whereas the S&P/TSX Composite is down 7.5%. That is a difference of almost 21% and it is not currency related as the Canadian dollar was roughly unchanged over this period. The difference primarily has to do with the fact that the Energy and Materials sectors of the TSX have not performed well. Both of these sectors are down over 20% since the end of 2010. We could very well see this change in the near future.

Globally, the MSCI EAFE Index finished the year up 10.3% (in Cdn$). The DAX (Germany) and the Nikkei (Japan) are two of the larger markets that were particularly strong. However, the latter is still far away from its most recent 2007 high.

In the bond markets, the return for 2012 was lower than we have seen in recent years. It is hard to say whether or not we have seen the end of the secular bull market in government bonds, but it is worth noting that the rate of decline in yields of late has subsided.

In terms of investment strategy, we continue to approach our portfolios with a ‘SIRP’ mindset (a term coined by economist David Rosenberg which stands for ‘safety and income at a reasonable price'). We still prefer to invest in good preferred shares yielding between 4% and 6% from companies like Artis REIT, Brookfield and Transalta. We also continue to favor the investment characteristics of Canadian corporate convertible debentures yielding between 5% and 7% - some of our favorites being Western One Equity 8.0%, Chemtrade Logistics 6.0%, Exchange Income 5.75%, and Dundee REIT 5.5%. In the equity side of the portfolio, we continue to own REITs like Pure Industrial REIT and solid dividend paying stocks like BCE, Enbridge and Atco.

We believe the SIRP strategy makes a lot of sense in developed equity markets. The European Central Bank and the US Federal Reserve seem to have put an implicit floor under the markets through various tools such as quantitative easing as we have written about in prior commentaries. On the other hand, the economic news is likely not good enough to drive a new long-term bull market. In this environment, income is a very important part of the total return picture.

One particular investment theme we are beginning to add to portfolios now is Japan. We have previously mentioned some very specific South East Asian economies that we believe are in the middle of longer term uptrends: Singapore, India, Taiwan and South Korea. We now believe that Japan may be in the early stages of a longer term uptrend of their own. It will inevitably be a bumpy ride, but if it proves correct, Japan equities may finally be breaking from their secular decline that began all the way back in 1989. One key thing to note is that we are buying their equity market but hedging out the currency risk (i.e. the risk of the Yen falling). The Japanese Yen has been relentlessly strong for many years; however we feel the risk of this trend reversing is high. The new Prime Minister of Japan, Shinzo Abe, has been very vocal about declaring a monetary regime change there and has vowed to do everything in his power to help his country emerge from its prolonged bout of deflation.

A New Year brings about new opportunities. The world's economies have become ever more complex and fast changing. It is our full time objective to stay on top of these trends and capitalize on them as they arise.

We would like to thank our clients for their continued trust in us.

Respectfully,

- **Your Milestone Team**