October 17, 2014

# *Twas the Calm Before the Storm*

*"Vows made in storms are forgotten in calm."*
*- Thomas Fuller*

***Bottom Line:***

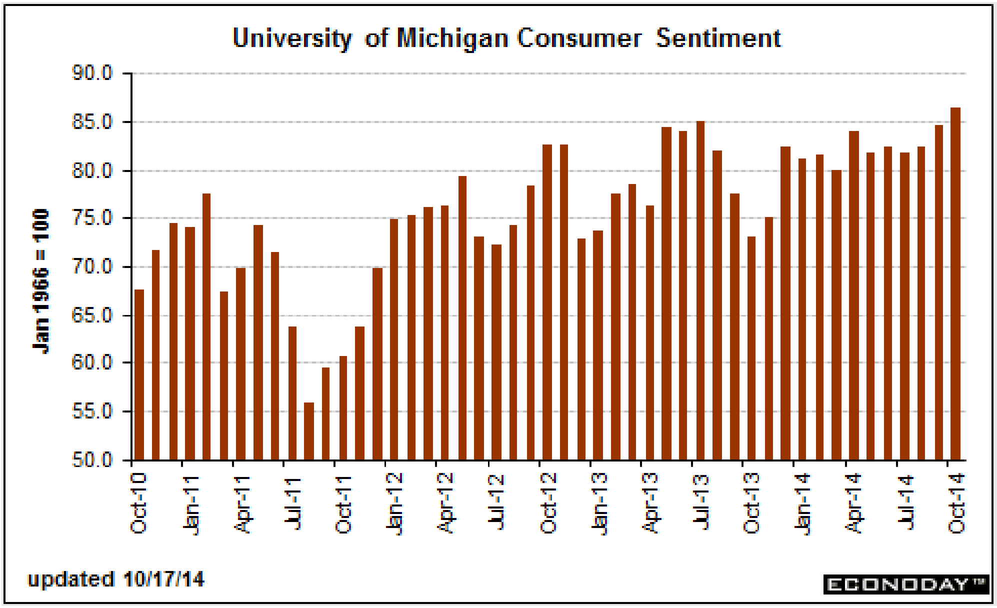
Last quarter we discussed the level of 'tranquility' we had experienced in the market place for a significant period of time. Although our outlook was positive, we noted that volatility may pick up in the third quarter as so often it does. In hindsight, this statement proved to be true but also an understatement. We have seen volatility not just rise but skyrocket higher, in just a matter of a few weeks and especially so far in October. This is the nature of the market and shows precisely why a long-term investor should maintain a diversified and balanced portfolio, and not go "all-in" on an asset class that may have been doing well recently.

Although we have seen volatility increase and equities enter into a corrective period of late, economic data out of the U.S. continues to be strong. Employment growth on a monthly basis has been well over 220,000 on average this year pushing their unemployment rate down to just 5.9% which is the lowest it has been since mid-2008. Driving this growth are falling jobless claims, whose four-week average is at its lowest level since June 2000. Other data also point to continued steady growth out of the world's largest economy. The final revision to second quarter GDP came in at 4.6% which was the highest growth rate in two and a half years, and the current median forecast for the third quarter is 3%.

There are likely numerous reasons for the recent rise in volatility, but some of the more prominent ones are likely a built up overbought market in need of a setback to release an over-bullish sentiment, continued geopolitical tensions out of Russia and the Middle East, the Ebola virus in West Africa, the meteoric rise in the U.S. Dollar and its negative effect on foreign markets and some recent deflationary economic data out of Europe.

Tony Dwyer, Canaccord Genuity's U.S. Portfolio Strategist, has been known to remark, "corrections are only considered natural, normal and healthy until they actually happen". At present, we continue to remain positive on equity markets and the economy in the medium to long term based on the strengthening U.S. economy and strong corporate balance sheets and profit growth in North America. We believe that we are likely more than two-thirds of the way through this correction, and that this is a cyclical correction within a secular bull market that is not over. We do not currently foresee a U.S. recession, nor do we see a global recession.

The U.S. consumer is also feeling very good as reflected in this month's widely followed University of Michigan Consumer Sentiment figure. It came in at 86.4 which is a new recovery high and best since July 2007. Of importance as a leading indicator, the expectations component of the index is where the bulk of the gains were, rising to its best level since October 2012.



Source: Bloomberg, Econoday

In addition, the yield curve remains steep which will aid in keeping any recession risk off the table for the time being. We may see some continued weakness in the short-term, which should provide good opportunities for the long-term investor.

Looking forward we have reason to be optimistic for the next year in U.S. equity markets. 2015 is year three of the U.S. Presidential Election Cycle which typically bodes well for the equity markets (see chart below). Anecdotally what takes place in year three is that the current administration endeavors to spur the economy in order to seduce voters in to re-electing that same party back in to power. Clearly economic and geopolitical signals could override this pattern but at this point, it could provide a tailwind for the markets.

**Stock Market Return by U.S Presidential Term Year**

**1948-2008**

| Year | Average Annual Return |
|---|---|
| 1 | 7.41% |
| 2 | 10.21% |
| 3 | 22.34% |
| 4 | 9.79% |

Source: S&P 500 Total Return Index

***Economic Overview:***

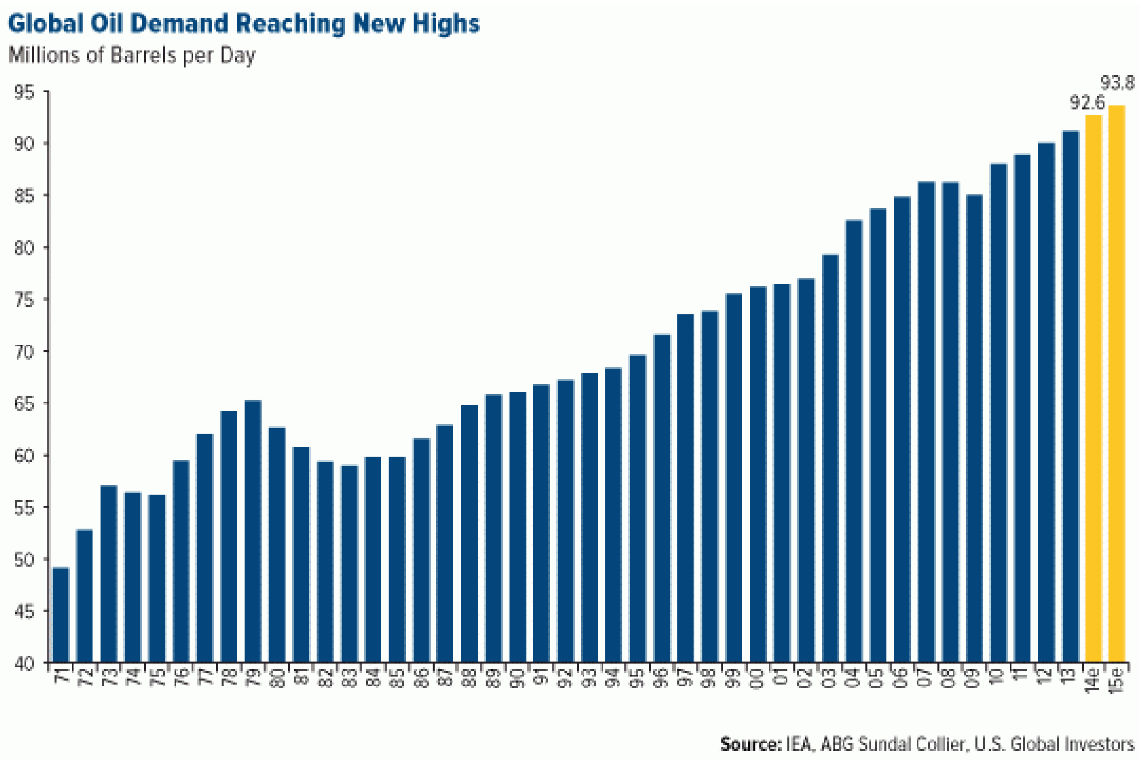
There are a plethora of issues that have hit the news of late. This is normally the case when volatility picks up, or more likely the reason for it.  Here are a few that are of interest to us:

*Oil Prices*

Perhaps the issue that hits the most at home is the recent waterfall-like collapse in the price of oil from well over $100USD back in June to as low as $80USD today.  Although Calgary is far more diversified in business than it once was, it is still resource city and the decline in the Energy stock sector has been alarming.  Most, including us, did not foresee such a steep decline.

It should be noted that lower oil prices is a double edged sword in that on one hand it is good for the consumer's pocket book, but not so good for the O&G business sector if prices stay low for a sustained period of time.

There are those who seem to believe the recent decline is due to declining demand.  This may be true in the short-term, but the overall picture of global demand for oil appears on track to continue its rise to new highs.  The following chart from the U.S. Energy Information Administration shows the rise in demand has been unrelenting through recessions, bull and bear markets, and looks set to continue this fairly steady rise.



The more likely factor is the supply side, where we have seen a U.S. shale drilling boom with domestic production hitting close to 9 million barrels a day. This is approximately a million barrels higher than just one year ago and the highest level in a quarter century. With this rise in production, the amount of imports from OPEC countries has been cut in half over the past five years, forcing them to compete with one another in Asia with recent price cuts. In addition, the U.S. is not the only country with increased production.

On the demand side, we are seeing an affect from the slowdown in Europe and then in Japan where the use of oil by utilities is being replaced by natural gas and coal. If we see the resurgence of nuclear plants next year in Japan as forecasted this demand could decline even more.

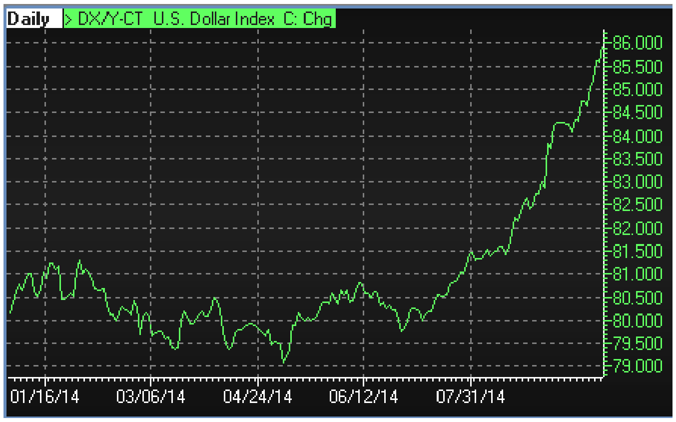
The recent oil price decline, being such a short period of time, has not had a major impact yet on production. However, if prices continue to drop or stay low longer, we will likely see production come off line and new development, production and drilling investment halted. In fact, according to a report from U.S. Global Investors and Deutsche Bank, with prices in the $80 to $90 range, there is roughly 650,000 barrels per day of production that needs to be supported at that level. Therefore, if we see sustained price below $80, we will likely see a significant drop in the supply of oil.

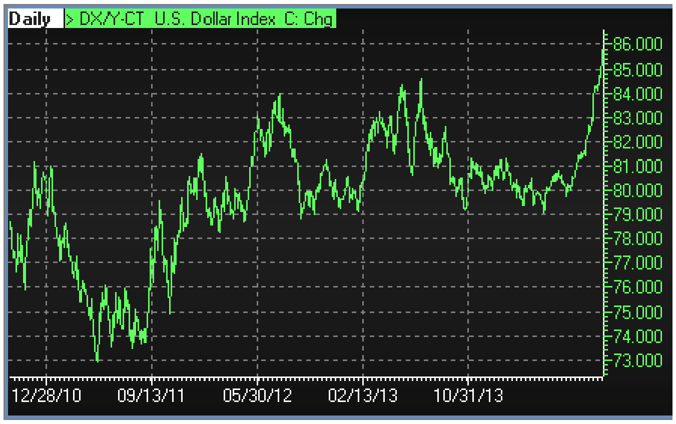
In addition, OPEC countries meet again in November, and we may see another cut in production to maintain their budgets. According to the same report, the world's two largest exporters of crude oil, Saudi Arabia and Russia (non-OPEC) have Brent breakeven prices of $95USD and $100USD respectively.

We feel this should all together act as a strong floor and support for oil prices at around $80USD. We are already there.

*The Rise of the US Dollar*

Another issue affecting us here at home is the recent rise of the U.S. Dollar. Just this past quarter, we have seen the Loonie fall rapidly from $0.94USD in July to as low as $0.88USD today. Looking back even further, it was as high as $1.06USD in July 2011. Most of us don't worry about this too much on a day-to-day basis, other than the fact that it costs us more to vacation down South. But there is a larger global effect to this. The Euro has fallen from about $1.55USD in March to as low as $1.40USD recently, and the Yen is in a similar situation with about a 10% short-term decline. The U.S. Dollar Index is now at its highest level in over four years. The following are year-to-date and four-year charts.




Source: Thomson Reuters

What does this all mean? The rise in the U.S. Dollar has mostly likely been propelled by the prospects of stronger economic growth and rising interest rates relative to most other major developed countries. And according to leading indicators, this divergence of growth against the rest of the world (particularly Europe and Japan) is likely to continue.

This is mostly good news for domestic bond investors as a strong dollar keeps inflation down by reducing the cost of imported goods and makes U.S. investments more attractive to foreign investors. In fact, the difference in yield between U.S. and German two-year notes has widened to an all-time level (U.S. yield being much higher). With the U.S. Federal Reserve ending its Quantitative Easing program, and with Europe likely stepping on the stimulus pedal even more, we could see a further widening of yield spreads in the future increasing the demand for U.S. debt. As a Canadian investor looking to diversify their fixed income portfolio, this should keep U.S. bonds as a more attractive alternative to foreign bonds for some time.

While we see the U.S. dollar likely remaining strong in the short-term, with projected annual deficits of $780 million per year for the next ten years and with rates rising at some point in the not-so-distant future, that strength may not prove to be long-lasting.

*Europe – Deflation?*

Some of the more worrisome economic data of late has come out of Europe. There were some indications and signs earlier this year that they were slowly climbing out of their funk, but these hopes have hit a setback. The European Union's ongoing battle to avoid deflation (declining consumer prices and wages) took a turn for the worse in September, with the annual rate of inflation for the twenty-eight member bloc hitting a five-year low at 0.4%. In fact, eight of the member posted a negative reading.

At this point, Europe as a whole is not in a period of outright deflation although there are pockets; however, the fear for economists and investment strategists is that consumer and businesses will postpone purchases of goods and services in anticipation of lower prices in the future. This expectation can spiral out of control, and this potential is what has caused most European equity markets to be some of the poorest performers this year.

At the center of this issue is Germany due to the fact it is the largest economy in Europe. Germany has been an engine driving much of Europe's growth but with the blowback of Russian economic sanctions against Europe, Germany is now approaching stall speed. In recent months, the European Central Bank (ECB) has lowered interest rates to record lows, offered banks new long-term loans and announced plans to buy private sector assets. The U.S. Treasury Department has issued statements saying Berlin can do more to help Europe and boost demand in the region.

With the recent economic data, there is now increased pressure on the ECB to act. Due to the actions we have seen from central banks around the world up to this point (U.S. and Japan), we see no reason to believe that action won't be taken to further stimulate the region. With equities already at much lower valuations than here, there could be selective opportunities at this point.

***The Markets & Our Strategy:***

Below is the 2014 performance summary of global equity and North American bond markets to October 4th, 2014:

| Equity Markets | | | | |
|---|---|---|---|---|
| **Canada** | **Level** | **Wkly Chg (%)** | **YTD** | **YTD C$** |
| S&P/TSX Composite | 14790 | -1.6% | 8.6% | 8.6% |
| S&P/TSX 60 | 856 | -1.6% | 9.2% | 9.2% |
| S&P/TSX Small Cap | 625 | -3.1% | 2.4% | 2.4% |
| **US** | **Level** | **Wkly Chg (%)** | **YTD** | **YTD C$** |
| Dow Jones | 17010 | -0.6% | 2.6% | 8.6% |
| S&P 500 | 1968 | -0.8% | 6.5% | 12.7% |
| Nasdaq | 4476 | -0.8% | 7.2% | 13.4% |
| Russell 2000 | 1105 | -1.3% | -5.1% | 0.5% |
| **International** | **Level** | **Wkly Chg (%)** | **YTD** | **YTD C$** |
| DAX | 9282 | -2.2% | -2.8% | -6.3% |
| FTSE 100 | 6528 | -1.8% | -3.3% | -1.2% |
| Nikkei | 15709 | -3.2% | -3.6% | -2.1% |
| MSCI EAFE | 1792 | -3.4% | -6.4% | -1.0% |
| MSCI World | 1675 | -1.9% | 0.9% | 6.8% |
| MSCI EM | 997 | -2.6% | -0.5% | 5.3% |

| Fixed Income | | | |
|---|---|---|---|
| **Indices / Rates** | **Level** | **Wkly Chg (%)** | **YTD** |
| DEX Universe Bond | 939 | 0.4% | 6.3% |
| DEX Real Return Bond | 528 | 0.8% | 12.6% |
| Mer Lynch US High Yield Master II | 1065 | 0.7% | 4.2% |
| LIBOR 3-month | 0.2316% | -0.6% | -5.9% |
| **Government Bond Yields** | **3-mo T-bill** | **10-yr Bond** | **30-yr Bond** |
| Canada | 0.92 | 2.094 | 2.608 |
| US | 0.01 | 2.435 | 3.124 |
| Spread | 0.91 | -0.341 | -0.516 |

*Source: TD Asset Management*

Equity markets around the world took a big setback in September. However, it would be remiss not to talk about the first half of October at the time of this writing due to the fact that the selloff has accelerated sharply. Although the TSX Composite was up 8.6% after the third quarter, by mid-October that number slumped down to less than 2%. In the U.S., we have seen the S&P 500's 6.5% gain drop down to less than 1% and the Dow Jones Industrial Average actually go negative for the year.

Internationally, the MSCI EAFE index was down over 6% after the third quarter and that swelled into double digit territory by mid-October. This is a similar situation for Japan's index. The MSCI Emerging Markets index has held up a bit better.

With the equity correction in force, we have seen long-term bond yields drop significantly, helping boost year-to-date returns for government and investment-grade bonds. The DEX Universe Bond index is now up over 6% to the end of the quarter and well over 7% recently. This is one of the more glaring discrepancies this year between what economists and strategists were predicting for 2014 and what has actually occurred. Most felt long-term rates would slowly rise this year, however, we have seen the opposite and significantly so. There has been an inverse effect on high yields bonds, however, which are only up about a third as much as the higher grade index.

Our Loonie is down over 5% against the greenback, and therefore, from a Canadian perspective this has been an aid for any global unhedged portfolio exposure. Gold is up slightly so far this year and the price of Oil (WTI) has declined over 7% to the end of the third quarter and another 10% decline into mid-October.

To reiterate our stance in the opening, we believe we are currently in a corrective period within an ongoing bull market and our strategy is based on this longer-term thesis. At this point, we have yet to see our medium to long-term indicators deteriorate near a level that changes this stance. However, we will be watching our indicators closely and will make adjustments as necessary.

We continue to monitor economic data as it arrives, primarily leading indicators, in addition to sentiment and market internals. Our investment decisions are based on a full market cycle and we continue to maintain globally diversified and balanced portfolios with a focus on capital preservation and risk-adjusted returns, while maintaining a solid income yield for our clients.

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

Respectfully,

- **Your Milestone Team**

*"One of the funny things about the stock market is that every time one person buys, another sells, and both think they are astute."*

*- William Feather*

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