



MILESTONE COMMENTARY

January 21, 2015

A Tale of Two Markets

"It was the best of times, it was the worst of times..."
- Charles Dickens

Bottom Line:

We thought this quote from Charles Dicken's classic, *A Tale of Two Cities*, best describes how Canadian (or perhaps Alberta) investors likely feel about equity returns and the economy in 2014, and particularly the last quarter of 2014.

On one hand you have the S&P500 and the NASDAQ in the U.S. rising 11.4% and 13.4% in addition to a currency rise of almost 10% versus the Canadian dollar, and on the other hand you have the S&P/TSX Composite rising 7.4% but with the S&P/TSX Capped Energy Index falling close to 20%. This last number does not tell the full story however, as many small to mid-cap resource names we are familiar with here in Alberta experienced price declines far worse. In addition, the TSX Composite performance was dominated by the large caps, as the S&P/TSX Completion index (TSX stocks not including the 60 largest) only rose 2.8% on a price basis.

The Energy sector's performance is indicative of the collapse in oil prices from over \$100US/barrel to under \$50US. We most certainly did not see this coming, nor did anyone for that matter; known in the industry as a 'black swan' event. It is in times like these, global diversification is highly beneficial, which is fortunately how our portfolios are broadly managed. Although we can't say our portfolios have not been affected by the slide in oil, we can say that the damage has been limited.

On the economic landscape, you have this same best and worst of times disparity with the U.S. economy continuing to strengthen while the Canadian economy weakens of late. Fortunately the U.S. is our largest trading partner, so as a whole we feel North America is the leader of growth for developed countries around the world.

From a longer term perspective, we continue to believe that we are in cyclical bull market that remains intact. There is definitely no shortage of global economic and geopolitical concerns, so caution is warranted here at least in the short-term. However, since 2009, markets have continued to climb the proverbial wall of worry so these concerns are a normal process for bull markets. With a vastly improving economic landscape south of the border, we are optimistic that the current cycle has a ways to go.

Economic Overview:

Oil Prices & Energy Market

The energy theme is one that we discussed in our last commentary, but we feel it worthy of revisiting as the trend has not just continued but intensified to a historic degree. At the end of the third quarter we commented that there was a pretty strong shelf of support for oil at the \$80US/barrel level in line with the 2011 and 2012 weekly lows. This turned out to be only the beginning as oil slid through this level and dropped another \$25 to the low \$50s in just a month's time.

This has stirred the debate about whether this is a demand or a supply issue. The answer is that it is likely both, as we have seen global growth slow more than expected. Recently the International Monetary Fund downgraded its GDP projections for global growth by 0.3% in each of the next two years, predicting 3.5% growth for 2015 and 3.7% growth for 2016. However, they note that most of the momentum is coming from an accelerating recovery in the U.S.

Last quarter we showed a chart that shows demand for oil has increased every year since 1983 (except the 2009 recession) and that trend is likely to continue for the foreseeable future. However, the demand growth of late has definitely slowed, along with supply growth outstripping this demand. It is possible the recent price decline has been more a supply issue, with the well-publicized U.S. shale boom and other international OPEC and non-OPEC oil countries not curtailing production to any degree. Saudi Arabia, the world's largest producer, seems to believe they can weather this storm longer than others as a low cost producer. There is an equilibrium at some point however. If prices remain at these levels (or slip further) for a long period of time it would have a definite negative impact on the Saudi budget which requires much higher levels of oil to sustain their social programs.

It is difficult to say where this equilibrium price is and where prices will go from here, but the International Energy Agency (IEA) recently stated "The global energy system is in danger of falling short of the hopes and expectations placed on it. The short-term picture of a well-supplied oil market should not disguise the challenges that lie ahead as reliance grows on a relatively small number of producers."

Canaccord Genuity's U.S. Portfolio Strategist, Tony Dwyer, recently made a very interesting observation about the current oil market in relation to history. Since West Texas Intermediate began trading in 1983 there have only been two other similar collapses in non-recessionary periods like we are in today. These are the 69% decline over a five months span in 1985-1986 and the 1996-1998 drop of 61%. The first instance was a result of Saudi Arabia trying to maintain market share and force non-OPEC producer shutdowns through overproduction. The second instance was a period of slowing global growth, a rising U.S. dollar and accelerating U.S. economic growth, in conjunction with the one-two punch of slowing corporate profit growth and expanding equity valuations.

Both of these cases have similarities to today in terms of characteristics, of being non-recessionary periods and also in terms of the magnitude of the price decline. It was only in

1986 did we see a 10-week drop as substantial as the current drop. We saw a sharp rebound in the price of oil over the next year in both of these previous times. We are definitely not forecasting a similar result this time as there are clear and real reasons for the current price of oil, many of which don't seem to be going away any time soon. History rarely repeats itself but it is interesting nonetheless to look at the past to perhaps help determine what may lie ahead.

Figure 1: Non-recession WTI oil price declines since 1983



Source: Bloomberg, Canaccord Genuity Estimates

The U.S. Dollar and Interest rates

The U.S. dollar and interest rates also seem to be a tale of two markets in terms of direction. You have one continuing to rise at what seems to be an accelerating pace, and you have the other falling rather quickly. We should note that the current decline in long-term government bond yields in the U.S. and Canada is also a big surprise to many. In fact, at the beginning of 2014, we only know of one well-known bond manager and strategist that forecasted a decline in rates, and almost all economist polled by Bloomberg had rates either holding steady or rising in 2014.

We have seen the U.S. 10-Year Treasury rate decline from a little over 3% at the end of 2013 to as low as 1.7% at the beginning of 2015. The Canadian rate has similarly dropped from about 2.8% to less than 1.5% early this year. Here in Canada and in the U.S., many of us think of these levels as extremely low, and that is very true from a historical perspective. However, these rates are actually quite high compared to the other developed countries. As you can see from this January 12th Bloomberg chart from DoubleLine Capital, German Bonds have dipped below 0.5% (yellow line) while Japanese and Swiss Bonds are down in the 0.30-0.20% range (green and pink lines). Of interest, in the last few days the Swiss 10-year yield has actually dipped below zero. This is no doubt shocking and a reflection of strong deflationary stresses in Europe. As Jeffrey Gundlach of DoubleLine Funds recently said, “this might be the chart of the year.”

US, German, Japanese and Swiss 10 Year Yields



Source: DoubleLine Capital, Bloomberg

The world of currencies is complex and there are many reasons for the current rise in the U.S. dollar. Many of our clients have wondered why our dollar is falling against the U.S. dollar to such a degree. We think it is best to look at it more in the sense that the U.S. dollar is rising against most currencies around the world, and thus it is not so much a factor of a weak Loonie. The U.S. Dollar surge is due to the fact that their economy is the strongest in the developed world with accelerating growth, as opposed to decelerating or even negative growth in Europe and Japan. In addition, for seekers of safe havens, U.S. is still at the top of the food chain and still the reserve currency of the world. Would you prefer a 10-year bond earning 1.9% (U.S.) or

a 10-year bond earning 0.5% (Germany)? Perhaps this flow of capital seeking safety, economic strength and higher long-term interest rates is another factor in the U.S. Dollar strength.

We would be remiss not to mention that at the time of this writing, the Bank of Canada surprised the markets and lowered its overnight bank rate from 1% to 0.75% citing the economic threat posed by plunging oil prices. This has pushed the Loonie even lower. The purchasing power parity (PPP) of the Loonie over the last few years has been around 80-81 cents, which is where the Loonie actually stands today. This is a decline of 23% over the last three and half years from the peak in mid-2011. The Canadian dollar tends to converge toward PPP over the long-term, and this time is no different. However, these relationships also tend to overshoot the mark in both directions. In the past, secular bear markets for our dollar have averaged declines of 30%, which suggests we very well may have more potential downside here, perhaps towards the 75 cent level or lower.

The Markets & Our Strategy:

Below is the 2014 performance summary of global equity and North American bond markets:

Equity Markets			
Canada			
	Level	2014	2014 C\$
S&P/TSX Composite	14632	7.4%	7.4%
S&P/TSX 60	855	9.1%	9.1%
S&P/TSX Small Cap	579	-5.2%	-5.2%
US			
	Level	2014	2014 C\$
Dow Jones	17823	7.5%	17.6%
S&P 500	2059	11.4%	21.9%
Nasdaq	4736	13.4%	24.0%
Russell 2000	1205	3.5%	13.3%
International			
	Level	2014	2014 C\$
DAX	9806	2.7%	-1.1%
FTSE 100	6566	-2.7%	0.1%
Nikkei	17451	7.1%	2.9%
MSCI EAFE	1775	-7.3%	1.4%
MSCI World	1710	2.9%	12.6%
MSCI EM	956	-4.6%	4.3%

Fixed Income			
Indices / Rates			
	Level	2014	
FTSE TMX Canada Universe Bond	961	8.8%	
FTSE TMX Canada Real Return Bo	531	13.2%	
Mer Lynch US High Yield Master II	1048	2.5%	
LIBOR 3-month	0.2556%	3.9%	
Government Bond Yields			
	3-mo T-bill	10-yr Bond	30-yr Bond
Canada	0.92	1.788	2.335
US	0.02	2.172	2.752
Spread	0.90	-0.384	-0.417

Source: TD Asset Management

There was a vast array of results from all parts of the world in 2014. The U.S. equity market continues to be the world leader hitting new all-time highs numerous times throughout the year. The S&P500 rose over 11% and the Dow Jones gained 7.5%. Our S&P/TSX Composite was above average rising 7.4%, but if you look overseas the results were much more mixed. The MSCI World index rose 2.9%, reflecting a mediocre year at best for global equities. Internationally, some of the best performers were the Nikkei (Japan) up 7.1%, the Sensex (India) up about 30% and the Shanghai Composite (mainland China) up over 50%. On the other hand, the FTSE 100 (UK) fell 2.7%, the MSCI AC Europe index dropped almost 10% and the Emerging Markets index declined close to 5%.

The Bond markets were the final tale of two markets. With great surprise to many, long-term government bond yields continue to slide. The result was a strong year for the FTSE TMX Canada Universe Bond posting an 8.8% total return. The other side of the tale was a struggling high yield market with a flight to safety resulting in the ML US High Yield Index returning just a 2.5% total return. In Canada the picture has been more somber, where the energy market comprises a large portion of our debt market, resulting in negative returns for many high yield bond managers in Canada.

On the currency front, the Canadian dollar declined close to 10% against the Greenback. Of particular interest, the Euro and Yen continue their slide against the US Dollar, both down 12% and 14% respectively on the year.

In the commodities space, we have discussed oil prices at length, but in other areas we had Natural Gas prices drop 32%, Gold decline 1.5% and Copper decline 17% in 2014. Lastly, we also witnessed lumber and agriculture prices drop for the most part.

To reiterate our stance in the opening and affirming what we suggested last quarter, we believe we are currently in a corrective period within an ongoing bull market and our strategy is based on this longer-term thesis. Our medium to long-term indicators, primarily determined by the U.S. Market, have not deteriorated to change that positive stance and thus our asset allocation weightings remain the same. With some caution warranted at the moment, 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**

“The pessimist complains about the wind;
the optimist expects it to change;
the realist adjusts the sails.”

- *William Arthur Ward*

CANACCORE Genuity
Wealth Management

 **milestone**
ASSET MANAGEMENT

Canaccord Genuity Wealth Management is a division of Canaccord Genuity Corp., a Member of the Canadian Investor Protection Fund, the Investment Industry Regulatory Organization of Canada (IIROC) and the Toronto Stock Exchange (TSX). Independent Wealth Management advisors are registered with IIROC through Canaccord Genuity Corp. and operate as agents of Canaccord Genuity Corp.

This newsletter is solely the work of the author for the private information of clients. Although the author is a registered Investment Advisor at Canaccord Genuity Corp., this is not an official publication of Canaccord Genuity Corp. and the author is not a Canaccord Genuity Corp. analyst. The views (including any recommendations) expressed in this newsletter are those of the author alone, and are not necessarily those of Canaccord Genuity Corp.

The information contained in this newsletter is drawn from sources believed to be reliable, but the accuracy and completeness of the information is not guaranteed, nor in providing it do the author or Canaccord Genuity Corp. assume any liability. This information is given as of the date appearing on this newsletter, and neither the author nor Canaccord Genuity Corp. assume any obligation to update the information or advise on further developments relating to information provided herein. This newsletter is intended for distribution in those jurisdictions where both the author and Canaccord Genuity Corp. are registered to do business in securities. Any distribution or dissemination of this newsletter in any other jurisdictions is prohibited. The holdings of the author, Canaccord Genuity Corp., its affiliated companies and holdings of their respective directors, officers and employees and companies with which they are associated may, from time to time, include the securities mentioned in this newsletter.