Quiet Counsel

Winter 2016
Investment Outlook

like what you see.

What We Expect in 2016 and Beyond

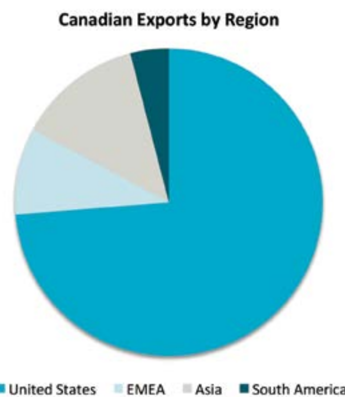
The Canadian Economic Backdrop

Historically, the Canadian economy and its capital markets have been highly correlated to those of the United States. Similarly, Canadian interest rates prior to 2015 were over 90% correlated with those of the U.S. This is not surprising given how intertwined the Canadian and U.S. economies are, with approximately 75% of Canadian exports going into the United States. (Figure 1)

Today, however, we are seeing a divergence. The U.S. economy is growing at twice the pace of the Canadian economy. This deviation has led to the current monetary environment where the US is tightening its monetary policy by raising interest rates while Canada is loosening theirs.

When assessing recession risks in Canada it is worth noting that Canada has never had a truly "Made-In-Canada" recession without being accompanied by recession in the United States.

Footnote: CIBC Avery Shenfeld: "Odds of Recession: What the Stats Are Saying" (January 2016)



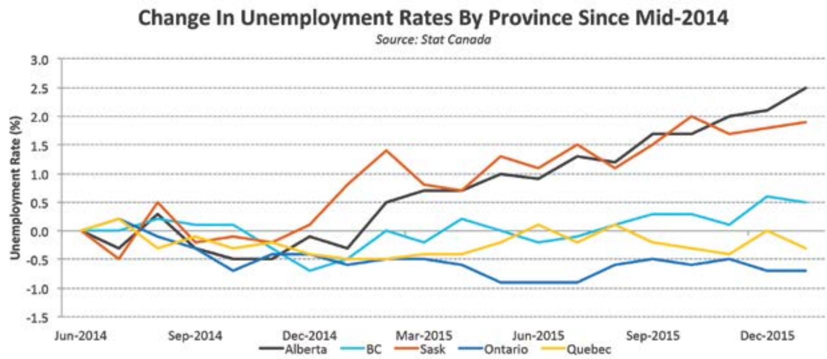
(Figure 1)

Toronto Office Opening

We are very pleased to announce the opening of Leith Wheeler's Toronto office and the addition of Marcel Leroux to our team. We have had the pleasure of knowing Marcel for the last 20 years and are confident he will be a great fit for our clients. Please see the back cover of this newsletter for our Toronto office contact information.

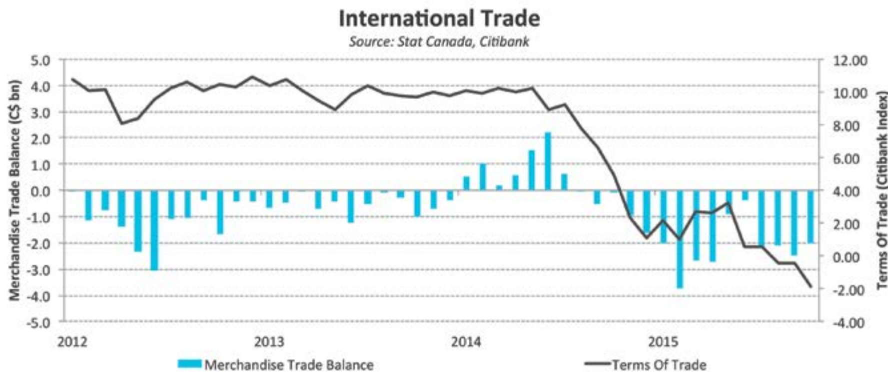
Download previous newsletters, and read some of Our Ideas online at:
LeithWheeler.com

Though the Canadian economy is highly correlated with that of the United States, as an oil producing country, the effects of lower oil prices has a profoundly different effect on our economy. In Canada's oil producing provinces, in particular, the impact has started to materialize with a notable rise in unemployment rates in Alberta and Newfoundland, and slowing or even declining property prices. (Figure 2)

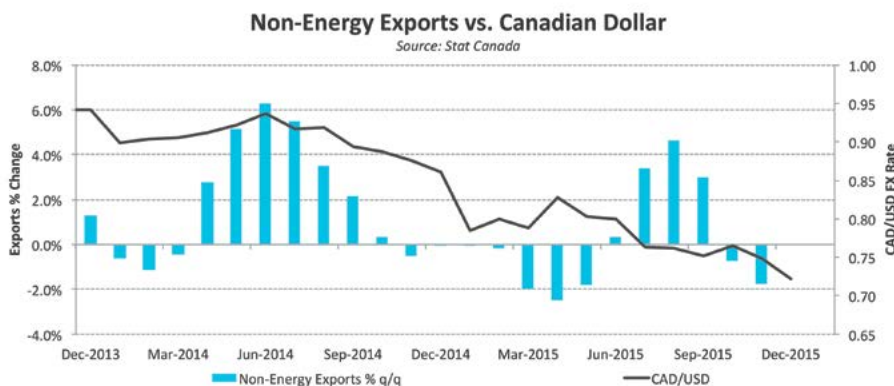


(Figure 2)

The impact of lower energy prices has also resulted in a significant shock to Canada's terms of trade, pushing Canada's monthly trade balance into deeper deficits.
(Figure 3)



(Figure 3)



(Figure 4)

Although lower oil prices also hurt U.S. oil and gas producers, they benefit the U.S. consumer in terms of increased savings and disposable income. The U.S. consumer accounts for 70% of U.S. Gross Domestic Product (GDP), rendering the United States a net beneficiary when oil prices decline.

In anticipation of the impact to Canadian household incomes and jobs from lower oil prices, the Bank of Canada lowered interest rates twice in 2015. Importantly, this was in stark contrast to the market's anticipation of the interest rate hike from the Federal Reserve in late 2015, its first since the global financial crisis in 2008. The effect was to put significant downward pressure on the exchange rate, with the Canadian Dollar depreciating to C$1.4690 (US$0.6808).

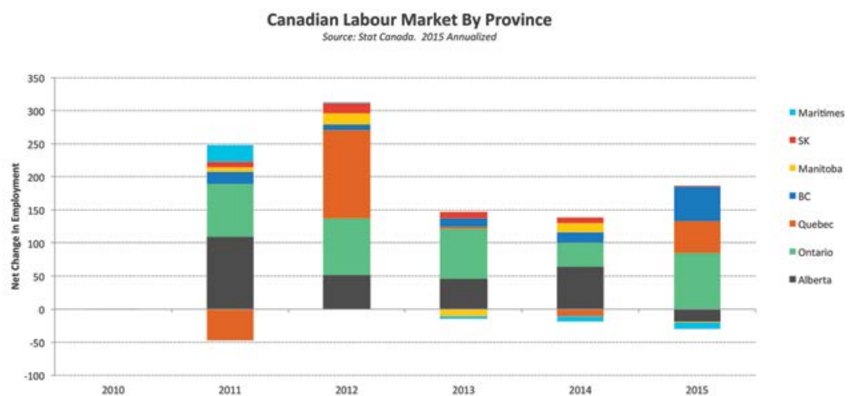
The weaker currency in Canada was intended to help revive some of the country's non-energy sectors, particularly manufacturing. So far, however, evidence of a rebound in non-energy exports has been limited. (Figure 4)

We believe this is partly the result of Canada's relatively high unit labour costs versus its major export competitors such as the United States and Mexico.

In addition, almost all of the currency adjustment since mid-2014 was in the form of U.S. Dollar appreciation versus many currencies, rather than Canadian Dollar depreciation. Although this adjustment still helps Canadian exporters versus domestic competitors in the United States, the Canadian Dollar has not significantly depreciated when compared to its other major trading partners such as Mexico or Europe. (Figure 5)

(Figure 5)

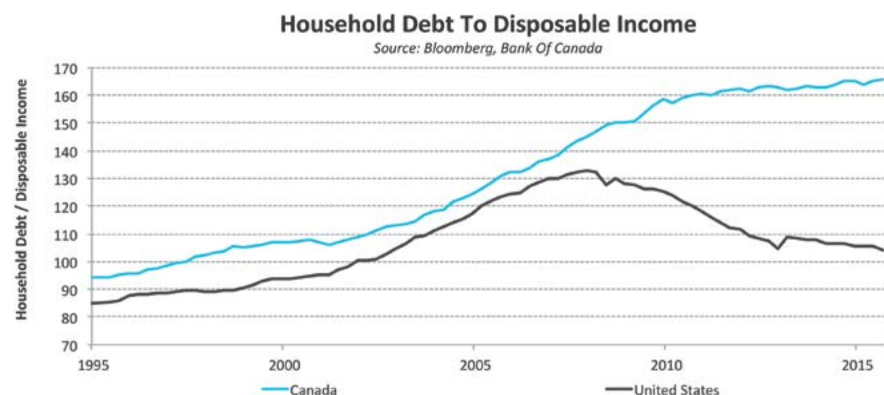
However, there are some signs that a weaker currency and an ongoing recovery in the United States is helping the overall labour market in Canada. In 2015, Canada added more jobs in total than in the prior two years. And importantly, jobs growth that had previously come from Alberta was supplemented by solid jobs growth in Ontario and, for the first time in three years, decent jobs growth in Quebec. (Figure 6)



(Figure 6)

We follow the Canadian labor market particularly closely due to the level of household indebtedness in Canada. Unlike the United States, Canada never really went through a household deleveraging as a result of the global financial crisis. In fact, household debt to disposable income continued to rise to record highs in late 2015.

The growing level of household debt poses a significant risk to financial stability in Canada, something that the Bank of Canada has frequently referenced in its Monetary Policy Reports. (Figure 7)



(Figure 7)

Our view is that this risk, albeit significant, is not necessarily imminent for two reasons. First, low interest rates mean that, despite high indebtedness, households remain able to service those debts. Second, the Canadian labour market has remained relatively firm in 2015. There are limited signs outside of Alberta and Newfoundland that the effect of lower oil prices has impacted the labour market; in fact there is some evidence that a weaker Canadian Dollar may be providing a boost to manufacturing sector jobs in Quebec and Ontario.

Short-Term Outlook For The Canadian Economy And Interest Rates

The above mentioned divergence between Canada and the United States, including in terms of household deleveraging, is one of the key drivers behind our outlook for interest rates.

Amongst other factors such as lower gas prices, our view is that the deleveraging in the United States post-2008 will provide a tailwind to U.S. economic growth over the next decade. Consumers in the United States have paid down debt and more recently have been saving a significant share of their gas price savings. We view this as delayed consumption and should eventually be very supportive for growth going forward.

This deleveraging is also important because it means that households in the United States are now less sensitive to a rise in interest rates than they were in 2008, supporting our view that bond yields in the United States should rise, but only modestly, over the medium-term.

By contrast, Canadian household debt has been rising and this will likely be a significant headwind for growth in the Canadian economy. Canadians are also more sensitive to a rise in interest rates now than they were in 2008. In fact, the decision by the Bank of Canada to cut interest rates in early 2015 was primarily due to the effect of lower oil prices on household incomes, and by inference, their ability to meet their debt servicing obligations. While in the long-run we expect Canadian bond yields to be driven higher by the United States bond market, over the next few years, we see limited prospects for Canadian bond yields to rise significantly.

So What Can Investors Expect Over The Next Several Years?

With rising equity market volatility and interest rates having fallen to generational lows, what can investors expect in terms of investment returns over the next several years?

Investment returns vary considerably based on the existing inflation environment at the time. We believe we will continue to see a stable inflationary environment. Looking back at historical returns during periods of stable inflation dating back to the 1920s, one can expect long-term equity market returns to be in the 7-11% range.

This is consistent with a valuation-based approach used to forecast future stock market returns by factoring in the starting valuation of the market using the price-to-earnings multiple (price paid for every dollar of earnings from the investment):

Beginning P/E Values	Average 10Y Returns
7 - 8x	14.2%
8 - 10x	13.6%
10 - 12x	9.9%
12 - 17x	9.5%
17 - 25x	8.5%
25 - 50x	7.6%

***Source: BMO Capital Markets/Bloomberg**

This methodology points to potential market returns of 9-10% over the next decade when the starting market valuation (based on P/E) is similar to that of today.

We apply the same valuation approach to assessing potential bond returns. As it turns out, in a stable inflation environment, the starting period government bond yield ishighly indicative of future returns:

Starting Yield	Average 10Y Returns
2 - 4%	2.50%
4 - 6%	5.60%
6 - 8%	6.90%
8 - 10%	11.10%

***Source: Bloomberg**

With long term government bond yields in the 2-2.5% range in Canada, the most reasonable expectation is that bond returns will be roughly in line with yields, also in the 2-2.5% range; much lower than those that many investors have grown accustomed to during the past 20 years.

Over the next decade, stocks should offer an attractive premium to bonds. Value stocks, in particular, should be well rewarded. We have experienced a historic period in the markets where growth stocks have outperformed value stocks for the last eight and one half years. This is the longest streak of growth outperforming value dating back to 1926. This streak continued into 2015 as evidenced by the Russell Growth Index handily beating the Russell Value Index shown in the table below.

Index	2015 Price Change (US$)
Russell Growth	4.0%
S&P 500	-0.7%
Russell Value	-6.2%

Furthermore, the unprecedented influence of "cheap" money created by the Federal Reserve's monetary policy has contributed to lower quality stocks outshining higher quality stocks. Our focus on quality has not been as well compensated during this long bull market cycle as we would have hoped. After managing through many investment cycles, however, we believe it is only a matter of time before our patient adherence to quality and valuation pay off.

This article is not intended to provide advice, recommendations or offers to buy or sell any product or service. The information provided is compiled from our own research that we believe to be reasonable and accurate at the time of writing, but is subject to change without notice. Forward looking statements are based on our assumptions, results could differ materially.

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