Outlook 2015: Sun and Cloud … With Thunderstorm Warning

RSP Reminder

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The decline in oil prices is Economics 100 on a grand scale, and although it will be good for consumers, there are serious cross-currents that promise turbulence ahead.

The good news is that the US economy is growing strongly, posting surprising GDP growth of 5% for Q4 and 2.7% for 2014[1]. Unemployment is below 6% and falling faster than expected; the drop in oil prices is a further boost that promises accelerating growth. The falling Canadian dollar will be good for Canadian exports and will offset to a large degree a contraction in the oil sands sector.

China's growth looks to remain very strong at 6%+, offsetting Europe and Japan, which will be lucky to see zero. On balance the world economy should grow reasonably well in 2015, however, the thunderstorm warnings arise from the Euro and Japan, whose political and economic policies are 'palliative at best'[2]. Both economies are crippled by structural impediments to growth, and political zeitgeist not capable of reform.

Below is a brief discussion of 5 important developments behind the cross-currents in the world economy, a more detailed look at the resulting threat of thunderstorms, followed by investment strategy comments.

1 Q4 growth, annual rate, Economist, January 10 2015
2 Signature Global Asset Management, 2015 Outlook, January 2015

Assante Capital Management Ltd.
130 Adelaide Street West
Suite #3401
Toronto, ON M5H 3P5

Phone: (416) 216-6532
Fax: (416) 216-6512
Email: choran@assante.com
Website: www.chrishoran.ca

The first development is the marvelous technological advancements in horizontal well drilling and hydraulic fracturing of oil-bearing shale known as 'fracking'. US oil and gas production has increased from 5 to over 9 million barrels per day since 2008[3] (!!).

The second development occurred at the US-China Strategic and Economic Dialogue in Beijing in July 2014 where Chinese finance Minister Lou Jiwei commented that China was comfortable with slower growth. Since China has been the dominant contributor to demand growth in commodity markets for the past 20 years, the world took note.

Slowing growth in demand from China for commodities, combined with surges in oil production from the US, has led to a temporary oversupply of oil. Since the demand for oil doesn't vary much with price (called inelastic demand in econospeak), the price of oil responds sharply to changes in either demand or supply.

The third important development was OPEC's November 27th meeting. The Saudi decision to maintain production volume in the face of increasing supply and falling price is a bold experiment in Economics 100. For over 40 years the Saudis managed world oil prices by cutting their production when necessary to bring supply back into balance with demand. By continuing to produce as the price falls, the Saudis are forcing the high cost producers to cut back their production to bring the market into balance.

The fourth important development is the strength of the US dollar. It is complicated, but a strong US dollar draws capital from around the world, including emerging economies, tends to reduce the price of commodities such as oil, copper, and foodstuffs, which are priced in US dollars, and increases the debt levels of emerging countries, whose debt is denominated in US dollars. The net effect of a strong dollar is a deflationary impulse around the world.

Deflation is unnerving in a high-debt world because it reduces incomes while leaving debts unchanged, which increases the debt burden.

The fifth thing is not so much a development as a non-development. The Euro countries are not making progress toward the policy changes required to put the Euro on a sustainable path, ditto for Japan. Both are exposed to the very dangerous combination of zero growth and very high debt.

Below we look at some of the cross-currents and storm clouds on the not-too-distant horizon.

Interest Rates

Clients have heard me warn of the danger that rising rates pose to bond markets and housing over the next few years (bonds fall as rates rise). The view at this point is that US rates will begin to rise in 2015, but US monetary policy will not be able to decouple completely from the ultra-low rates in Euroland and Japan, so the trajectory of US (and Canada) rate increases will be shallow.

Today's super-low interest rates are the result of central banks trying to stimulate post-crisis economic activity, but consumers want to pay down debt, not borrow more (except in Canada), so lower interest rates are having little effect – central banks are 'pushing on a string'.

3 Financial Times, January 2015

In addition, consumers deleveraging *en masse* takes capital out of the economy and parks it in bank deposits, pushing interest rates lower. At the same time, bank regulations in the US and Europe are driving banks to build more capital, which means lending less, not more. Finally, post-crisis risk-aversion has led many investors to park funds in deposits and short term bonds rather than equities, further adding to the supply of money.

The result of all this is weak economic demand and tons of cash sitting on the sidelines, instead of circulating in the economy. The world is awash in money, according to BCA, a research firm, and incredible as it sounds, nobody wants to spend it. In econospeak the velocity of money has plummeted.

The unfortunate reality is that Europe and Japan, having not made the adjustments to recover from the financial crisis, are skirting the edges of a classic 'Liquidity Trap'[4].

Not So Bad

The good news is that today's low inflation is not a true monetary deflation: much of the recent decline is in the volatile headline inflation, not the more stable core inflation. Headline inflation reflects the declines of commodities such as oil, iron ore (down 50% in 2014), copper (at 5-year lows), corn (down 40% in 2 years) as well as soybeans and wheat, resulting from rapid growth in supply, the strong US dollar, and several years of bumper crops.

These rapid and large price declines are price shocks: one-time price changes that temporarily reduce inflation. The decline is transitory because it falls out of the inflation numbers after a year. Price declines are unquestionably good for consumers, and consumer spending comprises about 70% of GDP.

Not That Good Either

All is not roses, however. The cross-currents are feeding several major storm clouds, and they aren't just out there on the horizon. It is not possible at this point to determine if they are moving closer, or passing us by. Compounding the problem (and mixing metaphors) the economic storm clouds have many moving pieces, making it very difficult to see the way through them.

First Storm Cloud - Oil Prices

While the decline in oil prices is unambiguously good for consumers, it will be painful for high-cost producers. A 50% decline in a critical commodity such as oil will likely have some serious consequences.

In the past, the Saudis maintained control of the oil market by cutting back production to keep prices high. Higher prices eventually encouraged new higher cost producers such as the Canadian oil sands, deep offshore such as Sugar Loaf in Brazil, and US shale oil. Each has many billions of barrels of oil, economic to produce at $100.

High-cost production will stop as cash runs out. Meanwhile, the Saudis can run budget deficits for a long time: their $20Trn sovereign wealth represents 40 years of GDP[5]. White-hot Alberta will cool a little, but it won't be serious: oil and gas' share of Canadian GDP is the same as in 2002, and in any case only employs 1.7% of the Canadian labour force[6].

The potential difficulties are in oil-producing countries that are mismanaged and cannot adapt to the low-price world, such as Russia, Venezuela, and Nigeria. The economic sanctions against Russia have led to a collapse in the ruble and a severe recession. Russia is a superpower in decline, and a candidate for serious social and political disruption[7].

4 Japan's crisis began in 1989 with an overleveraged banking system secured by overvalued real estate
5 Globe and Mail, January 19, 2015, Economist World Data
6 Stephen Gordon, Professor of Economics, Laval
7 Signature Global Asset Management, 2015 Outlook

Venezuela has been ineptly run for many years under Chavez and the collapse in oil revenues will have severe implications for that country. Nigeria is a kleptocracy with little global economic influence, but with a population of over 160 million is a candidate for humanitarian disaster as the collapse of oil revenues sparks civil war[8]. And civil wars, unfortunately encouraged by the West, lap all around Saudi Arabia.

Second Storm Cloud - The Euro

On the surface, the Eurozone is poised to continue its mild recovery. According to Eric Bushell at Signature Advisors, the constraint on credit from bank restructuring has been eased, so credit should be more readily available in 2015. Combined with a big boost from lower oil prices and less fiscal contraction, the Eurozone economies should pick up some speed. The risk to this 'muddle through' scenario is political, as we will see below.

At this point financing is cheap: Spain issued €23 billion of 10-year bonds in mid-January at the incredibly low rate of 1.5%. Clearly the bond buyers are not worried about Spain defaulting, but even this low yield does not get Spain out of the woods, because GDP is growing at only 1.3%.

The problem is anemic GDP growth and high debt - 175% of GDP in Greece, and over 100% in France, Italy, Ireland, and Belgium. Spain is 94%. When debt is that high, the economic growth rate must be higher than the interest rate, or the debt will grow faster than GDP, leading to a debt trap. The only way out is to run a fiscal surplus greater than the interest expense.

The prescription to boost economic growth is lower interest rates, higher government spending, and removal of structural impediments to growth. Unfortunately, rates are already zero, reforms are not politically possible without a crisis, and the Germans will not agree to large fiscal deficits.

The ECB's policy prescription of tight monetary and fiscal policy is a recipe for a 1930s-style depression. As Greece has demonstrated, hacking their way from a deficit to a surplus has shrunk the economy by 25% - itself boosting the debt/GDP ratio from 125% to 170%!

Euro countries are failing to use the current but temporary calm - granted courtesy of the central bank - to reform impediments such as employment for life, generous pensions at 57, professions protected from competition, large unproductive public sectors, protected and state-owned industries, and large-scale tax evasion. All need politically painful reform.

Even though the Euro remains popular among Greek voters[9], the prescribed austerity is not. And just because you want something doesn't mean you have what it takes to achieve it. If voters won't allow reforms without a crisis first, then they'll get the crisis. Reforms and growth take time, and with the new Syrzia government, Greece's politics may outrun economic events.

It is now apparent that a single currency among widely varying populations is a bad idea. Economic adjustments that would otherwise occur naturally via a depreciating currency must be made instead by forcing wages down with economic contraction and unemployment, both of which are at 1930s Depression levels - and is socially and politically unacceptable.

8 Nigeria's oil exports of $76bn comprise over 30% of total GDP; Economist World Data, 2014
9 70% of Greeks polled, Financial Times, January 2015

The Euro could survive for another 20 years. Or it could see its first exit this year. My guess is Greece demands a debt 'reschedule'. If the Germans balk, Greece will exit.

If Greece exits, the world will be a better place. The Euro is a political project hatched by political elites whose goal was manipulative 'political integration' of widely disparate populations[10]. As well, a single currency is quite unnecessary for free trade, as the US and Canada demonstrate.

It will be a fitting bookend for politics to take it apart.

Investment Outlook

The important thing is the thunderstorms above are not likely to cause serious economic damage to the United States or China. Or possibly even Europe. So the investment outlook is basically sunny – with chance of thunderstorms.

Euro Equities

The course of a Euro crisis is impossible to predict. As a well-known global money manager said to me in private, there are too many different routes, and too many moving pieces to analyze. The rumour mill says European banks have contingency plans for a Greek exit, which would likely be negotiated and controlled by the ECB and the IMF, precisely to limit damage[11].

A Greece exit from the Euro will lance a long-festering boil, and markets could easily respond with a relief rally in European equities. The current uncertainty has depressed euro equity valuations to 30-year lows vs. the US. So if you think the Euro will stumble through, or a Greek exit can be done in an orderly way, European equities are as cheap as they've been in 30 years.

Canadian Equities

The Canadian market is dominated by the banks, energy, and other resources. Banks offer nice dividends but low growth. Energy offers an opportunity as prices stop falling and the survivors emerge. There is also opportunity in smaller stocks, where the manager can buy auto supply, smaller finance, and other manufacturing firms that benefit from a low Canadian dollar.

US Equities

US equities have done well in the last couple of years, most notably 2013 but also double digits in 2014. Valuations at 15x earnings are very reasonable[12], and extremely good value vs. bonds and inflation. So the outlook is that equity gains will be supported by continued economic growth. Rising interest rates will not be a problem, because rates will only rise in response to economic growth.

Caution is warranted for retired investors or those about to retire. The prospect for serious short-term volatility in equity markets is high, as always, but also highly uncertain: the strength and size of the US and Chinese economies, boosted by low oil prices, could quite conceivably pull the Europeans through their doldrums.

I have long advocated investing with experienced, professional portfolio managers; this is not the time for DIY or index investing, as the indexes will be hampered by sector-related constraints such as energy or interest sensitivity.

Bonds

Bonds were the surprise of 2014, as the global shocks discussed above sent yields down and prices up. However, with the US looking at sustained recovery, and China's growth still strong, the bond performance of 2014 looks highly unlikely to be repeated. Possible, not likely.

10 Bank Credit Analyst, November 2012, Margaret Thatcher, 1999
11 From private conversations with bankers and global money managers, based on their private conversations with European bankers.
12 Based on 2015 earnings, per CI Quarterly Review, January 2015.

Government bonds in the developed world are artificially suppressed by central banks (see ‘pushing on a string’ above). Yields in the 10 year range are well below 2% in the US and around 0% in most of Europe. With inflation around 2%, the pretax return from bonds, in terms of purchasing power, is zero or lower. In Europe real yields are negative. Even lower after tax. Not good.

Investment grade corporate bonds trade very close to government bonds and so offer little more. Lower-quality corporate bonds, called ‘high-yield’ today (previously known as ‘junk’) offer yields in the 4%-8% range, which is at least something since the risk of default can be diversified away by holding a pool of them. Corporate bonds also hold opportunity for gain as the credit quality of the underlying company improves, so if we must hold bonds, my preference is a professionally managed pool of corporates.

The optimistic scenario for bonds is that the price declines from rate increases (bonds fall as rates rise) will be offset by the interest coupon so that investors eke out a small gain over the next several years. We are responding by keeping our holdings of bonds on the low side, and even lower in longer term portfolios, subject of course to volatility constraints of the client.

Conclusion

With zero interest rates, there is no safe place to hide. Investors retired or approaching retirement face only ugly choices: trying to withdraw 4% per year from a taxable bond portfolio guarantees that in 10 or 12 years you have lost half your purchasing power.

Equities, especially high quality companies with global businesses, healthy dividends and with good prospects for growth, are the investment asset of choice, but they expose your capital to gut-wrenching volatility.

My advice: retiring investors should plan their budgets very carefully. Know how much you really need to spend and how much would be ‘nice to have’. Portfolios should be designed very carefully with only enough in bonds to provide liquidity for a few years, and to provide downside protection as required.

The balance should be very carefully allocated to experienced portfolio managers who can skate between the overvalued bond-like pure dividend sectors such as utilities and real estate, and the specific undervalued opportunities such as US financials and now oil producers. The next few years are likely to belong to the careful stock-pickers that have the wisdom and judgment to find safety where safety usually isn’t, and to avoid the dangers that lurk where safety usually is.