Interesting Times

Here I was, thinking 2015 was interesting enough, and then January 2016 began with the worst first 5 days since 2008, and then the worst first 12 days of any year since 1929, and then The Worst Two Weeks of Any Year Ever[1]. But I'm getting ahead of myself.

On the surface, 2015 seemed quite satisfactory: most client returns for 2015 are in the single digit positive. This is actually quite good, considering some of the powerful undercurrents out there, as we shall see. Below are a few sample returns for major market indexes[2]:

	2015
Canadian bonds	+2.5%
Canadian High Yield bonds	-2.1%
Canadian Preferred shares	-15.9%
Canadian Equity (TSX)	-11.1%
Canadian Small Cap	-15.8%
US Equity (in US$)	-0.7%
US Equity (in C$)	+21.0%

A quick rundown on 2015:

Canadian bonds were slightly positive as short-term interest rates declined a little in Canada (bond prices go up as rates fall). High Yield, otherwise known as "Junk" bonds fell as mining and energy company health deteriorated. Preferred shares were clobbered (note below).

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Chris provides financial planning, investment planning and full implementation services to about 100 families.

We are pleased to welcome new clients. New clients should have $1 million or more of investable assets.

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[1] Financial Times, January 28, 2016
[2] All data: GlobeAdvisor except High Yield bond, Tacita Capital Management.

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Canadian share prices lost 11% (8% with dividends), and the Small Company index reflects a hammering in energy and mining shares.

The 20% difference between US equity returns in US$ and C$ terms is due to the depreciation in the Canadian $, which makes US investments more valuable to a Canadian investor.

Preferred shares had a very bad year: Preferreds, supposedly a safe asset class for income investors, were hammered in 2015 with a loss of almost 16%; this is actually a big improvement over September, when they were down almost 30%.[3]

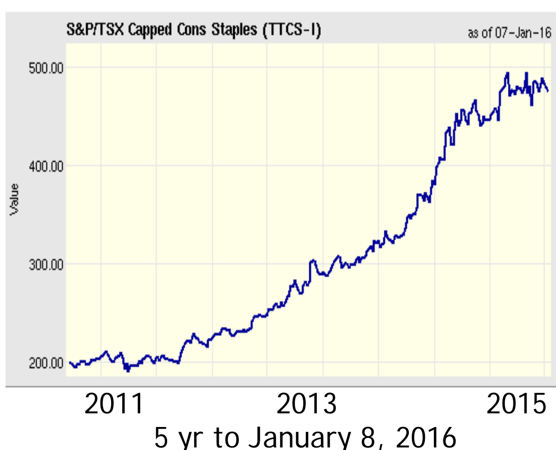
Preferred shares pay a fixed dividend, like bonds pay interest. Preferreds usually behave like bonds in that prices go down when rates rise, and vice versa. The damage was centred on 'rate-reset' prefs, which were supposed to protect investors from the expected rise in interest rates by 'resetting' the dividend upwards.[4]

Problem was, rates went down - twice in Canada - so the preferred rates were indeed reset – down! – and the value of the preferred shares was hammered. Fortunately we were lucky not to own any.

The year was marked by turbulence in August, with all segments of the Canadian and US markets dropping in unison, taking the indexes down 10% in one week. Since we hadn't had a correction worthy of the name in almost 4 years, we were assured by financial journalism that the world was indeed ending. Interestingly, the US market had recovered most of the decline by the end of the year, while the Canadian market had not. It is instructive to look a little closer.

The Canadian market index at -11% for 2015 masks some serious divergence below the surface. The consumer stock subindex was up about 17% in 2015, for a total rise of 250% since 2011, as the chart below shows.

Canadian Consumer Staples



2011 2013 2015
5 yr to January 8, 2016

Source: globeadvisor

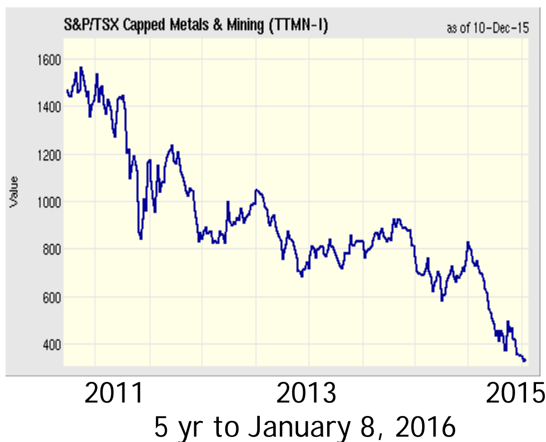
[3] Financial Post, November 12, 2015
[4] There is a story here, if you can pardon a little schadenfreud. I was on a conference call with a number of advisors from across Canada couple of years ago. The topic was how to invest for income in a zero-interest world. I had agreed with the call convener, and I continue to believe, that the retirement income problem is acute. The first several respondents, brokers at bank-owned firms, each dismissed the issue, breezily saying they just had their clients in rate-reset preferred shares yielding 4-5% and they couldn't see what the problem was.

The energy subindex was *down* about 29%, and mining stocks were hammered by a 50% decline in 2015, thereby completing a stunning 75% loss over the past 5 years, as the chart below shows.

Clients can be very grateful that we've been lucky enough to have very little exposure to mining companies these last few years.

It is not often that you see two more divergent pictures than these two charts. They tell us that clearly there are two strong undercurrents at play below the suface of the overall market indexes: the consumer-oriented sectors of the economy are doing well, while mining and energy are not. The spluttering hyberbolic doomsday apoplexy from financial journalism is all about the mining and energy sectors, whose problems are somewhat ironically, actually good news for consumers.

Canadian Mining Subindex



2011 2013 2015
5 yr to January 8, 2016

Source: globeadvisor

(Sharp-eyed readers will note that the vertical axes of the two charts understate the severity of the debacle in mining stocks. The mining chart vertical scale is a factor of 4x, where the consumer axis is only 2.5x.)

The reason for the obliteration of mining company value? Very simply, the strong demand for metals and energy in the 15 years (to 2011) was misinterpreted as a permanent shift reflecting the modernization of emerging economies, notably China, Brazil, India, and Indonesia[5]. Mining companies responded by developing large new mines, while the oil and gas industries were revolutionized by the high-pressure fracturing 'fracking' technology, which allows the vast reserves of 'tight oil' in shale oil deposits to be recovered economically. (The world's supply of natural resources is in fact unlimited, constrained only by the time and money to dig them up)[6].

This expansion of supply in metals and oil coincided with a slowing growth rate in China as that country continues the natural transition to a more services-based 'consumer' economy, while India is proving that conjuring up a modern economy is more difficult than they thought, and Brazil and Venezuela are demonstrating once again the crippling effects of corruption and foolish economic policy[7].

[5] The modernization of China began under Deng ShioPing after 1979; Indonesia's population at 250 million is the 4th largest in the world.
[6] See 'Running on Empty?' www.chrishoran.ca
[7] Classic policy errors include rich and early government-funded pensions, government deficits, loose monetary policy producing inflation at 15%, government micro-meddling in the economy, and lack of political will to make changes, Economist Briefing January 2nd, 2016.

The result is that oil prices are down more than 50%, copper is down 30%, and iron ore down 45%, in just the last 12 months[8]. The TSX, crippled by its heavy weighting in resources, remains 20% below its pre-crisis 08 and 14 highs, and is only about 8% higher than 2012, as the chart below illustrates.

Canadian Equity Market
10 years to 2015

TSX Index; Source: bigcharts

US Equity Market
10 years to 2015

S&P500 Index; Source: bigcharts

[8] Financial Times

By contrast, the US market finished 2015 fully 32% above its pre-crisis high and 70% higher than 2012. The US market is doing well, while Canada flounders, because the US market has entire industries that do not exist in Canada: healthcare, pharmaceuticals, automotive, aircraft, chemicals, telecom, and technology for instance, so it is a much more complete reflection of a modern economy. It is these broader economic sectors which are lifting the overall index.

The Consumer and Telecom sectors of the US market have sailed through the little January 2016 turbulence: as at mid-January they remained 6% and 10% respectively *above* their lows of August 2015, where the Materials and Energy sectors are 3% and 10% *below* the August lows[9]. The point is that the consumer, which comprises over 70% of a modern economy, is doing just fine.

Not that you'd know any of this from financial news media. You'd think that a 12% correction portended the end of the modern world.

So I must say I was delighted to have a number of clients greet the January decline by sending in 6-figure sums to invest. It is a sweet reward of my career to have clients – who have fought off panics of fear or seared their fingers with greed – now have the courage to face 'the worst first two weeks of any year since 1929' by sending over chunks of cash to invest.

Looking Forward: January correction?

Technically, yes, it's a correction: the total decline in the US market to the bottom (so far) January 20 was 12%.

I will grant that 2009 was actually traumatizing, so I understand why people are still a little afraid of the dark. But do journalists have any idea how frequently markets decline?

You might think we haven't had a 10% decline since – oh wait – the 12% in August 2015. And the one before that was 10% – hold your breath - just the year before in 2012[10]. The one before that was 19.5% decline in summer of 2011 when the Greek crisis bubbled up from the swamp. That was the year after the 16% decline in 2010. So declines of 10% or more happen literally all the time.

In fact, there have only been two years in the last 20 with a decline of *less* than 7%: 1994 and 2013. Yet, as we saw in last month's essay 'Four Decades', the US market is four *fold* higher in that time.

Financial journalists and alarmist bloggers cannot be adult enough, or maybe honest enough, to say that the average intra-annual decline in the equity market – from some high point to some lower point - within any calendar year since 1945 is 14%. The January 2016 correction, so far anyway, is a perfectly normal thing. They happen all the time and are nothing to be afraid of.

The psychology of market corrections

The fact that a market index happens to be falling lends an irresistible credence to whatever the media is bleating about, *even if the connection is totally spurious.* It could be the war in Kosovo, the Fiscal Cliff, Y2K, the Greek default, you name it. The media barrage, called an 'availability cascade' by psychologists, produces a perception error called a 'Narrative Fallacy'[11], where random data takes on meaning if it is spun into a story, in this case 'falling oil prices are bad'.

[9] At time of writing, end of January 2016; source: GlobeAdvisor
[10] Intra-year declines data from JP Morgan Asset Management
[11] The Science of News, www.chrishoran.ca , also the Black Swan, by Nicholas Taleb.

Will the decline in oil prices hurt the US economy? Short answer: no.

Longer answer: the anxiety over declining oil prices is a sad joke inflicted by newsmedia starved for bad news. You will recall that the world was also going to end when oil prices went from $50 to $140/barrel back in 2008. Well, if rising oil prices are bad news, then falling oil prices can't possibly be bad news too. So which is it?

It's very simple: falling oil prices are great for consumers, and not so good for producers. So if you are a Saudi prince, it hurts a bit. If you are a high-cost shale-oil producer in the Montana Bakken, you are probably out of business. But with gas at $1.71/gal in the US, - equivalent to C$.60/L - consumers have way more money in their pockets, and that's good[12].

Canada is somewhere in between. Unfortunately, Canada's recent moves to curtail Alberta's oil sands development, ban tanker traffic from Prince Rupert and delay pipelines to deliver Alberta oil, are ill-conceived and poorly timed policy decisions that will damage Canada's economic engine at an inopportune time. Such is the power of the anti-carbon *zeitgeist*.

Fortunately for the world economy, Canada doesn't matter.

The Million Dollar Question really is: Will crawling global growth derail the US consumer expansion?

Short answer: probably not.

Longer answer: First, clients are well aware that I do not pretend to make forecasts, as Yogi Berra said, 'Especially about the future'. My main goal here is not to try and forecast the outcome of future events; it is to provide positive and realistic data points to counterbalance and help pull you away from the negativity of daily news.

Back to the story: it is important to understand that the Chinese economy is not contracting, as the media loves to infer. The *rate of growth* is slowing - from 10% per year of the past 20 years to more manageable 6% or so.

China's growth is slowing. Well, it would have to, wouldn't it?[13] Slowing growth is perfectly natural, and in fact quite necessary, given China's size as now the world's 2nd largest economy. It's why Redwoods don't grow to the sky. And growth of 6% would still be huge, adding the equivalent of an entire Canadian economy to the world every 2 years.[14] Even 3% or 4% for 20 years would be transformative.

And the US economy is much more self-contained than say Canada's, so it is less sensitive to global conditions. Canada's foreign trade represents 31% of GDP, where in the US, trade is only 14%[15]. The United States' largest trading partners by far are Canada, Europe, and Mexico, and the largest of these is only 2% of US GDP. Even trade with Japan, the 3rd largest economy in the world, represents less than 1% of US GDP. Japan could disappear completely and the US economy wouldn't notice!

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[12] Source, AAA; US average price US$1.71/gal; Canadian equivalent about C$.60/l
[13] Nick Murray Interactive, January 2016, p1
[14] Data: Economist World in Figures 2014, at purchasing power equivalent.
[15] Data: Economist World in Figures, 2014

So China is not likely to derail the United States: Eric Bushell, head of Signature Global Asset Management, thinks China's growth rate will likely stabilize in the 6% range and "the problems of the rest of the emerging world will not be big enough to topple the current developed market recovery".[16]

China's economy is already two-tiered, with services, e-commerce, and consumption growing strongly: 'The Chinese consumer is very alive and well', with IMAX, Nike, and Apple's China order books experiencing growth in the 30% range, says Dina DeGeer, manager of the Mackenzie Canadian Growth fund[17].

China has 'already arrived' as a world economic power, now with 105 *million* middle class consumers - more than the United States - as well as more high-speed rail than the rest of the world combined, according to Charles Liu Yang Sheng[18] to a meeting your advisor attended in Dallas recently.

One final point about China: my positive view of China is not meant to suggest that we invest there. Yes, China has the potential to transform the world economy, as the emergence of the United States transformed the world economy in the 1800's, and the world will be a much bigger and better place with a billion more people having medicine and clean water, able to buy airplane tickets, BMWs and who knows, maybe Montana ranches. But China is still not a place to invest in directly (see Treaty of Nanking if you want to know why).

Bottom Line

The volatility in equity markets is normal (so far, anyway).

Keep in mind that a newly retired couple age 65 has 50/50 odds that one of them will be alive for almost 30 years. Inflation at only 2% will cut that couple's purchasing power in half. Protecting their purchasing power while withdrawing 4% to live on is a daunting task that requires equity investment for growth. Sorry folks, but Canadian government 10 year bonds at 1% won't come close. So get used to a little volatility. There's no way that I can think of to avoid it.

Nothing in your long-term plan has changed. Get out and live life. That's why you are really here.

[16] Signature Global Roadmap, Fourth Quarter 2015; Signature and Assante are owned by CI Investments
[17] Interview, December 2015
[18] Taiwan-born, US-educated, now Chinese citizen, founder of HAO Capital and former Chinese government diplomatic simultaneous translator, speaking at a CI conference in Dallas recently.

The Bourgeois Virtues, Deidre McCloskey

Deirdre McCloskey is Distinguished Professor of Economics, History, English and Communication at the University of Illinois at Chicago. The Bourgeois Virtues is a powerful survey of the economic reality and ethics that have increased our standard of living from $3/day to $137 today.

McCloskey takes on the critics of free enterprise capitalism and crushes them with evidence. It is serious, yet written with a sense of humour (her choice of the word 'bourgeois' is a poke at the sneering envy of the Marxists – since the word properly means 'educated, middle class urban dweller', we are all bourgeois).

Her main point is that free enterprise supports and encourages the virtues, (Faith, Hope, Love, Prudence, Justice, Courage and Temperance) and so supports the liberal democracy of the capitalist countries, led by 16th century Holland and England.

The baker, for instance, takes great courage, faith, and hope to set up the business, honesty and prudence to bake good things that people want to buy, and yes, love makes it easier to deal with difficult customers, and so grow the business.

McCloskey notes that transgressions against the virtues are not unique to capitalism any more than any other type of organization: fraud, greed, envy, and even murder are well-represented in every walk of life: government, academia, and even the religions. Inequality was much worse in all other forms of government, especially and ironically, the communists (where citizens were either deprived, starved or shot).

The book is a wonderfully refreshing barrage of counterpoints to the seemingly endless negativity surrounding capitalism these days. Who would have thought that business was virtuous?!

Assante does not promote The Bourgeois Virtues by Deidre McCloskey and the views shall not be used for product endorsement purposes.

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