Two Wrongs Don’t Make a Right!

Quarterly Commentary Q4 2015

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After seven years of the most accommodative monetary policy in U.S. history, the U.S. Federal Reserve (Fed) has increased interest rates a quarter-point with the target Fed funds rate moving from 0 - 0.25% to 0.25% - 0.50%. Under most circumstances, this relatively small increase should have little impact on the economy or financial markets. However, we believe the Fed’s prolonged and excessive use of quantitative easing (QE) over the past seven years will now present it with new challenges. The most pressing being the strengthening U.S. dollar and the accompanying flow of international capital, which will favour U.S. assets, in particular, short-term and long-term treasuries as well as equities. We cannot rule out the possibility of a correction in U.S. equities as credit and stock markets digest the impact and prospects of higher interest rates. The Atlanta Fed recently forecasted U.S. GDP in the fourth quarter will come in at an anemic .70% due to a drop in net exports, construction spending and the ISM manufacturing report showed further weakness.

Two wrongs don’t make a right. Having waited too long to raise interest rates, the Fed, in an attempt save its credibility, may be increasing rates into what appears to be a weakening economy, something that is rarely done. The ongoing fiscal constraints of both the public and private sector will further compound the problem thus creating more opportunities for active asset allocation if the Fed is forced to pause or even reverse course later this year.

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Will the U.S. dollar strength spark the next crisis?

We were somewhat skeptical of the Fed’s ability to raise interest rates without causing significant adjustments in global capital markets, particularly emerging markets that have borrowed trillions in U.S. dollar-denominated debt. The 21% rise in the U.S. dollar over the past year and a half combined with the weakening global economy will pose a problem for a Central Bank determined to raise rates. Although the Fed is not responsible for the global economy, they must be aware of the implications higher rates will have on the U.S. dollar and by default, global corporations and governments that have significant exposure to a strong dollar. We remain perplexed as to how the Fed can normalize interest rates and contain the U.S. dollar rally given that its global counterparts, the European Central Bank (ECB) and Bank of Japan (BOJ) remain accommodative. The interest rate differential amongst industrialized countries with capital markets capable of accommodating international capital will likely see more capital flow into U.S. capital markets and by default, the U.S. dollar will continue to strengthen. Unhedged foreign borrowers of U.S. dollars will require more domestic currency to buy back U.S. dollars as the debts mature. Had the Fed moved earlier to normalize rates, the resulting misallocations and the impact of the eventual unwind would have been reduced, perhaps significantly.

Although the Fed has been preparing markets for higher interest rates for the past two years, it has also made it clear that higher rates would be dependent on the economy hitting its target for unemployment and inflation. The unemployment target was achieved years ago, however, the inflation target of 2% as measured by the personal consumption expenditure index (PCE) remains somewhat elusive. The PCE price index, the Fed’s preferred measure of inflation came in with a 1.30% year-over-year increase, and although it is still below the target level, the Fed must be anticipating higher inflation. What was not addressed was the weakening global economy or the most recent Institute for Supply Management (ISM) report that came in at 48.6, dropping below the 50, which significantly increases the odds of a U.S. recession. If this proves to be the case, this interest rate increase cycle may become the shortest on record, and it risks exposing the Fed to further criticism as the U.S. heads into what is turning out to be a critical election year in which the electorate is growing increasingly distrustful of career politicians.
The Fed, in an attempt to be transparent, said it would be data dependent but without having achieved its inflation target and signalling more interest rates increases for 2016, it has created greater uncertainty and doubt. This can be seen in credit markets where interest rate spreads over Treasuries have widened out significantly, resulting in increased costs of financing and increased volatility in capital markets. We have long argued that once the Fed attempts to unwind its zero interest rate policy, we will find out very quickly where the excess misallocated capital has accumulated. The energy sector is the most obvious candidate for debt restructurings or bankruptcy, as the debt accumulated during the boom years comes due at a time when the underlying commodity price has collapsed, and capital becomes increasingly more concerned about risk which is something years of QE have masked.

U.S. global multinational corporations and highly leveraged foreign companies with U.S. dollar-denominated debt will face significant headwinds if the U.S. dollar continues to strengthen.

**China**

The Chinese economy, powered the global recovery over the past seven years, is now feeling the pressure of its over-reliance on debt-induced growth. The expansion in bank assets from US$ 8 trillion to over US$ 28 trillion kicked off a building boom that helped lift the global economy and which resulted in increased demand for commodities along with higher prices. The Chinese economy is now projected to grow at 6.3% in 2016, down a far cry from the double-digit growth rates experienced in the past decade. The deceleration of Chinese growth combined with competitive currency devaluations of its regional competitors is placing greater strain on its ability to maintain the quasi-currency peg to the U.S. dollar. The Chinese yuan was informally pegged to the U.S. dollar at a rate of about 6.2-to-1 for most of 2014 and 2015. China unexpectedly broke the peg in August 2015 (causing a meltdown in U.S. equity markets) and devalued the yuan to 6.3-to-1. Subsequent devaluations have seen the Yuan fall to 6.48-to-1.
Although these are relatively modest devaluations, they are clear evidence that the Chinese economy is slowing quickly and its ability to maintain the peg is in doubt. Countries with independent monetary policy and an open capital account that allows for the free movement of capital in and out will struggle to maintain the currency peg. They rarely ever stand the test of time as we witnessed earlier this year when the Swiss abandoned their peg to the Euro. We suspect China, which is slowing and has had over US$800 billion in capital outflows over the past year will eventually come to this realization they will have to restrict capital flows adjust the currency peg to the dollar which has an unsettling effect on capital markets as investors come to realize more devaluations lie ahead. If China adopts a more accommodative monetary policy, capital outflows will intensify and therein lies the problem for China. We believe China will eventually have no choice but to continue to devalue Yuan or allow it to float freely if China is ever going to challenge the U.S. dollar for international reserve status. The IMF recently announced it would be including the Chinese Yuan as a reserve currency in its special drawing rights, but we cannot help but feel this was a concession made to China as it struggles to revive its slowing economy. We believe they will eventually have no choice but to abandon the peg.

Europe

The European economy continues to struggle under its massive debt, high unemployment and a Central Bank that is now pursuing the unthinkable; that negative interest rates will stimulate its moribund economy. To compound matters, the wars in the Middle East have resulted in a migrant crisis that has seen member states close their borders, threatening the very core of the European Union’s open borders agreement which was the hallmark of the EU’s vision of one Europe.

We find it astonishing that little concern is given to the US$ 2 trillion in European bonds now trading at negative interest rates and the effect this will have on corporate pension plans and insurance companies’ abilities to meet future liabilities. In our opinion, negative interest rates are a sure sign of the complete desperation that has overtaken Europe and it is unsustainable
because banks cannot easily pass on the negative rates to depositors for fear of losing much needed capital, and it acts as a tax on savers which reduces consumption.

The passing of Bail-in legislation first trialed in Cyprus, took effect January 1, 2016, and we believe this will further shake the confidence of European capital and contribute to greater capital flows abroad. The EU bail-in legislation was clear to point out that taxpayers, via their Central Banks, are no longer on the hook for bailouts. The law was clear to point out that depositors are only insured up to 100,000 Euros. In our opinion, it should be clear to even the most casual observers that taxpayers are depositors, and they are relying on their respective governments to regulate and protect the financial system, something they failed to do, and it continues with the sanctioning of its negative interest rate policy. Negative interest rates further distort the pricing of risk, thus creating a situation that is even more precarious than that which prevailed before the 2008 financial crisis.

For obvious reasons, European banks have chosen not to pass on negative interest rates to depositors. They have instead increased lending rates on loans and mortgages, which run counter to the ECB’s intent to stimulate the economy. It is simply astonishing to us as to how the EU and ECB cannot admit that the Euro construct is flawed and that their goal of a unified Europe under one currency without fiscal unity is at risk of collapsing the entire European economy. As the economy continues to weaken, civil unrest will likely accelerate, and the migrant crisis may be the spark that ignites it. Should the European economy continue to decline, we expect a pick-up in capital outflows into U.S. dollars and the eventual demise of the Euro experiment.

While the slowing Chinese economy and Yuan devaluations remain front and centre, the European Union remains mired in an economic and social crisis that will eventually resurface.

**Markets**

The S&P/TSX Total Return Index fell -1.4% in the last quarter of 2015 and it was down 8.3% for the year. Six of the ten sectors posted negative returns led by the energy sector. The information technology, materials, consumer staples and financials sectors were the only sectors to advance during the quarter. The financial sector, which is the largest sector in the S&P/TSX, rose 1.7% during Q4 outperforming the broad market. The S&P/TSX underperformed the S&P 500 in Canadian dollar terms for a sixth consecutive quarter.

The beleaguered Canadian preferred shares market traded higher in the last quarter of 2015 as the S&P/TSX Preferred Share Index (TXPR) posted a gain of 5.3% in the last quarter but was down 19.3% in 2015. The S&P/TSX Preferred Share Laddered Index (TXPL), comprised of Rate-Reset Preferred shares, posted a gain of 8.4% (-23.8% for 2015). Generally, issues with variable dividends outperformed during the quarter, as they recovered from dramatically oversold conditions.

U.S. equities were heading for a yearly loss in 2015 but were rescued a surprising rally in the last quarter of 2015 which saw the Dow Jones Industrial Average gain 7.7% and the S&P 500 7.0%. The Dow and S&P 500 finished the year up 0.20% and 1.4% respectively.

The collapse in commodity prices continues to impact the Canadian equity market while U.S. equity valuations remain at elevated levels. Although the majority of stocks have fallen 10-20% from their 52-week highs, the U.S. indices have been, and continue to be supported by a handful of large market cap weighted stocks such as Facebook, Amazon, Netflix, and Google. At the end of December 2015, the S&P 500’s trailing earnings multiple was at 22 times earnings, and given the overall poor breadth, equity markets will be facing strong headwinds as we head into 2016. Given the markets uncertain reaction to further interest rate increases, high yield credit market spreads have widened out significantly. Lower interest rates and stable credit markets played a key role in financing share buybacks that, in turn, boosted equity markets and valuations. A strong dollar will negatively impact U.S. multinational corporation profits.

As we noted in previous commentaries, investors will be well served to pay close attention to what is taking place in the bond and credit markets. They have been the primary driver of equity markets over the past seven years, and now that the Fed is increasing rates, it is unknown the fallout that will occur from the prolonged suppression of interest rates and the resulting misallocations of capital. If the global economy is slowing and there is evidence of a decline in the U.S. GDP, the Fed may be raising interest rates into a weakening U.S. economy, which has the potential to accelerate the decline. The Fed may feel
compelled to resort to new measures such as an outright monetization of U.S Government debt. An outright debt monetization will present opportunities and pitfalls and a resumption of the secular bull market in Gold.

**Portfolio**

U.S. Equity markets staged a surprising recovery from the previous quarter selloff and we took the opportunity to increase U.S. equity exposure heading into what we expected to be a year-end rally and a weakening Canadian dollar. We increased U.S. equity exposure via S&P 500 ETFs and we added U.S. bank exposure, which we think will benefit from the Fed's interest rate increase. There was not much activity in Canada other than initiating a position in the beleaguered preferred share market using ETFs, which are more liquid allowing us to buy and sell with relative ease.

**Conclusion**

As we enter 2016, investors will be paying much closer attention to what is taking place in commodity, bond, equity, and most importantly, credit markets. The Fed’s accommodative monetary policy has come to an end, and after seven years of interest rate suppression, they now believe the U.S. economy has recovered and is no longer in need of the Fed’s support. There can be little doubt that Central Bank’s monetary policy played a significant role in boosting asset prices but it also led to an environment in which most investors seemed to have ignored fundamentals and risk as long as they believed Central Banks would intervene as they have often had to do over the last seven years.

This past December, the Fed increased its Fed funds target rate by 0.25%, and it outlined its intention to boost rates at least four times throughout 2016. If the Fed actually follows through with its plans, the resulting misallocations of capital combined with a strong U.S. dollar will begin the process of uncovering the misallocations of capital. As the year ended, capital outflows from high yield bonds and even investment grade bonds accelerated, a sign that “safe money” is becoming increasingly nervous. The yields on 30-day short-term Treasuries declined to 0.12% at year-end well below the Fed funds target range. We are not quite sure what to make of this, but it appears to us that capital flows into Treasuries will continue to influence short-term yields at a time when the Fed is trying to raise rates. The Fed will have to consider shrinking its balance sheet and selling Treasuries, something it said it would not have to do.

The Latin American crisis in the 1980’s and the Asian contagion/Russian debt default in 1998 were a direct result of prolonged and continued strength in the U.S. dollar. Given the extent of U.S. dollar-denominated debt borrowed by foreign borrowers, further U.S. dollar strength may be the spark that ignites the next crisis, as corporations and governments are forced to convert additional domestic currency or sell U.S. dollar assets to cover debt obligations. It is often times not the known risks that trigger crisis, it is the unexpected or unforeseen problems that market participants did not expect or anticipate. In this case, we would focus on the bond markets and the willingness of investors to continue to fund government debts, particularly governments that have no ability or plan to pay back the debts. The unforeseen risk is that bond investors collectively start to punish government policies by selling the debt, particularly the debt of governments that are trading at negative yields or offer little return after taxes and inflation. We sense that a shift in investor psychology will lead to increased volatility, particularly if Central Banks succeed in creating inflation. This will present opportunity, but it will require a more “active” approach to portfolio management.
We suspect the Fed is raising interest rates into a slowing U.S. economy and although we anticipate a Fed reversal later in the year, we cannot rule out a quicker reversal of policy should it become clear that the Fed is wrong in its assessment of the U.S. economy. If this was to happen, the Fed would be called on to not only defend the weakening economy, it will also have to defend its credibility. We cannot help but feel that the Fed will be called on once again to stimulate the economy, and with more than enough evidence that QE has not worked, we suspect they may resort to negative rates or outright debt monetization.

We can’t wait to see what unfolds in 2016 but remember, two wrongs rarely make a right. Investors will be well served by taking on a tactical approach to asset allocation and be in a position to take advantage of what lies ahead. May the force be with us in 2016!