China, Oil **and the Herd**

The COSGROVE-BROCK Group

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Philip’s Comments

Economic data and financial market uncertainty have taken decidedly different paths so far in 2016. History was made as financial markets greeted the New Year with a large dose of volatility and the poorest performance for markets on record at the beginning of a calendar year[1].

But are current market fluctuations justified by actual risks to the global economic picture? In this edition of our newsletter we will attempt to answer this question, and also provide a broader view of what factors will influence our thinking and our portfolio recommendations in the year ahead.

The recent volatility was particularly present in Canadian financial markets. Since the publication of our summer edition at the beginning of August 2015, titled “*A Familiar Feeling*”, the S&P/TSX Composite Index has fallen by 13.0%. Since its latest peak in April of 2015, the market has fallen by 17.4%[2].

The news is only slightly better for US markets, with the S&P500 falling by 7.5% since August and 9.1% since its latest high in May 2015[3].

The Canadian dollar has also come under serious pressure suffering a 5.9% decline against its US counterpart since August[4], and at one point in time trading at 0.6807 cents US – the lowest valuation since April 2003[5].

As for the price of oil, it has fallen by $11.55 since August, representing a 25.5% decline over the last six months[6]. As Canada continues to be seen by the world (with good reason) as economically linked to the price of oil, it is no wonder our dollar and our equity markets have faced so much adversity. It should be noted that in addition to the falling price of oil, interest rates are weighing on the value of our Loonie. In December, the US Federal Reserve proceeded with “lift-off”, a 0.25% increase in the Federal Funds Rate for the first time since the financial crisis. Meanwhile, the market continues to speculate as to whether or not the Bank of Canada will cut its key rate for the third time since January 2015. Should interest rates continue to rise in the US and potentially fall in Canada, we can expect further weakness from the Canadian dollar.

With the fourth quarter earnings season well underway, we see these macroeconomic factors reflected in corporate financial results. Energy companies, obviously, have faced the strongest headwinds with earning across the sector down 56% since last year, and some companies resorting to cuts to their dividend payments and future capital expenditure projects. Most other sectors are faring much better, with S&P500 profits (excluding energy) up 3%-to-4% since this time last year. Consumer-related companies have done particularly well, feeding off of recent strength in consumer spending to show year-over-year growth above 10%[7].

We are pleased that our approach to portfolio construction has helped reduce the sharpness of recent market volatility for many clients. Underweight exposures to energy producers and metals and mining, significant exposure to US-dollar-denominated assets,

and disciplined asset allocation have all acted as shock absorbers in recent weeks. It should be said though that even sound portfolio management has its limits at a time when a herd mentality sets into the market.

China's transformation

Volatility in the Chinese stock market was a theme of last summer's newsletter "*A Familiar Feeling*", as the instability of the Shanghai Stock Exchange (SSE) had spooked equity markets into a contraction. The worst of the volatility seemed to subside over the fall, but it returned with a vengeance this winter. Chinese officials, facing major declines of equities in the SSE enacted their "circuit-breaker" rules, shutting down the index on January 4th and 7th due to same-day market drops of over 7%. This mechanism, meant to restore order in a chaotic market, only served to cause panic in global markets. Chinese officials "deactivated" the circuit-breaker system just a few days after its introduction, followed by the resignation of Xiao Gang, chairman of the China Securities Regulatory Commission – the organization responsible for the introduction of the circuit-breaker system.[8]

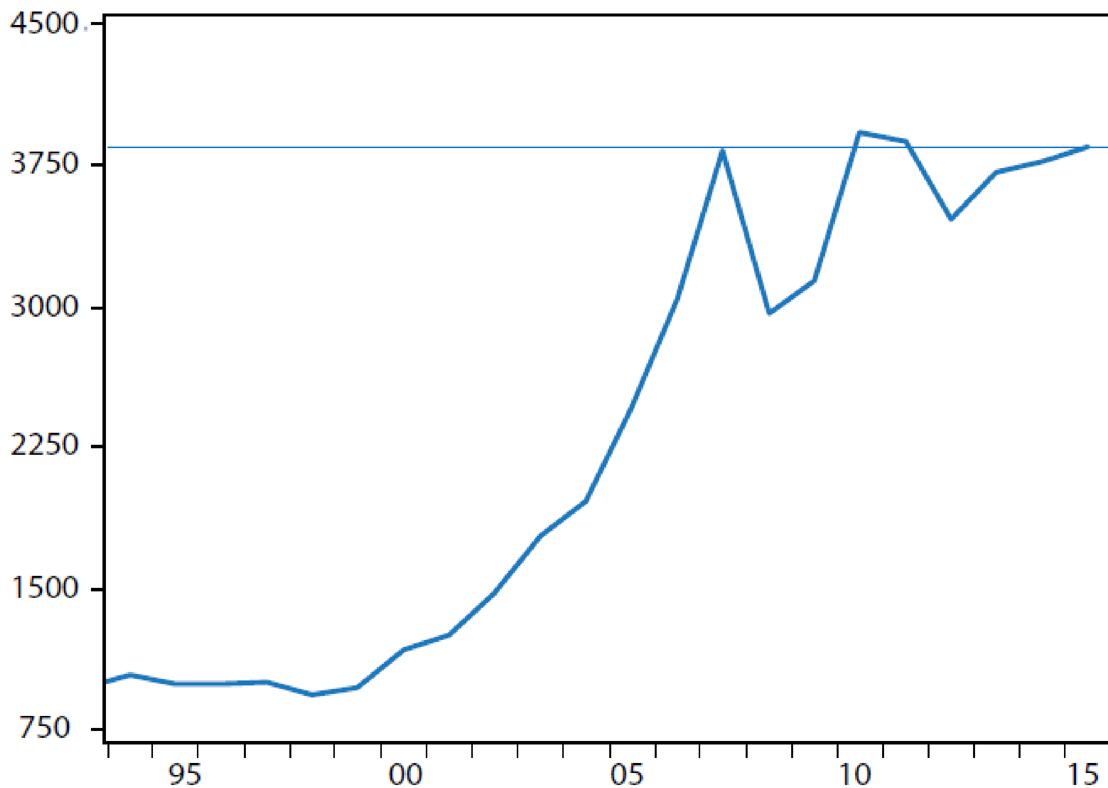
The chaotic gyrations of the Shanghai Stock Exchange may be responsible on any given day for market volatility worldwide but the actual impact of this market on global economic growth is questionable. What is more relevant is the transformation of the Chinese economy from a large, centrally-run, export-focused economy fuelled by the intense urbanisation of its citizenry to a more liberalised, consumer-based economy. The world is still very unsure about the ability of China to complete such a transition without causing a major dislocation in markets.

"Slowing growth" in China has therefore been held up as a chief culprit of slowing global economic growth. What does "slowing growth" actually mean when it comes to China? Based on numbers released by the Chinese National Bureau of Statistics, gross domestic product (GDP) growth in 2015 was 6.9%, generally in-line with the central government's target for the year. It was also the lowest published GDP growth figure in 25 years[9].

But there are two sides to the Chinese issue.

One the one hand, we have to remember that a lower percentage of a growing baseline number can result in a large absolute number. Until 2015, China had grown at an annual rate of over 7% for 25 years. The 6.9% growth rate in GDP last year represents economic expansion of over 3.8 trillion yuan, in 2010 prices (see Figure 1). This ranks 3rd on record in terms of annual growth in China, and well in line with the economic activity seen during the 2010-2015 global recovery[10]. A fair question would be: is the Chinese economy severely contracting, as some fear, or is it just following the more moderate growth trend of a maturing economy?

Figure 1: China Real Gross Domestic Product (GDP) over time (in billions of yuan)



Source: BMO Capital Markets

On the other hand, whether we believe that concerns about China's growth are overdone or not, there is little debate that the country's demand for natural resources has decreased significantly. This is perhaps a better measure of China's economic activity than any growth rate published by the country's government. It is also a measure that has a more direct impact on Canada's economic fortunes, as an exporter of energy and raw materials.

Chinese officials have reported that imports such as oil and iron ore from Africa (China is Africa's largest trading partner) fell by almost 40% in 2015[11]. Some of this can be explained by the falling price of oil, which is being driven in part by decidedly un-Chinese factors. But it would be prudent to assume that that some of this decrease in exports is also the result of an economy less reliant on heavy industry, and more reliant on the consumption patterns of its growing middle class[12].

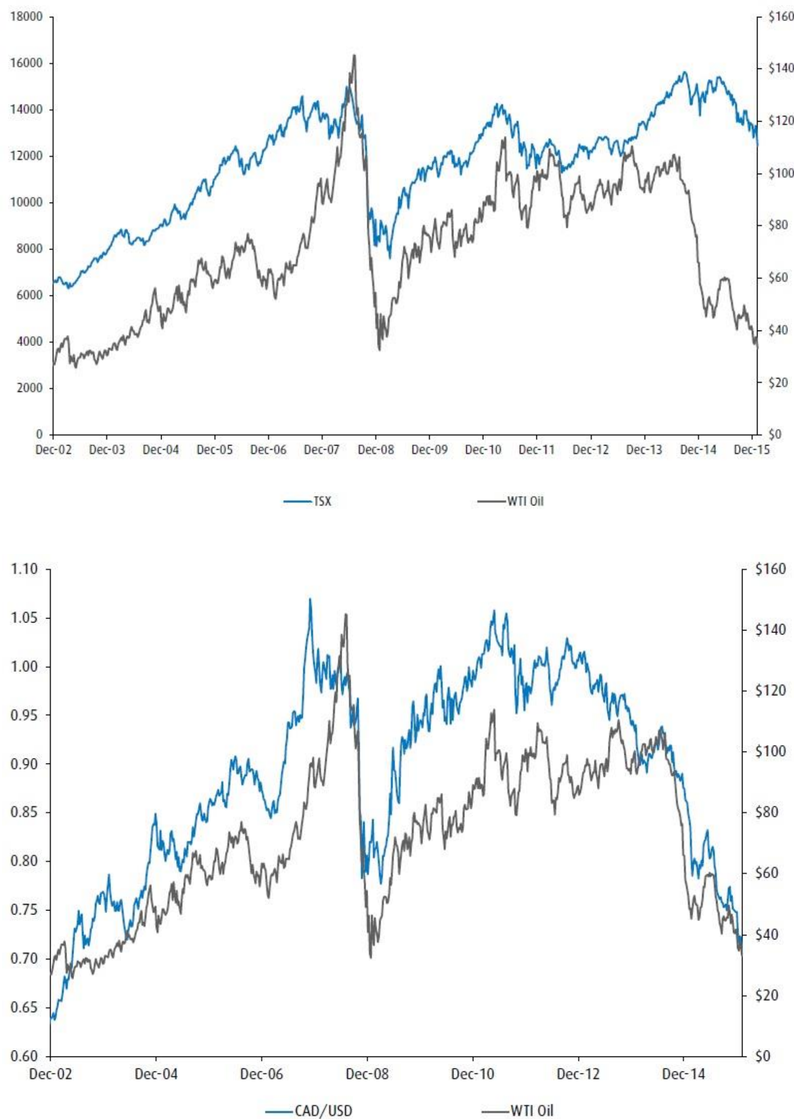
We think it is premature to conclude that the Chinese economy – an economy comprised of 1.4 billion people – is going to be a major drain on global economic growth for the foreseeable future. The likelier scenario, in our view, is that China will continue to be a source of volatility for global markets as it transitions and matures into an economy with a broader domestic consumption base. This transition, which will bring with it significant uncertainty, will also provide real opportunity for companies that can supply goods and services to China's expanding population of consumers. It will be important to position our portfolios to be able to take advantage of this opportunity.

Consequences of cheap oil

Preoccupation over the future growth of the Chinese economy has not been the only factor that has led to concern about the health of the global economy.

The precipitous fall in the price of oil over the course of the last 18 months has been worrisome, and global equity markets and currencies of oil-producing countries like Canada have followed the declining price of oil in lock-step (see Figures 2 and 3). But what has caused the decline in the price of oil, from over $105 / barrel in June of 2014 to under $30 / barrel in January of 2016? What are the long-term consequences of such a fall?

Figures 2 and 3: Canadian Markets and Currency Highly Correlated with Oil

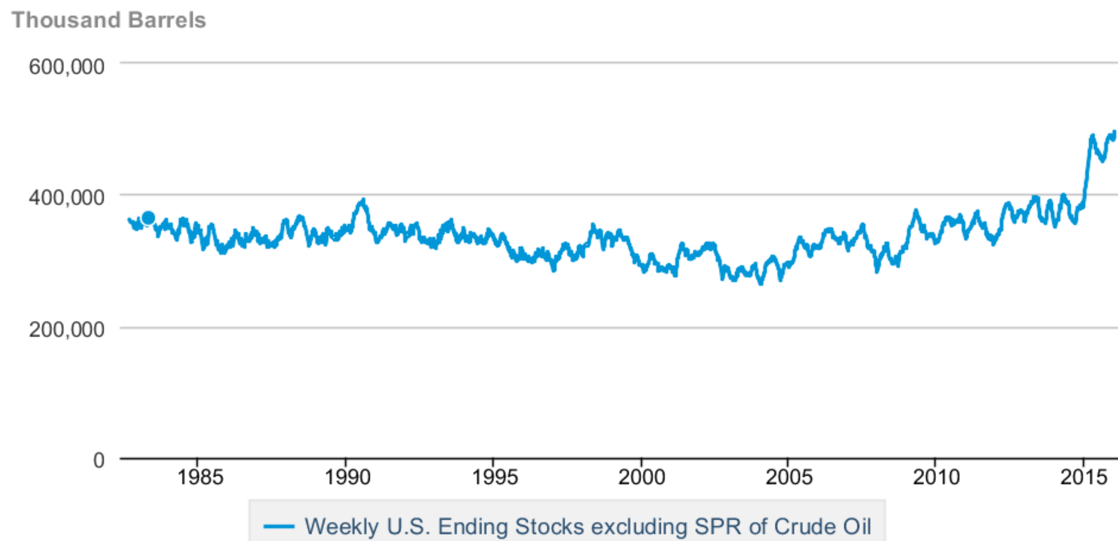


Source: BMO Capital Markets / Bloomberg

Increased oil supply has been responsible for the majority of the decline in the price of the commodity. Production of oil from US shale deposits and continued high level of output from the Organization of Oil Producing Countries (OPEC) have kept the oil

flowing, and this has allowed inventories to build up. Currently, according to the US Energy Information Administration, inventories of oil in the US stand at approximately 500,000 barrels – much higher than the long term inventory average[13] (see Figure 4).

Figure 4: Oil Inventories Remain Very High

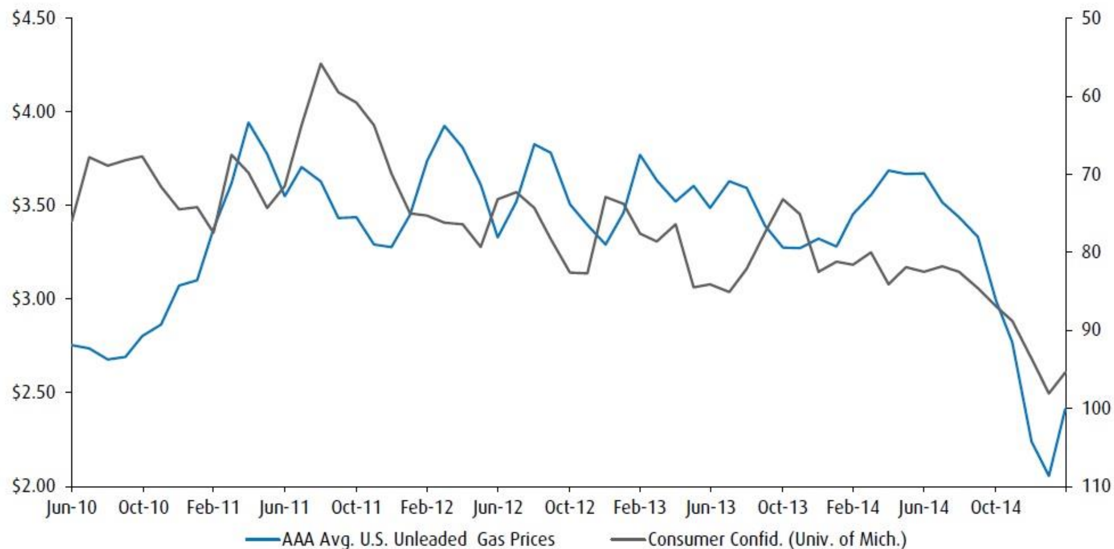


To Canada, a low price of oil is unquestionably harmful to our primary economic sector. The provincial economies of Alberta, Saskatchewan, and Newfoundland and Labrador all have some measure of reliance on oil production. As the price of oil falls and oil-producing companies are forced to curtail their capital spending, tax and royalty revenue to provincial and federal coffers will be affected, economic growth will likely decline and unemployment will rise. The Canadian dollar has proven to be directly linked and very highly correlated to the price of oil, so it stands to reason that as oil stays weak, the currency will stay weak as well. To our manufacturers and our exporters a devalued Canadian dollar is thought to be a benefit, as their ability to compete in foreign markets is enhanced. In Bank of Canada Governor Stephen Poloz's words, "*the non-resource sectors of our economy are receiving considerably more stimulus than we projected*"[14]. This provides a mechanism by which the economy's secondary sectors are stimulated when its primary sector falters. Such a process does not occur immediately or without significant disruption along the way. A lower currency also has significant drawbacks, including higher costs to import goods such as food and industrial equipment.

To countries that do not export oil, or for which energy production is a smaller segment of the national economy, a low price for oil is more likely to be seen as a benefit, lowering operating costs for various industries and allowing individuals to retain a greater portion of their disposable income. This point is supported by the strong relationship between lower gas prices and stronger consumer confidence (see Figure 5). It should be noted that most major markets such as the United States, Europe, Japan, and China,

representing the vast majority of global GDP, fall in this category and benefit from lower energy prices.

Figure 5: Gas Price vs. Consumer Confidence



Source: BMO Capital Markets / Bloomberg

Avoiding the herd

> "If everyone is thinking alike, then somebody isn't thinking."
> ***— George S. Patton Jr.***

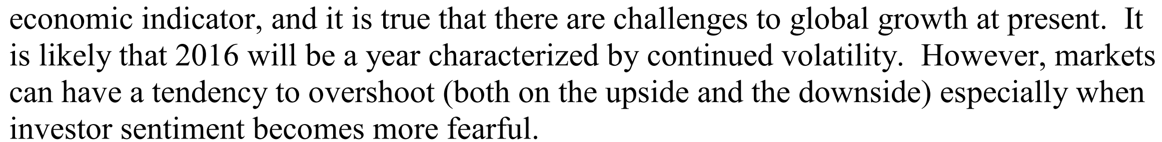
It is important, as investors, to have an understanding of the forces at work that affect the value of our investments. However it is also important to remember that there are times when fundamentals are not the main concern of financial markets. Over the long run free markets are excellent determinants of the fair market value of securities, currencies and commodities, but free markets can also be subject to short term gyrations that can be hard to explain based on fundamentals. Sometimes the herd takes over.

Some of the volatility we have seen in January seems to fall into this category. For example, if most world economies benefit from lower energy costs, why would equity markets move downwards globally in lock-step with the falling price of oil?

Doug Porter, Chief Economist at BMO Financial Group, commented on this phenomenon and on the fundamentals of the US economy in 2016[15]:

> "The market turbulence to start the year is not being primarily driven by economic events. While there has been some mild disappointment on certain indicators, we believe the U.S. economic outlook remains solid and that the risks of U.S. recession in 2016 are low."

We should not ignore the message that markets are trying to communicate to us. The performance of equity markets is generally considered to be a leading (forward-looking)


economic indicator, and it is true that there are challenges to global growth at present. It is likely that 2016 will be a year characterized by continued volatility. However, markets can have a tendency to overshoot (both on the upside and the downside) especially when investor sentiment becomes more fearful.

At times like these, in order to avoid joining the herd, we find it helpful to rely on fundamentals to guide our strategic choices.

- Do the companies we own have strong balance sheets, do they pay sustainable dividends, and are they leaders in their respective fields?

- Is our portfolio properly diversified, with representation from various industrial sectors, and enough individual equities to avoid the risk of over-concentration?

- Have we made the right asset allocation decision, based on our own personal financial situation, with enough assets in fixed income securities to address any need for immediate withdrawals?

As long as we are answering “yes” to these questions, we should be confident in our ability to withstand and endure market volatility.

Conclusion

The start of 2016 has seen renewed volatility in equity, commodity, and currency markets. Despite recent market action, we feel that our model portfolio is appropriately positioned to navigate these rough waters.

- Volatility in the Chinese stock market and over-arching concerns of slowing growth of the Chinese economy continue to weigh on markets. We are likely witnessing the natural evolution of China's economy to a more mature consumer-driven model.

- Energy prices remain low due to a problem of over-supply, slowing growth in China and increased production due to the lifting of economic sanctions in Iran. This will be a headwind for the Canadian economy, but is real stimulus for most of the world, in particular the United States. We have been pleased that our model portfolio's allocation to Energy stocks has been far smaller than the weight of the Energy sector in the Canadian stock market.

- Low commodity prices, low interest rates, accommodative monetary policy in Europe and Japan (quantitative easing) and a financially healthy US consumer have provided enormous stimulus to the global economy. We believe that in the medium term the positive impact of this stimulus will overshadow the short-term volatility markets have been subjected to lately.

- By focusing on shorter-term maturities we are maintaining our defensive posture in the fixed income side of our clients' portfolios. This will best prepare us for a rising interest rate environment, though in may be some time before this becomes a concern for Canadian investors.

Asset Allocation

Every investor's asset allocation target should be determined through a financial planning process. The portfolio's equity allocation should be in line with this target when our view on the markets is "neutral". At times, financial markets will present us with possibilities for greater growth or greater risks. Modifying the asset allocation of the portfolio to account for these factors is appropriate, so long as the investor's actual asset allocation does not deviate too severely from their plan and remains within their investor profile and risk tolerance boundaries.

At this time our view is that portfolios should be tilted as follows (deviations are a percentage of equity exposure, not a percentage of the total portfolio):

For example, a portfolio with a long term strategic target of 60% equity should currently be targeting a 66% equity weight, which represents 110% of the long term equity target.

Please note that our Model Portfolio is meant to be a guide as to the equity portion of our clients' portfolios – not their entire portfolio. Clients who have *Balanced* or *Income* investor profiles will require significant assets in fixed income securities in addition to the equities they hold.

Model Portfolio Metrics

	Model Portfolio	MSCI World Index[16]
Yield*	3.76%	2.57%
Portfolio Beta*	0.90	1.00
Number of Holdings	28	1653

Sector Allocation (Core Portfolio)		
Financial Services	30.0%	20.8%
Telecom. Services	7.5%	3.4%
Utilities	7.5%	3.2%
Consumer Staples	11.0%	10.4%
Consumer Discretionary	11.0%	13.3%
Healthcare	6.0%	13.5%
Information Tech.	6.0%	14.2%
Industrials	11.0%	10.7%
Energy	5.0%	6.1%
Materials	5.0%	4.4%

*As at 2016-01-29; source: Thomson ONE

Meet Our Team

Elizabeth I. Cosgrove, CFP

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Elizabeth became an Investment Advisor in 1983 after spending her first 8 years in the business working as an assistant. She received her securities license in 1980 by successfully completing the Canadian Securities Course and the Canadian Options Course. Elizabeth achieved her Vice President status in 2004. She has been practicing financial planning as a CFP® certificant since 1998 after successfully completing all six courses offered by the Financial Planners Standards Council. Elizabeth is fluently bilingual and offers her services in either French or English.

Elizabeth was born and raised in Ottawa in a family of eight. She currently resides in Manotick with her husband David. They enjoy golfing, gardening, bird watching and playing music.

Philip Brock, CFA, CFP, F.Pl., B.Com

Investment Advisor and Financial Planner

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Since his entry in the financial industry in 2004, Philip has advised many families on retirement planning, personal credit, and investment management. He holds a Bachelor's degree in Commerce from the University of Ottawa and holds the Chartered Financial Analyst (CFA) designation. In addition, he has been practicing financial planning as a CFP® certificant since 2007. Philip is happy to offer his services in French, English or Spanish.

Born in Montreal, Philip has lived in the National Capital Region since 1987. He currently calls Orléans home along with his wife Kathleen and their young sons, David, Jonathan and Nicolas. When he's not providing financial advice to his clients, he can usually be found on the curling rink or off in the woods on a canoe trip.

Patricia Butler, B.A.

Associate Investment Advisor

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Patricia has been in the financial services industry since 1985. She received a B.A. from Concordia University in 1987 and has completed the Canadian Securities Course and the Professional Financial Planning Course. She joined BMO Nesbitt Burns in March 2004. As Associate Investment Advisor, she engages with our clients around issues of financial planning and portfolio maintenance among others. Patricia is fluently bilingual and is happy to assist you in either French or English.

Patricia enjoys reading, playing soccer and golf and spending time with her husband and two children.

Debbie Kelly

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Debbie joined BMO Nesbitt Burns in 1999 after a career in banking. Debbie takes care of all the administrative needs of the team. She will be happy to assist you with any inquiries you may have regarding your accounts. It is also her role to reach out to our clients to coordinate the scheduling of periodic review meetings.

Debbie grew up in a large family in the Pontiac and currently makes Orléans her home. She enjoys spending time with her three granddaughters.

[1] USA Today, *Stocks close out week with worst start to year ever*, Adam Shell, January 9 2016

[2, 3, 4] Thomson One

[5] The Canadian Press, Loonie at lowest level since April 2003, January 20, 2016

[6] Thomson One

[7] BMO Capital Markets, Economic Research, *Global Equity Weekly*, Robert Kavcic – Senior Economist, January 29, 2016

[8] Reuters, *China's stock market regulator 'resigns' after circuit-breaker fiasco*, January 18 2016

[9] Thomson Reuters Eikon, *China GDP*, Staff, January 19, 2016

[10] BMO Capital Markets, Economic Research, *AM Charts – China GDP: 7% Growth is Already Gone*, Doug Porter – Chief Economist, January 20, 2016

[11] AFP, *China's imports from Africa plummet in 2015: officials*, January 13 2016

[12] CNBC, *Amid the turmoil, more Chinese climb into upper middle class*, Heesun Wee, January 21, 2016

[13] US Energy Information Administration, Weekly US ending stocks excluding SPR of crude oil, January 2016

[14] CBC News, *Stephen Poloz says Canadians pay the price for low oil as loonie tumbled: Don Pittis*, Don Pittis, January 21, 2016

[15] BMO Capital Markets Economics, *Talking Points – Powerbear*, Douglas Porter, January 16, 2016

[16] MSCI World Index, MSCI Inc, www.msci.com

[17] Profiles for BNS, BCE, GE, GWO, ITW, IFC, JNJ, MFC, SU, TD, and TRP replicated from the December 2015 Canadian Equities Guided Portfolio and US Equities Guided Portfolio, BMO Nesbitt Burns Portfolio, Action and Research Team, December 2015

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