Morin Dupont Lessard & Associates

Sound advice with outstanding service

April 2016

Newsletter #55

An "InCRUDEdible" Market (Except)

BMO Wealth Management

BMO Nesbitt Burns

Morin Dupont Lessard & Associates

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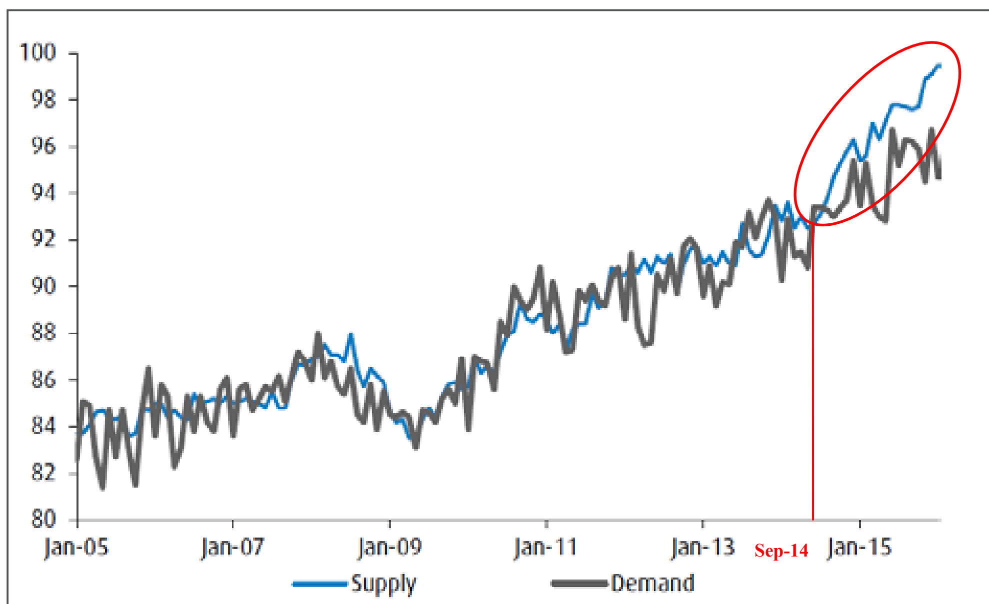
Oil now seems to be the key focus of world markets. Millions of jobs worldwide depend on it, and hundreds of billions of dollars in debt are related to its exploration, production and distribution. Conversely, low energy prices represent a huge tax cut to the benefit of consumers, enhancing their purchasing power. While a price of US$100+ for barrel of oil may be excessive, putting a brake on consumer and economic growth, at US$25, it creates significant financial pressure for producers and lenders. Meanwhile, the higher prices go, the more projects are initiated and the greater becomes the resulting production capacity.

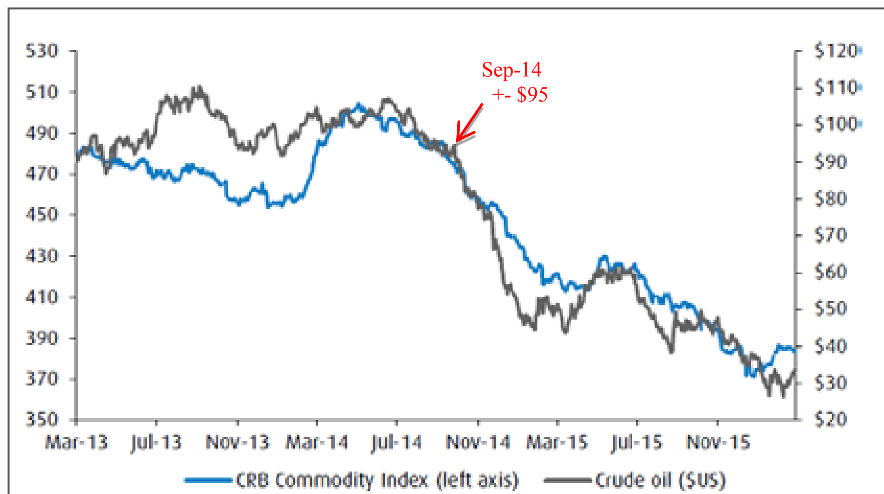
CHART 1: Global Oil Demand and Supply, Million bbls /day



Source : Bloomberg

Excess capacity eventually drives prices down as dictated by the rules of supply and demand and free markets.

CHART 2: Crude Oil and Commodity Prices



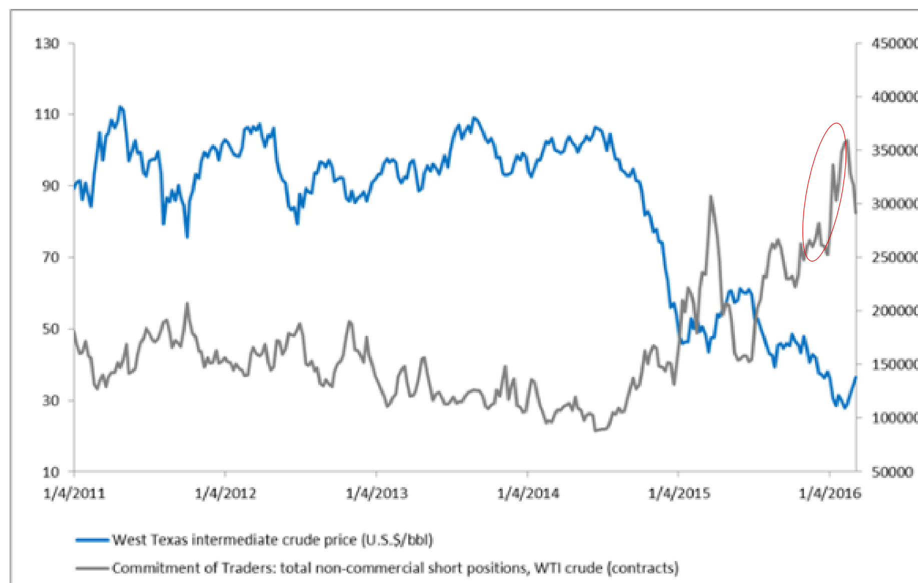
Source : Bloomberg

These periods of excesses can be referred to as “bubbles” such as the “tech bubble” of the 90s, the “real estate bubble” of the mid-2000s and, more recently, the “oil bubble” which started in the mid-2000s, reached $147/barrel in 2008, was interrupted by the financial crisis, then resumed its upward trend in 2009 to reach $114, benefiting from very accommodating monetary policies and the implementation of quantitative easing measures by the Federal Reserve Board (the Fed), the US Central Bank.

None of these extreme prices are good for the economy as they are a losing proposition for part of the equation. An arrangement where all parties involved benefit is referred to as a good deal. Somewhere between $100 and $25 is the point of equilibrium, the compromise that would benefit everyone. Easier said than done! OPEC was created to try to maintain such a balance, but has failed at the task for decades as the parties involved cheat by exceeding their quotas or selling their excess production to the black market, etc. Oil is also the most flexible source of energy and an absolute necessity in this day and age. Therefore to lock in access to this “black gold”, countries have gone out of their way to secure both the resource and its transportation routes and pipelines. Land control and jurisdictions have changed hands many times in oil rich countries over the decades. And as the world population grows, so does demand for energy. Russia, one of the world’s largest oil producers and suppliers, invaded Ukraine in recent years, a move that can be explained by this theory, as can its support of Syria. In fact, oil prices started its tumble after the Russian invasion of Ukraine. One theory had it that by maintaining excessive production, the US and Saudi Arabia would drive oil prices down, hurting Russia the most, adding to the impact of sanctions against that country. However, causing a systemic financial crisis isn’t helpful to anyone, especially since many banking systems were weakened seven years ago and have yet to regain their full strength. Ultimately oil prices between $50 and $70 would represent a sweet spot where everyone would benefit.

Unfortunately, thanks to speculators and hedge funds, oil prices have been and will continue to be very erratic, spiking up and down with very little fundamental justification. Last fall, Goldman Sachs predicted that oil would bottom out at US$20 a barrel. Other experts hopped on Goldman’s bandwagon, encouraging short selling activity.

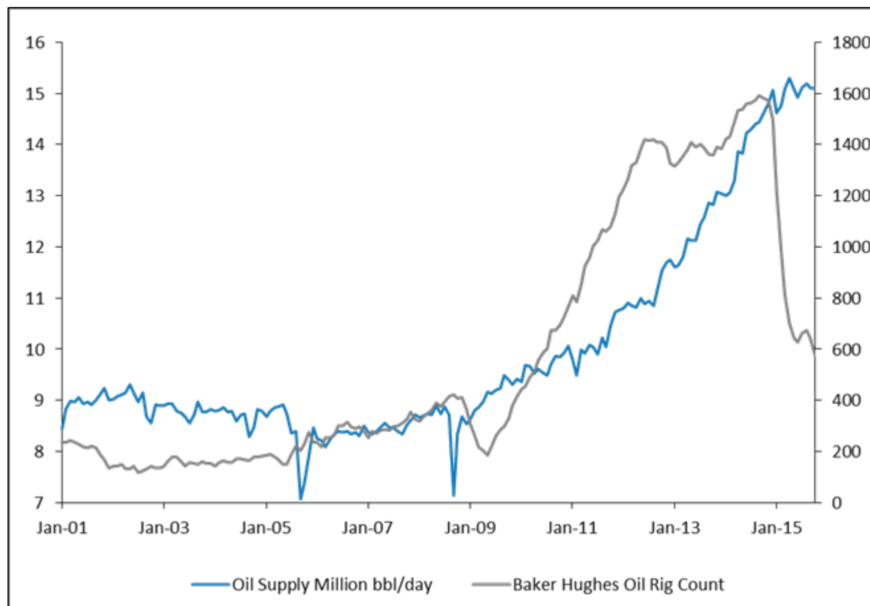
CHART 3: WTI vs Commitment of Traders total non-commercial short position WTI crude (contacts)



Source: Bloomberg

Short interest reached its peak early in the year, as more speculators joined in the frenzy. Although rig counts kept coming down, oil production continued to increase, further supporting short selling.

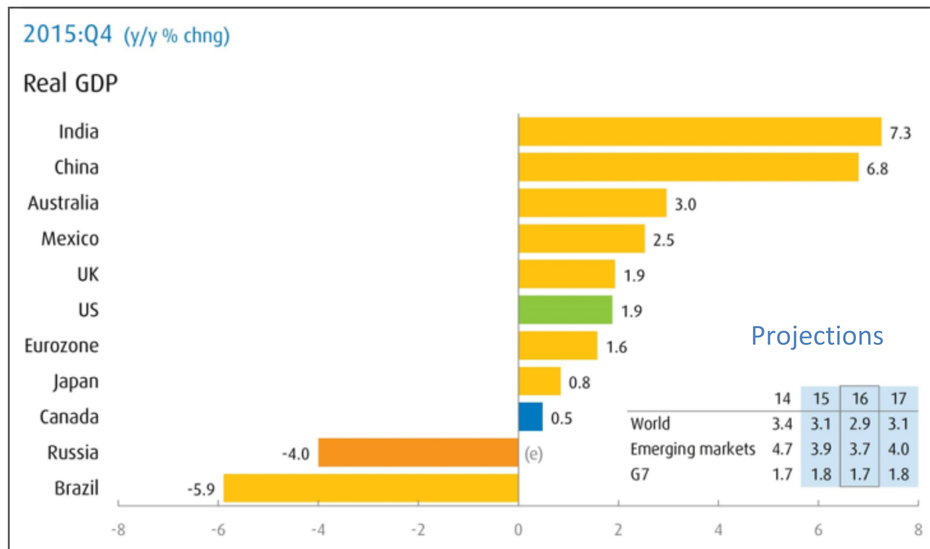
CHART 4: US Oil Supply vs. Baker Hughes Oil Rig Count



Source : Bloomberg

At the first hint of US oil production slowing, however, the race to cover short positions began, thus propelling the oil price rebound. Although it is quite possible that oil prices have bottomed out, it is likely we will see it pull back again given that world production still exceeds demand, and that inventories remain excessively high. In addition, as part of long-term inventory, there are over 1,000 capped oil ducts in the US ready to be brought in production quickly at a relatively low cost which may be a supply force to reckon with, potentially allowing the United States to have better control over world oil prices in the future. Furthermore, as of January 1, 2016, Mr. Obama rescinded the oil export ban that was introduced 40 years ago by George Bush Sr. Accordingly, volatility should continue to be very present until a pick-up in demand becomes more evident. For that to happen, we need world GDP growth to expand at a much faster pace than 2.5%. However, signs of a global slowdown in economic activity early in the year raised the fear of a global recession. Fortunately, the risk of world recession has retreated somewhat over the past several weeks, following a strengthening of Chinese commitments and economic stimulus in addition to the European Central Bank’s (ECB) intervention, deepening its quantitative easing (QE) program, and a welcome increase in German industrial production.

CHART 5: Global GDP growth actual and projected

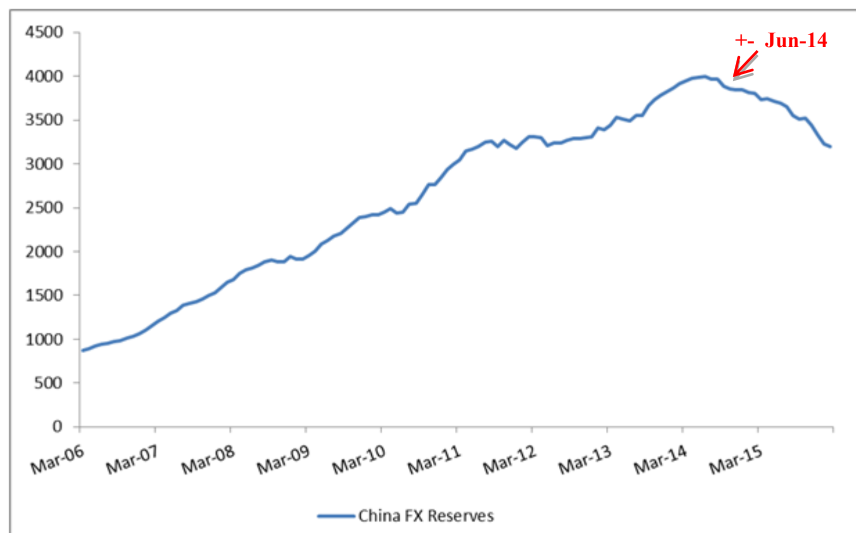


Source : BMO Capital Markets

CHINA

The Chinese economy as contracted significantly since the end of the last decade. The slowdown in infrastructure building in China spelled trouble for most commodity export dependant countries. China had begun to shift away from a manufacturing-based to a consumer-based economy. With a population of 1.2 billion, more than triple that of the US, the full potential of this country relies on consumption. China has been investing considerably in Africa to ensure a low cost source for its manufacturing base, while securing low cost products and accessible consumption. However, going through such a transition doesn't come without disruptions, and it does take time. The most important commodity becomes the currency. If the currency plummets because of hard landing of the economy and its resulting shock on consumer and investor confidence, then capital flows out, the currency devalues, derailing the move towards a consumer-driven economy. Unlike what many American protectionist politicians might say to garner electoral support, China is working hard to maintain its currency, using its US reserves to buy the yuan in the hopes of maintaining its value and purchasing power.

CHART 6: China FX Reserves (USD)



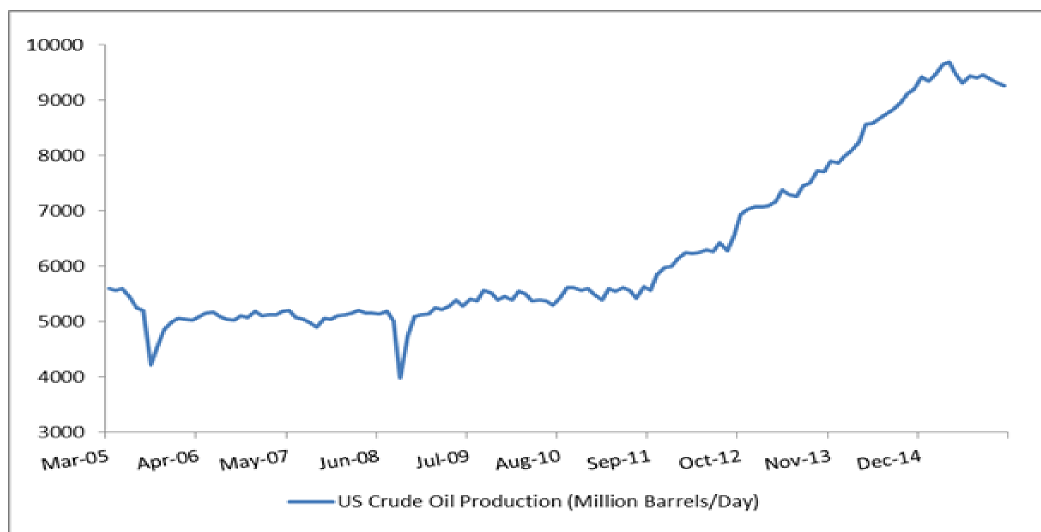
Source: Bloomberg

As a young country in a somewhat "regulated capitalistic platform" (for lack of a better description), China has made significant mistakes in the past year, confounding investors and destabilizing domestic markets. Recognizing these "rookie mistakes", China has opened its communication channels with the Western world, re-affirmed its commitments to economic reforms and reassured world investors that "China should no longer be a source of anxiety for global markets", according to the newly appointed Assistant Finance Minister, to enhance communication flow. Corporate China has extended its debt level considerably but the vast majority of Chinese businesses are owned by the State. Government commitments are therefore self-serving, which supports our conviction.

China is the second largest economy in the world today and, while the US is relatively immune to China's economy, given its autonomy, it has a huge impact on global GDP growth and the price of raw materials and energy. Consequently, a healthier China means better global growth which is better for everyone! China's GDP growth rate has fallen from 12%+ to barely 6% today. Although GDP growth is expected to contract in a consumer-based economy, domestic consumption remains weak on a per capita basis as it goes through the transition. It is a difficult balancing act that China is attempting to manage but one it is committed to achieve. In stimulating its economy, it is expected its energy demand will rise and help close the gap between global supply and demand. This will allow oil prices to reach more comfortable level for both producers and lenders.

If a more predictable, range-bound, crude oil price is the key to more sustainable world economic growth, then who would be the best candidate for controlling oil prices? Would it be Saudi Arabia, Russia, OPEC… or the US? Well, the US is in a better position than ever to do just that. It has doubled its daily production - from 4.6 million barrels a day seven years ago to 9.6 million barrels a day in 2015, outpacing Saudi Arabia.

CHART 7: US Crude Oil Production (million barrels per day)



Source: Bloomberg

The US uses the newest technology for nearly half of its total production, allowing them to increase or decrease the production much faster, with a much lower resumption cost than conventional producers. This allows for better inventory control and pricing. With US $ costs and US $ revenues, currency is less of an issue for them. Furthermore, US natural gas prices are the lowest in the world – under $2/MCF – and there are indefinite reserves… The combination of better oil price controls and the expansion of China's economic growth would spell good news for global GDP growth and world equity markets.

EUROPE

Although Mr. Draghi and the ECB finally launched their first round of quantitative easing back in March 2015, which was well-received by the financial community at the time, the European economy has barely expanded since. In the fall of 2015, he extended the program, set to end in September 2016, to March 2017. He intervened again recently (March 2016) to enhance the program further by increasing the scale of the security purchases from 60 to 80 billion Euros per month, adding corporate bonds to the mix and expanding the potential scope of the buyback program. Although these measures are deemed aggressive, it was the additional rate cut on commercial bank deposits, from negative 0.3% to negative 0.4%, that raised eyebrows. The Central Bank's negative interest rate policy is designed to push banks to lend rather than hoard cash. Hoarding cash now becomes a 0.4% cost for chartered banks, negatively impacting their earnings. This negative reinforcement can be very disruptive to the financial system and the source of an unintended consequence. Allow me to explain. Let us assume that the chartered or commercial banks of Europe start charging this new cost back to depositors…What could happen? Well, depositors might see fit to withdraw their money wreaking havoc and potentially increasing the risk of a run on banks. How helpful would that be? To avoid this risk, commercial banks will not pass on the cost to their clients, but rather will lend more, testing the limits of their minimum capital requirement, leaving them more vulnerable to unforeseeable problems. Why, then, is the ECB taking this huge risk? The belief is that such an action would promote lending and ultimately drive inflation up to a 2% target from a worryingly low annual rate of minus 0.2%. At a manageable level, inflation is desirable and the better of the two evils (inflation versus deflation). This is also why and how oil prices and global growth are becoming the most important variables.

Negative interest rates, now present in nine of the G20 countries, have become our biggest worry as such a strategy has not proven itself an effective tool and is perhaps starting to be seen as a last resort for central banks. As mentioned in many of my previous semi-annual letters, monetary policy would be most efficient were it combined with tax reform (spreading the wealth) and government spending in targeted infrastructure projects to create jobs and stimulate consumption. The last thing Europe needs now is for commercial banks to turn against the Central Bank and its depositors, and for the U.K. to exit the European Union! A spending commitment using targeted subsidies could stimulate further European growth and would add to China's effort. Britain's decision expected in June could cause uncertainty and market tremors.

NORTH AMERICA

The US started the year suffering from what seemed the counter-effect resulting from short covering in late December, propping up year-end performances, and rebuilding those short positions at the beginning of the year in view of negative earnings results in the financial industry in Europe and their side effects on US banks. Although Deutsche Bank sold some assets in the last quarter last year, as did Credit Suisse, it became more obvious in January that their reserves were quite low, when both having recorded very poor earnings. Asset sales are a way to raise reserves for banks. These actions became more transparent in January and

triggered a selloff sparked by the fear of Europe and China falling into a recession and dragging others along with them in a global chain reaction.

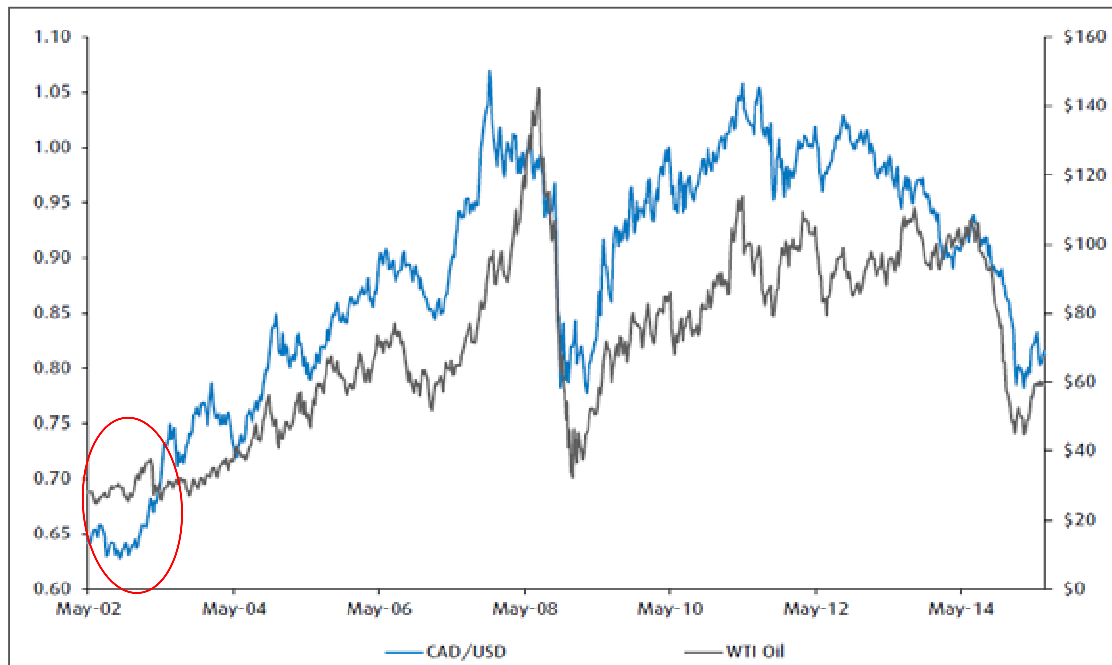
But as mentioned earlier, several measures combined with rebounding oil prices seemed to have lessened that risk. The US has enjoyed good economic results with an ongoing momentum in job creation, lower unemployment and improving ISM (Institute of Supply Management) and PMI (Purchasing Managers Index) numbers. Most importantly, the majority of newly created jobs in February (some 80% of the total) came from small- and medium-sized private businesses, the lifeblood the US. Over 140,000 of the some 214,000 new payroll jobs came from this core group. This is where the true US economy lies. Statistically, this group has not experienced job creation or wage increases for the past 15 years. This is the same group that has bled the most jobs, driving people into increasingly crippling debt during the last financial crisis. This group is now starting to see a light at the end of the tunnel – the sweet spot in the economy that is capturing most of the recent job growth.

The Fed, moving in the opposite direction to its peers in its monetary policy, is now facing a situation similar to what occurred in September 2015, when it held off on raising interest rates a mere 0.25%. That delay was justified by the anemic global growth and the weakening Chinese economy. It finally introduced a rate hike in December, projecting no less than three more hikes for 2016. Given today's extra efforts by both the ECB and the Bank of China, it seems more likely that the Fed's next move might now come in June 2016, at the earliest. We view these rate hikes as an important factor for valuation purposes. Although they suggest that the US economy is growing at a healthier pace and that inflationary pressures are developing, world growth – now that economies are increasingly linked – is not. Globalization is forcing the Fed's Janet Yellen to give more weight than before to world growth in her decision-making process. She has the responsibility of managing the return to a normal yield curve in the US without smothering the global recovery, while avoiding creating asset bubbles domestically. Talk about a juggling act! Valuations are therefore much more difficult as higher rates increase the discount of future cash flows and reduce the present value of companies. The impact may be nullified if world GDP growth is stronger. In addition, a rate hike ahead of the rest of world also raises the value of the US dollar. This phenomenon puts additional downward pressure on top line sales growth, which also translates into slower earnings growth. On March 16th, Mrs. Yellen expressed more dovish accommodative comments when she slowed the rate rise momentum, at least for 2016, from an expected four increases to one or two. The markets reacted very favorably as discounted valuations had pulled stocks down to 15 times earnings and stocks became oversold. At this point we believe US fundamentals are still favorable, especially given the Fed's more dovish stance for at least this year.

Meanwhile, Canada and Mexico are becoming extremely attractive markets for US companies. As mentioned in our recent RRSP/TFSA letter, lower corporate taxes as well as available qualified labour, lower transportation costs (proximity), better quality control and a reduce risk of intellectual property theft are all major positives for expanding US corporations.

While Canada is suffering from a commodity and energy collapse, it can largely benefit from a global recovery and, unlike other countries, Canada is committed to kick starting its economy by government infrastructure spending and some fiscal policy changes to accompany our accommodative monetary policy. Furthermore, Canada is in a position to grow its secondary sector (transformation) given its weaker currency. It should also benefit from continued economic growth in the US. The Canadian dollar may not be as correlated with oil prices going forward given the country's projected future deficits and debt expansion, which should have a counter effect on the loonie similarly to the late 1990's and early 2000's.

CHART 8: Canadian Dollar vs Oil 90% correlation Since 2003



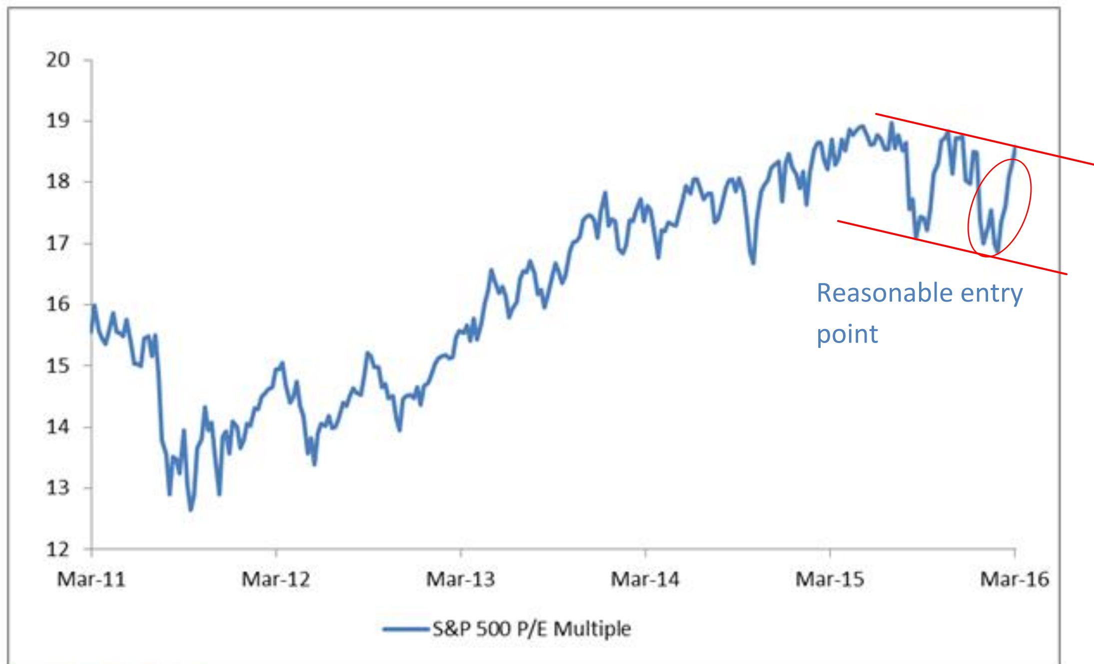
Source : Bloomberg

Canada seems to be poised to outperform many of its peers in the coming year or two. These are «in***crude***dible» times indeed!

Conclusion and strategy

China and Europe's stimulus efforts cannot be overlooked. Although monetary policy measures are pushing limits, they seem to be accompanied by exceptionally inflationary government spending efforts. I am confident deflation in Europe can be avoided and my belief is supported by Germany's significant increase in industrial production this past February. The return of China's commitment to spend in its economic platform should re-ignite Asian economies. Meanwhile, the underlying American economy, which is driven by a workforce of 145 million people in small- and medium-sized businesses (the lifeblood of America) – an estimated 82% of employment – is growing at a 3% to 4% rate. US consumers now enjoy a stronger balance sheet ($1.20 of debt per dollar of revenue compared to $1.71 in Canada), new jobs are being created, wages are going up as is spending, car sales are at a all-time highs, home prices are firming up (given extremely low inventories at 3.9 months), and so are home sales and household spending. Inflation has reached the 2% target and the Fed can justify tightening domestically. Meanwhile, global recession worries have brought US equity markets to an earnings multiple of 15 by mid-February a reasonable entry point if we avoid recession. This mid-February low point may be retested.

CHART 9: S&P 500 P/E Multiple



Source: Bloomberg

JP Morgan CEO Jamie Dimon personally bought 500,000 of his firm's shares on the open market on February 11th, for a total investment of $26.5 million, coincidently marking the low point of US stock markets. There is nothing better than action to support your beliefs. We remain bullish in current markets given our dependence on global growth and on more sustainable and stable oil prices in a higher price range.

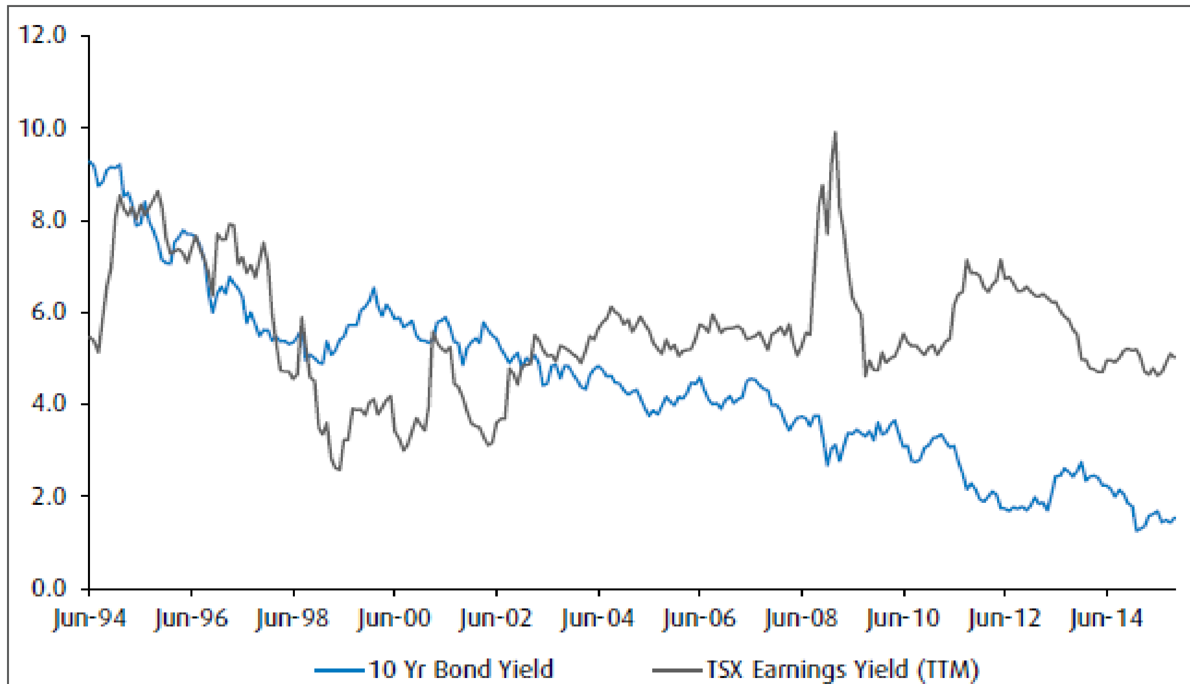
Market volatility will remain high until oil supply and demand reach equilibrium. We believe energy prices could retest the low $30-$35 range, which we think should be an entry point to raise our weighting in that sector to 6%+. This increased position will serve as a currency hedge against the US dollar at the same time. Exxon Mobil raised no less than $12 billion through a bond issue (the largest corporate bond issue) in early March which we believe could be used for consolidation purposes. Such an event could signal the end of oil's correction. Given our cautious approach, we will continue to maintain higher weighing in less cyclical sectors such as consumer staples, health care, utilities and telcos. We also encourage investments that are supported by the US housing recovery which we believe is still in its early stages. Related consumer discretionary stocks as well as financial services will prove to be appropriate investments. We also believe in maintaining at least a 6% weighting in technology stocks, with an emphasis on large cap companies with underleveraged balance sheet and significant cash on hand. The world's progress towards digitalization is creating endless opportunities and the possibility of unprecedented consolidation.

In the industrial sector, we are of the view that infrastructure investments should accelerate as well as stimulate transportation. While we will maintain our weighting in this sector, we are

propping up our materials sector slightly, making sure we have an exposure to lumber and gold as a safety net.

On average, TSX-listed stocks as well as US-listed stocks are returning a higher dividend yield than 10-year fixed income government bonds.

CHART 10: S&P/TSX Earnings Yield Versus 10-year Canada Bond Yield



Source: Bloomberg

Although this is a supporting case in favor of stocks, only bonds provide a true backstop in a portfolio. Given that volatility in equity markets has reached unprecedented levels, your fixed income exposure can alleviate anxiety levels, allowing you to buy on a big market pullback!

Hopefully, these guidelines will prove to be “**crude**dible”.

Sectors	Recommended Weighting April 2016	Trend
Consumer Discretionary	2%	↑
Consumer Staples	8%	↓
Energy	3%	↑
Financials	18%	
Health	4%	
Industrials	10%	↓
Materials	2%	↓
Technology	6%	
Telecom	5%	
Utilities	7%	
Total Equities	65%	

- *The suggested weightings are appropriate for a 65/35 equity/fixed income portfolio and should be adjusted based on your investor profile.*

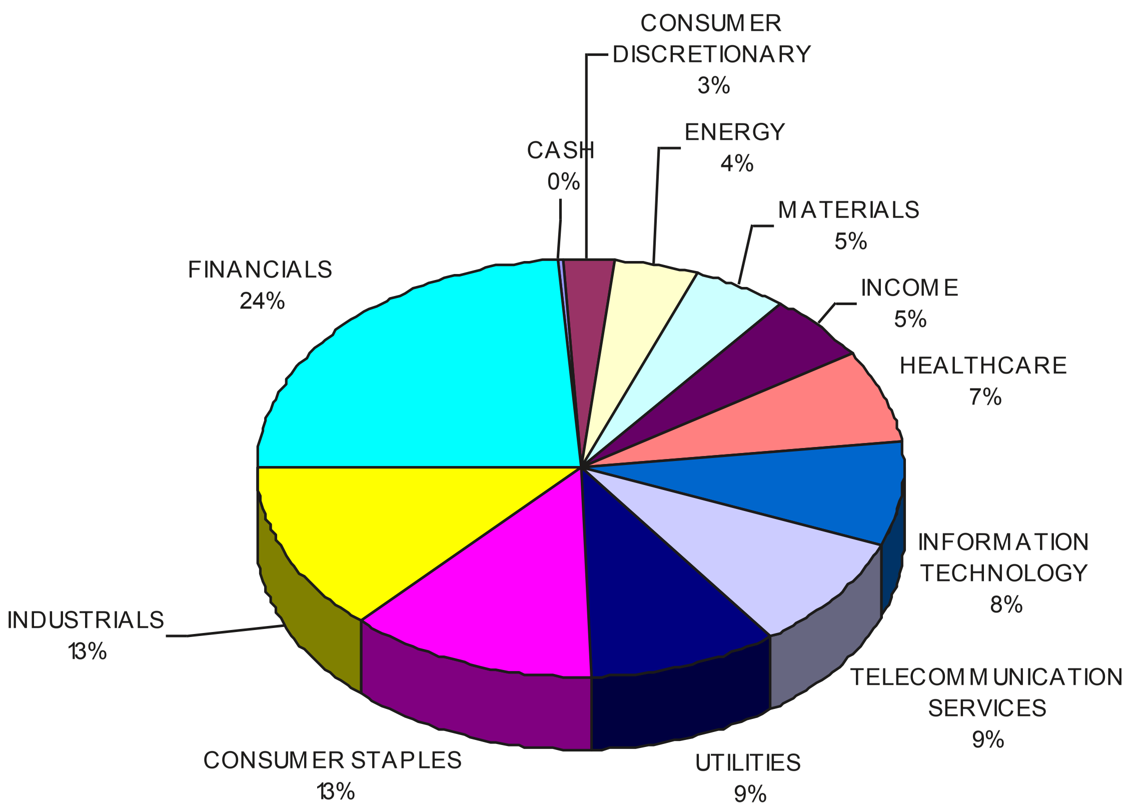
RECOMMENDED ASSET MIX				
INCOME PORTFOLIO			**BALANCED PORTFOLIO**	
Oct 2015	Apr 2016		Oct 2015	Apr 2016
5%	5%	CASH (maturities ≤ 12 months)	5%	5%
50%	50%	Fixed income (Bonds & GICs)	30%	30%
15%	15%	Convertible Debs. And Income Generating Securities	10%	10%
10%	15%	Equities	20%	25%
20%	15%	Foreign	35%	30%
Disclaimer: Subject to an evaluation of the risk profile of individual clients				

Year	T-Bills (return)	SP TSX[1]	SP TSX[2]	MODEL (return)
1990	13.20%	-17.96%	-14.80%	**5.94%**
1991	9.35%	7.85%	12.02%	**22.14%**
1992	6.67%	-4.61%	-1.43%	**10.50%**
1993	4.68%	28.98%	32.55%	**34.91%**
1994	5.19%	2.50%	-0.18%	**6.09%**
1995	6.42%	11.86%	14.53%	**8.09%**
1996	3.93%	25.74%	28.35%	**16.21%**
1997	2.85%	13.03%	14.98%	**21.05%**
1998	4.56%	-3.19%	-1.58%	**1.87%**
1999	4.67%	29.72%	31.71%	**19.96%**
2000	5.23%	6.18%	7.41%	**30.40%**
2001	3.73%	-13.94%	-12.57%	**9.54%**
2002	1.75%	-13.97%	-12.44%	**3.61%**
2003	2.22%	24.29%	26.72%	**22.23%**
2004	1.84%	12.48%	14.48%	**13.87%**
2005	2.53%	21.91%	24.13%	**15.73%**
2006	3.52%	14.51%	17.26%	**14.30%**
2007	3.59%	7.16%	9.83%	**8.06%**
2008	1.77%	-35.03%	-33.00%	**-28.07%**
2009	-0.75%	30.69%	35.05%	**29.37%**
2010	1.51%	14.45%	17.61%	**21.05%**
2011	0.58%	-11.07%	-8.71%	**4.18%**
2012	0.25%	4.00%	7.19%	**7.38%**
2013	0.30%	9.55%	12.99%	**18.14%**
2014	0.43%	7.42%	10.55%	**16.43%**
2015	1.60%	-11.09%	-8.32%	**6.36%**
* 2016	0.12%	4%	NA	**0.51%**
Return Compounded as of December 31, 2015				
3 years	0.77%	1.52%	NA	13.52%
5 years	0.63%	-0.65%	NA	10.35%
10 years	1.27%	1.44%	NA	8.58%
Average return since inception (YTD)				**12.31%**

* (YTD): Year To Date (March 31, 2016)

$100,00 invested on June 1st 1990 The returns are compounded monthly and revenues are reinvested. 1: Does note include income or dividend 2: Includes income and dividend

PORTFOLIO HOLDINGS AND ASSET MIX



By sub-Index %

BMO Nesbitt Burns

Morin Dupont Lessard
& Associates

Portfolio Return

Value as of
March 31, 2016
$ 2,026,040

Average
Return
12.31 %

$2,500,000
$2,000,000
$1,500,000
$1,000,000
$500,000
$0

Dec '90
Dec '92
Dec '94
Dec '96
Dec '98
Dec '00
Dec '02
Dec '04
Dec '06
Dec '08
Dec '10
Dec '12
Dec '14

Model
S&P TSX*
S&P TSX**
T-Bills

$100,000 invested on June 1st 1990

The returns are compounded monthly and revenues are reinvested.

**Does not include income or div*

***Includes income and div*

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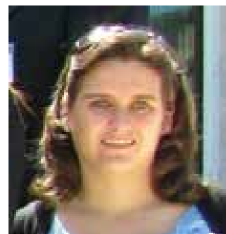

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