Morin Dupont Lessard & Associates

Sound advice with outstanding service

Newsletter #53 April 2015

Cheap Oil, Cheap Euro… The Bull has gone to Europe?!

(Excerpt)

BMO Wealth Management
BMO Nesbitt Burns

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Pierre’s comments

The raging bull that came out of hibernation six years ago, on March 9, 2009, has recently gone missing. Markets have been erratic, with no sense of direction and increased volatility. With only a single pause in 2011 (a correction of more than 10%), this bull has been working relentlessly for several years now. Perhaps the fact that he hasn’t been “Fed” since last November has something to do with his disappearance… It is true that the U.S. markets are getting a bit pricy, a victim of a relatively stronger economy and the sense of security that comes from owning U.S.-denominated securities, given the safe haven the U.S. currency provides. Since the Federal Reserve Board (Fed) put an end to its latest round of quantitative easing (QE3) last November, many other countries have implemented QE in one form or another to stimulate their economies and fight deflationary pressures. In essence, the tested theory is to stimulate growth by providing easy access to cheap money via low borrowing costs. However, consumers need to be comfortable financially to justify going on a spending spree. Thus, good and safe jobs are needed to stimulate consumer confidence. Like the chicken or the egg, it’s hard to say which comes first, but what we need is some sort of harmonized agenda, and this will take time. Among the foreign countries “Q”-easing right now are Japan and, more recently, Europe. The European Central Bank (ECB), which we expected to initiate a quantitative easing policy by the end of March 2015 according to our previous newsletter (October 2014), indeed announced such an action on January 22, officially launching the program on March 9, six years to the day after the start of the current bull market. Although favorable for foreign markets, the announcement resulted in the devaluation of foreign currencies versus the U.S. dollar, driving the latter to a 12-year high (see U.S. dollar index, Chart 1).

Chart 1

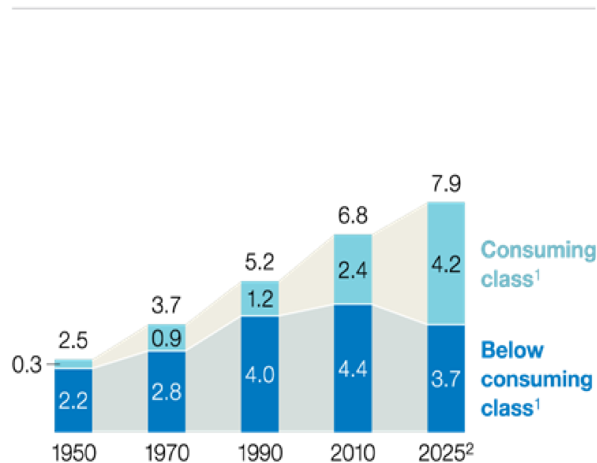
Source: Focus, March 13.

Although there have been lots of worries about the strength of the U.S. dollar in the press recently, the greenback has only returned to its 30-year average, but it has done so in a very short period of time. The impact on U.S. multinationals is significant, given the speed at which the U.S. currency increased in value. Foreign revenues and earnings are negatively impacted, forcing companies to lower their forecasted results. Analysts are reviewing their projections and generally lowering their target prices, reflecting lower earnings growth. On the bright side, multinationals have the capacity to hedge their currency risk short-term and realign their future production in weaker currency countries where they already have a foothold. This flexibility allows them to maintain their competitiveness over the longer term and better position themselves to capture the faster growing consumer base in emerging markets.

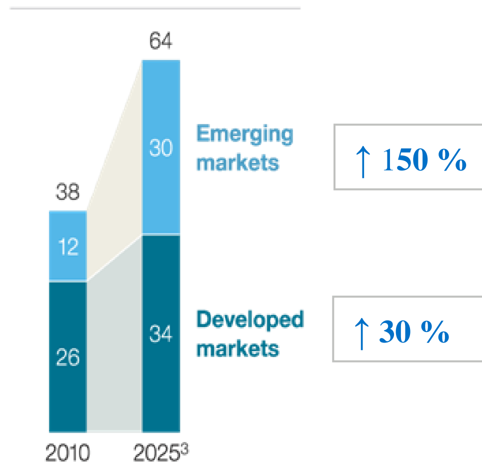
Chart 2

Emerging Market Consumption: The Biggest Growth Opportunity in the History of Capitalism (As Quoted From McKinsey, figures in USD)

World population, billions



World consumption, $ trillion



[1]Consuming class: daily disposable income is ≥$10; below consuming class, <$10; incomes adjusted for purchasing-power parity.
[2]Projected.
[3]Estimate based on 2010 private-consumption share of GDP per country and GDP estimates for 2010 and 2025; assumes private consumption's share of GDP will remain constant.

Source: Angus Maddison, founder of Groningen Growth and Development Centre, University of Groningen; Homi Kharas, senior fellow at Wolfensohn Center for Development at Brookings Institution; McKinsey Global Institute analysis

Source: McKinsey

The short-term impact, however, is harder to evaluate. It's a case-by-case situation, and destabilization causes uncertainty. When current price to earnings (P/E) multiples are slightly above historical averages, volatility sets in and investment confidence fades. And investors begin to wonder:

1)Is it time to sell?
2)Is this the end of the bull market?
3)Are we facing another meltdown?
4)What are my investment options?

Some quick answers:
1.Rebalancing is a better option
2.No
3.No
4.Geographical diversification

Before we review these answers in greater detail in our investment strategy section, it would be best to provide you with an update of where we stand economically in North America.

THE ECONOMY

The stories in Canada and in the U.S. are quite different. While the Canadian economy has been hit harder by last year's unexpected drop in oil prices, its consumer base is much more in debt than its U.S. counterpart and is not benefiting from large discounts at the pump or elsewhere. Canadian prices of many imported products (including food) have increased, because of a lower Canadian dollar. Unemployment is on the rise, as our commodity-driven economy suffers from lower commodity prices related to a rising U.S. dollar. Faced with a weakening Canadian economy, the Bank of Canada acted promptly, cutting its bank rate by a quarter of a point, from 1% to 0.75%, in January. It is likely that further cuts will be needed, especially if the Canadian real estate market comes under stress. While Canadian and U.S. indicators are going in opposite direction, where to invest can become utterly confusing.

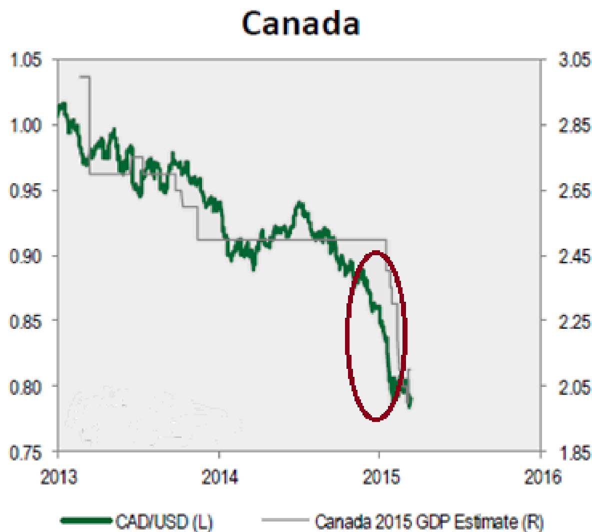
Table 1

Trend of Key Economic indicators

	CAN.	INDICATORS	U.S.	
① Poor Environment	↓	Bank Rate	↑	① Better Environment
	↓	Bond Yields	↑	
② Cheaper Stock Prices	↓	Dollar	↑	② Pricey Markets
	↑	Unemployment	↓	
	flat	Real Estate	↑	

One way to look at it is that things are obviously doing better in the U.S. and, as things continue to improve, we can find ways to take part in the upswing. However, too much good news can also mean counter-cyclical stimulus interventions by the Fed, including a hike in interest rates which would push the U.S. dollar even higher and have a negative impact on the markets. Meanwhile, as things worsen in Canada, our Central Bank will continue to intervene to stimulate our economy, providing a better investment environment. But what if we could have both? Let's take, for instance, a Canadian company that benefits from the accommodative Canadian monetary policies and whose main business thrives from exports to the U.S., where the economy is stronger. Imagine, on top of that, a 27% kicker on your margins, based on "new", favorable exchange rates! New? Well, Chart 3 shows the value of the Canadian dollar (in U.S. funds) over the last year. Note the significant drop from $0.89 in late November 2014 to $0.80 in mid-January, or a decrease of more than 10%.

Chart 3



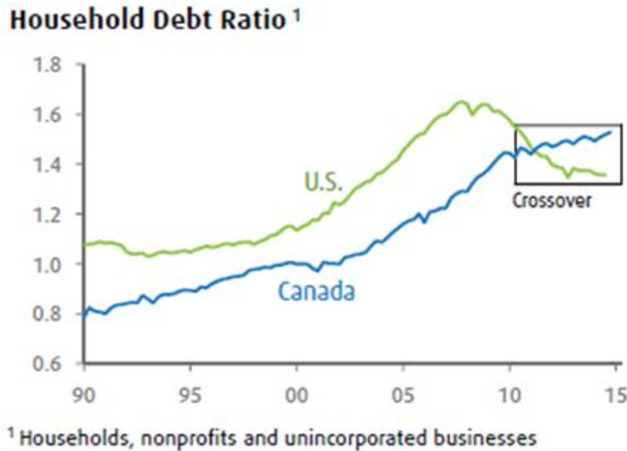
The impact of that sharp drop will only appear in first quarter 2015 earnings and will be significant. We believe we are in for some earnings surprises on the upside for Q1, and this will dictate the trend for the year for non-energy exporting companies.
On the consumer front, the U.S. is in much better shape, by far.

Table 2 **Consumer's Financial Strength**

	CAN.	INDICATORS	U.S.	
① Consumer Finances Weakening	↑	Debt	↓	① Consumer Finances Improving
	↓	Savings	↑	
② Stretched Real Estate Values	↓	Purchasing Power	↑	② Con sumer's Asset Values Strenghtening
	↓	Cash Flow	↑	

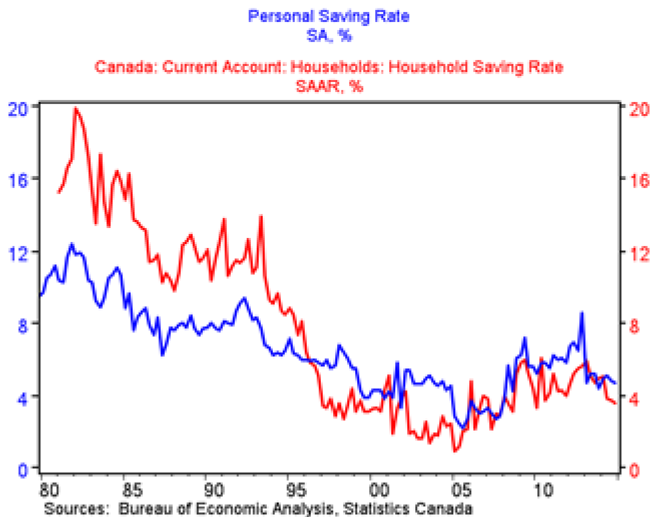
In fact, as shown in Table 2, U.S. consumers are reaping all the benefits at once. First, contrary to Canadians, their debt levels have steadily fallen since the Great Recession of 2008 (Chart 4).

Chart 4



Able to refinance their homes at extremely low, 30-year fixed rates, U.S. consumers' cash flows have improved. Employment has edged up, improving individuals' savings capacity and balance sheets. Meanwhile, Canada's household savings rate has been retracting for the past couple of years (Chart 5).

Chart 5



In the U.S., falling oil prices have also helped to free up additional cash, with gas prices down nearly 50% from their peak last year. Considering the total U.S. population, as well as more efficient consumption, the impact of such a reduction is equivalent of an injection of $500 million a day in the U.S. economy, according to AAA estimates. In addition, the strength of the U.S. dollar reduces the cost of all imported goods, allowing American consumers to buy more for less. Using an American consumer's disposable income, and subtracting the cost of food and energy (currently at extremely low levels) as well as the cost of financial obligations (also at all-time lows given the extremely low interest rates), you get the consumer's free cash flow. (Chart 6)

Chart 6 U.S. Consumer Free Cash Flow Hits ANOTHER Record

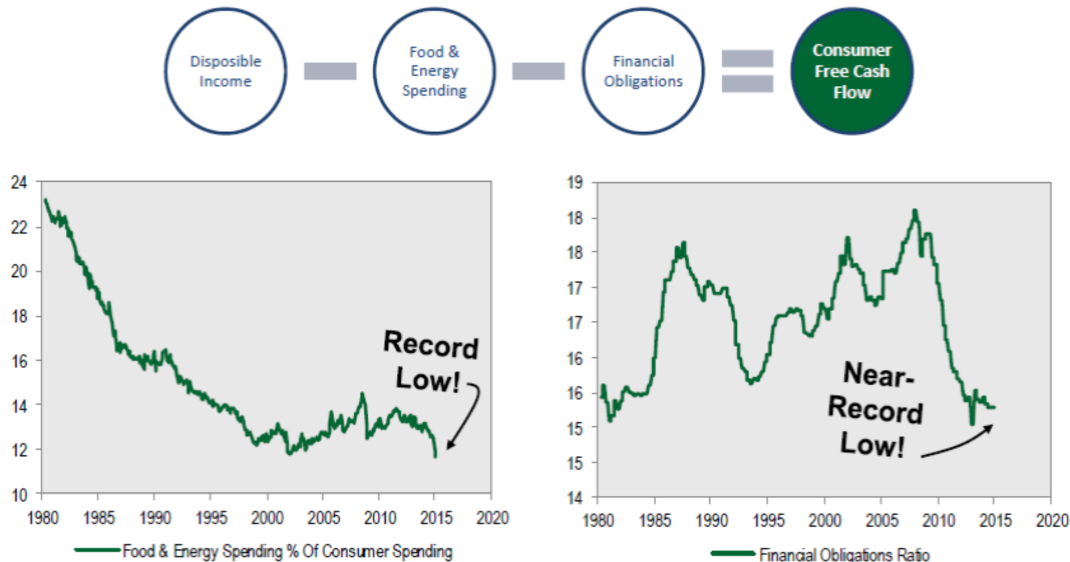
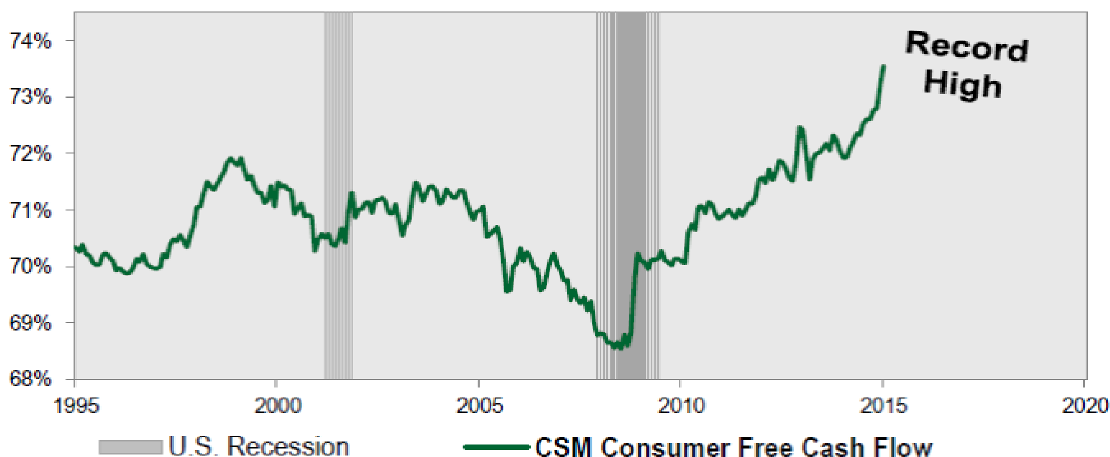


Chart 7

U.S. Consumer Free Cash Flow Hits ANOTHER Record

CONSUMERS ARE ENJOYING STRONGER EMPLOYMENT AND LOWER LIVING EXPENSES



While Americans are enjoying record free cash flows (Chart 7), Canadians have seen their real estate assets outperform those of the U.S. However, the growth in American households' financial assets has outstripped that of Canadian markets significantly. This situation is somewhat worrisome, as Canadian household debts are largely against real estate assets. Therefore, a contraction in Canadian real estate values could have a much more constraining impact on Canadian consumers than a stock market correction would have on the much less leveraged American consumers. Another point of view is that rising real estate values in the U.S. increases an American homeowner's borrowing power. Furthermore, the impact of higher mortgage rates in the U.S. is less damaging than in Canada, as mortgage rates are tax-deductible in the U.S.

The current slowdown in the Canadian economy following the collapse of the oil market should produce more negative consequences as the year progresses, which explains Bank of Canada head Stephen Poloz's quick reaction in January (with probably more to come). Oil-producing countries, like Canada, are now facing huge head winds, unlike oil-importing countries, which are taking advantage of lower energy costs.

Over the last several years, given improvements in hydraulic fracturing (a.k.a. fracking) technology, U.S. oil production has gone from 4.5 to 9.5 million b/d. Meanwhile, according to the Energy Information Administration (EIA), Saudi Arabia has more or less maintained its 9.6 million b/d crude oil production level. As well, increased environmental awareness has led to improvements in oil consumption efficiencies. This represents a huge swing in the supply and demand balance and may create disruptions in favor of consumers. Although companies have reacted swiftly by cutting capital expenditure programs, crude oil inventories are at all-time highs. Total rig count has gone from 1,500 in December 2014 to roughly 860 today. Will this be enough? This is why President Obama is considering lifting the ban on crude oil exports that was imposed by George Bush Sr. four decades ago. Such an action could help relieve the excess oil supply and create a significant number of permanent jobs in the U.S. Not a bad solution for Obama, and it may even get bipartisan support. However, speculating on government changes or initiatives has proven to be quite a challenge recently…

Head of BP (British Petroleum) Bob Dudley was quoted saying that "a drop from $100 oil to $45 oil contributes to a transfer of wealth of $1.6 trillion from oil & gas producers to consumers so that, depending on where you are in the world, this is great, but a drop of this magnitude in such a short period of time may have significant unintended consequences." Obviously there have been huge investments in oil and gas development projects that may not be lucrative for some time. Delays may cause a lack of cash flow in certain cases, especially where balance sheets are over-leveraged. As major shortfalls and possible bankruptcies start appearing, we could witness a confidence crisis in that industry, which could possibly lead to major wave of consolidations similar to what happened during the 2001-02 technology bust. The question is whether or not a crisis in this sector would smother overall investment confidence. In the presence of other negatives, such as rising interest rates, it could be enough to ignite a 20%+ correction. For Canadian investors this calls for further geographical diversification.

Europe

Meanwhile in Europe, ECB (European Central Bank) President Mario Draghi has implemented a quantitative easing program that will see the injection of 60 billion euros per month until at least September 2016. Fighting deflationary pressures has become his priority. (Chart 8)

Chart 8

Bond yields are at historically low levels in Europe and, as was the case for the U.S. a few years ago, this, along with a devaluation of the euro, should drive European markets on the upside. As Europe becomes more competitive thanks to a lower currency, new jobs will be created, consumer confidence will rise and its economy should blossom relative to others.

Table 3 shows the impact of various QE programs on equity markets in different countries. In most cases, the impact has been significant.

Table 3

Figure 14: Previous Quantitative Easing Periods

	Quantitative easing periods				Equity Price		Return	
	Start	End	Days	Years	Start	End	Total	Annualized
US								
QE1	11/24/2008	2/10/2011	826	2.3	876.8	1321.9	50.8%	22.4%
QE2	11/9/2010	12/22/2011	431	1.2	1165.3	1254.0	7.6%	6.4%
QE3	9/12/2012	2/24/2015	911	2.5	1404.1	2110.4	50.3%	20.2%
Japan								
First	3/20/2001	8/9/2006	1973	5.4	13175.5	15656.6	18.8%	3.5%
Second	1/24/2013	ongoing	782	2.1	9940.1	18466.9	85.8%	40.0%
United Kingom								
First	3/9/2009	8/2/2010	537	1.5	4228.9	5397.1	27.6%	18.8%
Second	10/5/2011	4/30/2013	594	1.6	5156.8	6430.1	24.7%	15.2%

Source: Bloomberg

We do expect a better outcome for continental Europe (excluding the UK) based on the embedded competitiveness brought about by a lower euro against the pound. Obviously, as mentioned in our January TFSA/RRSP letter, the investment risk for Europe appears to be more geopolitical whereas the improving economic environment combined with a cheap euro should attract foreign investments and stimulate M&A activity.
Continental Europe's performance as measured by the euro 50 Index was negative in 2014 in domestic currency (-8.6%). Although that performance becomes positive in U.S. currency, all the gains came from foreign exchange. In fact, the euro is down against the U.S. dollar from a high of almost 1.40 in May 2014 to roughly 1.08 today. According to Deutch Bank, the introduction of the ECB's quantitative easing combined with the Fed's tightening could send the euro as low as $0.85 U.S.
The story might be different for 2015 thanks to a better performing market and continued pressure on the euro. The Canadian dollar versus the euro is not expected to be as volatile. Therefore, a Canadian dollar investment in Europe should be currency hedged. This way our bull will be well covered while he enjoys a good time in Europe!

CONCLUSION AND INVESTMENT STRATEGY

In our last newsletter (#52), our investment theme was based on a U.S. residential real estate market recovery, and we continue to believe in this theory. As seen on the previous pages, U.S. consumers' free cash flows and their strengthening purchasing power resulting from a stronger currency and falling commodity prices are the main drivers behind this continued recovery. Although shocking news from the oil patch or a rise in U.S. interest rates may constitute disruptive events that could dampen investor confidence and momentum, I sincerely believe that consumers, as they find themselves financially stronger, will spend - albeit in smarter ways. Spending to create value – perhaps renovating a home after a long dry spell – could become a priority. Furthermore, new home sales in the U.S., which had fallen to very low levels, is now back to a mean number of 1 million per year. Seasonally, winter is usually the slowest quarter in home building and, as we enter the second quarter of 2015, we should expect an important rebound. On March 19, the CEO of Lennar, one of the largest residential builders in the U.S., said that "Early signals from this year's spring selling season indicate that the housing market is improving and disappointing single family starts and permit numbers should rebound shortly."

Given that residential real estate inventory levels have now reached the low end of the curve at 5.2 months, we should expect demand for new homes to increase and this bodes well with all segments of the economy that relates to construction i.e. lumber, security systems, hardware, furniture and appliances, etc. (Chart 9)

Chart 9

History shows that in the six months prior to a Fed tightening (rise in interest rates), the S&P 500 climbs in average 6.3% and Financials are up 12.2%, while three months after an interest rate hike, the S&P 500 is down 4.2%. Telcos show best in class in the aftermath of a rate hike compared to industrials and consumer discretionary stocks underperformance. This particular cycle is accompanied by unusual purchasing power with no inflation in sight, almost as if it was a delayed recovery. After all, interest rates are not at, or even near normal levels. One could argue that the strength of U.S. consumers' buying power may surprisingly bulldoze its way through a normalizing yield curve and support persistent but disciplined consumer discretionary spending.

Globally, deflation fears outstrip inflation fears by a large margin. The central banks' best weapon against deflation is inflation, and that goes against higher interest rates. Perhaps what the Fed's chairwoman Janet Yelen's biggest worry is to fall behind the curve, being too soft for too long, like Mr. Alan Greenspan did in the early 2000s. He himself christened the period as one of "irrational exuberance." We are not there yet!

As for the four questions in the introduction to this newsletter, we believe that rebalancing portfolios by reducing some excess exposure caused by stock appreciation back to original levels would make some sense. Some industries that are more sensitive to market corrections may be better sources of funds. Proceeds can be applied to your fixed income component, rebalancing it, and eventually reinvested in more appropriate industries, enhancing diversification. The action of taking profits and re-allocating capital to another asset class is called tactical asset allocation. A conservative investor would act in that direction, while a more aggressive strategy would be to use the proceeds and re-allocate to other sectors or regions.

Among our investment options, continental Europe is a good way to complement your portfolio and take advantage of the ECB's interventions. In the U.S., home building and renovation related stocks along with U.S. financials should be part of our rebalancing strategy. The bull is not dead… Just on a leave of absence! As he is no longer "Fed" in the U.S., he's taking advantage of cheap oil and a cheap euro to go off gallivanting in Europe, enjoying the ECB's hospitality! (In **E**urope, we take **C**are of our **B**ull.)

Sectors	Recommended Weighting April 2015	Trend
Consumer Discretionary	2%	↑
Consumer Staples	8%	
Energy	5%	
Financials	18%	↑
Health	4%	
Utilities	7%	↓
Industrials	9%	↑
Materials	3%	
Technology	4%	↑
Telecom	5%	

RECOMMENDED ASSET MIX				
INCOME PORTFOLIO			BALANCED PORTFOLIO	
Oct 2014	Apr 2015		Oct 2014	Apr 2015
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%	10%	Equities	25%	20%
20%	20%	Foreign	30%	35%

Disclaimer: Subject to an evaluation of the risk profile of individual clients

Sources:
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RBC Dominion Securities Research
ETCNBC.com
CIBC Institutional Research
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*Excerpts from the Canadian and US Equities Guided Portfolio, March 2015

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Cenovus Energy (CVE-T) 1,2,3,4,5,6AC,8,9

CGI GROUP (GIB'A -T) 5, 6C8

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Performance - T-Bills vs SP TSX vs Model Portfolio

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%	**16.41%**
*2015	0.18%	1.85%	0.00%	**3.16%**

Return compounded as of December 31, 2014

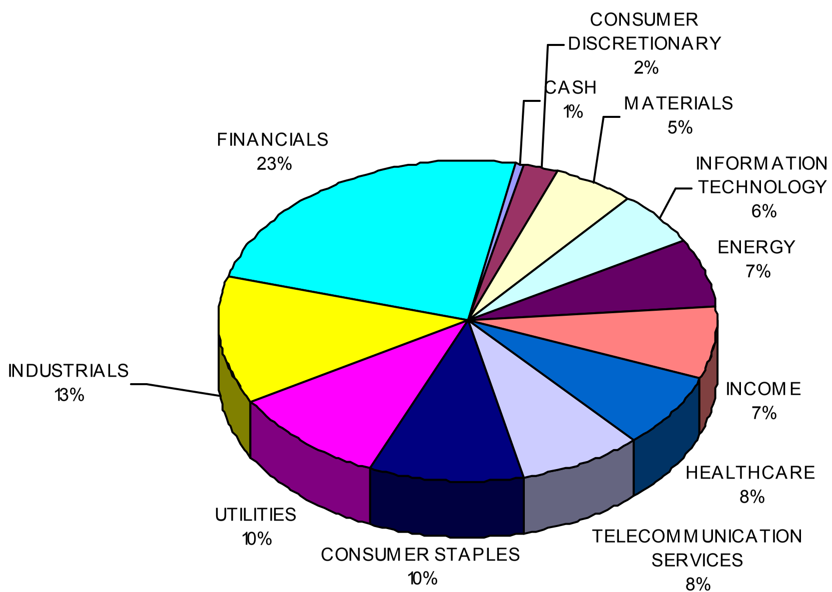
	T-BILLS (Return)	SP TSX[1]	SP TSX[2]	MODEL (Return)
3 years	0.33%	6.97%	0.00%	**13.88%**
5 years	0.61%	4.49%	0.00%	**13.24%**
10 years	1.36%	4.70%	0.00%	**9.49%**

Average return since inception 12.67%

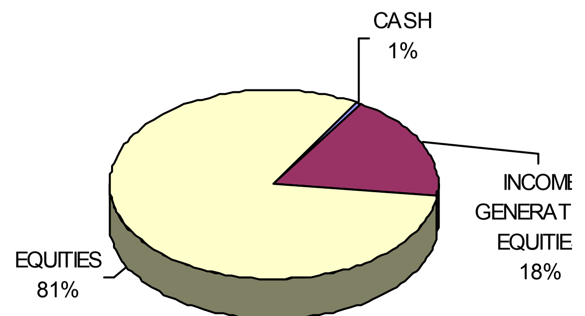
* (YTD) : Year To Date (march 31, 2015)
$100,000 invested on June 1st 1990
1: Does not include income or div
2: Includes income and div

The returns are compounded monthly and revenues are reinvested.
This chart represents only the Equity portion of the model portfolio, therefore 100% equities.
This may not be an exact representation of your portfolio and does not include fees and commissions.

PORTFOLIO HOLDINGS AND ASSET MIX



By Sub-Index %



By Category %

Morin Dupont Lessard & Associates

Portfolio Return

Value as of March 31, 2015

$ 1,954,778

Average Return

12.67 %

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

$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 Mar '15

$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**

For more information, please contact:

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