The Gruchala Wojtal Group Newsletter

BMO Wealth Management
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2nd Quarter 2017

The first half of the year has finished with modest gains across most of the developed markets around the world. The TSX is down slightly for the year (-.69%), primarily on the back of lower oil prices and a sell-off in interest rate sensitive areas of the market (telecommunications, utilities etc.). Overall, market complacency continues to be at historically high levels. Given historic seasonality, we expect the next few months to be relatively uneventful, apart from any irregular geopolitical events.

The Canadian Dollar has shown very strong appreciation in the last few months, from the 73 cent range at the end of April, to the 77 cent range at the end of June. This is beginning to have an effect on our US dollar positions. The US Dollar is now negative 3.35% against the Canadian Dollar this year. The bulk of the move has come in the last few weeks as the Bank of Canada has strongly hinted that they are going to raise interest rates in July, and another potential increase towards the end of the year.

This is a divergent tone in policy that has emerged only in the last few weeks. We have used this as an opportunity to increase our US dollars where appropriate in our portfolios. We feel a high-70; low-80 cent Canadian dollar for any sustained period of time will have negative effects on our economy. With any rise above 80 cents, we will continue to buy US Dollars.

Another significant influence has come from the Canadian bond market. As rates rise, it has a negative effect on our bond market (bond prices fall as a result of rising rates). This has us actively looking to add to our fixed income. We are increasing duration (years until maturity), from the 2-5 year range, to the 10-15 year range. Our view is that interest rate increases are not in a sustainable uptrend. This has also got us to revisit some purchases in interest rate sensitive names such as real estate investment trusts, utilities etc.

Underneath it all, what really gives us cause for concern is the amount of passive and quantitative strategies (mostly ETFs) that are creating unusual long-term trading distortions in the market. They are accounting for an increasing share of daily market trading volumes. The amount of volume that is actually represented by individuals as opposed to computer (automatic index rebalancing) is now approximately 10%. One example is Exxon, which has steadily increased in price despite its fundamentals deteriorating. It is being over-purchased by ETFs because it represents such a large component of its energy index weighting. However, when there is a market selloff, the ETFs will add to an automated selling momentum.

When you have index funds and quantitative strategies all buying businesses (within the indexes) indiscriminately at any price, it works to the benefit of the market on its way up, but when these vehicles turn from net inflows to net outflows, this passive dysfunction will cause periods of significant selling, illiquidity and trepidation in the markets.

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