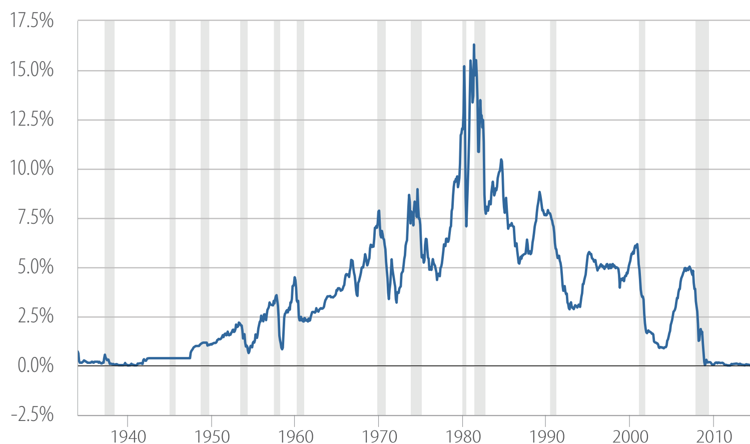
Market Perspectives

NOVEMBER 2014

There's Still Hope for the Patient

If interest rates were an ECG of the economy, the Yield on Short-Term US Treasury Bills chart shown below might suggest distress. Since the financial meltdown of 2008-09, short-term interest rates in the US have flatlined, suggesting a code-blue for the US economy, and by inference, that of Canada as well. In fact, not since the pre-war environment have interest rates been so low for so long.

As the winds of deflation blew through markets in October, the Canadian market caught a severe cold. Our cyclical stocks, which contributed to the S&P/TSX being one of the world's best performing markets in 2014, gave back much, if not all of their gains. While the strong US dollar bore much of the blame for the slide in commodity prices of oil, gold and certain base metals, when we examine the symptoms underneath the slide, we see a very different picture.



Source: Board of Governors of the Federal Reserve System
Shaded areas indicate US recessions - 2014 research.stlouisfed.org

Though its heartbeat may be weak, the US economy certainly has a pulse. For the past two quarters, US GDP has surprised to the upside, the US unemployment rate has hit a six-year low, and the Fed-speak is looking to raise interest rates. Yes, there are concerns in Europe and Japan, but the world's two largest economies, US and China, are growing at just below 4% and 7% respectively. The decline in the price of oil is the equivalent of a substantial tax cut, the impact of which we should be seeing shortly.

The extreme volatility of markets witnessed over the past 6 weeks is a conundrum. Specifically, growth and defensive stocks have rocketed to multi-year highs at the same time commodity stocks have hit multi-year lows. Central banks, especially in Europe and Japan, continue to inject liquidity to inflate, yet the markets want nothing to do with the sectors that benefit most from inflation.

One of the consequences of the significant six-year plus central bank injection of liquidity has been the impact on equity markets of the ever-growing pools of money that chase financial assets. Where there has traditionally been a link between financial markets and the condition of the economy, today that link is less significant. Trading now dominates investing, as hold periods for assets are measured in microseconds, not days or years. The players today are much more financial than operational; consider the fact that over 50% of warehoused (London Metal Exchange) copper is owned not by a producer or a consumer, but by a hedge fund! Over longer periods of time, investment fundamentals matter; in the short-term, however, they can be swamped by sentiment and liquidity.

As long-term investors, we continue to maintain our favourable view towards the companies we hold in our portfolios, including our commodity stocks. First, we own companies with well-positioned balance sheets that will enable them to survive the near-term storm. Second, we own companies that can generate free cash flow, even at currently depressed commodity levels. Third, and particularly with respect to Basic Material stocks, the companies are now exiting periods of heightened expansion capital expenditure. With infrastructure in place, and mines that operate as low-cost producers, they are not only viable now, but also well positioned when the inevitable turn in commodity price occurs. The old adage "the best solution for a low commodity price is a low commodity price" holds as true today as ever. In the meantime, we are very happy to collect our dividends, being paid while we wait. ●

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