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Economic and Capital Markets Outlook

December 2014

Summary

- Steadily improving economic conditions in developed markets, led by the U.S., will continue to drive global growth in 2015.
- Economic activity remains soft in Europe as geopolitical tensions are hurting confidence and credit conditions remain tight. The ECB's actions to provide further monetary stimulus are key to the region's recovery.
- Emerging markets are adjusting to correct external imbalances. While growth has slowed, the region is still expected to expand at twice the pace of developed markets.
- The slower growth in developing economies and the Eurozone resulted in a drop in the price of various commodities, including oil.
- The current imbalance between global oil supply and demand is temporary. While prices readjust, the global economy will get a boost.
- Equities are supported by fair valuations and solid corporate profit growth. Fixed income securities represent a poor risk-reward opportunity. We continue to expect a higher return from owning stocks compared with bonds and cash.

The global economy is expanding, driven by improving conditions in the United States, notwithstanding sluggish activity in Europe and Japan and weakness in some emerging market countries. On balance, however, fiscal, monetary and structural headwinds are dissipating and paving the way for an acceleration of economic activity in 2015.

Despite a positive global economic backdrop for the year ahead, prices for several major commodities have declined. The price of oil is down 50% from June, leading to a similar correction in energy shares. The oil market is in a temporary disequilibrium and the timing of the demand/supply readjustment is uncertain. The longer this situation persists, the more the global economy stands to benefit from a growth boost.

U.S. equity markets reached new highs during the fourth quarter and the S&P 500 Index is now trading at 15.7 times 2015 earnings. Valuations, while far from "bubble" territory, are fair and reflect expected returns in the range of 6%-7% over the next few years. In such an environment, disciplined stock selection within a well-diversified portfolio is of paramount importance.

Over the past year, 10-year bond yields in the U.S. and Canada have declined by 86 and 97 basis points respectively and have returned to their trough levels of July 2012. Longer government bonds have returned 1.5% to 2.5% per year over these 2 and a half years compared to 25% for Canadian equities and 27% for U.S. equities. We firmly believe that on an absolute and relative basis, long-term bonds are an unattractive investment. Our bond portfolio is invested in high quality securities and is positioned to protect capital when interest rates inevitably rise.

The U.S. economy is on a firm footing

During Q2 and Q3 2014, the U.S. economy recorded the fastest rate of growth for two consecutive quarters since 2003. Nominal GDP in Q3 2014 expanded by 4.3% or $728 billion compared with Q3 2013 and growth has been supported by all major segments of the economy. Indicators for the fourth quarter suggest a similar level of activity. An average of 258,000 jobs per month has been created between June and November and weekly earnings are up 2.4% year-over-year. Disposable income is rising by 3.5% and is supporting a 4.2% increase in consumer spending. U.S. retail sales showed a 5.1% increase on an annual basis for the month of November on the back of better car sales (+8.6%), building materials (+7.8%) and online shopping (+8.7%).

Companies are also seeing a substantial improvement in profits, which were up 10.0% in the third quarter compared with last year. Given the high level of capacity utilization, private capital spending has rebounded as companies have been reinvesting these profits. Spending on equipment is up 9.4%, investment in non-residential structures rose 10.9% and spending on R&D is 6.8% higher over the last twelve months. Going forward, business investment is expected to remain robust. The Institute of Supply Management (ISM) index of manufacturing new orders, a gauge of future production, was reported at 57.3 recently while the ISM index for new orders for services stood at 58.9. Both are well above the level of 50 which is consistent with an expansion.

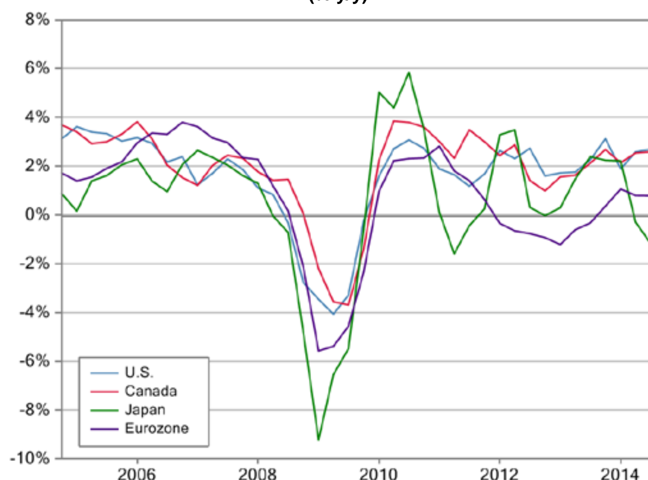
The U.S. housing market is in an upswing. Housing starts are running at an annual pace of 1 million, led by a 8.5% increase in the construction of single family homes. Demand for housing could be further stimulated by recent efforts to loosen mortgage credit. The two major government-sponsored mortgage entities, Fannie Mae and Freddie Mac, recently lowered the minimum down payment required for the purchase of a primary residence from 5% to 3%.

Looking ahead to 2015, we anticipate further gains in employment along with a pick-up in wages. This should continue to support consumer spending. Capital investment is expected to remain strong while the housing market recovery has considerable room to run. As the federal deficit is coming into balance, the government sector should begin to have a mildly positive impact on growth. Together, these drivers should help the U.S. economy expand by around 3.0% in 2015.

Rest of world growing at modest pace

Outside of the U.S., growth prospects are mixed. The Canadian economy is picking up alongside the U.S. and is benefitting from a lower dollar and an improvement in trade. Year-to-date, Canadian exports rose 9.9% versus the previous year and the upturn is broadly-based. Exports of consumer goods, motor vehicles & parts and machinery & equipment are up 15%, 11% and 8% respectively. Meanwhile exports of energy products, which account for almost a quarter of all Canadian exports, moderated to 2% year-over-year. Trade will continue to be an important contributor to our real growth forecast for Canada of between 2.0%- 3.0% in the year ahead.

Chart 1



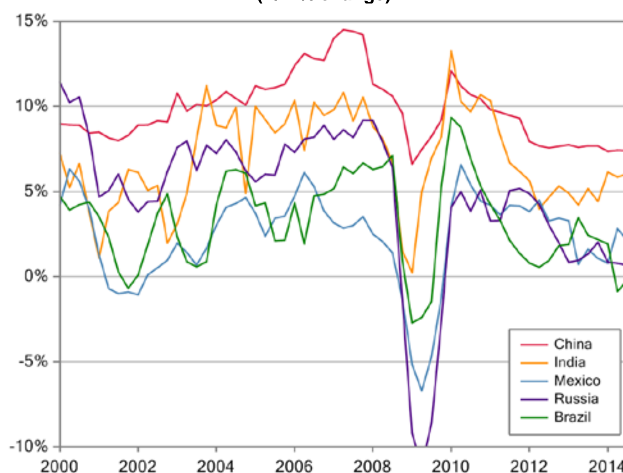
Indicators of global activity based on retail sales and industrial production show a recession in Japan, very little growth in the Euro area and a slowdown in several emerging economies (Charts 1 and 2). The Japanese economy has slowed significantly following April's 3% hike in the value-added tax. A pullback in consumer spending and investment led to the second consecutive quarterly decline in GDP at a rate of –1.2%. Economic activity is set to remain moderate next year as the International Monetary Fund (IMF) estimates that Japan will grow by 0.8% in 2015.

With the exception of the U.K. and Spain, where real GDP growth accelerated to 2.6% and 1.6% respectively in the third quarter, Europe's large economies are slowing. German real GDP growth was 1.2%, economic activity remains soft in France (+0.4%) while Italy has been contracting for more than a year (-0.5%). In aggregate, real growth in the Eurozone during the third quarter was 0.8%, in line with our forecast for the year.

Eurozone business and consumer sentiment deteriorated following the onset of conflict between Ukraine and Russia. The IFO Business Climate Index, a measure of German entrepreneurs' sentiment on current and expected business conditions, fell significantly as Russian tensions mounted. Geopolitical concerns contributed to tempering a nascent recovery in the region earlier this year and continue to represent a risk to the economic recovery. We continue to monitor the developments in the region as the size of foreign exposure to Russia by European banks totals $175 billion.

A second factor behind sluggish activity in Europe is tight credit conditions. The success of the European Central Bank's (ECB) measures to expand credit is ultimately dependent upon consumer and business demand for loans. A stabilization of tensions in the region and/or a re-emergence of pent-up consumer demand could provide the catalyst. In the meantime, however, the ECB is actively working to stimulate the supply of credit. The ECB's objective is to add $1 trillion of liquidity into the system and grow its balance sheet back to the level prevailing in 2012. The European Commission also announced the creation of a fund that will have the capacity to finance up to €315 billion of new investments over the next three years. It should be launched in 2015 and aid in stimulating overall credit.

Chart 2



Finally, a third factor hindering the recovery in selected Eurozone countries is the lack of structural reform, particularly on the labour front. The positive experience in Spain, where competitiveness, employment and economic growth have rebounded following labour market liberalization, should serve as a model to France and Italy. Overall, we expect real GDP growth in the Eurozone to remain at moderate levels, around 1% in 2015.

Turning to the emerging markets, real growth in China has slowed slightly to 7.3%, while India is growing at 6.0%, Mexico at 2.2% and Brazil at –0.2% (Chart 2). In Russia, the situation is volatile, as shown by the 43% drop in the ruble. The Russian economy is expected to fall into recession in 2015 as sanctions increasingly impact the economy, although the severity of the contraction is difficult to estimate at this point.

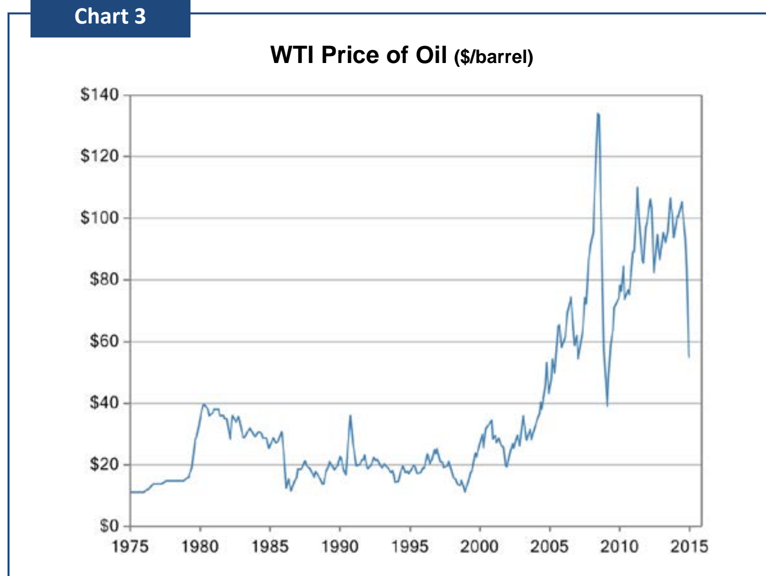
While developing countries may be experiencing different growth trajectories, a common theme linking many of these economies has been volatile foreign capital flows. As major central banks injected significant amounts of liquidity into the financial system in the aftermath of the financial crisis and developed country yields fell to low levels, foreign funds were attracted by higher-yielding emerging market instruments. The region reported strong levels of economic activity, with the developing world's real GDP growth averaging 6.9% in 2010-2011. When the U.S. Federal Reserve warned in the summer of 2013 that it would terminate purchases of U.S. government and agency bonds, foreign capital began to flow out of emerging markets. This prompted an adjustment process as economies were forced to correct their external imbalances (please see September 2013 *Economic and Capital Markets Outlook*). Real growth in the developing world slowed to 4.7% in 2013 and the IMF forecasts 4.4% in 2014.

Asset purchases by the Fed ended in this past quarter and the U.S. central bank will likely start to raise the policy interest rate in 2015. This, together with concerns that the Russian economy will deteriorate further may lead to additional capital flight from selected emerging market countries. The IMF is expected to moderate its 2015 forecast of 5% growth for the region, based on a weaker outlook for Russia, Brazil and China. As the different countries adjust to correct their external imbalances, they may experience a cyclical slowdown. However, these economies are still expected to grow in aggregate at twice the rate of developed markets. Moreover, their fundamental growth drivers (population growth, domestic consumption and infrastructure needs) remain supportive of elevated levels of growth in the medium to long term.

Aggregating our forecasts across the different regions, we expect that world real GDP will expand by 3.5%-4.0% in 2015, driven by a pick-up in growth in developed markets. While our outlook is tempered by the regional slowdowns referred to above, the global economy may experience a boost from the recent drop in energy prices.

Drop in oil price sparked by temporary supply/demand imbalance

Slower growth in several key emerging markets and the Eurozone resulted in a drop in the prices of various commodities. Iron ore, coal, and many of the base metals such as nickel, copper and zinc have experienced a downtrend since 2011, with most of these commodities priced at levels below their actual full cost of production. Oil prices, however, remained resilient until the summer of 2014.



The West Texas Intermediate (WTI) price of oil has now fallen by 50% since July and is approaching 2009 levels (Chart 3). Given the extent of the decline, it is important to assess the following: 1) what are the drivers behind the weakness in the price of oil and could this be a "new equilibrium"; 2) how long can low oil prices prevail; and 3) what does this imply for portfolios exposed to the energy sector.

During the second quarter of 2014, several economies experienced a reduced demand for oil. Demand for oil in Europe declined 3% and Japan consumed 5% less mainly due to a shift towards coal usage and the resumption of two nuclear plants for electricity generation. China's consumption growth slowed due to softer economic growth and government-mandated pollution reduction targets. Overall, global demand for oil increased marginally by 0.3 million barrels per day (mmb/d) during Q2, a reduction from the 1.0 mmb/d to 1.5 mmb/d annual growth seen in the last 2 years. At the same time, global supply rose by around 2% as the U.S. continued to increase oil production. Supply exceeded demand during the summer months by 1.3 mmb/d (Table 1).

Table 1 - Global Oil Demand and Supply (in millions of barrels / day)

2014 Oil Demand				2014 Oil Supply			
	Q2 YoY change	Q3 YoY change	Q3 level		Q2 YoY change	Q3 YoY change	Q3 level
U.S.	--	---	19.5	**Non-OPEC**	**2.3**	**1.9**	**56.8**
Japan	-0.2	-0.4	3.9	*Of which:U.S.*	*1.7*	*1.5*	*11.9*
China	0.2	0.2	10.4	**OPEC**	**-0.8**	**0.1**	**37.0**
Europe	–0.4	–0.1	14.6	*Of which:Saudi Arabia*	*0.2*	*-0.2*	*11.6*
Rest of world			44.7				
Global Demand	**0.3**	**0.6**	**93.1**	**Global Supply**	**1.6**	**2.0**	**93.7**
				Surplus Supply	***1.3***	***1.4***	***0.6***

Global demand recovered slightly in Q3 and stood at 0.6 mmb/d above 2013 levels, but excess supply remained virtually unchanged at 1.4 mmb/d. Given that oil demand tends to increase at approximately one-half the rate of global real GDP growth, expected growth of 3.8% (the midpoint of our forecast) implies 1.3 million additional barrels will be required in 2015. On the supply side, an analysis of global excess capacity shows that no country with the exception of the U.S. and to a lesser extent Canada has meaningfully added capacity in the last 5 years. A higher oil price incentivized production from Canadian oil sands and U.S. shale formations, but at current prices some oil reserves are no longer economic to drill. Companies may therefore decide to leave these barrels in the ground and wait until the price of oil normalizes.

An important aspect of global oil supply is the variability in cost structure and decline rates across the spectrum of reserves. Oil wells have a tendency to be most productive in the early years of operation

due to simple physics: as the wells produce oil, reservoir pressure levels drop and less oil is pumped over time. This tends to be especially problematic in shale oil, where most wells lose 80%-90% of their production following the first year, compared with a 7% decline rate for a conventional well. Currently, shale formations represent 70% of the 11.9 mmb/d of oil & liquids produced in the U.S., with the remainder sourced conventionally on land and the Gulf of Mexico. Therefore the average decline rate of oil produced in the U.S. is around 35% per year. If domestic companies were to halt investment in 2015, U.S. oil production would fall by 4.2 mmb/d.

In 2013, U.S. oil companies invested an aggregate $200 billion to replace and grow production by 4.6 mmb/d. Of this total, 3 mmb/d replaced “lost” production due to well decline and the remainder reflected incremental growth in new supply. The 50% decline in the price of oil implies oil producers will receive 50% less money to spend on new projects. Since producers tend to spend 100% of the money they earn annually, this may lead to a 50% or $100 billion reduction in capital spending. Taking into account decline rates and this drop in investment, we estimate that U.S. production growth will be nearly flat in 2015 and then decline in 2016.

The imbalance between global oil demand and supply does not appear to be reflective of a “new equilibrium”. As demand continues to increase in line with global growth and as supply reacts to cash flow pressures, it is unlikely that the current price environment will be sustained.

However, timing of oil market re-adjustment in uncertain

Current low oil prices, last seen during the 2008-09 recession, have been driven by high levels of volatile trading activity and fundamental uncertainty. Uncertainty stems from differing views on the sustainability of annual demand growth of 1.3 mmb/d and concerns that oil producers will not readjust oil production lower as they have tended to do in the past. We examine two scenarios in order to shed light on how long the price adjustment may play out.

Assuming demand growth for oil is consistent with an expanding global economy as outlined above and supply from U.S. shales and other producers does not grow in 2015, excess supply could be absorbed in less than a year.

On the other hand, due to geopolitical tensions and disruptions affecting various OPEC members namely Libya, Nigeria, Iraq, Iran and Syria, current production levels have been kept below their potential. If these troubled countries return to full capacity with no countervailing supply reductions by other OPEC members, oil production would increase in aggregate by 4 mmb/d. It would therefore take about 3 years to soak up the excess supply, with demand growth at 1.3 mmb/d. If during this time, global demand grows at only 1 mmb/d, the low range of our estimate, an additional year would be required to balance supply and demand.

Whether prices recover in 2015 or 2018, the world economy will likely get a boost. A lower oil price transfers spending power from producers to consumers as less money is spent on gasoline leaving more available for purchases of other goods and services. This will positively impact economic activity in oil importing countries including the U.S., Europe, Japan, China and India amongst others.

Estimates from the IMF, market strategists and our own research suggest that developed countries will benefit the most, ranging from a marginal increase in real GDP growth to 0.8% in 2015. For example, we estimate the net effect for the U.S. to be +0.2%. Oil exporters will likely experience a decline in growth. Canada, for example, may see an estimated –0.25% impact. On a net basis,

however, the benefits will accrue to a larger share of the world economy. Finally, lower oil prices also positively impact companies through improved profit margins as energy-related input costs decline.

Energy share prices reflect very attractive valuations

During the second half of 2014, oil exploration and production (E&P) company share prices declined between 35%-40%, consistent with the decline in the price of oil. The energy sector as a whole is down 18.4% (USD, 11.1% in CAD) and 21.4% in the S&P 500 and S&P TSX respectively. This follows an exceptionally strong period of energy stock prices: for the 2 years ending June 2014, this sector was up 58.4% in the US and 48.1% in Canada. Our equity portfolio exposure to global energy shares averaged around 15%. Investments have focused on companies with strong balance sheets, high quality assets and sustainable dividend yields.

We have stress-tested the value of our companies using WTI $65 per barrel over the next 5 years, a more pessimistic outcome than that outlined above. Under such a scenario, our oil company holdings provide a 15% annual return on investment. In our view, current valuations are extremely depressed and reflect an overly negative scenario.

Summary of Investment Conclusions

Notwithstanding weaker prices for commodity-related stocks, the S&P 500 hit an all-time high in December and U.S. equities generated a 24.2% total return for the year (expressed in Canadian dollars). For the rest of the world, equity market returns were diverse: S&P TSX +10.5%; DAX -1.5%; CAC-40 -1.7%; FTSE-100 +3.8%; Nikkei +4.4%. The MSCI Emerging Markets Index returned +7.0% and the MSCI World Index of developed countries recorded +15.5%, led by strong U.S. markets.

An average of brokers' estimates for profit growth shows U.S. and Canadian equity indexes are trading at a still reasonable 15.7X and 15X earnings respectively, yet valuations across companies are highly uneven. Expensive valuations are not deterring firms from pursuing mergers and acquisitions (M&A). Worldwide business deal volume increased by 61% in 2014 to $4.3 trillion, largely driven by a rise in North American M&A activity. Many of these transactions have been concluded at 12X earnings before interest, tax and depreciation, a level significantly higher than what would historically be considered reasonable value.

Notwithstanding evidence of market exuberance in the pricing of certain companies, we believe the overall expected return for U.S. and Canadian stocks over the next few years should be 6-7%, in line with future profit growth. Other regions offer more attractive equity valuations which imply somewhat higher expected returns. European equities trade at 14.2X 2015 earnings, U.K. stocks are at 13.2X, Japan at 13.6X while emerging market multiples where growth should be strongest are very reasonable at 10.5X. Our global equity portfolios, which are broadly diversified across all geographies and economic sectors, are priced at a very fair 13X 2015 earnings.

While equities continue to offer an attractive return potential, the same is not the case for bonds. The government of Canada 10-year bond yield ended the year at 1.79%, 97 basis points below the level at end-2013, almost retracing the entire rise from the previous year but still up 21 basis points from the trough in rates in mid-2012. At today's levels, we are persuaded that bond prices are disconnected from their fundamentals. While economic growth is running above 4% in nominal terms and above 2% in real terms, the 10-year yield is below both levels, signalling either a collapse in economic activity or a prolonged period of deflation. We view neither outcome as probable.

As noted in the last issue of LBA's *Economic and Capital Markets Outlook*, bond yields have been influenced by external flows and are artificially maintained below fair value. While normalization of yields may play out over a longer period of time, holders of bonds are not compensated as they wait. The return potential for longer-term bonds is minimal and will lead to a destruction of purchasing power, yet the risk is high given their extreme sensitivity to changes in yields. A patient approach consisting of favouring high quality, low-duration bonds and floating rate instruments will ensure that capital is protected and purchasing power is preserved over time.

We continue to favour a portfolio of carefully selected equities to both cash and bonds over the medium term.

All dollar references in the text are U.S. dollar unless otherwise indicated.

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