Portfolio Commentary

Third Quarter, 2015

Canada—*why bother?*

When it comes to stocks, this is a sentiment we've heard quite a bit lately and given the Canadian investor experience in recent quarters, it's certainly understandable: *our stock market has significantly underperformed its US cousin; our economy has flirted with recession on the back of plummeting energy prices; and the loonie has tumbled to levels that many of us thought had been left in the past.*

A few years ago, when our currency had achieved par with the US dollar and the TSX carried a meaningful valuation premium over the S&P 500, we increased the foreign allocation in many of our equity mandates, boosting the weight in non-Canadian stocks to as high as 50% in some cases. Though this seems like a rational move in retrospect, it went against broad consensus at the time and probably raised the eyebrows of at least a few clients. Coming out of the financial crisis, Canada was regarded as the global financial community's model citizen, with the world's strongest banking complex, a disciplined record of fiscal management, and an economy well-positioned to profit from the rapid growth of emerging markets. The US, on the other hand, was straining under a financial system on life support, ballooning deficits, and a manufacturing sector that was being dismantled in favour of cheaper offshore production. The greenback's glory days were behind it and analysts cast about with predictions as to which would grab the mantle as the world's new reserve currency. Each of these facts was well known and little disputed amongst experts and laypeople alike.

Popular investment recommendations at the time played to this backdrop by directing individuals to avoid US assets and load up on gold and other precious metals to sidestep the certain demise of paper money. Of course, since that time, American equities have dominated global asset performance, the US dollar has surged against virtually every major currency, and hard asset strategies have been largely eviscerated. *So much for the "end of empire" story*.

Today, the narrative around Canada is almost as gloomy as it was for the US half a decade ago: emerging market growth has plateaued, dampening the outlook for energy and other commodity prices; our housing market is set to crash, if for no other reason than it didn't during the financial crisis; and the already bludgeoned loonie stands little hope of rehabilitation in the face of these substantial headwinds. In fact, the high regard that global investors held for Canada just a few years ago, alongside their antipathy toward the US, can now be virtually flipped on its head; we

are suddenly the financial pariah, while our southern neighbour has convincingly snatched our position as the world's beacon of growth and stability.

Rather than motivating us to turn further away from Canadian markets, however, the depth and certainty of this dismal consensus is actually piquing our relative interest in local stocks. In other words, the more unanimous a particular market view, the more likely that it's already accounted for in asset prices. In such instances, investor sentiment and capital can become tilted so unequivocally in one direction that even a minor reversal against trend can cause the tightly wound spring to uncoil. So, instead of searching for additional data to support what most are already thinking anyway, we are more inclined to look in the other direction and ask "What could go *right* for Canada in the months ahead?" Below are some possibilities:

Energy

The quickest rebound in both the worldview of Canada and the performance of our financial markets would probably come via a recovery in energy prices. It's well known that the world is awash in crude, with the supply/demand balance having been tipped over by an unexpected surge in tight oil output from the US and compounded by OPEC's resistance to production cuts. This new dynamic is well-reflected in prices, though, with crude off by more than 50% over the past 15 months and testing the lows reached when demand collapsed during the financial crisis. While the drivers of today's price weakness are well known and incorporated by market players, any number of items could spark a reversal:

- To control costs, energy companies have been curtailing expansion and slashing capital expenditure budgets; at some point this concerted reduction in activity is likely to show up in aggregate output, which could catch energy markets flat-footed. As well, difficulties in the high yield bond market have all but choked off funding sources for many small and mid-sized producers, which will leave many challenged to maintain current operating levels.
- The shale oil technology that has boosted US energy volumes so dramatically in recent years is relatively new and many experts predict that the production profile of these wells will be characterized by fairly rapid declines from initial output levels; if this characteristic begins to take hold as tight oil properties mature, much of the future supply now embedded in oil prices might be called into question.
- The crippling economic effect of low oil prices on countries like Venezuela and Nigeria is fomenting social unrest in these regions; this turbulence, combined with the never ending Middle East maelstrom, means that the possibility of a geopolitical energy shock can't be discounted.
- Though Saudi Arabia still sits on a formidable stockpile of cash, its reserves are being run down rapidly as its budget deficit expands; at the same time, Russia is being squeezed between plunging oil revenues and steep economic sanctions. It wouldn't be unfathomable for

these two energy titans to come together at some point with a production management / price support strategy.

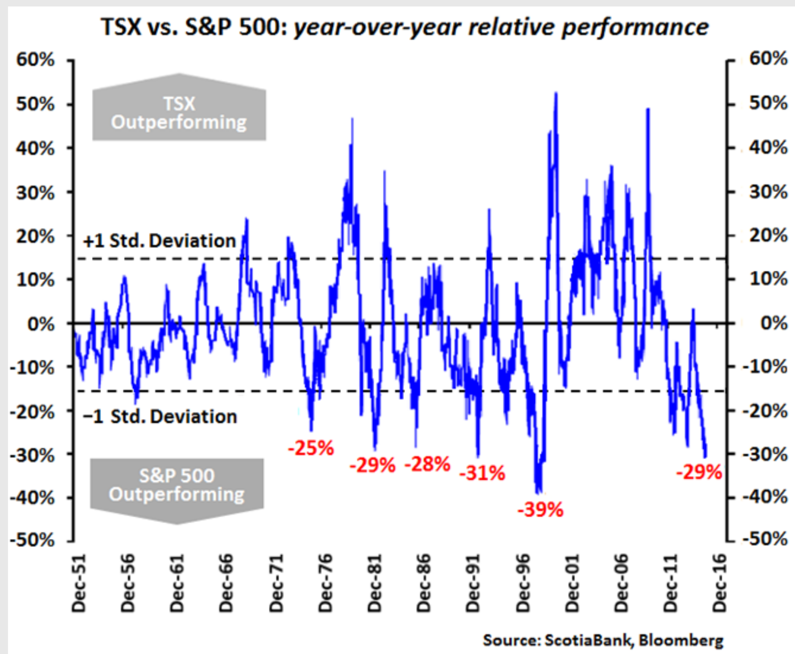
On the demand side of the equation, low prices appear to be encouraging usage. Despite lackluster economic growth in many parts of the world, global oil demand increased in August by its highest monthly rate since the summer of 2011, pushing total consumption to an all-time record. With a stable and rising demand backdrop, any supply disruption for oil would likely be reflected in prices relatively quickly.

More of the same on the economic front

Though Canadian GDP fell in the first two quarters of 2015, as the shock of suddenly lower energy prices was digested, the summer months were much stronger. The addition of 12,000 jobs in August caught economists by surprise, who were collectively calling for a loss of 5000 positions, and solid economic expansion was registered in both June and July, with both figures exceeding expectations. Economists now believe that third-quarter GDP is on track for annualized growth of between 2.5 and 3.0%, well above the 1.5% that the Bank of Canada had projected in its most recent forecast in mid-July. According to Douglas Porter, BMO's Chief economist, "There's now a very good chance that Canada actually may have grown a little bit faster than the U.S. in the third quarter."

A reversal of recent capital flows

When commodity prices and resource sectors are weak, foreign investors almost always shift capital away from Canada. This instinctive behaviour has been repeated in the current downturn , with monthly outflows from Canadian stocks reaching a two and a half year high in July. This leakage has contributed to a rare level of underperformance for the TSX vs. the S&P 500, as shown in the chart below:



Suite 1680, 1055 West Hastings St., Vancouver, BC V6E 2E9
Tel 604 669-3136 **Toll Free** 888 340-3136 www.**dixonmitchell**.com

DIXON MITCHELL
INVESTMENT COUNSEL

As the graphic illustrates, when the TSX has lagged the S&P by degrees similar to what we've experienced lately, such conditions have usually reversed themselves in fairly short order. Should Canada's recent economic growth in the face of severely depressed energy prices continue, outsiders may begin to regard us as something more than a one trick petro-economy and move to return capital to our markets. If oil were to rebound, the effect would be even greater.

Though it goes against the grain, we believe that a reconsideration of Canadian stocks is appropriate at this time. Just as it was with the US half a decade ago, so much of the received wisdom is tilted against our equity market and currency that both look more compelling from a long term perspective than they have in several years. With that in mind, it is likely that adjustments we make within portfolios over the coming months will be geared toward capitalizing on this potential opportunity.