REVIEW AND COMMENTARY
1ST QUARTER - 2016

During the first half of the first quarter 2016, North America equity markets experienced another sharp and relatively brief downward turn in prices. In Canada, further assaults on our dollar added to concerns for investors. It seems the frequency of these downturns, and the dramatic rumours that swirl around at the time, are increasing the ferocity of the price movements and the uneasiness of investors. While there are certainly market forces at work, the advent of 24/7 news services which are more than happy to fill hours with a proliferation of analysts who not only pretend to know exactly what caused these gyrations but also prognosticate, with utmost confidence, the short term future of asset prices adds greatly to the volatility. Commonly the most bearish and dire analysts get undue time in market downturns and likewise, the more bullish get more time during periods of increased confidence. Think back when Nortel was trading over a $100 per share, or the financial turmoil of 2008-2009, to remember how extreme the predictions can become.

Until mid- February, Canadian equity markets were pressured by a resounding cacophony of news sound-bites explaining why the Canadian Dollar was weakening. Much of this stemmed from weaker oil prices- some predictions were as low as $15 per barrel. The prospects of weaker oil prices, continued global economic weakness and a downward trending Loonie, led many international investors to think there would be a significant knock -on effect on the Canadian real estate prices (not just in Alberta). Canada, during that short period of time, had diminishing prospects , an almost perfect ‘equity’ storm which it was rumoured, led to a ground swell of these international investors (aka Hedge Fund Managers) to short (sell first, buy later) almost every single thing Canadian –equity- related they could: The Loonie, Banks, Utilities, Industrials and, of course, Energy stocks. It was an unsettling time particularly when you listened to all the doomsayers.

And, it wasn’t just Canadian equity markets that were under duress. Many of the developed economies’ equity markets suffered too. Economies world -wide continued to labour and many central banks lowered interest rates to a point where some of the largest financial institutions were being charged to keep their funds at their respective Central Banks (aka negative interest rates). U.S. equity markets fell from the same general sense of uncertainty regarding global growth but on a relative basis the US economy was one if the few bright spots. It was anticipated by many of the business reporters at the close of 2015 that the US Federal reserve would increase interest rates, even marginally, at least once during the quarter and no less than four times during 2016. Higher rates, though anticipated to be only marginally higher, unnecessarily concerned many investors. There were few bright spots for equity investors. Some of the selling pressure for large cap US equities was rumoured to be large Sovereign wealth funds that were forced to sell their most liquid assets (namely large cap North American equities) to make up for the funding short fall that many were suffering from the significant downward pressure of oil prices.

Toward the mid- way point of the quarter two important things happened that helped restore the confidence in the equity markets, particularly in Canada. One, was an upward turn in oil prices.

During the first six weeks of the quarter the price of oil sank toward the mid $20 range. Production remained robust among the largest producers and every attempt to discuss production cuts among OPEC and non-OPEC producers met without an agreement. Every oil- producing nation was struggling. Saudi Arabia discussed taking public Aramco (state owned Oil Company) , reduced domestic subsidies and ran significant budget deficits. They remained defiant that they would not consider any production reduction without a collective agreement amongst all producers. Russia kept producing as much oil as they could despite crippling deficits, the prospects of a prolonged recession and inflation exceeding 15% in 2015. Inflation in Brazil is running at about 60% and the economy is teetering on the brink of recession. Libya, according to the IMF and Deutsch Bank, need somewhere north of $185 per barrel to meet their budgetary needs. The list goes on and when the price of oil sank into the mid 20's discussion regarding reports of some kind of collaborative agreement started to surface more frequently. This added with significant reductions in spending on exploration and production among all Exploration and Production oil companies helped buoy prices while the simple law of supply and demand started to gain traction. Low prices meant many companies would be unable to continue exploring for oil- drilling rigs in the US were dropping precipitously. As well, the US Federal Reserve, in the light of further uncertainty regarding the majority of global economies announced they were not going to proceed with further interest rate increases as early as anticipated. This lessened the attractiveness of the US dollar, in turn making most others currencies (including the Loonie) more attractive and helped support prices of most commodities given so many are denominated in US dollars. So all those investors, who had been so negative on Canada, and all our many parts, reversed their opinions and our markets turned for the better.

Oil prices touched over $40 per barrel and the Loonie rallied from 1.46 Cdn/USD to 1.31 Cdn/USD (at the time of writing). Will oil continue to rise along with the Loonie? We think oil has bottomed. The Iranians are allowed to ramp back up their production after their agreement to limit their production and use of nuclear arms with the US Government and though they are reluctant to agree to any production freeze at current levels , they would certainly be interested in higher prices. A significant majority of OPEC and non- OPEC countries are in dire financial straits which may continue for some time but cannot in the long term. It is in every one of the major producers' best interest to allow oil to find a higher price level which will eliminate the financial strain so many of them are presently dealing with. Financial and civil unrest in many of these countries may lead to political instability, moreover the opportunity for ISIS and other terrorist groups to gain a significant foothold, if not control, in the region. This would be something no one would find acceptable. Production will decline naturally as demand increases but it will take some form of agreement in the short term to get oil prices to levels that would restore major producer's sovereign financial viability to so many badly needed economies. If an agreement doesn't happen in the near future, lower prices will force further production cuts which will increase prices.

So if lessons can be learned, there is some benefit of maintaining a long term perspective and not getting too distracted by short term noise. It is not that we would diminish the importance of daily events but it is important to keep an appropriate long term perspective. Short term gyrations are here to stay. Interestingly, at the time of writing, the short position in US equities is at an 8 year high- valued at over 1 Trillion US dollars according to an article from Bloomberg written by Dani Burger. I wonder if any of these investors were short Canada. Mind your next step but keep your perspective on the horizon. One thing for certain, there is a lot of buying power that will come from unwinding the short position and it might be from much higher levels.