Q2 - JULY 2016

Equity Markets

Equity markets finished the quarter on a volatile note, following the 'Brexit' vote signaling Britain's wish to leave the Eurozone. Markets had been broadly positive for the quarter and mostly regained their lost ground after the 'Brexit' vote. The S&P/TSX Canadian market added 4.2% for the quarter, putting it ahead of the United States centric S&P500's return of 1.9% (1.9% CAD adjusted), while the MSCI World index showed a gain of 1% for the period (1% CAD adjusted). Overcoming its volatility at the close of the quarter, the United Kingdom based FTSE100 added 3.1% for the period, though with currency impacts UK based investments showed losses of 4% in CAD$ terms. Oil continued to chart a largely positive path, rising from $38.34US per barrel at the start of the quarter to $48.33 at the close. Commodity based markets maintained a positive tone through the period, on the back of the move in oil. Despite this significant rise, the Canadian dollar was largely unchanged, adding 0.47 cents against the U.S. dollar for the period.

Fixed Income

Fixed income in Canada remained well bid, with all segments of the government bond curve offering lower yields at the close of the quarter, with the exception of instruments with under 90 days to expiry. Bonds of 5, 10, and 30 year term were lower in yield by 10, 16, and 28 basis points respectively. Neither the Federal Reserve nor the Bank of Canada undertook any policy action with regard to their benchmark overnight rates. Canadian investment grade debt moved significantly tighter to benchmark, supply of fixed income remained short. US government debt moved slightly wider, on expectations of an eventual move from the Federal Reserve, while high yield bonds were better bid on the rebound in energy prices leading to improvement of corporate balance sheets.

Predictions

Six months later, you could be forgiven for wondering what all the fuss was about. On January 8th, 2016 a prominent British bank issued a 55 page investment commentary that got the attention of the investment community and the popular press. "Sell (mostly) everything" appeared dead-centre of page three, a bold stance that sent a ripple through the investment community and magnified through the popular press. The call was supported by twenty pages of text and charts, making various cases for the cataclysm. Today, six months later, anyone who had taken the advice to liquidate their portfolios is very likely behind.

To date, the market has not collapsed, in fact the S&P 500 added over ten percent between the sell call made on January 8th and June 30th; the Canadian S&P/TSX added nearly fifteen percent. Those who only read to page three will have lost out further, not just in selling their shares based on bad advice. Deep into the research, on page 33, begins a very interesting discussion surrounding a very real and impactful event - the possibility of the United Kingdom "Leaving" the European Union, or the "Brexit". More on that later.

This may or may not be the point where we bring up the importance of "time in" the market versus "timing" the market but managing wealth is really about managing risk. For disciplined long term investors avoiding a permanent loss of capital is the prime objective. It takes discipline to trim or sell investments that are doing really well (oil stocks, tech stocks, income trusts) and redeploy the capital in less sexy places (bonds, etc.). Predicting the future doesn't have a positive return for most investors; prudently understanding your risk tolerance does.

The report did make a few good points if you're a trader. Oil pricing was noted as a systemic worry; lower oil pricing benefits consumers, but makes for difficult investing. Balance sheets were under pressure, dividend policies were under review, wells were being shuttered. The bank predicted that oil would trade to US$ 26 per barrel, with "clear risk of US$16". Oil continued to chart a lower course for the next six weeks, trading to a fifteen-year low of US$26.11 in February, but from there promptly reversed its course and trended higher, finishing June at US$48.33.

Brexit was discussed as theory, some five months before the fact. A trade recommendation followed on some pages later, noting that "in the event of Brexit, foreign demand for gilts may weaken". It is difficult to say whether or not that thesis worked out, bonds issued by the United Kingdom were substantially higher in price post Brexit, even as the Pound Sterling suffered horribly against other major currencies.

Six months later, Brexit is a reality, and the markets have become more volatile as the uncertainty surrounding the United Kingdom's role in unified Europe – should Europe remain unified – has increased. This volatility will pass, as it always does. Our certainty comes from the Asset Backed Commercial Paper debacle, the mortgage crisis in the United States, the near bankruptcy of Greece, the near bankruptcy of Iceland, oil at $16.70 in 2001 and $147.27 in 2008 and $26.11 in 2016, and slowing growth in China. So now what to do about Brexit?

This is of course is an incredibly complex system. By majority vote, the populace of the United Kingdom voted to leave the European Union. More precisely, their votes were to advise the Government that a majority would like to leave, as the referendum was non-binding. So this may be much ado about nothing, should the Government choose to defy the majority – though that significantly shortens a political career. It remains to be seen if the Government will begin the process of leaving, it remains to be seen what terms and concessions Europe will grant the United Kingdom, it remains to be seen whether Northern Ireland or Scotland will join Europe – these nations voted solid support for the status quo. It remains to be seen if the European Union continues to exist in its current form, nations will certainly act in their own self-interest, there can be no guarantee that the United Kingdom leaves or that any current member stays. The map may stay the same, the map may be totally redrawn. So how best to invest in uncertain times?

In the last fifteen years there have been an untold number of crises and flashpoints, reason after reason to sell (mostly) everything. There are many reasons to stay invested. In the long run, markets go up. Of course that qualifies as a prediction, but it hardly resonates as a bold one given the weight of history. Markets, measured by the S&P500, have increased by 104%, including dividends, over the last ten years. The same index has returned some 354%, including dividends, over the last two decades. Just as interesting is that the Canadian bond market has outpaced the equity market over the last 10 years (5.6% vs. 4.9%). As current events denature and fade into history, the market recovers its losses and powers higher. Time and time again.

Over the long term a balanced and diversified approach to investing has been the best "predictor" for your investing future. Over the last 10 years foreign equity markets have done a little better than Canada but the important thing is that they have taken turns being the leader providing mostly consistent returns. In the odd year when all equity markets suffered, if you held bonds in your portfolio then you owned a measure of protection. We can with certainty predict (sadly) that there will be more calamities in the world, that markets will remain volatile. and a that a balanced portfolio will, all things considered, do a good job!

Brexit will eventually be studied by historians and forgotten by long-term investors. In re-reading the research piece, one particular note stood out, some hard truth amongst wild conjecture. As it happens, it was the opening sentence. "Overview : there is a difference between forecasting something and it actually crystalising". We could not agree more, no matter how credible or informed the source might be, predictions are not promises, and that holds true whether they are good, bad, or simply to grab attention.