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Does What Happen in Canada Really Matter?

When it comes to most things that affect our day-to-day lives, what happens in Canada certainly affects us. When it comes to financial market returns though, virtually everything that is driving our market is coming from outside Canada—namely Europe, the United States and to a lesser extent China.

News from Europe has been a bit better of late. The European Central Bank and other Euro Zone members have thrown Spain a lifeline; and that support seems to be working as Spanish bond yields head lower. There is still a medium- to long-term risk though that some or all southern European nations (together with Ireland, and Belgium) may need to go through more drastic restructuring—resulting in a lack of clarity in terms of whether or not these countries will stay as full Euro Zone members.

In the United States, the Federal Reserve has again launched a massive bond (and mortgage backed security) buying program which will continue to promote an almost “free money lending situation”, with clearly stated goals of improving their economy, lowering unemployment, and (while they don't say this) keeping the U.S. government solvent by ensuring it pays very little interest on its growing debt.

China's economy appears to be leveling at about a seven and half percent growth rate which is “so-so for them” but would be fantastic for anyone else.

All aforementioned events in these outside countries affect resource prices, interest rates, and very importantly the “risk premium” that investors put on owning stocks. Of late that risk premium has declined a bit, interest rates appear to have nowhere to go but stay low, and resource prices have perked up a bit. This in turn is resulting in favorable financial conditions in the Canadian markets, in addition to good performance in foreign markets.

With respect to interest rates, the Bank of Canada would like to begin increasing short-term rates as they are concerned that low interest rates are incenting too much Canadian personal borrowing together with causing overvaluation in our domestic housing market. The ultra low interest rate stance of the U.S. Federal Reserve dampens the likelihood that our central bank will increase rates as in no way does the Bank of Canada wish to push an already overvalued Canadian dollar even higher.

Our high dollar means Canada's trade deficit continues to worsen, (hurting Canadian exporters) and also means the main road through my hometown of Tsawwassen (going towards my old home town in Point Roberts, USA) is so busy with cross-border shopping vehicles that retirement home residents wanting to cross the street are taking Olympic sprint training classes. Suffice to say that the Bank of Canada cannot increase interest rates at the moment.

While financial market news has been reasonably positive of late, the next set of news of course could go the other way. More important to us is how things go in the long-term. There, we envision a continued environment of low interest rates and with the stock market providing an earnings yield (the inverse of the current very reasonable price-to-earnings ratio-sorry for industry terminology) of over 8%, we can't envision an environment where ten-year government bond yields of 1.6% will provide anywhere near the return that stocks should provide over say the next ten year period.

What Are We Recommending Lately?

1. Firstly, a bit of housekeeping. An Enervest warrant has again been paid out to all holders of this investment. About once or twice a year, Enervest issues these warrants to you at no cost. We then sell them generating about enough money for four or five grande mochas at your local Starbucks. What is a warrant anyway? Warrants give you the right (but not the obligation) to purchase a few more shares of Enervest at a price a bit higher than the current price Enervest trades for. The market will initially give a small trading value to these warrants, and we need to sell them (before they expire worthless) in order to realize that value. We don't charge to sell these warrants.

2. We continue to purchase some new issue preferred share rate/reset dividend paying investments from quality companies. This type of preferred share is less sensitive to "interest-rate risk" because if interest rates eventually rise, these issuing companies have to either pay you a greater dividend or return your capital (which can then be reinvested at the then higher rate). This is only for non-registered or corporate money.

3. In registered accounts, we continue to buy investment-grade Canadian corporate bonds. Yields continue declining though so from a return standpoint, we must recognize that these bonds will not provide as high a return over the next few years as we have been used to earning in the past. We feel strongly though that given the age of our clientele (average age 63 years old) we must be very cognizant of capital preservation. And we also want to make sure that should markets experience a significant decline at any point going forward, we have adequate liquid and secure "ammunition" that can be utilized to take advantage of low markets. As an example of where we're at interest-rate wise, I never thought I would get really excited about a 3.45% yield investment–but today I felt that way when I saw a high quality corporate bond (at that yield) in our firm's increasingly lean bond inventory. I must be getting old because if I saw a 3.45% yield on something when I was younger, I wouldn't have been excited.

4. With respect to cash flow paying investments (that pay better than investment-grade bonds), we are okay with Canadian Real Estate Investment Trusts (although they have had a very strong move upwards over last few years and are certainly not cheap). High-yield bonds (through diversified low management fee, no load mutual funds) are okay as well; although the high-yield bond market has been quite strong of late and the yield spread that high-yield bonds pay relative to risk-free bonds has declined a reasonable amount.

5. ACM Commercial Mortgage Fund has provided solid returns thus far on what we deem to be a reasonably low risk investment. Our return expectation going forward on this investment is lower than what we've been earning so far – I would estimate 4.4% (per year) over the next few years.

6. We continue to pick up a U.S. based oil and gas income trust (that pays no tax at the corporate level) and currently pays out a ten and a quarter percent distribution.

7. In our Index of Stock Strategy, we are looking at taking profits on a few investments; and potentially selling (another half position) on our darling stock—Lululemon—and we are looking at adding some resource and technology exposure.

When comparing client returns versus indexes over the last few years, we are very pleased with the numbers we're seeing; and from a risk standpoint, we are as comfortable as ever with respect to the quality of your portfolio. We are particularly comfortable with the quality level of the fixed income investments that have been built into your portfolio over the last few years. If the markets do well, your portfolio will do fine. If the markets go the other way, we feel we are quite prepared to take advantage of what ever cards are dealt to us. Warren Buffett has always done it this way and I can't think of a better investor to follow for sound advice on what to do during uncertain times. As the last bit of good weather comes to an end in the next few weeks, we typically see clients refocusing on their portfolios. Questions may arise so please don't hesitate to call us on anything that's on your mind.

All the best,
CIBC Wood Gundy

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