LANDRY INVESTMENT MANAGEMENT

Market Review
Fourth Quarter 2015

Stock markets firmed up in the fourth quarter, and the U.S. market ended the year with a slightly positive return. The recent fluctuations may give the impression that the equity bull market is over, but a review of the returns in local currencies shows a two-tiered market. On the one hand, we have the developed countries, with the European exchanges and the Japanese stock market up 8.0%, followed by the U.S. market, which treaded water but still has the best performance over the past 3 and 5 years. On the other hand, we have emerging markets, which were up by 3.9%, and commodity-producing countries, such as Canada, declined by 1.4%.

For a Canadian investor, the most important event of 2015 was the oil price decline. It caused the stock market to fall and also brought about one of the Canadian dollar's largest depreciation in many years. The Canadian dollar lost 16.0% last year and has fallen by 32.0% since its peak in 2011. Although the currency adjustment will have a profound impact on the economic life of Canadians in the years to come; it has already affected portfolios by boosting the value of foreign assets. For example, in Canadian currency, the U.S. stock market has doubled over the past 3 years.

Returns in Canadian currency

	1 year	**3 years (annualized)**
Canadian equities	-8.3%	4.6%
U.S. equities	20.7%	28.5%
Europe and Pacific equities	18.1%	17.2%
Emerging market equities	1.3%	4.1%
Bonds	3.6%	3.7%
REITs	-4.4%	-0.2%
Canadian/U.S. dollar	-16.0%	-10.5%

Source: Bloomberg, December 31, 2015

As the year moves along, it is appropriate to review the trends that have developed in the markets in recent years:

1) An equity bull market began in 2009 and should last far longer than average simply because it follows one of the worst 10-year returns in history. Today, the U.S. market is no longer undervalued, and in the years to come we must expect a return more in line with its historical average of 6.0% to 8.0% a year.

2) A downward commodity super cycle began in 2011. Commodity cycles last far longer than equity cycles. In fact, they often last several decades, and the current downward cycle will be no exception because the aging population in the developed countries will slow global economic growth.
3) Canada did not take advantage of the positive commodity cycle of the 2000s to invest for the long term and is therefore very poorly prepared for this negative cycle. This situation implied that the Canadian stock market underperform relative to the U.S. market and to a decline in the Canadian dollar. The majority of these adjustments have already occurred, and now we need to ask ourselves where this process will take us.
4) More recently, we have developed the idea that interest rates will remain very low for a long time because the risk of inflation has been replaced by the risk of deflation. In a context in which governments are excessively indebted, the only way to stimulate demand is to cut interest rates.

Economic activity

For the next 3 to 5 years, the potential for economic growth in the United States is about 3.0% per year, whereas it will be less than 2.0% in Canada due to the fact that the country has made insufficient capital investments in recent years, not to mention that the active population will only increase by 1.0% per year over this period. Canada also has a record level of household debt and structural budget deficits in the provinces. Considering these factors and the low price of oil, Canada will be lucky to reach a growth of 1.5% in 2016.

The situation is quite different in the United States. The country is back to a 5.0% unemployment rate, which represents full employment, household debt is down to a comfortable level and government finances are back to normal. Moreover, businesses have tremendous amounts of cash, which, combined with these factors, will enable the United States to reach its potential this year.

Oil price

The price of oil will be the main determinant of Canadian portfolio returns in 2016. What if the oil price continues to fall to $20, for instance attaining prices similar to those reached in 1998? The stock market and the loonie will both decline, precipitating the economy into a recession. But if, on the contrary, the price of oil goes back up, the stock market and the loonie will also rise, and Canada could record some growth.

The drop in the price of oil is not the result of weak demand, but rather an excess supply from OPEC, especially in Saudi Arabia. OPEC cannot increase its output significantly, and U.S. output has already started to decrease. Moreover, the demand for oil is increasing more quickly than it did in previous years because its price is much lower. At the current rate, we can predict that the quantity consumed will match the quantity supplied in late 2016, and that the price of oil may start rising at that time.

Commodity prices

The decline in commodity prices accelerated in the second half of 2015. Was it a final wave of selling, like those that mark the end of a bear market? After all, the prices of several commodities are now below their production cost. Probably not, but this does not mean that the price of commodities cannot remain low for several years, because sufficiently robust demand is needed for these prices to rise.

Canadian dollar

The Canadian dollar fell very rapidly, and it is therefore difficult to identify a definitive sign on the balance of international payments. The trade balance, excluding oil, has begun to improve but its recovery is not yet pronounced enough to offset low price of oil since Canada is considerably more dependent on oil than it was 10 years ago.

At US$0.72, the Canadian dollar is trading at a discount of about 15.0% to its purchasing power parity, but that does not mean it will go back up anytime soon. Currencies can deviate from their purchasing power for several years, and at its last trough the Canadian dollar traded at US$0.62, or 15.0% below its current level. This simple analysis tells us that it is too late to take an excessively pessimistic perspective relative to the Canadian dollar.

European equities

With the first interest rate increase since 2008 in the United States, the Federal Reserve withdrew from the club of central banks that are making massive bond purchases to stimulate economic activity. This does not necessarily mean that the U.S. stock market will decline, but it does make it less appealing compared to Europe and Japan, where quantitative easing has been maintained. The European exchanges are especially attractive because they are less expensive than the U.S. market, their earnings trend is positive and the upside potential is far greater than it is in the United States.

Asset allocation model

Our asset allocation model considers 16 global financial markets and selects the seven with the most momentum. In the last quarter, the model held 40.0% cash with the remainder of the portfolio invested mainly in U.S. and European equities. These markets grew by 5.0% to 14.0% in the last quarter.

At the start of 2016, Government of Canada bonds were eliminated from the portfolio, which added U.S. REITs and Japanese equities to U.S. and European equities.

Cash	25%
U.S. equities	15%
NASDAQ equities	15%
European equities	15%
Japanese equities	15%
U.S. REITs	15%

DASHBOARD

	December 31, 2015
Canada	
Canadian dollar vs. U.S. dollar	=
Corporate bonds	+
Long-term government bonds	=
S&P/TSX 60	–
Small caps	–
REITs	--
United States	
U.S. dollar vs. euro	=
Long-term Treasury bonds	=
S&P 500	+
NASDAQ	+
Europe	
Euro vs. U.S. dollar	=
MSCI Europe	+
Asia	
Yen vs. U.S. dollar	=
MSCI Japan	+
Emerging markets	
MSCI Emerging Markets	-

=: neutral   + : overweighted   – : underweighted