THE RAE LIPSKIE PARTNERSHIP™ | PRIVATE WEALTH MANAGEMENT

March 2015 Overview

The more things change…

If there is a single piece of market wisdom that resonates with most investors, it is the necessity of a lengthy time horizon or, its corollary, the futility of short-term trading. But after a few decades of involvement with the stock market, it is interesting to note how short-term obsessions with certain data points have always been a big part of day-to-day market action. While the important longer term determinants (like profitability, growth and valuation) eventually prevail, markets have often been impacted by such fixations, including the following examples…

Inflation. This one takes us back to the 1970s and '80s when the release of inflation data terrified investors. Of course, that was when inflation was high and destabilizing to the financial system. Between 1973 and 1982, the CPI ranged from 7.2% to 12.5% and included 5 years above 10%. Inflation's direct connection to interest rates meant that investors reacted dramatically to every bit of data with any conceivable connection to prices, be it related to commodities, wages or the much anticipated monthly CPI announcement. Today, in contrast, central banks worry about *de*flation.

Money Supply. In the same time period as above, and for the same reasons, money supply growth became a mania du jour. Okay, it was actually reported on a weekly basis, but as the Friedman doctrine that "inflation is always and everywhere a monetary phenomenon" gained acceptance, investors watched like hawks the statistical output in the form of money-supply growth, and bought or sold accordingly. Today, many investors might ask: What is money supply?

The Fairway. Continuing on the historical theme, that period was a golden age of exploration for Canadian oil and gas companies. Exploration requires land, of course, and the early 1980s saw record prices for drillable land, both in western Canada and in the frontier areas of the arctic and offshore both coasts. For investors, this meant contracting 'land fever' and poring over land-sale reports in hopes of finding a company with leases 'on the fairway', a term coined by an oil analyst back in the day to designate prime, drillable property. Today, many of those companies (remember Dome Pete?) that soared on exploration prospects are either defunct or merged into another entity.

Interest Rates. Back to the present, the age-old worries about high interest rates are a thing of the past. Now investors watch diligently the day-to-day fluctuations, looking for signs of short-term stress and accompanying trading opportunities as rates in most countries slide towards zero and beyond.

Fed Minutes. Instead of the Fed's money supply data, investors now focus intently on minutes from the Fed's Open Market Committee, searching for clues about direction and timing, and moving markets hundreds of points in minutes.

Crude Stocks vs. Rig Count. With oil prices down 50%, investors have long forgotten about land prices. Now their trading trigger fingers hover over computers, anxiously awaiting weekly data on crude-oil inventories, ready to sell as supplies increase, and on the latest count of operating drilling rigs, just as ready to buy as reduced drilling activity suggests diminished supply prospects.

Jobs. On the first Friday of every month at 8:30 a.m. the U.S. Bureau of Labor Statistics releases employment data for the previous month. This report has become a jobs-producing industry unto itself as dozens of economists predict beforehand and comment after, with the Wall Street Journal even reporting a live blog on all the proceedings. There is usually a loud flurry of short-term trading activity when the details are announced. There is usually a deafening dearth of activity from true investors who discount the short-term noise.

THE LEARNING CORNER

What is Toystory?

Yes, we could be talking about a very popular kids' movie, but in this case it is actually a very popular Holstein bull, albeit named after the movie. That's right, a bull. Born in relatively modest Wisconsin surroundings in 2001, amidst little evidence of the rock star status that would eventually befall him, Toystory managed to enjoy an amazingly productive life. Sadly, he died recently but not before amassing some staggering statistics:

- He produced 2.4 million units of semen, a world record that easily eclipsed the previous 1.7 million mark. It is rare in the world of bovine artificial insemination to hit the million level so Toystory was definitely in a class of his own.
- His weekly production rate was double the average for bulls at the facility.
- No value has been attached publicly to this output but even a modest $40 per unit gets his revenue into the $100mm area. The original owner sold him as a calf for $4,000.
- Toystory sired an estimated 500,000 offspring in more than 50 countries. His daughters have been consistently higher than average in both milk production and profitability.

What do we learn from this cow tale? Toystory is a lot of bull. It pays to buy quality. The animal world is subject to income inequality too. Don't sell an investment too soon.

PRESIDENT OBAMA QUIETLY VETOES the KEYSTONE XL PIPELINE

THE BIG PICTURE

Two Shades of Grey

The perception of global economic growth of late is actually more like black and white than shades of grey – the U.S. economy is growing and the rest of the world is slowing. The performance of the U.S. economy certainly has been impressive – a noteworthy indicator of that performance was the creation of over 3 million new jobs in 2014, the strongest growth since 1999. Meanwhile the rest of the world appears to be either stagnant (Eurozone, Japan, emerging markets) or shifting into a lower gear (Canada, Russia, other oil-exporting nations). These differences have been sharply highlighted in the currency markets where the U.S. dollar has dominated, advancing sharply in 2014 to reach a peak last seen in late 2003. Interest rates have also been highly divergent, with the Federal Reserve Board in the US edging closer to their first post-Credit Crisis rate hike, while the rest of the world, Canada included, is implementing interest rate cuts. A growing number of countries are even experiencing negative interest rates, both in their short-term administered rates and in their bond markets out to terms of up to five years.

However – and this is part of the beauty of free markets – the self-correcting mechanisms of the capital markets are starting to take hold. The stimulative effects of more competitive exchange rates, and lower energy costs and interest rates are helping to boost more widespread growth trends, with emerging economies, Japan and the Eurozone showing improving trends - modestly improving, but improving nonetheless. An interesting indicator provided by Citibank called the "Economic Surprise Index" tracks the difference between reported economic data and the expectations for those results. Recently, that indicator for the Eurozone has moved sharply higher. Of course, the actual growth, while positive once again, remains fragile and subject to relapse, but it has to start somewhere. Even within Canada, we see this "re-balancing" taking place as the negative impact of low energy prices hurts our oil producing provinces, while the highly correlated drop in the Canadian dollar is providing a real boost to exporters who are witnessing growing sales volumes.

These adjustments don't occur overnight, but we are seeing signs of their impact, both positive and negative. A popular forward-looking tool, the Purchasing Managers Index, or PMI, recently rose to a seven month high in Europe thanks to expanding output, new orders and employment. Europe is also experiencing its best corporate profits reports in several years, with fourth-quarter earnings expected to improve by 19%, year-over-year. Meanwhile, U.S. corporations are experiencing some mild headwinds as weakness in earnings momentum in the Energy sector (no big surprise there), is starting to leak into some of the more broad-based industry groups in the S&P500. Of course, the powerhouse U.S. economy, still the world's largest, is the driving force behind latent improvements in other regions, and that won't change anytime soon, but at the margin there are signs of encouragement in other global economies and equity markets as well. A well-diversified approach ensures that investors are able to benefit from those trends.

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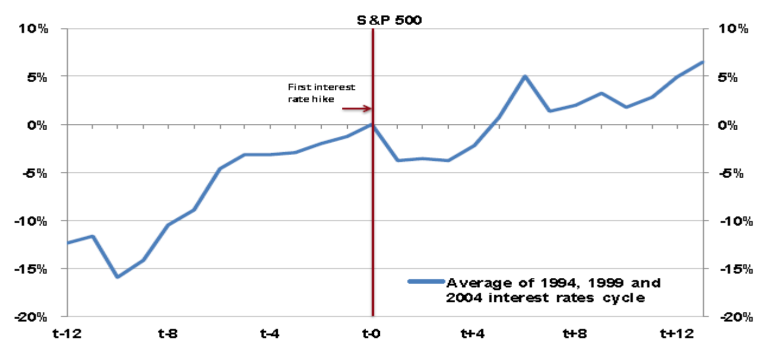
CHARTING OUR TIMES

As we pointed out in the Overview section of this newsletter, investors are constantly clamoring to discern the Federal Reserve Board's next move in its interest-rate chess game. This is important to investors because stock markets have benefited from many years of what some pundits have called the Fed's effective 'zirp' approach, or zero interest rate policy. The concern is that a move to increase rates will take away an important support for the economy and stock market, and signal a shift towards higher interest rates generally, including in the bond market.

For its part, the Fed plays its cards close to the vest, leaving analysts to scrutinize every word from every official, including Chair Yellen. Recently, in testimony before the Senate Banking Committee, Ms. Yellen paved the way for higher rates, suggesting the Fed could move away from its "patient" posture because "conditions have improved to the point where it will soon be the case that a change in the target range could be warranted". Perhaps not exactly a ringing endorsement, but the 'conditions' referenced include very strong numbers in the employment category, apparently Ms. Yellen's pet indicator, so higher rates sometime this year are likely.

What will this mean for the stock market? Interest rates are only one factor affecting stock prices, of course, but the chart below suggests that the market should react reasonably well. The chart shows the average of three previous cycles, the vertical-line inflection point where rates start to rise and the movement of the S&P 500 in relation to the cycle. The market tends to dip slightly immediately following a rate rise but recovers to show a good gain within 12 months. Previous cycles also repeat this positive picture to varying degrees. The reason for this upbeat reaction is simply because the rate rise is due to a strengthening economy which, in turn, is good for corporate profits, dividends and, as a result, stocks.



QUOTE of the DAY

Percentage Wise

Though lowering the interest rate
Is great for those who borrow,
What does it do
For those who
Are saving for tomorrow? *- Doris O'Brien*