Global Economic and Market Outlook

IIROC
CLS COMPLIANCE CONFERENCE 2014

Andrew McCreath
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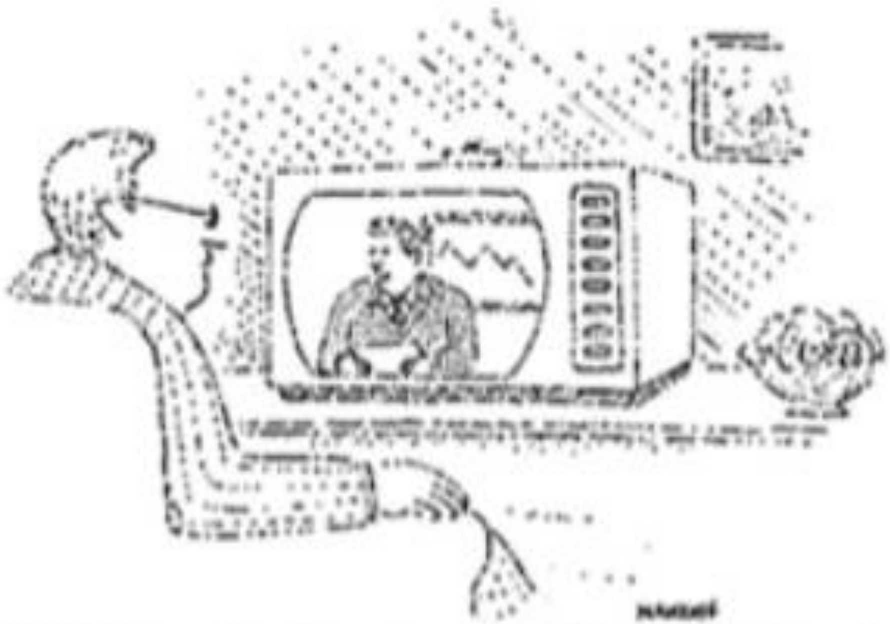
BNN Market Commentator

Andrew McCreath, CFA, President and CEO

Andrew is a Co-Founder of hedge fund Forge First Asset Management Inc. His 25 years of investment industry experience includes more than 15 years of managing money during which time he was a founding shareholder of two successful money management organizations that were sold to larger organizations.

After being a top-ranked sell-side securities analyst at leading investment banks for 7 years, Andrew moved to the money management side of the business. He was a founding shareholder of Synergy Mutual Funds which was sold to CI Financial in October 2003. Andrew started his first hedge fund business, Waterfall Investments, in April 2004 which was sold to Sentry Investments in August 2008 when Andrew also officially joined the Sentry team. During his three years at Sentry, Andrew managed the Sentry Diversified Total Return Fund, winner of 2010 Lipper Award, and the Sentry Market Neutral LP, winner of 2010 Morningstar Best Relative Value Hedge Fund (Gold in 2010). Once an entrepreneur and always an entrepreneur, Andrew left Sentry at the end of August 2011 to launch Forge First Asset Management, and now he is also a Market Commentator on BNN-TV, Canada's only all-business television station (www.bnn.ca), and Host of "Weekly with Andrew McCreath".



"On Wall Street today, news of lower interest rates sent the stock market up, but then the expectation that these rates would be inflationary sent the market down, until the realization that lower rates might stimulate the sluggish economy pushed the market up, before it ultimately went down on fears that an overheated economy would lead to a reimposition of higher interest rates."

Source: The New Yorker

Macro Environment

- Economic data has shown that the U.S. economy continues to take 2 steps forward and 1 step back, suggesting it **will continue to heal towards a 3% rate of GDP growth**. A rate >3% requires income redistribution, another leg up in capex growth and a greater contribution from the rest of the world.

- While improvements in the European banking sector have reduced near term ‘event risk’, the failure to address the transmission mechanism of credit in Europe and the inflexibility of the German, Italian and French governments to strike a ‘fiscal deal’, suggest **Europe will merely muddle along break-even economically and continue to offer a significant risk of deflation.**

- **China is destined towards below 7.5% GDP growth** given its choice of reform vs. stimulus, debt levels and problems with pollution. China’s outlook combined with subpar global trade growth implies disappointing Emerging Market GDP.

- While there will be winners and losers, the **40% decline in oil prices unequivocally catalyzes a modest rebalancing of the global economy and boosts growth**. Assuming prices remain low at least until late Spring 2015, the impact of low oil prices will be felt across all asset classes.

- **Canadian GDP growth will benefit from U.S. growth, but this growth will lag the U.S.** due to provincial debt, rising taxes, global supply growth in commodities, continued delays in our ability to expand our energy infrastructure, and now the fall in oil prices. With energy accounting for ~15% of our GDP, Canada’s dollar will fall towards US$0.80 during 2015.

- Expect U.S. wage growth to pick up by mid-year 2015 causing **short term interest rates, i.e., 2-year US Treasuries, to climb from ~50 bps today to 125+ bps** twelve months from now. Good demand for sovereign debt amidst decreased supply should **ensure long term interest rates increase less than short term rates, ‘bear flattening’ the yield curve**.

- Widening interest rate and GDP growth differentials combined with America’s growing energy heft and dominance of technology, the world’s biggest growth sector, suggest the **US dollar will continue to appreciate in 2015.**

- A rising U.S. dollar and rising supplies of most commodities suggest the **majority of important commodities will continue to be poor performers**.

- U.S. stocks are not cheap and **historically, ‘bear flattening’ trades hurt equity valuations** but **U.S. stocks remain the best broad market equity alternative**. However, for markets to go substantially higher, better economic growth is required to drive earnings or else investors must be willing to pay a higher P:E multiple.

CHINA

Destined for slowing growth

Leverage in China and GDP Growth Slowdown

- *Supportive policies mean China is continuing to get more leveraged.*

- *Total credit outstanding will likely hit 240% of GDP by end of 2014. Hence, China's various mini-stimuli focused on money and credit have failed to stimulate borrowing.*

High Leverage Means China Will Slow Down Further

- *Credit growth will have to slow down further – Once the leverage ratio stops rising, China's growth will also have to slow down.*

- *Bank loans outstanding rose by only 13.3% in August 2014, the weakest pace since 2005.*

Source: Gavekal Dragonomics

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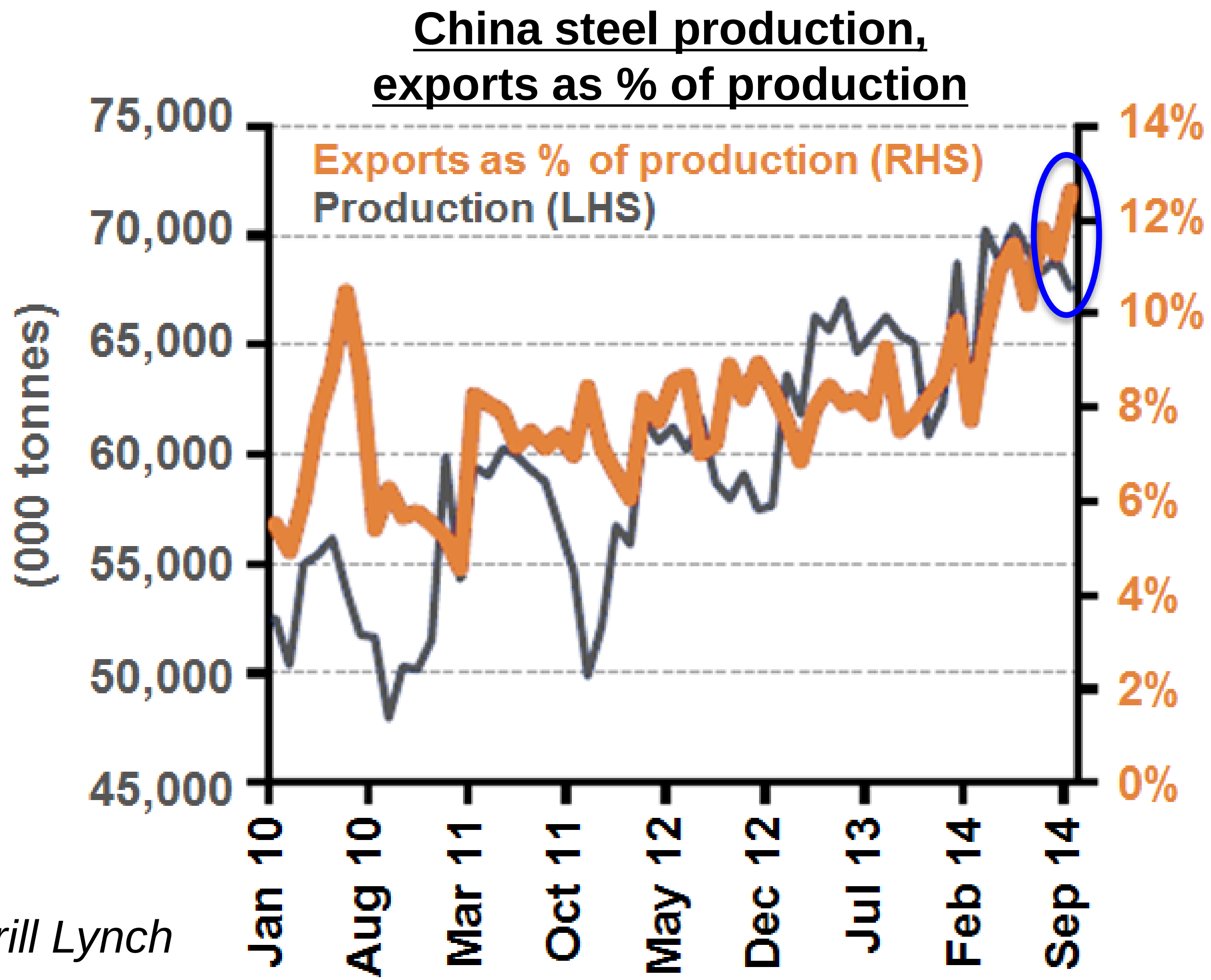
- *A further fall in potential and actual growth.*
- *Stop-start demand management to continue.*

Source: Goldman Sachs

- *Working through imbalances will increase macro and market volatility.*

Domestic steel supply > local demand drives growing exports, softer international steel prices, and weak demand for commodity imports



Source: BofA Merrill Lynch

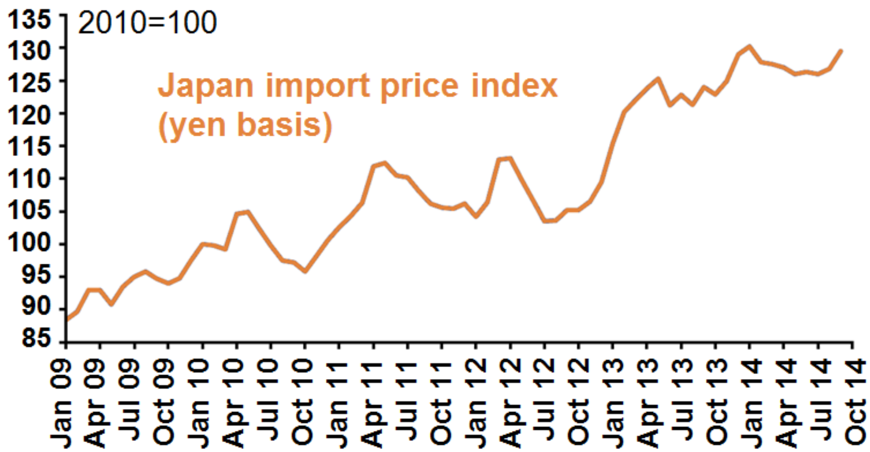
Not Good for Commodity Prices

Source: Deutsche Bank

JAPAN
The definition of an uphill battle

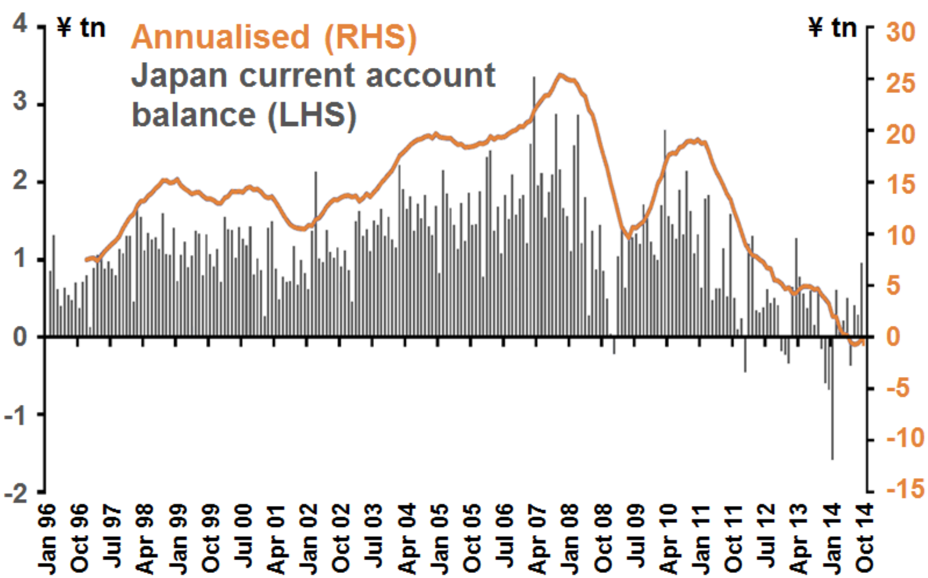
Japan – Weakening Yen and Current Account Deficit

Japan import price index (yen basis)



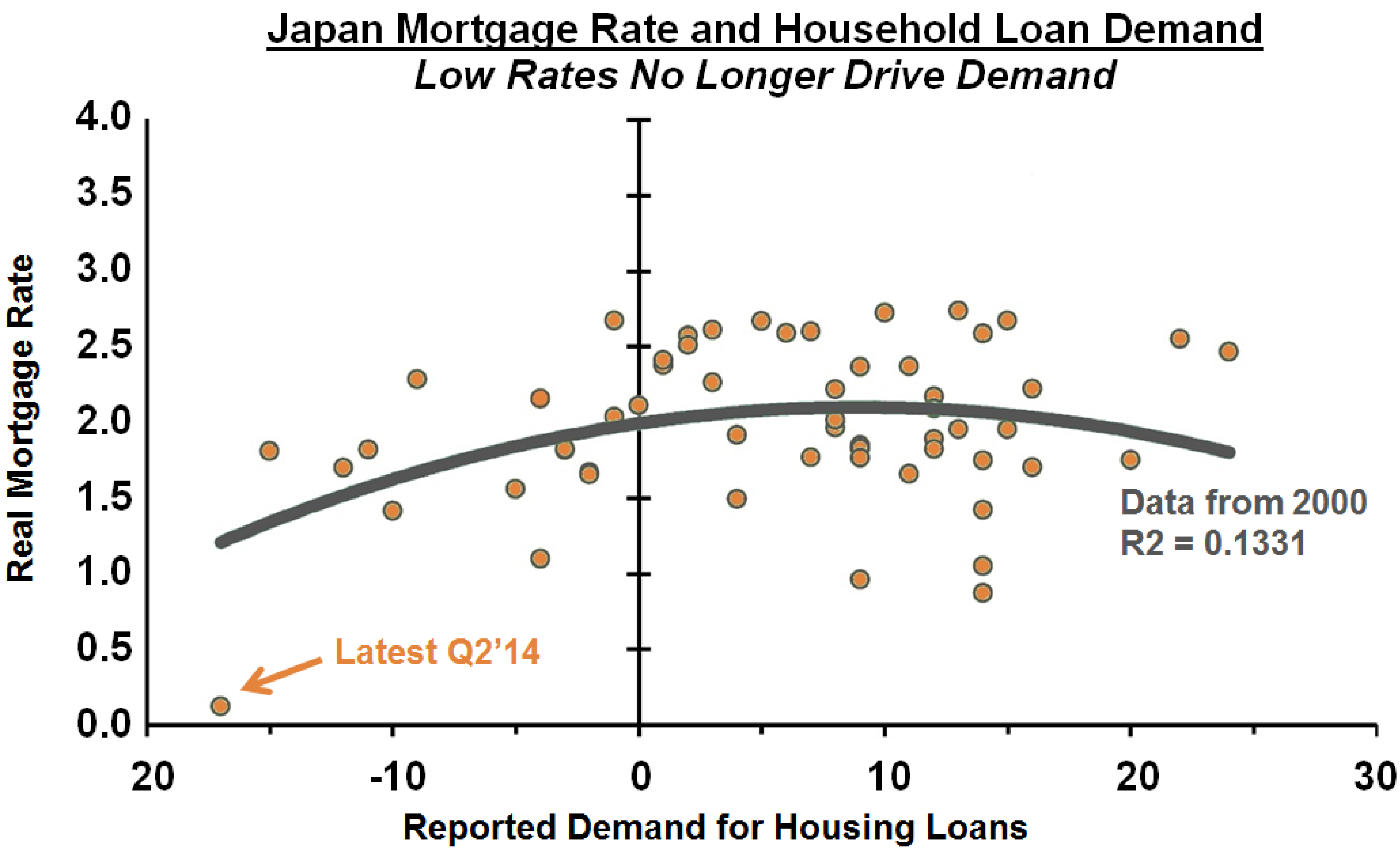
A weakening yen is unpopular with small and medium firms who employ about 70% of Japan's workforce – they face rising import costs, costs which are increasingly hard to pass on. The price of imports has risen by 22% in yen terms over the past two years.

Japan current account balance



The odds increasingly favour Japan moving into a structural current account deficit sooner rather than later, which also means that the odds favour the yen becoming a structurally weak currency, as opposed to one just traded on the latest move in BoJ QE operations relative to those of other G7 central banks.

Source: CLSA Greed and Fear

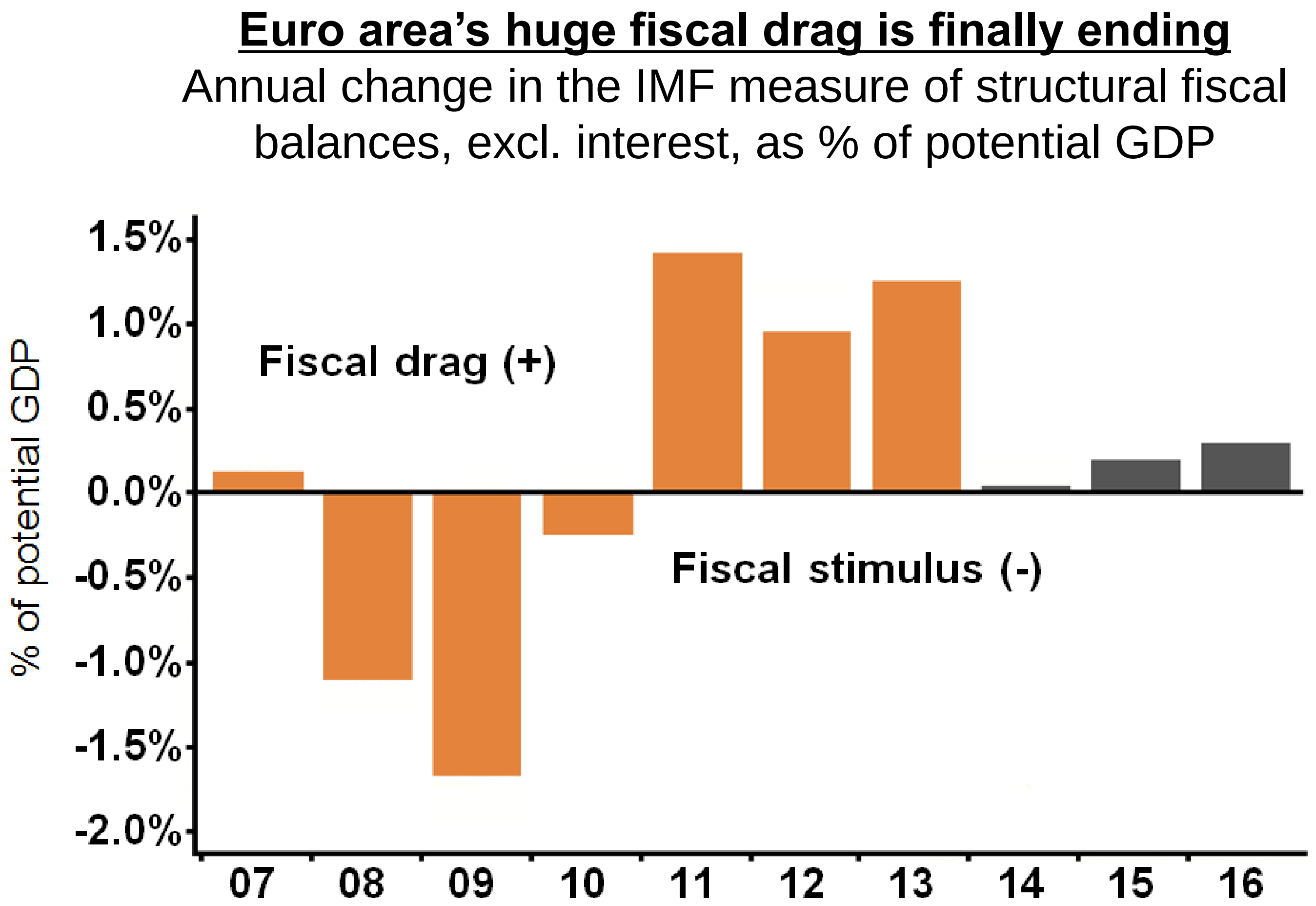


Source: Minack Advisors

EUROPE

Divided and tough to conquer

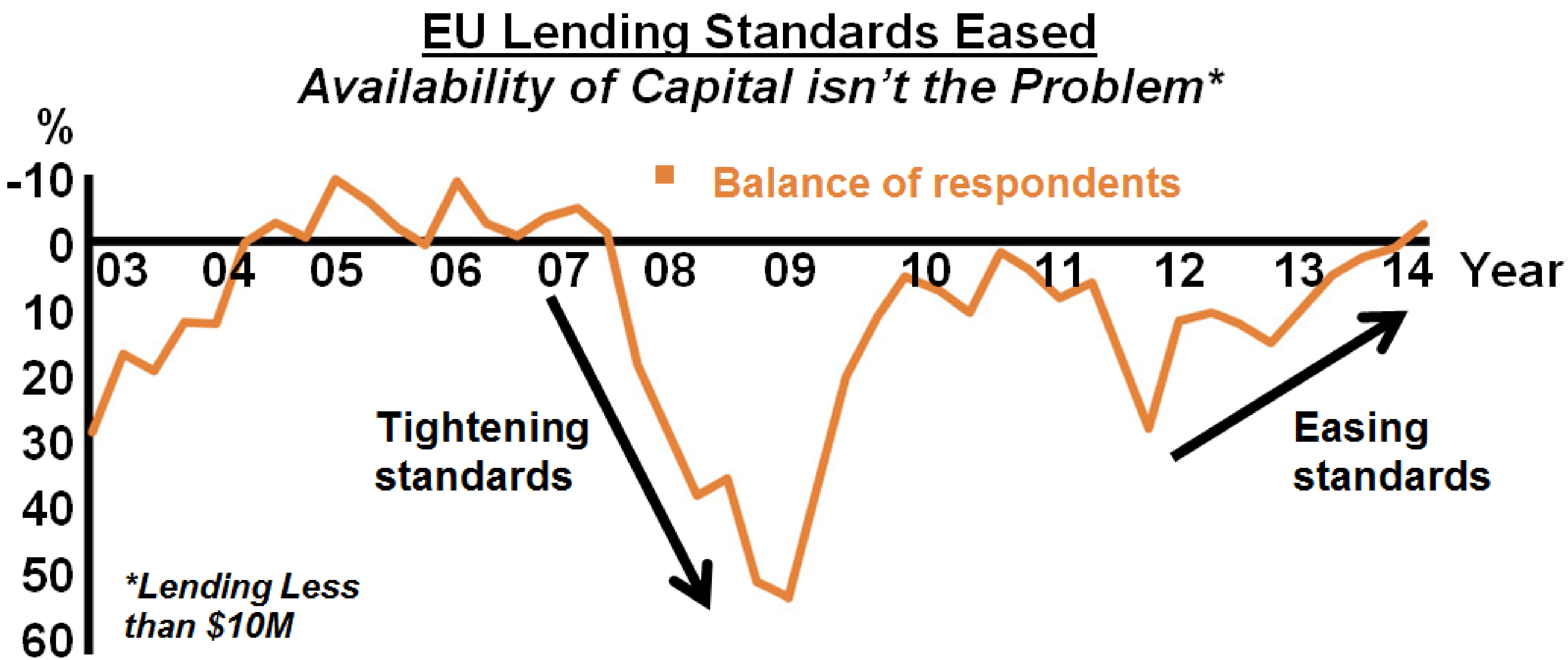
Euro Area’s Huge Fiscal Drag is Finally Ending



After three years of fiscal drag, the aggregate fiscal stance of the euro area has become neutral.

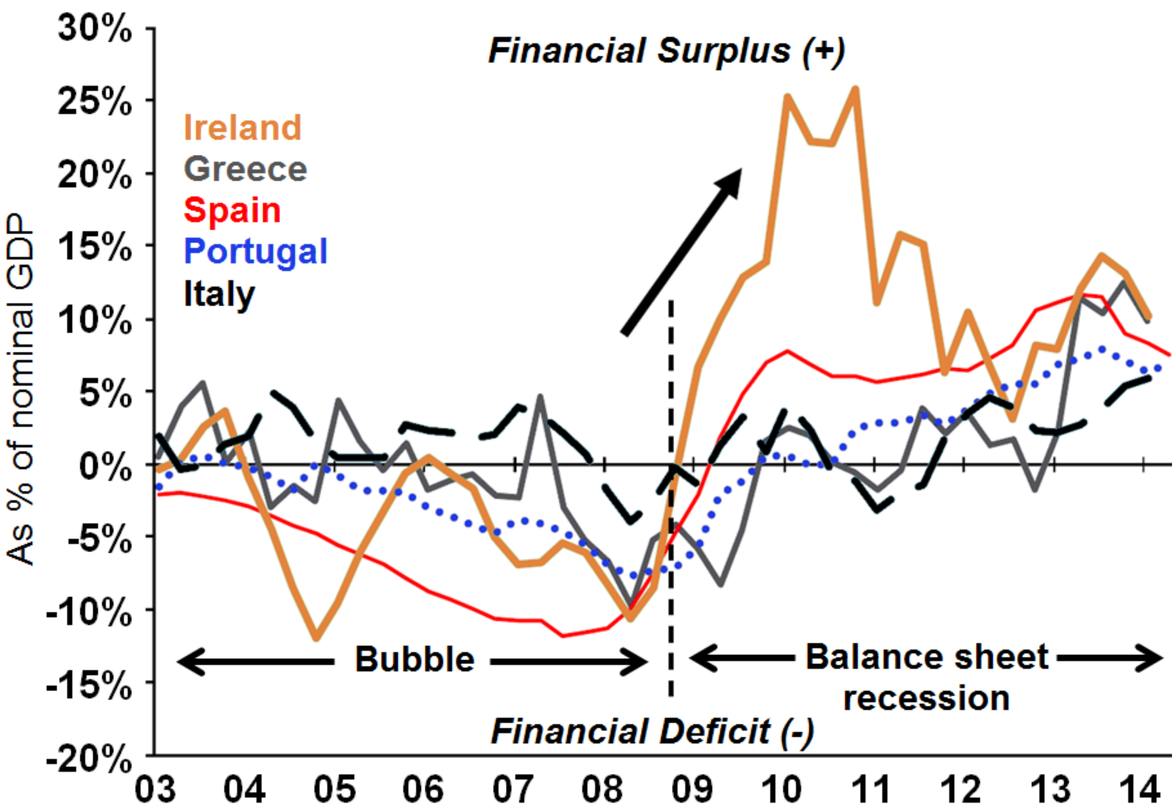
- *Moreover, fiscal policies are now incorporating tax cuts and spending cuts, rather than the tax hikes of 2011-2013.*

Source: Gavekal Dragonomics



Source: Deutsche Bank

Private-sector financial surplus in periphery grew after bubble burst

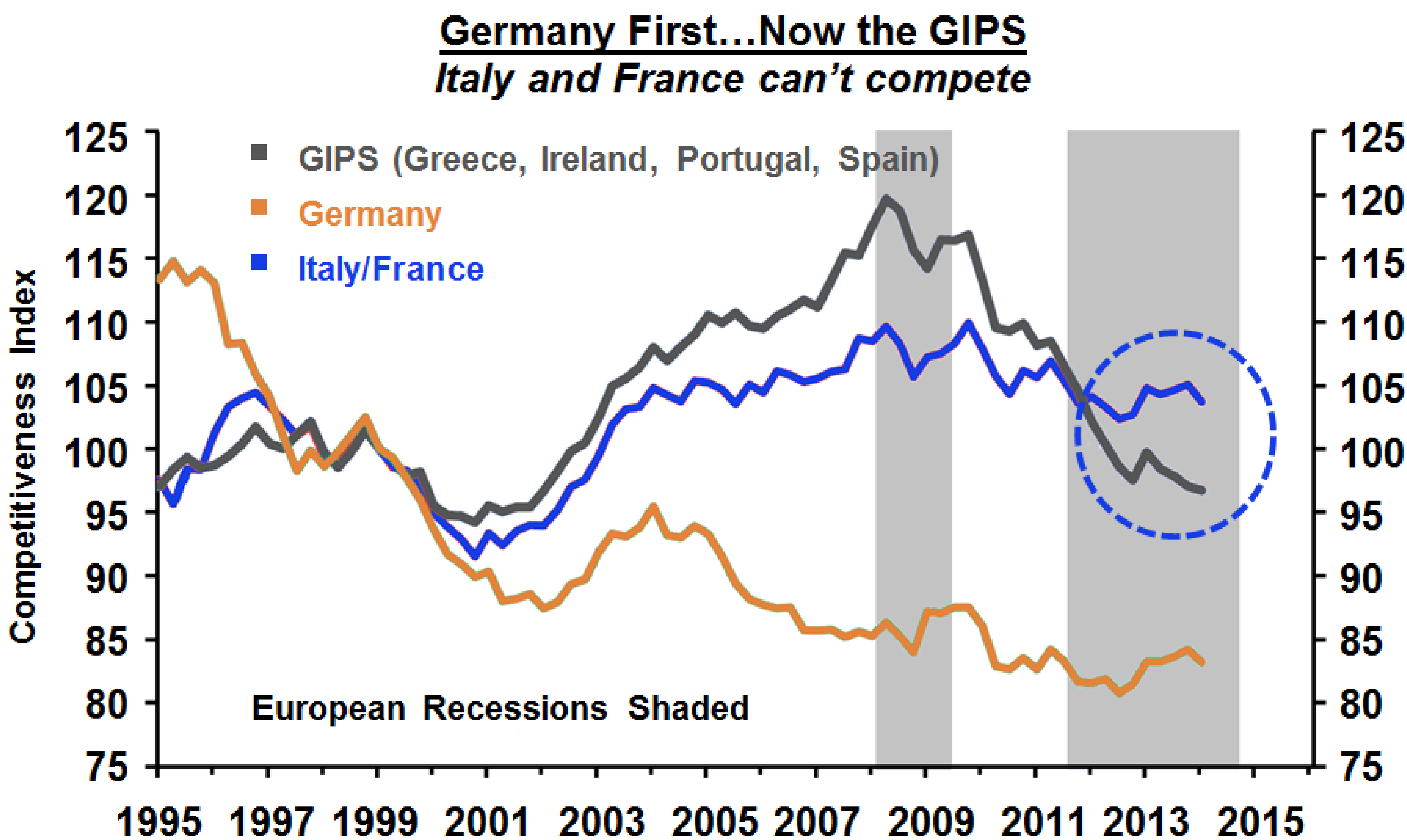


Source: Nomura

- *Businesses and households in all of the Eurozone countries with economic problems are saving heavily (i.e., in financial surplus) in spite of zero interest rates.*

- *With the single exception of Greece, those savings are far in excess of the fiscal deficits being run by their governments.*

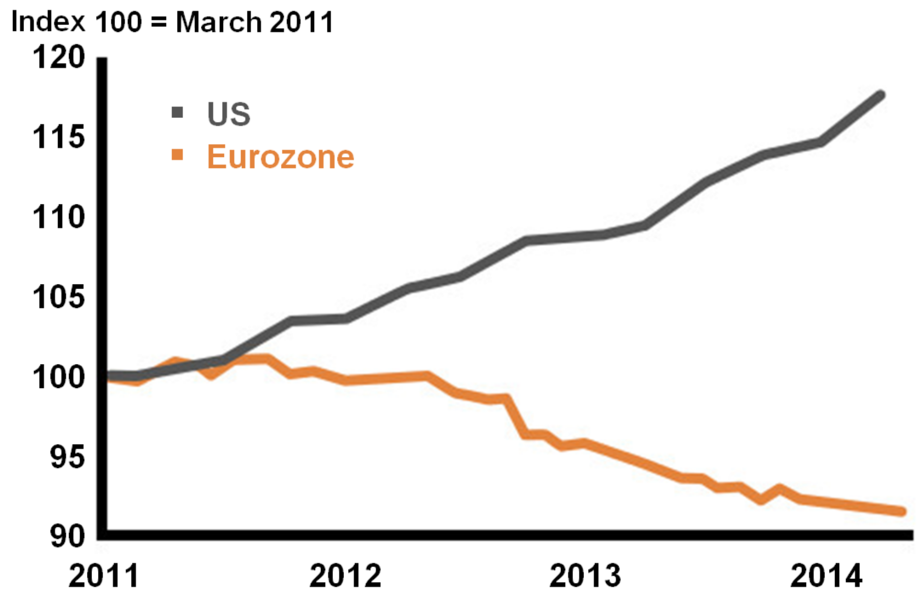
- *Two possible causes for the increase in savings: 1) the borrower-side problem of a lack of demand for funds; 2) lender-side problem of banks being unwilling to lend.*



Source: Minack Advisors

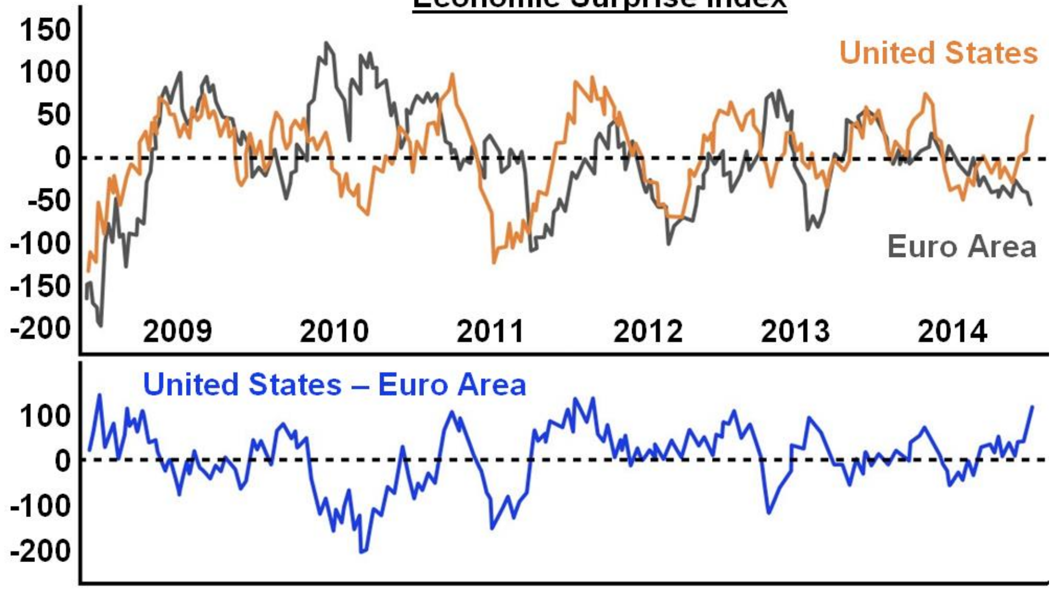
Europe vs U.S. – The Great Divide

Lending to Corps USA vs EU



Source: Deutsche Bank

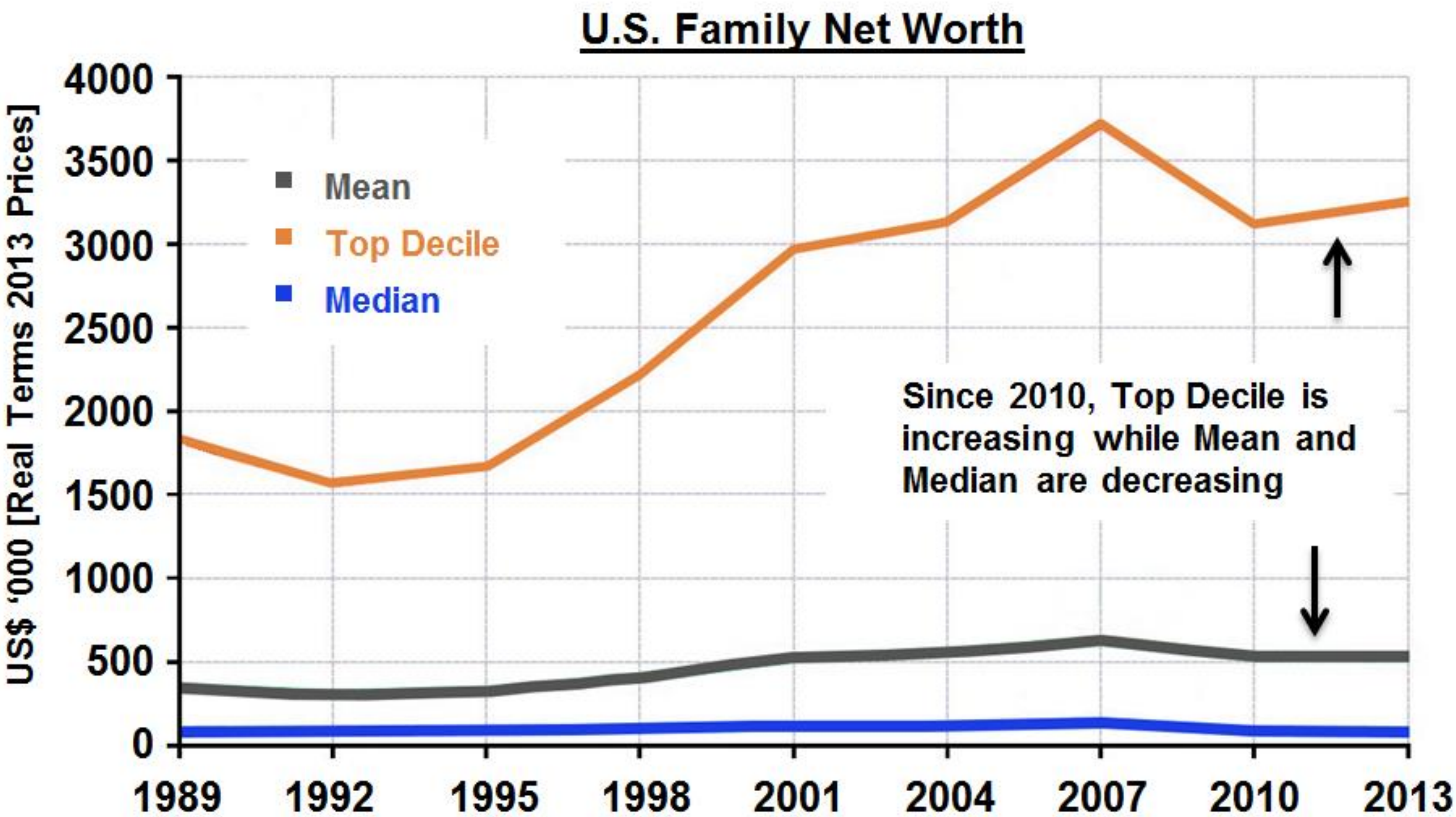
Economic Surprise Index



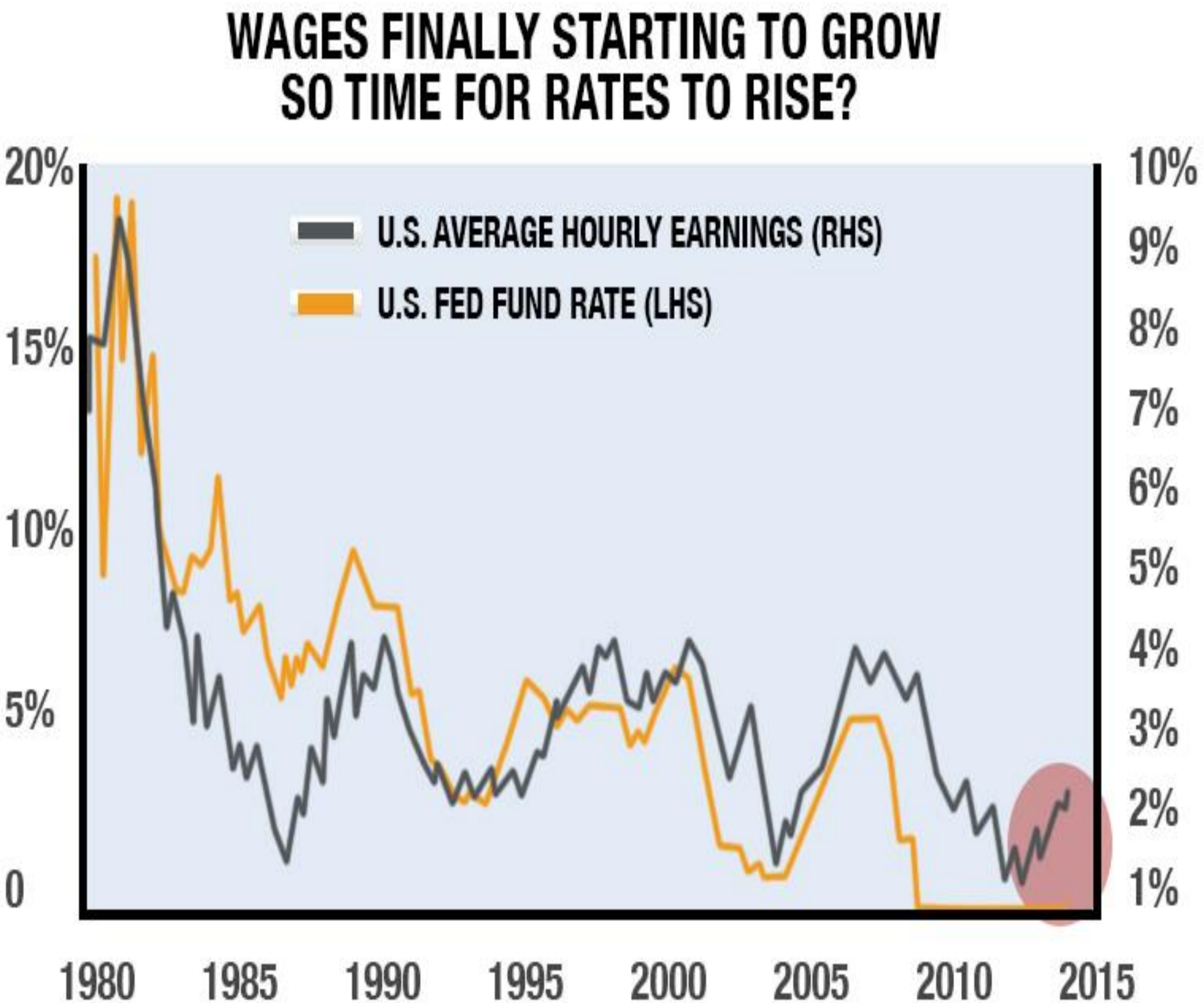
Source: Gavekal Dragonomics

USA

Best house on a bad street



Source: *Minack Advisors*

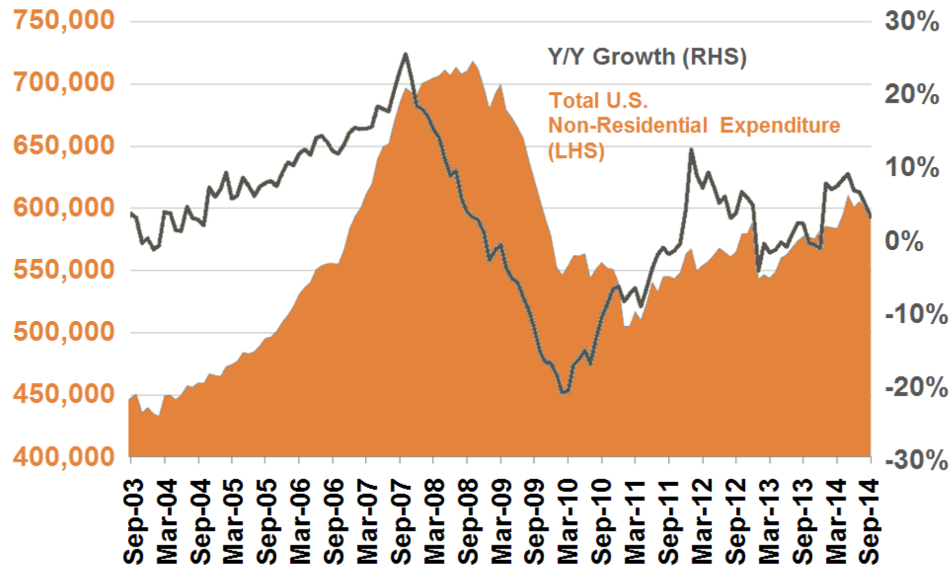


Source: Bloomberg

U.S. Economy Continues to Heal

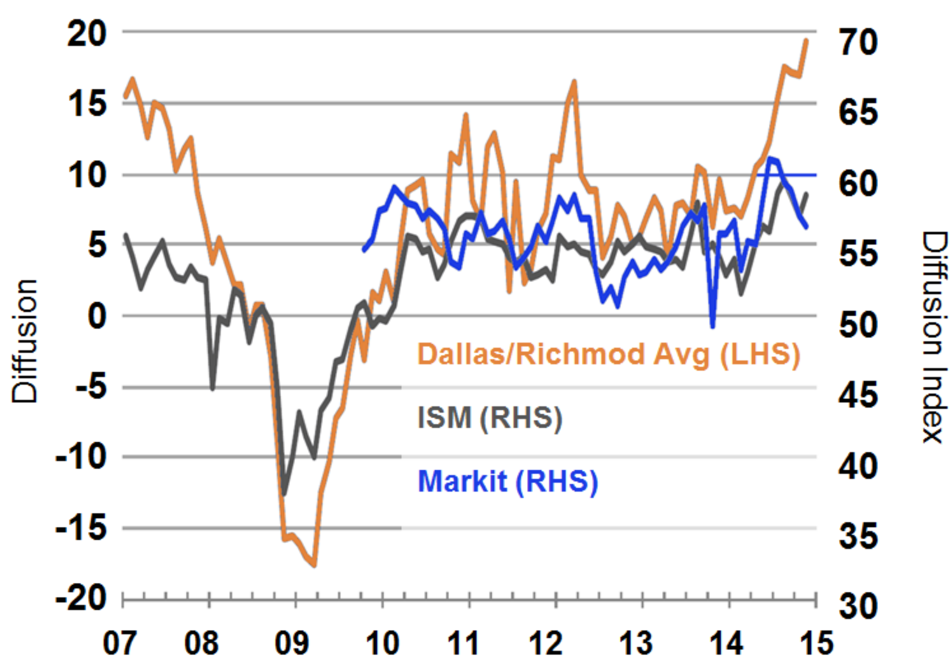
<u>**Total U.S. Non-Residential construction spending and Y/Y growth**</u>

Source: Morgan Stanley

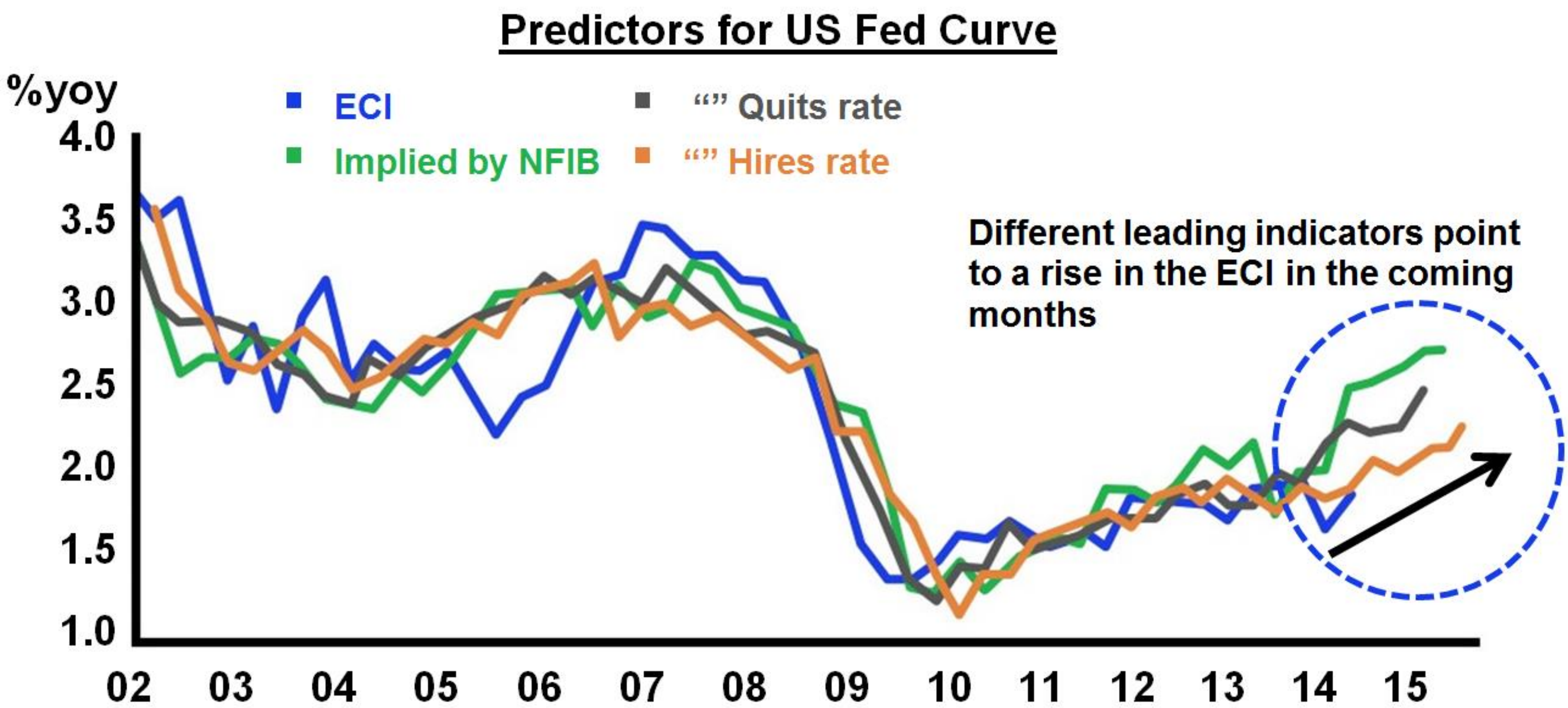


<u>**U.S. Non-Manufacturing Index**</u>

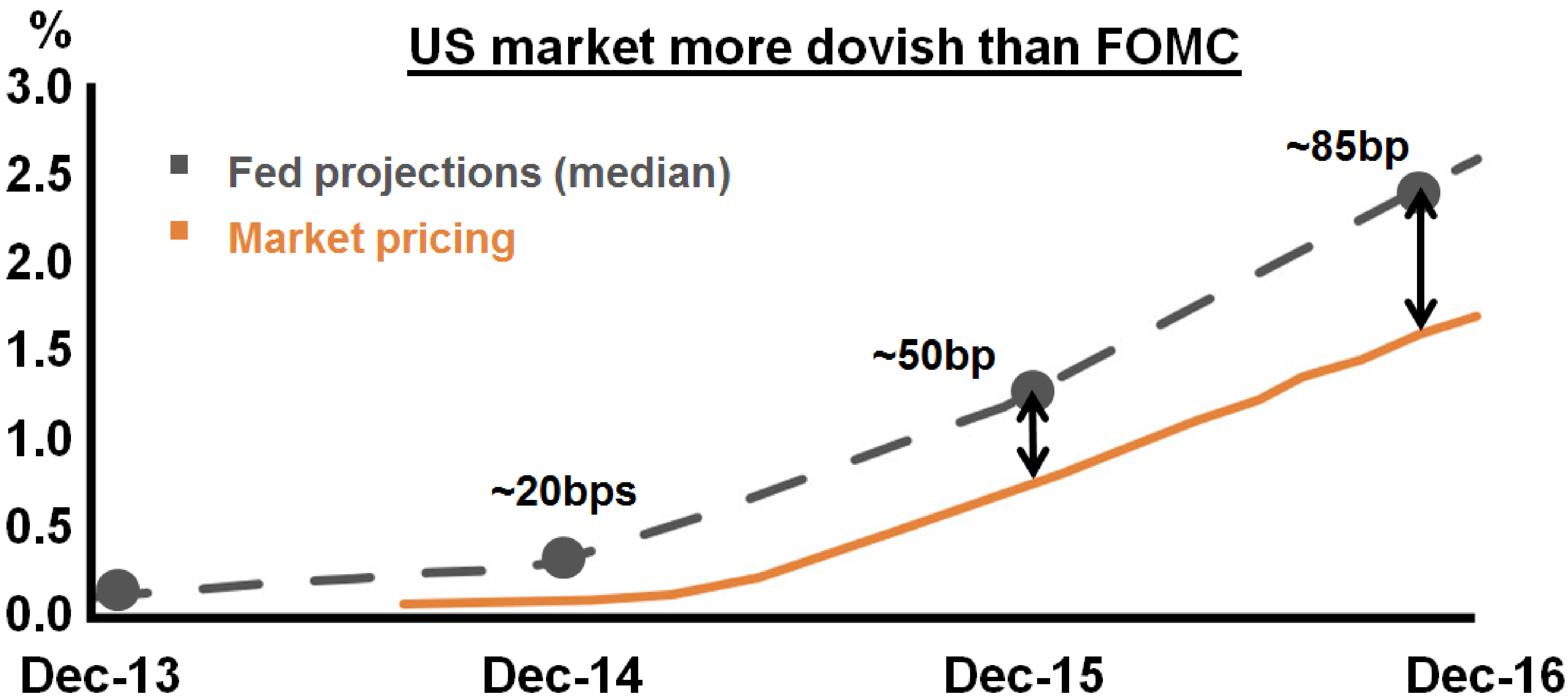
Source: Societe Generale



Interest Rates and Currencies



Source: Deutsche Bank

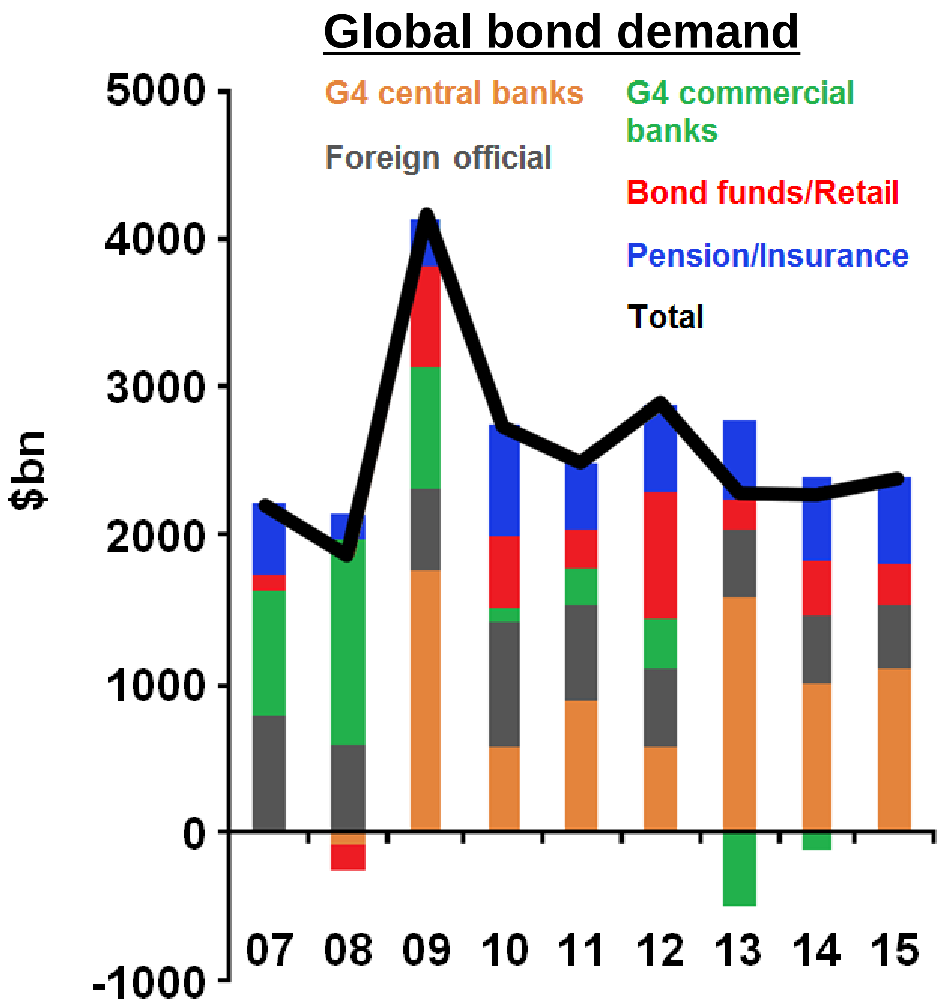


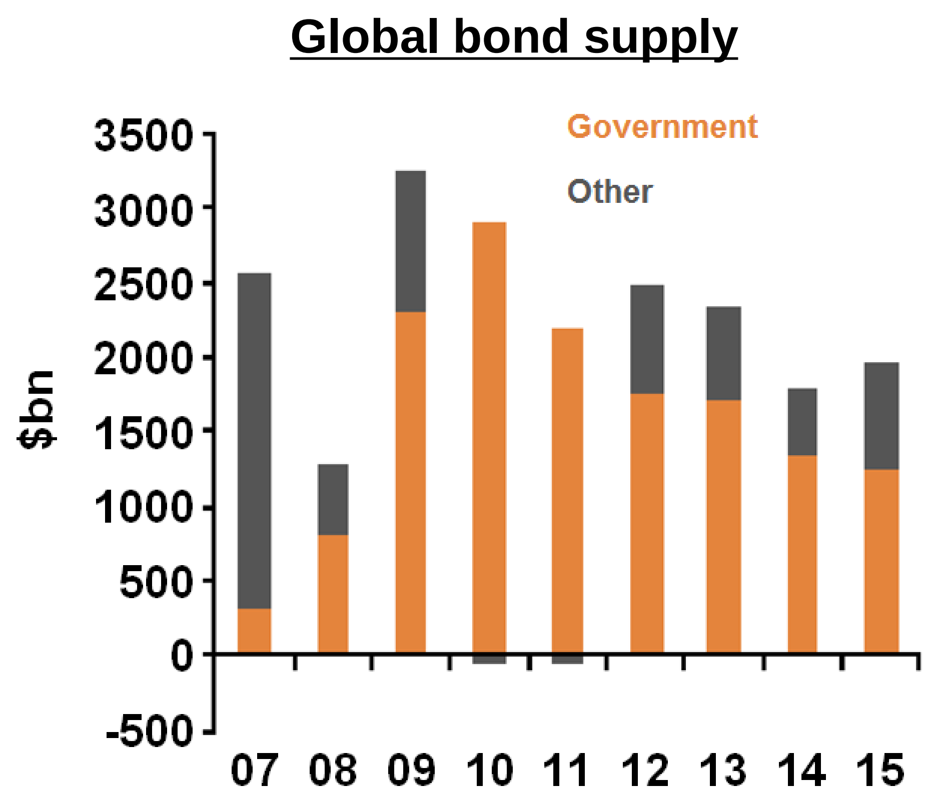
Source: Deutsche Bank

Supply/Demand to Keep Long-term Bond Yields Low

Bond demand is expected to rise by $100bn in 2015 globally to $2.4tr

Bond supply is expected to rise by $200bn in 2015 globally to $2tr





Source: J.P. Morgan

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The Impact of Falling Oil Prices

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Non-OPEC Country Winners and Losers

Winners	Losers
USA	Norway
Japan	Canada
Malaysia	Russia
Turkey	Brazil
India	UK

Sector Winners and Losers

Winners	Losers
Food, Drug Stores	Energy
Hotels, Restaurants	Materials
Airlines	Capital Goods
Autos	Banks
Utilities	

Source: FFAMI

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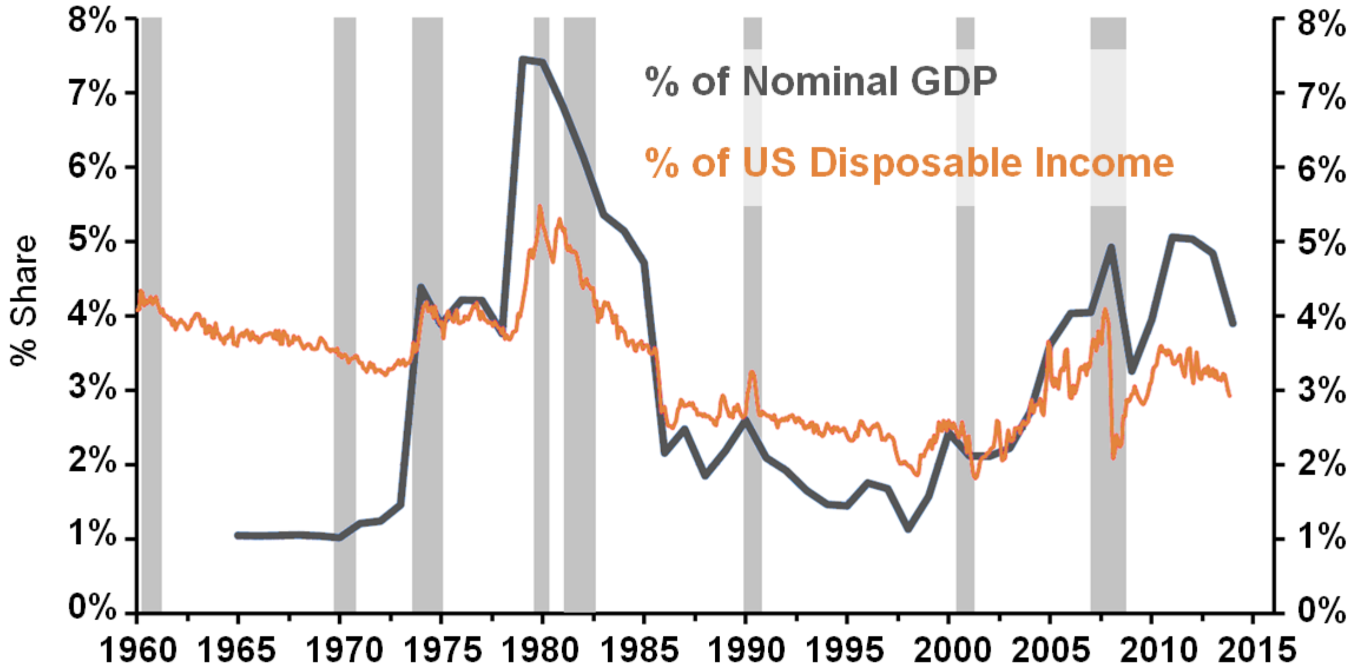
- *Supply-induced price falls are good for global growth.*

- *While falling prices dampen producer incomes, there is a partial offset in terms of rising volumes.*

The Benefit to Energy Consumers

Oil Consumption Spending Shares



- *Falling prices are an unambiguous positive for consumers.*

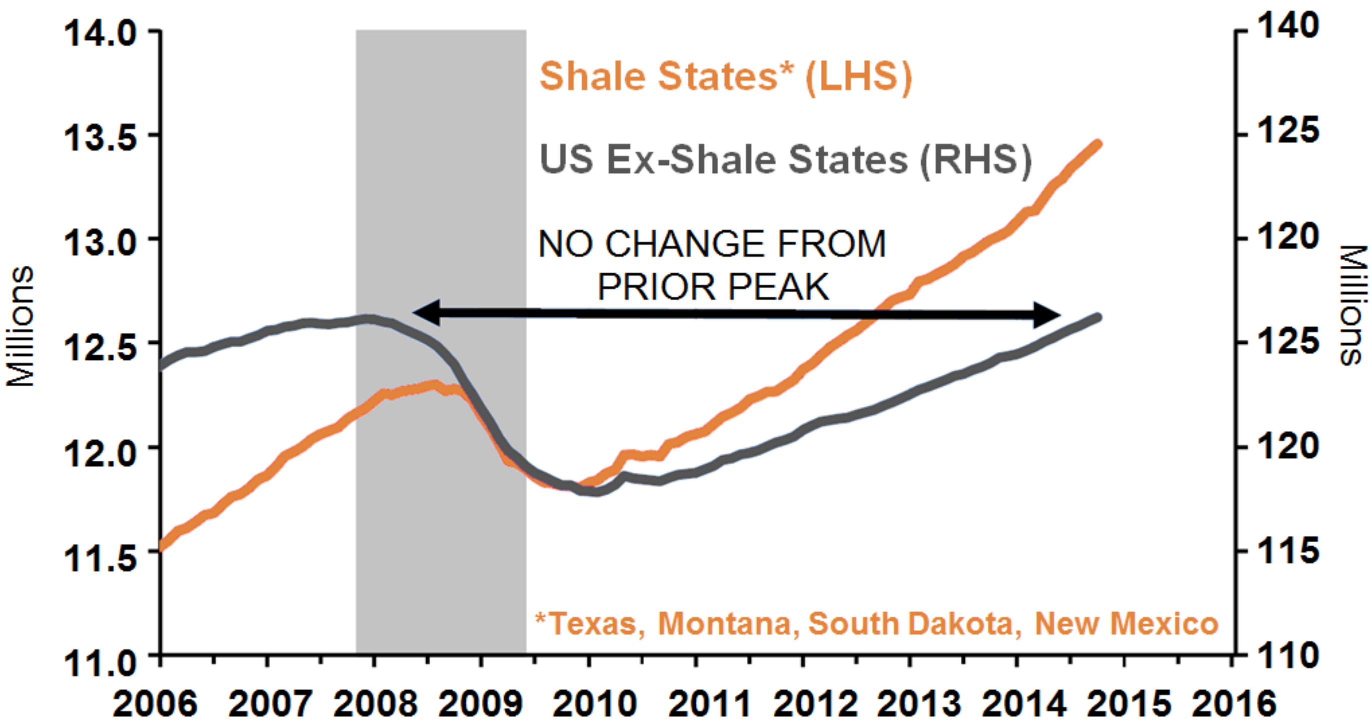
- *Current spot prices, if sustained, will reduce the cost of oil for consumers by around 1% of global income, or GDP.*

Source: Minack Advisors

- *Employment growth is a rough measure to detect secondary effects of oil price declines.*

- *Employment growth in "shale states" has been far stronger than in the rest of the country.*

U.S. Level of Non-Farm Payrolls, By State



- *Employment in non-shale states only returned to the pre-recession peak last month.*

Source: Minack Advisors

Equity Markets

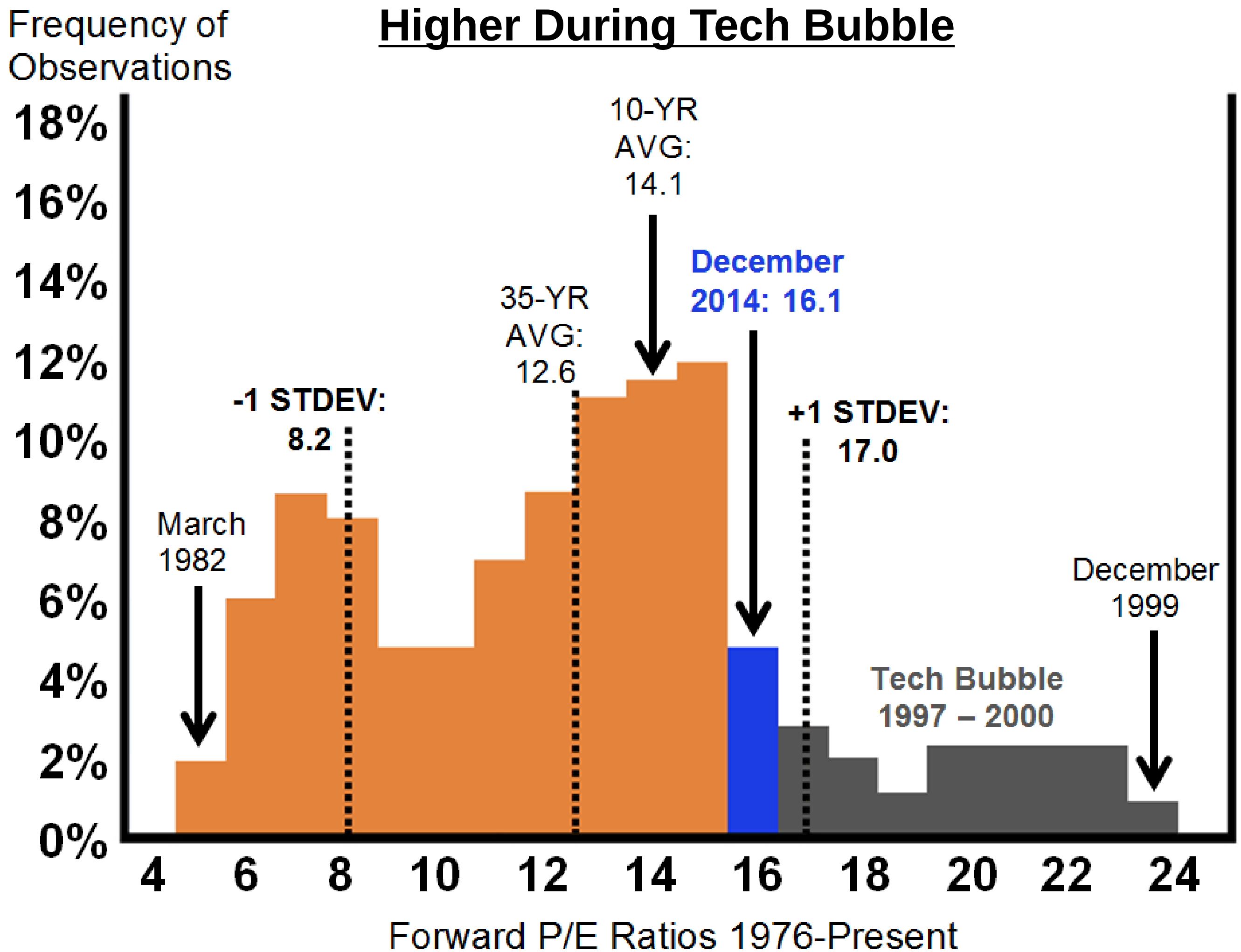
Episodes When Oil Fell > 30%, US$

Period	Start (M/D/Y)	Duration (Months)	Oil	Equity	Bond Yield (basis points)
1	25/11/85	8	-72%	+33%	-248
2	03/08/87	14	-46%	-5%	+6
3	05/01/90	5	-35%	-7%	+47
4	09/10/90	5	-59%	+14%	-92
5	13/10/97	14	-54%	+13%	-162
6	07/09/00	4	-41%	-11%	-64
7	14/09/01	3	-41%	+5%	+56
8	04/23/03	2	-32%	+9%	+31
9	09/08/06	5	-35%	+12%	-17
10	03/07/08	6	-76%	-35%	-183
11	19/06/14	5	-36%	0%	-40
AVERAGE		**6**	**-48%**	**+3%**	**-61**

Source: Citigroup

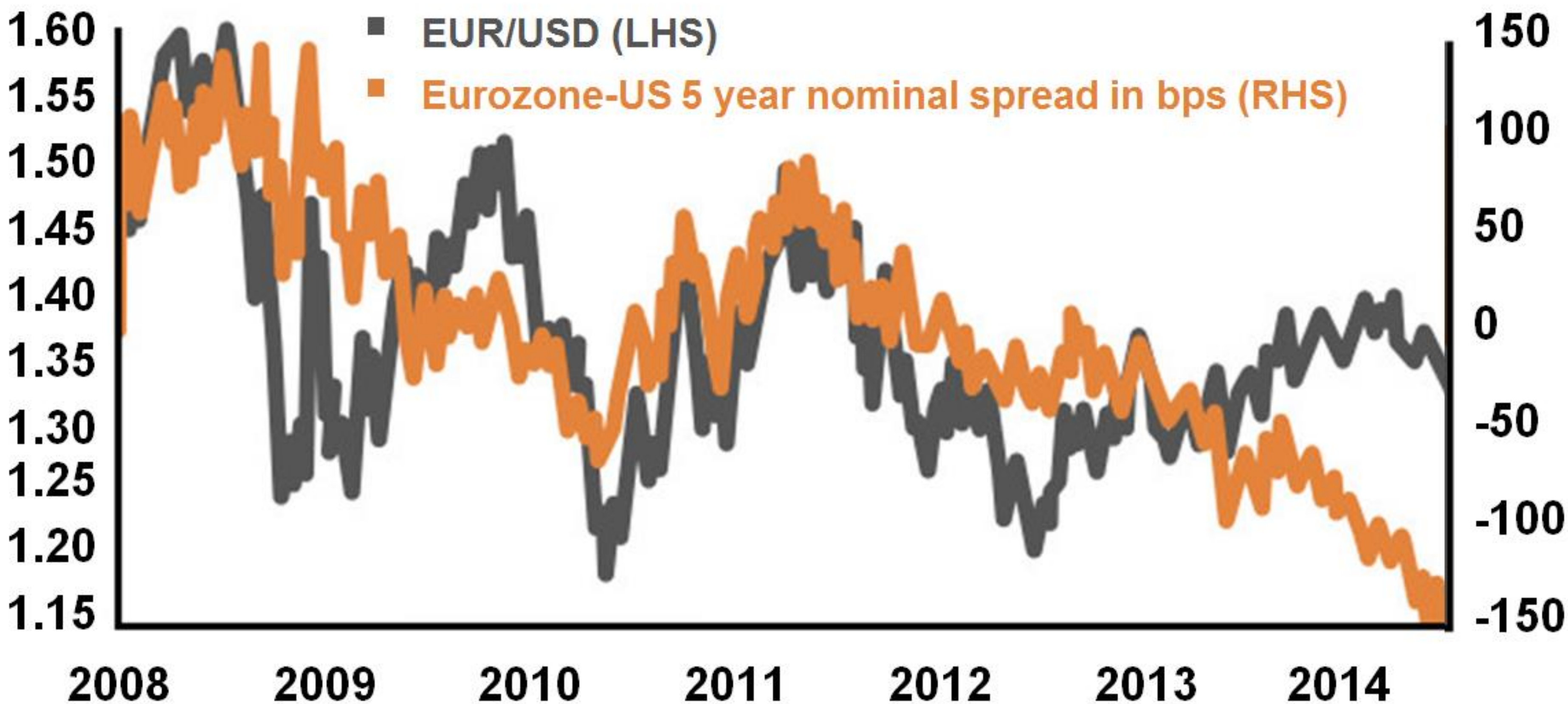
S&P 500: Forward P:E Ratios '1976-2014' Only Higher During Tech Bubble

P:E Multiple suggests the stock market isn't cheap!



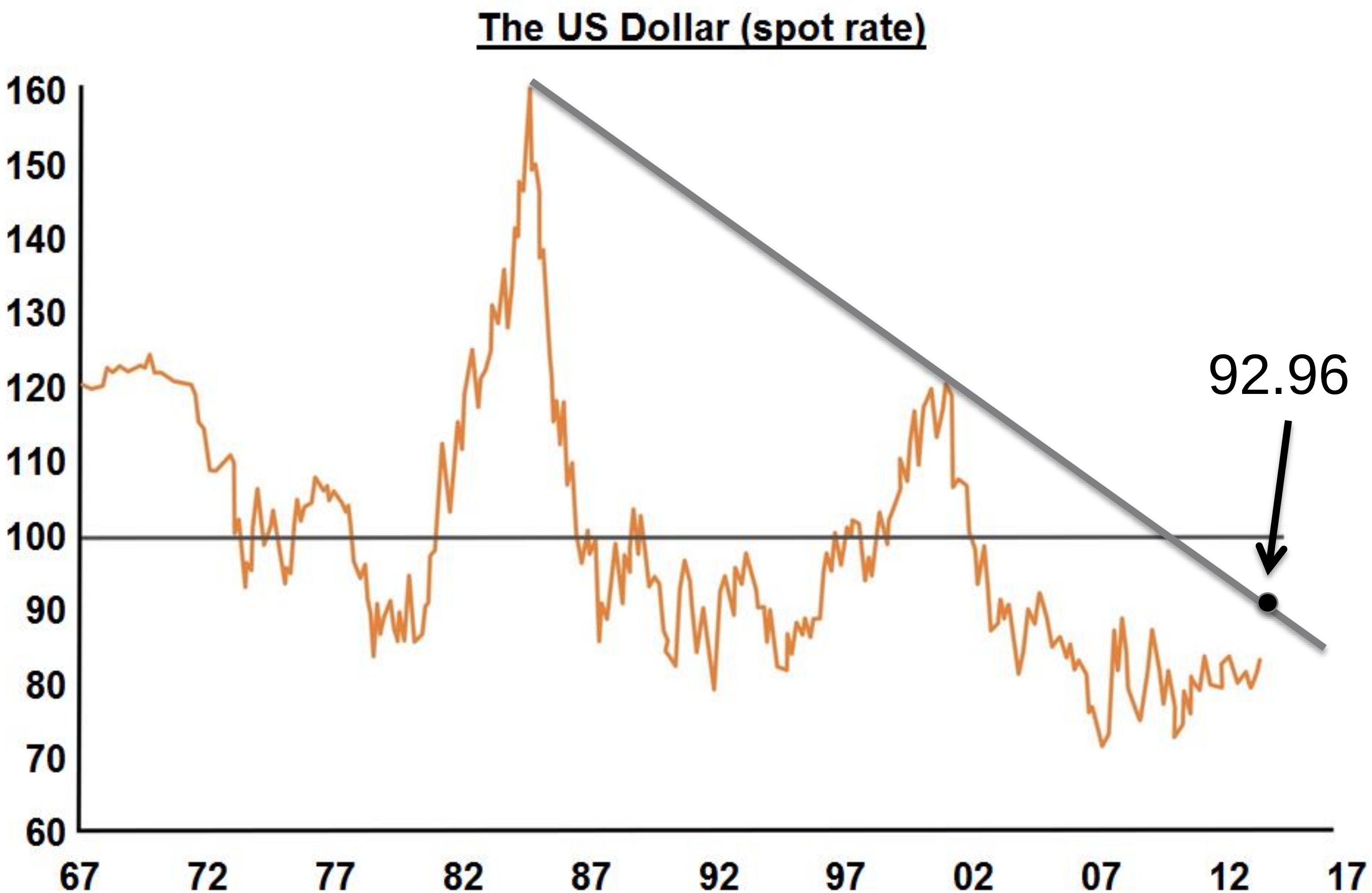
Source: Goldman Sachs

EUR/USD vs Rate Spread



Source: Deutsche Bank

The U.S. Dollar – DXY Index



Source: Bloomberg

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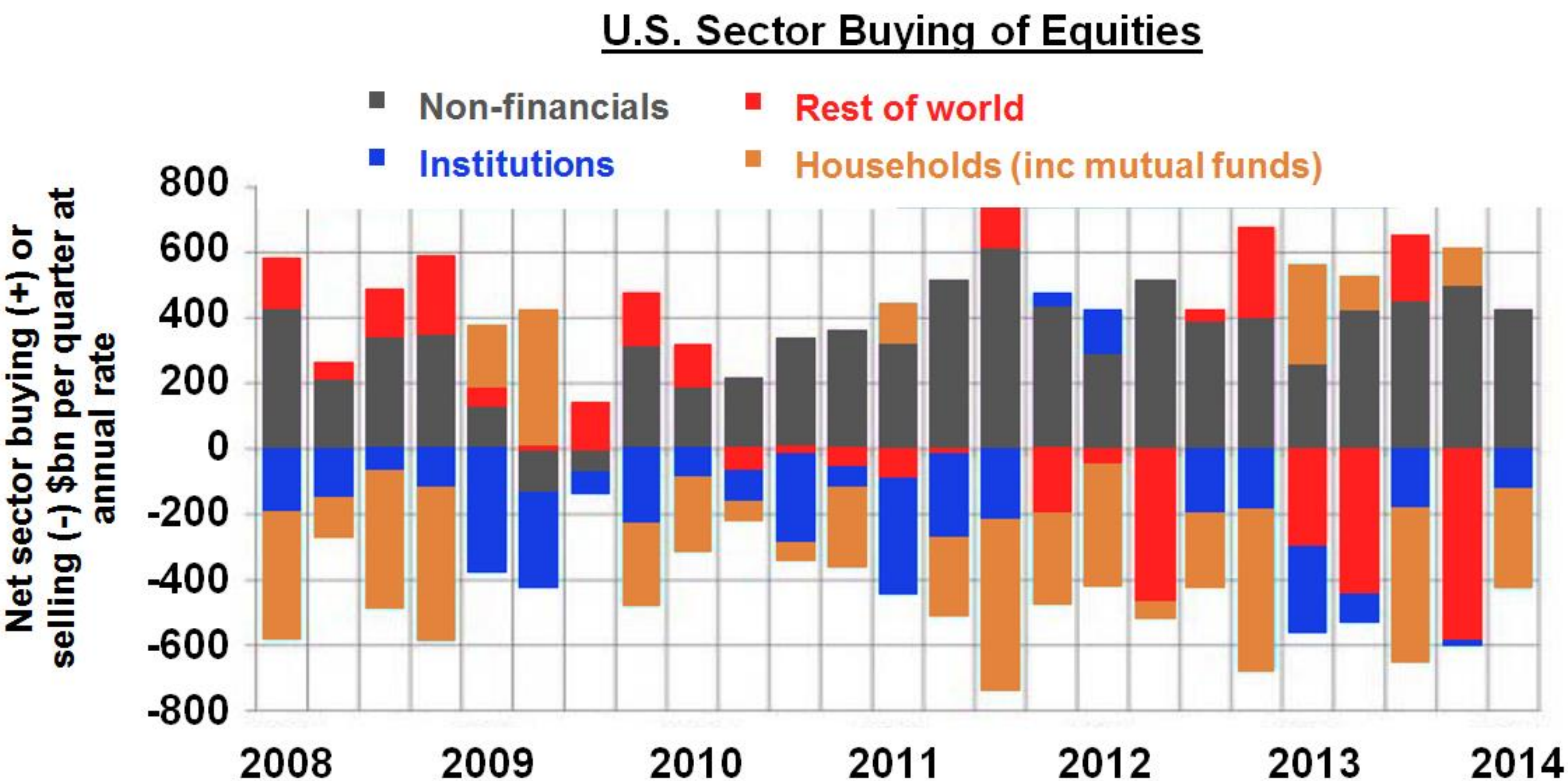
"The staff's periodic report on potential risks to financial stability noted that **recent developments in financial markets highlighted the potential for shocks to trigger increases in market volatility and declines in asset prices that could undermine financial stability**." – *Oct 29 FOMC minutes*

"The staff report also pointed to **asset valuation pressures that were broadening, as well as a loosening of underwriting standards in the speculative corporate debt and CRE markets; it noted the need to closely monitor these developments going forward.**" – *Oct 29 FOMC minutes*

In a speech to central bankers Friday in Paris, Fed Chairwoman **Janet Yellen** said **rate increases, when they materialize in advanced economies, "could lead to some heightened financial volatility."** New York Fed President **William Dudley**, at the same conference, issued a more detailed alert. "**This shift in policy will undoubtedly be accompanied by some degree of market turbulence,**" he said of future rate increases in the U.S. "**Moreover, it could create significant challenges for those emerging market economies that have been the beneficiaries of large capital inflows in recent years**." – *Wall Street Journal*



Source: Societe Generale Cross Asset Research

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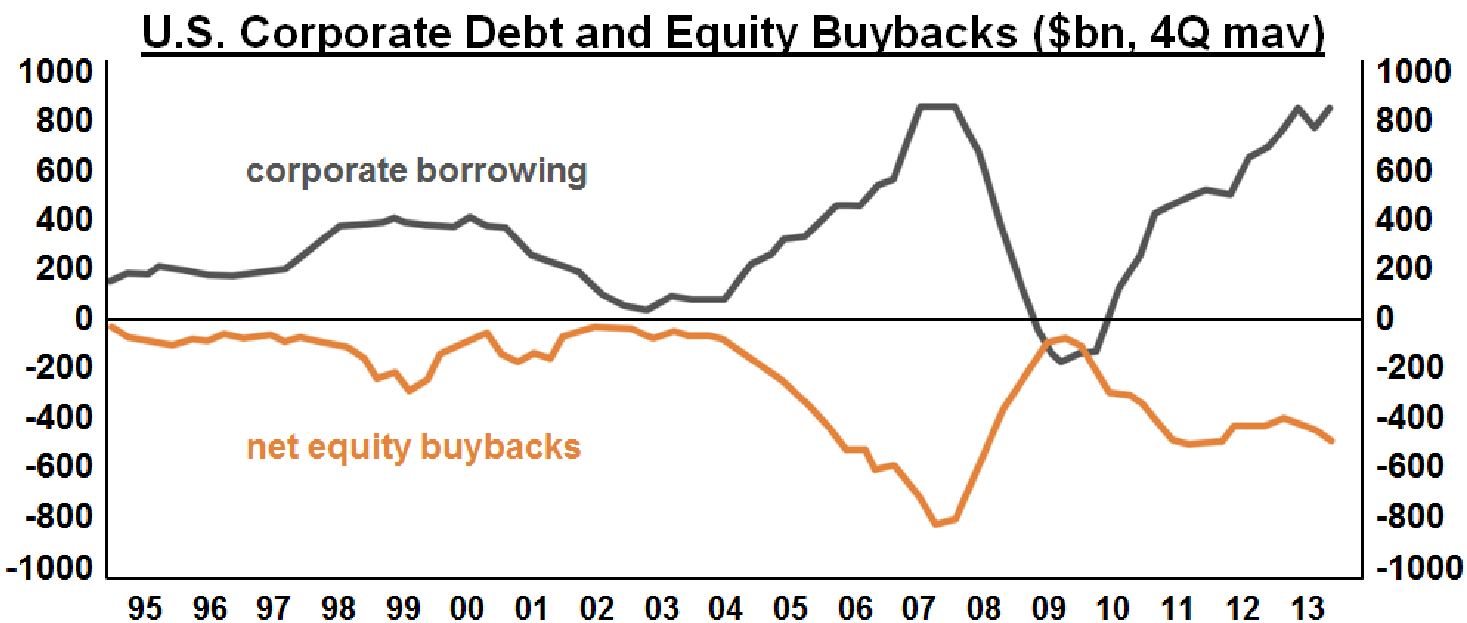
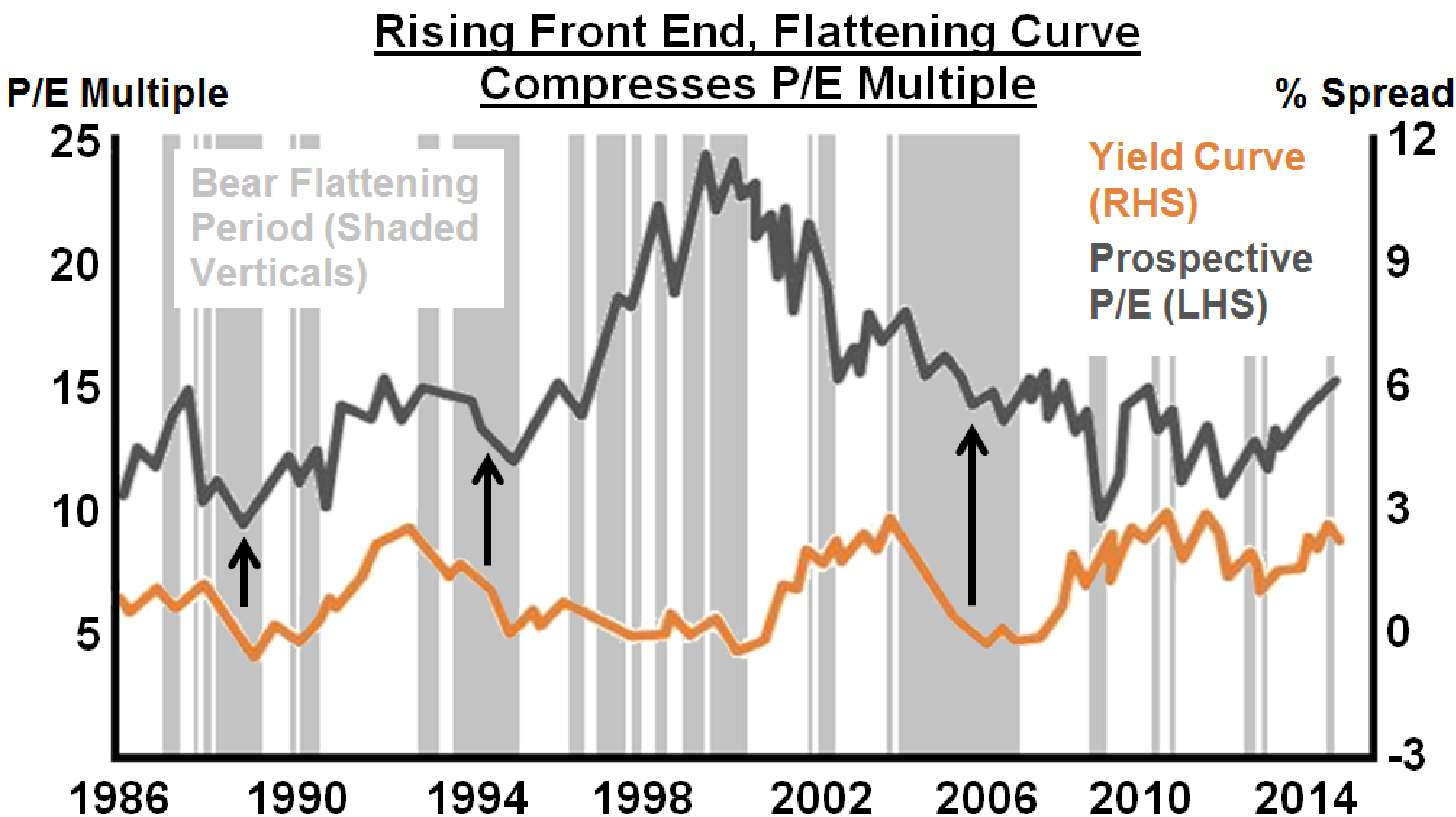
Between 2003 and 2012, the top 449 companies in the S&P 500 spent $2.4T, or more than half their profits, on buybacks. Including dividends, the total was 91% of total, cumulative income. Currently, 40% of S&P 500 companies are increasing their net debt (because their spending is greater than their cash flow on dividends, buybacks and capex).



Source: Societe Generale Cross Asset Research



Source: Minack Advisors

S&P TSX (white) vs. S&P TSX Venture (gold) 2001-2014

- *Canada has not kept pace with changes in the global economy and or capital markets area*
- *TSX Venture has decoupled from TSX in late 2011*
- *Adapt or else?*

Source: Bloomberg

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- Global GDP growth climbs from 3.2% in 2014 to 3.5% in 2015 - short term US interest rates climb ~1%, more than long term bond yields rise, flattening the yield curve to ~150 basis points.
- US dollar climbs to 93-94 cents on the 'DXY' as €, ¥ and £ all decline. Canadian dollar trades down to US$0.83 as BoC lags the FOMC in raising interest rates while taxes climb in Ontario and Ottawa joins most provinces in divorcing the Conservative Party.
- Energy will be the best performing Canadian sector in 2015, enabling the TSX to outperform the S&P 500 in local currency. Excluding wild cards, precious metals, basic materials, base metals and agricultural commodities will be flattish.
- European stocks will disappoint investors again while India will shine during the 1st half of 2015.
- Technology and Consumer Discretionary stocks will join Energy as best performing U.S. sectors, enabling the NASDAQ to reach an all-time high during 2015.
- Exiting 2015, rising interest rates, U.S dollar-induced stress on emerging markets and growing uncertainty about the 2016 Presidential election will cause equities to correct.

"The arithmetic seems correct yet I find myself haunted by the idea that the basic axioms on which the arithmetic is based might give rise to contradictions which would then invalidate these computations."

Source: The New Yorker

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