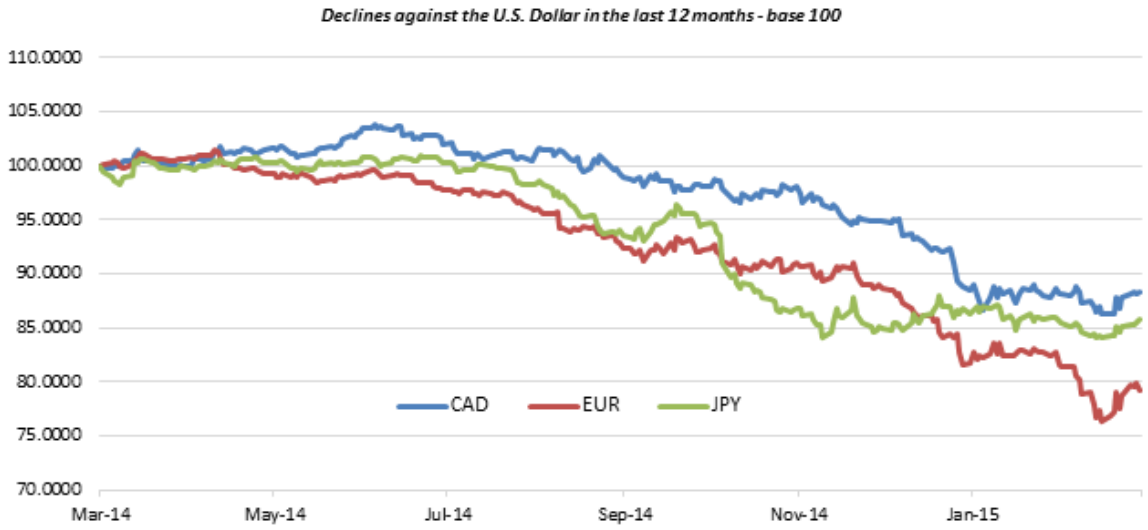
A LOOK BACK AT OUR APRIL 2015 COMMENTARY

Macro Matters

In managing an investment portfolio, it is the macro review and decisions that matter the most. The QE (Quantitative Easing – "money printing") fueled asset price recovery in the U.S. has been good for investors. A buy and hold strategy would have worked well throughout this roaring bull. Even in Canada, despite a few sharp pullbacks, an investor who put money into the stock market right at the peak in 2008 would be ahead today (April 2015), despite the subsequent precipitous drop in value during the Great Financial Crisis later that year. As the rising tide from QE lifted most boats, money flowed into exchange traded funds. In 2014, U.S. investors put $71 billion into these index tracking securities.

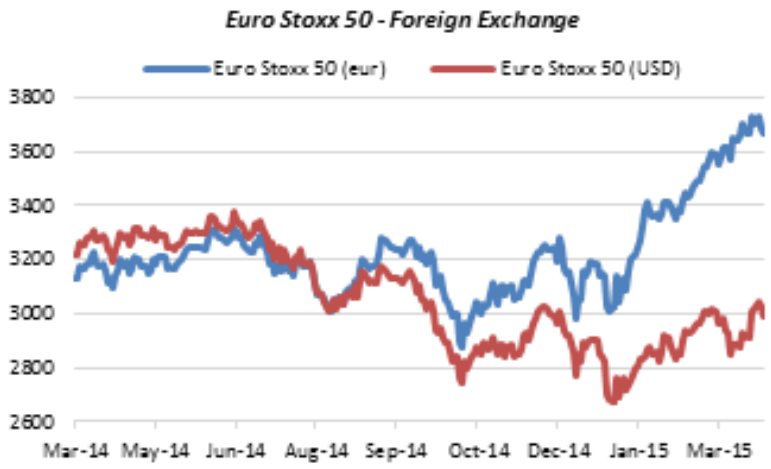
As we enter the sixth year of this equity bull market, QE will no longer be a factor for higher asset prices in the U.S. A continued rise of corporate profits, at a pace that at least matches expectations, is now essential for further market gains. This will become a bit more challenging with a U.S. Dollar that has risen meaningfully in the near term against the major global currencies, our Canadian Dollar included. The QE trade however, is alive and well in both Japan and in Europe, and investor attention has turned overseas leading to an outperformance of both regions' stock markets in 2015. It is important not only to recognize this macro shift, but also to decide how to buy into the Japanese or European equity markets in order to avoid currency losses. This is why macro matters.



Source: Bloomberg

A big preoccupation of market watchers, so far this year, has been the timing of when the U.S. Federal Reserve decides to move away from their current zero percent interest rate policy to the first rate hike in nine years. With continued improvement in the U.S. economy, it has been economic weakness in other regions of the world that has kept rates unchanged. Although this discussion has created some volatility in the markets, the actual impact of a modest rate hike is negligible, and is not likely to usher in a series of successive increases. That being said, U.S. interest rate policy will diverge from that of other global central banks which are still likely to cut rates in the near term. This policy divergence has been a big reason for the surge in the U.S. Dollar, with our Canadian Dollar being just one of the many casualties.

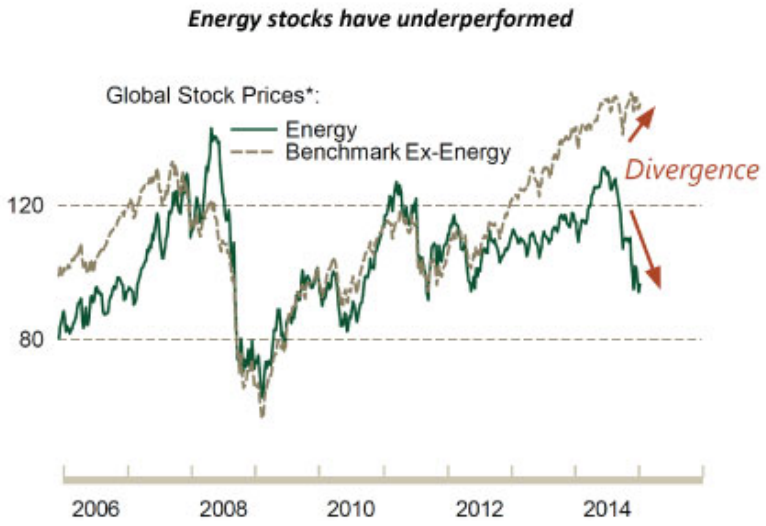
Currencies have played a substantial role in investment returns this year. The Euro Stoxx 50 Index for example has risen 18% in euro currency terms, versus a 15% rise in Canadian Dollar terms and a 7% rise in U.S. Dollar terms. How an investor chooses to take on the exposure, and anticipating not just equity market direction, but also currency direction (how monetary policy affects currencies) is just as important. An investment in the WisdomTree Europe U.S. Dollar Hedge Exchange Traded Fund (European equities with currency hedged to U.S. Dollars) has so far year to date returned 28% in Canadian Dollar terms, a far superior return to an investment that is not currency hedged or hedged to Canadian Dollars. In this specific example, investors benefit from both the appreciation of European equities and strength of the U.S. Dollar. Many European equities have performed well in the past year, but without the currency hedge, returns may have been marginalized or even negative in Canadian Dollar terms.



Source: Bloomberg

Staying with the macroeconomics discussion and its importance, the Bank of Canada in January, to the surprise of all, cut the overnight lending rate to banks by a quarter point to 0.75%. This action was due to already soft Canadian economic data and the decline of crude oil prices which is likely to put further downward pressure on Canada's economy. In response to the January rate cut, economists anticipated another cut in March, only to have Bank of Canada governor Stephen Poloz once again throw a curveball and not move on rate policy. This lack of transparency and unpredictability (which is a clear change in direction from former Bank of Canada head Mark Carney) has led to a prominent U.S. based bond manager to sell Canadian government bond holdings, citing the bank's erratic and opaque interest rate policy. Despite this lack of clarity, we remain positive towards the U.S. Dollar over the coming year, and will position portfolios for more U.S. Dollar exposure should we see any short term Canadian Dollar strength. The collapse of oil prices is likely to present more challenges to the Canadian economy, particularly from an employment perspective. We have already seen layoffs relating to Canadian energy production, but it remains to be seen if the economic fallout leads to a decline in other employment sectors (non-energy related) or have an impact on the Canadian housing market. A weak job market could subsequently lead to softer consumer demand, which is an important component of GDP growth.

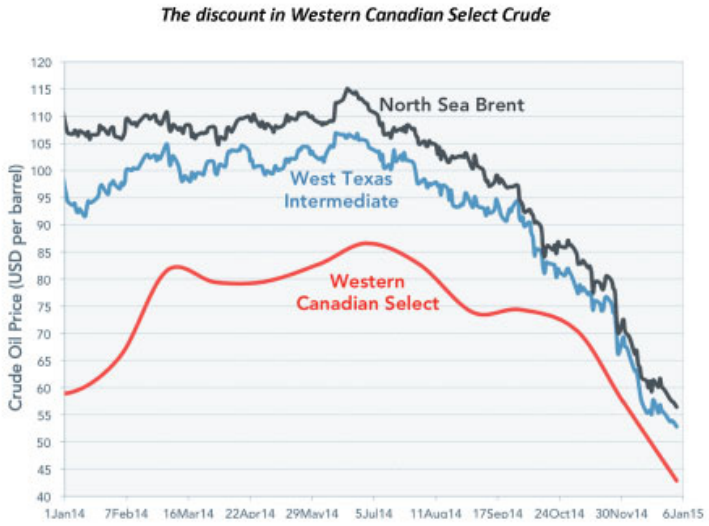
Our macro perspective led us to considerably underweight energy and resource sector equities over the past year. The breakdown in the commodity super-cycle leads us to continue to be bearish towards resource sector equities and to have a relatively negative viewpoint towards the Canadian equity markets. We will be largely absent from the "timing the bottom" trade in resource stocks, even if crude oil prices have bottomed. This bear market in commodity sector equities will need much more time to play out. Our philosophy has always been to invest in what has been working, and to be very cautious with whatever has not. There clearly has been a divergence of performance in energy and non-energy stocks, as earnings estimates for the energy sector have dropped off whereas earnings growth expectations have not been revised lower for non-energy companies.



Source: MRB Partners

Western Canadian Select Crude

When it comes to oil prices, most frequently referenced is the West Texas Intermediate (WTI) price which is the price at Cushing, Oklahoma, the main trading hub for crude oil in the United States. For Canada's oil sands producers, the relevant benchmark is Western Canadian Select (WCS), a heavy crude blend of bitumen, synthetic sweet crude and a diluent (thinner), priced at Husky's Hardisty Terminal in central Alberta. The thicker nature of WCS (versus WTI light sweet Crude) which requires transport to mostly U.S. based refineries that are configured to refine the heavy oil, and the higher costs associated with the transport (including oil by rail), results in a discount in the price of WCS from WTI, referred to as the differential which is currently about US$13 less per barrel. This puts WCS at about US$35 per barrel, leading to questions about the profitability of many of the oil sands producers given their higher costs of production. The numerous job cuts announced by the Canadian oil sands companies is probably a hint that a near term sustainable rebound in oil prices is unlikely.



Source: Oilsandmagazine.com

Going forward, we continue to favor U.S. dollars, underweight Canada and other commodity export biased economies, and overweight Japanese and European equities with U.S. dollar hedging. Our more aggressive mandates will continue to have exposure to the higher economic growth yet more volatile markets of India and China on a non-currency hedged basis. Our macro viewpoint of global economic growth with risk to the upside favours the more economically sensitive sectors, specifically the technology, industrial and financial sectors. Given continuing supply and demand imbalances, we remain underweight resource sector exposure. These macro decisions matter most.

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