WORTH ALLAYE-CHAN INVESTMENT COUNSEL

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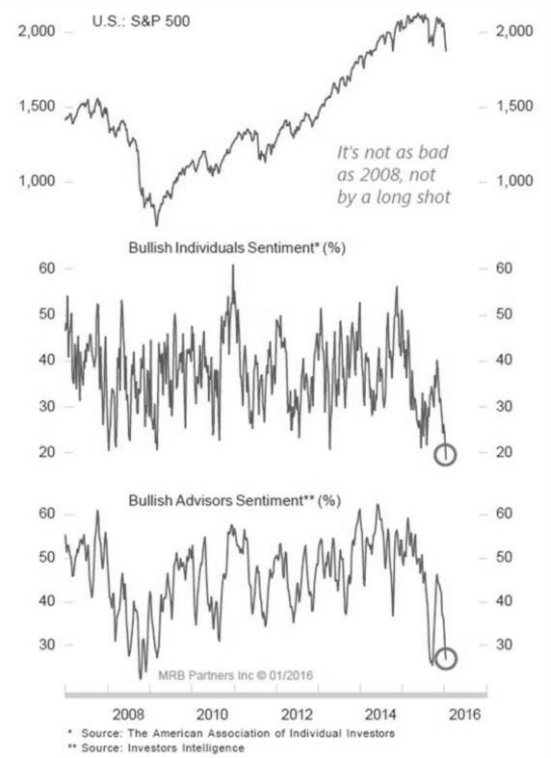
FIRST QUARTER COMMENTARY – CRISIS OF CONFIDENCE

"There is a massive gap between, on the one hand, the hard economic data and policy actions/intentions and, on the other hand, risk asset prices and investor sentiment. In 2008, the U.S. economy and global trade were spiraling downward, as the banking system appeared headed for collapse. In 2012, the euro area had slid into yet another major recession and investors feared the end of the euro with huge potential global contagion. Today, the U.S. and euro area's economies and banking systems are in much better shape, with positive growth momentum and policymakers determined to promote/sustain economic activity and stave off deflation. Either a recession is knocking at the door or investors have overreacted to concerns about China, oil prices and the knock-on effect on non-energy corporate bonds, negative policy rates, etc." – MRB Partners, February 2016

The global equity markets stumbled right out of the gates in 2016 as a multitude of concerns contributed to increased investor anxiety. While we cannot ignore the challenges faced by the global economy, the bigger risk may be indeed fear itself, with concerns about the global economy leading to weak global stock markets, a decline in consumer confidence, and an actual drop in economic activity. It is a concern that due to such collective pessimism, we can talk our way into a real recession.

Global economic growth has slowed in recent months, as we've witnessed a fairly broad slowdown in Europe, Japan, and the Emerging Markets. This had led to a global equity market selloff in risk assets (stocks, high yield bonds and commodities) for most of January and February as fears of a global recession and deflation worries dictated market direction. In fact, individual investor sentiment was more negative than at the height of the financial crisis in 2008 (*Chart 1*). The more recent rebound in the price of these risk assets has been aided by economic data that is supportive of soft but nevertheless positive economic growth continuing in the near term, the realization that the economy is actually not doing that poorly, and perhaps simply put a rebound from levels that were an overshoot on the downside due to overly pessimistic expectations.

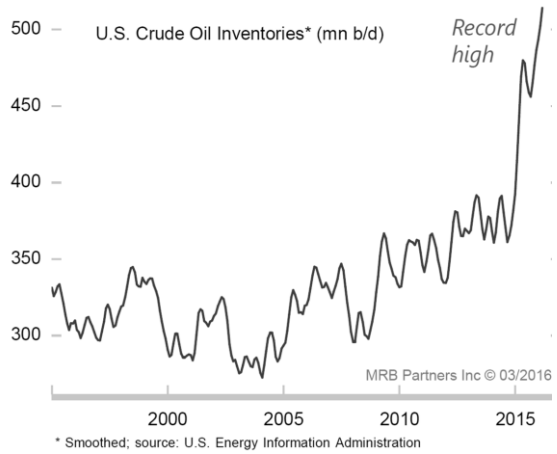
Chart 1: Are Investors Too Pessimistic?



Source: MRB Partners

Another indicator of this disconnect was the high correlation between the direction of crude oil and the direction of the stock markets. It is widely understood that lower energy prices are in general a benefit to the overall economy (except for energy exporters such as Canada and Australia) however a collapse in prices has a more destabilizing effect and increases risk of a contagion to other parts of the economy. Given the fear of this domino effect, equity markets became very highly correlated to the price of oil, with the decline in oil prices mirrored by the decline in stock prices. Worries that oil demand weakened due to the economy were misplaced, as clearly the decline in the price of oil is the result of excessive supplies and record inventories. Global oil demand continues

Chart 2: U.S. Crude Oil Inventories at Record Highs



Source: MRB Partners

to grow at a pace of 1.3% to 1.4% annually. The continued high correlation of stocks to crude oil naturally leads to the question of whether or not the recent rise in the price of oil is sustainable, and if not, what is the subsequent impact on the stock market? While demand and supply imbalances have been a main reason for the decline in oil prices, traders in the commodity, particularly short sellers (those looking to profit from a decline in the price of oil) have played a key role in the volatility of crude oil prices. The impressive rebound we've seen in recent weeks appears to be mostly short covering related; as prices begin to rise, short sellers need to buy back their positions to lock in gains or to avoid losses. Despite these short term price momentum swings, we continue to largely focus on the underlying fundamentals of the crude oil market, specifically oil inventories which continue to hold at or near record high levels (*Chart 2).* Thus we continue to be cautious about this recent recovery in oil and in risk assets. Within our managed portfolios, we have been selectively adding exposure to the energy sector, specifically securities that appear to be fundamentally undervalued and have balance sheets that should weather a prolonged period of low energy prices.

This rebound in crude oil prices has also led to a recovery in Canadian equities which had seen a peak to trough price decline of over 25% from April 2015 to January 2016, and subsequently since the January lows, an impressive recovery of 18% led by the resource sectors. Although this rally in Canadian equities is welcomed, it may be little more than a technical oversold bounce. Earlier within the quarter, the Canadian dollar fell to US$0.6805, a level not seen since 2003. The ensuing rally in oil along with the U.S. Federal Reserve projecting a more modest trajectory of U.S. interest rate increases has help lift the Canadian dollar back above US$0.77. Our outlook for Canadian stocks and for the Canadian dollar is tempered by the numerous challenges facing the Canadian economy over the coming period. Soft commodity prices may continue to weigh on GDP growth and employment particularly in the Prairie Provinces. Although manufacturing sector activity has also picked up in recent months, the strength in our dollar may once again become a drag for exports. Lastly, household indebtedness continues to be at record high levels along with a weakening employment outlook and bubbly real estate prices in Vancouver and Toronto. We approach Canadian banks with much caution given this backdrop, and see increasing loan loss provisions (and energy sector losses), softness in capital markets revenues, and credit growth that will be hard to come by.

Over the last two years, our managed portfolios have benefit from having a tactical underweight in commodities and a tactical overweight in U.S. dollar exposure which has served us and our clients well. The recent recovery in the commodities sector and drop in the U.S. dollar has led to underperformance in the short term for our mandates. Our focus on the underlying macroeconomic fundamentals means no shift in our tactical positioning towards currency or commodities exposure given good economic growth in the U.S. and global monetary policy that remains more biased towards lower rates compared to U.S. policy. We see the recent rally in commodities stocks as a low quality rally, more technical in nature with little fundamental support. Oversupply in commodity markets means caution is warranted. Security selection will be the key in this environment.

WORTH ALLAYE-CHAN INVESTMENT COUNSEL | RAYMOND JAMES®

Worth Allaye-Chan Investment Counsel | www.worthallayechan.com | worthallayechan@raymondjames.ca
Suite 2100-925 West Georgia Street, Vancouver, B.C., Canada V6C 3L2 | T: 604.659.8066 TF: 1.855.659.8066 F: 604.659.8449