WORTH ALLAYE-CHAN INVESTMENT COUNSEL

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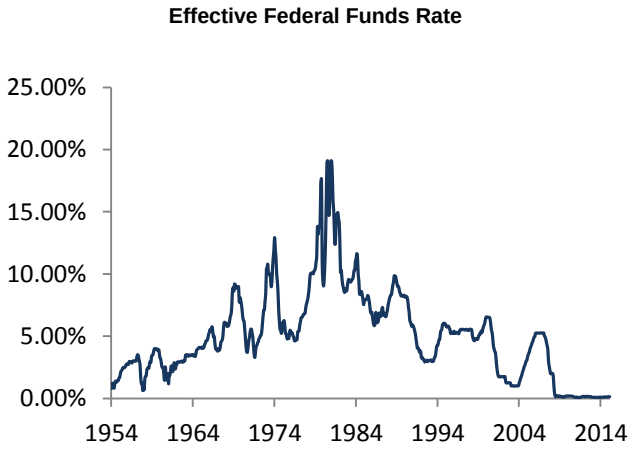
THIRD QUARTER COMMENTARY – Much Misplaced Focus

"The Federal Open Market Committee (FOMC) is firmly committed to fulfilling its statutory mandate from the Congress of promoting maximum employment, stable prices, and moderate long-term interest rates. The inflation rate over the longer run is primarily determined by monetary policy, and hence the Committee has the ability to specify a longer-run goal for inflation. The Committee reaffirms its judgment that inflation at the rate of 2 percent, as measured by the annual change in the price index for personal consumption expenditures, is most consistent over the longer run with the Federal Reserve's statutory mandate."
– U.S. Federal Reserve Statement on Longer-Run Goals and Monetary Policy Strategy, January 27, 2015

Will they or won't they? Hours and hours of commentary on channels such as BNN, CNBC, and Bloomberg news have been focusing on the U.S. Federal Reserve, and the timing of the first federal funds rate hike since 2006. Since the great financial crisis (2008-2009), the timing of the Federal Reserve's "next move" has been a preoccupation of market pundits, from guessing the end of Quantitative Easing (QE) one, two and three, to the current debate on when they will move away from a zero rate policy.

Whether it is the Bank of Canada or the U.S. Federal Reserve (the Fed), the mandate of any central bank is to maintain price stability by controlling the country's money supply, foster economic growth, achieve high employment, and stability in interest rates, financial markets, and foreign exchange. The recent amount of attention paid to the action or inaction by the Fed is misplaced, and mostly fabricated by the media to gain a captive audience. The actual impact on the economy and on investment strategy from any imminent rate decision is immaterial. The nervousness in the capital markets is due to many mixed signals. Economic growth has been very uneven, and while high employment has generally been achieved, lower commodity prices have kept consumer prices from rising. Volatility in emerging markets has also affected confidence in the economy, but perception and reality are quite different.



Source: Board of Governors of the Federal Reserve System

With a starting point at zero percent (technically at 0.00%-0.25%), the U.S. is a long way from rate policy normalization. In fact, it is possible that we will not get back to normalized rates during this economic expansion given the global economic risks. What is important however, is the path of change and the actual rate over the next few years. Any change in rates will likely occur at a snail's pace, with the Federal Reserve rate policy lagging the economy by design. Given our stance that the commodities supercycle is over, inflation is probably going to remain benign and well within the 2% target, despite more or less full employment. Bank of Canada policy is likely to trail that of the U.S. as economic risks in Canada remain pointed to the downside due to low energy prices and elevated concerns over record household debt levels.

RAYMOND JAMES

The Canadian dollar and levels of exports also are factors that the Bank of Canada will watch closely.

Investment risk appetite has declined in recent months amidst these global economic growth concerns, and only on two other occasions has risk appetite fallen to such levels post-2009. Since the crisis, investors have been quick to shun growth assets whenever there has been uncertainty about the health of the global economy. On each of these occurrences during this economic expansion, shifting money to growth assets (equities) has worked, and we do not see this current setback as being any different. We are expecting global economic data (particularly from the developed markets) that would be supportive of growth in corporate profits, and a resumption of the equity bull market.

From a tactical perspective, we continue to favour non-Canadian assets, and seek to maximize this exposure as dictated by the boundaries within each investment policy. Since reaching a post-crisis high in 2011, the Canadian dollar has retreated almost 30% versus the U.S. dollar. From May 2015, the decline in our Loonie translates into a 12% increase in value of U.S. dollar denominated assets in Canadian dollar terms on a currency basis alone. The factors behind this remain firmly in place; a weak commodity price complex, a slowdown in domestic economic growth, and continuing high household debt levels. Canadian federal and provincial government bonds will likely outperform their global counterparts (in local currency terms) since the Bank of Canada is unlikely to hike rates in the foreseeable future due to the risk of a material rise in mortgage rates which could be the catalyst for a housing price correction. Nevertheless, when compared to other asset classes, government bonds remain unattractive given extraordinarily low absolute yields, and the medium to longer term reward to risk remains unfavourable. Although a weak currency is indeed welcomed by exporters, it will not be enough to offset slowing domestic growth due to the collapse in commodity prices. We caution against playing the inevitable “bounce” in the commodities sector as the price impact from growing commodities supplies are unlikely to abate anytime soon.

The retreat in U.S. stock prices, although disconcerting in the near term provides a good entry point for investors as long as the modest global economic growth scenario remains intact. Since 2009, the rise in U.S. equities has been mirrored by a doubling in corporate earnings per share, and removing energy companies from this calculation results in an even more healthy earnings outlook. Though on an absolute basis valuations are fair, U.S. stocks appear inexpensive relative to cash and bonds. We believe a Federal Reserve rate hike will occur within the next six to eight months, which should be a catalyst for inflows into the U.S. financials sector.

Volkswagen’s recent misconduct may have short term implications on sentiment, but we see a continued corporate profit rebound in the Europe and subsequently a recovery in European equity prices. The European Central Bank will continue to be stock market friendly, boosting the prospects for outperformance of equity prices in the region. Likewise, weakness in Japanese equity prices due to this recent global growth scare should be seen as an opportunity to add exposure. A strong corporate profit picture, the collapse in commodity prices, and anticipation of weakness in the yen, further supports this bullish thesis. The European Central Bank and Bank of Japan maintain policy divergent from that in the U.S. Federal Reserve, so a currency hedged exposure remains necessary.

We continue to favour stocks over bonds and view that the current concern about the global economy will diminish. We remain cautious on our domestic economy and stock market, along with those of other commodity exporting countries. Our preference for U.S. dollar exposure remains unchanged, and we continue to seek opportunities in the U.S., and in U.S. dollar hedged exposures in European and Japanese equities.

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