WORTH ALLAYE-CHAN INVESTMENT COUNSEL

January | 2016

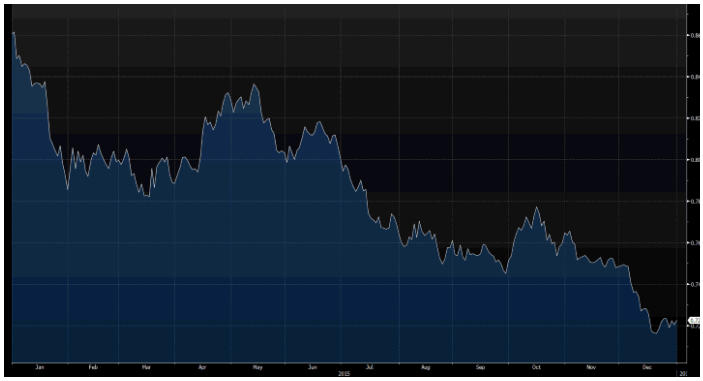
FOURTH QUARTER COMMENTARY – NAVIGATING THROUGH THE RISKS

"Although the possibility remains remote and the decline of oil prices should be a net benefit, the steepness in the decline however may also become destabilizing to the global economy. Net commodity exporting countries such as Canada, Australia, Norway and New Zealand would likely be the first to feel the pinch, with the potential negative impact to employment and investment demand, potentially impacting wealth. Elevated housing prices and highly debt-leveraged households are also characteristics of these countries, which have been previously supported by the commodity super-cycle. With the bursting of the commodity bubble, the risk to the global economy comes in the form of a collapse of import demand from these countries (unlikely to be meaningful enough to offset the benefits), or destabilization caused by massive moves in the foreign currency markets… Given the rapid slide in the price of oil, we continue to pay close attention to the net impact on economic growth." – Worth Allaye-Chan Investment Counsel, January 2015

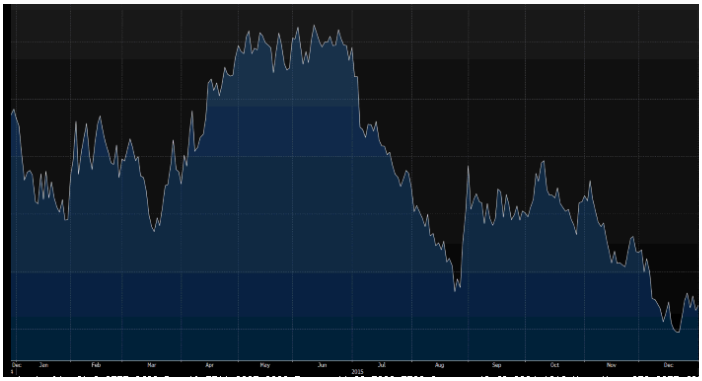
Our caution towards the commodity sector and related investments this time last year, has served our clients and us well. In the summer of 2014, we had noted a very ominous breakdown in the continuous commodity futures price index chart. In the decade prior, the "commodity super-cycle" as it was coined, had been a substantial tailwind for the Canadian economy. This period from 2001 onwards was characterized by demand outstripping supply, with China leading the way in the buying of raw materials for their numerous construction projects to fuel their overheated economy. This was a panacea for corporate Canada, as oil and mining companies benefited from seemingly endless demand for their product, and led to ambitious plans to increase output through new oil sands development and new mine builds. The optimism in Canada spread to households, reflected in the price of Canadian real estate. This rise was also mirrored by the level of indebtedness of the average Canadian household, and debt to income ratios continue to rise.

China's inevitable economic slowdown and the disorder within OPEC has ushered in and exacerbated this period of contraction in commodity prices. This is no more evident than in the charts of crude oil prices and the Canadian dollar. It seems like a distant memory, but in July 2014, West Texas Intermediate crude oil was priced at US$107 per barrel, and the Canadian dollar spot was at US$0.94. The steep decline in both was reflected in the performance of the benchmark of Canadian stocks (the S&P/TSX composite) which then had its first negative return year since 2011.

Canadian Dollar Decline (in USD) in 2015



Crude Oil (WTI) in 2015

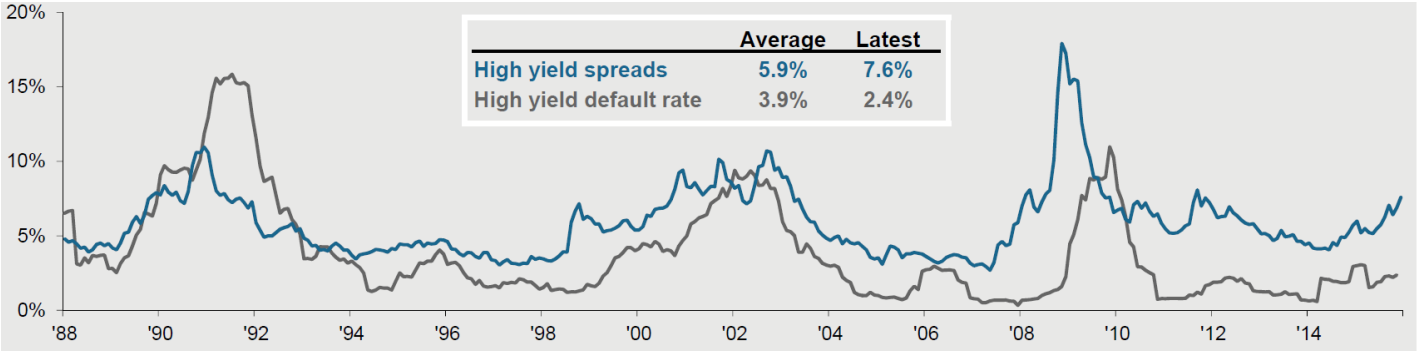


Source: Bloomberg

Our managed portfolios have benefit from being underweight the commodities sectors, and also by having maximized U.S. dollar exposure as allowed by investment policy. For the time being, this tactical positioning remains unchanged. However, we are cognizant that relative to history, the recent declines in both commodities prices and in our loonie are at extremes, and their current levels already discount some of the negative news. Thus, we are less bearish than we have been towards both for the upcoming year. Although we see no catalyst in the near term for little more than a short term bounce, the magnitude of downside for both have diminished dramatically.

In both Canada and in the United States, government and investment grade corporate bonds outperformed stocks in 2015, as global economic growth stalled. We anticipate the global economy will do better in 2016, and see a modest uptick in bond yields, allowing for stocks to outperform bonds in the coming year. The return of modest but positive economic growth should allow for two more rate hikes over the course of 2016, which is likely to put some upward pressure on U.S. bond yields over the course of the year. Although the Bank of Canada will probably stand pat on rates, Canadian bond yields are likely to be nudged slightly higher by their U.S. counterparts. High yield bonds (U.S.) are intriguing at current prices as the yield difference to the relevant U.S. government benchmark (the corporate or high yield spread) has widened dramatically. The average high yield spread since 1988 is 5.9%, with the current high yield spread at 7.6%, yet the rate of defaults in high yield bonds remains well below historical averages.

U.S. High Yield spreads and default rates

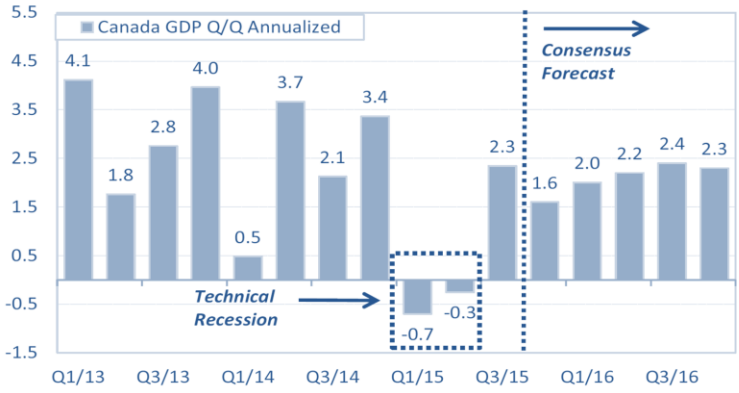


Source: JP Morgan Asset Management Q1 2016 Guide to the Markets

Canada's economy should stage a very modest recovery through much of 2016 primarily the result of easy year-over-year GDP comparisons. Recall that Canada was in a technical recession in the first half of 2015. The impact from prolonged depressed oil prices is likely to take its toll on employment, real estate, and consumer demand. Countering that is a lower Canadian dollar, which may aid exports. The Canadian stock market has already discounted a fair amount of this damage, and unless there is another substantial down leg in oil prices, should rebound from a poor 2015. Although Canadian equities are likely to provide a better total return than Canadian bonds, foreign investments should continue to represent a large component of a portfolio.

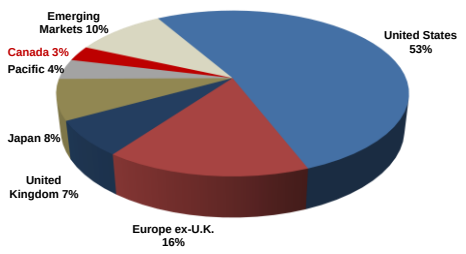
The U.S. economy continues to be a region of strength, and poised to improve further. Equity market valuations however reflect the anticipation of this strength, and as such further equity market gains will be highly dependent on corporate profit growth. Furthermore, tighter monetary policy is typically a challenge from a valuation perspective. Lastly, U.S. multinationals are disadvantaged competitively by a strong U.S. dollar, which specifically has a potential negative impact on sales growth. Despite these challenges, we still see total return for U.S. equities in Canadian dollar terms once again exceed the total return in Canadian equities.

Modest Recovery for the Canadian Economy



Source: Bloomberg, Raymond James Ltd.

MSCI All Country World Index

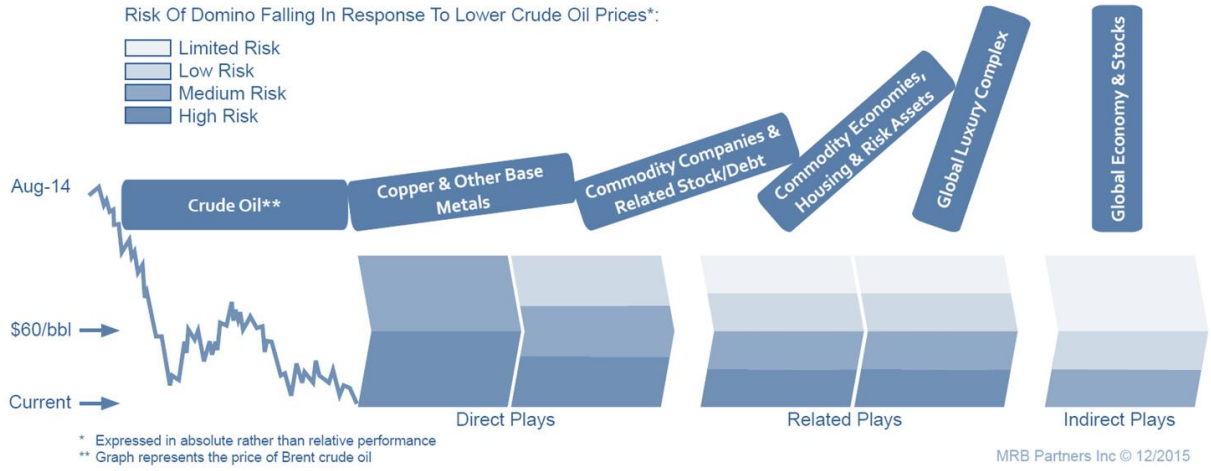


Source: JP Morgan Asset Management Q1 2016 Guide to the Markets

As we had anticipated last year, our global portfolios moved to overweight positions in European and Japanese equities. These positions, which have been primarily hedged to U.S. dollars, have outperformed other developed markets as well as the emerging markets. We see this outperformance continuing in 2016 as both Europe and Japan are fully committed to further monetary easing, and the potential for earnings recovery in those regions is much greater than in other developed markets. Further weakness in the euro and the Japanese yen should aid exports in those regions. As important as the U.S. dollar had been for Canadian investor portfolio returns in 2015, an overweight in Europe and in Japan will be as crucial for portfolios in the coming year. We continue to stress the need to look at investments from a global perspective. Total market capitalization of Canadian corporations represents only about 3% of the world's opportunities.

Our concerns have now shifted to the impact of the commodities sector collapse on the rest of the global economy, particularly when it comes to that of commodity exporting countries. Although it is widely acknowledged that weaker oil prices are generally good for the economy, collapsing prices have the potential to become destabilizing particularly to the economies of the commodity exporting nations (Canada, Australia, Brazil), which may lead to cascading damage to other asset classes. MRB Partners describes this as "The Commodity Dominoes", a scenario where collapsing oil prices lead to increasing contagion risks for a succession of assets. The collapse in crude oil has already brought down other commodity related asset prices, and with each domino falling, increases the risk that the next domino, in this case global luxury goods, will topple. We have seen in recent months a dramatic slowdown in demand for luxury goods in China. The last domino standing, which is the global economy and global stocks, isn't destined to fall; as in the game of dominoes, some may be left standing. This illustration does highlight the risks to the global economy and equity markets in 2016.

The Commodity Dominos (MRB Partners)



In addition to the risk of contagion from the collapse in oil prices, global markets are faced with a number of material headwinds. Geopolitical risks, while difficult to quantify, cannot be ignored as a possible negative for the global economy. Continuing conflict in the Middle East, Islamic extremism, and polarizing political viewpoints both within and between developed nations has the potential to cause greater stock market volatility. China remains a worry as their stock market and housing market gyrations pose a threat to the stability of the world's second largest economy, and perhaps the most crucial from a global economic growth perspective.

In summary, our main calls for 2016:

1) Global economic growth should re-emerge, but the Canadian economic recovery should lag.
2) Global developed equity markets should provide positive total returns, however the risk of a negative scenario playing out is higher in 2016 than it has been since 2011.
3) Canadian equity markets should recover from a negative 2015, but should still underperform the equity markets of Europe, Japan, and the U.S. in Canadian dollar terms.
4) Global investment grade bond yields should climb modestly, resulting in flat total returns in bonds. Canadian bonds should outperform global bonds as the Canadian economy sputters. The Bank of Canada may in fact lower rates if economic output continues to struggle.
5) High yield bond prices rebound as corporate spreads narrow, in particular non-energy related issues. Returns in high yield bonds could be competitive with stock market returns in Canada and in the U.S.
6) Oil bottoms, and is range bound (WTI at $40-$50 per barrel). Energy stocks find a bottom. Base metals and precious metals continue to underperform. Countries that are net importers of commodities should benefit from depressed commodity prices. High household debt in net commodity exporting countries, are a challenge for those economies.
7) China's economic growth rate continues to decelerate, yet the Chinese stock market reflects more of a hard landing scenario. China's stock markets more resemble a casino than it does a market of investable companies.
8) Volatility in the equity markets will be higher than it has been in recent years, on perception of China risk, geopolitical risk, and U.S. Federal Reserve tightening cycle.

We want to wish our clients, readers and their family good health, happiness and prosperity in 2016. We are truly thankful for the trust that our clients place in us, particularly through this past year of change. We remain steadfast in our commitment to provide portfolio and wealth management services with a client first approach.

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