Innova Market Insights

Equity Associates Inc.

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February 2016

Issue #42 – "Batten down the Hatches"

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"Tough times never last, but tough people do."
- Robert H. Schuller

Quite a start to the year! The Dow Jones Industrial Average (DJIA) and the S&P500, the two largest US stock market indices, began the 2016 calendar year with their worst start in 120 years. The historic Dow Jones shed over 1000 points, or 6% of its value in the opening week of trading.

As we've documented before, the months of November, December, and January are known for their particularly strong historical performance[1]. However, there is no such thing as a sure bet in the world of investing. Over-confident investors are quickly humbled when the market moves against them.

In large part, the drop in the markets was caused by two factors: oil supply and China. We've written exhaustively on both of these topics (Issue #32 – "Black Tar Friday" & Issue #40 – "Bought in China"). Our opinions on the two as long-term investment prospects could not be more divergent. This month's issue of Innova Market Insights will provide updates on our position regarding these two investments and how we will position our portfolio moving forward.

Oil

Despite finishing the month up +8.5%, crude oil remains fully -9.2% below its opening on January 1st. As discussed in previous issues, this is more a supply issue than a demand issue. The world's appetite for fossil fuels is undeniably waning. A surge in demand is expected in late 2016, however the weakening desire for oil in relation with the amount of oil on offer will continue to provide downward pressure on the price per barrel.

Three major producers are affecting the amount of oil available. Firstly, with the easing of sanctions, Iranian oil is being welcomed back into the markets. As one of the world's top oil producing nations[2], Iran has been stockpiling substantial amounts of light crude since the embargo began, all of which will now find its way into international trade.

Secondly, the United States shale gas boom has proven remarkably resistant to the precipitous fall in the price of oil. Driven in large part by cheap credit, the taps are still are 'on' with most producers, much to the dismay of the third major oil producer. In a bid to protect its market share, Saudi Arabia refuses to cut production levels and continues to pump the markets with its economically extracted oil.

Truthfully, this seems like a race to the bottom whereby eventually one of these two will crack. Production levels will be cut and provide some relief to the downward pressure on oil prices. As it stands, neither party is blinking so the rout on oil prices continues.

Given the very nature of the extraction industry, speculating on the price movements of this commodity is not well suited for the majority of our investors and so we have steered clear of this sector as much as possible.

China

As discussed in our recent issue of IMI, China is undergoing an important revolution from a manufacturing economy to a consumption-led one. This seismic transition comes with many shakes and tremors as we witnessed in the first weeks of 2016. In large part, it is caused by a significant flight of capital in anticipation of a controlled depreciation in the yuan's value.

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In the face of falling exports, the market believes that Beijing will force further depreciation in the value of their currency to help bolster exports. When faced with a volatile stock market and an over-valued real estate market, Chinese citizens are taking full advantage of the recent loosening of capital controls which allows them to invest higher proportions of their savings outside of the mainland.

The timing of the January drop was well anticipated by China watchers as it coincided with the expected easing of controls on the stock market operations of "Team China". As some of you may recall from our recent commentary, the Chinese government intervened in the stock market to stop last summer's rout by restricting the ability of large state-owned companies to sell Chinese stock, forcing them instead to hold on for the ride. This restriction was set to expire in early January before the Chinese New Year in hopes that by then, calm would have returned to the markets. Unfortunately, as is always the case with state intervention on free markets, this interference only kicked the can further down the road. Simply put, you can cage a bear but when it gets out it'll only be angrier…

Understanding this anger and hoping to capitalize from it, we began to add to our emerging market mutual funds in November and December of 2015. By infusing fresh cash into the holdings, our managers were able to take advantage of the opportunities as they presented themselves in January.

Or at least, that was the plan. We did not anticipate the market rout to be quite so pronounced and unfortunately, exposed our portfolio a little too early to the Chinese market which has lost fully -22% of its value since January 1st. That said, our target holding of 5% of the overall portfolio, the RBC Emerging Markets Fund faired quite well during that time period and only lost -4.46% for the month. It outperformed the losses on the Dow Jones, S&P, and Nasdaq, all of which lost more than that over the same time period despite being exposed to far more volatile markets.

Where do we go from here?

When compared to the recent drops in the US markets, Canada has fared considerably better, especially when we factor in the drop in oil and gas stocks. Having lost only 1.4% of its value in January, Canada provided some welcome outperformance when compared to international markets. Has the time come to begin allocating to Canada? Given its relatively minuscule size compared to worldwide markets (~2%), exposure to the Canadian stock market can be boiled down into pretty much three major sectors for investing:

- Commodities (oil, energy, mining, and precious metals stocks)
- Financials, (the 'Big 5' banks, Manulife, Sunlife, and Power Corp)
- The rest of the market (Telecoms, Healthcare, Consumer, & IT)

It will come as no surprise to our regular readers that we will not be exposing ourselves to the commodities and extraction industry for reasons that are too numerous to mention. Meanwhile, the "rest of the market" has fared exceptionally well and so does not present much of a 'value' at present. As such, is does not fit the purchase conditions of our tactical asset allocation strategy.

The 'Big 5' however are making their way back onto our radar. In mid-January, dividend yields on RBC's common share reached 5%, meaning that assuming no share appreciation or dividend increases, an investor could earn 5% per year in perpetuity so long as RBC honours their dividend payments.

Should valuations continue at these attractive levels, we will strongly consider a re-allocation to Canadian banks, if the real estate market stabilizes. In the meantime, we continue to favour our over-weight position in cash and protective securities as we batten down the hatches, expecting rough waters on the horizon.

1. AGF Market Insights: **Stocks Heat Up When It's Cold Outside.** http://info.agf.com/x0A0000h2Ef0P8F0ps4MsXk
2. US Energy Information Administration: **International Energy Statistics.** https://www.eia.gov/cfapps/ipdbproject/IEDIndex3.cfm?tid=5&pid=53&aid=1