The Economic Shell Game: Finding the Growth in 2014

After a strong rally for equity prices during 2013, it was generally assumed that a healthy correction in the market was needed in order to increase the longevity of the secular bull market and to cool down some hot momentum stocks which were trading at extreme valuations. Near the end of January of this year, the correction that many had been anticipating for months manifested at last; the S&P 500 fell 5.5% between January 22nd and February 3rd, led by sharp corrections in many 'story stocks' such as Facebook, Twitter, Netflix, and Tesla, as well as bio-technology stocks and 3D printing names. The Dow Jones and NASDAQ indices followed closely, falling 6.11% and 5.8% over the same time period, respectively. The TSX Composite, however, was less affected by the correction, relying on its precious metal names to cushion the blow, as many of the gold stocks benefitted during the correction period. The composite was down 3.6% over the period.

Despite the mid-quarter correction, an ensuing rally allowed most indices to finish the quarter with gains. The Dow Jones finished the first quarter with a gain of 0.80%, the NASDAQ was up 3.22%, the S&P 500 was also up 3.22%, and the S&P/TSX Composite was up 6.36% over the quarter. In contrast to the previous rally, however, the recent resurgence has been led by traditionally defensive sectors such as Utilities, as investors fear a further correction and are beginning to favour stocks with low price-to-earnings ratios.

Canada:

- Canadian headline and core inflation was reported at 1.1% and 1.2% annually to February.
- Bank of Canada Governor Stephen Poloz held the key Canadian interest rate at 1% and would not rule out a future cut to interest rates.
- The Bank of Canada also pared back its growth estimates for the first quarter to 1.5% and 2014 estimates to 2.3% due to the severe winter.

In an environment where value-oriented stocks are out-performing their highly valued counterparts, the second most since 2009[1], we continue to favour stocks which trade at attractive valuations and operate within industries that exhibit strong fundamental drivers. Many of these current opportunities are located within the Energy and Energy Services sectors, as well as the Financials sector.

"Worry, like a rocking chair, will give you something to do, but it won't get you anywhere." – Vance Havner

The stage is set for a dubious year as markets move forward with an uncertain fate and ambiguity persists globally. Geo-political tension surrounds Russia and the Ukraine, the Fed will continue the tapering of its QE program, a severe winter created unknown levels of economic impact and full-year Chinese economic growth seems as if it could disappoint estimates. On top of this, the S&P finished the first quarter merely 80 points away from the consensus annual target for the end of 2014[2], which leaves very little forecasted growth left for

[1] http://www.businessinsider.com/strategists-2014-sp-500-targets-2014-1

[2] http://www.ft.com/intl/cms/s/0/bc1cd46a-b697-11e3-8695-00144feabdc0.html#axzz2zpJs7Sch

the overall market from a capital appreciation standpoint.

With such a back-drop in mind, it is our belief that this continues to be a 'stock-picker's' market, where companies who can grow dividends and earnings on a consistent basis will likely outperform their more speculative 'momentum' counter parts.

> "Experience is a hard teacher, because she gives the test first, the lesson afterward." – Vernon Sanders Laws.

In case you hadn't noticed, we have recently experienced an extremely cold winter; historically speaking, temperatures averaged the lowest in approximately 20 years in some Northern U.S. and Eastern Canadian cities[3]. Economically speaking, cold weather tends to place a drag on certain weather-sensitive areas such as construction, and results in higher heating bills, lower consumption expenditure, and rampant flight cancellations. As such, the cold weather has been cited often as a major contributing factor to disappointing U.S. and Canadian economic statistics.

The magnitude and duration of these economic effects, however, is a debated topic, and it may be the case that poor weather has been used as a scape goat to dress-up an economic recovery that continues to lag estimates. Business weather intelligence provider Planalytics estimates that the polar vortex had a cumulative economic impact of $5 billion on the U.S. economy[4], with an additional $1.4 billion of lost revenue due to flight cancellations. In the context of a $17 trillion U.S. economy, it is hard to believe that this development should have any material impact on annual economic data. In the near term, it is also difficult to measure the impact, as depressed construction activity and consumption may be offset by growth to areas such as ski resorts, online shopping and heating oil. The visibility and anecdotal experiences of individuals allows the polar vortex to be used as an excuse for poor economic performance, however, moving forward, a high level of scrutiny will likely be applied to these areas which have attributed their underperformance to the weather, as they will be expected to show improvement with the absence of severe weather conditions. Housing, construction and retail sectors, specifically, will be under the microscope.

Also during the first quarter of 2014, Janet Yellen assumed her position as Federal Reserve Chair, and continued to reduce Quantitative Easing by $10 billion a month; the plan is expected to be phased out by the end of the year. The deadline to apply for insurance through exchanges has also come and gone for the Affordable Care Act – colloquially known as Obamacare – and the economic impact moving forward remains to be seen.

United States:

- U.S. GDP grew by 4.1%, on an annual basis, in 2013.
- Unemployment continued its downward trend to 6.7% as of April.
- Headline and Core inflation were reportedly up 1.5% and 1.7% in year-over-year terms for March.
- The labour force participation rate, as of March was stated at

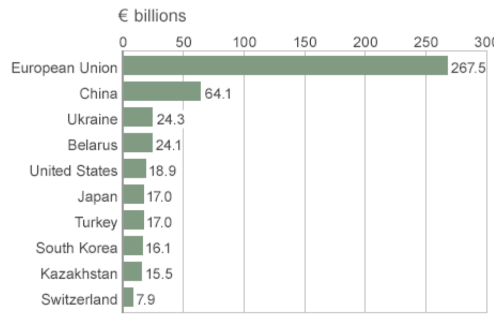
Despite global easing by central banks, low inflation persisted

[3] http://www.accuweather.com/en/weather-news/record-breaking-cold-winter-we/24831365
[4] http://www.planalytics.com/Article379.phtml

through the first quarter of 2014, as inflation in the Eurozone, for example, dropped to 0.5%. Although the European Central Bank and President Mario Draghi have promised to support the Eurozone by any means possible, the area continues to experience persistently high unemployment, political uncertainty, and weak wage growth which make resurgence in demand-side inflation unlikely.

With the Ukrainian-Russian development, another possible disruption to Eurozone growth has arisen. Due to the large trading relationships between Russia and the Eurozone, any escalation of this crisis has profound implications to both the European growth and global energy markets. **Exhibit 1** lists Russia's largest trading partners. The EU represents ~41% of all Russian trade, with the EU exporting mostly machinery, equipment, medicine, and agricultural products, and importing mostly crude oil and gas from Russia. According to the Energy Information Administration, European countries import 84% of Russia's oil exports, and about 76% of its natural gas, which highlights the absolute importance of this trading relationship for both Russia and the European Union.

Exhibit 1:



Source: Eurostat

Although specific strategic investments surrounding the situation in the Ukraine are purely speculative, the potential impact of a flare-up in the region, and possible contagion to the Eurozone, is enough risk to enhance the value of precious metal holdings as portfolio 'insurance'. The value of these holdings as insurance against geo-political risk and volatility can be seen by the fact that gold miners and bullion rallied during the aforementioned correction period of January – February this quarter.

> "When two people agree on everything, one of them is irrelevant." – Benjamin Carson.

The GDX and GDXJ, which are the gold miner and junior gold miner Exchange Traded Funds (ETFs), both experienced superior returns over the period. **Exhibits 2 and 3** display the performance of these ETFs against the performance of the S&P 500 during the correction. We continue to believe that holdings in precious metals are important moving forward, in order to protect against potential unforeseen events, such as what has occurred this year in the Ukraine.

Exhibit 2:

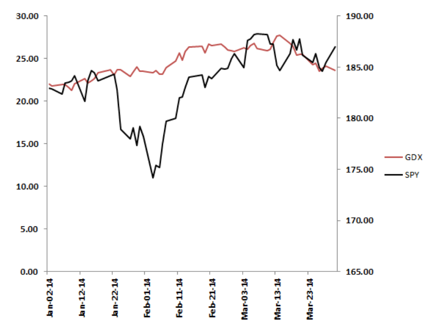
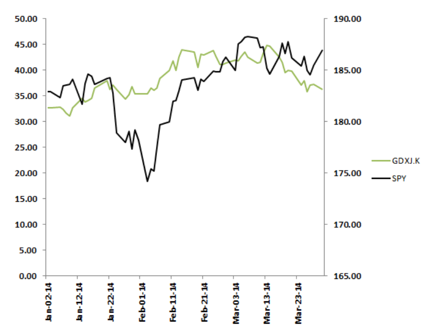


Exhibit 3:



Another development which has dominated the headlines during

2014 has been the Chinese growth story.

The nation is currently undergoing a difficult transition period, as it attempts to shift from an export-driven to a consumer-driven economy; a move which, given increasing domestic wages and manufacturing competition from neighbouring countries such as Vietnam, is needed to ensure strong future economic growth in the country. Coupled with corporate defaults, high leverage, dangerous pollution levels, and an aging population, this has acted as a major hamstring to global growth prospects.

Eurozone:

- The Eurozone recovery strengthened slightly in Q4 2013 to 0.3% quarter-over-quarter.
- The Eurozone's unemployment rate fell in February to 11.9% from 12%.
- Industrial production in the Eurozone rose as of February by 0.2% month-over-month.
- The ECB held the main interest rate at 0.25% in April.

According to a Wall Street Journal survey, economists place the Chinese growth rate as the number one threat to global growth[5] – and for good reason. During 2012, China surpassed the U.S. as the world's largest trading nation, measured by the sum of exported and imported goods, which speaks to the absolute importance of Chinese demand to the global economy. This relationship is especially apparent when considering some of the base metals, such as copper, or other commodities such as oil and iron ore, where China is the largest global importer. Base metals stocks' reliance on Chinese demand and growth adds an inherent level of uncertainty and potential volatility to the sector, which has led us to limit our exposure to the area for the time being.

The most recent GDP growth announcement placed China's year-over-year growth at 7.4%, which was below the government's target of 7.5%, but still above many pessimistic estimates. However, annualizing the first quarter of 2014 alone would result in full-year GDP growth of below 6%, economists say. It is hoped that the country will improve drastically over the remainder of the year, and that a slowdown early in the year was attributable to the 2-week Lunar Festival Holiday, but continued dedicated analysis is required.

"The market can remain irrational longer than you can remain solvent." -- John Maynard Keynes

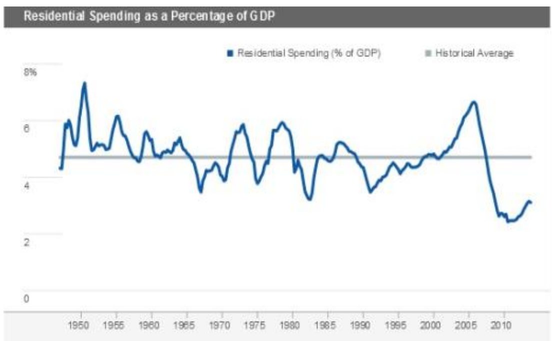
Alas, despite the ambiguity posed by geo-politics and Chinese growth, opportunities remain in our backyard, and, barring an unlikely crash of China or extreme escalation in Ukraine, the portrait of global growth, albeit slow, remains intact.

Residential spending, which includes new home construction, remodeling, and brokerage commission, is an example of a potential catalyst for the United States. Residential spending, which has traditionally averaged 4.7% of GDP, is currently measured at 3.7%, and has the potential to act as the proverbial tide to lift all ships, as a healthy resurgence in construction activity has enormous potential to translate to additional areas such as brokerage, transportation, and lumber. Less than a quarter of the nearly 2 million construction jobs lost during the financial crisis have been recovered, and an improvement to employment in

[5] http://online.wsj.com/news/articles/SB10001424052702304185104579437330513248834

that arena could give the U.S. economy the kick that is needed. **Exhibit 4** below shows a graph on residential spending, as a percentage of GDP, in the U.S.

Exhibit 4:



International:

- Chinese GDP slipped in Q1 to 7.4% year-over-year, below the previous 7.7%.
- Ex-Japan Asian growth was recently cut by 0.1% to 6.3% for 2013.
- On March 15th, the People's Bank of China announced that they would allow the yuan to trade at a band of +/- 2%.
- India grew 4.7% annually in the third quarter of FY 2013/2014.

Another area of optimism exists surrounding the oil and gas industry, particularly in North America. Experts have consistently under-estimated oil production growth since the advent of fracking technology allowed producers to access new fields and improve yields from current projects. The current 2020 forecast for oil production is 50% higher than it was a year ago, and much like residential spending, an uptick to oil and gas production volume would benefit a variety of industries, such as manufacturing, in the way of lower energy prices.

Canadian oil stocks are off to an attractive start, too, with their best performing first quarter since 2006. Investors have been able to look past further delays to desperately needed energy infrastructure, and are focused on the valuable long-term growth story. Persistent delays to pipelines have caused many energy names to ensure sufficient transportation exists outside of the proposed projects, however, it is estimated that Canada's economy loses $50 million a day from accepting lower prices for crude oil due to increased difficulty of delivery. If these projects are approved in the near future, which management of TransCanada is sure will happen if the decision is "based on facts and science", then there would surely be a boom to Canadian energy names.

In summary, despite new information and developments, our overall vision for 2014 remains the same; we believe that the global economy will continue to grow at a slow, sustained pace. Although the U.S. economy is at center-stage, the increasingly globalized economy necessitates that investors take a global point of view. Each individual economy is not an island, and with 13.6% of its current GDP stemming from global exports, the U.S. is no different. The IMF expects world-wide growth to pick up from 3% in 2013 to 3.7% in 2014 on the back of developed economy resurgence, while emerging markets are expected to improve slightly, but remain hampered by currency volatility and depressed commodity prices. Given the slow growth environment, and taking into consideration the strong rally in equities we have experienced in 2013, we plan on proceeding through 2014 with cautious optimism. While remaining vigilant concerning valuations and sector exposure, we will continue our focus on value-oriented stocks in attractive sectors, and be prepared to capitalize on future opportunities that may arise as a result of any future corrections.

MacNicol & Associates Asset Management: April, 2014