Market Commentary

Update on the Harbour balanced funds
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In our year-end commentary, I described a climate that was “hardly a table-pounding formula for a hot equity market,” and advised caution, suggesting that the case for a balanced approach was strong in a turbulent, low growth environment.

Since that time, equity markets globally have sold off violently and investors have become much less certain in their conviction of a global recovery. Everywhere they look, the influences seem to be negative, not positive. Sentiment, of course, plays a powerful role in valuation and market behaviour, and events also can have circular effects, with weak equity markets first signalling economic weakness – and then contributing to it.

The Harbour balanced funds have protected capital extremely well during this period and their combination of asset class flexibility and conservative security selection is well suited to these difficult times.

In this note I will take a look at some of the factors affecting both equity markets and investor perception, and tell you our thoughts about them. These aren’t forecasts, merely observations – and when the facts change, as economist John Maynard Keynes famously said, we’ll change our minds.

Central banks

Our view is that 2016 will be the year that investor confidence in central bank action will be severely tested. This year, we think you should expect more divergence in central bank action and less investor confidence in the effectiveness of their policies. The U.S. Federal Reserve’s “put,” as it is called, is not sitting as close to current equity market levels as it used to be.

Bank of Canada Governor Stephen Poloz made a very interesting comment earlier this year. In early January, he was asked under what conditions he would cut interest rates further and he responded by saying that he was waiting for the new Trudeau government to table its budget and that the level of stimulus provided would guide his next actions. He then, interestingly, suggested that he felt incremental monetary stimulus was of limited use and that fiscal action was what was really needed from the elected government. In his comment, a small ripple from a G8 nation, a leading central banker told the world that he thought his ability to stimulate economic response was limited at best. I think this will be the year that investors start to wonder whether central bankers can save them after all. We expect dispersion in central bank ideas and actions and think that this is going to drive further volatility and unpredictability.

OPEC

Saudi Arabia's actions continue to dominate the oil market. The price of oil has become the dominant market bellwether – correlated highly to global risk appetite. What happens to the price next is of course unknowable, but it is our view that Saudi Arabia will likely continue to press on supply throughout 2016 until we see significant dislocation in the North American oil industry. As unfortunate as this sounds, we think the challenges for North American energy producers are just getting started, and that this year will see significant triage around cost, employment and capital structure. With the stocks of large Canadian oil producers discounting prices more than twice the current level, we are not ready to make a material commitment of our clients' hard-earned assets to this area.

The banking sector

Battered by real and perceived energy-related losses, the fear of a rolling credit cycle, a tightening regulatory and capital environment, and a flat yield curve, credit-sensitive financials have not been a good place to be so far in 2016. Our exposure is negligible and while bank stocks are cheaper than they were a couple of months ago, the experience of the Japanese banks in the last month illustrates clearly that any hint of a negative interest rate environment is not one in which you want to own banks.

While bank stocks are cheaper relative to book value than previously, it is important to remember that banks are highly leveraged vehicles in an interlinked system and their valuations can, at times, reflect events elsewhere in the global financial structure. The recent experience of plunging values in European bank contingent convertible (CoCo) bonds has been a wake-up call to investors, showing that there is no free lunch. Created in theory to protect banks from systemic risk, CoCos, which offer more attractive yields than conventional bank debt, can "bail in" in a crisis, cancelling their coupons but converting to equity – a step that does not seem that great for CoCo or equity holders, but meets government objectives of mitigating "too big to fail," a theory that governments will assist business that have become so large and ingrained in the economy that their failure would have disastrous effects. The events remind me of the tale of Fannie Mae – the Federal National Mortgage Association – a "too big to fail" quasi-governmental public company that hit the wall in 2008, and public equity investors discovered – to their detriment – that policymaker concern was only for the health and integrity of the financial system and not for the rights of those who chose to play the

stock. When the price of a security with high financial leverage falls dramatically, the market is suggesting that something bad is about to happen – it's not a good idea to step in until you are absolutely sure you understand exactly what that might be.

China

China remains the elephant in the room as investors try to decipher real versus reported growth rates, the true health of the corporate and government balance sheets and whether or not more stimulus is forthcoming. In a world where every other nation has devalued its currency, it seems only reasonable that to minimize disadvantage, China will do the same. While its preference thus far appears to be using capital controls to contain outflows, if China devalues the renminbi again, it will release further deflationary pressures globally and drive commodity prices lower. Will it happen for sure? No, but as Clint Eastwood says in Dirty Harry, "Do you feel lucky, punk?" Those are not the sort of chances we are looking to take. A devaluation of course would have particular implications for Canada: lower oil prices = lower economic activity = lower interest rates = lower Canadian dollar, oil stocks and bank stocks. Caveat emptor.

Leverage and excess capacity

Energy and materials are the areas where excess capacity is most apparent – the result of years of cheap capital. The challenge is twofold – there's too much supply in a weak demand environment and what now seems clear in hindsight is that overbuilding was contributing to what we previously thought was normal growth. As we noted in December 2015, until the excesses are worked off, there won't be need for much investment. Excess capacity is perhaps most problematic to global growth. Eight years into the post 2008 quantitative easing world, U.S. capacity utilization is still below trend as easy money and a lack of market discipline has allowed the slack to be maintained. While there is much focus on the recovery in the U.S. economy, in our view, it's anemic. The sector that created most of the jobs in the U.S. in the last five years – energy – is now unwinding. If we erased that round trip from the records, U.S. economic growth would have looked less exciting years earlier – we've just deferred the structural problem. Many commentators offer odds on whether the U.S. will go into a recession; they seem to be about 20% at the time of writing, but I think that is missing the point. We don't need two negative quarters of growth to call stock valuations unremarkable – the U.S. growing at about 1.5% with high leverage, closer to average stock valuations, and the risk of external shock from geopolitical and financial risks seems to be one where articulating the runaway bull case is not very easy.

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Investing is by definition anticipatory – we try to imagine what might happen to the companies, countries and currencies to which we allocate our clients' capital. In this business, you never have all the information you need to make a perfect decision and you have to bring your own biases to the table. Are you the type of investor who worries more about the money you didn't make, or about the money you lost?

We find broadly in our investing process that if we worry about the downside, the upside takes care of itself. In this climate, caution is still the watchword.