2014 – A Year of Interesting Times

QAM Perspectives – January 2015

Quadrant's regular newsletter highlights topics we believe will affect markets or are important in understanding them.

"In investing, what is comfortable is rarely profitable."
Rob Arnott,
CEO - Research Affiliates

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At the beginning of every year we look back at the previous one and try to make sense of what happened as well as look forward to what 2015 may hold. 2014 was certainly a year of highs and lows and was filled with many market surprises.

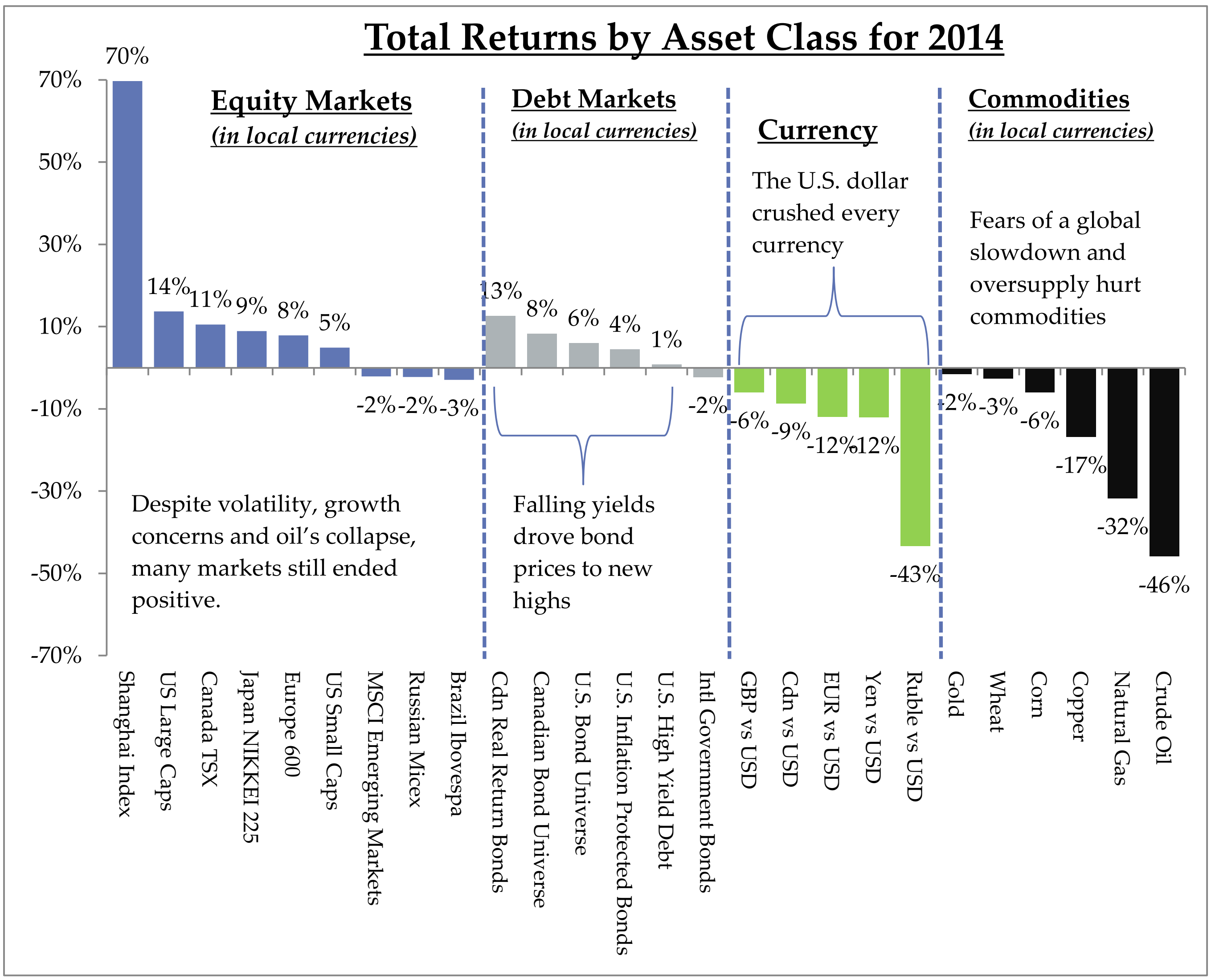
In previous newsletters we've discussed the dramatic decline in the price of oil and its impact on investments (see "The Fall of Oil") as well as the mini stock market correction in October (see "What Just Happened?"). The impact of a massive decline in energy prices, the rise of the U.S. dollar and the continued drop in interest rates have all had profound effects on the investment landscape. However, despite the drop in energy, broad equity markets in Canada and the U.S. ended with distinct gains. Last year again humbled most of those (including us) who expected interest rates to finally start to rise. Low inflation and a demand for any kind of yield, pushed interest rates lower again. Despite the massive amount of currency printed by the Federal Reserve, significant inflation has not reared its head. The drop in rates drove the prices of government and investment grade bonds higher.

Equity Market Total Returns (in CAD dollars)	Q4 - 2014	2014
Canada (S&P/TSX Composite)	-1.48%	10.55%
S&P/TSX Capped REIT Index	1.22%	10.22%
U.S. Large Caps (S&P 500)	4.92%	13.68%
U.S. Small Caps (Russell 2000)	9.72%	4.90%
MSCI EAFE	-3.45%	-4.20%
Germany (DAX)	3.50%	2.65%
MSCI Emerging Markets	-4.54%	-2.11%

Fixed Income Total Returns (in CAD dollars)	Q4 - 2014	2014
Canada Universe Bond Index	2.62%	8.28%
Canada Real Return Bond Index	1.53%	12.60%
US Investment Grade Index	1.86%	6.00%
US High Yield Bond Index	-2.07%	0.77%
US Treasury Inflation Protected Index	0.50%	4.49%

The drop in the Canadian dollar has been dramatic and has been driven in part by lower energy prices and an expectation that interest rates will rise in the U.S. The drop highlights the importance of being diversified internationally since it limits your exposure to any one geography and currency. The other important factor, as it relates to Canada, is the concentration in the energy and materials sector. By holding U.S. and international stocks, we reduce our exposure to these sectors.

Last year was a story of dispersion. Looking at the returns across and within asset classes makes that clear. Fears of a slowdown in China, Japan and Europe had ripple effects on commodity and stock prices. Central bank and government intervention has played a significant role in the asset class returns below. For instance, a rate cut in China, quantitative easing in Europe and economic reforms in Japan have created market volatility.



Looking forward to 2015, one thing we can be certain of is continued volatility. There will be significant trickle on effects around the world if energy prices stay at low levels for a prolonged amount of time. A number of governments and economies are dependent on high prices to balance their budgets and maintain employment. In more politically charged parts of the world, such as Iran and Russia, lower prices may push these governments towards greater isolation or to embrace the world community. It's a large question mark and a move in either direction will have an impact on markets.

Every year, Byron Wein, a former strategist at Morgan Stanley, comes out with his "Top 10 Surprises"[i] for the coming year. It's usually an interesting read and at the very least is a good thought exercise for things which could potentially happen. Some of our favorites for this year (because we agree with them) are: China reports that it's no longer growing at 7% per annum but is slowing to 5%, the Japanese recession, which started in 2014 continues into 2015 despite fiscal and monetary stimulus and finally that a booming U.S. economy pushes the S&P 500 up 15%. I would add another one of my own "surprises" to the list which is that the Bank of Canada cuts rates for a second time as low energy prices have a trickledown effect and slow the Canadian economy.

It's certainly entertaining to play with "what-if" scenarios, but ultimately what matters in investing is sticking to a discipline that maintains portfolio diversification and evaluates risk versus reward. We are constantly monitoring our portfolios to ensure that we are protected from interest rate shocks, sector gyrations or the impact of economic slowdown in any region or country. While there will always be volatility in asset markets (which makes them interesting), over long periods of time the power of investing can be related to a quote from Ben Graham – "Investors should not be too concerned with erratic fluctuations in stock prices, since in the short term the stock market behaves like a voting machine [determining prices based on popularity] while in the long term it acts like a weighing machine [determining value based on true economic value]."

[i] See http://ir.blackstone.com/news-and-views/Press-Release-Details/2015/Byron-Wien-Announces-Predictions-for-Ten-Surprises-for-2015/default.aspx