2016 - Another Year of Predictable Unpredictability

QAM Perspectives – January 2017

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

"People search the market's behavior for logic, there really doesn't have to be any"
Howard Marks, Co-founder of Oaktree Capital

Quadrant Asset Management
Suite 720, One Lombard Pl
Winnipeg, MB
Ph: (204) 944-8124
email: inquiries@quadasset.com
web:www.quadasset.com

At the beginning of each New Year, we at QAM like to look back at the previous one and try to make sense of what happened, as well as look forward to what the upcoming year may bring. The year 2016 was full of highs and lows, as well as many surprises.

The year began with equity and commodity markets around the world declining rapidly as investors feared that deflation, caused by falling oil prices and a slowdown in China could spark a global recession. Reacting to the investor mood, The Royal Bank of Scotland (RBS) on January 11, 2016 warned its clients to "sell everything" and to prepare for a "cataclysmic year". The bank predicted that the impending global deflationary crisis could cause equity markets to tumble by as much as 20%. This warning from RBS was only the first of many inaccurate predictions for the year which were issued by prognosticators of all kinds in 2016 (so many so, that QAM is fairly certain that forecasters of all stripes would like to forget 2016).

To hold off a potential deflationary crisis, global central banks acted and lowered interest rates. With new monetary stimulus, bond yields fell across the world. In Europe interest rates plunged deep into negative territory. At one point in 2016, Swiss bonds with maturities of up to 50 years had negative yields[1]. At its peak, almost 12 trillion dollars' worth of bonds had negative yields[2]. Canadian benchmark bond yields did not go negative, but they did decline to near historic lows. The decline in bond yields was positive for bond investors because bond yields and bond prices move in opposite directions. By September 2016 the Canadian Fixed Income benchmark (the FTSE TMX Bond Universe Index) was up over 5% for the year. These returns for fixed income did not last however, as interest rates rose sharply following the election of Donald Trump as U.S. president. It was not only fixed income instruments which declined with rising interest rates, it was also so called "bond proxies" such as a Utility stocks and Global Real Estate equities.

While specific details on President-elect Trump's economic policies have not yet been released, the general outline based on preliminary reports appears to be focused on new infrastructure spending, lower corporate taxes and less regulation. All of these policies are conducive to economic growth, as well as potentially inflationary. A pickup in inflation could result in central banks raising interest rates faster than expected. Depending on the pace of interest rate increases, potentially negative movements in fixed income could come sooner than expected. Corporate bonds could be spared, at least in part, due to further tightening of corporate spreads (the difference in interest rates between a corporate bond and a government bond of the same maturity). During the Q4 2016 rout of fixed income, corporate bonds were less affected than government bonds because corporate bond spreads did indeed tighten. The spread on the Bank of America Merrill Lynch US High Yield Index tightened almost 100 bps (1.00%) between Election Day and the end of the year. As rates rise further, the cushion which spreads provide is eroding and thus may not be as beneficial in the future. Rate-reset preferred shares should also fare better than traditional fixed income investments in the event of increasing interest rates due to their rate-reset characteristics.

Equity markets globally ended the year broadly up. Both Canada and the U.S. rose overall in 2016, with Canada finishing as one of the best performing equity markets in the world. In Canada, small caps outperformed larger firms. Smaller firms in Canada are disproportionately in the Materials and Energy sectors, specifically in the primary exploration business. Exploration companies in particular are buffeted more harshly by the change in commodity prices. In a year when oil prices fell to as low as $26 a barrel and ended the year up 100% from the low, it is no surprise that smaller commodity firms, especially those with stretched balance sheets (which rising commodity prices help alleviate) outperformed.

Equity Market Total Returns (in CAD dollars)	Q4 – 2016	2016
Canada (S&P/TSX Composite)	4.54%	21.08%
S&P/TSX Capped REIT Index	0.62%	17.63%
U.S. Large Caps (S&P 500)	6.43%	8.89%
U.S. Small Caps (Russell 2000)	11.56%	17.96%
MSCI EAFE	1.89%	-1.19%
Germany (DAX)	5.21%	0.04%
MSCI Emerging Markets	-1.88%	8.23%

Fixed Income Total Returns (in CAD dollars)	Q4 – 2016	2016
Canada Universe Bond Index	-3.47%	1.25%
Canada Real Return Bond Index	-4.58%	2.72%
U.S. Investment Grade Index	-0.66%	-0.38%
U.S. High Yield Bond Index	3.81%	11.30%
U.S. Treasury Inflation Protected Index	-0.44%	2.19%

Earlier in 2016 we at QAM discussed how the current bull market is now the second longest in history ("Bear in Mind the Aging Bull"). The bull market continued for the remainder of 2016, driven primarily through multiple expansions (paying more for each dollar of earnings). The S&P 500 (U.S. broad market index) ended a more than year-long "earnings recession" in Q3 2016. The primary reason for the decline in earnings was a sharp decrease in earnings of

Energy firms that struggled to keep profitable in the face of declining oil prices (excluding the energy sector, earnings for the index were positive). With rising commodity prices in the second half of the year, earnings for Energy firms began to grow again and the "earnings recession" ended. Expectations for earnings growth for the S&P/TSX Index for 2017 currently sits at 20%. This expectation may be difficult to meet.

Looking forward to 2017 and just as in 2016, there continues to be divergent expectations for interest rates in Canada vs the U.S. In Canada, where the economy continues to be held back by low oil prices, the expectation remains for the Bank of Canada to stand pat on short-term interest rates. In the U.S., the Federal Reserve continues to be in the process of slowly raising interest rates. Investors expect the Fed to continue to steadily raise interest rates over 2017. At their last meeting of the year in December 2016, the Fed released projections showing that the members of the Fed Committee expected to raise interest rates three times in 2017[3]. It should be noted however that these projections are internal guidelines only and do not necessarily reflect how policy may in the end turn out. For example, in December 2015 the Fed Committee released projections stating that they expected to raise interest rates by 1.00% (0.25% per quarter) for 2016[4]. In the end, the Fed only raised interest rates once (0.25%) in 2016. Inflation in North America continues to be below central bank targets, but this could change in 2017 as stimulus both announced (Canada) and expected (U.S.) flows into the economy. As mentioned before, a surprise burst of inflation could lead to more rapid normalization of interest rates than investors or central banks currently expect.

The headlines of 2016 swung wildly as expectations shifted from one extreme to another. In the aftermath of the surprise vote by the U.K. to leave the European Union in June (Brexit) and the election of Donald Trump as U.S. commander in chief, markets around the world plunged. Investors engaged in a panic sell-off in both instances. In both of these cases, short-term selling was a terrible decision, as almost immediately markets regained all that they had lost. In the very last update of 2015, we at QAM talked about what ultimately matters most for investors is the long term ("The 4Ds of Portfolio Management"). Portfolios should be designed to ensure that they strike the proper balance of risk and reward for the long term and should be able to ride out the inevitable short-term volatility which is naturally inherent in the capital markets. Whatever may be the cause of that volatility, be it Brexit, or Greece, or the U.S. debt ceiling crisis (remember those?), in the long term what matters is that the investor remains disciplined and sticks to a properly diversified portfolio. Although we at QAM may focus on the long term, that does not mean we ignore the short term. Our team is constantly monitoring our portfolios to continuously improve them and try to further insulate them from market movements. Years such as 2016 can be a helpful reminder that volatility is inherent in the capital markets and that all portfolios should be designed to ride out such short-term volatility so that investors can meet their long-term goals.

We at Quadrant Asset Management would like to welcome a new member to our growing team, Vern Doerksen. Vern joins QAM as a Private Wealth Manager with 12 years' experience as a trusted wealth management professional. Vern has deep roots in the community, having served as vice-chair of his church and as a coach for youth baseball and soccer. He can be reached at vdoerksen@quadasset.com.

If you or someone you know could benefit from our services, please have them contact our offices at 204-944-8124 or email us at inquiries@quadasset.com.

Lastly, all of us at QAM would like to wish you and yours a very happy 2017. Happy New Year everyone.

Notes

1) http://uk.reuters.com/article/swiss-bond-negative-yield-idUKL8N19R0X9
2) https://www.bloomberg.com/news/articles/2016-10-02/negative-yielding-bonds-jump-to-almost-12-trillion-after-ebbing
3) https://www.bloomberg.com/news/articles/2016-12-14/fed-raises-rates-boosts-outlook-for-borrowing-costs-in-2017
4) https://www.bloomberg.com/news/articles/2015-12-16/fed-ends-zero-rate-era-signals-4-quarter-point-2016-increases

Disclosures