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GLOBAL INSIGHT

FOCUS ARTICLE

Taking Canada's Pulse

We're checking the Canadian economy's vital signs and giving our prognosis for its outlook.

Matt Barasch

For Important and Required Non-U.S. Analyst Disclosures, see page 6.

All values in U.S. dollars and priced as of February 29, 2016, market close, EST, unless otherwise noted.

Focus Article

Taking Canada's Pulse
An Interview With Matt Barasch

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As the bear continues to stomp about and with markets whiplashed by volatility, we turn to the chief Canadian equity and structured note stategist at RBC Capital Markets, LLC for his diagnosis of the health of Canada's economy. The stress is significant and will take time to dissipate, but he points out some silver linings that may assuage investors' jitters.

Q. There's been a lot of volatility in the markets which has produced elevated investor concerns about the economy and financial markets. Contrast the current environment with the financial crisis.

A. While it's understandable that folks are still scarred by what took place back in 2008 and 2009, what markets are currently experiencing does not have much in common with what we went through back then. There was a "three-sigma" bubble in U.S. housing that had been building up for years and a U.S. banking sector that had massive exposure to this bubble and inadequate capital to deal with it if it went wrong. Of course, it went wrong and that produced a devastating bank balance sheet contraction. It took all the tools in the toolbox to get the global economy going again.

Today, banks are well capitalized, probably even overcapitalized in many cases, while there are no bubbles out there that are bursting around us. Yes, we have had a very large downward move in oil prices and there was a lot of debt issued by oil and gas producers before prices started to come down, but the size of this debt balloon (if we want to extend the analogy) is a drop in the bucket when compared to U.S. housing and the 2008–09 experience. We think today that we are dealing with a bunch of storm clouds coming together at the same time. These include: a Fed rate hiking cycle, which normally carries some wobbles; a Chinese economy that continues to shift from capital expenditure-based to operating expenditure-based, which makes China less predictable and slower growing overall; a U.S. presidential election, which increases uncertainty for markets and has some colorful characters, that probably enhances this uncertainty; and the aforementioned issues with oil. While it might be hard to imagine these storm clouds lifting, they will, and things such as the health of the U.S. consumer, the benefits of lower gasoline and heating oil costs, very stimulative global monetary policy, and compelling valuations on stocks make the outlook pretty interesting.

Q. What has been behind the disappointing performance of Canadian equities over the last 12+ months?

A. You could easily extend 12 months to five years as the S&P/TSX is roughly 1,000 points lower than it was in February of 2011. We think there has been a combination of factors. Oil is obviously the most recent one as the approximate 70% drop from the summer of 2014 has taken a lot of the steam out of a big chunk of the market, while it has also had a knock-on impact on those sectors that are indirectly tied to oil. Going back further, the broader commodity complex collapsed as years of overdeveloping in anticipation of Chinese demand growth that would go on forever, but then slowed sharply, left most commodities with poor supply/demand balances. Add to this gold losing much of its luster as the fear that stemmed from 2008–09 began to abate and you have accounted for a big chunk of the Canadian market that has been under varying degrees of pressure.

One of the easiest trades of the past five years for global investors might have been to position portfolios to reflect poor Canadian growth versus other markets since: (1) the loonie was about 20% overvalued five years ago; (2) our banks were not particularly cheap when compared to global peers; (3) they probably remembered reading an article somewhere that suggested our housing market was a bubble; and (4) oil started to crack along the way. Even Canadians have been similarly positioned to some degree by moving assets to the U.S. market.

The good news is that we think most of these are pretty long in the tooth and global managers are probably not that far off from feeling the same way.

Q. Can Canadian banks repeat their performance from the last five years over the next five years?

A. The Canadian banks did really well from 2011 to 2014, but the past two years have been a much tougher slog. We think the next five years are likely to be somewhere between these two periods in terms of performance. Look, it's going to be tough for the banks to grow earnings by more than say mid-single digits over the next little while as: (1) the yield curve is as flat as a pancake, which hurts net interest margins; (2) credit losses are going to get worse because of the collapse in oil prices and the likelihood of some loan-loss provisions there; and (3) loan growth is probably not going to be any great shakes as Canadian consumers are pretty leveraged and you can only leverage your population once.

This doesn't sound very encouraging, but the banks are starting from a very low valuation point relative to historical norms and some of the above will likely not turn out to be as bad as many fear. The Canadian banks have proven to be great stewards of capital over the past 15 years and we suspect that when we see provisions for credit losses over the next couple of quarters, they are not going to be nearly as bad as some suspect. This should help to boost valuations, so even if overall earnings growth is not great, the combination of a good dividend plus a bit of a valuation bump can still deliver an attractive return.

Q. Why are depressed oil prices more of a story in 2016 than in 2015?

A. We're not sure they are more of a story, but it's much more likely we are going to see some things happen in 2016. 2015 was a weird year because most oil companies entered the year pretty well hedged, so even though prices were down sharply, many oil companies had sold forward a chunk of their production at much-higher prices, so there was not a big incentive to cut near-term production. In addition, many of the shale producers "high-graded" their development, which means they essentially drilled the prospects that would give them the most production for the least amount of spending. Add to this additional barrels from Libya, Iraq, and the lifting of sanctions on Iran and it was almost like 2015 was a "punt the football and wait for 2016" year.

2016 is likely to play out much differently. There are no new barrels coming to market aside from what Iran can put together, while high-grading can only work for so long. Add to this about $400B in capital expenditure cuts and there is the potential that supply takes a bigger hit as we get into the later part of the year. Lastly, we'd note that there's a lot of debt that starts to come due this year (although more in 2017 and 2018) and this may force some more production off the market. Thus, it wouldn't surprise us if we were talking about higher prices as we get to later in the year, especially with demand continuing to rise in response to lower prices.

Q. How should Canadians view investing in U.S. equities at this juncture?

A. With the loonie now roughly 20% below fair value, Canadians probably want to throttle back a bit on U.S. exposure. But this does not mean they should take a hatchet to their U.S. exposure as the loonie is likely to trade below fair value (estimated to be in the low-to-mid-US$0.80s) for the next number of years. The Canadian market has not been this cheap relative to the U.S. market for a long time, so there is an opportunity to sell high and buy low for Canadians who went heavily into the U.S. market over the past half-decade. However, because of the diversification opportunities offered by the U.S. market and the likelihood the currency doesn't hurt you too much (won't be a tailwind, but doesn't mean it becomes a big headwind), we would still keep a healthy dollop of U.S. exposure.

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