Infomail

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Mid-Year Outlook

"The market, like the Lord, helps those who help themselves. But unlike the Lord, the market does not forgive those who know not what they do"

Warren Buffett

As I put pen to paper, we are literally at midyear 2015. Besides the usual observation on how fast time is flying, I thought it would make sense to take a look at how 2015 is playing out. Taking a quick look at some indices, here's where we stand at midyear:

TSX	+0.70%
Dow Jones	+0.43%
S&P 500	+1.71%
Nasdaq	+6.65%

In other words, except for the tech heavy Nasdaq (and that in a big part is due to heavily weighted Apple Inc), North American markets have basically done zero in six months of trading.

Overall, I would say the outlook is cautious. All the central bank over-applied medicine of low interest rates seems to have been very successful in inflating the value of financial assets, but has done little to stimulate global economic growth. Defenders of central bank policies would argue it would have been worse.

Companies are using that cheap financing to do stock buybacks and mergers, but efforts at real expansion remain questionable. On the consumer side, they seem to be focused on paying down excessive debt loads instead of spending, which once again means little benefit for the global economy.

A strong US dollar, combined with low export growth, seems to be stalling the US economy, and Europe, while getting better, might register an overall GDP growth of 1.00-1.50% at best, even with the huge EU quantitative easing program. In Canada, the energy sector crash has/will have a huge impact, while China continues experiencing growth pains while trying to convert from an export driven economy to a consumer driven one.

There is no doubt investors have enjoyed a period of relative low volatility in recent years, as the last 10% correction took place over three years ago. With valuations on markets higher, especially in the USA, we need the "earnings" side of the price/earnings valuations to start catching up to the "price" side.

We are also at an inflection point, in that the US Federal Reserve is looking to increase interest rates for the first time in a decade, and that will have a huge impact on corporate financing, the bond market, other income producing assets, and currency markets around the globe. I would suspect the Fed has telegraphed its intentions well, and odds are we get one rate increase in 2015, most likely at the September meeting, and maybe once more in December, before the US presidential election in 2016 when the Fed usually does zero.

The markets have acted indecisive so far in 2015, mainly because the economic data has been indecisive. Fears of deflation sent bidding up on US Treasuries and German Bunds which saw their 10 year yields fall to the 1.60% and 0.10% range respectively. But then inflationary concerns have kicked in lately and those yields have spiked in a very short time to the 2.45% and 1.10% range.

I've been writing for some time that I believe interest rates will likely remain lower for longer, even though the next move is up, they will still remain at historically subdued levels. There are several reasons for this, the rise of emerging markets in global production; high unemployment numbers and stagnant wage growth, along with an aging North American population are all having an impact.

At this point in time, 27 of the world's 34 major central banks are practicing some form of easy monetary policy in an effort to suppress interest rates. As a result, the media (and investors) are making too much out of the prospect of higher interest rates.

On the equity markets, the USA has been a leader, but the high US dollar has allowed the focus to shift to other parts of the world, as lower currencies elsewhere has allowed exporters to become more competitive. And that's why Euro and Japanese equities have led the charge so far in 2015.

The US economic recovery is entering its sixth year of expansion, and US corporate profit margins are near multi-year highs as a result. But despite that expansion, growth is becoming more volatile due to higher regulatory burdens under the Obama administration, accompanied by virtually NO fiscal or tax policy stimulus.

The much feared increase in interest rates by the Fed may create some short term knee jerk reaction, but I would guess Janet Yellen is more eager to stimulate the economy and much less likely to worry too much about inflation right now. She knows the Federal Reserve has many tools to deal with inflation, if and when it occurs. Therefore I would surmise she will move very slowly and cautiously on rates.

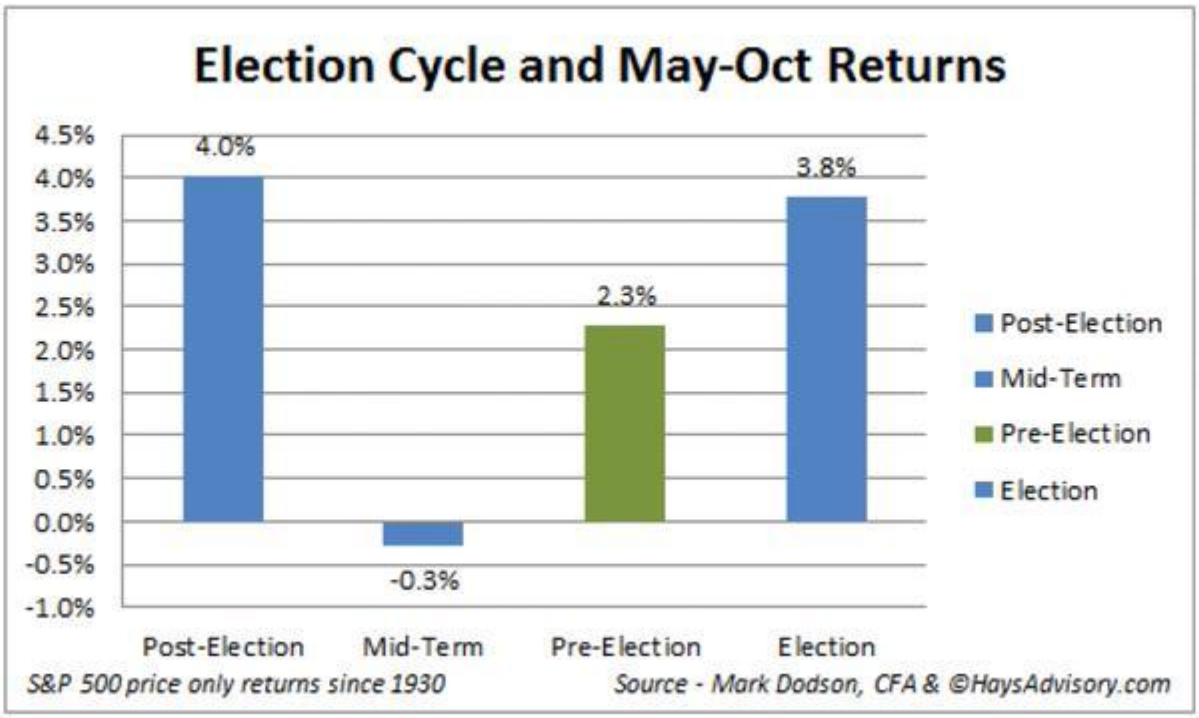
With Greece hogging the headlines, I still suspect a last minute deal gets done keeping them in the EU. I think it's only "kicking the can" down the road as they say, and at some point Greece will default and leave the EU. Either way, Greece needs societal reforms to become globally competitive but interestingly enough, if they can get through 2015, there are no more big repayments of third party debt for several years, so the maturity problem is very short term in nature, but no doubt, intense.

Keep it in perspective: Greece is only 2% of the EU's GDP. So the problem with Greece exiting the EU is more symbolic than economic, and the bigger worry is if it spreads to Portugal, Spain and Italy.

Canada, which is the fifth largest oil producer in the world, is having its own issues. The energy collapse will hammer the Federal coffers, but with the two largest provinces Ontario and Quebec struggling with budgets, and the newly-NDP-led province of Alberta surely to follow, there are issues. A total of about 11-12% of the Canadian economy (and jobs) are tied to the energy sector, so it's not insignificant.

The biggest problem ahead in North America is one which has not received a lot of media attention so far, but will soon, is the long term structural imbalances, specifically from pension and health care costs. You've seen recent discussions, strikes and unrest in Chicago. The whole state of Illinois is in trouble, and it's the "canary in the coal mine" of more to come. And yes, the President does hail from Illinois. More than 40 states have already had pension reform and are working on these structural imbalances, places like Detroit never did and suffered the consequences.

Looking ahead, the May to October period heading to the election does not look over ominous. It's also nothing to write home about either. Once you exclude the May to October periods of mid-term election years, the "Sell in May" phenomenon largely disappears. The period of May to October in election years has been positive roughly two-thirds of the time since 1930, averaging a return of 2.3%.



So on the positive side of the equation, we have the following:

- Low energy prices
- Low interest rates
- Low currencies (except US dollar)
- Eurozone improving
- Inflation remains benign
- Japan making structural reforms

And on the negative side:

- Deflation fears present
- US Q1 2015 GDP very weak – is it temporary
- Canadian economy suffers from low energy prices
- Is China getting better, or not?
- Greece

Historically, market cycles have typically ended when 70% or more of the world's central banks are tightening monetary policy. As mentioned earlier, today 80% are still practicing easing policies.

While I do believe we could get a 6-10% pullback this summer/early fall due to a knee jerk reaction to the Fed or Greece (or both?), I believe we still go a lot higher.

Stay tuned,

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