CIBC Wood Gundy | Papau Armstrong Schmidt Financial Group

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A Pill That Cures Nothing But Has Side Effects

Early in the first quarter of 2015 (Q1), the Bank of Canada unexpectedly reduced its overnight interest rate to 0.75 per cent from 1 per cent. The Bank acted in response to low oil prices, which it acknowledged will be negative for Canadian growth. With the rate at emergency lows prior to the cut, it is fair to question whether the cut will make much of a difference. It is also fair to ask whether the Bank of Canada has been sending Canadians mixed messages over the past few years.

During the 2008-2009 financial crisis, the Bank of Canada sharply reduced rates. Canadians responded strongly to this incentive by borrowing and spending, especially in relation to housing. Former Bank of Canada governor Mark Carney expressed concerns that rising household debt could be problematic when rates rise, but his message did not reach many Canadians. Now, with household debt at record levels, the Bank of Canada has created fresh incentive to borrow.

In our Q4 2014 newsletter, we questioned whether 2015 would be the year that high household debt to income ratios and inflated housing prices finally lead to tangible economic consequences. In the short run, the rate cut may have postponed any potential pain. Five year fixed mortgage rates are now below 3%. Canadian resale home prices were up 4.7% year over year across Canada in March, with only Winnipeg and Ottawa reporting a drop in prices.[1] This is happening despite increasing signs of unemployment in the energy sector and weak GDP numbers.

In a recent article on global property prices, the Economist magazine identified Canada as one of the world's most overvalued housing markets, suggesting that prices are 89% overvalued relative to rents.[2] While the precise degree of overvaluation is debatable, affordability is clearly stretched. According to mortgage insurer Genworth Canada, almost a third of Canadian first-time home buyers now rely on money from parents or other family members to pad their down payments. This is a Canada-wide statistic that examines purchases averaging around $293k, so we would imagine that this phenomenon is even more widespread in Vancouver and Toronto.[3] The psychological effect of ever-increasing house prices and ever-falling interest rates is powerful, and it has motivated many Canadians to stretch beyond their means.

Clearly the Bank of Canada would prefer to see low rates and the weak Canadian dollar channel business investment into new manufacturing capacity geared towards exports. Sadly, there are few signs that this is actually happening. Instead, we are seeing articles about major companies choosing to invest in other countries instead of Canada. For example, Toyota Motor Corp. (NYSE:TM) recently decided to locate new plants in Mexico and China. Mexico's low labor costs, free trade agreements and proximity to the United States were contributing factors. Toyota intends to move production of its Corolla compact car to the new Mexican plant in 2019 from a factory in Cambridge, Ontario. The Canadian plant will be rededicated to building more expensive cars instead of being shut down, which is positive, but we would have preferred to see some new Canadian manufacturing job creation.[4]

Canada now appears to have a job quality problem. CIBC maintains a Canadian employment quality index, which includes factors such as the distribution of full-time vs. part-time positions and the gap between the self-employed and employees. According to the index, the quality of Canadian jobs has dipped to a quarter-century low and has become a structural issue that could prove difficult to reverse. Since the late 1980s, there have been far more part-time positions created than full-time positions. Each recession has damaged the full-time employment outlook. Self-employment has also risen much faster than salaried positions over the years.[5] Many of the jobs that have been created recently have been in real estate and construction, which is likely unsustainable, the energy sector, which is now shedding workers, and government, which can act as a burden on the private sector.

Looking at the big picture, the Canadian economy will face a number of near-term challenges, especially if commodity prices remain at current levels. At this point in our weak economic recovery, interest rate cuts can be likened to a pill that cures nothing but has side effects. Interest rate manipulations are losing their effectiveness as a policy tool, partially because there is little room to maneuver with rates so low, and partially because borrowed funds are not being channeled into business investment that creates high-quality jobs.

Our intention in discussing these matters is simply to inform clients about some of the real risks that the Canadian economy is facing. As a practical matter, as Canadian investors, we will generally maintain a significant weighting in Canadian investments. However, we also need to remain open to opportunities in the United States and elsewhere in order to reduce risk and generate returns in this environment. We acknowledge that the U.S. dollar has appreciated significantly against the Canadian dollar, which somewhat reduces the attractiveness of U.S. investments. That said, we do not expect a return to currency parity in the near term.

Energy Sector Update

Having devoted the majority of our Q4 newsletter to the recent oil price decline, we will not allocate much space to the energy sector this time. We have been net buyers of the highest quality energy companies during this downturn, especially for clients with minimal energy sector exposure. However, we would not characterize the buying we have been doing as aggressive. It will be interesting to follow the energy sector's first quarter reports to determine how companies are performing in this challenging environment.

Two examples of high quality energy companies are Suncor Energy Inc. (TSX:SU) and Canadian Natural Resources Ltd. (TSX:CNQ). In early April, Suncor reported strong operational performance to March 31, 2015 and also announced that it is on track in its efforts to achieve a $1 billion reduction in its 2015 capital budget in response to low oil prices. The company also intends to maintain progress on key growth projects already in construction.[6] Suncor's shares reacted positively to the announcement and are now up 8.3% for the year as of April 22.

On March 5, Canadian Natural Resources announced its 2014 fourth quarter and year-end results. Highlights included strong gains in earnings and cash flow; however, these figures were mainly generated in a higher oil price environment. The company increased its quarterly dividend modestly from $0.225 to $0.23 per share, the fifteenth straight year of increases. In this environment, any increase in an oil company dividend is impressive. [7] Canadian Natural Resources shares have risen 12.5% year to date as of April 22.

We will also mention Schlumberger Ltd. (NYSE:SLB) as a high-quality large capitalization energy-services company that we have been buying for some clients recently. Schlumberger is a globally diversified technological leader with good long-term growth prospects and high profitability. Historically, Schlumberger shares rarely trade at a depressed valuation, and they are not exceptionally cheap today. However, we believe the quality of the business and its long-term growth prospects make the shares worth accumulating during this down-cycle.

A Material Change at General Electric

General Electric Co. (NYSE:GE) is a significant holding in both the Total Return and the High Yield discretionary managed portfolios. [8] On April 10th, the company's shares rallied by more than 10% after it announced an intention to dispose of the bulk of the assets of its GE Capital division over the next 24 months, including real estate and certain loans.[9] The company now projects that more than 90% of its earnings will be generated by industrial businesses by 2018, in comparison to under 60% in recent years. The capital raised from the sale of GE Capital assets will be returned to shareholders through dividends and share buybacks. We welcome these developments, as our purchases of GE shares for clients have always been motivated by GE's standing as a premier industrial company rather than any bullish thesis regarding the various assets within GE Capital. Now trading above US$28, the shares continue to offer a dividend yield above 3% as well as further potential appreciation if the company executes its plan for GE Capital.

TFSA Changes

The recently announced federal budget included an increase in the annual Tax Free Savings Accounts (TFSA) contribution limits from $5,500 to $10,000. The change is in effect for 2015, meaning that clients who have contributed $5,500 this year may now add another $4,500. The total allowable contribution over the lifetime of the plan now rises to $41,000. The TFSA now takes on increased importance as a retirement savings vehicle, especially for younger Canadians who have years to compound their money on a tax-free basis.

The Oddity of Negative Interest Rates

In late February, the New York Times published a story about a 36-year-old Danish woman who had been approved for a small business loan at a negative interest rate. To be precise, her rate was -0.0172%, meaning the bank would be paying her a little over $1 per month in interest. One pundit quoted in the article called this "a once-in-a-lifetime and once-in-history phenomenon."[10] We would agree that this is a financial oddity of major proportions. Other Danes are now being charged money by banks to hold their money – the article gives an example of savers receiving a 0.5% negative interest rate.

Bonds issued by several European countries are now trading at levels that give them negative yields to maturity. For example, Switzerland recently became the first country to ever issue 10-year debt carrying a negative yield.[11] Some institutional investors with impractically large amounts to invest are willing to tolerate negative yields due to the perceived relative safety of the bonds in comparison to other European investments. Some commentators point to the risk of deflation as a possible reason. Whatever the justification given, negative interest rates are simply economic insanity. We do not expect negative rates to arrive in Canada, but strange things often happen.

Conclusion

North American stock price performance has been fairly resilient in the first quarter of 2015 (Q1), despite some disappointing economic data. While we are generally satisfied with the performance of client portfolios, we are also prepared to confront a number of potential risks to stock price performance in the coming years. In addition to holding high-quality Canadian investments, we will continue to seek opportunities in the United States and elsewhere in order to reduce risk and generate returns in this environment. As always, we thank you for your business and invite you to contact us with any questions.

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[1] http://www.cbc.ca/m/touch/news/story/1.3032198

[2] http://www.economist.com/news/finance-and-economics/21648624-housing-markets-across-globe-both-underperform-and-overwhelm-property-puzzles

[3] http://www.cbc.ca/news/business/genworth-homebuyer-survey-hints-one-third-of-new-owners-get-cash-from-family-1.3023404

[4] http://www.reuters.com/article/2015/04/15/us-toyota-mexico-idUSKBN0N61IF20150415

[5] http://business.financialpost.com/news/economy/job-quality-in-canada-dives-to-record-low-and-theres-no-relief-in-sight-cibc-report-says

[6] http://www.suncor.com/en/newsroom/5441.aspx?id=1934730

[7] http://www.cnrl.com/upload/media_element/880/05/0305_q414.pdf

[8] **These discretionary portfolios are now available to Papau Armstrong Schmidt Financial Group clients. These portfolios were managed by Michael Armstrong and Andrey Schmidt prior to joining CIBC Wood Gundy and are now being co-managed with David Papau. We are offering these portfolios along with our Balanced Portfolio as part of our discretionary service for clients. Please contact us for more information regarding these discretionary portfolios.**

[9] http://www.genewsroom.com/press-releases/ge-create-simpler-more-valuable-industrial-company-selling-most-ge-capital-assets

[10] http://www.nytimes.com/2015/02/28/business/dealbook/in-europe-bond-yields-and-interest-rates-go-through-the-looking-glass.html?hp&action=click&pgtype=Homepage&module=second-column-region&region=top-news&WT.nav=top-news&_r=2

[11] http://www.marketwatch.com/story/behold-the-new-world-order-of-government-bond-yields-2015-03-23