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TOP BUSINESS STORIES OF 2014

THE OIL PRICE COLLAPSE

It was, to paraphrase Charles Dickens, the best of times and worst of times for the Canadian energy sector in 2014. The first half was marked by a steadily rising WTI oil price (+7.1%); the US economy recovering strongly from a difficult winter; and positive taxation concessions from the BC government on liquefied natural gas expansion. The S&P/TSX Energy Sector gained 19.2% through the first half. However, a combination of tepid economic data out of Europe and China, and steadily declining demand forecasts from the International Energy Agency created a much more difficult environment in the second half.

Of course, the most damaging blow to the energy sector was OPEC's late-November decision not to cut its production quotas. It was a significant shot across the bow in the ongoing 'cold war' between US shale producers and Saudi Arabia. The US has seen its domestic oil production expand from less than 4 mln b/d during the heart of the credit crisis to more than 9 mln b/d currently, which finally prompted OPEC to take action, or more accurately, inaction. Failing to cut production signalled that Saudi Arabia, which ostensibly has a much lower breakeven price than US producers, was willing to create abundant supply in order to drive prices lower, thereby shutting in US supply and preserving market share. The oil price ended the year down more than 50% from its June highs, essentially cut in half at US$53.27/bbl.

Our Take for 2015

We have long-term concerns regarding the energy sector driven by abundant supply and ever-improving extraction technologies, which are making oil production easier and more cost-effective. Further, the S&P/TSX Energy sector has underperformed global equity markets for more than 6 years and, given recent developments and excess global supply, there seems to be little on the horizon to change this pattern of long-term underperformance.

S&P/TSX Energy Index Relative to MSCI World (Global Equities):
Canadian Energy a Consistent Underperformer

Source: Bloomberg, Raymond James Ltd.

However, we believe that the near-term outlook for the oil & gas sector is more favourable. Valuations are attractive with some Canadian oil & gas stocks trading at 30% or more discounts to their long-term averages and with market participants starting to find value in the energy sector as witnessed by the $13.1 bln takeover announcement of Talisman Energy by Spanish oil-giant Repsol SA late in the year (see below “Let’s Make a Deal”). It’s also clear to us that both US shale producers and OPEC countries, even Saudi Arabia, are losing money at current oil prices. We highlight that although Saudi Arabia’s ostensible breakeven price (somewhere between ~US$10-20/bbl) is much lower than North American breakeven prices, it’s true breakeven price is much higher, perhaps closer to US$80/bbl (we’ve read some commentaries listing it as high as US$100/bbl). Saudi Arabia must spend billions combatting Arab Spring pro-democracy movements and to do this it must maintain extremely high standards of living for its citizens, which means, among other expenditures, offering big raises for government employees. Further, other OPEC nations have much higher breakeven costs, so it is doubtful that Saudi Arabia can be inflexible indefinitely with current output levels. It’s also likely that US producers will begin shelving some of their more expensive expansion projects (we’ve already seen 2015 capital expenditure budgets slashed for many Canadian and US producers). There’s also an old Wall Street expression that the best time to buy is when there’s “blood in the streets”. In other words, when the market is most fearful is when it’s closest to capitulation. Judging by the recent headlines, the market is certainly at or near panic levels with respect to the oil industry.

A potential early 2015 rally for the energy sector, continuing good performance in our consumer space (the S&P/TSX Consumer Staples and S&P/TSX Consumer Discretionary Indices were up 46.9% and 26.4%, respectively, in 2014) and expected strength in the US economy (see “Quantitative Easing Finally Ended”) position Canadian corporations and equities for a reasonably strong 2015. Despite the oil price concerns, the Canadian market still performed well in 2014 with the S&P/TSX Composite up 7.4% (10.5% if dividends are included). The Canadian equity market has in the past proven resilient in the face of lower oil prices. WTI oil, for example, averaged only US$20/bbl during the 1990s yet the S&P/TSX Composite advanced 112% (7.8% annually) including dividends.

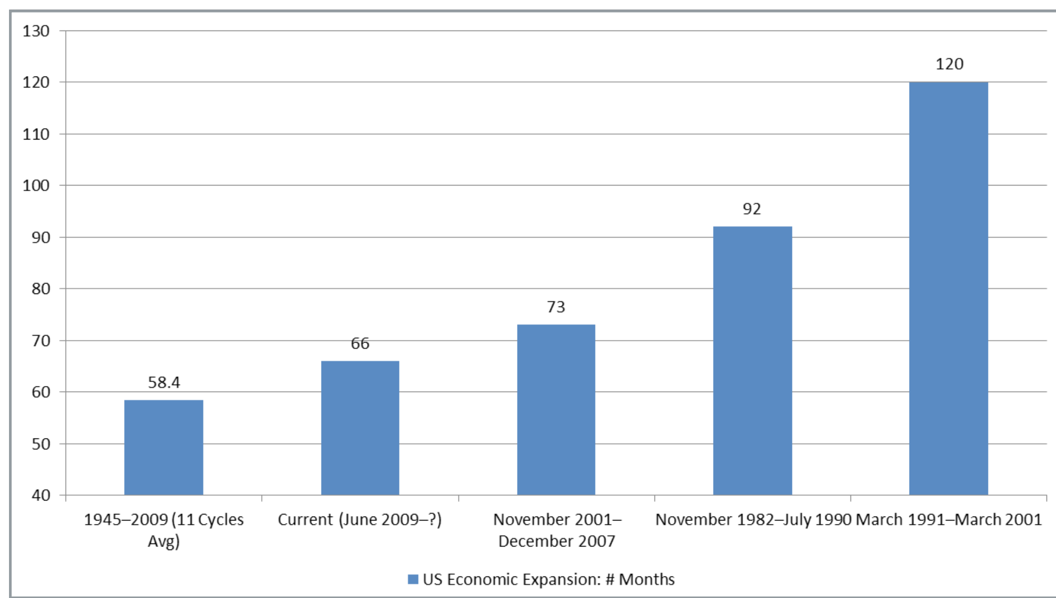
QUANTITATIVE EASING FINALLY ENDED

After three rounds of quantitative easing that saw the US Federal Reserve’s balance sheet expand from less than US$1 trillion (trn) before the credit crisis to more than US$4.5 trn currently, the Fed finally stopped the printing presses and ended its monthly purchases of bonds and other fixed income assets. The third, and apparently final, round of quantitative easing (QE3) was announced on September 13, 2012 and was concluded on October 29, 2014. QE is widely considered a key catalyst in the current US bull market, and thus, not surprisingly, the S&P 500 gained 41.9% on a total return basis (17.9% annualized) during QE3 (announcement date to wrap-up). Investors therefore became concerned as to whether North American equity markets would be able to stand on their own without the benefit of Fed stimulus. Despite some initial volatility in October, the S&P 500 resumed its ascent to finish the year near record highs, up 11.4% for the year (13.7% with dividends). The Dow Jones Industrial Average also crossed above the 18,000 level for the first time ever late in December.

Our Take for 2015

The majority of economic data suggests that the US economy remains healthy, which should continue to be supportive of equity markets. US GDP, despite setbacks at the beginning of the year due to unseasonably poor weather, finished the year strong with Q3 growth revised up to a very robust 5.0% in late December. The US labour market also performed well in 2014 with US monthly non-farm payrolls (a key job-market metric) averaging 241k compared to 194k in 2013, 186k in 2012 and -298k during 2008. The US unemployment rate has also steadily declined from a high of 10% in October 2009 to 5.8% at November 2014. The US unemployment rate now sits well below the Canadian unemployment rate at 6.6%. We believe the US economy is currently strong enough to no longer require Fed stimulus and we fully expect interest rate increases to begin mid-2015 or perhaps sooner if the economic data is supportive. Consensus also expects corporate profits to grow 13% y-o-y in 2015, which may prove optimistic, but certainly reflects the strength of the US economy.

Duration of Current US Economic Expansion Has Passed Long-Term Average, But Still Well Below Most Recent Expansions



Source: National Bureau of Economic Research

MAJOR EUROPEAN MARKETS STRUGGLED

Eurozone economies continued to struggle in 2014, particularly with low inflation. Inflation in Europe ended the year at only 0.3%—it was at 3.0% at the start of 2012 and has averaged 1.7% over the past five years. Periphery economies also continued their multi-year struggle. For example, the Greece unemployment rate ended the year at 25% and Spain at 24%. In June, the European Central Bank (ECB) became the first central bank to effectively take one of its key rates below zero, thus actually charging banks to hold money and encouraging them to lend. However, so far this has had a limited effect as inflation continues to fall, so the ECB's attempts to kick-start the Eurozone economy will be a key market focus in 2015. Most key European equity markets significantly lagged other global benchmarks in 2014.

Our Take for 2015

The big question now is will the ECB implement US-style quantitative easing. As a reminder, quantitative easing basically equates to government economic stimulus or the indirect printing of money to buy various fixed income securities thus keeping yields low to encourage both borrowing and the transfer of wealth to riskier assets such as equities. So far, the ECB has been buying various types of fixed income securities, but the main question is will they directly buy government debt. It's complicated, of course, by the Eurozone being 18 nations, so deciding what is bought and in what quantities is a major obstacle; the US and Japan, by comparison, had a relatively easier task with their QE programs—they only had to buy the fixed-income securities of one country, their own. European bond

yields (see “Bond Yields Continued to Fall”) are also already so low that there is some question as to whether QE (bond buying) will have much impact. Until the ECB has better articulated what its stimulus strategy will be, we advise investors to remain cautious of Europe as we start 2015. Valuations are attractive and Europe could be poised to outperform in 2015, but we would prefer a more clearly articulated ECB stimulus strategy.

MAINLAND CHINA: THE WORLD’S BEST PERFORMING MAJOR MARKET

The Chinese economy disappointed in 2014 due to a weak housing market, a ramp up in bad loans and muted lending from banks. China will likely finish the year with GDP growth just above 7% but still a far cry from the 10.6% growth that its economy averaged from 2004–2007 or even the 9.9% seen in 2010–2011. China, in short, is struggling to move away from an export and infrastructure-spending driven economy to a more fully integrated capital market system. So in late November, the market reacted very positively to the Chinese government opening up its markets more to outside investors. China announced that it would be establishing a trading link with Hong Kong (The Shanghai-Hong Kong Stock Connect) to establish freer trading between the two markets. Investors are now able to buy and sell an additional 568 Shanghai-listed equities. Mainland investors, meanwhile, are able to buy and sell 268 Hong Kong-listed stocks. This opens up foreign investment in many domestic Chinese stocks for the first time. A more accessible Shanghai market resulted in a 12% gain for the CSI 300 in November and a further 26% gain in December. Overall, the CSI 300 jumped 51.7% in 2014.

Our Take for 2015

There are currently daily quotas for buying mainland China securities (roughly US$2.1 bln), but if these quotas are raised, which many expect, there could be a further move higher for the CSI 300. Further, if China were to open up sufficiently to convince the MSCI, which is a major equity benchmark creator, to include the country’s shares in its flagship emerging markets index, then it could attract additional purchases from fund managers. (Fund managers often don’t buy securities unless they’re represented in a major index.) There remain a lot of questions, but the CSI 300, we believe, is one of the most important indices to keep an eye on in 2015. The Chinese domestic market in its entirety is worth about US$4.8 trn, so if it opens up further, look out.

The CSI 300 is volatile; however, the recent move in the relative strength chart of the CSI 300 vs. the MSCI World Index (global equities) is significant (see below). After testing the trendline multiple times over the past five years and failing to break above, the CSI 300 near year-end cleanly broke through. The more a trendline is tested with failure to break out, the more significant it becomes when resistance is finally overcome. Relative strength charts posit that periods of underperformance and outperformance tend to persist for many years. Could we now be entering a period of CSI 300 outperformance of global equities? We believe the CSI 300 is clearly a market to watch in 2015.

CSI 300 Relative to MSCI World: Major Upside Breakout

Source: Bloomberg, Raymond James Ltd.

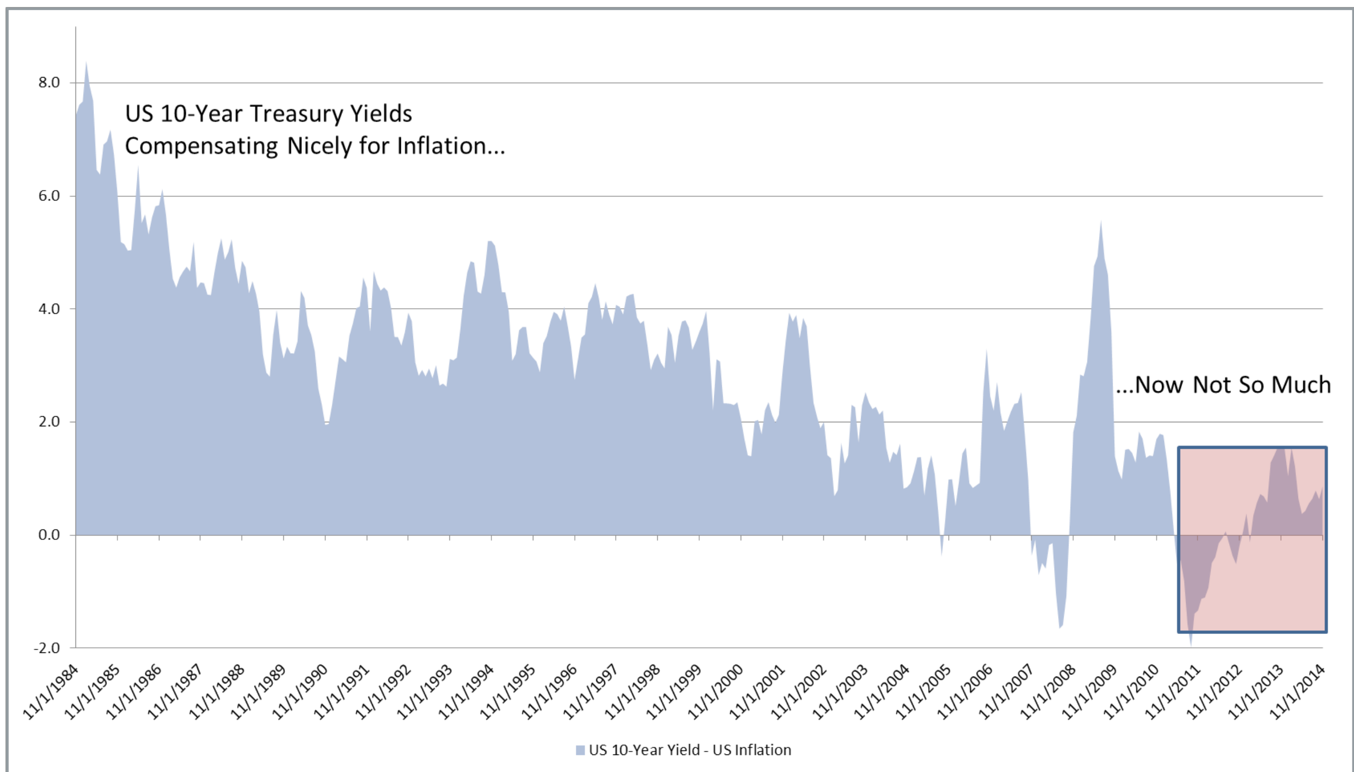
BOND YIELDS CONTINUED TO FALL

To the surprise of many, global economic uncertainty, particularly in Europe, drove bond yields lower. Remember there is an inverse relationship between yields and prices, so bond prices gained in 2014. The US 10-year Treasury yield lost nearly a full percentage point in yield, dropping from 3.0% at the start of the year to only 2.2% at year-end. For several years now, the US 10-year Treasury has barely covered inflation, or the basic cost of living (see chart below). Canadian bond yields experienced a similar decline with our 10-year declining from 2.8% to 1.8%. In fact, low yields continued to be the norm throughout most of the world. The Japanese 10-year bond yield, for example, fell from 0.7% at the start of the year to 0.3% at year-end and the German 10-year yield dropped from 1.9% to 0.5%.

Our Take for 2015

Declining bond yields is the trend most likely to reverse in 2015, at least in North America, as the US Federal Reserve is poised to begin raising rates likely by mid-2015. However, we expect the rise in yields to be gradual as the Fed has telegraphed its intentions to raise rates quite clearly to the market. Economists and analysts have certainly had difficulty (including us) timing the end of the epic 30-year bond bull market, but we believe investors, who have been achieving strong equity market returns and will, once again, realize almost nothing after inflation with bond yields (see chart below), will begin rotating out of fixed income into potentially more attractive equity markets.

US 10-Year Treasury Yield/US Inflation Spread: Treasuries Are Barely Compensating for Inflation



Source: Bloomberg, Raymond James Ltd. US 10-year Treasury Yield minus US CPI (Consumer Prices).

EBOLA: FEAR ITSELF?

Concerns over Ebola, a virus where the average death rate is roughly 50%, but can be as high as 90% in regions without proper medical care, made it on to North American radars in July when a Liberian government employee died of the virus, forcing Liberia, a West African country, to shut down most of its border crossings. The World Health Organization declared Ebola an “international health emergency” in August and the first person was diagnosed with the virus on US soil in late September, which caused media attention to reach a fever pitch. However, by year-end, much of the attention surrounding the disease dissipated as concerns over its spread in North America appeared to be exaggerated.

Our Take for 2015

The market, from time to time, finds a contagious disease or two to focus on (remember SARS? mad cow disease? avian bird flu?). These random outbreaks are hard to predict and can cause short-term market volatility. However, we encourage investors to focus on the usually very effective global healthcare response and to not get overly focused on the fear-inducing headlines. The market moves relatively quickly on to other issues. While not minimizing the seriousness of these viruses, fears of a zombie apocalypse are overblown.

“Ebola”* (White Line) Likely Caused Some Second Half Market Volatility (Orange)

Source: Bloomberg, Raymond James Ltd. * Bloomberg news stories mentioning keyword “Ebola” from June–November 2014 vs. CBOE SPX Volatility Index

RUSSIA: ON THE EDGE

After taunting Western nations by repeatedly and forcibly entering into Ukraine territory with so-called stealth invasions, Russia subsequently faced the full wrath of international sanctions, which became even more effective and devastating as the oil price plunged (see “The Oil Price Collapse” above). Russia entered into full crisis mode near year-end and raised its key interest rate to an eye-popping 17% in order to control the collapse of the ruble. The ruble still declined around 45% in 2014 vs. the US dollar. Russia ended the year on the brink of recession.

Our Take for 2015

2014 highlighted how leveraged the Russian equity market and economy are to the oil price. We get enough of that with Canada, plus the Russian market (the MICEX Index) is more than twice as volatile as the Canadian market. Further, Russia has now firmly established itself as an international pariah. In our view, there is no need to have exposure to this region.

JAPAN: ANOTHER RECESSION

Economists became increasingly disenchanted with Japanese Prime Minister Shinzo Abe's economic policies as an April sales tax hike, from 5% to 8%, helped plunge the economy into recession. At roughly the same time as the tax hike, Japan also announced an expansion of its stimulus program via more open-ended asset buying, committing to roughly double the country's monetary base by year-end to JPY270 trn (US$2.9 trn). The Japanese government remains stuck between a rock and a hard place attempting to control public debt (hence the tax hike) yet at the same time trying to stimulate the economy (hence the expanded asset buying). Neither approach worked effectively as the country drifted into recession. However, Japanese equity markets actually managed a modest positive return (+7% for the Nikkei 225), in part due to the continued debasing of the Japanese yen, which was supportive of corporate profits, and the weakening oil price, which alleviated energy import costs.

Our Take for 2015

Late 2014 data indicated that foreign fund flows into Japanese markets were down 94% y-o-y, indicating that global investors are becoming less bullish on Japan. Japan also continues to struggle with demographic and structural disadvantages including the fact that a quarter of its population is over age 65 and their debt-to-GDP ratio is roughly 240%. Further, the Abe-inspired bull-run for the Nikkei 225 Index may be getting long in the tooth as the Index has rallied more than 79% since Abe became prime minister on December 16, 2012, more than double the gains of global equities overall. Also, while the US QE programs have managed to keep that country out of recession, Japan, unfortunately, has not benefitted in the same way from its own fiscal stimulus. A recession, combined with a potentially over-extended equity rally, makes us cautious on Japan in 2015.

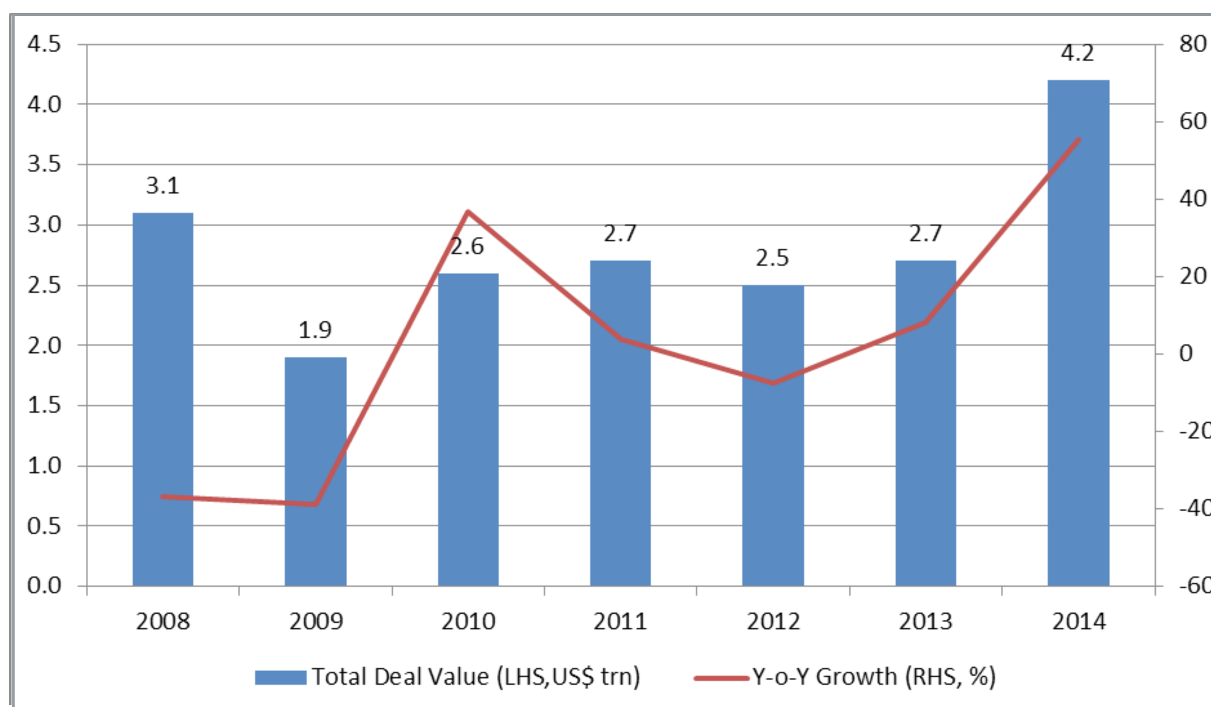
LET'S MAKE A DEAL: A BIG YEAR FOR MERGERS & ACQUISITIONS

M&A activity was extremely robust in 2014. Companies took advantage of low levels of corporate debt, plenty of available cash, low interest rates and healthy equity markets to wheel and deal at huge volume levels. There was US$4.2 trn in deals in the works globally in 2014, up nearly 60% y-o-y. Canada also got into the action with roughly US$135 bln in deals either announced, pending or completed, also a healthy 43% y-o-y increase. Our largest announced deal was the $13.1 bln Talisman Energy acquisition by Repsol SA and our largest completed deal was the $12.5 bln Tim Hortons takeover by Burger King Worldwide.

Our Take for 2015

M&A activity, of course, is not a clear indicator of future equity market direction, but the rise of M&A activity in the mid-2000s certainly contributed to the equity bull-run during those years. Growing deal sizes reflect corporate confidence, an accommodative interest rate environment and healthy balance sheets. 2015 M&A activity will have a tough time topping 2014 levels, but anything greater than US$2.5 trn would still mark a solid year.

2014: Huge Increase in Global M&A



Source: Bloomberg, Raymond James Ltd.

US DOLLAR: A CURRENCY POWERHOUSE

With Japan in recession, Canada struggling with low oil prices and Europe desperately trying to stimulate its economy, the year's standout economy was the US (see "Quantitative Easing Finally Ended"). Accordingly, the US dollar had a huge year with the US Dollar Index (DXY—the US dollar vs. a basket of world currencies) advancing more than 12%. The DXY has now gained more than 23% from its 2011 lows. Whether this marks the beginning of an even greater upside move, such as we saw in the mid-1990s to early 2000s when the US dollar advanced nearly 50%, remains to be seen; however, momentum is clearly on its side heading into 2015. The falling oil price, of course, also did no favours for the Canadian dollar as it fell more than 8% vs. the US dollar in 2014 to $0.86. The surging US dollar also created significant headwinds for the gold price (gold is denominated in US dollars therefore it became more expensive for foreign investors to purchase). After a brief rally in early 2014, the gold price dropped more than 13% throughout the remainder of the year, finishing almost perfectly flat overall at US$1,184/oz.

Our Take for 2015

Like it or not, the Canadian dollar is still a petro currency with the long-term correlation between the WTI oil price and CAD/USD at 92%, and rising even higher during the recent oil price decline. Therefore to be consistent with our call for a short-term bounce in the energy sector, we would expect the Canadian dollar to rally in early 2015, but given the persistent risks facing the oil industry, we believe it will continue to underperform the US dollar over the medium

to longer term. Investors also have to keep in mind that the long-term average for CAD/USD is only $0.81, so further downside is possible. However, for now, a short-term move to the high $0.80s may occur followed by a retreat back to the mid-C$0.80s where we think the Canadian dollar could be rangebound for the remainder of the year. The US dollar, meanwhile, remains well positioned to continue its rise against global currencies in 2015.

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