# TURNER INVESTMENTS COMMENTARY

**Hon. Garth Turner PC**

*Senior Vice President,*
*Private Client Group,*
*Financial Advisor*

416-346-0086

**Douglas Rowat**

*Vice President,*
*Private Client Group,*
*Portfolio Manager*

416-777-6403

**David Finley**

*Senior Vice President,*
*Private Client Group,*
*Financial Advisor*

416-777-7002

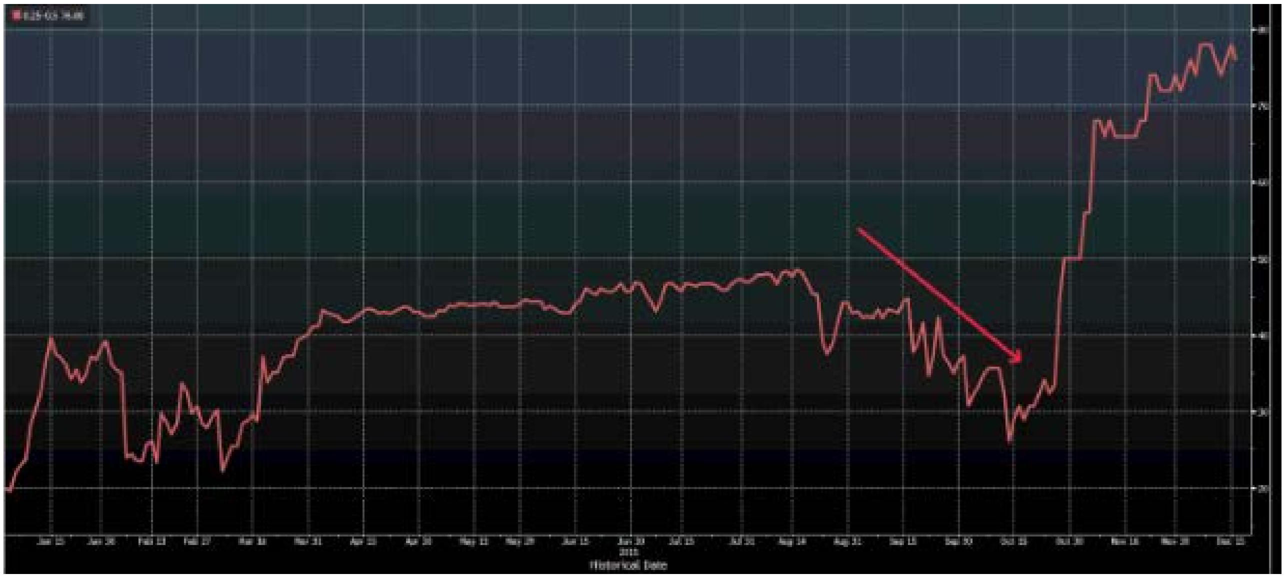
## TOP BUSINESS STORIES OF 2015

### THE US FEDERAL RESERVE RAISED INTEREST RATES

Will they or won't they? It was the year's mostly hotly debated topic before each and every US Federal Reserve (Fed) meeting in 2015. However, timing aside, it was simply assumed that the Fed would be raising its historically low benchmark overnight rate sometime before year-end. Then came the summer's market correction (see "US Markets Corrected" below). The volatility over the summer appeared to lead to conflict amongst Fed members and ultimately led to policy statements that some analysts called "maddening" in their lack of clarity. The Fed's decision to not raise rates at its September meeting due to concerns over global growth created significant market volatility, especially after the Fed stated that the global economy "could restrain US economic activity somewhat", which contradicted previous statements suggesting that the US economy was secularly strong. The market was also left to quantify the vague word "somewhat". This confusion was only amplified when individual Fed members spoke out afterwards and openly argued against the Fed's decision. The baffled market sent the implied odds of a Fed rate increase at its final meeting of the year on December 16 plunging, to a low of only 27% in October. In other words, investors and analysts now concluded there would be no interest rate increase in 2015.

Likely recognizing that it had actually *contributed* to market volatility rather than eased it, the Fed then made a concerted effort throughout the remainder of the year to clearly telegraph to markets that it would most definitely be raising rates by year-end. The Fed's October statement actually referenced a possible hike "at its next meeting", which was interpreted as a clear hint that a rate increase was coming. The odds of a December rate increase shot up accordingly (see chart below). Then—finally—on December 16 it happened: the Fed raised rates a quarter point to 0.50% ending the longest streak in modern history without a rate increase—roughly 114 months. The previous record had been a mere 49 months from May 2000 to June 2004. The era of cheap money and rock-bottom interest rates had come to an end.

**Dazed and Confused: Odds of a Year-End Fed Rate Increase Plunged in September and October**

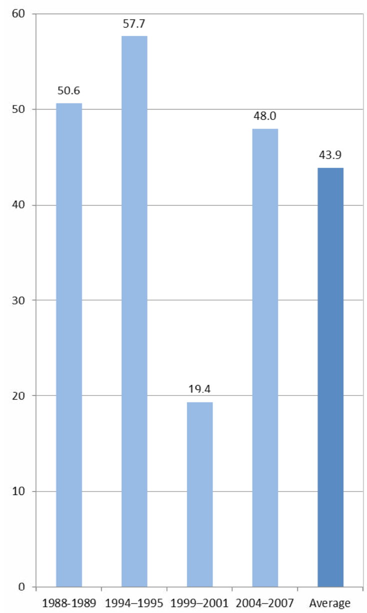


Source: Bloomberg. Chart illustrates the implied odds of a rate increase at the Fed's December 2015 meeting. The October low was 27% before rising to nearly 80% by year-end.

## *Our Take for 2016*

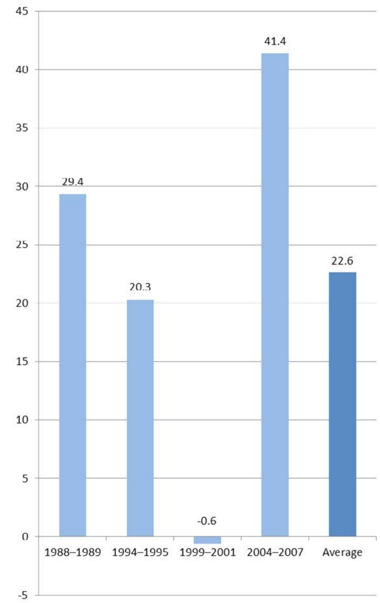
We're pleased that this seemingly endless debate over the Fed's rate decision, which has been overhanging the market for years, has now finally been resolved. However, attention must now be paid to the pace of future increases. The vote amongst Fed members at the December meeting was unanimously in favour of the rate increase, so this suggests the Fed's high level of conviction in both the strength of the US economy and its willingness to steadily raise rates in the future. We expect the increases will be done at a modest pace and there may even be lengthy periods of no increases, but the trend in interest rates over the next few years, we believe, will be unmistakably higher. How high? It's a difficult question to answer at such an early stage. The last four Fed rate-hike cycles all ended with the overnight rate above 5%, but such a level is unlikely this time given the very low base interest rates will be moving off of. The 25-year average for the Fed overnight rate is 3%, which we believe is a reasonable target. The past four interest rate–increase cycles have also lasted on average just shy of two years and have averaged 10 raises. We would expect this cycle to last a similar length of time. However, regardless of the duration or number of increases, we expect that corporate profitability and markets will be able to advance at a reasonable pace as interest rates steadily grind higher. The below chart highlights the profit growth and return of the S&P 500 over the past four Fed rate-hike cycles.

## S&P 500 Earnings Growth (%) During Previous Fed Rate-Hike Cycles




Source: Bloomberg, Raymond James Ltd. A rate-hike cycle is defined as a period of multiple increases in the Federal Funds benchmark overnight rate. Any rate cut ends the cycle. Earnings growth not annualized.

## S&P 500 Returns (%) During Previous Fed Rate-Hike Cycles

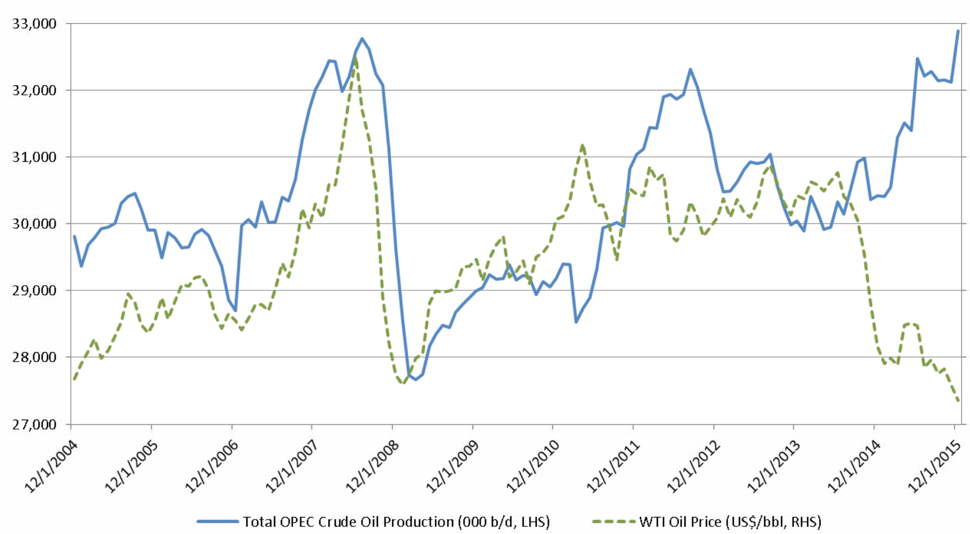



Source: Bloomberg, Raymond James Ltd. A rate-hike cycle is defined as a period of multiple increases in the Federal Funds benchmark overnight rate. Any rate cut ends the cycle. Market returns not annualized. Total return.

# THE OIL PRICE CONTINUED TO COLLAPSE

We thought 2014 presented the perfect storm for oil prices. We were wrong: the 2015 storm proved almost as perfect. After falling nearly 46% in 2014, the West Texas Intermediate (WTI) oil price plunged more than 30% in 2015 ending the year near its credit-crisis lows, and down almost 68% from its 2011 highs! Oil staged a brief rally to start the year, but the rally faded quickly after concerns rose over China's slowing economy (see "China: Volatile As Usual" below). As with 2014 however, an equally damaging blow for oil came from a late-in-the-year OPEC decision to maintain its production quotas. Mainly driven by Saudi Arabia, one of OPEC's lowest cost producers, OPEC declined to reduce its current production of 31.5 million b/d (an official rate—many believe actual output is higher). There was clear dissent within the OPEC ranks as other members with weaker economies indicated that they would prefer lower output to support prices; however, ultimately, OPEC remained committed to escalating its war with US shale producers and to forcing foreign oil and gas giants to mothball future, large-scale development projects.

## Zero Supply Reduction in 2015: OPEC Remains Committed to Driving Oil Prices Lower




Source: Bloomberg

### *Our Take for 2016*

Granted it seems pretty grim; however, as mentioned, the oil price ended the year near credit-crisis lows indicating that investors will likely start to recognize at least some value in the energy sector in 2016. We're also confident that almost all major oil producing countries are suffering significantly at current prices suggesting an eventual supply response either through lower production from OPEC or major development projects being scrapped. Oil has also declined sharply for two years in a row and we highlight that the last time it declined *three* years in a row was 28 years ago—in other words three down years for oil is a very rare occurrence. Oil is a volatile commodity and typically one or two sharp down years result in a similarly sharp recovery. For instance, the last time oil had back-to-back negative years (1997 and 1998—down more than 30% in both years) it rebounded the following year by 112%. While we certainly don't forecast such an upside move in 2016, we do believe a 'recovery bounce' is possible. This is why we feel it's important to still have exposure to Canada even though after 2015 it's tempting to abandon Canada completely (see "Woe Canada: Our Economic Struggles Continued" for other reasons to have Canada exposure).

However, these factors suggesting a move higher in the oil price must also be counterbalanced by the new reality of the oil industry—thanks to better discovery and extraction technologies oil supply is easily ramped up, which could cap any short- or medium-term price rallies. OPEC also appears willing to take its war with foreign oil producers to the limit. We believe there could be some modest strength in the oil price in 2016, but the days of US$100/bbl+ oil that we've seen in the recent past are long gone.

## US MARKETS CORRECTED

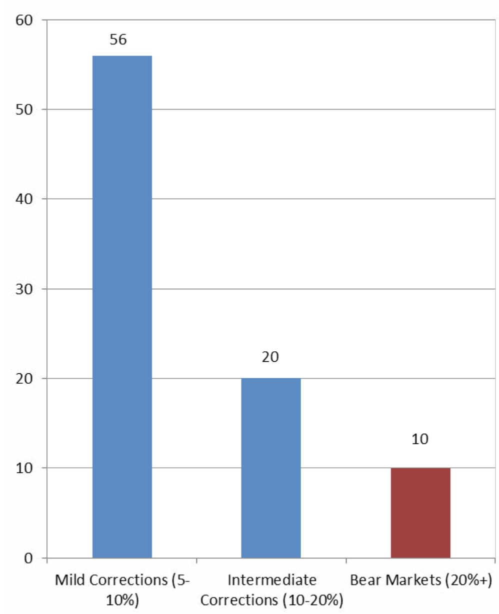
It had been roughly four years since the last intermediate market correction (a decline of more than 10%) for the S&P 500, but the benchmark US equity index finally succumbed to the pressure of China's slowing economy as well as the spring threat of a 'Grexit'. The S&P 500 dropped by more than 12% from its May highs before bottoming in early July. Ultimately, the S&P 500 finished 2015 down only slightly as it rallied strongly from its summer lows. Reasonably solid corporate earnings, strong economic data—in particular, labour market data—and more clarity from the US Fed on its interest rate policy were key drivers of the second-half rally.

### *Our Take for 2016*

Corrections tend to be short-lived and occur suddenly. The peak-to-trough duration for a mild correction, for example, is only about one month. Also, because corrections are frequent and occur often for imprecise reasons, consistently predicting them is nearly impossible. Therefore, there is little opportunity, or point, to attempt to reposition portfolios in anticipation of one. Further, we view corrections as a long-term positive: an important and necessary way for markets to reset their valuations (or 'blow off steam'), thus preventing more dangerous bubble formations from occurring further down the road.

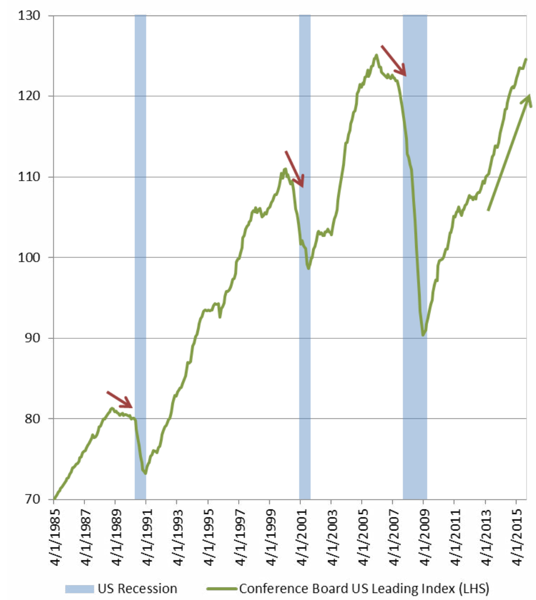
Bear markets, however, are different. Bear markets are not only longer lasting and much more severe than corrections, but, fortunately, much rarer and with causes that can be determined with more accuracy. Bear markets are almost always accompanied by recessions; therefore, if you can forecast a looming recession with even partial accuracy you may be able to avoid some of a bear market's damage. We view the 2015 S&P 500 correction as a normal occurrence within a long-term bull-market cycle and we further forecast a low likelihood of a US recession in 2016. US leading economic indicators, a combination of 10 key economic data points and one of many measures that we use to determine the likelihood of a US recession, presently show little cause for concern (see chart below right). We look for leading indicators to 'roll over' as a warning sign, but this is currently not occurring.

**Market Corrections Are Frequent**




Source: RBC, Raymond James Ltd. Chart notes number of S&P 500 corrections and bear markets since 1945.

**Still Little Indication of a US Recession**




Source: Bloomberg

## JAPAN: LAND OF THE RISING MARKET

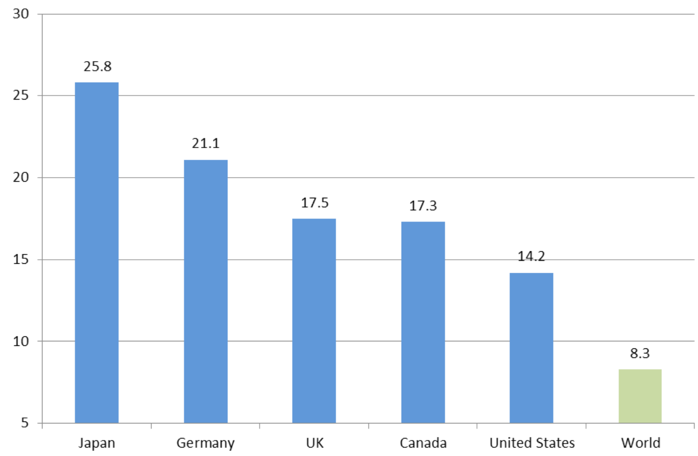
Typically, when a country falls into recession investors must be prepared for lacklustre performance from that country's equity market (a good example: Canada in 2015). However, such was not the case with Japanese markets in 2015. Japan fell into yet another recession this past year, remarkably its fourth in five years, as the country continues to battle deflation and a rapidly aging workforce. Normally, this would be cause for equity-market concern; however, Japanese markets *gained* in 2015 with the Nikkei 225 returning more than 9%. Ironically, it was assumed that the weak Japanese economy would lead to even more government fiscal stimulus, which was also a positive driver for equities in 2013 and 2014. Japan has absorbed a massive deficit over the past several years in order to stimulate its economy and indirectly spent trillions of yen to create inflation and liquidity. Japanese corporations meanwhile have also been benefitting from low Japanese wages and a weak Japanese yen, both of which have aided corporate profitability.

### *Our Take for 2016*

We highlight that it is extremely rare for Canadian investors to have any exposure to Japan, yet our clients have a portfolio weighting to Japan of roughly 3–4% (via their iShares MSCI EAFE ETFs). However, despite several years of strong market performance, we are not prepared to increase our Japanese weighting. We remain concerned over the long term by Japan's aging population (see chart below left) and note that there is risk that the Japanese government may eventually enact legislation that is detrimental to equities such as raising the minimum wage or, more significantly, reducing or eliminating its fiscal stimulus program. Eventually, we believe Japan's lack of forward economic progress will have a negative impact on its equity market.

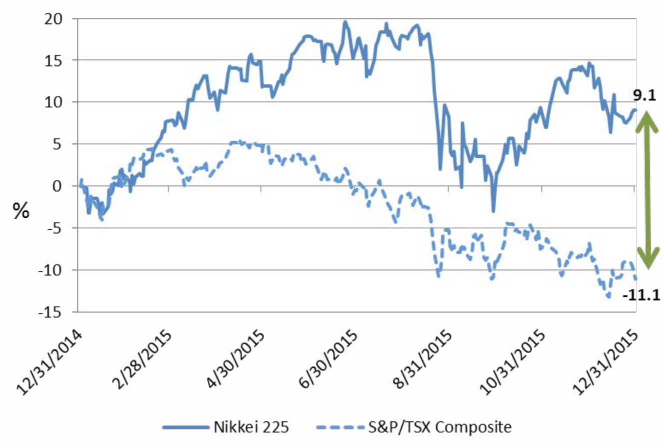
However, there are significant diversification benefits to having some Japanese exposure as it's a country that benefits from weak oil prices. Not surprisingly, Japanese equities have actually had a *negative* correlation to Canadian equities over the past several years and in 2015—a year of weak oil prices—the Canadian and Japanese markets moved in nearly opposite directions (see chart below right).

**% Population Over 65 Years**




Source: Bloomberg

**Japan vs. Canada: Japan an Excellent Hedge Against Weak Oil Prices**




Source: Bloomberg. % market returns for 2015. Simple price appreciation.

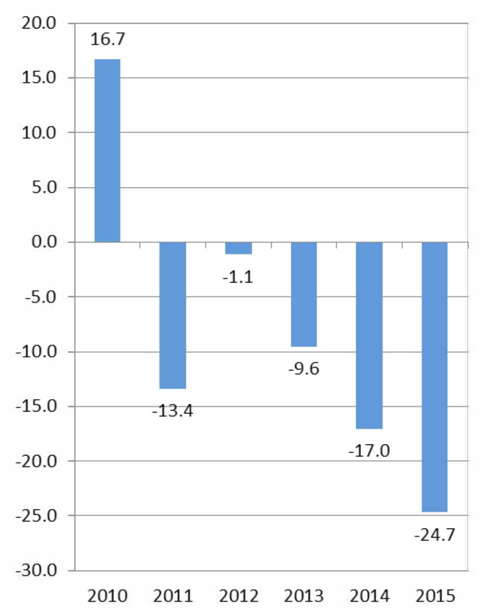
## WOE CANADA: OUR ECONOMIC STRUGGLES CONTINUED

While there were certainly many factors that led to Canada falling into recession in 2015, there was really only one main contributor: plunging commodity prices. The Bloomberg Commodity Index is comprised of various commodities ranging from grains, natural gas, oil, copper and gold. 2015 marked the fifth consecutive year of declines for the index and the Canadian economy finally gave out, no longer able to withstand the negative impact of weak prices. Lost in the shadow of 2015's drop in oil prices were an 11% and 26% fall in the price of gold and copper, respectively. While Canada did, technically, pull out of its recession part way through the year, the economy still remains weak and will likely end up showing barely 1% GDP growth for 2015.

### *Our Take for 2016*

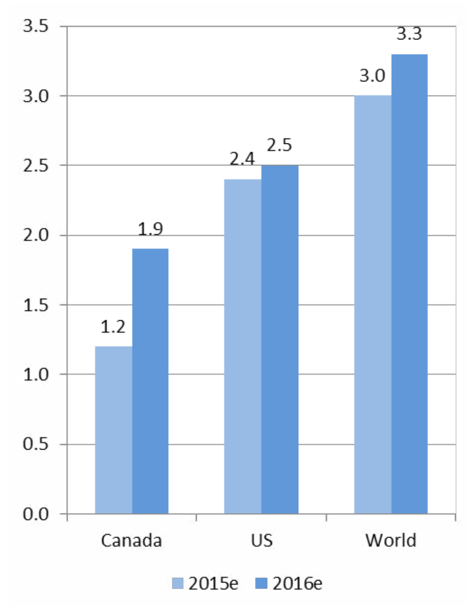
While consensus does expect 2016 to be a better year for Canada economically, it still seems likely that our growth rate will significantly trail that of the US and the rest of the world (see chart below right). One more reason why we keep our clients' portfolios focused more on global markets. However, while it's tempting to remove Canadian exposure completely from portfolios after 2015, it's important to remember that the Canadian market has managed to perform quite well in a weak commodity-price environment. For instance, the oil price averaged less than US$20/bbl during the 1990s and only once moved above US$40/bbl (during the Gulf War in the early 1990s) yet the Canadian market still managed to return 8% per year over the decade, including dividends. Not surprisingly, other sectors, such as consumer discretionary, consumer staples and financials, filled the gap left by energy. Even in 2015, despite another horrendous year for commodity prices, Canadian banks remained highly profitable with combined fiscal-year profits of more than $35 bln—a tribute to their geographic and business-segment diversification. A weak energy sector is not positive for Canada, but it's not the end of the world either.

**Bloomberg Commodity Index: Five Consecutive Years of Declines**




Source: Bloomberg. % y-o-y price change.

**Canada's 2016 GDP Growth (%) Expected to Again Trail US and the World**




Source: Bloomberg. Consensus forecasts.

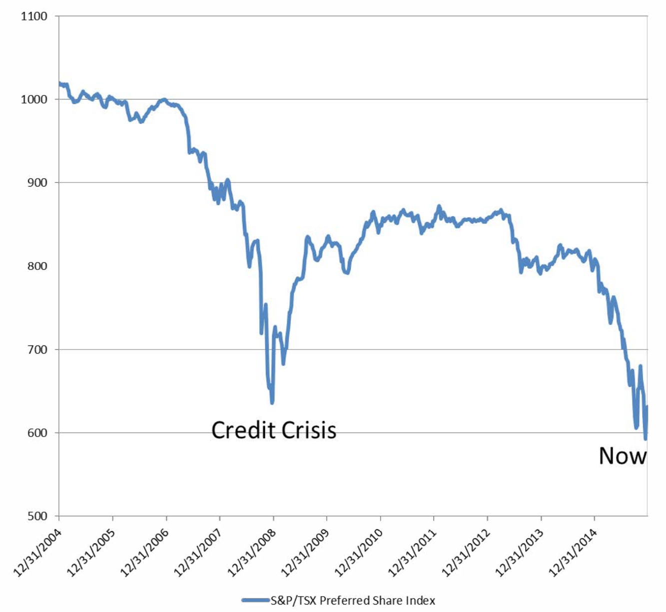
## TOUGH YEAR FOR CANADIAN PREFERRED SHARES

If there's one thing that Canadian preferred shares don't like it's falling interest rates. The two Bank of Canada interest rate cuts in 2015 sealed the fate of Canadian preferred share prices and led to one of the weakest performances for preferred shares since the credit crisis. Companies, particularly banks, creating abundant supply through new issuance, retail-investor selling, which tends to be undisciplined and reactionary, and finally downward pressure at year-end from tax-loss selling put the finishing touches on a year to forget for Canadian preferred shares. Preferred share prices fell a remarkable 19% in 2015. The attractive dividends limited the downside somewhat, but even after dividends, the sector still declined almost 15%.

### *Our Take for 2016*

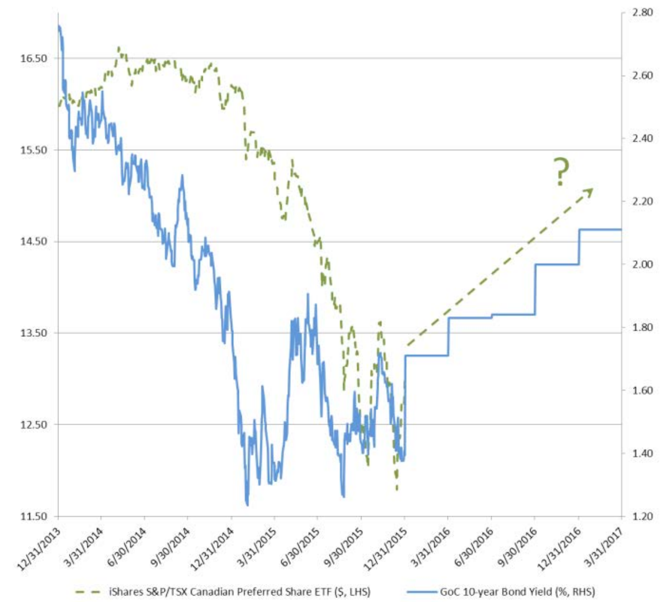
While 2015 was a dark year for Canadian preferreds, it wasn't without hope. At year-end, we finally saw the US Federal Reserve raise its overnight rate and we believe this could mark an extended period of steadily higher North American interest rates. The correlation between the US benchmark overnight rate and our own benchmark rate has been close to 90% over the past 30 years and we believe the Bank of Canada will not be able to adopt an interest rate policy that's in opposition to the US's for long. More importantly, the correlation between the US 5-year Treasury yield and the Government of Canada (GoC) 5-year bond yield has been greater than 95% over the past 30 years. Inevitably, where US bond yields go, Canadian bonds follow. Because most Canadian preferred shares are structured as 'rate resets' their dividends are indirectly pegged to the GoC 5-year bond yield. Therefore rising interest rates and bond yields are positive for prices. Given our interest rate outlook, we believe preferred shares are an important asset class for our clients to have exposure to over the next several years. Preferred share yields are now also compelling (roughly 5%) due to the 2015 sell-off and we believe this yield has become very attractive vs. other fixed income vehicles, such as corporate bonds, which could create additional buying interest for preferreds in 2016.

**It Would Likely be a Mistake to Sell Preferred Shares at Distressed Levels…**




Source: Bloomberg

**…And There's Upside Potential if Bond Yields Rise**




Source: Bloomberg. Rate-reset preferreds are pegged to GoC 5-year bond yields, but forecasts are only available for the 10-year yield. The overall relationship is similar however. The bond yields beyond 2015 represent the consensus forecast of 20 leading economists.

## CHINA: VOLATILE AS USUAL

It began with a bubble, as most major market problems usually do. From its June 2013 lows the Shanghai Stock Exchange Composite Index soared an incredible 164%, reaching a post–credit crisis high in June 2015. The return of the Shanghai Composite over this period was more than seven times the return of global equities overall! The dramatic gains were driven, as they always are, by rampant speculation. Ordinary Chinese investors were the cause of much of this recklessness as the Chinese government, in attempting to create more open and transparent markets, allowed retail investors to, in an almost entirely unregulated way, borrow money to invest, which they willingly did, driving the Shanghai Composite to unsustainable levels. Pure gamblers drove margin debt to a peak on June 18 of 2.27 trillion yuan (about US$370 bln), almost exactly coinciding with the Shanghai Composite's peak. Then, as the market began to unravel, the selling pressure from margin calls intensified and this margin balance fell in less than a month to only about 800 billion yuan. From its June 2015 high, the Shanghai Composite plunged an amazing 43% in just over two months before finally regaining some lost ground near year-end.

The market rollercoaster was also simultaneously accompanied by a devaluing of the yuan, an unexpected move by the Chinese government and one that raised concerns over China's economic growth. A devalued yuan was seen as a way for China to boost exports by making its goods cheaper abroad. This raised red flags for investors globally as the currency devaluation indicated a potential economic slowdown and prompted the summer sell-off for markets worldwide.

## *Our Take for 2016*

China was never going to be able to sustain the GDP growth rate that it enjoyed during the 2000s of better than 10% annually, so a moderation of this rate was inevitable. Even at around 7% GDP growth for 2015 (the current consensus estimate), China maintains an economic expansion many times that of most developed countries. Further, creating a new, more market-oriented regime for a country so large and underdeveloped is bound to be done imperfectly, which was certainly the case in 2015. While there are significant risks to investing in China, namely the country's large debt load and increasingly unstable housing market, we highlight that embracing volatility has always been the trade-off to gain exposure to this region's growth. In fact, the Shanghai Composite over the past 10 years has been about twice as volatile as the S&P 500. Because of this risk, we keep our clients' exposure to China modest (for now just 1–2%), but we want to ensure our clients still have exposure to the market's growth potential. And the growth has been incredible: including dividends, the Shanghai Composite has returned 14% per year over the past decade vs. only a little more than a 7% annual gain for the S&P 500. Even in 2015, for all its turmoil and volatility, the Chinese market still gained more than 9% vs. a slightly negative performance for the S&P 500.

**Living With Volatility: China Almost Always Riskier Than the US**


Source: Bloomberg. Rolling 6-month standard deviation. Standard deviation measures the level of variance or volatility of a particular market's returns.

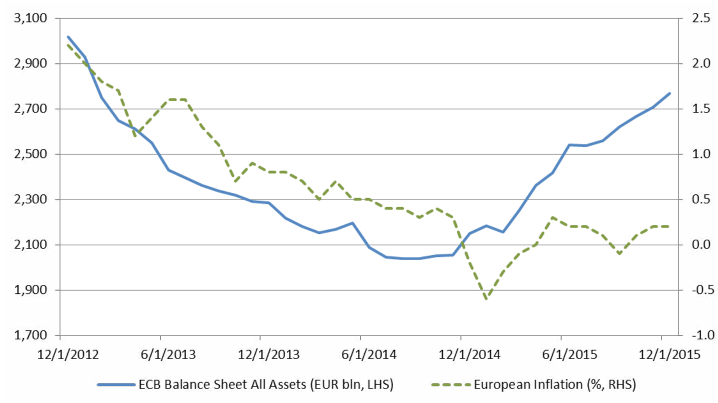
## DESPITE GREECE, EUROPE SHONE

You would think that Greece threatening (again) to leave the eurozone followed by a major terrorist attack in downtown Paris would almost certainly result in negative returns for European markets. Not so. In fact, Europe was one of the world's top performing markets in 2015. Such is the power of central banks. In March, the European Central Bank (ECB) launched a quantitative easing, or QE, program, committing to purchasing a massive EUR1.2 trn (EUR60 bln per month) of mostly government bonds in order to inject liquidity into the European economy and spark inflation. Comments later in the year from ECB President Mario Draghi that the stimulus program would remain in place "as long as needed" only added to the bullish sentiment surrounding European markets. Near year-end, the ECB said that its QE program would be extended by six months, through March 2017. In 2015, European equity markets overall advanced almost 8%, led by 10% gains for each of the Deutsche Boerse AG Stock Index (Germany) and CAC 40 (France).

*Our Take for 2016*

Our clients have meaningful exposure to European equities via their iShares MSCI EAFE ETFs. We will continue to monitor the impact that the ECB stimulus program is having on the European economy, particularly its inflation rate, which still, unfortunately, sits at a historically low level (see chart below). However, economic data out of Europe was mostly positive in 2015 and we may look to add to our clients' European exposure later in 2016.

**Despite Massive ECB Stimulus, the Inflation Rate Remains Very Low**




Source: Bloomberg

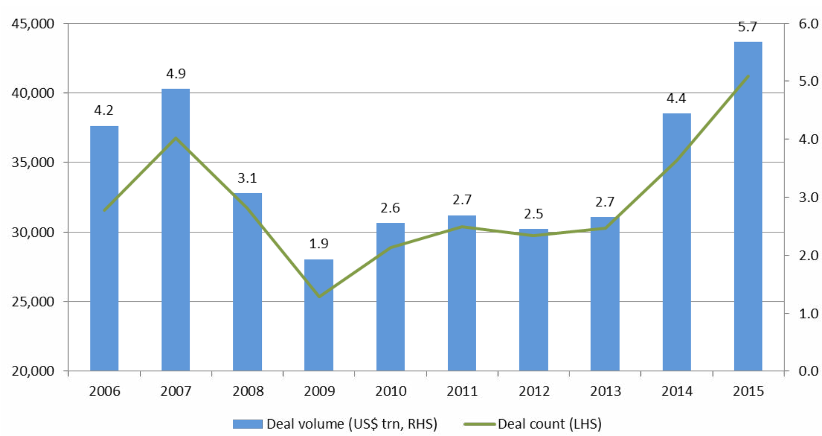
## M&A ACTIVITY HIT RECORD LEVELS

Led by health care giant Pfizer's announced US$184 bln offer for Allergan, one of the largest takeover deals in history, the global mergers and acquisitions market reached a record level in 2015. More than 41,000 deals were announced or completed in 2015 totaling almost US$5.7 trn in deal volume, a 30% y-o-y increase. Canada, unfortunately, did not share in the same M&A momentum, as our country's M&A volume declined by 38% y-o-y due to weakness in the energy sector. However, our largest announced takeover deal still came from the energy sector with Suncor Energy offering $4.5 bln in a hostile bid for Canadian Oil Sands.

*Our Take for 2016*

As we highlighted last year, growing deal sizes reflect corporate confidence, an accommodative interest rate environment and strong balance sheets. Therefore, we view 2015's M&A activity as one more indication of stable US and global corporate health. Unfortunately, we also noted last year that "2015 M&A activity will have a tough time topping 2014 levels". We were certainly wrong with this forecast. However, we will again state that 2016 M&A activity will have a hard time topping 2015 levels, but given the growing M&A momentum we've seen over the past few years, we could certainly be wrong again.

**Global M&A Activity Reached Record Levels**




Source: Bloomberg

## POLITICS TOOK CENTRE STAGE

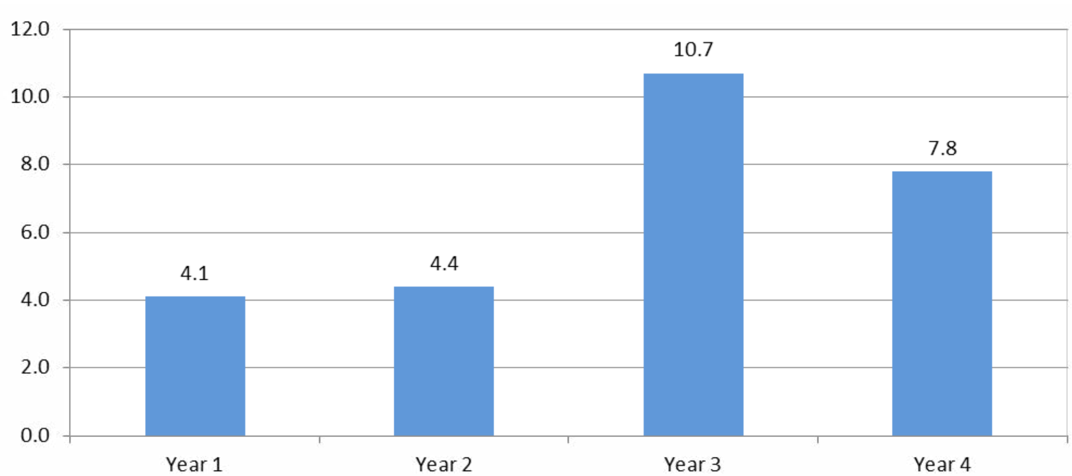
2015 was a year of contrast between Canadian and US politics. In the US, we saw the rise of outspoken billionaire businessman Donald Trump who announced his candidacy for president in June and who seemed to only gain in popularity amongst Republican voters with each outrageous comment he made. As his campaign progressed, Trump unveiled a more and more exclusionary platform, first proposing the building of an enormous wall across the entire US-Mexican border to keep out "rapist" illegal Mexican immigrants and then recommending the banning of all Muslims seeking entry into the US. Canada, meanwhile, saw the unexpected rise of Justin Trudeau who ran an energetic and progressive election campaign, one of the longest in Canadian history, which ultimately resulted in a Liberal majority government. Interestingly, Trudeau's policies were in stark contrast to Trump's as Trudeau's Liberal government openly accepted as many as 25,000 refugees seeking to relocate to Canada from war-torn Syria.

### *Our Take for 2016*

Trudeau's economic platform promised generous spending, particularly on infrastructure (as much as $125 bln over 10 years), a strategy designed to stimulate our fragile economy. However, it became apparent shortly after the Liberals took office that the legacy Conservative budget was in far poorer shape than was originally presented. It remains uncertain at this point how much flexibility the Liberals will actually have to spend their way out of economic trouble.

With respect to US politics, it's impossible to determine what Trump's next inflammatory comment will be or, more importantly, which party—Republican or Democrat—will ultimately form the next US government; however, from a market perspective, we are encouraged by the US presidential cycle. The presidential cycle suggests that US stocks do better on average in a president's third and fourth year in office, the logic being that presidents become pro-growth in their later years in power in order to ensure their party's success in the next election. While year three, which has historically been the best year for market returns, did not work out as history would suggest, year-fours, or election years, are also still traditionally very strong (see chart below). Given the strength we saw in 2015 in the US labour, housing, automotive and retail markets, it's likely that this momentum will continue into 2016. While we're not willing to bet on Trump becoming the next US president, we are willing to wager on the presidential cycle and do expect a better year for US markets in 2016.

**Presidential Cycle Still Suggests a Positive 2016: S&P 500 Average Returns (%) Since 1900 During Each Presidential Year**




Source: S&P Capital IQ. Data to December 2014. Price appreciation only, no dividends.

## A BAD YEAR OVER, A (POTENTIALLY) BETTER ONE JUST BEGUN

If it was bad, it likely happened in 2015. Economic and market turmoil in China, another near-miss with Greece, a deepening of the commodity bear market, a major correction for the S&P 500 over the summer, a recession in Canada, a gut-wrenching full-year 11% drop for the S&P/TSX Composite and Donald Trump—these were just a few of the storms that our clients and their portfolios had to weather over the past year. However, by being balanced and especially by being global (witness the solid results for Europe and Japan that we highlighted above) the majority of our clients' portfolios were likely to have only experienced a slight percentage decline. In other words, our defensive, global approach has been effective in preserving wealth and limiting downside risk over what has been a very difficult year.

So what happens in 2016? As we indicate throughout this report, we are optimistic. We believe that a very solid US economy, the world's largest, and a steadily improving European economy, collectively the world's second largest, create a positive backdrop for global equities. We also believe that the central banks in both of these regions have been taking the correct action—the Fed by finally raising interest rates and the ECB by initiating and extending its fiscal stimulus program—and have thus removed concerns that have been overhanging the market for several years. As for the Canadian market, well it's certainly not out of the woods yet, but, as we also highlighted, it has shown it can do quite well even with weak oil. We would also argue that with the oil price near credit-crisis lows and almost universally negative sentiment surrounding the energy sector, there's actually probably more upside than downside risk to owning Canada at the moment, which is why we have no immediate plans to lower weightings. If oil actually does rally, which is a definite possibility, then our market will, of course, benefit. There are certainly risks as we enter the New Year, China being an obvious concern, but we still expect and look forward to a better year for global and Canadian markets in 2016.


TURNER INVESTMENTS OF RAYMOND JAMES LTD.

40 King Street West
Suite 5300, Toronto, Ontario M5H 3Y2

Tel: 416-777-7000 | Fax: 416-777-7020

www.turnerinvestments.ca

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