

The last five years, and even the last 10 years have not been the most forgiving for Canadian investors. This year started no differently.

By mid-January 2016, a list of negative records had been broken – the worst beginning to a year **ever** in 140 years of stock market history, the steepest two-week decline in commodities and the Canadian dollar, the worst two weeks for the banking sector, and the list went on. What is even more telling is that on January 20, 2016 the TSX hit 11,515, the same level as it started the year 2006 - thereby marking 10 flat years for the Canadian Investor (excluding dividends).

Right now it's all about oil...

The major culprit behind this decline was the precipitous drop in the price of oil, a drop that defied even the most bearish prognosticator. By February 11, 2016, West Texas Intermediate Oil (WTI) had hit a 13-year low of \$26.20 per barrel. Adjusted for inflation, this was one of the lowest prices since the end of the Second World War.

Oil has collapsed by more than 75% from its highs of approximately \$110 per barrel in 2014. This decline exceeds the magnitude of the price shocks in oil seen in 1985/86. It now rivals the decline of high-flying technology stocks from 2000 – 2002 and overshadows the magnitude of 2008/2009 stock market crash.

The Canadian dollar has been following oil's price movement, and after two and a half years of declines, the dollar hit its lowest level in 12 years – 68 cents to one U.S. dollar. This equates to an appreciation of the U.S. dollar of over 45%, from par in 2013 to a recent high of \$1.47CDN. Only three times over the last 50 years has the Canadian dollar dropped that low versus the U.S. dollar - in 1984, again in 2001/2002 and now in 2016

Where did this price decline come from?

This dramatic price decline in oil resulted from four factors:

- clear signals from China that growth in their powerhouse economy was slowing (suggesting a reduction in demand)
- mild winter weather (which caused a huge buildup of heating-oil supplies)
- investors shorting the oil market on the expected lifting of sanctions on Iran (increasing Iranian oil exports)
- the usual seasonal pullback in January of refinery utilization after the seasonal drawdown in December

Why suddenly, for the first time in history, did lower oil prices not signify improved growth via energy savings for billions of households and businesses globally?

The jury is still out on this issue but the facts would point to expecting such savings related growth. The overwhelming majority of global consumers and companies benefit from cheaper crude as it is used for powering over one billion cars and trucks globally and in the production of many products

manufactured by diverse industries. The truth of the matter is that cheaper oil is a good thing for most companies (excluding energy companies, of course) and consumers.

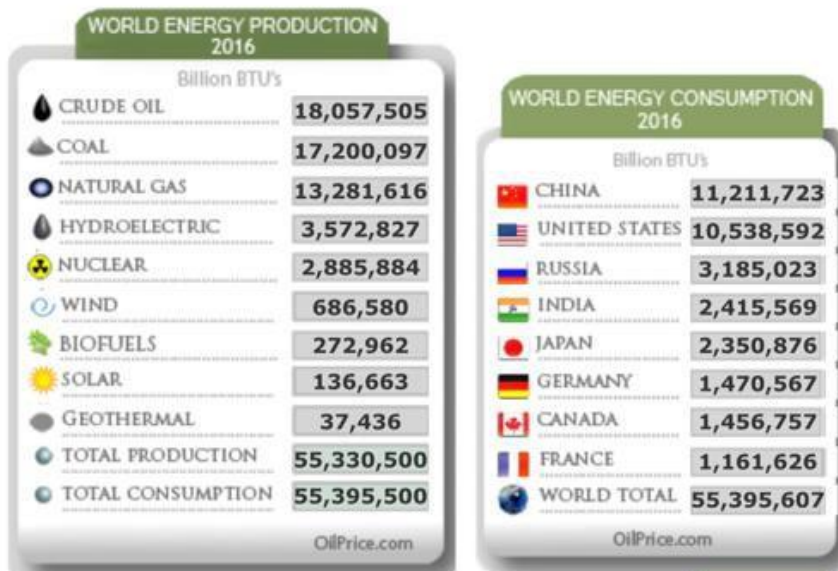
Constructive View on Oil Pricing

For those countries that rely heavily on oil exports for their sovereign revenue, low oil prices have slowed economic growth and put a dent in their sovereign wealth. Beyond this, stock traders may be subscribing to the misguided belief that low oil prices are signaling imminent global recession. Historically, 85% of the time oil goes down the stock market goes up. And every recession since 1970 has been at least accompanied by higher oil prices. But not this time.

We believe that imminent production cuts by global companies, bankruptcies among smaller players and OPEC collusion to cut output will cause an oil recovery in the second half of 2016. Russia is already cutting its production, as they are unable to pay their workers and balance their budget. Due to financial sanctions, Russian oil companies also have no ability to borrow overseas. Countries like Venezuela, Nigeria, Columbia, even China have nearly bankrupted their state run oil companies. Middle Eastern counties, Saudi Arabia included, for years have balanced their budget at a minimum price of \$70 per barrel. With oil hovering under \$30 today, their budget deficits will run for generations if the price of oil does not soon increase. Canada and the U.S. will see their production decline by 10-20% in today's price climate as it will not be financially viable for companies to continue extracting oil.

If the recovery in crude oil that we are forecasting by the second half of this year materializes, we anticipate it will bring with it a recovery in the equity market.

The charts below (courtesy of www.oilprice.com) show that global energy production is forecast for 2016 to simply keep up with world demand, actually falling slightly shy of requirements. While oil is only a portion of total energy produced, we see the opportunity in the future for oil to replace some of the energy requirements currently met through the use of coal. Coal's rising environmental cost, the increasing social backlash against its use and the high cost of extraction should encourage the transition away from the use of this fossil fuel.



The Market Looking Forward

Apart from a recovery in oil prices, we need three additional factors (albeit oil related) to see some market stabilization:

1) Data from China needs to stabilize. We don't need to see the data improving but we do need to see signs that the economy is stabilizing. The uncertainty over the slowdown in China has become the World's economic problem. Currency instability has put upward pressure on the dollar at a time when the Federal Reserve is looking to increase rates. The Chinese slowdown has been going on for some time, therefore stability even at lower levels of GDP growth, would be well received by the market.

2) The U.S. dollar needs to go lower. Normally, small and medium sized companies do well in a stronger dollar environment but as a result of global currency instability, the strength of the dollar has created headwinds for U.S. exporters. I believe that the dollar will weaken when the Federal Reserve begins to communicate that rate hikes will not happen as quickly as previously thought and the market realizes that the recently passed budget will widen the deficit, reversing the trend from the prior four years.

3) The spread between corporate bonds and Treasuries needs to narrow. Over the last eight months, bond spreads have widened considerably, increasing funding costs for many companies issuing debt. High yield issuance has all but stopped. Narrowing corporate bond spreads are an excellent leading indicator, particularly for small-cap and mid cap stocks.

What about Canada?

For over a year now, I have been saying that the commodity swoon is the best thing that has happened to Canada to encourage us to find our role as a leading democracy and innovator in the 21st century. Today I subscribe to that view more than ever.

For over 15 years, the Canadian government has been building a war chest by balancing the budget. As David Rosenberg from Gluskin Sheff noted in his latest newsletter :

"(...) my message to the new government is to begin to fight the economic forces with fiscal policy and stop the multi-year strategy of having the Bank of Canada shoulder all responsibility via the currency, which is a double-edged sword – yes, it makes exports more competitive, but it increases the costs of imported inputs to production and capital goods.

Now is not the time to cheapen up the currency any further for a quick antidote that only affects winners with long and variable lags in any event, not to mention how the losers (consumers, in other words) are ultimately affected – check out what imported food costs are doing and you will see that this policy of continuing to cheapen up the currency to buy up U.S. market share is extremely regressive (not to mention akin to the country accepting a national pay cut).

Now is the time for a swift and decisive fiscal boost – if the government wasn't spending years strengthening our nation's balance sheet as a weapon against downside economic risks as is the

case today, then what was the point of it all?"

Exactly my point! Now is the time for Canada to use all of the tools we have – infrastructure spending, tax breaks for new businesses, incentives for foreign companies to move some of their operations or headquarters here and increased and more efficient immigration rules. Globally there are many successful examples that show that fiscal policy changes have immediate effects that last much longer than employing monetary stimulus only (which has not worked in Japan for the last 20 years).

We live in a country that is the envy not only among the lesser developed nations, but also the developed countries of Western Europe who are currently struggling under a heavy social security burden, heavy taxation, increasing crime rate and recently an unprecedented influx of immigration from poor and war torn regions.

Even though Canada is the object of envy, looking at the Canadian market over the last five years would lead you to believe otherwise. On one hand we are a country that people enjoy living in and want to immigrate to, that constantly ranks number one in livability, democracy and freedom standards and a country where real estate (the best measure of popularity) has appreciated accordingly to its world status. On the other hand, the Canadian market has been flat for the last 10 years and has been a favorite short among global asset managers.

If the history of human kind teaches us anything, we know that ultimately common sense prevails and the countries that collect taxes, have a functioning government, a respect for democracy and human rights, a friendly business environment and accommodating fiscal policies thrive in the long term.

Although the Canadian investor has little to show for in the last 10 years, I strongly believe that (to paraphrase Ronald Reagan in his speech at National Republican convention in 1992): **“Canada’s best days are yet to come. Our proudest moments are yet to be. Our most glorious achievements are just ahead.”**

Inflated anxieties, The Fed, Chinese Dragon, Oil and Chicken Little

Last weekend, going through my books at my home office, I found a stack of children’s books that I used to read to my daughter over 20 years ago. One of the stories, Chicken Little and the Sky is Falling I found quite apt in today’s situation. I realized once again that very few readings can match the wisdom of childhood stories and fables. For those of you, like me, who over time have forgotten the story and for those without small children I enclose a copy of this timeless classic. For those with small kids (grandchildren count) I hope it will make a fun family read.

The moral of the story is simple – always check your sources for vital information carry an umbrella even on a sunny day and only pay attention to important things in life. That way you may never truly encounter a “falling sky”.

In this anxiety ridden market where both equity and high yield bond indices have been falling, even the Fed is yelling “the sky is falling” blaming China and depreciated energy prices.

In times like these, it is worth considering the advice given to Chicken Little by the wise king - sometimes simple solutions and explanations are the best remedy for seemingly complex issues (like a falling sky). Our “umbrellas” in today’s market are simply some undisputable fundamentals – the U.S. economy is not going into a recession – it is growing at 2.4%, an entire percentage point above its long-term potential, delineated by available labor and capital resources. The “glut” in oil is not as severe as it sounds – the world consumes approx. 94 million barrels of oil a day. The “sky is falling” doomsayers cry that the overproduction is one million barrels a day, conveniently forgetting to add that that is just 1% of today’s production and consumption equilibrium! This overproduction could be completely eradicated almost overnight with production cuts (which as mentioned, Russia has already begun). If that happens oil will finish the year in the \$60-70 range thus regressing to the long-term mean.

Lessons that we relearned in 2015/2016

We were humbly reminded by the recent market downturn of our long-standing mantras that we first coined over 15 years ago (just after the shock of the 9/11 attacks). Today they are even more important than ever:

- There is no single magic formula or style for all seasons
- There are no perfect hedges
- No one rings a bell at major tops or bottoms
- Liquidity squeezes may originate in faraway markets
- Each cycle has its individuality
- Don’t invest in countries that don’t or won’t collect taxes
- Accept the fact of uncertainties
- Realize how different responses are in bull markets than in bear markets
- The Future is never clear...Uncertainty is the friend of the buyer of long term values (Warren Buffet)
- Don’t try and figure out what the market is doing. Figure out a business you understand. (JohnMaynard Keynes)
- Recognize that you have to make decisions on imperfect information
- Never cease studying history, but don’t expect an exact repetition

Perhaps the most important lesson that I learn as I get older is how short life is and accordingly how we must keep our priorities straight. What dwarfs all else are your family, your friends and the opportunity to do useful work with people you like and respect. Life is much too short to get mad or stay upset for long. Find opportunities to laugh and enjoy, appreciate your blessings, and count yourself lucky.

As always, Christine and I are here to help you look after your financial life, and hopefully to provide a few of those moments to look at our prospects with optimism and joy and to help you to count yourself lucky.

I wish you all a happy rainless spring season in Vancouver (it looks like it has started already) and please feel free to call me to talk about yield spreads, inflated anxieties or even Chicken Little.

Yours, looking for an umbrella,
Martin Karcz

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