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Now What?

2015 had been a year of great anticipation. For movie buffs, the release of *Star Wars: The Force Awakens* was met with much fanfare and excitement, this on the heels of a huge build-up to the release. Similarly, market watchers have been anticipating their own monetary policy drama. After nearly a decade of unprecedented record-low rates, the Federal Reserve finally raised interest rates in 2015. Unlike the *Star Wars* release, the build-up was plagued with anxiety and trepidation as to how the market would react and what this would mean for the future. Fed Chair Janet Yellen, in her best Yoda impression, wisely reassured the market that future changes will be gradual and economic activity will continue to expand at a moderate pace.

The focus has quickly turned to what's in store for 2016? We anticipate the U.S. central bank plans to act as they have suggested, gradually. But we also believe market feedback will play a much larger role in the rate of change of monetary policy going forward than it has in the past. In particular, swift or out-sized changes in bond yields may force the Fed to move quicker than they may want to restore investors' confidence. All eyes will be on maintaining stability in the long end of the yield curve over the foreseeable future. In addition, renewed geo-political concerns and continued economic weakness outside of the U.S. will be material inputs.

There is no shortage of opinions on how this interest rate tightening cycle will play out. All of this assumes the growth and stability in the U.S. economy is sustainable in the first place. We believe this is still a big assumption and that the global economy remains fragile. Economies and stock markets are more interest-rate sensitive than at any other time in the past. For this reason, we believe extrapolating from previous tightening cycles may not be as instructive as many think. The following quote from Richard Fisher, Dallas Federal Reserve President speaks to this:

"We are sailing deeper into uncharted waters… And nobody – in fact, no central bank anywhere on the planet – has the experience of successfully navigating a return home from the place in which we now find ourselves."

Global Economies

While the U.S. economy has finally returned to a more stable footing, the majority of the rest of the world remains mired in weakness. Canada continues to struggle as it tries to offset the combination of commodity weakness and a highly levered consumer. European central bank head, Mario Draghi, continually proclaims "We'll do whatever it takes" to return the region to sustained growth. This has meant more stimulus in aggregate and for a longer period of time. So far this has shown little effect. Japan continues to try to ignite inflationary growth with numerous policies, yet sustainable improvement remains elusive.

Developing economies remain challenged and will likely stay this way for some time after the boom in growth in years past. The ability of Chinese authorities to manage their economy, currency, and now stock market is a real risk to global stability. The hand of government is much too involved in trying to steer its way to a particular outcome. But this is no different than what global central banks are doing. This should be seen as a warning flag to overly confident investors.

Market Review

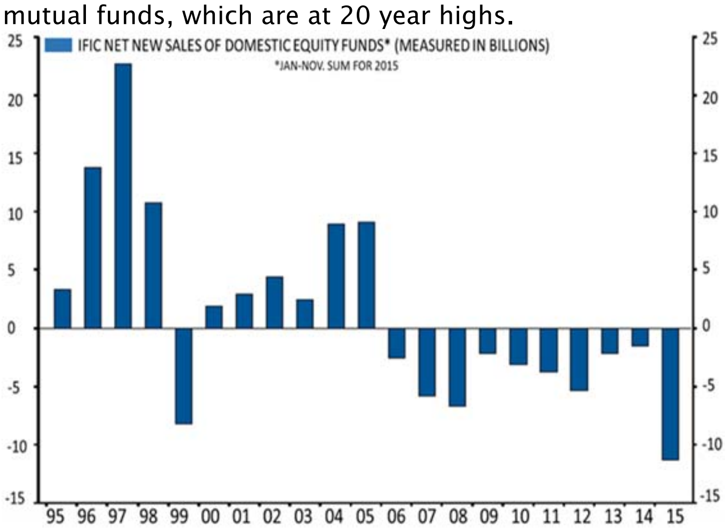
For Canadian domiciled investors, the primary source of returns in 2015 was exposure to foreign currency, particularly the U.S. dollar which surged nearly 20%. The Canadian stock market when compared with major indexes around the world posted some of the weakest absolute returns, with the S&P/TSX falling nearly 8.5%. The U.S. S&P 500 eked out a small gain (in USD) in its worst performance since 2008. Internationally, developed markets provided some gains while emerging markets fell precipitously. Canadian government bond returns were favorable with the 10 year bond generating over 6% while corporate bonds gained just over 2.5%.

Historically, our mandates have outperformed challenging markets by preserving capital and lagged stronger markets due to focusing more on risk management than return maximization. We remained consistent with our historical return characteristics in 2015.

Our global strategy posted double digit positive returns, thanks to foreign currency exposure, but lagged its benchmark. Owning strong business franchises with reasonable multiples was certainly not as attractive as investing in growth. A very small number of companies such as Amazon and Facebook posted spectacular returns which we could not, nor would not, try to attain. In Canada, our focus on balance sheets and sustainable business models steered us away from the majority of the largest detractors in the commodity sectors. That being said, we posted negative returns as the pressure in the Canadian market was broad. We have been adding to well valued cyclical businesses, however, they continued to fall in price. Small cap stocks were the most negatively affected within this marketplace, but we managed to significantly outperform the steep sell-off given our focus on quality franchises.

Our bond mandates performed in line or better than their respective benchmarks over the year. We remain defensively positioned and our high quality corporate bonds performed relatively well. In our balanced mandate, reducing our equity exposure by 10% during the year helped preserve capital, but weaker equity returns still resulted in a small loss of roughly 2%.

“Sell Canada” is the prevailing sentiment both globally and domestically. Given this year’s performance relative to some other markets, we wouldn’t be surprised to see this sentiment worsen in 2016. This broad pressure is creating favorable opportunities for attractive investment, but patience will be required. The following chart illustrates the net outflows in Canadian domestic mutual funds, which are at 20 year highs.



Source: Thomson Reuters Datastream, Canaccord Genuity estimates

Risk Budgeting

After more than five years of near 0% interest rates from money market funds, savings accounts, etc., investors have been pushed into taking on more risks with lower quality corporate bonds, longer duration bond strategies, or equities in search of an acceptable yield. Even though we’ve had a rate hike, interest rates remain near multi-decade lows and would require significant increases to compete with yields in other assets. The temptation to continue to seek out higher yield remains.

Rather than increasing one’s risk profile to attain a higher yield or paying a high multiple for a stock that has been outperforming the market, we believe the more prudent course of action is to focus on protecting capital in 2016. Longer term we are concerned by what the past decade of extraordinary policies mean for the future prices of stocks, bonds, and real estate. The significant demand for financial assets due to ultra-low rates is likely to diminish into the future, as either rates increase or economies struggle. We continue to expect a lower return environment with heightened volatility as monetary policy, the economy, and the markets adjust to a different environment.