

## Capital Flows

2014 has turned out to be an eventful but reasonably profitable year. Global stock markets finished in positive territory for the most part, but not without a dose of drama late in the year. While investors were focused on global central bank policy, the price of oil collapsed by roughly 50%, unnerving commodity focused markets from Norway to Canada.

Bond markets also rose in 2014. Global bond yields fell in the majority of countries throughout the year, with those regions which seemed most problematic only a year or two ago experiencing some of the biggest moves. The yield on the German 10 year Bunds reached an all-time low of 0.60% after falling over 1.30% in the year, the Spanish 10 year bond hit 1.65% after falling nearly 2.50%, and Euro deposits yielded negative returns.

Meanwhile the U.S. dollar continued to appreciate against the majority of other global currencies, driving foreign stock returns for Canadian investors.

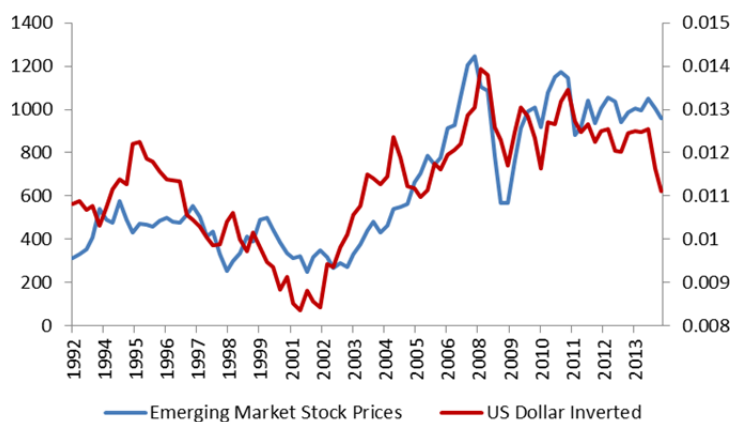
Not all markets improved though; there were certainly challenges. One of the most dramatic instances was that of Russia's, where the ruble fell roughly 50% against the dollar on the back of Western sanctions over Moscow's course on the Ukraine and the collapse in oil prices. The Russian central bank raised interest rates dramatically in an attempt to stem the slide, but with little effect. Faced with a currency collapse and surging interest rates, the Russian economy finds itself in a precarious position going forward. What is happening in Russia, and similarly in countries like Venezuela and Argentina, has potential implications for investors globally.

We should remember that Russia was part of the global growth story not so long ago. It is the R in BRIC (Brazil, Russia, India, China), an acronym which is often referenced when recognizing the major countries driving emerging market growth over much of the past decade.

The belief was that developed economies were past their prime and the future was to be found in developing markets. Many of these emerging economies were expected to drive demand and global GDP for a

considerable time. For nearly a decade, from 2000 to 2008, the story was their insatiable need for resources, their burgeoning middle class, and how their success could provide the impetus to drag the developed world economies upward with them. The global economy as a whole benefited under this scenario.

During this time period, an enormous amount of capital was diverted from developed to emerging economies and related investments (ie. commodities). There were many significant repercussions for asset prices, including a ten-fold increase in the price of oil. Another less talked about effect was the weakening of the U.S. dollar (USD). During this decade, the U.S. dollar fell considerably against a basket of global currencies as capital flows into these emerging economies proved a major boon to their growth. Historically, there has been a strong correlation between a strengthening U.S. dollar and weakening developing markets and vice versa as can be seen from the chart below (note: the USD is inverted for graphical purposes).



Source: Bloomberg

The stability of many of these parts of the global economy depends on the availability of foreign capital inflows. When financing slows or shuts off, it can have serious dislocating effects. With continued U.S. dollar strength a real possibility, risks associated with emerging market growth and/or stability could accelerate in 2015.

Over the last number of years there has been record borrowing by corporations in these geographies. Many institutional investors, fund managers, and individuals have direct exposure to these investments. If there is a bump in the road it will likely be broadly felt. Should the bump turn into something more, we should probably recognize that there are likely repercussions. If oil went up ten-fold on the back of increasing demand by China and other emerging markets, what is the appropriate price in a slower growth environment? Our guess is that oil prices have not declined only on the back of supply side issues with OPEC, but that the market has also priced in its concern with global demand in the near term.

### The Pendulum Swings

The status quo may be changing. Western Canada has been a major beneficiary of the emerging markets' need for resources. Meanwhile, Eastern Canada has been hampered by the associated ascent in the Canadian dollar as significant capital flowed into our economy. We wouldn't be surprised to see this trend reverse as the lower currency works to aid manufacturing and industry in the East, while lower commodity prices challenge the West. On a nationwide basis we expect a slowing of the overall economy given the material change in the resource sector, but the negative impact to be somewhat muted by growth in the U.S. economy and its associated beneficial impacts.

### Global Economy and Markets

The U.S. economy continues to gain momentum and businesses continue to report reasonable results. We were pleased to see the long awaited end to QE-3, although its effects will remain with us for quite some time. The U.S. Federal Reserve is trying to determine its own monetary policy but at the same time international events are muddying the water. The rise in the US dollar is a form of tightening on the economy (to some degree), while the fall in oil prices is the equivalent of a tax cut on consumers. Continued weakness in major global economies such as Europe and Japan and the apparent lack of inflation pressure allows the Federal Reserve some wiggle room in how they move forward.

Roughly a decade ago, the majority of global economies were growing and were somewhat in sync. Today, paths have diverged. The U.S. is preparing to tighten monetary policy whereas Europe, China, and Japan are involved with differing degrees of additional stimulus. We expect these divergences to result in uneven and muted global growth.

The bond markets seem to be pricing in deflation in Europe and Japan and the global relative rate structure is pushing yields down everywhere. We think they have overshot on the downside. At this time last year, the U.S. 10 year bond yield was over 3%. Today the economic recovery is further along, yet its yield is significantly lower at 2.2%. With investors desperate for yield, incremental return trumps any form of risk. Such behavior is most evident in both the high yield bond market and lower quality sovereign credits, where we feel investors are not being adequately compensated for the risks they are assuming. This is a by-product of too many years of extremely loose monetary policy. Unfortunately, too much capital chasing either lower quality or overvalued investments doesn't end well. This is true of stocks and bonds, and reminds us to ensure an adequate return profile for the risk we assume with our clients' capital.