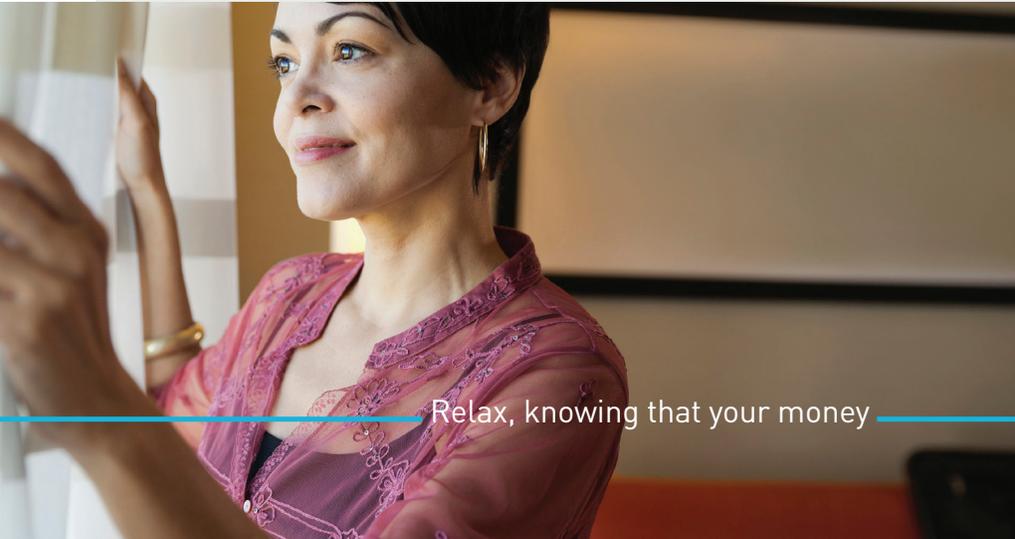


Quiet Counsel

Winter 2015
Investment Outlook



Relax, knowing that your money

 **Leith Wheeler**
INVESTMENT COUNSEL LTD.

Quiet Money.

won't.

2015 Outlook

Introduction

Investment returns continued to be rewarding for Canadians in 2014. The Canadian stock market rallied 10.6%, bonds returned 9% and foreign stocks, particularly in the United States, benefited from a significant further weakening in the Canadian dollar (returns of U.S. denominated investments by Canadians are improved when the U.S. dollar is strengthening versus the Canadian dollar).



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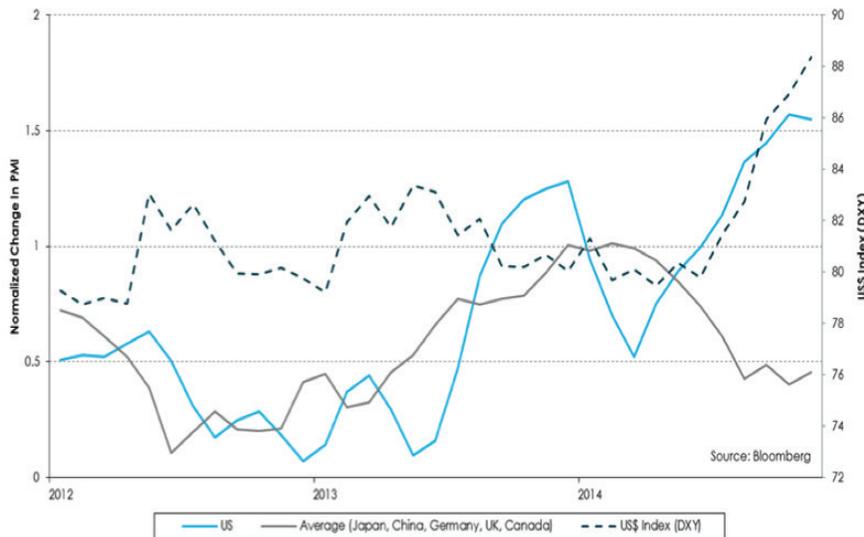
However, while portfolio returns were favourable, they occurred against a deteriorating global economic backdrop and increased market volatility. Most prevalent was the sharp decline in energy prices, which manifested itself further via rising global deflationary risks, unprecedented additional monetary stimulus and record low (and in some cases negative) bond yields in many developed market countries. The outlook for global growth has been lowered in spite of the positive impact on consumption from lower oil prices (i.e. less expense to heat and drive means more money for other consumption).

Given the increasingly uncertain investment environment, what should Canadian investors expect in 2015? We discuss below what Leith Wheeler believes are the top three investment themes for 2015 and how they might impact Canadian investors' portfolios:

1. U.S. Divergence and the Dollar
2. European Policy Effectiveness
3. The Fallout From Lower Oil Prices

U.S. Divergence and the Dollar

In our opinion, today's dominant investment theme is the divergence between U.S. economic growth and the rest of the world.



As shown in the above chart, leading economic indicators in the U.S. clearly diverged from the rest of the world in early 2014. Global interest rate markets then started to correctly anticipate additional monetary easing from major economies like Europe, Japan and China. In turn, this led to a broad-based strengthening in the U.S. dollar against almost every other major currency, including the Canadian dollar.

The effects of a stronger U.S. dollar should not be understated and are partly responsible for the sell-off we have seen in commodity markets that are denominated in U.S. dollars. A stronger U.S. dollar also results in the United States “importing deflation” from the rest of the world, since the cost of U.S. imports, denominated in U.S. dollars, falls. For now, the Federal Reserve

(the “Fed”) has viewed the dollar’s ascent as relatively benign, but a sharp acceleration in U.S. dollar strengthening would reduce the probability of interest rate hikes by the Fed in 2015, which would put further upward pressure on the U.S. Dollar.

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European Policy Effectiveness

In January 2015, the European Central Bank (the “ECB”) announced an open-ended program to purchase government bonds, effectively bringing them in-line with the Fed, the Bank of Japan and the Bank of England.

The move was unprecedented for the ECB and thought by many during the height of the Eurozone financial crisis as impossible (if not potentially prohibited) given the unusual institutional structure in Europe where currency and monetary policy is centralized, but fiscal policy and bond issuance remains controlled by the governments of member states.

The impact of the European program is difficult to assess on global and Canadian asset markets. The sentiment effect of such action normally helps riskier asset classes like stocks, evidenced by the outperformance of European stocks. It is more difficult to assess the impact on bond markets. Regardless, there is likely to be some “leakage” of liquidity from Europe into global bond markets as investors are crowded out of European bonds and instead look to invest in U.S. Treasuries and other liquid global bond markets, including Canadian Federal government bonds.

European policies could also impact whether the Fed raises rates in mid-2015. The extent of monetary policy

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easing globally might be presumed to give the Fed pause, but in fact the Fed has stated that easier financial conditions due to lower market interest rates in the United States make it easier for monetary policy to be tightened.

In Europe, only time will tell as to the effectiveness of quantitative easing, the phrase most commonly used to refer to a central bank's purchases of government debt intended to keep market interest rates low and encourage borrowing and stimulate investment. It should be noted that prior to the initiation of the ECB's bond buying program, encouraging economic signs have been found.

There are indications that consumer spending is making a comeback, particularly in Germany. Unemployment is coming down from lofty levels in parts of Europe, such as Spain where youth unemployment has been disturbingly high. Lastly, but very importantly following a financial crisis, the transmission of easy monetary policy through to the real economy is starting again – bank lending data and money supply are both suggesting that the worst of the credit crisis in Europe might be in the past.

The Fallout from Lower Oil Prices

By contrast, particularly for Canadian markets, the fallout from lower oil prices is more likely to be ahead of us.

Recent data on growth in the fourth quarter of 2014 showed a material

slowdown from earlier in the year. One source of weakness, however, is particularly concerning: the manufacturing sector in Canada was a drag on growth in November despite optimism that the sector would benefit from a weaker currency and a robust U.S. economy.

In addition, Statistics Canada revealed that the pace of labour market growth in Canada was significantly lower than previously assumed. Net labour market job growth was revised down from 15,000 to 10,000 per month during 2014, well below the long-run average of approximately 18,000 per month.

Although growth and employment are already disappointing, they are likely to get worse since the bulk of the impact from lower oil prices – i.e. cuts to capital expenditure and jobs from oil producers and service companies – has yet to materialize. To put this into perspective, we anecdotally have identified over \$3 billion worth of capital expenditure cuts for companies in the energy sector announced during the fourth quarter of 2014, which represents approximately 0.2% of Canadian Gross Domestic Product. The Bank of Canada itself is forecasting growth to slow to just 1.5% in the first half of 2015.

Given the above-mentioned cross-currents in the global economy, what should investors consider in terms of positioning their portfolios?

BOND MARKET Although bonds have outperformed over the past year, the outlook for 2015 is far from clear. As a result of the challenges in global capital markets we described above, Canadian bond investors will be faced on one hand with the deflationary impulse from Europe and lower oil prices, while also dealing with the prospect of U.S. Federal Reserve rate hikes driving global bond yields higher.

Therefore, we are conservatively positioned in terms of the direction of Canadian interest rates. Furthermore, given our forward-looking assessment of the impact of lower oil prices on the Canadian economy, our bond portfolios are currently positioned with the lowest exposure to Canadian corporate credit risk in over five years. This is not just to protect investors, but to ensure we can participate should opportunities emerge in corporate bonds.

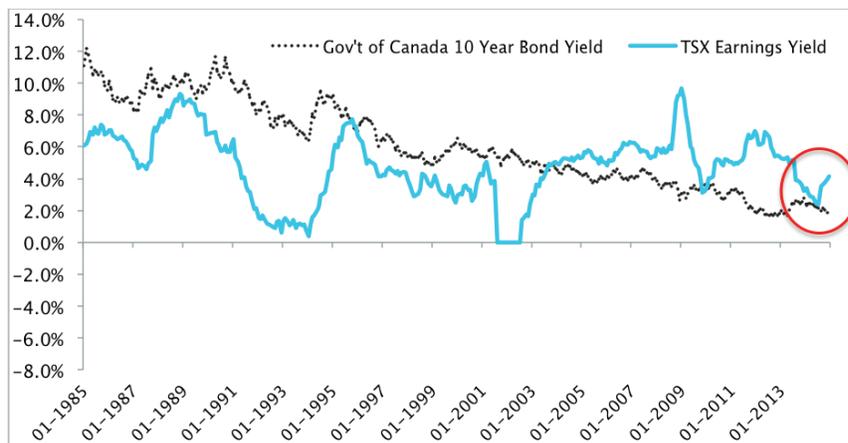
Overall, we expect returns from bonds to be in the 2% to 3% range for 2015. This forecast is far lower than prior years' results when sharply declining interest rates drove up bond prices. However, given the range of economic factors currently impacting global capital markets, we think bonds should provide relative stability for investors along with steady cash flow.

STOCK MARKETS Unfortunately, the 2015 outlook for stocks is no less murky. The above mentioned economic backdrop will restrict revenue growth for many companies, which does not bode well for increasing stock prices. At first glance, the market seems fully

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valued or perhaps even overvalued. However, this does not take into consideration the very positive financial position of many companies today. Furthermore, current stock prices also need to be compared to the current interest rate environment. The following graph indicates that, for example, the Canadian stock market value, based on its earnings yield (Earnings divided by Price (E/P), or the reciprocal of the more popular P/E ratio) compares favourably to bond yields. In fact, the benign and stable inflationary environment and low probability of interest rate increases in 2015 by the government of Canada are supportive of current stock prices.

We feel stock markets will produce total returns in a 5% to 7% range for 2015. Prospects across global stock markets are not homogeneous, as they will each be driven by their respective advantages and disadvantages. For example, the U.S. stock market looks more fully valued as investors have rushed into U.S. stocks to take advantage of their comparatively better earnings prospects recently. International stocks, on the other hand, are trading at



Source: FactSet, TD Securities

more attractive valuations, but are overhung with material risks, including the potential for weaker currency valuations.

Conclusion:

With stocks still expected to deliver better relative returns than bonds, we remain overweight stocks versus bonds and cash in client accounts. With so much uncertainty surrounding 2015 we expect our investment style should be a differentiator amongst market participants. As we have done since 1982, we aim to assemble portfolios

of investments that represent good value, while also offering a level of insurance, should things not work out as expected. Even with current low interest rates, we continue to invest in bonds where client mandates allow. Bonds provide a reliable source of income for investors, while also acting as an offset to the volatility clients face when investing in stocks, which we feel further protects our clients' capital.



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WINTER 2015 EDITION

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