



Perspectives Quarterly

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ODLUM BROWN
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First Quarter Reflections

What a roller coaster of a first quarter for investors! Stocks, bonds, currencies and commodities all experienced wild swings, most falling precipitously in the opening weeks of the new year, only to mount a sustained recovery throughout February and March.

If nothing else, this quarter has provided an impressive case study of how quickly markets, and investor sentiment, can turn. And it serves to remind us how basing our investment strategy on short-term market movements very often detracts from returns.

Stocks headed down from the first day of trading this year. The S&P/TSX Composite Index, which had just finished a tough 2015 with a total return of -8.3%, hit a low on January 20, 2016, after a decline of close to 9%. By February 11, the S&P 500 Index was down almost 11% for the year.

Before the end of January, the price of oil fell below \$30, with some experts calling for a drop below \$20. In the same timeframe, the Canadian dollar dropped to its low point of just under US\$0.69 on January 19. Corporate bond yield spreads widened to the highest levels seen since the financial crisis of 2008, as markets priced in a much greater likelihood of recession.

News outlets were printing extremely bearish headlines by mid-January, and there seemed to be no shortage of market prognosticators predicting the worst. In a story published by *The Globe and Mail* on January 13, writer Scott Barlow compares these market soothsayers to "busted clocks," which always say the same thing, making them generally useless but still correct twice a day by accident.

It can be extremely difficult to ignore these market predictions when they are being trotted out by the media during a particularly volatile period in the markets.

Here are just a few of the fear-inducing quotes that caught our attention:

"The currency will fall to a record low 59 U.S. cents by the end of 2016, Macquarie Group Ltd.'s David Doyle, Bloomberg's top-ranked forecaster for the Canadian dollar last year predicts."¹

"There are others like DoubleLine Capital's Jeffrey Gundlach, the world's largest private bond fund manager, who are advising investors to flee the market and head for the hills."¹

"[The Royal Bank of Scotland's] credit team said markets are flashing stress alerts akin to the turbulent months before the Lehman crisis in 2008. 'Sell everything except high quality bonds.'"²

Murray Leith, Odium Brown's Executive Vice President and Director, Investment Research, took a different stance. In the lead article of the February 2016 *Odium Brown Report*, entitled "False Alarm – No Need to Panic," Murray wrote:

We think investors are overreacting... Slower economic growth is quite possible, but a global recession is unlikely. More importantly, the odds of an economic slump in the United States are especially low... Reacting to the hype is rarely a good strategy. Rather, it's best to focus on underlying economic fundamentals and stick to your long-term investment plan. If anything, now is a good time to add to equity positions rather than get trampled rushing for the exit with the crowd.

In fact, just when it seemed like there was no end in sight to all the bad news, things started to turn around.

On January 27, the U.S. Federal Reserve decided against a further interest rate hike. After increasing its benchmark rate by 25 basis points for the first time in nine years in December 2015, it responded to deteriorating financial conditions and perceived weakness in the global economy by striking a more dovish outlook.

(In March, the Fed again chose to remain on the sidelines, keeping rates unchanged, and continued to emphasize its gradual approach, suggesting that there would likely be only two rate hikes rather than four in 2016.)

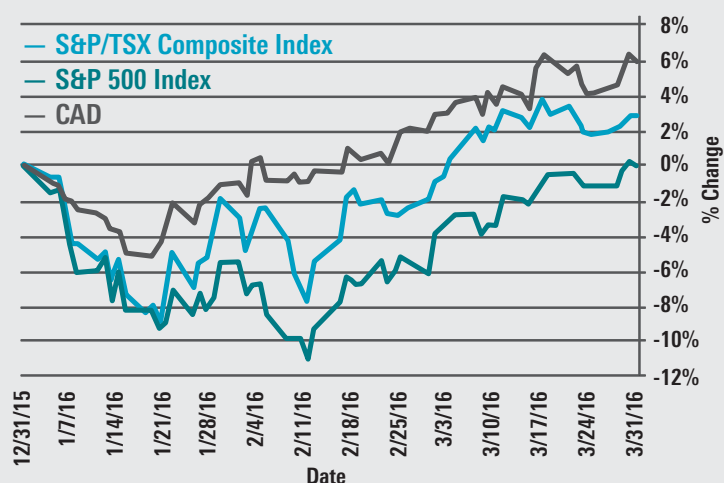
By the end of January, the price of oil also began to stabilize after rumours surfaced that key producing states were discussing production freezes, and as markets came to believe that supply and demand would edge closer to a rebalancing in 2016. By the end of March, oil had recovered to almost \$40 from its January low. This in turn supported a rally in the Canadian dollar, which ended March at US\$0.77, a gain of approximately 12.5% from its January 19 low. Over the entire first quarter, the loonie appreciated close to 6% against the greenback, which meant a substantial headwind for Canadian investors holding U.S. dollar assets.

On February 11, Jamie Dimon, CEO of JPMorgan, invested over \$26 million of his own money in JPMorgan stock. The stock price surged 8%, but perhaps more significantly, Dimon's move was taken as a sign of confidence and boosted market optimism more broadly.

Finally, a variety of improving economic data points in the U.S. gave markets greater confidence that the slowdown seen in late 2015 was transitory, and that the odds of a recession, particularly in the U.S., were low. The chart on the next page depicts the first-quarter volatility we have described.

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FIRST-QUARTER VOLATILITY



Source: Bloomberg

The larger point here is that over the short term, markets are extremely unpredictable and not always a good predictor of economic outcomes. Economic forecasts in general are notoriously unreliable. As Danish physicist and Nobel laureate Niels Bohr once said, "Prediction is very difficult, especially if it's about the future."

Investing requires some degree of optimism about the future. After all, it entails investing money now in anticipation of getting back more money in the future. History has validated that optimism, despite the many corrections and bear markets that have occurred over time.

In his 2015 letter to the shareholders of Berkshire Hathaway, famed investor (and optimist) Warren Buffett notes that it's an election year in the U.S. and that candidates can't stop talking about the country's problems. Many expect the next generation to be worse off than the current one for the first time in U.S. history.

Buffett disagrees entirely, and calculates that even with a 2% GDP real growth rate, the next generation can expect to enjoy a gain of 34.4% in *real GDP per capita* over the next 25 years.³ As a result, Buffett writes, "The babies being born in America today are the luckiest crop in history."⁴

It's easy to get caught up in short-term market psychology, but that can lead to poor investment decisions and impair investment returns over time. Successful investors accept the reality that the future is unknowable, but they take comfort in knowing that a sound long-term strategy is likely to lead to a good outcome.

Feel free to contact me if you have any questions or would like to discuss your investment portfolio.

¹ Source: "Top Links: Doom Fatigue, busted clocks, and a 59-cent loonie," *The Globe and Mail* website, January 13, 2016

² Source: "RBS cries 'sell everything' as deflationary crisis nears," *The Telegraph* website, January 11, 2016

³ Here's the math: with real GDP growth of 2%, and population growth of 0.8%, the result is 1.2% of per capita growth, which compounded over 25 years results in a gain of 34.4% in real GDP per capita.

⁴ Source: Berkshire Hathaway Inc. annual report and shareholder letter 2015, pages 7-8

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