Market Matters

NOVEMBER 2014 HIGHLIGHTS

- Oil prices plunged in November (see Table 2). News that ample global supply of oil would continue unabated by low prices and sluggish global demand expectations was poorly received by investors.
- Canada's energy sector, along with our petro-linked dollar, weakened substantially. Outside of the energy sector, the other S&P/TSX Composite sectors performed better. Year-to-date, non-resource sector returns have strengthened substantially (see Table 3).
- Most global equity markets performed well in November (see Table 1), with divergence coming primarily from the oil-producing countries (negatively affected by low oil prices) versus the oil-consumer countries (benefitting from low oil prices).
- A string of much better-than-expected Canadian economic data (strong jobs report, housing sale and price gains, above-target CPI, record auto sales, and better-than-expected GDP growth) has helped to counter some of the economic headwinds from low oil prices (e.g. drop in government revenues, hit to oil producers, spin-off industries and related employment).
- Dropping oil prices created downward pressure on Canada's bond yields (and positive returns for the Canadian bond market). Longer duration government bonds once again proved to be the winning strategy.
- China's economy shows signs of slowing (e.g. Beijing home prices dropped for first time in two years). This spurred the People's Bank of China to announce a surprise interest rate cut and boost expectations that more accommodative measures will be coming.
- With two consecutive quarters of negative economic growth, Japan fell back into recession, but the Nikkei was supported by an early federal election announcement and delays to the expected sales tax increase.
- Already the world's largest company by market capitalization, Apple reached a new record value of $700 billion valuation in November. That's simply enormous (according to us) and bigger than all euro zone banks combined (according to Bank of America Merrill Lynch)!

THE TOILS OF OIL

The story of the month was the dramatic drop in oil prices. November's 18% oil price drop, and the corresponding drop in gasoline prices, found its way into mainstream

Table 1
Summary of major market developments

Market returns*	November	YTD
S&P/TSX Composite	0.9%	8.2%
S&P 500	2.5%	11.9%
- in Canadian dollars	***3.9%***	***20.4%***
MSCI EAFE	3.4%	4.8%
- in Canadian dollars	***2.6%***	***3.4%***
MSCI Emerging Markets	1.1%	5.4%
FTSE TMX Canada Universe Bond Index**	1.5%	8.2%
FTSE TMX Canada all corporate bond index **	1.2%	7.3%

*Local currency (unless specified); price only
**Total return, Canadian bonds

Table 2
Other price levels/change

	Level	November	YTD
CAD per USD exchange rate	$0.876	-1.4%	-6.9%
Oil (West Texas)*	$66.15	-17.9%	-32.8%
Gold*	$1,167	-0.5%	-3.2%
Reuters/Jefferies CRB Index*	$254.37	-6.5%	-9.2%

*U.S. dollars

Table 3
Sector level results for the Canadian market

S&P/TSX Composite sector returns*	November	YTD
S&P/TSX Composite	0.9%	8.2%
Energy	-9.2%	-7.7%
Materials	3.7%	-5.2%
Industrials	-0.2%	20.7%
Consumer discretionary	6.4%	23.6%
Consumer staples	6.1%	36.1%
Health care	10.1%	29.4%
Financials	3.7%	13.4%
Information technology	5.2%	27.8%
Telecommunication services	6.7%	12.1%
Utilities	4.6%	13.7%

*Price only
Source: Bloomberg, MSCI Barra, NB Financial, FTSE TMX Global Debt Capital Markets Inc.

conversations around the rinks, malls, coffee shops and water coolers.

Canadian equity investors certainly felt the drag of another tough month for the energy sector, making the S&P/TSX Composite a laggard among many global peers. In contrast, Canadian bond markets experienced a positive effect from falling oil prices. Normally the positive economic results announced in November would cause relative underperformance and/or outright bond yield increases, but lower oil prices countered the benefit for our resource-centric economy, causing yields to fall instead.

A CRUDE BREAKDOWN

Why are oil prices dropping? Supply has outpaced demand. In today's globally-linked economy, factors affecting prices can seem overly complex and difficult to quantify. Bringing it back to the grandfather of all economic rules, "supply and demand dictate prices", can offer clarity:

Supply. US shale oil producers have been ramping up their production of oil by a third in the last 4 years, to nearly 9 million barrels a day. That is just 1 million barrels of oil per day short of Saudi Arabia's output.

The recent meeting of the Organisation of the Petroleum Exporting Countries (OPEC) resulted in a decision to not cut oil production to halt the rapid decline in the oil price. Saudi Arabia is said to have led the push for this decision, much to the chagrin of other oil producing countries like Iran, Algeria, Venezuela, and Russia who want higher oil prices to help balance their domestic budgets.

Demand. Low oil prices reflect the fact that global GDP growth has softened: China's economic growth continues to incrementally slow; the Eurozone's economic health remains fragile and stalled at, or near, 1% GDP growth; and Japan recently dipped (again) into recession. In short, the economic growth challenges around the globe have dampened future demand expectations for oil.

The losers. Beyond the obvious of oil producers (who will struggle with breaching their break-even points between the cost of producing the oil versus the net gain of selling it), the economic conditions of oil-exporting countries in general will suffer in an environment of commodity price volatility and dropping prices. Of particular note, the Russian economy is taking a big hit lately as the plunging oil prices lowered their currency and hurt their oil producers/exporters, all while they continue to feel the economic impact of US and European Union sanctions.

The winners. Several emerging market countries are net importers of oil, and therefore benefit from lower oil prices, such as India, Thailand, Indonesia, and most significantly China. Falling fuel costs are positive for consumers overall, boosting their purchasing power and supporting growth in the broader economy. Estimates are that the resulting drop in gasoline prices could equal the effect of an $80billion dollar tax cut for Americans.

Lower fuel costs also help to keep inflation in check and that in turn helps to keep central banks accommodative in their monetary policy. The accommodative central bank policies, low interest rates and downward pressure on yields have helped bond investors reap better returns, while helping businesses (outside of the resource sectors) shore up their balance sheets and grow with the opportunity to borrow money at low rates.

What's next? Supply and demand are both the cause and the cure to lower oil prices. When the price of oil drops below the level at which oil producers can turn a reasonable profit over time, they'll eventually cut production and curtail the available supply of oil on the market. When the scales tip, and global demand outstrips available supply, prices will once again rise. Unfortunately, the timing of that turn is notoriously difficult to predict, and much of the data used for decision-making relies on forecasts and, well, the uncertainty of economic predictions.

Fortunately for Canadians, our economic position going into the oil price glut was relatively healthy, and we can expect some of oil's drag on the economy to be offset by lower fuel costs for the manufacturing sector, a lower loonie to help exports, and the continued benefit from the economic recovery in the US.

FESTIVE GREETINGS

Amidst the festivities of the season we just can't miss the opportunity to thank you for your business, your trust and for friendships, new and old. From all of us at GLC, whatever is beautiful, whatever is meaningful, whatever brings you happiness, may it be yours during this festive season and throughout the New Year!