CUMBERLAND

"Déjà Vu, All Over Again"

Greece is back in the headlines. Do troubles in Russia and a collapsing ruble remind you of 1998 or does a Saudi Arabian led oil price war look like the 1980's all over again?

Because we've seen this before, the market isn't over reacting. But throw in a few other uncertainties such as a change in the Federal Reserve's monetary policy, the effectiveness of the European Central Bank's renewed monetary stimulation and potential deflation in Europe, and you have enough uncertainties to give investors pause and potentially impair the market valuation, the best gauge of investor sentiment. This is especially true when you include some contagion risk that adds the potential for any of these issues to metastasize into something more problematic.

So, maybe the best way to evaluate this market is to consider each of these issues separately and look at how they might impact investors' consensus expectations for this year. After all, it is these expectations that are baked into today's market valuation and it's the changes to these expectations that will influence the market's future direction.

So that I don't keep you in suspense for too long, let me declare that I am steadfastly bullish on this market. If there are caution signs out there, I think they relate to 2016 when the economy could be hitting on all cylinders and force the Fed to move more decisively towards normalizing interest rates. Until then, an improving economy and very accommodative monetary policy will support better earnings and possibly a higher valuation.

So, let's start with consensus expectation for this year. If I have any discomfort here, it's because I'm in agreement with most of them. Although the interest rate forecasts and earnings projections seem a little high, as U.S. rates might be more a function of the European Central Bank (ECB) policy than the Federal Reserve's and earnings projections might be on a slicker slope due to oil than most think.

Otherwise, this year's forecasts look a lot like last year's. According to a Bloomberg survey, ten year Treasury bond yields are expected to rise to 3.06% up from 2.17% at the year-end. Two year yields are forecast to more than double to 1.54% and the 30 year bond yield is predicted to climb to 3.7% from 2.7%.

On the economy, the Federal Reserve predicts GDP growth at between 2.6% and 3.0% with most private forecasters at the high end, unemployment falling below 5.3% and personal consumption expenditure (PCE) inflation to remain low between 1.0% and 1.6%.

As for the first rate hike, expectations now target the June 17th Fed Meeting.

S&P 500 earnings forecasts have been falling for this year due to oil and have settled at $126, still up 6% for the year plus another 8% for 2016 to $135.00.

The U.S. dollar is also expected to appreciate, which puts further pressure on the S&P earnings as it reduces the dollar values of overseas earnings. It also impacts the global competitiveness of U.S. companies as pricing power is diminished.

This combined with an energy sector that is hurt by declining oil prices makes this year's earnings projection more tenuous than normal.

So, against this set of expectations, let's take a tour of some of the uncertainties affecting this market. I'll start with the concern that is at the top of almost every forecaster's list – OIL.

Oil

The debate is whether the decline in price is a net positive or negative? The answer is neither. Oil is a zero -sum game; for every winner, there is a loser. Simplistically, the price decline results in a redistribution of purchasing power from autocratic-producing countries to industrialized countries.

Annualized, global outlays for oil totaled U.S. $3.8 trillion during June of last year. Therefore, a 50% plunge in the price of oil transfers U.S. $1.9 trillion from producers to users. Of this, about $915 billion benefits the 34 members of the OECD.

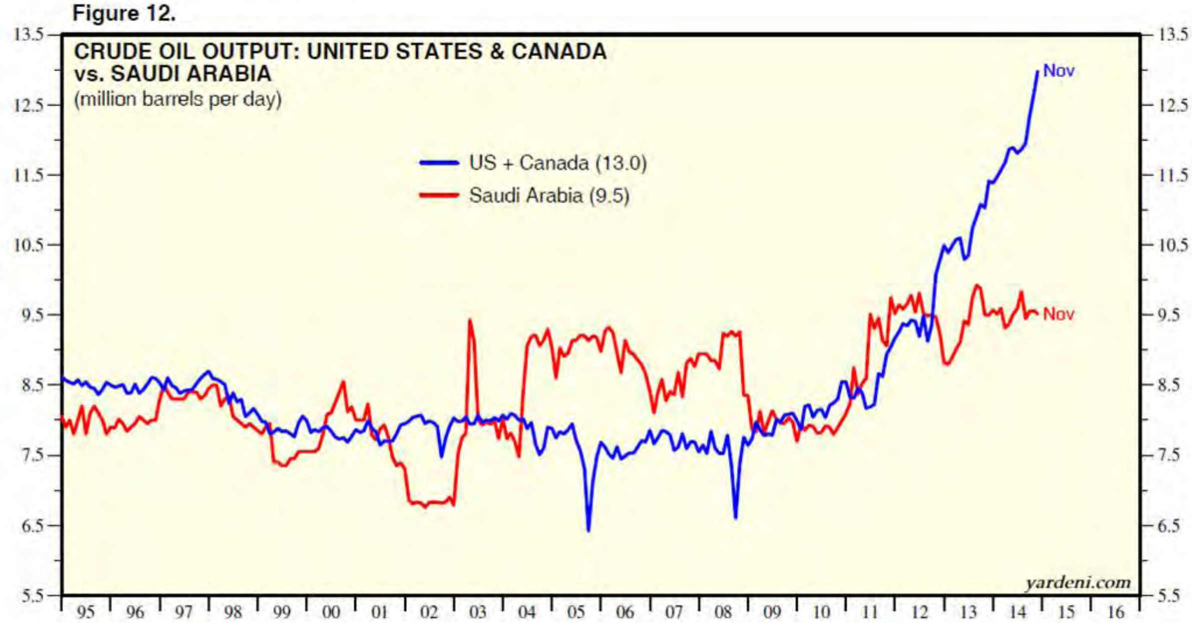
According to the IMF, every $20 decline in the price of oil will increase global growth by 0.4% within two to three years and cut inflation by 0.5%.

But rather than getting into a lengthy and detailed assessment of the oil market and the winners and losers, let me limit my comments to how it will affect consensus expectations and therefore the market.

So the oil price decline should be good, shouldn't it? Well, that depends.

Let's start with how it began. This sudden break in the price of oil shouldn't have been a surprise. In hindsight you can attribute the cause to either an over estimation of China's growing demand or an under estimation of U.S. "fracking" induced supply growth, as seen in this chart.

Figure 12.



Source: Oil Market Intelligence.

However, the unanticipated quadrupling of Libyan products to almost one million barrels per day (mbd) in September seems to be what pushed the price over a cliff.

By the end of October, global oil production had risen by 3.3 mbd in just five months to a record 93.0 mbd. Canada and the U.S. accounted for almost 1.0 mbd of that increase and were collectively producing 12.7 mbd compared to Saudi Arabia at 9.6 mbd and Russia with 10.6 mbd.

Demand wasn't far out of balance at 92.8 mbd but it had slowed to 0.8% year over year mostly due to the developed nations where growth has been flat in the U.S. but declining in Europe and Japan, which was down 4.1% in October.

Supply and demand were not far out of balance until you consider prospects for the growth in supply of about 1.3 mbd coming from the U.S. this year and a then planned increase of 400,000 bbls/day from Iraq in November.

Falling commodity prices are usually associated with a poor economy and the bears would point to declining OECD demand as the reason for the price break and a bleak outlook for the economy and equity markets.

The contrasting opinion is that there is too much supply causing the price decline and it is one of the unexpected consequences of "too cheap" money generated by the Federal Reserve that has flowed into the oil patch. We mostly agree with this side of the equation but you cannot ignore the fact that demand is weak, especially in Europe.

Either way, commodity prices look lower until supply and demand are rebalanced. Until then, we're likely to see lower inflation and continued monetary easing.

So what's the impact on the United States? It is still an importer of oil so they should benefit as the trade gap closes, which adds to GDP. In November, the gap dropped 7.7% from what it was in October.

The problem is a narrower trade gap also results in fewer U.S. dollars going to foreigners who usually sell those dollars. With few greenbacks heading overseas the dollar is likely to be stronger than anticipated, which is not good for companies that have to compete abroad or the value of their foreign profits as they get translated back to U.S. dollars.

It will, however push inflation down and likely cause the Federal Reserve to delay raising interest rates, suggesting interest rates won't go up as much as forecasters think. However, lower oil prices are also supposed to be good for consumers. The average household consumes about 1,000 gallons of gasoline per year according to the Federal Highway Administration. Gasoline peaked at $3.70/gal last April and finished the year around $2.19/gal after 103 consecutive declines.

In total, U.S. consumers spent U.S.$271 billion on gasoline and U.S.$27 billion on heating oil in 2013. So, total savings for consumers could exceed U.S.$200 billion or about $1,500 per household.

Trouble is, you can't count on all of that being spent. For lower income families living pay cheque to pay cheque, it may be the case, but higher income earners probably won't change their spending habits.

The other side of this equation is the oil patch. Shale plays require a high level of continuous investment to maintain output. Some estimate that this spending drop could amount to 0.5% of GDP.

Although the oil industry only employs about one million people, it added 101,000 high paying jobs in the last three years. However, this doesn't include the related jobs that depend on the energy industry from steel mill workers making pipe to truck drivers and manufacturers of tanker cars for the railroad.

It is also estimated that the energy industry accounts for almost 40% of the S&P 500 capital spending. That spending is currently expected to decline by 6% this year, the most in six years. Other industrial companies are also expected to cut capital expenses by as much as 15% this year.

So on balance, the negatives for the economy from oil seem to match the positives but appear to be more assured and immediate.

As for earnings, over the 12 weeks through December 25th, energy sector estimates have declined 30% or $38 billion to $90 billion as the sector accounts for about 11% of overall S&P 500 earnings, which have slid 3.2% from their high, so far. Outside of the energy sector, earnings estimates have remained relatively flat, indicating analysts are unsure of the consumer benefits or the related negative impact to other industries from oil's price decline.

However, some analysts suggest that $50 oil could result in a $6 per share cut to S&P 500 earnings.

That doesn't mean the S&P 500 earnings won't grow next year. But they might come in lower than expected which means the market's valuation is a bit higher than forecast.

For Canada it's slightly worse.

Analysts have already cut their energy earnings estimates by 25%. In 2009, a similar fall in the price of oil led to a 50% reduction in earnings so further estimate cuts maybe on their way. However, it is doubtful that we will see economic conditions deteriorate as severely as they did six years ago. Regardless, this worst case could cut sector earnings estimates by another 25% and overall TSX earnings by another 4% leaving earnings growth flat for the year.

Also, the negative impact is likely to be regional. Obviously, Texas and North Dakota in the United States will be worse hit than other oil consuming states.

In Canada, lower oil is an obvious negative to our GDP. The Bank of Canada estimates a hit of 0.3% to GDP while other forecasts see something greater than a 0.5%, trimming overall growth for this year to 2.2%. The Bank of Canada also predicts that a 40% decline in the price of oil will take about 5% off the value of the loonie taking it to about U.S. 81cents.

The negative impact from falling oil prices will also be regional, affecting Alberta, Saskatchewan and some of the Maritime Provinces the most. This leaves them open to further negative consequences if those governments should decide to cut back on their fiscal spending in the face of falling tax revenues.

On balance:

Lower oil prices = high U.S. dollar = lower inflation which hurts earnings estimates and U.S. competitiveness. It means likely lower or stable interest rates, not higher as the consensus believes and earnings could be lower.

For the economy, benefits from lower oil prices seem to be a trade off with the negatives. In the near term, the negatives appear to be more likely which could shave GDP growth expectations in the early part of the year.

This would again support a more accommodative monetary policy or a delay in raising rates as GDP forecasts, earnings estimates and the market's valuation are all likely too high.

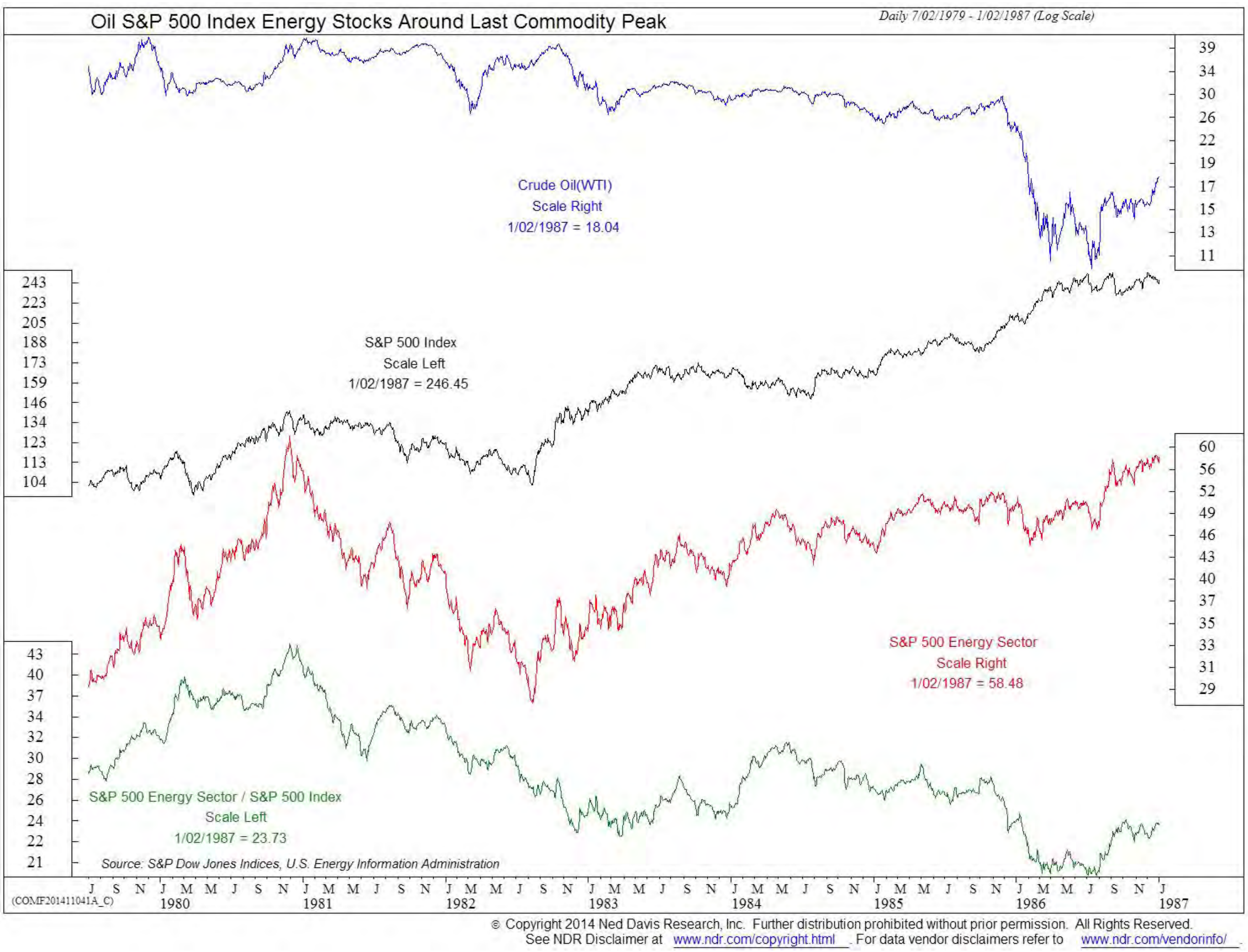
So, what do we see going forward?

In the near term, you're likely to see an overreaction in the price of oil as it overshoots to the downside. Part of this will be driven by speculators getting out of the market as represented by the recent buildup of future contracts.

Supply and demand factors are likely to get worse until U.S. production starts to decline in the second quarter.

For the year, the market is already oversupplied by between 0.5 and 1.00 mbd. Non-OPEC producers will potentially increase production by about 1.5 mbd while demand growth is estimated to be just shy of 1.0 mbd. Net net this leaves the oil market with an excess of 1.5 mbd of supply. Expectations are that this will have to be resolved through cuts to production. It's not an insurmountable amount and far less than what we experienced in the 1980's. So the problem is likely resolved in a shorter period of time after a price collapse deters additional drilling. One could then anticipate oil prices recovering to a higher but yet undetermined price, enough to reflect the new realities of supply and demand but below the threshold that is economic to stimulate additive reserve development.

What can we learn from previous cycles? There have been three previous major corrections, 1985-1986; 1997 – 1998 and 2008 – 2009. The full cycle usually takes about two years while the decline phase is usually six to eight months with the duration of the bottom lasting between three and five months. The average peak-to-trough price decline has been about 60% and one year after the low, prices are historically still 30% below the previous peak. Given that the price this cycle peaked in June, we should be getting close to the bottom, probably no later than this spring.



But let's look at the 80's specifically as shown in the above chart. In the early part of that decade, as today, you had a surge in oil production from the North Sea, the Alaskan North Slope and Mexico. During that period global demand fell by more than two million barrels per day due to a recession, greater conservation and a switch from oil to coal for electrical generation.

Initially, OPEC's response was to cut production by 9.8 mbd between 1980 and 1985. Saudi Arabia's contribution was from 10.3 mbd to 3.8 mbd.

In 1985, Saudi Arabia decided to set a price that cleared the market by increasing production. The price of oil plummeted from roughly $30 per barrel to $10.42 on April 7, 1986. Oil then spent from 1986 to 1990 in a trading range between $15 - $25/barrel.

That cycle is probably the worst case scenario. Back then the world had built up over 15 mbd of excess production capacity compared to about 1 – 1.5 mbd now.

Looking at a normal cycle would suggest prices bottom this spring and might start to recover in the second half of this year. 2016 should see further progress but not with prices significantly higher.

So there is probably a trade here, but not a long term investment thesis.

Current fundamentals aside, energy stocks could be considered a call option on troubles in a very unstable Middle East. Although OPEC has increased their production, there is very little spare capacity to offset any major outage and most of that spare capacity is in challenged areas such as Iran, Venezuela, Nigeria and Libya. And then there is Putin and the question of what a desperate politician might do to stay relevant.

So it's worth maintaining some exposure to this group as a hedge against political turmoil and a bounce even if the longer cycle doesn't seem that promising.

However, if you look at the oil chart on the 1980's, you can see that energy stocks followed the price of oil down but then bottomed and started to recover. Selectively you could have made money in the group even though they underperformed relative to the market.

Otherwise, the contagion risk for the group probably resides in the bond market. Since 2010 energy companies have raised $550 billion. The sector now accounts for 15.7% of the $1.3 trillion junk bond market versus 4.3% a decade ago. The decline in the price of those bonds, which is around 13.2% since June, has not only caused the spread between corporate and government bonds to widen, but the cost of funds and lack of appetite for further lending will impact the amount of capital that flows into the sector. This will consequently limit future capacity expansion which is exactly what OPEC is hoping for.

This could also back into financing for other industries Redemptions of high yield bond funds have picked up to almost $2 billion in the first week of December. Funds will have to sell bonds to meet these redemptions and with limit bids for energy issues, other corporates will have to be sold, potentially raising the cost of capital to even those outside of the energy sector.

Greece

I suppose the next high profile concern is Greece. The current government was not able to elect a President and was forced to call an election for January 25th. Right now the polls point to a victory by the left wing Syriza Party which advocates a renegotiation of the bail-out terms and a write-down on their sovereign debt similar to what was done for Germany in 1953. The party also would increase wages and expand the number of government jobs. But they are not advocating pulling out of the Euro.

Back in 2011 the threat of Greece withdrawing from the Euro sent shock waves through the continent as the fear of contagion would bring down the banking system and the European Union.

Today it's different. Financial contagion is not a concern. 75% of Greek debt is not tradeable. Although €20 billion of Greek debt matures this year, the European Central Bank (ECB) holds €6.7 billion and the International Monetary Fund (IMF) owns about €8.0 billion.

In the last crisis, the contagion risk was apparent in the sovereign bond market when yields on Spanish, Italian, Portuguese and other peripheral European countries bonds spiked higher. Italian 10-year Treasuries reached over 7% but today, yields 1.8%, which is the lowest on record. Yet, Greek bond yields have recently climbed to 9.41% from 5.57% in September.

So, if there is contagion risk this time, it is much less likely to be financial but instead precedent setting, that encourages other financially strapped countries to follow Greece's lead.

The likely outcome, should the Syriza Party win, is a centralist coalition government, as Syriza is unlikely to achieve a workable coalition. This will result in a lot of backtracking on election promises.

Further, it's possible Germany will agree to some concession. They did have some debt forgiven in 1953 and they're currently owed about €77 bn by Greece while the net present value of that debt is substantially lower than face value.

We could be underestimating the consequences of a change in the government. However, right now, Greece does not seem to be that important to the market.

Russia

Russia would be the other sovereign issue. Not only is the country suffering from sanctions due to its invasion of Crimea, their problems have been amplified by the collapse in the price of oil.

There is contagion risk here for the financial markets, political risk from potentially disparate actions by Putin and economic risk to Europe.

On the financial risk, the Russian government only has U.S. $38.7 bn in public sector debt. Against this, they have foreign currency reserves of almost U.S. $587 billion.

The problem is the $502 billion in private company foreign currency debt that equates to almost 25% of Russian GDP. Roughly $130 bn is set to mature this year. Unfortunately, sanctions are going to prohibit Western banks from rolling over this debt, potentially making it a sovereign issue and depleting Russian reserves.

Oil and gas account for 68% of Russia's exports and 50% of its Federal budget. They have already lost $90 bn in currency reserves which equals 4.5% of GDP as they defended the Ruble which is now down over 50%.

All of this has caused Russia's second and third largest banks to seek government aid to replace capital after sanctions cut them off from international financings.

To offset this run on their currency, Russia's Central Bank increased its benchmark interest rate to 17% from 10.5%. They've also seen inflation jump to almost 10% because of the weak currency.

Similar circumstances in 1998 saw the ruble decline 72% and Russian interest rates spike from 30% to 150%.

The fear is that Putin will play the default card as Russia did in 1998, or that he could become more militaristic as he wants to remain relevant and doesn't have much to lose.

Bottom line, the Russia situation is an uncertainty with potentially negative consequences. Defaults could back into the financial and bond markets and although Russia is not a big importer from Europe, their reduced demand has already cut European exports by 0.7%.

Europe

Let's finish our tour of macro concerns with a brief comment on Europe. Although they are net energy importers, the decline in the price of oil is not likely to be that beneficial, as they are one of the world's least oil intensive economies. Oil consumption has declined for six straight years and is now at a level last seen in 1969.

In addition, the European economy benefits from the recycling of petrodollars as Russians, Norwegians and Arabs alike enjoy spending money and buying assets in Europe.

So it's questionable whether a declining oil price will help Europe at all and leaves all the heavy lifting of economic stimulus to the ECB and a further devaluation of the Euro. Although currency devaluation may be a small help to the overall economy, it will also offset some of the deflationary pressure from oil. Furthermore, corporate profit margins benefit as European companies get about half of their revenues from outside the continent which will get translated back into more Euros.

Mario Draghi, head of the ECB, continues to talk about Quantitative Easing (QE) and expanding the central bank's balance sheet by €1.0 trillion. Yet there has been no concrete action and it's questionable whether any central bank stimulative action will do any good. The objective of QE is two-fold. First, it's intended to lower interest rates to stimulate business spending and second, to lift asset prices to create a wealth effect to trickle down into the rest of the economy. Unfortunately, interest rates are already low in Europe. In fact, sovereign debt yields are lower than in the United States; yet low yields haven't stimulated the economy. Consequently, it's questionable what another round of ECB asset purchases will accomplish. We still believe the source of Europe's economic problems is structural and resides with their overly regulated markets, especially labour.

On balance, we believe Europe's most successful exports to the U.S. will be deflation and lower interest rates.

Market

So, what does all this mean for the market?

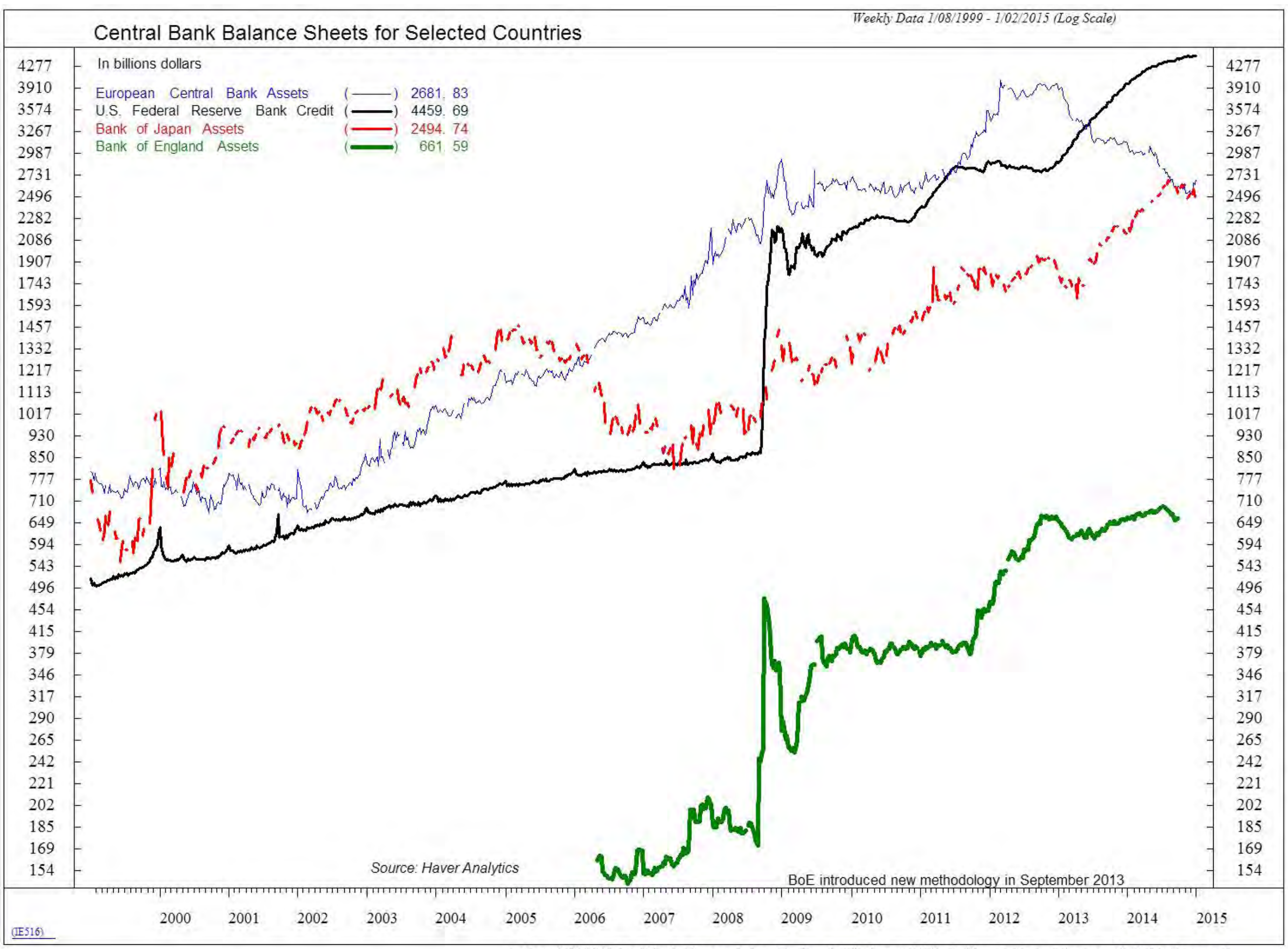
We've said for some time that we think this bull market will continue as long as the economy can make some progress and monetary policy stays accommodative. Our only concern has been with its absolute valuation which we think is a little on the high side.

The macro concerns surrounding Greece, Russia and contagions from oil create uncertainty which won't be good for valuations if investors move from optimistic to cautious. So, these issues could give us an overdue correction.

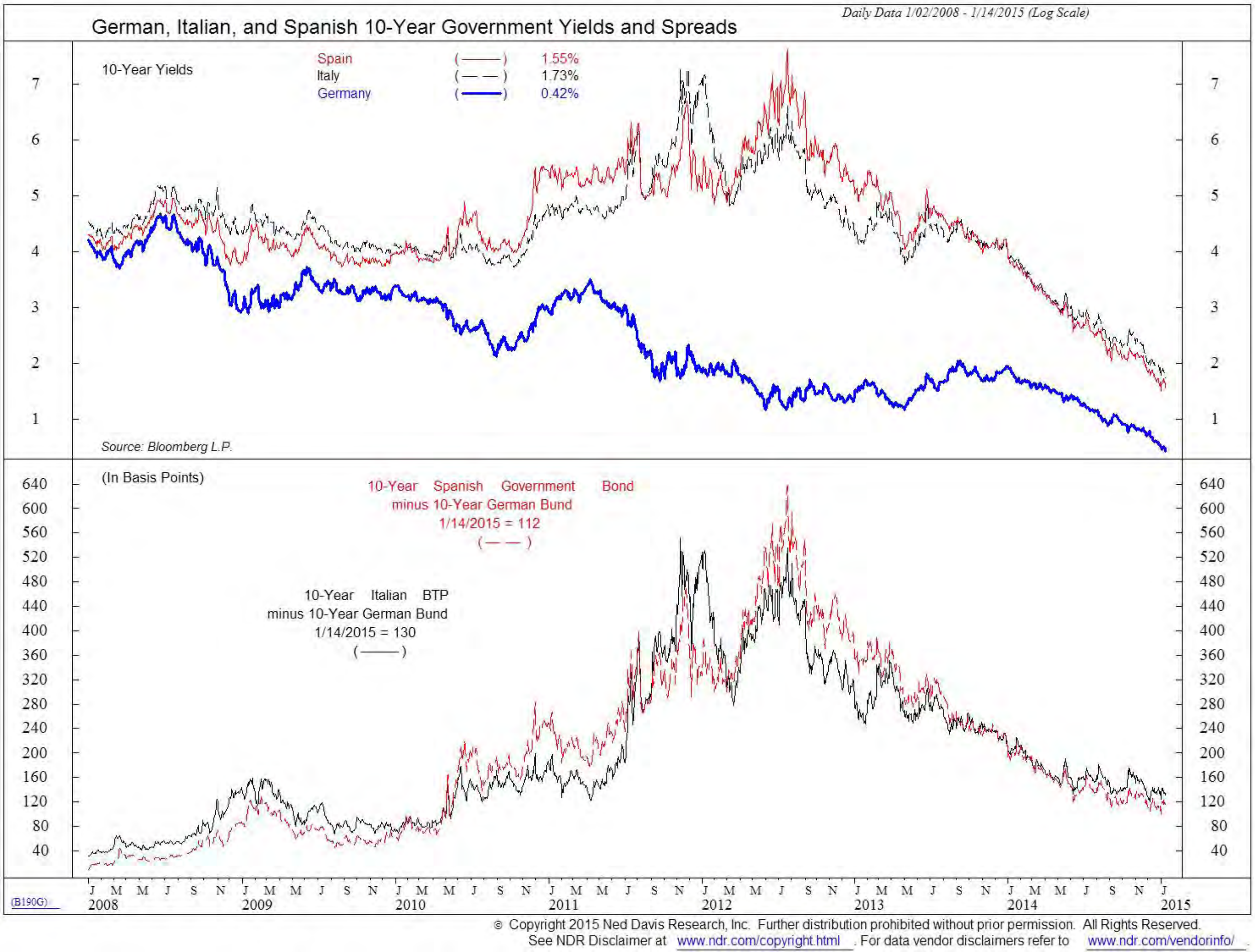
As for the economy and earnings, my bet is that lower oil will initially be negative. You are already seeing cuts to earnings forecast that make today's market valuations much more problematic.

The economy will feel the cutback in capital spending, slowing global growth, and the competitive disadvantages of a stronger dollar. All reasons why monetary policy should remain accommodative. So, relative to consensus expectations, the economy could underperform and interest rates could again surprise by staying lower than expected.

Monetary policy will continue to be the primary driver for this market. Although the Federal Reserve has ended their Quantitative Easing, the Bank of Japan and the ECB are picking up the slack as seen in this chart.

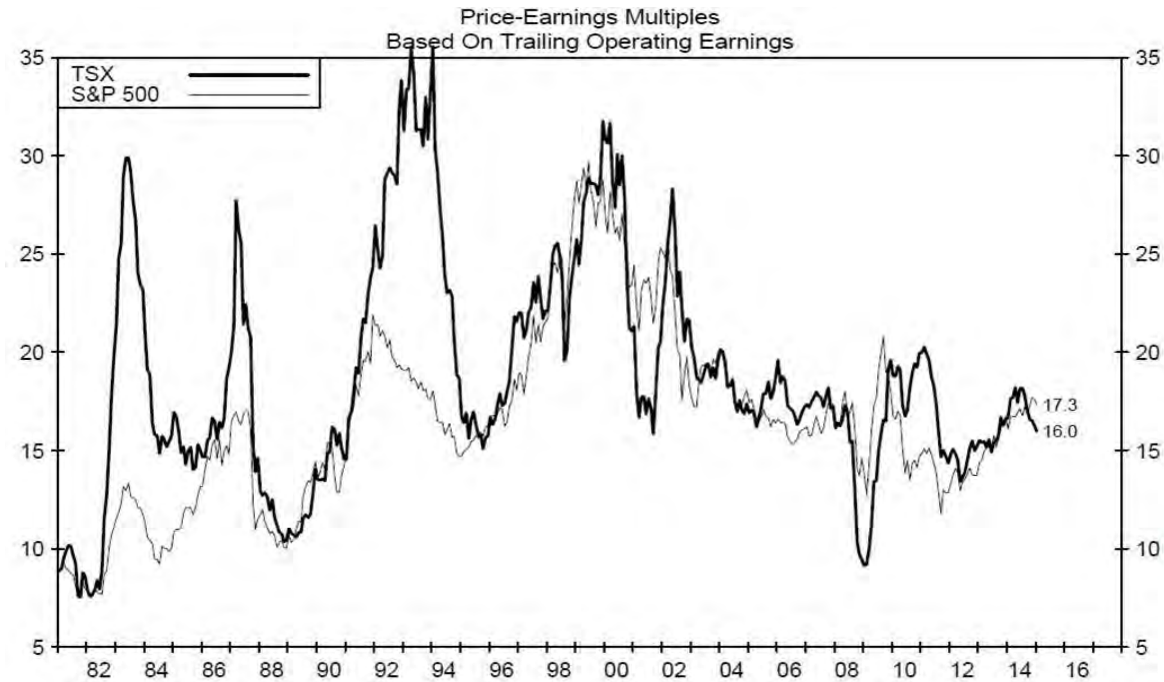


As long as the Japanese and European economies remain weak and their sovereign interest rates remain lower than comparable U.S. rates, money will flow into the U.S. as seen in the following chart.

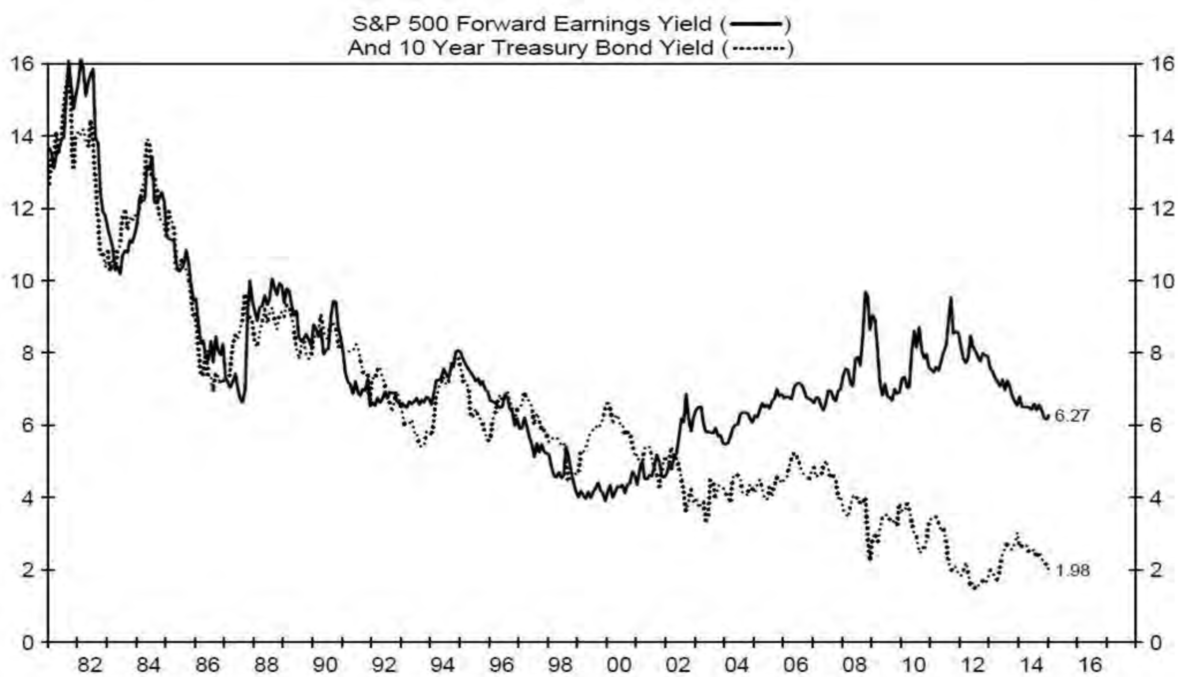


Liquidity is one thing but price is another. Should the Federal Reserve elect to raise interest rates (i.e. price), one could expect the dollar to soar even higher, further compromising U.S. economic competitiveness and driving inflation even lower. These are two outcomes the Fed would like to avoid. Consequently, it's hard to see what conditions would elicit a change in their monetary policy.

Yet, in the face of lower earnings adjustments, the markets are still trading at valuations above their long term average as seen in this following chart.



However, relative to interest rates the markets are cheap.



The valuation gap between earnings yields and falling interest rates is still at historically wide levels supporting higher market valuations

You can add a couple of other historic correlations to this positive view.

In the previous five, non-recession years, the S&P 500 has posted a 19% annualized gain for six months following a decline in oil.

There is also a very strong positive correlation between the S&P 500 Index and the U.S. dollar. In the previous seven episodes of the dollar soaring, the market has risen an annualized 17%.

This market may still be near all time highs but relative to other asset classes, it still looks cheap. The only exception might be commodities which is currently a little out of sync.

Commodities hit their peak on the back of China's growth story in 2008 when oil peaked at $145/bbl. China, it was then believed, would consume everything that could be produced. Capital poured into the sector and commodities became an asset class unto themselves with pension funds allocating billions to take advantage of the China growth story.

Somehow the concept of supply was forgotten in this demand driven story. After all, we were running out of stuff and whatever was left would require higher and higher prices to produce.

Well, here we are six years later. Oil production, along with iron ore, copper, nickel, you name it, is in excess supply. Growth is still there but unexpected supply has overwhelmed it as we contemplate the benefits of sub $50 oil, about a third of the 2008 peak.

In a world where things look expensive, commodity prices are one of the few things going in the opposite direction.

Is it time to buy? Well, in principle you buy commodities when there is excess supply not shortage, and we appear to be there.

Trouble is, these cycles play out over very long periods of time. A typical commodity cycle is sixteen years and this one only peaked six years ago.

The excess production will continue until the last marginal producers shut down and demand catches up.

In the meantime, the first symptoms of a bottom are in. New production budgets are being slashed and aggravated supply levels will eventually start to roll over. However, demand growth will remain challenged without another China to come along. Prices may initially bounce from oversold lows and then languish for an extended period. The only hope for oil is that the excess supply appears to be smaller this cycle than in the past. Regardless, resource stocks won't perform until commodity prices improve and oil is likely capped at something lower, possibly substantially lower than the previous peak as OPEC wants to assure its own place in the supply chain. The exception to this view would be conflict in the Middle East or Russia that affects supply which is a real possibility. So it's worth having a position in resources, even for nothing more than a hedge.

Nonetheless, in the big picture, commodities are one of the few asset classes that are starting to look cheap and bear watching by long term investors.

So, on balance, we're constructive on the market for 2015, but we might have to digest and factor in some macro uncertainty and lower earnings estimates before we resume an upward path.

GRC/amh
January 12, 2015

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