strathbridge
ASSET MANAGEMENT

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"By the Way"

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A year of frustration, and then, the worst start to a year in history. If you just looked at the S&P 500 return in U.S. dollars for 2015, you might figure nothing much happened last year. The index was down less than 1%, but with dividends had a return of +1.4%. As a sign of investor indecision, the S&P crossed "flat for the year" 30 times in 2015, by far the most on record. If, however, you tried to be smart, or are Canadian, the spread in possible returns was quite large. The average Canadian investor who owned the S&P would have had 16% more loonies to spend, given the decline in our dollar. If however, he stayed at home and owned the TSX, he lost 11%; or worse, owned the Small Cap Index down 15.8%; or the Venture Index down 24.4%. The latter two indices, being obviously over-exposed to resource stocks. Even within the S&P 500 itself, returns were widely skewed. If you owned the 10 largest stocks in the Index, you made 17%; if you owned all of the other 490, you lost 5%.

It has been a failing of mine over the last five years to spend too much time worrying about the negative effect of geopolitical events on financial markets. Just to mention a few: the Greek situation scared me; as did the wars in the Middle East and the Ukraine; also the shut-down of the U.S. Government in 2013. While these were short-term blips in the market, none of the events had any major impact on the continuation of the bull market for the S&P 500. Despite all that, I will not be dissuaded from continuing to be a worrier. No one gets rich being afraid, but lots of people get poor by not being prepared for bad news. Given we are now entering the eighth year of this bull market, there is more reason to be cautious. China is an obvious concern as the economy slows, the yuan and the stock market decline, and the ability of the central government to control everything is being called into question. The volatility in that market is quite remarkable; the Hong Kong Interbank lending rate went from 4% on Friday, January 8th to 13.4% the following Monday.

We may have developed a false sense of security about Europe after the ECB implemented quantitative easing, but we are not out of the woods yet. The immigrant issue is a serious divisive element between the various member countries, and inside Germany it has put Merkel's leadership under pressure. The Greek bail-out was thought to be a "fait accompli", but it is in fact not settled and negotiations are becoming more heated again. Keep an eye on Italy. Bad loans are at a record high, bank stocks are tanking, and the European Union is being asked to help. There's a lot more unrest around the world.

Still the U.S. is probably where we should place most of our attention, and could be the saving grace as a positive catalyst for global growth. Having said that, the fourth quarter GDP is looking weaker than expected, as consensus estimates are now well under 1%. That brings me to the Fed, which readers will know has always given me reasons to be unimpressed. In my opinion, they waited too long to raise rates, and now that they have (and indicated the likelihood of 4 more raises in 2016) events have turned against them. The slower GDP growth at home, coupled with problems in China, lower oil prices and volatile financial markets suggest a slower pace of increase in rates might well be in order. At best the Fed's ability to forecast is being called into question; at worst this could be a total embarrassment.

It is an election year for the U.S., and the outcome could have a meaningful impact on markets. Put simply, a Democratic victory will likely be bad for energy and healthcare stocks, while a Republican win would be good for energy, bank and defense companies. Unfortunately, one piece of common ground is they both hate Wall Street.

In summary, the weakness in the stock market so far this year is very concerning. Trend lines have been broken, and internal measures are abysmal, leaving the "burden of proof" on the bulls to move this market higher. When the market rallies, we need to see more participation from more stocks, i.e. an expansion in breadth. There is an increased potential for an economic or geopolitical event to be a serious negative. However, these lower markets offer opportunities for the intelligent and courageous investors with cash to deploy. Jared Dillian, one of my favorite newsletter writers says; "the bearish argument is always most compelling on the lows". I mentioned this positive spin to a fellow portfolio manager and his reply was "sounds great, you go first".

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