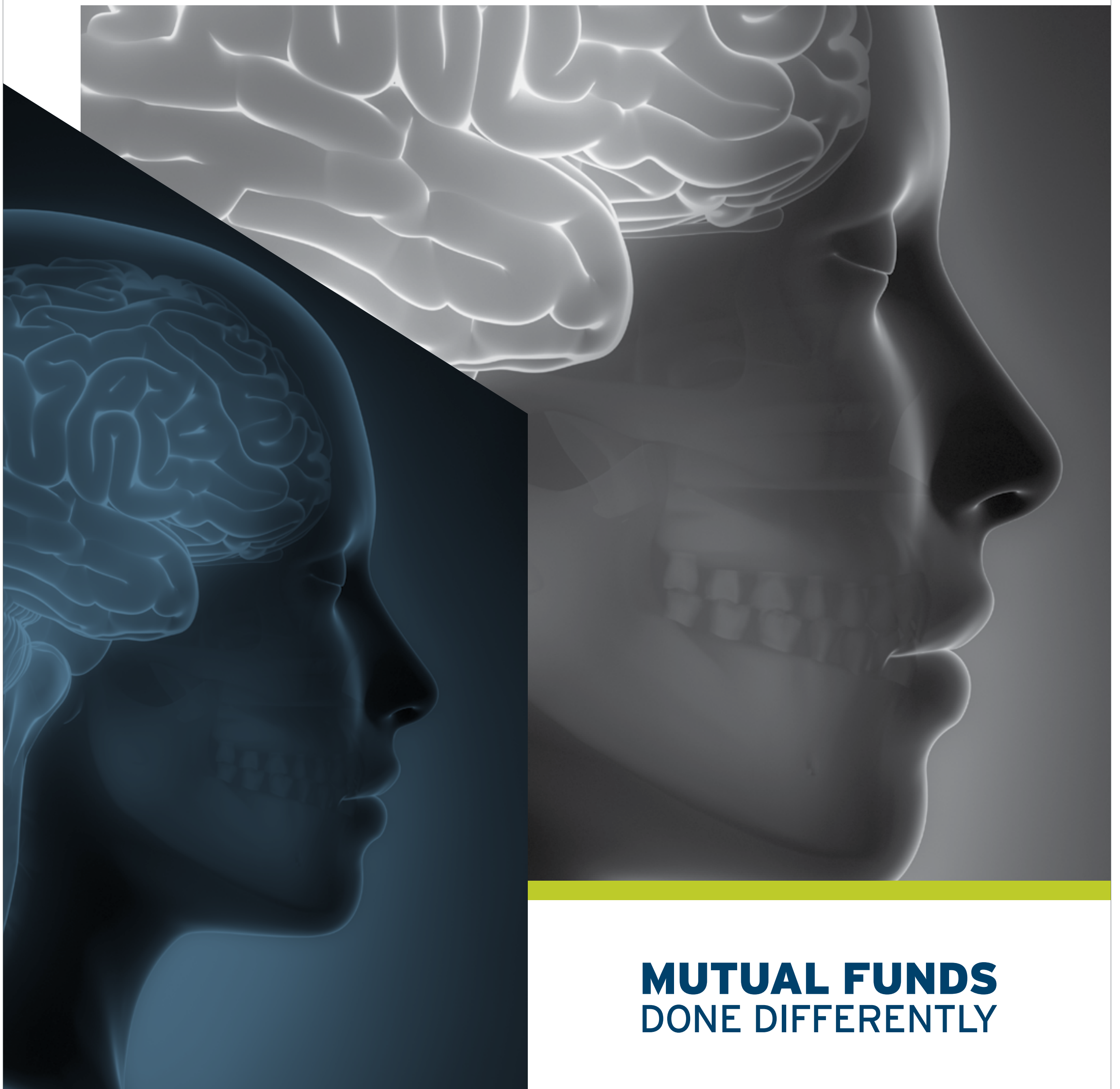
PART 2:

OUTLIERS, FORECASTS, AND MARKET TRENDS:

Economic Insights for 2015

AN NEI REPORT WINTER 2015



MUTUAL FUNDS
DONE DIFFERENTLY

NEI INVESTMENTS

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Economic Insights for 2015

CHRIS NICKERSON The topics we are discussing in this two-part series are outliers, forecasts and market trends for 2015. In this second issue, we examine market trends and the economic forecast for 2015. I am talking today with four members of the NEI portfolio management team: John Goldsmith of Montrusco Bolton, Christine Hughes of OtterWood Capital, Dara White of Columbia Management, and Todd Youngberg of Aviva Investors. I will start off with a broad question: The Federal Reserve has ended quantitative easing and potentially will increase interest rates in 2015. What are some implications for next year?

JOHN GOLDSMITH Well, if you take a look at the consensus, and if you take a look at short-term rates, expectations are that they are going to increase from 25 basis points currently to 95 basis points. If you take that a little bit further out, you know the ten-year rate is obviously going to be increasing well above 75 basis points. But on that note, I would say that the expectations over the last year and a bit have been wrong, in that they have been calling for increases in rates, especially toward the beginning of 2014, and that never actually happened. Yes, the U.S. economy is performing well, but let's compare that to what's going on overseas: it's a comparison with Europe, which is battling a disinflationary quasi-deflationary problem, and with Japan, which has had its own issues coming out of deflation for many years by imposing Abenomics and its own version of QE.

So where the implications really lie is, as long as Japan and Europe continue to stay in the QE camp, the U.S. dollar will have a hard time weakening against anything, and in that environment a strong dollar perhaps works a little bit against the revival or the renaissance of the U.S. manufacturing. I've never really seen a lot of great export superpowers with extremely strong currencies, but at the same time a U.S. dollar that doesn't weaken means that it's very difficult for gold and precious metals to do well. So I think the key play on the commodity side still centres on energy, primarily natural gas and oil.

CHRIS NICKERSON So rising rates in the U.S. likely mean a strong U.S. dollar, which makes sense. Todd, your thoughts on the topic?

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TODD YOUNGBERG It really depends on why the Federal Reserve is increasing the rates, where inflation is, where the economic growth is, and the market's perceptions of growth being sustainable. If inflation in the U.S. stays at 1.3% as measured by the consumer price index (CPI)—the core CPI was up 0.1% in November and is at 1.7%, by the way—it will probably be a measure that the Fed focuses on even further. If inflation remains unthreatening in the foreseeable future, the Fed can take it slowly. If inflation starts to show signs of increasing to around 2%, then the Fed will most likely act, and the expectation, of course, according to the euro/dollar curve, is that could happen sometime in the middle of the year. We would expect that if there's any over or under, it would probably be later rather than sooner, given the overall inflation environment.

However, the perception of the market is that the Fed appears ready to increase rates next year in order to provide more of a tool for monetary easing later—in other words, reloading their toolbox. It's really going to depend on the market's perception of the economy's strength and ability to absorb rate hikes without a detrimental impact on growth. We always have the saying, "Don't fight the Fed." We do believe that there'll be some market volatility when the Fed does start to increase rates, but we also think that they'll certainly take their time and not rock the boat or the recovery in the economy.

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CHRIS NICKERSON "Don't fight the Fed", words to live by, Todd. And it is interesting that you think the Fed will try to manage market expectation by raising rates in a controlled manner; thank you. What about elsewhere in the world? Christine, what are your views on the impact the new stimulus measures by the Bank of Japan and the European Central Bank will have on markets in 2015, or longer-term?

CHRISTINE HUGHES Yes, the stimulus measures, particularly by the Bank of Japan, are extremely aggressive; the European Central Bank, less so. The markets are waiting for the ECB and almost daring them to embark on full QE, which means buying sovereign debt. We will see how that shakes out next year. What the Bank of Japan is doing is providing a massive amount of liquidity to global markets. What is interesting and curious about QE is that it is impossible to tell ahead of time where the money is going to go, and which markets it's going to support, because it does leak out of the country in question. U.S. QE leaked into commodities and emerging markets. Where is Japanese QE going to leak into? Only time will tell, but we believe some of it is going to go into U.S. equities. This is particularly true for the second round of QE that Japan announced on October 31, 2014. What it means for the team here at OtterWood is the persistent strength in global asset prices. Generally we see a lifting of asset prices, primarily certain global stock markets, in the future.

CHRIS NICKERSON It looks like QE from one region can have an impact globally, and generally is favourable for equities. So far we have heard about impacts on the developed countries. Let's hear from the emerging markets' point of view. Dara, what do you think the effects of all the QE programs will be on capital flows in emerging markets?

DARA WHITE I think we addressed some of this in the first discussion of what's going to be different in 2015 compared with 2014. It's really hard to say whether the quantitative easing from the BOJ and ECB will offset the end of quantitative easing in from the U.S. I do think we have to be prepared for higher interest rates and asking just what that means for the emerging market universe. As I said earlier, I think the risks that were highlighted in 2013 were overstated, and if the end of QE and higher interest rates in the U.S. are because of positive economic growth in the developed world, then it is not necessarily a bad thing. It could actually even be a good thing.

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CHRIS NICKERSON So no "taper tantrum" expected in emerging markets. What about this new exchange link between Shanghai and Hong Kong, allowing foreign investors to access China A-shares directly, starting November 17? Have you seen any major trends related to this, and is there a potential for you to take advantage of this new link?

DARA WHITE There's been a surge in liquidity since that date, but it also coincides with the interest rate cuts we saw in China over a couple of weeks ago. What we really needed to see is the economy getting better and getting stronger. For us it's a still a wait-and-see approach. As I said, we have a more balanced view toward China than we have had for a number of years. Certainly the opening up of A-shares is a part–it's one reason for that. We do have the ability—or are currently working on the ability—to buy A-share companies. They are companies that we've long researched, and they are on our radar screen, but we have not purchased any as of yet.

CHRIS NICKERSON Thank you, Dara. Let's switch gears back to the U.S. Todd, it looks like the market is expecting the Fed to raise rates mid-2015; what would be the potential impact of a rate hike for the high-yield asset class specifically?

TODD YOUNGBERG High-yield bonds have historically had a low correlation to interest rate volatility, in fact they have a higher correlation to equities than fixed income, and that's the reason high-yield bonds have been viewed as more of an equity surrogate than a fixed-income asset class. They have provided very good diversification in a rising-rate environment, historically. Today we have seen spreads tighter than a few years ago, although wider than a year ago, at around 450 basis points today. The correlation to rates is actually slightly positive, reducing that

diversification benefit somewhat. However, the correlation is still relatively low, around 0.4 for the ten-year Treasury, and compared to around 0.9—almost one for one—between investment-grade bonds and the ten-year Treasury.

In the past, during the stages of monetary tightening, when the Fed started to increase the Federal funds rate, the high-yield bond market typically sold off temporarily, but that was then followed by a much longer period of spread tightening, if you look at 1994 and 2004 as examples. The main driver of high-yield return is default rate expectations, and with U.S. economic growth expected to be around 3% for the next year or so, with record earnings, very strong balance sheets, and only moderate releveraging on corporate balance sheets, default rates are expected to stay low for some time. In fact, today they're at 2.3%, and are expected to go up to only 2.4% over the next 12 months; that is about half the long-term average in the high-yield marketplace.

CHRIS NICKERSON Yes, high-yield bond performance is more linked to default rates than interest rates, and as long as corporate profits stay healthy, default rates should stay low. How about U.S. equities? After the strong return over the last few years, do you think there is still room for the U.S. equity market to move up? Is the U.S. economy strong enough for U.S. companies to continue to grow earnings even as global growth moderates?

TODD YOUNGBERG Without a doubt: even assuming there is no multiple expansion, equities can still rally against a backdrop of strong U.S. economic growth and earnings growth. Something that is interesting is that global dividend growth for 2014 is expected to have a double-digit increase, and that is expected to continue in 2015, with the U.S. leading the way. From a market psychology standpoint, investors are still relatively cautious and sceptical about this rally, even though we are at an all-time high. We believe that scepticism should continue to provide a bid to the market.

Then look at something that is relatively political in nature: the gridlock that we have in the U.S. Historically, when you have had a Democratic president and either a Republican-led Congress or Republican-led Senate, or both, which we have today, it has been very positive for the market—assuming that we do not go into any type of fiscal crisis again. And we certainly do not have some of those deadlines that we have had in the past.

So we think that the political structure of potential gridlock could be a positive for the market as well. And then, of course, one of the initiatives by the new members in the Senate and the house that might get through is a change to the corporate tax rate. Any type of restructuring in the corporate tax rate certainly would be a positive for cash flows for U.S. corporations.

So the answer is absolutely yes; assuming that multiples stay constant, there are a lot of positives that could continue to contribute to earnings.

CHRISTINE HUGHES At OtterWood we do believe there's still room for the equity markets to move up. As students of macroeconomics, we look to those factors when considering investing in any market. And with respect to the U.S., we have to look at the economic cycle and where we are in that cycle. In our opinion, we are only halfway through the economic cycle. We are at the same spot as approximately 1994 and 2004 in terms of the cycle. That is when interest rates started to normalize for those time periods, meaning the overnight rate started to climb higher. I think it will be an elongated process this time around, with years to go. I think we're only about halfway through, and typically at this point in time, equity markets continue to rise.

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Second, yields are still very, very low, and historically when yields are this low and the economy is growing, stock market multiples generally expand. Stock market multiples can expand until we get to 5% on the U.S. ten-year Treasury yield. At about 5%, investors look at the risk-returns for bonds and stocks and start taking money off the table in the equity market, thinking "If I can get 5% over ten years on a U.S. Treasury bond, I will take that any day," but we are still far from that level.

Third, in any market, when you see the equities rising *with* the currency, in tandem, that is a very self-fulfilling and strong equity market. It is not an equity market rally borne out of currency devaluation, and it tends to be stronger and longer in duration. We are seeing precisely that in the U.S. now.

CHRIS NICKERSON It sounds like there is agreement that the fundamentals for U.S. equities are sound and that U.S. equities could continue to go higher despite the recent rally. The U.S. dollar has strengthened quite a bit in 2014 against other major currencies. Do you expect the trend to continue, and what are the implications?

TODD YOUNGBERG We believe the U.S. dollar is likely to continue its multi-year upswing. Its fundamental valuations remain very supportive. The dollar is cheap relative to most major currencies and is expensive mainly against emerging market currencies that have structural challenges. Faster growth, improving balance of payment fundamentals, and quicker monetary policy normalization are all supportive of continued U.S. dollar strength. Lower oil prices are expected to be positive for the U.S. dollar as oil-importing nations experience a benefit to growth from lower oil prices. So we believe the trend is alive.

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CHRIS NICKERSON I would like to focus more on the U.S. dollar against the Canadian dollar specifically. Do you expect the trend to continue, or can there be reversal, and what are the implications for the Canadian market?

CHRISTINE HUGHES We do think that the U.S. dollar can continue to strengthen against the Canadian dollar, but at a more measured pace than we saw in the third quarter of 2014. We do believe in the U.S. dollar strength and dominance, particularly because we've seen the announcement from Japan and the implications of a weaker yen, and we've heard the promises from Europe to weaken the euro through QE. So against that, I think we'll see a stronger U.S. dollar. As it relates to Canada, though, we're still very tied to the U.S. economy, and as it continues to expand and rebound, so will the Canadian economy. Our CPI data, recent data for the back half of 2014, have been respectable—not as weak as everyone feared. We should see rhetoric from the Bank of Canada that moves them toward a strengthening-rate environment toward the middle of 2015 and the back half of 2015, which is currency supportive.

JOHN GOLDSMITH It all depends on a couple of things. First of all, Canada has got more of its GDP tied up in the home real estate market than the U.S. does. So if there's any weakening on the real estate side, obviously that will have negative implications for the banking sector and negative implications for the Canadian economy, and obviously, as a result, negative implications for the weakening of the Canadian dollar against the U.S. dollar. Once again, I think one of the key elements here–and you know I think it's a foregone conclusion that growth rate expectations are obviously higher in the U.S. than in Canada–is the liquefied natural gas potential that Canada has, which would make it an absolute outlier in terms of developed markets and the potential returns that people could derive from it. If the liquefied natural gas (LNG) projects get approved, that will have, I believe, a dramatic effect on the Canadian dollar, and I would expect to see a reversal—perhaps not Canadian dollar parity, but there certainly would be a reignition, if you will, of the energy sector and of interest in the Canadian markets, for a lot of foreign investors too.

CHRIS NICKERSON It sounds like the U.S. dollar will likely remain strong, which can be good for Canadian exports. However, there could be catalysts that can break the trend. Let's talk about scenarios: during October we experienced a sharp pull-back from the market, after which the markets recovered. If this happens in 2015, what are some opportunities that we need to take advantage of?

CHRISTINE HUGHES We expect 2015 to have its fair share of volatility. From a macro perspective, we are more bullish on equities than we are on bonds. We would take advantage of that opportunity and add to positions in that asset class during any kind of equity market volatility.

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JOHN GOLDSMITH You know, the sectors that have been affected the most since this—call it a—"mini-correction," have obviously been the cyclicals, energy and resources. The reality though is that in Canada energy and resources are typically always the most volatile sectors. Once again, if LNG prospects for approval go ahead at the beginning of the year, I would expect a massive rerating, not only on the expectations for EBITDA and earnings for the entire sector, but also in terms of multiples, which are near five-year lows.

As for materials, obviously what you would need is for China to surprise on the upside with regard to economic growth. There I believe you would get greater demand on all of the materials names. And finally, if for any reason the U.S. dollar were to weaken, that obviously would be very good for the gold market. In Canada today, gold equities represent 4.5% of the TSX composite, and silver equities represent slightly less than that; combined, we're looking at a 5.2% weighting. Let's recall that a couple of years ago, gold and silver were over a 12% weighting in the TSX. So needless to say, with any type of weakening of the U.S. dollar you would see a strong, strong move ahead with regard to gold and precious metals.

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TODD YOUNGBERG Yes, absolutely. It depends on why the pull-back is occurring: is it technical, is it forced selling by retail funds—and you know investors in fixed income have really accessed a lot of assets over the last several years—or is it maybe more fundamentally induced by a turn of the cycle? You have to make sure that you completely understand why the market is selling off, first and foremost, before you make any investment decisions. If it's a case of technical sell-off, such as retail selling and high-yield bonds—and we certainly experienced that a couple of times over the last year—we view that as a buy-in opportunity. It's a time for the investor to actually go the other way and be contrarian compared with the investors who are getting out, because the underlying fundamentals in a technical sell-off typically remain intact, and the underlying fundamentals today for corporate credit are incredibly strong, particularly for high yield.

Of course, one of the things that you never, ever want to do is double down on a losing investment, so I always want to make sure that we clearly understand why the pull-back is occurring. If it's technical, it's typically an opportunity; however, if it's a turn in the cycle because of a large fundamental event, then you might have to have apply more risk management in your approach.

DARA WHITE We look at volatility in markets as an opportunity. I discussed our process in the first discussion: having those upside and downside price targets on the names in your universe and the names in your fund really allows you to take advantage of when the markets decide to panic and to stretch out. That's often when we've become most active in terms of

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>
> DARA WHITE

trading and making sure we take advantage of that volatility. We welcome it and really try to use it to set up the portfolio to make sure it's positioned to capture the best upside and downside over long periods of time.

CHRIS NICKERSON It's great to hear that our portfolio managers are all prepared and have a well thought-out plan to handle volatility in their markets. I believe this is what sets truly active management apart from passive investing, and truly active managers can navigate volatile markets better than anyone. This concludes our manager roundtable. I want to take this time to thank our portfolio managers for their time and their insights, and thank our listeners for your time. If you have not already done so, please listen to our first issue in this two-part series, which focuses on outlier opportunities and outlier risks in today's markets. Thank you, everybody, and have a great day.