BAKER & EDWARDS FINANCIAL

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MARKET UPDATE

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Markets peaked in the spring of 2015 and have dropped significantly since then. You have probably also noticed that the daily changes have increased dramatically in the last 3 months. With the size of the headline drops I was pleasantly surprised that the net result for January was only a drop of 1.6%.
You are bound to be wondering what is going on. I think there are four main factors that have come together in this period.

1. USA
   Quantitative easing ended in the fall. This program of the central bank involved the bank buying government bonds to put more cash into the economy. This was supposed to force interest rates lower (which it did), and force people to put money to work in higher risk investments in order to make any kind of a return. It did lead people to invest into stocks, real estate, and emerging market economies, driving their valuations to unjustified levels. When the central bank raised lending rates (by o.25%) in December it signaled the end of this period. Speculators pulled back billions of dollars from the investments in order to repay their cheap loans. This eliminated the support for the high prices and they have already come down to more realistic valuations. These tactics also caused the US dollar to rise against all other currencies, making US manufacturers less competitive, but also driving down the price of most commodities because they are priced in US dollars. The currency situation appears to be turning in just the last few weeks and may start to cause commodity prices to rise (a good thing for Canada).

2. CHINA
   The second largest and fastest growing economy in the world is slowing down as it matures. Its growth rate may slow from 7.5% to 4 or 5% in the next few years. This is still twice as fast as the developed economies, but is viewed as a major hindrance. China did overbuild its economy I the past 15 years - for example, it is rumored to be shutting down more steel making capacity than any other country even has. This overbuilding created the tremendous demand for commodities around the world. The most obvious casualty of this was the great rush to build new mines throughout the world - the resulting surplus has decimated even the largest mining companies.

3. OIL
   Oil and gas production has soared in Canada and the US because of new technology called "fracing". This increased supply has almost made the US independent of foreign imports - the OPEC nations don’t like this and forced the price down to force North America to cut production. This is probably taking longer than they thought and is creating great harm to their finances. Saudi Arabia for example relies on income from oil to finance almost their entire budget. The result of this price war so far is that Venezuela and Nigeria are almost bankrupt, and Saudi Arabia has had to withdraw billions from its stock and real estate investments. Countries such as Norway and Russia have also had to withdraw billions from their investments.

4. VALUATIONS
   The cheap money and improving prospects in the US drove stock prices in the US to values that could only be sustained in ideal economic times. Those times stopped when quantitative easing stopped. The extreme valuations applied only to companies with a strong growth story - the US market ended 2015 with a 1.5% gain - but if the "FANG" stocks (Facebook, Amazon, Netflix, and Google) were eliminated, the market would have been down 7.5%.

The sum of all these events has made it painful to be invested, but at the same time makes this a good time to invest. Valuations are much improved over last year and as some of these factors return to more normal levels the prospect for gains is good. Fund managers are actually excited by the drops and the increased daily fluctuations – they now get to invest the cash they have been building while valuations were too high.
Your fear of the markets is understandable but needs to be put into context with your investment time horizon. If you want your money back in three months – don't invest! If you want it in three years, you should be able to accept some market risk in the expectation of a higher return. If you are building funds for your retirement and expect to draw on them for 30 or 40 years, you need the higher returns that can only come from having higher equity content.

RECOMMENDATIONS

For short term investors with a three year time horizon, we suggest you stick to corporate bond funds.
For mid-term investors (3 to 10 year horizon), a fund of funds approach will give you exposure to a wide variety of investments and constant adjustment to market conditions.
For long term investors, the core of your investments would be global equity or balanced funds. This is a shift from mostly Canadian-oriented funds. Key factors we look for are that the manager is able to shift from stocks to bonds or cash as he/she sees fit, and that they have the ability to hedge the currency. Global investors did very well in 2014 and 2015 as they Canadian dollar fell against the US. By the same token you could be hurt if the Canadian dollar rises – we want the manager to be able to deal with this risk.

We look for fund managers who are only trying to find 30-40 of the best companies in the world. These are the types of businesses that can do well in any environment, but whose share prices have been knocked down because of the market conditions. We also expect the fund managers to have most of their personal investments in the funds that they manage – this ensures that their interests are aligned with yours.

For investors who require growth but do not like the fluctuations of funds there is an option called segregated funds (essentially mutual funds with an insurance policy wrapped around them) that provide guarantees of your principal. As you would expect, these have higher fees but we would be glad to discuss this option with you.