WEEKLY
MARKET INSIGHTS

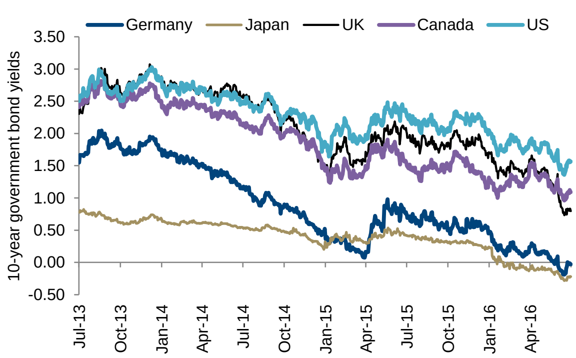
July 25th, 2016

THE LATEST MARKET INSIGHTS
FROM THE RICHARDSON GMP TEAM

Risk of a ~~Taper~~ Data Tantrum

Everyone is keenly aware bond yields are low and moved lower following the Brexit vote. Looking at 10-year yields, Germany joined Japan and Switzerland in the negative yield camp. Yields in the U.S. dropped down to 1.35% and Canada traded below 1.0%. Yes, if you buy a 10-year Canada government bond you will earn an annualized 1.0% return maturing in 2026. And Germany actually auctioned new bonds with a negative -0.05% yield, meaning you give Wolfgang money and in 10 years he promises to give a little less back to you.

The relentless downward march of bond yields



There are very good reasons bond yields are so low. Demographics and slow economic growth have savers outnumbering borrowers. It was a credit driven recession in 08/09, which has lingering impacts on the credit markets. European crisis, China faltering, Brexit, Trump all contribute to an investor mentality that prefers defense and capital preservation. Then we have quantitative easing that is very active in the UK, Europe and Japan. This bond buying soaks up supply of bonds and as a result yields are lower.

Lower bond yields have some very good benefits for investors, it inflates prices. We could get into discounted future cash flows, but we won't. Obviously lower bond yields mean the price of bonds goes up, and worth noting bonds have outperformed many equity markets this year. It also has a positive impact on real estate, thanks to lower financing costs, and equity markets. Within the equity markets some sectors or industries benefit a lot from lower yields, while some suffer due to lower rates. In the U.S. market, Telecom and Utilities are the top performing sectors this year, by a long shot. These sectors, given their yield and business characteristics, are often referred to as bond proxies (for the record, they aren't but that is what some call them). On the flip side, Financials take a hit on lower yields. For insurance companies, it is mainly due to lower return assumptions for matching future liabilities. For banks, it is due to lower net interest margins (NIM). For the record, Financials is the worst performing sector in the S&P 500 this year.

Taper Tantrum – Its origin was from when the Fed started 'tapering' its quantitative easing bond buying program. This created a market tantrum with equities and bonds moving lower. Now the Fed isn't buying bonds anymore, so no taper, but the outcome may have some similarities given the divergence between the economic data and some markets.

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Risk of a Data Tantrum

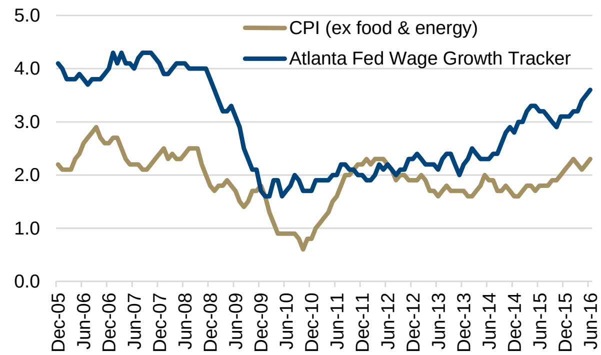
Bond yields in Canada and in the U.S. (North America) are where they are because German and Japanese yields are where they are. It is a global bond market and that creates money sloshing around looking for yield. While 1.0% in Canada sounds low (it is), it is higher than other countries. The risk is North American yields have become increasingly disconnected with the economic data. The data has been decent and is getting better. Unemployment has finally dropped below NAIRU of 4.94% (Non-Accelerating Inflation Rate of Unemployment) and we are seeing consumer prices and wages continuing to trend higher (top chart). CPI and wages are now expanding at their fastest pace since before the last recession.

Meanwhile inflation expectations, or more accurately the inflation rate baked into the bond market, is really low. The 2nd chart is the break even inflation rate priced into the bond market over the next five years along with the Citigroup Economic Surprise Index. The Economic Surprise Index being positive means the data has been coming in better than expected of late. Note the break-even inflation rate has risen a little in the past few days but still remains close to where it was during the market sell-off of January / February.

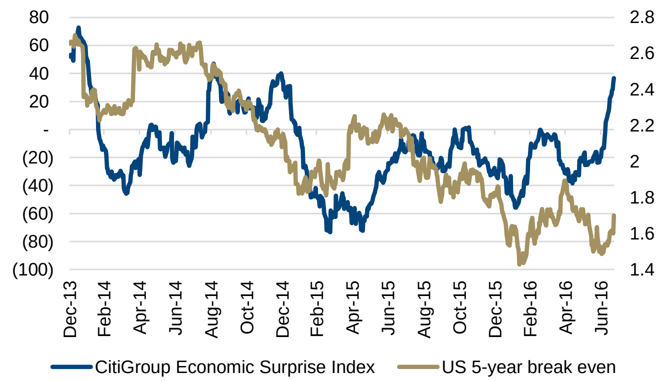
Successful investing has a lot to do with process, some luck, obviously being in the right place and at times avoiding taking on undue risk. Bond yields are very low, inflation expectations are very low, yet economic data is improving and inflationary components of the economic data are rising. This could all combine into an environment one could view as undue risk out there. Add to this the effective term in the Canadian bond market is at an all-time high, meaning it is very interest rate sensitive. And those bond proxies in the equity market are trading at valuations never seen before or at the very least not since near the tail end of the last bull market (chart 3). It just seems there is a lot of interest rate risk out there.

Now we are not calling for materially higher yields, but given the added sensitivity or duration risk in many pockets of both the bond and equity markets, the risk of a taper tantrum like event is high. Further reducing duration in bond portfolios, taking some profits in those bond proxies like Utilities, Telcos, Consumer staples and hedging into insurance/banks may prove to create a more tantrum proof portfolio.

Consumer Prices and Wages are Rising



Break-even Inflation uber low, Eco data on the rise



Bond Proxies at very elevated Valuations

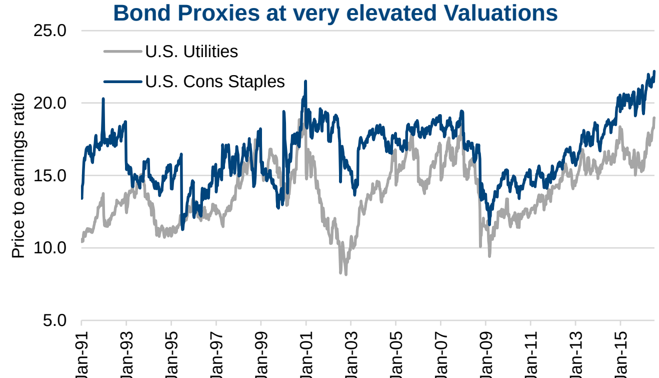
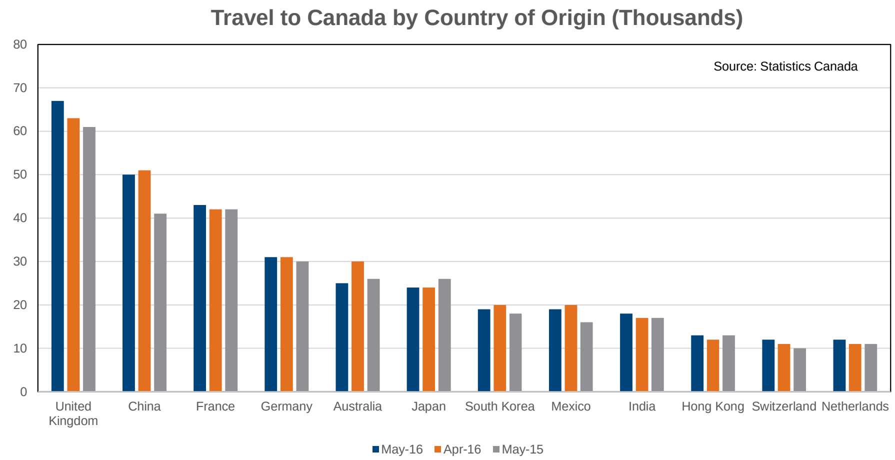


Chart of the Week

It's hot in Toronto today. Really hot and sunny. While some people might complain, one industry that is not complaining at all is the tourism industry. Not only is it being helped by decent weather but there were expectations in 2016 that tourism to Canada would pick up namely because the loonie fell below US$0.70 in January which allowed opportunistic Americans a chance to lock in their summer vacation plans at a discount. But have we seen the lower loonie translate into increased business for the tourism industry this year? We may have an initial answer as Statistics Canada recently released travel data between Canada and other countries for May.

According to the data it would appear that while travel numbers are somewhat flat when compared to April, there is a noticeable pick up in travelers to Canada from other countries when compared to May 2015. The chart shows the 12 countries which send the most tourists our way outside of the United States. Admittedly, the United Kingdom numbers could fall this month after the Brexit vote and the pound losing a decent chunk of its value, but on the whole Canada is welcoming more tourists so far in 2016 than it did a year ago.



We did exclude the U.S. from the chart only because the numbers were so large when compared to other countries that it would have made the chart look a little silly, so here are some statistics concerning our neighbours to the south. In May 2016, there were 1.991 million trips by Americans to Canada, which is flat when compared to the 1.990 million trips in April, but an improvement to the 1.838 million in May of last year. Those American trips with a one-night stay or more (i.e. excluding day trips and those crossing the border shopping) totaled 1.312 million in May, which was again basically flat to the 1.319 million last month but still a noticeable improvement to the 1.203 million Americans who stayed one night or more in May 2015. So it would appear that tourism is up this year and while we can't say with certainty that all the gains can be attributed to the loonie's decline, the weaker currency certainly isn't hurting. The effects of the loonie's weakness does work both ways though as Canadian trips south of the border have declined. In May, there were 1.609 million trips of one or more nights by Canadians (i.e. excluding day trips) to the U.S. which was higher than the 1.564 million in April, but lower than the 1.777 million seen las year. Admittedly this decline likely isn't as large as some might expect due to currency alone, but in all likelihood a trip to the United States is still a more affordable option for some Canadians than a trip overseas.

Charts are sourced to Bloomberg unless otherwise noted.