ECONOMIC TRENDS: AN INTERVIEW WITH MATTHEW STRAUSS

Matthew Strauss, Vice-President, Portfolio Management and Portfolio Manager of Signature Global Asset Management of CI Investment Inc., has over 18 years of investment industry experience. Currently, Mr. Strauss provides macroeconomic strategy on foreign exchange and emerging market components of the Signature mandates. Mr. Strauss is also a member of the Signature Asset Allocation Committee.

During his tenure as an economic and macro strategist, Matthew Strauss has gained extensive international experience in currency and fixed income markets. He was named "South African Economist of the Year" twice within three years by Reuters during what could probably be described as the most tumultuous period for the South African currency in modern history.

Mr. Strauss' career has included a number of years on the trading floor a role as the Chief Strategist at the largest retail bank in Africa, and more recently as a Senior Fixed Income and Currency Strategist at RBC Capital Markets. During this period, his views and opinions on financial markets were widely quoted in the media around the globe.

Mr. Strauss earned an international capital markets qualification from the UK, holds the Chartered Financial Analyst designation and is a graduate of the University of Stellenbosch, South Africa, where he received an Honours Bachelor of Commerce degree in Economics as well as a Masters degree in Economics.

What are your views on the current economic environment and financial market conditions?

Currently, we are at an inflection point for Canada and for the global economy. Since early 2009, the world's major economies have had very loose monetary policies and as a result, we've seen artificially low interest rates around the world. But May 2013 probably marked the end of low interest rate cycle in North America as the Federal Reserve indicated a greater willingness to start the process of slowly reducing quantitative easing programs. Over the summer, we experienced a sharp rise in yields (longer-term rates), from 1.8% to 2.7% for the 10-year Canada bond. Even though the Federal Reserve in the US surprised the market by not reducing their asset purchase programme in September, the decision was not seen as shelving the idea of reducing quantitative easing but rather pushing it out into the early part of 2014 as they wait for the US economy to recovery further. As a result, despite the downward correction in yields following the September meeting, yields are expected to climb slowly throughout 2014.

Europe is now doing somewhat better than originally expected and is slowly but surely working itself out of a recession (negative growth), with growth stabilizing somewhere between 0% and 1% during the next few quarters.

Thus, the world seems less scary than 10 months ago and the likelihood of another global recession has declined meaningfully.

One of the bigger risks in the United States continues to be political risk, where politicians are still continuing debates over funding their budgets, cutting fiscal spending, and increasing their total debt ceiling. One way or the other, fiscal spending (entitlements) will need to be scaled back, or taxes will need to be increased, or both. Meanwhile, the quarrelling continues, adding volatility to the markets.

Another risk lies with China. The Chinese administration, in response to worries about their unbalanced growth and inflation, engineered a slowdown to move China towards a more sustainable and balanced growth, not just growth driven by heavy industry and exports. During the first half of 2013 investors feared that China had applied the brakes too hard and Chinese growth might slow much more than planned. However, the Chinese administration showed a strong commitment to grow their economy at 7.5% in 2013 by introducing a mini stimulus package mid-way through the year. This seems to have succeeded

and the latest figures emerging from China are now surprising to the upside and the risk of a so-called hard-landing has abated.

What is your view for the 2013 year and beyond?

Overall economic activity?

There will be great opportunities within certain segments and industries, and on the small business side, even if the overall economic environment is not too strong. The Canadian dollar will likely trade between 90 to 95 cents in 2014, from the current 94 to 98 cents, and there could likely be further weakening thereafter. The economy will not reach full capacity until 2015 at the earliest.

Hiring and employment?

People will need to set realistic expectations going forward with the types of jobs available, salary expectations, etc. as the decline in the unemployment rate will only be gradual. However, the rate should continue to creep down slowly.

In looking ahead to 2014 -2015, what is your outlook for:

Inflation?

Inflation will be muted for the short term and perhaps slowly increase in the mid-term. However, we agree with the Bank of Canada that we would probably not see full capacity until after 2015, nor full employment anytime soon, so there is little risk of higher inflation in the near-term economic outlook.

Interest rates and bond yields?

Both the U.S. and Canada are experiencing slow growth, with less than 2% right now, a little more than 2% in 2014 and around 3% in 2015. The upside is that if we have low growth, interest rates will remain low for a longer period. With muted inflation in Canada for the next 1-2 years, the Bank of Canada is expected to keep interest rates at their current low levels for quite a while. However, over the longer term, interest rates will increase from where we are today.

Mortgage rates?

Mortgage rates in Canada are tied to bond yields, which, earlier this year, jumped by more than 110 basis points (1.1 percentage points) before declining in September and October. However, yields are expected to rise during 2014. As such, fixed mortgage rates should rise slowly over the coming years but not by leaps and bounds, perhaps 100 basis points (1.00%) over the mid-term. This increase, in and of itself, should not cause a housing market collapse.

Commodities in general and gold and oil in particular?

Commodities prices are driven, amongst other things, by economic growth and infrastructure investments made by emerging economies. With emerging market growth rates expected to be more muted going forward, and their economies now moving toward service oriented and higher value-added economies rather than pure infrastructure-building economies, there will be a more “normalized” demand for commodities, especially from China. The easy growth period for a commodity-based economy like Canada is behind us and diversification and productivity improvements are becoming critical to compete on the world stage. Gold also has a negative outlook overall, but there could be a couple of scenarios where gold could prove valuable.

How do you earn yield in a low interest environment?

Yes, that is a good question, one that most investors today struggle with, especially those who are in or near retirement and who wish to stay on the lower end of the risk spectrum, yet earn as much yield as possible from their low-risk investments. For the near term, investors/retirees can expect very little, zero or even negative real returns from the safest bond markets, i.e. government debt securities. These investors are being forced up the risk spectrum, within reason, to such vehicles as corporate bonds issued by very large, stable blue-chip companies; high-yield bonds issued by companies that are of lesser strength and with lower credit ratings; bonds issued by governments overseas and in the emerging markets; preferred and common shares of companies with stable high-dividend policies; and finally infrastructure and other such alternative investments. But as would be expected, as one chases higher yields, the inherent risk associated with these investments also rises and one must carefully budget and balance their risk exposure against the lure of higher yields.

What are your thoughts on the housing market in Canada at the present time?

The Canadian housing market has had a really good run for a dozen years now, and many have been calling for a pause, a correction or a downright collapse of the housing market over the last few years, and that hasn't happened. There have been many drivers behind this protracted real estate bull run, including the drop in interest rates over the last couple of decades, the shift in demand toward urban condo living, and the high level of family immigration, both inter-provincially and from overseas. In addition, demand was also boosted during/after the 2008 financial crisis, when wealth overseas started looking for a safe haven in hard assets, and as a safer economy Canada benefitted from this trend.

Vancouver is still seeing its fair share of newcomers to Canada, but demand from foreign investors looking at buying properties seems to have cooled somewhat. In Toronto, there will be a huge supply coming onto the market over the next 18 months, which may exceed demand and could potentially lead to a price adjustment for that market. It's probably fair to say that the Toronto and Vancouver condo markets are still frothy and may suffer from price stagnation or declines down the road. Having said that, if we do get a correction in the housing/condo market, it's highly unlikely to be as disruptive as the US event in 2008.

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What opportunities, if any, exist in the current economic and market conditions?

Employment seekers?

Job seekers need to set realistic expectations. This is not an environment where a job seeker can make lofty demands. There will be opportunities, but job seekers will need to be realistic about their expectations - including compensation levels.

For small business?

There will be great opportunities within certain segments for small businesses even if the overall economic environment may not be so strong.

Could you share a little about the impact of Canadian currency within a global portfolio?

I would suggest that going forward the loonie will face a few challenges and may drop in value about 3-4 cents annually for the next 2-3 years against the US dollar, perhaps even longer. Contributors to this will be Canada's high cost structures in certain industries, our low productivity growth especially compared to some of our trading partners, and the continued slowdown in resource and commodity demand from emerging countries like China.

With respect to risk and risk management, please provide your opinion on how you would guide investors to manage their risk.

Portfolio diversification between asset classes like cash, fixed income, real estate and equities is a fundamental approach to risk management in investing. Further diversification within each asset class could partly protect investors against volatility, e.g. within the fixed income space, investing broadly across sovereign debt, investment grade corporate bonds, high yield bonds, and perhaps even infrastructure investments. Similarly, within the equity space, investing broadly across geographies, industries, and company size often reduces the magnitude of large portfolio losses that may be suffered as a result of being too concentrated in one company or a single industry or country.

Canadians have a very strong home-country bias; many investors have a very large exposure to Canada in their investment portfolios. Going outside Canada into the developed and developing markets is a good thing from a risk diversification and potential return perspective.

Investing in emerging markets became easy over the last few years and one could simply invest in the emerging markets as a single basket and make money. It's very true – there was easy money to be made. However, going forward, there are some emerging markets that are really struggling. Investing in emerging markets can be good, but diversification and being selective will be key going forward.

What is your viewpoint on gold and what role does it play in a portfolio?

Gold's function as a safe haven or a hedge against inflation is very much intertwined with economic factors. Gold rose tremendously in value post-2008, both as a safe haven and as a hedge against inflation. In the last couple of years, once it became clear that inflation would not rise dramatically as some had forecasted, the price of gold declined sharply. Going forward, one could find reasons to hold a small percentage of gold in a portfolio, depending on one's risk tolerances and global macro outlook. For example, if one felt that the worst is behind us and that the world's economies are recovering slowly, there would be less reason to hold gold. However, if the world recovers too dramatically, that could lead to increased inflation. This in turn could be positive for the gold price if one believed that the world's troubles are not behind us. The U.S. Fed will keep printing money through their quantitative easing policies and that loose monetary policies in the U.S. and Europe will eventually lead to a loss of credibility for the major central banks and a loss of confidence in their ability to resolve the continued slowdown. If this were all to happen, then gold may be one of the best assets to include in one's portfolio to protect against the collapse in confidence of paper money.

If you were to leave investors with one thing to keep in mind when it comes to investing, what would it be?

Sometime over the summer, we reached a critical turning point, an inflection point, from a post-2008 period of very loose monetary policy and artificially depressed interest rates, to a period going forward where there will be less central bank intervention and interest rates will gradually be allowed to move more freely with the open markets. As such interest rates should move higher, albeit slowly, over time, starting with the longer term interest rates. This will have implications for all investment strategies, and may require small to significant adjustments to investors' current portfolios. Investors will need to be more nimble in their approach – a buy and hold strategy is probably not the best strategy going forward. For instance, those still exposed to investment grade sovereign debt securities may need to reduce these holdings to steer away from negative real returns or even outright losses. Investors may instead have to move up the risk spectrum into higher yielding debt securities or even high-dividend paying equities.

Canadian investors should also look outside of North America toward global equities. To compensate for taking on added risk in some of these asset classes, one might want to hold larger amounts of cash than usual, not only to balance portfolio risk but also to be positioned for pouncing on opportunities as they arise with market volatility. Gold could play a role here as well. We are going into a period of greater uncertainty, moving from a period when market behaviour was "managed" by central banks to a period of more open and free markets, and nobody knows exactly how this change will play out.

Given this important inflection point, things could turn out very differently from what so-called experts are predicting. As such, investors and those investing money on behalf of others will need to constantly review portfolio positioning, always asking whether it is time to move up the risk curve or whether it is time to be more conservative.