The Bigger Picture

A weekly snapshot of the markets

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Summary

Commentary: Deflation may be biggest influence on portfolio positioning for 2015 and beyond.
Chart of the Day: Crude oil to nat-gas price ratio drops below 20, level last seen in February.
Week ahead: ECB rate decision on Thursday, Canadian and U.S. payroll data on Friday; companies reporting this week – BABA, BCE, CPG, CUS, FTS, T, TLM, TRP, TSLA, WJA.

Commentary – Why deflation is becoming an increasing concern

Bill Gross discusses possibility in latest outlook, Watsa of Fairfax warned of it on Friday

Elvis Picardo, CFA

Bond guru Bill Gross, in his second investment outlook posted since he joined Janus Capital from PIMCO, said today that deflation is a growing possibility globally as governments struggle to create inflation and stimulate growth. In his commentary, Gross notes that both inflation and deflation are the enemies of stability and growth, but knowing which one is just around the corner can be difficult (see https://www.janus.com/bill-gross-investment-outlook).

Gross points out that almost all central bankers currently have a targeted level of inflation approaching 2%, with some arguing for higher levels now that deflation is a real threat in peripheral Europe. But, Gross points out, with interest rates at zero and quantitative easing approaching potential political maximums, there is "little water left to pour on the flames."

Gross says that central bankers have made a ".... fine attempt" to create inflation (four trillion dollars in the U.S., two trillion USD-equivalent in Japan, and a trillion dollars in the eurozone), but this stimulus is not working like it used to. Rather than spurring investment and innovation, these trillions are going straight into the "cement mixer" of the marketplace, so prices go up, but not the right prices. As an example, Gross remarks that while Alibaba's stock went from $68 to $92 in the first minute (of post-IPO trading), wages stagnate for years on end. So while one economy (the financial one) thrives, the other economy (the real one) withers.

Why is deflation – which is defined as a sustained decline in prices, or a negative rate of inflation – such a concern? Because it can have a couple of devastating effects on the economy.

Firstly, in a deflationary environment, consumers and businesses defer spending in the expectation that prices will fall further. This is not surprising, since the expectation that prices will rise – the usual consequence in a controlled inflation scenario – is the trigger that spurs most spending. Consumer spending is usually the biggest component of an economy, so a slowdown in it can have a significant negative effect. Secondly, deflation also increases debt burdens in real terms, which further reduces the spending capacity of consumers and businesses. While most North American companies presently have manageable debt loads, the same cannot be said for heavily indebted consumers in Canada and the U.S.

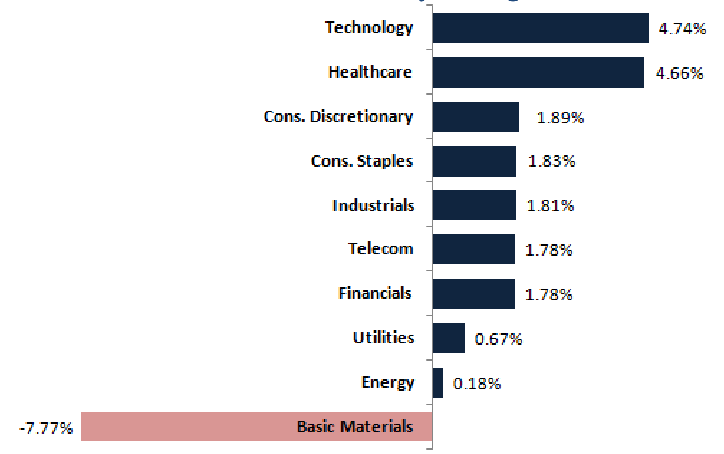
On Friday, Fairfax Financial chairman Prem Watsa said in a conference call that deflation is in the air, because of stagnant European economies, a slump in commodity prices, and a correction in Chinese real estate. Watsa noted that core inflation continues to be at or below 1% in the U.S. and Europe, levels that have not been reached since the 1950s. He said that Fairfax has increased its position in cash and U.S. Treasuries because of the risk of deflation.

One of the major reasons why central banks worldwide unleashed unprecedented waves of stimulus after the 2008-09 Great Recession was to stave off deflation and avoid Japan's experience. Japan grappled with deflationary forces for more than two decades after the Nikkei's 40% crash in 1990. Negative inflation prevailed in Japan for most of the period after 1999, only rising above 0% in Q4 of 2013 (Fig.1) as Prime Minster Shinzo Abe's radical policies ("Abenomics") took hold and finally boosted inflation, with core CPI at 2.3% in September.

The threat of deflation was palpable in the first months of this 5½-year expansion, but after receding as the recovery picked up steam, is again emerging as a potential threat. If it gets worse, deflation could be the biggest influence on portfolio positioning for 2015 and beyond.

Figure 1: Nikkei index vs. Japan core CPI (YoY %) – 1984 to Present

TSX Sector Watch – Weekly change for TSX sectors (week ended October 31, 2014)

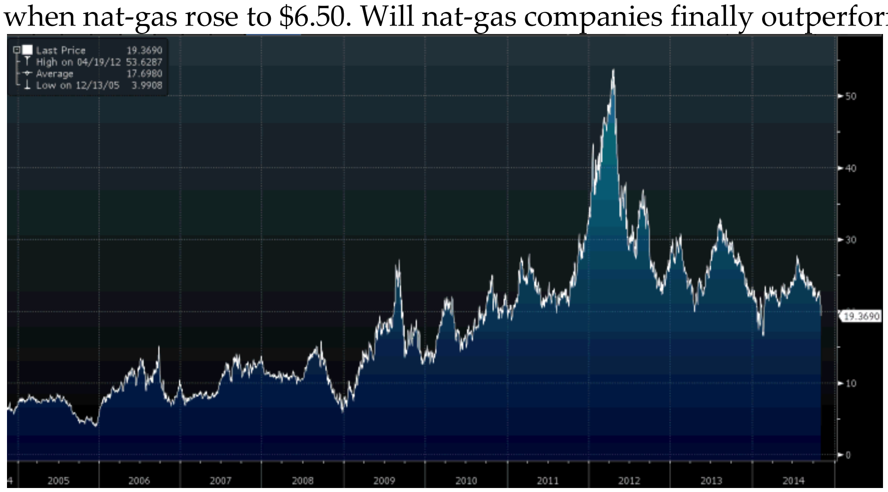


The TSX gained 70 points or 0.5% last week, as Friday's gain of 155 points saved the index from finishing in the red for the week. Last week's paltry gain came after a week when the TSX had its best weekly performance since July 2013 with a 316-point or 2.2% surge. The TSX lagged the S&P 500, which rose 2.7% for the week and closed at a record high on Friday. A massive 7.8% decline in the Materials group last week weighed down the index and offset gains by the other nine TSX groups. Gold and silver producers were the worst hit stocks in the index, accounting for nine of the 10 biggest decliners, all of which plunged at least 20%. While Yamana Gold was the worst performer of the precious metal producers with a 29% decline, Horizon North Logistics was the biggest overall decliner, down 35%.

Chart of the Day

Price ratio of crude oil to natural gas dips below 20

Crude oil (WTI) slumped 3% today to trade at its lowest in more than two years, even as natural gas had its biggest gain in four months on forecasts for unusually cold weather. As a result, the oil-to-gas price ratio dipped below the key level of 20, a level last seen in February when nat-gas rose to $6.50. Will nat-gas companies finally outperform crude oil producers?



The Week Ahead

Corporate earnings season in ramping up in Canada, just as the number of U.S. companies to report results has peaked. On the economic news front, there will be plenty of action in the second half of the week, with the European Central Bank (ECB) rate decision on Thursday, and Canada and the U.S. reporting jobs numbers for October.

The ECB's rate decision on Thursday will be closely watched, as speculation mounts that the bank may take more steps to spur growth and inflation.

The Canadian and U.S. economies have been diverging in recent months, as have their currencies. Data released last week show that Canada's GDP unexpectedly shrank in August as oil and gas extraction declined 2.5% to $96.9 billion. Conversely, the U.S. economy expanded at a better-than-expected 3.5% annualized pace in Q3; combined with a 4.6% gain in Q2, this was the strongest six-month performance since the second half of 2003.

On the jobs front, Canada's employment numbers are generally quite volatile, and September's data was no exception. The economy created 74,100 mainly full-time jobs, surging past economists' estimate of 20,000, while the jobless rate fell to a near six-year low of 6.8%. Friday's report is expected to show that the economy lost 5,000 jobs in October, with the jobless rate expected to hold at 6.8%. The U.S. economy is forecast to show job growth of 235,000 for October, following on September's 248,000 increase, with the unemployment rate flat at 5.9%.

Major Canadian and U.S. companies reporting quarterly results this week include –

- November 4 – ADM, Alibaba Group, Avigilon, Talisman Energy, TransCanada, WestJet
- November 5 – Enbridge, Kinross, Magna Intl., Penn West, Tesla Motors, Tim Hortons
- November 6 – ARC Resources, BCE, Canadian Natural, Crescent Point, SNC, Telus
- November 7 – Berkshire Hathaway, Canexus, Enerplus, Fortis, Whitecap Resources

Market Snapshot

At close today

S&P TSX	14537.62	-75.70	**Commodities**			**Yields (%)**	**Can.**	**US**
TSX Venture	766.10	-3.49	Canadian $ (US cents)	88.04	-0.76	90 Day T-Bill	0.87	0.01
DJIA	17366.24	-24.28	Gold (Spot)-US$	1165.55	-7.93	2-Year Bond	0.99	0.51
S&P 500	2017.81	-0.24	Oil (WTI-Dec.)	78.30	-2.24	10-Yr.Bond	2.04	2.34
NASDAQ	4638.91	+8.16	CRB Index	270.47	-1.49	30-Yr. Bond	2.59	3.06

Thought for the Day

"Not in the clamor of the crowded street, not in the shouts and plaudits of the throng, but in ourselves are triumph and defeat."– Henry Wadsworth Longfellow

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Buy: Expected total returns of 10% to 20% over the next 6 – 12 months.
Speculative Buy: Significant gains expected over the next 6 – 12 months, but entire investment may be at risk.
Hold: Expected total returns of 0% to 10% over the next 6 – 12 months.
Reduce: Expected total returns of up to -10% over the next 6 – 12 months.
Sell: Expected total returns of over -10% over the next 6 – 12 months.

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