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Fourth Quarter 2015

Oil Glut, Dollar Shortage

Global equities rallied in the fourth quarter, but not enough to produce positive returns for the year in most parts of the world, except among Japanese and U.S. large cap stocks, which ended the year up 9.57% and 1.38%, respectively (see chart below). There were precious few offsets – even typical safe havens such as long dated treasuries (-1.59%) and utility stocks (-8.39%) posted negative returns in 2015. Hedge funds were similarly challenged as many managers were either caught wrong footed or in crowded trades, their difficulties often compounded by diminished liquidity, particularly in the credit markets. As a result, some of the most widely followed and successful hedge funds delivered their worst yearly performance since 2008. While emerging market equities were basically flat in the fourth quarter, commodities slumped further and the entire EM commodity complex ended the year down sharply, a nagging refrain that has continued in January. To date, the negative effects of a slowing global economy and a stronger U.S. Dollar have savaged highly cyclical companies, exporters and weaker borrowers, with notable declines also occurring in more defensive sectors such as healthcare and consumer staples.

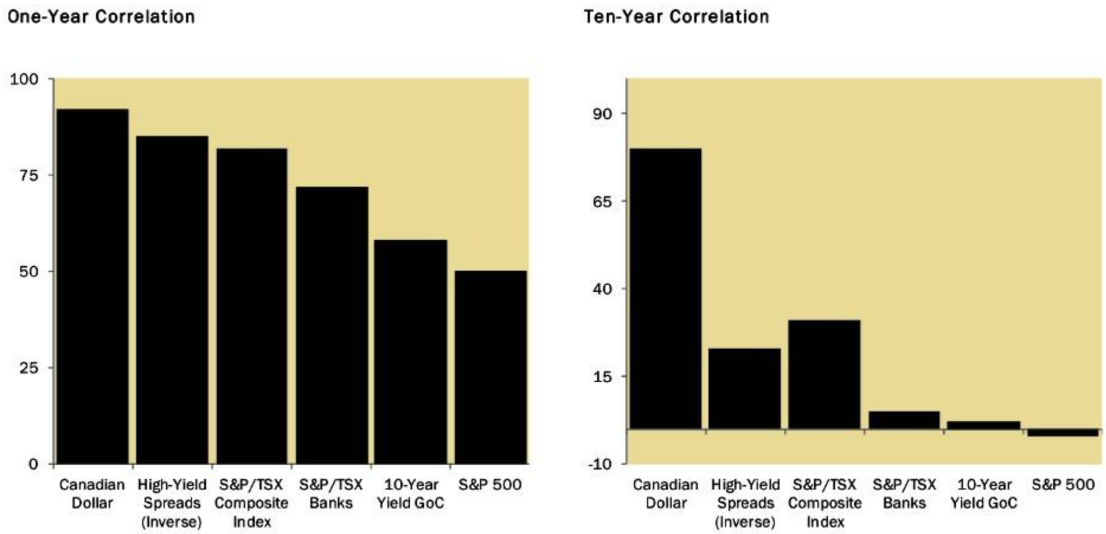
While the Fed is worrying about inflation, investors are more concerned about deflation. Oil prices have continued to weaken, U.S. fourth quarter growth is now expected to be less than 1%, and corporate earnings, the backbone of this bull market, are either viewed as anemic or peaking. Most developed and emerging equity indexes are down 5% to 10% thus far in 2016, the worst start to a calendar year in modern history. Investor and media sentiment is so poor at this writing that the economies of the U.S., Europe, China and Japan appear to be treading water in cement shoes made of cheap oil and a ¼ point U.S. interest rate rise.

Index or ETF	**Fourth Quarter 2015**	**Full Year 2015**
MSCI Japan	9.34%	9.57%
S&P 500	7.04%	1.38%
Barclays Capital U.S. Treasury 20+ Year	(1.38%)	(1.59%)
MSCI Europe	2.49%	(2.84%)
Russell 2000 Index (Small Caps)	3.59%	(4.41%)
Markit Ibox High Yield Bond Index	(1.48%)	(5.03%)
MSCI All Countries (ACWI) Ex U.S.	3.24%	(5.56%)
Euro vs U.S. Dollar	(2.82)%	(10.26%)
MSCI Emerging Markets	0.66%	(14.92%)
WTI Crude Oil	(17.85%)	(30.47%)
S&P GSCI (Commodities)	(16.63%)	(32.86%)
JP Morgan-Alerian MLP	(2.86%)	(32.96%)

Total Returns in U.S. Dollars. Source: BlackRock, Bloomberg. Returns are calculated with net dividends in U.S. Dollars.

The oil market certainly has our attention, both for its relentless sell off and for its headline relationship to equities and credit. It has been a long time since trading activity in so many different asset classes has tracked the price of oil so closely (see graph on page two), and the first time we have seen low oil prices cause such high anxiety. After all, both supply and efficiency gains have been outpacing demand for years, and consumers, automakers, airlines, hotels, farmers, manufacturers and more, most of whom haven't seen a tax cut in years, will surely benefit. The nervous market narrative has us all wishing for higher oil prices, of all things, while higher fuel economy standards, more viable alternatives, and new drilling technologies have converged to force a global reset of carbon based fuel prices. To us, it looks as if low oil prices will persist for many years. According to analyst David Rosenberg of the Canadian manager, Gluskin Sheff, "we are likely to see a vigorous supply response from non-OPEC producers this year as the financing taps have been turned off and roughly 90% of the world's production is non-economic at current prices."[1] In our opinion, the commodity shock is going to be substantial, as miners, drillers and traders have borrowed $3 trillion globally,[2] but there are probably enough positive benefits to offset the pain. Meanwhile Fed officials (their lessons learned from the last crisis) are engineering a "macro-prudential" rise in interest rates, hoping to get ahead of inflation pressures that may come when oil prices recover. We imagine they are at least rethinking their view of the balance of risks between inflation and deflation. When a mission critical commodity like oil drops from $110 to $27, then "stabilizes" at $40 to $50 after a wave of bankruptcies and job losses, is that really inflationary?

Correlations to the Price of Oil – Canada and U.S.[3]



Source: Haver Analytics, Bloomberg,, Gluskin Sheff

Investors have suffered through a number of sharp corrections in recent years, each one prompting serious existential questions about the risks and limits of government debt issuance, aggressive regulation, currency wars, low interest rates, and lately, collapsing commodity prices. That has been, and will likely continue to be, the nature of this recovery with its unprecedented monetary activism and its unsettling, volatile shifts in the terms of trade among nations. That said, no one knows in advance the exact tipping point when a country loses control of its currency, or how low oil can go before bottoming. For now, problems are most severe in countries that are heavy exporters of commodities or finished goods, and they represent the entire political spectrum, from totalitarian regimes (China, Russia, Saudi Arabia) to a range of democracies (Canada, Australia, Brazil, Argentina, southern Europe). Some countries may have the popular support and the means to finance long term, relatively peaceful economic restructurings and some may not. Due to rapid U.S. Dollar appreciation against their currencies, many foreign countries and companies with U.S. Dollar debt have seen a 25% jump in principal owed and in some cases a doubling of borrowing rates on new debt issued. The energy revolution makes it possible to envision a secular strong dollar, reduced dependence on Middle East oil, and a healthier balance of trade after decades of OPEC dominance and years of Chinese hypergrowth. We can even imagine a long term benefit similar to the peace dividend the United States and others received after the end of the Cold War. Unfortunately, the world has become much more interconnected since the 1980s, and its politics more fragmented, so it is also important to consider how destabilizing a sudden dollar shortage can be.

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[1] Rosenberg, David. *Breakfast with Dave.* Gluskin Sheff & Associates, Inc. January 14, 2016.
[2] The never-ending story. (2015, November). *The Economist.*
[3] This graph is reproduced from: Rosenberg, David. *Breakfast with Dave.* Gluskin Sheff & Associates, Inc. January 15, 2016.

We are in the process of making some changes to our clients' portfolios. In analyzing the portfolio mix, we felt there were three areas that needed enhancement – fixed income, international developed market equities, and U.S. small caps. Most client accounts won't see dramatic alterations to their overall equity allocation but will see changes in these three areas. With the fixed income allocations, we hope to provide a more diversified bond portfolio that combines funds that generate attractive income while responding in different ways to various interest rate scenarios. These new allocations follow a six month manager search and due diligence process, and a significant repricing in the credit markets. Within international developed markets, we aim to raise our underweight exposure by adding an active mutual fund manager and an equity ETF that seeks to minimize the market's peaks and valleys. Lastly, to further diversify our small capitalization equity exposure, we are adding a fund to this area as well. We believe these changes will strengthen client portfolios and better position them for the year ahead. If you have any questions, please give your Relationship Manager a call.

Robert G. Scott	**David H. M. Baker, CFA**
Chairman & CEO	*Managing Principal*

Special Note to Clients

It is a great pleasure to announce the promotion of Fraser McLean to Chief Investment Officer of North American Management, effective January 1st. We are all excited to see a new generation of talent recognized and rewarded for contributing so much to the success of the Firm. Our Firm is grateful for David Baker's nine years of leadership as CIO, for his handling of the Great Recession of 2008, and for the intellectual curiosity he brought to the role of CIO. David will, of course, continue to contribute to security selection and portfolio management in addition to his continuing roles of a senior partner, board member and advisor to many valued clients of the Firm.

Fraser has touched and improved upon processes in many different areas of the Firm since he joined us in 2011 from Acadian Asset Management, a global investment advisor in Boston. He has shown extraordinary initiative in finding ways to relate functions within MoneyGuidePro (our financial planning software) to asset allocation and portfolio management, in developing a consistent and informative portfolio review process, and, this year, in sourcing and evaluating new software that will provide many of the tools we need to better integrate our internal security selection with our stable of outside investment managers. Finally, he has devoted significant time to managing a number of client portfolios and to meeting with clients over the years. If you haven't already, I hope you have the chance to spend time with Fraser soon.

Robert G. Scott
Chairman & CEO

Source of data not specifically cited: Bloomberg.
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