Serber Speaking

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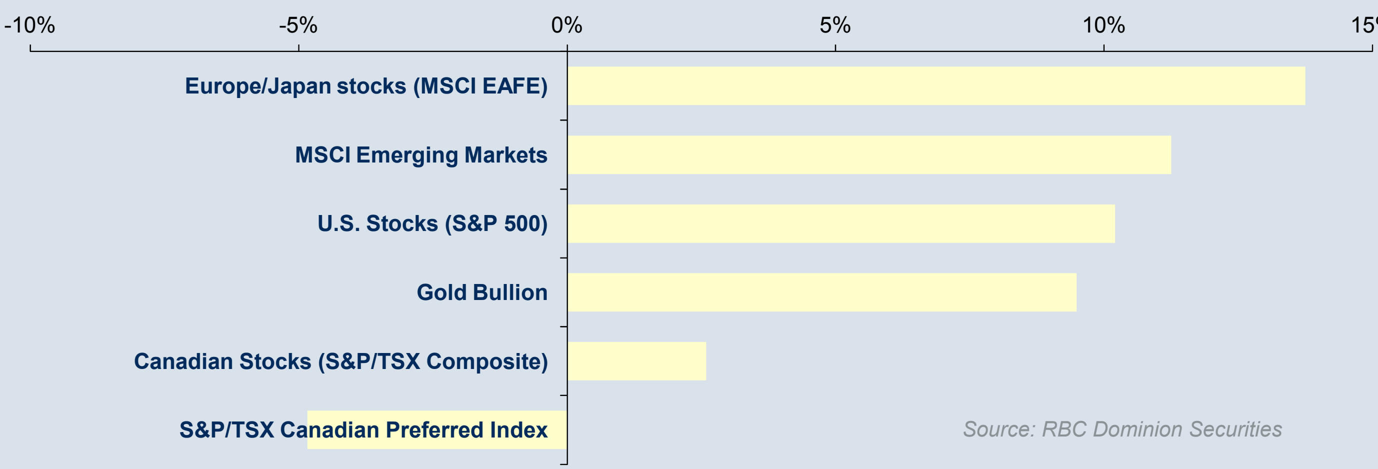
Commentary for the quarter ended March 31, 2015

Navigating the crosscurrents

In the January edition of this quarterly report, I asked whether it was time for some bargain hunting in depressed markets such as Europe and Japan, even though their economies were having difficulties. Fast-forward three months, and it turns out those markets have been the best performers year to-date, as seen on the chart below. This illustrates a point I've made on several occasions: when it comes to investing, what's important is not the story on the front page of today's headlines - it's all about what's going to be on the front pages six months from now!

In January, Europe seemed mostly a basket case, and Greece was threatening to spark another crisis. Three months from now, the story may well be about Europe's "surprising signs of recovery." In the meantime, European markets tacked on stellar gains in the first quarter. If one waits until the story in the paper is rosy, one may well miss the most meaningful financial gains.

Performance by Asset Class: January 1 to March 31, 2015 (in Canadian $)



Other regions have also generated strong results this year. Emerging markets "emerged" from a multi-year slump with a gain of 11 percent. U.S. stocks gained 10 percent, although this result was more to do with the Canadian dollar losing value against the greenback (down eight percent in the quarter) and less to do with the actual market return (two percent).

Meanwhile, the Canadian market underperfomed its international peers with a total return of 2.6 percent. A major contributor to this underperformance was the energy sector, which is suffering due to a lower price for crude oil (down from $100 per barrel to $60 over the last six months). Another drag was the Canadian banking sector, notching a four percent loss in Q1 as concerns surfaced about maxed-out Canadian consumers and the banks' credit exposure to the energy sector.

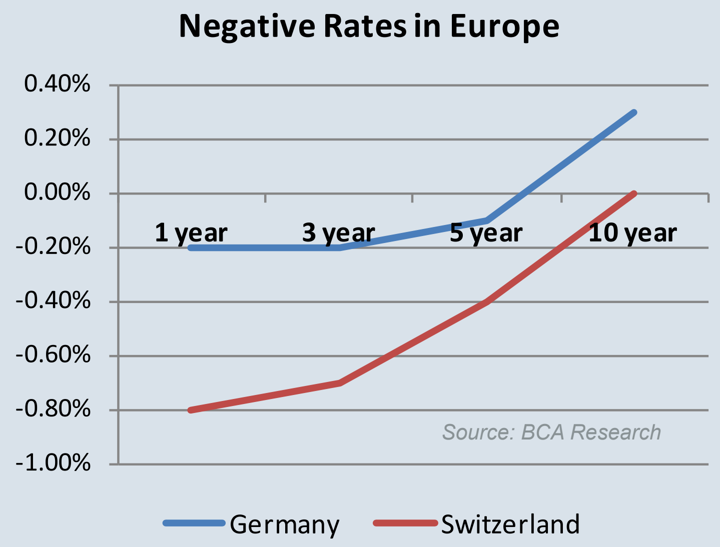
On the plus side, gold bullion had a positive impact on portfolios with a nine percent gain, as seen on the chart. Once again, though, it is worth noting that almost all of this gain was due to the fall in the Canadian dollar, not an actual rise in the USD price of gold itself. Finally, the worst performing segment for the quarter, and for our portfolios, was the preferred share market with a total return of minus five percent. The main culprit here is lower interest rate expectations, prompted by the Bank of Canada's (BOC) surprise cut in its overnight lending rate on January 21, from 1.00 percent to 0.85 percent.

Prior to January 21, most forecasters expected a gradual Canadian interest rate increase over the next year as the economy continues to expand. But after the January 21 rate cut and the BOC's indication that it would lower rates further if necessary to counteract the negative impact of falling oil prices, the prospect of higher rates any time soon is off the table. If anything, there is widespread belief that another BOC rate cut may come over the next several months.

As a result, Canadian interest rates in general, including longer-term bond rates, fell by about half a percentage point in Q1. The ten-year government bond yield, for example, fell from 1.80% to about 1.30%. A fall in interest rates makes existing bonds or preferred shares, with a *fixed* interest rate or yield, more attractive. That's why bond prices go up when interest rates go down, and vice versa. In the preferred share market, however, the majority of preferreds pay a *variable* dividend rate. After the BOC rate cut, variable-rate preferreds have taken a hit. As the rates are reset (typically every five years), the new dividend yield will be quite a bit lower than previously thought, based on current trends.

At current prices, I believe many preferreds are a good buy and am selectively adding to positions. There is good potential for capital gains, as the share prices will recover if and when interest rate expectations change. Meantime, the shares continue to generate solid cash income.

Interest Rates have to go up soon. Right?



When will interest rates start to go up? I wish I knew. For the past five years, forecasters have been predicting rates would start rising--and every year they have been wrong. For most of the globe, interest rates are actually going down. As seen on the chart at right, government bonds in Germany and Switzerland of five years or fewer currently offer negative yields. This means one is financially better off holding cash in a vault than investing in bonds.

One small bank in Denmark recently announced they will begin charging customers a 0.50% fee on deposits. Larger European banks could be forced into doing the same, in order to protect their profitability. In Canada, we complain about making "only" two percent on a GIC. In Europe, this would be a home run. A few years ago, most economists thought negative rates were impossible, yet now they are a reality. This underlines the fact that the global financial system is deeply into uncharted waters and that we need to be prepared for surprises. Partly for this reason, I hold about five percent of portfolios in gold, plus a few percent in gold mining equities.

That said, negative interest rates in Europe can be expected to kick-start their economy. It is likely that Europeans will decide to spend their money, rather than watch the value of their bank deposits decline in value. Banks, too, will be more apt to lend to avoid the pain of paying interest on the deposits they hold with the central bank. This should, other factors holding constant, boost GDP and be a factor behind hoped-for European headlines this summer about a "surprising growth spurt." If so, expect Japan to seriously consider joining the negative interest rate party.

Our Average Balanced Portfolio

	Current	Dec. 2014
Stocks	47%	41%
Bonds & Preferreds	32%	34%
Cash & GICs	16%	20%
Gold/Commodities	5%	5%

So, the global trend for rates is still down. The U.S. is the exception, and rates there should begin to slowly increase starting later in 2015 or early 2016. Low and generally falling rates provide support to the markets, as investors continue to seek out reasonable alternatives with the promise of a better yield. This should support the prices of dividend stocks, high-yield corporate bonds and other yield-producing "risk" assets for the coming year.

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Best and Worst of Q1 2015

	% Return
Cirrus Logic	54%
Marathon Petroleum	44%
Valero Energy	42%
Chicago Bridge & Iron	36%
Ryland Group	34%
Canyon Services Group	- 18%
Freeport McMoRan	- 16%
Micron Technology	- 15%
Transocean	- 13%
Vermillion Energy	- 12%

Best and Worst Stocks for Q1 2015

Three of the top five performers listed at right are companies newly added to the portfolio in January. These winners helped power our U.S. stock portfolio to a gratifying 16 percent gain for Q1, compared to the 10 percent gain for the S&P500 index. **Cirrus Logic** is a semiconductor producer of chips for portable audio, specifically for its largest customer, Apple. Annual revenues will top US$1 billion this year, and both top-line and bottom-line growth are projected to grow at a 10-percent clip over the coming three to five years. **Marathon Petroleum** and **Valero Energy** are both in the oil refinery business, which is one part of the energy industry that benefits from a fall in the price of crude oil. Lower oil prices lead to lower gasoline prices, which lead to more demand at the pumps. Since refiners make a spread on every barrel of oil refined into petroleum, the more demand, the more revenue. Valero recently raised its dividend by 45 percent, a sign of confidence that profitability is expected to remain robust. **Chicago Bridge & Iron** started in 1889 as a bridge design and construction firm. It is now a leading engineering and construction company with annual revenues of US$14 billion. We bought in January as a value play when the shares were trading at only seven times earnings, and so far that move has paid off. These shares have the potential to double over the next three to five years based on earnings growth and an expansion of the price/earnings multiple. Another January purchase was **Ryland Group,** a U.S. home builder with annual sales in the US$3 billion range. After five years of losses in the 2007-2011 period, the industry is on a firmer footing, and Ryland's profits look poised to grow by 15 percent annually over the next several years. Even after the 34 percent gain in Q1, with a P/E of about 12, significantly lower than average, the shares are a solid value play.

Losers for Q1 include several companies in the oil and gas industry. **Canyon Services Group** and **Transocean** both provide drilling services. **Vermillion Energy** is a mid-size Canadian oil and gas producer with operations in Western Canada and around the world. I sold all three early in Q1 to take our losses and move on to better opportunities. **Freeport McMoRan** is a copper and gold mining business that has suffered during the current period of low metals prices, and I also sold these shares in Q1. **Micron Technology** is a semiconductor manufacturer specializing in dynamic random access memory (DRAM) chips for computers. After strong gains in 2014, its shares took a breather in Q1. With a low P/E ratio of nine times and expected strong earnings growth, these shares should double over the next three to five years—and I plan to hold

I wrote in January that "portfolio returns in the four-percent to five-percent range for the year ahead seems like a reasonable expectation." In fact, balanced portfolios have generally gained that amount already in Q1. Since January the outlook for interest rates has turned benign, and I now believe portfolio returns for 2015 could be in the high single digits. For now, I intend to leave our risk exposure intact, although I'll be inclined to reduce risk as the year progresses, especially if the torrid pace of gains seen in Q1 continues. Stay tuned...

David Serber, Vice-President and Portfolio Manager

Wealth Planning Tip

If you pay private school fees for a child or grandchild and have non-registered investments, consider the tax-saving benefit of an **RBC-DS Family Trust.** Call or email to find out more.

RBC Wealth Management
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