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What We Think……

US: Deflation or Recovery?

Just as the Fed is finally loosening its hold on capital markets, especially bonds, the ECB is tightening theirs. Fortunately, from our perspective, Mario Draghi's grip is not as tight the one once applied by Ben Bernanke, and now to a lesser degree by Janet Yellen. While it is not formally *risk-off,* investors are begrudgingly preparing for a less-predictable Federal Reserve while, at the same time, navigating an increasingly confusing array of global forces. In our minds the biggest question, floating just beneath the surface, is whether Europe is gradually sinking into the same deflationary swamp that has engulfed Japan for the last twenty years, inevitably to be followed by the US and, maybe, even China; or is the US on a separate and distinct trajectory, ready to take off like a bald eagle (or at least a Canada goose) across the water, leaving most of its G7 colleagues behind.

Japan

No one disputes that Japan has been suffering through a deflationary environment for the better part of the last two decades. Following Japan's joint real-estate and stock market bust of 1989, it began to experience deflation beginning in 1995. Since that time, inflation has been negative for over 50% of the time. Many commentators blame the government and the BoJ for the inability of fiscal and monetary policy to create some permanence to a Japanese recovery. However, Japan's situation is not so simple, as its unique combination of demographics, culture, and politics have made it difficult to address its economic problems.

Japan's challenging demographics have been identified as a key challenge for the Japanese economy and the deflationary back-drop, and something that unfortunately will not get better soon. A combination of long life spans and few children has begun to invert Japan's population pyramid from a more desirable *normal* pyramid (see Figure 1). A declining young population has meant less income generation and less spending. Adding to the demographic issues are unique Japanese cultural traits including high savings rates, low labour force participation of women and a general disapproval of immigration.

Unfortunately, Japanese government policies have tended to aggravate Japan's deflationary fortunes rather than help them. In the early 1990's Japanese monetary policy was generally inadequate, allowing a deflationary psychology to set in over the ensuing decade. In 1997, to further exacerbate the situation, the government introduced a sales tax increase from 3% to 5% that many believe led to Japan's recession a year later. Between 2001 and 2006, the Bank of Japan pioneered a program of quantitative easing to raise the level of inflation and reinvigorate the economy. While there was some success, deflation did not disappear, reappearing again in 2007 (suggesting the size of the program was ultimately inadequate). Recently, Japanese monetary and fiscal policy has again been active, with the introduction of *Abenomics* initiated in 2012. Under Abenomics, the government implemented fiscal stimulus of ¥20 trillion, and the BoJ embarked on a QE program of ¥151 trillion aimed at increasing inflation to 2%. While there has been some uptick of inflation, aided by the recent sales tax increase from 5% to 8%, the economy is now slowing (somewhat reminiscent of the effects of the 1997 tax increase) and the most current inflation data suggest deflation may again be around the corner. Looking forward, Japan must face its future exposed to the *double whammy* of large government debt and little central bank manoeuverability.

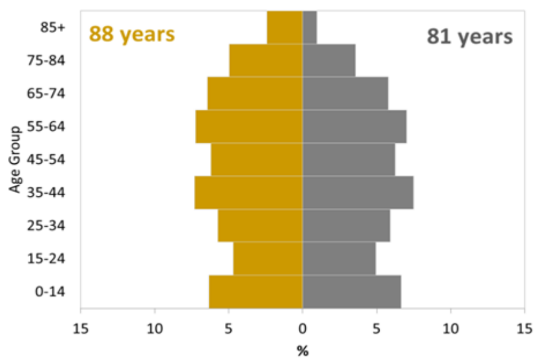
Eurozone

The Eurozone unfortunately appears to be going down the same deflationary path of Japan, although with different cultural and political dynamics. From a demographics perspective, Europe looks like Japan, only 20 years ago – the population is aging and there are not enough young people coming up from behind (see Figure 2). Significantly, immigration is a reality in Europe and fortunately (from a purely economic perspective) Europeans do not live as long as the Japanese – but the workforce is aging never-the-less. Troubling high rates of youth unemployment however, increases the likelihood that young Europeans will be underemployed through the length of their careers, reducing incomes and encumbering the region's growth potential.

With private indebtedness high in most of the Eurozone, it is left to governments to stimulate growth through policy actions. Unfortunately, the high rate of European government indebtedness and the already high level of taxes limit the ability of European governments to stimulate their economies through fiscal policy (think of the failed Hollande wealth tax). While interventionist monetary policy has certainly not been exhausted – the ECB's balance sheet is significantly lighter

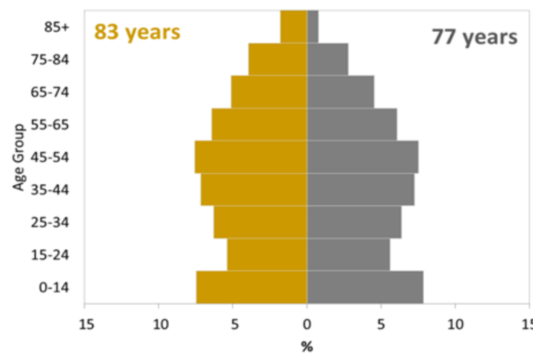
Population Breakdown by Age Group (with Life Expectancy at Birth)

Figure 1: Japan



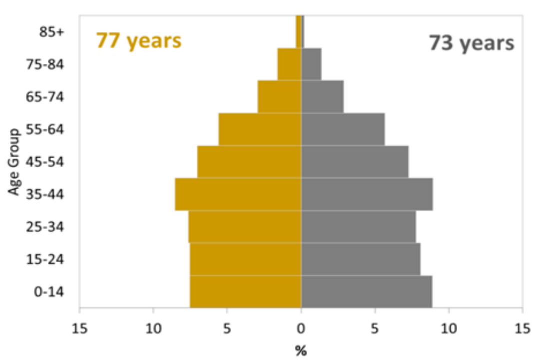
Source: Statistics Japan, CIA World Factbook & Lorica Investment Counsel Inc; September 2014.

Figure 2: Eurozone (EU17)



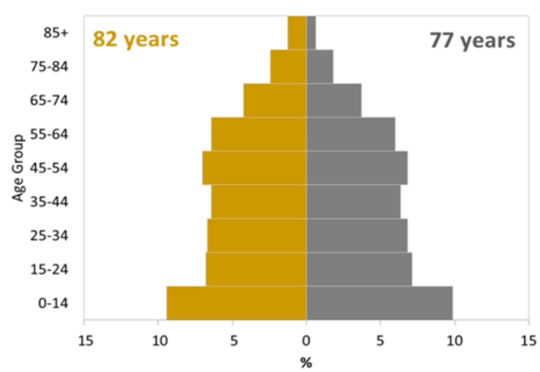
Source: Eurostat, CIA World Factbook & Lorica Investment Counsel Inc; September 2014.

Figure 3: China



Source: National Bureau of Statistics of China, CIA World Factbook & Lorica Investment Counsel Inc; September 2014.

Figure 4: US



Source: US Census Bureau, CIA World Factbook& Lorica Investment Counsel Inc; September 2014.

Female **Male**

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than that of either the Fed or the BoJ – the non-homogeneity of the Eurozone together with the greater degree of bank intermediation makes implementation of quantitative easing that much more challenging. ECB president Draghi has tried to conduct much of his monetary policy through guidance, but recent market response suggests that he will have to turn towards QE for more substantive progress. Perhaps the most aggressive, but inconspicuous, policy action can be found in the currency markets, where the Euro is in the middle of a secular devaluation against the US dollar. Unfortunately for the Euro, only 12% of its exports are directed at the US, while most of its other trade partners are experiencing similar devaluations.

Beyond government policy, the Eurozone suffers from a wide range of problems including: regulatory barriers and incoherence, high wages, gratuitous social programs, export dependence, and lofty tax rates. Unlike the US, Europe does not have a vital entrepreneurial service sector that is crucial to offset at least some of the declines in manufacturing. While Germany stands out as the Eurozone country that has a manufacturing base that potentially can withstand the malaise of the region, unfortunately just under $^2/_3$ of its exports are within troubled Europe.

China

It is difficult to think of China suffering a similar deflationary fate to advanced countries, given its relatively high growth rates of the recent past. But simmering below the surface are fundamentals that may portend a similar fate down the road. China's life expectancy has increased, and due to its *one child* policy, the proportion of working youth is declining (see Figure 3), and with it, future growth potential. Another feature of China's aging population that will likely impede consumption is the growth of its already high savings rate with the increased adoption of pension schemes and health care programs.

Beyond its once cheap labour force and its ability to foster manufacturing growth through central planning, China does not necessarily have unique industrial competitive advantages. In perhaps a surprising development, higher wages are forcing Chinese manufacturers to move towards mechanization – a deflationary force in at least the short run. And all is not necessarily copacetic when it comes to government stimulus. For much of the last two decades, any waning in Chinese growth was met with government spending on infrastructure and housing. However, to avoid creating economic imbalances, the Chinese economy requires reorientation towards consumer spending, which also implies slower growth rates and likely lower inflation.

While any move towards deflation in China will be slow, ultimately it will be difficult to know for sure if deflation becomes a problem, as measuring inflation is difficult enough in the most transparent of economies, let alone a more closeted China.

US

The US has the good fortune of having the most desirable demographic structure amongst its peers (see Figure 4). While the aging of the boomer generation is underway, there is a healthy bulge between 15 and 25 that will come into the workforce at some point over the next decade (perhaps later than previous periods as higher education sucks in more students). However, current data indicates that the labour force participation rate is declining and the most recent research suggests that it will continue to decline.[1] It should be noted that a significant amount of the

[1] Toossi, Mitra. "Labour force projections to 2022: the labour force participation rate continues to fall." *Monthly Labour Review*, Burea of Labour Statistics, December 2013, pp. 1-28.

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decline in participation will come from a combination of women exiting the workforce and lower participation amongst the young, partly due to delayed entry. At any rate, it will be hard to determine exactly what role demographics will play on US growth and inflation, but the picture is undeniably more attractive than elsewhere.

The other part of the US labour story, which to us, is reason for great optimism, is the job growth in some of the higher wage sectors. Admittedly the greatest amount of job growth is still in the lowest paying sectors such as hospitality, health care and retail which accounted for 37% of new jobs in the last 12 months. However, amongst higher earning sectors of manufacturing, wholesale trade and professional/business services (excluding administrative and waste management) which accounted for 21% over the same period, wage growth has averaged 2.4%. Although absent from the current jobs recovery is a steady contribution from the housing sector, given the still-high levels of household debt and the number of mortgages still under water, we doubt that this situation will change anytime soon. Given the current makeup of job growth, we expect it's behaviour as well as that of e economic growth to be moderate but less volatile.

Although Fed QE is coming to an end, overall monetary policy will continue to be supportive for some time. We expect the Fed to gradually raise rates beginning sometime in Q2 next year, as it responds to further declines in the unemployment rate despite modest inflation (constrained by a strong US dollar). Overall growth should be decent, at around 2-2½% and will not be significantly impacted by poor growth in Europe and Japan. Remember only 14% of US GDP is in the form of exports, which should serve the US well as it searches for consistency in its economy.

Interest rate increases by the Federal Reserve will ultimately push the front-end of the yield curve higher; however the back-end movement is less predictable. Investors have begun to take charge of longer-term bond yields, as the market detaches from QE and forward guidance. Yield volatility has increased as investors respond to economic fundamentals, geopolitical events and global bond yields and currencies making longer term bonds particularly risky.

Wandering The Universe of The Wandering Universe

Since I began my career at McLeod Young Weir in the mid 80's, the MYW Universe Bond Index (as it was known then) has undergone a host of name changes – all following ownership changes. Shortly after I started the index was renamed the Scotia Capital Universe Bond Index. Later, the name was changed to the DEX Universe Bond Index and finally it is now called the FTSE TMX Canada Universe Bond Index. But the name has not been the only thing that has changed over the last thirty years. While the name changes have been largely cosmetic, other more fundamental features have also changed, most notably the index duration and sector weights (see Figure 5), the rating agencies of record, and the inclusion of government agency debt and bank sub-debt with conversion features (this is currently a hot topic of debate as it pertains to NVCC).

The Universe has always been a relatively unbiased reflection of the liquid public investment grade debt outstanding issued by Canadian issuers in Canadian dollars. There was never any judgement process as to the propriety of the index as a proxy for liabilities of its users. Beginning in the 1980's the index was adopted by bond managers, consultants, investors, etc. as a convenient way to benchmark portfolios and performance. Later on, the Universe gained inertia and standardisation (similar to the Lehman, now the Barclays index in the US) as popular Index Funds and ETF's were benchmarked against it.

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As the bond management industry has matured and pension funds have gone in and out of surplus the view of the index has changed. During the previous decade, pension consultants – once the largest proponents of the index, began to realise that the index duration was not necessarily appropriate for the long-term liabilities of funds under their purview. The consultants initiated a large migration of pension assets to longer term benchmarks such as the FTSE TMX Canadian Long Bond Index or other custom benchmarks. The experience in the retail space however, has been entirely different as most managers managing portfolios for a retail audience have not changed their reference point and the Canadian Universe has maintained its dominant benchmark status.

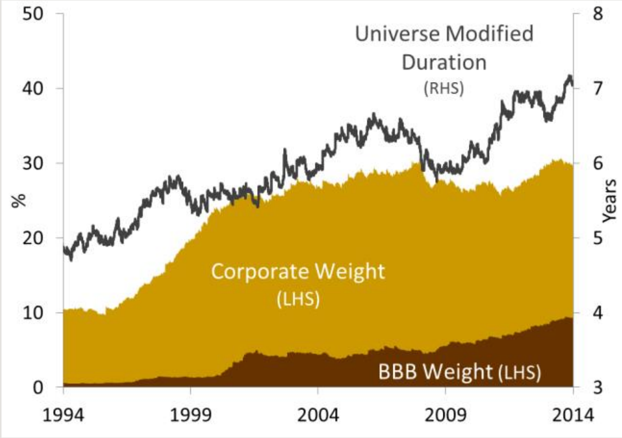
But as yields have fallen, issuance patterns changed and new sectors added to the index, the risk characteristics of the Universe have quietly changed. Today (as at September 30th), the overall Universe modified duration is 7.08 years (and likely to increase further), considerably higher than what it was twenty years ago (on September 30th 1994) when it was 4.89 years. Given that a bond's modified duration represents its price sensitivity to a change in yields, the Universe index has gotten 45% more risky as it relates to yields over the last twenty years. Naturally, one has to ask themselves, at the end of a 30-year decline in bond yields (with little room to go lower), is this an appropriate time to have such large yield sensitivity in one's bond portfolio?

Another significant risk characteristic that has changed over time has been the weight of corporate bonds in the Universe and, more poignantly, the weight of lower-rated corporate bonds. Again comparing today to 1994, the corporate weight has gone from 10.4% to 29.7%, while the BBB weight has gone from 0.63% to 9.2%. (At one time, riskier lending was largely done through private placements, or south of the border, or even by banks.) Again one has to ask themselves, does it make sense to hold more risk in the form of corporates and BBB's, just because there are now more public corporate and BBB issues outstanding in Canada?

We have concluded that now is not the time to have such significant duration risk in the portfolio, hence the relatively low duration of our Core and Focused Fixed Income portfolios. While there is arguably some room for yields to move lower over the next year, the dominant risk is still that yields move higher and hence our decision to protect the portfolio from such a scenario.

Our position with respect to corporate risk is mixed. We believe that yield spreads on short term corporates offers decent protection, (although less so for riskier credits) while there is a reasonable risk of spread widening in response to the emergence of *risk-off* psychology. We have chosen to overweight the portfolio on a market weight basis, but remain closer to neutral in terms of spread risk and above average in terms of overall credit quality.

Figure 5: Universe Modified Duration and Corporate & BBB Weights



Source: PC Bond & Lorica Investment Counsel Inc; September 2014.