

LIBERTY MARKET UPDATE

It's been a difficult year for equity markets as global index returns have been flat to negative (see Table 1 below). There are the usual explanations, such as debt worries over Greece, slowing of the Chinese economy and a collapse in commodity prices.

Table 1: Global Index Returns for 2015 (as at September 30th)

Index	Return in USD	Return in CAD
Canada (TSX)	-19.1%	-9.1%
United States (S&P 500)	-5.1%	9.3%
United States (Nasdaq)	-1.5%	13.6%
Mexico (Bolsa)	-12.5%	0.8%
Europe (Eurostoxx600)	-3.2%	11.4%
Japan (Nikkei)	-1.5%	-1.3%
Australia (S&P/ASX 200)	-15.5%	-2.8%
China (Shanghai Composite)	-5.9%	8.4%
India (Sensex Index)	-6.9%	7.2%

However, we believe there's more going on under the surface that the pundits are overlooking, or worse, ignoring: The negative effect of low interest rates for long periods of time.

Debt Doesn't Disappear

Low interest rates reduce interest income and force investors to invest more aggressively by buying riskier assets. On the consumer side, because interest rates are low, money is 'cheap'. This cheap money brings down the monthly payments associated with purchasing "stuff" such as bigger houses and cars. Cheap money also enables individuals to speculate more on the stock market by taking out margin loans (i.e. borrowing funds to invest in hopes of earning a return higher than what must be paid in interest).

Ultimately, however, investors should never forget the three Ds of investing: **Debt Doesn't Disappear**.

Debt at the Country Level:

Around the world, countries are trying to manipulate their currencies lower in the hopes that exports pick up. However, when every country attempts this exercise, countries get poorer, not richer. Brazil's currency has fallen 43% in 2015 versus the US dollar but it hasn't helped the Brazilian economy or its stock market. Unfortunately for the folks in Rio, the Brazilian stock market has fallen 7.2% in its own native currency and the World Bank's forecast for Brazil's Gross Domestic Product (GDP) for 2015 is -1.3%.



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Debt at the Corporate Level:

An article in *The Globe & Mail* of October 27, 2014 by Ian McGugan found some interesting data among the people he interviewed. While companies have poured money into stock buybacks and dividends, William Lazonick, a professor of economics at the University of Massachusetts Lowell said, “few have left little for investments in productive capabilities”. Lazonick also suggested that, “CEOs are acting in their own interests by using cash to bolster the price of the shares on which their compensation is based.”

McGugan also found that “Since the financial crisis, U.S. corporate profits have skyrocketed, but investment in new plants and equipment has grown slowly. For instance, CEOs have trimmed the proportion of their companies’ cash flow used for capital spending to about 40% from more than 50% in 2002, according to Bloomberg and Barclays plc.”

In the meantime, according to data compiled by Bloomberg, “CEO compensation at large U.S. companies was 204 times higher than the pay of workers on average in 2013, up 20% since 2009”.

In other words, spend for today to line executive pockets, don’t invest for tomorrow to help the employees and shareholders.

Debt at the Consumer Level:

People with mortgages like to chirp about how low their rates are. However, it’s important to note that a 3% mortgage is after-tax. For those in the highest margin tax bracket, the pre-tax cost of the mortgage is closer to 6%. Against a backdrop of Treasury yields at 0.5%, there’s a huge debt mismatch going on here. That debt is more onerous than it may appear.

Bill Gross, of Janus Capital Group, wrote earlier this year that, ““Making money by borrowing at no cost for investment in the real economy sounds like a no-brainer,” he said. “But, it comes with increasing risk in an environment of secular stagnation, demand uncertainty and with the return on investment closer to zero itself than an entrepreneur is willing to bear.”

According to a McKinsey Global Institute report, “global GDP growth is expected to average 2.1% a year over the next 50 years, or 40% below the 3.6% annual pace of the past 50 years.”

A fall in a country’s currency means people begin to import inflation (i.e. the cost to purchase necessary foreign goods - think food or heavy equipment - becomes more expensive) and their standard of living falls. With household balance sheets indebted to the max, there comes a tipping point when things head south, especially if wages aren’t keeping pace.

It doesn’t have to be a rise in interest rates that hurts an individual’s prospects. Higher costs from imports can do it alone. If oil prices hadn’t plummeted, there would probably be more stories of personal hardship.

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Barrie McKenna, in a *Globe & Mail* article, wrote that, “Robert Gordon, a Northwestern University macroeconomist, argues that the United States’ best years are in the rear-view mirror. Growth is almost over, he says, because productivity gains can’t keep pace with the “headwinds” of an aging population, widening inequality, public-sector debt and stalled educational attainment.”

And Mr. Gordon is, “highly skeptical of the power of innovation, pointing out that productivity has been steadily declining for years, unaffected even by the rise of the digital economy.”

More on Innovation and Destructive Technologies

The other bitter taste in this slowdown stew are the destructive technologies that have hit the scene with a bang. Here are just a few of what we’ve seen this year:

- 1) Smartphones have replaced laptops and other types of PCs.
- 2) Many coal companies face bankruptcy as the cost of natural gas, solar power and wind power have become more economically viable.
- 3) Content companies like Disney have been hurt by Netflix as consumers move to the Internet to watch their TV programs.
- 4) Moving off the grid may lessen the demand for utilities.
- 5) Telecoms have sold everyone a smartphone but they don’t own either the hardware or the software. Where’s the future growth for them?
- 6) New findings in healthcare could make billion dollar mega-drugs obsolete.
- 7) Uber has taken over the taxi industry.

These events and trends have the potential to alter the world as we know it. What can we invest in today that will still be around in 10-20 years?

The Case for an International Portfolio

It has been a bad year for Canada

It’s been a bad year for Canada and investors in all Canadian markets. No matter the investment instrument (stocks, bonds or currency), Canadian returns have been lousy. If investors haven’t considered it before, it’s certainly a good time to think about investing internationally.

The reasons for the underperformance of the TSX in 2015 are the heavy exposure (64%) to three sectors: Financials (36% of the TSX; down 6% for the year), oil and gas (19% of the index; down 23%) and mining and minerals (9% of the index; down 25%). If one of these sectors has a bad year (or decade), the TSX Index would suffer and so would investors.

From a historical perspective, too, Canadian stock returns haven’t been all that great when compared to US and international counterparts (see Table 2 below). The only decade of

outperformance was the 2000-10 period when commodity prices and the Canadian dollar rose. Ten years of outperformance out of 45 isn't a great track record.

Table 2: Index Returns by Decade in Canadian dollars with all dividends re-invested

Decade	S&P 500 Index Return	MSCI Global Index Return	TSX Index Return
1970-1980	7.1%	4.3%	7.5%
1980-1990	17.1%	14.8%	6.4%
1990-2000	20.6%	16.1%	11.1%
2000-2010	-4.0%	-2.7%	5.5%
2010-2015	17.5%	12.9%	7.4%

Those looking for solace in the bond market won't find it there, either:

Table 3: Bonds: 10-year current yields:

Country	Yield
South Africa	8.13%
Greece	7.79%
Brazil	15.94%
Mexico	6.03%
New Zealand	3.29%
Australia	2.59%
United States	2.03%
United Kingdom	1.80%
Spain	1.77%
Canada	1.46%
Japan	0.31%
Switzerland	-0.27%

The table above illustrates why investing in Canadian bonds doesn't provide much yield relative to other countries. There are clearly better opportunities elsewhere.

If you prefer to invest in Canadian bonds because of the perceived currency risk, the following table shows why an investor who owns a wide selection of bonds in different countries doesn't have to worry about currency risk.

Table 4: Currencies - CAD\$1 buys:

Country	Dec. 31, 2014	Sep. 30, 2015	% Difference
US Dollars	\$0.8605	\$0.7512	-12.7%
Euros	\$0.7112	\$0.6720	-5.5%
British Pounds	\$0.5524	\$0.4966	-10.1%



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Danish Krone	\$5.2971	\$5.0143	-5.3%
Swiss Francs	\$0.8556	\$0.7311	-14.5%
Norwegian Krone	\$6.4124	\$6.3961	-0.2%
Swedish Krona	\$6.7243	\$6.2865	-6.5%
South African Rand	\$9.9566	\$10.4087	4.5%
Japanese Yen	\$103.04	\$90.045	-12.6%
Australian Dollars	\$1.053	\$1.0704	-0.2%
New Zealand Dollars	\$1.1034	\$1.1744	6.4%

The chart above shows the change in value in 2015 of 11 different currencies versus the Canadian dollar. This year, only the South African Rand and the New Zealand dollar have fallen against the Canadian dollar. Stocks or bonds owned in other countries have clearly gained this year in value from the exchange rate difference.

This may also not be a one-year aberration. When Canada's currency falls, we import more inflation as imports cost more (food, clothing, home furnishings and new machinery) and our spending power erodes.

In the past, it was assumed the Canadian economy would fare better with a cheaper currency but things have changed. Our manufacturing base has eroded, especially as auto makers are receiving better terms-of-trade from the U.S. and Mexico.

Also making it worse are continued border delays and the Americans' demands that products carry a "Made in USA" stamp.

Finally, most currencies are cyclical. For the Canadian dollar, it took almost 40 years to go from par with the US dollar to 69 cents in 1998 and back to par. Over time, currency risk becomes benign.

To summarize, the investment rules-of-thumb to remember are:

- The 3 D's of investing: Debt Doesn't Disappear. Interest charges reduce free cash flow which in turn means less funds for reinvestment and/or dividend payments.
- Avoid heavy concentration in your portfolio. The greater the correlation, the greater is the risk.
- Owning foreign stocks and bonds provides investors with a natural currency hedge. Over time, the currency risk should become benign and provide for better returns.
- For greater exposure to global returns, investors need to own stocks that have little revenue exposure to Canada.
- Decide on the percentages you want in each currency (both stocks and bonds) before investing and then keep the percentages consistent.
- Keep some cash in the portfolio. If you believe the stock market has become stretched after 6 years of up markets, having 10% to 20% in cash is not a bad idea. If the market



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continues higher, you'll still participate in the gains. If the market corrects or crashes, you'll have cash ready to take advantage of lower prices.

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