REVIEW AND COMMENTARY
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'Talk like a dove and act like a hawk'

This quote is attributed to Larry Kudlow of CNBC in reference to his recent description of US Federal Chairperson Janet Yellen. In more common vernacular, this means that the Fed Chair will continue to talk about keeping interest rates low but start to make all the necessary preparations for the eventual raising of US interest rates. While the global equity markets ended the most recent quarter, and started this current quarter, with weakness and volatility some of this may be a reaction to the concerns over what effect higher interest rates will have on the market.

Ms. Yellen and the US Fed continue to suggest that the future course of interest rates will depend on economic data. While the US remains one of the few major global economies showing strength, it is important to remember that the US economy, much like the other economic juggernauts such as Germany and China, cannot continue to grow in isolation; they need major trading partners' economies to improve as well in order for growth to be sustained. Christine Lagarde, Managing Director of the International Monetary Fund (IMF), has expressed concern about a weakening global economy putting further pressure on growth estimates of not only the US but the afore mentioned economies . If the IMF's estimates are correct it would appear that there may be more time before interest rates are raised in the US. However, let's look at a bit of history when it comes to equity prices and rising interest rates just in case it happens faster than anticipated.

While the relationship between equity prices and interest rates are generally negatively correlated (interest rates go up, equity prices go down or interest rates go down, equity prices go up) this is not as common when interest rates are exceptionally low as they have been for the past several years. In mid-2004 when the discount (US interest) rate increased over a three month period from 2 to 2.75%, the US equity market increase by 10.3% over the next 12 months. Hikes in interest rates stopped almost 2 years later while stock prices peaked at all times highs (at that time) more than a year later in late 2007. Even when interest rates moved higher over a considerably longer term period--for example from 1962 to 1981--stocks over the same time period performed better than Treasury Bills and inflation as attested in a recent study done by Stansberry Research. Of course, market movements over that time frame are not linear and there were periodic corrections but long term equity investors were rewarded for their patience.

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Canadian equity markets reached new highs in the most recent quarter, as measured by the SP/TSX, but like the US equity markets have more recently come under pressure. Some of this was due to falling commodity prices. While lower oil and gas prices are beneficial to individual consumers and the most businesses, it put downward pressure on our equity index and currency. Some of this is simply reflecting a strong US dollar--which to some extent has become a safe haven as tensions around the globe have increased--this in turn put downward pressure on most commodities given most commodities are priced in US dollars. There are some additional factors that are responsible for the 'safe haven' trade. One is that geo--political tensions increased as headlines were filled with Russian aggressions in the Ukraine, ISIS militants beheading of American and British citizens, student led protests in Hong Kong along with the Ebola virus now afflicting US residents. Russia's influence continues to grow in the commodity circles: many G8 nations have imposed punishing economic sanctions. Russia has reacted by threatening to limit oil and gas exports to the rest of Europe which hurts the Euro and, if imposed, will weaken the economies of those nations. If Euro economies weaken, the less likely they are to import goods from China. As China's growth comes into question, commodities fall. In October, Saudi Arabia, instead of stemming falling prices by cutting oil production announced that they would rather lower accept prices which put additional downside pressure on oil prices. Some speculate that the Saudi's unwillingness to support prices is to discourage US recent progress towards energy self-sufficiency but an alternative explanation may be that lower oil and gas prices would not only further punish Russian imperialism but also weaken the resources of the radical groups in the Middle East such as ISIS that financially depend on oil and gas revenues, something of interest to both the US and Saudi Arabia.

Certainly Russia's economy is being strained and lower commodity prices will increase these pressures. While his popularity is at all times high (at least publicly), Putin is running the risk of an economic crisis in Russia that if remains unchecked may lead to civil discontent that may manifest itself in a reaction similar to a century ago when the Bolsheviks swept into power. It is hard to imagine that a suitable compromise won't be reached however history has shown these types of standoffs can last for decades.

So while the US economy is starting to gain strength its recovery will be limited given the tenuous condition of other major global economies thus increasing the likelihood that interest rates will not be rising any time soon. Yellen has stated that she would prefer to wait until the US economy has significant traction before acting. However, if a resolution to the Ukraine standoff were to materialize and the resumption of normal trade of goods were established, there should be an immediate and swift reaction to the long term prospects for the global economy and equity prices. We continue to remain dovish on rates and even when they start to move up initially, think equities will provide superior returns.

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