



George Stedman, CFA

RBC Dominion Securities Inc.

1501 McGill College, Suite 2150
Montreal, QC H3A 3M8

Tel: 514-840-7626

Fax: 514-840-7639

george.stedman@rbc.com

www.georgestedman.com

Monday, July 6, 2015

Second Quarter 2015

Stock markets, and our portfolios, were generally down a little in the second quarter. There were a number of particular concerns including the prospects of the Federal Reserve raising short term interest rates in the US, perhaps beginning in September and, the potential Grexit. Grexit is my new word of the month. It is shorthand for the exit of Greece from the Euro. There was much anticipation of the Greek referendum on austerity measures. The results were announced this past weekend. Consequences will follow.

Presumably the world is much better prepared for a Grexit than it was in July 2011 when I last wrote about it: “European authorities would appear to prefer to push Greece’s bankruptcy out long enough to give the bigger PIIGS (Portugal, Ireland, Italy, Spain. Greece only has 11 million people) time to get their government budgets in order and to get all (counter) parties prepared for whatever avalanche Greece’s default loosens.” The risk of contagion is hopefully less now, four years later. Grexit would likely involve redenomination of most Greek contracts and financial instruments and a devaluation of the new Drachma. I won’t attempt to trade on headlines about Greece, except to try to gradually buy on down days (BoDD).

It may be that after three years of gains, stock markets were looking for an excuse to correct this summer. I have often written about seasonality in the stock market and of my superstition that good bargains are often available when days get short in the fall. I have written too about the optionality of cash. Financial reserves are especially useful in reducing the stress of well-known unknowns not to mention the truly dangerous unanticipated events. Janus Capital’s Bill Gross, in his latest investment letter, warns of a potential sudden lack of liquidity. He counseled: “Hold an appropriate amount of cash so that panic selling *for you* is off the table.”



One of the worst performing stock market sectors last quarter, even worse than Energy, was Utilities. The S&P TSX Utilities returned minus 7.7% in the 2nd quarter in Can\$, the S&P 500 Utilities sector had a return including dividends of minus 5.8% in US\$. Utilities are the quintessential dividend income investment; they are largely bought for their predictable dividend income so they tend to suffer when the perception is that interest rates are set to rise because higher interest rates make bonds a better alternative.

For example Fortis, (Sempra Energy would serve equally well as a US example) the largest investor owned utility in Canada, has raised its dividend for 42 consecutive years, a record for a public corporation in Canada. The dividend has increased at about 9% annually for the last 10 years. Fortis serves 3 million customers in 9 jurisdictions – Arizona, New York, British Columbia, Alberta, Newfoundland and Labrador, Ontario, Prince Edward Island, Grand Cayman, Turks and Caicos. Fortis has regulated assets of \$26 billion, 43% of which are in the USA. Fortis's share price has dropped from \$42 in late January to about \$36 now, at which price Fortis yields 3.8%. Put another way, the price decline in 6 months is equivalent to over 3 years' worth of dividend income. The decline in the Utility sector has been largely about anxiousness about rising interest rates in the United States. If interest rates rise only gradually, Utilities just might do well. This weekend's *Barron's* observed that "starting in June 2004, the Fed began hiking rates a quarter of a percentage point at every Fed meeting. Instead of tumbling, Utilities rallied strongly."

The weakness in the Utility sector reflects growing confidence in the U.S. economy and anticipation of higher interest rates there. In Canada, on the other hand, disappointing economic growth data last week has the market now pricing in another interest rate cut by the Bank of Canada before year end. Such is the influence of U.S. markets that Canadian utilities (and other stocks bought for their dividend income, like telecoms and pipelines) seem to be influenced more by prospective U.S. interest rates than by the outlook for Canadian interest rates. Incidentally, the Canadian rate reset preferred shares that I wrote about last quarter are not at all helped by the prospect of a lower bank rate or lower 5-year Canada bond yields. Lower 5-year yields mean the new fixed dividends on extended issues will be reset lower.

Howard Marks, the so-called Zen capitalist, says: "The only constant is impermanence...the universe will go on without us...we have to fit into it and adapt to it." Marks told *The Observer* in late 2014: "What bigger mistake could there be than to think you can safely get high returns in a low-return world?" Adjust by reducing risk and expecting lower returns. Marks quotes Peter Bernstein: "The market is not a very accommodating machine; it won't provide high returns just because you need them."

Summer is not the time to clutter up investment portfolios with new selections, but rather to take a Zen like attitude of observation. I hope you will all have a chance to enjoy the good



RBC Wealth Management
Dominion Securities

weather and to visit our website which has been newly decluttered and revamped for summer.

Sincerely,

George Stedman, CFA
Portfolio Manager, Vice-President
Please visit us at www.georgestedman.com