Weekly Updates Issue # 577

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1. Weekly Markets Changes

[August 12, 2016]

S&P TSX	S&P 500	Dow Jones	NASDAQ	CAD/USD	Gold	WTI Crude
14,747.45 +98.68 +0.67%	2,184.05 +1.18 +0.05%	18,576.47 +32.94 +0.18%	5,232.90 +11.77 +0.23%	$0.7720 +0.44¢ +0.57%	$1,341.70 +0.30 +0.02%	$44.69 +2.71 +6.46%

2. Sales of drilling rights go from boom to bust

[August 12, 2016] Five years after Alberta raised a record-setting $3.5 billion at auctions of provincially owned oil and gas drilling rights, sales are on pace this year to set a historic low, part of a downward trend seen across Western Canada.

Through the first seven months of this year, companies invested just over $75 million for the right to drill for oil and gas on Crown land, according to the provincial Energy Department.

If sales continue at the same pace through the balance of 2016, they will add up to about $125 million — more than $100 million less than any annual figure in records going back to 1978 when the province adopted a scheduled sales process.

A big difference between 2011 and 2016 is the political party in power — the Progressive Conservatives then and the New Democratic Party now — but even the harshest critics of NDP tax increases and climate change policies say that's not why land sales have dried up this year.

Nor do observers pin the lack of interest solely on the two-year global oil price slump.

"You can talk about royalty rates and tax rates and you can talk about the government fiscal regime, the investment climate, interest rates, but in the oil and gas business, you can't beat the rocks," says David Yager, a Calgary oil

and gas consultant and outspoken supporter of the Opposition Wildrose Party of Alberta.

"What was discovered (leading up to 2011) was the source rock, the Montney and the Duvernay. The Montney in particular may be one of the greatest hydrocarbon and natural gas liquid reservoirs in Canada, if not in North America or the world.

"As soon as we find another of those, the land sales will spike again."

Alberta is not alone in posting lower sales for drilling rights. B.C. is also on pace to set a new record low with only $4.7 million raised from such sales so far this year. Its best year, according to government statistics, was 2008, when it raised $2.7 billion.

In Saskatchewan, about $12 million has been raised in the first half of 2016, the lowest year-to-date total since 1992. Its record year was also 2008, when it generated about $1.1 billion.

"Are we at pretty low numbers? Yes, that's a function of the cycle," said Brad Herald, Western Canada vice-president for the Canadian Association of Petroleum Producers.

"When cash flow is scarce, we do less on raw exploration."

Sales processes differ slightly between provinces but generally, producers nominate land they are interested in developing and the province then invites sealed bids on the parcels.

The winning bidders must drill wells on the property within a certain time period — two to five years in Alberta, for instance — or it goes back to the province.

"It's a different world now," said Gary Leach, president of the Explorers and Producers Association of Canada. "I think a lot of people expect maybe some of those leases that were bought may be reverting back to the Crown."

The Montney and Duvernay are still the rock stars of the oilpatch, although drilling levels have been halved since last year.

Brad Hayes, president of geoscience consulting firm Petrel Robertson, said oil and gas explorers have long known about the two formations because they drilled holes through them while seeking other zones. But it took the combination of horizontal drilling and multi-stage hydraulic fracturing or "fracking" before they could be profitably exploited, he said.

"Companies developed the technology and suddenly they could see value in huge tracts of land," Hayes said.

He said the boom turned to bust starting in 2012 simply because producers had bought up most of the best land.

In its spring budget, the Alberta government estimated it will collect revenue of just $95 million from land sales in the 2016-17 fiscal year ending next March, rising to $157 million the following year.

3. U.S. producer prices slide

[August 12, 2016] U.S. producer prices last month registered the biggest drop since September, pulled down by tumbling energy and food prices.

The Labor Department says producer prices slid 0.4% in July, first decline since March and biggest drop since a 0.5% fall last September. Over the past year, producer prices are down 0.2%. Energy prices fell 1% and food prices 1.1% in July from June. Corn prices plummeted 22.2%, biggest drop since September 1996.

Even excluding the volatile food and energy categories, core producer prices dropped 0.3%, biggest decline since February 2015. Since July 2015, core producer prices are up 0.7%.

4. Concordia stock plunges 25% on bad earnings news

[August 12, 2016] Concordia International stock plunged to the lowest level in more than two years on Friday, after the healthcare company suspended its dividend and wrote down the value of two products because of unexpected competition from generic drugs.

The shares traded as low as $15.50 in the first hour of trading at the Toronto Stock Exchange this morning–the first time since April 2014 that the stock has traded below $20 per share.

As of mid-morning, the stock was at $16, down $5.26 or 25% from the previous close.

Concordia shares had already lost about 80% of their value since rising above $100 per share a year ago, closing Thursday at $21.26, representing a market value of about $816 million prior to Friday's plunge.

The latest plunge was sparked by a number of announcements by the company, based in Oakville, Ont.

Among other things, Concordia's board suspended the quarterly dividend (worth 7.5 cents per share) to deploy the funds for business initiatives or debt repayment.

It also announced a US$570.4-million net loss from continuing operations, worth US$11.16 per share, primarily because of a US$567.1-million writedown of its Nilandron and Plaquenil product lines as a result of increased generic competition.

Concordia, which sells a variety of pharmaceuticals and medical devices, also lowered its 2016 guidance because of "unexpected competition on several products in our North America segment and current foreign currency exchange rates."

Simultaneously, Concordia announced that its chief financial officer, Adrian de Saldanha, will be leaving the organization after a transition.

He'll be replaced by Concordia executive vice president Edward Borkowski, previously a CFO with Amerigen Pharmaceuticals and Mylan–two other drug companies.

Concordia also said it's providing additional disclosure about certain transactions in 2015 and the first quarter of 2016, as a result of an Ontario Securities Commission review of Concordia's financial reporting.

5. FPSC creates additional oversight for standards

[August 11, 2016] The FPSC has created an independent panel to oversee its financial planning standards.

The FPSC, the body that oversees and enforces the CFP certification, says its new standards panel enhances its oversight and "supports the continued rigour, efficiency and relevance of FPSC's important work."

The 10-member standards panel includes certified planners and "members of the public with a keen interest in financial planning standards," the FPSC says in a release.

The panel will be chaired by CFP Susan Howe. Its other members, all certified planners, are Caroline Fallis, Warren Hope, William Jack, David Johnson, Ross McShane, Zeynep Onen, Elyse Pinsonneault, Lesley Poole, and Rhonda Sherwood.

The Ontario government has proposed regulations to oversee people who use the financial planner designation. The government has said the absence of a legal framework for financial advisory and planning services "has raised questions about proficiency, quality standards and conflicts of interest."

FPSC's board of directors will continue to be responsible for the organization's purpose and mandate.

The group's other oversight panels are the Level 1 examination panel, the CFP examination panel and the conduct review panel.

6. Lawsuit over audits seeks US$5.5B from PwC

[August 9, 2016] Accounting giant PwC squared off Tuesday in court with lawyers for a defunct mortgage company's creditors and investors over a

US$5.5 billion lawsuit, which claimed the Big Four firm failed through years of audits to uncover massive fraud at a failed Alabama bank.

The estimated US$21 billion fraud at Colonial Bank of Montgomery, Alabama, was orchestrated by top executives at the shuttered mortgage firm Taylor, Bean and Whitaker of Ocala, Florida. Six Taylor Bean senior executives and two Colonial employees were convicted of federal fraud crimes and went to prison. Colonial was shut down in 2009.

Steven Thomas, attorney for a trustee representing Taylor Bean creditors and investors, said PwC did seven audits while the scheme was ongoing and failed to find it. That means, he told a jury in opening statements, the firm should be held liable for billions of dollars in damages.

"PricewaterhouseCoopers had a job: detect fraud. And the second thing I'm going to prove to you is that PricewaterhouseCoopers failed to do its job," Thomas says. "When you don't do your job and people get hurt, it matters."

PwC attorney Beth Tanis counters that the lawsuit was essentially an attempt to get the firm to pay for money stolen in the fraud scheme by Taylor Bean, now represented by the trustee. She says the perpetrators, who were insiders, took elaborate steps to cover up their crimes and that other audits at the bank and mortgage company also missed it.

"The criminals were so successful at hiding these transactions that nobody found the fraud," Tanis tells jurors. "You can do an audit just right and not detect a fraud."

The scheme didn't come to light until a Colonial employee went to the FBI in July 2009, she adds.

The trial before Miami-Dade Circuit Judge Jacqueline Hogan Scola is expected to last about six weeks. The plaintiffs seeking US$5.5 billion in damages, plus possible punitive damages, include government-backed mortgage enterprises Freddie Mac and Ginnie Mae.

Taylor Bean was once one of Colonial's biggest customers but began encountering financial difficulties, according to court documents. Taylor Bean's top executive, Lee Farkas, worked out a deal with a Colonial banker to use improper overdrafts to meet expenses and payroll. That later morphed into a scheme in which Colonial was buying billions of dollars in fake, non-existent mortgages from Taylor Bean.

"This made these falsified transactions, these fraudulent transactions, look just like legitimate transactions at Colonial Bank," Tanis says. "Those fraudulent transactions just blended right in."

But Thomas says he would prove that PwC didn't look hard enough to uncover the scam at Colonial. That negligence, he says, allowed the fraud to flourish for years.

"They needed the gross negligence of an accountant," he says. "The evidence will show that accountant was the defendant, PricewaterhouseCoopers."
All those involved in the criminal fraud pleaded guilty except Farkas, 63, who opted for trial and was convicted of 14 fraud and conspiracy charges in 2011. He is serving a 30-year prison sentence.

7. Chinese ambassador warns relations with U.K. at crossroads

[August 9, 2016] China's ambassador to Britain has warned that U.K.-Chinese relations are at a crossroads following the U.K. government's delaying of a decision on a new nuclear power plant backed by Chinese investment.
In an article for Tuesday's edition of The Financial Times, ambassador Liu Xiaoming makes a direct link between the future of relations and the fate of the 18-billion-pound (US$23 billion) Hinkley Point project. He describes ties as at a "crucial historical juncture" and stresses the importance of "mutual trust" to the two countries' relationship.
Britain's new Prime Minister Theresa May surprised the business world when she stalled the deal last month in order to review the power project in southwestern England, financed by a Chinese nuclear power provider and French energy giant EDF.
The delay threw into doubt the "golden era" of ties proclaimed by Chinese President Xi Jinping during a visit to Britain last year.
The ambassador wrote that he hoped "the U.K. will keep its door open to China." He urged the British government to decide as soon as possible to proceed with Hinkley Point.
Some British politicians and diplomats are wary of the enthusiasm the previous government of Prime Minister David Cameron showed for boosting ties with Beijing.
Britain rolled out the red carpet for Xi during a lavish state visit in October, complete with a stay at Buckingham Palace as the guest of Queen Elizabeth II.
The two countries signed more than 30 billion pounds in trade agreements during the trip, as Cameron said Britain would be China's "partner of choice" in the West.
The visit also saw protests by pro-Tibet and human rights demonstrators concerned about the British government's lavish welcome for the Chinese leader.

And there was later embarrassment when the queen was caught on microphone saying Chinese officials had been “very rude to the ambassador” while the visit was being organized.

8. IFIC calls for changes to mutual fund taxation, group RRSP rules

[August 8, 2016] The Investment Funds Institute of Canada recently proposed federal budget measures for 2017. It would like to see initiatives that:

- contribute to Canada’s economic growth;
- support the middle class;
- enhance retirement savings; and
- enable Canadians with disabilities to achieve better standards of living.

Further, the investment industry would like the government to address the fact that mutual funds are taxed at a higher GST rate than other similar financial products. IFIC’s submission proposes that the government resolve this issue by qualifying mutual funds for a 100% rebate of the GST paid. Investors would benefit from such a move, says IFIC, because savings would flow through to them via a reduction of the tax component of funds’ MERs.

This kind of rebate would increase an investor’s accumulated earnings, enhance his returns and free more money for investment in capital markets, says IFIC’s submission. And, since a high proportion of investment funds are registered retirement savings plans, the rebate also could lead to higher retirement income levels—that would reduce dependency on public retirement income supplements.

Education and registered savings

IFIC is calling on the government to improve access to higher education by increasing awareness of, and making improvements to, Canada Education Savings Grants (CESGs) and Canada Learning Bonds.

“Canada’s future economic growth will depend on a well-educated workforce, but Canadians’ ability to save for their children’s education through RESPs is being dwarfed by escalating post-secondary education costs,” says Paul Bourque, IFIC’s president and CEO. “We propose increasing the lifetime CESG limits to $9,000 and removing the $500 annual limit on matching CESG grants.”

When it comes to retirement, IFIC supports changes to the rules governing group RRSPs to encourage employers to offer these accessible and efficient plans. Measures that would make group RRSPs more attractive to employers include:

- locking in employer contributions so that they can only be used for retirement savings;
- exempting employer contributions from payroll tax so that group RRSPs will be on the same footing as other pension plans; and
- enabling auto-enrolment similar to PRPPs, with employees retaining the right to opt out.

Finally, IFIC also recommends that the government eliminate barriers to setting up and participating in Registered Disability Savings Plans. "By eliminating these barriers, the government will contribute to better standards of living for Canadians with disabilities, and increase their ability to make meaningful contributions to Canada's economy," says Bourque.

9. How to invest in the age of permanently low interest rates

[August 8, 2016] When the bank of Canada's overnight interest rate plummeted from 4.25% in early 2008 to 0.25% in April 2009, no one thought that, seven years later, this bellwether would still be at barely there levels like the 0.5% we see today. In early July, the yield on 10-year Government of Canada bonds dipped below 1% for the first time. Not only that, rates are going negative in Europe and Japan. In America, the only developed country that's actually raised rates recently, Federal Reserve chair Janet Yellen is now saying that market forces could keep rates low for years.

But even that may be too optimistic an outlook, market watchers are beginning to think. With global growth barely budging and government and consumer debt at extremely high levels, it's conceivable that rates could stay this low indefinitely. "The longer rates are low, the harder it will be to raise them and the more painful that raise will be," says Eric Lascelles, RBC Global Asset Management's chief economist. "Absolutely yes, rates could stay low for a very long time." And that will require investors to adjust their strategy and their expectations henceforward—by paying more for equities, taking on more risk with fixed income and socking away more than they used to.

It wasn't supposed to turn out like this. When central banks around the world cut rates after the recession, it was meant to be a temporary measure to help stimulate the global economy. By making lending cheaper, consumers, corporations and governments would be able to borrow money inexpensively and put those dollars back into the economy, whether by buying goods or investing in businesses. Once global growth started revving up again, rates would revert to levels investors had grown used to, in the mid-single digits.

While some of this stimulus has worked—it's no coincidence that home prices in Canada have soared since rates fell in 2009—for the most part, it hasn't played out the way the experts thought it would. Global growth is still too slow—the planet's GDP is expected to grow by 2.4% this year, according to the World Bank, which is actually below its 2.8% growth in 2011. The gradual shrinkage of the working-age population in developed nations as well as China has so far failed to stoke inflation through wage increases. Some observers point the finger at labour-saving technology, others at the demographics of aging itself—seniors simply buy less stuff.

Central banks have backed themselves into a corner, says Juliette John, founder of Calgary-based Iris Asset Management. Economies are not expanding fast enough for them to raise interest rates, but the longer rates stay low, the less impact they'll have on growth. "Low rates have become less and less effective as time has gone on," she says. "We've got a situation where rates are not helping, and if they do raise them, then that will squash any fledgling momentum that there is."

All of that's to say that interest rates aren't rising any time soon, and when countries do raise them, they are certainly not going back to the double-digit figures seen in the 1980s and 1990s. It's unlikely rates will even get back to the 5% we saw prior to 2008, says Lascelles. What a "normal" rate environment may be is now anyone's guess. The Federal Reserve says a normal long-term rate is about 3%, but Lascelles thinks it could be around 2%. In any case, it's not moving much higher from here.

Up until now, many people have been building portfolios with the idea that rates will at some point rise, protecting themselves against interest-rate risk. But if you invest with the idea that rates will never rise again, or at least not for decades, then a lot of the tried-and-true investing rules that people have been following suddenly change.

For one, investors are going to have to get comfortable taking on more risk in their equity portfolios by buying stocks at higher valuations. Because people can't make much money in bonds on both rates and capital gains—since rates can't fall much further, we won't see the big fixed-income returns we've seen over the last 30 years of falling yields—investors need to be in the stock market. That's pushing valuations higher. "You can argue that there has been a distortion with respect to security valuations," says John. "There's greater risk-taking."

It's not unusual to see companies trading well above 20 times earnings these days, especially more bond-like businesses, such as dividend-paying consumer staples, utilities and other defensive equities, says Arthur Heinmaa,

chief investment officer at Cidel Asset Management. “Anything that has a whiff of an annuity can easily trade at 30 times earnings,” he says.
While that looks expensive based on past experience, if rates stay low for long, then it’s easier to justify paying that kind of price. Essentially, it comes down to how much you’re willing to pay for a 5% income stream on a stock versus 1% with a bond. “In that case, stocks may actually be relatively inexpensive compared to the interest rate,” says Heinmaa.
Investors also have to make high-yield bonds, such as corporate or emerging-market bonds, a more permanent feature of their portfolios, says Lascelles. These products pay well above the 10-year Canadian government rate, but they are riskier to own—the higher coupon corresponds to a higher chance of default. One option is to purchase provincial bonds, says Lascelles. Ontario Savings Bonds are paying a percentage point higher than the 10-year Government of Canada note, and the province is still extremely unlikely to default. “That’s a popular strategy,” he says. “You can more than double your return without incurring material risk.”
While investors will have to find stocks with higher yields, pay more for them and take on more risk in bonds, the biggest change in a permanently low-rate world is that people will need to set aside more of every paycheque if they want to keep the same goal for retirement income.
The prospect of lower-for-longer rates isn’t all bad. It offers a rare light of hope for young people with more debts than financial assets. It is savers who get hurt most in an extended low-rate world. With overall returns projected to range in the mid-single digits—that includes dividends—and guaranteed savings vehicles paying literally nothing, they will need to do more of the heavy lifting to meet their retirement goals. “The lower the rate, the more people need to save,” says Lascelles. “And that’s difficult enough as it is.”

Have a nice and fruitful week!