VERITAS

Summer 2014

DID YOU KNOW...

- A recently announced $2.4 billion auto manufacturing plant in Mexico represents less than half of the total investment made in the Canadian auto industry in the last five years.
- In a year when average hedge fund returns were two thirds less than that of the overall market, the 25 highest paid US hedge fund managers earned a combined $21.15 billion in 2013, up 50% from 2012.
- 81% of the global bond universe, including high yield or junk bonds, have yields below 4%.
- The UK has joined other EU countries including Finland, Italy and Norway in including prostitution and the drug trade in the calculation of its domestic economic output, immediately increasing it by 5%.
- The International Energy Agency estimates that $48 trillion in investments will be required over the next 20 years to keep up with global energy demand, with $40 trillion for energy supply maintenance alone.
- The ubiquitous barcode was introduced 40 years ago on a package of $0.67 Juicy Fruit gum, which is now on display in the Smithsonian.

CURRENT SITUATION

North American equity markets showed no signs of slowing in the second quarter. The energy sector, in part buoyed by rising oil prices as a result of tensions in the Middle East, and a strong showing from the materials group, propelled the TSX Total Return Index, which includes dividends, ahead 6.4%. The quarterly return takes the TSX up 12.9% so far this year, and finally takes it through the record levels it reached in 2008. Now, similar to the US experience, every incremental gain marks a new record high for the TSX. Interestingly, the new record was set six years to the day after the previous record high. Also of note is that this recovery took two years longer than the recovery from the last major correction in 2001, when the TSX fell 40%. But as the TSX fell by 50%, 25% further, in 2008, perhaps the protracted nature of this recovery should not be a surprise. South of us, despite an impressive 5.2% gain in the quarter, the US S&P 500 continues to lag Canada, up 7.1% to June 30.

There has been commentary in the press recently suggesting that fundamentals on both sides of the border are not keeping pace with market advances. Specific attention is being drawn to the slowing pace of earnings growth relative to the valuation levels of the markets, which are at, or just above historical averages as defined by their price to earnings ratio (P/E Ratio). The concern is that markets appear to be expecting further large gains in near-term corporate earnings, and if they do not materialise, equity markets will contract. This is a risk, but maybe not as big of one as is being made out. Although earnings growth might be moderating, the quality of those earnings is improving. They are being generated from higher revenues and against stronger balance sheets, as opposed to being the result of cost cutting while facing stagnant or declining revenues.

Another set of conditions has presented itself that could mitigate the risk of a significant market correction. Two of the big concerns expressed as the North American economies recovered were that employment was not picking up, and that the housing market remained depressed. These conditions have improved significantly. Reported in an earlier edition of *Veritas* was that all jobs lost in the US during the recession have been recovered, and now the jobless rate is declining. It has fallen 1.4% in the last year, the largest drop in 30 years, and jobs growth is the strongest it has been in eight years, with no decline in the participation rate. This is significant because it suggests that the improvements in the jobs market are occurring without dejected job seekers giving up the search. Although many of the jobs created are part time, and generally viewed as lower quality, they are

still jobs, and depending on the industry, part-time jobs have a pattern of leading to full time employment. On the housing front, in all but the most depressed markets, homeowners have recovered their lost equity. Ongoing support for the housing market is expected from accelerating creation of new households after a period of weakness during the recession. This is all contributing to absorb excess capacity in the US economy, which should result in continuing economic expansion and improving consumer sentiment and demand, but also leads to what might be the bigger risk to equity markets: rising interest rates. This is not a new theme but it bears repeating: rates can, and will go up, something of which investors seem to have lost sight. Rising rates are not necessarily bad, and in this instance are indicative of positive economic influences. The fact that the Federal Reserve recently announced that it intends to end its bond buying program (quantitative easing) in October supports this, and suggests that the Fed is increasingly comfortable with gains in US economic output.

Conditions in Canada remain good, and there is some modest economic diversification occurring as Canadian manufacturing sales have returned to pre-recession levels. Unfortunately, those levels are still a far cry from what they were 20 years ago. Canada still is a drawer of water (and oil and gas) and hewer of wood, and as such, Canada will do well when the world does well. This leads to a quick comment on Europe, which, except for soccer, has been out of the news for some time. Economic momentum in the Eurozone is building slowly. Not all regions are participating, but more are than not. Even some of the countries that were hardest hit during the recession and required bailouts, Greece for example, have successfully issued bonds in the public market. This is a strong indication that there is faith in the economic future of those countries and, by extension, Europe in general.

OUTLOOK

We have a neutral to modestly negative short term outlook for equity and bond markets, largely due to the changing interest rate structure. Markets will adjust to the higher rates, and our long term outlook for equity investments, but not necessarily for the broader markets, remains positive. Indicators, including the previously mentioned economic data, suggest that the broad lift the economic recovery provided to equity markets is largely over. Economies are entering a more mature and slower growth phase that will not benefit all sectors, further reducing market correlation and emphasising security selection. Bond prices are expected to remain under pressure for as long as interest rates are moving higher. This will present a challenge to bond portfolio valuations, but will also provide an opportunity for savers who, by buying GIC-like products with varied maturity dates, and rolling the maturity proceeds into new deposits of similar maturity, will be able to capitalise on the rising rates with no risk to capital.

STRATEGY

With the declining correlations between stocks, sectors and markets, the importance of adhering to an investment discipline that does not involve simply hugging an index becomes increasingly critical. Portfolio reviews on a company by company basis are an integral part of this discipline to ensure that portfolio holdings continue to exhibit the same characteristics now as they did when they were originally included in the portfolio. The discipline should not be altered to fit the holdings, rather the holdings must change to comply with the discipline. Wholesale shifts within the portfolio are generally not warranted unless a great deal of time has passed between reviews. But if regular reviews are undertaken, as is the case for our clients, and the discipline always has been to invest with a minimum three year horizon, the need for change is generally limited to strategic moves intended to take risk out of a portfolio, even if that is just a matter of re-weighting existing assets. Being an active investor means active portfolio involvement, not necessarily active trading. Please do not hesitate to call for further discussion.

R. Guy Amighetti, CFA, TEP
Portfolio Manager

Tel: 604-632-4081
Email: rga@vici.ca
www.vici.ca