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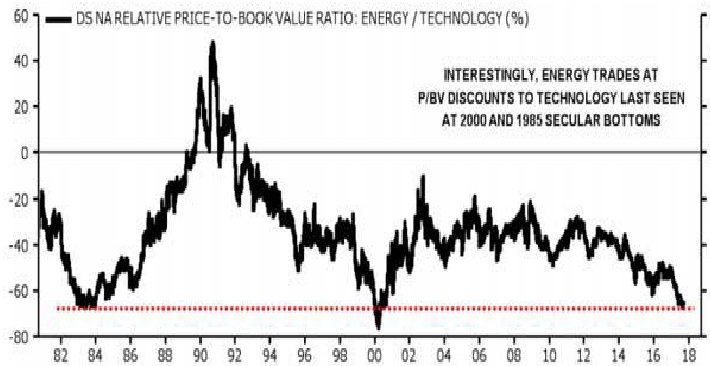
Searching for Value

A number of worries could have derailed the market's rise during the third quarter. Instead, investors shrugged off mounting tensions with North Korea, a deadly hurricane season and increased political turmoil with minimal concern. Market commentators point to the steady improvement in global economic activity and corporate profitability as the offsetting positives. While the global economic backdrop is firming, we'd suggest the key driver of markets remains abnormally low interest rates. Although rates are starting to move up, they remain extremely low by historical standards, providing little alternative to equities. By default, investors looking for anything more than low single digit returns are forced into the equity markets.

Gains in global equity markets were broad based in Q3, while bond markets were generally flat to down in the period. The Canadian market experienced some of the most significant changes. Early in September, the Bank of Canada surprised investors with an increase in its overnight interest rate for the second time during the third quarter on the back of much better than anticipated economic statistics. The Canadian currency continued to strengthen as yields in Canada increased considerably in a short period of time. While the economic data is certainly encouraging, we anticipate the growth rate to moderate and the strength in the currency to wane as a result.

Canadian equity markets continue to underperform the U.S., as they have since the market bottom in 2009. This has been a function of monetary policy measures, the resulting improvement in the U.S. economy, as well as weakness in commodity-related sectors to which Canada is highly exposed. It is our expectation that this relative outperformance will start to lose steam. We look for Canada's more cyclically oriented sectors to improve relative to those which have been driving the American market. For instance, the technology sector in the United States has been a major driver of positive returns, while Canada's energy sector has contributed to the lackluster performance.

The chart below compares the valuation of North American energy and technology shares. Discounts for cyclical businesses are back to levels not seen since 2000 and the mid 1980's. Higher growth rates and global economies that continue to strengthen could be catalysts that allow economically exposed businesses to attract more investor attention.



Source: Thomson Reuters Datastream, Canaccord Genuity estimates

Equity market valuations remain elevated, particularly for high quality dividend payers and for high growth stocks. While markets are broadly expensive, cyclical companies and those that have been negatively impacted by low interest rates continue to offer value. We believe the market is in the midst of shifting to these more value-oriented opportunities. We continue to position the portfolios in such names, avoiding the businesses investors have pushed to unsustainable valuation multiples.

High valuations do not always imply immediate risk, but they do translate into diminishing future returns with less downside protection if something goes wrong. Investors can't successfully compound their wealth with 2% bond yields alone; they must look to equity markets to supplement this anemic yield. While equity markets have provided those higher returns, we feel it would be imprudent to blindly extrapolate past performance into the future. As risks increase, we are focused on protecting our clients' capital rather than maximizing its growth.