QV UPDATE

Weekly Commentary | October 02, 2015

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Quarterly Review

After three years of consistent global stock market gains, equities retreated this past quarter. The sell-off was sharp enough to pull the majority of global indices into negative territory for the year. Worries surrounding deteriorating global economic growth as a result of the weakness in developing economies, such as China and Brazil, provided the catalyst. Analysts have cut their global growth estimates for 2015 to 3% from 3.5% and commodities continued their slide in sympathy with the negative outlook. The turmoil added pressure on the U.S. Federal Reserve to prolong their ultra-low monetary conditions while they wait and see how things play out. The market reacted negatively, but we believe there is good reason for the Fed to worry about what's happening in China.

The majority of our equity and balanced mandates held up relatively well to their respective benchmarks. This is of little solace though as they all posted negative results during the quarter. The Canadian market continues to be challenged by its natural resource exposure, weak economy, and negative sentiment by foreign investors. While the S&P/TSX Composite is down by nearly 8% in the quarter, it's the small cap market in Canada that is most exposed to a global slowdown given its preponderance of cyclical businesses. Canadian small caps, as measured by the BMO Small Cap Index (un-weighted) fell 17.5%. Our Canadian large cap model returned -4.8% and our Canadian small cap posted -6.8% (gross of fees). The Canadian balanced model fell 3.0%, while the comparable index dropped 4.3%. Twice this year we have reduced equity exposure in our asset mix to focus on capital preservation. The global model was more or less in line with the index, both posting an approximate loss of 1.5%. The weakness in the Canadian dollar continues to boost global equity returns.

Government bond markets provided some shelter in the period as investors looked for the safety of high quality bonds. Lesser quality debt, such as high yield paper, experienced losses as did corporate debt as credit spreads widened. Our bond portfolio performed roughly in line with its respective benchmark adding 0.15% for the quarter.

Global Growth

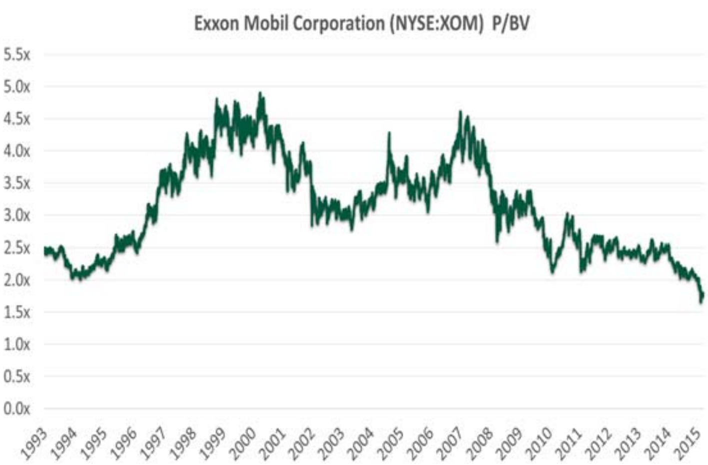
Why do China and the other emerging markets matter so much? For much of the previous decade the emerging markets were seen as the future engines of global economic growth, while the developed economies would be a drag. This spurred massive capital investment and a surge in what seemed like sustainable growth. During the 2008/2009 crisis, Asian countries borrowed heavily to maintain economic growth and served as a buffer for the rest of the world. According to McKinsey Global Institute, half of global debt issued over the past seven years went to emerging market economies, much of it to Asia. China alone accounted for about one-third of the rise in debt globally since 2007. Even when the world began healing, China kept its foot on the growth gas pedal. As an example, according to research from the Mises Institute, in the three years from 2011-2014 the Chinese economy used more cement during their construction boom than the United States had in the entire twentieth century.

The continued fragility of the global economy remains susceptible to a severe slowdown in growth from these countries. Especially since major economies such as Europe and Japan are still struggling. Up until last year China accounted for nearly a third of global economic growth. China's GDP is expected to expand by 6.8% in 2015, the slowest expected growth since 1990, according to the International Monetary Fund.

The Chinese expansion has been led by a debt-fuelled domestic construction boom. The productivity of much of those assets and their ability to service associated debt may be something the market focuses on next. In response to the ongoing slowdown, we saw China unexpectedly devalue its currency and further lower rates in an effort to boost domestic growth and try to support the crash in their speculative stock market. We would anticipate the Chinese authorities to increase stimulus if circumstances warrant it.

Portfolio Positioning

We remain focused on balance sheet strength and valuation as we believe the global economy remains challenged. P/E multiples for most stock markets are relatively high but not outrageous. The risk we see though is in the earnings which underpin the markets' valuations. That being said, we are beginning to notice more and more companies meet our initial standards for investment compared to this time last year. The businesses that are making our screens for further investment or analysis have seen their shares come under significant pressure. The market has already priced in a recession or worse for a number of these businesses. Unfortunately, these are often in sectors of the market where earnings are under pressure or future growth is unclear. Take for example Exxon Mobil, which we invested in during this past quarter. The energy industry is going through a major contraction and we don't know when oil prices will improve. But it is only under these uncertain conditions when one can invest in industry leaders at valuations lower than they've been in 25 years (based on book value).



Source: Capital IQ

The opposite can also still be found in the marketplace, where companies which have above average market growth or steady earnings are trading at very stretched valuation multiples. Take for example one of the high quality holdings we have sold in our global mandate, Brown Forman. The company is one of the largest spirit and wine companies in the world with recognizable brands such as Jack Daniel's. The following chart illustrates the P/E multiple, it is currently trading at roughly 30 times earnings, the highest level we have seen in 25 years. We sold it a while back because we felt the risk/reward trade-off was no longer favorable. The shares have just continued to climb. Sticking to a value discipline can be humbling in the near-term.

Source: Capital IQ

We'll leave you with one last thought on the sell-off in global markets. We believe there is a real possibility for stock markets to remain challenged. Corrections are normal and to be expected in any stock market cycle. They tend to diminish risky behavior, improve market opportunities, and reset investors' confidence levels, all good outcomes for the long term investor.