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Market Update
i.e. Things Are Down A Bit So "What's Up?"

The only thing up of late is the U.S. dollar. In terms of 'What's up with markets,' here is our take on things.

After a decent start to the year, we have seen weakness in financial markets since. This can be attributed to global economic growth numbers not quite meeting expectations (companies coming close to meeting expectations in term of profits, but not meeting expectations in terms of top line revenue growth), to the market's fixation with what was happening in Greece (although Greece got a deal that if implemented, will kick this problem down the road in a couple of years), to Chinese stocks taking a big haircut (this retail investor-driven market was poised for a big sell-off after an extensive unjustified rally), and to base metal prices and oil weakening further of late (hurting resource-based markets like Canada and Australia).

Globally, the average price to earnings ratio on stocks right now is about sixteen times forward earnings, thus markets have an earnings yield of 1/16 or 6.25%. Canadian bank stocks trade at just eleven times forward earnings (earnings yield of 9%). These reasonable stock valuations may continue to give downside support, as low-yielding cash gets attracted to stocks when markets sell off.

Regarding resource stocks (oil and gas, and mining including gold), they are the only area of the market that has experienced a significant sell-off. If we go by history, they are a good buy at these levels as economics tell us that from here, capital expenditures decline, which in turn – eventually – results in a decrease in supply; companies also cut costs and of course lower prices should result in an increase in demand.

In the early stages of a commodity price sell off, supply does not fall as firms continue to sell their commodities as long as they earn a price that is greater than their marginal cost of production. Longer term though, as said, supply does decrease as companies hold back on capital intensive investment, and the weakest of companies get taken over or file for bankruptcy.

Regarding base metal prices, even with China slowing, we think prices will eventually follow this traditional cycle, and improve from here. Regarding oil, it is a bit harder to tell. Concerns over global warming are increasing the usage of non-fossil fuel related energy, and we also have to consider the huge increase in supply that has resulted from fracking which was previously locked in shale plays. Higher cost U.S. and Canadian frackers and even oil sands projects here in Canada may be somewhat at risk longer term.

Our stance on commodity stocks is to maintain our underweight position on resource stocks but to have some exposure to companies with good balance sheets and lower costs than industry average.

Most client accounts have a reasonable degree of fixed income investments which is dampening volatility, and geographically our foreign diversification (stock-wise) is helping as some currencies (particularly the U.S. dollar) have increased relative to our Canadian dollar.

From a fixed income standpoint, we have discussed for a while now how challenging it is to get decent yields on bonds. While existing bonds have performed well, they are 'priced off of current interest rates' which today have low yields to maturity in the 2.5% range, for bonds with less than five years to go to maturity. In the interest of safety, we are keeping these bonds at present, but if markets surprise on the downside, we will look to deploy some of this liquid bond money into more attractive return investments.

For registered accounts, we continue to buy high-quality mid-term corporate bonds in the 3.5% area with maturities between six and ten years, and in non-registered accounts, we continue to add preferred shares in the 4% yield area. These preferred shares are a bit weak in price right now but seem very attractively priced. If interest rates increase in the future, issuers will have to pay increasing yields, so we get a decent yield (which is close to tax-free for middle income clients) without too much risk going forward.

For the first time in many years, we are seeing what are called 'perpetual' preferred shares being issued. They pay very attractive yields (close to 5%) and thus far we have seen TD, Royal, BMO and Canadian Utilities come to market with these. While these yields are very attractive in this low interest rate environment, we are exposed to 'interest rate risk' on perpetuals. If long-term interest rates go up more than what the market already expects, we will see some downside price wise. Adding a small amount to portfolios is fine though, from a diversification and yield standpoint.

We are a bit surprised to see the real estate investment trusts (REITs) continue to trade down somewhat, to a point where we can get average distributions of at least 6.5%, with some of our buy picks yielding close to 9%.

REITs are typically leveraged about 50%, so if we assume 1.5% per year growth in the value of commercial real estate over time, our return on equity (in terms of capital growth) would be 3% per year. Assuming distributions (which come from net rent) stay constant over time, total return (income and growth) would then be 9.5% per year. The actual trading price will of course vary in the shorter term as REITs can be almost as volatile 'price wise' as stocks at times; but in the long haul we think 9.5% per year would be a reasonable expectation of total return. The main risk to REITs is interest rates increasing more than current expectations. We do expect interest rates to increase but debt-heavy governments combined with tepid global growth rates will probably keep rates from increasing too much over the next couple of years.

As always, feel free to call us with any questions.

Regards,
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Yields/rates are as of July 30, 2015 and are subject to availability and change without notification. Minimum investment amounts may apply.

Securities

Bank of Montreal	2a,2c,2e,2g,3a,3c,7
Canadian Utilities Ltd.	13,2a,2c
Royal Bank of Canada	2a,2c,2e,2g,3a,3c,7
TD Bank	2a,2b,2c,2d,2e,2g,3a,3c,7

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