November 6, 2015

Celebrating One Year Together

It has been a very positive first year for the Papau Armstrong Schmidt Financial Group. Numerous clients have transitioned over to our discretionary model portfolios, and we are currently encouraging all clients to contact us regarding this service.

We offer three fully discretionary model portfolios, namely the Total Return Portfolio, the High Yield Portfolio and the Balanced Portfolio, further described in Appendix "A" to this newsletter. Our research efforts are now primarily devoted to finding investment ideas that will suit the criteria established for these models and contribute to their returns. As of November 1, 2015, the Total Return Portfolio and High Yield Portfolio have provided positive returns, with the former up 4.09% year-to-date and the latter up 5.12% year-to-date.[1] Given that the S&P/TSX Composite Total Return Index has declined 5.20%[2], we are pleased with these results. (The Balanced Portfolio was only recently launched, so it is not meaningful to provide return data at this time.)

In the third quarter of 2015, there were a number of interesting developments that affected client portfolios. We will begin by providing our current assessment of the energy sector.

Is the Worst Over for the Energy Sector?

We devoted our entire Fourth Quarter 2014 newsletter to the energy sector. At that time, we concluded that significant changes to global oil supply and demand fundamentals had caused the price decline. Various countries had increased supply, including the U.S., Russia, Iraq and Canada, in part due to improved extraction technology. The Organization of Petroleum Exporting Countries' (OPEC) had decided not to cut production. Also, at that time, global oil demand growth was weak. The International Energy Agency was projecting demand to be 93.3 million barrels per day for 2015. In light of these facts, we provided the following outlook:

> "Based on the evidence before us, we need to be prepared for oil prices to average US$65 or lower for the rest of 2015 or possibly longer. We will not venture a prediction on where the price bottoms for this cycle, but sub US$40 is entirely possible. The duration of the down cycle will prove to be more important than the ultimate low price."

Today, some 10 months later, the WTI Crude price is hovering around US$45. However, there are some encouraging signs. The International Energy Agency (IEA) now estimates that oil demand will be 94.5 million barrels per day for 2015 (compared to the 93.3 million previous estimate mentioned above). Sustained low prices have created this additional demand and have also impacted U.S. supply. After a three-decade high of

9.6 million barrels per day reached in June, U.S. production has dropped to 9.1 million and is projected to drop further to around 8.86 million in 2016.[3]

OPEC is likely pleased that U.S. production is dropping, but also very concerned about member countries' budgets. For example, the International Monetary Fund estimates that Saudi Arabia will have a budget deficit of 20% of its GDP this year.[4] Pressure has therefore been building on member governments, and there have been reports that Venezuela and Iran in particular want OPEC to cut production.

Whether or not OPEC cuts production in the near term, we now believe that the worst is over for oil prices and energy stocks. While we do not see a catalyst for an immediate bounce to US$65 WTI oil prices, it is likely to happen sometime within the next couple of years.

Our energy stock strategy will remain the same – we will stick to high quality, large companies that can weather the current low price environment. We now have a slight bias towards accumulating additional energy positions so that we are not underweight the sector in client portfolios.[5]

Our Auto Stocks Look Promising

U.S. auto sales are projected to hit record levels over the next two years, reaching a peak of 18.2 million new cars and trucks sold in 2017, according to IHS Automotive.[6]

One factor supporting this trend is the fact that many people delayed new auto purchases during the difficult times following the 2008-09 financial crisis. Those sales are occurring now, spurred on by low gas prices, low interest rates for auto financing, and longer-term auto loans with lower payments.

Looking at the 2015 and 2016 estimates, IHS is projecting 17.3 million units sold this year and 17.8 million sold in 2016. To put these numbers in context, the previous high-water mark for U.S. auto sales was 17.4 million in the year 2000.[7] Subsequently, in 2009, sales plunged to 10.4 million vehicles, reflecting the economic strain of the time.[8]

We believe that the current environment is positive for portfolio holdings Toyota Motor Corp. (NYSE:TM) and Ford Motor Co. (NYSE:F). [9] Both stocks remain inexpensive and pay significant dividends. Ford recently announced its third quarter earnings. Sales of its F-series pickup truck line were strong. Net income rose to US$1.9 billion from US$1.1 billion a year ago. Ford is now forecasting pre-tax profit of US$8.5 billion to US$9.5 billion for the full year.[10]

Toyota and Ford may benefit from the fact that major competitor Volkswagen AG is currently in disarray. In mid-September, we learned that Volkswagen had intentionally programmed some diesel engines to activate certain emissions controls only during emissions testing. The company is now the target of regulators in multiple countries. Some clients have inquired whether we are considering buying Volkswagen shares, proving that they are not afraid of contrarian ideas. At the moment, we do not have a strong view on the outcome of this scandal. The intentional malfeasance involved makes it more likely that the regulatory penalties will be severe. It seems wise to wait for further developments before considering the stock.

Monetary and Fiscal Policy Update

On September 17, the U.S. Federal Reserve opted to leave short-term interest rates unchanged. On the surface, this outcome would appear to be uneventful, but to many investors, it signaled a real risk that weak economies around the world could harm U.S. growth prospects. They specifically cited “heightened uncertainties abroad” as a key reason for further delaying a rate hike.[11] Although U.S. economic growth has been slower than expected since the 2008-2009 financial crisis, there has been a steady drop in the official unemployment rate from 10% in 2009 to 5.1% in August, among other positive developments.

On October 21, as expected, the Bank of Canada left its overnight lending rate unchanged at 0.5%, following two surprise rate cuts earlier this year. Rather than a potential hike, the speculation preceding the Bank of Canada’s announcement focused on the possibility of a further cut, as Canada’s economy remains weak. The Bank now projects that Canadian economic growth will be 2% in 2016 and 2.5% in 2017, lower than previous forecasts.[12] Low prices for oil and other commodities are one of the main factors reducing Canadian growth.

The election of the Liberals on October 19 may change the Canadian economic outlook, depending on whether they follow through on their promises for significant fiscal stimulus. Their platform mentioned aging infrastructure as a target for new public spending. It was interesting to see devout Keynesian economist Paul Krugman endorse the Liberal plan in the New York Times:

> So will the Liberals put their platform into practice? They should. Interest rates remain incredibly low: Canada can borrow for 10 years at only 1.5%, and its 30-year inflation-protected bonds yield less than 1%. Furthermore, Canada is probably facing an extended period of weak private demand, thanks to low oil prices and the likely deflation of a housing bubble. Let’s hope, then, that Mr. Trudeau stays with the program. He has an opportunity to show the world what truly responsible fiscal policy looks like.[13]

While we are more skeptical than Krugman regarding Keynesian economics, it is true that Canada can afford some intelligently chosen infrastructure upgrades.

Whether or not the Liberals are able to increase Canadian economic growth, as a practical matter, we will generally maintain a significant weighting in Canadian investments, as we are Canadian investors. However, we also need to remain open to opportunities in the United States and elsewhere in order to reduce risk and generate returns in this low growth environment.

Selected Company News – Unilever PLC

On September 2, we added to our Total Return Portfolio position in Unilever PLC (NYSE:UL), bringing it up to a weighting of approximately 6%. (We also hold Unilever in the High Yield Portfolio and the Balanced Portfolio.)

We felt comfortable increasing our weighting to Unilever at that level, as it is a high quality consumer staples company that will theoretically be less sensitive to weaker economic growth. Despite weakness in many of the emerging market economies it relies upon, Unilever’s recent reported results were encouraging, as revenues grew 5.7% year over year, stripping out the impact of currency exchange rates.[14]

Selected Company News – Citigroup Inc.

On October 15, U.S. financial services giant Citigroup Inc. (NYSE:C) posted better than expected profits.

Profits jumped 51% year over year, with a drop in legal expenses being one of the strongest contributing factors. The bank reported a profit of US$4.29 billion, or US$1.35 a share. That compares with the US$2.84 billion, or US 88 cents a share, it reported in the same period of 2014. Analysts were expecting a profit of US$1.28 per share.[15]

Top line revenue actually declined, but that is no surprise to us given that the bank's strategy is to become smaller and less risky. Commenting on the results, CEO Michael Corbat emphasized that the bank's strategy of shrinking, and homing in on big cities and wealthy clients will allow it to weather any environment. We continue to believe that Citigroup shares are undervalued at current levels.

Although Bank of America Corp. (NYSE:BAC) is our largest weighting in U.S. banking industry, we do want clients to understand that there is good potential present in our other U.S. banking investments, namely Citigroup, JP Morgan Chase & Co. (NYSE:JPM), and Wells Fargo & Co. (NYSE:WFC).

Conclusion

Despite the significant volatility in North American markets during Q3, we are generally satisfied with the performance of client portfolios. We are also prepared to confront a number of potential risks to stock price performance in the coming years, including a global economy that is weaker than we would prefer. In addition to holding high-quality Canadian investments, we will continue to seek opportunities in the United States and elsewhere in order to reduce risk and generate returns in this environment.

As always, we thank you for your business and invite you to contact us with any questions.

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APPENDIX "A"

DISCRETIONARY MODEL PORFOLIOS

We now offer the following three discretionary model portfolios:

1) Our Total Return Portfolio, which is focused on providing clients with an average annual return of around 8-10%, consisting mainly of capital gains and dividends.

2) Our High Yield Portfolio, which is focused on providing income-seeking clients with an average yield of 4%, plus around 2-3% of annual capital growth.

3) Our Balanced Portfolio, which is a more conservative portfolio that typically consists of approximately 50% fixed income investments and 50% equity investments.

We encourage clients to contact us for more information regarding these portfolios.

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[1] All return numbers discussed are taken from the returns of the model account for each respective discretionary portfolio. These numbers are generated using our software (ADP/Croesus V8), and individual clients' account performance may vary. These return numbers are not a promise of future performance.
[2] Source: Bloomberg, Nov. 2, 2015 - S&P TSX Index Total Return from Dec. 31, 2014 to Oct 30, 2015 with dividends reinvested in the Index = -5.2013%.
[3] http://www.bloomberg.com/news/articles/2015-10-20/after-year-of-pain-opec-close-to-halting-u-s-oil-in-its-tracks
[4] http://www.bloomberg.com/news/articles/2015-10-20/after-year-of-pain-opec-close-to-halting-u-s-oil-in-its-tracks
[5] According to McGraw Hill Financial, the energy sector made up 19.6% of the S&P TSX Composite Index as of October 30, 2015 (http://ca.spindices.com/indices/equity/sp-tsx-composite-index).
[6] http://www.detroitnews.com/story/business/autos/2015/10/14/ihs-sales-forecast/73937942/
[7] http://www.detroitnews.com/story/business/autos/2015/10/14/ihs-sales-forecast/73937942/
[8] http://www.reuters.com/article/2014/10/28/autonation-results-ceo-idUSL1N0SN0Y320141028
[9] We own Toyota Motor Corp. in the Total Return Portfolio and Ford Motor Co. in the Total Return Portfolio, High Yield Portfolio and Balanced Portfolio
[10] http://www.reuters.com/article/2015/10/28/us-ford-results-idUSKCN0SL1BG20151028
[11] http://www.wsj.com/articles/fed-leaves-interest-rates-unchanged-1442512974
[12] http://www.bnn.ca/News/2015/10/21/Bank-of-Canada-gets-stimulus-support-from-Trudeaus-win.aspx
[13] http://www.nytimes.com/2015/10/23/opinion/keynes-comes-to-canada.html?_r=0
[14] http://www.wsj.com/articles/unilever-sales-rise-on-ice-cream-emerging-market-demand-1444890665
[15] http://www.wsj.com/articles/citigroup-profit-jumps-on-lower-legal-expenses-1444910357

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David Papau, Michael Armstrong and Andrey Schmidt are Investment Advisors with CIBC Wood Gundy in Vancouver. They and their clients may own securities mentioned in this column. Their views do not necessarily reflect those of CIBC World Markets Inc.

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