Industry Sector Review

Elevated levels of risk in the market have returned. There are some signs of euphoria in the financial media, and institutional stock portfolio managers have committed virtually all their cash holdings into the recovery that began in March 2009, leaving little room for error. The market has strong upwards momentum, and cyclical stocks have led the charge. Yet the valuation of some stocks now appears stretched and trading volumes remain lower than one would expect for such a move. There is a significant possibility of a flat market or a 10-20% correction in the next six months. Even the possibility that the entire upwards move is merely a large bear market rally cannot be dismissed. The economy will determine the market's direction moving forward, not the other way around.

I continue to be wary of some of the economic data coming out of the US. When data is being seasonally adjusted, revised after the fact, or artificially influenced by government stimulus, it is important to focus on the underlying basis of economic performance and then project where the economy is headed.

Lately I keep returning to two key related questions. One – when bond investors start demanding materially higher interest rates from governments, how much will that limit the interventionist type of fiscal policy we have seen during the recent recession? Two – How long will bond investors tolerate the monetary policy of quantitative easing, or merely the printing of money to meet obligations? These are larger questions than I can answer here, and frankly I don't have definitive answers. I do think (and have thought for a long time) that these policies are placing the stability of paper currencies at risk. I also think there is a risk that we could be trading a current public market financial crisis for a future crisis of sovereign finance. I will continue to monitor the risks posed by these factors.

I want clients to understand that in addition to seeking profits, I am always thinking about risk management and capital preservation, since there is little point in making large profits during bull markets if bear markets are going to take them all away. History teaches that the stock market valuations of the last 15 years are not the long-term norm – valuations were quite a bit lower at previous bear market bottoms. History also contains several decades where stock performance disappointed most investors. While we can be quite happy about the recent performance of the Total Return Portfolio, we cannot simply extrapolate the current

upward move in the markets out into future years. We cannot count on a return to bubble valuations in order to make profits.

Therefore, I believe that yield-generating investments and disciplined valuation-driven trading are going to be the crucial ingredients needed to generate good investment returns moving forward. I remain confident in the current portfolio holdings. As discussed in past editions, I am selectively trimming higher volatility investments from the portfolio and replacing them with lower risk and higher yielding investments. This will make the portfolio somewhat less vulnerable to market turbulence.

Sector Outlook

Energy

The portfolio has consistently held several high quality Canadian energy companies. The long-term trend in the oil market is global demand putting pressure on global supply. America consumes 25 barrels of oil per person per year, China consumes 2 and India consumes 0.9. In 2009, China quietly became the world's largest car market, with sales exceeding the United States for the first time. In fact, Bloomberg.com recently reported that the collective demand for oil from China, India, Russia and the Middle East has now exceeded demand from the United States. Energy prices will benefit from continued long-term growth in developing nations.

Precious Metals

In past editions, I have frequently discussed the case for precious metals investments in this economic environment, including the protection they can offer against monetary and fiscal policy errors. While the actual physical prices of gold and silver have performed fairly well, the performance of the precious metal mining stocks we hold has been mediocre in the short term. Recent sector research that suggests gold equities are undervalued in comparison to the gold price by 35-45% and that the equities are trading at levels that would be appropriate for a US$800 per ounce gold price rather than the current US$1,150 price. It is likely that precious metals equities will perform well over the next 12 months.

Utilities

The utilities in the portfolio have performed exceptionally well. They have provided high yields and strong capital appreciation. I believe the utilities sector should continue to perform solidly.

Recently, in the Total Return Portfolio, I have added a 3% position in Exelon Corp. Exelon is an electric utility holding company doing business in the United States that generates the bulk of its earnings from low-carbon nuclear power generation. As the owner of the nation's largest nuclear power portfolio, it is the low cost producer of electricity in the wholesale markets in which it operates. The shares trade in U.S. dollars, which made for an opportunistic entry point in terms of exchange rates, and they have a dividend yield of over 4.5%. The shares are currently trading at a five-year low. Exelon stands to benefit from of any type of climate change regulation or legislation, particularly cap-and-trade, since nuclear power generation produces almost no carbon.

Financials

Long-term clients will recall that I was underweight financial stocks in 2007 heading into the financial crisis, and have never really taken an overweight position in the sector. Overall, this has served the portfolio well. Timely investments made during the crises at very depressed levels in TD Bank, Royal Bank and Great-West Life generated strong returns, but Great-West Life is the only one of the three that remains in the portfolio.

Having sold TD Bank and Royal Bank in November 2009, we have missed some of the upside, but I do not view them as undervalued at current levels (which exceed pre-crisis levels). The reason for their continued rise has more to do with accommodative monetary policy than sustainable improvements in their core businesses. Great-West Life has been a solid performer in the portfolio and remains well below its 2007 highs. I am also content to continue to hold Manulife Financial, as this insurer is arguably still undervalued.

Agriculture

Several economists that I greatly respect are very bullish on the Agriculture sector and are advocating long-term futures contacts on certain commodities. I am willing to follow their lead in a considerably more conservative manner. As the disposable income of people in developing countries increases, they tend to upgrade their daily diets. In recent years, producers of agricultural commodities have struggled to keep up with rising demand. It is likely that these trends will result in higher prices for agricultural commodities. Rogers Sugar Income Fund has been a huge winner in the portfolio, having been first added at $3.21. Agrium has also been a great investment with approximately 50% return since June 2009.

Services

The services sector category in the model portfolio is a bit of a grab-bag of attractive non-correlated service sector businesses. The two current holdings, CML Health Care Income Fund and Thompson Reuters have

essentially no economic connection to each other. CML was added recently and is currently trading at less than 10x forward enterprise value to EBITDA. The last time the company traded at these levels was in 2004, and investors who took positions at that time were rewarded handsomely. I will consider adding to the position if a good opportunity arises.

Base Metals

Vale S.A has given us massive gains. This large-cap base metal miner operates on five continents and has over 100,000 employees. I believe it is a good way to get medium-risk exposure to what is traditionally a very high risk and economically sensitive sector. While returns have exceeded 50% in a relatively short time, I am content to continue to hold the stock, as it suits the model portfolio well.

Conclusion

Thanks for reading another edition of The Armstrong Perspective. As always, I appreciate your business.

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Michael Armstrong is a Portfolio Manager with CIBC Wood Gundy in Vancouver. He or his clients may own securities mentioned in this column. The views of Michael Armstrong do not necessarily reflect those of CIBC World Markets Inc. CIBC Wood Gundy is a division of CIBC World Markets Inc., a subsidiary of CIBC and a Member of the Canadian Investor Protection Fund and Investment Industry Regulatory Organization of Canada. This information, including any opinion, is based on various sources believed to be reliable, but its accuracy cannot be guaranteed and is subject to change. CIBC and CIBC World Markets Inc., their affiliates, directors, officers and employees may buy, sell, or hold a position in securities of a company mentioned herein, its affiliates or subsidiaries, and may also perform financial advisory services, investment banking or other services for, or have lending or other credit relationships with the same. CIBC World Markets Inc. and its representatives will receive sales commissions and/or a spread between bid and ask prices if you purchase, sell or hold the securities referred to above. © CIBC World Markets Inc. 2015.