strathbridge ASSET MANAGEMENT

July 2014 Newsletter

PM Commentary - John Germain
Senior Portfolio Manager

The end of June marked the rise in Canadian and U.S. equities to all-time highs. The S&P/TSX Composite finally hit new highs, nearly 15 months after the S&P 500 performed a similar feat. It also marked the sixth consecutive quarter of gains for the S&P 500, the longest stretch since the mid 1990's. Small Caps also outperformed Large Caps in June as both the Russell 2000 and S&P/TSX Venture Indexes advanced more than their large cap brethren.

- The TSX Composite advanced 3.7% for the month of June and is up 11.2% for the first half of 2014, outperforming most global markets
- European equity markets however, continue to reflect growth concerns as the FTSE 100 (U.K.), CAC 40 (France) and the DAX 30 (Germany) all declined in June.
- Regarding the economy, the U.S. latest 1st quarter 2014 GDP revision came in worse than expected at -2.9% vs. the original -1%. At the same time, inflation seems to be heating up both north and south of the border as inflation in Canada for the first five months of the year was up 2.3% YOY, while the Personal Consumption Expenditure (PCE) Index in the U.S. increased 1.8% YOY.

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By The Way – Jack Way
Vice President

It has been a long time coming, but fundamentals do seem to matter again. Investors are paying attention to economic reports and corporate earnings with more interest than we have seen in the last five years. This is particularly true in the U.S. as investors have come to accept the fact that the Federal Reserve's quantitative easing will soon end, and that growth in GDP and earnings is required to move stocks higher. Fortunately, while not as robust as hoped, the data has been mostly positive. Core retail sales, a reflection of consumer spending, increased 0.6% in June and were revised upward to 0.2% in May. We were concerned the increase in gas prices at the pump would be a significant negative and therefore are relieved to see prices down again. The unemployment rate is down to 6.1% and job growth has exceeded 200,000 for 5 consecutive months. On the earnings front, first quarter EPS beat estimates by 4% despite the very weak GDP numbers, and Wall Street brokers are looking for growth around 10% in the remaining six months of 2014. The S&P 500 trailing price earnings multiple is currently 18x (16x 12 month forward estimates), which is not overly rich, but does mean that second half estimates will hopefully meet or exceed projections. We expect they will.

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Investment Ideas: Leveraged Canadian Bank and Lifeco Exposure

Top Ten Split Trust (TSX: TXT.UN and TXT.PR.A)

- Split unit trust designed to provide holders of Capital Units with quarterly tax efficient distributions through leveraged exposure to the six largest Canadian Banks (BMO, BNS, CIBC, NA, RBC and TD) and four Canadian Life Insurance companies (GWO, IAG, MFC, SLF) while Preferred security holders receive regular quarterly distributions of 6.25%
- Current leverage on Capital Units of approximately 3.2X (leverage declines as total NAV increases)
- Capital Units trading at approximately 12% discount to NAV while similar fund (TSX:TCT.UN) trust units without leverage trade at premium to NAV – quarterly tax efficient distributions of 7.5% of Capital Unit NAV
- Good entry point to buy leveraged exposure to Canadian Banks and Lifecos
  - Banks second quarter earnings per share grew 13% year-over-year from strong operating leverage as provisions for credit losses continued to decline and capital markets revenues improved due to trading and wealth management divisions
  - We expect dividends and share buybacks to increase going forward with Common Equity Tier 1 Capital ratios exceeding or approaching the 9.5% level we believe bank managements are targeting
  - The Canadian bank index is currently trading at 12.7x consensus 2015 EPS estimates which is about 77% of the TSX Composite P/E ratio, below the 10-year average of 81% which suggests there is some room for multiple expansion
  - Life insurance companies expected to benefit from higher interest rate environment and performance from wealth management divisions
  - Lifeco valuations reasonable with forward P/E ratio of 12.3x, well below the S&P/TSX Composite index of P/E ratio of 16.5x with potential for increased dividends

Top Ten Split Trust	Current Yield(2)	Annualized Total Returns(1) 1 Year	2 Year	3 Year	5 Year	Since Inception(3, 4)
Capital Unit	**7.5%**	**97.1%**	**138.7%**	**18.2%**	**16.9%**	**(2.2)%**
Preferred Share	6.1%	6.4%	6.4%	6.4%	6.4%	6.4%
Combined unit (Class A + Preferred share)	7.2%	23.4%	22.1%	9.4%	9.0%	2.9%

(1) For each period ending June 30, 2014
(2) As at July 18, 2014, based on most recently declared distribution annualized divided by the closing market price
(3) Total return since inception on February 3, 1997 to June 30, 2014 based on NAV per unit.
(4) The fund was formerly called First Premium U.S. Income Trust and changed its investment strategy and investment objectives to invest in the six largest Canadian banks and four Canadian life insurance companies using a split class structure on December 7, 2005.

PM Commentary - cont'd

- Global Central Banks continue to do what they can as quantitative easing in developed markets is combined with fiscal stimulus in emerging markets. Although the Federal Reserve continues to reduce the bond purchases each month, they still remain dovish and the June commentary suggested they are willing to take on some inflation risk in order to get employment on more stable footing. Meanwhile, the ECB has kept monetary policy accommodative by reducing its key benchmark rate to an unprecedented negative 0.1 percent in order to push Banks to start lending to individuals and businesses.
- At the same time, long-term interest rates continue to hover near the lows of the year with 10-year U.S. Treasury yields ending June at 2.52% and Canadian 10-years at 2.24%. Surprisingly, Spain and Italian Bonds are not that far away from U.S. Treasuries with their 10-year bonds closing June at 2.67% and 2.85% respectively, although experiencing much slower economic growth and much greater unemployment rates.
- The Materials sector was the best performing in Canada in June up 10.0% after lagging all other sectors in May. Gold and Silver stocks led the way up 17.6% and 25.4% respectively for the month. Health Care meanwhile lagged the TSX down 4.4%. The Energy sector remains the strongest performing sector in the TSX so far in 2014, up 19.2% vs. the TSX Composite up 11.2%. We continue to have a favorable view on Energy due to valuations but have reduced our overweight position by adding to the Golds .
- South of the border, Energy was the best performing sector up 4.9% benefitting from higher WTI oil prices on Middle East conflict in Iraq.
- Outdoor patio season must have ended early this year as Barley, after rising 12.7% in May, was the worst performing commodity in June, down 13.8%.
- Finally, volatility for the equity market continued to hover near the lows in June with the CBOE Volatility Index ("VIX") closing at 11.6. We closed out some of the put protection in the Gold Participation and Income Fund (GPF.UN) during the month as our view quickly changed due to rising inflation statistics and the Federal Reserve's willingness to allow inflation for the moment for the greater goal of increasing employment.

By The Way - cont'd

We are observing another difference between the past 5 years and today. Namely, the correlation across many different markets has become significantly weaker. Global markets had been going up and down as if synchronized, perhaps as a result of the injections of easy money from central banks. Now that fundamentals are becoming more important, differences in direction are apparent. The major developed markets are outperforming those of the emerging economies; of note would be the U.S. vs China. Sector performance is also diverging with tech stocks doing well, but consumer discretionary breaking down. In this environment, stock selection has again become important to obtaining outperformance.

There is a growing consensus that the next serious downtrend in all financial markets will have its genesis in the fixed income market. The quest for yield has forced investors to move farther out the risk curve. The issuance of junk bonds in the first half of 2014 is almost as large as all of last year as sovereigns and corporations come to market to take advantage of the appetite for yield. Many of these bonds have no collateral or covenants backing them up. While much smaller in size than the subprime mortgage markets of the mid 2000's, there is much similarity in that investors are ignoring risks and potential losses. Those subprime securities were mis-rated and not properly backed by real value, but what magnified the problem was the huge amount of derivative securities that were issued against those obligations. Today, a similar explosion in derivatives is happening in the bond market. The value of over-the-counter contracts is up 5x in the last decade. These types of securities have appeal over the bonds themselves because they require less capital, have cheaper transaction costs, and are more liquid in the current market. However, when the day comes that yields begin to rise (and they will likely rise faster than people expect), derivatives will add to the downside volatility much as they did in 2008 in the subprime market.

Those concerns deserve our attention, but for now markets remain on solid footing and should continue higher. Although, as one blogger recently pointed out, we are in a big bull market for complacency.

Forward Looking Information and Disclaimer

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