Integra Market Insights

Equity Associates Inc.

Jean-François Démoré
CFP, MBA, LLQP, HB CCS

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Issue #27 - "The Coming Correction"

Interesting Links from Around the Web

Referenced : The Case for Buying : Integra Market Insights
Ontario Budget : 15 Essential Aspects : Globe & Mail
Other : How Wolves Saved an Ecosystem : I Love Science

"Be fearful when others are greedy and greedy when others are fearful." - Warren Buffett

With both the US and Canadian equity markets nearing all time-highs and investor sentiment finally turning in the favour of buying stocks, I am reminded of the article we published in November 2008 following the big market meltdown of that year (see attached). In it, I argued three major points in favour of buying.

1- Humans are emotional in nature and their investment decisions are guided by greed and fear. At the time, it was clear to us that fear dominated the landscape and had pushed investments to artificial lows no longer in line with their economic fundamentals. Some companies were posting all-time profits records while their share prices sank to new lows, prompting us to feel that investors were motivated by fear rather than logic.

2- Global economics of a rising middle-class in emerging markets would lead to an important and marked increase in demand for goods, particularly drawing on commodities and well-established brands poised to profit in those markets, think Coca-Cola, Nike and Apple.

3- Interest rates at all-time lows would increase borrowing while improving profits of companies as they refinance old debt. This would further the yield gap between undervalued stocks and bonds making dividend-producing stock all the more attractive to investors.

Five and a half years later, the S&P500 total return has seen a 160% increase in value since December 2008 while the TSX Total Return index has experienced a more modest 78% return, only matching its prior peak in August of 2013.

With such an impressive rebound on the US market, the cautious investor must look over their shoulder and ask "Have the tables turned; Are the markets now over-priced?"

Let us review our three contentions for buying in 2008 and see if their wisdom is still sound in current markets.

1- *Buy Low, Sell High*
Despite the recent rise in high-frequency, computerized trading, alas the human condition still dominates the buying and selling of securities, and with it, the emotional baggage of the men and women behind the keyboards.

By historical measures, stock valuations in the US are now considerably above their historical means which would suggest that the equity markets are over-priced. However, individuals with deep pockets need a place to hold their money and so a good measure of valuation takes into consideration the yield on other securities, like government or corporate bonds.

When compared to those securities, stocks appear to be fairly priced and even have some room for growth, particularly if we continue to see the US economy recover and along with it, increases in corporate earnings. Further to this point, thanks in large part to government transfers of wealth, corporate balance sheets are in excellent fiscal shape and that money has yet to flow back into the economy (Expansion, Research & Development, Mergers & Acquisitions, etc.) or the hands of the investor by means of share buy-backs or increased dividend payouts.

All of these factors bode well for the stock market and poorly for the bond market.

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2- Although this trend continues to be a positive one, momentum has certainly shifted as all four of the BRIC (Brazil, Russia, India and China) have each experienced their own slowdowns. In Russia, geo-political risk has sucked foreign capital out of the markets while cronyism continues to weaken competitiveness of its firms in international markets. India remains crippled by an unwillingness to enact real economic and political change to a corrupt, bureaucratic system that refuses to reform. In China, several indicators point to some significant endemic economic issues that threaten the stability of the system as a whole, while its rapid development has led to some 'growing pains' resulting in civil unrest. Last of all, Brazil has been an economically stagnant over the past five years as it struggles with internal and external conflicts that have once again prevented it from being competitive on world markets. Although the future is still bright for the BRIC economies, it is clear that reforms are slow moving along with their economies.

3- Government policy remains one of the most contentious issues in economic policy today and is perhaps one of the biggest causes for concern regarding the stock market's existing valuations. As it stands, the central banks around the world are artificially transferring wealth to the private sector through ultra-low to no interest borrowings and inflationary monetary policy. What will happen to the economy when the party stops? This is largely unprecedented territory and it is unclear if everyone will have a chair when the music stops. One thing is certain: with so much cheap capital going around at such low rates, the bond market is generating little to no return. On its own, this may be the largest contributing factor in buoyant stock markets as investors and pension funds desperately seek to 'hit their targets' in an environment where bonds are yielding zero to negative 'real' rates of return.

Our view

In our opinion, markets have gotten ahead of their economic fundamentals. In large part, we feel that this is caused by central bank policy and cheap capital as discussed above. As such, we expect a moderate 'price check' correction particularly on the US stock market. We believe that this will be a healthy development to keep emotional investing in line with economics.

How this impacts you

Over the last two years, we have been systematically reducing the risk-levels of our investments in line with our Tactical Asset Allocation strategy that seeks to 'Buy Low and Sell High'. In other words, when stock markets are low, we buy stocks and sell bonds and vice versa. In this particular economic cycle, with very little upside to buying bonds, we have turned to shorter term bonds and cash to hedge our bets against what we deem to be an impending and necessary market correction. The success of our strategy will in large part depend on your ability to allow us to execute the necessary trades to 'buy low' when we feel this market correction has run its course.

To reiterate, we feel that a market correction is coming and have begun to prepare your portfolio to reduce exposure. Should the markets drop by 10%, if we can manage a drop of only 5%, it will be an important success. At that time, we will want to take a portion of our assets and buy low through moving from cash and bonds into equity, a strategic change in our asset allocation that coincides with the market realities. Although this seems logical and simple in theory, the emotions of the situation are what hinder the success of investors who allow fear and greed to dictate their financial decision making. My hope with this month's IMI was to remind you of the fear you felt in 2008 as the markets crashed and the importance on your long-term investment performance of reacting with logic when that times comes again, as we expect it to in the near term.

In the words of the Great One, Wayne Gretzky; "I skate to where the puck is going, not to where it has been".

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