

Market Comments: OPA!!

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Playing Chicken with a Dump Truck

It appears that the jury is now out in the case of Greece vs. Club Euro. The jurists are the Greek public. On July 5th, a country famous for not paying taxes, will ask its citizens if they should accept higher taxes, significant budget cuts, retirement age reforms and pension reductions, all imposed by foreign governments. The current Greek government is telling them to vote no.

Hmm, I wonder which way it will go?

How did we get to this ridiculous exercise in democracy? Game Theory, that's how. The Greek Finance Minister (Yanis Varoufakis) is a studied Economist and great fan of Game Theory. He's even written books about it. Game Theory has been used to analyze everything from terrorism (they have less to lose) to prisoners testifying against one another to children on bicycles hurtling toward one another on the road. Generally, it's the study of *what-the-other-side-will-do* and he's betting the other side will blink.

Varoufakis knows which way the public will vote and when they vote "no" the public will have spoken and the government will announce their hands are tied. This result means that to keep Greece in the European Union, a re-crafted package will be needed with "austerity" softened and the debt schedules pushed out, or maybe even forgiven. He's brilliant. I also think he's playing with fire.

In my mind he's on a bicycle and he's playing chicken with a European dump truck. The fact is, there are other bicycles behind him and these are being ridden by his counterparts from Italy and Portugal. If the European truck swerves, it will swerve around all three. We're not sure that the European Union can afford to lose this game of brinkmanship. At least not with other weak economies at stake and other countries like Spain and Ireland already playing ball and clearly ticked off.

Maybe it's my emotional side coming to play but I think that most of the western world is hoping for some tough measures out of the European Union. A fiscal spanking for Greece perhaps. Didn't we just bail out Greece in 2010 and 2012? Are the issues in this austerity package not the same ones from a few years ago? Not to pick on the people of Greece but we Canadians all wince under our tax burdens and we watch closely at what's going on with our pensions. Some of us even applaud the idea of pushing out the retirement age. The entitlement arguments and irresponsible tax habits of a broke country don't sit well with us or many of our trading partners.

However, that emotional take on the argument is unlikely to have much bearing on the outcome or translate into reality. Our belief is that the European Union will put together more proposals for Greece. They will soften the approach and try to get the Government of Greece to either cancel the Referendum or at least sponsor a "yes" vote to tilt its outcome. We also believe that the Greek government knows that an exit from the Union would create its own hardships. They talk about being embarrassed now. If they default on the IMF loan, they will be the first developed country to do so. They would join the ranks of DR Congo, Iraq, and Somalia among others. Now that's embarrassing. Further-to-that, a new currency would get crushed. A Big Mac cost 650 drachma in the year 2000. It might cost 6500 in a post default Greece. So if they default they will have to get used to paying cash on the barrel for international settlements and they better get used to feta and olives for dinner.

Whether our forecast is correct if our opinions have merit, the other fact is, capital markets hate uncertainty. In our last Outlook we wrote that markets had been getting expensive so these events don't help. While our chief concern is a negative event related to interest rates, we also know that when markets are expensive any reason can cause higher volatility and lower prices. And, right now we are seeing both. The closing of Greek banks seems to have had a chilling effect on markets. On Monday Greek banks remained closed and they will for the balance of the week. On Monday Capital markets around the world plummeted. The TSX and Dow were both down over 300 points. Gold rallied (a bit) and government bond yields were lower. This amounts to a classic "fear trade" we've seen it before and it always transient. As this is written, markets are higher although not enough to retrace yesterday's losses and they might actually turn lower on emotion tomorrow. Where the averages end at this latest crisis conclusion is anyone's guess.

Two things that are almost guarantees in the current environment are; volatility will be higher and the averages will recover and it's only the latter that is important. The world often moves from crisis to crisis (btw Puerto Rico is next) last year we had Ebola, Crimea and Japan's deflation to name a couple. There is always someone that writes that this is "The Big One" and we are all doomed. It's fortunate that it never plays out that way. No one likes volatility and for sure, somewhere in all of this, investment value is being torched but from our perspective it simply means remaining careful. Look for value, diversify your holdings, don't take unpaid risks and above all don't panic. The list below is a little walk down memory lane. I'm old enough now that I had the misfortune to have suffered the volatility of all the events below but the market recovered each time.

We've seen this before;

Black Monday (1987)

Dot-com bubble (1995–2000)

Asian financial crisis (1997)

Long Term Capital Management (1998)

Russian financial crisis (1998)

Economic effects arising from the September 11 attacks (2001)

Stock market downturn of 2002

Chinese stock bubble of 2007

United States Sub-prime related bear market of 2007–2009

Hold on a minute, did I say *misfortune*? To be sure if one had been a buyer at the conclusion of each crisis or down turn the results would be amazing. The key word here is "conclusion" and hindsight is 20/20. We actually never knew when a conclusion was at hand, so suffice it to say that had one simply stayed the course, then they would have fared just fine. For those with a firm confidence in history repeats and if Europe turns into a global crash then the big dips will be a time to be buying.

A few words on Value

One of the things that happens with broad market sell offs is that even good valued companies that we already own shed value. The silver lining is that with many companies that we follow but don't yet own, come back into the buy range that we would consider decent value. One of the key measures of value that we follow is the Price to Earnings ratio. It is a measure of how much one is paying in the stock market for a company's earnings power. While the whole market in aggregate still remains at the higher end of its range for this valuation metric, there are some world class companies now trading at great prices.

We combed our databases and have found over 500 large companies that fit what we call good value. We have managed to find good value in every sector and unsurprisingly we own a number of these companies already. Examples of our review of decent valued companies are below.

Value Candidates	Recent Price	Price to Forecast Earnings	Price to Normalized Earnings	Forecast Earnings	Normalized Earnings	Growth Forecast %	
Candidate Average		12.1	11.9	\$4.14	\$4.28	12.003	
AGU.	AGRIUM INC	\$120.80	15.0	11.9	8.066	10.117	14.479
AP.UN	ALLIED PTYS REAL ESTATE INV	\$35.05	16.0	9.3	2.194	3.781	11.839
AXL	AMERICAN AXLE & MFG HOLDINGS	\$21.47	7.6	7.1	2.837	3.018	14.668
ARI	AMERICAN RAILCAR INDS INC	\$50.89	9.0	13.2	5.656	3.860	13.968
ADM	ARCHER-DANIELS-MIDLAND CO	\$49.96	14.6	14.7	3.430	3.390	10.518
ACO.X	ATCO LTD -CL I	\$39.11	12.5	11.9	3.129	3.273	5.500
BBBY	BED BATH & BEYOND INC	\$68.62	12.7	14.1	5.398	4.882	10.586
BBB.B	BOMBARDIER INC -CL B	\$2.39	11.5	14.2	0.207	0.168	29.919
CFX.	CANFOR PULP PRODUCTS INC	\$14.86	8.4	9.3	1.759	1.604	10.392
CBI	CHICAGO BRIDGE & IRON CO	\$51.83	9.2	10.8	5.635	4.801	22.282
CSCO	CISCO SYSTEMS INC	\$28.16	12.6	13.7	2.234	2.057	8.961
ED	CONSOLIDATED EDISON INC	\$57.22	14.4	14.8	3.978	3.868	3.130
CJR.B	CORUS ENTERTAINMENT INC	\$16.04	9.3	9.9	1.720	1.618	4.553
EMP.A	EMPIRE CO LTD -CL A	\$86.72	14.4	14.0	6.034	6.182	8.670
ESRX	EXPRESS SCRIPTS HOLDING CO	\$87.17	15.4	14.1	5.665	6.185	22.412
FLR	FLUOR CORP	\$53.92	12.1	12.4	4.439	4.336	9.793
FOSL	FOSSIL GROUP INC	\$69.63	11.7	11.9	5.944	5.829	15.267
HFC	HOLLYFRONTIER CORP	\$40.64	10.5	5.5	3.885	7.361	19.186
HBM.	HUBBAY MINERALS INC	\$10.66	11.8	9.5	0.902	1.123	3.771
INTC	INTEL CORP	\$31.11	13.7	13.7	2.268	2.268	10.095
LEA	LEAR CORP	\$112.83	11.1	11.7	10.168	9.625	10.511
MOS	MOSAIC CO	\$43.49	12.5	9.5	3.484	4.567	11.809
POW.	POWER CORP CANADA	\$30.68	10.2	11.3	3.019	2.706	10.171
RTN	RAYTHEON CO	\$97.58	14.1	15.5	6.901	6.300	6.588
TD.	TORONTO DOMINION BANK	\$51.56	11.1	12.7	4.629	4.059	11.000

The companies in the table above represent what we believe to be pretty attractive value. We already own a number of these companies in our client portfolios and are currently investigating some of the others. I have listed two P/Es for each company one is based on future earnings and

the other is Normalized Earnings. The forecast is estimates of the earnings the company should deliver in the coming year. The Normalized earnings are based on the company's long term earnings potential. A similar version of this has recently made the press and is based on Robert Shiller's (see; CAPE EPS) view that earning expectations should be viewed in the context of a company's earnings cycle. A company with a low P/E based on forecasts might be expensive based on its long term trend in earning potential. We agree and have been producing our own normalized forecast for decades. We like to see both numbers at lower levels before we invest

So while capital markets are in turmoil and steeped in the psychological ether of Game Theory we are busily monitoring our portfolios and the market. We're pretty sure that the outcome of the game of chicken being played in Europe will have little to do with our portfolio themes such as Agriculture or Canadian Infrastructure and Engineering. We are also comforted knowing that our companies are more representative of the value shown on the list on the previous page than the market in general. Value itself should prove to be a cushion.

We also know that this is not a time for panic. The headlines that are causing the market volatility seen today will fade into something else, just as they always do.

And as my 12 year old would say..... *Keep Calm and Carry On.*

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