Seymour Investment Management

July 10, 2014

Global equity markets continued to perform well in the second quarter of 2014. The Canadian benchmark S&P/TSX Composite Index delivered a total return of 6.4% in the most recent quarter and 12.9% for the year to date. The comparable U.S. benchmark S&P 500 Total Return Index's returns were 5.2% and 7.1%. Fixed income returns were also positive which is reflective of a continuation of modest inflation and accommodative monetary policy.

Canadian and U.S. equity indices have reached record, absolute levels in recent months, which has led many investors and market commentators to question whether we are poised for another correction. They have asked "if the market has reached record levels, isn't it highly probable that a correction is looming?" We think that it is somewhat misleading to focus on the absolute level of a market index and would note that (1) despite the market's recent gains, equity valuations still appear reasonable (with the market trading close to long-term historical average levels) and (2) the macro-economic outlook remains constructive for corporate earnings growth. If the stock market were to consistently trade at precisely its long-term average multiple of earnings (say 15 times), then the market would reach a new high almost every year. This is because overall earnings tend to grow at around 7% per year (the notable exception being during recessions). We would expect that under this scenario, stocks would remain the best performing asset class (despite consistently trading at record levels).

A lot has changed since the stock market correction of 2008. The U.S. housing market has recovered significantly from its low and new home construction activity has contributed to a slow but steady improvement in employment. There is a positive wealth effect on consumers related to rising home prices, which has contributed to the growth that we have seen in consumer spending. The overall economy and corporate earnings have also grown substantially over the last six years, and corporate balance sheets have improved. In our view, all of these factors make the market more valuable than it was six years ago.

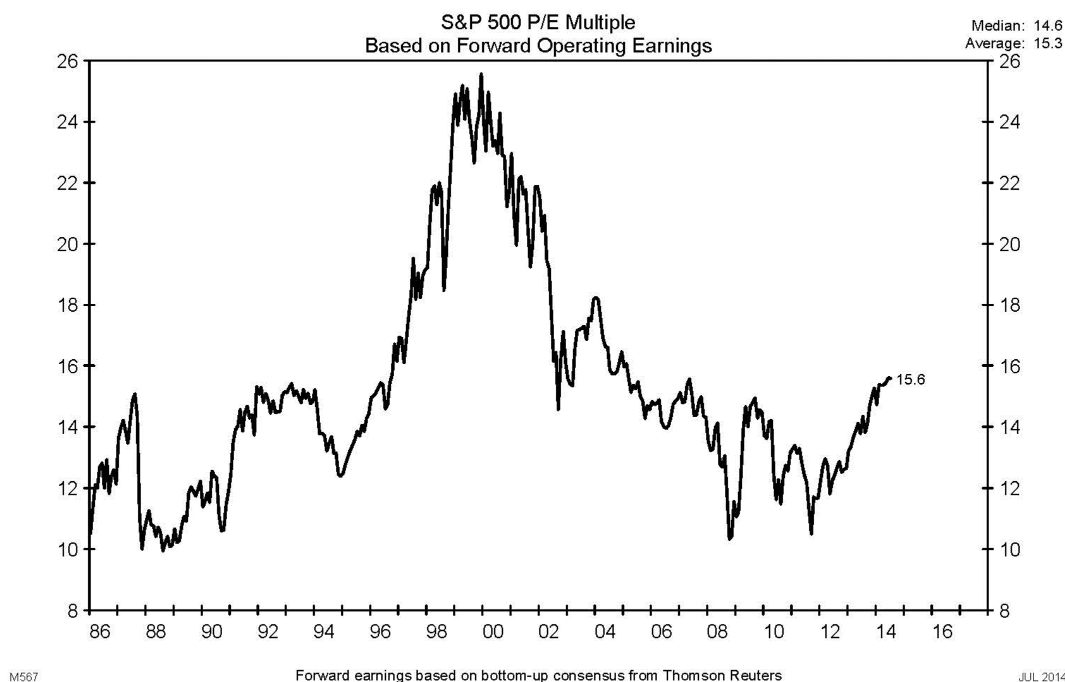
An analogy could be drawn to real estate. If an investor owned an apartment building in 2008 that had a market value of $10 million and generated $1 million per year in rent, then the building would have traded at 10 times cash flow (or a 10% capitalization rate). Six years later, if rents were to increase at 5% per year, that same building would be generating annual cash flow of $1.34 million. If the building were to continue to trade at 10 times cash flow, it would then be worth $13.4 million. This would be a "record high" value for the building despite the fact that it would continue to trade at the same multiple of 10 times cash flow. Of course, many of us are used to our homes or other real estate investments growing over time and often trading at "record levels".

Suite 1000 | 1285 West Pender Street | Vancouver, B.C. | V6E 4B1
Main: 604-659-1722 | Fax: 1-877-778-3770
www.seymourinvest.ca

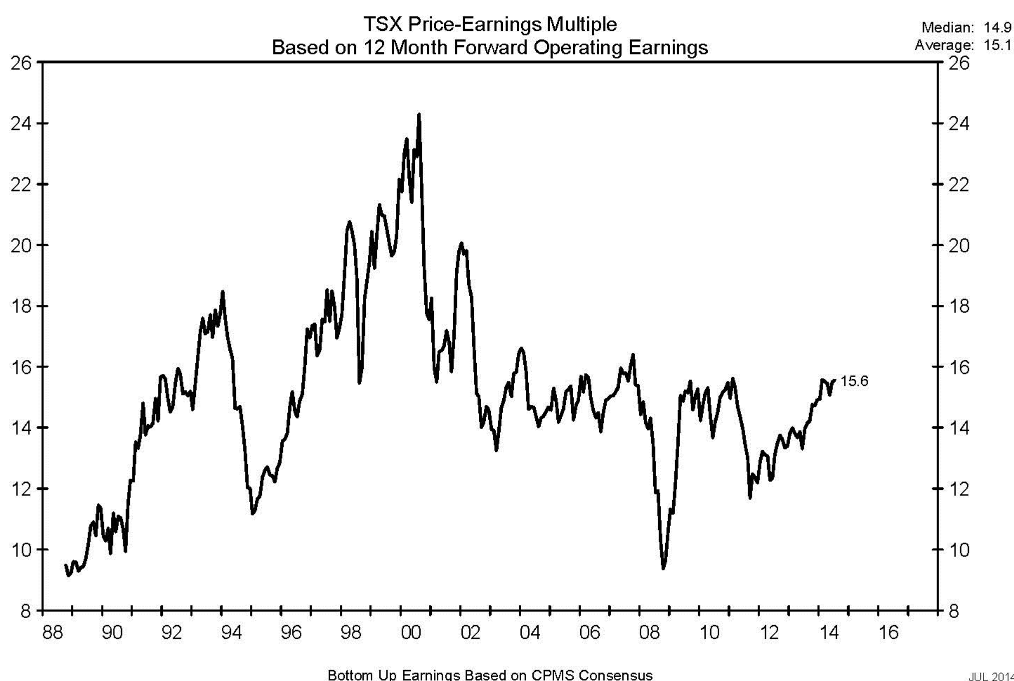
Corporate earnings growth is as important to the increase in the stock market as rental growth is to the increase in the value of an apartment building. As corporate earnings increase, so typically do dividends which can be thought of as "rent" for shareholders. Most companies have much higher earnings and dividends today than they did six years ago. It shouldn't surprise investors that the cost to acquire an ownership stake in those companies is slightly higher today than it was seven years ago.

We appear to be well on the way to another year of positive stock market returns in North America, and if so, 2014 would mark six consecutive years of positive returns from U.S. stocks while Canada would have recorded positive returns in five out of the six years. The duration and magnitude of the most recent stock market recovery are somewhat greater than the "average" bull market. (On average, equity markets tend to decline one year for every four that they rise). However, there wasn't much that was average about the 36% decline the U.S. market suffered in 2008. In fact, it has taken six years for equity markets to regain their previous highs. In light of the magnitude of the market decline in 2008, it shouldn't be surprising that the current recovery should be of greater magnitude and duration than typical recoveries.

In our view, a much better way to determine the attractiveness of equity valuations is to look at the price to earnings ratio in comparison to historical levels. As shown in the charts below, both the U.S. and Canadian markets are trading very close to their historical average multiples. To us this suggests that valuations are fair or reasonable.



Source: TD Securities



Source: TD Securities

Another way to look at equity valuations is in relation to bond yields. The earnings yield of a stock (or index) is simply the inverse of the price to earnings ratio. A price to earnings ratio of 15 times equates to an earnings yield of 1/15 or 6.67%. Equities tend to trade at an earnings yield that is a small premium to the long-term bond yield. This premium is referred to as the equity risk premium and is generally assumed to be the increased level of earnings that is required to entice investors to own equities over bonds to compensate for the volatility that is inherent in owning equities. As shown in the table below, the equity risk premium has generally averaged about 3 or 4%.

Annual Returns on Stocks, T.Bonds and T.Bills: 1928 - Current					***Risk Premium***	
Year	S&P 500	3-month T.Bill	10-year T.Bond		Stocks - T.Bills	Stocks - T.Bonds
1928 - 2013	9.55%	3.53%	4.93%		6.02%	4.62%
1964 - 2013	9.89%	5.07%	6.56%		4.83%	3.33%
2004 - 2013	7.34%	1.54%	4.27%		5.80%	3.07%

Source: Aswath Damodaran, January 5, 2014

Using the long-term average equity risk premium, current long bond yields of 3% would imply an earnings yield of around 6.5% for the overall market. This equates to just over 15 times earnings, or about where both the U.S. and Canadian equity markets are trading.

Our conclusion is that despite trading at "record levels", North American equity markets are still reasonably valued. We believe that long-term investors will be rewarded for owning equities with average share price gains that are commensurate with earnings growth.

We believe the current bull market is unlikely to end until a recession sets in. Although recessions are difficult to predict, we don't see any signs that would indicate that a recession is on the horizon. As RBC Capital Markets' Chief U.S. Market Strategist Jonathan Golub noted in his recent publication entitled '*Recessions (but Little Else) Kill Bull Markets*', recessions tend to follow a similar pattern:

> *"Typically, an accelerating economy burns through existing spare capacity. This leads to inflationary pressure, which forces the Fed to act. As markets anticipate rate hikes, the yield curve inverts. Growth slows and, more often than not, the economy rolls over, taking the market with it."*

Mr. Golub goes on to note that (1) currently the yield curve is very steep; (2) the ISM Manufacturing Index [which monitors employment, production inventories, new orders and supplier deliveries] is clearly in expansionary territory; (3) ample capacity would indicate there is little threat of a sharp move in inflation; and (4) capacity utilization appears below peak levels. All of these indicators point to continued economic growth (as opposed to the start of a recession).

Of course at some future date, we will find ourselves in a recession again (that we likely won't foresee) and the painful combination of lower earnings and valuations will result in a period of negative returns for equity investors. Nevertheless, we expect patient investors that stay invested through market cycles and own well managed companies with strong balance sheets will withstand the inevitable correction. These investors will enjoy the positive long-term returns that accrue to equity investors.

Despite having a positive macro view, we tend to invest in much the same way at various points in economic and market cycles. As we discussed in our last quarterly letter, we try to ignore what we view as 'noise' and invest for the long term in well-capitalized, high-quality companies with a view of holding these companies indefinitely. We buy companies that we believe will grow their earnings on a sustained basis over time. We try to do so at reasonable equity valuations. We sometimes use periods of weak share price performance to opportunistically add to these core positions, but we don't try to time the market.

As always, please don't hesitate to contact us with any questions or feedback that you may have. Best wishes for a safe and happy summer.

Warm regards,

The Seymour Team