MARKET COMMENTARY

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"Bull markets are born on pessimism, mature on optimism and die on euphoria." Sir John Templeton

Studying a chart of the S&P 500 we note that the upside breakout has come after nearly a two year consolidation, or trading range. I question whether we are anywhere near optimism, much less euphoria— Paraphrasing Jeff Saut (Investment Strategy, August 22, 2016).

Keeping market sentiment in perspective can be difficult as the financial reporting media tends to embellish the negative and spends little time on the positives. The Canadian TSX is still 3% below its high of 2007, and slightly below its twelve month high. It is however up from the February low of this year by 21%. It was during those February lows that the Royal Bank of Scotland recommended "selling everything". Clearly a bad call, as it received significant media attention and no doubt generated some anxiety for investors. During the early and middle stages of a bull market stock markets are leading indicators, and the recent recovery bodes well for future returns. Much like Mr. Saut, I don't sense euphoria but I do feel some optimism towards economic recovery supporting lower unemployment, higher earnings and higher market valuations.

A more quantitative measure of market valuation is the equity risk premium (ERP). In essence the equity risk premium is the expected return required to invest in a business above what would be the expected return from a risk free asset (such as a GIC); the greater the risk the higher the return.

Many strategists calculate the ERP for the stock market by taking the earnings yield of the S&P 500 (currently about 6%) and subtracting the 10-year treasury yield of 1.5% to produce an ERP of 4.5%, which is slightly below the average of 5.7% over recent years. This lower premium is likely a result of other asset classes not producing enough returns to justify the risks. In a persistently slow economy with prevailing low interest rates, equities may be the outperforming asset class for some time (Investment Strategy, August 22, 2016).

There are a multitude of portfolio management techniques we utilize to determine our client risk reward profile in relation to their objectives. To be sure, nine years of a sideways moving stock market, in combination with historically low interest rates, has made security selection and reliable cash flow significantly important.

The recent recovery in the Canadian market has been driven by dividend yields. The next phase up (which will last much longer) must be earnings driven. Our recent second quarter earnings reports were better than expected for a lot of our holdings. If that trend continues the equity risk premium will be maintained at acceptable levels and optimism for equities should continue. The expected rise in interest rates should be viewed as an indicator of economic strength initially providing support for equity markets until their competitive threat for capital diminishes the ERP.

On a loosely related topic fly fishing has been a passion of mine for a long time. To do it right one needs to have the best equipment, a vast knowledge of the species traits, understand the various environmental influences and then exercise skill and patience. As John Buchan said, "Fishing is a perpetual series of occasions for hope." We are ever hopeful for success but in portfolio management and tempting "rainbows" the tools, skill and patience have proven to outperform the "hope" strategy.

I'm totally in agreement with Mr. Saut that we are somewhere in the middle stages of a bull market and with the characteristic corrections along the way it should continue for some time. Our due diligence and patience should be rewarded.

Enjoy the remainder of your summer and don't forget this Babylonian proverb,

"The god's do not deduct from man's allocated span the hours spent in fishing."

All the best,

Graham