Investment outlook still positive, equity experts say

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MONTREAL, QUE.: DECEMBER 18, 2014 -- Cameron Fortin of Formula Growth Ltd., left, Bernard Gauthier of Jarislowsky Fraser Ltd, middle and William Kovalchuk of Claret Asset Management , right, are the three investment professionals who participate in the Gazette's annual look back and look forward for investors. (Marie-France Coallier / Montreal Gazette)

Marie-France Coallier / Montreal Gazette

Against all odds, North American equity markets extended their upward progression for a sixth year in 2014, with U.S. stocks setting the pace. This, despite a steep late-year fall in oil prices. For a professional perspective on what this might presage for the year ahead on the investment front, Montreal Gazette reporter Paul Delean met recently with three local portfolio managers for a roundtable discussion. Here's an edited version of that conversation with Cameron Fortin of Formula Growth Ltd., William Kovalchuk of Claret Asset Management Corp. and Bernard Gauthier of Jarislowsky Fraser Ltd.

GAZETTE: "For much of 2014, equity markets in Canada and the U.S. had recorded yet another solid advance. Then oil prices plummeted and the tide turned, only to suddenly reverse again. Were you surprised and have recent events fundamentally changed the outlook?

FORTIN: "It's hard not to be surprised by a move from $110 (per barrel of oil) to $55 in three months or so. But (the rapidity of the decline) may be a good thing. At least it allows producers to react quickly. If it had dropped like that over the course of a year, you might have seen more companies go under. Some will go under; these oil guys are very levered. Outside the oilpatch, though, it's actually pretty constructive for the rest of the economy. It's a nice tax cut for the average Canadian or American."

GAUTHIER: "Overall, though, the net effect for Canada is negative. And we don't see oil prices moving much in the next year from where they are now."

KOVALCHUK: "At Claret, we're not big fans of commodities so we didn't have the oil and gas exposure that everybody else has. The challenge for any commodity is that it's very difficult for management to set the selling price for their product. If you have a 20-year project, and you don't know what the selling price will be in five or 10 or 15 years, it's really tough to manage a project over 20 years. Once prices get too low, banks call in their loans, you have companies going bankrupt, stronger companies get the assets of weaker ones very cheaply. So it's a self-correcting problem. The Saudis, who instigated this, have a political purpose and a competitive reason for doing it. On the competitive side, it certainly sends a message to anyone making new investments with a break even point of $65-70 (a barrel) to reconsider those investments. I think they'd have to do this a little

longer to make that stick, and they probably will, so that everyone feels the pain."

GAZETTE: "Energy and materials are major sectors in Canada and they're hurting. Does that make Canada overall a less appealing investment market, or does it actually make it more appealing, given the valuation of everything else right now?"

GAUTHIER: "Financials are an equally important sector here and they too are facing big challenges because the Canadian consumer is highly-leveraged and that's a concern as far as the growth of the Canadian economy. Banks are proxies for the economy, so if the economy grows slowly, so do they. We don't expect spectacular returns from the banks in 2015, probably more in the 7 to 10 per cent range, including the dividend. The leverage ratio is a key issue, it's at all-time highs, and the Canadian consumer is vulnerable as a result. Debt-servicing is at the low end of the historical range only because interest rates are so low. Leveraging helped the economy grow in the last few years, but if we've hit the limit here, then growth of the economy will be moderate at best. The other area of concern for us is the automobile sector. There is some erosion of our competitiveness in that area, it's going to the Mexicans, and it's our second most-important export sector. Once the plants are in Mexico, it's not a depreciating Canadian dollar that's going to get them back."

FORTIN: "Our focus is on the U.S. and it has outperformed Canada the last two years. If you go back five, 10, 15, 20, 30 years, the U.S. stock market really has trounced the Canadian market. A big part of that is the lack of diversity in Canada. I think the real story in both countries right now is 'when are (interest) rates going higher?' Seems like the middle part of next year is the Fed's best guidance at this point. If rates

start going up in the States, maybe Canada can keep them low for a little bit longer but it will feel the pressure, too. How will that impact the real-estate market in Canada? Because it will be tough for the consumer. It's something we really haven't gone through in some time now."

KOVALCHUK: "On a good day, Canada is 4 per cent of the world's equity markets. Everyone has to look outside Canada. There are just so many sectors that aren't represented here, high-tech and pharmaceuticals to name two. Canada is a great place to live, but you really need to be a global investor these days and go beyond our borders."

GAUTHIER: "Stock-picking will be key next year. Yes, the market can have a direction, but it's important to compare the expected returns of specific stocks in the index. Some companies in Canada are very expensive and some are quite cheap, so I think you can have a decent year if you're positioned properly. Energy's seen a major decline from its peaks and if oil prices stabilize, there are few names in there that have a lot of upside, much more than the average of the index. Life insurance companies also are an area of interest for us right now. We find there's upside in certain areas there as well. Telecoms, REITs and energy infrastructure companies, we find expensive, and less attractive going forward. Overall, valuations in Canada and the U.S. are still about average and markets are reasonable. But the U.S. is going to grow more quickly than Canada."

KOVALCHUK: "We don't care where in the world a company is, we want to see solvency, cash flow and good margins. We've seen sort of rotating corrections, first in high-tech, now in energy, and I think that's something that will continue. But there's no shortage of companies out

there with wonderful balance sheets, great cash flows, great margins and great potential. Even something like the Charbonneau Commission, which knocked the stuffing out of everything to do with infrastructure … a lot of these companies collectively are cheap now. Either we buy them or the Americans will take them over because they're great businesses with great margins and the work needs to be done. And I guess now the taxpayer will get a better shake on the dollar. Overall, the market is not wildly expensive or wildly cheap; it's a stock picker's market."

FORTIN: "I agree. We're actually not that concerned about interest rates coming off such a low level. Where it will end probably will still be a relatively low level. Historically, in six of the last 10 tightening cycles, the year leading up to the first rate increase, the S&P (500) index was up just less than 10 per cent. And in the year following the first rate increase, the S&P also was up 9 and change. The third year, it was down just under 1 per cent. This is history, it doesn't predict the future perfectly, but it does show that even if rates start to increase, it doesn't necessarily mean that markets will fall off a cliff. The growth in the U.S. is constructive, the economy is humming along nicely, unemployment is getting back near its long-term average. We think the U.S. and particularly growth stocks are the place to be (for investors). With bonds, the yields are just way too low. Managers of companies we've met in the last month — and I've probably met with 50 myself in Montreal and New York in the past month or so — in general, across the board, they seem pretty confident. And lower energy prices are helping out in a handful of places that would have been areas of concern."

KOVALCHUK: "I don't think interest rates are about to turn the corner or go up anytime soon. I think we'll have low rates for longer than people think. I think it'll take a couple of years. Inflation is spotty at the moment. Energy prices being this low certainly doesn't do much

for the cause of higher inflation. And U.S. companies are lean and mean after going through the 2008 crisis. They're restructured, they're serious, their balance sheets are in good shape. They're well positioned going forward."

GAZETTE: "What do you make of the current value of the Canadian dollar?"

FORTIN: "It has been a big move (downward), but given the differences between the Canadian and U.S. economies, and the Canadian dependency on the states, to have an exchange rate that's 1 for 1, that hardly seems like where it should be. What's the right number? That's the million-dollar question. Could it be $1.20, or $1.25? Certainly. Something that probably is not here to stay is 1-for-1. And that is a good thing (for Canadian exporters)."

GAUTHIER: "The 1-for-1 actually put a lot of pressure on our manufacturing capacity. It was painful for a lot of companies."

GAZETTE: "So what are some of the individual stocks you like at this juncture, and why?"

KOVALCHUK: I'll mention (auto parts manufacturer) Martinrea International. That's just a great asset that's underutilized. They had a management shakeup and they're finally going to start doing a few things properly. Element Financial is another. They're in car leasing, railcar leasing, sectors the banks really have no interest in. Home Capital Group, which competes with the banks, is another. It's applied for a schedule-1 bank charter. It's time the big banks got some competition and maybe Home Capital can give them some. On the U.S. side, there's Mallinkckrodt Pharmaceutical, a wonderful cash-flow

business, which is in the pain-management business and wildly profitable. Everyone seems to hate retail these days, which is why I like a company like Bed, Bath & Beyond. It's really cheap, and attractive. I think people still want the shopping experience. They don't want to buy everything on Amazon."

FORTIN: RFMD (RF Micro Devices) is a chip provider, primarily for the cellular market. They're changing their name to Qorvo following acquisition of one of their competitors. They makes switches, filters, power amplifiers, the electronic guts of your phone. As cellphones have gotten more complicated, there's a much bigger opportunity for them. They stand to gain from the global switch from 3G to 4G phones. They're going from making 50 cents on 2G phones to $10-15 of content on 4G phones, so there's a huge opportunity for them. Another one, a consumer name, not listed in Canada but headquartered here, is Lululemon. It's finally getting its act back together. The new CEO has some really relevant skill sets to bring to the table and this stock could be a good little worker bee from here, in the $65 range by the end of the year. Their international growth is just starting. They're rolling out stores in Europe and Asia. I think there's a really nice multi-year story for them after what had been a very tough year."

GAUTHIER: "Manulife is one we like. It's the most international of our life-insurance companies. It has great exposure to Asia and is seeing strong sales growth there. They've adjusted their business model to low interest rates. Return on equity is moving from 10-11 to 12-13-14 per cent over time. There's both earnings and valuation upside. They've increased the dividend, have a lot of excess capital. CNQ (Canadian Natural Resources) is a strong company with one-third of its production from the oilsands, one-third from gas and one-third from light oil. It is a strongly-managed company with a very strong balance

sheet, improving cash flows, and has the optionality to acquire properties or make acquisitions. Everyone's negative on oil but there's a lot of instability in some of the countries that are the lowest-cost producers so things could change quickly if there was a little bit of turmoil in places like Libya or Venezuela. SNC-Lavalin has had issues. It's exposed to energy and laid off people. The market didn't like that which led to a price correction, but we like what (new CEO) Robert Card is doing there. All the top management is changed and we take comfort in the fact its competitors and clients still have high regard for it. The 407 (toll highway in Ontario) will be sold sometime in the near future and they'll surface some value from that."

GAZETTE: "So do you then foresee that North American markets will be ahead of where they are now by this time next year?"

FORTIN: "I think we'll be higher than where we are today. Even Europe is improving."

KOVALCHUK: "I think they'll be further ahead next year, for sure. We've had a wonderful market for the past year and I think it will just sort of continue onward. The exogenous shocks that could come in would be a Russian war, an Iranian nuclear event … all those things can happen, but I'm not counting on them."

GAUTHIER: "North America looks better to us than Europe. The U.S. is on the right track and Canada is right next door, and that helps a lot. I'm not positive on all equity markets, but if you had the choice between an expected 7-8-9 per cent return on the TSX, and compare that to a bond … it's obviously more risky, but the potential return is much nicer."

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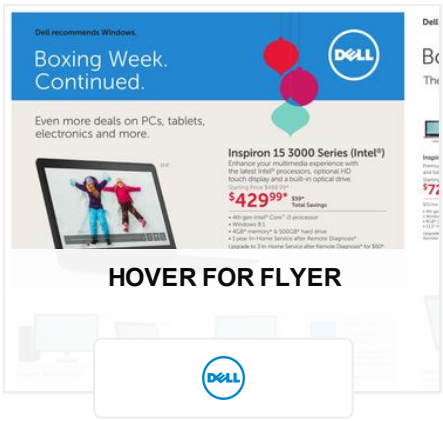
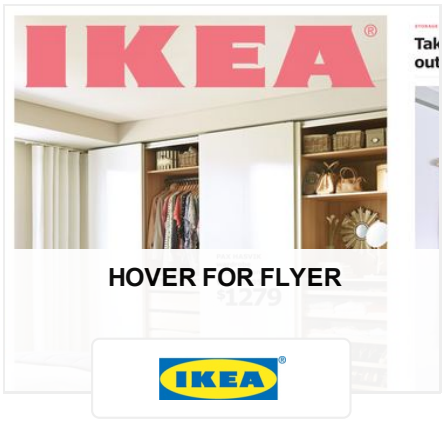
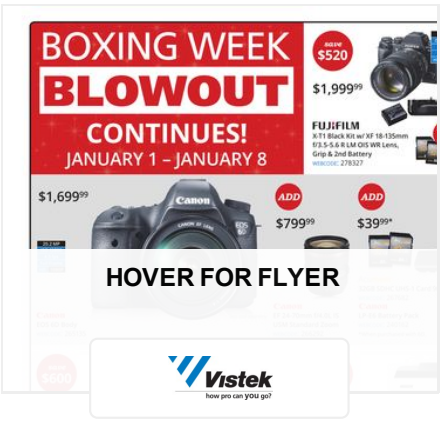
This Week's Flyers







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