FOYSTON, GORDON & PAYNE INC.
INVESTMENT COUNSEL

January 19, 2016

# This time, it's *not* different

It has been a challenging start to 2016 in Canadian and foreign equity markets.

There are several reasons that markets have fallen since the start of the year. However, amidst the investor pain are reasons for optimism. As pessimism reaches a peak, many attractive opportunities are emerging as Canadian stocks are the cheapest they have been since the depths of the Great Recession of 2008-2009.

The one constant to investing is that market corrections are invariably followed by market recoveries. This time, it's not different, and Foyston, Gordon & Payne's (FGP) investment strategy remains the same: buying good quality companies at attractive prices.

This paper explains the recent market correction and the potential investment opportunities these price declines are presenting to investors.

## Contributing factors

There have been a number of factors contributing to the severe market correction.

### A continued slowdown in the Chinese economy

China continues to be a key world growth catalyst, with its economy having grown at double digit rates for the past two or three decades. Chinese growth rates slowed to around 7% in 2015 and there are fears of further slowing. Arguably more destabilizing are concerns that Chinese economic data is unreliable and actual GDP growth levels may be below the officially-reported numbers.

### A severe correction in commodity prices

Slower growth in China has created temporary imbalances in supply and demand for energy and other commodities. Prices of commodities have corrected. Over the year, oil prices are down 31%, nickel is off 42% and zinc and copper prices have fallen by 26%. This commodity correction has negatively impacted resource-dependent economies such as Canada's.

### Fears over lower growth leading to a flight to safety

The U.S. dollar continues to strengthen relative to most currencies, particularly against the currencies of resource-dependent countries like Canada, Australia, and select South American countries.

### The falling Bank of Canada (BoC) rate

Fears over an economic slowdown in Canada as a result of the commodity correction, its potential effect on the economy, and its ability to infect Canadian banks (not a high probability risk) have resulted in two BoC rate reductions in 2015 and concerns over an additional pending rate cut this week. These rate cuts are acting to weaken the Canadian dollar which increases foreign input costs and raises the possibility of a long-forgotten return to stagflation.

## Reasons for optimism

While several factors have hurt the Canadian market, the negative sentiment has been universal and all major equity markets around the world have been negatively affected. Despite these significant headwinds, there are some reasons for optimism.

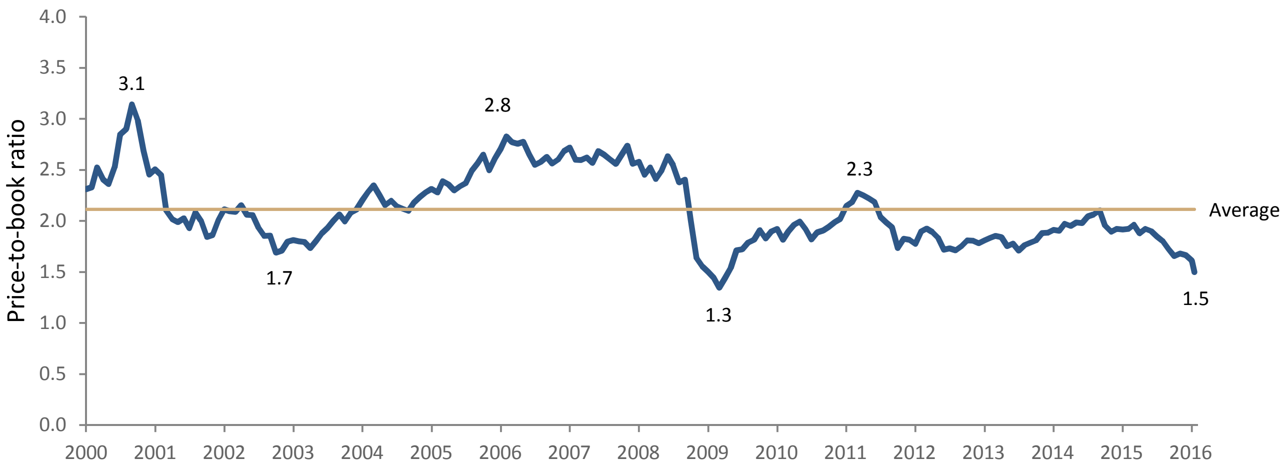
### The Canadian market is looking historically cheap

Canada had one of the worst-performing stock markets in the world in 2015. For the fifth year in a row, Canadian stocks underperformed U.S. stocks. This pattern of relative underperformance for the Canadian market has never extended to six consecutive years since the creation of Canada's TSE 300 Index in 1977. The current price-to-book (P/B) levels of the S&P/TSX Composite Index (currently 1.5x) have fallen to levels not seen since the worst part of the 2008-2009 market correction (just under 1.4x). At its peak during the bull market in 2010, the S&P/TSX was trading at a P/B of 2.3x. Prior to the credit crisis, this figure was as high as 3.1x.

FOYSTON, GORDON & PAYNE INC.

INVESTMENT COUNSEL

**Price-to-book ratio – S&P/TSX Composite Index**




Source: Bloomberg

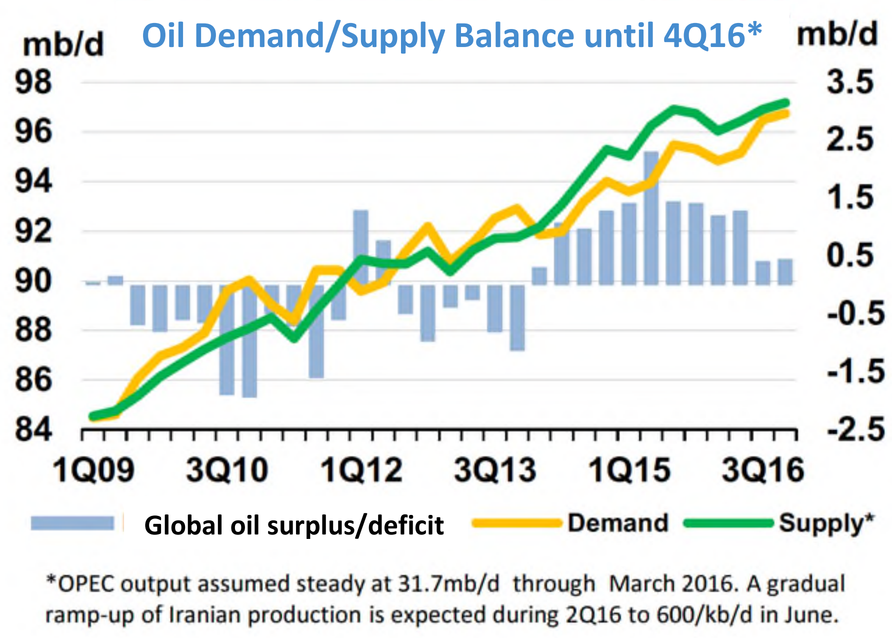
For these reasons, the Canadian equity market is significantly **undervalued** and offers investors a great buying opportunity. The correction has created opportunities at the individual stock level as well. Quality stocks that were too expensive to own in FGP's Canadian equity portfolios over the last several years are now trading at attractive prices.

**The supply/demand imbalance in Energy is temporary**

The response to the temporary supply/demand imbalance in commodities has been overdone. While global demand continues to grow, the energy correction has been caused by oversupply due to increased oil production in Saudi Arabia and Russia. Additionally, investors are concerned about a further increase in oil supply as new Iranian production hits world markets.

Supply is responding in North America, where capital spending has been curtailed, projects have been shelved, and wells have been shuttered. The rig count in North America has dropped by 70% since October 2014. Similar cuts have been made by oil companies around the world. Last week both BP and Petrobras announced large development cuts.

The world consumes more than 96 million barrels of oil a day. According to the International Energy Agency (IEA), there was an oil surplus of 2 million barrels per day (b/d) in the summer of 2015. As a result of growing demand and slowing production, this glut has shrunk considerably and is projected by the IEA to approach equilibrium by mid-2016. The impact of the current capital spending cuts and shuttering of projects will take up to a year to be fully realized. At that point, a supply deficit will develop and potentially cause a significant spike in the price of oil. It is important to recognize that restarting abandoned projects and getting oil flowing again will take many years. Similarly, it will take a lot longer than people think before Iran is able to significantly ramp up supply in its long-idled oil fields.




Source: International Energy Agency

**Recovery of metal and mineral prices will take longer**

The key global driver for Materials prices has been increasing construction and infrastructure spending in China. If growth levels continue to slow in China, it may be some time before global demand returns to peak levels. This situation has created instability which may require a supply response to address. A number of companies have shuttered projects and cut dividends in an attempt to preserve cash. However, unlike with Energy, demand is not growing.

For this reason, the portfolio has been carefully controlling its Canadian equity Materials weighting, which is targeted around market weight. The portfolio does not hold any precious metals. A significant portion of the Materials allocation is in fertilizer stocks, which have better long-term demand growth prospects due to a growing global population and a growing middle class in emerging markets. All Materials companies in the Canadian equity portfolio are well-financed, low-cost producers with long-life reserves.

A resolution of the supply/demand imbalances in the metals and minerals markets may require some of the poorly-financed and less-efficient producers to cease operations. The Materials companies in the portfolio are positioned to survive during this challenging period and ultimately thrive as demand corrects over time. Ironically, when these weak players fail, this will be a sign of the bottom, which will be a positive signal for the portfolio's holdings in this sector.

**Financial stocks are attractive**

Canadian banks are among the most financially stable and well-funded banks in the world. They are trading at historically cheap valuation levels with strong earnings growth and attractive dividends that are stable and increasing. The reasons for the banks' recent underperformance is tied to the large short positions on Canadian banks. Shorting Canadian banks was a key investment recommendation of Merrill Lynch analysts in 2015.

The negative view on Canadian banks, despite their strong earnings results, relates to fears over Canadian personal debt levels and growing resource sector loan defaults. Loan loss rates for the banks have been closely followed, and stress testing under the most pessimistic outlooks for the resource sector has been undertaken by FGP. Results show that the banks should remain profitable even at elevated default level scenarios given that they have well-diversified operations across industry sectors, business lines, and geographies. The portfolio holds an overweight position in Canadian banks and insurers. The temporary weakness in this sector has been used to increase positions at attractive prices.

**Characteristics of Canadian Banks**

| Bank | 2015 price change | 2016 price change to Jan. 15 | 2016 FGP price-earnings valuation | Dividend Yield | Year over year earnings-per-share growth* | Number of dividend increases in last four quarters |
|---|---|---|---|---|---|---|
| Royal Bank of Canada | -7.6% | -9.6% | 9.6x | 4.7% | 11.3% | Two |
| Toronto Dominion Bank | -2.3% | -8.8% | 10.2x | 4.1% | 10.6% | One |
| Bank of Nova Scotia | -15.6% | -6.6% | 8.6x | 5.4% | 6.4% | Two |
| CIBC | -8.7% | -6.9% | 8.7x | 5.4% | 6.1% | Four |
| National Bank | -18.5% | -10.4% | 7.6x | 6.0% | 3.0% | Two |
| Bank of Montreal | -5.0% | -9.3% | 9.9x | 4.7% | 2.3% | Two |
| ***Average*** | | | ***9.1x*** | ***5.1%*** | | |
| ***S&P/TSX Composite Index*** | | | ***14.1x*** | ***3.6%*** | | |

* As at banks' fiscal year end October 31, 2015
Source: FGP estimates, Bloomberg

**Economic growth not as bad as feared**

While economic growth is affected by continued uncertainty, it is not as grave as investors fear. The U.S. economy has performed more strongly than other industrialized countries and a modest European recovery appears to have taken hold. Chinese growth, while slower than projected, is still expected to exceed 5%. The current market swoon is being accentuated by investor fears. Elevated risk avoidance is causing a flight to the highest perceived quality investments and a liquidation of volatile investments.

## The strategy at FGP

These types of extreme risk-averse markets create opportunities for investors who maintain their long-term perspectives. Those investors who exited the stock market during the first quarter of 2009 missed out on a historic opportunity to capitalize when markets normalized. Often when pessimism among investors hits a maximum level, it signals that a market bottom is being formed. The negative headlines currently in the financial media seem to be hitting a peak. Similarly, investors are reacting negatively even when companies' financial results beat expectations. These are also signs of peak negative market sentiment.

The portfolio's strategy is to protect investors' capital and position itself for future success in severely correcting markets by maintaining FGP's discipline. This involves continuing to apply FGP's quality and value research methodology in a disciplined manner. In 35 years of successfully managing the assets of its clients, FGP has learned that the biggest mistake an investor can make is to decide that this time is different. This type of change in thinking leads to capitulation, which results in crystallizing losses and then missing out during the market's ultimate normalization.

Historically, the portfolios have added value by capitalizing on periods of extreme market volatility and negative sentiment. Volatility is the friend of investors who know the value of a business and the enemy of those investors who do not. In the cyclical areas of the portfolio (Energy and Materials), core holdings have been built with a focus on strong balance sheets and sustainable business models that will protect these companies from the worst consequences of the commodity downturn. In other sectors, the portfolio is using this period, where all stocks are being punished, to opportunistically improve its quality by adding stocks that have previously been too expensive to own. Defensive market sectors such as consumer staples, pipelines, railways and REITs, which have been carrying higher valuations than the market, have been underrepresented in the portfolios. The recent market correction is allowing FGP to research and evaluate some high quality companies in these sectors that may help improve the diversification and further enhance the overall quality of the portfolios.

It is important to remember that things are never as rosy as they look at the top of the market and never as grave as they appear at the market bottom. This time is **not** different, and investors who maintain their discipline and resolve will ultimately be rewarded.

-------------------------------------

FOYSTON, GORDON & PAYNE INC.

INVESTMENT COUNSEL



P.O. Box 200, 1 Adelaide Street East, Suite 2600, Toronto Ontario M5C 2V9

**Tel 416.362.4725 Fax 416.367.1183 www.foyston.com**