The Outlook: What to expect from 2014

The fourth quarter has come to a close and brought with it an end to a surprisingly strong year for equities. The S&P 500 continued its year-long rally, rising another 9.9% to finish the year at 1,848.36, while the S&P/TSX Composite underperformed once again, gaining 6.5% during the quarter and finishing the year at 13,621.55.

Despite a bull market year for equities and a persistent dichotomy between equity prices and economic fundamentals, we are not of the view that the market is severely over-valued moving in to 2014, or that we are currently in a market bubble. The chart below,

obtained through CNN, shows the S&P 500 and Dow Indices' price charts.

Canada:

- Canada's unemployment rate recently ticked down to 7.2% in December.
- The Canadian employment Participation rate was listed at 66.4%.
- The CPI in November was reportedly up 0.9% year-over-year.
- The BoC has maintained its key interest rate at 1% in a recent decision.

This chart shows a few important things. For one, both of these major markets exhibited a fairly stable rise through-out the year; the gains were consistent and did not concentrate on a handful of days which is a telling characteristic of a bubble. Additionally, it should be noted that the S&P 500 is currently up approximately 15% compared to the 2007 peak, where-as earnings are expected to finish 2013 up 16% in comparison to the same year. If you believe, that earnings are the key to equity prices, this metric is supportive of the fact that the market is not significantly over-valued.

In conjunction with price levels, the market seems reasonably valued on a valuation-basis as well. On a forward earnings basis, the S&P 500 is trading at 15.2 times earnings, versus a 30-year average of 14.4 times. In Canada, the S&P/TSX composite is trading at 14.7 times forward earnings. On a trailing basis, the composite trades at a 17.2 times earnings multiple, compared to a 30-year average of 18.1 times earnings. These metrics argue that the market is relatively fairly priced on earnings-to-date, however, the real question is whether or not these earnings can exhibit continued growth moving in to 2014.

> "The stock market is filled with individuals who know the price of everything, but the value of nothing."
>
> -Oscar Wilde

Corporate earnings expectations are a hotly-debated topic and one which we discussed briefly in our previous quarterly report. Earnings are driven by multiple factors, but the primary considerations are the over-all macro-economic environment, as well as corporate margins.

As discussed in our last letter, margins, as a percentage of revenues, are driven by a few primary factors: cost efficiency, cost of debt-financing (interest) and taxes. Of these primary factors, there are few that are likely to apply pressure to margins in the coming year.

United States:

- The CPI for the U.S. in December was reportedly up 1.5% in year-over-year terms.
- The NFIB Business Optimism Index was reported at 93.9, above estimates of 93.2.
- The unemployment rate in December was quoted at 6.7%, down from 7%.
- The Reuters/Michigan Consumer Sentiment Index was reported at 80.4, below estimates of 83.5.

American corporations currently are subject to one of the highest tax rates in the world (35%), so most believe that tax expenses are unlikely to increase and may even decrease. The Federal Reserve, despite undergoing tapering with its Quantitative Easing(QE) Program, has committed to remaining highly accommodative and assured the market that they will maintain short-term interest rates at historically low levels. Labour rates and wages, which are a large proponent of corporate cost-efficiency, are expected to remain stagnant as well, which should maintain gross margins as a percentage of revenues. In collaboration, all of this data points to the likely relative strong performance of those equities that can churn out top-line revenue growth. As a bottom line, corporations have proved capable at managing their margins, a fact that can be illustrated by the Citi Economic Surprise Index, whose performance can be seen in the chart below.

This index measures the percentage of corporations who report earnings that beat estimates and has been persistently rising since late 2013. Companies are consistently beating estimates, which is either a signal that market analysts have been too bearish, or that companies are remaining conservative in their own estimates. Both of these scenarios are bullish for equities if this trend should continue.

> "The pessimist complains about the wind; the optimist expects it to change; the realist adjusts the sails." – William Arthur Ward.

Europe:

- Consumer Confidence in the Eurozone was reported at -11.7, above estimates of -13.0.
- GDP in the third quarter for the Eurozone was reportedly up 0.1% in quarter-over-quarter terms.
- The unemployment rate in the Eurozone was reported at 12.1%, in line with estimates.
- The CPI for the Eurozone was reportedly up 0.7% in year-over-year terms.

With these thoughts in mind, it is clear to us that 2014 will be another 'stock-pickers' market, where we will focus our ability to choose strong companies who are likely to grow their top line revenues and exhibit an increase in earnings due to margin maintenance. With revenue generation being the key metric for 2014, we must take into account the likely macro-economic environment for the coming year and decide which areas of the market are likely to outperform in such a scenario.

Many of the fears that dominated the market in 2013 have generally subsided, as the Federal Reserve pursued its tapering initiative with a relatively positive response from the market, the sequester's results were largely absorbed, global growth outlook improved and the Eurozone recession subsided.

Despite overwhelming fear of the market's predicted response to tapering, equity markets actually rose in response to the announcement of the initiation of a tapering program that seeks to shave $10 billion off of the Federal Reserve's monthly purchases until the program is eliminated. Although set-backs may arise to stop the program from being phased out by the end of the year, the market seems to have viewed this program as a step in the right direction, which is a positive signal that market focus will return to fundamental analysis and step away from the 'Fed-focus' that it has exhibited as of late.

The effects of the sequester, although on-going, have largely been absorbed, with the estimated effect of the budget cuts translating into approximately 1.5% less GDP growth in the U.S. in 2013 than would have been exhibited without the program. Although some of the effects will continue to have some drag on the economy, the effects moving forward are estimated to more likely regulate to a drag-level of only 0.4 – 0.5% GDP. In conjunction with the first budget passed by Congress in 4 years, it is hoped that this will bolster business and consumer confidence and in turn translate into improved business investment and consumer spending.

> "The stock market is the story of cycles and of the human behaviour that is responsible for overreactions in both directions."
>
> - Seth Klarman

During 2013, the World Bank upgraded its forecast for global growth to 3.2%, from a previous estimate of 2.4%. This upgrade was justified by decreasing global austerity policies and improving advanced economies that are expected to assist export-reliant emerging markets return to healthy economic growth.

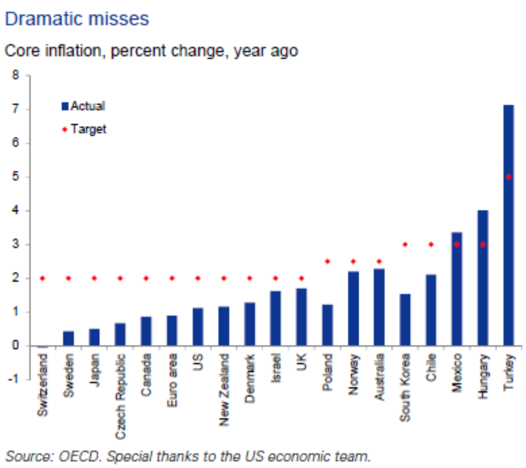
International:

- Chinese GDP in the fourth quarter was reportedly up 7.7% in year-over-year terms and 1.8% in quarter-over-quarter terms.
- The Leading Economic Index in Japan was reported at 110.8, above estimates of 110.6.
- The CPI in China in December was reported at 2.5% in year-over-year terms, slightly below 2.7%.
- The unemployment rate in Japan in November was reported at 4%, above estimates of 3.9$.

This upgrade in global growth optimism comes largely from an improving European Union, however, it should be noted that an emphasis should be placed upon *improving*, rather than healthy. Countries in the Euro area remain hamstrung by the recent recession and are still experiencing difficulties recovering, partially due to structural realities associated with being part of an Economic Union. Specifically, the major threat to the European economies in the coming year is deflation.

Deflation, characterized by steadily falling prices, is commonly misunderstood by the public as being a positive phenomenon. However, deflation can have dangerous economic implications and has recently been addressed by IMF Chief Christine Lagarde as "the Ogre that must be fought decisively."

Despite extremely accommodative monetary policy world-wide, inflation continues to stagnate or fall, as most major economies are consistently missing core inflation targets. The following graph exhibits this.



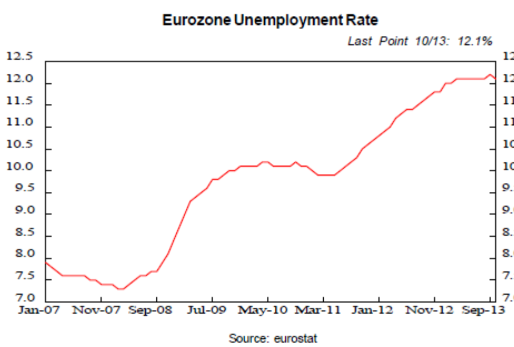
Although subdued inflation in developed markets such as the United States and Canada can be attributed largely to decreased consumer spending and de-leveraging, the Euro area deflation story is a bit more complex.

In the event of a recession, the typical response by a country's government is to devalue their currency, which in turn increases the attractiveness of their exports and allows themselves to increase activity in that sector and improve their economy. However, as the European Union members share a common currency, they are not able to utilize this tool. Accordingly, peripheral European countries have undergone cost-cutting initiatives by laying off workers and lowering wages in order to improve their cost structures and reduce their export prices in a bid to improve competitiveness in the global market. This practice reduces the amount of money available to the general public and thus creates decreased spending and deflation.

The major negative effects of a deflationary global environment can be seen on the corporate side, as wages are typically difficult to negotiate downwards and the relative value of debt outstanding increases, as the value of the money borrowed increases. These effects tend to decrease profitability of the companies, which are forced to accept lower prices for their products or services, while maintaining nominal wages and paying back increasingly valuable amounts of debt.

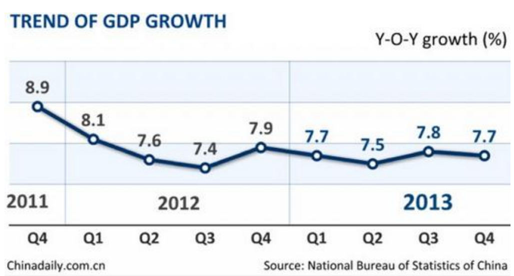
There are however, solutions to this scenario for the Euro area. The first solution would be to allow the weaker European economies to exit the Eurozone, effectively devaluing their currency and allowing their exports to increase in attractiveness. This option has been widely panned by the IMF and ECB, so is unlikely to occur. The more likely scenario is for the IMF and more specifically the healthier European economies such as

Germany, to foot the bill and bolster these economies until a time which they are able to support themselves. This is the option that the Eurozone seems to be pursuing, however, the risk is how long economies such as Germany remain willing to help out their weaker counter-parts. This scenario has the potential of dire consequences, although we would place a very small probability on the likelihood of any major tension or European Union break-up occurring. Despite the risks, this landscape reinforces the argument for slowly improving worldwide growth, as long as the IMF and ECB maintain supportive of the peripheral European nations. However, it also serves as a cautionary note of what could possibly rear its head to de-rail global markets



and also justifies the argument that Eurozone unemployment will likely remain historically high for the near future. See the chart above for a summary of persistently high unemployment in the Eurozone.

On the Asian side of the markets, focus remains on the tumultuous economies of China and Japan. Although Chinese GDP continues to fall on a percentage basis, the economy continues to grow at a strong pace and is likely to continue at such a rate in the near future and fuel demand for exports globally, especially from the Euro area. The following chart summarizes the decreasing growth, as a year-over-year percentage, in Chinese GDP.



Although commodity imports and economic growth remains strong in China, there are several factors that must be routinely observed in the coming year, the country's 'shadow banking' system being of the highest concern.

China's shadow banking system is a massive lending system outside of the formal channels, including activities by online finance programs, credit guarantee companies and microcredit firms. This market was $4.8 trillion in 2012, more than half the country's GDP and has been targeted by the country's leadership as a primary concern.

An example of the dangers of shadow banking is the recent funding of a Chinese coal company by China Credit Trust, which promised to return 10% a year upon origination, much higher than traditional deposits. However, the coal company has failed to achieve, key licenses for its activities and China Credit Trust has noted that it may not be able to pay $500 million that is due in the near future. This situation is an example of the dangers associated with shadow-banking and may well serve as a template for how the network will be dealt with by the country's leadership.

In Japan, Prime Minister Shinzo Abe has been successful with his massive monetary easing program in de-valuing the yen and – for the moment – decreasing the effects of rampant deflation that has plagued the country for years. The yen has depreciated to a level of approximately 105 yen per USD and has resulted in a large improvement for the companies exports and manufacturers. However, it is widely agreed that the economy must focus on structural reforms in the coming years in order to address their declining population, declining work force and aging population. The Japanese economy has returned to global growth for the near-term, but should be monitored moving forward due to its structural issues.

Overall, the outlook for North American equities seems to be largely positive, with most analysts estimating global earnings growth to amount to approximately 9% and the S&P 500 estimated to grow by 10-15%. Although over-valued yield stocks and momentum-based companies are likely to come under some scrutiny, value-based stocks and some growth stocks should have another year of good performance. Canadian equities, in general, are poised to out-perform their U.S. counterparts, as resource companies have been beaten up lately and are likely to gain attraction as global growth strengthens.

Gold prices are also likely to improve, as the commodity seems to have solidified its bottom and is unlikely to re-test its low of $1,180 that was reached last summer. The major sellers of the commodity were the exchange-traded funds (ETFs), which have, for the most part, sold all they are likely to sell. Despite this large selling by the ETFs, foreign and central bank demand was able to provide support for the price of gold and we expect that this demand should continue. In conjunction with the possible resurgence of demand from the ETFs, this could provide considerable upside for the price of bullion, which would provide a much-needed lift to precious metal stocks which have been shunned in the past couple of years.

2014 seems likely to remain a ‘stock-pickers’ market and we are confident in our ability to identify those companies with strong top-line growth opportunity and capable management that should perform well in the coming months. Although a healthy correction to the market is possible within the year, this would likely be seen as a buying opportunity (barring any major fiasco), as equity markets are predicted to end the year on a positive note.

MacNicol & Associates Asset Management: January 27th, 2014