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Market Bulletin

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Commentary

Debt debate weighs on stocks

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US equity indices last week posted their first weekly decline for this month, as investors unnerved by the political impasse took some money off the table ahead of the looming federal shutdown that is set to commence on October 1. On Friday, the U.S. Senate voted to finance the government through November 15 but removed language about cutting off funding for President Obama's health-care law, putting pressure on the House to avoid the shutdown. As we write this on Friday afternoon, it looks likely that debt-ceiling negotiations will carry on until the proverbial last minute on September 30, when spending authority expires.

What if neither party gives in and the shutdown does occur? For one thing, it would not be totally unprecedented. According to a Bloomberg article, a Congressional Research Service analysis shows that as many as 17 funding gaps occurred between 1977 and 1996. Two back-to-back shutdowns in 1995 and 1996 (Nov.14 – Nov.19 and Dec.16 – Jan.6) cut GDP by a quarter of a percentage point, according to Macroeconomic Advisers. It estimates a two-week shutdown this time would reduce GDP by 0.3 percentage point, while Moody's Analytics forecasts a three-to-four week shutdown would slash growth by 1.4 percentage points.

But the impact of a federal shutdown on economic growth would be overshadowed by the effect on financial markets and investor sentiment, if the events of 2011 are any indication. The political wrangling at that time led Standard & Poor's to downgrade the U.S.'AAA credit rating, leading to a spike in market volatility and a global stock-market correction that erased about $6-trillion in market cap from July 26 to Aug. 12, 2011. A repeat of that fiasco hopefully does not occur, since there have been major changes in the U.S. economic landscape over the past couple of years. As a Reuters columnist notes, spending reductions since 2011 have left little scope for further substantial reductions in discretionary spending. The Federal Reserve has also lowered growth expectations for the U.S. economy significantly since 2011, from an average of 4% before the debt ceiling debacle, to as low as 2% now. With the U.S. economy still vulnerable to shocks – internal or external – and U.S. equity indexes holding near record highs, a budget impasse and/or a federal shutdown could inflict significant damage on global equities. One can only hope that better sense prevails in Washington before things turn really ugly.

Equity Screens

Stocks at risk of a near-term decline

One of the biggest benefits of using an equity screen is that it can often unearth names that are a little off the beaten track. This week's screen has done precisely that, coming up with a bunch of stocks that are not really household names.

Being long equities, especially US stocks, is a strategy that has worked like a charm so far this year. Barring a last-minute collapse, it looks like even the month of September – historically the worst month for equities – will be unable to stop this year's bull run, with the Dow Jones up 3.0% so far this month (as of Sept. 27), the S&P 500 up 3.6%, and the Nasdaq Composite up 5.3%. But given that the risk of a significant pullback rises with every day that the markets continue to power ahead, we screened the broad US and Canadian indexes to identify stocks that could be vulnerable to profit-taking in the near term. Essentially we are looking for large-cap stocks with substantial debt and a high Price/Sales ratio that have outperformed the broad indices YTD. For a technical twist to these fundamental criteria, our final condition is that a MACD sell signal should have been triggered recently. Accordingly, our criteria are –

- Market cap > $1 billion
- Current Price/Sales ratio > 4
- Total debt to equity > 100%
- Days since MACD sell signal triggered < 10 (as of Sept. 27)

As can be seen in Table 1, only 9 stocks fulfilled these criteria. Seven of these are from the Russell 3000 and only two – lease financier **Element Financial** and **Valeant Pharma** – from the TSX. The stocks in Table 1 are ranked by their Short Interest Ratio, and as can be seen, three of these stocks have a SIR below 3 – **Ocwen Financial**, **Cheniere Energy** (a developer of LNG Terminals), and **AFC Enterprises** (which owns and operates Popeyes Chicken & Biscuits). The other four stocks are drug developer **Salix Pharma**, software company **Cornerstone OnDemand**, oil and gas company **Laredo Petroleum**, and multi-bank holding company **Glacier Bancorp**. <u>Please note that equity screens such as these are only a starting point for further analysis, and we strongly recommend that readers conduct their own due diligence</u>.

Table 1: Russell 3000 and TSX Composite stocks at risk of a decline

Ticker	Short Name	Price	Market Cap ($ bn.)	YTD chg. (%)	Price/ Sales	Debt/Equity (%)	Days Since MACD Sell Signal	Short Interest (% of Eqty Flt)	Shrt Int Ratio
OCN	OCWEN FINL CORP	$57.00	$7.74	64.8	5.4	242.5	2	3.48	2.15
LNG	CHENIERE ENERGY	$33.11	$7.91	76.3	26.6	228.5	3	5.64	2.63
AFCE	AFC ENTERPRISES	$43.49	$1.04	66.4	5.3	141.9	5	2.90	2.73
SLXP	SALIX PHARM	$67.19	$4.14	66.0	4.9	147.7	2	4.96	4.06
CSOD	CORNERSTONE	$53.11	$2.73	79.9	18.0	411.0	8	6.00	5.39
LPI	LAREDO PETRO	$30.00	$4.28	65.2	5.9	165.2	9	8.13	6.41
EFN	**ELEMENT FINANCIAl**	$12.74	$1.98	78.6	12.1	175.0	1	16.17	14.88
GBCI	GLACIER BANCORP	$24.30	$1.79	65.2	5.2	177.8	6	8.54	20.90
VRX	**VALEANT PHARMA**	$103.11	$34.31	72.9	7.8	189.3	2	4.42	30.51

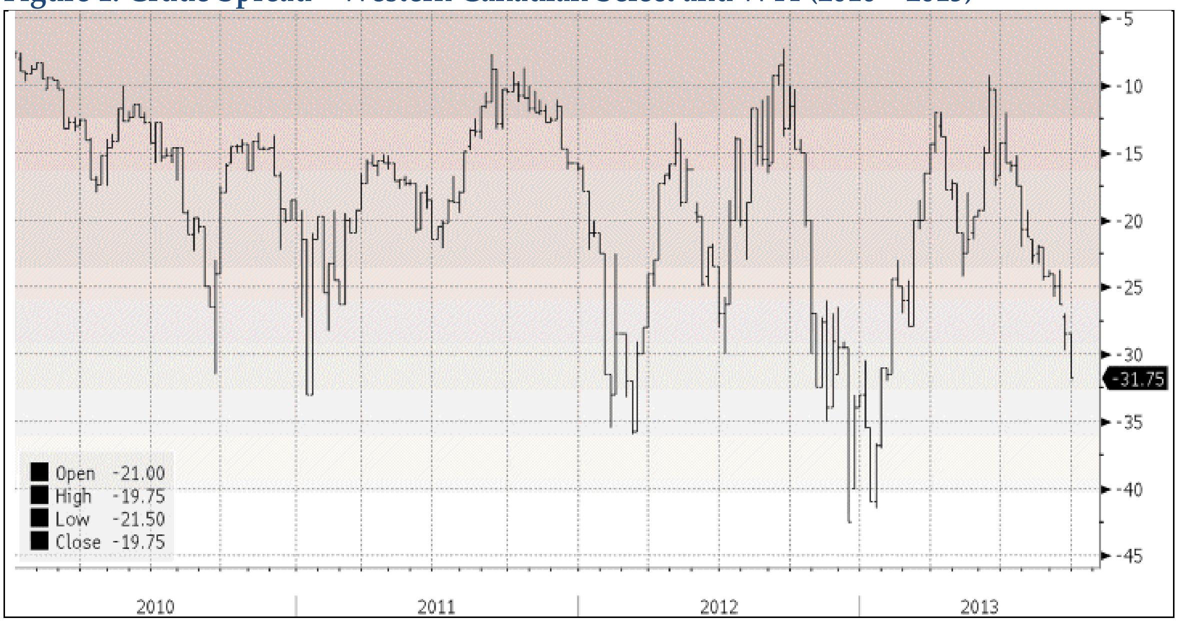
Source: Global Securities Research, Bloomberg

Chart of the Day

Canadian crude discount to WTI widens to eight-month high

Canadian crude is trading at the biggest discount to WTI since January 30 (Figure 1). As the chart shows, the spread narrowed to a low of less than $10 in September in the two previous years, but that narrowing occurred earlier this year, in June. Canadian crude has weakened in recent weeks on expectations of rising production from Alberta, while equipment breakdowns last week reduced demand for crude at refineries in the U.S. Midwest and Gulf Coast. Given that the spread has reached its widest in Q1 of the past three years, there is a possibility that it could continue to grow in the weeks ahead.

Figure 1: Crude Spread – Western Canadian Select and WTI (2010 – 2013)



Source: Bloomberg

Market Snapshot

At close on Friday, September 27, 2013

S&P TSX	12844.08	+2.46	**Commodities**			**Yields (%)**	**Can.**	**US**
TSX Venture	952.86	+4.73	Canadian $ (US cents)	97.06	+0.07	90 Day T-Bill	0.96	0.01
DJIA	15258.24	-70.06	Gold (Spot)-US$	1336.65	+12.56	2-Year Bond	1.20	0.33
S&P 500	1691.75	-6.92	Oil (WTI-Nov.)	102.87	-0.16	10-Yr.Bond	2.55	2.62
NASDAQ	3781.59	-5.83	CRB Index	286.98	+0.21	30-Yr. Bond	3.08	3.69

Thought for the Day

"You can't depend on your eyes when your imagination is out of focus." – Mark Twain

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