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Market Bulletin

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Commentary

Wrong time to abandon Canadian equities

Double-digit total returns quite possible for TSX in 2014

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A Bloomberg article on Friday, citing data from the Investment Funds Institute of Canada (IFIC), reported that Canadians sold about $780 million worth of domestic equity mutual funds in July and August. Canadian equity funds have recorded net outflows in every quarter since Q2 of 2011, and if the trend continued in September, the just-concluded Q3 would be the ninth straight quarter of outflows from these funds. The biggest beneficiaries of these outflows have been US equity funds, which had inflows of $1.79 billion in July and August. In the first eight months of 2013, net redemptions from Canadian equity funds (with at least 90% of Canadian holdings) amounted to $3.57 billion, while net sales of US equity funds were $5.17 billion. So inflows into US funds have exceeded redemptions of Canadian equity funds by $1.6 billion YTD, of which $ 1 billion occurred in July and August.

Canadian investors seem to be throwing in the towel with regard to domestic equities, a move precipitated by the massive under-performance of Canadian equities in comparison with US stocks in this bull market. The TSX lags the S&P 500 by over 15 percentage points YTD, and by 80 percentage points over the past 4½ years since this bull run commenced in March 2009.

In our opinion, this is the wrong time to be abandoning Canadian equities. The steady ratcheting down of global macroeconomic and geopolitical risk over the past couple of years may translate into robust global growth next year. The TSX, with its overweighting in cyclical sectors, may be well placed to benefit from this improved outlook for global growth, as it translates into higher prices for energy and commodities and improves earnings prospects for companies in these sectors. Another catalyst could be higher M&A activity in Canada, which at $71 billion YTD, is about one-third of the record $210 billion set in 2007. Backed by its dividend yield of 3.1%, double-digit returns are easily achievable for the TSX in 2014, in our view.

As every mutual fund prospectus will tell you, past performance is no guarantee of future returns. Canadian investors who are currently piling into US equities and dumping Canadian equities would do well to remember that caveat.

Equity Screens

Markets a-twitter over IPOs

With the imminent IPO of micro-blogging service Twitter Inc shining the spotlight on recent public offerings, we decided to review the larger offerings in the US and Canada this year. Twitter is looking to raise $1 billion, which would give it an implied valuation of $12.8 billion. While the IPO market is still far from the heady days that marked the market peaks of 2000 and 2007, investors have been increasingly receptive to public offerings, with the enthusiasm for some of these offerings being downright euphoric. For example, sandwich-maker Potbelly Corp (PBPB) had its IPO on Friday, and gained as much as 140 % from its IPO price of $14.

We used the following basic criteria for our screen –

- IPO in 2013
- Market cap > US$500 million
- Listed in US or Canada

87 IPOs this year fulfil these criteria, of which we have listed the 20 most recent (as of Thursday, October 3); the average gain for these 20 stocks since their IPO is 34.3%. Only one Canadian company appears on this list of 20 (TransAlta Renewables), and overall, there are only four Canadian firms in this list of 87. <u>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	GICS Sector	IPO Date	Mkt Cap($mn)	Price*	Chg.fm IPO
BURL	BURLINGTON STORE	Consumer Discretionary	10/01/2013	$1,781	$24.86	46.2%
ESRT	EMPIRE STATE REA	Financials	10/01/2013	$1,210	$13.20	1.5%
RMAX	RE/MAX HOLDINGS	Financials	10/01/2013	$899	$30.21	37.3%
RNG	RINGCENTRAL IN-A	Telecommunication Services	09/26/2013	$1,046	$16.91	30.1%
VMEM	VIOLIN MEMORY IN	Information Technology	09/26/2013	$614	$7.50	-16.7%
PEGI	PATTERN ENER	Utilities	09/26/2013	$1,177	$23.05	4.8%
PINC	PREMIER INC-CL A	Health Care	09/25/2013	$4,503	$31.06	15.0%
OPHT	OPHTHTECH CORP	Health Care	09/24/2013	$1,039	$33.24	51.1%
FUEL	ROCKET FUEL INC	Information Technology	09/19/2013	$2,002	$60.50	108.6%
MYCC	CLUBCORP HOLDING	Consumer Discretionary	09/19/2013	$952	$14.93	6.6%
FEYE	FIREEYE INC	Information Technology	09/19/2013	$4,754	$40.47	102.4%
XLRN	ACCELERON PHARMA	Health Care	09/18/2013	$702	$25.79	71.9%
BNFT	BENEFITFOCUS INC	Information Technology	09/18/2013	$1,150	$47.31	78.5%
TPRE	THIRD POINT REIN	Financials	08/14/2013	$1,493	$14.46	15.7%
EVHC	ENVISION HEALTHC	Health Care	08/13/2013	$5,087	$28.20	22.6%
RNW	TRANSALTA RENEWA	Utilities	08/09/2013	$1,134	$9.88	2.0%
CVT	CVENT INC	Information Technology	08/08/2013	$1,341	$33.38	59.0%
QEPM	QEP MIDSTREAM PA	Energy	08/08/2013	$1,266	$22.44	6.9%
WPT	WORLD POINT TERM	Energy	08/08/2013	$664	$20.13	0.7%
FI	FRANK'S INTERNAT	Energy	08/08/2013	$4,805	$31.30	42.3%

Source: Global Securities Research, Bloomberg

Chart of the Day

Global M&A activity still long way from 2007 peak

Figure 1 shows global mergers and acquisitions activity for the past 10 years. As can be seen, M& A activity is still a long way from its 2007 peak, or to be precise, about 58% below ($4.08 trillion in '07 vs. $1.73 trillion YTD). Of course, with close to three months still left in this year, global M&A could well exceed the $2 trillion mark, depending on how the markets fare over the rest of 2013. The average deal size YTD is currently at a six-year high of $87 million, although it remains well below the $118 million average of 2006-07. <u>However, the average premium being paid for target companies is a rich 27.3%, the highest in this Millennium. Overall, we believe that rising M&A activity could lend support to equity markets in 2014</u>.

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

Source: Bloomberg

Market Snapshot

At close on Friday, October 4, 2013

S&P TSX	12758.65	+23.53	**Commodities**			**Yields (%)**	**Can.**	**US**
TSX Venture	955.36	+11.51	Canadian $ (US cents)	97.13	+0.34	90 Day T-Bill	0.96	0.02
DJIA	15072.58	+76.10	Gold (Spot)-US$	1310.55	-6.22	2-Year Bond	1.18	0.33
S&P 500	1690.50	+11.84	Oil (WTI-Nov.)	103.63	+0.32	10-Yr.Bond	2.58	2.64
NASDAQ	3807.75	+33.41	CRB Index	286.45	+0.90	30-Yr. Bond	3.11	3.72

Thought for the Day

"My idea of a group decision is to look in the mirror." – Warren Buffett

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