June 2014 Newsletter

PM Commentary - John Germain
Senior Portfolio Manager

- After outperforming most global equity markets for the first four months of 2014, the S&P/TSX Composite gave up some ground in the month of May as it declined 0.3%. Meanwhile the adage “Sell in May and go away” didn’t pertain to most global equity markets this year as the S&P 500 Index advanced 2.1% to a new all-time closing high while the MSCI World Index advanced 1.9%. The NASDAQ Composite Index also snapped back rising 3.1% as the momentum out of growth into value stocks receded.
- Even with concerns surrounding the tapering of bond purchases by the U.S. Federal Reserve, decelerating economic growth in China as well as stretched valuations after exceptionally strong returns in 2013, equity markets have still provided good returns year-to-date with the TSX Composite up 7.2%, the S&P 500 Index up 4.1% and the MSCI World Index up 3%.
- Part of the allure of equity markets continues to be expectations that the global economy will continue to improve. With GDP in the U.S. declining by 1% in the first quarter of 2014, with most attributing the weakness to the harsh weather experienced this past winter, expectations are that consumers and businesses will start spending and producing again for the rest of 2014. The recently reported ISM Manufacturing PMI Index which came in at 55.4, up from 54.9 in April and 51.3 in January would suggest that growth has started to come back.

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By The Way – Jack Way
Vice President

Markets continue their inexorable rise. Profits are good, job growth is strong and inflation is contained; just to cite a few reasons to remain bullish. As we mentioned last month, this rally is not as strong and broad as others of the last several years, but is still impressive. The market is different in that, while profits are available, stock selection and timing have become much more important. No longer is the tide lifting all boats. Intermittent consolidations and pullbacks are to be welcomed so that markets can renew and refuel for the next leg higher. They also provide opportunities to test for signs of internal weakness that would warn of something more meaningful in terms of a decline. It is interesting to note that despite new highs there is still much skepticism among investors. Retail investors took $550 billion out of U.S. equity mutual funds in the five years ended 2012. In 2013, with the S&P 500 up 32%, retail investors only bought back $18 billion. Institutional investors also have avoided equities; in 2002 U.S. Endowment Funds held 50% of their assets in stocks, by the end of 2013 that number was 34%. That money will not necessarily come back during this cycle given the scars inflicted by the near disaster of 2008, but it remains potential ammunition for stronger markets and a positive for those with a contrarian bent.

The European Central Bank came through as advertised and took new initiatives to stimulate its economies. It stopped short of a program of quantitative easing, but moved aggressively with rate cuts and lending programs.

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Investment Ideas: Premium Income Corporation – Leveraged Bank Exposure

Premium Income Corporation (TSX: PIC.A and PIC.PR.A)

- Split share corporation designed to provide Class A shareholders with leveraged exposure to five Canadian Banks (BMO, BNS, CIBC, RBC and TD) and Preferred shareholders with regular monthly distributions (primarily taxed as dividends)
- Current leverage on Class A share of approximately 2.8X (leverage declines as total NAV increases)
- Good entry point to buy leveraged exposure to Canadian banks via Class A shares
  - On average, the Canadian Banks beat analyst’s expectations in the second quarter as earnings per share grew 13% year-over-year
  - The beat came from strong operating leverage at the domestic banking unit as provisions for credit losses continued to decline as well as better capital markets related revenues due to improved trading and wealth management revenues
  - We expect dividends and share buybacks to increase going forward with Common Equity Tier 1 Capital ratios exceeding or approaching the 9.5% level we believe bank managements are targeting
  - The Canadian bank index is currently trading at 11.5x consensus 2015 EPS estimates which is about 75% of the TSX Composite P/E ratio, well below the 10-year average of 81% which suggests there is room for multiple expansion

		Annualized Total Returns(1)					
Premium Income Corporation	Current Yield(2)	1 Year	2 Year	3 Year	5 Year	10 Year	Since Inception(3)
Class A Share	**10.5%**	**75.1%**	**40.7%**	**15.3%**	**38.7%**	**11.1%**	**13.8%**
Preferred Share	5.6%	5.9%	5.9%	5.9%	5.9%	5.9%	5.9%
Combined unit (Class A + Preferred share)	7.2%	23.3%	15.3%	8.6%	11.4%	6.1%	8.0%

(1) For each period ending May 31, 2014
(2) As at June 12, 2014, based on most recently declared distribution annualized divided by the closing market price
(3) Total return since inception on October 30, 1996 to May 31, 2014 based on NAV per unit

PM Commentary - cont'd

- At the same time, bonds have experienced inflows so far in 2014 with 10-year U.S. Treasury yields touching a low of 2.4% on May 29th after closing 2013 at 3.0%. We expect the decline in yields will provide support for equities as expected risk premiums have risen to levels where equities look attractive relative to bonds.
- Telecommunication Services was the best performing sector in Canada in May up 3.2% while Materials lagged the market down 4.2%. The Energy sector is also the strongest performing sector in the TSX so far in 2014, up 13.5% vs. the TSX Composite up 7.2% after underperforming the broader market in 2012 and 2013, on strong earnings and attractive valuations. We continue to have an overweight position in the Energy sector due to our favorable view on valuations.
- South of the border, Telecommunications Services was also the best performing sector up 3.4% benefitting from lower bond yields relative to the high dividend yields the Telecom companies payout.
- Although we expect economic numbers to rebound in the 2nd quarter as the impact from the harsh winter has passed, we will be watching economic releases closely to see if other factors such as China's GDP slowing, the removal of quantitative easing by the U.S. Federal Reserve and also the tensions between Russia and the Ukraine are having an impact
- Outdoor patio season is clearly upon us as Barley was the best performing commodity for the month, up 12.7% during the period.
- Finally, volatility for the equity market continued to decline in May with the CBOE Volatility Index ("VIX") hitting its lowest monthly closing level since January 2007 at 11.4. After increasing our call writing in the month of April, we decided to buy back some of the calls in May to take advantage of the lower volatility. We also purchased some put protection in the Gold Participation and Income Fund (GPF.un) during the month to take advantage of the lower volatility (ie. lower cost) as well as the seasonally weak period that Gold bullion and gold stocks typically experience in the June to August period.

By The Way - cont'd

European banks will now have the privilege of paying to keep their money at the Central Bank with the introduction of a negative interest rate for bank reserves. The Bank also left the door open for future QE should that be required. The economic effect of these programs is open for discussion. But as we have pointed out before, the fact that Central Bankers are prepared to take whatever steps necessary to support the economy gives comfort to those investors moving out the risk curve and keeps markets moving higher.

Of at least equal importance for the European Union is the backroom fight over who will be the new Commission President. Also of concern was the number of anti-Union candidates who gained seats in the recent European Parliamentary Elections. (It was strange to see those candidates cheering their election to the Parliament of a Union they oppose.) Among those elected were also many nationalist, anti-immigration, ultra-right wingers as well as the traditional Euro-sceptics. There was a low voter turnout and certainly a sense of "throw the bums out", but for whatever reason, it represents a shift in European politics that has potentially important implications for the longer term. As for the Presidency of the Union, the former Prime Minister of Luxemborg, Jean-Claude Junker was expected to take the position by virtue of his leadership of the party with the most members in the Parliament. However, this has met with disapproval from some member countries, particularly Great Britain. In short, the argument centers around the division of power between the Union and the governments of the individual countries. This is not just a dispute about Mr. Junker's current candidacy, but sets a precedent about the future of the Union and Great Britain's continued membership. The closest analogy I can think of is the struggle during the mid 1800's in the U.S. between the Federal Government and the proponents of state's rights - and we know how that ended up. Finally, we can't leave a discussion about Europe without noting that the Italian National Statistics Office reported "drugs, prostitution and smuggling will be part of GDP as of 2014". For all his faults, we must thank Silvio Berlusconi for his contributions to the growth of the Italian economy.

Speaking of voter dissatisfaction, in a stunning upset Republican Eric Cantor of Virginia became the first House Majority leader in history to lose in a primary. The winner, David Brat, is much more conservative (a "tea party" member if you will) who won handily by 11 percentage points in a heavy voter turnout. This more radical element of the party has been relatively quiet since taking the blame for last year's government shutdown. This victory, plus others in Texas and Mississippi will likely give it more confidence to press the conservative agenda. It is only one event, but it sounds like the first bullet has been fired in this mid-term election battle. Legislation could come to a standstill, and positions become more entrenched. President Obama is threatening to move unilaterally, through executive order, to enact some of the legislation he considers most important; such as immigration reform. Whether he has the authority to do so is open to question, but in any case this demonstrates the difficulty in finding compromise in the current environment. Let's hope this is not the beginning of a new round of government dysfunction in Washington. A clear winner in November will be able to set its own agenda, with implications for companies and markets.

Forward Looking Information and Disclaimer

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