strathbridge
ASSET MANAGEMENT

August 2014 Newsletter

PM Commentary - John Germain
Senior Portfolio Manager

After rising to all time-highs at the end of June, most major market indices retreated in the month of July based on:

- geopolitical concerns in both the Ukraine and the Middle East
- Argentina's debt issues towards the end of the month
- rising inflation expectations that could lead to an earlier normalization of US monetary policy.

The S&P/TSX Composite bucked the trend rising 1.2% for the month, while emerging markets also continued to advance with the Shanghai A Share Index leading all major markets up 7.5% and the MSCI Emerging Markets Index rising 2.5%.

Meanwhile, U.S. and European Indexes declined:

- S&P 500 Index down 1.5%
- FTSE 100 (U.K.) down 0.2%,
- CAC 40 (France) down 4%, and
- DAX 30 (Germany) down 4.3%.

All 3 major European Indexes are now in negative territory for the year.

Small Caps underperformed after outperforming Large Caps in June with the Russell 2000 and S&P/TSX Venture Indexes down 6.1% and 2.6% in July.

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By The Way – Jack Way
Vice President

The European economic recovery has moved from "fragile to frail" according to Nancy Lazar of Cornerstone Macro, one of our favorite economists. It's a subtle but meaningful distinction, suggesting an increasing possibility of a negative outcome for growth in the Eurozone. Germany has long been the growth engine, the stalwart dragging the rest of Europe along with it. But now it is being buffeted on many sides. German Industrial Production increased a very modest 0.3% in June, and is down 2 ½% from its peak in February. Both business expectations and leading economic indicators are also lower this year. The so-called periphery countries of Europe offer no help as they continue to show weak to negative growth. The best is Spain with increases that are encouraging but barely noticeable in the big picture. Italy, on the other hand is back in recession after second quarter real GDP declined 0.8% following the first quarter decline of 0.4%. This is the country's third such recession in the last 6 years, and GDP is now down 9% from the 2008 peak. Greece was pleased to announce that unemployment decreased in May to 27.2% from 27.3%; no more need be said. Slower growth in China and conflicts in the Middle East are also impacting German exports. Now the new big concern is the effect the ongoing hostilities in the Ukraine are having on Germany in particular, but also all European economies. There are strong trade ties to Russia, such that weakness in that economy, along with the…

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Low Volatility U.S. Equity Income Fund (TSX: LVU.UN)

Notice: 10% INCREASE IN DISTRIBUTION RATE AND TWO SPECIAL DISTRIBUTION OF $0.10 PER UNIT

- **Distribution Rate Increase:** 10% increase in the rate of distributions to 5.5% annually of Net Asset Value from 5.0% effective August 2014
- **Special Distributions**: $0.10 per unit payable to unitholders of record on September 15, 2014 and October 15, 2014
- Due to continued strong performance of the fund and realized capital gains expected to be in excess of regular distributions for the year
- Low volatility strategy with a focus on providing stable income
- Benefit from improving U.S. economy with broader industry diversification than the TSX
  - Valuations reasonable: Current P/E ratio of 17.1x compared to an average of 19.7x since 1991
  - Corporate earnings beating expectations
  - Housing and employment continue to improve
- Large-cap U.S. equities selected from the S&P 100 Index, many with multinational operations

		Total Return	
	Current Yield(1)	One Year	Since Inception(2)
Low Volatility U.S. Equity Income Fund	**5.7%**	**17.1%**	**26.2%**

(1) As at August 13, 2014, based on most recently declared regular distribution annualized, divided by the closing market price
(2) Total return since inception on March 13, 2013 to July 31, 2014 based on NAV per unit, annualized total return since inception is 18.3%

PM Commentary - cont'd

- As expected the U.S. economy bounced back from its weak first quarter GDP reading with the first print for 2nd quarter GDP coming in at 4%, much greater than the 3% expected. U.S. Consumer Confidence also rose to its highest level since October, 2007 on the back of better employment numbers.
- Global Central Banks seem to have achieved a soft landing, but loose monetary policies have started to show up in higher inflation numbers which we are watching closely.
- At the same time, long-term interest rates show no concerns of inflation and continue to hover near the lows of the year, with 10-year U.S. Treasury yields ending July at 2.56% and Canadian 10-years at 2.16%. Meanwhile, German and French Government Bonds are trading well below U.S. and Canada with their 10-year bonds closing July at 1.17% and 1.55% respectively, on a flight to safety as Russia – Ukraine tensions heat up again and also on expectations the ECB will eventually start with its own quantitative easing.
- Consumer Staples was the best performing sector in Canada for the month of July up 6.20%, led by Loblaw Cos. Ltd. after announcing a restructuring change on July 18 that will see Galen Weston Jr. take over as President from Vincent Trius. The Energy sector meanwhile lagged the TSX down 2.4% after outperforming the rest of the sectors for the first half of 2014. Similar to last month, we have reduced our weight in Energy and continue to increase our weighting in the Materials sector by adding to the Golds.
- South of the border, Telecom Services was the best performing sector up 3.7% benefitting mostly after a press release from Windstream Holdings Inc. on July 29th that it would spin off its physical assets into a Real Estate Investment Trust which wouldn't have to pay federal income tax.
- Finally, volatility picked up in July mostly due to geopolitical factors after an almost unsustainable calm for the last few months. The CBOE Volatility Index ("VIX") closed at 16.95 after trading around 12 for most of May and June. We increased our call writing during the month as we became more tactically cautious and the increase in volatility, mostly for our U.S. holdings, compensated us enough for selling away upside. Our view is that this is another correction in the 5% range and that we will be closing out our option positions sometime in August.

By The Way - cont'd

sanctions imposed, are certain to have a significant negative impact if the turmoil continues. Financial markets have shrugged off geopolitical risk with regularity over the past decade. In our minds this is the first occasion in some time where such a conflict could have a meaningful influence on the global economy.

In the face of the weakness, German 10-year bonds are currently trading at 1.05% (below July month-end yields), remarkably low and a major factor in pushing U.S. Treasuries below 2.5%. (The correlation between the two markets is 92%). Perhaps even more amazing to me, Bulgaria just sold 10 year bonds at 3.05% and the deal was three times over-subscribed. I admit to little knowledge about Bulgaria and its economy, but my sense is that its bonds should trade at more of a premium than 0.5% to U.S. Treasuries. The explanation for such a low rate would suggest investors do not fear sovereign risk as long as central bankers are there to prevent any defaults. Which brings us to the silver lining of European economic weakness (along with the fear of deflation); the European Central Bank (ECB) is close to implementing new policies of quantitative easing. It is now two years since ECS President Draghi said the Bank would do "whatever it takes to preserve the Euro". The time may be near when he will be called upon to back up these words. As we have said ad nauseum, such Central Bank easing has been good for financial markets, particularly risky assets, and until proven otherwise we would expect the same.

Like the one-eyed man in the land of the blind, the U.S. economy and market continue to offer the best opportunity for investors in our opinion. While the economy is not as robust as we might wish, reports (such as Jobless Claims falling to 289,000; Non-Farm Purchasing Managers Index rising to 58.7; and Factory Orders up 1.1% in June) continue to improve. And in times of stress and uncertainty the U.S. financial markets remain the safe haven. We are especially pleased to see U.S. corporations reporting strong earnings providing support for the stock market. On the policy front, the November mid-term election still looms large as to what legislation we might see over the next two years. In the meantime, the two parties have hardened their positions, and not accomplishing anything has become its own reward.

So despite some warts here and there, our expectations for U.S. capital markets remain long-term positive. Canada has no serious issues, but will not likely outperform until commodity prices and its trading partners, particularly China and Europe, become stronger.

Finally, geopolitical risk is as high today as ever. The situations in Gaza and the Ukraine are of special concern, given the potential impact on continued global peace and prosperity.

Forward Looking Information and Disclaimer

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