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Canadian stocks in the bargain bin

After a year of collapsing oil prices, a steadily weakening currency and an upcoming election that may not be investor-friendly, a lot of people are down on Canada. It seems each day we are treated to news stories about the next U.S. hedge fund that is running with a "short Canada" theme, waiting for our version of the housing crisis to emerge. This has weighed on the sentiment of Canadian investors, who are inundated with scary articles from the media (fear sells more papers than optimism) and wild market volatility in commodities and China's stock market.

We're not going to sugar coat it – recent economic data and the behavior of commodities has been far from encouraging, and the actions of our central bank to cut interest rates once again suggest they see continued weakness in the Canadian economy. We certainly won't lay claim to predicting all that has happened in the Canadian economy and the TSX, but we have had a long-standing view to make portfolios look less like the commodity-heavy TSX and increase U.S. dollar exposure. This has benefitted performance in our managed accounts, but it doesn't remove the frustration of watching a portfolio largely tread water year to date, with stalwarts such as the banks not performing despite a steadily growing stream of earnings. The dialogue has now changed to "why own any resources at all" and while we sympathize with that view, we have a hard time making an all-in bet that these sectors are dead forever, particularly from today's levels.

At times like this we think it makes sense to take a step back and ask how much of this is priced into markets? Let's take a quick review:

- Canadian interest rates sit near all-time lows across the yield curve, suggesting the bond market is pricing in low interest rates (and a weak economy with no inflation) for a long time.
- The Canadian dollar recently hit a 10-year low versus the U.S. dollar, and is 8% undervalued using purchasing power parity as a proxy.
- The TSX now sits at the same level it did 18 months ago and yields over 3%, double the 10-year Canada bond yield.
- The TSX Energy Index is down 35% from its 2014 highs as of this writing, pricing in a view that commodity prices do not recover for a long time.

Suffice it to say we feel that a lot of bad news is already priced into the market. Canadian banks are trading at 10x forward earnings estimates (versus a 20-year range of 8x-20x), have dividend yields >4%, and all indications we have thus far suggest their main business lines continue to chug along despite the weakness in commodities. Our favoured banks have significant international exposure that should benefit from stronger growth abroad and foreign currency translation. We also see opportunities in the energy infrastructure space, as many companies that make their living transporting petroleum products have sold off as if their livelihood is entirely tied to the price of crude oil. While growth rates aren't what they once were, we feel this is well reflected in the price, with a steady stream of dividends waiting for those taking a longer-term view.

History shows that it is U.S. recessions that lead to protracted bear markets, and that volatility outside of the onset of recession should be treated as a buying opportunity. We scour the economic data on a daily basis for hints that a U.S. recession is coming and continue to come up empty handed. While there is certainly a risk that Canada suffers a "technical recession" of two consecutive quarters of negative GDP growth, the pain is likely to be felt unevenly as a weaker currency eventually leads to an uptick in manufacturing and tourism in the non-resources sectors of the economy.

All corrections are uncomfortable, and in the midst of each one we have to make a judgment call: is this a run of the mill correction or the start of something worse? With the U.S. economy on track and Europe picking up speed, we think this is a typical correction, which is amplified on an index level by the heavy influence of the resources sectors in the TSX. We often talk about how it has been nearly 1400 days since the S&P 500 went through a 10% correction, but the TSX has seen a 10% correction as recently as October 2014, when the market fell 11.4% peak to trough on a closing basis. Since commodities peaked, the TSX has become a more volatile index than the S&P 500. It has gone through three corrections (-11.4%, -9.3% and -9.4% currently) in the past two years versus two >5% corrections of -5.76% and -7.4% for the S&P 500 and unlike the S&P 500, the TSX has not set a new all-time high since September 2014. This is a trend we expect to continue until commodities find some support, and argues once again for constructing a portfolio that deviates from the heavy commodity weightings in the TSX.

Our strategy has not been reliant on commodities "working" and for the most part we advocate holding the line on underweight positions in those sectors. While we risk underperforming the market on a sudden snapback in commodity prices, that is a risk we are willing to live with until we have more visibility. Outside of the resources, we see many great companies with a wide competitive "moat" and strong management teams trading at what we feel are discounts to intrinsic value. It is during weak markets when the groundwork is laid for strong future returns, and we feel the recent weakness in Canadian equities has opened up some interesting opportunities to deploy capital.

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