The Lato Letter – Summer 2012

Macro issues rose to the forefront once again during the second quarter leading to market declines in all North American equity markets, particularly in the commodity sensitive Canadian market. A statement I made in last quarter's commentary, "a whiff of macro-economic problems will continue to bring sharp sell-offs", certainly held true as we experienced several sharp sell-offs followed by robust rallies as markets reached strong support levels.

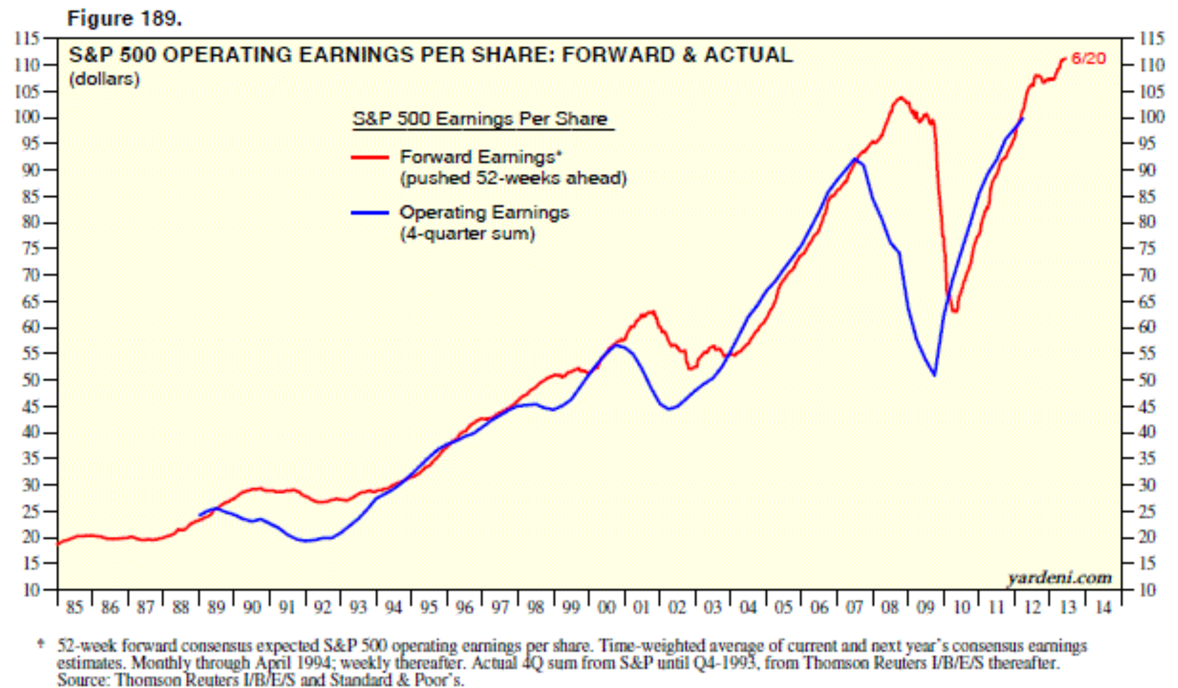
European concerns waned toward the end of the quarter with the results of the Greek election and a financing package for Spain put in place. However, there is no doubt that economic growth will be slow in Europe for the conceivable future and although the equity market did rally strongly on the aforementioned news, muted economic growth will slow continued earnings growth of many North American companies.

China has also seen slower economic growth over the last few months. The growth rates would still be highly desirable by North American economic standards but again any reduction will pressure the strength of their role as the marginal buyer of both raw commodities and finished products. Finally, after great job growth in the first quarter in the US, job growth has slowed in the second quarter while the uncertainty of an election campaign hangs over the market.

Now that I have presented some somber overtones, I continue to believe very strongly that as witnessed several times in the quarter there is strong underlying support to the North American equity market that is based on compelling valuations, very favourable monetary conditions and the balance sheet strength of the vast majority of North American companies. In other words, although those somber overtones are present, they are well discounted into equity prices. Markets have tremendous discounting abilities and have digested the impact of many of the macro-economic woes and should also begin to discount a return to more favourable global economic conditions well before they happen.

At the end of the day, macro-economic issues impact stock prices but the prime driver long term has been and always will be the underlying earnings of companies and the market as a whole. The chart below (courtesy of Yardeni Research Inc.) shows the earnings growth of the S&P 500 over the last 30 years. The financial crisis of 2008 obviously caused a significant interruption to the long term growth trajectory of earnings. After a recovery in 2009, the earnings growth trajectory is back on track and given the very low Price/Earnings (P/E) multiple of the market, even with the possibility of slowing earnings growth, equity markets represent good long term value at these levels.

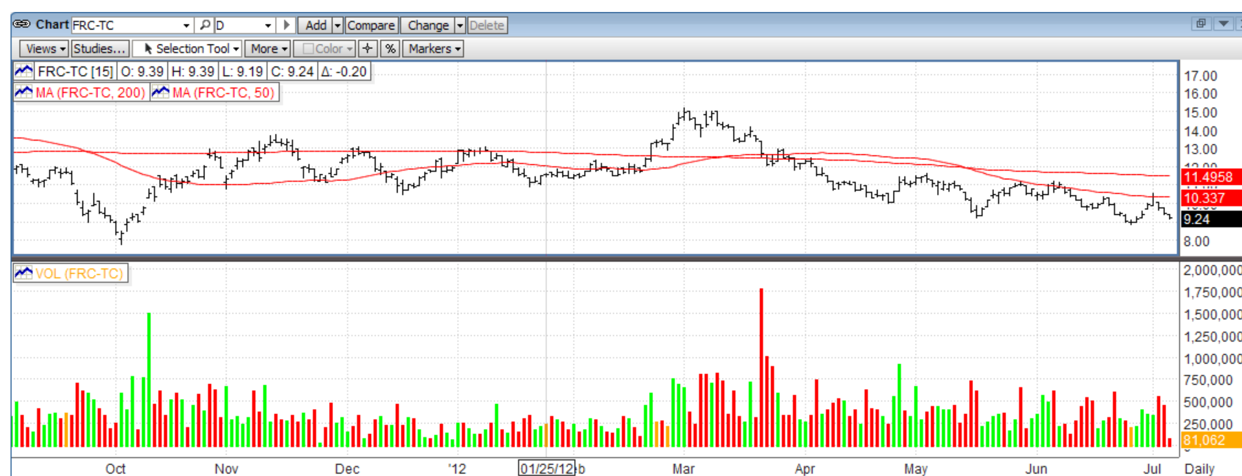
I don’t anticipate a robust upward move over the summer given the uncertainties and the continued skittishness of investors but also believe that any declines, similar to last quarter, will be contained because of the compelling valuations, positive monetary conditions and financial strength mentioned earlier.



One market that did exhibit strength during the last quarter was the natural gas market. Prices are still at historically low levels but are also significantly higher than they were three months ago. The stronger prices were reflected in the pricing of natural gas stocks such as **Tourmaline Oil Corp. (TOU-TSX, $26.88 on 30/06/12)** which was up 22% last quarter. Although some of the natural gas stocks did rebound nicely, the oil and gas service stocks continued to languish during the quarter and into the early days of the current quarter.

With the weakness within the group, I have taken the opportunity to add a new oil service stock to portfolios since the end of the quarter. **Canyon Services Group Inc. (FRC-TSX, $9.95 on 30/06/12)** was down 18% last quarter and almost 40% from its high last year in spite of year over year earnings growth of 22% in the first quarter.

Canyon provides specialized stimulation services to exploration and production (E&P) companies operating in the Western Canadian Sedimentary Basin (WCSB). Advanced stimulation technology deployed by Canyon includes the use of specialized fracturing and acidizing equipment, together with materials chemically engineered to develop and implement treatment solutions. The hydraulic fracturing division offers a complete line of hydraulic fracturing services and fluid systems.



With the increased utilization of horizontal drilling by exploration companies, the demand for Canyon's services has continued to increase in spite of the reduced explorations budgets of many of the companies operating in the WCSB. Canyon has increased its capacity significantly over the last several years but has maintained a very solid balance sheet while doing so. Canyon earned $1.51 per share in 2011 and is expected to earn $1.69 this year and $1.85 in 2013. The quarter end price equates to a P/E multiple of less than six times this year's earnings, which is well below the industry average. In addition, Canyon pays a 60 cent per share dividend, providing a dividend yield of over 6%.

Much like my earlier statement about not expecting a robust recovery for the market, I also would not expect an immediate and/or robust recovery in Canyon until exploration budgets for Canadian E&P companies begin to expand. Until then, the price represents a great entry point and the 6% yield provides solid support and income until then.

Market volatility may be the constant over the next quarter but my view that 2012 will be an average performance year for equities continues. That view is only tempered by my prevailing thought that if there is a surprise, it could very well be an upside surprise as investors as a whole eventually feel more comfortable about equities.