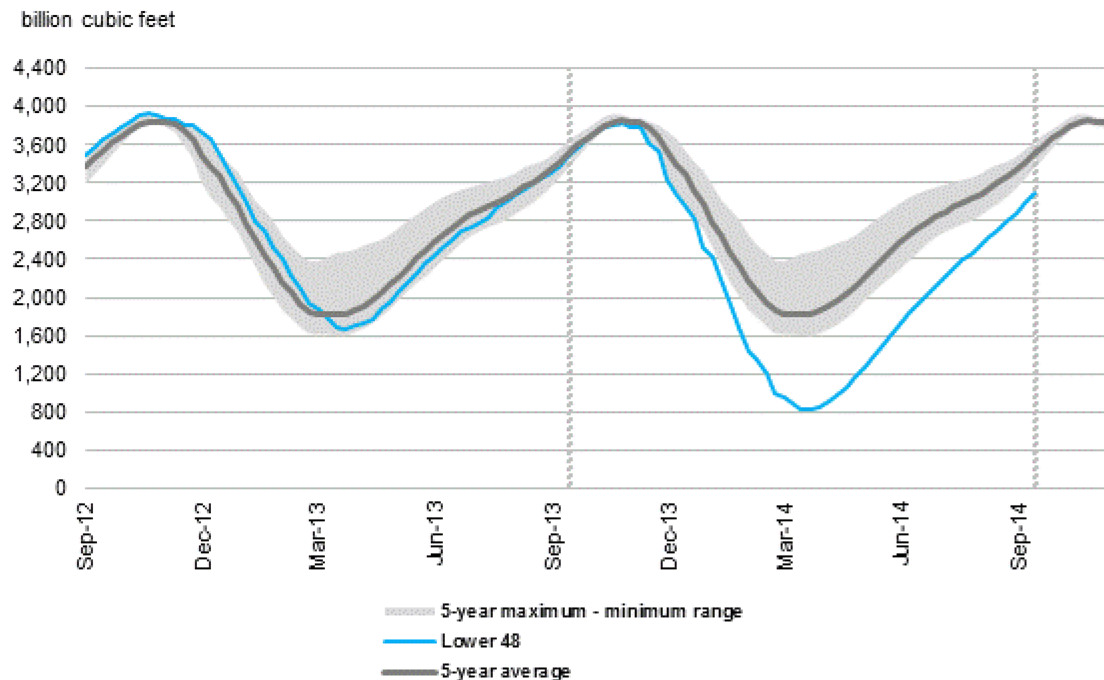
The Lato Letter – Fall 2014

Equity markets in North America set new all-time highs during the quarter but as the markets moved to those new altitudes there was a fair degree of turbulence. The question in the forefront of most investors' minds is whether or not these recent highs mark the end of the bull market that started in March 2009. Before presenting the reasons why I feel why the market has more upside to come, I will state upfront that I remain constructive on equity markets and continue to have maximum exposure to equities in the portfolios that I manage.

The third quarter was a difficult quarter and ironically, the group that I featured in last quarter's commentary caused the most difficulty. As I wrote about the energy group in that commentary: "After such a strong move in the group, the obvious question is whether or not the group has run its course and will be subject to a major correction. The answer to that question is that a correction in the group is a possibility but that the positive long-term outlook of these companies outweighs the risk/reward of taking profits and exiting the group."

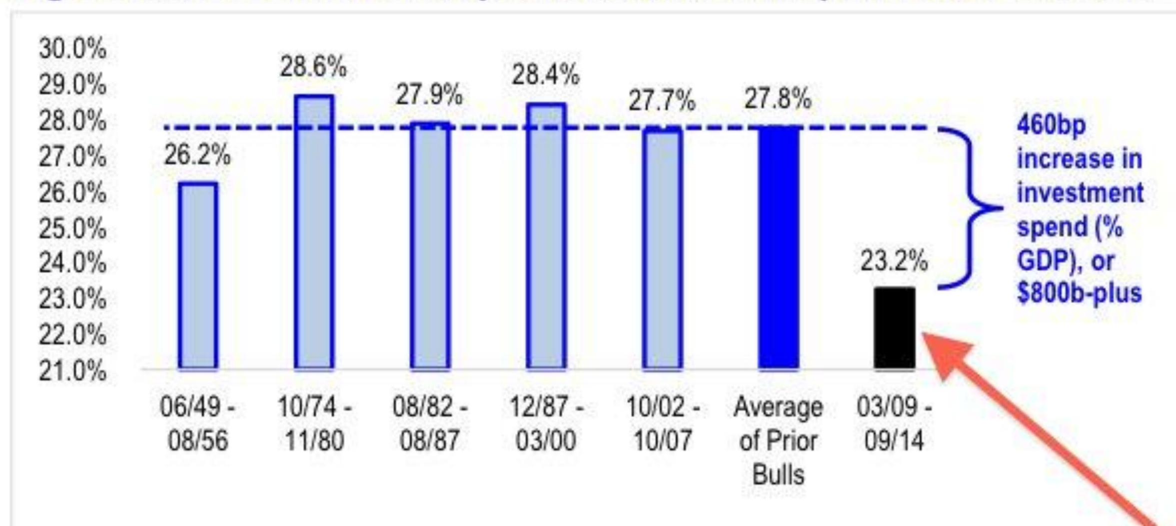


The correction in the group did happen as energy prices, particularly oil, softened during the quarter but in spite of the severity of that correction, my positive long-term outlook on the energy group remains intact. One of the reasons for that continued positive outlook is the supply and demand conditions that exist for natural gas in North America. In spite of a very mild summer that did not increase demand for natural gas fed air conditioners, inventory levels of natural gas are well below the five year average

inventory levels. The above chart, courtesy of the US Energy Information Administration, shows the current very low storage levels in the US. A similar pattern is also evident in Canada.

Production of natural gas has increased dramatically in North America over the last few years, which makes the low storage levels even more remarkable. I believe that production will continue to increase, particularly as the possibility of Liquefied Natural Gas (LNG) facilities becomes a reality and that increased production will benefit the service providers while, due to the low storage levels, will also still provide decent pricing and returns for the producers. A lower Canadian dollar will also help all of the companies featured in last quarter's commentary. The correction in the group was more than I anticipated but from current levels the outlook for significant returns into the end of the year is very bright.

Turning to this quarter and beyond, I remain constructive on North American equity markets. Tom Lee, a market strategist whose work I have followed for several years while he was at JP Morgan, has recently resurfaced at his newly founded firm: Fundstrat. In his initial report in mid-September, Lee argued that we are still a few years away from the end of this bull market. He cited four factors behind this belief:



Source: Fundstrat, BEA, Bloomberg.
Note: Bull markets greater than 5yrs; late stage is the last third of each respective bull market length.

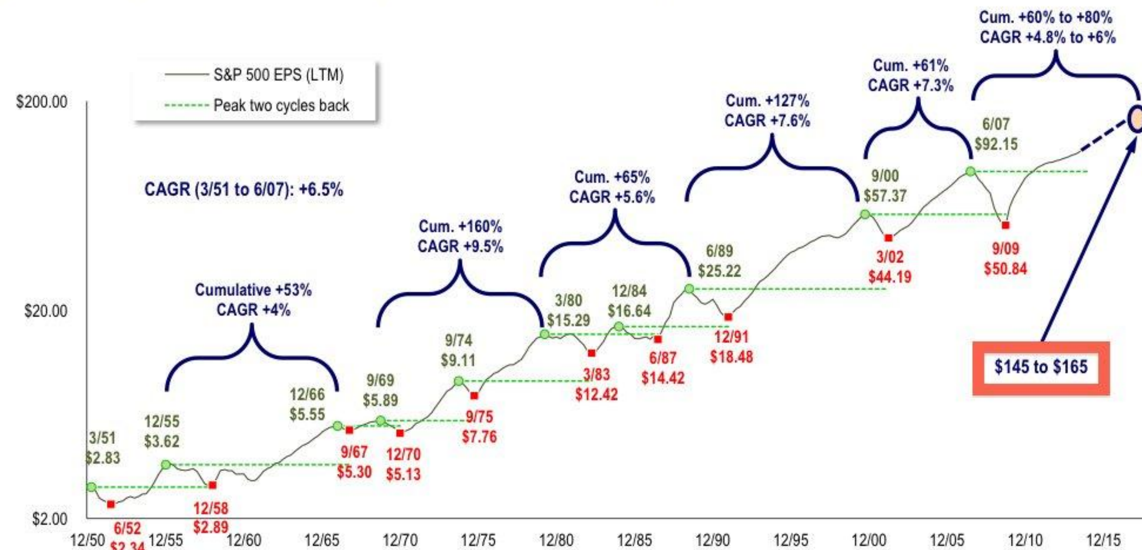
1) *Investment spending as a % of GDP usually peaks at much higher levels, around 27-28% compared to its current level of 23%.*

2) *Corporate profits (as measured by S&P 500 EPS) tend to surpass the prior cycle peak by 53% which suggests that a peak around $141 per share could be expected compared to current expectations for 2014 of $118 (see chart on next page). Using the current market multiple of 16.5 would suggest a level of approximately 2325 on the S&P 500 compared to its quarter end level of 1972.*

3) *The yield curve has historically inverted either prior to or shortly after a bull market peak and the current 75 basis points (1 basis point is 0.01%) spread is historically steep for any stage of a bull market and obviously well off late stage inversion.*

4) *Equity valuations at market peaks have historically been unattractive relative to bonds and currently the earnings yield (inverse of the Price/Earnings ratio) is 300 basis points above bond yields compared to normalized levels of 130 basis points below bond yields at market peaks.*

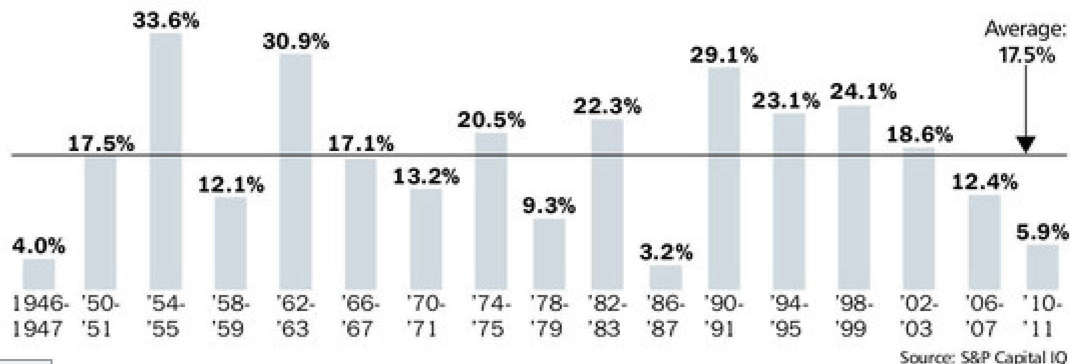
Figure 12: Long-term S&P 500 profits grow 6%-7% annually… implies peak EPS of $145-$165…



Source: Bloomberg, FactSet, Robert Shiller dataset, Fundstrat.

Another factor that favours a constructive stance is the US election year cycle. The US holds congressional elections in November of every other year, one of which coincides with the presidential election and one, such as this year, which is in the middle of the presidential term. As we approach the normal seasonal strength starting in November, we can also look favourably on the historical trend that years following mid-term elections are the strongest of any of the years in the presidential cycle. The chart on the next page from S&P IQ shows that in the post war era, the average return for the S&P 500 index following a mid-term election is 17.5%.

As I have mentioned many times in previous commentaries or in past issues of The Lato Letter, the memories of 2008 and 2009 continue to linger as investors search for the next market top. While it is sometimes very difficult to look past the negative news headlines, the most recent being "Ebola", we must look back at history as a guide to the future and as Tom Lee has pointed out, a number of fundamental indicators suggest that at this point we are not seeing the historic signals that accompany market tops. In addition, we can also look at the history of returns following mid-term elections. Together, they build a very strong case for remaining constructive.



The more investors look for that market top the less likely we are to see it until investors all become euphoric and give up their search. We are not close to euphoria yet.

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