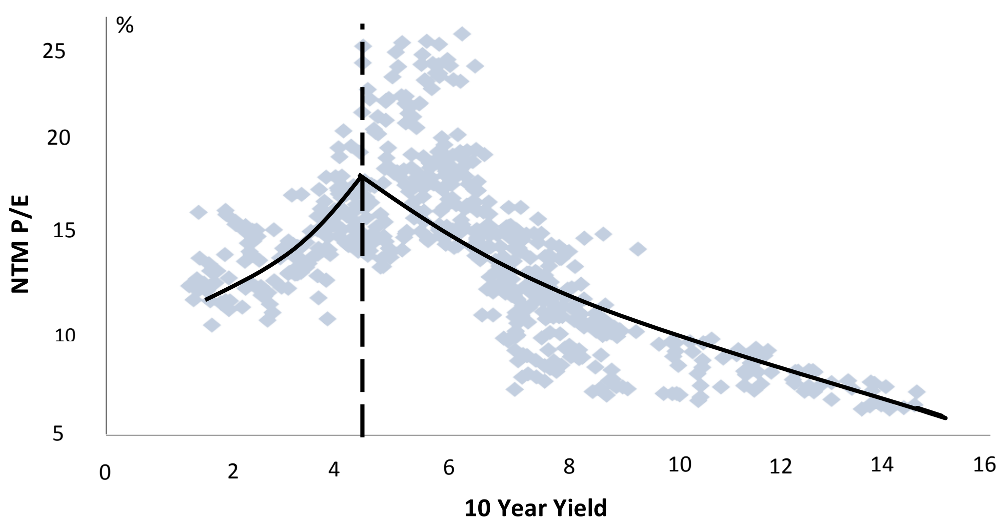
THE LATO LETTER – SPRING 2015

Watching the nightly news during the first quarter, one could easily have the impression that we are living under volatile market conditions. There was a great deal of day-to-day volatility but from beginning to end, North American equity markets continued their sideways action that has now lasted for five months. Since November 1, 2014, the S&P 500 Index has traded in a range of 1972 to 2217 or within 3.5% of the midpoint of that range and closed the quarter at 2068, slightly above the mid-point. Although overall, it was a very trendless period, Padlock's portfolios were able to rise well above trend and enjoyed very strong absolute and relative performance.

The first quarter also marked the ninth consecutive quarter that the S&P 500 index has enjoyed a positive return. Recent analysis by S&P Capital IQ's Sam Stovall showed that this nine quarter streak has happened only three previous times since WW II. In the three previous occurrences, the S&P 500 has always been positive and averaged a return of 8.1% in the next quarter.

The most discussed concern for equity markets has been the "inevitable" increase in interest rates orchestrated by the US Federal Reserve that will soon be upon us. There is no question that the prevailing very low interest rate environment has been a huge positive for stocks. Generally speaking, as low interest rates have been good for equities, high interest rates have not been good for equities. That being said, **higher** interest rates should not be automatically construed as being **"high"**.

S&P 500 Forward P/E vs. 10-Year Yield



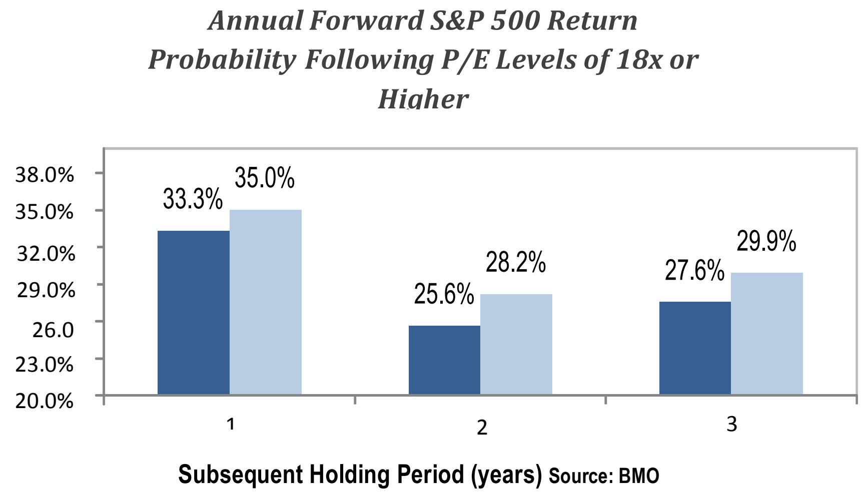
Source: Federal Reserve, S&P, Haver, and RBC Capital Markets

Note: 1964-present

Another major concern is that the Price/Earnings (PE) ratio of the market is much higher than it was a few years ago. Generally speaking as well, higher interest rates are co-related with lower PE ratios and so if we have higher PE ratios and interest rates are expected to rise, then that surely must be negative for equities or is it?

This chart, courtesy of RBC Capital Markets, is a monthly plot of the forward PE of the S&P 500 index against the yield of a 10 year US government bond over the last 50 years. As you can see, when the 10 year bond yield (which is currently yielding 1.90%) is roughly 6% or higher; the impact of lowering the forward PE (currently 17.5X 2015 earnings) begins to take hold.

The current 2015 estimate for S&P 500 earnings is $119 which equates to a forward PE of 17.5 times. As shown to the left, that PE ratio would lay well within the range of normal even if yields on US treasury bonds double to 3.80%. Furthermore, with a current estimate of $135 for 2016 S&P 500 earnings, the S&P would have to rise another 13.5% to a level of 2347 over the next year to be trading at 17.5 times 2016 earnings.

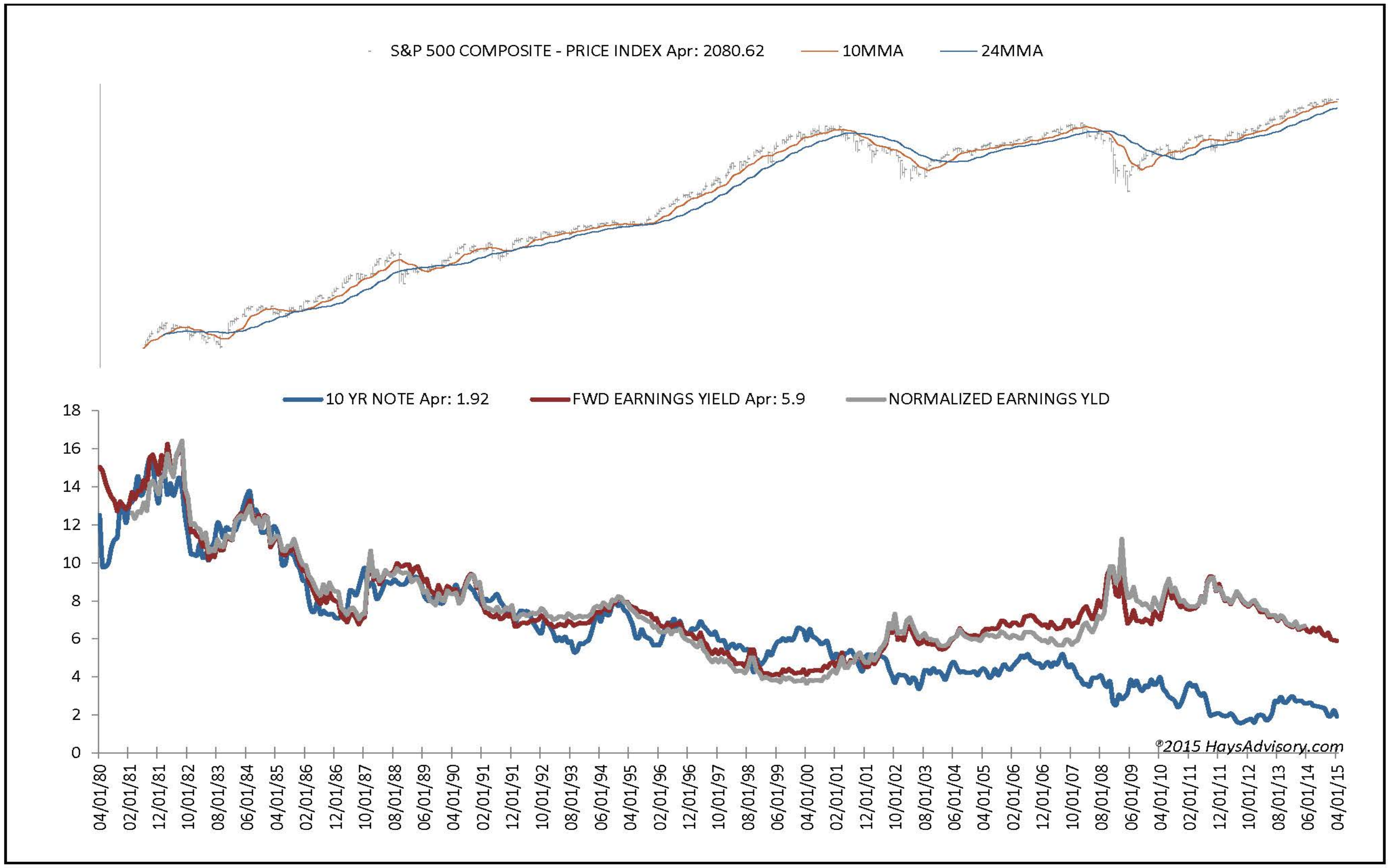


A different study done by BMO Capital Markets examined rolling returns for the S&P 500 Index when the PE ratio of the S&P rose above 18.0 times which is slightly higher than the current level. That study found, as shown in the chart above right, that in the large majority of cases returns were still positive over the next one, two or three periods (frequency of negative return shown in the dark blue bars). In fact, returns of over 10% per year occurred more frequently than negative returns (frequency of returns greater than 10% shown in the light blue bars).

These two studies don't dispute the fact that valuations have risen and the forecast that interest rates are anticipated to rise. However, comparing yields on fixed income vehicles to the earnings yield on equities continues to largely favour exposure to equities. Since the financial crisis, yields on 10 year US bonds have decoupled from the S&P 500 earnings yield (the earnings yield of equities is the inverse of the PE ratio; earnings divided by index level). This decoupling is shown in the chart on the next page, courtesy of Hays Advisory Services.

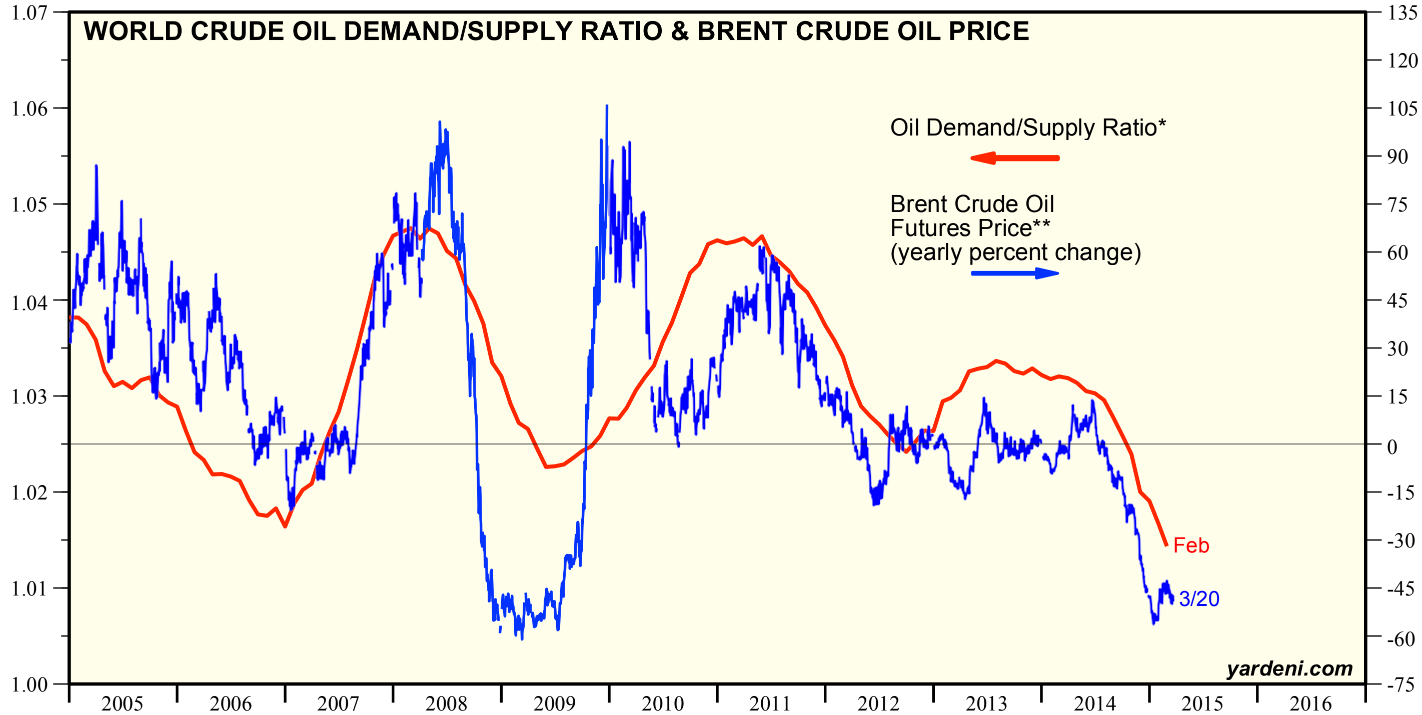
This decoupling is one symptom that persists from the huge shock to investors psyches resulting from the financial crisis. I have quoted the legendary John Templeton's stages of the market in previous commentaries and to quote him again; "Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria". With the US economic recovery now more firmly in place, our view is that we are somewhere between skepticism and optimism but certainly far from euphoria.

Stock Market Valuation



One area that has been a drag on the Padlock portfolios has been the energy group. Crude prices fell precipitously late last year, as demand did not keep pace with the significant increases in supply, particularly in North America. Crude prices stabilized in the first quarter as did the share prices of many of the energy holdings. Exploration budgets have been cut back dramatically for 2015 and those cutbacks have had a major impact on the service providers. Although it doesn't happen overnight, the combination of lower supply from reduced exploration and increased demand from more favourable prices should improve that demand/supply balance.

This chart from Yardeni Research shows the falling demand/supply ratio and the concurrent year over year change in the price of Brent crude. As that ratio turns up, and particularly when it stays above a level of 1.025, the year over year crude price is positive and in some cases very positive. With the demand/supply ratio at its lowest level in over fifteen years and with the cutbacks in exploration occurring, the ratio should turn up toward that 1.025 level and lead to year over year increases in the crude price.



As energy prices recover, share prices of energy companies, which normally lead that commodity price recovery by three months, should once again begin to carry their share of the load of the returns in Padlock's portfolios. Those portfolios have not been very active of late but I was encouraged when I read the following comment from Jeff Saut, the strategist at Raymond James, "Unfortunately, the SPX is exactly where it was in November of 2014 and has not put together two consecutive up sessions since mid-February. In such an environment the need to be active is a detriment to performance, not a plus! Indeed at times, in the stock market the best strategy is to be inactive, consistent with the mantra, "Sometimes me sits and thinks and sometimes me just sits.""