The Great Divergence

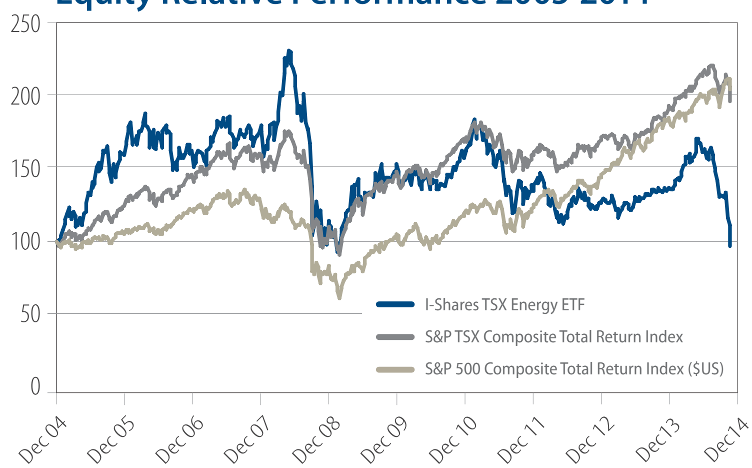
In the Canadian marketplace, Autumn came hard and Winter is looking nuclear. Since September 22, the TSX has fallen 9%, with Energy stocks down 34% and Materials stocks down 10%. The S&P/TSX Composite Index has gone from being one of the best in the world as of September 2014, to one of the worst - a divergence of considerable magnitude.

Divergence, in market speak, occurs when one security or asset class goes in the opposite direction of another. While divergence may signal risk, to us, it also signals opportunity. The key to divergence is to understand it, not to fear it.

2014 is historically unique. The bond market has seen yields go ever lower as investors seek the perceived safety of sovereign and other highly rated debt. At the same time, commodity prices have slid on fears of slowing global growth, reinforcing the bond trade as a place to hide. The bond and commodity markets are looking at a world through the lens of stagnation. Meanwhile, equity markets, particularly US equity markets and so-called "safe" growth stocks, (namely Consumer, Technology, and, to a lesser extent, Utilities), continue to hit new highs. While one part of the market is indicating "the party is over," the other is saying, "happy days are here again." Central banks around the world are doing what they can, printing money to promote the kind of growth that will benefit commodity markets, yet the equities that would benefit are priced for economic oblivion.

The greatest divergence observed in 2014 is the decline in oil shares relative to markets in general, with Energy stocks falling to levels last seen in the 2008-09 crisis. While the decline in oil prices was a surprise, stocks are priced as if the decline is over, ignoring the maxim, "the best solution to a low commodity price is a low commodity price."

Equity Relative Performance 2005-2014



Source: Bloomberg

Unfortunately, the Canadian marketplace has languished in the existing environment. While it is very disconcerting to see portfolio values diverge the way they have since their September highs (we own the same stocks you do!), we have seen divergences before and we will see them again. At Leon Frazer, our emphasis remains on growing the income in your portfolio through dividends. So far in 2014, two-thirds of the companies we own have raised their dividends, and we see more ahead in 2015. We believe that over time, dividend growth and portfolio appreciation go hand in hand. Our time horizon extends well beyond that of the day-traders and hedge funds that dominate short-term market activity, and this advantage is rewarded over time.

Comparing the companies in your portfolio to those held in 2008-09, the companies are, by and large, in much better shape. Thanks to balance sheet improvements and/or operational efficiencies, we believe our holdings can weather even the most serious of storms. We will not change our long-term views on the basis of temporary dislocations.

It is amazing what the power of a sale can do, particularly during the holiday season. Yet we are always taken aback that the stock market is the only place where, when goods go on sale, customers don't start buying until they see lines forming. The aggregate income produced by our portfolios has grown year-over-year, and stands to grow again in 2015. With many of our holdings hitting new all time highs, diverging from those stocks we own that are hitting 5-year lows at precisely the same time, we see an opportunity to rebalance funds by trimming high and buying low. With the discipline honed over 75 years, great divergences are seen as great opportunities. Clients who have been with us for decades already know how we operate. This is a great opportunity for our newer clients to gain an understanding of what it takes to use divergence to increase the compounding power of portfolio income. ●