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MARKET OUTLOOK

BY TIMOTHY E. BURT, CFA

The stock market performance of the third quarter of 2015 was another disappointment with most of the major global markets down from 7.0% to 12.0%. Again the U.S. stock market had the best results with the S&P 500 down 6.9%, the S&P/TSX down 8.6%, the German DAX-30 off 11.7%, the British FTSE-100 off 7.0%, and the French CAC-40 down 7.0%. From mid-April to the end of September, the major global stock markets suffered a severe correction. This was the first significant market correction since October 2011. Over that five month period, the S&P 500 declined 12.4%, the S&P/TSX declined 15.8%, the DAXx-30 fell 23.8%, the FTSE-100 fell 17.0%, the CAC-40 dropped 17.6%, and the Australian ASX-200 dropped 17.8%.

Beneath the surface, this correction felt much like a bear market. In fact, 62% of the S&P/TSX dropped 20% or more from their 2015 highs and 48% of the S&P 500 dropped 20% or more from their 2015 highs. A 20% downturn in prices tends to be the rule of thumb for indicating a bear market, and for a vast majority of stocks, this in fact occurred. This market had a lot of similarities to the stock market in 1998, both with major declines in energy prices and Asian currency wars. However, this was followed by very strong markets in 1999.

We feel that this correction/bear market is likely over and we should return to an upward trending path for the rest of the year. Our reasons for optimism include: stronger U.S. GDP growth, continued low inflation and low interest rates, better than expected corporate earnings, attractive stock values and high dividend yields, and excessive funds that continue to be invested in bonds and cash. Energy prices also appear to be gradually recovering.

The U.S. economy may be growing enough for the U.S. Federal Reserve Board to begin gradually raising interest rates before year-end. With second quarter GDP growth at 3.9% and the U.S. unemployment rate at 5.2%, we think the U.S. Fed is likely to boost rates by 25 bps either this month, or even more certainly, at the December meeting. U.S. annual inflation is currently at 0.2%, 10-year U.S. Treasury notes yield 2.0%, and 90-day U.S. Treasury bills are at a record low yield of 0.0%. Obviously, these conditions are ideal for stock investments.

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CARDINAL CAPITAL MANAGEMENT, INC.

We believe that the recession we experienced in Canada for the first half of the year is now over and the economy is once again growing, albeit at slow rates. Canada's inflation rate is currently 1.3% and its unemployment rate is 7.1%. Ten year Government of Canada bond yields are at 1.4%. The Bank of Canada is not likely to cut its bank rate any further, but is also not expected to raise it until sometime in the new year.

With U.S. oil well drilling and production cuts, crude oil prices have started to bottom out and recover from their August lows. We think that stronger global growth in 2016 will bring the forces of supply and demand into better balance and push prices back to the $60 - 65 U.S. a barrel range early next year. The Canadian dollar has also started to recover from its low of $0.745 U.S. to $0.775 recently. Once our federal election is over in Canada, a lot of investor uncertainty will likely be cleared up and allow for renewed consumer and corporate spending in the final quarter of the year, leading to stronger economic growth.

There is nothing that the markets hate more than uncertainty. By the time that you get this report, the Canadian Federal election on October 19 will be over and we may well have a new government in power. We would not be concerned if the Liberals prevail. Historically, the Canadian stock market has done well with Liberal governments. Bond yields are clearly not attractive at the current low rates, and there are many attractive stocks right now with good dividend yields. Everything is lining up to give us a strong performance in the fourth quarter of 2015.

CARDINAL RULE #5 – DON'T OVER-DIVERSIFY

BY HENRY HUDEK, MBA, FCSI, CFA

This is perhaps one of the more troublesome Cardinal Rules, especially for investment professionals, for whom diversification is almost sacro-sanct. Diversification is the Big Tool that allows one to reduce risk in a portfolio. For most investment managers, you can't over-diversify, and that perhaps, is one reason why so many of them appear to own almost every stock on the market. As you are all well aware, Cardinal's investment philosophy is one of owning large, high-quality companies with an established and proven business model. Understandably, there are only a few companies in Canada that meet that criterion. When you also consider that Cardinal will not over pay for a company, it narrows the list even further. We are generally pleased that our Canadian accounts are concentrated in 20 – 25 names, and believe that we add value through our process of analyzing and selecting companies. Why would we dilute the quality of our selection merely in order to add more names? Our history is one of out-performing the market, and we can't achieve that if we are not different than the market.

However, diversification does have its place. There are risks that are company-specific, or more importantly, industry sector specific. One of Cardinal's tasks is to try to manage those risks. Therefore we do try to find quality companies in complementary sectors and try to limit exposure to any one sector. In Canada this task is made much more difficult because of the dearth of high-quality companies in many industries, such as consumer goods, health-care and technology. The Canadian market is very heavily concentrated in Financials and Resources, each of which has sector-specific risks. We are constantly seeking to find companies in other sectors. With Tim Horton's and Shoppers Drug Mart now gone, that search got harder, and that is a key reason why we have been recommending that most clients diversify into a Canada Plus account at Cardinal where we can access high-quality companies outside Canada in sectors not available in Canada. With this approach we can manage accounts of up to 35 names. We can get better sectoral diversification. You may also have noticed recently that we added two retail grocers – Empire Corp and George Weston – to most Canadian equity accounts. They are high-quality companies that we have watched for some time. In this current correction they finally became cheap enough for us to add to the portfolio and diversify a portion away from banks and insurance companies. We will keep looking.

We do believe in diversification, but not to the extent that we will jeopardize client money by compromising on Quality. Our most crucial Risk Management Tool is the fundamental analysis of a company's Quality. If we never allow a low-quality company into the portfolio, we will never see the market value of that company decline to zero. We will never own a Bre-X, or a Nortel. But we do attempt to diversify as much as possible, given the constraints of our disciplined approach and of the marketplace around us.

INVESTMENT Q&A

Has there been any change to US oil production?

A decline in US oil production has taken longer than expected. US shale companies continued to spend well above their cash flows in the first half of the year due to external financing, hedges, or a hope that prices would recover. Prices did not recover, hedges have rolled off, and companies have begun to face the reality of living within their means. Reducing expenses simply means less drilling.

According to the weekly EIA data, US onshore oil production peaked at nearly 9.2 million barrels per day (mmbbl/d) in June. Since then, production has fallen 0.5 mmbl/d as of early October. This production level is still higher than last year's, indicating year over year growth of 4%. This is the lowest level of growth since the shale boom took off in 2012. The EIA's recent prediction is for 2016 US oil production to fall nearly 0.4 mmbl/d. The 2016 forecast has consistently been revised lower throughout the year, evidenced by the May prediction of flat production. Falling US production is one of many important factors leading to a rebalanced crude oil market. JEFF RANCE, CFA

What is an alternative way to invest in emerging markets?

Investing in emerging markets is not for the faint of heart. Emerging markets offer attractive investment opportunities given faster growth potential than developed markets. However, emerging market stocks can be quite volatile and unpredictable.

An alternative to direct investment in emerging markets is to invest in a global consumer company. Nestlé, for example, has been doing business for years in emerging markets. About 44% of Nestlé's sales are from emerging markets where sales growth has outpaced developed markets growth. Nestlé's sales are also less economically sensitive as they sell personal care products, food and water.

However, there are challenges for international companies like Nestlé. Declines in emerging market currencies mean lower sales numbers when converted back to the Swiss Franc. Currency movements tend to balance out over the long-term though and Nestlé's emerging markets business continues to contribute to consistent earnings growth, plus a growing dividend.

SHEILA WILSON-KOWAL, CFA

Tax Loss Selling - Should I or shouldn't I?

As 2015 draws to a close, investors begin to think about their tax situation, in particular, their capital gains situation. Tax loss selling is a common practice, especially when capital gains have been realized during the year. This practice of selling a security to realize a loss can help offset any capital gains realized during the year. After 30 days, that security (or securities) may be repurchased.

Clients may have experienced larger gains this year as we have sold some of our better performing stocks and repositioned portfolios more conservatively. While we understand that tax loss selling can be used to reduce realized capital gains, it usually does not coincide with the investment decision to hold the securities. Generally, the investment fundamentals should be considered first and the tax consequences second.

Despite the investment versus tax decision, we can accommodate tax loss selling for our clients. Please be aware that with tax loss selling, a portion of your portfolio will be out of the market for at least 30 days and may miss a rally in the stocks or market. As with any tax decision, your advisor or accountant should be consulted.. TERRY WONG, CPA, CMA, CFA

Why do some market corrections sting more than others?

Market corrections are never fun. And we have recently experienced one. The TSX has fallen almost 16% from its peak and the S&P 500 has fallen over 12% since spring 2015. Clients have had to endure not only a dip in their portfolio values, but also a number of backward looking stories in the media explaining what has gone wrong. This is normal.

Over the past fifty years, equity markets have posted annual returns of roughly 10% annually. Yet over that same time frame, the TSX has had 25 corrections where the market has fallen by more than 10% and the S&P 500 has had 22 such occurrences.

Thus, corrections of 10% or more should be expected every two years or so, and corrections of 20% or more tend to occur every four or five years. At Cardinal, we believe that the greatest risk for investors is not the volatility of temporary corrections, but rather the chance of missing out on the excellent long-term returns in the equity market.

Many investment managers will claim to be able to time these downturns, alternately sitting in cash or chasing aggressive equities depending on how pessimistic or optimistic they are. Consider though that in just the past two weeks, the TSX has already regained half of its losses. Few managers trying to time the market get out right at the peak and almost all will miss the quick rebound. The result is usually that these managers end up with significant long-term cash positions that drag down returns. Stick with companies you can trust, that pay you more each year and enjoy the long-term rewards of staying invested through volatility. EVAN MANCER, CFA

CARDINAL RESEARCH: SCOTIABANK FINANCIALS SUMMIT

BY ROBERT LAM, CPA, CA, CFA

Cardinal attended the annual Financial Summit held by Scotiabank at the beginning of September. The major Canadian financial institutions presented in a general session and hosted individual investor meetings. The conference always provides a good forum for investors to share thoughts with one another, as well as to hear managements' thoughts on prevailing concerns and opportunities.

Some of the recurring questions heard throughout the conference included: How manageable is energy exposure? How are the financials responding to potential competition from technology companies? What opportunities exist on acquisitions?

On energy, the commentary was consistent across the group with an expectation of credit losses from the energy weakness to increase as time passes. However, with stress tests run with mid-$30 oil to mid-$40 oil over the next few years the overall losses prove to be manageable. A reprieve in oil prices, changes to capital budgets, and corporate restructurings at energy companies are among recent changes that help to support this credit outlook, as do the banks' historical experience with sector credit issues.

On FinTech, all financial institutions discussed investment in technology, whether it is back office systems to streamline and automate processes; client-related functions such as mobile applications or client interfaces; or new ways to manage and analyze data to better serve and understand customers. We ultimately have a view that while there is a present threat from upstart companies to various segments of financial institutions, the current investments and the large, existing customer relationship base should mean that the impact occurs mostly at the margin.

On acquisitions, we find that the strong balance sheets and capital levels (barring the one-off equity raise by National Bank) are an area that is mostly underappreciated across the financials, but more so for insurance companies. During the conference, Sun Life announced its acquisition of Assurant's U.S. group benefits platform. The excess capital position, underleveraged balance sheet, and intent to acquire were all present prior to the acquisition, yet the market did not factor this potential into the company's earning power. We believe that this acquisition opportunity will cause investors to realize that financials still have reasonable growth opportunities ahead.

Overall, the meetings we had gave us continued confidence that the financial companies we hold will continue to be able to grow earnings, manage emerging threats, and, most importantly, continue to grow the dividends for the foreseeable future.

Q3 DIVIDEND INCREASES

Canada	% Increase
Bank of Nova Scotia	2.9%
CIBC	2.8%
Fortis Inc.	10.3%
Royal Bank of Canada	2.6%
Suncor Energy Inc	3.6%
U.S.A.	**% Increase**
JM Smucker Co.	4.7%
Microsoft Corp.	16.1%
Verizon Communications Inc.	2.7%
International	**% Increase**
Accenture PLC	7.8%

Source: Bloomberg
Reported in domestic currency