DM Monthly Report

January 2016

PORTFOLIO ACTIVITY

In December, we sold our Baytex Energy and Black Diamond Group holdings as part of year-end tax planning. We also took a significant profit when we liquidated our long term position in discount retailer Dollarama.

FEATURE STOCK

Badger Daylighting (BAD)

Shares of BAD, N. America's largest non-destructive excavating company, gained 26% in the final three months of 2015, as management released a strong 3rd quarter earnings report. The company's primary technology, the Badger Hydrovac system, is a truck-mounted excavation unit used to dig safely in areas with buried pipes and cables. Unlike traditional mechanical excavation, Hydrovac uses a pressurized water stream to liquefy the soil cover, which is then removed with a powerful vacuum system, virtually eliminating the risk of disturbing installed infrastructure. Despite weakness in the Canadian economy and several of BAD's key markets, the company was able to grow its Hydrovac service revenues by 5.2% in Q3, while its margins showed a strong recovery due to a focus on efficiency and cost management. As well, cash flow produced during the quarter allowed BAD to pay off its revolving credit facility.

CHINA IN A BULL SHOP

A couple of months ago we suggested that China's falling growth rate might be the early byproduct of a maturing economy (or one shifting from an export and investment base to one in which services and consumer expenditure play a greater role). If investors were worried about the PRC then, however, the Chinese government threw gasoline on the anxiety fire at the beginning of 2016 when it first devalued the yuan and then made a ham fisted attempt to control the path of local stock markets. These events triggered a steep fall in Chinese shares, which helped to spark a similar rout on developed markets; when the first week of January was over, the S&P 500 had posted its worst ever start to a calendar year. Given the hyperbole coursing through the financial media at the moment, we thought we'd address some of the big concerns surrounding the story:

China's sliding growth rate will imperil the global economy

Even though China's growth rate has been shrinking, the dollar value of its contribution to the world economy has actually remained fairly constant. This is because lower growth is coming off a much larger base—in other words, a 10% gain on a $5.1tn economy (China's GDP in 2009) is worth about the same as 5% growth in a $10.4tn economy (its size in 2014).

A slowdown in China will push the world into recession

Aside from industrial commodities (which have already been in a bear market for some time), China imports very little from North America and its contribution to the US economy, the world's most important, is negligible. As well, its financial and banking systems are relatively closed, unlike in 2008 when the sub-prime domino falling in the US was able to trigger a cascade through interconnected markets and set off a global crisis.

Devaluation of the yuan is reckless and potentially destabilizing

Because the Chinese government has traditionally pegged the yuan's value to the US dollar, it has appreciated significantly against most other currencies over the past few years. On a trade weighted basis (i.e. relative to a basket of major currencies), the yuan reset is less of a devaluation than it is an initial decoupling from the greenback.

This is the start of the "big one"

Canadian markets are definitely under pressure at the moment, but this is mostly a commodity story and our woes aren't likely to impact the world's major financial centres. In the US—still the most important source of economic leadership—job growth is solid, consumer balance sheets are strong, and banks are healthy. In this context, it seems more likely that any China-induced weakness will be recorded as temporary setback in stock prices and not an outright reversal in the market's underlying uptrend.

Suite 1680, 1055 West Hastings St., Vancouver, BC V6E 2E9
Tel 604 669-3136 **Toll Free** 888 340-3136 www.**dixonmitchell**.com

DIXON MITCHELL
INVESTMENT COUNSEL