December 11, 2015

Dear clients and colleagues,

Another year is ending soon and it has been one sadly marked by the refugee crisis and terrible terrorist attacks around the World.

From a global economic perspective, 2015 was marked by the strength of the US dollar coupled with the weakness in commodities and emerging markets. We also started to see divergence in Central Bank policies. On the public equity side, the best developed markets in local currencies were Japan and Italy, France and Germany. In US dollar terms, only Japan had positive returns. 2015 was similar to 2014 with another round of Abenomics in Japan, more quantitative easing in Europe and the Fed on neutral and getting ready to increase rates, which should happen next week. China was a big worry with its economy slowing, but we believe it has the tools to continue its realignment to a consumer economy with interest rates and fiscal policy flexibility. Volatility continued to be very high, especially for commodity prices and currencies. Finally, 2015 will set a record for the volume of M&A around the World, a trend we expect to continue in 2016.

Except for Nasdaq, US equity markets will likely finish the year with negative returns. Looking at individual names, more than 50% of the companies in the US are more than 20% below their peak price, which is, by definition, a bear market. The FANG (Facebook, Amazon, Netflix and Google) and Microsoft are responsible for over 60% of the gains in the S&P 500. Such deterioration in market breadth generally does not bode well for markets. However, we think a rotation into the rest of the market is the likely outcome for 2016. Commodity stocks were decimated and sell at their lowest price to tangible book ratio ever. It would not take a big increase in commodity prices to see these stocks perform extremely well in 2016.
More concerning is the High Yield Bonds index, which is negative for the first time since 2008, signaling stress in the fixed income markets.

A winning strategy in 2015 continued to be to buy the Megacap Tech names with momentum. This is a dangerous and crowded strategy. In that context, 2015 was another very difficult year for active money managers. 7 out of 10 funds focusing on large cap US stocks are trailing their benchmark. In small cap, the number is around 6 out of 10 funds.

So what does 2016 hold in store for us? First, let's review some of our expectations from a year ago:

We thought that the Global economy would grow faster in 2015 than in 2014, and it did. Global GDP growth should be around 3.6% in 2015, up from 3.3% in 2014. That growth was led by advanced economies (G20), which accelerated from 1.8% in 2014 to 2.3% in 2015. For 2016, we expect a similar growth number, with Europe and Japan having the strongest relative increases.

Structural reforms in Europe and Japan coupled with a more competitive exchange rate will help the two continue positive momentum while the US economy will continue its recovery, led by the consumer. China's economy will continue to stabilize, with continued investment in infrastructure driven by urbanisation. We are not concerned about a hard landing in China anytime soon.

Although we expect oil and other commodity prices to rebound next year, driven by a better supply/demand equation, emerging markets dependent on oil will suffer the negative effect from this year's low prices.

In 2016, inflation should accelerate, making the argument for low rates more difficult. Nevertheless, we do see Central Banks keeping interest rates low.

Oil prices will likely rebound to a range between $50 and $60.

We were wrong on US natural gas prices for 2015. Unseasonal weather and strong production kept the price very low. For 2016, the demand-supply balance will shift with the start of LNG exports and lower production. We forecast a price of $4/mcf at year end 2016, up from $2.00 today.

The Canadian economy will continue to underperform the other developed economies due to lower oil prices and high consumer debt. A positive factor will be the Canadian dollar, which should stabilize and be around $0.80 by the end of next year.

US equities will underperform the rest of the world, as their relative valuations are higher and the strong US$ will be a negative for large US based multinationals. The opposite will be true for non-US companies.

Large cap multinationals will face major headwinds as governments around the world will continue their war on tax evasion. More countries will move to adopt a so called "Google Tax".

Small cap will outperform. Drivers will be low relative valuations, higher profit growth, and a record merger and acquisition environment.

We do not think that there are more macro-uncertainties now than there always are. Volatility is here to stay.

The biggest risks are:

Geopolitical: Although the situation in the Middle-East is concerning, the biggest flash point is the South China Sea. The situation there remains tense and could flare up unexpectedly.

Economic: A domino effect caused by the default of Russia or Brazil or a large depreciation of the Chinese Renminbi.

We remain extremely positive about the outlook for our portfolio for 2016.

As mentioned earlier, global growth will be positive. Europe and Japan are recovering. Confidence in China will increase.

We currently have 62 companies in our Global portfolio and 56 in our EAFE portfolio. We plan to add a few names in the next two weeks. We are looking forward to introducing you to these companies in our future weekly comments.

The sales and earnings growth rates of the portfolio are forecasted to exceed 10%. These growth rates will be affected by the growth of the industries our companies participate in, but we also expect them to achieve market share gains. Most of our companies raised their dividend this year, a trend that we expect to continue in 2016. The expected yield of our portfolio is close to 3% at current prices. The companies we own have very strong balance sheets, providing protection from unforeseen slowdowns and the capacity to grow faster if desired. Finally, in 2015, we had a total of 6 companies that got acquired. We expect another busy year on that front next year.

We would like to wish you all a happy holiday season and a wonderful 2016. And peace for the World.

The Global Alpha Team