December 19, 2014

Dear clients and colleagues,

Another year is ending soon and it has been an interesting one. From an equity market perspective, the major stories were the strengthening US economy, the Abenomics shock treatment in Japan, and weakness in Europe and China. Volatility was very high, especially for commodity prices and currencies.

US equity markets led the way this year, but faced many challenges nonetheless. Only Apple, Microsoft, and a handful of other names really drove the market. Apart from those large cap technology stocks, utilities and REITs were the other big winners, driven by the collapse in bond yields.

In that context, 2014 was a very difficult year for active money managers. 8 out of 10 funds focusing on large cap US stocks are trailing their benchmark. In small cap, the number is around 7 out of 10 funds.

A winning strategy in 2014 was to buy Beta, momentum, and low ROE. This is certainly not a strategy for managers looking for good quality companies.

So what does 2015 hold in store for us? Below are some of our expectations:

The Global economy will grow somewhat faster than in 2014 and should be around its long term average of 3.5%.

Momentum in the US economy will continue. Europe will gradually pull out of low growth, driven by the impact of reforms, low interest rates, and a favorable exchange rate. China will stabilize its economy through continued investment in infrastructure. Japan should be the big winner as continuing reforms and lower corporate tax rates are to continue. Emerging markets will be divided between the oil and non-oil producing countries, with the latter enjoying stronger growth. South East Asia and India will be the major beneficiaries of lower oil prices.

Central Banks will keep interest rates low, helped by lower inflation as a result of lower commodity prices.

Oil prices will likely range between $40 and $60.

US natural gas prices will be the upside surprise, as the new demand-supply balance will shift with the start of LNG exports. We forecast a price of $5/mcf at year end 2015, from $3.50 today.

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

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.

There will be volatility. We have yet to see the full effect of the sudden drop in oil prices and emerging market exchange rates.

The biggest risks are:

Geopolitical. The situation in the South China Sea remains tense and could flare up very suddenly. It is, in our opinion, the primary risk.

Economic. A domino effect caused by the default of Russia or Brazil. A worsening of the real estate market in China.

Our portfolio consists of 60 outstanding companies. Their growth rates will be affected by the growth of their industries, but they will also gain market share. They have very strong balance sheets, providing protection from unforeseen slowdowns and the capability to grow faster if desired. Finally, the yield on the portfolio is almost 3%, a very attractive situation in an environment of low interest rates.

We would like to wish you all a happy holiday season and a wonderful 2015.

The Global Alpha Team