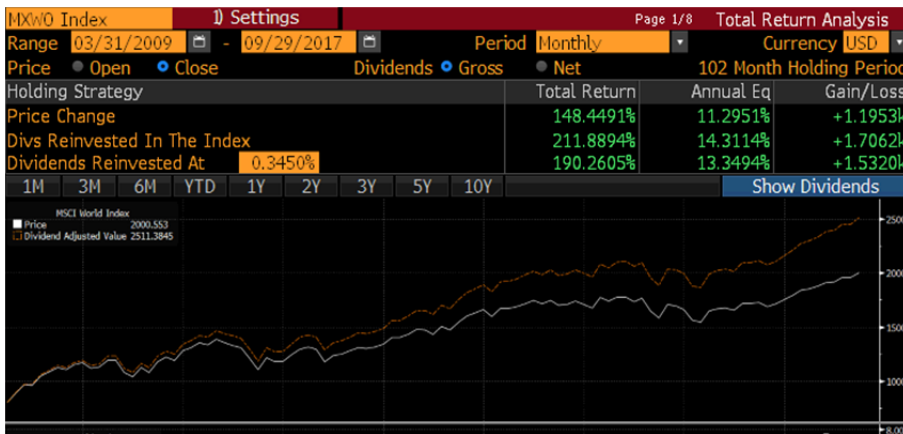


October 13, 2017

Dear clients and colleagues,

Stock markets around the world are reaching new decade or all-time highs. Most asset classes, from housing to bonds, are very expensive compared to historical valuations. The VIX index, a measure of risk and volatility, is at an all-time low.

The broadest equity index, the MSCI World Index, reached a new all-time high this week, up 212%, including dividends, since the bottom in 2009 (all US\$).



Source: Bloomberg

How expensive is the market? We hear a lot that the market is not expensive compared to early 2000 on a price-earnings basis. We disagree and believe the market is expensive. Using the price-to-sales ratio, a less volatile measure than earnings, we can clearly see this.



Source: Bloomberg

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Performance figures are stated in Canadian dollars and are net of trading costs and gross of operating expenses and management fees. Further information about the Global Small Cap Composite is available by contacting the firm. Global Alpha Capital Management Ltd. (Global Alpha) claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS. Global Alpha has not been independently verified.

We are currently at 1.72x the last 12 months' sales compared to the all-time high of 1.8x reached at the peak of the tech bubble and compared to 0.72x in 2009.

So what now, one could ask?

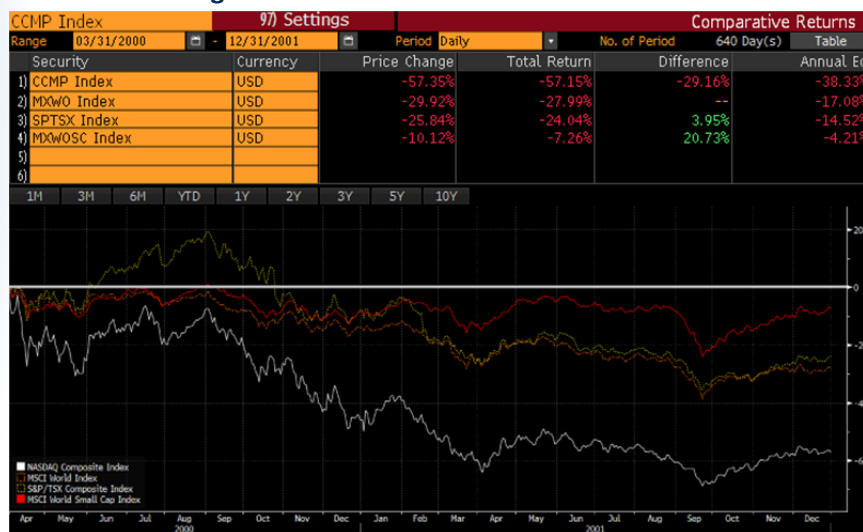
North Korea, the Middle-East, Spain, Brexit, etc.; should we be worried? Yes, but the market always faces uncertainty.

In our opinion, the most important change we are witnessing right now, and the one that will most likely have an impact on global equity markets longer term, is the increasingly acrimonious trade battles between the US and other regions of the world. From pulling out of the Trans-Pacific Partnership in January of this year to renegotiating the North American Free Trade Agreement, with a very uncertain outcome, we may be at the beginning of a reversal in global trade.

Although equity markets are expensive, we do not believe other asset classes offer a better alternative. Earlier this year, one of the largest sovereign funds in the world, the Norwegian Fund, actually increased its public equity weighting to 70% from 62.5% while reducing bonds. They used the long-term expected real return of equities over bonds to explain the increase. They also chose public equities over private equities and infrastructure, two asset classes they deemed did not offer enough of a return premium given their illiquidity.

When we look at public equities, small caps are still relatively attractive. Let's look at how global small cap stocks performed during the last two major market corrections. First, during the tech crash of 2000-2001.

**Protection During the Tech Bubble**



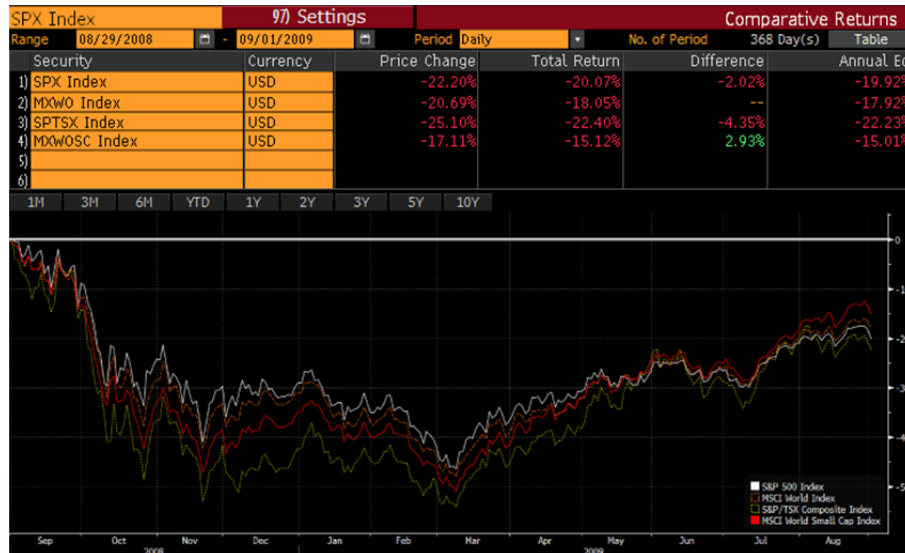
Source: Bloomberg

The MSCI World Small Cap Index (MXWOSC in the chart above) outperformed the MSCI World Index (MXWO) by a wide margin, and other indices by even more. And what about during the Global Financial Crisis of 2008-09?

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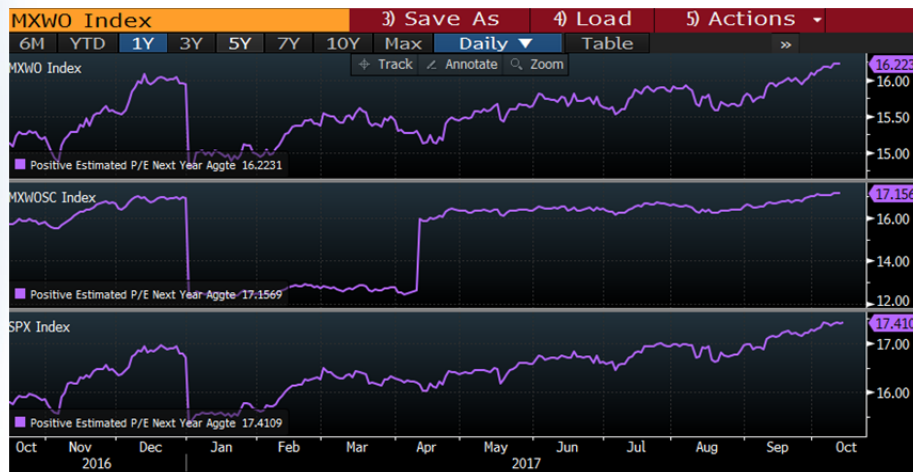
**Protection During the Global Financial Crisis**



Source: Bloomberg

Again, the MSCI World Small Cap Index performed better than the MSCI World Index and most other indices.

How about valuation?



Source: Bloomberg

As can be seen in the chart above, the MSCI World Small Cap Index (middle) sells for 17.1x next year's earnings. This compares to 16.2x for the MSCI World Index (top) and 17.4x for the S&P 500 (bottom).

One point to note is that this is after-tax earnings, and smaller companies pay a higher tax rate so could benefit more if countries lower their corporate income tax rates as they indicated they may do.

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What about growth?



Source: Bloomberg

This chart shows that the MSCI World Small Cap Index (middle) is expected to grow profits by 14.6% next year, an estimate that has increased in the last few months, whereas the MSCI World Index (top) is expected to grow at 7.1% and the S&P 500 at 8.5%, both of which have been revised down recently.

In conclusion, looking at current valuations, expected growth and past market corrections, we feel global small cap and international small cap equities provide an attractive risk-reward profile.

Have a good week ahead.

The Global Alpha Team

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