Market Insights

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Market Review

At the end of August everything on my dashboard below had turned down for the year. The silver lining is that we are now faced with opportunities not seen since the credit crisis. While the S&P/TSX closed August down for the year, there have been more meaningful corrections in the commodity and energy sectors. Even the Canadian banks sector was not immune to it and experienced significant volatility over the course of the month.

	December 31, 2014	August 31, 2015	Year to date Performance
TSX	14,632	13,859	-5.28%
TSX Venture	695	559	-19.57%
Copper	$2.92	$2.34	-19.86%
Gold	$1,184	$1,133	-4.31%
Silver	$15.59	$14.60	-6.35%
Nat Gas	$2.91	$2.71	-6.87%
Oil (WTI)	$53.27	$48.16	-9.59%

Table 1

Current investment climate

August was anything but calm in the stock markets! The Canadian and US markets sold off heavily in unison. In fact, Monday August 24 turned out to be another "flash crash" day. The Dow Jones opened that day to the downside, falling 7% or 1089 point, within minutes, before rebounding to close the day well above the low point. The Toronto exchange did not fare much better, losing 6% before rebounding. The catalyst for the flash crash was the 9% correction in the Asian markets which subsequently activated sophisticated trading algorithms active on our North American markets.

The corrective action in the markets has served an important purpose. It eliminated the argument of not having had a real (10%+) stock market correction in nearly four years. The fact that the markets had not experienced such a meaningful correction resulted in the significant buildup of cash sitting on the sidelines.

After significant corrections, stock markets will often remain volatile and markets will almost certainly attempt to retest the August lows, after a brief five to seven day rally exhausts itself. Historically, these corrections are often followed by short lived stock market rallies. Once this brief stock market rally runs out of energy the market will attempt to put in a double bottom.

A "double bottom" is text book for the markets having set a firm bottom or low point. With the double bottom now completed, the next phase in the markets will be positive resulting in the start of another leg up.

Our view currently is that [the] lows will have to be tested before any meaningful rebound can occur. Readers of my work know that is my bottoming sequence of choice. Indeed, in a "selling stampede," following a "capitulation low" (8-24- 15), you tend to get a 2 – 7 session rally. As stated, I think that rally began on Tuesday (8-25-15) and peaked on Thursday (8-27-15). Subsequently, at least most of the time, you see a downside retest of the lows. In the current case that would be the intraday lows on Monday, August 24th.   Jeff Saut, Chief Investment Strategist

To date, we have not yet seen the markets get close to retesting the August lows but when the retest occurs it should be seen as an opportunity to acquire further high quality companies with dividends for the next leg up in the markets. Of special interest is the Fear and Greed Index about which I spoke last month. The index had never been as low as it was during the August flash crash. Should the Fear and Greed Index be taken as sole indicator by which to gauge making investments in stocks or exchange traded funds (ETF), the current investment climate will likely not get much better as it will be difficult to achieve a fear measure lower than the 3 as set during the start of flash crash Monday.

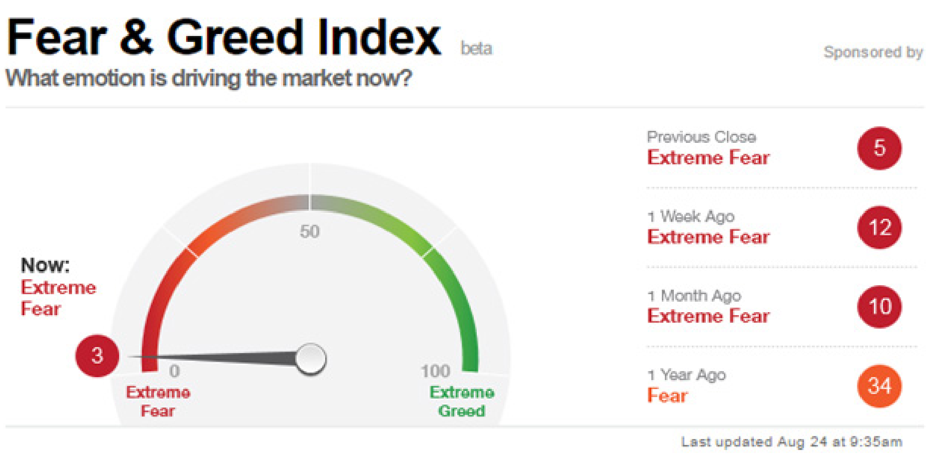


Illustration 1 Source: *CNN, Fear and Greed Index*

Oil Data

On August 31 the US Energy Information Administration (EIA) announced the release of a new monthly data set. The data, which is supposed to come out on a two month delayed basis, should prove to be more accurate that the somewhat inaccurate information which has been released up to this point. The new more accurate monthly data shows that US oil production already peaked during the month of April. This compares to the weekly oil production which show production peaking during June.

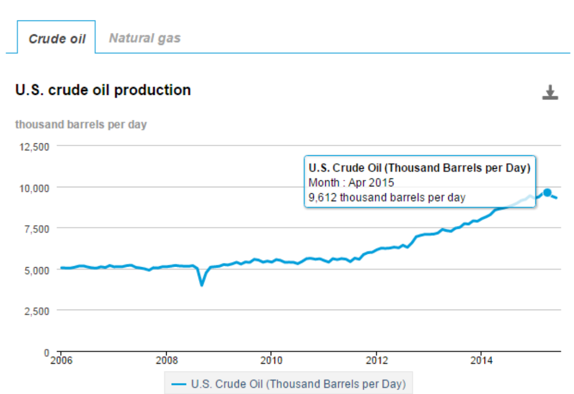


Illustration 2 Source:

US Energy Information Administration (EIA), US Government

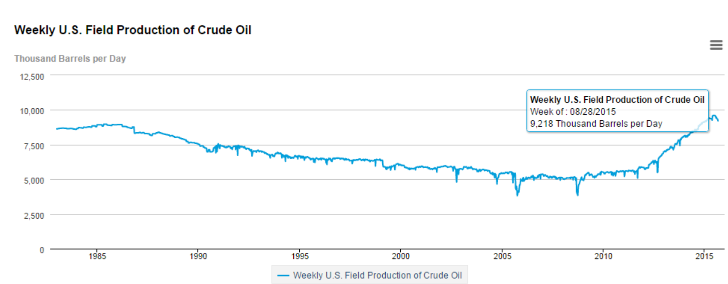


Illustration 3 Source:

US Energy Information Administration (EIA), US Government

Having closely tracked and analyzed the weekly US oil production figures published by the EIA, it is overwhelmingly clear that the current lag between oil rig drilling activity (rig count) and tying in production is approximately three to four months, not six months as what was thought to be historically accurate. One can make a case using existing data to extrapolate what current US oil production could be using several considerations.

Firstly, data is pointing to a significant drop in rig activity, which peaked in early 2015. Since then US rig count has fallen dramatically and seems to have stabilized in May at around 675 active drill rigs. Another consideration is the vast majority of US oil production that has come online since 2011 is high grade unconventional production which tends to have structural decline rates of 60-80%. Thirdly, and most importantly, are the new more accurate monthly EIA production figures. The EIA is now indicating that US production peaked in April at 9,620,000 barrels of oil per day (bpd) and has fallen to 9,296,000 bpd in June.

The conclusion one can make from the month over month decline rate combined with the weekly production data is that current US oil production is likely to be either close to 9,000,000 bpd or already below that.

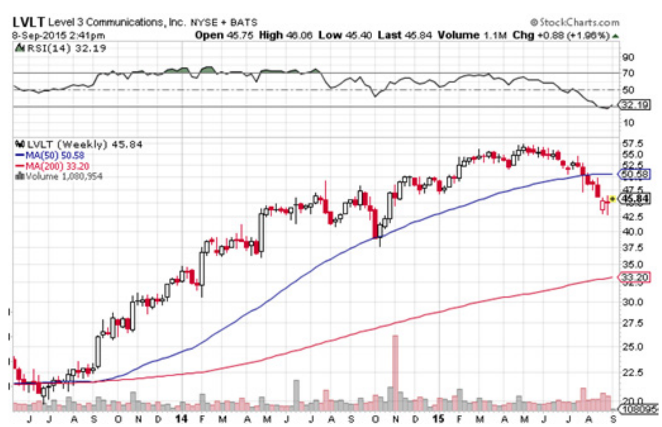
Earlier this year, Philip Verleger, an oil industry expert, went on record stating the EIA numbers are overstated. Verleger was clearly right! In a recent article published by Reuters, Verleger suggests US oil production numbers are much lower even than 9,000,000 bpd and we could very well be in a balanced oil market already. Mr. Verleger is not the only oil industry analyst who has commented on the new data the EIA has released. Paul Horsnell with Standard Charted Bank is on record stating:

> *"US crude oil output may be lower than we thought. We now believe that year-over-year falls will commence in October, and that output will fall below 9 million barrels per day in late Q4-2015. We lower our view on output after considering the latest US Energy Information Administration data."*

Verleger reinforces this sentiment: "The revisions are welcome. We have asserted for four months now that the Department of Energy has been overestimating supply. … The consequences of the change for global supply-and-demand balances are startling. … The surplus is going, going, gone."

Companies I am adding to the Dividend Growth Portfolio

This month we look at a Fibre Optic company and a Fertilizer company.



Level 3 Communications ($44.73, August 31, 2015) is a global communications provider. More specifically the company owns a vast network of fibre optic assets connecting North America, South America, Europe and South East Asia. The company over the past 15 years has been able to acquire fibre assets at excellent prices, mostly from distressed companies who were forced to liquidate assets. With smart phones and tablets becoming more powerful and faster and companies like Netfilx pushing out content, demand for fibre optic bandwidth is skyrocketing. The catalyst for adding Level 3 Communications now is that Google and the major telecommunications companies have been aggressively building the missing ingredient for Level 3 – fibre to the home or "the last mile" as it is also referred to. Verizon has stepped up its efforts further and announced an acceleration of its deployment of their 5G network. 5G means internet speeds 50 times faster than our current 4G system. Raymond James has a Market Perform rating on the company, other analysts have a median price target of $61.00 on Level 3 Communications.

Potash Corp. of Saskatchewan Inc. ($34.26, August 31, 2015)

Potash Corp. was founded in Saskatoon more than 60 years ago and has grown into one of the world's largest fertilizer producers. With the expansion plans at their Rocanville site, the company is in a position to grow output meaningfully by mid-2016. Capital outlays for these expansion plans, $3 billion, are virtually finished. It is the catalyst of increased revenue in the near term and a dividend yield of nearly 6% are reason to add this company to the Dividend Growth Portfolio.