

Global Insight

Special Report

Oh Canada: Value emerging from an unloved market

While Canadian equities are getting the cold shoulder from investors, the Canadian market has rarely been this cheap, which we think creates an interesting opportunity.

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For important and required non-U.S. analyst disclosures, see page 7

All values in Canadian dollars and priced as of Nov. 30, 2018, market close, unless otherwise noted.



**Wealth
Management**

Oh Canada: Value emerging from an unloved market



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While Canadian equities are getting the cold shoulder from investors, we think they're failing to see a salient fact—the Canadian market has rarely been this cheap. We acknowledge that the market outlook remains challenging, but we explain how this valuation opportunity has piqued our interest.

Nobody knows you, when you're down and out – Jimmy Cox

Investors in Canadian equities will be forgiven if the temptation to “throw in the towel” on Canada's market and buy more U.S. (or, frankly, anything else...how is bitcoin doing?) feels like the right approach. Investor sentiment towards Canada is terrible. That makes this a time when it may pay to consider the contrarian view. We discuss the headwinds facing the Canadian economy and look at the valuations of the TSX on both an absolute and a relative basis. Although the Canadian market outlook doesn't engender much excitement at the moment, the multiple compression of the TSX over the past two years reflects very pessimistic expectations, in our view. The “wall of worry” is clearly in place. Things may only need to get incrementally better for the TSX to recover some of its mojo.

No love for the TSX

Despite delivering levels of earnings growth similar to the S&P 500 since 2016 (see the table below), the TSX is actually down 1% on a price basis compared to a 22% gain for the S&P 500 in CAD terms. Over the past two years the Canadian index has suffered a 19% haircut on its forward P/E ratio against a more benign 7% squeeze for the U.S. benchmark.

TSX earnings growth and forward P/E ratio between Dec. 2016 and Nov. 2018

	Trailing EPS			Index Level			Forward P/E		
	30-Dec-16	30-Nov-18	Δ	30-Dec-16	30-Nov-18	Δ	30-Dec-16	30-Nov-18	Δ
TSX Composite	\$669.04	\$918.05	37%	15,288	15,198	-1%	16.5	13.3	-19%
S&P 500	\$142.79	\$194.35	36%	3,011	3,672	22%	17.0	15.8	-7%

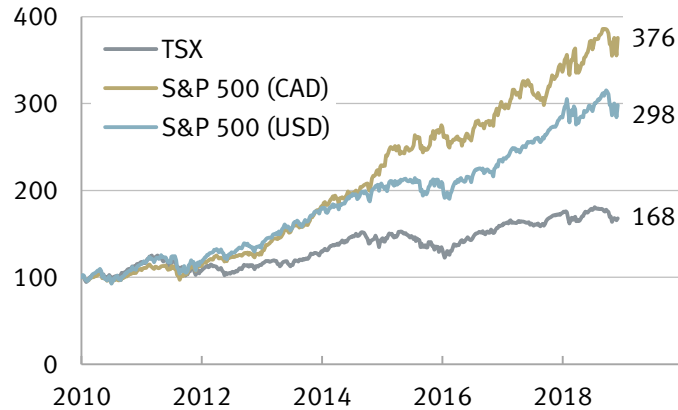
Source - Bloomberg; all data in CAD; “Δ” (delta) indicates percentage change over the time period shown.

The poor relative performance goes back even further. Aside from a few countertrend rallies, the TSX has reliably lagged the U.S. market over the last seven years as shown in the chart on the next page. While the Canadian economy and corporate earnings have recovered smartly from the oil-price-induced crunch four years ago, sentiment towards Canadian equities has remained unusually depressed.

Diagnosing the Canadian market

In our view, this poor relative performance stems from three broad concerns.

TSX total returns vs. S&P 500



Aside from a few countertrend rallies, the TSX has reliably lagged the U.S. market over the last seven years.

Source - Bloomberg; 1/1/10 indexed to 100; data through 12/20/18

Without the tailwind of higher commodity prices, the TSX has struggled to keep up with the S&P 500 since 2011.

- Eroding relative competitiveness:** Most notably, the relative competitiveness of Canadian corporations has been hit by the big cut in U.S. corporate tax rates. Once much higher than the posted Canadian rate, the U.S. rate is now somewhat lower. Additionally, the Trump administration has pursued an aggressive deregulatory agenda since 2017, while the regulatory burden in Canada has moved in the opposite direction, as environmental commitments and labour laws have become less business-friendly. At the same time, all provinces have raised the minimum wage.
- Indebted households:** Canadian household debt levels have surged to around 170% of annual income as of Q3 2018, up from around 130% at the start of 2006. The rise has been driven by ultra-low interest rates that have pushed debt servicing costs to historically low levels, together with a strong bull market in real estate prices. Results have included larger mortgages and, to a lesser extent, debt-financed consumption. This has raised concerns about future financial system vulnerability (e.g., loan defaults) and long-term growth prospects. These concerns have important implications for the economy and stock market because the Financials sector comprises over a third of the TSX, and personal consumption accounts for nearly 60% of Canadian GDP.
- Commodity dependence:** The commodities complex is crucial for the TSX. Despite the correction in commodity prices in recent years, natural resource stocks still make up almost 30% of the TSX. Without the tailwind of higher commodity prices, the TSX has struggled to keep up with the S&P 500 since 2011. The Energy sector is contending with inadequate pipeline capacity to move Canadian crude to export markets, forcing producers to ship greatly reduced volumes via more-expensive rail and truck and at heavily discounted prices. Given pipeline constraints are unlikely to be resolved in the near future, all this means Canadian oil could continue to trade at a deeper-than-usual discount compared with WTI, while investor interest in Canadian Energy companies is likely to remain listless.

Half empty or half full?

There is a growing temptation to “throw in the towel” on Canadian equities, and buying more U.S. equities may seem like the right approach. However, we are reminded of the words of wisdom from the father of value investing, Benjamin Graham:

Nine of the 10 past years have seen foreign investors continue to allocate capital to the Canadian market.

“In the short run, the market is like a voting machine—tallying up which firms are popular and unpopular. But in the long run the market is like a weighing machine—assessing the substance of each company.”

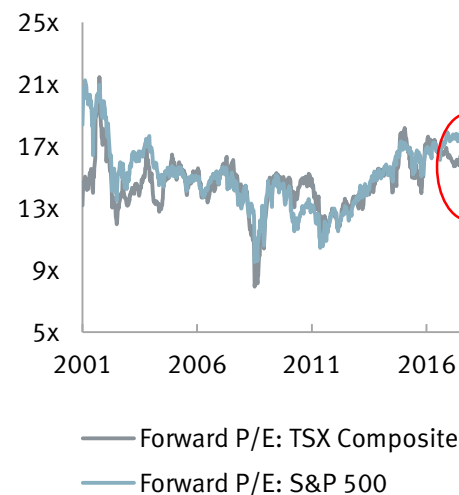
In this case, almost all of Canada is universally unpopular at the present time. Yet despite this, nine of the 10 past years have seen foreign investors continue to allocate capital to the Canadian market: net foreign purchases of Canadian equities have held up well in recent years, amounting to CAD183B since 2013.

Because stock markets are discounting mechanisms, many of the headwinds facing the Canadian market are already meaningfully priced into the valuations of Canadian businesses. Can things go from bad to worse? That’s always possible. But an investor should assess opportunity across a range of reasonable outcomes, giving heavy consideration to what one is paying for a basket of high-quality Canadian businesses.

From an absolute valuation standpoint, the TSX trades at roughly 13.1x forward earnings, an 11% discount compared to its long-term average of 14.6x; that’s almost one standard deviation below the historical average. On a relative basis, while the forward P/E multiples for the TSX and the S&P 500 have tended to move in sync historically, a big gap has opened up, as shown in the charts below. The TSX currently trades at an extraordinarily deep 15% discount to the S&P 500 on a forward P/E basis.

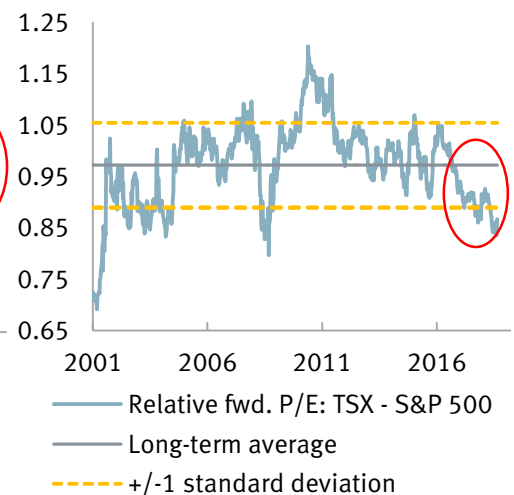
P/E multiples for TSX and S&P 500

Forward P/E multiples for TSX and S&P 500 tended to move together...



Relative forward P/E: TSX – S&P 500

...but valuations have dramatically diverged since 2016.



Source - Bloomberg

At current valuations, the Canadian market has rarely been this cheap. If we ignore the global financial crisis (because it was *the* global financial crisis), we have to go back to the early 2000s to find the last time Canada looked this cheap relative to the U.S. However, at that time the U.S. market was still dealing with the hangover of the dot-com era and valuations were very expensive—Walmart was trading at 57x earnings. It wasn’t so much about Canada trading cheaply as it was the U.S. trading at historically expensive multiples.

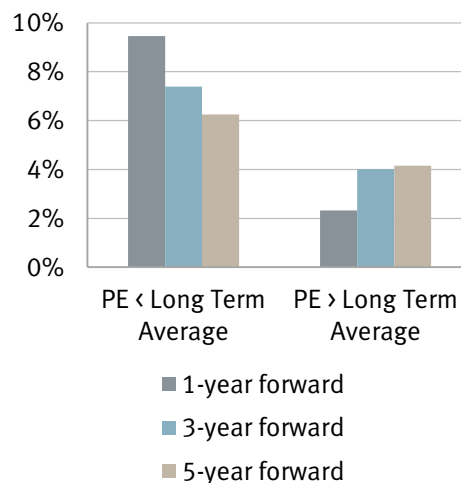
Value in the Canadian market

Valuations are seldom useful for timing entry points, but they are strong determinants of future long-term return potential. The chart at left below shows the 1-, 3- and 5-year forward returns for the TSX based on entry points that were either above or below the historical average. Unsurprisingly, forward return prospects were, on average, quite a bit more attractive across all time horizons if one had invested in the TSX when its forward P/E was below the historical average.

What about performance versus the S&P 500? The TSX has tended to outperform the S&P 500, on average, across all time horizons when it trades at discounts in excess of 10% compared to the U.S. market on a forward P/E basis, as shown in the chart at right below. In stark contrast, the TSX has meaningfully lagged after trading more expensively than the S&P 500.

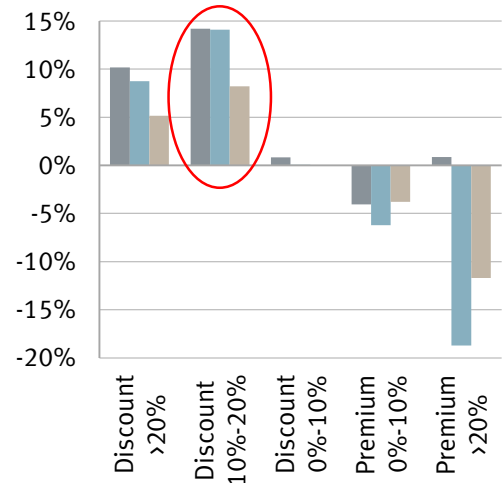
TSX returns when investing below and above historical average P/E

Lower starting valuations elevate average future return potential



Average annualized relative performance of the TSX vs. the S&P 500

Valuations eventually matter... in the longer term



Source - Bloomberg; based on price index

Parting thoughts on Canada

Investor sentiment towards Canada remains quite negative. That said, we think the unusually wide valuation gap that has opened up between the TSX and the S&P 500 warrants looking at the Canadian market through contrarian eyes. We acknowledge that some headwinds facing the Canadian market are unlikely to abate in the short term, but we contend that the market is fully reflecting investor concerns and discounting very little in the way of potential positive outcomes.

Perhaps some combination of OPEC and Alberta production cuts and/or progress on pipeline approvals will re-energize the energy market. Or perhaps a split U.S. Congress will soften the Trump administration's hardline trade stance. And soon, the leaders of both countries will turn their sights towards reelection, which may result in market-friendly policies in the near term. These are three possible outcomes to which the market is essentially assigning a zero probability. Investors are already behaving as if not much can get better, which is piquing our interest. Remember, in the words of Warren Buffett: be greedy only when others are fearful.

We contend that the market is fully reflecting investor concerns and discounting very little in the way of potential positive outcomes.

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