TAKOTA
Asset Management Inc.

Reflections

Partners in Capital Growth

APRIL 2015

Surfing

Equity Market Performance

During the first Quarter of 2015 excess capital in search of returns has continued to push up the market price of whatever is seen as “safe", “household” or “in fashion” investments, with risks of bubbles in some sectors.

However, as this excess of savings is due to weak overall demand, the reality of weak or uncertain economic prospects means that this effect does not trickle down to core sectors of the market, especially those sectors that are seen as requiring strong growth momentum to thrive. This includes most commodities, mining, materials. As a result prices in these sectors remain especially attractive, and in our view an excellent opportunity especially for money that can afford to wait to see a good return.

While we cannot say when the expected “lift off” will happen, whenever it does, given how much prices are currently depressed, the returns are bound to be impressive....

Surfing: like in investing, success comes from properly setting up - and bidding time.

Surfing - have you ever tried it? I often think about investing in terms of riding a wave.

About three years ago this summer a long-time friend and I went west to learn to surf. Needless to say, we greatly tried the patience of the transported New Brunswicker who was our instructor and whose name was appropriately Chance. But after a lot of thrashing about, we each finally managed to ride a few waves.

As investors, riding a wave is what we all want today, to ride a wave successfully.

However, it is easy to forget that the reason surfers are so fit is not from riding waves back to the beach. Surfers are fit from the exhausting amount of paddling they have to do to get out beyond the surf and in position to catch a wave. So the less glamourous reality is paddling for a long time, waiting and waiting for that wave, and with skill having a successful ride.

This is a good analogy for investing today. We are still paddling out and waiting for that wave – which today for us is a higher level of global growth, the type of growth which, from the current low base of currently attractive opportunities, would give us an exceptional ride.

We are optimistic we can see something on the horizon, but we have seen promising waves before that have flattened out before they could reach us.

In the meantime, there are company specific developments that improve or cement the underlying business values of companies we follow, and some of these developments are solid improvements that do increase intrinsic value and will lead to higher target prices. But the big ride will come from the type of economic growth that makes people optimistic and confident enough to believe that the 2008 corner has been finally turned. Then, expectations of further growth will pull up the price of all the commodities and materials required to satisfy the foreseen increased demand.

From our reading of the available literature, the current status appears to be:

US: the economy looks better; but the strength of the US$ may become a concern;

Europe: growth is showing some signs of a possible revival, but from a very low base and still looking fragile, with a continuing austerity mindset that is not helping. The recent improvements are mostly due to a minor relaxation of austerity pressures rather than, as is claimed, “austerity working”.

There are increasing pressures from the US Treasury, the International Monetary Fund and many others for Europe and especially surplus countries like Germany (whose trade surplus is much bigger than China's, in dollars and in percent of its economy) to move away from restrictive toward expansionary fiscal policies. So far to no avail.

European economies are paying a hefty price, in lost growth and increasingly in social disruptions aggravated by high levels of unemployment. This can be seen in the loss of popularity incumbent "austerity" governments are increasingly facing (UK, Portugal, Finland, Spain...).

Greece could end up being a game changer if it succeeds in changing the Eurogroup's approach toward growth. However, whatever the validity of Greece's arguments, this is highly unlikely. As explained last month, given the political fear of the unknown consequences should Greece leave the Euro, the highest likelihood is for a last minute muddle-through that will not resolve anything durably, leaving Europe at the mercy of the next crisis. But this is not new: this is what they have been doing since 2008. However popular pressures everywhere should prevent a return to stricter austerity, allowing the slight improvements already seen to continue.

China: growth is slower but still very respectable (7% versus the 14% of the previous decade). Focus is shifting from infrastructure building to consumption (a necessary evolution for China). Their economy is closely and cautiously managed, to this date rather successfully despite some imbalances. Not risk free, but overall quite good;

India: seems to have elected a leader who can start the process of unlocking the enormous potential in that economy; given the size of India, positive changes there could have a meaningful impact and supplement China's slower growth rate.

Japan: fighting unfavourable demographics, but recent policy changes have been helping;

Russia: while Putin seems to want to play a high stakes Game of Risk; the impact for now has been more political than economic. It is however worthwhile to remember that Russia is the European Union's biggest fuel supplier, providing the bloc with 30% of its gas, 35% of its crude oil and 26% of its solid fuels, according to Eurostat. Russia is also a large producer of some commodities, like nickel.

Canada: Canada's prospects are uncertain. The oil sector was expanded at the expense of the manufacturing infrastructure that is now needed to compensate for the oil sector slump. The housing market remains overheated in Vancouver and Toronto while weakening elsewhere. Risk is high of significantly slower growth in the near to mid future, especially if the expected real estate market weakening finally occurs.

So, growth prospects seem to be improving. The buzz phrase these days is "moderate optimism". What investors must remember though is that all forecasts are heavily tainted by the recent past, and that ***the best time for paddling out is when the waves are weak...***

Update: Allied Nevada Protected Bond Trade:
The Allied Nevada Protected Bond trade that was the subject of our February issue of Reflections has been wound down. The put contracts were sold for approximately full value. The subsequent sale of the bonds brought the total return from this trade to about 39%.

As always, please call if you have any questions.

Scott Leckie, CFA

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