Sionna Investment Managers

SOUNDBITE

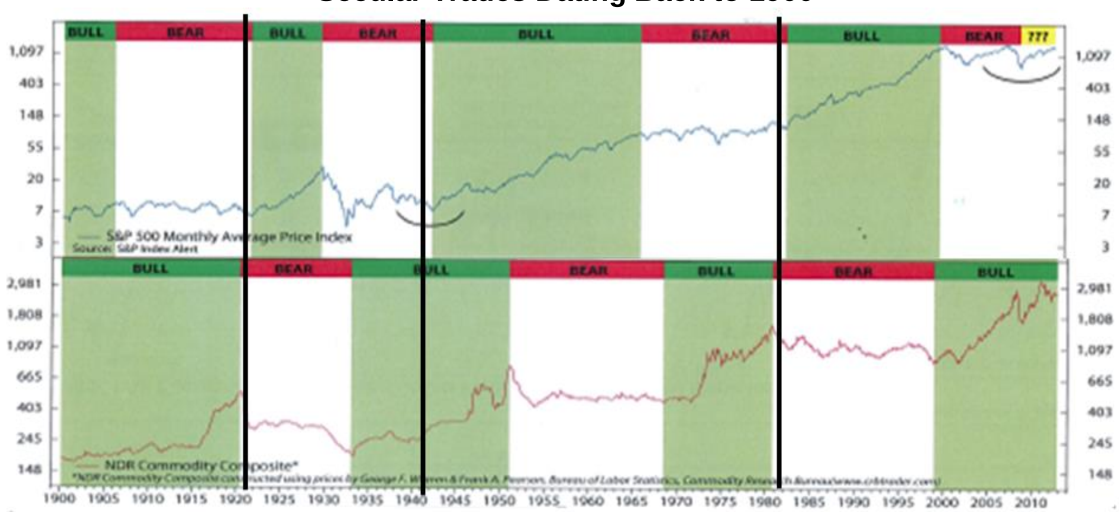
Wednesday June 19th, 2013

Good morning,

Sionna has some new insights into sideways markets we would like to share. In Chart 1, shown below, the green periods represent bull phases and the white periods highlight sideways/bear phases. The chart demonstrates how stock price trends are inversely related to commodity price trends. When equities are in a bull phase, commodities tend to be in a bear/sideways phase. This relationship seems to exist because the two asset classes tend to take cash and resources from each other in order to experience bull phases (greater than fundamental growth). The notable exception to this observation is the extended bull rally for commodities from 1942 to 1951. This out-of sequence, extended commodity bull might be explained by the post-war rebuilding that caused the rally to last somewhat longer than would be expected.

CHART 1

S & P 500 Monthly Average Price Index and NDR Commodity Composite, Secular Trades Dating Back to 1900



(Source: Ned Davis Research Group, February 2013)
(monthly data, Log scale)

Commodity bull phases have traditionally been good for Canadian equity returns given our significant resource exposure, and the current sideways market has been no exception. Chart 2 below illustrates the outperformance of the Canadian market relative to the U.S. market during the current sideways market - further evidence that the Canadian market benefits during an environments such as this.

CHART 2

Cumulative Return:
S&P/TSX Composite versus S&P 500

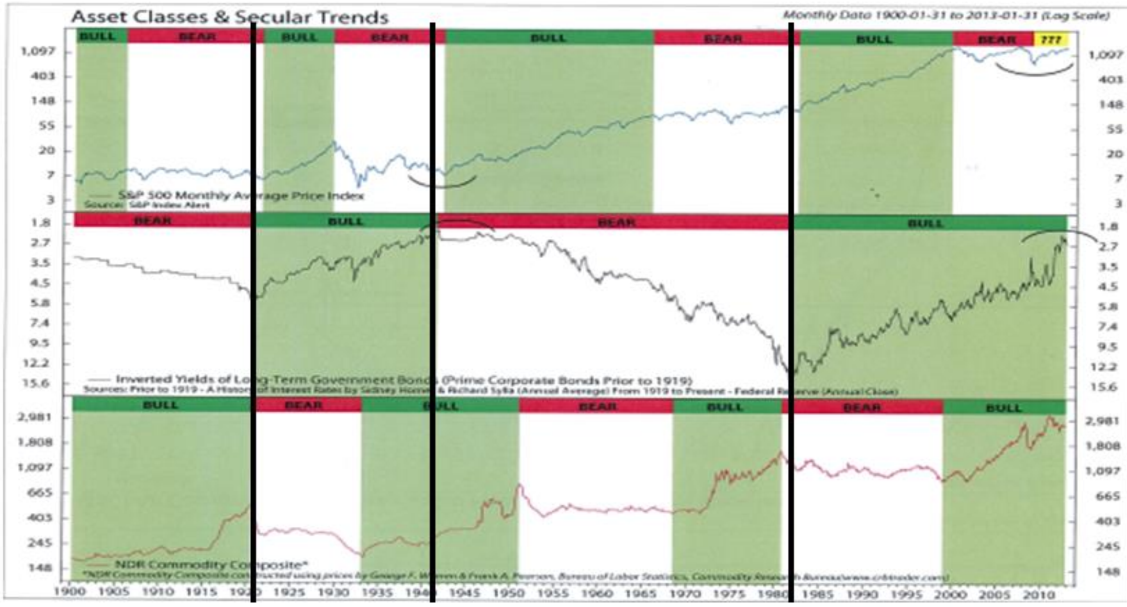
Index	Total Annualized Returns*	
	CND$	USD$
S&P/TSX Composite Index	5.6%	8.4%
S&P 500 Index	-0.3%	2.4%

(Source: Bloomberg, January 1, 2000 – March 31, 2013)

I had previously attempted to find a connection between interest rate movements and sideways markets, but to no avail. What I missed was that a full equity cycle (long-term average returns) consists of both a bull phase (above-average returns) and a sideways/bear phase (below-average returns). Further, it was possible to see a connection between 1) a full equity phase, 2) a full commodity phase and 3) a directional change in interest rates. The beginning of an equity bull phase occurs simultaneously with either a peak or bottom in long-term government bond yields. The following Chart 2 replicates Chart 1 above, but also includes long-term government bonds in the middle section. Rather than showing yields, the Chart illustrates the price of bonds, which are inversely related to interest rates. I have added the vertical black lines to better isolate the times at which previous simultaneous triple price shifts occurred.

CHART 3

S&P 500 Monthly Average Price Index, Inverted Yields of Long-term Government Bonds and NDR Commodity Composite, Secular Trades Dating Back to 1900



So what can this illustration of the past tell us about the future of our current market?

As we have discussed numerous times, sideways markets seem to last a minimum of 15 years, and tend to end when the market price-to-earnings (P/E) multiple has fallen below 10 times. Since we have already been in the current sideways market for just over 12 years, we suspect that the next shift could occur anytime within the next 18 months to five year. With that context in mind, in the space of a year or so we could see equities will enter a bull phase, commodities will enter their sideways phase and interest rates will start to rise (pushing the price of bonds downwards). Until then, we remain firmly in a sideways market, patiently waiting for multiples to fall to single digits. While some observers have suggested that the current equity market rally is an indicator that we are in the early stages of the next bull market, we disagree. We instead believe that the current rally is just a sideways market rally with continued volatility ahead of us.

However we are passionate observers of markets and find the sideways market theory useful in explaining longer-term market trends. In this spirit we wanted to share our most recent insights. While the absence of a bull market ahead of us may deflate the hopes of some investors, we find the continued volatility opportunistic. As discussed above in reference to Chart 2, the highly resource-exposed Canadian market tends to outperform in a sideways market. As bottom-up stock pickers with a neutral sector approach, we are able to find attractively-valued investments in the commodity-related sectors that still meet our stringent quality criteria. Building portfolios that consist of investments such as these has resulted in solid risk-adjusted returns in most market environments, and over the long term. We anticipate the current environment will provide similar opportunities for us to compound our clients' capital.

The Sionna Team

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