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Canada: Cheapest in a Decade

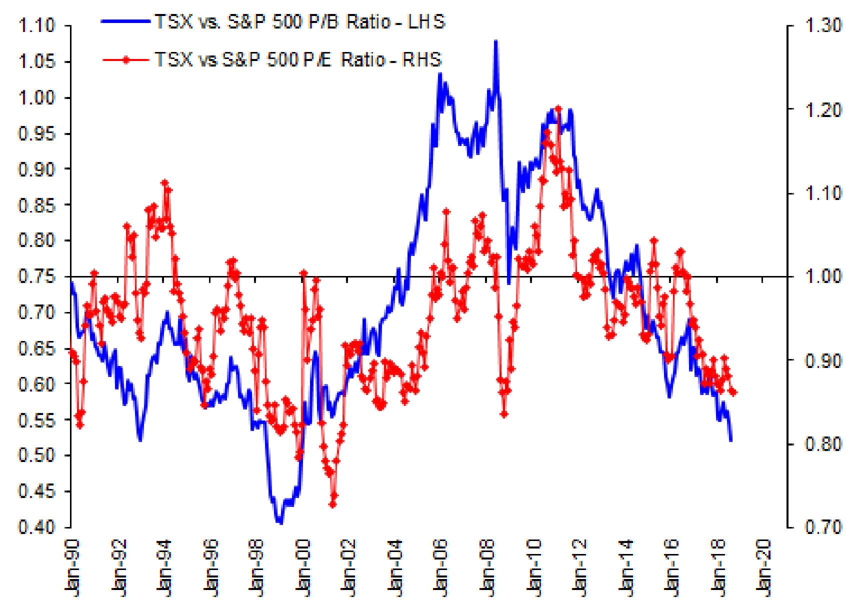
Canadian investors often like to compare and contrast our markets to those of our American neighbours. And being the polite and humble group that we are, we often focus too much on our shortcomings rather than highlighting our strengths.

Year to date, the performance of the Canadian equity index has trailed that of the U.S. At the time of writing, the S&P/TSX is roughly flat (dividends included) through 2018. Meanwhile, the U.S. has appreciated 10% (dividends included) over the same time period. As Canadian investors, this is not what we want to hear and we understand why this may create a dour sentiment in the marketplace today.

As value investors, we believe that negative sentiment and underperformance can sometimes create attractive investment opportunities. Finding undervalued opportunities is a key element of Sionna's investment strategy, which is why we pay attention to the valuation of the two markets on both sides of the border. As a result of the recent underperformance, the S&P/TSX is trading at a 15.6 times price-to-earnings multiple – roughly at its long-term average. The S&P 500, on the other hand, is trading at a 20.2 times multiple – near the top of its historical range and meaningfully above its average of 17 times.

This means that, relatively speaking, Canada currently looks inexpensive compared to the U.S. The following chart plots the relative valuation over a longer timeframe. A lower ratio implies that Canada is trading at a discount, and a higher one implies that Canada is at a premium. At today's levels the relative valuation is well below the average. Note that the discount hasn't been this wide since 2008, and indeed it has rarely reached such low levels.

S&P/TSX vs S&P 500 Forward Valuations



Source: Scotiabank GBM Portfolio Strategy, Bloomberg, Thomson Financial.

A similar discount is also observed in the price-to-book multiple, which is another yardstick in the value investor's toolbox. On this metric, Canada hasn't been this discounted since the early 2000s dotcom bubble. In fact, the relative price-to-sales, price-to-cash-flow and dividend yield are all well below their long-term averages.

There are a number of contributing factors that are causing investors to favour the U.S. over Canada in today's market: oil has been weighing on our index while the U.S. has gotten a boost from technology companies; NAFTA was an ongoing uncertainty and investors had been concerned about potential fallout if no agreement could be reached; and fiscal policy south of the border appears to be more stimulating for American companies. These factors tend to be the common causes for concern and are usually extensively covered in financial media.

However, none of these factors are new developments and we believe that some of these concerns are actually "priced in," so to speak. It is the tendency of market psychology to overreact to negative events. At Sionna, we prefer to keep a level head and focus on valuation. We continue to believe that future performance of stocks is significantly impacted by valuations at the point of entry. It's almost as if, by virtue of being at a large discount, Canadian stocks have a head start in setting future performance.

So what does this mean for the Sionna investment team? Even though we believe our home market is relatively undervalued at the moment, we are ever vigilant about bottom-up stock picking. The political and economic uncertainties that are present today all but demand us to invest defensively. Moreover, we continue to focus our efforts on finding attractively valued securities. This is in our knitting, and it allows us to capitalize on market mispricing in an intelligent way and without taking on undue risk.

