Marquest Monthly Pay Fund

MARQUEST ASSET MANAGEMENT INC.

First Quarter 2016 Review

Market Commentary

After underperforming the U.S. for five consecutive years, the TSX is finally starting to outperform its U.S. counterpart...at least for now. While pessimism towards both Canadian equities and the economy is still quite pervasive, we believe that we may have seen a bottoming out on a handful of commodities, which typically bodes well for Canada. Any positive news from emerging markets, Europe or commodities will likely provide positive momentum for Canadian stocks as well.

Canada has been a leading indicator for global weakness in equities and as such, investors have likely oversold and shorted Canada too aggressively. From where we sit, oil prices are now at cycle lows; and with the energy sector weighting within the TSX now approaching historical trough levels, the risk-reward equation becomes more balanced. While oil may be range bound in the near term, the best companies will prosper, and once again grow and acquire production. The obvious shorts are no longer obvious; and thus, wholesale shorting will no longer be the norm.

Global financial concerns have recently allowed the gold sector to attract bids. With negative interest rates in a number of countries, some are pointing to gold as a safe alternative to government and corporate debt. While we understand the logic of the argument, we also recognize that the gold equities really have no appreciable production growth potential. Rationalization, as well as merger and acquisition activity, is likely the only course for growth.

Over the past quarter, the Canadian market has followed a similar path to that of the U.S. A big downdraft in January was led by commodity-related securities. The Canadian financials sector corrected, but not to quite the same degree as the U.S. banks. Like the U.S. market, the rebound in oil prices solidified the market and set the stage for a substantial rebound led by all commodities. Due to the proliferation of shorts in our market, we had big moves in the golds, metals and oils. The financials also rebounded and have outperformed their U.S. counterparts by an approximate 2-to-1 margin. This is somewhat surprising, given the increased exposure of Canadian banks to energy, the struggling Western Canadian economy, and a less likely increase in net interest margins (no rise in Canadian rates = less spread). Nevertheless, it is now obvious that Canada, for the time being, is the beta trade, at least compared to the U.S. Coinciding with the rise in commodities, the Canadian dollar staged a massive rally, which underscores its "petro-currency" status.

Our view is that Canada remains susceptible to broad, tradable swings in sentiment. However, as time progresses, Canada will become increasingly correlated to the U.S. domestic economy and U.S. fundamental strength. As such, there will be quarters of outperformance and underperformance, but Canada should not continue to underperform the U.S. to the same degree it has in the past few years.

Market outlook

We are starting the second quarter with the Dow Jones Industrial Average, S&P 500 and NASDAQ all up (and the TSX down). The treasury yield is down 1 basis point, gold is down to $1218 per ounce and oil is at $36.67 per barrel. March was one of the biggest months in a long time, yet strength in the Canadian dollar wiped out much of the gain.

So, what will April bring? Forecasters are calling for S&P earnings to be down 8.5% in the first quarter, which is the biggest downdraft since the third quarter of 2009, when profits dropped 16%. Ninety-four companies have issued profit warnings and we expect more to do so in the coming days. Analysts have ratcheted down estimates, and earnings are in their own growth recessions. China continues to slow and early signs of banking problems have surfaced. Last year, utilities profits were down 16%, energy down 60% and materials down 7.3%. Forecasters are now preparing for a further energy earnings drop of 100%, and another 22% for materials. The industrials sector's earnings are forecasted to drop by 9% after a pretty rough year.

For the past year, markets have been tied to crude oil prices. The Saudi-Iranian conflict shows no sign of resolution. Iran oil exports have risen to 2.92 mm barrels per day and recent data shows further output. Saudi and Russian oil production also increased. A meaningful production freeze looks like an unlikely event.

Throughout the world, interest rates appear to be going down rather than up, and negative interest rates are now a common discussion. The market now believes we are unlikely to see any U.S. interest rate hikes in the near term. This will likely be the worst quarter for the energy sector, and the primary reason for the big drop in earnings (if you exclude energy, the numbers don't look so bad – but even then, they are mediocre at best). So what has changed since the Fed's December interest rate increase? Nothing, except for Fed Chair Janet Yellen's recent comments giving markets a green light in the near future. The Fed has taken a dovish stance, but it was only last December that it was bearish – underscoring how wishy-washy the current Fed is. Something has spooked it recently for it to do such a flip flop.

Portfolio Commentary

Throughout the quarter, we were focused on income and volatility. Two events impacted the Fund's near-term objectives: the weakness of the U.S. dollar versus the Canadian dollar, and the likelihood of very few interest rate increases. These events resulted in a rebound in commodity securities and underperformance of U.S. holdings (as the rise in the Canadian dollar negated U.S. returns).

On the income side, it now seems very unlikely we will see four interest rate hikes this year; we may be lucky to see one. Thus financials sector growth will be flat to low single digit. This is noteworthy because, to date, they have been strong dividend growers. During the quarter, Canadian financials recouped all their losses and some were even up 5% or more for the year. Their U.S. counterparts did not fare so well. After being down well over 20%, they have managed to recoup only 50% of their loss. The strength of the Canadian banks is surprising given their exposure to energy and the Western economy. Overall, we see the environment tightening for income returns as overall divided growth rates will decline and, given this, we have underweighted the financials.

Regarding volatility, the quarter was highlighted by the return of the commodity securities, with gold securities leading performance. It was not an area we had invested heavily in due to its lack of growth and inability to pay dividends. We will have to look for opportunities. The Fund's energy weighting has been increased, as we believe the supply and demand picture is slowly improving. We would be remiss not to discuss volatility of the Canadian dollar and its correction in January and February. Its rally basically negated any returns from our U.S. holdings, and the change in financial fundamentals has also caused a strategy shift. Our view was – and still is – that U.S. banks and financials provide better value than Canadian financials. However, without growth, values can be stagnant and therefore, we need to change our approach. Compounding current volatility has been the amount of shorts in the market. Aggressive short covering has caused the bounce in gold, metals and oil. Our view is that we need to see less volatility to make these areas investable again for the long term.

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