October 2013

"Most of us spend too much time on the last twenty-four hours and too little on the last six thousand years." -Will Durant

"It's the Economy, Stupid" –James Carville

Dear Client,

At the 11th hour, the U.S. Congress passed a bill that temporarily allows the government to avoid a debt default. The can has been kicked down the proverbial road until February 7, 2014. If the past couple of years are indicative of future negotiations on this issue, we can expect more of the same.

Putting things in perspective, this was the 18th time that the U.S. government has been shut down since 1976. The previous shutdowns were all eventually resolved and have largely faded from memory. The new round of budget negotiations will also get resolved. However, the ongoing uncertainty is having a negative impact not only on the U.S., but on the global economy as well. The frustration is especially apparent amongst the Chinese, who are the largest foreign owners of U.S. government debt.

The economy – slow growth

On October 8, 2013, the International Monetary Fund reduced its forecast for global growth for the sixth consecutive time in the past two years. The reason for the change in outlook was slowing growth in emerging markets. With government fiscal policy constrained by austerity measures and central banks mostly tapped out of monetary options, we may be facing an extended period of sluggish growth.

Until now, markets have held up well in spite of mediocre growth, as the Federal Reserve has kept the party going by refraining from tightening monetary policy. The Fed confounded but ultimately pleased investors in September by delaying the widely anticipated "tapering" or reduction of their bond purchases. However, it is becoming apparent that the impact from continued monetary stimulus is waning. At some point, investor focus may shift back to fundamentals such as earnings and revenue growth, which would make many of today's valuations harder to justify.

South Korea – a new den of opportunity?

We recently made our first investments in the South Korean market. While some Asian equity markets have seen sharp declines following "tapering" comments from the Federal Reserve, the Korean market has been more stable. This is due to several factors. As South Korea is a huge global exporter, its trade balance is in surplus. This leaves investors much more confident in Korea's currency, the Korean Won (KRW), particularly when compared to the currencies of countries such as India and Indonesia. In fact, while most Emerging Markets currencies have lost value against the US Dollar over the past twelve months, the Korean Won has actually slightly appreciated.

Although South Korea is Asia's fourth largest economy, growth has been subdued in recent years. This is hardly surprising given the state of the global economy. Nevertheless, according to Korea's Ministry of Strategy and Finance, the country is expected to see real GDP growth of 2.7% in 2013 and 4.0% in 2014. This is, in part, due to the government's efforts to stimulate the property market and support small and medium-sized enterprises. In May, the Korean parliament approved a government spending program of KRW 17.3 trillion (US $15 billion). Given that a revival of the housing market is seen as essential to boost economic growth, parliament is expected to pass further measures before the end of 2013 to support home purchases, a move that will have beneficial impacts on certain players in the South Korean economy.

Portfolio activity

One of the main beneficiaries of the stimulus efforts mentioned above should be the Korean banking sector. As such, our initial steps into the Korean market were made through investments in two Korean banks, namely **KB Financial Group** and **Shinhan Financial Group**. These banks, amongst the largest in South Korea in terms of revenue and total assets, are expected to benefit from the newly introduced government policies through increased mortgage lending and loan provision to the real estate/construction sector. This, in turn, should lead to improved earnings growth for both KB and Shinhan. Finally, both banks are trading at attractive valuations with price-to-tangible-book values of less than 1.0x and forward price-to-earnings ratios of under 10x. (source: S&P Capital IQ)

Back home in North America, we sold our position in **JC Penney** during the quarter at $13.17/share. The company's financial position continued to deteriorate and a return to profitability appeared a long way off – all due to a change in strategy by new management. While JCP may end up surviving and even thriving, the company's ongoing need for cash simply made it too risky to hold. If a company in our portfolio is not performing as expected, especially when its finances are becoming strained, we would rather take a partial loss than risk a potential disaster.

High Yield Bonds

A review of the high yield bond market and our high yield fund is available here: High Yield Quarterly

Conclusion

As long-term investors, we do not pay undue attention to "short-term events" such as the U.S. congressional theatrics – a movie we have seen many times before. Far more significant to us are the issues of navigating in a slow growth world and the impact that occurs when central banks ultimately start pulling in the lifeline of low interest rates. We remain comfortable with our cash position and focused on preserving the gains of the past year.

As always, we welcome the opportunity to discuss our outlook and investments with you.

Sincerely yours,

Lorne Steinberg
President