FRONT STREET

# Select Equity Fund

FORMERLY THE AURION II EQUITY FUND

COMMENTARY JULY 2016

FUND MANAGER
Greg Taylor

## OVERVIEW

Was that the low in bond yields? That is a question that has been asked over the last 30 years of this bond bull market only to be answered with a resounding, "No". So is it different this time? In the first week of July the benchmark US 10-year bond traded to a low yield of 1.35%, but quickly reversed to end the month over 1.50%. As yields have fallen, the income trade has seen increased inflows driving up the value of 'safe', high-yielding areas of the market such as consumer staples, telecoms and utilities. But if we really do see a low (or a bounce) in yields, all of these crowded areas will suffer and we could see a massive rotation back into lagging sectors (Financials and Healthcare). What is causing some to question if we will have a bounce in yields is that the world is actually doing ok. US economic data (while slow) is recovering, the emerging markets are performing well, and there are some early indications that wage inflation may be returning. Is it possible that if all of these factors remain strong, the Fed will have no choice but to raise rates before the end of the year taking yields higher? The market isn't expecting a hike this year, but the market has been wrong before.

The market rally that began from the Brexit dip continued through July driving many North American markets to record highs. What has been interesting with this move has been the way equities have disconnected from the oil price. For most of the last year equity markets have tracked oil, but that trend broke in July as oil fell almost 20% in the month and markets rallied. Some reasons for the oil sell-off are unique to that commodity, from supply coming back in troubled areas to hedging demands, but they did result in a sell-off that has been shrugged off. And while the Canadian Banks have traded like oil companies most of the year, they also ignored the selloff. The recent bull case for equities has been the TINA bid (There Is No Alternative), pushing investors towards equities in their search for higher income. This was highlighted in the month as the US 30 year bond yield moved below the dividend yield of the S&P 500 for the first time since 2009. In a low-rate environment, this flow of funds may continue to be a backstop dampening volatility in the market.

The TSX has been the strongest market among the G7 this year. Given our resource exposure, the Canadian market has been viewed as a proxy for strength in the emerging markets and as long as China and India keep growing the TSX should keep leading the charge. Base metals and energy are usually the best sectors for this theme and the fund has been overweight these areas for the past few months. While oil did sell off in July, the energy stocks have held up better, helped by a strong natural gas price, and copper's performance has kept names like First Quantum and Teck Resources moving higher.

The Front Street Select Equity Fund was up 3.5% for July and is up 12.1% for the year. August is traditionally a very volatile month and this year is shaping up to be no different. With a market at all-time highs heading into a second half of the year that will be filled with US politics and Fed hike debates there may be some merit to taking down risk. The gold sector remains the star for 2016 but that is a signal of the amount of fear in this market. So, while money coming to hide in equities can be a nice backstop, for the market to break out and move materially higher we do need to have bond yields stabilize and investors look to equities for growth – not income. Investors have been programmed of late to sell any potential of a rate hike, but if we start to look at a rate hike as a sign things are getting better, that might be what we need to move on to the next phase of this market.

FRONT STREET CAPITAL

33 Yonge Street, Suite 600
Toronto ON M5E 1G4

TORONTO 416.364.1990
TOLL FREE 800.513.2832

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