CELERNUS COMMENTARY – AUGUST 2015

"A little gale will soon disperse that cloud, And blow it to the source from whence it came. The very beams will dry those vapours up, For every cloud engenders not a storm."

~ William Shakespeare

Given the increase in equity market volatility over the last week, we feel impressed to communicate with our valued clients. Our desire is to provide context and insight regarding current events as well as to discuss how we are approaching heightened levels of volatility in our respective equity-oriented portfolios.

A (Very) Brief History of Bull Market Retracements

First the back-story. March 6, 2009 was an important date. On that day, North American equity markets reached the lowest levels that they would see during the 2008 bear market that saw the S&P 500 Index drop by approximately 40% and the S&P/TSX Composite Index shed a similar 48% of its value. Since that date, the S&P 500 Index has rallied 183% (not including dividends) while the S&P/TSX Composite Index has returned 72.80%.

During this six and a half year bull market, there have been a handful of equity market retracements that were near, or greater than 10%.

In 2010, the S&P 500 dropped 17.1% (measured on an intraday basis) as the European debt crisis began to take hold. Fears of bankruptcies from Greece, Portugal and Spain, as well as a forced bail-out of Ireland, prompted many to define the situation as a global financial crisis that could eventually spell the end of the euro.

Similarly in 2011, international debt problems began to roil equity markets as European borrowing challenges hit the headlines as did a downgrade of the U.S. credit rating by Standard and Poor's rating agency. The S&P 500 Index posted a peak-to-trough retracement of 21.6% in 2011.

The spring of 2012 saw the S&P 500 Index retrace 12.6% during a period in which Moody's rating agency cut the credit ratings of 15 major banks.

The year of 2013 saw a notable absence of material equity market retracements. Volatility remained low and equity buyers were motivated, driven largely by an absence of attractive opportunities in alternative asset classes.

2014 continued in similar fashion to 2013 as equity market buyers provided continual support to ever-rising equity indices. However, in the fall of 2014 events transpired to drive equities lower. Escalating geopolitical tensions saw the United States and its allies launch air strikes against ISIS in Syria. At the same time the first case of Ebola was confirmed on U.S. soil. In Asia, Chinese GDP growth of 7.3%, while stratospheric for any other nation, represented the slowest pace in five years and provided cause for concern. This drove an October peak-to-trough correction in the S&P 500 that was just shy of 10%. Curiously, the market rebounded as quickly as it fell resulting in positive returns for the month.

Retracements occur during solid bull markets. Retracements are a nuisance, but a reality.

Fast-forward to today, the S&P 500 Index is in the throes of a 12.5%+ correction while the S&P/TSX Composite Index is off by as much as 15% from earlier-year highs. Continued economic weakness in China has manifested itself in broad-based weakness in commodity prices (except gold) as well as Asian and emerging market equities. The Shanghai Composite has retraced as much as 42% from its earlier highs while the Hong Kong Hang Seng Index is down as much as 25%.

How Have the Celernus Equity-Oriented Funds Performed?

Shifting focus to the Celernus equity-oriented funds, as at the close of trading on August 25, the Celernus Absolute Growth Fund (CAGF) was down 5.6% on the year. This was 3.7% better than the S&P 500 and 4.5% better than the S&P/TSX Composite Index. The Celernus Equity Neutral Fund (CENF) was up 6.6% since its inception date of February 9, 2015. This was 15.4% better than the S&P 500 and 19.5% better than the

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S&P/TSX Composite Indices over the same period. While the Celernus Mortgage and Income Trust (CMIT) is not an equity-oriented fund, we do note that it has also posted a positive return – gaining 5.3% on a year-to-date basis.

	Return		
	Year to date	Versus S&P 500	Versus S&P/TSX
Celernus Equity Neutral Fund (CENF)*	6.6%	15.4%	19.5%
Celernus Absolute Growth Fund (CAGF)	-5.6%	3.7%	4.5%
Celernus Mortgage and Income Trust (CMIT)	5.3%	14.6%	15.5%
S&P 500	-9.3%		
S&P/TSX Composite	-10.2%		
FTSE 100	-7.4%		
Shanghai Composite	-6.3%		
Hong Kong Hang Seng	-8.9%		

Data: Bloomberg (As of Aug. 25, 2015)
*CENF launched on Feb. 9, 2015. Relative return calculations as of same date.

Economic Data is Consistent with Further Expansion (For Now)

It is our contention that the underlying U.S. economic data remains consistent with that which is typically found during a bull market. Our methodology for assessing the health of the U.S economy is data-driven and objective. We do our best to remove emotion from the process and are careful to not be swayed by subjective story-telling. If the numbers change, our view will change accordingly. At present, employment data, including Nonfarm Payrolls, ADP and Weekly Jobless Claims all continue to track constructively. Measures of economic activity, including ISM Manufacturing, Building Permits and New Orders for Manufacturers for Consumer Goods also remain consistent with dynamics found in an equity bull market. While equity risk, as measured by implied volatility, has surged, we note that US swap spreads, a measure of credit risk remain muted.

Slowing Earnings Growth Butts Heads with High Valuation Multiples

In our view, the challenge for U.S. equity markets over the last 12 months, has been reconciling positive, but slowing, earnings growth with lofty valuation levels that have left little room for further multiple expansion. Using a dividend discount framework, we believe that the constituents of the S&P 500 will generate an aggregate internal rate of return (IRR) of about 9.7% over the next 12 months. This assumes that broad-based estimates of earnings growth prove approximately accurate over the same period (famous last words.) 9.7% is below the 10-year average internal rate of return of 10.6%. Given that bond yields are at historically low levels, an IRR of 9.7% translates into a risk premium that is slightly more attractive than the average level of the last 10 years. However, a below-average IRR in a regime of higher-than average valuation creates a challenge for material upside to equity markets.

We highlight four key points as we proceed forward during these particularly volatile times.

1. Retracements ought to be expected.
They are a nuisance, but a reality. We believe that the current retracement represents a mid-cycle de-risking, but is not the beginning of an imminent bear market.

2. Economic data is positive.
At present, underlying data is consistent with further U.S. economic expansion. Such an economic data profile has historically proven constructive to higher equity markets. If the data deteriorates, so will our view. But up to now, it hasn't.

3. Earnings growth is declining but valuation levels remain elevated.
Given lower levels of (still-positive) earnings growth in the context of higher valuations, we believe that any upside to equity markets will be muted over the next 12 months. Earnings need to grow into their valuations or valuations need to drop in line with earnings growth. Currently, there is no easy trade. As such, we believe that active stock-picking strategies that seek to capture the benefits of single-stock return dispersion have a unique opportunity to provide attractive relative returns.

4. Diversification remains a free lunch.
Diversification through asset, strategy, market and individual security. At Celernus, we craft customized, diversified portfolios for our valued clients. More than simply assigning asset weights, our capacity to tap private lending markets in the mortgage fund (CMIT) and actively hedge equity exposure in our equity funds (CAGF,CENF) provides an additional element of diversification that is not common but is desirable – particularly during turbulent environments.

We appreciate your confidence and look forward to continuing in partnership with you as we make our way through these challenging times.

Regards,

Celernus Investment Partners Inc.