Market Bulletin

Issue No. 243
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Summary

Commentary

At the five-year anniversary of this global bull markets, our concerns include – rising geopolitical risk, investor complacency, frothy sectors, and China woes.

Recommendations

Sherritt International: Rating revised to Hold (from Buy), target lowered to $5.
SunEdison (formerly MEMC Electronic Materials): Sell to lock in gains**.**

Commentary – Five years and counting, but warning signs mounting

We are concerned about rising number of warning signs as bull market completes its fifth year

Elvis Picardo, CFA

Five years have passed since the 2008-09 crash that was precipitated by the global credit crisis, which resulted in most major averages plunging more than 50% in an 18-month period. The current bull market commenced on March 9, 2009, the day the S&P 500, Dow Jones Industrial Average, TSX Composite and MSCI World Index closed at multi-year lows. **But as this bull market enters its sixth year, there are an increasing number of warning signs that make us question the continued longevity of this aging bull**.

There is little doubt that equities have had a magnificent run over the past five years. US stocks have been the star performers, with the three major U.S. indices capturing three of the top five rankings for five-year returns, led by the Nasdaq Composite's 241.8% surge (Table 1). Apart from the U.S. indices, only Germany's DAX and Japan's Nikkei have added substantially to their gains over the past three years. Table 1 also shows that some markets stormed out of the starting gate when this bull market commenced, but have since faded dramatically; this group includes the TSX Venture index, and three of the four BRIC giants. **China's Shanghai Composite is the only major index to be in the red during this five-year global bull market**.

Here are a few reasons why we are now growing concerned at the five-year mark:

- **Rising geopolitical risk** – The deteriorating situation between Ukraine and Russia is a cause for concern, particularly because investors do not seem unduly worried about the potential for damage from the worst stand-off between the West and Russia in a quarter-century. This level of complacency can be dangerous.

- **Frothy sectors –** The end is nigh for bull markets when speculative frenzy increases and engulfs entire sectors. We are seeing some evidence of speculative froth in sectors like biotechnology and alternative energy (solar stocks, Plug Power etc.).
- **China woes –** A solar-cell maker today became the first Chinese company to default on its bonds. Does this signal the beginning of a wave of defaults?

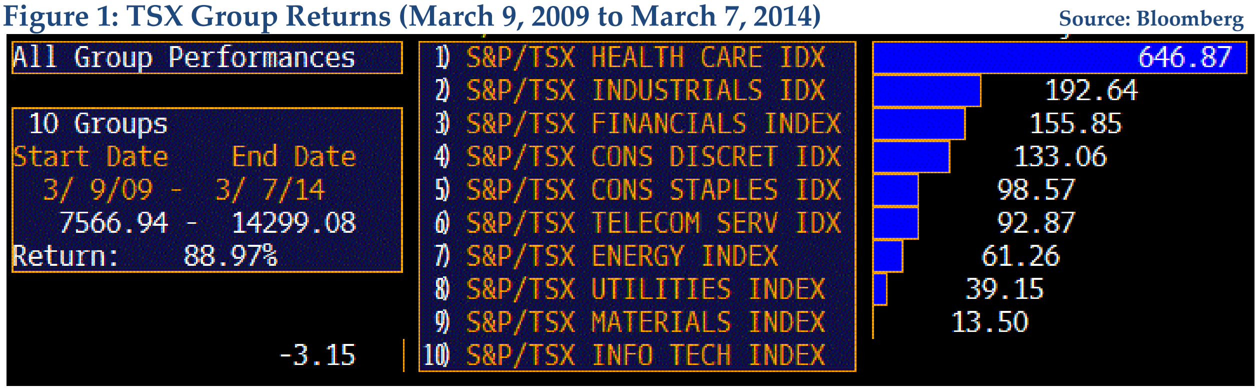
The TSX is up 5% YTD, leading the S&P 500 by more than 3 percentage points, which does little to reduce the huge gap with the U.S. index over the past five years; this underperformance is the result of the lagging Materials and Energy groups over this period (Figure 1). These sectors have performed a little better this year, taking the TSX closer to our 14,400 end-2014 target estimated in December. While we are hopeful of revising that target higher, in the near term, much depends on the resolution of the Ukraine situation.

Table 1: Global equity indexes – two-year, four-year and five-year performance (ranked by five-year performance – March 9, '09 to March 8, '13)

Country	Index	Two-year change	Four-year change	Five-year change
US	Nasdaq Composite	116.9%	155.7%	**241.8%**
US	S&P 500	95.1%	129.3%	**177.6%**
India	Sensex 30	126.3%	141.2%	**168.6%**
Germany	DAX	93.2%	116.3%	**153.3%**
US	Dow Jones Ind.	86.5%	119.9%	**151.3%**
Mexico	IPC	114.9%	161.3%	**129.4%**
Japan	Nikkei 225	49.4%	73.4%	**115.6%**
Russia	RTS Index	249.1%	165.8%	**101.1%**
Hong Kong	Hang Seng	109.9%	103.6%	**99.8%**
UK	FTSE 100	67.6%	83.0%	**89.5%**
Canada	**TSX Composite**	83.5%	69.6%	**89.0%**
France	CAC 40	58.5%	52.4%	**73.3%**
Australia	ASX 200	51.1%	62.4%	**73.2%**
Canada	**TSX Venture**	185.7%	37.3%	**28.1%**
Brazil	Bovespa	83.1%	59.0%	**25.9%**
China	Shanghai SE Comp.	41.7%	9.4%	**-2.9%**
Average		**100.8%**	**96.2%**	**107.2%**

Source: Global Securities Research, Bloomberg

Figure 1: TSX Group Returns (March 9, 2009 to March 7, 2014) **Source: Bloomberg**



Economic Analysis

Canada's job losses in February, lower trade volumes, renew slowdown concern
Loonie's Thursday gain short-lived as currency plunges almost a full US cent

Canada's jobs report for February came in weaker than expected, as the economy shed jobs for the second time in three months. Combined with a trade deficit number that showed lower volumes of exports and imports, the data drove the C$ down by almost a full US cent.

The Canadian economy lost 7,000 jobs last month, compared with expectations for a gain of 15,000, and following an increase of 29,400 in January. However, the headline jobs number (as usual) masks a number of conflicting facts that make it difficult to assess which way the economy is headed. On the plus side, full-time jobs increased by 18,900, although the 25,900 decline in part-time positions offset that gain (Table 2). On the negative side, the number of employees fell by 15,500, while the ranks of the self-employed increased by 8,600. The net loss of 15,500 in employee positions was caused by a steep decline of 50,700 in public-sector jobs, offset by an increase of 35,200 private-sector positions (another positive).

The net job loss of 7,000 was caused by a decline of 25,900 in the service sector (in areas such as health care & social assistance, financial services incl. real estate, and professional & technical services), partly offset by an increase of 18,900 jobs in the goods-producing sector (with modest increases in natural resources, agriculture, and manufacturing).

Provincially, employment fell in Quebec (led by part-time positions), increased in Alberta, and rose marginally in Ontario. British Columbia lost 10,400 jobs, split almost equally between full-time and part-time positions, and the jobless rate was unchanged at 6.4%.

On the trade front, Canada's merchandise trade deficit narrowed more than expected in January to $177 million, compared with forecasts of a $1.2 billion deficit and well below the December shortfall of $922 million (which was revised sharply lower from $1.66 billion initially reported). While one would expect a narrower deficit to help the C$, traders were concerned about lower volumes, with export volumes down 5.3% and import volumes down 2.6%. The trade balance has shown a deficit for all but two months since the beginning of 2012, as Canadian exports continue to flounder even as consumer spending props up imports.

Bottom-Line: The loonie is currently about a cent higher from its multi-year low of 89.10 cents reached on January 31. **The currency is little changed over the past month, and finds itself in the same position as it did after the January jobs report released on February 7, i.e. poised to test support at 90 US cents. In our opinion, downside risks to the loonie have increased given the marked deterioration in the geopolitical situation over the past month, since the currency is unlikely to be perceived as a safe haven in its current vulnerable state**.

Table 2: Canadian employment metrics (Source: Statistics Canada)

	Nov. '13	Dec. '13	Jan. '14	Feb. '14
Unemployment Rate	**6.9%**	**7.2%**	**7.0%**	**7.0%**
Employment (net change)*	**21,600**	**-45,900**	**29,400**	**-7,000**
Full-time	1,400	-60,000	50,500	18,900
Part-time	20,000	14,200	-21,100	-25,900
Worker classificn. (net change)	**21,600**	**-45,900**	**29,400**	**-7,000**
Employees	2,500	-8,000	1,100	-15,500
Self-employed	19,100	-37,900	28,300	8,600
Public/private sector (net chg.)	**2,500**	**-8,000**	**1,100**	**-15,500**
Public sector	-28,800	18,200	14,700	-50,700
Private sector	31,400	-26,300	-13,600	35,200
*totals may not add up due to rounding				

U.S. jobs gains of 175,000 in February top forecasts for first time in three months

Market reaction muted as Ukraine developments weigh on sentiment

The US economy added only 175,000 jobs in February, exceeding economists' median forecast of 149,000, while the January jobs gain of 113,000 was revised higher to 129,000. While those are not particularly strong numbers, investors were encouraged by the fact that this was the first "beat" in three months despite winter weather continuing to have a negative impact on employment. The unemployment rate ticked up to 6.7% (from 6.6%) as more people joined the workforce, although the U-6 measure of underemployment went the other way, declining to 12.6% (from12.7%) and down sharply from 14.9% a year ago. February's job gains continued to be driven by the US private sector (+162,000), with government jobs increasing by 13,000. Private-sector job creation continued to be led by service providers (+140,000) in sectors such as professional & business services and education / health services. Goods producers (+22,000) were led by the construction sector for the second month, adding 15,000 jobs after an increase of 50,000 in January. Manufacturing jobs were unchanged at a gain of just 6,000 last month, after January's 21,000 preliminary increase was revised significantly lower.

Market Reaction: There are a number of positive takeaways from February's jobs report – the increase of almost 700,000 Americans looking for work in the first two months of 2014, the sharp decline in the U-6 underemployment rate over the past year (which suggests more people are employed in jobs they like), as well as the decline of 900,000 in the number of long-term unemployed (> 27 weeks) over the past year. The jobs report enabled the S&P 500 to reach a new record today, but only time will tell if investors were right to ignore the Ukraine crisis.

Recommendations

On August 5, 2011, as global financial markets were rattled by the US debt-ceiling impasse, we had recommended two single-digit stocks that we thought had double-digit return potential (see link at http://www.globalsec.com/market_news/market_research.aspx). Our timing could scarcely have been worse, as Standard & Poor's downgraded the US credit rating later that same day (it was a Friday), triggering a two-month sell-off that was the worst since the dark days of early 2009.

Almost 2½ years later, those two stocks have moved in diametrically opposite directions, with one of them having almost *quadrupled* over this period, while the other is down 36% from our entry price. We provide below brief updates on these two stocks.

(Update) Sherritt – revising rating to Hold (from Buy), target lowered to $5 (from $7)
Level of leverage is a concern

Sherritt (TSX: S, $3.41) has rebounded from its 18% decline to a near five-year low of $2.82 on February 20, which was caused by the company's wider-than-expected Q4 loss and a 77% reduction in its dividend. While the stock's rebound from its low has been caused by enthusiasm for the stock's prospects on the back of rising nickel prices, Sherritt's level of leverage is a significant concern. **Accordingly, we are revising our previous Buy rating to Hold, while lowering our target price to $5, from $7 earlier**. We summarize below key recent developments at Sherritt:

- ***Financial Results*** – The company reported Q4 net loss of a whopping $673.8 million, largely due to impairment charges of $635.7 million, including an asset impairment charge of $466.8 million for its Coal business. As noted below, Sherritt had announced the sale of its Coal business on December 24, 2013, for estimated proceeds of $946 million (including $793 million in cash). Adjusted Q4 loss was $38.1 million or $0.16 per share, compared with an adjusted loss of $4.6 million or $0.01 per share a year earlier, and below analysts' break-even estimate. For the full year, net loss was $660.3 million; excluding charges of $600.3 million, adjusted net loss was $60 million or $0.21 per share.

- ***Recent Asset Sales***: In December, Sherritt announced the sale of its coal and potash assets to Altius Minerals for a combined all-cash value of $481 million, and the sale of its Prairie and Mountain Coal assets to Westmoreland Coal for assumed debt and cash consideration of $465 million sold. These transactions were designed to focus the company on its metals business (primarily nickel) and strengthen its balance sheet.

- ***Dividend Cut***: Sherritt announced it was slashing its quarterly dividend to one cent per share, from 4.3 cents earlier, when it reported Q4 results last month. While the dividend cut was anticipated to some extent after the announced sale of its coal operations – which was a notable contributor to free cash flow – the magnitude of the reduction took investors by surprise and caused the stock to plunge.

- ***On the plus side, although nickel looks promising*****.....** Nickel prices have advanced 11% this year on a couple of bullish developments. Firstly, Indonesia – which was responsible for 15.6% of mined nickel supply in 2013, according to WBMS data – banned unprocessed ore exports in January. If the Indonesian ban remains in place, it should help bring down current record levels of nickel inventories at the LME (Figure 2) and in turn help support higher nickel prices. Secondly, concerns about nickel supply constraints have been mounting as the political situation between Russia and Ukraine deteriorates. Note that Russian miner Norilsk Nickel is the world's biggest producer of refined nickel. As nickel now forms a larger component of Sherritt's business, higher prices could assist the company in achieving free cash flow sooner. The stock has displayed a tight correlation with nickel prices in recent months (Fig. 3).

- ***.... Sherritt's balance sheet is stretched***: Despite recent asset sales providing much needed liquidity, Sherritt's balance sheet remains highly levered, with its 2014 Net Debt/EBITDA multiple approaching 5x compared to 2.6x at its peers (Table 3). Sherritt's balance sheet is expected to remain stretched through 2014 and 2015, due to operations ramp-up this year and debt repayment next year. Shareholder-level free cash flow is not expected to turn positive until 2016.

Figure 2: LME Nickel inventories

Source: Bloomberg

Figure 3: Sherritt stock price vs. nickel price – Sept. 2013 to Present

Source: Global Securities Research, Bloomberg

Table 3: Sherritt financial forecasts* and peer multiples

($mm)	2014e	2015e	2016e
Cons. Sales	535.3	399.8	363.0
Cons. Adj. Income	-89.9	10.9	126.0
Cons. D&A	78.6	78.4	74.0
Cons. Capex	-171.0	-126.0	-168.5
Cash Dividends	-11.9	-11.9	-11.9
Debt Maturities	0.0	-275.0	-5.0
Est. Free Cash Flow	**-194.2**	**-323.6**	**14.6**
Est. Debt	1,684.2	1,445.9	1,421.3
Est. Cash	636.0	361.0	356.0
	1,048.2		
Cons. EBITDA	220	297	320
Est. Net Debt/Cons. EBITDA	**4.76x**	**3.65x**	**3.33x**
	Cons. N.Debt/EBITDA		
Teck Resources	1.96x	1.78x	1.74x
HudBay Minerals	3.47x	1.40x	0.67x
First Quantum Minerals	2.31x	1.58x	1.08x
Peer Average	**2.58x**	**1.59x**	**1.16x**

Source: Global Securities Research, Bloomberg
* Based on Bloomberg consensus forecasts

(Update) SunEdison (formerly MEMC Electronic Materials) – Sell

Level of leverage is a concern

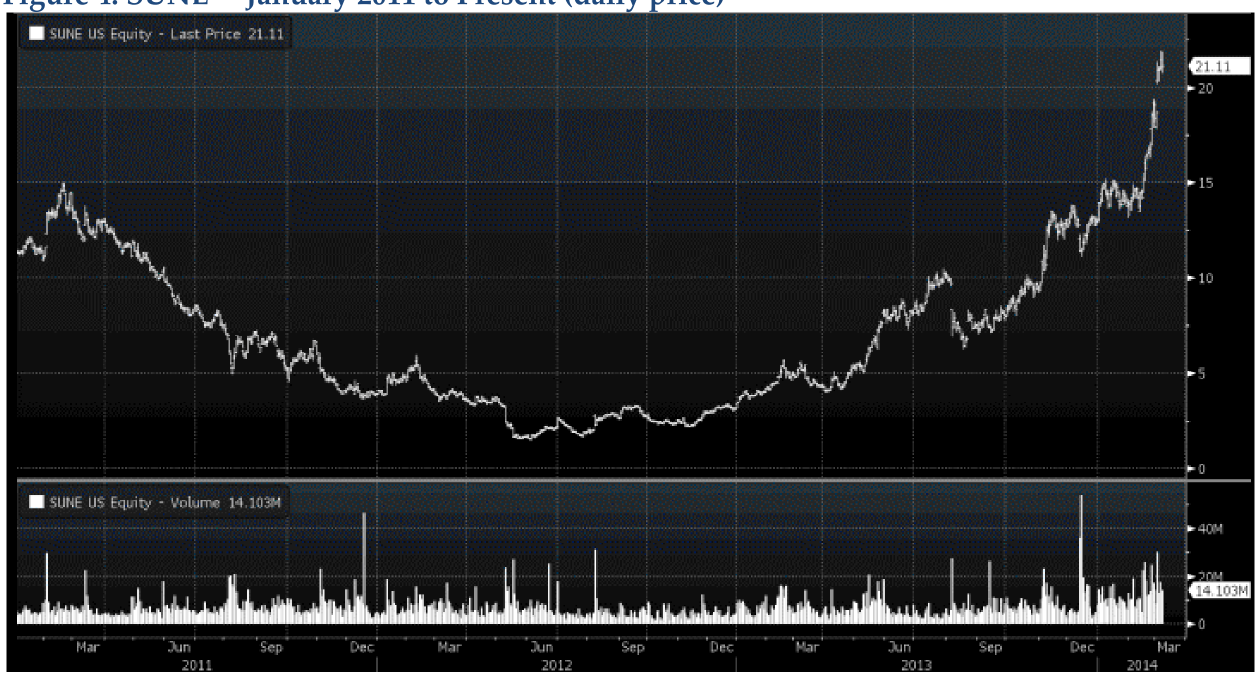
We had recommended SunEdison (SUNE: $21.11) in its previous incarnation as MEMC Electronic Materials, at $5.55 on August 5, 2011. With the stock up 280% since then, we strongly recommend selling the stocks to book gains.

SunEdison underwent a name change from MEMC Electronic Materials in June 2013. The name change seems to have turned the stock's fortunes around, as it has more than doubled since then (Figure 4).

The stock has benefited from a much improved environment for solar companies over the past couple of years. Investor enthusiasm for the sector has been revived by a number of factors – renewed interest in renewable energy, falling costs for photovoltaic cells, tax credit extensions, and an improved European economy.

The parabolic rise in many solar stocks has us concerned about the level of speculation driving these gains. With SUNE currently trading at its highest levels since November 2008, we think it may be best to book gains before the tide turns.

Figure 4: SUNE – January 2011 to Present (daily price)



Source: Bloomberg

Market Snapshot

At close on Friday, March 7, 2014

S&P TSX	14299.08	+27.16	**Commodities**			**Yields (%)**	**Can.**	**US**
TSX Venture	1043.01	+3.65	Canadian $ (US cents)	90.19	-0.83	90 Day T-Bill	0.82	0.05
DJIA	16452.72	+30.83	Gold (Spot)-US$	1339.98	-10.87	2-Year Bond	1.05	0.37
S&P 500	1878.04	-1.01	Oil (WTI-April)	102.58	+1.02	10-Yr.Bond	2.52	2.79
NASDAQ	4336.22	-15.90	CRB Index	307.19	-0.40	30-Yr. Bond	3.04	3.72

Thought for the Day

"Business is never so healthy as when, like a chicken, it must do a certain amount of scratching around for what it gets." – Henry Ford

IMPORTANT RESEARCH DISCLOSURES

Research Rating System
Strong Buy: Expected total returns of 20% or more over the next 6 – 12 months.
Buy: Expected total returns of 10% to 20% over the next 6 – 12 months.
Speculative Buy: Significant gains expected over the next 6 – 12 months, but entire investment may be at risk.
Hold: Expected total returns of 0% to 10% over the next 6 – 12 months.
Reduce: Expected total returns of up to -10% over the next 6 – 12 months.
Sell: Expected total returns of over -10% over the next 6 – 12 months.

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