

QV UPDATE

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The Bear is Awake!

Just when we thought the bear was in its hibernating slumber, this month has shown us it is alert in many markets. A bear market is defined as one that has dropped by 20% or more from its highs. The MSCI All-Country World Index and the stock markets in Canada, Germany, China, Britain, Japan and the NASDAQ in the US all reached bear market territory this month. One may ask, "Why is this happening?" Some will argue it is the price declines in oil; others point to China. It could also be poor liquidity or high valuations. We would suggest it is likely a combination of all of the above.

Commodity markets generally function in a similar way, but we will use oil as an example. Typically, a low oil price has been cured by supply cuts. However, today's oil market is very different from previous downturns in the last 40 years because Saudi Arabia, a major producer in OPEC, has stated it will not adjust production. This means the cartel activity will not prevail and it will be supply and demand forces that balance the oil market. Over the past few years, many analysts have declared oil cannot go below \$80 because oil sands producers require this price at a minimum to justify new production. There were two things missing from this analysis. Firstly, Canada and the oil sands are only one area of production in world oil markets. Other areas of the world have lower oil production costs and can make money at oil price levels below \$80. Secondly, oil service companies' pricing has come down meaningfully and productivity has increased, which has reduced the costs to bring the oil out of the ground and to market. Globally, the supply of oil has begun to decline as production cuts are occurring, but not as fast as hoped. Further, Iran has started to increase its production following the removal of sanctions. Usually, when the price comes down there is also an increase in demand as oil usage rises. We believe oil will move higher, but at what point and at what price? This could have been said at \$50, and \$40, but here we are at \$32 USD WTI. Similar dynamics are occurring in other commodity markets. How does this relate to the bear markets we are witnessing? As both up and down markets have shown

lately, they have been highly correlated with the oil price. There is concern the oil price and other commodity declines indicate the slowdown in the Chinese market is worsening and the globe may struggle in its growth. We would agree that China is slowing, but we do not believe this means there is no growth implied by the declines.

The drops have been very swift as have been the intraday reversals. Banks, which have been major market makers in equities and bonds, are restricted in trading their own books since new regulations were implemented after the financial crisis. This has resulted in lower liquidity. We have seen this play out mostly in the fixed income space, but it is also apparent in equity markets. Furthermore, when fear overwhelms investors and they withdraw from their investments, the investment manager doesn't have the luxury of timing their sales. They need to sell now!

We have discussed our higher than normal cash levels in most of our products due to rising equity valuations. We have also pointed out how the valuations are most elevated in stable sectors such as consumer staples, utilities and telecommunications. Declines have been swift in cyclical companies that we deem to be of high quality, but are trading at levels that imply the companies are impaired. Some companies will be impaired and may face bankruptcy, especially in the commodity areas. However, we have always been focused on balance sheets because companies with strong balance sheets can use those to acquire and strengthen their business or at least maintain their operation. A global brokerage firm recently announced that its investors should "sell everything except high quality bonds." This is encouraging. Market sentiment is very weak, and we have to be contrarian and take advantage of this opportunity. Does this mean we are putting all of our cash to work? No, but it does mean we are selectively buying companies that we believe have and will continue to make good decisions to persevere through this downturn.