QV UPDATE

Weekly Commentary | July 7, 2017

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Investing in an Aging Bull Market

It has been eight years since the bottom of the last major bear market and economic recession. This marks the second longest bull market in Wall Street history, as well as the third longest economic expansion over that timeframe. While this is an interesting statistic, it has very little practical value in telling us when the cycle will turn again. As the old stock market saying goes, bull markets do not die of old age. With old age, though, we typically find excesses in the market, increasing the need to focus on risk management.

Given the severity of both the recession and bear market of 2009, it may be possible for this expansion to push on for longer, surpassing even the decade long bull market of the 1990's. During the 1990's we had what was referred to as the "Goldilocks" economy – a perfect balance of moderate growth and low inflation which allowed for a market-friendly monetary policy. In the most recent Bank of America Merrill Lynch Fund Manager Survey, an all-time high 34 percent of respondents described the current economy as fitting the "Goldilocks" standard.

This backdrop helped global equity markets continue their upward march over the last three months. Nearly all major markets posted gains in the second quarter, with one exception being Canada. Bond markets around the world also rallied as the perceived pick-up in inflation seemed to moderate.

Housing – a major support or risk for the consumer and the economy?

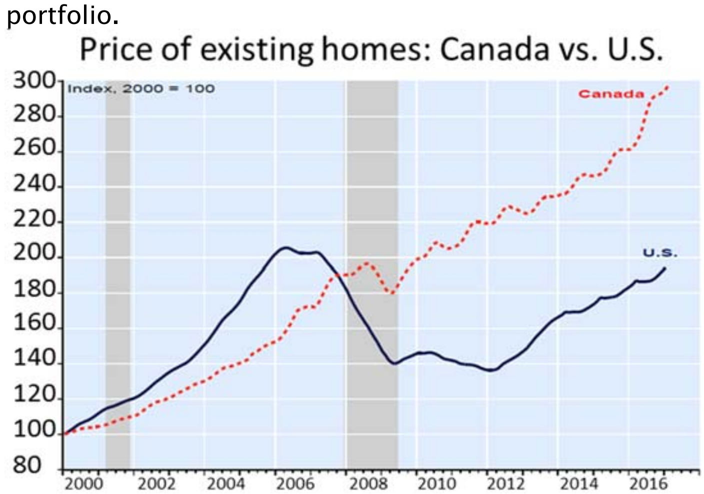
Consumer spending accounts for roughly two-thirds of U.S. GDP and is a major driver of the economy. The housing market is an important contributor to consumer confidence since home values are the largest part of net worth for most individuals. People feel wealthier when home prices are rising, leading to increased confidence and, in turn, spending.

The U.S. market has almost recouped its losses from the 2006 bubble and continues to gather steam with a relatively low home inventory, healthy buyer demand and increasing builder confidence. This price recovery is supportive of continued improvement in the economy. Ironically, this may be too much of a good thing if it pressures the Federal Reserve to continue to hike rates.

Canadian housing, on the other hand, had only a slight correction back in 2006 and has seen a number of specific markets increasing at an unsustainable pace. Signs of speculative excess have come to light causing the Bank of Canada to take note. Regulators have taken steps to tighten conditions and enable a soft landing, but that is never an easy task.

The central bank recently acknowledged that Toronto is now a bigger concern than Vancouver and, most worryingly, it is much more heavily indebted. A correction in the Toronto market would have far reaching implications given that the region has been responsible for nearly half the country's employment growth over the past two years. The Conference Board of Canada estimated that Toronto's economy grew by roughly 3.4% last year, accounting for nearly half of the country's growth in GDP.

Currently, both the U.S. and Canadian housing markets are a significant support for their respective economies. However, the overall Canadian economy is at greater risk with the possibility for select overheated real estate markets to pull-back significantly. We don't know when or if that will happen (corrections can sometimes go sideways rather than straight down), but it suggests the need for a prudently diversified Canadian equity portfolio.



Source: NBF Economics & Strategy (Teranet-National Bank, Case-Shiller via Datastream)

Risk Management

While markets continue to appreciate, a more pronounced divergence between the haves (growth) and have-nots (value) is developing. The first quarter of the year saw the largest quarterly outperformance of growth stocks versus value stocks in the Russell 1000 Index since 2009. That gap has continued to widen since then. In particular, a handful of growth stocks have been major beneficiaries. The so-called "FANG" stocks (Facebook, Amazon, Netflix, and Google) have soared in value to the point that these four companies have contributed nearly one-quarter of the gain in the S&P 500 since the beginning of 2015.

Source: InvesTech Research, May 12, 2017

In times like these our risk management process can feel more like a liability than an asset. In trying to maintain a reasonably valued portfolio with sound balance sheets, we end up trimming or selling holdings that continue to advance from expensive to really expensive, leaving gains on the table. We aim to recycle a dollar of capital into an investment that we believe has less downside risk and a greater likelihood of delivering above-average gains into the future. This new investment may require a catalyst or change in market sentiment to begin to appreciate, therefore patience is warranted. Any type of "risk management" during a bull market tends to reduce the portfolio's return. As difficult as it may be to watch the markets outperform when investors are feeling comfortable, we believe that long-term investing success depends not only on how much you make in the up markets, but also how much you preserve in the down ones.

We will continue to invest based on our risk management principles, even at the risk of short-term underperformance.

Canadian market

Oil prices corrected significantly in the quarter, suppressing returns for the Canadian marketplace. We must also remember that the Canadian market was one of the best performers in 2016, so a more muted return this year should be expected. While there will certainly be ongoing price volatility in our energy holdings, we believe it is one of the few sectors offering attractive valuations relative to the overall market.

Outlook for future returns

Not much has changed from our previous view. An improving economy does not necessarily mean an improving investment environment. Valuations, which were already high prior to the advance, continue to edge upwards. With elevated valuation levels, the margin of safety on the downside is less than we'd like and the upside return potential remains subdued.

Strategy Review

Q2/2017 proved to be a mixed quarter for our mandates. Our Canadian large cap strategy posted a -2.4% return, trailing the benchmark return of -1.6% due to security specific issues. Canadian small caps returned -0.6%, but beat the -5.1% return for the benchmark due to outperformance in the energy and materials sectors. Our global mandate return of 1.3% slightly trailed the 1.5% return for the MSCI World benchmark, largely due to our overweight energy exposure. Our Canadian bond strategy returned -0.1%, lagging the benchmark return of 1.1%, as our short duration portfolio was adversely affected by rising short-term yields. The Canadian balanced strategy posted a -1.4% return compared to -0.5% for its benchmark. All returns are gross of fees.

Looking forward we remain focused on ensuring our companies have balance sheet strength and reasonable valuations absent unsustainably low interest rates. Our bond strategy remains positioned to protect against losses should interest rates continue to move upwards. We won't try to force a higher return by increasing risk levels, but will look to take advantage when quality businesses go on sale and investor comfort is replaced by anxiety.