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A Correction in Perspective

Last week we were working on our outlook presentation for some upcoming meetings. One of the slides showed that it had been 308 trading days since the last 5% drawdown in the S&P 500. This was the second longest period without a 5% decline in over 80 years. The market decline that started on February 2nd proved this slide was no longer necessary in our presentation.

Some market participants use the number of trading days since a 5% decline to describe the sentiment in the market. A long period without a 5% decline may indicate that market sentiment is quite positive. Merrill Lynch analyst Savita Subramanian points out that 5% pullbacks in the US markets have typically occurred three times per year since the 1930s. True corrections, which are defined as a 10% retraction in the market, tend to occur once per year according to Ms. Subramanian.

Headlines such as "Global stock market turmoil: What's going on?" published on CNNMoney.com capture the short-term stock price movement but do not capture the long-term picture. From the peak on January 26, 2018, the S&P 500 had sold off 10.2% as of the close on Thursday, February 8th. This erased the gains made in the stock market since November 20, 2017. That is correct – the so-called "global stock market turmoil" simply brought the S&P 500 back to where it was about 80 days before. Investors need to remember that the S&P 500 had gone up 28.3% from the start of 2017 to its peak.

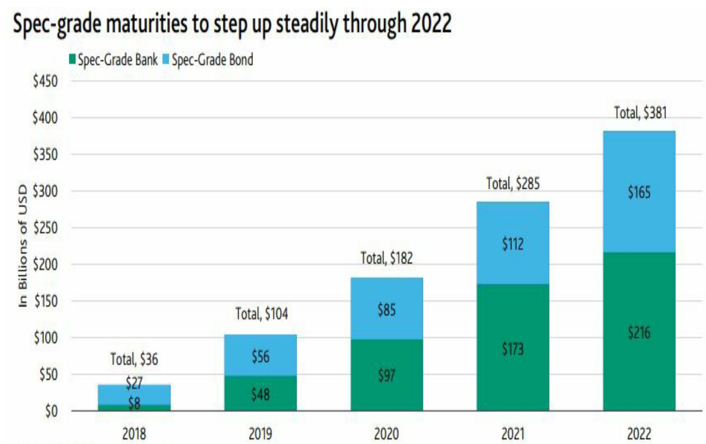
What about the TSX? It is down 8.2% from the start of the downturn on January 23, 2018 to the close of Thursday, February 8th. It was last at this level in September 2017. Performance of the TSX has not been as strong as the US market, but it was up 6.9% from the start of January 2017 to its peak in late January 2018. Although these declines are not easy to watch, a pullback was not only inevitable, but also long overdue by historical standards.

Some of the reasons cited for the recent market decline have been in the market for months. Companies have been adding debt to buy shares for a while. Jerome Powell, the new Fed Chairman, took office recently but his appointment was announced in November 2017. The Fed has been raising rates and has signalled that it is likely rates will continue to advance. Additionally, the wage inflation reported on Friday, February 2nd shouldn't have been a total surprise given the low unemployment levels in the US.

In previous letters, we have discussed the risk stemming from elevated valuations. Accompanying this has been optimistic expectations of further stock market gains by investors. We have tried to reduce exposure to the companies we believe have the highest valuation risk. We have also positioned our balanced funds conservatively with a 50% equity weight. We will take the opportunity of further weakness to increase our exposure to existing and potentially new companies with attractive characteristics. Alternatively, if we see markets continue to climb, we may reposition the portfolios more defensively.

What risks lie below the surface?

Debt levels and rising interest rates are topics discussed regularly. One thing we don't hear much about is debt refinancing. The chart below outlines the maturity profile for speculative bonds and bank debt in the US. The maturities ramp up significantly over the next few years.



Source: Moody's Investors Services

As the US economy continues to look strong with tax cuts and potential infrastructure spending, this may lead to higher rates. Recently, the companies in the chart have been able to refinance their debt a few years before the debt is due, in order to reduce the hazard that the maturity occurs during an unwelcome market environment. (Think the high interest rates paid by energy companies when oil was $30.) But what happens if rates continue to go up over the next few years and the economy slows as a result? This could occur if the economy becomes too robust and rates are increased aggressively. Many companies may not be able to service their debt at higher rates. They wouldn't have the ability to refinance and in a worst-case scenario may default on their obligations. This would hurt banks by increasing loan losses, affect companies' suppliers and may put downward pressure on valuations in some sectors. Risks are always around, but there are times when risks are priced into the market and other times when they are discounted or even dismissed. Our job is to try to review these risks and manage the potential impacts to our portfolios.