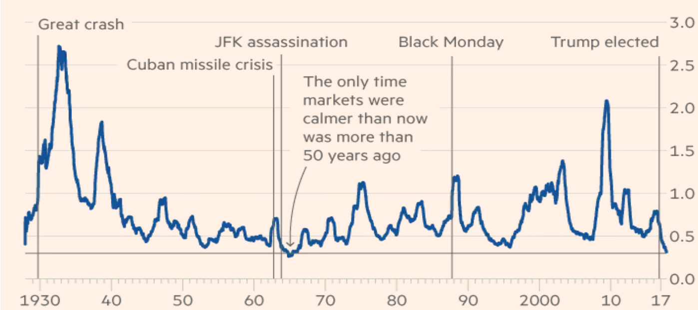
Markets in Transition

Despite all the talk about improving global economic conditions and investors clamouring to maximize returns, we think we're in the midst of a transition to more challenging times. It is therefore not the time to be increasing one's risk exposure. 2017 went down in stock market history as one of the smoothest annual rides investors have ever experienced (below).

Volatility vanishes since Trump victory

Daily change in S&P 500 (%, 12-month rolling average)



Source: Bloomberg, FT Research, FT graphic: John Authers & Joanna S. Kao

2018 started off right where the previous year ended, with global stock markets making higher highs. By January 26th, the U.S. market, measured by the S&P 500, was already up over 7% in USD. Not bad following last year's gain of nearly 22%. Investor fervour for stocks tested the limits of online brokerages, as surging trading volumes, new account openings and investor sentiment contributed to outages. The craze surrounding cannabis and cryptocurrency-related stocks confirms we are no longer in just an overvalued market - signs of a speculative stage are emerging. The love affair with overvalued U.S. technology stocks continued, with overly confident investors happily earning a mere 2-3% earnings yield, if that, in many cases.

Markets were gaining ground with little worry, until they weren't. In early February a swift correction took away the year's early gains, and more. The catalyst for the sell-off seemed to be the growing fear that inflationary forces were building. The labour market has been running at full capacity for some time now, but wage growth has been anemic. The January U.S. jobs report showed the strongest growth in wages since 2009 and a resultant spike in U.S. long-term bond yields gathered momentum thereafter. Closer to home, Canadian inflation stats also surprised to the upside. We are generally wary of putting too much emphasis on individual economic reports, but there does seem to be momentum building.

All Eyes on the U.S.

The U.S. economy continues to operate near full capacity with employment and consumer confidence approaching 20-year highs. Corporate earnings are healthy and the positive impacts of the much-anticipated tax cut have been built into the valuations of U.S. businesses. Now what? What's the encore? For this cycle, we expect the double digit return years to be behind us for the broad U.S. stock market and, in particular, the overvalued growth and technology stocks. Since the market bottom in 2009, the S&P 500 is up over 18% on an annualized basis, and expectations continue to be high. Although we expect continued economic expansion, the economy and the stock market are not the same thing. We anticipate positive economic news to be stifled by the accelerating need for the U.S. Federal Reserve to withdraw stimulus and increase interest rates. If U.S. bond yields continue to meander upwards, we expect them to pull global bond yields in the same direction. After decades of lower interest rates, we believe we are in the midst of a transition in global bond markets and expect interest rates to grind higher.

Higher interest rates do not necessarily mean immediate pain for equity markets. Higher rates are a signal that the economy is doing better and markets have often continued to perform well in this environment. The term "soft landing" is often used to describe a situation in which the central bank raises interest rates just enough to slow the economy without tipping it into recession. This is possible and would be the hoped-for scenario.

History, though, shows us that soft landings are not the most probable outcomes. To add to this, recent actions by U.S. President Trump are causing greater potential for instability. While tax reform and spending increases may be positive for businesses, never before has such stimulus occurred this late in an economic recovery. Any growth spurt could result in greater upward pressure on inflation, which will be a concern for both bonds and stocks. In addition, a new US$60+ billion potential trade war targeted at China could not only set off a wider global trade dispute, but also add to domestic inflationary pressure. We agree that some of the trade agreements in place need to be reviewed, but globalization has been the economic foundation for trade for decades. A drastic change in course is likely to have negative repercussions.

Asset Values and Risk Management

Over the past decade, the foundation for stock, bond, and real estate price inflation has been incredibly stimulative monetary policy. A generation of investors has become accustomed to cheap and available credit while asset prices have been determined using miniscule discount (interest) rates. We believe that higher interest rates will have a negative effect on these valuations. The policies that supercharged the pricing in these assets have likely borrowed from future years' returns. This suggests a lower level of overall returns should be expected over the next 3-5 years.

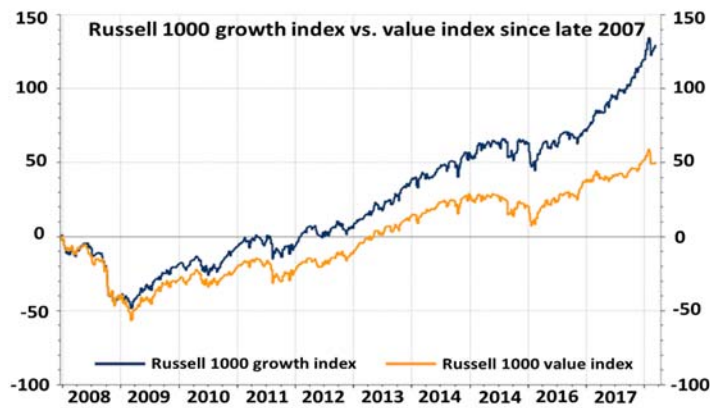
We can't predict the short-term variability in any market, but our risk management process does begin to wave yellow flags for us the deeper we get into a cycle. The irony in risk management, the process of considering one's returns in the context of the risks taken, is that it inherently mutes performance when markets are going up. Our portfolio management teams continue to struggle to invest in a market where valuation risk is high, balance sheets are getting stretched, and there are limited opportunities to find excellent businesses at reasonable prices.

Active Management with a Value Bias

Our relative results within certain strategies have been challenged as of late, lagging the market benchmarks. We are not doing things differently than in the past. Historically, it is not uncommon for us to lag toward the end of a cycle. In these cases, we have often been asked why we can't keep up with the markets. In these environments, clients will sometimes focus on the very short term rather than considering our track record throughout a cycle, or the circumstances leading to the performance.

It is with complete candour that we have said to all stakeholders that we don't outperform in all parts of a cycle. We will often lag in the most positive years, or those that fall deeper into an economic cycle, when risks are increasing. Historically, we have outperformed as markets transition to more challenging phases.

We offer an example below of the types of challenges an active manager with a value bias faces in the current market. Many investors will only consider the performance number without giving a second thought to how that number was generated or the risks inherent in producing a return that might meet the benchmark. The chart below compares growth stocks to value stocks in the U.S. market. Growth stocks have far outpaced value stocks since the beginning of 2009 and the gap has widened to the greatest spread since 1999.



Source: Thomson Reuters Datastream/Caroline Valetkevitch

More heavily exposed to value stocks, we have marginally lagged the global benchmark over this period. But when the market preference changes, and it always does, you won't find a significant proportion of overvalued positions in our strategy, like you will in the index. Still, investors aren't focussing on this right now. Why should they when it's been nothing but an up market? Successful investing needs to consider both the upside and downside. Risk management, solid balance sheets and reasonable valuations will all come to matter again at some point.

Summing it Up

This bull market has been partially fuelled by a once-in-a-generation collapse in interest rates and unsustainably stimulative monetary policy by central bankers. For now, growth-oriented stocks have been the biggest winners. These drivers might carry on for longer than expected, but when things turn, the drivers of the next market will likely change too.