

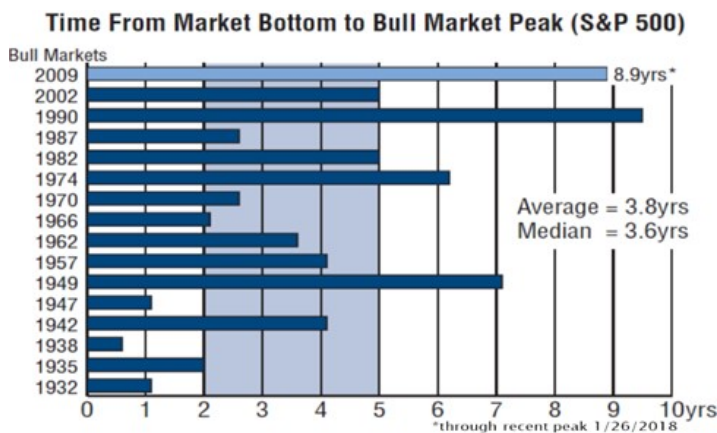
# QV UPDATE

Weekly Commentary | July 6, 2018  
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## Risk taking, past cycles ... and a silver lining

We are now in the tenth year of one of the longest bull markets of the past century and investors are feeling pretty good. And why shouldn't they? Economies have improved significantly from the tumult of the 2008–2009 financial crisis. Real estate prices have rebounded strongly and are higher in most markets. Stocks and bonds, private equity, infrastructure assets, etc. are all providing a positive experience for investors. Overall, people are feeling wealthier from the inflation in global asset prices over the past decade.



Source: InvesTech Research / April 20, 2018

Perversely, investors' propensity to take on risk seems to increase the longer a cycle lasts and the higher past returns have been. While they may not inherently be looking for risk, they tend to chase higher returns without consideration of increasing pressures. Historically, bull markets have peaked at the same time as investor optimism. The old adage referring to fear and greed driving the stock market remains very relevant today. There are clearly signs of excess and reasons to be cautious, but this doesn't precisely tell us when the next bear market will come or how much damage it will cause. One thing we are confident about – your best risk/reward opportunity doesn't arise at this stage of a market cycle. Often, it's the opposite.

## The U.S. economy & stock market

The U.S. economy continues to accelerate on the back of strong employment and consumer confidence approaching 20-year highs. Corporate earnings have surged due to the impact of recent tax cuts. Since the

market bottom in 2009, the S&P 500 is up over 18% on an annualized basis, and expectations remain high. In addition, the U.S. dollar has strengthened significantly against other major global currencies. In other words, it has been a very favourable backdrop for investors in the U.S.

Looking forward, President Trump says the U.S. must right the wrongs of previous trade agreements. In doing so he continues to cause a great degree of global uncertainty as his unpredictable negotiating tactics keep world leaders off-balance. His recent sparring match with the Canadian steel and aluminum industries, not to mention his threats on autos and jobs at Prime Minister Trudeau, are examples of this. In addition, there are likely to be significant global implications if the current stand-off with China escalates. For now, though, our guess is that it's just posturing.

The U.S. is looking to strengthen at the expense of other economies. We see this as a short-sighted approach given the interconnectedness of the global economy. It's one thing to negotiate a better trade agreement; it's another to significantly weaken the economies of global trading partners. Europe's economic growth remains fragile, Canadian markets have been hampered by NAFTA uncertainty and many developing countries have been struggling in the last few months.

## Buy America, sell Canada

Broadly speaking, we are of the view that investors are expecting too much from the U.S. stock market. Over the past year or two, there has been a real shift toward global investment and reduced exposure to Canadian assets. This is very much "rearview mirror investing" (ie. looking backwards instead of forwards). Investors have seen U.S. returns far outpace those in Canada. And, when adjusted for the strengthening U.S. dollar, the gap is even more pronounced. For example, the Canadian market has returned over 9% per year over the last five years, compared to the U.S. at 13.4%. But when you adjust the U.S. return for currency, it translates to 18.7% in Canadian dollar terms! These are some of the most pronounced relative returns we have witnessed in decades.

We don't believe we'll see anywhere near this type of outperformance going forward and expect these markets to revert as they have historically. Investors forget that, over the last 20 years, returns in Canada and the U.S. have been virtually the same. They also seem to have forgotten the period from 2002–2008 when the Canadian dollar strengthened significantly, materially weighing on their U.S. stock returns. The resulting mantra back then was: "Stay in Canada. Don't go global or you'll take on too much currency risk." Although foreign currency exposure has worked in Canadians' favour over the last number of years, it will work against them again at some point.

### Past cycles and the silver lining

We've seen cycles where certain markets and sectors outperform others. This most recent decade reminds us more and more of the 1990's, when both the U.S. stock market and the U.S. dollar generated significant returns. Back then, the bull market ended with the crash of the technology bubble. We're not suggesting an extreme of that magnitude is brewing in the U.S. today, but we are cognizant of significant excesses. Specific sectors and stocks are propelling the U.S. markets higher at the expense of more defensive companies. However, it is these companies that are offering us better value in our global mandates, and we welcome that.

In Canada, our currency continues to depreciate, as do many of our favourite holdings, some of them significantly. This is the silver lining we've been looking for when we consider future rewards. Within highly valued stock markets, one by one, opportunities are emerging. We haven't said that often in the last number of years. But with interest rates increasing, the Canadian market lagging, and investors tripping over themselves to buy growth stocks, good businesses have been pressured. These are the ones we've been adding to.

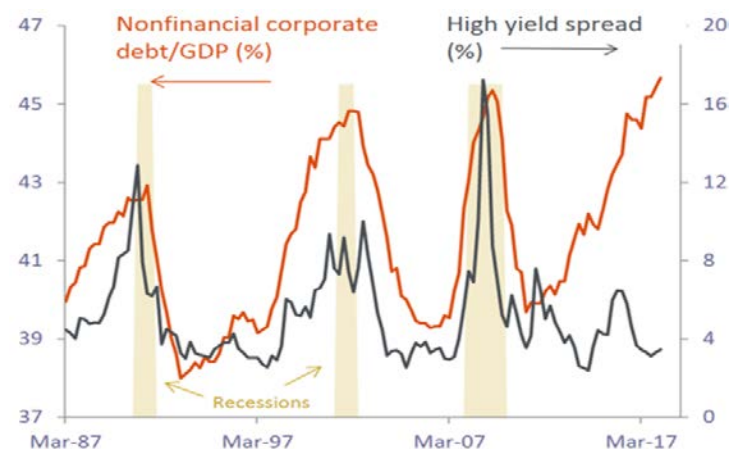
### Debt market update

The sub-prime real estate market kicked off the global financial crisis of 2008/2009. At that time, the majority of financial experts agreed that the issues would be contained to the real estate mortgage market. What they missed, though, was that excessive leverage in an interconnected financial world would result in the crisis growing and spreading rapidly.

After such a traumatic experience, you would think the global financial system would be more stable today, with

debt levels managed back down. While there has been increased regulatory oversight and improvements, the overall levels of debt in the economy continue to be elevated and yellow flags are waving. We have repaired the previous debt crisis by... potentially creating another one.

The amount of debt taken on by U.S. corporations has reached record levels, propelled by an unprecedented period of ultra-low interest rates. A significant amount of debt has been used for unproductive uses, such as share buybacks, without a corresponding investment in future growth to support the additional leverage. The low cost of debt has also led to abnormally high profit margins for companies, which will come under pressure as the cost of debt rises. The chart below illustrates our view that investors are reaching for higher return without considering increased risks. It shows that investors are receiving very little spread, or additional return, for taking on greater potential default risk in lower quality bonds, even as total debt levels remain at all-time highs.



Source: Bloomberg, PiperJaffray

We don't know when the high yield market will falter, but we certainly don't believe investors are being adequately compensated for taking on the additional risk in this market. We highlight the high yield market as a good example of the risk investors are accepting in order to reach for higher returns. This behaviour is very typical of late stage investing.

We are not reaching for return and remain committed to our process. Our philosophy of investing in quality businesses at reasonable prices helps ensure we are not exposed to undue risk. Although discipline and conservatism may lag other strategies in the short term, we are confident it will pay off as the cycle changes.