Diverging Trends Globally

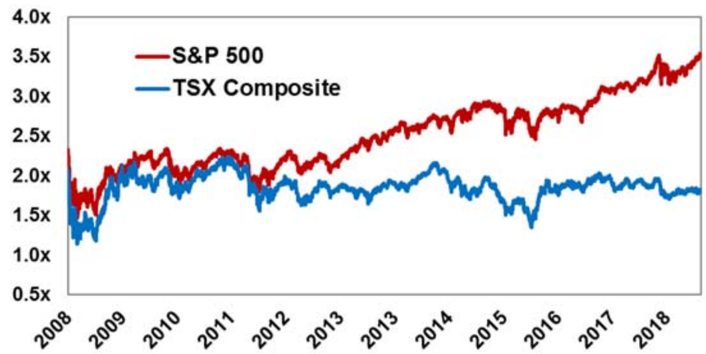
As a young man, I operated on a tight budget while nourishing a curiosity for the global economy. This led me to places like Argentina after a peso collapse, Brazil after hyperinflation, Iceland at the height of financial crisis and Bolivia during a period of political upheaval and nationalization. Through my travels, a common theme was how intertwined the global economy had become, even in South America's poorest country.

With the US stock market near all-time highs, one might expect the US to be the ultimate winner in a global trade war and conclude that investment risks are minimal. Don't be fooled. Although tariffs were much higher at the time, the US Smoot-Hawley Tariff Act of 1930 is probably the best precedent to consider. The Act broadly raised tariffs on imported goods by approximately 15%. By itself, this was expected to help Americans. Instead, tit-for-tat retaliation exacerbated the Great Depression, and more importantly, frayed US alliances over the long-term. At the time of Smoot-Hawley, global trade was a fraction of what it is today. Economic and geopolitical consequences from a trade war have never been higher.

Despite a robust US economy and equity market, there are signs of vulnerability. On Thursday, the WTO cut world merchandise trade forecasts for 2018 and 2019. Also, on Thursday, Ford Motor Company's CEO stated that metal tariffs have increased costs by approximately $1 billion. Ironically, the company sources most of its steel domestically. Under the hood of a rising US stock market, the shares of Ford and General Motors reached one year lows this week and are now well into bear market territory.

Diverging monetary policy is also a growing risk. The US raised rates again this week at a time when the rest of the world maintains a more accommodative policy framework. These dynamics are altering the state of capital flow. So far, implications have been severe in vulnerable economies such as Argentina and Turkey, while money continues to pour into the US as a perceived safe-haven. The US is not immune to risks associated with growing global divergence at a time when its market is increasingly suggesting otherwise. Take the price-to-book value of the S&P 500 vs. Canada's S&P/TSX. The multiple investors are willing to pay for equity in US-domiciled companies compared to Canadian businesses has widened markedly over the past ten years. This is not just a US vs. Canada phenomenon; this trend has occurred in all major markets.

Mind the Gap: S&P 500 Price/Book Multiple vs. the TSX



Source: S&P CapitalIQ

For Canada to minimize risks associated with a less-synchronized global economy, it is in our best interest to negotiate trade terms with the United States as best as we can, and to not cut off the nose to spite the face. At the same time, we need to aggressively pursue growing international opportunities as the US increasingly looks inward. Liquefied natural gas shipped from Canadian shores appears to be an obvious and significant near-term opportunity. Asia's appetite for natural gas is growing at an unprecedented pace as they try to reduce carbon intensity while managing their growing energy needs. As a resource rich alternative to the US, Canada can play an important role in supplying this demand in a highly responsible and economic manner.

With global divergences widening in an aging bull market, we believe an investment strategy focused on downside protection is more valuable today than at any point in the past decade. Compared to our benchmarks, we are positioned defensively. From a balanced strategy perspective, QV maintains outsized exposure to short duration bonds. Within equities, we are overweight in businesses such as grocers and utilities that have demonstrated long-term value creation over a cycle while exhibiting operational resiliency in more challenging economic periods.