QV UPDATE

Weekly Commentary | October 12, 2018

Joe Jugovic, CFA

Q3/2018 Commentary

The majority of global equity and bond markets struggled in the quarter. The U.S. market bucked the trend, surging by over 7%, posting its largest quarterly gain in nearly five years. U.S. stocks are now trading at their highest premiums relative to international shares as investors remain confident that the domestic economy will continue to outgrow its global peers. The chart below illustrates the decoupling in the U.S. market versus the rest of the world over the past couple of years. Typically, correlations are relatively high for equities, and it has been rare to see divergence of this magnitude.

Source: Bloomberg

What could derail the U.S. dominance?

Rising U.S. interest rates. After languishing throughout the summer, yields have resumed their march upwards. While rates remain at relatively low levels, we expect them to continue to increase and likely surpass market expectations in 2019. After spending an unprecedented amount of time with a zero-interest rate policy, the Fed has been carefully removing stimulus and reassuring investors of their gradual approach to normalizing monetary policy. Historically, tightening in the monetary landscape has been a precursor to more challenging periods for equity investors. Should there be any deviation to this gradual rate tightening cycle, we'd expect considerable volatility.

The stronger the economy, the more we should be concerned

The following chart shows the current extreme level of consumer confidence in the U.S. You'll note that high confidence levels, when the future looks bright, often precede a rate tightening cycle and a recession. As John Templeton wrote, "Bull markets are born on pessimism, grown on skepticism, mature on optimism, and die on euphoria." The one thing that is for certain is there is little pessimism or skepticism being valued in the U.S. market currently. For all the excitement investors espouse of multi-decade low unemployment rates and expected double digit earnings growth rates, they should watch what they wish for.

Source: InvesTech Research / September 21, 2018

Is that a little bit of blue skies we see there?

After over a year of NAFTA negotiations, it appears the parties have finally worked out a deal. For all the talk of the supposed worst deal America had ever entered into, in many ways the newly inked USMCA is not materially different from the previous agreement. What is significant, though, is that it represents a political win for President Trump and a reasonable outcome (compared to the potential alternative) for Canada. The potential for very damaging tariffs directed at Canada's auto industry and an uncertain trade landscape have kept a dark cloud over the Canadian economy and stock market. At least this is one less thing for investors to worry about.

Current and future opportunity

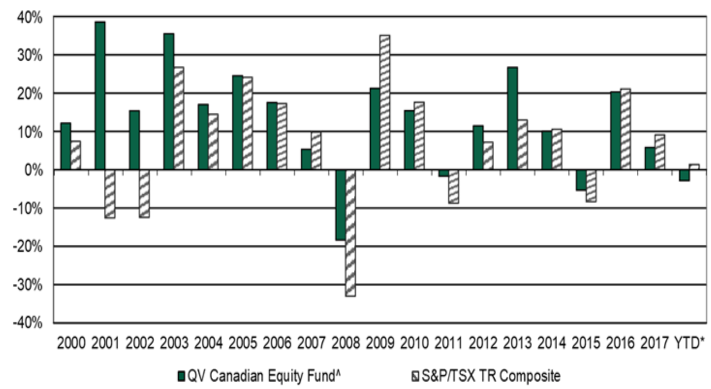
We highlight a number of points we feel are important to consider:

- 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 slower growing businesses. However, it is these companies that are offering us better long-term opportunities in our global mandates.
- A few years back the Canadian market looked fully valued to us. With the significant sell-off in energy prices in 2015, the worry surrounding consumer debt levels and lofty real estate prices, the onerous regulatory environment and the recent NAFTA uncertainty, international and domestic investors pulled away. This has created what we believe to be an opportunity to buy excellent Canadian businesses at fair prices again.
- 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.
- The proliferation of passive investment and computer program trading strategies are exacerbating the market dynamic where growth/momentum stocks are the big winners. We anticipate the next market downturn will shine a bright light on the shortfall of this style of investment. Until then, active managers like us will need to be patient.
- While higher interest rates may have an adverse effect on equity valuations and economic growth at some point, they are offering investors a more attractive yield within a fixed income portfolio. This is certainly welcome after years of punitively low rates for savers.

Focused on the long term

QV manages money with a value focus and a disciplined process which has been proven to deliver superior risk-adjusted returns over time. Does that mean we outperform in all time periods? No. Historically, we have lagged market benchmarks for many quarters, if not years, before making up the returns. For that, you can blame our risk management process which drives us to build a portfolio of quality businesses trading at reasonable valuations with strong balance sheets. Sometimes the market doesn't care about that "stuff", instead focusing on new technologies, growth, commodities etc. Also, sometimes we get our investments wrong and they significantly impact our concentrated portfolios. The chart below illustrates this for the QV Canadian Equity Fund. Although it has not matched the benchmark in all annual periods, over the past 20, 10, and 5 years, it has delivered gross returns of 12.4%, 8.0%, and 6.7% respectively. These returns include the recent challenges we have alluded to. The strategy holds up well relative to the TSX benchmark returns of 8.0%, 6.3%, and 7.8% over the same time frames.



^ Returns prior to 2007 reflect the Canadian equity carve-out of the QV Canadian Balanced Fund
* YTD as of September 30, 2018

In analysing our returns over longer periods of time, our value-add stems from both our willingness to be different than the market and our downside protection during very difficult periods. We're not talking about short-term volatility, but rather more challenging bear markets (20%+ fall in the stock market). This attribute is easily forgotten when markets are not extremely volatile.

Current Positioning

We are not investing in areas of excessive optimism, but rather in areas of uncertainty. Many of the businesses we have been adding to have already gone through a significant correction (i.e. bear market). Our portfolios offer differentiated characteristics from the indexes they are measured against. We remain disciplined, patient and focused. While our style of investing may not be in vogue at this stage of the market cycle, our process will not change. One thing we know from history is that markets will.