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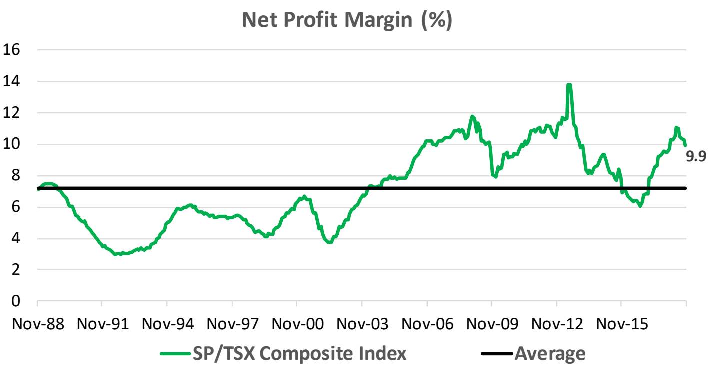
Waning Optimism

From leading economic indicators to consumer confidence reports, sentiment in North America is still flashing green with several measures at decade high levels. Business fundamentals have also been solid, observing the return on equity (ROE) of the S&P/TSX Composite Index break above its long-run average. Why then have we seen a rise in financial market volatility and bear market moves in oil and some stocks? At periods of high optimism and above-average profitability, it's often a good time to investigate what could upset the current environment.

Net profit margins of the TSX are near 30-year highs. As illustrated in the chart below, margins at ten percent are well-above the approximate seven percent average. The biggest drivers of improvement have been the energy and materials sectors as commodity prices have regained strength since late 2015.



Source: RBC Capital Markets

Value-biased managers, like QV, typically subscribe to the concept of mean reversion, i.e. data sets will revert towards an average. This is relevant to a company's earnings growth, margins, and valuation over time. In the case of corporate profit margins, there are several reasons to expect a normalization to occur. Across sectors, we are already seeing some pressure points. In energy, the benchmark crude (WTI) price is down 32% from its peak at the beginning of October. Going forward, this lower price per barrel will cover fewer fixed costs and hurt sector margins. In the consumer space, businesses are facing rising costs in transportation, labour, and from tariffs. For example, operating margins at Loblaw Companies, Canada's largest retailer, were trimmed approximately half a percent (before consideration of any offsets) because of minimum wage hikes. Finally, for all companies that hold debt, climbing interest rates will weigh heavier on their bottom lines. Data from Thomson Datastream indicates that non-financial companies in Canada have increased their net debt by nearly 250% since the beginning of 2009.

Therefore, the current margin level of the TSX seems unsustainable given the headwinds that tend to arise in the later stages of the business cycle. In terms of investment opportunity, we need to ask ourselves if lower margins are being priced in at current valuations. With the TSX trading at a price-to-book (P/B) multiple of 1.7x compared to its 30-year average of 1.9x, we believe it's getting close. In the last decade, the P/B of the TSX has only been lower at two other times: the energy crisis of late 2015 (1.6x), and the financial crisis of 2009 (1.3x).

Source: RBC Capital Markets

We believe the QV Canadian Equity Strategy is positioned in a way that should hold in well as the market recalibrates for a lower margin environment. The strategy is overweight consumer staples and utilities compared to the TSX. These two sectors display profit margins and P/B values that are relatively in line with their long-run averages, which offers some stability.

According to consulting company McKinsey's September survey of executives' sentiment on economic conditions, "it's the first time since December 2016 that a larger share of respondents say global economic conditions have worsened than have improved… and their outlook for the months ahead is also cautious." On the surface, the economic backdrop appears robust. However, investors have become increasingly sensitive to small misses in earnings and executives remain slow to deploy capital. Beneath it all, we see reasons for waning optimism.