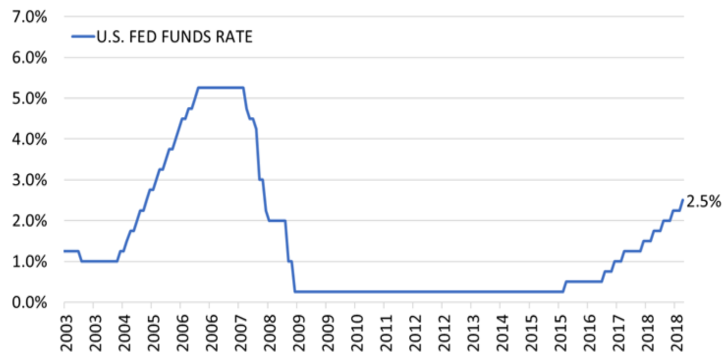
Q4/2018 Commentary –

Global stock markets plunged in the final quarter of the year, resulting in double digit annual losses for equity investors worldwide. Less than 12 short months ago, the consensus view was that a synchronized global economic expansion was finally taking hold, one that would propel stocks significantly throughout the year. The U.S. economy was firing on all cylinders with near record-low unemployment and high consumer and business confidence. Interest rates were forecasted to rise; but that was fine, as it just confirmed the growth in the economy. For much of the year, the U.S. economy delivered, and in turn, so too did its stock market. But it did so as a lone wolf, without the rest of the globe participating in the upside. The synchronized expansion never really took hold, and President Trump's strategy to regain economic dominance persisted at the expense of its major trading partners.

A lot has been written about the fallout of trade wars, including a slowdown in global growth, an increase in inflation and a considerable level of future global uncertainty. All of these are negatives for equity investors. It's bigger than just tariffs and investing, though. What is particularly worrisome to us is that the U.S. is embarking on a major shift in American foreign policy. Should the emerging China-U.S. rivalry grow, it would place many of America's long-time allies in an awkward position and expose them both politically and economically. Take, for example, the detainment of the CFO of Chinese telecom giant Huawei, or the recently inked U.S.-Mexico-Canada trade agreement that included a clause discouraging trade agreements between member countries and China. Our sense is that the market is becoming more and more concerned with the unpredictable and brash politics being played out on the international stage. Investors should brace themselves for further political shocks.

Monetary Policy

Trade issues have certainly unnerved investors, but the Federal Reserve continuing to tighten monetary policy remains the major concern. We have written often about the deleterious effects of prolonged zero interest rate policies. Economies and financial assets (stocks, bonds, real estate, etc.) have been propped up – in some cases, significantly – from their natural growth rates. But when the proverbial punchbowl is taken away, the crowd can get unruly. That is exactly what we're seeing. It's not just your average money manager whining about the Federal Reserve normalizing interest rate policy, but U.S. President Trump trying to influence and antagonize Fed Chairman Jerome Powell. As the chart below shows, the cost of money (interest rates) was driven to virtually nothing and was kept there for many years, spurring investors to take on more risk and encouraging corporations and governments to borrow excessively. That brings with it financial vulnerabilities as rates normalize.



Source: Bloomberg, QV Investors

We can't underestimate the significant impact of interest rates in our modern economy. Over the past number of decades, global economic growth has been built on the back of a massive growing debt pile. Consumer spending in mature countries remains a major driver of economic growth. Cars, houses, furniture, travel etc. are all influenced by cheap and plentiful credit. With over half a decade of near-zero rates, a lot of spending has been pulled forward and supported economic growth. What we've started to see in both the U.S. and Canada as of late is some weakening economic releases related to both the auto and housing industries. These major spending areas will be directly influenced by the ability of consumers to keep maxing out their credit.

Corporations have been binging on cheap debt this past cycle as well, resulting in record levels of non-financial corporate debt to GDP. This has helped businesses finance internal growth and acquisitions at low cost, contributing to the record profit margins and elevated earnings underlying market multiples. In addition, many corporations have tapped the debt market to provide liquidity for corporate buybacks, further supporting the stock market.

Given the dependence of both the stock market and economy on a continuation of low rates, investors are right to be concerned. For nearly a decade since the 2008 financial crisis, global central banks have gone to great extremes to support their economies. Today, though, more than 50% of central banks have stopped easing monetary policy. We don't expect this readjustment process to go smoothly and wouldn't be surprised to see the riskiest areas of both the debt and equity markets hit hard.

Canada

The Canadian stock market continues to struggle. The last quarter saw a collapse in the price of oil (WTI), but even worse for the domestic industry was a record discount in the price Canadian corporations receive for their products. Energy-related stocks have been under severe pressure as international investors abandon the market due to a multitude of regulatory and governmental issues.

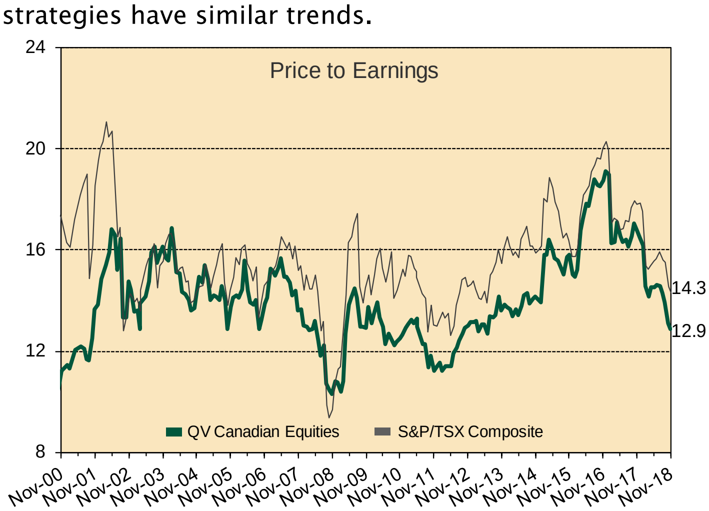
In the last couple of months we've seen the federal government spend billions to buy the Trans Mountain Pipeline project and provide emergency funding to the industry, while the government of Alberta looks at buying railcars, capping production, and encouraging the building of a refinery. Global investors realize we are scrambling and have more stable geographies to invest in. Sadly, Canada used to be considered the gold standard for stable resource development. Regardless of the quality of businesses we continue to hold, we remain disadvantaged by forces out of our control in our energy investments for the time being. A number of Canadian energy businesses are trading at multiples they did 20 years ago when oil prices (WTI) bottomed at nearly $10. We believe we are at the point of extreme pessimism for this industry, though the path forward looks very uncertain. Maintaining exposure to the highest quality businesses remains our strategy.

Outside of energy, the Canadian economy continues to move forward. However, challenges are mounting under the surface. Household debt levels remain at historic highs while key real estate markets are cooling. Simply put, the economy is more sensitive to interest rate hikes or an economic slowdown since debt levels are high. Canada also remains vulnerable to a U.S. slowdown given our highly interconnected economies.

Portfolios and Outlook

Our portfolios had mixed results in 2018 relative to their benchmarks. While we have typically outperformed the market in down years, that did not occur in all strategies. In addition to company-specific issues, the more defensive areas we typically invest in have not provided us with the protection we expected. We anticipate that will change in 2019 and look to make up for some of our shortfall. Many of these businesses have excellent quality assets and valuations which are very depressed. Fixed income portfolios held in well and protected capital for our balanced strategies as they are designed to do. Our conservative asset mix of roughly 50% equities also muted losses in a challenging year.

While 2017 was one of the least volatile stock market years in history, 2018 was a reality check. We expect a similar dynamic for 2019. While the economic and political challenges are growing, many businesses and markets we look to invest in have already had significant negative news priced into them. As the markets continue to sell off, future return potential for investors increases. We have been and will continue to add to our holdings. When we consider the longer-term opportunity in our strategies versus a couple of years ago, we believe it to be more favourable even though the economic backdrop looks potentially more challenging. This can be seen in the valuation of the QV Canadian Equity Strategy below. The portfolio is approaching historically attractive valuation levels for non-recessionary times, and other strategies have similar trends.



Source: Capital IQ, QV Investors