QV UPDATE

Weekly Commentary | January 18, 2019

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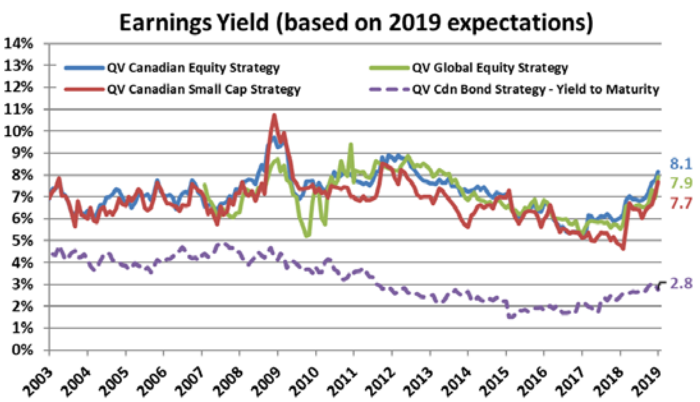
Patience

Following a tumultuous three months in the stock markets, with the US and Canadian indices down 13.5% (USD) and 10.1% (CAD), respectively, a common question is whether this correction presents a buying opportunity. We have been writing for some time about underlying issues in the overall stock market and have advocated for a neutral position (50:50) between cash/fixed income and equities in our balanced mandates given the elevated risks. Is this the time to shift the balanced strategy more heavily to equities?

The chart below illustrates the respective earnings yields (based on 2019 projected earnings) of our main equity strategies in comparison to the yield to maturity offered by our bond strategy. The earnings yield is a measure of how expensive a company (or portfolio) is in relation to its earnings. A higher earnings yield implies the potential for greater reward. As equity investors, we expect to be adequately compensated for the higher degree of risk associated with owning equities in comparison to bonds. We note that our three equity strategies are trading at the highest earnings yields since 2013.



Source: S&P Capital IQ & QV Investors

The decline in stock prices in the fourth quarter has resulted in better equity valuations, potentially improving prospective returns. However, in making our asset mix decision, we also consider other risks besides valuation that could affect equity values. We analyse whether current valuations account for these risk factors.

In our deliberations, we note that debt on US corporate balance sheets is higher than its last peak during the financial crisis in 2008. Canadian corporate debt is also at elevated levels. When you consider this in conjunction with record levels of household debt relative to incomes, the Canadian economy remains highly vulnerable to changes in interest rates and economic activity. Two years of steady central bank policy rate increases are finally impacting the North American economy, with housing and auto sales feeling the brunt of this tightening policy. It is also, though, resulting in higher interest costs for corporations and individuals, who have long become accustomed to low debt servicing costs.

We also consider the macro environment and the ensuing impact to corporate earnings. Economic indicators are pointing towards a slowdown in major global economies, including Europe, the US and the emerging markets, notably China. The US economy has led other developed nations in growth over the past two years, and its stock market has also outperformed over that period. A booming energy sector, tax cuts and low inflation all helped boost industrial activity and profit margins in the US. As we begin 2019, we believe that the record high US profit margins are vulnerable. The impact of higher interest rates, rising wages, slowing activity and potentially more tariffs could pose a further risk to earnings. Many stock valuations still reflect the record profit margins generated in the last two years. It is important to note that the recent correction only brought the earnings yield for the US S&P 500 Index to its 10-year average. In contrast, following eight years of relative underperformance, the Canadian S&P/TSX Composite Index now trades at an earnings yield above its 10-year average, presenting an opportunity.

Given all these considerations, we are maintaining our neutral asset mix positioning in our balanced strategy for now, while patiently waiting for more stocks to reflect a weaker profit outlook. Within our equity mandates, we have been active in purchasing existing positions where valuations are trading well below their long-term averages. As we see more of these opportunities emerge, we will gradually shift our asset mix towards more equities, ensuring we are adequately compensated for the risk we are taking.