QV UPDATE

Weekly Commentary | April 5, 2019

Joe Jugovic, CFA

QV Investors Inc.

Q1/2019 Commentary

What a difference a few months makes. Following an extremely volatile end to 2018, with global stock markets plunging, all major equity markets advanced in the first quarter of the year. The catalyst for this market reversal was a dramatic 180-degree turn in the outlook of the Federal Reserve. Shifting away from the current tightening cycle, Chairman Powell signalled there would be no further rate hikes in 2019, providing a huge psychological boost to investors.

While the U.S. continues to post healthy economic data, the global economy is showing signs of weakness. Growth in China's industrial output recently fell to a 17-year low alongside a rise in the jobless rate. With 2019 growth on track to land near 30-year lows, the Chinese government has increased assistance for the economy. Premier Li Keqiang announced hundreds of billions of dollars in additional tax cuts and infrastructure spending. In Europe, the central bank slashed its growth forecast for 2019 to just over 1%, an anemic rate of growth. ECB President Mario Draghi reiterated that interest rates are likely to remain at these record low levels at least until the end of the year, and also announced a fresh set of loans to European banks aimed at boosting the economy.

Where to from here?

While there is certainly no shortage of global economic concerns, when it comes to the stock market, the effects from returning to more accommodative monetary policy cannot be underestimated. The last three months prove just that. The weak economic data alongside continued uncertainty about trade wars and geopolitical concerns didn't disappear, yet markets generally surged ahead. By returning to neutral or potentially accommodative monetary policy, the central banks of the world are further prolonging this equity cycle.

The recent reversal by the Fed is reminiscent of other attempts in stock market history to stabilize markets. In the late 1990's, as the tech bubble was inflating, then Fed Chairman Alan Greenspan wasted no time easing policy when a little-known hedge fund called Long-Term Capital Management collapsed and sent the stock markets into free fall. This year, the recent plunge in markets due to growing global economic woes was enough to force Fed Chairman Powell to take soothing action. While these measures can provide a powerful short-term solution for investors, they can also create longer-term imbalances.

The fears that appeared at the end of last year have subsided for now, but we don't think investors should be increasing their exposure to risk assets. To be clear, while the near-term threat of higher rates has diminished for the time being, the greater concern is that the world is so overwhelmed by debt that the global economy can't afford higher rates. We are in year 10 of this cycle, and the level of debt and monetary stimulus already worked into global economies remains at or near unprecedented levels. There isn't a lot of dry powder for future stimulus. Consumers, businesses and governments are dependent on borrowing, with little savings for rainy days.

The world's bond markets are flashing warning signs with yields collapsing and major economies like Germany once again finding themselves with negative 10-year government bond rates. The inability of economic powerhouses like Europe or Japan to find their footing and show sustainable growth after prolonged and aggressive monetary policy is worrisome. But who knows – if China and the U.S. come to terms on trade, it may help all these interconnected economies.

Challenges within the Canadian economy are also growing. Like in many other global markets, real estate in Canada is slowing. This has been a major driver of the wealth effect for many Canadians over the last few decades, contributing to high levels of consumption. Also, significant levels of debt are tied to the value of real estate, as is the soundness of our banking system. A continued slowdown will impact the growth of our domestic economy. We expect the Canadian central bank will be prepared to act if challenges persist in this respect. Again, though, it would be to treat the symptoms (by easing consumers excessive debt payments) rather than addressing the real issue of absolutely high debt levels.

We anticipate heightened volatility for the remainder of the year as the struggles of the global economy draw focus from short-term monetary moves. In general, our portfolios remain well diversified and conservatively positioned, with historically attractive valuations that are better than the market. With uncertainty comes opportunity. We are finding pockets of good value in companies that have been beaten down by negative sentiment or ignored by the market. We will continue to invest in these businesses as many of them are leaders in their industries with track records of resilience. We can't be afraid of market cycles but rather will aim to use them to our advantage.

Copyright © 2019 QV Investors Inc. Readers may forward electronic versions of this Update. All views and projections are the expressed opinion of QV Investors Inc. and are subject to change without notice. This Update is provided for informational purposes only. QV Investors takes no legal responsibility from any losses resulting from investment decisions based on the content of this Update. Click here to subscribe to QV Updates.