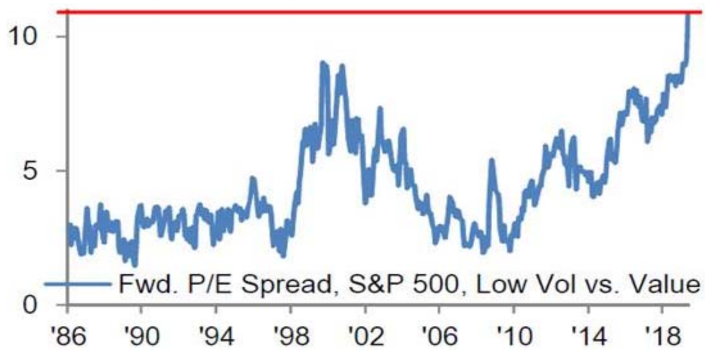
Q2/2019 Commentary

Global stock markets edged higher in the second quarter, following the strong rebound in Q1. While gains are welcome, markets seem to be struggling to advance meaningfully. Both Canadian and U.S. indices are roughly where they were 18 months ago, and a pick-up in volatility has made the ride bumpier for investors. While the length of a bull market does not forecast its end date, we sense this one is getting tired. Long expansions create a level of complacency and a willingness to extrapolate past returns into the future. Rather, investors should expect lower returns over the next decade compared to what we've seen over the last 10 years.

Bond markets also continued to rise, resulting in lower bond yields. Yields in many major markets either tested their previous 2016 lows or surpassed them on the downside. The share of global government bonds trading with negative yields has risen to new highs. Of note, the German 5-year and 10-year bonds traded to new lows, yielding -0.69% and -0.33%, respectively. Negative yielding debt is an odd circumstance; it reflects a buyer's willingness to pay a government to keep their money safe instead of expecting some return on it. As can be seen in the chart below, an enormous amount of global capital has been piled into these investments over this cycle. Investors' appetite to hold such investments continues to speak to the longer-term return challenges.

Source: Bloomberg, QV Investors

Falling growth prospects, trade tensions, a muted outlook for inflation and supportive commentary by global central bankers have been the catalysts for the recent surge in negative-yielding debt. This has reignited the global hunt for yield, growth and stability in equity markets. Stable businesses, which were already trading at higher multiples, have moved to record highs. At the other end of the spectrum, businesses that are more exposed to the economic cycle have been battered as investors run for safety. The chart below shows that investors are willing to pay an additional 11x earnings for low volatility stocks over value stocks. We wonder whether investors are confusing volatility with risk.



Source: J.P. Morgan

We invest in what we feel are quality franchises and have taken part in some of this upside. However, the majority of our portfolios are tilted toward businesses that we believe are undervalued - those from which we expect attractive risk-adjusted returns over a 3-5 year time period. These types of businesses continue to struggle as the markets remain very polarized. Investing requires us to take on manageable risks to try to generate an acceptable return. This is why we remain positioned as we are, notwithstanding the near-term challenges.

Trade war worries

For the past decade, central banks of the world have been stimulating slow-growing economies. In addition to the emerging threats of a global recession, central banks must also contend with the potential fallouts of a trade war.

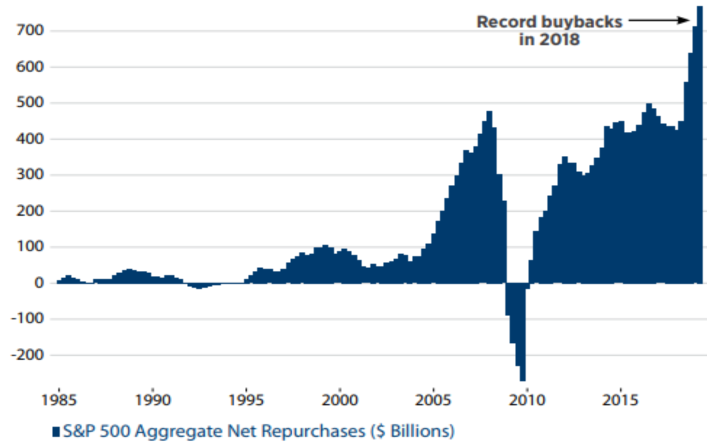
While the efficacy of zero interest rate policy is debatable given the continued challenges faced by economies, it has successfully lifted asset prices. Just the mention of a willingness to act by central bank chairs Powell and Draghi has provided stock market support. Trade war tensions will likely be one of the most significant tests for monetary stimulus. Historically, support from global central banks has restored confidence for both corporations and individuals. A prolonged trade war, unlike a domestic economic slowdown, has the potential to affect the global economy broadly and mute the near-term ability of monetary stimulus to reignite confidence.

The trade issue hit the Chinese economy when a slowdown was already in progress. Europe, Canada and many developing nations have been caught in the crossfire and have been struggling to gain economic momentum. The U.S., on the other hand, has been the world's shining economic light with near 50-year lows in unemployment, near record levels of consumer confidence and business optimism, and record highs in U.S. stock markets. Yet, with all these supportive economic tailwinds, Fed Chair Powell recognizes the need to provide insurance to bolster investor confidence and keep the expansion alive. More recent U.S. economic data is showing cracks, so the Fed may have the weakening data it needs to drop rates on its own accord rather than as a result of political pressure.

While a full-out economic recession may be averted, we believe an earnings recession is a likely outcome of trade tensions. The impact of the trade war on company profit margins – through disrupted supply chains, higher operating costs, or the need to absorb higher prices without passing them onto consumers – has the potential to be a material headwind to earnings growth. Economically, depending on the outcome, tariffs may be inflationary for the U.S. consumer, which still represents nearly 70% of U.S. economic GDP. Ultimately, however, tariffs slow economic growth.

The Trump tax cuts prolonged the earnings cycle in the U.S. market, jolted GDP growth and resulted in a flood of capital from foreign investors. The idea behind a more sustainable improvement to the economy was that corporate executives would increase business investment and spur productivity. But, in the face of uncertainty, firms are once again deferring long-term investment and instead buying back stock.

The following chart shows the surge in buyback activity in the U.S. market. It is another example of how economic stimulus, this time in the form of tax cuts, has found a way to inflate asset prices at the expense of more sustainable economic investment.



Source: Ned Davis Research, S&P Capital IQ Compustat

Looking forward

The market is approaching a T intersection. If trade issues are somewhat resolved, there could be a reversal of the recent flight to safety into negative-yielding bonds and low volatility stocks discussed earlier. If not, central banks will likely step in with stimulus. 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, and we remain focused on investing for the years, not months, to come. We continue to find 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.