Q3/2019 Commentary

The majority of global stock markets posted positive returns in the quarter, extending the first half's strong performance. While gains are welcome, markets continue to struggle to advance meaningfully and volatility remains elevated. Bond markets also continued to rise, resulting in lower bond yields. There was no shortage of negative headlines during the quarter. In fact, they seemed quite at odds with the relatively favourable return environment, which is not atypical of bull markets. Some of the challenges are ongoing, such as the continued global economic slowdown, trade friction, and an inverted yield curve which has historically preceded recessions. Toward the end of the quarter, geo-political concerns escalated with the bombing of Saudi oilfields and a formal impeachment process brought against President Trump. These issues may not dictate the direction of the market, but they do increase volatility.

One of the hallmarks of this long bull market has been its ability to shrug off perceived bad news and keep marching upward. But that march seems to have become more challenged as markets continue to struggle to move decisively to new highs. Abnormally low/negative bond yields continue to leave investors searching for higher returning assets, prolonging the current equity cycle.

Global economic growth continues to slow, with most major economies finding themselves in advanced stages of the business cycle. Germany has been Europe's economic engine for decades. Having narrowly avoided a recession last year, it is now sputtering and on the verge of one. China, the world's second-largest economy, continues to grow at a healthy rate but is expanding at the slowest pace since the early 1990's. In the U.S., economic results have been mixed as of late, with noticeable deterioration in manufacturing data. However, the consumer side of the economy remains strong – historically low unemployment and higher wages have propped up consumer confidence levels to near record highs (as seen in the chart to the right). Consumer spending represents nearly 2/3rd's of U.S. GDP. A meaningful deterioration in this dominant driver of the U.S. economy would serve as a significant red flag.

Source: RBC Capital Markets US Economics/CB/Haver

Investors find themselves in a precarious position as the future direction of economies and markets is tied to political headlines. In addition, global monetary policy seems to be very much dependent on those same outcomes. For example, positive news on trade tensions will mean a different path forward for monetary policy than what the market is currently anticipating. At the moment, no one knows, and we may not know for quite some time. Investing always entails making decisions in a framework of unknowns, but today's macro-economic issues create a heightened sense of unease and concern, not to mention unpredictability.

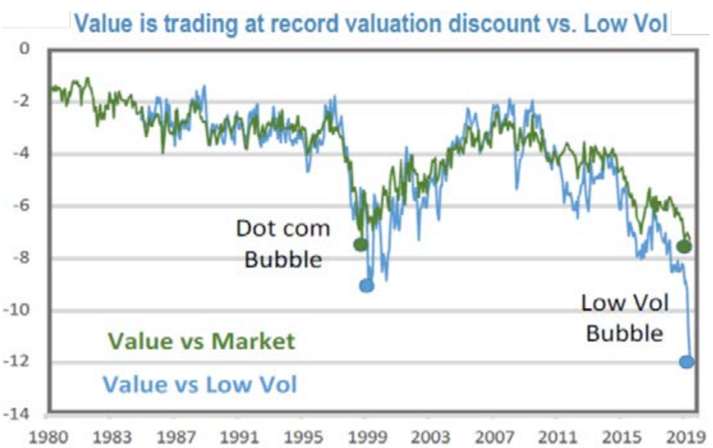
What does this all mean for the stock market?

The current concerns around growth, trade, the muted outlook for inflation and supportive global central bankers have been the catalysts for the continued 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, as have growth stocks. At the other end of the spectrum, businesses that are more exposed to the economic cycle or lower interest rates have been battered. This past 12 months has been extreme in this regard and has resulted in a very divergent stock market environment.

Market preferences shifted dramatically in September. In a short period, our equity portfolios doubled and tripled the market return, and our bonds provided the defensive characteristics we expected (see table below). On the days the markets slid, our portfolios went the opposite direction. Unfortunately, this shift in preference was short lived. But, as value investors, decades of financial market history remain on our side, suggesting that our portfolios will benefit when there is a more permanent shift in preference.

1 Month Gross Returns as of September 30, 2019			
Strategy	Strategy Return	Index Return	Value Add
QV Canadian Small Cap Strategy	2.35%	-1.08%	+3.43%
QV Global Equity Strategy	4.29%	1.73%	+2.56%
QV Canadian Equity Strategy	4.07%	1.69%	+2.38%
QV Canadian Balanced Strategy	2.01%	0.60%	+1.41%
QV Canadian Income Strategy	0.44%	-0.38%	+0.82%
QV Canadian Bond Strategy	-0.48%	-0.84%	+0.36%

We're not the only ones who see the divergences within markets. JP Morgan's Strategy team recently published a report titled "Largest Divergence Ever Presents Opportunity for Value and High Volatility Stocks." The report outlines that "the bubble of low volatility stocks vs value stocks is now more significant than any relative valuation bubble the equity market has experienced in modern history."



Source: J.P. Morgan QDS

Portfolio Positioning

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 balance those holdings with our long-term compounders which provide us with a ballast for troubled times. We will continue to invest in these businesses as many of them are leaders in their industries with track records of resilience. We are confident they will survive the outcomes of whatever headline hits us next.

Outlook

As the decade-long bull market continues its advance, the imbalances within both equity and bond markets are growing. While we have "missed out" on some of the return opportunities, they do not meet our tests for investment. Through different market cycles we have learned the importance of maintaining strong discipline to our investment style and, most importantly, remaining patient. We can do this when we know we have portfolios with competent management teams and sustainable business franchises.

While we may be out of favour in the near-term, history suggests we won't be in the long-term. We witnessed investors make significant returns in previous cycles - tech, growth, commodities - only to give it all back and more. Chasing returns or trying to "beat the market" without considering the risks involved was exactly the wrong thing to do. On the contrary, we are trying to manage risk through a cycle as opposed to blindly maximizing return. This is a basic tenant of our investing philosophy and one we won't waver on. It is in sharp contrast to index-based investing, where an investor takes on the returns of the market with no regard for the risks. Historically, when the market has shifted its preference, QV's risk managed approach to investment has delivered value and more than made up for "what it missed."