QV UPDATE

Weekly Commentary | January 3, 2020

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Q4/2019 Commentary

Global stock markets surged ahead in 2019, with the majority posting double digit gains. Bonds too rewarded investors with above-average historical returns. The Federal Reserve's pivot in January ushered in additional rate cuts, serving as the catalyst to spur on considerable gains. Abnormally low/negative bond yields continued to push investors to search for higher returning investments, prolonging the current equity cycle.

Global economic growth has been muted for some time now. While Germany has been Europe's economic engine for decades, it is now on the verge of recession, having narrowly avoided one last year. 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. Meanwhile, economic results in the U.S. have been mixed as of late. All that being said, the central banks of the world have not been sitting idle – instead, they have continued to implement significant policy measures to spur economic growth. We anticipate this stimulus to result in an improving global economy through 2020, but below-average historical growth (as has been the case for much of the past decade).

While economies will likely improve, investors must ask themselves how much of this positive outcome has already been priced into markets. Broadly speaking, corporate earnings growth has been below average, share buy-backs have been higher than average and multiple expansion (i.e. favourable sentiment) has been the greatest contributor to overall return by far. This optimism toward the future, evidenced by a willingness to pre-pay for forward earnings growth, will be a key factor for investors in 2020.

Most valuation metrics are stretched relative to history. At some point, earnings growth will be required to justify these levels. The following chart produced by Charles Schwab looks at a broad measure of corporate after-tax profits compared to the U.S. stock market, as measured by the S&P 500. The wide spread between the two suggests that either profits need to catch up with the market, or stocks will correct to align with profits.

Source: Charles Schwab, Bloomberg, Bureau of Labor Statistics. S&P 500 as of 11/30/2019. *Profits as of 9/30/2019 and with inventory valuation and capital consumption adjustments. Past performance is no guarantee of future results.

We wouldn't be surprised to see a bit of both in the next year – a pickup in profit growth and a pullback in overpriced securities. Companies with the highest expectations for earnings growth will suffer the most if their projections are not met. On the other hand, sectors of the market with muted growth expectations still offer outsized return opportunities. We continue to focus on these areas, not only for the potential return advantages, but just as importantly for the greater likelihood of downside protection.

Trade, elections, and whatever else comes up… but what actually matters?

Investors have seemingly become immune to the dramatic headlines we live with, impeachment and trade wars to name a few. Headlines and uncertainty will continue to be a dominant theme for 2020 with the U.S. presidential election taking place. While investors cheered for what looks like a phase-one trade agreement between the U.S. and China (whatever that means!), we should expect trade to continue to be a major concern.

Headlines will come and go, often with jarring short-term volatility. Investors can't afford to get distracted by these headlines, nor try to invest around them. The probability of consistently guessing the outcomes of such events is very low. We know that the fundamentals of the businesses we invest in and the prices we pay for them are what deliver returns in the long run. This is what matters most and is where we concentrate our efforts. We cannot avoid short-term volatility at the expense of long-term returns.

Discipline… not always easy

Some of our strategies have lagged their respective benchmarks. One of our biggest challenges continues to be the types of businesses we own – we're referring to the divergence between value and growth stocks. Like all previous stock market cycles in history, this too will change. While our risk management process has historically caused us to miss out on some of the biggest gains, it has ensured our portfolios were prepared for the challenging times that followed. We don't see any reason to think this time will be different.

We often get asked about the catalyst that will cause the value areas of the market to respond. We believe that as the central bank stimulus of 2019 works its way through the global economy and abnormally/unsustainably low interest rates trend upward, cyclical businesses (i.e. resources, industrials, financials) will have outsized potential to generate gains into the future. In the same vein, if growth improves and rates trend upwards, our short duration bond portfolios will minimize the headwinds from rising yields and provide a buffer should some macroeconomic event cause a significant sell-off in equity markets. Of note, while many other investors have written off Canada and developing economies, we do not share this view and remain committed to our domestic market.

There is temptation in any cycle, particularly when one's style of investing is out of favour, to drift toward what is working. We have no interest in doing that. The businesses that make up our portfolios are of good quality, have the balance sheets to sustain them, and offer us a strong valuation advantage relative to the broad market. Not to mention, our dividend yields surpass almost all global government bond market yields.

Outlook

As the decade-long bull market continues its advance, the imbalances within both equity and bond markets are growing. Risk taking is evident in the overheated initial public offering market and in the high levels of margin debt. Negative bond yields and the broad market conviction that bond yields can't go up are perpetuating a dangerous sense of perceived safety. The unwavering belief in the effectiveness of central banks and their ever-expanding use of leverage to grow and manage the global economy also pours fuel on this fire.

Chasing returns or trying to beat the stock market without considering the risks involved is exactly the wrong thing to do. On the contrary, we are trying to manage risk through a cycle. This is a basic tenet of our investing philosophy and one we won't waver on. Fortunately, given the current dislocation in the markets, we have an excellent opportunity set of companies to invest in through any environment we may find ourselves in.

A note to end the decade

As has been the case historically, long-term investment returns are best when markets are attractively valued and investors are frightened/not fully invested. The exact opposite is also true. When investors are confident and fully invested, they push up the value of the market, diminishing future long-term returns. The proportion of U.S. household wealth currently allocated to stocks is near peak levels. If the past is any guide, we should anticipate weak returns going forward in this environment. Data going back over 70 years shows that at current ownership/valuation levels, the average forward 10-year return has been only about 4%/year. While the U.S. has generated abnormally strong returns over the last decade, Canada (and much of the rest of the world) have underperformed. We expect there is a high probability that the inverse will be true going forward – muted relative returns from the U.S. as the data suggests.

QV mandates typically generate strong relative results at these types of market junctures. Over 20+ years, our process has generated solid returns our clients have come to appreciate. Ironically, the biggest value add hasn't occurred during the boom years but throughout the more challenging ones. We anticipate more of these over the next decade. We manage downside risk in our portfolios and are willing to position our strategies differently than the market. We believe the success of an investor should not be measured by how much they make in a given period of time, but rather how much they've been able to protect when the inevitable downturns come.