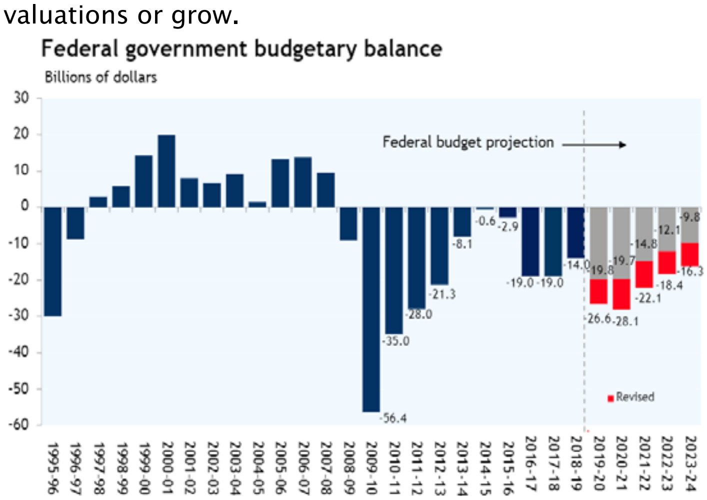
Ian Cooke, CFA

QV Investors Inc.

Accidentals

Last night, in my daughter's piano class, I learned about the ABCs of accidentals (notes such as sharps or flats that fall outside the basic key of the music). That is, Always Be Careful to observe accidentals. A pianist's failure to recognize these distinct elements within a composition would surely ruin the melody. Beyond the keyboard, it's equally important for investors to observe the distinctive notes shaping markets today and position their portfolios accordingly.

For example, one important consideration for the Canadian market is that monetary and fiscal stimulus have already been overplayed. Interest rates haven't moved up very much from lows reached in the midst of the financial crisis and the federal budget deficit is growing to near record levels for a non-recesionary period (see chart below). If something does go wrong in the Canadian economy, the traditional levers for bankers and politicians will be less powerful than in past downturns. With this backdrop, it is paramount to maintain a portfolio of businesses that can withstand a potential shock without needing to rely on low interest rates to support their valuations or grow.



Source: Department of Finance, RBC Economics

Another domestic concern continues to be the Canadian consumer. Debt-to-income ratios and debt service ratios remain near generational highs. Real retail sales have slowed down in recent years and the household savings rate has weakened. It's tough to see how the overextended Canadian consumer will improve materially over the coming decade, leaving the Canadian economy vulnerable. For businesses we own with direct exposure to the consumer, balance sheet strength is key – to provide flexibility for when tougher economic conditions materialize, or optionality to reinvest or grow dividends if the environment turns out to be stronger than expected.

Over time, markets are a strong indicator of burgeoning trends. Sometimes they are early, like when we had a technology stock bubble twenty years ago, but eventually they get it right. Today, the five largest companies in the S&P 500 are all technology companies – Apple, Microsoft, Alphabet (Google), Amazon and Facebook. Even seemingly frivolous signals can speak volumes about significant shifts in the investing landscape. Consider Time magazine's annual Person of the Year – Amazon CEO Jeff Bezos and Facebook CEO Mark Zuckerberg were given the title at the start of the last two decades, respectively. These individuals have been behind some of the powerful ideas that have helped shape the world since the millenium.

Last month, environmental advocate Greta Thunberg became Time's latest honoree. Undeniably, 2019 was a banner year in terms of environmental activism and the subsequent "greening" of capital markets. Many companies in the renewable energy space, including Tesla, the poster-company for electric vehicle adoption, reached all-time highs. Green bonds – those specifically intended to fund environmental projects – had record issuance of over $200 billion in 2019. The notion of green stimulus, where a government would directly issue these bonds to fund green projects, is gaining traction in the EU. By some estimates, the market for green bonds could reach more than $2 trillion annually. Greta represents the steadily increasing traction of the environmental movement, which is having countless impacts – on food, textiles, transportation and energy, to name a few. In this quickly changing landscape, environmental considerations are increasingly top-of-mind for us as investors and the leaders of the businesses we own.

Failure to recognize the defining characteristics and trends shaping markets would be to overlook risk while tuning out opportunity. Understanding them in the context of our long-term investment philosophy helps to avoid mistakes and produce beautiful music.