QV Update

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Pushing Through the Fourth

I settled into watching a Toronto Raptors basketball game on TV Tuesday night. In the first three quarters of the game, the Raptors came on strong and led by as much as 27 points. But as in the past, they began to stumble in the fourth quarter, losing their composure and eventually the game.

This was a reminder of how quickly momentum can swing in the opposite direction. We have heard warnings from market experts that global markets are advancing beyond what is supported by current economic growth drivers. At QV, we have expressed a similar cautious assessment. But as my colleague Clement Chiang stated last week: “We believe there is still room for the market to grow.”

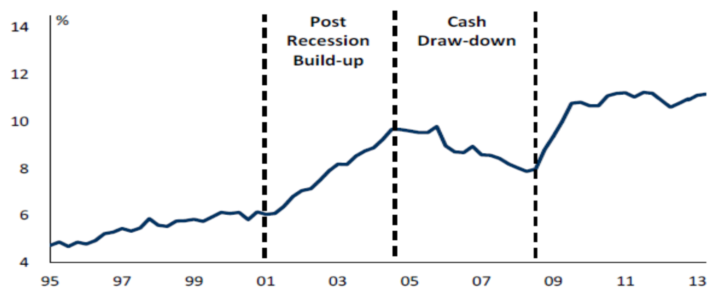
Source: S&P Capital IQ, Canaccord Genuity, QV Investors Inc.

The chart above shows the S&P 500 Composite Price Index in two ways: by the index level (green) and by the rolling five-year percentage change in its price (black). The former method depicts the S&P 500 reaching a historical high of around 1,800. The latter method suggests that while the market has enjoyed an unusual increase in price, it could be too early to call for a major asset price bubble. There are several assumptions made in using the rolling returns as a guide. Nonetheless, it is striking that there have been three periods of extreme exuberance since 1932 where the market has generated more than 200% gains over a five-year period.

To generate this type of return over five years requires compounding at a rate of 25% per year. In comparison, the past 30 years of S&P 500 earnings have grown at a compound annualized rate of around six percent per year. Under ‘normal’ conditions we would expect the market to grow at the rate of its underlying earnings, which implies a five-year return of almost 35%. Even a more aggressive ten percent growth assumption, such as that achieved by the Dow Jones Industrial Average over the past 20 years, implies a five-year return of 60%. We might conclude: 1. The market is very rarely normal, and 2. A 200% return over five years without supportive fundamentals would require excessive optimism.

The market currently sits at a five-year gain of 101% - not yet “excessive” as defined above, but is approaching that territory maybe a little too quick for our comfort. March 9, 2014 will mark five years since the lows of 2009. To reach a 200% return by March 2014, the S&P 500 would need to generate a return of 31% in its fifth year. So far it has already achieved 16%.

Corporations have the same tone from a year ago, delivering watchful macro and industry outlooks in the current earnings season. The chart below shows cash as a percentage of assets for companies on the S&P 500, excluding Financials. It highlights how after a period of significant capital outlays between 2005 and 2009, businesses have reigned in spending in an effort to preserve cash. This is a trend we have been observing in the base and precious metals sector, and more recently in the agricultural and fertilizer space.



Source: S&P, FactSet, RBC Capital Markets

Although we would prefer that companies reinvest excess cash to drive sustainable growth, we always applaud the strategy of maintaining balance sheet flexibility. For example, Suncor Energy (SU) merged with Petro-Canada in August 2009 and took on a substantial amount of debt in the process. Since then Suncor has used cash to deleverage its balance sheet, improve capital deployment in its oil sands operations, and refocus on reliable and consistent growth. Each of these actions has transformed Suncor into one of the low cost operators and leading free cash flow generators in the Canadian energy space today. If prudent capital management leads to more Suncor-like businesses (trading at Suncor-like valuations) in the market, we are encouraged by the opportunities to come. QV holds Suncor at a top weight across its Canadian large cap and balanced portfolios.

It is difficult to say whether the market is in the fourth quarter of the ball game, but we’re guessing it is getting closer. Businesses are certainly preparing for such a scenario. Ultimately, the investor’s ability to contain optimism will determine which direction the momentum swings.