the art of boring™

EP 132 | Quarterly Update | Q1 2023

David Fraser (00:00):

Hi everyone, welcome to another episode of the Art Boring Podcast. Believe it or not, Q1 2023—it's already in the books. Earlier today, I sat down with Greg Peterson. He's our asset mix chair and the manager of the Balanced and Global Balance Fund strategies here at Mawer. And today, we talked about some common themes like interest rates and inflation; then we also touched on Silicon Valley Bank, the financial sector, and our exposure to it as a whole; then I asked them whether or not [he] and the asset mix team made any adjustments, and his concerns around a recession. I hope you enjoy the podcast today.

Disclaimer (00:58):

This podcast is for informational purposes only. Information relating to investment approaches or individual investments should not be construed as advice or endorsement. Any views expressed in this podcast are based upon the information available at the time and are subject to change.

David Fraser (01:13):

All right Greg, thanks for being here again today to cover off the quarter. How are you doing?

Greg Peterson (01:19):

Good, David. How are you?

David Fraser (01:20):

Not too bad. We started off the year pretty well and that's coming off the back of a relatively rough 2022. So, with the good news with markets being up, is there anything new moving markets in that direction?

Greg Peterson (01:32):

Yeah, it is kind of nice having a quarter where everything was up. So, bonds were up, stocks were up, and cash is earning a half decent yield these days as well. So, everything was moving in the right direction, although not uniformly throughout the quarter, but it was a nice result nonetheless. The topics are still pretty similar to what we've talked about in past quarters, so, the two major themes or topics are still: inflation—I think we're just going to be talking about that for years, whether inflation is accelerating or moderating is always the ongoing theme; and then economic growth and corporate profitability is the other theme.

Greg Peterson (02:00):

So, both of those were driving markets and moving things in the first quarter. Inflation, really, around moderation inflation, so inflation's been moving in the right direction. It's been slowing. I'm sure our listeners don't feel like they're paying any less at the grocery stores and other places, but the rate of change has been moderated somewhat. So that's encouraging, and that's helped to provide some encouragement to both stock and bond markets, taking some of the edge off of bond yields and expectations around interest rates.

Greg Peterso (02:31):

And at the same time, economic growth has been fairly resilient. So, we still see fairly strong growth really in the developed world for sure. And that's one of the things that central banks are trying to pull back a little bit just to try and help the inflation story. But those two things help markets. So, still good corporate earnings through the quarter and moderation inflation expectations.

David Fraser (02:52):

In March we saw the European Central Bank raise rates 50 basis points and the Federal Reserve in the U.S. and the Bank of England raised rates 25 basis points. And they all cited that, as you pointed out, the attempt to continue to reign in inflation. Are higher rates doing what central banks want them to do? You're saying it's not increasing as rapidly as it was in the past, but we are still seeing inflation.

Greg Peterson (03:16):

It's hard to say because one of the challenges with monetary policy and interest rate policy is that there's a considerable lag before you see the impact of changes in monetary policy through the economy. So, it's a bit like steering an oil tanker. It's a massive ship and you turn the rudder and eventually it's going to start to turn, but it takes a long time for that to happen. Very different than driving your car, which has a quick impact. Central bank policy is very much like the oil tanker; it takes a long time to steer things. So, we may be starting to see some signs from interest rates and as we've seen, other impacts from higher interest rates, but as it relates to inflation, yeah, it's probably starting to take hold and have some impact, but it'll still takes some time to actually see that continue to work through.

David Fraser (03:57):

Is there anything in particular we'd be looking forward to turn around first and see those impacts?

Greg Peterson (04:02):

Well, there's a few areas that have already moderated. So, goods prices for the most part have slowed so that part of inflation has been decelerating. Stickier areas tend to be on the services sector and that's pretty typical—services tend to lag a little bit on that side. Rents have remained a bit higher on that side of things as well as labour inflation. Wage growth has still been very strong. And while that's not a bad thing, higher wages allow consumers to spend and have money to continue to enjoy things, that tends to help contribute to inflation, so central banks will be looking for wage growth to slow at some point as well.

David Fraser (04:37):

Is it fair to say you're thinking we are closer to the end of the rate hiking cycle than the beginning of it?

Greg Peterson (04:44):

I would say we're closer to the end of the rate hiking cycle, yes. We had a very dramatic change in rates last year, almost unprecedented in terms of the magnitude and the speed with which rates changed. And now it's a better taking time to see how that works out. We've already seen some impact from that through the banking sector in the United States. We did have a bit of a banking crisis pop up in March with the end, really, of Silicon Valley Bank. And that was in part a result from the rapid change in interest rates and higher bond yields in the U.S.

David Fraser (05:14):

So there's some cause for concern there around the financial industry. Do we have much indirect or direct exposure there?

Greg Peterson (05:22):

One of the things that the banking crisis did allow us [was] the opportunity to go back through our portfolios and just re-evaluate exposures. Of course, the team always knows the exposures we have, but you want to check for anything that's unexpected or more on the indirect side of things. We don't have a great deal of direct banking exposure. In the U.S. we have JPMorgan [Chase]. So, JPMorgan, unlike the regional banks that suffered some challenges on the deposit withdrawal, JPMorgan is a very liquid, a very well diversified U.S. bank, so I don't have the same concerns there.

And most of our banking exposure is in Canada. So, banks are still a very large part of the Canadian market, and as much as banks didn't perform great in the first quarter, the Canadian banks being a much more concentrated industry in this country and somewhat protected, we don't have the same concerns around banking here either. They're very well capitalized and also very diversified businesses, so don't have the risk to the same extent as what we saw with some of those small regional banks.

Greg Peterson (06:14):

And then same thing in Europe, we have very little banking exposure there as well. So, overall, we have less banking exposure than the market and none that concerns came up on in the past month.

David Fraser (06:24):

With the higher interest rates, that's really a cost of doing business, the cost of borrowing money. Is that putting pressure on any other business types or industries at the moment?

Greg Peterson (06:33):

Higher borrowing costs are going to impact any business that requires borrowed capital to fund their operations. So, there's definitely a higher cost. It'll pressure margins on businesses of that nature. Our team works through our portfolios to assess the impact of borrowing costs on the businesses that we invest in as well. We tend to be somewhat capital light in terms of our investment process and businesses we focus on, but it's still always good to be aware of that impact and there's always adjustments that are being made within the portfolio from that.

I will maybe just back up for a second, David, [to] one of the things you talked about—the rate of change in interest rates in Europe and with the Federal Reserve and so on. With that banking crisis in the U.S., it did bring a very quick tightening of financial conditions both in the U.S. and then outside as well. So, that is probably what led the Fed to just a quarter percent rate increase last time, unlike Europe. They're just at different points in [the] rate increase cycle, but those tighter financial conditions do help to slow things down somewhat as well. So, this, in a less pleasant way, may actually help on the inflation fight as well and cause the economy to slow a bit further.

David Fraser (07:42):

I guess that's what's happening on the business side of things. I often check in with you to see what's the strengths of the consumer because they're such a big driver of the economy, GDP. So, knowing that interest rates and inflation have been higher for some time now, how are consumers faring at the moment?

Greg Peterson (07:58):

Consumers are still in pretty good shape, so, unemployment is still exceptionally lower. Looking at it the other way, employment levels are very high historically at the moment. Wage growth is still very strong, so people still have money to spend and that's a good thing. It's not as good a thing for the inflation fight, so that is what they're trying to do, is bring those employment levels down somewhat, make resources a little more scarce and try and fight it from that side of things. But really, consumers are still in pretty good shape in North America for the most part. Higher borrowing costs for sure, so this should lead to slower consumer spending at some point, especially for big ticket items, but so far have been relatively healthy.

David Fraser (08:36):

On another note: thinking about the Canadian federal budget which was released last week in March, did anything stick out to you there?

Greg Peterson (08:43):

I think the only thing that really stuck out to me is that governments are still spending like gangbusters, so there's lots of money flowing into the system, whether that's in Canada, or if you look at the Inflation Act that was brought in the U.S., there's actually a lot of fiscal stimulus that comes with that too. So, there's a lot of money pouring into the economy from federal governments that doesn't make the job of central banks any easier. By nature, that spending is stimulative to the economy. That's probably the one thing that stood out the most. There [weren't] major changes on the tax side of things, but there's a lot of spending that's still taking place.

David Fraser (09:15):

Did we make any asset mix moves in Q1?

Greg Peterson (09:18):

Yeah, we made some changes to our asset mix models at the beginning of the first quarter, so we did a little bit of rebalancing, so added back to bonds somewhat, so increased our bond position somewhat. We also did just a bit of a trim on U.S. equity. So, with the U.S. slowing, higher interest rates down there, we've been trimming from U.S. equities for some time and just continued a very marginal trim and then also a marginal increase on the international side. International equities were hurt last year and underperformed other areas. Well, Canada was the strongest market last year for us, and so there's just a natural rebalancing and rotation that takes place.

As we look back in the first quarter, international markets were the best performing; Europe in particular outperformed Canada and the United States, and the United States was the weaker market in the first quarter.

David Fraser (10:04):

And do you expect that to continue or, I guess it's a tough question, but just trying to get a sense of what you're looking for in the future and trying to at least foresee a little bit?

Greg Peterson (10:14):

Yeah, crystal balls are still pretty foggy, David [laughter]. So, looking forward (they're foggy the best of times), but there's still a great deal of uncertainty that exists. We're still staying very well diversified across the portfolios. And that is one of the approaches you take when you have very high levels of uncertainty is just to stay fairly flat, very well diversified, keep things spread out and keep a relatively neutral mix, so that's where we're sitting currently.

That's probably what we'll continue to look to do this year: as we get a bit of drift (and we've had some fairly strong performance to start the year), we may see a little bit of rebalancing just to bring back some of that upwards drift on equities, probably from the U.S. And there's a couple themes there, too. We should see the U.S. slow, and the U.S. is still one of the more expensive markets globally. Europe is somewhat less expensive [and] may benefit from the reopening that's taking place in China, as well. We have seen China start to accelerate somewhat, [which probably will] be fairly bumpy and not a straightforward liftoff for the Chinese economy, but Europe does have more exposure to the Chinese market and exporting to China than what we have here in North America, so that might give Europe a bit of a boost.

David Fraser (11:21):

If you look globally, there's still a lot of talk about potential recession. Can you give us a sense of your current fears around the recession? Has your level of concern changed much in the last quarter?

Greg Peterson (11:32):

We don't try to predict recessions. We also don't fear them; recessions are just a natural part of the cycle. They're going to come. It doesn't matter what you do. Recessions offer a bit of a reset in the market as well. So, repricing of securities markets, reset for businesses. Some of the excesses that tend to build up in the marketplace get cleaned up as you go through a period of negative growth like that with a recession. Quite possible that we see a recession late this year, early next year. There's a large variety of opinions that are out there on this.

I think there's a couple things with that that we look at. So, we do focus on the securities within the portfolio and staying very well diversified. We don't completely ignore the macro picture. Naturally that has an impact on the companies that we're investing in. But with respect to maybe just a couple of points on that, is, expectations around the recession are going to impact expectations of around interest rates. So there's a bit of an ebb and flow to those expectations. In the first quarter, we saw the expectations come off from interest rates. So, if you're expecting a slower economy, you're probably expecting that at some point interest rate increases are going to stop and then eventually interest rates are going to perhaps come back down a little bit to fight some future recession. Markets are always forward-looking and working off of expectations, and those expectations shifted a little bit in the first quarter. So, starting to look at lower interest rates at some point down the road perhaps. It's one of the benefits, perhaps, of the recession. It takes this pressure off of rates.

Greg Peterson (12:55):

And then the other area would be just corporate earnings. So, it'd be natural to expect that as the economy's slowing, corporate earnings are likely to slow as well. Also not something to be fearful of—again, natural part of the cycle. I think there's a benefit for us in that if we do go through a period of slow growth or negative growth, it does put the market focus back on the quality of businesses and the quality of their earnings. And of course, we do focus on high quality businesses that are quite resilient and have strong competitive advantages that help to maintain their earnings. That focus back will help our investment style, or should help our investment style, as we move forward as well.

David Fraser (13:29):

I always throw these crystal ball questions at you, but it's very tough to predict these things. And I think on the most recent podcast, if listeners haven't heard, Jeff Mo goes into a great explanation on having contradictions in the portfolio where, no matter how the world plays out, we think in the long run, all of our businesses are wealth creating, but there's contradictions to capitalize on different markets as they unfold. So, as a bottom-up investor, it's a good reminder to give clients that sense that we aren't trying to predict, but we are trying to find good companies that'll do well in all market types.

Greg Peterson (14:02):

That's why you stay well diversified. It's the same thing from a balanced perspective. We have exposures—Canadian, U.S., international equities, and so forth—[and] I can't tell you which area is going to perform best quarter to quarter, but we have much more confidence in the long-term picture for the businesses as well as the different regions that we invest in over time. So, that tends to get smoothed out with the longer term focus.

David Fraser (14:22):

One of the indicators [for] trying to get a sense of where things are going (and this is the yield curve)—at the moment, U.S. treasuries, it's inverted, meaning that short-term rates are higher than longer term rates, which most investors see that as a negative signal. How do you think about an inverted yield curve?

Greg Peterson (14:38):

Historically, an inverted yield curve has predicated recession. It's been a good predictor in the past and it's quite likely that that's possible now too. So, the inverted yield curve could be telling us that a recession is coming. And it's really a function of short rates moving up much quicker and adjusting more so than long-term rates, which is how you end up with that inverted yield curve. So it's a function of central bank policy pushing short rates higher.

And that's the intention of higher rates from central banks is to slow the economy. It's not that they want to create a recession necessarily, but it's often a result of sharply higher interest rates very quickly, and that's likely what the inverted yield curve is telling us. And there's been times in the past where yield curves have inverted and we don't go into recession, but it doesn't happen very often. And as I said before, [a] recession's not something to be feared as an investor, it is part of that cycle. In terms of job availability and individual income, it does create a bit more fear for consumers and individuals from that perspective, so [I] don't want to dismiss that. But as an investor, it's a very natural course.

David Fraser (15:36):

Yeah, I think it's worth reiterating something you mentioned earlier, which is there is a self-equalization piece to all of this. So, if the economy's not doing as well, central banks are going to be less likely to raise rates, which is going to be a positive signal for markets and vice versa. It's important to keep that in mind that it's a balancing act, [and] hopefully central banks get it right and there's sort of a goldilocks scenario here, but I think it's important to point that out.

Greg Peterson (15:59):

It's one of the reasons we don't worry as much either. So, if you have slowing earnings growth due to recession or an economic slowdown, lower interest rates should help to provide some offset and support stock prices somewhat, so you do get that balance that's taking place.

David Fraser (16:13):

As we look ahead, is there anything else significant that's on your radar for Q2 or even further out?

Greg Peterson (16:19):

More of the same story for the most part, David. So, as we look further out... really, as I said, we still have a great deal of uncertainty with respect to where things go from here. Again, not unusual. Can't tell the future, so it's always uncertain. But for us right now, there's no strong conviction on any one direction or any one market. So, it's a matter of just staying well diversified. And that's likely how we'll continue with the balanced portfolios in the coming months too, is just to continue to rebalance, stay relatively neutral and flat until we have a bit more conviction on where things are going or perhaps some better information that comes along on the inflation front.

David Fraser (16:53):

As a reminder, we are a fundamental, bottom-up investor where we're looking business by business to find good companies. Regardless of what's happening in the macro environment we think these businesses will do well, and that's what the research team work very hard to do day in, day out. So, it's more of a micro focus business-by-business approach than that macro focus.

Thanks very much, Greg, for being here and sharing your thoughts with listers again. We always appreciate it.

Greg Peterson (17:17):

Yeah, thanks very much and I hope everybody enjoys the spring.