the art of boring™

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Disclaimer (00:25):

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David Fraser (00:41):

All right, welcome to The Art of Boring Podcast. This is the Q3 quarterly update. Our regular contributor, Greg Peterson, is here with me today and he's our Asset Mix Chair. Greg, thanks for being here again.

Greg Peterson (00:51):

Hey David, and hello to everybody that's listening.

David Fraser (00:54):

Let's jump right in. There's a lot to talk about this quarter. Markets have been more volatile than normal recently. What are markets reacting to, to create the sell-off, but also the big swings we're seeing day to day?

Greg Peterson (01:05):

Yeah, there's been massive swings in the markets over the course of the year and I don't think we need to tell our listeners that at all, because everybody [has] more than likely noticed that over the course of the year, and volatility continued through the summertime.

What was interesting this summer was—markets are always forward-looking and anticipatory and probably got ahead of themselves somewhat, but in a nice way for the rest of us. So we had the month of July where equity markets were positive, that spilled into August. I think it made us all feel a little better—at least we had some movement in the right direction of volatility. It gave us a little bit of reprieve from some of the negativity that we've had this year. And then of course by the time we got to the end of the third quarter that had slipped back away again.

So we actually ended the quarter with just a very, very slight decline, but massive swings. So if you didn't pay attention to what happened through the three months and you just looked at the end result, you're like, okay, well we just slipped a very little bit. But there's a lot of movement that took place during the quarter. And really what's leading to that, is just—not to ignore your question entirely, David [laughter]—we're going through a secular transition from lower interest rates and a period of low inflation for a very long time.

Greg Peterson (02:09):

And as you go through these inflection points or transitions, there tends to be a great deal of volatility because of the amount of uncertainty that's out there. So, the range of outcomes that exist at the moment… if you're somebody who's trying to forecast, which is obviously very difficult to do, but a very wide range of probabilities; and you have markets reacting to that fairly quickly based on little nuggets of information that come out from time to time. And much of that had to do with the inflation at the moment and the transition to higher interest rates. But every time we go through a period like this, and fortunately it's not that often, it is very volatile just [as] the markets try to grasp, "where are we going from here?"

David Fraser (02:45):

So it's been a tough year for investors. Is this normal, or is it different this time?

Greg Peterson (02:50):

It's both normal and different [laugh]. Markets going through transition and cycles is very normal; markets going through corrections of this nature also very normal. But I think what's most different this time is that this has been the worst bond market period, really, since World War II. So, we haven't seen this very often. And particularly for balanced or more conservative investors, normally when equities are going through a rough period like this and declining, you at least get some protection from bonds, or even some offset if bonds are going up at the time the stocks are falling.

This time we have both bond and stock markets dropping at the same time and in reaction to the same variables. It's inflation and higher interest rates that's causing both markets to decline. And I would say that's different this time, as we don't have that same offset from fixed income.

David Fraser (03:36):

So, has that changed our investment approach at all? Those dynamics that you mentioned?

Greg Peterson (03:40):

It hasn't changed our investment approach. We still focus on the same or similar long-term fundamentals that we always do. We do maintain a very broad and diversified portfolio. In the course of the year we have kept our bond weight somewhat lower in the [Mawer] Balanced Fund. That's not highly unusual for us—we do tend to have bonds relatively low. We have had bonds low this year and we've been reducing our equity weights through the course of the year also, just to be somewhat more conservative.

David Fraser (04:06):

So same approach, but a few adjustments made at the asset mix level?

Greg Peterson (04:10):

Adjustments at the asset mix level, also adjustments at the security level. So, adjustments are always taking place in the portfolio based on both long-term views, and then what we might see coming in the next little while. On the security level, adjustments have been taking place for quite some time, where we're starting to shift from higher value stocks and businesses [where] valuations have become a bit more stretched, or companies that we deem to be longer durations.

So, what I mean by that (duration is quite often a term used in the bond market), but long duration companies are really growth stocks where you're paying more for future growth than what you're paying for the current environment. And those stocks tend to be more sensitive to changes in interest rates or discount rates. So, our team has been gradually moving capital away from sort of longer duration stocks.

Tech companies are often a good example of long duration. You're paying for future growth; in many cases the businesses that have very strong cash flows [where] the valuation is based on today's cash flows and not so much the future. So that transition has been taking place within the portfolio.

And then from an asset mix perspective, it's just to stay fairly neutral, become more conservative, sort of "batten down the hatches" as it were, and try not to second guess or try to guess what's going to take place tomorrow.

I think one of the worst things we can try to do is to try to predict what's going to happen and then adjust portfolios in the short term based on that; [you start] to chase some of the short-term narrative that's out there at the moment, and the problem with the short-term narratives is that things often turn out in a different manner than you expect.

So, just as a very stark example today—we happen to be recording this podcast on the day that U.S. CPI came out. Inflation was a little bit hotter than the market expected. [The] day started with markets down about 2% this morning and now they're up and we're still a few hours away from close, so we'll see where we go. But the reaction to hotter inflation, you would naturally expect markets to go down, means that the Federal Reserve is likely to continue to raise interest rates even further, negative for stocks, and yet the market is moving the opposite direction. And that's something that can often happen.

David Fraser (06:11):

Just seems a case of the market trying to digest information. And a big piece of that is, as you pointed out and everyone is probably aware, the inflation piece, which is ultimately leading to the interest rate piece.

How difficult is it to predict where inflation's going? Are there any leading indicators we can look to provide insight there, or is it still too noisy?

Greg Peterson (06:33):

Yeah, it's always very noisy, so inflation is a tough one to grasp. Central banks have a very difficult time predicting where inflation is going. There are some indicators you can watch; things you can keep an eye on, particularly with the labour market. So, wage inflation often translates into goods and services inflation. So that's one area to keep an eye on, just for some signs of where things might be going. Commodities, input costs and so forth. So, we've seen some better signs on food inflation that's softened somewhat. There's some early indicators—used cars in this particular example—today, inflation there has been slipping back a little bit. Shipping costs… there's a few things you can watch early on that will take some time to gradually show up into the CPI numbers.

But I would say the labour market is probably the key to having some sense of where inflation is likely to go. And then the other thing that central banks keep an eye on is inflation expectations. There's a number of ways to gather inflation expectations. It can be implied in the markets, it comes from surveys of consumers and so forth. And why that's important is if inflation expectations start to move higher, it becomes more difficult for central banks to rein in inflation in the next little while. And what happens there is, if you as a consumer start to expect it… well, prices are going to continue to rise 4%, 5%, 6%. That gets baked in. You get used to that. It's very easy, then, for prices to just move up 4%, or, 5%, or 6% and continue to move at that pace. So that's one of the gauges that are watched quite closely—expectations.

David Fraser (07:58):

And how are consumers faring in the face of higher interest rates? Which [for] a lot of people the main issue there is repaying mortgages at higher rates and a higher inflationary environment. Are consumers holding up all right?

Greg Peterson (08:10):

Yeah, so far consumers are holding up really well. I will mention a couple things. So we're coming out of the pandemic, which was a very major disruption to the global economy and when you have a disruption of that size, you have some fairly large waves that come out of that. The first wave as we [went] through the global shutdown was a big surge in goods purchases. People are stuck at home, we have nothing else to do, let's buy some stuff and have it shipped in by Amazon or somebody. So you had a huge surge in goods that [has] kind of subsided. People run out of things to buy, now we're transitioning to services. So, businesses are opening back up, people are going in person to dine out, travel, and so forth. Now [that] we've kind of shifted from goods to services, that tends to be fairly bumpy as we move along.

And overall consumers are still in pretty good shape. Labour markets are strong, people are employed; we have pretty solid wage growth. And it depends on what country you're looking at—consumers are also in pretty good shape financially from a household-net-worth perspective. Consumer balance sheets in the United States are in very good shape. Debt was reduced coming out of the financial crisis in 2009, whereas other countries like Canada is perhaps not in as good a shape—where consumers here are carrying higher debt levels, higher debt servicing costs. And so higher interest rates and higher inflation are likely to put a bigger dent in Canadian consumers as we go forward.

Greg Peterson (09:30):

And one point to just make on that too is, in Canada we have a higher percentage of variable rate mortgages in this country. So higher interest rates translate into higher monthly expenses very quickly given the variable rates. Whereas if you look at a country like the United States, they have a much higher percentage of mortgages that are in fixed rates, so consumers there are locked in and not as exposed to rapid changes in interest rates from that perspective.

So, I would expect to see consumer spending starting to slow. We haven't seen it a lot, it's just started to soften. Not that we're trying to predict, but that would be the natural path of things, to start to see consumers slow down in the face of higher prices and higher monthly costs.

David Fraser (10:07):

As you say, the mortgage side of things is a big part of consumer expenditure and with rates going up that means mortgage rates have gone up. How does the Canadian real estate market look at the moment?

Greg Peterson (10:18):

I've been hearing for well over a decade how expensive the Canadian housing market is. And every time I go away to investment conferences, the rest of the world kind of harps on the Canadian housing market. We have seen activity slow significantly in the Canadian housing market. We've started to see prices soften somewhat. We haven't had a rapid change, but prices have certainly softened. And I think it's reasonable to expect that Canadian housing will continue to soften from here in the face of much higher mortgage rates and interest rates in what we've seen for some time.

[I'm] very hesitant to predict just given that it's been predicted for well over a decade and some much smarter people than me [are saying] the Canadian housing market needs to adjust lower, but it would seem reasonable that we're probably at that point. That would be my best guess—is that Canadian housing prices probably soften and decline somewhat from here.

Either way for us, that's just a headwind for Canadian consumers. So, we've talked in the past on this about our concerns around Canada because of household debt levels and then now, perhaps, deteriorating household balance sheets. [That] doesn't really create a great spending mood for Canadian consumers and likely [will] create some challenges here.

This also points to the challenges for the Bank of Canada. So, the Bank of Canada has been fairly aggressive in raising interest rates to deal with inflation here and they'll have a fairly fine tightrope to walk to not push the Canadian housing market too far.

David Fraser (11:35):

Another thing that's close to home here in Canada is energy. Have we reassessed our view of energy? It's had strong performance this year. Do we look at it any different at the moment?

Greg Peterson (11:46):

Yeah, energy is probably one of the bright spots for the Canadian economy. So, stronger energy prices— oil and gas companies and services companies are in a better position here and [it] has contributed to the Canadian economy in 2022. You can see it through tax revenues both at the federal and provincial level also, where it's been a strong contribution.

Within our portfolios we've added marginally to energy, [we] haven't made a significant change necessarily and for many of the reasons we've talked about in the past. So while yes, it does seem like a brighter prospect at the moment and companies are performing well, as you balance that against sort of longer term trends that may keep a cap on energy prices as well. Energy businesses are price takers. They can't set their own price, it's set by global markets. There's only so much that they can contribute in terms of competitive advantages. And so we've added somewhat because it seems they're in a good position at the moment, but not a wholesale change.

David Fraser (12:38):

And I think some of that attractiveness has come on the back of companies being more proactive and paying down debt and repurchasing shares and whatnot. So, it's more that side of things that's been more appealing as opposed to the high energy prices outright. Is that fair?

Greg Peterson (12:54):

Yeah, energy companies have been much more disciplined with capital expenditures and they've done a great job of managing their businesses, and so we've become more comfortable with their capital allocation and their long-term business model. So that has helped build the case for us.

David Fraser (13:08):

We always have a lot of clients asking about energy, but we also have a lot of clients who ask about foreign exchange. And we're seeing the loonie depreciate against a pretty strong U.S. Dollar. What's influencing the exchange rate right now?

Greg Peterson (13:20):

Yeah, there's a few things. One of the most central influences on foreign exchange is monetary policy. So, as much as the Bank of Canada has been raising interest rates, the Fed has been raising as much, and I think expectations are probably that the Fed needs to raise further. And I'd also say that to me, the currency is almost like your stock price for a country. So, there's some valuation on the economic situation for the Canadian economy that probably weighs slightly on the Canadian dollar versus the U.S. dollar.

So, the two combined monetary policy then economic prospects are likely a bit brighter in the U.S. And for some of the reasons we've talked about, U.S. consumers are in better shape; employment markets are running fairly strong down there, that helps to contribute. And then also in times of transition or higher risk environments like this, capital does tend to flood to the U.S. dollar.

Greg Peterson (14:07):

So, the U.S. dollar been up against the Canadian dollar this year—I think it was up about 6.5% in the third quarter, which actually helped by the way. So, your U.S. portfolio now is helped by that 6.5% appreciation of the U.S. dollar in the third quarter, but the U.S. dollar is up against all major currencies in part because of that capital flight to the U.S. dollar.

One thing I would just mention too, is that the Canadian dollar has actually held its own. We always look at it, or many of us look at it, relative to the U.S. dollar all the time, but the Canadian dollar is actually up significantly against the euro this year, the British pound, and the Japanese yen.

So, this has had the opposite effect on some of the international portfolio in that as those currencies are dropping against the Canadian dollar, the value is actually declining in addition to the stock decline, so it actually exacerbates the decline in international assets for the time being. Whereas [it's] the opposite on the U.S. side—growth in the U.S. dollar helps to offset some of the declines of the U.S. market for us.

David Fraser (15:02):

With the U.S. being such a strong currency, putting your asset mix hat on, does that change your assessment of how you look at the U.S. and how much we decide to allocate there?

Greg Peterson (15:11):

It does help us a little bit with the U.S. Because we're in times of pretty high uncertainty at the moment, having the U.S. dollar in our back pocket as it were as part of that allocation to U.S. equities is very helpful as a risk mitigator. We do look at that from that perspective. So, being the reserve currency of the world, much more comfortable holding U.S. dollar assets, in addition to the fact that the U.S. economy is likely somewhat more resilient, also.

So, there's many things that we have to try and balance on asset mix. One is if you look at valuations, [the] U.S. market probably still looks a bit more expensive compared to other markets in the world despite having come down significantly this year. But that valuation can also be justified given the strength of the businesses there, the resilience of their economy, and so forth as well. So you're paying up a little bit more for what's likely a more consistent and somewhat safer market.

David Fraser (15:59):

And those relative valuations don't always revert, do they? The U.S. has been "overvalued" for quite some time. It can sustain for longer than anticipated.

Greg Peterson (16:09):

It can. The U.S. market has been one of the top performing markets for a very long time—well over a decade. Usually there's some change to that. The U.S. dollar is an impediment for global companies based in the U.S. as they translate foreign revenues back into the U.S.—that's a bit of a headwind for them. We'll likely see that contribute to earnings and margins compression for U.S. companies going forward. But you're right, that can last for a very long time.

David Fraser (16:33):

Never an easy decision. And another tough one is there's been a bit of a change in the landscape, really, with cash and bonds. Now that rates have gone up, you're actually getting some yield there for investors. So, how does that change the dynamic when you assess cash and bonds and the yield that you're getting versus equities?

Greg Peterson (16:51):

You actually get paid to hold cash and earn a decent yield in bonds nowadays. So, holding cash—we do have a much higher cash weight in the Balanced Funds than we've had for some time and makes it less painful to hold cash. You don't feel like you have as big an opportunity cost because you're actually getting paid pretty decent rates on T-bills these days and other cash products. I think this is important too, because this is a change. We haven't had positive yields on cash and bonds. Well, we've had positive, but not very good yields for a long time.

And so I think for pensioners, pension funds, people who are living off of a fixed income, it's been a very difficult period and I think the fact that we actually have some decent yields coming back on the bond market is likely to be more helpful for that. We've definitely seen the decline in the prices this year and so the capital declined.

But there is a bit of an offset now—this is setting up a better environment going forward to actually earn more income. So the income component is readjusting and becoming more positive going forward.

For many years there was no alternative and you often heard that, the expression that "there is no alternative" and equities were the only place you could find any sort of returns. There are alternatives now. So [that] does provide some more optionality.

David Fraser (18:02):

We've talked a lot about the negatives out there. It's very easy to see those. But what positives are we seeing in the economy right now?

Greg Peterson (18:09):

I think the positives are, as I mentioned, the strength of consumer and labour markets. We're into this period with low unemployment rates and so forth. So, we're in pretty good position from that perspective. Depending on the country, consumers are in good shape. Businesses are, at least the businesses that we invest in, are in also very good positions and have strong competitive advantages. And one other thing that I think we probably talked about [and] mentioned last time too, is we spend a lot of time looking at the financial markets and the financial environment in general, and the financial system is also in pretty good shape.

So I mention that because the financial system is really the backbone of the global economy. If that's not in good shape, it's very difficult for everything else. And that is still fairly sound. We've seen a couple hiccups—the U.K. policy missteps have not been helpful; however, overall banks are very well-capitalized and that's quite different than what we saw back in 2008, which was really the last time that we went through a sustained downturn of this nature.

David Fraser (19:10):

Is there any concern there with what's going on in Europe? Either the U.K., what's happening in the bond market? Or, as we head into winter, there's concerns around energy and security as the Russian and Ukrainian conflict continues. Any concerns there, and what's our exposure to that part of the world?

Greg Peterson (19:27):

We always have concerns David, and certainly there's no shortage of things taking place in the world right now from a geopolitical perspective to really harm sentiments somewhat and make it more concerning. Europe has been pressured from Russia on the energy side of things and that's been very well-communicated, and people are probably very well-aware of that. One thing I would maybe point out is that Europe has done a very good job replenishing energy supplies going into the winter and also readjusting where their access to energy is coming from.

For instance, setting up floating LNG ports to try and improve and access LNG shipments from other part of the world and so forth. So they've done a pretty good job of reassessing energy supplies and making sure that they're in a good position for that. Naturally the unknown will be how cold this winter is.

If you have a very harsh winter, it's going to draw down those energy supplies. But by and large, they're in good shape at the moment. As far as the U.K. market goes, they have some things to work through with their pension funds and bond market. I suspect that the Bank of England will be ready to step in and help out as they need to. It's also a pretty fine balance for them too. The U.K. can't just write a blank cheque and say we're going to cover off everything and go back to our bond purchasing in face of much higher inflation.

So, they have a very careful message to try and broadcast to say, "we're tightening very carefully to try and deal with very high inflation, but we're not going to let the system fall apart at the same time either." The U.K. has some self-imposed policy and the steps that we would hope don't broaden out into the broader system.

David Fraser (21:00):

Absolutely. Another piece of all of this that moves markets is corporate earnings. So, we've just finished the third quarter, we're coming into earnings season… what are we expecting there and how is that going to shake out with interest rates and inflation affecting those as well?

Greg Peterson (21:17):

I think as we go into earnings season and as we go into 2023, you're likely to see earnings growth slowing and continuing to slow. So that's pretty widely expected for the most part in the face of higher interest rates. And also with higher prices out there, consumers are likely to start to slow spending somewhat. It's one of these waves that I was talking about. So, we had the "up" wave coming out of the pandemic for goods and then services. Things naturally have to slip back somewhat and can't continue at that pace for too long. So we're very likely to see that take place and also to have inflation on the demand side settle back down. You need to reduce demand somewhat. So higher interest rates are intended to reduce that demand. [A] longer winded way of saying we expect that earnings are likely to continue slowing and [add] more pressure on profit margins going forward.

Greg Peterson (22:03):

The difficulty is knowing how much of that's already priced in the stock markets. So, stock markets have declined significantly this year. Last quarter we talked about the fact that there was a valuation correction that took place because of interest rates... probably starting to reflect some of the expectations for slower earnings growth as well.

And it's tough to see where we're at in that period. So, we could certainly see more softness or weakness in markets ahead as we start to get into a weaker earnings. However, as we talked earlier about things not always being so obvious, it's also difficult to know whether that's going to cause the stock market to decline further. We've already had things come down somewhat. And the reason I say that is as we go into weaker economic growth and weaker earnings, expectations around interest rates are likely to change too. And what I didn't mention earlier, this is what really took place in July.

Markets were looking through to end of 2023 saying, well, economic growth is likely to soften, central banks are going to have to pause their interest rate increases or perhaps even start cutting rates later next year. And this is that anticipatory piece of markets looking much further forward. And so we had equity markets in July and August move up based on expectations that the Fed was going to cut rates in late 2023.

So, already gone and went through the entire increase in rates and already started to look at rates slipping. But my point is that there is some balance to that. As we get into weaker economic growth going forward, if that does happen, then expectations around interest rates are also likely to change. We could see bond yields at least pause or perhaps start to soften somewhat. And that could provide enough offset for stock prices that, even if we have weaker earnings, we don't necessarily have to see stock markets suffer much further.

David Fraser (23:41):

A lot for the market to digest as all of this unfolds—interest rates, inflation, earnings. But let's try and end on a positive note here: what opportunities does that create? The sell-off, the big swings, the indiscriminate panic selling, if you like. We're a long-term investor, we're an active investor, we're not too focused in on day-to-day moves. We try and buy these companies for the long term. Does some of what's happening provide opportunities for an investor like us?

Greg Peterson (24:08):

Yeah, that's an excellent point David. Much of our talk has been relatively short term when we're talking about a 12-month period or even anything plus or minus, that's relatively short term. And markets are a reflection of human behaviour and humans always take the most recent past and extrapolate that. And so you do have this pendulum swing with markets all the time and we're kind of on the down swing at the moment. And so you have very good companies that are not necessarily impacted so much by the short term, or at least their long-term story is definitely not impacted by what's taking place currently.

Greg Peterson (24:39):

And as their stocks get punished for maybe no particular reason it does provide opportunities for us to step in and to add to positions that we'd otherwise like to [and that have] perhaps have been too expensive for some time. Our Research team always has an inventory list, or just some of our current holdings that are perhaps affected, and they're on top of that all the time to either add new opportunities as they become cheap and more affordable, which we're starting to see more of. Or adding to existing holdings we really like and the markets have brought down for whatever reason, and gives us a chance to chip away at those as well.

So there are lots of opportunities that are uncovered. And every time you go through a period like this, it is a reset. Unfortunately, we don't get another up-leg or longer cycle that's a more positive cycle until you go through a bit of a reset in the markets like we do right now. So as unpleasant as this is, it really sets up the next cycle.

David Fraser (25:29):

Well, thanks very much Greg, I appreciate that. I know there was a lot of talk about things everyone has heard before—interest rates and inflation—but it's really what's driving the market today and appreciate you sharing your thoughts and we'll see you again next quarter, I hope.

Greg Peterson (25:42):

Yeah, thanks David. And probably it is more of the same. Things don't change that quickly in three months. We could go back to our Q2 recording and pretty much just replay that because it's much of the same. As you've pointed out, the topics don't change that quickly. But certainly lots of activity in the last few months.

David Fraser (25:58):

Absolutely, thanks very much.