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EP33 | Quarterly update 1Q 2019

00:41 **Cam Webster**

With us today is Greg Peterson. He is chair of the asset mix committee and lead portfolio manager on our balanced strategies. What we want to get into, Greg, is just reviewing the first quarter of 2019. My impression is, "wow! What a difference three months makes!" Because the fourth quarter of 2018 was not particularly a happy one. But first quarter—everything snapped back, it seems. So why don't we start there. What were the major drivers in the snap back in the quarter?

01:14 **Greg Peterson**

Hi Cam. Yeah, it's funny—it seems like it's a different quarter. The fourth quarter was a bit of a bad memory, and maybe distant already—even though it was only a few months ago. What's funny is I usually say to people [I] meet or talk [with] quarterly, "there's not a lot of change that takes place," especially when you're looking at long-term themes, economics...and to that point, there's actually not a lot that's changed, other than the markets have changed remarkably in the past few months.

So, rather than being kind of gloomy the way things were at the end of the year—and right at Christmas time—we've had a tremendous start to 2019 and a much better first quarter. I'm sure people feel a lot more comfortable about things today than they did back then. But if we look at what's taking place and sort of the overlying themes...there's really not that much difference. We still have trade concerns; we still have slowing economics for the most part. Those are two of the things that led to the sell-off in the fourth quarter, or some of the concerns in the fourth quarter.

02:05 **Greg Peterson**

The one thing that's changed is one of the lead drivers in the sell-off was that interest rates were moving higher, central banks were looking to tighten, and they were still taking away some of the stimulus of the last 10 years, essentially. ... That allowed markets to rebound so much from the fourth quarter. And that's really just a change in direction.

So, it's not that central banks have actually started to change course and lower interest rates—they've just relayed to the markets that they're now pausing or taking more time, likely to raise interest rates. Just that change alone has helped to provide more confidence in the equity markets. And the liquidity that comes with that has also helped to push stocks higher.

02:47 **Greg Peterson** So two parts to that, I think. One is just a rebound from being sold off in the fourth quarter, money piling back into equity markets to help that, and then also the change in tone from central banks. The Federal Reserve Bank of Canada has eased back, as well—well not eased—but just, [the] tone has changed in terms of direction and expectations around future interest rates: less likely.

03:14 **Cam Webster** From an asset mix point of view, given the volatility of the last two quarters and [you can] kind of draw a nice big 'V' on a chart: the down and then the snap back. How do you deal with that at the asset mix level?

03:27 **Greg Peterson** In this particular case, we're just trying to stay fairly balanced. We didn't see the risks as high as the market did in the fourth quarter. That led us to actually add a little bit to equity at the beginning of January (we were just slightly underweight our just sort of neutral position, if you will, in the balanced funds). So, we did add back a little bit; we didn't want the equity weight to drop that much further. And then we allowed it to move higher throughout the course of the quarter as well.

That softening tone from central banks and then also much lower bond yields over the quarter—which also helped on the liquidity side—made the environment more favourable for equities. We've let equities move back to neutral through the course of the quarter. Markets did most of that. We did add a little bit in the beginning of January, and that's where we sit today.

04:06 **Greg Peterson** So, what we're trying to do is balance concerns in terms of slowing economics and slowing earnings that we're seeing, with things being more favourable from an interest rate and bond yield perspective for equity markets at the moment.

04:19 **Cam Webster** I guess the questions I get from clients in this environment is, "why would equities and bonds go up at the same time?"

04:25 **Greg Peterson**

Yeah, it's a pretty nice environment where you have both bonds and stocks doing relatively well. ... Stocks were up much higher than bonds during the quarter; the TSX was up just over 13%. U.S. markets and Canadian dollar terms were up just over 11%, so [that] was a fairly strong move, whereas bonds were up just over 3%. Equities grow faster just because of that rate of change. So, the equity weight was actually higher within the portfolio and the bond weight kind of lags back a little bit, even though bonds are growing at the same time.

What happens is that our relative cash position comes down. Both are growing; cash is a little bit lower than it was before, and we're just trying to maintain that mix: keeping bonds at a level where we feel that they provide enough offset from a risk management perspective, because stocks won't go up forever. And we want to make sure that we have enough bonds within the portfolio to deal with that future volatility from stock markets.

05:17 **Greg Peterson**

As I mentioned, we added to equity a bit early in the quarter; we've allowed that weight to move higher. Towards the end of the quarter, we've been adding back to bonds because on a relative basis, they've actually shrunk in size or in proportion within the Balanced Fund.

05:33 **Cam Webster**

That explains it from an asset mix point of view. What would be the main drivers, though, that would push both equities and bonds up at the same time or vice versa? Is there something in that dynamic that you'd be worried about?

05:44 **Greg Peterson**

There are two different drivers, I think, there. Equity markets have been responding to the softening tone from central banks, and bond markets have been reacting (bond yields dropping), I believe, more because of slowing economics in addition to the softer tone from central banks. So, slightly different there—bond markets are more concerned about future economics and equity markets have taken some relief that interest rates are not likely to move much higher.

And the bond market also contributes too, because it does affect the discount rate for valuating stocks. That discount rate with bond yields has come down slightly. That's helped to lead to equity prices moving higher at the same time.

06:21	**Cam Webster**	In the quarter, we did have—at least in a few countries—in a few points in the yield curve, an inversion. Let's talk about the market's impression of the inversion now, versus the signal...it used to signal. Traditionally, if the U.S. yield curve inverted, that signalled a recession within 12 to 24 months of that [happening]. What's the market saying about that?
06:45	**Greg Peterson**	Investors would have seen a lot of headlines in the middle or later part of March [that] yield curves in Canada and the U.S. inverted for short period of time. As you indicated, historically that's a lead to recessions. Not perfect, though, so it's not every time that yield curve has inverted in the past has that led to a recession. In terms of the message this time around, there is still some manipulation of bond markets and respond expectations from central banks—just taking the message there. I'm not sure if it leads to the same message as it has in the past with that inversion, and it was fairly quick and not terribly deep.
07:19	**Greg Peterson**	And of course, the yield curve inversion is short rates being higher than long term rates. ... I think this time markets are not as concerned about that, because [for] one, it has turned around relatively quickly in the last little while. And the second part is it has led to more liquidity [being] available, [which] may help to soften the concerns over slowing economics going forward. I think the message is maybe a little different and maybe not as concerning as what we've seen in the past. And the other part of that too, is, if you do look at equity market performance after yield curve inverts—equities generally perform relatively well until you get to that point where we actually end up in a recession. But we don't see economic growth slowing enough to really lead to strong concerns about a recession in the next 12-18 months at the moment.
08:03	**Cam Webster**	Okay. How do you feel, Greg, about the theory of...investors being complacent or reliant on central banks just stepping in. We had [in the] fourth quarter lots of noise in the equity markets, everybody runs to the exit, stocks go down a lot, bonds do their thing—cushion the blow. It's been a decade or more...can we expect another decade of central banks just stepping in whenever things go awry?

08:30 **Greg Peterson**

Yeah, central banks are focused on a great deal by equity markets and bond markets to a certain extent as well. So, there is, perhaps, risk of some complacency. And the risk is that you have asset prices over-inflate in some areas, leading to bubbles, and eventually those bubbles burst and you have more pain in financial markets somewhere.

That's one of the concerns we had that. I think the markets are smart enough to look through [that] to some extent. So yes, we have the central bank put, if you will, in sort of protecting and helping out the markets. But at the same time, if you look at what drives central banks, its economic growth and primarily inflation.

09:04 **Greg Peterson**

Inflation risks right now are fairly benign I would say, or at least fairly moderate. So, if you look [at] that, it does help you to believe that central banks don't really need to move interest rates higher—at least in the short-term—until they see some more pressure from inflation. There's good reason why they're not moving. Are we too reliant on central bank moves? Yeah, perhaps a little bit, but that's a pretty important tool for moderating the economy as well. So, there's reason for that at the same time.

09:32 **Cam Webster**

You mentioned Canadian equities performed quite well. And I think they actually were amongst the leaders in developed returns in the quarter. The Balanced Fund carries a bit of an underweight in Canadian equity, so let's have a brief talk about that. Why still underweight Canada? What's going on in Canada?

09:49 **Greg Peterson**

Yeah, the Canadian market was one of the best performing developed markets in Q1. And you're right, we still continue to carry a bit of an underweight—we have less invested in Canada than we do in the U.S. and internationally. Our view on this is maybe a little bit like the early part of 2016, where Canada also was hit fairly hard in the fourth quarter. Some of this, to me, was a bit of a bounce in value; an upward correction, if you will, of Canadian stock values.

I don't think that the concerns for Canada have completely abated just yet, which leads us to continue with the same level. Some of those concerns are household debt levels and debt servicing levels in Canada remain very, very high—so that's likely to weigh on consumers; a fairly soft housing market also tends to weigh on consumers.

And as much as oil prices have improved for the Canadian energy sector, we still haven't found a way to move our oil to export markets. So, [while] that gives them a bit of a lift, we still need to see more clarity with respect to how they get to market for that to change. And then, on the other side of things—[from] a trade perspective—we still haven't got the ratification of the new NAFTA agreement with the United States. So, I think [there] remains a little bit of uncertainty with respect to how that affects a lot of our export markets in the auto sector, in particular.

10:59 **Greg Peterson** So headwinds haven't completely cleared. The one thing that we have going for us, perhaps, (well, there are a number of things going for Canada), but one is just valuation here is a bit better. Because the Canadian market hasn't performed as well over the last few years, Canadian stocks are at a pretty good starting point. So you may see some desire to add to Canada somewhat as we go forward, but [we] still need those headwinds to clear a little bit or those clouds to clear a little bit first.

11:22 **Cam Webster** So, still a strong argument to carry a globally diversified portfolio out there. Just maybe a stronger snap back in Canada because it got beaten down more so in the fourth quarter.

11:33 **Greg Peterson** Yeah. And on the flip side of that, you can make an argument still for the U.S. where valuations are a little bit higher. The U.S. consumer, who continues to drive about 70% of the economy in the U.S.—they're in a much better position. The U.S. consumer went through a deleveraging process several years ago; debt level's there have improved remarkably; unemployment is at record lows in the U.S.; job claims have hit a low not seen since 1969. So the labour market's in pretty good shape. Wage growth has been good, but not so good that it's actually pushing inflation in the U.S. The savings rate is relatively high in the U.S., which means people have disposable income available to continue to spend.

12:09 **Cam Webster** So is the U.S. the goldilocks of the global economies? Is everything going right in the U.S.? Sounds like it.

12:15 **Greg Peterson** Well, things are going relatively well—the offset is that stock prices are already reflecting that. So, they're already a little bit on the expensive side. And the U.S. economy is also slowing at the same time. We still have some runway perhaps, but we also have to recognize that those stock prices are [already] reflecting a pretty good scenario, and you may see a better value appear elsewhere in the world—likely outside of North America.

12:36 **Cam Webster** We've talked markets mostly so far, Greg, but any examples at the portfolio/holding level that maybe you'd highlight during the quarter for either how they reacted positively or negatively?

12:49 **Greg Peterson** Probably the common names that people are familiar with that have worked out quite well in the quarter [are] Alphabet, the holding company for Google; Visa; MasterCard...so, three of the U.S. names that have performed very well in the first quarter. All high quality companies. None of these I would declare as being cheap, but this is maybe a good example of high quality companies, very well managed, have some runway in their market, or their products and services that are being rewarded.

So, those are businesses that you don't mind holding despite the fact that you know that they're not cheap. Our preference would be to have great companies that are really cheap and have a lot of runway down the road. But these are good solid businesses that we know have good prospects for their revenue generation, some safety in terms of their market share, or their competitive position within their markets. So, more confidence, I guess, on the revenue side allowing to offset a bit on the valuation.

13:40 **Greg Peterson** Some other examples—if you looked globally—with the economic slowdown that we're seeing as well. If you look at car manufacturers in Germany, BMW has had a bit of pressure. Not just with the economics in Europe, but also the slowdown in China reflects a great deal on their business and ability to sell cars, so they've been under a bit more pressure.

Well-run businesses. You don't mind holding them, you know there's a bit of an ebb and flow to economics. You do perhaps adjust your weight a little bit in terms of how much exposure you have to those businesses, but it's fairly natural to see that. So that's maybe on the other side of things seeing a bit of a slow-down.

14:13	**Greg Peterson**	And then along those lines [of] picking on Germany, Fuchs Petrolub, [which] sells lubricants to industrial manufacturers such as BMW, also feeling a little bit of pressure of that slow down with Germany at the moment as well. Again, another great business you don't mind holding; that you know things will come back for them sometime down the road.
14:30	**Cam Webster**	Why don't we just wrap up, Greg, with set[ting] the stage for where we're at in terms of conditions. I guess, as we're speaking today, the yield curves are not inverted. So, there's that aspect. But what does the landscape look like right now?
14:43	**Greg Peterson**	On the positive we have central banks pulling back—we've talked lots about that. We have bond yields that are lower, so borrowing rates have come down, so consumers will notice this as well. That's maybe a bit of help in Canada; paints an even better picture for American consumers in that mortgage rates there have dropped with bond yields in the last little while. We've seen, perhaps, a bit of thawing on the trade front between the U.S. and China. I think that's led to some of those bounds in the first quarter: markets anticipating or perceiving that there's been some progress with trade, and that we might see some announcements come through on that side. And so I think that'll help to keep markets in fairly good shape for the foreseeable future.
15:18	**Greg Peterson**	That being said, we still have the reality that economic growth is slowing, earnings growth is slowing with that. And so eventually, that will slow down the impetus for equity markets to continue to charge ahead. I still believe that we see more volatility as we go forward. ... We've been talking about a late cycle; we've mentioned that [on] the podcast in the past. Maybe the cycle has been extended a little bit by the central banks right now, But you're still in the latter half at some point. And that tends to lead to higher volatility as markets are trying to perceive “what next?” And it's not that you worry about that a great deal, you just know that returns are likely to slow. You'll see more periods of volatility—maybe not quite like the fourth quarter, but something similar. Perhaps not as severe, but that should be expected and not something to worry about. Again, I talked about the natural ebb and flow in economics, [and] you have the same thing in stock

markets. So, we'll likely see more of that as we go forward, too.

Overall, the environment looks okay for now, but lots to watch for and just continue to make adjustments for it.

16:14 **Cam Webster** Thank you for that overview. I think it's realistic to think that not everything's great and not everything's so bad, it's somewhere in-between. But what does that mean for asset mix going forward?

16:23 **Greg Peterson** That means we maintain our balance for the time being. We stay with the traditional 60/40 split for the Balanced Fund, so 60% in equity, roughly 40% fixed income and cash. We have a bit more cash in lieu of bonds at the moment, because we've had a very strong rally in bond yields the last little while. Still believe that, over time, bond yields will continue to move higher, I just think that timeframe [has] extended out again. So it'll take much longer for bond yields to move significantly higher if we're right. And so that's what we maintain. We maintain that balance within the funds and within asset mix, generally.

16:55 **Cam Webster** Awesome. Thanks for joining us again and giving us a view on the Quarter, Greg.

16:59 **Greg Peterson** All right, thanks very much.