the art of boring™

EP45 | Quarterly update 3Q 2019

David Fraser	**00:40**	Welcome to "The Art of Boring" podcast! I'm David Fraser, an investment counsellor here at Mawer, and I'm lucky enough to have Greg Peterson here for yet another quarterly update. Greg is our Asset Mix Chair and the Balanced and Global Balanced Fund lead manager. Greg, thanks for being here.
Greg Peterson	**00:56**	Hi David, happy to be here.
David Fraser	**00:58**	So Q3 was yet another unpredictable quarter—a lot of noise out there. Depending on where you look, clients would have seen a lot of negative headlines and a lot of positives. What did you make of things?
Greg Peterson	**01:07**	I would agree—it was a very noisy quarter, which is not untypical these days. There is a great deal of noise, and it's often easy to look at the negative headlines and that side of the noise, if you will. You get caught up in that, and I always find that that [noise just] tends to sell a few more newspapers. Negative headlines tend to draw you [in] a bit more. We do look at some of these things; we don't follow it that closely. That noise can be very distracting. We try to focus on the longer term and determine what [will] actually affect that longer-term picture, [looking] for turning points along the way.
	01:36	By virtue of that, we don't get caught up in the noise so much, but I can see how that would be concerning for a lot of people—it's very easy to be drawn in by those headlines and then feel that you need to react and do something, whether it's to your portfolio, or other parts of your life to mitigate any downside or potential bad outcomes. So there's always that temptation. It's really important for us to focus on that longer-term picture.

	01:56	I would also add that things are always unpredictable when you're looking at any quarter. It's easy to look back, but if we're looking forward—despite the fact that we've probably said in this podcast that we're maybe in slightly more uncertain times than normal—anytime is always uncertain when we're looking forward.
		We never know with great certainty what's going to happen in the near term, but we have a fairly…"better" chance, if you will, [with] longer term trends and expectations. But the short term is always very difficult.
David Fraser	02:20	I'm not sure how much comfort it gives clients, but if we do look back, as you say, we've had some pretty strong performances year-to-date and even further back than that. So, it's always important to keep things in perspective. If there is volatility, it's never easy to stomach, but we have to look at the bigger picture.
		So, as you say, it definitely hasn't been all bad news this quarter—there's been a lot of positives out there. What are you telling clients to look for in terms of the positive side of the ledger?
Greg Peterson	02:46	I would say some of the positives are that, while we're talking about slower economic growth, the global economy is still growing. So, we're still on the right side of zero in terms of growth. The U.S. is relatively firm—it's running right along trend growth for the most part. That's not such a bad thing. Yeah, it's slowing somewhat, but they're still growing. And things are still positive for the demand side in the U.S.
		In particular, I do look at the U.S. consumer. Unemployment in the U.S. is near record lows. In fact, for the entire G7 as a group, [where we are right now], unemployment is very low historically. So, consumers still make up a big part of the demand equation. In fact, they make up two-thirds or better of the North American economy—so it's very important for us to look at the consumers.
	03:25	U.S. consumers have done a good job of de-leveraging in the past 10 years since the financial crisis. So their household balance sheets, if you will, are in better shape than they were 10 years ago. They don't carry the same levels of debt, their debt servicing is much better than it's been. If you combine that with full employment and strong wage growth, the U.S. consumer's in pretty good shape.

03:45 One other point to add to that too, is that U.S. consumers have been saving, so the savings rate has been running relatively [That means] they can start to spend more of their income than they have been, and can start to dip into that savings rate somewhat, as well. So, I think there's some upside on the consumer in the U.S.

To offset that a little bit, some of the media headlines have been around recession and inverted yield curves, and so the fear there is that just those headlines alone cause consumers to retrench somewhat and stop spending. That could actually sort of self-fulfill a little bit to slow things down further.

04:16 But I think on balance, things look a little bit more optimistic as far as consumers go in the U.S. And I also see [that] growth is fairly cyclical. We've been on a downtrend in some parts of the world. If you look at manufacturing globally and trade—[they've] been slowing for some time. Purchasing managers' indices peaked in the first half of 2018, so we may be just getting to the point where that cycle could be bottoming as well, and looking to pick back up and sort of resurge here at some point.

David Fraser 04:45 I just want to touch on one thing you said there. You mentioned you focus a lot on the consumer side of things, but you also mentioned the Purchasing Managers' Index (PMI). Now, selfishly, I wanted to ask you about this because I've been getting a few client questions. It's been in the headlines. Can you sort of explain a bit more [about] what it is, and why we're seeing it in the headlines?

Greg Peterson 05:01 Yeah, the Purchasing Managers' Index is widely used around the world as an indication of economic growth. (This is surveying supply chain management for the most part.) The intention there is that the purchasing managers' within a company are reflecting their prospects for growth, the sales that are coming up for their business, and having to buy a product, basically, to help fill those sales. (Whether that's product or service, both would apply.) Then, having to ensure that employment is at the right level to satisfy that as well. Historically it's been a very good indicator of the direction of economic growth.

05:33 Purchasing managers' indices have been slowing on the manufacturing side around the world, so that's been causing some concern that things are slowing and perhaps slowing more quickly. There's another component though, too: the non-manufacturing purchasing managers' indices have been slowing as well, but they haven't slowed as much as the manufacturing.

In countries like Canada and the U.S, services make up a bigger part of our economy than the manufacturing side. So, still good indicator that things are growing relatively well. But I think that's the fear—that there's a strong correlation between economic growth and the direction of purchasing managers' indices. And they have been slowing for some time.

David Fraser 06:07 And one economy that has [been] hit a bit more there is somewhere like Germany, who is more of a manufacturer on that side of things.

Greg Peterson 06:14 Yeah, Germany is definitely more on the export and manufacturing side of things, so it's been a bit more concerning there. Even in Germany though, the services component has remained positive, so it's not entirely bad. I think Germany has also been hit by the auto-cycle to some extent—auto sales in China have been slowing for a while, and Germany exports a lot of cars, particularly to China—so they've been impacted by that.

06:35 This is another area where, if you look at some of the cyclicality—you could be looking for China to start grow[ing] again at some point. China's been introducing somewhat more stimulus on the monetary side; I'd expect some fiscal response in China over time as well. And that may help to bring the auto demand back, as well as other demand from the Chinese, and would have a stronger positive impact for areas like Europe and Southeast Asia that are more oriented towards Chinese demand and probably less so for areas like North America.

So, as much as we export to China and China's a customer of both Canada and the U.S., we have a lower percentage of our trade going to China than Europe would, for instance.

David Fraser 07:15 I think your explanation there paints the picture of how interconnected we are as a world now with the U.S.–China trade war impacting places like Germany and other parts of Europe. So, it's a very complex world we live in, isn't it?

07:26 On that front, if we put on your Asset Mix Chair hat for a moment, I know there's been a little bit of debate within the team on U.S. versus international equity exposure. So, really since 2011, we've seen a strong run up in U.S. stocks but not as significant in international equities, creating for a little bit of a divergence there in valuations. Are you seeing opportunities there internationally? Given that difference in valuation?

Greg Peterson	**07:51**	Yeah, U.S. valuations are appropriate given the strength of the U.S. economy, and perhaps a bit on the optimistic side as well. I would say that U.S. stocks are pricing in "low rates for longer" from the Federal Reserve, and also bond yields in the U.S. I think they're also relatively optimistic on the outlook for a trade agreement between the U.S. and China, and perhaps the U.S. and everybody else. But the U.S. and China is really the main one there. Because it's priced with a fair bit of optimism that maybe limits the upside in the future for the U.S. market. And I think that we eventually see some rotation of leadership outside of the U.S. and most likely on the international side.
	08:28	If we do see China start to reflate their economy hiccup, I would expect to see some of that market leadership perhaps move to Europe. So, for a variety of reasons: one—we should see an improvement in trade and economic activity in Europe. And we're also coming off of lower valuations in Europe. Although, I hesitate a little bit in that valuations, they're are often discounted a bit to the U.S. It's just the nature of the market there. And then we do have some political issues in Europe that perhaps are also impacting valuations such as Brexit, and we still have some issues from the credit crisis from several years ago that haven't been fully resolved, although just don't make headlines anymore. In any event, that one I believe is manageable, and it's just a function of time. But that may be weighing on valuation so much in Europe as well.
David Fraser	**09:10**	Absolutely. And markets in the U.S. are pricing in another rate cut from the Federal Reserve—about an 80% chance at the moment. Are you expecting another rate cut before the year is out?
Greg Peterson	**09:21**	It's possible—that's as close as I come to expecting anything. We may see another rate cut out of the U.S. Federal Reserve before the end of the year. Those expectations in the market tend to have a bit of ebb and flow to them depending on what the markets are doing, or what the most recent data has suggested. If the Fed wants to be a bit defensive in terms of not letting economic growth stall completely—(they've taken out a bit of insurance with the two rate cuts this year)—I'm not sure if they feel that they have to lower rates a great deal more. And Chairman Powell has been indicating this in his speeches the last little while—just to reinforce that the U.S. economy is on firm footing; economic growth is really at a good pace there.

	09:59	I think he's doing this for a couple of reasons: one is to try and set expectations around the future of rate cuts, and then I think he's also trying to send a message to U.S. consumers to say, "Hey, things aren't that bad. Go ahead and spend money, please." So I think there's two points to his message there, so we may see another rate cut if they feel it necessary. But I'm not sure that they really need to.
David Fraser	10:17	Right. And I'll give you a break from predicting things in the future [laughs] because it's nice to talk about all of these macro issues and all of the headlines out there, but ultimately we are a bottom-up investor here, and some of our holdings have been showing signs of slowing earnings and now bounced back last quarter on improved results. So, how does some of our consumer staples like Japanese drug store Tsuruha or convenience store chain Seven & i—they're in our portfolio—how do they underline and bring all of this type of discussion back into our specific investment approach?
Greg Peterson	10:50	So, both of those companies are good examples of businesses that have bounced back. They had been under some pressure on the cost side of things—Seven & i: [the] tight labour market in Japan has caused some issues on wages for them, so it was a bit more on the cost side. Tsuruha—there was some criticism of their cost management previously as well. Businesses can go through a sort of ebb and flow to their own cycle. If we look at Tsuruha in Japan, I mean, it's a good fit in terms of its business model. It's a fragmented market for drug stores in Japan; there's room for consolidation, which is part of their growth model. It fits the demographics in Japan as well, with the aging population—you would expect that demand for drug stores would remain good going forward.
	11:28	This is one of the things that helps us to get through some of that cyclicality: the fact that these are good business models, they have some competitive advantages, and they have a runway for growth. They may go through some tough times; it doesn't mean you sell them off. We may trim holdings and reduce the weight in the portfolio based on some of that cyclicality, but it's not that we abandon that business model and move away entirely.

So, you stick with those really good businesses you have strong knowledge of the management teams and their ability to turn things around, or continue to manage them very well and get through the cyclical points. Those companies have had a bounce off of what was perhaps a tougher time previously.

David Fraser 12:02

It's really a case of the age-old phrase, which is, "it's not timing the markets. It's time in the market," isn't it? Those are a couple of examples that paint a good picture there.

Greg Peterson 12:11

Absolutely.

David Fraser 12:12

So, we've taken a look back on the quarter that's been. Looking ahead, we've got the federal elections coming up. I'm looking forward to it—it'll be my first year I'm able to vote here in Canada.

What are you keeping an eye on there with regards to policy changes and the election?

Greg Peterson 12:26

With respect to the Canadian election—we don't look at elections specifically, and certainly don't try to predict who's going to win them. (I would challenge anybody to try and figure out what's going to happen in Canada this time around.) Although there are lots of opinions on that. We do try to look for direction of policy, so, maybe if there's some commonality and the platforms for policy direction—whether it's regarding tax or other measures for business—they may come into the picture to help set up the environment somewhat. The same thing with the U.S. election coming up next year. I don't focus so much on the election, but perhaps if there's some direction, generally speaking, in policy that may change the environment in that country for the business climate.

13:04

We have a few things we're still looking at in this country and you've probably heard them in past podcasts if you've listened. Household debt in Canada—different than the situation in the U.S., in that we're still near record levels for household debt. I've heard it argued that the debt quality is a little bit better the last couple of years with changes to some of the mortgage rules, and so that's a possibility. But debt servicing is still relatively high, and I think that that's still constrains the Canadian consumer a little bit going forward. So we'll be watching for changes in that regard.

	13:29	We'll also be watching for changes in the housing market. Again, the housing market has stabilized somewhat more recently, but is still regarded—especially by people looking in on Canada—as relatively expensive, and being one of the few countries that hasn't gone through a bit of a bust on the real estate side. I don't think we have any imminent concerns, but it will be one of the areas that we look at largely as it relates to health of the Canadian consumer and what that means for our economy going forward.
David Fraser	13:52	And is there anything else on your radar upcoming?
Greg Peterson	13:55	Nothing specific on the radar—I think we do look at long-term trends, so things don't change very quickly. And unfortunately, if you listen to the podcast a lot, you'll probably hear the similar sort of themes and things being talked about over and over. The main thing for us is to watch for the leadership changing from the U.S. to elsewhere. That'll be very gradual. You can sort of equate that to turning an oil tanker: it doesn't happen very suddenly, it's a very long gradual process. Those are the types of things we'll watch.
	14:20	We do watch for improvement in trade talks—that'll be one area that will help business investment, I think. It's very difficult for businesses to invest if they don't know what the playing field looks like; improvements in trade agreements will be a big part of that. Whether that's China and the U.S., or that the new NAFTA agreement, which still has to be ratified in the U.S. and Canada—that's another hurdle, I think, in terms of improving our outlook for Canada. [It] will help Canadian businesses to understand what the platform looks like going forward and may help investment here. So those are a couple of areas we'll look at as it relates to the Canada, anyway: the consumer here, as well as the trade outlook for Canada.
David Fraser	14:56	All right, Greg. Well, that was great! Thanks so much for your time and sharing your thoughts today.
Greg Peterson	15:00	Thank you very much.