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David Fraser 00:41 Welcome to the Art of Boring podcast, I hope everyone had a nice break over the holidays and is staying safe and well out there. Thanks for joining us for the Q4 quarterly update for 2020. Our Asset Mix Chair, Greg Peterson, is joining me again today. Greg, welcome.

Greg Peterson 00:56 Hi, David. And Happy New Year, everyone.

David Fraser 00:58 Yeah, it's certainly a good new year to have behind us, I think, for a lot of people. It was a pretty turbulent 2020. So, other than the obvious, can you give us an idea of some of the major investment themes that you saw out there last year?

Greg Peterson 01:11 I think most of the major investment themes were the obvious, [laugh] in that we had the coronavirus pandemic last year, which was the biggest news of the year in causing economic shock. That led to the work-from-home theme around investing. So, with more people working from home, many tech companies did very well: Microsoft in particular helping to provide a lot of that platform—the technology side; and companies like Zoom, who we don't own, as more people were connecting by video. And of course, the online retailers like Amazon and then Shopify's platform in Canada.

01:44 I think those were the major themes on the positive side...naturally, with the economic shock and lockdowns last year, companies that were travel-related or more cyclical naturally didn't have as good a year for much of the year.

So, it was really a year of fiscal and monetary stimulus—economic concerns followed by a sharp rebound. So I'm not sure that I'm telling you anything that's not obvious, David.

David Fraser	**02:06**	Yeah, fair enough. I think everyone was pretty well aware of the major themes out there last year, unfortunately. We touched on this in the past, but there [are] still a lot of good questions from clients. They point out that we saw a strong performance in financial markets, if you like, in equities. (And you touched on some of them there with the big tech names.) But the overall economy, real economy, slowed down due to COVID. Can you give us some insight into why we saw that divergence between the real economy and financial markets?
Greg Peterson	**02:36**	Yeah, the real economy often does not align immediately with financial markets. Financial markets are always forward-looking for the most part. And so they're looking beyond what's taking place currently. So, while we may be in an economic slow down or recession, markets are looking past that quite often and so they'd be active in looking [for] where do we go from here? So that's part of it.
	02:54	As we got into the second quarter and the middle of 2020, markets were looking into “what next” and “what beyond” with respect to the rebound. And then I think the bigger theme was just the zero interest rates. There were very low interest rates and low discount rates that exist in much of the world. And those low interest rates really have a much stronger impact on stock prices and a short-term disruption to earnings. And so low interest rates has really been a continuing theme that's allowed markets to revamp and do very well.
David Fraser	**03:22**	Yeah, and from the sell-off in March, there was a quick and sizeable call to action from central banks and policy makers around the world, and that resulted in one of the quickest recoveries in markets ever. Do you think that kind of coordinated action gives you a little bit more comfort as you think about future market shocks? Or do you see the sizable responses as more of a one-off?
Greg Peterson	**03:44**	No, I think the coordinated response is something that has been around and is here to stay. Whether you believe in continued globalization or a move away from globalization, world policy makers do understand that they have to work together to make things resilient to survive the financial markets and economies.

04:03 I think what happened this time around is we saw a much faster coordination of this response than perhaps what we saw with the great financial crisis of 2008 and 2009. I think the speed of it was a major difference this time in terms of that coordination. And then also the speed of the fiscal stimulus that took place this time with governments providing support both to consumers and to businesses directly was also something that was much quicker. And I'm not sure that it was coordinated, but I think each country understood the importance of maintaining the ability of consumers to consume and to maintain some of their livelihoods.

David Fraser **04:37** And ultimately you have to pay the piper and we saw a lot of spending come from those governments. How do you think they'll deal with the debt that they took on in 2020 to combat COVID, and what does that mean for investors as we look forward?

Greg Peterson **04:50** I think higher spending from governments is going to be with us for a while yet. This as we combat some of the ups and downs with the pandemic and some of the regionalized lockdowns that will still trend even though we have vaccines starting to roll out.

05:04 High debt levels are really...we're able to maintain them for the time being because interest rates are so low. So, this does allow for governments to continue to take on debt without completely destroying their budgets. Higher debt levels will be around for some time and will take generations to pay down. And so it's a matter of how the governments move away from this or improve their balance sheets longer term. That's going to be a story for some time as we work through this and just see how it plays out.

05:31 The best scenario for governments is to continue to expand and grow GDP so that the debt becomes a lower percentage of their GDP. It's just like a household increase in their net worth so that the debt that they're carrying doesn't make up as a big percentage of their overall net worth. For countries, it's the same thing—looking at it relative to GDP.

05:49 But then quite likely this does lead to higher inflation at some point down the road. Now, that's been a concern for many years and just inflation never really seemed to make a comeback in developed countries. This time we'll probably see inflation start to pick up. And inflating away debt is not ideal; it is dependent upon how well it's managed as we go forward. But the idea behind that is a dollar tomorrow—if we have positive inflation—is worth less than a dollar today. If you're paying back that debt with the dollars that are deflated over time, then essentially it's a lower cost to reduce that debt.

David Fraser	**06:23**	And the best case scenario is that innovation and natural growth, isn't it? To expand the GDP. And then it becomes far more of a smaller problem to worry about over time.
Greg Peterson	**06:33**	Yes, exactly.
David Fraser	**06:35**	So, we touched on the spending that we saw from governments and a lot of that and monetary policy, I guess, [is] flowing into the financial markets. And I have a lot of clients asking as a result of that, do we think that valuations are stretched at the moment? What are your thoughts on that?
Greg Peterson	**06:51**	Valuations are a concern, so they are—with the markets bouncing back to the extent that they have and pushing higher—more expensive than they've been. Valuation in some of the expensive markets doesn't provide a very good timing tool, so they can stay expensive for some time—again, supported by low interest rates that help us to move through this. But eventually you do have to have some rationalization of value. The ideal way would be for earnings growth to catch up with valuations. That would be the ideal scenario.
	07:19	It does also make the possibility of market corrections a bit more likely. Although, as we've experienced in the past year, volatility is always right around the corner and so that's not something that's new either.
	07:32	So, we anticipate that that's a possibility. But I think that really, what valuations mean to us in context today is that future returns are likely more muted. So, despite the fact that we're often talking about the perspective of returns to decline or at least be lower returns going forward, that is what higher valuations tend to lead to. So, we're already starting at a higher point as we grow going forward and means of returns are likely to be a little bit lower.
David Fraser	**07:55**	It sounds like you'd be cautioning your clients: "Hey, let's tamp down return expectations," and [it] wouldn't be a huge surprise to see a bit more volatility out there as well.
Greg Peterson	**08:05**	Yeah, and any of my clients who might talk to you would tell you that I'm always telling them that, so it might be a bit of a broken record.

David Fraser 08:11 So, we'll take a look at the foreign exchange market for a moment. The Canadian dollar gained about 5% versus the U.S. in Q4—it's now the highest level in nearly three years. Other currencies have actually rallied against the U.S., so, it's not about the Canadian strength so much as it is about the U.S. [dollar's] weakness. What are you seeing in that part of the foreign exchange market?

Greg Peterson 08:33 Yes, so you've indicated it right there: it was really more about U.S. dollar weakness. When we were in the middle of the crisis early in 2020…whenever there's a crisis, money tends to flow to U.S. dollars. [The] U.S. dollar is still the reserve currency of the world; it's considered a store of value in times of crisis, and so that did drive up the U.S. dollar early last year.

08:53 There is a benefit to Canadians, given that the Canadian dollar is relatively volatile—in that when we go through periods of crisis, the Canadian dollar tends to sell off and decline in value as it did against the U.S. dollar last year. And so that helps to mitigate some of the portfolio volatility, because we do have a good percentage of assets invested outside of Canada and in the United States. And so that currency volatility helps reduce overall volatility for our clients.

09:18 I think the Canadian dollar rebounding in the fourth quarter is also representative of more cyclical swing that we saw in markets that started with the announcement for Pfizer with the first vaccine that was approved to become available. And you saw a shift in markets, and not just in currency markets, but also in stock markets and bond markets at the same time. So there was a fair bit of change that took place in a very short period.

David Fraser 09:41 And I think it's important for clients to understand with that exchange that you pointed out, it really does impact real returns when you convert them back to Canadian dollars. If all else being equal, the international equities increased by 1%, but the Canadian dollar also strengthens by 1%, then those gains already offset when you convert them back to Canadian dollars, aren't they?

Greg Peterson 10:02 Yeah, so there's an offset there. The Canadian dollar was a headwind in the fourth quarter, whereas it was a large positive in the first quarter of last year when markets were selling off.

David Fraser 10:12 Absolutely. On the asset mix side of things, we introduced the [Mawer] Emerging Markets Fund to our Balanced strategy, as well as we moderately increased our allocation to Canadian bonds and Canadian large cap equities. Can you give the listeners the sense of the thought process that led us to those adjustments?

Greg Peterson	**10:30**	There [are] a few things. So, this was one of the changes that took place in the fourth quarter. The bond increase—it was really a bit of a rebalancing within the portfolio. So, as equities move higher, even if bonds are relatively stable, they become a lower percentage within that portfolio.
Greg Peterson	**10:45**	It was a bit of a rebalance. And also rebalancing just to restock the bond weight, if you will, against future volatility. So, as much as there's been lots of talk about bonds not working as well as in the past given exceptionally low interest rates and prospects for higher interest rates to come, they still work well in times of equity market volatilities. And so we increased the bonds just to provide future offset to that equity volatility.
	11:09	On Canadian equity and emerging market increases...I'll speak to the Canadian equity increase first. With the announcement from the vaccine makers and the prospects [of] eventually starting to reopen economies, there was a change in the outlook to provide more support to more cyclical economies and more cyclical stocks, as well as more value-oriented stocks.
	11:30	And so Canada tends to be viewed as a...well, we're still a resource country for the most part. We tend to be more cyclical. So, this provides more support for Canadian equities as we go forward. That's just part of that reflation trade that we're seeing. Also, because Canadian equities have not performed so well over the last couple of years, they tend to provide better value at the moment as well—especially when compared to U.S. equities.
	11:52	Now, you could argue that there's reason for that value, but nonetheless they still offer more value and that should provide better expectations for long-term returns. But there [are] a couple of other pieces to that, too. For Canada, U.S. economic growth is still good. And with the change coming in government for the U.S. and fiscal support in the U.S., that growth is likely to help Canadian exports and providing support for the Canadian market.
	12:17	And then energy markets have been a bit more stable of late as well, and access to markets is approved for Canadian companies. So, on net, we would say that the outlook and prospect for Canada has improved We would acknowledge that household debt levels and balance sheets in Canada are still not spectacular. Real estate still plays a big part of our economy as well, so [we] still acknowledge that there [are] some potential headwinds for Canada. But we did want to add some of that just for that longer-term perspective.

	12:43	On the emerging market side—so we did introduce the Emerging Markets Equity Fund to the Balanced Fund in the fourth quarter. Now, this is not a brand-new add-in—emerging markets. We've already had emerging market exposure through our international equity and small cap portfolios. So, really what we were doing was making an allocation to increase the weight of emerging markets within the Balanced Fund.
Greg Peterson	13:02	So, we took it from about 3.5% to 4.5% in the fourth quarter, (the 3.5% being through the other strategies). [There are] a few reasons for this as well, and one is, again, the prospects for better economic growth down the road. So, one of our concerns after we get past the pandemic is we're back to the slow growth environment that we were in before, particularly in North America.
	13:23	And so emerging markets offers us exposure to potentially better growing economies. It also just adds broader diversity to our portfolios. What I mean by that, is broad diversification from an expansion perspective, but also diversity from an opportunities and growth perspective. And it also increases the number of businesses that we have on the emerging market side. So, through the other strategies we had roughly twenty companies that we had exposure to in emerging markets. By adding the Emerging Markets Equity Fund, that brings it up closer to about fifty names in total. So, broader diversification on the emerging markets side. And then with the emerging markets too, [it] brings better demographics, younger populations, better prospects for future growth, as we are looking much further ahead with respect to adding emerging markets to the Balanced Fund.
David Fraser	14:08	Great, well lots of detail there and I think clients will really get a lot out of that. So, thanks for sharing those thoughts—really insightful. On emerging markets, I know it wasn't the exact reason we added it—you provided some thoughts there—but they certainly had a strong 2020. Were there major themes that contributed to that strong year?
Greg Peterson	14:27	Yeah, there [are] a few macro themes that I think also helped with emerging markets. Low interest rates, again, helped emerging markets significantly. A great deal of liquidity in the world, so with monetary policy as loose as it is globally, greater liquidity does help emerging markets a lot. And then the lower U.S. dollar also tends to provide a benefit to emerging markets. So, there's a number of macro themes that have helped those markets and I think that those will continue to help emerging markets as we go forward.

David Fraser 14:53 Speaking of the U.S., listeners might recall that we trimmed our U.S. weight slightly in Q3 and we've done that in the past as valuations continue to rise there. Knowing that the U.S. outperformed international markets in 2020 as a whole, I assume we'll continue to monitor things there and look to trim, to keep things in check if that trend continues?

Greg Peterson 15:15 Yeah, that's just part of a regular rebalancing. Because the U.S. markets have been so strong, so that it doesn't grow to be a large weight within the balanced funds in our portfolios, we continue to trim that back. And also because I think the future prospects for the U.S. market, while still good, are not as great as they would have been a few years ago. So, this offers us an opportunity to trim back from U.S. and reallocate to others that we expect to have a bit more runway.

David Fraser 15:38 As the unrest in the U.S. continues, what are we watching in relation to impacts on our portfolio as a result of all of that noise going on down there?

Greg Peterson 15:47 I think the political happenings in the United States are still reflective of some of the trends that we've seen globally for some time. Bit more populism, little bit more unrest. [The] pandemic likely helped to accelerate that or expose it more than we've seen in the past. So, we're always looking to see how this may impact us. I think what we're more hopeful of and looking forward to, is the transition of power in the U.S. And hopefully the healing of some of the relationships for the U.S. with other trading partners and other governments around the world. I think a smoothing of those relationships and perhaps a normalization of the political environment in the U.S. as we go forward...that's just something that we're looking forward to to perhaps reduce some of that volatility and uncertainty that we've come to see.

David Fraser 16:32 And it seems like the incoming Democratic administration's a little bit more likely to continue with accommodative stimulus policies. Do you expect that? I guess it probably seems to be a consensus and it's probably already priced into the market now, anyway.

Greg Peterson 16:47 Yeah, with the Democrats taking both houses, naturally this does make it easier for them to implement their policies. Their policies are likely to be more fiscally stimulative. A lot of this is, at least initially, priced into the markets.

17:00 I think that continues to provide a benefit as we get through this year, also. It's another one of the reasons why we're not completely negative on U.S. markets, given that they're a little more on the expensive side. There's some benefit to continue with fiscal response as well.

Greg Peterson	**17:13**	Now, there['ve] been concerns that have been raised about inflation and what this does to U.S. debt levels down the road. And that's also one of the things that we're most concerned about as we look forward, but we still believe that inflation is relatively subdued for the next couple of years. We may see it pick up somewhat from time to time, but I think we have at least a two-year window where we have relatively low inflation still.
	17:34	You may see a normalization back towards sort of 2% on average for inflation, but we have some time. There's still a great deal of slack on the job market and their labour markets in the economy, and that slack is likely to give us some room before inflation starts to accelerate.
David Fraser	**17:49**	And I guess the other headwind there with the Democrats coming in is the increased likelihood of increased corporate tax rates or even personal tax rates as well.
Greg Peterson	**17:58**	Yeah, that's the common expectation is higher tax and somebody has to pay for all the spending that's taking place at the moment. However, I don't think that tax rates change so much that it offsets the fiscal impulse of it yet.
David Fraser	**18:09**	So, as we look ahead in 2021, the vaccine rollouts eagerly awaited, is there anything else at the outset of the year that you're keeping an eye on?
Greg Peterson	**18:20**	The vaccine rollout is the main one. I think we still have some time to go—you see this currently with the lockdowns taking place and changes in restrictions on many different markets. This will still be the theme for the next couple of quarters, I would suspect. It's going to take quite a while to actually roll out the vaccine sufficiently to reopen economies.
	18:38	That would be the main thing that we're watching. You have seen some mutations of the virus in the past while and different strains come through, so it'll be important that the vaccines are able to address that, too. So, we're not completely out of the woods, despite looking like that from a stock market perspective and that would be what we're keeping an eye on in the next several months. It's just to better understand that ebb and flow of economic growth and activity and where we go with the coronavirus.

David Fraser	**19:01**	So, obviously the coronavirus is out there and that's a big risk. Are there any other major risks to portfolios as we look ahead that you can foresee? I mean, I like to point out to clients that COVID came out of nowhere; it's one of the things that we always try and manage expectations because there are known unknowns and then, like COVID, there are unknown unknowns. So, is there anything else that's on your radar with regards to risk?
Greg Peterson	**19:24**	There [are] always many risks. There's a lot of things that we watch all the time. I think that the coronavirus is the main one at the moment. Inflation is one of our longer-term risks that we will also be keeping an eye on and one that I would say that we're more concerned about because it has a higher impact, but I think that the probability for the time being is still relatively low.
	19:44	And as far as the rest, there's risks to markets, to economies, there's chief political risks...these things are always out there. And so, for us, it's always about taking a balanced approach. Despite perhaps some of my comments sound like I may know what's coming and so on, we always hold those opinions fairly lightly—we never stray too far in one direction or another and always make sure we stick to our knitting with respect to our investment philosophy and process and understanding that the companies and ensure we provide high quality companies within our portfolios.
David Fraser	**20:13**	So, with that longer-term risk comes with inflation, what do you see the major impacts being there? Because equities are a pretty good inflation hedge when it comes to that. What other concerns do you have if that was to play out further down the line?
Greg Peterson	**20:26**	It depends on the pace of inflation. Inflation accelerates too much or too quickly, that could take interest rates and discount rates higher. We've talked about discount rates being supportive of equities at the moment, [but] if we have discount rates moving sharply higher, or moving higher quickly, that could undermine the stock markets, despite the fact that they may be a hedge against inflation. So, at some point there's a trade-off and you just want to ensure that inflation doesn't cross that line.
David Fraser	**20:50**	Perfect. As you say, we're not trying to predict things, those are the things that are on our radar that we're trying to relay to listeners, I guess. So that's great. Thanks so much, Greg. I always appreciate you providing your thoughts to listeners and thanks for joining me today and I look forward to speaking with you again in the second quarter.
Greg Peterson	**21:07**	Thanks David, and I'd just like to wish everybody a safe and happier year ahead.