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EP 100 | Quarterly update Q4 2021

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David Fraser: **00:41** Welcome to another episode of the Art of Boring podcast. You're lucky enough to actually be joining us for our 100th episode, so we're very happy about that. And thanks to all our loyal listeners.

Today, we'll be covering the Quarterly Update. We'll actually be extending that out back to the entire year of 2021 before we look ahead to the coming year. And joining me today, as always, is Greg Peterson who's our Asset Mix Chair. Welcome back, Greg.

Greg Peterson: **01:08** Hi David, Happy New Year. And Happy New Year to all of our listeners.

David Fraser: **01:11** Yeah, absolutely. We were talking before this and saying, there's a lot of the same headlines and one of those main headlines is COVID, of course. So, we all hoped that that would be behind us by now, but it's still out there and still affecting us, and [we] hope everyone's safe and well out there.

But as we look back on 2021, what were the main market movers of last year?

Greg Peterson: **01:32** Yeah, it's interesting looking back, David. I think we can just take the podcast from four quarters ago or a year ago, and just hit repeat for a lot of the things. So, hopefully not everybody's bored of the same topics out there. But most of the headlines are pretty consistent over the past year, and headlines rolling into 2022 are still pretty consistent in terms of what's driving investment markets.

So, as you have already pointed out, the pandemic and COVID is one of the top headlines with an ebb and flow to the coronavirus openings and closings in economies throughout the course of the year.

	02:03	That continues to be a theme, unfortunately. And I should say, looking back over the last two years, that if you expected a global pandemic the way we've had, you probably wouldn't have expected two such good years for investment markets and performance.
Greg Peterson:	**2:16**	So, it's been a bit ironic from that perspective. And I think, also, as we've said in the past, don't take current news and extrapolate or expect you can predict what's going to happen—but it's been a pretty good period despite the pandemic.
		The other drivers really, that we've talked about before, too, the stimulus from both monetary and fiscal authorities has helped markets in the past year. That's been pretty consistent, as well.
	02:37	Part of that from the monetary side is low interest rates, so there are still very low interest rates today. Earnings have been strong through the course of things. Some differences from different sectors, naturally, but overall, earnings have been pretty good. Then, the other big headline has been inflation that we've talked about quite a bit as well, and in fact there's a podcast out just recently with Samir and Rob that went a little deeper on the inflation story, as well. But those have really been the key drivers. On the inflation front you can go down a little further in supply chain disruptions, energy prices. There's a whole host of things that are out there that are impacting markets and economics at the moment.
David Fraser:	**03:09**	Despite a lot of those negatives, as you say, markets have been quite strong. And to your point, a big driver of that's been corporate earnings, which were extremely strong in 2021. What's been the main driver of those earnings?
Greg Peterson:	**03:21**	There's been a few things. I don't think you can boil it down to just a few, but I'll give you a few headlines, perhaps. One is just the bounce back from the pandemic. So, growth and pent-up demand have helped to fuel demand for goods and then services as those have become available, as well. So, there's very strong demand that's helped to drive the top line or sales.
		At the same time, companies have done a good job of managing costs for the most part. And I would say, almost anecdotally, that the pandemic and the worker shortages did cause some dramatic improvements in productivity and technology adoption. I don't have a lot of hard facts on that, but I've suspected that's also provided some boost to profit margins over the past couple of years, as well.

David Fraser: 04:04 Yeah, and it seems like that inflation—people are wondering, where is this inflation coming from. It's really both sides of the equation, isn't it? It's the supply chain issues—which probably most people have heard about or even experienced—but it's also that strong demand, isn't it? It's coming from both sides which is creating that environment of increasing prices.

Greg Peterson: 04:21 Yeah, absolutely. It's definitely both sides that are driving things at the moment. I would expect that over time both sides will subside, but as we've spoken already, it's lasting longer and a little hotter than most would have anticipated, including the central banks' and the Fed's recent acknowledgment that maybe this isn't quite so transitory, which I think was one of the more overused words earlier last year.

David Fraser: 04:40 And then, if we look to the labour market, we still see a high number of job openings with the labour force participation rate being lower than it otherwise has been. How does that impact businesses and the investment landscape?

Greg Peterson: 04:53 There's a few impacts from that. One is the availability of labour—just the ability to produce things or provide services is impacted, naturally. So, there's the bit of a shock on growth or activity levels from that side. It is inflationary itself, so, less workers [and] more demand for those workers drives up wages. And so we're seeing wages running hotter at the moment also, so that could have some impact on profit margins overall.

But there's definitely a challenge on the labour side and the current wave with the coronavirus and Omicron [variant] is making that even worse, currently—just as people are not available to show up for work because they're ill. So, there is definitely some disruption. It can have some impact on economic growth, impact on inflation, and that'll gradually work its way through the system as we get on with 2022, as well.

05:39 But there is also another piece to the participation rate that you brought up, and that is just people deciding to retire early. There's been a lot of people just drop[ping] right out of the job market, so fewer workers available. Unlike you and I, David, who are still here working.

David Fraser: 05:53 I was just about to say—is that your way of telling us you're not going to be on the Q2 Quarterly Update?

Greg Peterson: 05:57 No predictions there, no [laughter].

David Fraser: **06:01** All right. Well, let's take a look at Canadian markets. They had a strong 2021. What was happening here in Canada and why did we have such strong performance?

Greg Peterson: **06:10** Canada's benefitted from a few things. One is, we are still considered and still are a resource-oriented economy to some extent. So, that leads to be[ing] more of a cyclical market. We've talked a bit about the move to more cyclical parts in the market in the last year, year and a half—or actually really since the COVID[-19] vaccines were announced in November of 2020, there's been more of a rotation to the cyclical side. So, Canada has benefitted from that. Stronger commodity prices, demand has improved around the world, and perhaps some supply issues in some commodities. So, commodity prices have moved higher. That's been supportive of the Canadian market and the Canadian economy, as well.

06:47 And the other is that we're considered a bit of a value market. So, prior to late 2020, the Canadian market had underperformed for some time, [which] wakes our market somewhat more affordable or a bit more value-oriented, if you will. And so we've had this rotation away from growth into value and Canada's also benefitted from that side.

If you do a direct comparison between the Canadian and U.S. market, we have many more resource-oriented companies, or banks. Businesses are very reliant on current cashflows and you're investing them for current earnings and current cashflows. Whereas you look at some of the U.S. market where you have a lot more growth companies and technology companies in particular, and much of their current stock price or value is based on future earnings. There's quite a difference there. So, you've had a bit of rotation away from growth and into value, so Canada's been a beneficiary from that perspective.

David Fraser: **07:36** Oh, nice. Go Canada. Let's look at emerging markets. They had a relatively flat 2021, but they did have a strong 2020. Was there any common thread there that created the lackluster performance last year?

Greg Peterson: **07:48** So, developed markets were very strong through most of 2021. Emerging markets, as you pointed out, were weaker or certainly trailed. Now, there's a lot of diversity in emerging markets, so, because there's so many countries and regions that comprise emerging markets, it's tough to look at all of them, but if you look at one common theme overall, China was the biggest influence on emerging markets. Chinese tech companies in particular, peaked, I believe, in February of 2021. So, fairly early in the year.

Greg Peterson:	**08:14**	And part of that was driven by China's regulatory changes—starting to restrict certain sectors. Then also just the weakness in their property market (and property developers probably contributes to that somewhat, as well). And then general slowdown in China. So, unlike some central banks in the world that have become more accommodative over time, China's still trying to deal with some of the excesses in their system, and while they did start to become more accommodative towards the end of the year, they still have some way to go with that.
	08:43	China's been fairly consistent over the years of tightening or cleaning up parts of their markets; becoming a bit more restrictive but then opening other things up again; increasing or improving credit metrics and more availability of credit...so you had a very regular cycle with China. They seem to be off that cycle a little bit at the moment and just remaining slightly more restrictive, I think, to clean things up. But time will tell. So, China's been running a bit slower right now, and so for a variety of reasons it's had a bigger impact on emerging markets.
David Fraser:	**09:10**	Some of those property issues that you mentioned—listeners to this podcast or other investment outlets might remember the Evergrande story where there was concerns around the property developer and able to fulfill its credit obligations, so some of those regulations that you mentioned and changes have come off the back of the consumer, haven't they?
Greg Peterson:	**09:29**	Absolutely. And if anybody's curious as to the weights, for instance, in our Balanced Fund, we have less than a one-and-a-half percent direct position in China. So, it's relatively low. We still look at emerging markets for future growth. The developed world will eventually get back to a slower growth environment at some point and so you still look to emerging markets to continue that growth. We're relatively happy, I would say, or content with the weights where they are at the moment, so we haven't made any changes to that recently.
David Fraser:	**09:55**	You stole the thunder of my next question. That was going to be: what've we done from an asset mix perspective? So the answer is, stay pat, I guess?
Greg Peterson:	**10:02**	Yeah, we're more of the same. So here, I could repeat, probably the last couple of podcasts, as well [laughs]. Equity market's been strong; we have trimmed equity slightly. This past quarter was taking from [Mawer] U.S. Equity as well as a small amount from [Mawer International Equity], and moving that to cash and bonds.

Greg Peterson: **10:17** So, bond yields became more attractive early on in the fourth quarter, so we added a little bit to bonds. Bonds rallied through the quarter, became less attractive, and now suddenly in 2022 they're starting to look a little more appealing again [laughs], as we got a fairly quick reaction there. But really it's been more of the same: not allowing equity to drift any higher than it is currently within the portfolios due to that strong performance and just systematically adding back to bonds and cash for the time being, just to keep that risk management side of things in check.

David Fraser: **10:42** You mentioned that bonds had become more attractive. I guess that's partially the markets reacting to the December Fed minutes, which revealed that members are now more unanimous that rate hikes should start this year, and most people are predicting a lift-off in rates in March, with more of a consensus there in interest rate hikes coming sooner rather than later, it seems.

How does that impact your thinking with fixed income and equities as you go forward? You touched on it a little bit, but what are you thinking as you look to that with the potential rate hikes coming?

Greg Peterson: **11:14** Rate hikes have been a topic discussion for some time and very closely related to that inflation discussion, as well. I think part of the problem is that the longer the central banks keep policy as accommodative as they do, this inflation story becomes a bit bigger and it runs a risk that central banks are getting behind on dealing with inflation. Right now as we look at things, higher interest rates aren't a reason to be worried or concerned. Over time, it does adjust the discount rate higher, which has a bigger impact on growth stocks, and that's why we've seen some more volatility within growth stocks in the last while. But rising interest rates by themselves aren't a reason to be concerned for equities.

11:50 We do need to have interest rates rise. We're still at really emergency levels, and economies are functioning fine. There's no reason to have this much stimulus in the market. So, they do need to start to raise rates and normalize things. I should distinguish that this is really normalization of monetary policy, so it's getting back to where things should be, and it's not necessarily and tightening and becoming restrictive yet. There's a fine point for equity markets where higher interest rates and tightening or normalization is not so much of a problem.

Greg Peterson: 12:17 It would probably slow some of the equity market performance for the time being. It's really the absolute level of rates that becomes important as well, so if rates get to a point that the market deems to be too high, then that becomes problematic for equities. But I think that we're quite a ways off from that becoming a challenge.

12:35 They need to get through the normalization of policy before this becomes problematic. And I think, ironically, that if—we're mostly talking about the Federal Reserve Bank, but the Bank of Canada, as well—if they don't move soon enough and the market starts to get concerned that they're not dealing with inflation, then the bond the market will take it on themselves to start to move bond yields higher and deal with it and then central banks will be forced to catch up. I don't think that's a position they want to get into, so I'd be quite happy to see the two central banks, at least in North America, start to move rates sooner rather than later.

David Fraser: 13:05 As you said, if there's a strong economy, rising rates aren't always the worst thing. Equities can still move higher in a rising interest rate environment if the outlook is good enough. And also in the long run, as a long-term investor, you want higher interest rates in the fixed income market because you get more yield there. And that's one of the reasons that I think you have had lower fixed income exposure at the moment because the yield isn't there. But if that comes back, that is better for long-term investors.

Greg Peterson: 13:31 Yes, definitely, I would completely agree. Higher yields will be better for long-term investors, in particular for bond holders. There'll be a bit of a headwind for the time being. We saw negative performance out of bonds for all of 2021, despite it being somewhat positive in the fourth quarter. You may see that as we go forward, or at least it'll pressure returns from bonds. But I think it's a very worthwhile adjustment to the market. And if anybody's considering, "well, why are we holding bonds?" Well, bonds are still a very important part of that balanced portfolio from a risk mitigation perspective. So, the volatility in equity markets has picked up. I'd expect, as we're going through all these adjustments this year that it'll continue to run relatively high and volatility for equities is generally much higher than it is for bonds, so bonds have that anchor or mitigating factor to them where it just keeps the volatility of your portfolio from being as high as it otherwise would be if you had higher equity exposure.

David Fraser:	**14:22**	Yeah, and we get a lot of questions from clients about, "equities have had such a strong run over the last couple years. Have they got ahead of themselves?" Well, if they have, then that's where the fixed income piece comes in. If there's a bit of a sell-off there, then there's typically a rotation into fixed income, and that's why it's there—[to be] that cushion or that airbag.
	14:39	As we think about interest rates and interest rates rising, are there any industries that come to mind? I mean, financials is one for me that will more than likely benefit from increasing rates. And I know oftentimes we talk about being in two places at once. It's likely that rates go up, but by how much and how far? We're always trying to assess all of that, but ultimately, there are some industries that are going to benefit from rates going up.
Greg Peterson:	**15:02**	Yeah, there are areas—and you've mentioned the financials are one of the key areas that do benefit from higher interest rates. So, both the banks and the insurance companies will benefit. And for the banks, part of it depends on the shape of the yield curve as well, but overall, it was more beneficial, and that's why you've seen bank stocks performing quite well in recent times, because of the prospect of higher interest rates. So there are some natural offsets within the portfolio to help; the bank and insurance companies offset what higher interest rates might do to some of the growth stocks. And because we don't know the outcome for certain and we expect that interest rates are likely to go higher, you don't entirely sell off one part of the portfolio in favour of another because you don't know that outcome for sure, so the diversity remains very important.
David Fraser:	**15:42**	Yeah, and on that fact, how much exposure do we have in the [Mawer] Balanced Fund with financials? Last time I checked, it was hovering around the 20% mark.
Greg Peterson:	**15:50**	Yeah, and we'd still be in about the same neighbourhood today, so it does change slowly [laughs] and gradually.
David Fraser:	**15:56**	So a lot of diversification there if rates do go higher. Let's look ahead now at, there's a lot of geopolitical risk in Europe at the moment. There's unrest around Russia with Kazakhstan, the Ukraine and Belarus all having issues. How concerning is that? We probably don't have a good handle on it, but more importantly, how much exposure do we have to that part of the world?

Greg Peterson: **16:17** It's very concerning from a political and humanitarian perspective. We take these macro events into consideration as we look at the portfolios and expected outcomes and exposures, but really, we have very little direct exposure to that region of the world. We do have a couple of companies in Kazakhstan in our Emerging Markets [Equity] Fund. There is a very small exposure there. For the Balanced Funds, that represents less than a quarter of a percent, so it's pretty small if something did happen in that perspective.

I think the concerns more are the indirect exposure. So, what does this mean if the U.S. imposes sanctions on Russia? That could be a continuation of the entire natural gas market for Europe and higher energy prices there that pressure both consumers and profit margins for companies. And so those are factors we spend more time on as some of the indirect concerns, there.

17:05 However, I would point out, too, that this is very similar to what we've seen in other times. Macro events are not something you can predict, or, you do have to manage through them as they happen, but I'd point to the Russian annexing of Crimea a few years back, I think, when was it, in 2014, as a somewhat similar event. This may turn out to be different or bigger. Time will tell on that, but that is something we just have to be prepared to manage through.

David Fraser: **17:28** As the Research team always point[s] out to us, one of the biggest tools they have to mitigate risk is the actual weight in a fund. So, as you pointed out, we don't have a heck of a lot of exposure there, which is how we manage the risk in that part of the world. You mentioned that the U.S.—there's always tension between the U.S. and Russia. There's always tension between the U.S. and China, but the U.S. has had strong returns for quite a number of years now, and I had a client ask me recently, "Is there still room to run there?"

Greg Peterson: **17:59** And I keep getting the question, "Why do you keep trimming the U.S.?” [laughs] The U.S. is really one of the highest quality markets in the world. It's one of the most innovative and most liquid markets, and certainly the largest market for equities in the world as well, so you have access to very high-quality companies. I think that allows them to run with this somewhat higher valuation to begin with. There's more demand and more consistent demand for companies in the U.S.

Greg Peterson: **18:22** But it's also been chief among our concerns with the U.S. market [that]...valuations are running still high and with prospects of higher interest rates or higher discount rates, the higher value securities tend to correct a little sooner or perhaps a little harder. So, that's one of our bigger concerns and just why we've continued to trim U.S. and not allowing it to become a much larger weight within the portfolio.

18:45 The U.S. could still continue to run. Obviously we have no idea how things are going to work out, but because it has so many benefits and such a diversity of companies and such high quality companies, I don't worry about the U.S. that much. We could certainly see things correct around valuations there, but from a long-term perspective, it's still a very key part of an investment portfolio.

David Fraser: **19:06** Thanks, Greg. On behalf of listeners, we always appreciate you being here and sharing your thoughts with us.

Greg Peterson: **19:10** Thanks very much, David. Hopefully we're through the pandemic sooner rather than later, and hopefully we start to see inflation addressed sooner rather than later, but I'd expect that we'll continue to march forward and expect a bit more volatility this year. But that's not reason to be concerned and need to leave markets entirely.

So, volatility is to managed, not to be feared.