the art of boring™

EP 137 | Quarterly Update | Q2 2023

Disclaimer (00:25):

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David Fraser (00:41):

Hi everyone, thanks for tuning into the Art of Boring podcast. Today, Asset Mix Chair Greg Peterson and I'll be covering the highlights of Q2 before looking ahead to the second half of the year.

So, despite ongoing concerns, stocks generally performed well during the second quarter. Greg, is that a case of markets climbing a "wall of worry?"

Greg Peterson (01:02):

Hi David. Yeah, I would say so. I mean, markets were reasonably well-behaved in the second quarter by and large. Still, positive equity markets are pretty good despite us talking about risks all the time and things we're concerned about. So, the markets have definitely been climbing a wall of worry. There's been a fair bit of momentum, particularly in the United States and really, with technology stocks by and large.

David Fraser (01:22):

Yeah, and the big talking point was inflation again and we saw it pulling back a little bit further. What are your thoughts on where we stand right now and even looking ahead?

Greg Peterson (01:32):

I'm sure our listeners are very tired of inflation and investors in general are probably tired about talking about inflation. It'll be a key topic—has been for the last couple of years and it'll remain so for a bit of time yet. And the good news is, is that inflation has been behaving reasonably well. It's continued to slow down as many have expected, and the same thing in the second quarter. (So, inflation came down.)

In fact, the most recent numbers in Canada: inflation was just over 3% and the U.S. is right around 3% for headline inflation. Core numbers are still in the 4% neighbourhood or a little higher in the U.S., but still moving in the right direction and slowing down.

Greg Peterson (02:12):

So, a lot of the issues that caused the higher inflation, particularly in the supply side and shipping and so forth, those problems by and large have resolved themselves now that we're far enough away from the pandemic and shutdowns. The supply side is reasonably well behaved. And central banks are doing what they can to tame demand and slow the demand side of the inflation equation. And I think that that's continuing as well, particularly with goods inflation.

David Fraser (02:32):

Some positives there. And that meant we had some significant year-to-date gains on the S&P 500, but it was driven largely by a handful of tech stocks. The usual suspects come to mind. What implications does that sort of concentration of returns and market capitalization have for the overall market and investors like us?

Greg Peterson (02:55):

It was very concentrated in the first half of this year. In fact, if you go back to May, if you would've taken away the top eight stocks in the S&P 500, the S&P 500 would've been negative on the year-to-date back in May.

Things broadened out a little bit in the month of June, but even in June, if you take 44 stocks out of the S&P 500, it would still be negative. And there's quite a disparity, too, between the regular S&P index, which is a market cap-weighted index that we're familiar with. If you take that and compare it away against the equal weighted index where all 500 stocks contribute evenly towards index performance, there's a gap of probably about 10 percentage points between the two year-to-dates. So, it is very few stocks driving things.

Greg Peterson (03:33):

Some of it was fuelled by thoughts around artificial intelligence—[the] rapid deployment and very quick evolvement of that sector, which has driven, really, the top seven tech stocks in the S&P 500. So, it's been very narrow.

So, unless you're holding those seven big tech stocks, it's going to be very difficult to keep up with the market when most other stocks are sort of flat or, or perhaps negative over that time period. So, that's a challenge for managers who practice active diversification, risk management strategies—you're not going to concentrate your portfolios that much and really place bets, as it were, on a few securities. That'd be irresponsible of us in trying to protect your investors' assets, but that is effectively the only way to keep up in a market like that.

Now, these things are relatively short term. If you look at the S&P 500, the top eight stocks I think it was—or perhaps it was the top 10 stocks—make up over 30% of the index at the end of June. So, very concentrated.

Greg Peterson (04:26):

You have 10 stocks making up over 30% and you've got another 490 stocks that make up the other two-thirds, roughly. Reminds me a little bit of Nortel in the late '90s and or into 2000. And in 2000, if you recall in Canada, Nortel made up over a third of the TSE index at the time, or the TSE 300 back then, all by itself.

So, you had one stock that was over one-third and you had 299 stocks that made up the other two-thirds. So, very concentrated. And usually when you have market breadth that's that concentrated or lack of breadth, it's not very good. Eventually there's a reckoning that'll happen. Things don't continue that way for long. In fact, there's an example that was brought up in the firm here a little while ago and I think I've seen it elsewhere, too...

Greg Peterson (05:06):

If you go back to 2000—and you know, this [was] really the internet boom—Cisco Systems back then was providing the backbone for the internet, and with the growth of the internet and the dependence on it, it was going to be a huge boom for Cisco. The stock price went up. And while Cisco today is still a very important equipment provider that helps to fuel the internet, the stock price hasn't gotten back to where it was in 2000, 23 years later.

So, these manias can last and run up valuations on certain sectors or certain stocks. We had it a bit with cannabis stocks in Canada a few years ago. It typically doesn't last. So, things kind of come back to more reasonable valuations and we'd expect the same thing with the tech sector in the U.S.

David Fraser (05:46):

A lot of concentration, but for us we like to remain diversified and not get swept up in it. We know these things will come around from time to time, but diversification and thinking long term is probably the best way to go. Is that the summary of what you're trying to get across there?

Greg Peterson (06:01):

Yeah, diversification is really the basic tenet of risk management. So, while we don't hold all those stocks, we do have three of those companies that have done very well. So, Microsoft, Amazon, and Alphabet were three of the big players in the first half of the year all benefitting from AI or artificial intelligence to some extent. If any of our listeners use Microsoft's Bing search engine, you've probably seen an option come up to use their AI platform to help enhance your search on the internet. So, it's come out very quickly. Or [it seems like it has]. AI's been working for a long time in the background but it's having impact in the markets now.

David Fraser (06:36):

Yeah, it's an important point. I've been using Google exclusively for the last 10 years, probably like the majority of internet searchers. But with something like that, with AI, I think it's going to change the game a lot, and you do need to reassess which provider you're going to use. So, it can shake up that industry.

David Fraser (06:36):

Another sector that hasn't done as well and has had its challenges year-to-date has been the energy sector. What's contributed to the struggles there?

Greg Peterson (07:01):

Well, the energy sector being obviously reliant on commodity prices is really impacted by global economics, so I don't think there's anything in particular with the energy sector other than lots of concern [like] when we were talking about "the wall of worry" a few minutes ago. This concern about global demand and global economic growth has had more of an impact on commodity prices and the energy side to some extent. So, it's been relatively stable in my view.

We've seen oil prices bouncing around somewhat during the quarter, but overall, it averaged a fairly decent price, so I don't think that that was a major impact. I think the market might be looking forward to some degree, plus a little bit of disappointment on the economics side from China. There's lots of expectations that China finally ends their zero-Covid policy, start to get reemergence to their economy, and opening up. And it kind of sputtered a little bit. So, I think some of the demand expectations from China likely had an impact on oil stocks, energy stocks to some extent.

And the concerns or thoughts around a possible recession in the next… call it 12 months or so, likely dampens some of the enthusiasm for energy stocks as well. So I don't think there's any one thing in particular. OPEC has been managing supply just to try and maintain relatively stable oil prices and that seems to be the result. So far, anyway.

David Fraser (08:19):

In the U.S. banking system we saw a bit of a scare in March at the back end of Q1. Haven't heard too much about it this quarter. Is that behind us? How are we looking coming out the back of that?

Greg Peterson (08:32):

I don't know if it's entirely behind us. It's been shoved to the side for the time being. The immediate impacts of the banking sector scare [were] a fairly quick decline in bond yields and interest rates and a bit of a steepening of the yield curve as the markets started to expect that that banking crisis may slow economic growth and have an impact on liquidity in the U.S.

It actually had an immediate positive impact on the bond market and growth stocks to a certain extent because of the change in bond yields, and then that faded the way. So, the bond market was one area that didn't do as well in in the second quarter. In fact, bonds in Canada were just slightly negative and that's because the bond market started to realize—or perhaps they'd already realized—the inflation, stickiness of inflation, central banks keeping rates higher for longer, seem to set in a little bit more as we went through the quarter.

Greg Peterson (09:24):

Central bankers have certainly maintained their resolve that interest rates are going to stay higher for a period of time. One of the mistakes they don't want to do is cut rates too quickly and have inflation start to slip up. They want to make sure that it's fairly stable and well-maintained before they have to take interest rates down. And the economy has been fairly resilient—when you look at economic growth in North America or in Europe, it's been pretty good; for the most part it's been holding up quite well. And until we see that slow, I think it's hard to get inflation down [and] completely settled until you see a bit more of the pressure come off on economic growth, which is the demand side of the inflation equation.

David Fraser (10:02):

The economy's been surprisingly resilient in the face of quite steep and quick rate hikes. Are the impacts still waiting to flow through the economy, or do you expect things to remain resilient for the next little while?

Greg Peterson (10:15):

Monetary policy takes a long time to flow through and the effects to be felt in the economy, so, I think we're starting to see it somewhat. We started to see some slowdown, we started to see earnings rollover; I think over the last 12 months in the U.S. earnings are down about 10% roughly from Q2 of last year, which was sort of the earnings peak. And you're starting to maybe see some on the consumption side of things slow somewhat. And it takes some time. The housing market in Canada has still remained relatively resilient in part because of our population growth and limited supply, so that's held prices up here. The transmission mechanism for monetary policy takes time. So, I think we'll still see that, and we'll still see the slowdown come. And that's likely to take place over the next six to 12 months.

Greg Peterson (10:55):

Whether that ends in recession or not—and I think we talked about that in previous podcasts—it's hard to say. There's lots of talk about this lovely "soft landing" scenario that everybody would like to see, which is really inflation coming back under control and still maintaining positive growth. It's a little bit Goldilocks to me, but we'll see. It's still possible. But yeah, it's still taking time. And very simply put, as higher interest rates start to impact borrowers and consumers, particularly through mortgage rates and other lending rates, that'll have an impact. And it doesn't happen right away—we'll start to feel that in the next year or so.

David Fraser (11:27):

Yeah, so that soft landing piece, I just want to probe you a little bit more on that—returns have been quite strong year-to-date as we mentioned. Is the market too complacent in predicting that Goldilocks scenario potentially?

Greg Peterson (11:39):

I don't know if the stock market's complacent or just optimistic. I think in order to own stocks you have to be optimistic anyway, long term. But there's probably a little bit of that optimism. It might be just fuelled by current or short-term results in the recent past, and that earnings have actually—despite my mentioning that earnings are off year-over-year—they're still pretty good for the most part. And growth rates are still pretty good.

So, that's probably providing some of that optimism for stocks. And while we're seeing a decent growth rate now, at the same time we're seeing inflation slow. Everything is moving in the right direction, so it's kind of helping to fuel that optimism. But it's like walking a tight rope: you know it's pretty easy to fall on either side of that.

So, I would say that the market is probably priced for that soft-landing scenario, and anything that is different than that is going to cause some movement in the market—whether that's better or worse. So, I still expect to see volatility as we go through this as we actually see how things are really playing out.

David Fraser (12:31):

Let's put you on the hot seat, let's put you on that tightrope. If you were in charge of interest rates, would you be thinking, "hey, we've got to leave them where they are, we're at sufficient levels to slow things down, it's just going to take time?" Or do you still think we'd push them a little bit higher just to make sure that we do tamp down inflation?

Greg Peterson (12:48):

Fortunately, I'm not in charge of any central banks so I don't have to make those calls. It's just my personal view that they've likely done enough. Bank of Canada rate's at 5% now, which was just recent here since the end of the quarter. The [Effective Federal Funds Rate], or Fed Funds rate in the U.S. is just a hair over 5%, so they're roughly the same. I expect, too, that the Fed's likely to raise another quarter percent here in July then quite likely pause for a while if inflation remains behaved.

I would say that rates where they are now is good. Because monetary policy takes so long to actually take an effect, and we've had such a rapid and large change in rates in a pretty short period of time, I'd be inclined to wait now and just see how that works through the economy before pushing things too far. Because one of the concerns is a policy mistake: you keep ratcheting up rates and it's not until 18 months later you find out, jeez, we went too far and now we've really cratered the economy and made things very difficult. So, I would hold where things are.

David Fraser (13:42):

Thanks for entertaining that tough question [laughs].

Greg Peterson (13:44):

But I'm not in charge [laughs].

David Fraser (13:46):

Well, you are head of the asset mix committee—have we made any adjustments there in Q2?

Greg Peterson (13:53):

Yeah, we did make a couple of adjustments in Q2. As you know, our adjustments tend to be fairly subtle and gradual in nature. So, in April and then again in June we did trim equities both times. We've had a fairly good bounce in the stock market this year and so all we were doing is really taking away some of that bounce. So, we trimmed U.S. equities both times; we trimmed a little bit from Canada; added a little bit to bonds, despite the fact that bonds have still ended up negative for the quarter. Bond yields at this level are more appealing, so it's just a gradual process to add to the bond side away from equities.

And really, overall for us, the theme is there's a great deal of uncertainty where we go from here. I know even the groups that we follow and some of the analysts we follow—we've got one analyst saying, "do one thing over here," and the analysts over here with same respect seeing the exact opposite.

Greg Peterson (14:39):

So, lots of uncertainty and different paths that you can take. And for that reason, you tend to stay very neutral. So, keep things as well-diversified as you can, not entirely sure of the outcome, and just stay fairly close to your benchmarks and relatively neutral in everything. That's really why we've made these asset mix changes, is just to maintain that neutrality—respecting the uncertainty and the environment that we're in.

And maybe I'll just add—despite all this economic talk about possible recession and so forth that's not priced into equities, so we go down that path, it'll be more difficult for equities… it's a much longer story; however, when it seems so certain, "jeez, it's just got to slow down, and the economy's going to be terrible," perhaps. But on the other hand, when you look at the history of the S&P 500 in the U.S., since 1945, any time the S&P 500 is up over 10% in the first half of the year, it's averaged 8% in the second half of the year. So, the markets look through these things and it's hard to say exactly where the market's looking to, but right now it seems to be looking past inflation and past the earnings slowdown, and into the next phase already. So, we'll see how that works through.

David Fraser (15:40):

As you say, we're remaining relatively neutral; we've added a bit to cash there. How does the yield we're actually getting on cash now change the landscape? I mean, for a long time you were getting next to nothing on a risk-free asset, but now you're actually getting some return. How do you weigh that up with the risk-free nature of that versus equities that are a more risky asset?

Greg Peterson (16:00):

It makes you more patient. For the last 12+ years, cash has been earning virtually zero, so you haven't gotten anything to hold cash. You're very reluctant to hold cash. It's a drag on the portfolio—assuming that other asset classes or the other assets are going up. Now you're getting close to 5% on T-bill rates, so it does make you more patient. You don't mind holding a bit of cash waiting to see how things evolve and then gradually employing that cash, perhaps, as we move through the second half of the year. So, you're rewarded for being patient now, whereas in the past you weren't being paid for that.

So, I don't mind holding a little bit of cash. I don't like it long term. I always say cash is the most difficult thing to try and decide what to do with unless you're spending. If you need cash to spend, it's always good to have that raised ahead of time, but in the meantime, it doesn't hurt to hold a little bit.

David Fraser (16:45):

So, holding a little bit now, but hopefully not for the long term. What would you like to see to make you more comfortable to get back into equities?

Greg Peterson (16:53):

Going back to inflation, I think just inflation stability and continuing to move in the right direction, better visibility on getting back closer to target rates for inflation. And it's hard to see. I mean, we're getting pretty close. We're at almost 3%, 3.4% in Canada. Bank of Canada has a target range of one to three, so we're kind of getting into that range. Their bank's most recent forecast is that inflation gets back to their target more firmly in early 2025. So they've kind of pushed out their expectations around inflation. I wouldn't be surprised if it happens a little sooner, but we'll see about that. So, that would be one thing.

And the reason we're looking for inflation stability is to lead to interest rate stability. If we have more stable interest rates, it means your discount for valuing equities is more stable and more reliable, takes away some of that volatility and makes you a little bit more comfortable. Then now you're just talking about fundamentals and getting back to what we really focus on, [which] is the quality of business models and the ability of those businesses to earn or provide wealth for shareholders.

Greg Peterson (17:51):

And then even on the bond side of things, if interest rates stay relatively stable from here going forward, you've now reset the bond market to better yields. And if all else stays the same, then you get a decent return on bonds moving forward from here as well.

David Fraser (18:04):

It's quite easy to paint a rosy picture for bonds. Like you said, we're getting a good yield there now, and then if there is a bit of a recession or a bit of a pullback and rates go down, that could be positive. So, what's the opposite scenario to that where things don't go as well for bonds?

Greg Peterson (18:20):

It'd be inflation. So, sticky inflation, central banks having to keep rates high or higher would be the scenario that would unwind things for bonds. Otherwise, we would expect as you go into a slowdown or recessionary scenario, you get to the point where interest rates are coming down, bonds are coming back down, and then then we get back to the more normal correlation between stocks and bonds. And if we do get a bit of a slowdown on the equity side of things, then your bond portfolio provides some offset and mitigates any volatility on the equity side. So, that'd be getting back closer to normal. So, 2022 I would characterize as not normal and as long as inflation behaves, then we get back to normal in terms of that correlation.

David Fraser (18:58):

So you've done a good job of outlining that we could take multiple directions from here and considering the challenges of predicting variables like inflation and interest rates and even unexpected events, let's drill a bit deeper. How do our strategies allow for contradictions to ensure that we are prepared for a range of outcomes?

Greg Peterson (19:18):

When you build the portfolio, you ensure you have a well-diversified group of businesses and sectors that will do well in different scenarios. So, some companies that are able to pass on inflation through goods prices or perhaps they have such a strong market share that their customers are price takers and they can pass that through very easily. There's a number of scenarios on that side. And the other is you don't completely eliminate all of those businesses on the other side that maybe have very good long-term growth prospects but because they're paying for future growth, they're more sensitive to interest rates in the near term. And so you just adjust your weighting but maintain your exposures on both sides of the coin there. So, keeping both.

David Fraser (19:56):

Sounds like sound advice to me in a time of uncertainty. We've covered a lot there today, Greg, so thanks for your insights. I'm sure listeners got a lot out of that. Nice chatting with you today.

Greg Peterson (20:06):

Thanks David, and I hope everybody enjoys the rest of the summer.