the art of boring™

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Disclaimer (00:25):

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David Fraser (00:40):

Welcome to the Art of Boring podcast. We'll be diving into a Q2 quarterly update today. Asset Mix Chair, Greg Peterson, is with me. Thanks for being here again.

Greg Peterson (00:50):

Hi, David.

David Fraser (00:51):

All right. It's been a pretty tumultuous time to start 2022, and we are halfway through the year now, believe it or not. What are the main drivers of the negative performance we've seen in markets?

Greg Peterson (01:02):

Yeah, it's been a very rough first half of the year for investors of all sorts. And I'd say particularly for those more conservative investors that are used to having some benefit or risk mitigation from bonds. Really what's driving the markets, both bond and equity markets has been inflation for the most part. If you wanted to boil what's taking place down to one story, it's really around inflation and inflation's impact on interest rates and in particular increasing interest rates. And that's been the primary driver.

It's driven bond yields higher. Bond yields moving higher, of course has taken bond prices lower. So, this has been the difficult period for conservative and balanced investors. And then of course, higher bond yields and interest rates means higher discount rates for equities, and that's primarily what's taken equity markets down in the first half of this year as well.

I would say there's been a couple of stories this year as it relates to the equity markets. When we first started the year, it was very much a multiple compression or valuation impact on markets. Valuations were coming down. That was the primary story. Of course, valuations coming down was due to higher bond yields and interest rates or discount rates. And that was the first leg of this downside for equity markets. Then more recently as we came through the second quarter, [the] focus is starting to change to growth somewhat and slowing economic growth.

Greg Peterson:

And that's the second wave, if you will, to equity market weakness—[just the] expectations of economic slowing and perhaps a little bit weaker profit margins going forward.

David Fraser (02:29):

You mentioned their discount rates and how they change with interest rates. Can you go through the mechanics of how that works and how that impacts the valuations of companies?

Greg Peterson (02:38):

Stock prices are essentially the present value of future cash flows. When you're doing cash flow analysis on a business and you're looking at all of the future cash flows (earnings a business will earn), you discount that back to present value. Present value uses discount rates, which is affected by interest rates. And it's basically the higher your discount rate, the lower your present value of future cash flow. It's purely mathematics from that perspective, in that the higher your discount rate, the lower your present value. Present value equates to stock price, and so you end up with lower stock prices.

That's just one very simple explanation with respect to stock prices. Naturally there's many other things that affect that such as outlook; markets are largely driven by looking forward. And then market sentiment is another component of that as well. So, while we have a valuation correction that's taken place, it's hard to argue that sentiment is anything but weak. There's many things going on around the world that have driven investor sentiment and made the mood a little gloomier. The war with Russia and Ukraine, certainly one. There's other things taking place that have driven to weaker sentiment as well.

And I'll keep coming back and harping on inflation as part of that.

David Fraser (03:47):

Well, I did want to follow up on that as well, because you mentioned inflation which is another big piece of what's going on at the moment. And policy makers [have] had a pretty prompt and strong response to the global lockdowns with COVID to keep markets liquid and operating during that period. Is what we are seeing now with that inflation—is that a bit of, we are paying the piper for that unprecedented amount of COVID stimulus that we saw come through at the time?

Greg Peterson (04:12):

Yeah. The pandemic is continuing to have a huge impact on both economics and markets. The stimulus that was provided is certainly one driver of inflation, but there's also the disruptions of—we spoke about this before too—but disruptions to supply chains, shipping channels, and so forth. These continue to be impacted by the COVID pandemic, both from disruptions currently, and then just trying to catch up.

Greg Peterson:

So, you went through an unprecedented slowdown and halt to the global economy and shipping at one point a couple years ago, and you're still trying to deal with everything opening back up and trying to get that sorted out again and back in order. So, things aren't flowing terribly well. They're flowing better, but it'll take some time to work through this.

One thing, when we look back—the global economy has really become very, very efficient. And we're used to having things shipped just in time. There's not a lot of room for disruptions or error, if you will, as it relates to supply chains. And now I think we're seeing just the impact of that very high efficiency. You get some disruption like this—and there's very significant disruption with the pandemic—and it takes some time for that to work its way back through.

David Fraser (05:18):

And I guess we're seeing a lot of businesses pivot there and find different ways to fix their supply chain or having multiple places to draw from instead of just one to mitigate those issues.

How difficult is it going to be for policy makers to ensure a soft landing [with] the rising interest rates to try and dampen inflation? How concerning is that, that they don't overshoot and cause a bigger slowdown than they need?

Greg Peterson (05:41):

Yeah, it's a tricky job being a central banker. It's not a job I'd ever want [laughs]. You make decisions today that you're not going to see the impacts for, for either many months or well over year out. It's difficult for them to forecast. There's a strong likelihood that they do engineer a soft landing. A soft landing by definition is getting the inflation back under control without creating a recession and so you still maintain positive economic growth. The other side of it is they could push a little bit too hard, too fast and actually drive the economy into recession. And that's one of the concerns that's being talked about a lot in media right now. You're seeing the recession word pop up even more. I think Google searches on recession are spiking up as well. You can see that it's a pretty common concern out there.

One thing I would just maybe mention is that recession's not something to be overly concerned about. Especially for our investors who are primarily long-term investors, this is just part of the regular cyclicality of markets and economics. And whether we end up with a soft landing or end up in recession as part of trying to bring inflation back under control is really not something to be terribly concerned about. In fact, the recession is actually good for us in many ways because it brings the focus back onto quality of earnings again.

And so when I talked about the first half of this year being two different things that were taking place in the markets, valuation correction, and then concern around earnings, that focus back onto quality of earnings actually bodes fairly well for our investment style, which is what we focus on—high quality companies that can weather whatever environment may come up, including recessions. And so markets start to focus on earnings again and you start to see some of the premium come back for high quality companies that are quite resilient.

David Fraser (07:19):

The R word, the recession word—can you just give listeners the technical definition of what that means? It's thrown around a lot. I'm not sure everyone understands the actual rationale behind it.

Greg Peterson (07:29):

Yeah, the definition of recession quite simply is two calendar quarters in a row of negative growth, negative GDP growth. And so, the U.S. actually had negative GDP growth in the first quarter. There's a chance that they could end up fairly close to that in the second quarter this year, which would technically be a recession. Then there's this committee in the United States that actually defines and names whether we had a recession or not. And quite often that's many months later to say, "Oh, we were in recession six or eight months ago."

It's simply negative growth for a period of time; [that's] really what's recessionary.

David Fraser (07:59):

And with that, talk about a recession and the negative headlines—some of those we've talked about—we get a lot of nervous clients, which is completely understandable in combination with the market sell-off of course, that creates that anxiety. How are your conversations going with clients and what are you recommending through this tough time?

Greg Peterson (08:18):

I think the most important message is that what's taking place is fairly normal. We don't see this very often. This type of contraction in markets, particularly in the bond market; we very rarely see bonds sell off to this extent. But it is relatively normal in terms of markets reacting to inflation, current circumstances, and then looking forward. And the cyclicality is also fairly normal. The drivers each time are perhaps a little bit different in terms of what slows the economy down or brings markets down, but it's not something that's really out of the ordinary. So, that's usually the first message. Because you do look at headlines and there's so many things around the world to be concerned about. Sometimes it feels like the world's falling apart. Although I've thought that many times in the last 30-plus years as well. That's one part.

The other is—and you probably hear this quite often, too—is really not to pay attention to markets day to day. For one, that's what we're here for. However, there's a lot of noise to day-to-day movement and markets. And there's very little signal. And what I mean by that is, whether the market's up one day or down on any given day, it's really not telling you much. It's telling you the mood of investors on that particular day and it's extraordinarily short-term oriented, but it's not really giving you any good news, or feedback, or other signals about where are we going from here. And when you try to piece things together on day-to-day moves, or even week to week, it can be very stressful because you're really not getting good information from markets. You're getting a lot of the short-term noise.

Greg Peterson:

And it's the same thing with a lot of the headlines that we read. Many of the headlines are also very short-term focused and not really applicable to a long-term investor. So, I would also just caution to take too much about the variety of opinions that are out there at the moment, because they are quite vast. The range of outcomes that are possible in the next couple years are also very wide. So, just be very cautious about reading too much and trying to interpret too much from some of that short-term noise.

David Fraser (10:09):

Yeah, and a lot of that noise as you say is very macro-focused or top-down focused where there's trying to be big predictions on maybe its interest rates, or inflation, or where energy prices are going to be. We're a bottom-up investor looking at building portfolios business by business. Anything else changed in the way we approach investing?

Greg Peterson (10:28):

Nothing's changed to our approach to investing. And I think that's a very important question, David, is to think what can happen when you go through a dislocation of this magnitude and markets, as uncomfortable as they are, can lead to some bias creep, or some temptation to start to predict where we're going, and that sort of thing. And so for us, it's really making sure that we're sticking with our investment philosophy and process, following it very rigorously, perhaps sharpening pencils a little bit. And I can tell you, the team works even harder during periods like this. It makes you pine for the good old days when things are going up very regularly.

But no, the most important part is to stick to your knitting and make sure that you don't have any unintended exposures in the portfolio. For instance, companies that still have relatively high valuations or where your pain is significantly more for future growth, making sure you don't have too much exposure to those highly valued companies, things of that nature. So, just unintended consequences or unintended exposures within the portfolio and understanding the wide variety of risks that are out there.

David Fraser (11:28):

Yeah, and the one thing the Research team have made clear to us as we have our conversations with clients is, nothing's changed in terms of, they always want to be in good resilient businesses and have good strong portfolios regardless of whether that's two days ago or two years ago. Nothing's changed there. And the other thing that they point out is if, if clients saw us deviate significantly from our investment approach, that would be as an investor myself, I'd be worried about that because I'd be wondering why the change and why we're making alterations through our process. I think that's important that we do stick to our netting.

Greg Peterson (12:02):

Yeah, just maybe one example of biases or predictions. If you go back to the beginning of 2022, commodity stocks were much more in focus, particularly as Russia invaded Ukraine and energy security became a big concern. You had a spike in energy prices. You had a spike in energy-related businesses and oil and gas companies and so forth. It became very easy, well, not easy, but very tempting in the first quarter to say, "Well, it looks like energy's going to be extremely strong for the foreseeable future." Rotate there for a period of time. And then what you saw in the second quarter is the energy prices have come off their peak for now. We'll see where things go, but energy prices are off for the time being. Some of the focus is now shifting from that period and the concerns around energy security to economics and slowing economics and potential demand destruction for energy going forward. And so you've seen that whole sector slide back a bit. Energy's been weaker in the second quarter than it was in the first, but in the first it just seemed like the sky was the limit. That's the type of temptation that can come to play.

David Fraser (13:06):

Trees don't grow to the sky is a term that comes to mind there. I'm not sure who I'm stealing that off. I don't know who to credit, but certainly not mine.

We don't make those macro predictions, but we do make some tactical adjustments from an asset mix perspective. You're the chair of the asset mix team, what have we done year to date?

Greg Peterson (13:24):

With the uncertainty and the weakness in markets and expectations of higher discount rates and interest rates, we did reduce equity through the first half of the year. So, for the [Mawer Balanced Fund], for example, we reduced the equity weight by roughly seven percentage points. And we came through the end of last year with a fairly high equity weight in our portfolios and brought that back closer to neutral. We're fairly neutral at the moment. As we're reducing equity, we're increasing cash. But we also, as we came through towards the end of the second half, the bond weight was increasing in the portfolio as well. Bond yields have jumped up significantly. Our bond weight right now is almost three percentage points higher than it was at the beginning of the year. You're finally starting to get paid to hold bonds again.

Income yields are reasonable or becoming more reasonable there, [so] we started to pick up the bond weight in the portfolios. And I think one of the important things there is we're not quite back to what we would call a “neutral” weight for bonds. We're getting closer. But when you have this much uncertainty, usually your best move is to stay very neutral on things and stay very well-diversified because there is a wide range of potential outcomes, both good and bad as we go forward. So, you want to stay as diversified as possible and make sure you're not guessing what's going to take place and tilting your portfolio in that direction, following a guess or prediction.

David Fraser (14:46):

Without making that guess, what factors would you be weighing to reallocate from cash and fixed income into equities? Or are you comfortable given the higher interest rates, bond investors are actually getting some yield now, which they haven't seen for a long time. Are you more likely to be more comfortable there given that higher incentive?

Greg Peterson (15:05):

Yeah, I don't mind holding bonds and I don't mind holding cash now. How many years were we not paid to hold any cash and interest rates were near zero? If you take some good news out of this adjustment in interest rates, it's that you can actually hold cash and not feel terrible about it anymore. You are getting paid better there. So, we've made adjustments on the cash holdings within the [Mawer Balanced Fund] as well.

We're not in a big hurry to deploy cash. Really when you look at it, we are fairly close to neutral. It's not like we're not invested. We are still fully invested, we're just very well spread out. We still have about 60% of the portfolio in equities, about 32% in bonds roughly, and then the balance in cash. We're not in a hurry to move from cash.

Things that would help us to maybe reduce cash and move back in the direction of either bonds or equities...? Inflation is, again, is the primary driver right now. If we can see some sustainable moderation in inflation and inflation expectations, that would probably be one driver. And I think you'd see the market react positively and fairly quickly to that as well.

David Fraser (16:06):

One of the other benefits of bonds is they typically move in opposite directions to equities. This year has been a little bit different. What have we seen year to date? Has that relationship deviated a little bit?

Greg Peterson (16:19):

At the beginning of the year it definitely deviated. Bonds were the cause of the equity sell-off, if I can put it that way. The sell-off in bonds was caused by inflation. They were both dropping at the same time; that doesn't happen terribly often, fortunately. The premise of a balanced portfolio is really built on having protection from bonds when things aren't going well for equities. Well, in this case, things were going bad for both. But as we moved through towards the end of the second quarter and through June, we started to see that relationship come back closer to normal again. We had equity weakness, we had bond strength, and vice versa. So, that negative correlation between bonds and equities was starting to reappear and normalize somewhat. We'll see where that goes going forward, but we don't expect that that relationship is completely diminished. Bond volatility while high now typically is much lower than equity volatility.

David Fraser (17:10):

Looking ahead now, we've talked about it a lot, but as you said, it's a pretty key piece of it all right now—that's inflation. How important is it weighing the pricing power of the businesses that we look to invest in at the moment? So, their ability to pass on that inflation to the end consumer. That's got to be a big piece of what we're looking for for a good resilient business model right now.

Greg Peterson (17:31):

Yeah, that's one of the key questions, is how do businesses deal with inflation? Because while we have the concern around the economy slowing and perhaps a change in consumer behaviours because of higher prices, businesses have to deal with this as well. And whether it's from [a] revenue perspective or just having to deal with their own cost inflation on input costs and labour costs and so forth, high quality businesses typically have pricing power and the ability to pass those higher prices on to their customers. And that's one of the things you look for as a competitive advantage in a high-quality company.

So, there are companies in the portfolio, many companies as it relates to our investment philosophy, and looking at high quality businesses have this pricing power or some advantage that allows them to deal with higher prices. If you look at some companies like Novo Nordisk, it's a Danish pharmaceutical company that specializes in diabetes treatments, they have the ability to pass on higher costs to their customers, being very specialized like that. Other businesses like Essity, which is a Swedish hygiene and health company also have the ability to pass on higher prices to their customers.

David Fraser (18:35):

Another thing we've spoken about is resiliency of the consumer balance sheet on this podcast in the past and with the increase in inflation, how are consumers faring?

Greg Peterson (18:44):

Yeah, we're starting to see some change in consumer behavior as it relates to spending, but overall consumers are still in pretty good shape because while we have higher inflation, we also have higher wages. So, wage growth, while not currently keeping up with the inflation rate, has been positive. And then consumers came out of the pandemic with pretty healthy balance sheets too. And I should say that this isn't across the board. It does vary by region. We focus on American consumers and the focus is often on American consumers because they are the most consumptive group in the world. But the U.S. economy really drives a lot of global consumption and U.S. consumers really deleveraged or reduced their credit back in the global financial crisis in 2009. And so, U.S. consumers learned from that—being over-levered, not healthy—and they're still in very good shape today.

Household balance sheets in the U.S. are good. They have lots of cash. They have the ability to spend, despite the fact that inflation is taking away some of that spending power. Canadian consumers while still in good shape, are not in as good a shape as U.S. consumers. Household balance sheets in Canada do carry more debt and higher debt servicing expenses, which will be made worse, really, with higher interest rates. Canadian consumers while still okay for the time being, are at risk of higher interest rates weighing on their spending ability a bit more.

David Fraser (20:01):

Just how much of a concern is that?

Greg Peterson (20:03):

It's enough of a concern in Canada for us to keep us from increasing our Canadian equity weight higher. While we've moved it up in the past year or so because of Canada being more of a value and a bit more of a cyclical market and having good companies here as well, it's kept us from moving any higher just because we do have those concerns about consumer spending down the road.

While we always rib the U.S. market a little bit about being focused on consumers, the Canadian market is not that much different. In fact, much of the developed world economies are driven by consumers. We're no different here. I suspect that Canadian consumers will be pressured a bit in the coming years.

David Fraser (20:40):

Fair enough. So, we've touched on a lot of the negatives out there, but as you said, there's a wide potential of outcomes as we look ahead. What are the positives out there and what would a potential bounce back look like? How would that scenario play out?

Greg Peterson (20:54):

Yeah, one thing I think I'll mention in terms of expectations—and keep in mind, this is not a prediction [laugh]—I would expect that the recovery this time around is more drawn out. This is one of those less frequent market corrections not unlike the great financial crisis of 2009. It took some time for markets to recover coming out of that. If we look at our more recent past and corrections in the market, recovery happened very quickly. And in particular, the recovery from the pandemic in early 2020 was a very severe downturn followed by a fairly quick balance. And a lot of that had to do with the reaction of policy makers. I would expect that this time takes a little bit longer for things to recover, but we do certainly expect things to recover. The question is, how much time? That'll be the difficult part to answer.

In terms of what's good and likely to cause a recovery? Well, we should see inflation start to moderate at some point, and by moderate, I mean not going up any higher [laugh]. Even if we just see inflation start to soften somewhat. I've seen evaluations of where inflation's coming from, and there is still a big chunk of that that's coming from the supply side. Supply chain will eventually catch up. Shipping will eventually catch up. I recently went to Costco and was looking for an item. They told me it's still tied up because they can't get containers to ship it over from Europe. That stuff will catch up eventually and bring some of those prices back to something that's more reasonable.

And just while I'm on the inflation front, a couple of other things, too, even on the commodity side—energy prices have come down from their peak. We'll see where that goes from here, but we've also seen food inflation come down. Agricultural commodity prices have come off here in the last little while. There is hope that inflation does start to moderate at some point here and that'll take some of the pressure off of interest rates.

Greg Peterson:

We talked about consumers. Overall, in the developed world, consumers are in pretty good shape for the most part. There's some positives on that side of things. If we look to emerging markets, China has their Party Congress this fall, that tends to have some cyclical merits to it in that Chinese authorities do like to have their economy in good shape and things in good order as they go into the Congress and elections. That may help to tip the balance a little bit there as well. So, there are a number of things to be positive about.

And maybe just one other piece to that is really the backbone of all this, the financial system, is also showing to be in very good shape. We don't have concerns from cracks in the financial system like we've seen in the past with the financial crisis and so forth. Things are in relatively good shape. This will be just one of those things where you gradually work out of this.

And just while I'm on my soapbox, I'll maybe mention that these types of events are not bad for markets. This is actually pretty healthy. You go through market corrections where you we're starting to see some excesses in valuations. If you look at things like cryptocurrencies and special purpose acquisition corporations and so forth. There were elements of the market that were pretty frothy. This brings a lot of that back in line and we're starting to hear from the Research team too that some valuations are being more attractive and you get a little bit more excited about putting money back to work or adding companies that have either been too expensive in the past, have excellent business models that you want to invest in. This provides you that opportunity. Or even just adding a bit more to existing companies that are more fairly valued now. It gives you a chance to really reset and then set up for the next more positive part of the cycle.

David Fraser (24:07):

Yeah, lots of positives there. It's that one piece of our investment approach, the valuation piece. And certainly no one likes to see a sell-off in the market, but it certainly does help on the valuation front. Thanks very much, Greg, we'll leave it there. Lots of positives to end on, so I'm happy about that. Thanks for being here today and sharing your thoughts with me and our listeners.

Greg Peterson (24:26):

Yeah, thanks David, and I hope everybody has a great summer.