

QV UPDATE

Weekly Commentary | April 8, 2016
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Risk Persists

After starting the year with one of the worst stock market sell-offs on record, global markets rallied back to pare losses and in some cases gain ground in the quarter. Fears of recession, banking instability, and deflation were catalysts for the retreat. A resurgence of global central bank support and a rebound in oil prices provided the impetus to reverse the selling pressure. Government bonds offered a safe haven while corporate bonds sold off in sympathy with broader economic concerns. To sum up the first quarter of 2016: it was volatile!

The Domino Effect of Lower Commodity Prices – The continued pressure in commodity markets is having a considerable effect on global economies and stock markets. The commodity boom which took place from 2001 to 2008 resulted in a massive build-up of capacity and significant overproduction. Even with the recent rebound, much of the future development is uneconomic at current levels. Producers worldwide are in the midst of a very severe industry downturn to a degree they haven't experienced in decades. This is resulting in significant financial losses, mass lay-offs, and a survival mode mindset when it comes to balance sheets and growth. In addition, any company related to the commodity sector has seen its profits fall and growth plans slow considerably. The chart below of the CRB Index, a broad measure of commodity prices, puts into context the extent of both the boom and now the bust.



Source: StockCharts.com

The fall-out, though, is broader than just the companies involved in the production of commodities. China and other developing economies were at the forefront of the commodity boom. Their growth was the demand support for continually higher prices. Falling commodity prices suggest the growth of these developing regions is slowing. Much of the expansion of these economies was predicated on the availability of cheap and plentiful credit. Should the economies falter, the risk on the credit side increases dramatically. Continued global growth is necessary to pay for the massive global debts society has built up over the past few decades. Extremely low interest rates will help sustain the payments and supposedly spur on growth. But the situation leaves little margin for error. Risk persists.

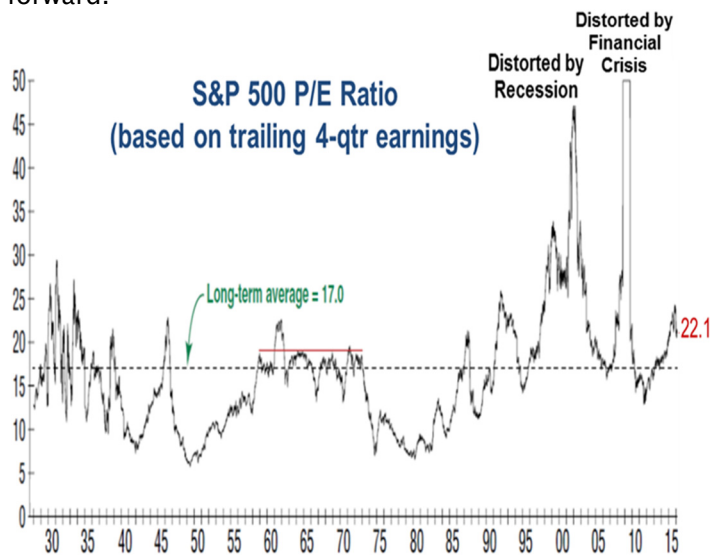
Deutsche Bank is illustrative of the potential risks which remain in the system. Seven years since the financial crisis, this major European bank seems to be in worse shape now than back then. The company has seen its stock price fall nearly 90% from its 2007 peak and trade even lower than in 2009. Investors are wary that it could be the next Lehman Brothers. Deutsche Bank has over \$1.5 trillion in assets vs. Lehman Brothers' \$650 billion when it collapsed. Deutsche Bank also has significant derivatives exposure. Some financial accident or erosion in markets has potential implications for Deutsche Bank and the like, and in turn the global financial system. The commodity collapse in and of itself is not the major risk to investors. Rather, it reminds one about the lack of global economic stability and the potential negative domino effects which still abound.

Since the 2008/2009 recession, anytime there has been uncertainty the markets have been able to depend on the central banks to set us straight. The first quarter of 2016 was no different. Japan surprised the markets by implementing negative rates. China cut their reserve requirement for the 5th time. The European Central Bank (ECB) expanded Quantitative Easing (QE) purchases by a third and announced they would also begin buying corporate bonds for the first time.

Mario Draghi, the head of the ECB, reassured markets again saying, “We have the power and willingness and determination to act. There are no limits to how far we are willing to deploy our (monetary) instruments.” Given the state of some of the European banks we’d guess Mr. Draghi really has no choice.

Investing Landscape

There are very few generalities we can speak of when discussing the current investing climate. We do believe, though, that broadly speaking stocks are not cheap and the likelihood of considerable earnings growth is low. The chart below shows the trailing P/E ratio of the S&P 500 at 22 times versus the long-term average of 17 times. We show the U.S. as it has the longest data set available for analysis. We would suggest the U.S. stock market is representative of most other global markets rather than an outlier. Major market corrections typically don’t take place because of valuations, but the depth and severity of a correction is certainly impacted from an exaggerated level of optimism. Alternatively, the upside from already elevated levels becomes muted going forward.



Source: InvesTech Research, March 11, 2016

While the previous chart would suggest one should be cautious, there are many companies that are trading near historical lows and vice versa. The best way to describe the current marketplace is one of haves and have nots. The haves are companies which are either perceived as safe and stable with above average dividend yields, or they are companies which have exhibited

above average earnings growth and stock price momentum. By and large, we don’t believe the opportunity over the next cycle will be in these businesses. On the other side of the equation we have the have nots. These companies are likely one way or another related to the commodity industry or cyclical in nature. These would include resource-related stocks, industrials, and financials. While we believe the global economic backdrop will remain challenging, we see many companies trading at levels which would indicate the market has priced in a lot of the bad news already. In a highly valued stock market these businesses offer reasonable opportunity for patient investment. We are focusing our efforts here.

Strategy Review

The Canadian stock market was the worst performer amongst developed markets in 2015, but led the charge in Q1 2016. Our large cap Canadian strategy outperformed the index and posted a gain of 6.4% (all QV returns are gross of fees). The QV small cap strategy gained 4.9% but significantly underperformed the index which moved up by 9.8% on the back of a surge in gold stocks. Our QV global strategy lost 2.6% compared to a loss of 6.5% for the index, as returns were negatively impacted by an appreciating Canadian dollar. The QV Canadian balanced strategy also outperformed its index, gaining 3.9% versus 3.1%, and the QV Canadian bond strategy gained 1.0%, underperforming its index return of 1.4%.

Looking forward, our focus remains on protecting capital in what we believe is a low return investment environment. For balanced mandates, bond returns remain constrained given the low level of government bond yields. Corporate bonds offer a reasonable premium after spreads widened over the past year, but are still at very low levels. That being said, bonds provide the portfolio with stability in what remains a highly uncertain environment. We continue to approach the market with a safety first mindset.