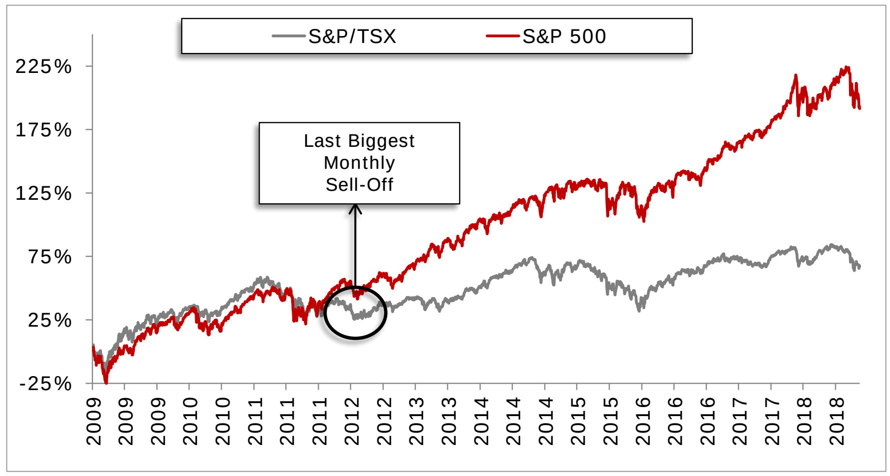
November 30, 2018

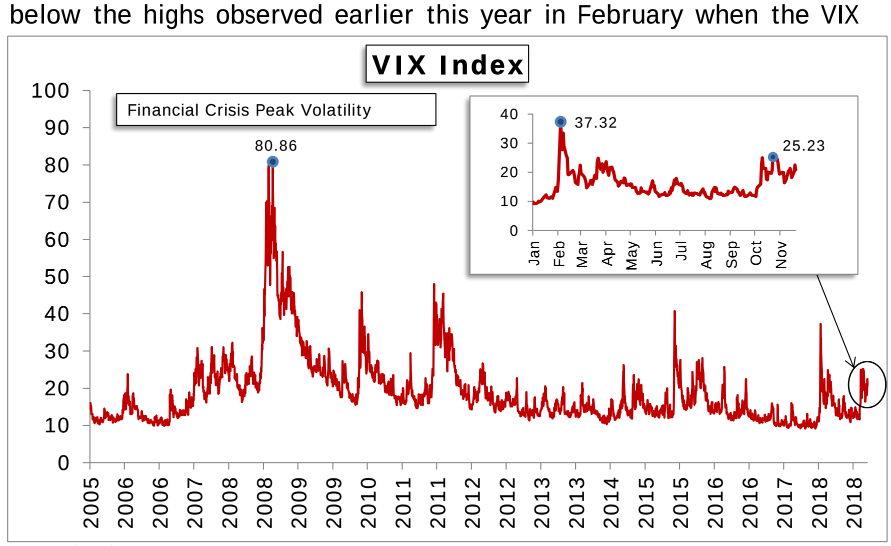
SEEING THE FOREST FOR THE TREES

In the past month and a half, the equity markets have been overwhelmed with an influx of negative sentiment from investors and analysts alike. Many have pointed to several reasons for the recent spike in volatility such as the trade-war, rising rates or slowing global growth. However rather than any one single problem it is the level of uncertainty that lies in the market at present that is truly to blame. Uncertainty breeds fear and irrationality and this is what continues to hang over the heads of investors.



Source: Bloomberg

Since the beginning of October, the S&P 500 Index (S&P) and the S&P/TSX Composite Index (TSX) have lost roughly 5.7% and 5.6%, respectively. This marked the worst month for these indices since 2011. It is worth noting though that since reaching the financial crisis lows, both of these indices and the equity markets in general have seen significant gains. In October the VIX, which is an indicator of market volatility and commonly referred to as a fear gauge, spiked over 100% to around 25 (the VIX has a range between 0-100; the higher the number the greater the level of volatility or fear in the markets). The rise in volatility has rekindled memories of 2008 as global growth cools, trade tensions between the U.S. and China intensify, U.S. interest rates and monetary policy tighten and geopolitical tensions elevate. To put this in perspective, while a higher VIX is often interpreted as a gauge of bearish market sentiment, the level reached in October was nowhere near that of the financial crisis. In fact, recent levels were below the highs observed earlier this year in February when the VIX pushed above 37.



Source: Bloomberg

With all the sensational headlines it is no surprise that negative sentiment has clouded the minds of Canadian investors but the question remains: have investors lost sight of the bigger picture? As a famous Nebraska-based investor once touted, *"Be fearful when others are greedy. Be greedy when others are fearful."* The relevancy of this quote is as strong as it was back when it was first uttered. There are many companies today that have been producing strong consistent cash flows but despite this, their share prices have been victims of the broader market sell-off. It is at times like these that long-term investors can remain greedy and buy shares of some high-quality companies trading at attractive valuations.

DESPITE MANY UNCERTAINTIES, THE U.S. REMAINS STRONG

Although we have seen some U.S. economic data that has been a little more modest as of late, the U.S. continues to be the economic frontrunner for the rest of the developed world. The most recent data show that the U.S. economy posted its fastest GDP growth in over 4 years and its strongest retail sales growth and corporate earnings growth in 7 years. Business and consumer confidence are at their highest levels in decades, unemployment has not been this low since 1969 and wages are growing at the fastest pace in a decade. Taking all of this into consideration suggests that

U.S. equities remain well-positioned relative to many other areas in the world where the macro-environment is not as robust. While trade tensions with China remain elevated, it has been reported that the world's two economic powerhouses have been inching forward towards a "mutually-beneficial" agreement. Clarity on this is expected to part some of the clouds overshadowing the equity markets and provide investors with some visibility regarding 2019 and beyond. Another area of concern has been the pace at which the U.S. Federal Reserve has been proceeding with its interest rate hikes. Federal Reserve Chair Jerome Powell has been hiking rates at a relatively strong pace, which has garnered some criticism from some corporate CEOs as well as President Trump. This appears to have begun to make Chairman Powell reconsider his hawkish stance, which many believe will be tempered at the December 18-19th Federal Reserve meeting (the market is currently pricing in a 76.0% probability of 25 basis point hike). This is likely to give the equity markets a boost as the prospects of a slower pace for rate hikes would allow the economy to continue to chug along for longer with less fear of a deceleration due to the higher rates. Global growth concerns still remain an ongoing issue as financial conditions have deteriorated in certain areas of the world and this has been seen in the lower commodity prices. Oil has been impacted as prices for West Texas Intermediate crude oil dipped with oversupply concerns remaining rampant. In Canada, the discount at which Canadian Western Select crude oil trades to West Texas Intermediate crude oil has widened further as pipeline takeaway capacity issues and refinery maintenance in the U.S. put further pressure on prices. Some relief on this front is expected to come shortly as refinery maintenance winds down in the coming weeks.

"Nobody buys a farm based on whether they think it's going to rain next year. They buy it because they think it's a good investment over 10 or 20 years."
– Warren Buffett (2018) –

LONG-TERM FOCUS & HIGH-QUALITY NAMES ARE KEY

While many investors have begun asking questions and perhaps have begun buying into much of the negative rhetoric, it is sometimes best to step back and re-assess the situation before acting. In these situations, panicking is never the best course of action. As mentioned in the quote above, a long-term focus is how investing should always be approached. A setback in the markets, while stressful, should not change one's long-term approach to achieving investment objectives. Investors who are considering exiting the equity markets at this stage should consider Mr.Buffett's guidance. As mentioned above, high-quality companies should always be the foundation of a diversified equity portfolio. With a focus on strong, consistent cash flows, healthy balance sheets and sustainable business models, investors can have more confidence in the durability of the companies they hold throughout the ebbs and flows of a volatile market.

While equity markets are modestly lower to flat in November and with October historically marking the worst month in equity markets, we would encourage investors to maintain positions in high-quality equities rather than reduce exposure to this asset class and shift to a large cash position. For those investors who are willing to stay the course and look to the longer term and past the negative headlines and uncertainty, the current volatility can reward sensible investors with favourable buying opportunities. Overall we need to consider that there is some fear in investor sentiment right now but generally that is a healthy thing in the context of the markets. Markets do not enter large corrections when the market sentiment is mixed with fear and greed. It is only when the balance of sentiment shifts decisively toward one side that the whole thing topples over. Presently, we do not seem to have reached that extreme level of bullishness yet and we do not see any signs that this will happen anytime soon.

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