CIBC Wood Gundy | Papau Armstrong Schmidt Financial Group

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Equity Markets Bounce Back in Q1

In recent Newsletters we have explained our view that we are near the peak of the economic cycle in Canada and the U.S. We still cannot definitively say that we will see a near-term recession in either country, but the increased risk of recession cannot be disregarded. Since bear markets in equities typically accompany recessions, we believe that the odds of a bear market beginning in the next year or two are rising. Clients who have read our recent Newsletters will already be familiar with this outlook. Clients will understand that our discretionary portfolios are already positioned somewhat cautiously. We are doing our best to manage the risks that we believe the markets are facing while still maintaining investments in a variety of high-quality companies. In other words, we want to participate in any further gains delivered by equities while not suffering the full force of any downturn.

North American equity markets did deliver strong gains in the first quarter of 2019 (Q1), erasing the sharp losses experienced in Q4 of 2018. At this point, the question is whether fundamentals - corporate earnings and economic growth - will be strong enough to push equities even higher. The tone of statements from the U.S. Federal Reserve and the Bank of Canada has been "dovish" lately, implying that further interest rate hikes will be minimal. This revised stance has supported the prices of risky assets, in contrast to declines in Q4 fueled by concerns that central banks would raise rates too far and too fast. Further gains from today's price levels will probably require some new good economic data as well as some optimistic statements from companies reporting their earnings. The next six months will tell us a lot about whether this economic expansion will keep going.

With no major changes in our market outlook in recent months, we are going to examine some new topics in this Q1 edition of our Newsletter, namely the recent surge in initial public offerings and the troubling rise in alternative lending in Canada. Finally, we will provide an update on the U.S. – China trade relationship, which we covered in depth in our Q2 2018 edition.

Initial Public Offerings – a Record Year?

2019 is looking like a big year for initial public offerings (IPOs). We do not expect clients to know much about IPOs, as we rarely discuss them and have never purchased them. A typical IPO involves a private company that is growing fast and needs capital. Investors buy shares directly from the company for cash. The company's shares are then listed for trading on a stock exchange and public trading begins. The company takes the cash raised by the sale of shares and typically uses it to fund growth. There are countless successful companies that never undertake an IPO. Many early-stage technology companies are acquired by large public companies. This can provide substantial financial returns to their venture investors. On the other hand, many mature and profitable private companies, like the Jim Pattison Group in B.C., do not need capital and do not want the scrutiny accompanying a stock exchange listing.

Historically, the biggest years for IPOs were 1999 and 2000, which came at the tail end of the late 1990s technology stock bubble. There were US$93 billion of IPOs on U.S. markets in 1999 and US$97 billion in 2000.[1] Will 2019 break these records? It appears that there could be more than US$100 billion in IPOs this year if markets stay buoyant. Notable IPOs already completed in 2019 include ridesharing company Lyft Inc. (NASDAQ:LYFT), social media company Pinterest Inc. (NYSE:PINS) and apparel maker Levi Strauss & Co. (NYSE:LEVI). There are bigger names yet to come, including ridesharing company Uber, flexible office space provider WeWork, and accommodation sharing company Airbnb.

Clients who have been with us for many years will be able to guess why we do not buy IPOs. They generally do not offer what we are looking for. It is very rare for shares of a high-quality company with a good business track record to be available at a reasonable price through an IPO process. In fact, many IPOs involve unprofitable companies. Lyft is a good example, as it does not appear to have any prospect of turning a profit anytime soon. Clients will understand that unprofitable companies are often very risky investments, and can be unstable in any economic downturn.

When an IPO involves a profitable company, like April's listing of videoconferencing company Zoom Video Communications Inc. (NASDAQ:ZM), the shares are often priced for perfection, making them risky if there are any missteps by the company. By all accounts, Zoom offers a solid product to its corporate customers, and there have been rumors of a potential takeover by Microsoft Corp. (NASDAQ:MSFT), the owner of Skype.

That said, with shares trading around US$70 in recent days, the company's stock market capitalization is approaching US$20 billion, around 20 times more than the company's valuation in a 2017 private financing.[2] This valuation is being given to a company with net income of only US$7.6 million for last year.[3] The excitement may be justified by the company's future results, but we do not see value in the shares today. One further difficulty with the best IPOs is that it can be very difficult to get any allocation of shares for clients. Conversely, the lower-quality IPOs often have shares available for purchase.

So why are all of these IPOs happening now? Companies time their IPOs to take advantage of strong stock markets. This helps maximize the amount of cash raised. It is no coincidence that 1999 and 2000 were record years for IPOs. Investor sentiment was overly optimistic during those years. Many suspect technology companies were able to raise huge amounts of money from investors, only to fail in the following years. Perhaps some companies seeking to go public in 2019 recognize that we could be nearing the peak of the economic cycle. They may be funding themselves when they can, rather than when they have to. A window of opportunity to go public can close quite easily, as history shows.

Although we have never purchased an IPO, we do study the best of them and sometimes add them to our watch list of potential holdings. For example, Airbnb in particular appears to us to have a great business model. If Airbnb does go public, we would read the available research on the company and check to see if the valuation is reasonable enough to consider. It will be interesting to follow the anticipated flood of IPOs throughout 2019 to see how many of them actually make it to market.

The Troubling Rise of Alternative Lending in Canada

We no longer believe generalizations about Canadians being financially responsible. There are now too many exceptions to this historical rule. In past decades, Canadians were frequently characterized as frugal and responsible with money and credit. Now when we hear those statements, it suggests that perception has not caught up with reality.

We have discussed Canadians' high debt to income ratios in depth in past Newsletters. Our Q1 2018 Newsletter, titled "Moment of Truth for Canadian Households", gets into the details, including the record use of home equity lines of credit. Now, it appears that Canadians are increasingly borrowing from alternative lenders, sometimes called "private" lenders. These lenders are offering unfavorable loan terms and charging very high interest rates, such as 8%, 12% or more. Their customers are often people who can no longer meet the lending standards of banks or credit unions.

According to a CIBC Capital Markets report, alternative lenders now account for around 12% of total transactions at the Ontario Land Registry. Their market share has been growing fast. The lenders are a blend of Mortgage Investment Corporations and individuals. The individuals in particular are completely unregulated.[4]

The situation in B.C. is similar. According to a recent story in the Globe and Mail, the number of private lenders in B.C. has exploded in the past few years. Property owners "use them if they are self-employed and don't have the necessary credit rating; to borrow first or second mortgages on their homes because they need to pay off Visa bills; to pay their kid's university fees; for a new car, or any number of reasons."[5] Both the CIBC report and the Globe and Mail article suggest that data on private lending may not be easily captured, and that Canadians may therefore be in more debt than is commonly known.

Our comments on these developments are threefold. First, borrowing money against a home at 8% or more may defeat any financial benefit that may come from homeownership. Second, private lending may prove less attractive than it appears to the lenders, as the historical loan loss rates may end up being misleadingly low. Third, if these types of loans continue to grow in market share, it could cause a rise in bankruptcies and financial instability in Canada. Overall, the rise of alternative lending is another nail in the coffin of personal financial responsibility in Canada.

The U.S. – China Trade Relationship

There is currently no trade deal between the U.S. and China, despite daily optimistic headlines throughout Q1. One trade analyst recently stated, "nobody is imagining that China is going to follow a Western liberal democratic model, or converge towards a market economy in the way that people hoped a few years ago."[6] There is a lot of content in this statement. It is really an admission of error. Possibly due to arrogance, policy makers in the Western world seem to believe that they can radically change other countries through persuasion, economic incentives or war.

In the years leading up to China joining the World Trade Organization in 2001, many were confident that increased trade would lead to political change in China. Two decades later, that has clearly not happened. With the old consensus shattered, the Western world is now offering an inconsistent set of responses to

China's rising economic and military power. While the U.S. is trying to negotiate new terms of trade, Italy has recently signed on to China's Belt and Road Initiative by signing billions of new trade deals.[7] Technology has been a large sticking point in U.S. – China negotiations. Both countries want to be the global leader in technology in the years to come. The U.S. is increasingly resistant to trade terms requiring companies that invest in China to transfer their technology to local Chinese entities. Despite the regular dose of optimistic headlines, we believe that our insight into the true status of the negotiations is quite limited. We are not counting on an imminent U.S. – China trade deal.

Conclusion

Despite the fact that we have not seen a recession in nearly a decade, we still do not believe that a Canadian and U.S. recession is imminent. On the other hand, we do believe that we are nearing the peak of this economic cycle. We therefore believe that the probability of a Canadian and U.S. recession in the next two years has risen significantly. Since bear markets in stocks typically accompany recessions, we believe that the odds of a bear market beginning in the near term are rising. In the short-term, the shift in central bank interest rate policy has been very supportive of risky assets. We welcome the short-term boost to returns, but also have to be vigilant about any deterioration in economic performance or corporate earnings growth.

Our discretionary portfolios are already positioned somewhat cautiously. Discretionary management gives us the ability to rapidly reposition portfolios if needed. We will do our best to manage the risks that we believe the markets are facing as well as look for new opportunities to profit.

Thank you for reading our Q1 Newsletter. As always, we look forward to communicating with you and answering any questions you may have about your personal circumstances, our discretionary model portfolios or other topics of interest. Thank you for your business.

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APPENDIX "A"

DISCRETIONARY MODEL PORFOLIOS

We encourage clients to contact us for more information regarding our three fully discretionary model portfolios, namely the Total Return Portfolio, the High Yield Portfolio and the Balanced Portfolio. Our research efforts are now primarily devoted to finding investment ideas that will suit the criteria established for these portfolios and contribute to their returns.

1) Our Total Return Portfolio is focused on providing clients with an average annual return of around 8-10%, consisting mainly of capital gains and dividends.

2) Our High Yield Portfolio is focused on providing income-seeking clients with an average yield of 4%, plus around 2-3% of annual capital growth.

3) Our Balanced Portfolio is a more conservative portfolio that typically consists of approximately 50% fixed income investments and 50% equity investments.

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[1] https://www.cnbc.com/2019/02/04/a-giant-ipo-wave-is-coming-as-unicorns-whet-investor-appetite.html
[2] https://techcrunch.com/2017/01/17/sequoia-invests-100-million-in-zoom-video-conferencing-service/
[3] https://www.bloomberg.com/news/articles/2019-04-17/zoom-video-communications-tops-ipo-range-to-raise-751-million
[4] CIBC Capital Markets. *Mortgage Stress Test: The Operation Was a Success, But…* April 18, 2019.
[5] https://www.theglobeandmail.com/real-estate/vancouver/article-how-private-lending-is-distorting-the-vancouver-housing-market/
[6] https://www.bbc.com/news/business-47848861
[7] https://www.bbc.com/news/world-europe-47679760

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