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2019 Trends to Watch

North American stock market performance in the fourth quarter of 2018 (Q4) raised the question of whether we had entered a bear market, but an early 2019 rally suggests otherwise. The S&P TSX Composite Total Return Index lost 10.1% in Q4 alone, finishing down 8.9% for the year. The U.S. S&P 500 Index lost 13.5% in Q4, finishing down 4.4%, including dividends.[1] From late September until Christmas, the S&P 500 lost nearly 20%.

Our discretionary portfolios outperformed the TSX in 2018. With our investment style of purchasing high-quality companies at low valuations, we expect to outperform in strongly negative years. Our Total Return Portfolio lost 2.86% in 2018, our High Yield Portfolio lost 6.89% and our Balanced Portfolio lost 2.36%.[2] Our High Yield Portfolio declined more than our other Portfolios in 2018 partially because slower-growth high-dividend stocks tend to be affected negatively by rising interest rates, which we saw throughout the year. Some of our High Yield Portfolio holdings now offer very attractive dividend yields. Our Balanced Portfolio is designed to be far less risky than the TSX, as it contains a large weighting in fixed-income assets. We have a clear expectation that our Balanced Portfolio will outperform the TSX in strongly negative years. Through the first several weeks of 2019, all three discretionary portfolios have recovered significantly and erased most or all of the losses incurred in 2018.

Discussing outperformance in comparison to the TSX when we have generated a loss for the year is not exciting, but it does indicate good risk management. Our outperformance in 2018 can be attributed to three main factors: 1) individual stock selection, including our bias towards high-quality companies; 2) our willingness to hold some cash in portfolios when valuations are unattractive; and 3) our diversification into U.S. equities, which in some cases outperformed the TSX.

Many of the same factors that contributed to the poor Q4 in North American equity markets are still relevant to 2019 and beyond, and we will discuss them in detail below.

Peak of the Economic Cycle Increasingly Likely

In our Q3 2018 Newsletter, we considered where we might be in the current economic cycle. We focused on this question because stock prices usually drop around the time that an economic cycle tips into a recession. We concluded that we are near the peak of the current economic cycle; therefore the risk of recession in the coming years cannot easily be brushed aside. Today, we cannot yet say that we will see a near-term recession in Canada or the U.S., but we are increasingly confident that we are near the peak of the economic cycle, due to new facts that emerged in Q4.

Interest Rates

If the North American economy was still going strong, we would expect to see multiple interest rate hikes during 2019 by both the Bank of Canada and the U.S. Federal Reserve. Instead, those central banks have changed the tone of their statements in recent months, implying that further rate hikes will be minimal. Central banks have access to excellent economic data, and they are clearly seeing some signs of a slowdown. They likely are also influenced by the downturn in stock prices, as the stock market is viewed as a leading indicator of economic performance. The more "dovish" tone from these central banks is neither "bad" nor "good". It is helpful for North American equities in the short run because it reduces the risk that rates will rise too far and too fast. It is also a sign of weakness for the economy in the medium term because it suggests that the economy is not growing fast enough to tolerate higher rates.

The last two recessions in the U.S. did not begin until a Federal Reserve rate hike cycle was complete and the Federal Reserve had started cutting rates. If the Bank of Canada and the Federal Reserve start cutting, we know the economic data is deteriorating. Part of the difficulty in projecting a slowdown or recession is the fact that interest rate hikes impact the economy on a delayed basis. In theory, the full impact of rate hikes is not felt until 12-18 months later. Therefore, it may be late 2019 or early 2020 before we see the full economic impact of recent rate hikes.

Quantitative Tightening

One year ago, we published our Q4 2017 Newsletter, titled "Strong Global Economy Faces New Risks in 2018". One of our key points was that central banks were transitioning from quantitative easing to quantitative tightening. As a reminder, the term "quantitative easing" refers to the central banking policy of buying large amounts of government bonds or other financial assets in order to stimulate the economy. For example, starting in 2008, the U.S. Federal Reserve embarked on several rounds of quantitative easing by purchasing Treasury notes, mortgage-backed securities and bank debt.[3] Central banks outside of the U.S., like the European Central Bank, have also done quantitative easing. To put these policies in perspective, globally, central bank assets ballooned from around US$6 trillion before the 2008-2009 financial crisis to over US$20 trillion in recent years.[4] In other words, central banks added an enormous amount of money to the global economy over the past 10 years.

Today, the U.S. Federal Reserve is no longer engaged in quantitative easing. Instead, the Federal Reserve is allowing US$30 billion or more of the Treasury notes that it owns to mature each month.[5] This is a policy called "quantitative tightening" that will reduce the assets it holds. It withdraws money from the economy. New buyers will have to purchase the fixed-income assets that the Federal Reserve is not buying. Back in 2017, we stated that quantitative tightening was one of the largest risks to global equity market performance in 2018. It is likely that it contributed to the equity market correction we saw in Q4. In early January 2019, Federal Reserve Chairman Jerome Powell stated that the policy of quantitative tightening will continue until the central bank's balance sheet is "significantly smaller" than it is today.[6] This means that even if interest rates stay at current levels, the overall process of monetary tightening will likely continue, potentially weighing on economic growth and stock market performance.

Shaky Real Estate Markets

With monetary policy tightening, it is no surprise that interest rate-sensitive sectors like real estate are starting to suffer. Residential real estate prices are currently declining in many high-profile cities around the world. This supports the view that we are near the peak in the economic cycle globally.

We have rarely discussed Australia, but it serves as an interesting example. For various reasons, including China's demand for its natural resources, Australia has avoided recession for close to 30 years.[7] Now, its housing market is in a severe downturn, catching some by surprise. Sydney and Melbourne's house prices have now dropped 11.1% and 7.2% respectively from their 2017 peak levels.[8] Weaker home prices in Hong Kong, New York City, and of course London, with Brexit looming, are also getting financial media coverage.

We frequently discuss Canadian home prices and debt-burdened households. In recent months, it seems that home prices in key cities like Toronto and Vancouver have generally been falling, although it depends on how the data is presented. In April 2018, we published our Q1 Newsletter, titled "Moment of Truth for Canadian Households", which was focused on Canadian household debt. We concluded that Canadian households have too much debt at a time of rising interest rates and lackluster growth in personal income. We projected that many areas of Canada would experience falling or stagnating home prices. Finally, we noted that rising rates combined with weaker home prices create a difficult environment, which can impact consumer spending.

At that time, the Canadian ratio of household debt to disposable income was at a record high level of around 170%.[9] To put that in perspective, the ratio has been rising steadily since 1990, when it was 90%.[10] Recent data shows the ratio is now closer to 178%, which is not an encouraging development, although the method of calculating this ratio may have changed.[11] In addition, a geographic breakdown of recent data shows that the ratio for Vancouver residents is now 240%, and it is 200% for Toronto residents.[12]

For most of the past decade, rising Canadian home prices have masked household debt problems, as some Canadians have been able to sell their homes to pay off debt or borrow more using relatively low-cost home equity lines of credit (HELOCs). At this stage, with home prices falling in many key markets, some over-leveraged Canadians are in a difficult financial position. After many years of positive contributions, it seems likely that housing will become a drag on Canadian economic performance.

The U.S. – China Trade Relationship

In July 2018, we published our Q2 Newsletter, titled "Global Trade Relationships in Focus". We examined the reasons why the U.S. and China have each imposed tariffs on certain categories of the other's imported goods. Two motivations for the U.S. include reducing its trade deficit and slowing China's growth into an economic and military superpower. We concluded then that there may be no immediate resolution to the trade dispute between the countries.

Trade negotiations between the countries are ongoing, which is a positive sign. Both sides have made optimistic statements regarding their progress. The U.S. has threatened to "increase tariffs on US$200 billion worth of Chinese imports on March 2 if China fails to take steps to protect U.S. intellectual property,

end policies that force American companies to turn over technology to a Chinese partner, allow more market access for U.S. businesses and reduce other non-tariff barriers to American products."[13]

The U.S.-China trade dispute has weighed on economic growth in both countries. A resolution would be welcomed by investors and would help both economic and equity market performance. Assuming that recent media reports are credible, the probability of a resolution has risen since last summer.

Finding Bargains in Choppy Markets

To us, a bargain investment is a high-quality business trading at an undervalued price. These types of companies often have a track record of surviving and thriving in many different economic environments. In some cases, they have a multi-decade track record of paying dividends to shareholders, often with frequent dividend increases. When these types of business trade at bargain prices, it often means higher than normal future returns for investors who buy their shares. As many clients know, we have not found many bargains in the past couple of years. This contrasts with 2009-2014, when we found numerous bargains, and sometimes could not understand why other investors were willing to part with shares so cheaply.

The positive side of choppy markets is that they can provide us with bargain investment opportunities. In the current market, we cannot say that bargains will emerge for sure, but the factors discussed above may create them: 1) an economic cycle likely somewhere near its peak; 2) monetary tightening; 3) weakness in certain real estate markets; and 4) an ongoing trade dispute between two of the world's largest economies.

The stock market's performance will often foreshadow what happens in the economic data. This means that once it is clear to investors that a recession has begun, it is often too late to avoid the drawdowns in investment accounts that accompany bear markets. As investors, we must therefore make decisions about increasing or decreasing our weighting in equities without certainty about where we are headed economically. Even if we believe that a bear market is imminent, for most clients, we will not decrease our equities weighting to zero. Conversely, if bargains emerge, we tend to buy them in stages over time. We think in probabilities, not absolutes. It is better to be somewhat right than absolutely wrong, and it is easy to be wrong about economic growth, interest rates and stock market turning points.

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 in 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.

Our discretionary portfolios are already positioned somewhat cautiously, given our views on the economic cycle. Discretionary management gives us the ability to rapidly reposition portfolios to potentially take advantage of bargain investments and reduce some of the pain of bear markets. 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 Q4 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] CIBC Capital Markets. Navigating Through 2019 (p. 10).
[2] All return numbers discussed are taken from the returns of the model account for each respective discretionary portfolio. These numbers are generated using our software (ADP/Croesus V9), and individual clients' account performance may vary. These return numbers are not a promise of future performance. Returns in the Balanced Portfolio should not be compared to the returns of the TSX Index, as the Balanced Portfolio will typically hold a substantial weighting in fixed-income assets.
[3] https://en.wikipedia.org/wiki/Quantitative_easing
[4] https://www.barrons.com/articles/bright-outlook-for-the-economy-and-stocks-1515812439?mod=bol-social-fb
[5] https://www.barrons.com/articles/bright-outlook-for-the-economy-and-stocks-1515812439?mod=bol-social-fb
[6] https://www.cnbc.com/2019/01/10/powell-says-balance-sheet-will-be-substantially-smaller.html
[7] https://www.theatlantic.com/ideas/archive/2018/12/what-australia-knows-about-recessions/578482/
[8] https://www.irishtimes.com/business/economy/australia-braces-for-hard-landing-in-housing-market-1.3749277
[9] https://www.bloomberg.com/news/articles/2018-03-15/canada-household-debt-to-income-ratio-holds-near-record-high
[10] http://business.financialpost.com/personal-finance/debt/no-way-to-know-if-debt-to-income-ratio-has-climbed-too-high-federal-officials
[11] https://business.financialpost.com/personal-finance/debt/statistics-canada-reports-key-debt-ratio-ticked-higher-in-third-quarter
[12] https://globalnews.ca/news/4762476/canada-household-debt-to-income-ratio/
[13] https://www.cnbc.com/2019/01/11/us-china-trade-war-steve-mnuchin-says-chinas-liu-he-to-visit-in-jan.html

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