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2020 Will Answer Many Questions

North American equity markets had a very strong 2019, erasing memories of their negative finish in 2018. We benefitted from the gains in our discretionary portfolios, but we are remaining levelheaded. There are many unanswered questions about the sustainability of the current equity market rally in the coming years. We believe that events in 2020 will answer those questions.

In 2019, equity markets benefitted from a huge swing in investor sentiment towards optimism. In many cases, investors were willing to pay higher valuations for businesses that did not improve much year-over-year. In this fourth quarter (Q4) Newsletter, we will examine whether investors' recent willingness to pay far more for equities is justified.

In 2019, a consensus emerged that central banks have no other choice but to support economic growth with continued low rates and money printing. Investors also seemingly accepted the narrative that the worst is over for global trade disputes, especially between the U.S. and China. We will discuss the possibilities below.

Generally we are quite happy with the business performance of the high-quality companies we own. However, as we have mentioned in recent Newsletters, we have been very selective in making new purchases at today's equity valuations. We remain a bit cautious overall in our discretionary portfolios, with higher than normal weightings in fixed-income holdings and cash. If equity markets continue higher at the current torrid pace, we will no doubt benefit. If we see a major correction in the coming months, we do have some lower-risk assets we can reposition to take advantage.

Extreme Swing in Investor Sentiment

Understandably, when equity markets rise significantly with minimal volatility, investors will start to feel pretty confident. This is human nature. That said, recent investors sentiment readings have become extreme, which is somewhat concerning.

In late 2018, investors were actually pessimistic about equity markets. In the many months since then, attitudes have completely changed, even though the underlying fundamentals of businesses and the global economy are not much different. There are indicators of investor sentiment that illustrate this swing quite well.[1] We do not expect that all clients understand the details of these indicators, nor is it necessary. We simply would like to share examples of the extremely optimistic sentiment.

The first indicator is the put/call ratio. Puts and calls are not equities. They are derivative contracts that benefit when equities fall and rise, respectively. When investors are buying a relatively high number of put option contracts, relative to call option contracts, it indicates that they are feeling negative. At the end of 2018, the put to call ratio was close to 1, an indicator of extreme negative sentiment. Now, in mid-January

2020, the ratio is closer to 0.5, an indicator of extreme optimism. Investors are now buying way more calls than puts.

The second indicator is the CNN Fear & Greed Index, a compilation of factors. This index "takes into account the ratio between the percentage of stocks hitting their 52-week highs relative to the percentage of stocks hitting their 52-week lows, as well as the put-call ratio, demand for junk bonds, demand for safe haven investments, market momentum and market volatility."[2] Near the end of 2018, this index was around 10 out of 100, indicating extreme fear. In recent weeks it has often exceeded 90 out of 100, indicating extreme greed.[3]

The third indicator is lesser known, but still interesting. It is Deutsche Bank's Consolidated Equity Positioning indicator. It measures how much exposure investors have to equities, and it is currently in the 96th percentile of historical readings, indicating extreme optimism.[4] It seems to suggest that there is not much more room for investors to shift portfolios towards equity ownership.

Clearly these three indicators suggest extreme optimism about equity prices. But why is investor optimism a bad thing? It may not be. There is no guarantee that extreme optimism will result in an equity market downturn; however, historically, extreme optimism has often been followed by periods of weak returns. Perhaps this is why famous investor Warren Buffett once said "be fearful when others are greedy and greedy when others are fearful." If most people are optimistic, there are fewer skeptics left over to be converted into equity buyers. Also, if anything goes wrong, there are lots of people who will be caught off guard by bad news and may decide to sell.

We do not base our investment decisions on sentiment indicators. Normally we ignore them, but currently the excessive optimism about equity markets looks like a warning sign.

Multiple Expansion (Paying More for the Same Thing)

When evaluating an equity investment, we are very concerned with the quality of the business, and also the price we are being asked to pay for the business. Right now, other investors are asking higher and higher prices for businesses that are not much different in terms of their earnings power or quality than they were a year ago.

A simple example may help make our point. Imagine that you were interested in buying a stable small business located in your community that earns around $200,000 per year after tax. Assume that the sellers offered it to you for $600,000 in late 2018 and you declined. Then, the valuation multiple was 3 times estimated earnings. Imagine they came back to you today and offered it to you for $1,000,000, and the earnings power of the business is basically the same. They now want 5 times estimated earnings. You would be paying more for the same thing, and your future return on investment would be worse. This is multiple expansion, and it has been happening in the public equity markets.

Looking at public equity markets today, we see various valuation multiples at or near multi-year highs. For example, the price to sales ratio for the U.S. S&P 500 is over 2.0 and at all-time record levels.[5] This is difficult to believe, given how ludicrously overpriced stocks were in 2000. The price to forward earnings ratio for the

S&P 500 is also elevated, although not at all-time highs. The S&P is trading around 19 times forward earnings, which is above the average ratio of 16.7 during the past five years and 14.9 over the past ten.[6]

Also, the price-earnings to growth ratio, or PEG ratio, sits at around 1.8 times, the highest level since the mid 1980s.[7] The ratio measures a stocks price to earnings multiple divided by its expected long-term growth rate in earnings per share. To put today's level of 1.8 in context, it used to be said that a multiple over 1 indicated overvaluation. Of course there is no guarantee that the growth rate that analysts expect will even occur. With all of these measures of valuation appearing high, it is surprising to note that Q4 earnings for the S&P 500 index in the U.S. are expected to be 2.1% lower than one year ago.[8] To us, it is a warning sign that valuations are rising strongly while earnings are stagnant.

We are not asking clients to take a detailed interest in these valuation multiples, as that is our responsibility. We are simply saying that we do care about how much we are being asked to pay for a business, and the current valuations appear to be elevated. This makes us more cautious than we would be in a typical year.

High valuations are not an indicator that can be used for short-term market timing. High or low valuations can persist for months or years, despite reasons they should come to an end. Despite that, we would argue that high valuations reduce the returns we can reasonably expect from equities over the next 3-5 years, and we are very focused on delivering good 5 year return numbers.

If in 2020 equity valuations keep increasing without better corporate earnings, then the risk of a major market correction will be higher. If on the other hand, we see better earnings growth and global economic growth, this risk will diminish.

Central Bank Support

Nobody alive today remembers life without central banks interfering in the economy. Before central banks, back in 1907, the financier J.P. Morgan (then the name of a living man, not just a bank), helped end a financial panic on Wall Street by providing his own funds as market support. This was one of countless crises that are now forgotten.

Central banks were supposed to help prevent these panics by becoming lenders of last resort. They were supposed to increase the stability of the financial system. However, at this stage of economic history, central banking is way too influential. In recent years, it seems like investors are placing more and more confidence in central banks to support economic growth and equity market gains. Obviously it would be better if economic growth and market gains were the direct result of good decisions by private sector individuals and businesses, and central banks stayed quietly in the background with a very limited role.

But that is not today's world. In late 2018, some investors began worrying that central banks rate increases and balance sheet reductions would go too far, causing problems for our over-indebted households, businesses and governments. In 2019, when central banks around the world ended up cutting rates and printing money again, some investors took it as a sign of indefinite central bank support for the global economy and equity markets.

Their reasoning is that central banks can no longer raise interest rates to normal levels because it will crash the economy, and that the central banks must constantly stimulate with new money printing to keep the economy going. Investors interpret this state of affairs as a reason to be optimistic about stocks in 2020.

There may be some truth to this perspective, as central bankers seem willing to fight off recessions. Even so, there are obvious risks to placing too much faith in central bankers, who have made numerous mistakes and bad predictions in recent decades. Their decisions will be under the microscope as never before in 2020.

U.S. – China Trade Negotiations

The U.S. and China continue to engage in a trade dispute that may prove difficult to fully resolve to the satisfaction of both countries. We continue to this trade dispute as significant to the global economy and to equity markets. The countries have now signed a “phase one” trade agreement of questionable substance that will involve China purchasing around US$50 billion annually of U.S. farm products.[9] While this is good news, China’s willingness to purchase U.S. farm products has never been the sticking point between the countries. Therefore, this phase one agreement may not progress smoothly to a comprehensive trade agreement.

Many equity investors now seem to believe that the U.S. – China trade dispute will not have any serious global economic consequences. The U.S. side has fed the media a consistent diet of positive comments about the negotiations since late 2018. Most of these comments have proven to be overly optimistic. We remain concerned that the real probability of a comprehensive trade agreement may be lower than expected, exposing equities to some future downside.

2020 U.S. Election

Many of us here in Canada have grown tired of all of the rhetoric around U.S. politics, but as investors we must face U.S. political risk again in 2020. So bear with us, as we have several brief comments on the topic. First, we note that the Trump Administration in the U.S. has probably done more equity market pumping through the media than any other U.S. Administration in history. Equity markets are fickle, so this is quite risky, but these actions may have had some positive effect on market performance. Second, there is no guarantee regarding the outcome of the 2020 election. Yes, it may appear that Donald Trump will win again, but many commentators were convinced that Hillary Clinton had the edge before the 2016 election.

Third, putting all opinions about President Trump aside, it is clear that the U.S. corporate tax cuts following the 2016 election has had a positive effect on U.S. equity market performance. Fourth, we can observe that the Democrats’ candidate has not been chosen, and some of the contenders are openly hostile towards large corporations and free markets. Fifth, it is very possible that if President Trump secures re-election, he will be emboldened to re-engage in trade disputes with less concern about the immediate economic and stock market impacts.

The 2020 U.S. election could end up being significant in economic history. Will Americans re-elect a President who is largely pro-business but engages in aggressive trade policy, or will they choose a candidate who is focused on re-distribution of existing economic resources? These are very different paths.

Conclusion

2020 will answer a lot of questions as key events unfold. We continue to own a large allocation to high quality stocks in our discretionary portfolios, but we are also somewhat defensively positioned. In practical terms, this means allocating more capital than normal to fixed-income holdings or cash. It also means heavily scrutinizing the quality and purchase prices of our equity holdings. Sometimes this can test our patience if markets do not provide good buying opportunities. Even so, overpaying for equities prior to a downturn can damage long-term returns, so patience is required.

While the current rally in equity markets has taken on a life of its own and could keep running higher for some time, it will simply amount to borrowing returns from the future if we do not see better corporate earnings growth and global economic growth this year.

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] https://www.marketwatch.com/story/as-investor-optimism-nears-2-year-highs-analysts-warn-of-stock-market-pullback-2020-01-13
[2] See note 1 above
[3] https://money.cnn.com/data/fear-and-greed/
[4] See note 1 above
[5] https://www.marketwatch.com/story/the-sp-500-is-now-more-overvalued-than-ever-per-this-measure-2020-01-08
[6] See note 5 above
[7] https://www.cnbc.com/2020/01/16/stocks-are-the-most-overvalued-since-at-least-the-1980s-based-on-one-measure.html
[8] https://insight.factset.com/sp-500-earnings-season-update-january-17-2020
[9] https://www.cnbc.com/2019/10/19/trump-says-he-hopes-us-china-trade-deal-will-be-signed-by-mid-november.html

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