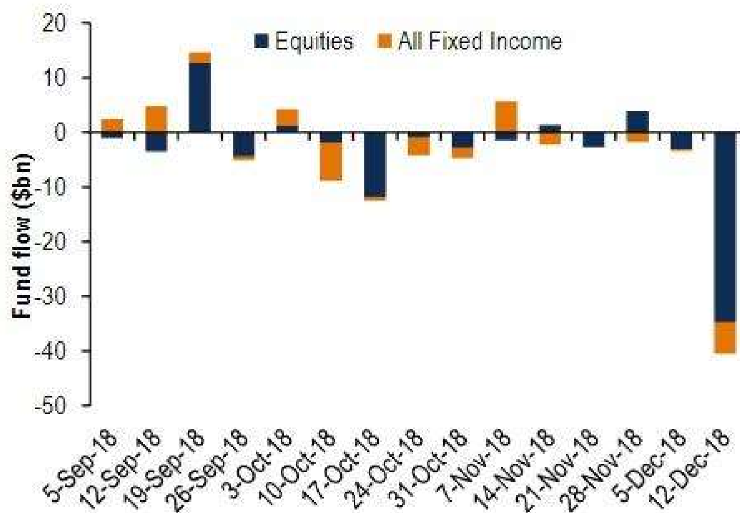
FIRST QUARTER REPORT – MARCH 31ST, 2019

The average investor in the US lost 9.42% last year. That's twice as much as the -4.38% return of S&P 500, and an underperformance of -5.04%. How? Investors are horrible at timing the market.

RECESSION FEARS

At the end of 2018, markets sold off as investors were worried about trade wars, a US recession, falling oil prices, and rising interest rates. Looking at the facts, corporate health is incredibly strong and the US economy is doing very well. The US currently has the lowest level of unemployment rate in 49 years, with no economic indicators pointing to an imminent recession.



[1]

As market volatility started to increase in September, investors reacted emotionally to short-term market movements. Instead of focusing on fundamentals, daily market moves dictated investment decisions. Emotion overcame logic. Selling caused more selling. Investors focused on the next day, rather than the next year. Short-term headlines caused investors to change long-term investment plans. Investors, who saw through the short-term noise and understood that fear was driving the markets, were able to take advantage of market volatility and get some amazing deals. Unfortunately, most investors reacted by selling into the volatility. In the chart above, you can see the inflows and outflows of US stocks and bonds. The massive outflow in December indicates investor selling which was selling low and into fear. This is after the S&P/TSX had dropped by 16% and the S&P 500 had dropped by 20%. What happened after investors sold? The US markets returned 20%, and the Canadian markets returned 18% from the market bottom on December 24th, to the end of the first quarter in 2019. Does it make sense now, why the average investor has such poor long-term returns? Selling at the end of last year would have

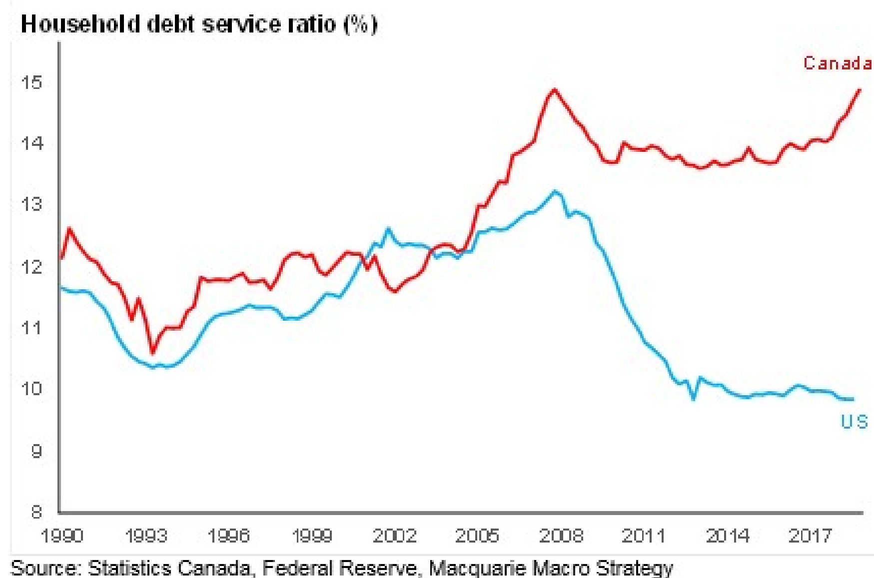
[1] Source: BofA Merrill Lynch Global Research, EPFR Global

a significant negative impact on your long-term returns, as you would have completely missed out on the proceeding rally and could put your financial goals in jeopardy.

Volatility is the friend of those who know the true value of a business, and the enemy of those that don't. We like volatility. Buying companies at prices well below their true value allows us to find businesses and investments that can provide long-term returns to our clients. Price dislocation in the short-term provides incredible opportunities for us in the long-term. The month of December provided these opportunities.

WHAT RISKS ARE WE WATCHING FOR NOW?

In Canada, it's our consumer. We've never had debt levels as high as they are relative to incomes. Rising interest rates have made the cost of servicing our debt also increase. The Debt Service Ratio (DSR) measures the proportion of household disposable income needed to service our debts. The higher our debt level or interest rate, the more our income will go towards our debt. It's like getting a pay cut. The more we spend on debt, the less we have to live on and spend elsewhere. The Household Debt Service Ratio (DSR) is back to the all-time highs that it hit in 2008, which is currently at 14.9%. This is one of the best indicators of future credit losses. When debt payments become too high, consumers can no longer afford to service their debts and this leads to defaults.

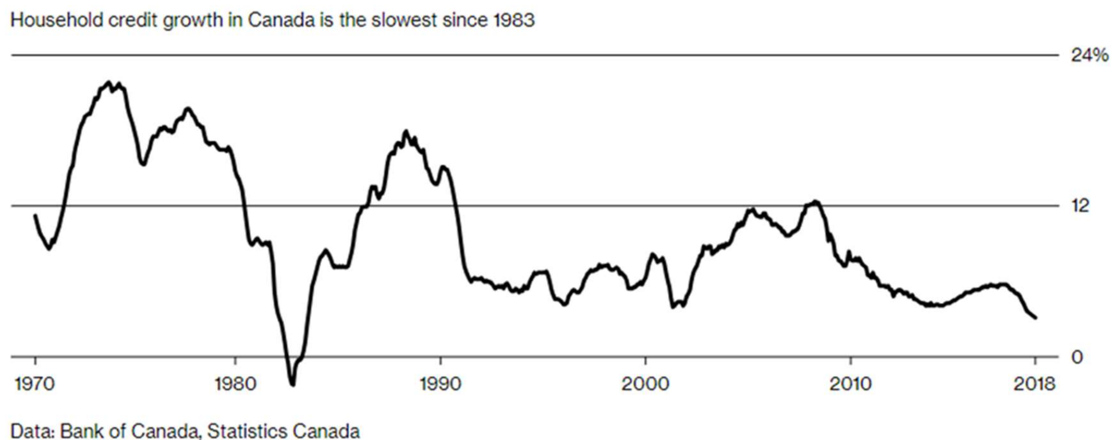


Source: Statistics Canada, Federal Reserve, Macquarie Macro Strategy

In a recent survey by the Financial Planning Standards Council and Credit Canada, 19% of those surveyed indicated they may have to sell assets or tap into RRSPs to reduce their debt burden. 62% indicated they may have to tap into more borrowing for credit card, consumer, and auto or mortgage debt. We are one of the most leveraged consumers in the developed nations. Any economic shock doesn't allow much wiggle room for the Canadian consumer. As you can see in the chart above, the Canadian consumer is not in a good position.

Not only are we being squeezed with high debt levels, housing prices have reversed course and are falling. For the first time since 1990, house prices declined nationwide. As home prices have fallen, sales have slowed significantly. In February, Toronto had the fewest home sales since 2009 and Vancouver had the fewest since 1985. In Toronto, detached house prices are down over 10% from their peak, and the average Vancouver detached house prices is down by a $1,000,000 or 33% from their peak. Credit growth in Canada has slowed down to its slowest pace since 1983[2]. I highlighted this point nine months ago, and since then credit growth has slowed down significantly.

[2] Source: https://www.bloomberg.com/news/articles/2019-03-26/canadians-are-feeling-the-debt-burn?srnd=premium-canada



One sector that would suffer from an increase in consumer defaults, falling house prices, and stalling household credit growth is our financial sector. In Canada, the financial sector is the largest component of our markets. It's close to 1/3rd. Since the financial sector is such a large weight in Canada, investors naturally have a large exposure to them. We love our Canadian banks. Over the past decade, they have done exceptionally well. Investors think this will continue. If you look at the top 5 largest mutual funds in Canada, on average each has over 30% exposure to the financial sector. Many investor portfolios would be significantly impacted by a slowing financial sector. Due to these risks with the Canadian consumer, we've been very careful with our financial exposure. There are still fantastic opportunities in Canada, however, we are finding them elsewhere.

In my last newsletter, I mentioned that we are closely watching the yield curve. In particular, a yield curve inversion. A yield curve inversion occurs when short-term rates are higher than long-term rates. If you walked into a bank, it would mean you would receive a higher interest rate on a 1-year GIC, then a 10-year GIC. Why would this happen? It's because our bond market thinks that the economy will slow down in the future. This causes long-term interest rates to fall from an expected slowdown, and an inversion occurs. When this occurs, banks curtail lending, and this leads to a potential recession. An inverted yield curve has happened before every recession in the US.

In early March, Canada's yield curve inverted. The US yield curve also inverted for the first time since 2006.

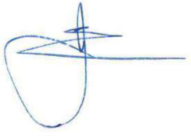
RECESSION! TIME TO SELL EVERYTHING?

No. First, for a yield curve inversion to be significant, it has to occur for at least three months. The yield curve has been inverted for far less than that. Second, an inverted yield curve doesn't guarantee a recession. Despite the fact that all recessions have been preceded by inverted yield curves, not all inverted yield curves have led to recessions. We are closely watching credit conditions, economic data coming out of the US and Canada, the actions of the Bank of Canada and the US FED, and closely monitoring the yield curve. We will be positioning portfolios accordingly.

Corporate earnings are strong. Valuations are attractive. The US economy is doing well. Canada has risks but we are avoiding those. We took advantage of the market volatility last year. We headed into the end last year with higher levels of cash than usual, and used that cash to add to new and existing positions with the market weakness. With recent developments, we are monitoring indicators closely and making adjustments accordingly.

If you have any questions on your portfolio, please let me know.

-Kind regards,



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