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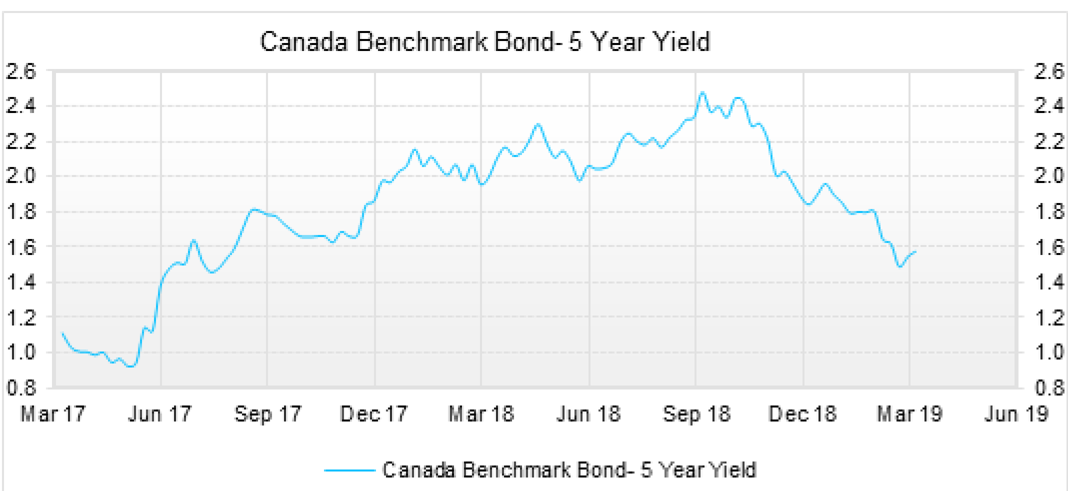
First Quarter 2019

The stock market was every bit as good in the first quarter of 2019 as it was bad in last year's fourth quarter. There were perhaps two main reasons for the stock market gains; lower bond yields and, optimism about an end to the trade war between the US and China.

The trade negotiations are expected to continue for the next four weeks or so. I should think there is plenty of time for fits and starts in the negotiations before they are wrapped up. A successful conclusion and an end to the tariffs would remove a considerable drag on global trade and the economy.

The decline in bond yields has been extraordinary. From a high of 2.48% at the beginning of October, the yield on the five-year Canada bond had fallen to 1.54% at the end of March.



Graph from Factset April 5, 2019

There have been some notable rather direct effects on our securities from the decline in bond yields. The deep discount government bonds that we bought last year have appreciated significantly closer to their par values as their yields have declined. Reliable dividend paying stocks like telephones and electrics have appreciated this year as their dividend yields compare more favourably to bond yields.

On the other hand, rate reset preferred shares have tumbled in price both because lower bond yields mean there is a prospect for the dividends to be reset lower when they reach their reset date and, because the slower economy, which lower yields portend, increases concerns about corporate creditworthiness. Rate reset preferreds look to me now to be the best bargain in fixed income but, I am mindful of those two risks, namely lower interest rates and lower credit ratings.

Interest rates fell so much in the first quarter that for a time last week the yield curve was inverted. Both in Canada and in the US the yield on the 30-day Treasury Bill was higher, at least briefly, than the yield on the 10-year Treasury Bond. This attracted attention because an inverted yield curve is considered a predictor of recessions. The yield curve last inverted in 2007, a year before the Great Recession, and it has inverted before all recessions in the last 60 years I believe. It now looks like the Bank of Canada's and the Federal Reserve's last rate hike late last year was their last, at least for now. It was, as a colleague of mine quipped, like a last kiss, we didn't know it at the time. Central banks control short term interest rates, bond markets control long term interest rates. The decline in bond yields suggests that the bond market is expecting the next move by central banks will be to lower short-term lending rates in response to a slowing economy.

An inverted yield curve can lead to a recession because lenders are disincentivized to lend money when long term rates are lower than short term rates. Bankers lend long and borrow short and they need a spread for that to be profitable. If lending dries up, so will economic activity.

There are several caveats to the fuss about the inverted yield curve. One is that it is not inverted today, as I write, and it was inverted only for a few brief days so far. The other is that there are several alternative interpretations. One is that the curve inverted not because central banks raised short-term rates so much but, because long-term rates fell. That this happened in an era of ultra-low interest rates may mean that the signal is distorted.

There is another completely different topic I want to address this quarter: What I do when my favourite stocks plunge in price. This, you will have noticed, has happened in more than one instance recently. I have never been a believer in so called stop-loss orders. That is the idea that if we have bought it at $10 and now it is $8, we should sell it to stop any further losses. That way of thinking doesn't make sense to me. All things being equal, if I thought it was good value at $10 it must be better value at $8. I don't want to sell simply because the price fell.

A 10% or 20% decline is one thing, but what about when the stock has, to use a bit of jargon, cratered? The first thing to recognize is that it happens sometimes. If the stock has crashed because the market has or because of some other macro-economic event, I will be inclined to buy more, incrementally, over a period of time.

If, as is more common, the stock has dived because of something like shockingly poor quarterly results, I'm more inclined to wait. I typically won't abandon an investment in a company I know and like if it is at least making profits. I will instead bide my time and be slow to average down. I will usually wait for a sign of improvement in their business before buying more. I will try to distinguish between a stock that is a good value from one that is a value trap. A value trap is a company whose business steadily deteriorates but the stock always looks cheap and keeps getting cheaper. Insider buying can be one way to tell the difference between a value stock and a value trap. If I come to feel that it was a mistake, I sell quickly.

Being able to be patient with a badly performing stock is I think a major advantage we have over institutional investors. Managers of mutual funds or other large pools of capital are often motivated at least in part by career risk. They cannot afford to be wrong for long out of fear of losing their jobs or, their clients. The tyranny of keeping up with indexes every quarter need not apply to us. To benefit from the opportunity that downtrodden stocks can offer we must, though, be able to resist the psychological pressure of appearing to be wrong.

I'm very pleased to announce that Alexa Perugini joined Team Stedman in January. Alexa had worked for RBC DS before on what's called a Transition Team, helping new teams transfer their clients to our firm. She is very knowledgeable about the intricacies of our back office paper work and bureaucracy. She has been a great help to Margarita and me. Please help her to feel welcome.

This week I finished coaching my son's Peewee hockey team, an unreasonably nerve wracking experience. Over the next few weeks I will try to recover from post-season stress disorder. I'm announcing my retirement as a hockey coach. As for baseball, we'll see.

Sincerely,

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