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Disclaimer	**00:25**	This podcast is for informational purposes only. Information relating to investment approaches or individual investments should not be construed as advice or endorsement. Any views expressed in this podcast are based upon the information available at the time and are subject to change.
David Fraser:	**00:41**	Welcome to the Art of Boring podcast! Thanks for joining us for another quarterly update. As usual, Greg Peterson is here with me. Greg's the asset-mix chair and Balanced and Global Balanced Fund lead manager. Greg, thanks for joining me.
Greg Peterson:	**00:53**	Thanks David.
David Fraser:	**00:54**	Well, it's been the best quarter for stocks since 1998 believe it or not, so there's certainly a lot to talk about. Why don't you give us an idea of what's on your mind as you look back at the second quarter of a pretty eventful 2020?
Greg Peterson:	**01:08**	Yeah, it's interesting looking at short time periods like this because we're coming off one of the best quarters sort of following one of the worst quarters just prior to that. So, definitely a strong bounce in the second quarter this year after the pandemic and economic shutdown caused markets to drop significantly in February and March. So that's really the story I think—it's just a rebound from where we were before. And a rebound largely created by stimulus packages from central banks and governments, as well as markets taking a more forward view and not looking, I think, at the present situation very much.
David Fraser:	**01:41**	Yeah, so that forward view, what do you mean by that?

Greg Peterson: 01:44 Markets are well aware of the present challenge to earnings. So, companies will not be performing well this year. Earnings are down significantly or negative in many cases. And so markets are always forward looking—they're always looking to" what next?" So we know that earnings are very poor this year; the economic numbers will be very poor this year. And so markets start to look into 2021-2022 and start to factor in what the recovery look like and how long [will] it take to get back to the same level of activity or level of sales over time. So that's what markets tend to do is they look past.

02:16 So, despite the fact that we're still watching headlines about the virus activity picking up in many parts of the world right now, and then concerns of a second shutdown, the market's already sort of done with that, if you will, and looking past to see what next. You've probably seen lots of talk about the shape of the recovery on the economy, whether it a V-shaped or U-shaped or what have you. I can't tell you exactly what that shape is likely to be, but the shape of the projection for interest rates is low for some time. So that's more important at the moment.

David Fraser: 02:44 Even though we're looking ahead to 2022-23, and it's been such a strong quarter, I suspect your thinking is we're still not out of the woods with it—the pandemic—and you're possibly cautioning clients to not get too comfortable. There might be more volatility on the horizon. Would that be right?

Greg Peterson: 03:00 Yeah, absolutely. There's most likely to be more volatility on the horizon. Naturally, we never know what's coming for sure, especially in the near term. But more volatility would seem quite likely, just as there's an ebb and flow to the virus and the pandemic and that could rattle markets a little bit in the short term. Now, I'd be surprised if we saw a sell-off as sharp as we did back in March, only because there is so much liquidity in the world at the moment through central banks. Central banks have taken some of the risks out of the markets by buying securities, quantitative easing—similar to 2008 and 2009—except they've taken it to a much bigger level this time, to the point where they're actually lending direct to companies, the Federal Reserve Bank in the U.S. by buying bonds. And so this liquidity is creating a floor in the markets at the moment.

03:45 So, I'd be surprised to see the sell-off to the extent that we did before, but certainly some more volatility. And there [are] a couple of things to maybe just mention around that too. So, while we have this stimulus in place and zero interest rates, the low discount rate, and the fact that the low discount rate is likely to be with us for a longer period of time, has a very strong impact on stock prices.

Greg Peterson: Just as you're taking the present value of future cash flows for those businesses, the lower discount rate increases the present value of those cash flows. That helps to provide some support to stock prices in the present, despite the fact that your inside of the equation is not very good right now, earnings are expected to improve over the next couple of years. And that low discount rate has a stronger impact. You can take away earnings for a year and the impact is going to be not nearly as significant as a low discount rate for a long time.

David Fraser: 04:36 So, it sounds like earnings accompanied with that very low discount rate…that current market valuations, you could argue, are justified?

Greg Peterson: 04:46 Yeah, to a certain extent you can justify it. I mean, you can make a case either way if you want [laughs]. But that's one thing I would say if people are concerned about headlines around what's taking place in the world right now, especially economic or virus-related—that it's not as clear as it might seem, in that we've been looking at some modest shutdowns in parts of the world again [and] it doesn't seem like we're likely to experience a full shutdown like we did earlier this year, as healthcare professionals have much more experience with this and things are adjusting as we go. The present headlines are not always what's driving the market, so it's important to look forward and not get caught up too much in what's taking place at the moment.

05:24 I also don't want to make it sound like, "Oh, we're just throwing caution to the wind, everything's all good now." But despite expecting more volatility, we manage through that.

The one thing I would advise people is that if you do have needs for cash or liquidity, to make sure you have that available in your portfolio in the near-term, but as far as longer term investment strategies—[that's] not something I would deviate from just due to current headlines.

David Fraser: 05:49 It sounds like you're along the lines of a phrase that's been thrown around a lot recently, which is "cautiously optimistic," I guess.

Greg Peterson: 05:55 Yeah, I think you have to be optimistic a certain extent to stay in the stock market.

David Fraser: 05:59 And you mentioned the significant stimulus we've seen from central banks. With all that stimulus throughout the world, should today's and even future taxpayers be concerned that tax rates may have to increase to pay for this stimulus?

Greg Peterson: 06:14 That's a great question! [laughs] Somebody will have to pay for all the fiscal spending that's taking place around the world at some point in time. I suspect it'll be generations behind us that will be paying for that. So, tax policy is always up in the air. There's still a lot of speculation about whether tax rates move higher from here. It would seem like the easy direction for tax rates to move, but it's not one that we can forecast with any certainty. But it would seem that there's a risk to higher taxes.

David Fraser: 06:39 And what are your thoughts on a divergence we've seen between the real economy and financial markets on the back of the stimulus?

Greg Peterson: 06:46 Yeah, so there's certainly a disconnect between financial markets and the current economy. And this is where you can have that disconnect—just because of the liquidity that's available at the moment. And then the forward-looking aspect of markets as well. So, investors are looking beyond what's taking place currently. That does create a gap. So, if you are trying to justify current market levels by looking at economic activity where it is today, you'll see that gap. It's really a matter of understanding that the markets are looking past this and trying to determine "what next?"

There are some risks that markets are perhaps a bit too optimistic about what the recovery looks like. Is activity at businesses back to normal next year or the year after? Does it take four or five years?

07:25 It's difficult to tell what investors have actually factored in, in terms of how quick that recovery takes place. But that does create a little bit of risk. If they're too optimistic about the shorter time period, then we may see a bit more volatility. And volatility is always something to be expected from stock markets. That's just something to manage through.

David Fraser: 07:43 Yeah, because nobody saw COVID coming, and there was a significant amount of… well, a really a big market sell-off as a result of that. So certainly always a good idea to stay on your toes.

If you put on your asset mix hat, do you expect to make decisions on how quickly different economies begin to open up in a post-COVID world?

Greg Peterson: 08:03

Yeah, to a certain extent, we do look at economic activity and expectations for improvement—probably more around businesses themselves in different markets and different geographies. Then also considering valuations and where things are more expensive. So, I think it's relatively easy to say that the U.S. market is a bit higher value than other parts of the world. That likely challenges future return expectations for the U.S., just because they are starting from a higher point. And then you would likely look to other parts of the world for better opportunity from a valuation of the long-term return expectations.

So that's part of what we look at, but then also looking at monetary policy in different parts of the world. Monetary policy everywhere is very similar at the moment—it's all low rates, quantitative easing programs of different sorts. But those are the types of things we look at. But then also based on input from our research team and what the various the asset classes are seeing with respect to their portfolios. It's important for us to distinguish that we're not managing to indices or to certain markets, but managing asset mix based on Mawer's portfolios.

David Fraser: 09:10

So you might have portfolio managers from the U.S. [Equity] Fund or the Canadian Equity Fund join you for example, and give you their thoughts on what's happening in their part of the world and what they're seeing there, is that right?

Greg Peterson: 09:22

Yeah, we receive input from everybody on the research team either directly or indirectly in some cases. That's important input for us to know what they're seeing and what they're thinking with respect to their portfolios. Both on the opportunity side, and then also risks that they're seeing in the portfolios.

David Fraser: 09:37

Absolutely. The pandemic seems to [have] expose[d] some vulnerabilities in the global supply chains as every country, really, around the world has gone into lockdown at different times. Is the pandemic poised to accelerate deglobalization as it magnifies nationalist and protectionist trends?

Greg Peterson: 09:55

It would certainly seem that way; we've been in a sort of deglobalization period for some time. The pandemic, I think, has exposed that even more. And with countries looking to have security around their supply chains, I think you see that accelerated a little bit at this point. It doesn't mean that globalization has gone, but I think some areas will move back to more local production. So, you could see more investment in healthcare in individual countries, food chain, and so forth that would be brought home and local.

Greg Peterson: And that's one area that could also lead to a bit more inflation, Higher pricing. Not producing goods in the most efficient parts of the world tends to lead to more expensive products and higher prices. So, I would expect that that maybe a slight pressure on inflation just from changes within global trade.

David Fraser: **10:40** So just on inflation there—we've seen relatively stable prices now for, well, really over three decades. But the pandemic has caused large shocks from both the supply and demand side of things. How do you see COVID and the subsequent stimulus efforts impacting inflation?

Greg Peterson: **10:57** So far, it's been deflationary. The drop in demand or the sharp drop in demand has put downward pressure on prices in the near term. I suspect that will probably continue for some time. And what's interesting about this discussion on inflation is we went through this with the financial crisis in 2009 as well. Expectations that the vast stimulus at the time and printing money from central banks would be inflationary. And of course, over the last 10 plus years, we haven't actually seen inflation pick up, pretty much. So, it's a tough question. So I you do suspect that we will see inflation at some point in the next few years. I think we're probably safe in the next 12 months or so, but it would be reasonable just given the amount of liquidity and the amount of stimulus that's out there to see inflation start to pick up.

11:41 Governments around the world are taking on more debt. You could see a point where the debt and the fiscal stimulus that's being provided direct to consumers starts to push on prices somewhat. [The] deglobalization trend, as we mentioned, could also be somewhat inflationary.

So, I think you start to see it pick up sometime in the next few years. And I reserve the right to be completely wrong on that! One of the things we're very careful about managing is hold[ing] your opinions fairly lightly and be[ing] open to other possibilities, as well.

David Fraser: **12:10** I think that's been a tricky question for a lot of people, because if you had gone back 10 years ago and said that these events would have played out as we've seen...I think most people would have thought, "yeah we'd see a lot of inflation out there," but it just hasn't come to fruition. I think it's been a point of discussion and many people like yourself asking, "Where is it? When will it come about and why haven't we seen it now?" So, I do respect your right to sit on the fence on that one a little bit because I think a lot of people are doing the same.

David Fraser: So, based on all of these types of discussions, did any changes come from an asset mix perspective in Q2?

Greg Peterson: 12:47 There's no significant changes during Q2. We did allow equity weights to move higher with the markets within the portfolios. But we're still relatively cautious where we're standing today. We haven't made any large changes; we're pretty happy with our positioning for the most part. The portfolios are broadly diversified, and we'll continue with that for the time being.

So yeah, I would say that there's no major changes other than allowing equity weights to drift back closer to a neutral position, but still staying just slightly underweight on equities, given the uncertainty and potential for more volatility in the second half of the year.

David Fraser: 13:20 And the balanced funds that you manage, they're typically holding around 40% fixed income and cash. With interest rates so low, where do we generate yield or income from with those portions of the portfolio?

Greg Peterson: 13:33 Yeah, with interest rates as low as they are, income will decline as bonds mature and rollover. And so, much of the return, if you will, from the fixed income side is likely to diminish as we go forward. I always say this very cautiously, given that I can't give you a direct call, necessarily, on interest rates. The important part for us is to maintain that balance.

So, one of the reasons for holding bonds in the portfolio is a risk mitigator. And we'd expect that if we do get more volatility in the stock market, bond yields are likely to decline and provide some offset. And so that offset is not going to come from income so much as it's going to come from changes in bond prices, or capital depreciation… potentially equity markets selling off.

14:14 I would say that looking forward, if we're right that inflation eventually picks up someday, bond markets are likely to get wind of that much sooner and we should see bond yields start to increase somewhat again. So that would cause us to be a little bit more cautious on the bond side, perhaps hold a bit more cash. But again, as with everything else, I always reserve the right to change that on fairly short order, given that bond yields have been moving in one direction for many decades, and eventually we'd expect to see that change, but probably not just yet.

David Fraser: 14:44 So it sounds like we're not in the business of trying to chase yield by taking on more risk in that fixed income portion of the portfolio.

Greg Peterson: 14:53 No, in fact, the fixed income portion of the portfolio has been improving liquidity in the past while. So, credit spreads have narrowed with the bounce back in markets and they've taken that opportunity to add a bit more liquidity through government bonds within the portfolio.

David Fraser: 15:06 Just wanted to touch on something that was a little bit unusual—what happened this quarter with West Texas Intermediate (WTI) crude oil that traded at negative 37 USD a barrel on April 20th. Probably don't need to get into all the specifics of the situation—it's probably fair to say it was a storage issue—however, I was wondering if you could remind us of where the balanced funds stand from an energy exposure perspective.

Greg Peterson: 15:30 Yeah, it was an interesting time in April. Oil prices almost touched on negative $40 a barrel—so, you're paying somebody 40 bucks to take your barrel of oil for you. That was a highly unusual situation, but it did maybe highlight the very sharp destruction in demand for energy during the quarter. And then also storage filling up around the world as production was still in place and [it took] some time to make changes to that.

At Mawer, whether it's the balanced portfolio or looking at our other asset classes, or the component asset classes, we have a very low weight in energy. It's not that we've made a call necessarily on oil prices and what we expect there—in part it's low demand at the moment [and] some of the metrics around individual energy companies that haven't been as appealing as other areas where we can allocate capital. So we've ended up with a very low energy weight within our portfolios.

David Fraser: 16:19 Now focusing closer to home, the ratings agency Fitch recently downgraded the government of Canada's credit rating one notch from AAA. If anything, what does this mean for Canadians and Canadian investors?

Greg Peterson: 16:32 In short order it probably doesn't change things very much—the other rating agencies still maintain the AAA status for Canada's government debt. So, if you look at S&P for instance, they still have AAA there. Now, it is not all unexpected in this environment either. Governments are taking on significantly more debt. And I think as far as Canada is concerned, that's not likely to change things much, given that we're still one of the higher rated sovereign bond markets in the world, and there's still significant demand for bonds from Canada. That demand is likely to keep bond yields relatively low compared to other jurisdictions. So I don't think it changes the picture very much. There's significant demand, and that's not likely to change given that we stack up well against other sovereign nations.

On its own, you would expect a downgrade would or could lead to higher borrowing costs, but it is one slight move from one rating agency, so I don't think it has much impact in the near term.

David Fraser: 17:23 Listeners of our recent podcasts may have heard us speak about trying to be in two places at once. The thought there is, as markets react to the uncertainty of something like COVID, we try and maintain our diversification and invest in different business models that may benefit from different market environments. Are there a couple of names that you can touch on that paint this picture?

Greg Peterson: 17:45 Yeah, there [are] a few securities that we could talk about in the portfolio. So, some that have been added more recently to the Canadian portfolio is Ritchie Bros. Auctioneers. Now Ritchie Bros. tends to be a bit counter cyclical. So, typically in an environment like this when economics are not good, or you have a more challenging economic environment, [we] tend to need businesses that need to remove equipment. Things tend to go up for auction. It increases their business at times when other businesses are struggling. So that's one that would fit perhaps with this environment.

Other companies that could do well in either. So Granite REIT is a real estate company that's been added to the portfolio recently in Canada. So, Granite focuses on distribution centres and warehouses and logistics. So, very much fits the online purchases and shipping that we're seeing now. But that isn't something that's necessarily just with the current environment; [it] would also fit as things recover and as activity levels start to pick up as well. So they should benefit from both climates.

David Fraser: **18:46** Great way to relay what we're talking about back to the portfolio and why we try and maintain that diversification.

Looking ahead, now, there could be a lot happening in Q3 in the second half of the year. What are you most interested to see how it plays out as economies attempt to reopen and get back to some normalcy?

Greg Peterson: **19:03** I would like to see things just settle down for a while [laugh]. I think we've had enough movement in the last couple of quarters. Ideally we would see just a gradual and steady return of economic activity. Of course, things are never in a straight line, so we'll see some ups and downs with that. But really for us it's steady as she goes, not making any dramatic changes as we look forward.

Really, we don't look at just quarter to quarter anyway. We are looking out into the future much like other long-term investors. And so it'd be nice for *our* investors to see something a little steadier as we go through the next quarter. But we can hope for that.

David Fraser: **19:36** All right, thanks so much, Greg. That's very insightful. It's always great to get your thoughts and give us a better understanding of what's on your mind and what's happening with the balanced portfolios. Thanks for joining me today.

Greg Peterson: **19:47** Yeah, thanks David. And have a great summer.