the art of boring™

EP96 | Quarterly update | Q3 2021

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David Fraser: 00:41 Welcome to another episode of the Art of Boring Podcast! Thanks for joining us for the Q3 Quarterly Update. As always, there's lots to talk about today and joining me to do that is our Asset Mix Chair, Greg Peterson. Greg, welcome back.

Greg Peterson: 00:54 Hi, David. Always a pleasure. Welcome, everybody.

David Fraser: 00:57 So as I was saying, there was a lot going on in Q3. What was moving markets out there?

Greg Peterson: 01:02 If you look back at the third quarter, it depends on what point we're talking from [laughs]. I would have loved to have ended the third quarter after the first week of September because everything was going splendidly up to that point. And if you look at the summer, I think there's really two main drivers in the better parts of the summer—and that was very strong corporate earnings (earnings have been very good across the portfolios), and very low interest rates or negative real rates. And so those two things, in addition to those two other things, but those two things primarily helped to push equity markets higher through the course of the summer.

01:34 As we got into the last three weeks of September, that's when things started to change. And it's wonderful how well September and October seem to live up to their reputation, perhaps more so this year than we've seen for a little while, but we did get a few things come up in September that caused markets to take a pause or a step back as we got towards the end of the quarter. A few things such as the regulatory tightening in China; energy shortages that are taking place in some parts of the world; talk of policy tightening in the US.

So there's a number of things. And then inflation started to come back into the conversation. Not that it ever really left, but that also helped to create a bit of a pause towards the end of the quarter, so it was very eventful.

The events prior to September were very positive and the events in the latter part of September, not so much fun.

David Fraser: 02:16 So a little bit of a pullback in September and the majority of investors probably have been a little bit spoiled with solid returns since the COVID sell-off. What are you saying to those clients who have been rattled by the recent volatility in September?

Greg Peterson: 02:29 Yeah, it's been a little while since we've had much of a pause or disruption. Actually, maybe not that long—I have to go back to the first quarter of this year—it seems very distant. We did get a bit of a turn in markets back then, as well. So it hasn't been terribly long, but it is just the natural course of equity markets, and to some extent bond markets as well. They can't go to one direction every day, forever. If they do that, they get well ahead of themselves.

02:52 Equity markets are a collection of human behaviour and human behavior tends to react and sometimes overreact in certain directions. So, I think the markets over the summer probably overreacted a little bit to all the optimism that was out there and got a little ahead of themselves. And currently we're seeing that come back to a bit of reality and just a bit of a pause.

Capital markets tend to get tired. Stock markets in particular can get a little bit tired, and I think that's where we were. And we also go through an evaluation in the fall, looking forward to the next year, and so you get this reevaluation of where we're at. And just probably a heightened sensitivity or a focus on some of the uncertainties and risks that are out there right now as well.

David Fraser: 03:28 So one of those risks that's making headlines is supply chains and they seem to be fragmented at the moment. What does that mean for inflation in the economy?

Greg Peterson: 03:37 For now it means inflation's running hotter than it has for quite some time. I think the numbers here in Canada is we're at an 18-year high for inflation. Germany is running at a 30-year high for inflation.

So, we have talked about this a lot this year, and it's been expected that inflation would be running hotter coming out of the pandemic for a variety of reasons—supply chains and shipping being two of the major bottlenecks or causes of higher inflation at the moment. I think it's also proven to be maybe just a little bit stickier and perhaps slightly less transitory than it was talked about earlier this year, but that's really what we're running into at the moment.

Greg Peterson: 4:11 If we wanted to look forward a little bit, I still believe that much of these issues and items will eventually iron themselves out. And we may come out of this with somewhat higher inflation than we had perhaps a couple of years ago, but a lot of the supply chain issues will eventually work their way out. It's just going to take some time.

David Fraser: 04:26 So, one of those talking points is the conversation about labour markets and that seems to have switched: not long ago, employment in the U.S. was about 10 million below the pre-pandemic level. And the main question was how difficult it would be to get those workers back on the job. Now, business commentary is all talk about labour shortages and stories about employers struggling to find workers.

What's going on there in the labour market? And how does that affect investors?

Greg Peterson: 04:54 Bringing people back into the labour force or finding labour in general has been a bit of a problem, especially in the United States. As you mentioned, that's pushed hourly wages higher for now. So that too, I believe, will iron its way out over time, but it is one of the things that's watched very closely by ourselves and by central bankers.

So, the employment picture is usually quite closely tied with the inflation concerns. If we have higher wage numbers that's ongoing for some time, that can create stickier consumer inflation as well. So that's one of the key metrics that we continue to watch. In the short-term that causes a bit of a challenge, but as I said, I believe over time you'll see that generally smooth itself out as well.

David Fraser: 05:32 Yeah, I guess we'll have to wait and see there and hopefully it does smooth itself out.

One thing that's been in the headlines— I'm sure listeners and anyone following the market would have heard about—the Chinese property developer, Evergrande. Can you tell us why they are in the headlines? What they do, and if we have any direct exposure here at Mawer?

Greg Peterson: 05:51 Yeah, you've probably seen Evergrande pop up in a lot of headlines in the last while. So, Evergrande is a large property developer in China building largely residential properties in many, many cities across the country, and really developing that at far too rapid a pace and very highly leveraged as well.

Greg Peterson: 6:10 And that's where they're running into part of the problem: the leverage of the company. So, there's roughly 300 billion U.S. [dollars] in liabilities that the company has, and about $86 billion [U.S. dollars] of that is indirect debt. And when you're moving this fast, cash flows aren't able to keep up with servicing that debt. And that's just one of the concerns with Evergrande at the moment. Continuing sales of the property to pay off debts—this is another piece of that puzzle for them as well. And then the bigger concern there is that this moves into the financial system and causes larger credit problems.

06:39 So, if one very large domino like this falls, how many other dominoes within the financial system fall as well? And so the risks seem largely contained within China and some investors think that way as well. Our own teams went through our portfolios just to see if there's any direct exposure to Evergrande, and there's no direct exposure within our portfolios to Evergrande. They always want to be very conscious of any other indirect exposures or problems that may come up from this as well. So far it looks like it's largely a Chinese problem, and others that invest there, but not something that should have a direct effect on us. And China should be able to contain that as well. I do believe they'll let the shareholders and Evergrande take the hit on this. So they are willing to take more, a bit more pain in their system than they have in the past, just to try and undo some of these imbalances that have developed over time.

David Fraser: 07:29 Yeah it seems like the market's shrugged off those concerns for the time being.

If we look a little bit closer to home, we had a relatively uneventful Canadian election in Q3. Not much has changed—pretty much status quo there [laughs]. Did we learn anything along the way? Are there policy changes that we're watching out for?

Greg Peterson: 07:46 Well, I think we did learn that an election costs over $600 million in Canada, so we did have that incurred. Looking at employment numbers, it did help to employ a few more people in the last couple of months as well, so there's maybe a direct benefit for some people. The election itself I don't think changed the landscape for us at all, so policy-wise, I don't think things changed very much. And so I'd look at the Canadian election largely as a non-event for the most part—at least as it relates to economic policy and our portfolios.

Greg Peterson: 8:13

And I think political direction globally has already been moving for the last few years in terms of bigger government and bigger spending, so I think we have more of the same to look forward to.

David Fraser: 08:23

Well that's great—I'm glad we figured out how much an election costs, that was weighing heavy on my mind; I was losing sleep about that one.

Sticking with Canada here: the energy sector was up 9.3% in September and was the only S&P sector in the positive. How does a move like that impact Canada?

Greg Peterson: 08:41

I'd say overall, it's beneficial to Canada right now. So this tightness in energy markets globally partly caused by demand continuing to pick up. And then you do have some disruptions such as Hurricane Ida coming through the Gulf of Mexico that disrupted U.S. production for some time. So we're sitting with higher energy prices right now, which naturally Canada's energy sector does benefit from. Some of the bottlenecks here for moving our energy is improving—such as the Enbridge Line 3 that's come online recently, improving exports to the United States. So, I noted that Canada has been shipping in excess of 4 million barrels of oil per day to the U.S.; that hasn't happened for a while. So overall I think this is a direct benefit to our country and naturally to Alberta and oil-producing regions as well. It's nice to see after the sector has suffered for some time.

David Fraser: 09:29

Yeah, I'm sure local oil producers here in Canada are enjoying the respite for the time being, which is great. Over to the asset mix side of things now: did we make any significant moves there this quarter?

Greg Peterson: 09:40

We made some changes in the course of the summer. So, we did trim equity back slightly—largely from the [Mawer U.S. Equity Fund] and [Mawer International Equity Fund]—and really, just to cash. So this was just part of our ongoing strategic changes within asset mix: making sure that equity doesn't push higher than we want to have it, however the exposure within the portfolios. For instance, I talked about the first part of the quarter being very strong. Naturally, equity drifted higher as a weight within the portfolios. So this was just a natural trim to keep that under control and keep it from running higher. So there's no significant move from that perspective. We did leave the [Mawer Canadian Equity Fund] weights to drift higher, so as a percentage within our portfolios, they're higher than they were at the beginning of the year or at any time last year.

Greg Peterson: 10:20 We do have somewhat more exposure to Canada from that perspective, but we're not likely to change it much going forward. Of course, I always reserve the right to change that in any given quarter, but we still have a few concerns with Canada. And we've mentioned them in this podcast before, as well. Part of that has to do with our reliance on housing in our country; residential real estate isn't the great way to build an economy entirely, and to be that reliant on it for jobs and growth. But we have been, and those prices are naturally very high—as people are likely experiencing at the moment. And we're likely going into a period of rising interest rates. So, when we have high levels of consumer debt, reliance on residential and the prospect of rising interest rates, it creates a fairly big challenge I think, for the economy going forward. And that's likely to limit our exposure to Canada from where we're at today.

David Fraser: 11:08 So we increased the exposure to Canada, but you pointed out some of the headwinds there. So I guess there's no such thing as a perfect investment [laughs].

Greg Peterson: 11:15 Beautiful country, just has some economic concerns.

David Fraser: 11:18 In an environment where real yields remain in negative territory, do we still feel that the long-term risk-return favours equities over cash and bonds?

Greg Peterson: 11:28 Yeah, we definitely still favour equities over cash and bonds, even on a risk-adjusted basis as we're looking forward. And of course, we're always looking over the long term, so we're not trying to be tactical with asset allocation and move it significantly based on short-term expectations. But given this environment that we're in that you mentioned—with negative real yields and really just low interest rates overall and corporate profitability still very good—equities are still a good place to be, despite the fact that we expect volatility to pick up.

11:55 And I do feel like we're a bit of a broken record on that. I'm sure we talk about expecting higher volatility all the time, but when you have a change in economic scenarios taking place, you're faced with central banks starting to shift policy as well. And some of the other uncertainties we've already talked about. So, anytime you have more uncertainty, you're likely to have more second-guessing within the stock market. And so you'll see more volatility take place as well. So going forward, we're still very confident on equities, still maintaining a very diversified approach, but we do expect or anticipate that there'll be more volatility going forward as well.

David Fraser: **12:29** I wanted to ask you as well on the correlation between fixed income and equities in a typical balanced fund. If fixed income and equities are expected to move in opposite directions for the most part, we've seen both equities and fixed income rise in recent times, with a little bit more volatility we saw in September. Did that change? Are equities and bonds still inversely correlated, meaning they still create that diversification benefit?

Greg Peterson: **12:54** Correlations are not fixed over time. They do change. And we did see towards the end of September and into October that the correlations between equities and bonds increased. So we had both markets falling at the same time. You could argue that the higher bond yields are perhaps what contributed, or definitely contributed, to equity markets slipping in the last little while. So that would be an increase in correlation between the two markets. This does happen from time to time as well—where you'll have both bonds and stocks falling at the same time. It's one of the things that we don't like to see happen, but it does happen. And that'd be one of the risks looking forward too, is that you have higher bond yields. Whether that's driven by bond investors' expectations of the economy, inflation, central bank moves, or what have you, that likely would lead to some repricing in longer duration stocks. With technology stocks, growth stocks that are being priced based on future cash flows—[those] tend to be much more sensitive to that.

13:46 We have seen that in the last couple of weeks. Similarly, we saw that earlier this year in the first quarter take place as well, so a bit of a rotation in equity markets. But I still expect that the relationship between stocks and bonds holds longer term.

After we get through some adjustment on bonds to what the near-term or the short-term future looks like, you should get back to that negative correlation between the two. That doesn't mean that we don't go through periods like this where they're both moving in the same direction at the same time. And even if that relationship held for a period of time, when we look at things from a risk management perspective, I always say, and people remember me mentioning this, that a bad day for bonds is never like a bad day for stocks. So from a risk management perspective, bonds still reduce volatility in your portfolio even if both markets are falling at the same time.

David Fraser: **14:32** Absolutely. Always a benefit there of bonds. And I wanted to touch on inflation again as well. I know we've talked about it in the past, but perhaps I'll come at it a slightly different angle and say, you can't predict it, however, I just wanted to get a sense of how you think our portfolios would fare if there was higher than expected and prolonged inflation.

Greg Peterson:	**14:53**	High inflation and prolonged inflation is our chief risk when we're looking at our portfolios and looking at things from an asset mix perspective. So, that would be the one thing that definitely keeps me up at night. However, as I mentioned earlier, I don't think that that's where we're heading, but we also don't predict. And we also don't manage portfolios based on those predictions. So, the approach for us really is the diversity that we have within the portfolio, the security selection completed by our Research Team and managing each of the underlying asset classes—understanding that there's perhaps some risk to that. But higher inflation would lead to higher interest rates, and higher interest rates naturally is the bond markets going to adjust lower based on higher interest rates and higher bond yields. Long duration equities are going to be challenged by that and be a headwind there for returns as well.
Greg Peterson:	**15:37**	If we are faced with a higher inflationary environment, I think one of the benefits of our research philosophy and process is that the companies we invest in tend to have a strong competitive advantage that allows them to pass on some of the pricing or perhaps advantages on the supply side of things as well to try and maintain their cost levels. So, the quality of these businesses is in part what helps us to work through periods of higher inflation. We're both looking for companies that have pricing power, the ability to pass on costs. or the ability to manage their costs better than their competitors.
David Fraser:	**16:07**	I think that points out a very important piece of our investment approach. We look for companies that have strong competitive advantage, high barriers to entry—meaning they can pass on that cost to the end consumers. And that's just...we're not doing that as a prediction of inflation, we just do that day to day because we think those are the best quality businesses.
Greg Peterson:	**16:27**	Yeah, that's the one thing that's within your control—is understanding the businesses, understanding the companies that we invest in. We can't predict the future on the macro side of things, so it's important to focus on what we can.
David Fraser:	**16:38**	Yeah, an important point there. Global GDP has now surpassed its pre-pandemic level, but output and employment gaps remain in many countries, and that's particularly in the emerging markets in developing economies where vaccination rates, unfortunately, are remaining a little bit lower. As we look to the asset mix, do you favour developed versus developing markets as the reopening continues?

Greg Peterson: **17:01** Yes, in the near term, I think COVID is better controlled in developed markets. I think the recovery and economics and developed markets, as you mentioned, has also been better. So, in the near term, we would favour developed markets. And of course our asset allocation and the allocation within our portfolios is largely developed market to begin with. So, I think that the headwind and challenge for emerging markets will continue for some time. And we don't make the change to fully pull out of emerging markets.

17:26 Just to give you an example of some of the exposures in the portfolio, we have about 1.5% of the [Mawer] Balanced Fund invested in China directly, so it's a relatively low weight, but we do look to emerging markets to provide long-term growth. So I think as we get past all of the effects of the pandemic—supply chain problems and so forth—we'd likely go back to a relatively slow growth environment in the developed world. And it would be the developing or emerging market world where we look to longer-term growth for a variety of reasons. One is just the growth of the middle class around the world and increased demand for goods, and they have a demographic advantage in many cases as well.

David Fraser: **18:00** When I speak to clients, I do get a little bit of concern with including emerging markets in portfolios, but that's the beauty of that bottom-up approach that we have—where we're going through these businesses one by one and trying to find good quality businesses and, hey, they can exist in these developing markets.

Greg Peterson: **18:16** Yeah, absolutely.

David Fraser: **18:17** So coming back to North American now—how do you feel about things in the U.S.? The government's debating infrastructure funding and the debt ceiling's come up again and it looks like we get the pleasure of revisiting that on December 3rd as they extend it down the road. What's happening in the U.S. there, and how's it affecting investors?

Greg Peterson: **18:36** The U.S. is still in good shape, despite some of their self-imposed problems like the debt ceiling. So, the debt ceiling is an artificial credit limit that the government imposed on themselves many years ago in the United States that other countries don't suffer through. They'll get past that. It's in nobody's interest for the U.S. to default on their debt. And I think that they, well, they should be able to get past some of the partisan wranglings down there on that. Whether this is something that's noisy in the near term, and we'll get past that eventually—the U.S. economy continues to be very sound.

19:04 I think our only challenge with the U.S. currently is that stocks in the U.S. are probably a little bit more expensive than other parts of the world as well. We've probably seen the better part of the return there, and so that continued economic growth is not likely to translate into as strong of returns as we've seen from the U.S. for the last decade or longer. That's not forecasting [laughs], let's just be clear: just look at where we're starting from today and expectations to some extent—the U.S. is always a core part of any global portfolio. And so that doesn't change from that perspective.

David Fraser: **19:36** Absolutely—makes up a big part of the global economy. And is there a heightened possibility of de-globalization post-pandemic as countries try to shore up supply chains for critical goods and reduce foreign dependence? It looks like there is a little bit of de-globalization going on there.

Greg Peterson: **19:54** Yeah, the un-globalization trend has been taking place for several years now. And as supply chains are brought more local, it is likely to increase costs over time, so that could pressure corporate margins and then profitability. We'd expect that that'll be a challenge going forward. That is one factor in the inflation equation as well that comes up and contributes there. So, there are things being brought home. And if you look at the United States at the moment—and the computer chip shortage has been talked about a lot globally—there's a couple of very large plant developments taking place in Arizona from both Taiwan Semiconductor, as well as Intel developing their new plants in the Phoenix area. So they are bringing this back. And then, this is part of what takes time. You can't just build a semiconductor manufacturing plant overnight; it takes quite some time to get that up and running. So this is what gives us some confidence that we get past a number of these supply issues, but it takes time to build them. And it's also another example of starting to bring some of the supply back local.

David Fraser: **20:50** I think that's an important point you make there, which is innovation. And we can't underestimate innovation and management. Who better to know their businesses and make those adjustments?

Greg Peterson: **21:01** Yeah, and that's a key aspect of our investment philosophy as well—is the management teams. Capable management teams that are able to adjust and adapt their businesses to a changing environment. And that's why we can invest in these companies for a long time without moving in and out—because we have the confidence in their management teams to adapt as they go forward.

David Fraser:	**21:18**	All right, Greg—well, we're coming to the end of the podcast here and you're almost off the hook. Just got one more point to make, and give a quick shout out: I hear we added one more listener to the podcast, which is always great. And I hear your sister's tuning in now.
Greg Peterson:	**21:31**	[Laughing] I told her to do a shoutout to her in the podcast.
David Fraser:	**21:34**	All right—Greg, thanks so much for joining us again today. On behalf of listeners, we really appreciate you sharing your thoughts. We'll see you again next quarter!
Greg Peterson:	**21:42**	Thank you. And I'd like to wish everybody well as we go into the fall.