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David Fraser: 00:41 Welcome to another episode of The Art of Boring podcast, thanks for joining us for the Q2 Quarterly Update. Our Asset Mix Chair Greg Peterson [is] joining me today. Welcome back, Greg.

Greg Peterson: 00:51 Thanks, David, and hello everybody. Hope everybody's getting the summer off to a good start.

David Fraser: 00:55 We missed your thoughts last quarter so we're expecting big things today.

So, we just past the halfway point of the year and we're pushing up against all-time highs in the U.S. What's been moving the markets of late?

Greg Peterson: 01:07 Yeah, it's been a pretty good quarter and really, year-to-date has been good as well. The equity markets have been behaving nicely if you don't look at a lot of the day-to-day noise. And the high-level themes haven't really changed that much, David. I was looking back over the last six months given that it's been a little while since I've been on the podcast, and if you look at things from a very high level and sort of ignore a lot of the noise that comes through from time to time, things haven't changed a great deal.

So, the primary drivers for markets are still expectations around growth—and we do see economic growth continuing to rebound from the pandemic from last year. So growth is really driving markets. That growth has translated to good corporate earnings from many different industries. And we still sit in an environment of low interest rates. Those things combined really have been the primary drivers for equity markets and also based on expectations looking forward.

David Fraser: 01:55 With that in mind, as we look to corporate earnings, as things open up, what are we seeing there? Because that's a bit more of a tangible takeaway, isn't it?

Greg Peterson: 02:03 Corporate earnings have been very good, especially as we look through our portfolios. We've been very happy with results thus far. And I think part of that too, is when we look at the high-quality businesses that we invest in, the companies we have have very strong, competitive advantages; they tend to have a more reliable revenue stream, for the most part; they're somewhat less cyclical. And so if you look at the market as a whole, though (you have all the companies in the market, basically), there are some sectors where things are starting to bounce back a little differently.

If you look at some of the service sectors that have been closed down or greatly restricted from the pandemic, they have a lot of room to improve still as we come out of this. But really, for a lot of the goods-producing companies and other businesses, [such as] technology companies that we invest in, has been pretty steady. So, it's not that we're having to go through a large recovery with them—these businesses have been steady throughout, and we'd expect that to continue as we go forward, as well.

David Fraser: 02:53 Yes, And that's, as you say, very indicative of the type of companies we like to hold, don't we? The ones that are a little bit more resilient to the downside there.

Greg Peterson: 03:00 Yeah, exactly.

David Fraser: 03:01 Speaking about growth, some are forecasting extremely strong growth for 2021: as high as 6% or so. Is there any concern that markets are priced for perfection and there's too much optimism out there?

Greg Peterson: 03:14 One thing I'll just say about the growth numbers—so, there are very strong growth numbers in much of the developed world; some areas of the emerging markets maybe slowed a little bit, and those are still a rebound number as well. So, economic activity in North America is pretty close to where it was pre-pandemic, and so we still have these growth rates continuing to roll through with a bit of momentum. Some of that's based on stimulus programs that continue, so, central banks continue to have their monetary stimulus programs in place, [and are] starting to taper and perhaps announce some changes that are up and coming. We have a great deal of fiscal stimulus that's still in place; government programs are still out there. And so there's a lot of liquidity and consumers have a lot of cash available to them to continue this growth. So, I think we see that going through this year.

03:55 Markets are certainly reflecting that. So, there's no secret that this is a very common theme and all investors are looking at pretty much the same story: stocks have done well. I'm not sure if they're priced for perfection, but they're definitely reflecting these expectations around growth. And so they are somewhat higher.

Greg Peterson: 04:12 I think you mentioned earlier, "bumping up against record-levels for markets," and it's not that there's a ceiling—growth will continue to contribute to higher numbers as we go forward. But it does leave less room for error right now. So, typically when markets have done well—really, have all these rosy details built into them—it does set them up for potential to disappoint or hold back somewhat. So, I wouldn't be surprised—and I think I said that last time too, so I apologize if I sound like a broken record—I'm never surprised if we have a bit of a market pullback or a correction.

That's something that could come in, maybe; a bit more likely when we're priced this well. And part of looking at that too, is just the fact that the equity risk premium is relatively low. So there's not a lot of margin for error built into stocks at the moment. I don't want to come across as being negative—we still expect that there's room for stocks to continue to grow and contribute, but they are pricing in most of the good news.

David Fraser: 05:04 And just to add to your point, I think members of our Research team—they're often speaking with different institutions to get a sense of what's going on—recently spoke with a major financial institution here in Canada, and that organization pointed out that they, like you, were relatively optimistic. In the economy we've got World War II levels of fiscal stimulus, wage growth, housing shortages, and strong consumer balance sheets. So, it sounds like you're in agreement with them where we might be in a slightly better position coming out of the pandemic as compared to similar situations we've experienced in the past with financial uncertainty.

Greg Peterson: 05:39 Yeah, I think we're in a pretty good position for the most part. If we're speaking about Canada in particular, the Canadian economy has benefited from this reflation trade and the boost in resource prices as the world opens up and activity levels resume. So that's been a strong contributor to Canada. We still have room for employment to improve in this country, although that's come back a long ways, too. I think the unemployment rate is just within 2% of unemployed coming back. So, that's largely recovered for the labour market. I still have some concerns about Canada, so I wouldn't agree with them completely—a good portion of our economic growth is still reliant on real estate and housing in particular. And I've mentioned before that we have some concerns that that's not reliable for a very long period of time.

Greg Peterson: 06:22 So, while that can contribute to the Canadian economy for now, I still think that that poses a headwind at some point. Good thing we're not market timers because I'm not sure when that point is, necessarily, but I don't think it's reliable over the very long term. The Canadian economy continues—or it needs to continue—to diversify in advance. And nothing may come of it from the housing sector; we may just work through this over time. Similar concerns around household balance sheets in Canada: while they've improved, they're still relatively high, and high real estate prices don't help that much. So, I think that becomes a bit of a headwind, but beyond that, Canadian economy still has room to improve.

David Fraser: 06:57 And, being Canadians, one thing we do is we always look south of the border to some extent—Biden's been in office there for a few months. What are you keeping an eye on there? Have there been any significant moods or proposals that are worth looking out for?

Greg Peterson: 07:11 Yeah, there's probably a number of things to watch because we don't watch government terribly closely; government policy does help to shape the economy and economic environment to some extent, but it's also very slow moving. So, maybe a couple of key points on policy in the United States would be around tax and corporate tax in particular. So that could be a real cost to business. As these things work themselves through, they may or may not have much of an impact, so we're very careful about the noise in the near term and what that translates to. Effective tax rates can often be different than the stated tax rates as well.

07:43 So our team continues to work through that. That's not so much a macro or asset mix concern, it's more considered and looked at from [a] security selection [standpoint], so, [as] our Research team pick companies and evaluate the companies that they invest in, it's a bit more significant in their world. And then from the macro side of things too, is just the fiscal spending—the other big piece of the U.S. policy at the moment, infrastructure spending and so forth. If Biden's able to move through much of what he's trying, that could be a good tailwind for the U.S. economy for time to come.

David Fraser: 08:14 Another point we've spoken about on this podcast in the past is inflation—it continues to create headlines, so I couldn't resist asking you about it today. But as you pointed out, we're a bit more long-term focused. So, do our thoughts on inflation differ from someone who might have a bit more of a short-term focus?

Greg Peterson: **08:33** I think our thoughts on inflation is...I'm not so sure we're as worried as you hear [what comes] up in the media or other pundits from time to time. We're looking very long-term for the most part, and as you mentioned, not so concerned on the short term. So, we have concerns around inflation as well—I would say that over the next few years, that's one of our key risks: inflation naturally has an impact on real returns, interest rates, and discount rates for stocks. It affects everything: both the stock and the bond market. However, I would say that we're not overly worried; we've been in a very deflationary world for some time. And as much as numbers have picked up in the past few months, which was widely expected and we talked about previously, I don't think that there's been too many surprises.

09:13 If you look through the inflation numbers and some of the things that have caused it to percolate up, one is the base effect which we talked about before, just the comparison year over year. That has an impact. Then we've had many supply disruptions in the past year as well, some of them COVID-related early on. As economies shut down, suppliers were also shut down for a period of time. It's not like a light switch you can just flick on and things come back again. That can take quite some time. Semiconductors and computer chips are a good example of that—you can't just flick a switch. It actually takes some time to make a chip. So it takes time for that supply to come back online. And that's had a very real impact on the auto industry, which has also been widely written about as well.

09:53 New car shortages have led to a spike in used car prices. Used car prices have translated into a bump in inflation, and that's something that will smooth out over time. And this is one of the reasons why we're not particularly worried in the short term. That'll gradually work its way through, and we'll get back to normal. I would think that the inflation may stick a little bit, so we're maybe not going back to very low rates of inflation, but perhaps averaging more what the central banks are trying to target—somewhere in around the 2% neighborhood or perhaps a little bit warmer. That's not concerning, I would say. And it's also highly anticipated. And quite frankly, the central banks have been trying to get there for the better part of over a decade, so if we can get there, then that's great [laughs]. But I'm always a little skeptical, and so we'll continue to evaluate that over time well.

David Fraser: **10:39** Well, that's a good well-rounded explanation there. What I was impressed with most is you avoided the use of the word "transitory," which has been the big buzz word of late.

Greg Peterson: **10:48** I was trying very hard.

David Fraser: 10:50 [Laughs] Well done. So, another thing that often moves markets is interest rates and central banks have a lot to do with that. What are we expecting in the way of interest rate moves as the reopening continues?

Greg Peterson: 11:03 Interest rates have been a hot topic for the last six months or longer—we did see that bump in bond yields as the bond market normalized to pre-COVID levels or pre-pandemic levels in the first quarter. And then since then we've seen bond yields gradually ease back down again. So they've retreated somewhat. I think some of the concerns around where interest rates are going have retreated somewhat as well. And fortunately, we're not predictors—we're not basing our decisions on predictions—however, if we look at the sort of longer term trends, it would seem likely that bond yields and interest rates do gradually move higher. We've been talking about this for a little bit as well. It's not that necessarily that they're reacting to fight inflation, it's just a recognition that economic growth is pretty sound.

11:45 And so we may have seen a peak in growth because we're rebounding from the pandemic. However, growth rates are likely to continue to run relatively high, and so interest rates will adjust to that and move somewhat higher as well.

I don't think they move significantly higher; it's not that we have to jump or double rates from where we are currently, but they should gradually move higher in the next, say, year and a half or so. And I don't think that that changes the story much. So, if that's the case and interest rates move a bit higher, it may have a slight impact on bonds in the near term. That's something that can be worked through over time and equities would likely adapt to that as well. So I don't think it ends the market story from where we are today.

David Fraser: 12:27 So it sounds like you're a little bit less concerned than the headlines might suggest with regards to the impacts of interest rate rises?

Greg Peterson: 12:35 Yeah. I find headlines are a little difficult. They have more of a...I don't know if I'd call it a trading focus or a short-term focus or just a need to explain what's happening right now, but we have the benefit of stepping back and trying to look at the more secular picture than try to piece that narrative together.

David Fraser: 12:51 Yeah, and that's the beauty of that long-term focus, isn't it? So we've covered a lot of topics there. And as you say, it's the topics we've covered before—they continue to lead the headlines, I guess. All of that being said and all of that discussion, have there been any significant asset mix changes this quarter?

Greg Peterson: **13:07** So, there's been some minor adjustments to asset mix, which is typically how we roll. It's a very iterative process in terms of adjusting asset mix, the markets do some of it for us and some of it we add as well.

So, if we look at asset mix in our Balanced Fund, for instance, since the beginning of this year, Canadian equity weights are higher than they were at the beginning of the year. So that's been both deliberate as well as the recognition that Canadian markets have been among the strongest in the world. So we've had a bit of market drift there. We've also been having slightly on the International [Equity] and Global Small Cap side—and this is partly looking forward to rotation in growth—so, likely moving away from the United States as we go forward. And by growth I don't necessarily mean economic growth; I expect U.S. economic growth to stay good. But their market's already priced for that, so I would expect to see more of a rotation away from the United States.

13:56 And that was also part of our rationale for adding the Emerging Markets [Equity Fund] to our Balanced Fund. We already have emerging markets exposure through some of our other asset classes and International Equity and Global Small Cap, but we did add a deliberate weight to emerging markets and increased that in the first half of the year, also. And if we look at where we're at today, emerging markets have not performed as well, partly because COVID is a little bit more difficult to control there, vaccine rollouts have been uneven. But as we look forward, we'd expect that vaccine rollout to improve, those markets to open up more reliably, and also benefit from growth in the developed world.

David Fraser: **14:33** Yeah, there is a bit of a divergence there, isn't there? Between the developed world and emerging world. So, from an asset mix standpoint, how we are attempting to or are we doing anything differently to try and capitalize on that? What could potentially be an uneven economic reopening?

Greg Peterson: **14:50** Our most deliberate move there is always to stay well diversified because we don't know which markets are going to perform as well. And we always hold many of these views lightly, so we do make some adjustments to asset mix to try [and] improve the opportunities for the portfolio as well as to manage the risk side of the equation. But we generally stay very well diversified.

David Fraser: 15:09 And the cash weighting in the asset mix—that's often an important component to building a resilient portfolio. I was just curious...have there been any significant adjustments as we've moved through the pandemic? So from the pre-pandemic world to the sell-off last March, to the recovery that really began from there to present day... have there been any significant shifts there?

Greg Peterson: 15:30 Yeah, the shift to now from late last year has been to reduce cash. We have very little cash in our balanced models. And that's really a recognition of the growth that we're expecting as well as low interest rates. There's not really a benefit to hold much cash at the moment. Eventually we may see some headwinds come up that would cause us to scale back to equity weights, such as the disappearance or the reduction of the equity risk premium. But for now, we're relatively happy with the lower cash weight. We don't have a need for that liquidity, so we are fully invested. Our equity weights are as high as I can recall them being and we balance that with the bond weight that we keep in the portfolio as well.

David Fraser: 16:08 Fair enough. So, staying fully invested and keeping that cash weight low because there's not a lot of reward there for it.

Greg Peterson: 16:14 No, there's not a lot of reward. And so anytime we make a decision on one asset class or to add or to reduce, it has to come or go to another one. And right now equities continue to look like the brightest space for us, which is why the cash levels are quite low. And also being long-term investors, there's not a real benefit to holding cash or much of it. And the other piece that I'll add there too, that we continually talk about, is we're not tactical, so we're not trying to time markets. And so we're not into cash and out of cash on a regular basis. This is very much how things tend to flow.

David Fraser: 16:45 Obviously not being tactical, but I'll ask this anyway—so COVID's created huge dislocations in the economy, and as we recover, economic data has been unusually noisy. The standard adjustment statisticians make to smooth out things like seasonal variation...they don't work as well in this environment, which has been distorted by the pandemic.

So, are we doing anything different to try and understand what's going on in the global economy? Knowing that the data is a little bit harder to wade through at the moment?

Greg Peterson:	17:17	It's a good point, David. So, economic data is a challenge at the best of times, and it's even more challenging in such uncertain times or sort of different times that we're going through currently. And fortunately, we don't live by the data that closely. We certainly study it and understand it; and keeping it high level I think helps as well. You can make some adjustments to, for instance, economic data or economic growth data. We know that the numbers are running very strong right now. We can also sort of determine the story around that in terms of why that's taking place. And then also building on that to say, well, where did we go from here?
	17:51	And if we look at GDP numbers running relatively hot at the moment, as we get through much of the stimulus and towards the end of this year, perhaps into next year, I think we're back to where we were before with a relatively low growth story in much of the developed world. And so that's really what we try to do: try to look at it from pretty high level, go back to where we were prior to the pandemic, and then our expectations of where we come through this as well.
		So, I think it can be done. If you were actually to have to nail this down, to figure out data month to month, that would be very difficult. But if you're working on secular themes, I think you can still make a rational case for where you expect things to go from here.
David Fraser:	18:29	Are there any indicators that you are leaning on in particular at the moment, that you're paying particular attention to?
Greg Peterson:	18:35	I think if we had to boil things down to one measure, it's probably the employment numbers and the labour markets. Labour markets do a couple of things for us. One, is if businesses are hiring, you're getting a good sense of...sort of ground-level and business expectations for where things go from here. If they're hiring, they expect things will improve and continue to grow. And so that's a good indicator from that perspective. And then from a macro picture as well, labour numbers and employment give us a good sense of slack in the economy or where we are from there too.
Greg Peterson:	19:05	So it gives us a fairly good read in terms of capacity within the economy. We still have a fair bit of capacity on employment numbers in the United States, but that would be expected to close sometime next year as well. And that relates to the inflation story. So, employment is also a good lead for us on where inflation may go from here.

As much as we give our opinion currently on where things are, we know that that's going to change day-to-day...or not so much day-to-day, quarter-to-quarter perhaps. Or as we go through [the year and on]. We're always very cautious of that and know that that will gradually change.

David Fraser: **19:37** Well, thanks, Greg. On behalf of listeners, thanks for being here today and sharing your thoughts again. Appreciate it.

Greg Peterson: **19:42** Yes. Thanks, David. And stay safe and I hope everybody enjoys their summer.