Investment Commentary: 6/2019

The stock market appeared on easy street the first four months of the year, riding a wave of enthusiasm from central banks dovish signals and the possibility of a trade deal between the US and China. It was a comforting combination, however the market quickly turned in early May when President Trump signaled he would be moving ahead with tariff increases on imports from China. Since then, there has been a lot of accusations and inflammatory remarks on both sides, which led to a stock market sell-off through out the balance of May. The S&P 500 finished the month down 6.4%, while small-cap stocks were down even more at 7.8%. Foreign stocks also sold off but to a lesser extent, the MSCI EAFE was down 4.7% while emerging market stocks were down 7.2%.

"With trade conflicts escalating, most of the impact has been felt in the equity markets, rather than the economy"

With trade conflicts escalating, most of the impact has been felt in the equity markets, rather than the economy. However, the bond market is currently signalling there may be issues ahead for the economy. As of early June, the bond yield curve has inverted with the 3 month yield higher than 10 year yield, a signal that is often considered a predictor of recessions. It's important to note there are other technical factors (negative yields around the world) that may be causing the yield curve to invert, making any prediction of a rescession less reliable than history would suggest. **To get a better read on whether the bond market is sniffing out a recession, we will be keeping a close eye on credit spreads. Credit spreads are often a telltale sign of any economic weakness ahead, particularly the high-yield market which represents the companies most at risk of a default in an economic downturn.** At this time, spreads have moved slightly higher but not enough to signal a pending recession. Should credit spreads start to widen sharply we would get a little more worried about the economy and stock market.

In this month's commentary we discuss secular themes that have the potential to disrupt the financial markets. We also discuss the outlook for emerging market stocks and highlight an interesting presentation from Cliff Asness we recently attended at the Morningstar Investment conference.

Secular Thinking

We have written over the years that one of the advantages investors have over the broad market is "Time Arbitrage." Which simply means using a longer term view to implement your investment strategy and using the market's short attention span and continual overreaction to "financial noise" to your advantage. To help form our long term investment views we like to tap into the thinking of firms we respect. When it comes to forming a secular opinion of the world, PIMCO is one of the very best. Here are some of the highlights from a secular forum they recently hosted:

One areas of discussion was secular trends that have the potential to disrupt the global economy, financial markets, and investment portfolios in the next three to five years. Here are the five secular trends they came up with and one trend they identified as a "super-secular" factor that will have major implications beyond the 3-5 year time horizon. Note all of the below have the potential to disrupt but may not, we view this as a good cheat-sheet for issues to keep an eye on:

1. **China**- economic growth has slowed in China and is likely to continue on a slowing path with greater volatility, especially if the trade war escalates. **Over the past decade Chinese debt has grown exponentially, and if their economy were to experience a sharp decline it could aggravate the downturn**. In an adverse scenario, the Chinese authorities could resort to aggressive currency depreciation, sending a deflationary shockwave around the world. Other concerns center on the impacts of global competition and the desire of China to expand their global sphere of influence. This could lead to heightened tensions and potentially a new "cold-war," as well as ongoing bouts of market volatility that we'll have to navigate.
2. **Populism**- there is a chance that growing populist movements, parties and candidates will continue to disrupt national and international politics and policy making. **In general, populism tends to be more inward looking and can lead to greater protectionism and barriers, which could be a real danger to the global economic system built on complex international supply chains and financial linkages.**
3. **Demographics-** simply put, **slower population growth and increasing longevity in the largest economies is contributing to slow economic growth, low inflation, and depressed interest rates.** There is no quick fix to demographic challenges and they will challenge economies for years to come. Japan was the first country to be impacted by aging demographics, Europe and China look vulnerable to the same trends.
4. **Technology**- the benefits of technology have been tremendous in terms of communication, lowering costs and growing productivity. **However there is a potential darker side of technology, it often disrupts industries and business and can lead to clear winners and losers.** The expansion of technology (think robots, artificial intelligence, etc.) could lead to temporary or longer lasting unemployment. Which could lead to discontent for the masses and further growth in populism.
5. **Financial Market Vulnerability**- unlike previous recessions, the recessions in the 2000's were primarily driven by the unwinding of financial market imbalances. **The concern is that instead of reacting to the news, it is financial markets that make the news.** There are several areas worth watching, including: debt levels, liquidity and valuation.
6. **Climate-Related Disruptions-** was identified as a super-secular issue that will be with us for years to come. This is an important topic that we won't try to tackle here but will address in future commentaries.

It's important to note that the above list is not a prediction of what's to come, but simply a list to keep an eye on for potential disruption over the next 3 to 5 years. We think it's a pretty good one!

Emerging Markets Have Value (if you can tolerate the volatility)

Emerging markets have changed significantly over the years. In fact, close to 80% of today's emerging market index is from countries that were not investable in the late 1980's. Countries such as Russia, China and Taiwan have opened up their markets and now comprise a large percentage of the index compared to back then. The changes at the sector level have been just as dramatic. According to Morningstar, technology stocks represented about 5.5% of the emerging markets index back in the late 1990's, compared to about 24% today (33% in the Asian markets). The chart below shows just how rapidly earnings in the technology sector has grown in the emerging markets relative to the overall market.

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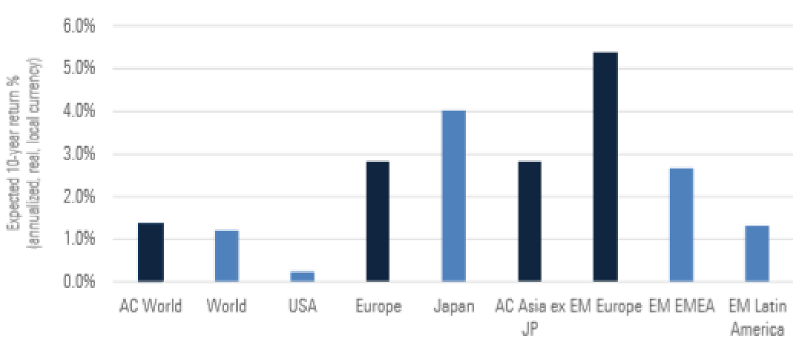
Exhibit 1 The Technology Developments in Emerging Markets have been Remarkable.

Source: Morningstar Investment Management calculation, Morningstar Direct, as at 30/04/2019.

Valuations in the emerging stock markets look attractive, especially on a relative basis. Here are some views from managers we respect on the return potential for emerging market stocks relative to US stocks. According to Research Affiliates valuations are much more attractive in the emerging markets. Their cyclically-adjusted-price- to earnings ratio (CAPE) is 13.7 in the emerging markets which ranks historically in the 29th percentile (lower is better), whereas the US stock market is trading at a CAPE ratio of 29.7 in the 95th percentile. Research Affiliates 10 year projections for real returns (minus inflation) is 6.8% for the emerging markets vs. 0.5% for the US. The research team at Morningstar has a similar view, with their 10 year projections for real returns showing far greater potential in the emerging markets than in the US, see the chart below:

Earlier this year, legendary investor Jeremy Grantham, co-founder of GMO, declared he was so bullish on the emerging markets that he's telling his own kids to invest more than half their retirement money in the asset class. His advice to investment professionals was, "What I would own is as much emerging-market equity as your career or business risk can tolerate… emerging market stocks are the only investment arena with a realistic shot a delivering 4.5% real returns annually over a decade." We wouldn't go as far as Jeremy Grantham, as we recognize the potential for higher levels of volatility and the occasional blow-up in the emerging markets, which can impact investors ability to hold on to them for the long-term, which is crucial to gain the benefits (see the next section). That being said, we do believe investor need to look forward and not in the rear view mirror to determine where the best future returns will come from. Depending on our client's risk tolerance we will be looking for opportunities to increase exposure to emerging markets in 2019, with an emphasis on value stocks.

Exhibit 2 Our expected long-term equity returns by region, using a "valuation-implied return" framework.



Source: Morningstar Investment Management calculation, Morningstar Direct, as at 30/04/2019. Forecasts are not a reliable indicator of future performance.

Quantitative Returns Have Been "Crappy"

Cliff Asness was one of the keynote speakers at the Morningstar Conference. Cliff is the founder of AQR, a quantitative investment firm with over $200 billion in assets under management. His firm is loaded with PhD's and is best known for its multifactor quantitative approach to investing in stocks. In other words they develop computer models and algorithms to select their investments and try to remove the inherent biases of human judgement.

Investment performance for their approach hasn't been great the past few years. In fact, Asness described his results as "crappy." Noting that making money by investing in some uncorrelated factors hasn't been easy for several years. Making matters worse for his firm, he said, is that when quantitative strategies underperform, there's no simple explanation owing to the complexities and nuances of the their multifactor approach. "People want to understand why a strategy is underperforming," he stated. Arguing that discretionary (human) strategies are easier for investors to understand. Mainly because when those strategies don't work, they at least have a good story why. Although investors may not be pleased with the underperformance, at least they understand it and will be patient. **"Sticking with a strategy is easier when you think you get it," Asness highlighted. "And sticking with a strategy is a prerequisite for succeeding with a strategy," he noted.** Asness then outlined three characteristics that make investment strategies easier to stick with than others:

1. Strategies where the intuition (a good story) about why the strategy succeeds or fails is easy to understand.
2. Strategies with very high risk adjusted returns (Sharpe ratios) that usually only have brief periods of underperformance, these are few and far between.
3. Strategies that aren't too maverick. In other words, approaches that are similar to others commonly practiced and widely owned. He noted that it's simply harder to stick with a strategy that doesn't look like everything else.

According to Asness, his firm's multifactor quantitative approach to investing goes zero for three on the above items. To some degree, he's talking his book, although there is wisdom in his comments. In our opinion, the investment environment has been highly skewed for several years towards growth stocks and that has been the primary drag on quantitative investment performance. We have not utilized many quantitative investment strategies over the past five years, but would not be surprised to see their investment performance improve in the years ahead. In fact, we are likely to start putting more quantitative managers on our radar screen and may start utilizing them if we can find the right the combination of a disciplined invest philosophy and process, with reasonable fees.

- AWM Investments (June 2019)