BNN MARKET CALL

***e*Research Corporation** is pleased to provide a comprehensive commentary from Wednesday's BNN Market Call Newsletter.

Set out below is the Market Outlook commentary from a leading portfolio manager, plus a Link to his 46-minute video interview.

MARKET OUTLOOK

Brian Madden, SVP and Portfolio Manager at Goodreid Investment Counsel
Focus: Canadian Equities

The first quarter of 2018 saw the return of two-way risk and volatility to equity markets after a nearly two-year hiatus. Markets like the S&P TSX Composite and the S&P 500 quickly shed 10 per cent of their value over a three-week period in late January and early February before recouping some of these losses. When all was said and done, the S&P TSX Composite notched a loss of 4.5 per cent, and the S&P 500 also gave back 0.8 per cent. Only bonds provided ballast to a balanced portfolio during the quarter, with the FTSE TMX Canada Short Term bond index eking out a total return of 0.2 per cent. Preferred shares which, in a sense, straddle the terrain between traditional fixed income and equity, also ended up slightly in the red with a total return of -0.2 per cent, as measured by the S&P TSX Preferred Share Index.

So, while the quarter was nothing to write home about, the time-worn principles of diversification by geography and by asset class as well as sound portfolio construction did help to mitigate the raw sting of an all-equity portfolio, or especially the sting of an all-domestic equity portfolio, as the U.S. dollar strengthened 2.5 per cent relative to the Canadian dollar during the quarter — as it often does in times of risk aversion.

Many investors seemingly were shocked by the swift setback this quarter, having being lulled into a sense of complacency by the relative dearth of even garden variety bull market corrections these last two years. We were not especially shocked or alarmed though, knowing full well that the unusual, eerie calm that had prevailed since the U.S. elections was the anomaly, rather than the norm.

We also expected that, as we move into the late stages of the economic cycle with valuations fair to full and with interest rate hikes taking hold, this unusual suppression of volatility would start to show some cracks. This did indeed occur.

Bull market corrections unfold in three dimensions: price, time, and investor psychology. Prices need to revert back to levels consistent with underlying economic fundamentals at the individual company level and, in the aggregate, at the major index levels. Time, in this case, is on investors' side, since the underlying value drivers like sales, cash flow, earnings, and dividends for each individual company continue to grow along with the economy overall. As such, slower corrections, like the one we saw in Canada from February to September of last year (-6 per cent over six and a half months), oftentimes need not be as deep in terms of price declines in order for that all-important price-to-value trade-off to reset to attractive levels.

Conversely, swifter declines like the one we saw more recently (-10 per cent over three weeks) are often deeper in terms of price impact. The effect of these is like ripping off a Band-Aid: it stings, but it is over quickly.

Crucially though in either case, investor psychology needs to reset, such that the pervasive, bulletproof and Teflon-coated dip-buying mentality is somewhat cleansed and purged from the markets. Some blood must be spilled and some greed must be displaced by fear in order to shake stock out of weak hands and to reset markets onto a firmer footing going forward. In our judgment, it is unlikely that a sufficient reset of investor psychology has occurred at this point to sound the all-clear on this latest bout of market volatility.

It is also possible that the current equity market weakness is, in fact, a harbinger of a deeper and longer drawdown in stock markets – a bear market. We don't know for sure, and to be perfectly honest, we won't know until after the fact, but we do know that "playing the long game" is the only strategy that makes any sense. Nobody likes bear markets, but they are a recurring reality of the investment landscape, and it is a mathematical truism that periods of above-average returns in stocks (above 8 to 9 per cent a year) necessarily are followed by periods of below-average returns.

Trying to pinpoint precisely when above-average returns give way to below-average returns is truly a fool's errand. So, setting and keeping realistic expectations is important, as is taking the long view and holding a well-diversified, professionally managed portfolio that pivots strategically to adapt to changing market circumstances, both to mitigate risk and to capitalize on opportunities.

Our specific portfolios have been dialing down beta and cyclicality over the last few quarters, with the Canadian equity portfolio, as of March 29, having a beta of 0.9 vs. a beta of 1.11 one year ago. Proactive profit-taking in high-beta cyclical Canadian companies, like Magna and Shopify, with the proceeds reinvested into a gold and a consumer staples company are just two of several examples of these types of strategic 'pivot' we have made in the portfolio to weather late-cycle market conditions.

Of course, we continue to systematically rebalance portfolios towards their target asset allocations which, as a practical matter late last year and early this year, involved selling over-weighted U.S. and Canadian stocks and reallocating proceeds to under-weighted bonds, preferred shares, and cash.

Meanwhile, amidst all the headline-grabbing turbulence in stock markets, the go-forward prospects for bonds and even cash, are quietly improving as rates rise, with five-year Canada bonds yielding 1.97 per cent at quarter end and two-year Canada bonds yielding 1.78 per cent: an improvement of 10 basis points in both cases relative to year-end levels. The backdrop for this increase in rates is a strong economy, with robust job creation and with inflation perking up. As a result, the Bank of Canada raised its overnight rate by 25 basis points in January.

Market participants, on average, are anticipating and pricing in two more hikes by the Bank of Canada this year, although expectations vary widely, with some significant outlier views predicated on things like the risk of a U.S. withdrawal from NAFTA and the risk of a disorderly decline in housing prices. Corporate bonds (such as those we investment in) yield even more, with yields now generally ranging between 2.4 per cent and 3.2 per cent depending on credit quality and the term of the bond, as the credit spread on investment grade bonds widened slightly during the quarter.

We continue to monitor important macro-economic indicators, like the slope of the yield curve, the availability and pricing of credit, job growth, retail sales, purchasing manager indices as well as market breadth and various other sentiment indicators, including the now infamous "VIX" option implied volatility measure that was closely intertwined with February's sell-off.

To summarize, most of these indicators are seeing some degradation, but remain at levels consistent with decent economic growth this year. An inversion in the yield curve would be very concerning, as would an outright decline in employment or in retail sales, given the importance of the consumer in both the Canadian and the U.S. economies. Any or all of these developments, among others, would likely prompt us to further pivot away from cyclical businesses in our equity portfolios, and towards companies exhibiting revenue visibility and stability, low operating leverage, formidable balance sheet and financial strength, and consistency of growth.

Moreover, developments like these, as unlikely as they may seem today with the economy humming along nicely, would be strong signals of an impending recession and positioning bond and preferred share portfolios for this would likely require some adjustments to enhance credit quality and perhaps to extend maturities as well. None of these scenarios are foregone conclusions however and, as pragmatic students of the markets, we are committed to interpreting corporate, economic and geopolitical developments as they unfold, recognizing that the most valuable tool in our toolbox is our ability to rethink previously held views and to change our minds and, by extension, to adjust our portfolios as circumstances change. This is the essence of active management: holding a differentiated view as expressed through a differentiated and high-conviction portfolio and practicing a flexible approach.

VIDEO: Brian Madden 46-Minute Video Interview <CTRL-CLICK> HERE

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