

DM Portfolio commentary

2nd QUARTER 2019

The cost of money and the price of stocks

The summer quarter began with North American markets having fully erased their steep decline of late-2018 and principal benchmarks reaching new highs in the process. We're not aware of anyone predicting such a powerful start to the year, one which saw the S&P 500 post its best first half in more than two decades and the Dow log its strongest June in 81 years, though we do recall several experts calling for continued trouble and, in more than a few cases, the bull market's outright demise.

Setting aside the capacity for stocks to humble those who ply at short term predictions, a look back at the past six months is worthwhile to get a sense of what might have sparked such a sharp turnaround and to see if the reversal provides any insight into broad investing conditions and optimal portfolio structure. As it turns out, though, almost none of the things that were bothering investors at the end of last year were resolved in the first half of 2019 and several actually deteriorated:

Geopolitics – while Russia and North Korea remain vexing as ever, China grew more belligerent in recent months, flexing its muscle in Hong Kong and adopting an even more bellicose tone toward Taiwan; Iran leapt to the front burner of concern as well, restarting its nuclear

enrichment program and downing a US drone in disputed airspace.

Trade – Brexit terms remain unresolved and the final cleaving of Britain from the EU is now that much closer, ominously set for Halloween of this year; USMCA (the replacement for NAFTA) is still unratified and receiving new resistance from the Democrat-controlled House of Representatives; and, most importantly, the US and China have yet to reach an agreement in their trade standoff, with new tariffs having been added since the beginning of the year.

White House – the President's pace of chasing straw men and paper tigers through the Twittersphere has not subsided and he shows no sign of shifting his energy from personal battles to policy development.

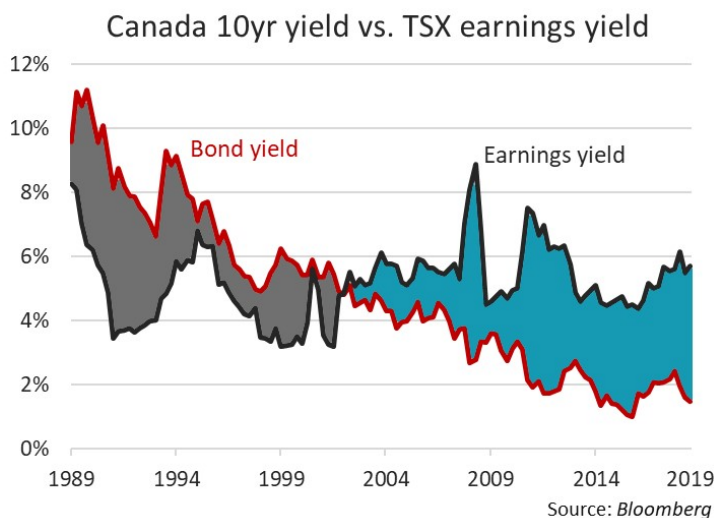
Earnings – the lift in share prices wasn't driven by an earnings surge, as profit growth is expected to be slightly negative for S&P stocks in the second quarter and only marginally better in Q3.

About the only thing that has changed in favour of stocks is the price of money. It's likely that the most significant contributor to the plunge in equity sentiment last fall emanated from the bond market, as markets began to price in the possibility of a sustained bump in inflation. At that time, the yield on the 10-year US Treasury

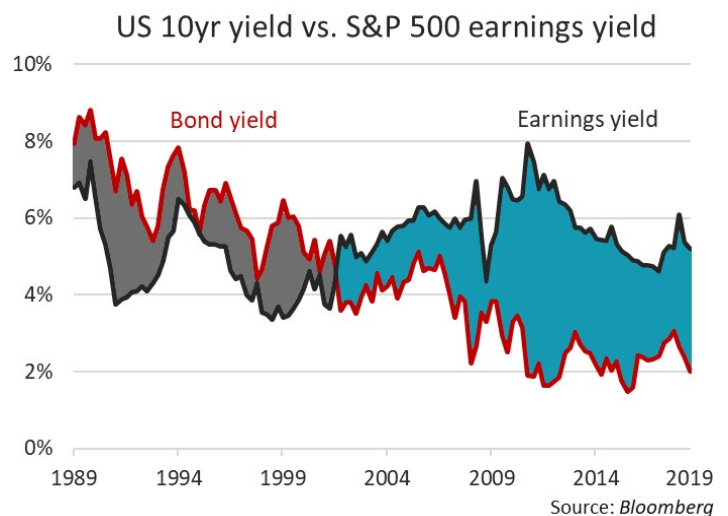
Bond rose above 3.2% for the first time in more than seven years and strategists began to talk about an extended period of tightening policy by the US Federal Reserve to keep economy-wide prices in check. Since then, however, inflation readings have been soft and global growth expectations have cooled. This change in outlook caused the yield on the 10-year to recede by well over a third to 2% by the end of the second quarter, a significant move over any time horizon, let alone a six-month span. Though we can't say with certainty exactly how much the fall in bond yields contributed to the rebound in stock prices, it was undoubtedly a meaningful factor.

The level and direction of interest rates are important for stocks for a number of reasons, not the least of which is valuation: if six or eight percent can be earned on a guaranteed note,

investor expectations for stock performance are going to be commensurately high; if just 2% is available in the bond market, though, stocks are likely to be priced to offer a lower absolute return. Currently, the companies comprising the TSX and S&P indices trade at about 17x trailing earnings, meaning that for every dollar of corporate income generated over the past 12 months, the market is requiring a new purchaser of shares to pay about \$17. If we flip this ratio around and divide 1 by 17, this gives us an earnings yield of just under 6%, which might not sound like an extraordinary return on its own but happens to be very attractive compared with what's now offered on alternatives. In fact, the positive spread between the earnings yield on North American equities and Canadian and US 10-year government bond rates has rarely been as high as it is now:



The charts above plot North American earnings yields (black line) against 10-year government bond rates (red line) over the past 30 years. As you can see, earnings yields have tended to hover in the 4-6% range over the past three



decades (notwithstanding short-lived spikes and troughs), while bond rates have been on a persistent downward path. It's also notable that for roughly the first half of the period, the income rate on Canadian and US 10-year government

bonds exceeded that implied by corporate earnings and prevailing share prices (grey shaded area), but around the turn of the millennium the relationship flipped, with government bond rates passing decisively below earnings yields (blue shaded area). This condition continued to expand over the ensuing decade and a half, so that the advantage for stocks is now substantial in both absolute terms and relative to history.

This stretched relationship might help to explain why markets suddenly reversed course this year and why declines since the 2009 bottom have been marked by their brevity. Not long after markets retreat and investors digest whatever news item or collective worry has precipitated the drop, they seem to reassess relative value and conclude that, compared with the traditional alternative, stocks look pretty attractive. If interest rates stay low for an extended period and, perhaps more importantly, if investors begin to believe that such a state will be long lasting, the implications for stock valuations and prices could be significant. At the very least, it seems logical that low bond yields would provide a measure of downside support to stock prices and, for the past decade at least, this appears to have been the case.

The low rate backdrop carries additional implications for stock investing and asset allocation. First, as mentioned, the decline in bond yields from last fall was spurred by a drop in consensus expectations for global growth. This is important because in a low growth environment, earnings appreciation is naturally harder to come by and so companies which are

able to provide this to investors become comparatively more attractive. During both the long but historically tepid economic recovery from the depths of the sub-prime crisis and in the most recent market rebound, dynamic areas such as technology and internet retailing have led the way, while slower growing sectors like utilities and commodity producers have fallen behind. At the same time, the value stock sub-index in the US has trailed the growth benchmark by a significant margin, with strategists repeatedly calling for a reversal of this trend that never seems to come.

For the most part, cheap stocks tend to be capital heavy – utilities with massive power generating plants; auto makers and other industrials with complex manufacturing facilities; and commodity producers with lots of property, heavy equipment, and exploration gear. A pure value manager's interest is piqued when he or she can buy such assets for pennies on the dollar, leaving a supposed margin for error on investment in classic Benjamin Graham style. If money is free (or nearly free), though, and such fixed assets can be replaced or replicated with minimal financing cost, perhaps they're not worth as much as they once were. In such an environment, maybe brands, networks, market share, and innovation are where the real value is. In the recent past, the market has said that this is so.

The thirst for growth and the desire to deemphasize fixed capital can also be seen in the behaviour of individual companies: Walmart wants to retail like Amazon, Disney wants to stream like Netflix, and Marriott has entered the

homeshare space, hoping to capture some of Airbnb's 'virtual' success. Each of these moves is notable not only because of its progressive nature, but because they are all "capital light" – in other words, each is designed to generate revenue without the costly burden of a bricks and mortar retail store, a sprawling theme park, or a towering hotel.

Within DM portfolios, we see this dynamic in the fortunes of stocks like JP Morgan Chase and Visa, both of which are very well-run providers of financial services. The first is an exceptional operator in banking and corporate finance but, in addition to its proven acumen and renowned management team, a purchaser of its shares gets exposure to 5000 or so branches which require ongoing maintenance and periodic refurbishment to maintain customer appeal and which are subject to rising rents and other tenancy issues.

The second, on the other hand, owns a dominant global payments system which is essentially run on computing power in office space which can be

situated in whichever jurisdiction offers the best mix of cost and logistics. While both companies have outperformed the broad market over the past decade, Visa's edge has been extraordinary, with the stock besting the S&P 500's return by a factor of nearly four through the 10-year span.

The questions raised in this commentary are the type we ponder every day in the stewardship of your assets. Unfortunately, in investing there are few definite answers, only possibilities and probabilities. The wider we cast our research net, however, and the more factors we consider, the better we're able to weigh potential outcomes and construct portfolios that strike an effective balance between opportunity and risk. Amongst these inputs, we expect that the level and direction of interest rates and the ability of companies to generate strong growth with 'capital light' business models will continue to meaningfully impact both equity markets and our portfolio allocations for several years to come.

All the best of the summer on behalf of the entire Dixon Mitchell team!