Brexit, Exits and the Art of Staying Put

QAM Perspectives – July 2016

Quadrant's regular newsletter that highlights topics we believe will affect markets or are important in understanding them.

"Whenever you find yourself on the side of the majority, it is time to pause and reflect."
Mark Twain

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Q2 2016 in Review

Q2 2016 started off strong as most markets continued a slow climb that began in the first quarter. The Brexit vote in Europe introduced heightened volatility near quarter-end and overshadowed the relatively strong performance preceding it.

Equity markets initially sold off following the Brexit and safe haven assets increased. While US and Canadian markets quickly rebounded, European equities only partially made up for losses.

The S&P/TSX Composite Index in Canada returned 5.1% (including dividends) over the quarter. Gold continued its rally and oil prices increased substantially, making the TSX one of the best performing indices over Q2.

The S&P 500 Index finished the quarter up 2.5% in Canadian dollars. The MSCI EAFE Index was down 1.2% in Canadian dollars.

Fixed income markets finished positive over the quarter mostly due to capital appreciation associated with reductions in interest rates across the yield curve. Yield curves around the globe shifted lower as investors sought safe havens from perceived risks and continued to require less and less compensation for lending their money to sovereign nations. Central bank manipulation appears to be playing a major part in this and we, at QAM, continue to position clients' portfolios with the premise that this form of intervention is not sustainable.

Preferred shares showed stability over the quarter and ended with a net positive total return. This asset class still offers good value in our opinion in regards to yield and credit risk.

Macro themes have been dominating stock market moves for quite some time now and could be frustrating for fundamental investors in the short term. More often than not this is when some of the best long-term, bottom-up driven investment opportunities appear particularly when equity managers remain focused on risk management through a careful selection of quality investments as QAM managers do.

After a difficult 2015, commodities have rebounded and are outperforming other sectors on a year to date basis. A key concept on which our entire investment process is based is "reversion to the mean" and it seems to be working once again.

"Animal spirits are back in North America" said Halliburton CEO Dave Lesar just recently. We argue that they have been there all along and even as low interest rates support capital markets for now, eventually, when the global economy improves, interest rates won't be able to stay at these historic lows for much longer.

Equity Market Total Returns (in CAD dollars)	Q2 - 2016	YTD	1 Yr	3 Yr	5 Yr
Canada (S&P/TSX Composite)	5.07%	9.84%	-0.21%	8.26%	4.20%
S&P/TSX Capped REIT Index	9.60%	21.30%	12.65%	8.42%	8.36%
U.S. Large Caps (S&P 500)	2.47%	-2.54%	8.12%	19.72%	18.96%
U.S. Small Caps (Russell 2000)	3.80%	-4.07%	-3.03%	14.82%	14.99%
MSCI EAFE	-1.19%	-9.93%	-6.05%	10.08%	8.52%
Germany (DAX)	-5.47%	-14.55%	-8.70%	8.48%	6.16%
MSCI Emerging Markets	0.77%	-0.02%	-8.24%	5.90%	2.45%

Fixed Income Total Returns (in CAD dollars)	Q2 - 2016	YTD	1 Yr	3 Yr	5 Yr
Canada Universe Bond Index	2.62%	3.85%	5.14%	5.37%	4.89%
Canada Real Return Bond Index	3.65%	5.31%	4.97%	6.28%	3.93%
US Investment Grade Index	2.22%	-1.16%	10.39%	11.62%	10.07%
US High Yield Bond Index	5.83%	1.46%	2.80%	10.03%	10.56%
US Treasury Inflation Protected Index	1.87%	0.39%	8.54%	9.81%	8.91%

Source: Bloomberg – as of June 30, 2016

Brexit, Exits and the Art of Staying Put

After more than a year of waiting, the S&P 500 achieved a new record high on Monday July 11.

The bull market is now over 2,680 days old, during which it's climbed an average of 0.08% each trading day. The bull market that began in 1990 lasted 2,836 days. If this current bull market lasts that long at its current pace, some analysts project that the S&P 500 will finish the year 12% higher (sitting at 2,162 as of the time of writing).

We at QAM think that these types of projections are elegant math at best or simplistic analysis depending on circumstances. A basic understanding of financial history is enough to recognise how manic the markets can be at times. History is full of examples of the "madness of crowds". In our view, nobody should even attempt to invest in the capital markets without the realization that there have always been cycles that eventually reach a point of too much optimism or pessimism. Sir Isaac Newton came up with the three laws of motion, which were the work of genius. But Sir Newton lost a fortune in the South Sea Bubble. He later said "I can calculate the movement of the stars, but not the madness of men."

The key here for professional portfolio managers is to be cognizant that these points of extreme optimism or extreme pessimism are more often than not identified in hindsight, not so much as they happen.

To many analysts the bull market looks anxious, given elevated political uncertainty around Britain's departure from the European Union, U.S. corporate earnings that are set to drop for another quarter (that would make Q2 the fifth quarter in a row of negative earnings growth for the S&P 500) and lagging economic growth globally.

We will know after this letter is published, whether or not this extended earnings recession in the U.S. is over or not. Consensus expectations are for it to persist. If the index does report a decline in earnings for Q2, it will mark the first time the index has recorded five consecutive quarters of year-over-year declines in earnings since Q3 2008 through Q3 2009. This is something that we at QAM are monitoring closely.

Interestingly, stocks don't seem to care with the S&P 500 still near record highs. With the S&P 500 trading at about 17 times expected 12 month earnings and its Canadian counterpart at 17.5 times, valuations appear stretched. One reason for elevated valuations is low bond yields. 30-year bond yields of around 2% is not exactly an attractive alternative.

Robert Shiller has defined a bubble as "a situation in which news of price increases spurs investor enthusiasm, which spreads by psychological contagion from person to person, in the process amplifying stories that might justify the price increases and bringing in a larger and larger class of investors, who, despite doubts about the real value of an investment, are drawn to it partly through envy of others' successes and partly through a gambler's excitement."

Analysts have been warning about a bubble in bonds for the last 4-5 years or so yet rates continue to fall. In early July the 10 year US treasury yield hit the lowest level on record at lower than 1.4% (1.57% as of time of writing this).

Enter Central Banks. The hope of course is for more stimulus in the UK, the Eurozone and Japan, and a reversal of course in the US. Traders now are pricing in little chances of a hike in the Fed rate until at least the end of 2017. Probabilities for a move were as high as 55 percent at the beginning of June.

So this after-Brexit rally is not very different to all rallies before it since the Financial Crisis of 2008-2009. There is no real enthusiasm, no fundamental drivers but ever pricier bonds leave no alternative but to buy stocks. US stocks had been trading sideways since US QE asset purchases ended in 2014. Now low bond yields show that the liquidity spilling from other Central Banks can overcome this, so US stocks have moved higher.

For now this peculiar post-crisis logic seems to be here to stay leaving record low bond yields to coexist with record high stock markets.

This is a difficult environment and, in some sense, unchartered investment territory, given exceptional levels of Central Banks intervention. Investors trying to make money or preserve capital need to be calm and focus on their long term plans.

Whatever the long term asset allocation is, investors have to remember that rebalancing back to its original target weights will almost always mean going against the crowd.

We continue to believe that long-term investors are going to be well served by investing in a well-diversified portfolio that reflects their risk tolerance, time horizon, and income & liquidity needs.

Brexit or not.

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