QuietCounsel

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Investment Outlook

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Zig When They Zag: Four Consensus Views to Reject in 2022

Consensus thinking can often be wrong, but after prolonged periods of great disruption, it can be tempting to adopt: "Stocks are up a lot so they must be expensive. Inflation is a clear and present danger. Global is always best. You should dump all your bonds."

As active investors we rely on periods of herd behaviour like this, when consensus pricing creates pockets of opportunity. For a brief period in March 2020 for example, consensus was that COVID would demolish global economies and that seemingly no price was too low for stocks, even ones that were established, generated lots of cash flow, had big competitive advantages, and could weather a protracted storm. We bucked consensus and bought stocks in what would be the biggest asset mix change in the 40-year history of our firm, selling nearly $800 million of bonds and redeploying those proceeds into equities. We had a very compelling opportunity to buy stocks at a massive discount and executed the bulk of the trade within a day of their lows.[i]

In this article, I'll go through four consensus views that prevail today, ones which we think deserve some rigorous questioning.

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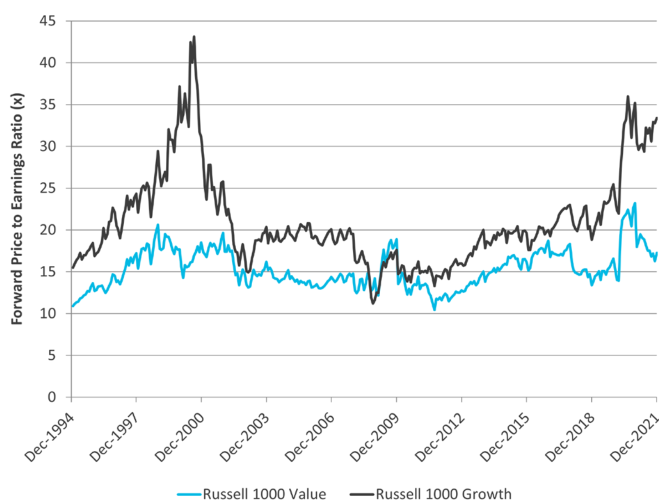
Consensus View #1: "Equities are expensive"

Through December 2021, the S&P/TSX and S&P 500 indices were both up over 90% from their March 2020 lows, so it is an understandable short leap to suggest stock prices may now be "expensive." The trouble with this perspective is that it treats the market as a single entity, when it is in fact an amalgam of hundreds of businesses, each with their own potential upside or downside.

When you group the market into "value" and "growth" segments, two very different pictures emerge. Figure 1 shows that since the last major correction in 2008/2009, the price/earnings ratio (a commonly cited valuation metric) for growth stocks has more than doubled to nearly 35x. In the US especially, a big part of this expansion has been underpinned by real earnings growth by large Technology stocks, which has emboldened investors to pay higher and higher multiples of those earnings, far into the future. Part of it has also undoubtedly arisen from investors ascribing the same faith (and multiples) to lower-quality growth companies.

Figure 1: Russell 1000 Value and Russell 1000 Growth Indices, 1994 - 2021



Source: Bloomberg, Leith Wheeler

Compare these valuations to the price/earnings multiples for value stocks, which remain around their long-term average of 15x. It's important to recognize that the decline of this blue line from the recent peak of 2020 does not represent a retrenchment of value stock prices. Far from it. The value stock prices have actually risen over this time, but the expected earnings from these companies has just risen more. Growth stocks are also up, but their prices have continued to pull away from the expected earnings that might underpin those prices.

The result is a bifurcated market, where growth investors are placing increasingly tenuous bets. Value investors like us by contrast are positioned much more conservatively.

Conclusion #1: Despite market gains, we are still able to build client portfolios with businesses selling for compelling prices.

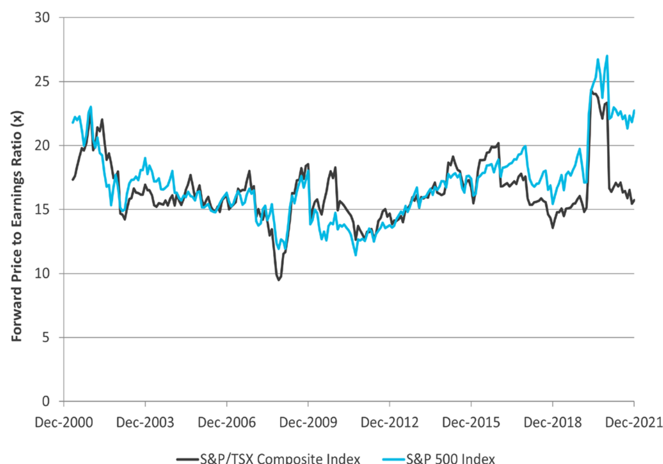
Consensus View #2 "Global equities are a superior option to their Canadian counterparts for domestic investors"

We have long built client portfolios with a mix of Canadian, US, and International stocks to harness diversification benefits and give our clients exposure to high-quality companies from around the world. After observing an increase in the debate surrounding allocations to Canada versus global stocks, we did a recent analysis of the benefits and pitfalls of investing in each region. (We also hosted a webinar which can be found here.)

The key finding of that work was that ***over the last 25+ years, an investment in Canadian stocks would have produced a superior risk-adjusted return relative to global stocks.*** When we looked at Leith Wheeler's Canadian portfolio in particular, which exceeded TSX returns by over 2.5% per year[ii], the results were even more compelling. These findings gave us data to support our long-term view that a material exposure to Canadian stocks remains justified in our clients' portfolios.

Turning our eye from the past to the present, a quick glance at current P/E valuations shows a big difference between Canadian and US stocks. Figure 2 shows that while they tracked fairly closely for many years, US stocks are currently about eight multiple points higher than Canadian ones. The margin of safety is therefore much lower in the US, while Canadian stocks are trading in line with their long-term average of ~15x earnings[iii].

Figure 2: Price/Earnings Ratios of Canadian and US Indices, Dec 2000 – Dec 2021



Source: Bloomberg, Leith Wheeler

Finally, Canada has a number of world-class businesses that warrant material weightings relative to foreign comparables. Take Canadian banks, for example, which are oligopolistic companies with strong pricing power, a favourable regulatory environment, dominant businesses across banking, insurance, capital markets, and wealth management, and the ability to generate consistently high returns on capital while maintaining conservative balance sheets. See Figure 3 to see how they stack up against the biggest and best in the US: with few exceptions, they carry lower P/E multiples and higher capital ratios (the amount of cash held as security against loans – higher is better). Over time we've tended to hold about one-third of clients' Canadian holdings in Financials, and this decision has contributed meaningfully to our long-term performance.[iv] One final point is that many Canadian Financials also have significant franchises outside of Canada, with large branch networks, trading platforms, and capital markets and asset management businesses in the US and elsewhere.

Figure 3: Canadian vs US Banks Statistics as of December 31, 2021

	Forward Price to Earnings Ratio	Tier 1 Capital Ratio
Bank of Montreal	10.6	15.4%
CIBC	10.1	14.1%
Royal Bank	12.1	14.9%
TD Bank	12.1	14.9%
Scotiabank	10.9	13.9%
JP Morgan	13.3	15.0%
Bank of America	14.0	12.2%
Citigroup	7.6	13.9%
Wells Fargo	12.9	12.9%
Morgan Stanley	12.9	19.3%

Source: Bloomberg and Leith Wheeler estimates

Conclusion #2: The Canadian market offers many very high quality companies to own, trading at a discount to global peers, and which in aggregate have delivered superior risk-adjusted returns for our clients relative to global over the past two dozen years. Maintaining a higher allocation to them makes sense.

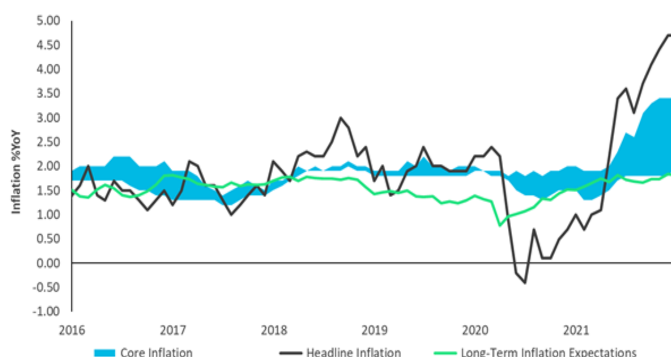
Consensus View #3: "Inflation is a reason for concern."

The trouble with the topic of inflation is there are in fact many different measures of it, and sometimes folks can inadvertently interchange them. At a high level, each version measures some form of price changes of a basket of goods over a period of time. The question is, what's in the basket?

Headline inflation measures the cost of all goods and services in an economy. **Core inflation** measures the increase in cost of all goods and services *except for food and energy*. These two items are backed out because their prices tend to vary more widely over the short-term (making headline inflation a less reliable marker). Core inflation is arguably the most important inflation metric because it most directly informs central bankers' decisions about hiking or cutting interest rates. **Long-term inflation expectations** reflect how the market believes inflation will impact the economy over multiple cycles. You can derive this number by looking at long duration bond prices.

Figure 4 shows that of these three indictors, headline inflation is the only one that has actually deviated materially from its long-term average.

Figure 4: Measures of Canadian Inflation, 2016 - 2021



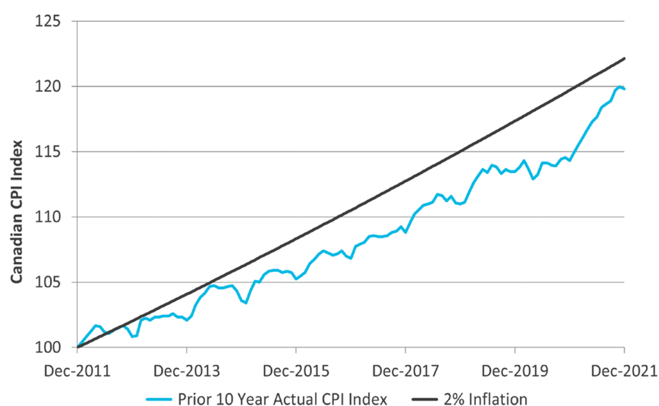
Source: Statistics Canada, Bloomberg

As we wrote in November in "Transitory" Inflation and Looking Beyond the Headlines, there are many valid reasons for inflation to be high right now, with the main driver of these being a collision of supply chain bottlenecks and demand levels that exceed even pre-pandemic levels, across multiple industries. It will take time for these to work out and in the meantime, wages will come under pressure and grocery bills will rise – but that doesn't mean we've entered a period of sustained, above-average year-after-year price increases across all products and services.

Core inflation is up but is still a reasonable 3%[v], and the many structural factors that have kept inflation below the Bank of Canada's long-term goal of 2% for the past 10+ years, remain in place. These include the aging of the baby boomers, globalization, technology's ability to reduce the costs of production, distribution, and service provision, and finally, central banks' tools to put the brakes on overheating economies.

Figure 5 shows how the Bank of Canada's 2%-per-year target rate of inflation (the black line) compares with what actually happened to core inflation (the blue line) through the 10 years ended December 2021. As you can see, even with the late surge, we remain below the BoC's long-term vision of healthy growth.

Figure 5: Canadian Consumer Price Index – 2% target and actual, December 2011 to December 2021



Source: Bloomberg, Leith Wheeler

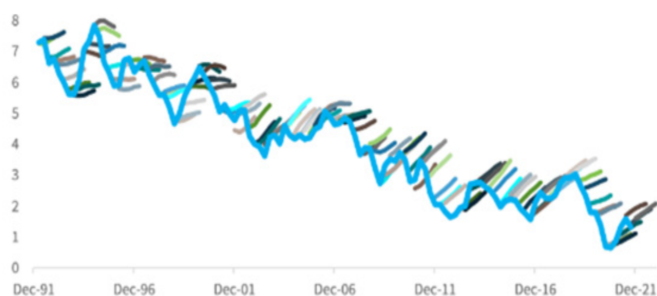
Conclusion #3: Inflation is up but the recent increase is related mainly to supply-chain disruptions due to the pandemic. We should see the pace of inflation fall on a year-over-year basis later this year as supply-demand bottlenecks work their way through.

Consensus View #4: "Bond yields are about to rise sharply"

Since the high inflation of the 1970s, bond yields have steadily declined throughout the developed world. (Recall: bond yields fall as prices rise.) The 2008 global financial crisis and the subsequent period of slow growth and very low inflation resulted in bond yields converging near 0%. Fears of a sharp rise in government bond yields and significant negative returns from government bonds, which existed over most of the past decade, have largely failed to materialize. However, the recent rise in inflation and the upcoming start of the interest rate hikes in the US and Canada has renewed these concerns.

Before diving into the technical reasons, it is useful to look at a history of the market consensus' bias toward the belief that "rates are due to rise." See Figure 6. In it, the actual path of 10-year US Treasury bond yields is in blue. At all points in time along the way, the 'hairs' trailing most often up and to the right reflect the market's forecast for those 10-year yields. How consistently dour were their outlooks!

Figure 6: 10-year US Treasury Yields (actual in blue) and Forecasts (the hairs), 1991 – 2021

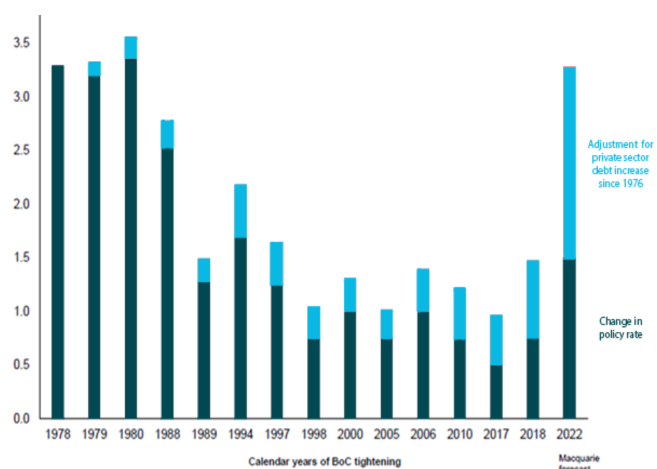


Source: Survey of Professional Forecasters, Barclays Research

Regardless of how inflation materializes, we continue to think that concerns of a sharp spike in interest rates are largely unfounded. The main reason is the high level of private debt (excluding banks) in the economy today would make any rate increases "feel" much worse than similar interest rate increases in the past.

Figure 7 shows this phenomenon. The green bars show actual Bank of Canada (BoC) interest rate increases, and the total bar height (green + blue) shows how those hikes "felt" at the time – reflecting how much debt was held by the barber shops and manufacturing plants and car dealerships that were carrying debt that might be impacted by higher short-term rates. Central bankers may feel pressure to increase rates today – per the green bar, six times to boost them 1.5% this year – but after two years of COVID-19 it would create a significant strain on the broader economy, to levels not seen since 1980. This significantly higher debt load translates directly into the economy's inability to tolerate higher interest rates.

Figure 7: Years of Bank of Canada Increases Since 1978 – Adjusted for Impact of Non-Financial Private Debt



Source: Macrobond, Macquarie Macro Strategy

Importantly, though, while sustained high inflation data could prompt the central bank to raise short-term rates, this would not necessarily cause long-term bond yields to spike. The reason is a sharp rise in short-term policy rates could trigger a rapid slowing in economic growth or even a recession, which would tend to push longer-term bond yields lower, rather than higher. This can happen because when the economic outlook worsens, investors flock to safer investments – and increase their government bond holdings.

Finally, the yields we see today reflect the market's view, which includes an expectation of nine rate hikes in Canada in 2022 and 2023. The Bank of Canada would have to hike *even more than that* to cause these expectations to rise. In other words, a fairly conservative viewpoint is already baked into bond market prices. In our current view, the balance of probabilities suggests we'd be more likely to see a pause along the way, than an additional hike.

Conclusion #4: We are entering an environment where central banks will be raising interest rates, but market prices already reflect this expectation. A surprise spike would only come if the already negative outlook proved too optimistic. Additionally, an increase in short-term interest rates does not mean long-term rates will also rise. (We're not headed to 1981 mortgage rates; the environment is very different).

Conclusion

To summarize, equity markets have been very strong but ample opportunities remain for disciplined, fundamental managers, especially within the "value" segments of the market where we focus. Your portfolio continues to benefit from many great Canadian companies held across a swath of industries, and as a whole, the Canadian market is attractively priced relative to its global peers. Inflation is undeniably present in everyone's day-to-day right now, but we expect it to begin decelerating through the end of this year. This calming of inflation should be helped by the freeing up of locked supply chains and interest rate hikes by the Bank of Canada, intended to cool excess demand. The market has incorporated a large number of hikes into current bond prices so it would take a very large surprise to prompt even further hikes – meaning bond yields should be relatively safe at these levels. As such,

investors should maintain their bond exposures and let bonds do what they do best: provide a shock absorber for an inevitable future check-back in equity markets, and generate (small but growing) interest income.

Endnotes

[i] Note that this timing proved particularly fortuitous as it's not our goal to ever pick the top or bottom of any market, bu rather to buy when pricing is compelling and sell when it is dear. We wrote in Market Update: March 20, 2020, "When we might hit the bottom of the market is impossible to predict; however, we believe that the long-term returns from the equities in our portfolios are extremely compelling despite the risk right now."

[ii] Reflects the period May 31, 1995 – September 30, 2021. Within the context of the cited study, published in the Fall of 2021, May 1995 represented the earliest, comparable performance date for the Leith Wheeler Canadian Equity Fund and global equity strategy. Over the period, the LW Canadian Equity Fund outperformed the S&P/TSX Index Fund by 2.5% per year. It was based on Series B until Sep 30, 2004 and Series A thereafter.

[iii] Recall that all Leith Wheeler equity portfolios are managed to a value style, however, so tend to trade at lower multiples than the market.

[iv] For taxable investors, the generous dividends paid by Canada's Financials (and Utilities and Consumer Staples companies) also receive preferable tax treatment.

[v] Canadian core inflation is actually a range of three indicators. The blue bar shown represents the range of these three, the mid-point of which was 3.0% at Dec 31, 2021.

IMPORTANT NOTE: This article is not intended to provide advice, recommendations or offers to buy or sell any product or service. The information provided is compiled from our own research that we believe to be reasonable and accurate at the time of writing, but is subject to change without notice. Forward looking statements are based on our assumptions, results could differ materially.

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