The Petticrew Report – February 2019

2018 Year-end consolidated Performance and Portfolio reports should now be in your hands. We have heard from many of you and wish to share some of the perspectives, comments, and questions we have been hearing. We believe that there is wisdom to be gained from listening and evaluating the differing viewpoints as it is all too easy for an investor to view their own perspective as the only reality.

There is nothing like stating the obvious – 2018 came to a difficult and humbling end for investors, to say the least. From new S&P500 index highs in September, markets sentiment quickly swung to prognostications of recession, perceived overly zealous interest rate increases, trade wars tantrums, and a US government shut down over a wall. Investors had a great deal to stomach, never mind interpret.

In the self-effacing world of investing that Mike and I guide our clients through, years like last year continue to build upon our character, knowledge and investment philosophy. In the 4th quarter of 2018, not very much went well for Canadian or US investors, or truly for any investor looking for growth globally:

- The S&P/TSX Composite closed down ~ 12%
- The broad US market, as measured by the S&P 500, down ~ 6%.
- Investors with Chinese exposure (luckily not us) suffered greatly as Shanghai's stock market ended down almost 25%.

This was the first year since 2011 that our client's portfolios declined. Did we beat the TSX? Yes. Are we proud of it? No. We never like to deliver negative rates of return.

1 – 3 – 5 year rates of return:

Recent discussions have understandably focused on the recent past. For many, but by no means all, it has identified a more fearful mindset or a feeling of genuine frustration. This is truly very understandable, especially for our newer clients and for those nearing or in early retirement. The negative returns in 2018 erased the positive returns of 2017. We fully recognise that the resulting 2 year rate of return is close to zero. Additionally, 2018 does very little for 3 year and 5 year returns.
At the end of 2017, 3 year and 5 year net (after fees) compound rates of return were ~+8% and ~+12.5% respectively. Replace the spectacular returns of 2013 with the negative returns of 2018 and a different picture emerges when viewing those multi-year returns. They drop to ~+3.25% and ~+6% respectively.
What a difference a year can make.

10 year rates of return:

At the end of 2017 many clients were less impressed by 5 year returns north of 12% and more concerned by 10 year returns in 5.5% range. Again, *what a difference a year can make*. We came through a negative year but see our 10 year compound annualized returns actually increased significantly. How is this possible?

Simply put, again, *what a difference a year can make*. The financial crisis impacted returns of 2008 have dropped from the 10 year rate of return numbers. Replacing 2008 with 2018 moved our 10 year rates of return move up from ~6% to ~8.5%.

Are we proud of our 10 year returns? Absolutely. It was just over 8 years ago we made a strategic decision to move back into US equities. This was after being void of US stocks for the previous 8 years. We received huge push back from many clients at the time as they perceived the US to be a much higher risk than Canada in a post-financial crisis era. Many of you recall that in 2003 we had repatriated our US investments back to Canada. We missed the then coined "Lost Decade of Wealth" (US Markets were flat, and negative in C$ terms, from 2000-2010) in US stocks. From June 2008 to present the TSX has suffered more than a decade of negligible returns, sitting only ~500 points higher than where it was before the Financial Crisis.

In hindsight, these two strategic moves have been crucial to our client's long term returns. The higher weightings in US stocks allowed us to reduce the impact of the Canadian market's significant underperformance since 2008.

These are not easy decisions and the distribution of investments in the US and Canada will continue to be critical. Similar to how we received push back on moving capital into the US markets in 2003, today we often get push back on why we own anything in Canada after a long period of US market outperformance. Simply put, these decisions only look easy with the value of hindsight. We are still firmly of the belief that high quality Canadian companies will provide steady dividends and will always have a place in a diversified portfolio.

Hindsight!

There is wisdom to be gained from retracing past moves in markets. We firmly believe that any long term investor who fell prey to the downward move before Christmas 2018 and initiated a dramatic shift (a rush to cash) in their investment strategy is left in a terrible predicament. We witnessed this in 2008 and to a lesser degree in 2011. We would characterize this investment psychology predicament as follows:

- It is all too easy to sell when markets are down. It comes with a sense of relief, and that the worrying can stop.
- If the short term move proves correct, and markets move lower, the feeling of affirmation will outweigh any urge to repurchase at lower prices. In short, whilst markets are dropping it is all too natural, too human, to believe that the trend will continue.

- More often than not, investors will not feel comfortable reinvesting until after a year or several years of market recovery and perceived stability/removal of perceived risks. In our experience, with that comfort comes higher prices and significant loss of capital appreciation over the long term. In our opinion, it is why so many investors (not our clients) never experience long term growth investing in stocks.

We wish none of this for you, our clients.

As per our note in October, when the correction took hold, we focussed on fundamentals and not on emotions. Nearly ¾'s of 2018's decline has already been recovered during January 2019. Portfolios are now higher than they were at the end of October. *What a difference a month can make…*

We hope the above dialogue helps put much into perspective.

Looking Back:

A lot has changed since January of 2018. Sentiment during the first month of last year was bullish. US corporate tax cuts were passed by Congress. Financial conditions were relatively easy and the global economy was exhibiting synchronised growth. Stocks rallied but suffered a quick a sharp correction (one of 2 corrections last year) but confidence prevailed and stocks rallied to new highs by the end of the summer.

So, what happened?

The list of negatives to impact market sentiment is/was long:

- Trade wars weighing on corporate sentiment on earnings forecasts
- The Fed (Federal Reserve) perceived to be raising interest rates too much, and too fast, to their highest level in a decade
- President Trump petulantly demanding appropriation of $5 billion to build a southern border wall from Congress, with a newly elected Democratic majority House of Representatives in waiting. The longest US government shutdown in history began.
- Brexit - the possibility of a "Hard Brexit" (exit from the EU without a negotiated deal) looking more likely
- French citizens protesting in Yellow Vests with President Macron offering concessions to this group in tax concession that may push France to the brink of violating EU budget rules
- China – slowing GDP growth
- Canada – as the National Post so eloquently editorialized, "the only country in the world that can't make money off drugs or oil"

Let's also not forget that approximately 150 hedge funds *closed their doors* in December (due to poor performance causing massive indiscriminate selling) which was one of the key contributors to the dramatic sell-off during the days prior to Christmas.

So, as stated above – *what a difference a year makes*. We feel like we have been saying that almost every year for the past decade as the slower global growth landscape, and low interest rates, has created many

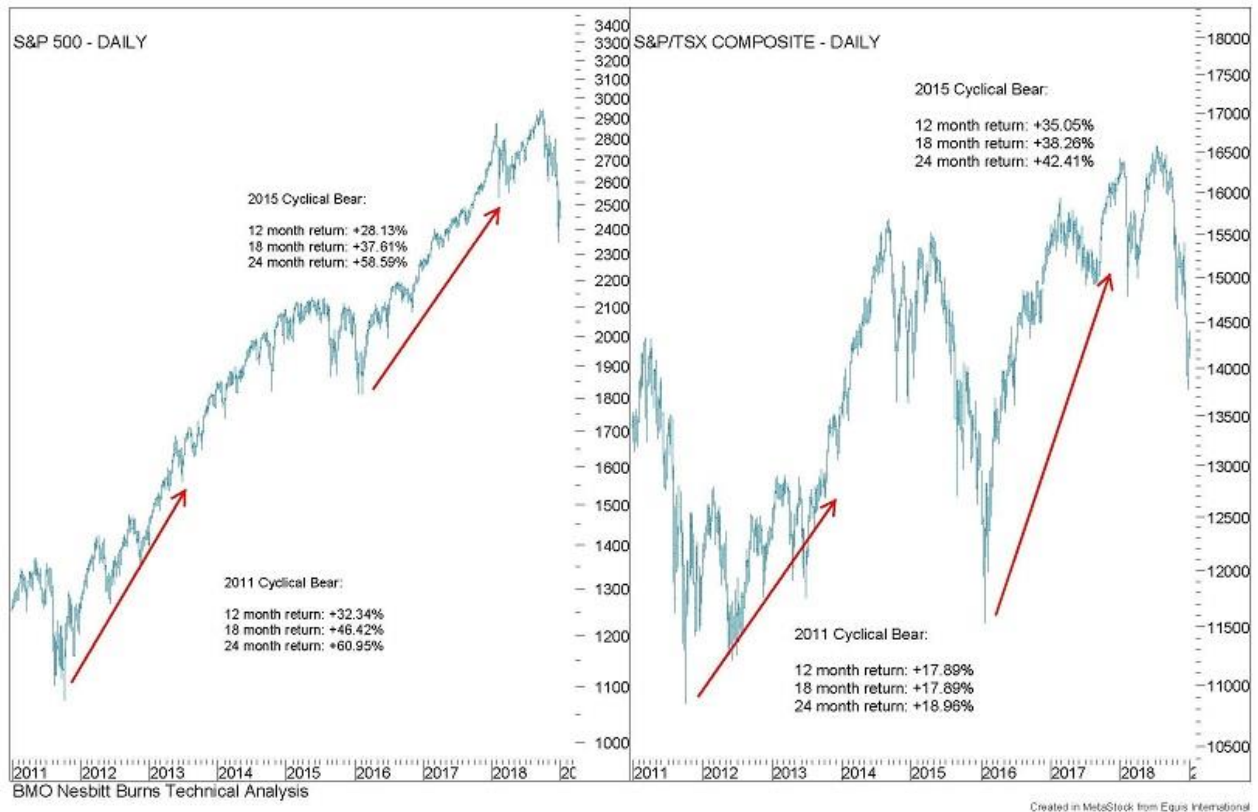
wild swings in sentiment each year. Long term growth has been persistent. Sentiment has swung from optimistic to fickle seemingly dozens of times. We cannot emphasize enough that this is not 'unprecedented'; no matter high many times the TV squawk box commentators overuse that word.

The only event that we found unprecedented was the sharp sell-off during the shortened and traditionally low volume*,* trading on Christmas Eve. It felt like a cruel and unseasonal prank executed by some '14-year old hedge fund traders' (as our colleague Brian Belski refers to them).

A**ll the above is now history – where do we in The Petticrew Group feel we are going in 2019?**

WE continue to believe we are in a secular U.S. bull market. We were *very fortunate to avoid the last cyclical bear of 2015* and indeed reported positive returns for all client accounts in the 7-9% range. We did suffer in the cyclical bear of 2011 only to swiftly post the above average returns mentioned in following years discussed at the beginning of this commentary.

We believe 2018 was a cyclical bear, similar to 2015 and 2011, within the overall long term bull trend. MOST importantly, as highlighted with the two attached charts, the returns coming out of cyclical bears are nothing short of astounding. We have conviction that 2019 and beyond will paint a similar picture.



Is 2018/2019 a replay of 2015/2016?

In late 2015 there were significant concerns about a Global recession, led by a sharp slowdown in China and further supported by a steep decline in oil prices. Sound familiar?
Beijing eased very aggressively in 2015, both monetarily and fiscally, and additionally devalued the yuan. Early in 2016 the Federal Reserve softened its interest rate stance. Sound familiar?

Although skepticism about global growth remained headline news and very vocal concerns of many market experts, by early 2016 Beijing's stimulus started to help their economy and quickly was evident in financial markets – globally.

In early 2016 we witnessed emerging markets/currencies start to outperform. Oil prices stabilized and started to rally. Materials shares started to outperform (this was very good for Canada…but only for a couple of quarters).

By late first quarter, early second quarter of 2016 it became evident that global growth was improving. We believe a similar movie is being played out right now.

Within the last few weeks Beijing has announced:
-Increased rail infrastructure spending by 40% year over year for 2019. Yes, that isn't a typing error – 40%
-Foreign bond issuance for 33 mainland companies – more liquidity into the system
-Mortgage rates for first time home buyers has been reduced, courtesy of the Bank of China
-Hints of automobile incentives, on the heels of weak December sales.

Are there important differences that differ from 2015 /16? Yes and many (trade wars / U.S. government shutdown again/ Trump tweets etc. etc.) - but we believe wholeheartedly that Beijing wants the economy to pick up and they will take *whatever measures required* until it is clear that growth is back in the Chinese economy. We also believe that the China – US trade war will be put to bed. We just need to get the end result that allows both Governments to walk away with a WIN.

Why do we care so much about growth in China?

China's economic activity has continued to drive global growth for the past five years. We believe that a reflation of the Chinese economy is positive for:

- Emerging markets with strong ties to China
- Commodity driven economies – which include Canada, Australia, Chile and South Africa
- Developed economies – which include Japan and Germany
- U.S. multinationals

So almost all benefit!

Our Strategy

At the risk of sounding like a broken record we are accumulators of good companies when fear causes others to sell. We don't buy stocks, we invest in companies – there is a distinct difference. In volatile times, investors have to remind themselves that stocks represent real ownership in companies, and that holding quality companies with strong balance sheets and earnings over time will deliver better returns than GIC's and Bonds. With that in mind, we do need to remind clients that in our financial planning work, retirement and estate planning, that we factor in an assumed 6% growth rate. Long-time clients will attest – we have exceeded that number over 10 / 15 and 20 years.

We keep a resolute focus on the fundamentals of the markets. We believe we are in the midst of the best investment opportunities we have seen in over three years. It does not feel like a market to just jump on a wave and ride. It is an opportunity to draw on our experience, knowledge, and our top-ranked equity research analysts and strategists to deliver valuable financial counsel and excellent returns for our clients.

Final words

There were no places to hide in 2018!

In the words of Freddie Mercury and Queen: 2018 - “Another one bites the dust…”

-Elizabeth and Mike

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