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Let's connect

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Market Gyrations

Equity markets may be entering the third correction of 2019 and the fifth since the US China trade war began in early 2018. With every correction we must determine if this is the beginning of the end of the bull market. Deep analysis is done by major investment houses on the question in an effort to steer clients in the highest probability direction.

Before we examine that topic however, we should understand that we are living in a unique time from a financial perspective. The expansion that was engineered in the Great Recession of 08-09 never really flowered. Central banks worldwide flooded us with cheap money to stimulate demand however the response of the nations' economies was anemic. The side effects have been many and are still playing out. Most important is that monetary policy is a failure. It hasn't worked to stimulate sufficient demand in the world economies.

The only current alternative is easing fiscal policy, or running deficits in other words. This must be considered on a country by country basis as not every country is trying to maximize economic growth. China desires to deleverage its economy given the massive debt on balance sheets there, so there likely won't be much response. China won't suffer greatly as they continue to grow at 6 percent. Germany is constrained by law and culture to run surpluses, except when on the onset of recession, which would be catalyst for a complete policy reversal and running deficits. The UK is due to ease no matter soft or hard Brexit suggesting upside for UK currency and assets in the short term before an eventual collapse. In the US federal massive deficits has been the administration's policy since 2016 and won't change. In Canada, Liberals and possible consortia will increase deficits while Conservatives would run to balance budgets. As you can see governments, generally, are not positioned to deal with the looming crisis.

Asset prices of equities and desirable real estate will continue to increase, since there is a limited supply and their yields are too high compared to the fixed income alternative. The effect of the lower interest rates will be profound for defined benefit pension schemes. Their liabilities have increased dramatically due to the discount rate effect in that future fund liabilities have a much higher present value. As an interesting case study GE has 600,000 pensioners. The pension funding deficit has increased 25% this year to $27.5 billion as a result of the interest rate declining since the end of the last fiscal year. That works out to $46,000 per retiree. The pension problem can only be rectified by longer working lives, increased saving or reduced benefits. GE is cutting benefits for some new retirees and has frozen the pension scheme for 20,000 current employees. These actions are only the beginning.

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There are no current policy responses anywhere to deal with the black hole of negative interest rates and the secular stagnation that is overtaking the world.

With regard to the equity markets, we seem to be ignoring the implications of the above monetary abnormality and focusing only on the China US trade war. For the main question regarding the outlook for a recession, the answer is “no time soon. “ The reasons are that typical preconditions that were in place for previous recessions are not in place now. First, total personal and corporate debt on balance sheets are stable and in aggregate have not run up, which usually happens. Second, there are three past times when shock disruptions in the geopolitical sphere have crashed economies but, in today’s case, the trade tariffs are a slow moving affair and effects are somewhat offset by central banking monetary easing and some fiscal easing. The expectation is for below trend growth for the next year. Markets should be in a bottoming process for the next few quarters. For the drawdowns, another question might be the magnitude. While market indices are near all-time highs, the attribution of the advance is balanced between cyclical and non-cyclical areas meaning a much more stable footing to support near current levels and to provide for future advances. Institutions are neutral to slightly negative on cyclical assets which is a good sign. As usual, retail positioning is not relevant.

In conclusion, committing funds to equity markets in this area is the highest probability positive action one could take at this time.

In the Spotlight: Wells Fargo

Travellers to the US will know of Wells Fargo (“WFC”) with bank branches seemingly everywhere. WFC is as big, in market capitalization terms, as RBC and TD combined. It holds balance sheet assets of US $1.9 trillion and it has three reporting segments namely, wholesale banking, community banking, and wealth and investment management. In the deposit market WFC is #1 or #2 in 40% of the 430 US metro markets in which it competes, placing it amongst the top deposit takers. WFC has always out-earned its cost of capital, even during recent troubles.

WFC medium term problems stem from a corporate sales culture that had run amuck. Millions of accounts of all types were fraudulently opened by employees attempting to achieve sales goals. Management responsibility for this malfeasance carried through to the top of the bank. Sanctions were imposed by US regulators that capped balance sheet assets at year-end 2017 levels of $2 trillion. Regulators eventually demanded that the CEO charged with correcting these problems be fired because of the slow pace of progress. This was done in late March 2019.

The new boss is Charlie Scharf, a well experienced financial services executive. Scharf will initially focus on regulatory issues including lifting the asset cap. In addition, there are a whole host of M&A and operational issued that must be addressed. WFC shares are trading below long term norms and progress towards the resolution of many of the regulatory and operational issued should see the valuation metrics improve. WFC trades at a PE of 10 and at 1.25 times book value. It offers a dividend yield of 4 percent, so we are well paid while we wait.

We are long term owners of the stock.

Ask Brian

Hello Brian,

I have read that pursuing a dividend growth approach to stock selection is the best strategy for stock investments. Do you agree?

Regards,
Ralph

Dear Ralph:

There have been a number of Canadian financial journalists who advocate this approach. Writing on this topic is frequent, so it indicates that the subject finds resonance amongst readers. The journalists portray the method as intuitive and simple to operate on one's own. As well, many asset managers explicitly target this interest by offering funds with those two words in their fund name.

The strategy is to own stocks with a long history of increasing dividends every year. The method thus reduces stock candidates to larger companies in somewhat stable sectors that have the ability to first pay, and then increase dividends consistently. Thus, you eliminate many companies that retail investors may be drawn to from the rumour circuit and from popular areas such as cannabis. The risk of wholesale capital loss/ruin is reduced. In addition you could argue that the stock price is irrelevant since the dividend keeps rising and you were satisfied with the yield on purchase. No need to worry about daily market news; it doesn't matter. Once the initial decision and buys are made, you can carry on with your life.

Well, I disagree. Investing is not simple and attempts to make it seem so are naïve.

The first clue that something is off is that the strategy is described as "a bridge to equities" in some quarters. In other words, it's an image, a simulation, a half measure. Inherent in the approach is compromise of a fashion. So, what are they?

By requiring dividend payments it means that you can't include the most dynamic companies that are on a growth trajectory. They require their cash flow to finance growth and so don't pay dividends.
Second, the strategy is typically overly focused on income and ignores valuation. It is not always a good idea to buy a stock and sometimes it is wise to sell even if the yield is high. Along the same, line some adherents wish their favorite stocks to decline so they can buy at higher yields. This makes no sense at all. I prefer my stocks to go up.
Dividend growth approach is a simplistic strategy designed to produce inferior returns. In addition it contains more risks and potential for loss than is initially apparent.

Regards,
Brian

Sources: Financial Times, BMO Capital Markets, RBC Capital Markets, J.P. Morgan, Barron's, Wall Street Journal, The Globe & Mail

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