Feb 5th, 2018

Wha' Happened?

For those of you who have seen A Mighty Wind by Christopher Guest might remember a scene where Fred Willard's character talks about a failed 1970s sitcom he was on where when something would go wrong, he would turn to the camera and use his catchphrase "Wha' happened?" Given the action in equity markets last week, it's worth asking this question and explore what's going on out there. Despite strong Q4 earnings, volatility is up and a welcome correction, as we had predicted for 2018 and wanted to see, is now underway. It shouldn't be too surprising given that US equities had been off to the fastest start since 1987 and a lot was being priced into stocks in the near term. What's amazing to me is how quickly investors have gone from optimism to fear when what we are seeing appears to be a healthy, textbook correction. Perhaps it's just because complacency had set in and investors have forgotten what corrections feel like but given the strong economic backdrop, we would suggest taking advantage of the dip and put money to work this week as we strongly believe we will see markets set a short term low within the next few days coinciding with a definitive reversal in the VIX index. At the time of writing, the VIX index is approaching 20 for the first time since 2016 and last week was the worst week for equities since early 2016 (see chart below). We feel it is unlikely for the VIX to spike much above 25 on this move given the current slope (unsustainable acceleration denoting panic) and it is more likely to end the week below 15 suggesting an equity recovery is possible, keeping in mind that more negative news flow could come on February 8th as another continuing resolution is necessary to keep the US government open.

The correction is pretty broad-based and global and is being blamed on fears of higher inflation and the impact of higher interest rates. Global bond yields have been rising rapidly and on Friday morning, the US released a strong jobs number that showed wage inflation of 2.9%, the most in many years. Wage inflation, in isolation, is not necessarily an indicator of broader inflation if there are productivity gains to offset it and there were some reasons for the bump such as one-time minimum wage increases in many states and some of the tax reform bonuses working their way through worker paycheques. Although higher long bond yields are negative for high-yielding bond proxy equities, the broader stock market is actually positively correlated to rising long bond yields until somewhere north of 4%, especially when the reason for higher yields is stronger global growth which is the case here. On this basis, the risk-reward opportunity is getting a lot more attractive quickly as equities fall given that recession indicators are not flashing warning signals and neither are high yields bonds. Growth equities tend to do the best in periods of rising inflation and interest rates as we saw in 2013.

The TSX has been hit harder than most developed markets to start the year but we believe the TSX is simply retracing the recent breakout of a 9-year base which could set the TSX up for a significant multi-year move to the upside. As you can see in the chart below, since 2008, the TSX has been trading in a wide and slightly upwardly trending range that was resolved to the upside last fall. The top end of this range has been rising from the low 15000s to the upper 15000s. In October, we broke clearly out of the top of that range and continued higher until this pullback that is retesting the breakout. To us, it looks very similar to when we called the start of the secular equity bull market in the US in July of 2013. We all know what US equities have done since then. If the TSX can stabilize around current levels and reclaim the breakout, it would be very constructive and at that time, we believe it would be prudent for investors to allocate more funds toward Canadian equities as the risk-reward would be quite favourable given valuations, earnings performance and how much Canada has lagged versus other markets.

One other interesting story this morning is Broadcom formally offering $82/share for Qualcomm which would be the largest technology deal in history and one of the largest M&A deals ever. This is inline what we talked about in our Themes Letter where we suggested that megamergers were likely to be seen this year and this would be a great example. Supposedly a bid in the $80s is enough to get this deal done, according to the notes I saw this morning.

This correction is what many investors have been waiting for so what are you waiting for?

Alex