2019 – First Quarter Review

MARKET REVIEW

The past six months have seen the return of volatility to the equity markets which was largely absent for all of 2017 and the first nine months of 2018. The first quarter of 2019 saw the market gain back virtually all the losses from the fourth quarter of 2018. While the swings both up and down in the market over the past six months have been reasonably large they cannot be categorized as extreme and are well within what we would expect in the context of historical market trends. In fact, looking at market history, the outlier is not the increased volatility over the past six months; rather it was the lack of volatility for the preceding two years that was surprising.

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Looking at specific regions, the Canadian market[1] was up 13.3% in the first quarter. The Energy sector, which led the way down in 2018 was up 15.6% in the first quarter. The only sector that did not produce double digit percentage gains in the quarter was Materials which was up 8.5%.

In US$ terms, the U.S. market[2] was up 13.5% for the quarter. Currency, which helped Canadian investors in 2018 worked against them in the first quarter. In CAD$ terms, the U.S. market was up 11.3% in the quarter. The International Developed[3] markets lagged the North American market; up 7.8% in the quarter in CAD$ terms.

Long-term government bond rates were down a little for the quarter, but overall bond returns were reasonably flat for the quarter.

THE TROUBLE WITH BONDS

Perhaps the most common topic we discuss with clients, both in our quarterly letters and in ongoing communication, is that a diversified basket of equities, while volatile in the short-term, is the best way to protect and grow the purchasing power of capital over the long-term. In addition to this, we consistently remind clients about the importance of setting aside near-term spending needs in an asset that is not subject to volatility of the overall equity market, typically short-term government bonds or something similar.

An asset class we do not discuss much is long-term bonds and a fair question would be – What is wrong with long-term bonds?

Bonds vs Equities

Before we discuss the bond market in any great detail we should first revisit a few basic concepts about the bond and equity markets. We ask that the reader bear with us – the next section may be a little dry and technical.

Both governments and corporations can issue bonds (debt) to raise capital to fund operations. A bond is simply a contractual agreement between an investor and a borrower to lend/borrow on certain terms. This is similar to a mortgage or lease, the primary difference being there is an active secondary market for investors to buy and sell outstanding bonds. In general, the terms of the bond (length of time to maturity and schedule of payments) will be determined by the issuer and the interest rate is set by the market. Typically the shorter the term and the lower the credit risk of the issuer (i.e. probability of failing to meet payment obligations), the lower the interest rate the market is willing to accept. Federal governments typically pay the lowest interest rates as they are considered to have the lowest likelihood of default. Once the bond has been issued, the investor is typically free to sell that bond to other investors in the

[1] S&P/TSX Composite
[2] S&P 500
[3] MSCI EAFE (Europe, Australasia, Far East)

secondary market. The price of outstanding bonds that trade in the secondary market moves inversely with the prevailing interest rates in the market, meaning that as interest rates rise the value of outstanding bonds falls and vice versa. The longer the time to maturity the greater the price sensitivity to interest rate movements. In most cases, the shorter the term of the bond and the higher the credit quality, the lower the price sensitivity. This is why we recommend short-term liquidity needs be set aside in short-term high quality bonds. The return potential is low, but so is the possibility of short-term price movements.

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Equity is only issued by corporations and is basically an ownership stake in the underlying business. Generally speaking there is no contractual obligation that the issuers make any predetermined payments to equity holders. The value of the equity stake is determined primarily by the current and future cash flow potential of the business and how much the market is willing to pay for those potential cash flows. The higher the perceived certainty over the future cash flow; the more the market is typically willing to pay for those cash flows. Over time the growth in earnings and cash flows is what generates the positive long-term returns in equities. In addition to this; equities typically provide better inflation protection since earnings and cash flow should rise with inflation, albeit with a lag.

Types of Investors

Much of our discussion around investing and markets takes for granted that the goal of the investor is to protect and grow the purchasing power of the underlying capital. These investors could be termed ‘Real Return Investor’. The vast majority of Cypress clients could be described as Real Return Investors; however it does not describe many bond market participants.

Given the amount of attention that the equity market receives in the media and cocktail party conversation it may surprise some clients to learn that the bond market is actually much larger than the equity market. The total value of all publically traded US equities is estimated to be $34 trillion, compared to the outstanding US bond market (government and corporate) which is estimated to be $43 trillion.

Crucial to understanding how the bond market functions is the knowledge that many, perhaps most, bond market participants are actually not concerned with protecting and growing the purchasing power of the underlying capital the way a typical individual investor would be. This is important because these investors are typically much larger and more sophisticated than individual investors and therefore set the price, interest rate and terms.

Examples of investors not primarily concerned with protecting and growing purchasing power:

Life insurance companies – Life insurance companies are big players in the bond market, particularly corporate bonds. The primary goal of those tasked with investing life insurance premiums is to match the asset (invested premiums) to the liabilities (insurance benefits).

Financial institutions – for regulatory reasons banks and other lenders are required to hold a certain amount of capital in bonds.

Monetary Authorities – Central Banks are tasked with managing inflation, economic growth and foreign exchange rates and this is accomplished in part by buying and selling bond securities.

Below is a table of who actually owns US government bonds. Individuals and Mutual Funds (which are typically owned by individuals) are the two groups that one would expect to be concerned with long-term growth of purchasing power, much like the typical Cypress client. The other investors listed below have very different goals.

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Holders of U.S. Treasury Securities
USD Billions

	Individuals	Mutual Funds	Banking Institutions	Insurance Companies	Monetary Authority	State & Local	Foreign	Pension Funds	Other	Total
	11%	13%	5%	2%	13%	4%	36%	15%	1%	100%
2018	1,901	2,238	897	366	2,223	688	6,347	2,693	250	17,603

Source: Securities Industries and Financial Markets Association (SIMFA)

The Federal Reserve in the US holds over 11% of the outstanding 10 year US Treasury and many of the largest investors in Verizon and Apple bonds (two of the largest corporate bond issuers) are the likes of MetLife, State Farm and AIG which are life Insurance companies.

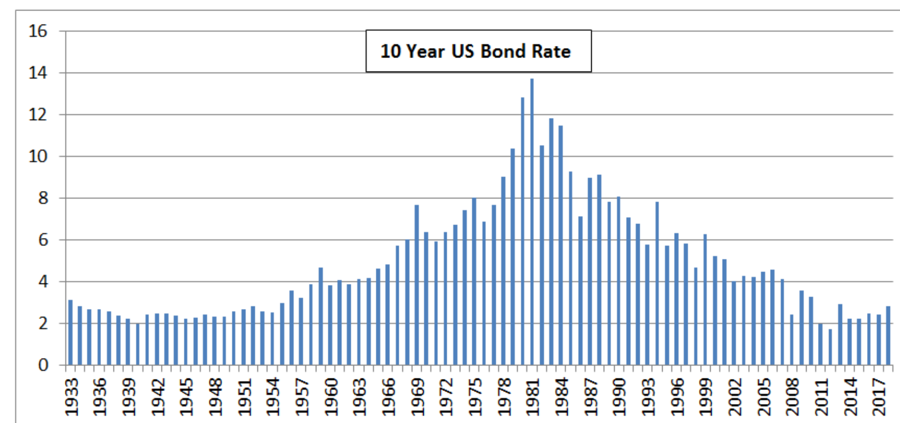
The point of this discussion is not to delve too much into the intricacies of the bond market, but some basic knowledge is crucial to understanding the overall market dynamics. *The reason long-term bonds are likely to do such a poor job of protecting and growing purchasing power over the long-term is that the price is set primarily by buyers that are not concerned with protecting and growing purchasing power.*

First principles of investing require defining goals. For most individuals investing in the bond market means investing alongside those that have very different goals. We should note that equity holders can also have different goals, for example short-term traders versus long-term holders. However the tension between the competing goals in the equity markets typically results in higher short-term volatility as opposed to lower long-term returns.

The fact is there is nothing 'wrong' with bonds. The majority of bondholders have no problem meeting their goals and objectives. The trouble is that if the goal is to protect and grow purchasing power over the long-term, most bonds are not designed or priced to meet that goal.

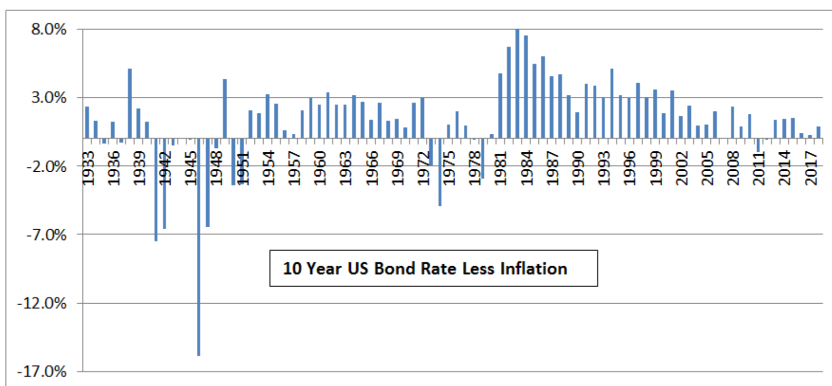
A BRIEF HISTORY OF LONG-TERM RATES

Many Cypress clients will recall a time when, in fact, an investor could achieve a reasonable return on bonds. Below is history of the 10 year US bond back to 1933.



Source: http://www.econ.yale.edu/~shiller/

The late 1970s and the early 1980s look like the prime time to be a bondholder, but it is clear from the graph that those high rates are the outliers over the last 90 years. Also, it is important to consider the impact of inflation. Below is the after-inflation yield on the 10-year over the same time period.



Source: http://www.econ.yale.edu/~shiller/

Owners of bonds, especially government and high-grade corporate bonds, should have little expectation of those bonds protecting and growing the purchasing power of capital over the long-term.

It was not until inflation dropped materially in the early 1980s that bonds offered an effective way to protect and grow purchasing power. In periods of high interest rates and lowering inflation, long-term bonds make a great investment. Today, however, we have low rates and low inflation making bonds less attractive. A close examination of the graph above shows that in recent years the 'real return' on long-term government bonds has been barely above zero, and in 2011 was actually negative.

If we could help our clients achieve the long-term goal of protecting and growing purchasing power by owning more bonds we would. Our desire to keep our clients exposed as much as possible to a diversified basket of equities is not the results of some inherent 'like' of equities or 'dislike' of bonds. Rather it is a dispassionate analysis of what the various asset classes are designed and priced to do. Owners of bonds, especially government and high-grade corporate bonds, should have little expectation of those bonds protecting and growing the purchasing power of capital over the long-term because, quite frankly, they are not designed or priced to do so.

OUTLOOK AND STRATEGY

The return of volatility over the past six months has not impacted our long-term view that the best way for clients to protect and grow purchasing power is by owning a diversified basket of equities. The recent volatility does, however, highlight the need to have short-term spending needs set aside. If an investor was forced to sell equities on December 24, 2018 it would have not made for a very merry Christmas. At that point most global equity markets were down between 15% and 20% from their summer highs, but have since rebounded almost entirely.

We will reach out to clients in the coming weeks, however if your cash or spending needs have changed materially or you feel your current portfolio does not reflect your expected liquidity needs do not hesitate to contact us.

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Please see our website www.cypresscap.com for our most current disclosure document.