QV UPDATE
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The Race to Negative

The spectre of a competitive currency war is looming following the Bank of Japan's surprise decision to cut their overnight lending rate below zero on January 29th. Japan now joins the Euro region, Switzerland, Denmark and Sweden in adopting negative interest rates.

Negative interest rates mean that depositors must pay to hold their money at the bank. This policy is designed to provide more incentive for banks to lend, and in turn, for businesses and individuals to invest and spend rather than holding excess cash at the bank. A zero-bound interest rate regime was also intended to spark the same type of activity. One could argue that ultra-low rate policies were at least effective in encouraging investment in equities and bonds. Its influence on stimulating sustainable economic growth is questionable.

The rebalancing of the Chinese economy towards consumption, combined with the slowdown in the energy producing countries, has had a material impact on growth outlook. At the same time, US domestic economic strength is being offset by a contraction in their manufacturing sector. All of these factors contributed to the slowdown in global growth from over 5.5% in 2010 to 3.1% in 2015.

Given the mixed results from seven years of low interest rate policies, what could negative rates possibly achieve? Central bankers will argue that it is a more forceful attempt to loosen credit and spur inflation. The immediate impact, though, is currency. The Japanese yen fell 2.0% against the US dollar after their negative policy rate announcement. A lower currency makes their exports more competitive, which they hope will stimulate more investment in their economy. Essentially, inflation targeting policies are being replaced by currency targeting policies. We ask, when does this race end? It hurts the profit margins of the banks, punishes savers, and promotes further debt accumulation in already indebted economy. It also encourages investor risk taking, adding to the volatility already present in the marketplace.

The Bank of Canada (BoC) did not require negative rates to depreciate the loonie. The oil price did that alone. High personal debt levels and a continuation of the weak commodity price environment may allow the BoC to avoid resorting to negative rates. Given the US remains our largest trading partner, we expect the BoC to be more influenced by the path and direction of US policy over the policy settings of Europe and Japan. So far, the US is still poised to increase rates in 2016.

Conversely, the prospect of further rate hikes, coupled with an improving economy keeps pushing the US dollar higher. For US based companies, their strengthening currency does provide an opportunity to purchase international assets at much lower values. Perhaps that was a trigger for the second attempt by the US home improvement chain Lowe's to purchase Canadian retailer **Rona Inc.** Lowe's intends to pay a large premium of more than twice Rona's share price to win over shareholders, this time with Board approval. Shares of Rona increased over 98% following the announcement. Rona is owned in our small cap and small-mid cap strategies. At time of our purchase, Rona offered an attractive valuation, and a new management team focused on debt reduction and shareholder value creation. Improving company financials and the falling loonie perhaps helped sweeten the deal for Rona shareholders. Lowe's concessions to the Quebec government, including maintaining the head office in Boucherville, will hopefully help get the deal approved.

This was welcome news for our small cap strategies as sentiment towards Canada remains poor. The resource sector, our currency, high consumer debt levels, all cast a negative shadow on Canada. As investors, we see good long term buying opportunities in great businesses when the outlook is grim. We are now seeing valuations in many Canadian companies at levels near the lows of 2009. We continue to be conservative in our asset mix given the uncertainty of our current policy environment and its impact on market volatility. Importantly, the volatility in the currency and equity markets has brought opportunity to use our lower loonie and to buy Canadian businesses that have the balance sheet and franchises to navigate through this uncertain economic environment.