QV UPDATE

Weekly Commentary | October 03, 2014

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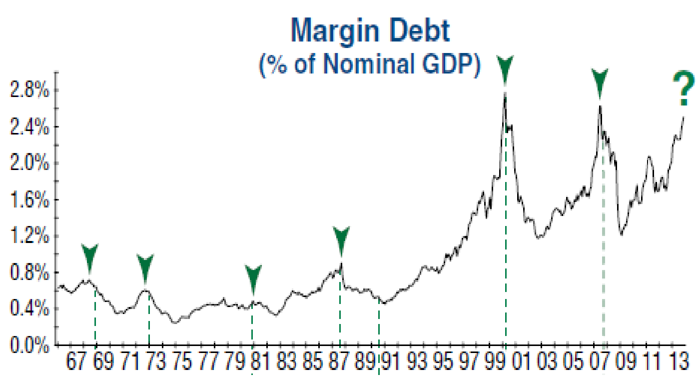
Not much has changed…yet!

In preparing for this quarter's market overview we reviewed our past few quarterly reports. In reality little has changed. Our predominant theme has been the continued impact of low interest rates in encouraging risk taking and propping up asset values globally.

A recent example of this is an excerpt from The San Diego Union-Tribune which reported that the pension board members of the San Diego County public-pension plan unanimously approved a new investment strategy that dramatically increases the use of "leverage," the margin debt we refer to later on. The board clearly states that the goal is to raise the risk of losses in hopes of lifting returns, because the government and its workers haven't saved enough to fully fund cheques promised to retirees in the future. The Chief Investment Officer commented "We're trying to bring up the risk, not keep the return and dial down the risk". Leverage (debt) has increased from 35 percent to 100 percent of the assets in the pension fund.



Source: InvesTech Research / January 10, 2014

This growing optimism and risk taking by investors has been widespread. This is well illustrated by the chart above which shows nearly 50 years worth of data depicting the use of borrowed money to invest in the stock market. You don't find investors willing to behave this way at the beginning of a cycle when valuations are attractive and the odds are in their favour. This has historically been a late stage reflection of optimism and greed, and it grips both individual and institutional investors.

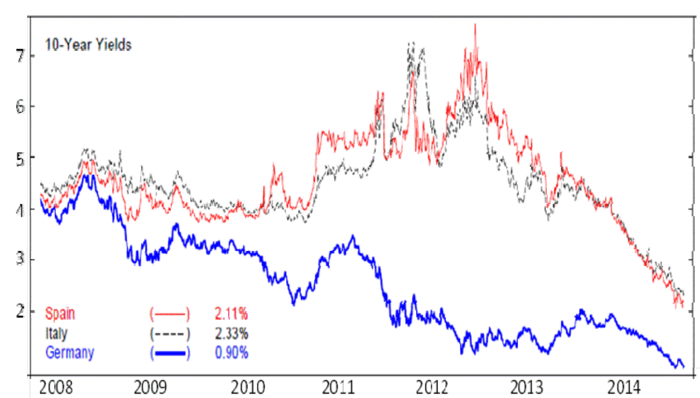
Where does this willingness to take additional risk come from?

Fed vows to keep interest rates low for "considerable time"

(CBSNews.com - 9/17/14)

Investors are overwhelmingly convinced that the Federal Reserve will continue to promote policies which are very supportive of asset inflation. The quote above shows the message in plain English; anytime the market gets skittish the Fed tries to calm it down and reinforce their support. It's not just the Fed. Recall when Mario Draghi, President of the European Central Bank (ECB), declared he would do "whatever it takes" in Europe. It is this type of continual backstopping that is raising the bar in risk taking.

This past quarter Mr. Draghi unveiled further plans to stimulate the weak European economy. The ECB will actively purchase bonds and cut interest rates further, with certain rates in Europe now negative. European bond yields fell considerably as a reflection of the poor economic data but also as investors recognized the monetary impact of such policy. German 10-year yields fell to less than 1%, their lowest level ever. Dutch and French 10-year government bond yields are at 500 and 250 year lows, respectively. The chart below shows the yields of Spain and Italy, considered lower quality credits, falling precipitously as they offer a higher relative yield to Germany.



Source: 2014 Ned Davis Research Inc.

Maybe we are too skeptical, but QV has a tough time putting so much faith in policy-makers and the long term benefits of their actions. Economics is not a science, as much as the markets try to make it out to be. For that reason we shouldn't assume that the actions of today will have predictable outcomes in the future. The policies over the past five years have been extreme; investors are desperate for yield and are behaving that way. The current backdrop for investors is a challenging one given the need to take on more risk in an attempt to achieve marginally higher yield.

The individual normally comfortable in GICs is being pushed into dividend yielding stocks. The bond manager who typically would buy high quality investment grade bonds finds themselves dabbling in substandard credits to squeeze out a little more yield. The equity investor lives by the notion that there are very few alternatives so stocks remain their best relative bet. What happens when something changes? Will the GIC refugee have the stomach to hang on with the volatility of stocks? Does the equity manager still like his potentially overvalued company when there is an alternative? We doubt it.

As Seth Klarman, a well-respected investment manager recently wrote, "Increasingly, hopes and dreams are being capitalized as if the future is certain and nothing can go wrong, as if up cycles such as the present one don't inevitably sow the seeds of the next decline."

Change

Change is upon us with the Federal Reserve bringing their most recent stimulus plan to a close. We think back over the last number of years, each time they attempted to do this the economy weakened and the market followed. This most recent iteration of Quantitative Easing (QE) was more aggressive and longer lasting. They are now working hard to assure the markets that normalizing interest rates will be very gradual and will not create any shocks.

We know the market doesn't like surprises; the Federal Reserve has left itself very little wiggle room by its assertive stance on interest rates. When we ponder potential shocks, the two most likely scenarios are on opposite ends of the spectrum. One is that the U.S. economic growth accelerates more than what both the Fed and the market expects next year. This would force the Fed to step back from their time frame and act more aggressively. The second outcome is an economic relapse similar to the last few times the Fed reduced their stimulative programs (QE). Both of these would be departures from the current widely accepted consensus that rates will move up slowly and the economy is doing relatively well. Not too hot and not too cold, just right for continued gains.

The currency markets are already reflecting change as the U.S. dollar (USD) continues to strengthen against a basket of global currencies. We believe a strong U.S. dollar is possible for some time and that it could have meaningful implications. The considerable weakness in the USD during much of the 2000-2010 period supported emerging market growth through foreign investment and the boom in commodity prices. We believe further strength in the USD will act as a headwind for both of these into the future. When you review economic history, prolonged strength in the USD has been associated with major challenges such as the crisis in Latin America in the mid 1980's and the Asian crisis in the late 1990's. We remain cautious in our exposure to investments in many of these regions.

Inside the Funds

All in all there was not a significant change in Net Asset Values of the funds over the period. In general, equities and bonds improved marginally. Global investments continued to benefit from a weaker Canadian dollar, and smaller companies underperformed larger ones.

We have continued to trim our more highly valued holdings and allowed cash reserves to grow. Our focus remains on managing risk in the funds rather than trying to maximize returns, unlike the folks at the San Diego public- pension plan.