QV UPDATE

Weekly Commentary | October 24, 2014

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Reality Check

Our thoughts and prayers go out to the individuals and family members directly affected by the events in Ottawa and in Quebec this week. The sense of peace and security we enjoy as Canadians was seemingly altered in one day. This new reality comes at a time when economic uncertainty in Canada and globally is heightened, and investor anxiety has intensified.

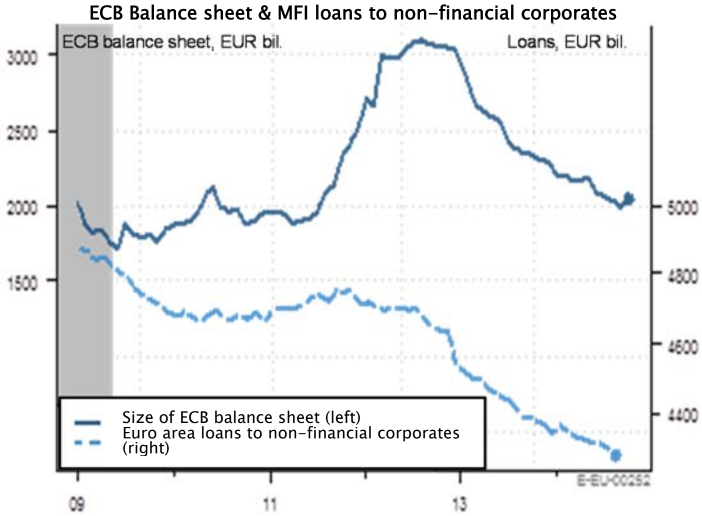
The reality of slow growth hit the equity markets in October, prompted by weaker reported growth in Germany and China and a sharp drop in crude oil prices. Signals from the world's central banks that policy will remain accommodative seemed to have calmed the markets for now, but the reality that monetary policy is not a panacea for future growth is becoming evident.

Market optimism following the European Central Bank's (ECB) decision to move to negative policy rates was short lived. Since then, declining industrial output in Germany and near zero inflation rates have created doubts to the effectiveness of ECB stimulus policies. The Japanese and US experiences suggest that improvements in economic output and confidence will take longer to materialise than anticipated by investors, and by the central banks that carry out these policies.

The issues in Europe are not easily remedied by lower borrowing rates. The chart below depicts the continued decline of Euro area loans to non-financial corporations.

Deleveraging banks saw no use for LTRO funds

ECB Balance sheet & MFI loans to non-financial corporates



Source: Pavillon Global Markets (ECB data via Bloomberg)
Shaded areas - U.S recessions

Unlike American and Japanese quantitative easing (QE) programmes, the ECB does not have authorisation to purchase sovereign debt, and are limited to buying corporate bonds. Euro-style QE targets the private sector by lowering borrowing costs and encouraging re-investment. Whether the private sector responds by selling their bonds and boosting capital investment is the larger question.

The ECB recently began purchasing bonds issued by European banks. This is the second programme targeted at banks. The ECB's first attempt to boost lending (as shown in dark blue in the previous chart) had little effect, perhaps indicating that banks were more focused on repairing their balance sheets versus increasing loans.

The Bank of Canada, in its third quarter policy report, wrote about the continued slack in the Canadian economy, in particular, the lack of business investment. Apart from energy companies, the Bank noted that few companies are planning to expand capacity. While our lower dollar is supportive for our export industry, sustained improvements in our main export markets are needed to boost capital investment, increase capacity, and provide more robust labour market growth.

To that end, the United States is finally showing steady improvements in industrial output and employment, six years following the recession. On a more worrying note, Bloomberg reported recently that S&P 500 listed companies will spend about 95% of their earnings on share buy backs and dividends in 2014. If this is true, how can real economic expansion take place?

Reliance on low borrowing costs to fund share buy backs can only work to boost earnings for so long. At some point, businesses must take the lead to grow through reinvestment and expansion. Only then can we get real, sustained growth. The end of American QE this quarter should hopefully set the stage for a market refocus on operating earnings and revenue growth. We expect the market may be disappointed in the pace of this growth. In the event of further equity market weakness, we will use our excess cash reserves to redeploy capital at more attractive valuations.