QV UPDATE
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When is Nothing Something?

Last week, as Brexit concerns grew, capital flocked to perceived safety and German 10-year government interest rates sank below zero for the very first time. This morning, with confirmation that British voters have decided to exit the EU, consensus has been proven wrong and panic is rippling through the markets. Stock markets are retreating, gold is surging and German yields have dipped solidly below zero once again. Brexit will receive the most attention in the near term, but our greater concern is that never before have such magnificent amounts of money flocked to such minuscule returns. When risking capital for next to nothing, reactions to events like the Brexit reverberate, with heightened volatility across asset classes. This is where we find ourselves today.

We are in a world supported by record monetary stimulus, keeping rates near rock bottom levels. Germany is not alone in this precarious world of "nothing notes". Last year, Switzerland became the first government to issue long-term debt with a negative yield and Japanese 10-year yields declined below zero earlier this year. Sovereign debt carrying negative interest recently topped $10 trillion globally, and now accounts for nearly one third of all outstanding government debt according to Fitch Ratings. Zero is also creeping into the non-sovereign world. Earlier this month, Toyota Motor Corp. sold yen bonds with the lowest coupon ever for a Japanese company, issuing notes at a yield of 0.001%.

Zero is different from other numbers. In some mathematical instances, zero simply does not work. Have you ever tried to divide by zero? Over time, we suspect governments will realize that zero interest rate policies (ZIRP) are a broken formula as well. ZIRP can stimulate in the very short term, pulling forward consumer demand for interest sensitive purchases such as cars and housing. Nevertheless, what happens after initial demand has been fulfilled? Regardless of how low the rate, the car and the house eventually need to be paid-off and one still needs to save for retirement.

The challenge for the saver in a zero or near zero interest rate environment should not be understated. Wealth cannot compound with a zero. For example, ten years ago, a fifty year old Canadian wanting to retire with an approximate $1 million nest egg at the age of 65 could achieve this through saving $500,000 and investing in 10-year Canadian government bonds yielding around 4.65% (assuming reinvestment at a similar rate). Fast forward to the present, a fifty year old desiring that same $1 million nest egg (never mind adjusting this up to compensate for 10 years of inflation) needs to initially save close to $835,000. Saving greater than 65% more is required now because 10-year government bonds in Canada have gravitated closer and closer toward zero, currently at 1.18%. The longer rates stay near or below zero, the less this stimulates global consumption and the more it accelerates the need to save more or take greater risks.

What do Bernie Sanders, Brexit and Donald Trump all have in common? More and more voters are questioning the status quo. For those that are taking greater risks, event risk like this morning's Brexit announcement require resolve. Unfortunately, those least able to afford making mistakes are the ones most likely to make them. Zero is not a reflection of a healthy environment and we cannot rest comfortably in the assumption that the cost of capital will be zero forever. Investors risking more today than ever before need to be well aware that increasingly, money is chasing lower returns while challenges to the status quo are growing.

In our portfolios this morning, we are holding steady in the wake of the Brexit news. We have identified levels where we would buy our most directly exposed businesses to the Brexit. For businesses we were buying yesterday, we are buying today. The fundamentals supporting these businesses have not changed overnight. It will take several years for Britain and the EU to hammer out new trade agreements and it is in both parties best interest to work effectively together. This morning's wild market swings reflect the reality that more money is being risked despite little appetite for it, increasing the need for some to react hastily. Nothing has become something.