QV UPDATE

Weekly Commentary | August 05, 2016

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Summer Diversions

The Olympic Games open today in Rio de Janeiro, Brazil. Like many, I look forward to the diversion offered by the feats of Olympians over what currently dominates the news headlines. Brexit, US election rhetoric, terrorism, economic weakness, and low oil prices, all reinforce the cycle of negative sentiment that continues to weigh on business confidence.

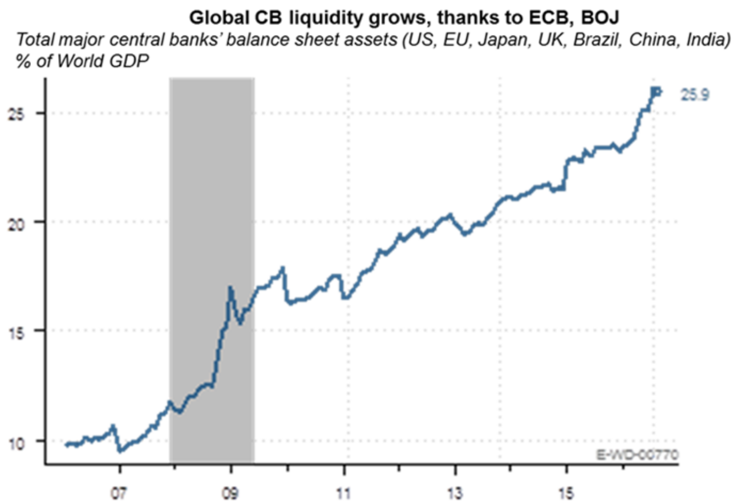
Bucking this trend of negative news is the recent performance of the equity markets. In July alone, the major US and Canadian stock exchanges rose over 3.5%, while global equity markets were up roughly 4.5% in Canadian dollar terms. With earnings growth challenged in most sectors, and economic uncertainty intensifying, this strong rally in the equity markets may be explained by the persistence of the low interest rate environment that leaves investors little choice but to take on more risk for the opportunity of positive real returns.

In a slow growth and low inflation world, the policy responses have thus far been to do more of the same. These coordinated monetary policies include zero or negative interest rates, and central bank bond purchase programs to lower borrowing costs. Their goal is to lift inflation expectations to sustainable levels above 2.0%. Any talk of diverting from these policies has typically been met with an equity market correction.

Therefore, in the face of economic uncertainty following the Brexit vote, it is no surprise that the Bank of England cut their main policy rate to 0.25%, and expanded their bond purchasing program. The US Federal Reserve Bank did not surprise either, keeping their policy rate at 0.25% in July, and their inaction seemed to at least appease investors. No summer diversions here.

Disappointing the market was the apparent lack of policy action in Japan. Despite increasing fiscal spending and maintaining their negative policy rate, the market was expecting more. Nearly three decades of low interest rate policies is not producing the desired inflation and growth targets. Credit growth is slowing again after an initial pick up in 2014. The quantity of bank notes is apparently increasing, but it is not circulating in the economy. Some evidence of cash hoarding is emerging. In their new era of negative rates, one can understand the need to hold more cash in the face of diminishing returns. The government is now turning to direct income transfers and business loans to encourage spending. More of the same in Japan is clearly not working to break this cycle of low productivity and weak capital investment.

The chart below depicts the balance sheet expansion of the major central banks as a percentage of GDP. We note that the expansion is on an uptrend again.



Shaded areas = U.S. recessions
Source: Pavilion, Global Macro Strategy & Research, July 2016

Central banks have been funding governments, banks and now corporations through their bond purchases since 2008. Liquidity is not an issue. Structural issues of an aging population, excess industrial capacity, and too much debt have not been addressed. As a consequence, low interest policies have served to lift most asset prices and have supported further credit accumulation. This reliance on debt upon more debt to try to spur inflation perpetuates a downward economic cycle of low income and productivity growth. This is the Japanese experience. With the persistence of anemic growth rates even after unprecedented policy accommodation, we question whether that will be the global experience to come?

We recognize that equity markets may continue to rally if central bank policies do not change. However, we remain focused in addressing rising valuation risks in the strategies. In response to a strong Canadian equity market rally and rising corporate debt levels, we trimmed Canadian equities in favour of global equities in our balanced mandates. We are augmenting low sovereign bond yields by investing in provincial, municipal and high quality corporate bonds. Our asset mix remains equally balanced between fixed income and equities, reflecting our concerns about rising risks. If equity valuations continue to rise to levels that jeopardize capital, we will revisit our asset mix again. In the meantime, it appears our summer diversions will be limited to the Olympic Games. Therefore…Go Canada Go!