QV UPDATE
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QV Investors Inc.

Back to School Blues

Stocks go toward stimulus as schoolboys from their books,
But stocks from stimulus, toward school with heavy looks
~crudely hijacked from Shakespeare~

As sun-drenched dreams of summer fade in the renewed labour of September's studies, so too have the stable markets investors enjoyed through the dog days of August. September can be a tough month for the S&P 500. Over the last 30 years, it is the only month where returns were more often negative than positive. Two weeks in, it looks like September may live up to its historical reputation once more.

The shift in seasons hasn't been the only change afoot. In July, the US 10 year bond (UST) yield reached a new all-time low of 1.3%. It has since catapulted back to 1.7%. Meanwhile, bond and stock prices have recently started moving in the same direction. This is unusual. According to the Wall Street Journal, historically such occurrences often coincide with inflection points in asset price movements.

Last week's announcement that the European Central Bank will stand pat on current stimulus measures has added to recent market volatility. The alphabet soup of hawkish and dovish comments from Federal Reserve governors ahead of next week's FOMC meeting has too. More interestingly, Japan's central bankers seem to have tacitly acknowledged practical limits to their bond buying expedition and that their economy and financial system may be better served by a steeper yield curve. Taken together, such shifts give pause for thought. In 2012, the UST bottomed at 1.4%, a similar level to this summer, before peaking above 3% in 2014. The S&P 500 rose steadily in this period from a low initial price-to-earnings (P/E) ratio of 12.8x. Today, stocks hover near a 10 year peak at 17.1x. The implication in recent positive correlations with bond prices may be that both stocks and bonds are expensive this time.

Consensus shares this opinion. A recent Bank of America survey found more than 50% of global fund managers believe both stocks and bonds are overvalued – a near peak since 2003. Meanwhile, the volume of inverse and volatility ETF's, which have generally ranged between 1-2% of NYSE trading volume, recently spiked to over 7%[1]. If further asset price volatility is imminent, the masses have never been so prepared.

The common thread amidst the noise remains the future path for the US 10 year yield. While we have no intention to call a bottom in long term interest rates, we question: is 3%-4% so unreasonable over the next few years? Maybe, but it also wasn't so long ago that rates waffled around this range and 1.3% seemed unimaginable. Prudency requires that we consider such possibilities and any resultant risks they pose. Asset prices exist in the realm of the relative. Their behaviour is not dissimilar to celestial bodies in a solar system, held in orbit by US Treasury bond yields – i.e. the risk free rate.

Currently, 78 names in the S&P 500 trade above 20x earnings and have long term expected growth rates below 11%. If these growth rates slow or valuations revert back towards more normal market multiples of even 16x, investors will likely receive no better than mid-single digit annual returns over the next 3-5 years. Not bad if the only alternative is the UST yield at sub 2%. But not very good if it yields 4% given the small incremental return compared to the greater degree of risk which accompanies investing in stocks. To generate more acceptable double digit returns in the above example, one must assume multiples remain elevated. This would generally imply above average growth remains intact or more attractive investments don't become available. The probability that both conditions unfold to plan becomes increasingly unlikely as time passes.

We don't know the future path of interest rates, but we remain attuned to potential shifts in the landscape that could affect our portfolios. Our risk management process naturally limits our exposure to investments which mostly only make sense in a world of low bond yields. It has also led us to strong businesses, within the financial sector in particular, which should benefit if interest rates rise, but which can still thrive if the current regime persists.

[1] The Daily Shot, Sentiment Trader