QV UPDATE

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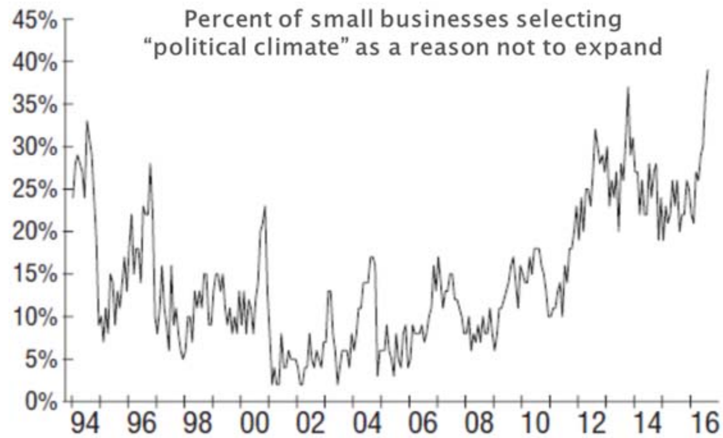
Relatively speaking, everything is absolutely fine...

Quarterly Review – Post June's Brexit scare, the majority of global stock markets posted positive returns. The fear created by the surprising vote was short-lived. Ironically, the potential negative consequences of Brexit seemed to act as a catalyst for investors. The perception that unprecedented monetary stimulus would remain in place given the new uncertainties likely acted to buoy markets.

The Bank of Japan just last year announced they were implementing a negative interest rate policy. Surprisingly, this quarter they changed course to a zero rate policy, effectively pulling back. We view this as recognition that not only have their policies been marginally effective, but possibly counter-productive. We have written in these letters about the limits and unknown consequences to the grand monetary experiment central bankers around the world have embarked on. This recent twist seems to be an admission that they have gone too far. Europe's Mario "we will do whatever it takes" Draghi may be the next one to realize they don't have the capacity to do what it takes.

With concern growing that monetary policy may be reaching its limits, more discussion around the need to implement fiscal stimulus is now taking place. Fiscal tools may well be the next leg of policies aimed to amplify economic growth rates. Given the platforms which both U.S. presidential candidates have laid out, this seems to be very likely.

Speaking of U.S. presidential candidates – The 2016 U.S. presidential election has taken on a life of its own. This campaign has been unlike any other and its implications have caused considerable uncertainty, particularly given the building global anti-establishment movement. The possibility of a Trump victory is real. Historically, markets don't like uncertainty, but the following chart shows it's not just investors. In a recent poll of small businesses, the National Federation of Independent Business (NFIB) reported that nearly 40% of business owners cited the political climate as a reason not to expand, an all-time high for this survey.



Data: NFIB – National Federation of Independent Business
Source: InvesTech Research/September 23, 2016

We will not speculate on the outcome, but if Brexit serves as an example of what a shock to the markets looks like, there is a likelihood of increased volatility. In circumstances such as these, we do not try to implement short-term trading strategies based upon some anticipated outcome. We do, however, consider how future policies may affect the industries or businesses we are invested in. If we feel there is a material risk, we will act accordingly. We maintain diversified portfolios, holding companies that have survived under all kinds of economic scenarios for many decades. This election will not be the end of these franchises nor the U.S. economy. Once the uncertainty has diminished, those worried business owners may actually begin expanding again.

Forget the election for a second, what about the economy? – The U.S. economy continues to show near full employment, consumer confidence remains healthy, and wage inflation is growing. Rates remain superficially low for this economic backdrop. Global uncertainties are part of the reason, but more so, central bank asset buying programs are pushing rates down everywhere. We expect the rate tightening cycle to commence post the election and wouldn't be surprised, barring any major global financial accident, to see rates move up more quickly than what the market is currently anticipating. Just a few years back, the 10-year U.S. Treasury moved up towards 3%; this past quarter it was at 1.6%. Is the U.S. economy really that much worse now? We don't think so.

What about at home? – The Canadian economy remains in a more fragile position than the U.S. With continued record high levels of personal debt, anemic growth, and overheated residential real estate markets in areas such as Toronto and Vancouver, we do not expect rate tightening by the Bank of Canada anytime soon. Policy makers continue to implement new real estate regulation to try to address rapid house price appreciation in select markets. Using tools that have broad implications to address specific regional problems could create unintended consequences we need to be mindful of.

It just seems backwards – The S&P 500 dividend yield is 2.1%, while the 10-year U.S. Treasury yields 1.6%. This spread is even more pronounced in Canada, with the TSX dividend yield of 2.9% nearly triple the 1.0% on the Canadian 10-year bond. It is rare to have a situation where the dividend yield exceeds the bond yield, especially by such a degree. Given the paltry level of income from bonds, investors have become conditioned to receive a significant portion of their total return from price gains. On the other hand, many equity investors are piling into expensive high dividend yielding stocks and funds for their income, regardless of the potential risk of capital losses. In today's low yield environment, investors are buying bonds for gains and stocks for income.

With bonds having such a low coupon the probability for meaningful gains is limited, and the potential for negative returns is amplified with small upward movements in rates. With stocks having no contractual obligation to repay principal in the future, the risks are elevated, thereby potentially erasing one's dividend income and more. In many cases, the rewards just don't justify the additional risks. We continue to buy bonds for safety and as a shock absorber for more volatile but potentially higher returning equities.

Relatively it's all good, Absolutely not so much – The most profound support for the stock market remains the bond market. When one considers the valuation of stocks relative to interest rates, they still look extremely attractive. Generally speaking though, when one considers the absolute valuation levels, they are very high in aggregate.

As long as current yields (ie. GIC's, savings accounts, etc.) aren't perceived as a reasonable investment alternative, and investors remain focused on the relative advantage of equities, market multiples can stay elevated. That being said, should interest rates at some point become a more acceptable investment alternative and compete with those 2%-3% dividend yields, many of these higher yield, higher multiple stocks will lose their valuation support. There is also another scenario which can be damaging to highly valued stocks. Investors can lose confidence in the financial markets and demand a higher return than what they are currently receiving. For stocks with high absolute valuations, there is little room for error. When something does go wrong, the relative argument can lose its lustre very quickly.

Yes, it's confusing, much like investing in bonds for gains and stocks for income. Our experience when investing in assets based on their relative merit is that they need to make sense as a standalone investment, not just compared to something else.

Strategy Review – The majority of our mandates fell short of their respective benchmarks in the past quarter, but still posted healthy returns given the composition of our portfolios. We remain committed to building portfolios consisting of quality franchises which will survive the election and the rate cycle. We have focused our efforts on ensuring our companies have balance sheet strength and defensible valuations absent unsustainably low relative interest rates. From today's levels, we believe the 3-5 year return outlook will be muted from the most recent experience. We won't try to force a higher return by increasing risk levels, but will look to take advantage of any market volatility to add good quality businesses when they go on sale.