# QV UPDATE

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## A Year of Change and Extremes

"Nobody knows anything" – screenwriter William Goldman

The quote above best describes 2016. With the surprise Brexit outcome, the Trump victory, and the Chicago Cubs finally winning the World Series after 108 years, the art of forecasting seems to be the year's biggest loser! Consider the Royal Bank of Scotland who, in early January, advised clients to "sell everything", fearing a deflationary crisis neared!

2016 was a fascinating year of extremes in stocks, bonds, commodities, and maybe most of all – perception. The opening weeks recorded the worst-ever performance for the nearly 120 year-old Dow Jones Industrial Average. To suggest it was a tough start to the year would be an understatement. Stock markets around the world plunged on fears of a major slowdown in China and the uncertainty of a rate tightening cycle in the U.S. Globally, most markets ended the year in green, with the Dow Jones posting a 13.4% return to rank as one of the best performing global indices in 2016. Go figure.

Early in the year, stocks weren't the only troubled area. The price of oil (WTI) hit a low of $26 in January only to find itself up 100% by the end of the year. While equities and commodities were under pressure, global bond markets reached new all-time price highs (and new yield lows) by mid-year. A number of major markets traded down into negative yield territory, something not seen before in the history of finance. This didn't last long though, as bond markets sold off sharply into year end.

Conventional wisdom, time for a change? The most significant factor in the appreciation of the stock market, bond market, and real estate market globally has been extremely low interest rates. The impact that aggressive central bank monetary policy has had on inflating asset prices is significant. Recent conventional wisdom with regard to interest rates has been a "lower for longer", if not forever, mindset. This perception has justified what seems to be, in many cases, distorted valuations. We illustrate our point with the chart below, showing real German 10-year bond yields.

The real yield is the nominal yield less inflation. At the very least, investors would want their investment to protect their purchasing power and offset inflation. The data in the chart goes back to the late 1950's. In all prior periods, investors generated a positive real return. The current value of this bond just doesn't make any sense to us. Yet its yield is being used to justify why other assets offer reasonable value. Yes, anything compared to less than zero looks relatively good, but is it reasonable to use zero as the basis for comparison? Unless prudent investment is dead forever, at some point the market will re-price these assets to once again deliver a positive real yield.


Source: Federal Reserve Bank of St. Louis, Bloomberg, Statistics Bureau

European and Japanese bond yields plummeted over the past few years with other global bond markets following suit. U.S. yields fell too low given relatively positive economic conditions. A catalyst for change has arrived in the most recent U.S. election. Now the U.S. bond market is leading the rest of the world – but with higher yields. We are in the midst of a change in perception on the future of interest rates. The belief that abnormally low rates are the remedy to restore economic growth is shifting to a realization that the effectiveness of monetary policy may be exhausted. Fiscal policy measures are now being implemented and we expect the low interest rate extremes to normalize over time.

Speaking about the U.S. election – Potential for major change comes with the election of Donald Trump. We can speculate about the nature of his policies going forward but there's far too much we don't know to make any conclusions. What we do know is he is a businessman and intends to be a pro-business president. Investors have a newfound enthusiasm for domestic economic growth based on the combination of new infrastructure spending, less regulation, and lower corporate taxes. In theory, if everything works as planned, it would result in massive fiscal stimulus and significant increases in GDP growth, jobs and corporate profits. It would also result in higher inflation and an expansion of debt financing, which is already at stretched levels. Depending on how he handles the re-negotiation of trade deals, it may mean higher geopolitical tension and a shift away from global trade. America becoming "Great Again" at the expense of other economies would have consequences.

The market will be very keen to see the details of Mr. Trump's policies to ascertain what the potential impact to the economy will, in fact, be. From what we know today, we would expect the proposed initiatives to provide a boost to headline economic growth. That being said, the U.S. economy was stable and growing pre-election. U.S. jobless claims dropped to a 43-year low while unemployment fell to 4.6%. Consumer confidence has improved to a near 10-year high and wage growth has been trending upwards.

One of the potential risks of the Trump economic plan is not that it doesn't work, but rather that it works too well. U.S. interest rates are too low for the type of acceleration in growth the market is anticipating. The thought of a material pick-up in inflation had been so far removed from investors' minds that it has caused a swift sell-off in the bond market. Equity investors generally like inflation, to a point, as it amplifies profits. Bond investors dislike it because it raises interest rates, reducing the value of the bonds they hold. The two can't go in opposite directions indefinitely. At some point, higher interest rates become attractive enough to offer competition against highly valued stocks.

Does this make us more bullish on equities? The short answer is no. Broadly speaking, the market was highly valued before the election; and now, even more so. Lots of potential good news has been priced in. Over the past few years we have been able to take advantage of sectors and companies which have been out of favor, such as energy, financials, and industrials. Many of these opportunities are now fairly priced. A potentially better economic backdrop, though, does provide us with hope that the higher valuations will be supported by improved earnings growth. This would be important in supporting equity prices.

Outside the U.S. At the start of the year, it was feared the Canadian economy was on the precipice of a meltdown as investors worried about a housing collapse and low oil prices. Sure enough, the Canadian stock market ended up being one of the best performing equity markets in the world in 2016! Before we get too excited, though, global economic growth remains below trend, debt loads are incredibly high and the European banking system remains fragile. The most recent example is the Italian parliament having to authorize a U.S. $28-billion bailout of Monte dei Paschi, the world's oldest bank.

Strategy Review – Our annual performance was quite favorable given the inherently lower risk portfolios we manage. Our Canadian large cap strategy posted a 20.3% return versus 21.1% for the benchmark. Canadian small cap had the highest absolute return of 27.6%, but lagged the 40.6% return for the supercharged benchmark. Our global mandate posted a return of 10.5% versus 4.9% for the MSCI World benchmark. Our Canadian bond strategy returned 1.8%, just ahead of its benchmark at 1.7%. All returns are gross of fees.

Looking forward we are focusing our efforts on ensuring our companies have balance sheet strength and defensible valuations absent unsustainably low interest rates. Our bond strategy remains positioned to protect against losses should interest rates continue to move upwards. From today's levels, we remain of the belief that the 3-5 year rate of return outlook will be muted from our historical experience. We won't try to force a higher return by increasing risk levels, but will look to take advantage of good quality businesses when they go on sale.