QV UPDATE

Weekly Commentary | April 7, 2017

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What's changed?

Between Brexit and the U.S. election, reading quarterly investment commentaries in 2016 was more interesting than usual. The first quarter of 2017 really had no blockbuster news to sway the market. It was for the most part a continuation of the backdrop set in Q4/2016 post the election of President Trump. Almost all global equity markets continued their upward march. Investors remain optimistic that the changes President Trump promised during his campaign will continue to be a tailwind for both the economy and stock market.

Will President Trump's reforms take hold? Late in the quarter, the failure to reform the health care act was a sneak peek into challenges the new administration may face. We expect the Republican Party's reforms to take time. The important point for investors is that the markets have given the administration the benefit of the doubt that they will be successful. A lot of good news has already been priced in. Markets are supportive at the moment, but may become impatient if expectations for the future do not pan out.

Our baseline assumptions on a few of the key reforms that have the ability to materially impact the markets over the next year are as follows:

Corporate taxes – There will be a reduction in tax rates. But not to the degree that was originally suggested, given the considerable federal debt levels and additional plans for infrastructure spending. President Trump campaigned on a 15% corporate tax rate, while the current rate tops out at 35%. Anything less than a cut to 20-25% may be disappointing given the markets' expectations.

Deregulation – There will be a significant reduction in regulation. This will be supportive of U.S. banks, homeowners, and consumers as lending conditions will improve. U.S. banks have seen their profitability levels, as measured by ROE, depressed at roughly 2/3rd's of what they were before the 2008-2009 crisis.

Infrastructure spending – It's coming and no doubt it's going to be big. That being said, these things take time. Look no further than the Canadian Liberal election promises on infrastructure spending a couple of years back. The market is ahead of itself in anticipating the immediate impact to the economy from this initiative.

It is easy to point to the renewed vigour of the stock market since the election and suggest the move is based solely on political change. The basic fundamentals of the U.S. economy were improving before the election and continue to do so. All types of confidence surveys, from consumer confidence to business optimism, continue to march upwards. One caveat on the confidence surveys is that the hard economic data released as of late is lagging the apparent strength of these surveys. Still, data from manufacturing to non-manufacturing activity continues to improve. Initial claims for unemployment recently hit a near 45-year low and more and more companies are raising wages. Importantly, after nearly 2 years of broadly stagnant earnings growth, the picture here is improving as well. To be clear though, much of the weakness in earnings over the past couple of years was from businesses affected by the major fall in commodity prices.

Improving trends, but is it sustainable? We need to put these positive trends into context. The stimulus from a near-zero interest rate environment continues to be a major driver of the economy. Even with such an accommodative background, absolute growth levels remain below historic averages. We still question how sustainable the positive trends will be when monetary policy tightens, given the continued excessive use of debt. We're not the only ones concerned.

"If rates go up, you're going to see something that's not pretty. It's all a big bubble". – Donald Trump, August 8, 2016

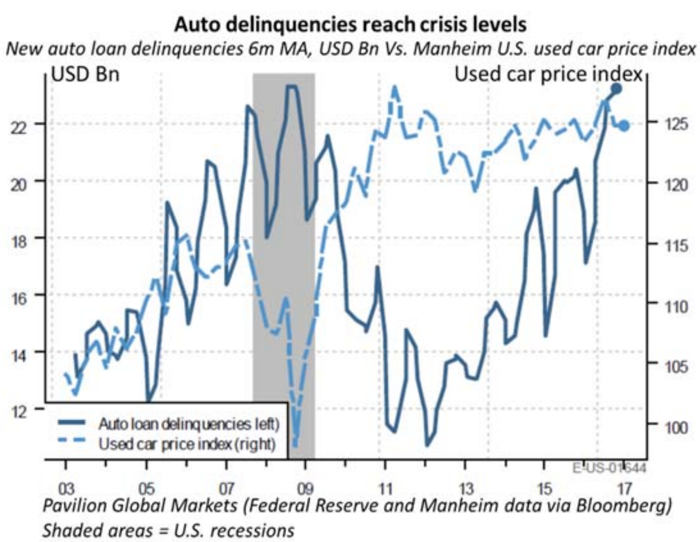
Hmmm. President Trump feels we're already in a bubble, yet his policies are to drive growth and, in turn, increase interest rates… we may have a problem down the road. We're not sure what his market forecasting record is!

Two major areas of recovery in the U.S. economy which we feel have been significant beneficiaries of extremely low rates are homes and vehicles. Given the consumer drives roughly 70% of U.S. GDP, the sustainability of their willingness and ability to buy is very important. To date, low rates have encouraged and enabled consumers to continue spending.

The chart below shows U.S. median home prices versus the long-term Consumer Price Index. Prices have surged again post the 2008 collapse to what looks like inflated levels.

Source: NAR, Bureau of Labor Statistics – from InvesTech Research / March 17, 2017

The chart below contains data from the Federal Reserve showing that new auto loan delinquencies (those with payments past due for 90 days or more) have reached levels similar to 2008.



Source: Pavilion Global Markets – Out of Focus / March 17, 2017

The global economy – Broadly speaking, global economies seemed to be improving as they entered 2017. In Europe, business surveys are at their highest levels in 6 years and productivity and industrial activity continues to show progress. China and other Asian economies also seem to be stabilizing after a difficult year in 2016. The Canadian economy is showing some diverging data points, with the Bank of Canada still fairly cautious on their outlook for economic growth. Most recently, exports from our manufacturing sector have picked up but the sustainability of this remains questionable. Specific Canadian real estate markets and consumer debt levels remain stretched. This will likely have an impact on longer term growth rates.

Outlook for future returns – An improving economy does not necessarily mean an improving investment environment. Valuations, which were already high prior to the advance, are now even higher around the globe. Despite the positive trends and the potential for beneficial change, there are not many bargains to be found in the equity markets. With elevated valuation levels, the margin of safety on the downside is less than we'd like and the upside return potential remains subdued.

Strategy Review – Following 2016's favourable performance, we had mixed results in Q1/2017. Our Canadian large cap strategy posted a 2.4% return, matching the benchmark. Canadian small caps returned 0.1%, compared to 3.9% for the benchmark. Our global mandate posted a return of 3.9% versus 5.7% for the MSCI World benchmark. Our Canadian bond strategy returned 1.3%, just ahead of its benchmark at 1.2%. The Canadian balanced strategy posted a 1.9% return compared to 1.8% for its benchmark. All returns are gross of fees.

Looking forward, we remain focused on ensuring our companies have balance sheet strength and reasonable valuations absent unsustainably low interest rates. Our bond strategy remains positioned to protect against losses should interest rates continue to move upwards. We won't try to force a higher return by increasing risk levels, but will look to take advantage when quality businesses go on sale.