

# QV UPDATE

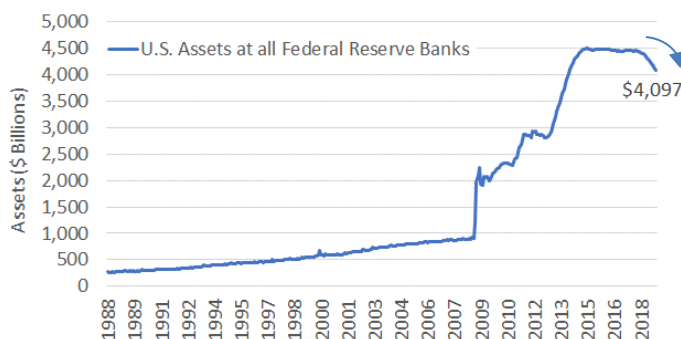
Weekly Commentary | December 14, 2018

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## The Changing Beat in the Background

With the year 2018 almost at a close, it's fair to say that market gyrations this year were greater than last year. Increased global trade tensions and higher interest rates were some of the reasons that led to the higher volatility. But another reason that is often overlooked is the changing landscape of central bank liquidity. Sometimes we grow so accustomed to the pace of music playing in the background that we forget just how extreme and unprecedented these quantitative easing (QE) programs really are. The chart below shows the collective assets on the balance sheet of the U.S. Federal Reserve (Fed). Three rounds of QE expanded its asset base to a record \$4.5 trillion dollars. Now nine years and nine months after the financial crisis, the Fed is moving in the opposite direction by tapering off its asset base, gradually pulling away from the extreme levels of market intervention. Furthermore, while the Bank of Japan (BOJ) is still making large-scale asset purchases, the European Central Bank (ECB) announced a halt to its asset purchases just yesterday. The ECB will still maintain the size of its balance sheet but will not be expanding it further. It will likely take some time before the ECB and BOJ join the Fed and begin unwinding their bloated portfolios, but the shift in tempo, however marginal it is at this point, is worthy of highlighting given the increased market volatility and higher levels of corporate leverage we see today.



Source: Haver Analytics & QV Investors Inc, Nov 2018

As mentioned, stock market volatility in 2018 has been notably higher than in 2017. While some may think that the intra-year declines in 2018 were abnormal, in fact it was 2017 that was the exception. According to JP Morgan Asset Management, the largest intra-year decline of the

S&P 500 in 2017 was -3% (vs -10% in 2018 YTD). Since 1980, intra-year market declines of equal or lesser magnitude occurred in only 5 of the past 38 years. So, historically speaking, the volatility seen in 2018 is much closer to the norm suggesting that it would not be unusual to experience more of the same going forward.

The bond market has also experienced a material change over the last few years. Government bond yields have risen from a combination of both central bank rate hikes and higher inflation expectations. The QV Canadian Bond Strategy is now yielding 2.9%, a level that hasn't been seen since 2011. But while higher bond yields are good for lenders that can earn a higher rate of return, the opposite is true for borrowers.

One of the excesses that has been a product of these near zero interest rate policies is the material increase in corporate leverage. With such attractively low financing rates, corporate managers took on large amounts of debt to fund acquisitions, share repurchases, and other corporate activities. As a result, non-financial corporate debt as a percentage of GDP is now at an all-time high in both Canada and the United States. We believe the market will eventually reward those borrowers that have demonstrated balance sheet discipline and correct those that have been aggressively relying on debt when the cycle turns.

Attempting to time the next market downdraft is very complex and difficult to get right. But instead of trying to predict the next downturn, investors can prepare themselves for it. Bonds provide both diversification and liquidity benefits within an overall balanced strategy. These are important attributes to have as markets adjust to a world of less central bank support. We believe our balanced strategies are conservatively positioned to weather higher volatility and are ready to invest in opportunities that arise.

We have no future-predicting abilities. We do believe, however, that it is sensible to assume that the supports used to prop the markets in the past cannot be relied upon in the future. The background music that has dictated much of the market tone is changing its beat and the value investors in us welcome a change in tune.