QV UPDATE

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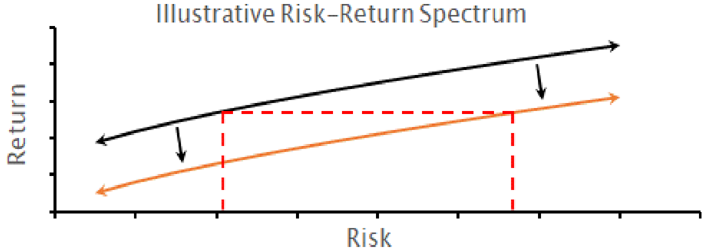
The Four Most Dangerous Words

The next U.S. Federal Reserve meeting is scheduled for the end of July, with the market fully pricing in a policy rate cut announcement. In fact, the market is not just expecting one rate cut, but three cuts (25 bps each) between now and the end of the year. Opposing these market expectations are a handful of key economic indicators that we believe in totality do not support the need for such a policy response. The U.S. economy is running with a strong labour market, an inflation rate that is essentially on target, and financial conditions that remain extremely accommodative. As it stands, the Fed is delivering on its dual mandate by fostering economic conditions to achieve full employment and price stability. So it's puzzling that a rate cut is actually under consideration.

We understand there are other global forces at play. There is a record ~US$13 trillion of negative yielding debt outstanding today. Global economic growth is slowing. Non-financial corporate debt levels are elevated. And trade war risks remain front and center. But equity markets continue to grind higher, in part because of the Fed's commitment to do what is necessary to prolong this economic expansion. This unwavering support of risk markets by the Fed seems to be a classic case of the tail wagging the dog and risks both the Fed's credibility and the effectiveness of its policy toolkit to stave off a recession whenever it occurs.

In the meantime, the lower for longer (bond yields) theme continues to support higher valuations across asset classes. Broadly speaking, miniscule bond yields have shifted the risk-return line downward (illustrated below), forcing investors to take on more risk for returns that have historically been earned from lower risk investments.

Illustrative Risk-Return Spectrum



Source: QV Investors Inc.

In fact, global interest rates are so low and have been for so long that we are starting to hear many investors chant the four most dangerous words of investing, "this time is different". Historically when the market fully believes in these four words, the next chapter has been a painful experience.

This is not to say that it is true or not. It is very convincing to believe that low interest rates are here to stay given structural themes at play, be it demographic dynamics, technological disruption, etc. But why do we back ourselves into these situations that force us to answer obscure macro-level questions that are difficult to answer with any shred of accuracy? Perhaps it's just in our human nature. A question so complex likely has a highly complex answer that's dependent on a broad set of assumptions that are in constant flux. The point is that the future will always be uncertain and that an ounce of conservatism will go a long way.

Investing is a risky endeavour. The prudent investor with a long-term horizon would most likely approach all opportunities cautiously, diversify appropriately, and prepare for volatility. In today's low return environment full of dangerous four-word phrases, try to keep it simple and stay true to a few investment tenets.

- Markets move in cycles, swinging between the extremes of euphoria and misery
- Over time, high quality franchises will likely strengthen fundamentally more than low quality franchises
- The valuation you pay today is a good indication of what your future return will be 3-5yrs out

Our balanced strategies are more conservatively positioned, primarily as a function of slimmer risk-reward opportunity sets available today. As market cycles adjust, so will investment prospects. We will position our strategies appropriately to benefit from investments that offer a much more attractive risk-reward profile when the time comes.

Investing is also a long-term endeavour, one in which you are often remembered more for your losers than your winners when it is all said and done. Invest wisely not emotionally. Now, those are four words we can live by.