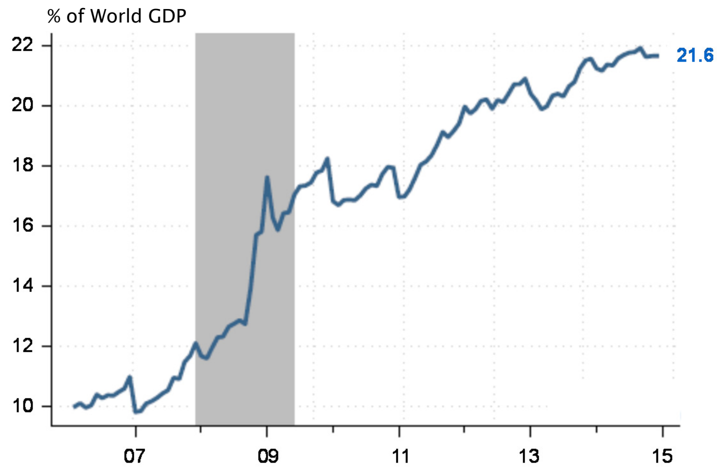
Joe Jugovic, CFA

The Race to Zero… or Less

The first quarter of 2015 saw over twenty central banks execute stimulus measures, not to mention Europe's inaugural Quantitative Easing (QE). The chart below shows the massive expansion in major central banks' balance sheet assets since 2006. In roughly eight years they have more than doubled as a percentage of world GDP. Stock and bond markets have made investors enormous profits since then, aided by these actions. The global economy though is another story. We know the stock market is supposed to lead the economy, but we fear that the market has already priced in a significantly better future. If this is the case, it either leaves prospective returns diminished or lessens the cushion if the outcome is not as expected.

Global liquidity injection still on an uptrend
Total major central banks' balance sheet assets
(US, EU, Japan, UK, Brazil, China, India)



Source: Pavilion Global Markets (data via Datastream)
Shaded areas = U.S. recessions

The shaded bar in the chart above highlights the financial crises. The message from policy-makers then was that these were extreme times and needed urgent and unprecedented measures. We recall being told that the patient was on the operating table and whatever had to be done to save them was fair game. How is it that those emergency measures have now become commonplace, with even more remedies being introduced? What are the boundaries for central bank policy and what will the longer-term outcomes be? Are global central bankers over-estimating their ability to steer the economy and in turn setting us up for yet another future shock? These questions will have longer term meaningful answers. Given the continued use of unconventional policies over the past six years, history offers us little in the way of a road map. We believe we are seeing the extreme outcomes that the multi-decade long build-up of global debt has produced.

The consequences of today's very low rates are that savers and investors have to take on more risk to generate an adequate return. Broad-based asset inflation in stocks, bonds, and real estate is leading to continued boom and bust cycles. Most troubling is the aggregate debt that continues to accumulate as opposed to being paid off given there is little incentive to save and great incentive to borrow.

This past quarter Europe kicked off their own significant quantitative stimulus program and European bond yields continued to evaporate. Investors are paying governments to take money off their hands as a number of European banks are paying negative absolute yields for deposits. Not all is lost for savers though; if you lend your hard earned money to the Government of Germany for 10 years you can achieve just over 0.15% annually on your investment! If it is true that everything is relative, I guess it's better than the negative 0.10% on Switzerland's 10 year bond.

Trillions of dollars are being invested in securities yielding close to or less than nothing. Central banks have become to institutions what the mocked mattress has historically been for individuals; security. There is one big difference though, no mattress we know of ever provided double digit returns like European bonds have in the most recent past. If interest rates were to ever rise it would become immediately evident that extremely low yielding bonds are not a financial mattress equivalent.

Earnings, Oil, Rates, and Currency

We just completed another quarter of earning releases. Share buybacks have been and continue to be a source of earnings per share growth and stock gains. Companies in the S&P 500 have spent more than $2-trillion on their own stock since 2009, underpinning some of the gains. The dollars spent on buybacks and dividends in 2014 equated to nearly 95% of S&P 500 company earnings. Profits remain at elevated levels due to a healthier economy, record margins, low rates, and aggressive repurchases. It will be hard for companies to get off this buyback treadmill.

Oil prices continued to slide throughout the quarter with adjustments to capital spending and headcount readily apparent in the companies directly impacted. Bank of Canada Chairman Steven Poloz surprised the markets and cut interest rates by 25 basis points as insurance from the adverse impact of falling oil prices on the overall Canadian economy. We remain committed to the high quality energy businesses we own, but don't anticipate a quick recovery.

The U.S. dollar continues to strengthen relative to the majority of other global currencies. Given the improvement in the U.S. economy in conjunction with a potential tightening cycle we anticipate the U.S. dollar to remain in a relative position of strength, but the pace of change to diminish considerably from the past twelve months. Outside of the U.S., many countries continue to lower interest rates with the goal of weakening their currencies to stimulate their domestic economies. We expect this to continue.

Portfolio Positioning

Investors remain positive on equities due to the lack of a reasonable yielding alternative. With what appears to be negative real yields on many fixed income assets, equities are the de-facto higher yielding investment. Given how low bond yields are today, that would be true if the stock market traded at considerably higher valuations.

This is where we scare ourselves. If that argument holds and stocks continue to escalate to very high valuations, the offices of QV Investors and most value firms will be full of miserable people. We do have to recognize that anything is possible in investing, but are not building our portfolios on that premise.

For individuals and institutions aiming for a 6%-8% return, it is getting more challenging given the historically low level of bond yields. We have great respect for stock market and economic history; having learned that to be successful long term investors the goal is not to attempt to maximize returns all the time. History teaches us that the risk for loss magnifies the deeper we are within a market cycle. The natural inclination is to take additional risk to generate higher returns. We believe the prudent course of action is to accept the likelihood of a lower return profile going forward.

Trying to manage risk in a market that is more enamoured with maximizing returns can become frustrating. Focusing on companies with very strong balance sheets and better valuations has been a relative performance deterrent in the short term. By building a bond portfolio with a lower duration and higher quality bonds we have also had to sacrifice short term gains for what we believe to be longer term stability. We leave you with a few points which we believe are important:

- *significant gains have been made in the past six years in both stock and bond markets, we should prepare for diminished future returns*
- *this is not the right time to take on additional risk; don't worry how much your neighbour says they made*
- *monetary policies may continue to provide the support to inflate asset prices to levels none of us think reasonable*