Wendy Booker-Urban

QV Investors Inc.

Living with Neutral

The term "neutral" has been cited frequently in recent months in describing the current policy environment. PIMCO, the famed global bond manager, recently referred to their new investment strategy framework as "The New Neutral", a slight alteration from their previous strategy, "The New Normal". The premise of "New Neutral" is that the Federal Reserve Bank's neutral policy rate is closer to 0%, lower than the widely accepted 2.0%. In this context, neutral implies low real policy rates for the foreseeable future.

PIMCO reasons that the policy rate needs to be lower as the world remains awash in debt. Aggregated debt has not fallen; it has just shifted between the government and the private sectors. Global growth will remain below potential, and as a result, inflation pressures will be contained.

In his presentation of the Bank of Canada's second quarter Monetary Policy Report, Governor Stephen Poloz recently referred to their current policy settings of 1.0% as neutral. In defense of his neutral description, Mr. Poloz argues that inflation is moving to target and is within policy ranges. Neutral is by definition unbiased towards one policy stance or another. According to the Bank of Canada, the current policy rate is "where it needs to be" to achieve their inflation target of 2.0%.

In her address this week to the US Senate Banking Committee, Federal Reserve Chairwoman Janet Yellen referred to the slack in the US labour market for justification of their below normal policy rate. Despite opposing views aired by two colleagues on the Federal Open Market Committee, recent improvements in the US labour market and a pick-up in inflation do not apparently warrant monetary policy normalization.

Is PIMCO correct? At 0% in the US and 1.0% in Canada, and a reluctance to raise rates despite diminishing deflation risks, are we at neutral? If Japan is our comparison, then yes. Japan continues to be mired by slow growth and low inflation 25 years after their debt crisis. Near zero policy rates have been the norm in Japan since the mid 1990's.

Nearly six years following the financial crisis, the Bank of Canada maintains its accommodative policies given the "unbalanced" growth in our economy. Personal consumption, housing and resource exports continue to be the main growth drivers. The expected rebound in our non-resource exports has not occurred. In the words of Stephen Poloz, "animal spirits" are lacking in Canada's corporate world. While the cost of capital or access to it is not an issue, the willingness to re-invest for expansion in an uncertain global economy is. Broader corporate investment tends to lead to a sustainable level of economic growth, and a more balanced economy. We have relied for too long on sectors dependent on a continuation of these low interest rate policies, such as housing, to support our economy.

Despite launching even more aggressive fiscal and monetary policies last year, economic growth in Japan remains low at 1.0%. While their stock market rallied in anticipation of improved growth, the pick-up in business investment has been slow to materialize. Confidence is not recovering as fast as central bankers and investors had predicted. That is the crux of the issue in Japan, Canada and now in Europe.

Low single digit revenue growth is the norm for many companies in a broad array of industries such as banks, food retailing, and telecommunications. We continue to apply greater conservatism to our corporate valuations in this slow growth environment. Our value discipline prevents us from justifying higher valuations based on the premise of an extended period of low interest rates. Improving measures of profitability and credit quality must be present for this justification.

We have been living in PIMCO's "New Neutral" world for some time now. If this is to change, business confidence must improve to stimulate greater capital investment. This in turn should bolster employment and incomes, two of the Fed's prerequisites to rate normalization. In the meantime, our low interest rates fuel greater market risks as valuations climb higher. Neutral may describe the stable policy environment, but its level implies a growth issue not easily, nor quickly, resolved.

Copyright © 2014 QV Investors Inc. Readers may forward electronic versions of this Update. All views and projections are the expressed opinion of QV Investors Inc. and are subject to change without notice. This Update is provided for informational purposes only. QV Investors takes no legal responsibility from any losses resulting from investment decisions based on the content of this Update.