QV UPDATE
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Autopilot

Where has the time gone? It seems like only yesterday the market was fretting about Greece going broke or the U.S. falling over the fiscal cliff. If that didn't worry us all enough, there was the announcement of Hostess, the maker of Twinkies filing for Chapter 11 bankruptcy. Ahhh, those were good times for investors who seek opportunity in worry. What's left to fret about? There's the Ukraine and Iraqi situation, but these recent upheavals barely get the markets attention. Even the pullback of monetary stimulus by the U.S. Federal Reserve, otherwise known as tapering, seems to be met with significantly less angst today. The market seems to be comfortable cruising along on autopilot.

Without uncertainty, value investing becomes more and more challenging. It's difficult to find opportunity when assets are priced for a favorable outcome. One of the major tenants of successful long term investing is managing the downside risk. Ironically, it is easier to do this when the outlook is cloudy and the mood is unsettled. This is not the environment we find ourselves in today. We long for a little bit of fear (opportunity), but instead we're stuck with a market lulled into a state of calm.

There has certainly been significant improvement. From the depths of the financial crisis, the U.S. economy has been rebuilding itself. Take for example the following chart which shows U.S. Industrial Production (blue line) hitting new all-time highs. Production is up at a 4.6% annualized rate in the six months ended May, nearly the strongest it's been in the current recovery. The U.S. economy has witnessed a slow but improving employment picture, resurgence in its domestic manufacturing base, a rebound in housing, and a booming energy sector to name a few positives. In addition, many state and municipal governments have started to spend their growing tax revenues.

While these are certainly healthy indicators for the future direction of the U.S. economy, we shouldn't lose sight that some of the improvement is likely the result of the continued zero interest rate policies. We continue to question the sustainability of the upturn without help from the Federal Reserve.

The stock market is a leading economic indicator, not a coincidental one. Based on our calculations much of the improvements have been priced in. That being said, the ultimate level to which the markets can trade to has more to do with emotion than calculation. It becomes much more about art than it does science the further along we go.

Trust in Government, Trust in Policy

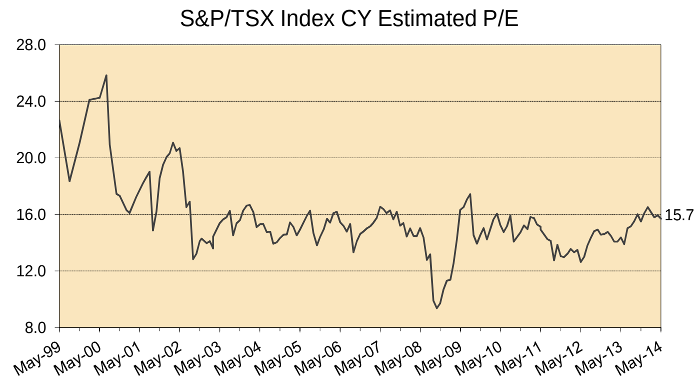
Not all economies have shown the same type of improvement as the U.S. Take Europe for example. The chart above also shows Europe's Industrial Production (red line), not exactly a picture of health. This quarter the European Central Bank announced its newest supportive monetary policies to spur the economy. A weak Europe is not a good thing for China and many other emerging economies as Europe is a large customer for their goods. China's status as a market darling for much of the last decade has soured.

China's consistently high 10% GDP rate of growth has now slowed to the 7.5% range. This is enough of a slowdown to move the government to introduce additional stimulus programs, with the reassurance that more could come.

Not to be outdone by the rest of the world's economic intervention, Japanese Prime Minister Shinzo Abe this quarter outlined his "third arrow" growth strategy. His first "two arrows" drove down both interest rates and the value of the Yen. This third arrow is focused on restructuring corporate Japan, lowering tax rates, and improving competitiveness.

Our concern may be misplaced. But what continues to puzzle us is five years post the recession we still have governments around the world engrained in managing and stimulating their economies. Today's markets continue to be highly supported by these benign interest rate policies. The lack of real investment yield has far reaching implications into all assets and geographies of the investment landscape. The central banks have certainly succeeded at creating inflation in home prices, stock markets, bond markets, art markets, and infrastructure markets. They have pushed capital out of low risk investments into anything else that can provide a higher return. Low rate policies remain the primary driver of asset values around the world, period.

The far-flung consensus is rates will stay low for long, economies will continue to improve, and inflation will remain low. We've learned to be wary of widespread certainty; the market has a way of frustrating the majority. The following chart illustrates the Price/Earnings ratio of the Canadian market. The valuation expansion suggests it is prudent to become more conservative in our asset mix. In doing so, we reduced our equity exposure within balanced mandates and continued to trim higher valued positions in equity only strategies.



Source: Capital IQ

Looking Forward

The Canadian equity market has been one of the best performing markets globally year-to-date. This follows on the heels of 2013's weak relative performance (still was up about 13% on an absolute basis). All sectors have posted gains, with the cyclical resources, particularly Canada's energy patch leading the way. Our portfolios continued to perform reasonably well, but have not kept up to the strong pace year-to-date after significantly outperforming last year. The same can be said of our fixed income and global portfolios which managed to grow their value but not at the same extent as the marketplace.

We are concerned by the distortions the very low interest rates are causing, as well as the fact that savers are being penalized and forced to accept more risk to achieve a reasonable return. There is the real possibility that this environment is prolonged and that the risks continue to build. We have had to manage through similar markets in the past. We have learned that we must stay disciplined to our process even if that means giving up some potential return in the near term. Protecting capital in this environment is challenging, but we will not shift our strategy to autopilot and ignore the risks.