QV Investors

QV Update

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Preparing for a Lower Dosage

Never before has the rate of money printing been so furious and prevalent in the history of mankind. In a recent speech, Bank of Canada's Deputy Governor John Murray commented that four of the most influential central banks (European central bank, U.S. Federal Reserve, Bank of England and the Bank of Japan) hold bank assets anywhere between 20% to 33% of GDP, with the Bank of Japan planning to increase its balance sheet to nearly 60% of economic output. The sheer volume of liquidity seemed to have stabilized the global economy from financial ruin. The promotion of greater risk appetite has translated to improved confidence levels. However, excessive risk taking and debt accumulation has the potential to create another financial crisis. Quantitative easing (QE) must be tapered to avoid long-term addiction to easy money policies.

Unwinding the support system will likely be met with market volatility, as assets are re-priced to reflect higher interest rates. Hinting is now the new policy. Forward guidance and transparency are used to inform market participants well beforehand to ensure an orderly exit rather than a frantic one. Step 1 is to slowly ease the foot off the throttle (tapering) and ensure that the timing and intent is well communicated. Step 2 would be to assess U.S. economic health free of QE. Step 3 would be to tighten monetary policy if a 6.5% jobless rate and 2.0% inflation rate are reached. The game plan, as it stands, is well communicated.

We see North American interest rates continue their upward trend as capital flows out of the bond market and buying pressure from heavy-footed central banks retract. Barring an exogenous shock, we roughly estimate that the U.S. treasury and Canadian government 10-yr yields could rise to a range around 3.5% over the next year. A slow and well-communicated tapering is necessary to avoid shocks to the economy. As of writing, Canada's debt-to-disposable income ratio rose to a new record of 163%, as of Q2 2013. We welcome higher interest rates to stem the growing domestic threats of over leverage.

While we believe the momentum for higher bond yields will continue, we are cognizant of issues that may limit interest rates from being excessively high. Firstly, not all advanced economies can exit from their monetary policies in unison. The Eurozone is still mired in recession and Japan is nowhere near a recovery. John Murray pointed, "The lack of synchronization in policy stances across countries should help to moderate the reaction of global interest rates." Meaning, historically range bound interest rate differentials should place a limiter on higher rates. Secondly, the U.S. budget is nowhere near balanced and remains in a net deficit position. (Side note: the debt ceiling debate part 2 will be returning to your home screens in the coming months.) Higher rates translate to a greater proportion of the national budget allocated to interest payments; a waste of tax dollars. Lastly, we're seeing a disharmony of economic data to support the case for a self-sustainable economic recovery. For example, while the U.S. unemployment rate has improved from 10.0% in 2009 to 7.3% last month, the labour participation rate has declined, implying a shrinking labour force. The lack of unified data suggests the economy remains in a fragile state. These issues we believe place limiting pressure on rising bond yields over the near term.

Our bond portfolios remain in a shorter duration position relative to the benchmark. As of last month, the QV Canadian Bond Fund held a modified duration of 4.8 vs the DEX Universe Index of 6.7. A lower sensitivity to rate movements mitigated capital losses from the sharp rise in bond yields over the past four months. A focus on capital preservation over yield benefitted the Funds. But now with higher yields and a steeper yield curve, we are finding better value in mid-maturity (5-10 years) bonds than before. We remain constructive on corporate credit (40% of QV Bond Fund), as we continue to identify stable to improving credit profiles that are additive to the portfolio's yield. We remain defensively postured and will reinvest coupons and maturities at higher rates as they come due. Ultimately, our duration positioning is reflective of the value we find in the market and the divergence from the DEX should narrow as we see rates edge higher and the yield curve steepen.

Our response to a rising rate environment in our balanced strategies is to remain underweight fixed income (35% of portfolio). Equity valuations based on dividend and earnings yields remain superior to that of bonds. But a shift in asset mix may be warranted if bond yields march higher and relative value improves.

As long term investors we applaud a higher bond yielding environment as capital can be invested at higher rates of return. Fixed income still plays an important role in a diversified balanced strategy. It acts as a shock absorber in times of market distress, and as a source of liquidity and income over time.