QV Update

August 23rd, 2013

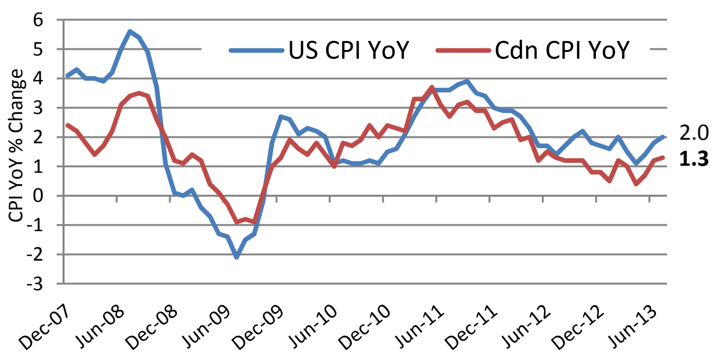
Wendy Booker-Urban

Summer Reflections

As I return to my desk following a brief summer respite from the world of investing, catching up on the news that moved the markets can be a harrowing experience. During my absence, gold stocks found new life despite write-offs in excess of $25 billion. Long-term bond yields continued their march higher even though central bank rate hikes seem a distant reality. Now popular market strategists are garnering press declaring the end to the secular bull market in bonds. Wow…I was only away for two weeks!

The recent trends in the market indicate inflation fears are back. While standard measures of inflation, the Consumer Price Index (CPI), and the Producer Price Index, are not reflecting these fears. Continuous improvement in the US labour market is signalling higher wages and therefore rising inflation pressures sooner than some expected.

We have been here before. Inflation fears were prevalent in the summer of 2011 as CPI in the United States reached 3.9% following a period of rising commodity prices. Canada's CPI also rose to 3.7%. Stagflation was the worry then; inflation combined with negative growth.



Source: Bloomberg, QV Investors Inc.

What followed was part two of the European solvency crisis, the US debt ceiling debacle, and the US credit rating downgrade. The European economy headed for recession, and another round of quantitative easing was launched in the US to prevent a deflationary spiral. Commodity prices began to fall, as did headline inflation.

The difference this summer is the cause of these "inflationary pressures." Nearly three years of US job growth, coupled with steady declines in the unemployment rate (now at 7.4%) and lay-offs, all support a potentially healthier US economy. Tighter labour markets should eventually improve incomes and boost consumer demand. Consumer confidence reached a 5-year high in July, reflecting these improving employment trends. These cost pressures feel a bit more sustainable than the commodity push inflation seen in 2011.

With deflation risks abating, investors have turned their focus to inflation protection. Hence the renewed interest in gold and the increase in redemptions from bond funds. The US Federal Reserve Board's recent Minutes disclosed consensus for a reduction in their bond purchases, providing comfort to investors of diminishing deflationary fears.

While we have been "early" to this view of rising inflation pressures, our inflationist view was tempered with the knowledge that necessary debt reduction by all levels of governments and Canadian consumers will hamper economic growth. This scenario has played out through annual GDP growth of 1.7% in the US and 1.6 % in Canada during the first half of this year. Top line sales growth has also been generally anemic in reporting companies. In other words, the deleveraging cycle is still playing out and will temper GDP growth.

Since the Fed's tapering comments in June, investors are looking beyond this year and are considering the Fed's actions as confirmation of a more sustainable economic recovery. Apart from a renewed weakness in manufacturing, incoming data suggests a continuous improvement in financial conditions and confidence. In the US, where 70% of their economy depends on consumer spending, these factors are crucial for their economy to flourish. For Canada, a strong US economy should bolster our export dependent economy.

For these trends to be sustainable, both US and Canadian economies must be able to withstand higher market interest rates resulting from rising inflation expectations. During my two week break, 10 year bond yields in Canada and the US increased by 0.2% to 2.7% and 2.8% respectively. This follows their 0.6% move higher in the second quarter. Mortgage rates have moved higher in response. An economic recovery supported by low borrowing costs must prove that it can withstand a rise in interest rates to be sustainable. For the United States, improving employment trends must continue and are key to the sustainability of this recovery. Incomes must start to rise; confidence cannot wane.

To protect against rising rates, our balanced fund retains a higher exposure towards equities and dividend growth. In our fixed income portfolios, our shorter term bond strategy has helped our relative performance and limited price fluctuations, but we continue to expect low to negative short term returns in a rising rate environment. Companies with low debt burdens and positive cash flow generation will have more flexibility in this environment. This remains a focus in our analysis of our holdings and future opportunities, including gold companies. We continue to expect a steady rise in bond yields in the context of a slow but improving US economy. The risk is that inflation expectations rise too quickly, and that a steady rise becomes a sharp rise in yields – a hindrance to equities, bonds, and to the economy. We are not of that view…yet.