Quarterly Newsletter

LorneSteinberg Wealth Management

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> ***"Compound interest is the eighth wonder of the world. He who understands it, earns it ... he who doesn't ... pays it."***
> –Source Unknown

Less Than Zero

Dear Investor,

Remember the good old days?

Ten years ago, investors could buy government bonds in both Canada and the U.S. and earn a return in excess of 4%, with inflation at about 2%. Those with non-taxable accounts (RRSPs, pension funds, IRAs) were able to earn a risk-free return comfortably above inflation, and meet their long-term needs with a healthy allocation to fixed income.

Unfortunately, times have changed and what was then considered a "risk-free return" is now more appropriately termed a "return-free risk."

Today, over $10 trillion of government bonds have a negative interest rate, and an additional $7 trillion yield less than 1%. The following table of 10-year government bond yields highlights the current interest rate environment:

Canada	0.97%
U.S.	1.39%
France	0.13%
Germany	-0.17%
UK	0.78%
Switzerland	-0.68%
Japan	-0.29%

Source: Bloomberg (July 5, 2016)

Until recently, the idea of negative interest rates was nothing more than a concept. After all, who would lend money knowing that there was a guaranteed loss of principal upon maturity? Now NIRP (negative interest rate policy) is a tool being used by several central banks, in an effort to stimulate lending, discourage saving, and thus boost the economy.

Historically, central banks only set short-term rates, not long-term rates. Long-term rates were primarily determined by investors, through the bond market. Since the financial crisis, however, central banks have been driving down rates in the U.S., Europe and Japan by buying trillions of dollars of longer-dated bonds via a process known as quantitative easing (QE).

The goal of QE is to reduce the long-term cost of capital and encourage businesses and consumers to spend money, invest and spur economic growth. Yet seven years after the financial crisis, and a record amount of monetary stimulus, global growth remains sluggish. This does not mean that QE is not working. It only suggests that the global economy might be in even worse shape without it.

Zero rates - winners and losers

When real (inflation-adjusted) interest rates are high, investors have an incentive to save. When rates are low, they have an incentive to borrow.

With rates for a five-year fixed term mortgage under 2.5%, there has never been a better time to be a borrower than the present. Variable rates are even lower. Is it any wonder why condo construction in Canada and many other places continues unabated?

One of the big winners in the current low rate environment are the countries that have been struggling since the financial crisis to reduce their debt. After years of austerity, which has put a strain on global growth, governments are ready to start spending again. When countries, such as Italy and Spain, are able to borrow money at 1%, we expect to see some long-awaited fiscal stimulus, which will bring relief to central bankers who have bemoaned the lack of government spending over the past number of years.

Corporations have also been taking advantage of low rates, by increasing their borrowing. However, an increasing proportion of these funds are being used for share buybacks and dividend increases, which may provide a short-term boost for stock prices, but do little for the real economy. According to Thomson Reuters, in 2015, U.S. corporations spent more money on share buybacks and dividends than they earned.

Among the losers in this environment are the banking and insurance sectors, which have been amongst the worst performing segments of the market. Insurance companies have long-term liabilities and require higher interest rates to cover these liabilities and earn an acceptable return. Bank earnings are also being negatively impacted by low rates, as their net interest margin (the spread that they earn on bank loans less the cost of deposits) is being squeezed.

Of course, pensioners who are living off their savings are also being punished, as they can no longer survive on the return from government bonds and bank deposits.

Zero rates - not zero risk

The risk of keeping rates at such low levels for an extended period of time is that it distorts our perception of what is “normal.” A recent ad from a large Canadian bank touted its attractive 5-year GIC rate of 1.6%. If 1.6% has become an eye-catching return, investors may be losing perspective.

The longer that yields remain at these levels, the greater the danger that investors continue to reach for yield and drive up asset prices (stocks, real estate, etc.), a key ingredient in the formation of bubbles. Much of the investment community suffers from “short-termism,” and the lessons from the financial crisis are becoming a distant memory.

The same is true for borrowers. Consumers are once again buying homes with excessive leverage, believing that low mortgage rates are here to stay. A risky assumption.

Looking at the stock market, it is apparent to us that a number of sectors are rather fully valued, to say the least. With bond yields as low as they are, investors have been chasing so-called “dividend stocks” as a source of increased income generation. The utilities, pipeline and telecom sectors are all trading at valuations that make little sense from a fundamental perspective. Over the past number of years, many of the companies in these sectors have also been raising their dividends at a much higher rate than their earnings, which is not a sustainable business model.

It is important to emphasize that stocks are not bonds, and making investments guided by dividend yields, rather than valuation, is not a good recipe for capital preservation.

Many retirees who thought they had enough money to support themselves are faced with daunting choices of how much risk to assume in order to meet their retirement goals. Pension funds that require a certain rate of return to meet their long-term obligations are facing the same conundrum. In many cases the only “solution” is to increase risk.

Zero-interest rate policies have played a role in keeping the global economy afloat. However, low interest rates are creating serious problems for savers and much of the financial sector, while increasing the risk of another asset bubble.

High Yield Bonds

A review of the high yield bond market and our high yield fund is available here: **High Yield Quarterly**.

Final thoughts

When will we see higher interest rates?

Rates usually rise as fears of inflation increase. Thus far, central banks have been more worried about deflation than inflation. With so much uncertainty around the world, most central banks are indicating that rates will not go up any time soon.

However, investors need to be especially vigilant in today's environment and focus on preserving capital. While stocks may look attractive in this rate environment, it is important to remember that the value of a business is a function of its long-term earnings and cash flow. Even if rates remain at these levels for the next few years, investing in overvalued assets is never a good strategy.

As noted in the quote at the beginning of this letter, compound interest has always been an essential ingredient in wealth creation, but today, traditional fixed income, such as government bonds and GICs, no longer offer adequate yields. Up to now, investors have benefitted from low yields as valuations have risen for most asset classes (equities, real estate), but negative yields will not last forever.

The best way to navigate markets, regardless of interest rates, is to remain laser-focused on investing in a diversified portfolio of great businesses that trade at compellingly attractive valuations.

As always, we welcome the opportunity to discuss our outlook and investments with you.

Sincerely,

Lorne Steinberg
President