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> *"Turn out the lights, the party's over, they say that all good things must end…"* -**Willie Nelson**

The Fed: Changing its Tune

Dear Investor,

Though I can't confess to being a big country music fan, Willie Nelson is one of those singer-songwriters who has managed to transcend different genres and his lyrics often resonate by delivering a simple message (no - I am not his publicist.)

Investors and borrowers have enjoyed good times since the end of the financial crisis. Record low interest rates contributed to strong returns from most asset classes including stocks, bonds and real estate. Mortgage rates below 3% have enabled many long-time renters to become homeowners, but hopefully those homebuyers have paid off some principal, as mortgage rates are on the rise.

The era of zero interest rates appears to be coming to an end.

On June 29, 2006, the Federal Reserve Board raised its key interest rate by 0.25% to 5.25%, its last increase of that cycle. As the financial crisis unfolded in 2008, the Fed started cutting rates, eventually reducing them to near-zero. Due to the severity of the economic downturn, and the subsequent slow recovery, the Fed and several other central banks also embarked on a program of quantitative easing (QE) – buying up bonds in order to keep long-term rates low – in order to stimulate private sector spending and boost inflation. QE drove down the cost of loans and mortgages and resulted in a bull market for real estate and other assets, including financial assets. A consequence of QE is that the Fed now carries over $4 trillion of bonds and related instruments on its balance sheet. The European Central Bank (ECB) and the Bank of Japan hold another $9 trillion between them.

On December 17, 2015, with the economic recovery finally kicking in, the Fed raised rates for the first time in nine years. Since then, it has raised rates three more times (to the current level of 1.00% - 1.25%), and has indicated that it expects the rising rate trend to continue for the next several years.

With the U.S. unemployment rate now at 4.4% (5% is considered full employment), the Fed indicated in April that its $4 trillion QE program had served its purpose, and that it would start to unwind this policy in 2017. Thus far, the Fed has done a masterful job of managing investor expectations, and the recent rate hikes have not significantly impacted markets. However, shrinking its $4 trillion balance sheet while raising interest rates, suggests that investors should be prepared for rising bond yields, which translates into higher rates for loans and mortgages.

Inflation, wherefore art thou?

Unemployment is down and the economy is growing. The one thing missing from this picture is rising inflation. The stated inflation target of central bankers in Canada and the U.S. is 2%. Strong employment gains are usually followed by rising wage rates, increased consumer demand and higher inflation. Yet, throughout this recovery, inflation has been muted. In fact, since the financial crisis, central bankers have voiced as much concern about deflation as inflation.

So why raise rates if inflation is still well below target?

Stephen Poloz, governor of the Bank of Canada, recently answered that question by saying: "when you are driving towards a red stoplight, you ease up on the accelerator well before you get there instead of waiting for the last second to stop."

Changes in interest rates can take 1-2 years before having an impact on the economy, so central bankers have to act in anticipation of inflation based on their best estimates (or "guesstimates!") of future inflation, and clearly both the Federal Reserve and the Bank of Canada believe that their respective economies are strong enough that it is time to start slowly applying the brakes.

Despite Brexit and various geopolitical issues, the global economy is picking up steam. The World Bank's mid-year forecast is for growth of 2.7% in 2017 and 2.9% in 2018 (versus 2.4% in 2016), with improvement expected in most of the world; Europe being the notable exception.

At the Fed's June 2017 meeting, the "dot plot"[1] projection is that the Fed Funds rate would be at 2.9% in 2019, up from about 1% today. If short-term rates rise to that level, one can expect longer-term yields to increase as well, which does not bode well for borrowers.

There are a number of theories as to why inflation has remained dormant thus far, but there is little doubt that technology is having an impact. The acceleration of online retailing, manufacturing automation and energy efficiency have kept prices low for consumers and businesses. At the same time wages have remained stagnant, due in part to the kinds of jobs that are being created.

Today's auto factory looks very different from that of yesteryear. It is filled with robots and other automated equipment, requiring many fewer employees than in the past. This ongoing shift from unionized manufacturing jobs to non-unionized jobs at Amazon warehouses and the like is keeping wage inflation in check, despite the low unemployment rate.

The inflationary impact of monetary expansion (QE) and low unemployment is not yet evident, and is resulting in confusing theories among economists. This probably explains the dispersion of future rate projections by the Fed governors. As stated above, the aggregate estimate for the Fed Funds Rate in 2019 is 2.9%. However, the individual projections from the Fed governors ranged from 1.1% - 4.1%, indicating that at least some of the Fed economists do not believe that they can rely on past trends this time around.

Markets

The strong U.S. dollar has been a consistent theme over the past few years; however, recent comments and the subsequent rate hike by the Bank of Canada caused the Canadian dollar to rally. Commodity prices have remained weak since the financial crisis, and we note that the 10-year return for the mining, gold and energy sectors of the S&P/TSX is negative.

We have avoided energy and mining for the most part – the exception being Alcoa and three integrated energy companies (preferring to focus on businesses with more stable cash flows). When oil prices are low, energy companies cut back on exploration spending, which ultimately reduces supply and causes prices to rise. This cycle, however, is not yet unfolding as one might expect, for four major reasons:

1. The fastest growing form of energy today is renewables. Wind and solar are gaining market share every year, displacing some oil demand.
2. Energy efficiency remains an ongoing trend, due in large part to policy makers who are focused on reducing the global carbon footprint. This is true not just in the west, but also in China and India. Every new vehicle and appliance is more energy efficient than previous models, which is bending the demand curve downward.
3. Technology has reduced the cost of producing oil, and this has had a major impact in the U.S. where fracking has helped increase U.S. daily oil production from 5.6 million barrels in 2011 to about 9 million barrels today.
4. In past cycles OPEC would curtail production when prices were low. However, today a number of OPEC members, as well as several other large oil producing nations, are in weak financial condition, and cannot afford to turn off the taps. Venezuela, Mexico, Russia, Libya, Iran and Iraq all fall into this category.

Global equity markets have been underpinned by low interest rates and low earnings growth, but many sectors of the market appear rather fully valued. In general, Europe and Japan continue to offer the most value, and U.S. technology companies, such as Cisco and Microsoft, remain compellingly attractive.

For bond investors, government bonds will only deliver coupon returns in a rising rate cycle and, if inflation picks up, "real" returns may be negative. High yield remains the best option for fixed income investors given its shorter duration, current fundamentals and low default rates.

High Yield Bonds

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

Final Thoughts

In retrospect, everything looks obvious, but the future is always uncertain. We all have to make decisions with incomplete information, and history suggests that reducing risk when valuations are high is usually the correct strategy. The Fed is raising rates, despite low inflation, because the risk of keeping rates too low for too long is greater than the risk of slowing down the economic expansion.

We are maintaining a conservative position in our portfolios, because in a rising rate environment, we view the risk of a market correction to be greater than the risk of missing out on some upside. In its most recent annual report, Berkshire Hathaway disclosed that it is holding a record high cash position (approximately $80 billion). It is hardly surprising that after the rally in asset prices since the financial crisis, investors would want to hold on to some liquidity in case there is a correction.

Will the Fed's rate hikes and balance sheet reduction turn out to be the equivalent of turning out the lights at the party? No one knows for sure, but rising rates may create opportunities to spend our cash.

We welcome the opportunity to discuss our outlook and investments with you.

Sincerely,

Lorne Steinberg
President