October 2018

> ***"All crises have involved debt that, in one fashion or another, has become dangerously out of scale in relation to the underlying means of payment."***
> *— John Kenneth Galbraith, A Short History of Financial Euphoria*

End of an era

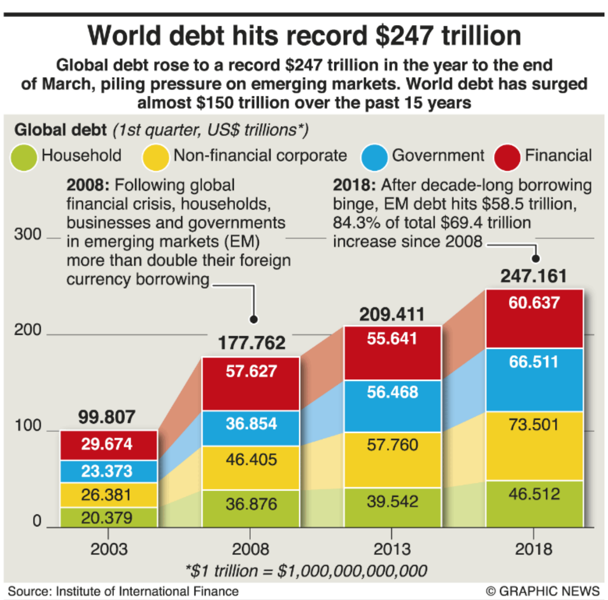
Dear Investor,

September ended on a somewhat ominous note, as the U.S. central bank raised interest rates for the third time in 2018 and forecast ongoing rate increases over the next 2 years. With unemployment at an all-time low and inflation over 2%, the U.S. Federal Reserve Board is focused on trying to maintain a reasonable level of growth, while ensuring that inflation does not get out of hand.

Virtually all markets experienced extreme volatility into October and suffered a sell-off, including government bonds (for example, US 10-year Treasury Notes are down 4.6% in 2018). We remain conservative with a significant cash weighting, but we are not immune to the volatility.

Global debt

Following the financial crisis, interest rates fell to record lows and cheap money resulted in a borrowing binge. At the same time as rates are rising, global debt as a percentage of GDP is at an all-time high. According to a recent study by the Institute of International Finance (IIF), combined global government, corporate and household debt now stands at $247 trillion – about 318% of GDP, versus 248% in 2003 (see chart below).



As investors face a rising interest rate environment, higher debt levels suggest that rate hikes may have a larger impact on the economy than during past tightening cycles, with 'debt service' accounting for an increasing portion of global GDP.

Emerging markets

As noted in the IIF chart, emerging market (EM) debt has increased markedly over the past decade. There has been a significant buildup of debt in China over the past decade (from 162% of GDP in 2008 to 246% by the end of 2017).[1] The Chinese government is now implementing policies designed to slow credit growth without damaging the economy, but this is no easy task. China's growth in the third quarter decelerated to its slowest pace since the financial crisis, but it is too early to assess the effectiveness of these recent policy measures.

One consequence of rising U.S. rates is that funds are flowing out of emerging market equities and into U.S. dollars. This is a major reason behind the sell-off in EM equities, most notably China, where the Shanghai Composite Index is down 20% over the past year.

The Asian financial crisis in the late 1990s was due, in part, to elevated debt levels funded by foreign investors combined with inflated asset prices. When investors started to withdraw their funds, asset values collapsed.

The situation is very different today than it was then, but as demonstrated by the recent weakness in EM stock markets, the outflow of foreign funds from these markets continues to have a major impact.

Emerging markets remain the driver of global growth, and any economic slowdown in those markets will negatively impact global growth.

Final Thoughts

The recent low interest rate cycle has come to an end, and debt levels are elevated – not a great combination. The result is usually a blend of reduced spending and higher taxes, ultimately causing a slowdown in economic activity.

Investors often have short memories, but Canada had its own debt crisis in the early 1990s. Government debt had risen to 72% of GDP and the Wall Street Journal published an editorial in 1995 calling Canada "… an honorary member of the Third World."[2] The government responded by implementing the GST, raising additional taxes and sharply cutting spending, resulting in a recession.

John Kenneth Galbraith's quote at the beginning of this letter acts as a reminder that excessive debt has been a major cause of financial crises throughout history. The same holds true for companies. Those that rely on increasing leverage to fund their growth, are the ones that end up in trouble.

With respect to our portfolio, we remain focused on our strict investment criteria: investing in financially sound, global businesses that generate free cash flow, and are trading at attractive valuations. These companies should create shareholder value over time and are less vulnerable to the inevitable shifts in interest rates or the global economic cycle.

Sincerely,

Lorne Steinberg
President

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[1] Bloomberg (https://www.bloomberg.com/quicktake/chinas-debt-bomb)
[2] Wall Street Journal (https://www.wsj.com/articles/SB10001424052748703302604575295020861075324)