July 2019

> ***"The four most dangerous words in investing are 'This time it's different."*** *-Sir John Templeton*

A New World?

Dear Investor,

Markets have rebounded strongly thus far in 2019. In fact, the first half of this year is essentially the inverse of the second half of last year. In 2018, the Fed signaled it was going to continue raising interest rates, which negatively impacted just about all markets. This year the Fed reversed its guidance and markets are forecasting a number of rate cuts, which has resulted in a rebound of asset values and a return of investor optimism.

In the "real" world, the picture is not quite as rosy. Although there does not appear to be a recession on the immediate horizon, the World Bank has lowered its global growth forecast for 2019 and 2020, citing weakening trade and investment.[1] The U.S. economy was boosted last year by the Trump tax cuts. Going forward, growth is slowing and, with interest rates already at low levels, the benefit of further rate cuts may not be that significant.

Slowing growth, trade issues and the strong U.S. dollar are also having a negative impact on corporate earnings. Despite the strong stock market, earnings for the S&P 500 are forecasted to grow by only 3-4% in 2019,[2] making it hard to justify current market valuations.

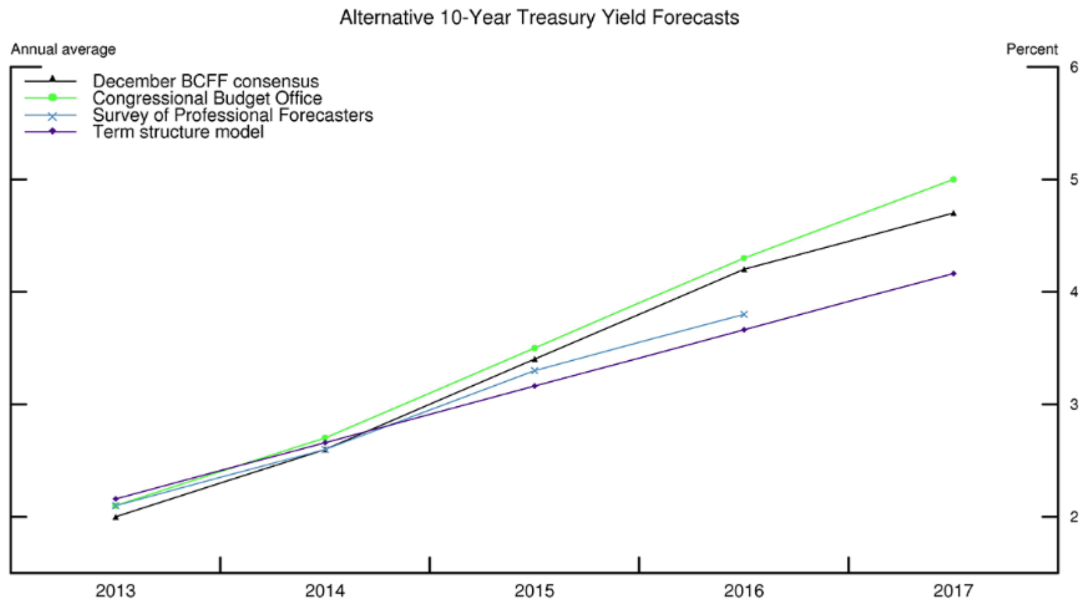
With central banks maintaining near-zero interest rates, inflation still below desired levels and asset prices continuing to rise, the question to ask is: **are things different this time?**

The Old World

The common storyline of previous economic cycles is as follows:

- The economy begins to slow.
- Spending and investment decline and inflation decelerates.
- Central banks cut interest rates to stimulate spending and investment.
- Consumers respond to lower rates by increasing consumption, while businesses increase investment.
- The economy rebounds, growth accelerates and inflation increases.
- Central banks raise interest rates to reduce the rate of growth and keep inflation at desired levels.

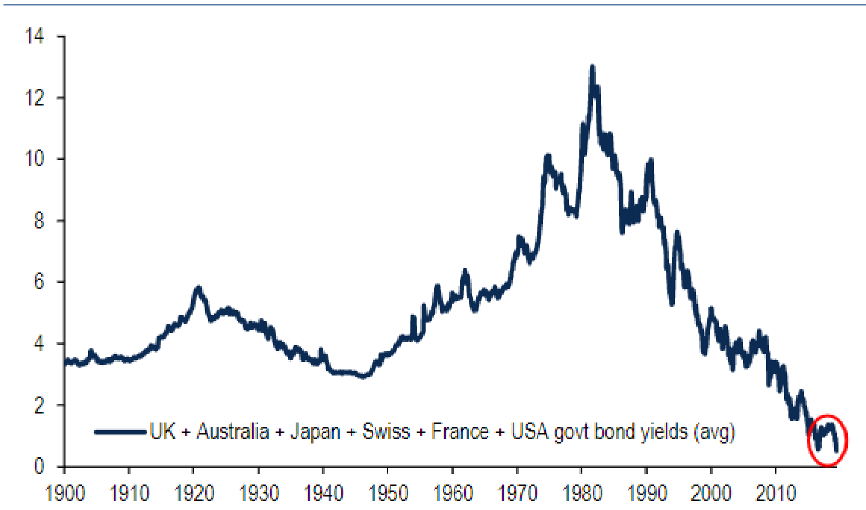
When the financial crisis took hold in 2008-2009, central banks responded by aggressively lowering interest rates, as well as employing other methods, to stimulate the economy and avert a depression. The results of the past decade indicate that these efforts were largely successful, as the global economy rebounded fairly quickly and there has been steady growth ever since. However, central bankers originally predicted that the record low interest rates would be temporary and that, as the economy recovered, rates would return to more normalized levels. In 2013, then-Fed chair Ben Bernanke suggested that by 2017, 10-year U.S. government bond yields would return to more normalized levels of about 4%, as indicated in the chart below from 2013).[3]



(Source: https://www.federalreserve.gov/newsevents/speech/bernanke20130301a.htm)

The assumption that yields would rise was based on the experience of previous economic cycles. As the economy improves, inflation starts to rise, and yields increase in response. However, unlike past cycles, thus far we have seen no meaningful increase in the inflation rate. In fact, central bankers are concerned about the lack of inflation, and thus the level of global bond yields remain at near-zero levels, as indicated in the chart below.

Chart 5: Global bond yields at new record lows ahead of key payrolls print



Source: BofA Merrill Lynch Global Investment Strategy, Global Financial Data, Bloomberg. Note chart shows simple average of equal weighted 10-year bond yield for USA, Switzerland, France, Australia, UK, Japan.

The New World

Thus far, despite a 10-year recovery, this cycle is not behaving like past ones. As long as inflation remains muted, central bankers can keep the party going by maintaining rates at current levels; thus encouraging consumers, corporations and governments to continue borrowing record amounts of debt, which is driving the economy. However, the longer this situation persists, the more comfortable investors become with record low rates, record-high debt and hefty valuations.

In past cycles, this type of situation has never ended well, but no one knows whether the current environment will continue for six months or six years (or even longer). Notwithstanding, with corporate earnings growth waning, it is becoming increasingly difficult to justify rising stock market valuations.

Value and our portfolio

As value investors, we need to stay focused on owning a portfolio of strong businesses trading at attractive prices, and not get lulled into the trap of buying expensive companies simply because others are doing so. Despite the fact that markets are not cheap, a quick look at a number of metrics will provide a sense for the relative "value" of our portfolio versus the broader market:

	Steinberg Global Value Fund	S&P 500
P/E ratio	13.9	23.6*
P/Book Value	0.9	3.5**
Dividend yield	2.9%	1.9%*

*Wall Street Journal July 14, 2019
**YCharts, July 2019

Regardless of the valuation of the market as a whole, our portfolio consists of strong businesses that are trading at attractive valuations. While it is getting harder to find equities that meet our conservative valuation criteria, we will only invest in companies that are trading at levels that present excellent long-term return potential, as well as offer a margin of safety (in case the market takes a tumble). One company which meets these criteria is Bank of Nova Scotia (BNS), which we recently added to our portfolio.

BNS is more geographically diverse than the typical Canadian bank, with one-third of its loan book outside North America. Like its domestic peers, it is very well capitalized, with a high-quality loan book more than fully funded by a large base of deposits. Modest revenue growth and tight cost controls should continue to provide some degree of earnings and dividend growth. The weakness in the financials sector afforded us the opportunity to pick up the stock at a valuation of 10 times earnings, with a dividend yield of close to 5%.

We will continue to seek out such opportunities as they arise.

High Yield Bonds

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

Final Thoughts

As this era of low inflation and low yields drags on, a number of economists and Wall Street strategists are talking about the "new normal," whereby inflation can remain at low levels for an indefinite period while the economy continues to grow. If that is indeed the case, then there would be no need for higher interest rates, and low rates would continue to support higher asset prices.

If bond yields were to remain below 2% for an extended period, then investors may continue to drive up the prices of stocks and real estate to much higher levels than would be justified by historical metrics.

The longer this era of low rates continues, the more we read about the "new normal." Despite the various risks that exist, be they geopolitical, economic or social, and the fact that we are now in the longest global recovery in almost 70 years, markets continue to rise, and investors are becoming increasingly complacent.

No one can predict whether things are truly different this time, or if this is simply a longer cycle and inflation and interest rates will return to more normalized levels. The history of investing is full of stories when investors believed "this time it's different." Remember the dot-com bust of the early 2000s and the runup to the financial crisis ten years ago? In both cases, investors believed that asset prices could continue to rise, in spite of expensive valuations. In the end, they were proven wrong.

Maybe things **will** turn out to be different this time, but we certainly wouldn't bet on it.

Sincerely,

Lorne Steinberg
President

1. World Bank: Global Economic Prospects, June 2019
2. Goldman Sachs, July 2019
3. Ben Bernanke speech, March 1, 2013