THE FED: ONE AND DONE?

Instrument (Inception)	July 2019 Return	Year-to-Date Return	Compound Growth
Venator Founders Fund* (March 2006)	**0.4%**	**10.4%**	**11.2%**
Venator Income Fund (August 2008)	**0.8%**	**6.8%**	**10.7%**
Venator Select Fund (September 2013)	**1.6%**	**20.0%**	**15.6%**
S&P/TSX Total Return (March 2006)	0.3%	16.6%	5.6%
Russell 2000 (March 2006)	0.6%	17.7%	7.3%
S&P Toronto Small Cap (March 2006)	3.1%	13.9%	1.8%
S&P 500 (March 2006)	1.4%	20.2%	8.8%
Merrill Lynch High Yield Index (August 2008)	0.6%	11.2%	8.1%

**** Venator Investment Trust is also available as an extension of the Founders Fund strategy; its monthly performance mirrors the Founders Fund, and it is eligible to be held in both registered & non-registered accounts***

The markets continued their interest rate/money flow fueled 2019 rise (for those of us that still remember how 2018 finished), finishing modestly up for the month of July despite the generally disappointing earnings out of corporate America. Venator Founders Fund finished flat for the month due to mixed performance among its smaller cap names; while the primarily long-exposed Venator Select Fund continued to keep up with North American markets. Meanwhile, Venator Income Fund continued to benefit from improved credit fundamentals across its high yield bond holdings, and higher stock prices have also had a positive effect on its convertible bond positions.

We continue to find new opportunities due to the bifurcation of growth and value in the market, although I must concede that, in a market built largely on ETF and algorithmic momentum, it's getting increasingly difficult for value to get recognized without a liquidity event. We see too many research bulletins asking whether value will ever outperform again (which it will), or whether one can pay too much for growth in a low rate environment (which you can). A personal favourite research title was 'The Amazing SPYderman', in reference to the S&P 500 index and its ETF, which has materially outperformed every major market for the past five years, including the US small cap market, which historically outperforms in periods of euphoria. This mega-cap bull market is difficult to ignore and we would note that, when our investors see our soon to be published semi-annual financial statements, they will see a few familiar names such as Alphabet/Google, FedEx, Disney and Salesforce.com mixed in with our usual motley crew of unknowns, unloved, and otherwise hidden gems.

We expect the interest rate debate to dominate over the next few months before we go all-in on the Democratic party nomination and subsequent election cycle. The last day of July saw the Fed get bullied into reluctantly cutting rates in a strong economic environment, which is quite rare (referring to it as a 'mid-cycle adjustment'). Contrary to popular belief, the Fed tends to react to economic data rather than anticipating it (as per a speech I heard from former Chair Bernanke a few years ago). Even the language used by Chairman Powell, and the split decision of the Board, suggested that this was a contentious cut; and it was followed by a seemingly definitive statement that the market should not anticipate a multiple rate cut cycle moving forward. This news sent the market tumbling 2% in the span of an hour and brought the wrath of a President who is much more concerned with the level of the stock market than any of his predecessors (Obama only seemed vaguely aware that the stock market existed at all).

My personal belief is that you want to load the rate cut gun when times are good so that you have rate-cut bullets to fire when things go bad. That said, I must concede that we are in strange times that necessitate low rates in order to maintain competitiveness. Those who are supportive of cutting rates seem to fall into one of four camps:

1) ***We need cuts to get ahead of a potentially weak economy*** (this involves economic forecasting which is more of a coin flip than anything)

2) ***We can afford to cut rates because inflation is benign*** (labour watchers and companies looking at raising prices due to ongoing US-led trade wars might disagree with this thesis)
3) ***Rates shouldn't have been raised as much as they were is the first place*** (we could go either way on this one)
4) ***We are now in world where global rates are headed below zero***

It is this last argument that carries a degree of validity, and the only one that merits real examination. Interest rates are historically low and in a race to the bottom. In the most established financial markets, anything over 5% seems to scream 'high risk', whereas this line used to be drawn at over 15%. In Europe, *negative* interest rates are becoming the norm, and we are starting to see *negative yielding high yield bonds!!!* Globally, negative yielding bonds now exceed $13 trillion. I have yet to find a reasonable explanation as to why so many investors are willing to pay people to borrow their money at the risk of default (versus keeping money in a cash account). The only place where this makes any sense is in the convertible bond universe, where investors are willing to pay for the five-year call options that come with the principal protection (we would note that many new convertible issues come with sub-1% coupon rates at this point).

Despite the occasional lunacy suggesting that the US dollar will soon be replaced as a global reserve currency, the reality is that 'not in my lifetime' still applies. At this juncture, a 10-year US treasury bond yielding 0% would still be a competitive offering in the current global rate environment vs the Euro, Pound or Yen. In that context, the Fed does have the ability to race to the bottom in terms of rate competitiveness in the perceived absence of inflation, although I would suggest that we are entering a globally-coordinated dangerous territory whereby we are working on a decent global economy without a safety net.

To the extent that we can continue down this road smoothly, the current bull market can find another leg if the cost of debt keeps decreasing. Borrowing at low rates to buy back stock is probably not the best use of this power over the long-term (although most CEOs and investors likely don't plan to hold their options/stock beyond ten years, so it could be a moot point for capital allocation purposes) as low rates will not last, but the debt still needs to be repaid, or at least refinanced. That said, capital investment could prove worthwhile for growth purposes if the economic demand is there.

While Venator Income Fund would naturally benefit from a continued drop in interest rates, and an acceptance of lower credit quality, it's worth considering what happens to a globally diversified, interest sensitive REIT like long-term holding Northwest Healthcare in such an environment. As the owner of medical office properties and hospitals under long term, triple-net inflation protected leases, the company could be categorized as ultra-defensive. Putting aside the puts and takes that lower rates have on its development/acquisition/growth strategy, in a vacuum, the continuation of lower borrowing rates could add upwards of $0.20/share to its distribution, while the low-risk nature of the business could see the dividend yield drop below 5%, sending the stock from the current near all-time highs of around $12.00 to upwards of $20.00. While this may be an optimistic scenario, so is investing in negative yield bonds (paying someone money for a guaranteed loss, so you can take on the privilege of risk of default).

As always, we reserve the right to change our mind!

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