To prevent widespread fallout, the U.S. Federal Reserve (Fed) dropped the Fed Funds rate to 1% in order to stimulate the economy. By late 2002/03, the economy had recovered, not surprisingly led by the interest-sensitive housing sector. As house prices increased, homeowners turned to home equity loans and spent their newfound wealth. The Fed had succeeded in boosting consumer confidence, which resulted in increased spending and higher levels of debt. An economy built solely on debt and credit rather than savings was not a strong foundation and it was only a matter of time before cracks appeared. The housing boom was based on a presupposition that home prices would continue to rise. Once again, with each new high, complacency set in and the naysayers, who were advising caution, were dismissed outright as alarmist. When it became clear that the globally syndicated AAA loans fuelling the housing boom were anything but AAA,
It doesn’t matter... until it matters

Quarterly Commentary Q3 2014

declining house prices suddenly mattered as investors scrambled to liquidate the debt. The subprime crisis quickly morphed into the global financial crisis of 2008/09.

Today, Central Banks are being used by their respective governments to guide monetary and, in our opinion, quasi-fiscal policy. The artificial suppression of interest rates has helped reduce the debt service costs of heavily-indebted governments and consumers. It has also resulted in rising asset prices, another wealth effect similar to the housing boom created by the Central Banks, and led by the Fed a decade ago. Rather than now dealing with the structural imbalances that remain, governments continue to rely on their respective Central Banks to finance their over-spending in hopes that the economy will gain sustainable traction. In many cases, cash-starved governments have resorted to increased taxes and tax enforcement, agreeing to share tax information with other G20 countries. The implications of rising taxation in a fragile global economy will no doubt be a drag on growth going forward and in our opinion will result in lower economic growth and less tax revenue, not more. Governments simply refuse to address the structural issues and are attempting to solve a debt problem by encouraging more debt. They are now trapped in a state of perpetual indebtedness and denial. This may continue as long as the Central Banks are able to suppress interest rates and maintain confidence in the fiat currency. To maintain confidence in the U.S. dollar, the Fed is now proposing to raise interest rates; however, they are doing so at a point in time in which it appears as though the global economy is weakening. The expectation of higher interest rates, although very much needed in our view, will impact global asset prices and capital flows. It remains to be seen if the Fed can raise, or attempt to normalize, interest rates in a global economy that has become so intertwined. A global slow down or recession at this point in time will be problematic given that the Fed is already at the zero bound level of interest rates. Their only option could be to continue with liquidity injections and deal with the consequences.

With the European economy on the verge of a Japanese-style deflation, it continues to be plagued by structural imbalances, chronic unemployment and an ill-conceived monetary union. As the Fed winds down its quantitative easing program, the European Central Bank (ECB) has had no choice but to ramp up its own version of Quantitative Easing (QE). On top of the $1 trillion Euro Targeted Longer-Term Refinancing Operations (TLTRO), the recently announced $1 trillion Euro asset purchase plan is a line of credit that European financial institutions are able to drawdown for the purpose of lending to businesses and consumers. This has resulted in negative interest rates in Germany, France, Austria, Finland and Ireland on debt maturing in less than two years. It has also lowered rates on the peripheral countries that are in recession. It remains to be seen if it will be enough to counter what appear to be mounting deflationary forces. In the words of a Spanish business owner:

Is QE Really Ending?
As a side note, the Fed’s balance sheet continues to expand even though QE is winding down. It is hard to reconcile the U.S. debt increase of $1 trillion over the past year, to a total of $17.7 trillion, while the Obama administration and the U.S. Treasury both report that the fiscal deficit shrank to $589 billion over the past 11 months of fiscal year 2014. If the deficit is running at under $600 billion, then why is the total debt increasing at over US$1 trillion? It has left us wondering: Is QE really ending?
“We’re not interested in borrowing money to expand. Demand is too limited to make it worth the risk of using someone else’s money.” Bloomberg News September 25, 2014.

Further compounding the problems facing Europe, the recent imposition of sanctions on Russia, along with a slowing Chinese economy, will further weaken the stagnating European economy. The ECB, with its latest pledge to buy asset-backed securities of seriously questionable quality, shows the extent to which they will go to save the Euro dream. It also indicates they are nearing the end of their rope.

Global Perspectives

Given the tenuous backdrop, the Fed remains on target to end its fourth iteration of QE this fall. It remains to be seen how the economy and more importantly, equity markets will respond given that previous attempts at ending QE were premature.

The economy and equity markets slumped after the Fed ended QE in 2011. Yields on sovereign debt in Europe spiked, threatening the solvency of financial institutions and sovereign governments. By the summer of 2012, the European Central Bank President, Mario Draghi pledged to “do whatever it takes to preserve the Euro”. The Fed did its part by launching its most aggressive open-ended QE program, which started off at $40 billion per month and was expanded to $85 billion per month by December 2012. Aggressive action of this nature was cheered by equity markets, but for the wrong reason in our view. It was a sure sign of mounting stress within the financial system leading us to conclude that QE has and continues to be an ineffective solution.
The Fed has taken the view that the U.S. economy is in recovery and has prepared markets for the prospects of higher interest rates as they end QE. Up until September this year, equity markets remained resilient, buoyed by the fact that although the Fed was withdrawing – other central banks were ramping up with QE. Surprisingly, the Chinese Central Bank had to inject liquidity into its bank sector, which to us is a clear signal that the overleveraged Chinese banks are under tremendous stress. The situation bears close attention as the implications of a slowing Chinese economy will reverberate globally.

The Fed’s suppression of interest rates led to a surge of capital flows into emerging markets, which in turn responded by issuing higher-yielding U.S. dollar-denominated debt. Now that the Fed is ending QE, the impact on emerging markets could be severe and could lead to a repeat of the 1997 Asian contagion. This unwinding will result in capital flows back into the U.S., resulting in further upward pressure on the U.S. A rising U.S. dollar will increase debt service cost in emerging markets on a currency-adjusted basis. The negative interest rates in Europe will also impact capital flows in favour of the U.S. dollar. Those calling for the imminent demise of the U.S. dollar may have to wait. The follow-on effects of a rising U.S. dollar on asset prices, exports and inflation targets will be of great concern to the Fed. We expect a gradual and measured approach from the Fed given the implication that one wrong move could have on the economy and financial markets. We find it hard to imagine a scenario in which interest rates can be increased in a highly leveraged and intertwined world.

Perhaps one of the greatest risks facing the global economy is the risk of default in the highly leveraged Chinese economy. The unrivalled infrastructure spend was financed in large part by an equally unrivalled credit expansion that has dwarfed that in the U.S. by a factor of almost two.

Last year, in an attempt to cool the overheating Chinese economy, the Chinese Central Bank attempted to tighten credit, which led to a spike in overnight lending rates, which in turn placed the over-leveraged financial sector in distress. The Chinese Central Bank was forced to reverse course, but it did expose the fragility of the Chinese growth miracle. As spending on infrastructure slows, the Chinese Central Bank has had no choice but to inject liquidity into the system. The evidence of a slowdown is particularly noticeable in falling commodity prices, specifically iron ore prices, which recently hit a 5-year low. A pronounced slowdown in China will have negative implications on commodity-based countries and those with significant trade with China.
We have grown weary of worrying about risks that do not materialize or when they do materialize, do not seem to matter. Yet we know that, at some point, it will matter.

**Markets**

Global equity markets continued their move higher over the past year, disregarding weakening economic fundamentals, the Ebola virus, wars in Gaza, Iraq, Ukraine and more recently, civil unrest in Hong Kong. The equity bulls will cite the recovering U.S. economy, low unemployment and rising equity markets as evidence of recovery. The bears, on the other hand, will defer to the subpar GDP growth, a falling participation rate that understates the unemployment rate and the Fed’s suppression of interest rates as the primary driver of equity markets.

It is our opinion that the equity markets are, and will continue to be, under the direct influence of central bank policy and their ability to suppress interest rates. Central Banks have been used, by their ineffective and tapped-out governments to seduce investors into believing that artificially-low interest rates will continue to support rising equity markets. We know from past experience that central bank policies have resulted in irrational exuberance and believe that this time is no different. The continued suppression of interest rates results in the misallocation of capital and eventually leads to significant and increasingly painful adjustments. That being said, central banks continue to use monetary policy which has a positive impact on assets prices which in turn creates a sense of wealth. If the economy were to weaken or equity markets sell off, we would expect the Fed to once again intervene with a new round of QE. The markets would more than likely respond favourably to the news, but at some point in time, they will succumb to the realization that the economy cannot sustain itself without a continuous flow of liquidity. Expect more volatility over the near term as markets adjust to the Fed’s attempt to end QE. For now, Central Banks appear to be in full control of financial markets using what can only be described as extreme monetary policy, as we have learned, it can last for a long time but not forever.
Portfolio

We made changes to the portfolio during the quarter, taking advantage of the pullback in equities in September. We sold Crescent Pont Energy Trust and added Freehold Royalties. We added positions in junior gas producer Delphi Energy. We added to our position in Paramount Energy, which we believe is in a position to outperform in the sector. We also took advantage of the appreciation of a long time gold holding selling half the position in Franco Nevada. We selectively added in some exposure in the REIT sector. The shares of Canadian Energy Services split 3 for 1 in July and we continue to hold this position as it continues to experience above average growth in the oil and gas service sector.

It is important to remember that in the long term fundamentals (earnings, the economy and interest rates) will override short-term movements. We continue to look for opportunities to invest in companies that are growing, well managed and have strong balance sheets and underlying fundamentals not recognized or appreciated by the markets.

Conclusion

The amount of sovereign debt outstanding has simply grown too large and almost impossible to pay back without a significant increase in non central bank induced GDP growth, increased taxation or the continued suppression of interest rates and its resulting consequences. Although equity markets have been buoyed by the Fed’s quantitative easing programs, it has led to distortions in pricing risk, which in turn has compelled investors, savers and pensioners to boldly go to where they have not gone before on the risk spectrum. Although the globally-coordinated suppression of interest rates can continue, at some point, one has to acknowledge that there are consequences and that they will matter.

If the past is any indication of what to expect going forward, the Fed’s previous attempts at ending QE have been short-lived and we feel it is far too early to suggest that the Fed will be afforded a graceful exit after such a prolonged period of interest rate suppression. Although the Fed has been given some breathing room, the stagnating global economy has forced the European, Japanese and Chinese Central Banks to implement their own versions of QE in an attempt to stimulate growth. If the slowdown deepens, equities will continue to adjust to this reality, creating opportunities for investors to position themselves for when the Fed blinks.

Implication of Negative Interest Rates – Pension Fund Crisis

In a zero interest rate world or a negative interest rate world, institutions and pension funds will be hard pressed to meet their target returns without adjusting asset allocation in favour of equities over cash and bonds. The question is, will they and what are the implications. Market participants have taken the view that equity valuations are elevated and that Central Banks will continue to pursue the wealth effect policy of higher asset prices, which will offset the poor returns on bonds. The overriding premise being that Central Banks are in complete control and they will do whatever is required to support equity markets.

The Fed has to know that at some point interest rates must rise. However, the dilemma governments and central banks face is two-fold. 1) Adjusted for risk, investors are not being sufficiently compensated to continue funding sovereign deficits. 2) The longer interest rates remain suppressed, the greater the impact on savers, insurance companies and pension funds with fixed obligations. Moody’s investor services reported that the 25 largest U.S. public pensions face about $2 trillion in unfunded liabilities due to inadequate pension contributions, growing liabilities and subpar returns from the fixed income portion of assets. Moody’s has now adopted a more conservative approach to assess financial viability, and this alone will have a dramatic impact on states and local government’s ability to fund the pension plans. Detroit’s bankruptcy is a perfect example of what happens when plans are abused and underfunded. Chicago is not far behind Detroit and Moody’s recent downgrade of Chicago’s debt as a result of their underfunded pension has cast a spotlight on what is shaping up to be a major crisis, not just in America but globally.
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