Rateshock: Equities

Monthly Perspectives | Portfolio Advice & Investment Research

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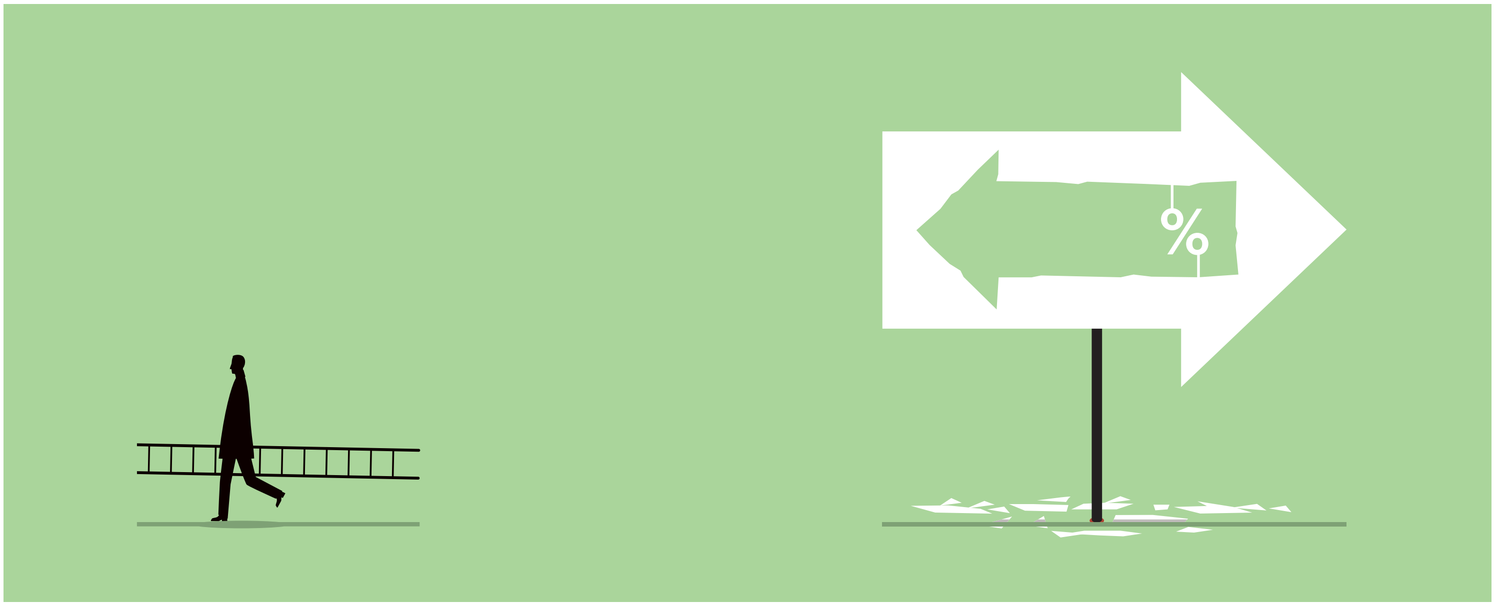

For the previous issue of Monthly Perspectives entitled "Rateshock" we sat down with three leading fixed income portfolio managers to get their views on the current state of fixed income markets. The underlying theme of our discussion was the relentless decline of interest rates over the past few decades and the impact this downtrend has had on the fixed income side of client portfolios.

The catalyst for this theme was the recent trend reversal witnessed in North America, where central banks began raising interest rates, potentially foreshadowing more to come. The projected rate hikes by the U.S. Federal Reserve (Fed) and its balance sheet reduction plan combined with increases in U.S. Treasury issuance are all likely to put pressure on long-term interest rates in the United States. Positive economic momentum in Canada and across Europe also points to further moderate rates increases in these regions. This being said, we believe the effects of rate increases will likely be modest as rate hikes will most likely be at a measured pace. We expect rate increases to continue in 2017 and 2018 as the global economy continues to strengthen and the first step towards long overdue rate normalization happens. While most investors are aware of the potential negative impacts that rising rates can have on their fixed income investments (when interest rates go up, bond prices typically go down) what may be less clear is that raising interest rates can have both positive and negative impacts on equity positions.

In this issue of Monthly Perspectives, we had a very simple base question: should clients be concerned about the equity side of their portfolios and the potential for rateshock? To explore this question and to better understand where equity opportunities will be in this new landscape, we sat down with three thought leaders in the equities market to get their perspective, and where they see the opportunities and obstacles as we head into the fall.

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Rateshock: Equities

The portfolio managers we spoke to were Tim Elliott, President at Connor, Clark & Lunn Funds; Peter Lampert, Portfolio Manager at Mawer Investment Management; and Chris Blake, Senior Portfolio Manager at TD Wealth. Tim Elliott works closely with the alternative strategies group that manages the CC&L Global Market Neutral Fund, Peter Lampert is the co-PM on the Manulife World Investment Fund, and Chris Blake manages the Core Equity Portfolios.

Brad Simpson: The benchmark S&P 500 Index (S&P 500) is near its record high, its valuation is stretched across numerous metrics, and the economic recovery is one of the longest in post-World War II history — all at a time when the U.S. Federal Reserve (Fed) is tightening monetary policy. Are equity markets in an imminent risk of falling into a correction?

Tim Elliott: Valuations are elevated across many asset classes including stocks, bonds and real estate in certain markets, which is a result of the easy monetary conditions that were introduced following the financial crisis. Though stock market valuations are above long-term averages, we are nowhere near levels seen in the late 1990s (see figure 1), and much of the recent gains in equity markets have been driven by company earnings growth as opposed to simply an increase in the multiple that investors will pay for the same dollar of earnings.

It is also important to note that not every stock trades at the market average – there are cases of extreme overvaluation in certain stocks, while others appear quite reasonable given their earnings potential in an environment where global growth is improving.

We don't believe the market will correct simply because of higher valuations, rather the next bear market will be triggered by the next recession, which may be the result of a policy error (i.e., central banks tightening too quickly) or some other unforeseen factor.

Peter Lampert: Equity markets are always at risk of a correction, but we don't spend time trying to predict when the next pullback might occur. We don't think many people can consistently predict the future and time the market. Instead, our investment philosophy is to buy wealth-creating companies, run by excellent management teams, trading at discounts to their estimated intrinsic values. We hold these companies for the long term and remain fully invested throughout the cycle.

One example in the fund we manage is Tsuruha Group, which operates a chain of drug stores in Japan. Tsuruha will continue to provide its customers with good products at convenient locations and competitive prices, while also creating value for shareholders by consolidating the industry and opening new stores.

Figure 1: Valuations: S&P/TSX Composite Index vs. S&P 500 Index

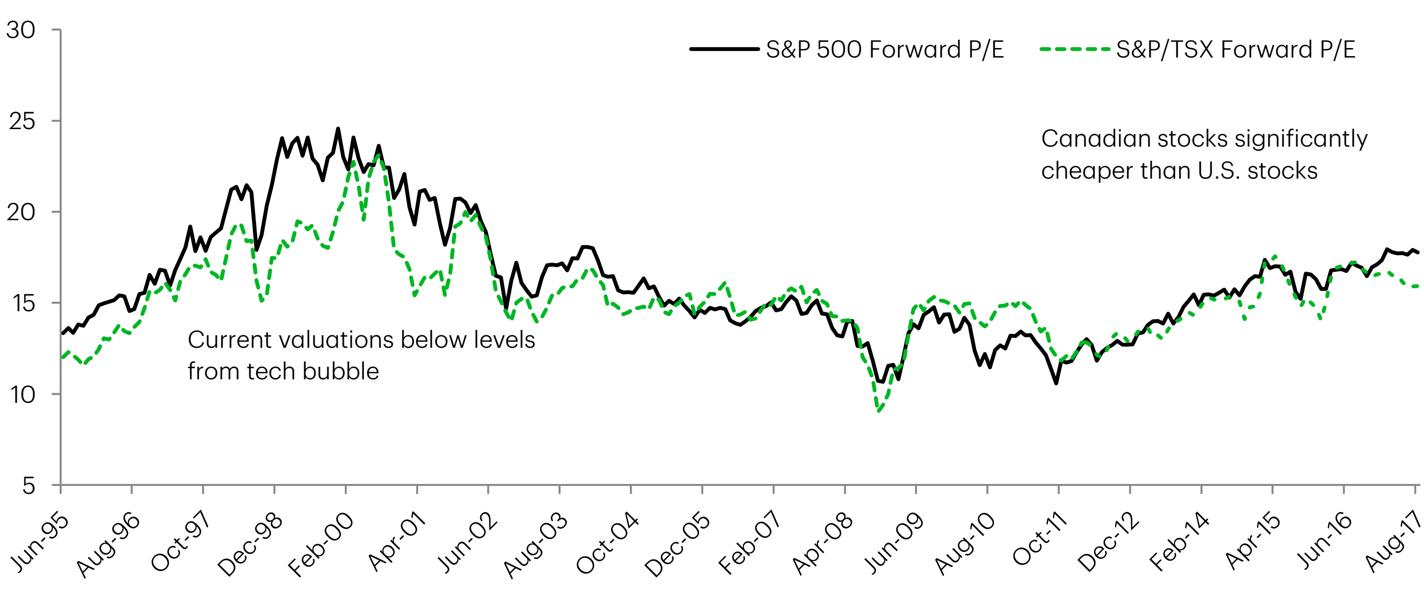
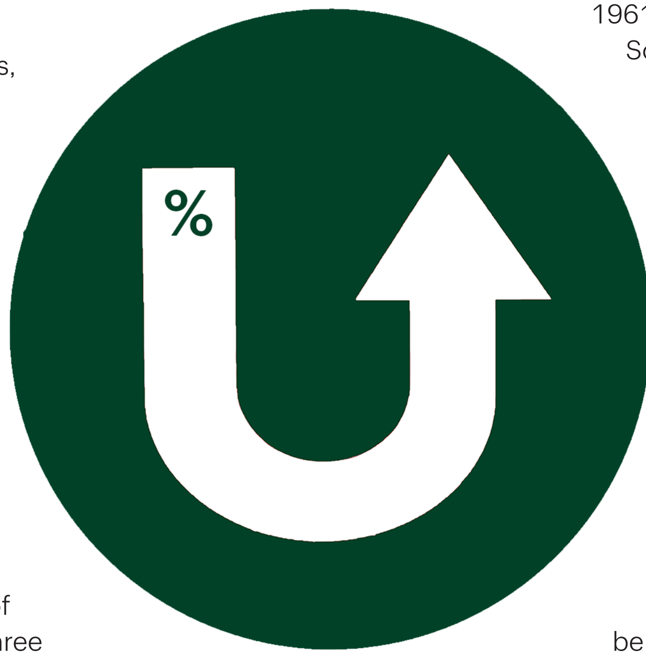


Chart provided by Connor, Clark & Lunn Investment Management Ltd. Data is sourced from Bloomberg Financial LP.

Regardless of the short-term volatility in the stock market, Tsuruha will most likely become more valuable over time, which we expect will be reflected in its long-term shareholder returns.

Chris Blake: That is a question that a lot of market participants are pondering. But the things that are in plain view rarely precipitate a correction. Usually, these items end up being the pre-conditions in which some external force acts to catalyse a correction. Let's unpack those items. Yes, the market is at all-time highs – but so are earnings. And, while the price to earnings ratio is moving towards the record levels set in the 1999 – 2000 technology bubble, the tech boom was just that, one sector at extremely high valuations while the rest of the market was reasonable to underpriced.



Yes, the Fed is raising interest rates, but it is important to remember that the Fed has three mandates established by congress under the Federal Reserve Act: maximum employment, stable prices, and moderate long-term interest rates. I think we can all see that the employment mandate is being fulfilled with headline unemployment at what are for modern times, low rates. Historically, unemployment has been lower (almost four years of less than 4% in the late 1960s, three years of sub 4% in the early 1950s with a 2.5% low in 1953). As for stable prices – headline CPI, currently at less than 2%, is right in-line with what the Fed views as "consistent over the longer run with the Federal Reserve's statutory mandate." For the final mandate, it is difficult to argue that long-term interest rates are anything other than moderate.

In his Humphrey-Hawkins testimony in mid-1997, former Fed Chairman, Alan Greenspan, provided a model that looked at equity valuations relative to the market yield on the 10-year treasury bonds. The model showed a strong correlation between the 10-year government yield and the earnings yield on the S&P 500, which persisted from roughly 1981 until that time. Based on that model, the current P/E ratio for the S&P 500 would be in the mid-40s. Now that doesn't make sense because the market understands that yields have been pushed to an abnormally low level as a result of quantitative easing that happened in the wake of the financial crisis. Further, the market understands that the abnormally low interests rates are temporary, so it will not fully discount the abnormal rate. However, the market is still struggling with what the correct valuation should be.

The business cycle in the United States is, so far, the third longest on record based on data from the National Bureau of Economic Research. From the June 2009 trough, the business cycle is now 87 months long. The longest was March 1991 to March 2001 (120 months), and the second longest took place from February 1961 to December 1969 (106 months). So the expansion is long in the tooth but history would suggest that longer is still possible, as there are no rules on how long an expansion can last. European growth has been picking up in the last year, which could easily help add many months of growth for North America.

The last point I will make is that we have an economy that remains debt fueled and any major increase in rates could swiftly end the expansion and produce a recession. I have to believe that the Fed is aware of this. Remember the Fed's job is not to decide that the business cycle is too long but rather to accommodate as long a cycle as is possible within its mandates of employment, price stability and moderate interest rates.

Summing it all, I think that; 1) the markets are primed to see interest rate increases at a moderate pace, as communicated by the Fed; 2) We are in the late stages of the economic cycle. I do not believe that we are so clever that there will be no more cycles in the economy; and 3) a correction will be caused by some exogenous unbalanced variable that we don't yet see. The markets are very good at discounting the expected, it is the unforeseen that always causes problems.

Brad Simpson: Interest rate sensitive stocks represent a significant weighting in many client portfolios. Shares of telecommunications, pipelines and utilities companies are said to be inversely connected to rising interest rates, meaning that if interest rates rise, these companies' stock prices suffer. Many may also be concerned about their bank stocks as well. What's your take?

Tim Elliott: With ultra-low interest rates globally, central banks have forced savers to take on more risk in their portfolios to earn a decent return, resulting in strong money flows into dividend paying stocks and higher-risk bond strategies.

What is less obvious is how these strategies will perform when interest rates rise. In the case of dividend paying stocks, it is important to note that not all will respond the same to rising interest rates. Companies and stocks with no growth potential that offer a high and stable dividend yield and can be regarded as 'bond proxies' are likely to perform poorly as rates rise; this effect will be compounded for securities that carry high valuations.

On the other hand, dividend paying stocks of companies that will benefit from higher rates and generally higher economic growth in the form of growing revenues and profits can perform quite well, which would include certain banks and life insurance companies for example.

What is most important is that investors understand the level of interest rate sensitivity in their portfolios, as what may be viewed as a 'defensive' portfolio may provide little defense against a shift from declining to rising interest rates.

Peter Lampert: We estimate the intrinsic value of every stock in the portfolio based on our own discounted cash flow models. Key inputs to value any company are the projected future cash flows and the discount rate. If rising interest rates are driven by a strengthening economy, then we might expect the impact of higher discount rates to be offset by higher expected future cash flows.

On the other hand, if interest rates rise without any economic improvement or increase in expected future cash flows, then stock valuations may prove to be too high, which could result in a market correction. One exception to this generalization is our bank stocks, such as DBS Bank in Singapore, which has a low-cost deposit base and would likely benefit from rising interest rates on its loans. Although we don't know which scenario will unfold, our approach is to consider a variety of scenarios and invest in companies when we assess the odds to be favourable.

Chris Blake: Traditionally, interest rate sensitive stocks do drop when interest rates rise. But, I think we need to examine the reasons behind that market reaction. Telecoms, pipelines and utilities (and the banks – but I do look at them differently – more on this later) are all typically slower growth, more highly leveraged enterprises that pay dividends, which investors seek to generate income. When interest rates rise, there are two dynamics that affect stock prices. First, there is the relative attractiveness of the dividend, which changes. Short-term interest rates become more attractive 25 basis points at a time, and the history of interest rate cycles over most current investors' lifetimes has been that interest rate increases happen in multiples and in rapid succession. The second effect is on the operating business, which as a result of the Fed rate increases, will eventually see an increase in its cost of funding, which will absorb any increases in cash flow to pay higher interest on outstanding debt (this obviously does not happen immediately but as tranches of debt in the capital structure come up for re-funding). That will leave less of the firm's cash flow available for shareholders, potentially reducing future dividend growth or share re-purchases.

For banks, things are a little different. Banks typically earn more money as rates rise because they re-price all of their outstanding loans. There can be a short-term trade-off on banks for interest rate increase based on the relative attractiveness, but longer-term interest rate increases help drive profit growth.

And finally, let's bring up the most dangerous four words known to investing: This time is different. Why? Because the interest rate cycle that we foresee will be slow and shallow, yet the market is treating some of these equities as if this is normal. Considering where we see interest rates headed over the next 18 months, we currently see an opportunity to buy equities at discounted valuations in some of these interest rate sensitive sectors.

Brad Simpson: Looking at the 12-month forward P/E ratio of the MSCI All-Country World Ex-US index, we are currently seeing one of the largest valuation gaps between U.S. and non-U.S. markets. Is it time to invest in global markets in a big way?

Tim Elliott: There is no question that certain stock markets currently offer more attractive levels of overall valuation than the U.S. The Canadian market is a good example, where the discount to U.S. stocks is at fairly extreme levels vs. historical averages (see figure 1).

However, we would caution investors from massive portfolio shifts in pursuit of higher returns, as history tells us this is not a successful long-term strategy. Investors should be mindful of any concentration in their portfolios, be it to a certain country, sector or directional exposure to interest rates.

Because the timing of asset class returns is very difficult to predict, the most prudent strategy is to diversify across asset classes that can perform well over time, but that are uncorrelated (or move differently) with one another, to ensure that the risk side of the portfolio is accounted for; rather than just returns.

Though simple in theory, this approach is difficult in practice – especially when markets are in an extreme state of optimism (fear of missing out); or pessimism (fear of losing more).

Peter Lampert: Manulife World Investment Fund is an International equity fund that invests in markets outside of Canada and the U.S. We think it always makes sense for investors to maintain a well-diversified global portfolio. This continues to be true today as valuations currently appear to be more attractive outside of the U.S.

Our portfolio managers are bottom-up stock pickers, but still perform macroeconomic country reviews to determine where the opportunities might be more abundant. This can often result in landing on investments in unexpected countries outside of North America.

Chris Blake: Within the Core Portfolios, we do not place money in non-North American assets. That said, I do find the valuation gap intriguing. The question is what will transpire. Will the gap close as a result of a decline in U.S. valuations, or by an increase in global valuations outside the U.S.? I believe that we are in a long cycle and that the growth outlook around the world remains positive, so I think the gap will more likely close as investors gravitate to the lower valuations relative to growth potential found outside the United States. I am concerned that the increasingly protectionist attitude we see coming from the United States could ignite trade friction that could easily upset the global growth trajectory. We hope this is nothing more than negotiating rhetoric amounting to little in the way of trade barriers rising. If not, trade will fall, upsetting world growth, in which case, all bets are off.

Brad Simpson: The never ending question: What is happening to growth and inflation?

Tim Elliott: Given the severity of the Great Recession, the global economy had been stuck for several years in a mid-cycle phase of low growth and inflation, where the U.S. economy was the lone bright spot globally. More recently though, we have seen a move to synchronized global growth where Europe, China and even Canada have joined the U.S. in an expansion mode.

This suggests that we are moving into the late phase of this economic cycle, which will persist for some time until we peak and decelerate into the next recession. We expect the current phase to continue for another one to three years as none of the more reliable recession indicators are yet flashing yellow, let alone red.

Meanwhile, inflation has been stubbornly low, and below the targeted levels of most central banks who must continue on the delicate path of encouraging continued growth and inflation, while beginning to withdraw the stimulus that was injected into the global economy to promote growth following the financial crisis.

Peter Lampert: We appear to be in a Goldilocks scenario with strong growth and low interest rates. The global economy is in a period of synchronized economic growth with all major economies performing well. At the same time, interest rates and inflation remain low, which may be driven by technology, which has driven down the cost of many goods and services.

Chris Blake: Essentially, North America and Europe are now facing a demographic trend similar to what Japan has been suffering with since the 1990s, and so growth and inflation in the mature economies have been muted by the effects of demographics. As the baby boomers, the largest demographic cohort to exist in Europe and North America (until we got to the millennials) head into their retirement years, they are spending significantly less money on "things" and more money on experiences such as travel, concerts and sporting events. This is why we see some pricing power and inflation in these areas of the economy but it is not widespread, nor is the growth high. As for the next "largest generational cohort to exist", the millennials are now entering their household formation years and should eventually offset the decline in boomer spending. The benefit that North America and Europe have over Japan is a higher rate of immigration, which also helps offset the decline in boomer spending.

Brad Simpson: With central banks tightening, growing geopolitical tensions and natural disasters (which seem to be happening every other day) is it time to batten down the hatches? What are you doing in your portfolios to prepare for something going wrong?

Tim Elliott: In addition to being prudently diversified, we do have certain strategies that can actually benefit from a pickup in market volatility, which we would agree seems imminent.

In our equity market neutral strategies, we buy the stocks that we believe are the most attractive; and simultaneously short sell the stocks which are the least attractive. We do this many times over, across many stocks, sectors and countries, to construct a portfolio that has no exposure to the direction of equity markets.

The returns in these strategies are driven by the difference, or spread, in the performance between long and short positions. We have been managing market neutral strategies for institutional investors for many years, and have generated strong results in volatile markets historically.

Though these strategies won't keep pace when stock markets are surging, as has been the case recently, they can serve as an important tool in reducing overall portfolio risk as market volatility increases.

Peter Lampert: The news headlines can appear frightening, but the reality is that investors have always faced such risks. Our goal is to build a resilient portfolio that can survive the storms and perform well regardless of how the global economy unfolds and without betting on one particular outcome. We do this by investing in great companies with great management teams, buying them at reasonable prices, avoiding businesses with large downside risks, and ensuring the portfolio is well-diversified while avoiding too much exposure to any single risk.

An obvious reaction by some managers is to move to a heavy cash weighting and wait for the markets to correct. However, as mentioned earlier we think it's very difficult to predict the future and time the market. So we stay invested and build "all season" portfolios.

Chris Blake: At the best of times, it is difficult to predict turns in the market so we tend not to "batten down the hatches". That said, our style of equity management has shown itself to be defensive over time. The Core Portfolios have a history of slightly lagging the market in sharp upward moves and then outperforming in market downturns. That characteristic flows from our disciplined process of choosing equities for the portfolios. Each company is selected based on balance sheet strength and with a clear view of why we own them – our investment thesis. The companies are then under constant evaluation to ensure that our investment thesis still holds. If central bank tightening is significant enough that we believe it will choke off consumer spending for example, we might sell a company that is heavily levered to consumer spending and purchase something less cyclically exposed – that would be a natural evolution in the portfolio holdings. We also tend to hold a number of equity positions that are considered "defensive" by nature – gold companies and utilities for example. We choose these companies on the basis of having strong business fundamentals in growth and stability. Additionally, while they provide defense against sudden shifts in the geopolitical environment, they also provide performance in the absence of sudden risks.

Monthly market review

		(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)
Canadian Indices ($CA) Return	**Index**	**1 Month**	**3 Months**	**YTD**	**1 Year**	**3 Years**	**5 Years**	**Since 1/1/2012**	**10 Years**	**20 Years**
S&P/TSX Composite (TR)	51,702	3.06	3.68	3.57	9.18	4.54	8.06	7.61	4.06	6.56
S&P/TSX Composite (PR)	15,635	2.78	2.98	1.62	6.17	1.48	4.89	4.37	1.04	4.07
S&P/TSX 60 (TR)	2,464	3.54	3.98	3.35	10.47	5.28	8.79	8.26	4.17	6.96
S&P/TSX SmallCap (TR)	989	2.06	2.36	-2.37	1.21	2.45	3.94	3.09	1.41	-
U.S. Indices ($US) Return	**Index**	**1 Month**	**3 Months**	**YTD**	**1 Year**	**3 Years**	**5 Years**	**Since 1/1/2012**	**10 Years**	**20 Years**
S&P 500 (TR)	4,888	2.06	4.48	12.11	18.61	10.81	14.22	15.09	7.44	7.00
S&P 500 (PR)	2,519	1.93	3.96	10.55	16.19	8.50	11.83	12.46	5.14	5.01
Dow Jones Industrial (PR)	22,405	2.08	4.94	12.79	22.38	9.55	10.77	10.51	4.89	5.32
NASDAQ Composite (PR)	6,496	1.05	5.79	15.69	22.29	13.07	15.83	16.59	9.17	6.98
Russell 2000 (TR)	7,310	6.24	5.67	10.51	20.74	12.18	13.79	14.06	7.85	7.53
U.S. Indices ($CA) Return	**Index**	**1 Month**	**3 Months**	**YTD**	**1 Year**	**3 Years**	**5 Years**	**Since 1/1/2012**	**10 Years**	**20 Years**
S&P 500 (TR)	6,100	1.60	0.48	7.38	12.85	14.85	19.79	20.34	9.88	6.46
S&P 500 (PR)	3,144	1.47	-0.02	5.89	10.55	12.46	17.28	16.99	7.53	4.48
Dow Jones Industrial (PR)	27,961	1.62	0.92	8.03	16.44	13.54	16.17	14.86	7.28	4.78
NASDAQ Composite (PR)	8,107	0.59	1.74	10.81	16.35	17.20	21.47	21.67	11.66	6.43
Russell 2000 (TR)	9,123	5.76	1.62	5.84	14.88	16.27	19.34	19.26	10.30	6.99
MSCI Indices ($US) Total Return	**Index**	**1 Month**	**3 Months**	**YTD**	**1 Year**	**3 Years**	**5 Years**	**Since 1/1/2012**	**10 Years**	**20 Years**
World	8,016	2.28	4.96	13.76	18.83	8.30	11.62	11.45	4.81	6.12
EAFE (Europe, Australasia, Far East)	7,801	2.53	5.47	17.07	19.65	5.53	8.87	8.44	1.82	5.03
EM (Emerging Markets)	2,346	-0.37	8.04	21.48	22.91	5.28	4.36	4.32	1.65	6.67
MSCI Indices ($CA) Total Return	**Index**	**1 Month**	**3 Months**	**YTD**	**1 Year**	**3 Years**	**5 Years**	**Since 1/1/2012**	**10 Years**	**20 Years**
World	10,004	1.82	0.94	8.96	13.06	12.25	17.06	16.53	7.20	5.58
EAFE (Europe, Australasia, Far East)	9,736	2.07	1.43	12.13	13.85	9.37	14.17	13.38	4.14	4.50
EM (Emerging Markets)	2,927	-0.82	3.90	16.36	16.94	9.12	9.44	9.07	3.97	6.13
Currency	**Level**	**1 Month**	**3 Months**	**YTD**	**1 Year**	**3 Years**	**5 Years**	**Since 1/1/2012**	**10 Years**	**20 Years**
Canadian Dollar ($US/$CA)	80.13	0.45	3.98	4.40	5.10	-3.52	-4.65	--	-1.57	0.51
Regional Indices (Native Currency) Price Return	**Index**	**1 Month**	**3 Months**	**YTD**	**1 Year**	**3 Years**	**5 Years**	**Since 1/1/2012**	**10 Years**	**20 Years**
London FTSE 100 (UK)	7,373	-0.78	0.82	3.85	6.86	3.64	5.13	4.99	1.32	0.02
Hang Seng (Hong Kong)	27,554	-1.49	6.95	17.95	18.27	6.31	5.74	6.18	0.15	3.07
Nikkei 225 (Japan)	20,356	3.61	1.61	6.91	23.75	7.97	18.07	16.70	1.95	0.65
Benchmark Bond Yields		**3 Month**		**5 Year**		**10 Year**		**30 Year**		
Government of Canada Yields		1.00		1.77		1.92		2.50		
U.S. Treasury Yields		1.04		1.92		2.24		2.88		

Canadian Bond Indices ($CA) Total Return	Index	1 Month	3 Months	YTD	1 Year	3 Years	5 Years	Since 1/1/2012	10 Years
FTSE TMX Canada Universe Bond Index	1015.61	-1.90	-2.22	0.42	-2.70	2.91	2.76	2.88	4.74
FTSE TMX Canadian Short Term Bond Index (1-5 Years)	695.28	-0.41	-1.22	-0.17	-0.36	1.53	1.82	1.77	3.29
FTSE TMX Canadian Mid Term Bond Index (5-10)	1106.89	-1.52	-3.00	-0.20	-2.91	3.10	3.14	3.33	5.45
FTSE TMX Long Term Bond Index (10+ Years)	1615.52	-4.32	-3.21	1.49	-5.86	4.63	3.66	4.03	6.59

Sources: TD Securities Inc., Bloomberg Finance L.P. TR: total return, PR: price return. As at September 29, 2017.

Important information

This report is for informational purposes only and is not an offer or solicitation with respect to the purchase or sale of any investment fund, security or other product. Particular investment, trading, or tax strategies should be evaluated relative to each individual's objectives. [Graphs and charts are used for illustrative purposes only and do not reflect future values or future performance.]This document does not provide individual financial, legal, investment or tax advice. Please consult your own legal, investment and/or tax advisor.

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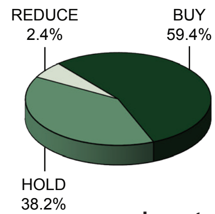
Action List BUY: The stock's total return is expected to exceed a minimum of 15%, on a risk-adjusted basis, over the next 12 months and it is a top pick in the Analyst's sector.

BUY: The stock's total return is expected to exceed a minimum of 15%, on a risk-adjusted basis, over the next 12 months. SPECULATIVE BUY: The stock's total return is expected to exceed 30% over the next 12 months; however, there is material event risk associated with the investment that could result in significant loss. HOLD: The stock's total return is expected to be between 0% and 15%, on a risk-adjusted basis, over the next 12 months. TENDER: Investors are advised to tender their shares to a specific offer for the company's securities. REDUCE: The stock's total return is expected to be negative over the next 12 months.

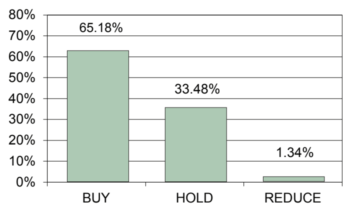
Overall Risk Rating in order of increasing risk: Low (7.8% of coverage universe), Medium (39.3%), High (43.8%), Speculative (9.0%)

Distribution of Research Ratings



Percentage of subject companies under each rating category—BUY (covering Action List BUY, BUY and Spec. BUY ratings), HOLD and REDUCE (covering TENDER and REDUCE ratings).
As at October 2, 2017.

Investment Services Provided



Percentage of subject companies within each of the three categories (BUY, HOLD and REDUCE) for which TD Securities Inc. has provided investment banking services within the last 12 months.
As at October 2, 2017.

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