TD Wealth

The New Narrative

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Ten years after the financial crisis, I feel that we are at a critical inflection point. We need to assess what drove investment returns over the past ten years and determine if those factors still hold true today and more importantly, if they will hold true going forward. I sense there is a new narrative and we need to act accordingly.

1. Monetary Policy – The financial crisis in 2008 forced central bankers around the world to reduce short term interest rates to zero and to borrow money to buy long term bonds and bring those rates down as well. This is known to as quantitative easing. Ultimately, their objective was achieved as outright financial collapse was averted. Rates at zero, not only created asset inflation, but also reduced volatility and increased the value of financial assets like bonds and other income producing investments. Now that the economies are out of crisis, central bankers are going in the opposite direction – raising interest rates. Although the trajectory and speed will be different for each country, the fact remains that interest rates are going higher. Caution is warranted on those investments that increased in value only because of declining interest rates.

2. Populism and Fiscal Policy – In the past ten years, there has been significant asset inflation in real estate, stocks, bonds and private businesses. However, asset inflation does not impact everyone equally. The bulk of significant asset ownership rests with a small percentage of the population. Consequently, those who have not benefited are now electing governments that will make their lives better. A case in point is the rise of Populism. These leaders all have a similar script – raise taxes on the wealthy, spend on projects to improve the average citizen's income and protect their own country interests. Unlike the coordinated central bank effort we saw in the past, we now have a higher risk of conflict between nations, increasing disparity between countries and greater currency fluctuations.

3. Inflation and Economic Growth – Inflation has been essentially non-existent for the last ten years. This is partly due to structural issues like demographics and technology, but is also largely based on the employment of monetary policy. Although there has been asset inflation, it did not translate into actual economic inflation. Because the small percentage of people who own the assets did not translate the increase into an equivalent increase in spending. In my opinion, the primary drivers of inflation are government spending and higher wages. Both of these factors will increase to levels we have not seen in the last decade. As well, inflation will be higher, but we may not get to the rates of the 1990s because of the structural issues. Unlike owners of assets, those who experience wage increases do tend to spend more. This may drive economic growth and increase the expectation of future growth. At the same time, issues such as automation and potential trade conflict will likely prevent runaway economic growth.

4. Trajectory of the US dollar – since 2008, the US dollar has gained significantly versus global currencies. It was the economy that first emerged from the financial crisis and displayed growth while others were struggling. It was the first to raise rates and experienced a booming stock market that attracted capital from around the world. Although I do not expect this to change immediately, I believe in the adage that investing is about looking at the windshield as opposed to the rear view mirror. We are seeing growth in the rest of the global economies and the gap between the USA and others is narrowing. Higher interest rates will start to impact their economy and the recent boom from the tax cuts will begin to wane. The anti-trade and anti-immigration policies will likely have a negative impact on the USA and their currency. Intuitively, those countries hurt by a strong US dollar could become beneficiaries should the reverse happen.

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5. Experience instead of things – Although not new, this theme continues to garner attention. Not only are baby boomers interested more in experiences versus things, but so are the millennials. If the global economy does grow because of higher wages and monetary policy, it could be different industries that benefit than those we have seen in the past

As for how this narrative impacts investments, the table below highlights how we will be positioning portfolios over time:

Fixed Income

- Maturities less than 5 years and focus on countries that are going to raise rates at a slower pace (for example, Canada).

Equities

- Focus on companies with low debt levels that are able to pass on higher costs to their customers. Dividends matter, but the rate at which the company can grow the dividend is more important than the current dividend.
- International investments in on Asia and Emerging markets offer the best risk-return opportunity. The current trade rhetoric has put pressure on those countries but allocating capital over time will result in attractive returns in the next five years.
- The stock market in North America is fully valued. Some companies are still creating value in their business by divesting assets, making strategic acquisitions or focusing their business on industries that will grow in the coming years.
- High growth areas that warrant further reflection include EV (Electric Vehicles,) 5G technologies and the Internet of Things, and the growing use of Blockchain Technology known for Cryptocurrencies, but is actually the backbone behind how some of the largest companies today are thinking about the way transactions will occur in the future.

Alternative Investments

- It is possible that the economy grows, but the stock market in North America has already priced in all the good news. Private Debt or Infrastructure investments may provide higher returns than fixed income and less volatility than equities. However, these investments are not risk free and may have liquidity issues. We would consider holding these in the context of an overall portfolio.

The narrative has changed dramatically and I think it would be naïve to assume that what has worked in the past will continue to work. Since we are going to be forced to think differently, it will impact the type of investments we will hold going forward.

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