TD Wealth

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A shift from the U.S. to the rest of the world.

Back in 2012, we made a conscious effort to shift some of our holdings into the U.S. market despite the fact that the U.S. debt was downgraded just months earlier. Our rationale was that the stock market was relatively cheap at just under 13x earnings, the U.S. was becoming energy independent and the economy was slowly starting to improve. Our confidence was further bolstered by the fact that the stock market value, as measured by the S&P 500 Index, was virtually at the same value as it was in the year 2000. It was a lost decade. Anecdotally, when I reviewed portfolios for new clients, very few if any, had U.S. holdings. To top it off, overall investor sentiment was negative towards the U.S.

Fast forward to today and the U.S. debt and deficit is much larger than it was back in 2012. The stock market is now 18x earnings when the long-term average was closer to 16x; the U.S. is energy-independent and is looking to export oil; the S&P 500 has been the best market in the world over the past 5 years and that the U.S. economy has been the best performing in the world. Add to the fact that they now have one of the lowest corporate tax rates in the world. This is all good news – so why would we look elsewhere? Well, the axiom of "buying low and selling high" comes to mind. It seems intuitive that if you buy an asset that is expensive relative to the long-term average (18x versus 16x), it's likely that you will earn a lower than average rate of return in the coming years. The opposite is also true.

The Price-to-Earnings ratio (P/E) has long been used as a means to compare the stock market value from previous periods and with other markets around the world. However, the flaw in this ratio is that it just looks at earnings from the previous year and does not take into consideration inflation. Dr. Robert Shiller won a Nobel Prize in Economics by coming up with a ratio that takes into consideration the average earnings of a market over 10 years and adjusts it for inflation. This is called the CAPE (Cyclically Adjusted Price-to-Earnings) ratio. He was able to go back and apply this ratio to the stock market as a means of predicting future returns. As you might have guessed, if you bought the stock market when the CAPE ratio was low, returns over the next 5 years tended to be higher than if you bought the stock market when the CAPE ratio was high.

As of December 2017, the U.S. market was trading at 32x CAPE, International Markets were at 17x and Emerging Markets at 15x. The table on the next page predicts the annualized returns over the next 5 years based on the starting CAPE ratio for those markets.

Starting CAPE	Under 10x	10–15x	15–20x	20–25x	Over 25x
U.S.	17.3%	14.0%	10.1%	9.5%	.5%
International	n/a	9.9%	18.5%	8.5%	1.6%
Emerging Markets	20.2%	20.8%	7.7%	2.1%	-0.3%

Time will tell but based on this ratio, much of the good news might be priced into the U.S. stock market and the opportunities are abroad.

Canadian Dollar stalled between slowing economy and NAFTA fears

Since 2000, the two main drivers of the Canadian economy have been the energy industry and housing. As oil rose from the low teens in early 2000 to over $100 a barrel in 2011, it created a lot of jobs and drove economic growth especially in the Province of Alberta. As oil prices receded, it was housing that took the baton to lead the economy. A construction boom fueled by low interest rates and foreign investment drove 4th quarter GDP in 2017 to 3%! However, that did not last long. The two interest rate increases in 2017 and a change in the mortgage rules last January are clearly having an impact on housing and, as an extension, the Canadian economy. Our economy is slowing. This puts the Bank of Canada on hold for further interest rate increases. Obviously, the threat of the U.S. pulling out of NAFTA further complicates matters but irrespective of that, I do wonder what will drive our economy going forward. The weakness in the Canadian dollar as of late is reflecting some of these concerns. If the U.S. does in fact pull out of NAFTA, it would not be surprising to see the Canadian dollar trade down to the low $0.70s. If there is an agreement, there should be a short term bounce in our currency to the low $0.80s. I would use that as an opportunity to buy U.S. dollars.

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