TD Wealth

Q3 of 2019

Quarterly Portfolio Management Update

Commentary

My daughter celebrated her first birthday in July. She is a happy child. In this first year, my daughter has had one "first experience" after another. Each time, these simple discoveries fill her with wonder and, increasingly, remind me of how simple the world can be - *should be?*

Most days when I arrive at home after work, my daughter is sitting in her playroom enjoying the company of one of her stuffed animals. Something special happens the moment she realizes I am there. Her face completely lights up - it's *happiness* in its purest form. There are no distracting thoughts pulling her away from that joyous feeling. For a quick instant, the only thing that matters is me.

In my daughter's world, there is no nuance - nothing is too complex. She doesn't understand the laws of physics, but has learned that her ball will fall when she drops it. If something is familiar and makes her happy, she smiles. If something is wrong or if something scares her, she cries. If something is unknown - but not intimidating - she will inevitably put it in her mouth and try to eat it. There is a simple rhythm in her life as a toddler, with predictable knock-on effects.

In contrast, the world in which we live as adults can be very intricate. We rarely allow ourselves to be fully consumed by one thought or one emotion. Instead, we regularly manage competing demands at the same time. For each task, we weigh the probability of one outcome versus another. Moreover, we try to decide on the efficacy of various signals to arrive at those presumed results. And, unlike children, we bear the consequences.

I have a tendency to prefer more information than less. I like to dissect problems; to carefully think about possible solutions and the various outcomes of each. However, I have started to doubt this disciplined approach - at least its usefulness in *every* situation. If I were to take a page from my daughter's book, then perhaps adults make things

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harder than they need to be. It is easy to become distracted by complexity. In my first year as a father, I have become aware that there are times when analysis is not necessary. There are times when simple awareness will suffice.

With this in mind, I have added a few rules to my decision making toolkit:
1. Sometimes, when making a decision, defining and focusing on one's principles and considering only the root factors will suffice.
2. Sometimes, when trying to decide which signal matters, the most obvious one should prevail.
3. When we think about the world around us - family dynamics, political tensions, economic policy, financial markets, etc. - we should acknowledge and remember that things can be both simple and complex.

Market Update

The current bull market just broke the record for the longest running recovery in history. By many measures, it seems like the economy may be topping out. However, the market's upward momentum seems relentless.

At present, almost every traditional indicator is pointing to a global economic slowdown. On a year-over-year basis, and only to name a few - North American freight shipments are down; capital goods new orders are down; U.S. car sales, clothing sales, and retail full-service restaurant sales are down; global semi-conductor sales are down; and, home prices are down. Further, corporate and government debt levels are higher than they have ever been, with concerns over a strengthening U.S. dollar making the ability to service and roll those loans precarious, to say the least.

In spite of these concerns, the S&P 500 and S&P TSX were positive 18.54% and 16.22%, respectively January through June 2019. This, by most accounts, is a breakdown in traditional market behaviour. To many investors, this does not make sense. It does not seem sustainable. However, it is possible that some of us are distracted by the complexity of an immensely complex system. In many ways, market action today is easier to grasp than markets of days gone by - especially, if you convince yourself to look at the system with fresh eyes, much like my daughter.

Central bank intervention and the need for perpetual fiscal stimulus would historically give investors cause for concern about future growth and their ability to help generate meaningful returns. However, this year, anticipated rated cuts have buoyed markets and regularly pushed them to higher highs. There could be hundreds of possible explanations for this, but ultimately, it is not complicated. Lower interest rates push equity markets higher - or rather, have pushed equity markets higher. I am not saying this is right or wrong - it simply is, or has been, the case for the past 6 or 7 years. There is a disconnect between traditional economic analysis and current economic reality; between the more mature analytical interpretation versus a more simplistic acceptance of the world in which we live.

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Our View

In our Q2 commentary I said that the market is increasingly driven by narratives. The stories we're told become more important than the events they're describing. I also noted that investors still need to play the game. That is, identify the narratives driving performance and allocate their assets accordingly. I believe we are approaching an inflection point. It represents the resolution between two competing narratives that our team has been evaluating for quite a while.

As noted, investment returns in the current market do not seem to rely on income, earnings growth, cash flow, or current yields. Rather, they seem to depend on an abundance of cheap money and policy intervention to push prices higher and stem volatility. While it is entirely possible for this to continue for a while longer, one would need to have 100% conviction in the central bank's ability to get interest rate and monetary policy decisions exactly correct in order to take on elevated levels of equity and credit risk.

We are currently positioned for markets to normalize and for investors to once again rely on fundamental economic indicators to dictate market movements. We believe central banks will continue to see diminishing returns from stimulus programs and that investor's conviction in their efficacy will wane. Also, it is likely that the global slowdown that is presently reflected in the data will roll into a recession.

It is important to note that we are thinking about the present rhythm of the market from various angles, considering both simple and complex decision rules. We weigh the probability of one outcome over the other and, more importantly, the potential impact of being right or wrong in both scenarios. We still believe that there is likely more risk than investors should be willing to take on for the potential or expected returns in equity and fixed income markets and thus we remain underweight in both.

From the Bayswater Group,

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[i] Real Vision, Is Recession Coming?, Raoul Pal, July 14, 2019.

[ii] Real Vision Think Tank, The Killer Charts, July 2019.

[iii] Bloomberg Finance L.P. as at June 30, 2019. Total index values and returns.

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