TD Wealth

Commentary – Q2 2018 – Populism vs Pluralism

In political terms, the concept of *populism* refers to a range of approaches which emphasize the role of the *people* who exhibit moral rectitude juxtaposed against the *elite* who are presented as corrupt. The political actor engages in a movement designed to incite mistrust amongst various demographic groups in an effort to *divide and conquer* and ultimately win an election. This type of political tool has been harnessed throughout history as a means to power, but has only a tangential relationship to political ideology. Examples could be cited from the left or right side of the political spectrum, and the term itself has a fluidity that has seen it co-opted by both extremes. At this moment in history however, whether in the form of Brexit negotiations between the United Kingdom and continental Europe, or in the form of global trade *sword rattling* by the United States (U.S.) and the rest of the developed world, this rhetoric threatens global financial stability and risks harmful inflationary pressure at some point in the future. The more we see of the populist sentiment taking hold in parts of the West, the greater the threat to democratic ideals that have characterized our society since the end of the Second World War.

There is no doubt that the current state of the global economy, including the Canadian one, is strong, and stock markets are generally reflective of that fact. During the second quarter, the Standard & Poor's 500 (S&P 500) TSX Composite Index (S&P/TSX) rose by 6.77% with ten of eleven sectors posting positive returns and growth stocks generally out-performing their value counterparts. The U.S. markets recovered lost ground in the second quarter with the broader S&P 500 Index (S&P 500) up by 3.43% and the tech heavy NASDAQ moving ahead by 6.61%. As in Canada, U.S. growth stocks outpaced value names. It should be noted that the current market strength has been years in the making, with business conditions growing increasingly favorable, interest rate policy accommodative (up to now) and corporate balance sheets in generally strong health compared to where they were a decade ago.

However, human beings, including Presidents, do unpredictable things and this in turn can make financial markets dynamic. As an example, trade negotiations can often be characterized by abrasive rhetoric as participants on all sides try to extract maximum benefit; - this seems to be the case now. While negotiations of this type are by their nature unpredictable, the outcomes ultimately need not be negative. That said, over the course of the second quarter, it has become clear that Canadian competitiveness has suffered a number of setbacks. Recent tax reform in the U.S., has effectively wiped out Canada's favorable position in corporate taxation. In addition, Canada's export sector has also been affected by uncertainty surrounding North America Free Trade Agreement (NAFTA) negotiations.

As a result, we believe that the Bank of Canada (BoC) is wise to take a *wait and see* approach; at least until the U.S. mid-term election season has run its course. At that point, there may be more clarity in terms of how much rope the U.S. administration will be given to pursue this ultimately destructive course of action. Further, as has been previously noted, a lack of pipeline capacity is one of the most pressing competiveness challenges facing Canada's important

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energy sector. Despite these headwinds, Canadian business investment trends have been holding up well, and the attractiveness of Canada as a destination for foreign dollars has shown few signs of abating.

As widely expected, the BoC left its overnight rate unchanged from the winter at 1.25% in late May, but telegraphed its intention to tighten again as early as the start of the third quarter. The central bank acknowledged Q1 Gross Domestic Product (GDP) growth in Canada was higher than the 1.3% it had forecast earlier in the quarter, thanks to robust exports and business investment. The BoC also noted that because of rising fuel prices, it now expects inflation to be a bit higher than what was forecast in the early spring. While there are uncertainties with respect to tariff and trade conflicts and a potential slowdown in the residential housing market, the central bank nonetheless has maintained its hawkish stance with respect to interest rate policy.

The BoC has a good amount of flexibility now as Canada's fiscal position is quite sound. In the longer term, this may act as a counter-balance to the relative disadvantage we find ourselves in compared to the U.S. with respect to personal and business tax rates. After a slow start to the year, the domestic economy seems to be gaining steam, with Gross Domestic Product (GDP) estimates running at 2% plus well into 2019. Unemployment numbers have also been encouraging. Correspondingly, inflation estimates have returned to the BoC's 2% target range. At the same time, the BoC has signaled caution with respect to its rate normalization program. A number of factors are driving this hesitative stance: as mentioned several times in this space, the Canadian housing market, while robust and with room to run, can be undermined by a rate tightening trend on the part of the BoC.

Ultimately we believe that in the short term, it is a given that Canadian government bond yields will stay below their American counterparts. This will most likely keep the Canadian dollar (CAD) trading toward the lower end of its projected range (i.e. trending towards $0.75 U.S.) well into 2019, barring any major surprise move up in commodity and/or oil prices. Oil prices have been and will be for the foreseeable future intertwined with the value of the CAD and indeed the prosperity of the country. With supply expressly curtailed by the Organization of Petroleum Exporting Countries (OPEC) over the last few years, demand has been allowed to catch up and is now seemingly in equilibrium at current price levels. Indeed as global growth continues, and the renewed focus on infrastructure spending in China has come back into view, the demand for oil has grown sharply and is forecast to continue. On the supply side, while the U.S. shale production revolution has been a concern, its capacity is limited, and there are plenty of geopolitical threats that could send the market into a supply shock. To be sure, although the longer-term environment for fossil fuel consumption is negative, the transition to more sustainable forms of energy we believe will be a multi-decade process.

For the next quarter and indeed the rest of the year, the economic and political headlines will likely be dominated by a struggle between the forces that wish to sow discord and division amongst allies and the *pluralists* who seem to view society as a broad array of overlapping social groups, each with their own ideas and interests. *Pluralism* encourages governance through compromise and consensus in order to reflect the interests of as many of these groups as possible. Will citizens push back against recent divisiveness or will we see continued upheaval to the status quo? Do recent summit meetings suggest perhaps the complete eradication of the Group of Seven (G7) as a unified voting block or will cooler heads ultimately prevail? And finally, are we seeing a repudiation of the North Atlantic Treaty Organization

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(NATO) and its post-war goals of peace and prosperity for its member nations? These are some of the issues that should be considered as we head towards the halfway mark of the Trump administration's first term and the U.S. mid-term elections in the fall.

Best regards,

Cameron Stirling, CIM®
Investment Advisor
TD Wealth Private Investment Advice

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Sources: TD Wealth – Q2-18 – Quarterly Market Review; Mudde, Cas; Kaltwasser, Cristóbal Rovira (2017). Populism: A Very Short Introduction. Oxford: Oxford University Press. ISBN 9780190234874; Forward Perspectives TDAM June 2018; TD Wealth – Straight Forward – Summer 2018;

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