TD Wealth

Cold, hard facts

Monthly Perspectives // Portfolio Advice & Investment Research March 2018

What goes up, must come down

Brad Simpson, Chief Wealth Strategist

Cold, hard facts are observed certainties. They are truisms derived by experience. A great example of this is Tessa Virtue's and Scott Moir's dazzling, breathtaking, gold-winning blend of athletic power and artistic grace; so is the fact that I have no idea what a Choctaw turn, twizzler, flutz, kiss and cry, lutz jump or triple Salchow are.

As I write this, the earth's orbital star generously shares its beautiful morning light across the Haro Strait as will it again tomorrow. What goes up, must come down is a colloquial turn on Newton's law of gravity. This is another cold hard fact proven true in February as stocks and bonds both went down in value in unison despite what academics with their Greek formulas and questionable theories say.

This serves as a blunt reminder of the necessity of building diversified portfolios that go beyond traditional allocations to investments that hedge and derive returns outside of public markets. Politicians will spend more than they raise, and critics will decry that not enough was done in the federal budget.

Winston Churchill's sage remarks hold true today as they did more than a half a century ago: "We contend that for a nation to try to tax itself into prosperity is like a man standing in a bucket and trying to lift himself up by the handle". To consider all of these points, please proceed and read our cold, hard facts aboout the market and the federal budget below.

Relief correction

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Yes, you read that right. The title of our market correction commentary is Relief Correction due to the simple fact that this market genuinely needed a relief from going up. We would argue that this correction came just in time, helping divert equity markets from something much larger and more costly down the road. Back in June 2016, we wrote a Monthly Perspectives called Volatility. In it, we made the case that markets need volatility; it is what makes them healthy.

It's incredible the fear that seems to come with its mere mention, but it is important to keep a level head. In fact if you are prepared for it, volatility can be a positive contributor to your long term financial well-being. The reason for this is that volatility, if experienced in reasonable quantities, is actually critical to a healthy financial market because it helps establish a much needed balance in the financial system.

A financial environment with moderate volatility sees investments that are poorly functioning go down in value, while ones that are functioning well going up. A financial environment without appropriate volatility sees all assets, good or bad, go up in value, which is unsustainable in the long term. Always remember: time wounds all heels.

The question that warrants due consideration is whether our current environment is well balanced and in good health?

We believe a well-functioning financial environment needs three key things:

Cognitive diversity - investors in a marketplace must have opposing views on the value of underlying assets,

Full disclosure - investors must share equally in having access to all the information there is to be known, and

Rewards and penalties - investors who have a view based on all the known information and get it wrong should lose money; those who get it right should make money.

If one of these component parts fails to function effectively, there is usually a price correction leading to modest volatility. If all three are severely impaired, as was the case in Credit Crisis of 2008, the likelihood of financial crisis is incredibly high because financial markets are at their least effective state at the extremes. During jubilant market highs, investors in droves are willing to pay more for less return, and in manic market lows, investors en masse are looking to pay less for more return. It is not all good, nor is it all bad. A healthy financial system works by striking a balance between the two.

Until February, we were missing two of these three ingredients. First, we had little cognitive diversity. The near universal, positive narrative went something like this: central banks are still accommodative, the global economy is in a synchronized upswing, earnings per share growth is in the double digits and the big overhaul of the American tax system is going to be a real positive for global markets. The new, negative narrative is as follows: restrictive central banks will lead to higher interest rates, which will be stoked by excessive inflation, made worse by unnecessary fiscal stimulus in the form of American tax cuts, causing the unwind of the carry trade, which will lead to headwinds for equities and bonds. Welcome back cognitive diversity (table 1).

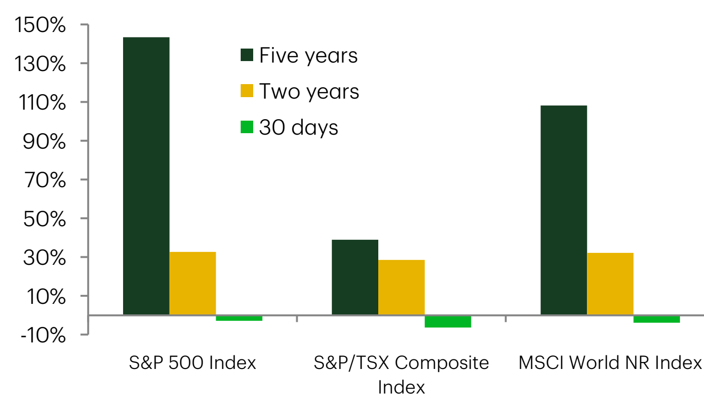
Table 1: Cognitive Diversity

Cognitive Diversity	
Established positive narrative	New negative narrative
Supportive central banks	Restrictive central banks
Synchronized global upswing	Fiscal stimulus will lead to escalated tightening
Tailwind from tax overhaul	Pick-up in inflation expectations
Double digit earnings growth	Headwinds for stocks and bonds as the carry trade unwinds

The second missing piece, rewards and penalties, was disproportionately skewed to the rewards side of the ledger. Let's consider the two big factors going into this correction:

Returns: equity returns for the past five years have been good and in the last two years they have been just short of fantastic (figure 1).

Figure 1: Good to Great Equity Returns



Source: Bloomberg Finance L.P. As at February 13, 2018.

Relief correction (cont'd)

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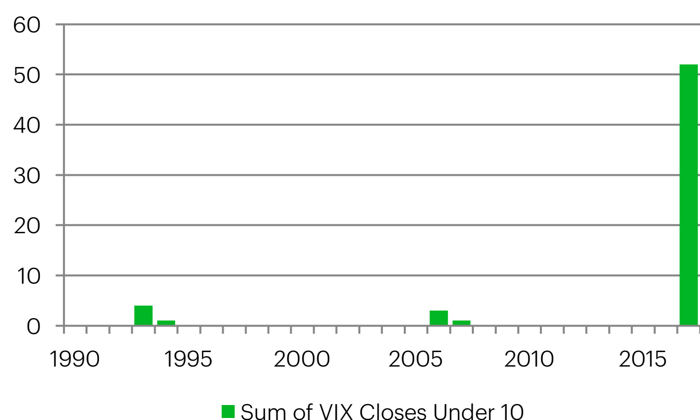
Volatility: In 2017, the S&P 500 Index was up every month. Furthermore, there were 53 days that the VIX (the so called fear index) was below 10. For clarity this has never happened before. Never. Looking at figure 2, that is as extreme of a difference as you can get.

Figure 2: Volatility: A Slumber Like No Other



Source: Bloomberg Finance L.P. As at February 13, 2018.
VIX: CBOE Volatility Index.

Great returns, little ups and downs, mix in a principal residence and a few rental condos that are worth a bunch more now than they were a few years ago and investor sentiment towards markets was somewhere between giddy and giddy. In the first week of the new year, bullishness was 55% higher than the average. Recently the tides have turned to a bearish sentiment in line with historical norms (figure 3). We were beginning to live in a world that was all about the good, with no worry about the bad. Perhaps the biggest sign of this can be seen in the sky rocketing trade volumes and valuations for crypto-currencies and cannabis stocks. Think about this in terms of Maslow's hierarchy of needs. With investors' traditional assets priced at all-time highs, many were feeling the peace of mind that can come with the family purse feeling a little heavier. The net result: a susceptibility to speculate and toss some capital to the more wild side of the financial spectrum. We just published a special edition of Monthly Perspectives called: Fables, Foibles and Bubbles. The title says it all.

The starting point of this commentary was that the current volatility is a real positive. Our belief is that financial markets are an open complex system; they are akin to a biological system and not the cold and mechanical machine that traditional finance would have you believe. Financial markets have good and bad days; they learn, they adapt and sometimes they get a bit sick. The old adage "what doesn't kill you makes you stronger" may be a perfect way of looking at things right now. Hormesis is a term used in biological sciences to describe the benefit a living thing gets from taking low doses of something that is otherwise toxic or harmful. This is what we have right now, a low dose to inoculate the system to help make it healthier.

Figure 3: Survey Results

For week ending January 4, 2018

16% Bearish

For week ending February 8, 2018

35% Bearish

Source: AAII sentiment survey. As at February 8, 2018. Data represents what direction members feel the stock market will be in the next six months. The American Association of Individual Investors survey measures the percentage of individual investors who are bullish, bearish, and neutral on the stock market short term; individuals are polled from the AAII Web site on a weekly basis. Only one vote per member is accepted in each weekly voting period.

Relief correction (cont'd)

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Now here is the tricky part: where do we go from here?

The starting point is to understand this is all part of the process of a healthy environment. The next part is to keep this in context. Historically, bear markets tend to happen in periods of recession. Globally economic fundamentals appear healthy with purchasing managers' indices (PMIs), industrial production, job creation and overall activity strong.

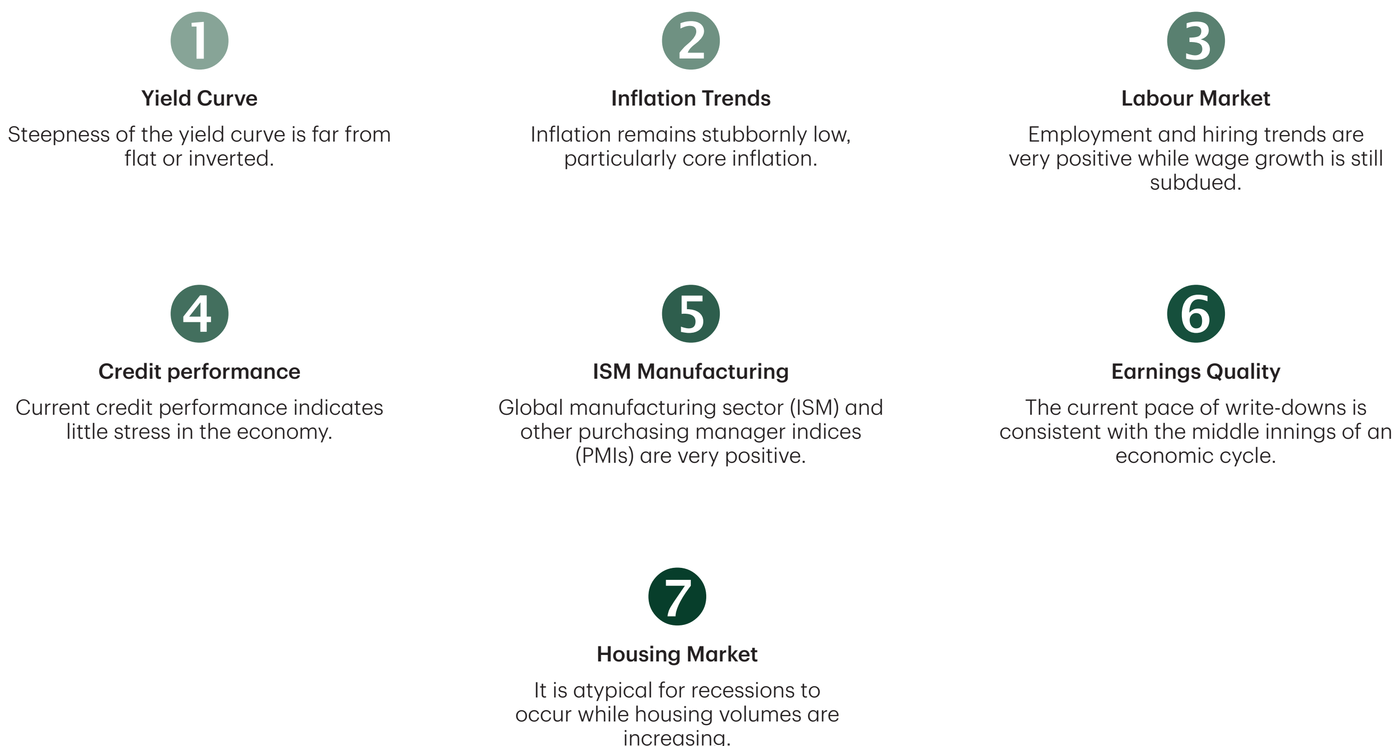
Another consideration is the fact that market corrections, even modest ones, bring out the doomsday agents. Financial articles will be full of hyperbolic words like rout, rocketed, imploded and convulsed. Strategists and portfolio managers who have made bearish predictions for years will come out of the woodwork and their views will be considered sound by some despite their poor track records in recent years. The little benchmarked Dow Jones Industrial Average will be reported incessantly because it has a big number and hence its numerical swings are typically large. Distressed trader photos will manifest everywhere. Finally, charts will have a truncated vertical axis to make small changes look big. In the middle of all this it is hard to keep context.

At TD Wealth, we build and manage portfolios for these moments. We think the following from our winter 2018 strategy Double Doppelgänger says it all:

"We are nine years into an economic and stock market recovery and it's about as good as it gets. We have accelerating global economic growth, easy monetary policy and little volatility. To borrow from a recent cover of The Economist, we are in the middle of the bull market in everything. But somewhere, lurking out there where and when you least expect it, is the darker side of the market and those who invest in it. No one can predict when it will appear. Think of this document as our way of preparing for the good and bad ahead and making sure our client portfolios don't get hit by a double doppelgänger."

We are at a transition point and believe that this may be an appropriate time to make sure your portfolio is built for the potentially good and bad that may lie ahead. Your advisor is there to help you prepare for both possibilities.

Figure 4: Seven Indicators of a Healthy Economy



Source: Credit Suisse.

Federal Budget 2018/19

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Private company business owners may heave a sigh of relief following the federal budget delivered by Finance Minister Bill Morneau on February 27, 2018 ("2018 Budget"). The 2018 Budget did not revive various private company tax proposals, previously announced on July 18, 2017 ("2017 Proposals"), aimed at closing, in the government's view, certain tax loopholes. Those proposed measures, which were dropped by the government in view of unfavorable public feedback, included limiting access to the lifetime capital gains exemption available to business owners to reduce their taxes when they sell their businesses, and curtailing certain tax planning opportunities which may enable a tax-efficient intergenerational transfer of a business to family members.

One of the 2017 Proposals which the government did not abandon, but modified in the 2018 Budget, relates to the taxation of passive investment income earned in a Canadian-controlled private corporation ("CCPC"). The government regards the ability of a business owner to hold a passive investment portfolio inside a CCPC as providing an unfair advantage to the business owner over the average individual salaried taxpayer. Since corporate tax rates are generally lower than personal tax rates, there is usually an incentive to retain after-tax earnings in a CCPC, giving rise to more funds being available for investment inside the corporation by a business owner than for an individual taxpayer who uses, for example, after-tax employment income for investment purposes.

The 2017 Proposals in respect of the taxation on passive investment income proposed elaborate and complex measures which would have subjected private corporations earning passive investment income to punitively high tax rates. The 2018 Budget proposes simplified changes to the small business deduction and to the refundable dividend tax on hand, in an attempt to restrict certain tax advantages currently enjoyed by private corporations earning passive investment income. Here are some of the changes in brief:

Small Business Deduction ("SBD")

Currently, a CCPC, together with its associated corporations (e.g., a subsidiary), may claim an SBD on active business earnings of up to the $500,000 small business limit. This effectively allows active business income up to the threshold to be taxed at 10% (federally for 2018). Any excess business income is subject to the general corporate tax rate of 15% (federally for 2018). The SBD is reduced to the extent that the CCPC, together with its associated corporations, has taxable capital employed in Canada in excess of $10 million, and is completely eliminated where the taxable capital of the associated group reaches $15 million.

The 2018 Budget proposes to reduce the small business limit where investment income of the CCPC exceeds $50,000. Specifically, the 2018 Budget reduces the small business limit by $5 for every $1 of investment income above a $50,000 threshold. For example: Assume your CCPC does not have taxable capital in excess of $10 million, there are no corporations associated with your CCPC, and your CCPC earns investment income of $100,000. Under the 2018 Budget, your CCPC's small business limit would be $250,000, i.e., $500,000 – [($100,000 - $50,000) x 5]. Any business income in excess of this $250,000 would be subject to the general corporate tax rate. If your CCPC earns investment income of $150,000, the reduction of $500,000, i.e., ($150,000 - $50,000) x 5, would completely wipe out the small business limit. Where there is a reduction to the small business limit due to the reduction under the proposed rule and the existing taxable capital reduction, a CCPC would be subject to the greater of the two reductions.

There are proposed adjustments to the method of calculating investment income as well as an expanded rule which may deem two related (but otherwise unassociated) corporations to be associated corporations for the purposes of the application of the small business limit.

To explain how a CCPC may be affected by the proposed measures, the 2018 Budget provides the following chart which shows the reduced business limit available to a CCPC at varying levels of business income and investment income.

Table 2: Active business income qualifying for the small business tax rate under new business limit ($)

Business Income	Investment Income				
	50,000	75,000	100,000	125,000	150,000
50,000	Not Affected				0
75,000					0
100,000					0
200,000				125,000	0
300,000			250,000	125,000	0
400,000		375,000	250,000	125,000	0
500,000		375,000	250,000	125,000	0

Source: Government of Canada. www.budget.gc.ca. As at March 1, 2018.
Note: Assumes that the corporation has less than $10 million of taxable capital.

Federal Budget 2018/19 (cont'd)

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Refundable Dividend Tax on Hand ("RDTOH")

Under existing rules, a CCPC is taxed on investment income at about the same rate as an individual at the highest marginal tax rate. When the CCPC pays a taxable dividend to its individual shareholder, the RDTOH regime allows the CCPC to recover a portion of the tax previously paid, in an amount approximate to the amount of tax payable by the individual shareholder on receipt of the dividend.

The 2018 Budget proposes to create a new RDTOH account and redefine the existing one, by segregating the RDTOH account into "eligible RDTOH" and "non-eligible RDTOH", in order to restrict a CCPC from obtaining an RDTOH refund where it pays eligible dividends funded from active business income. The 2018 Budget proposes that such RDTOH be refunded only when a non-eligible dividend is paid. An exception may be provided where the RDTOH is generated from eligible portfolio dividends received from Canadian public companies (e.g., dividends from TD Bank shares), and the CCPC pays an eligible dividend to its shareholders to recover a RDTOH refund. There are transitional rules to calculate the two different RDTOH pools.

Time to Act

The proposed rules generally apply to taxation years that begin after 2018. If your CCPC holds an investment portfolio generating substantial investment income and benefits from the SBD, or if your CCPC is one of a group of associated corporations, which may consist of investment holding companies and/or operating companies, which benefits from the SBD, now is the time to act. In view of the time-sensitive nature and the potential impact of the proposed changes, as private corporation business owners, you should consult with your TD investment advisor and your professional tax advisor to determine how these tax changes may impact you and your business and assess any potential planning opportunities.

The boat remains unrocked

TD Economics / Highlights

The federal government recently unveiled a 'stay the course' budget plan, devoid of any notable surprises.
Below are highlights from TD Economics.

- Faced with an improved fiscal starting point, the federal government has chosen to spend the windfall, leaving the projected deficit profile essentially unchanged relative to that shown in the Fall Economic Statement.
- The budget shortfall is expected to remain at around 1% of GDP for the foreseeable future, helping bring the debt-to-GDP ratio gradually lower through time.
- A grab-bag of spending initiatives were introduced, including funding for basic research, Indigenous Peoples, and others. The Working Income Tax Benefit has been expanded and given a new name, and a five week 'take it or leave it' parental leave benefit was introduced.
- Equally notable were areas that remained untouched. Little was done to address international competitiveness concerns in the wake of U.S. tax changes. On the flip side, this also meant that the treatment of options and capital gains was left unchanged.
- In total, about $20 billion was allocated over six years for new measures, less than half of what was announced in the government's inaugural budget in 2016.
- Ultimately, the modest stimulus introduced today seems to strike a roughly appropriate balance given a still-solid economic outlook, but one that faces significant downside risks. Anyone hoping for a 'big bang' will likely have towait for next year's pre-election budget.

Visit economics.td.com for full report

Market review

		(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)
Canadian Indices ($CA) Return	Index	1 Month	3 Months	YTD	1 Yr	3 Yrs	5 Yrs	Since 1/1/2012	10 Yrs	20 Yrs
S&P/TSX Composite (TR)	51,644	-3.02	-3.23	-4.37	3.23	3.47	6.92	7.37	4.33	6.48
S&P/TSX Composite (PR)	15,443	-3.19	-3.89	-4.73	0.28	0.45	3.79	4.24	1.29	3.97
S&P/TSX 60 (TR)	2,472	-3.07	-3.34	-4.42	3.73	3.94	7.53	8.07	4.40	6.64
S&P/TSX SmallCap (TR)	967	-4.51	-4.16	-6.58	-4.45	3.57	4.00	2.78	1.84	-
U.S. Indices ($US) Return	Index	1 Month	3 Months	YTD	1 Yr	3 Yrs	5 Yrs	Since 1/1/2012	10 Yrs	20 Yrs
S&P 500 (TR)	5,308	-3.69	2.96	1.83	17.10	11.14	14.73	15.70	9.73	6.86
S&P 500 (PR)	2,714	-3.89	2.50	1.50	14.82	8.85	12.37	13.28	7.39	4.87
Dow Jones Industrial (PR)	25,029	-4.28	3.12	1.25	20.26	11.34	12.23	12.33	7.39	5.52
NASDAQ Composite (PR)	7,273	-1.87	5.81	5.35	24.85	13.58	18.14	18.11	12.34	7.32
Russell 2000 (TR)	7,451	-3.87	-1.76	-1.36	10.51	8.55	12.19	13.82	9.75	7.52
U.S. Indices ($CA) Return	Index	1 Month	3 Months	YTD	1 Yr	3 Yrs	5 Yrs	Since 1/1/2012	10 Yrs	20 Yrs
S&P 500 (TR)	6,799	0.36	2.33	3.97	13.22	12.03	19.88	20.12	12.71	6.30
S&P 500 (PR)	3,476	0.14	1.87	3.64	11.01	9.71	17.41	17.61	10.30	4.31
Dow Jones Industrial (PR)	32,060	-0.26	2.48	3.38	16.27	12.23	17.27	16.62	10.31	4.96
NASDAQ Composite (PR)	9,316	2.25	5.15	7.57	20.71	14.49	23.44	22.62	15.39	6.76
Russell 2000 (TR)	9,545	0.17	-2.36	0.71	6.84	9.41	17.22	18.16	12.73	6.96
MSCI Indices ($US) Total Return	Index	1 Month	3 Months	YTD	1 Yr	3 Yrs	5 Yrs	Since 1/1/2012	10 Yrs	20 Yrs
World	8,550	-4.10	2.38	0.98	18.00	8.81	11.31	12.77	6.64	6.09
EAFE (Europe, Australasia, Far East)	8,159	-4.50	1.93	0.30	20.69	6.15	7.54	9.69	3.30	5.13
EM (Emerging Markets)	2,606	-4.60	7.12	3.36	30.97	9.37	5.39	7.31	2.99	8.18
MSCI Indices ($CA) Total Return	Index	1 Month	3 Months	YTD	1 Yr	3 Yrs	5 Yrs	Since 1/1/2012	10 Yrs	20 Yrs
World	10,951	-0.07	1.75	3.11	14.08	9.67	16.31	17.07	9.53	5.54
EAFE (Europe, Australasia, Far East)	10,451	-0.49	1.30	2.40	16.68	6.99	12.36	13.88	6.11	4.57
EM (Emerging Markets)	3,339	-0.59	6.47	5.53	26.62	10.24	10.12	11.40	5.79	7.61
Currency	Level	1 Month	3 Months	YTD	1 Yr	3 Yrs	5 Yrs	Since 1/1/2012	10 Yrs	20 Yrs
Canadian Dollar ($US/$CA)	78.07	-4.03	0.62	-2.06	3.43	-0.79	-4.29	-	-2.64	0.53
Regional Indices (Native Currency) Price Return	Index	1 Month	3 Months	YTD	1 Yr	3 Yrs	5 Yrs	Since 1/1/2012	10 Yrs	20 Yrs
London FTSE 100 (UK)	7,232	-4.00	-1.29	-5.93	-0.43	1.35	2.60	4.73	2.08	0.01
Hang Seng (Hong Kong)	30,845	-6.21	5.71	3.09	29.92	7.51	6.03	8.06	2.40	5.07
Nikkei 225 (Japan)	22,068	-4.46	-2.89	-3.06	15.43	5.49	13.81	18.17	4.96	1.36
Benchmark Bond Yields		3 Month		5 Yr		10 Yr		30 Yr		
Government of Canada Yields		1.14		2.00		2.18		2.33		
U.S. Treasury Yields		1.61		2.58		2.81		3.09		

Canadian Bond Indices ($CA) Total Return	Index	1 Month	3 Months	YTD	1 Yr	3 Yrs	5 Yrs	Since 1/1/2012	10 Yrs
FTSE TMX Canada Universe Bond Index	1,030	0.15	-1.06	-0.65	1.01	0.85	2.82	2.91	4.39
FTSE TMX Canadian Short Term Bond Index (1-5 Yrs)	697	0.28	-0.40	0.06	-0.40	0.61	1.56	1.71	2.89
FTSE TMX Canadian Mid Term Bond Index (5-10 Yrs)	1,112	0.48	-1.54	-0.65	-0.95	0.72	2.84	3.18	4.94
FTSE TMX Long Term Bond Index (10+ Yrs)	1,676	-0.26	-1.64	-1.63	4.33	1.26	4.50	4.33	6.45

Sources: TD Securities Inc., Bloomberg Finance L.P. TR: total return, PR: price return. As at February 28, 2018.

Important information

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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 (7.0% of coverage universe), Medium (38.0%), High (45.6%), Speculative (9.4%)

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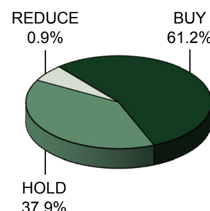

Percentage of subject companies under each rating category—BUY (covering Action List BUY, BUY and Spec. BUY ratings), HOLD and REDUCE (covering TENDER and REDUCE ratings).
As at March 1, 2018.

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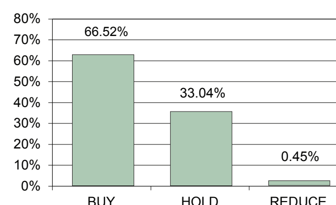

Percentage of subject companies within each of the three categories (BUY, HOLD and REDUCE) for which TD Securities Inc. has provided investment banking services within the last 12 months.
As at March 1, 2018.

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