TD Wealth

The final act

Monthly Perspectives // September 2019

15 minutes

In this issue

The final act: Brad Simpson, Chief Wealth Strategist, TD Wealth
It was all yellow: Beata Caranci, SVP and Chief Economist, TD Economics
Saudi attacks: Return of the geopolitical risk premium: PAIR, TD Wealth

"Out, out, brief candle!
Life's but a walking shadow, a poor player
That struts and frets his hour upon the stage
And then is heard no more: it is a tale
Told by an idiot, full of sound and fury,
Signifying nothing."

– William Shakespeare, *Macbeth*

The final act

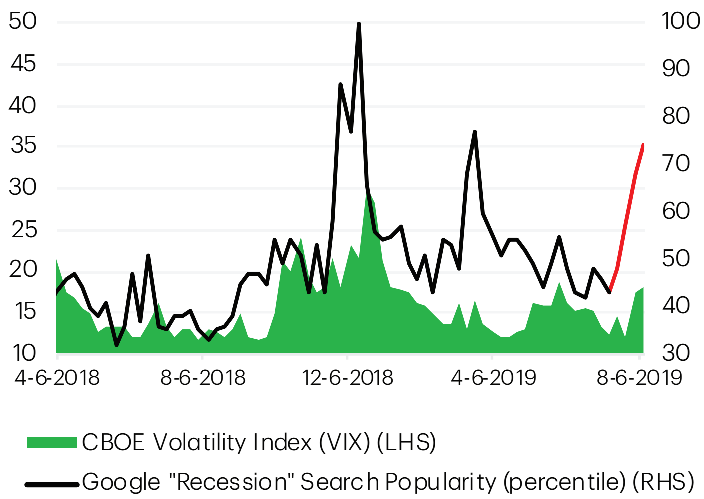
Brad Simpson, Chief Wealth Strategist, Head of Portfolio Advice & Investment Research, TD Wealth

The markets these days have got me thinking about Shakespeare, and in particular the feeling you get when you read the Bard's tragedies—you know, that sense of inevitable impending doom as you flip through the final pages, with the hairs rising on the back of your neck. Macbeth, if you can recall, is especially fatalistic. In the play's final act, King Macbeth is tormented and torn between the nature of life and death. As his enemies approach the castle walls, set to fulfill the dreaded prophecy that foretells his demise, Macbeth defiantly declares himself ready to have his life come to an end. ...

Eek. That is some morbid stuff—but if the rising dramatic tension feels in any way familiar, it's because the recent bout of volatility has brought out both the doomsayers and the dreamers. A month ago, on August 14, the Dow had a very bad day indeed, suffering its fourth worst daily decline in history (-3.05%). But the way the pundits jumped on it, you could have sworn it was 1987 with Black Monday around the corner. Then, one week later, the Fed steps in with some soothing words about "acting appropriately" and President Trump issues some conciliatory remarks about Chinese trade, and all of a sudden we're back with the bulls and running hard.

Neither reality, for the record, is an accurate portrayal of the current market environment. As of September 20, the S&P 500 is up a considerable 18% for the year, and equity valuations are by no means extravagant. At the same time, there are mounting concerns about the health of the global economy. Turning to our trusty Recessionary Indicators Scorecard (Figure 1), we can definitely see fewer "thumbs up" relative to April 2019. Chinks in the economic armour have started to appear, and that has provoked uncertainty and fear, as we can see from the increased market volatility running alongside the dramatically increased number of Google searches for the word "recession." (Figure 2)

Figure 2: VIX versus "recession" searches



Source: Bloomberg Finance L.P. as at August 6, 2019

Figure 1: Recessionary indicators dashboard

Start of Recession	Yield Curve	Inflation Trends	Labour Market	Credit Performance	ISM Manufacturing	Earnings Quality	Housing Market
Nov. 1973	👎	👎	👎	👎	👎	--	👎
Jan. 1980	👎	👎	👎	👎	👎	--	👎
July 1981	👎	👍	👍	👎	👎	--	👎
July 1990	👎	👎	👎	👎	👎	👎	👎
Mar.2001	👎	👎	👎	👎	👎	👎	👉
Dec. 2007	👎	👎	👉	👎	👎	👎	👎
Apr.2019	👉	👉	👍	👍	👍	👍	👍
Present	👎	👎	👍	👉	👎	👉	👉

👎 Recessionary 👍 Expansionary 👉 Neutral

Source: PAIR, as at August 15, 2019

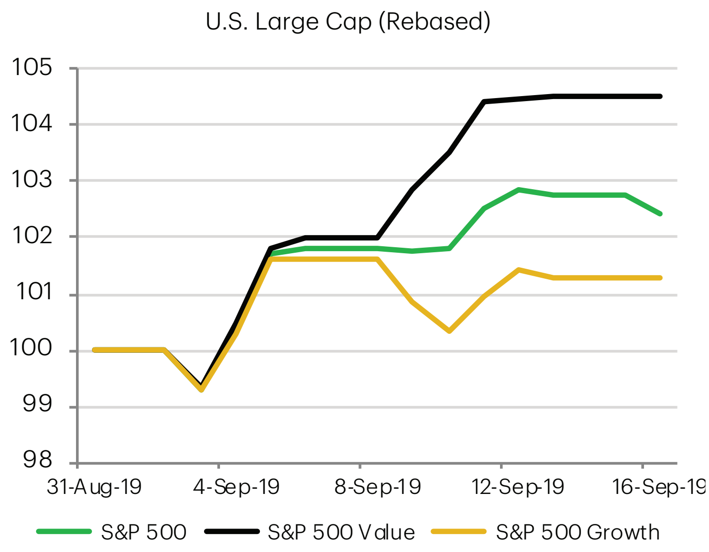
To be clear, we are not predicting an imminent recession. So far, the folks at TD Economics are telling us that a significant contraction in the United States is still a ways off. (More on that below from our Chief Economist, Beata Caranci.) What we are choosing to acknowledge, rather, is that we are now very likely in the late stages of a historic period of growth—at 122 months, the longest economic expansion in American history—as well as the late stages of an equity bull market. We are, so to speak, in the final act of this dramatic narrative, where tensions are brought to a boil and conflicts are resolved.

"All that lives must die," and that includes bull markets. So says the Bard. But that doesn't mean the play's over quite yet. As anyone who has had to sit through a high-school production of Macbeth will tell you, that final act can go on for a long time.

In many ways, the environment of today is reminiscent of the late 1990s.

In many ways, the environment of today is reminiscent of the late 1990s. Like today, growth (tech) and momentum stocks were all the rage. Then the curtain began to fall on them, while value and small-cap companies came to life. Figure 3 highlights how value companies have significantly outperformed growth companies since the end of August 2019, while tech darlings have retreated and energy companies have rebounded. In the first 20 days of September, the S&P/TSX Capped Energy Index jumped 14.2%.

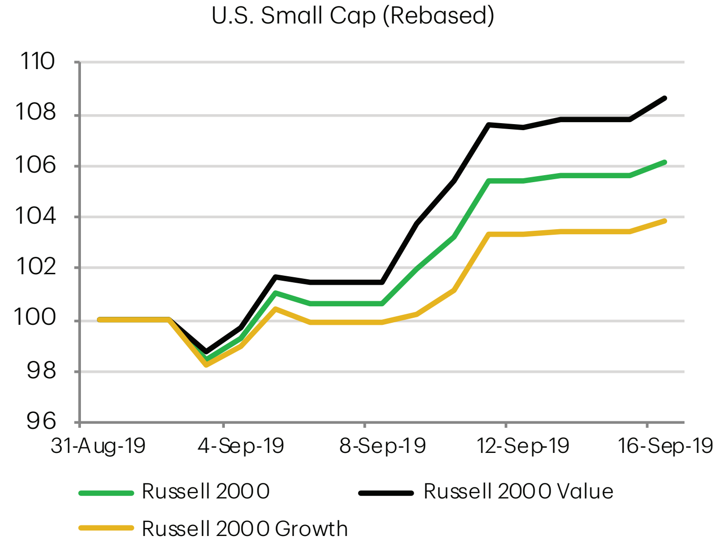
Figure 3: S&P 500 value vs. growth
Value outperformed since August 30, 2019.



Source: Bloomberg Finance L.P. as at September 16, 2019

We can see the same trend reversal in the small-cap market. Figure 4 highlights how small-cap value companies have outperformed small-cap growth companies during the same time period. It's still too early to tell if this late-stage behaviour will play out, but it does bear watching and calls for some portfolio adaptations.

Figure 4: Russell 2000 (small caps) value vs. growth
Small-cap value has outperformed



Source: Bloomberg Finance L.P. as at September 16, 2019

In hindsight, the real question may not be why the markets have been so turbulent lately, but rather, why it's taken so long. Equity markets have been climbing a "wall of worry" this year, with investors lifting share prices to record highs despite what would appear to be mostly bad news.

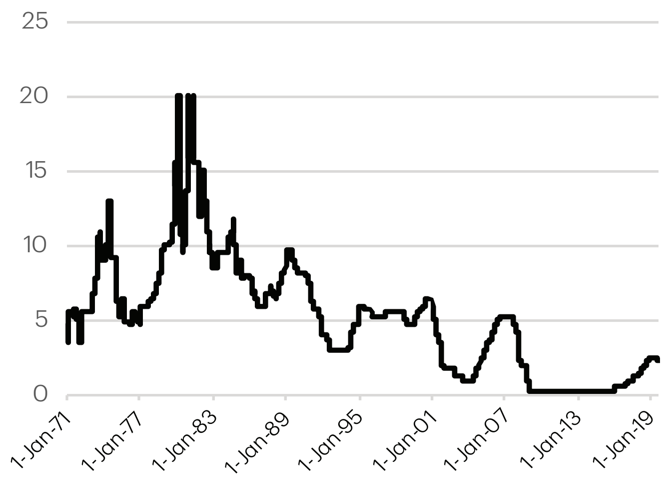
The real question may not be why the markets have been so turbulent lately, but rather, why it's taken so long.

We've seen the U.S. and China settle into an interminable trade war. We've seen a global economic slowdown begin to take hold. Weakened corporate earnings. Weakened manufacturing numbers. Low inflation, which has prompted central banks to cut rates further into emergency territory. The Fed started with a cut in late July, and the ECB followed up with its own rate cut earlier this month, along with a restart of quantitative easing. And let's not forget about that dreaded harbinger of recession, the yield curve inversion.

Heightened sensitivity around interest-rate movements is a product of the extraordinary period of monetary policy we're witnessing. Nobody has seen this kind of thing before. (See historical U.S. policy rate, Figure 5.) Hyper-stimulus has grossly distorted the market, turning common sense on its head. This is a world where bad economic news is cheered on by investors because it strengthens the argument for a rate cut, and vice versa.

In the weird world of today, recessionary indicators that may have seemed reliable—such as the inversion of two-year and 10-year Treasury yields—may not be quite as infallible,

Figure 5: U.S. Fed policy rate - 1971 to present



Source: Factset, as at September 16, 2019

so we have to be careful with behavioural biases that lead us to follow rules of thumb. After all, there's still much to like in the current market. Equities remain fairly valued, corporations are well capitalized, the consumer remains resilient, and central banks are willing to act and have become more accommodative. For bondholders, meanwhile, corporate credit spreads against commensurate Treasury durations have come down from late last year, and still have room to fall (Figure 6), which in turn should lead to price appreciation.

In the following pages of this month's Perspectives, you'll find two great articles that offer some insight into where we are and how we can prepare for the market cycle's eventual curtain close. In the first, Chief Economist Beata Caranci provides an update on the rapidly shifting economic landscape, with an eye to some of those recessionary indicators we're following. And in the second article, we discuss the impact of recent attacks on Saudi energy facilities.

In the current environment, it's important to remain focused on long-term goals and to maintain a process-driven, thoughtful decision-making approach. Here at TD Wealth, our investment philosophy is called Risk Priority Management. It has seven core principles, the first of which is to "adapt and look forward," and that's exactly what we intend to do. In recent months, we've made significant changes to our Risk Priority Portfolios that have boosted our allocation of underlying real assets, as a way of dampening volatility and hedging against correlated markets. We're going to be adapting as we move along here. □

Figure 6: U.S. investment-grade and high-yield spreads

Source: Factset, as of September 16, 2019

It was all yellow

Beata Caranci, SVP and Chief Economist, TD Economics

This title isn't a reference to Coldplay's hit song, but rather the observation that struck when we updated our U.S. Leading Economic Index. Six of our eight indicators flashed yellow. The last few months have brought a seismic shift in several areas:

1. **Our global economic outlook has been downgraded to 2.9%, marking the thinnest cushion in a decade to absorb political and economic shocks.**
2. **Small green shoots that materialized on global trade over the spring were stepped on during the summer. And, further trade escalation in August will not help matters.**
3. **Longer-term yields have shifted down in parallel with falling expectations for economic growth. This has reinforced yield-inversion dynamics in countries like the U.S. and Canada, while others have seen a large tranche of yields move into negative territory.**

Against this backdrop, it's not surprising that recession talk is top of mind among our clients. A deep dive shows that there is no evidence in the hard data that the U.S. is headed for a recession, but some warning flags indicate higher odds over the next 12-24 months.

Dynamics at Play

The incidence of "recession talk" shot up over the summer to higher levels than prior periods of market angst (i.e., stock market correction in December 2018 and the Chinese revaluation episode in 2015). A catalyst was the inversion of the U.S. yield curve.

Any recession probability model that contains the yield curve as an explanatory variable will show high odds of a recession, typically within the 50% to 60% range. Yield inversion is unquestionably a good signal of a recession. But, its record is not perfect, and these days the signal may be distorted by a host of other factors that depress yields, including unconventional central bank policies in other parts of the world and changes to banking regulations. In any event, models where the yield curve is the primary focus will always predict high odds once inversion occurs.

The more important piece of the puzzle comes into play when the focus of recession probability models is switched to economic indicators. Doing so causes recession odds to fall measurably, within the 20% to 30% range. What accounts for the difference? Timing.

The signal from yield curve inversion has a long lead time of 12 to 24 months, while those driven by economic indicators offer small windows of typically only a few months. Herein lies a key piece of information. All of our predictive models are telling us that a period of slower growth is on deck for 2020, particularly as the weight of tariff hikes come to fully bear on production and consumer costs. But, the signal has not yet arrived that negative financial market sentiment has bled through the economic data. Nothing is written in stone: a recession may be in our future, but that risk is not imminent.

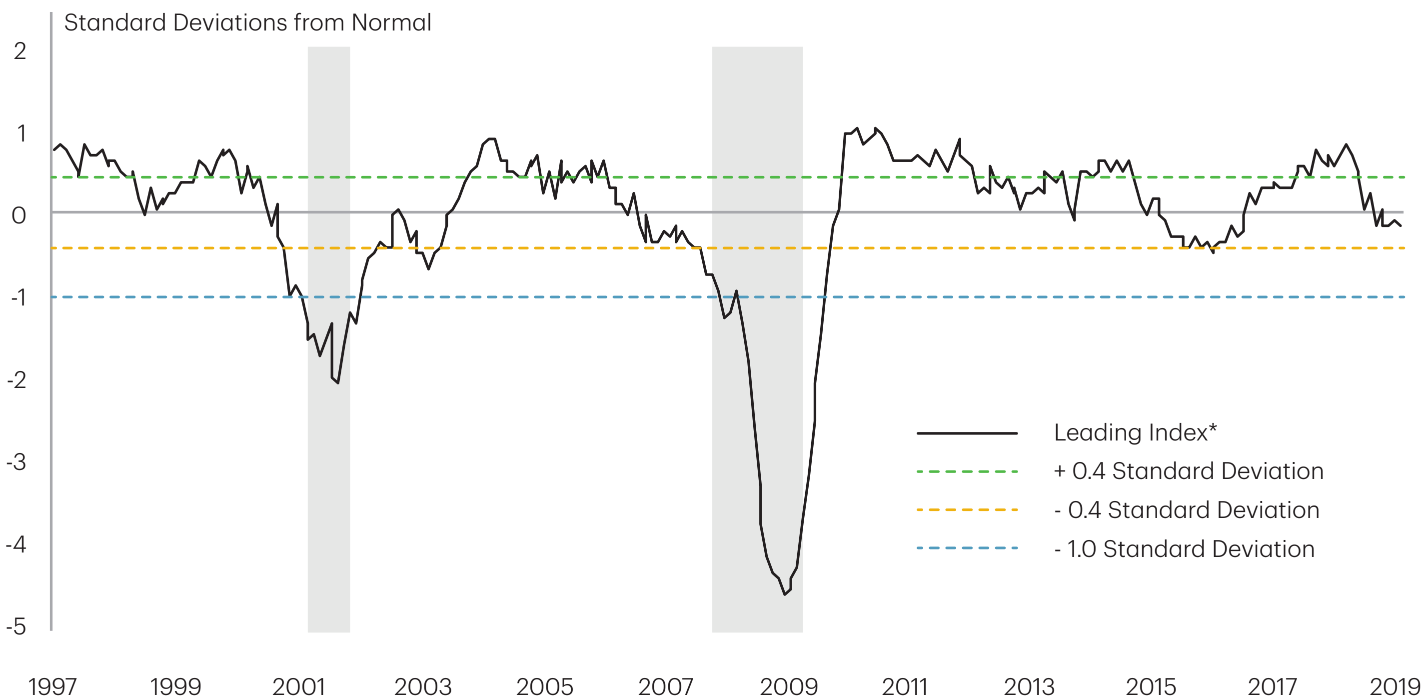
Within the economic data, our Leading Economic Index (Figure 7) shows six of eight indicators flashing a cautionary yellow. This is not a surprise for those indicators capturing business sentiment and output, which have been well telegraphed in the data for months. What caught our eye over the summer was the deceleration in hours worked. Is this a sign that businesses are responding to uncertainty by pursuing more cautionary hiring? Time will tell if the trend deepens. If so, it would be harder for the mighty U.S. consumer to stand strong, in the face of a compromised job market.

In fact, the timing of the trade escalation couldn't have been worse. We have been perpetual optimists that the U.S. consumer has strong underpinnings and present a key source of upside risk to our forecast. However, as the full force of the tariffs comes to bear on production and market sentiment, we will be more cautious on our U.S. outlook for 2020. And, the near-term data on consumer spending may not be the best guide for next year.

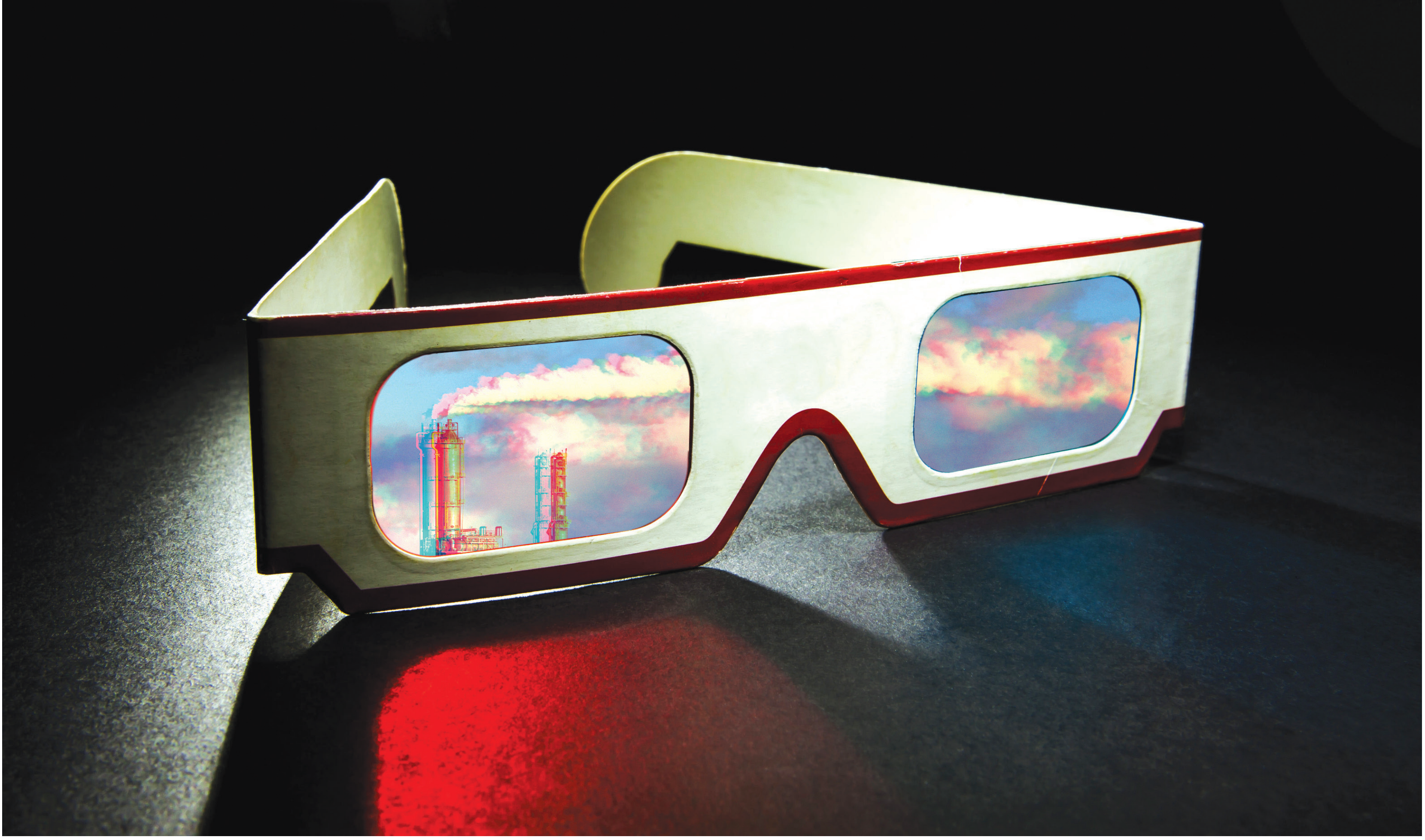
Consumers are likely to front-load purchases this fall to get ahead of tariff-related price hikes on some of their favourite items. This may leave our Leading Economic Index prone to a false signal, requiring more emphasis to be placed on what hours and job conditions are telling us. Don't forget, we have likely not seen the peak in trade tensions, as the U.S. administration will be releasing a ruling on whether European and Japanese auto imports should be subject to a higher tariff. Europe is a larger U.S. trading partner than China.

The economics community needs to be humble during this period of extreme political uncertainty. Economic models are not designed for political shocks, which create more complex outcomes that require significantly more forecast judgment. And, with the U.S. being the source of political uncertainty, it may result in stronger feedback loops between countries than predicted by pure model dynamics. In this context, it is completely reasonable for central banks to err on the side of caution on any evidence of fault lines forming in the economic data. □

Figure 7: TD Economics leading index indicator flashing yellow



* Index is comprised of eight leading economic indicators. Readings of 0 are consistent with historical average (1997-present) points in the business cycle. Readings of -0.4 are typically associated with a "warning" signal, whereas readings of -1.0 are consistent with a recessionary environment. Source: TD Economics, as of July 2019



Saudi attacks: Return of the geopolitical risk premium

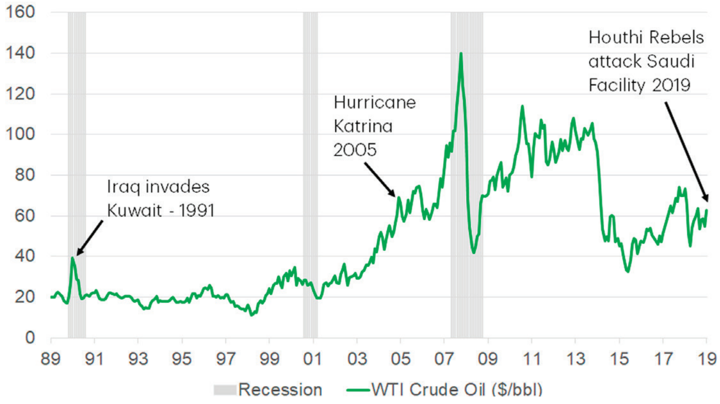
Portfolio Advice & Investment Research, TD Wealth

On the weekend of September 16, a series of drones attacked Saudi Arabia's oil infrastructure, including its largest oil processing facility in Abqaiq and the nearby Khurais oilfield. Aramco announced that it has suspended about 5.7 millions of barrels per day of production, which represents 5% to 6% of global oil supply. The oil processing complex in Abqaiq is Saudi Arabia's largest facility and processes more than half of all crude produced in the country. It is the world's largest petroleum processing facility, and its strategic importance cannot be understated.

This disruption to oil supply is one of the largest in history, surpassing the loss of Kuwaiti and Iraqi supply in August 1990. There were reports on Monday afternoon about a statement from Aramco that suggested a majority of Abqaiq output could be down for weeks. Other reports say it will take much longer, likely months, and still others speculate that it may come back online relatively quickly.

Beyond the immediate supply disruptions and the impact to oil prices, this event highlights the geopolitical risk to oil supplies. With the U.S. pointing the finger at Iran, tensions in the region seem to be escalating. The Saudi-led Yemen coalition said its preliminary investigation showed that Iranian weapons were used in the attack and were not launched from Yemen. This has increased the risk of a regional conflict. It also highlights the deterioration in regional security and will add to the risk premium in the price of crude. The broader implications of higher energy prices include a lift in inflation, which could influence the path of central banks and potential rate cuts.

Figure 8: Oil prices and recessions

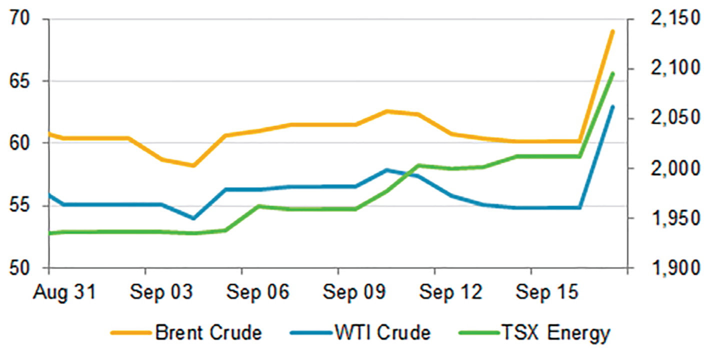


Source: FactSet, as at September 16, 2019

Equities

The implications of higher energy prices are relatively broad throughout equity markets. The immediate reaction of higher oil prices is a rally in the energy sector, and there was a significant rebound for many oil and gas companies on Monday, with some companies experiencing returns of 15% (i.e., ECA 19.2%, ERF 13.3%, HP 13.0%). If we look to historical "black swan" events for reference, equities tend to react significantly in the first two to three days of trading and then revert back to starting levels over the following week. During this initial reaction, the more levered energy companies will often outperform the sector, while conservative defensive energy companies stand to benefit longer term.

Figure 9: Crude oil vs. S&P/TSX Energy



Source: Bloomberg Finance L.P. as at September 16, 2019

Companies within the industrial sector are impacted by higher energy prices in a couple of different ways: on revenue as well as on the expense line. Fuel cost is a significant component of operating expenses for many industrial companies, particularly within the transportation industry, but are largely mitigated through fuel surcharges and passed on to end customers. The impact on rail companies is negligible, since they have fuel surcharges in place that adjust for moving fuel prices, albeit with a two-month lag. Higher oil prices in the current environment could be a net positive for rail companies as they can lead to a switch in business from trucking to rail (a much more fuel-efficient business relative to trucking) and potentially growth in the crude-by-rail business, which should more than offset any impact of higher fuel costs.

Materials is another sector that will be impacted by higher energy prices, as some segments experience higher operating costs due to higher fuel expenses, which can be a significant component of operating costs for mining companies. However, within the materials complex, gold companies may benefit. Bullion prices could rise given the potential increase in geopolitical tensions, as well as the possible lift to inflation expectations, both of which are supportive to the yellow metal over the medium term.

The initial implication for consumer goods companies is margin pressure with higher operating costs, as transportation and freight costs increase, pressuring the "cost of goods sold" line item. However, over time, as consumer companies are able to increase prices to offset the higher transportation costs, the net effect can become a positive factor through margin expansion. Consumer companies often increase prices to offset higher operating costs relatively quickly, but tend to be slow to reduce prices when operating costs decline. When the price of coffee beans increase, coffee chains are quick to increase the price for a cup of coffee. However, ask yourself when you last saw the price of a cup of coffee at your favourite caffeine supplier go down, despite the price of beans having recently declined to multi-year lows. Coffee beans are currently trading at close to decade lows, while the average price of a cup of coffee is as high as it has ever been. As such, the spike in energy prices could result in a lift to operating margins for consumer companies over time.

Global Markets

The surge in oil prices will likely have divergent impacts across countries depending on whether they are net importers or exporters, the size of their economies, and how reliant their industries are to crude oil. Importers such as Turkey, South Africa and India are a few emerging markets that come to mind. The magnitude of the impact will also depend on how long the supply disruption lasts. The spike in price could have an adverse impact on current accounts and weaken currencies, especially if the country already faces balance-of-payment and foreign-reserve pressures. These forces could drive inflation higher for some emerging markets. If the disruption is just a transient or isolated event and doesn't lead to major geopolitical crisis, then it is unlikely to put a dent on emerging-market economies. However, the timing of the oil disruption is concerning, since global markets are also facing trade wars and an economic slowdown. Major exporters, such as Canada and Norway as well as their currencies, will likely benefit from the disruption, although that's likely to be temporary given the breadth and depth of advanced economies.

Remain focused on long-term goals

It is important to remain focused on long-term goals and to maintain a process-driven, thoughtful decision-making approach, particularly in this environment. Here at TD Wealth, our investment philosophy is called Risk Priority Management and is well equipped to cope with the challenges of the current market, by employing asset-based and risk-factor-based diversification. □

“Be not afraid of greatness:
Some are born great,
Some achieve greatness,
And some have greatness
thrust upon ’em.”

– William Shakespeare, *Twelfth Night*

Market performance

		(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)
Canadian Indices ($CA) Return	Index	1 Month	3 Months	YTD	1 Yr	3 Yrs	5 Yrs	Since 1/1/2012	10 Yrs	20 Yrs
S&P/TSX Composite (TR)	57,632	0.43	3.32	17.13	4.35	7.20	4.10	7.41	7.33	7.03
S&P/TSX Composite (PR)	16,442	0.22	2.52	14.80	1.10	4.05	1.02	4.24	4.23	4.38
S&P/TSX 60 (TR)	2,790	0.49	2.96	16.73	5.12	8.16	4.97	8.13	7.30	7.13
S&P/TSX SmallCap (TR)	950	-1.48	6.01	12.18	-5.24	0.10	-1.27	1.99	5.08	-
U.S. Indices ($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)	5,898	-1.58	6.87	18.34	2.92	12.70	10.11	14.00	13.45	6.09
S&P 500 (PR)	2,926	-1.81	6.34	16.74	0.86	10.47	7.87	11.64	11.11	4.06
Dow Jones Industrial (PR)	26,403	-1.72	6.40	13.19	1.69	12.79	9.08	10.57	10.77	4.56
NASDAQ Composite (PR)	7,963	-2.60	6.84	20.01	-1.81	15.17	11.70	15.68	14.76	5.48
Russell 2000 (TR)	7,519	-4.94	2.37	11.85	-12.89	7.89	6.41	11.10	11.59	7.88
U.S. Indices ($CA) Return	Index	1 Month	3 Months	YTD	1 Yr	3 Yrs	5 Yrs	Since 1/1/2012	10 Yrs	20 Yrs
S&P 500 (TR)	7,841	-0.49	5.03	15.32	4.81	13.19	14.66	18.06	15.65	5.46
S&P 500 (PR)	3,891	-0.71	4.51	13.76	2.71	10.94	12.33	15.61	13.27	3.45
Dow Jones Industrial (PR)	35,101	-0.62	4.58	10.30	3.55	13.28	13.59	14.50	12.92	3.94
NASDAQ Composite (PR)	10,586	-1.51	5.01	16.94	-0.01	15.66	16.31	19.80	16.99	4.86
Russell 2000 (TR)	9,996	-3.88	0.61	8.99	-11.29	8.35	10.80	15.05	13.76	7.25
MSCI Indices ($US) Total Return	Index	1 Month	3 Months	YTD	1 Yr	3 Yrs	5 Yrs	Since 1/1/2012	10 Yrs	20 Yrs
World	8,987	-2.00	5.05	15.63	0.84	10.24	6.75	10.86	9.81	5.26
EAFE (Europe, Australasia, Far East)	7,763	-2.58	1.93	10.14	-2.75	6.44	2.38	7.02	5.49	4.08
EM (Emerging Markets)	2,253	-4.85	0.02	4.21	-3.99	6.15	0.75	3.84	4.43	7.36
MSCI Indices ($CA) Total Return	Index	1 Month	3 Months	YTD	1 Yr	3 Yrs	5 Yrs	Since 1/1/2012	10 Yrs	20 Yrs
World	11,947	-0.90	3.25	12.68	2.69	10.72	11.16	14.81	11.95	4.64
EAFE (Europe, Australasia, Far East)	10,320	-1.49	0.19	7.33	-0.97	6.90	6.61	10.83	7.54	3.46
EM (Emerging Markets)	2,996	-3.78	-1.70	1.55	-2.23	6.61	4.92	7.54	6.46	6.72
Currency	Level	1 Month	3 Months	YTD	1 Yr	3 Yrs	5 Yrs	Since 1/1/2012	10 Yrs	20 Yrs
Canadian Dollar ($US/$CA)	75.22	-1.10	1.74	2.62	-1.80	-0.43	-3.97	-	-1.91	0.59
Regional Indices (Native Currency) Price Return	Index	1 Month	3 Months	YTD	1 Yr	3 Yrs	5 Yrs	Since 1/1/2012	10 Yrs	20 Yrs
London FTSE 100 (UK)	7,207	-5.00	0.63	7.12	-3.03	2.05	1.11	4.73	3.91	0.01
Hang Seng (Hong Kong)	25,725	-7.39	-4.37	-0.47	-7.76	3.84	0.78	8.06	2.69	3.28
Nikkei 225 (Japan)	20,704	-3.80	0.50	3.45	-9.45	7.03	6.06	18.17	7.03	0.86
Benchmark Bond Yields		3 Month		5 Yr		10 Yr		30 Yr		
Government of Canada Yields		1.62		1.16		1.14		1.41		
U.S. Treasury Yields		1.95		1.35		1.49		1.99		
Canadian Bond Indices ($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		1,143	1.88	2.98	8.70	9.55	9.39	3.95	3.73	4.56
FTSE TMX Canadian Short Term Bond Index (1-5 Yrs)		734	0.66	0.80	3.34	4.54	5.14	1.96	2.05	2.48
FTSE TMX Canadian Mid Term Bond Index (5-10 Yrs)		1,233	1.88	2.55	8.05	16.86	8.12	3.85	3.93	4.93
FTSE TMX Long Term Bond Index (10+ Yrs)		1,989	3.41	6.07	16.40	16.14	15.70	6.64	5.80	7.47

Sources: TD Securities Inc., Bloomberg Finance L.P. TR: total return, PR: price return, as of August 30, 2019.

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