TD Wealth

A Point of View

Quarterly Commentary Q2 2019

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Chris Susel, CIM®, FCSI®, CIWM, TEP
Vice President, Portfolio Manager & Investment Advisor T: 416 308 8445
chris.susel@td.com

Mike Bowcott, CIM®, FCSI®
Vice President, Portfolio Manager & Investment Advisor T: 416 308 8461
mike.bowcott@td.com

Michael Garside
Client Service Associate
T: 416 308 8473
michael.garside@td.com

John Sharp
Client Service Associate
T: 416 307 9149
john.sharp@td.com

Juan Barahona
Client Service Associate
T: 416 308 8460
juan.barahona@td.com

Maple Ridge Advisory Group
TD Wealth Private Investment Advice
79 Wellington Street West, 10th Floor
Toronto, Ontario M5K 1A1
T: 1 866 220 0208
F: 416 308 1971

Welcome to Maple Ridge Advisory Group

We are excited to launch Maple Ridge Advisory Group as part of TD Wealth Private Investment Advice. Our focus is on providing wealth advice utilizing the full resources of TD Bank Group, to gain a deeper understanding of our client's values, goals and objectives and to help deliver solutions, ongoing advice and service knowing that you and those you care about are in good hands and well advised.

From left to right - John Sharp, Juan Barahona, Michael Bowcott, Chris Susel and Michael Garside
(*Maple Ridge Advisory Group is a part of TD Wealth Private Investment Advice, a division of TD Waterhouse Canada Inc. which is a subsidiary of The Toronto-Dominion Bank.*)

Caught between a Rock and a Hard Place

It has been over 10 years since global Central Banks, led by the U.S. Federal Reserve (the Fed), embarked on what we would describe as an extraordinary Central Bank monetary policy experiment which resulted in a historical low in interest rates in North America and negative interest rates in Japan and Europe, which still prevail today. No one could have predicted the length or extent to which Governments and their respective Central Banks would go with their quantitative easing, but it is becoming increasingly apparent that they have painted themselves into a corner and are **now caught between a rock and a hard place.**

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The suppression of interest rates began in March 2009 and its effects were far reaching as it boosted asset prices, thereby triggering the intended wealth effect. Consumers were able to refinance debts and borrow at historically low interest rates to finance consumption and purchase real estate. Asset prices recovered sharply, propelled higher by a dramatic increase in corporate share buybacks, which had the dual effect of reducing shares outstanding and boosting earnings and dividends which created a positive feedback loop for yield challenged investors. The Fed began to raise interest rates in December 2015 and with reasonably strong economic growth, investors adjusted to the Fed's change of policy. Their confidence was bolstered in early 2017 when newly elected President Donald Trump, who campaigned on corporate and personal tax cuts, was able to get them passed by Congress, providing yet another boost to earnings growth on a per share basis.

With equity markets up sharply in early 2018, Fed Chair Jerome Powell confidently stated in October 2018 that the Fed would continue to raise interest rates even though there were clear signs that the global economy was slowing. The Feds interest rate increases were impacting global growth, destabilizing emerging markets and affecting capital flows in favour of U.S. assets, thus boosting the U.S. dollar. With the tax cut stimulus wearing off, President Trump turned his attention to trade, slapping tariffs on America's key trading partners and threatening to do more. Fearing the Feds policy stance and an escalating trade war, equity markets, as measured by the S&P500 index, dropped 20% from their October 2018 peak into year-end.

After repeatedly questioning the Fed's normalization policy and fearing that the Fed's policy would trigger a recession, President Trump made it known that he was looking to replace his appointed Fed Chair Jerome Powell. The stock slide ended abruptly in late December when the Fed Chair declared that quantitative tightening (rising interest rates) was on hold. Equity markets rallied sharply off the December lows, stumbling briefly in May because of increasing trade tensions and word that the department of justice and federal trade commission were opening anti-trust investigations into index heavy-weights Facebook, Google and Amazon. The drop-in equity prices in May was halted when word leaked out that President Trump was once again considering ways to replace or demote his recently appointed Fed Chair. This was then followed up by timely comments from a few Fed governors who had suggested the Fed would be considering lower interest rates to sustain the economic expansion if the economy were to weaken.

There is an old saying when it comes to the markets, "don't fight the Fed", which means, based on historical averages, investors can do well to invest in a way that aligns with current monetary policies of the Federal Reserve Board, rather than against them. President Trump seems to have taken this literally but the Feds sudden change in policy has some questioning the Fed's independence. We think it may be more to do with the European Central Bank (ECB).

Just prior to the Fed's statement, ECB President Draghi hinted at interest rate cuts and another round of quantitative easing in light of the fact that the ECB's negative interest rate policy had already proven to be ineffective. The thought of a lender paying a borrower for the privilege of extending a loan is simply preposterous. The reality is that negative interest rates can create fear and a stronger inclination to save and invest rather than consume as the ECB had hoped. There is little doubt that America was a major beneficiary of the ECB's misguided policies which continue to mobilize capital flows in favour of U.S. dollar investments, bonds and equities. The ECB's negative interest rate policy is indirectly financing capital flows out of Europe to the U.S. where investors can earn a risk free 2% interest rate on U.S. Treasuries (unhedged) versus a negative .37% rate in German Bonds, and that is on top of the resulting FX gains due to the appreciating U.S. dollar. Is it any wonder why European corporations are borrowing in Euro's to finance U.S. investments including U.S. acquisitions? The ECB is leaning towards doubling down on a policy which exposes their inability to exit from a policy that cannot possibly be maintained without consequences. The resulting strength of the U.S. dollar has drawn the ire of U.S. President Trump who continues to champion his version of fair-trade policies which can be easily derailed by a strong dollar which he attributes to foreign government currency manipulation. As the international reserve currency, the U.S. has had a distinct advantage but with that comes an obligation to supply dollars to the world to facilitate trade. The Fed's policies have confounded President Trump who openly challenges his Fed chair threatening to replace him. We should not have been surprised by Fed Chair Jerome Powell's recent comment, "*Do not assume the U.S. Dollar status as a reserve currency is permanent."* This is the first time we can recall a Fed Chair questioning the status of the U.S. dollar as a reserve currency.

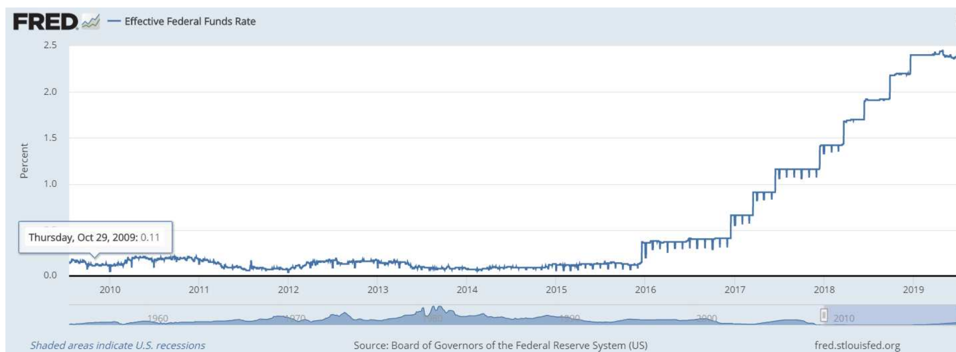
The Central Banks ability to exit gracefully from quantitative easing has proven to be elusive. They have essentially admitted it and it reinforces our view that they will have no choice but to attempt to maintain lower interest rates for longer even if it means accepting higher levels of inflation and asset prices. This reality will have profound implications for consumers and investors. The Central Banks have painted themselves into a corner or as they say, they are "**caught between a rock and a hard place".**

A Crypto Currency

Given the plight of Central Banks, we should not be surprised by Facebook's white paper discussing the launch of a new digital currency in 2020 called the Libra. Facebook proposed to back the new virtual currency with yet to be determined short-term government debt obligations and fiat currencies of various countries. In this regard, it is distinctly different from Bitcoin, as it does not seek to replace fiat currency as much as it does to reduce the costs of transacting globally, including sending and receiving money electronically. Facebook is creating a digital wallet called the Calibra as well as a new subsidiary called the Libra association made up of for-profit companies (PayPal, Facebook/Calibra, Uber, Visa, MasterCard, Vodafone, and various venture-capital powerhouses) that will oversee and confirm transactions and stand to profit from interest earned on deposits and transaction fees, which will presumably be lower than existing options. Given that Facebook has over 2 billion active users, the ability to gain momentum quickly is a distinct advantage and it will no doubt become a significant disruptive innovation that will have profound implications for the financial services sector and global Central Banks. If we are correct in our assessment that global Central Banks are backed into a corner, we should not be surprised by the almost US$200 rally in Gold or the increased purchases of Gold by Central Banks over the past year, the most since the early 1970's. **We should also be mindful of the implications for investors, as monetary policies now play a significant role in financial cycles and that Central Bank reactions or inactions influence those cycles, not the least of which is influencing short-term sentiment and risk-taking.**

Markets

Equity markets rallied sharply during the first half of 2019, stumbling only briefly in May but gaining momentum in June once the Fed hinted at the possibility of rate cuts later this year. Canadian equity markets were range-bound through Q2/19, trading within five percentage points, as the S&P/TSX Composite Index rose 2.58%. U.S. equity markets seesawed in Q2/19, falling sharply on trade pessimism in May, and then rebounding in June on dovish comments by the Fed. The S&P 500 Index rose 4.30%, the NASDAQ rose 3.87% and the Dow was up 3.21%.
Fixed income markets are pricing in a 100-basis point drop in the Fed funds rate from 2.25% to 1.25%. Given that markets are now driven by short-term sentiment and are increasingly sensitive to monetary policy, the risk to investors is the Fed not cutting interest rates enough or at all.



Portfolios

Our discretionary portfolios were active during the quarter. In the Canadian Growth Portfolio, we sold Inter Pipeline, Northland Power, First Service and Canfor and added, Suncor, Trans Alta Renewables, Manulife and Cogeco. In the U.S. Growth portfolio, we sold Walgreens, Accenture, NetApp and Emerson, adding Cisco Systems, Pepsi, Microsoft and Grainger WW.

Conclusion

Though the Fed believes that the economy is poised to continue expanding at a moderate rate, it has also acknowledged the increasing risks to sustaining growth, with trade and global economic uncertainties being of particular concern. We believe the Fed will cut rates and they may do so sooner rather than later, but if they delay, we should expect equity

markets to react negatively. Lower interest rates in combination with fiscal stimulus in advance of the 2020 U.S. Presidential election could prove to be a significant catalyst for higher equity prices.
Most levels of government continue to live beyond their means and if Central Banks remain accommodative and supportive of debt growth, they will continue to do so. It is becoming increasingly clear that they have little desire, or more to the point, ability to pay back the debts without resorting to fiscal restraint or raising taxes, which is problematic for any politician seeking re-election. The next way to deal with unpayable debt is to inflate it away, but that has proven to be elusive and it will likely require new extraordinary measures which have yet to be conceived. It is our belief that if Central Banks are to be successful in creating inflation above their 2% target, it will require coordinated global Central Bank intervention on a scale and size that dwarfs what has already occurred over the past decade.

In the meantime, we believe that the adage, "don't fight the Fed" is still very much a reality when it comes to investor psychology. As the Central Banks continue to fight the forces of disinflation with little success, we sense that we are in the early stages of a monetary reset in which governments and Central Banks are forced to introduce new extraordinary measures, the most often cited being modern monetary theory (MMT) in which Central Banks are called upon to finance government spending. We sense we are on the verge of a new investment paradigm in which investors should redefine the risk/reward dynamic of various asset classes based on the actions of Central Banks.

Contact us today

Chris Susel, CIM®, FCSI®, CIWM, TEP
Vice President, Portfolio Manager & Investment Advisor
T : 416 308 8445
chris.susel@td.com

Mike Bowcott, CIM®, FCSI®
Vice President, Portfolio Manager & Investment Advisor
T: 416 308 8461
mike.bowcott@td.com

Michael Garside

Client Service Associate
T: 416 308 8473
michael.garside@td.com

John Sharp
Client Service Associate
T: 416 307 9149
john.sharp@td.com

Juan Barahona
Client Service Associate
T: 416 308 8460
juan.barahona@td.com

Maple Ridge Advisory Group
TD Wealth Private Investment Advice
79 Wellington Street W, 10th Floor
Toronto, Ontario M5K 1A1
T: 1 866 220 0208 F: 416 308 1971
www.mramg.ca

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