TD Wealth

Follow the Money

Quarterly Commentary Q3 2017

In this issue

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Follow the money was the catchphrase from the Watergate film "All the President's Men." It is even more pertinent today as we try to assess the short and long-term implications of the massive amounts of liquidity global Central Banks have injected into financial markets. Their collective balance sheets have expanded almost US$15 trillion since the global financial crisis, which is an extraordinary amount of money. The Central Banks have purchased government and corporate debt including troubled bank debt and in doing so, they have purposely encouraged extreme levels of complacency that not even the threat of nuclear war can undo. Financial market participants have placed a disproportionate amount of faith in Central Banks to the point where they have come to accept the absurdity of negative interest rates, or more to the point, being paid to borrow money. But it doesn't stop there. The Bank of Japan (BOJ) and Swiss National Bank (SNB) have created money out of thin air to purchase equities. In the case of the SNB, they now own over US$84 billion in securities in the index heavy weights such as Apple, Google, Amazon, Facebook and Exxon Mobile to name a few. Not to be out done by the SNB, the BOJ has been propping up the Japanese stock market by creating money to buy index funds and it is now one of the largest shareholders in nearly 25% of Japan's listed companies. Is it any wonder the indexes continue to advance steadily and the Nikkei index has broken out of a 25-year trading range but still well below its all-time high back in 1989?

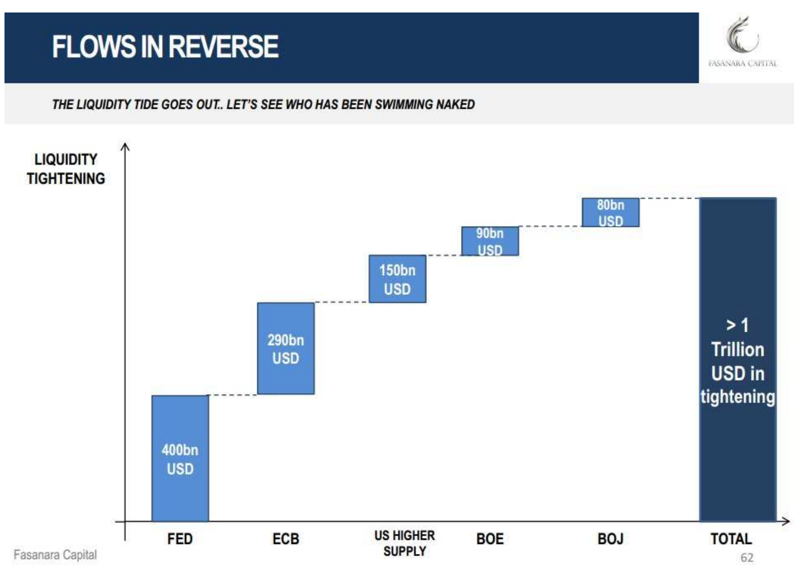
Nikkei Index

Macro Trends – September 30, 2017

Investor's confidence in Central Banks has them believing that not only can the Central Banks exit from their experimental monetary policy, they are also prepared to reverse course quickly should the economy, or more to the point, equity markets falter. We will soon find out if this confidence is misplaced as the U.S. Federal Reserve (Fed) is in the beginning stages of attempting to shrink its balance sheet which has increased five-fold since the global financial crisis of 2008/09. The Fed will attempt to "unwind" its massive US$4.5 trillion balance sheet with minimal market disruption and without triggering a recession brought on by higher interest rates. We liken it to performing a blindfolded high-wire act at a thousand feet without any practice or experience to guide them. We certainly understand the Fed's desire to normalize interest rates but given the extent to which they have distorted and suppressed them, Fed controlled normalization will be challenging, particularly if inflation reasserts itself or if the Trump administration complicates matters. With unemployment at 4.2%, increasing wage pressures and rising household incomes, the potential for a spike in inflation is possible if the President succeeds in getting his across the board tax cuts approved. Other than asset price inflation, the consumer price index and the Fed's preferred measure of inflation, the personal consumption expenditure (PCE) index has been kept in check for now by the disinflationary forces and excessive debt levels. We have always struggled with the notion that Central Banks would be able to solve a global debt crisis by encouraging the accumulation of debt. The Trump administration is only going to complicate matters by pressing forward with large tax cuts and its plans to cut the trade deficit. To prevent the U.S. fiscal deficit from soaring and to reduce the trade deficit, the President will require lower interest rates. The President's policies are simply incompatible with the laws of economics. As the international reserve currency, the U.S. has been obligated to supply dollars to the world and they have done that by running large trade deficits and those surplus dollars sent abroad are for the most part recycled back into U.S. Treasuries. Now that the U.S. is becoming more self-reliant on oil, the supply of dollars is declining and if the Trump administration is successful in renegotiating trade deals, the supply of dollars will decrease further. The Trump agenda is incompatible with the U.S. dollars ability to be the international reserve currency and we may be seeing the early stages of a U.S. dollar crisis as countries move to de-emphasize it for trade purposes. If foreign investors reduce their purchases, who will be called upon to finance the U.S. debt and deficits?

Flow of Funds

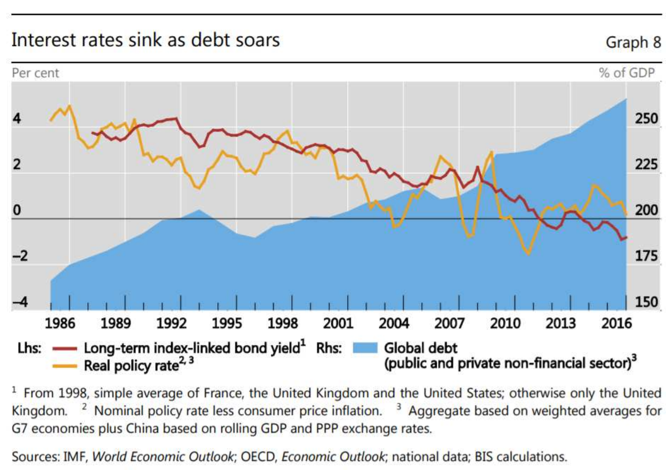
Since the global financial crisis (GFC) of 2008/09, global debt has increased by US$57 trillion to over US$217 trillion of which almost $US10 trillion of that debt is at negative interest rates in Europe and Japan.[1] With the exception of the U.S. Federal Reserve (Fed), global Central Banks have continued to expand their balance sheets at the rate of almost US$300 billion per month. But that may be coming to an end assuming the Fed and its counterpart Central Banks follow through on expectations to withdraw almost US$1 trillion of liquidity in 2018. Rather than debate the sustainability, sensibility or absurdity of what global Central Banks have done, we have chosen to just **"follow the money"** flows and try to determine the risks and opportunities for investors.



Fasanara Capital – September 30 2017

[1] Financial Post June 28 2017

The Fed has begun the process of reducing its balance sheet in measured steps, starting with a modest US$10 billion per month, increasing slowly over time.[2] At this initial pace, it will take almost 30 years to reduce its balance sheet back to pre GFC levels of US$800 billion. Although we continue to have our doubts as to the Fed's ability to unwind its massive balance sheet, all that matters for now is that markets believe it is possible. This is a far cry from the 2013 "taper tantrum" when just talking about raising rates sent equity markets reeling. The Fed was forced to delay its rate increases until Dec 2015, and not surprisingly, global equity markets fell 8-12% over the next six weeks, bottoming in late January 2016 after several Fed governors eased concerns with dovish talk. The Fed's policy change led to a sharp rally in the U.S. dollar from mid-2014 into January 2017 and this led to calls from both the International monetary fund (IMF) and Bank of International Settlements (BIS) for the Fed to delay normalization as the dollar rally threatened to destabilize global markets. The appreciating dollar had taken a toll on commodity prices, particularly oil, and it was placing great strain on an already over-indebted global economy that leveraged up on relatively inexpensive $US dollar denominated debt. At that point, we should have realized that the Fed had become the Central Bank to the world. Interestingly, the Bank of International Settlements chief economist Claudio Borio recently stated "***the world has become so used to cheap credit that higher interest rates could derail the global economic recovery"***[3] a stark warning from the banker of Central Banks. In another report, Borio suggested that Central Banks might have to consider adjusting monetary policy by "***putting less weight on inflation and more weight on the longer-term real effects of monetary policy through its impact on financial stability."***[4] We are surprised this did not send global bond markets into a tailspin. We can assume bond markets do not believe inflation is sustainable in an over-leveraged economy burdened by excessive debt but we must be aware of the increasing potential for exogenous shocks such as **an inflationary spike that would not sit well with bond markets, particularly European bond markets where negative interest rates and inflation would be a toxic combination**. Higher interest rates would crush over-leveraged consumers, not to mention the impact it would have on Gov't deficits. In the case of the U.S. Gov't, a one percent increase in interest rates on their US$20 trillion debt equates to an additional US$200 billion a year in interest costs. If the Trump administration can get its tax cuts approved and can shrink the U.S. trade deficit at the same time, the recycling of U.S. dollars from abroad back into Treasuries will also decline, increasing the odds of an expanding U.S. fiscal deficit at a time when the Fed is supposedly no longer a buyer, at least for now anyway.



[2] Washington Post – Sept 20, 2017

[3] *Financial Times , Sept 17, 2017*

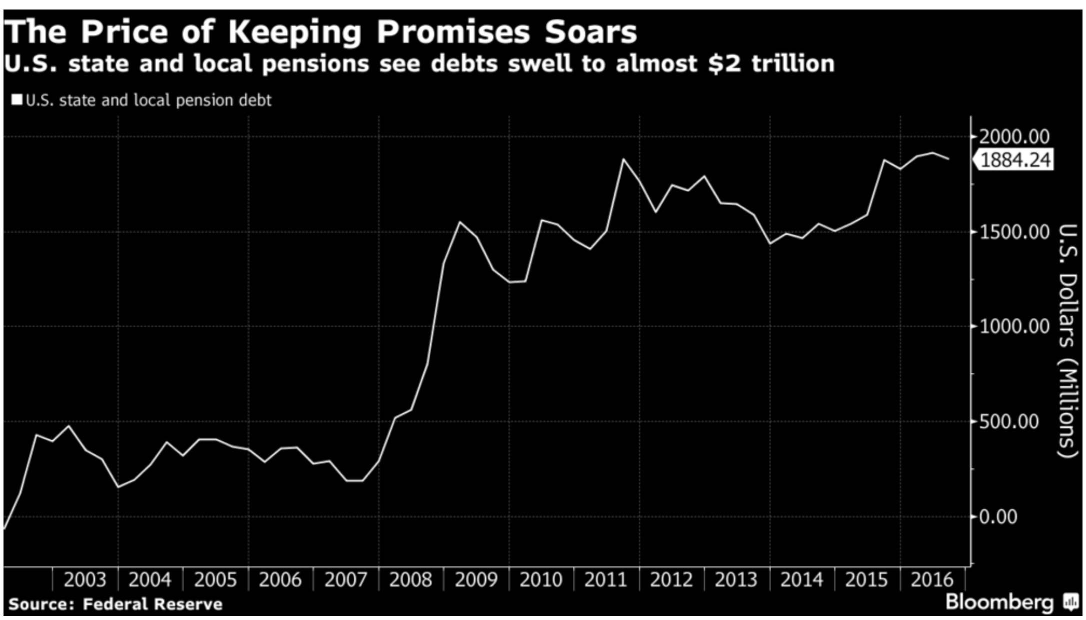
[4] *Borio Quotes – Through the looking Glass* - 22 September 2017

Retirement

The retirement landscape in North America has also been impacted by the prolonged suppression of interest rates and even more so in Europe and Japan, where interest rates are negative. The psychological impact on savers, retirees and pensioners who are also consumers is devastating as they face the prospects of having to save two to three times as much money to be able to afford a comfortable retirement. Negative interest rates in Europe and Japan are contributing to the disinflationary environment where the need to save outweighs the desire to consume all but the essentials. For baby boomers and retirees, the search for yield has become a search for returns which in most cases means taking on greater risks at a time when they should be doing just the opposite, or so we were once led to believe.

A growing number of pension funds face a similar reality as the forecasted actuarial returns of 7-8% are just not available in a 1-3% interest rate world. Over the past decade, pension funds have countered by reducing exposure to fixed income in favour of equities or alternative investments but even that has resulted in significant funding deficits that can only be addressed by increasing contributions or reducing payouts. A growing number of states and cities across the U.S. are facing acute funding crises that will require either increasing taxes substantially to fund contributions, cutting core services or reducing pensions and benefits for current and future retirees. Some states have attempted to address the funding shortfalls, but given that it is obviously a career limiting move for most politicians, many states and municipalities have continued to maintain the status quo while politicians pretend their plans are solvent and public employees and retirees are none the wiser.

According to Bloomberg, it is estimated that overall unfunded pension obligations have risen from $292 billion to $1.9 trillion since the start of the GFC when the Fed began its interest rate suppressing quantitative easing (QE). The Fed's prolonged use of interest rate suppression has become problematic and the evolving pension crisis will eventually have to be addressed as a growing number of baby boomers are retiring each day and those with government pensions expect to get what was promised.



Bloomberg, Sept 10, 2017

Normalization

We have argued for some time now that the Fed’s ability to normalize interest rates would be problematic given the distortions and misallocations of capital its policies have fostered. Higher interest rates in combination with higher debt levels risk sending the economy into recession. The Trump administration's plan to cut taxes will only complicate matters if it results in higher debt, deficits or an inflationary spike that causes the Fed to over-react. We see no easy way out for the Fed and we suspect they will eventually come to the same conclusion and will be forced to reverse course or expand their toolbox should the economy or financial markets stumble.

Markets

The Canadian equity market was stronger in Q3/17 as the S&P/TSX Composite Index (S&P/TSX) returned 3.68%. Seven out of the eleven sectors posted a positive return. The Energy, Materials and Financials sectors, which are the largest sectors in the index, have rebounded after a slow start in the first half of the year. U.S. equities delivered a positive return during the quarter. The S&P 500 Index gained 4.48% Q/Q, the Dow Jones Industrial Average Index rose 5.58% Q/Q and the NASDAQ Composite Index returned 6.06% Q/Q. In Canadian dollars, The S&P 500 Index gained .40% Q/Q, the Dow Jones Industrial Average Index rose 1.46% Q/Q and the NASDAQ Composite Index returned 1.92% Q/Q.[5]

Conclusion

With interest rates at historical lows and negative interest rates in Europe and Japan, the challenge facing Central Banks is to reduce stimulus without unsettling the bond markets and endangering growth. We are seeing signs of a possible short-lived inflationary shock in the U.S. and Europe which might alarm bond markets that continue to believe the over-leveraged global economy has a disinflationary bias. This could be problematic if it causes the Central Banks to over react and markets believe it is driven by sustainable growth. We could see an increase in fund flows out of bonds and into real assets including equities accelerate.

We will focus on the foreign exchange markets and in particular, the direction of the U.S. dollar. Although many are calling for the dollars demise, we believe there are dynamics in place that could send the dollar higher leading to a dollar crisis. That could come in the form of exogenous shocks emanating out of Europe, rising geopolitical tensions in North Korea that lead to a flight to safety (risk-off) or it could simply be international capital flows seeking higher relative returns. The Fed's normalization of interest rates could increase global capital flows out of Europe and emerging markets and that likely would send the dollar higher. The Chinese and the Russians are moving quickly to reduce their reliance on the U.S. dollar for trade as evidenced by their move to price oil in domestic currencies. What has not been addressed is what the oil exporters will do with those currencies. China and Russia do not have deep liquid bond markets to reinvest the excess funds. The Chinese have proposed a convertibility feature into Gold, but it remains to be seen if it will appeal to oil exporters who have used the U.S. bond markets to invest their petrodollars.

For the time being, the U.S. dollar and the bond market are seen as the safety net for international capital and as long as the markets believe the Fed is in control, the orderly unwinding of its balance sheet will continue as the economy returns to stable growth. The equity markets, led by the Dow Jones Industrial Average, continue to move higher, propelled by money flows out of low yielding bonds and into index funds (equities) with little regard for elevated valuation metrics. The Trump administration's tax cut proposal has played a significant role in the equity market advance and if investors are to remain fully invested in equities, they must be convinced the tax cuts will materialize and that Central Banks are prepared to do whatever it takes to promote stability, which as we have seen in the case of the BOJ and SNB, has evolved into creating money out of thin air to buy equities. If they miscalculate and lose control of the bond markets, we should expect a significant increase in volatility, which is a polite way of saying correction. For now, our advice is to **"Follow the money."**

[5] TD Waterhouse Sept 30, 2017

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