TD Wealth

Clash of the Titans

Quarterly Commentary Q1 2017

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Will the prospect of sustainable inflation in a highly leveraged global economy threaten to expose the shortcomings of Central Bank experimental monetary policies? Should inflationary pressures prove to be more than transitory, the U.S. Federal Reserve (Fed) tightening bias will place it on a collision course with the newly elected Presidents economic agenda. At some point the President will realize higher interest rates will run the risk of derailing his aggressive pro-growth economic agenda centered on lower taxes, less regulation and fiscal stimulus. Investors have concluded the President will be successful implementing all of his proposals without giving due consideration to the possibility that Congress will delay or not approve the President's agenda. The continued strength in the U.S dollar and the Fed's tightening stance will also have to be resolved, as it may neutralize the Presidents fiscal measures. That being said, we would not underestimate the President's ability to get his way with Congress or the Fed, however, the President will soon face a more formidable foe when the laws of economics come back into focus.

Central Bank monetary policies have played a key role in masking over the growing fiscal and structural imbalances of spendthrift Governments. The Fed has certainly played a leading role and the imbalances created, particularly in regards to the U.S. dollar is no exception. Candidate Trump's condemnation of the Fed for its easy money policies and resulting bubbles in the equity markets will be front and centre should the Fed continue to normalize interest rates in response to near full employment conditions and rising inflationary pressures. We are prepared for a showdown as we suspect President Trump and the Fed will soon pivot. Fasten your seatbelts!

Inflation

There are two measures used to track inflation. The more common is the headline grabbing consumer price index (CPI) and the other being the personal consumption expenditure (PCE) or core CPI, which is the Fed's preferred measure because it excludes the more volatile food and energy components. The core measure may give a more accurate reading of where inflation is headed, but since people do buy food, fill up their gas tanks and heat their homes, headline inflation as measured by CPI more accurately represents actual inflation for consumers. Over the past year, CPI has risen 2.8%, the highest rate over the past five years, while the annual rate of growth for Core CPI jumped to 2.1% and is now above the Fed's target of 2%.

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When it comes to forecasting, the Fed does not have an enviable track record. However, with unemployment at 4.6%, rising wage pressures and core CPI above its target rate, the Fed maintains its tightening bias even though there are clear signs of a slowing economy. Traditional retailers struggle to compete with the likes of Amazon while auto demand and used car prices are declining. The Atlanta Fed dropped its Q1 GDP forecast for the first quarter to .6%, down from 3.4% as of February 1, 2017. If the economy slows or the equity markets stumble, we believe the Fed will quickly reverse course when it becomes clear that inflationary pressure brought on by higher oil prices over the past year wanes. The Fed's tightening bias along with other market distortion continues to boost the U.S. dollar. A strong dollar has greater implications for the global economy, not to forget the disinflationary impact of lower cost imports. We understand the Fed's rational for raising interest rates but we believe it is backward looking and does not take into consideration the global imbalances Central Bank monetary policies have promoted. A strong U.S. dollar and higher U.S. interest rates continue to attract global capital but it threatens to unsettle global markets and derail the President's economic agenda.

U.S. Dollar

As we have noted in prior commentaries, interest rate manipulation by Central Banks leads to misallocations of capital. The prolonged use of interest rate suppression leads to even greater misallocations which are not easily unwound without consequence. In this case, we are referring to the trillions of U.S. dollars that left the United States in search of higher yields. Emerging market corporations and governments were happy to take advantage of the relatively low cost U.S. dollar denominated debt funding. These U.S dollar debts will be maturing over the coming years and they will have to be paid back in U.S. dollars. As the dollar strengthens, borrowers will have to buy more U.S. dollars to pay back the loans, which leads to higher demand for dollars. The Fed's tightening bias is only going to exacerbate the problem as it becomes clear that there is a potential shortage of U.S. dollars available globally. The U.S. is importing less oil and the shortage is likely to worsen if the President is successful with his economic agenda which includes allowing U.S. corporations to repatriate the trillions of dollars held overseas at favorable tax rates. The President and his team are also focused on reducing trade imbalances and by definition that means a shrinking of the current account deficit and a resulting decline in the supply of U.S. dollars globally.

The U.S. dollar is the international reserve currency and it also is the primary international currency used for global trade. An excessively strong dollar gave rise to the 1980's Latin American crisis and the late 1990's Asian and Russia crises. It not only risks unsettling emerging markets and the global economy, it also poses a serious problem for the President and his economic agenda, setting the stage for an inevitable showdown with the Fed.

Trump vs. the Fed

Having severely criticized the Fed for its accommodative monetary policies, candidate Trump was quick to chastise the Fed and its policies accusing it of blowing bubbles in the stock market. We suspect President Trump will come to a different conclusion and will be forced to take on a more conciliatory approach with the Fed and its Chair, Janet Yellen. We cannot rule out the possibility of the Fed becoming political but given that the President has the opportunity to appoint three Fed governors this year, it is unlikely and we expect the Fed itself will become politicized.

In our view, the greatest risk facing the global economy is how to address the global trade imbalances and in particular, the impact a rising U.S. dollar will have on the global economy and the President's economic agenda. The Bank of International Settlements warned that the U.S. dollar has become the new fear index, replacing the VIX volatility index as a barometer of risk and it should be clear to even the President and the Fed that something must be done to prevent the dollar from derailing the global economy and the President's agenda.

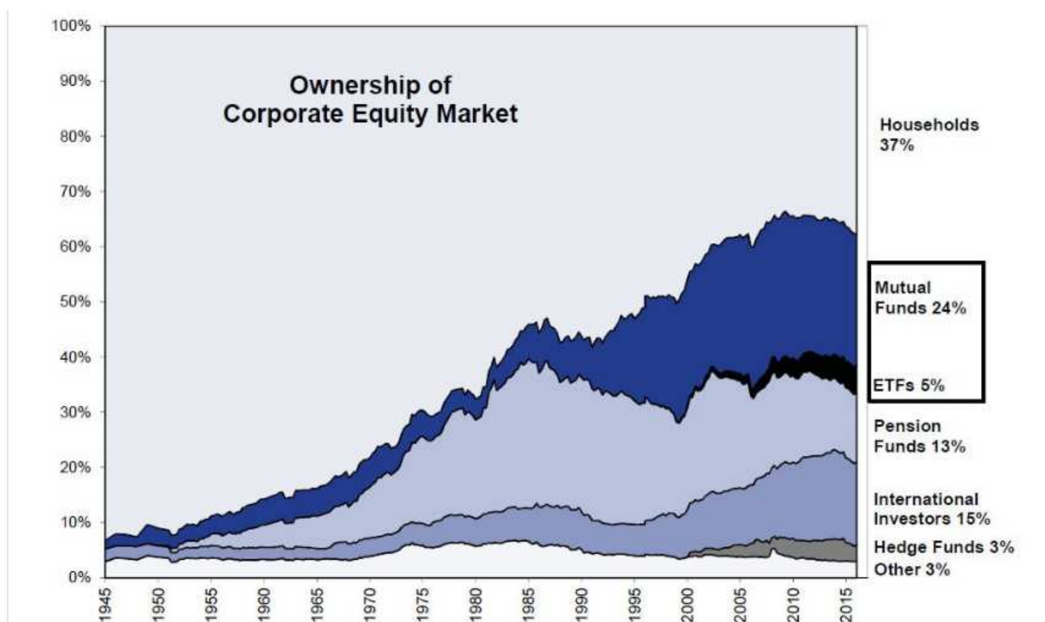
Although we cannot rule out another rate hike in June, the prospect of further rate hikes is diminishing quickly. In our view, it is only a matter of time before the Fed comes to the same conclusion and reverses course, moving from its tightening bias to an easing or even a fourth round of quantitative easing (QE). The Fed has been attempting to reflate for the past eight years and as we have learned from the Japanese experience, it is not an easy task. The Fed will be called on to do more and if it fails to deliver, it will have to deal with an unpredictable President who is used to getting his way.

Markets

The Canadian equity market rose in Q1/17 as the S&P/TSX Composite Index (S&P/TSX) returned 2.41%. The healthcare and energy sectors were the only sectors to decline during the quarter. Large-cap Canadian stocks outperformed small- and mid-caps, and growth stocks underperformed their value counterparts.
The Trump rally continued its advance in the first quarter of 2017. The S&P 500 Index (S&P500) gained 6.07% Q/Q, the Dow Jones Industrial Average Index (Dow) rose 5.19% Q/Q and the NASDAQ Composite Index (NASDAQ) returned 10.13% Q/Q. Large-cap U.S. equities outperformed small-cap and mid-cap stocks, and U.S. growth stocks outperformed their value counterparts.

The rally in equity markets appears to be pricing in perfect execution of the Trump economic agenda while dismissing the incoherent or inconsistent parts of his proposals. Markets have discounted the impact of lower corporate taxes and the repatriation of corporate cash held abroad which could be used for stock buybacks or for increased dividends. If we suspend our ideological views which have kept us cautious, we understand why markets have rallied and will likely continue to rally if these policies are enacted. The U.S. economy continues to attract capital and a strong dollar will only accelerate capital flows and demand for dollars. What markets have not considered is the possibility of an economic slowdown/recession or delays in getting the Presidents fiscal policies passed by Congress. The greatest opportunity for investors is the continued flow of capital into U.S. markets, but it is also its greatest risk if the U.S. dollar continues to rally and those risks destabilize the global economy. Investors have been so distracted by Trumphoria that they have ignored the rising geopolitical tensions in Syria and North Korea. The equity market rally over the past eight years has been deeply distrusted by investors. However, given that equity markets have only experienced shallow pullbacks along the way, retail investors have been allocating increasing amounts of capital into equities from bonds, particularly passive index strategies.

We are closely monitoring the increased appetite for index funds amongst retail investors, as it fuels higher equity markets while overshadowing company specific equity valuations. As market cap weighted indexes attract large capital flows, the large cap high P/E multiple companies are propelled higher. This is all well and good as long as equity markets continue to rise, but as more capital flows into passive investments, equity market corrections can quickly turn into panics in a market with limited liquidity. We will devote more time to this topic in a latter commentary. Suffice it to say, equity markets are being driven by Trumphoria and notwithstanding corrections, they appear to want to move into the next and perhaps final phase of the long running eight year rally.



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Conclusion

The equity bull market is in its eighth year and although there have only been mild corrections along the way, it has been one of the longest and arguably most distrusted bull markets we can recall. Since the election of President Trump, the prospects of fiscal stimulus, tax cuts and less regulation have led to a heightened sense of enthusiasm and confidence amongst investors. To continue higher, equity markets will require corporate earnings growth or some validation that President Trump's policies will be moving forward in a timely manner. If there are setbacks along the way, such as the President's determination to enforce tariffs including renegotiating NAFTA, investors must be prepared for increased volatility and the risk of a more meaningful correction.

We have been monitoring the increasing fund flows into passive indexing strategies with great interest as it signals an increased confidence and the improving risk appetite of investors. However, it also represents a growing risk which is very much underappreciated.

As we stated earlier, in our view, the greatest risk facing global markets is the U.S. dollar. If the U.S. dollar continues higher as we suspect, this will not sit well with the President or the international community. The stage is set for an inevitable clash between the President's economic agenda and the Fed, Congress and the laws of economics. We are not suggesting the end of the U.S. dollar, but we are of the view that it is only a matter of time before the world, including President Trump demands an alternative to the U.S. dollar. In the meantime, notwithstanding the increased probability of a correction in equity markets, we appear to be setting up for what could be the final stages of the long running equity bull market, as capital flows and the rotation from bonds to equities are likely to accelerate under the pro-growth economic agenda of the President.

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