TD Wealth

Tightening with a Twist

Quarterly Commentary Q2 2017

In this issue

Quantitative Tightening	1
Flow of Funds	2
Markets	4
Conclusion	5

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
Assistant Investment Advisor
T: 416 308 8460
juan.barahona@td.com

Maple Ridge Asset Management Group
79 Wellington Street West, 10th Floor
Toronto, Ontario M5K 1A1
T: 1 866 220 0208
F: 416 308 1971

The U.S. Federal Reserve (Fed) raised interest rates for the fourth time since December 2015 and the most recent increase this past June came with an unexpected twist. The Fed announced plans to reduce its US$4.5 trillion balance sheet by selling U.S. Government Treasury bonds and mortgage-backed securities it purchased under its quantitative easing (QE) program from 2009-2014. The prolonged suppression of interest rates over the past eight years unleashed a wave of liquidity that not only boosted asset prices, it also resulted in an increase in global debt of US$60 trillion to over US$217 trillion dollars. There are many reasons why the Fed feels compelled to raise interest rates. They have recapitalized the banks and if they do not normalize rates now, they will have very little room to lower them when the next recession arrives. Some would argue higher rates are needed to avert a pension/retirement crisis or to cool off speculation in the housing and equity markets. We believe the Fed has backed itself into a corner and must now attempt to prevent further misallocations of capital which would lead to an even bigger crisis.

Investors have placed a high degree of confidence in Central Bank omnipotence but we feel it is somewhat misplaced as the underlying structural and fiscal imbalances continue to mount and the growth in debt continues to outpace the growth in GDP. An additional dollar of debt adds only marginally to GDP and additional debt only robs from future purchases, making a recession combined with higher interest rates all the more toxic.

Meanwhile, investor complacency is at an all-time high and fund flows into equity markets via passive exchanged traded index funds continue to outpace and to outperform risk-adjusted returns from active managers. The influence of passive strategies over active has obscured "*true price discovery*" and the relative outperformance of passive over active has led to a sea change in investor psychology that may soon be tested when the Fed begins to sell securities, or what we will call quantitative tightening (QT). Market weighted equity indexes are being led higher by a handful of companies that are dominating their sectors to near monopoly status. In fact, some have argued that they are the new utility stocks offering predictable earnings and growth, immune to competitive disruption or Gov't intervention. It begs the question, can it get any better?

Quantitative Tightening

This interest rate cycle is unlike any other, given the extent to which Central Banks suppressed interest rates and expanded their balance sheets. It is unprecedented in the history of Central Banks. The Fed has proposed selling $90 billion of securities in 2017 and $510 billion in 2018. This is the first time in eight years that the Fed will be withdrawing the very liquidity that has fueled the economy and driven asset prices higher. We have been surprised by the apparent lack of concern amongst investors who must ascribe to the view that if QE was good for markets, so is QT.

Maple Ridge
Asset Management Group

TD

We remain skeptical as to how the Fed will be able to normalize interest rates in a debt–addicted over-leveraged economy without triggering a recession. There is simply not enough growth in the economy, and what growth there has been has come from the Fed's QE stimulus. The post-election equity market rally is based on a belief that the President's stimulus plan (lower taxes, capital repatriation and infrastructure spending) will be forthcoming soon, but even that is looking less likely as the President has found ways to alienate the opposition as well as those in his own party. It appears as though we will not see any meaningful progress until 2018, but even if we did, we are not sure the anticipated growth will be sufficient enough to overcome the impact of rising interest rates on the economy and Government debt service costs.

We have been perplexed as to how the Fed was going to be able to raise interest rates and contain the U.S. dollar rally that began in 2014 when the Fed was only talking about raising rates. Interestingly, the Bank of England and Canada have recently signaled their intention to raise interest rates, which may provide cover for both the European Central Bank and Bank of Japan to follow. However, it must be coordinated, or the dollar will move higher and that risks unsettling emerging markets who had gorged on the Fed induced low cost $U.S. denominated debt. As we have learned from history, a bull market in the international reserve currency ($US) has a destabilizing effect on the global economy.

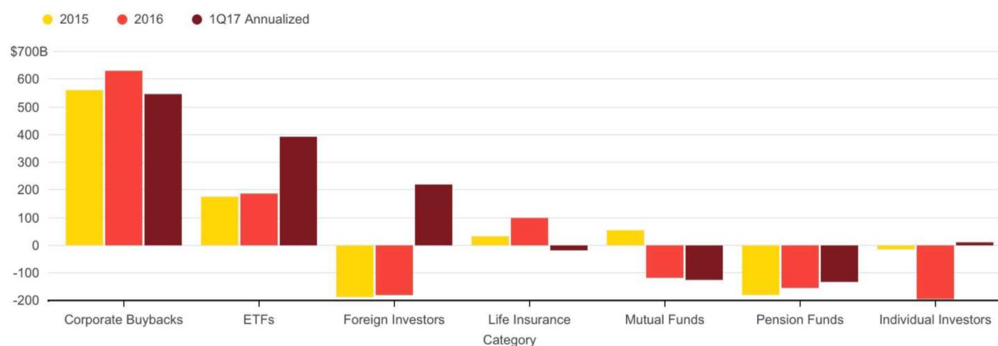
A strong dollar will almost certainly draw the ire of the U.S. President, who's "make America great again" agenda is predicated on a weaker dollar and a reduction in the trade deficit. The President will soon get a lesson in economics and come to realize that for the U.S. dollar to remain as the international reserve currency, the U.S. is obligated to supply dollars to the global economy and it must run a trade deficit, which can only be offset through the capital account. The President has also called for lower taxes on the repatriation of U.S. dollars held by corporations offshore. There is already a shortage of U.S. dollars as the U.S imports less oil and higher interest rates and the repatriation of cash will only increase the shortage, leading to increased demand and a much stronger dollar. The U.S must continue to supply dollars to the world, or the world will demand an alternative.

Flow of Funds

Global equity markets remain resilient in light of the Fed's tightening bias and increased geopolitical tensions in the Middle East and North Korea. In spite of rising equity valuations, mediocre economic growth and the Fed's hawkish stance, investors have taken it in stride under the perception of Central Bank omnipotence. This is more than likely because there have only been modest pullbacks in equity markets over the past eight years and any corrections greater than 5-10% have been accompanied by Central Bank intervention in the form of QE or forward guidance.
Another factor that is having an increasing impact on markets is the flow of funds into passive Exchange Traded Funds (ETF's) strategies which continue to benefit from their construct and relative outperformance over active managers. In the second week of June 2017, investors poured US$31.6 billion into global ETF's, beating a previous weekly high of US$26.5 billion in April 2017. The primary benefactors being the S&P 500 Index (S&P500), The NASDAQ Composite Index (NASDAQ), and The Russell 2000 Index, all of which hit new highs.

Bull Run

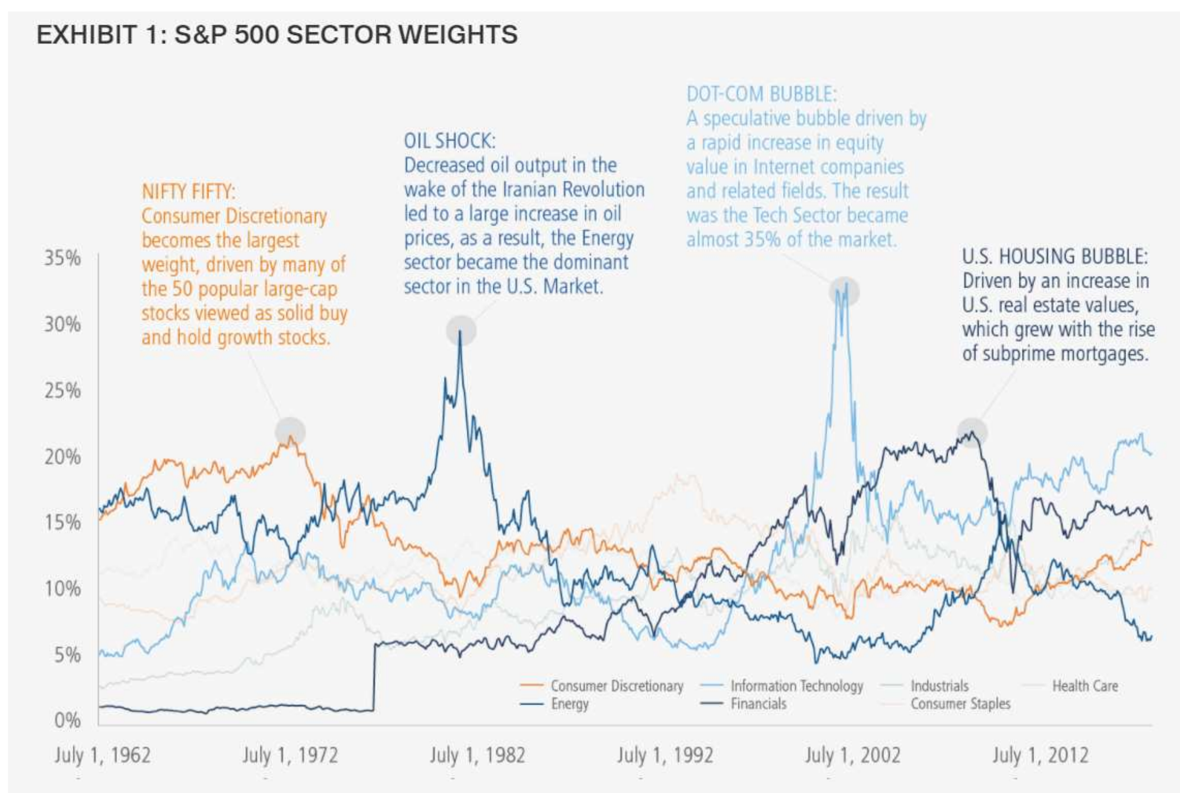
Corporations are still the largest buyer of stocks, followed by ETFs



Source: Federal Reserve, Goldman Sachs

Q1 2017

There is no denying the appeal of index funds, as market cap-weighted ETF's have dominated in terms of fund flow and relative performance but it comes with a caveat emptor. The stock's weight within the index will change based on its price. The more a stock's price appreciates compared to others in the index, the more its weight increases in that index. The reverse is also true when a stock price declines and therein lies the problem. For example, Microsoft has a lock on the personal software sector, Google dominates internet advertising, Amazon's disruptive internet sales model is an apparent game changer for retail and Facebook's social network advertising monopoly continues to grow while Apple continues to provide products that compel users to overpay for devices that seamlessly access the internet. The dominance of these companies in their respective sectors is equaled by the increasing dominance they exert on the performance of market cap weighted indexes and a growing list of sector and theme driven ETF's that now outnumber the individual company stocks that comprise them! The more money that flows into ETF's, the greater the influence these companies will have in driving index returns higher and of course, the reverse flow of funds will have the opposite effect. One need only consider the August 2015 flash crash, which saw the Dow Jones Industrial Average fall 6.5% and some ETF's drop well below their net asset value by 20-30% as investors panicked and rushed for the exits.



Source: Market Weight- Bloomberg – Mar 31 2017

Investors have become enamoured with low-cost index funds based solely on performance to the exclusion of risk-adjusted returns. If ones time horizon is 10-20 years, these significant market corrections become blips on long-term performance graphs but the majority of investors are easily influenced by fear of loss and they often exit at the most inopportune time.

For example, Exxon Mobil is a constituent in many indexes such as the Dow Jones Industrial Average Index (Dow) and S&P 500 Index (S&P500) and it makes up 25% of the iShares U.S. Energy ETF, 22% of the Vanguard Energy ETF, it's in the Dividend Growth ETF, Deep Value ETF, Momentum ETF and the Low Volatility ETF's. Exxon continues to buy back its shares and boost its dividend while its underlying commodity, oil, has declined 50%, and it has seen its revenue and earnings decline by 46% and 75% respectively while its debt levels have grown and the dividend-payout ratio is over 3x earnings.

Other significant factors influencing share prices are corporations using excess cash or borrowings to fund stock buybacks and dividends, which in many cases, influence share prices by allowing corporations to manage their reported earnings, a financial engineering exercise. A new buyer of equities which has garnered very little exposure are Central Banks. The Swiss National Bank, Switzerland's Central Bank, now has an equity portfolio of over US$80 billion funded by creating Francs out of thin air to buy equities. The bank is believed to hold 22% of its assets in equities and the newly created money has found its way into names like Facebook, Alphabet (Google), Microsoft, Apple and even Exxon Mobile, further boosting the influences these names exert on market cap weighted indexes. The Bank of Japan (BOJ), having reached the limits of its bond buying and desperate to weaken its currency, has also been actively buying Japanese equities. The BOJ has been buying exchange-traded funds and is now the leading shareholder in nearly a quarter of Japan's listed companies. The bank is a top 10 shareholder in 833 of Japan's 3,675 listed companies and has played a key role in propping up the stock market when needed, bolstering household and business sentiment.

The BOJ has a growing stake in many companies *(size of stake in percent)*

1	Advantest	16.6
2	Fast Retailing	15.0
3	Taiyo Yuden	14.1
4	TDK	13.5
5	FamilyMart UNY Holdings	13.4
6	Toho Zinc	12.9
7	Trend Micro	12.4
8	Comsys Holdings	12.1
9	Konami Holdings	11.8
10	Nissan Chemical Industries	11.5

Estimates; based in part on publicly disclosed material

Source: Nikkei Asian Review - June 26 2017

Have we entered a new world in which Central Banks are now prepared to debase their currency and continue to inflate equity markets? If this is the replacement for QE and a counter to QT, it will confound those investors who remain on the sidelines and still believe fundamental valuations still matter. It also creates an environment where valuations and risks are elevated by the machinations of Central Banks who appear prepared to do whatever it takes to maintain the illusion of sustainable economic growth. We are not sure how this all ends or what the implications are but we do know that money or fiat currency is being debased at an alarming rate while the structural and fiscal imbalances continue to grow, leading to the next fire for Central Banks to extinguish.

Markets

The Canadian equity market declined in Q2/17 as the S&P/TSX returned -1.64%, although eight out of the eleven sectors posted a positive return. The S&P/TSX declined primarily due to the performance of the energy, materials and financials sectors, which are the largest sectors in the index. The energy sector was the largest detractor from performance, declining 8.28%, as West Texas Intermediate (WTI) crude oil fell 9.01% Q/Q in response to perceptions that OPEC-led production cuts are failing to substantially reduce a global crude glut.

U.S. equities delivered a positive return in Q2/17. The S&P 500 gained 3.09% Q/Q, the Dow rose 3.95% Q/Q and the NASDAQ returned 4.16% Q/Q. Nine of the eleven sectors in the S&P 500 delivered a positive return during the quarter, with gains led by the health care and industrials sectors.

Conclusion

After eight years of interest rate suppression via QE, the Fed has begun the process of withdrawing liquidity, which has been a significant tailwind for equity markets. We recall the extreme levels of volatility that hit equity markets in 2013 when the Fed first uttered the words "tapering" and now that they are raising interest rates and shrinking their balance sheet, equity markets have responded favourably. Investors have either concluded that quantitative tightening is a sure sign of economic strength or they believe that the Fed will eventually be forced to reverse course. We have argued in the past that once the Fed's QE program began, the resulting misallocations of capital would only be made known once the monetary stimulus was withdrawn. We have reached that point in time and we will soon find out if the Fed can gracefully exit from QE. We remain skeptical and expect the Fed will be forced to expand its toolbox and we would not rule out more QE should the economy or equity markets falter. This could spark yet another sharp rally in equity markets if Central Banks are forced to provide more liquidity, which we suspect they will do.

To be clear, the Central Banks have been engaged in outright currency debasement and although this has not resulted in runaway inflation in the real economy, it has and continues to be reflected in asset price inflation. There is little doubt that rising equity markets and home prices have boosted investor and consumer confidence but they are not capable of addressing the root cause of the problem, mounting fiscal and structural imbalances. Fundamentals, business prospects, balance sheets, cash flow and earnings have been overshadowed by the increasing dominance of fund flows into index funds, which are in turn driven by the liquidity provided by a handful of Central Bank academics. It is only when the tide goes out that we see who is swimming naked!

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
Assistant Investment Advisor
T: 416 308 8460
juan.barahona@td.com

Maple Ridge Asset Management Group
79 Wellington Street W, 10th Floor
Toronto, Ontario M5K 1A1
T: 1 866 220 0208 F: 416 308 1971
www.mramg.ca

Maple Ridge
Asset Management Group

The information contained herein has been provided by the Maple Ridge Asset Management Group and is for information purposes only. The information has been drawn from sources believed to be reliable. Graphs and charts are used for illustrative purposes only and do not reflect future values or future performance of any investment. The information does not provide financial, legal, tax or investment advice. Particular investment, tax, or trading strategies should be evaluated relative to each individual's objectives and risk tolerance.

Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the fund facts and prospectus, which contain detailed investment information, before investing. Mutual funds are not guaranteed or insured, their values change frequently and past performance may not be repeated.

Commissions, management fees and expenses all may be associated with investments in exchange-traded funds (ETFs). Please read the prospectus and summary document(s) before investing. ETFs are not guaranteed, their values change frequently and past performance may not be repeated. ETF units are bought and sold at market price on a stock exchange and brokerage commissions will reduce returns. Index returns do not represent ETF returns.

Certain statements in this document may contain forward-looking statements ("FLS") that are predictive in nature and may include words such as "expects", "anticipates", "intends", "believes", "estimates" and similar forward- looking expressions or negative versions thereof. FLS are based on current expectations and projections about future general economic, political and relevant market factors, such as interest and foreign exchange rates, equity and capital markets, the general business environment, assuming no changes to tax or other laws or government regulation or catastrophic events. Expectations and projections about future events are inherently subject to risks and uncertainties, which may be unforeseeable. Such expectations and projections may be incorrect in the future. FLS are not guarantees of future performance. Actual events could differ materially from those expressed or implied in any FLS. A number of important factors including those factors set out above can contribute to these digressions. You should avoid placing any reliance on FLS.

Index returns are shown for comparative purposes only. Indexes are unmanaged and their returns do not include any sales charges or fees as such costs would lower performance. It is not possible to invest directly in an index.

Maple Ridge Asset Management Group consists of Chris Susel, Vice President, Portfolio Manager, Investment Advisor and Michael Bowcott, Vice President, Portfolio Manager and Investment Advisor. Maple Ridge Asset Management Group is part of TD Wealth Private Investment Advice, a division of TD Waterhouse Canada Inc. TD Waterhouse Canada Inc. is a subsidiary of The Toronto-Dominion Bank. TD Waterhouse Canada Inc. – Member of the Canadian Investor Protection Fund.

All trademarks are the property of their respective owners.

® The TD logo and other trade-marks are the property of The Toronto-Dominion Bank.