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As Good As It Gets?

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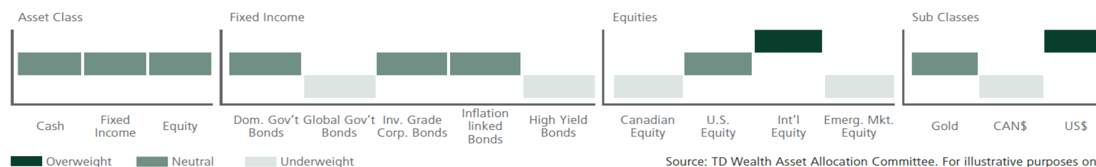
As we approach the holiday season I want to revisit a recurring theme from 2017, the extended equity market rally and if this is as good as it gets? I will start by provided some context of where we are in the business cycle, a quick reminder of some of the main factors that I watch to help identify if we are on the verge of a collapse then conclude with some investment strategy ideas and 4 non-financial keys to help you towards a successful retirement.

The global economy appears to be in a goldilocks scenario with strong economic growth signals across the board with little evidence of nearing an end yet low and stable inflation. The world's economies are growing in a synchronized fashion and although long in duration we are not seeing the typical excesses that occur in advance of a recession. This has allowed central banks to keep interest rates low providing a further tailwind to growth and helps to explain the long tenure of this business cycle from crisis levels. Although I view the probability of a recession over the near term as relatively low, I do see rising risks on the horizon with investor sentiment higher and central banks around the world beginning to taper their emergency support. Stocks, in general, have continued to do well driving valuations to new highs and volatility to new lows. The stock market is always good at foreshadowing what is expected but's it's what's not expected that typically causes a crash.

As a reminder, there are four factors that I watch closely outside of the economic data to help predict if a recession and market crash are imminent. The first is investor emotions also known as sentiment and as we move through a market cycle investor's collective emotions can help determine where stock prices might go. I believe that the best time to buy stocks is when investors are pessimistic. Skepticism slowly brings more investors into the market as stocks usually provide better returns than their alternatives, especially in a low interest rate environment. Then we move through the two late cycle stages starting with optimism followed by the point of euphoria when all cash is depleted and investors consider borrowing to invest because everything continues to do so well. This is summed up best by Warren Buffet who said "be fearful when others are greedy and greedy when others are fearful". Based on the conversations I have amongst investors, professionals and peers I would argue that we are currently somewhere between skepticism to optimism as stocks continue to outperform. Investors either feel like they missed the rally and are waiting on the sidelines, or looking to add more money to winning positions without fear. The next corresponding factor to monitor is liquidity and by that I mean cash on the sidelines. Most recently we have started to see the slow depletion of record cash levels from large institutional players like mutual and hedge funds. That said, cash levels are not yet near 0 levels, take for example again Warren Buffet who's company Berkshire Hathaway just reported $109 billion in their third quarter earnings report, well above the average $20B level. Cash on the sidelines is also affected by the next factor, money supply which is accommodation by central banks by keeping interest rates low and adding cash to the markets by buying their own bonds. The unprecedented level of the collapse resulted in a comparable level of central bank accommodation by way of ultra-low rates and excessive expansion of balance sheets. As we know from Canada's two most recent rate hikes and the four from the U.S. the environment is becoming slightly little less accommodative but arguably still far from restrictive. The actual price of stocks known as valuations is the next factor I turn my attention to. As I will highlight in my investment strategy section, the prices of stocks are quiet high but could continue to grind higher if earnings continue to improve. If earnings were to start to fall, the high valuations would be an extreme cause for concern but bull markets typically don't fail solely because stocks become expensive. The last factor but certainly not least is the yield curve which I have spoken about in great detail in recent publications because of its importance. I maintain that it provides the heaviest weight in predicting the next recession with the last 7 recessions since the 60's having come after a yield curve inversion. In simple terms, this is when short term yields rise above long-term yields as this chokes off growth, liquidity and valuations all at the same time. It appears North America is now in a rising interest rate environment and I want to take my next section to spend a little more time analyzing the potential ramifications.

To summarize, based on the factors that I monitor I still maintain the view that for most, it makes sense to remain fully invested. Given where I believe we are in the business cycle I feel that for most it is appropriate to take a neutral stance across asset classes. I believe at some point in the next 1 to 3 years the time will again come to reign in risk and lean towards defense but for now, its business as usual focusing on owning the stocks of the strongest companies, with proven cash flows, consistent dividends and experienced management teams that can continue to grow earnings.

Asset Allocation Summary



Source: TD Wealth Asset Allocation Committee. For illustrative purposes only.

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Reference Rates	
Prime Rate CAD	3.20%
Bank Rate CAD	1.00%
3 Month CDOR	1.411%
3 Month LIBOR	1.392%
Fed Funds USD	1.250%
CAD (Spot)	1.2768

MM Funds (current yield)	
TD Cdn MM Fund	0.58%
TD Prem MM Fund	0.92%
TD US MM Fund	0.94%

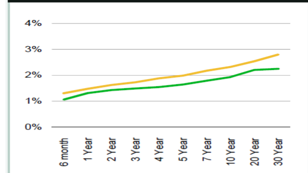
November 6, 2017

TD Mortgage Corp. GICs	
1 year	1.25%
2 year	1.50%
3 year	1.60%
4 year	1.70%
5 year	1.80%

Source: TD Securities - All Charts

USD Terms, over $100,000	
30 - 59 days	0.50%
60 - 89 days	0.55%
90 - 119 days	0.60%
120 - 179 days	0.65%
180 - 269 days	0.70%
270 - 364 days	0.80%

Yield Curve

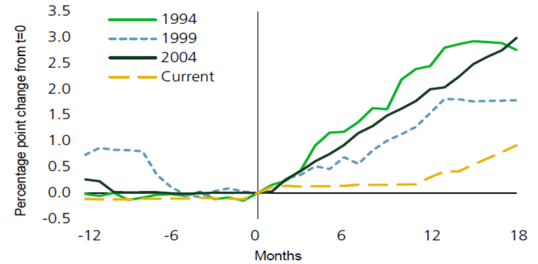


Data: Bloomberg LP

Interest Rates & Inflation

The improvement in economic conditions has allowed some key central banks to start turning the policy dial from emergency toward neutral. Canada recently followed the U.S. with two rate hikes this summer accompanied by the Bank of England, the European Central Bank and China leaving Japan as the minority who is still providing extraordinary stimulus measures. Higher rates can slow the economy as it immediately increases expense for any company or individual who holds variable credit obligations like lines of credit or mortgages. It also lowers the incentive for banks to lend long term on mortgages at marginal rates only to have to pay higher interest payments on short term obligations like GICs. The important thing to point out here is that this normalization of rates is off to a slow start as indicated by figure 1 illustrating the current and previous path of US interest rates.

Figure 1: Current cycle is different from past tightening periods



t=0 refers to the start of U.S. monetary policy tightening cycles. Percentage point change from t=0 in monthly effective federal funds rate. The graph refers to tightening cycles beginning January 1994, June 1999 and June 2004 with the current cycle beginning December 2015. Source: Bloomberg Finance L.P. and Haver Analytics. As at June 2017.

Looking at the U.S. Federal Reserve Bank (Fed) specifically, shifting the dial from emergency to neutral in a slow and calculated manor should allow them to continue offering significant accommodation, as rates remain historically low, while also providing it with room to maneuver if economic growth slows. Looking at Canada, the pause in interest rate increases at the September meeting suggests that they were taking a similar approach in getting interest rates out of emergency territory and adding some ability to maneuver in the future, should economic conditions worsen. My forecast calls for 3 hikes from the U.S. in the next 12 months likely continuing at their December 6th meeting with Canada poised to raise twice in 2018 if economic conditions don't deteriorate. I believe a policy miscalculation, by way of rates going up too far too fast, could spark the next recession and that's why I dedicate so much time to watching and analyzing the interest rate environment.

To add a little uncertainty here, in November President Trump announced a new Fed chairperson, the person who ultimately decides the path of interest rate increases. The replacement of current Chairperson Janet Yellen will be by current Fed Governor Jay Powell effective February 3, 2018. Although Mr. Powell is expected to have a similar policy stance he is two things that Janet Yellen is not, a Republican and a lawyer marking the first Fed Chairperson in several decades not trained as a macroeconomist. I have uncertainty about how Powell might respond to unexpected shocks to the economy not having economics as a background for his education. The Fed has been effective at communicating the path of rates which gives me confidence that we won't see any policy surprises despite the new leader.

In summary, it's a fine line that the heads of global central banks have to walk between rising rates to high causing a slowdown in growth and not having rates high enough to combat the next inevitable recession. As nobody knows what the future will hold, The only productive answer for investors is have faith in the vast knowledge of central bankers, with their coordinated efforts, transparent policies and use the best information available at any given time to make your investment decisions.

Investment Strategy

The recovery from the financial collapse is the third longest on record in post-World War II history based on data from the Bureau of Economic Research. It has now been 88 months since the recovery started in June 2009. This trails the second longest of 106 months from February 1961 to December 1969 and the longest of 120 months from March 1991 to the March 2001 tech bubble burst. The S&P 500 Index has not seen a 3% drawdown since the U.S. election last November. Rising valuations from extremely oversold levels have been the constant tailwind over the past eight years as companies focused on lowering expenses which allowed profit margins to go up even at stagnant or lower earnings. Although valuations are above long-term averages, as you can see from figure 1, we are still a ways off levels of the 1990s. Back in January I argued that valuations were getting stretched and with companies having already exploited the majority of their cost-cutting abilities, earnings had to improve for stock prices to rise any further. Fortunately, through the first half of the year we saw double digit earnings growth with third quarter earnings being reported equally as good at current. I don't believe that the market will correct simply because of higher valuations as the things in plain view seldom cause a recession. The bull market can be sustained without rising valuations as long as companies continue to grow their profits.

Figure 1: Valuations: S&P/TSX Composite Index vs. S&P 500 Index

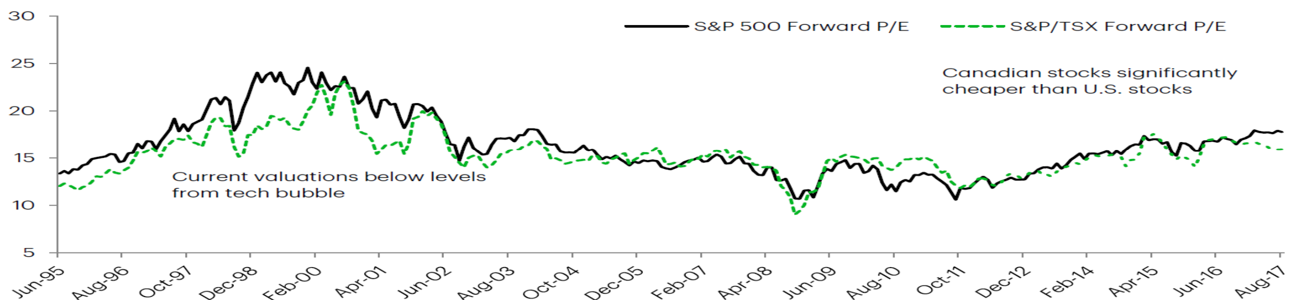


Chart provided by Connor, Clark & Lunn Investment Management Ltd. Data is sourced from Bloomberg Financial LP.

Investment Strategy *con't*

With the driving force of market gains prior to 2017 being on the back of valuations increasing across the board, most markets, sectors and stocks have benefitted together. As the business cycle matures, I believe it will only be those that can maintain earnings growth that will continue to rise. Just as we are witnessing the growth of robo-advisers and exchange traded funds (ETF), the rise of the stock picker may be resurging. There is considerable divergence within the investment landscape as certain stocks and sectors and even markets are at extreme overvaluation levels while others appear quite reasonable. It's more challenging than ever to identify acceptable risks and opportunities. A broad example of this is the Canadian market where the discount to U.S. stocks is at fairly extreme levels vs. historical averages. That said it's not as simple as just having broad exposure to the Canadian market because as you can see from figure 1 these valuation gaps have the potential to last for extended periods of time. Investors should be mindful of any concentration in their portfolios whether it is a certain country, industry or sector and we know that the Canadian market is heavily weighted to commodities. Oil prices reached a level not seen in more than two and a half years last week begging the question of whether there is an investment opportunity. Falling inventories, an extension to OPEC production cuts, a slowdown in U.S. shale production and some unexpected Middle East unrest has the price per barrel up $10 U.S. in the past month. Although valuations may look attractive, I don't think we will see any kind of a spending increase in Alberta and my outlook for an improvement in earnings within the oil sands remains bleak. This is a sector where I maintain an extreme underweight position holding only one of the largest Canadian players, Suncor **(SU)** who I believe still has some room to grow earnings whereas any broad Canadian ETF or robo-advised portfolio is probably going to have substantially more exposure to the sector.

A rising theme with the corporate landscape is the improvement of technology and the positive effect that it can have on earnings and in turn stock performance. Technology seems to be disrupting every sector in some degree. Take for example consumer stocks, specifically retail. We know that giants such as Amazon are changing the way people shop and consistently growing earnings and market share. When one company is adding market share others have to be losing and the shift in technology has taken a chunk out of traditional brick-and-mortar retailers, look at Sears for the most extreme case. Online retail sales have been growing by a solid 15% per year, which is roughly four times the growth rate for the brick-and-mortar retailers. It's not all bad news for the traditional retailer. If a company can hold revenues constant but reduce labor costs its profit margins should go up. You can see evidence of how retailers are executing this at any major grocery store or pharmacy by way of the dreaded self-check-out isle.

It is important to understand that one key feature of the technology landscape is that revenues typically flow to the top players in the space. The digital sector is associated with winner-take-all dynamics as a result of economies of scale providing a huge cost advantage. It's no surprise that the FANG stocks continue to top headlines and last week we saw some bellwethers Amazon, Microsoft, Google and Intel all report earnings that shot the lights out. If you're investing for the long term you have to take into consideration the trends in the ever-changing investment environment and should consider some exposure to technology. Amazon **(AMZN)** and Microsoft **(MSFT)** continue to be core growth holdings within my portfolios as well as a broad sector overweight with First Trust's Tech Giants ETF **(TXF)**.

Another long-term trend worth paying attention to is the effects of an aging demographic. It's no secret that baby boomers make up the largest percentage of the North American population and as they head into retirement, they are spending significantly less money on "things" and more money on experiences such as travel and luxury. The consumer discretionary sector houses the majority of companies that provide such experiences and the right companies should be able to continue to grow earnings by taking a piece of the dollars spent on experiences. Lastly, a defensive sector where an investor ought to consider having some exposure is healthcare where with an aging population requiring services regardless of where the market cycle goes.

In summary, for the first time in many years I feel like a strategically built portfolio with overweight's to the right sectors could significantly outperform the broad stock market. Choose wisely.

4 Non-Financial Keys to help Towards A Successful Retirement

The majority of clients that my team looks after are close to if not already enjoying retirement. I spend a lot of time discussing and preparing retirement, tax, estate and income strategies but in this last section I want to discuss 4 keys that can help ensure a happy retirement that have nothing to do with money.

1. Hobbies

For most of us, work consumes the majority of our time and many people forget to consider how they plan to spend that time when they no longer have the obligation of a career. Now you should obviously spend a lot of time analyzing how much income you'll need to sustain your retirement years but it's also important to think beyond financial considerations. Are you going to fill your days on a golf course or tennis court? If so, does it make sense to look into a membership somewhere or would you get sick of playing the same course, court or people day in and day out? Much like me, many of my clients enjoy volunteering and taking some of their time to give back to their communities, favorite organizations or even within their previous career field. I personally grew up playing sports and if I had more extra time, I would certainly dedicate some of it to teaching or coaching in some capacity.

Perhaps there is something that you've thought about achieving in your life that you just haven't had time for? Travel seems to hit the top of the list of a lot of retirees and maybe your favorite destination happens to be Italy. Would it make sense to sign up for some Italian lessons or join a travel program focused on learning a language abroad?

From my experience, busy retirees tend to be happier retirees. I believe that the happiest retirees should engage in three to four regular ongoing activities and those with the busier schedules tend to be the happiest. Relaxation is always an important part of the schedule, but you should also occupy some time with things that you enjoy.

2. Exercise Your Body

For some, your hobbies could include some exercise but for most this needs to be scheduled into your calendar. The importance of your health when it comes to happiness can't be overstated. If you've never spent much time in a gym the thought of going can be overwhelming. Maybe you want to look into a personal trainer to help get you started. Cardiovascular health is most people's number 1 problem so maybe you want to buy a new bicycle or join a walking group for alternative means of exercise. A creative way to encourage yourself to exercise more is to get a dog and walk it twice a day. While we can't predict health concerns, the best first step is prevention. Take care of yourself both now and in retirement. Eat well and don't neglect your physical or mental health.

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3. Exercise Your Brain

You need to find other means of staying sharp in retirement because you'll no longer be in the office working through strategies or at the job sight coordinating the next project. You can use simple strategies to exercise your brain like word skills, games or socializing. Read as much as you can, reading is a great brain exercise. You can read books, newspapers or magazines. An electronic e-reader is great way to download and read anything that your heart desires and is easy to take with you anywhere. I got one for my mother last Christmas and it sits in her purse wherever she goes. Try reading things that teach you something new, such as history or skills or anything that interests you. Write something. Writing requires loads of thinking. This can be as simple as writing about things that you've experienced in a journal for your grandkids to enjoy in the future or as creative as a made-up story or an article submission on topics that you know about. Other unique strategies for training the brain include using your non-dominant hand, learning a musical instrument, playing chess, puzzles or even a weekly game of scrabble.

4. Spousal Communication

The last, but certainly not least, consideration as you move into retirement is communication with your spouse. You've chosen your spouse as the person you want to spend the rest of your life with, but you're probably not used to that being together every waking moment. Communicating your retirement intentions is invaluable when it comes to making sure you're both on the same page. Are there activities that you will engage in together? For most of us, you have had separate careers and spent the lion's share of your days apart so maybe there are some activities that you still want to do separately.

Are you both retiring at the same time or is one of you still going to continue working? It can be challenging for one spouse to get up with the alarm clock and go through the throws of getting ready for work while the other snoozes away in bed. Maybe it's a better routine for the retired spouse to get up at the same time and have a coffee or read the newspaper to make the morning easier on the other.

While financial security is the key ingredient in a successful retirement plan, be sure that you also take the time to think about the non-financial considerations that can make for a healthy and happy retirement.

Personal Note

It's easy to get caught up in the realities of daily living and let the important things that make us human fall to the backburner. Every now and again, we like to take a weekend, head over to the cabin on the sunshine coast and take some time to explore our creativity whether that be painting, drawing, hiking through the forest or even just reading a book beside the fire. As I sit in the cabin over this rainy Remembrance Day, long weekend I share my time between writing this newsletter and reading a riveting new book named "Sapiens" written by Yuval Harari, I am reminded of an inspiring quote from Elie Wiesel.

"Without memory, there is no culture. Without memory, there would be no civilization, no society, no future"

So whether Remembrance Day has a specific meaning in your family history or not, be sure to take the time this month to remember those who fought for our freedom and gave their lives so that we could live as happy and free as we do.

With the holiday season right around the corner I wish you and your family the very best,

Marley

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