TD Wealth

Trading Punches

Monthly Perspectives // May 2019

Finding reason in Rocky II

Brad Simpson, Chief Wealth Strategist, Head of Portfolio Advice & Investment Research, TD Wealth

One of my favourite boxing scenes of all time can be found in the cinematic classic Rocky II, where the "Italian Stallion" squares off against the champ, Apollo Creed, in their fateful rematch.

Picture it. We're in the 15th round of an epic prize fight, and both boxers have been through a war. As they meet in the centre of the ring, Apollo tells Rocky, "You're going down." Rocky, in typically blunt fashion, responds, "Nah, no way." They're both too exhausted to block a punch, instead testing their chins as they take turns flailing haymakers at each other. Then, as the round comes to a close, Rocky throws a left cross and they both tumble in slow motion to the ground — *a double knockdown!*

That, incidentally, is what the markets feel like these days. With a U.S.-China trade deal in sight, the bulls advance. *Jab-jab-cross.* Oh, but wait, the White House is threatening new tariffs, and bears counter. *Job-cross-hook.* Bulls rally on the possibility of a rate cut. *Jab-cross-hook.* But record job numbers argue in favour of a hike. *Right cross-left hook*. Oil prices surge on Saudi supply cuts. *Jab-cross-uppercut.* But then they fall on surplus U.S. inventory. *Jab-uppercut-left hook.*

You get the picture. The trouble is, there's a lot of conflicting information swirling around right now. The demand for more and more information, and faster please, has allowed the best voices to be drowned out by self-serving messages. Sensational headlines sell newspapers, unfounded prognostications give talking heads the profile they crave—but investors register all of it indiscriminately.

Instead of better advice, we're being pulled in by the latest counterintuitive storyline, all in an effort to gain an edge. This has accelerated the news cycle and amplified market noise to deafening levels, thereby spurring volatility. Just take a look at the CBOE Volatility Index (Figure 1). In early May, after reports that trade talks were faltering, the VIX recorded its highest level since January.

Noise. To a large extent, that's what this is, and unfortunately, we're all susceptible to it—some more so than others. At TD Wealth, the term we use to measure one's sensitivity to noise is called "reactiveness," and it's one of five dimensions of personality—along with openness, conscientiousness, extraversion and agreeableness—that our Discovery Tool assesses as part of our process for getting to know clients.

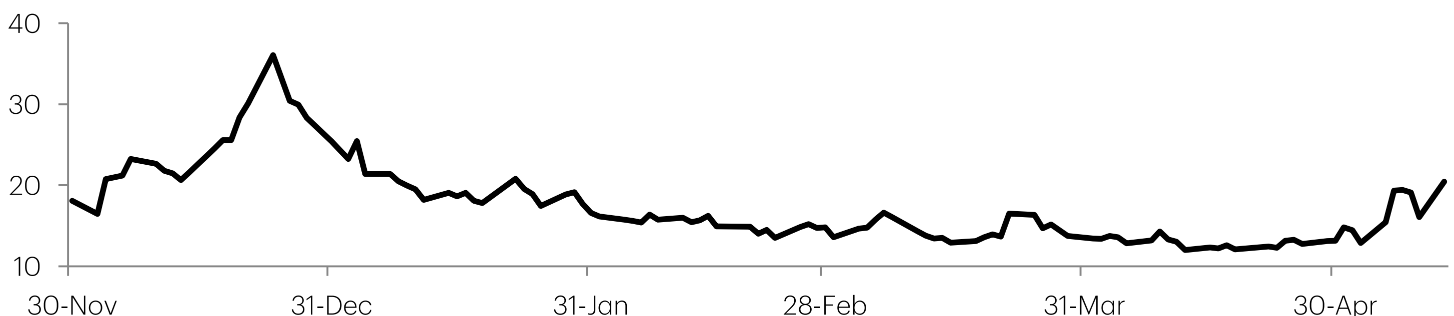
Reactiveness is perhaps the most important of these traits when it comes to behavioural finance because it relates to our tendency to respond to emotional stress. At one extreme, you find people who are "calm under pressure," and fail to pull the trigger even when it's called for; at the other, you find people who are "quick to react," and therefore prone to selling at precisely the wrong time.

A bit of reactiveness can actually be a good thing, as long as you're relying on the best information—and *only* the best information—but that's easier said than done. In a world of conflicting signals and contradicting experts, it's hard to make rhyme or reason of any of it. How can you tune out the market noise while tuning in to the best advice possible?

That's where we come in. The goal of this month's *Perspectives* is to reach out to some of our brightest minds to get a sense of where this market is headed. For investment strategy, we've gone to none other than Bill Priest, CEO of Epoch Investment Partners in New York. Priest is a legendary investment manager whose career in finance spans more than half a century. In an excerpt from his quarterly newsletter, he gives investors three reasons to remain cautious as we move into the longest economic expansion in American history.

For an outlook on commodities and energy, we've called on Bart Melek, Head of Commodity Strategy at TD Securities, who's been keeping tabs on the metals and energy space for some 20 years. Melek has been quoted by every business media outlet you can point a stick at, from Bloomberg to the *Wall Street Journal* to *Barron's*. In his latest update, he and his team offer their opinion on how the U.S. president's trade threats are likely to influence the price of oil, base metals and gold.

Figure 1: Rocky Comeback (CBOE Volatility Index, VIX)



Source: Bloomberg Finance L.P. as of May 13, 2019

And, finally, for the big economic picture, we've gone to TD Chief Economist Beata Caranci and Senior Economist James Orlando, who tap into first-quarter data to assess the threat of recession, or lack thereof, and what that means for equity markets and bond yields.

Blocking out the market noise starts with an acknowledgement that not all sources of information are equal. Some voices merit more consideration than others. After all, watching Rocky and Apollo wail on each other for 15 rounds, you might not have guessed, in the heat of the moment, that Rocky was destined to pull himself up on the count of 10 to win the championship. But any true connoisseur of the genre could have told you it was inevitable from the start.

Back from the brink

William W. Priest, CEO, Co-CIO and Portfolio Manager, Epoch Investment Partners

The following is a lightly edited excerpt from Epoch Investment's Quarterly Newsletter, published in April 2019. To read the article in full, please visit www.eipny.com.

Early 2019 looked like the mirror image of late 2018. The good news is that markets have moved back from the brink, and we anticipate a relatively benign mid- to high-single-digit return to stocks for the remainder of the year. That said, this cycle is well into its late innings and we now outline three reasons to maintain a cautious investment stance.

Reason 1: Soon to be the longest expansion in U.S. history

The last recession officially ended in June 2009 and the current expansion will shortly celebrate its 10th birthday. Moreover, 118 months is close to the longest U.S. expansion ever experienced (120 months). However, all good things must come to an end as suggested by a host of indicators, including the (almost) inverted yield curve and weak consumer expectations. Precisely when, though, is anyone's guess, as the record of failure to predict recessions is virtually unblemished.

Reason 2: The approaching Minsky Moment; stability breeds instability

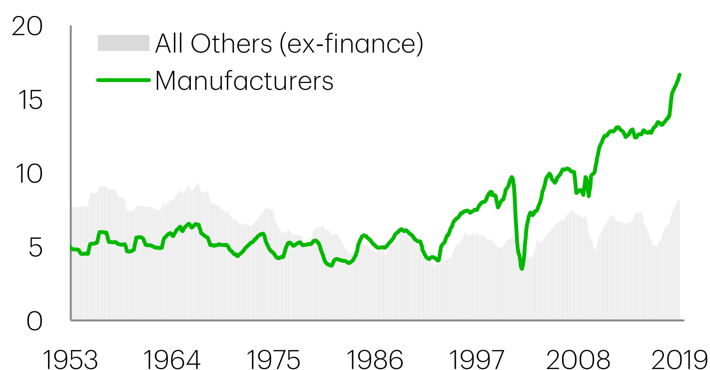
The second reason concerns the risks arising from the high and rising level of debt throughout the U.S. economy. While corporate leverage might not be the direct cause of the next recession, it is certain to act as an amplifier, making the repercussions considerably more damaging for both the real economy and the equity market. Policymakers agree, with this point emphasized in February by Fed Chair Powell and in early April by the IMF.

... We firmly believe that the corporate debt market will be at the epicenter of the next financial crisis. Just as distinguished economist Hyman Minsky would have predicted, a decade characterized by record low interest rates and a flood of central bank liquidity has produced an accident just waiting to happen.

Reason 3: Manufacturing margins have peaked

Four factors explain why manufacturers' margins have more than doubled over the last two decades: (i) the reduction in effective tax rates; (ii) the decline in interest rates; (iii) wage savings from offshoring; and (iv) the reduced wage bill resulting from more efficient domestic plants. The first two of these factors are likely fully played out, with the third starting to reverse over the past two years, and the last continuing to plod along, but not moving the needle very much. With opportunities for labor cost arbitrage largely behind us, and global supply chains under threat from trade tensions (especially pertaining to tech hardware), the likelihood of further margin expansion is quite low in our view (Figure 2).

Figure 2: U.S. Manufactoring Margins Have Peaked (S&P 500 Index, Net profit margins, %)



Source: Empirical Research Partners, as of December 31, 2018

Consensus expects S&P 500 EPS growth of only 3% this year, down markedly from 20% in 2018 (due in large part to the EPS sugar high that resulted from the end-2017 tax reform). However, consensus expects EPS growth to bounce back to 12% in 2020, an outcome that assumes significant margin expansion. As mentioned, we are thoroughly skeptical regarding the possibility of double-digit earnings growth at this stage of the cycle.

... In spite of the concerns described above, our outlook is for relatively benign markets during the remainder of 2019, but followed by a rockier path in 2020 and 2021. Epoch has always favored companies that consistently and sustainably generate free cash flow, and possess superior managements with a proven track record of allocating that cash flow wisely between return of capital options and reinvestment/ acquisition opportunities. We believe such companies are the most probable winners and the ones most likely to provide investors with the best returns. In today's challenging, late-cycle investment environment we believe these principles are ever more important.

Gold up on trade angst

Bart Melek, Head of Commodity Strategy, TD Securities

The following is a lightly edited excerpt from TD Securities' Commodities Weekly newsletter, published on May 7.

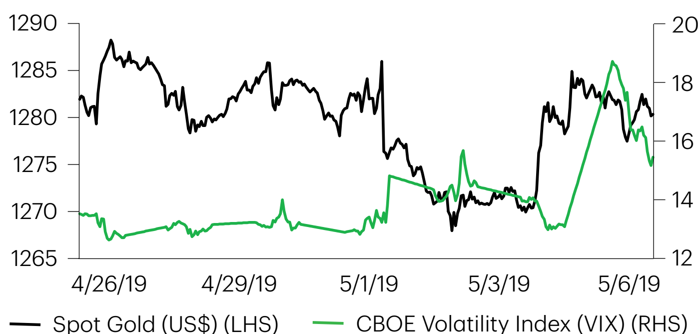
U.S. equities, copper and crude oil all plunged after critical trade talks with China seem to have collapsed, renewing concerns that a full-blown trade war between the world's largest economies may materialize. The market turmoil started after President Trump slammed China in a tweet that stated he is willing to impose tariffs on virtually all imported goods.

He tweeted that "The Trade Deal with China continues, but too slowly, as they attempt to renegotiate. No!" ... "The 10% will go up to 25% on Friday. 325 Billions Dollars of additional goods sent to us by China remain untaxed, but will be shortly, at a rate of 25%." The U.S. president then restated that message, tweeting, "The United States has been losing, for many years, 600 to 800 Billion Dollars a year on Trade. With China we lose 500 Billion Dollars. Sorry, we're not going to be doing that anymore!"

Despite the very harsh words from the White House directed against China, equities, crude oil and copper all rebounded after the initial shock. Indeed, gold also moderated from its daily high, which suggests that there was some return of risk appetite.

The market seems to believe that the U.S. president is making aggressive statements in order to incentivize his Chinese partners to come to a deal sooner rather than later, and it does not signal a willingness to enter a full-blown trade war. For commodities this is good news, as a trade war is almost always very bad for prices. Less trade means less demand, which almost always translates to looser markets or surpluses. Indeed, it is no surprise that commodities and other assets sold off immediately following Trump's tweet attacks. However, once the market gave itself permission to be hopeful a deal will materialize, prices rebounded.

Figure 3: Gold Rises on Volatility



Source: Bloomberg Finance L.P., as of May 13, 2019

While we do think that a trade deal will eventually be made between the U.S. and China, as we have argued for quite a while now, it will take time and the situation may still deteriorate temporarily. As such, following the recent rally in commodities, we don't expect much more improvement until there is more certainty. Conversely, nor do we expect another sharp rout.

Given the higher risk due to recent developments on the market and political fronts, and the fact that markets have already priced in the best-case scenario on the trade file and the economy, as the U.S. and China macroeconomic data moderates, any rebound is unlikely to get prices to highs seen recently in the near term, with the exception being gold (see Figure 3).

Still, short term OPEC+ supply discipline and Iran sanctions should help crude come close. Since base metals will not have the same help on the supply side, the recovery there is to be less robust. The higher market volatility and risk profile should see an increase of capital flows into gold from both private and official sectors. Gold at US$1,300 per ounce is well within reach.

Searching for the bottom

Beata Caranci, SVP & Chief Economist, and James Orlando, Senior Economist, TD Economics

Since the closing months of 2018, we noted that the first quarter of 2019 would be make-or-break for the global economy. The slowdown that took root was a reflection of overlapping event risks colliding with mature business cycle dynamics. Financial market volatility set in play rampant talk of recession, which risked undermining business and household confidence. Fortunately, improved financial conditions are now being followed by early signs of stabilization in the economic data that are closing out the first quarter. Even though the data are not blowing our socks off, we'll settle for a bottom forming in economic momentum.

Stable growth is enough to push risk assets higher

Overall sentiment towards risk assets has improved due to two main factors. The first was an easing in negative economic data surprises, and the second was the quick response by major central banks towards a dovish tilt (Table 1).

By the time March economic data began to roll in, a handful of key leading indicators, like manufacturing sentiment, offered some confidence in stabilization. At the same time, the service side of major advanced economies proved solid, as did labour markets. Importantly, there are two call-outs on this front.

Table 1: Central Banks 2019 Real GDP Forecasts

	Tightening Bias		"Patience"
	6 months prior	3 months prior	Today
U.S. (Q4/Q4)	2.5%	2.3%	1.9%
Canada	2.1%	1.7%	1.2%
ECB/European Commission	1.8%	1.7%	1.1%
Bank of England	1.8%	1.7%	1.2%

Source: Central Banks, as of May 13, 2019

When the going gets tough, China gets going on fiscal stimulus. A large injection of stimulus has underpinned market confidence that it's only a matter of months before real economic activity responds in kind. In turn, this will help shore up global trade flows. Across the pond, the U.S. economy was defiant in the face of negative market sentiment. The tracking for real GDP growth in the first quarter is coming in at around 2.5%. This is more than double initial estimates, despite a number of negative temporary factors hitting the quarter, such as a lengthy government shutdown and weather disruptions. The consumer was not in fine form, but did make a late-quarter appearance that will help propel economic momentum again towards the 2% mark in the second quarter.

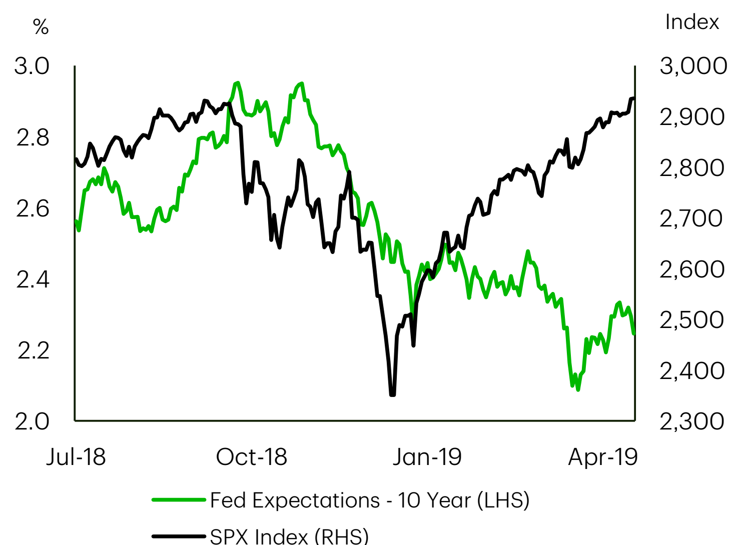
Market sentiment received a second boost from the decisive action of central banks, led by the Federal Reserve, to respond to deteriorating sentiment by putting future rate hikes on ice. This monetary support spurred risk taking, evidenced by an S&P 500 Index that is now at a record high (Figure 4) and corporate credit spreads that have dropped below their average since 2010.

Not only did the Federal Reserve use forward guidance to remove any market pricing for higher interest rates, it also announced an earlier end to the normalization of its balance sheet. Several Fed members went further in also hinting that they were open to cutting interest rates. The U.S. 10-year Treasury yield responded by dropping to 2.34% on March 28, causing the yield curve to invert against the three-month yield. This held for no more than a handful of days. Given the yield curve's strong track record of predicting recessions, its inversion captured significant market attention. However, a look back at history shows that inversions need staying power to have predictive power. In the U.S. and Canada, the yield curve has inverted for short periods (of less than a week) and not resulted in a recession on several occasions. The better recession signal occurs on yield inversions over the course of months.

The direction of bond yields

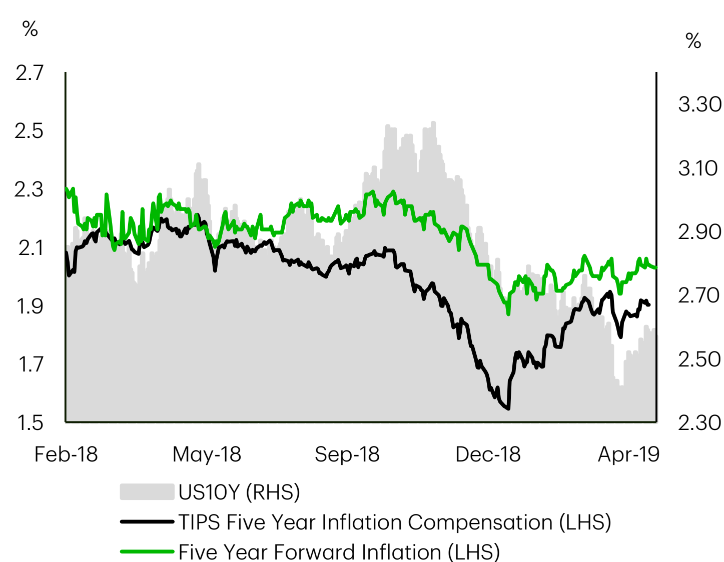
Nonetheless, the Federal Reserve's dovish tilt has prompted market participants to believe that the next move in the policy rate will be a cut. We view this as premature. In our view, the current level of the policy rate is right around the neutral level. If economic growth continues to stabilize as our tracking implies, then the Federal Reserve has got it right on rates just as they are. On the inflation front, market based measures have clearly bottomed (Figure 5) and with wages increasing above 3% on average, we forecast that core measure of inflation will begin to improve in the next couple of months. As the data begin to confirm this trend, market pricing for the policy path and inflation should unwind the pricing for a cut and offer some slight upside for Treasury yields. We maintain our year-end target of roughly 2.85% for the 10-year Treasury yield.

Figure 4: Equities Jump with Dovish Monetary Policy



Source: Bloomberg Finance L.P., TD Economics L.P., as of April 24, 2019

Figure 5: Market Pricing for U.S. Inflation Stabilizing



Source: FRB. TD Economics, as of April 24, 2019

A sustained break above this mark would likely need a few conditions to materialize. Importantly, inflationary pressures would have to become significantly more threatening. By extension, economic momentum would have to heat up much more than we are currently expecting. Likewise, global risks would need to recede. Europe is front and centre in our minds. With Italian bank weakness, populist disruptions in France, and Germany's dependence on trade flows, growth in Europe is treading water. It would not take much of a data miss to undermine confidence once again in the region's prospects. And, it may get worse for them yet. As progress occurs with U.S./China trade talks, the U.S. Administration is now lining Europe and Japan within its sights as the next target. China had the luxury of high growth during the tit-for-tat tariff inflictions, which is not afforded to the economies of either Europe or Japan. Lingering economic threats will ultimately cap the upside for yields globally.

Taking Canada's pulse

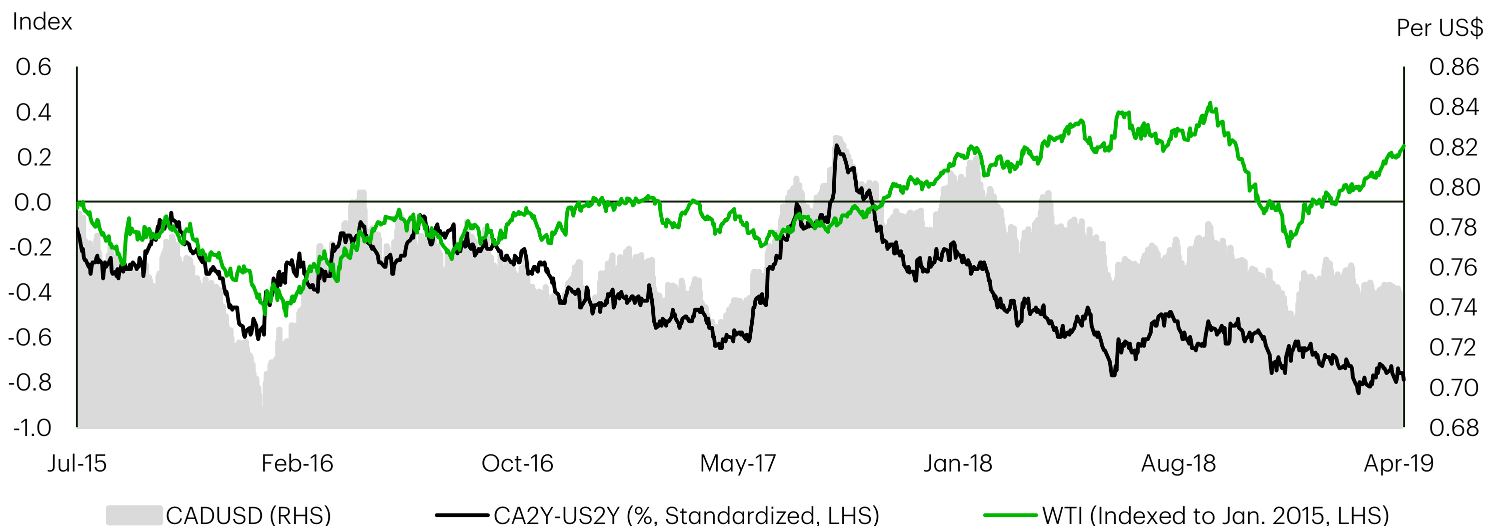
The Canadian economy has also showed some signs of stabilization. The first quarter was a blow-out in terms of job creation, even with the slight pullback that occurred in March. China's fiscal stimulus announcements have caused a rebound in broader commodity prices. Likewise, Alberta's initiatives to narrow oil spreads via production curtailments have proven successful, alongside a rebound in oil prices more broadly due to global developments. Lastly, the Bank of Canada has tempered investor nerves. It too followed in the footstep of the Federal Reserve by tilting to a more dovish stance and downgrading the outlook in alignment to the reality of the data. Government yields have subsequently dropped and mortgage rates are starting to follow. This will help highly levered Canadian households, particularly as the housing market remains stuck in a cooling pattern.

For the Canadian dollar, there isn't a lot of scope for a sudden upward push. It has been largely range-bound between 73 and 77 U.S. cents since last summer. Several dominant factors play into why this is the case. In a typical econometric model, a handful of variables capture the bulk of the movement of the loonie. These are energy prices, U.S.-Canada yield spreads, and the market's perception of risk. When movements in these variables fail to largely "explain" changes in the value of the dollar, the residual gets larger, indicating that there's more going on than meets the eye. Over the last few months, there have been offsetting push and pull forces coming from the main variables. Commodity prices and risk-on sentiment have supported the loonie, while yield spreads have pushed against this dynamic (Figure 6). More interestingly, the residual has captured a greater-than-usual amount of significance. We suspect this is likely due to political risk and related economic uncertainty, stemming from both the international front, as well as domestic issues related to developments in the energy sector. So just like we think there's some, but limited, upside to yields, the same holds true on the Canadian dollar, as long as U.S.-Canada interest rate spreads remain constrained (and we think it will) and geopolitical risks remain in play.

Bottom Line

The global economy is starting to show signs of improvement. This is good news, but it's premature to get excited given its early days and now the test will be on evidence that momentum can indeed strengthen into the second half of this year. Despite firming economic momentum, the multitude of significant global risks will likely continue to limit the degree to which bond yields can make any significant headway.

Figure 6: CAD Stuck Between Oil and Yield Spreads



Source: EIA, FRB, WSJ, TD Economics, as of April 24, 2019

Market performance

		(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)
Canadian Indices ($CA) Return	Index	1 Month	3 Months	YTD	1 Yr	3 Yrs	5 Yrs	Since 1/1/2012	10 Yrs	20 Yrs
S&P/TSX Composite (TR)	57,541	3.22	7.55	16.94	9.60	9.10	5.60	7.74	9.07	7.01
S&P/TSX Composite (PR)	16,581	2.97	6.69	15.76	6.23	5.92	2.50	4.56	5.92	4.40
S&P/TSX 60 (TR)	2,796	3.94	7.92	16.97	11.48	10.13	6.68	8.55	8.97	7.13
S&P/TSX SmallCap (TR)	935	-0.27	2.56	10.41	-6.77	1.78	-0.61	1.86	7.09	-
U.S. Indices ($US) Return	Index	1 Month	3 Months	YTD	1 Yr	3 Yrs	5 Yrs	Since 1/1/2012	10 Yrs	20 Yrs
S&P 500 (TR)	5,894	4.05	9.48	18.25	13.49	14.87	11.63	14.67	15.32	6.05
S&P 500 (PR)	2,946	3.93	8.94	17.51	11.25	12.57	9.35	12.31	12.94	4.04
Dow Jones Industrial (PR)	26,593	2.56	6.37	14.00	10.06	14.37	9.91	11.19	12.53	4.61
NASDAQ Composite (PR)	8,095	4.74	11.17	22.01	14.56	19.24	14.49	16.72	16.77	5.96
Russell 2000 (TR)	7,964	3.40	6.50	18.48	4.61	13.60	8.63	12.51	14.10	8.16
U.S. Indices ($CA) Return	Index	1 Month	3 Months	YTD	1 Yr	3 Yrs	5 Yrs	Since 1/1/2012	10 Yrs	20 Yrs
S&P 500 (TR)	7,911	4.51	11.80	16.34	18.69	17.48	16.25	19.10	16.68	5.61
S&P 500 (PR)	3,954	4.39	11.25	15.62	16.34	15.12	13.88	16.64	14.26	3.61
Dow Jones Industrial (PR)	35,695	3.02	8.63	12.16	15.09	16.97	14.46	15.48	13.85	4.18
NASDAQ Composite (PR)	10,866	5.20	13.53	20.04	19.81	21.94	19.24	21.23	18.15	5.53
Russell 2000 (TR)	10,690	3.86	8.75	16.57	9.40	16.17	13.13	16.86	15.44	7.71
MSCI Indices ($US) Total Return	Index	1 Month	3 Months	YTD	1 Yr	3 Yrs	5 Yrs	Since 1/1/2012	10 Yrs	20 Yrs
World	9,070	3.60	8.25	16.70	7.08	12.02	7.91	11.53	12.20	5.33
EAFE (Europe, Australasia, Far East)	7,988	2.91	6.33	13.33	-2.73	7.77	3.09	7.77	8.45	4.32
EM (Emerging Markets)	2,429	2.12	3.24	12.30	-4.68	11.66	4.42	5.09	7.87	8.21
MSCI Indices ($CA) Total Return	Index	1 Month	3 Months	YTD	1 Yr	3 Yrs	5 Yrs	Since 1/1/2012	10 Yrs	20 Yrs
World	12,174	4.06	10.54	14.82	11.98	14.56	12.38	15.83	13.53	4.90
EAFE (Europe, Australasia, Far East)	10,722	3.37	8.58	11.50	1.73	10.22	7.36	11.94	9.73	3.90
EM (Emerging Markets)	3,260	2.58	5.43	10.49	-0.32	14.19	8.75	9.15	9.14	7.76
Currency	Level	1 Month	3 Months	YTD	1 Yr	3 Yrs	5 Yrs	Since 1/1/2012	10 Yrs	20 Yrs
Canadian Dollar ($US/$CA)	74.50	-0.44	-2.08	1.64	-4.38	-2.22	-3.98	-	-1.16	0.41
Regional Indices (Native Currency) Price Return	Index	1 Month	3 Months	YTD	1 Yr	3 Yrs	5 Yrs	Since 1/1/2012	10 Yrs	20 Yrs
London FTSE 100 (UK)	7,418	1.91	6.45	10.26	-1.21	5.92	1.82	4.73	5.74	0.01
Hang Seng (Hong Kong)	29,699	2.23	6.29	14.91	-3.60	12.13	6.06	8.06	6.70	4.09
Nikkei 225 (Japan)	22,259	4.97	7.15	11.21	-0.93	10.13	9.25	18.17	9.69	1.45
Benchmark Bond Yields		3 Month		5 Yr		10 Yr		30 Yr		
Government of Canada Yields		1.67		1.61		1.77		2.00		
U.S. Treasury Yields		2.42		2.34		2.54		2.93		

Canadian Bond Indices ($CA) Total Return	Index	1 Month	3 Months	YTD	1 Yr	3 Yrs	5 Yrs	Since 1/1/2012	10 Yrs
FTSE TMX Canada Universe Bond Index	1,091	2.25	2.43	3.80	5.22	2.65	3.65	3.25	4.39
FTSE TMX Canadian Short Term Bond Index (1-5 Yrs)	725	1.11	1.33	2.00	3.64	1.57	1.87	1.96	2.48
FTSE TMX Canadian Mid Term Bond Index (5-10 Yrs)	1,186	2.28	2.45	3.92	6.32	2.39	3.68	3.57	4.92
FTSE TMX Long Term Bond Index (10+ Yrs)	1,814	3.73	3.89	6.16	6.58	4.24	6.09	4.76	7.12

Sources: TD Securities Inc., Bloomberg Finance L.P. TR: total return, PR: price return, as of April 30, 2019.

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