TD Wealth

Capital Markets Overview

Spring 2017

Review - First Quarter of 2017

Here are the returns for the popular indexes for the first quarter of 2017:

TSX Composite Index (TSX)	2.4 %
S&P 500 Index (CDN $)	5.0 %
Popular bond index	1.2 %
Preferred share index	6.25 % (approximately)
90 day Treasury Bills	.1 %

Source: Bloomberg Finance L.P., 2017 annual returns

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Following the solid performance of our model portfolios in 2016, we lagged a little bit in the first quarter of 2017 as we managed1.7% in the Canadian model and 4.6% U.S. in the U.S. model (see section on Model Portfolios). We are happy with these results and believe that by including our selections of preferred shares, we were able to match the benchmark returns on a net to net basis.

As outlined in our Winter Capital Markets Overview (CMO), the big decision for most of you – *IF you want better returns* – is to give us the appropriate Investment Profile (see later in this CMO) and hence the appropriate asset mix of 'fixed income' and 'equities' ('common shares', or 'stocks'). *This depends on your risk tolerance* – so please keep reading this CMO. While the U.S. Federal Reserve (the Fed) have now started to increase interest rates, they remain very low relative to historical levels and fixed income returns will likely be poor to negative as yields rise. We will do our best to earn you a positive return in Fixed Income markets but it will be a very difficult period for most bonds and other fixed income positions. You can only invest in 2 primary asset classes – (1) Equities, and (2) Fixed Income (with Cash Reserves being a sub-sector of the Fixed Income asset class). ***Clients must make their own 'asset mix' decisions by giving us the appropriate Investment Profile***. This aspect of our investment advisory services to you is ***not*** covered by our 'discretionary service'. Discretionary portfolio management decisions are done at the portfolio level – NOT at the asset mix level. Your asset mix 'precedes' our discretionary portfolio management service. We hope everyone clearly understands this. We can only give you our ADVICE with regard to your individual asset mix or investment profile – but that is NOT part of the discretionary service that we offer. Call us if you do not understand.

Let us move to a quick discussion of the fixed income and equity markets. The last recession that we experienced was in late 2008 and into early 2009. That was a full 8 years ago!! The stock market does NOT like recessions because corporate earnings usually decline and as a result, pulls the market prices for most individual companies down. The business cycle that has since occurred over the past 8 years has witnessed rather sluggish economic growth rates in the 2% annual range – rather than 3% to 4% more normal rates. We forecasted this trend if you care to re-read our previous CMO's. Many consumers have hit the wall and can spend no more.

The TSX hit a low of 7,479 in March, 2009. It closed March 31, 2017 (this Friday past) – at 15,547. This is a gain of 8,068 points or 108% over the past 8 years – a simple average of 13.5% per annum (plus dividend yield). This is an impressive annual return given the sluggish economic growth rates; perhaps too impressive and we are a tad worried that the markets are ahead of themselves. Since 1959, we have kept track of the business cycle returns. We feel 58 years is enough historical data to identify trends. But economies do change (i.e. compare technology trends today with what they were in the 1960's). Over the past 58 years, we have had 7 business cycles with an average length of 7 years. So at 8 years the current cycle is getting a little 'long-in-the-tooth'. The average length of the recession that followed each period of economic growth is 1.3 years and the average decline for these 7 recessions is a negative 11.5% but could be higher if measuring just the time period of the recession.

We, at Arnaud Wealth Management Group (AWMG), try our best to avoid recessions. BUT there are no guarantees. Here is our forecast for Equities and Fixed Income returns:

Fixed Income – the Fed have increased short term interest rates 3 times by 25 basis points each time. We feel that the markets have priced 3 more rate hikes in 2017. *This is NOT good for fixed income returns*. The yield on a 2 year U.S. government bond is 1.25% while the yield on a 10 year government bond is 2.39% - a positive spread of 1.14% or 114 basis points. In Canada, the 2 year yield is 0.76% while the 10 year yield is 1.63% for a spread of 0.87% or only 87 basis points. Obviously, the Bank of Canada is not as willing to increase rates as much as the Fed. But 3 more 25 basis point hikes over the balance of 2017 – in either country - might eat into these spreads and the yield curve could head towards becoming 'flat' or 'inverted'. This would definitely forecast a pending slowdown or recession. Inflation trends MUST NOW BE WATCHED VERY CAREFULLY. Returns are going to be muted in fixed income land over the next 2 or 3 years. Preferred shares – a sector of the fixed income markets and the sector we have liked a lot in the past year or so – are up 6% in the first quarter of 2017 but most preferreds – according to David Arnaud – the AWMG team's fixed income specialist are now fairly valued and becoming expensive. To quote David – "nothing is cheap any more in fixed income land – credit spreads are really tight". We would not be surprised to see very low to negative returns in the next couple of years with Fixed Income portfolios. Please be forewarned!! The bottom line for this asset class is to expect 'income only' – returns will disappoint in 2017 and going forward for two or three years.

Equities – it is becoming more and more difficult to find undervalued equities – most companies are fairly to over valued. Most clients want a properly diversified portfolio – implying at least 20/25 individual selections. While very difficult to predict, I might suggest that as many as 50/60% of a particular 20/25 stock portfolio are fairly to fully valued – some overvalued. That said, we do <u>NOT</u> see a recession on the near or intermediate term horizon (say the next 1 to 2 years) so we do <u>NOT</u> feel our clients are exposed to a large recessionary correction (i.e. 20%- +++- remember 2008 when the market was down 50% - most of you do). However, we could easily get a 10%+ correction. The last correction we had in Canada was between April, 2015 and January, 2016 when the market went down 24% thanks largely to the decline in oil and gas prices. During the same period in the U.S., the S&P 500 Index declined only 8.3% and most Canadian clients did not feel much pain because the CDN Dollar declined along with oil and gas prices. Here is a look at oil prices in the past 3 years:

March, 2014	$101.58
March, 2015	$ 47.60 (down 53%)
March, 2016	$ 38.34 (down a further 19%)
March, 2017	$ 50.60 (UP 32%)

Source: Bloomberg Finance L.P., 2017 annual returns

We believe that oil prices should trend higher – perhaps to $65/70 ++ and this will help oil and gas stocks. Our target for the TSX is 16,000 (now at 15,547) and we 'may' have to revise it upwards to a higher level if oil prices move higher before reducing exposure for a recessionary decline down the road. But there exists a definite possibility of a 10%+ correction and we are cautious at the moment and raising our cash reserves in both our Canadian and U.S. models. We may even buy some 'portfolio' puts as portfolio insurance if we feel strongly about a correction – this is to help protect a portion of your portfolios. There is a saying in our business that you should "sell in May and go away". It is now April – so if we are to have a correction – it could be soon. Just an educated guess on our part but we believe in seasonal trends.

Here are some comments about equities from Dave. His overview of Donald Trump is that he has failed twice now on healthcare and travel bans and he may want to get on board with tax cuts as soon as possible but if the Border Adjustment Tax gets any wind behind it, he could get another loss – this would NOT be good for equity markets. Without strong earnings (we will find this out in the next couple of weeks as companies report 1st Q earnings) or global growth recovery – the equity market could correct the way it did 6 month's into Reagan's Presidency. Dave looks for a 2nd half bounce in energy prices. We are both on side with this forecast.

The bottom line for equities is to be cautious for the next few months (April through July) and expect a modest correction. Our target is still 16,000 for TSX but we would prefer a lower entry point for most of our newer equity selections.

Our Investment Profiles (repeated from our Winter CMO)

We operate with 7 basic Investment Profiles and have updated them since moving to TD Wealth Private Investment Advice. We occasionally ask you to complete a Profile questionnaire which analyzes your objectives *and* risk tolerances. This exercise leads to a Basic Investment Profile with the associated 'asset mix'. You are free to redo the questionnaire at any time on a voluntary basis although we may ask that you do it every 7 or 8 years pending our views of the capital markets. We are NOT yet ready to ask you to do this but it will occur likely in the next 2 or 3 years. Here are the profiles with an upper and lower asset mix constraint *AND a 'target' level*:

	Cash Reserves (no risk)	*Fixed Income (less risk)*	*Equities (more risk)*
Ultra Conservative	0% to 100% - **target 75%**	0% to 40% - **target 25%**	**0%**
Conservative Income	0% to 100% - **target 30%**	0% to 100% - **target 50%**	0% to 35% - **target 20%**
Balanced Income (Conservative)	0% to 30% - **target 5%**	50% to 90% - **target 60%**	10% to 50% - **target 25%**
Balanced (Conservatively Balanced)	0% to 30% - **target 5%**	40% to 70% - **target 45%**	25% to 65% - **target 35%**
Balanced Growth (Aggressively Bal)	0% to 30% - **target 5%**	20% to 60% - **target 30%**	45% to 75% - **target 50%**
Growth (Aggressive)	0% to 50% - **target 5%**	0% to 50% - **target 10%**	50% to 100% - **target 70%**
Aggressive Growth (V Aggressive)	0% to 60% - **target 5%**	0% to 60% - **target 0%**	70% to 100% - **target 80%**

Note that target levels above do not necessarily add to 100%. The difference is allocated to Alternatives.

Using and Understanding the Importance of Your Investment Profile

You can change your profile at any time. BUT it will likely require you to re-sign an Investment Policy Statement for each change. I would like to give you an example.

First, however, you should note the 'Target' levels above. This is what we normally strive towards in managing your investments and portfolios with us. *We believe our Target Levels are quite conservative*. For example, Canada Pension has about 60% of your assets in Equities – see above for how we might classify this (i.e. between Aggressively Balanced and Aggressive). Do you think the CPP program with 60% in equities is aggressive? If you have any questions – please do not hesitate to contact us.

As an example, let us assume you were a client with a 'Balanced (Conservatively Balanced)' profile above. Let us further assume you had this profile for all of 2016 and that we managed your portfolio according to the asset mix outlined above:

5% would have been assigned to Cash Reserves = 5% of 90 day T-Bills of 0.5% = 0.025%

45% would have been assigned to Fixed Income = 45% of Popular Bond Index of 1.7% = 0.765%

35% would have been assigned to Equities as follows:

25% to the CDN equity market of 21.1% = 5.275%

10% to the U.S. equity market of 12.0% = 1.20%

15% would have been assigned to the 'Alternatives' asset class = estimated at 1% return

Total potential return before management fees = 8.265%

Less management fees – using estimate of 1.4% = 6.865%

I might suggest that most of you had returns in excess of 6.865%. But 6.8% is very reasonable for 2016 – all things considered. Again, please call us if you do not agree or wish to change your Investment Profile.

Given the fact that the TSX was up 21.1% last year – please do not immediately jump to the conclusion that your return is far too low. If you have asked us to manage your investment assets in a conservative manner and you were assigned 1 of the first 4 Investment Profiles above then– the highest possible return that you would have achieved is 6.865% - NOT 21%. To achieve a return closer to 21% you had to inform us to move you to a more aggressive profile. Even if you had chosen the more aggressive 'Growth' profile – your net return would have only been 13.69% - NOT 21%. You can easily do the math yourself – I have given you all the numbers you need. ***It all depends on how much you want in equities or stocks!!!*** All this said, we caution you that this is NOT the time to get greedy. Please review the 58 year ROR provided in our Winter CMO. Do NOT misunderstand. We do NOT think we are heading into a recession in the near term. So we feel comfortable with our target of 16,000 for the TSX in the next year or so. We need you to understand that if you ask us to be 'conservative', then we believe you should accept 'conservative' returns. This is likely to mean returns will be lower than you might otherwise prefer for the next couple of years or so until we have and get through the next recession. Then you may increase your exposure to equities when they have declined due to a future recession. We feel that this is the more conservative route and patience is key.

Fees

I would like to spend some time on the subject of 'fees'. To our clients this is an expense and some of you might think they are too high. There exists a lot of coverage of this subject in the media. Here is the fee structure that TD Wealth recommends (they allow us to charge more – a 'premium fee' and also less – a 'discount fee') as the 'standard fee structure'. Beside it I have indicated our AWMG fee structure – this is for portfolios that wish to have more than 25% in equities (the theory being that you want potential solid returns and this generally speaking can only come with a weighting of 25% or more in the equity markets). Fees are also a function of the size of your portfolio – the higher the size, the lower the percentage fee.

Portfolio Size	TD Recommends	AWMG Charges - more than 25%	AWMG Charges - less than 25%
$100K to $499K	2.00% or 1.50%	1.95%	1.40%
$500K to $999K	1.75% or 1.25%	1.70%	1.15%
$1MM to $1.9MM	1.50% or 1.00%	1.40%	0.85%
$2MM to $4.9MM	1.25% or .75%	1.15%	0.75%
Above $5MM	Negotiable	Negotiable	Negotiable

Mutual fund fees are generally higher than the above percentages but this would require a long explanation and most of their fees are hidden – so call us if you would like an explanation. You should also note that a 'transaction cost' for buying/selling anything is normally NOT included in a mutual fund MER (Management Expense Ratio) and this can be a very misleading expense if the Portfolio Manager is even a little proactive in the pursuit of returns. Furthermore none of the mutual fund fees are tax deductible whereas our fees above ARE tax deductible for taxable portfolios and we have found a method for reducing the fees for registered accounts (i.e. RSP's, RIF's, and TFSA's) to ease the expense burden – after tax – to our clients (please call us to ensure this option is applicable in your situation). Our fees are 'higher' than the fees in an ETF (Exchange Traded Fund) but again the management expense of an ETF is NOT tax-deductible and there are hidden buy/sell transaction costs to also consider.

Years ago, I was among the very first advisors in the investment industry to switch to charging a flat fee for my service. The reason for this was because I got very tired of apologizing and justifying the large percentages that were charged for each trade on a commission basis (about 2/3%+). For example – we have made 20 changes to our model portfolios so far in 2017 (the past 3 months). We have an $800,000 CDN model and a $340,000 U.S. model = $1,140,000. Let us assume this is a 40% equity weighting of a $3,000,000 total portfolio (the balance going into preferred shares and/or bonds/GIC's). Per the above – the fee on a $3 million portfolio would be $3,000,000 times 1.15% = $34,500 annually or $8,600 per quarter (some or all of this may or may not be tax deductible). The cost of 2% commissions on the 20 trades would be $9,000 and we have not even discussed the cost of buying $1,860,000 of Fixed Income investments (such as preferred shares and/or bonds). Charging a client 'commissions' can be 'very expensive', the tax treatment is also different, so I would rather charge a flat tax deductible fee. Some clients say – "Well, Tim, I wish to buy-and-hold for the long term and charging me a 2% commission is not all that bad if looked at over a 10 to 20 year period". I agree – but only if you truly mean you can buy-and-hold an equity portfolio through a recession where the declines can be around 20% to 40% - on average. I have yet to meet any client that can do this without making me feel very guilty for not warning them prior to such a decline.

Discretionary versus Non-Discretionary Fees

The other issue that must be discussed is the difference between 'discretionary' and 'non-discretionary'. Our fees are the same for both services. You have a choice to be charged:

1. A full service commission every time a trade is executed. And you must approve the terms of the trade being executed in advance. This is usually 2% or 3% per trade – bonds being about 1%.
2. A full service advisory fee (see above for the rates) but you must approve the terms of the trade being executed in advance.
3. A full service discretionary fee (same rates as above) but we decide on the entire makeup of the portfolio – the sectors and stocks that we choose are our decisions – NOT yours.

You can have all 3 of the above if you want but you will need 3 separate accounts and you must keep track of everything and this can get very onerous.

What Would We Recommend?

Without any reservation – we strongly suggest that you let us use our 'discretionary' powers and let us make the bulk of the decisions (i.e. – Number 3. above). That is – give us your portfolio and let us use our 'years-of-experience' to make most of the decisions. We are not always going to be right but I do not know of very many clients that have our level of knowledge. And clients must understand that we cannot call you as frequently as you might like because we spend much of our time analyzing what/when stocks, bonds, preferred shares, etc. to buy and what/when to sell. There is one decision we cannot make and that is your 'Investment Profile' and by extension – your 'Asset Mix'. Every client must make this decision within reasonable parameters but we suggest it be done in accordance with the direction of the business or economic cycle. Keep reading this CMO and perhaps you will understand.

Model Portfolios

Canadian Equity model

After a stellar 2016, so far in 2017, this model is doing reasonably well and has closely matched the TSX Index benchmark. You may recall that we revamped this model a year ago in March, 2016 and moved away from 2 Canadian models with different objectives (growth versus dividend income) to one model thereby combining these goals or objectives.

We are currently making a few changes – selling our Prometic Life and eventually our entire position in Western Energy Resources and may soon sell Liquor Stores, Cargojet, and Evertz if it moves a little higher. The objective of these moves is to increase the Cash Reserves in the model portfolio to about 20%

In the Interest-sensitive Sector, we hold **T D Bank (4.4%), Element Financial (2.9%), and Brookfield Asset Management (4.0%)**. In the Consumer Sector we hold **Parklawn Corporation (4.9%), Maple Leaf Foods (4.4%)**, **Liquor Stores (4.3%), K- Bro Linen (4.4%),** and **Medical Facilities (4.2%)**. In the Industrials Sector, we hold **Air Canada (6.4%), Cargojet (6.3%), Evertz Technologies (4.8%), Aecon (4.1%), and Chorus Aviation (12.4%)**. Finally, in the Resource sector, we hold **Parex Resources (8.0%), Western Energy Resources (3.9%), Trans Canada Pipe (3.9%)**, we added a position in **Altagas Receipts (3.5%)** to go along with our final position in **Encana (5.8%).** I have highlighted the weight for each position in parentheses.

U.S. Equity Model

We have made many changes in the first quarter of 2017. We sold our positions in Bristol Myers, Visa, Amazon, Home Depot, Intel, and Unilever and bought positions in **Merck, Western Digital, Newall Brands, General Electric, Microsemi, Monsanto, and AIG Warrents while adding to Gilead.** In the Interest-sensitive Sector, the model holds **Bank of New York Mellon (7.4%)** and **AIG Warrents (4.5%)**. In the Consumer Sector, we have **Merck (4.8%), Starbucks (5.4%), Gilead Sciences (5.8%)**, and **Newall Brands (5.9%).** In the Industrials Sector, there is **Delta Air (4.9%), Google (12.3%), Allergen (5.5%),**

General Electric (5.5%), Microsemi Corp (4.6%), Western Digital (8.7%), and Monsanto (5.7%). We have no holdings in the Resource Sector – allowing our Canadian Model to do the work for us in this regard. Our positions above combine for an 81.0% weight and we hold a 19.0% weighting in Cash Reserves to reflect our cautious position.

Some Tax and Financial Planning Items

Insurance Needs

As part of the AWMG wealth approach, our team incorporates insurance solutions to help provide protection and manage the risks of our clients. We can connect you with Graeme Gordon, Estate Planning Advisor with TD Wealth Insurance Services who would be happy to meet with you and explore insurance products to help complement your needs. He can offer competitive rates from some of the country's leading insurance companies for term and permanent (Universal and Whole Life) life insurance, disability, critical illness and long-term care insurance products. Should you like to explore insurance solutions options, please contact Tim Arnaud at 416-512-6181 who can connect you with this TD Specialist.

Synthetic Loans

A synthetic loan is another means of obtaining affordable capital. As long as you have non-registered assets that can be used as collateral, we can raise inexpensive forms of debt in the market by borrowing/short selling Government of Canada Bonds. This strategy sounds complicated but it isn't at all. We then provide you (or other family members) the funds with the proceeds raised from borrowing and shorting the bonds. The rate of the loan is based on the bond's yield to maturity. In most cases these yields are substantially lower than conventional bank lending rates. This interest is also tax deductible. Short selling does involve some risk. It also involves the potential for capital gains if yields rise. Please contact us to learn more about Synthetic Loans so that we can discuss in detail the potential benefits (and risks) of this strategy to determine if this could be suitable for you. We think that it may be a good idea to explore this option should you wish to borrow funds.

RSP and TFSA Contribution Limits

The 2017 contribution limit for TFSA's is $5,500 bringing the maximum total limit to $52,000. If you are uncertain whether you have made all your contributions you may call Revenue Canada (Rev Cda) at 1-800-959-8281 and press * to speak to an agent. Unfortunately we cannot do this for you since Rev Cda will only speak to you.

The 2016 limit for RSP's was $25,370 (this has passed). The limit for 2017 is $26,010 and you can do this at any time this year up until March 1, 2018 and the limit for 2018 is $26,230.

Investment Policy Statements

TD Wealth have made changes to their IPS's (Investment Policy Statements) so we will be sending you revised copies for you to sign. Now would be a good time to review your Investment Profile.

Spousal Loans

If one spouse pays more in taxes than the other spouse, it may be possible to set up a spousal loan to reduce total family taxes. Call us to discuss this aspect of tax planning. This should be done and we do all the paperwork and it costs nothing to do.

CRM 2 – New Client Statements, Return calculations, and fee disclosure

The regulatory body for the investment industry (IIROC) have told everyone that we must disclose fees being charged and calculate returns for all clients. While it has taken far too long for this to develop, we are thrilled and endorse all that will occur. In July, you will be receiving revamped client statements outlining your returns on a 'money-weighted' ROR basis. We currently provide you with returns on a 'time-weighted' basis and will inform you of the difference in our next CMO. Fees will be disclosed as well.

Summary

For as long as this business cycle lasts, we believe Equities will continue to outperform Fixed Income. Our target for the TSX remains at 16,000 and we will review this target if and when we get there. We do NOT think this is a 'risk-free' target and clients – especially conservative clients – should be forewarned. We are likely to be in the 7^{th} or 8^{th} inning of this 9 inning ball game if one wants to think of the business cycle as a ball game. We will keep all of you informed if we see any typical recession indicators on the horizon. Some have already started to occur such as high real estate values and rising interest rates. Rising oil and other commodity prices would be another. Should this occur, we will send you all a strongly worded message to reduce equity exposure. But we are NOT there yet. We could easily get a 10% 'correction' but NOT a necessary 'bear' market of 20%++. We will see you in June…..our best to all of you.

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