TD Wealth

BREXIT – The Electorate Awakens

Quarterly Commentary Q2 2016

In this issue

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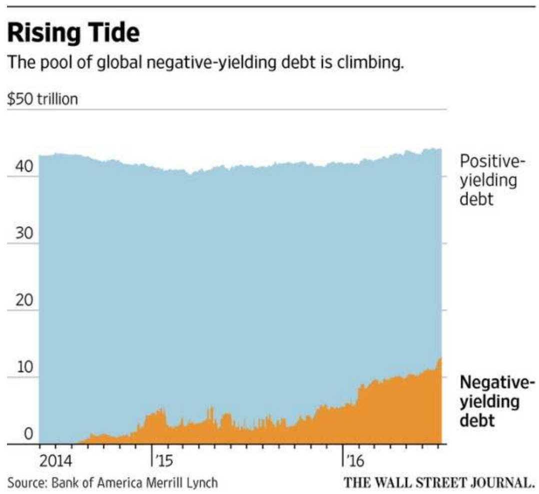
"The UK will extricate itself from the EU's extraordinary and opaque system of legislation: the vast and growing corpus of law enacted by a European Court of Justice from which there can be no appeal. This will bring not threats, but golden opportunities for this country – to pass laws and set taxes according to the needs of the UK". Boris Johnson- former Mayor of London, England

The British electorate has taken the historic action of voting to exit from the European Union (EU), ending a 43-year economic connection with Europe. Until the terms of separation are known, it will be difficult to predict the economic and fiscal impact on the British and European economies. Could the resulting uncertainty with regards to business investment and exports, in combination with rising anti-euro sentiment with other EU member states be enough to tip the EU into recession? A recession would then expose the underlying fragility of the European banking system, which has so far been insulated by Central Bank's extraordinary monetary policy, which has resulted in over US$13 trillion globally of negative yielding debt. If that were not enough, the U.S. Federal Reserve's (Fed) official stance on raising interest rates is at odds with its counterpart Central Banks, which are lowering them. International capital flows will continue to seek refuge in the U.S. and the Fed will be hard pressed to stop it without reversing policy. The fate of the global economy and equity markets are still inexorably linked to the actions or inactions of Central Banks. The Central Banks seemed to have painted themselves into a corner and are running out of options, with their credibility on the line. We see only one way out and that will involve significant Central Bank intervention, which will present challenges and opportunities for investors.



As of July 10 2016

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BREXIT

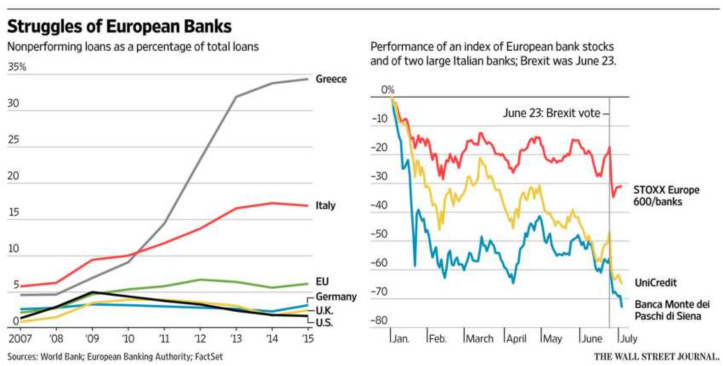
There is a growing discontent amongst the electorate, which is targeted at the career politicians and global elites. The majority of the working middle class and ageing baby boomers have slowly come to the realization that their elected representatives no longer represent them.

We have argued and will continue to argue that the Euro construct was flawed from its inception. A monetary union in the absence of a fiscal union and unified debt is an untenable situation, which will likely meet its eventual demise unless the EU itself is restructured. Although Britain had a unique relationship with the EU by maintaining control over its monetary policy, the remaining EU members have in effect ceded their domestic monetary policy to the European Central Bank (ECB), giving up their ability to confront domestic issues while having to comply with the onerous rules, restrictions and dictates of the EU. We will not be surprised if the EU faces more referendums as other independence movements gain momentum. This will only lead to greater uncertainty and increased international capital flows in favour of the perceived safety of U.S. Treasuries and U.S. dollar assets. This will likely impact the capital ratios of leveraged European banks, which have been kept on life support by the ECB. We believe that the Fed and its counterpart Central Banks will be forced to deal with the destabilizing impact of a strengthening U.S. dollar on emerging markets and commodity markets, not to forget the corporate earnings of U.S. multinational corporations.

In pursuing a "do whatever it takes" monetary policy, the ECB's negative interest rate policy has compounded the problem by squeezing bank's net interest margins, since they cannot easily pass on negative rates to depositors for fear of sparking bank runs. Not only are they damaging the financial institutions, they are crushing savers and retirees, many of which will have to save more and spend less once they realize retirement is becoming an unattainable goal. Increasing levels of debt in combination with high unemployment and low-interest rates are taking a toll on a restless electorate.

Global equity and fixed income markets will now have to contend with the fallout from Brexit and the increased likelihood that other EU member states will follow Britain's lead. The uncertainty is currently being reflected in the falling share prices of European banks, which are under intense scrutiny due to a rise in non-performing loans at a time when banks net interest margins are being squeezed by the ECBs negative interest rate policies.

There is a crisis mounting in Italy as the financial sector struggles under the weight of 360 billion euros of non-performing loans. The Italian Government has proposed a state bailout using taxpayer's money, but this would violate the EU Bail-In legislation, which took effect on January 1, 2016. The rules state that losses are to be borne by investors and shareholders before taxpayer's money can be used to help failing lenders. The situation is further complicated by the fact that European Banks have been shoring up their risk capital by issuing higher yielding contingent convertible bonds (CoCos), which can be converted to equity in the event of financial hardship. The trigger clauses vary but as Italian bank shares continue to fall, there is growing concern that the yield-challenged depositor and voters who bought the bonds will face losses. In the case of Italy, it is believed that over 40% of the Bank issued CoCo bonds were bought by unsuspecting depositors, who jumped at the chance to buy the higher yielding bonds, but did not fully understand the risks. **We suspect this is not just an Italian problem–it is a European problem, which explains why several notable European financial institutions share prices are under pressure. (See Q1 commentary regarding Deutsche Bank)**



As of July 5 2016

In our view, the EU and its member countries will have to act quickly to calm investors and depositors before panic sets in, and depositors rush to remove funds from troubled lenders. The ECB and global Central Banks cannot afford to allow the contagion effects of a European Bank failure to spread. They will have no choice but to respond or they will risk the fallout from the public's loss of trust in all banks including Central Banks. **Brexit is equivalent to the tide going out and we will soon find who has been swimming naked, or in other words, who is most exposed.**

U.S. Elections

The upcoming U.S. election is yet another sign of political upheaval as the presumptive nominees, Hillary Clinton (Democrat) will face off against Donald Trump (Republican). There is no point in discussing the merits of each campaign; this election can be stripped down to the bare bones. Clinton versus Trump is an election that pits the establishment candidate against the perceived anti-establishment candidate. There is no denying that Trump has struck a chord with voters who feel left behind and are fed up with the growing income inequality, unsustainable entitlement programs and a government that no longer represents their view of America.

The 2016 Presidential election threatens to be the most divisive U.S. election in recent memory and depending on the outcome, it will have implications for not only the U.S. economy but the global economy as well. Hillary Clinton is seen as the career political operative or establishment candidate who will medicate the masses with entitlements while maintaining the status quo. Trump, on the other hand is threatening to uproot the establishment including the backroom operatives who run the Republican Party. His campaign is focused on "making America great again" and his approach is to put America first when it comes to trade, particularly with China. Clearly, he is not aware that the Chinese maintain a quasi-currency peg to the U.S. dollar and even that is tenuous at best. Should he be elected and target alleged unfair trade practices, it could accelerate the timetable for Chinese Yuan devaluation. A devaluation of the Yuan will unleash a deflationary shock that Central Banks will have no choice but to confront with more extraordinary monetary policy initiatives, which we suspect will include outright debt monetization. A Trump Presidency may roil markets in the short term but should present opportunities for investors should Central Banks "do whatever it takes" as we have come to expect.

Markets

The Canadian equity market rose 5.1% in the quarter ending June 30, 2016, (9.8% YTD). The rise in the Canadian equity market was driven primarily by the energy and materials sectors as commodity prices continued to recover during the second quarter. In Q2/16, West Texas Intermediate (WTI) oil rose 26.1% (30.5% YTD), reaching a peak of US$51.23/barrel on June 8th, partly over concerns of oil supply disruptions resulting from the May wildfires in the Fort McMurray region. The price of gold bullion rose 7.3% in Q2 (24.6% YTD) with a large portion of the gains occurring due to the uncertainty leading up to and following the UK's surprise vote to leave the EU.

U.S. equities delivered mixed results in Q2/16 as the S&P 500 Index (S&P 500) gained 2.5% Q/Q (3.8% YTD) and the Dow Jones Industrial Index rose 2.1% in Q2 (4.3% YTD), while the NASDAQ composite returned -0.2% in Q2 (-2.7% YTD). On a year-to-date basis, the Canadian dollar rose by 6.7% against the U.S. dollar, detracting from relative returns for Canadian investors as the S&P 500 returned -2.5%, the Dow Jones lost 2.1% and the NASDAQ returned -8.6% in Canadian dollar terms.

Portfolio

We increased North American equity exposure during the quarter in advance of the Fed's interest rate decision when it became clear the Fed was not going to be able to raise interest rates. Although we were surprised by Brexit results, the portfolios holdings in U.S. Treasuries and precious metals exposure outperformed while most global equity markets fell more than 3-8%. We believe the Brexit vote will provide a positive backdrop for long bonds and precious metals and we will continue to be vigilant as we look for signs of inflation should the Fed fall behind the curve.

Conclusion

Notwithstanding Brexit and the upcoming U.S. elections in November, we believe that global equity markets will eventually refocus their attention back to the Fed and its ability (or inability) to raise rates. Having prepared markets for higher interest rates, the Fed has acknowledged that its domestic policy mandates, price stability (inflation) and low unemployment have taken a back seat to international imbalances.

We have argued over the past few years that Central Bank quantitative easing, which suppressed interest rates, boosted equity and fixed income markets and promoted debt-fueled growth was not sustainable and this would be proven once the Fed began the normalization process. The Fed must now try to unwind the imbalances it has created while preventing the U.S. dollar from strengthening. If it cannot raise interest rates as we suspect, they risk not only destroying what's left of their credibility, they also risk igniting inflation should they be forced into outright debt monetization, which in our opinion is the only way out of the debt induced deflationary cycle that is gripping Japan and now Europe and eventually North America. We can only hope that the Fed does not follow the Bank of Japan and the ECB down the path of negative rates before they come to the realization it does not solve the problem, it perpetuates it.

We remain focused on the U.S. dollar, the Yuan currency peg and the unfolding banking crisis within the EU. Although we expect markets to react favourably to the Fed pause on higher interest rates, we sense a period of greater volatility and uncertainty lies ahead as market participants come to understand why it is that Central Banks cannot raise interest rates. Although we have questioned and been critical of their policies, we must respect the fact that market participants continue to act on their confidence that Central Banks are able and prepared to continuously avert crisis. We see this as problematic but have come to accept that our opinions do not matter until they matter. In the meantime, we will continue to look for opportunities that will certainly unfold over the coming months and years.

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