TD Wealth

The Fear of Missing Out (FOMO)

Quarterly Commentary Q4 2017

In this issue

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Fake news, the threat of nuclear war, and the fear surrounding Donald Trump's Presidency did nothing to shake investors' confidence in 2017. The global economies have entered a synchronized growth phase driven by a heightened sense of optimism that Central Banks have accomplished their goal and are now in a position to withdraw their support. President Trump has embarked on a massive fiscal stimulus program that includes significant tax cuts for corporations and a trillion dollar infrastructure program which is expected to drive corporate earnings higher. Cryptocurrencies and marijuana stocks captured the fascination of investors, posting gains of 200%-2000%. Investor bullishness reached new heights as the Dow Jones Industrial Average (DJIA) and S&P500 index (S&P500) experienced record low volatility, having not experienced a down month throughout the entire year. The Economist magazine has labelled it the "bull market in everything". There may not be a lot of fear in today's market, and if there is, it is the **fear of missing out (FOMO).**

Have Central Banks succeeded in restoring the global economy to sustainable economic growth? Has their liquidity and suppression of interest rates for the past nine years distorted the pricing of risk and encouraged risk-taking under the pretense that Central Banks are the failsafe to faltering markets? We are about to find out as the U.S. Federal Reserve (Fed) attempts to withdraw liquidity and reduce its US$4.5 trillion balance sheet. There is no precedent for what Central Banks have done and there is certainly no road map to help guide us through the Central Bank generated bull market in everything. We have argued in the past that there will be no graceful exit for the Fed and although they may have been granted some breathing room with the rollout of the Trump administrations fiscal stimulus program, no one seems to be asking the question as to who will be financing these massive deficits. The bond market is already jittery adjusting to the Fed's withdrawal and now they will have to contend with much higher U.S. deficits and a potential lack of buyers for U.S. debt as the President goes out of his way to alienate foreign buyers with his tough talk on trade. The President is on the verge of igniting a trade war with the same foreign governments who have been significant buyers of U.S. debt and his fiscal stimulus program raises the prospects of an inflationary response that will not sit well with bond markets. As Central Bank liquidity recedes and global liquidity tightens later in the year, the pricing of risk may once again become relevant. In the meantime, equity markets are due for a pause but it appears to us that they want to go higher!

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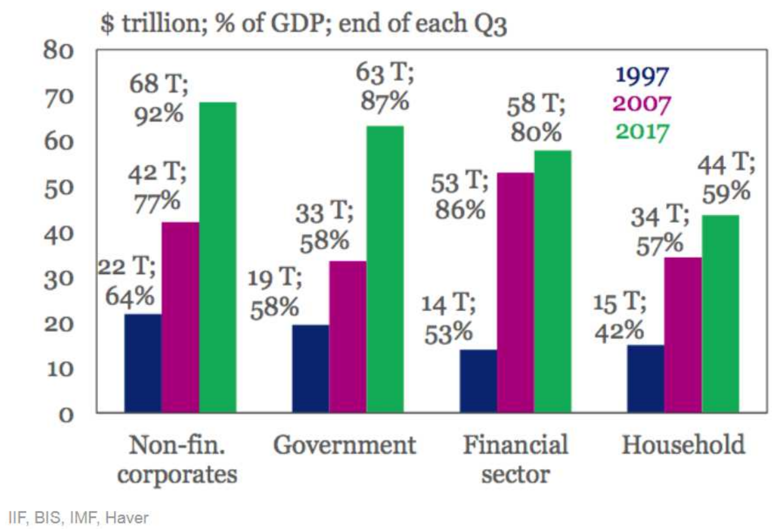
Follow the Money

The Central Banks have collectively expanded their balance sheets over the past nine years by almost US$20 trillion and although the Fed has begun the withdrawal process, its counterpart Central Banks in Europe and Japan continue to inject liquidity but have signaled their intent to withdraw later this year. That may prove to be a challenge, particularly for the European Central Bank (ECB), which has distorted its capital markets to such an extent that European junk bonds and Greek Gov't debt trade at lower yields than U.S. Treasury bonds. If the global economy continues to pick up the pace, leading to an unexpected rise in inflation, the combination of historically low-interest rates or negative interest rates in Europe and Japan could prove toxic for bond investors. Capital flows out of Europe or Japan could accelerate in favour of U.S. dollar assets.

We must now consider the potential impact of the extensive fiscal stimulus package President Trump is putting in place and what effect it will have on the U.S. fiscal deficit. The President has succeeded in implementing one of the most investor-friendly tax reform packages we can recall and heavily favours corporations over individual taxpayers, which will no doubt boost earnings. The President has also proposed a trillion dollar infrastructure program that will only add fuel to the fire, but it will also lead to much higher debt and deficits. The new Fed Chairman, Jerome Powell, will be facing some serious challenges over the coming year, not the least of which is reconciling the Fed's withdrawal from funding Gov't debt and with the President's agenda that will likely see debts and deficits soar. We suspect at some point, the Fed will have no choice but to reverse course if higher interest rates threaten to derail the economy, triggering a recession. According to the Institute of International Finance, global debt (gov't, corporate, and household) increased US$16.5 trillion during the first nine months of 2017 to US$233 trillion. The impact of higher interest rates would be felt globally and at all levels of the economy, particularly at the consumer level where global household debt stands at US$44 trillion. Debt service becomes a problem not only for the borrower but for the lender as well.



Institute of International Finance – January 4 2018

President Trump is relying on substantial fiscal stimulus in combination with renegotiated trade deals that he believes will accelerate U.S. growth, lead to higher wages and increased tax revenues. This is somewhat analogous to the logic Central Bankers used to justify QE, thinking banks would extend loans to willing borrowers who would invest in plant and equipment to meet the anticipated consumer demand that never really did materialize as expected. Most of the liquidity found its way into the financial system, boosting asset prices while consumers retrenched and recovered from the housing price and stock market collapse. The Trump fiscal stimulus heavily favours U.S. corporations and this has not gone unnoticed by U.S. equity markets, which have rallied 40% since the Presidents election.

President Trump has deservedly taken credit for the stock market rally and his plans to introduce significant infrastructure spending are fueling the rally. It is highly unusual to bring out a massive stimulus in the later stages of an economic recovery, but it is clear the President is priming the pump in hopes of a Republican sweep in the mid-term elections in 2018, and a strong set up for his second term in 2020.

Trump's Fed

Prior to his appointment as Fed Chairman, Jerome Powell had been critical of the Fed's policies and it remains to be seen if he will embark on a new course or follow the accommodative stance of his predecessor's. For some perspective, back in 2012, Powell stated, "**I think we are actually at a point of encouraging risk-taking, and that should give us pause. Investors really do understand now that we will be there to prevent serious losses. It is not that it is easy for them to make money but that they have every incentive to take more risk, and they are doing so".** Fairly strong words from what was then a relatively unknown Fed governor who will now lead the most powerful Central Bank in the world. In referring to the Fed's expanded balance sheet, Powell stated, "**Why stop at $4 trillion? The market in most cases will cheer us for doing more. It will never be enough for the market. Our models will always tell us that we are helping the economy, and I will probably always feel that those benefits are overestimated. And we will be able to tell ourselves that market function is not impaired and that inflation expectations are under control."**

We are not sure what to make of the incoming Fed Chairs comments other than to conclude that whatever convinced Trump to appoint Powell, it is likely a result of Powell's deep understanding of what the Fed was doing with quantitative easing (QE) and why it was doing it.

What could go wrong?

The President has made it known that he plans to shrink the current account deficit by renegotiating trade policies, while at the same time, he has launched a massive stimulus program that will need to be financed. With the Fed reducing its holdings of U.S. Treasuries, the only options remaining are foreign and domestic buyers. Fund flow data suggest domestic buyers, specifically, retail investors are in the early stages of shifting asset mix from bonds to equities, while foreign buyers have also reduced purchases as the Trump administration threatens to renegotiate trade deals while his administration imposes tariffs and pushes for a lower U.S. dollar. This sort of posturing does nothing to encourage foreign buyers to purchase U.S. debt and it also risks igniting a trade war that would send the global economy into a tailspin.

With the U.S. economy at full employment and the prospects of a significant fiscal stimulus, the odds of an uptick in inflation have increased and that would rattle the already jittery bond markets. It is possible that the Fed may overreact by stepping up interest rates quicker than equity markets expect. We must admit it is hard to imagine a sustainable uptick in inflation given the amount of debt that has been accumulated, a sharp rise in interest rates would quickly counter the fiscal stimulus with higher debt service costs and a selloff in risk assets, triggering recession, which usually follows an inverted yield curve within 6-12 months.

We suspect the incoming Fed Chair is well aware of his dilemma and we believe he will have no choice but to tolerate higher levels of inflation or risk a selloff in risk assets. As we noted in a previous commentary, Claudio Borio, chief economist for the Bank of International Settlements, the Central Bankers banker stated, **"we may need to adjust monetary policy frameworks accordingly. As I shall explain, that would mean putting less weight on inflation** and **more weight on the longer-term effects of monetary policy through its impact on financial stability (financial cycles). Incidentally, the stronger focus on financial stability would bring central banking closer to its origins**.

What would lead to a correction in equity markets, a recession, inflation, an interest rate spike, a major Central Bank misstep, increasing trade frictions or war? It is hard to imagine the President or his newly appointed Fed Chairman would tolerate any of these possibilities, but they would tolerate higher inflation if they could make it happen and that would necessitate a change in asset mix if it proved sustainable. Inflation reduces the value of money and it also reduces the value of debt.

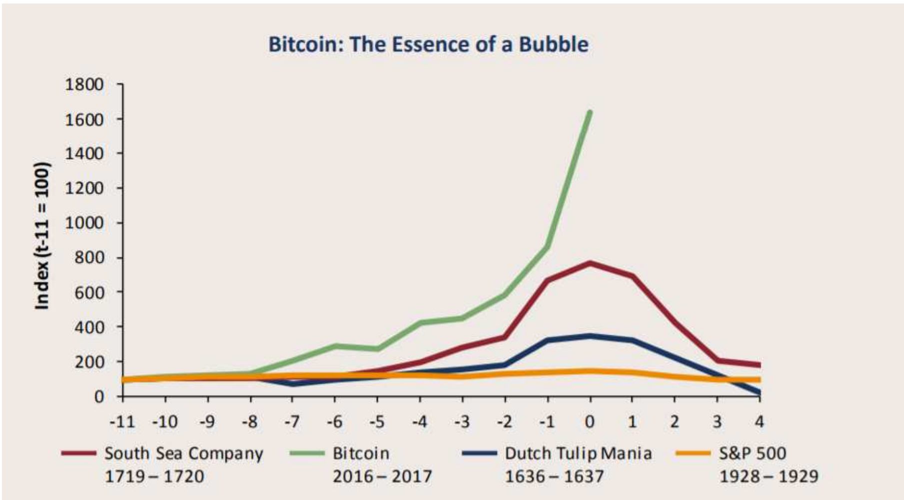
Cryptocurrencies or Cryptoassets?

In a world where Central Banks create money out of thin air (liquidity), we should not have been surprised by the emergence of an alternative to fiat currencies. Bitcoin was conceived as a Peer-to-Peer Electronic Cash System. Built on what has become known as blockchain (software), transactions are transparent and un-alterable. Its appeal comes from its construct, only 21 million coins and the fact that it does not need or have a central authority such as government or financial intermediaries to govern or confirm the validity of transactions. Bitcoin is a trusted decentralized network that was launched at the height of the global financial crisis in January 2009 and its creator, the elusive Satoshi Nakamoto, embedded the following sentence into the first block (Genesis) of the chain. **The Times 03/Jan/2009 Chancellor on brink of second bailout for banks"**

So Bitcoin was apparently developed to provide the world with a roadmap to creating an honest monetary system that could be used to transact or become a store of value over time. Although Bitcoin has proven to be less functional as a currency, it does offer compelling evidence that a distributed ledger using blockchain has the potential to be a disruptive technology. Bitcoin may not live up to its original intent, but it has shown to be secure and it could potentially function as a store of value as its adherents believe it to be such. It is important to note that Bitcoin has never been hacked or compromised and that is telling in and of itself. Its success has been measured in price appreciation, but we believe that is due to the underlying technology and proof of work. It has spawned a slew of cryptocurrencies, many of which we would refer to as wannabe copycats or get rich quick schemes but there are a handful including some that appear to address real-world problems and therefore have real-world utility.

There are issues with Bitcoin, one of which is scalability due to its slow transaction speed and increasing costs to confirm transactions (aka mining). To confirm transactions, it requires considerable computing power which incurs significant electricity costs. Bitcoin is not tangible and this alone leaves many to conclude it is the equivalent of a digital tulip. We understand the skepticism but unlike tulips, Bitcoins supply is capped at 21 million coins. With limited supply, if more users embrace it, in theory, the price should continue to appreciate, but even that may not be the case any longer as its core developers have seen fit to fork the original Bitcoin. They have created duplicate coins forked off the original Bitcoin chain meant to address Bitcoins shortcomings.

Although governments cannot shut down Bitcoin's distributed ledger, they can make it difficult for Bitcoin to operate if they choose to prevent exchangeability back into the financial system. We are surprised they have not moved faster on cryptocurrency regulations, given the surge of neophyte investors, all hoping to cash in on a craze many barely understand. We believe that governments need to get out in front of this mania by putting in place regulations and rules to help protect the investing public but they should not dictate or prevent investors from exchanging their fiat currency for investments they perceive to be of value. Blockchain technology is transformative and disruptive and it has the potential to transform many sectors of the economy such as financial transactions, medical records and property ownership. Its promise of offering decentralized transaction without the need for intermediaries has yet to be proven. As for the original Bitcoin, it may not function well as a currency, but it has offered convincing evidence it could be used as a store of value as long as others believe it to be. Valuations aside, Bitcoin is not tangible but it is a crypto asset with value to those who invest in it, just as rare coins, stamps, gold and art are all assets.



MarketWatch Dec 15, 2017

Wall Street is beginning to understand the significance of blockchain/cryptocurrencies/cryptoassets. Goldman Sachs has announced plans to create an institutional crypto trading desk while the Chicago Mercantile Exchange (CME) and the Chicago Board Options Exchange (CBOE) have both launched bitcoin futures. It is our view that blockchain technology and digital currencies are going to be around for a long time.

Markets

Canadian and U.S. equity markets had a strong finish to the year. The S&P/TSX finished up 9.1% for the year with almost half the return coming in the fourth quarter, which was up 4.4%. U.S. equity markets outpaced Canadian markets, even with the strong rally in the Canadian dollar, which rose with the S&P500 index up 11.5% in Canadian dollars (21.8% in $US) in 2017, registering a gain of 6.6% in the fourth quarter. The Dow Jones Industrial Average was up 16.8% in Canadian dollars (24.5% in $US) on the year and 11% in the fourth quarter. Not only did the U.S. indexes hit record highs last year, but they also set a record by not registering a single down month throughout all of 2017.

Passive investing using index funds continues to gain momentum but they do obscure the fundamentals and valuations of its underlying constituents in market cap weighted indexes. We certainly understand investor's affinity towards index funds given that most active managers have not kept pace. However, as share prices and intrinsic value continue to diverge, picking the right equities as opposed to the hot equities with the largest market caps and highest valuations will at some point become problematic.

Conclusion

For the past nine years, equity markets have climbed a wall of worry, as Central Banks countered the underlying economic weakness and fragility of the financial system with trillions of dollars in liquidity, most of which found its way into financial markets. With the global economy entering a synchronized growth phase, the Fed has begun to shrink its balance sheet and normalize interest rates. Our concerns over elevated equity markets have been diminished somewhat with the passage of the Presidents investor-friendly tax package, which is expected to boost S&P500 index earnings 5% - 10%. The U.S. equity market rally has accelerated to the upside in response to the massive fiscal stimulus which comes in the late stages of a long-running expansion. Bond markets were already grappling with the Fed’s withdrawal and now they will have to deal with the funding of the President's fiscal stimulus and the potential inflationary impact of injecting trillions of dollars into an economy that is already running at full employment. The potential for overcooking the economy has jumped a few notches and we must be prepared for higher interest rates and what affect that may have on equity markets.

Investor sentiment is transitioning from the wall of worry stage to the guarded optimism stage as equity markets move higher and volatility hits record lows. Most individual investors who have been hit with punishingly low interest rates for the past nine years have been increasing their exposure to equity from bonds. As markets move higher, we sense a new type of fear has emerged, it is the fear of missing out (FOMO) and that gives us concern in the short-term. With the exception of cryptocurrencies and marijuana stocks, we do not believe we have entered the euphoria stage, but we may be getting closer if equity markets continue to melt-up without correcting. Although we do not see any signs of recession, we must be mindful of the increasing risk of correction and we recommend investors position their portfolios accordingly.

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