TD Wealth

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# Extra Time

**June 2018**

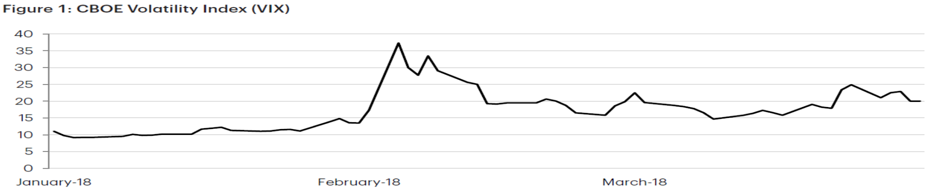


The U.S economy has now been in growth mode for 108 months, making it second only to the 1991, 120-month expansion which set the record, as per TD Economics. If this recovery was a soccer match I would say we are tied 2 - 2 and definitely later into the second half. As we creep closer and closer to the longest expansion in history, the question remains, "how long will this last?" Will we have some glory and finish the game in a win at the 90th minute or will the stalemate lead to extra time or even shoot outs? In this month's publication I will provide a quick summary of the first half of 2018 and my outlook over the near-term followed by an investment strategy update. I conclude with the usual note on what I've been or, in this case, will be up to.

Let me start off by expressing that although we are in the second half, there is still a lot of game left. My view is that this expansion still has some room to run and could easily continue for well over a year or two but a recession in the next 3 to 5 years is more likely than not. As I've written in the past, the nature of the current economic expansion is quite a bit different than expansions of the past. For much of those 108 months, growth had been lacklustre at best, supported mainly by government intervention with weak employment, poor earnings and limited productivity improvements. Only in the last few years has the economy been able to stand on its own two feet which makes me believe we could have a longer runway than some think. Good or bad, the economy most recently got a shot of octane in the form of the tax-reform package in the U.S. Importantly, the last few years of organic economic growth have been delivered with low inflation and strong corporate earnings. Unemployment in the U.S. is at a low not seen in almost eighteen years but wage growth, which is an important indicator of inflation, has remained lower than forecast. I'd be remise if I didn't state that this is somewhat skewed due to people who were unavailable to work declaring themselves as such, lowering the number of people in the employment pool. Unemployment remains impressive nonetheless.

There's no such thing as a free lunch as equity investors learned through the 1st half of the year with a spike in volatility. Last year we witnessed only 8 days where the markets moved 1% up or down and the U.S. S&P 500 Index (S&P500) closed positive every month of the year which has never happened before. We can compare that to over 40 days of 1% or more moves in the markets this year with 2 negative, 2 positive and one arguable flat month for the S&P500 through the first 5 months. With these headwinds for stocks, a common conversation that I have with clients is "what are we supposed to do now?" The answer to that obviously needs to be personalized for each individual but the overarching theme is: Sometimes a good defense can be the best offense but I do not believe it's time to sub off our offensive players to bring on the defensive squad yet. For those not as familiar with soccer strategy, I mean it's not yet time to make any drastic defensive portfolio changes.

Figure 1: CBOE Volatility Index (VIX)



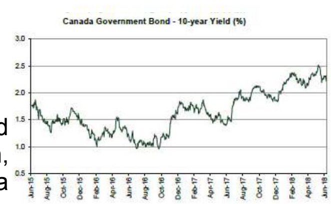

Source: FactSet as at March 31, 2018. CBOE: Chicago Board Options Exchange.

**Equity Markets**

| Canada | Level | Wkly Chg (%) | YTD |
|---|---|---|---|
| S&P/TSX Composite | 16314 | 0.7% | 0.6% |
| S&P/TSX 60 | 964 | 0.7% | 0.5% |
| S&P/TSX Small Cap | 642 | -1.0% | -2.8% |
| **U.S.A.** | **Level** | **Wkly Chg (%)** | **YTD** |
| Dow Jones | 25090 | -0.9% | 1.5% |
| S&P 500 | 2780 | 0.0% | 4.0% |
| Nasdaq | 7746 | 1.3% | 12.2% |
| Russell 2000 | 1684 | 0.7% | 9.7% |
| **International** | **Level** | **Wkly Chg (%)** | **YTD** |
| DAX | 13011 | 1.9% | 0.2% |
| FTSE 100 | 7634 | -0.6% | -0.7% |
| Nikkei | 22852 | 0.7% | 0.3% |
| MSCI EAFE | 2000 | -0.5% | -2.5% |
| MSCI World | 2134 | -0.2% | 1.5% |
| MSCI EM | 1114 | -1.9% | -3.9% |

**Fixed Income**

| Indices / Rates | Level | Wkly Chg (%) | YTD |
|---|---|---|---|
| FTSE TMX Canada Universe Bond | 1041 | 0.8% | 0.4% |
| FTSE TMX Canada Real Return Bond | 583 | 2.0% | 3.1% |
| Mer Lynch US High Yield Master II | 1271 | 0.4% | 0.7% |
| LIBOR 3-month | 2.3259% | 0.0% | 37.3% |
| **Government Bond Yields** | **3-mo T-bill** | **10-yr Bond** | **30-yr Bond** |
| Canada | 1.23 | 2.217 | 2.245 |
| US | 1.90 | 2.921 | 3.047 |
| Spread | -0.67 | -0.704 | -0.802 |




Source: TD PAIR, June 15, 2018

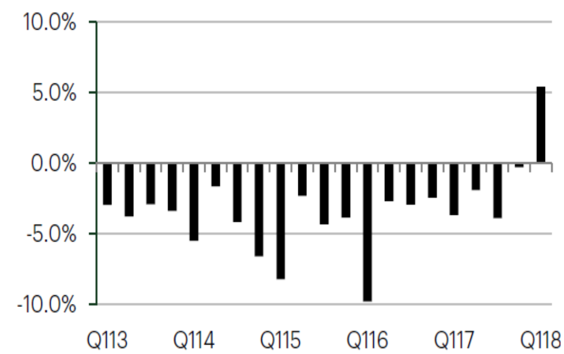
I want to share some highlights from around the world as we continuously hear about a coordinated global expansion when the reality is not quite that. Japan's economic recovery is only in its 67th month, long behind that of North America. The Eurozone recovery is somewhat mixed but similar to Japan as a whole at 62 months with European government's still strongly supporting with quantitative easing. Looking to the emerging markets, we see more inconsistency with some countries like Brazil and Russia having only just begun recovery, maybe the World Cup will help the latter. Then we have China, who held the title for the fastest growth for a number of years, starting to slow. In summary, I believe the varied state of global economies makes a compelling argument for having some strategic international diversification within your portfolio.

As a prelude to the following investment strategy, I continue to believe that equities can deliver positive mid-single digit returns in 2018 as global growth and corporate earnings remain strong and supportive. I prefer U.S. and international equities over Canadian as international valuations (prices) are attractive and the U.S. has a stronger growth profile. As Canadian investors, its's imperative we still have Canadian exposure in our portfolios, but we need to be aware of the possible side effects of high house-hold debt, changing mortgage rules, higher rates and any potential impact of the ongoing trade dispute.

To avoid repetition of my February and April publications I am not going to delve into the 7 economic indicators that I use to assess if a recession is around the corner but I will state that there have been no fundamental changes which leave me with a green light on stock exposure. Since my last report we have seen another earnings season as well as continued changes to valuations. Firstly, over the longer-term, one of the most important indicators of where stock prices go is where earnings go. We just got through 2018 Q1 earnings and as a whole, there were strong increases across the board with 78% of S&P 500 companies reporting positive earnings and sales surprises. Earnings grew 11% last year, are expected to grow 19% in Q2 (which would be the second highest since 2011) followed by another 11% next year. That kind of tailwind would go a long way toward limiting losses, even as valuations are at the higher end. As we experience it, volatility is painful, but one benefit to the rocky start to 2018 has been a slight repricing of stocks. There was a lot of concern about high stock prices when the S&P500 set a record high late January. The index subsequently fell to a 10% loss on two occasions, once in February and again in April. A common measure for stock price is valuation or the price/earnings ratio (P/E) and as valuations go up, concerns of the stock market overheating follow. One benefit of the large sell-offs through the 1st half of the year has been a 16% drop in P/E's, bringing stock prices to a more reasonable and, I believe, sustainable level.

Avid readers know that interest rates and the path of governments are vital to the strength of the economy. At time of writing, the U.S. Federal Reserve Bank just raised interest rates as anticipated. The change in language left the door open for at least 1 if not 2 more hikes in 2018, likely September and again in December. When assessing the impact of interest rates on the economy a lot of market prognosticators look at the trends in the 10-year U.S. Treasury yield for a few reasons. First, the 10-year yield is a reliable indicator of stock market sentiment as U.S. government bonds are viewed as a "safe haven" and when there is fear, that yield falls due to demand. The 10-year is also an indicator of expectations about future growth and inflation by discounting current interest rates. Lastly, the 10-year plays an important role in the yield curve when comparing to short term (90-day or 2-year) yields. When short term rates move higher than the 10-year, what we call an inverted yield curve, a recession typically follows. With the 10-year holding steady around 3.00% today having already priced in the June hike, I continue to feel confident that the interest rate market is not showing any signs of recession yet.

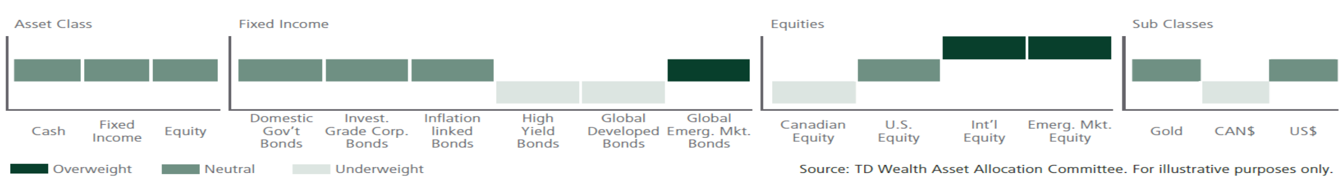
Figure 2: S&P 500 Change in Quarterly Bottom-Up EPS




Source: FactSet as at May 11, 2018. EPS: Earnings Per Share.

In summary, when I look at economic and interest rate factors, I am still comfortable being fully invested, keep the starting line-up on. A well balance portfolio should still provide positive performance in the near term and if you are comfortable owning equity in your portfolio, I would continue to recommend a full allocation to the level you are comfortable with.

Asset Allocation Summary

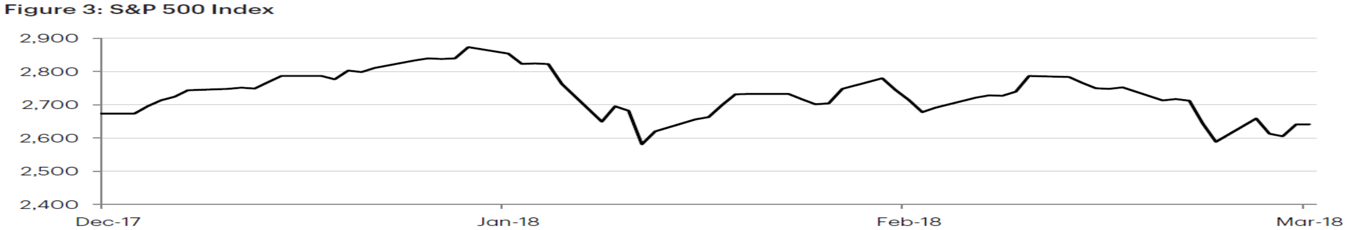



Source: TD Wealth Asset Allocation Committee. For illustrative purposes only.

# Investment Strategy

The majority of stock markets are little changed year to date, despite the large swings up and down we have witnessed. At time of writing both the Canadian S&P TSX Composite Index and the U.S. S&P 500 are about back to where they started in 2018. The flat performance reflects numerous factors impacting investments for the good and the bad. This list should be of no surprise including such positives as the strong underlying economy, the U.S. tax-package approval, consumer confidence and the previously mentioned elevated earnings followed by a number of negatives including interest rate increases, inflation fears, tepid business confidence, geopolitical concerns and most recently the fear of trade wars. I believe the tug of war between good and bad news will likely continue going forward and as a result, volatility will remain elevated. My continued confidence comes from taking what I believe to be the best information available at any given time to make a fundamental call as to where we are in the business cycle to determine if I am confident owning equities. Once comfortable owning equities, playing offense, I use the technical data available to help me score goals by deciding which countries, then sectors followed by stocks that I think will win in this type of an environment.

Figure 3: S&P 500 Index




Source: FactSet as at March 31, 2018.

My data currently tells me that I want to own U.S. equity, Canadian equity followed by international equity. Within those geographies I want to make sure that I have overweight exposure to the industrials, the consumer discretionary and the technology sectors in those orders.

| RANK | CHG | ASSET CLASS | TOP CATEGORY IN ASSET CLASS | |
|---|---|---|---|---|
| | | | USD | CAD |
| 1 | | U.S. Equity | Small Growth | US Small/Mid Cap Equity |
| 2 | ↑ | CAD Equity | --- | Canadian Equity |
| 3 | ↓ | Intl Equity | China Region - Developed | Asia Pacific Equity |
| 4 | ↑ | Commodity | Natural Resources | Natural Resources Equity |
| 5 | ↑ | Cash | Ultrashort Bond | Canadian Money Market |
| 6 | ↑ | Bond | High Yield Muni | Canadian Long Term Fixed Income |
| 7 | ↓ | Currency | Currency | --- |

| Rank | Chng | Equity Name |
|---|---|---|
| 1 | | Industrials EWI |
| 2 | | Consumer Discretionary EWI |
| 3 | | Information Technology EWI |
| 4 | | Healthcare EWI |
| 5 | | Energy EWI |
| 6 | | Consumer Staples EWI |
| 7 | | Financials EWI |
| 8 | | Materials EWI |
| 9 | | Telecommunications EWI |
| 10 | | Utilities EWI |
| 11 | | Real Estate EWI |

Source: SIA Charts, June 6, 2018

Firstly, the industrials sector continues to benefit from a growing economy late in the business cycle. An easy way to think of this sector is companies that build, move or create things that if you drop them they hurt your foot. One example in the sector that moves those things that hurt your foot is **Canadian National Railway (CNR)** which has had a nice return year to date, is important to the movement of all things across countries and let's face it, they're not building many more railroads these days. Consumer discretionary is a wide ranging sector of all things that consumers buy when they have extra cash in their pocket. A perfect example of this is **Home Depot (HD)** which has facilitated plenty of home improvements with consumer's new found home equity wealth. A couple other very different examples in the discretionary sector that I own are **Planet Fitness (PLNT)** and **Vail Resorts (MTN)** both of which have had outperformance through 2018. Lastly, the information technology (tech) sector. There's no surprise that tech has had a huge run as we've seen productivity improvements across all enterprises with the adoption of digital tools. You might think of **Amazon (AMZN),** which in full disclosure is a holding in my portfolios, but AMZN is actually in the previously mentioned consumer discretionary sector. My core tech holdings include **Microsoft (MSFT)** and semiconductor company **Texas Instruments (TXN)**. Some interesting reorganization is about to take place within traditional sectors which will force the trade of billions of dollars of stock over the next few months. Technology heavyweights, Alphabet (GOOG) and Facebook (FB) along with consumer discretionary large caps Disney (DIS), Comcast (CMCSA) and Netflix (NFLX) will all be joining the telecommunications companies Verizon, AT&T and Century Link in a new sector named Communications this September. The forced trades will be a result of massive sector exchange traded funds (ETFs) having to rebalance their portfolios through the September date. Keep an eye on all these stocks as they may provide some opportunities.

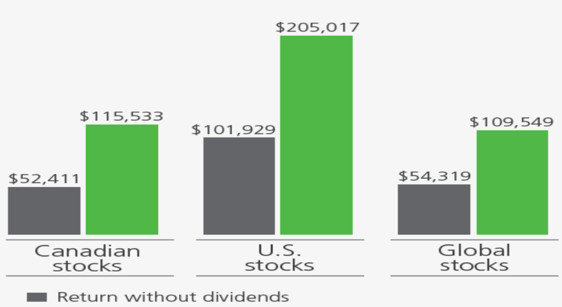
In summary, although the markets are largely flat for 2018, there continues to be pockets of opportunities within specific sectors and geographies and it might be a good time to review and rebalance if you're not confident in your allocations.

# The Power of Dividends

My investment strategies are in large designed for those saving for or entering into retirement. As a result, I have always had a strong focus on those companies that have a history of paying dividends. Dividends are extremely helpful in accumulation over time as they add to investment returns. They also provide a buffer through volatility and have the added advantage of preferential tax treatment in most cases. I've added a little further information below as dividends have aided me when assessing two investments as I will almost always go for the company that has had a consistent dividend over time. The caveat to that is to be sure not to just choose the highest paying company as their underlying financials may be in jeopardy due to their high dividend, look for consistency of cash flows over the long term.

## Dividends can help your retirement savings grow by adding value over time

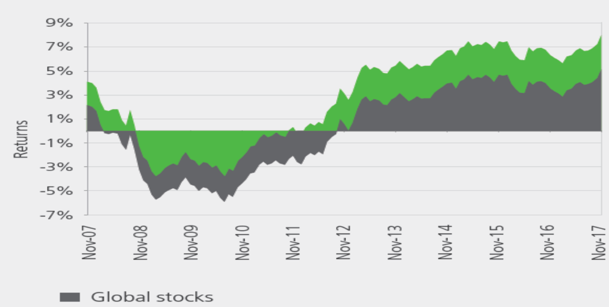
Long-term investing has the benefit of compounding. When you reinvest dividends over the long term, the power of compounding is magnified.[2]




Source: ®Morningstar ®Direct, from July 1, 1991 to November 30, 2017

## With retirees 5X more sensitive to losses[3], dividends can help provide a buffer

The regular income you receive from dividends can help provide your investments with a buffer when markets are more volatile during your retirement years.[4]




Source: ®Morningstar ®Direct, for the period July 31, 2006 to November 30, 2017

2: Source: Morningstar Direct, for the period December 31, 1986 to November 30, 2017. Canadian stocks—S&P/TSX Composite Index, U.S. stocks—S&P 500 Index—CDN$ Global stocks-MSCI World Index-CDN$.
3: Behavioral biases: Tackling loss aversion, Millman, 2016. 4: Source: Morningstar Direct, for the period November 30, 2007 to November 30, 2017. Global stocks—MSCI World Index, 10-year rolling returns.


Graphic Source: TD Asset Management

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# Personal Note:

If you haven't noticed by my analogies through this newsletter, I am a bit of a football (soccer) fan. Because of this, I have habitually chased international football tournaments around the world for the past 10 years which has taken me from South America through France to Italy and next on to Russia. With the World Cup having just kicked off, I am counting down the days and fanatically filling out immigration documents to catch the last 2 weeks of the grand show from the ground in Russia. A group from my soccer community were lucky enough to draw tickets to the final three games over a year ago and the dates are fast approaching. We will be spending a few days in Sochi, St Petersburg and Moscow for match 59, 61 and the finals. Keep eyes out for us proudly displaying our Canadian flag and team Canada jersey's despite no Canadian appearance since 1986. But who cares, everyone loves Canadians. On the kick-off week to World Cup 2018 we also got the brilliant news that World Cup 2026 will be housed in North America shared between Canada, U.S. and Mexico. This hosting decision likely assures the Canadian National Team a seed back on the world stage. The only unfortunate thing is that our beloved B.C. government denied any games here so we'll have to travel to Alberta, Ontario or Quebec for any Canadian action. Finals have been allocated to New Jersey so that might give me an excuse to visit.

I wish you all well through the amazing summer months and get out there and enjoy all that our beautiful province has to offer.

*Marley*

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