TD Wealth

2nd Quarter 2018

August 2018

Schacter Palazzi | Wealth Management

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Quarterly Commentary North American Model Changes:

Change	Equity Name	Symbol	Sector	Exchange
Sell	T-Mobile	TMUS	Telecommunications	NY
Sell	LyondellBasell Industries	LYB	Chemicals	NY
Buy	Verizon Wireless	VZ	Telecommunications	NY
Buy	Westlake Chemical Corporation	WLK	Chemicals	NY
Sell	Lockhead Martin Corporation	LMT	Aerospace	NY
Sell	WSP Global Inc.	WSP	Industrial	TSX
Buy	Valero Energy	VLO	Energy	NASDAQ
Buy	Encana Corp.	ECA	Energy	TSX

President Trump, ACT 2 - No Intermission?

While I did promise not to write about President Trump in any length after client feedback from some of my previous quarterly commentaries, one can understand that some of the recent market fluctuations can partly be blamed on some of the “interesting” developments coming out of Washington. Generally, people look forward to an intermission as a break from a great show to converse about what they just saw and what is potentially coming. Unfortunately, with our southern neighbours and the constant news cycle including overuse of Twitter, my opinion is that the intermission might be a long time coming for financial markets.

With all of the emotional news items entering our lives recently: Provincial elections, Donald Trump, Trade wars, and general world turmoil one can be forgiven for experiencing stronger than normal emotional reactions. One can certainly be excused in thinking that many types of investments are not doing well right now and I hear a number of my clients beginning to question if Canada is even a good place to have investments for the next 10 years (I disagree with this line of thinking). At the beginning of the year, I thought 2018 would likely be a more difficult year but I expected select companies to continue to do well. Fast forward to today and the one thing that comes to mind is opportunity! At no time in history have we had a U.S. based leader who can move the markets almost daily. Think about it this way...everyone loves a good sale and getting a good deal...for some reason when it comes to our investments, we dislike it when things go down and when things go on sale.

SP North American Model

The discussion highlights some of the most frequently asked questions by our clients.

Q: Andrew, our bonds keep going down so why do we continue to hold on to them and are there alternatives?

A: As interest rates go up (and they are edging higher in both the US and Canada) bonds drop in price as existing issues are re-priced to reflect the new environment. For this reason, for clients with fixed income, I am attempting to keep levels as close to the target weight or slightly below at this point. Remember bonds serve as a line of defense if equities run into turbulence or the economy downshifts. In our personal view, we really don't see a recession over the next 12 months and we think we will see an upside in corporate profits especially from our Canadian companies as they have underperformed their US counterparts so far in many industries. Alternatives to bonds really depend on one's appetite for risk. I could argue BCE (we currently hold in North American and Canadian models) might be good income replacement as it currently has a dividend yield of 5.40% as of July 15, 2018. Look a bit closer at what BCE has done since January 1st, 2018 and investors would have noticed BCE shares have fallen almost 7.42% during the same time period eating up "all of the dividend yield" for 2018.

Q: Andrew, in our last review meeting you mentioned you would be keeping your North American model at 70% Canadian. Any reason you wouldn't be adding to your U.S. names especially with the outperformance of the U.S. markets?

A: Another way to look at this is that the Canadian equities market is currently undervalued relative to the US markets. The economic growth cycle in Canada is slightly positive and has increased at a slow and steady path (compared to the US), while corporate earnings growth and wages remain stable.

Based on TD Economics, Canada's economy expanded by a relatively strong 3% in 2017 and statistics show growth remains steady so far in 2018. We know Trump's tariffs and lack of a new NAFTA agreement have made investors pause on Canadian investments as a whole. Recent increasing higher oil prices oil price trends are a welcome sign for the Canadian energy sector although I have to admit that the government's recent takeover of the Trans Mountain Pipeline adds a layer of uncertainty in my opinion. Canada's frothy housing market also constitutes another threat as rising mortgage rates and other government measures are beginning to have an effect.

Nonetheless, I have mentioned before and will reiterate that the majority of my Canadian companies have earnings that come from outside Canada. I have profiled names like Couche-Tarde, TD Bank, Encana, Royal Bank, and CNR as some examples of companies that benefit greatly by assets held outside of Canada. For many of these assets, the management teams of those companies continue to actively seek strategic ways of diversifying their income streams to complement their Canadian based revenues.

By continuing to invest in these Canadian names in our portfolio, we are getting their active Canadian business along with exposure to other geographical segments, and at the same time receiving a tax efficient Canadian dividend yield.

Q: Andrew, we see you have gone back to oil and gas after removing Paramount Resources, at a loss I might add, so why go back now? Wouldn't you be better off adding to your technology names like Apple and PayPal which have both done so well?

A: Very fair question as a few attempts to find the bottom of the Canadian oil market has proved elusive to us over the past couple of years. I have stayed with

[1] Source: Russell Investments, Thomson Reuters DataStream. As of 5/31/2018. In local currency. Negative equity market is determined using the S&P 500 as the proxy for U.S. equities.

my discipline on stop-losses and that is the main reason I came out of Paramount earlier this year.

I believe that the inventory glut in oil has finally been worked off (OECD commercial crude oil inventory statistics from EIA, dated 1st quarter 2018). These depressed oil prices over the last few years have led to a meaningful reduction in investment which has now resulted in a production shortfall despite U.S. shale efforts. The recent U.S. decision to re-apply sanctions to Iran will reduce that country's oil exports by up to 500,000 barrels per day by the end of the year and up to 700,000 barrels per day by the end of 2019. Venezuela's economy remains in a free fall as is their oil production. I added Encana here in Canada as a 4% weight mainly because over 60% of production comes from the U.S. with remaining coming from Canada. I also added Valero Energy, the largest refiner in the U.S. These two positions are complementary. I also felt that the downside in this sector is somewhat limited as names like Encana have hardly moved despite the improving fundamentals of the oil market.

I am well aware of the outperformance of technology but, as the majority of people need income on a regular basis, it is difficult to add there now. It is possible that our technology weighting could increase as opportunities present themselves but that might not happen right away.

ETF Model Change:

Change	Equity Name	Symbol	Sector	Exchange
Sell	Canadian Dividend Index	PDC	PowerShares	TSX
Buy	S&P TSX Capped Composite	ZCN	BMO ETFs	NY

Challenges of late cycle investing

We are inching closer to the decade mark of the current bull market. To this point the stock market has been fueled by low inflation, low volatility and increased money supply due to emergency measures taken by global central banks to fight deflationary forces created by the 2008 financial crisis. As we transition into the second half of 2018, we believe we are entering the transition phase of the market demonstrated by near full employment, inflationary pressures and the determination by the Federal Reserve to increase interest rates and remove monetary stimulus. The monetary policy change has been partly responsible for the re-emergence of volatility during the first half of 2018. We note that the risk of a policy mistake increases as the bull market continues to age. So far, investors have chosen to focus on the strong global growth numbers and a U.S. economy that is still getting a jolt from fiscal stimulus. Therefore, while the tailwinds of growth still outweigh the headwinds for now, we remain cognizant that this balance could shift as the year progresses.

SP Global Tactical ETF model Investment Changes during the quarter:

During the second quarter, there was one material change within the SP Global Tactical ETF model. We elected to shift our Canadian exposure away from a dividend focus to a broader based Canadian stock exposure. This move reflected our view that we are in the later stages of the economic cycle. Late cycle expansion typically favours commodity stocks while dividend stocks can lag due to rising rate pressures. Holding a broader based Canadian ETF allowed us to capture some additional sector exposure that we feel will benefit from late stage economic expansion.

Currency:

As a global model, changes to the value of the Canadian dollar against international currencies can materially add or detract from investment performance of the model during a given quarter or year. We wish to remind our investors that for the most part, we attempt to neutralize the impact of currency on the performance of the SP Global Tactical ETF model. Given the material weakness year to date of the Canadian dollar versus many international currencies, the model is not capturing short-term gains from this weakness. During periods of extreme weakness or strength in the Canadian dollar, we may add an element of currency exposure if we feel our long-term view suggests doing so. However, our current long-term view is that the U.S. dollar will weaken against international currencies, supporting our view that the portfolio should remain as close to currency neutral as possible.

A lot of news coverage has been discussing the trade wars between the U.S. and its trading partners. Does this threat change your view on investing globally?

We think the concerns of a trade war are likely misguided. The tariffs proposed by the Trump administration have largely been symbolic, representing roughly 0.40% of the nation's GDP. With the U.S. being a consumer- and consumption-based society, we feel it has a lot to lose in a trade war. The U.S., has large fiscal deficits and we believe it is important to continue with the import savings of cheaper foreign goods. We continue to think the threats made to date are largely political posturing ahead of the mid-term elections. However, if the threat of tariffs becomes wider ranging; the damage to the U.S. over the long term would be severe. If the trade war does escalate, we would expect the U.S. dollar to strengthen and U.S. economic growth and corporate profitability to weaken.

Gold and Silver:

Why do we continue to hold gold and silver in the portfolio especially given that they do not earn any dividends?

After a strong year for both gold and to some extent silver in 2017, we expected more of the same heading into 2018. However, year-to-date, we have seen what we believe is a bear market bounce in the USD as the market has focused on a hawkish Federal Reserve, growth related to tax cuts and the prospects of continued rate increases throughout 2018. Fundamentally, we believe that the rally in the USD hit its peak in 2017 and that recent policy decision taken by the Trump administration to lower taxes and not address widening fiscal deficits and government debt pose a significant challenge to U.S. growth and long-term strength in the USD. When the market will turn its attention to these concerns is unknown. However, we feel that both gold and silver will benefit tremendously when markets do turn, and as such, believe a modest weight in both metals will be supportive to the portfolio in the future.

Typically, we see gold and silver perform well as yields in the United States drop as the opportunity cost of holding gold diminishes with falling rates. Despite the latest move in rates, both gold and silver have remained lower as currency markets have overpowered the signals coming from the interest rate market. We believe the tone from central banks will get less hawkish, and they may signal a little less enthusiasm to raise rates. We are expecting to see a more meaningful contribution from both metals to the model as we close 2018 and throughout 2019.

United States: Modest Underweight

We believe that the economic cycle is elongated and now faces a likely headwind from monetary tightening. In the short term, we viewed the recent corporate tax cuts as favourable for the U.S. market as the majority of the early savings have gone to fund corporate stock buybacks. As this stimulus wears off we feel that earnings growth not multiple expansion will drive returns. As such, we feel that overall returns will be more modest and stock selection will become more important. To that extent, we feel a modest underweight of U.S. equities is prudent.

Europe

We continue to see a range bound trade in European equities in the near term. However, looking forward, we view European shares as cheap relative to U.S. equities and believe there will be enough economic momentum in Europe to act as a catalyst and unlock some value. Our core exposure to Europe is a covered call option writing strategy against high dividend paying European equities. Therefore, while we wait for equity prices to make a sustained move higher, we will look to generate enhanced income along with capital appreciation. Our belief is that global growth will support certain sectors of the European market. However, a moderation in domestic growth and political risk could pose challenges to the financial sector. The positive and negative factors should support our use of option writing as a tool to convert range bound volatility into enhanced yield.

Japan

The portfolio has a modest weight in Japanese equities. We continue to believe that Japan is benefiting from global growth. Shareholder-friendly corporate behaviour and solid earnings support our view. In addition, the central bank of Japan monetary policy remains relatively accommodative. Policy buying has been supportive of equities as the Bank of Japan continues to step in and support equities by buying exchange traded funds of Japanese stocks.

Emerging Markets

Based on a long term-view, we believe emerging markets broke out of a 10 consolidation trading range last year. As we look at charts of world markets excluding the United States, we see that breakout confirmed across Europe, Japan and emerging market indices. Our belief is that the United States has been the early market to break to the upside. However, with equity valuations at or near record levels in the United States, we feel that world markets led by emerging market equities are entering a sustained period of outperformance. This catch-up trade should benefit many global markets, including Canada, though in the short term a rising USD dollar, trade tensions and elections could be sources of volatility. However, we believe that an allocation to global equities and the emerging markets is essential over the next three to five years.

Thanks again for all of your questions this quarter and if you have a question that was not covered here, please don't hesitate to reach out to us directly.

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