TD Wealth

1st Quarter 2018

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Schacter Palazzi | Wealth Management Team

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In this issue:

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North American Model Changes:

Change	Equity Name	Symbol	Sector	Exchange
Sell	Cigna Corporation	CI	Health Care	NY
Sell	Paramount Resources Inc.	POU	Consumer Discretionary	TSX
Sell	Corning Inc.	GLW	Technology	NY
Sell	Johnson and Johnson	JNJ	Health Care	NY
Sell	Eastman Chemical Compnay	EMN	Materials	NY
Buy	Sherwin Williams Company	SHW	Materials	NY
Buy	PayPal Holdings Inc.	PYPL	Financials	NASDAQ
Buy	UnitedHealth Group Inc.	UNH	Health Care	NY

U.S. Versus China…….and the winner is…..

The first quarter of 2018 has quickly ended up resembling a ride at Canada's Wonderland, with the first three weeks of January marking a quick ascent in equity markets that was followed by not one, but two major pullbacks in equity prices. In March, President Trump took his first shots on trade, announcing tariffs on aluminum and steel imports (although thankfully he excluded most major US trading partners including Canada). As the quarter ended, the biggest fear in markets was that Washington (via President Trump) would become entangled in an all-out trade war with China, and after the quarter ended, the President announced tariffs on $50 billion of Chinese trades. China immediately retaliated by slapping duties of up to 25% on U.S. food imports and many other U.S. imports. The collateral damage has been large U.S. corporations like Boeing Company (BA – not owned in our model) which fell from $371.60 on February 28 to $311.20 on March 28 – price data from

Thomson One, a drop of 16.25% on fears China may not buy as many airplanes from them. In a recent survey from RBC Capital Markets that was quoted in the Globe & Mail, politics dominated the concerns of survey participants. In fact, trade wars, geopolitics and President Trump were seen as the biggest risks to stock prices. This quarter also brought us news that technology bellwethers such as Facebook had user data wind up in the hands of a private company without the full knowledge of those users. On the bright side many of our company holdings continue to do well, so let's get to some of the most popular questions this quarter:

SP North American Model

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

Question: Andrew, we recently met with you in January but a lot has changed in the markets recently. Is there anything that has you particularly concerned?

A: I am always looking for changes in the outlook for all of the companies in the portfolio, evaluating if any economic changes or shifting industry conditions could affect them in an adverse way. One issue I am monitoring which could affect some of our Canadian positions is the BC government decision to introduce more penalties for foreign home ownership. While I don't think a correction in housing prices is imminent, I do think a pullback has some unintended consequences. While buyers of real estate in areas of Toronto and Vancouver would welcome a pullback in housing prices, it could be taken very negatively by all the homeowners who have paid increasingly high prices and are carrying larger than normal debt loads. On February 24th, 2018, the Globe & Mail reported that the Bank of Canada has estimated that a 25% pullback in housing in the Greater Vancouver market would result in 1 in 4 mortgages being underwater, a scenario that sounds eerily similar to the U.S. housing market when things went south. TD Economics is only calling for a 5% correction in the Canadian real estate market according to a February report, and higher immigration could be a catalyst for keeping prices relatively strong. Nonetheless, with housing representing close to 22% of Canadian GDP (Gross Domestic Product), I am reviewing which of our companies have exposure to the risks we may be facing. (The key risk would lie with Canadian banks having a domestic focus). While the intrinsic value of companies continues to be a major factor in our security selection, we may look to incorporate some higher growth companies while overweighting some higher dividend paying companies to offset the potential loss of dividend income should we feel a need to move away from some banks.

Question: Andrew, we noticed you added to Enbridge but this position continues to underperform. What are you seeing in this name that others aren't?

A: A few things have happened since we added Enbridge to the portfolio in the 1st quarter. First, the prospect of rising interest rates has had a negative effect on all major dividend payers in the market with Enbridge having one of the higher yields at 6.9% as of March 31st. Secondly, a recent policy statement by the Federal Energy Regulatory Commission (FERC) stated that the Commission would no longer allow pipelines' Master Limited Partnerships to recover income tax in their rates. Although both Enbridge and TransCanada both stated that the impact on them was limited, shares dropped in value on the news. Also, the company recently closed its merger with Spectra Energy, which was effected through an exchange of Enbridge shares for those of Spectra. This type of transaction often brings a certain amount of temporary pressure on the equity of the "acquirer" – in this case ENB – as some "Acquiree" shareholders chose to sell and move on to invest elsewhere in the market.

We believe that ENB's disclosure and guidance at its December investor day helped address the outstanding concerns and uncertainty. ENB has already identified the bulk majority of the sources of funding for its $22B capital spending and $4B debt reduction program over 2018-2020. Furthermore, we believe that ENB is setting up for a year of strong operational performance in 2018. ENB brought $12B of growth capital projects into service in 2017, which was the company's largest program ever. ENB will have the benefit from a full year of operations from these projects in 2018. The capital program for 2018 is less aggressive, with ENB targeting to bring $7B of projects into service in 2018. ENB is also tracking ahead of expectations with respect to the Spectra Energy-related synergy target of $540 million synergy target, and synergy target may be revised upward based on management optimism. Consequently, we believe ENB offers a good reward to risk at this time. For my Ontario residents, Enbridge is projecting cost savings in Ontario of up to $750 million from a proposed merger of Spectra's Union Gas distribution network with its own franchise. While we seem to be swimming against the herd at present, we feel that patience will be rewarded.

Question: Andrew we noticed you mentioned in the first quarter returns would not be as good but you expressed optimism for this year despite some of your misgivings. Has your view changed with the market sliding so quickly? What is your game plan going forward?

A: This question has been asked multiple times over the past 5 weeks and while many people have remained calm, a number of you have expressed worry over your portfolios and the continual flow of bad news coming from both the United States and Canada. It certainly is possible that one more inopportune Tweet from President Trump could put us back on the performance roller coaster. That being said, first quarter earnings season begins in mid-April and with the recent market pullback and overall S&P 500 earnings growth projected at 17.3% according to FactSet, it should be an upbeat reporting season that should help everyone focus back onto corporate earnings and business fundamentals. In my opinion, earnings are likely to remain supportive of share prices at these recent levels over the next 12 months at the very least. Remember the U.S. economy will likely benefit from a substantially lower tax rate, a record year for share buybacks and an ongoing global recovery should work to increase the bottom line of many of our holdings.

We like the current make-up of the portfolio and market volatility does not really change our thought process at the moment. As mentioned earlier we aren't afraid to make changes where necessary and will continue to monitor all aspects of the portfolio despite the recent challenging market conditions.

Question: Andrew you always seem very positive in your views, what would make you change your mind in terms of future outlooks?

A: The phrase "the market is a voting machine" comes to mind when I see many questions coming in asking for my thoughts on the future. We have been positive on equity markets for quite some time now and that viewpoint continues to hold true. Almost all of our portfolio constructions have centered on both income and growth. This allows our investors to withdraw money even in times of economic stress. I will admit we are definitely in the early innings of monetary tightening or rising interest rates so markets will likely not have as big a tailwind as it once had. My expectation at this point is to not expect a repeat of recent year's strong performance but rather more muted returns similar to my comments at the end of last year. I will leave everyone with a few stats to contemplate. Most bear markets coincide with economic recession so one thing we look at our leading indicators of recessions. The most prevalent indicator is an inverted yield curve (when short term interest rates exceed long term interest rates – in particular, the U.S. Fed Funds rate being above the 10 year Treasury Bond yield) which can signal that a recession is 18 months away on average. Currently we have none of the typical signs of recession therefore we believe recessionary risks through 2018 are low at this point:

Sign of Recession	Present Today
Inverted Yield Curve	No
ISM Manufacturing PMI below 45	No
Positive Inflationary Trends	No
Capacity Utilization above 80%	No
Housing Starts Declining	No
Labor Market Weakening	No
Leading Economic Indicators Negative	No

Question: What has been the biggest change in the markets lately as far as you are concerned?

A: I would say the biggest change in markets has been the negative sentiment toward the technology sector. President Trump tweeting about Amazon lately and the Facebook data collection scandal has brought risks in the sector to the forefront of everyone's mind. People who use these services have started to question the benefits of technology relative to the costs, creating some uncertainty about whether this sector can continue to grow at the same pace. Once people start to realize services (think Facebook, YouTube etc..) which are now seen as free come with a hidden price (price being allowing your personal information to be used and in the case of Facebook shared) it will be interesting to see if people change their behavior. I don't think we are moving backwards with technology but changes might be coming which could affect corporate earnings (i.e. regulatory actions on the part of governments that would mandate greater spending on compliance and other such safeguards). We are not overweight in technology and this could very well turn out to be a great opportunity, but only time will tell.

Please feel free to contact us if you have any further questions or concerns. We would like to thank everyone who has recently completed one of our client experience surveys as it helps us to improve our levels of service.

Questions regarding our SP Global Tactical ETF Model:

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For a second quarter in a row, there were no material changes in the ETF model. The decision to remain less active is due to our belief that the model is well positioned to capitalize from the trade made during the third quarter of last year. Several of the trends we identified in 2017, including our continued interest in Emerging Markets (EM), an increase in general market volatility and a pick-up in the rate of inflation, remain in the early stages and we see them accelerating throughout 2018. We believe the portfolio is positioned to capitalize from these trends.

One area that has been a drag on performance during the quarter has been the model's Canadian equity exposure. We are actively reviewing this holding and may shift a portion of the holding into other areas of the Canadian market. Looking ahead to the second quarter, we intend to maintain our positions in strategies that can generate return in market conditions that may trend sideways and display ongoing periods of volatility. Option based income strategies and preferred share exposure are two areas where we think we can generate tax efficient income and capital gains.

On a positive note, as we have discussed in prior newsletters, the model is largely currency hedged to the U.S. dollar. With the ETF model's global focus, we made the decision a few years ago to limit currency swings as either contributors or detractors on performance. During the quarter, the Canadian dollar displayed some meaningful weakness. However, with the hedges in place in the model, this has been a near neutral event.

Q: The emerging markets gained momentum throughout 2017 after several years of poor performance. Are you planning to continue holding exposure to Emerging Market equities?

A: Many investors tend to have a home bias when it comes to country exposure. The majority of Canadians tend to have an overweight position in Canadian and North American equities. Similarly, in the United States, many Americans tend to hold the majority of their equity exposure in U.S. equities. Add to that several years of U.S. equity market outperformance relative to foreign markets, and it is safe to assume investors in North America are very comfortable with an overweight in U.S. stocks.

It is also not surprising to see a lack of exposure to Emerging Market (EM) equities despite a strong year of returns in 2017. In the past, EM countries were heavily dependent on developed market economies for success. From 2011 to 2015, EM equities experienced five years of underperformance, intensified by the strength in the U.S. dollar and weakness in commodity prices. However, years of structural reform are putting domestic growth on a self-sustaining path in key emerging market countries. In 2016, we saw EM economies bottoming, with reductions in balance of payment risk, broad strengthening of EM currencies, re-balancing of Chinese growth and the stabilization of commodity prices.

Unlike the aging population in North America, Emerging Market countries have a growing population of younger workers that are contributing to an evolution in emerging market production from manufacturing and exports, to imports and consumption. Correspondingly, the International Monetary Fund predicts that 70% of the world's GDP growth is expected to come from emerging market countries in the next five years.

Valuations in Emerging Markets look relatively cheap compared to developed market equities. According to Yardeni Research, the forward price earnings ratio of developed market economies has risen from 12 times earnings in 2012 to a current forward multiple of over 17 times. During that same time period, Emerging Market forward price earnings multiples have risen from 10 to their current valuation of approximately 12 times forward earnings. Despite some near-term concerns and risk in Emerging Markets, including recent protectionist measures undertaken by the U.S. government and tax reform allowing the repatriation of U.S. companies' cash holdings, we feel that the region trades at a significant discount to developed markets despite having superior fundamentals.

We expect to maintain and possibly to add to our current weighting in the Emerging Markets space in the foreseeable future. Despite improving returns in recent years, we feel the region remains an underrepresented asset class in investment portfolios, resulting in an attractive investment opportunity.

Q: I have heard you mention that the portfolio contains holdings that can benefit from rising volatility. Can you provide an example of one such holding?

A: During the quarter, we experienced a sharp correction in February with the S&P 500 Index dropping almost 9% from the January highs. A strong payroll number and an uptick in inflation drove U.S. bonds lower, which caused some investors to worry that growth and equity multiples could be negatively impacted as 10-year treasury yields climbed towards 3%. As markets pulled back, volatility linked strategies began to unwind, which exacerbated the move and generated a huge spike in general market volatility usually referenced by an index called the VIX. Against this backdrop, we had strong performance from our model holding Purpose Premium Yield Fund ETF - (PYF – T), which seeks to benefit during periods of higher volatility. As we discussed in our last quarterly commentary, we envision that 2018 will be a more volatile year for both the stock and bond markets. We feel it is important to seek out some strategies whose goal is to generate equity like returns with what we believe is less risk than a pure equity position. We also believe that a holding such as the Purpose Premium Yield Fund ETF offers our investors the opportunity to generate income and capital gains. The current yield (as of March 31st) on the position is just over 5% and we would not be surprised to see a bump in the dividend along with some additional capital appreciation if market volatility remains elevated throughout the year.

ETF Model	
Canada - Neutral	Continued uncertainty surrounding NAFTA, a slowing housing market and poor management by the government as it relates to pipeline infrastructure permitting are a few of many issues weighing down the Toronto Stock Exchange. Dividend stocks were particularly hard hit during the first quarter amid concerns of higher inflation and rising bond yields. The only Canadian ETF within our model, which has a dividend focus, was caught up in the market selloff. As the broader North American markets declined late in the quarter, we did see some signs of stabilization in Canadian dividend stocks.
United States - Underweight	Recent tax cuts pose a threat to the bond market and will likely lead to much bigger budget deficits. The U.S. Federal Reserve is gradually tightening and deficits are widening despite a growing U.S. economy. Higher interest rates may pose a threat to U.S. consumers pressured under the weight of record debt loads. With the U.S. Federal Reserve intent on reducing its balance sheet, we expect trillions of dollars of treasuries to be issued in the next year, which may potentially result in weakness for the U.S. dollar. We are taking a different view of the economy than the U.S.Federal Reserve and believe that growth will slow, inflation will rise and unemployment will increase. In addition, we believe U.S. stocks are expensive based on historic price earnings multiples and based on price to sale ratio of the S&P 500.
Europe – Neutral	Sustained above trend economic expansion is supportive of cyclical stocks. Earnings momentum has slowed somewhat and strength in the Euro currency remains a drag on company results.
Emerging Markets - Overweight	Economic reforms, improving corporate fundamentals and reasonable valuations support EM stocks.
Japan - Neutral	Improving global growth, more shareholder friendly corporate behaviour and solid earnings growth continue to support our positive view of the region. However, given the escalation in trade tensions and an appreciating Yen, we have a neutral view for the coming quarter.
Commodities & Precious Metals - Overweight	We expect a weakening USD to propel prices for commodities such as industrial metals, agriculture, energy and precious metals.

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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