TD Wealth

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Schacter Palazzi | Wealth Management

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Quarterly Commentary North American Model Changes:

Change	Equity Name	Symbol	Sector	Exchange
Sell	Encana Corporation	ECA	Oil and Gas	TSX
Sell 50%	HCA Healthcare Inc.	HCA	Healthcare	NY
Buy	The Walt Disney Company	DIS	Media	NY
Buy	Apple Inc.	AAPL	Technology	NY
Buy	Brookfield Property Partners L.P.	BPY.UN	Real Estate	TSX
Buy	Terago Inc.	TGO	Software	TSX

Encountering “pot-holes” while driving doesn’t mean you won’t reach your destination!

To say 2018 equity market returns were completely unlike 2017 might be a slight understatement. In 2017, we had slow growth, low inflation, and low interest rates in the U.S. and Canada; 2018 was a very different story, growth improved and solidified, inflation rose to more “normal” levels and threatened to break above, and as a result, central banks increased interest rates. Stuck between rising interest rates and major political noise coming out of both Ottawa and Washington, 2018 finally saw a break to a long winning streak in equities as they moved decisively down in the last 3 months of the year.

Generally we don’t get too fussed by noisy headlines but we do agree the level of volatility has ratcheted up of late. One thing that helps us focus in times like these is paying particular attention to the performance of the businesses that make up our portfolios. In truth, nobody knows exactly when the markets will experience a pullback, how sharp it could be, or how long it might last (much as some media pundits beg to differ). And, we try to not spend too much time trying

to forecast such things as politics – while politics can change things very quickly, they can reverse just as rapidly. Ditto for central bankers when it comes to interest rates. Our most important use for monitoring these situations is to constantly evaluate the climate to ensure that changes to our investee companies does not warrant any changes in our investment stance. As we noted in our September letter we made several changes in that quarter, ahead of the recent turmoil.

The best analogy I can use is to tell you that investing is like a long car ride: As drivers, we do our best to get you to your destination even if the road ahead isn't always smooth!

Let's get to the most asked questions the last quarter:

Q: Andrew we were quite pleased with where our portfolio was headed by the end of September but obviously a lot has changed in the past 2 months! Is this all based on President Trump and the effects of China etc.? What do you see as the major reason and should we be doing anything about it?

A: I believe the most damaging news to the markets so far in 2018 has been the relentless rise of interest rates in the United States. Yes, protectionism and fading U.S. fiscal stimulus are also culprits, as are the occasional outbursts from Washington. Despite all of these economic drags, I now feel global growth in 2019 will likely be better and with stock markets bringing valuations down, corporations will have a lower bar to achieve. Businesses who continue to operate efficiently and improve their dividend payouts are likely places we will continue to focus on.

As far as any major changes I would expect us to not do too many at this point but for those of you in balanced mandates we would likely look to add to equity if asset allocations are out of balance.

Q: Andrew where do you think we are in the business cycle as I remember the last recession being very painful on our portfolio's? What are some of the issues you are watching on our behalf?

A: I believe we are likely near the end of the business cycle especially since both the United States. Federal Reserve and Bank of Canada have been raising interest rates over the past year. I also think that the economy in North America is currently experiencing solid growth that we believe will carry at least through the early months of 2019. If anything, the equity market pullback makes it possible for companies to continue to outperform (especially companies operating in the right economic sectors and the ones that can adapt to evolving conditions). I would however expect more volatility in 2019. One of the issues we are watching is China. The trade dispute with the United States could easily affect markets in either a positive or negative way. Think of it this way, the main damage done by tariffs is higher prices on goods. Often however, whether it be here in Canada or the U.S., there is not always a domestic alternative to importing a product so a company (or a country in this example) ends up paying more for its imports. The effects of protectionism take some time to become broadly evident, so we will be reviewing our holdings a bit more carefully when assessing their future, and their balance sheets during this set of quarterly earnings reports. We also believe that Europe will be messy in 2019, marked by Brexit, Italian politics and even new ECB leadership.

Q: I know you have this question from multiple clients each year but could you give us your forecast on equities both in Canada and the US as it pertains to our equity component? You mentioned before you thought 2018 might be difficult, so do you feel the same in 2019?

A: With the violent sell off in equity market in December again demonstrating why US markets are the place to be relative versus the rest of the world. Canada and other international markets once again underperformed. That said, I would expect both the Canadian and International markets to outperform US markets in the year ahead simply because their lower relative valuations give them more room to move.

While I do have access to TD Economic forecasts I decided to take a look at what some of the competitor numbers are currently on the forecast front. RBC Global Asset Management on their global investment outlook forecast a +6.1% for the S&P 500 Index and +10.8% for the S&P/TSX Composite Index. Frankly, I find forecasting to be very difficult at the best of times – more so now that we live in a world with a number of non-normal factors affecting valuations of everything from equities to real estate. One must always take daily market valuations with a grain of salt.

I honestly feel that with the sell off at the end of last year and valuations of most companies being reset, 2019 might prove to be decent. However, I strongly feel the volatility we experienced in the last quarter might stay with us for some time.

Estate Planning and Tax!

We are particularly excited that we are bringing, estate planning and tax planning services to our households in 2019 as offered by our partners on the Wealth Advisory Services team. There remain a number of families who either have not done this process or simply require an update. I am also happy to report that we have introduced behavioural analysis to many of our people via our online tool Discovery tool. It really helps us refocus on what it important to our clients overall, and helps identify blind spots (this is an excellent time to complete the analysis with the return of market volatility). If your annual meeting is coming up soon, expect to see an email from one of our team members (Steve, Henry, or Nino) prior to meeting with us.

TFSA News!

I am happy to be able to announce that Tax Free Savings account (TFSA) limits are finally moving up to $6,000.00 per annum starting January 1st, 2019. They had been stuck on $5,500 per annum since the last Federal election when the Liberals came into power. If you are not on our automatic deposit program, please send your deposit online or via your bank starting January 2nd, 2019.

Taxes Are Coming!

Tax packages won't be sent out until late February or early March but if your accountant needs anything sooner please don't hesitate to contact the office directly and we will do our best to get the information to you as quickly as possible.

As always if you have any questions, please reach out to one of the team.

Hoping everyone has a prosperous new year!

Andrew, Jeff, James, Nino, Stacey, Henry,
Steve and Jane

As we enter 2019 we continue to believe that the markets will remain volatile. In particular, we anticipate that investors will have to brace for higher volatility during the first half of 2019. Therefore, we intend to be more defensive early in the year as a result.

During early fall of last year, we added approximately 10% cash weight to the model. We intend to be opportunistic with this cash sometime in the first half of 2019. However, in the near term we intend to remain defensive, as such we will continue to hold our cash weight in the model. We remain encouraged by opportunities in foreign markets as they are deeper into bear market territory and trading at relatively low valuations. That said a catalyst will be necessary for current circumstances to change. At the forefront will be the trade tension between China and the U.S. A trade agreement coupled with lowered U.S. growth expectations could be a catalyst for global markets. In past newsletters, we have mentioned that a valuation discount exists in emerging markets. Last year, we modestly increased our weighting to emerging markets. In hindsight, the move was made a little early. We are not ruling out a further increase to our emerging market positions as they tend to outperform off of market bottoms. Overall, we think 2019 will be a good year for equities, however the prediction on an outlook of market and sector selection will be important elements if investors are judging returns over the very short term. We encourage investors to view equity performance over a long-term return horizon, however, as we head into 2019, we recognize numerous uncertainties that face the markets. Couple this with the recent volatility experienced

toward the end of 2018 it is understandable that the human element of short-term analysis and fear may be top of mind for some investors.

As we look back on 2018 the United States stood out as the lone market in the world attracting capital inflows from investors around the world. The equity market performance particularly in the early portion of the year drove investor enthusiasm. Technology continued to be a strong driver and a heavy influence on the major stock market averages like the S&P 500 and NASDAQ. The flow of capital out of international markets including Canada was notable when you look at index returns in 2018. The second half of 2018 brought both equity and credit market struggles, but this volatility was not about a sea of change in macroeconomic fundamentals. Rather, the volatility was more about investors buying the rumour and selling the news. Tax cuts, stock buybacks buoyed growth projections in the early half of 2018. The growth brought forward the U.S. Federal Reserve rate hikes, however, higher rates coupled with trade tensions, tariffs, a stronger U.S. dollar and the unwinding of central bank balance sheets ultimately led to severe pressure on U.S. growth projections. As a result, the projected growth was no longer sustainable and market returns suffered globally.

Despite recognizing the overvaluation in the U.S. markets the ETF model performed below our expectations last year. The model was hurt by a strong United States Dollar (USD) as we were positioned in strategies that would have benefitted from a weaker USD. The good news is the USD is beginning to show some of the weakness we anticipated last year which should help our positioning as we enter 2019. In addition, we remind investors that most of our positions are currency neutral as such we were not able to pick up significant return from a weaker Canadian dollar throughout 2018.

As we look out into 2019, we believe a recession in the U.S. is a low probability at this point but do expect growth to moderate in and around the 2% level. The deceleration in growth should alleviate pressure on the U.S. Federal Reserve to raise rates. This policy change would be the opposite of what they communicated in 2018 and should help the positioning within the ETF model and extend the current economic cycle yet again.

Investors, until the end of this cycle, are likely to favor quality companies that can demonstrate true earnings growth in a persistently slow growth environment. We believe that the USD will show signs of weakness in 2019. This should benefit the ETF model lifting riskier assets such as base metals, precious metals and emerging market equities. A weaker USD should help energy prices which is usually a key driver for the Canadian equity market. We have become less enthusiastic about European equities and may reduce our weighting in 2019. We will retain the majority of our market exposure via our covered call option writing strategy to drive yield from what we hope is a volatile yet range bound European market.

In the United States we are looking to increase our exposure particularly to ETF's that screen for quality, low leverage and low Price-Earnings Ratio (P/E ratio) companies. If we are correct and the USD weakens it could be a catalyst for earnings growth of multinational U.S. corporations. As such we will look to position any new U.S. holdings in ETF's with exposure that fit this bias. Canada should benefit next year if we get a rebound in risk assets. Once again, a weaker USD, a resolution to China/US trade, the signing of Canada-U.S.-Mexico Agreement (CUSMA) and a stabilization of global growth would be a net benefit to Canadian stocks. We would use any early year weakness to add to our Canadian holdings.

Areas within the portfolio where that we would look to reduce would be our allocation to cash, precious metals, U.S. option writing, European Covered calls and preferred shares. Our current allocations to these positions remain unchanged as we see to many uncertainties in the near term. We believe these positions will be more defensive in the near term and offer better protection of our capital relative to the general market averages.

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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