TD Wealth

Game of Groans

Quarterly Commentary Q4 2018

In this issue

Markets 2
Portfolio 2
Conclusions 2

Chris Susel, CIM®, FCSI®, CIWM, TEP
Vice President, Portfolio Manager & Investment Advisor T: 416 308 8445
chris.susel@td.com

Mike Bowcott, CIM®, FCSI®
Vice President, Portfolio Manager & Investment Advisor T: 416 308 8461
mike.bowcott@td.com

Michael Garside
Client Service Associate
T: 416 308 8473
michael.garside@td.com

John Sharp
Client Service Associate
T: 416 307 9149
john.sharp@td.com

Juan Barahona
Assistant Investment Advisor
T: 416 308 8460
juan.barahona@td.com

Maple Ridge Asset Management Group
79 Wellington Street West, 10th Floor
Toronto, Ontario M5K 1A1
T: 1 866 220 0208
F: 416 308 1971

It would be an understatement to say 2018 was a tough year as equity investors had the carpet pulled out from under their feet in the last quarter. We are of course referring to the 15-20% correction that shook North American equity markets in the fourth quarter of 2018. With evidence of a strong economy but growing concerns over liquidity, the Fed indicated that it would continue on the path to interest rate normalization and this we believe was enough to send equity markets into a tail spin. Investors who were expecting the Santa Clause rally were handed a lump of coal with U.S. equities selling off sharply in December, registering the steepest December decline since the great depression. If that were not enough, investors were already grappling with the Trump tariffs, an escalating China trade war and the prospects of a Trump impeachment as Democrats took control of the House, which from our perspective is a political ploy meant to weaken the Republicans in advance of the 2020 U.S. Presidential election.

The Dow Jones Industrial Average and the S&P 500 index declined 11.83% and 13.97% respectively in the fourth quarter while the TSX composite Index, having gone nowhere all year, fell 10.89%. When all was said and done, the Dow, S&P500 and the TSX Composite indexes ended the year down 5.63%, 6.24% and 10.89% respectively.

Meanwhile, all this occurred while the U.S. unemployment rate sank to 3.7%, near all-time lows, while the U.S. economy, as measured by GDP, posted its best year since 2005, with GDP coming in at 4.2% in the second quarter and 3.5% in the third quarter of 2018. U.S. corporate profits continue to rise as a result of the Trump tax cuts and we saw evidence that wages are on the rise. This has left many investors questioning the Fed's quantitative tightening stance, leading to concerns of policy mistakes that could trigger a recession. Although it has been joked about that the stock market had forecasted 9 of the past 5 recessions, the Fed has forecasted none of the past five recessions and therein lies the problem for equity investors. The Fed has a dismal track record when it comes to forecasting and we believe that under Chairman Jerome Powell, it will have underestimated the impact that rising interest rates have on an over-indebted global economy. That, in combination with the impact of President Trump's tariffs and trade wars, has led to a very noticeable decline in economically sensitive equities, which have fallen 25-40% and are in our view, a far better predictor of recessions than Wall Street pundits, economists and the Federal Reserve. The selloffs have been exacerbated by the increasing influence of computerized trading and liquidity issues brought about by investor's excessive enthusiasm for index funds.

As we have argued in the past, solving a debt crisis by encouraging the use of more debt is not a viable solution, unless growth in the economy is sufficient to generate the revenues required to service the debt obligations in a rising interest rate environment. The growth in global debt now tops US$250 trillion and the U.S. Government debt is now approaching US$22 trillion and heading much higher over the coming years as a result of the Trump tax cuts. The Fed interest rate increases in combination with running off its balance sheet by US$50 billion per month has led to a reduction in liquidity and tightening of credit conditions. In theory, if the growth of the Fed's balance sheet encouraged investors to buy stocks and corporate debt, then as the Fed raises interest rates and reduces its balance sheet the inverse should likely be expected and stock and bond prices should fall, as they have done.

It is important not to get caught up on the size of the debt as long as the economy is growing at a decent pace and one must realize that there are countries in far worse shape than the U.S. However, a strong U.S. economy with rising wages and inflation over 3% is of great concern to the Fed and that is why they believe they must continue to raise rates. This in our opinion heightens the risk of a policy error that the Fed does not consider the fallout implications of higher interest rates on not only the U.S. economy but the global economy as well. It does not take much of an interest rate hike to neutralize the impact of the Trump tax cuts in an overly indebted U.S. economy. As we have stated before and will again, we believe that there is no graceful exit from quantitative easing.

What we have to be mindful of is that Central Banks have told us that they are prepared to do whatever it takes to prevent another global financial crisis. Unless that has changed and we do not believe it has, we should continue to take advantage of opportunities as they present themselves. We must also be prepared for policy errors that may cause further selloffs over the coming months while looking for signs that the Fed is rethinking its quantitative tightening bias which we believe is inevitable.

Markets

The Canadian stock market is no higher now than it was in the summer of 2008—ten years of no returns other than dividends and a lot of volatility. Corporate earnings have risen more than 30 per cent over this time frame and the TSX Composite price/earnings multiple now sits at 13.3 times, the lowest it has been over the past five years. It is now two-and-a-half points discount to the S&P 500, the widest valuation gap since June 2004. The Canadian equity market is reflecting the impact that rising interest rates will have on a heavily indebted economy along with the fallout of the collapse in Canadian crude oil prices relative to U.S. crude oil prices, which at one point had a price differential of $40. The Canadian energy sector has a significant weighting of almost 20% in the TSX Composite index.

We are now seeing opportunities for investors in Canadian equities, particularly high quality dividend payers, which have been hit hard as a result of the interest rate increases which are now moderating.

Portfolios

We continue to expand our discretionary managed portfolios with the introduction of the concentrated Canadian Equity Income portfolio along with the Core Dividend portfolio, Canadian Growth Portfolio and the US Growth Portfolio. We believe the sharp selloff in equity markets, particularly in Canada has presented opportunities to acquire high quality companies with above average yields and near term capital appreciation.

We also believe that there is an opportunity to increase the weight towards the equity income portfolios as the yield on the Core Dividend Portfolio is 3.63% and the concentrated Equity Income Portfolio is over 6%.

Conclusion

Policy mistakes from our perspective remain the biggest threats to global growth in 2019 and beyond. Whether it is the tariffs or trade wars, rising budget deficits in the US, high debt levels in the US, Europe and Japan or the potential missteps by Central Banks, they all pose threats to the global economy.

We would not read too much into the current U.S. Government shutdown dispute or the likelihood of the Democratic Congress threats to impeach President Trump. Although this may lead to more volatility in equity markets, we see very little chance of President Trump being impeached. From our perspective, only a faltering economy and stock market could stop President Trump from seeking and receiving a second term in office.

The good news is that the probability of such policy mistakes seriously hurting global growth in 2019 is still relatively low and we also believe that the Fed is now aware of the issues given the sharp selloff in equities during the fourth quarter of 2018. We expect to see increased levels of volatility during the first quarter of 2019 emanating from the U.S. as Trump's agenda unfolds and his political foes up the ante prior to the 2020 Presidential election. We expect the Fed will likely be more accommodating as the year unfolds and we will look to take advantage of the opportunities greater volatility potentially brings.

Contact us today

Chris Susel, CIM®, FCSI®, CIWM, TEP
Vice President, Portfolio Manager & Investment Advisor
T: 416 308 8445
chris.susel@td.com

Mike Bowcott, CIM®, FCSI®
Vice President, Portfolio Manager & Investment Advisor
T: 416 308 8461
mike.bowcott@td.com

Michael Garside
Client Service Associate
T: 416 308 8473
michael.garside@td.com

John Sharp
Client Service Associate
T: 416 307 9149
john.sharp@td.com

Juan Barahona
Assistant Investment Advisor
T: 416 308 8460
juan.barahona@td.com

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Toronto, Ontario M5K 1A1
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www.mramg.ca

Maple Ridge
Asset Management Group

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