TD Wealth

Be Careful What You Wish For

Quarterly Commentary Q2 2018

In this issue

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Over the past year, U.S. President Donald Trump has set the U.S. in a new direction. He has criticized the North Atlantic Treaty Organization (NATO), slapped punitive tariffs on America's closest allies and at some point, he will likely turn his attention to the International Monetary Fund (IMF) when he comes to realize a strong U.S. dollar threatens his economic agenda. Trump's new world order touches every corner of the globe and it is apparent that the President is putting the world on notice. The U.S. is no longer going to foot the bill if it is not in America's best interest. On the domestic front, the U.S. economy and U.S. equity markets continue to respond favourably to the President's "Make America Great Again" agenda but it may run into headwinds as the President attempts to renegotiate international treaties and obligations.

On the surface, the President's economic agenda is having a positive effect on the U.S. domestic economy, but the laws of economics will eventually confront him. Soaring budget deficits, a strong U.S. dollar and a hawkish U.S. Federal Reserve (Fed) are setting the stage for an eventual showdown between the President and his appointed Fed Chair, Jerome Powell.

The U.S. economic expansion is now the second longest running expansion on record and although they do not die of old age, they eventually do turn into recessions when monetary policy changes from accommodative to restrictive. The economic expansion from 2009 was induced by an unprecedented increase in Central Bank liquidity (interest rate suppression) that has resulted in the swelling of global Central Bank balance sheets to well over US$20 trillion. In the case of European and Japanese Central Banks, their extraordinary monetary policy resulted in controversial policy which gave rise to negative interest rates. Fed policy continues to diverge from that of its counterpart Central Banks in other countries and it continues to signal higher interest rates are in the cards, which at some point will likely be problematic.

The President has embarked on a massive stimulus program late into the expansion and at a time when the economy is running at full employment and he has also implemented tariffs on the US's trading partners, which have been met tit for tat with retaliation. The potential for sustainable inflation or a brief spike has risen significantly. The questions to be answered are how will the bond market, Fed and President react and what are the implications for the President's economic agenda. We note the continued rise in oil prices is having an effect on U.S. consumers and the President has responded by using his now famous twitter account demanding that Saudi Arabia pump more oil. In fact, he has even suggested that the U.S. may consider releasing oil from the U.S. strategic petroleum reserves. If the oil market is as tight as the President intimates, he appears to have put the world on notice, including traders and speculators that oil prices are going higher. The Fed is in a tight position and will feel the pressure to continue to raise interest rates as long as it does not destabilize the economy, equity markets, or more importantly, the President's economic agenda. If the Fed over-reacts, it could trigger a recession. If the Fed fails to keep pace with inflation, it risks undermining the bond markets and sending interest rates higher.

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Credit Tightening

The Fed's divergent interest rate policy in combination with the President's significant reduction in taxes applied to U.S. corporations repatriating cash held offshore is creating tight global credit market conditions overseas. Tight credit is primarily affecting emerging markets where an over-reliance on U.S. dollar-denominated debt financing is now creating demand for U.S. dollars as the dollar strengthens. Borrowers must not only service the debts, they must also pay them back in U.S. dollars. In Europe, U.S. dollar LIBOR rates have jumped from a low of .30% in 2016 to over 1.90% today. From our vantage point, the demand for U.S. dollars is likely to accelerate for two reasons:

1) The Fed's intention/need to normalize rates
2) The global demand for U.S. dollars is expected to remain strong due to what we will call a global dollar shortage brought on by the repatriation of U.S. dollars and the Fed's divergent monetary policy.

The Fed is raising rates, making dollar assets more attractive and they are shrinking their balance sheet, quantitative tightening (QT) which is reducing liquidity. Adding fuel to the dollar rally is President Trump, who is attempting to shrink the supply of U.S. dollars globally by reducing the current account deficit (fewer dollars) with his trade policies. This is counter-intuitive and it conflicts with the U.S. Government's obligation as the international reserve currency to supply U.S. dollars to the world for commerce and trade. Shrinking the current account balance can only be offset by expanding the capital account (capital outflows) but the Fed's divergent monetary policy has the opposite effect as it attracts global capital to U.S. dollar assets and the demand for dollars increases. At some point, we feel that the inevitability of a showdown between the President and the Fed is a certainty. Will it be before or after the U.S. mid-term elections in November?

We should not underestimate the potential for a misstep by the Fed or the U.S. President. There are no winners in trade wars and the thought of initiating one with America's allies, who also happen to be the U.S. Governments largest creditors is preposterous. U.S. equity markets, for the most part, have ignored the President's antics, likely due to the corporate tax cuts and the resulting boost to corporate earnings as well as the repatriation of trillions of U.S. dollars held abroad, which will probably find their way into productive investment, or more likely be used for increased dividends or share buybacks. Higher U.S. interest rates and trade wars have so far not impacted equity markets and we suspect global capital flows are likely to continue to favour U.S. dollar assets. We expect the dollar and equity markets to continue to benefit but are mindful of the risks of a misstep by the Fed and the President.

"Trade wars are good, and easy to win." - President Donald J Trump. March 2, 2018

A significant risk to global markets is rising trade protectionism stemming from the U.S. Presidents belief that the playing field, as it relates to trade, is unfairly slanted in favour of America's trading partners. Although we could argue that it is not as uneven as the President suggests, we have to accept that the President believes that it is until proven otherwise. You would think that the trillions of dollars earned and held offshore by U.S. Corporations would be a good clue. That being said, there are only temporary winners in a trade war and as the costs begin to escalate, we suspect cooler heads will prevail and the President will have extracted some concessions from America's trading partners which he will use to appease his support base in advance of the U.S mid-term elections and certainly well before the 2020 election.
Meanwhile, in the face of a trade war, the global economy continues to advance at a modest rate and the U.S. is picking up the pace on the back of a stronger consumer, buoyed by the President's massive fiscal stimulus program. The Canadian economy is moderating as the fate of the North American Free Trade Agreement (NAFTA) clouds the outlook, but we do anticipate this will be resolved as the rhetoric dies down and the facts emerge. We expect Canada will offer up some minor concessions.

Markets

The S&P TSX composite index rose 6.77% in the quarter ended June 30, 2018, with ten of eleven sectors posting positive returns led by energy and financials while utilities were falling. U.S. equity indexes posted gains led by the NASDAQ up 6.6% with the S&P500 index up 3.43% and the Dow Jones Industrial Average up 1.26%. Six of the ten sectors in the S&P500 posted gains led by technology.[1]

[1] *Source: July 4, 2018: TD Wealth, Quarterly Market Report - Portfolio Advice & Investment Research

Over the past 18-months, equity markets have transitioned from an interest rate-driven to an earnings-driven secular bull market. Given the economic and geopolitical backdrop, we believe we are at the point in time where fundamentals matter, as compared to passive (indexing) investing, which masks the risks of its underlying constituents.

Portfolio

During the quarter, we sold Power Financial and bought Canadian Imperial Bank of Commerce (CIBC) in the core dividend portfolio. In the Canadian growth portfolio, we sold Emera, Richelieu Hardware and WSP Global while adding Enghouse Systems, National Bank and Brookfield Asset Management. The U.S. growth portfolio was active during the quarter selling ABBVIE, Hasbro, Humana, Intuit, Juniper Networks and Motorola while adding Proctor and Gamble, T Rowe Price, Paychex, Oracle and Hershey Company.

Conclusions

The U.S. economy and equity markets continue to power ahead in spite of tariffs and trade wars, primarily driven by President Trump's massive fiscal stimulus program. The equity market resiliency is telling us that an escalating trade war is unlikely. What is known is that U.S. corporate earnings are expected to increase 10-20% over the next four quarters and earnings forecasts for the S&P500 are forecasted to hit $200 in 2020. The question we need to be asking ourselves is, can it get any better or better yet, what can upset the apple cart?

In our view, the Fed may pose a more significant problem for the financial markets than many expect as they are forced to react to higher inflation. This has been compounded by the President's tariffs and massive fiscal stimulus in a tight labour market. The pace of US inflation is now outpacing wage gains late in the business cycle as inflation moves up to 2.9 from one year ago compared to a 2.7 per cent gain in average hourly earnings. Given that the U.S. is applying tariffs on imports, producer and consumer prices are likely to move higher over the coming months and the Fed is at risk of falling behind or making a policy mistake if it was to over-react. We should expect the Fed to continue to raise the federal fund rate at its Sept 26th, 2018 Fed meeting and they will likely continue to increase rates in December and perhaps into 2019. The possibility of inverting the yield curve and triggering a recession is heightened as is the risk of raising the ire of the U.S. President.

Although the Fed is supposedly independent of the Gov't, we are mindful that Jerome Powell was President Trump's appointment. We believe that the Fed will talk tough on inflation and continue to raise interest rates. International capital flows will continue to favour U.S. dollar assets and a strong U.S. dollar will eventually elicit a response from not only the President but also the international community who will demand action. In our view, the risk to global financial markets is not President Trump or a trade war, it is a rising U.S. dollar that eventually triggers a dollar crisis. We have argued for many years that there is no graceful exit for Central Banks. **It is a classic case of "Be Careful What You Wish For".** Position yourself accordingly.

NOTE: Going forward, we will be releasing our commentaries on a semi-annual basis.

Contact us today

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