TD Asset Management

PRIVATE **INVESTMENT** COUNSEL

insights

Mid-Year Report

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Summer brings a valuable opportunity to take vacation and recharge, but also to examine what transpired in financial markets and in your portfolio during the first half of 2019. Equally important, it is time to outline what we believe may be in store for the second half of the year before you go on vacation.

First Half Review

The fear that nearly brought equity markets face-to-face with the bear market during the last three months of 2018 disappeared almost as quickly as it appeared sending equity markets sharply higher during the first half of 2019.

At the beginning of 2019, the TD Wealth Asset Allocation Committee identified a number of themes and made several changes to our positioning to take advantage of cheaper stock prices that became attractive due to the temporary market correction. Let's take a look at where we are at the halfway mark of 2019.

Overweight equities and underweight fixed income. Our prognostications proved directionally correct as North American equity markets outpeformed fixed income markets. Specifically, we favoured U.S. equities while recommending a neutral weight to Canadian equities, and a modest underweight position in international equities as earnings growth was expected to be modest given the weak economic growth and high political risks. Key reasons for our favouring the U.S. at the beginning of the year were reasonable valuations and the expectation that U.S. corporate earnings growth would continue to be healthy. Our hunch on U.S. corporate earnings proved true as U.S. corporate earnings came in better than feared as 76 percent of S&P 500 companies reported earnings that exceeded analysts estimates for the first quarter of 2019[1].

Favour corporate credit relative to government bonds as spreads have widened significantly. Muted inflation and high household debt levels in Canada were expected to contribute to a lower rate environment from a historical perspective. More specficially, we anticipated low single digit fixed income returns. Consequently, we recommended investors shift to high quality corporate investment grade bonds due to the potential of higher inflation adjusted returns and corporate bonds did in fact outperform government bonds over the first half of 2019. But government bonds did provide returns that were higher than we expected as renewed trade tensions saw investors flock to the safety of government bonds.

Table 1: Asset Class Returns (%)

Fixed Income	YTD Jun'19	Q4 2018	2018	1 Year	3 Year	5 Year
FTSE Canada Universe Bond	5.6	1.8	1.4	7.0	3.0	3.7
FTSE Canada All Government Bond	5.5	2.1	1.5	7.2	2.7	3.7
FTSE Canada All Corporate Bond	5.7	0.9	1.1	6.7	3.7	3.9
Equities	**YTD Jun'19**	**Q4 2018**	**2018**	**1 Year**	**3 Year**	**5 Year**
S&P/TSX Composite Index	16.2	-10.1	-8.9	3.9	8.4	4.7
S&P 500 Index	13.4	-8.6	4.2	9.7	14.4	15.3
MSCI EAFE Index	9.1	-7.6	-6.0	0.4	9.3	6.5
MSCI Emerging Markets Index	5.9	-2.2	-6.5	0.9	11.3	7.2

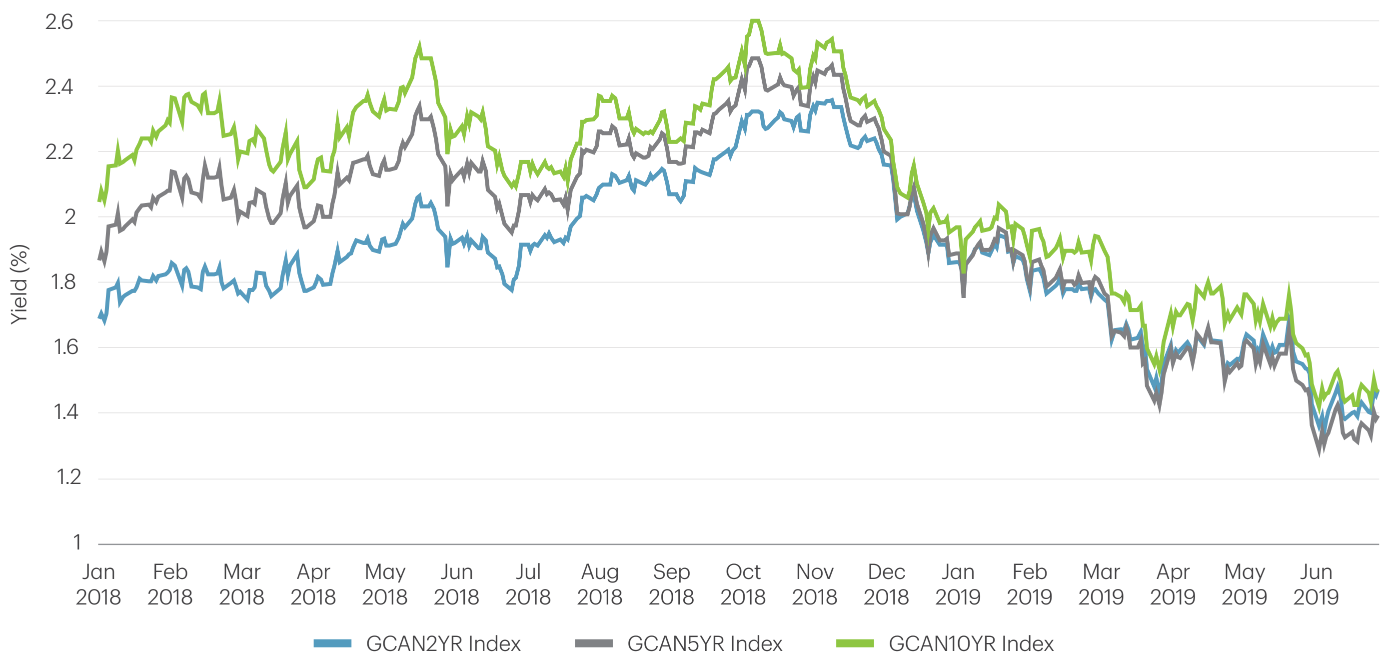
Source: Morningstar Direct, TD Asset Management Inc. Annualized periods (1-, 3-, 5-year) as at June 30, 2019. Indices are total return.

2019 Second Half Outlook

We are in one of the longest economic expansion periods and longest bull markets in history, which is leading many to speculate that the end is imminent. We do not share that view because unlike living animals, bull markets and economic expansions do not simply end because of old age.

Despite some evidence of slowing global growth and trade risks, we continue to believe that recessionary risk remains low for North America. So, our hunch is that we will continue to move ahead in a slow growth – not zero growth – economic environment, which could lead to higher corporate earnings, albeit at a slower pace than we've recently seen.

Chart 1: Government of Canada Bond Yields



Source: Bloomberg Finance L.L.P., TD Asset Management Inc. as at June 28, 2019.

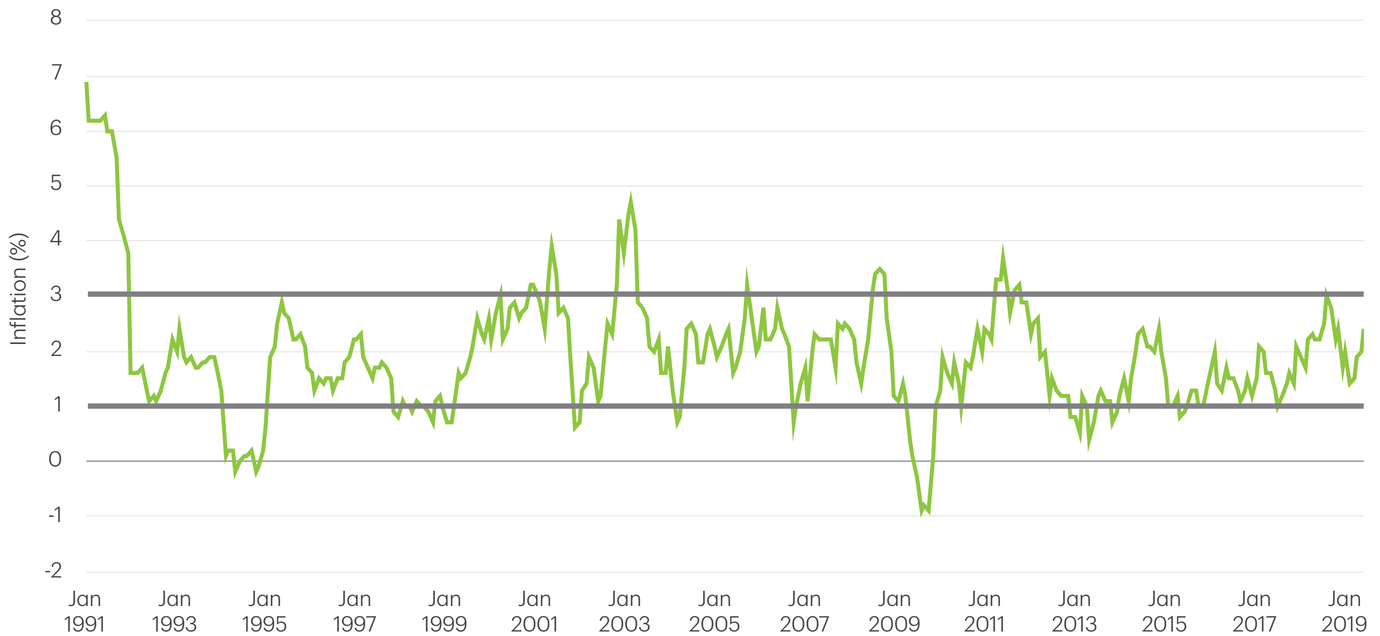
Canadian Fixed Income: How Low Can We Go?

Canadian government bond yields continued to fall as expectations for rate hikes all but disappeared due to concerns around slowing global growth and volatile trade tensions **(Chart 1)**. With Canadian government bond yields at rock bottom levels, we expect bond yields will remain in a range near these current low levels. Consequently, we continue to favour investment grade bonds for their higher real yields relative to governent bonds.

While market watchers including us are expecting the U.S. Federal Reserve Board (the Fed) to cut interest rates, it is not clear that the Bank of Canada (BoC) will also follow with rate cuts. Since 1991, the Bank of Canada has successfully instituted its road map to interest rates where the BoC aims to maintain inflation between one and three percent **(Chart 2)**. The road map is simple to use. As inflation rises to three percent, the BoC would raise interest rates. And

as inflation slides towards one percent, the BoC would start lowering interest rates. With inflation currently sitting at around two percent and with no clear evidence of economic deterioration, it is our hunch that the BoC will remain on the sidelines for the remainder of the year.

Chart 2: Canadian Consumer Price Index



Source: Statistics Canada, Bloomberg L.L.P., TD Asset Management Inc. as at June 28, 2019.

Oh Canada!

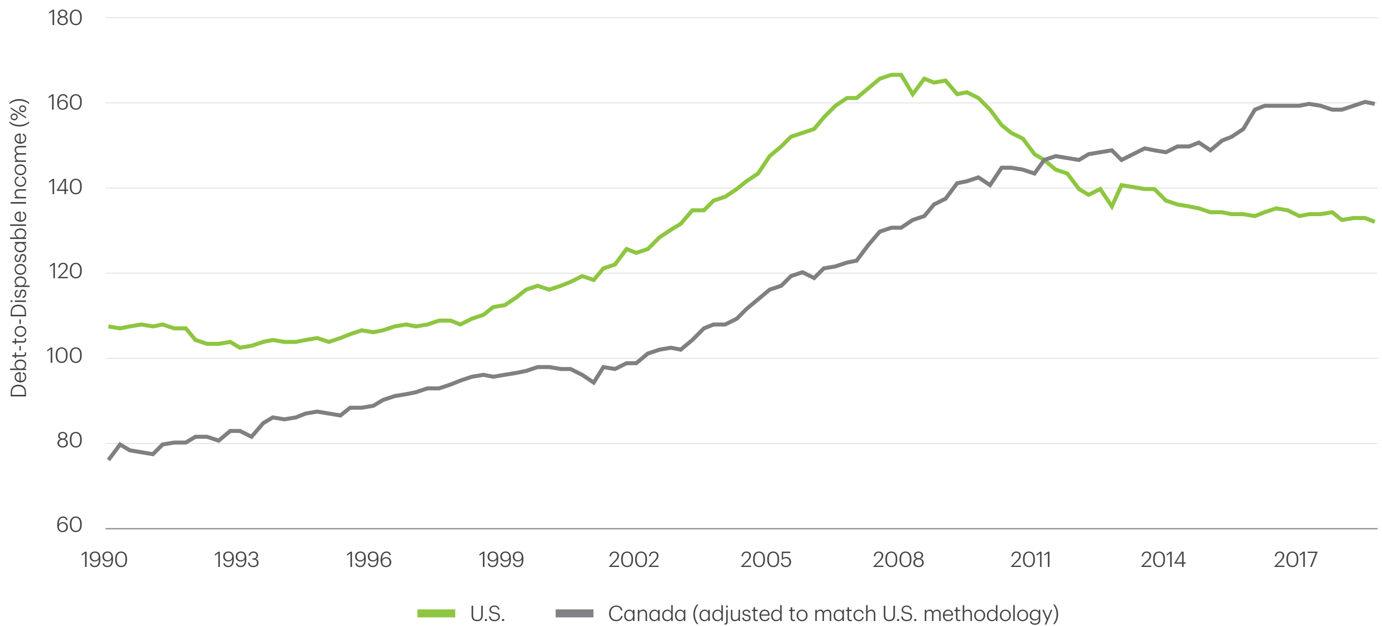
Going back to our economics 101 class, recall that Gross Domestic Product (GDP) = Consumption + Investment + Government expenditure + Exports – Imports. The two largest contributors are typically consumption and investment, which are the two variables that form the foundation of our view on Canada.

We continue to remain constructive on Canada, however there are two key headwinds that tempers our outlook for Canada. The first is the Canadian consumers who have to contend with high debt levels **(Chart 3)**.

But, the good news is that we've had eight years of solid continuous job growth which has driven the Canadian unemployment rate to new record lows. And with the spectre of rising interest rates in Canada all but gone, we hope that this will give Canadian consumers time to work down their debt to a more manageable level. But the fact

GDP = C + I + G + NX

Chart 3: Canadian Debt-to-Disposable Income 1990 to 2018

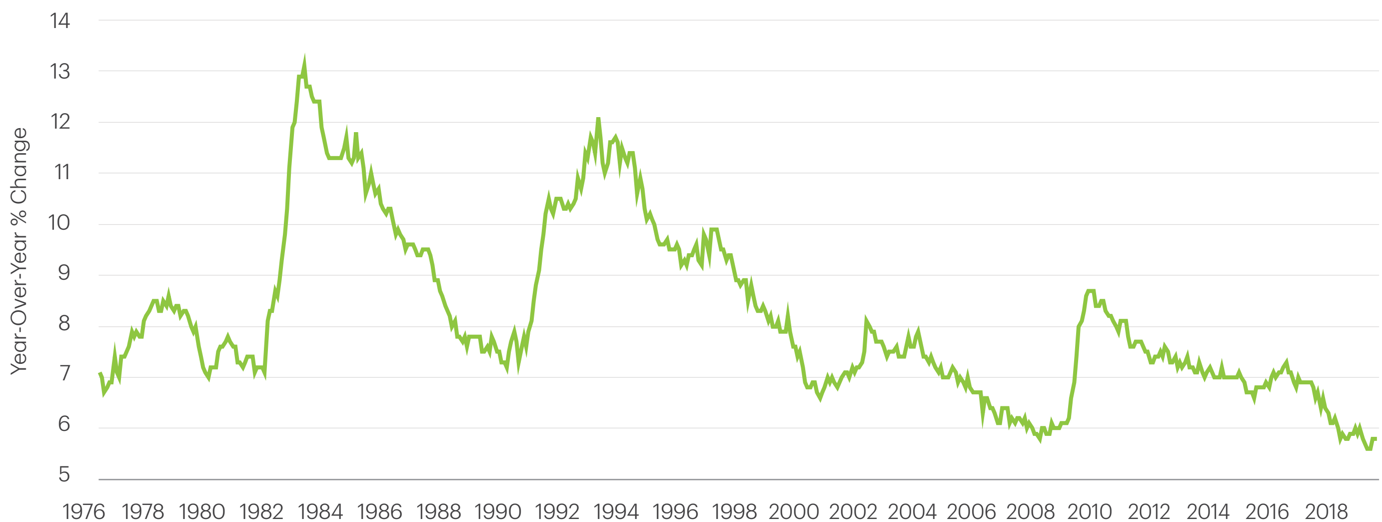


Source: Statistics Canada. Federal Reserve, Bureau of Labor Statistics. Debt includes mortgages, credit cards, personal loan plans, lines of credit and other loans. Disposable income includes all income net of taxes, as at June 28, 2019.

remains that high debt levels and lukewarm housing in Canada is expected to keep a lid on consumer spending for a time.

Turning to investment, it is our belief that business spending will also continue to be tepid due to the gridlock that is slowing Canada's ability to export its oil. The energy sector is the second largest sector of

Chart 4: Canadian Unemployment Rate %

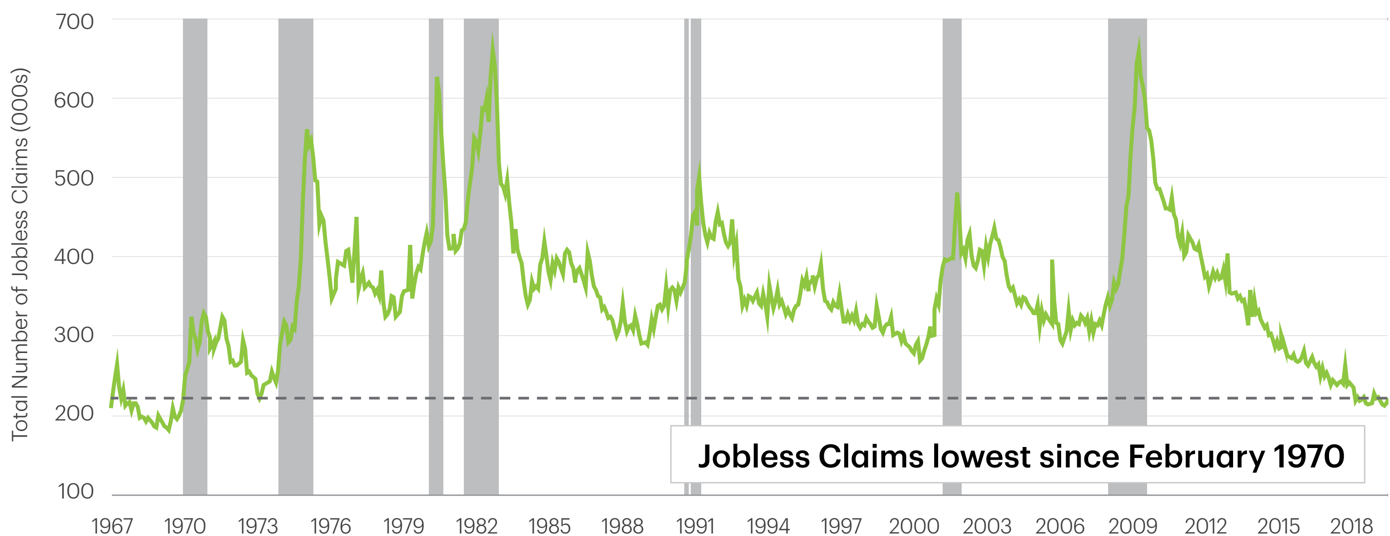


Source: Bloomberg Finance L.L.P., TD Asset Management Inc. as at June 28, 2019.

the Canadian stock market and accounts for almost 11 percent of nominal GDP. For more details on the Canadian energy sector, read our special report Decoding the Canadian Crude Conundrum. There are early signs that the we are seeing a modest recovery as oil production curtailments seem to be working combined with improved global oil prices and a lower gap with Canadian oil prices. Additionally, while one quarter does not make a trend, Canada also saw an unexpected surge in machinery and equipment investment at the beginning of 2019.

And one quick thought on our banking sector given the recent headlines suggesting that our banks were at risk of material detioration. We continue to believe that Canadian banks remain good value despite some investors who believe the opposite. Canadian banks remain well capitalized and even if we enter a soft patch, we believe that Canadian banks are well positioned to weather any potential storm given their balance sheets are healthier than the period leading up to the financial crisis. More importantly, the Canadian banking business model survived the worst financial crisis of our lifetimes relatively unscathed - the Canadian banking sector did not lose money on full year basis during the financial crisis and more importantly no Canadian bank cut their dividend during the worst financial crisis of our lifetime.

Chart 5: U.S. Initial Jobless Claims with Recessions Highlighted



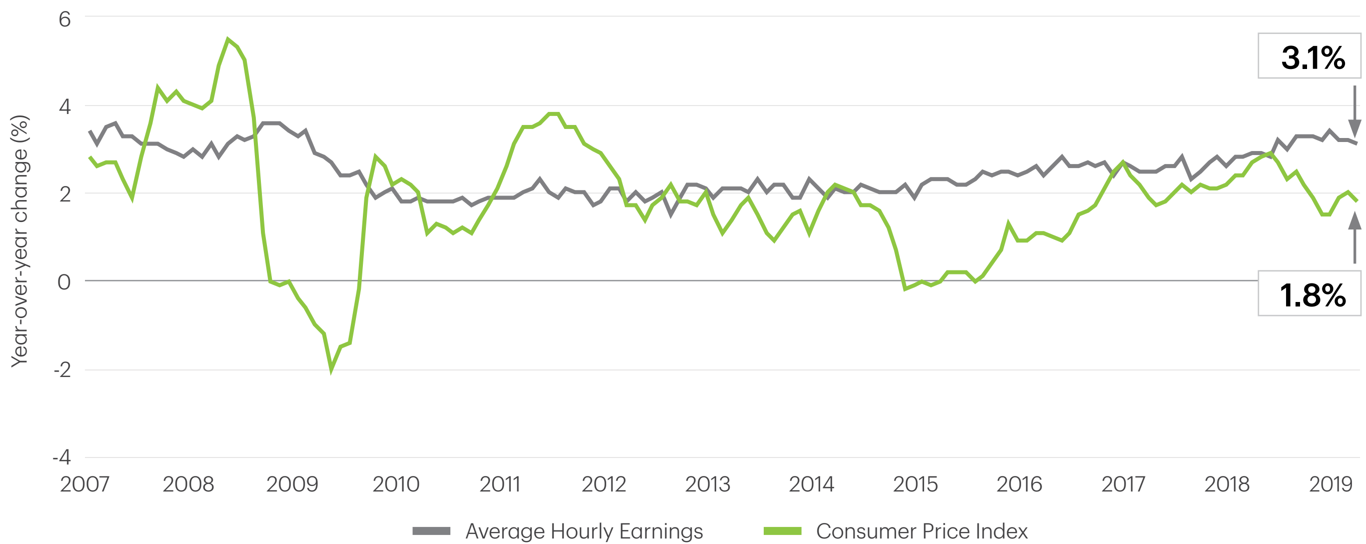
Source: Bloomberg LLP., Bureau of Labor Statistics, TD Asset Management Inc. as at June 28, 2019.

United States

Since the beginning of the year, the U.S. stock market has staged a brisk rally, yet we continue to believe that U.S. stocks will record rewarding returns even from these levels and U.S. stocks presents lower risk compared to Canadian equities at this time.

Recall that consumption is one of the main drivers of economic growth, typically representing over 70 percent of U.S. GDP. With U.S. employment booming - hovering near 50 year lows - we believe that the U.S. consumer will be a support driver of the U.S. economy. Strong U.S. employment has also been reinforced by hourly earnings that have been outpacing inflation, which should help foster consumer spending. Not only has employment been strong, but just when you thought U.S. manufacturing was dead, 264,000 new manufacturing jobs were also created, which was the greatest annual increase since 1997[2].

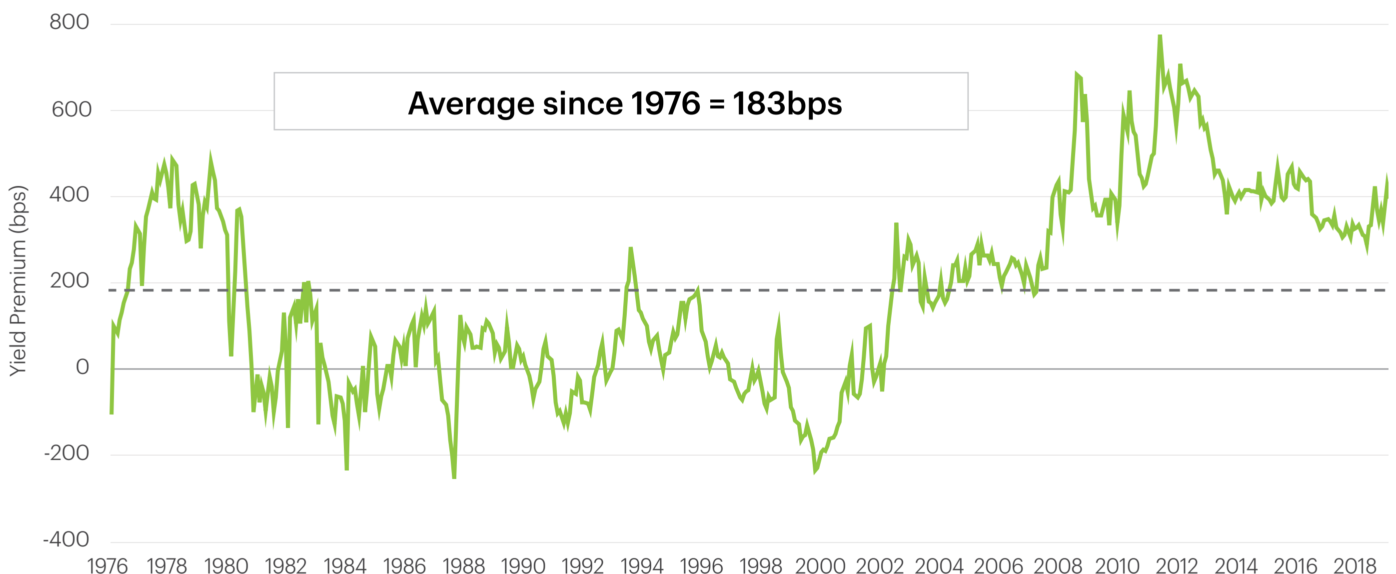
Chart 6: U.S. Average Hourly Earnings & U.S. Consumer Price Index



Source: Bureau of Labor Statistics, TD Asset Management Inc.

U.S. corporate health also remains healthy with companies generating very strong free cash flow. We anticipate the combination of modest earnings growth, two to three percent dividend yields and stable valuations should deliver mid-to high single digit returns over the next 12 to 18 months. Valuations are also supportive of U.S. equities. The U.S. stock markets earning yield (earnings divided by share price) is approximately 6.0 percent, which is higher than the 2 percent yield of a 10-year U.S. Treasury Bond. The significantly higher stock earnings yield indicates that stocks are not only inexpensive, but that they should earn higher returns than bonds.

Chart 7: S&P 500 Yield Premium (Earnings Yield – 10yr Treasury Yield)



Source: Bloomberg L.L.P., TD Asset Management Inc.

And with interest rates expected to fall, monetary policy should become more accommodative in the U.S. and should help alleviate some of the uncertainty of the ongoing trade war.

Chart 8: Fed Futures Point to Lower Interest Rates

Source: Bloomberg Finance L.L.P., TD Asset Management Inc.

International

Finally, our last theme is that international equities remain a complicated area to invest. European stocks represent good value at these current levels, however the economic outlook for Europe remains challenging. In Asia, our hunch is that the stimulus in China should help drive a growth pick up in Asia.

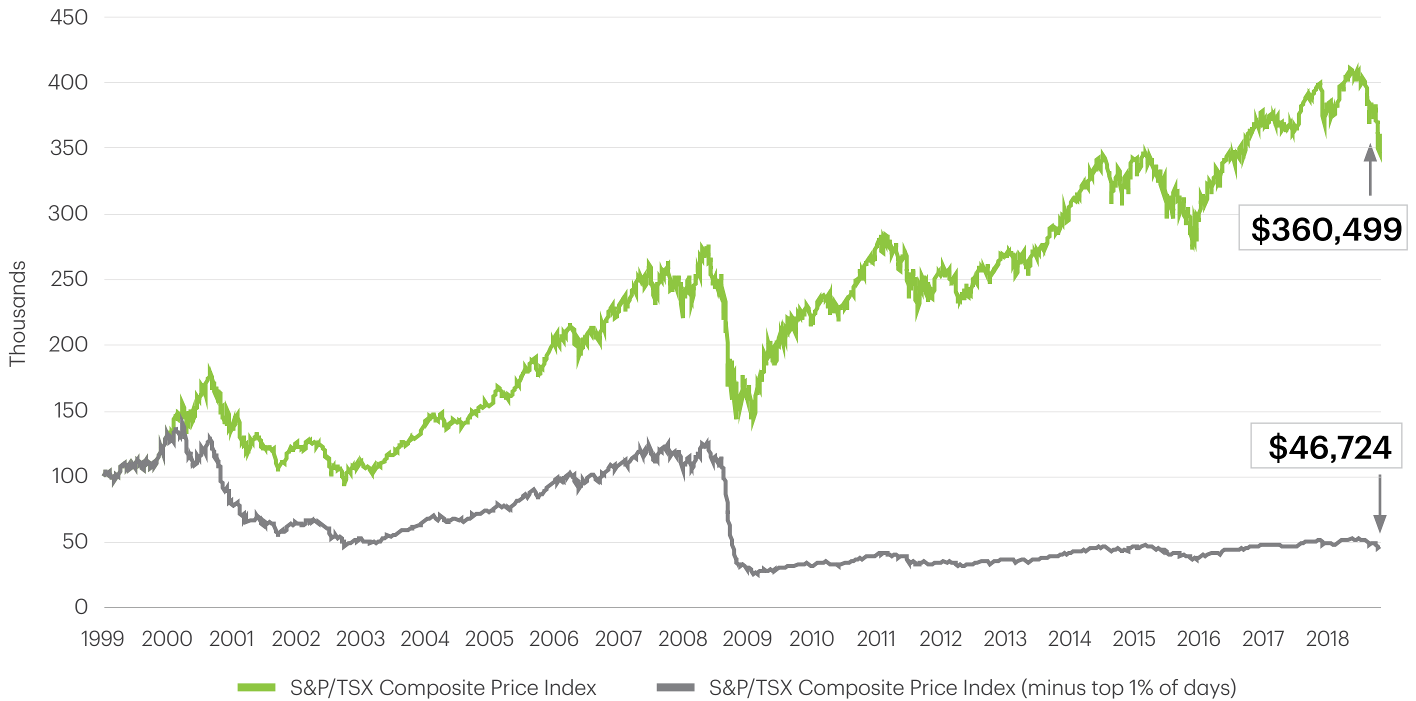
Final Thoughts

As we look ahead to the second half of 2019, one of the key risks to our outlook remains the trade frictions between the U.S. and China, which is expected to create episodes of short term volatility. For more details on the ongoing trade saga, read our special report Trump, Tariffs and Trade Wars – 3.0. In our view, this conflict is likely to persist for a prolonged period of time, but we do not think it will tip the global economy into a recession.

While we remain optimistic on the longer-term outlook for equities, periods of volatility will undoubtedly be unnerving and the temptation to move to cash will likely be high. Dietrich Bonhoeffer once remarked that the best-informed man was not necessarily the wisest and that there was a danger that in the multiplicity of knowledge one was at risk of losing sight of what is essential. What is essential when it comes to investing is to stick to your

Chart 9: S&P/TSX Composite Index — Growth of $100,000

January 1, 1999 to December 31, 2018



Source: TD Asset Management Inc. and Bloomberg Finance L.P. Data as of December 31, 2018. For illustration purposes only. The index returns are shown for comparative purposes only. Indexes are unmanaged and their returns do not include any sales charges or fees as such costs would lower performance. It is not possible to invest directly in an index. The graph is used only to illustrate the effects of the compound growth rate and does not reflect future values of any fund or returns on investment of any fund.

investment plan and not get distracted by short term noise. There are two ways in which you can make money in the markets. Either you are an investor or you are a trader. No doubt you can make money trading by moving in and out of investments, but it is a risky proposition when you consider that missing just one percent of the best days can signficantly reduce your long-term portfolio as shown in **Chart 9**. There have been 5,218 trading days between January 1999 and December 2018. For instance, if you had invested $100,000 in January 1999, but missed just one percent of the best days or 52 days, your portfolio would be worthy $46,724. Staying invested through the tech bubble, the financial crisis and the sovereign debt crisis, would have yielded a portfolio worth $360,499.

Final Thoughts

For more information, please contact a
TD Wealth Private Investment Counsel Portfolio Manager

[1] Source: FactSet. All views expressed are as at June 30, 2019.
[2] Source: Bureau of Labor Statistics.

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