Investing in Uncertain Times

Backdrop and Perspective
Since the 2008 financial crisis, investors have endured a series of rolling crises as the developed world has been forced to confront a mountain of debt and take corrective action in an environment of extreme political dysfunction across many countries. Deleveraging is an extremely difficult and painful process as it ultimately requires people to adjust to lower standards of living than they had become accustomed to. The current environment is all the more challenging as deleveraging is happening on a global scale, and for certain countries, it will likely involve one or a combination of the following: (1) debt default/restructuring; (2) entitlement reforms; (3) wealth transfers. The global deleveraging process that began roughly four years ago needs to continue to run its course and is the cause of our outlook for low economic growth, low returns, and continued volatility in financial markets.

To put the current situation in perspective, let’s look back: in our view, equity markets are still in a secular bear market. Historically, stocks have experienced long-term bull and bear cycles that typically last between 15 and 20 years. As illustrated in Chart 1, the Dow Jones Industrial Average has gone through periods of secular bull markets (late 1910s-20s, mid 1940s-60s, and early 1980s-90s) and secular bear markets (1930s-40s, 1960s-70s, and 2000 to present). It’s our belief that the current secular bear market began in 2000 with the popping of the information technology bubble and may well persist for some time yet as we work through the global deleveraging process. While we believe that equity markets are likely to remain challenging and volatile over the next few years, it is important to emphasize that we believe we are in the seventh inning of this process, and that better days do lie ahead.

Chart 1: Long-Term U.S. Equity Cycle

Source: Bloomberg Finance L.P. As of May 28, 2012
Investors should consider a defensive posture in the short term, while keeping cool heads and remaining focused on the longer term in order to navigate through the turmoil. Below we offer some thoughts on possible outcomes to the near-term risks, and some ideas on how to position investment portfolios to help weather the ongoing storms.

Greece …

The focal point of the latest crisis is again Europe, specifically Greece, with the possibility of a Greek disorderly exit from the euro zone becoming a higher probability. Following the indecisive May 6th election, a caretaker government has taken the helm until the country can return to the polls on June 17th. Reports of Greek banks facing accelerated withdrawals as citizens remove money from banks and concern that the anti-austerity party could win the June 17th election has brought talk of Greece’s potential exit from the euro zone to the forefront. The country is divided over the question of remaining part of the euro zone when the cost is extreme austerity.

Greece has already defaulted on its debt once this year, imposing losses of more than 70% on its privately held bonds. However, another default is being discounted by the market, as its newly minted bonds that replaced the restructured debt are currently trading at approximately 15% of face value.

…In Or Out

We cannot emphasize enough that the situation is very complex and outcomes are unknown. TD Economics has written several articles examining possible outcomes and timelines, as well as the possible impact on North America. From our perspective there are two potential near-term scenarios, or outcomes that should be considered. The first scenario is that the June 17th election results in a government that sticks to a European Union/International Monetary Fund austerity program and remains part of the euro zone. The second, albeit extreme scenario, is that the commitment to the austerity plan is broken and Greece leaves the euro zone abruptly. The base case assumption is that Greece remains part of the euro zone, at least for now.

In the event that Greece exits the euro in the near term, an outcome which markets have begun to discount, one would expect a serious market response as concerns would erupt about contagion to the financial system globally. Greece’s exit would raise questions regarding the potential for further withdrawals from the euro zone, particularly Spain. In this situation, the impact to global markets and economic growth would be severe. We would likely see a coordinated effort by central banks to provide liquidity, which could ultimately provide the catalyst for the return of the “risk on” trade. This would have the makings of volatile market conditions in the extreme, first down, then, potentially, up. This is not, in our view, the most likely scenario.

However, even with the base case scenario that Greece remains part of the euro zone for now, we anticipate continued volatility and uncertainty due to the challenges associated with the austerity measures and ongoing deleveraging. Greece is not alone, as eight out of 17 euro zone governments have been voted out of office in the last couple of years in a growing wave of anti-austerity backlash. The biggest risk to best-laid-plans is political upheaval and social unrest.

What To Do?

Liquidity

Investors need to ensure that they can tolerate the expected continuation of market volatility. In our opinion, the best way to do this is to distinguish between savings and investments. Savings represents the portion of an investor’s assets that must remain secure and liquid. Basic financial planning suggests setting aside a minimum of three to six month’s worth of expenses to cover living expenses or emergencies. Given the expectation for continued volatility in financial markets, we believe investors should consider carrying a higher than normal level of savings to help ensure they are not forced to liquidate investments in the event of a downturn in the equity markets.

Investment Portfolio

Investors should review their portfolio asset mix and holdings. Whether you hold common stocks, preferred shares or bonds, investors need to understand the potential risks. Look for opportunities to exit positions which may be particularly vulnerable, such as companies with stretched balance sheets, a track record of disappointing results or a strategy that is not working out. Look instead to high-grade your portfolio with companies that have solid balance sheets, excellent market positions and first rate management teams.
Remember that equity portfolio volatility can be reduced through proper diversification and by including dividend paying stocks. Within equity portfolios, emphasize large cap, high quality, dividend paying stocks. Small cap stocks generally outperform when the economy comes out of recession, not when there is risk of continued weakness. Also, be wary of very high-yielding stocks as they are generally high risk. Unfortunately, we are in a low-rate environment, so expectations for yield may need to be reset if capital preservation is also a priority.

A slowdown in global economic growth or a global recession will weigh heavily on commodity prices and the resource-heavy Canadian equity market. For Canadian investors, we suggest looking south of the border for exposure to more defensive sectors such as health care and consumer staples. With its breadth and depth, the U.S. equity market provides investors with opportunities that in some cases simply are not available in the Canadian market and helps reduce exposure to the resource stocks. Investors may also consider focusing on companies that have more leverage to the U.S. domestic market than the European marketplace.

Carrying a higher cash balance can help provide a cushion in a declining equity market, but it also provides investors with the ability to act quickly in the event that a liquidity-driven “risk on” trade returns. If the situation in Europe deteriorates to a degree that the central banks act, we believe we could see another liquidity-driven rally in risk assets such as commodities and stocks. Having cash on hand will enable investors to react quickly to this and redeploy funds into the equity market to take advantage of potential opportunities to buy great companies when they are on sale.

Finally, the potential for shocks remains, with Europe being the catalyst. As such we continue to advocate maintaining exposure to gold as a form of insurance.

Closing Thoughts
We see three key risks to the global economy and financial markets over the near term. First and most important are the problems in Europe, with Greece being the current lightning rod. Second is the concern about slowing growth in China. Third is a looming election in the U.S. and the fiscal cliff in 2013 (potential tax hikes, forced spending cuts, revisiting the U.S. debt ceiling) and the potential impacts on the U.S. economy. The risks and uncertainty are reflected in the record low, or near record low, interest rates in countries such as Germany, Switzerland, Austria, the United Kingdom, Finland, the United States, Canada, and Japan which are an indication of stress in global financial markets, with capital fleeing risk for safety.

As we highlighted above, we believe that better days lie ahead, but as investors in a volatile and uncertain environment, we can position portfolios to weather potential storms and be prepared for opportunities as they arise.
Appendix A – Important Disclosures

TD Waterhouse Disclaimer
The statements and statistics contained herein are based on material believed to be reliable, but are not guaranteed to be accurate or complete. This report is for information purposes only and is not an offer or solicitation with respect to the purchase or sale of any investment fund, security or other product. Particular investment, trading, or tax strategies should be evaluated relative to each individual’s objectives. Graphs and charts are used for illustrative purposes only and do not reflect future values or future performance. This document does not provide individual financial, legal, investment or tax advice. Please consult your own legal, investment, and tax advisor. All opinions and other information included in this document are subject to change without notice. The Toronto-Dominion Bank and its affiliates and related entities are not liable for any errors or omissions in the information or for any loss or damage suffered.

TD Waterhouse Canada Inc. and/or its affiliated persons or companies may hold a position in the securities mentioned, including options, futures and other derivative instruments thereon, and may, as principal or agent, buy or sell such securities. Affiliated persons or companies may also make a market in and participate in an underwriting of such securities.

TD Waterhouse represents the products and services offered by TD Waterhouse Canada Inc. (Member – Canadian Investor Protection Fund), TD Waterhouse Private Investment Counsel Inc., TD Waterhouse Private Banking (offered by The Toronto-Dominion Bank) and TD Waterhouse Private Trust (offered by The Canada Trust Company).

The Portfolio Advice and Investment Research team is part of TD Waterhouse, which is a subsidiary of The Toronto-Dominion Bank.

Research Dissemination Policy
TD Waterhouse makes its research products available in electronic format. TD Waterhouse posts its research products to its proprietary websites for all eligible clients to access by password and distributes the information to its sales personnel who may then distribute it to their retail clients under the appropriate circumstances either by email, fax or regular mail. No recipient may pass on to any other person, or reproduce by any means, the information contained in this report without the prior written consent of TD Waterhouse.

Analyst Certification
The TD Waterhouse Portfolio Advice & Investment Research analyst(s) responsible for this report hereby certify that (i) the recommendations and technical research opinions expressed in the research report accurately reflect the personal views of the analyst(s) about any and all of the securities or issuers discussed herein and (ii) no part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the provision of specific recommendations or views contained in the research report.

TD Securities Disclaimer
“TD Securities” is the trade name which TD Securities Inc. and TD Securities (USA) LLC jointly use to market their institutional equity services.

TD Securities is a trade-mark of The Toronto-Dominion Bank representing TD Securities Inc., TD Securities (USA) LLC, TD Securities Limited and certain corporate and investment banking activities of The Toronto-Dominion Bank.

Trade-mark Disclosure
Bloomberg and Bloomberg.com are trademarks and service marks of Bloomberg Finance L.P., a Delaware limited partnership, or its subsidiaries. All rights reserved.

All trademarks are the property of their respective owners.

© The TD logo and other trade-marks are the property of The Toronto-Dominion Bank or a wholly-owned subsidiary, in Canada and/or in other countries.