Insights & Strategies

PRIVATE CLIENT SOLUTIONS

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Having a Tantrum: The Great Unwind

The world's central banks have pumped approximately $19 trillion into the financial markets since the 2008-2009 financial crisis. For their efforts, the global economy avoided a prolonged and painful economic slowdown. However, the pace of the global economic recovery has been shallower than most would have anticipated given the sheer amount of liquidity created. Nonetheless, central banks are contemplating how to reverse the extraordinary measures taken almost a decade ago.

Quantitative Easing: A Brief History

Nominal interest rates are theoretically bound by zero thus limiting their effectiveness to counteract a sharp and sudden contraction in the economy. Looking for alternative tools to stimulate growth, central banks turned to quantitative easing (QE). QE is an unconventional monetary tool that involves a central bank purchasing securities and holding those securities for an extended period of time. In any transaction there is a buyer and a seller; the seller receives cash and the buyer receives a product, good or service. In the case of QE, financial institutions are the sellers of securities and the central banks are the buyer. Financial institutions receive cash in exchange for securities that a central bank holds on its balance sheet. With liquidity injected into the financial system, institutions seek ways to earn a return by making loans, increasing the overall money supply in the economy. This is one of the more important mechanisms in the QE process to spur economic activity through the extension of credit. Large-scale bond purchases by central banks also put upward pressure on bond prices, thus lowering borrowing costs for consumers and corporations encouraging consumption and investment. However, an unintended (or intended depending on who you ask) consequence of lower nominal yields is that it pushes investors into riskier assets as they attempt to find higher yielding substitutes. Another important consequence of QE is the wealth effect. In theory, the inflating of asset prices such as equities, bonds and real estate increases consumer confidence and encourages consumers to spend on discretionary items. In an economy like the US that is largely driven by consumption, the wealth effect can have a large positive impact on economic growth.

Bank of Japan & QE

Following an asset price bubble collapse in 1991, Japan experienced a period of economic stagnation referred to as the "Lost Decade". By 1999, the Bank of Japan (BoJ) had cut its key lending rate to zero in response to deflationary pressures caused by the collapse. However, economic conditions did not respond. In an attempt to flood Japan's banks with liquidity, the BoJ enacted an asset purchase program in 2001, becoming the first modern central bank to enact QE. The program initially purchased government bonds, but would later be expanded to include riskier securities such as asset-backed securities, commercial paper and equities.

Please read domestic and foreign disclosure/risk information on Page 11.

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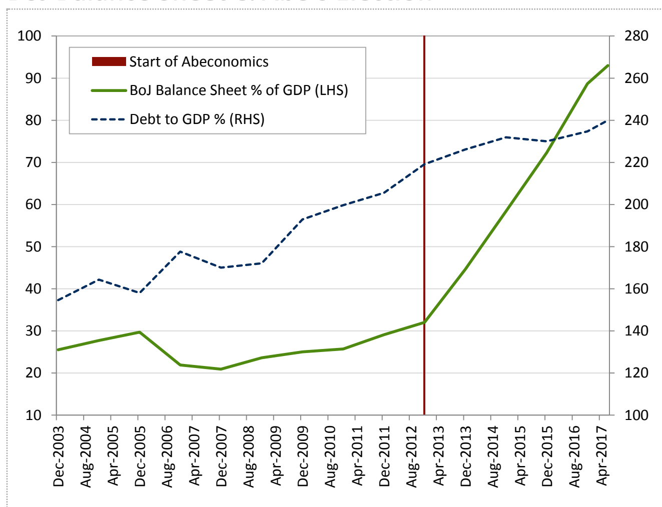
2200-925 West Georgia Street | Vancouver BC Canada V6C 3L2.

The election of Shinzo Abe as Prime Minister in 2012 marked a new chapter in Japan's monetary and fiscal history. Prime Minister Abe enacted an aggressive stimulus program that eased monetary conditions, increased fiscal spending and introduced structural reforms. The three pronged approach would be coined "Abenomics" and would see the BoJ's balance sheet experience an exponential expansion. The Japanese government would also increase debt issuance to support its fiscal stimulus measures. The BoJ's balance sheet as a percentage of GDP has grown to 90% and Japan's debt-to-GDP to 230%.

BoJ Balance Sheet & Abe's Election



Source: Bloomberg, Raymond James Ltd.

Federal Reserve & Friends

Policies similar to those undertaken by Japan have also been enacted by other central banks in response to the US financial crisis. In the case of the US Federal Reserve, the Fed was quick to act in 2008 which is often cited as a reason the US did not experience its own lost decade. The Fed cut short-term interest rates to zero and launched a program to purchase US treasuries, government- and mortgage-backed securities. Between 2008 and 2014, the Fed expanded its balance sheet by over US$3.0 trillion to US$4.5 trillion, or 24% of US GDP. The Fed stopped buying large scale quantities of assets in October 2014. Since then, it has kept the size of its balance sheet constant, buying just enough to replace maturing securities.

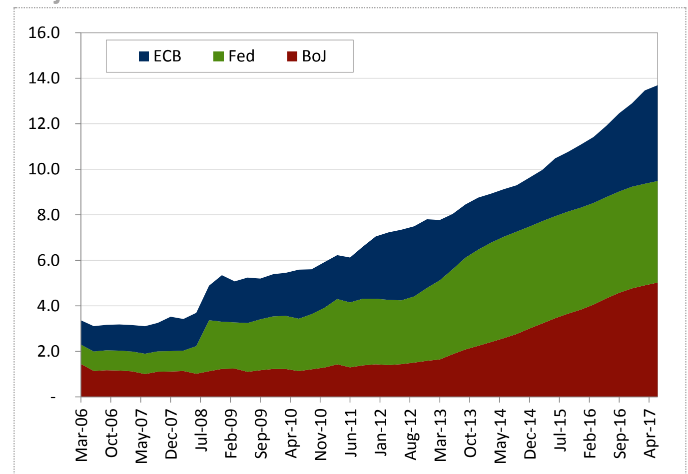
In total, major central banks – the US Federal Reserve, Bank of Japan, Bank of England, European Central Bank, Swiss National Bank, Riksbank and People's Bank of China – have expanded their balance sheets by approximately US$19 trillion over the past nine years, or approximately 25% of world GDP, more than four times the pre-crisis level.

Central banks now own a fifth of their governments' total debt. Japan is an extreme example as the BoJ is a top-10 shareholder in about 90% of the Nikkei 225, according to Bloomberg. Needless to say, central bank's activities have been truly unprecedented.

Economists have debated the merits of unconventional monetary policy and the impact it has had on the real economy. Several studies have shown QE lowered long-term borrowing costs and credit risk, which had a modestly positive impact on overall GDP growth. However, the impact of QE can more easily be seen on asset prices. Since the implementation of US QE, the S&P 500 has gained 188%, while US GDP has risen just 32%. In this view, QE has been very successful in creating paper wealth, but less effective in increasing overall economic output.

The challenge facing central banks, if they decide to unwind this unprecedented stimulus, will be the market's ability to absorb the sales of these assets without causing large negative reactions.

Major Central Bank Balance Sheets



Source: Bloomberg, Raymond James Ltd.

Quantitative Tightening

The Fed has signalled it will begin the process of unwinding its balance sheet, potentially this year. As the architect of US QE, former Fed Chairman Ben Bernanke has outlined his expectations for the Fed. Bernanke believes the Fed should first normalize the fed funds rate, which suggests increasing the fed funds rate to approximately 3.0%. Once achieved, he believes the Fed can then begin to reduce the balance sheet in a slow and steady manner.

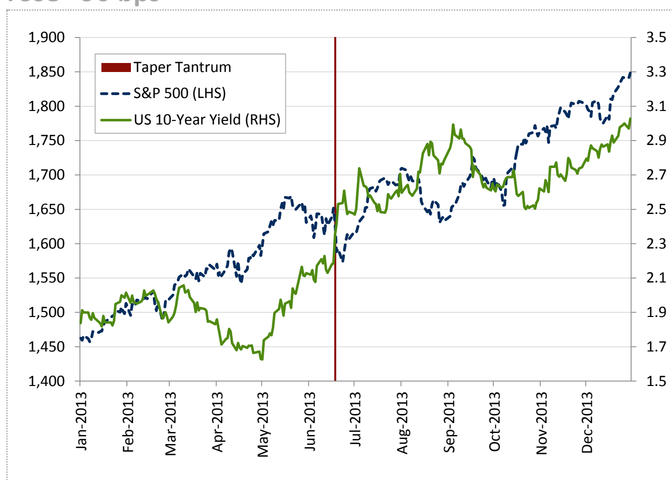
"Since the effect of balance sheet reduction on broader financial conditions is uncertain, it is prudent not to begin that process until short-term interest rates are comfortably away

from their effective lower bound, leaving the Committee room to offset any unanticipated effects."

However, Fed Chairwoman Janet Yellen and most of her colleagues have a desire to shrink the size of the balance sheet before the fed funds rate achieves normalized levels. Under this double-barrelled tightening approach the Fed would start by selling US$10 bln a month and increasing the value every quarter until it reaches US$50 bln.

In theory, the balance sheet normalization, or quantitative tightening (QT), should have the opposite impact of QE. The central bank will sell securities back to financial institutions, draining the financial system of liquidity. Financial institutions would become less willing to lend, borrowing costs for consumers and corporations should rise, and economic activity should slow. However, this is uncharted waters for any central bank so it is difficult to know how the market may react to QT. The closest example we have is the 2013 "Taper Tantrum". On May 22, 2013, Bernanke indicated the Fed would begin reducing its asset purchases by roughly US$70 bln per month in bond and mortgage-backed securities and on June 19, the FOMC voted to scale back the purchases. Equity and bond markets did not react well to this news; the US 10-year government yield rose over 90 basis points and equities initially slipped by over 5.0%.

Taper Tantrum: S&P 500 Slipped 5.7% and LT yields rose ~90 bps



Source: Bloomberg, Raymond James Ltd.

Implications

Mark your calendar. September 19-20 will be an important date in US monetary history. Either the Fed decides to further tighten monetary conditions or kick the can down the road, as suggested by Bernanke. If the Fed announces their intention to unwind the balance sheet this year, it will be critical to watch the reaction of asset prices over the coming days and weeks, particularly in light of the Fed's view that "any reaction in financial markets to such a change would likely be limited."

With the US Fed expected to raise rates one more time in 2017 and potentially unwind its balance sheet, this double-barrelled tightening approach could prove to be disruptive to financial markets. However, counteracting the US tightening cycle will be the activities of other central banks, which remain supportive. Further, US corporate earnings have been strong and global economic activity is on an upswing, both of which are supportive of equities.

Nonetheless, the US is potentially entering unchartered waters and financial conditions are tightening rather than easing. This raises the potential for US equities to underperform relative to other regions that appear more attractive from a monetary cycle perspective. As we discussed in our August issue, "*when we put that into context with what is happening in the US (Fed raising rates and planning the unwinding of quantitative easing), we see a stark comparison between a central bank that is actively aiding economic expansion and another that is tempering it."*

While the Fed's decision is pending and the market's reaction to QT is uncertain, we believe some of this risk can be mitigated by diversifying into regions where monetary policy remains supportive, in particular Europe.

As for investors' US allocation in an investment portfolio, we take a closer look at the market's reaction to the taper tantrum to see how segments performed during a period when the Fed scaled back its asset purchase.

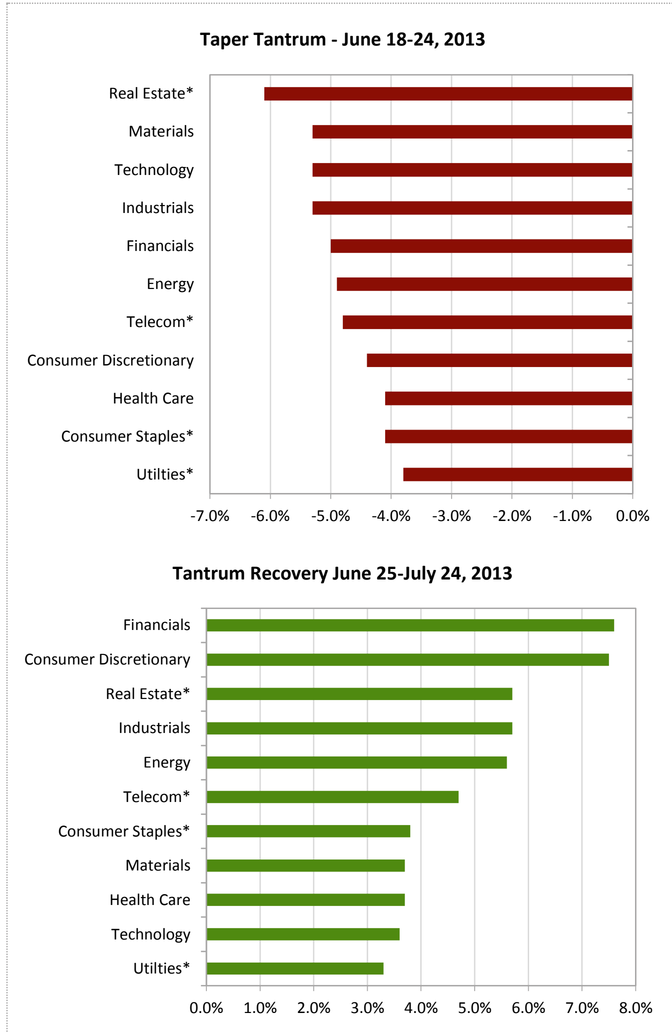
US Equity Market Reaction

From an equity market point of view, the taper tantrum was relatively short and benign. Following the initial drop in US bond yields on June 18, the S&P 500 saw a 5% drop over five trading days but the momentum quickly reversed and recovered all the losses within two weeks. Within three months the S&P 500 had risen 10% from the June low.

That said, another short-term tantrum by markets is possible, and looking at the 2013 price action can give investors some insight as to how different sectors of the US equity market could be impacted. The chart below breaks down how the S&P 500 performed by sector during the taper tantrum, followed by performance in its quick recovery. Analyzing the price action over the June-July period doesn't give us that much insight. During the tantrum, the sell-off was reasonably correlated. With the exception of real estate on the high end and utilities on the low end, all sectors dropped within a narrow range of -4.1% to -5.3%, with an average of -4.8%. On the rebound, the performance was more dispersed with a

spread between 3.3% and 7.6% and an average gain of 5.0%. Whether a sector was interest rate sensitive/defensive (denoted with an asterisk) did not have a large bearing on performance either.

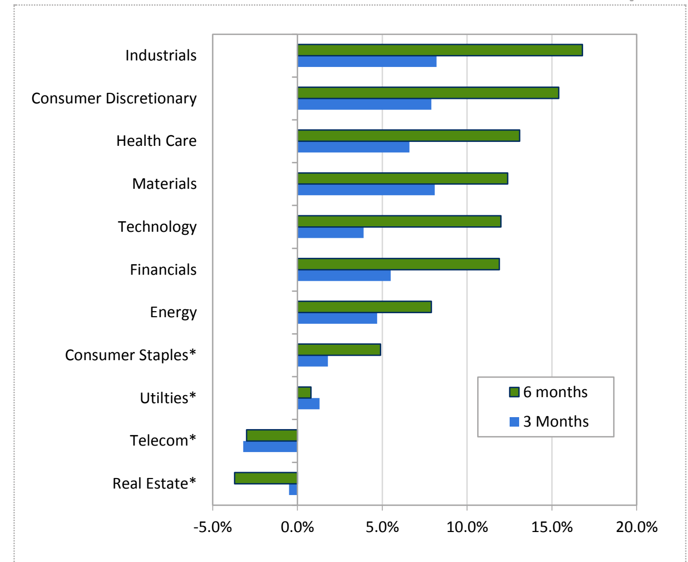
Pre and Post Taper Tantrum Performance



Source: Bloomberg, Raymond James Ltd.

However, if we look at the sector performance at three and six month intervals following the onset of the taper tantrum, we see a different picture. Over both periods, all four interest rate sensitive sectors are firmly at the bottom of the pack and significantly underperforming with an average return of -0.3%. The average return for the other seven sectors was 12.8% over the six month period. In other words, the taper tantrum did not change the positive direction of equities as a whole nor that of the higher risk/return sectors within the S&P 500.

3 & 6 Month Performance After the Start of the Taper



Source: Bloomberg, Raymond James Ltd.

Our conclusion is that although the unwinding of QE could have some short-term implications to markets, we do not think equity investors should take their eyes off the specific fundamentals that drive the asset class. The liquidity impact from asset sales will be felt mostly in the bond and mortgage markets and if the taper tantrum gives us any kind of analogue, equities (specifically growth-sensitive cyclicals) should continue to outperform.

Jason Castelli, CFA
VP & Portfolio Manager

Robert Mark, CFA
Portfolio Manager

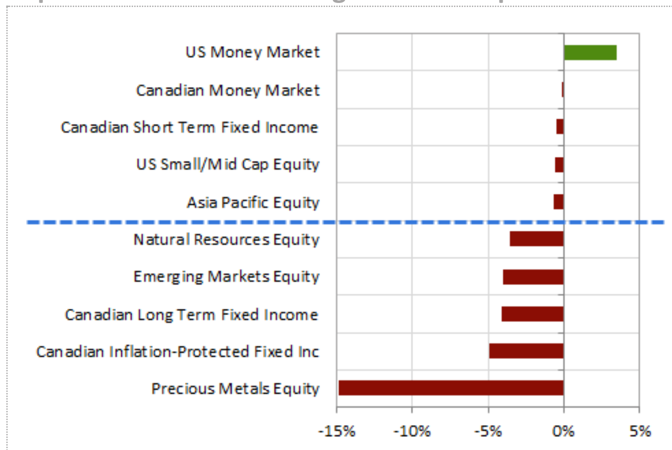
Asset Class Impact of 2013 QE Taper

While the last QE taper tantrum caused a lot of pain in US equity markets in the short term, in the six months following, it seemed to be all but forgotten. A common saying in finance that can be found on every fund fact sheet is "historical returns are not indicative of future performance". This is something we agree with. However, we are also believers that historical returns can give useful guidance to see how certain asset classes have behaved against a similar backdrop to an upcoming event. As we consider what the potential impact of "quantitative tightening" might look like, we look to what impact the US Federal Reserve's 2013 QE tantrum had on global asset classes through the returns of ETF categories.

Pre Taper Tantrum

Using the same analysis as above, pre-taper tantrum, nothing looked incredibly attractive from an absolute return standpoint as almost every asset class was in negative territory.

Top 5 & Bottom 5 ETF Categories: Pre Taper Tantrum



Source: Morningstar, Raymond James Ltd. (June 18 – 24, 2013)

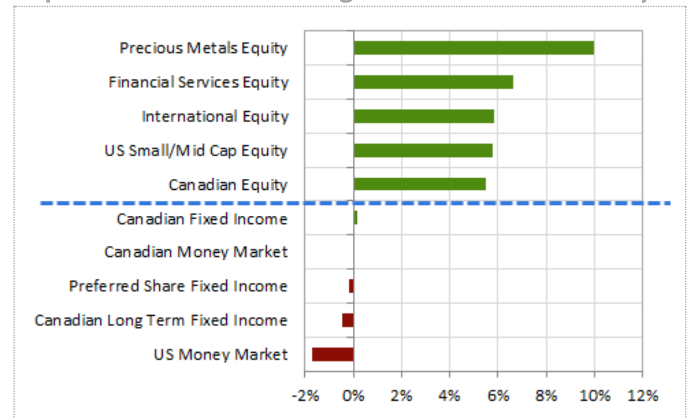
Short-term fixed income was the best asset class to be in. US money market funds posted the strongest (and only positive return) ahead of the taper tantrum as the USD caught a bid on the expectation of stimulus removal and short-dated bonds materially outperformed long-bonds. Canadian bonds experienced similar returns, but didn't benefit from currency and were essentially flat to slightly negative. Another outperformer was US small cap equity, which significantly outperformed the S&P 500's 5% drop over five trading days. This makes intuitive sense as currencies have historically tended to appreciate during times of monetary tightening, posing a headwind for large-cap multinational companies whose foreign revenues will be worth less when they convert back to local currency. This type of environment favours small cap companies.

The worst performing asset classes were long-dated fixed income and cyclically sensitive asset classes such as commodities; precious metals took a whopping 15% hit.

Tantrum Recovery

What is interesting, however, is that many of the best performing asset classes pre-tantrum ended up being the worst in the recovery as risk assets bounced back sharply.

Top 5 & Bottom 5 ETF Categories: Tantrum Recovery

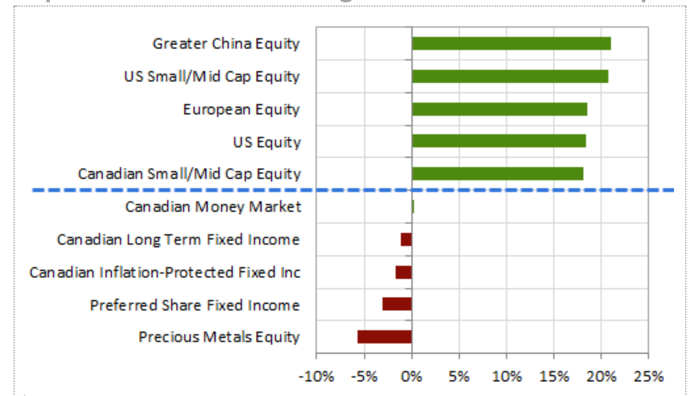


Source: Morningstar, Raymond James Ltd. (June 25 – July 24, 2013)

US money market gave back much of the initial gains as the USD retraced slightly and the yield curve moved far too fast, and many other fixed income categories gave up significant ground relative to equities. Also worth noting is that US small caps continued their strong performance in the following month, and large-cap international equities picked up steam relative to the US as investors sought regions offering more accommodative monetary policy.

Hindsight is 20/20

Top 5 & Bottom 5 ETF Categories: 6 Months Post Taper



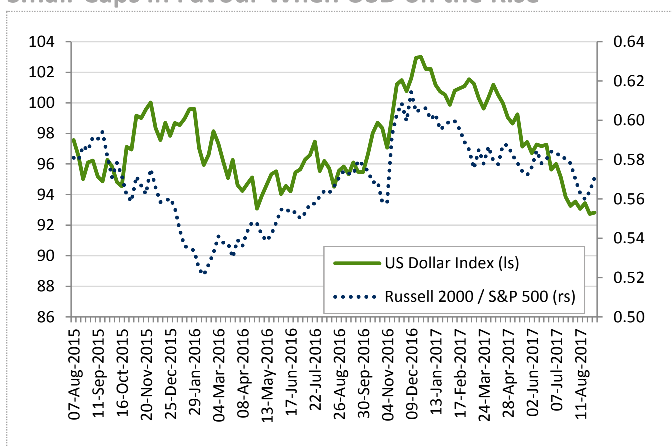
Source: Morningstar, Raymond James Ltd. (June 25 – July 24, 2013)

Hindsight is 20/20. Those who sold out of equities would have been left in the dust. Looking further down the road, in the

six months following the taper, equities rebounded massively, posting returns of 15% in many markets, making many wonder what all the short-term concerns were.

Unfortunately for us, we cannot change the past, and what's next should be our focus. Ultimately we believe there will be short-term noise and the bull market will live on, but we can conclude a couple of important points from our experiences in 2013. A rising currency as seen following the 2013 QE taper tends to support small-cap, domestically-oriented stocks on both the downside and upside. It will be important to watch the tone of the Fed (hawkish/dovish) and the reaction of the US Dollar Index following a balance sheet reduction announcement. A lot of recent negative sentiment has weighed on the US dollar which has favoured US large caps relative to small caps, with the S&P 500 outperforming the Russell 2000 by nearly 7% this year. With the large underperformance, and considering there is a lot of negative sentiment around the USD that could trigger a short squeeze, now may be an opportune time to look for tactical US small cap exposure. Using the 2013 taper as a guide, it might not even hurt to wait for the announcement to gauge the tone of the Fed. After all, the strong relative performance continued to play out in the six months following. To play this through an ETF, we favour **iShares US Small Cap ETF (XSU-T)**, which tracks the Russell 2000 Index. It is important to note XSU is hedged and doesn't offer any currency returns, giving pure play exposure to US small caps. A hawkish Fed should also show renewed life in the financial sector on the back of a rising yield curve. The sector has given back much of the gains that were seen following the Trump presidential victory in November 2016.

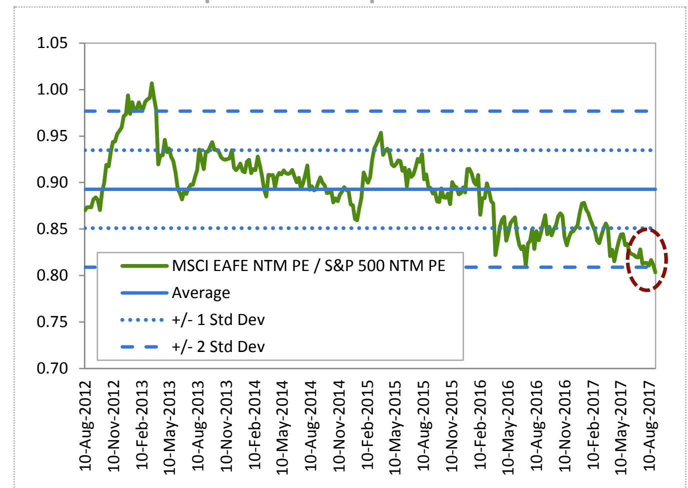
Small-Caps in Favour When USD on the Rise



Source: Bloomberg, Raymond James Ltd. (June 18 – 24, 2013)

Second, while global equities did underperform fixed income in the short term, they came screaming back and significantly outpaced fixed income. The initial knee-jerk reaction was to buy fixed income in a safe haven move; however, monetary tightening signals that rates should move higher (fixed income price negative). Any short-term sell-offs could provide an attractive entry point into equities. International equities are trading at more attractive valuations than the US (see following chart), and there are still areas that have accommodative monetary policy. Don't abandon ship on short-term weakness.

International Equities at Steep Discount vs US



Source: Bloomberg, Raymond James Ltd. (June 18 – 24, 2013). NTM = Next Twelve Months

One of our favoured funds for international exposure is **CI Black Creek International Equity**. The fund typically holds 25-30 names with the top 10 names representing roughly 45% of the fund, showing the management's conviction in the investment team's top ideas. The fund is led by long-time investor Richard Jenkins, although some of the heavy lifting has been handed to Evelyn Huang who was named a PM in 2013. The fund has posted spectacular returns, outperforming its benchmark and peers on a 1-, 3- and 5-year basis.

	1Yr	2Yr	3Yr	5Yr
CI Black Creek Intl Equity	16.0%	8.9%	9.0%	17.2%
MSCI EAFE NR C$	12.4%	5.2%	7.9%	13.8%
Intl Equity Category Avg	12.1%	2.2%	7.3%	12.4%

Source: Morningstar. As at August 31, 2017. Performance greater than 1 year is annualized.

Andrew Clee, CFA, CMT
MF/ETF Specialist and PM

Are Strip Bonds For Me?

For those seeking a periodic income stream, there is obviously a variety of interest-bearing bonds to choose from. However, for those without the need for such periodic income and who seek safety of principal with a known guaranteed return, strip bonds can be an ideal investment choice if held in non-taxable accounts (e.g., RRSP, RRIF, TFSA, etc.).

What Are Strip Bonds & How Are They Made

A strip bond is a type of zero-coupon bond created by stripping out the coupon payments from an existing corporate, municipal, provincial, or federal bond. The credit rating of a strip bond will be the same as that of the bond from which it was stripped. What you are left with is the coupon which represents the interest portion, and the residual which represents the principal portion that is ultimately repaid at maturity. These components are then sold individually to investors as entirely new securities at a discount to face value.

Let's Take a Deeper Dive

Since strip bonds are sold at a discount to their face value, their prices are always below par. The interest earned is the difference between the discounted purchase price and the maturity value ($100.00). This difference is amortized over the period and a portion is included in income each year as interest income. This creates tax implications which may make strip bonds a poor investment choice if held outside of a tax-sheltered account; however, if you hold them in registered accounts (e.g., RRSP / RRIF), you effectively defer the tax liability on your return until the time you withdraw your investment.

One of the key features of strip bonds is that irrespective of the fluctuations in interest rates, the yield earned on your investment is locked in as long as the strip bond is held to maturity. Another defining feature of a strip bond is that since it doesn't make interest payments, you don't have to worry about the reinvestment of interim cash flows. In other words, you effectively mitigate the reinvestment risk which can otherwise be found in conventional coupon-paying bonds.

Because strip bonds make no periodic interest payments, the duration is always equal to its stated maturity, which is higher than that of an otherwise equivalent coupon-bearing bond. This higher duration property found in strip bonds introduces a yield-pickup opportunity over the straight issue from which it was stripped. Interesting to note, strip bonds also exhibit greater sensitivity to interest rate fluctuations, which means that a strip bond will appreciate more in price when there is a decline in interest rates, and depreciate more in price when interest rates rise. As a result of this heightened sensitivity to interest rate volatility, you can tailor your investment strategies by incorporating the use of strip bonds with a given duration and higher convexity than otherwise comparable coupon-bearing bonds, and benefit from the market volatility by presenting you with favorable trading opportunities. However, those who buy strip bonds with the intent of holding them to maturity are once again immune from the market value impact caused by fluctuations in interest rates as the maturity value is known at the time of purchase and remains constant.

Since strip bonds are discount securities, you can leverage a small cash commitment at the time of purchase. The interest on a strip bond compounds until maturity, which is advantageous for those who do not require periodic income. This implies that a modest investment today can grow over time with this attractive compounding feature.

Lastly, strip bonds also have a wide selection of maturities, with terms ranging anywhere from 6 months to 30 years. For investors with predefined future cash flow needs (like retirement), this can be an attractive feature. You can essentially use strip bonds to construct a ladder-type portfolio in order to match the underlying maturity proceeds with your future cash flow needs.

Advantages & Disadvantages of Strip Bonds

Advantages

- Benefit from the power of compounding interest (a marginal capital investment can yield a large maturity payout known at the time of purchase).
- Guaranteed return if held to maturity (this is determined at the time of purchase).
- Wide range of available terms and high-quality issuers.
- No interest rate risk if held to maturity.
- No reinvestment risk as coupons are not received.
- Credit risk can vary depending on the issuer.
- Current secondary market.

Disadvantages

- No interest payments (thus not recommended for those who require an income stream).
- Significant tax liabilities if held outside of tax-sheltered accounts.
- Liquidating your position prior to maturity will expose you to interest rate risk and may result in a loss.

Let's Recap

Strip bonds can play a significant role in an investment portfolio and, according to the Bank of Canada, "the strip bond market in Canada has grown substantially since the late 1980s and is now an integral part of Canadian fixed-income markets." If you are looking for an investment with a competitive return and would feel at ease knowing what your exact return to maturity would be on the investment if held to maturity, then strip bonds can definitely be the way to go.

Ajay Virk
Fixed Income Specialist

Sample Strip Bond Portfolio

Overall Portfolio Analysis

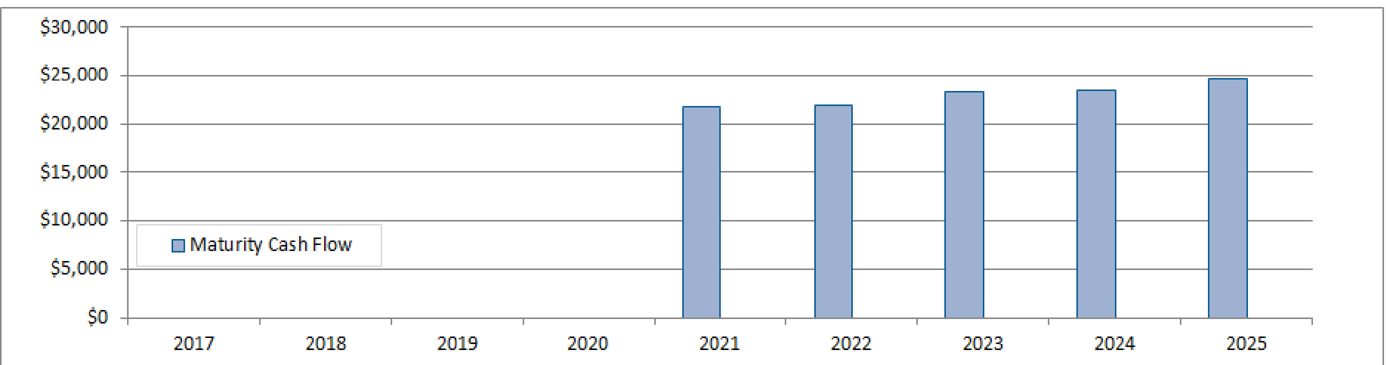
Pricing Date		Portfolio Parameters							Portfolio Value *(rounded values)*		
ISSUE PRICES AS OF:	6-Sep-17	*Weighted Rating	Total Maturity Value	Total Premium (Discount)	Weighted Yield to Maturity	Weighted Annual Equiv.	Weighted Term (years)	Weighted Duration (Mod.)	Total Accrued Interest	Total Principal Cost	Total Portfolio Investment
BOND SETTLEMENT:	Standard Conventions										
		A high	$115,239	-13.22%	2.48%	2.48%	5.67	5.53	$0	$100,000	$100,000

Individual Issue Analysis

Issuer	Coupon Rate	Maturity Date	Debt Rating	Maturity (Par) Value	Offering Price	Yield to Maturity	Annual Equiv.	Term (years)	Duration (Mod.)	Accrued Interest	Principal Cost	Total Cost
Loblaws CPN	0.000%	1-Mar-21	BBB	$21,751	$91.950	2.44%	2.44%	3.48	3.40	$0	$20,000	$20,000
Ontario Provincial CPN	0.000%	8-Mar-22	A high	$21,990	$90.950	2.13%	2.13%	4.50	4.41	$0	$20,000	$20,000
CIBC CPN	0.000%	7-Jul-23	AA low	$23,256	$86.000	2.62%	2.62%	5.84	5.68	$0	$20,000	$20,000
Ontario Provincial CPN	0.000%	2-Jun-24	A high	$23,474	$85.200	2.41%	2.41%	6.74	6.58	$0	$20,000	$20,000
BNS CPN	0.000%	20-Jun-25	AA low	$24,768	$80.750	2.78%	2.78%	7.79	7.58	$0	$20,000	$20,000

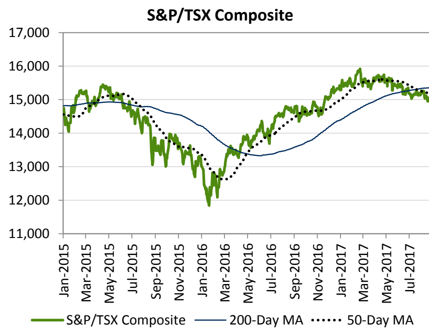
Total Cash Flow Analysis

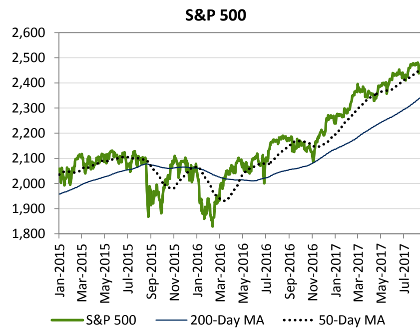
	Maturity Cash Flow	Coupon Cash Flow	Net Total Cash Flow
Total	$115,239	$0	$115,239

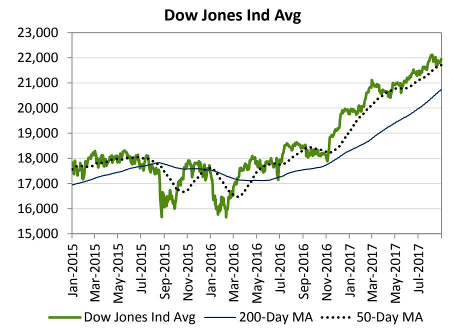


Charts of Interest

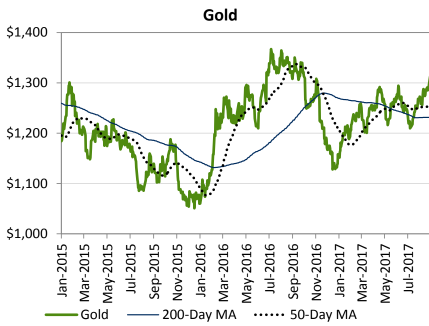
Markets

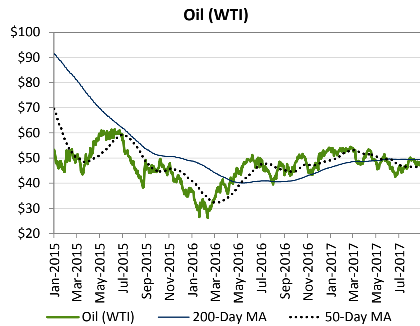


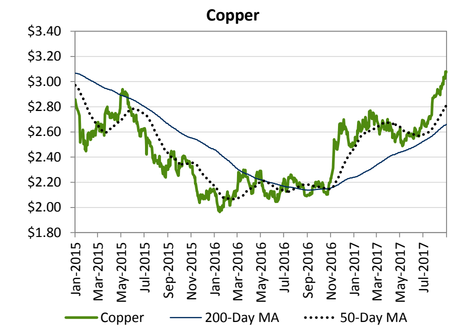




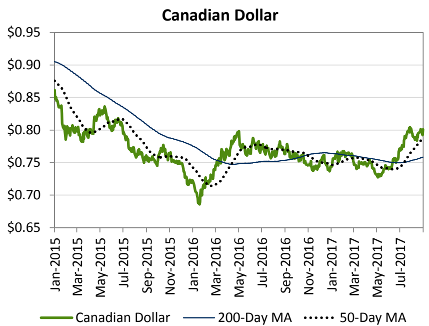
Commodities

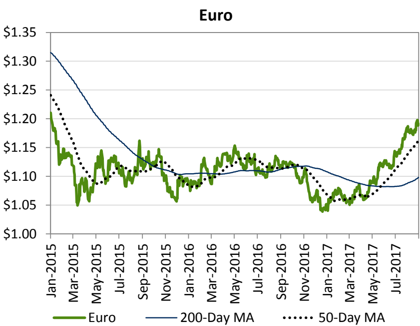


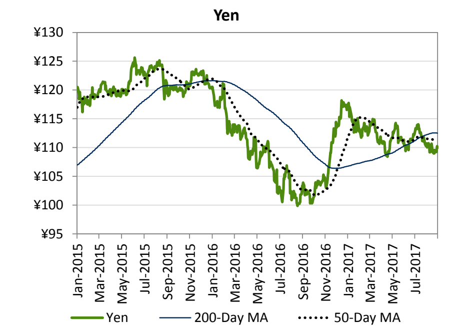




Currencies







Source: Bloomberg, Raymond James Ltd. Performance as at August 31, 2017.

Investor Profiles and Asset Class Weightings

Recommended Asset Allocation	Capital Preservation	Conservative	Moderate	Growth	Aggressive Growth
Cash	7%	7%	7%	7%	7%
Bonds	70%	60%	35%	15%	0%
Can Equities	20%	23%	23%	23%	28%
US Equities	3%	10%	20%	33%	35%
Intl Equities	0%	0%	15%	22%	30%
Tactical Asset Mix (Bonds include cash)					
Bonds | Equities	77 | 23	67 | 33	42 | 58	22 | 78	7 | 93
Strategic Asset Mix (Bonds include cash)					
Bonds | Equities	80 | 20	70 | 30	50 | 50	30 | 70	10 | 90
Asset Ranges					
Cash	0-20	0-20	0-20	0-20	0-20
Bonds	60-100	50-90	20-70	10-50	0-30
Equities	0-30	10-50	30-75	50-90	70-100
Description	May be appropriate for investors with long-term income distribution needs who are sensitive to short-term losses. The equity portion of this portfolio generates capital appreciation, which is appropriate for investors who are sensitive to the effects of market fluctuation but need to sustain purchasing power. This portfolio, which invests primarily in fixed-income securities, seeks to keep investors ahead of the effects of inflation with an eye toward maintaining principal stability.	May be appropriate for investors with intermediate-term time horizons who are sensitive to short-term losses yet want to participate in the long-term growth of financial markets. The portfolio, which fixed-income securities tend to make up the largest proportion of holdings, seeks to keep investors well ahead of the effects of inflation with an eye toward maintaining principal stability. The portfolio has characteristics that may deliver returns lower than that of the broader market with lower levels of risk and volatility.	May be appropriate for investors seeking a balance between capital preservation and capital growth. This portfolio, which is a split between fixed-income securities and equities, seeks to keep investors well ahead of the effects of inflation with an eye toward maintaining principal stability. With roughly half of the portfolio invested in a diversified mix of Canadian and international equities, investors should be comfortable with moderate fluctuations in the portfolios.	May be appropriate for investors with long-term time horizons who are not sensitive to short-term losses and want to participate in the long-term growth of the financial markets. This portfolio, which has a higher weighting in equities, seeks to keep investors well ahead of the effects of inflation with principal stability as a secondary consideration.	May be appropriate for investors with long-term time horizons who are not sensitive to short-term losses and want to participate in the long-term growth of the financial markets. This portfolio, which is primarily invested in equities, seeks to keep investors well ahead of the effects of inflation with little regard for maintaining principal stability. The portfolio may deliver returns comparable to those of the broader equity market with similar levels of risk and volatility.

Important Investor Disclosures

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