TD Asset Management

The Imbalance Game

Volatility continues to be top of mind for investors. In fact, for nearly two years there has been an uptick in various economic headwinds and sources of volatility. Deflationary pressures in Europe, risks from abroad that emerged from countries like China and Greece, and the scale and pervasiveness of global debt have all been contributors to market ups and downs.

That being said, it's important to take a step back and look at the big picture. Are these really independent issues or are they symptoms of a bigger challenge at hand? Investors could benefit from understanding that there is a lot more at play than any particular economic headwind.

Policy distortions, defined as inefficiencies resulting from economic intervention by governments and/or central banks, can be categorized into two types: Foreign exchange distortions and government and fiscal policy distortions. **TD Asset Management Inc.'s (TDAM) research suggests that the combination of these two distortions may be creating economic imbalances, hampering global growth.**

1. Foreign exchange distortions

Foreign exchange distortion refers to situations where a country's currency is kept persistently below or above its fair value. Generally speaking, there are two main types of foreign exchange rate policies that countries utilize – a floating exchange rate and a fixed exchange rate. Let's take a closer look at each.

A floating foreign exchange rate is one that is allowed to fluctuate in response to market forces and can often act as a "self-correcting" mechanism that helps manage imbalances in supply and demand. For example, if demand for a particular currency in a slowing economy is low, its value naturally decreases. This decrease in value makes imported goods more expensive and weakens purchasing power. But at the same time, the cheaper currency becomes more affordable, often resulting in greater foreign investment and an increase in exports. Both of these can lead to greater economic productivity and therefore help a slowing economy get back on the path to growth.

The second type of exchange rate policy used by some countries is a fixed exchange rate. This type of exchange rate does not fluctuate in response to supply and demand and is "pegged" or fixed at a predetermined ratio against the value of a more stable or internationally prevalent currency, like the U.S. dollar. This can lead to foreign exchange distortions since a pegged exchange rate does not have the natural self-correcting mechanism seen with a floating exchange rate. China's Renminbi is one example of a pegged currency. The pegged currency may have helped China generate growth by supporting exports and investment into the economy; however, there is concern that this is unsustainable in the long-run. The economic principle of diminishing returns suggests investment will generate lower returns in the future and an economy exclusively dependent on exports is vulnerable to shocks if global economic growth slows and demand for exports declines.

Another example of a foreign exchange distortion is occurring in Greece, as evidenced by the challenges it faces from its economy remaining tied to the Euro. During the sovereign debt crisis, Greece was burdened with persistent trade deficits, which means it continued to import more than it exported, despite the fact that the economy was struggling. This link to the Euro meant there was no independent currency which reflected the reality of the challenges faced by the Greek economy. Instead, the Euro reflected the strength of all member states. For both China and Greece, foreign exchange distortions ultimately led to an environment that created unsustainable growth.

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2. Government and fiscal policy distortions

The second policy distortion that can create internal imbalances and limit growth is government and fiscal policy distortion. This can refer to both inefficient government spending or inappropriate tax and social policy.

Excessive and/or inefficient government spending generally leads to higher debt. When the debt burden reaches unsustainable levels, a country becomes vulnerable to a debt spiral where its credit lifeline could be cut in a hurry, and possibly result in a full-blown financial crisis and recession.

Inappropriate tax and social policy is another example of fiscal policy distortion. Household consumption is a key contributor to economic development, so misguided tax policies, or a lack of social policy that supports sustainable household consumption, can actually hinder growth. In particular, policy that does not effectively address concerns of income and wealth inequality is especially detrimental to long term economic growth.

New thinking for your important challenges

We are sharing this new thinking with investors to shed light on some of the deep-rooted issues facing the global economy today. Unless structural reforms are made, we will be dealing with these issues for the foreseeable future. It is against this global economic backdrop that we expect equity market returns to be in the low to mid-single digits, yields on fixed income assets to remain lower for longer and extreme levels of volatility becoming the norm. Understanding the specific challenges of the day can help investors make informed investment decisions and plan accordingly. In this environment, an asset manager that can identify and make sense of the issues can help investors protect their capital and take advantage of opportunities that arise.

Investors are encouraged to take a long-term view and approach investing with a focus on specific goals. Your Financial Planner or Advisor can help you create a portfolio that aligns with your personal objectives in the context of current economic challenges.

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