TD Wealth

The Kite

Portfolio Strategy Quarterly | Q2 2023

April 28, 2023

In this issue

The Kite.

The other day, I was gliding through Beacon Hill Park in Victoria with the cherry trees in full bloom, and as I rolled into Clover Point, I stopped to watch people participate in one of the great pastimes of the area: flying kites. I marveled at the engineering of the kites and thought about what it must be like for the individuals holding their lines as the winds twisted and turned and died, and then suddenly came back to life. And then I started to think, that's an awful lot like what investors must feel like these days.

We've had geopolitical angst the likes of which we haven't seen in a generation, historically high inflation, and a slew of rate hikes from central banks around the world to combat it. Then, in March of this year, these rate increases triggered a banking crisis. Terrified investors piled into money markets, thinking this was the beginning of the end … but not so — a quick response from governments and central banks managed to pull off another rescue. The mountain of concern disappeared and a relief rally took hold, as though nothing had happened.

We need to remind ourselves that investment is about achieving client objectives, not about keeping track of the day-to-day gyrations of macroeconomic data and financial markets. That's better left to the portfolio managers, which is not to say that investors should be totally hands-off. You need to know what you own, why you own it, and have reasonable expectations as to how your investments will perform in a highly transitional environment. But we should also remember that the goal is not to move in lockstep with the rapidly shifting gusts of wind — that's impossible. The goal is to keep the kite aloft. In all seasons. No matter how the winds blow. And if your kite is well-constructed, it will.

Be well,

Brad Simpson
Chief Wealth Strategist, TD Wealth

Cracking Complexity

Complexity

La la la

That's the sound of equity markets trying not to acknowledge heightened risk of recession. Valuations are sitting at 12-month highs and the equity risk premium has actually fallen. This suggests that investors believe (most evidence to the contrary) that the risk of a recession is lower.

Base effects

The second quarter is about to deomonstrate the importance of denominators, given that y/y inflation will be measured against Q2/22, when prices were rising their fastest. Inflation may fall rapidly from here on out, but the Fed isn't expected to hit its 2% average target until early 2025.

Cash trap

Q1 saw the biggest unwinding of long positions in over 10 years, as investors stampeded into cash, term deposits and money-market funds. Those who locked in at rates below inflation run the risk of negative real returns.

8%

That's what a 10-year U.S. Treasury bond will return if yields fall from today's historic highs of 3.5% to a highly plausible 2.5% by March 2024. This highlights the diversifying potential of bonds.

Services crack

The services side of the economy has seemed invincible, but we're beginning to see chinks in the armour. The ISM Services PMI fell 3.9 points to 51.2 in March. Airlines, hotels and restaurants have all seen their businesses flatten.

Labour cracks

Job openings, while still healthy, are finally coming down faster than expected. The recent Challenger survey, for instance, reported that U.S.-based employers announced 90,000 layoffs in March — the highest since the pandemic began three years ago.

Barbells

In Q1, the best performing stocks, by far, were tech and tech-related, but the other top performances came from high-quality value names. This reflects a divergence of opinions on the market outlook. In this environment, a "barbell" approach that includes both growth and value names may work well.

50%

That's the occupancy rate for the office sector compared to pre-pandemic. Vacancies have reached over 16% in the U.S. and Canada, and in Q4/22, the number of global real estate transactions tumbled 63%. We're maximum underweight domestic and global real estate.

Adaptation

Remember the 10/10/10 Rule

How are you likely to feel about this in 10 minutes vs. 10 months vs. 10 years? Be patient. There's a reason it's considered a virtue.

7 Years Bad Luck

Markets are awful at predicting central bank decisions. In 2008, investors were bracing for hikes, which didn't actually occur until seven years later. Then, in 2015, they vastly underestimated the speed of those hikes. Bottom line: The Fed responds to data, not sentiment.

Be Compensated

The goal of factor diversification is to reduce unintended risk exposures and target exposure to compensated factors while minimizing exposure to uncompensated factors.

High-odds Proposition

Over the long term, it's been almost impos sible to lose money on the broad market. The probability of making at least some money on the S&P 500 over a five-year period is 85%; over a 20-year period it's 100%.

Process Over Prediction

We manage investments based on a guiding set of principles designed to work in a world that's constantly changing. We focus on investor's goals and true diversification. We build resilient portfolios that aim to perform regardless of the environment.

Foursquare

There are four basic economic environments: rising growth, falling growth, rising inflation and falling inflation. Markets react as economies shift from one to another, but transitions are unpredictable and can be fraught. We don't predict the future, we invest in all four areas.

True Diversification

To prosper in this new world, investors need a contemporary portfolio approach with true diversification, balancing: (1) broad asset allocation and (2) risk-factor diversification with (3) a deep understanding of financial behaviour.

Tactics on the Margins

Tactical or dynamic shifts should only be made at the margin, in an intentional and risk-controlled manner. Strategic asset allocation remains the principal driver of portfolio performance and is paramount in helping investors achieve their objectives.

PSQ2.2023 | Executive Summary

House Views | Fixed Income, maximum overweight: Yields across fixed income are well above the lows of the past decade and offer attractive potential returns. With the North American monetary-policy cycle in a late stage, we will soon be on the other side of the rate cycle. The asset-allocation committee still believes there's considerable value in domestic and global bonds and investment-grade credit; however, they are more cautious about high-yield credit as high interest rates and a deteriorating economic backdrop will likely cause default rates to rise. • **Equity, modestly underweight:** The committee believes there is further risk to earnings, and that valuations are elevated. However, over time, they expect higher-quality companies to overcome current headwinds. Strong free cash flow within the Energy sector and relatively attractive valuations within Financials may present attractive opportunities in Canadian equities. • **Alternatives / Real Assets:** Here the view is mixed. High inflation, interest-rate volatility, and mounting recessionary fears have dampened transaction activity, prompting a flight to quality within the market. The committee is **maximum underweight** in Canadian and global real estate. However, for other alternative assets, such as infrastructure, they maintain a **modest overweight** view, particularly for those assets that generate stable, growing cash flows regardless of market conditions.

Factor Analysis | Rising-growth, falling-inflation assets: Equity and credit both had strong returns in Q1, despite looming threats. Inflation was still high, economic activity was slowing and financial conditions were tight. Nevertheless, interest rates and the equity risk premium both trended lower, pushing up equity multiples. • **Falling-growth, falling-inflation assets:** The banking crisis in March did some of the Fed's job by tightening financial conditions. Rate volatility spiked and short-term yields moved lower. These developments reminded everyone of the risk of recession amid the widely accepted soft-landing scenario, and allowed bonds to take on the role of diversifier again. • **Rising-inflation assets:** If equities are pricing in a soft-landing scenario, while fixed income is signalling recession, commodities seem to be reflecting something in between. Copper continued to show strength on China's reopening. Oil, on the other hand, saw both supply and demand shocks during the quarter. Gold, meanwhile, benefited from lower real rates and strong demand from central banks.

Economy | Similar to a Formula One driver, central banks need to find the right balance of speed, control, and strategy to cross the finish line without rolling over the economy. A strong tailwind from inflation and employment has kept the Fed biased towards tightening monetary policy, but leading indicators are starting to point to some obstacles on the road. The Fed should pause after its next meeting to ensure it doesn't put too much pressure on the economy. The Bank of Canada has already paused, but that doesn't mean rate cuts will occur right away as a cyclical upturn has taken hold.

Fixed Income | With yields finally reaching attractive levels, the income component of fixed income is back. The inherent short-term volatility in yields will likely persist as markets try to price in central-bank cuts driven by the varying probability of severe stress events and this will drive market participants to constantly reprice the future path of policy rates and economic growth. The attractive income cushion should provide a buffer to these bouts of volatility. Additionally, the ability of bonds to fulfill their traditional roles of a risk diversifier will be restored in the economic downturn.

Continued on next page

■ **Equities |** Analysts are still expecting positive earnings growth in 2023 for U.S. stocks, but we believe this may downshift in coming months. While the multiple for the S&P 500 has fallen slightly (from 20x to 18.7x), it is still not reflective of the risk we see in the estimates. • **Quantitative attribution analysis:** In the first quarter of 2023, the top three sectors were the cyclicals of technology, communication services and consumer discretionary, while defensive sectors lagged. This implies that market participants are looking past the threat of an economic downturn. However, contributions from the tech sector are more likely due to a trading phenomenon than the result of widespread hopes for an economic expansion. Other major contributions came from quality names with high return on capital, strong revenue generation and stable balance sheets. • **International, EM:** Global macro conditions have continued to deteriorate, and we are increasingly seeing the impact of tightening by global central banks on the economy. This all could lead to short-term pain for the more cyclical sectors of the equity universe, and particularly EM and international stocks, given that they are more exposed to these cyclical sectors. While risks in many regions remain elevated, low relative valuations may present attractive opportunities on a selective basis.

■ **Real Assets |** The real estate market has been hit by rate hikes. Global transaction volume for this sector tumbled 63% y/y in Q4/22. Tighter lending conditions and disagreements between buyers and sellers over property valuations are responsible for this decline. Real estate valuations have also decreased by about 3.5% since their peak in June 2022 and this trend is expected to continue as the market adjusts to higher interest rates. The market is in the process of recalibrating to one of the quickest hiking programs in decades. We believe things will stabilize in the latter half of the year as economies and investors digest the slower pace of hikes and anticipate potential rate cuts. However, in the near term, risks remain elevated.

■ **Currencies | USD:** The banking turmoil reinforced a pivot against the USD. We see a period of decoupling from non-USD currencies rather than a correlated downturn in the months ahead. The global macro regime is shifting, with the world moving towards a balance of growth and inflation drivers, and the USD-positive bearish regime is ending. While the U.S. dollar may see near-term resilience, short-term rallies should be met with skepticism. • **CAD:** Falling energy prices and the BoC's decision to pause rates below the Fed should make it difficult for CAD to appreciate against the greenback. But the impact of tightening might be more severe in Canada because households here have higher leverage and much shorter fixed-rate mortgage terms, and the economy is more sensitive to falling commodity prices. However, these negative factors seem to have been at least partially priced in.

■ **Commodities |** Resources have underperformed our expectations of late, with the broad commodity basket down 8% in the first three months of 2023. Although we remain constructive in the medium term, near-term challenges, have dampened sentiment more than expected. • **Credit Crisis:** Increased risk aversion prompted investors to unwind long positions to the lowest level in over 10 years. Bank liquidity issues tightened credit standards, which will likely put a drag on economic growth and demand. • **Underwhelming Chinese data:** Data was positive though less robust than many had expected, prompting investors to take a wait-and-see approach. However, strong data could lure them back into commodities. Given that China is a material commodity consumer, the velocity of their reopening and its impact on growth will be meaningful. • **Russian Energy Supply:** Russia has responded to severe energy sanctions by increasing its seaborne crude and product exports, which pushed the market into surplus and weighed on prices. However, recent data suggest sanctions may finally be affecting Russian production. • **Mild winter:** Another factor that weighed on energy prices was sharply reduced demand from North America and the EU, as both continents had some of their mildest winters in 70 years. It's unlikely that the EU will get this lucky again going into next winter and energy prices should reflect that.

Aloft on a Windy Day

Brad Simpson, Chief Wealth Strategist, TD Wealth

I ride a road bike and I love it. The other day I was gliding through Beacon Hill Park in Victoria with the cherry trees in full bloom. It really is one of the most beautiful places in the world, situated along the Strait of Juan de Fuca, held by the Olympic Mountain range. All this beauty does come at price, though — it can be quite windy, which is a curse or a blessing depending on what you like to do.

As I rolled into Clover Point, I stopped to watch people participate in one of the great pastimes of the area: flying kites. I marvelled at the engineering of the kites and thought about what it must be like for the individuals holding their lines as the winds twisted and turned and died, and then suddenly came back to life. And then (failing miserably in my attempt to get my mind off work) I started to think, that's an awful lot like what investors must feel like these days.

We've had geopolitical angst the likes of which we haven't seen in a generation, historically high inflation, and a slew of rate hikes from central banks around the world to combat it. These higher interest rates permeate every crack in the global economy. They have an impact on how we pay for things, what we earn on our savings, our employment prospects and even our general confidence in the economy itself. They can also have some unintended consequences.

In March of this year, as Murphy might have predicted, these rate increases triggered a banking crisis, first with regional banks in the United States (SVB, Signature) and then of course with Credit Suisse in Europe. Terrified investors piled into money markets, thinking this was the beginning of the end ... but not so — a quick response from governments and central banks managed to pull off a magic trick that would have made David Copperfield proud. The Treasury steps in to guarantee uninsured depositors. The Fed steps in to provide liquidity. The mountain of concern disappears and a relief rally takes hold, as though nothing had happened.

In the first quarter, you had equity markets performing well, suggesting all was well, while volatility in the bond markets suggested otherwise. You had the U.S. Treasury Secretary talking up the strength of the economy, while the International Monetary Fund suggested the outlook was, in fact, quite dire. It's a complex system, in other words, with big conflicting winds pulling and pushing on that tiny kite of ours:

Crosswind 1: A bearish narrative would suggest that the growing risk of recession is bound to create a cautious outlook for equity markets. Shaky economic data could prompt revisions to earnings guidance, leading to analyst downgrades and compression of forward P/E multiples. There's plenty of evidence to support this, including: a sustained yield-curve inversion; a broad-based decline in monetary growth; tightening of lending standards; and the risk of a banking-crisis recurrence. The rapid rise of interest rates, moreover, continues to trickle through to the real economy, so we expect to see more of an impact over the next few quarters. Given that the S&P 500 is currently sitting at a valuation of 18.5x forward earnings — its highest level in a year — there's also significant earnings risk. In Canada, meanwhile, home prices relative to income remains notoriously among the highest in the world, and a "higher for longer" interest-rate regime may impact market liquidity as households allocate more of their income to servicing mortgages than saving and investing. Lastly, the equity risk premium (the difference between earnings yields and government bonds) has also fallen back to low levels, suggesting that investors have become complacent about the risks.

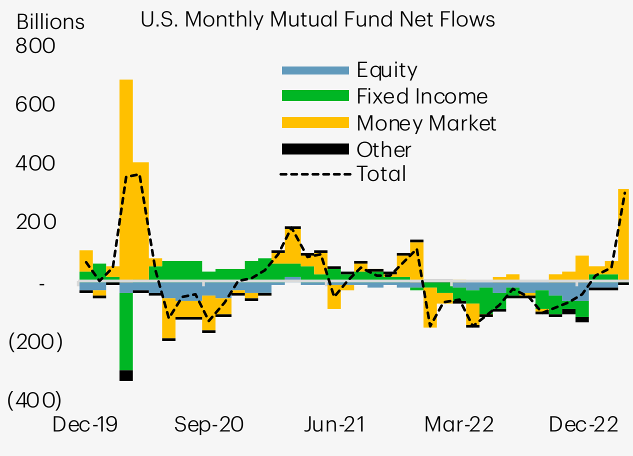
Crosswind 2: The other, more bullish narrative goes something like this. Equity markets may continue to move higher as stocks outside the tech sector join in the rally. This view of the markets would suggest that the challenges that economists are waiting for were already priced in late last year when the market was at its lows. It's true that multiples are elevated, but that could be easily corrected by a good earnings season. Support for this narrative includes the behaviour of the real estate markets, which have corrected but not severely. The jobs market, meanwhile, remains strong. Inflation is rolling over, which could allow central banks to pause or pivot. All of this would support consumer spending, which could be the pillar that supports growth and keeps the economy from going into recession. Another pillar of support could come from the reopening of the Chinese economy. Oil and gas producers in Canada, moreover, are generating some of their highest levels of free cash flow in years. One could also point to the global underinvestment in metals production over the past decade, which has tightened metals markets and created opportunity for Canadian metal companies.

In addition, investor cash balances are elevated, which could lead to a surge of inflows and squeeze out a large cohort of short-sellers, which would provide yet another boost.

The winds are jostling around all over the place, and at the end of your string is this seemingly fragile piece of canvas whose defiance of Newton's Third Law comes down to the strength of the kite itself. So, ask yourself this question: Was it constructed to meet the needs of the person at the other end of the rope?

The good news is that the immediate crisis posed by interest rates seems to be over. Outflows from the banking sector have decelerated and reversed to inflows. The liquidity crunch at regional banks also seems to have subsided (for now, at least). The bad news is that we still have to contend with the rate jitters and economic malaise that seemed to be gripping the markets before the crisis came to light.

Figure 1: Extraordinary move into money markets



Source: Morningstar and Investment Co. Institute as of March 30, 2023

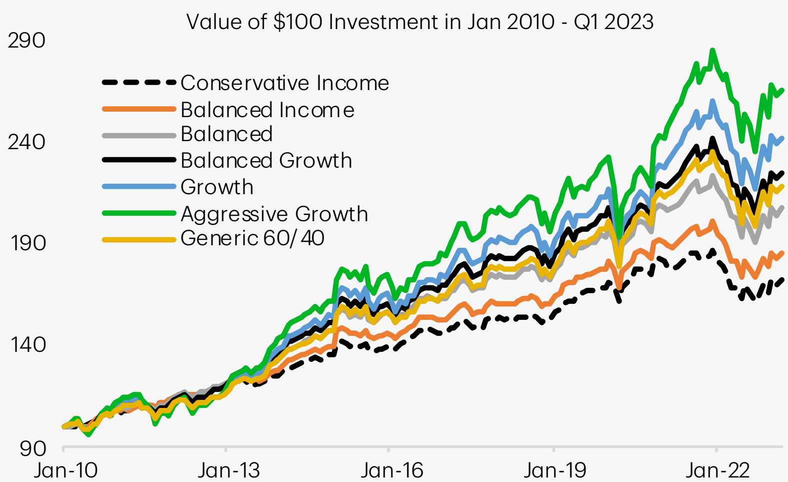
One sign of the weakening sentiment has been the extraordinary move into money markets (Figure 1), which allow investors to lock in cash for short periods of time. I know it's wise keep some powder dry, but this move was a great deal more than that. The stampede into money markets during the first quarter was in historical terms a considerable outlier, if you exclude what happened at the beginning of the Covid pandemic. I think, in many cases, this was the kind of emotional decision that seems to make a lot of sense at the time but eventually, when the panic subsides, is revealed to be a possible mistake.

Figure 2 highlights returns for six passively managed portfolios. I share this because it highlights the theoretical returns between the most conservative benchmarked portfolio and the most aggressive, plus the generic returns of a traditional 60/40 benchmark portfolio* — all of which were very positive, despite the very dire news that dominated the airwaves throughout much of the quarter.

What's really driving the move into money markets is uncertainty — and fear of a worst-case scenario — which always becomes more intense as you move through a major economic transition. That being said, it does feel like the divergence of opinions on the market has widened to extremes.

These are precisely the times when I like to fall back on a well-worn aphorism of mine: It's not what you think, but how you think. Investors far too often try to make decisions in the heat of the moment, by cobbling together whatever information they can quickly grasp — an approach that's bound to fail over time.

Figure 2: The value of a portfolio approach across risk profiles



	Q1/23 Return
Aggressive Growth	5.2%
Growth	5.0%
Generic 60/40	4.9%
Balanced Growth	4.5%
Balanced	4.1%
Balanced Income	3.8%
Conservative Income	3.6%

Source: Bloomberg Finance L.P., Wealth Investment Office as of March 30, 2023

Our approach, by contrast, is to quantify our decision-making processes, so that when we get into an environment like this one, we're prepared for it. We do this in a very structured way, by looking at the indicators for four areas: (1) the economy; (2) the industrial manufacturing sector; (3) consumer spending; and (4) the jobs market (Figure 3).

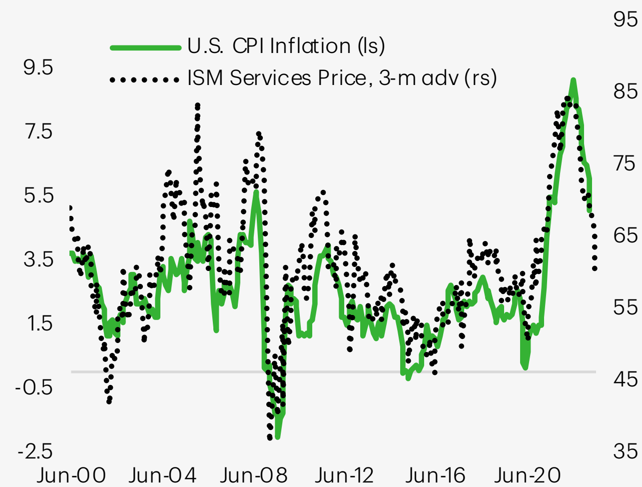
Now, among these indicators, the economic and goods manufacturing data are viewed as leading indicators, while the jobs market and consumer spending are viewed as lagging indicators. In Figure 3, we can start to see the trajectory of the economy. While the jobs market remains strong and consumer spending has been resilient, we need to stress again that these are lagging indicators. Overall economic growth, meanwhile, has been slowing consistently, and purchasing managers indices (PMIs) for the manufacturing side of the economy have already fallen in contractionary territory.

It's true that, according to the same PMIs, the services side of the U.S. economy is still expanding — and the services side is much larger than the manufacturing side — but we're starting to see signs of weakness there as well. As interest rates rise, so do mortgage payments and credit card bills. Debt-servicing costs, which may have seemed light when interest rates were at rock bottom, will start to feel onerous, and that has an effect on consumer confidence more generally. The recent flattening in airline passenger numbers, hotel occupancy, and spending at restaurants, for instance, suggest that a degree of caution is creeping into consumers' spending decisions.

These findings all seem to argue against the bullish "no landing" scenario of continued growth, and in favour of a "soft landing" or even a bearish "hard landing" scenario entailing a significant recession. The question then becomes, which one will it be? Can inflation be vanquished before the economy falls into recession? It's a borderline call at the moment, but there are a couple of positive developments on the inflation front.

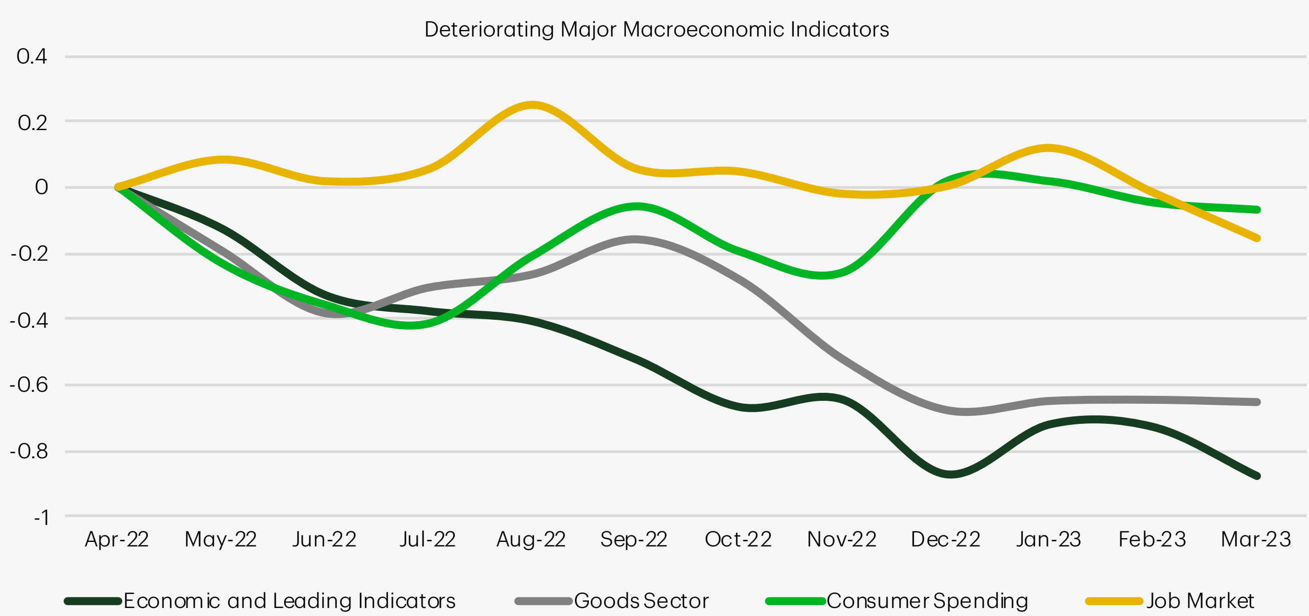
If the aforementioned leading indicators prove accurate, it's only a matter of time until consumers cry "uncle" and rein in their spending, which will drag down the gravity-defying services sector — and with it, inflation. A real services slowdown is like Kryptonite for inflation, as you can see in the accompanying graph (Figure 4).

Figure 4: The last stand for the consumer and inflation



Source: Factset as of April 10, 2023

Figure 3: Lagging indicators starting to weaken



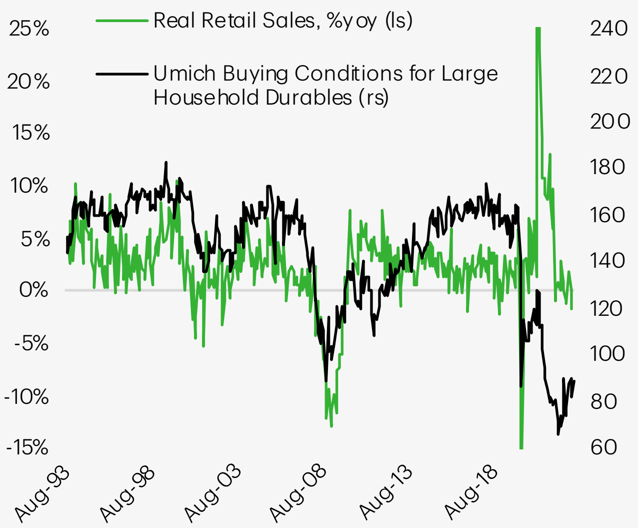
Source: Wealth Investment Office as of March 31, 2023

There are plenty of signs that consumers are pulling back on spending, despite the strong labour market, given the decline in purchasing power and drain in excess savings accumulated during the pandemic (Figure 5). One of many ways to gauge the strength of consumers is to look at the default rate on consumer credit. In aggregate, default rates for consumer loans are still lower than before the pandemic (Figure 6). The details, however, reveal a more concerning picture. During difficult periods, consumers tend to first default on credit cards, and subsequently car loans, before finally defaulting on their mortgage. The default rate for bank cards has risen to 3.37% in March 2023, compared to 3.28% just before the pandemic. The deteriorating growth outlook and looser labour market is expected to translate into an even higher default rate in the coming quarters.

There are also signs that the labour market is starting to shift. A weaker labour market and moderation in wage growth should prevent core services inflation from rising significantly above current level, although forecasting the peak would be a difficult game to play (Figure 7).

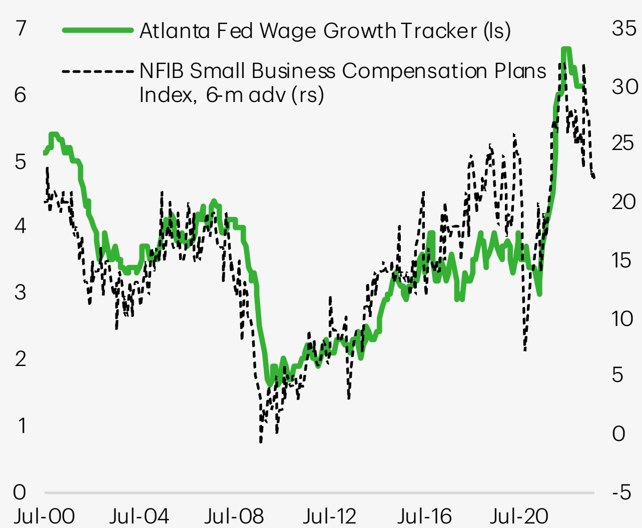
Continued progress on inflation hinges on the strength of the labour market going forward, which makes leading indicators on employment important to monitor. It's encouraging to see that wage growth is cooling, despite a near record-low unemployment rate and an elevated vacancy-to-unemployed ratio. There are several leading employment indicators to support the argument for a much weaker labour market in the coming quarters.

Figure 5: Retail sales are contracting



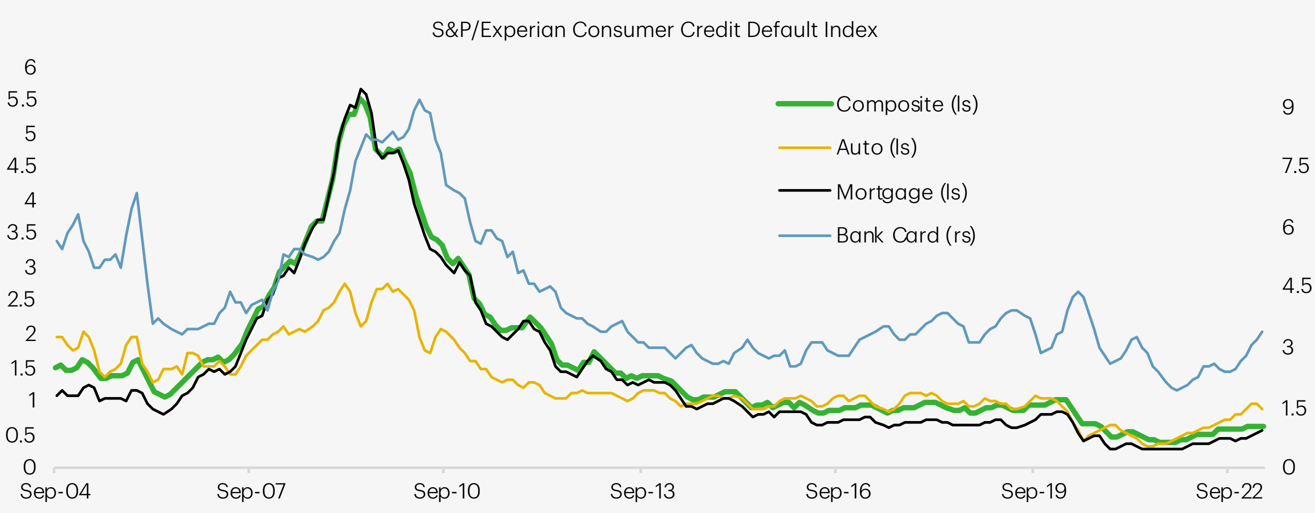
Source: Bloomberg Finance L.P, Wealth Investment Office as of April 5, 2023

Figure 7: Wage growth is moderating, too



Source: Bloomberg Finance L.P, Wealth Investment Office as of April 5, 2023

Figure 6: Consumer defaults are rising



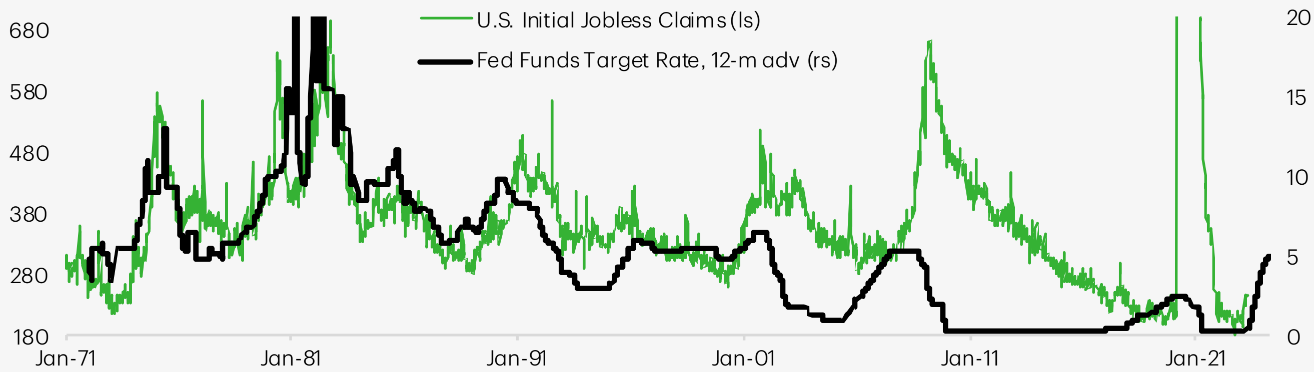
Source: Bloomberg Finance L.P, Wealth Investment Office as of April 5, 2023

First, initial jobless claims have been trending higher and consistently tracking the historical 12-month lag of the change in policy rate (Figure 8). Given the rapid increase in interest rates over the past year, the rise in jobless claims in the coming year may also be faster than historically had been the case.

Second, corporate layoffs have accelerated as executives streamline their operations in the face of a weaker macro outlook (Figure 9). This has led to a higher continuing jobless claim, where the rise (y/y) above the zero line is considered recessionary. There have been only three instances over the past 50 years, in 1985, 1993, and 1996, when a new business cycle begins without being preceded by a spike in unemployment (Figure 10).

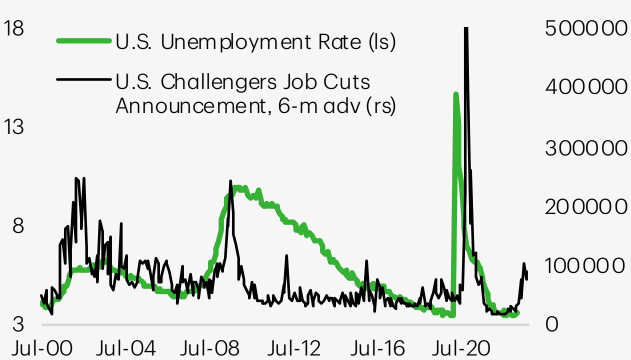
Third, the demand for temporary help, which historically has led the headline non-farm payroll employment, has contracted relative to last year's level and is now pointing to a contraction in headline non-farm payroll by the end of Q3/23 (Figure 11). Meanwhile, a tightening in loan standards has highlighted the risk that the unemployment rate could rise to 5.6% by September 2023 from the current 3.6% (Figure 12). This would place the beginning of the recession at some point in Q2 or Q3.

Figure 8. The rise in initial jobless claims is tracking the rise in FFR, with a lag



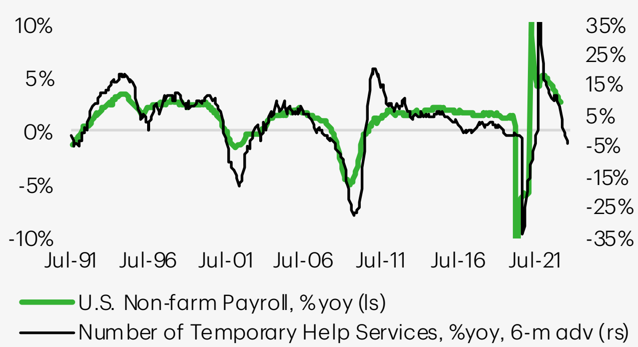
Source: Bloomberg Finance L.P, Wealth Investment Office as of April 5, 2023

Figure 9: Rising job cuts point to increase in unemployment



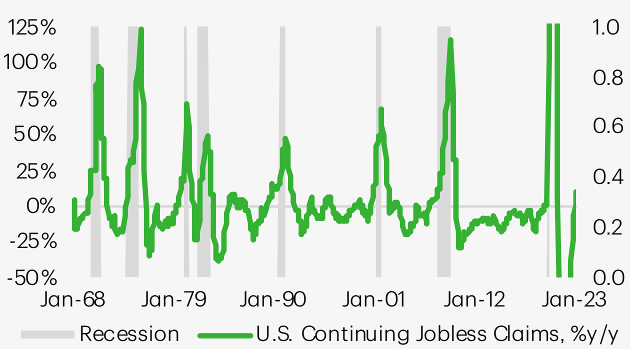
Source: Bloomberg Finance L.P, Wealth Investment Office as of April 5, 2023

Figure 11: Temporary help demand is contracting



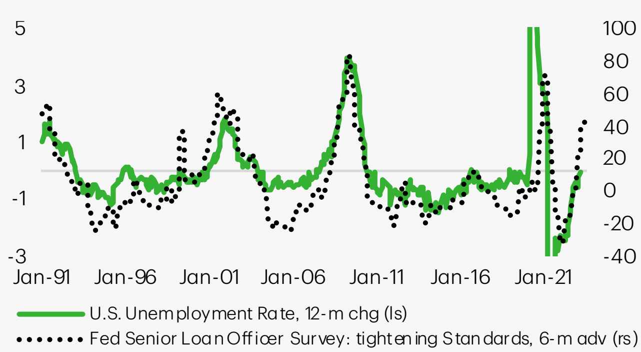
Source: Bloomberg Finance L.P, Wealth Investment Office as of April 5, 2023

Figure 10: Continuing jobless claims is recessionary



Source: Bloomberg Finance L.P, Wealth Investment Office as of April 5, 2023

Figure 12: Risk of a 2%+ increase in unemployment rate



Source: Bloomberg Finance L.P, Wealth Investment Office as of April 5, 2023

Should the current trend continue, Canadian inflation would be close to the Bank of Canada's target range of 1% to 3% by the back half of this year. It would probably be nearer to the upper bound of that range, but still, if you think about where we were, that's pretty extraordinary.

But let's not pop open any champagne bottles just yet — at least, not until the much more influential U.S. central bank is able to reach its own target. The core PCE deflator (the Fed's preferred measure of inflation) isn't expected to reach the Fed's average 2% target until early 2025, although it wouldn't be surprising to see that number getting closer to 3% by the end of this year, at which point inflation will be well under control.

At the end of the day, the debate between hard and soft landings may be missing the point, which is that, regardless of the recession scenario, the macro indicators continue to suggest that we are in the late stages of the economic cycle (Figure 13), and that begs the question: what kind of allocation works best in this kind of environment?

To start with, investors need to rise above the fray for a moment and think about what they are investing in. Often what gets lost in our world of 24-hour market news and ease of trade is the fact that investment ultimately is about owning something. I think knowing this helps when we enter periods of time like we saw in the first three months of the year.

The following are six companies we own across our enterprise. Many of our clients don't own them and likely never will. My sharing them should not be deemed an investment recommendation to go out and purchase. I share these just as an example of quality businesses that are meant to be owned. I'm not saying that they are trading today at the ideal entry point. They are just examples of what underpins all the abstract agglomerations and derivative relationships that make up a portfolio. They are also intended to give you a sense of what it means to own something, as opposed to speculating on a generic market forecast for the coming quarters.

Figure 13: Indicators point to late stage of the economic cycle

	Summary table (Historical Percentage)	Apr-22	May-22	Jun-22	Jul-22	Aug-22	Sep-22	Oct-22	Nov-22	Dec-22	Jan-23	Feb-23	Mar-23
Economic and Leading Indicators	Conference Board US Leading Indicator	64.5	50.7	38.1	26.7	22.4	19.2	14.5	12.9	10.6	11	9	9
	ISM Manufacturing PMI	68.8	69.6	46	41.3	43.7	25.9	18.5	12.5	9.4	5.9	7	4.3
	ISM Services PMI	74.8	61.8	55.9	61.8	57.4	54.3	36.2	48.4	6.6	41.3	40.5	12.2
Goods Sector	ISM New Orders/Inventories	16.1	12.5	4.7	2.7	7	2.3	5.5	5.9	3.1	1.9	7.4	6.6
	US Industrial Production, %yoy	87	73.6	60.6	73.6	75.5	93.3	74.4	45.6	31.8	34.6	29.5	29.5
	Sales to Inventory Ratio	11.8	6.6	5.5	3.5	1.9	1.1	2.7	3.1	1.9	3.5	3.5	3.5
Consumer Spending	Conference Board Consumer Confidence	76.3	63.7	55.5	50.3	64.9	74.8	61	59.4	76.7	71.6	64.1	66.5
	University of Michigan Consumer Sentiment	11.4	3.9	0	0.3	3.5	4.3	6.2	2.3	5.5	10.6	12.5	8.2
	US GDP Real Disposable Personal Income, %yoy	0	0	1.1	1.1	1.1	3.5	3.5	3.5	7	7	7	7
Job Market	US Initial Jobless Claims (inversed)	91	98.5	94.1	91	97.7	100	98.1	94.1	97.7	99.7	89.8	86.7
	US Employees on Nonfarm Payrolls, mom chg	72.8	89.7	90.9	94	88.1	87.7	84.2	80.3	68.8	92.1	84.6	68.5
	ISM Manufacturing Report on Business Employment	39.7	32.2	22	29.5	68.5	27.1	30.7	24.8	37.4	35.8	25.5	16.5

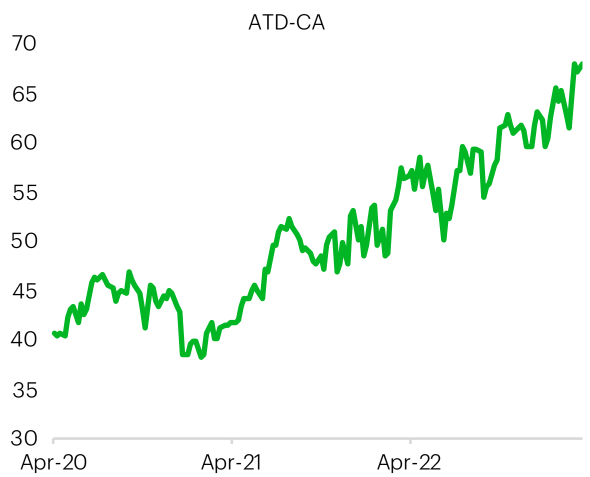
Source: Bloomberg Finance L.P., Wealth Investment Office as of March 2023. This chart shows 12 macro indicators as released over the past 12 months, based relative to 100 being the historical best level for each indicator.

Fundamental Metrics Table

Ticker	Company	Sector	Price	Return on Capital (ROC)	2023 EPS Growth	P/E to Growth Ratio (PEG)	P/E Relative to 10 Yr. Avg.
ATD-CA	Alimentation Couche-Tard Inc.	Consumer Staples	$67.52	16.4%	15.1%	3.0	1.0
KLAC-US	KLA Corporation	Information Technology	$372.41	48.3%	15.3%	5.6	0.8
SU-FR	Schneider Electric SE	Industrials	$152.60	14.4%	9.8%	4.5	1.2
TMO-US	Thermo Fisher Scientific Inc.	Health Care	$569.23	10.8%	2.0%	2.5	1.1
TSCO-US	Tractor Supply Company	Consumer Discretionary	$249.56	23.5%	8.2%	2.3	1.0
GWW-US	W.W. Grainger, Inc.	Industrials	$665.00	42.8%	12.6%	1.5	1.0

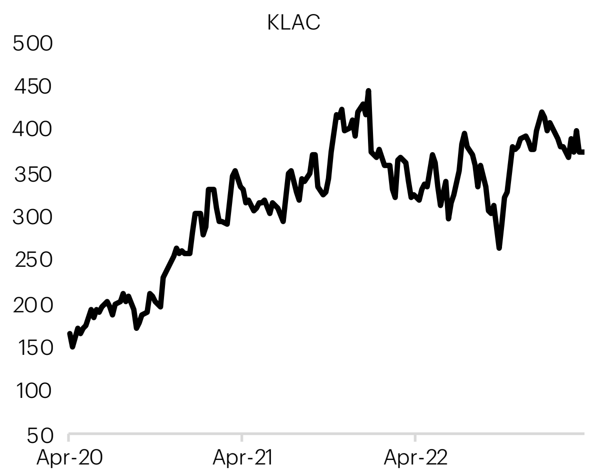
Alimentation Couche-Tard (ATD): This is a Canadian company that, over more than 40 years, has become a global leader in the operation of fuel service stations and convenience stores under the Circle K, Ingo and Couche-Tard brands. The company derives 66% of revenue in the United States, 13% in Canada and 21% in Europe. ATD has a track record of growth through both organic means and through acquisition, growing sales at a compound rate over 13% and operating earnings at more than 22% over the past 10 years. A major contributor to ATD's success has been its ability to purchase franchises and improve the operating performance of its acquisitions by improving marketing and product assortment, as well as enhancing sales and profitability.

Figure 14: Stores at gas pumps



Source: FactSet as of April 14, 2023

Figure 15: Process control and yield management systems

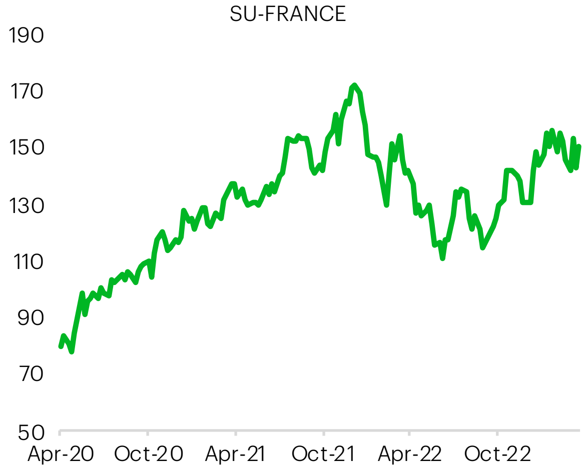


Source: FactSet as of April 14, 2023

KLA-Tencor (KLAC): KLA is a leading semiconductor equipment manufacturer specializing in process control. The company provides equipment and software solutions used to inspect the most advanced semiconductors. The manufacturing process for semiconductors, which are the backbone of all electronic devices, is both costly and complex. KLA allows its customers to improve manufacturing yields and deliver continued innovation. Artificial intelligence; electric vehicles; and "internet of things" devices are a few of the many applications that will require advanced semiconductors in the future. Over the past decade, KLA has compounded sales and earnings at 11% and 16%, respectively, driven by the rising demand in semiconductors across many end-markets and rising manufacturing complexity. 79% of sales are derived from equipment and 21% from services. With continued growth in semiconductor demand, the company can sustain equipment sales growth in line with the broader industry, which is expected to enjoy compounded annual growth rate of 6% to 8% through 2030. Today KLA has an install base of over 56,000 units, which provide significant multi-year, subscription-like service revenues, thus improving KLA's business quality.

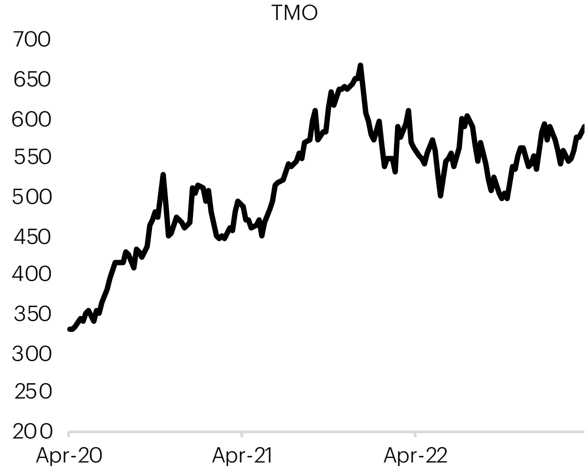
Schneider Electric (SU): Schneider Electric is a global provider of energy management and industrial automation solutions. The energy-management segment drives 77% of revenue and distributes a diverse range of electrical products and solutions to numerous end markets, such as industrial, residential, commercial, power and utilities. The industrial-automation segment drives 23% of revenue and includes industrial control products, software and solutions for discrete, process and hybrid industries. The product and solution range is broad across both segments spanning from EV chargers to surge protection for data centres to sensors and RFID systems. The company operates globally, with North America, Asia-Pacific and Western Europe representing the majority of the business at 32%, 30% and 24% of sales, respectively. Schneider's portfolio of products and services are well aligned with secular trends of electrification, energy efficiency, energy security and industrial automation. Schneider's capable management team has capitalized on these underlying trends to drive strong organic growth and a five-year EPS compounded annual growth rate of nearly 11%. The outlook remains positive as electrification and automation momentum builds. Underpinning these trends is a backdrop of supportive policy, structural underinvestment in the grid, onshoring of globalized supply chains and accelerated urgency for diversified and sustainable energy sources.

Figure 16: Digital automation and energy management



Source: FactSet as of April 14, 2023

Figure 17: Life science tools

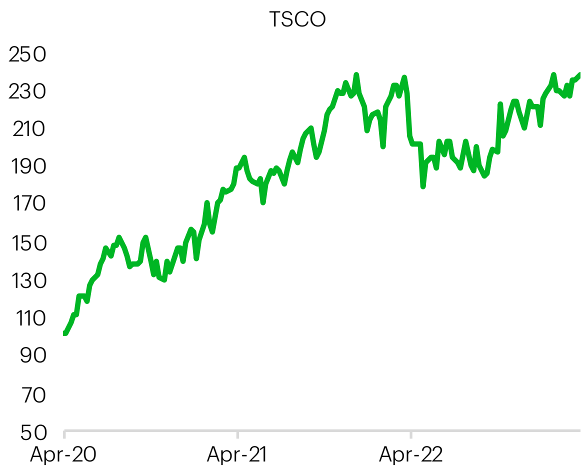


Source: FactSet as of April 14, 2023

Thermo Fisher Scientific (TMO): This company is the leading global provider of tools and services used to discover and manufacture drugs, with many of the industry's leading brands, and unmatched depth of capabilities. Thermo's product offerings range from simple lab supplies (e.g., pipettes and safety goggles), all the way to complex instruments ranging from electron microscopes, chromatography machines, DNA sequencers and bioreactors. Thermo has diversified customer base comprising pharma, biotech, academic, industrial and clinical customers, with 74% of sales recurring from consumables and services, with low sensitivity to the economic cycle, and from customers who prioritize quality over price. Life-sciences tools are a “pick-and-shovel” play on the secular growth in life sciences R&D. Investing in tools allows investors to participate in the long-term secular growth of life-sciences R&D, without having to take the R&D risk of investing directly in Pharma or Biotech, where there is a high level of serendipity in drug discovery (around 90% of phase 1 drugs ultimately fail). With many new biologic drugs coming to market, in addition to the first wave of biosimilar copies of older drugs, there will be strong demand in the decade to come for bioproduction consumables and services. With the acquisition of Patheon, PPD and other assets, Thermo can now provide an end-to-end solution to their pharma and biotech customers. Thermo has grown EPS at a 16.7% compounded annual growth rate over the past decade, and is well positioned to continue to post mid- to high-single-digit organic growth, and low- to mid-teens EPS growth in the years to come.

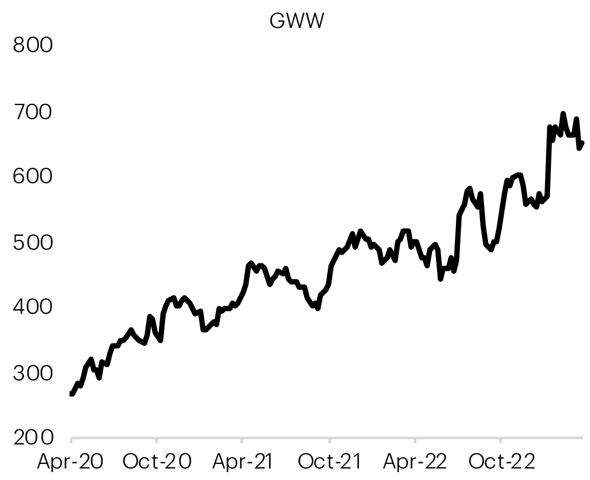
Tractor Supply (TSCO): Tractor Supply is America's largest operator of retail farm and ranch stores. Operating more than 2,000 stores in 49 states, TSCO has spent over 80 years serving recreational farmers, ranchers and suburban/rural homeowners. Animal supplies, half of sales, have been the largest growth driver. The other half is diversified among home improvement, seasonal products, clothing, footwear and agriculture. The company serves a niche rural lifestyle retailing industry with multiple secular tailwinds: de-urbanization, pet ownership, onshoring/reshoring and housing mismatch. With only 8% market share and low competition, Tractor Supply has a long runway for growth. Tractor Supply management has been skilled at allocating capital to successful growth initiatives. The highest ROI projects are just getting started and will serve as multi-year tailwinds: Project Fusion will see all stores remodelled and modernized; Side Lot Project will transform underused outdoor space for garden centres. Looking back, Tractor Supply has demonstrated a consistent business model that drives attractive shareholder returns throughout the business cycle. Over three decades, TSCO posted negative same-store sales growth only in 2009. Remarkable consistency has compounded free cash flow at 20% annually over the past 10 years. This has allowed the dividend to grow at 25% compounded annual growth rate and for 2.3% of shares to be repurchased annually.

Figure 18: Retail farm and ranch stores



Source: FactSet as of April 14, 2023

Figure 19: Maintenance, repair and operations



Source: FactSet as of April 14, 2023

W.W. Grainger (GWW): W.W. Grainger is a leading supplier of maintenance, repair and operating (MRO) products, with operations in North America, Japan and the United Kingdom, and over 4.5 million active customers. It operates through two segments: High-Touch Solutions N.A. and Endless Assortment. The High-Touch Solutions N.A. segment offers over two million MRO products as well as services such as technical support and inventory management, while the Endless Assortment segment offers customers access to over 20 million items. The company is a consistent capital compounder with 5-year compound annual growth rate of 7.9% for revenue and over 20% for earnings per share, generating an average return on equity of over 50% over that period. The stock has followed, with an average annual price change of almost 19% versus 9.6% for the S&P 500 and 7.3% for the industry.

Investors also need to remember why they are investing. What are their objectives? Are they short-, medium- or long-term objectives? The priority and time horizon assigned to each objective — as well as the client's own risk profile and behavioural proclivities — comprise the internal client-specific factors that drive allocation. As for the external client-agnostic factors, which relate to the economic and market environment, that's when we go to the experts — specifically our very own asset allocation committee, which is composed of a group of senior leaders and portfolio managers who meet monthly to hash out their views on the economy and provide guidance for asset-class weighting across the institution. What follows is a breakdown of the committee's current thinking:

Fixed Income:

The committee is maximum overweight fixed income. Yields across the asset class are well above the lows of the past decade and offer attractive potential returns. With the North American monetary-policy cycle in a late stage, we will soon be on the other side of the rate cycle heading down. The committee still believes there's considerable value in domestic and global bonds and investment-grade credit; however, they are more cautious about high-yield credit and think that the risk of widening spreads is considerable.

Equity:

The committee remains modestly underweight equities overall. They believe there is further risk to earnings, and that valuations are elevated. However, over time, they expect higher-quality companies to overcome current headwinds. The committee is watching for macro warning signals that will precipitate an eventual defensive shift. They are currently recommending a "barbell" strategy, with high-quality tech leadership alongside defensive and value stocks.

Alternatives / Real Assets:

Here the view is mixed. High inflation, interest-rate volatility, and mounting recessionary fears have dampened transaction activity, prompting a flight to quality within the market. The committee is maximum underweight in Canadian and global real estate. However, for other alternative assets, such as infrastructure, they maintain a modest overweight view, particularly for those assets that generate stable, growing cash flows regardless of market conditions.

Then there are the sub-classes like gold and cash. For these, we need to step back and reflect for a moment on that stampede into money markets in the first quarter. And we need to distinguish between a defensive positioning and outright capitulation. When investors move a significant portion of their portfolios into cash and term deposits like GICs, they have effectively folded. They are no longer investing — they are market-timing, and there's plenty of evidence to show that market-timing just doesn't work. Investors tend to be at least a few days late on the way down and a few days late on the way up, and that makes all the difference.

In the case of GICs specifically, the emotional decision to get out of the markets makes even less sense, because there are bonds that are virtually equal in terms of their safety but provide more liquidity and higher yields due to tax efficiency. A lot of the time, investors are paying for the guarantee without considering just how unlikely it would be for a major Canadian bank, let's say, to default on its bonds. So, the starting point for people who are heavily weighted in cash is to begin to think about moving some of that into fixed income investments.

The very short end of the fixed income market, for instance, can provide attractive yield with only a small amount of interest-rate and credit risk. Investors should also be looking at "unconstrained" funds, which provide the flexibility to take advantage of opportunities across asset classes, markets, sectors, whether long or short the market. In addition, income investors can take advantage of risk-mitigation strategies, which help preserve capital during market downturns. Examples include derivatives-based strategies and factor-based strategies like low-volatility.

For equities, meanwhile, the name of the game is selectivity, which explains to some extent the allocation committee's "barbell" approach, combining value and defensive names with growth names. The idea here is to look deeper into corporate fundamentals like cash flow in order to pick the kinds of sectors and companies that do well in the late stages of the economic cycle (Figure 20). In the equity market, we often find these in quality and dividend-paying stocks, which are also good at preserving capital during a market downturn. At the same time, we're following the committee's guidance by staying invested in high-quality tech leadership.

Figure 20: Equity positioning through the economic cycle

	Stage of the Economic Cycle			
Equity Portfolio Considerations	Early Stage	Mid Stage	Late Stage	Recession
Style	Growth	Growth	Value	Value & Income
Business Cycle Positioning	Cyclical	Cyclical	Defensive	Defensive
Sectors	• Financials • Technology • Discretionary	• Technology • Comm. Services • Industrials • Discretionary	• Energy • Materials • Staples • Health Care • Utilities	• Health Care • Utilities • Real Estate

Source: Wealth Investment Office, April 12, 2023

Keep in mind that the rally we've seen in equities has been narrow. The returns in Q1 were positive, even bullish, but much of the return was driven by just a few companies — the big growth tech companies that were weak performers in 2022. But outside of those few big names, you can still find really good companies with terrific cash flow.

The case for a defensive allocation is strong right now, despite an unusual divergence of opinions. While economists are clearly forecasting a slowdown, equity analysts are forecasting earnings growth. For our part, we think that, because earnings growth is very closely tied to GDP, analysts will eventually come around to the macro assessment. Earnings estimates for 2023 have already declined, from $226 to $219, but we believe there is further downside risk as we move through the second quarter. Valuations in the U.S. and Canada remain somewhat elevated, with forward P/E at around 18.5x. We'll be watching management comments and guidance for the Q1 earnings season closely.

So, that's our take, but ultimately we don't know how the winds are going to shift. We need to remind ourselves that investment is about achieving client objectives, not about keeping track of the day-to-day gyrations of macroeconomic data and financial markets. That's better left to the portfolio managers, which is not to say that investors should be totally hands-off. You need to know what you own, why you own it, and have reasonable expectations as to how your investments will perform in a highly transitional environment.

But going back to our kite analogy, we should remember that the goal is not to move in lockstep with the rapidly shifting gusts of wind — that's impossible. The goal is to keep the kite aloft. In all seasons. No matter how the winds blow. And if your kite is well-constructed, it will.

Leading Macro Indicators

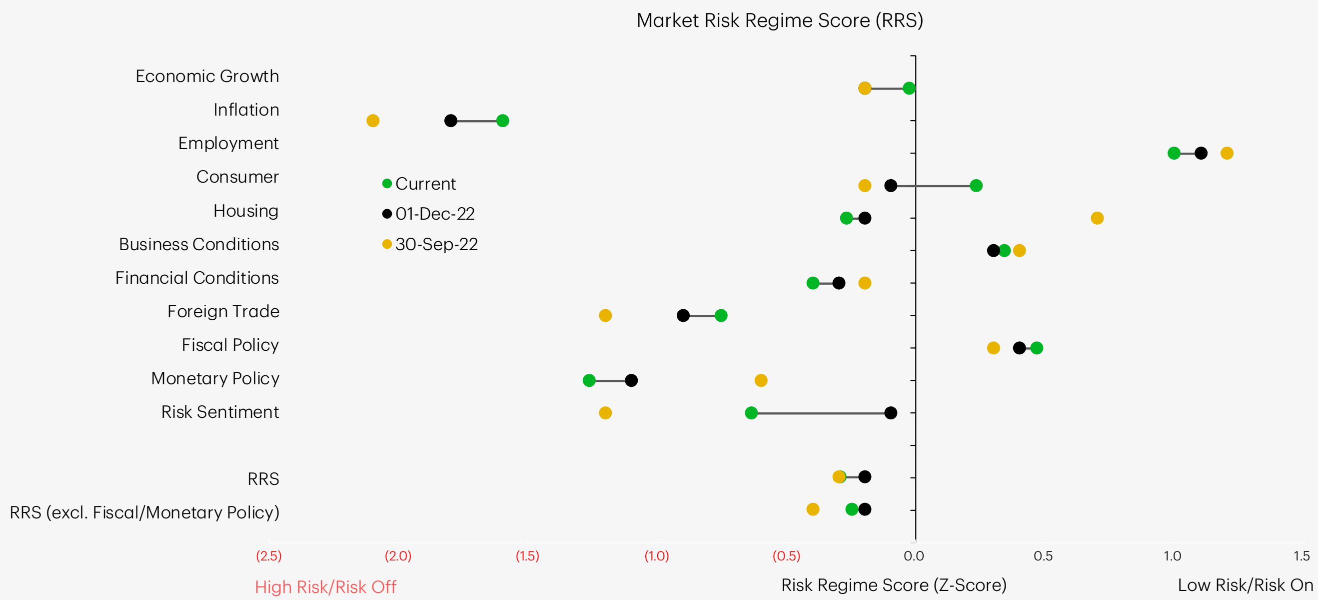
The overall risk regime score remains weak and macroeconomic conditions continue to deteriorate

As part of our process-driven approach to investment management, we monitor key variables that inform our understanding of the risk and macroeconomic environment. For each indicator, we calculate current values and compare them against recent trends and long-term data using a standardized approach that makes it possible to aggregate across indicators. Figures 1 and 2 summarize the overall condition and aggregate score of the indicators.

Figure 1: Market risk regime scores

Indicator	Overall Condition	Current	Dec-22	Sep-22	Jun-22
Economic Growth	Weak	(0.0)	(0.2)	(0.2)	0.2
Inflation	Weak	(1.6)	(1.8)	(2.1)	(2.0)
Employment	Strong	1.0	1.1	1.2	1.2
Consumer	Neutral	0.2	(0.1)	(0.2)	0.0
Housing	Weak	(0.3)	(0.2)	0.7	1.3
Business Conditions	Neutral	0.3	0.3	0.4	0.8
Financial Conditions	Weak	(0.4)	(0.3)	(0.2)	0.0
Foreign Trade	Weak	(0.8)	(0.9)	(1.2)	(0.8)
Fiscal Policy	Neutral	0.5	0.4	0.3	0.5
Monetary Policy	Weak	(1.3)	(1.1)	(0.6)	(0.2)
Risk Sentiment	Weak	(0.6)	(0.1)	(1.2)	(0.5)
Risk Regime Score (RRS)	**Weak**	**(0.3)**	**(0.2)**	**(0.3)**	**0.1**
RRS (excl. Fiscal/Monetary Policy)	**Weak**	**(0.2)**	**(0.2)**	**(0.4)**	**0.0**

Figure 2: Movement in market risk regime scores



Scores represent number of standard deviations away from long-term average.
Source: Bloomberg Finance L.P. and Wealth Investment Office, as of March 21, 2023.

Risk conditions deteriorated slightly in Q1 and our risk regime score remained at a weak level as the U.S. business cycle continued to contract. The overall market risk regime score fell to -0.3 at the end of Q1 from -0.2 at end Q4. Although macro conditions remain unsupportive for risk assets, equities ticked up and bond yields slipped amid expectations for the end of monetary policy tightening.

Monetary policy, risk sentiment, financial conditions, and housing scores exerted the biggest drag on the overall risk score as the Federal Reserve lifted the policy rate and signs of instability in the financial system emerged. Meanwhile, employment, fiscal policy, and consumer scores remained relatively strong, preventing the overall score from deteriorating further.

Below are some notable changes compared to Q4:

• Our score for monetary policy slipped further to -1.3 at the end of Q1 from -1.1 in Q4. The Fed has hiked the policy rate by 425 basis points (bps) over the past 12 months and money supply growth fell below zero on a year-on-year basis, draining liquidity in the market. The decline in the monetary policy trend also coincided with deteriorating risk sentiment, and financial and housing sector conditions. Our risk sentiment score slid from -0.1 to -0.6 standard deviation below the long-term norm and its overall condition moved from neutral to weak as treasury and equity volatility jumped. The inversion of the yield curve and widening credit spreads pushed financial conditions further into the red. House prices continued to fall driving both housing sector activity and sentiment lower in Q1.

• Inflation, foreign trade, and economic growth remained weak in Q1, although scores for the three categories stopped short from deteriorating further. The inflation score actually rose to -1.6 (from -1.8): both headline and core inflation fell at a slower-than-expected pace while inflation expectations declined slightly. Foreign trade stabilized at a negative level amid the lack of improvement in trade and the current account balance in the U.S. The economic growth score rebounded to 0.0 (from -0.2) although real GDP growth remained below its long-term potential.

• Fiscal policy and business conditions remained in neutral while overall conditions for consumer actually improved to neutral (from weak). Compared to Q4, the U.S. budget balance improved and government debt as a percentage of GDP fell, boosting the score for fiscal policy to +0.5 in Q1 from +0.4. The score for business conditions remained 0.3 as the deceleration in industrial production and private investment was partially offset by the strength of the service sector. Even though consumer sentiment deteriorated and goods spending decelerated in Q1, consumer spending on services accelerated, pushing the consumer score to above zero.

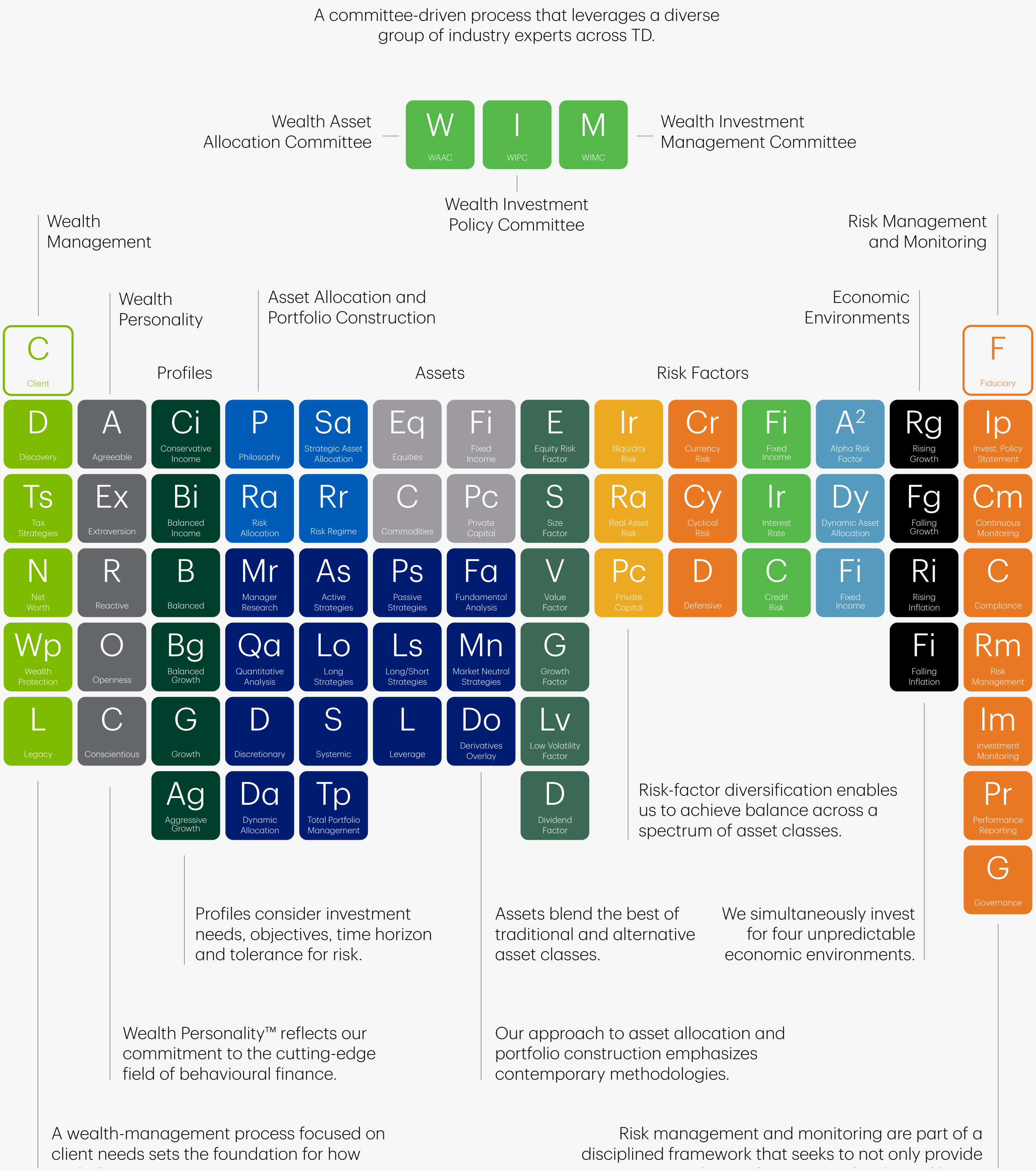
• Only employment boasted a "strong" overall condition and the employment risk regime score held in at one standard deviation above the long-term norm. Despite the softer data on employment, the unemployment rate (at 3.6%) is still hovering near record lows. While wage growth moderated it remained at levels inconsistent with the Fed's 2% target. Initial jobless claims were below historical averages. All these data points reflect a strong and healthy economy. However, the deterioration in risk sentiment and in the more cyclical and rate-sensitive sectors of the economy means employers will likely cut back on hiring in coming quarters, potentially accelerating the normalization process in the labour market.

Overall broad conditions for risk assets deteriorated slightly in Q1 as tight monetary policy, risk sentiment, financial conditions and housing was partly offset by the stabilization in fiscal policy, business conditions, and an uptick in consumer. Economic growth will likely continue to decelerate in Q2 and we expect markets to focus on any signs of weakness in employment, consumer, and business conditions.

Elements of Wealth Management

Investors are often left to make decisions without any formal process. Our solution? Follow an investment philosophy — a guiding set of principles designed to work in a world that's constantly changing, often with dramatic impact on financial markets. At TD Wealth, we call that philosophy "Risk Priority Management," and it provides the foundation for our decision-making process. That process is then broken down into its most basic components, similar to a periodic table of elements, as illustrated below, with groupings and weights. These components comprise our entire process, from wealth management to risk management to monitoring. All in all, there are 72 "elements" that fall into eight categories.

Figure 1: Elements



Wealth Asset Allocation Committee

The TD Wealth Asset Allocation Committee (WAAC) is composed of a diverse group of TD investment professionals. WAAC's mandate is to consider the financial-market environment and provide direction and themes for equities, fixed income, real assets and sub-classes for the next six to 18 months.

Considers the financial-market environment and provides direction and themes

Utilizing risk factors to manage exposures, we build and manage portfolios that blend the best of traditional and alternative asset classes.

Committee members:

David Sykes, CFA .... Chief Investment Officer, TD Asset Management Inc (Chair)

Michael Craig, CFA .... Managing Director & Head of Asset Allocation & Derivatives, TD Asset Management Inc.

Anna Castro .... Managing Director, TD Asset Management Inc.

Justin Flowerday, CFA .... Head of Public Equities, TD Asset Management Inc.

Jennifer Nowski, CFA .... Vice President & Director, TD Asset Management Inc.

Michael Augustine CFA .... Managing Director & Head of Fixed Income, TD Asset Management Inc.

Alex Gorewicz .... Vice President and Director, TD Asset Management Inc.

Jeffrey Trip, CFA .... Managing Director and Head of Alternative Investments, TD Asset Management Inc.

Colin Lynch .... Managing Director and Head of Global Real Estate, TD Asset Management Inc.

Kevin Hebner, Ph.D. .... Managing Director, Epoch Investment Partners, Inc.

William Booth, CFA. .... Managing Director, Epoch Investment Partners, Inc.

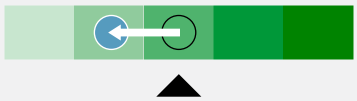
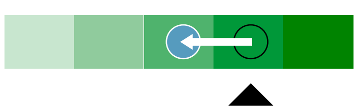
Brad Simpson, CIM, FCSI .... Chief Wealth Strategist, Wealth Investment Office, TDW

Sid Vaidya, CFA, CAIA .... U.S. Wealth Investment Strategist, TD Wealth USA

Bryan Lee, CFA .... Vice President & Director, TD Asset Management Inc.

Direction from WAAC

Core Asset Class Allocations

	Positioning	Rationale
Cash & Equivalents	**Modest Underweight**  Previous Month	We prefer allocating to fixed income versus cash and equivalents. While cash returns have become more attractive based on current rate environment, fixed income total returns should outperform over next 12 months.
Fixed Income	**Maximum Overweight**  Previous Month	We maintain a maximum overweight to fixed income as yields across the asset class remain well above the lows of the past decade and offer attractive, risk-adjusted potential returns. We believe fixed income will outperform equities over the next 12 months. Bonds can also provide diversification benefits, reduce overall portfolio volatility and preserve capital.
Equity	**Modest Underweight**  Previous Month	Our outlook for global equites remains cautious. Corporate earnings continue to face headwinds as nominal growth slows and further profit deterioration is expected amid the challenging economic backdrop. Over time, we expect higher-quality companies to overcome current headwinds, but we expect further market volatility to create better entry points. Despite the recent failure of two of U.S. regional banks, we believe that the banking system overall is soundly capitalized, and liquid, and that the situation will stabilize.
Alternatives	**Neutral**  Previous Month	We believe that an allocation to alternative assets such as commercial mortgages and infrastructure can benefit client portfolios. Alternative assets can provide inflation protection and attractive absolute returns, while acting as long-term portfolio stabilizers via their diversification benefits and less correlated income streams.

Maximum Underweight | Underweight | Neural | Overweight | Maximum Overweight

Fixed Income - Maximum Overweight

	Positioning	Rationale
Domestic Government Bonds	**Modest Overweight**	As fears of broader banking system contagion have eased, and volatility has decreased over the past month, the bid for the safety of government bonds has subsided for now. With the continued pause in the Bank of Canada's ("BoC") monetary tightening cycle, government bonds will continue to respond to economic developments. If those developments result in inflation remaining above the BoC's 2% target and the BoC hikes its policy rate further, government bonds will remain an attractive source of risk-adjusted income. This income increases the likelihood that they will continue to generate positive nominal returns.
Investment Grade Corporate Credit	**Neutral**	With the stress experienced in the banking sector, investment grade credit spreads have become more attractive across Canada, the U.S., and Europe. We see compelling investment opportunities for lower duration (5-years and shorter) corporate bonds given appealing all-in yields, but remain more cautious on longer duration corporate bonds given the continued uncertainty around the global economic backdrop.
High Yield Credit	**Modest Underweight**	Higher interest rates and a deteriorating economic backdrop will likely cause default rates for high yield bonds to rise from currently low levels. Corporate earnings will likely continue to be under pressure in the near term, eroding credit fundamentals. This could result in further volatility and downside risk for credit spreads, despite the high potential returns in the sector.
Global Bonds Developed Markets	**Neutral**	Recent banking stresses add a new layer of uncertainty with respect to the future path of inflation. Although central banks continue to maintain a tightening bias, investors are indicating that the global rate hike cycle is drawing to a close and that they expect monetary policy to pivot noticeably towards rate cuts in the second half of the year.
Global Bonds Emerging Markets	**Neutral**	The dispersion of returns within emerging markets has presented some opportunities. We are comfortable maintaining a neutral outlook as yields are attractive in some regions where central banks have proactively hiked interest rates, while bond returns will likely decline in other regions where central banks are still early in normalizing monetary policy.

Equities - Modest Underweight

	Positioning	Rationale
Canadian Equities	**Neutral**	We expect rate hikes to stall in 2023 if inflation continues to decline. The full effect of higher rates on the consumer and real estate market remains to be seen. As such, we anticipate that the Canadian economy will slow in 2023. However, strong free cash flows within the Energy sector, and relatively inexpensive Financials stocks, may present attractive opportunities.
U.S. Equities	**Modest Underweight**	The U.S. economic outlook remains weak and could weigh on corporate profits. There is also some uncertainty around the U.S. Federal Reserve's policy actions as it balances the need to lower inflation with the pressure higher rates are starting to put on the economy. We maintain a modest underweight outlook for U.S. equities as a result.
International Equities	**Neutral**	While international stocks face similar concerns regarding corporate profits and macroeconomic conditions, as well as some uncertainty regarding the health of the European financial system, we find that these risks are reflected in valuations and may provide better relative returns.
Chinese Equities	**Modest Overweight**	As China resumes its reopening plan, we expect to see an increase in demand for travel and leisure, luxury goods as well as energy and commodities. We beleive global supply chains will return to some sense of normalcy. Chinese equities could see relative outperformance over the next 12-18 months.
Emerging Market Equities (excluding China)	**Neutral**	Emerging markets equities continue to be challenged by persistently high inflation, concerns over global central bank monetary tightening, and the prospect of recession in many western economies. Our outlook for emerging markets remains cautious while recognizing that low relative valuations may provide a good entry point in the coming months.

Alternatives - Neutral

	Positioning	Rationale
Commercial Mortgages	**Maximum Overweight**	We maintain a maximum overweight to commercial mortgages. Commercial mortgages continue to provide accretive income while insulating investor returns from the increased volatility in interest rates.
Private Debt (Universe)	**Modest Overweight**	We maintain a modest overweight to private debt. High credit quality and global diversification provides safety in a potentially recessionary environment. Incremental income and potential capital appreciation from interest rate moderation provide upside.
Domestic Real Estate	**Maximum Underweight**	We are maximum underweight to Canadian real estate. Higher inflation and mounting recessionary fears remain a risk. We maintain broad diversification with the ability to enhance portfolio quality through value-add and build-to-core strategies.
Global Real Estate	**Maximum Underweight**	We are maximum underweight to global real estate. Higher inflation and mounting recessionary fears remain a risk. We remain focused on high quality assets and global diversification, with higher weights to multi-unit residential and the alternatives real estate sector.
Infrastructure	**Modest Overweight**	We maintain a modest overweight to infrastructure. Increases in cash flow from higher-than-expected inflation is buffering rising interest rates. Investor appetite remains strong, particularly for energy transition investments and critical infrastructure sectors that generate stable, growing cash flows.

Sub-Asset Classes

	Positioning	Rationale
U.S. Dollar	**Maximum Underweight**	We continue to expect USD weakness as interest rate differentials peaked several months ago. Following a very strong 2022, we believe that the USD's fundamental valuation, whether looking at historical averages, interest rate differentials, or U.S. growth versus global growth, remains overvalued.
Commodities (Gold, Energy, Metals, Agriculture, Carbon)	**Modest Overweight**	We are constructive on commodities as key markets such as oil and copper remain finely balanced and are supported by limited inventories, producer discipline and/or supply shortfalls, with demand potentially benefitting from a China recovery. Gold has benefited from a flight-to-safety that may reverse as confidence in the banking system is restored. A weaker USD would also be a tailwind for the commodities complex.

In April, the Wealth Asset Allocation Committee (WAAC) released an updated asset allocation framework. The new framework is a two-tier system. At the top tier, the investment universe is divided into four core asset classes: Cash & Equivalents, Fixed Income, Equities, and Alternatives. The second tier is further divided into sub-asset classes. Within each tier, the relative asset allocation view will sum to zero, which directionally indicates the committee's preference among different core asset classes and sub-asset classes. This change aims to provide a general guideline and allows investors to adopt portfolios overlayed with their own unique objectives and constraints.

The Wealth Investment Policy Committee (WIPC) made no changes to its dynamic asset allocation in April. At the top asset class allocation tier, WIPC maintained an underweight position in equities, an overweight position in fixed income, a neutral position in real assets and a neutral position in cash. This is closely aligned with WAAC's core asset class allocation view. Within equities, WIPC continues to be 2% underweight Canada and U.S. equities, which funds the overweight in emerging market equities as well as fixed income.

International equities remain neutral and emerging market equities is maintained at a modest 1% to 2% overweight. China is the biggest component in emerging markets and the remainder of emerging market countries tend to have high correlation with China.

Within fixed income, WIPC continues to hold a 2% to 4% overweight position in domestic government bonds, and a neutral or a modest 1% overweight position in investment grade corporate bonds. WIPC's current positioning is aligned to emphasize a higher quality part of the fixed income universe. WIPC also maintained a modest 1% underweight position in high yield bonds. Positioning in inflation linked bonds and global bonds remains neutral.

Within real assets, WIPC maintains the overall positioning at neutral with a modest 1% overweight position in mortgage/private debt and a modest 1% underweight position in real estate/ infrastructure in four of the risk profiles. The positioning is directionally aligned with the WAAC guideline and our clients primarily invest in publicly traded real estate and infrastructure, which are trading at discount valuations and currently reflect elevated risk in the sector.

Figure 1: Direction from WAAC: strategic positioning

	Asset Class	Underweight		Neutral		Overweight
Fixed Income Maximum Overweight	Domestic Government Bonds				●	
	Investment Grade Corp. Credit			●		
	High Yield Credit		●			
	Global Bonds - Developed			●		
	Global Bonds - Emerging			●		
Equities Modest Underweight	Canadian			●		
	U.S.		●			
	International			●		
	China				●	
	Emerging Markets excl. China			●		
Alternative / Real Assets Neutral	Commercial Mortgages					●
	Private Debt				●	
	Domestic Real Estate	●				
	Global Real Estate	●				
	Infrastructure				●	
Sub-Classes	U.S. Dollar	●				
	Commodities				●	

Source: Wealth Asset Allocation Committee, as of April 13, 2023.

Wealth Investment Policy Committee

The Wealth Investment Policy Committee is composed of a diverse group of TD investment professionals. WIPC's mandate is to interpret WAAC views and set general asset-class weights for each investor profile.

Interprets WAAC views and sets general investor profile asset-class weights

Utilizing risk factors to manage exposures, we build and manage portfolios that blend the best of traditional and alternative asset classes.

Committee members:

Brad Simpson, CIM, FCSI .... Chief Wealth Strategist, Wealth Investment Office, TD Wealth (Chair)

Michael Craig, CFA .... Managing Director, Head of the Asset Allocation & Derivatives, TDAM

Anna Castro, CFA .... Managing Director, TDAM

Jafer Naqvi .... VP & Director, TDAM

Christopher Lo, CFA .... Senior Portfolio Manager, Head of Managed Investments, WIO, TD Wealth

Fred Wang, CFA .... Senior Portfolio Manager, WIO, TD Wealth

Aurav Ghai, CFA .... Senior Fixed Income Analyst & Portfolio Manager, WIO, TD Wealth

Mansi Desai, CFA .... Senior Equity Analyst & Portfolio Manager, WIO, TD Wealth

Strategic and dynamic asset-class weights by investor profile (Condensed view)

Asset Class	Balanced Income		Balanced		Balanced Growth		Growth		Aggressive Growth	
	Strategic	Dynamic	Strategic	Dynamic	Strategic	Dynamic	Strategic	Dynamic	Strategic	Dynamic
Cash	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%
Fixed Income	63.0%	66.0%	48.0%	51.0%	33.0%	36.0%	23.0%	26.0%	0.0%	2.0%
Government	32.0%	35.0%	24.0%	27.0%	17.0%	20.0%	11.0%	14.0%	0.0%	2.0%
Corporate	31.0%	31.0%	24.0%	24.0%	16.0%	16.0%	12.0%	12.0%	0.0%	0.0%
Equity	35.0%	32.0%	50.0%	47.0%	65.0%	62.0%	75.0%	72.0%	98.0%	96.0%
Canadian	11.0%	9.0%	15.0%	13.0%	20.0%	18.0%	23.0%	21.0%	29.0%	27.0%
U.S.	14.0%	12.0%	20.0%	18.0%	26.0%	24.0%	30.0%	28.0%	40.0%	38.0%
International	7.0%	7.0%	10.0%	10.0%	13.0%	13.0%	15.0%	15.0%	19.0%	19.0%
China/Emerging Markets	3.0%	4.0%	5.0%	6.0%	6.0%	7.0%	7.0%	8.0%	10.0%	12.0%

Source: Wealth Investment Policy Committee, as of April 13, 2023.

Strategic and dynamic asset-class weights by investor profile (Expanded view)

Asset Class	Balanced Income		Balanced		Balanced Growth		Growth		Aggressive Growth	
	Strategic	Dynamic	Strategic	Dynamic	Strategic	Dynamic	Strategic	Dynamic	Strategic	Dynamic
Cash	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%
Fixed Income	56.0%	59.0%	41.0%	44.0%	26.0%	29.0%	16.0%	19.0%	0.0%	2.0%
Domestic Government Bonds	20.0%	24.0%	14.0%	18.0%	9.0%	13.0%	5.0%	9.0%	0.0%	2.0%
Inflation Linked Bonds	4.0%	4.0%	3.0%	3.0%	2.0%	2.0%	1.0%	1.0%	0.0%	0.0%
Invest. Grade Corp Bonds	19.0%	20.0%	14.0%	15.0%	9.0%	9.0%	6.0%	6.0%	0.0%	0.0%
High Yield Bonds	4.0%	2.0%	3.0%	1.0%	2.0%	1.0%	1.0%	0.0%	0.0%	0.0%
Global Bonds - Developed	6.0%	6.0%	5.0%	5.0%	3.0%	3.0%	2.0%	2.0%	0.0%	0.0%
Global Bonds - Emerging	3.0%	3.0%	2.0%	2.0%	1.0%	1.0%	1.0%	1.0%	0.0%	0.0%
Equity	32.0%	29.0%	42.0%	39.0%	57.0%	54.0%	67.0%	64.0%	85.0%	83.0%
Canadian	10.0%	8.0%	12.0%	10.0%	17.0%	15.0%	20.0%	18.0%	25.0%	23.0%
U.S.	13.0%	11.0%	17.0%	15.0%	23.0%	21.0%	27.0%	25.0%	35.0%	33.0%
International	6.0%	6.0%	8.0%	8.0%	11.0%	11.0%	13.0%	13.0%	15.0%	15.0%
China/Emerging Markets	3.0%	4.0%	5.0%	6.0%	6.0%	7.0%	7.0%	8.0%	10.0%	12.0%
Alternatives	10.0%	10.0%	15.0%	15.0%	15.0%	15.0%	15.0%	15.0%	13.0%	13.0%
Commercial Mortgages/Private Debt	7.0%	8.0%	7.0%	8.0%	7.0%	8.0%	7.0%	8.0%	0.0%	0.0%
Real Estate/Infrastrucutre	3.0%	2.0%	8.0%	7.0%	8.0%	7.0%	8.0%	7.0%	13.0%	13.0%
Fixed Income	65.0%	69.0%	50.0%	54.0%	35.0%	39.0%	25.0%	29.0%	2.0%	4.0%
Equity	35.0%	31.0%	50.0%	46.0%	65.0%	61.0%	75.0%	71.0%	98.0%	96.0%

Source: Wealth Investment Policy Committee, as of April 13, 2023.

Factor Exposure

Asset Classes	Fixed Income Factor	Equity Risk Factor	Currency Risk Factor	Illiquidity Risk Factor	Alpha
Factor Positioning	Overweight	Underweight	Underweight	Neutral	Dynamic
Cash	●				●
Fixed Income					
Domestic Government Bonds	●				●
Inflation Linked Bonds	●		●		
Investment Grade Corp. Credit	●	●	●		●
High Yield Credit	●	●	●	●	●
Global Bonds - Developed	●		●		●
Global Bonds - Emerging	●		●	●	●
Equity					
Canadian		●			●
U.S.		●	●		●
International		●	●		●
China		●	●		●
Emerging Markets ex China		●	●		●
Alternatives					
Commercial Mortgages/Private Debt	●	●	●	●	●
Real Estate/Infrastructure	●	●	●	●	●

Source: Wealth Investment Policy Committee, as of April 13, 2023.

Economic Outlook

The Fed's Drive to Survive

Beata Caranci, SVP & Chief Economist and James Orlando, CFA, Director & Senior Economist | TD Economics

Highlights

- Similar to a Formula One driver, central banks need to find the right balance of speed, control, and strategy to cross the finish line without rolling over the economy.
- A strong tailwind from inflation and employment has kept the Fed biased towards tightening monetary policy, but leading indicators are starting to point to some obstacles on the road.
- The Fed should pause after its next meeting to ensure it doesn't put too much pressure on the economy.
- The Bank of Canada has already paused, but that doesn't mean rate cuts will occur right away as a cyclical upturn has taken hold.

Binge watching shows on Netflix doesn't usually help us understand the challenges facing central banks, but the Formula One (F1) docuseries, Drive to Survive, offered some insights. F1 drivers will push the limits of mechanical engineering to win a race. Their supercharged cars average a maximum speed of 220 miles per hour (mph). But despite all the metrics at their disposal, most drivers don't rely on speedometers. That's because winning involves more than maximizing the speedometer. The driver must find the perfect balance of speed, control, and strategy.

The same concepts apply to the Federal Reserve. It has already achieved speed with the 475 basis points (bps) in interest rate hikes over the last year. The downshift to smaller increments of 25 basis points over the last two meetings in the face of still-high inflation demonstrates some element of control. Now the question is whether they've got the right strategy to not crash and burn the economy. With the smell of burning rubber wafting up from stress among regional banks, will the Fed push the limit on what the economy can handle or take a pit stop?

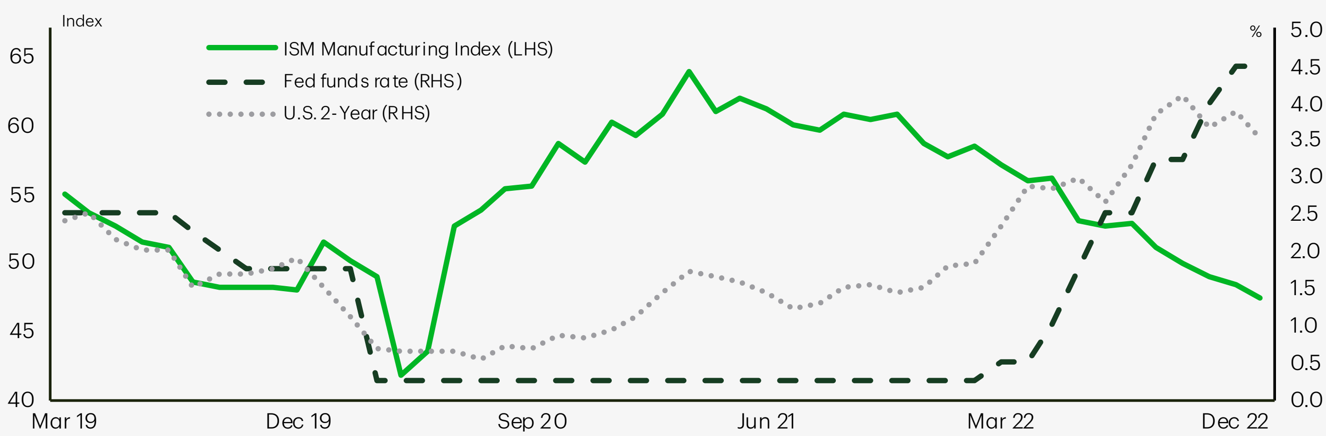
Hitting its limits

Leading economic indicators are signaling that the U.S. economy may be approaching its limits. The ISM manufacturing index has been a reliable historical indicator in predicting economic slowdowns, or outright recessions. Business sentiment has steadily declined since interest rates began rising more than a year ago (Figure 1). Initially, it was coming off lofty levels, but it moved into contractionary territory five months ago and hasn't yet found a bottom.

Although a rapid downshift in the new orders subindex (currently at 44.3) was the first signal that momentum had turned, that negative sentiment has now bled broadly into all areas of the survey.

Concern over the economy's engine could be contained if not for some clanking now also coming from the service side. This ISM index is sitting just a hair above the break-even 50 threshold and has shown some uncharacteristic volatility in recent months. Not surprisingly, our TD Leading Economic Index is waving a yellow flag, signaling that the economy is at risk of stalling within the next three-to-six months.

Figure 1: Business Sentiment Dropping As Rates Rise



Source: FRB, ISM, TD Economics.

That caution is also showing up in the employment statistics. Yes, you read that right. The jobs market is softening. Sure, the economy clocked in 236k new jobs in March, but the engine is rattling under the hood. Fewer sectors are behind the thrust of new hiring. Three-quarters of those jobs were created by just three sectors – hospitality, government, and health/education. This reinforced a theme that appeared in prior months that a smaller group of sectors were contributing to the top-line job figures. In addition, the track is shortening for two of those sectors – hospitality and government. We have been flagging these sectors for about six months as being among the remaining few to reflect the final legacy of the pandemic.

Both sectors were climbing out of a deep deficit in employment. As a result, these two sectors have accounted for an abnormally large job impulse that has boosted the headline figure and obscured the fact that the broader economy is not showing the same eagerness to hire. We estimate that the hiring impulse from this narrow group of employers will be nearing exhaustion within the next couple of months, setting up a pivot point in the summer months. Job vacancy data offer some validation. Many sectors are already scaling back job postings (Figure 2). Given that the labor market is a highly lagging indicator, when there's smoke, it could be just a matter of time before fire appears.

By placing a strong emphasis on the labor market to justify ongoing rate hikes, there's valid concern that a strong pace of job hiring risks reigniting consumer spending and inflation. However, the job market is a well-established lagging indicator. Looking in the rear-view mirror while driving forward carries its own risks, particularly when obstacles are starting to appear along that path. The central bank must be mindful of the two-sided nature of risks.

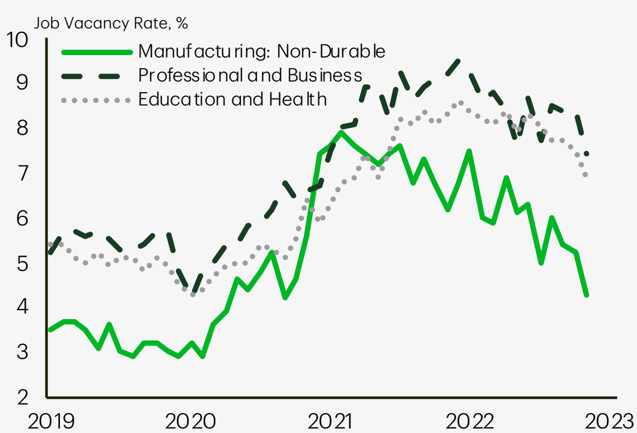
And those regional banks

Smoke has also emerged within the banking system. The failure of SVB, Signature, and Credit Suisse are largely a by-product of mismanagement, but the rising interest rate environment amplified those outcomes by reducing the market value of bank assets and squeezing liquidity in situations where interest rate risk hadn't been appropriately managed. Were those banks isolated anomalies, or canaries in the coal mine of other interest rate risks lying in wait?

Market participants usually don't wait around to find out the answer. Even though the Fed, FDIC, and U.S. Treasury have responded with safeguards, consumers and businesses have stripped a significant amount of deposits out of regional banks (Figure 3). At the very least, this should lead to some tightening of credit lending standards, particularly among those concerned over the stability of the deposit base and potentially tighter bank regulation. According to the Fed, small banks make up about one-third of industrial and commercial loans and about one-half of real estate loans.

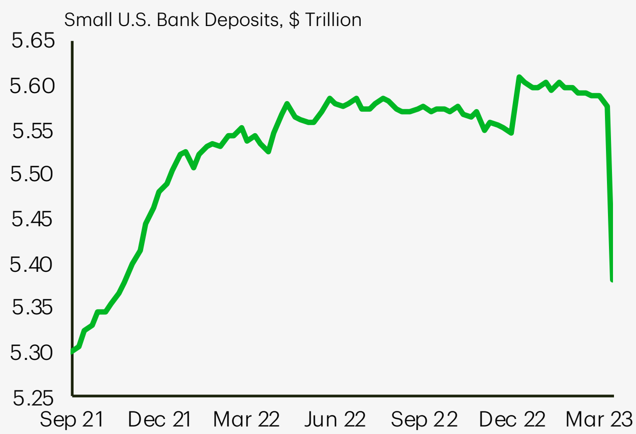
Bank lending standards were already tightening prior to recent events due to higher interest rates raising the cost of funding and pushing up delinquency rates. In the Fed's Senior Loan Officer Survey, 43% of lenders reported tightened standards. This survey was completed prior to the failure of those banks and marks a huge shift from last summer when lenders were not tightening at all.

Figure 2: Labour Market Loosening



Source: BLS, TD Economics.

Figure 3: Small Banks Seeing Deposit Flight



Source: FRB, TD Economics.

Equities cheering, but the bond market crew is calling for a pit stop

Financial markets appear to be of two minds right now (Figure 4). On one side, equity markets are bouncing off their lows. The S&P 500 is trading just shy of its 2023 high, even with the regional bank stock index sputtering at a floor established in mid-March. This deviation signals a belief that the regional bank risk has been successfully ring-fenced, limiting contagion to the rest of the economy.

The bond market has a different view. The U.S. 2-year Treasury yield is hovering around 4%, marking a significant retracement from the March high of 5.05%. Markets think the Fed will need to stop hiking after the next meeting in May, and quickly reverse course with rate cuts as early as September. Bond markets are clearly focused on the risks to the outlook, evidenced by the Treasury volatility index sitting at more than double its average of the last decade. Meanwhile, the equity market volatility index is calmly back to its historical average.

Which is the more likely path? We think the answer rests in between these two extremes. It would be unusual for the Federal Reserve to cut rates just four months following its final hike. The average timeline is between six and twelve months, and typically against a much lower inflation backdrop. The Federal Reserve would need to be strongly convinced that inflation was not just trending towards their 2% target, but that the economic backdrop can sustain it there. This places the likely timing for the first rate cut to materialize in the timeframe of Q4 2023 to Q1 2024, at the earliest.

Bank of Canada already in the pit

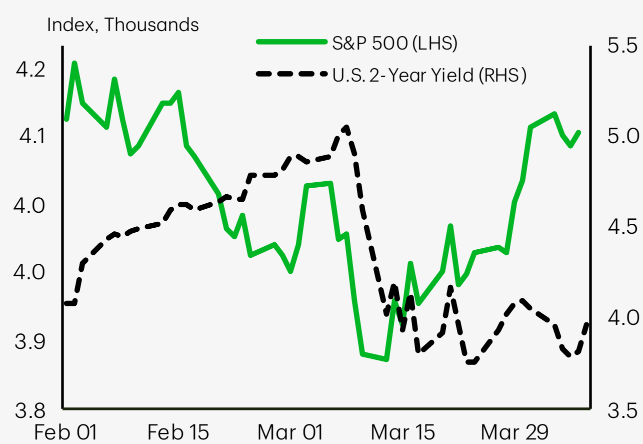
The Bank of Canada has been in a pole position among central banks since last year. It was one of the first to raise rates and also to accelerate the pace – even delivering an eye popping 100 basis point hike in July 2022. It was neck-and-neck with the Fed until it announced a pause back in January. Many now view this decision as quite prolific. Inflation has been cooperating, and even easing a bit more than the central bank had expected. While consumer prices are still 5.2% above last year's level, the timelier 3-month rate of price growth is a mere 1.6% (annualized). Canada has recently benefitted from a significant drop in gasoline and diesel prices, but the trend is not just due to energy. Core inflation measures have also trended lower. The BoC's preferred median and trim measures of inflation are now at 3.8% and 3.3% on a 3-month basis, after peaking at 7.6% and 8% in the middle of 2022. This speaks to a moderation in price pressures across the consumer basket. Should the current trend continue, overall Canadian inflation would reach close to 3% y/y by this summer and potentially drop into the BoC's target range of 1% to 3% in the back half of this year. The trend justifies the BoC taking a pause.

Similar to the U.S., the Canadian labour market has remained solid, but here too there are curious sounds coming from under the hood. The 6-month job tally has amounted to 371 thousand new positions, nearly twice as much as the average annual employment gain during the prior business cycle! However, the data were boosted by hiring in non-cyclical sectors, like government, health care and education. These tend not to be sensitive to interest rates or the business cycle, with employers within other industries showing less vigor. In the March data, that theme faded a bit, but now the data revealed just three sectors were hiring, with the rest either flat or scaling back workers. In other words, just like the U.S., the breadth of the job market has looked less impressive during this final leg.

However, there is a key differentiator between the two countries. Canadian households continue to benefit from significant government financial supports with a job market at full employment. The combination has reignited consumer spending through the first quarter of this year. With government policy at odds with the central bank, it could forestall the needed calming in price pressures as the year presses forward. But, for now, the trend is our friend on inflation.

For the BoC, we believe that rate cuts would need to be preceded by a convincing slackening in the job market and erosion in economic momentum. This places the timing close to year-end or early 2024. In other words, just as the rate hike cycle started in Canada and the U.S. in close alignment, so too will the rate cut cycle.

Figure 4: Equities Recovered, Yields Staying Low



Source: S&P, FRB, TD Economics. Last observation: April 07, 2023.

Asset Class Analysis

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Quarter in Review

Interest rate jitterbug

Fred Wang, Senior Portfolio Manager, Asset Allocation | TD Wealth

The first quarter of 2023 delivered more market movers than we'd seen in a long time, although not necessarily on the monetary-policy front. The Bank of Canada delivered a 25-bp hike in January, as anticipated, then indicated it would issue a "conditional pause" to let the economy adjust to last year's rapid rate hikes. In Canada — where households are highly indebted relative to peer economies — consumers are rate-sensitive. That's due in part to nuances in Canadian mortgage rules, though, so it might be prudent to take a wait-and-see approach there. In the U.S., meanwhile, the Federal Reserve also pulled back in the first quarter, hiking rates a total of 50 bps (from 125 bps in Q4), although the Fed did signal that it would need to remain flexible to incoming data.

So far, the inflation and employment numbers have been coming in hot, indicating a still robust economy. This defied expectations coming into 2023, when most market participants were calling for inflation to cool and the economy to slow, at least in North America. In Europe and the United Kingdom, where inflation had just barely come off peaks, central banks were still in fighting mode. The Bank of England (BoE) and the European Central Bank (ECB) delivered 75 and 100 bps in rate hikes, respectively — sizeable increases, although also slightly less than the 125 bps apiece delivered in Q4 2022.

Then there was the banking crisis. After the fallout, we observed significant downward repricing of policy rates in the futures and swap markets, indicating a growing belief that central banks would pivot away from hawkishness on the deflationary shock of the crisis. The rapid response from the U.S. and Swiss governments, however — including guarantees for uninsured depositors and, in the case of Credit Suisse, a government supported takeover by UBS — has helped to cushion the shock. Although the market's expectation of a near-term policy pivot is still alive and well, there is some uncertainty as to the timing. In any event, by the end of Q1, equity markets had largely looked past the bank failures and volatility in rates. Indeed, if anything, growth stocks used the lower rates to enjoy another leg up (see our "Outlook on Equities" for more insights there).

Meanwhile, in China, monetary policy has been operating within its own sphere. The policy objective of the government has been to limit excess leverage in order to reduce systematic risk. As a result, the People's Bank of China (PBoC) has been hesitant to lower interest rates. Instead, the Bank has resorted to liquidity injections in order to stimulate the economy. First, the PBoC in Q1 injected 550 billion renminbi of liquidity through its medium-term lending facilities. Second, the reserve ratio was lowered in March to further release liquidity into the economy. Although this policy action resembles what major central banks had been doing at the outset of the pandemic to prevent their own liquidity crisis, the goal for the PBoC is less reactive and mainly pro-growth.

Last but not least, the Bank of Japan welcomed its new governor, Kazuo Ueda, in April. The academic economist turned central banker had been working in an advisory capacity for the bank. Ueda studied under Fed Vice-Chair Stanley Fisher at MIT in the '80s and is believed to favour stimulative monetary policy as a means of fighting the structural headwinds of the stagnating Japanese economy. The swap market has also priced in, since Ueda's appointment in February, a more dovish path for the Japanese policy rate.

On the economic front, we continue to see stubborn inflation and an overall slowdown in economic activity, even though there have been conflicting signals in the housing sector. Inflation in developed economies is still much higher than central bank targets of 2%. February's headline inflation numbers in Canada and the U.S., for example, were 5.2% and 6%.

That being said, inflation in the U.S. and Canada has been trending down from the peak in mid-2022. The market expectation based on the U.S. inflation linked bond and the swap markets have been range bound this year between 2% and 3%, which is meaningfully below the current effective federal funds rate. Both the Fed and the Bank of Canada have been content with the inflation normalization that's occurring in the goods sector, but there's still concern over the more persistent yet uncertain prospect of inflation in the services sector (excluding shelter).

Given that both Canada and the U.S. entered their peak inflation months between March and June of last year, the incoming second-quarter data — which will enjoy favourable base effects — will be crucial for the inflation narrative and market expectations going forward. Across the pond, UK CPI inflation came in at 10.4% in February, higher than the Bloomberg consensus estimate of 9.9%. The risk of runaway inflation in the UK is still very real and probably the highest among developed markets. The latest eurozone CPI inflation came in at 6.9% in March, which is a significant drop from the peak of 10.7% in October 2022, but still a long way to the ECB's 2% inflation target. Finally, Japan's CPI inflation, after hitting a peak of 4.3% in January, dropped to 3.3% in February, driven by an over 10% drop in fuel and utilities prices. The trend could take some pressure off the incoming BoJ governor.

In today's economy, we observe a few conflicting signals. On the positive side, employment in developed markets, for instance, is still robust. The U.S., eurozone, UK, Canada and Japan are all seeing historically low unemployment. This tight labour market has, in turn, kept wage growth high and led to higher costs for businesses, especially for the labour-intensive services component. These higher wage costs are then, much to the chagrin of central banks, passed on to consumers in the form of price inflation. Central banks are essentially trying to cool this inflation by using higher interest rates to reduce demand for goods, services and ultimately employment, with a hope to maintain narrowly positive GDP growth. This "soft landing" scenario still seems to find favour in today's market; at the same time, the downside risk is also real. Manufacturing activity has been deteriorating. The latest J.P. Morgan Global Manufacturing PMI in March, for instance, stood at 49.6, below the expansionary threshold. All five major developed economies are now in contractionary territory for manufacturing. The only bright spots are in the emerging markets. China and India saw manufacturing PMIs at 50 and 56.4, respectively, much higher than their developed-market (DM) counterparts.

A number of sentiment survey results are also worrisome. So far, consumer spending in developed markets has been holding up, thanks to strong employment and excess savings from Covid-era stimulus cheques. Now, however, as higher inflation and interest rates sink in, we're beginning to see consumer expectations in the U.S. and Canada come down. This more deflated sentiment is also shared by business leaders. By the end of 2022, the Duke University CFO survey showed that corporate executive optimism about the U.S. economy was only slightly above the pandemic low.

Figure 1: Asset-class performance by macroeconomic environment

Economic Environment	Falling Inflation					Rising Inflation				
			MTD	QTD	1 Year			MTD	QTD	1 Year
Rising Growth	Equities	Global	2.4%	7.0%	-5.6%	Commodities	GSCI	-1.1%	-4.9%	-10.0%
		US	3.7%	7.5%	-7.7%		Energy	-3.5%	-8.6%	-11.0%
		Canada	-0.2%	4.6%	-5.2%		Oil	-1.8%	-5.7%	-24.5%
		EAFE	0.5%	7.5%	3.8%		Natural Gas	-16.1%	-39.9%	-62.0%
		EM ex. China	2.3%	3.6%	-13.3%		Copper	0.7%	8.5%	-9.8%
		China	-0.5%	4.7%	-1.8%		Agriculture	3.4%	-0.4%	-8.4%
		US Small Cap.	-4.8%	2.7%	-11.6%		Industrial Metals	0.3%	0.7%	-21.0%
		Global REIT	-2.8%	1.7%	-19.4%					
		Global Infra.	2.4%	3.9%	-3.5%					
	Corporate Bonds	Global IG	2.1%	3.1%	-5.0%	Emerging Market Debt	Hard	1.4%	2.2%	-5.9%
		Global HY	0.5%	2.9%	-3.4%		Local	3.8%	4.8%	-0.8%
		Private Debt	0.0%	3.2%	2.5%					
Falling Growth	Nominal Gov't Bonds	Global	2.5%	3.1%	-3.8%	Inflation-Linked Gov't Bonds	Global	3.4%	3.7%	-11.2%
		US	2.9%	3.0%	-4.5%		US	2.9%	3.3%	-6.1%
		Eurozone	2.4%	2.5%	-11.8%		UK	6.1%	4.3%	-27.5%
		Japan	1.9%	3.2%	-2.1%		Canada	0.7%	-0.2%	-5.7%
		Canada	2.5%	3.4%	-2.4%	Commodities	GSCI	-1.1%	-4.9%	-10.0%
							Energy	-3.5%	-8.6%	-11.0%
							Gold	7.8%	8.0%	1.6%

Source: Morningstar Inc. as of March 31, 2023. Note: All returns are in local currency unless indicated otherwise.

Deloitte's CFO survey, meanwhile, shows the availability of new credit hitting its lowest level since 2010. This was confirmed by the Fed's latest Senior Loan Officer Survey, which showed broad-based credit tightening in the U.S. for commercial and industrial loans, as well as commercial real estate loans.

Difficulty in acquiring credit could amplify the effect of higher interest rates on the real economy. This year's episode of "March Madness" — when the world witnessed the second largest bank failure in U.S. history — could further negatively impact the risk appetite for banks and therefore their willingness to lend, which would ultimately increase the odds of a recession.

We look at multi-asset performance from the perspective of four broad macroeconomic regimes (Table 1). Although the framework has served us well in the past in establishing a relationship between the top-down macro narrative and asset returns, the signals we received in Q1 were confusing at best — filled with surprises and wild reversals. Anyone positioned to benefit from the trending market was caught off guard. Our PSQ from Q1 entitled "Right Here, Right Now" seemed to be a perfect name for that kind of market environment. Although investors may have a medium-term view of the market, they're being forced to manage the volatility and short-term risk along the way.

The expectation coming into the year was that inflation would normalize, triggering an end to monetary tightening. The anticipation of a pivot fuelled a strong comeback for previously beaten-down, rate-sensitive assets in January. Speculative growth and heavily shorted stocks rebounded, which in turn benefited large-cap growth overall. Bonds were also up under this narrative, with interest rates down and credit spreads tightening. It felt like the market was eager to move in a new direction after 2022. Then, in February, fresh monthly data poured cold water over embers of hope — inflation was stubborn and employment was still robust, leading interest rates and risk assets to shift accordingly. The fixed income market started to price in a more hawkish Fed, and equities gave up some of their gains from January.

Going into March, several events rocked the markets. First, bank failures were back after the Fed delivered its fastest hiking program since the '70s. Fixed income market saw crisis-level volatility, especially on the short end. In a matter of days, the implied federal funds rate, based on the futures market, priced in more than seven cuts in 2023. The two-year U.S. Treasury yield suffered its second-largest drop since the '70s (without a recession). Meanwhile, credit spreads widened and WTI oil dipped below US$70 per barrel.

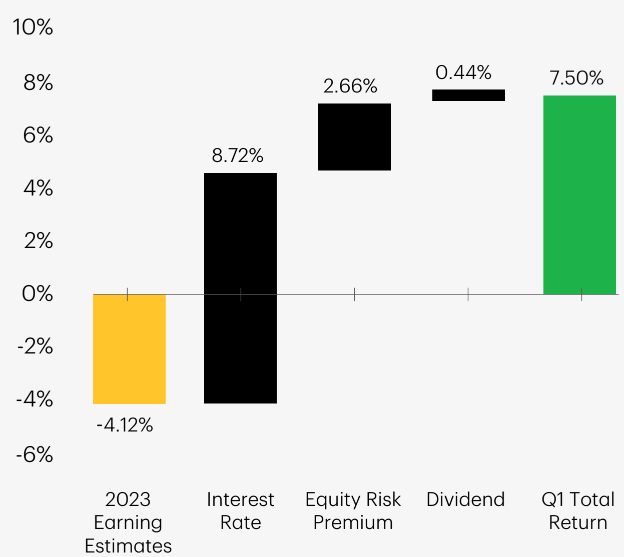
This all suggested that the market was quickly pricing in a recession scenario. However, the speedy response from governments (which guaranteed uninsured deposits) and OPEC+ (which announced a supply cut of 1.5 million barrels per day) kept oil markets tight and equities relatively calm, squeezing short-sellers who had positioned for a recessionary scenario just days prior.

Deflationary Growth: Rising-growth and falling-inflation assets

Equity markets and corporate credit both had strong returns during the first quarter. Equities, however, seem to have priced in a rosy scenario for the global economy. U.S. and Canadian inflation did trend lower while employment remained robust, but the underlying macro environment was more complex. First, the upside risk of inflation was still high, with a number of inflation releases coming in much higher than consensus. Also, economic activities, such as industrial production and manufacturing PMIs, were trending lower. Financial conditions were also tight, based on both asset prices as well as sentiment surveys.

Nevertheless, interest rates and the equity risk premium both trended lower in Q1, pushing up equity multiples despite the threat of cuts to earnings guidance in 2023. As it stands, the market is concentrated in high-priced growth names, mostly in the broad tech space, whose stocks are sensitive to interest rates. Without a shock on the fundamentals, these names tend to do well as interest rates falls. In Figure 2, we break down the Q1 total return of the S&P 500 into four components.

Figure 2: S&P 500 Q1 Return Breakdown



Source: FactSet. As of March 31, 2023

We can see that the total return was driven primarily by interest rates and, to a lesser extent, by the lower equity risk premium (measured using the 2023 earnings estimate).

The price performance of credit was also driven by lower interest rates in the quarter. The spread for both investment-grade and high-yield credit was little changed from year-end levels. However, the attractive carry locked in from 2022 also added to the positive total return of credit year-to-date. In relative terms, the reward for taking credit risk still seems more attractive than equities. In Figure 3, we show the change of credit spread and equity risk premium (based on forward 12-month earnings estimates).

Deflationary Contraction: Falling-growth and falling-inflation assets

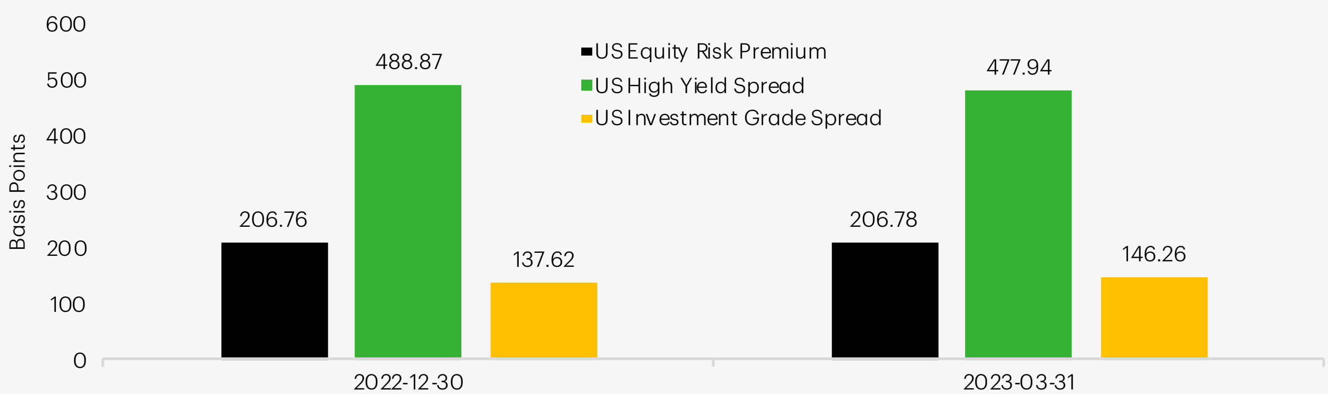
Nominal government bonds and other rate-sensitive assets tend to perform well when economic expectations are weak. Although inflation pressure is still present, the banking crisis in March did some of the Fed's job by tightening financial conditions. Rate volatility spiked and short-term yields moved significantly lower to price in a recessionary policy rate path later in 2023.

These developments did two things to the market. First, they served as a catalyst to remind everyone that the risk of recession was still relevant amid the widely accepted muddle-through, soft-landing scenario. In the wake of a crisis, stubborn inflation and robust economic activity could both fade quickly. Second, the deflationary shock proved that, when recession concerns take hold, volatility in risk assets can come back, allowing bonds take on the role of great diversifier again. The foundation of asset allocation — negative bond/equity correlation — could return. This scenario played out in March of this year. Figure 4 shows monthly correlation between stock and bonds, which finally became negative again.

Inflationary Growth and Contraction: Rising-inflation assets

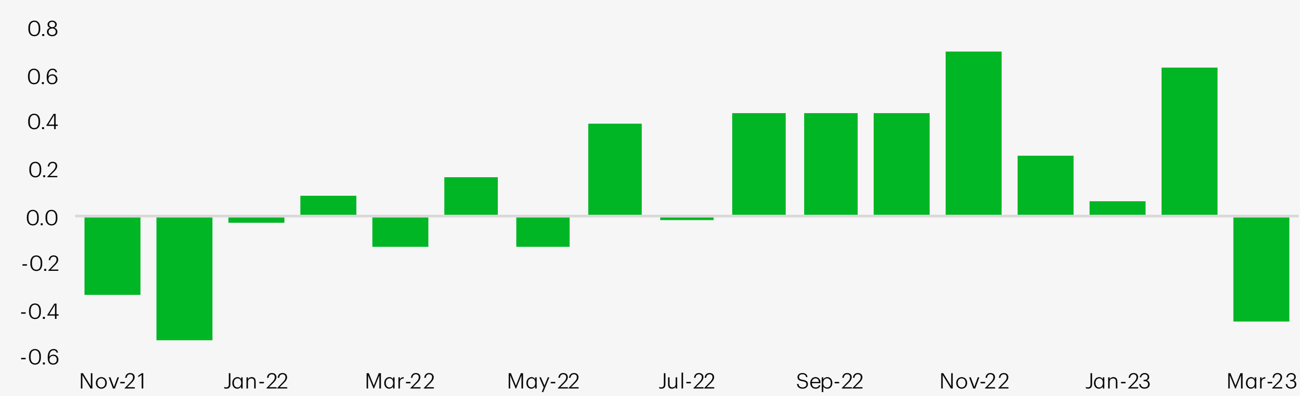
An inflationary environment with positive growth tends to benefit certain parts of the commodity complex and certain growth assets, including industrial metals, energy and emerging-market currency and debts, while a stagflationary environment tends to depress real rates and therefore benefit gold and inflation-linked bonds. In Q1, although we did see some inflationary pressure, the commodities complex

Figure 3: U.S. Corporate Spreads vs. Equity Risk Premiums



Source: FactSet. As of Mar 31, 2023

Figure 4: Monthly Stock/Bond Correlations



Source: FactSet. As of Mar 31, 2023

as a whole underperformed, except for copper. One explanation might be that growth prospects were uncertain given conflicting macro signals and tighter financial conditions. If equities are pricing in a sanguine soft-landing scenario, while fixed income is screaming recession, commodities seems to be hinting at something in between.

Some of the price moves in commodities were nuanced and subject to the idiosyncratic market dynamics. Others might have taken a cue from the global macro-economic backdrop. Copper, for example, which enjoyed an initial bounce right after China's announcement that it would end its zero-Covid policy, continued to show strength. Oil, on the other hand, saw both supply and demand shocks during the quarter. Oversupply and the warm weather led to a bear market in natural gas. Gold, on the other hand, benefited from lower real rates in March as well as strong demand from central banks, ending the quarter 8% higher.

In our last edition of PSQ, we argued that inflation-linked bonds tend to excel in an inflationary environment with below-trend growth. Today's economy does resemble such a regime. Although inflation is cooling, it is still high and far from its 2% target. Growth is slowing, with a real risk of a recession. In this type of environment, we may see real rates trending lower, supporting inflation-linked bonds. The first quarter's outperformance of these bonds confirmed our belief.

Geopolitical Risks

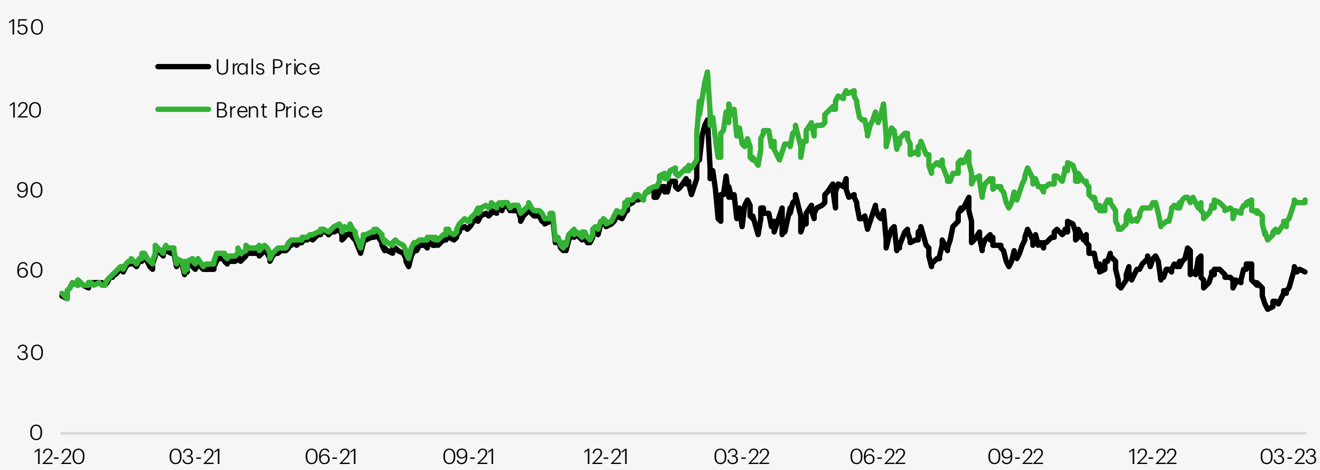
The world sure was busy during the first quarter on the geopolitical front. The China-U.S. relationship was still front and centre, with several scuffles exchanged. The quarter started with the U.S. shooting down an alleged Chinese surveillance balloon over its territory. And then China saw the Netherlands and Japan both joined the U.S. to ban exports of advanced chip-making equipment. By the end of March, China voiced its dismay over U.S. House Speaker Kevin McCarthy's meeting with Taiwanese President Tsai Ing-Wen. None of these events resulted in constructive discussion.

The war in Ukraine had its first anniversary in February. After a long and largely fruitless winter offensive by the Russians in the east, Ukrainian forces are reportedly preparing for a counter-offensive. So far, the war is contained, without dragging other countries into the fighting. (although there are recent reports conflicting prospects of a resolution in the near term)

The war is nowhere near its end. Russia is still able to finance the war with energy exports, even though the demand for Russian oil has changed, while Ukraine continues to receive weapons from NATO allies, giving it a technology edge on the battlefield. So long as the conflict continues, the risk of wider spread negative implications remains heightened.

The geopolitical risks — in the form of an arms race, bigger and longer proxy conflicts, or even a spreading theatre of war — are likely to stay high. What's the implication for commodities? Since the war broke out, the demand for oil, which was a typical commodity, has de-commoditized, meaning the price of two seemingly same grades would have significant diversion. Due to the sanction and price cap on Russian oil, Urals crude has been priced at a significant discount to Brent (Figure 5). This in turn has complicated the inflationary dynamic in Europe and most of the developed world who can only import the non-sanction crude, resulting a sticker shock at the pump.

Figure 5: The War De-Commoditized Oil



Source: FactSet. As of Mar 31, 2023

Outlook on Fixed Income

Maximum Overweight

Prospects bright but keep your seat belts fastened

Aurav Ghai, Senior Fixed Income Analyst | TD Wealth

It's uncertain who coined the phrase "there are decades where nothing happens and there are weeks where decades happen" but it appears particularly apt for financial markets. In Q1, investors couldn't decide whether we were heading for an economic boon or a Minsky moment and bond markets weren't insulated from these wild swings.

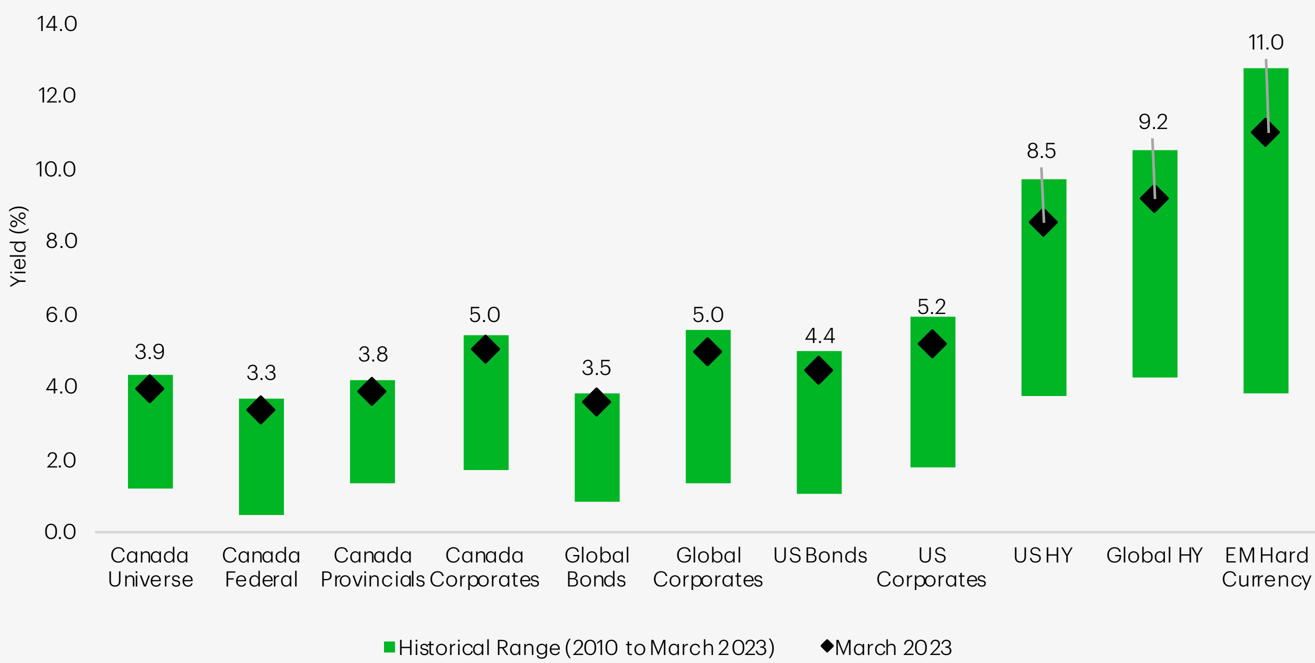
Taking a holistic view, we are at the stage in the cycle where we need to differentiate between trends that are a normal part of slowing momentum and tighter policy, and those that reveal vulnerabilities. While we don't see any indication that recent stress in the banking sector suggests a broader systemic crisis is imminent, we do see structural constraint to growth which may increase if banks need to raise more capital in the next 12-18 months.

Given where we stand today, we believe market pricing of terminal rates is a bit lower than where it should be and it's a stretch to expect policy cuts this year. That said, we are without doubt looking at the finish line of this hiking cycle and suspect other central banks are eager to emulate the Bank of Canada's (BoC) "conditional pause."

Difficult trade-offs for central banks lie ahead. The effects of tighter monetary policy have started to manifest and these will become more pronounced as they eat into economic growth this year before eventually clipping inflation. Given present circumstances, avoiding even a modest recession would be challenging. Even though central banks have a myriad of tools at their disposal (as we saw with the liquidity infusion by the Federal Reserve (Fed) after the collapse of Silicon Valley Bank), the government bond market is pricing in a lower policy rate because it's anticipating a severe credit event.

While allocating to fixed income has been a challenge for multi-asset investors and last year's record-breaking drawdowns didn't help, fixed income performance during the March banking crisis did indicate the return of much needed downside protection from bonds. We believe the correction in global bond markets has ended and the negative correlation between risk and government yields should return. Therefore looking forward, the income and diversification on offer from bonds is far more enticing. Today's starting yields provide attractive entry points and yields across fixed income sectors are at levels not seen in over a decade offering real potential for future returns (Figure 1).

Figure 1: Yields, the key valuation metric for fixed income, near 12-year highs



Source: Bloomberg Finance L.P., Wealth Investment Office (WIO), as of March 31, 2023

This healthy yield cushion also implies bonds will be able to deliver positive returns and offset losses from challenging equity markets.

While investors shouldn't throw caution to the wind, we believe the investment outlook and conviction for bonds has strengthened further:

- We are maximum overweight fixed income investments in general and overweight domestic government bonds. Canadian and U.S. government bonds are more attractive at current yields and offer opportunities for income generation and downside protection if we go into recession this year. Yields shot up over 2022 and, historically, higher starting yields have been associated with higher total returns. We expect price/yield volatility to decline in coming months as forward guidance from central banks and the extent of the economic slowdown becomes clearer.
- We are neutral investment grade (IG) credit as we expect the challenging economic conditions to widen spreads though they should remain far from past recessionary levels. We are mindful of the resilience offered by robust balance sheets in high quality credit and we expect technicals to remain supportive and the healthy yield cushion to offset losses. We continue to focus on fundamentals and valuations amid varying drivers of future performance.
- We maintain our modest underweight view on high yield (HY) credit. The HY credit market remains in its unique cycle with changing characteristics that have improved overall quality and tightened spreads. This should keep spreads from returning to previous recessionary levels, but they will widen if the growth outlook keeps deteriorating.

Government Bonds

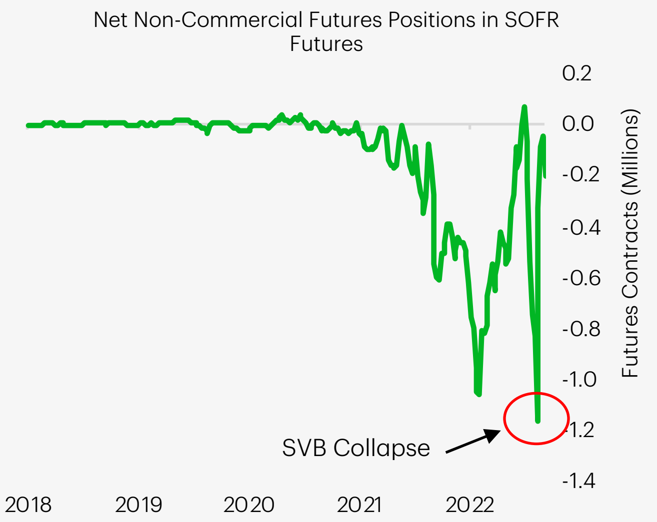
Government bonds are trying to price in the following blind spots and uncertainties.

1. Risks to banking stability. Inflows into money market funds (MMFs) grew at an exponential pace and suggest deposits were flowing out of banks and into MMFs. Bank data through March confirms that banks continued to lose deposits while bank borrowings remained high. This has been a headwind for small banks, but as of late April, the flows appear to have abated.
2. Potential credit crunch. The timing and magnitude of a potential credit crunch remains uncertain—even Fed Chair Jerome Powell admitted as much.
3. Inflation risks linger. Most investors as well as the Fed assume that a credit crunch will lower inflation. However, the Federal Reserve Bank of New York's inflation persistence indicator has held up and the Fed's preferred gauge, the core Consumer Price Index (CPI) ex-shelter, has been sticky too.

Amid these uncertainties, we maintain our overweight view on government bonds: yields have risen sharply over the past year and, historically, starting yields have had a powerful correlation with bond returns. Today's yields offer investors both improved opportunities for income generation as well as more downside protection. On top of that, if we do slip into recession in 2023, we know we can count on government bonds to perform well.

While we may be close to, or have exceeded peak government bond yields, the data-dependent bouts of volatility will likely persist—fixed income investors will remain opportunistic—keeping yields range bound in coming months (Figure 2). It would be quite a stretch to call for plummeting yields unless markets experience a severe systematic stress event. If more banks fail, it could trigger a crisis of confidence which would put the brakes on economic growth. On the other hand, it will take time to understand the full implications of diminished credit provisioning and restore confidence which means investors may downplay strong economic data in the near term. On top of that, investors will be watching for any weaker-than-expected data that could be interpreted as an early sign of greater economic distress. As a result, price rallies and declining yields in government bonds could be quick and sharp, while a move to higher yields or bond selloffs could seem positively glacial.

Figure 2: Repricing shorter maturity government yields after SVB collapse can be attributed to short covering by traders



Source: Bloomberg Finance L.P., WIO, as of March 31, 2023

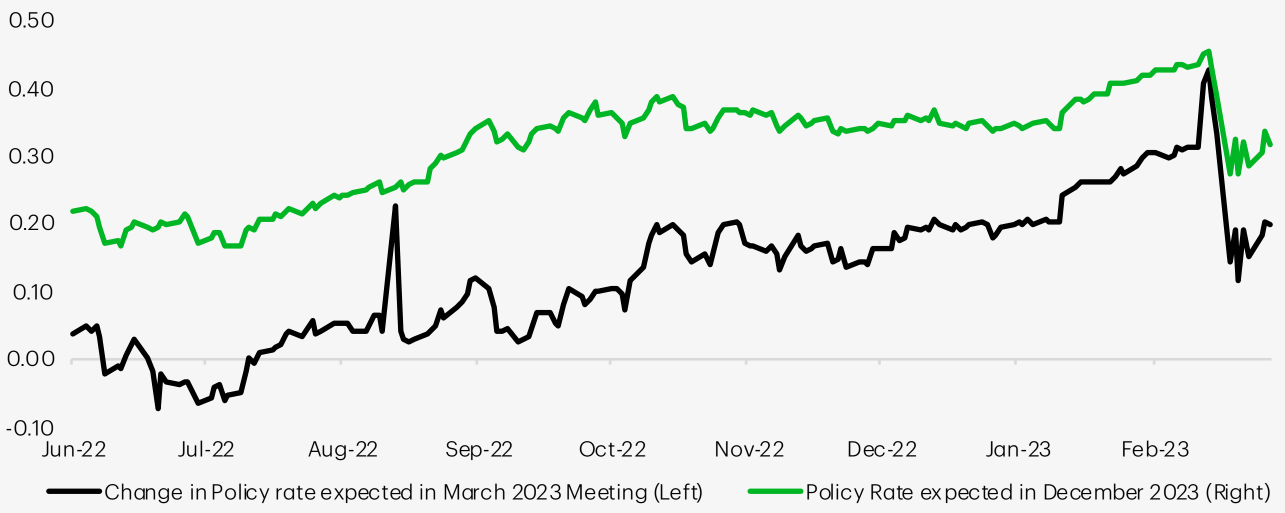
We anticipate inflation to continue slowing but we expect it to remain sticky. Broadly, we believe central banks will hold their policy rate pause. Neither immaculate disinflation or severe economic downturn are our base case scenario therefore we do not expect policy cuts this year. Importantly, and as we witnessed during the Silicon Valley Bank (SVB) crisis, central banks have tried and tested toolkits and deep pockets they can access to deal with a liquidity crunch. They can also use more targeted remedial methods instead of resorting to policy rate cuts.

Our key themes for government bonds are:

1. Fed policy rate pricing will remain volatile

Over March, heightened uncertainty about the state of the banking system fuelled large swings in government yields across the maturity curve. Market-implied policy rates have been particularly volatile reflecting the elevated uncertainty about the near-term policy rate path (Figure 3). As a result, shorter maturity government yields experienced unprecedented swings. Lack of liquidity and high implied volatility in government bond options markets have underpinned elevated implied volatility in the government yields market (Figure 4). We believe elevated volatility levels are unlikely to persist for long and current economic fundamentals warrant a lower rate regime, but heighted volatility will very likely resurface again as the economy hits more roadblocks that spread to the real economy. Importantly, volatility brings opportunity and since government bond yields are expected to remain range bound, an astute, and nimble active fixed income manager can post strong returns with tactical duration adjustments to the portfolio.

Figure 3: Volatile pricing for expected Fed policy rate



Source: Bloomberg Finance L.P., WIO, as of March 31, 2023

Figure 4: Volatile interest rate markets

Source: Bloomberg Finance L.P., WIO, as of March 31, 2023

In March, the Federal Open Market Committee (FOMC) raised the Fed Funds target range to 4.75%-5.00% driven by high core inflation and a tight labour market, Fed Chair Powell said. He also laid out a two-tier approach to separate monetary policy from recent financial stability issues by using the discount window and the bank term funding program (BTFP) facility to guarantee sufficiently liquid market conditions for banks.

However, despite the recent string of stronger-than-expected inflation and labour market data, it's clear that the FOMC has accounted for any fallout from the recent financial market turmoil and the uncertainty around the severity of it. Essentially the hard data and the fact the Fed is behind the curve in terms of its war on inflation warranted a higher terminal Fed funds rate than the one implied by the December forecasts. However, the elevated uncertainty following recent banking sector instability made the FOMC hesitant to commit to more hikes after May.

North of the border, BoC stayed the course in March and held the overnight rate at 4.50%, recommitting to its conditional pause. The policy statement noted that inflation has slowed in line with projections and the restrictive policy is helping to slow demand.

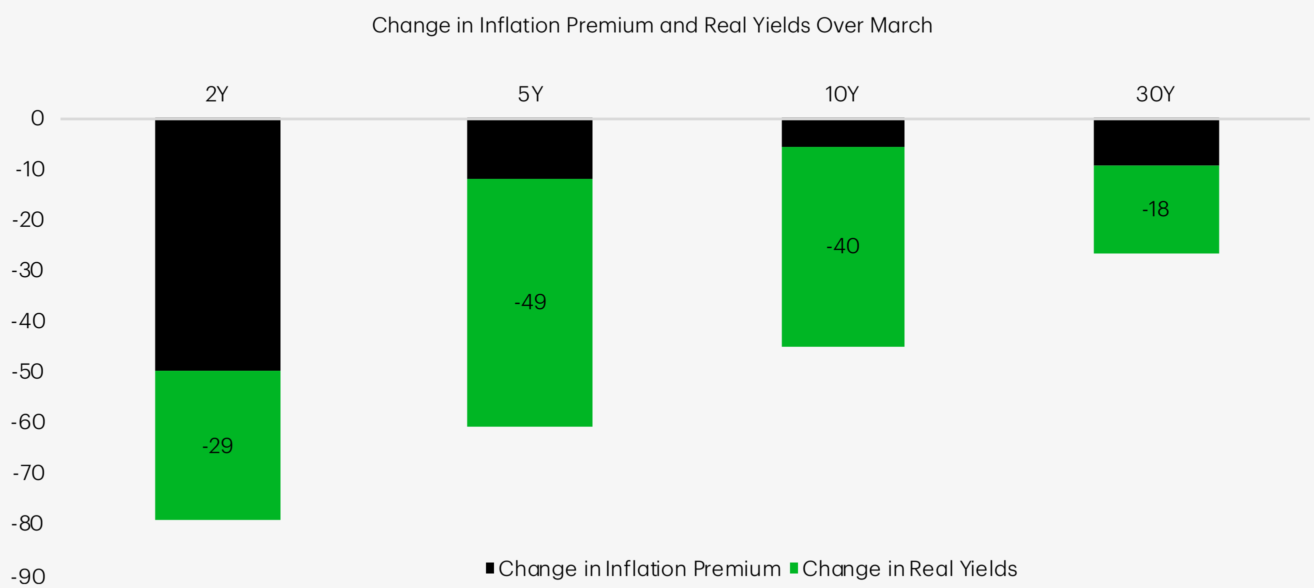
At this point, we'd like to consider an alternate scenario where, if the next prints for U.S. core inflation and the labour market remain strong, the Fed could be pushed to hike the policy rate beyond the May meeting and settle on a terminal target range of 5.25%-5.50% at the June meeting. This implies 25 basis point (bps) increases at both the May and June meetings. On the other hand, in Canada we're still expecting growth to soften and maintain our base case view that the BoC will hold at 4.50%, however our conviction is increasingly tenuous.

Slower than expected deceleration in inflation and labour markets present upside risk to both base case views for policy rates and downside risks will be determined by the effects of tighter monetary policy over coming quarters.

2. Moderate credit tightening should temper inflation, but upside risks remain

As credit tightening is anticipated, real yields (nominal yields adjusted for inflation) decline across maturities reflecting the perception that there is less need for restrictive monetary policy. Figure 5 shows how government yields have changed from before the demise of SVB to the end of March. Prices at the short end of the curve shot up and 2-year real yields tumbled by 29 bps . While credit tightening can have the same effect as policy rate hikes, investors have been so focused on negative economic outcomes that they seem to have forgotten about the impact of inflation and the tight labour market and have therefore underestimated medium-term inflation and its associated risks. It's unlikely that credit tightening with a near-term policy rate pause will lead to a severe recession or a decline in the near-term inflation currently expected by markets. We believe inflation, on a medium-term basis, will be structurally elevated in this cycle and higher than currently priced in.

Figure 5: Markets priced in a more cautious Fed after SVB's collapse but only a slight adjustment to inflation risk premium



Source: Bloomberg Finance L.P., WIO, as of March 31, 2023

Given recent inflation data, the Fed still has a way to go to bring inflation under control. The 3-month and 6-month moving averages for Non-Farm Payroll (NFP) changes seem to have stabilized at about 300,000, and wage growth remains too high to be consistent with the Fed's 2% inflation target. The labour market isn't cooling fast enough and this cooling is necessary to slow inflation in the services sector. As a result, momentum in core services inflation excluding housing services is still high and likely to settle near an average that is quite a bit above the pre-COVID level (Figure 6).

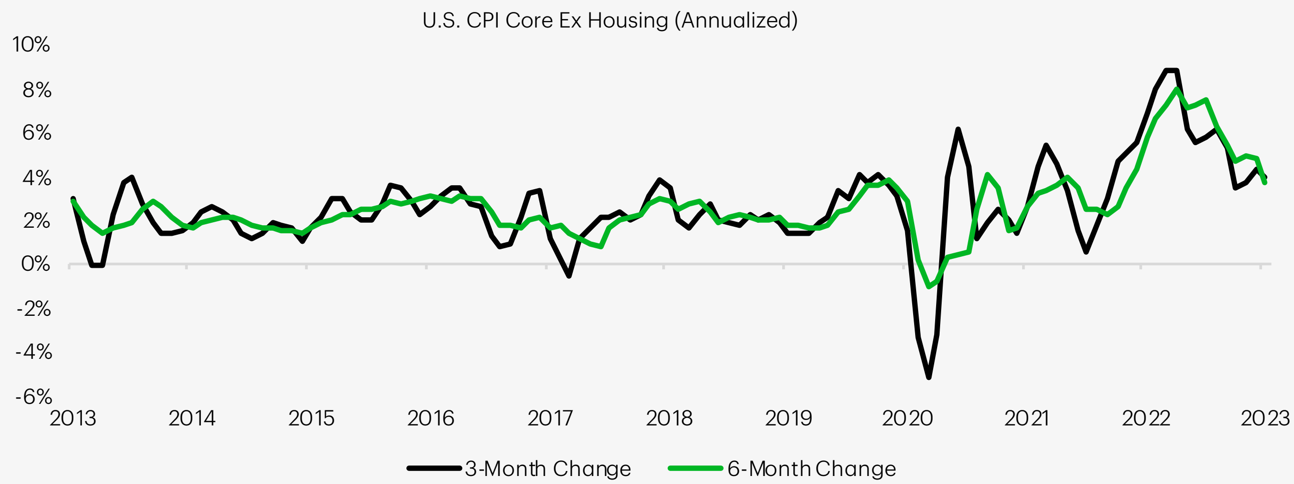
Credit: Investment Grade and Sub-Investment Grade

We maintain our long-held view of wider spreads in coming quarters. We expect the banking crisis to remain contained and see no evidence of systemic risk in the financial sector. Spreads will exceed March peaks if the U.S. economy enters into recession this year, however, technicals will likely remain positive and peak spreads should be lower than previously anticipated.

We are neutral on IG credit and maintain our defensive stance on HY credit. We believe the value proposition of owning short-dated IG bonds as a total return product is attractive; that segment now offers close to the highest all-in yield since the late 1990s, excluding the 2008/2009 recession (Figure 7). Higher yield offers more protection if spreads widen but higher quality credit will widen less than others. IG's yield cushion coupled with balance sheet strength make us more comfortable owning IG over HY in spite of potential spread widening.

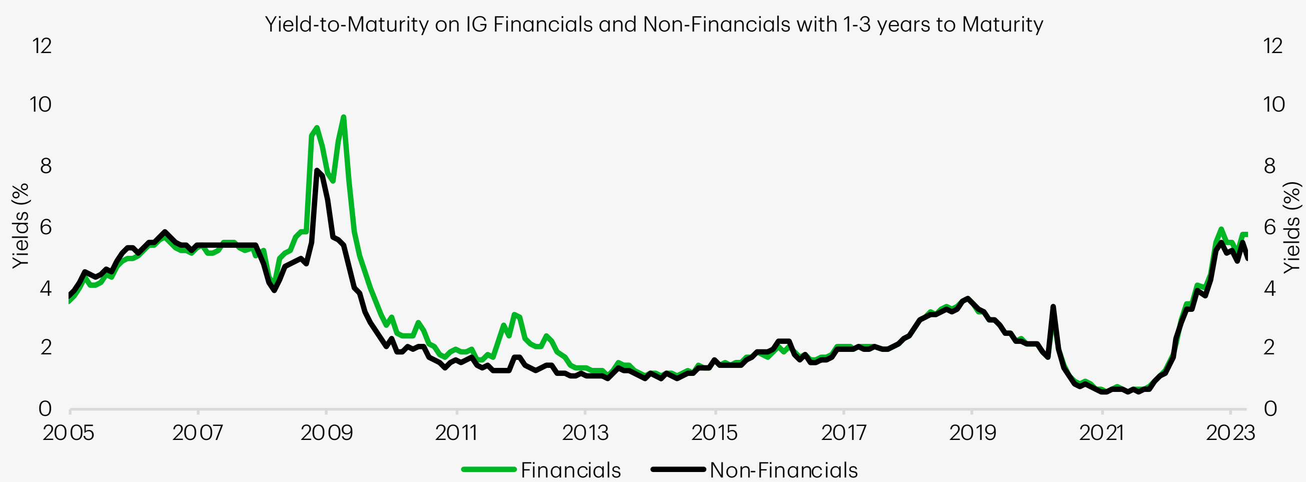
Overall, we remain cautious on credit spreads in the near term due to their strong correlation with government bond yield volatility. With yield volatility set to decline in coming quarters, we continue to focus on fundamentals and relative value.

Figure 6: Housing or shelter inflation is expected to roll over but other CPI components remain sticky



Source: Bloomberg Finance L.P., WIO, as of March 31, 2023

Figure 7: Shorter maturity IG offers yields not seen in decades



Source: FactSet, WIO, as of March 31, 2023

Our key themes for IG and HY credit are:

1. A policy rate pause could test credit spread resilience and hurt lower quality borrowers.

A break from hawkish central bank moves and government bond yield volatility bodes well for higher quality IG credit and bolsters the case for embracing income in IG. But we see two tension points that need to be resolved:

- We don't know the full effects of tightening on the economy. Recession is a definite risk and corporate earnings face challenges. We'll probably see growth-earnings and inflation problems resolve in H2 but the low point for growth might not be clear and could test the resiliency of credit spreads.

- Lower quality borrowers will be hurt most by a longer period of higher rates. While IG credit tends to do well after the Fed's final hike in a cycle, floating rate bank or leveraged loans and, to a certain extent HY, underperform relative to IG bonds. While weaker balance sheets were protected somewhat by termed-out maturity walls, this buffer will recede if the pause extends for a longer period.

Companies with leveraged loans and floating rate liabilities (think capital structures that rely on loans only or are loan-heavy) will likely be hurt the most. Other IG and HY borrowers that rely mainly on bonds will feel what's called the affordability squeeze when they're refinancing. We favour IG over HY because higher quality companies have more options when it comes to deleveraging and finding sustainable debt solutions. HY and lower quality corporations are more likely to be forced into capital destruction, distressed exchanges, and defaults.

The HY primary market can probably function with double-digit coupons for the rest of 2023. Maturities start to matter at least 12 months ahead of time for issuers and rating agencies and only 8% of the outstanding leveraged credit market is due by the end of 2024. However, refinancing plans will come into play for another tranche of HY bonds and leveraged loans by the end of 2023 and this group is more at risk of adverse credit events if funding rates don't improve dramatically.

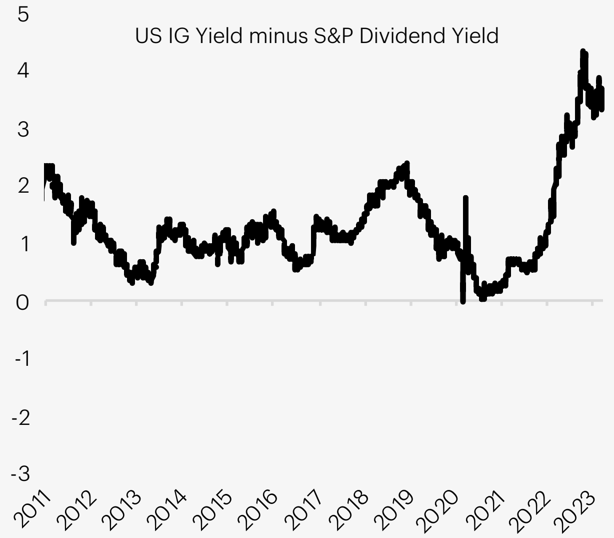
2. Higher yields bolster demand

We haven't seen such high fixed income yields since the Global Financial Crisis. However, with the yield reset of 2022, all-in yields in IG and HY can now compete with equity earnings yields and higher yields in public fixed income markets are starting to win out over less transparent private credit (Figure 8). The longer this regime lasts, the greater the opportunity for strategic reallocation to quality income-generating assets like IG credit or even higher-quality HY bonds. As such, we believe demand from insurance, pension funds, mutual funds, and retail—the key investors in U.S. corporate credit—should, after the tumult of H1, improve in H2.

3. Interest rate volatility remains driving force behind spreads

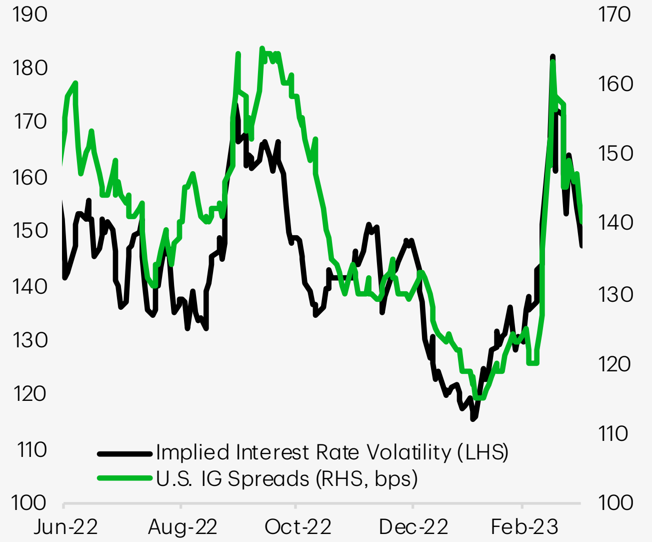
Credit performance would be incomplete without referring to the strong and unusual correlation between interest rate volatility and credit spreads, driven by fears of weaker economic and credit conditions (Figure 9). Since January 2022 there have been five meaningful jumps in government yield volatility and each of them has led to wider credit spreads.

Figure 8: Relative value favours credit over equity for income



Source: Bloomberg Finance L.P., WIO, as of March 31, 2023

Figure 9: Strong co-movement between interest rate volatility and IG credit spreads



Source: Bloomberg Finance L.P., WIO, as of March 31, 2023

Those bouts of volatility were driven mainly by the market repricing Fed policy rates whenever the Fed indicated it would raise rates as needed to curb inflation. Policy rates are now only 25bps-50bps from the peak rates forecasted by the Fed in March. While implied rates volatility fell after the March meeting, credit spreads widened on the fears of slower growth combined with news of distressed banks and rating downgrades for smaller banks. The correlation between government yield volatility and spreads could break down with policy rate pauses. However, there should always be a broad correlation as risk assets prefer periods of low government yield volatility and higher uncertainty for credit means higher volatility for bonds. When the Fed is on policy rate pause and out of the limelight credit spreads are driven by economic growth trends and corporate earnings forcasts.

4. Higher HY default

Q1 has already surpassed the combined total notional defaults of 2021 and 2022. In 2022 HY credit logged defaults equivalent to US$11bn in notional value, translating into a overall issuer-weighted default rate of only 2.0%. Given recent high-profile bankruptcies and a rare IG credit default, credit investors may want to explore a few interesting aspects highlighted here:

- In the broader HY index, the share of bonds trading at recovery levels or below $50 has crept up to 1.8% (Figure 10). This can be interpreted as this year's floor for the market-expected default rate. While 1.8% is well below the 8% peak of 2016 and 2020, it's still elevated compared to the less than 1% annual defaults in normal years since post-GFC.

- The share of the HY credit index rated Caa2 or lower, and on downgrade watch or outlook negative by at least one rating agency is low but increasing.

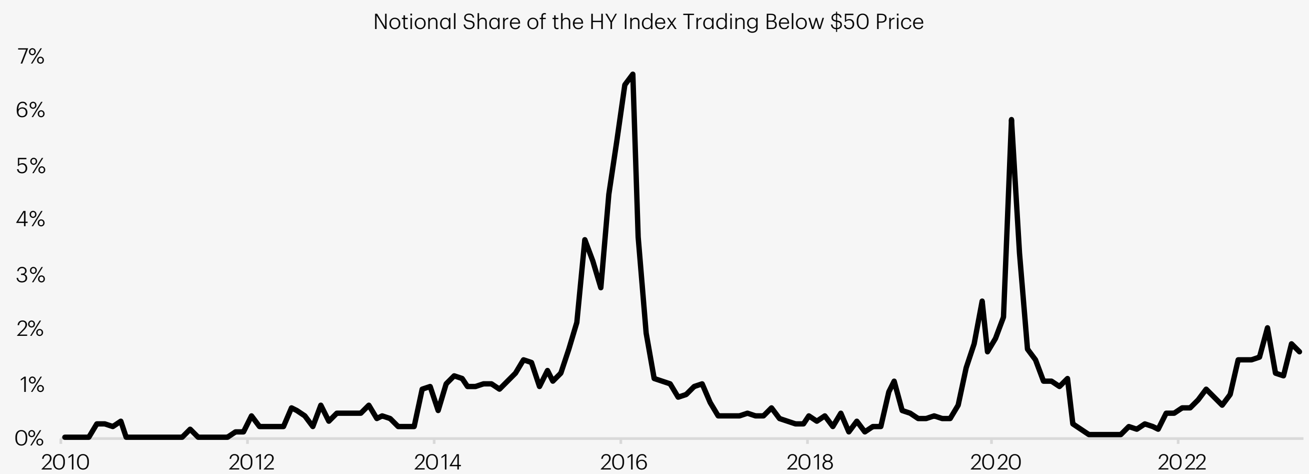
Given these dynamics and our overall view of higher recession risk, we expect a step up in default rates however they will remain far lower than prior peaks. Remember that the low default rate post-GFC was an anomaly compared to long-term average defaults of 4.3% over the last 25 years.

Higher Yields and Diversification

In past PSQ reports we've highlighted that central banks walk a tightrope when they raise rates to temper inflation. The recent stress in the banking sector is a prime example. Engineering the taming of inflation with an economic soft landing is a challenging task that often fails. Companies, and sometimes entire sectors, crack along the way. The Fed's pace of hiking over the last year has been astonishing meaning the potential effect on economic activity could be even more pronounced. As such, the current cycle doesn't differ materially from others in history.

Over the coming months the Fed will face more challenges from weaker growth than inflation. That's not to say inflation will slide neatly back to the Fed's target but rather that the Fed will be battling growth scares as much as inflation. When tighter credit conditions put the squeeze on the economy, small and midsize enterprises (SMEs) are likely to be hurt because smaller regional banks are key to providing credit to small businesses—which account for about 50% of U.S. employment. Any drain on SMEs will roll over into labour markets and then, later, inflation. This is why we believe the Fed is near the end of its hiking cycle although it's far from ready to do an about-face and start easing. Any move to a rate-cutting cycle will be dictated by how fast the real economy responds to recent tightening.

Figure 10: Share of HY market trading at "recovery value" elevated



Source: Bloomberg Finance L.P., WIO, as of March 31, 2023

Where does that leave Fixed Income? It's clear that the income on offer from bonds is now far more enticing. Yields for the global government bond benchmark jumped about 266 bps in the past 15 months and HY bond yields are in the high single digits. Valuations in inflation-adjusted terms also look more attractive—while the roughly 1% real yield on global government bonds may not sound particularly exciting, it's a post GFC high and close to long-term averages.

The potential for bonds to support a portfolio amid the most challenging conditions—such as a much deeper recession than we envisage or mounting geopolitical tensions—is perhaps most important for multi-asset investors. For example, if 10-year U.S. Treasury bond yields fell from 3.5% to 2.5% from March 2023 to end March 2024, that would represent a return of approximately 8% which should cushion the downside in stocks. Few risk-off days over the past quarter actually witnessed this diversification potential where equity markets were down, and bonds were up. Such diversification properties simply weren't available for much of the past decade when yields were so low.

We are maximum overweight for the fixed income market overall. The fixed income reset in 2022 was brutal but necessary. Now investors have the best ability in over a decade to build diversified portfolios and fixed income has once again earned its place in the multi-asset toolkit. In the current investment landscape, an astute and nimble active fixed income manager can post strong returns with tactical duration adjustments when government bond yield moves are overstretched and given our base case expectations for wider spreads there's a valid case for long/short credit strategies.

A Final Note on Fixed Income

With yields finally reaching attractive levels, the income component of fixed income is back. The inherent short-term volatility in yields will likely persist as markets try to price in central bank cuts driven by the varying probability of severe stress events and this will drive market participants to constantly reprice the future path of policy rates and economic growth. The attractive income cushion should provide a buffer to these bouts of volatility. As an example, a 3.5% yield for a U.S. government bond (as of March end) will need a 50 bps increase in yield to post 0% return over the next 12-months. Additionally, the ability of bonds to fulfill their traditional roles of a risk diversifier, will be restored in the economic downturn. We reiterate the key aspects of fixed income investing:

1. Fixed income portfolios are not meant to capture upside risk.

2. Fixed income is more than just government bonds. The current market environment calls for a flexible approach to building resilient fixed income portfolios, including diversifying sources of return within fixed income and emphasizing relative-value opportunities when generic beta exposures don't look compelling.

3. Maybe the most important aspect is that duration, or interest rate risk, still has a role to play in portfolios. Duration tends to have a negative correlation to other risk assets and the role of duration and the fixed income asset class, as a whole, has taken a beating in the high inflation environment but we need to remember that higher yields translate into enhanced downside protection if markets sell off. Importantly, this long-term negative correlation with risk assets tends to act as an insurance policy or a risk hedge and this is unlikely to change looking beyond the current high inflation environment. With more policy rate hikes on the horizon and low convictions around the direction of government bond yields, we don't suggest investors offload all duration-heavy solutions or core bonds. Rather, we encourage tactical adjustments because we firmly believe there is an appropriate place for duration as a hedge in portfolios.

If investors move towards lower duration and riskier credit solutions in the fixed income sleeve, they must remain vigilant of the inherent drawdown risks as losses in the riskier parts of fixed income can be severe. Importantly, with higher yield on offer within high quality fixed income, the need to dive into riskier fixed income components might be unnecessary. Finally, investors must monitor potential total return losses, and they should not overlook the attractive levels of all-in yield or the income that fixed income investments can deliver from now on.

Consider the drawdown risks that are acceptable in a portfolio and evaluate probable income versus probable drawdowns instead of probable returns versus probable volatility.

Outlook on Equities

Modest Underweight

Fasten your seatbelts

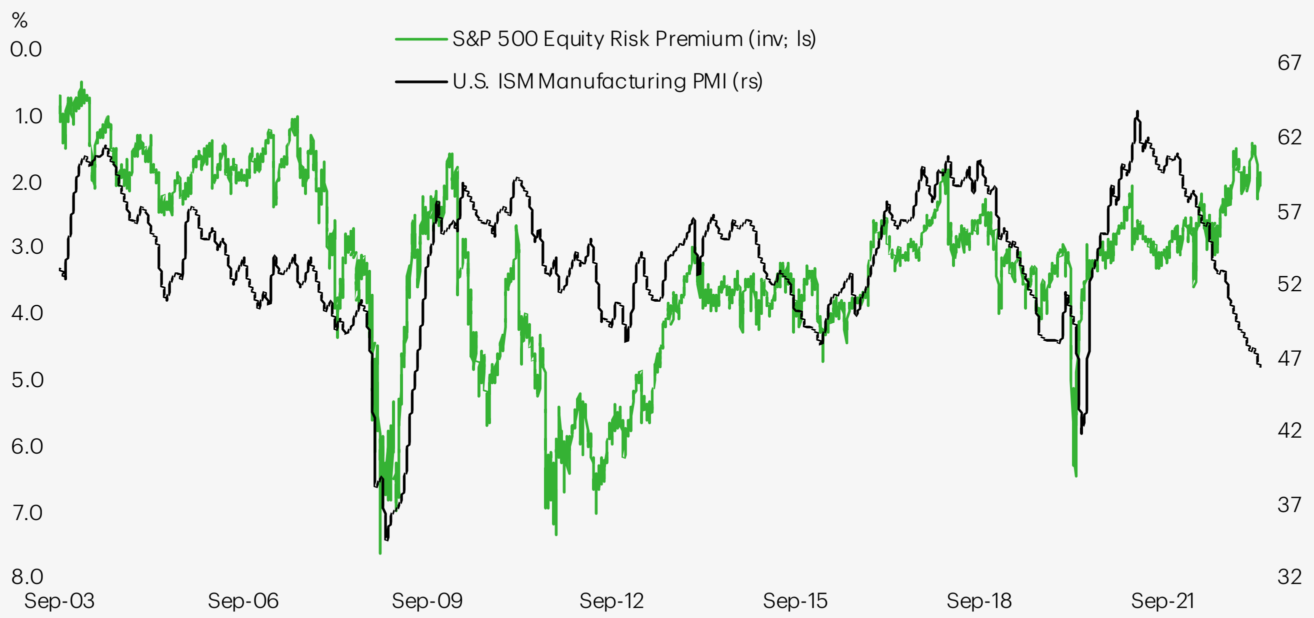
David Beasley, Senior Portfolio Manager; Chris Blake, Senior Portfolio Manager; and Kevin Yulianto, Portfolio Manager | TD Wealth

There have been several remarkable developments over the past 12 months that support our cautious view on equities. First, the full-year 2023 earnings estimate for the S&P 500 has fallen to $219 from $226 as growth slows and the risk of recession grows. Second, while the forward earnings multiple for the S&P 500 has fallen slightly (from 20x to 18.7x), it is still not reflective of the risk we see in the estimates. Indeed, despite long-term Treasury yields having risen from 2.4% a year ago to 3.4% today, the equity risk premium has actually compressed by 64 basis points (bps), from 2.66% in March 2022 to 2.02% — a far cry from the historical correlation, where the threat of recession tends to lift the risk premium (Figure 1). Third, investors' positioning has shifted from moderately bullish to a more defensive stance. And finally, the internal dynamics of the equity market have themselves changed, with prominent sector and factor rotations. For instance, financial stocks have suffered from the impact of the recent regional banking crisis, while technology stocks are bid again amid the decline in yields.

On the macro front, we are starting to see more definitive signs of easing in the labour market as we near a turning point in the business cycle. Job openings are finally coming down faster than expected, and an increasing number of companies are now focused on trimming excesses in their workforce. The recent Challenger survey, for instance, reported that U.S.-based employers announced 90,000 layoffs in March — the highest since the pandemic began three years ago. We also expect credit standards to tighten in the wake of the regional banking crisis. This will make credit pricier and more difficult to access for businesses and consumers alike, potentially curtailing expansion plans, driving loan default rates higher.

Meanwhile, high-frequency indicators continue to highlight diminishing consumer demand and a pullback in business expansion plans. The contraction in the new orders component of the ISM manufacturing survey in recent months continues to highlight a slowing of the U.S. economy, which bodes poorly for earnings growth. The decline in inflation and spending by consumers and businesses should weigh on nominal top-line growth for U.S. businesses, while profit margins are likely to continue to fall as companies find it increasingly difficult to pass on cost increases to strapped consumers who've already drained their excess savings.

Figure 1. U.S. equities not pricing in a slowdown



Source: Bloomberg Finance L.P., Wealth Investment Office, as of April 5, 2023

The leading indicators we monitor show that the downward revision in earnings estimates is still tracking the deterioration in the macro picture (Figure 2). Analysts are still expecting positive earnings growth in 2023 for U.S. stocks, but we believe this may downshift in coming months as executives across corporate America turn more cautious in their first-quarter earnings call. In sum, we believe the risk for U.S. equity earnings remains a headwind.

We remain cautious on U.S. equities for the near term. Over the long term, more than 90% of the change in stock prices can be attributed to the change in earnings per share (EPS). Currently, however, fluctuations in price are mostly being driven by sentiment. Although investors are wary of the risk of recession, U.S. stock prices today remain at a premium relative to their historical averages, with particular resilience of the mega-cap tech stocks that account for a significant share of the broad index. If earnings continue to deteriorate in the coming quarters, as expected, it's hard to see how U.S. stocks could rise much from their already elevated levels.

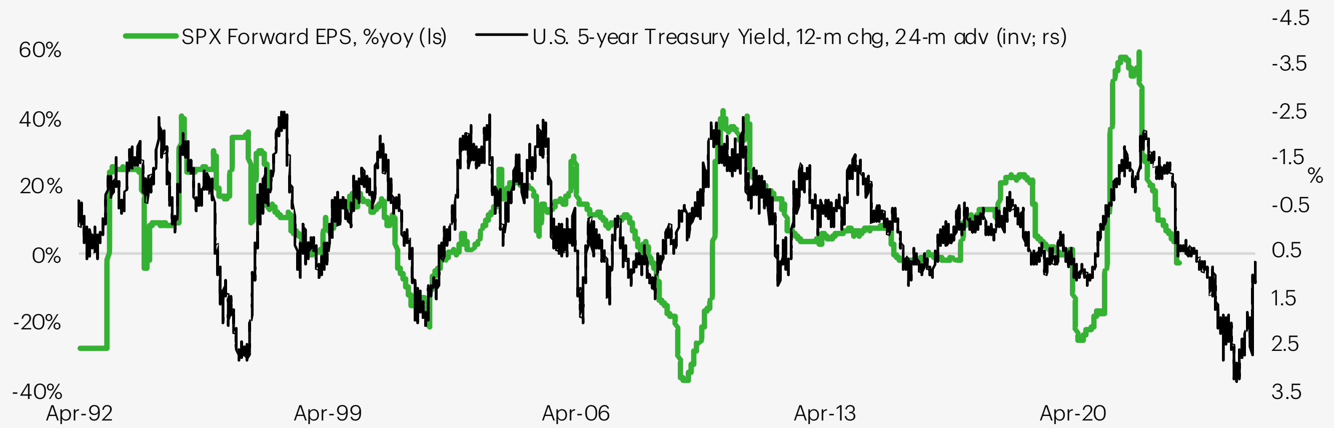
In Canada, we have a neutral view as we expect rate hikes to stall in 2023 if inflation continues to decline. The full effect of higher rates on the consumer and real estate market remains to be seen. As such, we anticipate that the Canadian economy will slow in 2023. However, strong free cash flows within the Energy sector, and relatively inexpensive Financials stocks, may present attractive opportunities.

Quantitative Attribution Analysis

Aside from top-down macroeconomic indicators and bottom-up fundamental research, there's an important third leg of the analytical stool: signals from market behaviour. Observing price and volume behaviour provides insights into how market participants are interpreting data and anticipating the next phase of the market cycle. That interpretation may deviate from what's implied in the data, which are often lagging indicators.

One of these signals, for instance, comes from sector rotation flows. Sector rotation is the movement of funds from one sector to another as investors anticipate the

Figure 2. Earnings estimates face headwinds



Source: Bloomberg Finance L.P., Wealth Investment Office, as of April 5, 2023

Figure 3: Equity rotation and positioning through the economic cycle

	Stage of the Economic Cycle			
Equity Portfolio Considerations	Early Stage	Mid Stage	Late Stage	Recession
Style	Growth	Growth	Value	Value & Income
Business Cycle Positioning	Cyclical	Cyclical	Defensive	Defensive
Sectors	• Financials • Technology • Discretionary	• Technology • Comm. Services • Industrials • Discretionary	• Energy • Materials • Staples • Health Care • Utilities	• Health Care • Utilities • Real Estate

Source: Wealth Investment Office, April 12, 2023 next stage of the economic cycle and the industries that are expected to show relative outperformance in that stage. The table in Figure 3 shows how sectors are expected to behave (in a "textbook" scenario) for each stage of the economic cycle, from early expansion to contraction.

During 2022, the top three performing sectors in the S&P 500 were energy, utilities and consumer staples. As shown in the table, this is indicative of a late-stage economy that's moving towards a slowdown or recession. However, in the first quarter of 2023, the top three sectors were the cyclicals of technology, communication services and consumer discretionary, while defensive sectors like health care and staples lagged with negative returns.

According to the sector-rotation model, this implies that market participants are looking past the threat of an economic downturn, such as a slow growth "soft landing" or recessionary "hard landing," and instead expect the economy to go from late-stage directly to expansion — aka, the "no landing" scenario.

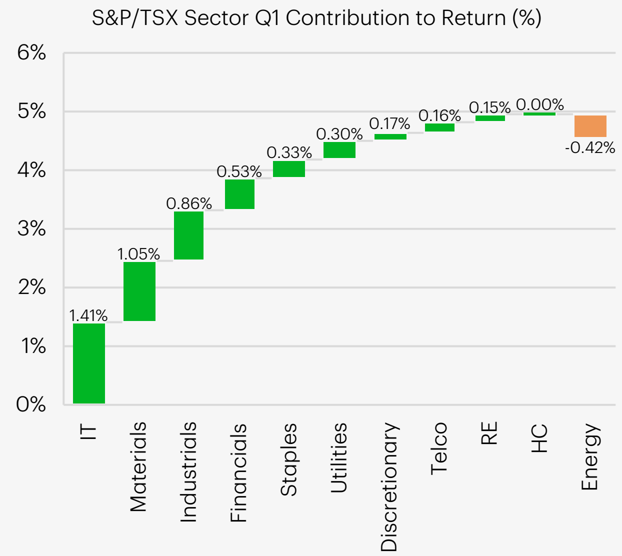
This signalling contrasts markedly with market strategists and economists, who largely forecast a cyclical slowdown at best and a recession at worst. Equity analysts need to be able to, first, reconcile the data with the behaviour, and second, separate signals from noise, in order to answer the question: what is the best risk-reward positioning for the second quarter of 2023?

The market's signalling suggests that investors are returning to cyclical growth over defensive value, but if we take a closer look, with attribution analysis, we can glean more insights from these flows. The total return for the S&P/TSX Composite and S&P 500 in the first quarter of 2023 suggests a bullish tone, up 4.5% and 7.5% respectively. For further clues of what the market may be pricing in and where expectations may be leaning, however, we turn to attribution analysis.

As noted, the most significant return contributors so far this year within Canadian and U.S. equity markets have come from the information technology sector and tech-related sectors, such as the S&P 500 consumer discretionary sector (where Tesla and Amazon make up almost 40%) and the S&P 500 communication services sector (where Meta and Alphabet make up close to 50%). Looking under the hood of these sectors reveals a dichotomy: (1) much of the contribution to performance in Q1 came from the worst performing stocks from 2022; and (2) much of the remainder can be attributed to high-quality, reasonably valued companies, which may be considered defensive and relative safety plays.

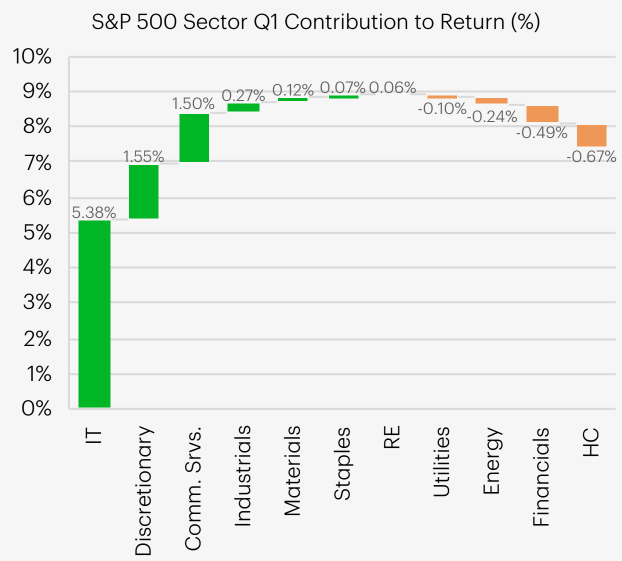
In Canada, the biggest contributor in the first quarter was Shopify, down over 70% in 2022 but up over 35% in Q1 and accounting for more than half of the IT sector's contribution to the S&P/TSX performance (Figure 4). Similarly, in the U.S. market, weak performers in 2022, such as Nvidia (-50% in 2022), Tesla (-65%) and Meta Platforms (-64%), each rallied over 60% in the first three months of 2023 and contributed almost 2.5 percentage points of the total 7.5% index return in the quarter (Figure 5).

Figure 4: S&P/TSX Q1 return contributions by sector



Source: Bloomberg Finance L.P., Wealth Investment Office as of March 31, 2023

Figure 5: S&P 500 Q1 return contributions by sector



Source: Bloomberg Finance L.P., Wealth Investment Office as of March 31, 2023

These contributions are more likely due to the characteristics of a counter-trend rally, which is common within a broader bear market, rather than an economic recovery. In other words, the market behaviour we've witnessed this year could be more of a trading phenomenon than the result of widespread hopes for an economic expansion.

Other major contributions, after all, came from quality names with high return on capital, strong revenue generation and stable balance sheets, such as Constellation Software and CGI Group in Canada, and Apple and Microsoft, which contributed over 2.7 percentage points to the S&P 500's return. These contributions indicate a defensive allocation to quality. Large contributors to the Canadian market returns were also from defensive areas, such as precious metals and consumer staples.

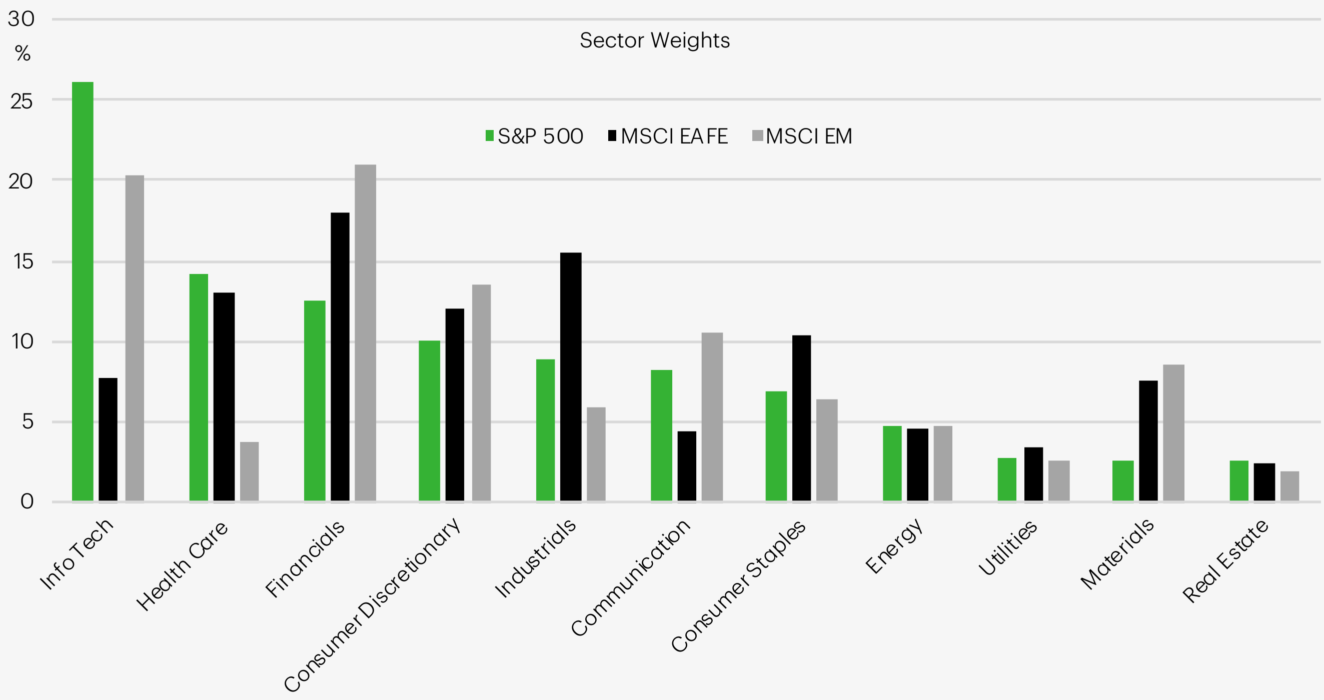
First-quarter performance, therefore, appears to have been a mix of, on one side, counter-trend bear-market trading behaviour and, on the other side, high-quality large-cap strength, while Canadian defensive and safe-haven equities supported the thesis that a defensive rotation is still in play. This suggests that market sentiment as we enter the second quarter may still be leaning towards defence and quality factors. The equity markets may have prematurely leap-frogged recession fears, which may come back as the reality of economic, fundamental and quantitative/technical data continue to point to a late-stage slowdown.

International and Emerging Markets

International and EM equities performed roughly in line with U.S. stocks in the first quarter of 2023, with international stocks trading flat relative to the S&P 500 index and EM stocks lagging by only 3 percentage points. A slightly weaker greenback, a mini-rebound in European economic activity since October 2022 and a continued recovery in China — these have all supported the relative performance of international and EM stocks. Over the past months, however, global macro conditions have continued to deteriorate, and we are increasingly seeing the impact of tightening by global central banks on the economy. Manufacturing PMI surveys in both the U.S. and euro area remain in contractionary territory, although the pace of decline has slowed. Meanwhile, the combination of a high policy rate and ongoing quantitative tightening should continue to drain liquidity from the market, potentially exposing the more fragile borrowers.

This all could lead to short-term pain for the more cyclical sectors of the equity universe, given uncertainty around when the business cycle could bottom. EM and international stocks remain attractive relative to the U.S., but because foreign stocks are more exposed to these cyclical sectors (Figure 6), that relative appeal is in decline. Financials, consumer discretionary, industrials, energy and materials account for 39% of the U.S. equity universe, compared to 57% and 54% for international and EM stocks, respectively.

Figure 6: International, EM stocks heavy in cyclicals



Source: Bloomberg Finance L.P., Wealth Investment Office, as of April 5, 2023

Moreover, the potential for further decline in long-term yields amid recession fears is also supporting the performance of long-duration stocks, which are commonly found in the info tech sector and account for a quarter of the U.S. benchmark.

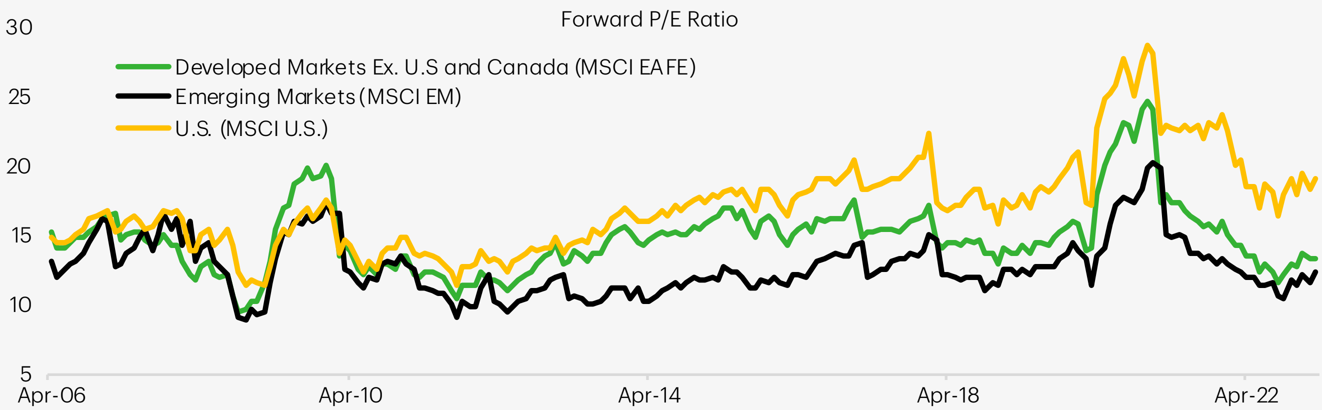
It's not all gloom and doom for international and EM equities, though. Investors with a long-term horizon and higher risk tolerance should accumulate on weakness to benefit from the coming acceleration in global growth, potentially in the second half of the year. First, valuations for international and EM stocks continue to screen cheap relative to their respective historical averages, while U.S. stocks are currently trading at a premium (Figure 7).

Second, there is less concentration risk in the EAFE and EM equity benchmarks, with much lower exposure to the increasingly scrutinized mega-cap tech companies. The beefing up of anti-trust efforts by regulators in both the U.S. and Europe could translate to greater difficulty for the tech giants to acquire potential competitors and limit their expansion. Third, the likelihood for a weaker dollar in the medium term and stronger Chinese economic recovery should provide a larger boost for economic growth in European and EM countries and the financial performance of international and EM stocks.

The case for investing in emerging-market stocks is even stronger. The monetary-policy tightening in several EM countries is well ahead of the curve, and their central banks could begin cutting rates soon, providing much-needed support for the region's growth. Declines in policy rates have historically generated a tailwind for equity multiples (Figure 8).

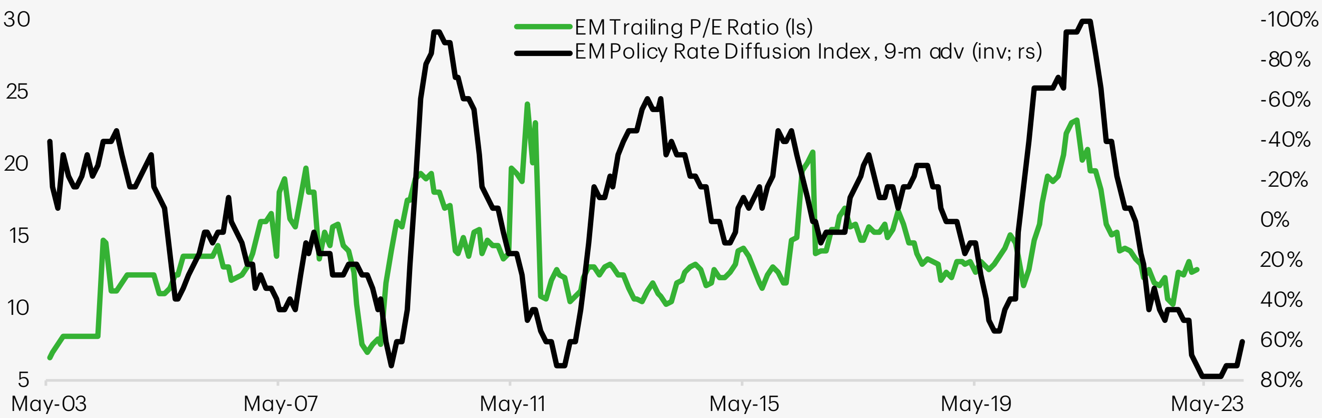
Chinese policymakers, meanwhile, are still in easing mode and its economic recovery has further to go. Although we think the current recovery will be driven primarily by the service sector, demand for commodities should stay supported at a time when supply for energy and select base metals is constrained. This may be a boon for the terms of trade for many Latin American countries, where equity markets have historically been highly correlated with commodity prices. Investing in EM, however, is fraught with risk, and it pays to be selective when investing in EM countries; investors should consider the mix of sector exposures, local currency movements against the dollar and the geopolitical environment.

Figure 7: International, EM stocks still attractive



Source: Bloomberg Finance L.P., Wealth Investment Office, as of April 5, 2023

Figure 8: EM rate cuts could boost multiples



Source: Bloomberg Finance L.P., Wealth Investment Office, as of April 5, 2023

Outlook on Real Assets

Difficult times ahead

Neutral

Kenneth Sue, Senior Alternative Investments Analyst | TD Wealth

The real estate market has been hit by the interest rate hiking cycle. Global transaction volume for this sector—which is very sensitive to changes in interest rates--tumbled 63% year-over-year (y/y) in Q4 2022, representing a decline from US$550 billion (bln) to US$200 bln. Tighter credit lending conditions and disagreements between buyers and sellers over property valuations are responsible for this decline. According to Co-Star Group, real estate valuations have also decreased by about 3.5% since their peak in June 2022 and this trend is expected to continue as the market adjusts to higher interest rates.

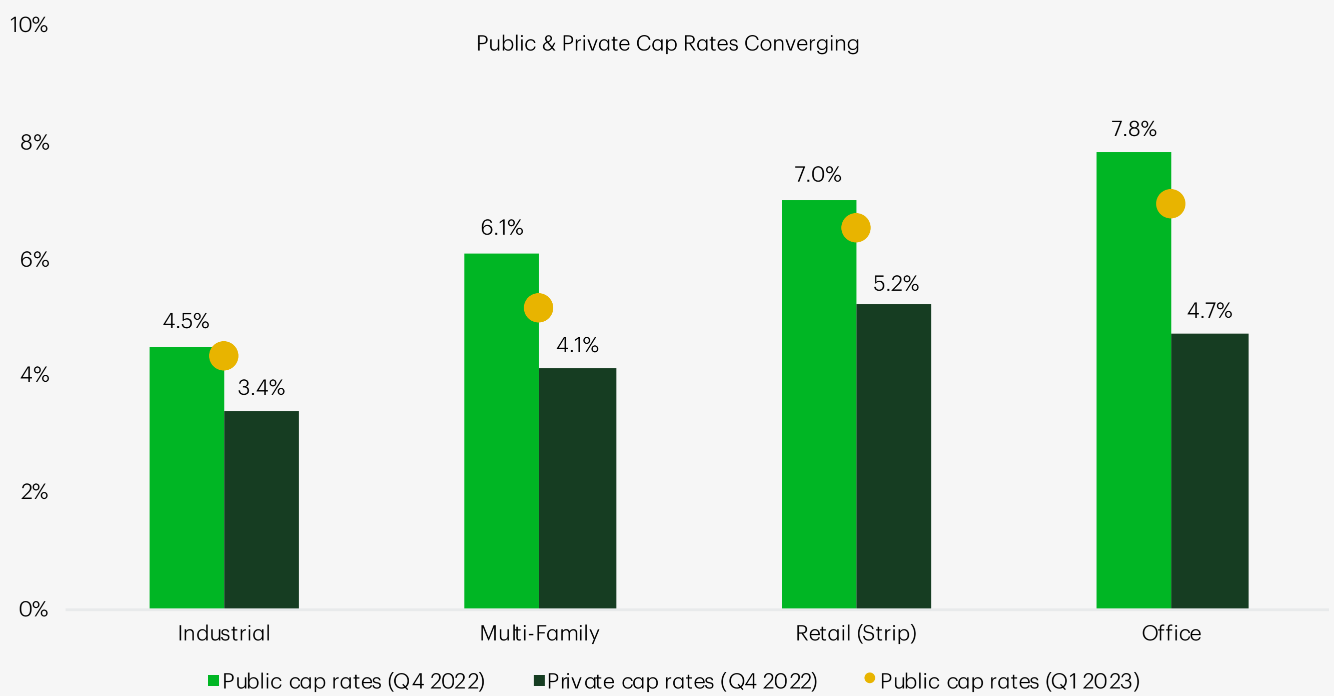
While public markets are a useful forward directional indicator of valuation levels in private markets, they do tend to overcorrect. Currently, there is a divergence between public and private capitalization (cap) rates but public cap rates, which were buoyed by market strength at the start of the year, are trending down towards private cap ratios. (Figure 1). We expect cap rates--which gauge the profitability of and returns on a real estate investment--to keep converging (public rates are expected to keep sliding while private cap rates will increase) in 2023 until stabilizing in the latter half of this year.

The office sector, the second largest after multi-family, has become a focus because of its size and low tenant occupancy which sits at only 50% of the pre-pandemic level. Ongoing rightsizing efforts by tenants are driving office vacancies to post-pandemic highs of over 16% in the U.S. and Canada. Although there have been notable office defaults in recent months, overall delinquencies and distressed sales remain below pre-pandemic levels. The office and multi-family sectors remain bright spots in real estate due to a lack of inventory and excess demand, but rent growth has slowed in recent months, leading to higher cap rates.

The real estate market is in the process of recalibrating and rebalancing in response to one of the quickest hiking cycles in decades. We believe things will stabilize in the latter half of the year as economies and investors digest the slower pace of hikes and anticipate potential rate cuts.

It is essential to note that rates will eventually normalize, creating opportunities in the real estate market, particularly with inflation moderating and interest rates being held at intentionally unsustainable levels by the U.S. Federal Reserve.

Figure 1: Public Cap Rates on the Decline



Source: Green Street Advisors and Altus Databridge, Wealth Investment Office (WIO), Q1/2023

Special Addition: Commercial Real Estate Debt Markets

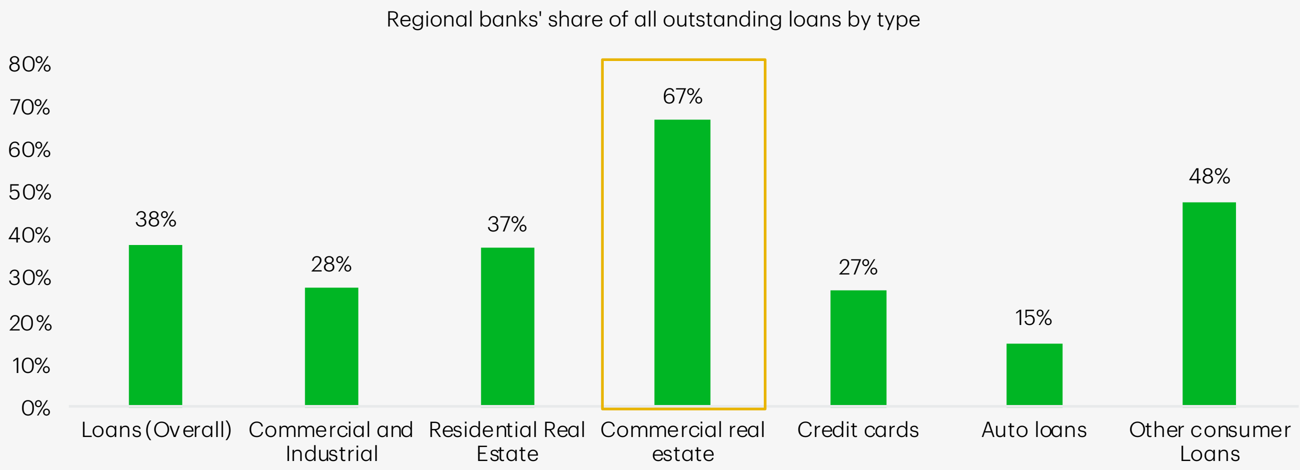
Everyone seems to be eyeing up regional banks and their exposure to commercial real estate after the collapse of Silicon Valley Bank (SVB) and Signature Bank, which was one of the largest lenders in the commercial real estate (CRE) market. This is justified because regional banks have a comparatively higher exposure to CRE relative to their share of overall loans in the market (Figure 2). Indeed, all banks have pulled back on lending, tightening underwriting standards, which in turn have tightened credit conditions in the CRE loan market.

And while everyone is focused on regional banks, it's crucial to highlight that they may not be the most vulnerable to potential CRE loan losses in the next 24 months: that title would go to commercial mortgage-backed securities (CMBS). This is because regional banks have only recently become major players in the CRE market. While regionals were responsible for 27% of all CRE originations in 2022, they had a much smaller presence just a few years ago, accounting for only about 17% of market originations.

Regionals are now the biggest players in the CRE loan market but most of the loans on their books are relatively recent and not due until well into the future. CMBS however has been a larger source of CRE loans in the past and so even though originations are the same for CMBS and regionals in 2015-2019 and 2021, more CMBS loans are maturating this year. (Figure 3).

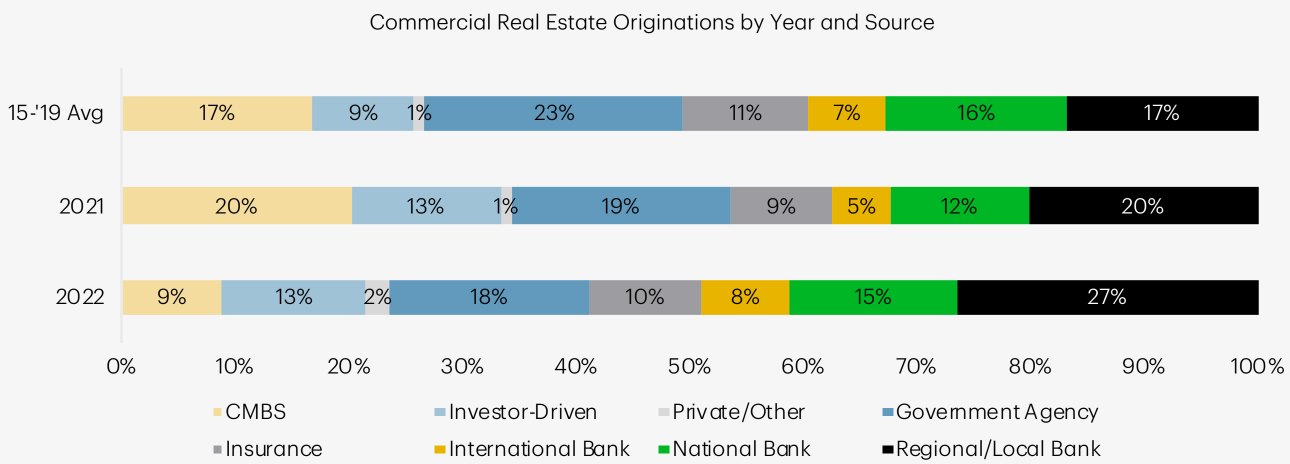
This is an important consideration since most of the significant underwriting activity by regionals has occurred over the past couple of years. Since CRE loan terms typically run five to ten years, the maturity cliff for regionals won't arrive until 2026-2027 whereas the maturity cliff for CMBS is 2023.

Figure 2: Regional banks have high exposure to CRE loans



Source: U.S. Federal Reserve, WIO, Q1 2023

Figure 3: Commercial real estate originations by year and source



Source: MSCI Real Capital Analytics, Q12023

In fact, less than US$50 bln of the roughly US$400 bln in CRE loans maturing in 2023 are on the books of regional banks. By contrast, almost US$150 bln of CMBS loans are due this year. This is arguably the real indicator of CRE credit stress levels. While we expect an increase in defaults and delinquencies throughout the year especially after the low levels seen during the pandemic, the spike in interest rates from zero, and the decline in valuations because of higher interest/discount rates and slower rent growth. Indeed, Fitch Ratings is forecasting an overall doubling or quadrupling of delinquency rates starting in the first half of this year (Figure 4).

We're already one quarter into 2023, and despite forecasts by Fitch Ratings, delinquencies and defaults—aside from a few that grabbed the headlines—on a national level have held steady (Figure 5).

Given the dramatic interest rate hikes, the higher interest costs, lower valuations, credit tightening, defaults and further credit tightening, we could see significant disruption in the real estate market.

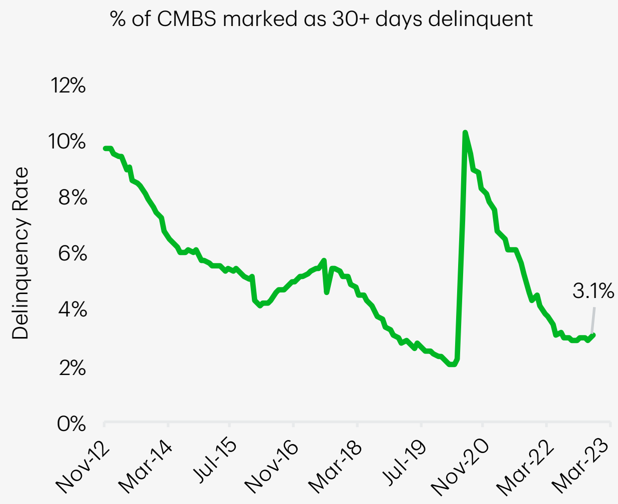
However, we believe that all stakeholders, including regulators, government bodies, and financial institutions, are working to prevent such an outcome. This approach includes providing support to financial institutions and borrowers to ensure the market remains stable and resilient as they have done in the case of SVB and Signature.

It's essential to note that during times of stress, alpha can be generated, and active management will be especially crucial over the next few quarters to navigate the commercial real estate market as it undergoes a widespread repricing.

TD Wealth has a Neutral recommendation on Alternative Assets. An allocation to alternative assets such as commercial mortgages and infrastructure can benefit portfolios. We are maximum underweight domestic real estate and global real estate as higher inflation and mounting recessionary fears remain a risk. We remain focused on high quality assets and broad diversification with the ability to enhance portfolio quality through value-add and build-to-core strategies.

Overall, alternative assets can provide inflation protection and attractive absolute returns, while acting as long-term portfolio stabilizers via their diversification benefits and less correlated income streams.

Figure 5: CMBS delinquencies muted despite interest rate spike



Source: Trepp as of March 31, 2023

Figure 4: CMBS delinquencies expected to rise

Property Type	Current Delinquency Rate (Oct 2022)	Projected Delinquency Range by YE 2023	Pre-Pandemic Delinquency Rate (Mar 2020)	Pandemic Peak	Historical Peak
Retail	5.70%	10.8% - 11.3%	3.50%	11.60%	11.60%
Hotel	4.90%	8.3% - 8.8%	1.40%	18.40%	21.30%
Office	1.20%	3.5% - 4.0%	1.30%	1.90%	8.80%
Multifamily	0.30%	1.6% - 2.1%	0.40%	0.70%	17.60%
Industrial	0.40%	0.8% - 1.3%	0.30%	0.70%	10.90%

Source: Fitch Ratings, Oct 2022

Outlook on Currencies

Still data dependent

Kevin Yulianto, Portfolio Manager | TD Wealth
TD Securities FX Strategy

The story of our factor framework in 2022 was one of commodities (terms of trade), inflation (buying upside momentum), carry (long USD cash), and momentum. Those themes faded in late 2022, reflecting the reduction in global tail risks, well-populated positioning and the decline in risk premiums. China pushed forward to reopen much faster than expected, while the eurozone economy has endured the energy shock, thanks to a warm winter. Another point of interest is the shift in relative equity performance, where global markets are expected to outperform the U.S.

The banking turmoil in mid-March reinforced a pivot in favour of the Rest of World (ROW) over the U.S. While financial stress increases the tail risks to the left-hand side of the U.S. dollar outlook, it does not appear as though this will morph into a global financial crisis. As of mid-April, the risk appears to be contained and the longer we go without banking turmoil, the less risk there is to the near-term outlook for the U.S. dollar.

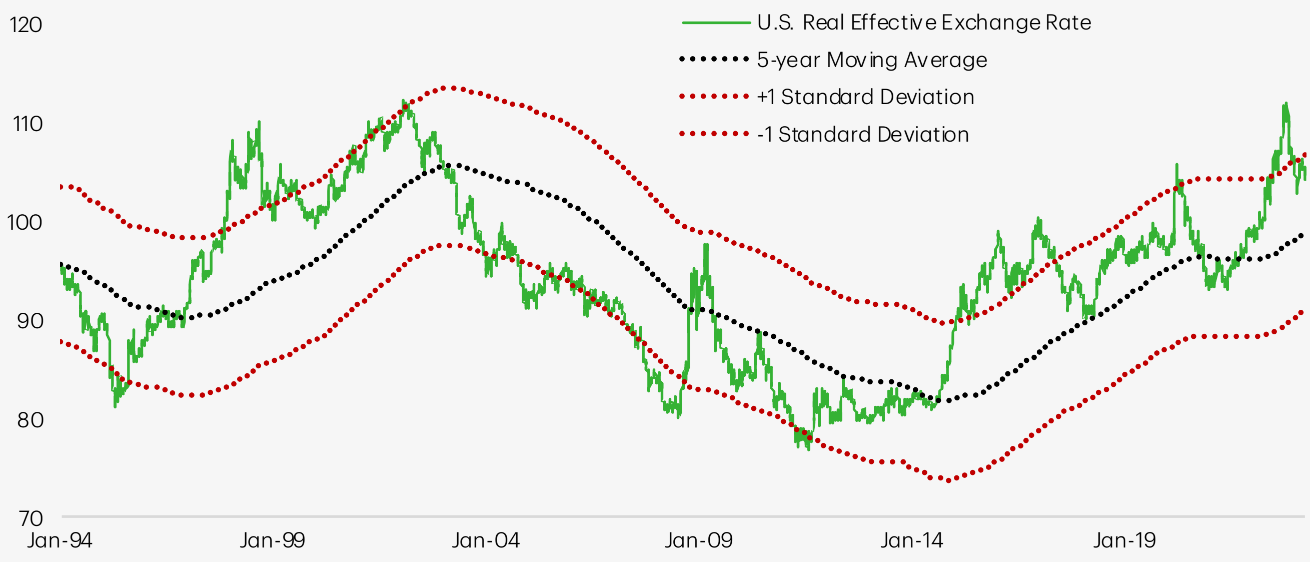
One of the key questions at this point is whether a slowing U.S. economy will pull the ROW down with it and how much more the Fed will tighten rates amid rapidly slowing data. Recent evidence suggests that the U.S. economy will not drag the ROW down, particularly as China's economy acts as a buffer against the slowdown. We see a period of decoupling rather than a correlated downturn in the months ahead.

In the very near term, we anticipate data to remain a critical determinant of the U.S. dollar performance. On a broader scale, the global macro regime is shifting again and the U.S. dollar is no longer tracking the significant macro themes of 2022, namely, inflation and terms of trade. The world is moving towards a balance of growth and inflation, and the U.S. dollar positive bearish flattener regime is ending.

The Fed's focus on steadying the prospects of aggressive credit tightening has introduced fresh U.S. dollar liquidity. The stress has raised the alarm bells on the competing interests of two R-stars: One for financial stability, the other for macroeconomic objectives. This reality has changed the outlook on Fed pricing and could alter the yield curve regime with time. It has also reinforced the narrative around the ROW outperforming the U.S., reflecting PMIs, consensus expectations and data surprises. We still expect another one or two Fed rate hikes, which will likely introduce some turbulence.

The shift in the macro backdrop led us to mark down our U.S. dollar profile in mid-March. Rates, equities, and terms of trade baskets drove a more cautious near-term outlook for the U.S. dollar in mid to late March. As of mid-April, the U.S. dollar has managed to form a double bottom after a string of underwhelming U.S. data. It is likely going to remain somewhat rangebound

Figure 1: The U.S. dollar is expensive and may remain so in the near term

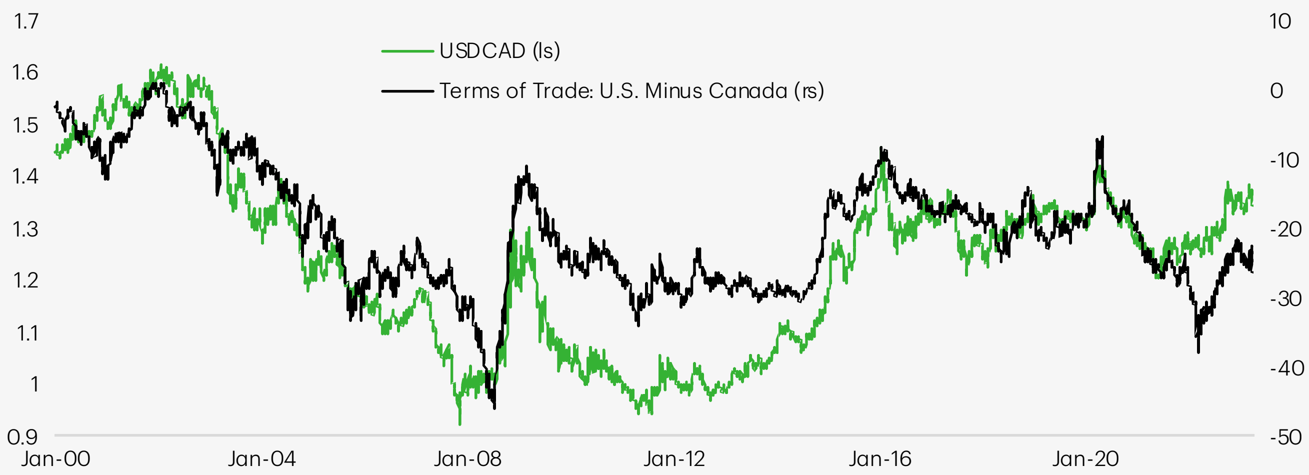


Source: Bloomberg Finance, L.P., Wealth Investment Office (WIO), as of April 5, 2023 the longer we go without further banking turmoil. While the U.S. dollar may see near-term resilience, buoyed by another Fed hike, the broader view of the global macroeconomic landscape reveals a less USD-friendly environment, indicating that short-term rallies should be met with skepticism.

Another key feature of currency markets now is the rapid shift of correlations. Factor performance is changing quickly amid a wide variance across performance. In that vein, it raises the question about the importance of historical correlations to growth and rates.

There are multiple considerations for the Canadian dollar. On the surface, falling energy prices and the Bank of Canada (BoC) pausing its policy rate hike at a level below the Federal Reserve should mean the Canadian dollar will find it difficult to appreciate against the greenback. Dig a little deeper though and you realize the impact of monetary policy tightening might be more severe in Canada than the U.S. because Canadian households have higher leverage and much shorter fixed-rate mortgage terms compared to the U.S. On top of that, the Canadian economy will face additional headwinds if an economic slowdown coincides with falling commodity prices. However, these negative factors seem to have been at least partially priced in by the market. Figure 2 shows that the uptrend in the USD/CAD may have overshot fundamentals, with relative terms of trade more recently favouring the loonie.

Figure 2: USD/CAD has diverged from terms of trade differentials



Source: Bloomberg Finance, L.P., Wealth Investment Office, as of April 5, 2023

Figure 3: Foreign exchange forecasts for G10 currencies

Summary G10 FX Forecasts									
	Spot	2023				2024			
	Apr 3, 2023	Q1 A	Q2 F	Q3 F	Q4 F	Q1 F	Q2 F	Q3 F	Q4 F
USD/JPY	133	133	125	122	120	120	118	118	115
EUR/USD	1.09	1.08	1.11	1.13	1.14	1.15	1.12	1.14	1.16
GBP/USD	1.24	1.23	1.24	1.26	1.29	1.28	1.27	1.28	1.32
USD/CHF	0.91	0.92	0.92	0.92	0.91	0.91	0.89	0.88	0.87
USD/CAD	1.35	1.35	1.36	1.34	1.32	1.29	1.27	1.26	1.26
AUD/USD	0.68	0.67	0.69	0.71	0.70	0.70	0.72	0.73	0.74
NZD/USD	0.63	0.63	0.63	0.63	0.64	0.65	0.65	0.66	0.67
EUR/NOK	11.24	11.36	11.00	10.80	10.60	10.20	10.40	10.00	9.90
EUR/SEK	11.29	11.28	11.50	11.20	11.10	11.00	10.80	10.70	10.50
DXY	102.38	102.51	100.40	98.50	97.30	96.60	97.80	96.50	94.70

Source: TD Securities as of April 3, 2023

Outlook on Commodities

Near-term challenges dampen sentiment

Hussein Allidina, Managing Director and Head of Commodities | TD Asset Management

We maintain our constructive view on commodities and believe that a decade of underinvestment will result in a structural bull market over the medium term. This view stems not only from our understanding about where we are in the commodity investment cycle, but is also supported by the global energy transition, geopolitics, and more volatile weather patterns.

That said, commodities have underperformed our expectations of late, with the broad commodity basket down 8% in the first three months of 2023, and even more relative to bonds and equities, which generally posted positive returns in the quarter. Although we remain constructive in the medium term, near-term challenges—the credit crisis, softer data out of China, stronger-than-expected Russian energy supply and a mild winter globally—have dampened sentiment more than expected.

1. Credit Crisis

The ghosts of past financial crises spooked global markets in March, weighing on commodities in two ways. First, we saw a sharp change in positioning: increased risk aversion prompted investors to unwind long positions to the lowest level in over 10 years. Then, we witnessed a reassessment of expectations: bank liquidity issues tightened credit standards, which will likely put a drag on economic growth and demand. All said, we are less constructive than our last update, but believe the market has priced in far too pessimistic a view.

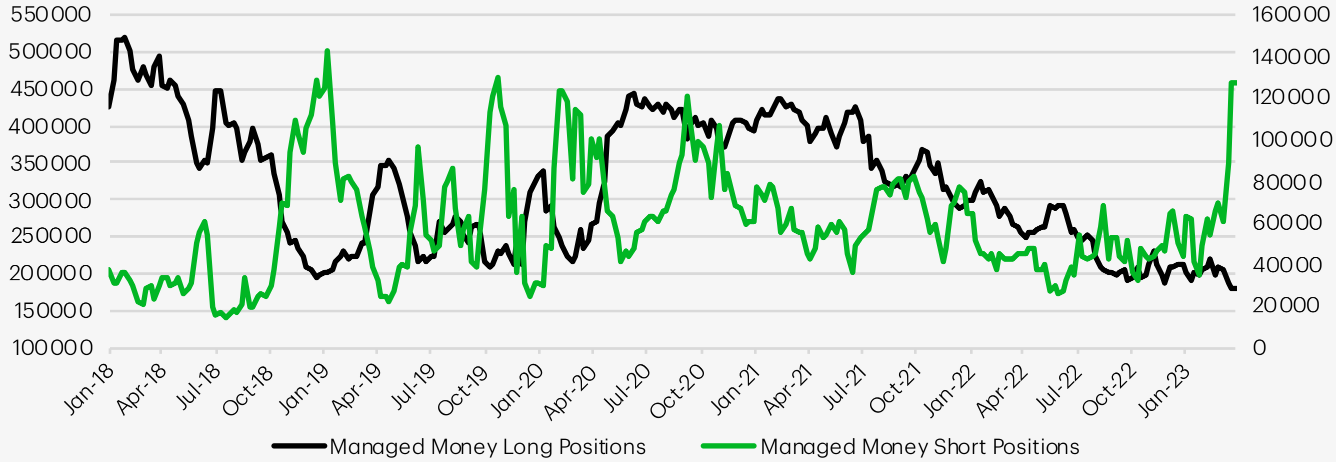
2. Data from China Not as Robust as Expected

Much of the China reopening trade was priced into markets by Q4, with copper and aluminum both rallying about 10% from early October into the end of 2022. Data was positive though less robust than many had expected, prompting investors to take a wait-and-see approach. However, strong data could lure them back into commodities. Travel (domestic flights at 85% of 2019 levels), dining, and tourism data have been encouraging but offset by disappointing hard data such as rising metal inventories, and weaker land sales (down 29% y/y) and car sales (down 8% y/y). As China is a material commodity consumer, the velocity of their reopening and its impact on growth will be a meaningful determinant of commodity prices throughout 2023.

3. Russian Energy Supply

Two important deadlines came and went: the European Union restrictive measures on crude in December and further restrictive measures on crude products in early February. In both cases Russia reacted similarly; it began front running export bans by increasing its seaborne crude and product exports which pushed the market into surplus and weighed on prices. Russian production has defied expectations, as has been their access to a "shadow" tanker fleet which has helped them not only maintain exports but actually grow them. However, recent data suggests sanctions

Figure 1: Credit crisis has resulted in significant risk-off positioning



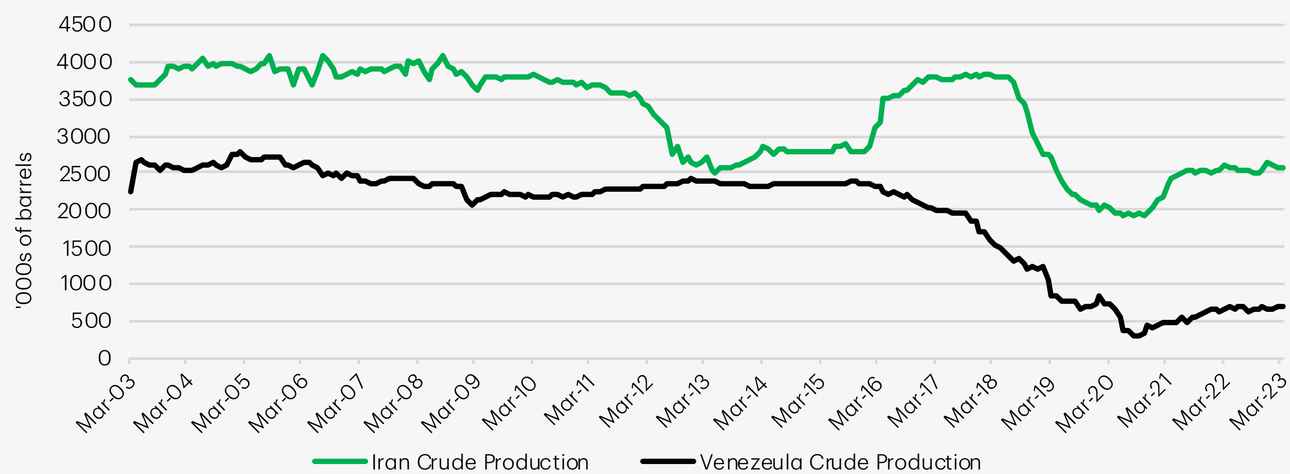
Source: Bloomberg Finance L.P. as of March 31, 2023 may finally be affecting Russian production: exports started to decline in late March, in line with Russia's announcement that they would be cutting production by 500k barrels a day. The big question remains how will production evolve over time. Our sample size is small, only Iran and Venezuela, but historically sanctioned countries haven't been able to maintain pre-sanction production levels (Figure 2).

4. Mild winter in EU and North America slashes demand

Another factor that weighed on energy prices was sharply reduced demand from North America and the EU, as both continents had extremely mild winters, some of the mildest in 70 years. This allowed the EU to exit winter with much higher inventory levels than anyone forecasted, relieving pressure on global LNG markets and causing gas prices to plummet. The energy issues in the EU are an ongoing concern as the lack of Russian gas was compounded by continued nuclear plant maintenance issues in France and reduced hydro power generation due to lower than normal water levels in Southern Europe. It was fortuitous that the EU's second warmest winter ever took place just when the EU was at its most sensitive to gas supply. It's unlikely that the EU will get this lucky again going into next winter and energy prices should reflect that.

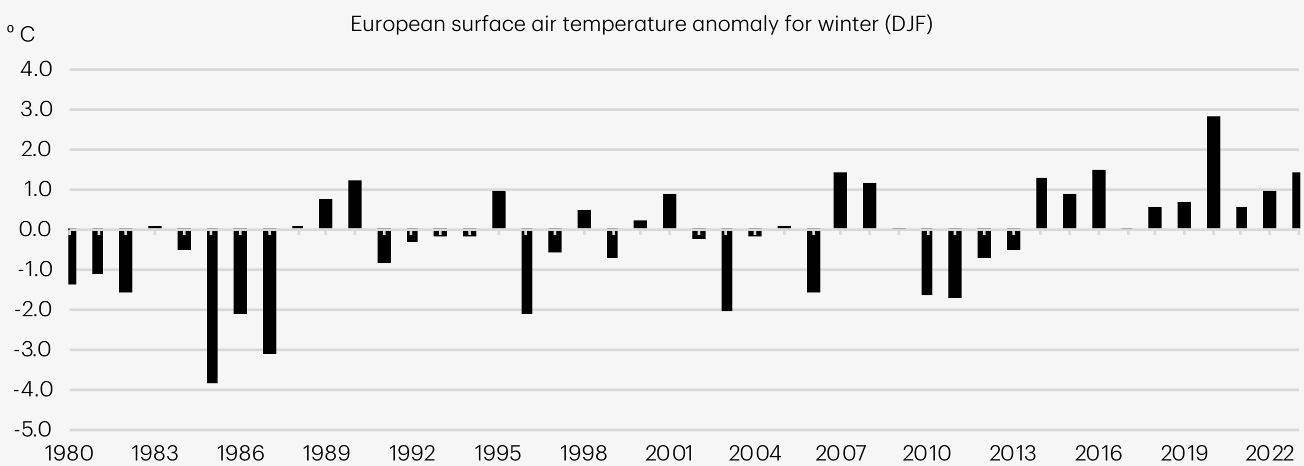
The average temperature for Europe from December 2022 to February 2023 was 1.44°C above the 1991-2020 average for the season. This is the joint second-warmest winter value on record for Europe.

Figure 2: History suggests sanctions will reduce Russian energy supply



Source: Bloomberg Finance L.P. as of March 31, 2023

Figure 3: Very mild winter helped Europe manage energy needs



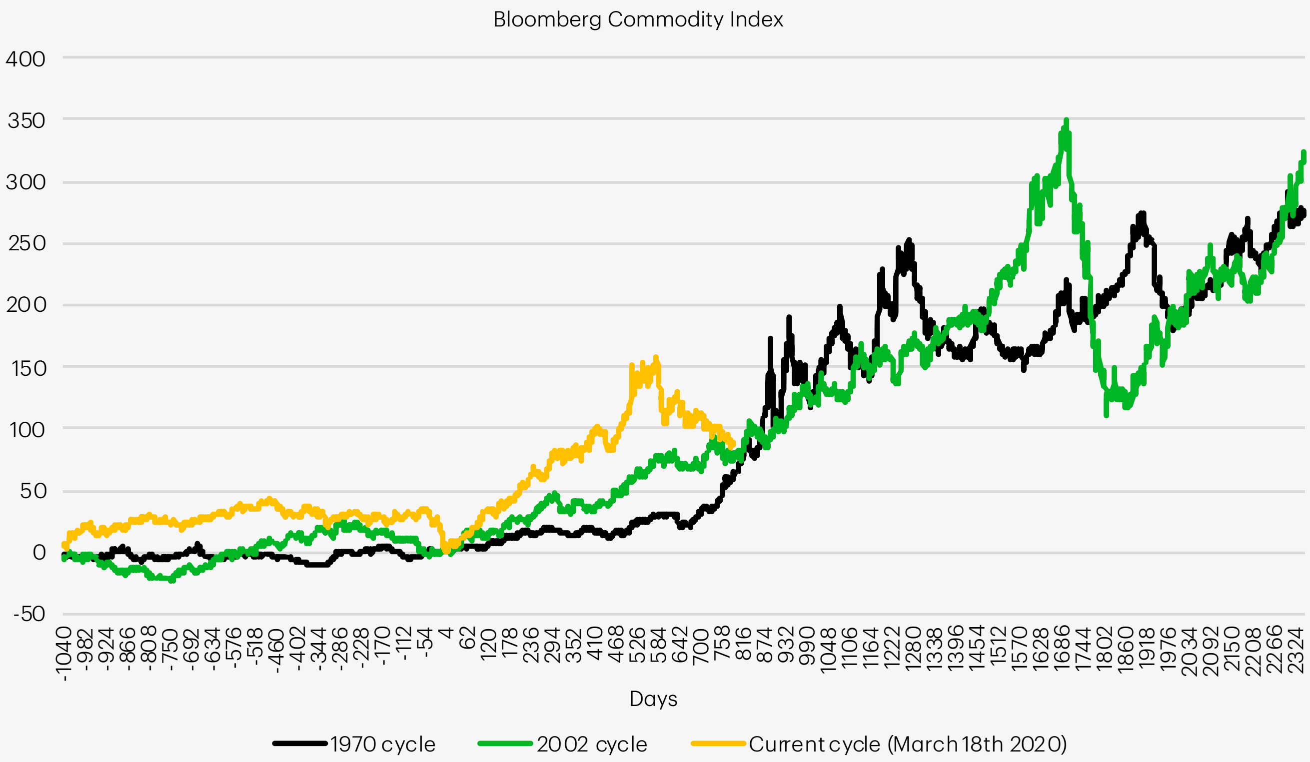
The average temperature for Europe from December 2022 to February 2023 was 1.44°C above the 1991-2020 average for the season. This is the joint second-warmest winter value on record for Europe.

Conclusion

In a world of heightened uncertainty, it is unlikely that commodities will rise in a slow and steady fashion. Instead, it will be a process of fits and starts, higher highs and higher lows. This is how previous cycles have played out and we don't expect this round to be any different.

As we wrote in Q1, weaker and more volatile prices will only delay much needed investment on the supply side, possibly portending an aggressive move higher when growth does eventually stabilize and improve.

Figure 4: Early stage of the commodity supercyle



Source: Bloomberg Finance L.P., TD Asset Management, as of March 31, 2023.
Note: The data series is indexed to 0 at time 0.

Market Performance

Canadian Indices ($CA) Return	Index	(%) 1 Month	(%) 3 Months	(%) YTD	(%) 1 Year	(%) 3 Years	(%) 5 Years	(%) 10 Years	(%) 20 Years
S&P/TSX Composite (TR)	78,625	-0.22	4.55	4.55	-5.17	18.02	8.80	7.86	8.91
S&P/TSX Composite (PR)	20,100	-0.60	3.69	3.69	-8.18	14.53	5.52	4.66	5.94
S&P/TSX 60 (TR)	3,845	-0.47	4.11	4.11	-5.66	17.41	9.28	8.45	9.18
S&P/TSX SmallCap (TR)	1,263	-0.43	4.50	4.50	-12.56	27.64	5.74	4.62	0.06
U.S. Indices ($US) Return									
S&P 500 (TR)	8,791	3.67	7.50	7.50	-7.73	18.60	11.19	12.24	10.37
S&P 500 (PR)	4,109	3.51	7.03	7.03	-9.29	16.71	9.25	10.11	8.21
Dow Jones Industrial (PR)	33,274	1.89	0.38	0.38	-4.05	14.93	6.66	8.60	7.39
NASDAQ Composite (PR)	12,222	6.69	16.77	16.77	-14.05	16.65	11.59	14.10	11.68
Russell 2000 (TR)	9,500	-4.78	2.74	2.74	-11.61	17.51	4.71	8.04	9.76
U.S. Indices ($CA) Return									
S&P 500 (TR)	11,898	3.10	7.41	7.41	-0.06	16.76	12.27	15.51	9.92
S&P 500 (PR)	5,561	2.93	6.94	6.94	-1.76	14.90	10.31	13.31	7.77
Dow Jones Industrial (PR)	45,032	1.33	0.30	0.30	3.92	13.14	7.70	11.77	6.95
NASDAQ Composite (PR)	16,541	6.10	16.68	16.68	-6.91	14.83	12.68	17.42	11.22
Russell 2000 (TR)	12,857	-5.31	2.65	2.65	-4.26	15.68	5.73	11.18	9.31
MSCI Indices ($US) Total Return									
World	12,623	3.16	7.88	7.88	-6.54	16.96	8.57	9.44	9.45
EAFE (Europe, Australasia, Far East)	9,772	2.61	8.62	8.62	-0.86	13.52	4.03	5.50	7.82
EM (Emerging Markets)	2,491	3.07	4.02	4.02	-10.30	8.23	-0.53	2.37	9.63
MSCI Indices ($CA) Total Return									
World	17,083	2.59	7.79	7.79	1.23	15.13	9.62	12.62	9.00
EAFE (Europe, Australasia, Far East)	13,226	2.04	8.54	8.54	7.38	11.75	5.05	8.57	7.37
EM (Emerging Markets)	3,371	2.50	3.93	3.93	-2.85	6.54	0.43	5.36	9.18

Currency									
Canadian Dollar ($US/$CA)	73.89	0.56	0.08	0.08	-7.67	1.58	-0.96	-2.83	0.41
Regional Indices (Native Currency, PR)									
London FTSE 100 (UK)	7,632	-3.10	2.42	2.42	1.54	10.40	1.58	1.76	3.81
Hang Seng (Hong Kong)	20,400	3.10	3.13	3.13	-7.26	-4.75	-7.48	-0.89	4.39
Nikkei 225 (Japan)	28,041	2.17	7.46	7.46	0.79	14.02	5.50	8.50	6.49

Benchmark Bond Yields	3 Months	5 Yrs	10 Yrs	30 Yrs
Government of Canada Yields	4.40	3.02	2.90	3.00
U.S. Treasury Yields	4.80	3.58	3.47	3.65

Canadian Bond Indices ($CA) Total Return	Index	1 Mo (%)	3 Mo (%)	YTD (%)	1 Yr (%)	3 Yrs (%)	5 Yrs (%)	10 Yrs (%)
FTSE TMX Canada Universe Bond Index	1,085	2.16	3.22	3.22	-2.01	-1.57	0.89	1.88
FTSE TMX Canadian Short Term Bond Index (1-5 Years)	746	1.22	1.82	1.82	0.70	0.09	1.33	1.45
FTSE TMX Canadian Mid Term Bond Index (5-10)	1,204	3.16	3.85	3.85	0.00	-1.01	1.46	2.16
FTSE TMX Long Term Bond Index (10+ Years)	1,686	2.61	4.72	4.72	-7.17	-4.27	-0.20	2.22

HFRI Indices ($US) Total Return (as of March 31, 2020)								
HFRI Fund Weighted Composite Index	17,676	-0.81	1.18	1.18	-2.06	10.55	4.69	4.44
HFRI Fund of Funds Composite Index	7,226	0.14	1.57	1.57	-1.10	7.47	3.27	3.33
HFRI Event-Driven (Total) Index	20,121	-1.65	1.40	1.40	-2.18	11.68	4.49	4.61
HFRI Equity Hedge Index	27,462	0.89	3.38	3.38	-2.88	12.71	5.19	5.41
HFRI Equity Market Neutral Index	6,133	0.02	0.59	0.59	2.30	4.08	1.82	2.87
HFRI Macro (Total) Index	18,352	-3.20	-2.95	-2.95	-0.87	6.86	4.50	2.64
HFRI Relative Value (Total) Index	14,202	-0.49	1.38	1.38	0.01	7.68	3.59	3.86
HFRI Indices ($CA) Total Return (as of March 31, 2020)								
HFRI Fund Weighted Composite Index	23,904	-1.49	1.13	1.13	6.11	8.80	5.70	7.45
HFRI Fund of Funds Composite Index	9,771	-0.55	1.52	1.52	7.15	5.77	4.27	6.31
HFRI Event-Driven (Total) Index	27,210	-2.33	1.35	1.35	5.98	9.92	5.50	7.63
HFRI Equity Hedge Index	37,137	0.19	3.33	3.33	5.22	10.93	6.20	8.46
HFRI Equity Market Neutral Index	8,294	-0.67	0.53	0.53	10.84	2.44	2.80	5.84
HFRI Macro (Total) Index	24,818	-3.87	-3.00	-3.00	7.39	5.17	5.51	5.60
HFRI Relative Value (Total) Index	19,206	-1.18	1.33	1.33	8.35	5.98	4.59	6.86

Sources: TD Securities Inc., Bloomberg Finance L.P. TR: total return, PR: price return, as of March 31, 2023.

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