A Baker's Dozen
The Year Ahead: 2024

Market Insights | December 2023

Wealth Investment Office

A baker's dozen.

This is the time of year when investment houses like ours take account for the year that was and begin to consider the year that will be. Simply put, these year ahead documents, like the one you are holding in your hands, are table stakes for investment firms. This is where investment strategists summarize their thesis for the upcoming year. Whenever I speak in public, someone inevitably asks me before I make my way to the stage: "Did you bring your crystal ball?" It is always said with a smile and delivered in a spirit of goodwill. I always answer the same way: "I have never met anyone who can divine the future."

It is human nature. We humans have been making predictions from time immemorial about apocalyptic events that will lead to our extinction; the fact that I am writing this sentence disproves those predictions and the prognosticators' ability to make them. The simple fact is, we don't know the future, and if we did, we still wouldn't because in the knowing we would alter its course by our actions. What we can do is frame the present and know with certainty how we will make decisions when uncertain things occur. The proverb "fools rush in where angels fear to tread" comes to mind.

There is no shortage of risks and opportunities for us to frame for the year ahead. Deglobalization, climate and a commodities super-cycle, China's challenging economic prospects, the United States' daunting presidential election, inflation, interest rates and the promise of AI, to name a few. Predictably, we started out with 10 considerations – nice to see David Letterman continues to have influence in popular culture. Our investment team came up with roughly 100, which demonstrates the intricacies of investment management. As the Chief Wealth Strategist, my job is to distill the list down to what we believe will be the most influential on our clients portfolios.

With that in mind, please find our baker's dozen on how we will be framing the year ahead as we utilize our Wealth Strategy Process to guide and manage portfolios in 2024.

Be well,

Brad Simpson

Chief Wealth Strategist, TD Wealth

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Where we were

We spent a good part of last year just getting used to the new normal, after the Fed's unprecedented tightening campaign. Rates were going up faster than the market could comfortably adjust, leading to volatility and bizarre correlations between stocks and bonds. It was clear that the U.S. and Canada were in the late stages of the economic cycle, but there was uncertainty about what would come next.

Early in the year, the fear of a painful recession in North America was palpable. But the same could not be said for advanced economies around the world. The so-called "global economy" was being unbundled by extreme monetary policy, protectionism and the rising geopolitical risks around the world. Indeed, today — with Germany in recession, the U.S. showing resilience and China fending off deflation — you can make the argument that there is no unified global economy comprising the world's most powerful nations, but rather a series of regional economies, each dealing with their own interests (Figure 1).

Figure 1: Then and Now

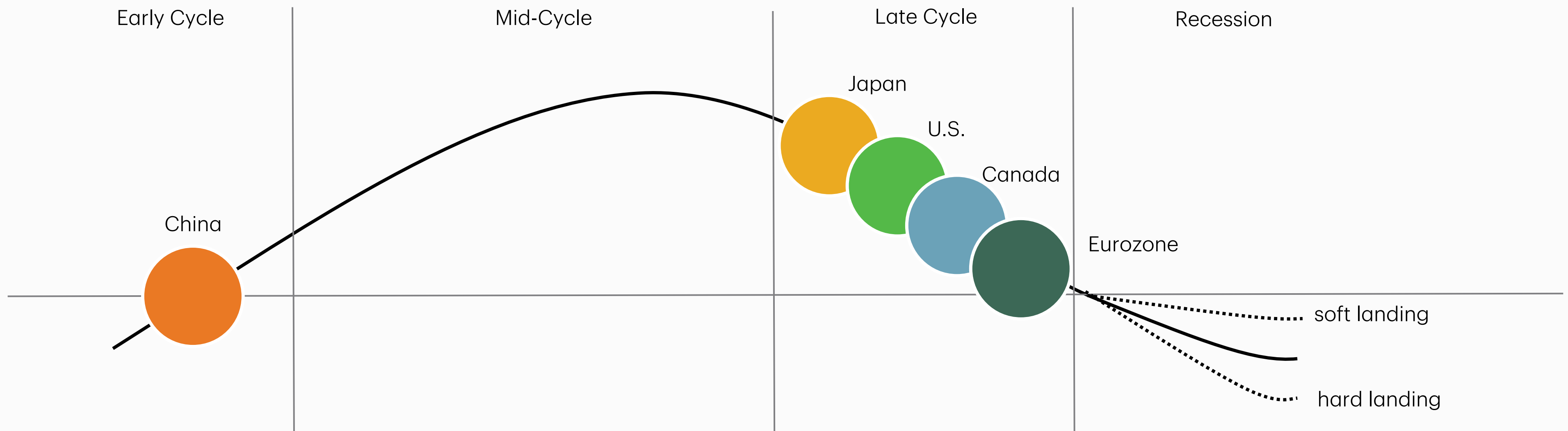
Then: The Global Economy

	Upside Risk		Current Positioning	Downside Risk
Macro Indicator	**Early Stage (22%)**	**Mid Stage (42%)**	**Late Stage (22%)**	**Recession (13%)**
Economic Growth	High	Moderate	Low	Negative
Inflation	Low	Moderate	High	Low to Negative
Monetary Policy	Loose	Neutral	Tight	Loose
Term Premium	High	Moderate	Low	Low to Negative
Credit Conditions	Loose	Loose but Tightening	Tight	Enter: Tight; Exit: Loose
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: TD Wealth Investment Office as of December 31, 2022.

Figure 1: Then and Now

Now: The Fragmented Economy



For illustrative purposes only

In America at least, things started to change midway through the year. The Fed was nearing the end of its tightening program, even as the U.S. economy exhibited surprising strength. The inverted yield curve was still telling us that recession was likely, and investors were still drawn to the perceived safety of Big Tech, but you could almost hear the murmurs of optimism that, maybe, just maybe, it wouldn't be as bad as everyone was expecting. Earnings, after all, had not cratered. Real estate prices had not crashed. The U.S. consumer was still spending freely. And, best of all, inflation was coming down steadily. With all these positive signs, hope started to creep into the market that perhaps a soft landing was not out of the question.

It was around this time that we at the Wealth Investment Office published our "mid-year check-in." These too have become de rigueur in the wealth management industry in recent years. At the time, we were bullish on fixed income, as yields were at levels not seen since before the global financial crisis. And we were modestly underweight in terms of equities, cautious about the headwinds facing corporate earnings.

But we also were careful to frame these convictions around a number of caveats, emphasizing the level of uncertainty we were dealing with as the economy was adapting to a record-breaking campaign of rate hikes. In fact, we called that mid-year check-in "The Uncertainty Principle," stressing the fact that forecasts are not predictions and that professional investment strategy was not about placing bets on any particular scenario but, rather, about assessing the probability of various scenarios and positioning to capitalize on the ones that we felt were most likely, while also protecting against unforeseen events. If we are nothing else, we are consistent.

Some of the trends we highlighted in June stayed in place throughout the year, while others were overtaken by events we had not, or could not, have anticipated. Herewith, a breakdown:

☐ What we got right

Geopolitical risk to rise.

In our June edition, we suggested that — even as Chinese relations deteriorated and the Russian invasion of Ukraine continued — geopolitical instability was likely to get worse. Unfortunately, this is one we got right. In late August, six countries (Saudi Arabia, Iran, UAE, Argentina, Egypt and Ethiopia) joined the BRICS intergovernmental organization. One of the goals of the BRICS bloc is to establish a more representative international order. Two months later, the tragic conflict in the Middle East began. While the events unfolding in Gaza, China and along the Russian border may seem disconnected, they are part of a trend that we have been concerned about.

Inflation to fall but remain above target.

The trouble continues to be tight labour markets. The pandemic and retiring baby boomers have supported historically low unemployment numbers, which are keeping wage growth high, particularly on the services side of the economy. So, while the price of goods is set to normalize, wage growth in services should keep inflation elevated until the labour market cools. This has proven to be the case so far.

Fixed income to rise from historic lows.

Our bullish call on fixed income was a bit early with long-term yields continuing to rise until October. Why the delay? Late in June, the Fed sent a “higher for longer” signal that led long-term Treasury yields higher. They’ve since fallen, leading to the biggest month-over-month bond rally in nearly 40 years. Our positive outlook on fixed income proved correct given that: (1) we explicitly proposed a long-term strategy on fixed income; (2) historically, yields have been the primary determinant of returns on government bonds; and (3) yields have started to come down convincingly since October. If we’re right, this is just the beginning.

☐ What we got wrong

Energy prices to rise.

Given the dearth of oil and gas development in recent years, we felt that prices had bottomed. We were right in that respect: In the third quarter of 2023, West Texas Intermediate oil (WTI) rose from about US$70 to US$90 per barrel — but it was a short-lived bump. As news emerged over the extent of China’s economic slump, forecasts for global energy demand fell. In Q4, WTI fell from US$90 back down to US$75. Over the long term, however, we still believe that insufficient capital expenditures in oil and gas will lead prices to rise.

Mega-caps to loosen their grip on the markets.

By mid-2023, with rate hikes approaching their terminus, we felt that a rotation to more reasonably priced cyclicals was set to happen. Then, in August, chipmaker Nvidia Corp. posted its second consecutive quarter of blowout earnings on the back of demand for AI applications. The promise of artificial intelligence has propelled tech stocks through the remainder of 2023. That being said, we’re now starting to see undervalued cyclicals begin to outperform.

Labour markets to weaken.

The jobs market has proven more resilient than expected, possibly due to the continued retirement of baby boomers. The youngest members of this cohort, born in 1964, are now aged 59. While we continue to believe that the labour market is bound to loosen as the U.S. and Canadian economies plod through a year of economic stagnation, the last wave of boomer retirements may keep the jobs market tighter than expected.

Where we are right now

Many of the questions that we struggled with in 2023 remain top-of-mind as we enter a new year: Will the Fed start cutting rates in the first half of 2024, or were policymarkers serious about their "higher for longer" projection in June? Will the Magnificent Seven mega-caps continue to dominate equity markets, or will we begin to see a return to value investing? Will global conflicts begin to cool, or will we see an escalation of geopolitical tensions?

This much we know for sure: Here in North America, we are still in the late stages of the economic cycle, waiting patiently to see whether central banks have done enough to bring down inflation while preventing a deep recession — the elusive soft landing we're all hoping for. Here's how we've positioned to manage these "known unknowns."

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

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

Equities (neutral): We believe that the equity market has a balanced return outlook. Earnings growth has been challenged over the year but is now starting to stabilize and show signs of positive momentum. Despite the recent rally, some of the more cyclical areas of the market remain attractive from a valuation standpoint.

Fixed Income (modest overweight): As the normalization of inflation appears to be slowing alongside waning economic growth, the Bank of Canada continues to debate the need to further tighten monetary policy and to reinforce its higher-for-longer policy rate path. On the flip side, this may also imply higher-for-longer income returns within the asset class. We continue to believe that fixed income will outperform equities over the next 12 months and that bonds can still provide diversification benefits, reduce overall portfolio volatility and preserve capital.

Alternatives (neutral): We believe that an allocation to alternative assets can benefit diversified portfolios especially when implemented over the long-term. 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 2: Strategic and dynamic asset-class weights by investor profile

Asset Class	Balanced Income		Balanced		Balanced Growth		Growth		Aggressive Growth	
	Strategic	Dynamic	Strategic	Dynamic	Strategic	Dynamic	Strategic	Dynamic	Strategic	Dynamic
Cash	2.0%	1.0%	2.0%	1.0%	2.0%	1.0%	2.0%	1.0%	2.0%	1.0%
Public Fixed Income	56.0%	57.0%	41.0%	42.0%	26.0%	27.0%	16.0%	17.0%	0.0%	1.0%
Domestic Government Bonds	24.0%	26.0%	17.0%	19.0%	11.0%	13.0%	6.0%	8.0%	0.0%	1.0%
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%
Public Equities	32.0%	32.0%	42.0%	42.0%	57.0%	57.0%	67.0%	67.0%	85.0%	85.0%
Canadian	10.0%	10.0%	12.0%	12.0%	17.0%	17.0%	20.0%	20.0%	25.0%	25.0%
U.S.	13.0%	15.0%	17.0%	19.0%	23.0%	25.0%	27.0%	29.0%	35.0%	37.0%
International	6.0%	4.0%	8.0%	6.0%	11.0%	9.0%	13.0%	11.0%	15.0%	13.0%
China/Emerging Markets	3.0%	3.0%	5.0%	5.0%	6.0%	6.0%	7.0%	7.0%	10.0%	10.0%
Alternatives	10.0%	10.0%	15.0%	15.0%	15.0%	15.0%	15.0%	15.0%	13.0%	13.0%
Commercial Mortgages	4.0%	5.0%	4.0%	5.0%	4.0%	5.0%	4.0%	5.0%	0.0%	0.0%
Private Debt	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	0.0%	0.0%
Real Estate	1.0%	0.0%	3.0%	1.0%	3.0%	1.0%	3.0%	1.0%	4.0%	3.0%
Infrastructure	2.0%	2.0%	5.0%	6.0%	5.0%	6.0%	5.0%	6.0%	9.0%	10.0%
Fixed Income	58.0%	58.0%	43.0%	43.0%	28.0%	28.0%	18.0%	18.0%	2.0%	2.0%
Equity	32.0%	32.0%	42.0%	42.0%	57.0%	57.0%	67.0%	67.0%	85.0%	85.0%
Alternatives	10.0%	10.0%	15.0%	15.0%	15.0%	15.0%	15.0%	15.0%	13.0%	13.0%

Condensed

Asset Class	Balanced Income		Balanced		Balanced Growth		Growth		Aggressive Growth	
	Strategic	Dynamic	Strategic	Dynamic	Strategic	Dynamic	Strategic	Dynamic	Strategic	Dynamic
Cash	2.0%	1.0%	2.0%	1.0%	2.0%	1.0%	2.0%	1.0%	2.0%	1.0%
Public Fixed Income	63.0%	64.0%	48.0%	49.0%	33.0%	34.0%	23.0%	24.0%	0.0%	1.0%
Government	32.0%	33.0%	24.0%	25.0%	17.0%	18.0%	11.0%	12.0%	0.0%	1.0%
Corporate	31.0%	31.0%	24.0%	24.0%	16.0%	16.0%	12.0%	12.0%	0.0%	0.0%
Public Equities	35.0%	35.0%	50.0%	50.0%	65.0%	65.0%	75.0%	75.0%	98.0%	98.0%
Canadian	11.0%	11.0%	15.0%	15.0%	20.0%	20.0%	23.0%	23.0%	29.0%	29.0%
U.S.	14.0%	16.0%	20.0%	22.0%	26.0%	28.0%	30.0%	32.0%	40.0%	42.0%
International	7.0%	5.0%	10.0%	8.0%	13.0%	11.0%	15.0%	13.0%	19.0%	17.0%
China/Emerging Markets	3.0%	3.0%	5.0%	5.0%	6.0%	6.0%	7.0%	7.0%	10.0%	10.0%

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

Figure 3: Evolution of leading and lagging indicators

	Summary table (Out of 100 Score)	Nov-22	Dec-22	Jan-23	Feb-23	Mar-23	Apr-23	May-23	Jun-23	Jul-23	Aug-23	Sep-23	Oct-23	Nov-23
Economic and Leading Indicators	Conference Board US Leading Indicator	12.9	10.6	10.6	9	7.7	7.6	8.7	8.7	11	9.9	9.5	9.9	9.9
	ISM Manufacturing PMI	12.5	9.4	5.9	7	4.2	7.2	6.8	3.8	5.7	8.7	14.8	6.1	6.1
	ISM Services PMI	48.4	6.6	41.3	40.5	12.8	14.5	10.3	32.4	20.2	37.7	28.6	13.7	13.7
	ZEW US Expectations of Economy	11	17.7	33	47.2	25.6	19	12.5	17.9	16	37	33.2	23.2	20.9
	10/2-year Spread	0.3	1.5	0.7	0	2.3	2.6	1.1	0	0.3	1.5	3.8	6.4	4.9
Goods Sector	ISM New Orders/Inventories	5.9	3.1	1.9	7.4	7.3	11.4	6.4	20.2	17.9	25.1	27.4	22.1	30.1
	US Industrial Production, %yoy	45.6	31.1	38.9	31.8	28.7	31.6	30.5	27.4	30.1	29	28.2	24.8	24.8
	Sales to Inventory Ratio	3.9	2.7	4.7	1.9	2.7	1.9	5.7	1.9	5.7	6.8	4.5	4.5	4.5
	US Durable Goods New Orders ex-Transport, %yoy	40.1	31.1	38.5	36.6	34.6	30.5	33.2	33.5	35.8	38.1	40	40.8	40.8
	Capital Goods New Orders Nondefense ex-Aircraft, %yoy	50.3	39.7	62.2	47.6	43.5	39.6	51.5	43.8	37.4	38.5	38.1	40.8	40.8
	US Capacity Utilization, %	82.2	68.5	76.3	75.5	74.7	78.6	75.1	68.3	76.3	75.5	74	66.4	66.4
Consumer Spending	Conference Board Consumer Confidence	59.4	76.7	71.6	64.1	66.5	64.8	60.3	78.6	82.8	76.3	66.4	54.9	59.5
	University of Michigan Consumer Sentiment	2.3	5.5	10.6	12.5	8.5	10.3	4.5	11.8	22.1	18.3	16.7	11.4	8.3
	Adjusted Retail & Food Services Sales, %yoy	74	72.4	85.8	66.1	17.1	8	15.6	8.7	24.8	24.8	47.7	20.2	20.2
	US GDP Real Disposable Personal Income, %yoy	3.5	7	7	7	57.9	76.7	76.7	92.3	92.3	92.3	84.3	84.3	84.3
	US Job Openings, %yoy	25.5	24	18.5	13.3	10.5	15.6	12.5	12.2	9.1	23.6	16	20.2	17.1
	US Auto Sales Total Annualized, %yoy	81.4	75.5	64.9	71.2	85.9	85.8	96.1	96.5	95.4	91.6	93.5	61.8	76.3
Job Market	US Initial Jobless Claims (inversed)	94.1	97.7	99.7	89.8	86.8	79.4	82.1	76.8	85.9	84	95.5	89.4	90.9
	US Employees on Nonfarm Payrolls, mom chg	80.7	68.8	92.1	71.2	61.8	62.2	79	32.8	68.7	48.8	81.6	44.6	44.6
	Kansas City Fed Labor Market Conditions	94.8	95.6	95.2	94.4	90.6	91.6	89.6	86.2	93.1	82.8	85.1	81.6	81.6
	ISM Manufacturing Report on Business Employment	24.8	37.4	35.8	25.5	16.3	33.2	43.8	22.5	7.2	24	40.8	16	11.8
	US Employees: Temporary Help Services	96.4	94	95.2	94.4	93.3	93.1	92.7	88.1	84.7	82	79	81.2	81.2

Source: FactSet, Wealth Investment Office, as of November 30, 2023.

Leading economic indicators in the U.S. continue to point to a slowdown. Traditional gauges of future industrial and economic activity are now, on average, within the 30th percentile of their historical ranges (Figure 3), and they're still deteriorating. Consumer confidence, however, has remained strong, even as individuals express pessimism over the economy. This apparent contradiction is a result of the strength of labour markets. A shortage of workers has kept wage growth elevated, allowing some consumers to shrug off the forthcoming downturn.

Job creation, which is typically a lagging indicator, remains the focus for most investors. It remains healthy for now, but in recent months employment gains have been lower than expected and are expected to decelerate further. The rising trend in the unemployment rate bodes ill for household income, which should translate to a further reduction in spending and economic growth. Already, retail sales are decelerating as consumers begin to cut back on spending.

The accompanying table (Figure 4) shows the historical percentile ranking for indicators in major global economies, highlighting the deteriorating trend in the U.S., Canada, Europe and Japan. The European and Canadian economies are more vulnerable to recession given the magnitude of shock these economies have experienced from tightening monetary policy. Canadian households, for example, are more levered compared to those in the U.S., while European economies have been suffering disproportionately due to the Ukraine-Russia war and tensions in the Middle East.

Figure 4: Evolution of indicators for major economies

		Nov-22	Dec-22	Jan-23	Feb-23	Mar-23	Apr-23	May-23	Jun-23	Jul-23	Aug-23	Sep-23	Oct-23	Nov-23	1-year Change
U.S.	Manufacturing PMI	0.186	0.15	0.114	0.129	0.086	0.107	0.103	0.075	0.1	0.121	0.191	0.102	0.102	↓
	Non-manufacturing PMI	0.508	0.082	0.44	0.433	0.15	0.172	0.129	0.336	0.225	0.39	0.308	0.17	0.17	↓
	Industrial Production, %y/y	0.48	0.344	0.419	0.358	0.318	0.326	0.301	0.29	0.315	0.308	0.301	0.265	0.265	↓
	Retail Sales, %y/y	0.749	0.738	0.867	0.67	0.164	0.082	0.154	0.093	0.243	0.243	0.485	0.198	0.198	↓
	Unemployment Rate	0.965	0.993	1	0.965	0.993	1	0.922	0.965	0.993	0.897	0.898	0.862	0.862	↓
	Job Vacancies, %y/y	0.273	0.257	0.2	0.146	0.111	0.161	0.13	0.126	0.096	0.23	0.163	0.205	0.174	↓
Canada	Manufacturing PMI	0.21	0.184	0.315	0.342	0.052	0.289	0.157	0.105	0.21	0.026	0	0.097	0.024	↓
	Economic Mood Index	0.014	0.036	0.043	0.05	0.086	0.101	0.188	0.202	0.159	0.173	0.134	0.099	0.092	↑
	Industrial Production, %y/y	0.434	0.227	0.735	0.264	0.097	0.256	0.666	0.195	0.776	0.369	0.269	0.879	0.357	↓
	Retail Sales, %y/y	0.551	0.684	0.566	0.354	0.15	0.218	0.064	0.053	0.15	0.103	0.216	0.216	0.216	↓
	Unemployment Rate	0.979	0.99	0.99	0.99	1	1	1	0.957	0.957	0.957	0.947	0.947	0.947	↓
	Job Vacancies, %y/y	0.238	0.079	0.17	0.125	0.056	0.068	0.034	0.022	0	0.011	0	0.032	0.087	↓
Europe	Manufacturing PMI	0.157	0.236	0.315	0.289	0.184	0.105	0.078	0.026	0	0.052	0.048	0.024	0.121	↓
	Non-manufacturing PMI	0.23	0.333	0.435	0.564	0.692	0.871	0.717	0.538	0.461	0.153	0.309	0.142	0.214	↓
	Industrial Production, %y/y	0.767	0.161	0.422	0.544	0.204	0.326	0.139	0.243	0.146	0.075	0.06	0.06	0.06	↓
	Retail Sales, %y/y	0.043	0.035	0.093	0.053	0.021	0.043	0.093	0.2	0.2	0.121	0.035	0.035	0.035	↓
	Unemployment Rate	0.99	0.968	0.968	0.968	0.968	0.968	0.968	1	1	1	0.947	0.947	0.947	↓
	Job Vacancies Rate	0.651	0.651	0.651	0.651	0.651	0.651	0.651	0.651	0.651	0.651	0.642	0.642	0.642	↓
Japan	Manufacturing PMI	0.21	0.157	0.157	0.078	0.263	0.289	0.447	0.368	0.315	0.315	0.146	0.17	0.121	↓
	Non-manufacturing PMI	0.538	0.641	0.717	0.846	0.948	0.974	1	0.846	0.82	0.923	0.809	0.619	0.642	↑
	Industrial Production, %y/y	0.297	0.387	0.2	0.297	0.351	0.451	0.652	0.433	0.243	0.179	0.205	0.351	0.351	↑
	Retail Sales, %y/y	0.842	0.82	0.67	0.82	0.677	0.569	0.677	0.483	0.584	0.627	0.574	0.602	0.602	↓
	Unemployment Rate	0.959	0.993	0.959	0.921	0.804	0.846	0.846	0.887	0.887	0.846	0.881	0.922	0.922	↓
	Jobs to Applicants Ratio	0.824	0.835	0.824	0.817	0.802	0.802	0.788	0.781	0.77	0.77	0.762	0.776	0.776	↓
China	Manufacturing PMI	0.263	0.105	0.157	0.763	0.368	0.289	0.578	0.5	0.157	0.657	0.512	0.268	0.585	↑
	Non-manufacturing PMI	0.076	0.128	0.384	0.692	0.948	0.871	0.923	0.487	0.538	0.307	0.19	0.261	0.261	↑
	Industrial Production, %y/y	0.021	0.01	0.01	0.01	0.053	0.132	0.035	0.078	0.043	0.089	0.088	0.095	0.095	↑
	Retail Sales, %y/y	0.014	0.025	0.025	0.025	0.422	0.91	0.594	0.075	0.06	0.1	0.124	0.138	0.138	↑
	Unemployment Rate	0.099	0.198	0.198	0.121	0.341	0.55	0.55	0.55	0.341	0.55	0.894	0.894	0.894	↑

Source: FactSet, Wealth Investment Office, as of November 30, 2023.

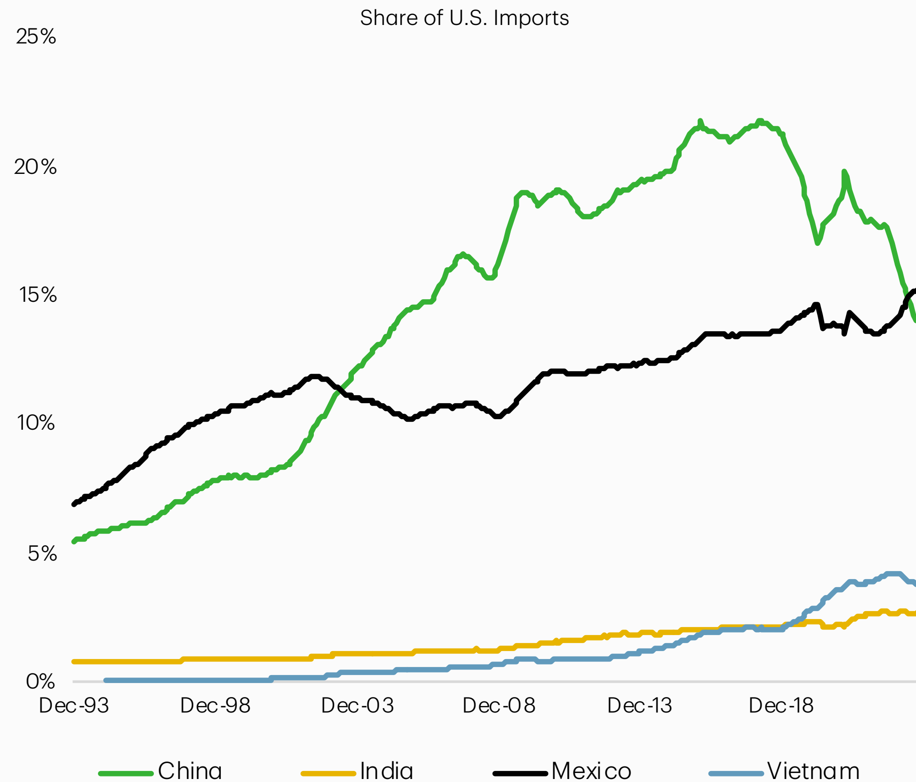
Although the economic recovery of China was disappointing in 2023, macro indicators coming out of the Middle Kingdom have been improving over the past few months, in contrast to the worsening trajectory for developed economies. We have seen China's industrial production and retail sales start to rebound, while policymakers there continue to gradually ease monetary and fiscal policies, acknowledging the weaker-than-expected economy. The years-long crisis in the Chinese property sector continues to pose a risk for Chinese consumer spending and the country's banks. However, given the slowing growth outlook across developed countries going into 2024, China will likely contribute to a greater share of global growth in 2024.

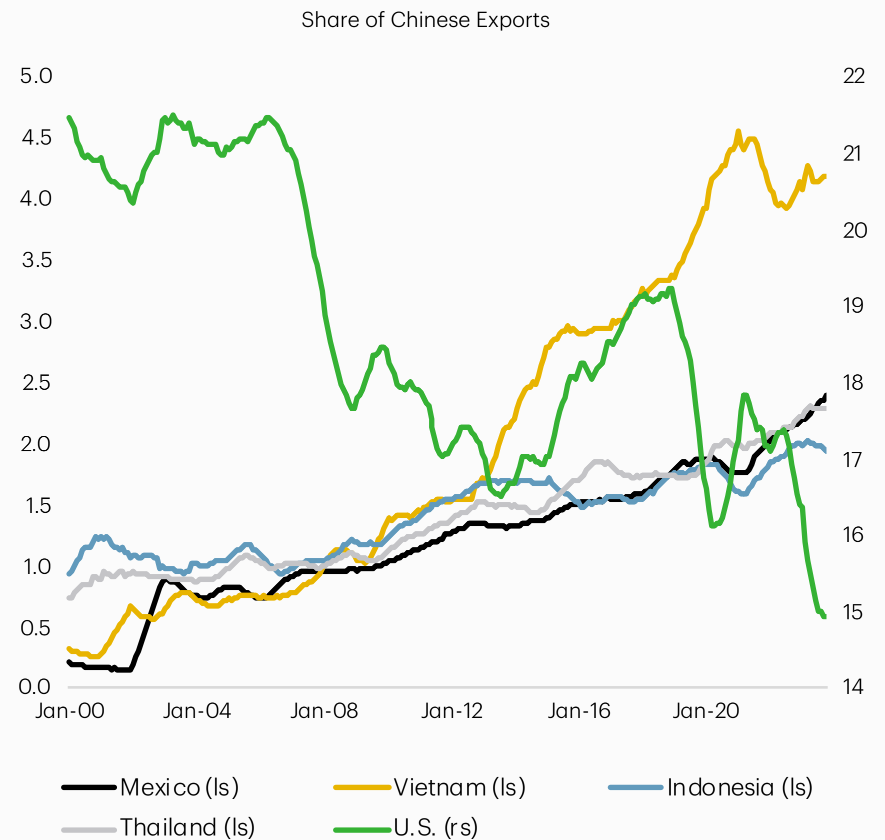
Where we’re headed

Rising geopolitical tension between the U.S. and China have rejigged trade flows globally, allowing for the integration of emerging and frontier economies into the global supply chain. Because trade ties tend to improve relationships between economies, it's to be expected that the fragmentation of the global economy will lead to rising geopolitical risk. As such, there will be winners and losers from the shift in trade flows, with several emerging-market nations benefitting from the "China plus one" strategy. Vietnam, for example, has been gaining market share as a destination for Chinese and global exports. Other Asian countries and Mexico could also benefit from this trend, either through the establishment of manufacturing bases by foreign companies, or as a location where Chinese goods pass through before being re-exported to the West.

1. 'Friend-shoring' will continue as deglobalization takes hold

Certain countries will be net beneficiaries from the global supply-chain reorganization.





Source: Wealth Investment Office as of November 27, 2023.

2. Defense spending to rise amid heightened tensions

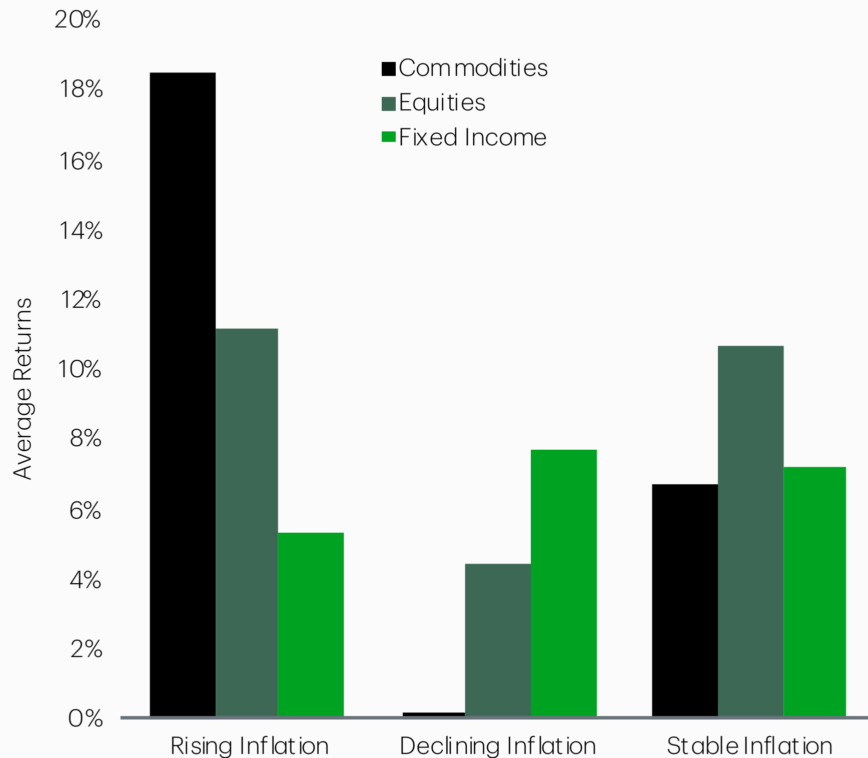
Global leaders have increasingly pushed their nations toward protectionism and adversarial regionalism — a world where it's about us and them.

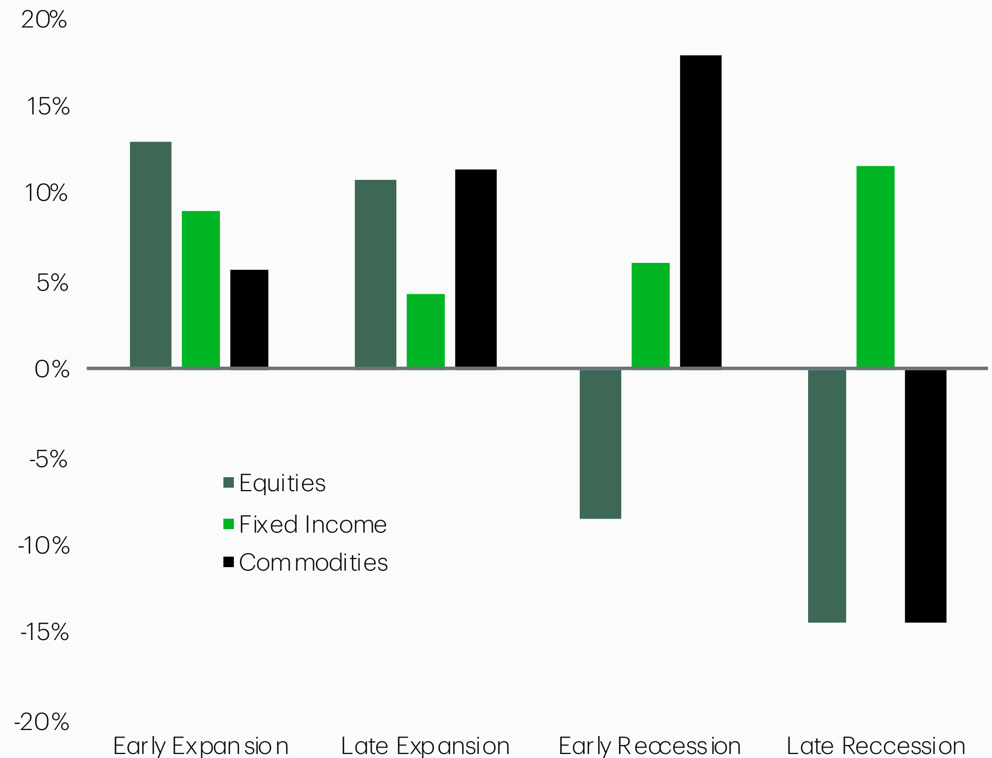
Source: Wealth Investment Office as of November 27, 2023.

The impact of geopolitical risk on financial markets is usually short-lived; however, that risk premium — whereby equity investors demand a higher potential return to compensate for the higher risk — may linger in the markets. During times of war, governments also tend to allocate more funds to defense spending and less money on social welfare, with obvious benefits for the defense industry. On the other hand, the risk of armed conflict may depress sentiment in certain regions, and it may also have long-term implications for the creditworthiness, and therefore the currency of nations that are increasing deficits and taking on more debt. The U.S. dollar, for instance, which remains highly valued despite steep deficits and credit downgrades, may face headwinds as a result of the geopolitical environment.

3. Commodities to outperform

Inflation is likely to stay above the 2% target level for longer than expected.





Source: Refinitv Datastream, TD Asset Management as of March 31, 2023.

In a world of rising geopolitical tension, countries will want to secure a supply of raw materials. Low prices have kept miners from investing in new projects, even as the need for base metals has risen. The transition to renewable infrastructure will require an enormous influx of raw materials, which should boost prices. On the energy side, meanwhile, worries about renewables may be exaggerated. It's true that, over the span of 30 years or so, energy demand will increasingly be met by renewable options, but until then oil and gas will be necessary. Here too, underinvestment will likely lead prices, which have recently been depressed by weak Chinese demand, to rise. Policymakers there are boosting economic stimulus, and energy demand is poised to rise. Precious metals, finally, benefit from heightened geopolitical risk and the potential for U.S. dollar weakness. It's a world in which commodities are expected to perform well.

4. China to recover from its economic woes

Chinese policymakers have to balance the need to maintain growth along with domestic financial stability.

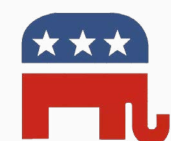
Source: Wealth Investment Office as of November 27, 2023.

Chinese policymakers have begun to acknowledge the nation's weak growth conditions and are, as a result, stimulating the economy, while the property crisis is being contained so far (at the expense of the state-owned banks). As such, we think the Chinese economy has hit its cyclical bottom. Growth numbers have been improving over the past quarter, and we think they'll continue to do so. This improved outlook on China bodes well for base metals as well as European economies, given their strong trade ties. China could be first in, first out in the cycle.

5. A Trump win could dramatically alter the landscape

U.S. equity markets have historically rallied 12% during election years. Could it be different this time?

Election Year
S&P 500 Index Return
Avrage (1928 - 2020)



+15%

+8.5%

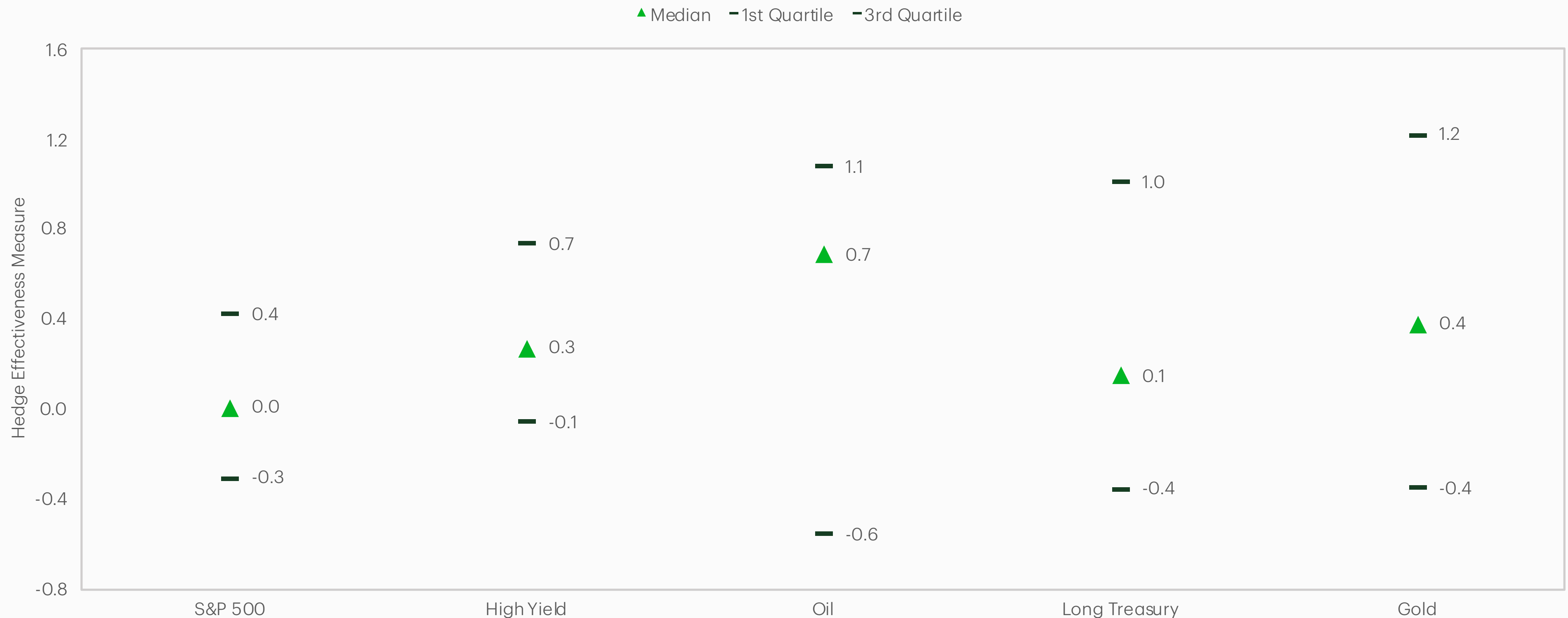
Election Year	President	House	Senate	S&P 500 Index Total Return
1928	Hoover	R	R	43.60%
1932	Roosevelt	R	R	-8.20%
1936	Roosevelt	D	D	33.90%
1940	Roosevelt	D	D	-9.80%
1944	Roosevelt	D	D	19.80%
1948	Truman	R	R	5.50%
1952	Eisenhower	D	D	18.40%
1956	Eisenhower	D	D	6.60%
1960	Kennedy	D	D	0.50%
1964	Kennedy/Johnson	D	D	16.50%
1968	Nixon	D	D	11.10%
1972	Nixon/Ford	D	D	19.00%
1976	Carter	D	D	23.80%
1980	Reagan	D	D	32.40%
1984	Reagan	D	R	6.30%
1988	Bush	D	D	16.80%
1992	Clinton	D	D	7.70%
1996	Clinton	R	D	23.10%
2000	Bush W.	R	R	-9.10%
2004	Bush W.	R	R	10.90%
2008	Obama	D	D	-37.00%
2012	Obama	R	D	16.00%
2016	Trump	R	R	12.00%
2020	Biden	D	R	18.40%
		Election Year Historical Average S&P 500 Index Total Return		11.59%

Source: Senate.gov, Whitehouse.gov, and House.gov, FactSet as of December 31, 2020.

The year preceding a U.S. presidential election has historically coincided with decent equity performance, although the range is admittedly wide: from the 44% ascent enjoyed during the Roaring '20s Hoover campaign (in the lead-up to the Great Depression) all the way to the 37% plunge suffered during the financial-crisis Obama campaign. It should also be noted that, in the year preceding a Republican victory, stocks rose 15%, compared to 9% for Democrats. We are not political analysts and are certainly not making any predictions about who might be President in 2025, but with Trump leading in many of the polls, we are preparing for the possibility of a second Trump term and what that would mean for the U.S. economy and global markets. So-called "entitlement spending" (health care and pensions) could be vulnerable under Trump, but so too could defense spending, if Trump were to cut off support for Ukraine. Investors might benefit from a move to deregulate the financial industry, although that would come at the cost of longer-term risks. Further, a Trump presidency would signal a more volatile style of diplomacy, with greater focus on domestic issues (like the southern border) at the expense of foreign issues (like the U.S.-China relationship). Most importantly, a Trump presidency has the potential to strain the union itself, making the management of tail risks highly important in 2024.

6. Hedging amid heightened geopolitical uncertainty

Geopolitical risk is better hedged using commodities and bonds

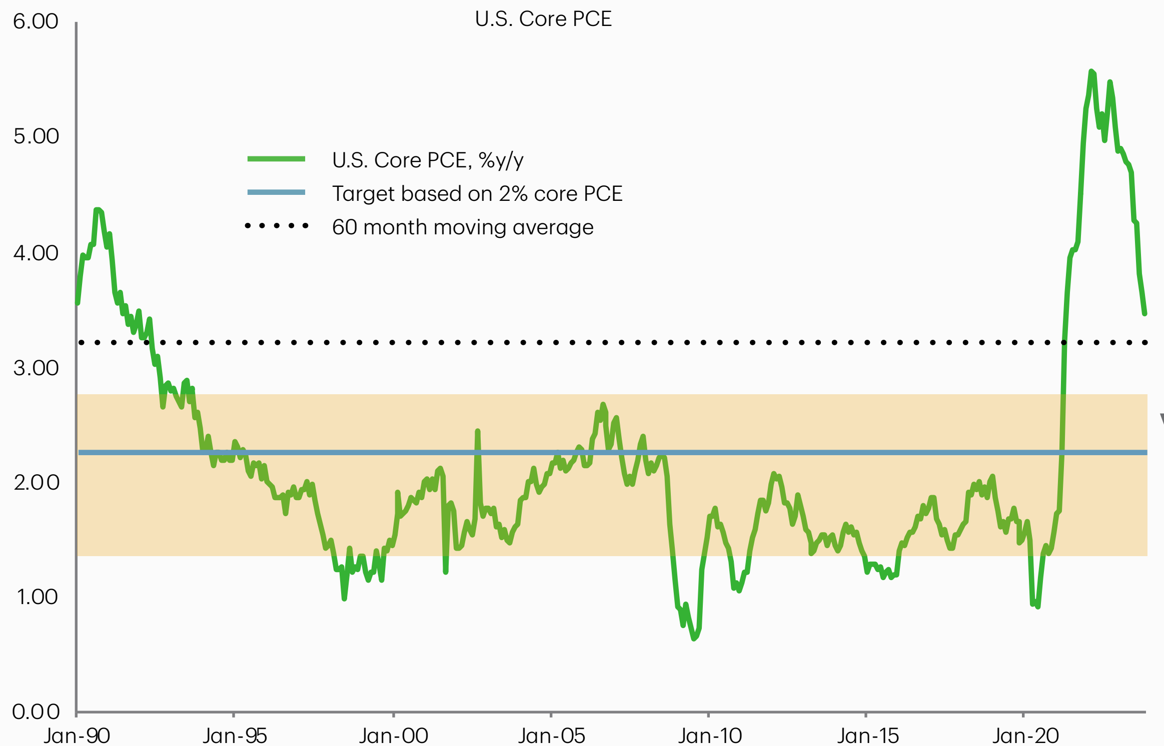


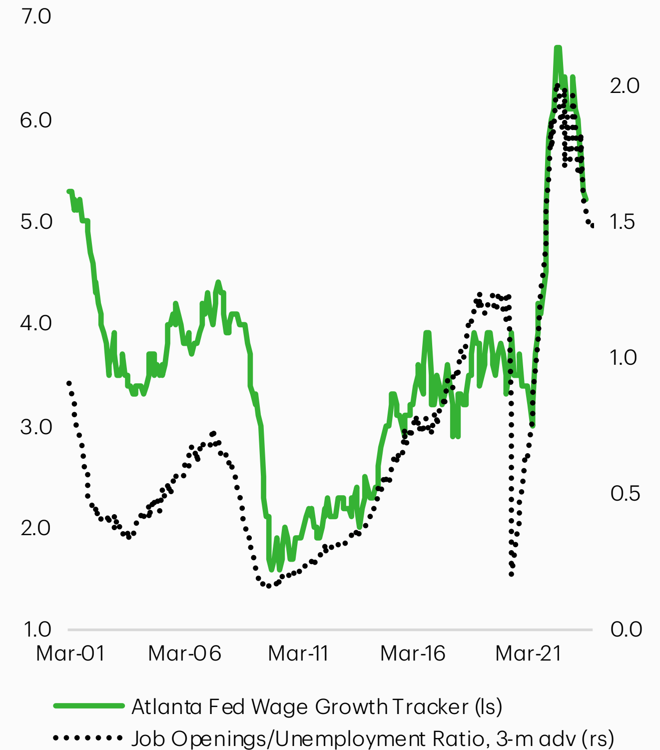
Source: FactSet, policyuncertainty.com, Wealth Investment Office as of November 30, 2023; hedge effectiveness is defined by using realized 1-month return divided by the implied volatility of 25-delta options when the Global Gepolitical Risk index experiences top decile increase.

We continue to believe that global geopolitical risk will intensify in the coming years, so we want to allocate to asset classes that we believe are best suited to reduce the risks and provide enhanced diversification. With this in mind, we consider the effectiveness of using protection options in different asset classes during periods of heightened geopolitical risk. To test this, we consider the impact on different option/protection strategies when the global geopolitical index escalates. If the realized asset price change significantly surpasses the implied volatility embedded in the options before the event, that tends to lead us to believe that the assets tend to offer the best hedge/protection. Our work in this area suggests that oil and gold offers, perhaps, the best hedge against geopolitical risk, giving us another reason to have exposure, both passive and active, to commodities. Interestingly, although most of the time equity options are used as a form of protection, their effectiveness at hedging geopolitical risk is actually quite poor. This provides another reason for us to consider incorporating commodity-based strategies in our investment portfolios in the new year.

7. Reaching target inflation will be a hard slog

The battle against inflation has been a 2023 story, but the hard part back to the 2% target still ahead.



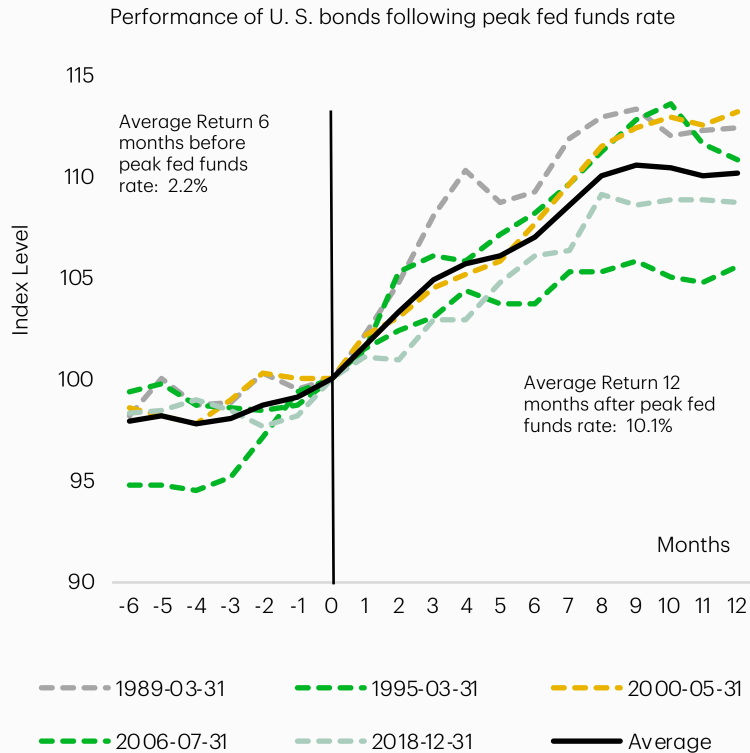


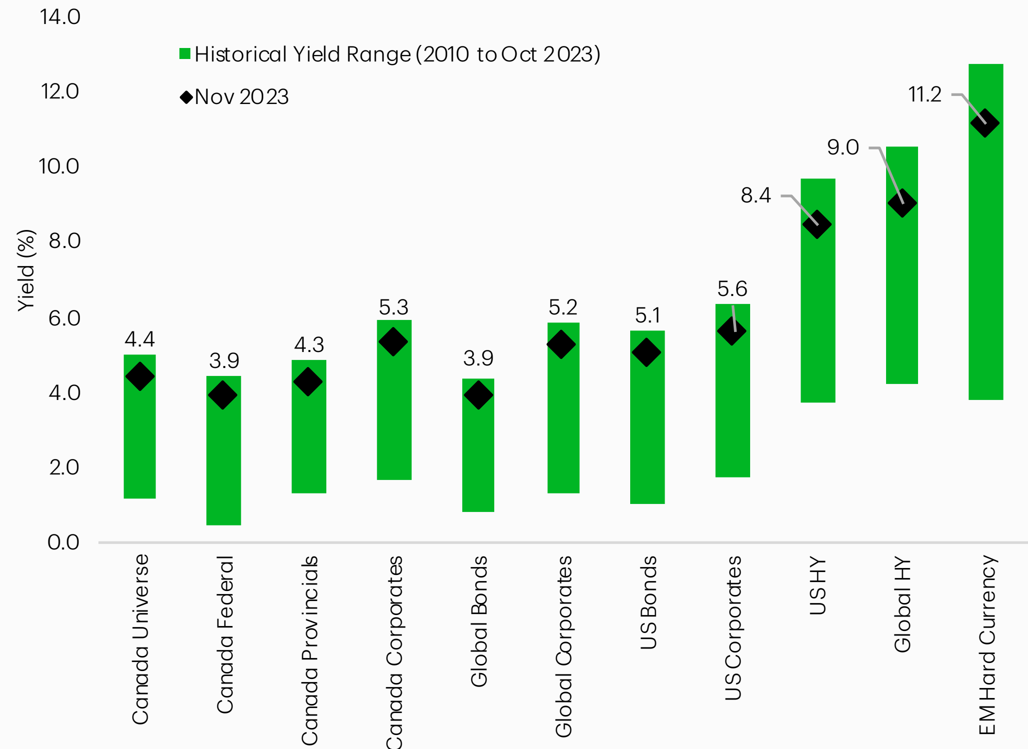
Source: Bureau of Economic Analysis as of December 1, 2023.

We've seen inflation come down faster than expected in the United States. Most categories are below the highs witnessed during the pandemic; some are even lower than the pre-pandemic level. Shelter costs, which accounts for 34% of the consumer price index, are coming down too, although it's taking some time to show up in the data. And even wage growth is starting to come down alongside an easing in the labour market — all of which is great news for investors looking for a rate cut in early 2024. But we think the easy gains on the inflation front are behind us and the trek back to the Fed's 2% target will be slower than the progress made over the past year. If it is, it could lend credence to the Fed's suggestion that a "higher for longer" policy rate may be required.

8. Fixed income to rebound from a volatile year (Old school income)

Yields remain near their historical high, a promising environment for bond investors.





Source: Factset, Wealth Investment Office as of November 30, 2023.

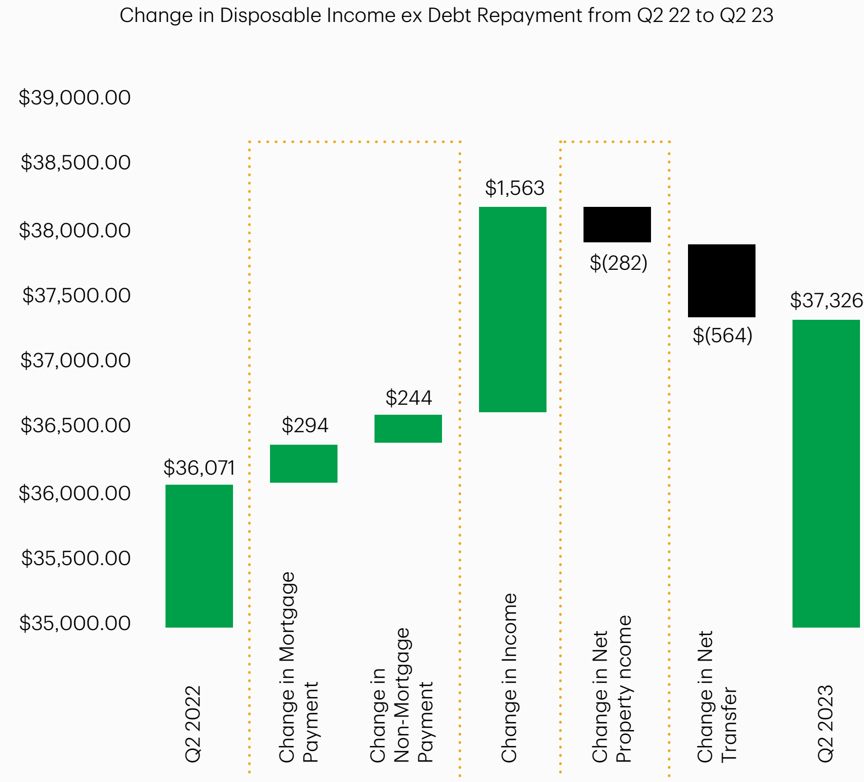
Our conviction for bonds remains strong.

Current yields are at levels not seen since the early 2000s and the bond market is well positioned to deliver attractive returns in the years ahead simply based on yield. History tells us that the biggest determinant for fixed income return is the current yield, and right now the yield is very attractive. Since the global financial crisis, as interest rates declined to zero per cent, fixed income returns were derived in large part from capital gains and to a lesser degree, from interest rates (yield). As we shift back to the 'old school era' of fixed income, we see returns derived in large part from interest income (yield) and to a lesser degree from capital gains.

With the current policy rate over 5%, the Fed will have room to cut rates if and when needed while maintaining the long-term neutral rate above 2.5%. That should result in 10-year government bond yields in the 3% to 4% range over the medium term. It's a promising time for fixed income investors across the spectrum.

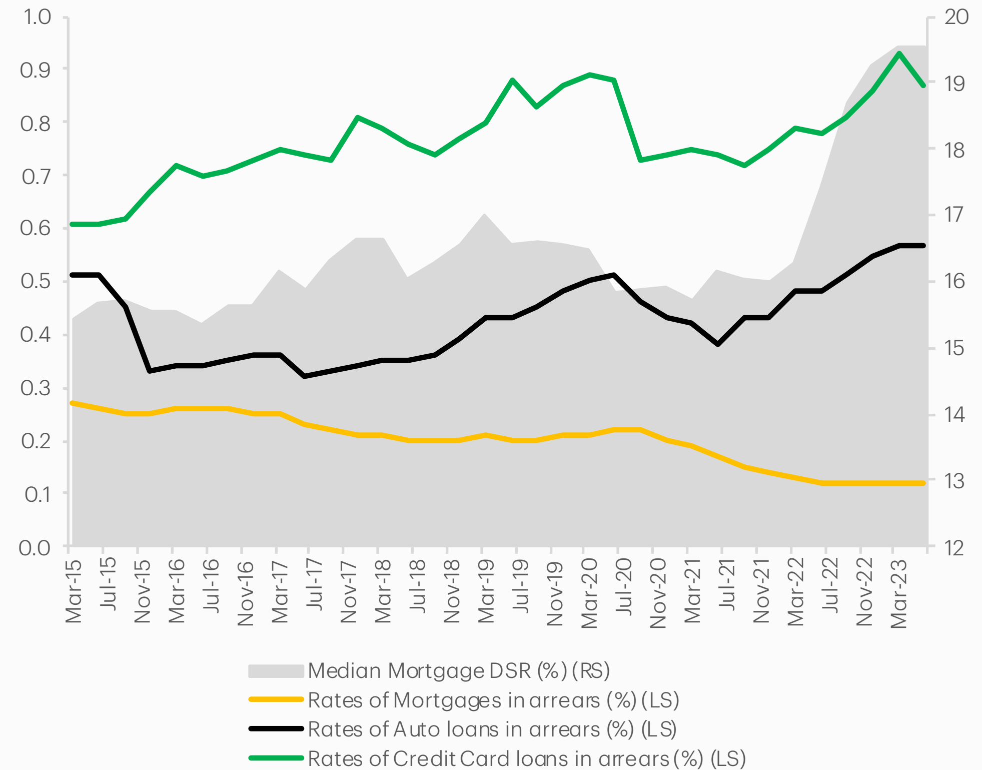
9. Higher interest costs to dampen consumer spending and borrowing

Households extending debt repayment ...



Source: Wealth Investment Office as of September 30, 2023.

... but mortgages remain a priority

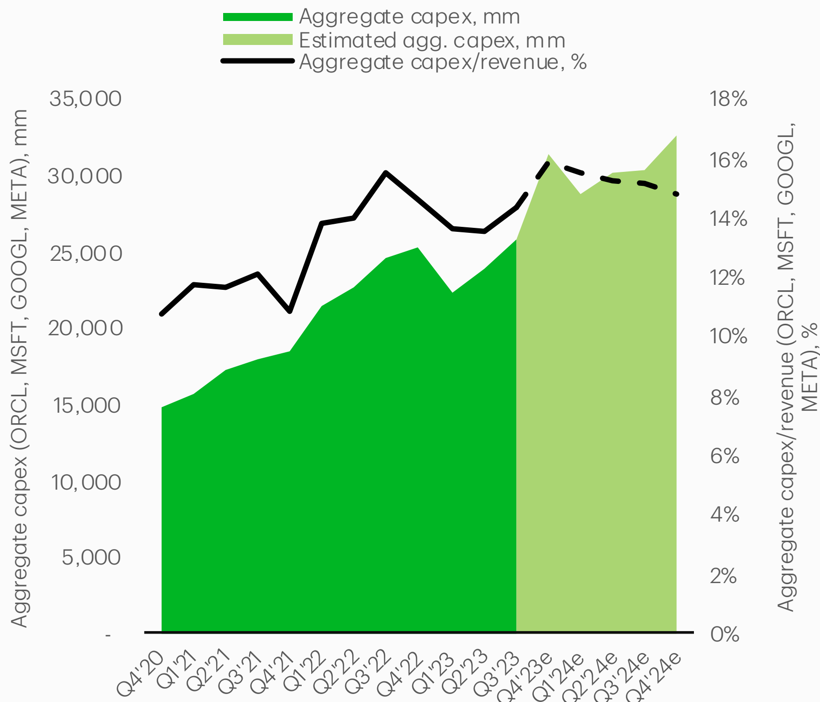


Source: Bank of Canada, FactSet, Wealth Investment Office as of November 8, 2023.

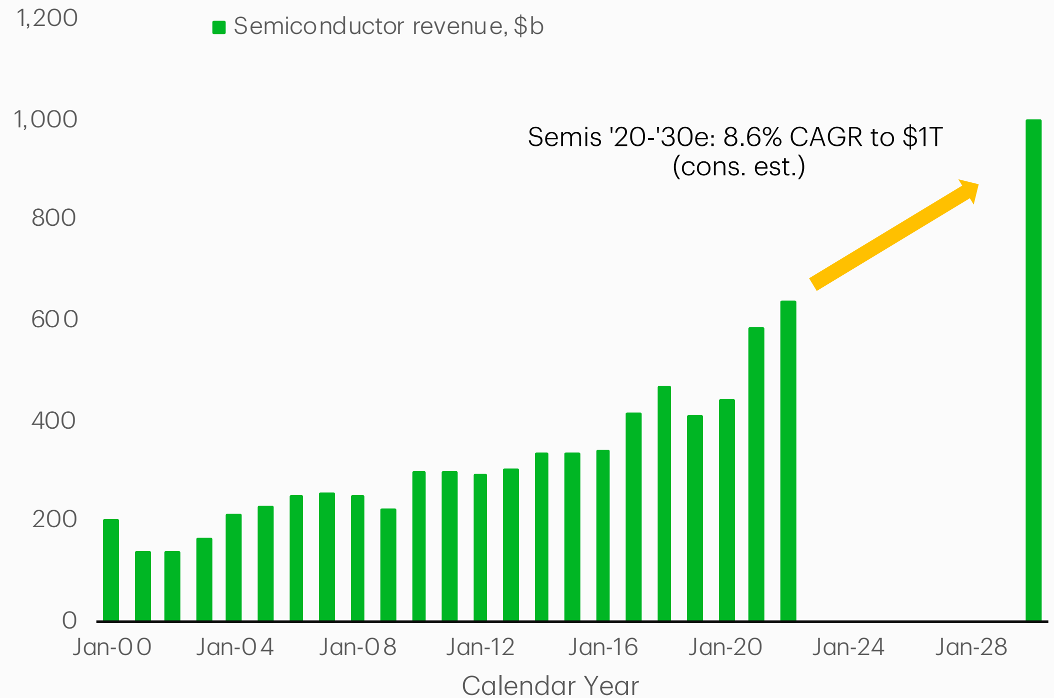
Aside from wage gains, Canadians are also enjoying higher interest income — although not enough to offset higher interest costs. Net interest expense per capita has risen by $282, leading consumers to delay debt repayment both for mortgages and other loans. Going forward, we know that employment income may not grow as quickly, and banks may not be able to provide the kinds of deferrals they have been. As a result, it's highly likely that growth in disposable income will slow, which would have a large impact on consumer spending. But will this translate into a spike in defaults and bankruptcies? Delinquencies are already trending higher, so it sure looks like we're heading towards the end of the credit cycle. It may take some time to play out, though, given the fact that we're coming off an era of exceptionally low interest rates, with defaults at extreme lows.

10. Development of AI to power ahead, despite any slowdown

Capital investments in AI are defying the trend of a general economic slowdown.



The semiconductor industry is set to bottom in 2024 before resuming its growth trajectory.

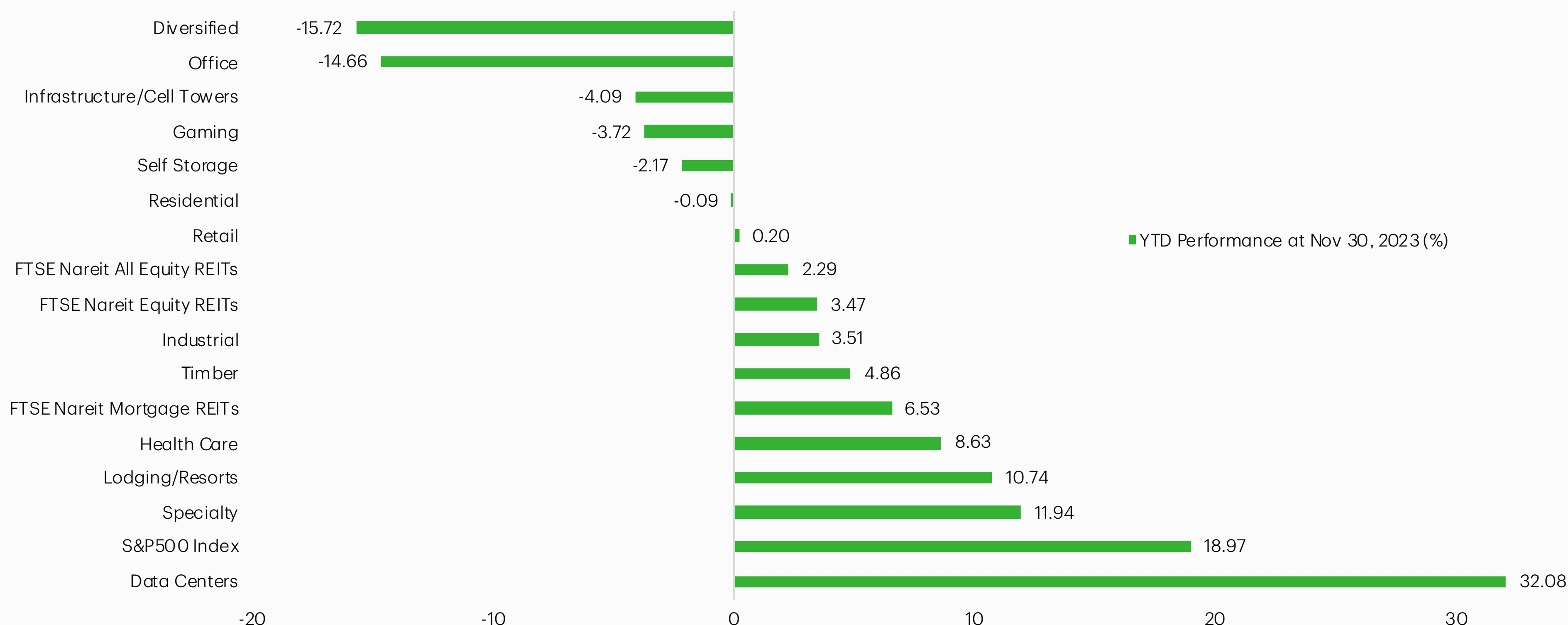


Source: FactSet, Wealth Investment Office as of November 28, 2023.

The AI revolution promises to cut costs and raise productivity across a gamut of industries, but getting it off the ground will require an enormous amount of infrastructure. In time, generative AI technology will make data a key competitive differentiator for companies that have collected vast amounts of proprietary information on customers, competitors, end markets and products, but only a few of the mega-caps will be able to overcome the initial investment barrier in order to develop new productivity tools. One area that is set to benefit immediately is semiconductor industry, which is set to double over the current decade, driven by multiple trends. The supply chain has been highly centralized, and inventory managed rigidly, which led to shortages during the pandemic. Geopolitical tensions are also a concern for some countries (i.e., China-US relations over Taiwan). We don't believe the AI sector will be immune from an economic downturn; however, the promise is such that healthy cash flows arising from new investment dollars will propel the industry toward rapid development.

11. Real estate performance will continue to diverge

Real estate performance has run the gamut, due to divergent trends in remote working and cloud computing.

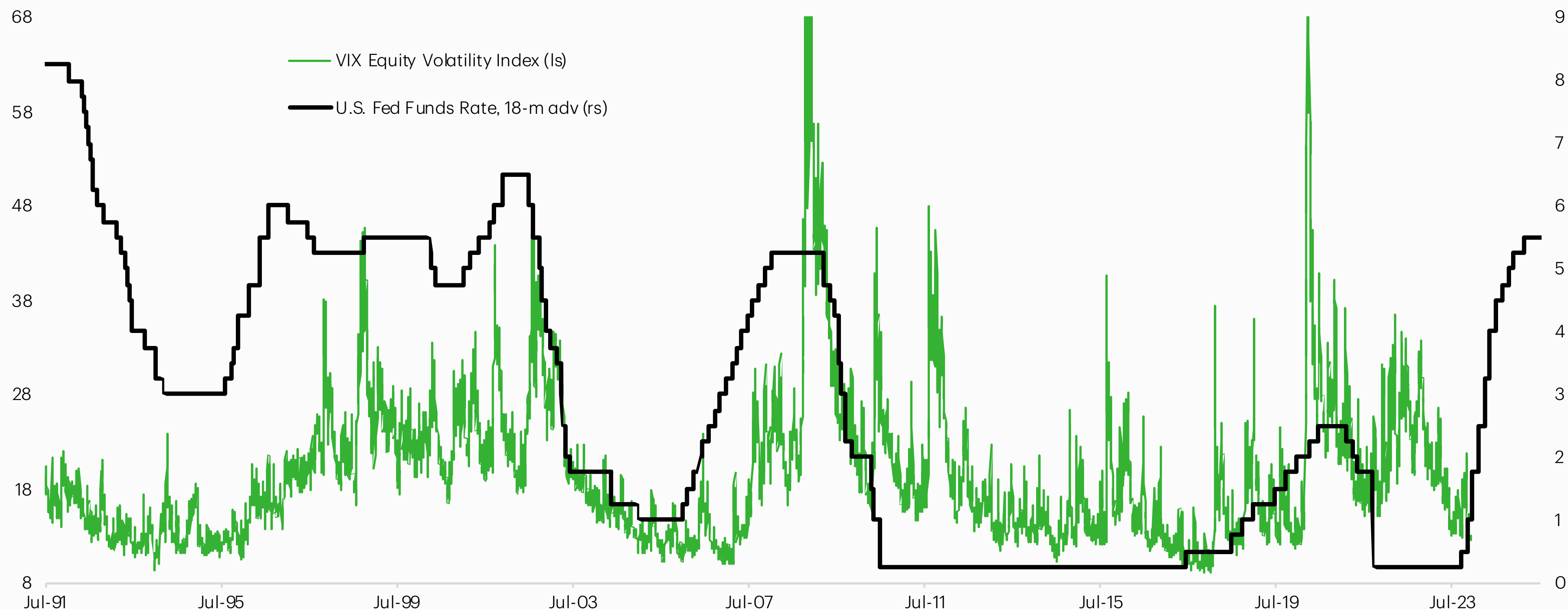


Source: Nareit, Wealth Investment Office as of October 31, 2023.

While vacancy rates for traditional offices in the U.S. are above 20%, and rents are under pressure, there are many other areas in the sector that have appeal. Logistics, for example, is enjoying vacancy rates at only 4% in the U.S. and rent growth that materially exceeds inflation, driven by e-commerce and onshoring of manufacturing. In the same way that e-commerce drove demand for warehouses, demand for data centres is being driven by cloud computing, content creation and the AI revolution. The sector is also experiencing regional divergence. In the United Kingdom and the Nordic countries, much of the repricing in commercial real estate has been done. In Germany less so, and in the United States it's about two-thirds done. Meanwhile, in Canada, it would be hard to argue that the pension funds have been quick, or prudent, in pricing their assets in the space.

12. Equity volatility likely to rise

Muted equity volatility this year will likely reverse in 2024

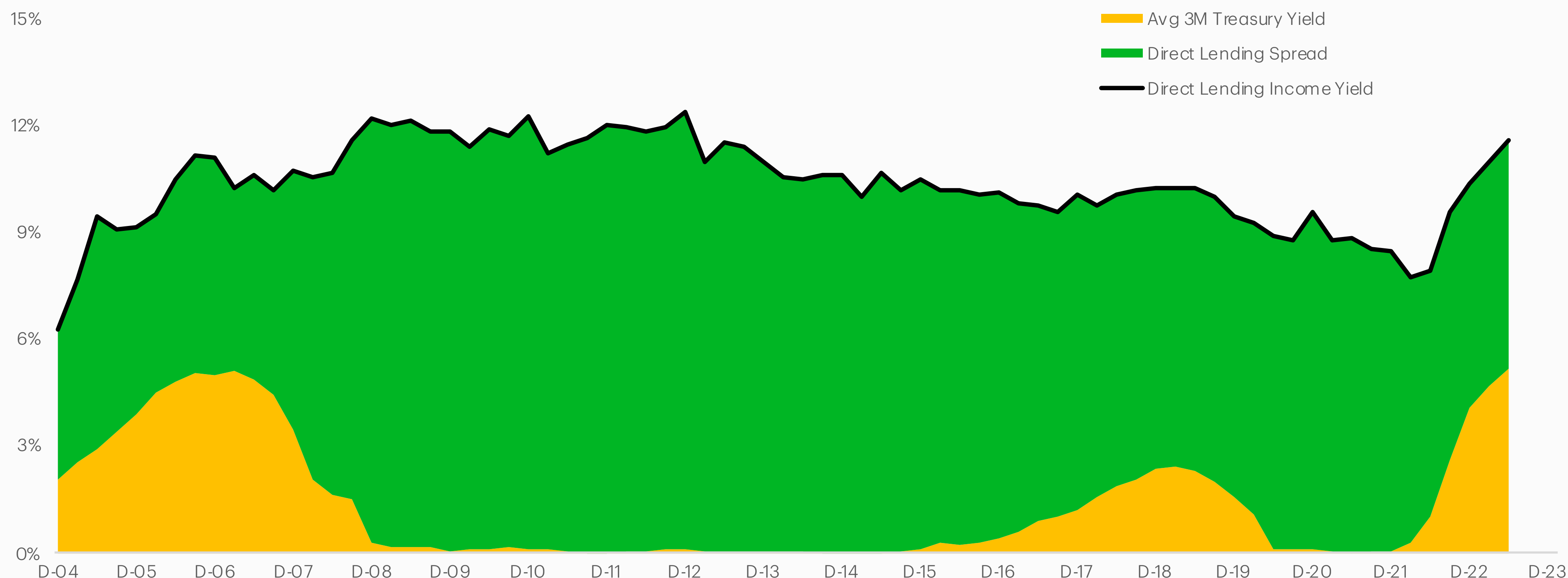


Source: FactSet, Wealth Investment Office as of December 2, 2023.

The fear of recession and muted equity returns early in 2023 turned out to be unwarranted as U.S. and global equity markets delivered double digit returns for the year. Although long-term bond yields did increase significantly throughout the first three-quarters of the year on the back of monetary-policy tightening, equity multiples expanded amid improving risk sentiment and positive news on AI. Equity earnings growth remained challenged, but investor optimism on the prospect of a soft landing supported equity valuations. Given the historical time lag between monetary policy tightening and its impact on the broader economy and financial market, plus the prevalent unstable geopolitical environment, we expect to see increased equity volatility in 2024. On a positive note, expectations that the Fed will start to cut its policy rate in 2024 could support higher equity valuations. However, investors need to be mindful of the softening employment and growth outlook, which could weigh on earnings growth this year.

13. Private assets present opportunities amid higher rates

Higher interest rate pushed direct lending yield close to the highest level since 2004



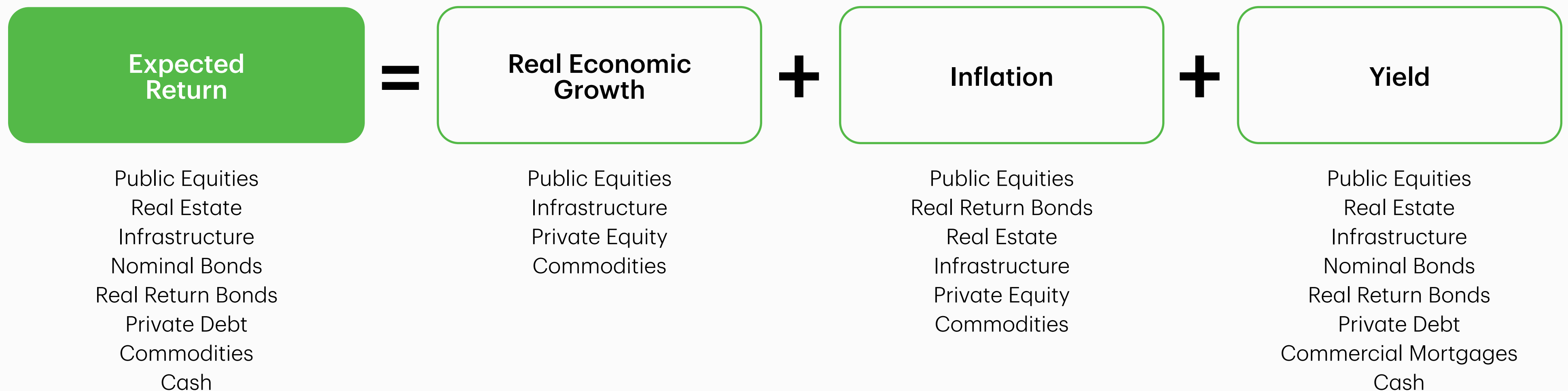
Source: FactSet, iCapital, Clffwater Direct Lending Index, Wealth Investment Office as of June 30, 2023.

We believe that 2024 will be a pivotal year for private markets. The key to finding opportunities within this space will be to distinguish the nuances for each type of private asset. For example, conventional wisdom is that higher interest rates are a negative for private assets. We believe this is misguided, given that most loans in the direct-lending space have floating rates. As a result, private debt may enjoy one of the best return environments since the global financial crisis. Current bank lending and corporate credit issuance have slowed, creating a structural opportunity for private lenders to not only fill the void but to pick the best borrowers — thanks to less competition. Private assets have been dominated by institutional investors for decades, as seen by high levels of allocation. Going forward, there will have to be a hand-off from existing investors, given that institutions have to rebalance their portfolios. This should create an opportunity for new entrants from the private wealth space, which are still holding historical amounts of cash after the pandemic. Further, the secondary market offers attractive potential returns for the new buyers. We believe this could lead to interesting opportunities in the secondary private-asset space as deals in that market restart. Last, but not least, the ailing office and retail space could present unconventional redevelopment opportunities. The huge bifurcation between the struggling and thriving real estate sectors could attract investors looking to buy the right properties at very low prices and repurpose them to profit from the large divide.

The long-term outlook

Each year, our partners at TD Asset Management develop long-term capital-market assumptions (CMAs) that serve as the foundation for our outlook on capital markets over the next seven to 10 years. These forecasts for major asset classes guide our decisions on strategic asset allocation and portfolio construction over the longer term. They are integral to our process-driven approach to investment management because they ground our investment process around a shared market outlook and a common set of economic inputs. We use the CMAs as building blocks for constructing forward-looking policy asset mixes and portfolios, based on the unique circumstances of our clients and engineered to achieve their goals.

Figure 1: Building-block approach

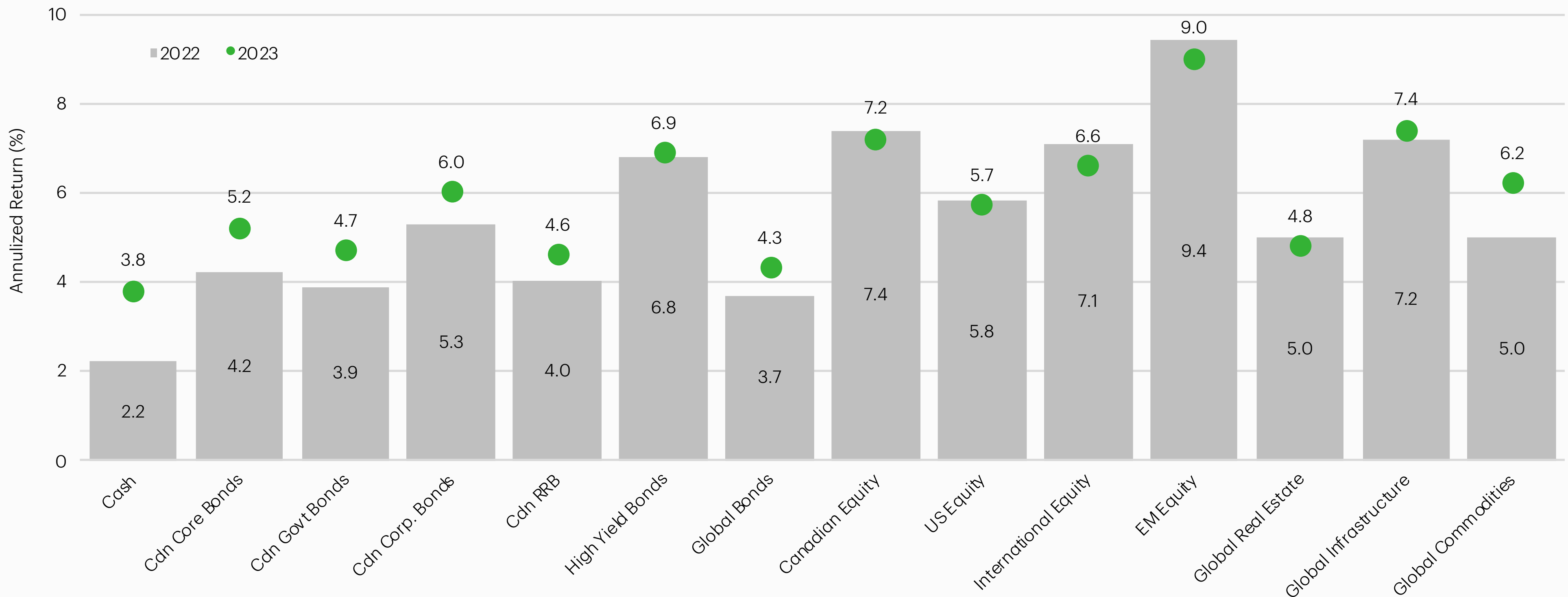


Since our last CMA update one year ago, financial markets have been quite volatile while the macroeconomic backdrop has remained much more resilient than most expected. From an economic perspective, with the resilience of the U.S. economy, the Federal Reserve and most central banks have maintained a hawkish stance given that inflation, while declining significantly over the year, still remains stubbornly above target. At the same time, resilient economic growth in the U.S. has been supported by tight labour markets, which continue to provide support to consumer spending.

The asset-class assumptions are long-term in nature, reflecting average annual expectations over a horizon of seven to 10 years. The methodology assumes that long-run historical relationships remain fairly constant and that most asset classes will trend according to structural macroeconomic factors over time. This allows strategic asset mix decisions to rely on intermediate and long-term trends rather than attempting to time near-term cycles.

We use a building-block framework to establish the long-term return and risk expectations for various asset classes. As shown above, this framework combines consensus expectations for real economic growth, inflation and income yield for applicable assets. We also incorporate idiosyncratic factors into the framework in order to capture items that may not be reflected in those first three categories, such as the premium/discount in the market, the real asset capital expenditure experience of various companies and the supply/demand components of commodities.

Figure 2: CMA expected return comparison (2022 vs 2023)



Source: TD Asset Management and TD Wealth Investment Office as of November 2023.

This graph compares the current CMA expected returns to the estimates from last year. We have seen a remarkable increase in interest rates over the past two years, and that resulted in a significant increase in the expectations for fixed income markets from 2021 to 2022. Given that rates are expected to stay "higher for longer," the future return expectations for fixed income have nudged slightly higher again this year, especially for cash, which has increased from 2.2% last year to 3.8%. For reference, the expected return on cash as of September 2021 was 0.1%. The remarkable increase in rates has resulted in a higher yield on fixed income as we move into 2024 and over the long term. As noted, the increase this year is much more modest than what we saw between 2021 and 2022. We believe we are close to the end of the rate-hiking cycle and that rates are very close to peak levels. While we believe returns for fixed income will be quite attractive, we caution that volatility could remain elevated in the near term. Fixed income markets are very sensitive to economic data and expectations for when and how central banks may pivot to an easing cycle in 2024. As such, there could be volatility around economic data releases.

Several building blocks are applied to forecasting equity returns, given our belief that real earnings growth broadly reflects real economic growth. Equities are also able to compensate for inflation through pricing power and many provide a dividend yield. The top-down methodology (using the macroeconomic outlook to arrive at the equity-market forecast) is our main approach for valuing equities, which is broadly consistent with the approach taken for other asset classes. While there are some shortcomings to this approach — that it ignores, for instance, the impact of equity valuation and fails to address the composition of the market — we believe that over time, our seven- to 10-year horizon, these issues are resolved by a reversion to mean. However, it's important to highlight the shortcomings, given that they can be more significant for short-term expectations. As an example, the fact that mega-cap tech names in the U.S. market accounted for all of the positive performance in 2023 can cause distortions to a top-down outlook in the near term. This is why we also utilize a bottom-up cross-check when arriving at our equity-market return forecasts. For reference, the bottom-up approach often leads to higher forecasts for equities, which is important to consider when reviewing expectations over a shorter time horizon.

Within equity markets, the forecast returns for public equity markets has declined modestly for 2023 versus 2022, largely driven by a lower inflation figure and a slightly lower yield forecast. Overall, the forecast for Canadian equities fell from 7.4% to 7.2%, U.S. equities fell from 5.8% to 5.7%, international from 7.1% to 6.6% and emerging-market equities from 9.4% to 9.0%.

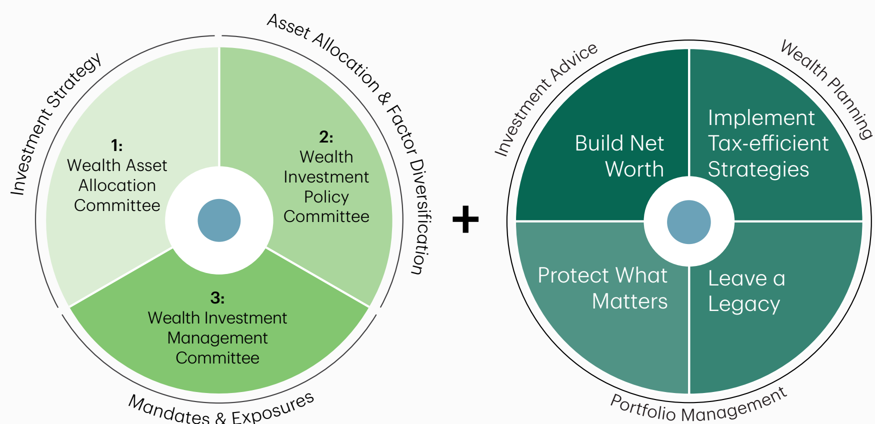
The expected returns for private real assets are generally difficult to forecast due to a lack of publicly available data. We take asset-specific approaches while further validating through our building-block approach, if necessary. When it comes to real assets, nuance is very important. While the return expectation for global real estate is 4.8%, there is a wide range of forecasts for different types of real estate assets within the asset class. Although high interest rates present a challenge for real estate in general, office and retail assets are experiencing headwinds from societal and consumer behavioral changes while industrial and residential sectors are still seeing historically low vacancy rates and robust demand. It is a similar situation when considering global infrastructure. Many assets benefit from long- term stable and inflation-linked contracted cash flow while others, such as renewable energy and energy transition related assets could also enjoy long-term structural tail winds. Overall, we have modestly reduced our forecast for global real estate from 5.0% to 4.8% and modestly increased our forecast for global infrastructure from 7.2% to 7.4%.

We have added the global commodities asset class to the matrix of asset-class return forecasts. Overall, we are constructive on commodities over the next seven to ten year horizon, given that key markets, such as oil and copper, remain finely balanced and are supported by limited inventories and producer discipline with demand potentially benefitting from a China recovery or stimulus measures. In addition, structurally higher inflation as a result of supply chain de-risk, the energy transition, years of under investment, and higher interest rates or 'carry' are also expected to provide support to commodity prices.

One final note. Investors must always be very mindful of the trade-off between return and risk across key asset classes — from low-risk, low-return core bonds to higher-risk, higher-return credit and equities. Emerging-market equities are expected to generate the highest absolute return among equities, but at a much higher risk. Real assets and alternatives are expected to generate superior risk-adjusted returns, even when we de-smooth their returns to remove some of the impact of infrequent pricing. Also, the illiquidity risk embedded in private assets must be taken into consideration. Risk tolerance measured by standard deviation should not be the only guidance when constructing a portfolio with private assets. Therefore, we believe having a diversified portfolio is still superior to just selecting certain asset classes with higher return or lower risk.

The four pillars of wealth management

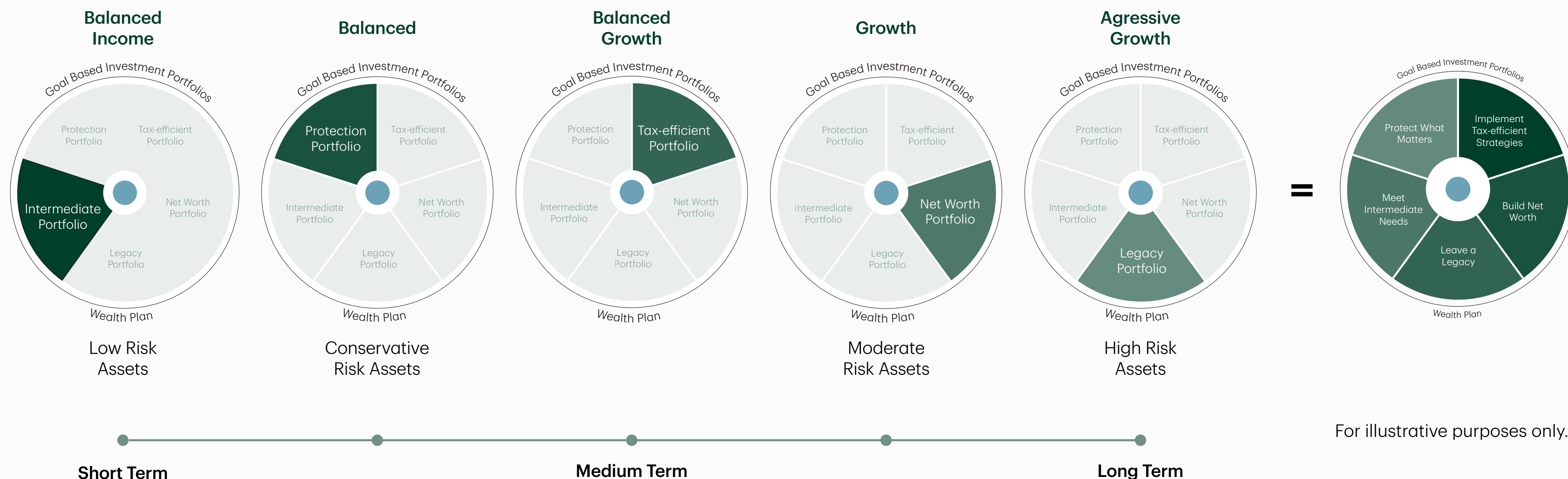
The foundation of process driven investment management



You want to know you are on track to achieve your goals. A goals-based approach to investing aims to bridge the gap between your goals and your portfolio's outcome.

We think a good starting point for any financial goal is to lay the foundation of a plan. While it's hard to be definitive, most investors share four common objectives: **(1) grow net worth; (2) preserve what they've earned; (3) protect what matters; and (4) build a personal legacy.** Instead of a one-size-fits-all solution, investors need to consider their primary objectives and, where it makes sense, create a specific portfolio to match the needs for each objective. We believe it is possible to structure portfolios based on investment time horizons while mitigating volatility through risk-factor diversification. This approach will help investors take the appropriate amount of risk to meet their goals.

Goal Based Portfolios



For illustrative purposes only.

Looking ahead

In these pages, we have stepped back and framed the near term and longer-term trends that will likely drive financial markets in the year to come. Remember, this is what might be. From our perspective, these are the baker's dozen that we are using to frame the challenges and opportunities we see ahead of us this year.

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1. 'Friend-shoring' will continue as deglobalization takes hold

There will be winners and losers from the shift in trade flows, with several emerging-market nations benefitting from the "China plus one" strategy.

2. Defense spending to rise amid heightened tensions

During times of war, governments tend to spend more on defense spending. On the other hand, the risk of armed conflict may depress sentiment in certain regions, with long-term implications for the creditworthiness of nations.

3. Commodities to outperform

The transition to renewable infrastructure will require an enormous influx of raw materials, which should boost prices. On the energy side, meanwhile, worries about renewables may be exaggerated.

4. China to recover from its economic woes

We think the Chinese economy has hit its cyclical bottom. Growth numbers have been improving over the past quarter, and we think they'll continue to do so.

5. A Trump win could dramatically alter the landscape

We're not calling the election, but with Trump leading in many of the polls, we are preparing for the possibility of a second term and what that would mean for the U.S. economy and global markets.

6. Hedging amid heightened geopolitical uncertainty

Our work suggests that oil and gold offers, perhaps, the best hedge against geopolitical risk.

7. Reaching target inflation will be a hard slog

We think the easy gains on the inflation front are behind us and the trek back to the Fed's 2% target will be slower.

8. Fixed income to rebound from a volatile year

Our conviction for bonds remains strong. Current yields are at levels not seen since the early 2000s and the bond market is well positioned to deliver attractive returns.

9. Higher interest costs to dampen consumer spending and borrowing

Net interest expense per capita has led consumers to delay debt repayment both for mortgages and other loans. It's highly likely that growth in disposable income will slow, which would have a large impact on consumer spending.

10. Development of AI to power ahead, despite any slowdown

We don't believe the AI sector will be immune from an economic downturn; however, the promise is such that healthy cash flows arising from new investment dollars will propel the industry toward rapid development.

11 Real estate performance to remain divergent

While vacancy rates for traditional offices in the U.S. are above 20%, and rents are under pressure, there are many other areas in the sector that have appeal. Demand for data centres, for instance, is being driven by cloud computing, content creation and the AI revolution. In this sector, nuance is everything.

12. Equity volatility likely to rise

Given the historical time lag between monetary-policy tightening and its impact on the broader economy and financial market, plus the prevalent unstable geopolitical environment, we will likely see increased equity volatility in 2024.

13. Private assets present opportunities amid higher rates

Private debt may enjoy one of its best return environments since the global financial crisis. Going forward, there will have to be a hand-off form existing investors given that institutions have to rebalance their portfolios. This should create an opportunity for new entrants from the private wealth space, which are still holding historical amounts of cash after the pandemic.

As we move forward, our approach will be to follow our principles, which are based on the conviction that markets are adaptive. Financial markets are always evolving as its participants learn and innovate. At TD Wealth, we have the advantage of being able to rely on the institution's breadth of skills to deliver sound investment strategy and nimble positioning. To navigate the opportunities and the challenges, ultimately, it's our philosophy, people and process that make the difference.

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