TD Wealth

Market Outlook

Investment Strategy Quarterly **Q4 2016**

TD Wealth Asset Allocation Committee Overview

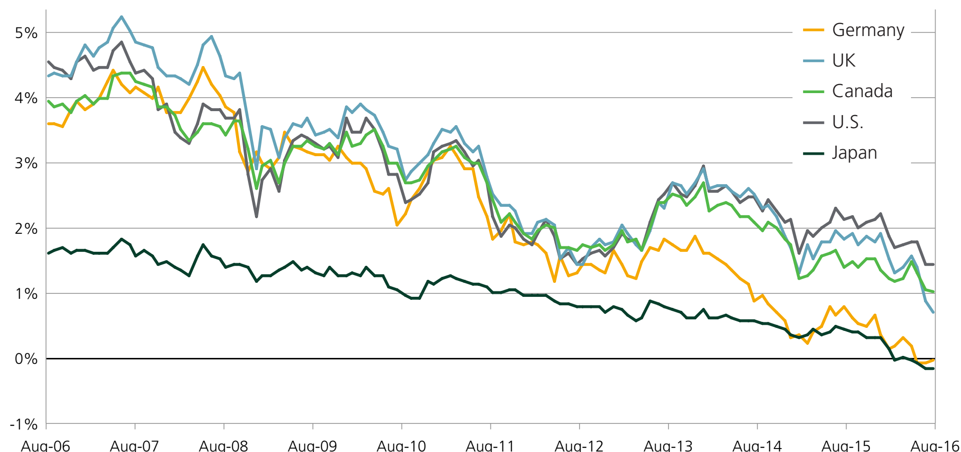
- High debt levels and demographic trends imply a persistent low growth environment.
- Overall, we expect an environment of muted returns - low single digits for fixed income and low to mid-single digits for equities - accompanied by episodes of volatility across asset classes.
- High debt levels, tepid earnings growth, full valuations, emerging market and political risks are all potential sources of volatility.
- Ongoing implementation of unprecedented policies, including negative interest rates and the potential for helicopter money, creates a wide range of possible economic and market outcomes.
- Cash, domestic government bonds and gold all provide insurance against the risk of extreme outcomes.

Following an exhausting few days surrounding the surprising Brexit vote toward the end of June, volatility took a much needed holiday and stayed muted for the remainder of the summer. While brief, the post-Brexit volatility was sharp, sending many investors scurrying for the relative safety of government bonds and leading 10-year government yields to hit record low levels in the U.S., U.K., Germany, Switzerland, France, Denmark and Sweden. However, markets recovered quickly as investors digested the news and continued to place their confidence in the support that central banks have been providing to financial markets.

And that support has been unprecedented. With the hope that low interest rates would stimulate economic growth, global central banks have decreased rates to historically low levels, engaged in massive asset purchase programs that infuse financial markets with hundreds of billions of dollars every month, and several have resorted to paying negative yields (i.e. charging for deposits). Yet the results have not reflected these monumental efforts. In fact, they've been lackluster at best, with economic data only showing modest improvement: economic growth is low, productivity is low, capital investment is low. The outlook doesn't look much rosier—over the summer, the International Monetary Fund downgraded its forecast for global growth in the wake of Brexit.

As the effectiveness of current measures appears to be waning, the TD Wealth Asset Allocation Committee ("we") believes the next round of stimulus will include aggressive fiscal spending. We

Chart 1: Developed Market 10-Year Government Bond Yields



Source: Bloomberg Finance L.P., as at August 31, 2016

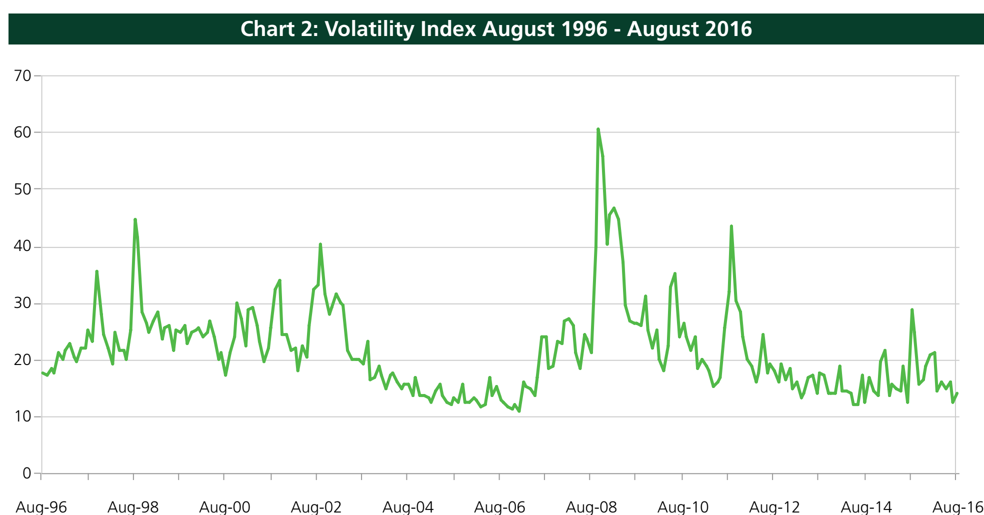
are already seeing this in Asia, where the Chinese government has been making substantial investments in infrastructure and recently announced a 50% expansion in railway infrastructure spending. In Japan, Prime Minister Abe has announced a meaningful fiscal spending program, amounting to approximately 1.5% of the country's gross domestic product, that will focus on infrastructure, public welfare and earthquake reconstruction. Closer to home, we also expect fiscal spending to pick up in Canada, and if Hillary Clinton wins the November election, we expect she will support additional fiscal expenditures in the U.S. Depending on the size of the programs, fiscal stimulus could spur growth, which in turn would be a tailwind to corporate revenues and earnings, which have been flat to modestly negative in 2016 versus 2015. (For more information, please see the September 2016 edition of forward Perspectives.)

In spite of the current insipid economic backdrop, equities and fixed income continued to march higher over the summer, trading near all-time highs. Markets appear to be engaged in a tug-of-war between low growth and weak earnings, which are restraining gains, and stimulative central banks, which are spurring them. This reinforces our neutral stance.

In terms of fixed income, given stubbornly weak growth and inflation, the global trend toward negative yields continued, and spilled over into longer-term bonds in recent months. For example, Germany issued 10-year bonds with a negative yield for the first time ever, Japan issued a 20-year bond with a negative yield, and Switzerland issued a 40+ year bond with a negative yield. Not to be left out, corporate bonds have also joined the fray—particularly in Europe. Globally, approximately $680 billion of corporate debt now offers negative nominal yields.

Broadly, we believe that caution is warranted. We expect assets to move modestly higher (we believe bonds will provide coupon-like returns and stocks will

Chart 2: Volatility Index August 1996 - August 2016



Source: Bloomberg Finance L.P., as at August 31, 2016

provide low to mid-single digit returns), however, we also expect periods of elevated volatility. While there was a brief Brexit-related uptick in volatility during June, overall, volatility has been notably low over the past several years. For example, as of the end of August the 5-year average level of the VIX Index, which measures implied volatility, was approximately 19% lower than the 20-year average,[1] and from late June to early September, the S&P 500 Index traded in a historically narrow range. In large part it's the actions of global central banks that are suppressing volatility, as their massive asset purchase programs are flooding markets with liquidity.

However, investors shouldn't become complacent; a number of catalysts could reignite volatility. In addition, during this lengthy period of relative calm investors have been moving further out the risk spectrum and leverage has increased, which could amplify volatility's negative effects when it returns. Risks we are monitoring closely include the upcoming U.S. election, stresses in Europe and increasing interest in protectionism in a number of regions, all of which may cause uncertainty. This uncertainty is likely to lead to choppy markets and episodes of volatility. It may also reduce confidence, which would weigh on investment and trade, ultimately restraining already sluggish global growth and increasing the risk of global recession.

Outlook

Our expectation is that global growth will continue to be sluggish, interest rates will remain at historically low levels and stocks will provide positive but modest returns. However, possible policy surprises coupled with high levels of debt globally create the potential for a wide range of potential economic and market outcomes. Therefore, we believe it is crucial to retain a long-term perspective and maximize diversification benefits within portfolios. As such, we maintain our preference for a diversified investment portfolio including high quality dividend paying equities, government and investment grade corporate bonds, plus a modest allocation to cash and gold, where allowed by investment guidelines.

While we maintain our broad positioning, we did make one change during the quarter: downgrading global government bonds from underweight to maximum underweight, as very low real and nominal yields coupled with increasing liquidity concerns make the current risk/reward dynamic unattractive.

Equity/fixed income split

Neutral equities versus bonds

We are neutral equities versus bonds. We believe bonds will provide low single digit returns and equities will provide low to mid-single digit returns. While bond returns may be modest, they offer diversification,

Please see final page for important disclosures.

some income and can have an important stabilizing effect on portfolios. In terms of equities, we expect earnings growth to be tepid and with valuations already approaching or at fair value, we anticipate that equity returns will be moderate. Although equities are expected to provide slightly higher returns than bonds, we anticipate episodes of elevated volatility. We continue to prefer high quality dividend paying equities that offer a stable, gradually rising stream of income.

Geographic split

Prefer North American equities

We prefer North American equities over international and emerging market equities. In Europe, growing political uncertainty, ongoing sluggish growth and threats to the earnings outlook all heighten risk. Within the emerging markets, valuations are attractive, but high debt levels, slowing economic growth and weaker commodity prices pose risks.

Corporate/government bond split

- *Overweight cash*
- *Neutral domestic government versus investment grade corporate bonds*
- *Underweight high yield and global government bonds*

We remain overweight cash, which should provide stability in times of increased volatility. Yields remain very low; however, domestic government bonds can offer stability and diversification benefits, which should be helpful amid increasing volatility, and investment grade corporate bonds offer an incremental yield advantage. We remain underweight high yield bonds as we are concerned about select pockets of stress and believe that default rates may rise, particularly in the commodity space, and as noted above, we are now maximum underweight global government bonds.

Canadian/foreign currency exposure

Underweight the Canadian dollar

Broadly we expect the Canadian dollar to remain low for an extended period and believe it will underperform the U.S. dollar.

Gold can be viewed as a currency alternative, and we believe an allocation to gold may provide insurance against the risk of extreme outcomes.

TD Wealth Asset Allocation Committee:

The TD Wealth Asset Allocation Committee was established to deliver a consistent asset allocation message and be the originating source for active asset allocation advice across TD Wealth. The committee has three prime objectives: articulate broad market themes, provide macro-level asset allocation and identify the major risks on the horizon.

Committee Members:

Chair: **Bruce Cooper**, CFA
Chief Investment Officer,
TD Asset Management Inc.
and SVP, TD Bank Group

Anish Chopra, CA, CFA
Managing Director,
TD Asset Management Inc.

Michael Craig, CFA
Vice President & Director,
TD Asset Management Inc.

Glenn Davis, CFA
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[1]Source: TD Asset Management and Bloomberg Finance L.P. The information contained herein has been provided by TD Wealth and is for information purposes only. The information has been drawn from sources believed to be reliable. Where such statements are based in whole or in part on information provided by third parties, they are not guaranteed to be accurate or complete. Graphs and charts are used for illustrative purposes only and do not reflect future values or future performance of any investment. The information does not provide financial, legal, tax or investment advice. Particular investment, trading, or tax strategies should be evaluated relative to each individual's objectives and risk tolerance. TD Wealth, The Toronto-Dominion Bank and its affiliates and related entities are not liable for any errors or omissions in the information or for any loss or damage suffered. Certain statements in this document may contain forward-looking statements ("FLS") that are predictive in nature and may include words such as "expects", "anticipates", "intends", "believes", "estimates" and similar forward-looking expressions or negative versions thereof. FLS are based on current expectations and projections about future general economic, political and relevant market factors, such as interest and foreign exchange rates, equity and capital markets, the general business environment, assuming no changes to tax or other laws or government regulation or catastrophic events. Expectations and projections about future events are inherently subject to risks and uncertainties, which may be unforeseeable. Such expectations and projections may be incorrect in the future. FLS are not guarantees of future performance. Actual events could differ materially from those expressed or implied in any FLS. A number of important factors including those factors set out above can contribute to these digressions. You should avoid placing any reliance on FLS. The TD Wealth Asset Allocation Committee ("WAAC") is comprised of a diverse group of TD investment professionals. The WAAC's mandate is to issue quarterly market outlooks which provide its concise view of the upcoming market situation for the next six to eighteen months. The WAAC's guidance is not a guarantee of future results and actual market events may differ materially from those set out expressly or by implication in the WAAC's quarterly market outlook. The WAAC market outlook is not a substitute for investment advice. TD Wealth represents the products and services offered by TD Waterhouse Canada Inc. (Member – Canadian Investor Protection Fund), TD Waterhouse Private Investment Counsel Inc., TD Wealth Private Banking (offered by The Toronto-Dominion Bank) and TD Wealth Private Trust (offered by The Canada Trust Company). Bloomberg and Bloomberg.com are trademarks and service marks of Bloomberg Finance L.P., a Delaware limited partnership, or its subsidiaries. All rights reserved. All trademarks are the property of their respective owners. ® The TD logo and other trade-marks are the property of The Toronto-Dominion Bank.