TD Wealth

Market Outlook

Investment Strategy Quarterly

Q3 2018

TD Wealth Asset Allocation Committee (WAAC) Overview

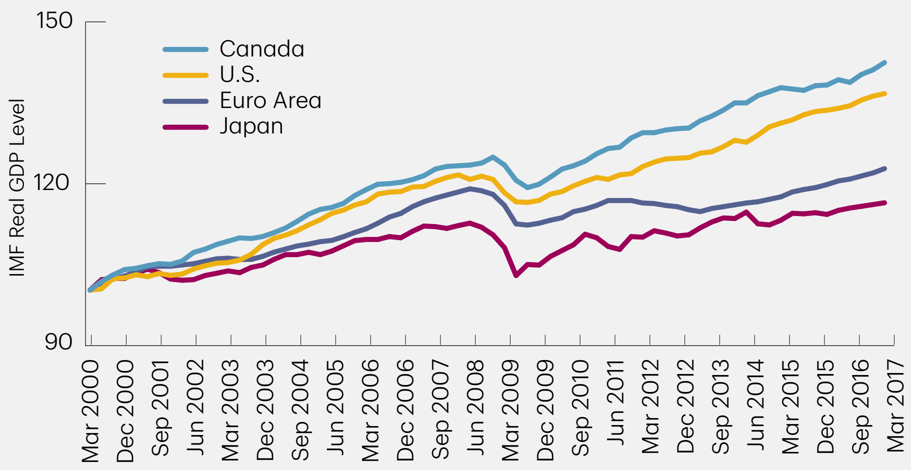
- Volatility likely to rise, driven by central bank tightening, a closed output gap, fear of rising inflation and heightened trade frictions
- Central banks transitioning policies from emergency to neutral, but expect lower for longer rate environment to continue
- Neutral rating in equities reflects strong corporate fundamentals offset by quantitative tightening in the U.S. and slowing growth globally
- We anticipate protracted conflict between China and the U.S. on issues of trade and technology leadership
- Cautious on the Canadian dollar due to elevated household debt, risk of NAFTA failure and the expectation of slower rate increases from the Bank of Canada versus the U.S. Federal Reserve

Over the past quarter, the global economy continued to fire on all cylinders. Governments are spending after years of austerity and private sector consumption remains strong against the backdrop of historically low unemployment rates. Despite the tightening cycle in the United States, and various headwinds, the global economy remains poised for growth.

U.S. protectionist talks remain a key risk that may potentially derail one of the main engines of global growth. On June 1, the U.S. imposed tariffs on imports of steel and aluminum from Canada, Mexico and the European Union, and those countries immediately announced their intention to retaliate. NAFTA negotiations and the U.S. trading relationship with China remain contentious. Another potential risk is an overheating U.S. economy. This could compel the U.S. Federal Reserve (Fed) to accelerate the pace of its interest rate hikes, which could negatively impact global financial markets, particularly among emerging-market nations.

Expectations of rising inflation caused the yield on 10-year U.S. Treasuries to

Robust Global Economic Growth



Source: Bloomberg Finance. As of March 31, 2017.
All data represents IMF Real GDP Figures and use a rebased value to illustrate growth.

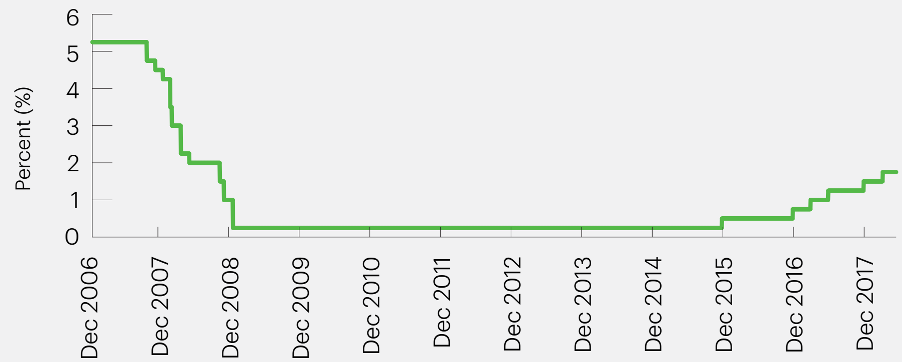
Rising 10-year Treasury Yield

Source: Bloomberg Finance L.P. As of May 30, 2018 hit 3% for the first time since January 2014. This comes against the backdrop of the Fed raising interest rates by 0.25% in their first meeting under new Fed chair Jerome Powell. While crossing 3% is noteworthy, the WAAC continues to believe that the increase in rates will be gradual and subdued. This is due in part to the fact that inflation remains on target but also due to the low level of yields on a global basis.

Rising bond yields can create headwinds for equity markets. However, valuations have come down to more reasonable levels in recent months and continued earnings growth – backed by a fundamentally strong economy – is expected to remain a key driver for equity returns. Our expectation is that rising earnings and falling equity multiples will combine to deliver positive returns in 2018, but lower than what we have seen in recent years.

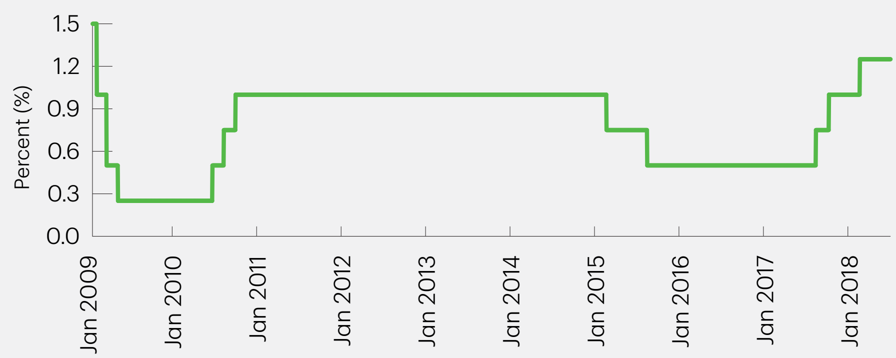
In Canada, economic fundamentals remain mixed. Robust government spending and improved oil and gas exports can potentially provide additional support for sustained economic growth. In addition, wages may rise due to tighter labour dynamics. However, households will still feel the pinch of higher interest rates on the back of record levels of debt. The housing market also appears to have slowed, responding to the recent increase in interest rates and the government's new mortgage rules. The Bank of Canada (BoC) left the overnight rate at 1.25% at its most recent meeting in May. The bank has tightened policy three times since the middle of last year. Our expectation is that interest rates in Canada will rise more slowly than in the U.S, mirroring the relative strength of the two economies.

U.S. Federal Funds Rate



Source: Bloomberg Finance L.P. As of May 30, 2018

Bank of Canada Overnight Rate Target



Source: Bloomberg Finance L.P. As of May 30, 2018

Throughout the year, we have been watchful of the rise in protectionism and the risk it poses for further volatility. We expect trade frictions to persist for some time and continue to focus on the actions of central banks around the globe. Central banks appear to be moving cautiously as any misstep in policy action can be detrimental.

WAAC Positioning

While economic fundamentals and corporate earnings remain strong, we believe that the themes of rising yields, central bank tightening, and fears over heightened trade frictions are likely to persist, potentially leading to greater volatility in the coming months. Our theme of "lower-for-longer" remains in effect for interest rates, and low to mid-single digit returns continues to be our base case for equities.

Against this backdrop, we have maintained our positioning at the asset class level, which is neutral across cash, fixed income and equities. However, we have made changes to our positioning within those asset classes, which are included below. We believe a balanced approach is warranted and favour a diversified portfolio that includes:

1. High quality equities that may have the ability to increase their earnings and dividends in a low growth environment, thereby helping to protect the real value of investors' savings
2. An allocation to cash to help provide stability and safety of capital
3. An allocation to high quality domestic government bonds and investment-grade corporate bonds to help provide some income, diversification and stability

Equities

- Neutral Canadian, U.S, international and emerging market equities

Despite episodes of volatility over the past quarter, most equity markets performed generally well. We continue to believe that equities will deliver positive mid-single digit returns in 2018 as global growth, corporate earnings and free cash flow remain strong and supportive. Within equities, valuations continue to be most attractive in the international space. European stocks are benefiting from a solid economy, strong earnings growth and a European Central Bank that continues to hold interest rates close to zero. Political risk in Europe has mostly declined; however, Italy's new populist government is causing renewed concern for political turbulence in the region. Other increasing risks to equities within international markets include the potential for a protracted conflict between China and the U.S. on issues of trade and technology leadership, as well as the possibility of a broader trade war.

We are neutral U.S equites. Free cash flow is strong and attractive versus fixed income yields. In addition, it is anticipated that corporate tax cuts will add significantly to earnings in 2018. Valuations have declined in 2018 and are now at more reasonable levels than they were earlier in the year. We expect earnings growth to slow as the impact of tax cuts and fiscal stimulus fade.

We have moved from underweight to neutral within Canadian equities. Despite strong Canadian equity market returns in the latter half of the quarter, we have concerns over elevated levels of household debt, pipeline politics and uncertainty surrounding the outcome of NAFTA negotiations. Canada's reliance on cyclical, capital intensive sectors compared to high growth businesses in the Health Care and Technology sectors remains an ongoing challenge. Rising oil prices however can provide a boost in returns.

Fixed Income

- Neutral cash, domestic government bonds, investment grade corporate bonds and inflation-linked bonds
- Maximum underweight high yield and global developed market bonds
- Neutral global emerging market bonds

Overall, our outlook for bonds hasn't changed and coupon-like returns are anticipated in the low single digits. We are neutral domestic government bonds as they can offer diversification, stability and modest income. Our view is also neutral for investment grade corporate bonds. Spreads have narrowed, but may still offer a yield advantage over government bonds and the economic backdrop is supportive for corporate health. Break-evens have been gradually rising, but are still reasonable from a historical perspective, so our neutral rating has been maintained for inflation-linked bonds.

We are maximum underweight high yield bonds as they are quite expensive and narrow spreads make the risk/reward dynamic unattractive. Within the global developed bond space, we are currently maximum underweight, as low nominal and real yields in Europe and Japan are not very compelling. We have moved to neutral from modest overweight in the global emerging market bond space. Discrete emerging market opportunities with attractive real yields are being mitigated by weakening currencies and trade concerns.

Canadian/U.S. currency exposure

- Maximum underweight the Canadian dollar vs. the U.S. dollar
- Neutral the U.S. dollar

The Canadian dollar has weakened recently, and we still expect it to underperform the U.S. dollar in 2018, driven primarily by differences in central bank policy rates and economic growth prospects. U.S. economic strength supported by fiscal policy, an easing regulatory framework, the Fed's continuous march to neutral interest rates and quantitative tightening generally provide a more muted bias towards the U.S. dollar trade weighted basket.

Gold

- Neutral gold

We believe an allocation to gold can provide insurance in a portfolio against the risk of extreme outcomes. However, we do not currently believe that this insurance is currently required. ■

TD Wealth Asset Allocation Committee

The TD Wealth Asset Allocation Committee (WAAC) 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, seek to provide macro-level asset allocation direction and help identify the major risks on the horizon.

Committee Members:

Chair: **Bruce Cooper**, CFA
CEO & CIO, TD Asset Management Inc. and SVP, TD Bank Group

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

Glenn Davis, CFA
Managing Director, TDAM USA

Kevin Hebner, PhD
Managing Director, Epoch Investment Partners, Inc.

David McCulla, CFA
Vice President & Director, TD Asset Management Inc.

Robert Pemberton, CFA
Managing Director, TD Asset Management Inc.

Brad Simpson, CIM, FCSI
Chief Wealth Strategist, TD Wealth

David Sykes, CFA
Managing Director, TD Asset Management Inc.

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

Geoff Wilson, CFA
Managing Director, TD Asset Management Inc.

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