TD Wealth

Reality Check

Portfolio
Strategy
Quarterly

Q3 2021

July 29, 2021

In this issue

Reality Check.

In the second quarter, the stimulus-induced exuberance that gripped the markets seemed to wear off a bit. Bitcoin and meme stocks fell back to Earth, the 10-year yield shrunk below 1.4% (even amid inflation fears) and investors moved away from economically sensitive cyclical stocks, under the assumption that the post-pandemic expansion will soon come to an end, and that we will eventually be returned to a world that looks much like it did in January 2020, before Covid-19 changed everything.

This is highly unlikely. So much has changed since then. Monetary policy, fiscal policy, science, medicine, business — if we were playing a boardgame, we'd have to create a whole new set of rules and players to provide an adequate metaphor. We are living through a grand experiment in the way governments govern and everyday people live their lives, and nothing is likely to return to "normal." Not really.

We believe the next quarter is going to provide a reality check. The economy seems to be moving from the early stages of an economic cycle to the mid stages. If that seems like an impossibly rapid shift, consider the denial that so many of us felt when the pandemic began. Remember when many of us thought this would all quickly go away, or that it wasn't as bad as the news was reporting. The global economy has gone through a traumatic ordeal. And while it's tempting to think that vaccines will enable us to simply hit the reset button, that's just not the reality. There is no reset button as we move into this new economic environment.

Stay safe and be well,

Brad Simpson

Chief Wealth Strategist, TD Wealth

Cracking Complexity

Complexity

Peak Everything

The U.S. reopening sent a tsunami of demand against the weakened global supply chain. Business confidence and consumer sentiment shot up to historic peaks in May and June, as did U.S. inflation, which rose 5.4%. Many of these metrics have started to roll over.

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That's the number of FOMC members who now believe rate hikes are coming in 2022. The market seems to agree, although the median view is still calling for two hikes in 2023 (a year earlier than previous estimates).

Inflation Growth > 40 Years

The Fed is in no rush to cool down the economy, even after April and May posted the biggest m/m increases in core CPI since 1981. The Fed and the market both believe that the spike in prices will soon pass.

Revenge Retail

May retail sales in the U.S. skyrocketed 28% y/y as pent-up consumers splurged on big-ticket items. In Canada, where the average adult has socked away $5,800, the splurge is only beginning.

Upgrades Galore

Corporate debt downgrades outnumbered upgrades by a 3:1 ratio in 2020. This year, that trend has reversed itself completely, with upgrades outnumbering downgrades 4:1, and 21 issuers returning to investment-grade status.

Early to Mid

Everything is faster than normal. Equity exposure rotations and changing leadership are happening at an accelerated pace. Active management is your friend in this environment; high-quality companies with strong cash flows should significantly outperform speculative names.

Scheduled Arrival in Europe

While business confidence in Europe is at a 14-year high, the surge in growth has not yet been priced into European cyclicals and value stocks, which are trading at discounts. The rotation we've seen elsewhere may continue in Europe for some time.

Remote Rethink

Despite talk of hybrid offices and remote working, employers have upwardly revised their office needs. According to a Colliers survey, 46% were looking to reduce space in June 2020; now only 29% are looking to do so.

Adaptation

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.

"A Big Grain of Salt"

The Fed Chair urged the markets not to take the "dot plot" too seriously. These have historically been poor at predicting rate hikes. In 2014, the dot plot showed eight hikes over two years. There were only two.

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.

Stage-based Tactics

We use an “economic cycle framework” that tactically under- or overweight asset classes, sectors and risk factors that are likely to under- or outperform during various stages of the economic recovery.

Bulls Over Bears

Since 1942, the average U.S. bull market has risen 151% over 52 months. That compares to the average bear market falling 32% over 11 months. Bull markets on average go about five times further and five times longer than bears.

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.

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.

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.

PSQ3 | Executive Summary

House Views | Fixed income modest underweight: We remain constructive on investment-grade corporate bonds, despite spreads narrowing to pre-pandemic levels. • **Equities modest overweight:** We anticipate that the latter part of 2021 will see increased market volatility, and more subdued returns, but we expect equities to continue to advance broadly and deliver returns in excess of fixed income. • **Real assets / alternatives modest overweight:** The asset class continues to offer stable returns, with low correlation to other asset classes, and an imbedded inflation hedge through contracted increases in revenue. • **Sub-classes underweight:** Underweight USD as corporate profitability growth shows signs of peaking, while concerns grow over fiscal deficits; neutral gold as the Fed's hawkish pivot diminishes the safe haven, despite some uncertainty around the global economic recovery and inflation risks.

Risk Environment | Indicators for risk sentiment have fallen from recent peaks but remain resilient as investors anticipate the end of the pandemic. • **Economic Growth (Strong)**: Consensus forecasts now expect 6.4% real GDP growth in the U.S. for 2021, a 40-year high. • **Inflation (From Strong to Weak):** Investors discounted inflation risks after the June Fed meeting signalled early rate hikes in 2023. • **Employment (Neutral):** Weekly jobless claims are at pandemic lows, but a recent rise may signal a slowdown in job growth. • **Consumer Sector (Strong):** Consumers remain optimistic about recovery as the U.S. economy fully reopens. • **Housing (Strong):** U.S. housing indicators are stronger than before the pandemic. • **Business Conditions (Strong):** PMIs continued to rally alongside the reopening of the U.S. economy. • **Financial Conditions (Strong):** U.S. financial conditions remain extremely loose, aided by abundant liquidity and strong risk appetite. • **Foreign Trade (Neutral):** The U.S. current account deficit deteriorated further to 3.2% of GDP in Q2, in line with the long-term average of 3.3%. • **Fiscal Policy (Accommodative):** The White House faces obstacles in passing its infrastructure package, but global governments still prefer spending over the kind of austerity imposed after the 2008 financial crisis. • **Monetary Policy (Accommodative):** June marked an inflection point as the Fed signalled earlier-than-expected hikes, with possibly two by the end 2023. • **Risk Sentiment (Strong):** Implied volatilities remain subdued. Strategists are neutral, but U.S. investment advisors remain bullish.

Factor Analysis | Asset classes that benefit from accelerating economic growth (equities, corporate bonds, emerging-market debt and commodities) outperformed in Q2, although leadership has shifted back to U.S. stocks and non-cyclical sectors. • Nominal government bonds and other rate-sensitive assets, which tend to perform well when economic expectations are weak, rebounded in Q2 as growth expectations peaked and inflation expectations weakened.

Economy | On the state of the U.S. economic recovery, Chief Economist Beata Caranci and Senior Economist James Orlando describe the factors underlying the incredible resilience that continues to be shown. GDP and employment are quickly closing in on their potential. Inflation is currently overshooting 2%, and even with its undershoot in the early days of the pandemic, it is well on its way to meeting the Fed's new average inflation framework. The Fed is recognizing this upturn in the economy but has been hesitant to change its tune on its policy stance. As long as the recovery continues as expected, policy will shift to ensuring that inflation expectations remain well anchored and financial stability risks do not threaten future economic growth. This all sets us up for higher longer-term yields and an earlier exit from ultra-low rates. While the median FOMC voter now shows the start of the rate-hiking cycle in 2023, market participants have been preparing for an earlier exit from the zero-policy stance. The first step in the rate-hiking cycle is priced for late 2022 / early 2023. TD Economics shares this view, grounded in a forecast that fully absorbs economic slack by the end of this year. This is occurring thanks to booming equity markets, rising house prices and a strong government safety net — all of which support robust consumer spending. TDE expects full employment to be reached by the middle of next year and core PCE inflation to stay above 2% for the next few years. Given its mandate of full employment and average inflation of 2%, the Fed would have a hard time standing still on a zero-bound policy rate by the end of 2022.

The policy rate, however, is a blunt tool. It works in the aggregate, but not with surgical precision. Once there's significant progress and critical mass on healing the labour market, Caranci and Orlando suggest that the keys should be turned over to fiscal policymakers to address specific shortcomings through financial aid and employment services.

Fixed Income | Total returns for global bond markets were down 3.21% as of mid-year, largely driven by higher average yields and average credit spreads that began the year tight, then got tighter before more recently widening. Corporate debt still holds opportunities but even here it looks like we're about to enter a range-bound period. We are modestly constructive on investment-grade credit because it's resilient to interest-rate volatility, receives implicit support from central-bank bond purchases, has a broad investor base to digest new supply, and because its higher yield compensates for underlying risks. We maintain our underweight view on government bonds despite higher yields. We also maintain our defensive view on high-yield credit. Fixed income portfolios aren't meant to capture upside risk. They provide quality income and ballast through downside protection. For those clients heavily invested in fixed income, we need to focus on probable income versus probable drawdowns instead of probable returns versus probable volatility.

Equities | The heightened risk sentiment and inflation expectations that peaked in Q1 started to come down in Q2: 10-year yields fell to 1.4%, while one-year breakeven rates on inflation-protected securities fell to 3.2%. With the current manufacturing PMI at a 20-year peak of 62.1, business confidence may have already topped out, which could lead the rotation into cyclicals to slow down. Cyclicals may very well continue to lead the rally in equities, but the pace of appreciation is not expected to be as rapid going forward. As for the broader North American index, forecast growth in EPS seems also to have also reached its peak. Many strategists see the possibility of a near-term pullback in North America, but for the time being it may be best to stick with active management and focus on thematic trends. We continue to believe that equities offer attractive potential, particularly the value pockets, but moving forward, prudent stock selection will offer higher alpha in segments where expected growth is fully priced into valuations. We remain overweight on international and emerging markets, given their reasonable valuations and higher exposure to cyclicals.

Real Assets | As we pass the halfway mark of 2021, valuations have recovered and even exceeded the highs of the early 2000s. Office landlords and tenants have begun to crystalize their return-to-work plans, boding well for the hard-hit sector. Industrial real estate has seen availability rates fall to historic lows. Retail continues to see softening as vacancies trend upwards to their highest since 2017. House prices have fallen for three consecutive months after reaching all-time highs in March. And, finally, private markets for infrastructure have seen an explosion of interest by both investors and portfolio managers.

Currencies | TD Securities believes that, while the USD currently owns a premium over other G10 currencies, positioning is moderately unfavourable from a tactical point of view. A resurgence of pessimism could help turn the tide for the USD, though. The CAD, meanwhile, may continue to perform well once global growth and delta variant concerns abate. The Bank of Canada has been an early hawk, but there is room to pare down tightening expectations over the next year, lessening CAD's near-term allure.

Commodities | There have been concerns about the impact of Chinese near-term demand for metals on prices, and the risk of a correction. • The Fed's hawkish tilt in June sparked a sell-off in gold, but TD Securities believes that the Fed's emphasis on full employment and average inflation should see gold recover most of its recent losses. Accommodative monetary conditions are likely to persist well into 2023. • TDS expects the price of WTI crude oil to be range-bound as the market awaits details on the forthcoming OPEC+ deal. TDS sees WTI trading around US$70 per barrel through 2022.

The New Seven Summits

Brad Simpson, Chief Wealth Strategist, TD Wealth

In the first quarter, global investors seemed to be mired in a mania of sorts. With cryptocurrencies skyrocketing, meme stocks confounding analysts and short-sellers alike, "blank-cheque" acquisition vehicles coming out of the woodwork, and a 10-year Treasury yield that doubled within those three months, the visible hand of the central bank was everywhere, and fiscal spending was all the rage.

A quarter later, the pendulum has swung back to some extent. Bitcoin and meme stocks have fallen back to Earth, the 10-year yield has shrunk below 1.4% (even amid inflation fears) and investors are moving away from economically sensitive cyclical stocks, under the assumption that the post-pandemic expansion will soon come to an end, and that we are about to return to a world that looks much like it did in January 2020, before Covid-19 changed everything.

This is highly unlikely. So much has changed since then. Monetary policy, fiscal policy, science, medicine, business — if we were playing a boardgame, we'd have to create a whole new set of rules and players to provide an adequate metaphor. We are living through a grand experiment in the way governments govern and everyday people live their lives, and nothing is likely to return to "normal." Not really.

Instead of moving backward, we are moving forward, which is consistent with our belief that investment markets operate within an open and complex system. Market dynamics are shifting rapidly because the mechanisms underlying those markets are evolving rapidly. In the space of a year, we have gone from pandemic to recession to recovery. This process usually takes years. In fact, according to the National Bureau of Economic Research, the Covid-19 recession in the U.S. ended in April 2020 — making it the shortest in American history, at two months.

We believe the next quarter is going to provide a reality check. The economy seems to be moving from the early stages of an economic cycle to the mid stages, which is consistent with what we're experiencing right now:

- economic growth going from high to moderate
- inflation moving from low to moderate to high
- monetary policy moving from loose to neutral
- credit conditions starting to tighten

Mid-stage already? If this seems impossible, remember the denial that so many of us felt when the pandemic began. Remember when many of us thought this would all quickly go away, or that it wasn't as bad as the media were reporting. The global economy, similarly, has gone through a traumatic ordeal. And while denial is a human frailty, and it's tempting to think that vaccines will enable us to simply hit the reset button, that's just not the reality. There is no reset button as we move into this new economic environment.

We are here

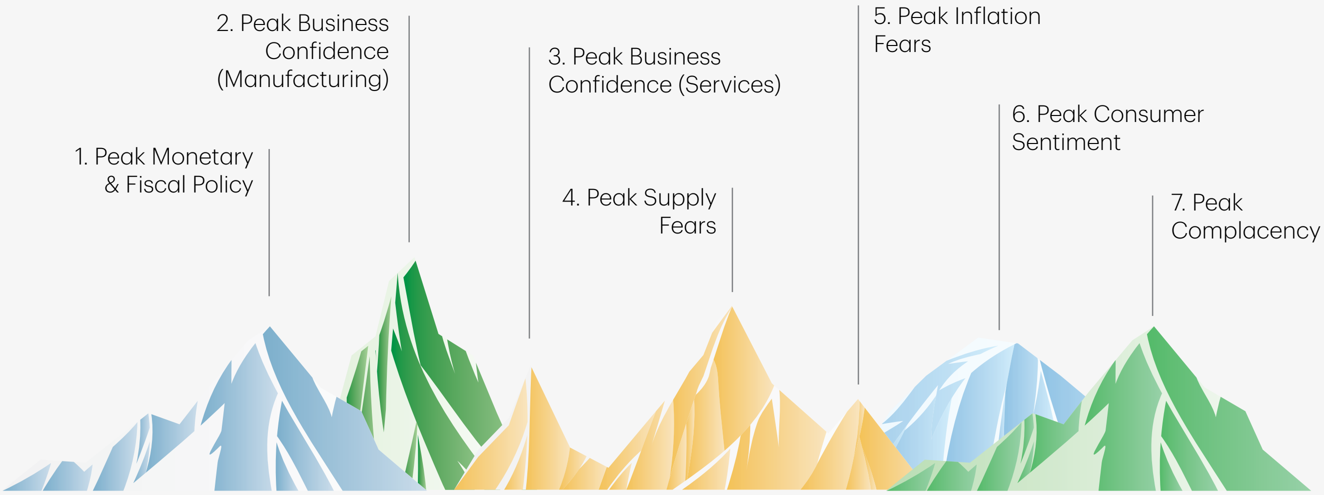
Macro Indicator	Early Stage	Mid Stage	Late Stage	Recession
Economic Growth	High	Moderate	Low	Negative
Inflation	Low	Moderate	High	Low to Negative
Monetary Policy	Loose	Neutral	Tight	Loose
Term Premium	High	Moderate	Low	Low to Negative
Credit Conditions	Loose	Loose but Tightening	Tight	Enter: Tight; Exit: Loose

Source: Bloomberg Finance L.P., TD Wealth. As of June 30, 2021.

Lots of tailwind with little turbulence: Is this as good as it gets?

We're coming through a period during which market conditions have been supported by an incredible number of tailwinds. That leaves investors with one question foremost on their minds: "Is this as good as it gets?" In an effort to address that very question, we'd like to welcome you all to peak everything! If financial markets were climbers, then in the second quarter of 2021, they would be a fusion of Sir Edmund Hillary, Tenzing Norgay and Junko Tabei ascending the new seven summits.

The New Seven Summits



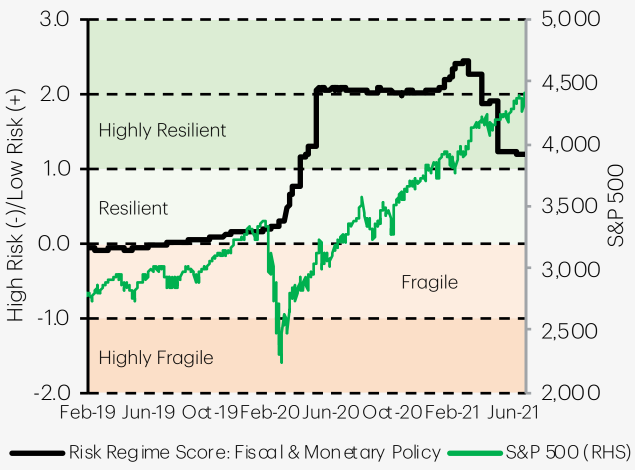
1. Peak Monetary & Fiscal Policy

Financial conditions are still extremely loose, with interest rates expected to remain around zero until late next year. In June, however, an inflection point was reached, and the Federal Reserve accelerated its timeline for rate hikes. Although the U.S. labour market has lagged the rest of the economy, things could change dramatically in the fall, when pandemic benefits expire and children go back to school. If the workforce remobilizes en masse, that could provide the signal needed for the Fed to begin preparing for the end of ultra-loose monetary policy.

Fiscal policy is trickier to measure, but it's hard to imagine a number bigger than the recently agreed upon spending boost of $3.5 trillion over 10 years in the United States. President Biden had proposed even more, but pushback from debt-conscious conservatives forced the administration to scale back its ambitions. As the service side of the economy returns to full force, trillion-dollar spending packages — paid for by the debt of future Americans — will be harder to sell politically.

According to our in-house blended measure of fiscal and monetary policy (Figure 1), which we use to gauge the impact of these two critical components of the financial system, fiscal policy has been pretty steady for the past year, hovering between +1.5 and a pandemic peak of +1.8. Monetary policy, however, has plummeted over the past few months, from +3.1 to just +0.6 — still accommodative, but nothing compared to earlier in the year.

Figure 1: Fiscal and Monetary Composite Scores



Note: scores represent number of standard deviations away from long-term average. Source: Bloomberg Finance LP, TD Wealth as of July 22, 2021

2. Peak Business Confidence (Manufacturing)

If we look at our best gauge for manufacturing business confidence, we find that the ISM Manufacturing Index reached a peak of 62.1 in May before falling to 60.6 in June. Time will tell, but it's possible that the month of May has already marked the highpoint for manufacturing in the current cycle.

3. Peak Business Confidence (Services)

The same may be true for services, even though the travel and leisure sector is far from full recovery. The ISM Services Index fell to 60.1 in in the latest business sentiment survey. That's still historically high, and certainly expansionary, but it's down from the post-pandemic peak of 64.0 in May.

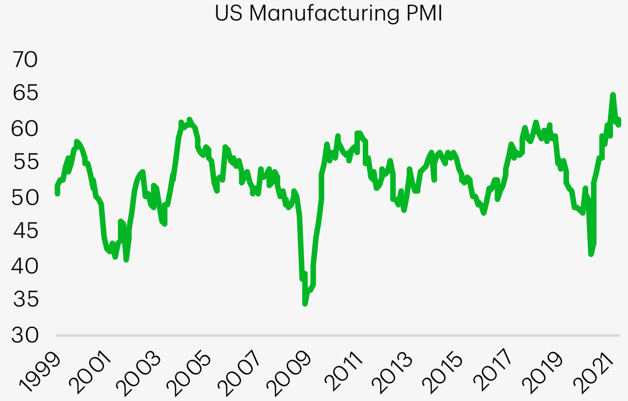
4. Peak Supply Fears

Almost everyone has a story about trying to buy durable goods without success in the current environment, where a surge in demand has met a compromised global supply chain. The good news is that fresh supply is starting to come in. The shipments component of the Cass Freight Index has shown considerable improvement, along with trade volumes (Figure 4). This is a healthy trend for inventories, which are beginning to normalize.

The residential housing market has also been experiencing supply constraints, as rock-bottom mortgage rates lure in a wave of homebuyers, but new data all suggest that the market imbalance has already peaked in the United States. Single-family home sales have slowed through the early months of 2021, reflecting some softening in demand. At the same time, the sales-to-listing ratio has come down as new supply enters the market. The supply of new single-family homes has been rising since October 2020, while the supply of existing homes has been ticking higher since the turn of the year.

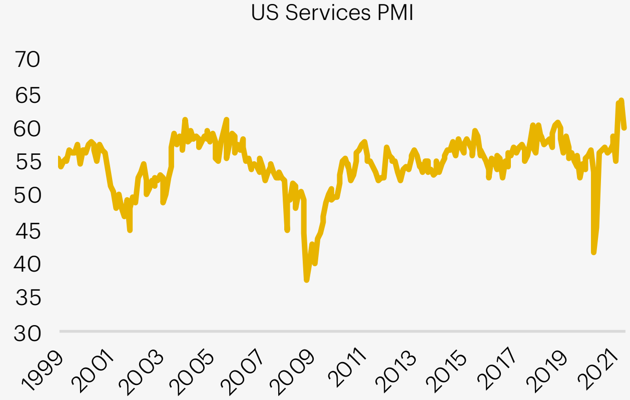
North of the border, meanwhile, monthly existing home sales continued to fall from their dizzying heights, down 8.4% in June. For the second month in a row, sales were lower in every province, with the steepest drops seen in British Columbia (14.6%) and the Atlantic provinces (9.8%). Since peaking in March, home sales are down 25%, although they remain historically elevated.

Figure 2: Peak Manufacturing PMI



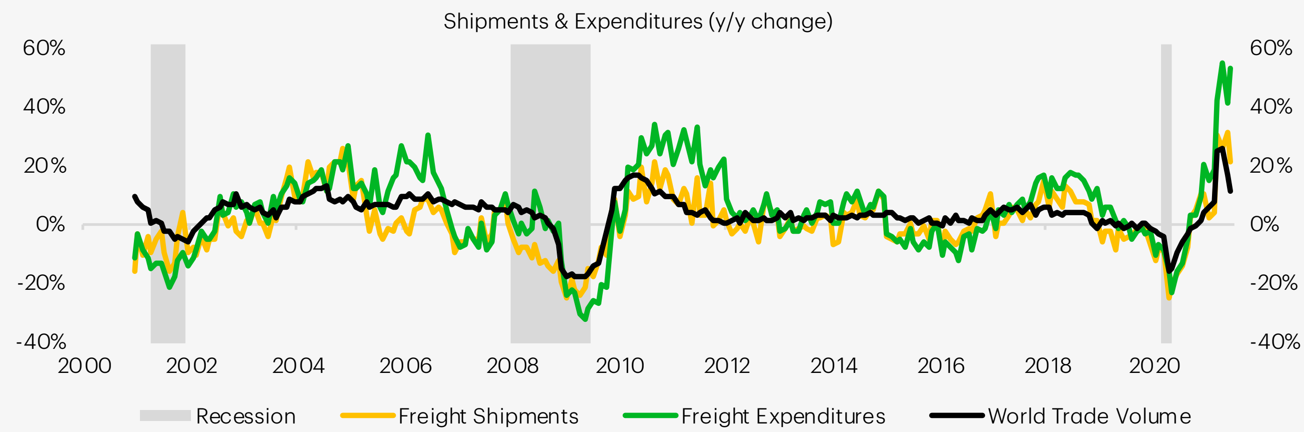
Source: Bloomberg Finance LP as of July 22, 2021

Figure 3: Peak Services PMI



Source: Bloomberg Finance LP as of July 22, 2021

Figure 4: Shipping Improvements



Source: Bloomberg Finance LP as of July 22, 2021

Finally, there's the price of lumber — a well-worn topic of discussion for furloughed workers looking to take advantage of their quarantine by finally building that backyard patio. Since reaching a peak in May, lumber prices have fallen 75% (Figure 5).

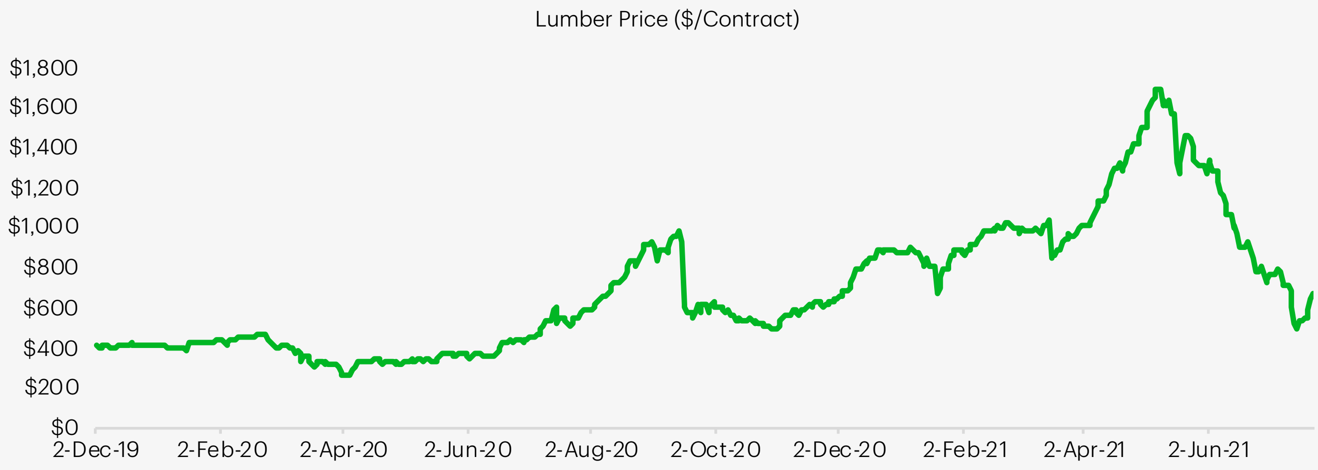
5. Peak Inflation Fears

The U.S consumer price index (CPI) rose 5.4% year-over-year in June. Stable Core CPI — which strips out volatile food and energy prices — still managed to rise 4.5%, the fastest annual rate since 1991. In July, Fed Chair Jerome Powell said inflation had been "higher than expected and hoped for."

Let's hope that this isn't his Irving Fisher moment. Frankly, I have heard more about inflation over the past six months than I have in my 30-year career combined. (I guess you could say the concept of inflation is currently experiencing inflation.) While this has a ways to go, we have likely already seen the peak for inflation fears. Google searches for the question "What is inflation?" hit an annual high in May and are down 30% since then (Figure 6).

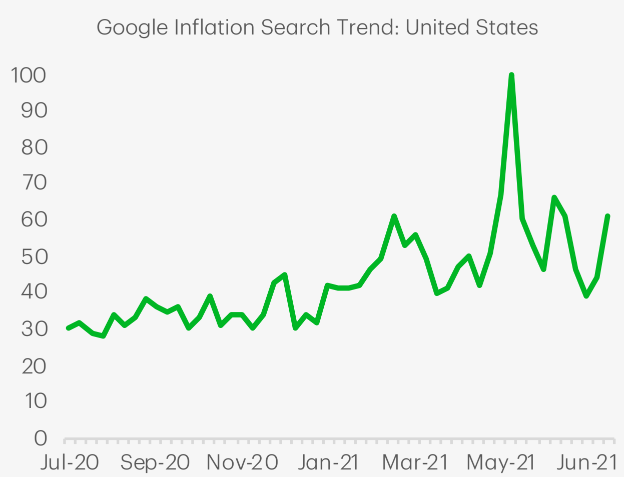
May also marked the peak for breakeven rates for inflation-protected securities. Breakevens soared to eight-year highs as the market priced in a decade of inflation over 2.5%. Equity markets fell hard on the news, but the panic was short-lived, as investors came around to the Fed's argument that inflation would likely be "transitory." Fears were further eased a month later, when the Fed took action by accelerating its schedule for rate hikes. Breakeven rates have consequently fallen, and inflationary hedges like bitcoin have been unable to benefit from the inflation scare (Figure 7).

Figure 5: Peak Supply – Lumber Prices



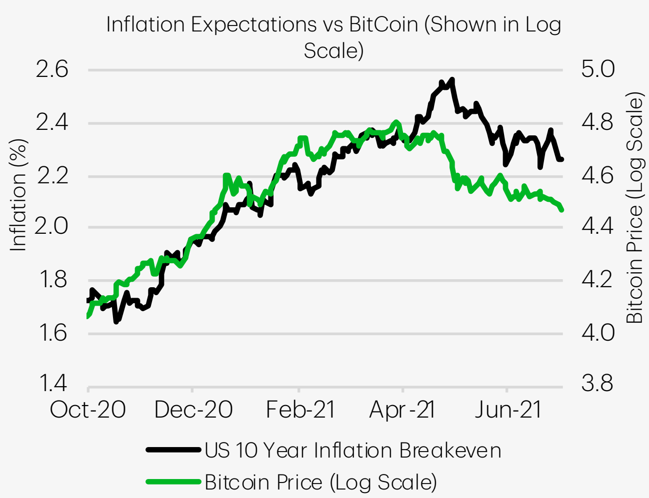
Source: Bloomberg Finance LP as of July 22, 2021

Figure 6: "What is inflation?"



Source: Google as of July 20, 2021

Figure 7: What breakevens and bitcoin are telling us



Source: Bloomberg Finance LP as of July 22, 2021

6. Peak Consumer Sentiment

Nearing the end of the first quarter, the compounded effects of high savings and fresh stimulus, in the form of direct $1,400 cheques, led Americans to splash out on big-ticket items like cars, helping lift consumer spending in the first quarter by an extraordinary 11.3%. As the economy reopened, U.S. consumers began to feel like the worst was finally behind them. April marked the high point for the University of Michigan's consumer sentiment index, at 88.3. Since then, however, states with low vaccination rates have seen a resurgence of the highly contagious delta variant of Covid-19, sapping consumer confidence. In July 2021, the UofM index dropped to a five-month low of 80.8.

7. Peak Complacency

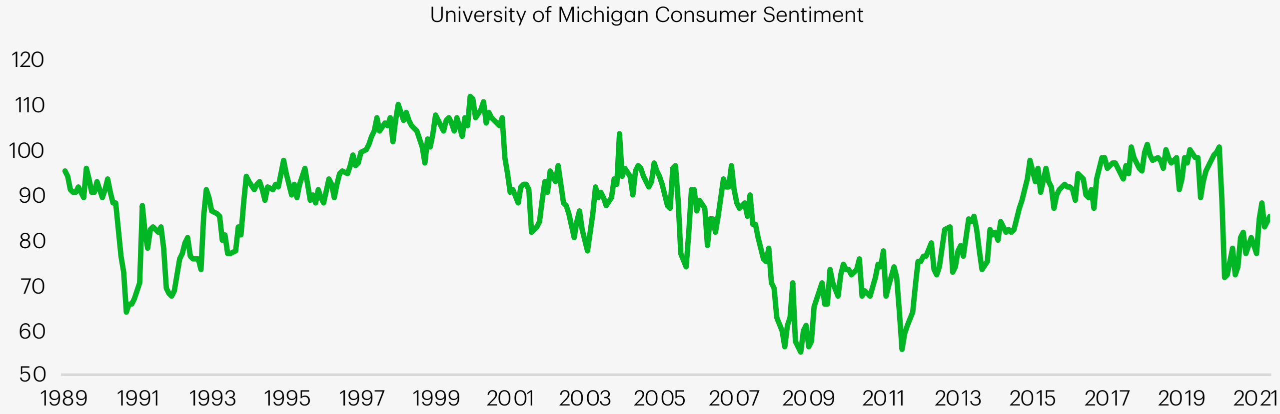
Back in May 2020, near the depths of the market crash, 30-day implied volatility for the S&P 500 climbed over 80. Fourteen months later, it was in the mid-teens (Figure 9). Talk about a journey from nothing but fear to fearing nothing at all.

Not surprisingly, the CBOE Volatility Index (VIX) has started to escalate in recent days. Since the start of July, when the VIX reached its post-Covid bear-market low, the VIX curve flattened and eventually inverted. This is likely the crescendo for peak everything, with perhaps the biggest signal being the rotation out of reflationary trades.

There are legitimate worries. With uneven vaccine supply around the world, macro data is more mixed, especially in China. In addition, there are fears around Fed tightening and the potential for a policy error. There are concerns about peak global fiscal support, and more recently, rising disruptions related to Covid-19 and the delta variant. All of these are playing out in real time.

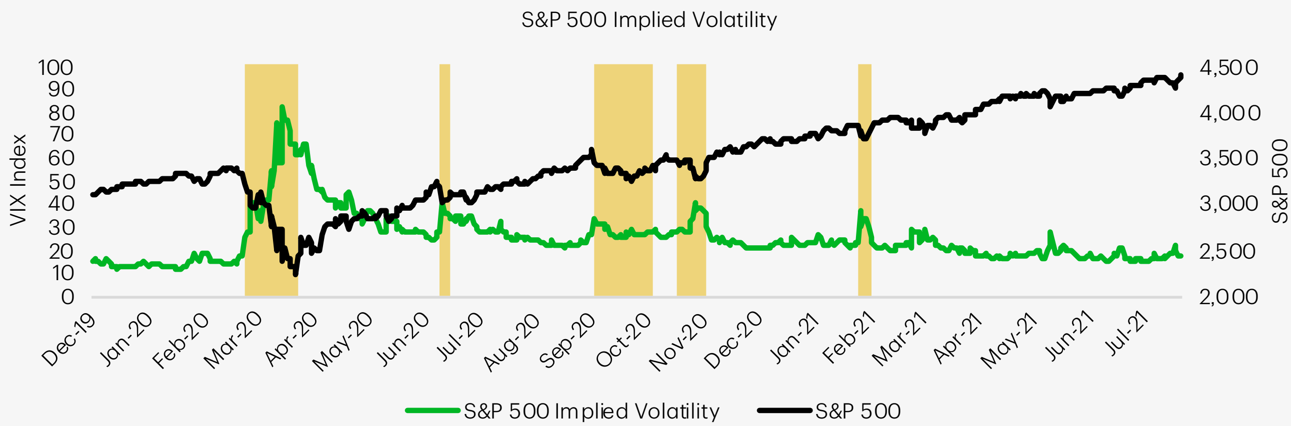
However, let's be mindful of where we are at. We are not rapelling down these peaks to arrive at Base Camp Pre-Covid. No, this is a completely new environment: a mid-cycle transition. Typically, these coincide with important equity-market leadership changes, where early-cycle investments begin to suffer from the thin air of higher altitudes.

Figure 8: Consumer Sentiment



Source: Bloomberg Finance LP as of July 22, 2021

Figure 9: Peak Complacency



Source: Bloomberg Finance LP as of July 22, 2021

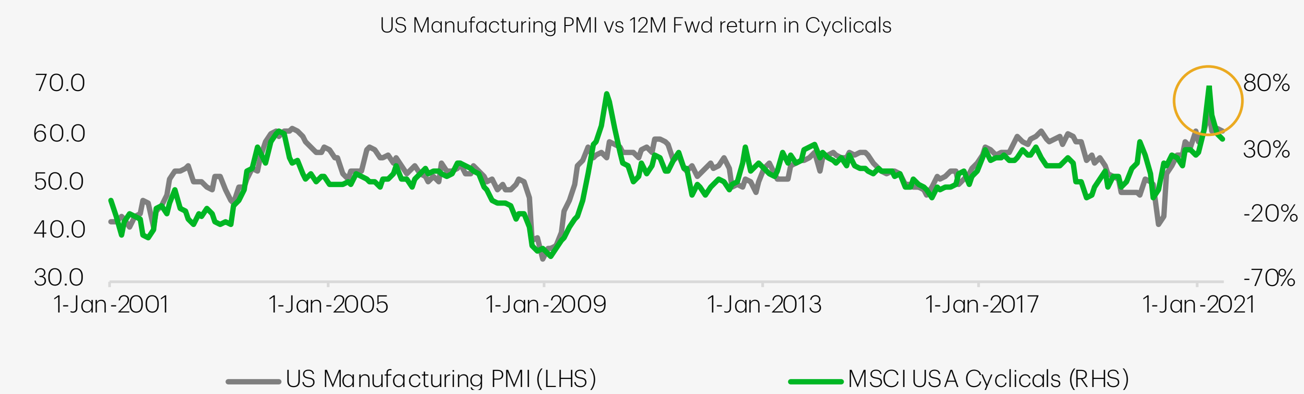
Looking at the U.S. cyclicals sector over the past 20 years (Figure 10), we find that it moves in tangent to growth in the U.S. manufacturing PMI, our so-called second peak. With the manufacturing PMI hitting a high of 62.1 in May, we believe the strong rotation into cyclicals should slow down now. Cyclicals could continue to lead the rally in equities, but the pace of appreciation observed between November 2020 and early April 2021 is not expected to be the same going forward.

In the broader sense, this shift should be good news for equity investors — but not so good for speculators. Low-quality equities led the rally for most of 2021 (Figure 11). As we move from an early-stage recovery to a mid-stage one, however, the market's focus will revert back to high-quality companies that can generate high positive free cash flow over the longer term. In recent weeks, high-quality equities have come back to life and have begun to outperform low-quality ones. We call times like these "show me markets." That's when corporate earnings growth is typically the dominant driver of equity returns, which is what we expect to see over the next 12 to 18 months. For investors who are passionate about strong businesses, these are the moments you live for.

Despite some signs of growth slowing, markets continue to exhibit healthy long-term fundamentals. We maintain our preference for equities over fixed income; however, the rate of return for equities is likely to moderate as the pace of earnings growth momentum abates. Some temporary inflation volatility may persist as the global recovery unfolds. We continue to view this as more of a cyclical phenomenon versus a longer-term structural shift. This view is largely supported by global central banks and has been reflected in the recent decline in long-term bond yields. Beyond inflation concerns, primary market headwinds include: the uneven pace of vaccinations globally; outbreaks of Covid-19 variants; increasing fiscal deficits; and elevated equity valuations. Most importantly, investors and portfolio managers should maintain properly diversified portfolios, managed to meet the client's specific goals and needs.

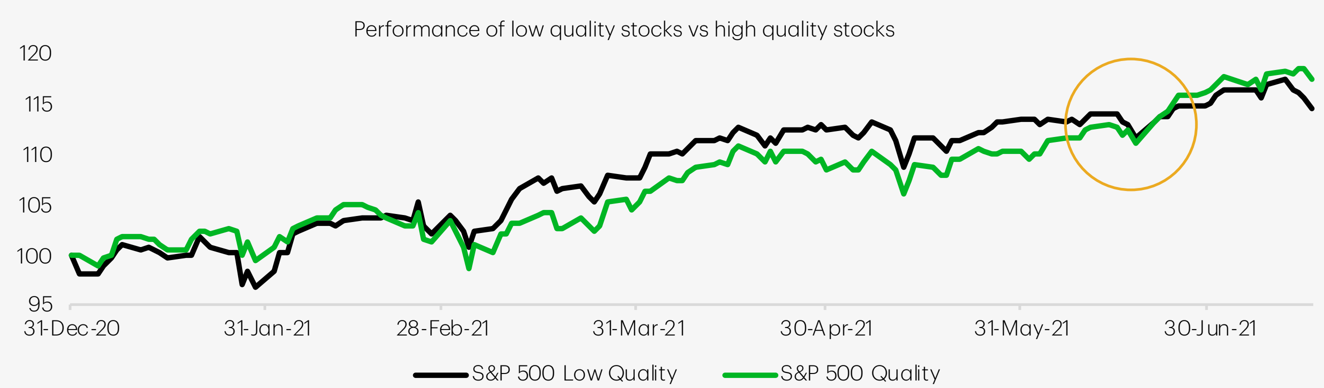
Investment is full of peaks, and of course the odd valley, but most of the time you are on the ascent. Whatever the terrain, we structure our portfolios to maintain a solid footing. We approach asset allocation with that as our core premise, and we make adjustments as the landscape unfolds. After all, you never know what's over the summit. ☐

Figure 10: Manufacturing Peak = Cyclical Peak



Source: Bloomberg Finance LP as of July 16, 2021

Figure 11: The Dawn of the "Show Me" Market"



Source: Bloomberg Finance LP as of July 16, 2021

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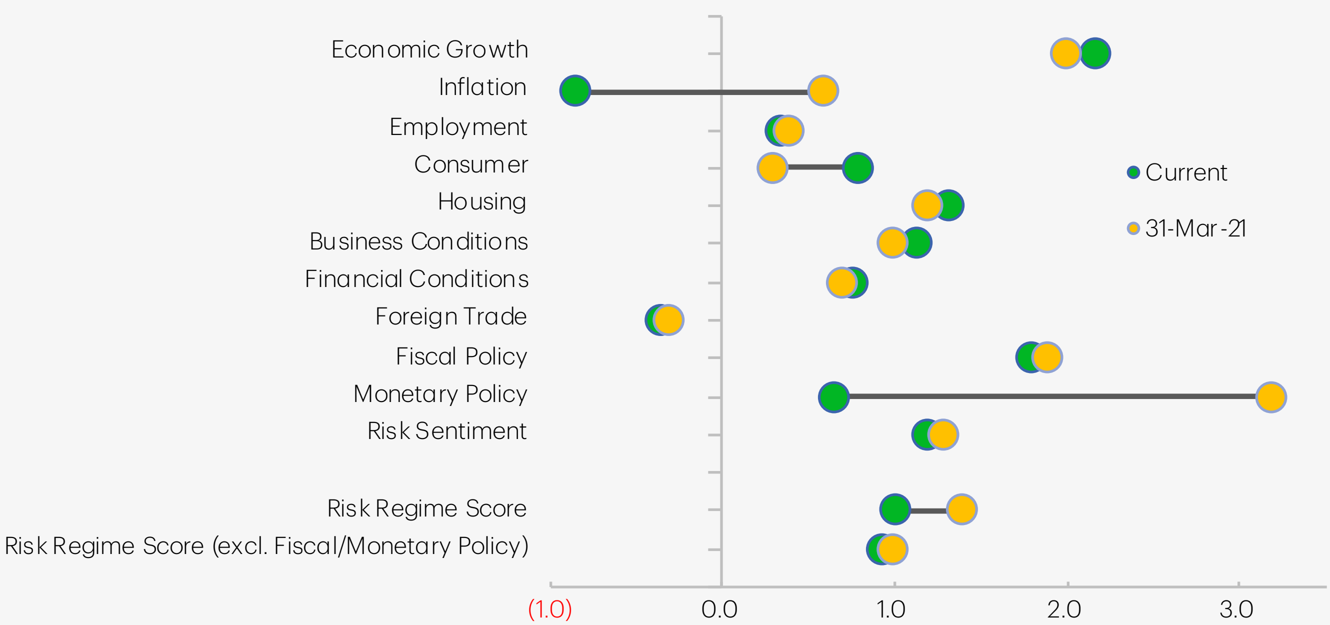
Leading Macro Indicators

We closely monitor many variables to inform our understanding of the economic and financial environment. For each indicator, we calculate current values and compare them against recent trends and long-term history using a standardized approach that makes it possible to aggregate across indicators. See Figure 4 on page 63 for the full list. The table and graph below summarize the overall condition and aggregate score of the indicators.

Figure 1: Market Risk Regime Scores

Indicator	Overall Condition	Current	31-Mar-21	31-Dec-20
Economic Growth	Strong	2.2	2.0	(2.6)
Inflation	Weak	(0.8)	0.6	(0.4)
Employment	Neutral	0.3	0.4	0.3
Consumer	Strong	0.8	0.3	(0.1)
Housing	Strong	1.3	1.2	1.1
Business Conditions	Strong	1.1	1.0	0.0
Financial Conditions	Strong	0.8	0.7	0.5
Foreign Trade	Neutral	(0.3)	(0.3)	0.0
Fiscal Policy	Accomodative	1.8	1.9	1.9
Monetary Policy	Accomodative	0.7	3.2	3.4
Risk Sentiment	Strong	1.2	1.3	0.9
Risk Regime Score	Low Risk	1.0	1.4	0.8
Risk Regime Score (excl. Fiscal/ Monetary Policy)	Low Risk	0.9	1.0	(0.1)



Source: Bloomberg Finance LP and TD Wealth as of June 30, 2021. Scores represent number of standard deviations away from long-term average

Our various indicators for risk sentiment have fallen from recent peaks but remain resilient in Q2 as investors continue to hold bullish views on global economic growth and anticipate the end of the pandemic. U.S. government fiscal stimulus is still accommodative and the Federal Reserve (Fed) has maintained its loose monetary policy despite the recent shift to a more hawkish tone on future rates. Investors continue to favour risk assets but growth expectations are more subdued. With the U.S. moving to late-stage economic recovery and the perceived likelihood of monetary tightening in the near term, investors have narrowed their focus to reliable growth and quality segments of the market.

Unlike Q1, when risk conditions improved across the board, risk indicators in Q2 moved in different directions as investors witnessed notable shifts in the macro environment. U.S. economic growth, consumer, housing, business and financial conditions improved slightly but not enough to offset significant declines in monetary policy and inflation indicators. Economic growth continues to support risk assets mainly because progress on the vaccination front has allowed most states to ease restrictions. Data for business activities and corporate earnings are still coming in above forecasts although investors expect earnings growth to decelerate after multiple quarters of positive surprises. The level of fiscal and monetary support remains staggering as the U.S. government and the Fed try to engineer a robust and more inclusive recovery, not just for financial assets but for the real economy as well.

When we aggregate indicators the overall risk regime score stands at +1.0 (a notable decline from +1.4 at the end of Q1), which still indicates a resilient regime that should support risk assets. Inflation data and the Fed's hawkish shift on monetary policy were the main drivers behind the decline in the risk score. The inflation score fell from +0.6 standard deviation above the historical norm to -0.8 standard deviation below and the monetary policy score tumbled from +3.2 to +0.7 standard deviation above the norm. Risk appetite also slipped and fiscal policy indicators retreated on the back of rolling obstacles and challenges to the Biden administration's fiscal agenda. On the positive side, we saw stronger data on economic growth, consumer sentiment, housing, business conditions, and financial conditions. Overall, and despite the continued threat of COVID-19, mainly in emerging markets, risk conditions continue to support risk assets.

Fiscal and monetary policies are central to all macro environments and they continue to weigh heavily in our aggregate risk regime score. They remain well in positive territory with a combined score of about +1.2, which indicates they're accommodative. However, since Q1, the risk environment has been resilient even when we strip out the impact of fiscal and monetary support. This is still true at the end of Q2. Excluding fiscal and monetary accommodation, the risk regime score stands at +0.9 which is almost the same as Q1. This score reflects an above-average, or resilient, risk environment. The variation (or lack thereof) between the two scores suggests risk sentiment isn't as dependent on fiscal and monetary actions as it was in H2 2020. This is particularly the case for monetary policy because investors have already priced in an earlier-than-expected tightening cycle. Despite this change, fiscal and monetary policy still underpin the overall risk regime so any unexpected shock from either would have a significant impact on investor risk sentiment. □

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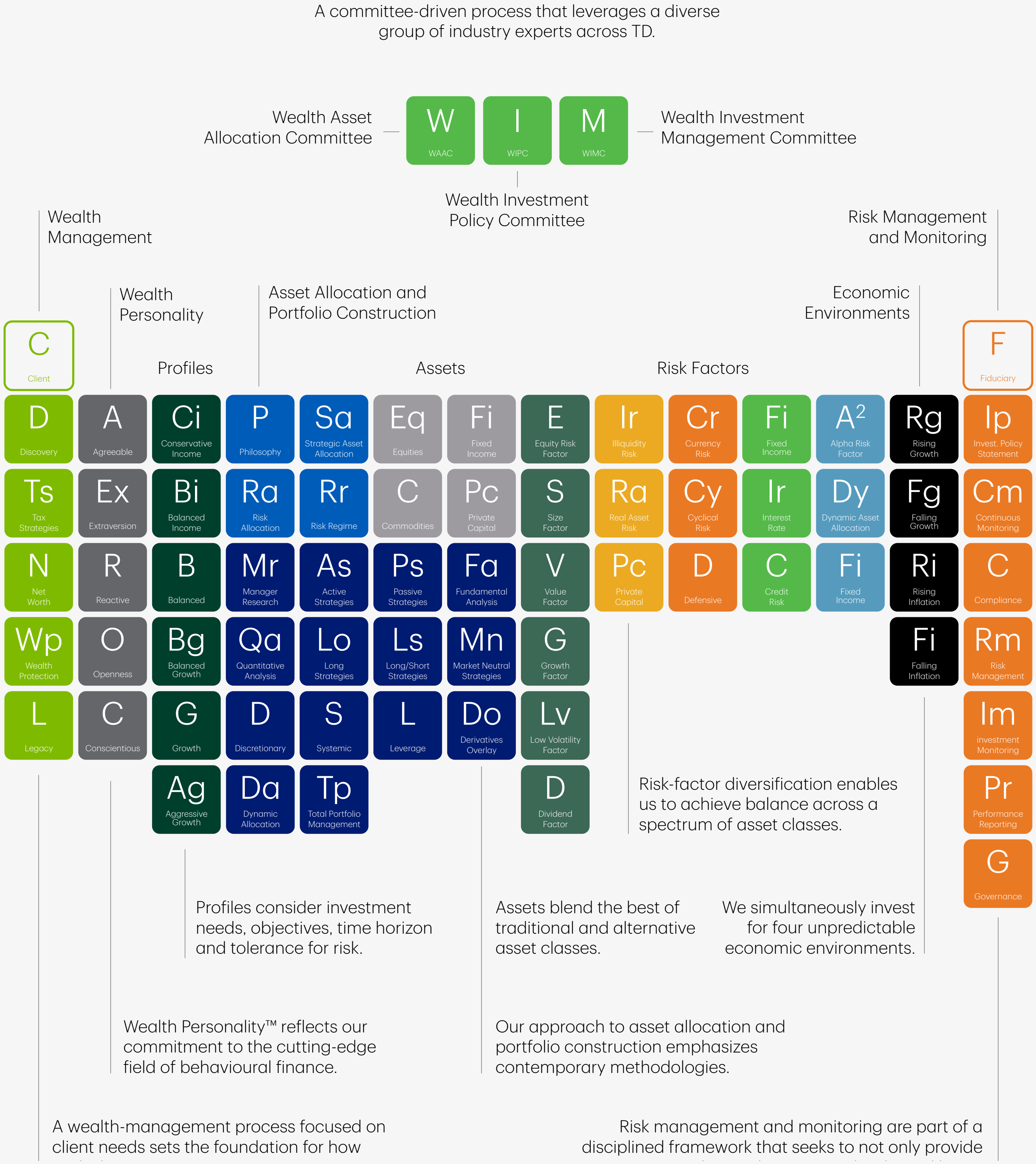
Elements of Wealth Management

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 prevailing six to 18 months.

Considers the financial market environment and provides direction, themes and current stance.

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

Committee members:

Robert Vanderhooft, CFA	**Chief Investment Officer, TD Asset Management Inc. (Chair)**
Robert Pemberton, CFA	Managing Director, TD Asset Management Inc.
David Sykes, CFA	Managing Director, TD Asset Management Inc.
Michael Craig, CFA	Managing Director, TD Asset Management Inc.
Ted Welter, CFA	Managing Director, TD Asset Management Inc.
Kevin Hebner, Ph.D.	Managing Director, Epoch Investment Partners, Inc.
Brad Simpson, CIM, FCSI	Chief Wealth Strategist, TD Wealth
Sid Vaidya, CFA, CAIA	U.S. Wealth Investment Strategist, TD Wealth
Glenn Davis, CFA	Managing Director, TDAM USA
Bryan Lee, CFA	Vice President & Director, TD Asset Management Inc.

Direction from WAAC

Strategic Positioning

	Asset Class	Underweight		Neutral		Overweight
Fixed Income Underweight	Domestic Gov't Bonds	●				
	Investment Grade Corp Bonds				●	
	Inflation Linked Bonds				●	
	High Yield Bonds		●			
	Global Bonds - Developed	●				
	Global Bonds - Emerging			●		
Equities Overweight	Canadian					●
	U.S.				●	
	International				●	
	Emerging Markets excluding China				●	
	China				●	
Alternative / Real Assets Overweight	Commercial Mortgages				●	
	Domestic Real Estate			●		
	Global Real Estate				●	
	Infrastructure				●	
Sub-Classes	Gold			●		
	Canadian Dollar vs U.S. Dollar				●	
	U.S. Dollar vs Basket of Currencies		●			
	Cash	●				

Source: TD Wealth Asset Allocation Committee, as of July 8, 2021

WAAC Positioning – Changes

Global Real Estate - Neutral to Modest Overweight
(Previously a component of Commercial Real Estate)

The economic recovery has progressed in many countries given virus containment, easing of restrictions and accelerated vaccine rollouts. Optimism is building as society moves toward normalcy in many places. Over the last year, essential retail has proven to perform well given their defensive nature and sentiment towards other retail assets has improved, particularly among enclosed shopping centres. As workplaces reopen, cities are witnessing a progression toward increasing physical occupancy in offices. We believe that an allocation to global real estate can serve as a compelling component to portfolios through its income advantage, inflation hedge and potential to improve risk-adjusted return outcomes.

High Yield Bonds – Neutral to Modest Underweight

High yield bonds have rallied significantly over the past year and while they remain a consideration for a diversified fixed income portfolio, valuations and extremely tight spreads have made high yield less compelling. Improving corporate fundamentals combined with constructive credit conditions suggest that some areas of the high yield market can still offer adequate compensation for risk, but we remain highly selective at this time.

WAAC Positioning – Current Monitoring

Fixed Income – Modest Underweight

We remain constructive toward investment grade corporate bonds, despite narrow spreads.

Despite the lower for longer interest rate backdrop, fixed income can still provide income potential, capital preservation, and act as a shock absorber for investment portfolios. Bond markets may continue to be subject to volatility from an uneven recovery, inflation concerns, and a slightly more hawkish U.S. Federal Reserve (the Fed). The uneven pace of global vaccinations remains a key impediment to growth, particularly in developing nations that have experienced slower inoculation distribution and have seen outbreaks from COVID-19 variants. Global central banks, however, continue to reaffirm their commitment to incorporating accommodative policies to support the economy and do not appear eager to deviate from current rate and quantitative easing programs. As a result, long-term rates have declined significantly from their recent peak levels as inflation is expected to remain under control as supply chain bottlenecks clear.

We remain constructive toward investment grade corporate bonds, despite spreads narrowing to pre-pandemic levels, and are comfortable with our modest overweight view. Corporate bonds continue to offer a yield advantage over government bonds of which we maintain a maximum underweight view, due to their uncompelling value prospects.

Equities – Modest Overweight

We continue to expect equities to advance broadly, and deliver returns in excess of fixed income over the next 12-18 months.

Our outlook for longer-term global economic and equity market growth remains favourable. The pace of pent-up consumer spending will likely continue to bolster growth in the shorter-term but then begin to moderate in the following months. Earnings growth has rebounded and encouragingly we are continuing to see positive earnings surprises and estimate revisions in most markets. We anticipate that the latter part of 2021 will see increased market volatility, and more subdued returns, but we expect equities to continue to advance broadly and deliver returns in excess of fixed income.

We maintain an overweight view to Canadian equities, supported by improving fundamentals for the Canadian economy, particularly in areas like Commodities, Financials and Energy assets. Rapidly improving vaccine distribution and easing of restrictions, should allow business activity to accelerate and drive Canadian equity market outperformance.

We remain optimistic toward European economically sensitive countries (U.K., Germany, France), which continue to benefit from reopenings. As business and consumer activity rebound this should be supportive of improving corporate fundamentals and drive equity returns higher. However, recent virus outbreaks in parts of Europe remain a concern.

In Asia, policy uncertainty and regulatory concerns have weighed on China's relative performance in recent months, and on Asian markets as a whole. However, looking forward, Asian and emerging markets growth prospects remain attractive and equity valuations provide a relative discount to developed markets on the basis of forward priced-to-earnings multiples.

Alternatives/Real Assets – Modest Overweight

Commercial mortgages continue to provide resilient income streams.

Commercial mortgages continue to provide resilient income streams with the collection of principal and interest payments, while our exposure experienced zero impairments or defaults through the pandemic.

In Canada, transaction activity within the real estate market has rebounded and 2021 is expected to be one of the highest on record in terms of volumes. Canada is also forecast to lead all G7 countries in terms of employment and population growth over the next five years. These economic indicators should support real estate valuations across major markets.

We maintain a modest overweight to infrastructure as the asset class continues to offer stable returns, with low correlation to other asset classes, and an imbedded inflation hedge through contracted increases in revenue. Momentum is gathering for new infrastructure as economies emerge from the pandemic and governments seek to bridge an enormous gap in spending.

Sub-Classes

We retain an underweight outlook for the U.S. dollar versus global counterparts

The Canadian dollar has weakened versus the U.S. dollar recently, alongside oil price volatility as OPEC+ producers clash over supply increases amid rising demand. Despite recent weakness, we expect the improving Canadian economy, and more hawkish Bank of Canada to be supportive of current or modestly higher levels for the currency.

The U.S. dollar has strengthened against major currencies driven in part by more hawkish guidance from the Fed. However, the U.S. dollar may weaken over the coming quarters as the pace of U.S. economic and corporate profitability growth show signs of potentially peaking, coupled with concerns over increasing fiscal deficits.

Gold has been a relative underperformer and volatile this year. Gold experienced some pressure as the U.S. dollar strengthened following the Fed's perceived hawkish shift. We remain neutral in our outlook for gold despite some uncertainty around the global economic recovery, inflation risks, and virus outbreaks in certain countries.

Current Investment Themes

Our Wealth Asset Allocation Committee keeps a running watch list of themes that guide our decision-making. Current themes include:

1. Despite growth indicators showing some signs of slowing, markets continue to exhibit healthy long-term fundamentals. We maintain our preference for equities over fixed income; however, the rate of return for equities is likely to moderate as the pace of earnings growth momentum abates.

2. Some temporary inflation volatility may persist as the global recovery unfolds. We continue to view this as more of a cyclical phenomenon versus a longer-term structural shift. This view is largely supported by global central banks and has been reflected in the recent decline in long term bond yields.

3. Beyond inflation concerns, primary market headwinds include the uneven pace of vaccinations globally, outbreaks of virus variants, increasing fiscal deficits, and elevated equity valuations.

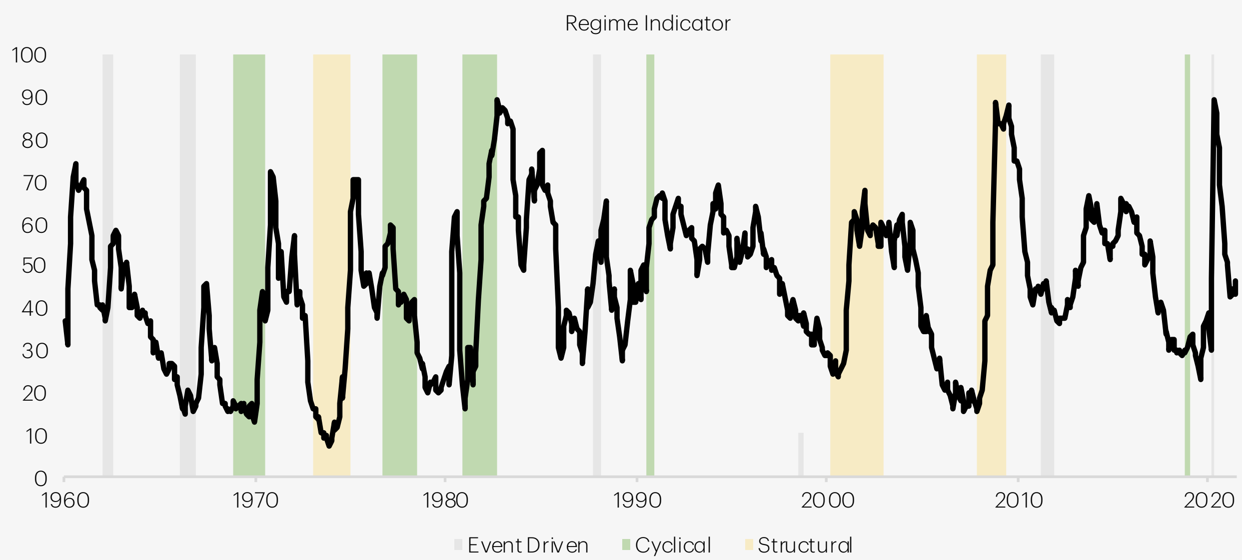
4. Within fixed income we maintain our overall underweight bias, but with a modest overweight to investment grade corporate bonds. We see value in certain segments of the credit market, despite the tightening of spreads. Corporate bonds also provide a yield advantage to government bonds, which remain uncompelling due to their negative real returns.

5. In our view, where appropriate, portfolio exposure to alternative assets may take on greater importance to achieve higher relative returns at more acceptable volatility levels. Alternative assets, such as mortgages, infrastructure and real estate can also act as a hedge against inflationary risks.

Regime Score

Our regime work points to a good, not great investment environment. We believe a number of factors are indicating that the global economy is moving from the early stages of an economic cycle to a mid-stage recovery. The indicator score is currently at 46 which we consider "fair value" zone. The higher the score, the more bullish, the lower to more bearish. Most of the previous bear markets are captured when this indicator is falling below 30. □

Figure 1: Regime score of 46 indicates 'Fair Value'



Note: The indicator is scaled form 0 to 100. The higher the more bullish, the lower the more bearish. Most of the previous bear markets are captured when this indicator is falling below 30.

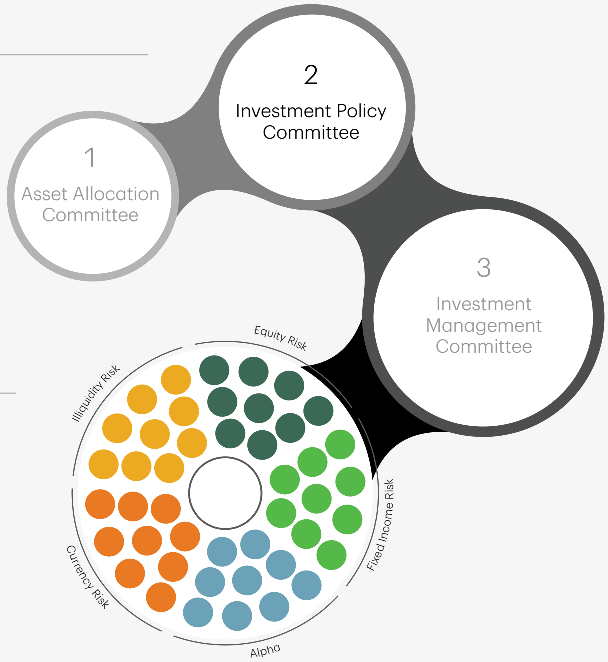
Source: TD Wealth Asset Allocation Committee and Refinitiv Datastream, as of June 30, 2021

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, TD Wealth (Chair)

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

Amol Sodhi, CFA, CIM ....VP & Director, TDAM

Anna Castro, CFA ....VP & Director, TDAM

Christopher Lo, CFA .... Head of Managed Investments, TD Wealth

Alice Lim, MBA ....Head of Product Governance & Marketing, TD Wealth

Van Hoang, FRM, CFA...Senior Macro Strategist, TD Wealth

We employ a greater spectrum of asset classes including: fixed income, equity and real assets

Strategic and dynamic asset-class weights by investor profile

Asset Class	Cons. Income			Balanced Income			Balanced			Balanced Growth			Growth			Aggressive Growth		
	Strat	Dyn	Diff	Strat	Dyn	Diff	Strat	Dyn	Diff	Strat	Dyn	Diff	Strat	Dyn	Diff	Strat	Dyn	Diff
Cash	2.0%	2.0%	0.0%	2.0%	2.0%	0.0%	2.0%	2.0%	0.0%	2.0%	2.0%	0.0%	2.0%	2.0%	0.0%	2.0%	2.0%	0.0%
Fixed Income	78.0%	71.0%	-7.0%	63.0%	56.0%	-7.0%	48.0%	41.0%	-7.0%	33.0%	26.0%	-7.0%	23.0%	16.0%	-7.0%	0.0%	0.0%	0.0%
Government	39.0%	35.0%	-4.0%	32.0%	27.0%	-5.0%	24.0%	19.0%	-5.0%	17.0%	11.0%	-6.0%	11.0%	5.0%	-6.0%	0.0%	0.0%	0.0%
Corporate	39.0%	36.0%	-3.0%	31.0%	29.0%	-2.0%	24.0%	22.0%	-2.0%	16.0%	15.0%	-1.0%	12.0%	11.0%	-1.0%	0.0%	0.0%	0.0%
Equity	20.0%	27.0%	7.0%	35.0%	42.0%	7.0%	50.0%	57.0%	7.0%	65.0%	72.0%	7.0%	75.0%	82.0%	7.0%	98.0%	98.0%	0.0%
Canadian	6.0%	8.0%	2.0%	11.0%	13.0%	2.0%	15.0%	17.0%	2.0%	20.0%	22.0%	2.0%	23.0%	25.0%	2.0%	29.0%	29.0%	0.0%
U.S.	8.0%	10.0%	2.0%	14.0%	16.0%	2.0%	20.0%	22.0%	2.0%	26.0%	28.0%	2.0%	30.0%	32.0%	2.0%	40.0%	40.0%	0.0%
International	4.0%	6.0%	2.0%	7.0%	9.0%	2.0%	10.0%	12.0%	2.0%	13.0%	15.0%	2.0%	15.0%	17.0%	2.0%	19.0%	19.0%	0.0%
Emerging Markets	2.0%	3.0%	1.0%	3.0%	4.0%	1.0%	5.0%	6.0%	1.0%	6.0%	7.0%	1.0%	7.0%	8.0%	1.0%	10.0%	10.0%	0.0%

Strat: Strategic, Dyn: Dynamic, Diff: Difference. Source: Wealth Investment Policy Committee, as of July 8, 2021

Expanded Strategic and dynamic asset-class weights by investor profile

Asset Class	Cons. Income			Balanced Income			Balanced			Balanced Growth			Growth			Aggressive Growth		
	Strat.	Dyn.	Diff.	Strat.	Dyn.	Diff.	Strat.	Dyn.	Diff.	Strat.	Dyn.	Diff.	Strat.	Dyn.	Diff.	Strat.	Dyn.	Diff.
Cash	2.0%	2.0%	0.0%	2.0%	2.0%	0.0%	2.0%	2.0%	0.0%	2.0%	2.0%	0.0%	2.0%	2.0%	0.0%	2.0%	2.0%	0.0%
Fixed Income	71.0%	64.0%	-7.0%	56.0%	49.0%	-7.0%	41.0%	34.0%	-7.0%	26.0%	19.0%	-7.0%	16.0%	9.0%	-7.0%	0.0%	0.0%	0.0%
Domestic Gov't Bonds	25.0%	21.0%	-4.0%	20.0%	16.0%	-4.0%	14.0%	10.0%	-4.0%	9.0%	4.0%	-5.0%	5.0%	1.0%	-4.0%	0.0%	0.0%	0.0%
Invest. Grade Corp Bonds	24.0%	24.0%	0.0%	19.0%	19.0%	0.0%	14.0%	14.0%	0.0%	9.0%	9.0%	0.0%	6.0%	6.0%	0.0%	0.0%	0.0%	0.0%
Inflation Linked Bonds	5.0%	8.0%	3.0%	4.0%	7.0%	3.0%	3.0%	6.0%	3.0%	2.0%	4.0%	2.0%	1.0%	1.0%	0.0%	0.0%	0.0%	0.0%
High Yield Bonds	5.0%	4.0%	-1.0%	4.0%	3.0%	-1.0%	3.0%	2.0%	-1.0%	2.0%	1.0%	-1.0%	1.0%	0.0%	-1.0%	0.0%	0.0%	0.0%
Global Bonds - Developed	8.0%	3.0%	-5.0%	6.0%	1.0%	-5.0%	5.0%	0.0%	-5.0%	3.0%	0.0%	-3.0%	2.0%	0.0%	-2.0%	0.0%	0.0%	0.0%
Global Bonds - Emerging	4.0%	4.0%	0.0%	3.0%	3.0%	0.0%	2.0%	2.0%	0.0%	1.0%	1.0%	0.0%	1.0%	1.0%	0.0%	0.0%	0.0%	0.0%
Real Assets	7.0%	7.0%	0.0%	10.0%	10.0%	0.0%	15.0%	15.0%	0.0%	15.0%	15.0%	0.0%	15.0%	15.0%	0.0%	13.0%	13.0%	0.0%
Mortgages/Private Debt	7.0%	7.0%	0.0%	7.0%	7.0%	0.0%	7.0%	7.0%	0.0%	7.0%	7.0%	0.0%	7.0%	7.0%	0.0%	0.0%	0.0%	0.0%
Real Estate/Infrastrucutre	0.0%	0.0%	0.0%	3.0%	3.0%	0.0%	8.0%	8.0%	0.0%	8.0%	8.0%	0.0%	8.0%	8.0%	0.0%	13.0%	13.0%	0.0%
Equity	20.0%	27.0%	7.0%	32.0%	39.0%	7.0%	42.0%	49.0%	7.0%	57.0%	64.0%	7.0%	67.0%	74.0%	7.0%	85.0%	85.0%	0.0%
Canadian	6.0%	8.0%	2.0%	10.0%	12.0%	2.0%	12.0%	14.0%	2.0%	17.0%	19.0%	2.0%	20.0%	22.0%	2.0%	25.0%	25.0%	0.0%
U.S.	8.0%	10.0%	2.0%	13.0%	15.0%	2.0%	17.0%	19.0%	2.0%	23.0%	25.0%	2.0%	27.0%	29.0%	2.0%	35.0%	35.0%	0.0%
International	4.0%	6.0%	2.0%	6.0%	8.0%	2.0%	8.0%	10.0%	2.0%	11.0%	13.0%	2.0%	13.0%	15.0%	2.0%	15.0%	15.0%	0.0%
Emerging Markets ex. China	2.0%	3.0%	1.0%	3.0%	4.0%	1.0%	5.0%	6.0%	1.0%	6.0%	7.0%	1.0%	7.0%	8.0%	1.0%	10.0%	10.0%	0.0%
Fixed Income	80.0%	73.0%	-7.0%	65.0%	58.0%	-7.0%	50.0%	43.0%	-7.0%	35.0%	28.0%	-7.0%	25.0%	18.0%	-7.0%	2.0%	2.0%	0.0%
Equity	20.0%	27.0%	7.0%	35.0%	42.0%	7.0%	50.0%	57.0%	7.0%	65.0%	72.0%	7.0%	75.0%	82.0%	7.0%	98.0%	98.0%	0.0%

Strat: Strategic, Dyn: Dynamic, Diff: Difference. Source: Wealth Investment Policy Committee, as of July 8, 2021

Dynamic positioning by risk factor weights

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

Source: TD Wealth Investment Policy Committee, as of July 8, 2021.

Economic Outlook

Adopting A Risk Management Approach On Central Bank Policy

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

Highlights

- A swifter path for the economic recovery is expected to lead the Federal Reserve to begin to raise the policy rate by the end of 2022.
- Monetary policy is a blunt tool. Central bankers will have difficulty fine-tuning it to achieve goldilocks outcomes for all groups in the labor market. That responsibility is better placed with fiscal policymakers.
- As 2022 approaches, we expect central bank communication to tilt toward a risk management lens, with a focus on the risk of leaving rates too low for too long.

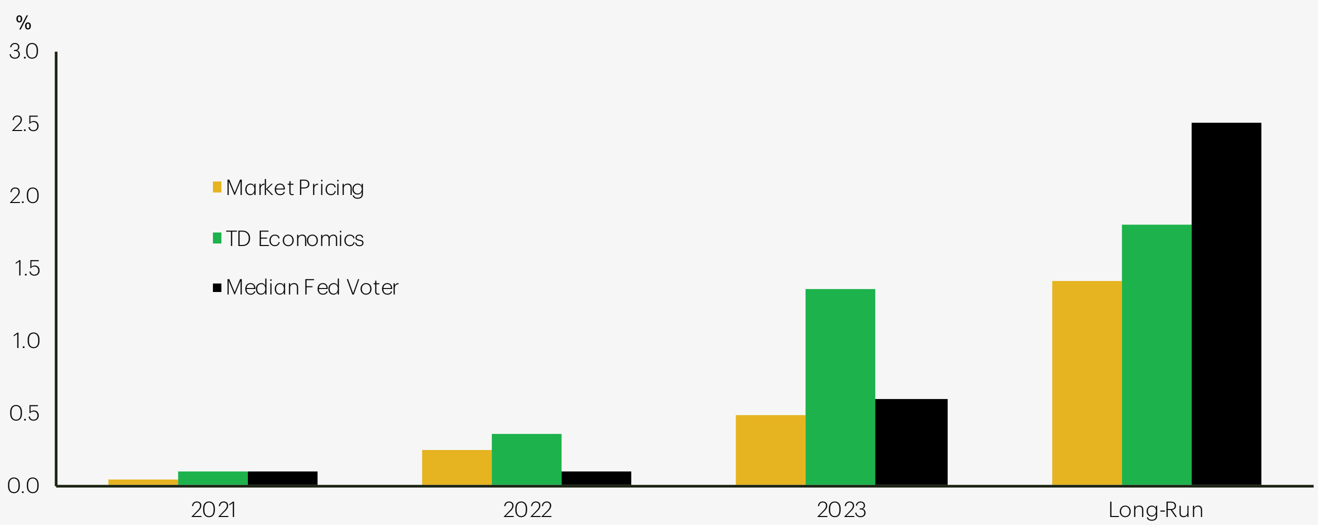
U.S. economic data are serially exceeding expectations. From the ISM manufacturing and service data that reveal not just resilience but strength, to households that show a strong appetite to spend their accumulated savings, the determination of the U.S. economic rebound cannot be denied. This sentiment was echoed by Federal Reserve Chair Jay Powell when he stated that the economy is "at an inflection point." Evidence supporting the reflation narrative is likely to continue in the months ahead, prompting Fed members to adjust their forward guidance, cementing expectations for an earlier rate hike cycle and an end to Quantitative Easing (QE).

Rate Hikes: The Horizon is Coming Into Focus

In the Federal Open Market Committee's (FOMC) Summary of Economic Projections, members have dramatically upgraded their employment and inflation outlook over the last few months. The median voter now sees the unemployment rate dropping below its estimate of longer-term "full employment" in 2022. Core PCE inflation is also expected to remain at or above 2% for the next few years. Effectively, the Fed looks to have met its broad policy mandate a year earlier than it predicted just six months ago. This aligns to a pull-forward in FOMC expectations for rate hikes.

While the median FOMC voter now shows the start of the rate hiking cycle in 2023, the individual voting card reveals a growing number expecting earlier rate hikes. Seven FOMC members expect rate hikes in 2022. Back in January, only one member stood in the 2022 camp. With respect to how high rates can get, FOMC members have been steadfast in believing that the policy rate will eventually end up between 2% and 3% (Figure 1).

Figure 1: Expect Earlier Rate Hikes



Source: FOMC, Bloomberg Finance L.P., TD Economics, as at June 23, 2021

Market participants have been more aggressive than the Federal Reserve and have been preparing for an earlier exit from the zero-policy stance. The first step in the rate hiking cycle is priced for late-2022/early-2023, with the policy rate eventually peaking between 1% and 1.5% ten years from now. In other words, market pricing is more optimistic than the Fed on the start of rate hikes, but less optimistic with respect to the endpoint.

We share the view of the market on the near-term, but are in between the market and the Fed on the policy rate endpoint, expecting it to land at roughly 1.85%. Our near-term view is grounded in a forecast that fully absorbs economic slack by the end of this year (Figure 2). This is occurring thanks to booming equity markets, rising house prices, and a strong government safety net, all of which support robust consumer spending. By extension, we expect full employment to be reached by the middle of next year and core PCE inflation to stay above 2% for the next few years.

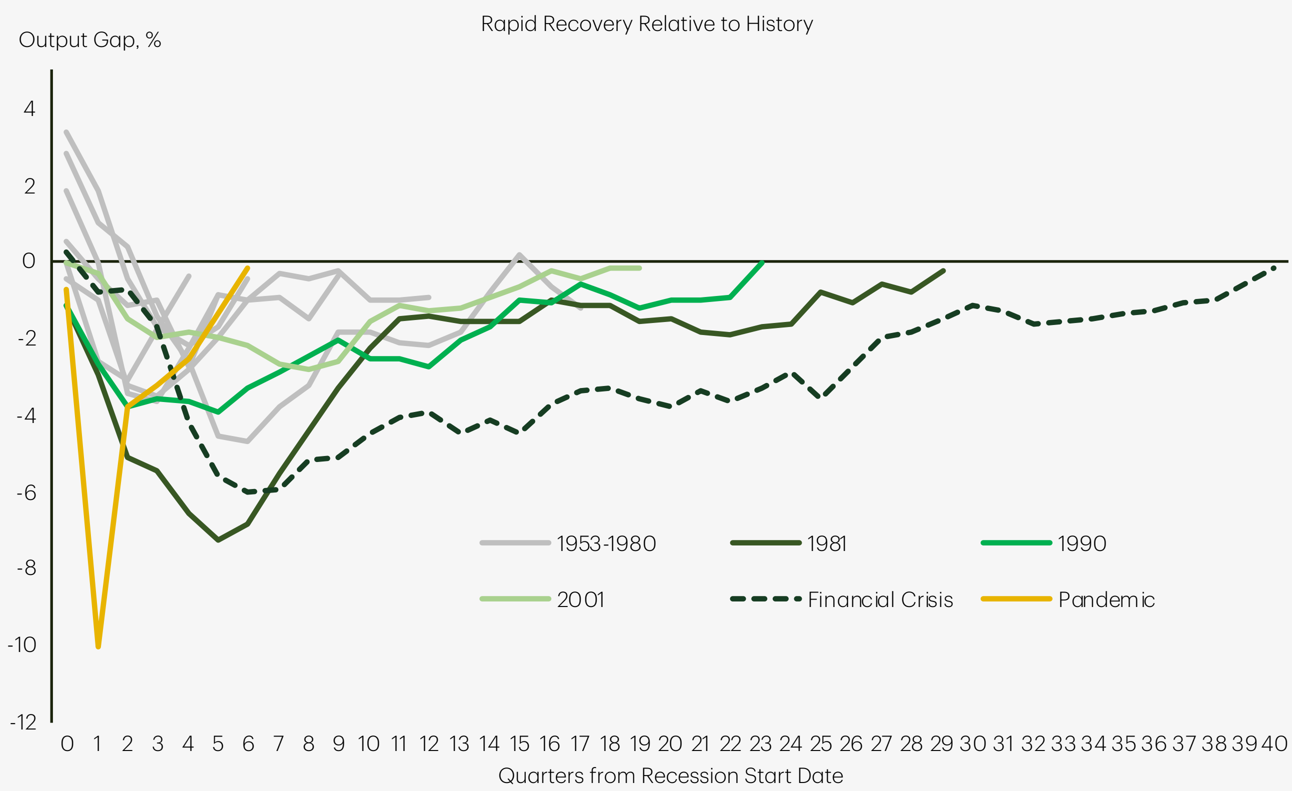
Given its mandate of full employment and average inflation of 2%, the Fed would have a hard time standing still on a zero-bound policy rate by the end of 2022.

Pressure Testing the Forecast

Between the inflation and employment mandates of the Federal Reserve, we have greater confidence in our inflation outlook. That's because the Fed has indicated repeatedly that it is attempting to pursue a policy approach that is in greater alignment to inclusive employment outcomes. This presents three risks to the forecast. The first is that with a broader range of labour market indicators, it is harder to interpret when "full employment" is achieved. The second is that the absorption of workers may occur more slowly than anticipated as businesses prove cautious in rehiring or have learned to adapt with fewer workers. The third (and the most probable outcome), is that re-hiring occurs in sectors that differ relative to where workers were displaced by the pandemic. This could leave the post-pandemic labor market with a greater number of discouraged or structurally unemployed workers.

Even in this world, it's hard to see the Fed holding the policy rate at the zero bound. We have long been told by central bankers that the policy rate is a blunt tool. It works in the aggregate, but not with surgical precision.

Figure 2: The economic output gap is expected to be absorbed by year-end



Source: CBO, TD Economics as at June 23, 2021

Once there's significant progress and critical mass on healing the labor market, the keys should be turned over to fiscal policymakers to address specific shortcomings through financial aid and training/employment services. Sustaining a zero-policy rate would do little to influence the outcome for a 55-year-old worker who was displaced from the tourism industry. The risk management lens will need to become focused in the other direction. Leaving rates too low for too long fuels excess behavior in other segments of the market (like asset prices) that can put financial and labor market stability at risk. We are already seeing some of this risky behavior in the stock market, and the housing market is the next most highly exposed. Resetting Wall Street and Main Street expectations for ongoing easy money will take on greater importance during this period of economic slack absorption in both GDP and the job market, even if the latter is imperfect.

Addressing the Balance Sheet

If our economic forecast is correct, the Federal Reserve will have to reconsider its balance sheet policy in short order. Recall that at the onset of the pandemic, the Fed dusted off and expanded upon its policy playbook from the Global Financial Crisis (GFC). It re-started liquidity programs to ease short-term borrowing constraints and re-launched its QE program to put downward pressure on yields. It also broadened the types of assets it purchased to include riskier corporate debt. Furthermore, it cemented itself as the lender of last resort through its Main Street Lending and Paycheck Protection Program. Put another way, it opened and deployed the war chest.

Despite a robust recovery forming, the Fed is still actively purchasing government bonds and mortgage-backed securities (MBS) at a clip of $80 billion and $40 billion a month, respectively. In its policy statement, the Fed has declared that it will continue QE until "substantial further progress has been made toward the Committee's maximum employment and price stability goals." This is likely to be achieved within the next several months, offering an opportunity for the Fed to pivot communication and signal an easing of asset purchases before the end of 2021.

This provides some upside for our yield forecast. The last time the Fed signaled an adjustment to its QE policy in 2013, the UST 10-year yield shot up 132 basis points in just four months (also known as the taper tantrum). At the time, the Fed was only hinting of an end to new purchases, it wasn't even debating an unwind of its balance sheet. The point here is that an adjustment to QE policy acts as a strong forward guidance signal and investors will quickly price higher yields as a result.

This time around, the 10-year yield has already jumped 122 basis point from the August 2020 low. That is a big move without any signal from the Fed that it will tighten policy. We do not expect an additional 100 basis points tacked on once the communication adjustment to QE policy occurs, but some volatility is likely, and the UST 10-year could reach 2% quicker than previously thought.

What Does this Mean for our Yield Outlook?

Our readers know that the driving force behind the rise in government bond yields since August 2020 has been the rise in inflation expectations and the anticipation of an earlier start to the central bank rate hiking cycle. Given our expectation that the Fed will hike at the end of 2022 and eventually get the effective policy rate to 1.85%, the fair value of the UST 10-year yield is around 1.7% to 1.8% today. We see the 10-year rising to our long-term target of 2.5% over the next couple of years, although as we note above, the speed of adjustment is a wild card.

With the UST 10-year yield currently trading around 1.4%, it is just a little lower than our estimate of fair value. When we break down this yield into the path for rates and the term premium, we calculate that just over 40% of the 10-year yield is due to Fed policy rate path expectations. The rest is investors demanding compensation for the risk that inflation will overshoot and that the Fed may surprise the market with more rate hikes. In other words, investors aren't banking that the Fed will raise rates as high as we think it will, but they want more compensation for this risk.

Bottom Line

The economic recovery continues to show incredible resilience. GDP and employment are quickly closing in on their potential. Inflation is currently overshooting 2%, and even with its undershoot in the early days of the pandemic, it is well on its way to meeting the Fed's new average inflation framework. The Fed is recognizing this upturn in the economy but has been hesitant to change its tune on its policy stance. As long as the recovery continues as we expect, policy will shift to ensuring that inflation expectations remain well anchored and financial stability risks do not threaten future economic growth. This all sets us up for higher longer-term yields and an earlier exit from ultra-low rates. □

Asset Class Analysis

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Quarter in Review

Peak Growth, Lower Expectations

Risk assets continued to set new records in Q2, driven by successful vaccination campaigns that have caused Covid-19 cases to plummet and allowed economies to reopen across the developed world. As a result, the U.S. and other developed economies have rebounded aggressively, despite recent upticks in inflation. By contrast, developing economies remain under pressure from slow vaccination rollouts and renewed shutdowns. Unlike last quarter, when higher growth and inflation expectations propelled pro-cyclical assets and equity sectors to new heights, government bond yields and inflation expectations reversed course and yield curves flattened during Q2. This shift halted the aggressive rotation into value stocks that started in Q4 2020. As the quarter ended, many developed countries have vaccinated most of their eligible population, although the vaccination rate has stalled at just above 50% in the U.S. Major economies have largely reopened or are on pace to reopen fully in Q3. At the same time, new Covid-19 cases continue to plummet worldwide despite the spread of a more infectious delta variant that is wreaking havoc on countries that have been slow to roll out the vaccine.

Meanwhile, major central banks continued to provide accommodation and liquidity, pushing companies to raise record amounts of capital through equity and debt markets, and driving abundant M&A activities. Consumer and business confidence remain strong. Corporate earnings have recovered and are projected to exceed pre-pandemic levels over the next 12 months. As a result, major economies (notably the U.S.) are now expected to generate substantial growth. In fact, U.S. growth is expected to beat the already high forecast range of 6% to 7% from last quarter. This level of growth would allow the U.S. economy to recover fully and shift back to the growth path it was on before the pandemic. All these factors continue to propel risk appetite higher as volatilities across asset classes remain near historic lows.

Risk Factor Diversification

Asset allocation is the principal driver of portfolio performance which means asset mix design is crucial to portfolio construction. We focus on risk-factor diversification and the underlying risk characteristics of asset classes — not asset class labels — to construct asset mixes. Asset classes have a common set of macroeconomic phenomena or risk factors that drive performance. Key macroeconomic risk factors include economic growth, interest rates, credit spreads, inflation, liquidity and currency risk.

Because of these risk factors, each asset class has environmental biases that govern how it performs under a variety of market scenarios. Some asset classes (equities, corporate bonds, commodities, emerging-market debt) perform well in rising-growth environments, while others (namely, government bonds) do well in the opposite environment. Nominal government bonds perform well under disinflationary conditions while inflation-linked bonds benefit from inflationary environments. This framework of risk factors and environmental biases forms an intuitive four-quadrant matrix that captures underlying exposures and shows how key asset classes have performed historically over market cycles. Each of the four scenarios have occurred about a quarter of the time based on historical data (Figure 1).

Factor diversification targets exposures that provide a return premium over time while minimizing exposure to uncompensated factors, limiting exposure to any single factor and reducing the impact of factor cyclicality. All factors go through unique cycles and prolonged periods of underperformance. Take, for example, the value factor: it has lagged for over a decade, underperforming by well over 30% in 2020 alone, while the growth factor rallied. By focusing on factor diversification, we can build robust portfolios that generate more stable return steams, which help protect capital when we need it most.

As with any investment, there are no guarantees. That's why it's crucial to start with a well-constructed, well-diversified asset mix, designed to match the unique circumstances and long-term goals of each investor and to help them work towards achieving those goals.

Macro Environment Perspective

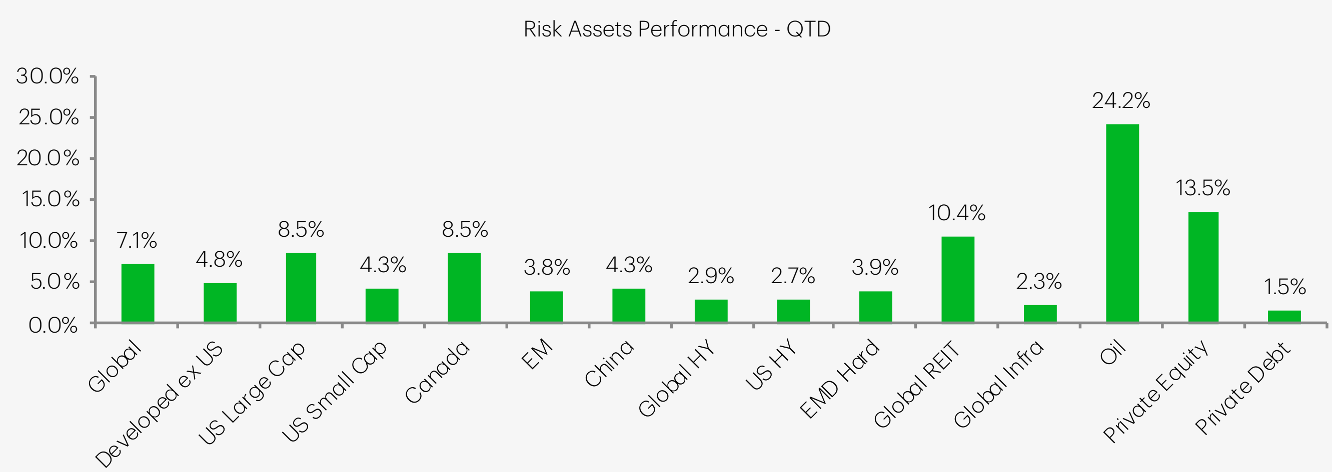
If we look at Q2 through a macroeconomic perspective with four kinds of environments (Figure 1) — rising and falling inflation; rising and falling growth — the two “rising growth” quadrants continued to lead. Asset classes that benefit from economic recovery outperformed in Q2 as investors continued to favour risk assets (Figure 2) in light of strong economic growth (although this trend is expected to slow). Expectations for inflation, however, weakened over the near term after rising significantly during Q1. In large part, this had to do with the Federal Reserve’s shift in June to a more hawkish stance on managing inflation risk, which brought rate-hike expectations forward.

Figure 1: Asset Class Performance by Macroeconomic Environment

Economic Environment	Rising Inflation						Falling Inflation					
			MTD	QTD	YTD	1 Year			MTD	QTD	YTD	1 Year
Rising Growth	Commodities	GSCI	4.3%	15.7%	31.4%	57.4%	Equities	Global	2.1%	7.1%	13.4%	36.8%
		Energy	9.6%	22.1%	48.4%	72.6%		US	2.3%	8.5%	15.3%	40.8%
		Oil	10.8%	24.2%	51.4%	87.1%		Canada	2.5%	8.5%	17.3%	33.9%
		Copper	-8.7%	6.6%	20.8%	55.8%		EAFE	1.4%	4.8%	12.7%	27.1%
		Agriculture	0.3%	12.3%	19.1%	57.9%		EM	0.8%	3.8%	7.9%	36.1%
		Ind. Metals	-3.6%	9.6%	19.5%	49.4%		China	-1.5%	4.3%	1.0%	27.7%
	Emerging Market Debt	Hard	0.9%	3.9%	-1.0%	6.8%	Corporate Bonds	Global IG	1.1%	2.4%	-0.9%	3.7%
		Local	-1.1%	3.5%	-3.3%	7.3%		Global HY	0.8%	2.9%	2.7%	13.6%
								Private Debt	0.4%	1.5%	3.3%	11.7%
Falling Growth	Inflation-Linked Government Bonds	Global	0.3%	2.9%	0.2%	3.3%	Nominal Government Bonds	Global	0.5%	0.7%	-2.4%	-1.4%
		US	0.6%	3.2%	1.7%	6.5%		US	0.6%	1.7%	-2.6%	-3.2%
		UK	-0.2%	3.6%	-3.0%	-4.0%		Eurozone	0.5%	-0.6%	-3.0%	-0.2%
		Canada	1.7%	3.5%	-4.0%	2.1%		Japan	1.4%	-1.9%	-2.9%	-5.2%
								Canada	1.0%	1.8%	-3.9%	-3.6%

Note: All returns are in local currency unless indicated otherwise. Source: Bloomberg Finance LP, as of June 30, 2021.

Figure 2: Performance of Risk Assets



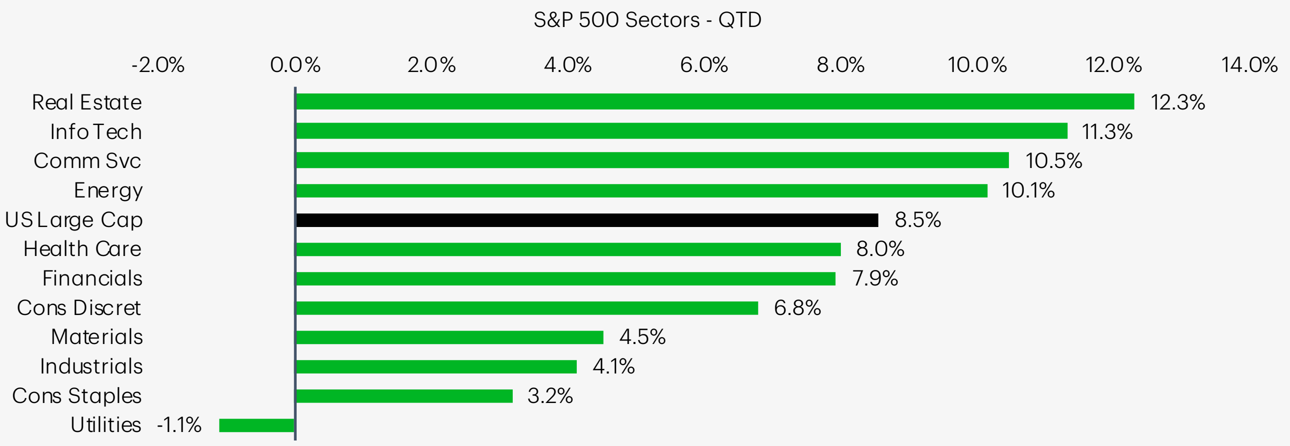
Source: Bloomberg Finance LP as of June 30, 2021

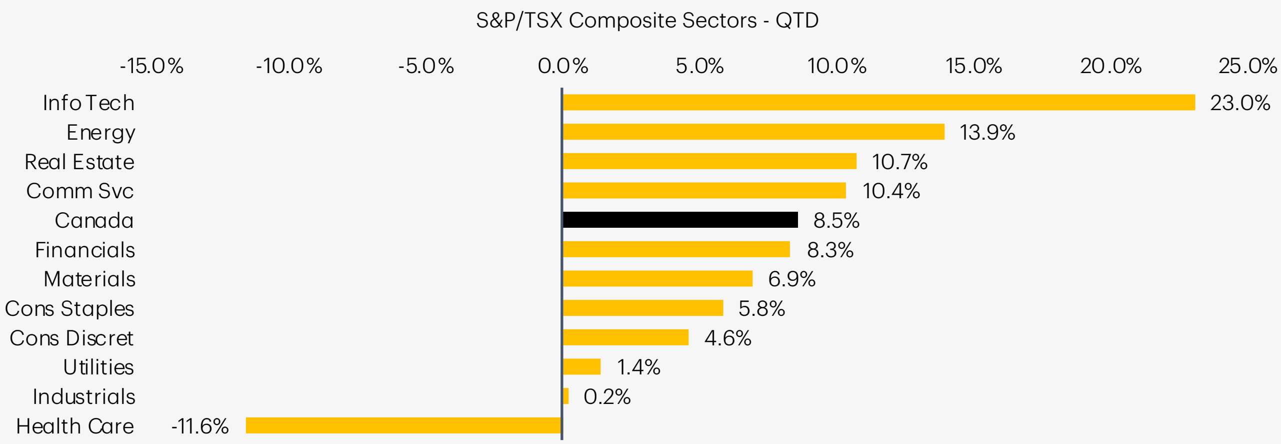
In this strong growth environment, equities and commodities were the clear winners. Commodities again delivered double-digit returns, benefiting from the rising growth and demand outlook (coupled with supply constraints), despite flat inflation expectations. Although inflation expectations were a detractor for inflation-linked bonds, they benefited from the fall in the real cost of borrowing. Moreover, corporate bonds benefited from strong risk appetite, as credit spreads continued to tighten. The rally in rates also helped corporate bonds produce low single-digit returns. At the same time, falling growth assets, particularly nominal government bonds, produced modest returns as yields fell alongside easing growth and inflation expectations, particularly in the U.S. The following sections summarize asset-class performance through our four-quadrant perspective.

Rising Growth Assets

The rally in equities accelerated and broadened out further in Q2 after a strong Q1 (Figures 3), although the leadership has shifted back to U.S. stocks and non-cyclical sectors. Global equities gained 7.1%, led by strong performances from U.S. (8.5%) and Canadian stocks (8.5%). Both U.S. and Canadian stocks posted record highs by the end of Q2 as initial fears about monetary tightening subsided. U.S. stocks were boosted by robust corporate earnings growth, although the outlook going forward has moderated. Last quarter's leaders (developed markets outside the U.S., at 4.8%, and small-cap equities, at 4.3%) underperformed this quarter as the global recovery matured. However, unlike last quarter when earnings growth rebounded sharply, the rally in U.S. equities in Q2 was mainly driven by P/E expansion as earnings growth decelerated. Earnings growth remains the main driver of U.S. equities performance year-to-date, which is consistent with the recovery story. Moreover, after outperforming since the start of the economic recovery, small-cap stocks underperformed in Q2 as the junk rally stagnated. Over the past 12 months, U.S. small-cap stocks almost doubled in value, which is twice the returns of U.S. large-caps.

Figure 3: Equity Performance by Sector



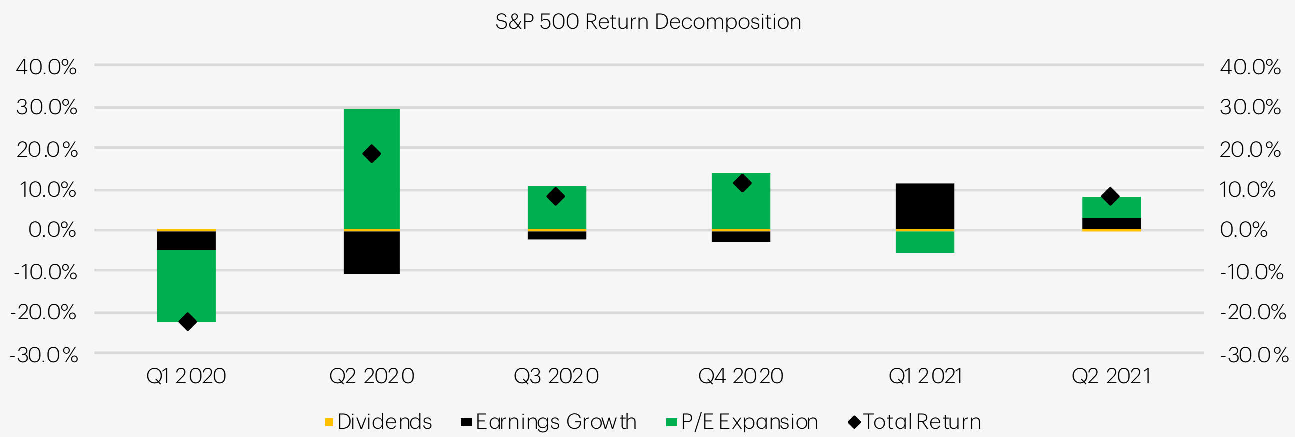


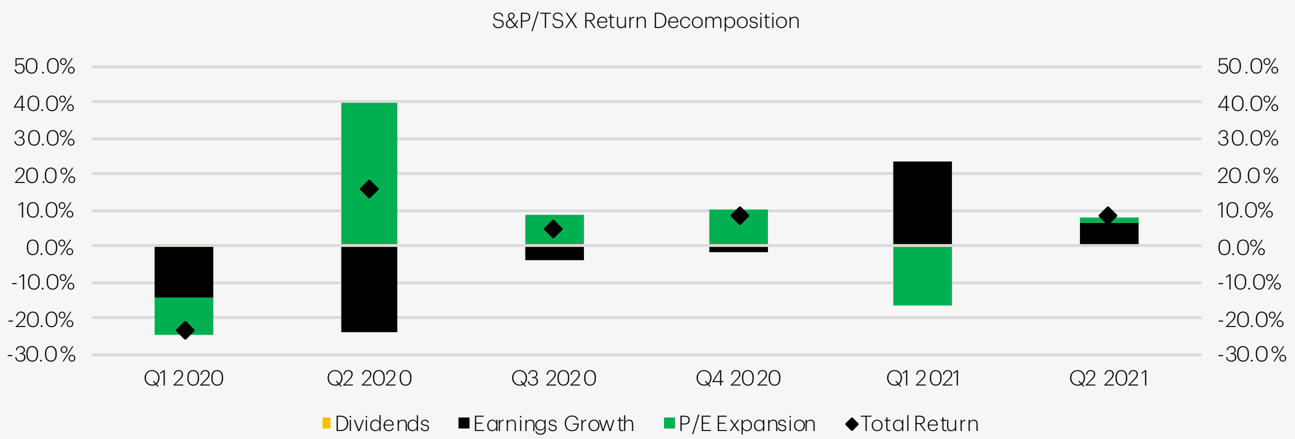
Source: Bloomberg Finance LP as of June 30, 2021

Among U.S. equities, gains were broad-based, with all sectors except utilities generating positive returns. The main difference this quarter was that non-cyclical sectors (except energy) led the rally. Real estate was the top performer (up 12.3%) after lagging for most of the pandemic, as the post-pandemic outlook for real estate improved. Housing markets continued to surprise on the upside, supported by falling mortgage rates. Technology and communication stocks also generated strong performance as investors shifted back to reliable mega-cap growth names that outperformed early in the pandemic. Energy continued to rally, up 10.1%, as demand continued to outstrip supply. Cyclical sectors, such as financials (up 7.9%), consumer discretionary (up 6.8%), materials (up 4.5%) and industrials (up 4.1%) underperformed in Q2 as macro conditions shifted to the mid and late stage. These sectors continued to be supported by strong economic growth and demand outlook, although expectations have now eased following multiple quarters of positive growth and earnings surprises. Utilities was the only sector that suffered losses, as policymakers drastically trimmed the Biden administration's infrastructure spending package to about US$1 trillion, down from US$2.3 trillion unveiled in March. Financials were hurt by both falling yields and flattening yield curves, which adversely impact their lending margins. Technology stocks have lagged as investors shift to value stocks alongside the recovery and reflation story; however, during Q2, the reflation trade was put on hold and investors rotated back to growth stocks.

Canadian stocks generated strong gains in Q2, led by the continued rally in commodities. The S&P/TSX Composite Index surged 8.5%, driven by non-cyclical sectors such as technology and communications, while more economically sensitive sectors lagged (Figure 4). Technology led the rally with gains of 23.0% (largely due to Shopify) as investors rotated back to growth stocks; however, in terms of weighting, the index was led by the 13.9% gain in the energy sector. Energy generated strong returns as WTI crude jumped by 24.1% in Q2 on the back of the robust demand

Figure 4: Return Decomposition of S&P 500 and S&P/TSX Composite





Source: Bloomberg Finance LP as of June 30, 2021

outlook and continued supply constraints. Unlike last quarter, health care was the biggest detractor in Q2, with double-digit declines, due to tanking cannabis stocks, although the entire sector only accounts for 1.5% of the broad index. Overall, like Q1, the rally in Q2 was driven by earnings growth for Canadian stocks as P/E expansion was negligible. Multiples expansion has been a detractor to performance year-to-date while earnings growth has rebounded.

After leading in Q1, developed markets outside North America continued to post modest returns in Q2, supported by strong corporate earnings and economic sentiment, although EAFE stocks underperformed U.S. and Canada. EAFE equities rose 4.8% (led by almost double-digit gains from French stocks) as most European economies eased lockdown restrictions following successes on vaccination. Like in the U.S., defensive sectors such as real estate outperformed alongside technology. Business confidence continued to be bullish, with manufacturing and service PMIs at or near all-time highs. Composite PMIs ended the quarter at slightly under 60, which is well above expansion mode. UK stocks trailed with a return of 5.7% as growth expectations eased and rising Covid-19 infections stoked investor concerns. The rotation from cyclicals to defensive sectors also detracted, given the UK's heavy exposure to financials, which were also hurt by falling interest rates. After a record Q1, Japanese stocks trailed in Q2 due to renewed Covid-19 outbreaks, the slow vaccine rollout, and the extension of an emergency lockdown leading up to the Olympics. Corporate earnings were in line or slightly ahead of market expectations, while economic data continued to point toward recovery over the near term.

Emerging-market (EM) stocks continued to underperform in Q2. This underperformance was driven by weakness from Chinese equities, which recorded gains of 4.3% during the quarter as the Chinese government and regulators continued to rein in credit growth and tighten policy, in an effort to manage excesses in the market. Chinese equities were also hurt by the rotation away from technology, which dominates the market. EM outside China outperformed Chinese equities but faced headwinds from a stronger U.S. dollar at the end of Q2, despite the rally in commodities. Brazil, Taiwan, and South Korea were key outperformers with high single-digit returns. Unlike developed markets, which have largely recovered from the pandemic, Covid-19 and its delta variant continue to wreak havoc across developing economies, exacerbated by the slow pace of vaccination. Covid-19 weighed on EM stocks in Q2.

One of the major themes since November 2020 has been the strong rotation into value stocks after their 30% underperformance in 2020 (Figure 5). This rotation was fueled by confidence in the economic recovery, a rise in yields and steepening of the yield curve. Economically sensitive, underpriced stocks outperformed significantly during this period, alongside small-caps and low-quality stocks. This rotation came to a halt in Q2 as the Federal Reserve implied an earlier tightening cycle, with two rate hikes planned in 2023. As a result, growth stocks rebounded alongside expectations of slower economic growth after multiple quarters of faster-than-expected expansion.

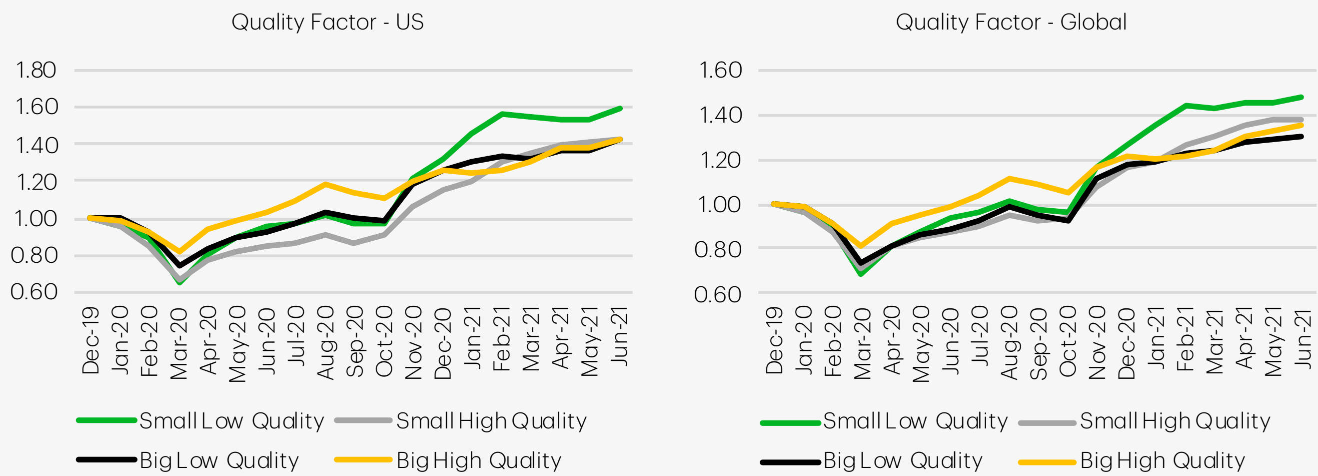
Figure 5: Value vs Growth Performance

	Q1 2021			Q2 2021			2021 YTD (June 30, 2021)		
Index	Value	Growth	Value - Growth	Value	Growth	Value - Growth	Value	Growth	Value - Growth
MSCI ACWI	8.9%	0.3%	8.6%	4.8%	10.0%	-5.1%	14.1%	10.3%	3.8%
MSCI EAFE	7.4%	-0.6%	8.0%	3.0%	7.4%	-4.4%	10.7%	6.8%	3.9%
MSCI EM	4.1%	0.6%	3.5%	5.7%	4.4%	1.2%	10.0%	5.0%	5.0%
MSCI USA	10.2%	0.5%	9.7%	5.2%	12.5%	-7.3%	15.9%	13.1%	2.8%
S&P 500	10.8%	2.1%	8.6%	5.0%	11.9%	-6.9%	16.3%	14.3%	2.0%
Russell 2000	21.2%	4.9%	16.3%	4.6%	3.9%	0.6%	26.7%	9.0%	17.7%

Source: Bloomberg Finance LP as of June 30, 2021

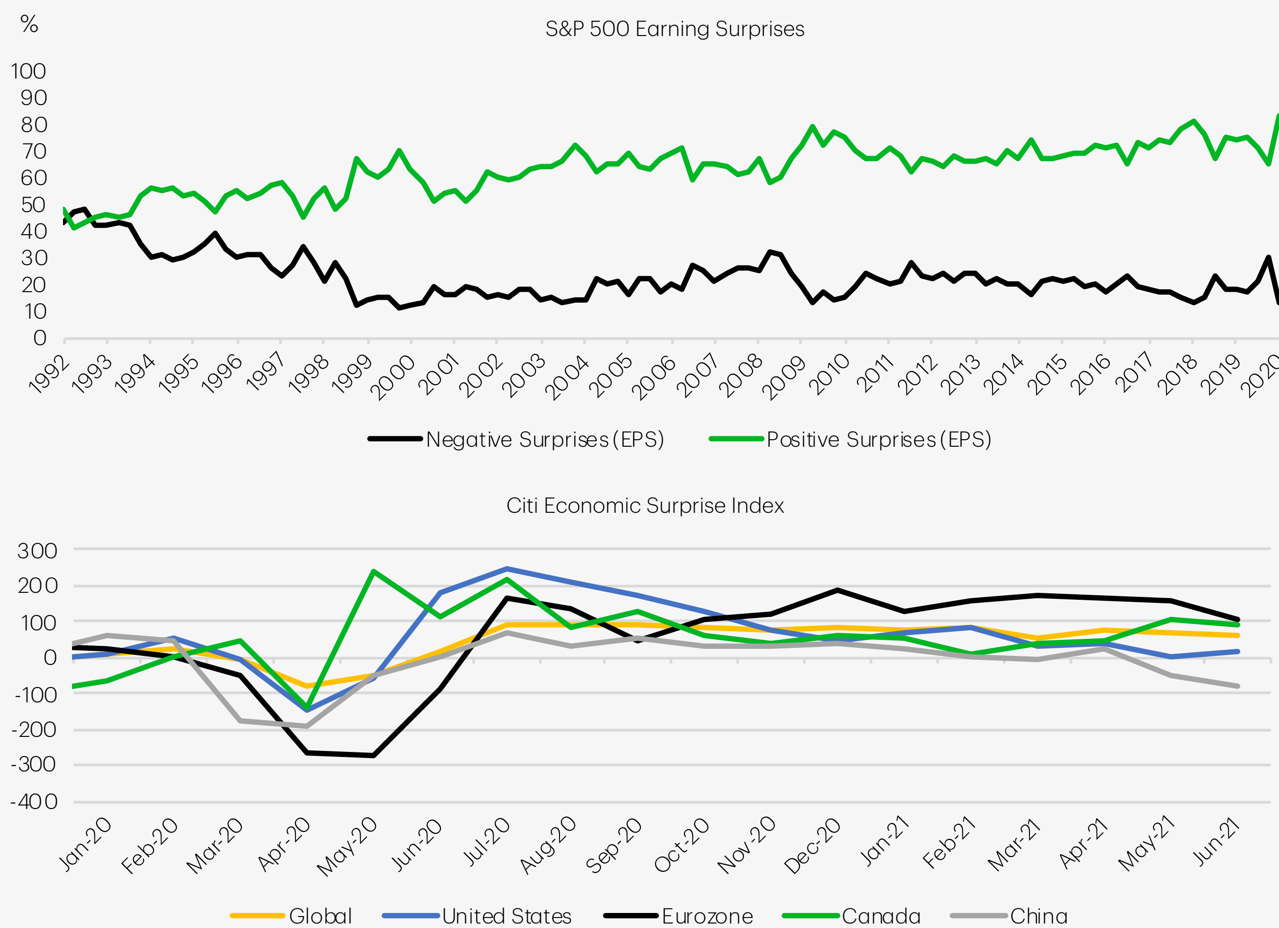
Thus, after underperforming by up to 10% during Q1, growth stocks outperformed value by up to 7% in Q2 across key markets. Investors also shifted back to higher-growth and to some extent higher-quality companies (Figure 6), as they deemed growth opportunities to be more limited post-pandemic, once the recent demand shock subsides and the Fed slowly withdraws stimulus, leading the global economy on to a more sustainable growth path. The proportion of companies beating earnings estimates over the past few quarters is expected to come down from their 90% highs. Economic surprises have also eased after a few quarters of beating expectations (Figure 7).

Figure 6: Performance of Quality Stocks since Q4 2019



Source: Ken French Library, AQR, TD Wealth as of June 30, 2021

Figure 7: Earnings and Economic Growth Surprises



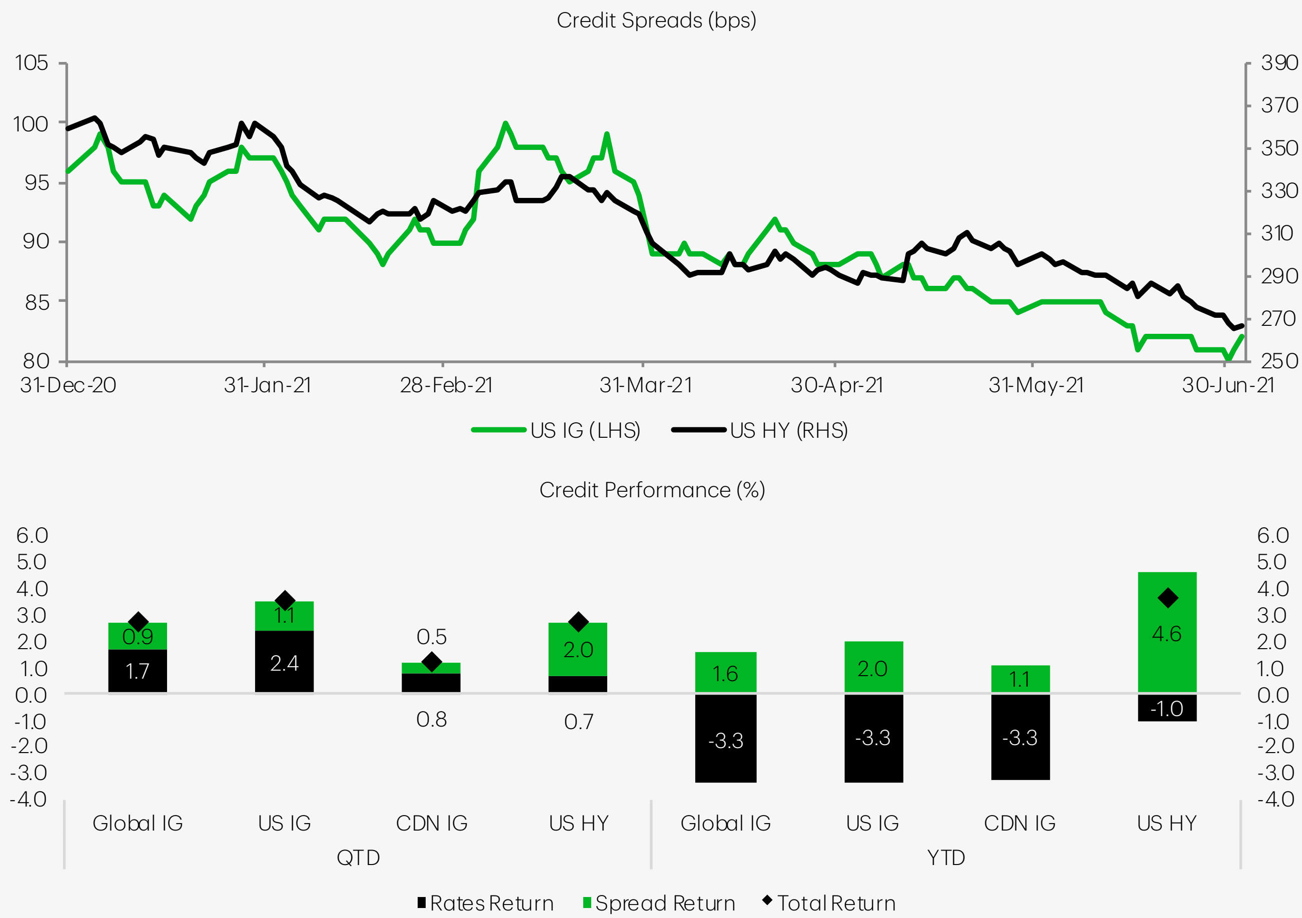
Source: Bloomberg Finance LP as of June 30, 2021

The flattening of the U.S. yield curve reflects this lower growth and inflation outlook — not surprising since value typically underperforms when an economy transitions from the early to late stage of the cycle. Concurrently, after lagging early in the economic recovery, higher-quality stocks have started to rally as smaller-cap, lower-quality stocks stagnate.

Beyond equities, corporate bonds generated modest gains during Q2, supported by further tightening in both investment-grade (IG) and high-yield (HY) credit spreads, on top of broad gains from lower government bond yields (Figure 8). Demand for credit continues to benefit from central bank support and the ongoing economic recovery. This supportive environment helped credit spreads tighten further beyond pre-pandemic levels. The economic recovery theme also benefited emerging-market debt, which gained 3.9% in U.S. dollars (3.5% in local currencies), backed by lower U.S. real interest rates (i.e., the difference between the nominal yield of a government bond and its inflation-linked counterpart) and a depreciating U.S. dollar against a basket of EM currencies. While U.S. government bond yields declined during the quarter following hawkish policy announcements from the Fed, central banks continued to provide support and liquidity. The Fed shifted its tightening schedule to 2023 in a surprise move but continues to purchase Treasuries and mortgage-backed securities (MBS) in the secondary market at the same pace as last year (US$120 billion a month), despite much better economic and market conditions. However, the scale of monetary accommodation is on the decline as evidenced by the fall in M2 money supply growth in Q2.

As part of the ongoing risk rally and demand for scarce yield, investors continued to pour capital into credit, which exhibited calm despite higher volatility in the government bond market. Credit spreads continued to tighten over Q2: U.S. IG credit spreads contracted by 11 basis points (bps), to 80 bps, and U.S. HY spreads narrowed aggressively by 42 bps, to 268 bps. Both IG and HY credit spreads are now well below their levels at the start of 2020. Credit spreads tightened further as corporate fundamentals improved with better interest coverage ratios, and investors continued to expect low risk of corporate defaults. Most sectors

Figure 8: Credit Spreads and Performance



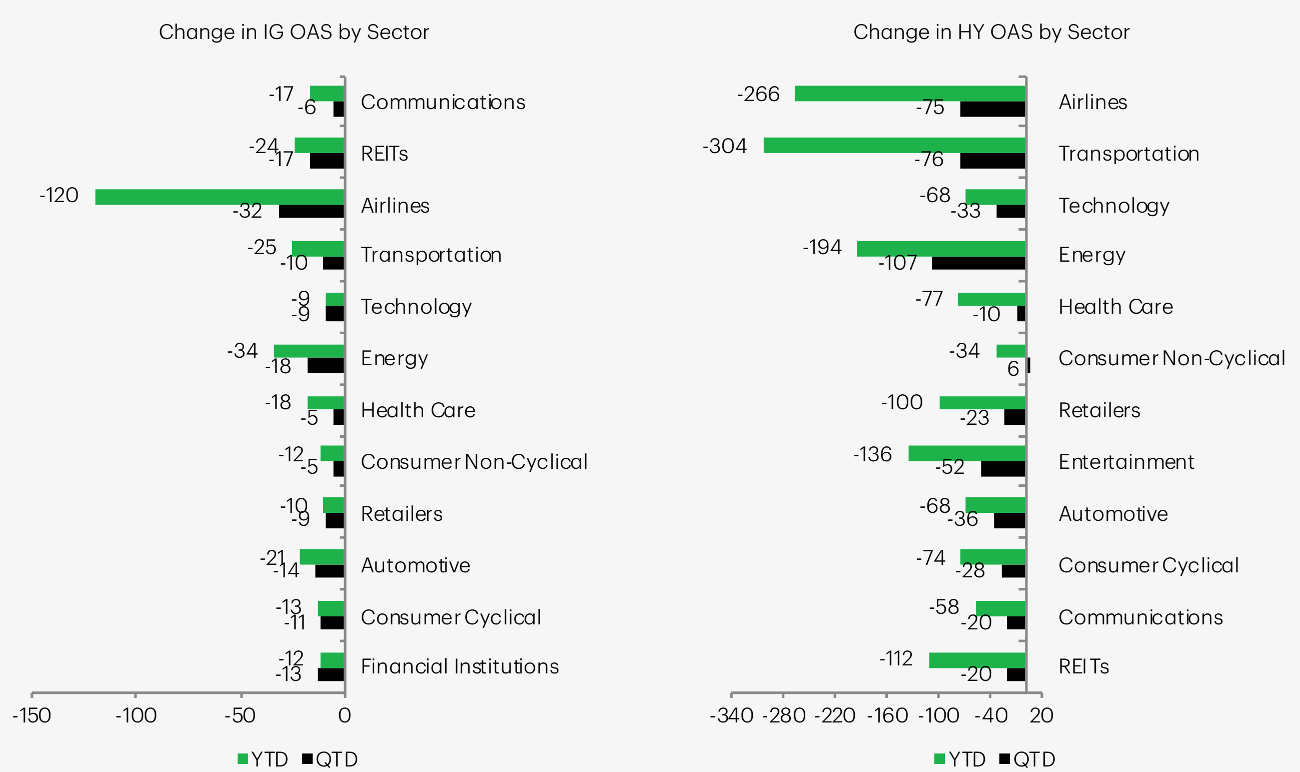
Source: FactSet, Bloomberg Finance LP as of June 30, 2021 within the IG and HY credit universe posted positive returns, but similar to Q1, sectors hardest hit by the Covid-19 shutdown were the top beneficiaries (Figure 9). Spreads for IG credit issuers within the airline, real estate and energy sectors contracted by 17 bps to 32 bps. Similarly, spreads for HY credit issuers within the airlines, transportation, energy and entertainment sectors tightened by 52 to 107 bps. Within IG and HY credit, spreads for sectors that were most severely impacted by the pandemic have tightened so much that they are now comparable to their broad indices.

Changes in credit spreads varied across the credit-quality spectrum. Spreads for investment-grade issuers tightened by 11 bps, on top of already extremely low spreads during Q1. Within U.S. IG credit, lower-grade credit outperformed higher-quality in a macro environment favourable to risk assets, as spreads tightened by up to 12 bps for BBB-rated issuers. The performance pattern was similar across the HY credit spectrum as lower-quality credit experienced greater compression. However, lower-grade U.S. HY bonds performed in line with IG bonds as the latter benefited more from higher interest-rate sensitivity amid falling government bond yields. HY credit bonds are more sensitive to economic growth and have less sensitivity to falling interest rates compared with IG credit bonds.

CCC-rated spreads contracted by 73 bps, while BB-rated spreads tightened by 25 bps. Overall, U.S. IG credit bonds gained 3.5% during the quarter. These gains were predominantly due to their interest-rate sensitivity or duration exposure as government bond yields fell sharply during the quarter, although the credit market produced positive returns on a duration-hedged or pure spread-tightening basis as well. U.S. HY credit bonds gained 2.7%, mostly due to spread compression since interest rates are less of a factor for lower-grade bonds.

Canadian credit underperformed due to its lower interest-rate sensitivity, and because Canadian government bond yields did not fall as sharply during the quarter. Canadian IG credit spread tightened by a relatively modest 3 bps during Q2, for an overall return of 1.3%. However, IG credit underperformed the 1.7% return for the FTSE Canada Universe Index. As in the U.S., segments that were most impacted by the economic shutdown, such as airlines and real estate, benefited from greater tightening as investors price in the resumption of travel and office life. However, in contrast to the U.S. credit market, there was less dispersion across the credit-quality spectrum as spreads tightened by similar levels across credit quality.

Figure 9: Change in U.S. Investment Grade and High Yield Corporate Bond Spreads



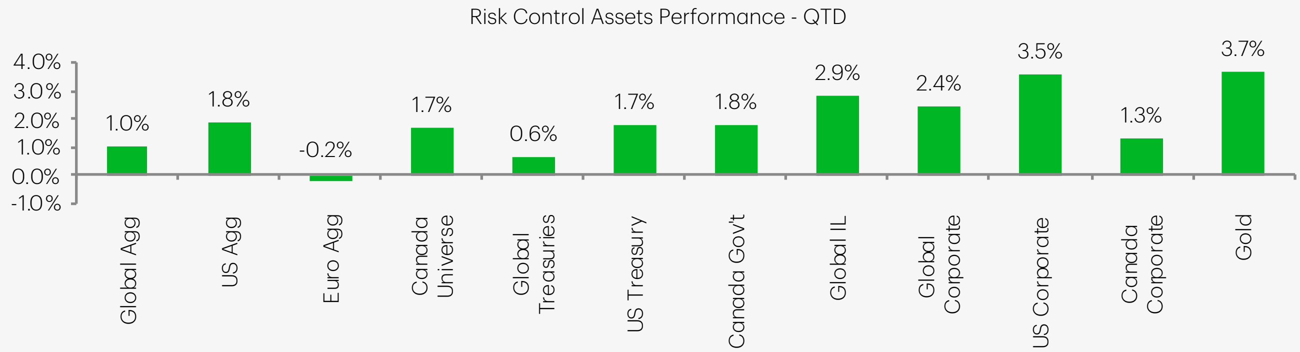
Source: FactSet as of June 30, 2021

Other rising-growth assets, notably commodities, continued to rally as investors price in strong global growth over the near term, combined with tight supply conditions for key components. The resurgence in economic activity boosted the demand outlook for commodities, driving energy (crude oil and natural gas) to multi-year highs. Supply conditions remain tight as OPEC maintains production limits on crude despite the aggressive rally in prices. Other commodities that are closely linked to the economic recovery (such as agriculture and industrial metals like aluminum, lead, nickel and copper) generated strong returns, on top of sharp rallies over the past year. Commodities overall returned 15.7% in Q2, led by a 24% surge in crude.

Falling Growth Assets

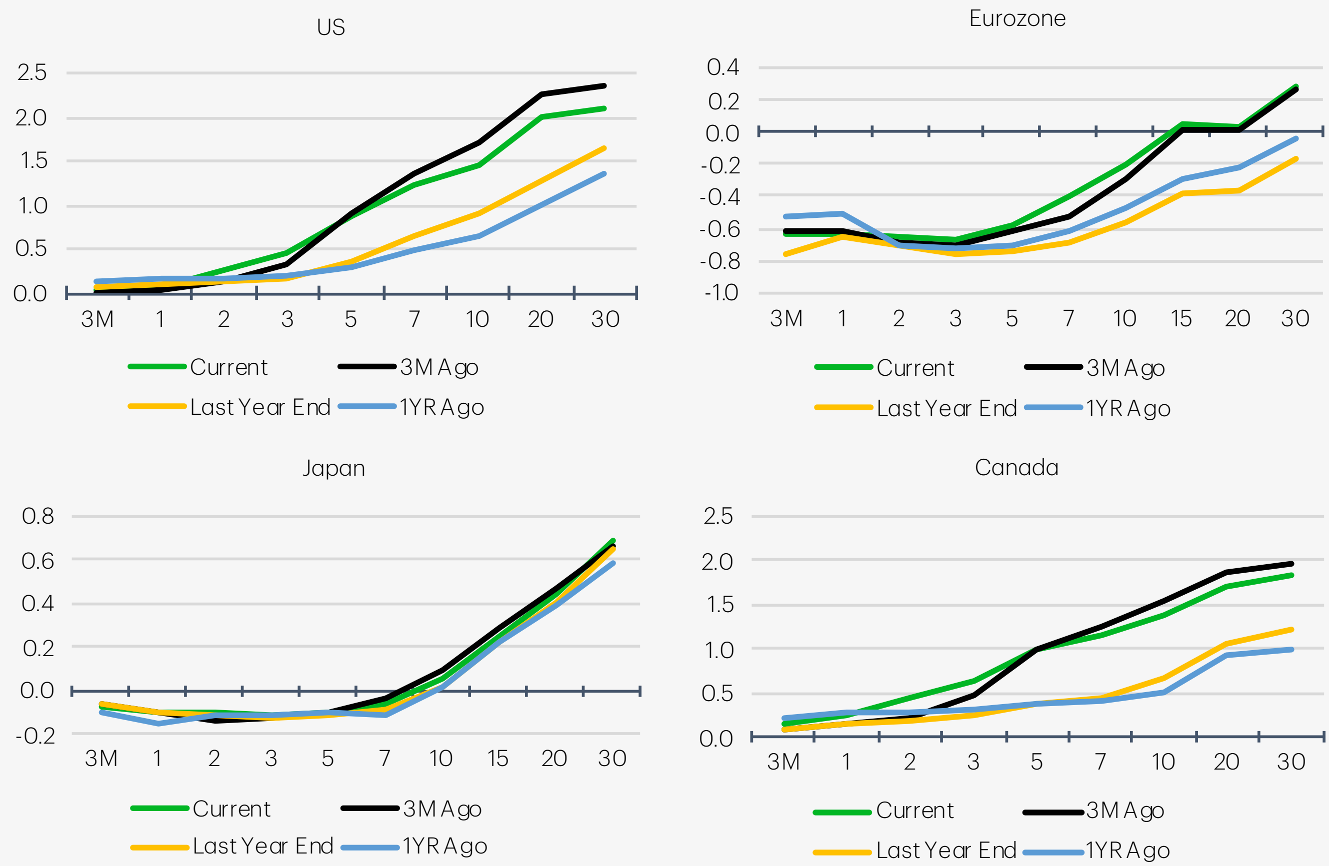
Nominal government bonds and other rate-sensitive assets, which tend to perform well when economic expectations are weak, rebounded in Q2 as growth expectations peaked and inflation expectations weakened. Global fixed income, based on the Bloomberg Barclays Global Aggregate Bond Index, gained 1.0% in Q2. U.S. government bond yields tumbled and the yield curve flattened (Figure 11), which drove sizeable gains in longer-maturity profiles or more rate-sensitive assets, with the U.S. 20-year-plus Treasuries index up 6.6%, for example.

Figure 10: Performance of Risk Control Assets



Source: Bloomberg Finance LP as of June 30, 2021

Figure 11: Government Bond Yield Curves



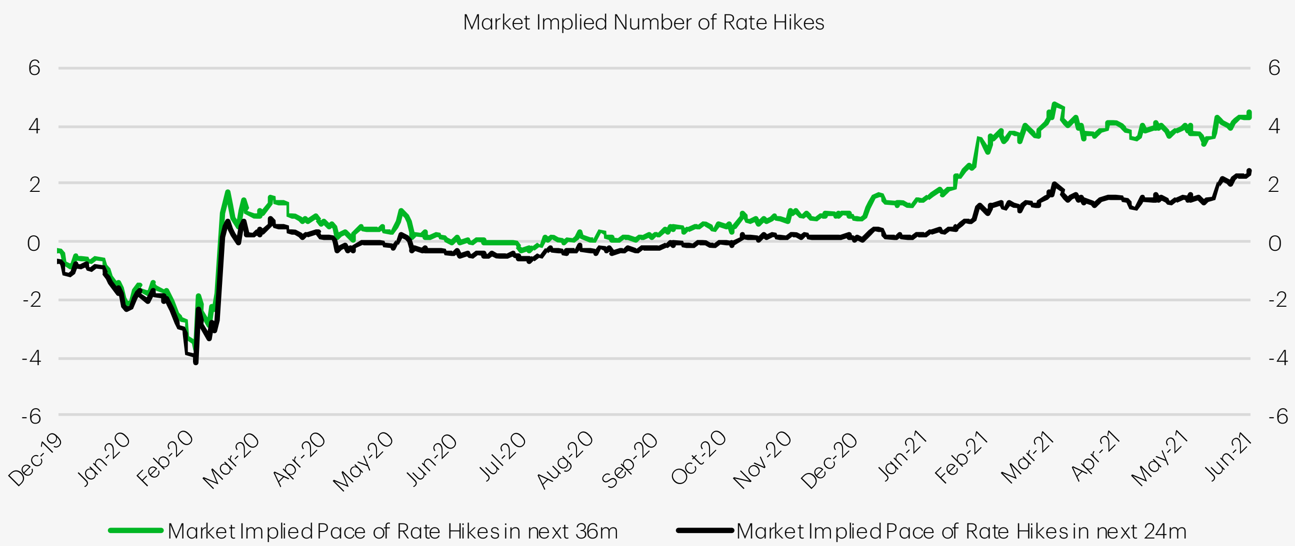
Source: Bloomberg Finance LP as of June 30, 2021

After selling off in Q1 amid rising economic growth and inflation expectations, U.S. government bonds rallied in Q2, with a 1.7% gain as investors priced down the risk of higher inflation after the Fed implied a quicker pace of rate hikes at its June policy meeting. As a result, U.S. 10-year government bond yields retraced some of the increases from the past quarter and ended Q2 at 1.47%, which is 23 bps lower than at the beginning of the quarter. Most of the rally in government bond yields was driven by falling real yields, as breakeven inflation was flat. The U.S. government bond yield curve also flattened significantly as shorter-maturity yields rose and longer-maturity yields fell. Shorter-maturity government bonds sold off and their yields rose as investors priced in earlier-than-expected rate hikes (Figure 12). At the same time, longer-maturity government bonds rallied, and their yields fell significantly, as investors priced in peak economic growth and weaker inflation over the intermediate to longer term as pandemic-induced liquidity and demand shocks recede. The spread between two- and 10-year U.S. government bonds contracted by 34 bps over the quarter. Despite the shift in monetary policy, government bond yields remain low and accommodative by historical standards, while implied volatilities for government bonds remain near historic lows, reflecting calm. In shifting its policy stance, the Fed kept its forecasts on growth, inflation and unemployment for 2022 and beyond unchanged. However, it upgraded growth and inflation forecasts for 2021 to 7.0% (from 6.5%) and 3.4% (from 2.4%) to reflect improved economic conditions and rising inflationary pressures.

Canadian government bonds also rallied during Q2, with a 1.8% gain. Canadian 10-year government bond yields, for example, fell from 1.53% to 1.39% during the quarter, which is modest compared to U.S. yields since the Bank of Canada is already expected to tighten more quickly than the Fed. However, the fall in yields had a bigger impact on Canadian bonds due to the higher rate sensitivity of the broad index, which helped Canadian government bonds perform in line with U.S. government bonds. The Canadian government yield curve also flattened in Q2 as shorter-maturity yields rose while longer-maturity yields fell. The BoC had earlier in the quarter switched to a more hawkish stance than the Fed. While the BoC continues to buy bonds in the open market, it has trimmed its balance sheet by $200 billion, mostly by ending its repo operations. The flattening of the government yield curve reflects a more modest outlook for the Canadian economy given that business and consumer activities have already bounced back much faster than expected, following Canada's world-leading progress on vaccination after a slow rollout and renewed lockdowns during Q1.

Eurozone bonds (both government and corporate) underperformed U.S. and Canadian bonds, with a loss of 0.2%, as growth expectations for major European economies remain bullish after lagging the U.S. and Canada earlier in the year. Business and investor sentiments have strengthened as the region successfully vaccinates its populations and continues to ease lockdowns. This is a reversal from last quarter, when European economies faced an escalating third wave of the pandemic (exacerbated by a slow and

Figure 12: Number of Rate Hikes Expected by Markets



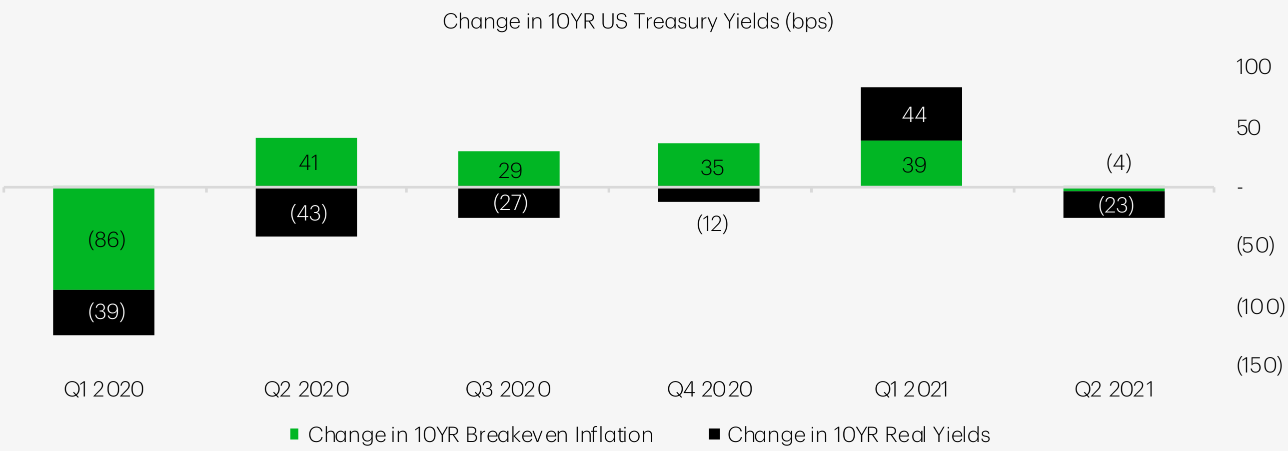
Source: Bloomberg Finance LP as of June 30, 2021

disorganized vaccine rollout) and renewed economic shutdowns. Unlike the U.S. and Canada, eurozone government bond yields rose during the quarter. German 10-year yields increased by 8 bps, while equivalent French and Italian yields rose 13 and 14 bps, respectively. Unlike Q1, when the eurozone economy contracted by 0.6%, the latest PMI readings show that the eurozone is in aggressive expansion mode, as the region catches up to the U.S. While sentiment is bullish on European growth, pressures have emerged on multiple fronts. The euro has rallied aggressively against the U.S. dollar, which puts pressure on exports and the ongoing recovery. It appreciated by 8.2% against the dollar in 2020 but depreciated by 1.1% in Q2 2021. The European Central Bank remains committed to its accommodative monetary policy, although discussions about rolling back monetary stimulus have commenced amid inflation concerns.

Rising and Falling Inflation Assets

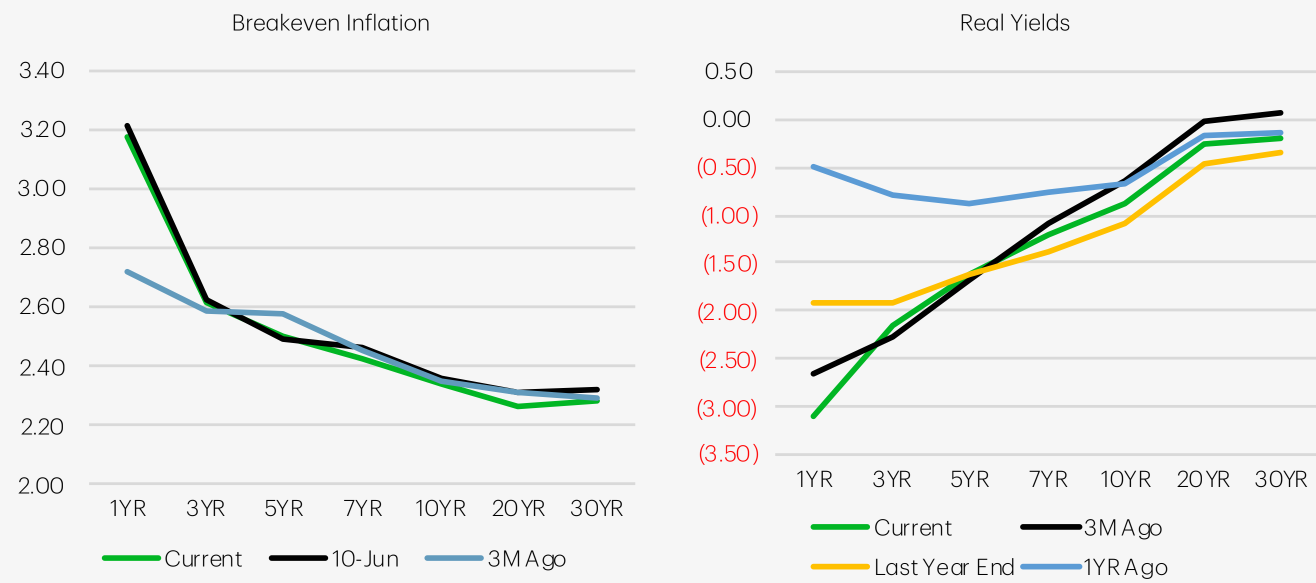
During Q1, long-term inflation expectations, based on 10-year expected or breakeven inflation rates, climbed to 2.4% for the U.S and just above 1.3% for the eurozone. Both were boosted by fiscal and monetary support and confidence in the economic recovery. This reflation trade propelled cyclical assets to phenomenal returns, but that came to a halt in Q2. Despite surging realized inflation (both headline and core CPI, as well as PCE), bond investors continued to discount longer-term inflation risk given that inflation breakeven rates remained flat during the quarter (Figure 14).

Figure 13: Contributions to Changes in 10YR U.S. Treasury Yields



Source: Bloomberg Finance LP as of June 30, 2021

Figure 14: U.S. Inflation Expectations and Real Yields



Source: Bloomberg Finance LP as of June 30, 2021

The Fed and the market continue to deem higher inflation to be transitory — a product of short-term demand and supply pressures that is likely to fade. Inflation expectations weakened further in June as the Fed zeroed in on inflation risk and shifted to a more hawkish tone. Weaker inflation expectations were a headwind for inflation-linked bonds. U.S. long-term inflation expectations ended the quarter virtually unchanged at 2.3%, although that's down from a peak of almost 2.6% in May, the highest in since 2013.

Despite weaker inflation expectations, inflation-linked (IL) bonds generated positive returns in Q2 due to falling real yields. After peaking at -0.6% during Q1, real yields for 10-year U.S. government bonds fell back to almost -1.0%, triggering gains for inflation-linked bonds. Real yields are now within 20 bps of the historic lows reached during the pandemic. The U.S. Treasury inflation-protected securities (TIPS) yield curve also flattened modestly during the quarter, pushing the entire real yield curve back below zero up to the 30-year mark. Thus, U.S. IL bonds rose 3.2% in Q2, outperforming the 1.7% return of their nominal counterparts. The fall in real yields had a larger impact on IL bonds due to their longer duration or higher real rate sensitivities. Inflation expectations remain above the Fed's average inflation target of 2%, but the perceived risk of higher inflation has subsided with the shift in policy from the Fed. Global inflation-linked bonds similarly gained 2.9%, in line with U.S. IL bonds, and outperformed the 0.6% return for global nominal bonds. Canadian real-return bonds generated returns comparable to their global counterparts, after sharp losses in Q1.

Falling inflation expectations would normally be a headwind for commodities, but they continued to benefit from the recovery in economic activity and tight supply conditions. Commodities posted a third straight quarter of double-digit returns. Within commodities, energy rose 24.2% while agriculture and industrial metals gained 12.3% and 9.6%, respectively. Energy benefited from strong demand expectations as global growth accelerates. At the same time, they benefited from supply constraints, with crude rising to almost US$75 per barrel. Similar to last quarter, oil prices were supported by tight supply conditions and the decision by OPEC and its allies to maintain production limits. Moreover, gold — often considered a partial hedge against inflation — gained 3.7% in Q2 despite lower inflation expectations, as investors priced in slower long-term growth. During Q2, gold benefited from falling real yields and a slowing economic recovery in the U.S. However, the appreciating U.S. dollar toward the end of the quarter was a headwind. □

Outlook on Fixed Income

Practising Prudence

Underweight

Range bound and dot plots are phrases investors have been throwing around in this fascinating fixed income environment. And it's not surprising when we've seen such rich valuations amid some of the highest monthly core inflation numbers in 40 years. Total returns for global bond markets measured -3.21% as of June 30, 2021, largely driven by higher average yields (peaking in early April and remaining range bound since) and average credit spreads that began the year tight, then got tighter, before more recently widening. Record fiscal stimulus in the U.S. on top of the ultra-easy monetary policy kept the economy turning over while widespread vaccination campaigns enabled the U.S. to reopen faster than expected.

Within the fixed income market, corporate debt still holds opportunities but even here it looks like we're about to enter a range-bound period. We are modestly constructive on investment grade credit—while being cautious of expansive valuations—because it's resilient to interest rate volatility, receives implicit support from central bank bond purchases, has a broad investor base to digest new supply, and the relatively higher yield on offer compensates for underlying risks. We maintain our underweight view on government bonds despite the higher yields. We also maintain our defensive view on high yield credit.

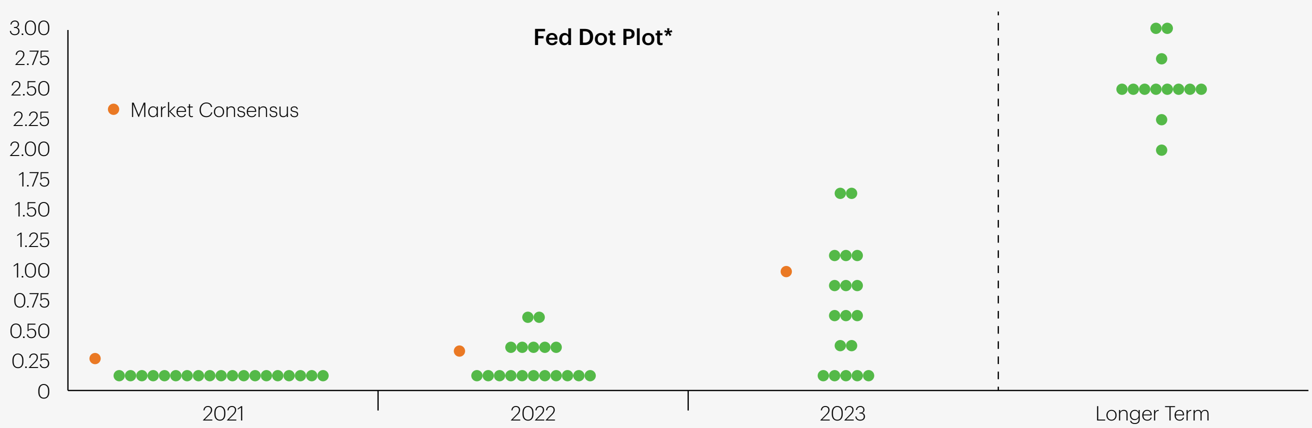
Fixed income portfolios aren't meant to capture upside risk. They provide quality income and ballast through downside protection. For those clients heavily invested in fixed income, we need to focus on probable income versus probable drawdowns (or peak to trough movement) instead of probable returns versus probable volatility.

Government Bonds and Inflation

Government bond markets have decided U.S. inflation is transitory. And we agree. We expect the mix of supply chain bottlenecks, pent-up demand, and labour supply constraints to keep U.S. inflation high in 2021. But these factors should fade with time, so we anticipate a drop in core personal consumption expenditure (PCE) inflation year over year in 2022. The big surprise was how quickly bonds reached this conclusion. Since mid-May, medium-term inflation expectations have dropped even though the U.S. consumer price index (CPI) hit a 13-year high of 5% year over year (y/y). Bond markets, the Federal Reserve (Fed), and our forecasts indicate inflation will be short-lived and we don't see any fear of inflation coming back during this Northern Hemisphere summer. After all, if the month-over-month increases in core CPI inflation for April and May—the biggest since 1981—didn't ruffle government bond markets in Q2, what will?

This consensus view of short-lived inflation underpins our stance: we believe concern the Fed will launch a sudden tapering and spark a pullback in risk assets is overblown. Yes, the Fed is gearing up to taper, and yes, the median Fed dot plot (Figure 1) now shows two hikes in 2023, but this isn't much different from market pricing. Even Fed Chair Powell noted in June that investors would get "a lot of notice" on tapering. With the jobs recovery slowing in Q2, we expect a well-communicated paring down of purchases across 2022.

Figure 1: The Median Dot Plot Shows Two Rate Hikes in 2023, Closer to Market Expectations.



* Each shaded circle indicates the value (rounded to the nearest 1/8 percentage point) of an individual FOMC member's judgment of the midpoint of the appropriate target range for the federal funds rate, or the appropriate target level for the federal funds rate at the end of the specified calendar year, or over the longer run. Source: Federal Reserve, TD Wealth. As of June 30, 2021

Central Banks Unlikely to Derail Risk Rally

At the June 9 meeting, the Bank of Canada (BoC) kept rates on hold at the effective lower bound and maintained purchases of Government of Canada (GoC) bonds at the "tapered" $3 billion a week pace effective in April. We expect further tapering given the strong economic growth in Canada and market expectations for rising inflation over the rest of 2021. This is in line with the BoC's guidance that its stance on purchases will be informed by the "strength and durability" of the recovery. Another taper looks increasingly likely at the July meeting as the BoC gradually reduces the impact of quantitative easing—another indication that Canada's central bank is approaching rate lift-off. Overall, we still expect the BoC to hike policy rates before the Fed. Overnight swap market prices are signalling a rate liftoff in first half of 2022 followed by almost 175 basic points (bps) of hikes in total over the next four years. Any such increase would be the most aggressive policy rate hiking cycle in the Group of Five (G5) countries and one that we believe the BoC will have difficulty delivering on. On another note, the BoC's balance sheet continues to decline due to reduced Treasury-bill and repo (or repurchase agreement) holdings and despite ongoing GoC bond purchases.

Across the border, the Fed sparked excitement at its Federal Open Market Committee (FOMC) meeting in mid-June, mainly because its dot plot, which signals interest rate direction, has turned far more hawkish. The median now implies two rate hikes in 2023, and as shown in Figure 1, seven of the 18 Fed members expect rates to start climbing in 2022.

Even if investors ignore the more extreme dots on both sides, three FOMC members are each calling for two, three and four hikes in 2023. This is a significant change since March yet the Fed's economic projections—for growth, inflation and the jobless rate—in 2022 and 2023 have not changed materially. (Figure 2) The Fed's big change was aimed at 2021 when it upgraded its growth forecast to 7.0% (from 6.5%) and jacked up its core PCE inflation forecast to 3.4% (from 2.4%), partly reflecting the upside inflation surprises of April and May.

So what happened to the Fed's claims that it would allow inflation to overshoot? Has it given up on the Ftlexible Average Inflation Targeting (FAIT) framework or does it believe the inflation overshoot is occurring in 2021? It's too early to tell. What's clear is that the Fed's reaction function relative to its 2022-23 forecasts has changed.

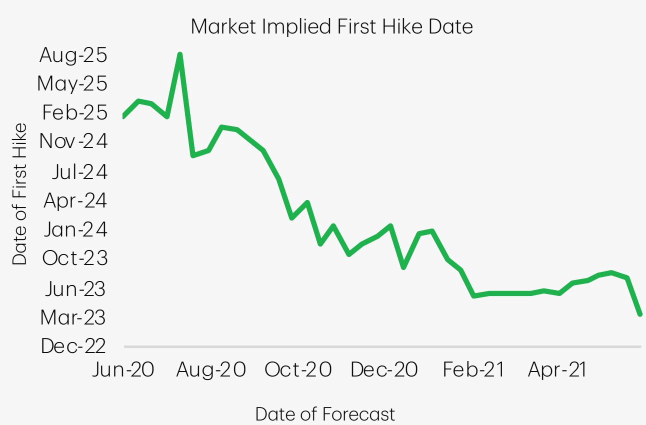
Despite all the noise around the dot plot changes in 2022-23, we believe dots plots have historically been a poor predictor of Fed actions several quarters out. In fact, at the June press conference, Chair Powell urged markets to take the dot plot with a "big grain of salt". Remember 2014 when the dot plots showed four hikes for 2015 and four more for 2016? The Fed raised rates only once each year. The dot plot for 2019 also showed increases but the Fed cut interest rates by 75bps instead. The dot plot offers a modal outcome (representing the number that appears most often), not a probability-weighted average like market pricing. Finally, markets are now priced for the first policy rate increase to occur in H1 2023 (Figure 3), so the Fed would have to hike significantly faster to take markets by surprise.

Figure 2: June FOMC Summary of Economic Projections (Compared with March)

Q4/Q4 % change (unless Indicated)	2021	2022	2023	Longer run
Change in real GDP	7.0	3.3	2.4	1.8
March Projection	6.5	3.3	2.2	1.8
Unemployment rate (%, Q4 avg)	4.5	3.8	3.5	4.0
March Projection	4.5	3.9	3.5	4.0
PCE Inflation	3.4	2.1	2.2	2.0
March Projection	2.4	2.0	2.1	2.0
Core PCE Inflation	3.0	2.1	2.1	-
March Projection	2.2	2.0	2.1	-
Federal funds rate	0.1	0.1	0.6	2.5
March Projection	0.1	0.1	0.1	2.5

Source: Federal Reserve, TD Wealth. As of June 30, 2021

Figure 3: Markets Pulled Forward the Start of the Hiking Cycle, Indicating the Same for Tapering Timeline



*Using 1-month OIS. Source: Bloomberg, TD Wealth. As of June 30, 2021

Translating "Transitory"

Supply-demand imbalances have pushed prices to levels well above pre-pandemic trends for several different categories. (Figure 4) The most important examples are cars (new, used, and rental); the microchip-affected consumer electronics category (video, audio, photographic, and information processing equipment); and groups that experienced very large increases in demand during the pandemic (sports and recreational vehicles, sporting equipment, furniture, and appliances). Price increases in these categories, plus the normalizing of prices in travel services (up from the depressed levels a year ago), pushed year-over-year core PCE inflation to 3.39%. We believe these supply-constrained categories are likely to remain firm for at least a couple more months. Used-car auction prices seem to have stabilized, but consumer prices tend to lag auction prices by a month or two. Consumer electronics prices are also likely to rise further as the full impact of the microchip shortage materializes. Importantly, and further ahead, we expect most of these temporary increases to revert, at least partially, to pre-pandemic trends.

What if "Transitory" isn't Transitory?

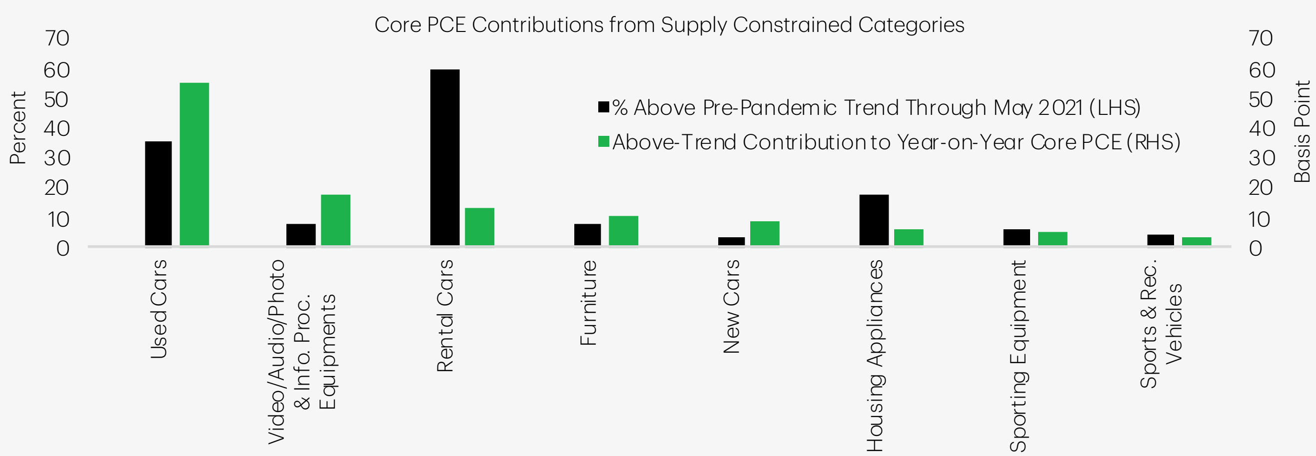
The Fed has restated that the recent uptick in inflation is transitory despite adopting a more hawkish tone in its June communications. At the same time, it has highlighted that supply constraints could trigger more persistent upside pressures. The tension between these two positions raises questions around how the Fed differentiates permanent from transitory shocks and how long inflation needs to remain elevated before the Fed no longer treats it as transitory. For the Fed, inflation isn't simply a change in the price level in any given year: it's a process to be understood and managed, with the focus on which changes in the aggregate price level are likely to become systematic and ingrained. In a first scenario that is also our base case (transitory inflation), the hawkish shift in tone could bring significant benefits if the Fed is able to guide markets and keep long-run inflation expectations anchored. It's unlikely the jump in U.S. inflation caused by economic reopening will affect underlying inflation so labour markets should have time to heal. That said, in a second scenario, if upside risks to inflation materialize and the Fed finds itself further behind the curve than it intended, it could normalize rate policy more forcefully than anticipated. This might open the door for a disorderly unwind of its accommodative stance. A third scenario we cannot rule out is if the Fed's hawkish turn in June turns out to be an overreaction and markets see the Fed as insufficiently committed to its new framework. This outcome would probably damage the credibility of the FAIT framework.

The Taper Chase

Let's consider another scenario: let's say the Fed attempts to wrap up tapering in a shortened period and starts hiking by late 2022, raising the real policy rate above 0% to ensure any inflation overshoot remains temporary. Financial markets are not prepared for this outcome so it might trigger a sell-off in risk markets. This will also bring the risk rally of the past five quarters to a shuddering halt. Ultimately, though, we expect this risk scenario to remain just that – a risk, not our base case.

Given the expected near-term volatility and our base case scenario of steady but modestly higher medium-to-longer maturity government bond yields, we're not fond of owning a lot of interest rate sensitive or duration-heavy (i.e. longer maturity government bond) assets at this juncture. We are not expecting a taper tantrum and we believe parallels with 2013 are wildly overblown.

Figure 4: Supply-Demand Imbalances Push Prices Above Pre-Pandemic Trends



Source: Department of Commerce, TD Wealth. As of June 30, 2021

Despite the Fed's hawkish turn, its reaction function remains much more dovish than past easing cycles and there is still room for inflation expectations to increase. We expect government bond supply to remain heavy even as the Treasury cuts auction sizes later this year which should re-steepen the government yield curve. (Figure 5) Valuations are rich, and the pace of demand from Liability Driven Investments (LDI) and banks should slow in the second half of 2021. More persistent upside surprises in inflation (especially if driven by wage pressures) or an unexpected full passage of the U.S. administration's fiscal packages could challenge this stability.

Here are a few of the rate arguments from various market participants:

The case for continued lower rates: 1) Growth stalls due to a COVID resurgence; 2) Transitory inflation that does not sustainably reach 2% and keeps the Fed away from taper talk; 3) A sudden hawkish shift from the Fed backfires and drives risk asset weakness and negative economic feedback.

Risks to the high side: 1) Growth continues to outperform expectations; 2) The employment picture is less mixed than it currently appears; 3) Inflation fears become more acute.

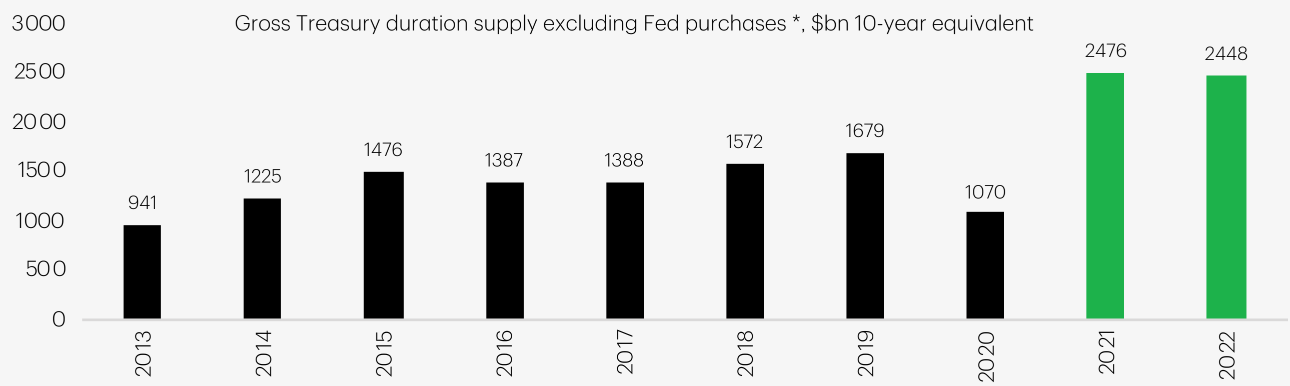
Investment Grade Credit

U.S. Investment Grade (IG) Credit spreads stand at 80 bps, 16bps tighter on the year. So far this year, IG credit rallied alongside almost all risky asset classes thanks to the three-pronged stimulus: fiscal and monetary support and the vaccine rollout. While these supports will remain in place they won't be as strong in H2 as they were before, and IG spreads (or valuations) are much tighter now than at the start of 2021. Therefore, we believe we're about to enter a neutral range-bound period for IG credit, hovering around current tight levels.

Fixed income is never an exact science and market drivers could upset our neutral view. For example, a rise in government bond yields could entice more yield buyers into the market resulting in tighter-than-expected spreads. Over the past two months, U.S. IG spreads hit a three-year low (and a post-Global Financial Crisis low if one adjusts for duration and ratings) despite the decline in government bond yields. Investors expecting higher yields jumped into the market just as yields turned lower, upsetting the typical negative correlation we see between government yields and spreads. If government bond yields move up again these buyers may continue to add risk and be less likely to wait for even higher yields further down the road. Less IG credit supply over the next two quarters and improved credit metrics due to very strong corporate earnings in coming quarters could also support tighter spreads.

We're also watching several factors that could widen spreads by year end. These include risks around inflation and the Fed's balancing act of gradually reducing monetary accommodation without disrupting markets. Investors are comfortable that the recent increase in inflation is, for the most part, transitory, but it's early days yet. Some market participants may see the start of Fed tapering as a turning point for investments in long duration fixed income like IG credit. There are also risks around the potential for higher tax rates, more anti-trust scrutiny and a more aggressive regulatory environment in general as the new U.S. administration moves through its priorities. Mergers and acquisitions (M&A) activity has been benign for IG credit markets so far in 2021 but this may not continue if more aggressive and larger deals are announced. And, most importantly, spreads are tight implying rich valuations, and carry (or income) is very low, so the market's ability to absorb the unknown is also low.

Figure 5: Treasury Supply Cuts Expected Later This Year But Duration Supply to Remain Heavy by Historic Standards

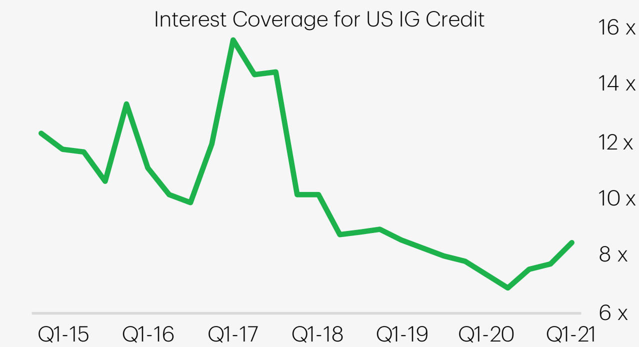


*Assumes gross Treasury issuance forecast of US$4.4tn for 2021 and US$3.9tn for 2022, and assumes Fed tapers by US$12bn Treasuries each meeting beginning in December 2021. Source: Federal Reserve, TD Wealth. As of June 30, 2021

Some of the high-level issues affecting the global IG credit market include:

- The global need to replace negative yielding assets with positive yielding ones, such as U.S. IG credit, is set to continue; even though the stock of negative yielding debt has declined modestly year to date, it's still about US$14 trillion or roughly twice the size of the overall IG market.
- Fundamentally, IG credit balance sheets look set for marked improvement over the next few quarters. (Figure 6)
- M&A remains a risk, though so far the majority of transactions have been small in size: bolt-on acquisitions rather than debt-laden transformational transactions which are riskier for bondholders. (Figure 7)
- The technical picture remains positive in most regards, with net supply set to fall by half and the duration of issuance becoming much shorter.
- Fund flows have remained robust considering year-to-date total return for IG credit is still negative while hedged U.S. IG credit yields are still attractive for overseas investors.

Figure 6: Slower Debt Growth & Lower Interest Expense Improved Coverage



Source: Bloomberg, TD Wealth. As of June 30, 2021

- U.S. IG credit excess returns over the same maturity government bonds are up 197bps year to date as of June end. This goes against historical precedent based on this year's starting point. As well, nearly 15% of the U.S. credit market is trading close to its market-weighted call price—a warning signal on valuations.

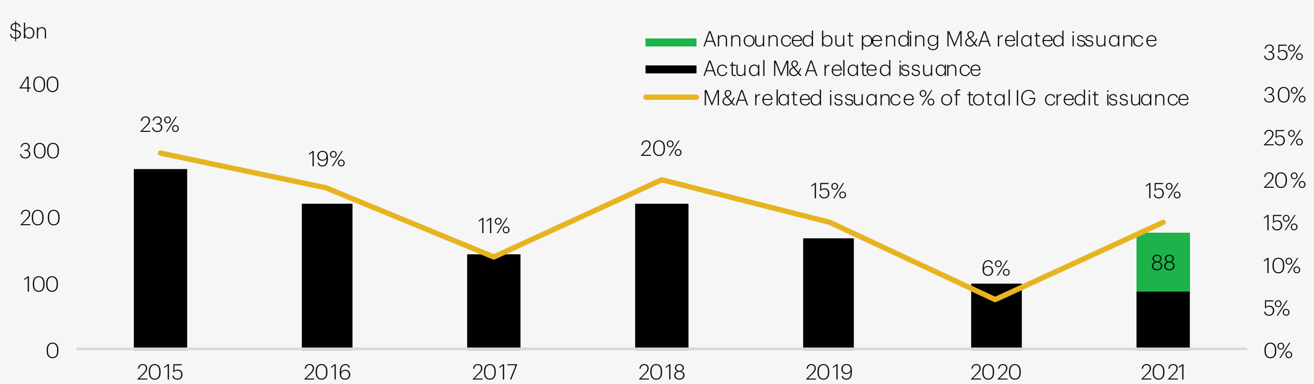
Sub-Investment Grade or High Yield Credit

The macroeconomic outlook for H2 appears to be a sweet spot for high yield (HY) credit given the extent of global economic recovery, improving credit fundamentals, and the still-accommodative Fed for the balance of the year. While we see little value in current prices, it's also hard to tell what might happen to push them lower.

The start of 2021 marked the lowest level of HY credit default activity in any calendar year since 2011. US$5.25 billion of defaults year to date has been the lightest six-month stretch since the six months ended September 2018 (US$3.8 billion of defaults). With modest default activity so far this year, negligible distressed volume (US$34 billion), wide-open capital market conditions (US$338 billion debt refinancing year to date), and a sharp global economic recovery underway, the market consensus on forward default rates is at a record low. This explains the historically low spread levels for this universe.

We continue to believe in the fallen angel/rising star theme we've been discussing for a few quarters. In fact, some of the 3% of IG credit that was downgraded to high yield in 2020 (fallen angels) now has the potential to be upgraded to IG credit (rising stars). After downgrades outnumbered upgrades by a 3:1 ratio in 2020, we argued in our last PSQ document that a combination of the U.S. reopening and ongoing balance sheet repair could position a greater number of HY companies to return to IG. So far this year,

Figure 7: M&A is the 2021 Wild Card. Low Yields, Better Growth Suggest an Increase



Source: Bloomberg, TD Wealth. As of June 30, 2021 upgrades have outnumbered downgrades by a 4:1 ratio (Figure 8), and we have seen 21 separate issuers make the transition back to IG ratings. (Figure 9) We maintain our view that the upgrade cycle will continue thanks to above-trend (albeit decelerating) GDP growth and while this may provide attractive spread compression to some issues, the current tight spreads lead us to have a defensive stance overall.

Balancing Act

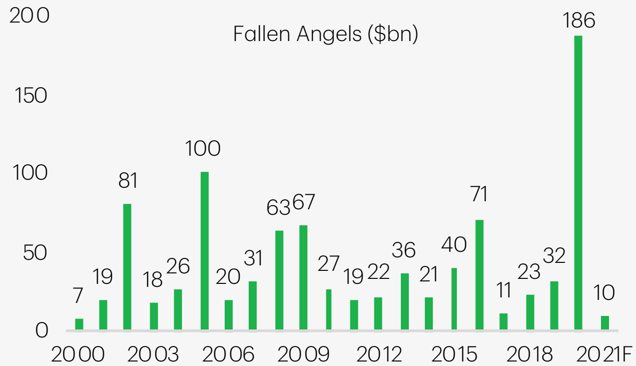
It is incumbent upon fiscal and monetary policy makers, business leaders and investors to forecast the future. They use quantitative models to chart the path forward: to project employment, interest rates, economic growth, profit margins and stock multiples. Unfortunately, these models—built upon historical relationships—break down in periods such as this.

The disparity of forecasts captured in the Fed's dot plots highlights just how challenging it is to pinpoint future trends. This difficulty is also apparent in the disappointing number for April nonfarm payrolls (which eked out an increase of 266,000 compared with the 1 million consensus estimate) and the surprise in Q1 earnings results (the S&P 500 recorded 50% EPS growth compared with consensus of 20%). In such an environment, investors are forced to place less weight on any specific piece of data and focus instead on the larger mosaic. The muted response to both the jobs report and Q1 earnings is evidence of this phenomenon.

We believe that inflation, while transitory, won't dissipate until supply chain and other post-pandemic disruptions are resolved. While policy supports remain in place, there is a sense that peak support is waning. Yes, one (or more) infrastructure bills seem likely, but markets have largely priced these in. Investors and Fed officials are already looking past the taper to prospects of higher rates. While seven of the 18 Fed officials expect hikes before the end of 2022, in line with the market consensus, pricing in the futures market remains focused on 2023. But these views are interpretive and subject to change and all of this will just make rates markets more fascinating in the months ahead. We reiterate our base case scenario for stable yet modestly grinding higher government bond yields. In credit markets, we expect spreads to remain stable for the coming months. We are modestly constructive on investment grade credit while maintaining our defensive view of HY credit.

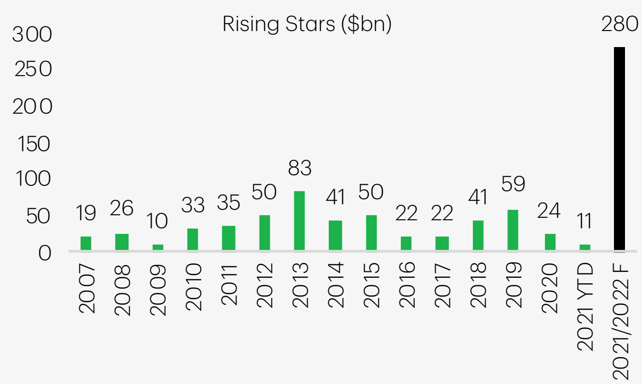
Fixed income encompasses more than just government bonds. Duration or interest-rate sensitivity provides downside protection during a risk sell-off, and while government bonds or higher duration investment grade credit might struggle if interest rates climb, this investment environment has historically supported risk assets. We need to remember that fixed income portfolios are not meant to capture upside risk but rather to provide ballast through downside protection along with quality income. While multi-asset portfolios will be tweaked to run higher risk in the current high-growth environment, the role of the duration and fixed income asset class, as a whole, has not diminished: higher yields translate into enhanced downside protection if markets sell off. Of course, it's prudent to evaluate losses from duration-heavy investments over this year, but we should not completely discard this diversifying asset class due to its poor returns in a pro-risk environment. While moving towards lower duration and riskier solutions in the fixed income sleeve we need to remain vigilant of the inherent drawdown risks versus enhanced yields or the desire to capture market upside. We need to consider the kind of drawdowns acceptable to clients who are investing heavily in fixed income and evaluate probable income versus probable drawdowns, instead of probable returns versus probable volatility.

Figure 8: Fallen Angels Minimal



Source: Bloomberg, TD Wealth. As of June 30, 2021

Figure 9: Market Forecasts US$280bn of Rising Stars over Next Two Years



Source: Bloomberg, TD Wealth. As of June 30, 2021

Outlook on Equities

Time to rein in expectations

Overweight

After a year of suppressed economic growth, 2021 got off to a promising start. Growth and earnings expectations for 2021 and 2022 soared as it became clear that the global vaccination rollout would happen much faster than expected. Early in the recovery, the rally was focused on growth and tech stocks, but in Q1, the rally reversed itself, lifting deeply discounted pockets of the market — value and cyclical stocks, mainly — that had been hit the hardest at the beginning of the pandemic. These pockets also happen to be less vulnerable to the rise in yields and inflation that are part in parcel with these kinds of recoveries. In March, 10-year Treasury yields rose from 0.9% to 1.74%, and one- and two-year breakeven rates on inflation-protected securities rose to 3.9% and 2.7%, pricing in high inflation for the interim period.

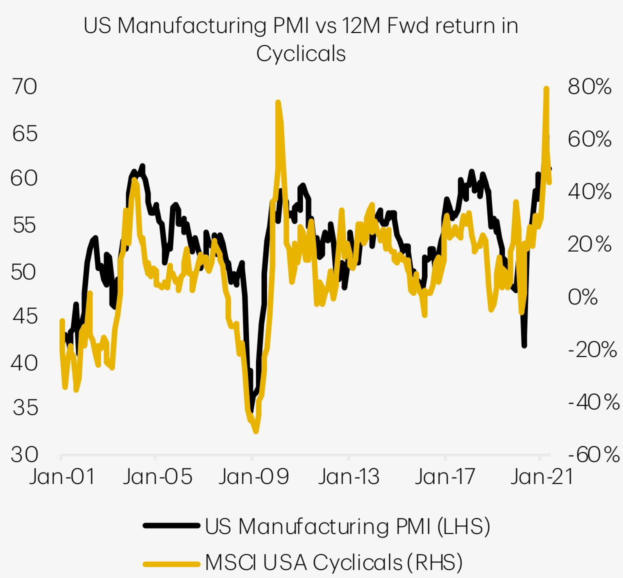
Some of these numbers, however, started to come down in the second quarter: 10-year yields fell to 1.4%, while one-year breakeven fell to 3.2%. What this indicates is that, despite higher-than-expected U.S. inflation numbers in the second quarter, the market has already priced in the peak of economic growth. This sentiment also seems to fly in the face of recent business confidence indices. In May, the U.S. Composite Purchasing Managers Index (PMI) reached a peak of 68.7, signaling robust economic growth.

The incongruity seems to a more forward-looking perspective. Looking at the past 20 years, cyclical sectors have moved in tandem with growth in manufacturing PMIs (Figure 1). So, with the current Manufacturing PMI at a 20-year peak of 62.1, business confidence may have already topped out, which could lead the rotation into cyclicals to slow down. Cyclicals could still lead the rally in equities, but the pace of appreciation observed between November and early April 2021 is not expected to be as rapid going forward.

As for the broader index, forecast growth in earnings per share seems also to have also reached its peak. S&P 500 EPS estimates for 2021 and 2022 have risen sharply this year (Figure 2), to $189 and $211 respectively, relative to actual EPS of $141 in 2020. This suggests limited potential for significant upside from here.

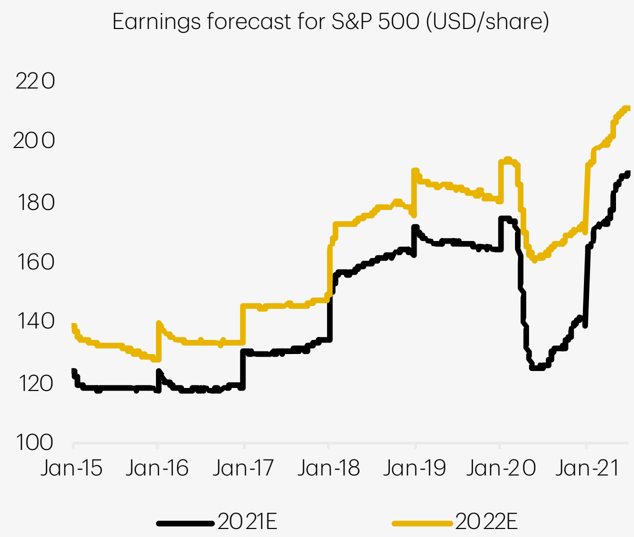
We continue to believe that equities offer attractive potential, particularly the value pockets. Moving forward, however, prudent stock selection will offer higher alpha in segments where expected growth is fully priced into valuations. That being said, a few questions remain: (1) Do current valuations price in the expected increase that's still to come in economic and earnings growth? (2) Which are the areas that still provide attractive reward/risk ratio? (3) Where do we go from here for 2021 and 2022?

Figure 1: Peak manufacturing PMI signals weaker performance for cyclicals



Source: Bloomberg Finance LP as of June 30, 2021

Figure 2: Upward revisions for S&P 500 EPS seem to have peaked



Source: Bloomberg Finance LP as of June 30, 2021

North America

Following a sharp recovery from the pandemic low of last spring, equity markets in North America have reclaimed all lost ground and moved on to set new highs. Year-to-date returns from major North American indices are solidly into double-digit territory on the back of vaccination and "reopening" progress. The question for us now is: What can we reasonably expect from the balance of 2021?

With stock valuations and index multiples at multi-decade highs, the answer to that question may seems obvious. But given the traditional trade-off between the stock market and the bond market — where rates on 10-year Treasuries closed at 1.45% in June, while dividends alone on the S&P 500 yielded 1.35% — it may still be easier to argue in favour of equities.

It's no great stretch, after all, to believe that the S&P 500 dividend will grow over the coming 10 years. From 2011 to the end of 2020, the S&P 500 saw dividends per share grow from US$25.60 to US$56.50 — an increase of 121%. We certainly can't guarantee a similar outcome, but with 10-year Treasuries offering a negligible 7.4% advantage in cash flow yield over the S&P 500, it's difficult to argue in favour of bonds. Even corporate debt makes little sense with the Bank of America Merrill Lynch U.S. Corporate Bond index yielding just 2.10%. At least with equity, there's a strong likelihood that dividends will grow while broad indices rise in line with the overall economy.

It's likely that the rising tide of economic renewal in a post-Covid economy has already been priced into the equity market and that the next phase will involve a separation of wheat from chaff. The stocks that are likely to continue to grow will be the ones with the strongest economic prospects and the ability to continue generating strong free cash flow, which can be used to repurchase shares or increase dividends in the coming years.

As we head into Q2 earnings season, equity markets have plenty of things to worry about: (1) we appear to be at a momentum peak in y/y growth; (2) positive earnings revisions may similarly be peaking; (3) interest rates are more likely to increase than decrease; and (4) inflation, although said to be transitory, may be more enduring than some believe. There is a saying that the market has to climb a wall of worry. There certainly seem to be a few worries available.

Over the second quarter, the market has churned considerably, possibly signalling a change in leadership. Many strategists see the possibility of a near-term pullback as the market considers the compounded impact of peaking momentum and high valuations. It is possible. But if there is a pullback, it may be the kind of pause that refreshes and allows for a reset.

Equity Themes to Watch

Infrastructure. While there has been a bit of a political bun-fighting around the issue in the U.S., having public works in one's district should be a positive for re-election and, with mid-terms coming, politicians will be eager to get shovels in the ground. Engineering and construction companies are set to benefit, as well as suppliers of equipment and materials.

Electric grid. Over the next decade, the electric grid will require an upgrade, as automakers commit themselves to electrification, creating enormous demand. At the same time, most governments in the world are transitioning to renewable energy sources. These changes will require an upgrade to the grid that will likely include energy storage facilities of some sort.

Hydrogen. One relatively clean way to store energy would be to use water and electricity (from a renewable source) to produce hydrogen. The hydrogen can then be used to power generators and fuel cells. It's inefficient, to be sure, but in some areas of the world, the ability to generate renewable electricity will exceed local demand, so being able to store that energy for export will be important. Hydrogen is being studied as a key future fuel. A successful transition will no doubt require many new technologies to be developed over the next five to 10 years.

Reshoring. The idea of bringing manufacturing that had been out-sourced to lower-cost countries is another theme that will play out over the coming years. The rise of protectionism, compounded by the pandemic, has caused upheaval in many supply chains. It seems reasonable that companies will begin to bring at least some portion of production closer to the end consumers.

ESG. We are beginning to see valuation premiums being placed on companies that have high ESG (environmental, social, governance) characteristics. This trend is likely to strengthen over the next five to 10 years, offering the most ESG-observant companies an advantage.

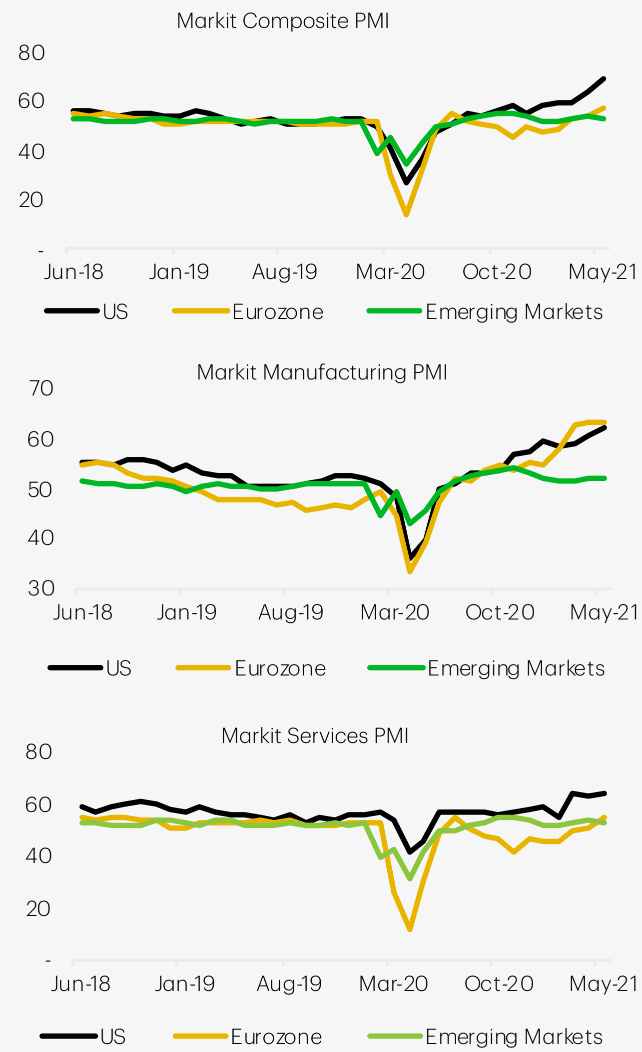
For the time being, it may be best to stick with active management and focus on thematic trends (see sidebar) that will likely play out over the next few years. Of course, even stocks that are riding secular trends are likely to fall during a general market sell-off (should one occur), but the idea here is that future growth should help to mitigate any near-term pullback.

International

We remain overweight in international equities mainly because they continue to be attractively priced, and because we believe the strong rotation into value and cyclicals has yet to play out in Europe and Japan, where the vaccination rollout and economic reopenings have been slower. Even if you were to assume that 2021 and 2022 earnings growth for international equities had reached a peak, valuations for international developed markets don't yet reflect this growth when compared to a basket of global equities (Figure 3).

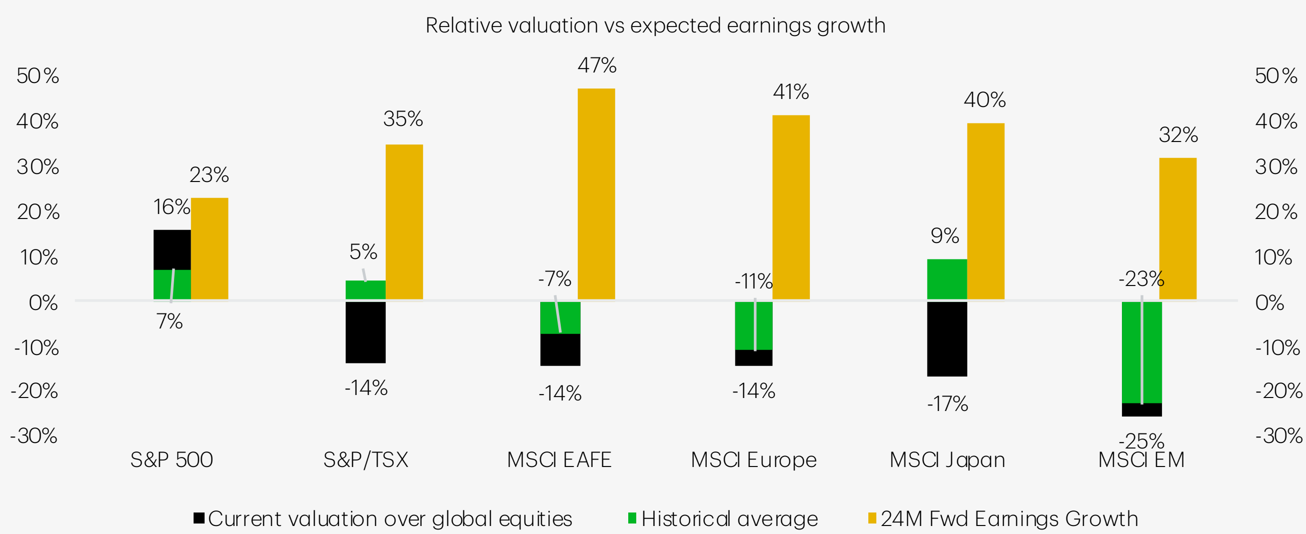
The slow pace of the vaccination rollout in Europe, and higher case counts, have prolonged the period of lockdown on the continent, although that situation is expected to change as we enter in second half of 2021 and vaccinations ramp up. This development has greatly lifted expectations for economic activity (Figure 4). While the composite PMI for the eurozone has yet to reflect the recovery growth that has been observed in the United States recently, the manufacturing PMI has climbed to 63.1 — higher than in the U.S. The rebound on the service side of the economy, meanwhile, still has plenty of room to grow.

Figure 4: Room for growth outside the U.S.



Source: Bloomberg Finance L.P. as of June 30, 2021

Figure 3: International equities offer a favourable reward/risk ratio



Source: Bloomberg Finance L.P. as of June 30, 2021

Although the eurozone manufacturing PMI is close to its 14-year high, we believe this surge in growth has not yet been priced into European cyclicals, which are trading at a 3.3% discount to broader European equities, compared to a historical premium of 6.8%. Value stocks in Europe are also trading at a significant 27% discount, compared to a historical discount of 16%. This suggests that the strong rotation into cyclicals and value stocks that we've seen in global equities will continue for some time in Europe (Figure 5).

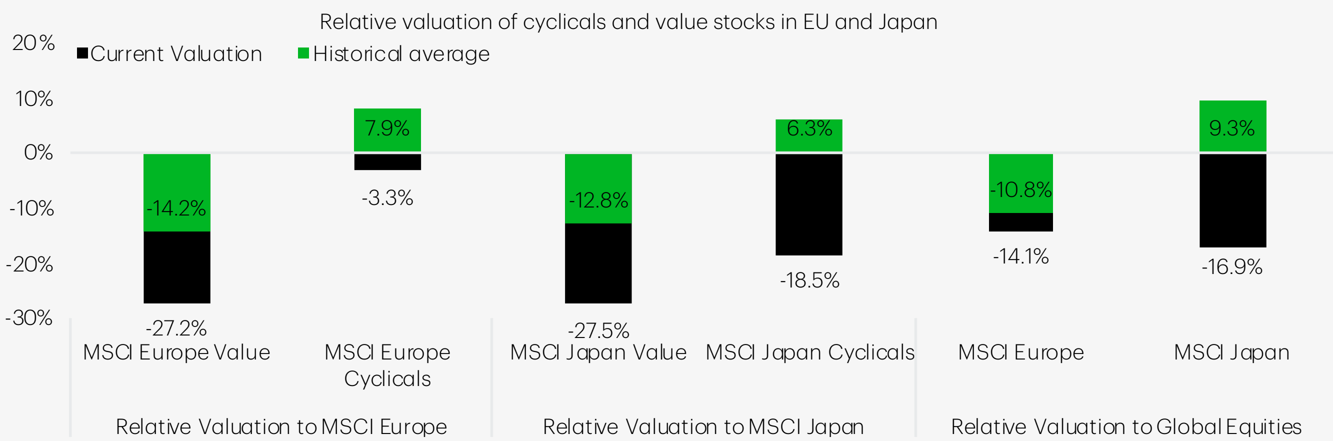
Appreciation in Japanese equities paused in the second quarter, as the pace of vaccination disappointed. Japan has not even managed (by May) to inoculate 10% of its population. Although economic shutdowns in Japan were never as stringent as in North America and Europe, the slow pace of vaccination in Japan significantly reduced the premium that the market was willing to pay for economic stability there. As in Europe, Japanese value and cyclical stocks are trading at a larger discount to Japanese indices than their historical averages would account for. This indicates that the rotation theme, similar to Europe, has yet to play out.

Another important differentiator between U.S. and international equities involves the inevitable decision to start tapering off the enormous amount of bonds being purchased every month by central banks to fund governments and prop up the global economy. While a few Fed officials have signalled a desire to begin "thinking about thinking", Europe has maintained its dovish stance amid lukewarm inflation data. That being said, if the European Central Bank were to begin tapering, this move would result in a spike in 10-year government bond yields. This, in turn, would likely provide a further boost to value stocks, given that value is considered to be a short duration play and is least vulnerable to fears over rising yields.

Emerging Markets

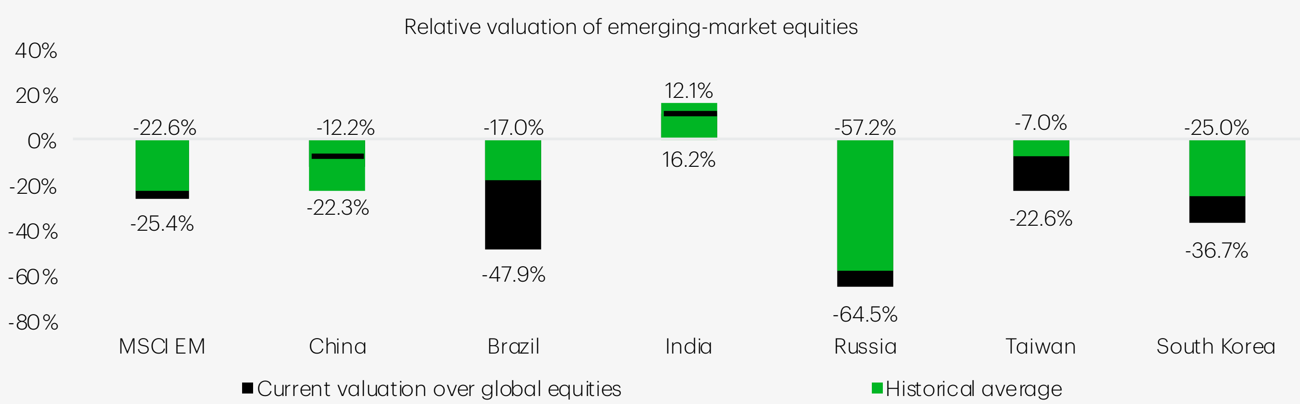
We remain overweight in emerging-market equities, primarily because of their reasonable valuations relative to developed markets (Figure 6). EM equities typically offer the highest return during commodity booms and therefore can be seen as an inflation-protection play. Another reason to maintain an overweight position in emerging-market equities is the fact that close to 55% of the MSCI Emerging

Figure 5: International stocks still in recovery mode



Source: Bloomberg Finance L.P. as of June 30, 2021

Figure 6: EMs (except China) trading at a discount to global equities



Source: Bloomberg Finance L.P. as of June 30, 2021

Markets Index provides cyclical exposure, compared to the MSCI All Country World Index's 48% cyclical exposure. This additional exposure to cyclicals should prove beneficial as emerging-market economies move towards recovery.

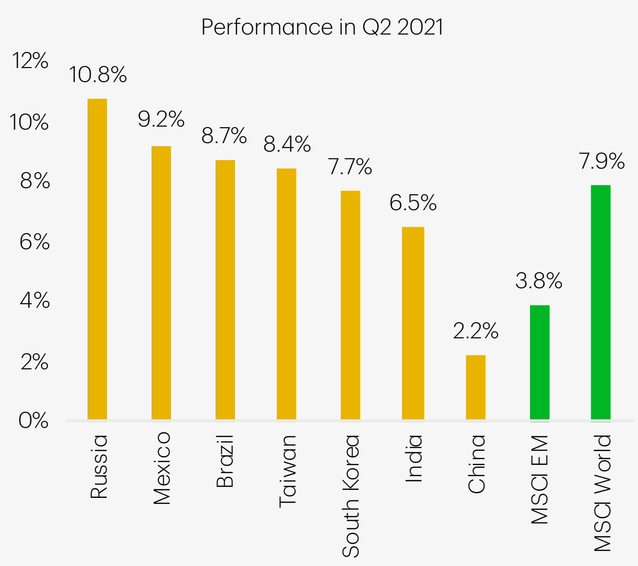
However, as in the case of U.S. equities, you can divide EM equities into two baskets: (1) defensive growth plays in China, Taiwan and South Korea, which drove the 19.1% return by the MSCI EM in 2020; and (2) regions with higher exposure to cyclical equities, such as India, Brazil, Russia and Mexico. Breaking down performance by nation (Figure 7), we can see that appreciation among the first basket of EM countries has already slowed down, especially in China, while countries that have higher exposure to commodities and cyclical equities, such as Russia, Brazil and Mexico, recorded higher performance in Q2 2021. That being said, the slow pace of vaccination in this second basket of emerging-market nations may discourage the market from fully pricing in the recovery play. Taiwan, meanwhile, is a peculiar case, given that a global microchip shortage has led to skyrocketing prices for the country's dominant sector.

Despite the overall sluggish performance recorded so far by EM equities, we believe they provide a more attractive reward/risk ratio than developed markets, for three reasons: (1) Most emerging-market countries have yet to experience a rebound in economic activity and growth, due to slow vaccination programs and rising Covid cases; (2) As most people in the developed world get vaccinated and economies open up completely, spare vaccine capacity can be redistributed to emerging markets, while the surge in demand jump-start the global supply chain; (3) The boost in infrastructure and green-energy spending will continue to support commodity prices, which should benefit emerging-market equities the most. In commodity booms of the past, EMs have recorded the highest return — around 16%, compared to an average of 8.5% in developed markets (Figure 8).

The one major caveat for EMs is the potential for rate hikes and the resulting currency appreciation in developed markets, particularly for the U.S. dollar. We continue to believe that the Fed's overall dovish stance on rates will cap yields in developed markets, but if inflation (which we believe is transitory) gets out of hand, it could trigger a spike in yields across global markets. Another risk may come from EM central banks themselves, as they look to normalize rates to pre-Covid levels. Rates that rise too quickly could pose a threat to EM equities by hindering economic recovery.

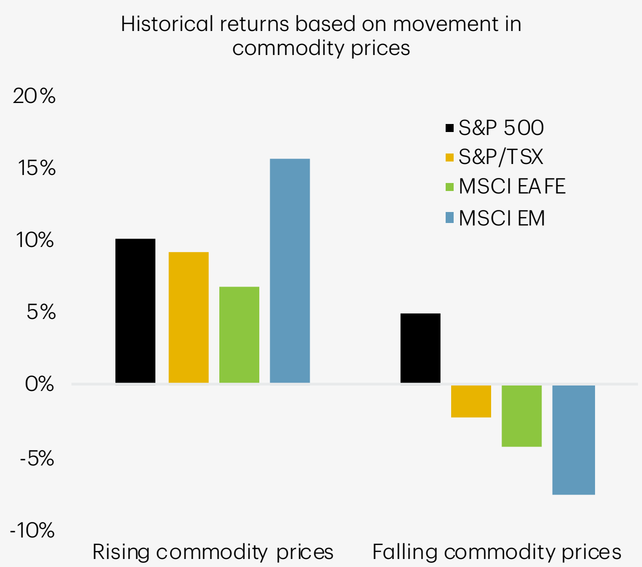
So far, Brazil, Russia and Turkey have hiked their rates, while other nations maintain a dovish stance or have not yet been bold enough to raise rates. While the possibility of a sudden rise in yields may be a risk over the interim period, higher growth expectations for 2022, along with sustained growth over the long term and current reasonable valuations, all act as a positive catalyst. □

Figure 7: EM nations with commodity exposure lead the rally



Source: Bloomberg Finance L.P., as of June 30, 2021

Figure 8: EMs outperform during commodity booms



Source: Bloomberg Finance L.P., as of June 30, 2021

Outlook on Real Assets

Overweight

The uneven road ahead

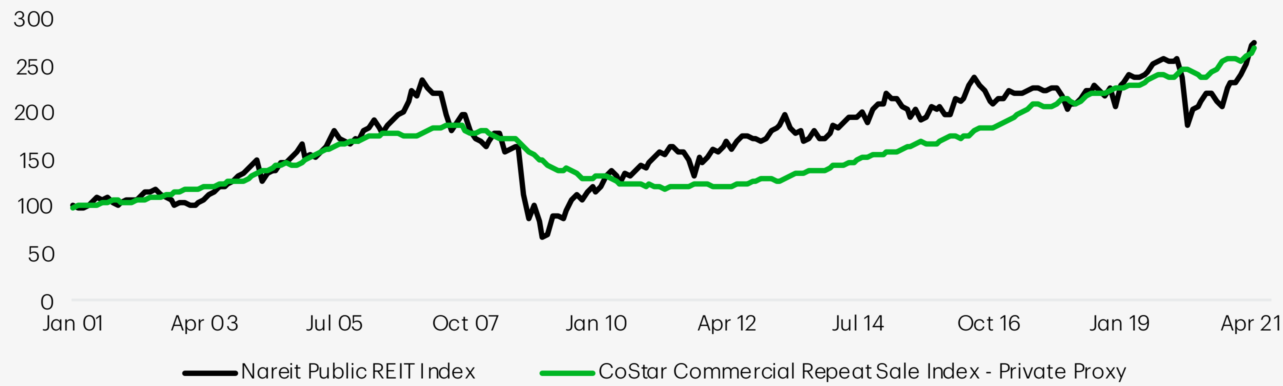
Real asset valuations have recovered and even exceeded the highs of the early 2000s thanks to unprecedented monetary and fiscal policy (Figure 1). Indeed, demand in the sector has been lifted further by inflationary concerns, given the fact that the contracted operations underlying real assets can often pass on inflationary costs to their consumers, providing a real return and yield.

That said, we expect inflation to be transitory, as supply chains catch up with demand and consumers draw down their pandemic-induced savings with a bit of “revenge spending.” This can already been seen in the lumber industry, where prices have dropped 70% from their peak earlier this year as mills catch up to demand, which has slowed over the recent months.

As the race intensifies between Covid-19 and virologists battling the pandemic, it’s becoming increasingly clear that the speed of the economic recovery will depend both on access to vaccinations, as well as efforts to contain the spread of the disease. That’s because vaccines provide governments with an alternative to shutting down their economies. In North America, for instance, where regional economies have largely reopened, governments are grappling with flagging demand for vaccinations. Meanwhile, lower-income continents face acute supply shortages, with some countries yet to start mass vaccination campaigns (Figure 2). As long as vaccine access remains uneven, we can expect the same for the global recovery.

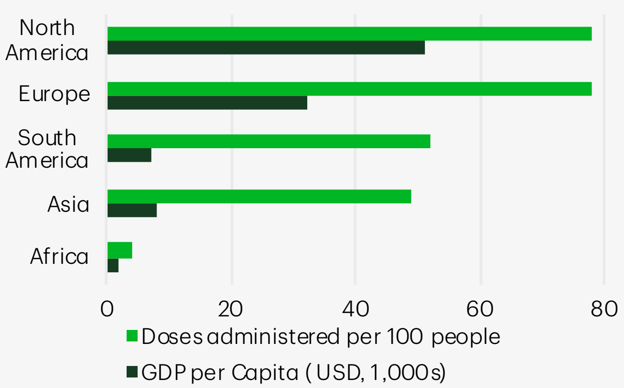
As we pass the halfway mark of 2021 and vaccinations progress, office landlords and tenants have begun to crystalize their return-to-work plans, boding well for a sector that has been hard hit by the pandemic. When formulating a return-to-work plan, employers rank safety as their top consideration, followed by productivity, collaboration, culture — all considered more important than operational savings (Figure 3). Not surprisingly, though, after health and safety considerations, productivity is the top consideration, with employers perceiving a 20% drop in productivity among their workforces due to remote work, according to a survey by Colliers.

Figure 1: Real assets up on inflation hedge



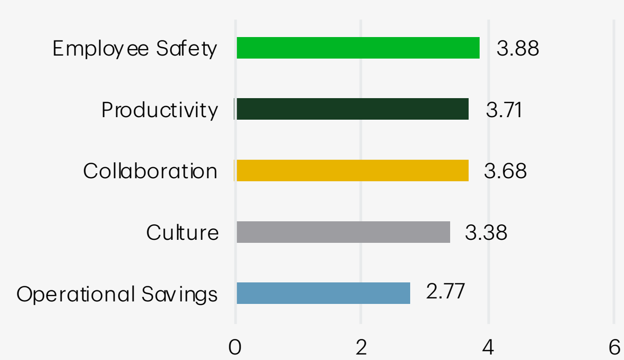
Source: Nareit, CoStar, TD Wealth as of June 2021

Figure 2: Rich countries first to vaccinate



Source: New York Times, IMF, TD Wealth as of July 2021

Figure 3: Employer Remote Working Considerations



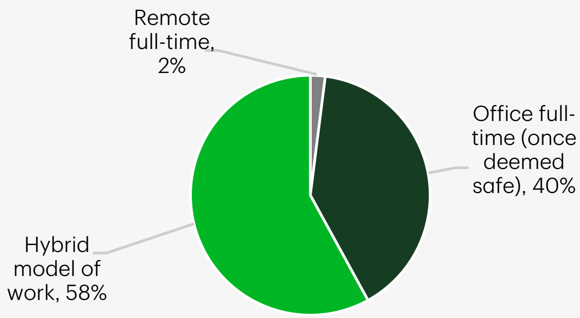
Source: Colliers as of May 2021

It's no surprise that employers are increasingly adopting the hybrid office model, with the majority indicating they would be implementing such a model (Figure 4). What remains unclear, however, is the preferred number of days in the office, with 66% undecided. The number of days in the office will affect overall space requirements, with more days in the office potentially translating into higher space requirements to fit a larger number of concurrent employees.

Despite the uncertainty, employers have upwardly revised their office needs. For example, in a Colliers survey conducted in June 2020, 46% of employers were looking to reduce their office space; since then, however, that number has fallen to 29%, with the majority of employers looking to keep their current space or increase it. Of the employers who are looking to reduce their office space, the majority are looking to do it by 2022, implying extended vacancies in the near term despite improving fundamentals (Figure 5).

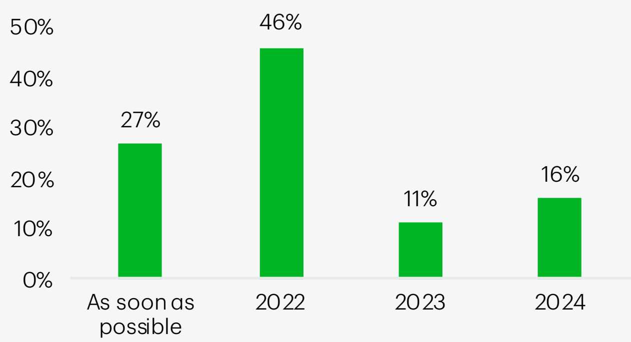
TD Wealth holds a modest overweight stance on real assets. Both public and private real assets have exceeded pre-pandemic valuations on the strength of improving fundamentals across all sectors and accommodative fiscal and monetary policy. We believe real assets are a key allocation within portfolios, offering protection against inflation and providing real returns to investors.

Figure 4: Hybrid Office Intentions



Source: Colliers as of May 2021

Figure 5: Timeline for office reductions



Source: Colliers as of May 2021

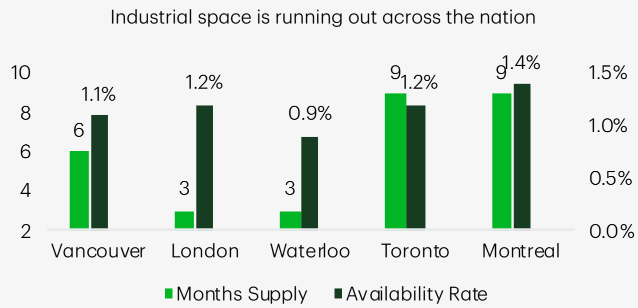
Industrial

The Canadian industrial real assets sector continues its assault on the record books, with availability rates falling 60 bps over the second quarter, to a historic low of 2.3% across the country. Availability rates have fallen in every urban market from Vancouver to Halifax. In fact, if current demand and supply trends continue, several Canadian markets risk running out of space within a year (Figure 6). Accordingly, net rents have risen in 10 out of 11 markets over the past quarter, boosting the national average 2.9% to $9.54 per square foot. In London, Ontario, for example, extremely low availability rates led net rents to jump 25% q/q.

Demand for industrial space is diverse, flowing from a broad range of sectors: while e-commerce continues to be a major driver of demand, accounting for 45% of leasing activities in Q2, other sectors have also seen an increase in demand exceeding pre-pandemic levels (Figure 7).

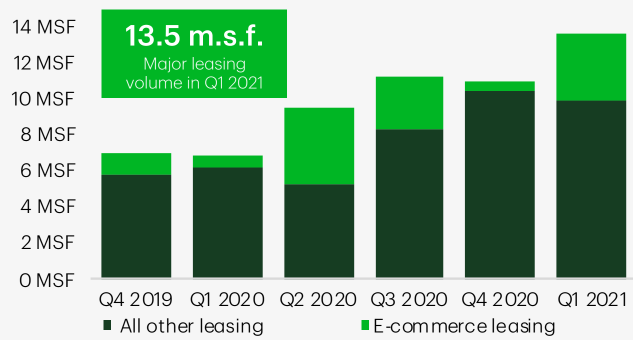
New industrial supply is forecasted to be constrained over the next couple of years, providing support for current rents as the lack of viable development plots, combined with rising construction costs, have limited new construction to only 25 million square feet or merely 1.4% of existing inventory. Without new supply over the near term, we expect rents to continue their march upwards as the economy continues to recover and competition for existing space heats up.

Figure 6: Running out of space



Source: CBRE as of June 2021

Figure 7: Diverse Demand



Source: JLL Research Q1 2021

Office

The Canadian office sector continued its recovery, recording a second consecutive quarterly improvement, with vacancy growth decelerating as tenants ramp up activity around reopenings, sales tours and renewal discussions in the second half of the year (Figure 8). In fact, out of the five North American cities with the lowest downtown office vacancy rates, four can be found in Canada: Vancouver (6.6%), Toronto (10.0%), Ottawa (10.6%) and Montreal (11.1%), in part due to Canada's relative success in controlling the pandemic.

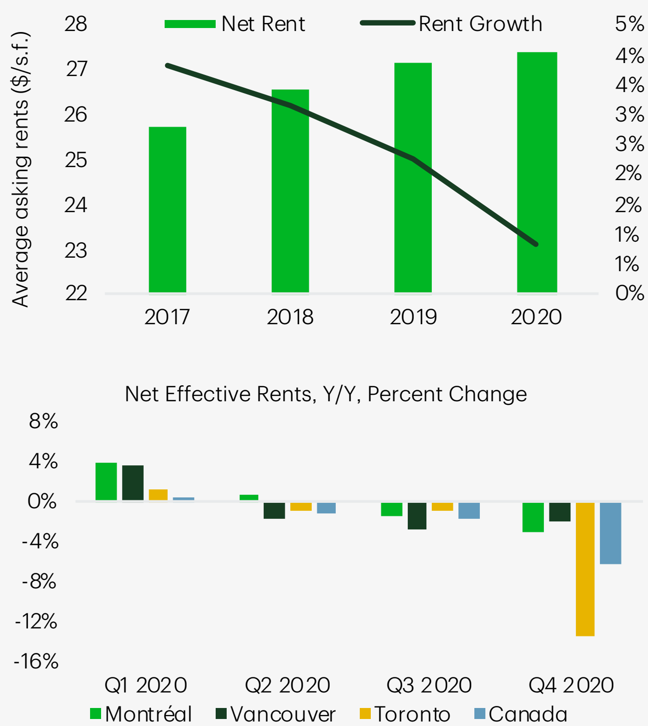
Net absorptions for the quarter were -2.9 million square feet, a 26% improvement q/q led by a decrease in new supply completions (144 thousand square feet versus 1.5 million square feet last quarter) and a decrease in sublease vacancies (reversing the trend over the past few quarters). Turn-key and fully furnished sublease spaces, in particular, continue to be in high demand because of their flexibility. These spaces are typically ready to move into, and offer lower capital expenditures and shorter sublease terms. Supply is also a factor, given that sublessors are now upwardly revising their office needs. As a result, Class A office building net rent held stable nationally at $20.68 per square feet. We believe the near-term picture continues to improve, with tenants upwardly revising their office demand and preparing for a return to office in the second half of 2021.

Longer-term, however, potential oversupply of office space remains a headwind, with 13.7 million square feet under construction and much of it planned or started prior to the pandemic when market dynamics were vastly different. As a result, if current trends hold, we expect vacancies to be elevated for the next few years, until supply and demand dynamics reach a new equilibrium.

Retail

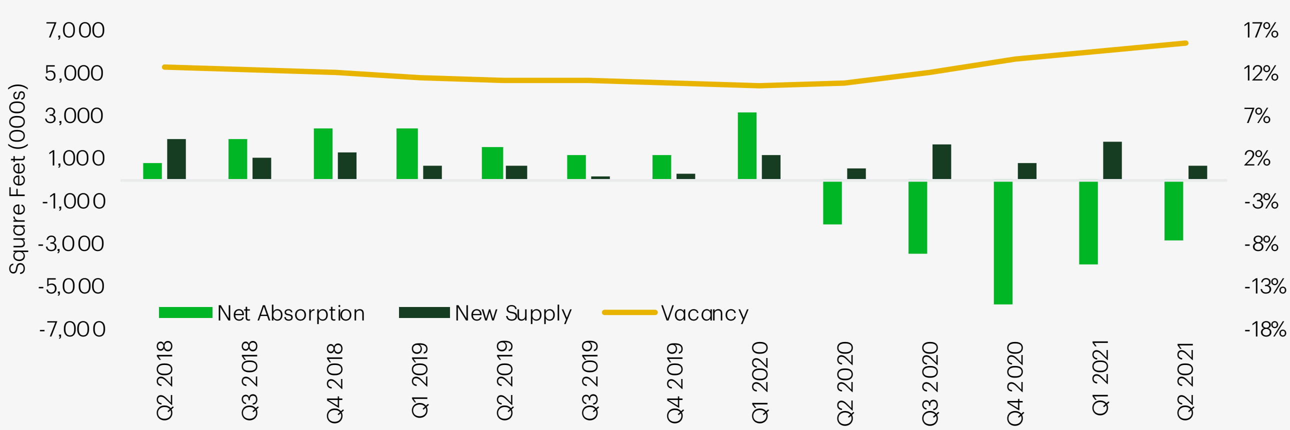
The retail sector continues to see softening as vacancies trend upwards to 3.6%, the highest since 2017 — a trend that we expect to continue into 2022 as retail continues to redefine itself in a digital age. While asking prices for rent have continued to grow throughout the pandemic to an average of $27.37 per square foot across Canada (Figure 9), net effective rent (rent paid) has fallen for the third consecutive quarter as landlords provide concessions and willingness to help tenants with a good chance of surviving the pandemic.

Figure 9: Landlords concede on rents



Source: JJL as of May 2021

Figure 8: Supply and Demand



Source: CBRE as of June 2021

That said, green shoots of recovery are beginning to materialize within the sector. First, consider the fact that Canadians have saved $180 billion in 2020 — or roughly $5,800 per adult — much of which is expected to be spent in a bout of "revenge spending." This trend has already been playing out in the United States, where the economy has to a large extent reopened (Figure 10). May retail sales in the U.S., for instance, reached US$620 billion, a 28% increase y/y. Second, with nearly 80% of the eligible Canadian population having already received their first vaccine dose, the prospect of economically punishing lockdowns in the future have diminished.

Last but not least, the government has been highly supportive of the retail sector by providing generous benefits during the pandemic. The current rent-subsidy program, which covers up to 65% of rent for tenants suffering a decline in revenue, has been extended to September 2021. To illustrate, while there have been more than 1,400 permanent store closures in 2020, request for bankruptcy protection and creditor settlements in March have actually decreased year-over-year.

Residential

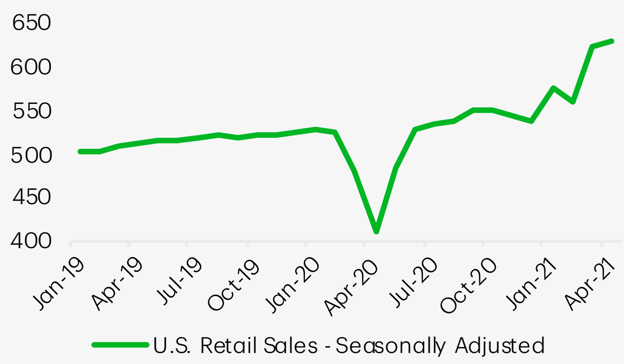
After reaching all-time highs in March 2021, the average price for a house in Canada has fallen for three consecutive months to $679,000, after the most motivated and financially able market participants transacted earlier in the year. Indeed, the market has loosened significantly after reaching a March sales-to-listing ratio of 90.6. (i.e., the number of homes sold per number of new listings). Given that sales-to-listings remain high, at around 70, the trend reflects moderating sales activity in a still chronically undersupplied market (Figure 11).

A slight uptick in mortgage rates and a stricter mortgage stress test by the Office of the Superintendent of Financial Institutions have also worked to bring prices down. Nevertheless, we expect both home prices and market activity to remain at elevated levels on the back of historically low interest rates, constrained housing supply and a resumption of immigration, which accounted for 86% of population growth as recently as 2019.

In the rental housing market, vacancies rose across the board due to the pandemic (Figure 12). While asking prices have grown over the past year, landlords have offered incentives such as rent-free months to lure tenants back, effectively lowering net rents in the short term.

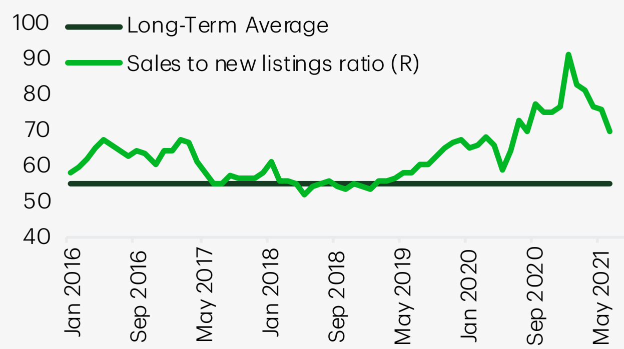
Vacancies for studio and one-bedroom units rose the most due to a number of factors. For instance, demand from young professionals and university students, who typically occupy smaller units, has been subdued by the emergence of remote working and learning. International students, in particular, have been able to continue to attend classes remotely from their home countries.

Figure 10: U.S. retail sales have recovered in a big way



Source: U.S. Census Bureau as of June 2021

Figure 11: Sales have cooled since the spring market



Source: CREA as of July 2021

Figure 12: Rental vacancies have increased across the board

	Studio	1-Bedroom	2-Bedroom	3-Bedroom	Average
October, 2020	4.60%	3.50%	2.80%	2.60%	3.10%
Y/Y change	140 bps	120 bps	60 bps	80 bps	80 bps

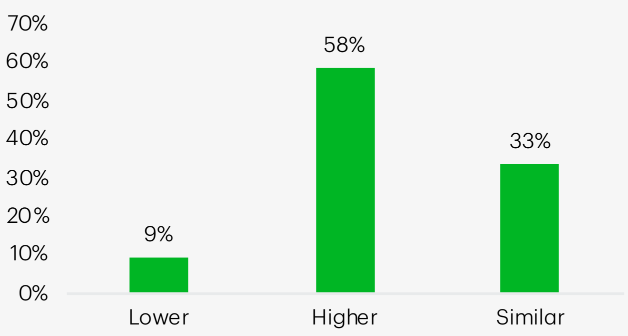
Source: Colliers Canada as of July 2021

Moreover, the ability of professionals to work remotely has removed a major incentive for them to remain close to rental rich downtown office areas, particularly given the fact that most offices and downtown amenities in Canada remain closed due to the pandemic. Additionally, with more time spent working at home, people preferred to upsize their accommodations, driving demand for larger rental units.

The pandemic has had an outsized effect on renters. Most job losses occurred in the lower-wage sectors, where renter households are more likely to reside. For example, in 2017, the median renter household in Ontario earned close to $46,000, while the median homeowner household earned close to $95,000. To further illustrate, mortgage delinquencies for homeowners declined to 0.25% in 2020, lower than pre-pandemic levels, while 91% of landlords surveyed by CMHC saw similar or higher arrears (Figure 13).

Despite short-term headwinds, interest in multi-family assets remains robust given the lack of housing stock nationally. At the same time, favourable immigration-driven demographics have drawn investment levels rivalling 2019 into the sector (Figure 14). Longer-term, as in the ownership market, we expect the rental sector to be boosted by a combination of immigration, office reopenings and broader economic recovery.

Figure 13: 2020 loans in arrears vs. last year



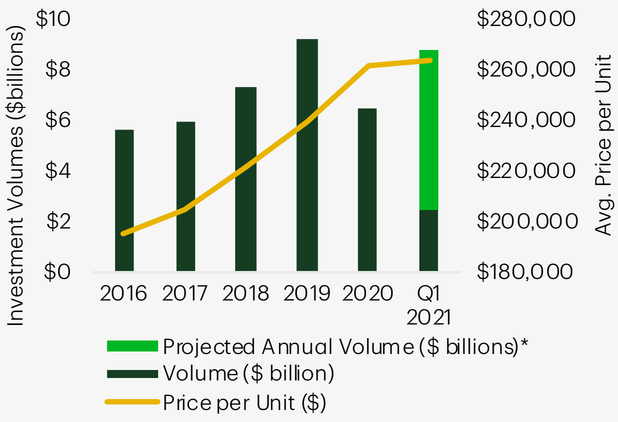
Source: CMHC as of January 2021

Infrastructure

As the U.S. president continues to gather bipartisan support for his landmark infrastructure bill, the private markets have seen an explosion of interest by both investors and portfolio managers. The second quarter saw a record 328 infrastructure funds targeting US$328 billion in capital — potentially an indication of manager sensitivity to investor concerns regarding low yields and inflation.

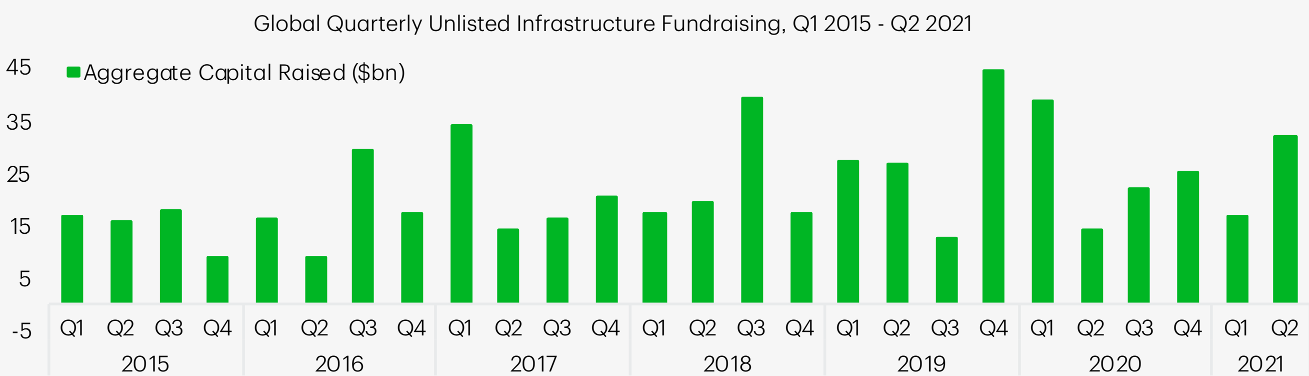
Infrastructure assets typically operate in near monopolistic environments paired with relatively inelastic demand. They therefore possess the ability to pass on inflationary costs to their customers. Furthermore, Q2 saw capital inflows reaching US$32 billion — above the historical average of US$25 billion — making it one of the highest capital-raising quarters in recent history (Figure 15). Activity was focused in Europe where the lion's share of capital was raised (US$20 billion). Europe has been a leader in green infrastructure, targeting 55% lower emission in 2030 compared to 1990, with renewable energy a major area of focus. □

Figure 14: Residential building investment ramps up



Source: Realnet, Altus Data Solutions, Colliers as of Q1 2021

Figure 15: Bundles of capital raised



Source: Preqin as of July 2021

Outlook on Currencies

Neutral the USD near term

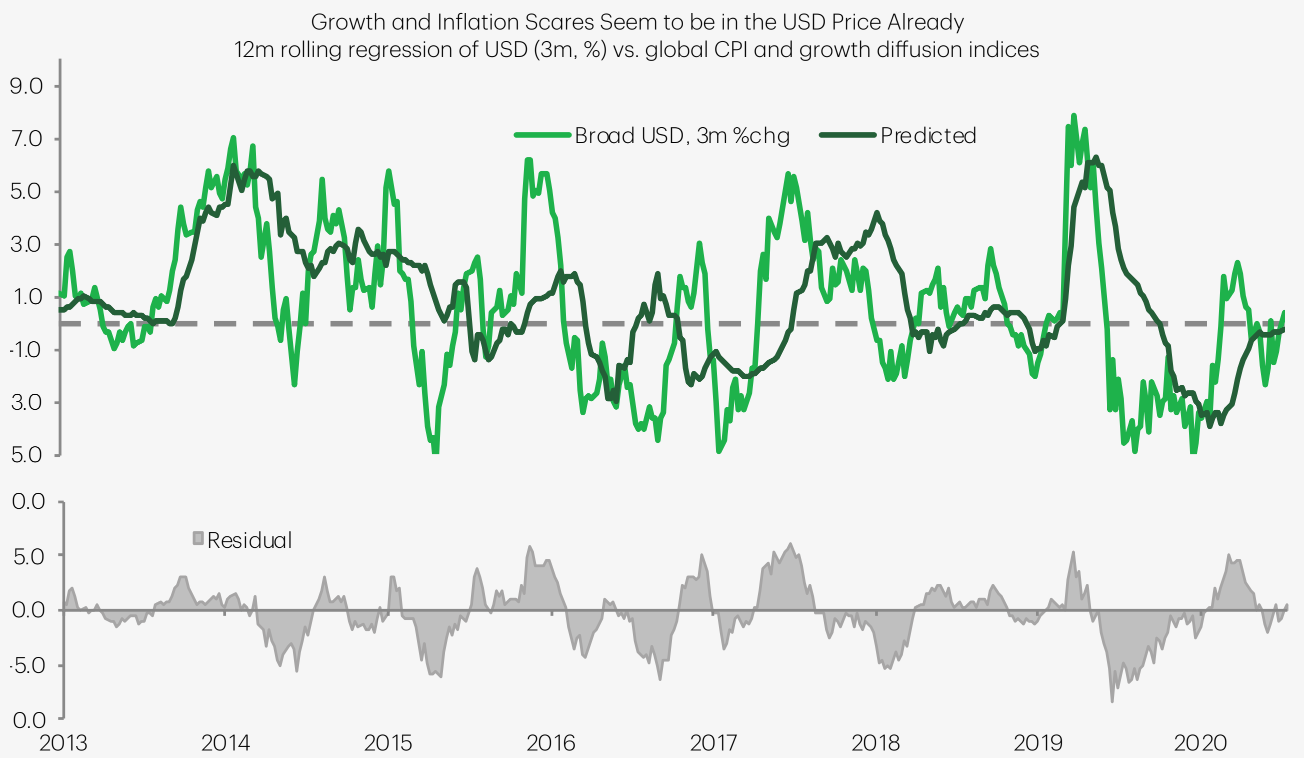
Mazen Issa, Senior FX Strategist, TD Securities

The thematic market pendulum has swung once again. Several central banks have turned more hawkish, just as the global growth cycle has started to peak. This has some folks worrying that a more hawkish shift in central-bank stances is coming at the wrong time, though this seems to be more like a case of eating your cake and having it too. Indeed, the market has gone from warning the Fed that it is behind the inflation curve, back in May, to now suggesting its hawkish pivot is risking a policy mistake.

While a slowdown was always expected given the unsustainably high run rate of growth earlier this year and fiscal boost wears off, the market is more worried that the delta variant could pose a more acute threat to the outlook than initially perceived. A reintroduction of more stringent lockdown/mitigation measures and slowing vaccination rates have shifted the market's recent focus from an inflation scare to a growth scare, while putting a damper on reflation trades. Indeed, U.S. 10-year real yields have returned to cycle lows and breakeven inflation rates have rolled over more forcefully.

While U.S. economic data remains on solid ground, there are unambiguous signs of a slowdown across the globe. The share of emerging-market manufacturing PMIs in expansionary territory has been halved. Developed-market manufacturing PMIs have been slow to follow, but they are likely not too far behind. A key question going forward is whether the ramp-up in household savings translates into services consumption as the sugar high from goods-based consumption moderates.

Figure 1: Growth, inflation scares appear priced in USD



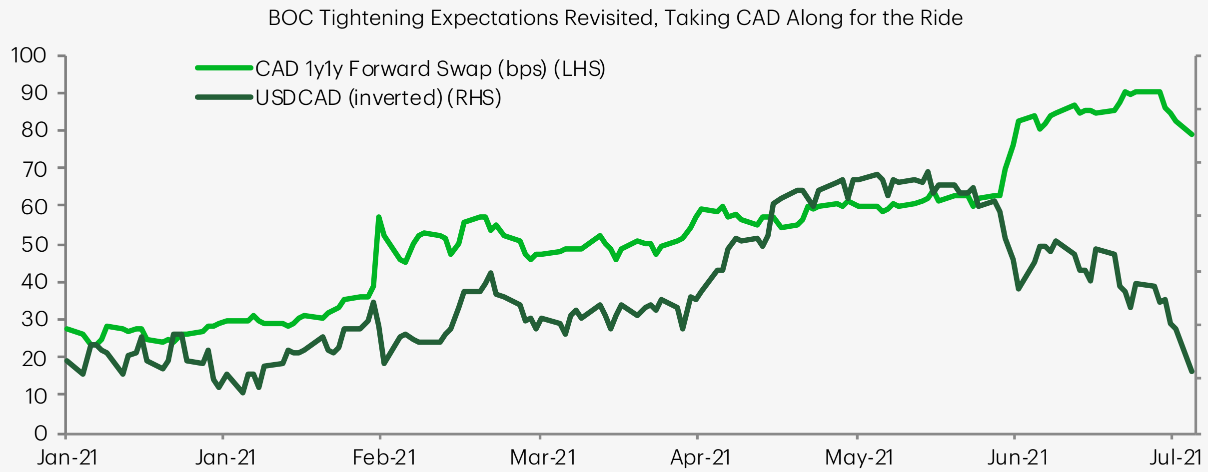
Source: Macrobond, TD Securities as of July 12, 2021

Such concerns have helped to reintroduce more balanced risks around the U.S. dollar as the wall of worry gets higher. As global mobility starts to lessen and global growth expectations adjust lower, the USD looks a bit better situated, particularly against its high-beta peers in Asia and commodity currencies. But we think that some central banks will remain relatively resolute in their stances, given stellar economic performance (e.g., the Reserve Bank of New Zealand), though currency appreciation may be harder to come by against a backdrop of wavering risk sentiment. The USD currently owns a broad-based premium versus the G10, and positioning is moderately unfavourable from a tactical point of view. A resurgence of abject pessimism could help turn the tide more favourably for the USD during a more seasonally challenging time.

Canadian dollar attractively valued

The Canadian dollar has had a very strong first half of the year. Going forward, we think the currency can perform well once global growth and delta concerns abate. The Bank of Canada has been one of the early hawks, but ambitious market pricing against the current global backdrop suggests that there is room to pare down tightening expectations over the next year, lessening CAD's near-term allure. We still expect the BoC to hike in late 2022, however. Domestically, the Canadian economy has performed very well, and the Business Outlook Survey suggests this should continue into the second half of the year. Once the initial storm passes, we are inclined to see USD/CAD return to below 1.25 towards year-end. □

Figure 2: Bank of Canada policy supports the loonie



Source: Macrobond, TD Securities as of July 19, 2021

Figure 3: G10 Currency Forecasts

	Spot	2021				2022			
	Jun 24, 2021	Q1 A	Q2 F	Q3 F	Q4 F	Q1 F	Q2 F	Q3 F	Q4 F
USD/JPY	111	111	110	107	108	106	105	105	104
EUR/USD	1.19	1.17	1.19	1.20	1.19	1.20	1.21	1.22	1.23
GBP/USD	1.40	1.38	1.39	1.41	1.42	1.43	1.44	1.44	1.45
USD/CHF	0.92	0.94	0.92	0.91	0.91	0.92	0.92	0.92	0.92
USD/CAD	1.23	1.26	1.24	1.22	1.21	1.22	1.23	1.23	1.24
AUD/USD	0.76	0.76	0.75	0.77	0.78	0.80	0.80	0.80	0.80
NZD/USD	0.71	0.70	0.70	0.71	0.72	0.73	0.74	0.74	0.74
EUR/NOK	10.18	10.03	10.27	9.80	9.70	9.60	9.50	9.50	9.50
EUR/SEK	10.12	10.24	10.22	10.00	9.80	9.60	9.50	9.50	9.50
DXY	91.8	93.2	92.0	90.7	91.2	90.6	90.0	89.4	88.8

Source: TD Securities as of June 24, 2021

Outlook on Commodities

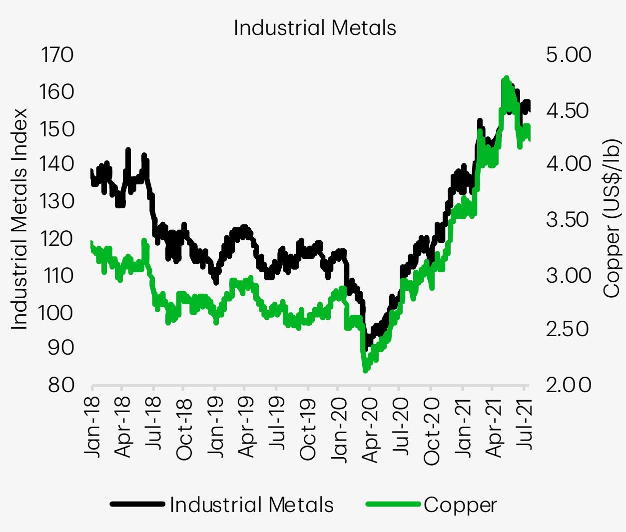
Growth is at a turning point

In our last quarterly update we wrote about the likelihood of a supercycle in industrial metals, driven by a Green Revolution. This Green Revolution — which has been fuelled by timely, coordinated and massive Covid-19 stimulus geared towards metal-intensive green infrastructure — will meet a decade of underinvestment to generate structural deficits over the medium and longer term.

However, while the conditions are ripe for a supercycle over the coming decade, there have been concerns about the impact of Chinese near-term demand on metal prices and the risk of a correction. Recently we have seen some of the froth come out of the metals complex as China's State Council escalated its crackdown against commodity speculators and hoarders. The speculative positions that were cause for concern earlier this year are now divesting and causing weakness in base-metal prices.

As we move further from peak reflation, demand indicators are weakening alongside micro-level data in China. Macro-level indicators also suggest Chinese deleveraging and a waning U.S. fiscal impulse will sap the winds out of the sails for demand growth. Metals supply risk is keeping prices bid, but a release of strategic reserves could dent this risk premium, with copper in the crosshairs given massive stockpiling. We believe prices will continue to consolidate over the near term, before an ESG-driven supercycle can fully take hold in the coming years.

Figure 1: Headwinds in the near term



Source: Bloomberg Finance L.P., as of July 15, 2021

Conditions may be ripe for a supercycle to form in the coming decade, supported by green infrastructure investment, increasing EV market share and lacklustre investment in new mining capacity, but the near-term drivers are more speculative in nature. Bottom line: China still controls the short-term commodity cycle, and the tailwinds of earlier this year have now turned into headwinds in the near term.

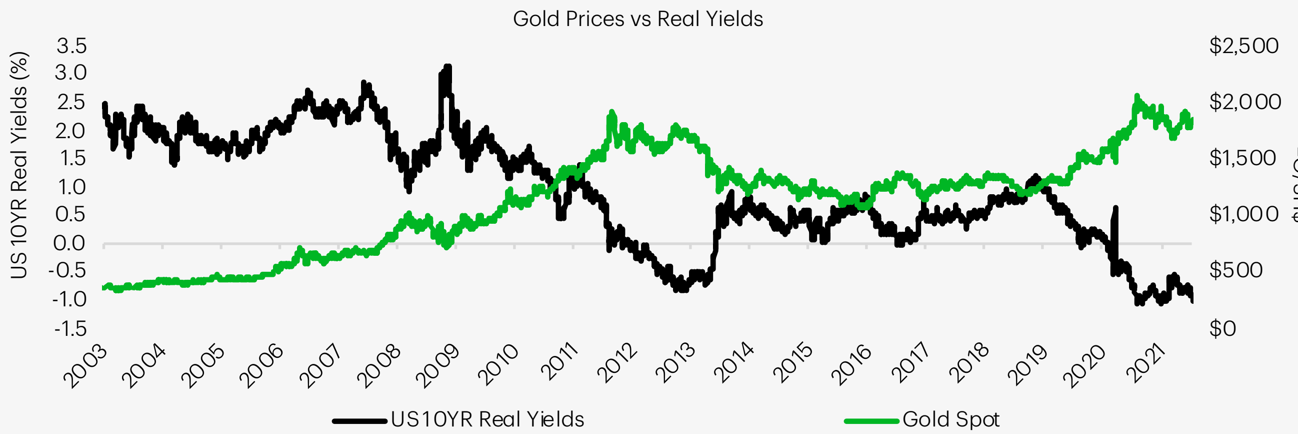
In Fed and Data We Trust

Just as gold rebounded over US$200 per ounce from late-March lows to trade around US$1,900 in early June, and market chatter appeared to have turned bullish again, there was a significant Fed-driven reversal, with the yellow metal falling back to US$1,770 in the days following the June FOMC meeting. The FOMC dot plot shifted hike expectations forward to late-2023 (with the median showing a 50-bp tightening) and Chair Powell has started the process of preparing markets for QE tapering. As such, this shift caused a sell-off in the precious metal.

Despite the recent sell-off, we believe that the Fed's continued emphasis on its full employment mandate should see gold recover most of its recent losses. The relatively new flexible average inflation targeting policy framework — and the implied willingness to overshoot inflation targets for a period should the output gap remain wide — are just a few reasons why very easy monetary conditions are likely to persist well into 2023. In this context, the U.S. central bank should keep real interest rates highly accommodative for a prolonged period, which will support gold prices. At the same time, various mine site disruptions and other constraints will continue to limit supply growth.

As we have noted in previous reports, we believe gold's role as a diversifier within an investment portfolio will continue to provide downside protection, as it can act as a hedge against inflation and currency risk. We believe central banks, which have been buying at a record pace over the past several years, will continue to add gold to their reserves. With gold ETFs and gold bar hoarding likely to see new increases again, and supply from primary sources only managing 1% to 1.5% growth, the physical markets are expected to tighten a great deal. We believe investors and central bankers like the fact that gold is a highly liquid yet scarce asset. At the same time, it is no one's liability — unlike the vast majority of other financial assets.

Figure 2: Low real yields a boost for gold



Source: Bloomberg Finance LP, as of July 15, 2021

OPEC stalemate

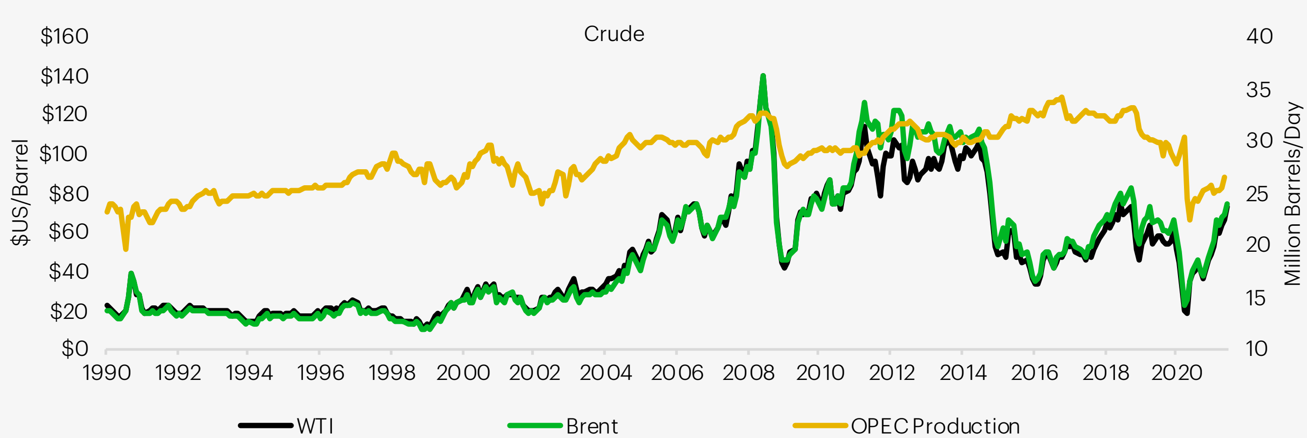
The tantrum in energy markets in early July had more to do with global macro than with the OPEC news. Our return decomposition flags that a deterioration in commodity demand signals mostly drove energy prices lower in early July, tying into the death of the reflation trade in rates markets. OPEC's status quo production agreement argues for a temporary but sharp tightening in market balances, which should be positive for prices as long as the status quo prevails. Ultimately, we expect a negotiated agreement, which should see global energy output rise as consumer nations and interested parties — including the U.S. and Russia, increase pressure on OPEC to reach a deal. Until that time, we expect the price of WTI may remain rangebound as the market waits for details on how this will be resolved. And it is unlikely that the end to sanctions against Iran will result in an outsized change in supply/demand conditions through much of that period.

After current uncertainties and a period of elevated prices, we believe that OPEC+ will come to an accord that will continue to allow supply to match demand growth.

Elsewhere, the spread of delta-variant infections in Asia is having a significant impact on mobility for the region, with congestion data for most cities tracked in the region showing a substantial decline in mobility. However, the risk to energy demand is mitigated as pent-up demand for travel surges outside of Asia-Pacific, with air travel contributing to gains, which should still lead to epic demand growth in August. This increasingly points to a less cohesive world for energy demand.

Longer-term, TD Securities sees WTI trading at around US$70 per barrel as the economy normalizes through 2022. A surge significantly higher is unlikely given that OPEC+ is keen to deploy its spare capacity. □

Figure 3: Supply and demand uncertainty keep crude rangebound



Source: Bloomberg Finance LP, as of July 15, 2021

Risk Environment

Down But Still Resilient

Our various indicators for risk sentiment have fallen from recent peaks but remain resilient in Q2 as investors continue to hold bullish views on global economic growth and anticipate the end of the pandemic. U.S. government fiscal stimulus is still accommodative and the Federal Reserve (Fed) has maintained its loose monetary policy despite the recent shift to a more hawkish tone on future rates. Investors continue to favour risk assets but growth expectations are more subdued. With the U.S. moving to late-stage economic recovery and the perceived likelihood of monetary tightening in the near term, investors have narrowed their focus to reliable growth and quality segments of the market.

Unlike Q1, when risk conditions improved across the board, risk indicators in Q2 moved in different directions as investors witnessed notable shifts in the macro environment. U.S. economic growth, consumer, housing, business and financial conditions improved slightly but not enough to offset significant declines in monetary policy and inflation indicators. Economic growth continues to support risk assets mainly because progress on the vaccination front has allowed most states to ease restrictions. Data for business activities and corporate earnings are still coming in above forecasts although investors expect earnings growth to decelerate after multiple quarters of positive surprises. The level of fiscal and monetary support remains staggering as the U.S. government and the Fed try to engineer a robust and more inclusive recovery, not just for financial assets but for the real economy as well.

When we aggregate indicators the overall risk regime score stands at +1.0 (a notable decline from +1.4 at the end of Q1), which still indicates a resilient regime that should support risk assets. Inflation data and the Fed's hawkish shift on monetary policy were the main drivers behind the decline in the risk score. The inflation score fell from +0.6 standard deviation above the historical norm to -0.8 standard deviation below and the monetary policy score tumbled from +3.2 to +0.7 standard deviation above the norm. Risk appetite also slipped and fiscal policy indicators retreated on the back of rolling obstacles and challenges to the Biden administration's fiscal agenda. On the positive side, we saw stronger data on economic growth, consumer sentiment, housing, business conditions, and financial conditions. Overall, and despite the continued threat of COVID-19, mainly in emerging markets, risk conditions continue to support risk assets.

Understanding the Market Risk Environment*

Our philosophy is to build resilient portfolios that are well diversified across key factors and don't depend on any single market environment to provide returns. However, from a strategic asset allocation perspective, we monitor and assess markets so we can decide, within defined parameters, when to de-risk a portfolio. We use a broad set of indicators based on business, investor and analyst expectations to gauge risk. Most of these are leading indicators and are, therefore, forward-looking. This helps us understand not only past events but what investors expect in the near term, which should already be reflected in asset and security prices.

We use this risk-management framework to take advantage of how asset classes behave under different risk scenarios and make strategic risk allocation decisions in portfolios over the intermediate to longer term. Risk assets such as stocks and credit tend to perform well during more resilient environments, while safe-haven assets such as government bonds tend to outperform in more fragile environments. We advise against using this framework to make short-term tactical bets or market-timing decisions. Over the longer term, the main determinant of portfolio returns for most clients will likely be asset allocation rather than any other active portfolio decisions.

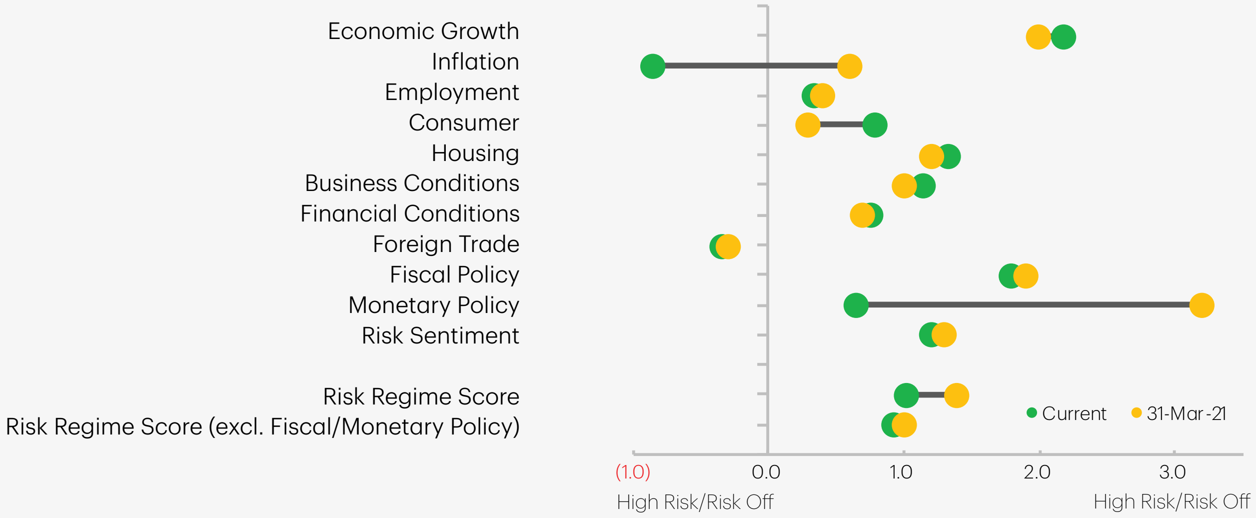
Figure 1 highlights the data that inform our understanding of the current risk environment. There are 11 broad indicators (all based on the U.S. market) ranging from macroeconomic variables — productivity growth, inflation, employment and foreign trade account — to variables representing key stakeholders such as consumer spending, housing conditions, business conditions and financial conditions. We also include high-level policy variables — government and fiscal policy, and monetary policy — as well as measures of market and investor sentiment that are driven by expectations and indicate forward-looking risk appetite. We use a standardized approach that makes it possible to aggregate across indicators to assess the current value of each indicator and compare it against recent trends and long-term history. Because each indicator is measured in different units, we use their historical dispersions to convert distinct indicators to Z-Score values. This allows us to compare indicators on a consistent basis.

*See Figure 4 for a complete table of the indicators and the Appendix for Glossary of Terms.

Fiscal and monetary policies are central to all macro environments and they continue to weigh heavily in our aggregate risk regime score. They remain well in positive territory with a combined score of about +1.2, which indicates they're accommodative. However, since Q1, the risk environment has been resilient even when we strip out the impact of fiscal and monetary support. This is still true at the end of Q2. Excluding fiscal and monetary accommodation, the risk regime score stands at +0.9 which is almost the same as Q1. This score reflects an above-average, or resilient, risk environment. The variation (or lack thereof) between the two scores suggests risk sentiment isn't as dependent on fiscal and monetary actions as it was in H2 2020. This is particularly the case for monetary policy because investors have already priced in an earlier-than-expected tightening cycle. Despite this change, fiscal and monetary policy still underpin the overall risk regime so any unexpected shock from either would have a significant impact on investor risk sentiment.

Figure 1: Market Risk Regime Scores

Indicator	Overall Condition	Current	31-Mar-21	31-Dec-20
Economic Growth	Strong	2.2	2.0	(2.6)
Inflation	Weak	(0.8)	0.6	(0.4)
Employment	Neutral	0.3	0.4	0.3
Consumer	Strong	0.8	0.3	(0.1)
Housing	Strong	1.3	1.2	1.1
Business Conditions	Strong	1.1	1.0	0.0
Financial Conditions	Strong	0.8	0.7	0.5
Foreign Trade	Neutral	(0.3)	(0.3)	0.0
Fiscal Policy	Accomodative	1.8	1.9	1.9
Monetary Policy	Accomodative	0.7	3.2	3.4
Risk Sentiment	Strong	1.2	1.3	0.9
Risk Regime Score	Low Risk	1.0	1.4	0.8
Risk Regime Score (excl. Fiscal/ Monetary Policy)	Low Risk	0.9	1.0	(0.1)

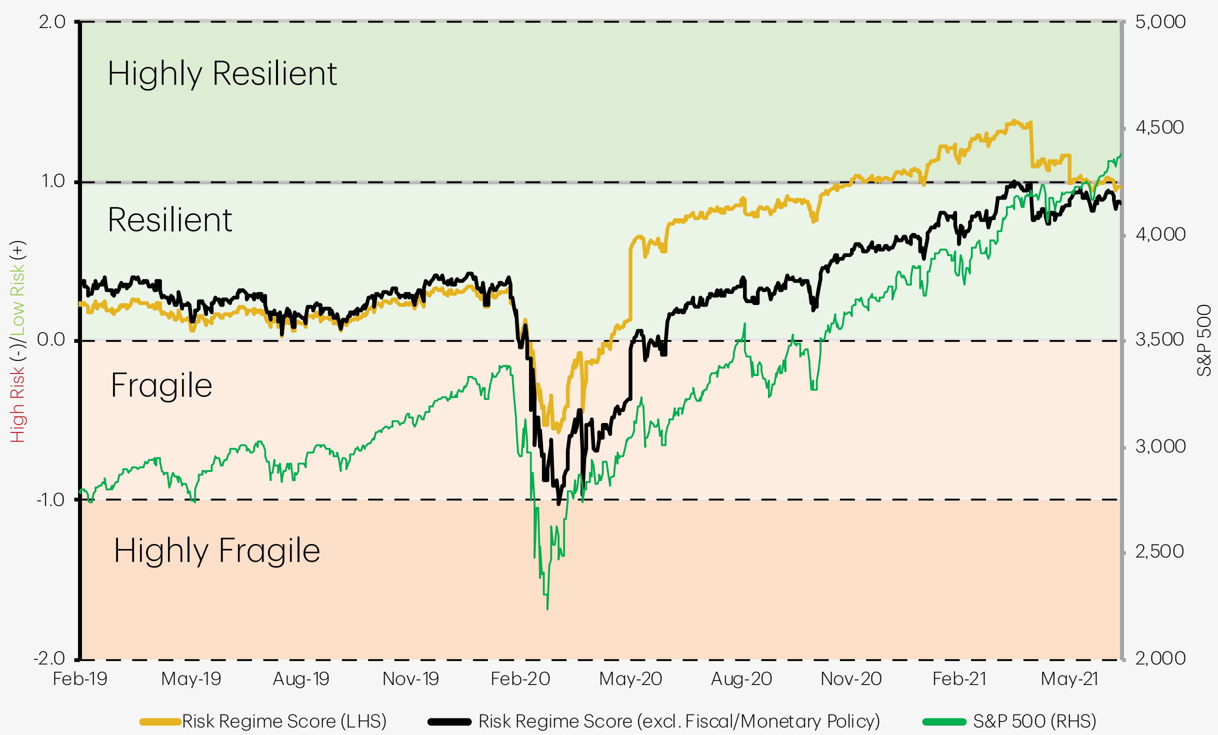


Source: Bloomberg Finance LP and TD Wealth as of June 30, 2021. Scores represent number of standard deviations away from long-term average

Figure 2 shows the risk regime score since the start of 2019, before the pandemic. We see the collapse from well above 0 (which indicates a stable environment) to a low of -0.73 on April 21, 2020 during the early days of the pandemic when markets were in a tailspin. Since then, the risk score climbed from +0.80 at the end of 2020 to +1.40 at the end of Q1 when economic growth expectations and risk appetite peaked. The score drifted back down to +1.0 as expectations for growth and inflation weakened and higher policy interest rates became a closer reality. Excluding government and central bank stimulus, the score is only 0.1 standard deviation lower, which is a big improvement from the 1.0 difference recorded at the end of 2020 and the 0.4 difference at the end of Q1. This narrowing gap reflects the greater market resilience since the end of 2020. It also highlights the Q2 shift in monetary policy from accommodative towards a tightening cycle—a shift that was largely expected during the transition of the U.S. economic recovery from early to late cycle.

Since Q2 2020, the risk environment has steadily improved and equity markets have progressively recorded new highs. Previously out-of-favour areas of the market—such as financial and consumer discretionary stocks, as well as small cap and emerging market equities—have bounced back. Both growth and inflation have consistently surprised on the upside. Q2 marked a shift in this trend as the Fed switched to a more hawkish position on monetary policy suggesting to investors that it may start raising rates and tapering bond buybacks sooner than previously indicated. At the same time, investors have started to price in slowing economic and corporate earnings growth as well as weaker inflation growth. The flattening U.S. Treasury yield curve is a reflection of this change. However, the Fed continues to maintain its loose monetary policy so actual tapering or rate hiking is likely still a few quarters off. Of course, if the economic recovery powers ahead and inflation keeps ticking upward, tapering and tightening could come even sooner. While the risk environment remains resilient and supportive for risk assets, we expect more dispersion in performance across and within asset classes so it's important to size active investments appropriately and maintain risk-factor diversification.

Figure 2: Historical Risk Regime Scores



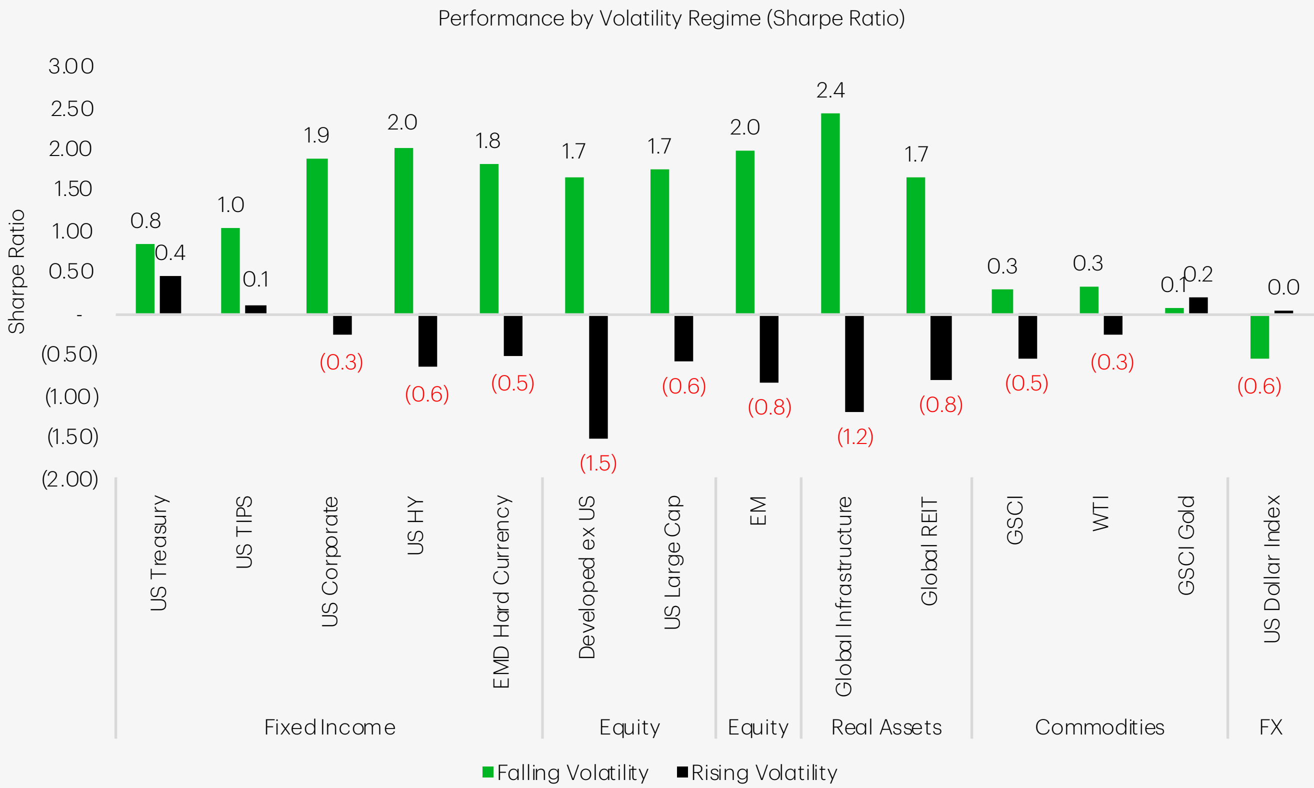
Note: scores represent number of standard deviations away from long-term average
Source: TD Wealth and Bloomberg Finance L.P., as of June 30, 2021

Fixed income and equity markets remain susceptible to shocks or rotations given their elevated valuation levels. Credit is still a key risk. Credit risk appetite remains strong: spreads for investment grade and sub-investment grade credit have tumbled below pre-pandemic levels in spite of record new issuance in 2020 and so far this year. The massive new corporate bond supply was met with enthusiastic demand given the dearth of yield in higher quality bond markets. Central bank support and the liquidity infusion has reduced credit spread volatility and ensured that downgrades, in the case of investment grade, and the default rate, in the case of sub-investment grade credit, have fallen to pre-pandemic levels leading to a positive risk regime score. That said, we recommend investors proceed with caution as there is inherent risk in extreme credit spreads (both high and low). While the likelihood of downgrade and default is reduced during economic recovery, the easy funding environment has increased the number of companies that are highly susceptible to rate hikes and deterioration in the economic environment, especially as we enter the later stages of the economic cycle. Since November, we've experienced a market shift toward cyclical sectors such as financials and energy along with a strong rotation from more expensive growth stocks into cheaper value stocks. Q2 saw a reversal of this rotation as investors piled back into growth and higher quality stocks.

While a resilient risk regime is one where greater risk tends to generate greater return, it's important to maintain true diversification and assign risk budgets according to the risk environment. In Figure 3, we use VIX (implied volatility for U.S. stocks) and MOVE (implied volatility for U.S. Treasuries) indices going back to 1990 and the Sharpe ratio to show asset class performance under different volatility regimes. The Sharpe ratios for risk assets are all negative in a rising volatility environment and almost all positive when volatility is falling. This indicates that risk assets perform well in a falling volatility regime and perform poorly when volatility is rising and the opposite is true for safe-haven assets. It also suggests there is no reward for bearing risk in an environment of rising volatility. Anyone who can exploit this phenomenon stands to gain but it's incredibly difficult. At the end of June, VIX and MOVE indices were tracking well below their historical averages, which is favourable for risk assets all else being equal. But even in a strong risk environment it's crucial to focus on building portfolios that are resilient across all risk regimes.

For a full breakdown of all indicators see the following section.

Figure 3: Asset Performance by Volatility Regime



Source: TD Wealth and Bloomberg Finance L.P., as of June 30, 2021

Figure 4: Market Risk Regime Indicators

U.S. Macro Indicators	Measure	Current	12M Ago	LT Average*	Z-Score	Current State	Trend	Overall Condition
Economic Growth	Real GDP Growth (qoq %, saar)	6.4	(31.4)	2.2	0.8	Positive	Improving	Strong
	Real GDP Growth (YoY %)	0.4	(9.0)	2.0	(0.7)			
	Real GDP Economic Forecast (YoY %)	6.6	4.1	2.0	2.2			
Inflation	Headline CPI	5.0	0.6	2.2	2.3	Negative	Worsening	Weak
	Core CPI	3.8	1.2	2.0	3.8			
	CPI Forecast (YoY %)	3.5	1.7	2.2	1.1			
	10YR Breakeven Inflation	2.3	1.3	2.0	0.8			
Employment	Unemployment Rate (%)	5.9	11.1	5.9	(0.0)	Neutral	Neutral	Neutral
	Initial Jobless Claims (000s)	371	1,436	402	(0.1)			
	Wage Growth (yoy %)	3.6	5.0	2.7	0.9			
Consumer	Consumer Confidence (1985=100)	127.3	98.3	94.9	1.2	Positive	Improving	Strong
	UofM Consumer Sentiment	85.5	78.1	86.4	(0.1)			
	Consumer Spending (MoM %)	0.0	6.5	0.4	(0.3)			
	Household Consumption (YoY%)	11.4	(33.2)	2.6	1.5			
	Household Consumption Forecasts (YoY%)	8.0	4.2	2.6	0.9			
	Household Debt to Disposable Income (%)	85.4	88.0	109.1	(1.8)			
	Household Debt Service Ratio (%)	8.2	8.8	11.2	(2.2)			
Housing	S&P/Case-Shiller Composite (YoY %)	14.9	3.5	4.5	1.2	Positive	Improving	Strong
	Home Builders Index	81.0	58.0	51.0	1.4			
Business Conditions	Capacity Utilization (%)	75.2	68.7	77.0	(0.5)	Positive	Improving	Strong
	Industrial Production (YoY %)	16.3	(11.0)	0.7	3.3			
	Industrial Production Forecasts (YoY%)	6.0	3.3	0.7	1.1			
	Private Investment (YoY%)	(3.4)	(46.6)	3.5	(0.4)			
	Private Investment Forecasts (YoY%)	10.4	5.7	3.5	0.4			
	12M EPS Forecasts (S&P 500)	190 (YoY: 33.7%)	124.8	97	2.6			
	Markit US Composite PMI	63.7	47.9	53.3	1.5			
	Markit US Manufacturing PMI	62.1	49.8	53.2	1.7			
	Markit US Services PMI	64.6	47.9	53.4	1.5			
Financial/ Credit Conditions	3M LIBOR/OIS Spread (%)	0.05	0.24	0.26	(0.7)	Positive	Improving	Strong
	10Yr Treasury Yield (%)	1.47	0.66	3.33	(1.3)			
	10YR/3M Yield Spread (%)	1.43	0.53	1.65	(0.2)			
	10YR/2YR Yield Spread (%)	1.22	0.51	1.22	(0.0)			
	IG Credit Spread (% OAS)	0.77	1.42	1.43	(0.9)			
	HY Credit Spread (% OAS)	2.68	6.26	5.40	(1.1)			
	Net Debt to EBITDA (S&P 500)	130%	166%	283%	(1.1)			
	Financial Conditions Index (Bloomberg)	1.3	(0.5)	(0.4)	1.2			
	Financial Conditions Index (Chicago Fed)	(0.7)	(0.3)	(0.3)	(0.7)			
Foreign Trade	Current Account (% of GDP)	(3.2)	(2.5)	(3.3)	0.1	Positive	Improving	Neutral
	Current Account Forecast (% GDP)	(3.6)	(2.3)	(3.3)	(0.2)			
	Trade-Weighted Broad Dollar (2006=100)	112.8	120.8	103.8	0.9			
Fiscal Policy	Budget Balance (% of GDP)	(15.0)	(15.3)	(3.9)	(2.8)	Positive	Improving	Accomodative
	US Budget Balance Forecast (% GDP)	(14.5)	(10.1)	(3.9)	(2.6)			
	Government Spending (YoY %)	5.7	2.5	1.3	1.6			
	Government Spending Forecasts (YoY%)	2.0	1.4	1.3	0.3			
	Government Debt (% GDP)	100.1	79.2	55.0	2.3			
	Government Debt Forecasts (% GDP)	104.5	107.1	55.0	2.5			
Monetary Policy	Fed Funds Rate (%)	0.25	0.3	1.9	(0.9)	Positive	Stable	Accomodative
	Monetary Base (YoY %)	17.3	52.7	12.9	0.2			
	M1 Money Supply (YoY %)	18.1	335.4	21.4	(0.0)			
	M2 Money Supply (YoY %)	13.8	22.9	7.1	1.6			
Risk Sentiment	Implied Volatility - S&P 500	15.8	30.4	20.2	(0.5)	Positive	Improving	Strong
	Implied Volatility - US Treasury	57.3	54.1	87.3	(1.0)			
	Implied Volatility - Oil	32.7	57.7	38.1	(0.3)			
	CBOE Equity Put/Call Ratio	0.4	0.5	0.6	(1.8)			
	Strategist Consensus (S&P 500)	4,213 (Change: -2%)	2,999	1,784	3.3			
	Retail Investor Bullish/Bearish Ratio	1.3	0.7	1.17	0.3			

Risk Regime Score	1.0	Positive	Improving	Low Risk
Risk Regime Score (excl. Fiscal/Monetary Policy)	0.9	Positive	Improving	Low Risk

Risk Regime Score: Below 0 means market conditions are riskier than average. Above 0 means coditions are less risky than average.
*Long term average: since 1999 (or earliest data is available). Source: Bloomberg Finance L.P. and TD Wealth, as of June 30, 2021.

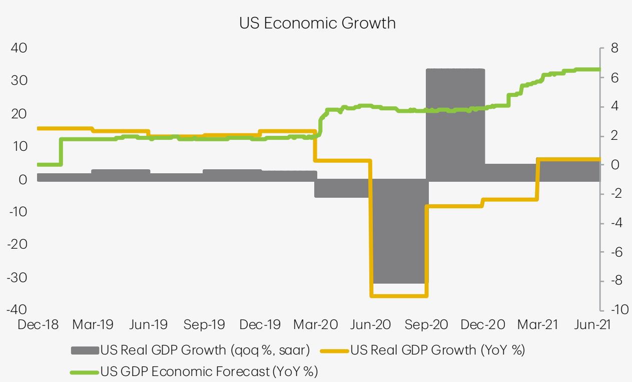
Economic Growth (Strong, Unchanged from Q1)

- U.S. real GDP surged by 6.4% quarter-over-quarter (q/q) in Q1 as the economy reopened and business and consumer activities returned to normal, boosted by stimulus payments. This growth is an improvement from the 4.3% y/y growth in Q4. The advance was driven by a 11.4% rise in consumer spending, which accounts for more than two-thirds of economic activity, and a 11.7% increase in business spending.

- Real GDP is expected to rise by 6.4% in 2021 based on consensus forecasts. That's the highest level in about 40 years although it's only a modest improvement over the 6.2% forecast of Q1. This outlook is likely too conservative as the Fed recently upgraded its 2021 growth forecast to 7.0% and some strategists are forecasting growth greater than 7% for the year, which would mean the highest growth rate since 1951.

- Consensus forecasts for 2021—in line with the latest forecasts from the International Monetary Fund (IMF) released in May—project U.S. economic growth to hit 6.4% in real terms (up from the 5.1% forecast in January), before moderating to 3.5% in 2022. The IMF expects the U.S. to fare better than other developed economies, including the eurozone and Canada, which are expected to expand by 5.0% and 4.4% respectively.[1]

Figure 5: Historical and Forecast U.S. Economic Growth



Source: Bloomberg Finance L.P., as of June 30, 2021

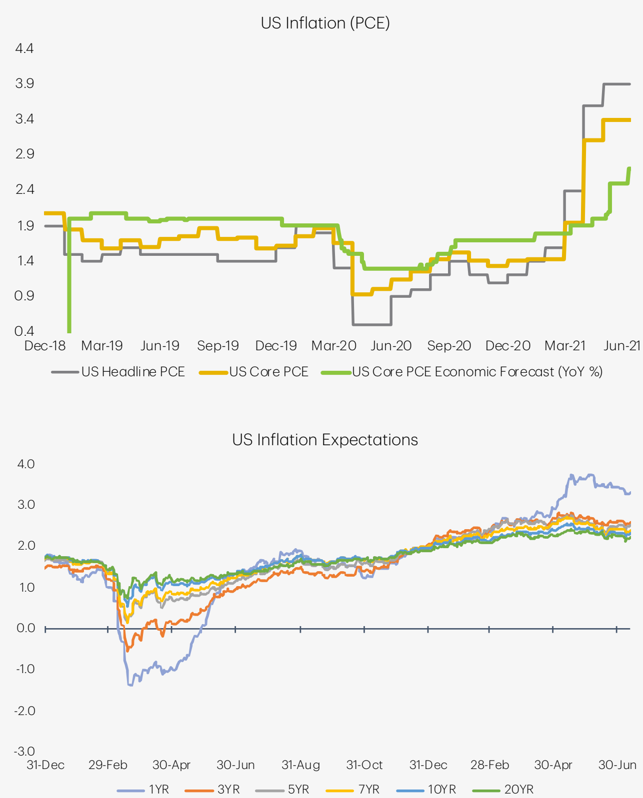
Inflation (Changed to Weak from Strong)

- U.S. Headline Consumer Price Index (CPI) inflation continues to spike, reaching 5.0% y/y in May 2021 (the highest annualized increase since 2008), compared with a 2.6% y/y change at the end of Q1.[2] Core CPI inflation, which excludes food and energy, logged the largest increase since 1992, jumping to 3.8% y/y in May 2021, from 1.6% y/y in Q1. The recent increases in headline and core CPI are well ahead of expectations. Both headline and Core CPIs are now much higher than their historical averages of about 2.0%. The main contributors to the surge in CPI are prices for food as well as used cars and trucks (up almost 30% y/y). Housing prices have also surged but housing is a lagging indicator, so recent CPI data are understated as they do not fully factor in the strong increases in housing costs.

- The Fed's preferred measures of realized inflation, headline Personal Consumption Expenditure (PCE), rose to 3.9% y/y in May 2021, up from 2.4% at the end of Q1. Core PCE more than doubled to 3.4% y/y from 1.4% in Q1. Both are well above the 2.0% target and current market expectations of a 2.7% rise for 2021.

- After trending up over the past few quarters, long-term expectations based on break-even inflation rates, remained flat at 2.3% at the end of Q2. Investors discounted the risk of elevated inflation after the FOMC meeting in June signalled rate hikes ahead in 2023. (For more information on the Fed dot plot see Outlook on Fixed Income.)

Figure 6: Historical and Expected U.S. Inflation



Source: Bloomberg Finance L.P., as of June 30, 2021

1. IMF. World Economic Outlook. April 2021.

2. Inflation data for June was released mid-July and showed further acceleration in prices. CPI increased to 5.4% versus the 4.9% forecast by economists. Core CPI also spiked to 4.5% in June.

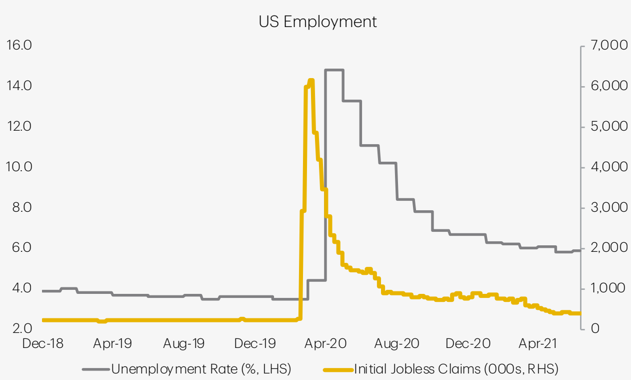
Employment (Neutral, Unchanged from Q1)

• U.S. Jobless data in Q2 improved, extending the Q1 trend. Weekly claims fell to about 370,000—the lowest level since the pandemic began and comparable to typical jobless claims pre-pandemic. However, the most recent claims number rose unexpectantly, possibly signalling a slowdown in job growth now that the economy has largely rebounded.

• The unemployment rate fell to 5.9% in June, compared with 6.0% at the end of Q1, due to strong recovery in the service sector. This figure is comparable to the long-term average unemployment rate but above expectations of 5.6% for the end of Q2. While the pace of employment growth is strong, with non-farm payrolls above estimates, the labour force participation rate has stagnated. As such, the number of employed in Q2 changed little, with employment still about 7 million below the February 2020 pre-pandemic level.

• Wage growth remains strong at 3.6% y/y, in line with expectations. Tight labour supply across services and lower wage sectors boosted wage growth.

Figure 7: U.S. Employment



Source: Bloomberg Finance L.P., as of June 30, 2021

Consumer Sector (Strong, Unchanged from Q1)

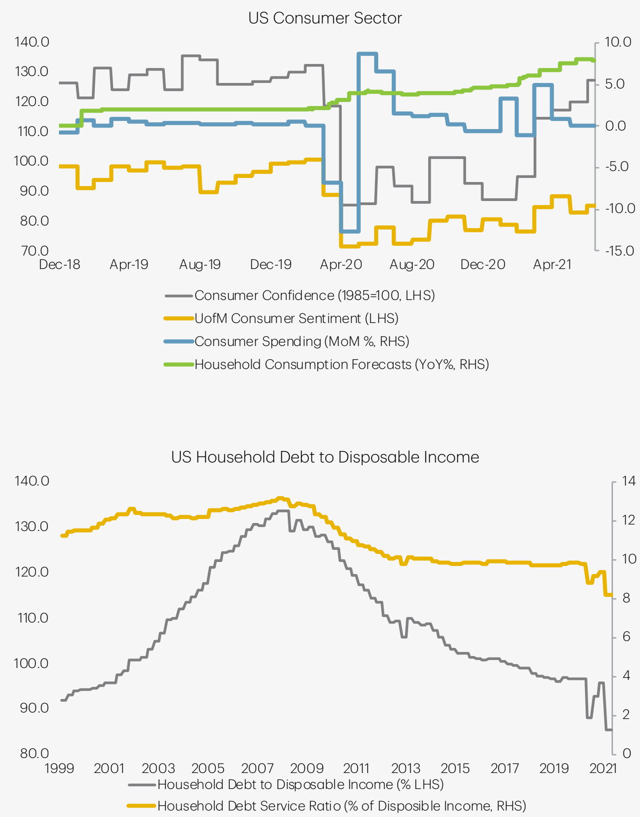
• The Conference Board Consumer Confidence Index spiked again to 127.3 points (from 109.7 points in March). The latest reading, much higher than the long-term average of 94.9, indicates consumers remain optimistic about recovery as the U.S. economy fully reopens.

• U.S. consumer spending was flat as of the latest data in June. This is well below the long-term average changes in consumer spending. This deceleration in consumption growth shows that consumer spending has normalized—supported by one-time stimulus cheques from the government—after a period of pent-up demand.

• Household consumption is now expected to rise by 7.9% in 2021, up from the 6.1% estimate in March but slightly below the May estimate.

• Household debt levels and debt-servicing costs remain at their lowest levels in over 20 years. Households with liquidity on the sideline are better equipped to withstand economic shocks and support recovery.

Figure 8: U.S. Consumer Sector and Household Debt



Source: Bloomberg Finance L.P., as of June 30, 2021

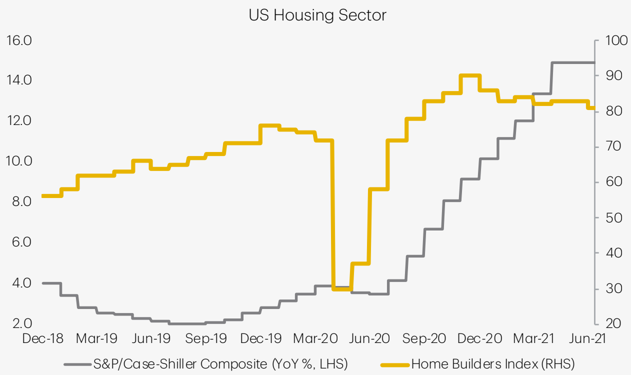
Housing (Strong, Unchanged from Q1)

• U.S. housing indicators continue to bounce back and are much more robust than before the pandemic.

• The S&P/Case-Shiller Home Price Composite Index, which measures residential home prices across the U.S., jumped 14.9% over the past year (compared with 11.1% as of March 2021 and 8.0% as of December 2020). This is a lagged composite but still a bullish sign for the economy.

• The National Association of Home Builders (NAHB) Housing Market Index remains strong at a level of 81 (from 82 in March). It hit a record 90 in November 2020, bouncing from the low of 30 in April 2020. (A number above 50 indicates an optimistic view on home sales.)

Figure 9: U.S. Housing Sector



Source: Bloomberg Finance L.P., as of June 30, 2021

Business Conditions (Strong, Unchanged from Q1)

• U.S. capacity utilization ticked up again in Q2 to 75.2% from 73.8% at the end of Q1 (after dropping to a record 64% in April). Capacity utilization is still lower than its long-run average of about 80% since 1972, which indicates slack in the economy.

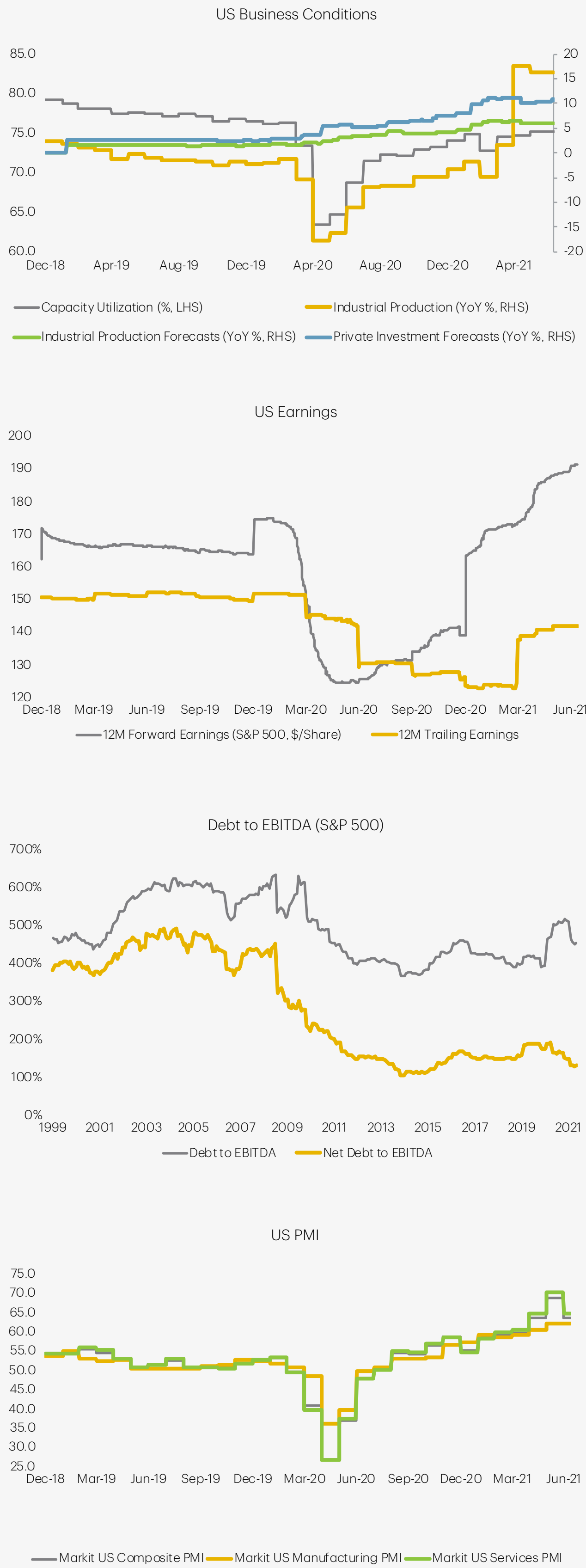
• Industrial production rebounded in Q2, up 16.3% y/y (compared with a 5.5% y/y contraction in December and a 15.3% y/y decline in June 2020). The numbers were close to flat going into March 2020.

• For 2021, industrial production is expected to expand by a slower 6.1% (compared with 6.3% in Q1) and private investment by 10.7% (compared with 11.1% in Q1).

• Trailing S&P 500 earnings remain slightly below pre-pandemic levels, but analysts expect EPS to jump by 34% over the next 12 months, according to Bloomberg data. This would push earnings above pre-pandemic levels. The increase is driven by the broad-based recovery across the U.S., especially cyclical sectors. Corporate health remains resilient; leverage ratios after adjusting for balance sheet cash are below pre-pandemic levels.

• Purchasing managers' indexes (PMI) continued to rally alongside the full reopening of the U.S. economy. Manufacturing and services PMIs ended Q2 at 62.1 and 64.6 respectively (compared with 59.1 and 60.4 in Q1)—still above the 50-point mark that indicates a highly expansionary outlook. The rebound in PMI for services, which accounts for more than 77% of the U.S. economy and was hurt most by the shutdown, is especially strong. Services PMI fell to a low of 27 in April, while manufacturing dropped to 36.

Figure 10: U.S. Business Conditions and PMIs



Source: Bloomberg Finance L.P., as of June 30, 2021

Financial Conditions (Strong, Unchanged from Q1)

• U.S. financial conditions remain extremely loose, aided by abundant liquidity and strong risk appetite. Concerns remain that financial and credit conditions are too loose, overheating the market and driving weak or low-quality companies to take on excessive leverage that makes them vulnerable in a downturn. This is especially important with rate hikes on the horizon and economic growth decelerating because many of these companies don't generate enough earnings to meet the carrying cost of their debt.

• The Chicago Fed's weekly National Financial Conditions Index was unchanged from last quarter at -0.70, which indicates easy lending conditions. This is within 0.10 point of the lowest value recorded by the index in the past 20 years. Risk and credit conditions continue to underpin improvements in financial conditions from March 2020, when the index reached +0.34. By comparison, the index peaked at almost +3.0 standard deviation in 2008 when financial conditions tightened drastically.

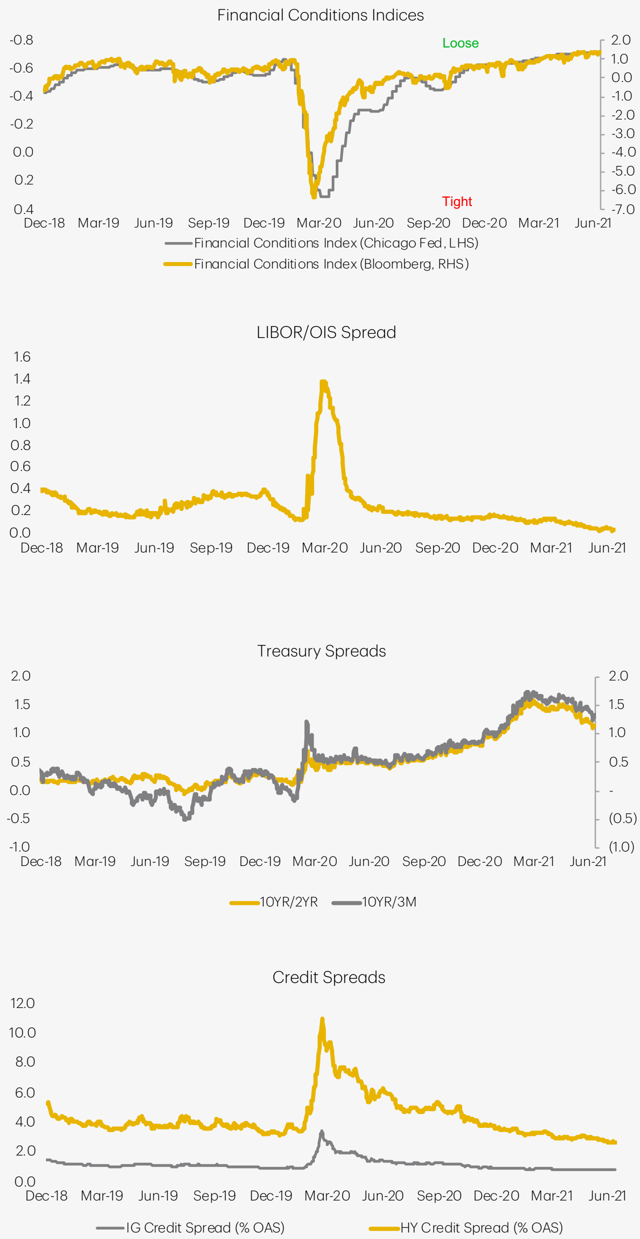
• The Bloomberg Financial Conditions Index sits at a record high of +1.3, also indicating ultra loose financial conditions compared to its long-term average. That's up from +1.1 in March and +0.6 in December 2020, and is a stark reversal from the -6.3 March 2020 low.

• 10YR/3M and 10YR/2YR spreads widened in Q1 after long-dated Treasury yields spiked, pushing term premium to multi-year highs. In Q2, we saw this trend reversed as the U.S. Treasury yield curve flattened. The 10YR U.S. Treasury yield retraced some of its increase, falling from 1.74% at the end of Q1 to 1.47% at the end of June and then to about 1.30% by mid-July. This flattening of the yield curve was largely bearish in nature and occurred after the Fed's hawkish turn: investors started to anticipate a slowdown in economic and inflation growth and also responded to technical factors within Treasury markets (central bank purchases, foreign purchases, lower issuances, and institutional investor rebalancing).

• Despite continued record issuances in Q2, investment-grade corporate bond spreads tightened further—bolstered by robust demand—and are now at 77 basis points (bps), well below the long-term average of 143bps. At the same time, major corporations have healthy balance sheets and are sitting on record liquidity which, if put to debt-friendly activities (like paying down debt) or capital expenditure, could compress spreads further. Many companies (especially banks) have announced substantial dividend increases and share buybacks after receiving clearance from the Fed following the annual Dodd-Frank Act Stress Tests (DFAST) exercise.

• High-yield bond spreads have tightened further and now stand at less than 2.7%, below their pre-pandemic levels (HY spreads were 3.36% as of December 31, 2019) due to the improved economic outlook and reduced probability of default. Spread levels are near all-time lows and analyst consensus points to a default probability of 5.5% over the next 12 months (the lowest since 2007). Higher market beta sectors directly impacted by COVID-19 restrictions, such as transportation and retailers, also benefited from significant spread compressions in Q2 as investors prepared for the U.S. economy to fully reopen.

Figure 11: Financial and Credit Conditions



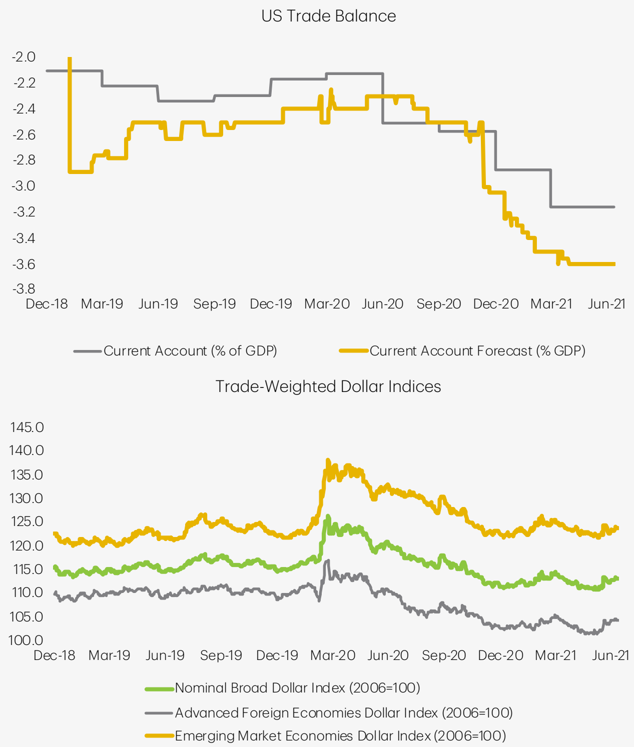
Source: Bloomberg Finance L.P., as of June 30, 2021

Foreign Trade (Neutral, Unchanged from Q1)

• The U.S. current account deficit deteriorated further to 3.2% in Q2 (compared with 3.0% in Q1 and 2.7% at the end of 2020) as imports rose alongside the U.S. economic recovery while demand for U.S. exports slipped, hampered by economic weaknesses abroad. The Q2 number is in line with the long-term average trade deficit of 3.3% of GDP. The current account deficit is expected to deteriorate to 3.6% for 2021.

• Meanwhile, the U.S. dollar, after depreciating since the pandemic started, with a pause in Q1, has started to appreciate again versus a trade-weighted basket of developed and emerging foreign currencies which will put pressure on U.S. exports. The recent round of appreciation began after the Fed's monetary policy update in June.

Figure 12: External Trade Account



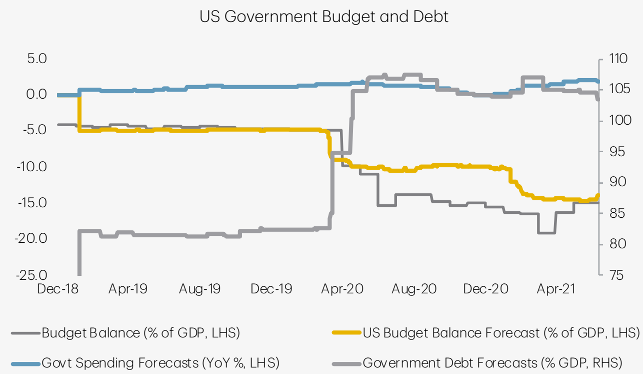
Source: Bloomberg Finance L.P., as of June 30, 2021

Government/Fiscal Policy (Accommodative, Unchanged from Q1)

• U.S. fiscal accommodation is expected to remain elevated, although the Biden administration continues to face obstacles in passing the slimmed-down infrastructure package announced in Q1 which casts doubt on other planned fiscal spending packages. However, globally, there is more appetite for maintaining government spending post-pandemic in contrast to the austerity measures that major governments implemented after the 2008 global financial crisis.

• The federal deficit in 2020 soared to US$3.1 trillion, or more than 15% of GDP and much higher than the 10% deficit in 2009. Federal debt jumped to 100%. According to the Congressional Budget Office, the deficit in 2021 is expected to remain at about US$3 trillion, or 13.4% of GDP, and federal debt is expected to climb to 103% of GDP.

Figure 13: U.S. Government Budget and Debt



Source: Bloomberg Finance L.P., as of June 30, 2021

Monetary Policy (Accommodative, Unchanged from Q1)

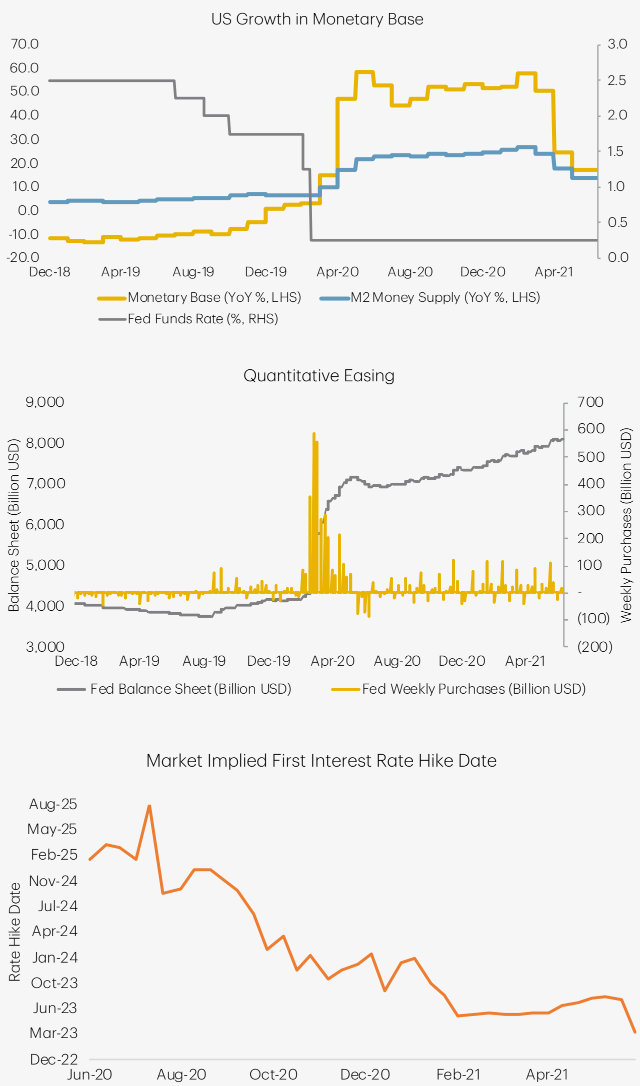
• June 2021 marked an inflection point in the Fed's monetary policy as it signalled an earlier-than-expected monetary tightening schedule, with possibly two rate hikes by the end 2023. These changes appeared in the Fed dot plot chart, which signals interest rate direction, and came after the Fed said in March that rate hikes wouldn't begin until at least 2024. At the same time, growth in M1 and M2 money supply have decelerated from their historic peaks in Q4.

• Despite the shift in policy tone, the Fed is maintaining its program to buy government and agency mortgaged-backed security (MBS) bonds, at a monthly pace of US$80 billion and US$40 billion respectively, for the foreseeable future.

• The Fed is committed to its accommodative policy stance and anchoring policy rates near zero until 2023 although markets are pricing in earlier tightening given the robust recovery and rising inflation expectations. It's expected the Fed will start to wind down its bond purchases, however, before any tightening. This tapering could happen well before the first rate hike in 2023. By comparison, the Bank of Canada started tapering its bond purchases in Q2 and announced further tapering in July.

• Average inflation targeting reinforces the Fed's focus on labour market recovery and inflation. The Fed has allowed inflation expectations to breach 2.0%, letting the economy run hot in 2021 even though financial assets and forward corporate earnings had achieved record highs. However, with realized inflation breaching multi-decade highs, it switched course by hinting at an earlier-than-expected monetary tightening schedule. This shift likely marks the beginning of a monetary and credit tightening cycle.

Figure 14: U.S. Monetary Base and Central Bank Stimulus



Source: Bloomberg Finance L.P., as of June 30, 2021

Risk Sentiment (Strong, Unchanged from Q1)

• Despite recent turbulence in bond markets, implied volatilities for key assets remain subdued, supported by the successful vaccine rollout, aggressive economic reopening, and abundant liquidity. Such a low volatility environment is typically favourable for risk assets.

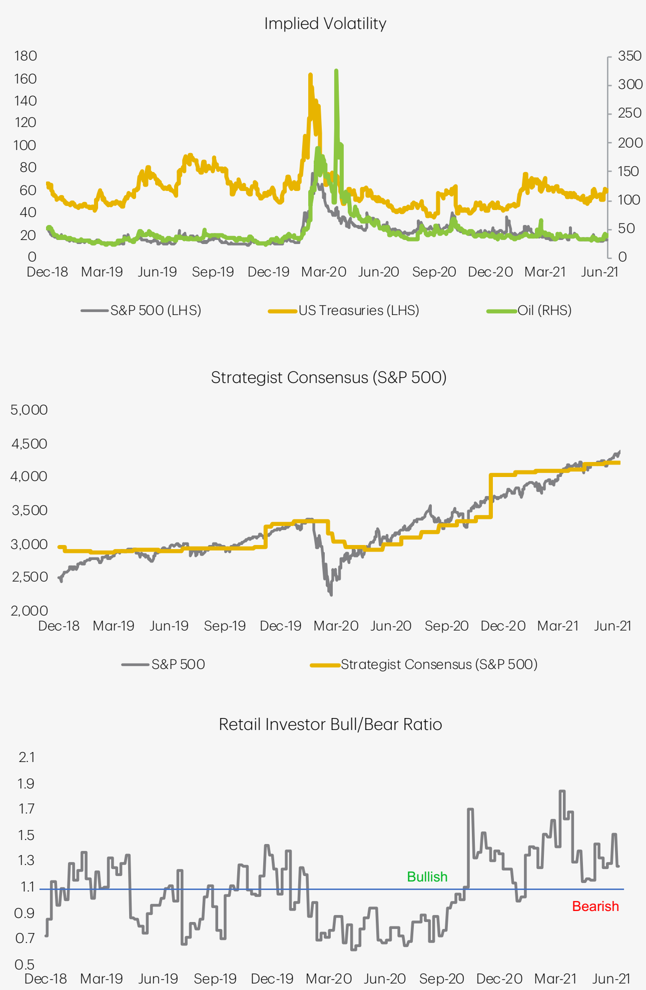
• Implied volatilities for U.S. stocks, using 3-month, 6-month and even 12-month forward options, continued to fall in Q2, hovering around 20 (compared with mid-20s at the end of December), suggesting investors expect below-average volatility beyond the next 30 days.

• The MOVE Index also points to prevailing calm in the market. It ended Q2 at 57.3, lower than where it ended Q1 and far below its long-term average of 87, although it has ticked up since the Fed's hawkish policy shift in June.

• After reaching a record high at the end of Q2, when the S&P 500 rallied by 8.5%, consensus estimates by investment strategists (as compiled by Bloomberg) remain neutral on a forward basis. Strategists expect the S&P 500 Index to remain flat at about 4,200 over the next 12 months.

• Unlike the neutral strategist consensus, U.S. investment advisors remain bullish on the markets (after a bearish turn earlier in the quarter). □

Figure 15: Implied Volatility



Source: Bloomberg Finance L.P., as of June 30, 2021

Market Performance

Canadian Indices ($CA) Return	Index	(%) 1 Month	(%) 3 Months	(%) YTD	(%) 1 Year	(%) 3 Years	(%) 5 Years	(%) 10 Years	(%) 20 Years
S&P/TSX Composite (TR)	74,881	2.48	8.54	17.28	33.85	10.80	10.77	7.44	7.74
S&P/TSX Composite (PR)	20,166	2.20	7.83	15.67	29.97	7.40	7.47	4.25	4.91
S&P/TSX 60 (TR)	3,648	2.74	9.00	18.59	33.56	11.36	11.58	7.97	7.95
S&P/TSX SmallCap (TR)	1,327	0.49	9.15	19.78	57.72	9.23	7.34	3.56	0.05
U.S. Indices ($US) Return									
S&P 500 (TR)	8,943	2.33	8.55	15.25	40.79	18.67	17.65	14.84	8.61
S&P 500 (PR)	4,298	2.22	8.17	14.41	38.62	16.49	15.41	12.52	6.48
Dow Jones Industrial (PR)	34,503	-0.08	4.61	12.73	33.66	12.44	13.99	10.76	6.13
NASDAQ Composite (PR)	14,504	5.49	9.49	12.54	44.19	24.53	24.53	17.99	9.99
Russell 2000 (TR)	11,897	1.94	4.29	17.54	62.03	13.52	16.47	12.34	9.25
U.S. Indices ($CA) Return									
S&P 500 (TR)	11,084	5.07	6.99	12.19	28.05	16.30	16.51	17.76	7.52
S&P 500 (PR)	5,327	4.96	6.62	11.38	26.07	14.17	14.30	15.38	5.41
Dow Jones Industrial (PR)	42,765	2.60	3.11	9.74	21.57	10.19	12.89	13.58	5.06
NASDAQ Composite (PR)	17,977	8.32	7.92	9.55	31.15	22.04	23.33	20.99	8.88
Russell 2000 (TR)	14,746	4.67	2.79	14.42	47.37	11.25	15.34	15.19	8.15
MSCI Indices ($US) Total Return									
World	13,174	1.52	7.89	13.33	39.67	15.59	15.44	11.26	7.84
EAFE (Europe, Australasia, Far East)	10,219	-1.10	5.38	9.17	32.92	8.77	10.79	6.38	6.25
EM (Emerging Markets)	3,283	0.21	5.12	7.58	41.36	11.67	13.43	4.65	10.44
MSCI Indices ($CA) Total Return									
World	16,329	4.24	6.34	10.32	27.04	13.28	14.33	14.09	6.75
EAFE (Europe, Australasia, Far East)	12,667	1.55	3.87	6.28	20.90	6.59	9.73	9.09	5.18
EM (Emerging Markets)	4,069	2.89	3.61	4.73	28.57	9.44	12.34	7.31	9.33

Currency									
Canadian Dollar ($US/$CA)	80.68	-2.61	1.46	2.72	9.95	2.04	0.97	1.02	1.02
Regional Indices (Native Currency, PR)									
London FTSE 100 (UK)	7,037	0.21	4.82	8.93	14.06	-2.69	1.59	1.70	1.11
Hang Seng (Hong Kong)	28,828	-1.11	1.58	5.86	18.02	-0.15	6.75	2.56	4.05
Nikkei 225 (Japan)	28,792	-0.24	-1.33	4.91	29.18	8.88	13.07	11.36	4.07

Benchmark Bond Yields	3 Months	5 Yrs	10 Yrs	30 Yrs
Government of Canada Yields	0.14	0.98	1.39	1.84
U.S. Treasury Yields	0.05	0.89	1.47	2.09

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	1,179	0.96	1.87	-3.46	-2.33	4.16	2.64	3.90
FTSE TMX Canadian Short Term Bond Index (1-5 Years)	767	-0.20	0.06	-0.52	0.71	3.06	1.94	2.30
FTSE TMX Canadian Mid Term Bond Index (5-10)	1,288	0.50	1.54	-3.00	-1.34	4.70	2.58	4.25
FTSE TMX Long Term Bond Index (10+ Years)	1,997	2.81	4.45	-7.37	-6.69	5.11	3.49	5.96

HFRI Indices ($US) Total Return (as of March 31, 2020)								
HFRI Fund Weighted Composite Index	18,211	0.40	4.07	10.08	27.49	8.71	7.94	5.12
HFRI Fund of Funds Composite Index	7,421	0.45	2.80	4.87	18.20	6.29	6.11	3.85
HFRI Event-Driven (Total) Index	20,698	0.37	3.78	11.59	29.98	7.94	8.35	5.50
HFRI Equity Hedge Index	29,714	0.95	5.08	12.26	36.88	11.37	10.89	6.49
HFRI Equity Market Neutral Index	5,896	0.33	2.80	4.76	7.48	1.68	2.57	2.60
HFRI Macro (Total) Index	17,396	-0.86	3.67	7.99	14.58	5.78	3.16	2.02
HFRI Relative Value (Total) Index	13,929	0.36	2.44	6.24	15.14	4.94	5.31	4.73
HFRI Indices ($CA) Total Return (as of March 31, 2020)								
HFRI Fund Weighted Composite Index	22,596	3.22	2.70	6.97	16.17	6.64	6.97	7.81
HFRI Fund of Funds Composite Index	9,208	3.28	1.45	1.91	7.72	4.27	5.16	6.50
HFRI Event-Driven (Total) Index	25,682	3.20	2.42	8.45	18.45	5.88	7.38	8.20
HFRI Equity Hedge Index	36,869	3.80	3.70	9.10	24.74	9.25	9.89	9.21
HFRI Equity Market Neutral Index	7,315	3.16	1.46	1.81	-2.06	-0.26	1.65	5.22
HFRI Macro (Total) Index	21,585	1.93	2.31	4.94	4.42	3.76	2.23	4.62
HFRI Relative Value (Total) Index	17,283	3.18	1.10	3.25	4.92	2.94	4.37	7.40

Sources: TD Securities Inc., Bloomberg Finance L.P. TR: total return, PR: price return, as of June 30, 2021.

Appendix A

Glossary of Terms

Bloomberg Financial Conditions Index: This index tracks the degree of financial stress using money-market spreads, bond-market spreads, broad equity prices, and volatility trends relative to historical values. Here, a positive value means relatively easy financial conditions while a negative value means tighter-than-average conditions. The average is based on pre-GFC financial conditions from 1994 to 2008.

Bond duration: Bond duration is a way of measuring how much bond prices are likely to change as interest rates move. In more technical terms, bond duration is measurement of interest rate risk or sensitivity.

Capacity utilization: Measures how close an economy is operating relative to its estimated maximum sustainable productive output without causing strains on existing resources.

Headline consumer price index (CPI): Measure of the average change in the price for a basket of goods and services bought by consumers between two time periods. It is a measure of inflation that is based on prices for food, clothing, shelter, utilities, transportation fees, etc. Monthly price changes are seasonally adjusted to remove the effects of seasonal variations.

Core consumer price index (CPI): This measure of inflation is the same as Headline CPI but excludes food and energy prices because these tend to be very volatile and may have an outsized impact on the overall inflation calculation.

Conference Board Consumer Confidence Index: The confidence index is based on surveys of consumers' perceptions of current business and employment conditions, as well as their expectations for six months hence regarding business conditions, employment, and income. The index is normalized to its value in 1985.

CBOE equity put/call ratio: A measure of market sentiment based on the trading volume of put option contracts compared to call option contracts. A value above 1.0 means more investors are trading put options than call options, which imply investors are bearish about the market. A value of below 1.0 means more investors are bullish.

Current account balance: The current account is a country's trade balance plus net income and direct payments. The trade balance is a country's imports and exports of goods and services. The current account also measures international transfers of capital. A current account is in balance when the country's residents have enough to fund all purchases in the country. Residents include the people, businesses, and government while funds include income and savings and purchases include all consumer spending as well as business growth and government infrastructure spending. The goal for most countries is to accumulate money by exporting more goods and services than they import – this state is called a trade surplus.

Federal Reserve Bank of Chicago's weekly National Financial Conditions Index: This measure combines risk, credit, and leverage indicators to provide a sense of how loose or tight financial conditions are across money, debt, and equity markets. It shows the standard deviations of indicators relative to their historical data going back to 1971. A value of 0 signifies average financial conditions, while a positive value means tighter than average, and a negative value means looser than average.

Fiscal stimulus: In a recession, the government may decide to increase borrowing and spend more on infrastructure spending. The idea is that this increase in government spending creates an injection of money, also known as fiscal injection, into the economy and helps to create jobs.

Household debt service ratio: Measures the percentage of disposable personal income that's required to service debt payments (both mortgages and consumer debts). This measure provides an indication of the carrying cost of household debt.

Initial jobless claims: A weekly government report that measures the number of individuals seeking government unemployment benefits for the first time.

Industrial production: Measures the real output of the manufacturing, mining, and electric and gas utilities industries.

Implied correlations: Represent market expectations of diversification or dispersion across a basket of S&P 500 stocks. Implied correlations are calculated using single-stock option contracts and option contracts on the S&P 500. A higher number means options investors expect stocks within the S&P 500 to move in tandem with each other, while a lower value means investors expect greater dispersion in performance.

Implied volatility: A short term measure of risk sentiment based on transactions in the options market. The VIX Index measures expected volatility for the S&P 500 equity index while the MOVE index measures expected volatility for US Treasury bonds. There is also a VIX Index for expected volatility in oil prices that is based on option contracts on the United States Oil Fund (USO).

Investment-grade and high-yield bond spreads: The difference between the yield on an investment-grade or high yield corporate bond versus the yield on the 10-year treasury bond. These measures represent the embedded risk in corporate bonds. Spreads are narrower when investors are willing to take on more risk and wider when investors are not willing to take on more risk.

LIBOR/OIS spread: This measure illustrates the relationship between liquidity in financial markets and stress in the short-term funding market for secured and unsecured lending. A wider spread indicates high interbank borrowing costs.

Monetary base: The monetary base refers to that part of the money supply which is highly liquid (i.e. easy to use). The monetary base includes notes and coins in circulation along with commercial bank deposits with the Central Bank. In the money multiplier model, an increase in the monetary base can lead to a bigger proportional increase in overall money supply. This is because if banks see an increase in their deposits, they can lend out a bigger sum of money and keep the same proportion in reserve.

M1 money supply: M1 money supply includes coins and currency in circulation—the coins and bills that circulate in an economy that are not held by the government treasury at the central banks, or in bank vaults. Closely related to currency are funds held in chequing accounts, also known as demand deposits. These items together—currency, and chequing accounts in banks—make up the definition of money known as M1, which is measured daily by the central banking system.

M2 money supply: A broader definition of money, M2 includes everything in M1 plus other types of deposits including; funds in *savings accounts*, money market funds as well as funds invested in certificates of deposits (less than $100,000). In short, all these types of M2 are money that we can withdraw and spend, but which require a greater effort to do so than the items in M1.

National Association of Home Builders (NAHB) Housing Market Index: This index measures home builders' view on current and future (6 month forward) residential house sales, based on monthly surveys. A reading of above 50 means homebuilders on average have a positive outlook on home sales; a value below 50 means they have a negative view.

Purchasing managers' indexes (PMIs): A monthly measure of the business outlook of purchasing managers across primary industries. PMIs provide an indication of business conditions and health of the economy on a forward-looking basis. PMIs are completed for both manufacturing and service sectors. A reading of above 50 means purchasing managers expect an expansion in the economy while a measure below 50 means they expect contraction.

Retail investor bullish/bearish ratio: A measure of investor sentiment based on the proportion of investment advisor (retail investors) that have a positive outlook on the US market compared with those that are pessimistic about the market. The outlook horizon is the next 6 months. A higher ratio means that more retail investment advisors are bullish than bearish and vice versa.

S&P/Case-Shiller Composite Index: A monthly composite that measures single-family home prices across the US. It seeks to measure changes in the total value of all existing single-family housing stock. Note that sales of new homes are not included in the index. The index is normalized to have a value of 100 for January 2000.

Term premium: The term premium is the compensation investors require for holding a long-term bond compared to rolling over a series of short-term bonds with lower maturity.

10-Year U.S. yields: The return on 10-year US government bonds, which are historically used as benchmark interest rates. They represent the prevailing borrowing costs and the expected returns from risk-free rates.

10YR/2YR and 10YR/3M spreads: These spread measures represent the difference in yield between shorter-term government bonds and longer-term government bonds. They provide an indication of the shape of the yield curve. Historically a negative spread between 10-year and 2-year government yields has been considered a signal for recession.

Trade-weighted dollar index: This index tracks the value of the U.S. dollar against a basket of currencies (where weights are calculated using trade data).

Unemployment rate: Measure of the number of unemployed as a percentage of the active labor force (people 16 years of age and older). This measure is also seasonally-adjusted.

Yield curve: Illustrates the tradeoff between yield and term of a type of bond. In general, short-term bonds carry lower yields as the longer we commit funds, the more we should be rewarded for that commitment, or rewarded for the risk we take that the borrower may not pay us back. This is reflected in the normal yield curve, which slopes upward from left to right on the graph as maturities lengthen and yields rise. There are times, however, when the curve's shape deviates, signaling potential turning points in the economy.