TD Wealth

Things have changed

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In this issue

Things have changed.

We live in an era where there is a great deal of uncertainty, which is driving a lot of investors to begin to climb the “wall of worry.” I’ve always found that the best way to deal with fear is to put it front and centre and address it.

At the beginning of the year, we surveyed our advisors to gauge, from their conversations with clients, their greatest concerns to market stability in 2025. There were four: global trade war, tech valuation plunge, geopolitical conflicts and higher inflation, which together do a good job of encapsulating the predominant fears shared many investors today.

To prosper in this and future environments, it’s going to take more than just the traditional tools of finance. We believe investment success is predicated on the ability to adapt as the world unfolds. We also believe in the concept of “consilience” — the linking together of principles from different disciplines — in seeking to understand, profit and manage risk.

How to invest for the next decade is a conundrum for sure, but it's one that I know we’re ready for.

Be well,

Brad Simpson
Chief Wealth Strategist, TD Wealth

Cracking Complexity

Complexity

Mission Accomplished?

Has the war on inflation been won? U.S. CPI rose for three straight months in Q4 (2.4% September, 2.6% October, 2.7% November, 2.9% December) and tariffs are expected to lift prices even more. Against this backdrop, rate-cut expectations for 2025 have plummeted.

Action on Extraction

Higher inflation expectations and improving growth expected in China have supported commodities. Since bottoming in mid-December, commodities have rallied 6.1% (as of January 27), led by the energy basket. Almost every commodity is higher, while equities and fixed income have retreated.

Gold Correlation = Negative

Gold was up 26% in 2024, which is especially remarkable given the strength of the USD and real rates (which historically have been inversely correlated). We see precious metals, and gold in particular, continuing to outperform as central banks continue their purchases.

Mag-493

Yes, the U.S. equity index screens expensive, but there are opportunities in the smaller left-behind stocks. In fact, analysts expect earnings for small-cap U.S. stocks to grow 44% this year, outpacing large-cap stocks.

Ready to Deal

M&A transaction activity has signalled green shoots of recovery. The first three quarters of 2024 saw a meaningful increase of 17% year-over-year in deal values after a slower 2022 and 2023 (albeit well below peak levels seen in 2021). Continued monetary policy easing should provide a tailwind for private-equity buyouts.

The Sober Market

For an indication of how risk-averse the bond market has become, look at the spread between the Canadian and U.S. 10-year yield. For the past 25 years, it's been close to zero, but in the past month it's dropped 140 bps, suggesting bondholders expect inflation to return in the U.S. but not necessarily in Canada.

U.S. Trade Surplus

The new president has made a big deal of Canada's trade surplus with the U.S., but in reality trade is balanced. The U.S. is on track to record a deficit with Canada of roughly US$45 billion in 2024 (or a mere -0.2% of U.S. GDP). Excluding energy, however, the U.S. actually enjoys a surplus of US$45 billion.

Digital Money ≠ Smart Money

Bitcoin is perceived to be a big winner in the wake of the U.S. election. But ETF flows show the average bitcoin ETF trade size is only US$17,000 — the smallest among the most active ETFs. Institutions simply don't trade at such low levels, suggesting a high proportion of speculative individual traders.

Adaptation

7 Years Bad Luck

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

True Diversification

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

Tactics on the Margins

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

High-odds Proposition

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

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.

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.

Calm Before the Storm

Extended periods of market calm can breed complacency. Remember, peace time doesn't last forever. Being mindful of that, sticking to your process, staying diversified and adapting to the environment around you is always the best course of action.

Reason over Intuition

Propagandists have long used headlines to influence the populace. Now social media is reinforcing that influence a hundred-fold, and it's interfering with investment decisions. Trust the numbers, not the media.

PSQ1.2025 | Executive Summary

House Views

Fixed Income, modest underweight: With the Bank of Canada ("BoC") policy rate now lowered to the top end of its estimated neutral range, additional rate cuts are expected to be delivered carefully in order for the BoC to maintain flexibility to respond to a wide array of domestic or international macroeconomic and political uncertainties. Given the extent to which the Canadian bond market has outperformed other bond markets over the past two years, we expect only modest low-to-mid single digit total returns over the next 12 to 18 months. Nevertheless, against a backdrop of continued monetary policy easing, we expect that bonds will continue to provide stable income and preserve capital. **Equities, modest overweight:** We are overweight Equities as we expect positive earnings growth to continue to drive attractive relative returns over the medium term. While U.S. markets had a strong 2024, equity returns were broadly positive across many geographies and sectors. Earnings growth (as represented by the MSCI All Country World Index) has been partially captured by the market in valuations, and we believe current valuations are justified given the backdrop of modest economic growth. **Alternatives, modest overweight:** We believe that an allocation to alternative assets can benefit diversified portfolios especially when implemented over the long-term. Alternative assets can provide inflation protection and attractive absolute returns, while acting as long-term portfolio stabilizers via their diversification benefits and less correlated income streams. Given the nature of private asset classes as well as the present phase of value adjustment in several markets and asset classes, we believe that this may be an attractive time to increase or consider an allocation to alternative assets.

Quarter in Review

In 2024, global equity markets performed strongly amid U.S. economic growth, driven by consumer and government spending. Canada's growth lagged on a per capita basis. Emerging markets saw mixed performance, with India showing growth despite high valuations. **America is already great.** The U.S. economy showed resilience in 2024, driven by its service sector, which is less volatile than manufacturing. Despite inflation pressures and debt concerns, U.S. equities outperformed globally, achieving double-digit earnings growth and multiple expansion, contrasting with challenges in other high-growth and expensive markets. **MAGA forces at play.** Trump's campaign spurred market shifts, with optimism over tax cuts boosting small-cap stocks but raising debt sustainability concerns, driving higher Treasury yields. A strong U.S. dollar pressured emerging markets, while Trump's pro-business agenda fueled hopes for corporate investment, deregulation, and M&A activity, impacting sectors like renewable energy and oil. **Market exuberance in the U.S. vs. labour exodus in China.** In the U.S., economic optimism, AI innovation, and expectations for a business-friendly government under Trump fueled market sentiment. However, challenges loom, including geopolitical tensions, fiscal deficits, and deglobalization risks. Meanwhile, China faces economic struggles, with weak property sales and urban employment below trend, impacting its middle class and GDP. Urban-rural employment shifts suggest discouraged urban workers returning to rural areas, threatening long-term growth. Structural trends and opportunities in innovation and deglobalization remain key considerations.

Economics

Canada is the largest export market for the U.S. and makes up one of the smallest trade deficits, owing largely to U.S. demand for energy-related products. **Trade in the auto sector is balanced between the two nations.** While President Trump has mused that the U.S. could replace Canadian auto exports with its own domestic supply, the highly integrated North American supply chains is a major complicating factor. **Flipping this argument on its head, Canadian auto manufacturing has room to expand.** Canada produces only 14 car models but consumes 325 models. The U.S. produces 121 models of the 328 models consumed by Americans. **With respect to Trump's assertion that the U.S. subsidizes Canada to the tune of US$200 billion per year, it's unclear where this number is derived.** In any event, rather than a subsidy, the U.S. trade deficit is a by-product of U.S. economic outperformance relative to other countries.

Fixed Income

With the start of the rate cutting cycle firmly in hand in Canada and the U.S., fixed income markets delivered relatively attractive returns over 2024—the FTSE Canada Universe Bond Index was up about 4.23%. **We maintain our modest underweight view on fixed income** as we believe returns going forward will largely be in line with average historical levels, and mainly composed of the coupon. **We hold a neutral view on domestic government bonds.** Canadian government bonds are attractive at current yields and offer opportunities for income generation and downside protection, but we expect yields to be volatile in the short term given the uncertain outlook for the economy, potential U.S. tariffs, and the monetary policy end point. Importantly, Canadian government bond yields have remained highly correlated to U.S. government yields which are affected by circumstances that don't tend to impact Canadian bonds at all. **We remain modest overweight on investment grade (IG) credit.** IG spreads are still tight and we believe Canadian IG corporate bonds, with their slightly wider spreads, are more attractive than U.S. IG. We expect softening economic conditions to widen spreads (indicating the market is pricing in more risk) but only by a modest amount given continued expectations for a soft landing. We remain focussed on high quality credit—companies with robust balance sheets—and we expect technicals to remain supportive and healthy yields to mitigate losses from price volatility. **We hold a neutral view on high yield (HY) credit.** HY spreads are extremely tight, reflecting their rich corporate valuations, and have little room to tighten further. We expect HY spreads to widen if the growth outlook is softer than anticipated although the improved quality of this universe and lower expected net issuance should keep spreads from returning to previous recessionary levels. We continue to favour the higher quality cohort of the HY credit market and floating rate loans (also known as bank loans or leveraged loans) offer better relative value than traditional fixed-coupon high yield bonds.

Equities

Over the past two years, U.S. equities achieved historic gains, driven by leadership in technology and cyclical sectors, despite modest GDP growth. Canadian equities, while strong, differ in sector composition, with gold producers and grocery retail dominating materials and staples. Tariff concerns cloud Canada's outlook, while U.S. momentum continues, supported by cyclical growth. **U.S. Healthcare: Pick your stocks and be ready to rotate.** U.S. healthcare stocks underperformed in 2023 and 2024, trailing the S&P 500 by 22% and 20%, respectively, with a 20% valuation discount. Historically defensive, healthcare outperforms in downturns but struggles in bull markets. The sector requires active stock selection, as top and bottom performers vary significantly. **Canadian Real Estate: Improvement expected.** Canadian REITs had a positive 2024, managing higher rates with disciplined balance sheets and low leverage. Double-digit returns are expected in 2025 due to stable interest rates, cash yields, and multiple expansion. **International Equities: Stagnant economic activity, tariff threats cloud recovery.** The MSCI EAFE underperformed in late 2024 due to European economic stagnation, weak manufacturing (especially in Germany), and China's slowing demand. While ECB rate cuts could improve growth, earnings remain muted. Japan shows promise with corporate reforms and wage growth, despite sluggish manufacturing. **Emerging Markets: Political risks loom over earnings growth.** Emerging market equities faced challenges in Q4 2024 due to political shifts, China's slowing rally, and cautious investor sentiment. China's growth relies on stimulus to boost weak consumer spending, while exports improved. Taiwan gained from AI-driven demand, led by TSMC. India's growth slowed amid high valuations and tighter policies. South Korea's political turmoil hurt equities despite strong earnings. **Potential Impact of Import Tariff on International, EM Equities.** U.S. tariff threats, including potential 10%-60% levies on imports from China, Canada, and Mexico, pose significant risks to global trade and economic growth. Tariffs could hurt key U.S. trade partners, disrupt supply chains, raise inflation, and marginally impact U.S. growth.

Alternatives

Transaction activity recovers amid hopes for deregulation, with private-equity investors focusing on liquidity. Private lending offers income opportunities, while property selection is critical in the evolving real estate landscape. **Private equity.** Liquidity remains critical for limited partners (LPs) entering 2025 due to prolonged holding periods and high unrealized valuations, with global buyout companies often held longer than anticipated. Limited transaction activity is driven by wide bid-ask spreads and high financing costs, which have delayed exits and acquisitions. General partners (GPs) rely on secondary markets, continuation funds, and mid-market strategies like buy-and-build acquisitions to create value and maintain distributions. Corporate carve-outs remain a growing opportunity. **Private credit.** Public-credit spreads have tightened significantly, offering limited compensation for default risk.

U.S. investment-grade and high-yield bonds are priced at historical lows. Private credit, particularly direct lending and asset-backed finance (ABF), offers attractive risk-adjusted yields. Direct lending yields low-double-digit returns with strong protections, while ABF provides downside protection via low macroeconomic correlation. **Real estate.** U.S. commercial real estate in 2025 faces mixed prospects. While solid economic conditions support growth, challenges include supply-demand imbalances, softening fundamentals, declining occupancy rates, and muted transactions. Property performance remains bifurcated, with offices facing ongoing demand uncertainty.

Currencies

2024 saw mean reversion, but Q4 marked a shift to macro trends and U.S. dominance. **Tailwinds for the U.S. dollar.** Investors favor trends, supporting a bullish U.S. dollar outlook amid strong fundamentals. **What we are watching in 2025.** 2025 will focus on geomacro trends, with geopolitical risks and resilient U.S. fundamentals supporting the dollar despite global economic challenges and potential destabilization risks. **Trudeau and Trump add to the loonie's woes.** The Canadian dollar faces challenges from U.S. tariffs, productivity gaps, and political uncertainty limiting fiscal reforms. **Trump 2.0 and Trade Wars.** Trump 2.0 emphasizes tariffs, raising inflation risks and supporting a stronger U.S. dollar.

Commodities

The Bloomberg Commodity Index gained 4.7% in 2024, driven by inflation expectations, stable growth, and diversification demand amid market shifts. **Energy: Better-than-anticipated setup.** Commodities, especially oil, outperform due to tighter-than-expected crude stocks, bullish fundamentals, sanctions on Russia, and under-ownership amid inflation hedging. **Metals: Base metals turning the corner.** Metals rise on tightening inventories, China's recovery, and gold's strong performance driven by central bank demand. **The Outlook: Still early innings.** 2025 will be volatile, with commodities benefiting from underinvestment, rising global demand, and supportive macro factors.

Times are strange

Brad Simpson, Chief Wealth Strategist; Kevin Yulianto, Portfolio Manager | TD Wealth

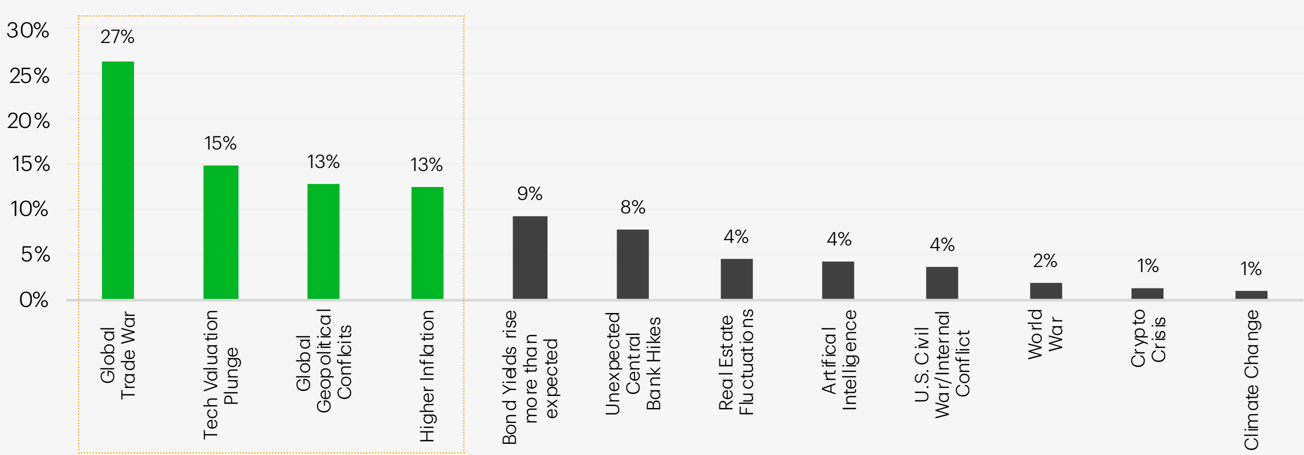
It sure does feel like a different world today. We live in an era where there is a great deal of uncertainty, which is driving a lot of investors to begin to climb the "wall of worry." I've always found that the best way to deal with fear is to put it front and centre and address it.

At the beginning of the year, we surveyed our advisors to gauge, from their conversations with clients, their greatest concerns to market stability in 2025. There were four: global trade war, tech valuation plunge, geopolitical conflicts and higher inflation, which together do a good job of encapsulating the predominant fears shared many investors today. Before digging into them, it's worth pointing out that, if we went back 10 years ago, except for climate change, none of these "greatest concerns" would have registered. Things have changed.

1. Global Trade War

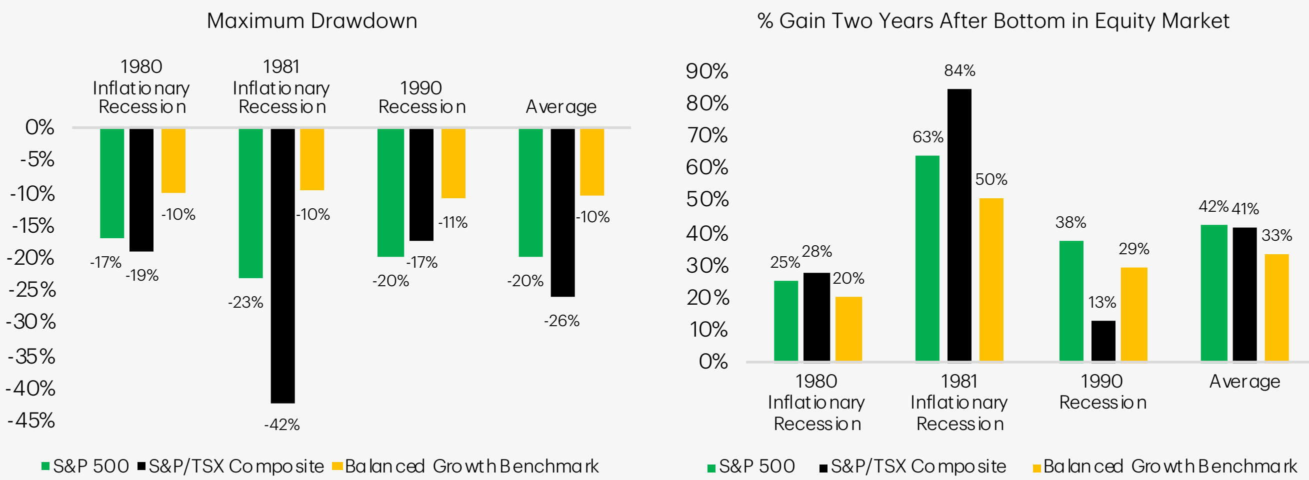
We know the market is concerned about the risk of a global trade war and tariffs imposed by the new Trump administration. We will spill a lot of ink addressing this issue in this quarterly publication, but I'm going to cut to the chase here. When investors say they're worried about trade tariffs, what they're really saying is that they are concerned that tariffs will lead to a recession, which will lead to an equity-market correction. Figure 2 looks at the past three big recessions and tallies percentage decline for the S&P 500 (17%, 23% and 20%) and the S&P/TSX Composite (19%, 42% and 17%). Next, it produces an average loss for the three recessions: 20% for the S&P 500; 26% for the S&P/TSX.

Figure 1: What do clients believe is the greatest risk to market stability in 2025?



Source: Wealth Investment Office as of January 6, 2025 *Based on 412 respondents to a Slido survey

Figure 2: Time and diversification more than make up for the occasional recession



Source: Factset, Wealth Investment Office as of January 17, 2024

But more importantly (for one's nerves) we also consider the gains that occur over the two years proceeding these market bottoms: for the S&P 500 (25%, 63% and 38%) and for the S&P/TSX (28%, 84% and 13%). Similarly, we calculated the average gain for the two years after the bottom: for the S&P 500, 42%; and for the S&P/TSX, 41%.

We then decided to add another element to this scenario — that would be the yellow bar depicting the return of a diversified benchmark portfolio. We did this to reflect the fact that most clients don't have all their investments in equity portfolios and instead have a measure of diversification. To do so, we utilized our balanced-growth benchmark. This changes the perspective a great deal.

The balanced-growth benchmark, in the three correction periods, was down 10%, 10% and 11%, and had an average loss of 10% for the three recessions. In the following two years, the upside for the balanced growth benchmark was 20%, 50% and 29%, which averages out to around 33%. The upside is not as good as being in all equity, but correspondingly the downside was way less painful.

While past returns are not indicative of future ones, this does take a lot of the uncertainty out of the picture. Investors may not know what the U.S. president is going to do next, but they can have a good idea what a diversified portfolio will do in the best-case and worst-case scenarios. Further, since equity markets on average experience a 10% correction almost every year, such a drawdown — after the last two years of stellar returns — should not be viewed as a crisis in the making.

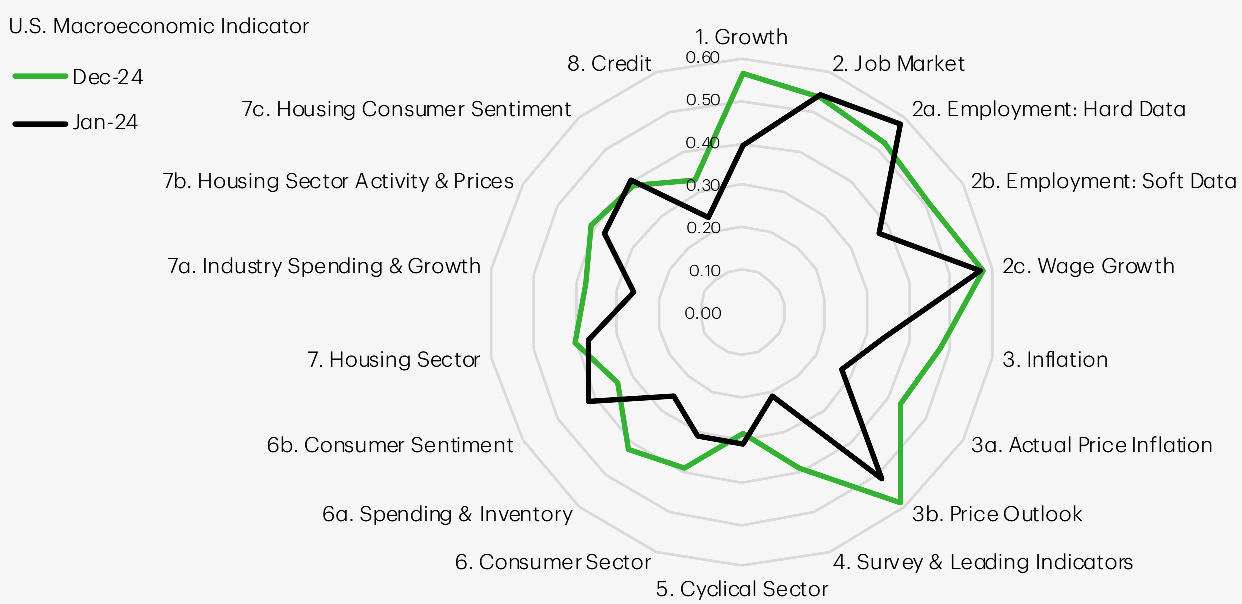
2. Tech Valuation Plunge

Equity returns over the long run are largely driven by earnings growth, which are ultimately fuelled by economic growth. Back in 2023, investors were worried about future economic growth and the threat of an economic slowdown through 2024 and into 2025. During this time, many of the constituents of the S&P 500 were struggling to deliver top-line growth, and positive sales surprises were falling noticeably behind earnings surprises. The consensus for early 2025 (where we are now) was a hard landing into a recession.

In an environment with those types of expectations, buying Big Tech growers made a lot of sense; they were perceived to be the only big names that were still growing. Well, here we are in 2025, and we can finally retire the debate on soft versus hard landing. All indications suggest that the U.S. economy has indeed soft-landed, and perhaps has already entered a mid-stage economic cycle. This means that looking beyond these big tech companies now is quite compelling.

Even as the Fed pursued its most aggressive campaign of monetary-policy tightening in four decades, the U.S. economy barely decelerated, although in hindsight this was helped by loose fiscal policy and massive spending packages under the previous administration. In fact, the U.S. economy saw improvement across various metrics in 2024, with the exception of employment, which is still on a softening trajectory (Figure 3).

Figure 3: The U.S. economy improved in 2024



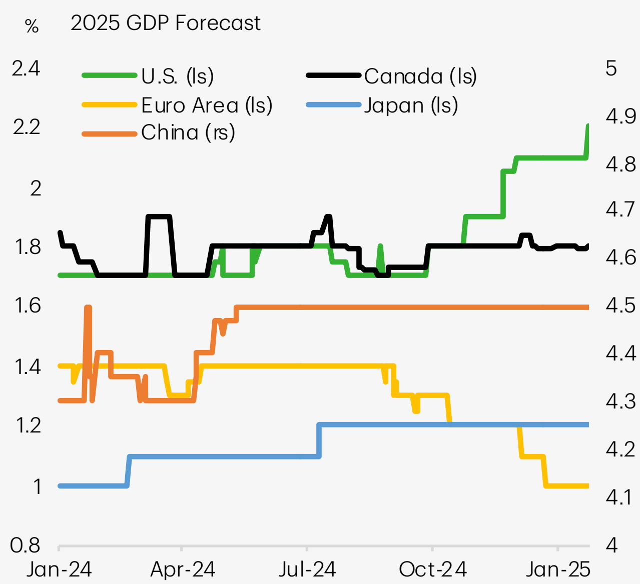
Source: FactSet and Wealth Investment Office as of December 31, 2024

This year, economists think U.S. exceptionalism is likely to continue, even as the rest of the world limps forward (Figure 4). This is probably best illustrated by the very strong performance of the greenback, which is near its two-decade high relative to America's trading partners (Figure 5).

The higher yield offered for investing in U.S. government bonds, along with capital inflow into U.S. equities, have supported the dollar's appreciation. The contrast between the U.S. and the rest of the world (RoW) is also reflected in the yawning gap between the U.S. 10-year yield and the copper-to-gold ratio (Figure 6).

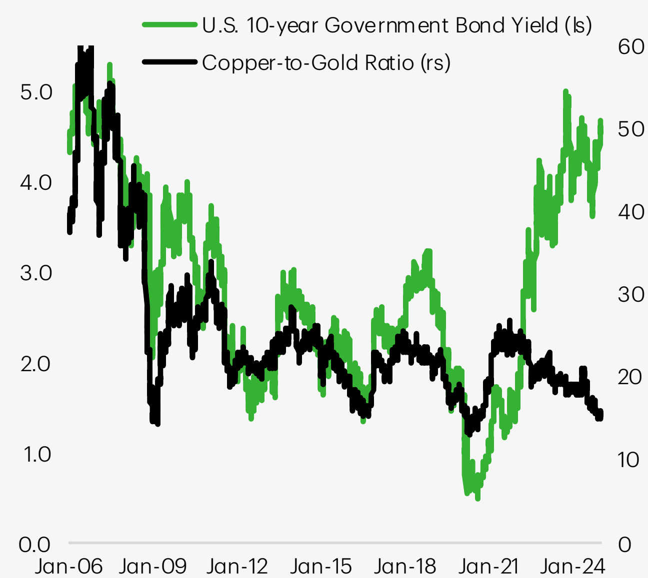
As the U.S. 10-year yield climbed back to 4.7% — the high in 2024 — China's fell to below 1.7% from 3.4% in 2020. We need to remember, however, that the economy and the financial markets have a self-correcting mechanism. First, a strong dollar is deflationary for the U.S. economy because it reduces import prices for many of the goods and services Americans consume. Second, a weak economic outlook for the rest of the world could eventually weigh on U.S. growth once the impact of fiscal policy diminishes.

Figure 4: U.S. GDP forecast has risen, Europe not so much



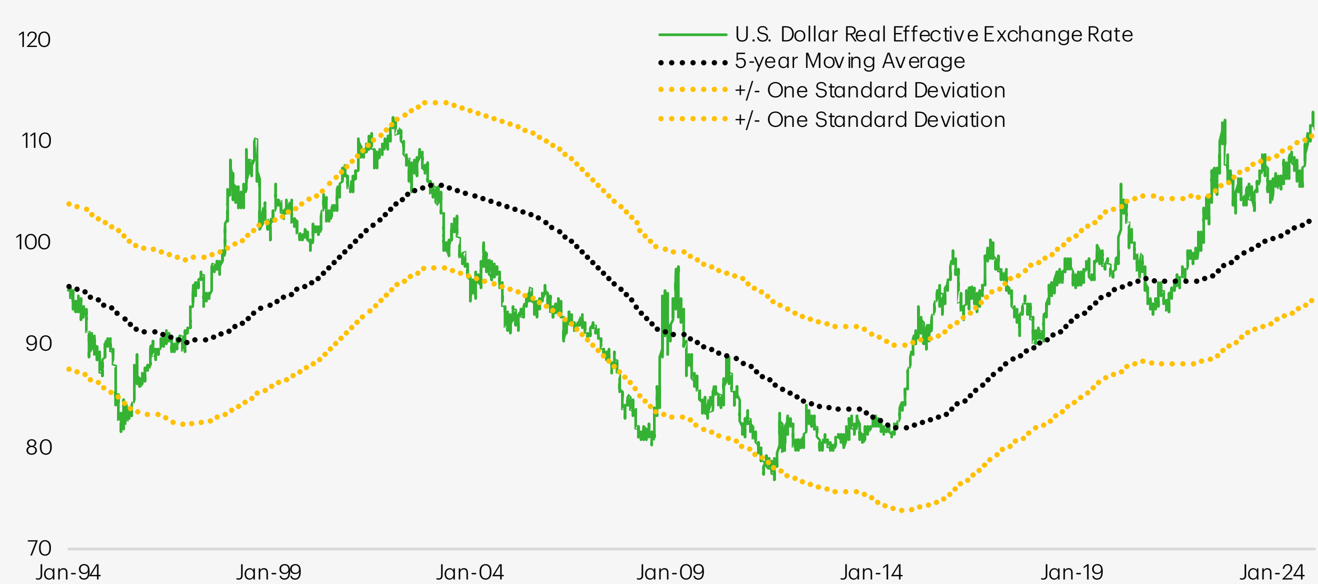
Source: Macrobond and Wealth Investment Office as of January 10, 2025

Figure 6: U.S. yield divergence from copper-to-gold ratio highlights the growth discrepancy between U.S. and RoW



Source: FactSet and Wealth Investment Office as of January 10, 2025

Figure 5: USD at two-decade high



Source: FactSet and Wealth Investment Office as of January 10, 2025

To reiterate, from a cycle perspective, we are potentially entering a mid-cycle expansion phase in most developed countries, with the exception of Japan (Figure 7), as manufacturing PMIs stabilize while services remain strong. We define this phase of the business cycle as a period of recovery in the cyclical sectors following a non-recessionary slowdown (i.e., similar to the U.S. economy in 2013 and 2016).

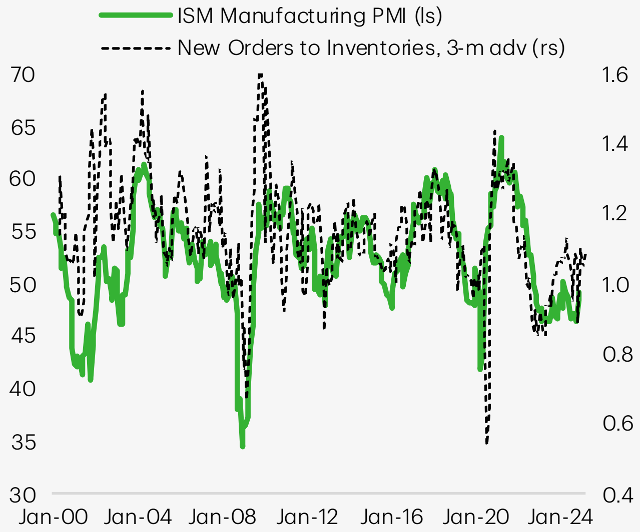
The ongoing monetary-policy easing by the Fed, Bank of Canada, European Central Bank and People's Bank of China is a tailwind for growth and should help activity in the rate-sensitive sectors to pick up. Encouragingly, we have seen new orders tick higher relative to inventories for the manufacturing sector — a leading indicator for the headline index (Figure 8). So, without a clear negative catalyst for the economy and financial markets, asset valuations could remain high.

Back-to-back annual returns of more than 20% on the S&P 500 have lifted valuations into rich territory, driven mainly by the outperformance of mega-cap tech stocks. The relevant question today is, where — with the S&P 500 trading at 22x earnings and bond yields potentially marching a bit higher — should investors allocate?

The good news is that U.S. stocks are still expected to deliver on the earnings front, with EPS forecast to grow at a healthy 14% to 16% this year. The risk primarily comes from elevated valuation multiples, which have been rising despite the rise in long-term yields — dragging the equity risk premium to a negative level.

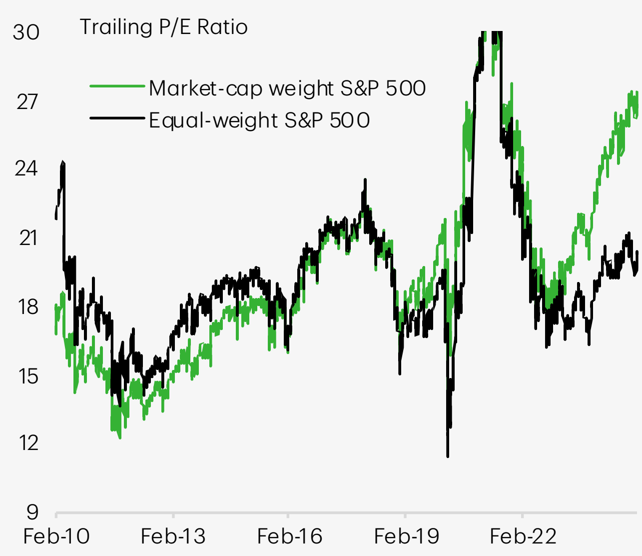
But investors would be remiss to simply ignore U.S. stocks based on an expensive headline index. Yes, the U.S. equity index screens expensive based on all traditional valuation metrics, but there are opportunities in the smaller left-behind stocks outside the info-tech sector (Figure 9).

Figure 8: New orders point to an acceleration in U.S. manufacturing



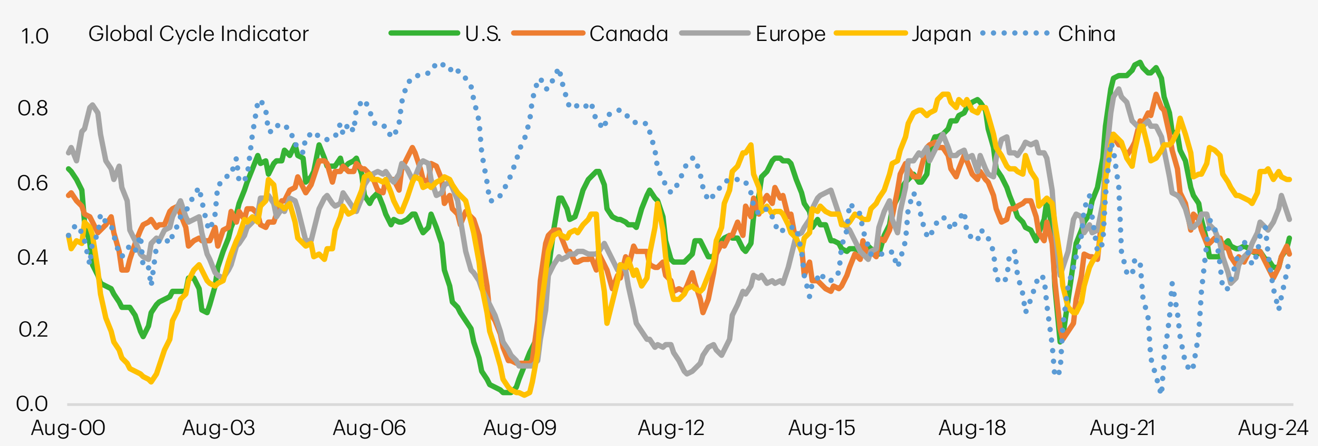
Source: Macrobond and Wealth Investment Office as of January 10, 2025

Figure 9: Median P/E ratio for U.S. stocks is around historical average, much lower than the market-cap index



Source: FactSet and Wealth Investment Office as of January 10, 2025

Figure 7: U.S., Canada and Europe are seeing a mid-cycle expansion

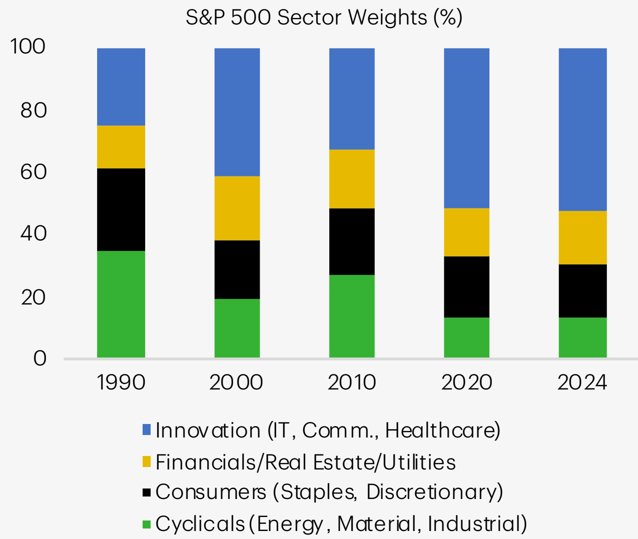


Source: Macrobond and Wealth Investment Office as of January 10, 2025

Our base-case scenario of an upswing in the manufacturing PMI means the risk/reward trade-off for stocks down the market-cap tier and cyclicals are becoming more attractive (Figure 10). In fact, analysts expect earnings for small-cap U.S. stocks to grow 44% this year, outpacing large-cap stocks (Figure 11).

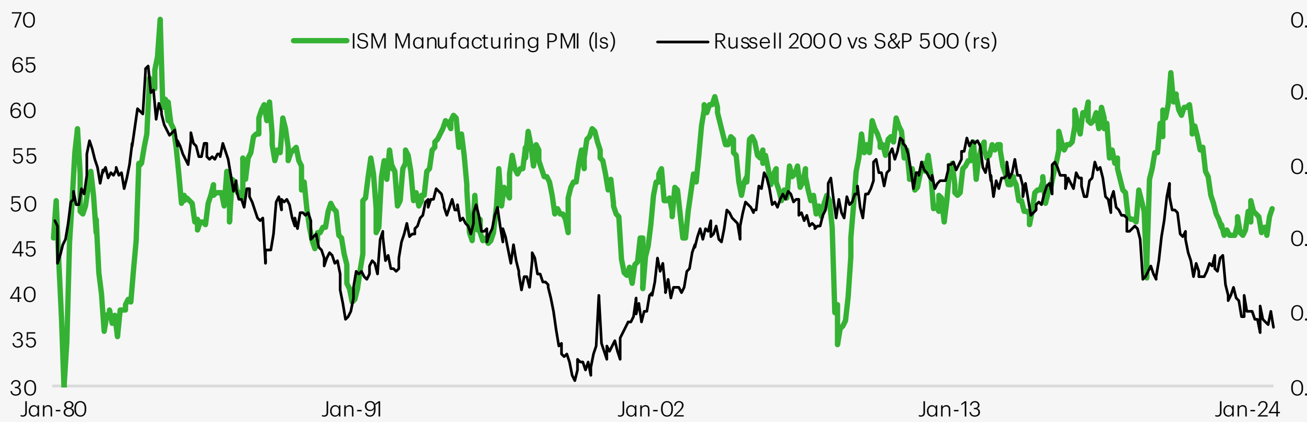
The rise of passive investing has contributed to the trend that has seen large-cap stocks take an increasing share of dollar inflows allocated to the asset class, while small- and mid-cap stocks receive less allocation over time. The composition of the U.S. stock market itself has been changing over time, with innovative sectors taking a larger share of the index (Figure 12). Even active managers have been chasing the mega-cap tech stocks as they move higher due to the fear of materially underperforming the benchmark. For active U.S. equity managers in 2023 and 2024, diversifying inside the S&P 500 benchmark hurt their average performance.

Figure 12: S&P composition has shifted toward innovation over the past three decades



Source: FactSet and Wealth Investment Office as of January 10, 2025

Figure 10: Small- and mid-cap stocks perform better during cyclical recoveries



Source: FactSet, Macrobond and Wealth Investment Office as of January 10, 2025

Figure 11: Small- and mid-cap earnings expected to outpace large-caps

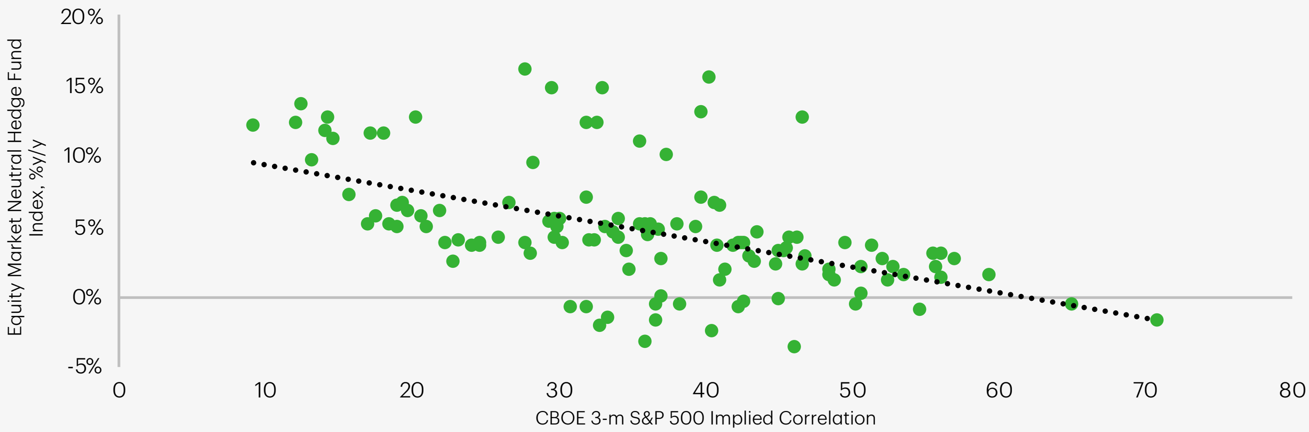
Source: FactSet and Wealth Investment Office as of January 10, 2025

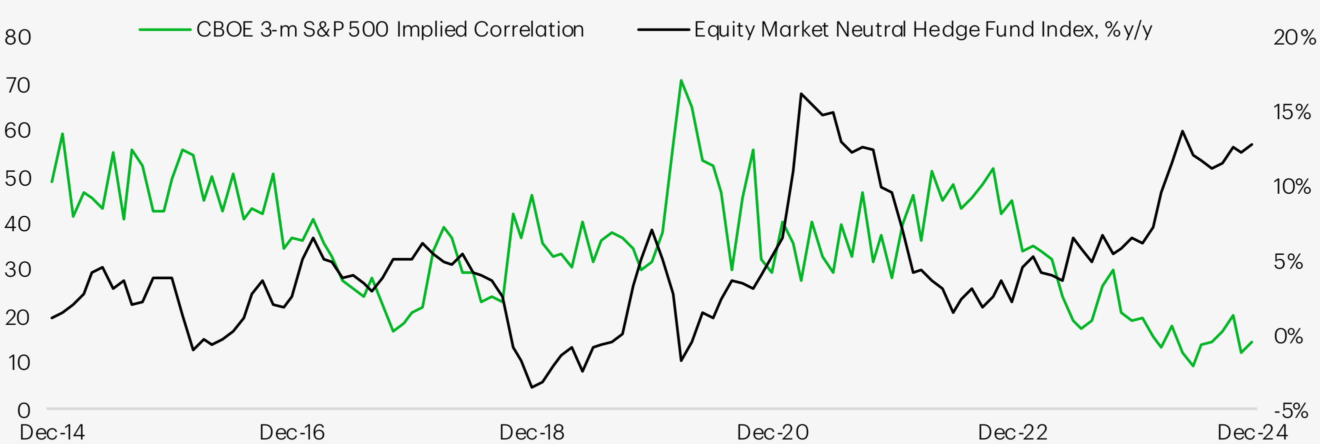
This year has the potential to reverse this trend. That's because this stage of an economy tends to favour the S&P equal-weighted over its cap-weighted counterpart. This shift also lends itself to directional strategies. If equity-market performance broadens this year, as we expect, stock prices will increasingly be driven by idiosyncratic company factors rather than macro forces.

Perhaps this helped contribute to the selloff that shook the markets following Chinese startup DeepSeek's introduction of its foundation model, which seems to perform in line with GPT4, developed by industry leader OpenAI. While the introduction of DeepSeek and the scare it has put into the AI investment theme may be painful for some equity positions in the near term, the constructive thesis is alive and well. How to invest in this area for the next decade will be a great challenge for sure, with lots of ups and downs. Structurally, we continue to want to invest in this theme, but we need to make sure we evolve with industry developments. The AI investment theme is expected to go through cycles — broadly from infrastructure build-out and training, to application development through inference, to eventually making its way to revolutionary improvements in productivity at downstream beneficiary companies over time. The market has been focused on the first stage for most of the current bull market, but with the implication that usage costs may come down meaningfully, we may see rapid progress in the application stage, opening up new market opportunities. We saw the market price this in during the recent tech selloff, with several related software names showing strength. We also think that this is a market looking for a reason to sell some of the high-performing S&P 500 market-weight tech constituents in favour of opportunities found in the broader market. This is consistent with our current view of overall portfolio allocation. Both areas continue to provide opportunity.

This is a boon for active managers who can parse the winners from the losers across sectors inside the overall index. Long-short and market-neutral strategies tend to perform better during periods of declining and low correlation within the equity market, and we have already started to see this play out in 2024 (figure 13). We think this opportunity has just begun. Following two years of multiple expansion driving the S&P 500, investors can reduce their long equity factor exposure.

Figure 13: Environment favours active and directional (hedging) equity strategies





Source: FactSet, Macrobond and Wealth Investment Office as of January 10, 2025

Lastly, there's the increasing availability of private capital. This also allows companies to expand without tapping capital in the public markets, essentially shifting the availability of investment opportunities to private equity and credit players. As of late, slow IPO and M&A activity has been delaying the exit of portfolio companies in the private space and rewarding investors in the private-equity secondary strategy as liquidity providers. On the fixed income side, meanwhile, private credit is becoming a competitive player against traditional bank lending for small and mid-size companies that can't access the bond market. The leveraged loan market has also seen strong inflows due to its floating-rate structure, presenting an alternative to traditional bond investments.

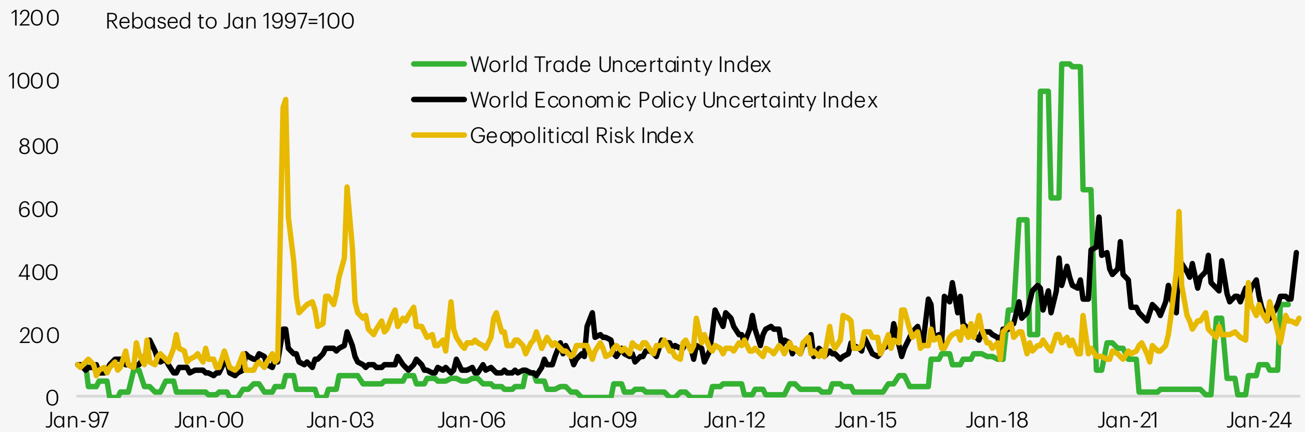
3. Geopolitical Conflict

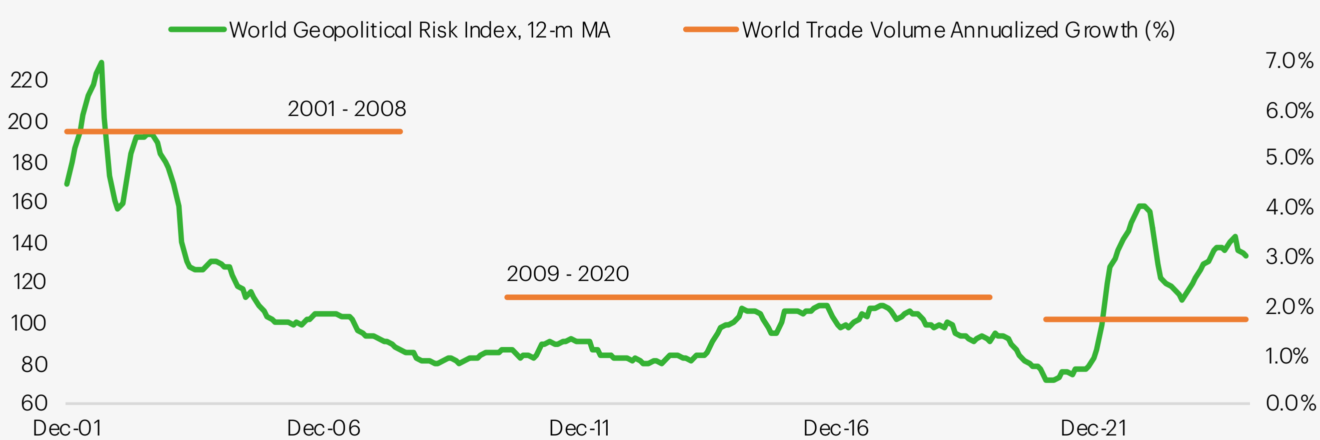
There is indeed a great deal to be concerned about in today's geopolitical environment, but as I have just shown above, there are also a lot of diversification strategies we can use to reduce the impact on portfolios from this sort of risk. Moreover, a big correction due to the unsettled geopolitical environment is far from inevitable. There are still so many unknowns. The war in Ukraine continues to rage, and in the Middle East, Israel has managed, with U.S. assistance, to neutralize multi-pronged threats from Iran by weakening its allies in Gaza, Lebanon and Syria. And beyond kinetic warfare, investors must also prepare for trade warfare, with the U.S. refocusing on its rivalry with China.

With global cooperation on the decline, geopolitical risk will increasingly be top-of-mind for executives searching for new markets in which to expand, build new factories or source raw materials. The top panel of Figure 14 illustrates the rise of three uncertainties around the world: (1) economic uncertainty; (2) policy uncertainty (world trade); and (3) geopolitical uncertainty — namely, the "Uncertainty Trinity" that we have written about in the past.

Now, with the U.S. and Chinese governments engaging in tit-for-tat sanctions on the export of sensitive technology and materials, the disruption in the global supply chain is translating to an increase in cost for businesses and consumers. From a trade perspective, the trend towards globalization has weakened as governments enact protectionist policies.

Figure 14: Uncertainty Trinity continues to intensify





Source: Economic Policy Uncertainty, Matteo Iacoviello, Macrobond, as of January 17, 2024

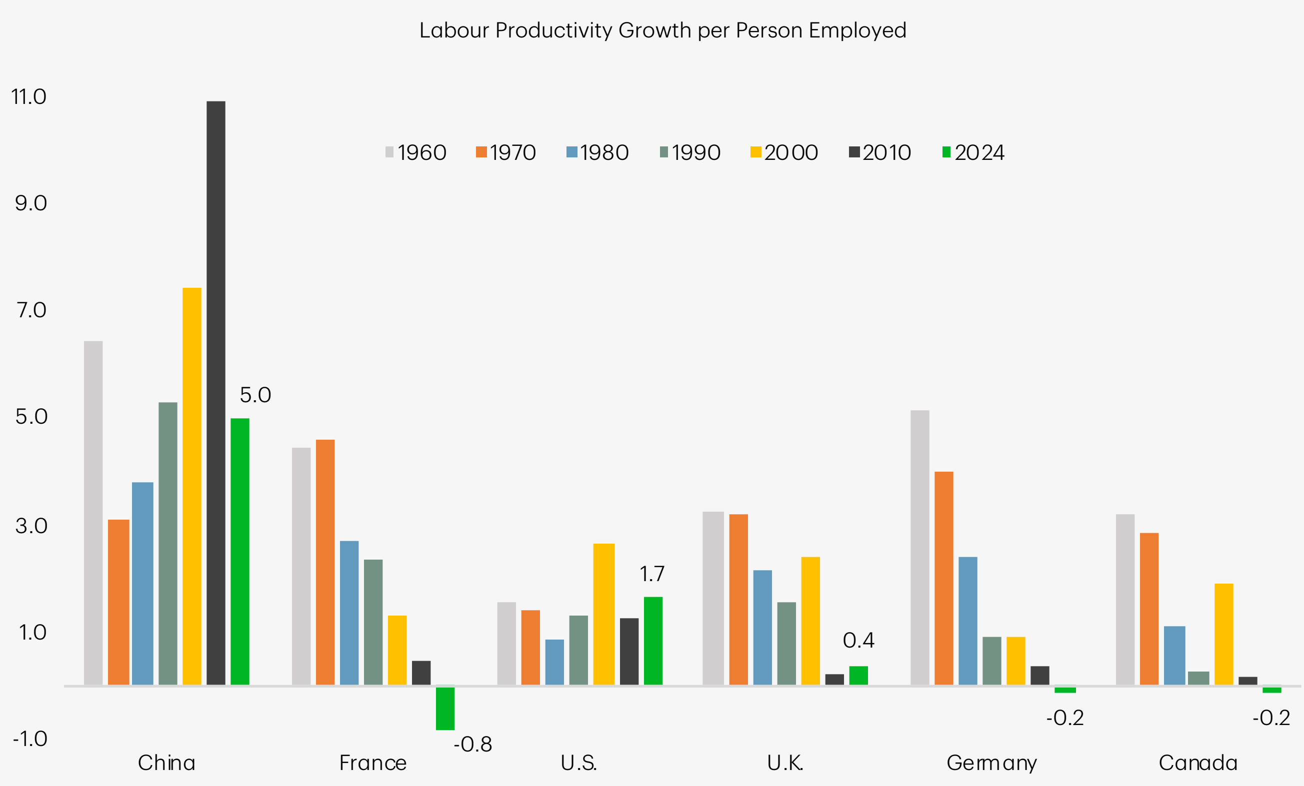
Whereas the decade following China's induction into the WTO in 2001 saw rapid growth in global trade, this slowed significantly after the global financial crisis and the pandemic. China, the world's factory over the past two decades, is now itself facing rising labour costs, an aging demographic and political changes that are driving multinationals to outsource their manufacturing base to other countries across Asia, such as Vietnam for electronic manufacturing and Bangladesh for textiles. The threat of import tariffs may alter the calculation for companies high in the value chain on whether to outsource their manufacturing overseas or build it on U.S. soil. Automation is likely the primary beneficiary of this, as management teams look for various avenues to cut costs.

Economic policy uncertainty will also remain elevated this year, given that more than 60 countries went to the polls in 2024 — mostly with the incumbents losing. In the U.S. and Europe, we have seen voters shift to the right amid dissatisfaction on centre and centre-left governments that were in power during the inflationary period following the pandemic. This, of course, leads to the big question: Does this shift to the right foreshadow the Canadian experience, with an election coming sometime between now and October?

Canada is in a particularly difficult spot as we weather the increasingly hostile global environment. As one of the most interest-sensitive developed countries — with high household debt and a high share of cyclical sectors in the economy — Canada has seen disappointing growth post-pandemic. Our open economy and dependence on energy exports put Canada in a fragile state compared to consumer-heavy economies such as the U.S. Moreover, Canada is facing a wide range of domestic issues, including housing affordability, intra-provincial trade barriers that hamper growth and chronically low productivity (Figure 15).

The change in the geopolitical landscape, however, presents opportunities for Canada to adapt to the needs of the world and our southern neighbour. Canada's abundant supply of energy resources and critical minerals could substitute Chinese supply of the latter, integrating Canada into the high-tech supply chain. In addition, deregulation among several key industries such as the energy and manufacturing sectors could provide a much-needed boost to productivity growth. In a world where growth is scarce, investors are willing to bid on companies that innovate and deliver consistent sales and earnings growth. Canada has the potential to be a place where these companies can thrive.

Figure 15: Productivity growth has declined globally, including in Canada



Source: Macrobond and Wealth Investment Office as of January 10, 2025

4. Higher Inflation

Last year at this time in our Year Ahead document we wrote that we thought inflation was going to be stickier than expected, and indeed it has been. After falling to a low of 2.4% in September, U.S. CPI inflation has actually started to tick upwards again. As of December, inflation stood at 2.9%. What's more, U.S. yields have been heading higher on renewed inflation concerns amid still-solid growth as well as nagging fiscal worries in light of a policy slate from the new U.S. government that is widely considered to be inflationary.

This indeed is concerning, but not unusual if we look at it a bit more broadly. In Figure 16, we look at the U.S. consumer price index from 1950 to 2024. As you can see, the line fluctuates above and below the Fed's target range. Periods of high inflation are usually followed by smaller, lower-intensity inflation regimes. Taking the analogy from an earthquake, the major shock is followed by multiple aftershocks, and it takes time for the impact to dampen out. In other words, inflation is actually behaving in a consistent way and not out of the ordinary.

Conclusion: A winding but worthwhile path

Figure 17 is a picture from a successful ad for Maxwell Cassette Tapes when I was a kid (please explain what that is to folks born after 1990). We think it aptly captures the average investor's experience in the current environment. Events around the globe are happening so fast, and the volume just keeps getting amped up.

To prosper in this and future environments, it's going to take a lot more than just the traditional tools of finance. We believe investment success is predicated on the ability to adapt as the world unfolds. This belief is at the foundation of our investment philosophy, Risk Priority Management.

We believe in the concept of "consilience" — the linking together of principles from different disciplines — in seeking to understand, profit and manage risk in a complex physical, biological, social, cultural and technological world.

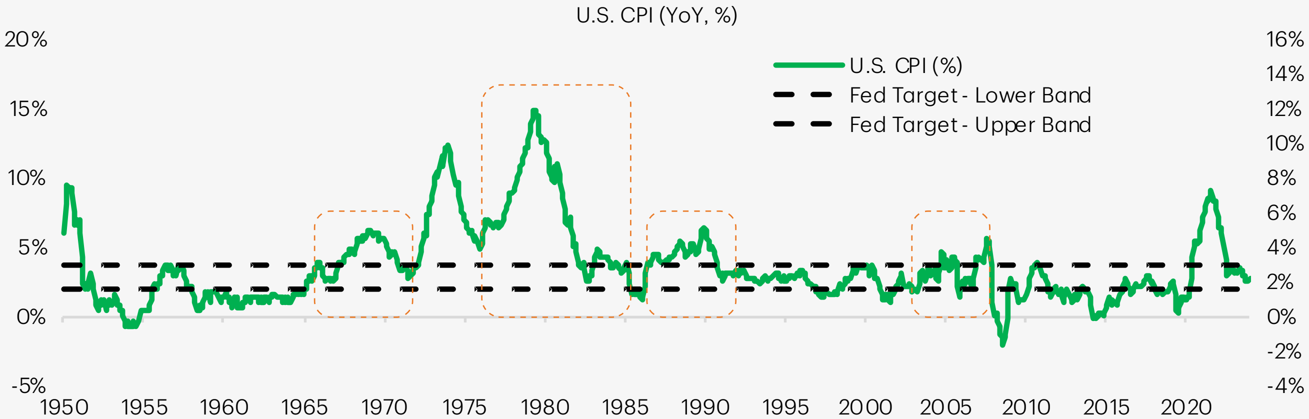
How to invest for the next decade is a conundrum for sure, but one that we know we're ready for. There are going to be lots of ups and downs. Every era brings different challenges and opportunities, and no one knows how it will unfold precisely.

For a compelling argument on the power of diversification, take a look at Figure 18. We've assembled six bar charts that compare the Sharpe ratio (measuring risk-adjusted returns) across U.S. stocks, non-U.S. stocks, bonds and commodities from 1970 to 2024. Commodities performed best during the stagflationary 1970s, while U.S. stocks dominated in the 1990s and over the past 10 years. Bonds, meanwhile, shone during the 2000s crisis. Overall, however, the results are mixed — with risk-adjusted returns balancing out in the end. We think strong diversification is the best way to tackle the quarter ahead and the ones that follow.

Figure 17: Things are changing fast and the volume is high ...

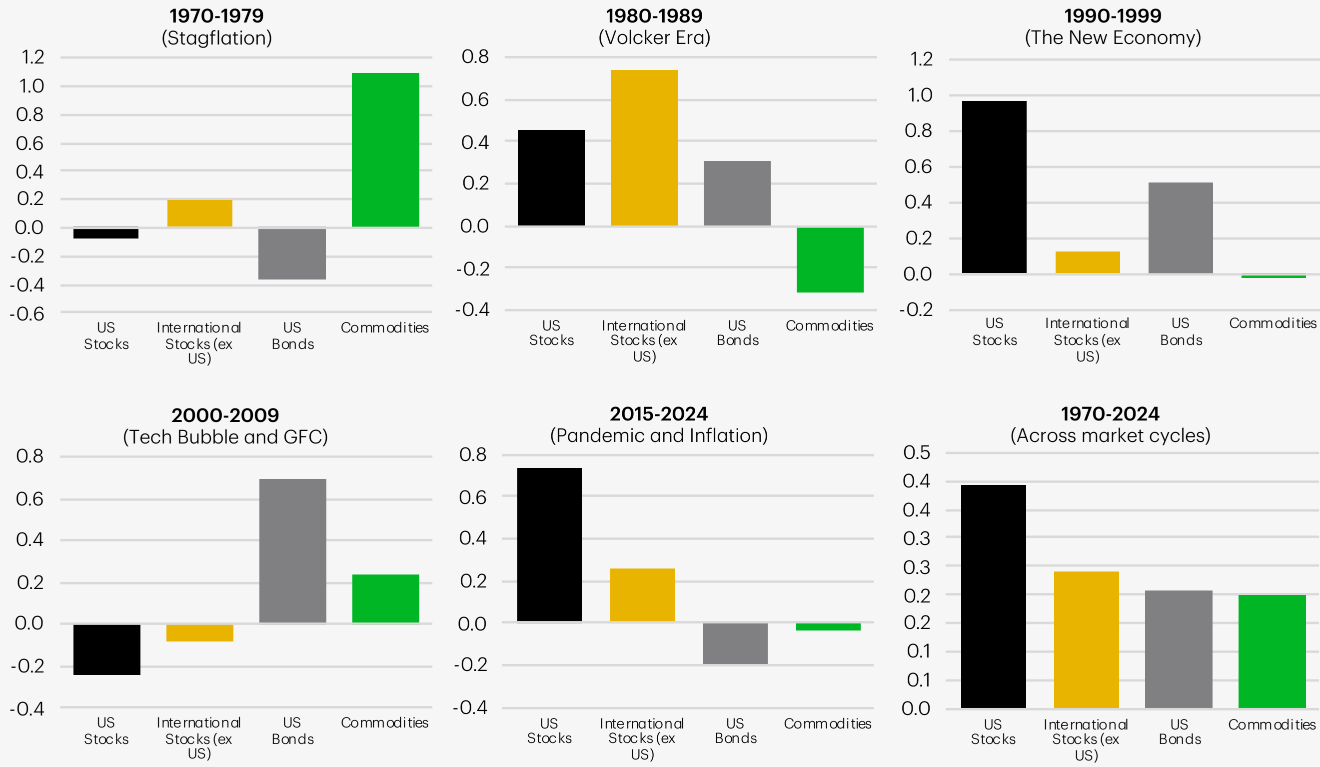
For illustrative purposes only

Figure 16: Inflationary "earthquakes" followed by multiple aftershocks



Source: FactSet, Wealth Investment Office, as of December 31, 2024

Figure 18: ... but over the long run, diversification wins



Source: AQR, Barclays Live, Bloomberg, Ibbotson Associates (Morningstar) as of December 31, 2024. Note: Excess returns are in excess of cash proxied by the ICE BofAML U.S. 3-Month T-Bill Index. U.S. Stocks are defined as the S&P 500 TR Index. Non U.S. Stocks are defined as the MSCI EAFE Net Total Return USD Index. Bonds are defined as the Bloomberg Barclays U.S. Government Bond Index and, prior to 1973, the Ibbotson U.S. Intermediate Government Bond Index. Commodities are defined as the Bloomberg Commodity Index.

Our Positioning

Cash – Modest Underweight

Fixed income- Modest Underweight. We believe returns in fixed income from here on out will come from of the coupon received, in the mid-single-digit range. As such, we are maintaining a modest underweight outlook. We also note that we expect bond markets to remain relatively volatile.

Equities - Modest Overweight. The U.S. economy will continue to outperform peers. Domestic demand, including consumer spending, makes the U.S. economy less sensitive to geopolitical shocks. Furthermore, the current geopolitical backdrop — elevated trade uncertainty, stagnating globalization, increasingly protectionist policies — have all made the U.S. a haven for capital. However, U.S. inflationary pressures are likely to resurface. We believe the U.S. is in a mid-cycle economy, which bodes well for small- and mid-cap equities. As manufacturing PMIs improve, the equal-weighted S&P 500 index tends to outperform its market-cap-weighted counterpart.

Alternatives - Modest Overweight. The run-up in private-equity net asset values between 2018 and today has been dramatic. This, coupled with a slowdown in exit activity due to the higher cost of capital, has left many limited partners (LPs) in a cash-negative position and looking for paths to liquidity. These dynamics have created a favourable environment for opportunistic liquidity providers in the secondary market, which we anticipate will persist over the medium term.

Commodities - Modest Overweight. We live in a world where geopolitical competition continues to increase, military spending is growing, the energy transition is unfolding, and where inflation is more volatile than it has been in decades. This is a world where commodities and gold — which tend to have minimal correlation with stocks and bonds — should fare well, providing strong diversification benefits to portfolios.

Leading Macro Indicators

Overall risk regime score improved slightly in Q4

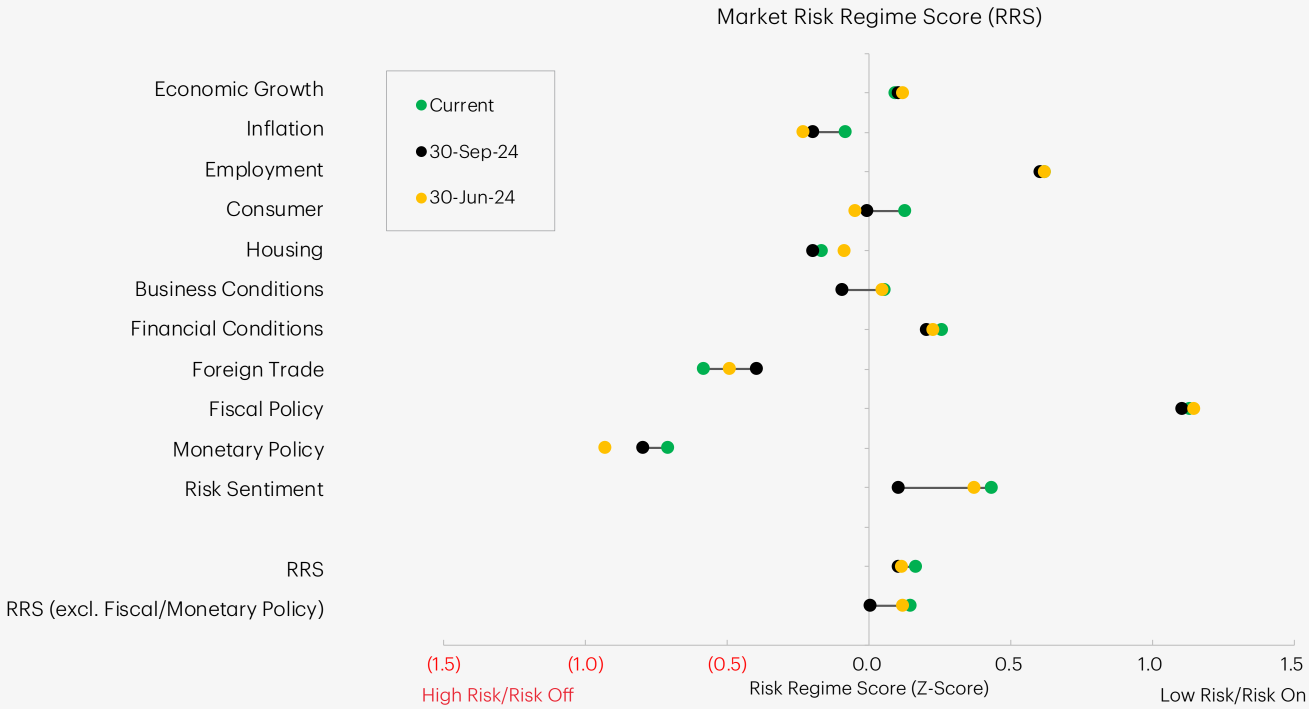
As part of our process-driven approach to investment management, we monitor key U.S. variables that inform our understanding of the risk and macroeconomic environment. For each indicator we calculate current values and compare them against recent trends and long-term data using a standardized approach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

Figure 1: Market risk regime scores

Indicator	Overall Condition	Current	Sep-24	Jun-24	Mar-24
Economic Growth	Neutral	0.1	0.1	0.1	0.1
Inflation	Neutral	(0.1)	(0.2)	(0.2)	(0.2)
Employment	Strong	0.6	0.6	0.6	0.8
Consumer	Neutral	0.1	0.0	(0.1)	0.3
Housing	Neutral	(0.2)	(0.2)	(0.1)	0.1
Business Conditions	Neutral	0.1	(0.1)	0.0	(0.1)
Financial Conditions	Strong	0.3	0.2	0.2	0.2
Foreign Trade	Weak	(0.6)	(0.4)	(0.5)	(0.3)
Fiscal Policy	Strong	1.1	1.1	1.1	1.1
Monetary Policy	Weak	(0.7)	(0.8)	(0.9)	(1.0)
Risk Sentiment	Strong	0.4	0.1	0.4	0.3
Risk Regime Score (RRS)	**Neutral**	**0.2**	**0.1**	**0.1**	**0.1**
RRS (excl. Fiscal/Monetary Policy)	**Neutral**	**0.1**	**0.0**	**0.1**	**0.1**

Source: FactSet, WIO as of December 31, 2024

Figure 2: Change in market risk regime scores



Scores represent number of standard deviations away from long-term average.
Source: FactSet, Wealth Investment Office as of December 31, 2024

At the end of Q4 the overall market risk regime score improved slightly but remained neutral—the scores for risk sentiment and financial conditions rose while foreign trade and monetary policy remained weak. U.S. equities and bond yields both rose sharply as the outlook for the U.S. economy improved and expectations for the Fed to ease monetary policy at a slower pace took hold.

Monetary policy continues to exert the biggest drag on the overall risk score, although the score improved slightly as the Fed trimmed the policy rate in Q4. Employment and fiscal policy remained strong while the score for foreign trade deteriorated as the U.S. trade deficit widened. The following are notable changes for Q4 compared to Q3:

• Monetary policy and foreign trade remained weak in Q4. The Fed is now expected to reduce rates at a more moderate pace after slicing 100-basis points off the policy rate in the second half of 2024. The score for monetary policy improved gradually over 2024 but the policy rate remained in restrictive territory. At the end of Q4, the score for monetary policy ticked up to -0.7 from -0.8 in Q3. The score for foreign trade fell from -0.4 to -0.6 at the end of Q4 on the back of the strong U.S. dollar. The current account deficit remained elevated.

• Scores for employment and fiscal policy remained in positive territory. The labour market softened further while still remaining healthy amid a moderating quit rate, wage growth, and rising jobless claims. Even though the hiring rate slipped below the pre-pandemic level, there is little sign that companies are actively laying off workers. The score for employment is unchanged at +0.6 in Q4. Our fiscal policy score also sat unchanged at +1.1 at the end of Q4; U.S. government spending continues to support economic growth and the government fiscal deficit is forecast to stay elevated under a Republican government.

• Risk sentiment and financial conditions recorded major changes in Q4. The score for risk sentiment improved to +0.4 at the end of Q4 from +0.1 in Q3 and its overall condition returned to strong from neutral. Volatility across various asset classes continued to fall following the carry trade unwind in Q3 and investors were bullish on equities. The score for financial conditions rose to +0.3 in Q4 from +0.2 at end Q3 as corporate bond spreads narrowed to record-lows amid expectations for a robust U.S. economy.

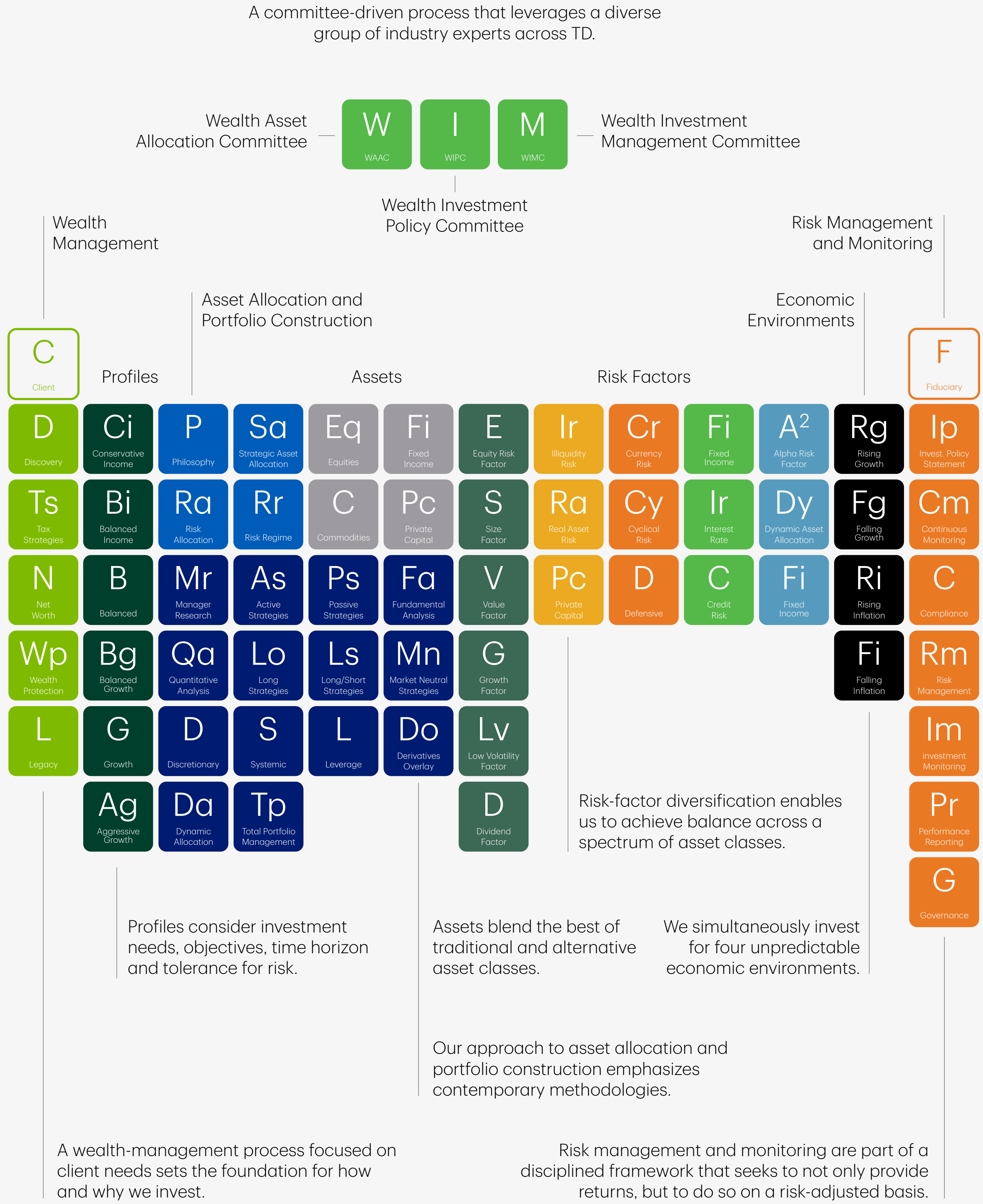
• Economic growth, housing, inflation, consumer, and business conditions were all relatively unchanged and remained in neutral overall condition in Q4. The real GDP growth forecast is still above the 2% level, supporting the +0.1 score for economic growth. The score for inflation moved up to -0.1 in Q4 from -0.2, with progress on inflation shadowed by rising concerns over the impact of potential U.S. tariffs on imported goods and the immigration policy under a Trump presidency. The overall condition for housing was unchanged at -0.2 and the score for consumer improved slightly in Q4 to +0.1 from 0.0 in Q3.

Broad conditions for risk assets gained a little ground in Q4, driven by improved in risk sentiment and financial conditions. Monetary policy remained tight but should continue to ease over 2025 and economic growth is expected to stay robust. Encouragingly, the scores for employment and fiscal policy remained strong and this should support economic growth in Q1. Although the macroeconomic outlook is favourable for risk assets, market participants have already fully priced this in and financial markets are trading at elevated valuations compared to historical data.

Elements of Wealth Management

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

Figure 1: Elements



Wealth Asset Allocation Committee

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

Considers the financial-market environment and provides direction and themes

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

Committee members:

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

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

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

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

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

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

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

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

Bruce MacKinnon .. Managing Director, Head of Private Debt Research & Origination, TD Asset Management Inc.

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

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

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

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

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

Direction from WAAC

Core Asset Class Allocations

	Positioning	Rationale
Cash & Equivalents	**Modest Underweight** Previous Month	We are underweight Cash as in a declining rate environment the other asset classes should provide more attractive returns.
Fixed Income	**Modest Underweight** Previous Month	As Canadian data stabilizes around the Bank of Canada's ("BoC") economic forecasts against a backdrop of domestic political uncertainty, and tariff threats from the new U.S. administration, additional policy rate cuts are expected to be delivered carefully to provide the BoC flexibility to respond to a wide array of possible developments. Given the extent to which the Canadian bond market has outperformed other bond markets over the past two years, we expect only modest low-to-mid single digit total returns over the next 12 to 18 months. Nevertheless, we expect that bonds will continue to provide stable income and preserve capital.
Equity	**Modest Overweight** Previous Month	We are overweight Equities as we expect positive earnings growth to continue to drive attractive relative returns over the medium term. While the U.S. market had a strong 2024, equity returns were broadly positive across many geographies and sectors. Earnings growth (as represented by the MSCI All Country World Index) has been partially captured by the market in valuations, and we believe current valuations are justified given the backdrop of modest economic growth.
Alternatives	**Modest Overweight** Previous Month	We believe that an allocation to alternative assets can benefit diversified portfolios especially when implemented over the long-term. Alternative assets can provide inflation protection and attractive absolute returns, while acting as long-term portfolio stabilizers via their diversification benefits and less correlated income streams. Given the nature of private asset classes as well as the present phase of value adjustment in several markets and asset classes, we believe that this may be an attractive time to increase or consider an allocation to alternative assets.

Maximum Underweight · Underweight · Neural · Overweight · Maximum Overweight

Fixed Income - Modest Underweight

	Positioning	Rationale
Domestic Government Bonds	**Neutral**	We believe the BoC has room to reduce its policy rate further, however, we expect that it will be more measured in how quickly it cuts the policy rate given U.S. economic resilience, a stronger growth outlook, and higher expected political volatility at home and abroad over the next 12 to 18 months. As the easing cycle progresses, we expect yields on shorter government bonds, which are more sensitive to the monetary policy cycle, to fall faster than that of longer government bonds.
Investment Grade Corporate Credit	**Modest Overweight**	Investment grade spreads remain tight overall and reflect a modest softening of the global economic backdrop. We see Canadian investment grade corporate bonds as more attractive than U.S. investment grade corporates as spreads in Canada continue to be meaningfully wider.
High Yield Credit	**Neutral**	All in yields remain relatively attractive and high yield credit spreads have tightened to levels not seen since 2007, in part absorbing the bulk of the recent sell off in Treasuries. At near-historic lows, spreads remain expensive and provide little protection from a deterioration in credit conditions, a weakening consumer or further increases in Treasury yields. While the overall quality of the high yield universe has been improving, there remain companies with challenged capital structures that will become increasingly unsustainable with slowing growth andor rising interest rates. We continue to find the best opportunities in the mid to higher quality cohort of the market including leveraged loans that are offering a yield advantage over equivalent bonds on a risk-adjusted basis.
Global Bonds Developed Markets	**Neutral**	As investors anticipate stronger global growth over the coming year, as well as significant political uncertainty, global bond markets are grappling with what implications this will have for inflation, fiscal deficits, global trade, and currency dynamics. Therefore, we expect opportunities across developed market bonds to vary over the next 12 to 18 months.
Global Bonds Emerging Markets	**Modest Underweight**	The recent strengthening of the U.S. Dollar has led to a challenging environment for emerging markets, particularly those with large U.S. denominated liabilities. Furthermore, the threat of tariffs along with sluggish economic growth outside of the U.S. will cause uncertainty to remain elevated and will likely impact growth expectations across many emerging market regions. However, we continue to believe that there will be tactical opportunities in countries with high and stable monetary policy rates, sound fiscal policy and resilient growth fundamentals.

Equities - Modest Overweight

	Positioning	Rationale
Canadian Equities	**Modest Overweight**	The Bank of Canada ("BoC") has cut rates significantly since the spring of 2024 as inflation has subsided and the economy showed signs of slowing. We believe that these cuts are supportive of consumers and businesses, which should allow economic growth to reaccelerate. This contributes to the expected S&P TSX Composite Index ("TSX") 2025 earnings growth of ~12%, which creates a supportive backdrop for returns. Within the TSX, banks could benefit from the stabilization of credit and resource companies generally have low leverage and attractive free cash flow.
U.S. Equities	**Modest Overweight**	S&P 500 Index 2024 returns were driven by both multiple expansion and earnings growth. While mega cap technology firms have been a significant contributor to returns, partly driven by AI opportunities, most sectors finished the year in positive territory. The S&P 500 Index is expected to generate ~14% earnings growth in 2025. While the Technology sector is a key source of growth, earnings are expected to accelerate outside of technology. The incoming U.S. administration appears to offer some potential business friendly policies, but could create uncertainty in terms of trade, etc. The S&P 500 Index commands a premium valuation due to its higher technology exposure.
International Equities	**Modest Underweight**	International Equities returns might lag due to weak economic activity and political instability, particularly in the EU. Japanese equities look attractive on a relative basis, with momentum building behind a corporate reform agenda aimed at boosting profitability and valuation multiples. The Japanese stock market and yen might experience additional volatility depending on how the Bank of Japan continues with its process of raising rates versus the Fed potentially cutting rates further.
Emerging Market Equities	**Modest Underweight**	Emerging Markets (EM) central banks, including China, Chile and Mexico, have been cutting rates. EMs might face challenges from potential changes to U.S. trade and tariff policies. China continues to struggle with challenges in its property sector, but has recently announced monetary stimulus that could provide some stabilization for its economy.

Alternatives - Modest Overweight

	Positioning	Rationale
Commercial Mortgages	**Modest Overweight**	Commercial mortgages continue to provide accretive income while insulating investor returns from the increased volatility in interest rates.
Private Debt (Universe)	**Modest Underweight**	High credit quality and global diversification provides an income ballast in an uncertain economic environment. Incremental income and potential capital appreciation from interest rate moderation provide upside.
Domestic Real Estate	**Neutral**	We believe a significant portion of the value adjustments in the Canadian commercial real estate space have been taken. Moving forward we see more reason for confidence in the multi-unit residential, retail and industrial spaces, while the flight-to-quality within office continues.
Global Real Estate	**Modest Underweight**	We believe the majority of the value adjustments have occurred in the U.S., UK and Nordic countries, while other regions, such as Australia, are in the midst of value adjustments.
Infrastructure	**Modest Overweight**	Moderating risk-free rates have been reflected in lower discount rates which has led to strong valuations for infrastructure assets. We have seen a shift in focus from core infrastructure assets to core-plus and value add as investors seek greater growth and higher return potential from their infrastructure allocations.

Sub-Asset Classes

	Positioning	Rationale
U.S. Dollar	**Neutral**	The USD has remained strong against global currencies as relative growth differentials still favour the U.S. economy, and by extension the USD. Some USD weakness may be expected in the near-term, however, currency risk is not expected to be a major factor affecting returns as any USD softness is expected to be modest. The USD provides diversification in portfolios considering the range of risks in the near term.
Commodities (Gold, Energy, Metals, Agriculture, Carbon)	**Modest Overweight**	Gold delivered solid gains in 2024 due to continued demand from central banks and investors. Investor demand could shift depending on the geopolitical environment and risk appetite. Gold has recently faced a headwind from U.S. long-term real yields, which have rebounded despite Fed rate cuts. Metals prices have been subdued and at this point the announced Chinese stimulus measures appear unlikely to significantly improve demand. Oil has rallied to start the year on the strengthening of U.S. sanctions on Iran and Russia. OPEC+ continues to support the market with its recent decision to delay supply increases.

Figure 1: Direction from WAAC: strategic positioning

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

Source: Wealth Asset Allocation Committee, as of January 16, 2025.

Wealth Investment Policy Committee

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

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

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

Committee members:

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

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

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

Jafer Naqvi .... VP & Director, TDAM

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

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

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

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

In alignment with the Wealth Asset Allocation Committee (WAAC), the Wealth Investment Policy Committee did not make any changes to the asset allocation weights this month. The committee continues to have a modest overweight allocation to Equities and Alternatives, a neutral exposure to Commodities, and a modest underweight exposure to Cash and Fixed Income.

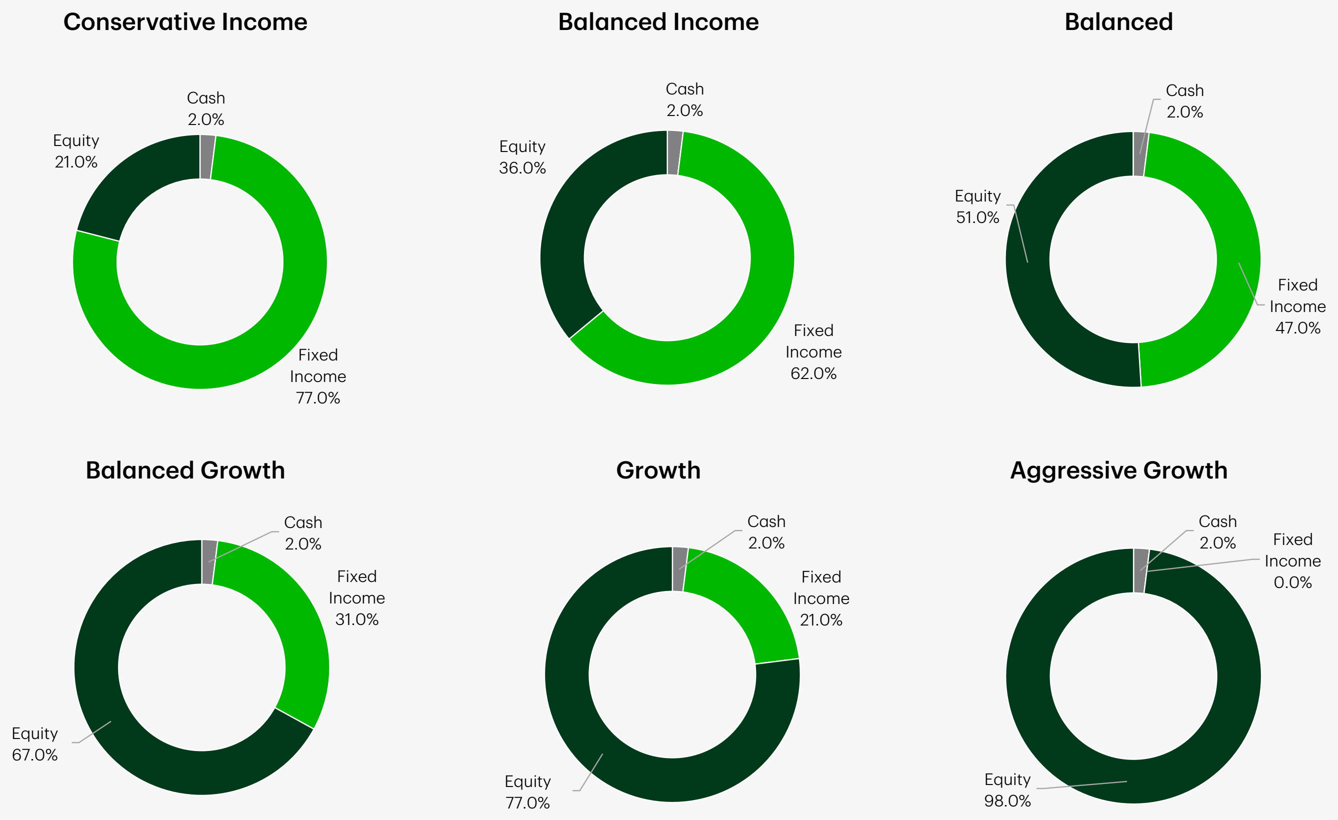
Within Fixed Income, the allocation to Domestic Government bonds remains unchanged at a modest underweight position, Investment Grade Corporate Bonds is unchanged at a neutral to modest overweight position, and High Yield remains at a neutral weight. Global Bonds - Developed Countries remains neutral in all profiles and Global Bonds – Emerging Markets remains underweight in all profiles.

Within Equities, the allocations are unchanged and remain modest overweight Canadian and U.S. equities and modest underweight International and Emerging Markets.

Within the Alternatives asset class, the allocations are also unchanged. The committee maintains a neutral position in Real Estate and Private Credit, and a modest overweight to Mortgages and Infrastructure by 1pp across all the investor profiles.

The allocation to Commodities remains at a Neutral position across the profiles.

Dynamic asset-class weights by investor profile (Condensed)

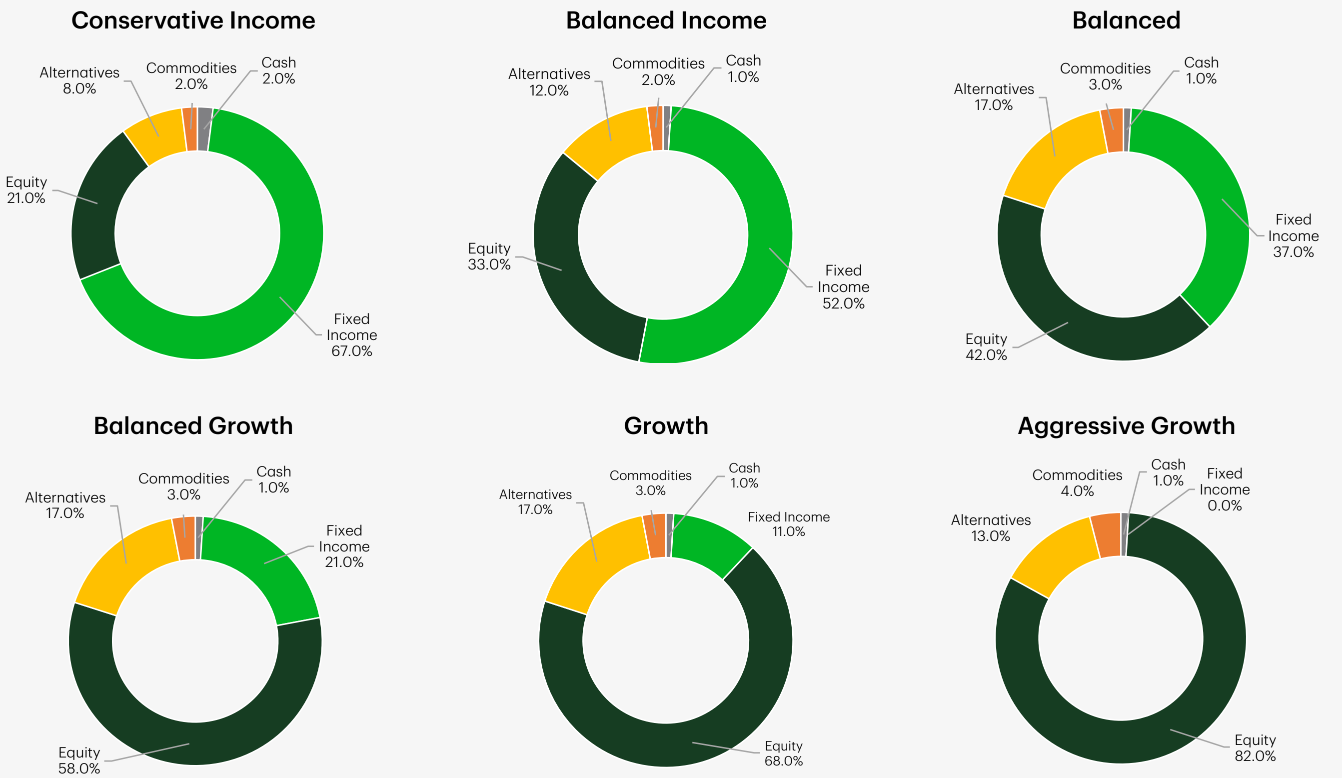


Strategic and dynamic asset-class weights by investor profile (Condensed)

Asset Class	Conservative Income		Balanced Income		Balanced		Balanced Growth		Growth		Aggressive Growth	
	Strat.	Dyn.	Strat.	Dyn.	Strat.	Dyn.	Strat.	Dyn.	Strat.	Dyn.	Strat.	Dyn.
Cash	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%
Public Fixed Income	78.0%	77.0%	63.0%	62.0%	48.0%	47.0%	33.0%	31.0%	23.0%	21.0%	0.0%	0.0%
Government	39.0%	37.0%	32.0%	30.0%	24.0%	22.0%	17.0%	15.0%	11.0%	10.0%	0.0%	0.0%
Corporate	39.0%	40.0%	31.0%	32.0%	24.0%	25.0%	16.0%	16.0%	12.0%	11.0%	0.0%	0.0%
Public Equities	20.0%	21.0%	35.0%	36.0%	50.0%	51.0%	65.0%	67.0%	75.0%	77.0%	98.0%	98.0%
Canadian	6.0%	7.0%	11.0%	12.0%	15.0%	16.0%	20.0%	22.0%	23.0%	25.0%	29.0%	31.0%
U.S.	8.0%	10.0%	14.0%	16.0%	20.0%	22.0%	26.0%	29.0%	30.0%	33.0%	40.0%	42.0%
International	4.0%	3.0%	7.0%	6.0%	10.0%	9.0%	13.0%	11.0%	15.0%	13.0%	19.0%	17.0%
China/ Emerging Markets	2.0%	1.0%	3.0%	2.0%	5.0%	4.0%	6.0%	5.0%	7.0%	6.0%	10.0%	8.0%

Strat: Strategic, Dyn: Dynamic. Source: Wealth Investment Policy Committee, as of January 16, 2025.

Dynamic asset-class weights by investor profile (Expanded)



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

Asset Class	Conservative Income		Balanced Income		Balanced		Balanced Growth		Growth		Aggressive Growth	
	Strat.	Dyn.	Strat.	Dyn.	Strat.	Dyn.	Strat.	Dyn.	Strat.	Dyn.	Strat.	Dyn.
Cash	2.0%	2.0%	2.0%	1.0%	2.0%	1.0%	2.0%	1.0%	2.0%	1.0%	2.0%	1.0%
Public Fixed Income	69.0%	67.0%	54.0%	52.0%	39.0%	37.0%	24.0%	21.0%	14.0%	11.0%	0.0%	0.0%
Domestic Government Bonds	28.0%	26.0%	22.0%	20.0%	15.0%	13.0%	9.0%	7.0%	5.0%	3.0%	0.0%	0.0%
Invest. Grade Corp Bonds	24.0%	25.0%	19.0%	20.0%	14.0%	15.0%	9.0%	9.0%	5.0%	5.0%	0.0%	0.0%
High Yield Bonds	5.0%	5.0%	4.0%	4.0%	3.0%	3.0%	2.0%	2.0%	1.0%	1.0%	0.0%	0.0%
Global Bonds - Developed	8.0%	8.0%	6.0%	6.0%	5.0%	5.0%	3.0%	3.0%	2.0%	2.0%	0.0%	0.0%
Global Bonds - Emerging	4.0%	3.0%	3.0%	2.0%	2.0%	1.0%	1.0%	0.0%	1.0%	0.0%	0.0%	0.0%
Public Equities	20.0%	21.0%	32.0%	33.0%	41.0%	42.0%	56.0%	58.0%	66.0%	68.0%	82.0%	82.0%
Canadian	6.0%	7.0%	10.0%	11.0%	11.0%	12.0%	16.0%	18.0%	19.0%	21.0%	22.0%	24.0%
U.S.	8.0%	10.0%	13.0%	15.0%	17.0%	19.0%	23.0%	26.0%	27.0%	30.0%	35.0%	37.0%
International	4.0%	3.0%	6.0%	5.0%	8.0%	7.0%	11.0%	9.0%	13.0%	11.0%	15.0%	13.0%
China/Emerging Markets	2.0%	1.0%	3.0%	2.0%	5.0%	4.0%	6.0%	5.0%	7.0%	6.0%	10.0%	8.0%
Alternatives	7.0%	8.0%	10.0%	12.0%	15.0%	17.0%	15.0%	17.0%	15.0%	17.0%	12.0%	13.0%
Commercial Mortgages	4.0%	5.0%	4.0%	5.0%	4.0%	5.0%	4.0%	5.0%	4.0%	5.0%	0.0%	0.0%
Private Debt	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	0.0%	0.0%
Real Estate	0.0%	0.0%	1.0%	1.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%
Infrastructure	0.0%	0.0%	2.0%	3.0%	5.0%	6.0%	5.0%	6.0%	5.0%	6.0%	9.0%	10.0%
Commodities	2.0%	2.0%	2.0%	2.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	4.0%	4.0%
Fixed Income	71.0%	69.0%	56.0%	53.0%	41.0%	38.0%	26.0%	22.0%	16.0%	12.0%	2.0%	1.0%
Equity	20.0%	21.0%	32.0%	33.0%	41.0%	42.0%	56.0%	58.0%	66.0%	68.0%	82.0%	82.0%
Alternatives	7.0%	8.0%	10.0%	12.0%	15.0%	17.0%	15.0%	17.0%	15.0%	17.0%	12.0%	13.0%
Commodities	2.0%	2.0%	2.0%	2.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	4.0%	4.0%

Strat: Strategic, Dyn: Dynamic. Source: Wealth Investment Policy Committee, as of January 16, 2025.

Economic Outlook

Setting the Record Straight around the Canada-U.S. Trade Relationship

Marc Ercolao, Economist; Andrew Foran, Economist | TD Economics

Highlights

- Canada is the largest export market for the U.S. and makes up one of the smallest trade deficits, owing largely to U.S. demand for energy-related products.
- Trade in the auto sector is balanced between the 2 nations. While President Trump has mused that the U.S. could replace Canadian auto exports with its own domestic supply, the highly integrated North American supply chains is a major complicating factor.
- Flipping this argument on its head, Canadian auto manufacturing has room to expand. Canada produces only 14 car models but consumes 325 models. The U.S. produces 121 models of the 328 models consumed by Americans.
- With respect to Trump's assertion that the U.S. subsidizes Canada to the tune of US$200 billion per year, it's unclear where this number is derived. In any event, rather than a subsidy, the U.S. trade deficit is a by-product of U.S. economic outperformance relative to other countries.

As Canadian's brace for a long period of "deal making" under President Trump's tariff strategy, here's a primer on what's at stake and the facts behind the rhetoric.

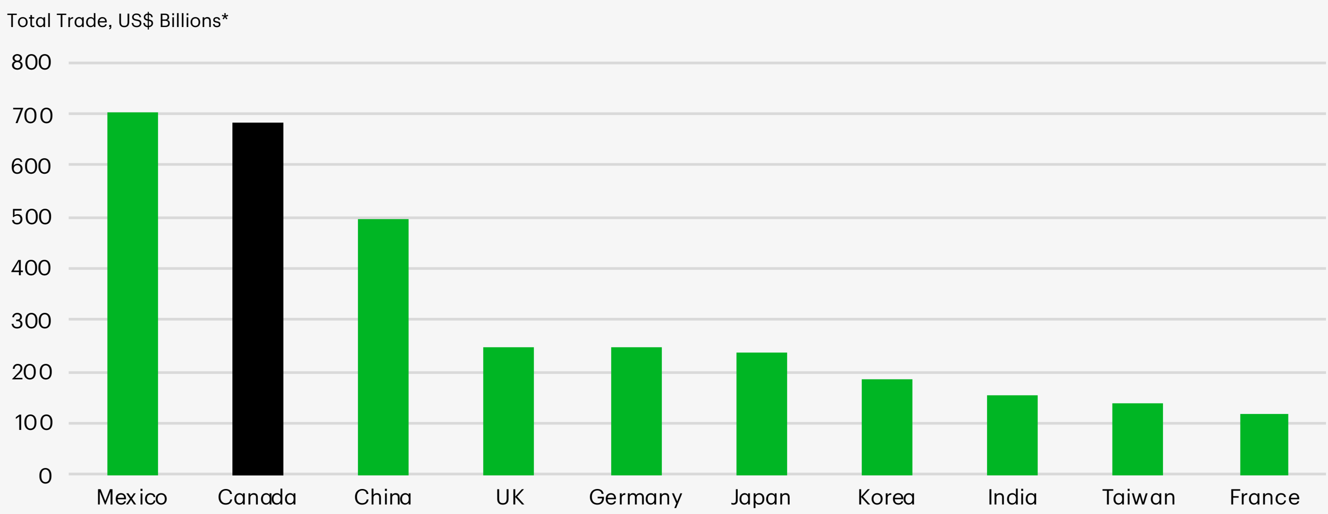
In addition to border security concerns, Trump has argued that "the United States can no longer suffer the massive trade deficits that Canada needs to stay afloat," claiming that the U.S. subsidizes Canada to the tune of US$200 billion annually. How "massive" is the deficit and is there validity to this claim of subsidization?

Canada is America's second largest trading partner, but number one export market

In the first three quarters of 2024, roughly C$800 billion or (US$600 billion) of goods crossed the Canada-U.S. border. Including trade in services boosts these totals to C$910 (US$683 billion).

- That is the equivalent to C$3.6 billion in total import and export flows each and every day.
- Only Mexico edges out Canada (figure 1).

Figure 1: Canada Is the Second Largest Trading Partner to the U.S.



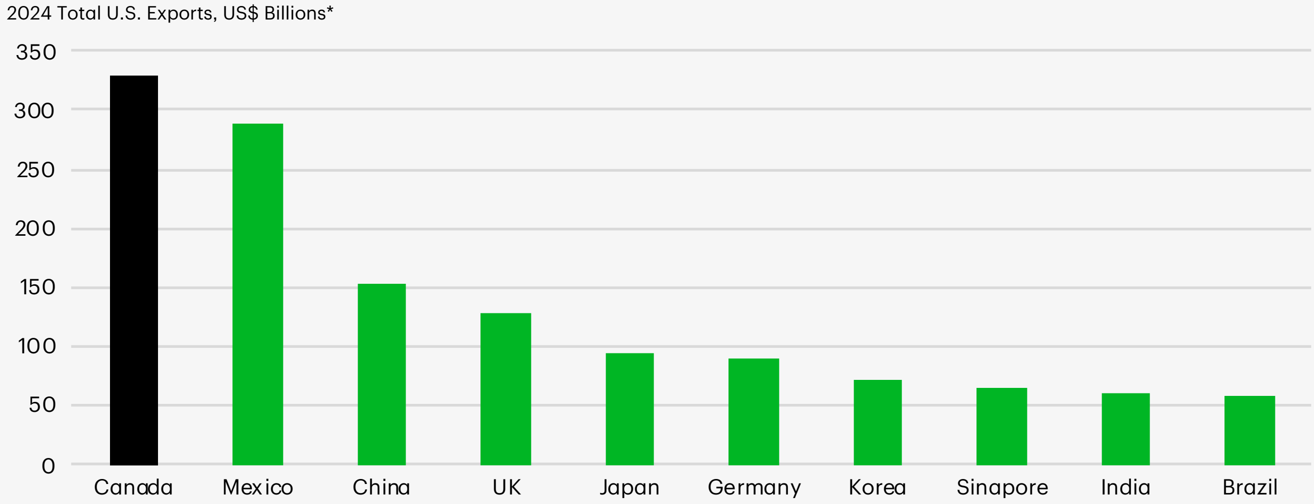
*Through January-September 2024. Source: Census Bureau, TD Economics.

- But when it comes to which country dominates in buying American products, Canada is the single largest market by a large margin with nearly US$350 billion goods and services crossing Canada's border over the first three quarters of 2024. (figure 2). Some 34 U.S. states sell more goods to Canada than any other foreign economy.
- Trade between the U.S. and Canada is highly integrated. Most Canadian exports are inputs used by American businesses in their own production – more so than with other trading partners[1]. Thus, a disproportionate share of the negative tariff impacts on imports from Canada would be through the channel of business supply chains and productivity that would drive higher costs and inflationary pressures at the retail level.

Figure 2: Canada Remains the Most Important Hub for U.S. Exports

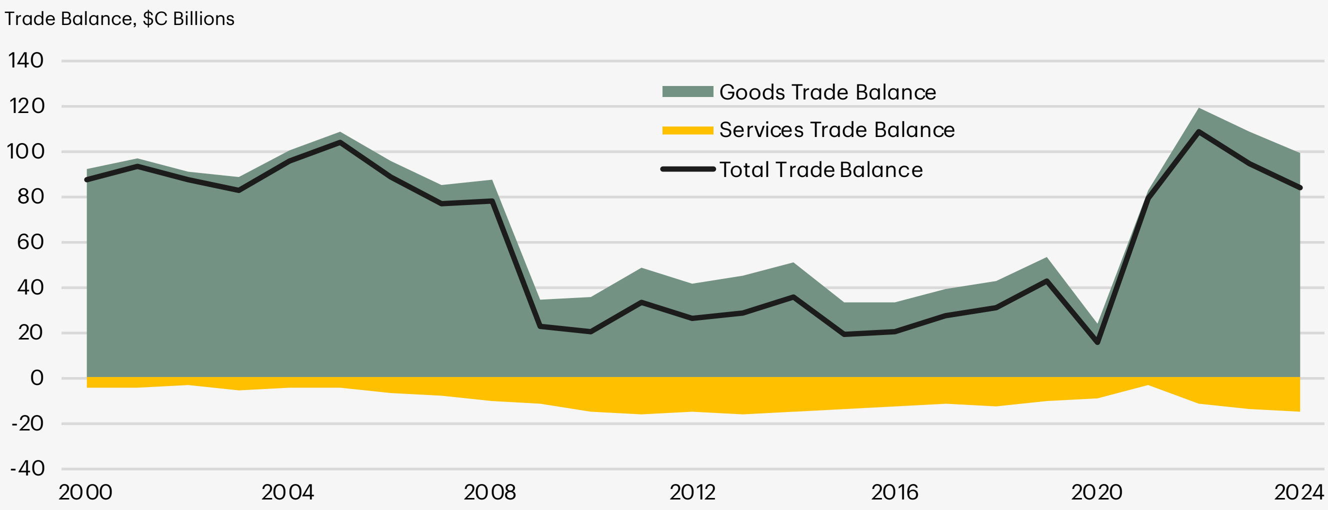
From the American lens, trade with Canada is balanced

- Based on Statistics Canada data, Canada's merchandise trade surplus with the U.S. last year was on track to reach C$100 billion in 2024. That equates to 3.2% of Canadian GDP.
- The U.S., however, enjoys an edge in services trade, mainly related to Canadians flowing over the American border. This impact shrinks the trade surplus to C$85 billion, or 2.8% of Canadian GDP (figure 3).
- Looking at the trade situation from the U.S. lens yields smaller figures, partly reflecting different data measurement. Applying Census Bureau figures, the U.S. is on track to record a trade deficit with Canada of roughly US$45 billion in 2024 (or a mere -0.2% of U.S. GDP). In Canadian dollars at the spot rate, this would amount to $65 billion.



*Through January-September 2024. Source: Census Bureau, TD Economics.

Figure 3: Canada's Trade Balance with the U.S.



Source: Statistics Canada, TD Economics.

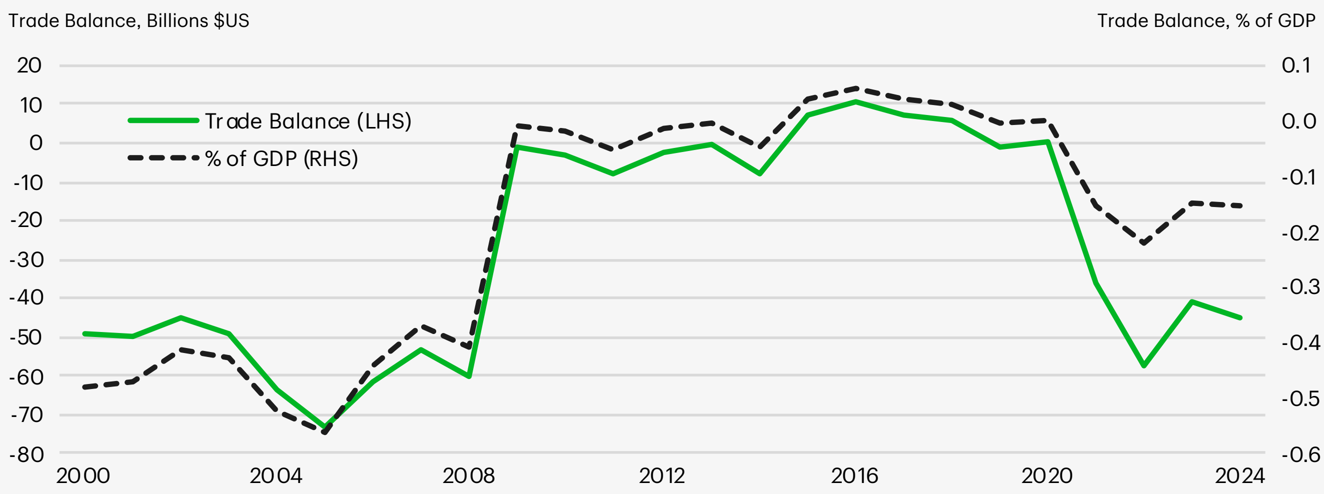
Since Trump 1.0, the U.S. trade position eroded against Canada

- The U.S. trade deficit with Canada has deteriorated since Trump's first mandate – a fact that is probably not lost on the President as he presses on using tariffs as a primary international policy tool.
- Indeed, between 2016 and 2020, the U.S. posted a modest annual average surplus with Canada of around US$20 billion.
- Some of this weakening of the U.S. position with Canada reflects the outperformance of the U.S economy since the pandemic, as well as a material increase in Canadian energy exports southward.
- Despite this loss of ground, the U.S. trade shortfall with Canada remains below its record of almost US$75 billion in 2005 (figure 4).

U.S. trade deficit with Canada is the second lowest among trading partners

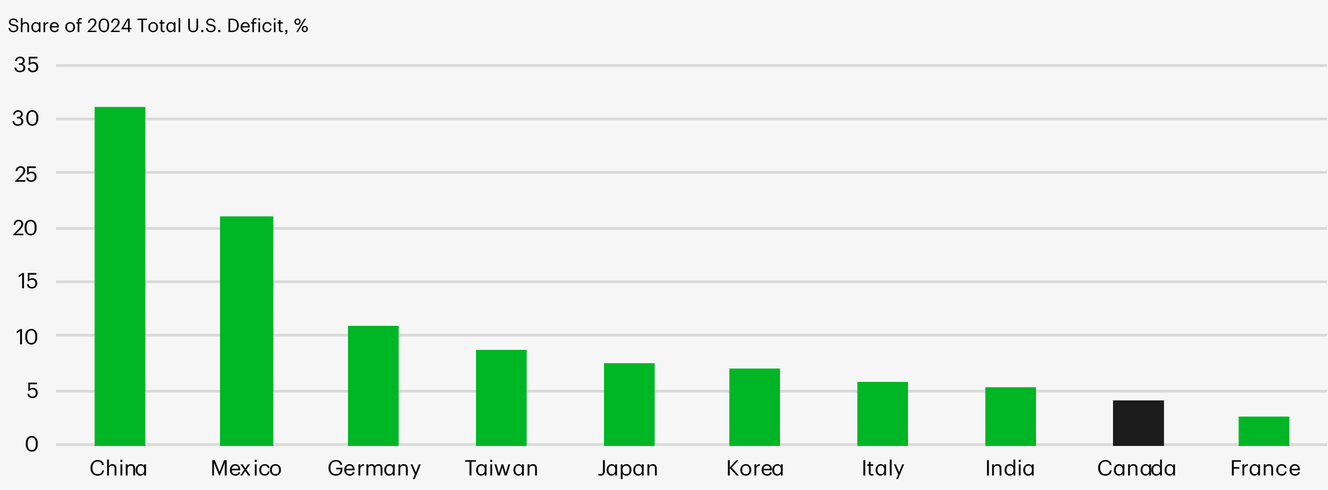
- Figure 5 shows where Canada stacks up against other major countries.
- The ~US$45 billion shortfall with Canada in 2024 places as the second smallest, behind only France. That amounts to a mere 4% of the overall U.S. trade deficit. So, in essence, reducing imports from Canada would barely move the needle.
- The U.S. trade deficit with Canada was 1/8 the size of China's and 1/5 that of Mexico.

Figure 4: The U.S. Deficit With Canada Is Not an Emergency



Source: Census Bureau, TD Economics.

Figure 5: Canada's Small Contribution to the U.S. Trade Deficit



Source: Census Bureau, TD Economics.

America registers a trade surplus with canada in autos

- A fact that is not well known: the U.S. is a net exporter to Canada of manufacturing goods, particularly motor vehicles and parts.
- The auto sector is the poster child for integrated trade between the two countries as well as Mexico. North American auto parts cross all three border up to 7 to 8 times prior to final assembly of a vehicle[2].
- In terms of final assemblies, Canada supplies around 8 to 9% of what Americans consume annually, while Mexico is closer to 20%, with U.S. production satisfying about 50%.
- Given this high integration, the auto sector would face some of the deepest negative impacts from tariffs.
- By some estimates, average U.S. retail car prices could rise by roughly $3k, though that would depend on retaliation actions by both trading partners. In the event of strong counteractions, severe trade dislocations and significant economic consequences would occur, leading to collapsing demand in all three countries.

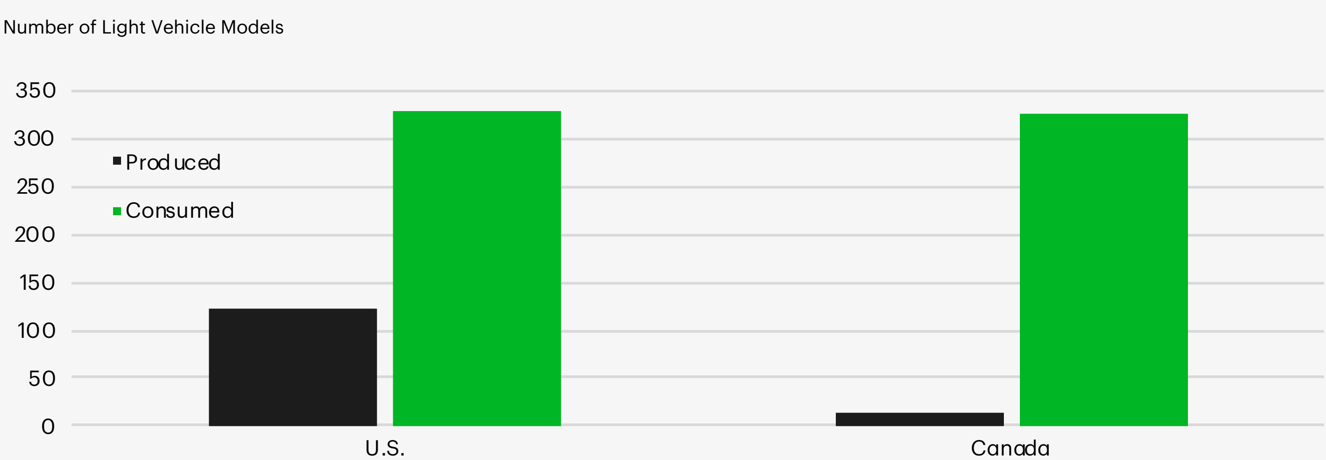
Could the U.S. replace Canadian auto supply through higher domestic production?

- The president-elect recently mused: "Canada makes 20% of our cars. We don't need that. I'd rather make them in Detroit."
- The statement exaggerates the share of vehicles sold in the U.S. that are produced in Canada by roughly 10 percentage-points. The U.S. could conceivably look to shift this production state-side, but significant near-to-medium term challenges to replacing Canada's annual exports of around 1.5 million units.
  - To fill that gap, the U.S. would need to raise production by more than 10% relative to current levels. Based on the average production capacity of 225k units for existimg assembly plants, that would mean roughly 6 new plants would be required. Full-onshoring of all non-U.S. production would require a 75% boost in U.S. production and more than $50 billion in new investment.

This doesn't factor in onshoring/expanding parts production in the assembly of those vehicles. Failing that, the U.S. would increase its reliance on parts imports.

  - This would come at a hefty price tag for U.S. domestic producers, especially in the full-onshoring scenario.
  - The other challenge surrounds vehicle choice for American consumers. It's one thing to boost production volumes. It's another to provide the diversity of vehicle choice. Consider that in the U.S., there were 328 different vehicle models sold in the U.S. last year, with only 121 of them being produced domestically.
- What if we re-engineer the president-elect's argument? Could Canada on-shore production to meet its domestic needs and deliver a shot in the arm to manufacturing.
- This would pose an even greater lift in reorienting factories, supply chains and user-choice. Canada currently only produces 14 models of vehicles, while consuming 325 models (figure 6). Absent a seismic shift in production methods towards efficient, high-variety, low-volume processes, Canadians would likely have to consume materially fewer varieties of vehicles to produce all of its own vehicles.

Figure 6: Neither the U.S. nor Canada Produces a Majority of Domestically Consumed Vehicle Models



Source: Wards Intelligence, TD Economics.

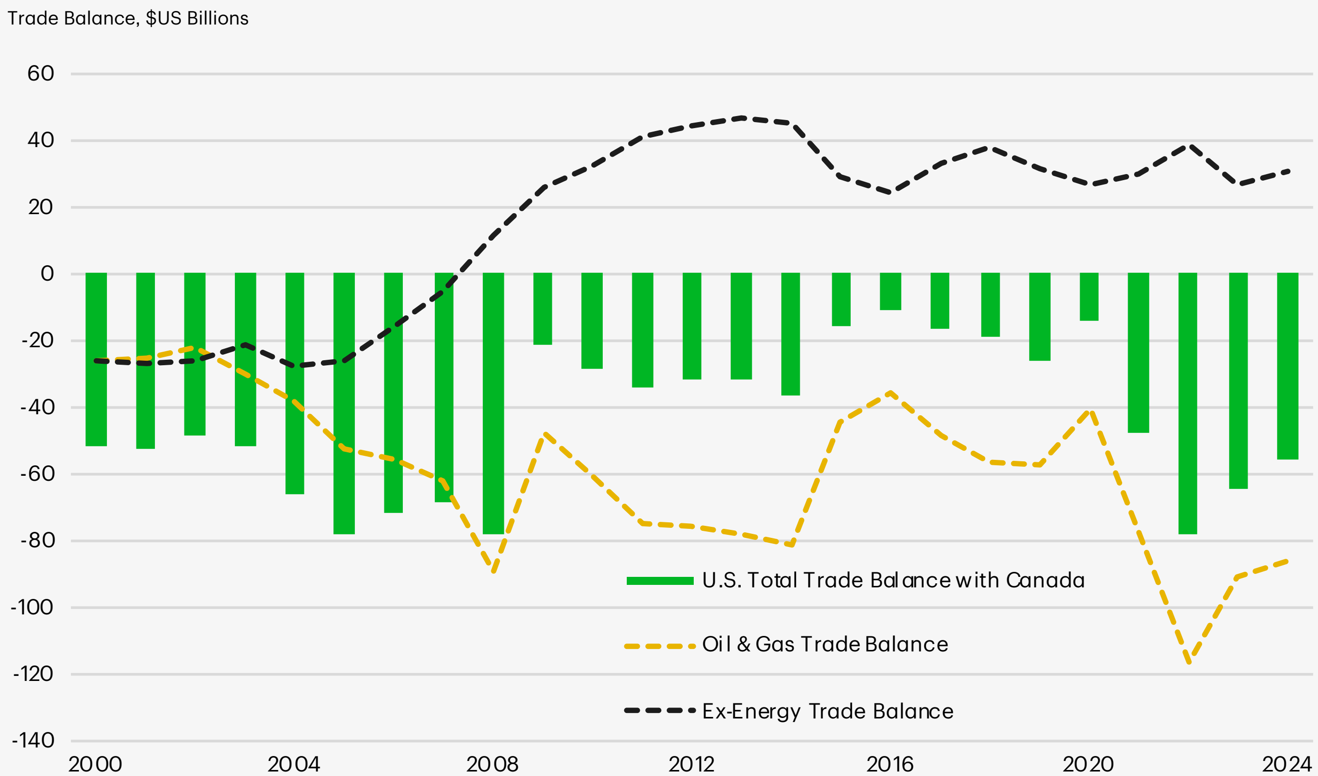
Energy accounts for all of the U.S. trade deficit with Canada

- The trade narrative shifts dramatically when trade flows are decomposed into energy and non-energy components.
- Last year, Canadian exports of energy products (oil, natural gas, power) to the U.S amounted to nearly $170 billion., or almost 1/3 of total shipments. In contrast, energy accounted for only 6% of all U.S. imports. Put simply, Canadian sources are critical to U.S. energy security.
- Remove Canadian energy exports from the equation and the trade story flips. Ex-energy, the U.S. enjoys a trade surplus with Canada of around C$60 (US$45 billion). (figure 7)
- Canada's trade advantage in energy has been rising steadily in recent years, most recently on the back of the Transmountain Pipeline Expansion (TMX) that, in turn, has sharply boosted Canadian oil exports to the U.S. west coast in addition to Asian markets.
- Canadian crude is a key supplier to U.S. refining, predominantly in the mid-West, with a steadily growing share in the Gulf coast. Since many refineries are built to process Canadian sour, heavy crude, it's difficult to shift away from that feedstock to alternative sources. This is true even from the U.S.'s Strategic Petroleum Reserve, which is largely comprised of conventional crude. Countries that could fill the gap are Mexico and Venezuela, but the latter would require lifting sanctions. Given Mexico already enjoys the second largest trade surplus with the U.S., this shift in demand would further widen that chasm, potentially allowing it to overtake China in the pole position.
- If tariffs were extended to Canadian crude oil, it could lead to an immediate jump in U.S. gasoline prices of as much as $0.30-0.70 per gallon. One of the most price-transparent and inflation-sensitive areas for consumers is the movement in gasoline prices.
- Elsewhere, in 2023, Ontario also directly supplied electricity to 1.5 million U.S. homes and is a major exporter of power to Michigan, Minnesota and New York.

Canada is an important supplier of critical minerals

- Beyond energy, Canada is also an important supplier of other key commodities, including metals and critical minerals. Notably, on the U.S. government's 50-item critical mineral list, the U.S. is a net importer of 43 of these minerals.

Figure 7: The U.S. Runs a Consistent Surplus with Canada if not for Energy Trade



Source: Census Bureau, TD Economics.

- While China dominates global production of more than half of the critical minerals outlined by the U.S. government, Canada has been supplying 50–80% of its needs in zinc, tellerium, nickel, and vanadium (figure 8).
- Outside of this, Canada has abundant reserves of cobalt, graphite, lithium, and rare earth materials that are core to reaching goals on clean energy technologies.

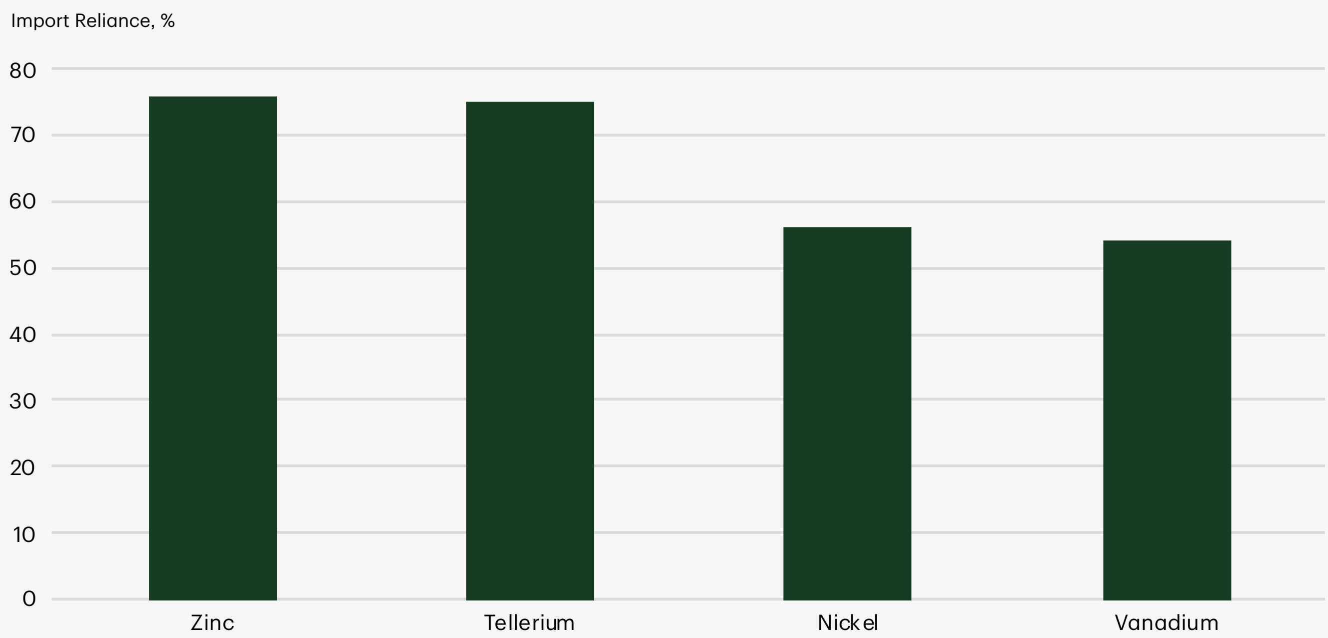
So, what about Trump's claim that the U.S. is subsidizing Canada by US$200 billion?

- It's unclear where President Trump or his team derived this number. In a recent press conference, he referred to it while discussing America's "massive" trade deficit with Canada. Yet, it is roughly 4 to 5 times the officially reported statistics.
- In any event, a trade deficit is not a subsidy. That would ring true, if for example, the U.S. government transferred US$45 billion annually to Canadian companies out of goodwill, but Americans are receiving value for the dollars spent in the form of goods and services. The trade deficit the U.S. runs with Canada reflects their economic outperformance and above-average spending of Americans, that's driving a hunger for energy products.
- Moreover, the greenback's reserve currency status also creates massive demand for U.S. financial assets, which in turn allows the U.S. to finance its global consumption at a lower cost.
- It could very well be that President Trump is also factoring in other costs that the U.S. incurs.
  - For example, the spending required to bring Canada's defense spending to 3% of GDP as per Trump's goal amounts to around US$45 billion.
  - But taking into consideration both the deficit and Canada's military spending shortfalls still leads to a sizeable gap vis-a-vis the $200bn estimate.
- On the other side of the ledger, often overlooked are the net benefits to the U.S. from Canada's status as a reliable supplier of energy and other goods that are used for both domestic consumption and profitable investment opportunities[1].

Bottom Line

Some of the datapoints in this report may come as a surprise to readers. The bulk of the U.S. trade deficit with Canada is owing to energy. Outside of that, the scales tip into America's favour. Even with this data, it's proven insufficient to fend off trade attacks that will extend well beyond this current bout. In mid-2026, the USMCA comes under review. Regardless of the deals that will eventually be struck between countries, the lesson that should be learned in Canada is that there can be no guarantee against future tariff attacks.

Figure 8: The U.S. Is Reliant on Canada for Key U.S. Critical Minerals



Source: USGS, TD Economics.

1. https://centreforfuturework.ca/wp-content/uploads/2025/01/Whos-Subsidizing-Whom.pdf
2. https://crsreports.congress.gov/product/pdf/IF/IF11387#:~:text=Across%20the%20region%2C%20hundreds%20of,products%2C%20according%20to%20industry%20representatives

Asset Class Analysis

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Quarter in Review

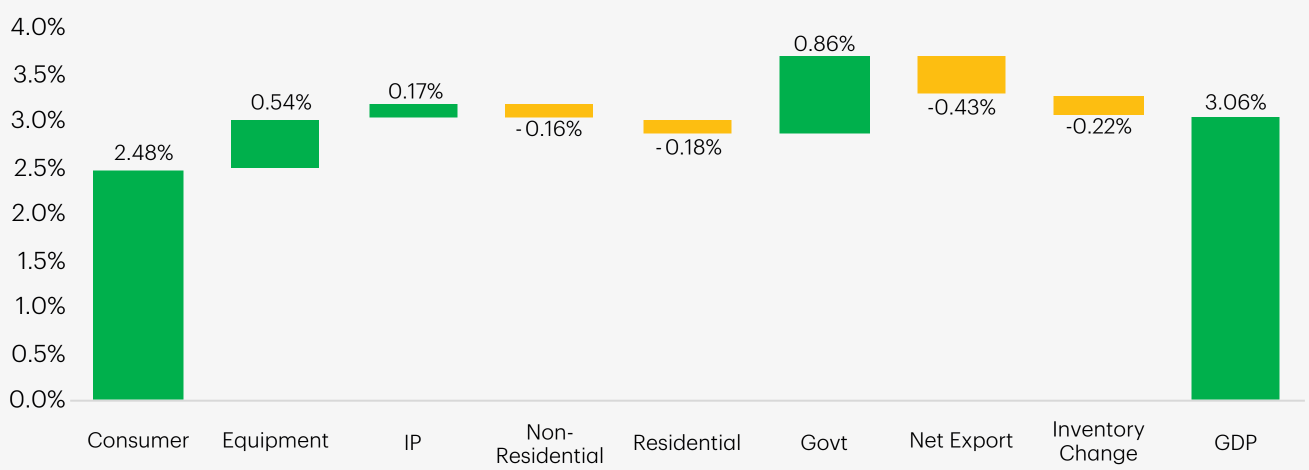
The party carried on

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

It was a banner year in 2024, with strong equity-market returns globally. The election of Donald Trump to a second term brought our attention back to government policies and the market implications. The potential for tax cuts and deregulation revived the hope for an extended economic cycle, while the threat of tariffs and tighter immigration policy stoked fears of higher inflation and debt sustainability. In the wake of the election, U.S. exceptionalism continued. GDP grew at an annualized rate of 3.1% in the third quarter, supported again by strong consumer and government spending (Figure 1).

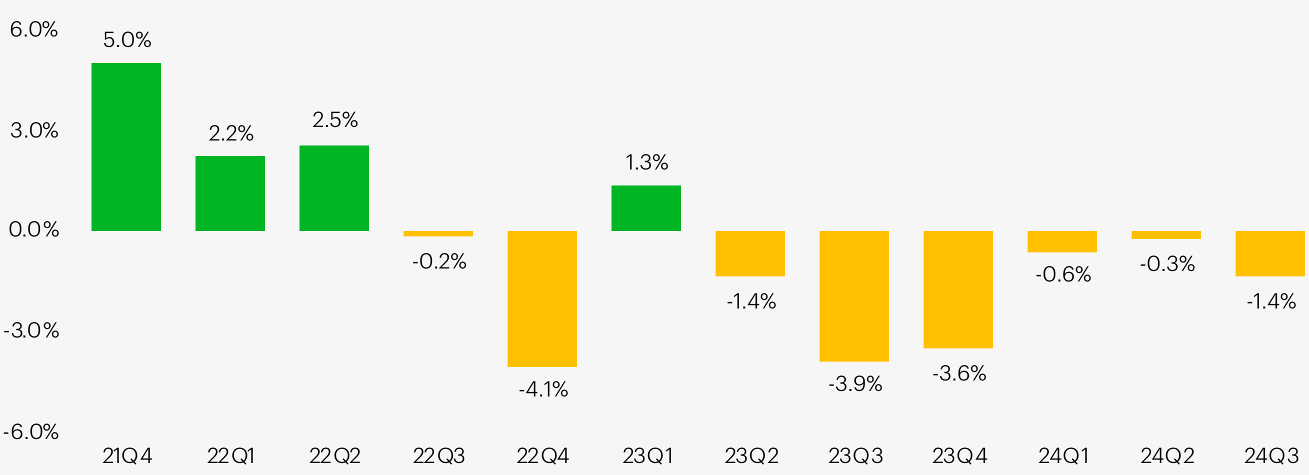
In Canada, meanwhile, economic growth continues to lag. Supported by the strongest population growth in the developed world, the Canadian economy seems to be growing. However, on a per capita basis, GDP growth has been negative for the past six quarters (Figure 2). This is one of the reasons the Bank of Canada is expected to remain dovish relative to the Federal Reserve.

Figure 1: U.S. Q3 GDP Growth Breakdown



Source: Macrobond, Wealth Investment Office as of December 31, 2024

Figure 2: Per Capita QoQ GDP Growth in Canada



Source: Macrobond, Wealth Investment Office as of December 31, 2024

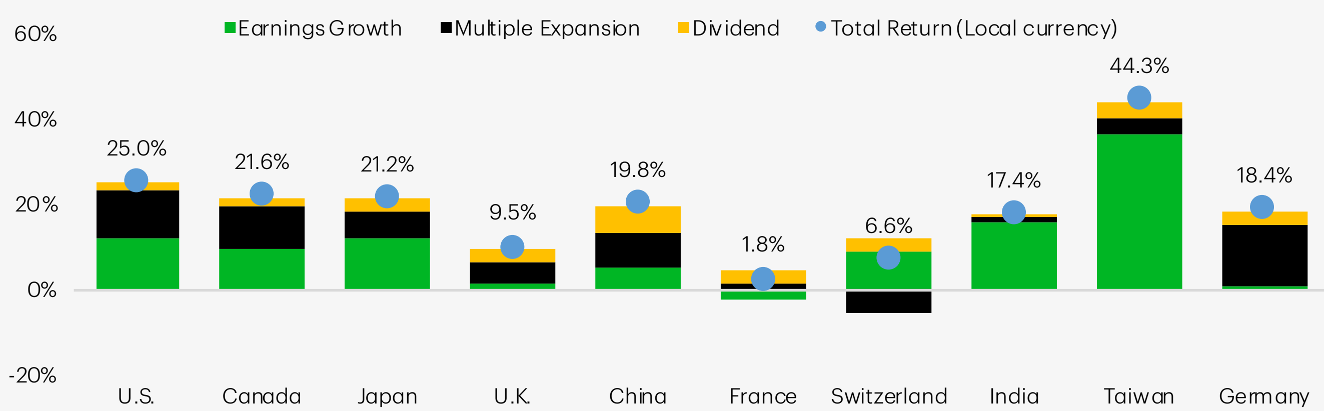
Last year, risk assets took centre stage. Figure 3 shows the equity-return breakdown for the 10 largest equity markets in the world. There are three points to note here. First, as our title suggests, the party in equity markets extended into 2024 after a strong 2023. In local-currency terms, seven out of the 10 markets generated a double-digit return. Eight markets saw multiples expand together with earnings growth. Second, outside the U.S., Canada, Japan and Switzerland in the developed markets all saw healthy earnings growth as well. Thirdly, Taiwan and India within emerging markets are seeing higher earnings growth than the U.S. in local-currency terms. And in India's case, forward earnings multiples struggled to expand in 2024, as the equity risk premium stayed below -2%, indicating extremely expensive valuations.

On one hand, it's fascinating that the most expensive (India) and cheapest (China) markets are both in the emerging markets; on the other hand, India's 2024 performance tells us that, even with extremely high valuations, earnings growth can still carry the market higher. The only prerequisite is that corporations will need to continue growing their earnings. This could provide us with some good perspective on how we think about U.S. equities today.

America is already great

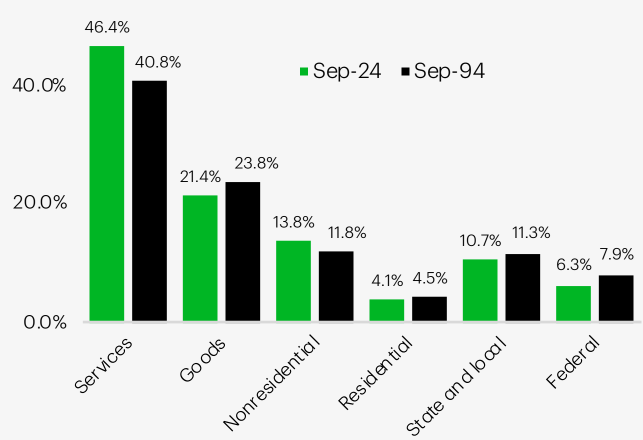
The U.S. continued to demonstrate exceptionalism during the quarter. However, it came with a blessing and a curse. We are all aware of the fact that U.S. consumers are the backbone of this economy. However, I think that the U.S. economy has shown itself to be structurally resilient against interest-rate changes and the global economic cycle. This is probably why the U.S. managed to stay healthy even as the rest of the world caught a cold during the latest rate-hiking cycle. Drilling into long-term GDP composition data, Figure 4 shows the weighting of different components of U.S. GDP today versus 30 years ago. It's clear that the U.S. economy has more exposure to the services sector compared to manufacturing. This might be the reason that, although manufacturing PMIs have indicated contraction for a long time, we have not yet seen a recession. Figure 5, meanwhile, shows the three-year

Figure 3: Top 10 Equity Markets Return in 2024



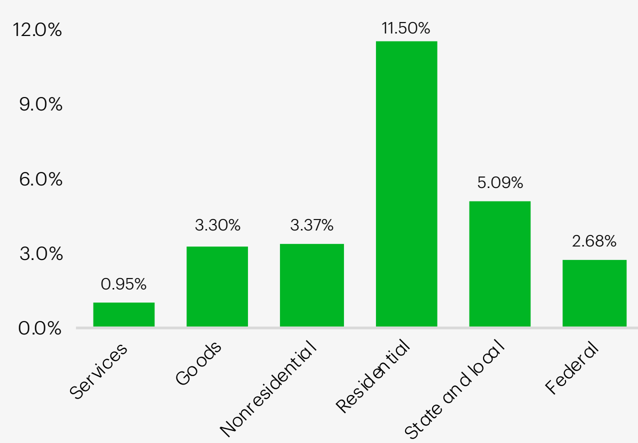
Source: Macrobond, Wealth Investment Office as of December 31, 2024

Figure 4: U.S. GDP Weighting in 2024 vs. 1994



Source: Macrobond, Wealth Investment Office as of December 31, 2024

Figure 5: U.S. GDP Component Growth Rate Volatility



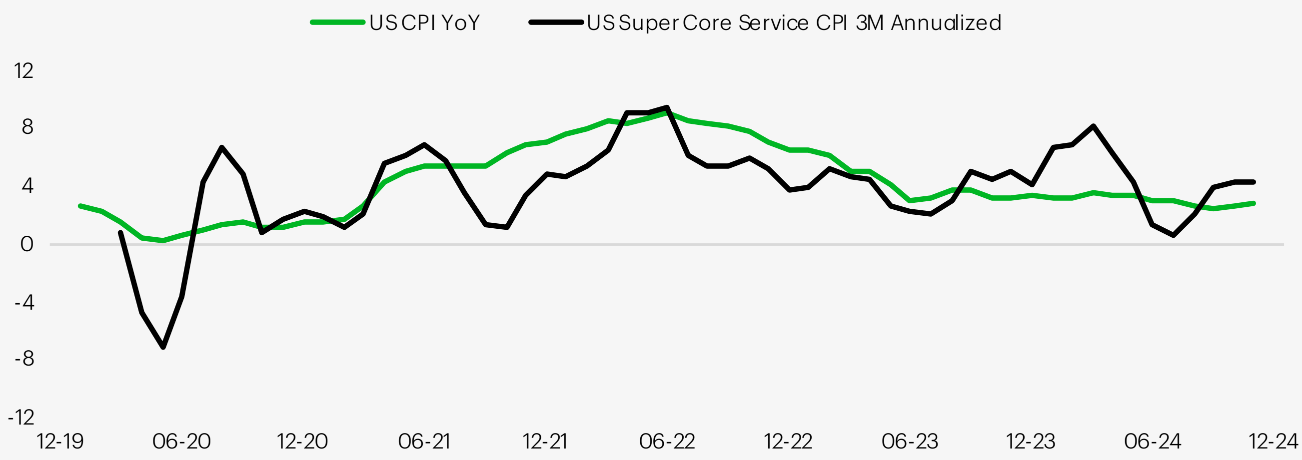
Source: Macrobond, Wealth Investment Office as of December 31, 2024

volatility in the growth rate for these components in today's GDP. From this, we can see that services are not just a larger part in the today's economy, they're also less volatile, with annual growth-rate volatility of merely 1%. That's the cornerstone of the resilient U.S. economy.

However, such a robust growth profile also brings a side effect. As it surprises us on the upside, inflation starts to creep up. Figure 6 shows that both year-over-year CPI measure and the super-core services CPI inflation measure in the U.S. moved higher during the second half of 2024. This directly impacted market expectations for the policy-rate trajectory. Over the course of Q4, the federal funds rate futures market shifted from pricing in more than eight cuts over this rate-cut cycle to below three. Together with renewed concern over U.S. debt sustainability, the higher inflation added to the yield rally we saw in Q4.

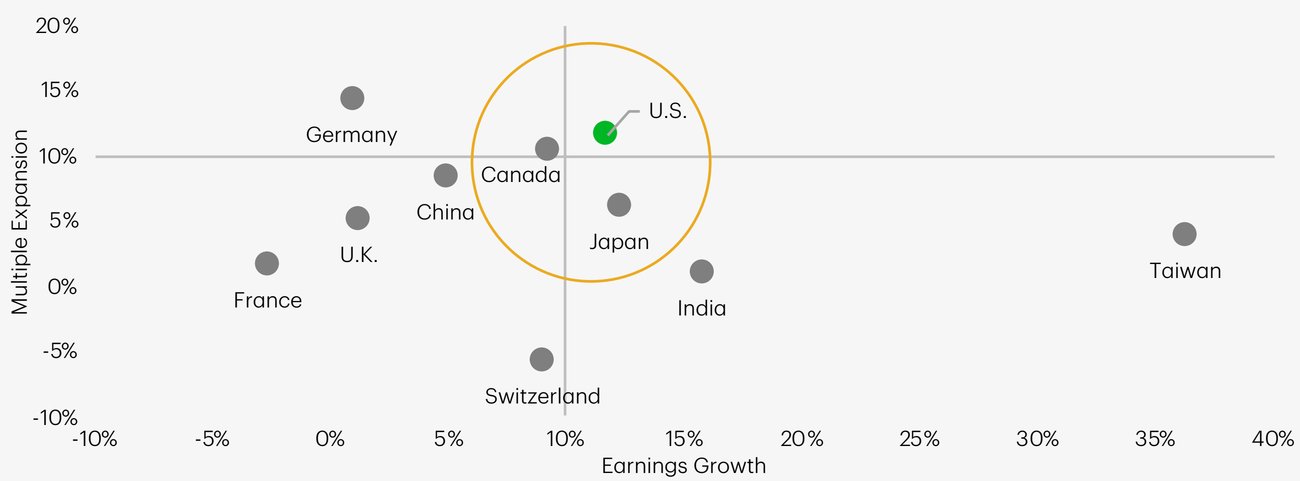
In the equity market, American exceptionalism is also loud and clear. Using the same data shown in Figure 3, we see that the U.S. is the only market in the world where we saw both double-digit earnings growth and multiple expansion in 2024 (Figure 7). A rising P/E multiple can be explained in part by investors becoming more confident in persistent earnings growth going forward. We can also see that, for extremely expensive countries like India, it's hard to be more confident (reflected in muted multiple expansion) about the longevity of earnings growth, since it's already staggeringly high. Therefore, high Indian equity returns have to come from the successful delivery of the high earnings growth. For higher-growth countries like Japan and Taiwan, the risk of monetary restriction and geopolitical conflict might keep investors from committing to higher prices relative to earnings. In the graph, the closest neighbours of

Figure 6: U.S. Inflation Gauge Creeping Up



Source: Macrobond, Wealth Investment Office as of December 31, 2024

Figure 7: Earnings Growth vs. Multiple Expansion



Source: Macrobond, Wealth Investment Office as of December 31, 2024

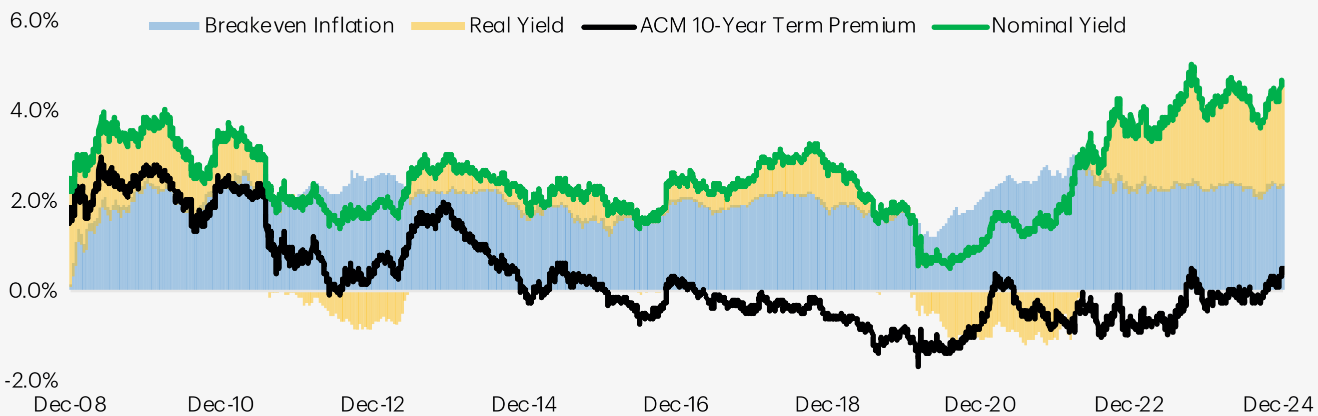
the U.S. are actually Canada and Japan, both with respectable earnings growth and healthy multiple expansion. More importantly, these two markets still offer attractive equity risk premiums in the 300 bps and 500bps context, a meaningful pickup compared to the U.S.

MAGA forces at play

As Trump's campaign gained traction, the markets were also on the move. First, with the expectation of cutting corporate and capital gains taxes, equity markets celebrated by bidding up small-cap and domestically focused companies. However, less tax revenue also means deteriorating debt affordability and made U.S. Treasuries less desirable. Of course, debt sustainability concerns don't signal that the U.S. is on the verge of a debt default. It just makes this remote possibility less remote, which is priced into the long-term Treasuries.

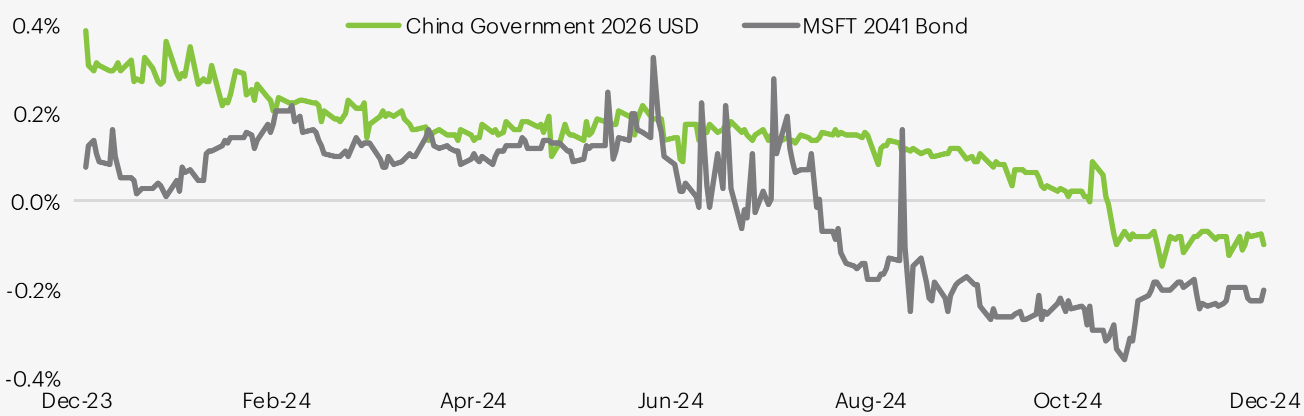
As a result, we did observe both the term premium (the premium investors demand for holding long-duration Treasuries versus rolling Treasury bills at the prevailing rate) as well as the real yield (the premium investors demand for taking inflation risk when investing in nominal bonds) moving higher (Figure 8). One way of explaining this is that the market now has embedded a credit-risk premium into the longer-term paper, although such a credit-risk component is still tiny. Another observation is that certain corporate or sovereign papers with ironclad credit profiles have started to trade with a negative spread against U.S. Treasuries of similar maturities (Figure 9). Although this phenomenon is by no means common or new, together with Trump's policy chatters, it just confirms that concerns about government debt and fiscal deficits are getting real in the U.S., regardless of which party is in power. These moves should be closely monitored as Trump's policy announcements start to hit the newswire. It could challenge the notion of risk-free assets today and reset how we evaluate all financial assets.

Figure 8: 10-Year Yields Moving Higher in Q4



Source: Macrobond, Wealth Investment Office as of December 31, 2024

Figure 9: Spread Over U.S. Treasury Benchmarks



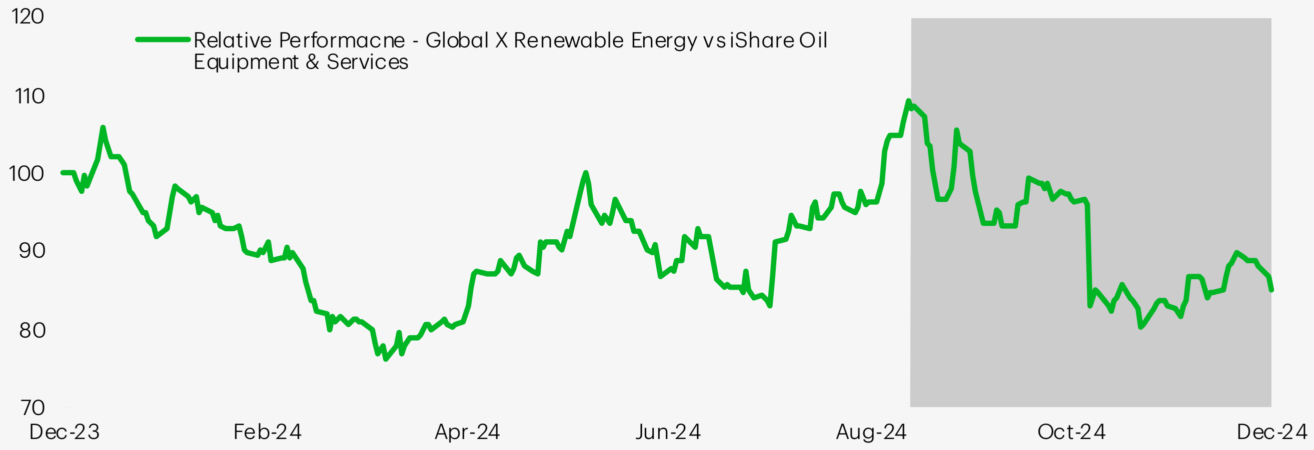
Source: Macrobond, Wealth Investment Office as of December 31, 2024

Another direct outcome of higher yields and a more hawkish Fed is the stronger U.S. dollar, especially when many global central banks are still knee deep in a rate-cutting mode. The dollar's rally was truly phenomenal in Q4: the DXY U.S. dollar index, which measures the dollar's worth against six other major currencies, went up almost 8% over Q4. A strong dollar is bad news for many emerging-market economies that rely on capital inflows. This is why we saw emerging-market currencies suffering depreciation, many of which approached or hit multi-year lows.

To deliver on his "Make America Great Again" policy agenda, Trump is also widely expected cut taxes and broadly deregulate, unleashing the markets' "animal spirits." Bitcoin's blockbuster performance in the quarter is one example of this. Besides that, Trump is also viewed as a supporter of the oil and gas industry and might roll back some of the climate-related policies from the Biden administration. Figure 10 shows the relative performance of the Global X Renewable Energy ETF against the iShare Oil Equipment and Services ETF. We can see the significant underperformance of the former as we moved through the election cycle.

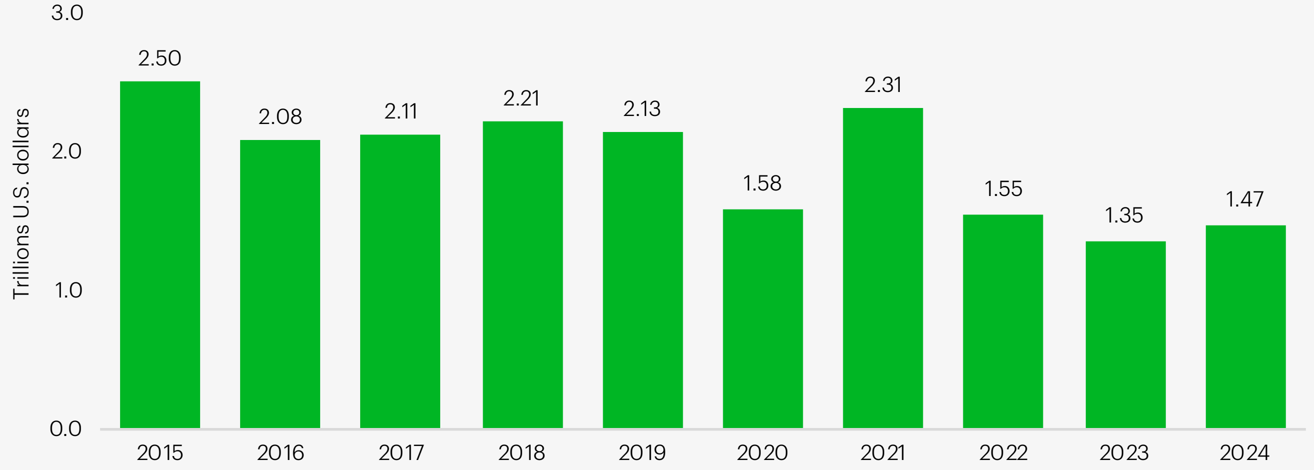
The other hope is that a business-friendly government under Trump could revive corporate investment, capital-raising and M&A activity. In previous publications, we have discussed the significant amount of dry powder that private-equity and -debt managers are holding in this tepid deals environment. Figure 11 shows that, except for the outlier year of 2021, U.S. M&A volume has not surpassed the $2 trillion mark in over five years. There are signs of early enthusiasm regarding the M&A revival already. We observed that, in Q4, merger arbitrager hedge funds saw significant performance improvement, reflecting heightened investor confidence with regards to deal completion.

Figure 10: Relative Performance of Renewable Energy vs. Oil Equipment & Services



Source: Macrobond, Wealth Investment Office as of December 31, 2024

Figure 11: Corporate M&A Volume from 2015 to 2024



Source: Macrobond, Wealth Investment Office as of December 31, 2024

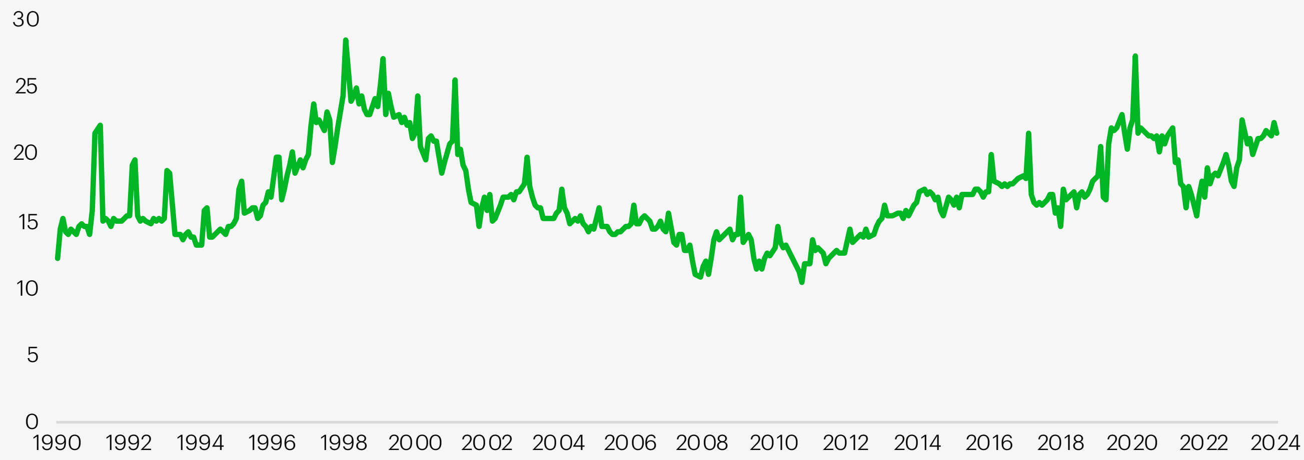
Market exuberance in the U.S. vs. labour exodus in China

In November, Taylor Swift played six concerts in Toronto. The total economic impact is estimated to surpass a staggering $280 million for the city. Globally, Swift's Eras Tour brought in over $2.2 billion, making it the highest-grossing tour of all time. The resale tickets were in high demand, and we heard stories about the jaw-dropping mark-ups that fans paid for these hot commodities. The equity market is no different; as sentiment runs high and returns are good, positioning is crowded, and things also get more expensive.

First, let's look at a few valuation metrics. Figure 12 shows the price-to-earnings (P/E) multiple of S&P 500 since 1990, based on forward 12-month estimated earnings. It shows that the P/E ratio continued to rise in 2024 to 21.6x at the end the year, its highest level after the dot-com era when removing the outlier Covid period in 2020. Many agree the market is expensive. However, valuation multiples should never be considered alone. Sometimes, they should be viewed in the context of what risk-free assets can offer (i.e., 10-year U.S. Treasuries).

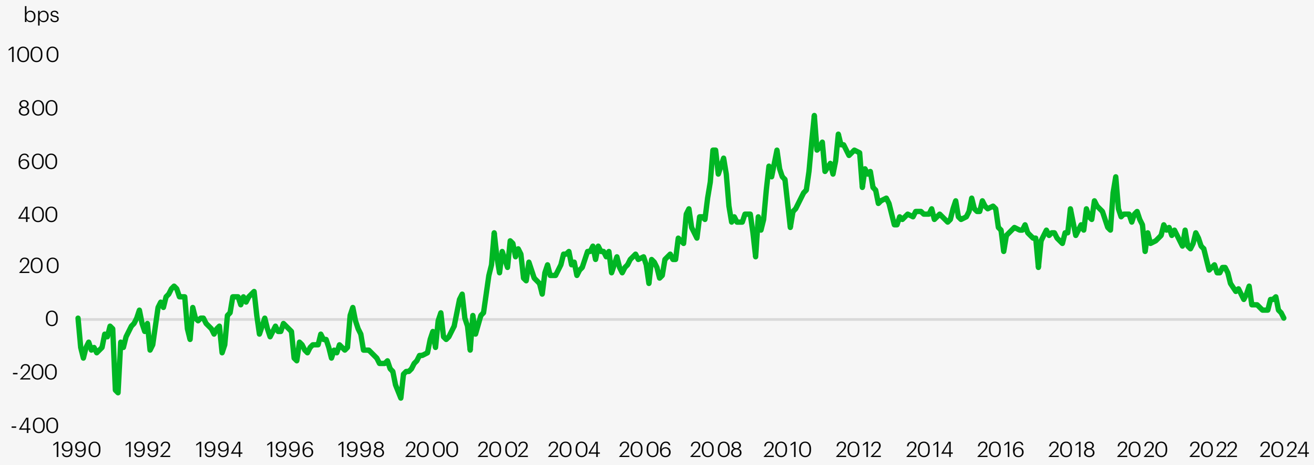
That brings us to Figure 13, where we show the equity risk premium of the S&P 500 since 1990. There are two takeaways here. First, after Covid, the equity risk premium trended down, confirming the diminishing return investors demanded to hold the S&P 500. By the end of 2024, it stood at only 6 bps. No doubt, expectations are high and the S&P 500 is expensive. The second thing to note is that, if we look back to the 1990s, we've already seen an environment where the equity risk premium was even lower and stayed negative for a prolonged period. This coincided with the second longest economic expansion in the U.S. and was characterized by robust productivity growth mostly under the Clinton administration.

Figure 12: S&P 500 Price to Forward 12-Month Earnings Multiple



Source: Macrobond, Wealth Investment Office as of December 31, 2024

Figure 13: S&P 500 Equity Risk Premium



Source: Macrobond, Wealth Investment Office as of December 31, 2024

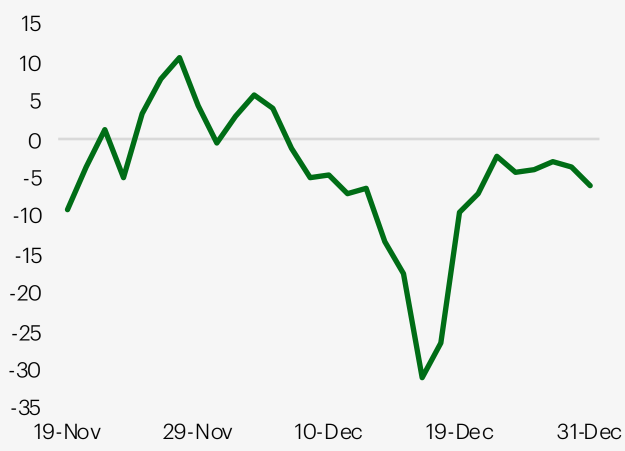
There are key differences between the economy today and back then, but the key question is whether the equity risk premium can go even lower into negative territory. I guess the answer will have to start with "it depends". On one hand, we should be opportunistic about innovation, given the emergence of AI and endless downstream opportunities that could come with it. On the other hand, we are more likely moving into a new cold war than coming out of one, as in the 1990s. Looking ahead, the world will likely become more segregated rather than unified, not to mention the fact that fiscal deficits are more likely to stay high rather than revert to a surplus as in the '90s.

Borrowing from Warren Buffett's words of wisdom, "in the short term, the market is a voting machine." It really depends on the collective narrative from the crowd — are we voting to focus on the long-term growth themes or temporary disruptions from economic, policy or geopolitical surprises. In the long run, however, the market is a weighing machine. We should evaluate individual opportunities and focus on the ones that are not only beneficiaries of innovation and productivity growth but are also insulated from the risks of deglobalization and fiscal deficit continuation. Or, conversely, we may find beneficiaries of these structural trends.

We mentioned that Bitcoin is viewed as a winner in the lead-up to the Trump administration. And there's definitely some hot air lifting the cryptocurrency's price. BlackRock's iShare Bitcoin Trust (IBIT) has been the most successful ETF launch in history. Not only did the ETF grow to a $50-billion behemoth over the course of 2024, its options also started trading on November 19 — instantly becoming one of the most active ETF options, with daily option notional reaching $1.9 billion in December (Figure 14).

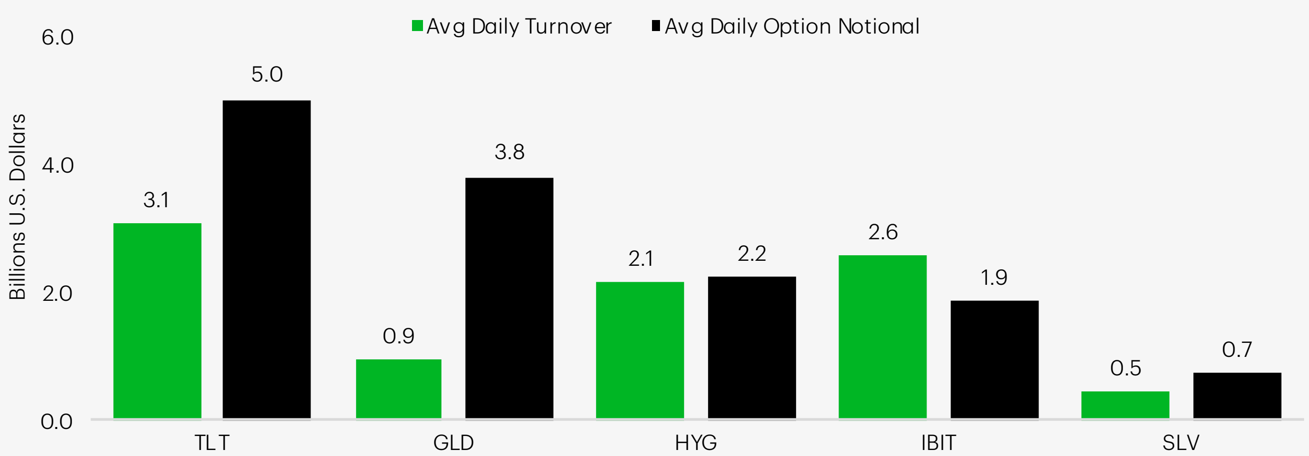
Some of the ETF's statistics caught our attention. First, the average trade size of IBIT is only $17,056, making it the smallest among the most active ETFs, most of which have many large institutional block trades. That's an indicator that there might be more retail flow. For comparison, another speculative ETF like SLV (for traders who want to bet on the price of silver) has a larger average trade size of $24,609. The other data point of note is in the option skew of IBIT. Right after the options started trading, the implied volatility of out-of-the-money calls was higher than the out-of-the-money puts most of the time and the skew went below -30 (Figure 15). For reference, usually, option skew would be positive due to risk aversion among investors, valuing downside protecting put options more with higher implied volatility. In short, it is a sign of irrational exuberance.

Figure 15: 25-Delta Option Skew for IBIT: Implied Volatility of 25-Delta Put – Implied Volatility of 25-Delta Call



Source: Macrobond, Wealth Investment Office as of December 31, 2024

Figure 14: December Daily Turnover & Option Notional



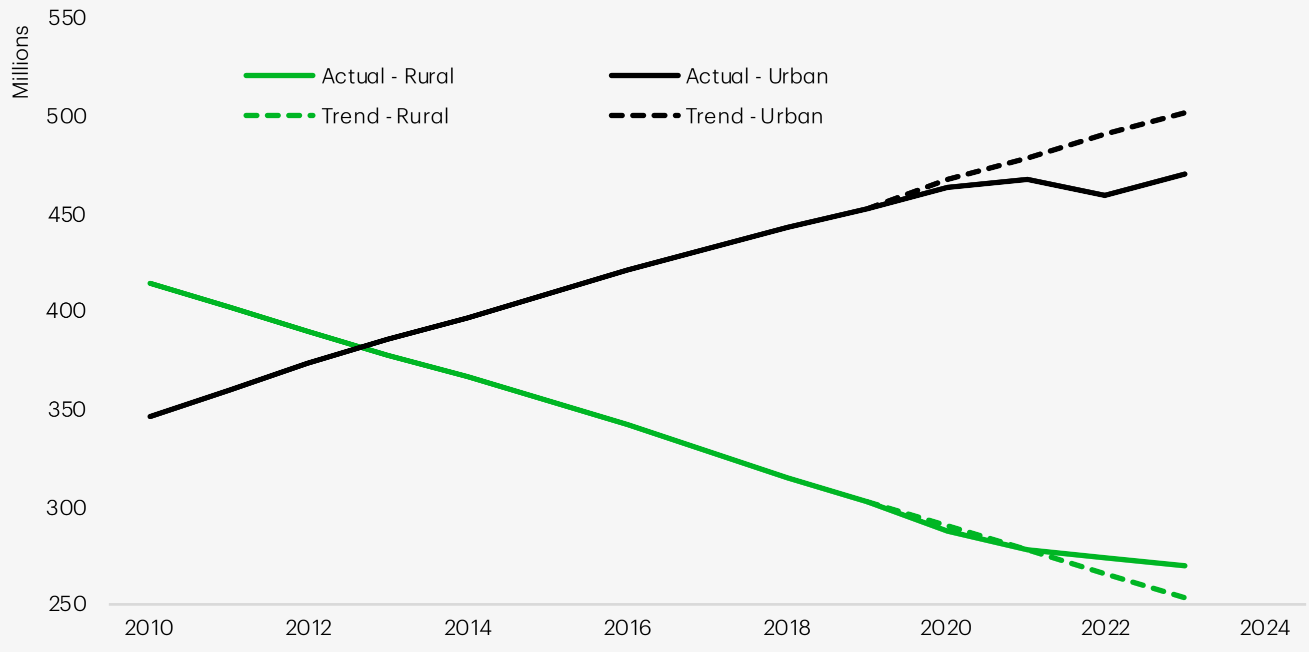
Source: Macrobond, Wealth Investment Office as of December 31, 2024

While the U.S. market was exuberant in Q4, China's economic and market challenges remain. The announced fiscal and monetary easing policy measures failed to meet market expectations. One by one, cities have gradually removed restrictions on property purchases, hoping to revive sales activity. However, year-to-date residential sales as of November stood at 7.5 trillion renminbi, still about 20% below the level from one year ago. The fear is that the damage from a prolonged economic slowdown and the negative wealth effect from a softening property market will not only hit consumer confidence, but could also reverse the structural trends that have benefited China in the past, such as urbanization and the rise of the middle class.

Figure 16 shows total urban and rural employment in China now compared to pre-COVID. We can see that, from 2010 to 2019, China's urbanization was going strong, which fuelled the growth of the middle class, the service sector, real estate and consumption. However, since Covid, in absence of sizeable fiscal stimulus, urban employment growth stalled, falling below trend, while rural employment has been growing above trend.

One explanation is that discouraged urban workers are moving back to rural regions to seek employment and live a more affordable life. This is reasonable, given that the hardest-hit real estate development sector employs primarily migrant workers from rural areas for urban construction work. As of 2023, total urban employment was 32 million below trend while rural employment overshot trend by 16 million. The implication could be chilling. First, urban employees are likely to contribute more to the economy than their rural counterparts. On an aggregate basis, this reverse migration trend is a negative shock for consumption. Second, there are still 16 million workers missing from the workforce. The negative impact to GDP could be detrimental if the trend continues.

Figure 16: China's Urban & Rural Employment vs. Trend



Source: Macrobond, Wealth Investment Office as of December 31, 2024

Outlook on Fixed Income

Modest Underweight

Stable, Attractive Income Is Back on Offer

Aurav Ghai, Senior Fixed Income Analyst | TD Wealth

Government bond yields remained the most topical driver of bond markets over the fourth quarter and 2024 broadly, as central banks shifted their attention from taming inflation to maintaining healthy growth and employment. This shift is more apparent in Canada and Europe, where both economies are more vulnerable than the U.S. Over the fourth quarter and as a part of this shift, Canada and the U.S. received bigger-than-expected policy rate cuts but, surprisingly, government bond yields still shot up. If 2024 showed us that monetary policy isn't everything driving bond-market returns, this year seems likely to cement that lesson by amping up the focus on fiscal policy and other government measures.

Government bond markets had another tough year finding direction and few of us expected to see the riskier segments of fixed income become the top performers of 2024 (Figure 1). This has been the case for the past two years running, highlighting that market participants, given the lack of recession or another financial crisis, were willing to take on the risk. This risk tolerant behaviour stretched valuations for segments like Canadian and U.S. high yield to all-time highs so it's unlikely they'll have much fuel left to deliver another stellar performance. Whatever 2025 brings, it definitely won't be a smooth ride.

Overall, we believe central banks will ultimately continue lowering short-term, or front-end, rates as they try to return to neutral monetary policy conditions, but the path could be bumpy and it will be different for every region around the world. We may be in a rate-cutting cycle but the spike in government bond yields in the fourth quarter reminds us that we need to be prepared for anything. As we have written many times before, no easing cycles are alike and, given that central banks are still digesting a host of uncertainties, policy rate forecasts might as well be written in sand. Whether we like it or not central banks globally are trying to manage the impact of geopolitical risks, the slowing labour market, the reduced pace of U.S. disinflation, and policies from the new U.S. government. We expect volatility to continue and caution to set the tone for 2025. The good news is that there will be ample opportunities for fixed income portfolios to reap the rewards of active management.

Figure 1: Fixed Income Returns

Canada Gov	Canada IG	Canada HY	Canada RRB	US Gov	US IG	US HY	US IL	US Loans	Global Gov	Global IG	Global HY	US MBS	EMD (USD)

2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
22.0%	18.3%	19.2%	8.3%	13.2%	3.8%	16.6%	10.0%	2.1%	14.9%	13.0%	6.0%	-0.9%	12.6%	10.8%
15.0%	14.0%	19.0%	8.2%	9.3%	2.8%	16.1%	8.5%	2.0%	13.6%	11.5%	5.2%	-6.2%	12.5%	8.1%
14.9%	11.0%	16.5%	6.2%	9.2%	2.7%	15.1%	7.4%	1.5%	13.2%	9.0%	5.1%	-9.9%	12.1%	8.1%
12.3%	10.2%	15.9%	5.8%	8.6%	2.0%	9.9%	7.0%	1.1%	13.2%	8.7%	4.7%	-11.1%	9.7%	7.2%
11.1%	8.9%	11.7%	0.8%	8.4%	2.0%	9.7%	5.9%	0.3%	11.6%	8.7%	3.6%	-11.2%	8.8%	7.0%
10.1%	8.3%	10.6%	0.8%	8.2%	1.5%	5.9%	5.2%	0.2%	10.4%	8.3%	1.8%	-11.7%	8.4%	5.1%
9.4%	8.2%	10.4%	0.8%	7.6%	0.9%	5.7%	3.6%	0.0%	8.8%	8.1%	-0.8%	-12.3%	8.2%	3.7%
7.6%	7.2%	7.3%	-0.7%	7.1%	0.3%	4.8%	3.4%	-0.5%	8.1%	7.5%	-1.1%	-12.3%	7.5%	3.3%
7.3%	6.5%	6.2%	-0.9%	6.0%	-0.1%	3.7%	3.3%	-1.5%	8.0%	5.7%	-1.1%	-12.6%	6.1%	2.7%
6.5%	5.4%	5.3%	-2.0%	4.4%	-0.5%	3.7%	2.2%	-1.8%	7.7%	5.2%	-1.3%	-12.8%	5.9%	2.0%
6.5%	5.1%	3.4%	-2.0%	3.7%	-1.7%	2.9%	2.0%	-2.8%	6.5%	5.0%	-1.8%	-14.3%	4.1%	1.8%
6.3%	3.2%	2.9%	-6.0%	3.2%	-2.4%	1.5%	1.8%	-3.0%	6.4%	4.2%	-2.2%	-14.6%	3.8%	1.0%
5.9%	2.4%	2.8%	-9.3%	2.5%	-2.8%	0.9%	1.7%	-3.3%	6.1%	3.8%	-2.3%	-16.3%	3.2%	0.1%
4.1%	2.1%	2.6%	-13.1%	1.2%	-4.5%	0.8%	0.7%	-6.1%	5.6%	1.8%	-3.0%	-19.0%	2.0%	-0.5%

Source: MorningStar, Wealth Investment Office, as of December 31, 2024.

Even with the global move towards easing, government yields will likely remain higher than pre-COVID levels and for longer than expected. Given the overwhelming macroeconomic uncertainty, bonds are offering yields, or income, on the higher side of the historic range. After quite a dry spell, this reliable income source has once again become an important component of the broadly diversified portfolio, with the added benefits of limiting exposure to the higher price volatility of equities and offering downside protection. (Figure 2).

- With the start of the rate cutting cycle firmly in hand in Canada and the U.S., fixed income markets delivered relatively attractive returns over 2024—the FTSE Canada Universe Bond Index was up about 4.23%. We maintain our modest underweight view on fixed income as we believe returns going forward will largely be in line with average historical levels, and mainly composed of the coupon.

- We hold a neutral view on domestic government bonds. Canadian government bonds are attractive at current yields and offer opportunities for income generation and downside protection, but we expect yields to be volatile in the short term given the uncertain outlook for the economy, potential U.S. tariffs, and the monetary policy end point. Importantly, Canadian government bond yields have remained highly correlated to U.S. government yields which are affected by circumstances that don't tend to impact Canadian bonds at all.

- We remain modest overweight on investment grade (IG) credit. IG spreads are still tight and we believe Canadian IG corporate bonds, with their slightly wider spreads, are more attractive than U.S. IG. We expect softening economic conditions to widen spreads (indicating the market is pricing in more risk) but only by a modest amount given continued expectations for a soft landing. We remain focussed on high quality credit—companies with robust balance sheets—and we expect technicals to remain supportive and healthy yields to mitigate losses from price volatility.

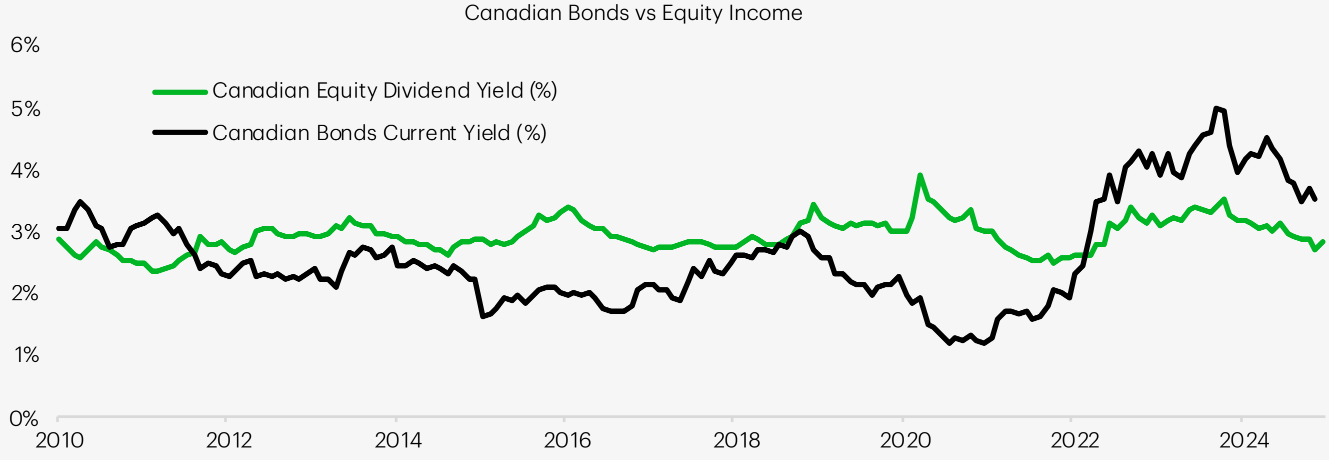
- We hold a neutral view on high yield (HY) credit. HY spreads are extremely tight, reflecting their rich corporate valuations, and have little room to tighten further. We expect HY spreads to widen if the growth outlook is softer than anticipated although the improved quality of this universe and lower expected net issuance should keep spreads from returning to previous recessionary levels. We continue to favour the higher quality cohort of the HY credit market and floating rate loans (also known as bank loans or leveraged loans) offer better relative value than traditional fixed-coupon high yield bonds.

Government bonds

Fiscal excesses drove inflation in 2021 and 2022, which triggered the central bank tightening cycles in 2022 and 2023. Last year policy rates crested and began their descent. We believe the key theme for 2025 will be the expectation for, or rather the speculation around, the endpoint for central bank easing cycles. Elevated levels of government bond issuance will persist and become another major theme for fixed income investors.

As always, one of the most important factors in the global government bond universe is the U.S. Federal Reserve (Fed). After starting its easing cycle in September, the Federal Open market committee (FOMC) eased rates for the third time in December, bringing Fed funds to 4.25%-4.50%. However, forward guidance turned unexpectedly hawkish on the back of heightened uncertainty around inflation. Based on current data, our expectations are in line with the Fed's December projections, or the dot plot, which

Figure 2: The Good Old Days of Income Are Back



Source: FactSet, Wealth Investment Office, as of December 31, 2024. S&P/TSX Composite index is used as a proxy for Canadian equity and Bloomberg Canada Aggregate Bond Index is used as a proxy for Canadian bonds.

suggests a long pause, probably in the first half of 2025, amid increased government policy uncertainty especially around potential tariffs, sticky core inflation, and the resilient economy. Bear in mind that the Fed's movements and forecasts are based on the latest economic data (data dependent) and any change in data could upend current projections. Let's not forget our lessons from the last couple of years: no one has been able to consistently and accurately forecast macro-economic details.

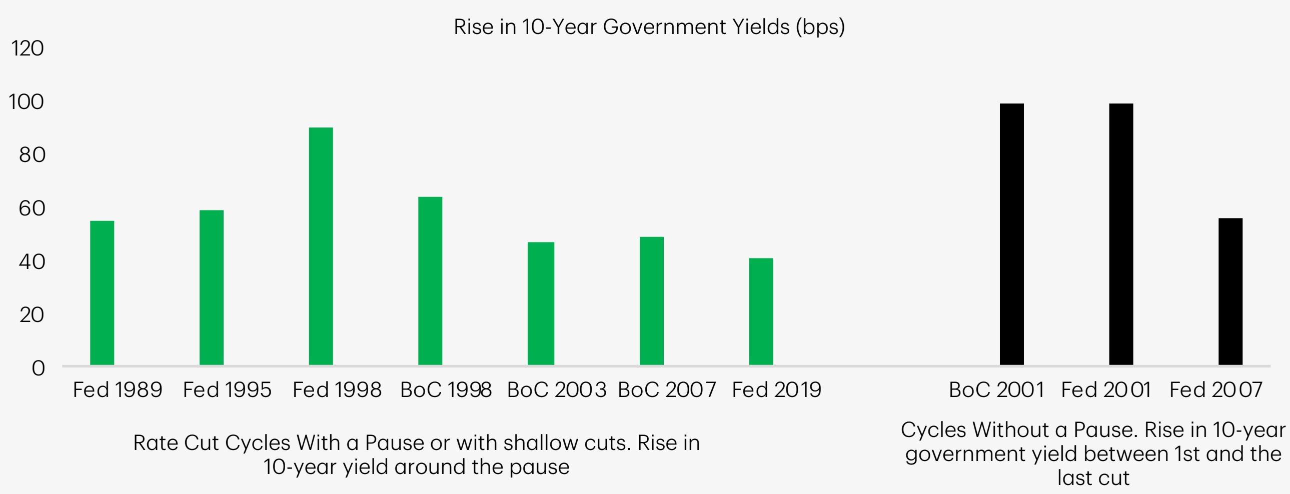
The consistent theme for U.S government yields will be volatility and a murky path forward, at least in the near term. The ongoing uncertainty around the Fed's neutral policy rate will keep investors cautiously interested and speculating because a lot of buyers for higher yielding government bonds are waiting for either volatility to subside or higher yields to compensate for the heightened volatility.

The Bank of Canada (BoC) cut the overnight rate by 50 basis points (bps) in December and by 175 bps since it started easing in July 2024, taking the policy rate to 3.25%. But markets were caught off-guard when the BoC shifted in December and signalled a more gradual approach going forward as it tries to figure out the best neutral rate for the economy. Now that the BoC is at the top of its estimated neutral range, it can slow the pace of easing and we believe it will revert to cutting in 25-bp increments, possibly with a pause. Potential U.S. trade talks and the impact of new immigration policies on economic growth will likely affect the near-term outlook for the policy rates. Canadian government yields remain highly correlated with U.S. government yields; even after 100 bps of rate cuts the difference between U.S. and Canada 10-year government yields has hardly changed.

We are neutral on Canadian government bonds. As expected, Canadian yields outperformed U.S equivalent yields when rate policies for the BoC and the Fed diverged. But we need more evidence supporting much lower terminal rates relative to the U.S. for this divergence to continue and, in its absence, Canadian yields will be at the mercy of the more volatile U.S. government yields. We believe it's still best to take a longer-term view on government yields because Canada and other non-U.S. developed economies could still experience a more difficult landing than the U.S. After the strong performance of the past quarters, the outlook for Canadian government bonds is now more balanced over the medium to long term and therefore we encourage everyone to take a risk-managed and opportunistic view of government bonds and yields (or interest rate duration).

When it comes to government bonds and the continued bouts of volatility, active management is the way to go. Since 2021, only actively managed interest rate duration that has tapped into tactical opportunities has been able to perform well. When we look at past easing cycles for the BoC and the Fed, most had a "soft landing" narrative heading into the first cut. As the cuts progressed, however, the narrative began to change. Several times during past easing cycles, initial cuts reignited economic growth and central banks were forced to put further cuts on hold or end the cycle with fewer cuts than expected—for example in the 1995 Fed rate cut cycle (Figure 3). During these cycles bondholders suffered painful drawdowns and we experienced something similar in the fourth quarter when expectations of shallow cuts or a pause drove yields higher. Even if we consider the past easing cycles with no pause or steeper cuts, like the 2001 or 2007 Fed rate cycles, government yields were volatile and increased between rate reductions.

Figure 3: Government Yields Volatile in Past Easing Cycles



Source: FactSet, Wealth Investment Office, as of December 31, 2024.

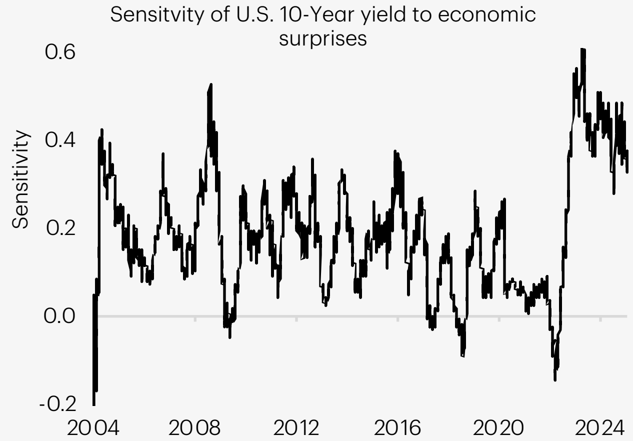
Therefore the notion that government yields will only move down during the policy easing cycle is misplaced. Government yields can be highly volatile irrespective of the type of the easing cycle we are in.

There are just too many moving parts to commit to any particular outcome right now. To successfully navigate this cycle and economic reactions to policy changes, we need to be able to adjust our approach on the fly.

Key Themes for Government Bonds

- Economic Surprises Still Driving Government Yields. While a slew of negative economic surprises led to an increase in expected policy cuts and drove government yields lower from May to mid-September, the dynamic flipped in the fourth quarter and the U.S. 10-year government bond yield ended almost 70 bps higher overall. The Fed has delivered 100 bps policy cuts since September and government bond yields rose almost 100 bps—despite consistent messaging from the Fed that the medium- to long-term policy rate should be 3% and 150 bps lower than the current level. Government bond yields have been highly volatile and are reacting to economic surprises (Figure 4). But the sensitivity of government yields towards economic surprises has jumped significantly since 2023 and, importantly, we don't expect this relationship to weaken in the coming months.

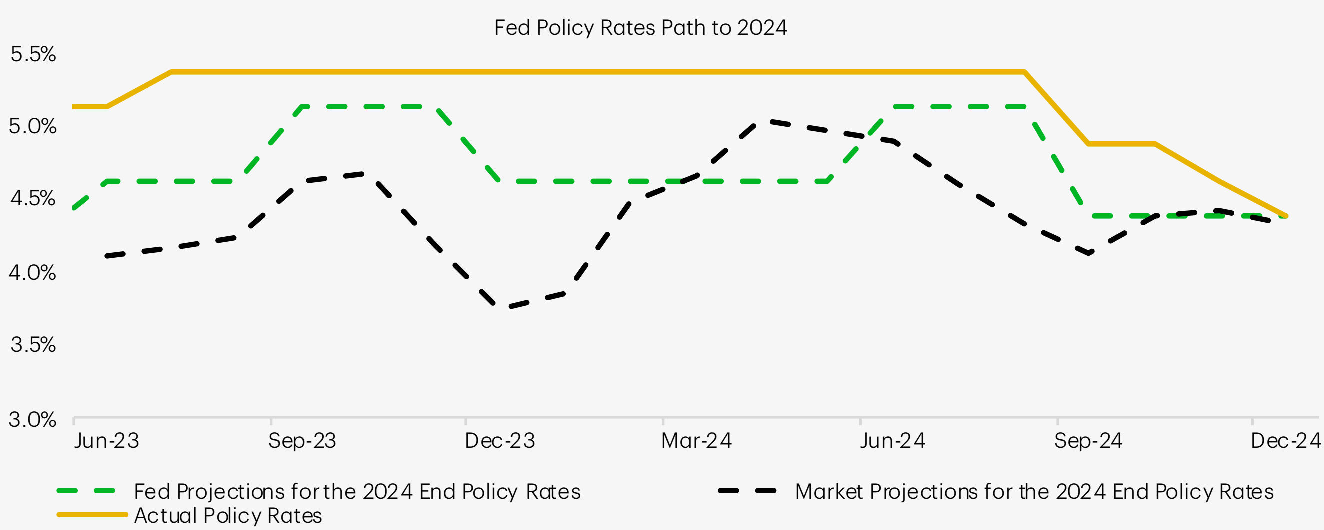
Figure 4: Government Yields Still Reacting to Economic Surprises



Source: FactSet, Wealth Investment Office, U.S. Citigroup Economic Surprise Index as of December 31, 2024.

- Policy Rate Projections and Market Expectations are Written in Sand. A potential policy shift under Donald Trump's administration has increased uncertainty regarding the outlook for U.S. monetary policy. This may lead to a wider margin of errors in forecasts for the policy rate. Historically, and particularly in recent years, the Fed's dot plot projections have often failed to predict the actual rates. This tendency stems from the Fed's data-dependent approach and unanticipated changes in inflation and growth. Forward rates, which typically reflect average market expectations, have struggled to accurately predict realized rates and have experienced heightened volatility (Figure 5). For instance, in December 2023, the 1Y1M forward rate—a one month rate starting one year in the future—was more than 65 bps below the December 2024 policy rate, while the dot plot had projected a rate 25 bps higher than the actual outcome. The significant discrepancy underscores the reality that, since we still can't see into the future, missing the mark on rate forecasts should not be surprising. As a result, it is essential to adopt a tactical approach when investing in government bonds, especially during periods of monetary policy shifts. This strategy can better position investors to navigate the challenges ahead.

Figure 5: FOMC, Market Projections, and Actual Policy Rate for End 2024

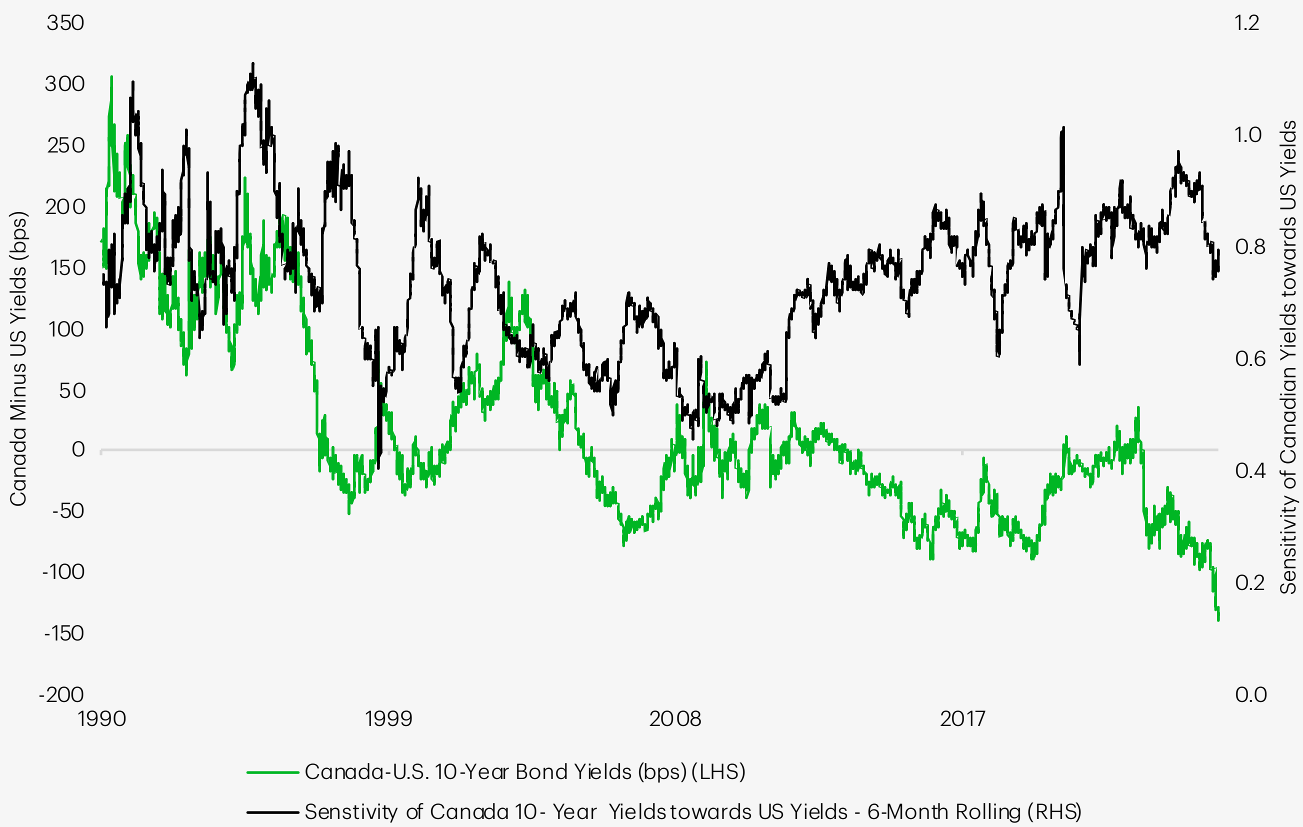


Source: FactSet, Wealth Investment Office, as of December 31, 2024.

• U.S. Government Bond Yields Affect Everything. Relative to the U.S., Canadian long-term government bond yields have been turned on their head. Before 1995, Canadian long-term bond yields were typically one percentage point above their U.S. counterparts, or even higher. That changed after Canada got its fiscal house in order in the late 1990s, and as Canadian inflation began coming in below U.S. inflation trends. For the next 25 years, spreads (Canadian yields minus U.S. yields) tended to toggle around the zero line and were still slightly positive as recently as mid-2022 (Figure 6). But in recent weeks, those spreads have gone to new extremes, dropping to roughly -140 bps for 10-year bonds. This reflects factors in both economies. 1) U.S. yields are forging higher on renewed inflation concerns amid still-solid growth as well as nagging fiscal worries in the light of an ambitious policy slate from the new government. 2) Canadian yields, while pulled up from September lows by their strong ties to U.S. yields, are subdued because of the tariff threat and the possibility that the BoC will need to respond even more aggressively. Let's just say that fixed income is the one market that has largely priced in the tariff risks. We don't believe Canadian yields will become significantly less sensitive to U.S. yields from here, but we do believe Canadian yields are likely to outperform U.S. yields: if U.S. yields are pushed higher for domestic reasons, Canadian yields will also rise, but less so. The BoC's easier monetary stance and lower terminal rate will not be able prevent Canadian yields from rising in the above scenario. This muddies the outlook for Canadian government bonds.

• U.S. Government Policies Likely to Impact Bonds. Trump's policies concerning trade, fiscal policy, and regulations are likely to influence the performance of government bonds in the coming months. Elevated inflation, driven by fiscal stimulus and adjustments to the trade policy, may compel the Fed to adopt a less accommodative stance than previously anticipated. Currently, markets anticipate fewer interest rate cuts in the U.S. this year, indicating a shift in expectations. Investors will be closely watching the Fed's monetary policy adjustments in response to Trump's initiatives. The recent increase in 10-year Treasury yields suggests that investors are seeking higher returns for holding longer-term securities, primarily due to concerns about fiscal policy. Globally, we expect an increasing divergence in monetary policy, as the U.S. economy demonstrates greater resilience and stickier inflation than other developed markets. Conversely, major economies like the eurozone are facing a structural economic slowdown, which is likely to lead the European Central Bank (ECB) to continue its pace of rate reductions in the near future.

Figure 6: Performance, Sensitivity of Canadian Government Yields vs. U.S yields



Source: FactSet, Wealth Investment Office, as of December 31, 2024.

Credit: Investment-Grade and Sub-Investment-Grade

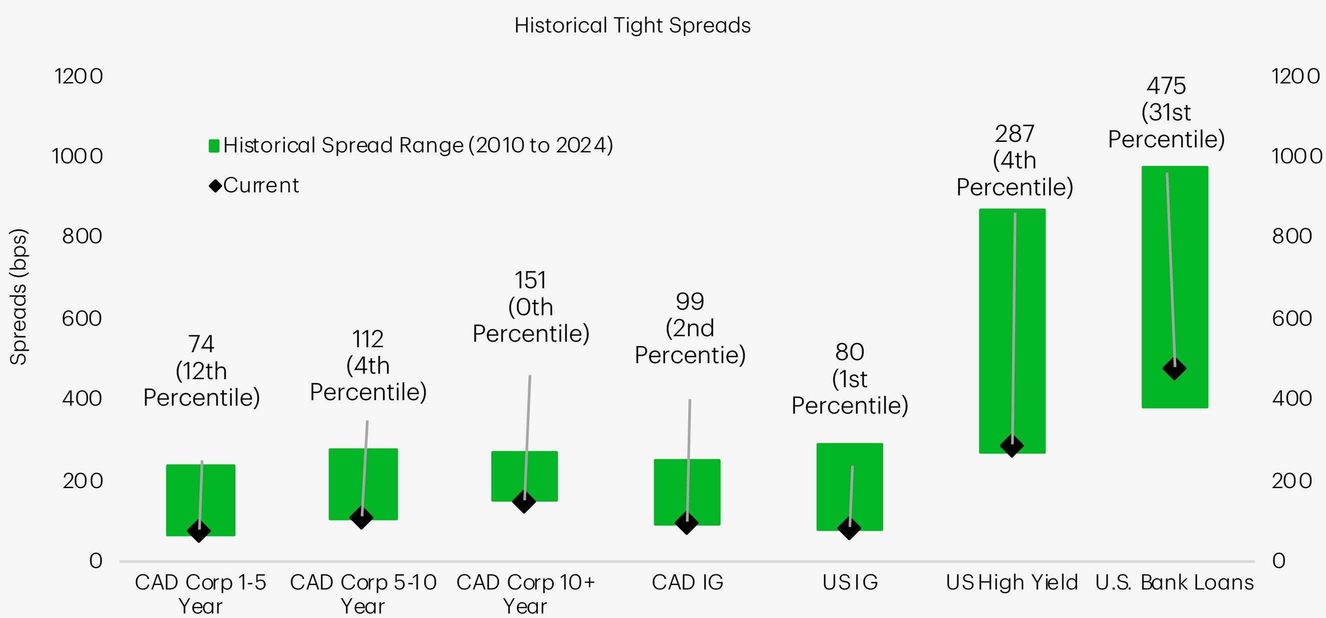
The current environment remains supportive from a credit-investor perspective. Companies and consumers have proven resilient to higher interest rates, driven by a private sector that has been reducing leverage since the Global Financial Crisis. IG corporate earnings growth remains stable, labour markets are still tight, and consumer data continues to show signs of strength. But we consider corporate bond valuations relatively elevated on a spread basis, although they remain attractive from a yield perspective. Historically attractive yields have enticed a resurgence of yield-motivated buyers to the market, providing strong technical support for the asset class. Taken in aggregate, we are constructive on the cycle and see benefits for credit investors in an environment where we expect government yields to remain range bound.

Our long standing view of modestly wider spreads has not materialized yet, but we are not discouraged and maintain our view. We are cautiously optimistic and focussed on finding pockets of opportunities through actively managed credit allocations. (Spreads are a way of measuring risk premium over a government bond of similar maturity: a wider spread means the market is pricing in more risk, narrower spreads, less risk.)

We maintain our modest overweight view on IG credit and our neutral stance on High Yield (HY) credit. We expect Canadian IG to fare better than U.S. IG on a relative basis as it still has a small amount of room to tighten further whereas U.S. IG is currently trading almost at the tightest level since 2010 and at the first percentile spread level compared to its past 15 years (Figure 7). Within the broader IG complex, we prefer short-dated Canadian IG bonds as a total return investment because they continue to offer very attractive all-in yields with lower interest rate sensitivity and are expected to keep offering better forward excess returns than the longer maturity corporates. Spreads for the shortest Canadian IG credit with 1-5 year maturity are trading at the 12th percentile with some room to tighten whereas spreads for long maturities are trading at almost the tightest levels. Higher yields provide more protection if spreads widen (risk premium increases) and, importantly, higher quality shorter maturity credit will widen less than the broad IG index.

We expect U.S. HY spreads to widen more relative to IG if fundamentals deteriorate and credit conditions tighten. Based on current valuations, the U.S. HY credit spread is trading at the fourth percentile and very close to the tightest levels historically and does not offer any premium for assuming the credit risk. But within the broad HY universe, U.S. bank loans, with floating coupons based on the short-term rate, are trading at the 31st percentile and with a modestly higher spread cushion or premium. Therefore, within HY credit we prefer U.S. bank loans over the traditional fixed coupon HY credit bonds. Broadly we're more comfortable owning IG, with its better outlook and balance sheet strength, over HY. Given the wide range of views on the economic outlook, credit investors should rely on active management and sectoral trends.

Figure 7: Current Spreads Show Little Room to Tighten Further



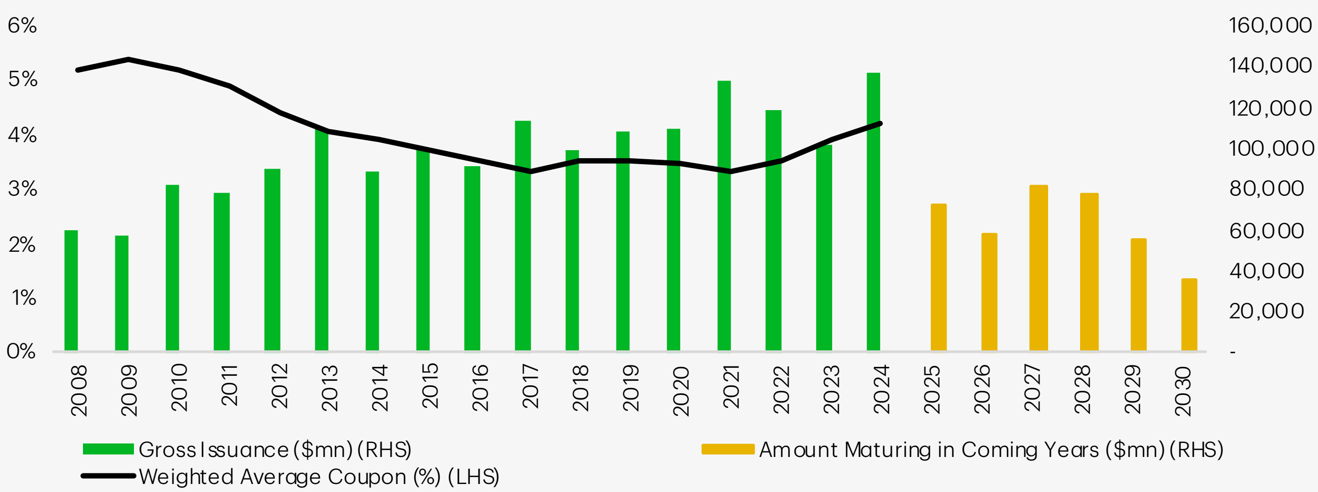
Source: FactSet, Wealth Investment Office, as of December 31, 2024. Using historical month-end spreads since January 2010.

Key Themes for Credit or Corporate Bonds

• Demand and Supply. Strong fund flows amid elevated yields in credit, combined with historically high coupon payments, drove persistent demand for credit and supported credit spreads (Figure 8). A weighted average coupon for the Canadian IG index of 4.20% on the total amount of bonds outstanding ($540 bln) is close to $23 bln in annual coupon payments and represents a 24% increase in average annual coupon cash receipts compared with two years ago. While coupons on newer bonds should begin to drive a reduction in that figure as rates moderate, we expect it could take a couple of years before the average coupon drops back to the mid-3% seen two years ago. Higher coupons will likely sustain demand in 2025 which will see about $70 bln in bonds outstanding maturing—far below the overall $140 bln issuance in 2024. Broadly, we expect demand/supply balance in the credit markets to remain stable in coming quarters conditional on still-solid economic growth and policy rate cuts.

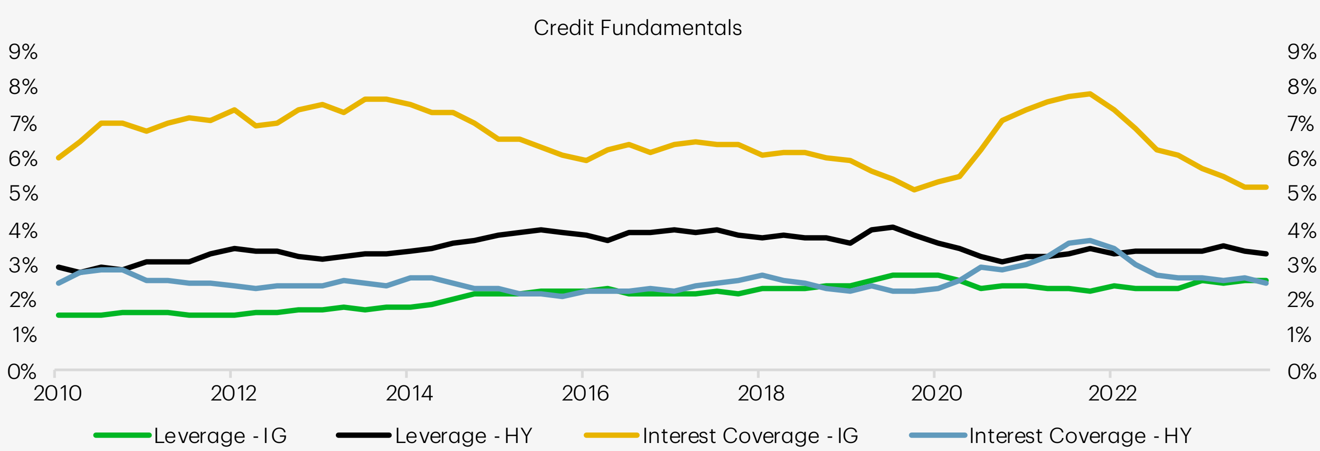
• Credit Fundamentals. U.S. corporate balance sheet ratios are close to long-run averages heading into 2025. Leverage in U.S. IG has modestly increased and has remained stable for U.S. HY, while maintaining the de-leveraging that started after 2020 in both these segments (Figure 9). A bit worryingly, the interest coverage ratio (which measures the ability to pay interest on outstanding debt) for U.S. IG has tumbled since 2022 and is near a 14-year bottom. On the other hand, interest coverage ratios for HY credit are close to long-term averages with no material change over the past year. Looking forward, we believe that the end of balance sheet discipline will likely have a negative impact on IG credit fundamentals this year. First, M&A activity should pick up given the more favourable anti-trust regulatory environment under the Trump administration and a larger share of M&A activity will be funded with debt. Second, with 2022 and 2023 U.S. recession risks mostly gone, equity investors no longer want companies to repay debt and instead want them to return cash to shareholders.

Figure 8: Canadian IG Credit Highest Coupon Since 2012, Digests Record Gross Issuance



Source: FactSet, Wealth Investment Office, as of December 31, 2024.

Figure 9: Stable Credit Fundamentals



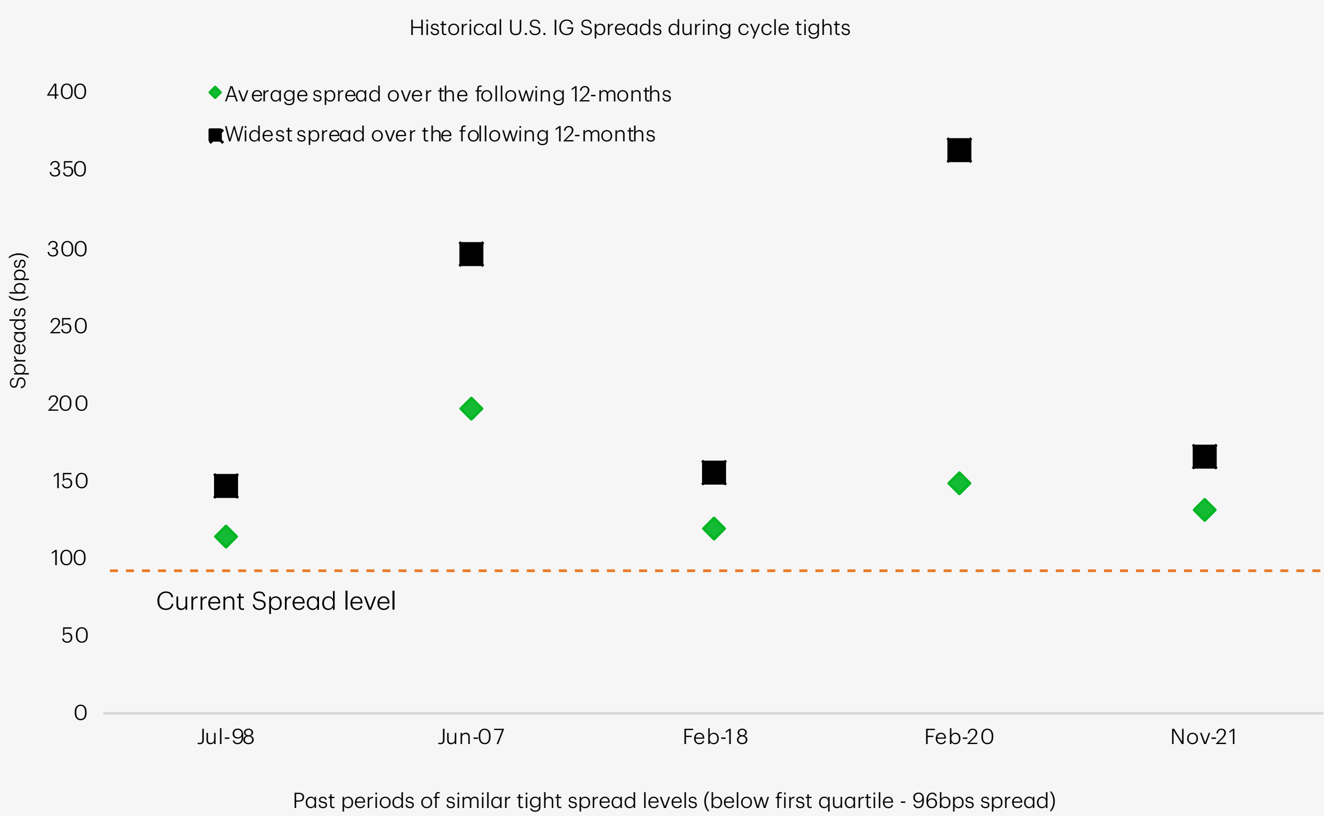
Source: FactSet, Wealth Investment Office, as of December 31, 2024. Leverage and interest coverage are the median values of U.S. corporate bond universe. Leverage is net debt/EBITDA.

As a result, the recent unusual IG de-leveraging cycle is likely over, and we expect faster debt growth in 2025 for U.S. non-financial IG issuers. This will be in part offset by improving earnings growth and stabilizing borrowing costs, but overall will likely translate into moderately higher IG gross leverage (which evaluates a company's risk exposure and financial health). Even if we assume a 1%-2% increase in interest costs from higher current yields, the coverage ratio (a company's ability to service its debt) will remain stable at or close to long-term averages. The risk scenario for IG and HY credit fundamentals is economic growth disappointing while issuers re-lever to improve EPS growth.

• Spreads are Tight. What now? Historically, periods of tight credit spreads have often been followed by significant and sharp widening, as observed in previous downturn credit cycles. These selloffs typically align with recessions, similar to the 2007-2008 GFC. However, there have also been instances where spreads widened moderately before stabilizing within a prolonged credit cycle (Figure 10). While predicting the timing and magnitude of these movements is near impossible, understanding their underlying factors is crucial to evaluating how credit spreads may change. Uncertainty about future fiscal policies, stubborn inflation, or sluggish economic growth can all influence credit spreads. If these issues persist, the Fed may adopt a more hawkish stance, which could increase balance sheet stress for leveraged firms and result in much wider credit spreads. However, if we assume the cause of these fluctuations are temporary, rather than the result of broader economic downturn or major policy shifts, investors will likely seize opportunities to reinvest in credit markets as more favourable entry points arise.

• Active Management Offers More When the Market Offers Less. Credit has entered 2025 underpinned by fundamental and technical support, but this may deteriorate as the year wears on. The most immediate challenge we see entering the new year will be valuations. Therefore, we believe that credit in 2025 will be about turning cautious eventually—but not immediately. Hence, correctly picking credit, curve positions, sectors, and initiating or trimming credit risk hedges, will matter more when the overall credit market offers less. We believe the resilient credit spreads that were so friendly to credit in 2024 are coming to an end. The challenge is that this won't happen immediately. Therefore, we believe it's prudent to let the active manager own the credit and be in the market to sell or buy the credit risk as and when the opportunity arises.

Figure 10: Historically, Spreads Widen in the 12 Months after Tight Levels



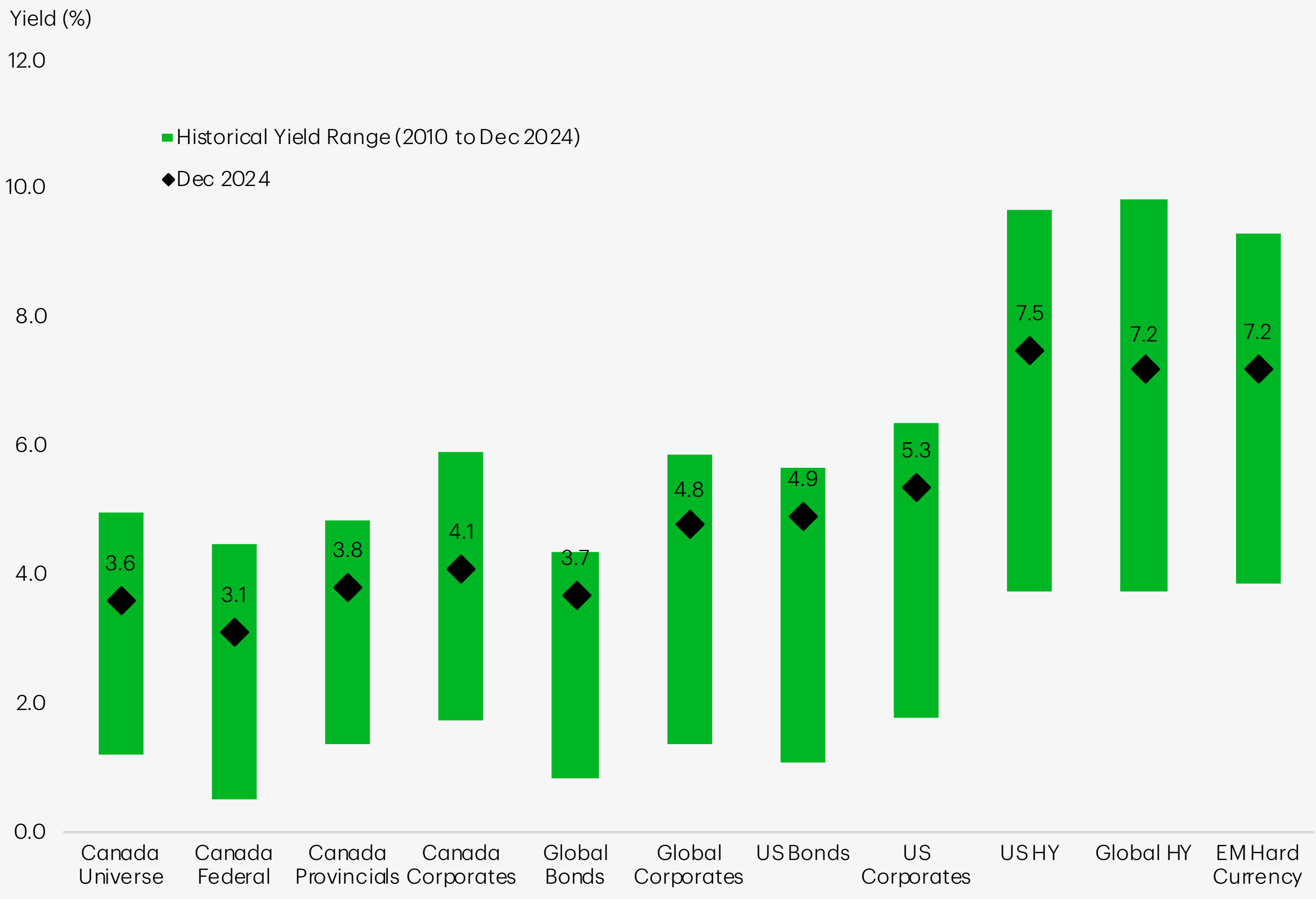
Source: FactSet, Wealth Investment Office, as of December 31, 2024

Higher Yields and Diversification

We urge investors to hold a balanced and diversified portfolio. While we believe returns for Canadian fixed income over the next 12 months will be on par or lower than 2024, it's still possible to earn attractive yields in most segments of the fixed income market right now (Figure 11). Current yields are at attractive levels, providing a buffer against volatility and adding the income back into the fixed income mix. Based on current high yields and market conditions, we believe there is compelling value in high quality, liquid public fixed income. Starting yields are attractive compared with other assets across the risk and liquidity spectrum–including cash–and historically, starting yields have been a strong indicator of long-term fixed income performance. Government bonds and duration will be attractive to those investors with a slightly longer time horizon. Buying opportunities can arise quickly in periods of uncertainty. Active management that balances duration and credit exposure and makes tactical adjustments will help investors sort through the wide range of government yields and capture strong returns.

We maintain a modest underweight view on fixed income overall. Having said that fixed income continues to offer an attractive opportunity to build diversified portfolios. After the turbulence of high inflation and rising rates, and even if growth turns problematic, the bond market will likely return to more conventional behaviour. Our base case for fixed income is to earn attractive income without substantial capital gains from falling government bond yields. In the current landscape, an astute active fixed income manager versed in long/short credit strategies and able to make tactical duration adjustments when government bond yield moves are overstretched, could realize more attractive returns.

Figure 11: Yields Still Attractive



Source: FactSet, Wealth Investment Office, as of December 31, 2024. Global HY: Bloomberg Global High Yield Hedged to CAD, EM Hard Currency: JP Morgan EMBI Global Core Hedged to CAD.

Outlook on Equities

Modest Overweight

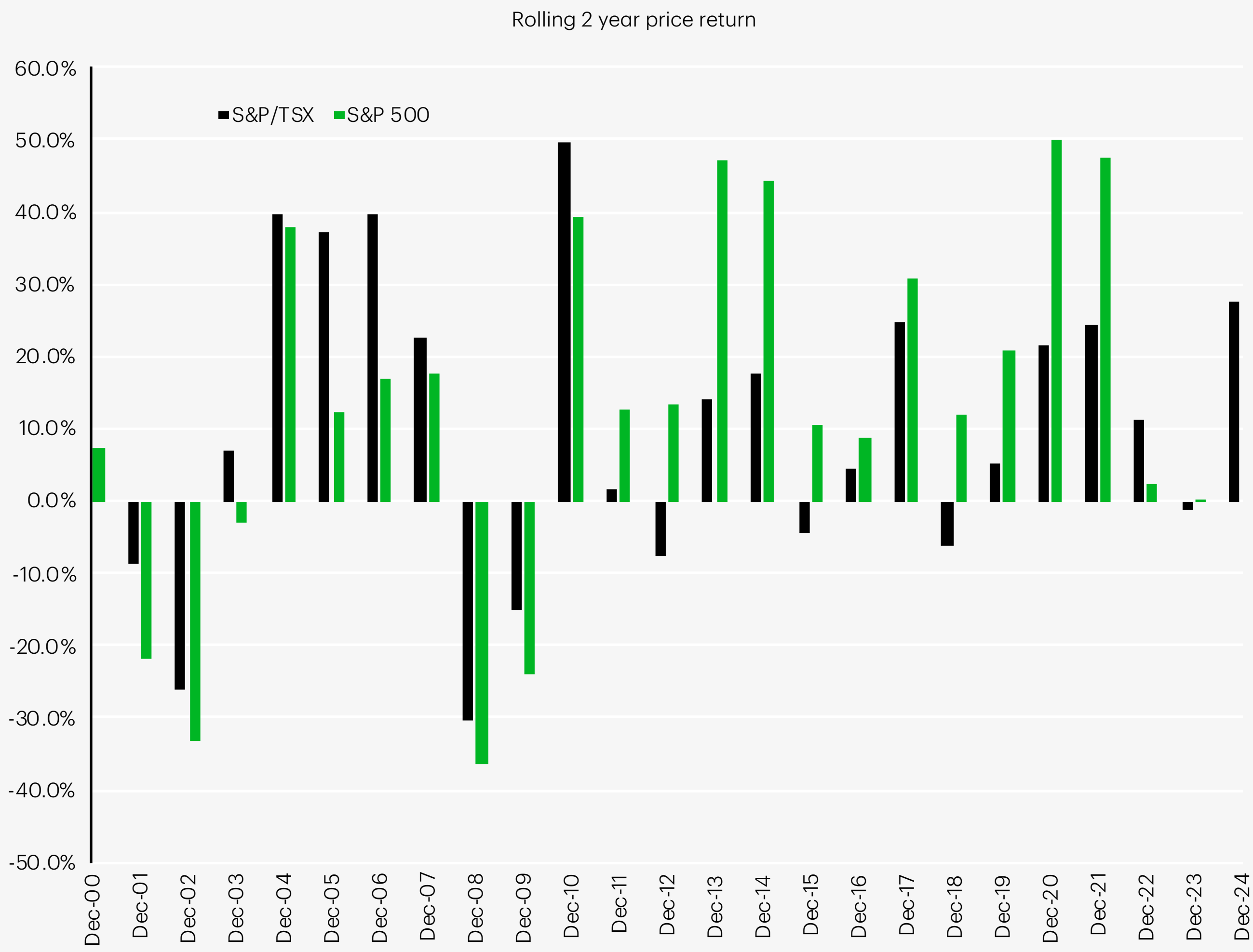
After historic run for growth stocks, keep an eye on defensive laggards

David Beasley, Senior Portfolio Manager; Christopher Blake, Senior Portfolio Manager; Mansi Desai, Senior Equities Analyst; Chadi Richa, Senior Equities Analyst; Andrej Krneta, Senior Equities Analyst; Neelarjo Rakshit, Senior Equities Analyst; Kevin Yulianto, Portfolio Manager | TD Wealth

U.S. equities recorded a historic run over the past two years. In fact, the S&P 500 posted a 53.2% price return over 2023 and 2024–the largest gain in any two-year period since 1998 when we were in the middle of the dot-com bubble. The S&P/TSX also had a good run, up 27.6%, its largest two-year increase since 2010.

Leadership—relative strength from a concentrated group of equities—is a driving force in broader stock markets, and U.S. equities account for over 60% of global equity market capitalization, resulting in U.S. companies having significant influence on global equity markets. The S&P 500 is the most common representative of U.S. equities because of its relative diversification as a broad market portfolio proxy with 500 companies across 11 sectors and because it includes the highest quality, largest technology growth stocks in the world. Five companies–Apple, NVIDIA, Microsoft, Amazon, and Alphabet–make up about US$15 trillion (tln) or over 30% of the index's total market capitalization. In fact, the individual market cap of Apple, NVIDIA, and Microsoft is greater than the entire S&P/TSX Composite Index which explains why U.S. equities dominate research coverage in North American stock portfolios.

Figure 1: Rolling Two-Year Performance of S&P 500 Index and S&P/TSX Composite Index



Source: FactSet, Wealth Investment Office, as of December 31, 2024.

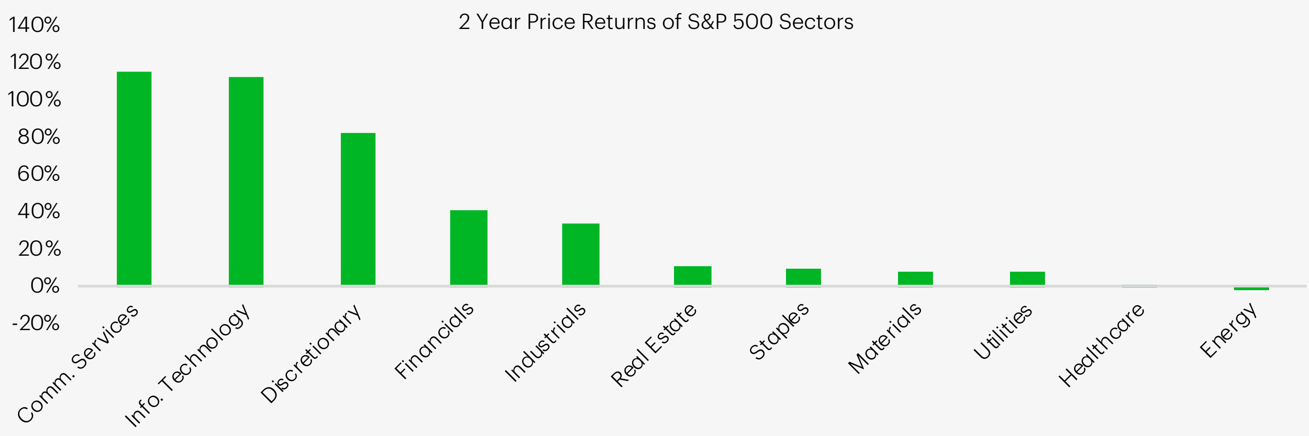
Over the last two years, leadership within the S&P 500 has been dominated by remarkable gains in technology and other highly cyclical sectors even though U.S. economic growth has been lackluster over the same period. Real U.S. GDP growth was 2.9% in 2023 and is expected to be about the same for 2024, which is just about the average for the last 20 years. Over the past two years, communications services, information technology and consumer discretionary were the top performers, while energy and healthcare were the worst (Figure 2).

We maintain our modest overweight view on U.S. equities.

From an index perspective, Canada shares some common ground with the U.S. The information technology (IT) sector has been the leader of performance for the S&P/TSX Composite, followed closely by the largest sector - financials. However, there the similarity ends. Canadian communications services underperformed because of its component companies. Canada has no Netflix or Meta equivalents. Other differences between the S&P/TSX and S&P500 sectors include, for example, consumer staples and materials. Consumer staples in Canada are dominated by grocery retail and in the U.S. by food producers and consumer packaged goods companies. In Canada, half of the materials sector consists of gold producers which are not a major factor in the S&P 500 materials sector. For comparison purposes, we have included rolling two-year sector returns for the S&P/TSX Index in the same order as the S&P500 (Figure 3).

A few months ago, it was relatively easy to look forward to a Canadian economy that was heading for a soft landing—although probably not as soft as the U.S.—and that would get some help from U.S. economic re-acceleration. After the U.S. election though it became clear that the United States-Mexico-Canada Agreement would not protect Canada from Donald Trump's tariff proposals and, in fact, it seems Canada has been chosen for some of the highest tariff rates. Imposing a 25% tariff on all goods from Canada would be painful for the Canadian economy and, as such,

Figure 2: Rolling Two-Year Performance of S&P 500 Sectors



Source: FactSet, Wealth Investment Office, as of December 31, 2024.

Figure 3: Rolling Two-Year Performance of S&P/TSX Sectors

Source: FactSet, Wealth Investment Office, as of December 31, 2024.

potential tariffs will continue to cloud the outlook for Canadian equities until clearer policy proposals are enunciated. We maintain our modest overweight view on Canadian equities.

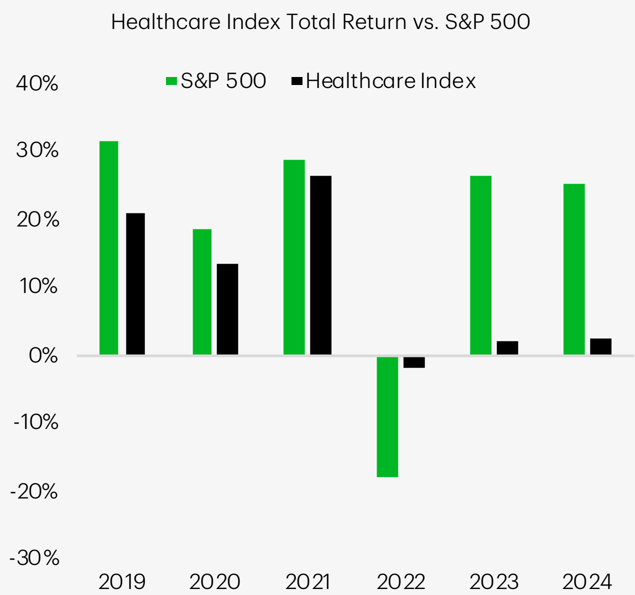
It's quite possible that this type of 'American exceptionalism' will continue to manifest in the U.S stock market, leading with continued momentum in cyclical growth. Within a quantitative and technical process, a trend-following approach would favour the continuation of this momentum and treat each correction as a buying opportunity. However, on the other end of the quantitative/technical process tool kit is a contrarian mean-reversion trade. That is where we find two of the biggest laggards in the S&P 500 which are known for their defensive characteristics: healthcare and real estate. If and when the cycle slows, we expect these sectors to come out of hibernation and flows to return as fund managers look to reposition more defensively. We are shining a light on each of these sectors here, with the focus on U.S. for Healthcare and Canada for Real Estate.

U.S. Healthcare: Pick your stocks and be ready to rotate

U.S. Healthcare stocks posted another terrible year in 2024 and the sector overall was one of the worst performing in 2024. The S&P 500 Health Care Index underperformed the broader S&P 500 by 20% in 2024, after it had already underperformed by 22% in 2023. Last year, only five of 60 companies in the S&P 500 Health Care Index outperformed the market. The valuation gap for the sector is wide relative to historical data and it’s trading at a 20% discount to the S&P 500 on forward-earnings multiples, compared with a 5% discount to the 20-year historical average.

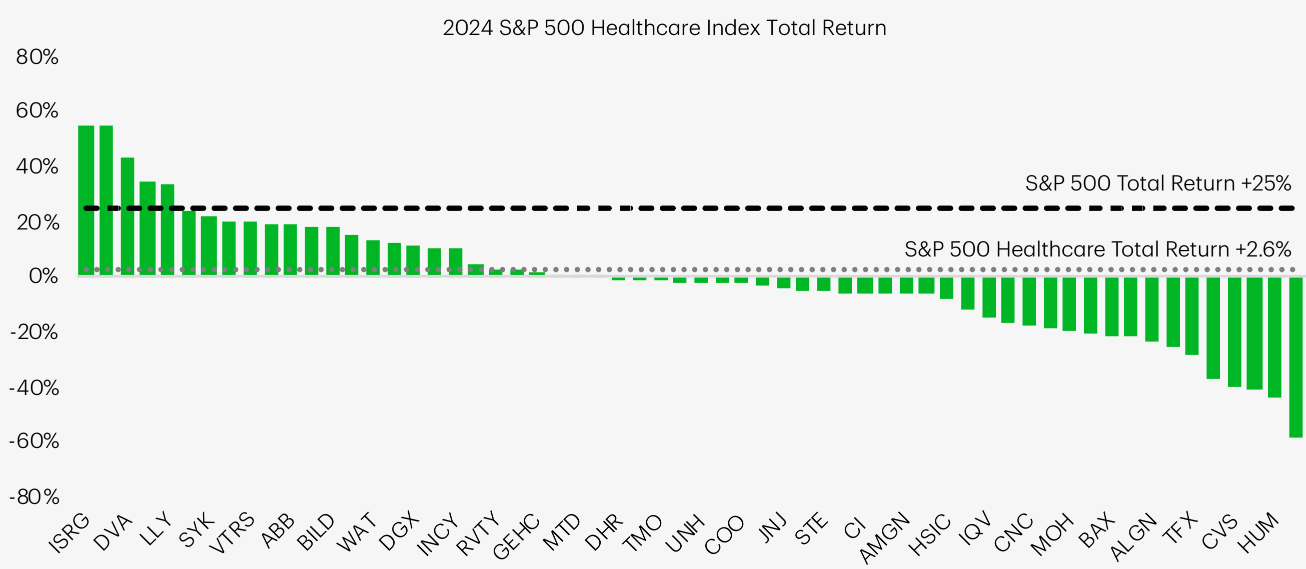
Given the drastic underperformance in the last two years, it's important to take a step back and remember that healthcare is a defensive sector. On a total return basis, healthcare underperforms the S&P 500 during bull markets and outperforms when markets are heading down. In fact, healthcare underperformed the S&P 500 in every bull market over the last five years on a total return basis. However, during the down market of 2022, healthcare was resilient. In 2022, the S&P 500 Health Care Index posted a -2% total return compared with -18% for the S&P 500. In the 2022 downturn, 38 out of 58 names, or 65% of the Healthcare sector, outperformed the S&P 500 Index.

Figure 5: Total Returns for S&P 500 Health Care Index vs. S&P 500



Source: FactSet, Wealth Investment Office, as of December 31, 2024.

Figure 4: Total Return for S&P 500 Health Care Index Constituents (2024)



Source: FactSet, Wealth Investment Office, as of December 31, 2024.

Healthcare is a stock picking sector. Every year there is a very wide discrepancy between top and bottom performers. In 2024, the top healthcare stock was Intuitive Surgical (ISRG) with a 55% total return, and Moderna (MRNA) fared the worst, down 58%. The year before painted a similar picture. Total returns for the top healthcare stock performer in 2023, Eli Lilly (LLY), was 61% while bottom performer Moderna lost 45%. Winners win big and losers lose big. This means we need to be nimble in managing healthcare holdings.

Looking into 2025, healthcare will be an interesting sector to watch, particularly because the new administration in the U.S. is expected to drive regulatory changes that will impact several companies and subsectors. Despite being generally unloved by investors, healthcare is a behemoth industry that cannot be ignored. The global market for healthcare is a staggering US$9 tln, with the U.S. accounting for US$4.5 tln.

The U.S. healthcare system is a complex myriad—it's not at all surprising that users are disgruntled, and the government is keen to make changes. Out of all OECD countries, the U.S. spends the most on healthcare (18% of GDP compared with 10%-12% for OECD peers) with the worst results. Life expectancy in the U.S. is only 77 years old, below the 80-84 years expected for people in most OECD countries.

Looking forward, we are thinking about healthcare as defensive in the context of portfolio construction. We want to avoid subsectors with uncertain regulatory risks, including pharmaceutical companies under pressure from drug price negotiations, managed care companies in the process of multi-year turnarounds, and pharmacy benefit managers (PBMs). (Donald Trump has said he wants to make changes to ensure PBMs, which act as middle agents between pharmaceutical companies and consumers, are more transparent.) Instead, we're looking at healthcare subsectors like MedTech (medical technology) and orthopedics which will see long-term growth from an aging population globally and benefit from the more defensive characteristics of lower headline and regulatory risk.

Canadian Real Estate: Improvement expected

On balance, 2024 was a positive year for Canadian Real Estate Investment Trusts (REITs); they successfully navigated higher interest rates while maintaining disciplined balance sheets and efficient access to cost-advantaged capital. Unlike their private real estate market counterparts, which have faced significant challenges raising capital (with longer fundraising periods and lower proceeds), Canadian REITs have maintained low leverage ratios by focusing financing activities on fixed interest rates, long-term maturities, and unsecured debt.

From a total return perspective, the December 2024-early January 2025 selloff set Canadian REITs up well for double-digit (perhaps even 15%-20%) returns through a combination of modest cash yields (which are used to assess the profitability of real estate), moderate adjusted funds from operations/unit growth (which determines the trust's ability to pay out future dividends), and multiple expansion.

We remain confident that the yield spread for the Canadian REIT sector funds from operations (a measure of operating performance) will narrow to below its long-term average of 5.2% through 2025 and 2026 for two reasons. 1) We believe the combination of the weakening Canadian dollar, stabilizing interest rates, and a historically low price/net asset value of 78%, could provide a positive catalyst for increased transactions and/or M&A activity. 2) The S&P/TSX Capped REIT Index, in our view, warrants tighter spreads relative to historical levels: the retail segment has a 40% weight in the index and boasts the strongest fundamentals in over a decade and apartments hold a 30% weight and are benefiting from the lowest cost of capital though insured financing offered by the Canadian Mortgage and Housing Corporation (CMHC).

We believe the outlook for Canadian real estate in 2025 is mixed, from a fundamental point of view, but remain optimistic that trading valuations will improve throughout the year. While declining interest rates could unleash pent-up demand and improve investor sentiment as well as transaction activity across Canada, the potential impact on real GDP growth from the proposed net population growth freeze and possible U.S. tariffs could lead to a lower REIT valuation ceiling than previously envisioned for 2025.

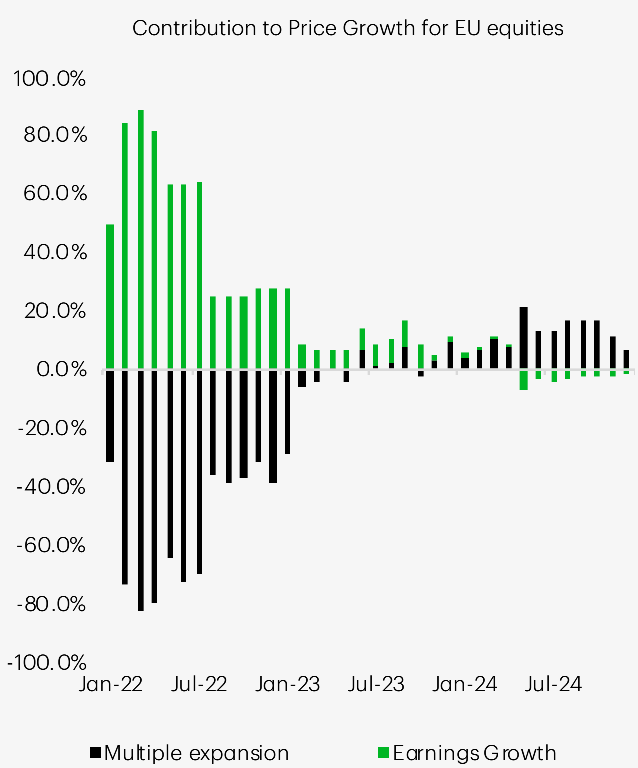
Population growth and real GDP growth are key drivers of real estate demand and of rent growth. From a property-type perspective, in 2025, apartments would likely be most directly affected, followed more indirectly by retail, office, and industrial demand, with senior housing the least affected. One could argue that REIT prices have adjusted to reflect the added uncertainty regarding Canada's reduced immigration targets, to the point where we see upside should these targets not be met. Specifically on Canadian retail, the federal government's December 2024-February 2025 tax holiday could result in better-than-expected holiday season spending, while the prolonged Canada Post strike could have boosted brick-and-mortar foot traffic during the traditionally strong fourth quarter.

International Equities: Stagnant economic activity, tariff threats cloud recovery

The MSCI EAFE continued its lacklustre performance in the fourth quarter of 2024 amid economic stagnation in Europe and the threat of higher U.S. tariffs. Although services PMI in Europe is hovering close to or higher than 50, the manufacturing sector is struggling to show signs of revival. Industrial production in Europe has languished in negative territory for 18 straight months. The slump in manufacturing activity, especially in Germany, is largely due to weakening demand in China combined with strong competition from Chinese players (especially in the auto segment), sluggish global economic growth, and the higher interest rate environment.

However, as the European Central Bank (ECB) transitioned to cutting rates, economic forecasts for 2025 and 2026 also moved to reflect an acceleration in GDP growth but the rate of growth is expected to remain lower than the historical average and translate into lower earnings growth. Although valuations are reasonable, stagnant economic recovery is weighing on earnings growth for European equities. Price appreciation for European equities, although not significant, was driven by multiple expansion, not earnings growth which remained muted (Figure 6).

Figure 6: Stagnant Economic Recovery Reflected in Earnings Growth for Euro Area



Source: FactSet, Wealth Investment Office, as of December 31, 2024.

We believe current valuations reflect the risks for the euro area, and we expect equity returns to be muted for the first half of 2025. There are, however, factors which could improve growth prospects for Europe. 1) Given the economy's higher sensitivity to interest rate changes, if the ECB announces a series of rate cuts this year, it could revitalize manufacturing activity (assuming inflation remains within the ECB's target range). 2) If China keeps announcing large-scale fiscal stimuli, it will strengthen demand. 3) If the Ukraine and Russia manage to negotiate a ceasefire, it would take the pressure off rising energy prices.

Japan remains a bright spot for international equities buoyed by the government's push towards corporate governance reforms and the potential end to almost three decades of deflation. However, like Europe, Japan's recovery in the manufacturing sector has been sluggish mainly because of weaker demand in China. Although Japan's services PMI is above 50, the manufacturing PMI has been below 50 since June 2024. Complications to watch in 2025 include: 1) Will the Bank of Japan (BoJ) lift rates further based on the rising trend in inflation? Higher rates would strengthen the yen and impact the yen carry trade. A strong yen is viewed as a risk because Japanese stocks tend to perform better under a cheaper yen, however, the strong U.S. dollar may keep a lid on the yen thereby limiting its impact. 2) Since March 2024, Japan has recorded over 2.0% wage growth, breaking away from its almost 0% wage growth post the 1990 debt crisis. Corporates must maintain wage growth above 2.0% to sustain positive real wage growth which in turn boosts consumer spending. The BoJ has often reiterated its stance on higher wage growth because when wage growth is healthy and the underlying economy can sustain an inflationary environment the central bank will be able to maintain higher interest rates.

The U.K. continues to struggle with low productivity, labour supply constraints and persistently high rent inflation, the latter of which is making a big dent in household pockets. On top of that, the fiscal stimulus announced by the new Labour Party could revive the spectre of inflation. Investors are concerned this would limit the Bank of England's (BoE) attempt to cut rates and support the economy. While the U.K.'s services PMI hovers above 50, its manufacturing PMI has since September, dipped below 50 after a decline in new orders. Given that inflation is more of a concern for the services industry and price growth for the goods industry is lower, there should be some headroom for BoE to cut rates if demand weakens further. Nonetheless, we do not expect a significant acceleration in earnings growth in the U.K. at least until later in the first half of 2025.

Emerging Markets: Political risks loom over earnings growth

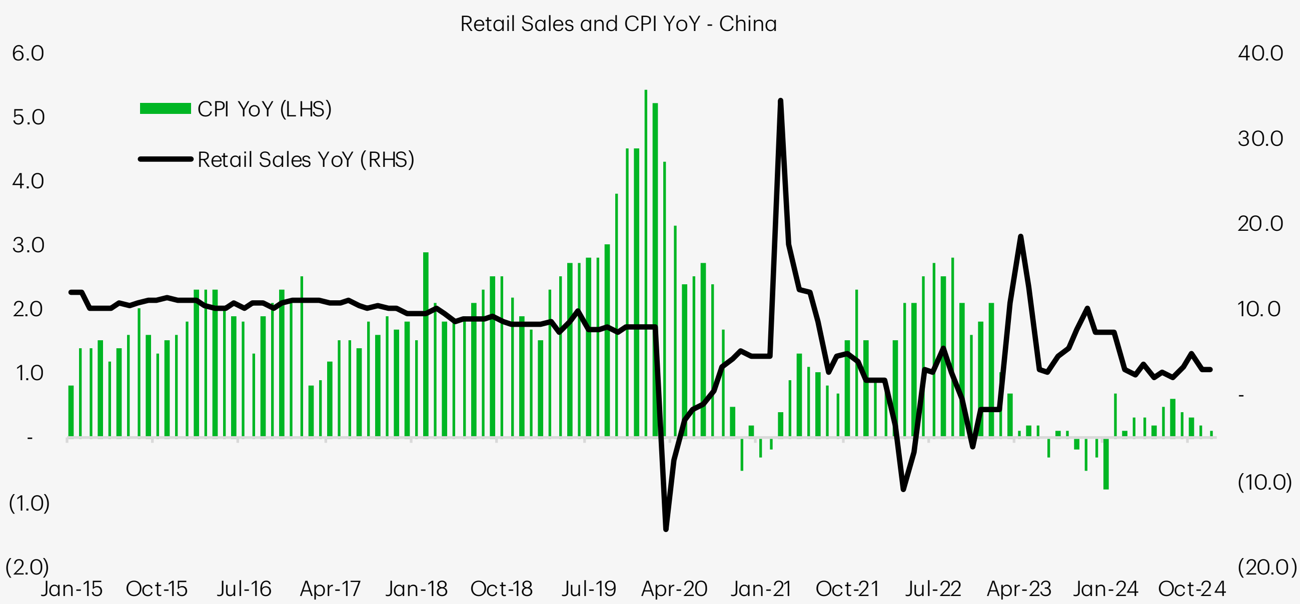
The fourth quarter of 2024 was challenging for emerging market equities mainly because of the changing political landscape in EM and the U.S., and the pause in the equity rally in China. In the quarter, China equities lost nearly half of their September 2024 increase. The government continues to stimulate the economy by allocating an additional US$11.0 bln in 2025 to its consumer voucher program, boosting sluggish demand in the household sector. Markets are expecting a series of large-scale stimuli that might be enough to revitalize economic activity and lift flagging confidence of both domestic and global investors. Since the September 2024 stimulus package, China's manufacturing PMI has been over 50, however consumer spending is still weighing on the economy. For example, retail sales growth has been below its historical average of 10% since December 2023 (Figure 7).

For China, exports were the highlight of 2024. It successfully began to redirect exports to countries outside of the U.S., recording an average 6.0% growth over the past four quarters up from the average 4.0% decrease in 2023. However, exports won't be enough to deliver 5% growth to the world's second-largest economy. It will take time to boost household confidence which will lift consumer spending. In the near future, growth from China's investments into advanced technologies like chips and EVs, might not be as attractive as the growth from its once-booming property sector. However, over the long term we expect China's investment in these sectors to spur economic growth. In addition, the CPI has been below 1.0% for the past 22 months so the Chinese government and the People's Bank of China will be monitoring the deflationary trend. Given these conditions, we expect the Chinese government to announce continued stimuli and other measures to achieve its 5.0% growth target.

Taiwan equities continue to ride the wave of surging AI investments and benefit from the leadership of Taiwan Semiconductor Manufacturing Co, the world's largest semiconductor foundry. TSMC has now become an integral part of many global portfolios of active equity managers, and we believe this trend will be sustained in the near future as the adoption of AI increases.

India continues to be a strong structural growth story in EM equities. However, in previous editions of PSQ we highlighted our concerns about stretched valuations and these have, in fact, resulted in muted performance in the fourth quarter and 2024. On top of this, investors have turned cautious because economic growth is expected to slow to 6.8% in 2025, after recording average GDP growth of 7.5% between 2014 and 2023 (excluding 2020). Tighter fiscal spending, higher interest rates, reduced consumer spending, and tighter lending norms are clouding growth prospects for the year ahead. However, if demand or growth weakens further, the Reserve Bank of India still has room to reduce rates and increase economic activity.

Figure 7: More Fiscal Stimulus Required to Keep Deflation out of China



Source: FactSet, Wealth Investment Office, as of December 31, 2024

In South Korea, equities recorded earnings growth of over 30% in 2024 compared with a historical average of 10.0% but the good news seems to be overshadowed by political turmoil. South Korea's president, Yoon Suk Yoel, was impeached on December 14 by the opposition-controlled National Assembly over his decision to impose martial law. Almost two weeks later the same parliament voted to impeach acting president Han Duck-soo. Yoon Suk Yoel was arrested in January plunging the country into deeper crisis, political division and further damaging its international reputation and stock market valuations. This ongoing political uncertainty has severely impacted the prospects for South Korea equities which saw some of the biggest selloffs from foreign investors since 2020, slicing 14% from P/E multiples in December 2024.

The performance of Latin American equities remained muted in the fourth quarter on the back of concerns over the political situation in Brazil, a recent uptick in inflation in Brazil, and weakening demand from China. About 30% of exports from Latin America go to China so any change can severely affect growth prospects for these countries. A revival in global demand would help Latin American equities given their region's exposure to commodities, but we believe the outlook for growth will remain subdued until we see a turnaround in demand from China.

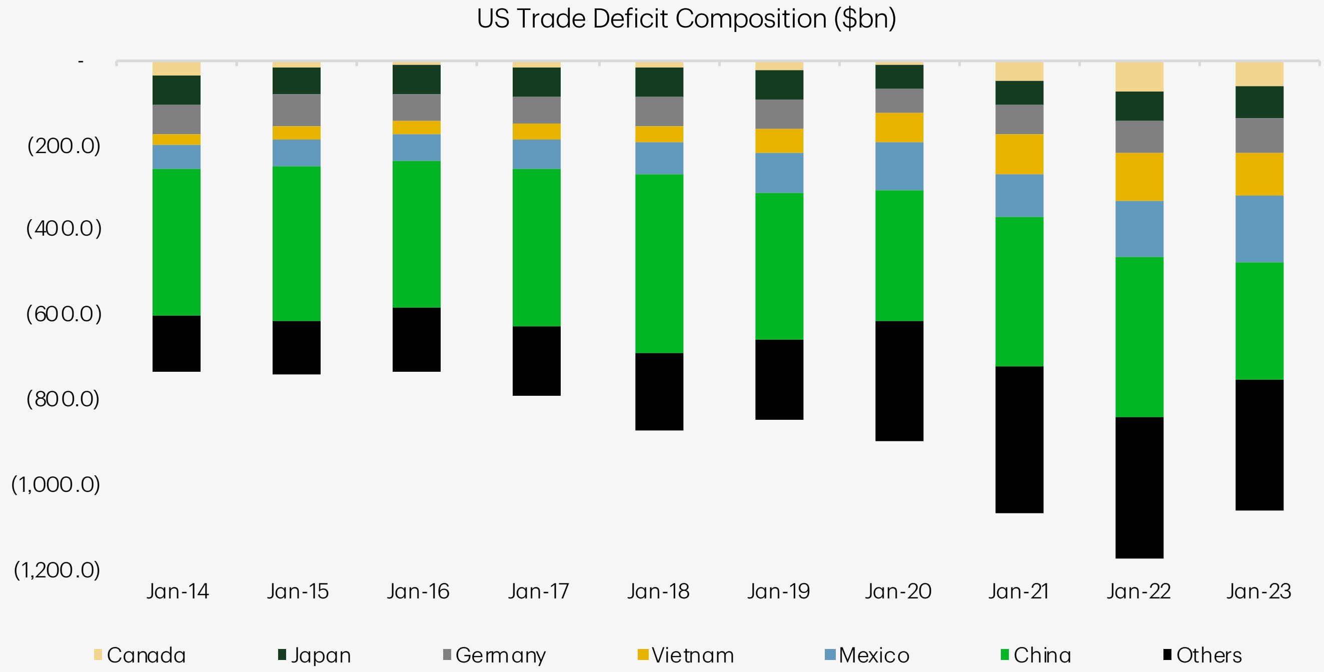
In recent years Mexico equities have benefitted significantly from the trend to nearshore manufacturing to the U.S. This has doubled its share of foreign direct investment flows into emerging markets to 10.0%. However, given the change in leadership in the U.S. and the potential impact of a 25% import tariff, many companies have withheld their investments, damping growth prospects for Mexican equities in the near term.

Potential Impact of Import Tariff on International, EM Equities

The key threat to equities this year could be U.S. tariffs which would disrupt global trade and economic growth. Even before Donald Trump's inauguration, he said he would impose 10% tariffs on all U.S. imports, 60% import tariffs on China, and 25% on goods from Canada and Mexico. If fully implemented, this could be disastrous for global economic growth and could spike U.S. inflation by 50bps-150bps.

Based on economic data, we believe full implementation of these tariffs will hurt U.S. economic growth as well as growth for the countries targeted. The U.S. economy has run on a trade deficit over the past four decades that totaled US$1.06 tln in 2023. This will of itself limit aggressive U.S. tariffs on major importing partners because more expensive imports will enlarge its already wide trade deficit (Figure 8).

Figure 8: U.S. Trade Deficit with Key Importing Partners Limits Tariffs



Source: FactSet, Wealth Investment Office as of December 31, 2024.

Interestingly, the countries that Donald Trump has threatened with tariffs (primarily Canada, Mexico, and China) are also the U.S.'s key export partners. However, the economic impact of tariffs will be felt much more by Canada (where exports account for 33% of GDP) and Mexico (where exports contribute 36% to GDP). The U.S. receives almost 75%-80% of Canadian and Mexican exports (Figure 9). Over the years, imports from Canada (primarily energy and auto) and Mexico (vehicles and electricals) have become an integral part of the U.S. supply chain and tariffs will have an inflationary impact. In an ironic twist, Trump, who criticized the Biden government for its management of inflation, will have to tread lightly lest he come under the same scrutiny. Trump's potential 10% tariffs on all U.S. imports will hurt the U.S. economy, albeit marginally at 50 bps, if key export partners retaliate with similar tariffs on U.S. exports.

When it comes to China, if the U.S. imposes 10% additional tariffs (and given that China exports form 20% of its GDP, of which U.S. is 15%), it will cost China about 0.3% of its GDP. However, a 60% import tariff on Chinese goods will erase 1.8% from its GDP.

Based on Trump's previous term in the White House, we believe these tariff threats are, to a large extent, negotiating tools the Republicans will use to address deeper issues with the targeted countries. For example, in 2019, Trump said he would impose a tariff as high as 25% on Mexican goods—unless Mexico stopped the flow of illegal immigration into the U.S. The tariff threat was dropped shortly after the U.S. reached an agreement with Mexico to curb irregular migration.

Given the risks discussed, we maintain an underweight stance on international and emerging market equities in the near term. We believe uncertainty around tariffs will suppress currencies and the returns on international and EM equities in the coming months. Amid this, structural weakness in China will continue to dampen the growth outlook for EM and international equities. If inflation remains rangebound, central banks globally have the power to reinvigorate economies by cutting rates and boosting underlying demand which would underpin a rise in EM and international equities.

Figure 9: Economic Impact of Possible Tariffs

U.S. - Top 5 Importing countries	U.S. imports as a % to GDP	Economic impact (as % of GDP) of 10% import tariffs	U.S. - Top 5 exporting countries	Country exports as % of U.S. GDP	Economic impact (as % of GDP) of 10% import tariffs
Canada	25.7	2.57	Canada	1.94	0.19
Mexico	29.9	2.99	Mexico	1.76	0.18
China	3.0	0.30	China	0.80	0.08
Germany	4.3	0.43	Netherlands	0.47	0.05
Japan	4.4	0.44	Germany	0.42	0.04
				Total Impact on U.S.	0.54

Source: World Bank, FactSet, Wealth Investment Office, as of December 31, 2024.

Outlook on Alternative Assets

Modest Overweight

Recovery on the horizon as liquidity loosens

Shezhan Shariff, Senior Alternative Investments Analyst; Neelarjo Rakshit, Senior Equity Analyst | TD Wealth

As transaction activity slowly recovers, with hopes for more M&A volumes under a deregulated and looser financial environment, liquidity is top-of-mind for private-equity investors. In the credit sphere, meanwhile, private lending continues to offer compelling income, which will become increasingly valuable as the Fed's easing cycle progresses and medium-term interest-rate volatility persists. Finally, in real estate, property-type selection remains paramount, as winners and losers emerge in this new economy.

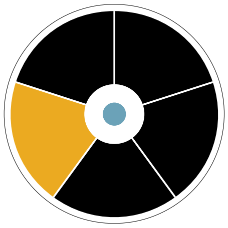
Private Equity

Liquidity remains the top issue for limited partners (LPs) going into 2025. This is due to relatively muted transaction activity, with the bid-ask spread between buyers and sellers of private companies remaining wide, albeit narrow relative to the past two years. As holding periods stretch longer than anticipated — 46% of global buyout companies have been held for four years or longer, according to Preqin — and unrealized values reach record highs (US$3.2 trillion), LPs are pressing general partners (GPs) to return capital.

UBS Asset Management reports that today's operating environment has supported good fundamental performance at most privately held companies, with GPs generally reporting positive top- and bottom-line figures. A small percentage are still suffering from supply-chain and labour-cost overhangs. High-quality "trophy" assets are changing hands, but the median company is challenged by a mismatch of seller and buyer valuation expectations.

Private equity is not immune to changes in financial markets or rate changes. As with other markets, it is cyclical and timing can be challenging. Deal volumes decline when there are shocks, like we have seen over the past two years. However, capital deployed during challenging periods has historically performed well, benefiting from lower entry multiples and shifts in the business cycle. For example, the 2001 and 2009 vintages of U.S. buyout funds have each delivered median net IRRs above 20%, with upper-quartile returns in excess of 25%, according to Preqin.

Financing costs influence pricing decisions, creating a disconnect between the price expectations of sellers who acquired assets under one interest-rate regime relative to the price expectations of prospective buyers operating under another. If interest rates were



Why consider adding alternatives to your portfolio?

Investors with a long-term horizon could benefit from including exposure to alternative investments in their portfolios, namely private equity, private credit, unlisted real assets, such as real estate and infrastructure, and hedge funds. Alternative investments can enhance portfolio risk-adjusted returns through cash flows and valuation drivers that are different in nature to those found in companies that issue publicly traded equity and fixed income securities. Additionally, unlisted real assets provide investors with income streams that rise and fall with inflation, unlike the nominal dividends and interest payments that are typically received from stocks and bonds.

Privately held assets in general help to reduce portfolio volatility due to relatively muted drawdowns across market cycles because they're less influenced by the noise that sometimes causes dislocations in public markets. Beyond exposure to a wider cross-section of systematic risk factors, private markets provide opportunities to capture additional skill-based risk premiums and generate attractive absolute returns. This is by virtue of lower information efficiency that rewards specialized origination capabilities, active ownership that requires operational intervention and capital-structure optimization, and trading illiquidity that enables long-term compounding of capital.

TD Wealth maintains a neutral weight on private-market alternative assets.

expected to remain constant, asset prices would simply adjust to the new reality, and the market would clear. But if the current interest-rate regime is expected to be temporary, buyers and sellers will continue to struggle to agree on fair market value (FMV).

Medium-term interest rates have been volatile over the past three years. Since the U.S. regional banking crisis began in March 2023 — amplified by dovish comments from the Fed chair toward the end of that year — markets have routinely priced massive reductions in interest rates, which encouraged financial sponsors and target-company corporate-development teams to postpone acquisitions into the future, when the cost of leverage was expected to be lower. (Why borrow today at elevated rates when financing costs will return to more "normal" levels in the not-too-distant future?) The value of the "real option" to delay a transaction increases with the probability and magnitude of the potential fall in interest rates, lest a seller leave dollars on the table.

According to Carlyle, the pace of FMV gains in private equity has slowed since 2022 compared to prior years. GPs who paid top-of-the-market valuations in 2021 have seen valuation-multiple compression, but often this was offset by robust operating profit growth. As a result, there was positive, albeit muted, value creation on paper. Total market multiple (TMM) uplift at exit has averaged 0.4x since 2018, with peak uplifts of 0.5x in 2020 and 0.7x in 2021. More recently, uplifts have ranged from 0.2x to 0.3x since 2023. While GPs have largely exited above the mark, they have benefited from the fact that they are not yet forced sellers, by choosing to sell holdings that can achieve strong valuations.

Carlyle is seeing longer holding periods, with the median reaching seven years by the end of 2023 — the longest on record. This compares to four years in the mid-2000s and 5.5 years in the late-2010s. GPs are waiting for valuation multiples to increase and bid-ask spreads to narrow again before exiting. This is evident from the fact that only 9% of deals made in 2021, a period of peak valuations, have exited; by contrast, an average of 20% of deals exited within three years for 2015 to 2019 vintages. The ability to optimize exit timing is an advantage and hallmark of private equity. As long as underlying portfolio companies continue to perform, funds will accrue NAV over time and opportunistically sell their holdings.

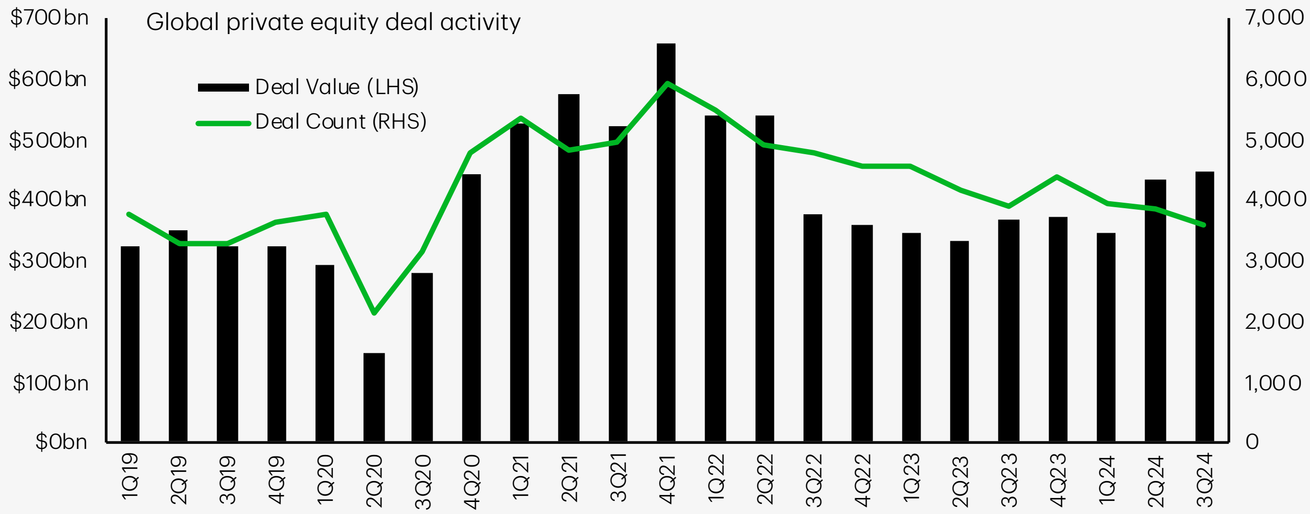
When GPs can't exit their portfolio companies through trade sales to their counterparts or via initial public offerings (IPOs) to public-market institutional and individual investors, they can't fund distributions to their LPs. One way for cash-strapped LPs to proceed is through secondary market sales of their closed-end fund units to liquidity providers — such as Hamilton Lane or Blackstone Strategic Partners — at nominal discounts to net asset value (NAV). The secondary market for such LP-led deals serves as an important relief valve for the private-equity community and remains in vogue going into 2025. Additionally, this demand has driven GPs to explore innovative strategies to create liquidity options for LPs, and private-equity sponsors continue to turn to secondary markets, and especially continuation funds, to drive distributions to paid-in capital (DPI). Such GP-led transactions have increased by over 50% in the past year, and secondary volumes overall have increased by nearly 60% year-over-year, on pace to set a record in 2024, according to UBS Asset Management.

With limited turnover in ownership, GPs are increasingly turning to mid-market companies, implementing buy-and-build and bolt-on acquisitions strategies as central pillars of value creation. By integrating smaller add-ons, a company's entry multiple can be "bought down," provided these smaller businesses can be successfully integrated into the platform investment. The rapidly growing platform then becomes more attractive to buyers and can hopefully command a higher valuation at exit, thereby earning back the multiple expansion that had previously been a given.

Another angle is the corporate carve-out — the purchase of a non-core or unloved business from within a large company. These are especially popular where the larger organization is viewed as inhibiting growth, or the business unit is burdened with a less-favourable valuation. Companies have been divesting non-core assets at a rapid pace in recent years, a buying opportunity for private equity that has always existed but is growing as part of GP sourcing.

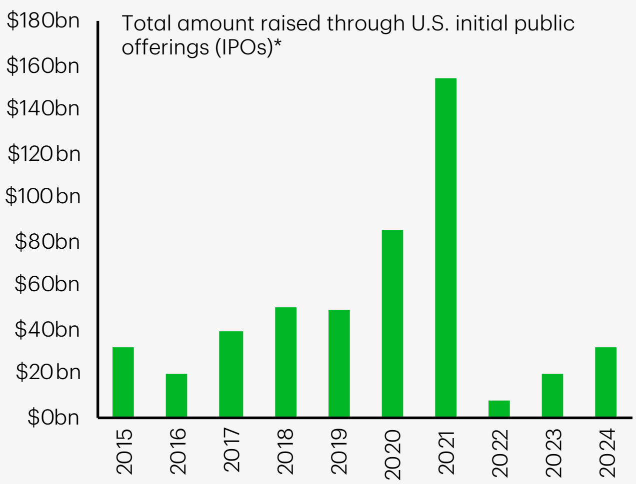
There may be good news on the horizon. With 100 basis points (bps) of policy-rate cuts by the Fed late last year, implying that the inflation cycle may be in the rear-view mirror, transaction activity has signalled green shoots of recovery. As shown in Figure 1, the first three quarters of 2024 saw a meaningful increase of 17% year-over-year in deal values after a slower 2022 and 2023, albeit well below peak levels seen in 2021. Continued monetary policy easing should provide a tailwind for financial sponsors and the broader buyout and mergers & acquisitions (M&A) markets, including renewed IPO windows, boosting investor confidence in deal valuations. We expect exit activity to pick up, but it will take time for the build-up of NAV to work its way through the system.

Figure 1: Deal values have increased 17% y/y after a slow 2022 and 2023



Source: Wealth Investment Office, Preqin, UBS Asset Management as of September 30, 2024

Figure 2: U.S. IPO market's slow recovery



*Data excludes special purpose acquisition companies (SPACs)
Source: Wealth Investment Office, Factset as of December 31, 2024

Additionally, Figure 2 shows that IPO volumes are slowly recovering towards levels seen in the mid-2010s. Some notable names touted in the press that may be on the docket for public-equity capital raises in 2025 include fintech payments processor Klarna, AI compute provider CoreWeave, medical supplier Medline, fintech mobile banker Chime, AI-driven call centre software developer Genesys, liquified natural gas exporter Venture Global, and identity manager SailPoint.

Notable Deals in Q4

BlackRock paid US$9.3 billion in stock and a further 2.9 million in shares (worth US$3 billion) in five years for HPS Investment Partners, an alternative asset manager with US$148 billion in assets under management (AUM) that has traditionally dominated the junior debt and preferred equity corners of the private-credit universe. This follows prior acquisitions of Global Infrastructure Partners (US$12.5 billion) and private-markets data group Preqin (2.55 billion pounds), a testament to BlackRock's expansion of its capabilities.

Mubadala Capital, the alternative asset management arm of Mubadala Investment Co., is taking Canada's CI Financial private in a $12.1-billion all-cash deal, implying $4.7 billion of equity value. Following transaction close, CI will continue its Canadian operations with its current structure and management team and will be independent of Mubadala Capital's other portfolio businesses.

In a US$8-billion transaction including debt, Blackstone acquired a majority ownership position in Jersey Mike's Subs, a founder-owned high-growth submarine sandwich franchisor with an established brand, capital-light business model, approximately 3,000 locations in all 50 states, and No. 2 franchise 500 ranking.

Blackstone and Vista Equity Partners acquired collaboration software-as-a-service (SaaS) offering Smartsheet in an all-cash take-private deal valuing the company at US$8.4 billion. Blue Owl Capital led the US$3.2-billion private-debt financing to support the acquisition, a club deal priced at the secured overnight financing rate (the U.S. benchmark for floating-rate loans, aka SOFR) plus 650 bps, with participation from 20 other lenders including Carlyle, HPS and Ontario Teachers' Pension Plan. This includes a US$2.9-billion annual recurring revenue (ARR) loan and a US$300-million revolving credit facility. The rate rises to SOFR plus 700 bps if payment-in-kind is toggled.

Private Credit

Spreads in public-credit markets have compressed significantly over the past two years and currently trade at or near cycle tights. Looking at data from the Federal Reserve Bank of St. Louis, U.S. investment-grade corporate issuers can price new issues in the low-80-bps context, the most expensive in two decades, and capital can be raised in the U.S. high-yield corporate-bond market for approximately 275 bps, which is below the all-time 5th percentile. Arguably, public credit is priced to perfection, with limited compensation for potential default risk should the U.S. economy falter. Alternatively, there remain compelling opportunities in private-credit direct lending and asset-backed loans, the latter offering the most favourable risk-adjusted yields, according to Carlyle.

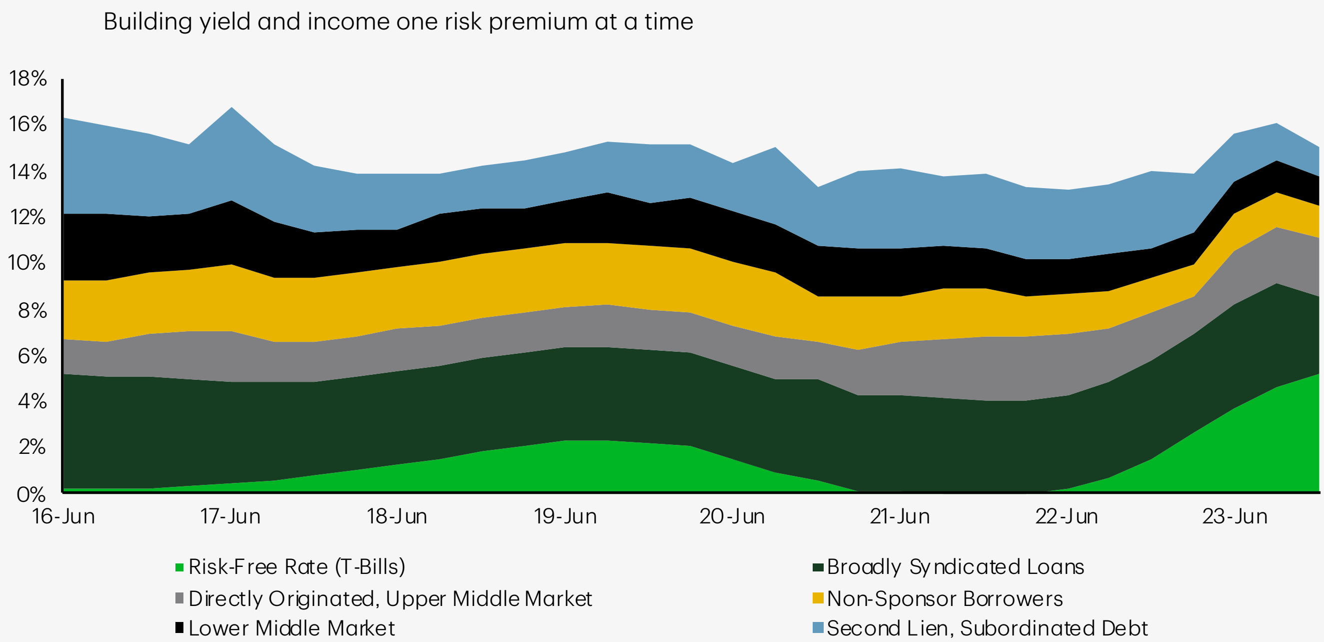
Direct lending to companies in the middle market continues to deliver compelling low-double-digit returns on first-lien senior-secured debt with conservative underwriting, asset stability and robust lender protections. Non-accruals, payment-in-kind and defaults remain manageable for top-quartile fund managers. Base rates are declining but will likely hover around 3.5% over the medium term, based on three-month SOFR futures as well as median policy rate projections from the Federal Reserve.

Spreads for directly originated first-lien senior-secured loans to sponsor-backed companies in the upper middle market remain compelling at around 500 to 600 bps. Figure 3 shows that these can be enhanced as we intentionally build yield through exposures to non-sponsor-backed companies, lower middle market deals and second-lien or subordinated positions down the capital structure.

Alternative capital providers supplanting traditional lenders is now a familiar tale. Banks faced increased capital regulations following the global financial crisis and subsequently retrenched from corporate lending, effectively inducing direct lending as a mainstream asset class. As traditional lenders face further headwinds, the next chapter in the private-credit story may be the migration of asset-backed finance (ABF) towards alternative capital providers. Along with other capital requirements, the Basel 111 endgame - which is tied to political policy and could change - stipulates a 100% risk-weighting for unrated assets, common within the ABF universe, regardless of true risk, requiring banks to hold an outsized amount of capital and thus potentially rendering this type of lending unfavourable for banks.

ABF is a form of private credit backed by pools of contractual assets that amortize principal continuously, such as loans, leases and mortgages. This compares to direct lending, which is backed by the cash flows of individual companies and typically pays back principal at maturity. According to Brookfield Oaktree, underlying assets in the US$5.5-trillion ABF universe reflect the breadth of the global economy, such as aircraft leases, credit card receivables, car loans, consumer loans, residential/commercial mortgages, music/pharmaceutical royalties, corporate litigation, factoring platforms and other financial assets that can be used as security for loans to generate liquidity, such as synthetic risk transfers (SRTs).

Figure 3: Private credit has something for everyone



Source: Wealth Investment Office, Preqin as of September 30, 2024

It's important to note that alternative lenders currently play a smaller role in ABF than in mainstream direct corporate lending — the latter dominating the private-debt landscape, with close to US$250 billion of dry powder to deploy, according to Preqin. ABF underlying assets have low correlation to macroeconomic and market factors, offering downside protection and cash yield. These assets are held in a special purpose vehicle (SPV) whereby the private-credit fund manager can control the risk profile through eligibility criteria and concentration limits. Collateral can easily be moved under lender control with limited friction costs.

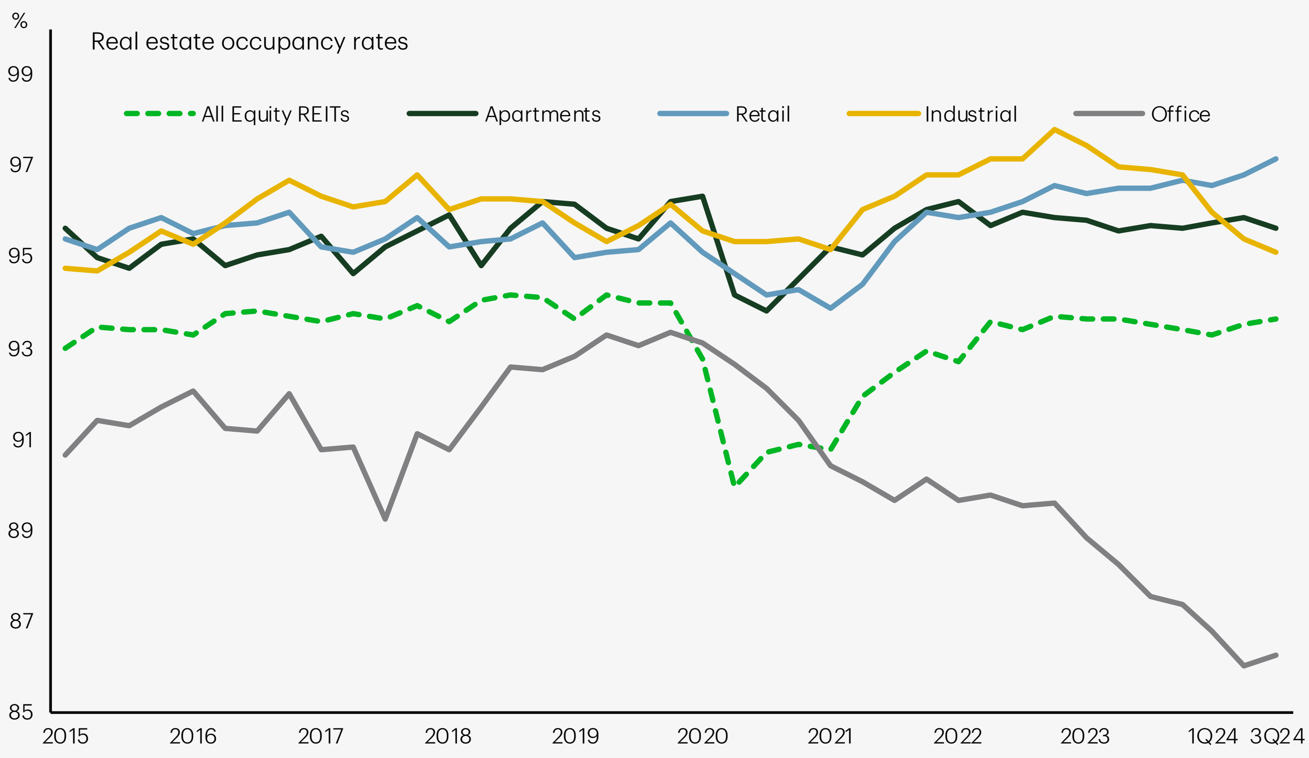
Real Assets

U.S. commercial real estate (CRE) performance in 2025 could remain mixed, making property-type selection paramount in the sector. On one hand, healthy GDP growth, steady unemployment numbers, a moderating pace of inflation and limited recession fears suggest that U.S. economic conditions remain solid. On the other hand, the CRE market remains stuck in a holding pattern driven by a combination of persistent supply-demand imbalances, softening fundamentals, a lingering gap between public and private real estate valuations, and muted property transaction activity. Moreover, there are both residual and emerging risks, namely the threat of onerous tariffs and trade conflicts with Canada and Mexico that may slow or derail economic growth.

We envision a scenario where property-level performance remains bifurcated. Several traditional property types remain marked by incessant supply-demand imbalances, declining occupancy rates, and moderating rental growth rates, which could place pressure on property-level operational performance in 2025. Figure 4 shows that retail-sector occupancy rates, for instance, have plateaued after enjoying rising occupancies through 2023 and early 2024. Occupancy rates for apartments and industrial properties have also dropped off through 2024 due to record amounts of new supply following record rent growth over the past several years. Office occupancies, on the other hand, continue to reflect an uncertain demand environment given more widespread remote work.

Not all is doom and gloom, however, given that most modern-economy property-types should continue to exhibit more robust fundamentals relative to traditional property types. Demand for data centres from AI hyperscalers, for example, is likely to persist. The outlook for health-care real estate also remains positive, particularly for senior housing, where demand from an aging population — coupled with limited new supply coming online — could continue to push rent growth higher.

Figure 4: Apartments/retail stable, industrial rolling over, office in a trough



Source: Wealth Investment Office, NAREIT as of September 30, 2024

Outlook on Commodities

Modest Overweight

Commodities firing on all cylinders

Hussein Allidina, Managing Director and Head of Commodities; | TD Asset Management
Humza Hussain, VP & Director, Commodities | TD Asset Management

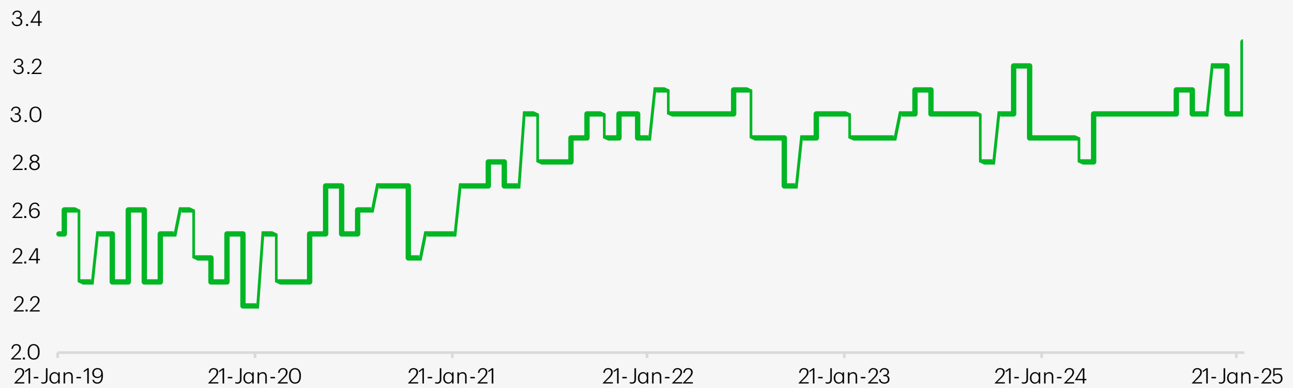
Through 2024, the Bloomberg Commodity Index (BCOM, CAD-hedged) returned 4.7%, helped by a late-year rally that has continued into 2025. The market has pivoted from the narrative that tariffs would be a drag on global growth to one where Trump's policies are seen as inflationary. Economic data has also been supportive, including stronger-than-expected gasoline demand and job numbers. Since bottoming in mid-December, BCOM has rallied 7.5% (as of Jan 15, 2025), led by the energy basket. Almost every commodity is higher, while equities and fixed income have retreated, attesting to the diversification benefits of including commodities in a portfolio.

We believe this robust performance of late is a function of many factors, both micro and macro. On the macro front, higher inflation expectations and stable growth (improving in China) have supported the flow of investment capital into commodities. Investors have been seeking diversification as rich equity valuations give them pause, and the fixed income market has not been the stable diversifier it once was. Recently, fixed income has faced headwinds such as higher rates (especially on the longer end of the curve) as well as higher inflation expectations. Collectively, the need for diversification and inflation protection has supported recent flows into commodities.

Energy: Better-than-anticipated setup

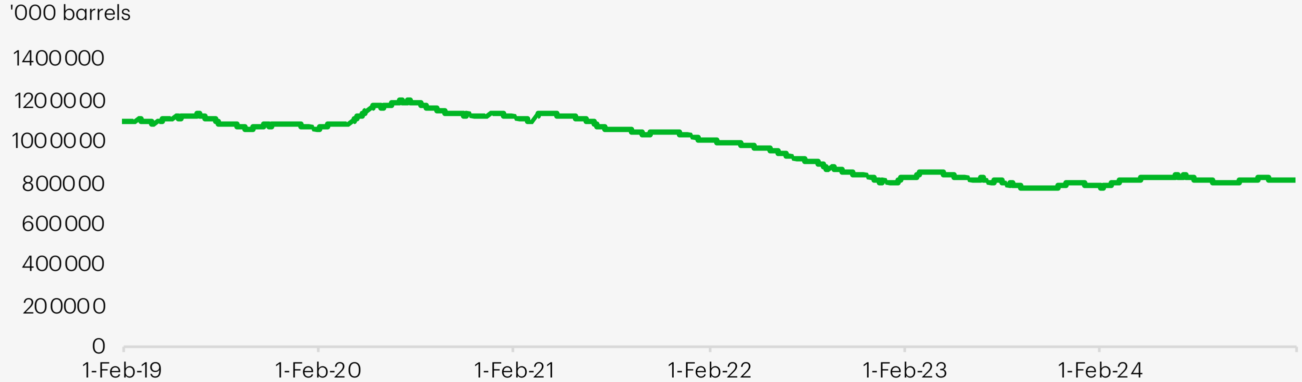
On the micro front, commodities have found support from better-than-expected fundamentals. In energy — and oil in particular — the consensus was far too bearish (arguably since mid-2024, following the release of very weak Chinese oil demand data). This consensus had centred around the idea that 2025 balances would shift from deficit to surplus due to weak demand, non-OPEC supply growth, and the need for OPEC to return barrels from spare capacity. However, crude stocks have been much tighter than bearish expectations.

Figure 1: Inflation expectations on the rise



Source: FactSet, TD Asset Management as of January 21, 2025

Figure 2: U.S. crude stocks in decline



Source: FactSet, TD Asset Management as of January 21, 2025

This is reflected not only in available inventory data (Figure 2) but also in the shape of the forward curve (where more backwardation represents a bullish trend), positive refinery margins, and generally constructive cash prices globally. Biden imposing his strictest sanctions to date on Russia has only provided further support.

We remain of the view that crude fundamentals should remain relatively constructive throughout the year, supporting price and structure. Non-OPEC supply should grow, but we anticipate continued downward revisions to lofty estimates (particularly in Brazil and the U.S.) We are also skeptical that OPEC spare capacity is as high as some bears argue, and we don't see the group returning barrels until needed. Oil remains the best hedge against inflation and is under-owned; further upside is likely, especially if Trump 2.0 leads to lost supply from Iran, Russia and Venezuela.

Metals: Base metals turning the corner

Metals have also found support from tightening inventories and an improvement in China. Scrap copper imports (Figure 3) were very strong in 2024 (the highest in six years), and import volumes in November were up more than 10% year-over-year. Part of this strength may reflect some front-running ahead of possible Trump tariffs, but activity in China is generally seen as improving from the lows of mid-2024.

One of the biggest stories of 2024 was gold, up 26%, which is especially remarkable given the strength in both the USD and real rates (which historically have been inversely correlated with gold). We see precious metals, and gold in particular, continuing to outperform as emerging-market central banks continue their purchases. ETF interest is also likely to remain supportive, especially as concerns over equity performance and the sustainability of debts/deficits return to the forefront.

The Outlook: Still early innings

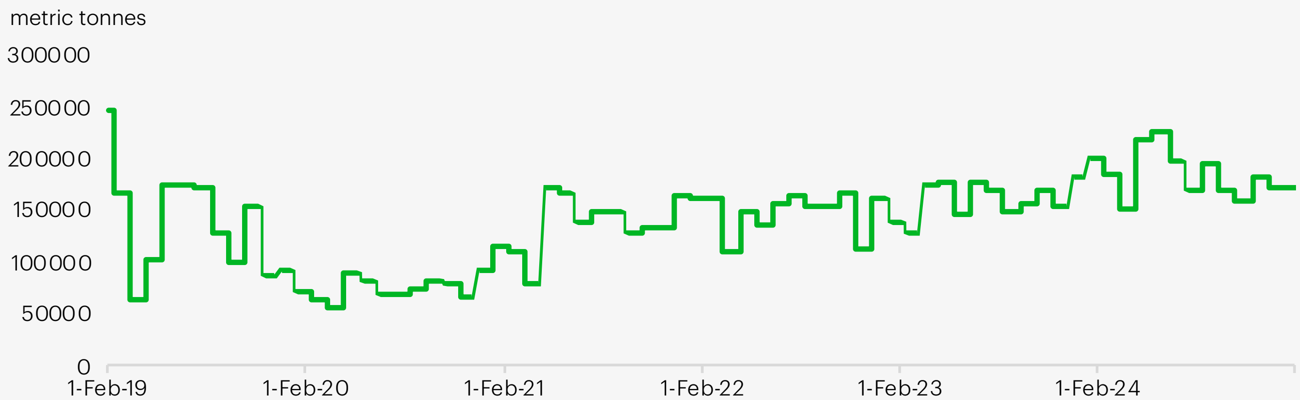
This year is likely to be a volatile one for all assets, particularly with heightened trade and geopolitical risks. We believe we are still in the early stages of the commodity "investment" phase, which historically has resulted in meaningful total-return performance (above the long-term annualized 10% per annum that the Bloomberg Commodity Index has generated since 1960).

The biggest risk to the outlook is growth, and growth today seems to be holding up well. Chinese growth is important for commodity demand, but this is not the 2000s, when commodity balances could accommodate the type of growth China exhibited in the last supercycle. Put differently, even with a very weak China (and Europe) in 2024, commodity inventories tightened, and returns were positive. Why? Because commodity supply has been challenged following more than 10 years of underinvestment (the exploitation phase of the cycle).

Furthermore, emerging markets such as India, Indonesia, Malaysia, Vietnam and Nigeria are experiencing income growth and, by extension, increased commodity demand. The next decade is likely to see far more commodity demand in the developed world as well, driven by increased capex to rehabilitate old-economy infrastructure (bridges, roads), reshoring, and new-economy investments (AI, power generation, energy transition).

We strongly believe that portfolios with a commodity allocation will outperform those without, owing not only to the constructive microeconomic factors but also to the supportive macroeconomic environment. The optimal allocation over time is 5% to 10%, but in periods of heightened inflation, where "core" assets are challenged, optimal allocations are even higher.

Figure 3: Scrap copper imports at six-year highs



Source: FactSet, TD Asset Management as of January 21, 2025

Outlook on Currencies

A Cheerful Pessimist's 2025 Guide to GeoMacro

TD Securities, Global Rates, FX & Commodites Strategy

Last year, 2024, was a year of reversal — all mean reversion, no trends and little conviction. Remember data dependence? This began to change in Q4, underscoring a pivot in the U.S. data narrative, Fed repricing and Trump 2.0. Trump is only a piece of this story, but the implications will dictate the early market themes to start the year. Mean reversion is out, and macro trends are back.

Tariff threats, even if just bargaining chips, will insert a new risk premium into markets, reinforcing U.S. momentum in growth and equity performance. The U.S. dollar provides a nice carry boost to boot. Meanwhile, the rest of the world's (ROW) growth and data trends have softened, while Europe deals with ongoing political uncertainty and symptoms of stagflation.

Tailwinds for the U.S. dollar

We think investors prefer to trade trends. They are easier to follow, and timing contrarian entry points is also much harder. With that in mind, we believe this could reinforce a supportive backdrop for the U.S. dollar through most of the first half of 2025. Our quant/macro framework also remains bullish on the U.S. dollar versus G10 currencies, despite signals that positioning and short-term valuations are stretched.

This setup reflects a shift in market fundamentals, where key factors like growth and inflation momentum favour the U.S. dollar. What's more, our global regime indicator sits in a bullish U.S. dollar environment, underscoring deceleration in the ROW. We expect the U.S. dollar (BDXY) to retest the 2022 highs, suggesting core long exposure.

What we are watching in 2025

We expect 2025 will be the year of geomacro trends — a term that captures a mix of international affairs, geopolitics and macro markets. This underscores the importance of geomacro over central banks and data dependence, especially given that central bankers can't control these external forces. The uncertainty over tariffs and Trump 2.0 should boost the risk premium, favouring the U.S. dollar.

Most of the price action in 2024 was dictated by factors that mean-reverted, suggesting a lack of conviction and few macro trends. The change toward Q4 reflected the impact of the resilient U.S. economy, Fed repricing and expectations of Trump 2.0. In turn, we see this handover to 2025 providing a lift to geomacro trends, aiding the U.S. dollar through fundamental roots.

For currency markets, the focus has been a mix of equity momentum and carry, and both factors are positive for the U.S. dollar at this point. Emerging-markets (EM) carry has massively underperformed, and the G10 carry basket continues to massively outperform the EM one, which again, is another U.S. dollar influence.

Another sidebar to this story is the fact that the ROW has been quickly losing steam, reflecting the impact of Europe and China. Europe appears mired in stagflation, while China has yet to deliver the bazooka package needed to remedy its balance-sheet recession. The heightened risk environment likely boosts the risk premium as well. There are a number of factors we expect will support the U.S. dollar, which appears to be the only game in town.

The wrinkle in all of this is that U.S. dollar strength potentially destabilizes the world, which could sow the seeds of its own demise. Trump's focus is the trade deficit, and an overvalued U.S. dollar will make it worse. We believe this is a year to expect the unexpected, including a grand FX bargain.

Trudeau and Trump add to the loonie's woes

We remain bearish on the Canadian dollar due to local risks (i.e., diverging Fed-BoC policy) and global risks. Canada is at risk of tariffs from the U.S. given the heavy trade reliance on the U.S. In addition, Canadian productivity has drastically lagged behind the U.S. While we believe the outlook for the loonie remains challenging, we would also view any dips in the USD/CAD as potential buying opportunities, since we believe the downside is limited.

For the Canadian dollar to benefit from any change in leadership, there needs to be a strong pivot to the centre, favouring a more pro-business government. However, there is no clear path here. In fact, political uncertainty will likely prevent any imminent, meaningful fiscal package from the government in the next six months.

Trump 2.0 and Trade Wars

Trump 2.0 has begun, and leading up to January 20, the talk of the town was all about tariffs, trade policy and related macro impacts. While we believe that Trump's political north stars are to reindustrialize the Rust Belt, reduce the trade deficit and weaken the U.S. dollar, that's not the script for early 2025.

Initially, the threat of tariffs — and, if realized, the potential boost to inflation — are factors that should increase risk premiums and favour the U.S. dollar. The countries most at risk are likely those with three factors: (1) a trade surplus with the U.S.; (2) a current account surplus; and (3) a cheap currency.

Figure 1: Foreign Exchange Forecasts for G10 Currencies

	2025				
	Jan 13, 2025	**Q1 F**	**Q2 F**	**Q3 F**	**Q4 F**
USD/JPY	157	152	150	148	145
EUR/USD	1.02	0.99	1.00	1.03	1.05
GBP/USD	1.21	1.18	1.19	1.21	1.25
USD/CHF	0.92	0.92	0.91	0.90	0.89
USD/CAD	1.44	1.48	1.46	1.43	1.40
AUD/USD	0.62	0.59	0.60	0.63	0.64
NZD/USD	0.56	0.53	0.54	0.56	0.57
BBDXY	1321	1349	1334	1301	1273

Source: TD Securities as of January 13, 2025

Market Performance

Canadian Indices ($CA) Return	Index	(%) 1 Month	(%) 3 Months	(%) YTD	(%) 1 Year	(%) 3 Years	(%) 5 Years	(%) 10 Years	(%) 20 Years
S&P/TSX Composite (TR)	102,231	-3.27	3.76	21.65	21.65	8.58	11.08	8.65	8.12
S&P/TSX Composite (PR)	24,728	-3.59	3.03	17.99	17.99	5.23	7.70	5.39	5.04
S&P/TSX 60 (TR)	5,009	-3.36	3.80	21.04	21.04	8.34	11.44	9.06	8.53
S&P/TSX SmallCap (TR)	1,505	-3.30	0.69	18.83	18.83	4.15	8.93	6.01	4.24
S&P/TSX Preferred Share(TR)	2,108	2.59	3.49	24.70	24.70	2.66	6.51	3.05	2.98
U.S. Indices ($US) Return									
S&P 500 (TR)	12,912	-2.38	2.41	25.02	25.02	8.94	14.53	13.10	10.35
S&P 500 (PR)	5,882	-2.50	2.07	23.31	23.31	7.26	12.73	11.07	8.22
Dow Jones Industrial (PR)	42,544	-5.27	0.51	12.88	12.88	5.40	8.31	9.09	7.10
NASDAQ Composite (PR)	19,311	0.48	6.17	28.64	28.64	7.27	16.57	15.09	11.54
Russell 2000 (TR)	12,060	-8.26	0.33	11.54	11.54	1.24	7.40	7.82	7.79
U.S. Indices ($CA) Return									
S&P 500 (TR)	18,580	0.34	9.10	36.22	36.22	13.73	16.92	15.55	11.35
S&P 500 (PR)	8,464	0.22	8.74	34.35	34.35	11.97	15.08	13.47	9.20
Dow Jones Industrial (PR)	61,221	-2.62	7.08	22.99	22.99	10.03	10.57	11.45	8.07
NASDAQ Composite (PR)	27,788	3.29	13.11	40.16	40.16	11.98	19.00	17.58	12.54
Russell 2000 (TR)	17,354	-5.70	6.89	21.53	21.53	5.69	9.65	10.15	8.77
MSCI Indices ($US) Total Return									
World	17,352	-2.57	-0.07	19.19	19.19	6.85	11.70	10.52	8.55
EAFE (Europe, Australasia, Far East)	11,158	-2.25	-8.06	4.35	4.35	2.17	5.24	5.71	5.31
EM (Emerging Markets)	2,853	-0.09	-7.84	8.05	8.05	-1.48	2.10	4.04	6.38
MSCI Indices ($CA) Total Return									
World	24,970	0.15	6.46	29.87	29.87	11.55	14.03	12.91	9.53
EAFE (Europe, Australasia, Far East)	16,056	0.48	-2.05	13.69	13.69	6.65	7.43	8.00	6.26
EM (Emerging Markets)	4,106	2.70	-1.81	17.73	17.73	2.85	4.24	6.29	7.35

Currency									
Canadian Dollar ($US/$CA)	1.44	2.70	6.35	8.62	8.62	4.41	2.06	2.16	0.90
Regional Indices (Native Currency, PR)									
London FTSE 100 (UK)	8,173	-1.38	-0.78	5.69	5.69	3.44	1.62	2.21	2.68
Hang Seng (Hong Kong)	20,060	3.28	-5.08	17.67	17.67	-5.00	-6.58	-1.61	1.73
Nikkei 225 (Japan)	39,895	4.41	5.21	19.22	19.22	11.48	11.02	8.62	6.42

Benchmark Bond Yields	3 Months	5 Yrs	10 Yrs	30 Yrs
Government of Canada Yields	3.14	2.97	3.23	3.33
U.S. Treasury Yields	4.33	4.38	4.58	4.78

Bond Indices ($CA Hedged) Total Return	Index	1 Mo (%)	3 Mo (%)	YTD (%)	1 Yr (%)	3 Yrs (%)	5 Yrs (%)	10 Yrs (%)
FTSE TMX Canada 91-day Treasury Bill Index	472	0.33	1.08	4.92	4.92	3.81	2.48	1.71
FTSE TMX Canada Universe Bond Index	1,169	-0.69	-0.04	4.23	4.23	-0.60	0.79	1.98
FTSE TMX Canada All Government Bond Index	1,094	-0.87	-0.40	3.31	3.31	-1.32	0.27	1.60
FTSE TMX Canada All Corporate Bond Index	1,440	-0.14	1.03	6.97	6.97	1.47	2.31	3.04
U.S. Corporate High Yield Bond Index	303	-0.58	-0.16	7.20	7.20	2.10	3.42	4.47
Global Aggregate Bond Index	259	-0.92	-1.44	2.41	2.41	-1.23	0.01	1.62
JPM EMBI Global Core Bond Index	529	-1.80	-2.67	5.12	5.12	-2.25	-0.99	2.26
S&P/TSX Preferred Total Return Index	2,108	2.59	4.20	24.70	24.70	2.66	6.51	3.05

Source: TD Securities Inc., Morningstar®, TR: total return, PR: price return, as of December 31, 2024

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