TD Asset Management

Market Perspectives + 15 Minutes = Current Insights

Year Ahead 2020 | Q1 2020

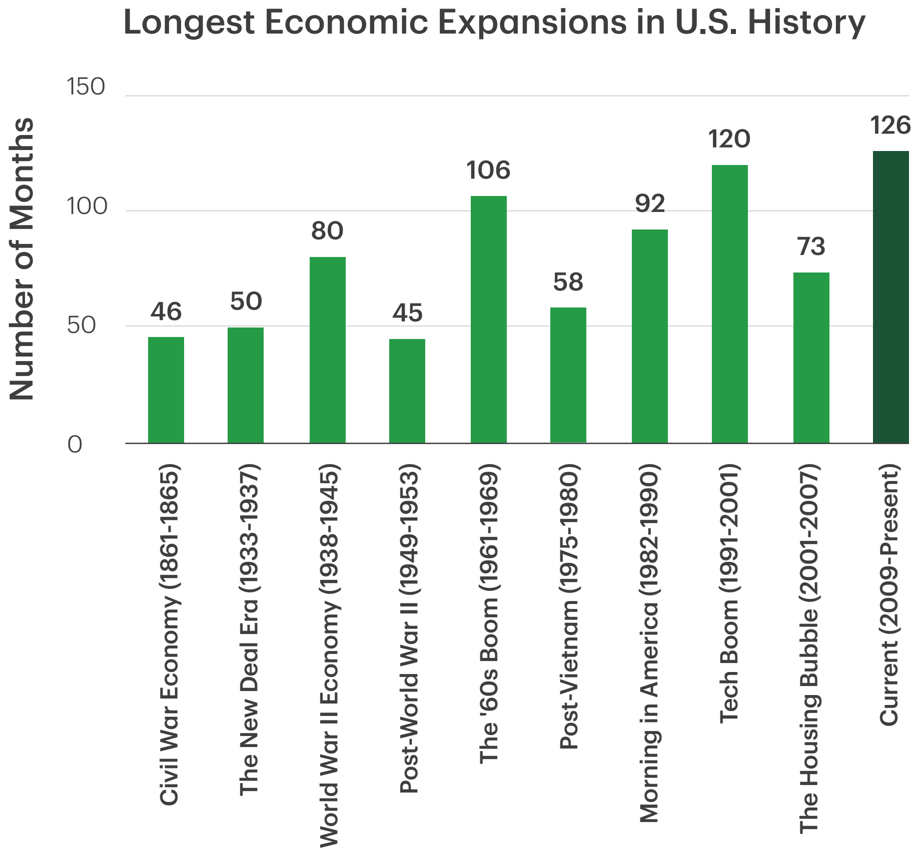
TD Wealth Asset Allocation Committee (WAAC) Overview

- Remain overweight equities and underweight fixed income
- Expect lower for longer rate environment to continue with inflation low and central banks accommodative
- Corporate credit and private debt continue to provide an incremental yield advantage versus government bonds
- We anticipate a protracted conflict between China and the U.S. on issues of trade and technology leadership
- Volatility will continue primarily driven by growth versus slowdown expectations and U.S./China trade war
- Demand for urban living and global infrastructure supports stable and growing income for real assets

Market Outlook

The Enduring Economic Expansion
A cycle of resilience

It's official! The U.S. economic recovery from the devastating Great Recession (2007-2009) made history in July 2019, as the 121-month expansion became the longest on record. According to the National Bureau of Economic Research, the previous record spanned 120-months (1991-2001) and many will recall the dotcom implosion that punctuated its calamitous end. In December, the cycle extended to the 126-month mark and continues to roll along.



Economic Expansion Defined

An economic expansion is an increase in the level of overall economic activity. It is a period of expansion measured by Gross Domestic Product growth.

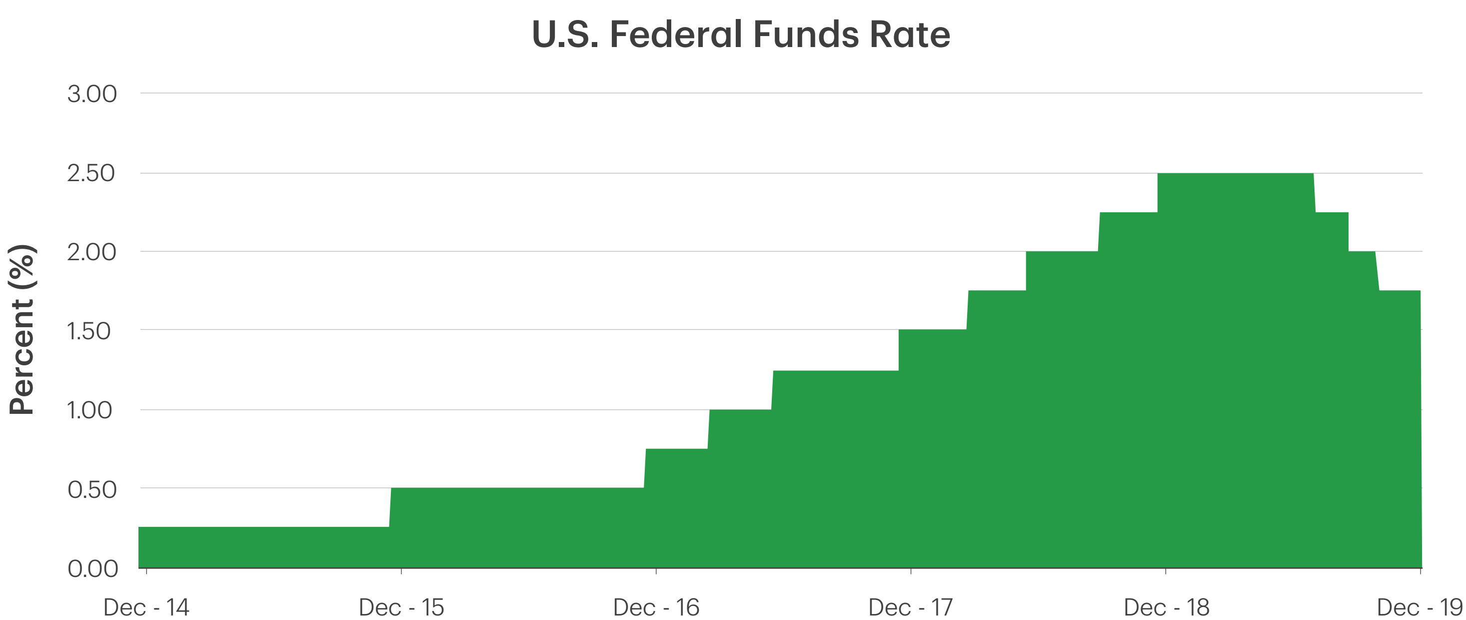
The four stages of an economic cycle are also known as the business cycle and comprised of: expansion, peak, contraction, and trough.

The current cycle has endured despite many market pundits claiming that an economic slowdown or recession is inevitably looming on the horizon. What has been the key driver behind the unprecedented run in business activity? What has it meant for equity market performance, bond yields and central bank policy?

Source: As of December 2019.
U.S. Business Cycle Expansions and Contractions, The National Bureau of Economic Research
http://www.nber.org/cycles.html

Central banks to the rescue

Following a relatively shallow rate hiking cycle, the U.S. Federal Reserve (the Fed) swiftly pivoted from hawkish to dovish and cut interest rates three times in 2019, responding to subdued inflation expectations, slowing global growth rates, and negative repercussions from trade wars. While there has been no shortage of criticism directed at the Fed, history may prove that a "soft landing"—the best possible outcome of central bank policy—may have been achieved in this cycle.



Source: Bloomberg Finance L.P. As of December 31, 2019.

Similarly, central banks from around the world are using monetary policy to help manage and support the economy. As growth has moderated, central banks have lowered rates or utilized expansionary monetary policy measures to boost spending and investment.

At home, the Bank of Canada (BoC) has not been shy about expressing concerns regarding the domestic picture and has cited the global deceleration in economic activity and unpredictability of the U.S./China trade relationship as potential risks to future growth. As a result, the BoC maintained its already low benchmark rate at 1.75% throughout 2019, while cutting its outlook for economic growth for 2020. However, the BoC has expressed a receptiveness to adjusting rates lower in the future as it focuses on global developments and their impact on the outlook for growth and inflation.

Bank of Canada Overnight Rate Target

Source: Bloomberg Finance L.P. As of December 31, 2019.

How have equity markets responded?

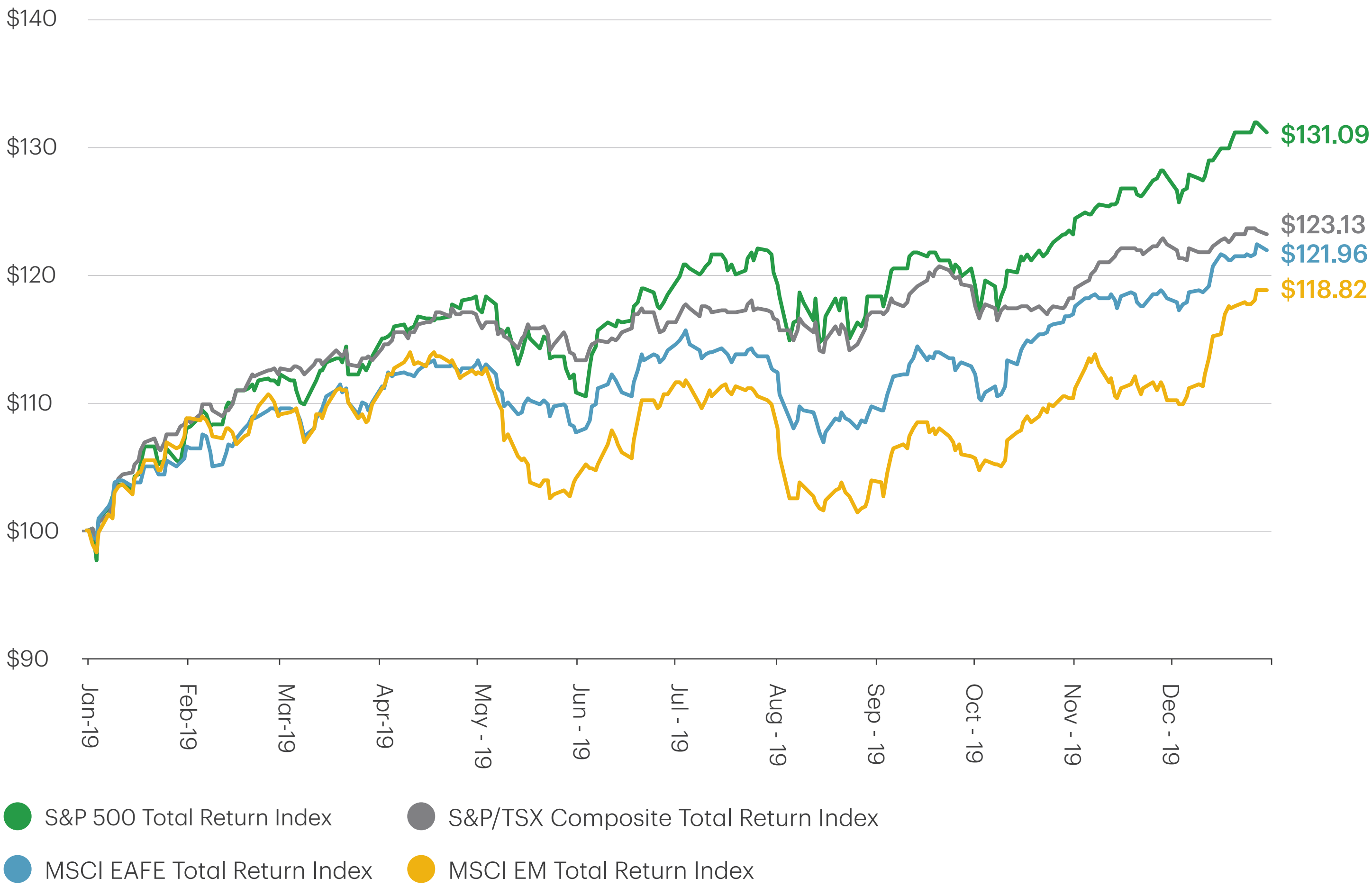
By the end of 2018, equity returns were at levels often witnessed after sharp drawdowns, corrections or recessions. Markets recovered in 2019, delivering double digit gains globally and above 20% in the U.S. and Canada (in Canadian dollar terms). Since September, we have also seen value stocks recover, and more recently emerging markets equities have risen, an asset class where we have maintained an overweight view throughout the year.

The late stages of the economic cycle are historically noteworthy as they often bring high potential market returns but are also associated with a wall of worry, that prevailing risk factors will eventually bring pain when the music stops.

Recovery

Index returns over the past 12 months

The growth of $100



Source: Bloomberg Finance L.P. As of December 31, 2019

What seems more probable at this point is that we are enduring the third mini slowdown within a very long cycle. While the cycle has been long, the amplitude of the growth has been relatively slower than typical cycles. As a result, we have seen fewer excesses, and it is excesses that have often ended cycles. Encouragingly we are seeing some early economic indicators bottom out or turn up from their recent lows.

Unyielding to the Curve

If market concerns were a popularity contest, the yield curve would have been second only to trade wars in 2019. Flat to inverted yield curves have been prevalent around the world, and typically follow a central bank tightening cycle or precedes a recession or slowdown. A yield curve inversion is often considered a warning signal for financial markets; however, significant time can elapse before a possible economic downturn or major market decline occurs.

Fueling recession concerns is the fact that we are in the longest economic expansion on record, but expansionary cycles do not end abruptly without reason. While moderating growth and geopolitical concerns continue to weigh, the North American economy and corporate health remain strong and central bank policies appear to be delivering the intended outcomes.

Since the global financial crisis and subsequent recession, the economy has witnessed a prolonged yet steady recovery at the lowest growth rates on record. Combined with low inflation, central banks have been afforded latitude to deploy stimulative measures for longer periods to help maintain a steady economic course, with relatively fewer interest rate hikes in between. This central bank balancing act has helped extend the current cycle and may propel equity markets even higher in 2020.

Wealth Asset Allocation Committee (WAAC) positioning

Our view for 2020

Economic data across the globe largely disappointed to the downside in 2019. European economies have been particularly tenuous, with some countries on the verge of recession, if not already in recession. The Chinese economy has been relatively stable, but excess leverage remains an ongoing concern. Additionally, the protracted trade war between the U.S. and China, a decline in business confidence in the U.S. and elsewhere, have all been fodder for an undercurrent of investor uneasiness throughout the year. On the positive side, North America continues to be supported by healthy consumer spending, a solid job market and incrementally higher wages. Overall, bonds and equities delivered solid gains across most major global markets, with North American stocks closing out the year near all-time highs.

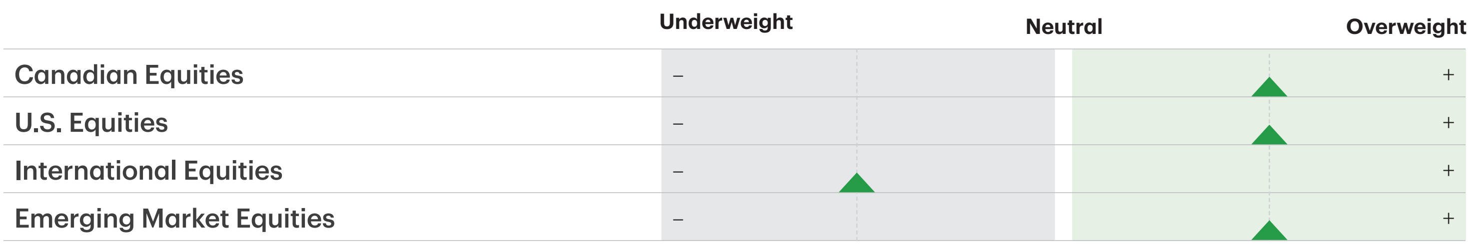
We believe equities will continue to deliver gains in 2020, but at a more subdued level.

Looking ahead, we continue to be cognizant of a convergence of macroeconomic factors that may influence the performance of financial markets. While some factors are supportive of continued economic growth, any optimism should be tempered with potential risks clouding the horizon, namely geopolitical developments, trade protectionism, and potential for central bank missteps. However, the recent progress between the U.S. and China on trade, the UK's retreat from the brink of a no-deal Brexit, and global central banks commitment to accommodation – are all positive developments for markets.

Equities

You Should Know...

We believe equities will continue to deliver gains in 2020, but at a more subdued level. Overall, Canadian equities are priced at a forward Price-to-Earnings discount to U.S. stocks and are inexpensive relative to global peers.



Although Canadian economic growth is expected to lag the U.S., we believe opportunities exist for **Canadian equities.** The labour market, despite a recent negative print on payrolls, continues to look reasonable with wage growth of over 4%. Additionally, quality Canadian companies continue to generate increasing free cash flows and improved fundamentals. Overall, Canadian equities are priced at a forward Price-to-Earnings discount to U.S. stocks and are relatively inexpensive relative to global peers. With the overall S&P TSX Composite Index paying a dividend yield of approximately 3%, we believe the Canadian equity market presents solid opportunities for long-term investors.

We also feel that concerns among global investors about a collapse in the Canadian housing market is unwarranted. We have witnessed pockets of stress across regions of Canada, but this has not translated to an outright economic shock. Canada still has favourable demographics and high immigration, and we feel that this will continue to support property markets, but do not expect future gains to mirror the dramatic increases of past years.

On the risk side, Canada is not immune from the hazards associated with the uncertain geopolitical climate, and disturbances to the world economy could result in domestic weakness. Elevated levels of Canadian household debt also remain a concern, and may weigh on consumption growth, particularly in the event of rates creeping higher.

The U.S. economy remains the world's largest, and while it may have shown signs of slowing, labour markets are still quite strong with healthy consumer spending. We do not anticipate a near-term recession and are seeing signs of a resumption in growth. We expect corporate earnings growth to remain broadly positive but at more moderate levels compared to 2019. Companies are generating positive free cash flows and are expected to continue to boost dividends and repurchase shares. Market valuations appear to be reasonable, despite being at the higher end of the valuation range from a historical perspective.

All eyes are on the political situation in the U.S., particularly on the upcoming 2020 presidential election, where the outcome could have a range of implications for markets. With a Democratic victory, though a lower probability unless we see a recession, could result in meaningful changes to policy and contribute to market uncertainty. Despite the noise coming from the political arena, and around the globe, there are several reasons we continue to maintain our overweight stance on U.S. equities, including:

- **Growth has slowed but we do not expect a recession in North America**
- **Free cash flow generated by companies has been impressive, leaving corporations in good financial position to raise dividends, and repurchase shares**
- **Despite higher relative valuations, multiple expansion (higher Price-to-Earnings ratios) may be driven by the low interest rate environment**
- **U.S. unemployment rate remains near 50-year lows and wages and hours worked have been increasing**

We maintain a modest underweight stance on **international equities** as the eurozone continues to grapple with sluggish growth. Global trade tensions continue to weigh, particularly in Germany, due to its large reliance on international trade compared to its counterparts. Eurozone economies are fragile as Manufacturing Purchasing Manager's Indices (PMI) remain in contractionary territory across the region. The European Central Bank has shown a commitment to accommodative monetary policy and keeping bond yields contained through its stimulus measures, however our outlook remains cautious. On the positive side, geopolitical concerns weighing on the region have subsided somewhat, with some progress made on the trade front, and the probability of a no-deal Brexit dropping considerably.

We maintain an overweight outlook for **emerging market equities**. A combination of continued easing and fiscal stimulus by global central banks, and progress between the U.S. and China on trade, reinforce our view. Forward Price-to-Earnings ratios for emerging markets stocks are considerably lower than many developed Markets. These lower equity valuations, coupled with China's commitment to fiscal stimulus, suggest that we may see stronger market performance over the long term. However, uncertainty around ongoing pro-democracy protests in Hong Kong have dampened signs of progress on trade negotiations.

Alternative investments

	Underweight		Neutral		Overweight
Canadian Real Estate	–			▲	+
Commercial Mortgages	–			▲	+
Global Infrastructure	–			▲	+

We maintain a modest overweight to **Canadian Real Estate**. Sound fundamentals across property types has allowed for year-over-year net operating income growth, particularly in assets located in transit-linked nodes in major urban areas. Projections for robust population growth is expected to tighten demand and supply dynamics, while the role of e-commerce and technology will transform uses within retail and industrial assets. We believe active management will play a critical role to preserve capital and grow multi-generational income streams over the long term.

We maintain a modest overweight to **Commercial Mortgages**. Following volatility in late 2018 and early 2019, the commercial mortgage spread premium over corporate bonds has stabilized near long-term averages and remains attractive. A flat Government of Canada ("GoC") yield curve has caused the additional yield for extending maturity on term mortgages to become less compelling. Conversely, prime rate floating mortgages, which are used on real estate at earlier stages of the real estate life cycle (i.e. land, construction, interim/bridge financing), have become increasingly attractive.

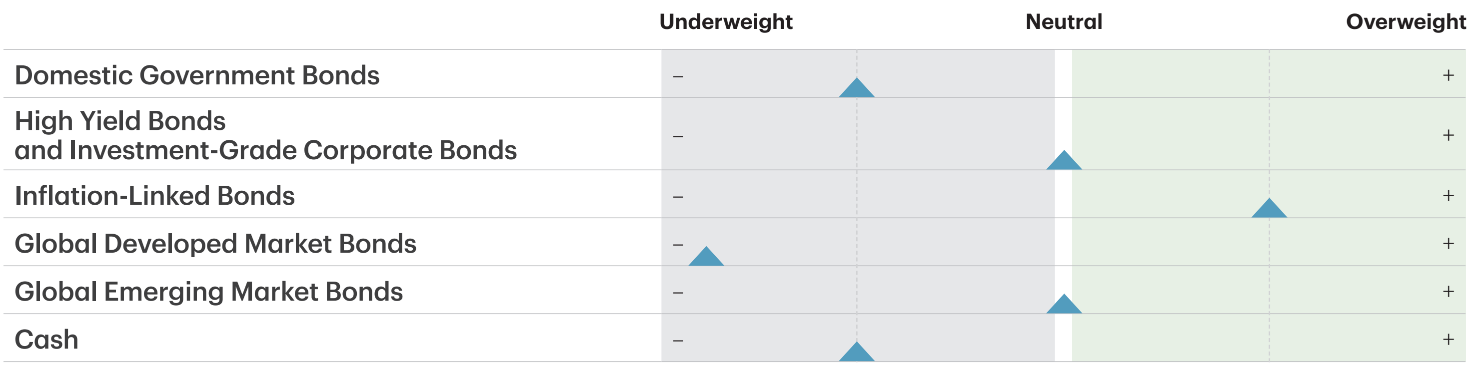
Our strategy heading into 2020 is focused on combining value-add opportunities within floating prime rate loans with stable high-quality term loans. We believe this pairing can provide higher risk-adjusted returns, facilitate less duration risk and more nimble capital deployment.

We maintain a modest overweight to **Global Infrastructure**. Despite solid gains across all asset classes this year, the last twelve months have seen increasing volatility given global macro-economic headwinds, highlighting the need for private infrastructure in portfolios. We believe that direct, private infrastructure investments provide stability and income to a portfolio, but also can benefit from an active investment approach as we enter the late stages of the economic cycle in 2020.

Fixed Income

You Should Know...

Our overall outlook for bonds remains unchanged as we view the spread of expected returns between equities and fixed income as justification for our overweight stance on equities versus fixed income.



We maintain an overall underweight view for bonds, as the spread of expected returns between equities and fixed income reinforces our preference for equities.

Yields declined throughout 2019, driven by a wave of easing and dovish central bank policies across the globe. Policy makers have become increasingly data dependent and stated an almost unified commitment to using accommodation to sustain the economic expansion. We expect bond yields to remain in a range near current low levels, as global growth expectations continue to be subdued and markets price in rate cuts for the coming years.

In December, we reduced our rating on Investment **Grade Corporate and High Yield bonds** to neutral from modestly overweight, primarily due to full valuation levels. Corporate and High Yield bonds continue to offer a yield advantage over government bonds, and we remain positioned with an emphasis on liquidity and quality in our portfolios. We remain neutral and defensive in emerging markets and anticipate opportunities will arise amid broader volatility.

We continue to underweight **domestic government bonds** due to expectations of muted returns in a prolonged low inflation and interest rate environment. We expect coupon-like returns in the low single digits for the foreseeable future, particularly in light of highly accommodative central banks.

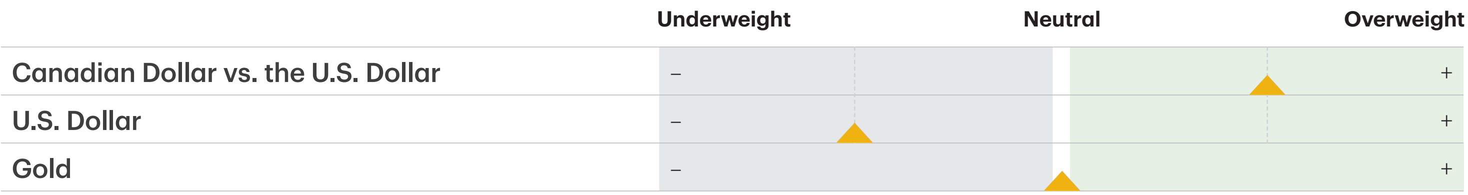
During the year we shifted from neutral to modest overweight **inflation-linked bonds**. While a significant surge in inflation is not in the Committee's forecast, inflation insurance is inexpensive for investors looking to protect against a rise in interest rates driven by a shift in expectations. We also moved from neutral to modest underweight cash. As overnight interest rates continue to fall around the globe, the real return on cash and the optionality it provides portfolios is diminished.

Within the **global developed bond space**, we maintain a maximum underweight view, as low or negative nominal and real yields in Europe and Japan are not compelling from a risk-reward perspective.

Canadian/U.S. currency exposure & Gold

You Should Know...

The potential for continued slowing U.S. economic growth, coupled with a highly accommodative Fed, could put downward pressure on the USD versus a trade-weighted basket of currencies.



Throughout 2019, we maintained our modest underweight view on the USD. The potential for continued slowing U.S. economic growth, coupled with a highly accommodative Fed, could put downward pressure on the USD versus a trade-weighted basket of currencies.

Slowing global growth and geopolitical tensions have driven up demand for safe-haven assets and the price of gold in 2019. We believe an allocation to gold can provide insurance in a portfolio against the risk of extreme outcomes, however we do not believe this insurance is required at this time.

TD Wealth Asset Allocation Committee

The TD Wealth Asset Allocation Committee (WAAC) was established to deliver a consistent asset allocation message and be the originating source for active asset allocation advice across TD Wealth.

The committee has three prime objectives:

Committee Members

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