TD Wealth

Things have changed

Portfolio Strategy Quarterly I Q1 2025

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Things have changed.

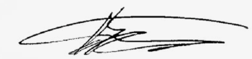
We live in an era where there is a great deal of uncertainty, which is driving a lot of investors to begin to climb the "wall of worry." I've always found that the best way to deal with fear is to put it front and centre and address it.

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.

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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

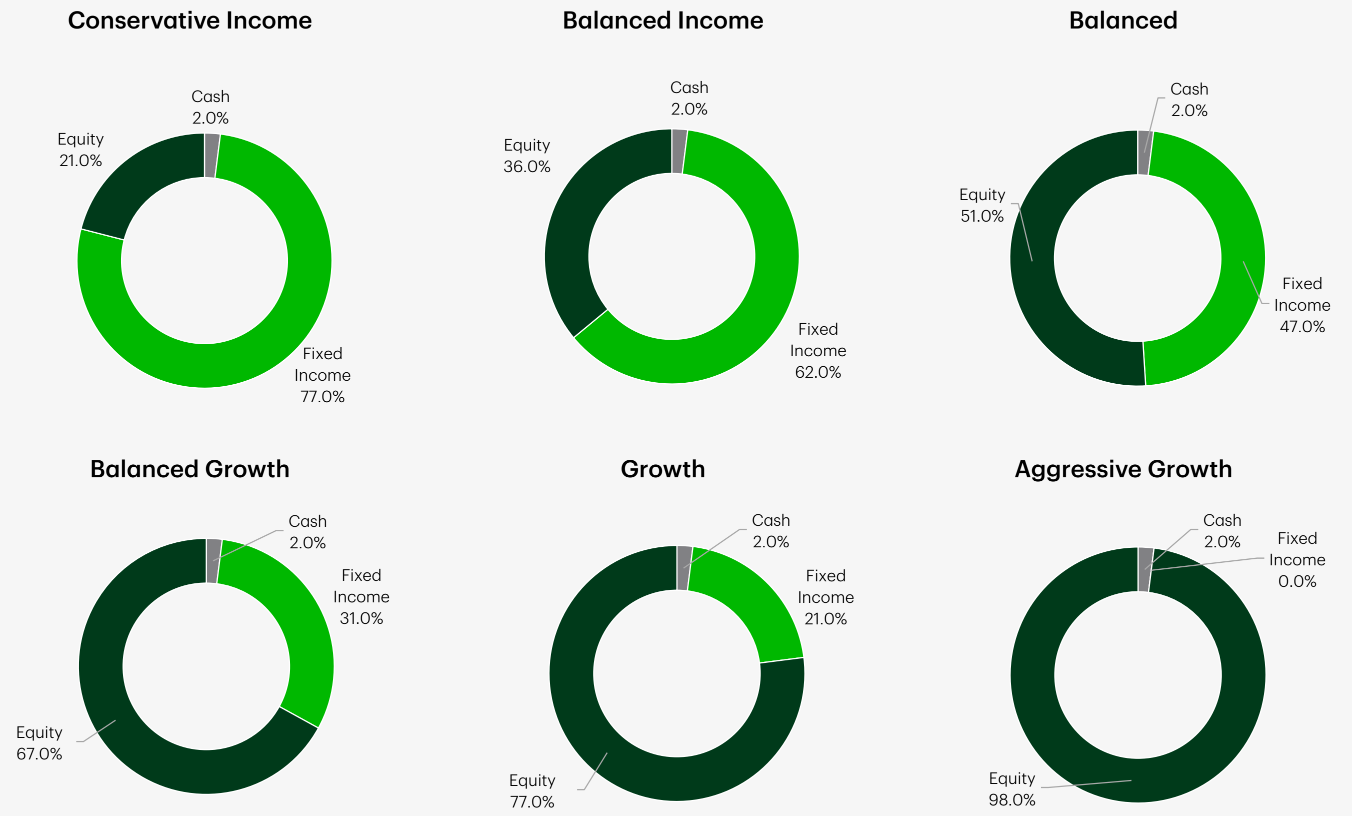
The Bloomberg Commodity Index gained 4.7% in 2024, driven by inflation expectations, stable growth, and diversification demand amid market shifts. **Energy: Better-than-anticipated setup.** Commodities, especially oil, outperform due to tighter-than-expected crude stocks, bullish fundamentals, sanctions 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.

Figure 1: Direction from WAAC: strategic positioning

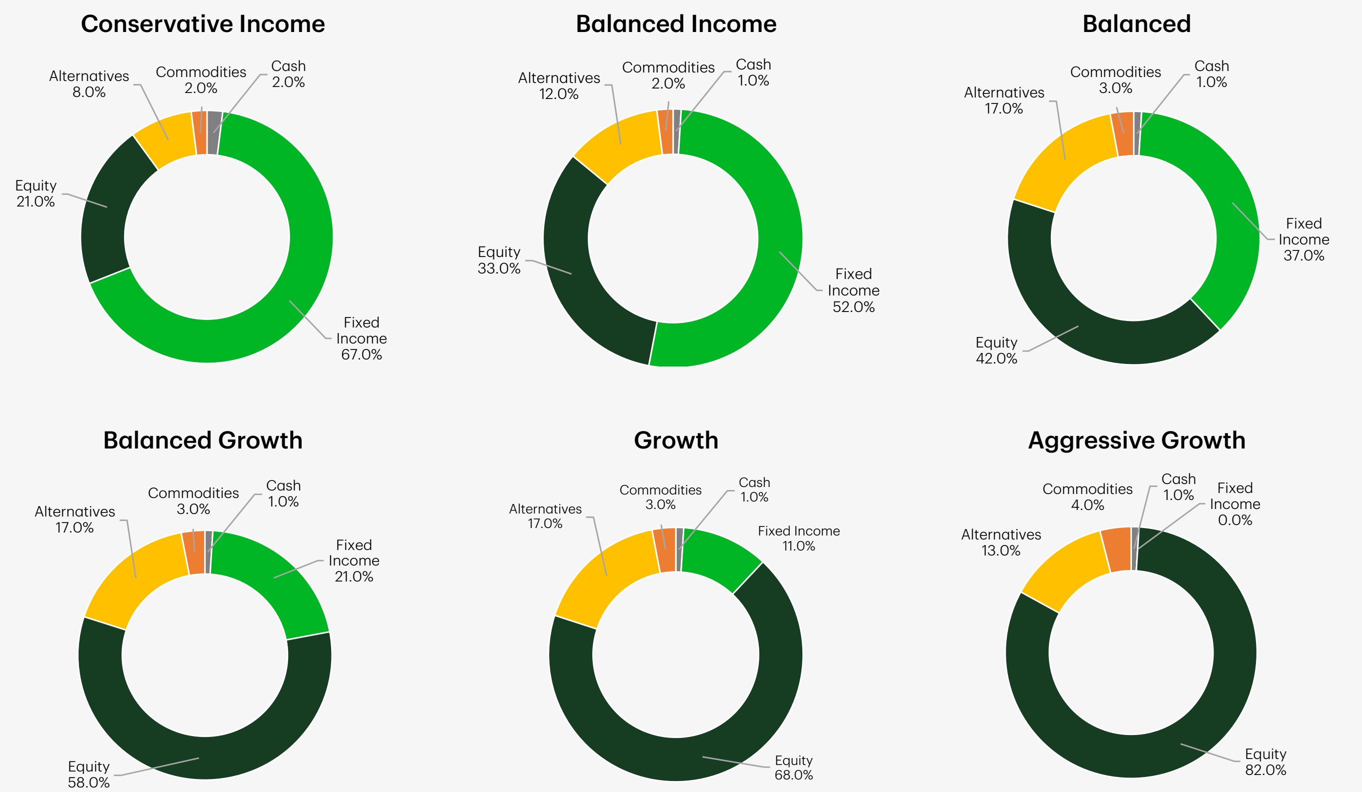
	Asset Class	Underweight		Neutral		Overweight
Cash & Equivalents Modest Underweight			●			
Fixed Income Modest Underweight	Domestic Government Bonds			●		
	Investment Grade Corp. Credit				●	
	High Yield Credit			●		
	Global Bonds - Developed			●		
	Global Bonds - Emerging		●			
Equities Modest Overweight	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.

Dynamic asset-class weights by investor profile (Condensed)



Dynamic asset-class weights by investor profile (Expanded)



Source: Wealth Investment Policy Committee, as of January 16, 2025.

Summary | Q1 2025

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. We think strong diversification is the best way to tackle the quarter ahead and the ones that follow.

Fixed Income | Modest Underweight

- We believe returns going forward will largely be composed of the coupon.
- We hold a **neutral** view on domestic government bonds as yields, while potentially volatile, are attractive.
- We remain **modest overweight** on investment grade (IG) credit. IG spreads are still tight and we believe CDN IG corporate bonds, with their slightly wider spreads, are more attractive than U.S. IG.
- 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.

Equities | Modest Overweight

- We are **modest overweight** U.S. equity as the S&P 500 Index is expected to generate 14-16% earnings growth in 2025. Further, the equal weighted S&P 500 index tends to outperform in a mid-stage economy. This bodes well for companies in the small- and mid-cap as well.
- Stagnant economic activity, tariff threats cloud a recovery as such, we maintain a **modest underweight** position in international and emerging-market equities.

Alternatives | Modest Overweight

- We are **modest overweight** infrastructure as a shift in focus from core infrastructure assets to core-plus and value potentially provides greater growth and higher return potential .
- M&A transaction activity has signaled a green shoots of recovery. Continued monetary policy easing should provide a tailwind for private-equity buyouts.
- We are **neutral** domestic real estate and believe a significant portion of the value adjustments in the CDN commercial real estate space have been taken. Moving forward we see more reason for confidence in the multi-unit residential, retail and industrial spaces.

Commodities | Modest Overweight

- Commodities provide strong diversification benefits to a portfolio, which is even more attractive in the current strained geopolitical environment. We see precious metals, and gold in particular, continuing to outperform as emerging-market central banks continue their purchases.

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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