TD Asset Management

NEW THINKING

forward
PERSPECTIVES

The Great Canadian Uphill Battle

While pockets of opportunity exist, headwinds remain for Canadian equities

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In March 2017, the Wealth Asset Allocation Committee (WAAC) made a decision to underweight Canadian equities in favour of international equities. Throughout 2018, one of our key themes has been a preference for global over Canada from an equity perspective and, after reviewing our stance, WAAC ("we") retain this positioning.

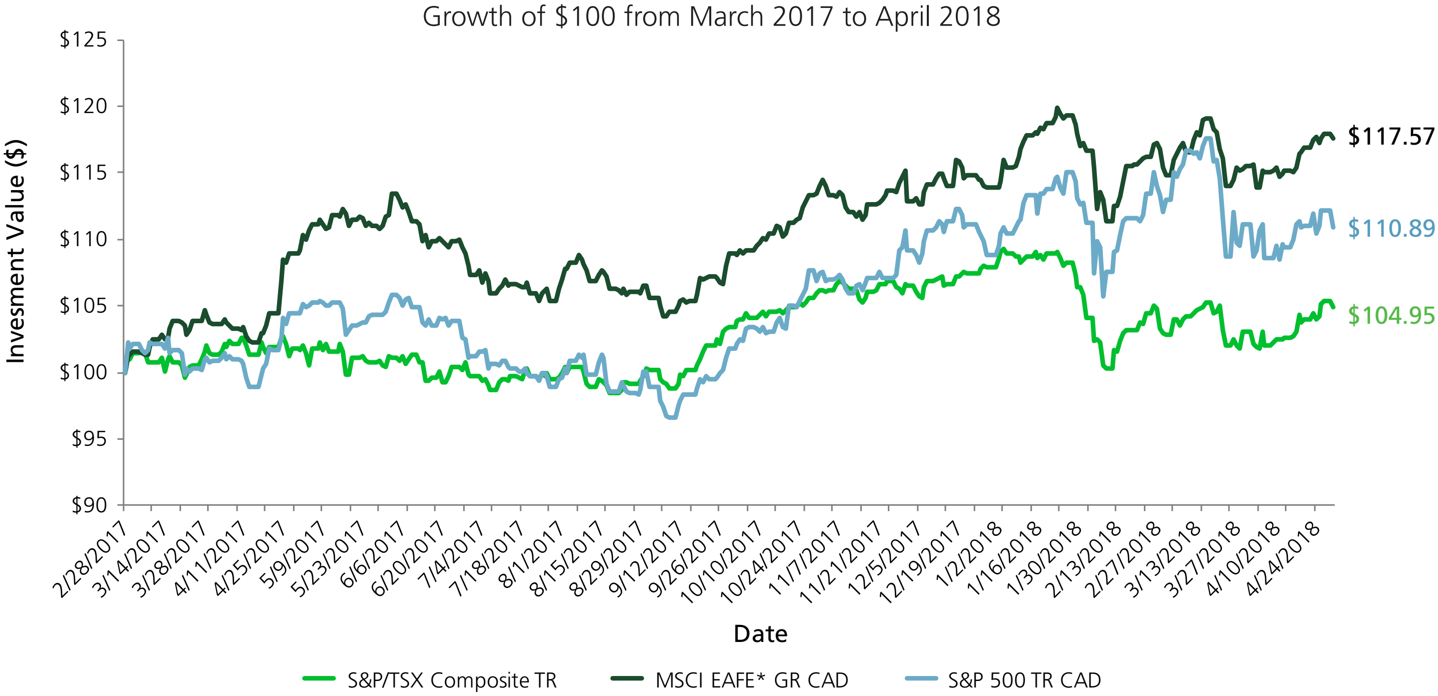
When we made this decision over a year ago, Canadian equities, which had performed strongly over the previous year, were close to their all-time highs. With economic and earnings growth expected to be muted, we didn't feel there was a significant impetus for further equity gains. In conjunction with the positioning change to Canadian equities, we increased our international equity weighting, due in large part to our expectations for European equities. European equity returns had lagged those of their North American counterparts and valuations were attractive, sitting well below their all-time highs. Economic momentum was also favourable, with earnings poised to benefit from improving economic growth and higher inflation in the region.

What has happened since?

Since we made the decision to underweight Canadian equities, they have lagged their global peers as illustrated by the chart below. Canada's stock market ended 2017 with the lowest equity market returns among developed nations. The country's lagging performance can be attributed to the many headwinds facing the country including, economic

Canadian equities lagged global markets

Growth of $100 from March 2017 to April 2018



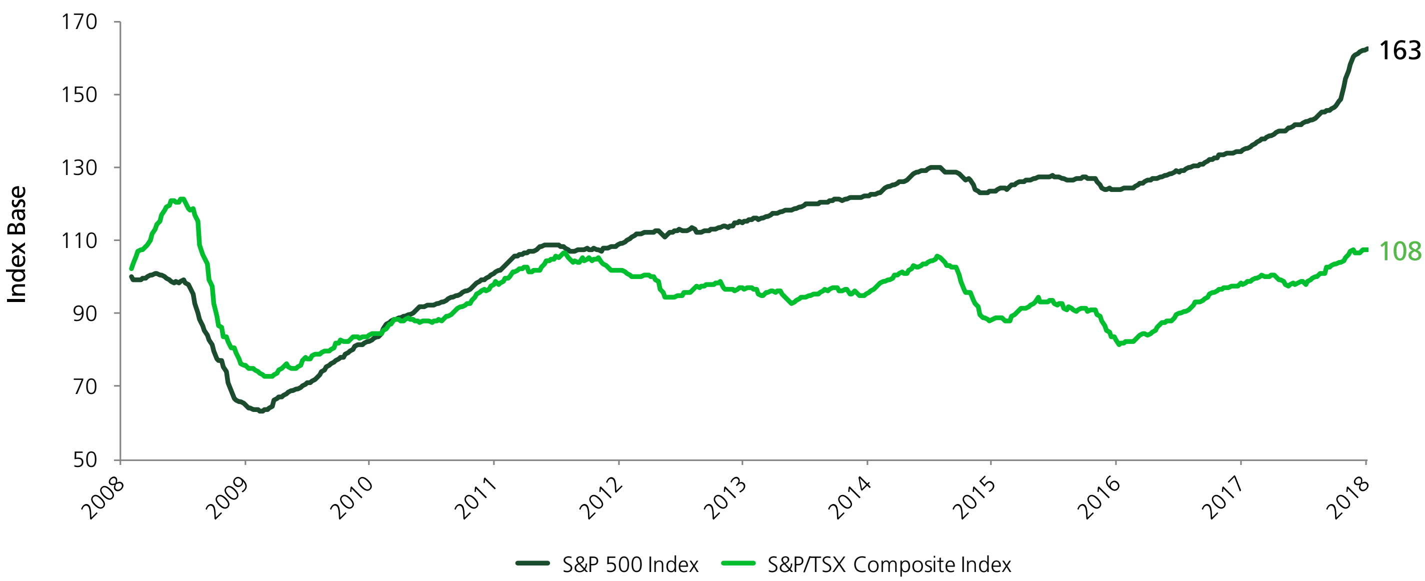
Source: Bloomberg Finance L.P., Data as of April 30, 2018

*Europe, Australasia and Far East

growth sustainability, uncertainty surrounding the North American Free Trade Agreement (NAFTA) as well as the sector composition of the Canadian market, with its minimal weight in the high flying technology sector and heavy weights in resources and financials. These differences have driven large divergences in earnings growth between Canada and the U.S. in recent years, as seen in the chart below.

Canadian earnings have materially underperformed the U.S. over the last 10 years

Forward Earnings

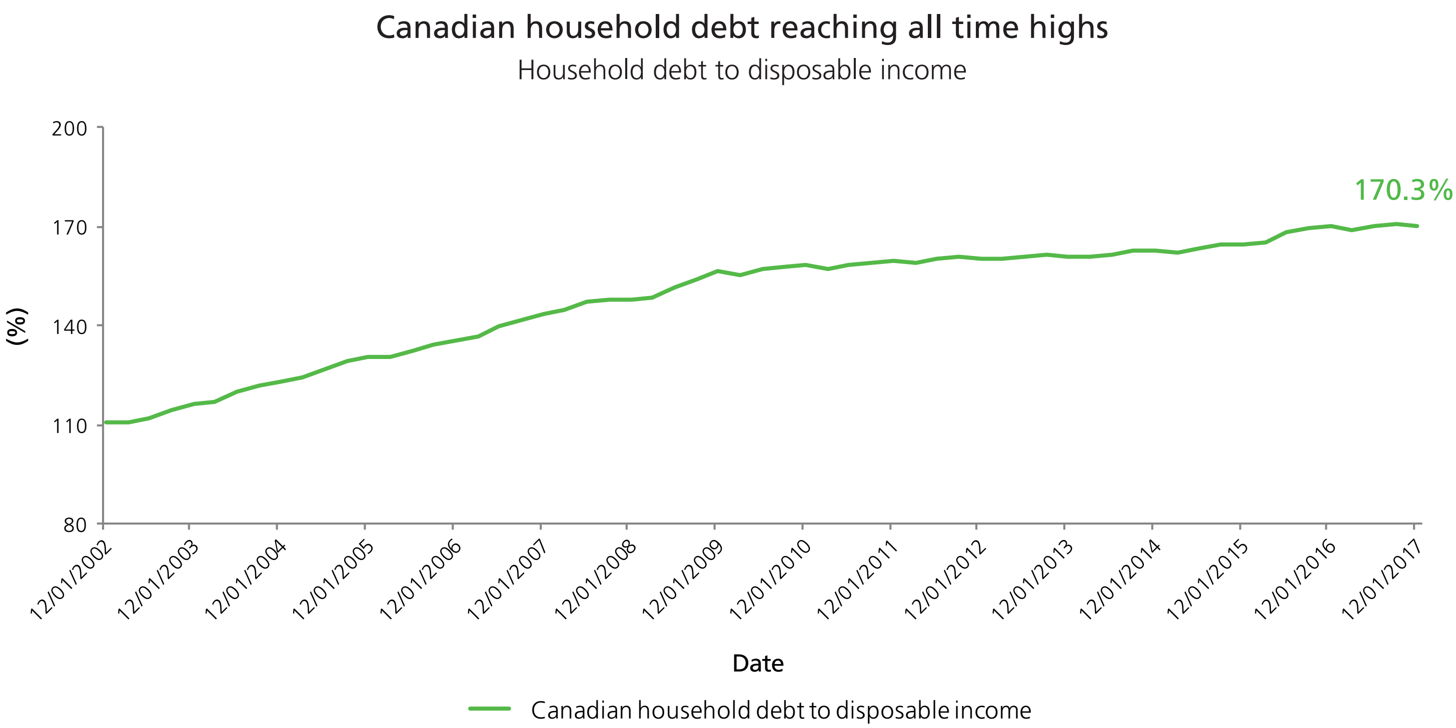


Source: Bloomberg Finance LP, TD Asset Management. As of March 16, 2018.
Index Base begins at 100 for both Indexes.

At this juncture we don't see the headwinds facing Canada subsiding meaningfully enough for a reversal in the trend, and while Canadian equities have performed relatively well recently, we feel they may underperform again in 2018 for reasons we will outline below. This is in contrast to what we see in international markets (EAFE) and the U.S. Strong economic growth, more broad-based earnings growth and reasonable valuations all point to potentially stronger gains globally. Canada isn't all "doom and gloom" though, as we do see some pockets of opportunity (discussed a bit later). For now, let's outline the top headwinds we feel may still provide for a challenging investing environment in Canada.

High household debt - New data continues to show rising debt levels in Canada, with the average Canadian now owing $1.70 for every dollar of disposable income[1]. This degree of indebtedness is a new record for Canadians. The Canadian housing market and other interest rate sensitive industries have taken a hit in recent months, and the expectation is that this trend may continue, should debt and interest rates continue to increase in lockstep in the near term.

The greatest risks to the management of household credit-market debt are economic shocks that lead to job losses that make debt servicing difficult or increases in the interest rate that raise debt-servicing costs. Even without a dramatic rise in risks, our base case is that growth in Canada may remain lackluster for some time as consumers retrench and repair their balance sheets. This in turn may create headwinds for domestically focused businesses.

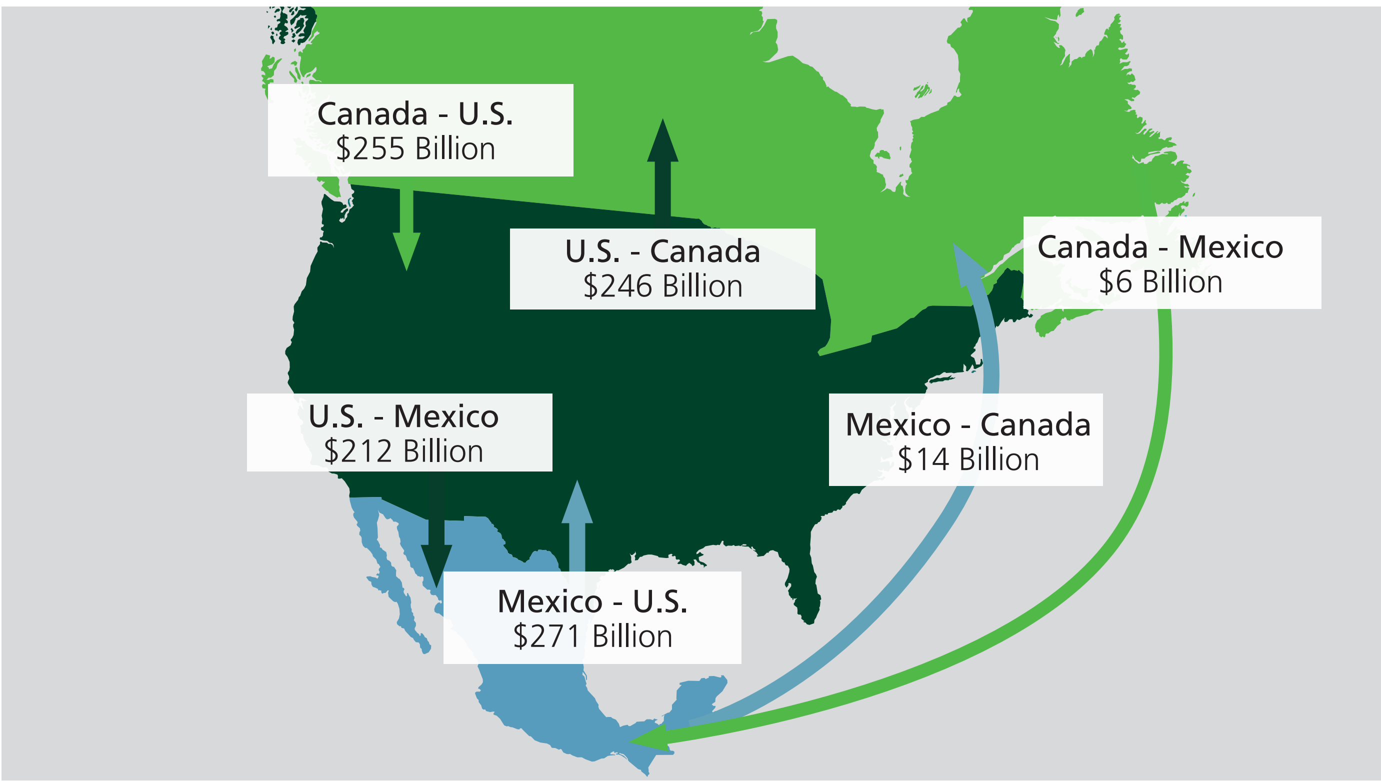


Source: Bloomberg Finance L.P., Data as of December 1, 2017

NAFTA uncertainty - NAFTA, which has underpinned economic integration and prosperity in North America for nearly 25 years, has come under intense scrutiny by the U.S. The current U.S. administration announced it was looking to renegotiate and rewrite the terms of the trade agreement in an effort to transform the U.S. economy for decades to come. After several rounds of meetings with NAFTA leaders, the final outcome still remains unclear, and more rounds of negotiations are being planned for the near future.

In 2016, Canadian exports to the U.S. stood at $255 billion (USD), which accounts for about three-quarters of all outward trade from Canada. That's equal to roughly 20% of this country's economy. Canadian companies, meanwhile, currently have roughly $475 billion worth of cross-border investment in the U.S., and NAFTA supports about 3.4 million Canadian jobs by way of trade and investments with the U.S[2]. Our belief is that NAFTA has benefited all three member countries and that a modified agreement that is mutually beneficial is still possible. However, U.S President Donald Trump and several members of his administration appear to be increasingly antagonistic to free trade. Depending on the outcome from the NAFTA negotiations, we would anticipate the Canadian dollar to be negatively impacted.

Flow of trade between NAFTA partners



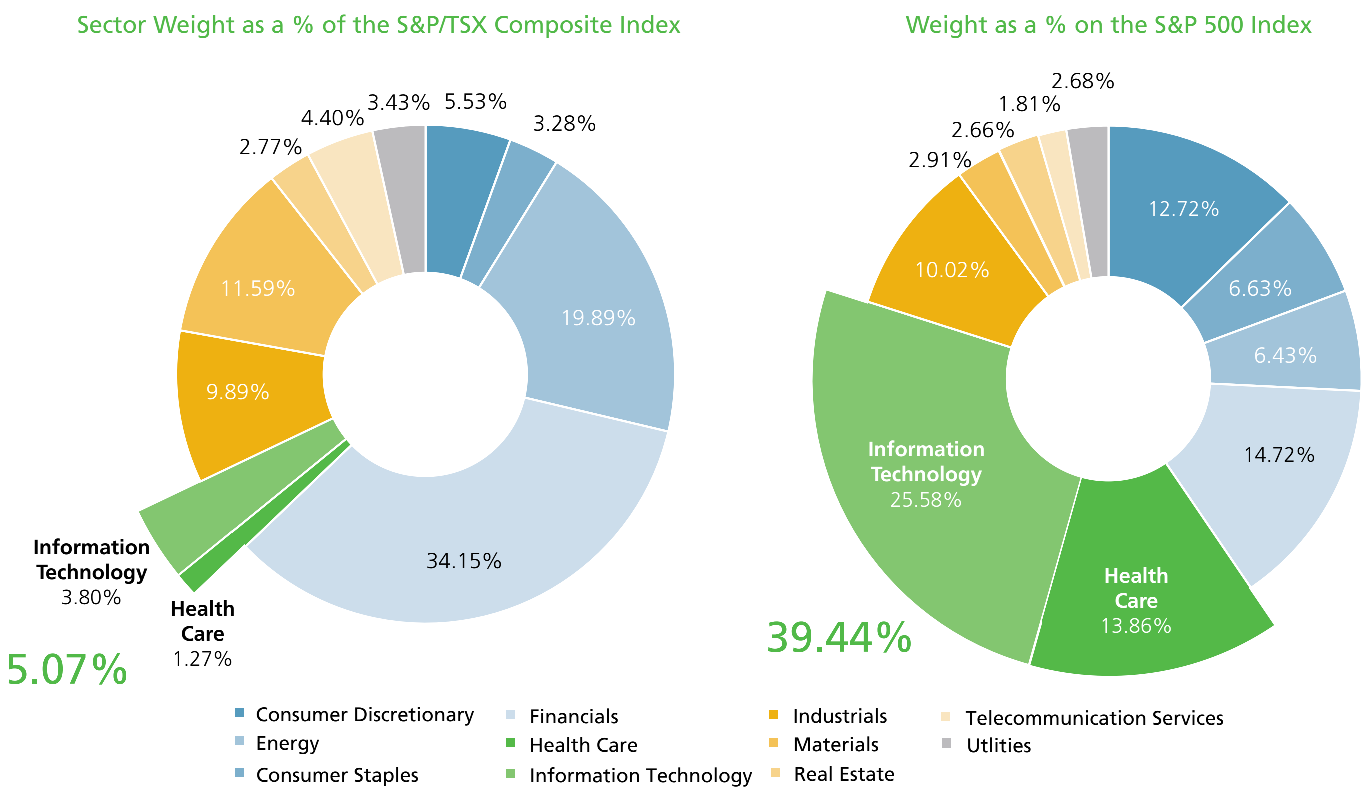
Source: U.S. Census for U.S.- Canada and U.S. - Mexico trade flows (2016 data). Statistics Canada for Canada-Mexico trade flows (2015 data). All figures in U.S. Dollars.

Politics surrounding pipelines - Though Canada has the third-largest proven oil reserve in the world[3], the extraction of oil from these reserves has proven particularly difficult in recent years. These challenges are not necessarily due to any natural hindrances, but may stem from government intervention on both Federal and Provincial levels. The news pertaining to the ongoing delay in building Kinder Morgan's Trans Mountain pipeline is the most recent example of politics impacting economic development within Canada. Similar circumstances stemming from political intervention were also what led to the cancellation of both the Northern Gateway pipeline and Energy East project in prior years.

Energy plays a crucial role within the Canadian economy and political impediments to investment in the industry have far-reaching effects. Suncor's CEO recently noted that his company's investment in Alberta will be constrained until there is better visibility on pipelines being built and the pipeline debate is likely an overhang on foreign investment in the country[4]. As such, the politics of pipelines can be considered a headwind that may be inhibiting Canada's economic growth and holding back Canadian equities.

Sector composition - Over the 10 years leading up to 2017, the technology and healthcare sectors in the U.S. grew their earnings per share at a compound annual rate of 10% and 8% respectively. Combined, these sectors comprise of close to 40% of the U.S. market, compared to only 5% of the Canadian market[5]. The structural underweight in the Canadian market of these high growth, high cash generative businesses in favour of more cyclical, capital intensive sectors is an ongoing challenge for Canada, and a compelling reason for global diversification for Canadian investors. Given that innovation in technology and healthcare may drive the economy for years to come, we anticipate earnings growth in these sectors may continue to be strong.

Canada's structural underweight to high growth sectors



Source: Bloomberg Finance L.P. As of May 21, 2018.

Pockets of opportunities in Canada

While there are obvious headwinds, pockets of opportunities do exist in Canada. Energy producers and banks are two sectors we think could provide some bright spots for Canadian equity markets in 2018.

In the energy sector, high quality producers have been lowering their costs for many years. This means that, as oil prices have rallied on the back of the Organization of the Petroleum Exporting Countries (OPEC) production cuts and global inventory declines, those quality producers are now starting to generate significant free cash flow that may translate to dividend growth over time. These stocks have generally lagged the market in recent years and consequently their valuations now look attractive. If interest rates increase, financials — particularly the banks — may benefit and see higher profits. The costs of loans for bank's customers generally increase faster than interest payouts to investors on investments like term deposits and Guaranteed investment certificates (GIC), allowing them to increase the spread between lending and borrowing and increase revenue. Moreover, recent concerns about the housing market have had a somewhat detrimental impact on bank stock prices as well, which may provide an opportunity to invest in high quality companies at a good valuation.

Taking advantage of international opportunities

While there are pockets of opportunities in Canadian equities, valuations may be more attractive in the international space. Canadian investors today still underestimate the strength of the global economy and overestimate their exposure to global investments. With international economic growth accelerating, fundamentals suggest that the Europe, Japan and emerging markets, specifically the cyclical sectors within these regions, may be a source of returns in the coming months.

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About TD Asset Management

TD Asset Management (TDAM), a member of TD Bank Group, is a North American investment management firm. Operating through TD Asset Management Inc. in Canada and TDAM USA Inc. in the U.S., TDAM brings new thinking to investors' most important challenges. TDAM offers investment solutions to corporations, pension funds, endowments, foundations and individual investors. Additionally, TDAM manages assets on behalf of almost 2 million retail investors and offers a broadly diversified suite of investment solutions including mutual funds, professionally managed portfolios and corporate class funds. Collectively, TDAM manages over C$295 billion in assets as at September 30, 2017.

[1] Bloomberg Finance L.P., period ending December 31, 2017
[2] Export Development Canada, 2016
[3] U.S. Energy Information Administration, International Energy Statistics, accessed 3 Sept. 2016.
[4] Financial Post, Feb. 8, 2018
[5] TDAM, Bloomberg Finance L.P.

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