# The Perfect Gift

Monthly Perspectives
December 2023

15 minutes

# The Gift-Giving Season

Aurav Ghai, Senior Fixed Income Analyst | TD Wealth

*"There are going to be periods when there's agony and other periods when there's a boom. And I think you just have to learn to live through them. ... Sometimes it's night and sometimes it's daylight. Sometimes it's a boom, sometimes it's a bust."* — Charlie Munger

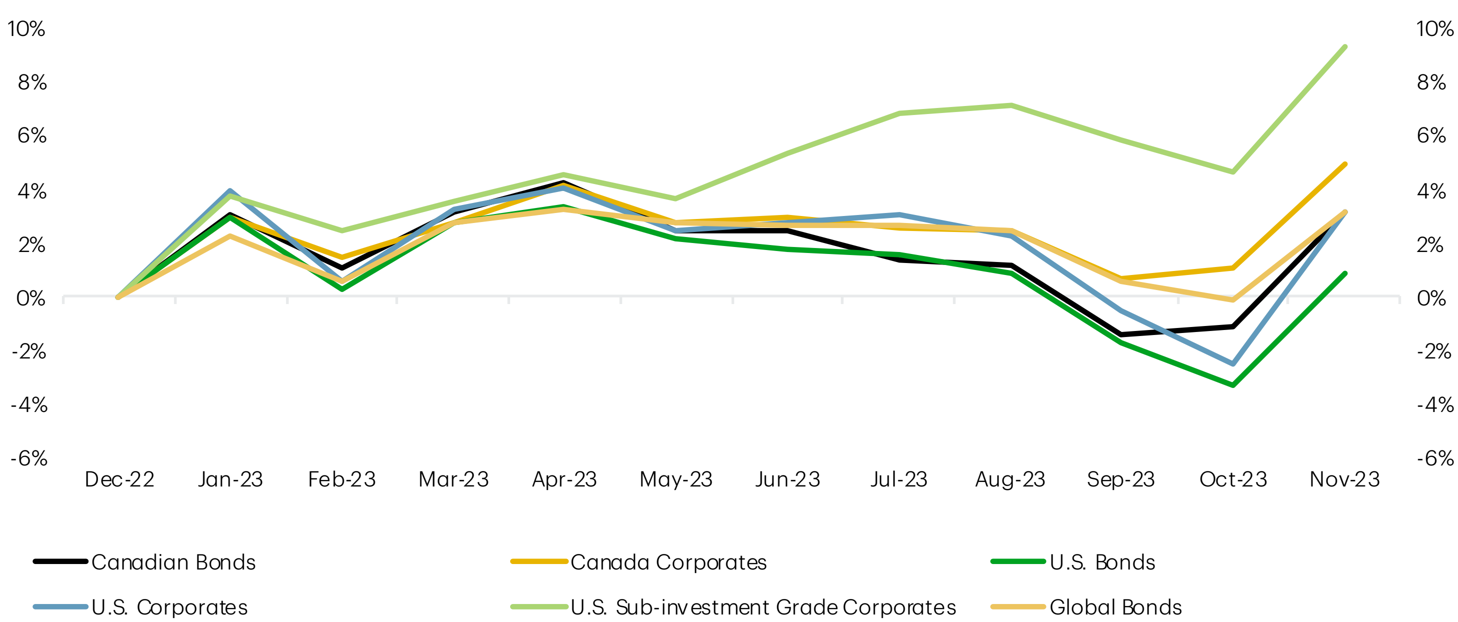
For the holidays this year, fixed income investors wanted only one thing (and it wasn't their two front teeth). The ascent of long-term yields over the past two years — from 1.50% in early 2022 to around 5% in October 2023 — led to some of the leanest months in modern history for bond investors. By the beginning of Q4, bond investors were bracing for the unprecedented possibility of a third straight year of losses. What they desperately needed was a rally — and boy did they get one.

November turned out to be a month for the record books, with investors frantically bidding up the price of bonds and sparking the best month since the 1980s. This in turn ignited a powerful rally in everything from stocks to corporate bonds to emerging markets. Government bonds leapt as the 10-year Canadian yield dropped by over 50 basis points (bps) to 3.55%, while the equivalent U.S. yield fell by over 60 bps to 4.33%. Overall, the bellwether Canadian bond index (FTSE Canada Universe Bond Index) returned 4.3% over November, while the U.S. equivalent (Bloomberg U.S. Aggregate Index) returned 4.4%. All of which is to say, fixed income is making a comeback, and investors are taking notice, with key players — both domestic and international — reassessing their shorts and betting that this positive sentiment will continue, thereby sustaining the rally.

Of course, months like November will always lead the astute investor to pause and revisit the broadly bullish outlook on bonds in order to avoid confirmation bias, but we nevertheless acknowledge that this rally was a long time coming.

So maybe our Christmas gift has been delivered early? As shown in Figure 1, the performance over November was so stellar that it could have made for a respectable annual return for 2023, with the year-to-date Canadian bond index up 3.2%, the U.S. bond index up 0.9%, and credit markets performing even better with the Canadian corporate index up 4.9% and the U.S. equivalent up 3.2%.

Figure 1: YTD cumulative performance




Source: MorningStar, Wealth Investment Office. As of November 30, 2023.

**What was the catalyst behind the bond rally in November?**

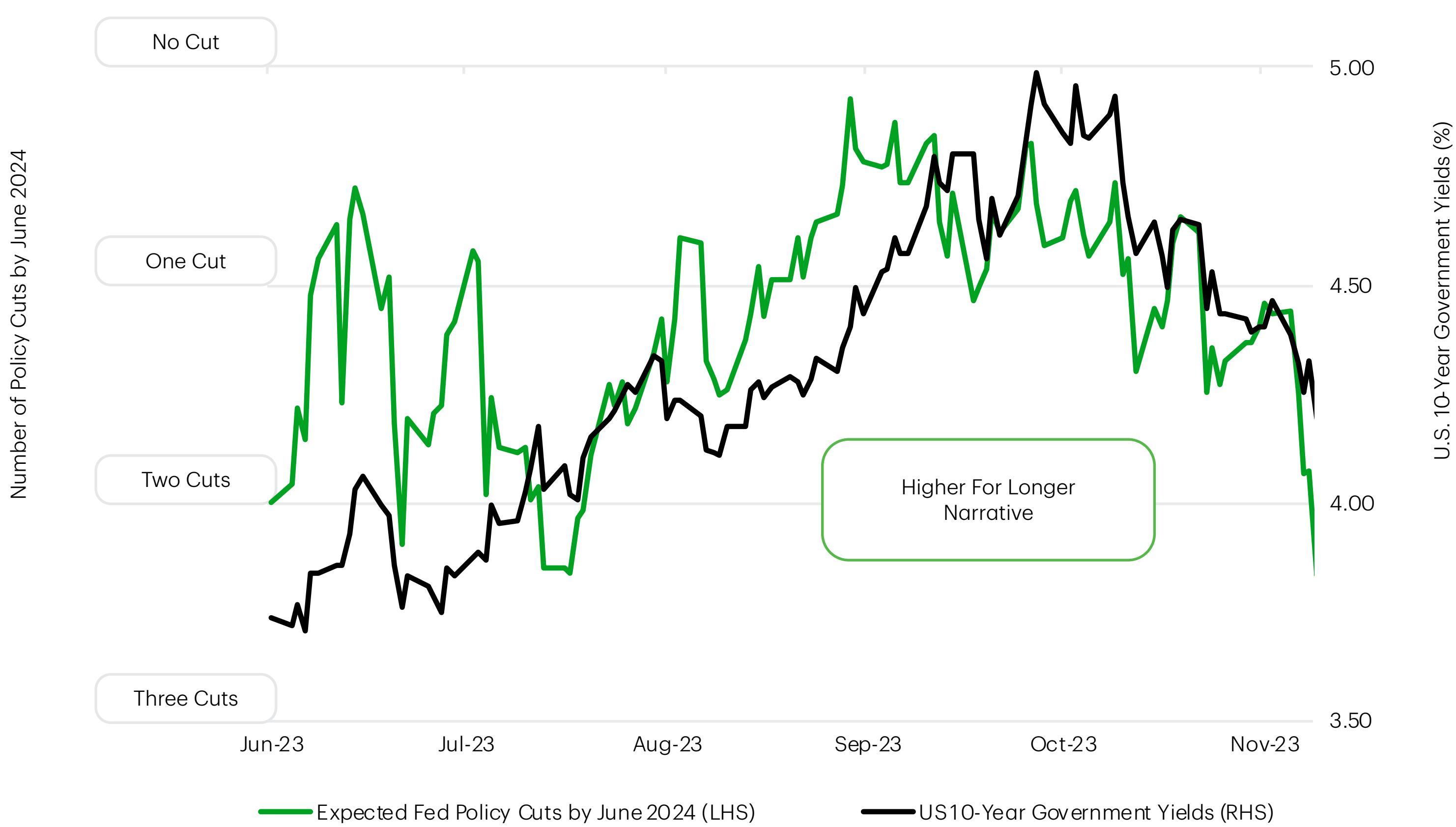
The most likely catalyst was the release, on November 14, of consumer price index (CPI) inflation data. The release likely reinforced the Federal Reserve's (Fed) resolve to pause the current hiking campaign as the effects of tighter monetary policy continue to work through the economy. Core U.S. inflation (excluding food and energy) cooled more than many observers had expected, rising just 0.23% in October. This wasn't far below the consensus estimate, yet the welcome surprise sparked a meaningful immediate rally in bond markets.

One can argue that the bond markets were primed for this rally, the seeds having been sown at the Fed meeting of November 1. In that meeting, Fed officials signalled a prolonged pause, and seemed to set a higher bar for future rate hikes amid contractionary monetary policy and tighter financial conditions. Softer October inflation data, plus the uptick in unemployment, reinforced the slower pace of U.S. activity that Fed officials had been expecting, and markets were eagerly waiting for this validation.

Despite appearances, it was not merely reduced inflation — or, rather, the reduced expectation of future inflation — that drove yields lower and the bond prices up. The nominal yield of a government bond with a 10-year maturity can be split into two components: the yield minus expected inflation (aka real yield); and the expected inflation itself, as determined by the market for inflation-protected securities (aka the breakeven). It's the real yield that creates weaker or tighter conditions for market participants. And since the turn in the market in early 2022, the changes in the nominal yield of a government bond have been driven almost entirely by real yields. Inflation expectations over the longer term haven't changed much at all, suggesting that markets viewed the spike in inflation as a post-pandemic anomaly rather than a structural shift in the economy.

Investors were far less confident, however, in the 2024 trajectory of the Fed's policy rate, leading to outsized influence on real yields. In Figure 2, we can see how the market's expectations for the policy rate have swung back and forth depending on the dominant narrative at the time, most recently swinging back to expectations of easier policy and an assumption that the Fed will not be that aggressive after all. From our perspective, what's important to note here is that this assumption has emerged without substantive guidance from the central bank.

Figure 2: Market expectations of the policy rates




Source: Bloomberg, Wealth Investment Office. As of November 30, 2023.

**Is the market right to change its narrative so fast?**

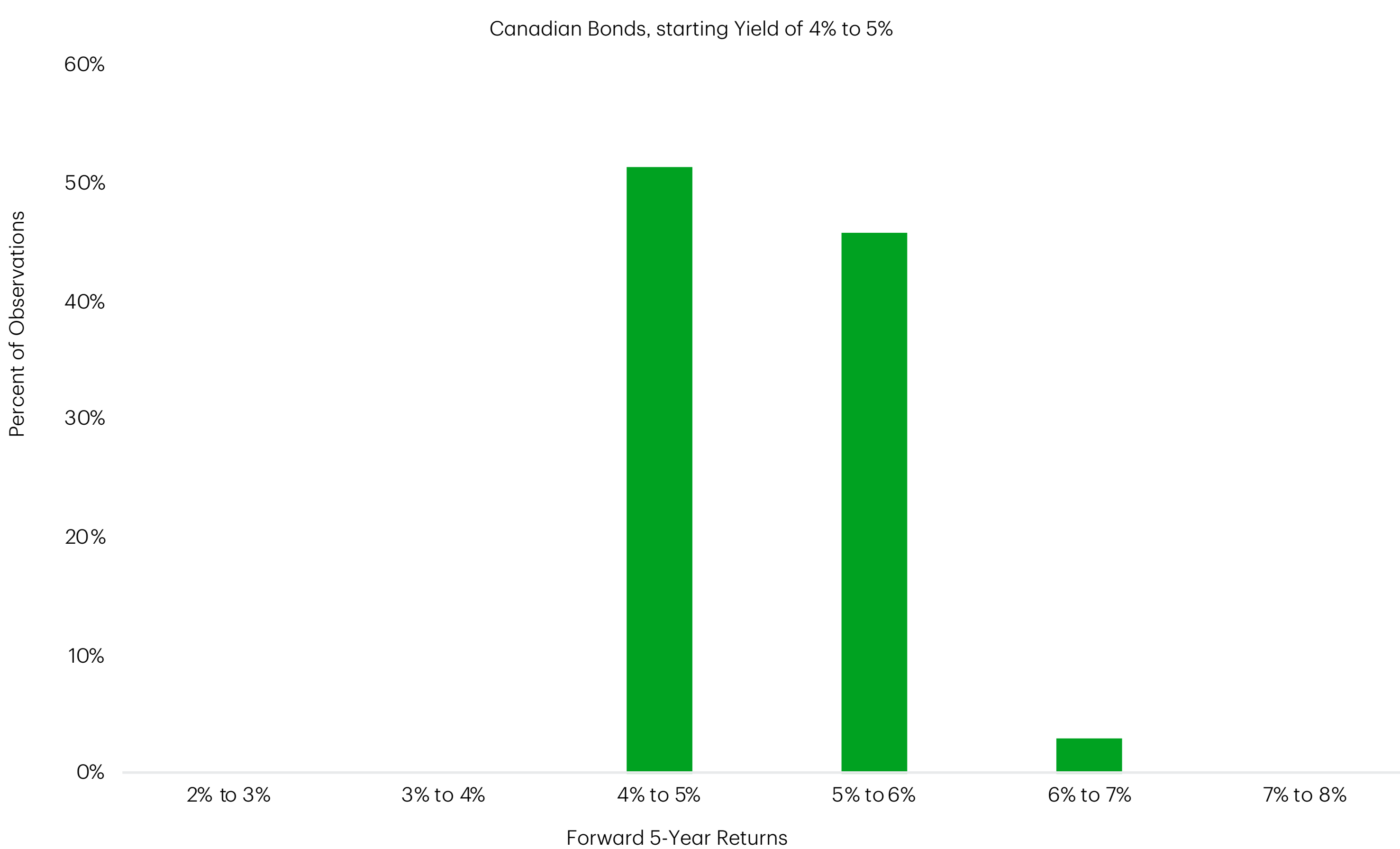
If history is any guide, neither the Fed nor the market is very good at predicting the future policy rate. Markets persistently predicted policy rate hikes throughout the decade following the financial crisis, when rates stayed at or close to zero, and persistently understated how far the Fed would go during the most recent cycle. From our learnings, and with ample humility, we now understand that markets tend to create their own reality; therefore, we will take current market expectations with a grain of salt.

**Does it change our outlook on fixed income?**

No, we still believe the investment outlook and conviction for bonds remain strong. Yields are still close to levels not seen since the early 2000s, and the bond market is well positioned to deliver attractive returns in the years ahead, driven simply by yields, which are a good indicator of future returns (Figure 3). Also, higher yields provide more cushion against volatility. Investors can earn attractive yields in almost all segments of the fixed income market. As the November bond rally showed us, it would be fabulous if a drop in yields and higher prices helped boost capital gains (which are more tax-efficient than the coupon portion of total returns), but even without those gains, fixed income is expected to flourish at current yields.

We remain modest overweight in our fixed income positioning because we believe fixed income has once again earned its place in multi-asset or diversified investment portfolios, providing investors with the best opportunity in over a decade to build diversified portfolios. After a turbulent couple of years of high inflation and rising rates that challenged portfolios, investors may see a return to more conventional behaviour in both stock and bond markets in 2024 — even as growth is hindered in many regions. Our base case for fixed income is to earn that attractive income without getting too ambitious about any substantial capital gains from falling government bond yields. Importantly, and as with any investment, we will be wise to maintain realistic expectations from the asset class.

Figure 3: Looking ahead from here, starting levels favor fixed income




Source: Bloomberg, Wealth Investment Office. As of November 30, 2023. Canadian Bonds = FTSE Canada Universe Bond Index.

# Thanks, Charlie

Brad Simpson, Chief Wealth Strategist | TD Wealth

Within the investment community, Charlie Munger was our Saint Nick. Every year, the vice-chair of Berkshire Hathaway and his legendary investment partner, Warren Buffett, would travel down to Omaha, Nebraska, for the company's annual conference, and bestow the gift of wisdom and common sense upon shareholders and other attendees. Over five decades, even as markets grew increasingly volatile — disrupted by technology and globalization and the 24-hour news cycle — Munger was a port in the storm, putting us at ease with his good humour, his razor wit and his impregnable pragmatism. He gave us so many gifts over the years. Below you'll find some of my favourites.

Here's his take on:

### ...the importance of reading:

*"In my whole life, I have known no wise people (over a broad subject matter area) who didn't read all the time — none, zero. You'd be amazed at how much Warren reads — and at how much I read. My children laugh at me. They think I'm a book with a couple of legs sticking out."*

### ...self-pity, a subject he would be well aware of, having lost his nine-year-old son to leukemia:

*"Life will have terrible blows, horrible blows, unfair blows, it doesn't matter. Some people recover and others don't. ... [Epictetus] thought that every mischance in life ... was an opportunity to learn something, and that your duty was not to be immersed in self-pity but to utilize the terrible blow in a constructive fashion."*

### ...the difference between knowing something and just knowing something by name:

*"I frequently tell the apocryphal story about how Max Planck, after he won the Nobel Prize, went around Germany giving the same standard lecture on the new quantum mechanics. Over time, his chauffeur memorized the lecture and said, 'Would you mind, Professor Planck, because it's so boring to stay in our routine, [what if] I gave the lecture in Munich and you just sat in front wearing my chauffeur's hat?' Planck said, 'Why not?' And the chauffeur got up and gave this long lecture on quantum mechanics. After which a physics professor stood up and asked a perfectly ghastly question. The speaker said, 'Well I'm surprised that in an advanced city like Munich I get such an elementary question. I'm going to ask my chauffeur to reply.'"*

### ... trying to replicate someone else's path to success:

"If you want to get rich the way I did, by learning a little bit about a hell of a lot, I [wouldn't] recommend it. ... If I want a proctologist, I do not want a proctologist who knows Schopenhauer or astrophysics, you know? I want a man who's specialized. That's where the market is. And you should never forget that. On the other hand, I don't think you'd have much of a life if all you did was proctology.

### ... the difference between wanting something and deserving it:

*"The safest way to get what you want is to try and deserve what you want. Spend each day trying to be a little wiser than you were when you woke up. Discharge your duties faithfully and well. Systematically, you get ahead, but not necessarily in fast spurts. Nevertheless, you build discipline by preparing for fast spurts. Slug it out one inch at a time, day by day. At the end of the day — if you live long enough — most people get what they deserve."*

### ....settling for what you can get:

*"I think life is a whole series of opportunity costs. You know, you've got to marry the best person who is convenient to find who will have you. Investment is much the same sort of a process."*

### .... living a successful life:

"You don't have a lot of envy, you don't have a lot of resentment, you don't overspend your income, you stay cheerful in spite of your troubles, you deal with reliable people, and you do what you're supposed to do — all these simple rules work so well to make your life better."

### ...the importance of keeping it simple:

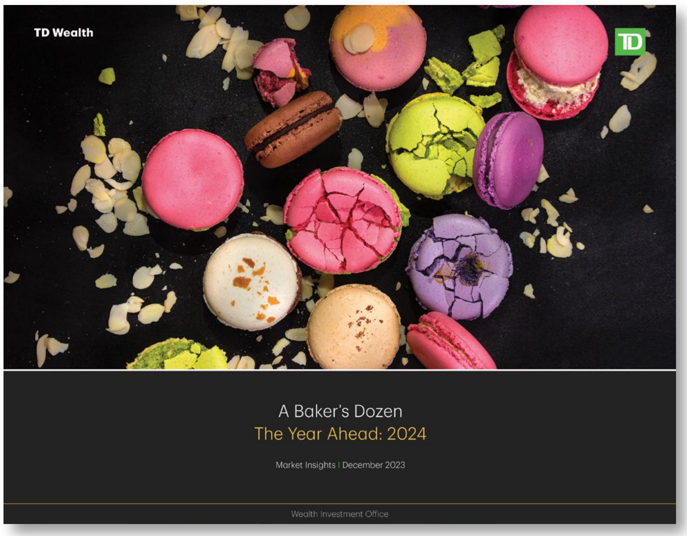
"It is remarkable how much long-term advantage people like us have gotten by trying to be consistently not stupid, instead of trying to be very intelligent."

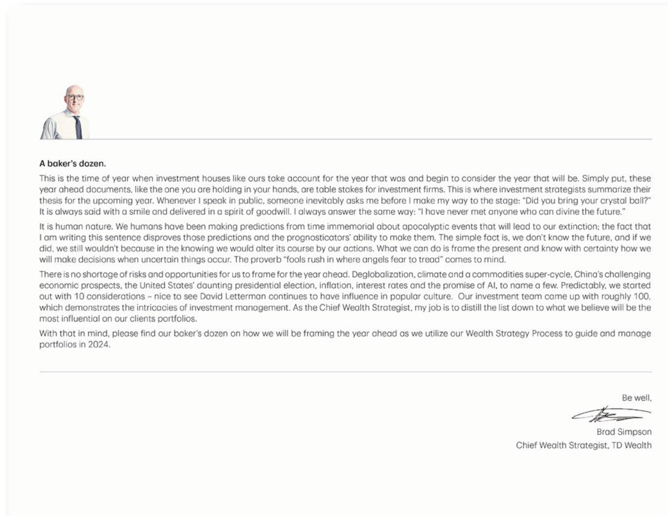
### ....the importance of operating within your own competence:

"I don't play in a game where the other people are wise and I'm stupid. I look for a place where I'm wise and they're stupid. You have to know the edge of your own competency. I'm very good at knowing when I can't handle something."

# ... and a Happy New Year

We're going to close off this year of Perspectives with a glimpse into next year. We've just published our Year Ahead document, which offers 13 themes —a baker's dozen, so to speak —that we think will be important for next year. We'll save all the hard analysis for January, but until then, here's a sneak peak at the trends that we believe will drive financial markets in the year to come. Remember, this is what might be. If there's one certainty, it's that no one can predict the future, and that includes us. We can, however, prepare for the near- and long-term trends that we think will represent challenges and opportunities in the year ahead.



**A baker's dozen.**

This is the time of year when investment houses like ours take account for the year that was and begin to consider the year that will be. Simply put, these year ahead documents, like the one you are holding in your hands, are table stakes for investment firms. This is where investment strategists summarize their thesis for the upcoming year. Whenever I speak in public, someone inevitably asks me before I make my way to the stage: "Did you bring your crystal ball?" It is always said with a smile and delivered in a spirit of goodwill. I always answer the same way: "I have never met anyone who can divine the future."

It is human nature. We humans have been making predictions from time immemorial about apocalyptic events that will lead to our extinction; the fact that I am writing this sentence disproves those predictions and the prognosticators' ability to make them. The simple fact is, we don't know the future, and if we did, we still wouldn't because in the knowing we would alter its course by our actions. What we can do is frame the present and know with certainty how we will make decisions when uncertain things occur. The proverb "fools rush in where angels fear to tread" comes to mind.

There is no shortage of risks and opportunities for us to frame for the year ahead. Deglobalization, climate and a commodities super-cycle, China's challenging economic prospects, the United States' daunting presidential election, inflation, interest rates and the promise of AI, to name a few. Predictably, we started out with 10 considerations – nice to see David Letterman continues to have influence in popular culture. Our investment team came up with roughly 100, which demonstrates the intricacies of investment management. As the Chief Wealth Strategist, my job is to distill the list down to what we believe will be the most influential on our clients portfolios.

With that in mind, please find our baker's dozen on how we will be framing the year ahead as we utilize our Wealth Strategy Process to guide and manage portfolios in 2024.

Be well,

Brad Simpson
Chief Wealth Strategist, TD Wealth

[The Year Ahead: 2024](#)
[A Baker's Dozen](#)

### 1. 'Friend-shoring' will continue as deglobalization takes hold.

There will be winners and losers from the shift in trade flows, with several emerging-market nations benefitting from the "China plus one" strategy.

### 2. Defence spending to rise amid heightened tensions.

During times of war, governments tend to allocate more funds to on defence spending. On the other hand, the risk of armed conflict may depress sentiment in certain regions, with long-term implications for the creditworthiness of nations.

### 3. Commodities to outperform.

The transition to renewable infrastructure will require an enormous influx of raw materials, which should boost prices. On the energy side, meanwhile, worries about renewables may be exaggerated.

### 4. China to recover from its economic woes.

We think the Chinese economy has hit its cyclical bottom. Growth numbers have been improving over the past quarter, and we think they'll continue to do so.

### 5. A Trump win could dramatically alter the landscape.

We're not calling the election, but with Trump leading in many of the polls, we are preparing for the possibility of a second term and what that would mean for the U.S. economy and global markets.

### 6. Hedging amid heightened geopolitical uncertainty.

Our work suggests that oil and gold offers, perhaps, the best hedge against geopolitical risk.

### 7. Reaching target inflation will be a hard slog.

We think the easy gains on the inflation front are behind us and the trek back to the Fed's 2% target will be a long and difficult one.

### 8. Fixed income to rebound from a volatile year.

Our conviction for bonds remains strong. Current yields are at levels not seen since the early 2000s and the bond market is well positioned to deliver attractive returns.

### 9. Higher interest costs to dampen consumer spending and borrowing.

Net interest expense per capita has led consumers to delay debt repayment both for mortgages and other loans. It's highly likely that growth in disposable income will slow, which would have a large impact on consumer spending.

### 10. Development of AI to power ahead, despite any slowdown.

We don't believe the AI sector will be immune from an economic downturn; however, the promise is such that healthy cash flows arising from new investment dollars will propel the industry toward rapid development.

### 11. Real estate performance to remain divergent.

While vacancy rates for traditional offices in the U.S. are above 20%, and rents are under pressure, there are many other areas in the real estate sector that have appeal. Demand for data centres, for instance, is being driven by cloud computing, content creation and the AI revolution.

### 12. Equity volatility likely to rise.

Given the historical time lag between monetary-policy tightening and its impact on the broader economy and financial markets, plus the prevalent unstable geopolitical environment, we will likely see increased equity volatility in 2024.

### 13. Private assets present opportunities amid higher rates.

Private debt may enjoy one of its best return environments since the global financial crisis. Going forward, there will have to be a hand-off from existing investors given that institutions have to rebalance their portfolios. This should create an opportunity for new entrants from the private wealth space, which are still holding historical amounts of cash after the pandemic.

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As we move forward, our approach will be to follow our principles, which are based on the conviction that markets are adaptive. Financial markets are always evolving as participants learn and innovate. At TD Wealth, we have the advantage of being able to rely on the institution's breadth of expertise and skills to deliver sound investment strategy and nimble positioning. To navigate the opportunities and the challenges ahead of us, it's our philosophy, people and process, ultimately, that make the difference.

## Market Performance

| Canadian Indices ($CA) Return | Index | (%) 1 Month | (%) 3 Months | (%) YTD | (%) 1 Year | (%) 3 Years | (%) 5 Years | (%) 10 Years | (%) 20 Years |
|---|---|---|---|---|---|---|---|---|---|
| S&P/TSX Composite (TR) | 80,872 | 7.48 | 0.56 | 7.54 | 2.28 | 8.82 | 9.23 | 7.42 | 7.84 |
| S&P/TSX Composite (PR) | 20,236 | 7.22 | -0.28 | 4.39 | -1.06 | 5.59 | 5.89 | 4.21 | 4.84 |
| S&P/TSX 60 (TR) | 3,977 | 7.92 | 1.18 | 7.68 | 1.88 | 9.44 | 9.46 | 8.01 | 8.24 |
| S&P/TSX SmallCap (TR) | 1,221 | 4.84 | -3.22 | 1.00 | -0.86 | 5.24 | 6.80 | 3.85 | 3.61 |
| S&P/TSX Preferred Share(TR) | 1,677 | 9.47 | 7.93 | 5.04 | 3.21 | 1.70 | 2.12 | 1.23 | 2.17 |
| **U.S. Indices ($US) Return** | | | | | | | | | |
| S&P 500 (TR) | 9,879 | 9.13 | 1.74 | 20.80 | 13.84 | 9.76 | 12.51 | 11.82 | 9.73 |
| S&P 500 (PR) | 4,568 | 8.92 | 1.33 | 18.97 | 11.95 | 8.04 | 10.60 | 9.72 | 7.59 |
| Dow Jones Industrial (PR) | 35,951 | 8.77 | 3.54 | 8.46 | 3.94 | 6.65 | 7.08 | 8.37 | 6.72 |
| NASDAQ Composite (PR) | 14,226 | 10.70 | 1.36 | 35.92 | 24.05 | 5.26 | 14.18 | 13.36 | 10.42 |
| Russell 2000 (TR) | 9,635 | 9.05 | -4.37 | 4.20 | -2.56 | 1.13 | 4.78 | 6.13 | 7.60 |
| **U.S. Indices ($CA) Return** | | | | | | | | | |
| S&P 500 (TR) | 13,417 | 6.85 | 2.12 | 21.13 | 14.46 | 11.47 | 12.98 | 14.62 | 9.98 |
| S&P 500 (PR) | 6,204 | 6.64 | 1.71 | 19.29 | 12.56 | 9.73 | 11.06 | 12.48 | 7.83 |
| Dow Jones Industrial (PR) | 48,826 | 6.49 | 3.92 | 8.75 | 4.50 | 8.31 | 7.53 | 11.09 | 6.97 |
| NASDAQ Composite (PR) | 19,321 | 8.38 | 1.73 | 36.29 | 24.73 | 6.90 | 14.66 | 16.21 | 10.67 |
| Russell 2000 (TR) | 13,086 | 6.77 | -4.02 | 4.48 | -2.04 | 2.71 | 5.22 | 8.80 | 7.84 |
| **MSCI Indices ($US) Total Return** | | | | | | | | | |
| World | 13,872 | 9.43 | 1.73 | 18.55 | 13.56 | 7.56 | 10.53 | 8.89 | 8.43 |
| EAFE (Europe, Australasia, Far East) | 10,152 | 9.30 | 1.34 | 12.84 | 12.96 | 4.32 | 6.51 | 4.39 | 6.20 |
| EM (Emerging Markets) | 2,540 | 8.02 | 1.16 | 6.08 | 4.65 | -3.66 | 2.73 | 2.50 | 7.37 |
| **MSCI Indices ($CA) Total Return** | | | | | | | | | |
| World | 18,840 | 7.14 | 2.10 | 18.88 | 14.18 | 9.24 | 10.99 | 11.62 | 8.68 |
| EAFE (Europe, Australasia, Far East) | 13,787 | 7.01 | 1.71 | 13.15 | 13.58 | 5.94 | 6.95 | 7.01 | 6.44 |
| EM (Emerging Markets) | 3,450 | 5.76 | 1.53 | 6.37 | 5.21 | -2.16 | 3.16 | 5.07 | 7.62 |

| **Currency** | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| Canadian Dollar ($US/$CA) | 73.63 | 2.14 | -0.37 | -0.27 | -0.54 | -1.54 | -0.42 | -2.45 | -0.23 |
| **Regional Indices (Native Currency, PR)** | | | | | | | | | |
| London FTSE 100 (UK) | 7,454 | 1.80 | 0.20 | 0.03 | -1.58 | 5.96 | 1.32 | 1.15 | 2.74 |
| Hang Seng (Hong Kong) | 17,043 | -0.41 | -7.29 | -13.84 | -8.36 | -13.51 | -8.45 | -3.32 | 1.64 |
| Nikkei 225 (Japan) | 33,487 | 8.52 | 2.66 | 28.33 | 19.73 | 8.20 | 8.42 | 7.90 | 6.18 |

| Benchmark Bond Yields | 3 Months | 5 Yrs | 10 Yrs | 30 Yrs |
|---|---|---|---|---|
| Government of Canada Yields | 5.04 | 3.63 | 3.55 | 3.36 |
| U.S. Treasury Yields | 5.40 | 4.27 | 4.33 | 4.50 |

| 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 | 448 | 0.42 | 1.30 | 4.31 | 4.66 | 2.09 | 1.78 | 1.28 |
| FTSE TMX Canada Universe Bond Index | 1,084 | 4.29 | 1.94 | 3.15 | 1.45 | -3.77 | 0.89 | 2.02 |
| FTSE TMX Canada All Government Bond Index | 1,023 | 4.46 | 1.79 | 2.54 | 0.62 | -4.38 | 0.47 | 1.77 |
| FTSE TMX Canada All Corporate Bond Index | 1,303 | 3.81 | 2.37 | 4.94 | 3.86 | -2.04 | 2.07 | 2.73 |
| Bloomberg U.S. Corporate High Yield Bond Index | 272 | 4.40 | 1.83 | 8.58 | 7.84 | 0.87 | 3.34 | 3.78 |
| Bloomberg Global Aggregate Bond Index | 245 | 3.33 | 0.71 | 3.17 | 1.89 | -3.36 | 0.64 | 1.87 |
| JPM EMBI Global Core Bond Index | 480 | 5.86 | 1.12 | 4.66 | 4.82 | -5.48 | 0.12 | 2.14 |

| Credit Suise ($US) Total Return | Index | 1 Month | 3 Month | YTD | 1 Year | 3 Year | 5 Year | 10 Year |
|---|---|---|---|---|---|---|---|---|
| HFRI Fund Weighted Composite Index | 313 | 1.92 | 3.20 | 6.18 | 8.16 | 5.28 | 3.76 | 1.71 |
| HFRI Fund of Funds Composite Index | 807 | 2.37 | 0.93 | 6.60 | 6.53 | 5.20 | 4.69 | 2.79 |
| HFRI Event-Driven (Total) Index | 1,306 | -0.78 | 1.03 | -6.48 | -7.48 | 7.46 | 6.98 | 4.38 |
| HFRI Equity Hedge Index | 772 | 1.46 | 1.67 | 5.09 | 5.20 | 6.06 | 5.72 | 3.92 |
| HFRI Equity Market Neutral Index | 962 | 3.72 | 2.40 | 10.01 | 10.21 | 5.37 | 5.80 | 4.68 |
| HFRI Macro (Total) Index | 398 | -2.95 | 0.77 | -2.30 | -1.32 | 9.85 | 7.11 | 3.96 |

Source: TD Securities Inc., Morningstar®, TR: total return, PR: price return, as of November 30, 2023.

# Wealth Investment Office, TD Wealth

**Head of Wealth Investment Office**
Brad Simpson | Chief Wealth Strategist

**North American Equities:**
Chris Blake | Senior Portfolio Manager
Chadi Richa | Manager, North American Equities
David Beasley | Senior Portfolio Manager, Global Equities
Kevin Yulianto | Quant Equity Portfolio Manager, Global Equities
Andrej Krneta | Manager, Global Equities
Neelarjo Rakshit | Analyste principale, Actions

**Managed Investments:**
Christopher Lo | Head of Managed Investments
Fred Wang | Senior Portfolio Manager
Aurav Ghai | Senior Fixed Income Analyst
Mansi Desai | Senior Equity Analyst

**Investment Consulting:**
Brian Galley | Head of Investment Consulting
Shanu Kapoor | Senior Portfolio Consultant
Richard Nguyen | Senior Portfolio Consultant
Shaun Arnold | Senior Portfolio Consultant
Greg McQueen | Senior Portfolio Consultant
Duncan Morton | Senior Portfolio Consultant
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Shaiara Hossain | Portfolio Consultant
Joseph Abinaked | Portfolio Consultant
Dan Iosipchuk | Portfolio Consultant
Jack Zhang | Analyst
Leroy Li | Analyst

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