current PERSPECTIVES

TD Wealth Asset Allocation Committee (WAAC) Asset Mix Update

The complexities that need to be considered when evaluating global markets have increased over the years – and so far, 2019 is no exception. Over the past 18 months we have been cautious in our positioning due to various factors including market volatility and economic uncertainties. At the same time, we have been patiently waiting to further scale into equities when buying opportunities present themselves.

The decision to remain patient and maintain a neutral stance with equities and fixed income has, for the most part, been the prudent position. During this time, equity valuations were high and spreads in the credit market were fairly tight.

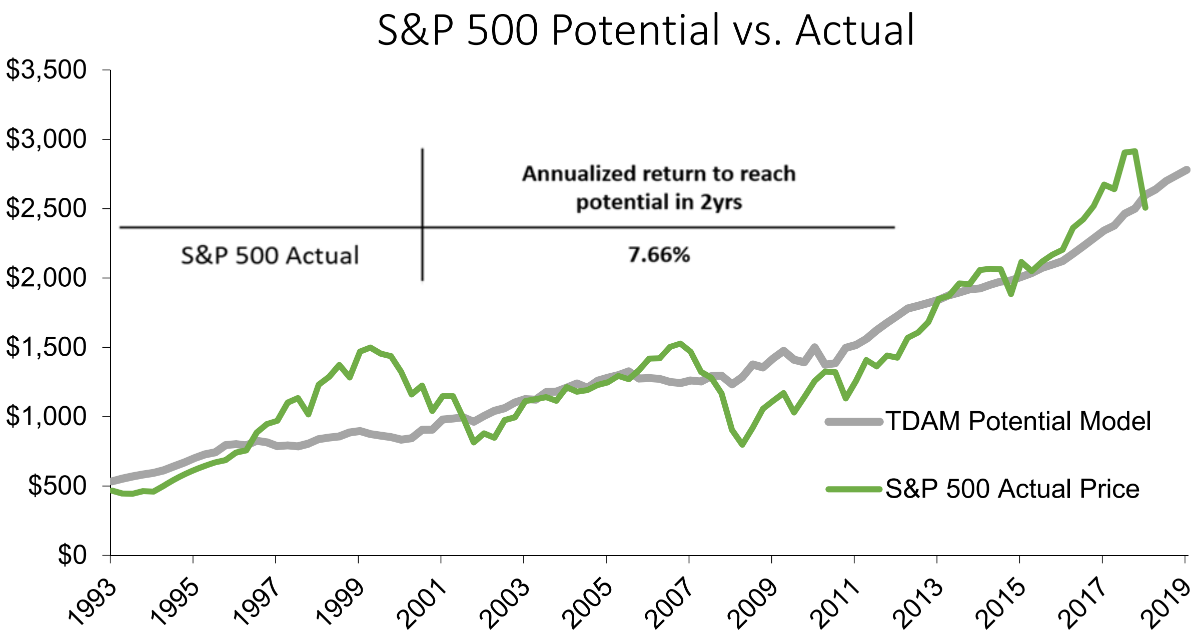
Central banks, including the U.S. Federal Reserve (Fed) and the Bank of Canada (BoC), were raising rates and removing quantitative stimulus. Moreover, the European Central Bank (ECB) recently ended its quantitative easing program. Additionally, signs of slowing global growth - particularly in China and Europe, and more recently in the U.S. - became evident and trade frictions (particularly between the U.S. and China) had become increasingly pronounced.

January 2019: Asset Mix Change

Due to the headwinds noted above, equities delivered negative returns in 2018 as rising earnings were offset by declining valuations. After this period of lackluster performance, at our January WAAC meeting, we **upgraded equities to overweight from neutral**. There were three primary reasons for the upgrade.

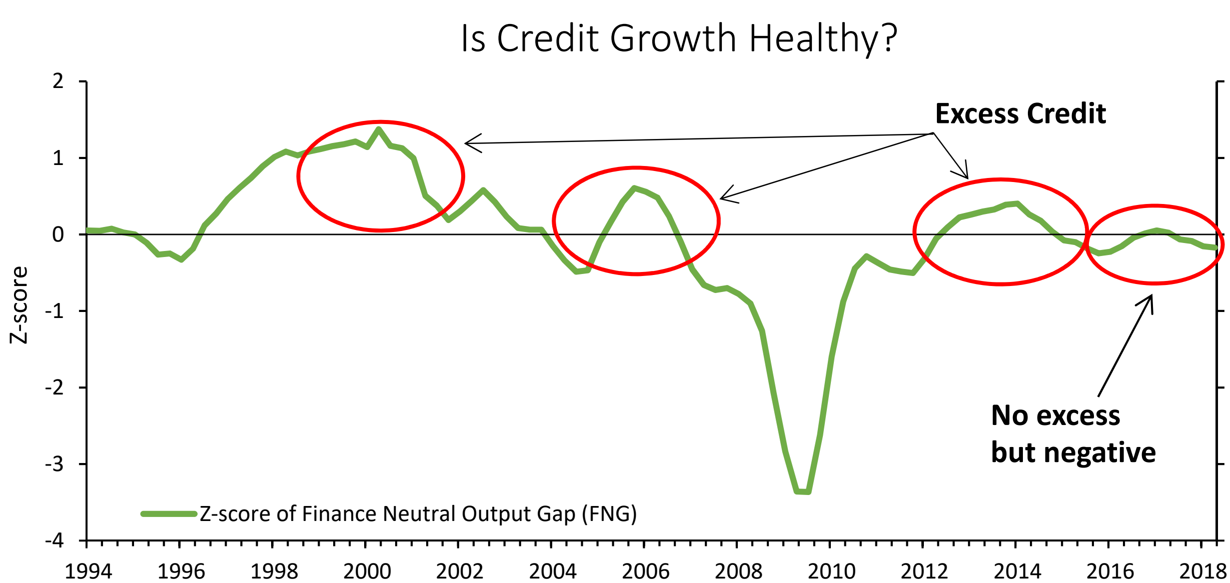
The first was valuation. The recent declines in equity prices coupled with higher earnings have brought valuations down to more reasonable levels – for example, U.S. stocks are trading around 15-16 times forward earnings and have returned to fair value on our proprietary valuation tool seen in the chart below. Canadian stocks are trading at 13-14 times forward earnings, while emerging market (EM) equities, which have been punished particularly hard, now have forward earnings in the high single digits. At this time, we feel that equities have been discounted to reflect slower growth and softer earnings. Overall, corporate health remains robust with companies generating very strong free cash flow. We anticipate the combination of modest earnings growth, 2-3% dividend yields, and stable valuations should deliver mid-to-high single digit returns in the next 12-18 months.

The second was that, in our view, central banks are likely close to the end of their cycle of rate hikes. Inflation has remained muted through this cycle and we believe that a combination of high global debt and technological innovation will continue to keep a lid on prices. This is confirmed by looking at market expectations for inflation, which are subdued. When combined with decelerating global growth, these low inflation expectations are likely to lead central banks to pause further hikes. This in turn should, in our view, support valuations at current levels.



Source: Thomson Reuters Datastream, TD Asset Management. As of December 31, 2018. For illustration purposes only.
TDAM Potential Model: Is showing the level of potential for the S&P 500 index.

The third rationale for the equity upgrade was our belief that, while growth will slow, a recession is unlikely. The global economy has experienced a slow-motion recovery ever since the global financial crisis ten years ago. One of the benefits of this is that fewer economic imbalances have developed in the system – this is in contrast to the period prior to the crisis when the American consumer took on significant debt to buy real estate or in the late 1990s when corporations binged on capital investment in the technology and telecommunications areas, as shown in the chart below. We anticipate that, as fiscal stimulus fades, growth in the U.S. will retract to trend levels but that it will stay positive and a recession will be averted.



Source: Thomson Reuters Datastream, BIS, TD Asset Management. As of December 31, 2018. For illustration purposes only.
Z-score is the number of standard deviations from the mean a data point is. But more technically it's a measure of how many standard deviations below or above the population mean a raw score is.

While upgrading equities in January, we **<u>downgraded fixed income to an underweight position from neutral</u>**. Fixed income provided stability to portfolios in a volatile equity environment in 2018 but yields and expected returns remain in the low single digits as our "lower for longer" theme remains in place. In our view, the spread of expected returns between equities and fixed income justifies an overweight stance on equities and an underweight stance in fixed income at this time.

Within these asset classes we have also made several tactical shifts:

Emerging Market (EM) equities - <u>Moved to modest overweight from neutral</u>. EM valuations are attractive after a significant underperformance in recent years.

Domestic Government Bonds <u>- Moved to modest underweight from neutral</u>. At current levels, low single digit returns are expected, however domestic bonds can offer diversification, stability and modest income.

Investment -grade Corporate Bonds - <u>Moved to modest overweight from neutral</u>. Higher rates and slightly wider spreads mean that investment grade corporate bonds now provide real (after inflation) returns. We have a strong preference for the quality end of the spectrum, given signs of stress at companies with weak balance sheets.

High Yield Bonds - <u>Moved to modest overweight from modest underweight</u>. Spreads widened in the second half of 2018 to attractive levels and there is now a greater opportunity to add value through security selection.

U.S. dollar versus trade-weighted baskets of currencies - <u>Moved to modest underweight from neutral</u>. Slowing U.S. economic growth coupled with the Fed reaching the end of their rate hike cycle could put downward pressure on the U.S. dollar versus a trade-weighted basket of currencies.

Risks we continue to monitor

While we are now more positive on the near-term prospects for equities, we will continue to monitor several risks in 2019. Ongoing protectionist measures caused by escalating trade frictions, particularly between the U.S. and China, could dampen economic growth and result in higher inflation, placing downward pressure on equity valuations.

Additionally, there is always the risk that central banks will commit a policy error as they reduce their accommodation. Tightening monetary policy to more normal levels, while not adversely affecting economic growth or threatening financial stability, is a delicate balancing act. Policy change that is too aggressive remains a possibility and could create volatility and a difficult environment for investors. Debt also remains high globally at the government level and in some cases the corporate level, which can lead to structurally slower growth over the next few years.

We currently do not expect a recession to materialize this year and feel the risk of this is low. While global growth is likely to continue to slow, there are fewer imbalances in the broad economy today to trigger a recession than in the recent past (e.g. 2008/09 global financial crisis, tech meltdown) and our data reinforces this view.

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