TD Wealth

Market Outlook

Investment Strategy Quarterly

Q4 2017

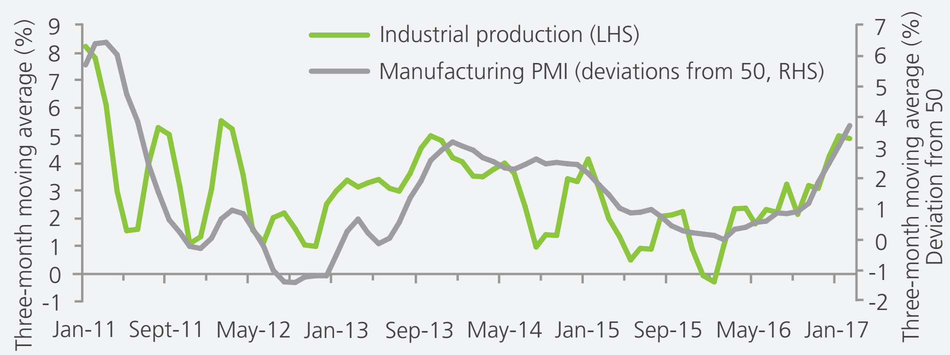
TD Wealth Asset Allocation Committee Overview

- Broadly neutral outlook balances optimism about a cyclical economic recovery against policy uncertainty and ongoing structural challenges
- Expect low single digit fixed income returns; yields likely to rise only modestly as inflation remains well contained
- Neutral rating in equities reflects strong corporate fundamentals offset by stretched valuations in the U.S.
- Preference for international equities driven by attractive valuations and potential for higher growth and inflation to boost earnings
- Friction between the U.S. and its trading partners could cause volatility, and global imbalances remain high

Ten years on from the beginning of the financial crisis, central bank balance sheets have ballooned while key policy rates have dropped close to historical lows. Both of these are results of central banks' efforts to encourage economic growth, which stalled in the wake of the crisis. While growth has remained subpar based on historical comparisons, it has been improving amid a global cyclical upturn that began in the latter part of 2016.

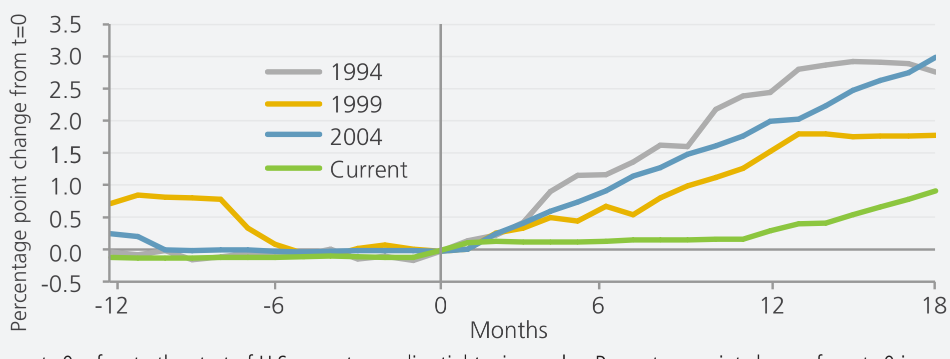
These improvements have allowed some key central banks to begin nudging the monetary policy dial away from 'emergency' and toward 'neutral.' The U.S. Federal Reserve (the Fed) and the Bank of Canada (BoC) have begun slowly reducing their unprecedented monetary accommodation and are expected to continue normalizing their policies. The key word in the previous sentence is slowly. As the chart to the right illustrates, this cycle of rate increases in the U.S. has been much shallower than past cycles.

Global growth has picked up



Source: International Monetary Fund - World Economic Outlook, April 2017.

Current cycle is different from past tightening periods



t=0 refers to the start of U.S. monetary policy tightening cycles. Percentage point change from t=0 in monthly effective federal funds rates. The graph refers to tightening cycles beginning in January 1994, June 1999, and June 2004 with the current cycle beginning December 2015

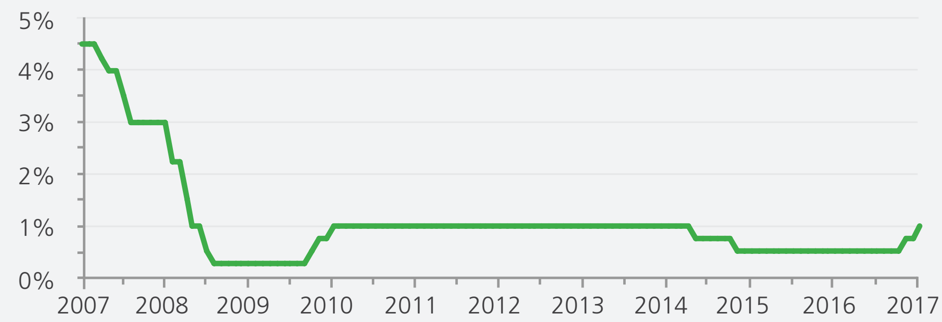
Source: Bloomberg Finance L.P. and Haver Analytics. As of June 2017.

Moving in a slow and measured way toward a neutral stance, in which real short-term rates would be zero as opposed to negative, should allow the Fed to continue offering significant accommodation while also providing it with room to maneuver if economic growth slows. It also may help to rein in credit growth, which appears to be late cycle. We expect other central banks to take a similar approach, which we have already begun to see from the BoC. The BoC began adopting a less dovish tone in some of its speeches in June, and in July it increased its key rate from 0.50% to 0.75%, causing the loonie to soar. The BoC raised the rate again in September, moving it from 0.75% to 1%, which was a bit of a surprise to markets and sent the loonie up to a two-year high.

The rate increases were noteworthy because they were the first increases in seven years. However, it's important to maintain perspective. The overnight rate is now 1%, the same level it remained at from September 2010 - January 2015 as the BoC held it steady in an effort to support the economy following the financial crisis. The BoC lowered the rate in 2015 in response to the sharp decline in oil prices. Now that many of the effects of lower oil prices appear to have been absorbed, the BoC has removed its oil-related accommodation, but it has not yet removed the accommodation it provided in the wake of the financial crisis. As we mentioned, the dial is being moved from 'emergency' to 'neutral,' not to 'tight'.

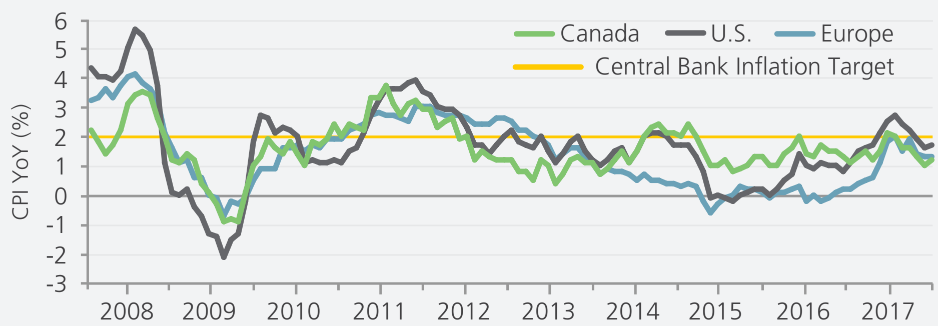
The BoC actions reflect strong economic growth over the past few quarters. If the economy continues to show strength, it's reasonable to anticipate that the BoC may raise the rate once or twice more over the next 12 months. But even so, the rate would still be low from a historical perspective. In addition, we believe Canadian economic growth will decelerate, particularly if the consumer sector weakens, which is likely given elevated debt levels. Foreign investment and exports could pick up the slack and help drive the economy, but the higher loonie is likely to restrain growth in these areas. This, plus the fact that inflation is well below the BoC's target, will likely lead the BoC to remove its accommodation slowly.

Bank of Canada Overnight Rates
September 2007 - September 2017



Source: Bank of Canada. As of September 2017.

Inflation



Source: Bloomberg Finance L.P., as of July 2017.

Anemic inflation

Although economic growth has been stronger, global inflation has remained stubbornly low. It has persistently come in below central bank targets – missing the mark for more than 60 consecutive months in North America and for more than 100 consecutive months in Europe and Japan. Its future doesn't look rosy either. The World Bank, International Monetary Fund, European Central Bank and Fed have all recently lowered their expectations for inflation over the next 2-3 years, and we also expect it will remain low as technological advancements, high debt levels and changing demographics are likely to restrain it. In addition, while manufacturing and services Purchasing Managers' Indices (PMIs) continue to indicate economic expansion, they are showing signs of deceleration, and we believe this period of cyclical growth may have peaked. If growth were to slow again, this would be a further headwind for inflation.

In addition to influencing central bank policies, low inflation is also likely to impact investors. Absent meaningful inflation, companies will have limited pricing power, although low wage inflation should provide some offset. And since long-term bond yields are affected by inflation expectations, they are unlikely to rise significantly for some time to come. For equity markets, low bond yields are likely to translate into persistently elevated valuation multiples versus history.

WAAC Positioning

During the quarter, sentiment was dampened by an expanded investigation into Russian interference in the U.S. Presidential election, threats of nuclear conflict with North Korea and a devastating hurricane season. Nonetheless, equities proved resilient and rose as economic data was supportive. We have maintained our positioning at the asset class level, which is neutral across cash, fixed income and equities, and we made no changes to our positioning within those asset classes. We continue to believe a balanced approach is warranted and favour a diversified portfolio that includes:

1. High quality equities that have the ability to increase their earnings and dividends in a low growth environment and thereby protect the real value of investors' savings.

2. An allocation to cash to provide stability and safety of capital.

3. An allocation to high quality domestic government bonds and investment-grade corporate bonds to provide some income, diversification and stability.

Equities

- Overweight international equities
- Neutral U.S. equities
- Underweight Canadian and emerging market equities

We are neutral equities. The push they've received from good global economic data may be waning. While we expect them to generate positive returns (in the mid-single digits), we don't believe investors will be appropriately rewarded for the risks associated with an overweight position at this time, and it may be useful to have some dry powder so that any pullback in markets can be used to increase positions.

In the U.S., earnings growth is strong, corporate fundamentals remain solid and dividend yields are attractive versus bond yields. However, valuations are quite high, which is why we are neutral U.S. equities. We are cautious about Canada and are underweight Canadian equities, which have lagged this year. Although Canadian economic growth has been surprisingly strong in recent quarters, moving forward, elevated household debt, modest oil prices and low productivity are likely to be headwinds, and we expect growth to slow. Decelerating economic growth, low inflation and soft commodity prices may weigh on the earnings of Canadian companies.

Currently, our geographic preference is for Europe, where valuations are attractive, profit margins are improving and earnings have been strong the past two quarters in spite of a rising euro. In addition, economic growth has been accelerating and PMIs have been strong, which should be positive for earnings per share growth. Europe does face long-term structural challenges, but we believe that the region presents investment opportunities over the next 12-18 months, which is our outlook horizon.

We remain underweight emerging markets as broad pockets of stress are evident. A number of countries face challenges related to weaker commodity prices and uncertain policy direction, including Brazil, Russia, China, India and South Korea. High debt levels are also a concern, as is the potential for a reduction in liquidity.

Fixed Income

- Neutral cash, domestic government bonds, investment grade corporate bonds and inflation linked bonds
- Maximum underweight global government bonds and high yield bonds

Breakevens have moved down and the yield curve has flattened since the U.S. election, indicating that fixed income investors are skeptical regarding a reflationary "Trump bump." With structural issues likely to moderate inflation, we expect long-term bond yields to remain low, and with central banks raising key rates cautiously, yields on short-term bonds are also likely to remain low.

Although yields and returns on bonds may be low, we still consider fixed income an important portfolio component as it offers stability and some income. We remain neutral domestic government bonds, investment grade corporates and inflation linked bonds. We are maximum underweight global government bonds as very low real and nominal yields make the risk/reward relationship unattractive, and high yield as spreads have continued to narrow.

Canadian/U.S. currency exposure

- Underweight the Canadian dollar
- Overweight the U.S. dollar

As we noted above, the Canadian dollar has been strong since the July Bank of Canada rate hike. However, we believe it is close to the top of its range and expect it to underperform the U.S. dollar moving forward.

U.S. dollar remains strong, but accelerating growth and inflation in Europe should be positive for the euro, which will likely reduce the relative outperformance of the U.S. dollar versus a basket of global currencies.

Gold

- Neutral gold

We believe an allocation to gold may provide insurance against the risk of extreme outcomes. While there are still meaningful risks globally due to continued imbalances in the global economy, near-term political uncertainty in Europe has lessened.

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: articulate broad market themes, provide macro-level asset allocation and identify the major risks on the horizon.

Committee Members:

Chair: **Bruce Cooper,** CFA
CEO & CIO, TD Asset Management Inc. and SVP, TD Bank Group

Michael Craig, CFA
Vice President & Director, TD Asset Management Inc.

Glenn Davis, CFA
Managing Director, TDAM USA Inc.

Kevin Hebner, PhD
Managing Director, Epoch Investment Partners, Inc.

David McCulla, CFA
Vice President & Director, TD Asset Management Inc.

Robert Pemberton, CFA
Managing Director, TD Asset Management Inc.

Brad Simpson, CIM, FCSI
Chief Wealth Strategist, TD Wealth

David Sykes, CFA
Managing Director, TD Asset Management Inc.

Sid Vaidya, CFA, CAIA
U.S. Wealth Investment Strategist, TD Wealth

Geoff Wilson, CFA
Managing Director, TD Asset Management Inc.