TD Wealth

Market Outlook

Investment Strategy Quarterly

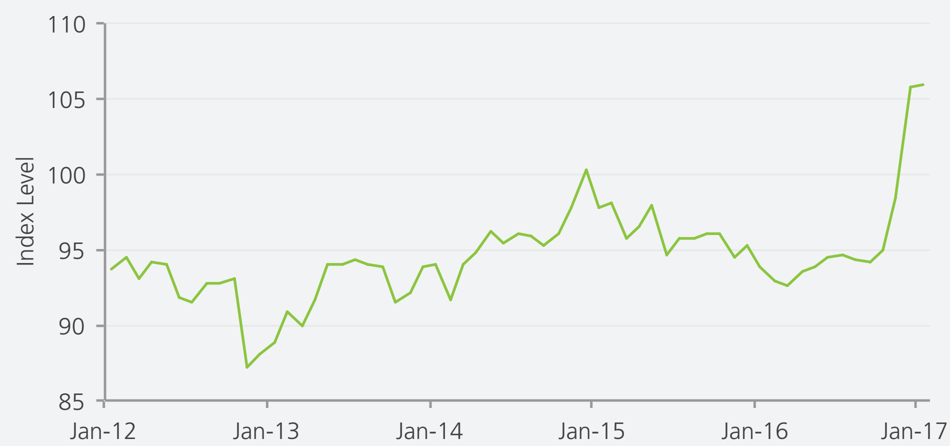
Q2 2017

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; current levels of yields reflect optimism on growth and likely to rise only modestly
- Equities returned to neutral to reflect stretched valuations and risk of policy disappointment
- Preference for U.S. equities and currency driven by the potential for lower corporate taxes and stronger growth
- Friction between the U.S. and its trading partners could cause volatility, and political risk in Europe remains high

The U.S. economy continued to strengthen over the first quarter of 2017, building on the momentum that we witnessed in the latter part of 2016. The labour market appears sound, with robust job creation and declining unemployment. At 4.7%, the current level of unemployment represents close to full employment. Wage, manufacturing and housing data have also been solid. Combined with enthusiasm for some of President Trump's proposed policies, this economic acceleration has spurred optimism. A number of North American stock indices continue to reach all-time highs, consumer confidence is rising and, as shown in Figure 1, small business owner optimism recently reached an all-time high.

Figure 1: NFIB Small Business Optimism Index
January 31, 2012 – January 31, 2017



Source: Bloomberg Finance L.P. Used with permission of Bloomberg Finance L.P., as at January 31, 2017.

Encouragingly, accelerating growth is not limited to the U.S.; we are seeing improvements globally as well. Purchasing Manager Indices (PMIs), which are a leading economic indicator, are positive in most developed countries (see Figure 2), and growth and inflation in Europe are finally showing signs of life. This is promising as we have not seen a coordinated economic recovery across major regions since 2010.

And yet, in spite of these positive signs and broad optimism, there is also a contradictory undercurrent of uncertainty. For example, in the minutes of its February meeting, the U.S. Federal Reserve (the Fed) used the word "uncertainty" 25 times, and the global Uncertainty Index recently reached an all-time high (see Figure 3). Overall, this dichotomy between optimism and uncertainty reflects the tug-of-war that exists for investors.

On the one hand, we have the positives of a seeming cyclical recovery in economies and optimism about some of President Trump's proposed reflationary and business-friendly policies. On the other hand, we have the risks associated with stretched valuations in North American equities; potential investor disappointment at the pace of policy implementation in the U.S.; political uncertainty in Europe, including questions about the future of the euro; plus the negative effects from possible protectionist trade measures in the U.S. As these forces play against one another, we may experience an increase in volatility, and there is also potential for a short-term pullback in equity markets.

WAAC Positioning

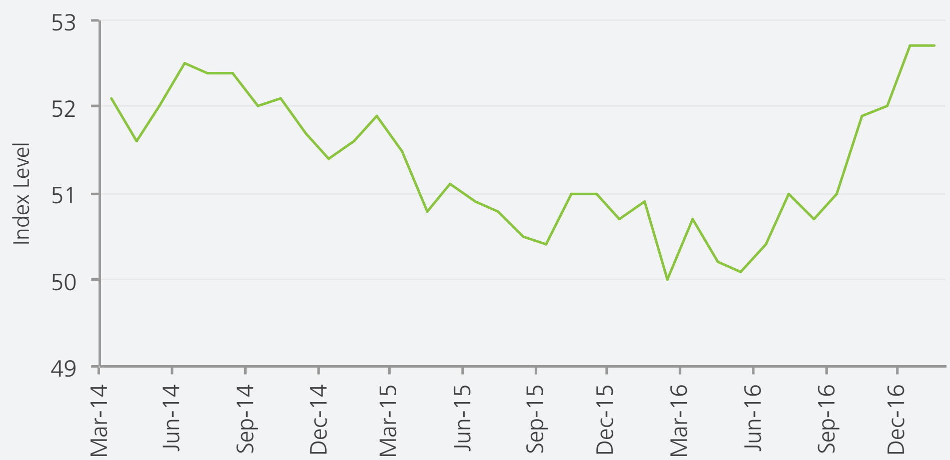
Broadly, stocks and yields have risen over the past few months, due in large part to reflation expectations driven by signs of improvement in the global economy and by enthusiasm for some of President Trump's policies. Yet many potentially problematic structural issues remain unresolved, such as high debt levels, low productivity and an aging population. We believe that the reflationary push for equities may be waning and the current risk/return dynamic favours a more neutral stance. Therefore, over the quarter we moved to a more conservative position at the asset class level and are now neutral across cash, fixed income and equities.

Within fixed income, we increased domestic government bonds from underweight to neutral and reduced high yield from underweight to maximum underweight. Within equities, we have reduced Canadian equities to underweight and increased international equities to neutral. We have also reduced the U.S. dollar from maximum overweight to overweight.

Overall, we favour a diversified portfolio that includes:

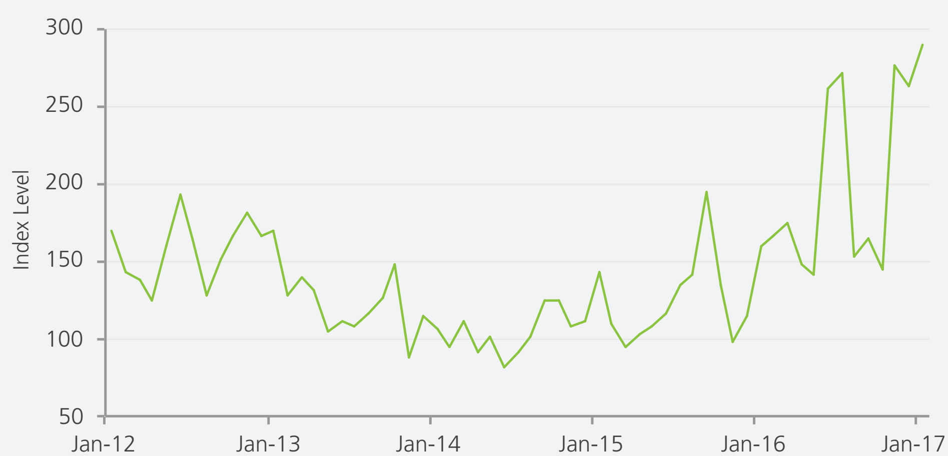
1. High quality equities, particularly U.S. equities, that have the ability to increase their earnings and dividends in a low growth environment and thereby protect the real value of investors' savings.
2. An allocation to cash to provide stability and safety of capital.
3. An allocation to high quality domestic government bonds and investment-grade corporate bonds to provide some income, diversification and stability.

Figure 2: JPMorgan Global Manufacturing Purchasing Managers' Index
March 31, 2014 – January 31, 2017



Source: Bloomberg Finance L.P. Used with permission of Bloomberg Finance L.P., as at January 31, 2017.

Figure 3: Global Economic Policy Uncertainty Index
January 31, 2012 – January 31, 2017



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Equities

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

While valuations are stretched, we remain overweight U.S. equities as stronger economic growth and higher inflation should be beneficial for revenue growth and the proposed corporate tax cuts would provide a meaningful boost to corporate earnings. The proposed repatriation of offshore profits would also be a positive and may lead to shareholder friendly activities such as share buybacks and special dividends. We remain mindful of the potential for increased volatility and a short-term pullback, but broadly we anticipate U.S. equities will outperform their peers and deliver mid- to high-single digit returns.

We have increased our international equity weighting, due in large part to our expectations for European equities. European equity returns have lagged those of their North American counterparts; valuations are attractive, sitting well below their all-time highs; and economic momentum is favourable, with earnings poised to benefit from improving economic growth and higher inflation in the region. While political risks are still a threat, they appear to have been priced into markets.

Conversely, Canadian equities, which performed strongly over the past year, are close to their all-time highs. With economic growth and inflation expected to be muted, there may not be significant impetus for further equity gains. Therefore we have reduced Canadian equities to an underweight.

We are also underweight emerging markets as broad pockets of stress are evident due to high debt levels and slowing growth, and a strengthening U.S. dollar may increase risk.

Fixed Income

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

Yields have moved up modestly and there is potential for further modest increases, but we do not expect them to move meaningfully higher than current levels. Broadly, we believe the Bank of Canada will hold its key rate steady for some time to come. While the Fed is likely to continue increasing the federal funds rate over 2017, we expect it to remain low both in real terms and from a historical perspective. Longer-term yields in the U.S. may move modestly higher as they are more sensitive to changes in economic growth and inflation.

Given this, we upgraded domestic government bonds as the stability and diversification they provide to portfolios are attractive. Our move to maximum underweight for high yield bonds reflects the continued narrowing of spreads.

We remain neutral investment grade corporate bonds as their incremental yield versus governments can be a benefit, and our neutral weighting in inflation linked bonds reflects their reasonable valuations. Global government bonds are still rated as maximum underweight as very low real and nominal yields make the risk/reward relationship unattractive.

Canadian/U.S. currency exposure

- Underweight the Canadian dollar
- Overweight the U.S. dollar vs. a basket of global currencies

We expect the Canadian dollar to remain low for an extended period and believe it will underperform the U.S. dollar. With respect to the U.S. dollar versus a basket of global currencies, we have reduced our maximum overweight to overweight. While the U.S. dollar remains strong, accelerating growth and inflation in Europe should be positive for the euro.

Gold

- Neutral gold

We believe an allocation to gold may provide insurance against the risk of extreme outcomes, and there are still meaningful risks globally, due to continued imbalances in the global economy and political risks. Our neutral weighting is a reflection of our optimism about U.S. equities and the potential for higher economic growth and inflation in the U.S.

TD Wealth Asset Allocation Committee

The TD Wealth Asset Allocation Committee 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.

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CEO & CIO
TD Asset Management Inc.and SVP, TD Bank Group

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Vice President & Director,
TD Asset Management Inc.

Glenn Davis, CFA
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