Market Perspectives

Sharpening Our 2020 Focus

Q3 2020

TD Wealth Asset Allocation Committee (WAAC) Overview

- Neutral equities overall with a bias towards U.S. equities and underweight fixed income.
- We are modestly overweight U.S. equities; however, recent optimism has pushed valuations to the higher end of fair value. Longer term, we expect U.S. equities to outperform due to their relative quality advantage over global counterparts.
- Interest rates and inflation to remain at low levels. Aggressive monetary and fiscal policy responses have prevented a 2008-type crisis but may become a long-term drag on economies.
- While we are underweight fixed income, we remain selective with a focus on opportunities in corporate credit. Wide spreads have narrowed due to liquidly stabilization, but still represent attractive yields.
- Amid the economic damage, earnings and employment data remain weak, but some encouraging data is emerging. A short and sharp recession is unfolding as forecast, but the speed of recovery will be dictated by treatment and vaccine progress.
- Robust diversification across our real asset and private debt strategies has provided relatively stable income resiliency through the current crisis.

Market Outlook

Q2 Bull Run Subdues Q1 Bear Assault

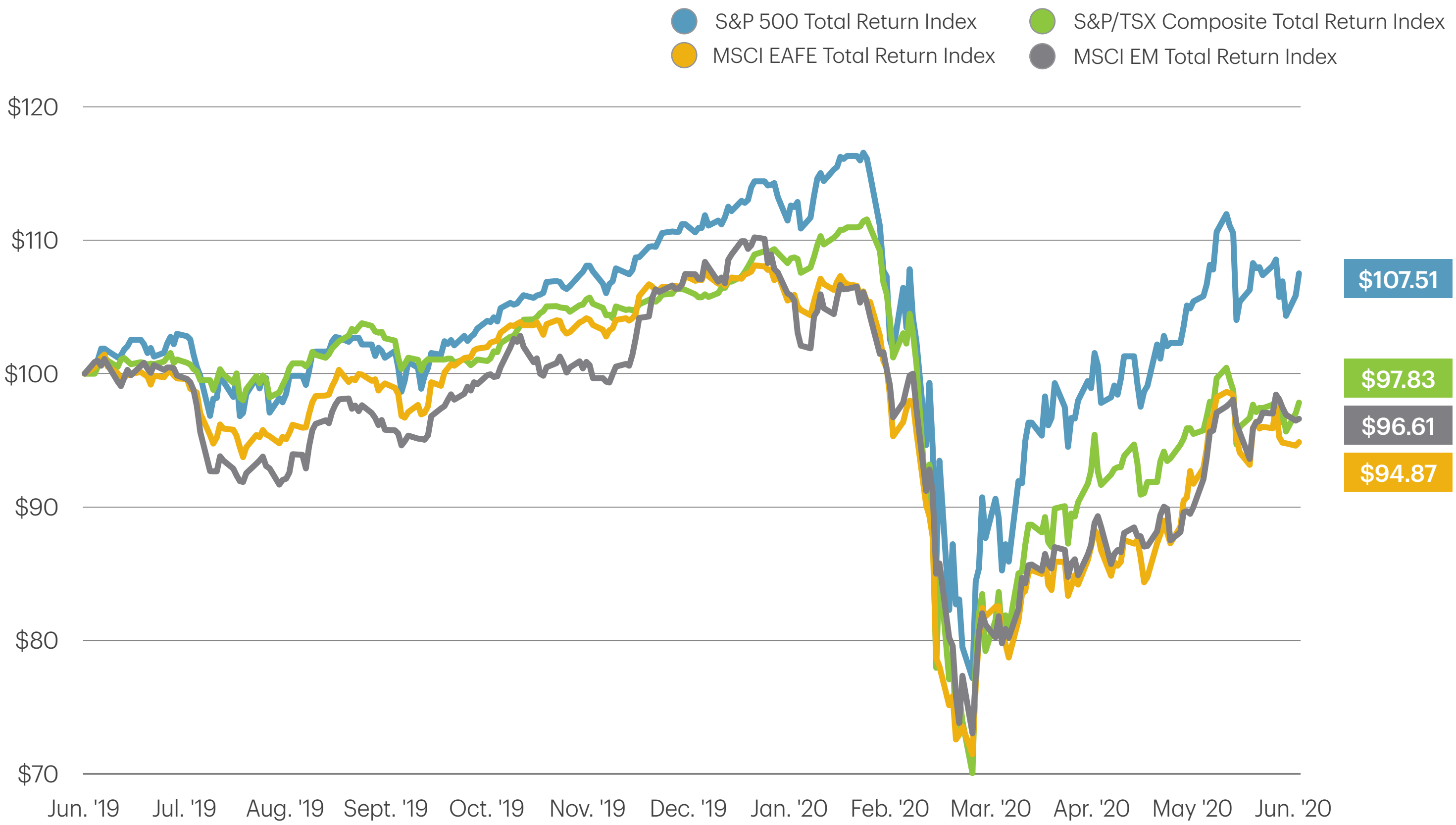
We've all been warned not to poke bears, and in the investment world we've also learned about the risks associated with standing in the way of a raging bull—a bull market that is. The prudent approach for market participants is often to ride the bull's (figuratively speaking) momentum forward while taking profits to hold to long term risk allocations. The momentum was decidedly to the upside for most of the quarter, but as coronavirus infections began to surge globally, and particularly in the U.S., bears began to threaten again at quarter end.

Global equity markets experienced an aggressive upward rally from their March lows as investors looked beyond near-term uncertainty to the expectation of a robust economic rebound. In fact, the fastest bear market on record was offset by the most rapid recovery in history during the second quarter of 2020. U.S. equities as measured by the S&P 500 Index recovered a significant percentage of their pandemic driven losses and remain well above March lows (**Chart 1**). Equally astounding has been the Nasdaq 100 Composite's resilience, as it shook off the first quarter bear assault and broke out to reach record highs, before retreating amid elevated quarter-end volatility.

A confluence of factors have underpinned equity market strength including an unwavering commitment by global central banks to maintain market functionality, an almost limitless flood of fiscal stimulus by governments, and expectations that the reopening of global economies will spur a rapid recovery in business activity. Additionally, confidence that pharmaceutical advancements will produce a successful coronavirus treatment or vaccine by year-end has contributed substantially to the market recovery. This optimism has eclipsed fears of a still struggling corporate and consumer environment, rising geopolitical risks, depressed crude prices due to severe demand disruptions, and prevailing concerns of a second wave outbreak.

Despite these risks, some economic data points are showing encouraging signs of a rebound, particularly on the jobs front in North America and strong retail sales figures out of the U.S. that shattered May expectations as consumers return to their spending ways.

Index Returns Over the Past 12 Months — The Growth of $100



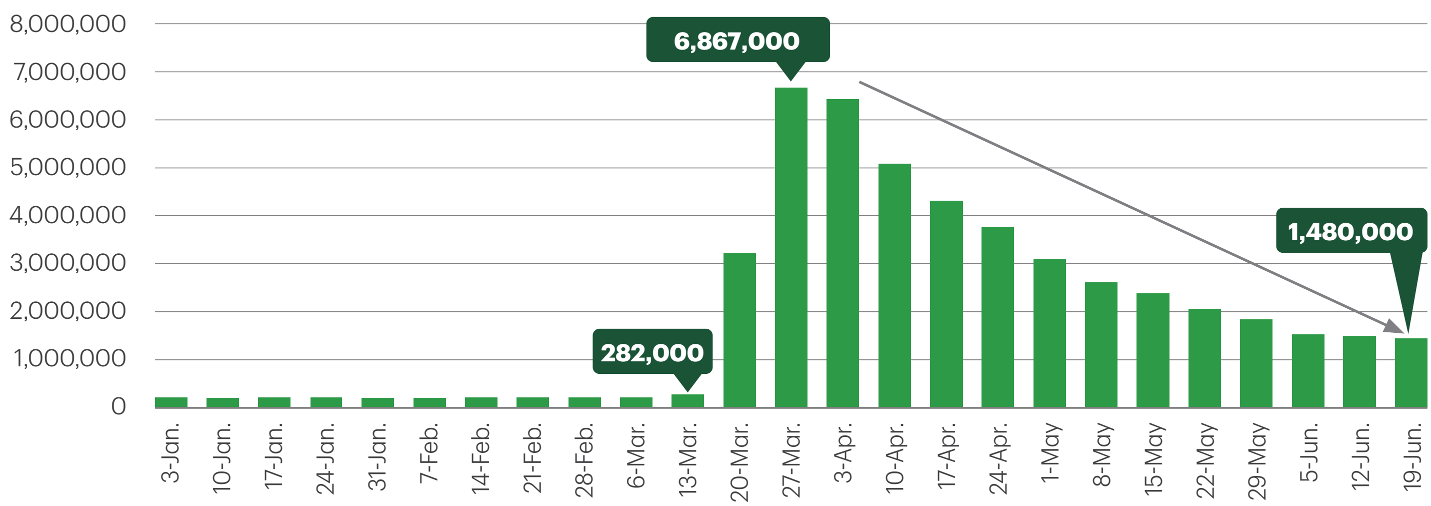
Source: Bloomberg Finance L.P. As of June 30, 2020.

Jobs Recovery in View

Looking back to the onset of the COVID-19 outbreak—which now feels like ages ago—markets were gripped by fears of the unknown economic consequences of the virus, fueled further by a deepening Saudi-Russian oil price war. Fast-forward to today, and fears of these shocks have subsided somewhat. Easing concerns was OPEC+ agreeing to extend April production cuts of approximately 10 million barrels per day until the end July to help rebalance oil markets, and a commitment from most central bankers and governments to continue injecting record stimulus into economies at unprecedented speed. A notable beneficiary of these unparalleled policy measures has been the job market.

As economies began to shut down in March, U.S. weekly initial jobless claims spiked from 282,000 to 6.7 million in just two weeks. Following a massive 20 million jobs lost in April, the numbers steadily improved on a weekly basis. Then as a major surprise to most prognosticators, the U.S. regained a whopping 2.5 million jobs in May compared to estimates of a 7.5 million loss, with initial claims dropping to about 1.9 million. More recent figures continue to show a decrease in claims albeit at a slow but steady pace. On this side of the border, Canada also delivered impressive gains, by adding almost 290,000 jobs in May, versus expectations for a loss of 500,000 jobs.

Year to Date U.S. Initial Jobless Claims (Weekly)



Source: U.S. Department of Labor/ https://www.dol.gov. As of June 26, 2020.

While there is still considerable ground to recover, the trend remains encouraging as economies continue to benefit from stimulus boosts and the reopening of businesses. It is important to note that the stock market doesn't typically wait on the sidelines for a full job recovery before driving equity prices higher. With markets looking outwards, the improving job picture has ignited confidence that a robust recovery is unfolding and paving the way for improving corporate fundamentals. For comparison purposes, after initial jobless claims peaked in April 2009 during the Global Financial Crisis, it took about 5 years for employment to fully recover. During the same period equities, as measured by the S&P 500 Total Return Index, enjoyed a 126% cumulative return, equivalent to a 19% annualized gain. This reminds us of the significant opportunity cost of staying in cash during periods of uncertainty. The dramatic March sell-off, followed by continued bouts of elevated volatility, has created a lot of fear, and a likely reason why many investors rushed into cash and cash equivalents. The volatile investment climate also illustrates the difficulty of attempting to time the market and why massive amounts remain uninvested.

While we may identify opportunities to marginally elevate cash levels to manage through periods of heightened volatility and risk, TDAM believes staying invested according to long term asset allocations has proven to be a powerful investment philosophy that can help to consistently achieve long term goals. Equity bulls don't wait to invest in high quality businesses with durable competitive advantages—they maintain these positions as part of a diversified portfolio and increase exposure to sustainable businesses that become dislocated from their fair value.

Recover

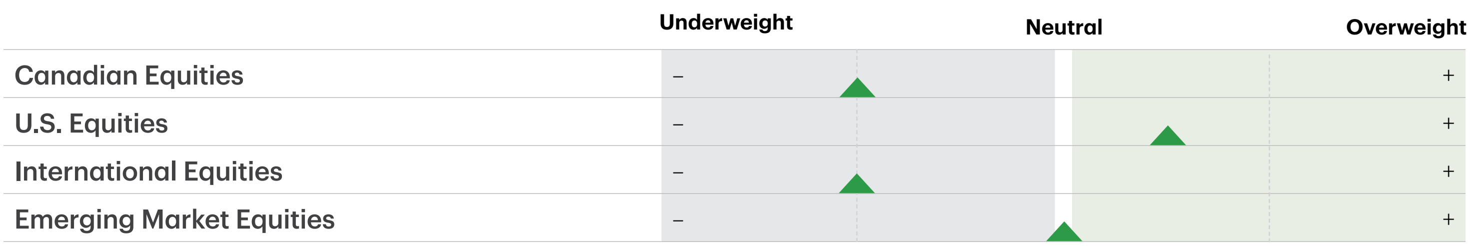
WAAC Positioning and Outlook

Many of our views expressed over the quarter for the various asset classes covered below were influenced by our frequent assessment and analysis of the virus' full potential impact on fundamentals, such as corporate earnings, default rates and long-term inflation expectations.

There have been encouraging signs of improving financial activity as economies reopen. At TDAM, we continue to believe that the path of the virus may still impact the sustainability of the current equity and credit market recovery. Significant risks remain on the horizon for many companies, sectors and global economies. To mitigate these risks, our investment portfolios continue to be tilted to high-quality companies and assets that can meet our disciplined investment process, best withstand elevated periods of volatility, and deliver strong risk-adjusted returns over the longer term.

Equities

You Should Know... We are modestly overweight U.S. equities for their relative quality advantage versus global counterparts.



Global monetary and fiscal stimulus measures continue to support risk assets like equities. Positive jobs reports, retail sales figures and a gradual restoration of global business activity could suggest the worst of the contraction is in the rear view. The U.S. Federal Reserve (the Fed) has all but guaranteed low rates into 2022 and positive signs of fiscal coordination by the European Union is adding to optimistic views for a sustainable recovery. We remain wary of the mounting trade hostilities between the U.S. and China however which could weigh on confidence and impede the rebound.

We are modestly overweight U.S. equities for their relative quality advantage versus global counterparts. Regardless, the almost unbridled optimism that has pushed valuations to the higher end of fair value, may be unsustainable near term. Our 12-18 month view remains optimistic and in the absence of material shifts to the fundamental outlook, we will continue to seek opportunities to add to portfolio risk on meaningful market pullbacks.

We are modestly underweight Canadian equities. Despite a moderate recovery in crude prices, global oil markets are grappling with the potentially lengthy process of rebalancing. This, coupled with high household indebtedness, may continue to burden the Canadian economy and hinder its pace of recovery.

We remain neutral on Emerging Markets (EM). Relative equity valuations appear attractive as they have not rebounded as sharply from the March sell-off as other markets, and may be discounted by comparison. Rising tensions between the U.S. and China on issues of trade though could weigh on EM prospects and remains a substantial long-term risk.

Fixed Income

You Should Know...

Actions by central banks to restore market functionality have contributed to an improved tone in both the U.S. and Canadian markets.

Actions by central banks to restore market functionality have contributed to an improved tone in both the U.S. and Canadian markets. The improving demand picture should continue to support the rally in corporate credit. Given the significant rally in equity markets, corporate bonds offer a relative yield advantage compared to near record low sovereign yields.

In June, the Fed announced that it would expand its foray into credit and purchase individual corporate bonds, in addition to the exchange-traded funds it was already buying. The measure is part of a continuing effort to support market efficiencies and ease credit conditions. Similarly, the Bank of Canada implemented the Corporate Bond Buying Program, where it committed to purchase an intended $10 billon in Canadian corporate bonds to sustain market stability. The rebound in corporate credit was a welcome development in both Canada and the U.S. as record levels of new investment grade bonds hit the market. This enabled the fixed income portfolio managers at TDAM to position portfolios in new and liquid corporate securities as credit spreads rebounded from the March peak.

Elsewhere, we remain neutral high yield bonds. With spreads remaining relatively wide due to the impacts of COVID-19, default risk remains elevated, particularly in the Energy sector. High yield bonds do offer a significant incremental yield advantage over government bonds, and we remain positioned with an emphasis on liquidity and quality in our portfolios.

Our longer-term return expectations for government bonds are for near-zero returns in developed markets. Yields have dropped sharply, and we expect monetary and fiscal policy coordination to suppress rates in the coming years. This diminishes the strategic case for holding nominal government bonds.

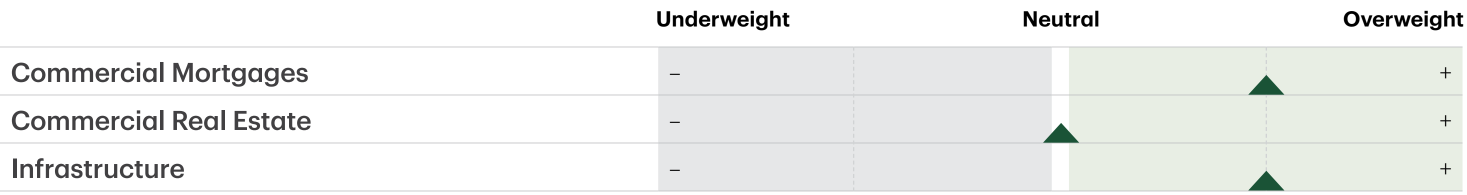
Within the global developed bond space, we reaffirm our maximum underweight view, as low or negative nominal and real yields remain uncompelling from a risk-reward perspective.

improved

Alternative Assets

You Should Know...

We retain a positive view on commercial mortgages with origination starting to regain traction across Canada.



Real estate transaction activity slowed over the past quarter but is expected to pick-up over the third and fourth quarter. The real estate market appears to be gaining some confidence with Canadian provinces implementing reopening plans. However, estimates for 2020 real estate transaction volume is for a 50%-60% decline from 2019 levels. We maintain a neutral view on commercial real estate.

We retain a positive view on commercial mortgages with origination starting to regain traction across Canada. Spreads stabilized in April and tightened in May between 5-45 basis points, depending on the quality of the mortgage. Lenders have a strong bias towards quality, while underwriting standards have tightened. Lender preference had previously been much stronger for shorter term loans, but life insurance companies are once again lending and willing to take on duration.

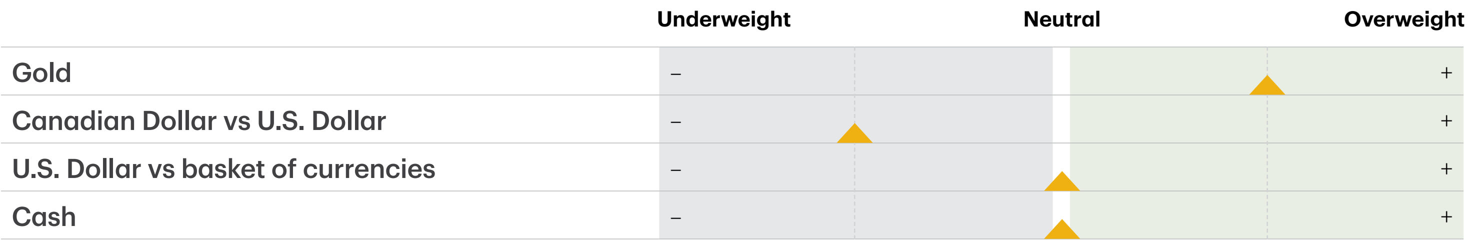
Infrastructure transaction activity is expected to be busier in the third and fourth quarter of 2020, as several processes slated for earlier in the year had been delayed. There is a focus on carefully watching counterparty risk and ensuring counterparties are government, national or international businesses with strong balance sheets. As the economic consequences unfold, there is an expectation of some income disruption for private real asset owners and lenders depending on the asset, location, or sector. This disruption is taking form through rent relief, payment suspension or debt servicing modification requests coming from certain tenants, asset operators, or borrowers.

neutral

Sub Classes

You Should Know...

Over the first half of the year, gold has been buoyed by the uncertain economic fallout from the global pandemic. This backdrop is expected to continue to prompt safe-haven demand for the metal and we expect these conditions to persist over the next 12-18 months.



Over the first half of the year, gold has been buoyed by the uncertain economic fallout from the global pandemic. This backdrop is expected to continue to prompt safe-haven demand for the metal and we expect these conditions to persist over the next 12-18 months. The commodity also offers diversification benefits and can be a useful hedge during periods of elevated risk.

The U.S. dollar came under some pressure late in the quarter but we expect the currency to hold its value over the coming months as economic activity in the U.S. gradually expands. However, we are cognizant that potential risks associated with the Fed's aggressive liquidity measures in response to the crisis could weigh on the dollar.

Despite some late quarter strength in the Canadian dollar, we maintain a modest underweight view. The Canadian economy continues to face risks associated with weak oil prices and high household indebtedness, which will likely weigh on the currency for the foreseeable future.

TD Wealth Asset Allocation Committee

The TD Wealth Asset Allocation Committee (WAAC) was established to deliver a consistent asset allocation message and be the source for active asset allocation advice across TD Wealth.

The committee has three prime objectives:

1. Articulate broad market themes
2. Provide macro-level asset allocation
3. Identify the major risks on the horizon

Committee Members

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