TD Wealth

Time out

MONTHLY PERSPECTIVES | PORTFOLIO ADVICE & INVESTMENT RESEARCH

July 2014

In this issue

Martha Hill, CFA

With the first half of the year behind us, we took a quick time out to examine our expectations for 2014 as outlined in our December 2013 issue of Monthly Perspectives. At the time, we called for continued moderate economic growth, further advances in equity markets and outlined our expectations for interest rates to gradually increase, but remain low relative to historical levels.

In this issue, TD Economics provides an update on the outlook for global economic growth. We revisit expectations for interest rates, which year-to-date have moved in the opposite direction of the original forecasts for 2014, and we examine the changing dynamics in the preferred share market and the role fixed income and preferred shares play in investors' portfolios. Additionally, with the equity bull market now in its 64th month, we discuss the potential for a market correction in the near term and what that could mean for investors.

Looking ahead to the second half of 2014, we conclude that the majority of our key investing themes for the year remain in place. The global economy is expected to continue to expand, albeit at a modest pace. After defying expectations for the first half of the year, we believe interest rates will begin to creep higher. The combination of slow growth and low interest rates should continue to support equity markets. We encourage investors to review their portfolio with their investment advisors to ensure it remains aligned to their investment goals and risk tolerance.

TD ECONOMICS

Global economic outlook

Craig Alexander, Senior Vice President & Chief Economist, TD Bank Group

Global economic growth began the year on a soft note, but our expectations for an acceleration in the coming quarters is unchanged. From 3.0% in 2013, global real GDP growth is expected to rise to 3.3% in 2014 and 3.7% in 2015. The strength is expected to come from the advanced economies, as many emerging markets will struggle with slower-than-normal expansions.

A weak start does not preclude a stronger finish

The biggest disappointment came in the United States, where the economy posted a contraction of 2.9% in the first quarter. The weakness reflects a confluence of factors including poor weather, an inventory correction and a slowdown in the housing market. Most of these should prove temporary. Going forward, sustained job growth, diminished fiscal drag, improved household balance sheets, and rising business confidence will provide solid impetus to domestic demand over the remainder of this year. Real GDP growth is expected to average above 3.0% over the last three quarters of 2014, and come in at 3.1% in 2015.

Slower growth in Canada in the first quarter has led us to edge down our forecast for the Canadian economy to 2.2% this year (from 2.3% previously). For 2015, real GDP growth has been raised a touch higher to 2.6% (from 2.5% previously). Continued low interest rates will support domestic spending and investment, while a lower Canadian dollar and a stronger U.S. economy will eventually fuel stronger exports and business investment.

Economic growth across the euro zone was positive in the first quarter, but at 0.7% annualized, it underwhelmed expectations. Of particular note, the contrast in economic performances amongst some of its largest members was stark. Germany's economy continues to outperform, whereas growth stuttered in Italy and France. The combination of slow growth and high unemployment has created concerns about deflation. However, the European Central Bank (ECB) provided additional stimulus in June and promised more to come, demonstrating that it will act to prevent deflation from taking hold.

In response to looser monetary settings, the euro has fallen from its 1.40 level vs. the U.S. dollar. A lower euro will help to raise inflation and will be beneficial for some of the euro zone's peripheral economies that have been reliant on exports to generate economic growth. Economic growth in the euro zone will likely remain uneven, but financial conditions are supportive. Overall, real GDP growth is expected to rise from -0.4% in 2013 to above 1% this year.

Elsewhere in Europe, economic activity has surprised on the upside. The level of real GDP in the UK should finally surpass its pre-crisis peak this quarter, and the economy should expand by above 3% annually in 2014. The labour market has improved far faster than anyone expected. Given this improvement, Bank of England (BoE) Governor Carney recently signaled that the first rise in the Bank rate "could happen sooner than markets currently expect."

Improvement in Western Europe has had positive implications for some of the European Union's eastern members. However, risks are high, as the full ramifications of the conflict between Russia and the Ukraine are not known.

In Japan, strong economic growth in Q1/14 in anticipation of the consumption tax hike will likely be followed by a contraction in Q2/14. However, growth should turn positive over the second half of the year and average 1.3% for 2014.

The greatest risks to the economic outlook remain in the emerging market economies. China's economy grew 7.4% year-over-year in the first quarter of 2014, a marked deceleration from the 7.7% pace recorded last year. Moreover, on a quarter-over-quarter basis, growth fell below 6% annualized. As a result, authorities have announced or implemented more than twenty "mini-stimulatory" measures over the past several months to support the economy. These measures should allow China to grow by 7.4% in 2014; however, the upside beyond this point is limited. China is currently experiencing a slowdown in its property market, with negative implications for the economy. For 2015, we anticipate that real GDP growth will be 7.0%.

The deceleration in China continues to weigh on economic growth in a number of emerging markets. This is especially true for countries that are dependent on non-food commodity exports, whose prices have fallen. Higher local policy interest rates, and in some cases, elevated inflation are other factors exerting a drag on developing economies. Political developments in some emerging markets, such as Russia, Thailand and Venezuela, are also negatively impacting economic activity.

While risks abound, the fundamentals suggest that the most likely path forward is a stronger global economy. However, the pace of growth is likely to be moderate, which will keep inflation contained. This also implies that interest rates will remain very low through the remainder of this year. The U.S. Federal Reserve (Fed) and the Bank of Canada (BoC) may consider short-term interest rate hikes in 2015, but they are more likely in the second half of the year and the tightening will be limited. The expected outperformance by the U.S. economy should lead the U.S. dollar to strengthen against most currencies, including the Canadian dollar. Commodity prices will be supported by an improving global economy, with energy prices being a wild card as they are affected by the evolution of geopolitical risks. The decline in bond yields experienced in the first half of this year is inconsistent with the outlook for improving economic conditions. Accordingly, bond yields should reverse course, but the increase is expected to be modest.

FIXED INCOME

A tricky transition

Sheldon Dong, CFA; Scott Booth, CFA

"Read last year's market predictions and you'll never again take this year's predictions seriously." Morgan Housel

At the half-year mark, and given the notorious history of soothsayers, we are somewhat surprised that the major themes in our 2014 fixed income forecast have held form—that the global economic recovery remains fragile and that interest rate policies may stay low for even longer. In combating the worst financial crisis since the Great Depression of the 1930s, the world's major central banks unleashed, and continue to unleash an unprecedented set of policy measures that have created an uncharted course for the interest rate and other financial markets. The world has become less synchronized in its economic recovery, making the transition back to normalcy for interest rates tricky.

Perhaps the biggest surprise so far this year has been the decline in global interest rates following their rise in 2013, as investors positioned for better global growth and the removal of emergency central bank measures that suppressed rates to record low levels. More specifically, the focus was on the withdrawal of the Fed's quantitative easing (QE) program that is still ongoing. However, global economic growth has not progressed as well as expected so far this year due to harsh winter conditions in North America, a tepid recovery in Europe and slowing growth in China and other emerging markets. The World Bank in June revised its global growth forecast for this year to 2.8% from a prior prediction of 3.2% in January. From a global perspective, the Fed's gradual withdrawal of monetary stimulus has been countered by a new stimulus package delivered by the ECB in early June. The ECB not only cut its benchmark refinancing interest rate to a record low of 0.15% (declared to be the absolute floor), the deposit rate (the rate commercial banks receive for deposits at the central bank) was cut from zero to minus 0.1%, becoming the first major central bank to take one of its main rates negative. As well, the ECB unveiled its own version of quantitative easing to stimulate credit conditions beyond the interest rate cuts, suggesting the low rate policy may be in force through the end of 2016. In a highly connected financial world, lower European interest rates have helped to lower interest rates in North America and abroad, as investors searched for yield on a relative basis.

Financial markets continue to be deeply affected by central bank largesse. The financial crisis enabled central banks to be bolder in maintaining and evolving exceptional monetary and credit stimulus, which in turn has significantly bolstered the prices of stocks, bonds and other assets as a means of stimulating the economy. According to Michael Hartnett, chief investment strategist at Bank of America Merrill Lynch, "financial assets are bound to be attractive when the price of money is zero: 56% of the world economy is currently under the spell of zero rate policies."

In the world of near-zero percent interest rates, investors continue to take on more risks in an attempt to reach their desired financial goals. While this remains fruitful during a time of synchronized global monetary accommodation, investors should monitor their risk and strategic asset allocation as both credit and stock markets could correct meaningfully when the end of zero interest rates is threatened. However, getting the timing right is always tricky. The BoE may be among the first of the major central banks to begin the transition to a higher interest rate cycle as Governor Mark Carney warned households, companies and financial markets to prepare for an interest rate rise. With regard to Canada and the U.S., TD Economics continues to forecast that the BoC will keep interest rate policy unchanged until the third quarter of 2015, while the Fed is not expected to do the same until the fourth quarter of 2015.

Rather than placing market timing bets as to when interest rates may turn higher again, our preference for fixed income is to embrace the unknown and invest to attain certain investment goals. We continue to advocate asset allocation within the fixed income portion of an investment portfolio to meet the main goals of liquidity, capital preservation and income generation.

A few words on preferred shares

Preferred shares have performed well in the first half of 2014, rebounding after a dismal performance in 2013. Positive credit market conditions and declining Government of Canada bond yields have provided a supportive backdrop. In our 2014 outlook, we highlighted an anticipated wave of redemptions estimated to total roughly 24% of all outstanding rate-reset preferred shares in the Canadian market, which is likely to occur in the first nine months of 2014. Most of the redemptions (about $5.5 billion) are coming from Canadian banks who first issued these securities to shore up capital during the financial crisis. To replace the redemptions, Canadian banks have started to issue so-called Basel III compliant preferred shares—a requirement that all non-common share capital instruments issued on or after January 1, 2013 must contain provisions that require the instruments to be converted into common shares if the regulator determines that the issuing bank is no longer viable. Investor demand has been very strong as the coupon rate on these new rate-reset preferred shares has dipped from 4.0% initially to 3.90% recently. Market performance seems to have been heavily influenced by the balance between primary market activity and redemptions. New issuance seems to weigh on the market, while redemptions appear to be supportive as funds get reinvested. This dynamic is likely to remain a key factor influencing market performance in the coming months. Given the interest rate sensitivity and low market liquidity for preferred shares, we believe they are best suited to meet income generation goals that are fully realized through longer investment horizons.

NORTH AMERICAN EQUITIES

Taking stock mid-year

Martha Hill, CFA

The first half of 2014 has unfolded largely in line with our expectations, but not without surprises. Our 2014 outlook called for positive but moderate equity market returns comapred to 2013. The U.S. equity market, as measured by the S&P 500 Index (S&P 500) has advanced year-to-date, but the gains have been smaller than those experienced in the first six months of 2013.

After being outpaced by the U.S. equity market for the past three years, the Canadian equity market has surprised to the upside and outperformed the U.S. during the first half of 2014. Fuelled by the energy, materials and industrials sectors, the S&P/TSX Composite Index (TSX) has not only regained all of its losses since the 2009 lows, but has now reached new all-time highs, advancing 10.4% while the S&P 500 was up a more modest 5.6% (6.6% in Canadian dollar terms) year-to-date (as at June 26, 2014).

Potential for a market pullback

Although the broad market experienced only a minor pullback early in the year due to concerns over U.S. GDP growth and geopolitical tensions, there was a significant correction in the high flying social media stocks and the U.S. biotech sector.

Soon after, equity markets continued to climb higher, extending the bull market to its 64th month. While this bull market is mature, it is not without precedent. As stocks continue to move higher, investors are questioning how long the advance can continue as a correction is likely overdue.

> We would not be surprised to see equity markets pull back in the near term

We would not be surprised to see equity markets pull back in the near term. The combination of relatively optimistic investor sentiment readings and extremely low volatility suggests there is a sense of complacency, which from a contrarian perspective, can set the stage for a correction. At the same time, we are in a traditionally weak seasonal period for the equity markets as trading volumes tend to be lower during the summer months. Potential triggers for a correction could include: geopolitical risks such as the current violence in Iraq and tensions in Ukraine; disappointing economic data out of the U.S., China or the euro zone; or it could be as simple as investors taking profits or a lack of buyers as we move into the summer.

Markets remain supported

Should the equity markets correct, we would not view the pullback as the beginning of a bear market due to the constructive fundamental backdrop. Global economic growth, while moderate, remains supportive for equities. Earnings expectations for the U.S. and Canada are constructive with consensus growth estimates of roughly 8% for the S&P 500 and 6% for the TSX over the next 12 months. As forward earnings estimates have increased, equity market valuations have contracted somewhat since the beginning of the year. Both the S&P 500 and TSX are currently trading at roughly 16x forward earnings compared to approximately 19x in late 2013. At roughly 16x forward earnings estimates, the indices are trading slightly above their long-term averages of 15.3x (S&P 500) and 15.8x (TSX).

Interest rates also remain supportive. Although the Fed is systematically unwinding its QE, monetary policy remains accommodative, and the Fed moves have been well-telegraphed thus not surprising the market. It is also important to remember that the unwinding of the Fed's QE and eventual rise in the Fed Funds rate is positive in that it suggests that the U.S. economy is healthy enough to grow without excessive monetary stimulus.

Looking forward

Looking ahead to the second half of the year, we believe the key themes highlighted in our 2014 outlook remain intact. We continue to prefer equities over fixed income and maintain a preference for high quality large cap stocks. U.S. economic growth is expected to continue to outpace Canadian growth, which continues to support our long-held belief in investing in the U.S., particularly in sectors under-represented in the Canadian equity market. We maintain a cyclical bias within equity portfolios based on expectations for continued economic expansion. Although interest rates are expected to move higher, we anticipate they will remain extremely low relative to historical levels, suggesting that investors will likely continue to look to high-quality dividend-paying stocks as a source of income.

Figure 1: S&P/TSX and S&P 500 Performance

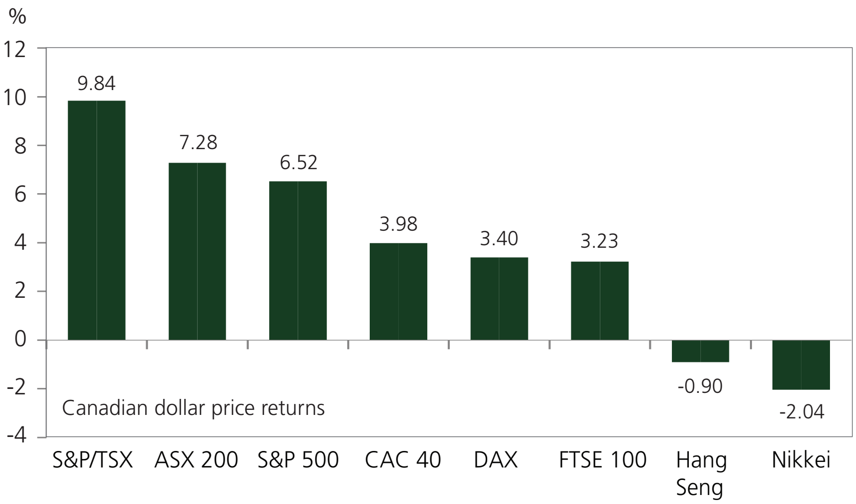
Source: Bloomberg Finance L.P. As at June 25, 2014.

THE LAST WORD

A picture is worth 1000 words

Scott Booth, CFA

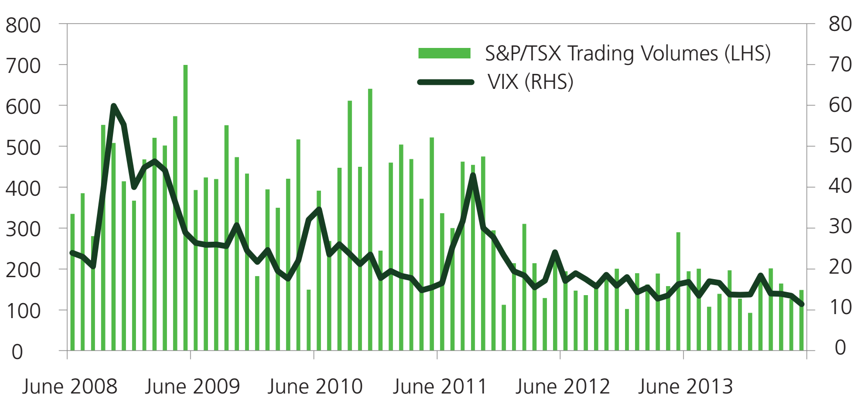
Figure 2: Global Stock Market Performance



The Canadian stock market has outperformed other developed global markets in Canadian dollar terms year-to date, aided by a resurgence in the heavily-weighted energy sector.

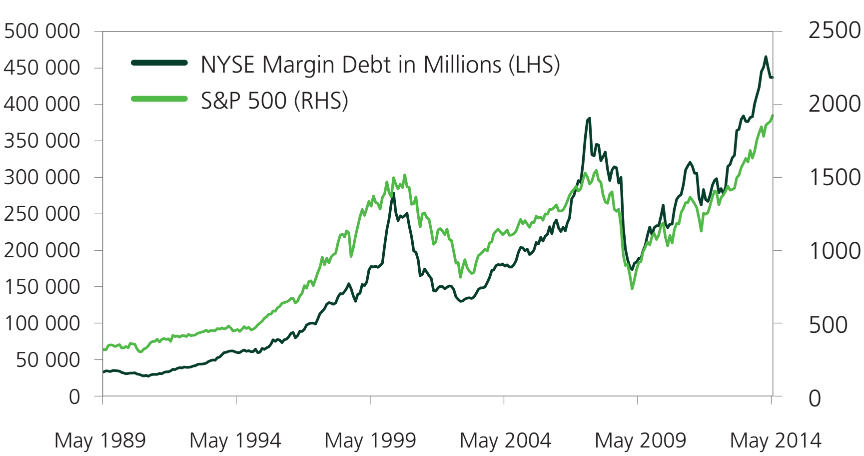
S&P/TSX Composite Index (S&P/TSX) - Canada
S&P/ASX 200 index (ASX 200) - Australia
S&P 500 Index (S&P 500) - United States
CAC 40 Index (CAC 40) - France
DAX Index (DAX) - Germany
FTSE 100 Index (FTSE 100) - England
Hang Seng Index (Hang Seng) - Hong Kong
Nikkei 225 Index (Nikkei) - Japan

Figure 3: TSX Trading Volumes (millions) and Market Volatility



The large gains in equity markets have been supported by the accommodative monetary policies of the developed world's central banks. Two of the hallmarks of this rally have been low volatility and low trading volume. The VIX Index, which captures market expectations of near-term volatility and is considered a gauge of investor fear, has fallen to new post-financial-crisis lows. The total volume of shares traded on the Toronto Stock Exchange, measured in millions of shares, also continues to trend lower.

Figure 4: S&P 500 Index Performance and NYSE Margin Debt



U.S. margin debt has also been trending higher, reaching a recent peak of US$465 billion at the end of February 2014, before turning lower in recent months. Rising margin debt is viewed as a positive for equity markets as it captures improving market sentiment. Margin debt often peaks before the market does, and for that reason, the recent declines are noteworthy.

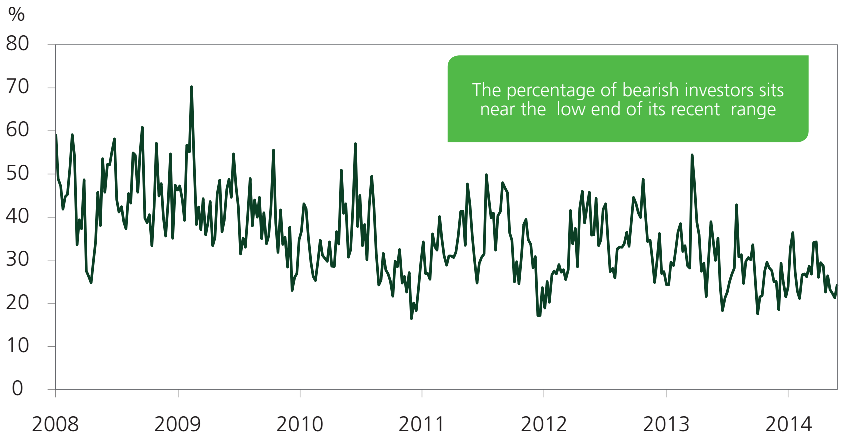
Source for charts: Bloomberg Finance L.P. As at June 25, 2014

THE LAST WORD

A picture is worth 1000 words (cont'd)

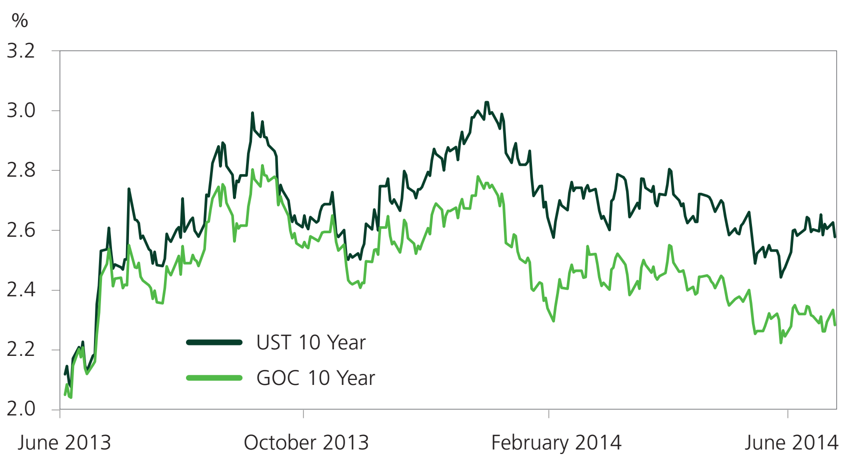
Scott Booth, CFA

Figure 5: Investor Sentimtent, Percentage of Bearish Investors



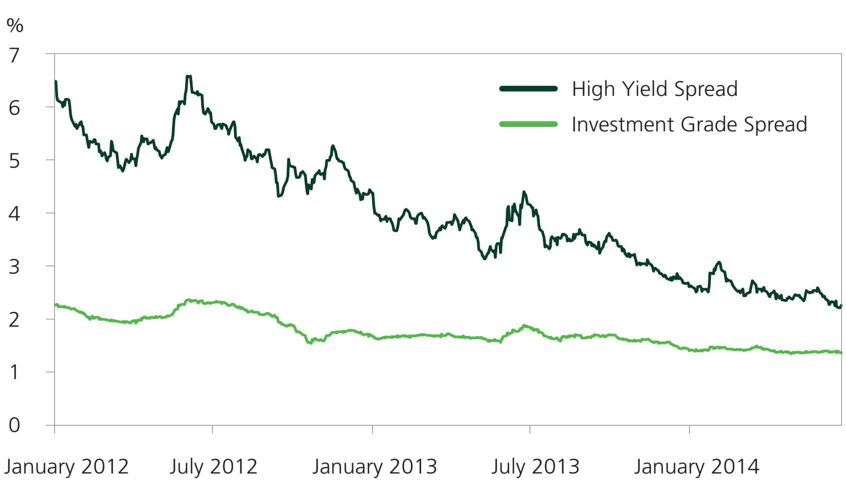
Recent surveys of investor sentiment continue to show a scarcity of bearish investors, with the most recent readings marking 2014 lows. The contrarian investor might raise concerns about the American Association of Individual Investors bearish sentiment readings being so strongly skewed towards a bullish outlook.

Figure 6: Government of Canada Bond and U.S. Treasury Yields



The consensus view for 2014 was that North American government bond yields would finish the year higher than where they started. So far, that view has not panned out, as slower than anticipated growth and falling yields in Europe have increased the relative appeal of both Government of Canada (GOC) bonds and U.S. Treasuries (UST), driving a supportive bid in the market and resulting in lower yields. GOC 10-year yields are down 51 basis points (bps) from where they finished 2013, while UST 10-year yields are down 49 bps over the same period.

Figure 7: Investment Grade and High Yield Credit Spreads



Credit market conditions remain very strong, both in the investment grade and high yield spaces. The incremental return that investors receive for investing in corporate over government bonds continues to decline towards pre-crisis levels, begging the question, is there enough compensation provided for the additional credit risk?

Source for charts: Bloomberg Finance L.P. As at June 25, 2014

PERFORMANCE MONITOR

Monthly market review

		(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)
Canadian Indices ($CA) Return	**Index Level**	**1 Month**	**3 Months**	**YTD**	**1 Year**	**3 Years**	**5 Years**	**10 Years**	**20 Years**
S&P/TSX Composite (TR)	45,523	4.07	6.41	12.86	28.66	7.60	11.01	8.77	9.26
S&P/TSX Composite (PR)	15,146	3.71	5.66	11.19	24.87	4.43	7.86	5.89	6.85
S&P/TSX 60 (TR)	2,103	3.89	6.32	12.19	28.31	7.47	9.66	8.97	9.89
S&P/TSX SmallCap (TR)	1,015	7.04	9.36	18.04	36.22	2.74	14.06	5.12	-

U.S. Indices ($US) Return	Index Level	1 Month	3 Months	YTD	1 Year	3 Years	5 Years	10 Years	20 Years
S&P 500 (TR)	3,552	2.07	5.23	7.14	24.61	16.58	18.83	7.78	9.79
S&P 500 (PR)	1,960	1.91	4.69	6.05	22.04	14.07	16.35	5.56	7.70
Dow Jones Industrial (PR)	16,827	0.65	2.24	1.51	12.86	10.67	14.78	4.89	7.98
NASDAQ Composite (PR)	4,408	3.90	4.98	5.54	29.53	16.70	19.16	7.97	9.59
Russell 2000 (TR)	5,590	5.32	2.05	3.19	23.64	14.57	20.21	8.70	9.81

U.S. Indices ($CA) Return	Index Level	1 Month	3 Months	YTD	1 Year	3 Years	5 Years	10 Years	20 Years
S&P 500 (TR)	3,792	0.27	1.64	7.54	26.55	20.61	16.83	5.36	8.37
S&P 500 (PR)	2,093	0.11	1.12	6.45	23.94	18.01	14.38	3.19	6.32
Dow Jones Industrial (PR)	17,964	-1.12	-1.25	1.89	14.62	14.49	12.84	2.53	6.59
NASDAQ Composite (PR)	4,706	2.07	1.40	5.94	31.55	20.73	17.14	5.54	8.18
Russell 2000 (TR)	5,968	3.47	-1.44	3.57	25.57	18.52	18.18	6.26	8.40

MSCI Indices ($US) Total Return	Index Level	1 Month	3 Months	YTD	1 Year	3 Years	5 Years	10 Years	20 Years
World	6,443	1.83	5.05	6.52	24.71	12.45	15.62	7.84	7.70
EAFE (Europe, Australasia, Far East)	7,050	0.99	4.34	5.14	24.09	8.59	12.27	7.42	5.89
EM (Emerging Markets)	2,080	2.70	6.71	6.32	14.68	-0.06	9.58	12.30	6.61

MSCI Indices ($CA) Total Return	Index Level	1 Month	3 Months	YTD	1 Year	3 Years	5 Years	10 Years	20 Years
World	6,878	0.04	1.46	6.92	26.66	16.32	13.67	5.41	6.32
EAFE (Europe, Australasia, Far East)	7,526	-0.78	0.78	5.54	26.03	12.34	10.37	5.00	4.53
EM (Emerging Markets)	2,220	0.89	3.06	6.71	16.47	3.39	7.73	9.77	5.24

Currency	Level	1 Month	3 Months	YTD	1 Year	3 Years	5 Years	10 Years	20 Years
Canadian Dollar ($US/$CA)	93.67	1.79	3.54	-0.37	-1.53	-3.33	1.72	2.30	1.30

Regional Indices (Native Currency) Price Return	Index Level	1 Month	3 Months	YTD	1 Year	3 Years	5 Years	10 Years	20 Years
London FTSE 100 (UK)	6,744	-1.47	2.21	-0.08	8.50	4.29	9.68	4.21	4.28
Hang Seng (Hong Kong)	23,191	0.47	4.69	-0.50	11.48	1.17	4.76	6.56	4.99
Nikkei 225 (Japan)	15,162	3.62	2.25	-6.93	10.86	15.60	8.77	2.49	-1.53

Bond Yields	3 Months	5 Years	10 Years	30 Years
Government of Canada Yields	0.95	1.53	2.24	2.78
U.S. Treasury Yields	0.20	1.63	2.53	3.36

As at June 30, 2014

Sources: TD Securities Inc., Bloomberg Finance L.P. TR: total return, PR: price return.

APPENDIX A

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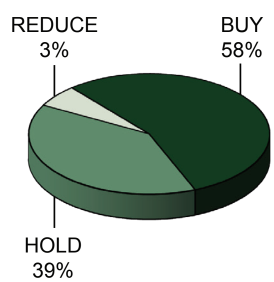
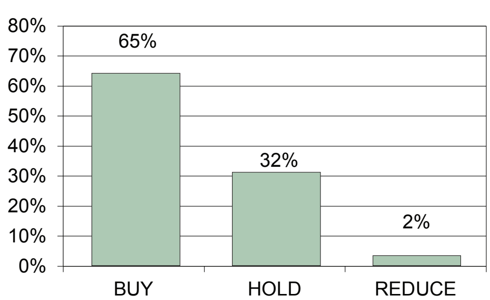
Action List BUY: The stock's total return is expected to exceed a minimum of 15%, on a risk-adjusted basis, over the next 12 months and it is a top pick in the Analyst's sector. BUY: The stock's total return is expected to exceed a minimum of 15%, on a risk-adjusted basis, over the next 12 months. SPECULATIVE BUY: The stock's total return is expected to exceed 30% over the next 12 months; however, there is material event risk associated with the investment that could result in significant loss. HOLD: The stock's total return is expected to be between 0% and 15%, on a risk-adjusted basis, over the next 12 months. TENDER: Investors are advised to tender their shares to a specific offer for the company's securities. REDUCE: The stock's total return is expected to be negative over the next 12 months.

Distribution of Research Ratings^



^Percentage of subject companies under each rating category—BUY (covering Action List BUY, BUY and Spec. BUY ratings), HOLD and REDUCE (covering TENDER and REDUCE ratings). As at July 3, 2014.

Investment Banking Services Provided*



*Percentage of subject companies within each of the three categories (BUY, HOLD and REDUCE) for which TD Securities Inc. has provided investment banking services within the last 12 months. As at July 3, 2014.

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