Market Outlook

Investment Strategy Quarterly

Q4 2014

Doubling Down

After a solid first quarter, during which the S&P/TSX Composite Index (TSX) outpaced the S&P 500 Index (S&P), 5.2% versus 1.3%, ending the TSX's three-year period of underperformance, Q2 began on a similar, spirited note.

While Q1 U.S. economic data was very soft, with GDP growth initially estimated at 0.1% and later revised to -2.1%, the results were largely anticipated due to extremely harsh weather throughout the Midwest and along the East Coast. As a result, investors once again looked through unsettling "macro" economic data to the underlying "micro" fundamentals of corporate earnings, as they have so often done since 2009.

Given this Q1 economic contraction, the S&P's Q1 year-over-year earnings growth of 1.3% on a 0.9% increase in revenue was, while tepid, deemed acceptable by investors. The percentage of companies beating revenue and earnings estimates was 51% and 69%, respectively, and while less impressive than prior quarters, the outcome was generally viewed as better than anticipated. This was particularly so as the financial sector, which had been a driver of growth in previous quarters, saw its earnings decline 6.6% in Q1, reflecting: 1) further compression of margins as bond yields unexpectedly declined; and 2) legal settlement costs with U.S. federal agencies related to past mortgage lending practices. Net of the financial sector, S&P revenue and earnings advanced 3.3% and 3.6%, respectively.

Meanwhile, Canada's GDP shrank 0.9% in Q1 and TSX earnings rose 5.1% on a solid 9% increase in revenue. Improving exports, a modest decline in the Canadian dollar and energy sector strength boosted both the economy and corporate earnings. The TSX followed suit and advanced 5.6% in Q2, outperforming the S&P's 4.7% gain for the second consecutive quarter (see chart 1).

The Geopolitical Backdrop

While North American stock markets rose roughly in line with earnings growth in Q2, two regional conflicts continued to dominate the headlines in the July–September timeframe.

Market Outlook Summary Table		
Area of Focus	**Investment Question**	**Recommendation**
Equity/Fixed Income Split	Are stocks or bonds more attractive?	We favour stocks over bonds with emphasis on large-capitalization dividend growth stocks.
Canadian/U.S./ International Equity Split	Are Canadian, U.S. or International stocks most attractive?	We are equally overweight U.S. and Canada, have a neutral stance among major international markets and have no position in emerging markets.
Corporate/ Government Bond Split	Are investment grade Canadian corporate bonds or government issues more attractive?	We are overweight corporate bonds for their combination of incremental yield and shorter duration than government bonds.
Canadian/ Foreign Currency Exposure	Will foreign currency exposure add or detract from total returns for Canadian investors?	We believe the Canadian dollar is fairly valued at its current level and are maintaining our neutral position.

As documented in recent issues, Russia's February 28 incursion into Crimea and the ensuing conflict in eastern Ukraine evoked concern in the West but resulted in little financial market response. In our view, markets accurately deduced that while Russia had a strategic interest in Crimea, home to Russia's Black Sea fleet, and to a lesser extent Ukraine as a whole, the West had no treaty obligations toward Ukraine and few economic ties so a military response was improbable.

The biggest financial market impact has been in Russia, where its RTS equity index is above its 2014 lows but still down 19% year-to-date. The ruble, meanwhile, has slipped 2.7% from its February 28 level by early September, recording new all-time lows. This decline would be greater were it not for three Russian central bank rate increases since February to a current 8% and an approximate 250 basis point increase in the 10-year Russian bond spread versus the German bund (see chart 2).

While Russia's economy and financial markets have suffered most from both trade sanctions and capital flight, there has been a corrosive effect on Europe as well. There, GDP growth is stuck around 1% year-to-date, the DAX (Germany) and FTSE 100 (UK) indices are sharply underperforming their North American counterparts and the euro is down 4.8% from its February 28 level.

The expanding conflict in Syria and Iraq, the emergence of ISIS and increasing involvement of the Iranian and U.S. military captured worldwide attention in Q3.

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While past hostilities in the Middle East almost invariably caused an expansion of the political risk premium and higher oil prices, Q3 saw quite the opposite. As illustrated in chart 3, West Texas Intermediate (WTI) actually declined from its late June peak around US$107/barrel to US$94/barrel by early September, driven by stable production in surrounding middle-eastern countries, rising output in the U.S., below-estimated consumption growth in Europe and a firmer U.S. dollar.

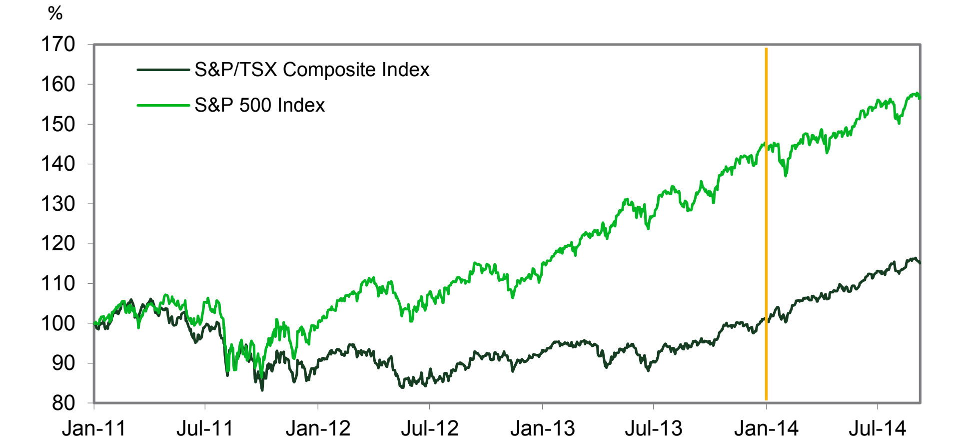
Q2 Earnings Deliver

After the weather-induced Q1 2.1% contraction in U.S. GDP, the American economy bounced back strongly in Q2, recording growth of 4.2%. This strong performance was broadly-based, reflecting an uptick in personal consumption, non-residential construction and both state and local government spending. Not surprisingly, Q2 S&P earnings growth of 7.7% showed marked improvement from Q1's 1.3% figure, with 65% of companies beating revenue estimates and 74% exceeding analyst earnings estimates. All ten S&P sectors saw earnings growth, with an 8.1% gain in health care and information technology sectors while the financials lagged again with only a 1% improvement.

After Canada's GDP contracted 0.9% in Q1, the second quarter saw a rebound to 2.5% growth, mirroring many of the same trends seen south of the border. Canadian household consumption expanded 3.8%, led by auto purchases, residential investment spiked 11.7% after Q1's 5.6% drop, and most tellingly, exports jumped 17.8%. TSX earnings responded, with 15% year-over-year growth, abetted by an expansion of operating margins from 9.7% to 10.2% and led by a 41% jump in energy sector earnings.

As has generally been the case in recent years, investors once again overlooked the macro issues and focused on earnings growth in the third quarter, resulting in two-month returns of 3.2% and 2.2% for the TSX and S&P, respectively, in the July-August period.

Chart 1: S&P/TSX Composite Index vs. S&P 500 Index



Local Currency Price Returns. Source: Bloomberg Finance L.P. As at September 9, 2014.

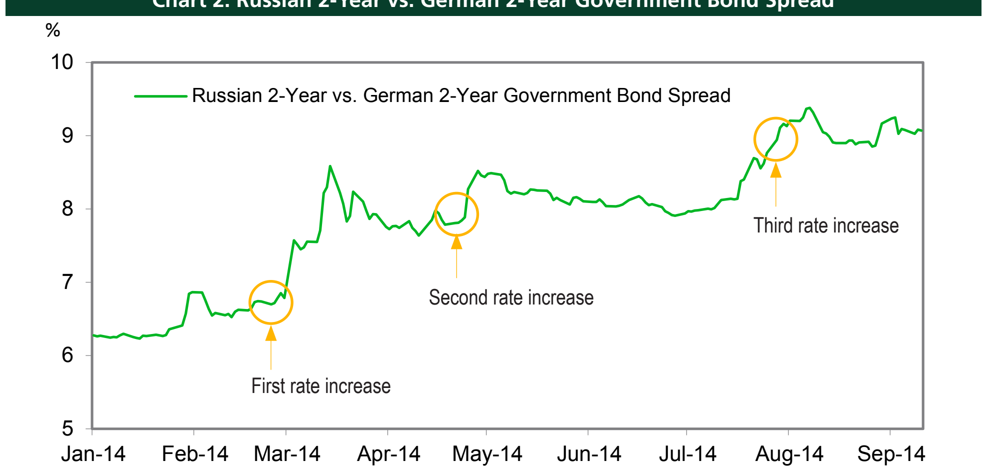
The ECB Doubles Down

Our last edition's section entitled "The Atlantic Divide" chronicled the sharp and increasing contrast between the economic recovery in North America and that in Europe. We outlined how, in response to very low inflation and GDP growth data, the European Central Bank (ECB) loosened monetary policy on June 5. More specifically, the ECB cut its deposit rate on banks' excess reserves to a negative figure for the first time and introduced a new lending program to provide up to 400 billion euros in funding to small- and medium-sized businesses.

On September 4, in the wake of uncomfortably weak inflation and GDP data, the ECB doubled down on more accommodative monetary policy, cutting both its main refinancing rate and the above-mentioned rate on excess reserves by a further 10 basis points. The latter underscored the ECB's desire to have banks lend more money rather than store it with the central bank. While these rate cuts will not have much economic impact given already-low rates, a new program (similar to Quantitative Easing (QE)) to purchase asset-backed securities may have greater impact as such purchases, as TD Economics points out, create additional incentives to lend to the real economy, in contrast to conventional QE that involves purchase of government instruments.

The biggest impact of the ECB's commitment to use additional unconventional instruments will very likely be a lower euro. The ECB's twin concerns are low growth and the potential for deflation, and a cheaper currency is often an antidote to both, boosting exports to stimulate growth while increasing the cost of imports with attendant inflation. Chart 4 indicates that the euro reached approximately EUR/USD 1.40 in May and about EUR/USD 1.30 after the September 4 ECB announcement, well below the all-time high of about EUR/USD 1.60 in 2008 but far higher than the EUR/USD 0.92 level in 2002. Competitive

Chart 2: Russian 2-Year vs. German 2-Year Government Bond Spread



Source: Bloomberg Finance L.P. As at September 10, 2014.

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devaluation is often used by governments in credit crisis recovery periods and is a tool Europe is increasingly willing to employ.

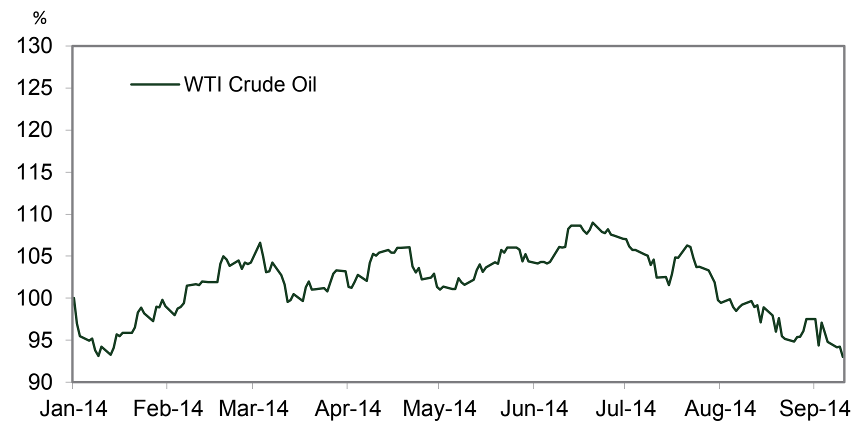
Market Outlook

1. Equity/Fixed Income Split

With North American stock markets near record highs, it is timely to re-examine our long-held preference for stocks over bonds, based on what we have judged to be the superior risk/reward relationship of equities. Our current views are summarized below:

- With the S&P and TSX trading at roughly 17x 2014 estimated earnings and 16x our 2015 forecast, North American stocks are fairly valued in absolute terms. At the same time, stocks' earnings yield (earnings/share price) remains over double the 10-year U.S. Treasury and Government of Canada bond yields (see chart 5), so share prices are very reasonably priced relative to fixed income. Overall, equities' valuation is a mild positive.
- The North American economic outlook is generally positive and 2015 estimated growth in the 2.5%+ range should result in upper-single digit earnings growth, which will in turn be supportive for stocks.
- Monetary policy remains highly accommodative and while the U.S. Federal Reserve (Fed) will likely raise its benchmark Fed Funds rate in mid-2015, rate hikes will likely be constrained by slow growth, high government debt loads and contained inflation.
- Bond yields are extremely low in nominal terms and even lower in real terms, net of inflation, rendering bonds unattractive. While increases in bond yields will likely be limited by the lacklustre environment cited above, it is unlikely that bonds will generate much more than coupon returns, making their risk/return relationship unfavourable.

Chart 3: WTI Crude Oil



Price Returns. Source: Bloomberg Finance L.P. As at September 10, 2014.

For the reasons enumerated, we continue to favour stocks over bonds and maintain our overweight position in the former and underweight in the latter. With equities fairly valued, investors should ensure they have a margin of safety embedded in their portfolios to protect them from exogenous shocks. Reflecting this, we re-emphasize our preference for the large-cap stocks with a history and prospects of rising dividends, coupled with solid defensive characteristics.

Regular readers of this column will recall we eliminated our tactical overweight in gold in the spring of 2013 around the US$1,375/oz mark. Since the price of bullion has dropped about US$150/oz in the intervening period, we have been frequently asked if we intend to initiate new positions. We view gold as insurance against extreme outcomes and with risk lower than had been the case, we believe gold is not inexpensive at current levels. In addition, the U.S. dollar has and should continue to show strength, which acts as a headwind for gold. As a result, we are not initiating a new tactical position.

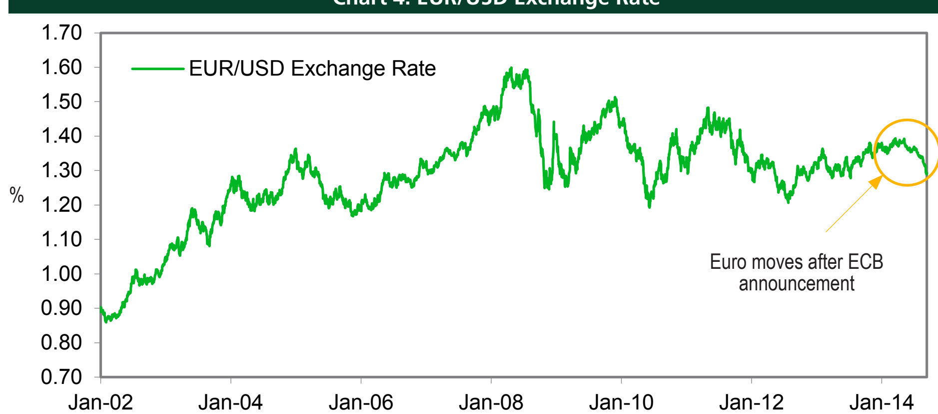
2. Canadian/U.S./International Equity Split

Earlier this year, we trimmed our long-standing, significant overweight in U.S. equities, eliminated our overweight in developed international markets and adopted an overweight in Canada equal to that of our U.S. position. We reasoned that the TSX would end its three-year underperformance versus the S&P due to stronger earnings, closure of a modest valuation gap and a rebound in Canada's energy sector. So far, this has worked out and the TSX has outperformed year-to-date.

The recent decline in the euro, coupled with modest European growth, has reinforced our emphasis on European firms with global reach that will be the beneficiaries of euro weakness and are characterized by substantial, rising dividends.

Overall, we are maintaining our equal, overweight stance in Canada and the U.S., neutral position among major international markets and no position in emerging markets.

Chart 4: EUR/USD Exchange Rate



Source: Bloomberg Finance L.P. As at September 10, 2014.

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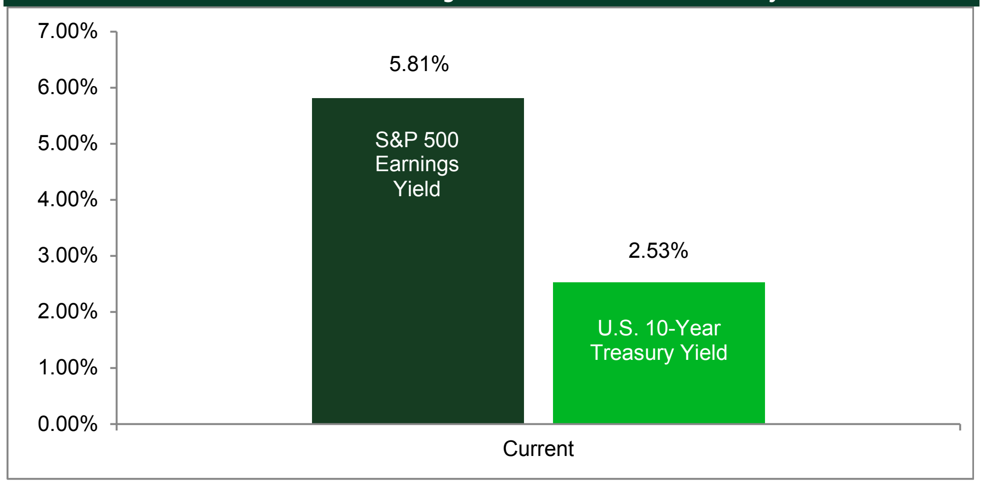
Chart 5: S&P 500 Index Earnings Yields vs. U.S. 10-Year Treasury Yield



Source: Bloomberg Finance L.P. As at September 10, 2014.

3. Corporate/Government Bond Split

As stated above, we continue to find few redeeming virtues in government bonds and have preferred investment grade corporate issues for their higher coupons and shorter duration, which lowers interest rate risk. As a consequence, our substantial overweight position in the corporate sector is unaltered.

The B of A Merrill Lynch High Yield Index spread over U.S. Treasuries is currently about 4%, significant in absolute terms but near historic lows. Meanwhile, the Securities Industry & Financial Markets Association (SIFMA) advises that, not surprisingly, U.S. corporations are taking advantage of these low rates and have issued a record US$197.4 billion in high-yield debt year-to-date. This has the potential to end badly, we do not like the risk/reward relationship and have no position in the high yield segment.

4. Canadian/Foreign Currency Exposure

The increasingly accommodative monetary stance of the ECB and euro weakness has, of course, been reflected in relative strength of both the U.S. dollar and Canadian dollar versus the euro, which will likely be sustained. Meanwhile, we do not envision an increase in commodity prices that would lift the Loonie versus the greenback nor is it likely that the Bank of Canada will increase short-term interest rates prior to action on the part of the Fed. At the same time, Canada's trade and current account numbers have shown significant improvement and should provide support for the currency. The net result is that the Loonie seems fairly valued and our neutral stance is maintained.

TD Wealth Asset Allocation Committee:

The TD Wealth Asset Allocation Committee was established to fulfill a vital role in delivering a consistent asset allocation message across TD Wealth. The committee is the originating source for active asset allocation advice and guidance across TD Wealth. In fulfilling this role, 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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