Market Outlook

Investment Strategy Quarterly

Q2 2014

Emerging Markets in the Spotlight

The fourth quarter of 2013 was marked by crises averted, fears unrealized and financial markets that chose to view the world as a glass half full.

Starting in October, the quarter began with a month dominated by the U.S. federal budget debate, government shutdown and the need to increase the federal debt ceiling. With the U.S. Government fiscal year beginning on October 1, the Republican-dominated House of Representatives wanted to pass a 2014 budget bill that would defer the implementation of the Patient Protection and Affordable Care Act, better known as Obamacare. However, the Democrat-led Senate would not acquiesce, resulting in an impasse. Without approved funding, much of the U.S. government shut down from October 1-16, the first such closure in 17 years, costing US$24 billion, as estimated by Standard & Poor's. A compromise was finally reached on October 16, and a major crisis was averted, extending government funding and the debt ceiling. A relief rally ensued and both the S&P/TSX Composite Index (S&P/TSX) and S&P 500 Index (S&P 500) recorded broad-based 4.5% gains for the month (chart 1).

In November, we witnessed a stark illustration of the differences between the Canadian and American economies and financial markets. Partly in response to the interim nuclear pact reached with Iran and partly due to a firm U.S. dollar, gold and oil fell 5.4% and 3.7%, respectively, as their political risk premiums decreased. As a result, the Canadian materials, metals and mining, and global gold sub sectors recorded sharp losses, offset by strength in the financials, industrials and telecommunications sectors, finishing the month with an overall gain of 0.3%.

In marked contrast, the U.S. equity market, with its limited exposure to commodities, was driven by Q3/13 earnings, which featured average top-line growth of 3.9%, a better figure than that exhibited in prior quarters, plus solid earnings growth of 4.5%. The advance also exhibited a wide breadth, with 68% of S&P 500 companies exceeding consensus earnings expectations and nine of ten sectors experiencing growth. Investors responded positively to these results, sending the S&P 500 2.8% higher for the month of November, notably better than its Canadian counterpart.

In December, the anticipation of the U.S. Federal Reserve's (Fed) meeting dominated the month as investors waited for news regarding the potential reduction or "tapering" of the Quantitative Easing (QE) program. On December 18, when Fed Chairman Ben Bernanke announced that monthly bond purchases would be reduced in January by US$10 billion to US$75 billion (US$40 billion in long-term Treasuries and US$35 billion in mortgage-backed securities) the worst fears were not realized and stocks rose sharply, with investors taking the view that the Fed's move signaled confidence in the strength of the U.S. economic recovery. This view was reinforced by Q3/13's revised 4.1% GDP growth and Q4/13's solid 2.4% growth, the deceleration reflecting reduced inventory accumulation. The net result was a broadly-based equity rally, with the S&P 500 advancing 2.4% and the S&P/TSX gaining 1.7%.

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 and are maintaining our substantial underweight in bonds.
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 have removed our underweight, adopting a neutral position.

Emerging & Developed Economies' Tenuous Link

From the depths of the credit crisis and market meltdown of 2008/2009 to the present, one of the recurring themes in financial markets has been the clash between positive corporate fundamentals and worrisome macroeconomic issues. The macro concerns have varied from the size of the U.S. debt and deficit to sovereign debt in Europe to QE, and its impact on the Fed's

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balance sheet and long-term implications. Each of these cases has been played out in the court of the financial markets and to date, the positive fundamentals have prevailed. In Q1/14, emerging markets' problems were the dominant macro headwind, reprising their role from the late spring and summer of 2013.

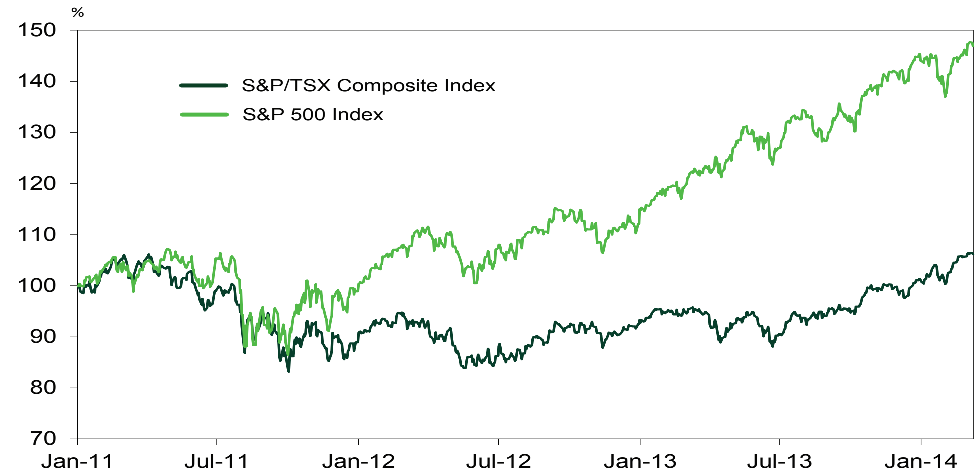
In May 2013, when Bernanke intimated in Congressional testimony that the improving pace of U.S. economic recovery could allow for less accommodative monetary policy, speculation that QE would be tapered caused the 10-Year Treasury yield to rise sharply from 1.65% on May 1 to 2.90% by Labour Day. This spike in U.S rates caused many investors, who had sought out higher yielding emerging market debt in recent years, to repatriate their funds to the U.S., which offered more competitive yields plus better credit quality.

For many emerging markets, especially countries such as Brazil and India, which had funded substantial current account deficits with foreign capital at a relatively low cost, the sudden funds outflow caused acute problems. Specifically, as their locally-denominated bonds were sold, the currencies came under pressure, which had to be supported via higher interest rates. Brazil, for example, has raised its short-term benchmark rate by 325 basis points (bps) since last spring, and India by 75 bps from 7.25% to 8.0%. This monetary tightening, aimed to support the currencies and rein in the current account deficits, had a predictably negative impact on emerging equity markets (table 1), which performed very poorly relative to developed markets during the May-December 2013 period.

The China Effect

On January 22, 2014, China's Manufacturing Purchasing Managers Index (PMI) fell from December's 50.5 reading to 49.6. This seemingly modest decline held significance because 50 is the demarcation line between expansion and contraction. Thus, the sub-50 report implied slower Chinese growth, which in turn, meant fewer exports of raw materials from developing countries to China, a very important market. As in 2013, the impact on emerging markets was immediate and negative. Downward pressure on currencies, higher interest rates and falling stock markets resulted in the MSCI Emerging Markets Index dropping 6.6% in January.

Chart 1: S&P/TSX Composite Index and S&P 500 Index Price History



Source: Bloomberg Finance L.P. Data from January 1, 2011 to March 11, 2014. Local currency returns.

Russia's Ukrainian Incursion

In late February, in response to regime change in Ukraine, Russian personnel entered Crimea, a Ukrainian province that is the site of Russia's Black Sea naval base and a large Russian ethnic population. Both the Russian ruble and stock market fell sharply in response (chart 2), with the currency hitting a record low on fear that Russia's economy, with tepid growth of 1.3% in 2013 and current inflation of 6.2%, could deteriorate further. Meanwhile, the Russian stock market, which was already selling at a low P/E multiple, caused by a political risk discount reflecting the regime's limited respect for property rights, fell 7% in the first week of March as investors feared further deterioration and capital flight.

Developed Markets' Focus on Fundamentals

While emerging markets captured the headlines in Q1/14, investors in Canadian and U.S. equities remained focused on what were generally positive fundamentals. S&P 500 Q4/13 results exceeded expectations with 71% of companies beating consensus earnings estimates, and 62% beating sales forecasts, resulting in the second successive quarter of strong revenue growth. The economic backdrop also remained favourable, with Q4/13 Canadian and U.S. GDP growth of 2.9% and 2.4%, respectively, and growth prospects of 2.4% and 2.7%, respectively in 2014.

The net result was that in January and February, while the MSCI Emerging Market Index fell 3.6%, the S&P 500 and S&P/TSX notched gains, notwithstanding the adverse market impact of the Chinese PMI data in January. Over the two months, the S&P 500 managed a modest advance of 0.8% while the S&P/TSX rose 4.3%, its outperformance driven by more positive sentiment toward the materials, mining and gold sub sectors.

The sharp divergence in performance between developed and emerging markets over the past year serves as a reminder that while emerging markets have grown rapidly and account for a sizeable portion of global GDP, they remain fragile and subject to pullbacks should credit conditions or growth prospects deteriorate. They are volatile as a result and in our view, typically best invested in indirectly via multinationals with strong emerging market exposure.

Table 1: Index Returns

Index	Total Return
S&P 500 Index	24.90%
MSCI EAFE Daily Net Index	17.20%
S&P/TSX Composite Index	12.88%
MSCI Emerging Markets Daily Net Index	3.67%

Source: Bloomberg Finance L.P. Returns in Canadian dollars from May 1, 2013 to December 31, 2013.

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Market Outlook

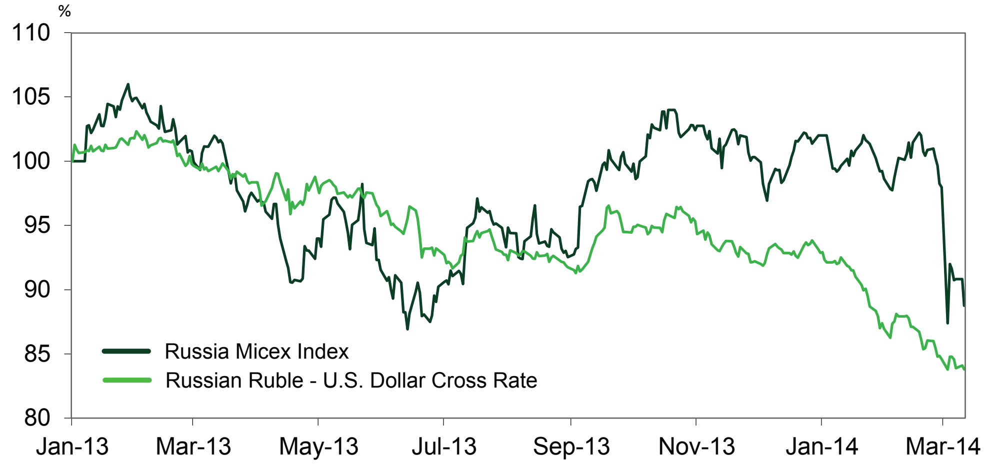
1. Equity/Fixed Income Split

March 6 and 9 of this year marked the five-year anniversaries of the S&P 500 and S&P/TSX lows of the 2008-2009 bear market. From their respective lows of 667 and 7,479, both markets have risen sharply, sparking much discussion about the formation of a stock market bubble. We do not think this is the case and continue to favour stocks over bonds for the following reasons:

- While some sub-groups, such as social media and biotech are trading at elevated valuations, equities in general are reasonably valued in our view. The S&P 500 is trading around 16 times our conservative US$116 estimate of 2014 earnings while the S&P/TSX multiple of current earnings approximates 15.5. Admittedly, both multiples have expanded over the past year but remain in line with historical averages. Meanwhile, equity valuations relative to fixed income are very good, with both indices displaying earnings yields over double their respective 10-year federal bond yields.
- The economic backdrop is supportive, with forecast GDP growth of 2.7% and 2.4% in 2014 for the U.S. and Canada, respectively. Overseas, Europe should generate growth of 1% or so, its first since the credit crisis while China avoids the much-feared hard landing, with growth in the 7% range.
- Monetary policy remains accommodative, despite the tapering of QE. Short-term interest rates will likely be unchanged and very low throughout 2014. Additionally, the yield curve remains steep, typically positive for equities.

In light of the above, we continue to overweight stocks and underweight bonds. Our emphasis on the less economically-sensitive stocks has worked to date (table 2) and should again prove effective in the coming year. Our thesis remains that we are in a period characterized by modest economic growth and low interest rates.

Chart 2: Russia's Micex Index and Ruble - U.S. Dollar Cross Rate Price History



Source: Bloomberg Finance L.P. Data from January 1, 2013 to March 11, 2014.

Therefore, we have and continue to favour high quality stocks with a history and prospects of increasing dividends. These issues should continue to provide substantial, growing, tax-efficient income and solid total returns in concert with well-controlled risk. In contrast, bonds are expected to generate only modest income and total returns that are not likely to improve substantially in the months ahead.

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

Our long-standing overweight stance in equities has been principally in the U.S. with a lower international overweight and neutral Canadian position. We believe this should now change and that Canadian and U.S. equity positions should now be equally overweight, with this shift funded by a modest trimming of U.S. and international equity weights. Our reasons for this change are as follows:

- Much of the S&P 500's recent outperformance of the S&P/TSX was a function of the S&P 500's expanding P/E multiple, especially in 2013. Further expansion of the S&P 500 multiple is possible if we see a flight to U.S. assets from less stable countries but may not transpire as the multiple has now risen to its historical average, and less accommodative monetary policy could be a headwind to multiple expansion. More likely, the S&P 500 will advance in line with mid-single digit earnings growth, which, together with dividends, should generate an upper-single digit return, in line with the S&P/TSX.
- The decline of the Canadian dollar from parity with the U.S. dollar to 90 cents, will improve the competitiveness, revenue, operating margins and earnings of many Canadian firms, boosting S&P/TSX performance relative to the S&P 500.

Table 2: S&P/TSX Composite Index Group Returns

Sector Index	Price Return	
	% Change	% CAGR
S&P/TSX Health Care Index	218.92	47.20
S&P/TSX Industrials Index	55.06	15.74
S&P/TSX Consumer Staples Index	53.12	15.26
S&P/TSX Telecommunications Index	36.83	11.02
S&P/TSX Consumer Discretionary Index	35.94	10.78
S&P/TSX Financials Index	25.43	7.85
S&P/TSX Composite Index	**1.33**	**0.44**
S&P/TSX Energy Index	-7.12	-2.43
S&P/TSX Utilities Index	-7.95	-2.72
S&P/TSX Information Technology Index	-37.46	-14.49
S&P/TSX Materials Index	-49.48	-20.36

Source: Bloomberg Finance L.P. Returns are from January 1, 2011 to December 31, 2013.
CAGR: Compound Annual Growth Rate

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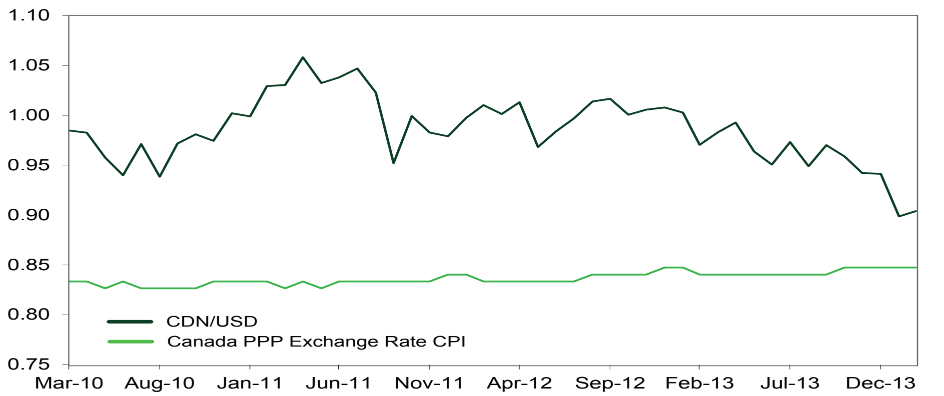
Chart 3: CDN/USD Cross Rate vs. Purchasing Power Parity (PPP) Exchange Rate



Source: Bloomberg Finance L.P. Data from March 31, 2010 to March 11, 2014.

- Over the past three years, the S&P 500 has outperformed the S&P/TSX by a cumulative 4,900+ bps, opening up a modest valuation gap between the two markets, which suggests improved relative performance on the part of the S&P/TSX.
- The Canadian energy sector, which has performed poorly in recent years, should do better due to four factors: improved pricing for Canadian heavy oil and natural gas, a lower Canadian dollar, firming oil demand reflecting synchronous global growth and a tightening American supply/demand balance for crude, according to the U.S. Energy Information Administration. A firmer energy sector should improve the relative performance of the S&P/TSX.

In February 2012, we established a tactical overweight position in emerging markets, which proved beneficial until its elimination in April 2013, due to our perception of their impending difficulties.

Overall, we now have overweight positions in the U.S. and Canada, a neutral stance among major international markets and no position in emerging markets.

3. Corporate/Government Bond Split

We are maintaining our substantial overweight in investment grade corporate bonds as they continue to offer worthwhile incremental yield versus government issues and present less interest-rate risk by virtue of their shorter duration.

A willingness to trade the above-mentioned interest-rate risk for credit risk has pushed high yield bond spreads to very low levels, which we find inadequate for the risk entailed. As such, we are keeping our underweight in place.

4. Canadian/Foreign Currency Exposure

After its decline from parity versus the U.S. dollar to the 90 cent level, the Loonie is trading around its purchasing power parity (chart 3). While currencies often overshoot fair value and negative sentiment abetted by soft economic stats could push the Canadian dollar lower, we believe it is fairly valued at its current level and have removed our underweight, and adopted a neutral position.

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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Vice Chair, Equities,
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Geoff Wilson, CFA, Managing Director,
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