TD Waterhouse

Market Outlook

Investment Strategy Quarterly

Autumn 2012

Central Bankers Rule

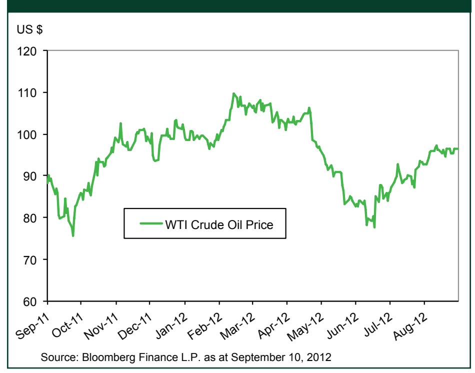
One of the key characteristics of financial markets' recovery since their depths in early 2009 has been the extent to which that resurgence has been a consequence of central bank initiatives. This has never been more clearly the case than in 2012 to date.

The first quarter of 2012 saw a continuation of the strong rally that began in Q4 of 2011, as fears of a U.S. double-dip recession eased, along with concerns surrounding European sovereign debt. A pivotal reason for stocks' Q1 advance was, as mentioned in our last issue, European Central Bank (ECB) action.

To recap, on December 8, 2011, the ECB announced a program of 36-month, 1% loans to European banks. They did so to help restore liquidity of the banks, which were having a difficult time raising longer-term deposits to fund their loans. This initiative significantly eased liquidity concerns and attendant fears of European bank failures. The ensuing Q1 rally saw the S&P 500 Index (S&P 500) and S&P/TSX Composite Index (S&P/TSX) advance 12.0% and 3.7%, respectively, propelled by their Financial sectors. Reduced fear of bank failures in Europe and their potential impact on North American banks caused U.S. and Canadian Financial sub-indices to rise 26.4% and 10.2%, respectively in Q1.

In Q2, hope gave way to worry about renewed economic weakness, evidenced by continued soft Purchasing Managers Index (PMI) data in China and weak employment numbers in the U.S. At the same time, intensifying economic pressure on southern Europe, exemplified by difficulties in the Spanish economy and banking sector in particular, caused Spanish and Italian 10-year bond yields to spike. These concerns were manifested in the price of economically-sensitive crude oil, which dropped sharply from over US$105/barrel in March to US$80/barrel by late June (see Chart 1). Not surprisingly, equity markets went into reverse in Q2, with the S&P/TSX falling 6.4%, led by the Energy, Materials and Metals & Mining sectors, while the S&P 500 slipped 3.3%. In both markets, financial stocks gave up much of their Q1 gains.

Chart 1 - Price of Crude Oil



Leaning on Monetary Policy

As stated above, central banks' monetary policies have played a major role in boosting equity markets and other "risk" assets during the recovery of recent years. This is illustrated in Chart 2, which is well worth studying.

In the Fall of 2008, the U.S. Federal Reserve (the Fed) announced it would begin buying US$500 billion in mortgage-backed securities (MBS) which would serve to both lower long-term interest rates and inject liquidity into the financial system, which had been in the throes of a credit squeeze since the demise of Lehman Brothers in September of that year.

Continued on page 2

Market Outlook Summary Table

Area of Focus	Investment Question	Recommendation
Equity/Fixed Income Split	Are stocks or bonds more attractive?	We continue to prefer stocks over bonds. Emphasize high quality dividend paying stocks.
Canadian/U.S./ International Equity Split	Are Canadian, U.S. or International stocks most attractive?	We are maintaining a neutral position across the developed geographic regions and an overweight stance for emerging markets.
Corporate/ Government Bond Split	Are investment grade Canadian corporate bonds or government issues more attractive?	Corporates continue to provide a worthwhile pickup in yield, therefore we recommend corporate bonds over government bonds.
Canadian/ Foreign Currency Exposure	Will foreign currency exposure add or detract from total returns for Canadian investors?	The Canadian dollar is expected to trade within a narrow range around par vs. the U.S. dollar.

Continued from page 1

The program, initially termed Quantitative Easing (QE) and later QE1, was expanded in March 2009 by another US$750 billion and extended until April 2010.

The left-hand graph in Chart 2 illustrates the advance of the S&P 500 over the course of QE1 and the table below records the apparent impact on risk assets. While correlation is not cause-and-effect, the 32.5% rise in the S&P 500 over the period, accompanied by strong advances in the Commodity Research Bureau (CRB) Index, gold and the commodity-sensitive Australian dollar strongly (AUD) suggest QE1 had a significant impact. At the same time, the perceived risk in credit markets diminished, reflected in the 152.7 basis point drop in the CDS North American Investment Grade Credit Default Swap Index (CDX IG). Lastly, U.S. Treasury yields rose, prices fell and, not surprisingly, the U.S. Dollar Index (DXY) declined as well.

After the US$1.25 trillion QE1 program, Fed Chairman Bernanke presaged QE2 in his now-famous August 27, 2010 speech at Jackson Hole, Wyoming. QE2, like QE1, consisted of MBS purchases, totalling US$600 billion and completed in monthly instalments between late 2010 and April 2011. As the middle graph of Chart 2 and the supporting table indicate, QE2 had a similar, though more modest, salutary impact on risk assets and credit markets as did QE1.

Operation Twist, cited in Chart 2's table, was initiated in September 2011 and unlike QE1 and QE2, did not involve the Fed printing money and expanding its balance sheet to purchase long-term securities. Instead, the Fed sold short-term U.S. Treasuries and bought long-term bonds to keep their yields and, in turn, 30-year mortgage rates as low as possible. As the right-hand graph and table in Chart 2 illustrate, stocks advanced and the CDX IG fell during this period. Of note, the DXY rose during Operation Twist, in contrast with the prior periods of monetary easing. To a great extent, this U.S. dollar (USD) strength was the mirror image of euro weakness and as the USD rose, gold and other commodities, denominated in greenbacks, fell concomitantly.

Overlapping most of Operation Twist was the ECB action announced in December 2011, described above and termed Long Term Refinancing Operations or LTRO's on the bottom line of Chart 2's table. Here again, equities advanced and credit concerns ebbed in response.

Leading up to Q3, the strong impact of monetary policy on financial market performance was clear, though a trend of diminishing returns was also evident.

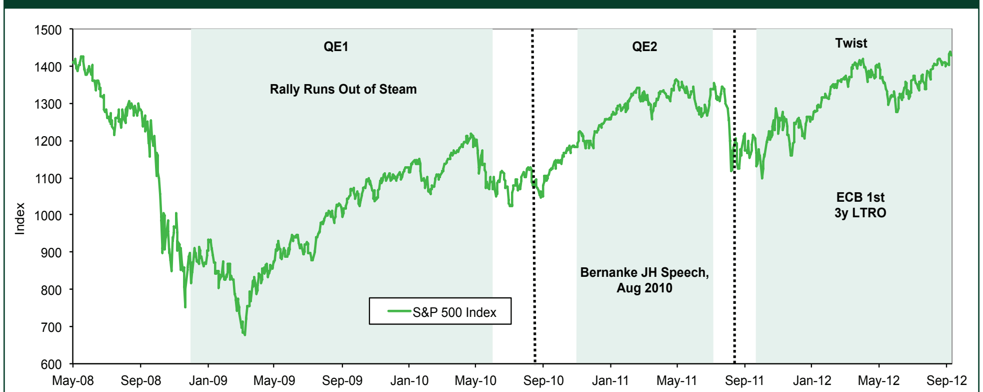
Q3 Stimulus

As documented above, Q3 opened on the heels of Q2's reversal, which reflected both soft U.S. economic data, especially employment, and Europe's renewed sovereign debt issues. Relief for equity markets came, as has been the case so often in this recovery, from sound fundamentals, as Q2 earnings were solid, if unspectacular. Specifically, 68% of S&P 500 companies beat Q2 earnings estimates though only 40% exceeded revenue forecasts, reinforcing economic concerns.

On July 17, in his semi-annual testimony to Congress, Fed Chairman Bernanke described job growth as "frustratingly slow", giving rise to speculation about QE3. Subsequently, on July 26, ECB President Mario Draghi stated that "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro", which was widely interpreted as a precursor to more monetary stimulus. Sure enough, after Labour Day, the ECB announced its Outright Monetary Transactions (OMT) program to purchase, without limit, bonds with a term of up to three years from embattled European governments, helping to reduce their funding costs and preserve the euro. The market response was immediate and dramatic, with equities, gold and the euro all rallying in response to this latest monetary stimulus, while the 10-year U.S. Treasury and Government of Canada (GOC) bonds fell and their yields rose from recent lows.

No less dramatic was the response, one week later on September 13, to the Federal Open Market Committee (FOMC) announcement of more monetary easing.

Chart 2 - Central Bank Liquidity Has Powerful Effect On Risk Assets



Source: Reuters EcoWin, Citi Research and Bloomberg Finance L.P. as at September 10 2012

Starting Period	From	To	SPX	CDX IG Index (bps)	CRB	Gold	UST 10y	10s30's	DXY	AUD
QE1 Announcement	11-30-2008	4-5-2010	32.5%	-152.7%	40.4%	38.5%	1.06	0.33	-6.3%	40.7%
Jackson Hole (JH)	8-27-2010	4-11-2011	24.4%	-23.4%	27.4%	18.3%	0.94	0.03	-9.5%	16.8%
Twist Announcement	9-21-2011	3-19-2012	20.8%	-44.8%	-4.0%	-6.7%	0.52	-0.04	3.2%	5.7%
LTRO Announcement	12-8-2011	3-19-2012	14.2%	-36.9%	3.9%	-2.7%	0.40	0.08	1.2%	4.4%

Source: Reuters EcoWin, Citi Research and Bloomberg Finance L.P. as at September 10 2012

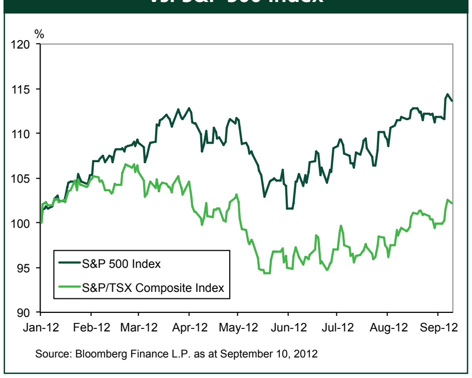
Continued from page 2

The Fed's latest, highly-anticipated initiative, had three key elements. First, the period in which the Fed Funds rate would be kept in its current 0-0.25% range, was extended from late 2014 until mid-2015. Second, QE3 was announced, with monthly, US$40 billion purchases of long-term MBS and U.S. Treasuries to inject further liquidity into the system. Third and in contrast to QE1 and 2, QE3 was open-ended, tying continuation of monthly bond purchases to the unemployment rate, a departure from past Fed practice.

Markets responded instantly to the FOMC announcement and risk assets rallied hard across the board. Stocks, gold and the CRB rose as did the euro, while the USD fell and bond yields edged higher. Asian and European equity markets followed suit.

Once again, monetary stimulus, either anticipated or announced, proved a catalyst for equity markets, which staged a solid Q3 advance by early September (see Chart 3).

Chart 3 - S&P/TSX Composite Index vs. S&P 500 Index



China's Fiscal Response

As outlined in the last issue, China has also engaged in monetary easing this year, reducing its one-year lending rate by 25 basis points in June to 6.31%, the first such cut since 2008. China also sliced its Reserve Requirement Ratio (RRR) three times to 20%, from last November through May. These cuts have been enabled by falling inflation, with the Consumer Price Index (CPI) slipping to 2.0% by August while the Producer Price Index (PPI) recorded a drop of 3.5% in the year ending August 31, the sixth straight monthly decline.

Central Bank intervention notwithstanding, Chinese economic data have been weakening, with August Industrial Output growth of 8.9% representing the slowest such growth since May 2009. Similarly, the August Manufacturing PMI fell below 50 for the first time since November 2011. In response to this persistent weakness, China, with much more fiscal latitude than other major economies, announced a US$157 billion infrastructure program in early September, encompassing 60 rail, highway, port and airport projects. This announcement, which sparked a rebound in the long-depressed Shanghai Composite Index, with ripple effects in world markets, served as a reminder of China's balance sheet strength and as a rare example of fiscal response in a world dominated by monetary intervention.

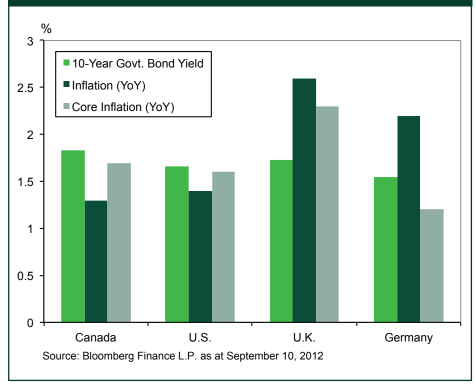
Market Outlook

1. Equity/Fixed Income Split

Our thesis, outlined in numerous past editions, is that we are and will be in a period of relatively low economic growth, interest rates that will be lower for longer than history would suggest and below-average investment returns. Government bonds, driven by both a flight to safety and accommodative monetary policies, are expensive. Chart 4 serves as a reminder that government bond yields are below inflation in major western economies, a far cry from the positive real yields demanded by investors over time. While central authorities will strive to maintain low short and longer-term interest rates to foster economic growth, bond yields may ultimately rise. We expect bond returns to be in the 0-2% range in coming years.

Equities, we feel, offer better value, whether viewed in absolute or relative terms. The S&P/TSX and S&P 500 are trading at around 13X and 13.8X 2012 estimated earnings, respectively, offering below-average valuations. Meanwhile, both indices' earnings yields approximate 7% and compare favourably with GOC and U.S. Treasury 10-year yields of 1.85% and 1.66% at the time of writing.

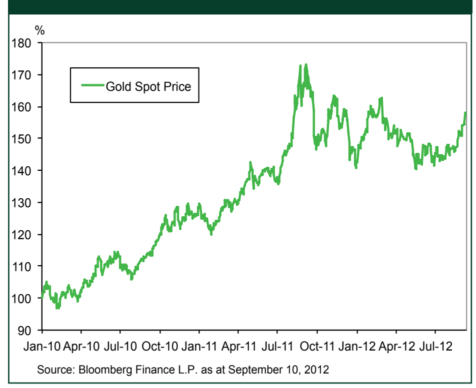
Chart 4 - 10-Year Government Bond Yields vs. Inflation



Our tactical position in gold, introduced in early 2010 remains in place. The correction in gold, which saw the price fall from over US$1,900/oz. in the Summer of 2011 to less than US$1,600/oz. recently, was largely a function of the decline in the euro to the $1.20 USD level and the concurrent rise in the greenback, which depressed the price of USD-denominated commodities, including gold.

With the euro recovering and a host of stimulative monetary policies being introduced, bullion has rebounded (see Chart 5) to over US$1,700/oz. and we are maintaining our position as a hedge against extreme outcomes.

Chart 5 - Gold Spot Price Performance



Overall, we continue to favour stocks over bonds, and have an overweight position in the former and significant underweight in the latter.

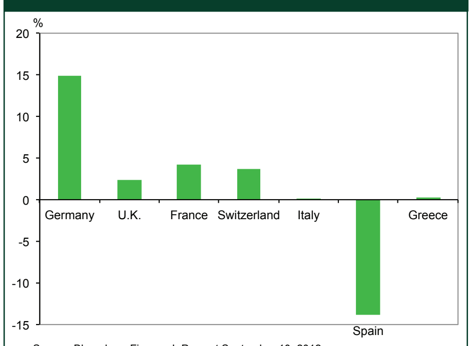
Continued from page 3

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

The S&P 500 has continued its out-performance of the S&P/TSX in 2012 to date, consistent with the performance gap evidenced in 2011. The Canadian index's underwhelming performance has largely been a function of weakness in the resource sectors due to softness in commodity prices. Fortunately, we have been advocates of the dividend growth stocks, the majority of which are in the more defensive sectors of the Canadian market and which have sharply outperformed the broad index. As stimulative policies breathe life into commodity prices (see Charts 1 and 5), the near-term relative performance of the resource stocks should improve though we prefer dividend growth stocks longer term.

Within the major international markets, we continue focusing on the northern European large caps that are in more defensive industries, have global reach and significant, rising dividends. This has proven beneficial as the bifurcation between northern and southern Europe has been very pronounced (see Chart 6).

Chart 6 - Equities - YTD Return In CAD



Source: Bloomberg Finance L.P. as at September 10, 2012

Emerging markets, in which we have an overweight position, have been disappointing but should be beneficiaries of the expansive monetary policies cited above. Valuations remain attractive, economic growth is relatively strong and we expect outperformance in the year ahead.

In sum, we are maintaining our neutral stance across the Canadian, U.S. and major international markets with an overweight in emerging markets.

3. Corporate/Government Bond Split

Corporate bonds continue to be overweight due to their incremental yield and shorter duration versus government issues, providing greater income and reduced interest rate risk as a result.

High yield bond issuers are still exhibiting balance sheet improvement plus below-average default rates and wide spreads versus both government and investment grade corporate debt. High yield debt has demonstrated solid total returns since we adopted an overweight position in Fall 2011 and we are maintaining our position, as it remains attractive for risk-tolerant investors.

4. Canadian/Foreign Currency Exposure

Our stance has been that the Canadian dollar (CAD) would exhibit a trading range around par versus the greenback, a position that would dictate a neutral posture for the CAD vis-à-vis foreign currencies. The loonie has, in fact, traded between $0.98 and $1.02 in recent months, reflecting movement in the price of oil and fluctuations in the USD. Our view remains unchanged and our neutral position stands.

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 Management. The Committee is the originating source for active asset allocation advice and guidance across TD Wealth Management. 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.

Wealth Asset Allocation Committee Members:

Co-Chair: **R.B. Kenneth Miner**, CFA,
Vice Chair, Fixed Income,
TD Asset Management

Co-Chair: **Bruce Cooper**, CFA,
Vice Chair, Equities,
TD Asset Management

Bob Gorman, MBA, CFA,
Vice President, TD Waterhouse

Geoff Wilson, CFA, Managing Director,
TD Asset Management

Les Grober, MA, CFA, Managing Director,
TD Asset Management

Anish Chopra, CA, CFA,
Managing Director, TD Asset Management

Glenn Davis, CFA, Managing Director,
TDAM USA

Richard Vandale, MBA, CFA,
Managing Director, TDAM USA