TD Wealth

Market Outlook

Investment Strategy Quarterly

Q3 2016

TD Wealth Asset Allocation Committee Overview

- High debt levels and demographic trends imply a persistent low growth environment.
- Overall, we expect an environment of muted returns - low single digits for fixed income and low to mid-single digits for equities - accompanied by episodes of volatility across asset classes.
- High debt levels, tepid earnings growth, full valuations, emerging market and political risks are all potential sources of volatility.
- Ongoing implementation of unprecedented policies, including negative interest rates and the potential for helicopter money, creates a wide range of possible economic and market outcomes.
- Cash, domestic government bonds and gold may provide insurance against the risk of extreme outcomes.

It's no secret that central banks dropped key lending and deposit rates to emergency levels as they attempted to stimulate economic growth and inflation following the financial crisis and associated recession. But with growth and inflation remaining stubbornly low, onlookers began to wonder, "How low can they go?" The somewhat surprising answer was, "Lower than zero." The European Central Bank, three European countries outside the euro zone and, most recently, the Bank of Japan all instituted negative rates as the efficacy of low rates and asset purchase programs appeared to be waning. Currently, approximately one-third of global government bonds have negative yields.[1] This has led investors to begin asking if negative rates will also be adopted by North American central banks. While the TD Wealth Asset Allocation Committee (WAAC, we) believes rates will remain low for a prolonged period of time, we do not believe that they are likely to turn negative in North America.

North American growth is lethargic, but it is positive. In Canada, annualized GDP growth was 2.4%[2] in the first quarter in spite of weak business investment, as household consumption remained supportive. Employment continues to expand, and both core and total inflation are within the Bank of Canada's target range of 1-3%. In addition, the new federal government has committed to providing significant fiscal stimulus, which should promote growth. Given this backdrop, we believe it is unlikely that the Bank of Canada will need to adopt unorthodox policies, such as quantitative easing, negative rates or, as we discuss later, unfunded fiscal stimulus (colloquially known as "helicopter money").

In the U.S., first quarter annualized GDP was 1.1%[3], which is slow from a historical perspective, but still positive. Although the June non-farm payrolls number was very

Chart 1: S&P/Case-Shiller U.S. National Home Price Index March 2008 - March 2016

Source: Bloomberg Finance L.P. As at June 7, 2016 weak, the broad employment backdrop is solid, with improving weekly jobless claims, hourly wages and hours worked helping to increase take-home pay. This more stable employment landscape is being reflected in housing market strength, with house prices rising meaningfully from their lows and new home sales surpassing their pre-crisis level. It also bodes well for consumption, which is a major component of economic growth. As household debt burdens decline (consumers have been deleveraging significantly) and employment and wages increase, we expect consumption to continue to contribute to growth.

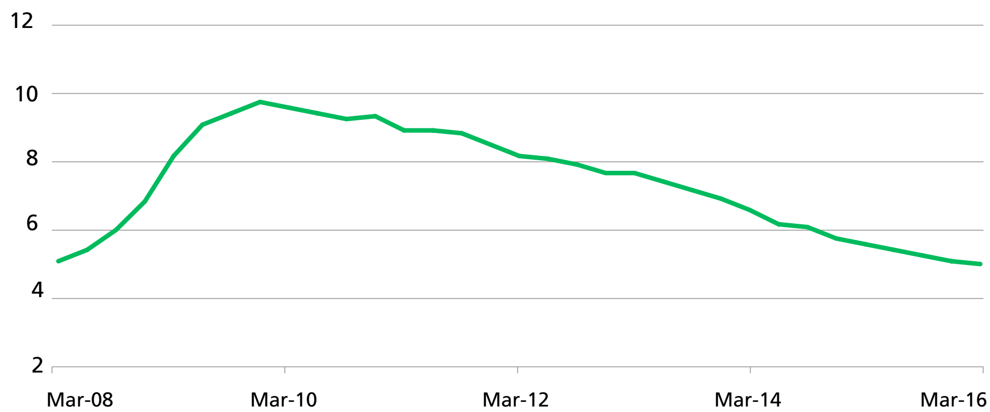
So while growth is slow, the economy is growing, jobs data is reasonable and consumption is set to pick up, all of which point to a stable economic backdrop, not an economic emergency — yet the U.S. Federal Reserve's (the Fed) federal funds rate is at an emergency level. However, given the recent shock of the UK's decision to leave the European Union, we would anticipate that the Fed will be on hold for some time. Overall, we expect the loosest tightening cycle in Fed history and a continuation of the lower for longer interest rate environment.

Unorthodox monetary policies

In spite of low (and negative) rates, global economic growth continues to languish as demographics, overcapacity and elevated debt levels all weigh on it. This prompted the International Monetary Fund (IMF) to downgrade its 2016 and 2017 growth forecasts in April. With these underlying conditions unlikely to change in the near term, we believe the low growth, low return environment will persist for some time to come.

To counter this, central banks are continuing to employ unorthodox measures (quantitative easing, zero interest rates and negative interest rates), as they attempt to spur growth and inflation. However, these measures may well have reached the point of diminishing returns, which has led to speculation about the potential implementation of even more exotic policies, such as helicopter money, which could stimulate demand and inflation.

Chart 2: U.S. Unemployment Rate (%) March 2008 - March 2016



Source: Bloomberg Finance L.P. As at June 7, 2016

Helicopter money would essentially combine fiscal and monetary policy: governments would provide fiscal stimulus (e.g. infrastructure spending, direct cash payments to citizens, tax cuts) that would be financed directly by the central bank. We believe Japan is the country most likely to seriously consider this method given it has been battling deflation for more than two decades. We believe it is less likely to be implemented in Europe or North America in the next 12-18 months. If Japan were to implement this type of policy, likely outcomes would include: higher Japanese yields, a lower yen, a higher U.S. dollar and higher gold prices.

Outlook

As mentioned above, toward the end of June the UK surprised onlookers by voting to leave the European Union. The unexpected decision caused a selloff in markets as volatility spiked. Because the UK's exit is unprecedented, it is unclear how it will unfold, and we believe that negotiating the terms of its departure will take years. In addition, Brexit may fuel support for populist parties in other European countries. Overall, we expect a lengthy period of uncertainty in the UK and Europe.

With uncertainty around events in Europe and future central bank policy decisions, we remain cautious and have adopted a more conservative position. During the quarter, we upgraded gold from modest overweight to maximum overweight as it can provide insurance against the risk of extreme outcomes. We also upgraded the U.S. dollar as higher relative yields, lower political risks and better economic growth make it more attractive than many of its global counterparts. In a related move, we downgraded the Canadian dollar as we believe it will underperform the strengthening U.S. dollar. We also downgraded international equities as the current risk/reward relationship is not compelling.

In the current environment, there is a broad range of potential outcomes, and we believe it is crucial to retain a long-term perspective and maximize diversification benefits within portfolios. As such, we maintain our preference for a diversified investment portfolio, including high quality North American dividend paying equities, government and investment grade corporate bonds, plus a modest allocation to cash and gold, where allowed by investment guidelines.

Equity/fixed income split

Neutral equities versus bonds

We are neutral equities versus bonds. We believe bonds will provide low single digit returns and equities will provide low to mid-single digit returns. While bond returns may be modest, they offer diversification, some income and can have an important stabilizing effect on portfolios. In terms of equities, we expect earnings growth

Please see final page for important disclosures.

to be tepid and with valuations already approaching or at fair value, we anticipate that equity returns will be moderate. Although equities are expected to provide slightly higher returns than bonds, we anticipate episodes of elevated volatility. We continue to prefer high quality dividend paying equities that offer a stable, gradually rising stream of income.

Geographic split

Prefer North American equities

We prefer North American equities over international and emerging market equities. In Europe, growing political uncertainty, ongoing sluggish growth and threats to the earnings outlook all heighten risk. Within the emerging markets, valuations are attractive, but high debt levels, slowing economic growth and weaker commodity prices pose risks.

Corporate/government bond split

- *Overweight cash*
- *Neutral government versus corporate bonds*
- *Underweight high yield*

We remain overweight cash, which should provide stability in times of increased volatility. Yields remain very low; however, government bonds can offer stability and diversification benefits, which should be helpful amid increasing volatility, and corporate bonds offer an incremental yield advantage. We remain underweight high yield bonds as we are concerned about select pockets of stress and believe that default rates may rise, particularly in the commodity space.

Canadian/foreign currency exposure

Underweight the Canadian dollar

Broadly we expect the Canadian dollar to remain low for an extended period and believe it will underperform the strengthening U.S. dollar.

Gold can be viewed as a currency alternative, and we believe an allocation to gold may provide insurance against the risk of extreme outcomes.

TD Wealth Asset Allocation Committee:

The TD Wealth Asset Allocation Committee was established to deliver a consistent asset allocation message and be the originating source for active asset allocation advice across TD Wealth. The committee has three prime objectives: articulate broad market themes, provide macro-level asset allocation and identify the major risks on the horizon.

Committee Members:

Chair: **Bruce Cooper**, CFA
Chief Investment Officer,
TD Asset Management Inc.
and SVP, TD Bank Group

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

Michael Craig, CFA
Vice President & Director,
TD Asset Management Inc.

Glenn Davis, CFA
Managing Director,
TDAM USA Inc.

Kevin Hebner, PHD
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[1]Source: Bloomberg L.P., May 31, 2016. [2]Source: Statistics Canada, May 31, 2016. [3]Source: Bureau of Economic Analysis, June 28, 2016. The information contained herein has been provided by TD Wealth and is for information purposes only. The information has been drawn from sources believed to be reliable. Where such statements are based in whole or in part on information provided by third parties, they are not guaranteed to be accurate or complete. Graphs and charts are used for illustrative purposes only and do not reflect future values or future performance of any investment. The information does not provide financial, legal, tax or investment advice. Particular investment, trading, or tax strategies should be evaluated relative to each individual's objectives and risk tolerance. TD Wealth, The Toronto-Dominion Bank and its affiliates and related entities are not liable for any errors or omissions in the information or for any loss or damage suffered. Certain statements in this document may contain forward-looking statements ("FLS") that are predictive in nature and may include words such as "expects", "anticipates", "intends", "believes", "estimates" and similar forward-looking expressions or negative versions thereof. FLS are based on current expectations and projections about future general economic, political and relevant market factors, such as interest and foreign exchange rates, equity and capital markets, the general business environment, assuming no changes to tax or other laws or government regulation or catastrophic events. Expectations and projections about future events are inherently subject to risks and uncertainties, which may be unforeseeable. Such expectations and projections may be incorrect in the future. FLS are not guarantees of future performance. Actual events could differ materially from those expressed or implied in any FLS. A number of important factors including those factors set out above can contribute to these digressions. You should avoid placing any reliance on FLS. The TD Wealth Asset Allocation Committee ("WAAC") is comprised of a diverse group of TD investment professionals. The WAAC's mandate is to issue quarterly market outlooks which provide its concise view of the upcoming market situation for the next six to eighteen months. The WAAC's guidance is not a guarantee of future results and actual market events may differ materially from those set out expressly or by implication in the WAAC's quarterly market outlook. The WAAC market outlook is not a substitute for investment advice. TD Wealth represents the products and services offered by TD Waterhouse Canada Inc. (Member – Canadian Investor Protection Fund), TD Waterhouse Private Investment Counsel Inc., TD Wealth Private Banking (offered by The Toronto-Dominion Bank) and TD Wealth Private Trust (offered by The Canada Trust Company). Epoch Investment Partners, Inc. is a wholly-owned subsidiary of The Toronto-Dominion Bank and an affiliate of TD Asset Management. TD Asset Management operates through TD Asset Management Inc. in Canada and through TDAM USA Inc. in the United States. Both are wholly-owned subsidiaries of The Toronto-Dominion Bank. The TD Bank Group means The Toronto-Dominion Bank and its affiliates, who provide deposit, investment, loan, securities, trust, insurance and other products or services. Bloomberg and Bloomberg.com are trademarks and service marks of Bloomberg Finance L.P., a Delaware limited partnership, or its subsidiaries. All rights reserved. All trademarks are the property of their respective owners. ® The TD logo and other trade-marks are the property of The Toronto-Dominion Bank.