TD Wealth

Market Perspectives

The Year Ahead 2019

TD Wealth Asset Allocation Committee (WAAC) Overview

- Overweight equities and underweight fixed income as equity valuations now discount global earnings slowdown
- Expect lower for longer interest rate environment to continue with central banks close to the end of their tightening cycle
- Corporate credit attractive versus government bonds as spreads have widened significantly
- We anticipate protracted conflict between China and the U.S. on issues of trade and technology leadership
- Episodes of volatility may be driven by trade frictions, potential for central bank missteps and slowing global growth

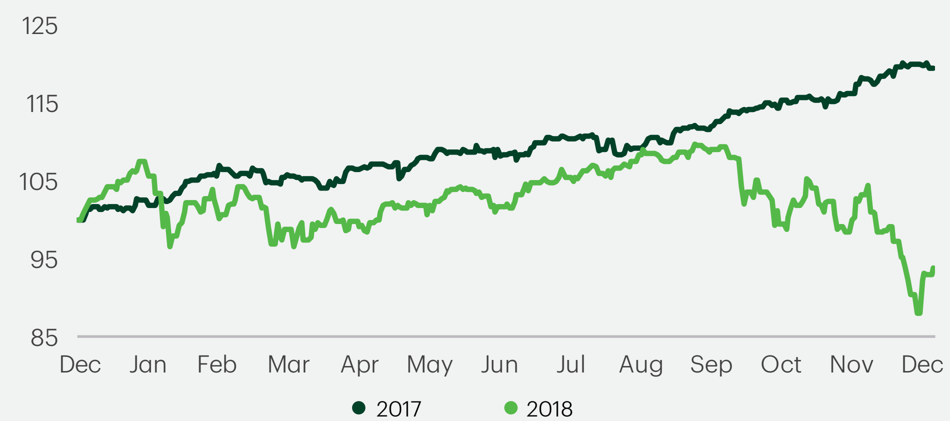
2018 – The year of peaks and valleys

What a difference a year makes. In 2017, a pick-up in global growth boosted corporate profits and commodities which led to a very strong year for equity markets. Naturally, 2018 began with enthusiasm for global stocks.

Positive economic data including strong earnings growth and improving employment numbers kept the momentum going early in the year, with many markets hitting new all-time highs. However, this was short lived. Worry over central banks' tightening monetary policy and rising bond yields led to a quick and sharp equity market correction globally. This was also short-lived as focus turned again to strong global growth fundamentals allowing stock prices to rise.

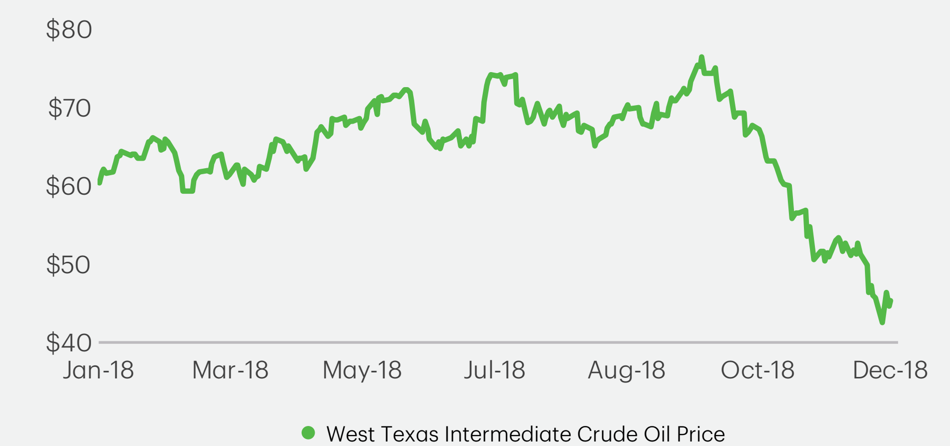
Volatility was back with a vengeance towards the end of the year, sparking an equity pullback that left most major global indices giving back their 2018 gains and leaving them in the red for the year. Renewed concern that the U.S. Federal Reserve (Fed) was raising rates too aggressively, signs of slowing global

S&P 500 Index — 2017 vs. 2018



Source: Bloomberg Finance L.P. Using 100 as a staring point. Data as of Dec. 31, 2018.

Oil prices slid dramatically



Source: Bloomberg Finance L.P. Data as of Dec. 31, 2018.

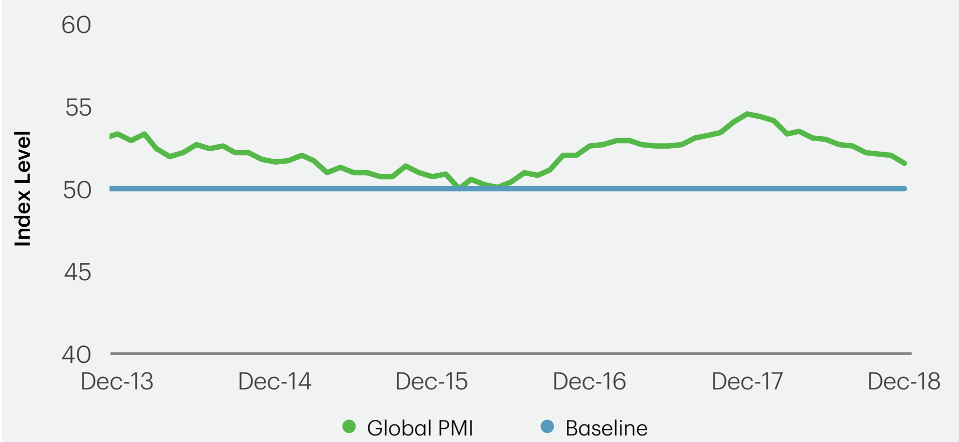
growth and persistent trade frictions, particularly between the U.S. and China, led the retreat in equity prices. Technology stocks were among the hardest hit, as were resource equities, caused by the drastic drop in oil prices. The impact on markets in 2018 can largely be summarized by three key factors:

The U.S. and everyone else — Overall, the U.S. economy continued to surge forward and demonstrated a divergence in growth versus the rest of the world. This strength was on the back of firm labour markets, fiscal stimulus and robust corporate health, all of which are supported by the lower for longer interest rate environment. This strength contrasted with the rest of the world, where growth appears to be slowing. The European economy, as indicated by Purchasing Managers Index (PMI) data, appeared to have shifted down a gear, and the data out of China was quite patchy, indicating growth in the world's second largest economy is not as strong as the official data would suggest.

Trump, tariffs and trade wars — Global trade was the main headline maker and one of the primary market influencers of 2018. The Trump administration continued to escalate the threat of a U.S. trade war with China after announcing the intent to impose a 10% tariff on $200 billion worth of Chinese goods, which could be increased to 25% in early 2019 if an agreement is not reached between the two countries by then. The additional tariffs, on top of tariffs passed earlier in the year, means roughly half of the products that China sells to the United States each year will be hit by U.S. tariffs. This in turn could begin to affect the U.S. consumer and impact equities over time.

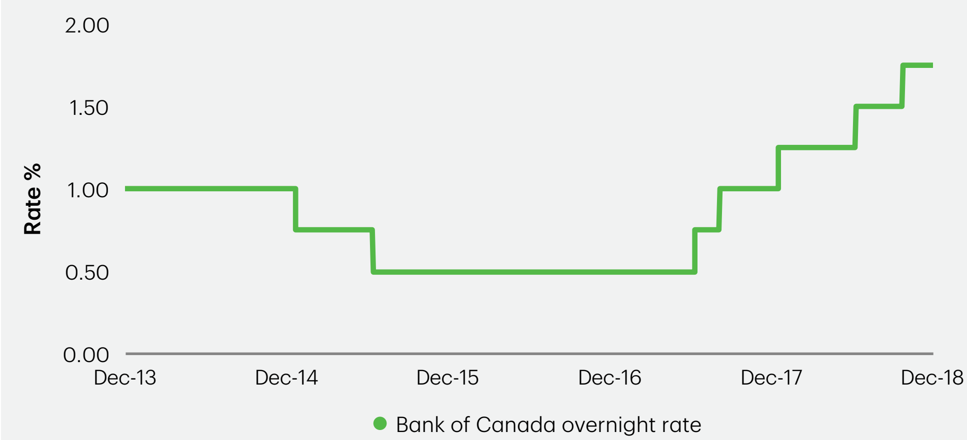
Removal of monetary stimulus — The tightening of monetary stimulus was another key market and headline influencer in 2018, particularly in North America, with the Fed raising the key short-term interest rate by a quarter point four times in 2018. In Canada, the Bank of Canada (BoC) also raised its overnight benchmark rate by a quarter point three times last year. In Europe, the European Central Bank (ECB) wrapped up its stimulus program at the end of the year, even as risks from trade protectionism, Italian populist policies, and Brexit loom ever larger.

Global PMIs still expanding, but beginning to slow



JPMorgan Global Manufacturing PMI; Baseline = 50
Source: Bloomberg Finance L.P., JP Morgan, Markit. Data as of Dec. 31, 2018

Bank of Canada steadily raising rates



Source: Bloomberg Finance L.P. Data as of Dec. 31, 2018.

Wealth Asset Allocation (WAAC) positioning

What does 2019 have in store?

Global growth has decelerated recently, with relatively soft numbers in Europe and China. There are also signs, like a slowing housing market, that indicate U.S. economic growth is decelerating. Structural factors, such as slow growth of the labour force in the U.S. and Europe and cyclical factors, such as full employment in the U.S. and fading fiscal stimulus, will likely combine to bring growth in the developed world to 1.5% - 2.5%. In China and the emerging world, growth in 2019 will depend in part on whether China implements aggressive fiscal stimulus to offset the drag from trade wars with the U.S.

We believe the lower for longer interest rate environment will continue. Central banks are likely close to the end of their tightening cycle as global growth has slowed and inflation expectations remain muted. In Canada, we continue to believe that the high level of household debt will slow the economy if interest rates move higher, which in turn, mean that significantly higher rates will not be required.

Earnings growth is likely to slow in 2019 as the impact of tax reform in the U.S. dissipates and slower global growth feeds through to slower revenue growth for companies. Higher interest rates also mean debt refinancing is now a headwind for corporate earnings as opposed to the tailwind it has been for the past 10 years. However, earnings growth is still likely to be positive and we would look for increases in the low to mid-single digits in Canada and the U.S.

In 2018, equities delivered negative returns as rising earnings were offset by declining valuations. By the end of the year, these valuations had become sufficiently attractive that in January, we upgraded our equities to overweight from neutral. We anticipate the combination of modest earnings growth, 2-3% dividend yields and stable valuations should deliver mid-to-high single digit returns in the next 12-18 months.

While upgrading equities in January, we downgraded fixed income to an underweight position. Fixed income provided stability to portfolios in a volatile equity environment in 2018 but yields and expected returns remain in the low single digits. In our view, the spread of expected returns between equities and fixed income justifies an overweight stance on equities at this time.

We will continue to monitor several risks heading into 2019. Persistent trade frictions between the U.S. and China, slowing global growth and central bank actions could all have implications for financial markets. Continued protectionist measures caused by escalating trade frictions could dampen economic growth and result in higher inflation, placing downward pressure on equity valuations. Additionally, there is always the risk that central banks will commit a policy error as they reduce their accommodation. Tightening monetary policy to more normal levels, while not adversely affecting economic growth or threatening financial stability is a delicate balancing act. Policy change that is too aggressive remains a possibility and could create volatility and a difficult environment for investors. These all remain key risks to global growth that we will continue to closely monitor.

Steady hands are paramount during periods of acute volatility as we focus on companies we believe to be at the high-end of the quality spectrum, particularly those that generate substantial free cash flow and return that cash to shareholders through rising dividends over time. We continue to believe a balanced approach is warranted and favour a diversified portfolio that includes:

1. High quality equities that may have the ability to increase their earnings and dividends in a low growth environment, thereby helping to protect the real value of investors' savings

2. An allocation to cash to help provide stability and safety of capital

3. An allocation to high quality corporate bonds, including both investment-grade and high yield, to help provide some income, diversification and stability

Equities

- Neutral Canadian equities
- Modest overweight U.S. equities
- Modest underweight international equities
- Modest overweight emerging market equities

We maintain a modest overweight in U.S. equities and neutral Canadian equities. With late 2018 equity market declines, U.S. equity valuations were brought down to more reasonable levels. However, with central banks tightening, we don't expect price-earnings multiples to expand and equity returns will be driven by earnings growth and dividend yields. North of the border, Canadian equities trade at a significant discount to U.S. equities. This may provide a long-term opportunity, but valuations are likely to remain depressed until the discount on Canadian oil prices narrows versus West Texas Intermediate oil (WTI).

We maintain a modest underweight in international equities. Valuations are attractive relative to those in North America, and any ongoing accommodation from the European Central Bank (ECB) should continue to support them. However, earnings growth is likely to be modest given weak economic growth and political risks remain high in Italy and the United Kingdom. We moved to a modest overweight position in Emerging Market (EM) equities. EM valuations are attractive after a significant under-performance in recent years.

Fixed Income

- Neutral cash and inflation-linked bonds
- Modest underweight domestic government bonds
- Modest overweight high yield bonds and investment-grade corporate bonds
- Maximum underweight global developed market bonds
- Modest underweight global emerging market bonds

Muted inflation and high household debt will keep rates low from a historical perspective. We moved to modest underweight domestic government bonds. At current levels, low single digit returns are expected, however domestic bonds can offer diversification, stability and modest income.

We moved to modest overweight investment grade bonds. Higher rates and slightly wider spreads mean that investment grade corporate bonds now provide real (after inflation) returns. We have a strong preference for the quality end of the spectrum, given signs of stress at companies with weak balance sheets. We also moved to modest overweight high yield bonds. Spreads widened in the second half of 2018 to attractive levels and there is now a greater opportunity to add value through security selection.

Break-even rates, the difference between nominal and inflation-linked bonds, have been gradually rising, but are still reasonable from a historical perspective. Thus, our neutral rating has been maintained for inflation-linked bonds. Within the global developed bond space, we are currently maximum underweight, as low nominal and real yields in Europe and Japan are not very compelling. We remain modest underweight in the global emerging market bond space. Emerging market debt has been hit by issues including rising interest rates, a stronger U.S. dollar, and the threat of a global trade war, and we feel that these factors will continue to weigh on these assets.

Canadian/U.S. currency exposure

- Modest underweight the Canadian dollar vs. the U.S. dollar
- Modest underweight the U.S. dollar

The Canadian dollar has weakened, and we continue to expect it to underperform the U.S. dollar in 2019, driven primarily by differences in economic growth prospects. Slowing U.S. economic growth coupled with the Fed reaching the end of their rate hike cycle could put downward pressure on the U.S. dollar versus a trade weighted basket of currencies.

Gold

- Neutral gold

We believe an allocation to gold can provide insurance in a portfolio against the risk of extreme outcomes. However, we do not currently believe that this insurance is required. ■

TD Wealth Asset Allocation Committee

The TD Wealth Asset Allocation Committee (WAAC) 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
CEO & CIO, TD Asset Management Inc. and SVP, TD Bank Group

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

Glenn Davis, CFA
Managing Director, TDAM USA

Kevin Hebner, PhD
Managing Director, Epoch Investment Partners, Inc.

David McCulla, CFA
Vice President & Director, TD Asset Management Inc.

Robert Pemberton, CFA
Managing Director, TD Asset Management Inc.

Brad Simpson, CIM, FCSI
Chief Wealth Strategist, TD Wealth

David Sykes, CFA
Managing Director, TD Asset Management Inc.

Sid Vaidya, CFA, CAIA
U.S. Wealth Investment Strategist, TD Wealth

Geoff Wilson, CFA
Managing Director, TD Asset Management Inc.