TD Asset Management

PRIVATE **INVESTMENT** COUNSEL

insights

SPECIAL EDITION

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Special Edition

20/20 signifies visual acuity or clarity of vision and has been used figuratively to describe perfect vision. As we move past the first quarter of 2020 and head into the summer months, we currently have anything but perfect vision, so many of the themes that we have consistently capitalized on over the past year have now changed. But before we look at the themes we think will dominate the remainder of this year, it's always helpful to look at where we've come from for perspective.

Market Review

The last decade that spanned between 2010 and 2019 marked the second longest bull market since World War II. While it was a great time for global equity markets, it was a decade that was filled with crisis and uncertainty such as the European sovereign debt crisis, risks of double-dip recessions, destabilization in the Middle East, the collapse of oil prices, sovereign debt downgrades (including the U.S.), negative interest rates and trade wars, just to name a few.

Despite this abundance of bad news and contrary to the expectations of many investment pundits who believed it would take decades to recover from the great financial crisis of 2007 to 2009, global stock markets recovered faster than most expected and continued to break through record levels all through 2019.

As we began the new year, easing trade tensions between the United States and China fortified investor confidence to a seemingly unshakeable level. This confidence helped propel global equity markets to even higher levels during the first few weeks of 2020 despite two early back to back crises – the Iran missile attacks and the onset of COVID-19. However, that confidence that took over a decade to repair was unwound in a matter of days as the COVID-19 pandemic spread across the world.

The COVID-19 pandemic will likely have negative short-term economic consequences and with these changes in events, we've made some amendments to our outlook that we wanted to share with you.

Equities

Despite the potential short-term risks associated with COVID-19, we continue to believe that equities will outperform fixed income over the long term. However, until there are more concrete signs that the environment is improving, we believe equity markets will remain volatile. With volatility expected to persist, we are moving our short-term view on equities to neutral from our previous recommendation to overweight equities. While the recent sharp surge in global equity markets from the year-to-date low that was reached on March 23 is encouraging, we do not believe that we are out of the proverbial woods yet.

“ we continue to believe that equities will outperform fixed income over the long term. ”

Global equity markets are still lower year-to-date, but stock market valuations are not at levels that we would consider undervalued. The S&P/TSX Composite Index is trading at approximately 14 times forward earnings, the S&P 500 Index is trading at approximately 16 times forward earnings and international markets as represented by the MSCI Europe, Australasia, Far East Index (MSCI EAFE) is approximately 13 times forward earnings – all within what could be considered historical averages. On a positive note, the stock markets earnings yield, which is the inverse of the price earnings ratio, are significantly higher than government bond yields, which is supportive of equity prices. As an example, the earnings yield of the S&P 500 Index is approximately 6.1% or 5.4% higher than the 0.67% yield of the 10-year U.S. Treasury Bond.

So, stocks might not be at bargain basement prices, but we do think investors can take advantage of the recent recovery from the March 23 year-to-date lows to take advantage of some of the themes we think will stand out this year.

Table 1: World Equity benchmark returns in Canadian Dollars

Index (Price Return in Canadian dollars)	23 Mar 20 To 15 Apr20*	Year to date**	1 year**	3 year**	5 year**	10 year**
S&P/TSX Composite Index	24.3%	-20.9%	-14.2%	-1.9%	0.9%	4.1%
S&P 500 Index	20.9%	-12.2%	-1.3%	7.4%	9.2%	14.3%
MSCI Europe Australasia Far East Index	14.1%	-15.6%	-8.6%	0.8%	2.1%	6.7%

*At April 15, 2020, source Bloomberg Finance LP
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Theme 1: Market leadership will continue to focus on more defensive, large-cap stocks that have less economically sensitive revenue, stable dividends and strong balance sheets.

This theme is best reflected in U.S. and international equity markets, where we find larger companies relative to Canada and we find equity markets that are more diversified than our domestic stock market.

As illustrated in Table 2, the energy and materials sectors represent approximately a quarter of our stock market, which we expect will face headwinds that are outlined in Theme 2 below.

Global equity markets not only can provide lower exposure to the economically sensitive sectors such as materials and energy, but global equity markets can also have higher exposure to defensive sectors and sectors that we expect may perform well during this period such as consumer staples, technology and health care.

Defensive

Table 2: Global Equity Benchmark sectors

Sector	S&P/TSX Composite Index	S&P 500 Index	MSCI EAFE Index
Energy	12.4%	2.7%	4.0%
Materials	13.6%	2.4%	6.7%
Financials	29.5%	10.6%	16.5%
Industrials	11.7%	7.8%	14.2%
Consumer Discretionary	3.6%	10.4%	11.1%
Consumer Staples	4.7%	7.8%	12.6%
Health Care	1.0%	15.9%	14.3%
Information Technology	8.9%	25.6%	7.6%
Communication Services	6.1%	10.8%	5.5%
Utilities	5.4%	3.4%	4.2%
Real Estate	3.2%	2.9%	3.3%

As at April 20, 2020 , source Bloomberg Finance LP

Theme 2: Commodity prices are expected to remain low, which we expect will be one of the main contributors that will keep a lid on Canadian stock market performance.

The resource sector – energy and materials - represents approximately a quarter of our domestic stock market and approximately 10% of Canadian gross domestic product (GDP). We expect that the resource sector will remain under pressure this year as we believe commodity prices will remain at these lower levels until there are signs that demand is recovering, which we expect may occur in the second half of this year.

Consumption – consumer spending and business spending - is the largest driver of Canadian GDP and the expected weakness in the resource sector will keep on a lid on both in the short term. On a positive note, while our domestic stock market may face headwinds, we believe that our financial sector remains healthy as Canadian banks have strong balance sheets and conservative dividend policies.

> **“… energy and materials - represents approximately a quarter of our domestic stock market”**

Theme 3: Hunting loons in Canada is illegal, but it will likely not stop investors from taking shots at the Loonie.

Weaker commodity prices will likely keep investors from investing in Canada so we expect that currency risk will likely not be a major factor affecting portfolios since the Canadian dollar is not likely expected to appreciate significantly in relation to the U.S. dollar and even international currencies like the Japanese Yen. Increasing exposure to global currencies may help to add diversification to your portfolio.

As illustrated in Table 1, when translated back into Canadian dollars, global stock markets have performed better than Canada partially due to the strength of global currencies, many of which have appreciated relative to the Canadian dollar.

With these three themes, we believe that Canadian's should consider broadening their portfolios borders by investing in the U.S. and international markets.

Fixed Income

Elevated contagion fears around the world have driven investors to the safety of government bonds, sending yields lower. The bond rally underscores the safety appeal of fixed income in uncertain environments to protect against declines in riskier assets.

Given the uncertainty in global data, and expectations for a prolonged low inflation and rate environment, we expect the risk-free rate of return offered by domestic government bonds to provide coupon-like returns, which is currently in the low single digits. There are two components of a bond's total return – the interest payment and the capital gain/loss that results from changes in the price of the bond over time. The following table shows how much of the return of the Scotia Capital Universe Bond Index was attributed to these two factors in each calendar year since 1980 (Table 3).

Table 3: Scotia Capital Universe Bond Index*

Year	Interest	Capital Gain/Loss	Total Return
2000	6.9	3.3	10.3
2001	6.7	1.4	8.1
2002	6.3	2.5	8.7
2003	5.8	0.9	6.7
2004	5.6	1.6	7.2
2005	5.2	1.3	6.5
2006	5.6	-1.0	4.6
2007	5.0	-1.3	3.7
2008	5.0	1.4	6.4
2009	4.7	0.8	5.4
2010	4.4	2.4	6.7
2011	4.2	5.5	9.7
2012	3.7	-0.1	3.6
2013	3.5	-4.7	-1.2
2014	3.6	5.2	8.8
2015	3.3	0.3	3.5
2016	3.1	-1.4	1.7
2017	3.0	-0.5	2.5
2018	3.0	-1.6	1.4
2019	3.0	3.9	6.9
Avg	4.6	1.0	5.6

*As at April 20, 2020 , source Bloomberg Finance LP

Interest represents over 80% of the total return an investor can expect to earn from fixed income investments. Low single digit government bond yields may be discouraging for investors who are seeking income, but we do see opportunities in Canadian corporate bonds, which are expected to modestly outperform government bonds as Canadian corporate bonds offer a yield premium relative to government bonds. With yields at these levels combined with the expectation that yields may be lower for longer, we recommend investors continue to take a diversified approach and not just chase after yield.

Bonds have been resilient in previous periods of rising interest rates and have bounced back quickly after periods of negative returns. Our fund managers believe that their strategy of selectively emphasizing corporate bonds will continue to provide strong relative returns in any interest rate environment.

Final Thoughts

As we look forward, while we may not be out of the proverbial woods just yet, we do believe that we are walking in the right direction. Globally we've seen central banks and policy makers take decisive action to mitigate the effects of the global slowdown and quarantine measures are slowing the rate of infections. While there are some positive signals, as evidence-based investors, we do need to see more evidence of the following:

1. We need to see the growth curve of the rate of infection plateau.
2. We are looking for governments to open their economies by allowing people to go to work beyond just a few industries, provided such actions are warranted in the circumstances. It is encouraging to see signs that some economies may be ready to re-open such as Texas, which represents one of the world's top ten economies – equivalent to the size of Canada. But, we would need to see signs of re-opening across more industries beyond just State Parks and some elective surgeries.
3. We hope to see concrete plans on how infections will be controlled, or even hopefully a development of a vaccine for the virus as this will significantly reduce the risk of a second wave of coronavirus.
4. Finally, we would need to see signs that corporate earnings and global economies are showing signs of stabilization.

Undoubtedly the temptation to sell everything and move to cash can be high as you may start to experience motion sickness from the constant gyration and barrage of provocative headlines. This temptation is normal. But history offers lessons. Giving in to our emotions by selling investments and moving to cash during troubled times can often lead to disappointment. This is because weak markets have historically been followed by recoveries. If your personal circumstances permit, a better approach may be to take a long-term view because even with the inability to predict where exactly future returns will be year-after-year, the historical data generally supports staying invested over time.

For more information, please contact a **TD Wealth Private Investment Counsel Portfolio Manager.**

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