TD Asset Management

NEW THINKING

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**PERSPECTIVES**

# Balancing Act: Weighing optimism and caution

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June 2017

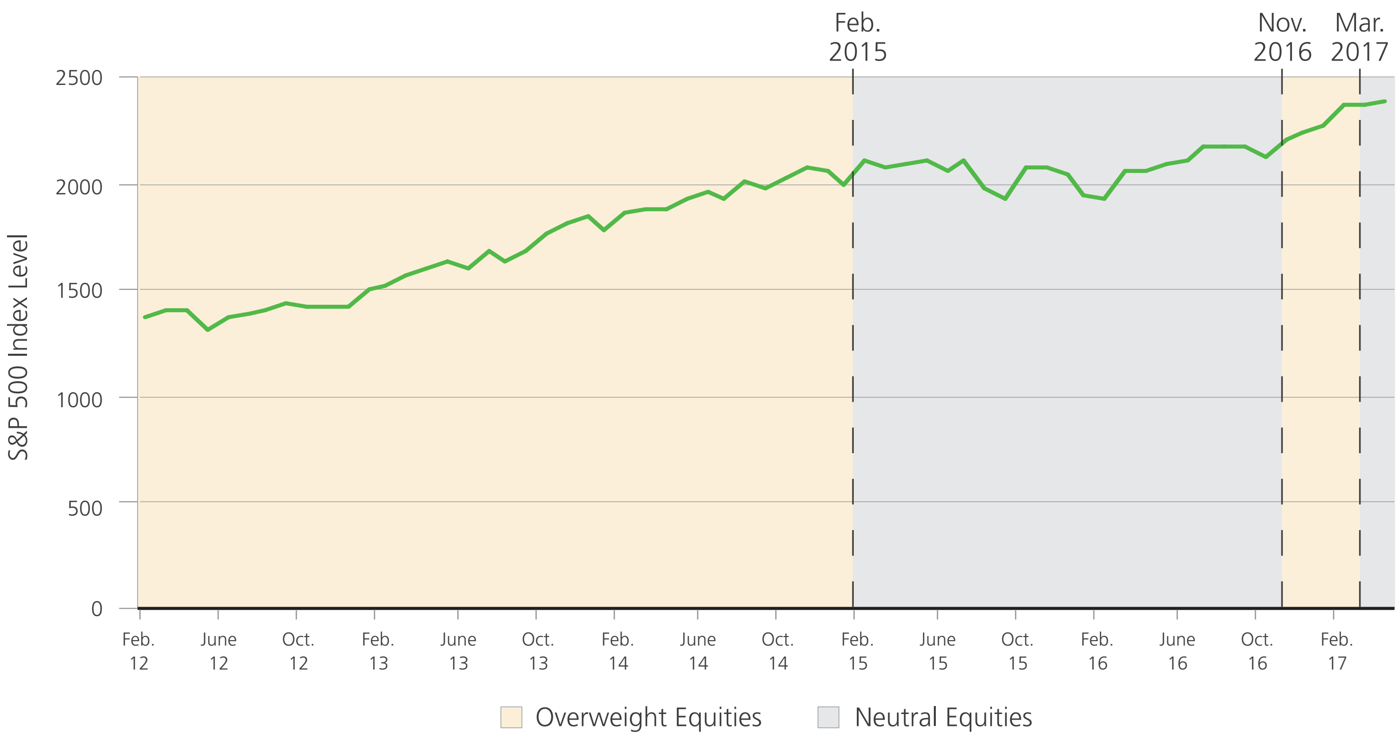
# Balancing Act: Weighing optimism and caution

Over the past several months, we've often used a tug-of-war analogy to describe the investing backdrop as we've witnessed a number of competing forces at play, including optimism vs. uncertainty, cyclical growth vs. structural restraints, and high valuations vs. potential for earnings growth. After weighing a variety of factors, the TD Wealth Asset Allocation Committee (WAAC, we) decided that conditions warranted a more balanced approach, and in March 2017 we moved to a neutral position across asset classes by reducing equities and cash from overweight to neutral and increasing fixed income from underweight to neutral.

## Scaling back stocks

After being overweight equities as an asset class for several years, in February 2015 we moved to a neutral position as we felt that tailwinds were dissipating and the risk/reward dynamic was becoming less compelling. In November 2016, immediately following the U.S. presidential election, we increased our equity weighting to overweight. In the four months that followed, the S&P 500 Index rose 8% amid burgeoning investor enthusiasm about the new administration's policies and their potential to support earnings growth. After this boost, we moved equities as an asset class back to neutral in March 2017.

## Chart 1: WAAC Equity Positioning



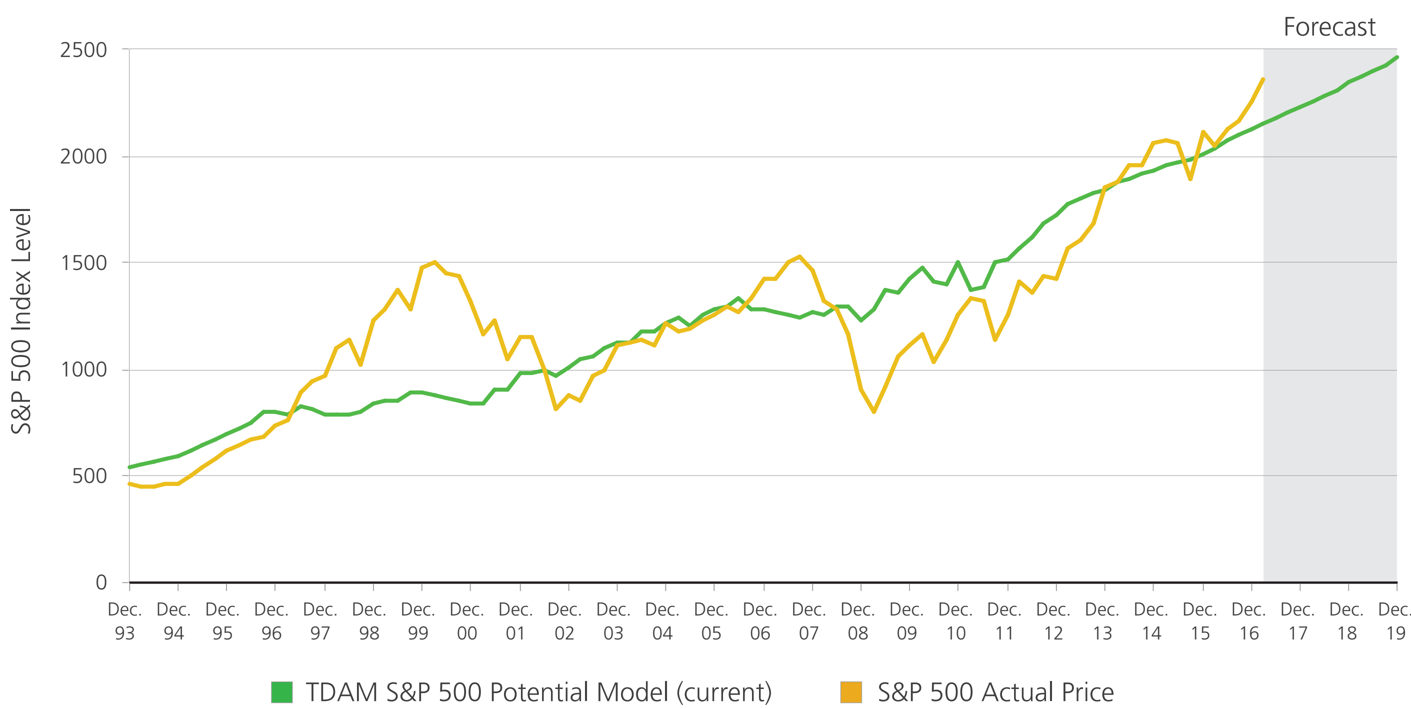

Source: TD Asset Management. As at: May 11, 2017.

Our decision to move equities back to neutral was based on three key factors: stretched valuations, possible policy disappointment and ongoing concerns over structural issues.

1. North American valuations are relatively high. The long-term average price earnings multiple[1] (p/e multiple) for S&P 500 stocks is 15X. When we made our shift, the average price earnings multiple was over 18X, about 20% above the long-term average. The current low bond yield environment is likely to offer support for slightly higher equity p/e multiples than we have seen historically. However, we don't expect multiples to rise sustainably higher from here as it is likely to be challenging for businesses to further improve their margins and revenue growth is likely to be in line with GDP growth, which we expect to be modest. In addition, p/e multiples tend to be supported by low equity market volatility. With volatility near multi-decade lows, it is unlikely this factor will be a tailwind going forward.

   Overall, as Chart 2 demonstrates, S&P 500 stocks are trading above our forecast. While equities may continue to move upward given current momentum, we are active investors who look for quality investments and take a disciplined approach to investing—and we believe that current valuations warrant caution.

## Chart 2: TDAM S&P 500 Price Potential




Source: TD Asset Management, Bloomberg Finance L.P. Data as at March 31, 2017.

In Canada, equities are close to their all-time highs following a strong 2016. That performance is unlikely to be repeated this year given muted economic growth prospects, weaker commodity prices and elevated levels of household debt.

2. When we moved to an equity overweight in November 2016, we expressed this as an overweight to U.S. equities. As noted above, they have experienced strong returns since the election, due in part to investor excitement over promised pro-business policies, such as lower corporate taxes and reduced regulatory burdens. We believe that the probability of these policies being passed has declined in recent months as the political climate in Washington may hamper the administration's ability to effect legislative change. While the probability of these policies passing is certainly not zero, it is not something we are comfortable relying on.

3. The global economy has experienced something of a resurgence lately, driven in large part by cyclical factors. Growth may continue to accelerate from the very low base in Europe, which was one of the factors in our decision to move to an overweight in international equities (see "Europe: Entering the opportunity zone" for more information). However, we don't expect sustained acceleration in North America as persistent structural problems such as high debt levels, demographics and sluggish productivity[2] remain. In addition, the U.S. economy is operating at close to full capacity with unemployment at the lowest level in years. We therefore believe that we will continue to be in a lower-for-longer growth environment. This type of environment will be particularly challenging for higher beta stocks (such as commodities), which is part of our rationale for underweighting Canada and emerging markets.

It's important to note that our return to neutral for equities as a broad asset class does not mean that we are negative about them—we expect equities to deliver mid-single-digit returns. However, we don't believe that investors will be compensated for taking on the additional risk of an overweight position at this time.

When investing in equities in the current environment, it is key to focus on high quality companies and to incorporate them into a portfolio that contains three key elements:

- an emphasis on risk management that helps ensure risk taking is being properly compensated;
- a high level of diversification to help mitigate the impact of market movements; and
- a focus on quality companies with strong balance sheets, high returns on capital and consistent cash flows that are positioned to prosper in a difficult environment.

## Europe: Entering the opportunity zone?

From a geographic standpoint, we remained overweight U.S. equities until early May, when we reduced them to neutral and increased other international equities. Our overweight to U.S. equities was supported by our expectation that several of the new administration's proposed policies would benefit the earnings of U.S. corporations. As noted above, the probability of these policies being passed appears to have declined recently and the uncertain environment in Washington may fuel further bouts of volatility. In addition, valuations are elevated and profit margins are close to peak levels. All of these factors led us to take a more conservative position.

Our current geographic preference is for international equities, and we have moved to a modest overweight position in them based on our expectations for outperformance in Europe. It's no secret that the euro zone has struggled to find its footing following the financial crisis of 2008/2009—the 10-year averages for key economic indicators are weak: economic growth is a paltry 0.1%, industrial production is -0.1%, retail sales 0.3% and the unemployment is 10.1%.

However, we may have reached an inflection point, at least cyclically. Recent economic data has been more positive, with growth and inflation rising and Purchasing Managers' Indices (which tend to be a leading indicator for stocks) showing strength. Given the region's weak performance over the past decade, there is still plenty of slack in the economy, which means it should be able to grow without igniting inflation. This could be good news for investors as corporate sales and margins tend to accelerate during this part of the cycle.

In addition, liquidity is improving; monetary policy remains supportive, with the ECB committed to providing stimulus; and fiscal policy could potentially provide additional support for stocks. For example, France's new government wants to reduce taxes, which would help corporate earnings. Finally, European equity returns have lagged those in North America over the past 3 years, and they are approximately 15% below their all-time highs while their North American counterparts are at or close to all-time highs, which makes relative valuations attractive.

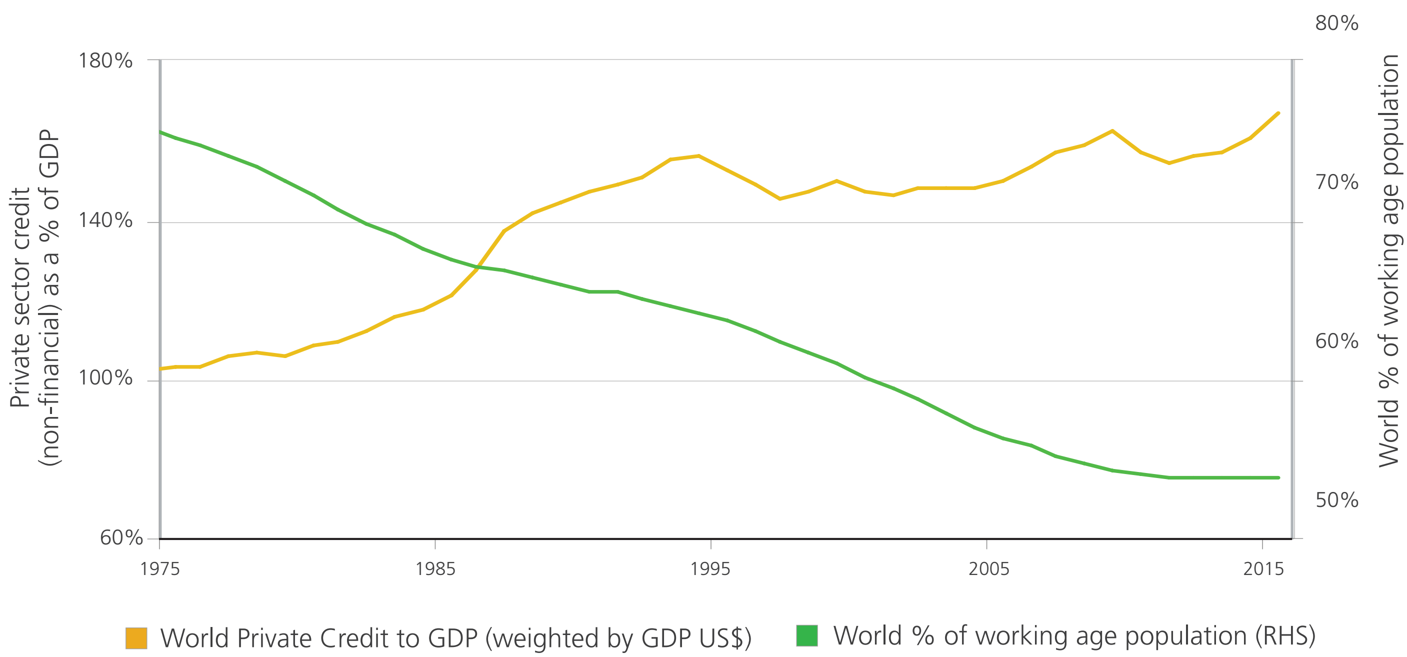
While we are positive about Europe's prospects currently, WAAC's outlook horizon is only 12-18 months. We believe this is likely to be a short-term opportunity as Europe still faces significant long-term headwinds, including the viability of the euro and policy concerns (i.e. will euro zone countries address critical structural issues). In addition, the health of Italian banks is a concern, as is the potential resurfacing of political uncertainty. Currently, however, we believe that risks have been overpriced and there are opportunities in the region.

## Finding Value in Fixed Income

Coincident with moving equities to neutral, we also moved to a neutral weighting in fixed income after being underweight for several years. North American bond returns have lagged those of equities over the past 5 years, and while we expect bonds will continue to underperform equities, they are a valuable part of portfolios, offering income, stability, diversification and the potential to reduce volatility. In addition, the uptick in yields during the second half of 2016 has improved the income offered by bonds and prices are reasonably attractive.

Some people are curious about the decision to move fixed income to neutral given their assumption that yields will continue to rise, which would clearly be a headwind for bond valuations. While it's true that short-term yields are likely to increase as the U.S. Federal Reserve (the Fed) continues to raise the federal funds rate, we don't expect a broad increase in yields. In fact, we expect the lower-for-longer rate environment to continue for some time to come. Long-term bonds are driven by growth and inflation expectations rather than changes in the Fed's short-term lending rate, and we anticipate that growth and inflation will moderate, which will restrain yields at the longer end of the curve. In other words, the 'bondageddon' some investors fear does not appear imminent.

## Chart 3: Structural Headwinds Hindering GDP Growth




Source: World Private Credit to GDP: Bank for International Settlements; TD Asset Management.
World % of working age population: The World Bank – World Development Indicators, as of January 2015.

## Our view

Valuations are stretched in North America, economic growth is expected to slow and the tailwinds associated with the new administration may recede, particularly given recent uncertainty in Washington—which may also fuel further episodes of volatility. In addition, difficult long-term structural issues remain unresolved. Overall, this reinforces our decision to take a more cautious approach and to have a neutral weighting across asset classes (cash, fixed income, equities). We continue to favour a diversified portfolio that includes:

- High quality equities that have the ability to increase their earnings and dividends in a low growth environment and thereby protect the real value of investors' savings.
- An allocation to cash to provide stability and safety of capital.
- An allocation to high quality domestic government bonds and investment-grade corporate bonds to provide some income, diversification and stability.

This disciplined approach—along with a focus on the long term—should help investors navigate the challenging environment they face today.

## About the author

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## About TD Asset Management

TD Asset Management (TDAM), a member of TD Bank Group, is a North American investment management firm. Operating through TD Asset Management Inc. in Canada and TDAM USA Inc. in the U.S., TDAM brings new thinking to investors' most important challenges. TDAM offers investment solutions to corporations, pension funds, endowments, foundations and individual investors. Additionally, TDAM manages assets on behalf of almost 2 million retail investors and offers a broadly diversified suite of investment solutions including mutual funds, professionally managed portfolios and corporate class funds. Collectively, TDAM manages over C$294.6 billion in assets as at March 31, 2017.

[1] A stock's price earnings multiple represents how much investors are willing to pay for that stock's earnings stream.

[2] For more information on productivity, please see TD Asset Management's article The Paradox of Productivity and Monetary Policy.

Unless otherwise stated, all market statistics sourced from Bloomberg Finance L.P.