TD Wealth

Market Outlook

Investment Strategy Quarterly

Q3 2017

TD Wealth Asset Allocation Committee Overview

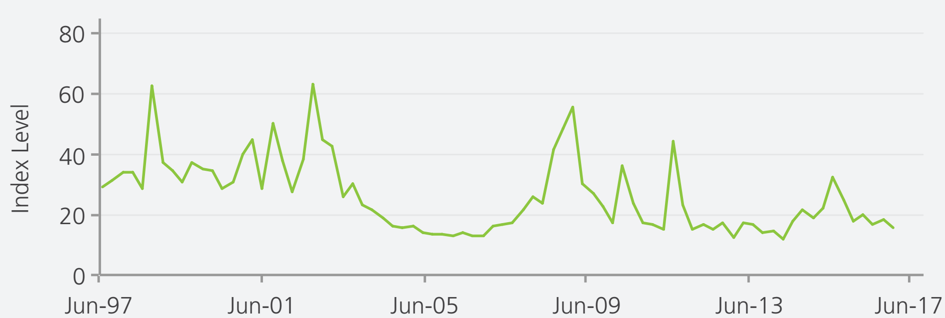
- Broadly neutral outlook balances optimism about a cyclical economic recovery against policy uncertainty and ongoing structural challenges
- Expect low single digit fixed income returns; yields likely to rise only modestly as inflation remains well contained
- Neutral rating in equities reflects stretched valuations and risk of policy disappointment
- Preference for international equities driven by attractive valuations and potential for higher growth and inflation to boost earnings
- Friction between the U.S. and its trading partners could cause volatility, and global imbalances remain high

Politics have dominated the news cycle since the start of the year. Close to home, the year began with a focus on the new U.S. President's inauguration, and since then the press corps has been kept busy following the adventures of the new administration. In May, ongoing investigations into possible Russian interference in the U.S. election dominated headlines and the S&P 500 dipped notably for a couple of sessions as speculation mounted that the U.S. might find itself in the midst of another impeachment trial. However, the downturn was short lived and the market soon resumed its upward trajectory. Overall, the atmosphere in Washington appears acrimonious, which may make it difficult for the government to pass legislation.

In Europe, a number of elections were held; perhaps the most closely watched one was in France, where the neophyte centrist party En Marche bested the far right's Front National. The result was generally met with relief as the Front National had promised to hold a referendum on the country's membership in the European Union, which would likely have fueled uncertainty. However, the fact that the election was held between these two seeming longshots rather than the more traditional French parties showcases signs of discontent felt by the population. In the UK, voters celebrated the anniversary of the surprising Brexit referendum result with another surprising result, this time reducing the incumbent Conservative party's majority government to a minority. This unexpected development will likely make it more difficult for the Conservatives to govern and could potentially create uncertainty during the negotiation of terms for the UK's exit from the European Union. As in France, the UK election highlights a divided electorate, and with imbalances remaining globally, we expect that political turmoil could resurface.

In spite of political tensions in Europe and the sometimes turbulent events in Washington, financial markets remained sanguine for the most part. Stocks and bonds continued to move higher and, with the exception of the brief hiccup in May amid the impeachment chatter, volatility is well below the historical average.

Chicago Board Options Exchange Volatility Index
June 30, 1997 – May 31, 2017



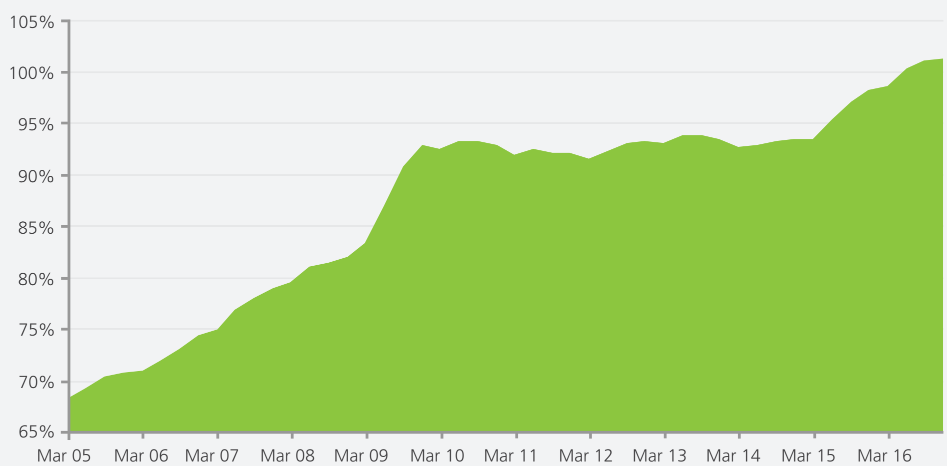
Source: Bloomberg Finance L.P., as at May 31, 2017.

Coordinated Global Growth

Perhaps less headline worthy, but no less important for investors, were developments regarding economic growth. The coordinated global growth we began to see earlier this year continued, with economies advancing across developed countries over the quarter. Canadian economic growth was surprisingly strong during the first quarter, rising almost 3.7%. However, we believe that growth will be more muted in upcoming quarters. A large contributor to this good result in Q1 was household spending, but this is likely unsustainable as already-high household debt levels continue to increase. In addition, a prolonged period of low oil prices would also be a headwind for growth. While the price of oil has moved up from its lows, inventories remain high. Demand for oil is increasing and OPEC has extended its production cuts into 2018, which should help to lower inventories; however, shale oil production is expanding in the U.S. and offsetting some of these gains. We believe that oil will trade in a range that will allow low-cost producers to generate reasonable cash flows, but that is unlikely to spur capital investment, which could weigh on domestic economic growth.

Further afield, U.S. growth was positive at 1.7%, although it appeared somewhat subdued in contrast to Canada's vigorous result. Employment data remains strong in the U.S., with the unemployment rate close to a 10-year low, and we anticipate growth may accelerate slightly from this level although it is likely to remain modest. The European recovery continued as the economy grew 1.9% in Q1, supported by household spending and fixed capital formation. Growth in China was stronger than expected at 6.9%; however, Chinese government debt levels are expanding as it is providing aggressive stimulus. We believe that growth in the region will slow as the transition toward a more sustainable, consumer-based economy continues, which is likely to restrain demand for commodities.

Canadian Household Debt to GDP
March 31, 2005 – December 31, 2016



Source: Bloomberg Finance L.P. as at December 31, 2016.

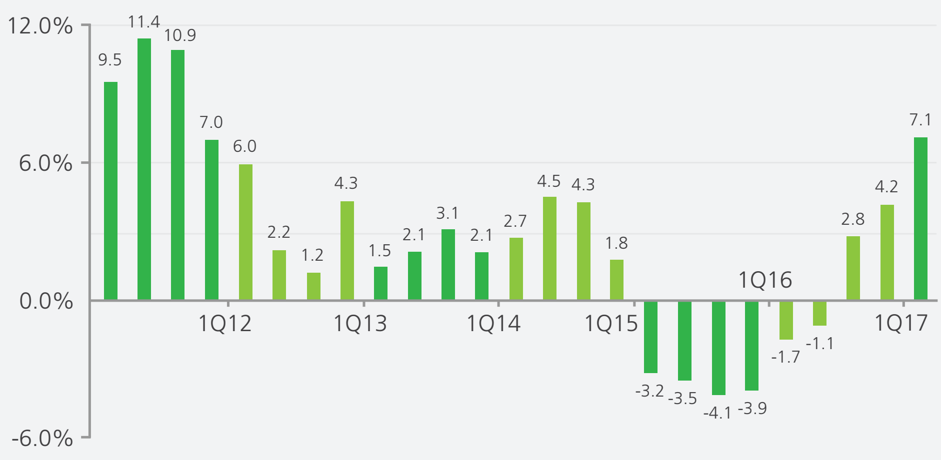
As we discuss in the next section, expanding economic growth is helping to support corporate earnings growth. However, fixed income yields remain low as investors appear to share our belief that ongoing structural issues, such as low productivity, high debt and an aging population, will moderate growth and inflation for some time to come.

Earnings Growth

Amid this positive economic growth, Canadian banks reported their second quarter earnings in May. Earnings growth was in the low double digits, and underlying data indicated that the banks are in good shape, with strong credit quality and capital levels. In Europe, first quarter earnings growth was robust, rising more than 20%, and was especially strong in cyclical sectors such as Energy, Materials and Consumer Discretionary. This was a positive sign as European earnings have been weak since the financial crisis.

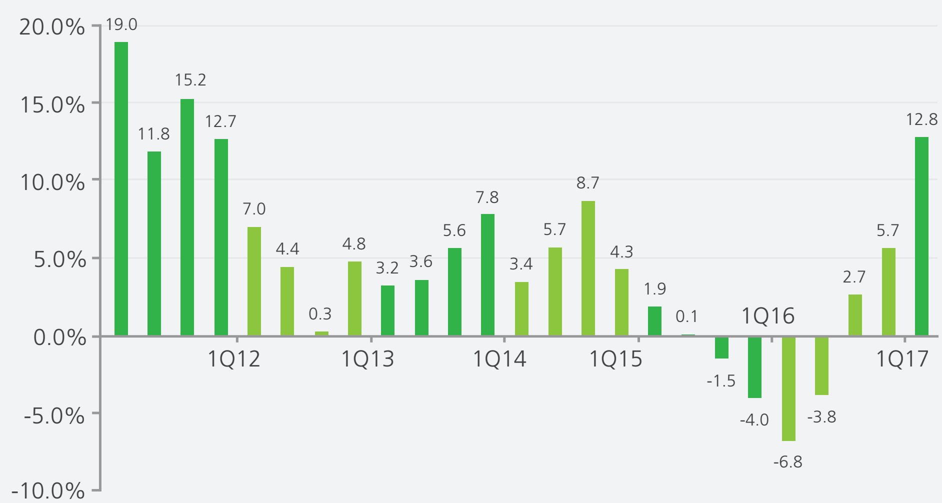
Not to be left out, S&P 500 companies joined their global counterparts in surpassing expectations and delivering very good results. During Q1, both revenue growth and earnings growth for S&P 500 companies reached their highest levels since 2011. Combined with notable margin improvements and ongoing share buybacks, earnings per share (EPS) grew at almost 15% in the quarter. Gains were widespread, with 10 out of 11 sectors outperforming analysts' predictions, and globally focused companies outperformed domestic ones, which further highlights the recovery going on in Europe.

Q1 2017 Revenue Growth of S&P 500 Companies



Source: Bloomberg Finance L.P., as of March 31, 2017.

Q1 2017 Earnings Growth of S&P 500 Companies



Source: Bloomberg Finance L.P., as of March 31, 2017.

While we expect earnings to continue to grow, U.S. earnings growth may have peaked this quarter. A year ago, it was negative, making comparisons look attractive; year over year comparables will be much higher going forward. Overall, while we expect economic growth and earnings growth to slow in North America, we expect them to be positive, and cash flows should continue to be resilient, all of which should support equities.

WAAC Positioning

We believe the current risk/return dynamic continues to favour a conservative stance. Therefore, we have maintained our broad asset class positioning, which is neutral across cash, fixed income and equities, but we did make some changes to our positioning within those asset classes during the quarter:

U.S. Equities
Modest Overweight to Neutral

International Equities
Neutral to Modest Overweight

Our geographic preference shifted during the quarter, and we moved U.S. equities to neutral and international equities to modest overweight. While earnings and cash flow in the U.S. remain resilient, valuations are relatively high, profit margins are close to their peak and the "Trump bump" that followed the U.S. election seems to have subsided as questions arise about the new administration's ability to pass its pro-business policies. Conversely, valuations in Europe are attractive and profit margins are improving. Economic growth in Europe has been accelerating and the Purchasing Managers' Indices (PMI) have been strong, which should be positive for EPS growth. In addition, the European Central Bank (ECB) remains highly accommodative, which should be supportive of European stocks, while the U.S. Federal Reserve Board ("the Fed") continues to slowly tighten its policies. Europe does face long-term challenges in the form of structural issues and political polarization, but we believe that the region presents investment opportunities over the next 12-18 months, which is our outlook horizon.

U.S. Dollar Index
Maximum Overweight to Modest Overweight

We expect the U.S. dollar to remain strong, but the improving economic backdrop in Europe is likely to be positive for the euro. In addition, we don't expect interest rate differentials to widen meaningfully. Combined, these factors are likely to moderate the relative outperformance of the U.S. dollar versus a basket of global currencies.

Overall, we continue to favour a diversified portfolio that includes:

1. 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.

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

3. An allocation to high quality domestic government bonds and investment-grade corporate bonds to provide some income, diversification and stability.

Equities

- Overweight international equities
- Neutral U.S. equities
- Underweight Canadian and emerging market equities

We are neutral equities as the reflationary push that they have benefited from may be waning and we don't believe investors will be appropriately rewarded for the risks associated with an overweight position at this time. As noted above, geographically we have a preference for international equities as we believe that European equities are attractively priced relative to their North American counterparts. We are neutral U.S. equities, which we believe will continue to provide positive returns, but the tailwinds that justified an overweight position appear to be dissipating.

We are underweight Canadian equities. As noted earlier, household debt is elevated, so at some point the support that consumer spending has been providing to economic growth is likely to fade. In addition, weaker demand growth for commodities and the modest price of oil are also likely to be headwinds for economic growth and for the Canadian equity market. With economic growth and inflation expected to be modest, companies may find it challenging to grow their earnings meaningfully.

We are also underweight emerging markets as broad pockets of stress are evident due to high debt levels and slowing growth, and a strong U.S. dollar may increase risk.

Fixed Income

- Neutral cash, domestic government bonds, investment grade corporate bonds and inflation linked bonds
- Maximum underweight global government bonds and high yield bonds

Bonds provide stability and diversification to portfolios as well as some income, and we remain neutral domestic government bonds, investment grade corporates and inflation linked bonds. There has been a lot of noise about the potential for interest rates to rise, but we do not expect them to move meaningfully higher in the near future. Given the significant output gap in the Canadian economy, we believe the Bank of Canada will keep interest rates low for some time to come. While longer-term Canadian bond yields may increase marginally, we believe they will be restrained by modest economic growth, high debt at the government and household levels and low productivity. In the U.S., while the Fed is continuing to gradually increase the federal funds rate, we expect it to remain low both in real terms and from a historical perspective. Longer-term yields in the U.S. may move up modestly as economic growth and inflation advance, but we don't expect significant increases.

We are maximum underweight global government bonds as very low real and nominal yields make the risk/reward relationship unattractive. We are also maximum underweight high yield bonds as spreads have continued to narrow.

Canadian/U.S. currency exposure

- Underweight the Canadian dollar
- Overweight the U.S. dollar

We expect the Canadian dollar to remain low for an extended period. Divergent monetary policy, more attractive yields and expected higher relative economic growth and inflation in the U.S. should lead the U.S. dollar to outperform the Canadian dollar.

U.S. dollar remains strong, but accelerating growth and inflation in Europe should be positive for the euro, which will likely reduce the relative outperformance of the U.S. dollar versus a basket of global currencies.

Gold

- Neutral gold

We believe an allocation to gold may provide insurance against the risk of extreme outcomes. While there are still meaningful risks globally due to continued imbalances in the global economy, near-term political uncertainty in Europe has lessened.

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
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 Inc.

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.