**TD Wealth**

# Market Outlook

Investment Strategy Quarterly

Q1 2017

## TD Wealth Asset Allocation Committee Overview

- Central bank accommodation has peaked and the policy baton is being passed to fiscal stimulus
- Fiscal stimulus expected to accelerate U.S. growth; however, global growth still constrained by high debt levels and demographics
- Returns from fixed income are expected to be low and U.S. fiscal stimulus may push yields modestly higher globally
- Preference for U.S. equities and currency driven by the potential for lower corporate taxes and accelerating growth
- Political risk remains high in Europe and a higher U.S. dollar may create stress in emerging markets

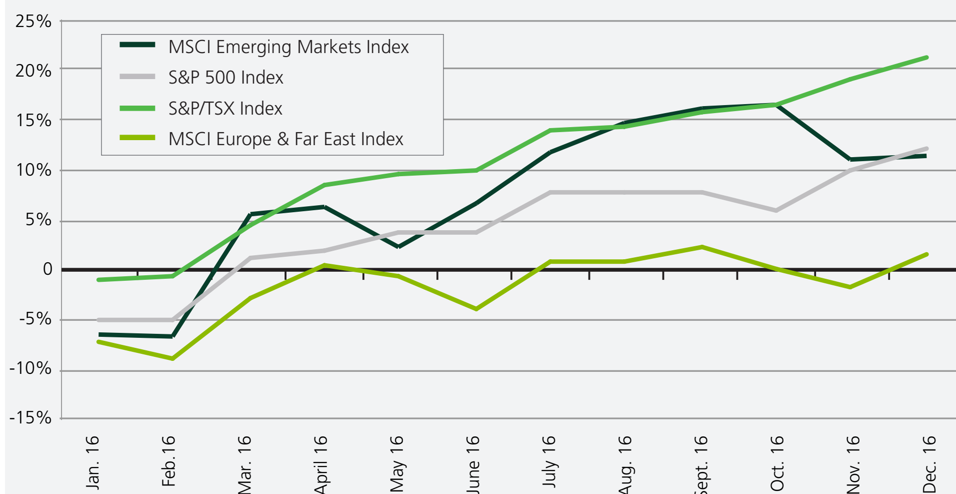
2016 got off to a rocky beginning, with global equities posting their worst start to a year ever amid fears over weak global economic growth and heightened geopolitical tensions. However, stocks and investors proved resilient, with North American equities posting strong returns for the year and a number of U.S. indices reaching record highs during 2016. Both the S&P 500 and S&P/TSX indices benefitted from robust returns in the previously hard-hit Energy and Materials sectors. After reaching a 12-year low in February, oil prices moved up meaningfully, sparked by increasing demand and lower production, which began to reduce the sizeable inventories that had been weighing on prices. Gains in the Materials sector were supported by developments in China, including supply-side reforms and signs that the economy there was stabilizing. Canadian equities outperformed their U.S. counterparts, in part because of the high concentration of Energy and Materials companies in the S&P/TSX index, although Canadian bank stocks also performed very well.

Further afield, emerging market equities also benefitted from stronger commodity prices and posted gains. However, EAFE equities lagged and finished the year with only modest returns as they struggled to overcome the weak start to the year, the Brexit surprise, concerns over the future of the euro plus ongoing high unemployment, low growth and low inflation in Europe.

For bonds, 2016 was really a tale of two halves. During the first half, concerns about stubbornly weak economic growth and inflation led central banks to remain very accommodative, particularly the Bank of Japan and European Central Bank. This sent yields lower, as did Brexit fears—at one point in the summer, more than $10 trillion worth of global sovereign government bonds offered negative yields. However, with central bank monetary policy appearing to have peaked, it seemed increasingly likely that governments would begin turning to fiscal stimulus to spur economic growth. This caused optimism to return and sent yields higher in the second half of the year.

Overall, North American bonds finished 2016 in positive territory, although returns were modest. In Canada, corporate bonds outperformed governments, with corporate returns supported by their incremental

**Figure 1: Equity Index Returns 2016***




*Total Returns
Source: Bloomberg Finance, L.P. As at January 3, 2017

yield advantage. During the year, the Bank of Canada remained on hold, keeping its key rate steady at 0.5%, where we expect it to remain for some time to come. In the U.S., corporate bonds also outperformed government issues. In mid-December, almost exactly a year after its previous increase, the U.S. Federal Reserve (the Fed) raised the federal funds rate by 25 basis points, noting strength in the labour market and moderate economic growth. While the Fed is likely to make additional increases to the federal funds rate over 2017, we believe the rate will remain low for an extended period and expect this will be the loosest tightening cycle in Fed history.

During 2016, there were a number of surprises—Britain voted to exit the European Union, the Rio Olympic Games were a success, the Chicago Cubs won the World Series, Donald Trump won the U.S. election, and OPEC members reached a deal to reduce oil production. Less surprising was that volatility continued to flare up periodically, offering a reminder that investing is rarely a smooth journey, which is why we encourage investors to take a long-term approach, invest in high quality assets and maximize diversification benefits within their portfolios.

## The Year Ahead

As we transition from 2016 to 2017, all eyes will be on Washington, where the transfer of power from Democrats to Republicans will take place. Donald Trump's election victory reflects dissatisfaction with the current state of affairs, which we also witnessed with Brexit and the recent Italian referendum. The TD Wealth Asset Allocation Committee ("we") believes this rejection of the status quo will continue in 2017, particularly in Europe, and it may fuel further bouts of volatility.

Once he takes office, Mr. Trump plans to implement ambitious fiscal stimulus and tax reduction policies. These are expected to accelerate economic growth in the U.S., setting it apart from other developed markets, where growth is being restrained by elevated debt levels and demographics. We believe the move toward fiscal stimulus will be necessary elsewhere as well. The effectiveness of monetary policy appears to have peaked, meaning governments will need to reduce their reliance on it and instead embrace some of the fiscal policy tools available to them as they attempt to spark growth and inflation.

Broadly, increased growth and inflation bode well for U.S. equities, but they are likely to be headwinds for North American and global bonds as they may spur yields modestly higher. As a result, we are overweight U.S. equities and underweight bonds. Given the potential for volatility and the wide range of possible economic and market outcomes globally, we are also overweight cash as it provides stability and offers flexibility to take advantage of opportunities as they arise.

Below is our current positioning and some of our broad thoughts on what may unfold in financial markets during 2017.

### Equity

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

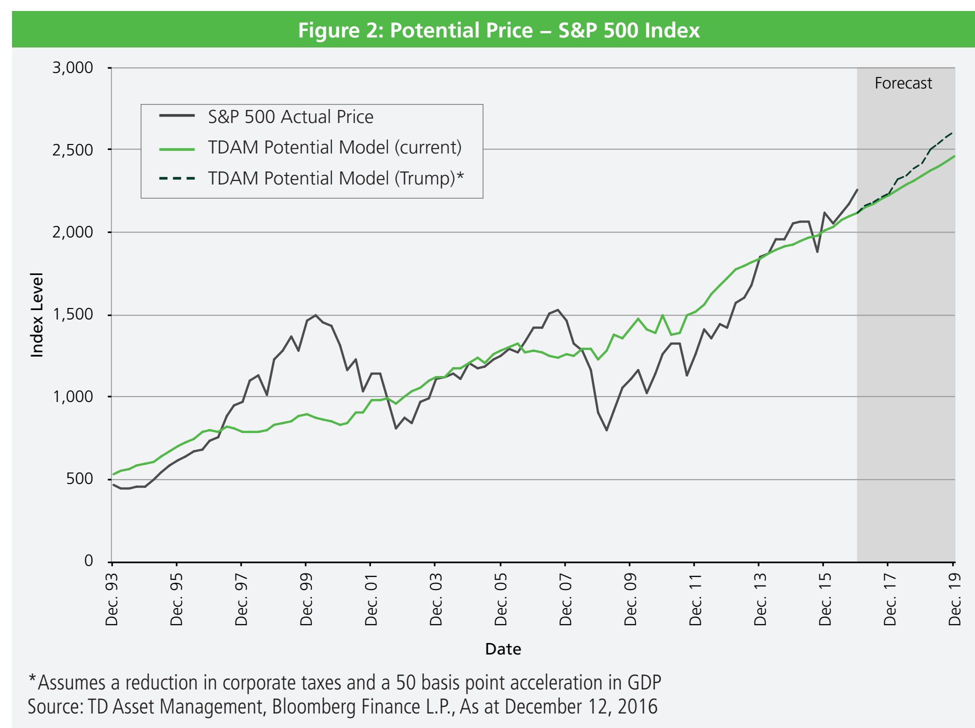
We are overweight U.S. equities as stronger economic growth and higher inflation should be beneficial for revenue growth and the proposed corporate tax cuts would provide a meaningful boost to corporate earnings. The repatriation of offshore profits should also be a positive and may lead to shareholder friendly activities such as share buybacks and special dividends. Figure 2 shows TD Asset Management's S&P 500 Potential Price Model, which highlights the possible impact from Mr. Trump's policies on the S&P 500.

U.S. sectors that stand to benefit notably from Mr. Trump's proposed legislative changes include Industrials, Financials, Consumer Discretionary and IT. While valuations are on the high side of fair from a historical perspective, we believe they are sustainable. We continue to prefer high quality dividend paying equities that offer a stable, gradually rising stream of income.

We are neutral Canadian equities, which are generally fairly valued, particularly after their strong run in 2016. A number of Canadian companies should benefit from the strengthening U.S. economy, and the Industrials and Financials sectors in particular are likely to benefit from Mr. Trump's policies. However, weak commodity prices are depressing earnings and with Canadian economic growth and inflation expected to remain modest, Canadian equities are likely to underperform their U.S. counterparts in 2017.

Equities in some European regions are attractively valued, but overall there are a numbers of threats to corporate earnings, including persistently low growth and inflation and stubbornly high unemployment.

**Figure 2: Potential Price – S&P 500 Index**




*Assumes a reduction in corporate taxes and a 50 basis point acceleration in GDP
Source: TD Asset Management, Bloomberg Finance L.P., As at December 12, 2016

In addition, growing political uncertainty and doubt about the future of the euro all heighten risk, leading us to be underweight international equities. We are also underweight emerging markets as broad pockets of stress are evident due to high debt levels and slowing growth, and a strengthening U.S. dollar may increase risk.

### Fixed Income

- Overweight cash
- Neutral investment grade corporate bonds
- Underweight domestic government bonds and high yield bonds
- Maximum underweight global government bonds

We remain overweight cash, which should provide stability in times of increased volatility. Domestic government bonds can also offer stability and they provide diversification benefits, but we are underweight as overall returns are expected to be low. Our neutral weighting in investment grade corporate bonds is based on the incremental yield advantage they offer over governments. We remain underweight high yield bonds as spreads are tight, and we are maximum underweight global government bonds as very low real and nominal yields make the risk/reward relationship unattractive.

Broadly, we believe the Bank of Canada will hold its key rate steady for some time to come, and while the Fed may increase the federal funds rate over 2017, we expect it to remain low both in real terms and from a historical perspective. This is likely to keep short-term rates anchored, but U.S. fiscal stimulus may push longer-term yields modestly higher as they are more sensitive to changes in economic growth and inflation. This creates what is known as a bear-steepener scenario, depicted in Figure 3, which could lead to negative returns from some bonds.

### Canadian/foreign currency exposure

- Underweight the Canadian dollar

We expect the Canadian dollar to remain low for an extended period. Conversely, higher growth and inflation in the U.S. combined with benefits from the repatriation of overseas assets should all drive the U.S. dollar higher relative to other global currencies. We believe the Canadian dollar will underperform the strengthening U.S. dollar.

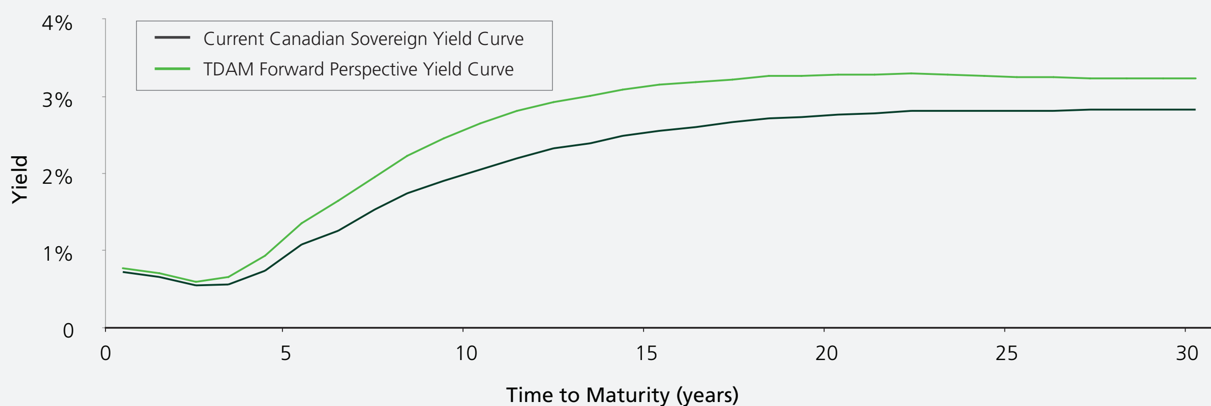
### Commodities

- Neutral gold
- Underweight oil

We believe an allocation to gold may provide insurance against the risk of extreme outcomes, and there are still meaningful risks globally. Our neutral weighting is a reflection of our optimism about U.S. equities and the potential for higher economic growth and inflation in the U.S.

Oil inventories remain high, and Mr. Trump's policies are likely to increase supply, which will restrain the price. While the recent OPEC deal appears to be a positive step, compliance with these quota agreements has been an issue in the past, and it is unclear whether this one will have a meaningful impact on inventory levels.

**Figure 3: Expected Yield Curve Movement**




Note: For illustrative purposes only
Source: TD Asset Management, Bloomberg Finance L.P., As at December 12, 2016

*As we head into the new year, all of us here at TD Asset Management extend our best wishes to you for a happy, healthy and prosperous 2017!*

## 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:

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CEO & CIO
TD Asset Management Inc.and SVP, TD Bank Group

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

**Glenn Davis,** CFA
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