TD Wealth

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Future Outlook

Monthly Perspectives // January 2019

Life-sized predictions

Brad Simpson, Chief Wealth Strategist

What a difference a year makes! A year ago, all was right with the world, and investors couldn't see how anything could ever go wrong. Today, mired in a financial market correction, investors are having a hard time believing that things could ever be right again. Either way, they're being myopic—things are never as good, or bad, as they appear.

For investors, year end is an odd time of year. It's a time when we take stock of what we own and how those investments performed, and then try to decide what to do next year. Often, this is done without much context, as investors sift through the never-ending stream of outlook pieces published this time of year, with titles like "Buy these 25 growth stocks for huge gains," "The five best investments for 2019" and of course the innovative and creatively titled, "[INSERT FIRM HERE] Global Investment Outlook 2019."

Far too often, forecasting and investment often go hand in hand. We look to experts to give us insight into the future, and then we make investment decisions based on their outlook. But we rarely stop to think about whether these forecasts will help us make better investment decisions. Perhaps this year the best resolution you could make is this: Ignore all expert forecasts for 2019.

If you did this, what would you do? Here's one idea: What if, instead of trying to predict what might happen in a month or a year, you decided that this was the time to make life-sized predictions—predictions based on your long-term plans and how you see your life playing out. The good news is that these kinds of predictions are going to be far more accurate, because they're based on you, and because you've already set many of these plans in motion, dramatically increasing the likelihood that they will come to fruition.

We think a good starting point might be to lay the foundation—or let's say the building blocks—of your plan. While it's hard to be definitive, most investors share four common objectives: (1) growing and protecting their wealth; (2) minimizing taxes paid; (3) making sure that what they hold dear is covered if something goes wrong; and (4) leaving some sort of footprint that will make a difference when they are no longer inhabiting this planet.

While many of us share these common goals, there are also goals that are more immediate and more personal. Let's imagine a fictional family, the Rileys—John and Paula and their two children Ringo and George. They have a handful of goals: to retire; to pay for George and Ringo's education via RESPs; to buy a sailboat; and to make sure they expect the best and plan for the worst.

Our first graph (Figure 1) outlines the number of years required to fund each goal and the required annualized returns based on the current amount of capital. The Rileys also have an emergency fund invested short-term based on two years of income equaling $250,000. Furthermore, the Rileys have set up credit facilities in case they have to make an immediate purchase, or if an unforeseen opportunity or crisis arises. (Sometimes the best assurance is a simple a line of credit for short-term borrowing.)

It's important to note here that nowhere in the common building blocks, or in the Rileys' very personal goals, has the stated objective ever been to maximize earnings by selling at all-time highs. Of course, the Rileys would like to earn as much as they can, but not at the risk of failing to achieve their objectives: retirement, education, big sailboat, cash for opportunities, and the assurance that their income will be covered if something really bad happens.

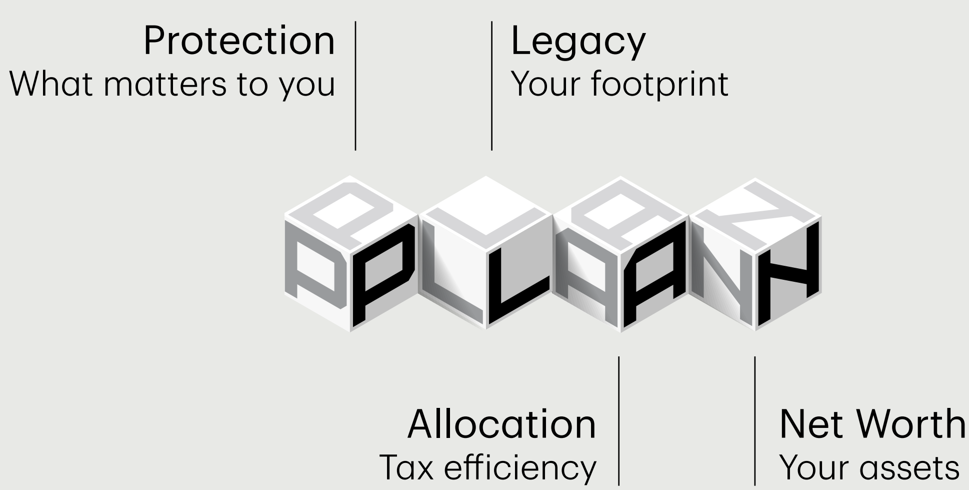

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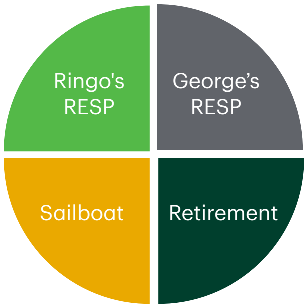
Figure 1: The Rileys: Goal-based planning



Objective	Current Amount Allocated to Objective	Future amount/or annual income required	# of Years to Funding	Required Annualized Returns
Ringo's RESP	$59K	$70k	3	5.86%
George's RESP	$55K	$70K	6	4.1%
Sailboat	$215K	$350K	7	7.21%
John & Paula's Retirement	$2.225M	$5M	12	6.98%

For illustrative purposes only.

To achieve these objectives, a good strategy might be to take the Rileys' financial assets, break them down into component parts, and create a portfolio based on each goal. Our next graph (Figure 2a) shows the long-term returns for each component in what we believe is a contemporary portfolio: fixed income, equity, real assets and absolute return strategies.

As you can see, in order to achieve these objectives, bonds and Canadian equities alone would not have sufficed and met each of the Riley's objectives. However, the portfolio which incorporated each of the investment components would have met each objective, as would U.S. equities, real assets and absolute return strategies individually. However, Figure 2b also shows how using this mix of strategies manages the ups and downs of financial markets by using a measurement called the Pain Index, which measures the depth, duration and frequency of losses. In this case, the type of risk being measured is capital-preservation risk. The lower the value, the better: a value of 0.0% indicates that an investment has never lost money. Relative to equities, the consolidated portfolio met the Rileys' objectives, provided a better return and with a lower pain index.

Figure 2a: Annualized Return from 1992 to November 2018

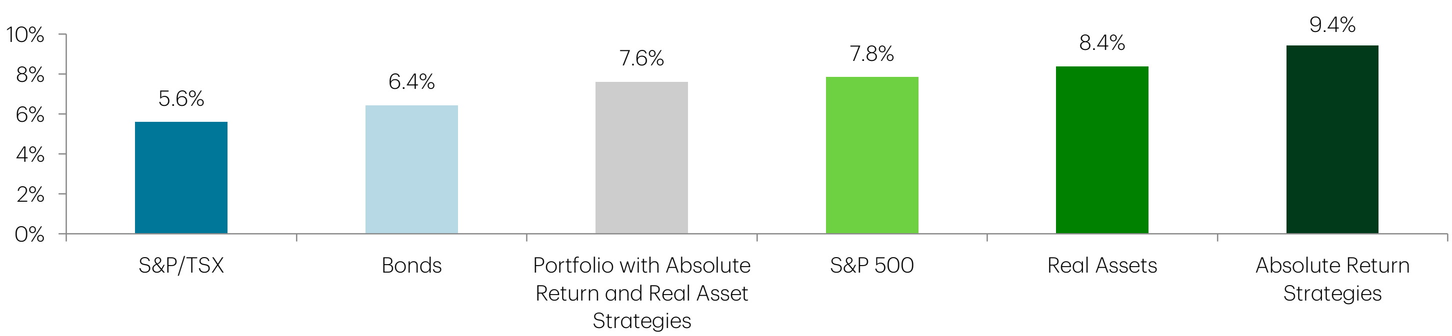
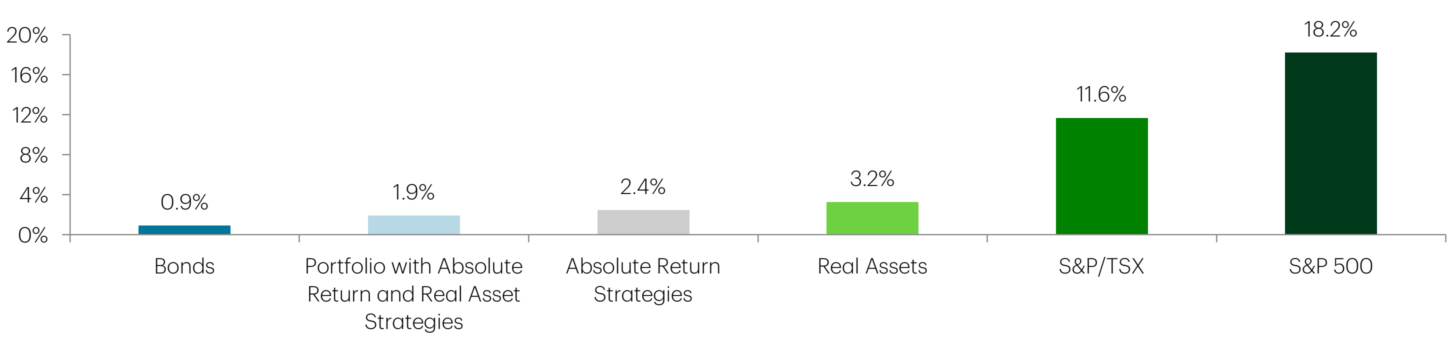


Figure 2b: Pain Index from 1992 to November 2018



Bonds consist of an allocation to the FTSE TMX Canada Universe Bond Index. Portfolio with HFRI & Real Assets consists of a 20% allocation to the S&P/TSX Composite Index PR, 20% S&P 500 PR Index, 35% FTSE TMX Canada Universe TR Index, 15% HFRI Fund Weighted Composite Index and 10% Morningstar US Real Asset TR Index. Prior to June, 2000, the Dow Jones US Real Estate Index has been used as a proxy for the Morningstar US Real Asset TR Index. Absolute Return Strategies are represented by the HFRI Fund Weighted Composite Index. All returns in C$. Source: Bloomberg Finance L.P. , Morningstar, PIMCO.

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For the Rileys, a good way of looking at this is, the sooner the cash is needed, the more important it is to manage for less pain. This means that the nearer your goal, the more likely you'll have the money you need to afford it. Using your financial assets as something you can borrow against adds another level of security. The magic of structuring financial assets this way is it dramatically reduces the fears that arise when life takes you by surprise or when markets fluctuate, as we are seeing right now.

So let's look at some of the life-sized predictions, both good and bad, that can happen over the next 20 or 30 years:

Ten personal things bound to happen over time:
Death
Divorce
Marriage
Personal injury or illness
New career
Retirement
Serious change in health of family member
Birth of a child
Education/advancement
Large purchase

Ten market things bound to happen over time:
Central bank policy error
Geopolitical challenges
Big deficits leading to onerous debt
Bull market
Bear market
Recession
Goldilocks economy
Innovation
Free trade
Renaissance

Here's the point of all this: If you are going to make predictions, you better be excellent at it. But because the world is so complex, making predictions is a low-odds proposition, unless you're talking about the kinds of life-size predictions that you're determined to make happen.

Experts rarely admit to not knowing the answer to something. When they're put on the spot, they'll usually construct an answer using what limited information they have. It's easy and relatively risk-free, given that most forecasters are never held to account for predictions that turn out to be dead wrong, and therefore they have no incentive to improve their forecasting abilities. In short, these people are in the business of talking or writing and making a case for their predictions.

Readers and listeners generally have a short attention span, and the original forecast is often forgotten before the experts' forecasts play out as right or wrong. However, if the forecast proves to be correct, we will promptly be reminded by the experts of their superior forecasting abilities. It is therefore easy to form the impression that the forecasters' abilities are validated.

Boiled down to its essence, investment is about the process of decision-making, not the decisions themselves. You can make one or two bad decisions with a good result, but you can't make a series of bad decisions over the long-term and not have it end badly. Unfortunately, investors are often put in a position of making these decisions without any formal process.

Our solution: Create an investment philosophy, a guiding set of principles that will work in a world that is in a state of constant change, often with dramatic impact on financial markets. At TD Wealth, we call that philosophy "Risk Priority Management," and it provides the foundation for how we make decisions. More importantly, it provides our clients with the knowledge, and the comfort, of knowing how we are going to make decisions with certainty, particularly when uncertain things occur.

This article, for example, is based on our seventh principle:

Provide for lifetimes over market cycles: Rarely are goals only about maximizing the value of investments over a single period of time. A goal might be to maintain the same standard of living or save for retirement or, in the case of entrepreneurs, to prepare for the sale of their business. Another goal may be the purchase of personal-use real estate or the funding of a child's education. Passing on a proportion of wealth, setting up a philanthropic foundation and being able to cover unexpected financial needs may all be goals, and each will likely make up a specific portfolio and require a strategy based on an asset-balanced and risk-factor-diversified portfolio approach.

As we move into 2019, let's make some life-sized predictions—that some things will go wrong, and many others will go right. The same is true for financial markets in which we invest. Let us expect the best and plan for the worst. Let's have a well thought out wealth plan and a portfolio with true diversification, balancing asset and risk-factor diversification with our financial behaviour, which can have an incredible impact on our investment success. By doing this, we will considerably increase the likelihood that we will have a prosperous 2019 and beyond.

What to expect

Beata Caranci, SVP & Chief Economist | James Orlando, CFA, Senior Economist

Three years ago, the U.S. Federal Reserve (Fed) raised its policy rate for the first time since the global financial crisis. Now, with 200 basis points under its belt (as of December 4, when this was written) and another 25 bps expected before year end, the Fed's target rate will have entered the bottom end of its range for the neutral rate, cited as 2.5% to 3.5%. This leaves the Bank facing a couple of important questions in 2019.

How high will rates go?

The policy decisions of the Fed are based on its dual mandates of full employment and stable prices. On the former, the mandate has already been filled in a broad sense. Unemployment sits at 3.7%, well below the Fed's assumed natural rate of 4.5%. Businesses are reporting increased difficulty in filling positions, and aggregate wage growth has breached 3% for the first time since the 2008 recession.

Increased wage pressure is eventually passed through to consumer prices. After years of disinflationary pressures, the Fed's preferred consumer inflation metric, core personal consumption expenditures, has largely stabilized around the 2% target. There are no alarm bells going off on this front, and recently the trend has even ebbed, but the balance of risks is tilted to the upside.

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Taking all of this into account, we expect the Fed to raise rates closer to the mid-point of the neutral range (Figure 3). Volatility in equity market movements can become exaggerated at this stage of the interest-rate cycle, but this does not necessarily correlate with a downturn in the economic cycle; it amounts, rather, to a series of warning shots being fired by investors, as expectations for corporate earnings and risks are recalibrated.

How much do global and financial market risks matter?

At this point, 2018 marks the worst year for global equity returns since 2015. Safe-haven flows have, in turn, pushed the greenback up by 8% against its broad trading partners over the year. This narrative is drawing a lot more investor concern, and you can bet the Fed is closely watching these developments.

The source of deceleration largely stems from emerging market economies. By the same token, U.S. growth hit a high water mark about three months ago. Although this was delayed by fiscal stimulus, momentum is ultimately constrained by the economic fundamentals. GDP growth for the fourth quarter, for instance, is tracking about 2.5%, down from close to 4% annualized during the previous two quarters.

It's worth noting, however, that we have not yet seen a true confidence shock. Recent market movements are still within the realm of normal, and the CBOE Volatility Index (VIX) is sitting at its historical average. If there is a significant and sustained deterioration in equity prices (20% or more) alongside measures of business and consumer confidence, the Fed will hit the pause button on rate hikes.

What to expect from the Bank of Canada?

Like the U.S. economy, the Canadian economy is demonstrating stable prices, with several core measures of inflation around 2%. The Bank of Canada is also in a position of normalizing interest rates back to neutral levels (which we think is between 2.25% and 2.5%) sometime in 2019.

Even with the Bank's inflation mandate essentially filled, there are risks to the outlook that are unique to Canada and may slow the timing of rate hikes. The most familiar of these is the longstanding risk related to overleveraged households. Recently, though, a new kid on the block has shown up as a primary risk—weak Canadian energy prices. An intensification of shipping constraints has resulted in heavily discounted Canadian oil prices. Even with refineries ramping up production and more rail capacity becoming available, it will take time to reduce high inventories.

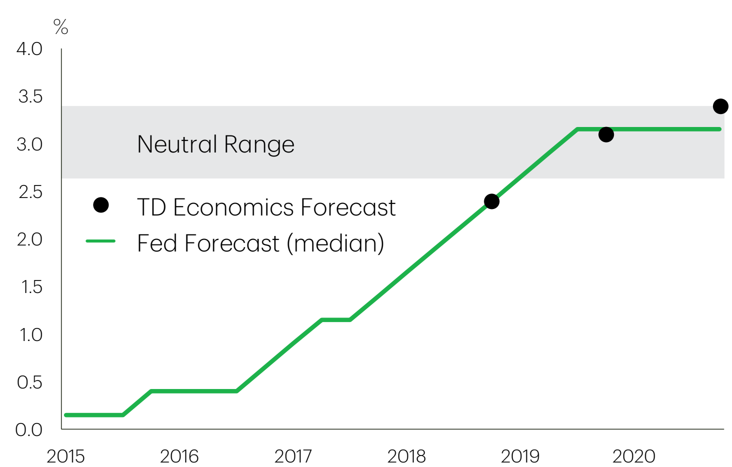
As of December 4, our tracking for real GDP in the fourth quarter of 2018 is below the Bank of Canada's 2.4% forecast by roughly a full percentage point (annualized). This suggests the timing of the next rate hike would be better suited for March or April, even though financial markets currently have high hopes of a January 9th rate hike.

Bottom Line

The Fed was on course to raise its policy rate to the bottom end of the neutral range in mid-December. This sets up 2019 as the year to slow the pace of hikes and find the sweet spot within the neutral range. The U.S. economy is facing tight labour markets. With economic momentum continuing to overshoot the potential pace, this should keep the Fed's bias towards further upward nudges in the policy rate towards the mid-point of the neutral range. One should also be mindful that 2019 will carry forward elevated risks related to trade policy and investor aversion. Any large deviations from expectations on this front will cause the Fed to move to the sidelines.

As for the Bank of Canada, the focus will be on the intersection of domestic risks to international risks, with the latter marked by slowing global momentum, softening commodity prices and any escalation in U.S. trade tensions with other countries. The signing of the U.S.-Mexico-Canada Agreement (USMCA) clearly mitigates a key domestic risk, but others have popped up in its place, like the energy sector. The Bank has long reinforced that it is data-dependent and not on a preset course. We think two rate hikes are on the docket for 2019, which is a downgrade from our prior view of three hikes in light of the recent domestic risks and unexpected weakening in economic momentum.

Figure 3: The Fed getting to neutral



Source: FRB,TD Economics. All values are for the effective fed funds target.

Are we there yet?

Sheldon Dong, VP, Fixed Income Strategy I Chadi Richa, CFA, Preferred Shares Analyst

Economies and financial markets are ever dynamic and complex. As the global economy continues to recover from the severe recession caused by the global financial crisis in 2007 and 2008, central banks have been reducing or removing extraordinary monetary stimulus. The combination of higher interest rates and wider corporate credit spreads were substantial headwinds that made 2018 a challenging year for fixed-income assets.

There is currently no shortage of concerns bedeviling the markets, but at their root are interest-rate movements. While the path for policy rate hikes has been gradual, the movement in bond yields has been more volatile, with the speed and magnitude of these movements appearing to underlie the dominant financial market theme ending 2018—the defensive rotation out of risk.

At the end of November, the benchmark FTSE Canada Bond Universe Index was up 0.05% year to date (on a total-return basis), while the Bloomberg Barclays U.S. Aggregate Bond Index was down 1.79%. The Bank of Canada (BoC) added two more rate hikes in 2018—each one 25 basis points (bps)—to its three hikes in 2017, lifting its target policy rate to 1.75% from a historic low of 0.50%. The U.S. Federal Reserve (Fed) maintained its gradual path toward a neutral policy rate, with four 25-bps rate hikes in 2018 to a target range of 2.25% to 2.50%.

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Further out on the yield curve, the Government of Canada 2-year yield began the year at 1.68% and moved up to 2.94%, as of December 19, while the 10-year yield fell from 2.05% to 2.00% over the same period. Similarly, the U.S. Government 2-year yield has jumped from 1.89% to 2.67%, while the 10-year yield has increased from 2.41% to 2.80% (peaking at 3.26% in early November).

Looking ahead, more of the same can be expected—at least early on in 2019. Gradually and moderately rising bond yields are anticipated as monetary stimulus continues to be reduced by the BoC and the Fed, although both central banks are viewed to be in advanced stages in their policy-tightening cycles. TD Economics is forecasting two rate hikes each for the Fed (ending this tightening cycle at a range of 2.75% to 3.0%) and the BoC in 2019, and one further rate hike for the BoC in 2020.

Market volatility is expected to remain part of the investment landscape, as its suppression by central banks is further unwound. Credit spreads widened moderately from historically low levels in 2018 and are anticipated to further increase modestly in 2019, as tighter monetary policy slows economic growth and raises borrowing costs, which consequently raises financial risks for corporations.

Outside North America, recent communications from central banks in Europe, Japan and China have acknowledged a downshift in economic growth and inflation. As a result, they remain accommodative in their policy actions and communications. But divergence of global monetary policy is expected to narrow in 2019, with markets already gradually pricing in reduced stimulus from central banks in both Europe and Japan (both areas still have negative interest rates).

The combination of gradually rising interest rates and widening credit spreads are expected to remain headwinds for fixed-income investors in 2019. While not an ideal shorter-term outlook, higher rates and credit spreads ultimately provide better opportunities to meet the longer-term goals of fixed-income investors. The increase in market volatility in 2018 served as a reminder of how fast markets can change and why investors should take a longer-term cyclical and strategic view, rather than take a more difficult approach that seeks to time the market over the short term.

Preferred Shares

Preferred shares had a rough time in 2018, losing 13.54% as of December 18, 2018, and erasing almost all the gains of 2017. Various factors contributed to the market decline, but the sell-off has generally been disconnected from underlying fundamentals and has therefore created entry opportunities for the disciplined long-term investor.

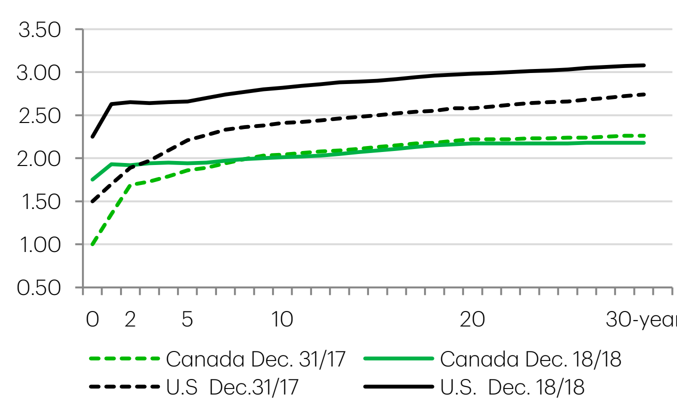
A look at the Government of Canada's 5-year bond yield illustrates this disconnect nicely. Despite the reversal of an upward trend, the 5-year yield was still up in mid December, having risen 7 bps by December 18, while preferred-share investors saw dividend increases of 15% on average. This rising dividend should have given valuations a lift from levels at the beginning of the year, but the opposite happened—prices on preferred shares fell, resulting in a higher dividend yield on investment-grade fixed rate-resets, from 4.5% at the end of 2017 to 5.06% by the end of November 2018.

Fixed rate-resets declined 10.24% during the first 11 months of the year, while floating rate-resets declined 5.04% over the same period, despite a 64-bps rise in the 3-month Treasury bill rate. Perpetuals, on the other hand, declined 8.00%, which seems to be an overreaction to a mere 12.4-bps rise in the 30-year Government of Canada bond yield.

We believe Canadian preferred shares offer an attractive return potential, with credit spreads expected to revert to their normal level. For the risk-averse investor, we recommend a 20% to 30% allocation of preferred-share exposure to actively managed exchange-traded funds. ETFs are very liquid and can be sold more easily than individual securities in case the investor needs the funds or wants to reduce exposure to the market.

For this type of investor, we also recommend a reduction of portfolio volatility through an allocation to fixed rate-resets with a floor feature. An allocation to perpetuals, meanwhile, will act as a hedge against a decline in interest rates. However, it's worth noting that, during a severe market sell-off, widening spreads pressure all segments of the market, regardless of interest-rate movements.

Figure 4: Rising government bond yields in 2018



Source: Bloomberg Finance L.P. As at November 29, 2018.

Equities: All shook up

Christopher Blake, Senior Portfolio Manager, North American Equities

Just over a year ago, as November came to a close, the S&P 500 hit 2647.58, up 18.3% in 11 months. It proceeded to run up nearly 8% by the end of January on euphoria stemming from the U.S. Tax Cuts and Jobs Act (TCJA). To be sure, there was a lot of froth in the markets already: Bitcoin (remember that?) hit a peak in December 2017, at nearly US$19,000, and pot stocks were continuing to rise. Markets were hot!

But equities cooled rapidly as market participants registered a few unsettling facts. First, valuations were looking pricey. In fact, the S&P 500 was trading at over 18.5 times forward 12-month estimated earnings (Figure 5)—the highest since the dot-com bubble of 1999-2000. There was also some doubt around the long-term benefits of the TCJA, and by this time the trade war rhetoric was generating uncertainty over cost structures.

The market well understands that this economic cycle has been a long one. At 114 months, the current cycle has moved into second place and, if it gets to June 2019, we will have seen the longest U.S. expansion since 1850. The United States, however, is but one economy, and the strength it has exhibited in 2018 was sustained mainly by the TCJA, which is a one-time tax cut. Future earnings growth must come from the real economy.

This is not to say that personal tax cuts had zero impact on the real economy. It put money into the hands of American consumers, who did what they do best. But the effects there are also transitory. The TCJA was basically like throwing a pint of gasoline on a campfire. The fire burns more brightly for a minute or two, but then returns to the way it was burning before. The problem now is that the fire is running down, and the wood pile is running dangerously low.

Outside the United States, meanwhile, European and Asian economies are soft. Purchasing Managers' Index (PMI) numbers throughout Europe and in Southeast Asia are falling alongside China's slower GDP growth—a growth rate being further slowed by the impact of American tariffs.

The damage inflicted by the trade war can also be seen in developing markets. The United States, remember, is one of the world's largest exporters, and trade wars, despite what you may have heard, are not "good and easy to win." They are hard on profits, and particularly so for large U.S. multinationals. While corporations can, over the long term, adjust production to different geographies, the near-term hit to profit is very real.

Trade isn't the only area of concern. The U.S., having given away tax revenue with the TCJA, is facing a much larger deficit in 2018. Compare this year's projected deficit, at US$833 billion (4% of GDP), to fiscal 2016, when the deficit stood at US$585 billion (3.1% of GDP). 2019 is looking even worse, with an anticipated deficit of US$984 billion as President Trump threatens to block budgetary approval to secure his proposed border wall.

Then there's monetary policy. With the lowest unemployment rate in 50 years, wages are rising—and these costs that are eventually passed on to consumers in the form of higher prices. Inflation is, as a result, rising slightly and leading the U.S. Federal Reserve to march interest rates up at the front end of the yield curve. That may lead to a dreaded "inversion," when short-term interest rates are higher than long-term ones—a scenario that typically indicates recession on the horizon.

Recent market dynamics may also lead to unflattering year-over-year earnings comparisons. To this point, we have seen bottom-up earnings estimates for 2019 drift downward—not meaningfully, only a couple percent. But markets react to momentum, and when it's negative, they don't like it. At the same time, the earnings expectations for the 2018 calendar year have drifted upward, so earnings growth is declining.

What the market is trying to do right now is predict the next recession—something it's not very good at. Nobel laureate Paul Samuelson famously proclaimed in 1966 that the stock market had "accurately predicted nine of the last five recessions." In the 50 years since then, stock markets have no more learned to predict a recession than pigs have learned to fly. In fact, their track record has possibly proven worse. So, with no degree of accuracy, we're guessing that a 35% to 50% possibility of recession is priced in. Until there is some greater level of certainty around the path of the economy, we expect equity markets to remain challenged in the coming months.

Figure 5: S&P 500 Index Price to Next Twelve Month Earnings

Source: FactSet as at December 5, 2018.

Sectors in review

North American Equities Team, PAIR

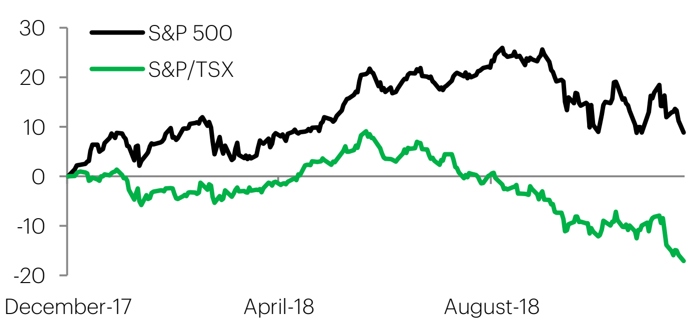
Figure 6: Sector Recommendations

Sector	U.S.	Canada	Preference
Consumer Discretionary	Under	Under	Canada
Consumer Staples	Market	Market	U.S.
Energy	Over	Over	U.S.
Financials	Over	Over	Canada
Real Estate	Market	Over	Canada
Health Care	Over	Under	U.S.
Industrials	Market	Market	Canada
Information Technology	Market	Under	U.S.
Materials	Under	Market	Canada
Communication Services	Market	Market	U.S.
Utilities	Market	Market	Canada

Source: Portfolio Advice & Investment Research. As at December 20, 2018.
Over: Overweight; Under: Underweight; Market: Marketweight

Consumer Discretionary

Figure 7: Consumer Discretionary: S&P 500 vs. S&P/TSX (C$)

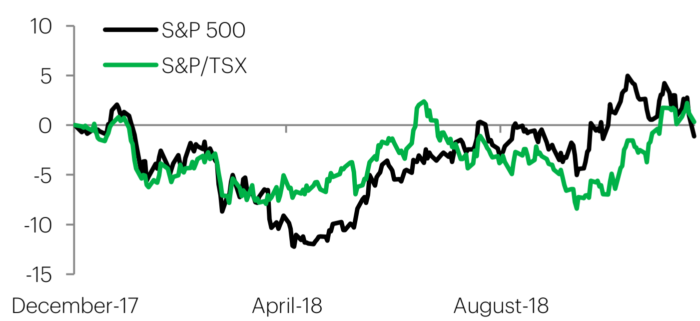


*Total return in C$. Capped S&P/TSX index.
Source: Bloomberg Finance L.P. As at December 17, 2018.

We are changing our view of the consumer discretionary sector to underweight. In the U.S, the sector has outperformed the broader markets, propelled by tax cuts and robust consumer confidence, while in Canada, the sector has materially underperformed the index due to company-specific missteps along with the impact of trade tensions for some subsectors. The sector is trading slightly above historical levels in the U.S., and considerably below historical levels in Canada. In the coming year, earnings in the sector are expected to grow faster than the broader market. We anticipate that strong consumer spending, driven by solid consumer confidence, rising wages and low unemployment should continue to benefit the sector. In addition, the U.S. sector should benefit from further tax stimulus when Americans file their tax returns in 2019. Offsetting these positives, we believe that trade tensions and anxiety about the end of a protracted cycle could weigh on the higher-multiple names in the sector. Pick for 2019: Canadian Tire Corp.

Consumer Staples

Figure 8: Consumer Staples: S&P 500 vs. S&P/TSX (C$)



*Price return in C$. Capped S&P/TSX index.
Source: Bloomberg Finance L.P. As at December 17, 2018.

We are upgrading our view for consumer staples to marketweight from underweight. In the U.S., the sector has underperformed the S&P 500 year-to-date, while Canadian staples have outperformed the S&P/TSX Composite, with both jurisdictions trading slightly below historical levels. Late in 2018, however, staples outperformed on both sides of the border, as the market sold off on trade fears and macro outlook worries. Earlier in 2018, the sector was weighed down by negative sentiment, as rising input costs and anemic top-line growth weighed on performance. Headwinds that had plagued the sector—including wage growth, input cost inflation and higher transportation costs—are now beginning to ease, and pricing power appears to be improving, which may increase margins, particularly for lower-margin subsectors like grocers. Expectations for EPS growth over the next 12 months are pessimistic, which may leave room for surprise upside. The pace of interest-rate increases, meanwhile, may surprise to the downside. Valuations may also be buoyed by ongoing fears about the end of the late-cycle expansion. Picks for 2019: Mondelez International Inc., Alimentation Couche-Tard Inc.

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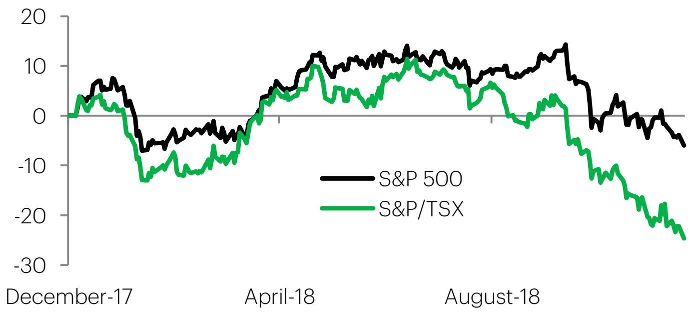
Energy

Figure 9: Energy: S&P 500 vs. S&P/TSX (C$)

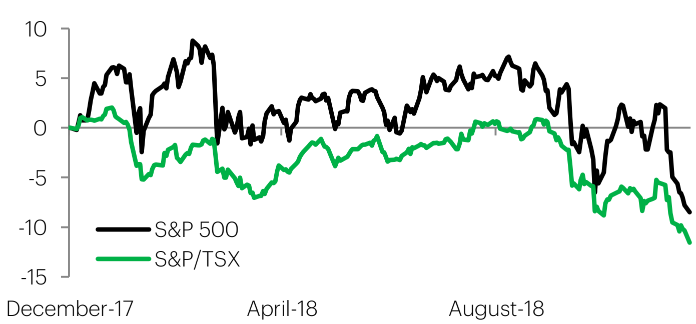


*Total return in C$. Capped S&P/TSX index.
Source: Bloomberg Finance L.P. As at December 17, 2018.

We are reiterating an overweight view for energy the sector, which had underperformed the broader markets in 2018. In October and November, crude oil plunged 33.5% to oversold levels on compounded worries: weakening global economic growth; weakening outlook for oil demand; worries about surging supply; and the negative impact of a strong U.S. dollar on consumption. In early December, OPEC and other major oil exporters agreed to cut their production by 1.2 million barrels per day (mmbld). The Alberta government, meanwhile, has mandated 0.325 mmbld in production cuts. Combined, these actions should help rebalance oil markets. Before these cuts were announced, the U.S. Energy Information Administration estimated that 2019 global oil supply would outstrip demand by 0.60 mmbld, so with 1.525 mmbld in production cuts, there's a suggestion the market could be materially undersupplied in 2019. Supply shocks in Africa, the Middle East and Venezuela could tighten the market further. With forward multiples below market average, and earnings growth above market average, and with yield, return and free cash flow continuing to improve, the energy sector has started to look like a value play at a time when the market leadership appears to be moving from growth to value. Picks for 2019: Canadian Natural Resources Ltd., EOG Resources Inc.

Financials

Figure 10: Financials: S&P 500 vs. S&P/TSX (C$)

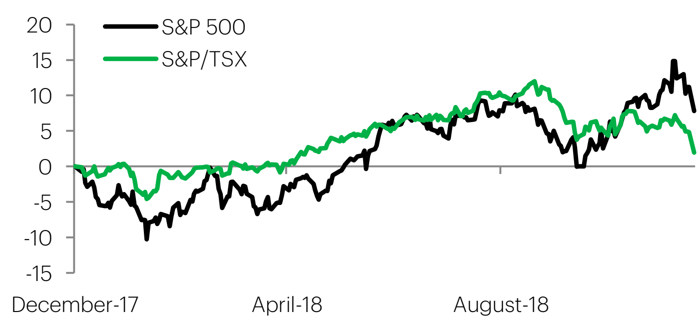


*Price return in C$. Capped S&P/TSX index.
Source: Bloomberg Finance L.P. As at December 17, 2018.

We continue to favour the financial sector—and the banks in particular—for their strong earnings power, history of dividend increases, conservative capital positions, share repurchases, and their defensiveness in volatile markets. Canadian banks recently reported lacklustre fourth-quarter earnings but provided incrementally positive guidance for the upcoming year. Looking to 2019, we expect revenue growth for Canadian banks to be in the mid to high single digits. Cost-cutting initiatives continue, and the associated positive operating leverage should play a prominent role in the 2019 narrative for Canadian banks. This bodes well for future earnings growth and dividend increases for the sector. Much like their Canadian counterparts, the U.S. banks continue to trade at attractive discounts. The U.S. banks reported strong earnings and cash flow growth in late October. However, former regulatory tailwinds may now turn into headwinds as control of the House of Representatives switches to the Democrats, who favour additional regulation. Another major risk for the U.S. banking sector is the threat of a more normalized and less forgiving credit environment. Nevertheless, we continue to like the U.S. banks and the risk/reward they provide at current levels. Pick for 2019: Canadian Imperial Bank of Commerce.

Real Estate

Figure 11: Real Estate: S&P 500 vs. S&P/TSX (C$)



*Total return in C$. Capped S&P/TSX index.
Source: Bloomberg Finance L.P. As at December 17, 2018.

Our view of real estate over the coming year is positive, as the U.S. Federal Reserve limits itself a measured pace of rate hikes in 2019. Valuations in this sector remain at or near historic lows (in certain subsectors) with excellent growth potential in the short to medium term. We continue to like the sector for its strong income generation, solid growth in funds from operations and discount valuations. Many companies in the sector also continue to execute on strategic plans to divest non-core assets, firm up balance sheets, buy back stock and streamline operations, all of which should add to the profitability and attractiveness of the sector. Pick for 2019: RioCan REIT.

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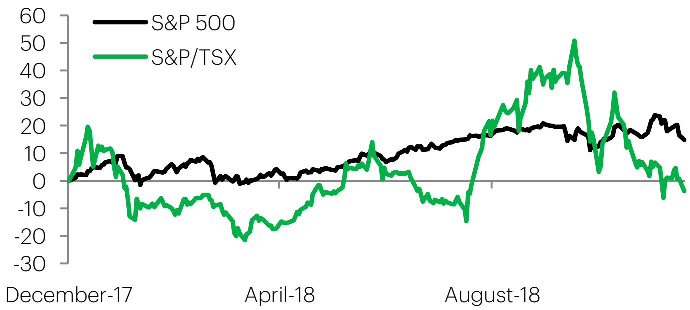
Health Care

Figure 12: Health Care: S&P 500 vs. S&P/TSX (C$)

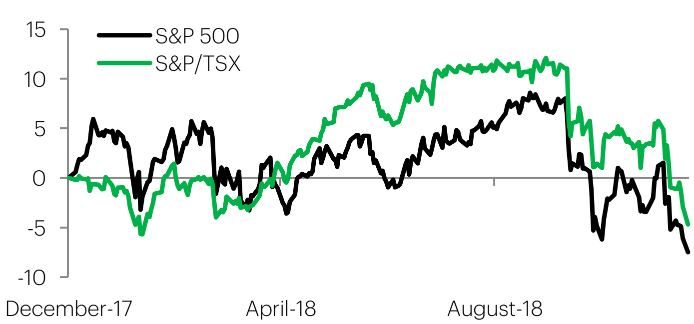


*Total return in C$. Capped S&P/TSX index.
Source: Bloomberg Finance L.P. As at December 17, 2018.

Health-care issuers in the U.S. should continue to generate strong earnings and free cash flow, and return a significant amount of capital to shareholders. We expect drug pricing to remain a hot topic in 2019, since it appears to be on the U.S. president's radar screen. Innovations and new therapies, however, may fuel growth in the sector, as numerous trials, particularly in heavily researched fields such as immuno-oncology, are set to release results. The introduction of bio-similars should also capture some of the spotlight as several large, brand-name therapies come off patent in 2019. It will be particularly interesting to see how quickly bio-similars are able to capture market share versus incumbent therapies. Given large cash balances and more reasonable valuations in the sector, we continue to expect mergers and acquisitions (M&A) to be a theme going forward. While M&A took a pause in 2018 as the industry sussed out their prospects under the new U.S. president, we expect it to revive in 2019 as many obstacles have been removed. Our view remains that the health-care sector in Canada lacks appeal, given a lack of breadth and depth. Pick for 2019: UnitedHealth Group Inc.

Industrials

Figure 13: Industrials: S&P 500 vs. S&P/TSX (C$)

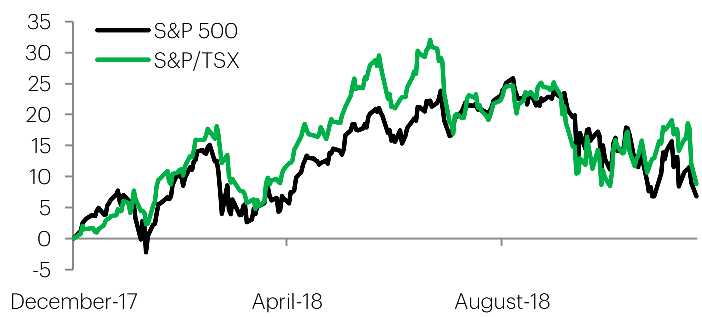


*Price return in C$. Capped S&P/TSX index.
Source: Bloomberg Finance L.P. As at December 17, 2018.

The Canadian industrials sector was relatively strong in 2018, greatly outperforming the S&P/TSX Composite Index, while its U.S. counterpart has significantly underperformed the S&P 500. The strong outperformance in Canada was mainly driven by solid returns in the commercial services and supplies subsector and the road and rail subsector, and partially offset by weakness in airlines, machinery, distributors, and aerospace and defense, while the underperformance in the U.S. was led by aerospace and defense, electrical equipment, building products, machinery, and construction and engineering, and partially offset by strength in commercial services, air freight, and road and rail subsectors. For 2019, we continue to be cautious on industrials overall, given late-stage concerns around trade and global growth, which have impacted certain companies and subsectors. Although valuations have pulled back significantly, particularly in the U.S., we believe it is prudent to maintain a defensive bias. As a result, we continue to prefer the Class 1 rails given their strong competitive advantages, attractive growth profile, diversified revenue mix and defensive characteristics. Pick for 2019: Canadian National Railway Co.

Information Technology

Figure 14: Information Technology: S&P 500 vs. S&P/TSX (C$)



*Price return in C$. Capped S&P/TSX index.
Source: Bloomberg Finance L.P. As at December 17, 2018.

We expect 2019 to be a challenging year in the technology sector after a very polarized performance in 2018. Even among FAANG stocks (Facebook, Amazon, Apple, Netflix, Google)—which led the S&P 500 for the first eight months of the year—performance has proven uneven, with Facebook down about 20% year-to-date (as of Dec. 10) and Amazon and Netflix both up 40%. In 2019, we anticipate that slowing economic growth globally will result in a reduced level of business and consumer confidence, which will slow investment and purchases of technological goods. The subsector that leads the group, semiconductors, reached very close to bear-market territory in late October, closing down 19.9% before staging a halting recovery when measured by the performance of the Philadelphia Semiconductor Index. It remains down 18.6% (as of Dec. 10). Picks for 2019: Qualcomm Inc. and Microsoft Inc.—a barbell strategy. Microsoft is trading at highs but is performing exceedingly well as its software and services transition to the cloud, while Qualcomm sports a very low valuation, but generates a lot of cash that it returns to

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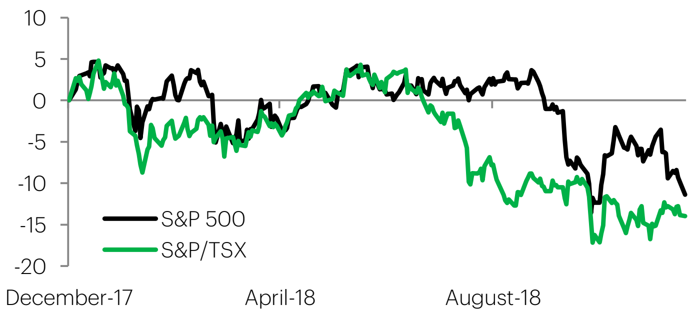
shareholders, and may benefit from catalysts in early 2019. Another quasi-financial name to add to the list: Visa Inc.

Materials

Figure 15: Materials: S&P 500 vs. S&P/TSX (C$)

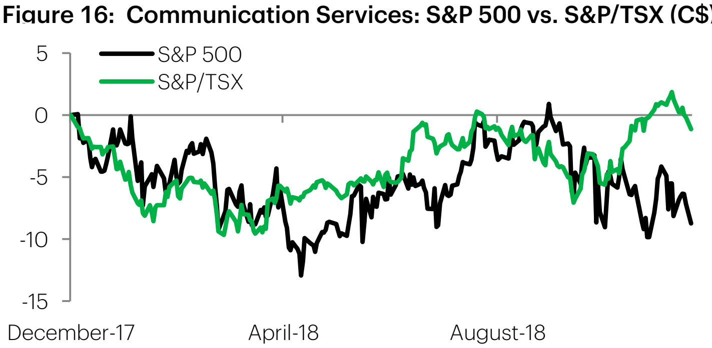


*Price return in C$. Capped S&P/TSX index.
Source: Bloomberg Finance L.P. As at December 17, 2018.

It's been a challenging year for the materials sector, both in Canada and the U.S., with each national sector substantially underperforming its respective broader index year-to-date. The main factors that have impacted commodity prices, and the sector in general, include an escalating trade war, slowing global growth and a stronger U.S. dollar, as the Federal Reserve continues to tighten monetary policy. In Canada, the underperformance was led by base and precious-metal producers as well as the forestry subsector, and partially offset by relative outperformance in agriculture, chemical, and the container and packaging subsectors. In the U.S., metals and mining, containers, and packaging and construction materials led the laggards, partially offset by the chemicals subsector. For 2019, we expect there to remain heightened levels of volatility in the sector, given the uncertainty around trade and weakening global growth. However, fundamentals in base metal and agriculture are still strong, and the overall markets remain relatively tight. We are becoming increasingly positive on the precious-metals complex given attractive valuations and improving fundamentals for gold as we expect the Fed to moderate the pace of interest rate hikes in 2019. Pick for 2019: Teck Resources Ltd.

Communication Services

Figure 16: Communication Services: S&P 500 vs. S&P/TSX (C$)

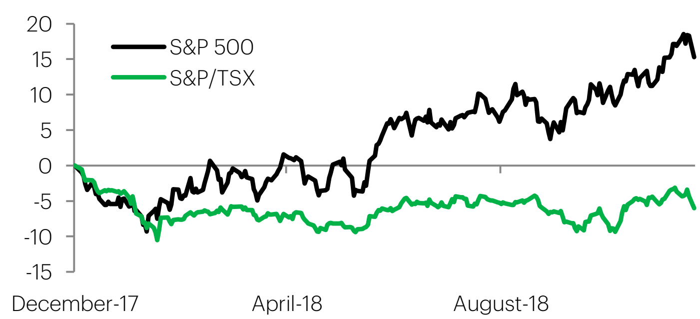


*Price return in C$. Capped S&P/TSX index.
Source: Bloomberg Finance L.P. As at December 17, 2018.

The Canadian communications sector declined 0.85% on a year-to-date basis (as of December 18), outperforming its U.S. counterpart, which declined 14.16% over the same period. We continue to favour this sector and its infrastructure-like characteristics, with stable earnings power. Valuations have come down a bit in 2018 but are still at the top end of historical levels. The industry is undergoing a strategic shift as consumers migrate from traditional linear video services, such as cable and satellite, to streaming services like Netflix. As a result, media content is becoming a valuable asset that traditional infrastructure companies, such as phone and cable, are moving into as a means of compensating for the loss of subscribers. Notably, AT&T has completed the acquisition of Time Warner, while Comcast, after losing a bid for Fox assets to Walt Disney, has acquired Sky. On the wireless front, we still favour operators in Canada, where the market is still experiencing healthy growth, despite the entry of Shaw Communications' Freedom Mobile brand. Picks for 2019: BCE Inc., Telus Corp., Walt Disney Co.

Utilities

Figure 17: Utilities: S&P 500 vs. S&P/TSX (C$)



*Total return in C$. Capped S&P/TSX index.
Source: Bloomberg Finance L.P. As at December 17, 2018.

Canadian utilities declined 10.47% as of December 18, 2018, and continue to trade at a discount to their U.S. counterparts, which rose 2.91% over the same period. The primary reason for the divergence is a more favourable regulatory environment in the U.S., where regulated utilities are allowed to earn a higher return on equity and to rely more on equity for their capital funding. Despite the Canadian sector's underperformance since the beginning of 2018, valuations remain historically elevated, making their dividend yield less attractive. The same thing can be found in the U.S. market. where the yield spread between U.S. utilities and the S&P 500 stands at 1.21%, below the three-year average of 1.51%, while the spread between the sector's dividend yield and the 10-year U.S. government bond yield is at 0.53%, near the decade low. We continue to favour companies with a predominantly regulated asset base, stable earnings, solid balance sheet and exposure to high-growth markets. Picks for 2019: Fortis Inc., Emera Inc., Brookfield Renewable Partners L.P.

Market performance

		(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)
Canadian Indices ($CA) Return	Index	1 Month	3 Months	YTD	1 Yr	3 Yrs	5 Yrs	Since 1/1/2012	10 Yrs	20 Yrs
S&P/TSX Composite (TR)	49,204	-5.40	-10.11	-8.89	-8.89	6.37	4.06	5.73	7.92	6.62
S&P/TSX Composite (PR)	14,323	-5.76	-10.89	-11.64	-11.64	3.26	1.01	2.61	4.77	4.04
S&P/TSX 60 (TR)	2,390	-5.55	-8.93	-7.58	-7.58	7.18	4.98	6.56	7.86	6.79
S&P/TSX SmallCap (TR)	847	-3.53	-14.38	-18.17	-18.17	5.20	-0.29	0.52	6.64	-
U.S. Indices ($US) Return	Index	1 Month	3 Months	YTD	1 Yr	3 Yrs	5 Yrs	Since 1/1/2012	10 Yrs	20 Yrs
S&P 500 (TR)	4,984	-9.03	-13.52	-4.38	-4.38	9.26	8.49	12.69	13.12	5.62
S&P 500 (PR)	2,507	-9.18	-13.97	-6.24	-6.24	7.04	6.28	10.35	10.75	3.63
Dow Jones Industrial (PR)	23,327	-8.66	-11.83	-5.63	-5.63	10.21	7.07	9.67	10.27	4.77
NASDAQ Composite (PR)	6,635	-9.48	-17.54	-3.88	-3.88	9.84	9.70	14.28	15.45	5.69
Russell 2000 (TR)	6,722	-11.88	-20.20	-11.01	-11.01	7.36	4.41	10.43	11.97	7.40
U.S. Indices ($CA) Return	Index	1 Month	3 Months	YTD	1 Yr	3 Yrs	5 Yrs	Since 1/1/2012	10 Yrs	20 Yrs
S&P 500 (TR)	6,800	-6.70	-8.86	3.98	3.98	8.73	14.03	17.52	14.35	5.01
S&P 500 (PR)	3,420	-6.85	-9.34	1.96	1.96	6.53	11.71	15.08	11.95	3.03
Dow Jones Industrial (PR)	31,825	-6.31	-7.08	2.62	2.62	9.68	12.54	14.37	11.47	4.17
NASDAQ Composite (PR)	9,052	-7.16	-13.09	4.52	4.52	9.31	15.30	19.18	16.71	5.09
Russell 2000 (TR)	9,171	-9.62	-15.90	-3.23	-3.23	6.85	9.74	15.17	13.19	6.79
MSCI Indices ($US) Total Return	Index	1 Month	3 Months	YTD	1 Yr	3 Yrs	5 Yrs	Since 1/1/2012	10 Yrs	20 Yrs
World	7,772	-7.57	-13.31	-8.20	-8.20	6.91	5.14	9.65	10.29	4.91
EAFE (Europe, Australasia, Far East)	7,048	-4.83	-12.50	-13.36	-13.36	3.38	1.00	6.24	6.81	3.96
EM (Emerging Markets)	2,163	-2.60	-7.40	-14.25	-14.25	9.65	2.03	3.61	8.39	8.85
MSCI Indices ($CA) Total Return	Index	1 Month	3 Months	YTD	1 Yr	3 Yrs	5 Yrs	Since 1/1/2012	10 Yrs	20 Yrs
World	10,603	-5.20	-8.64	-0.18	-0.18	6.39	10.51	14.36	11.48	4.31
EAFE (Europe, Australasia, Far East)	9,615	-2.39	-7.78	-5.78	-5.78	2.88	6.16	10.79	7.97	3.36
EM (Emerging Markets)	2,950	-0.10	-2.41	-6.75	-6.75	9.12	7.23	8.05	9.57	8.22
Currency	Level	1 Month	3 Months	YTD	1 Yr	3 Yrs	5 Yrs	Since 1/1/2012	10 Yrs	20 Yrs
Canadian Dollar ($US/$CA)	73.30	-2.50	-5.11	-8.04	-8.04	0.48	-4.86	-	-1.07	0.58
Regional Indices (Native Currency) Price Return	Index	1 Month	3 Months	YTD	1 Yr	3 Yrs	5 Yrs	Since 1/1/2012	10 Yrs	20 Yrs
London FTSE 100 (UK)	6,728	-3.61	-10.41	-12.48	-12.48	2.53	-0.06	4.73	4.26	0.01
Hang Seng (Hong Kong)	25,846	-2.49	-6.99	-13.61	-13.61	5.65	2.09	8.06	6.03	4.84
Nikkei 225 (Japan)	20,015	-10.45	-17.02	-12.08	-12.08	1.69	4.20	18.17	8.49	1.86
Benchmark Bond Yields		3 Month		5 Yr		10 Yr		30 Yr		
Government of Canada Yields		1.65		1.86		1.93		2.14		
U.S. Treasury Yields		2.42		2.49		2.65		2.97		

Canadian Bond Indices ($CA) Total Return	Index	1 Month	3 Months	YTD	1 Yr	3 Yrs	5 Yrs	Since 1/1/2012	10 Yrs
FTSE TMX Canada Universe Bond Index	1,051	1.35	1.76	1.41	1.41	1.86	3.54	2.86	4.16
FTSE TMX Canadian Short Term Bond Index (1-5 Yrs)	710	0.87	1.36	1.91	1.91	1.00	1.73	1.77	2.51
FTSE TMX Canadian Mid Term Bond Index (5-10 Yrs)	1,141	1.60	2.42	1.91	1.90	1.49	3.66	3.17	4.81
FTSE TMX Long Term Bond Index (10+ Yrs)	1,709	1.86	1.87	0.31	0.31	3.23	6.05	4.09	6.39

Sources: TD Securities Inc., Bloomberg Finance L.P. TR: total return, PR: price return. As at December 31, 2018.