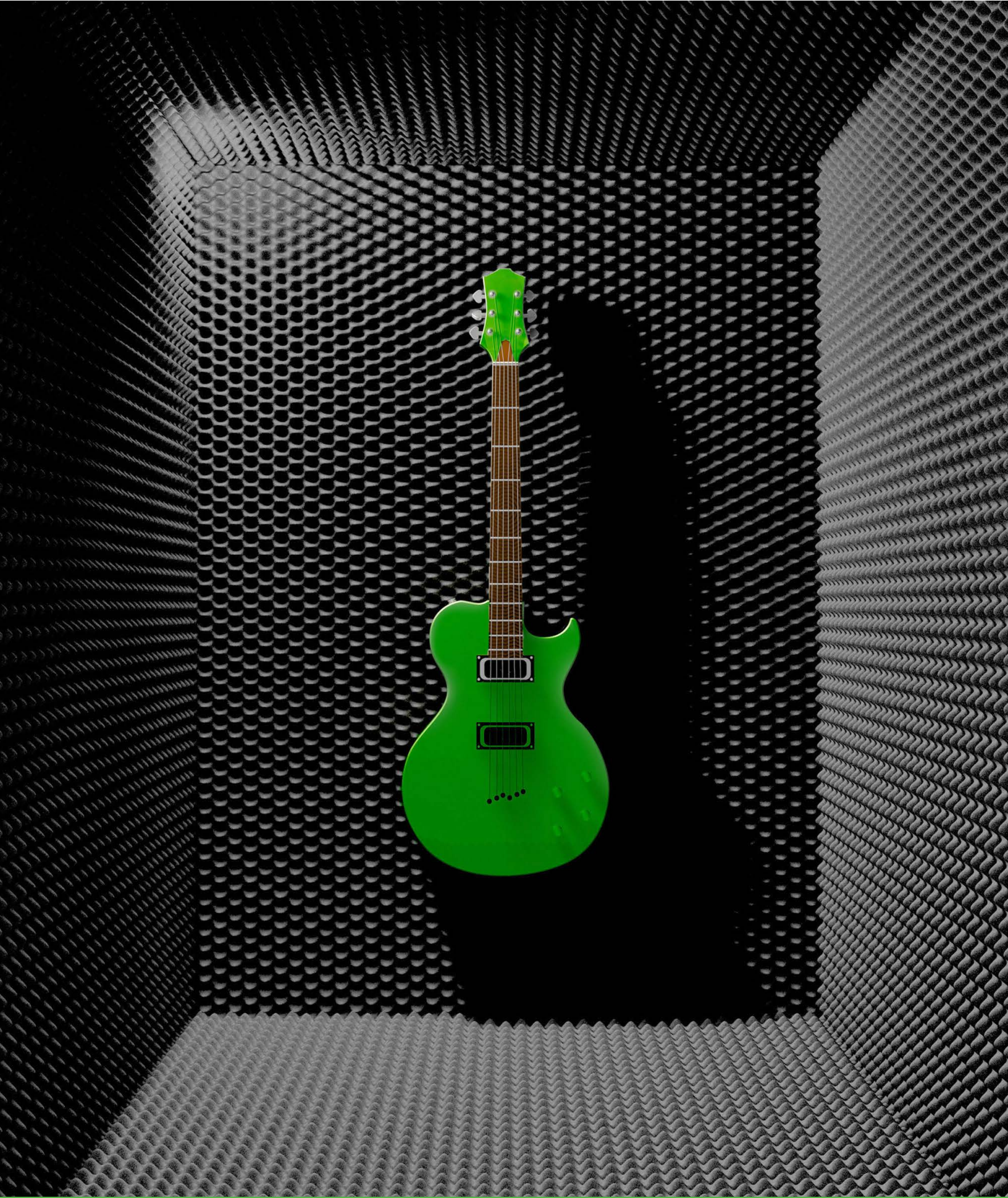


Sound Proof

Portfolio Strategy Quarterly | Q3 2023

July 27, 2023



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Sound Proof.

I have spilled a lot of ink in these pages over the past few years trying my best to shed light on the impact of the experimental monetary and fiscal measures that have been used by policymakers to manage modern financial markets. A byproduct of this trial-and-error method is the havoc it often wreaks to the relevance of past data that portfolio managers use as part of their decision-making process — a cautionary tale for anyone who thinks that just “crunching the numbers” is enough to make decisions in the age of “Big Data.”

It’s easy to be skeptical of arguments that suggest “this time is different,” but we need to be open-minded and honest about our level of foresight. No one should underestimate the unusual dynamics at play. The measures taken to manage the inflationary aftermath of a global economic lockdown have generated a lot of distortion.

That being said, there’s at least one data set that may still be of some use. Markets do still seem to move with the pull and push of monetary and fiscal policy. However, it’s important to be mindful of the fact that a distorted market environment like the one we are in leads to constant second-guessing. Investors appear to be highly confident of one outcome (bearish: a recession is coming); and then a month later highly confident of the opposite (bullish: a new economic cycle has begun).

This is not how you craft an investment strategy, let alone a long-term, goals-based financial plan. Regardless of what happens over the short term, a well-constructed portfolio is designed to navigate extreme scenarios. A good investment strategy is low-conviction over the short term and high-conviction over the long term. It navigates destructive resonance by taking the mid-range where it is more quiet. That’s how you, as an individual, can move away from high-amplitude, high-frequency investment decisions. It’s how you turn down the volume.

Be well,

A handwritten signature in black ink, appearing to read "Brad Simpson".

Brad Simpson
Chief Wealth Strategist, TD Wealth

Cracking Complexity

Complexity

Sentiment Swings

The market has swung between extreme bearishness in Q1 (with money-market assets up 17% in H1) to extreme bullishness in Q2 (with tech premiums at the 98th percentile of their historical range). Investors are being pushed and pulled by mixed economic signals.

Beneath the surface

Seven tech-related stocks have accounted for nearly 100% of the return on the S&P 500 this year. These seven comprise close to 28% of the index, which is now trading at a lofty 20x forward earnings. But if you strip out these seven, the S&P is trading at a reasonable 16.3x. International stocks, meanwhile, are trading closer to 13.3x.

Apple > 2000

Then there's the most valuable public company in the world. Apple's valuation, at over \$3 trillion, is now greater than the combined market capitalization of all 2,000 small-cap issuers on the Russell 2000 index.

Cheap Energy

Oil and gas stocks, on the other hand, are trading at attractive levels, with an enterprise value just 3.7 times estimated EBITDA. This metric has only fallen below 4x in 2008 (a much worse economic environment). The historical average is 6x

Bonds are Back

After a decade or more on the back bench, bonds are coming into their own. Investors can tap into attractive yields in almost all segments of the fixed income asset class. The potential for bonds to support a diversified portfolio amid challenging conditions is attractive — if the 10-year Treasury yield falls from 4% to 3% over the next 12 months, it would represent an absolute return of 7%.

18 Months

July marks 18 months since the Fed started raising rates. Eighteen months is also the maximum amount of time required for monetary policy changes to be reflected in the economy. With the policy rate at 5.25% and inflation having fallen to 3%, there will be much less pressure on the Fed to hike from here.

9 Months

Investors expecting an immediate round of cuts, however, may have to wait a while. Over the past three cycles, the Fed held the policy rate at the peak for an average of nine months before starting to cut, although the range is wide at seven to 14 months.

Overshot?

The Fed is expected to raise rates by at least another 25 bps. Meanwhile, U.S. jobless claims are starting to rise and the unemployment rate is expected to approach 5% in the coming quarters. Are we there yet? Have we missed the exit?

Adaptation

Remember the 10/10/10 Rule

How are you likely to feel about this in 10 minutes vs. 10 months vs. 10 years? Be patient. There's a reason it's considered a virtue.

High-odds Proposition

Over the long term, it's been almost impossible to lose money on the broad market. The probability of making at least some money on the S&P 500 over a five-year period is 85%; over a 20-year period it's 100%.

Be Compensated

The goal of factor diversification is to reduce unintended risk exposures and target exposure to compensated factors while minimizing exposure to uncompensated factors.

Tactics on the Margins

Tactical or dynamic shifts should only be made at the margin, in an intentional and risk-controlled manner. Strategic asset allocation remains the principal driver of portfolio performance and is paramount in helping investors achieve their objectives.

True Diversification

To prosper in this new world, investors need a contemporary portfolio approach with true diversification, balancing: (1) broad asset allocation and (2) risk-factor diversification with (3) a deep understanding of financial behaviour.

Foursquare

There are four basic economic environments: rising growth, falling growth, rising inflation and falling inflation. Markets react as economies shift from one to another, but transitions are unpredictable and can be fraught. We don't predict the future, we invest in all four areas.

7 Years Bad Luck

Markets are awful at predicting central bank decisions. In 2008, investors were bracing for hikes, which didn't actually occur until seven years later. Then, in 2015, they vastly underestimated the speed of those hikes. Bottom line: The Fed responds to data, not sentiment.

Process Over Prediction

We manage investments based on a guiding set of principles designed to work in a world that's constantly changing. We focus on investor's goals and true diversification. We build resilient portfolios that aim to perform regardless of the environment.



PSQ3.2023 | Executive Summary

■ **House Views | Fixed Income, maximum overweight:** Yields within fixed income are well above the lows of the past decade and offer attractive, risk-adjusted potential returns. While government bond rates have been volatile in the first half of the year, the outlook is positive as nominal total returns remain appealing. However, spreads within the corporate universe of fixed income have tightened and become less attractive. We maintain a Neutral view on Investment Grade corporate credit and continue to see attractive opportunities in the lower duration universe, less than 5-years whereas tight credit spreads throughout the high yield universe remain unattractive. As such we continue to maintain a Modest Underweight in High Yield credit. • **Equity, modest underweight:** The committee continues to hold a cautious stance on equities over the short term. Global equity markets have climbed year to date, with mega-cap tech stocks accounting for the bulk of the increase. This has resulted in a very tight equity risk premium, at a time when earnings risk remains elevated. This suggests there is limited return potential in the near term, hence the Modest Underweight stance. Over time, they expect higher-quality companies to overcome current headwinds. Strong free cash flow within the Energy sector and relatively attractive valuations within Financials may present attractive opportunities in Canadian equities. The committee is watching for macro warning signals that will precipitate an eventual defensive shift. • **Alternatives, Neutral:** The view is mixed within Alternative Assets. Overall, alternative assets can provide inflation protection and attractive absolute returns, while acting as long-term portfolio stabilizers via their diversification benefits and less correlated income streams. The committee believes an allocation to select alternative assets such as Commercial Mortgages (Maximum Overweight), Infrastructure and Private Debt (Modest Overweight) can benefit diversified portfolios. The committee is Maximum underweight in Canadian and global real estate. However, even still there are compelling opportunities in real estate, but investors must take a very intentional and nuanced approach.

■ **Quarter in Review |** The second quarter was marked by strong equity-market performance. A few mega-cap growth stocks rallied and outperformed other names to drive equity markets higher. Artificial intelligence (AI) became the buzzword of the earning season, and names directly exposed to the theme benefited significantly. **U.S. debt ceiling:** The resolution of the U.S. debt-ceiling situation in June led to some outsized dislocations in the market, especially for Treasury bills, which turned out to be a tactical opportunity. **Investor sentiment revived:** Investor sentiment improved significantly. Money-market inflows started to fade, while inflows to equity funds became positive in June. The VIX (aka, the “fear gauge”) hit its lowest level since the onset of the pandemic. The poster child of semiconductor industry, NVIDIA hit a new high. **Geopolitical risks:** Structural changes on the geopolitical front continued to play out, with the most important being deglobalization and China/U.S. relations. U.S. Secretary of State Antony Blinken and Secretary of the Treasury Janet Yellen visited Beijing. The main takeaways from the U.S. State Department's statement include keeping bilateral communication open, managing competition to avoid conflict and partnering where necessary on global issues like climate change and global economic stability.

■ **Economy |** Was it truly an innocent slip when Federal Reserve Chair Powell referred to the decision to not hike rates in June as a “skip” in the meeting cadence? Probably not. The Fed is treating every meeting as a live decision of “go” or “no go”. This is a shift from the previously telegraphed path of continuous rate hikes, where only the magnitude was the point of discussion. And this is a good thing. • The Federal Reserve has moved to a meeting-by-meeting approach as it explores the stopping point on interest rates. • We think that occurs at 5.50%, but even in that case, the Fed will need to ensure communication jawbones the market to prevent a drop in yields. • The Bank of Canada has already jumped back in with another hike after pausing in January. The population surge poses a challenge for a central bank that would prefer to remain on the sidelines but cannot ignore the demand shock.

■ **Fixed Income |** Income and diversification on offer from bonds is more enticing. Today's starting yields provide attractive entry points and yields across fixed income sectors are at levels not seen in over a decade offering real potential for future returns. This healthy yield cushion also implies bonds will be able to deliver positive returns and offset losses from other riskier investments. We remain maximum overweight fixed income investments in general and modest overweight domestic government bonds. We remain neutral investment grade credit as we expect the challenging economic conditions to widen spreads. We maintain our modest underweight view on high-yield credit.

■ **Equities** | Global stock markets are trading sharply higher in the first half of this year, with U.S. equities leading the pack. But the breadth of this rally is the narrowest on record for the S&P 500: seven large-cap technology companies have accounted for close to 100% of the returns so far in 2023. • **Energy – Value and Income:** The supply-demand balance for oil has tightened structurally. At the same time, companies have generally moved their capital allocation framework away from investments in growth (like new rig deployments) and towards shareholder returns in the form of dividends and stock buybacks. These factors have turned oil and gas into a late-stage target of value and income investors this cycle. • **Banks – Income Opportunity:** Investing in banks is a negative art that emphasizes exclusion rather than searching for the stock with the highest upside. This is especially important due to the significance of banks, particularly Canadian banks, as income-generating investments. We believe that current valuation levels are reasonably attractive and reflect the near-term headwinds to earnings growth. • **Technology – Multiple Paths to Growth:** While navigating through the post-pandemic demand normalization, we remain focused on the macroeconomic trends that will help grow earnings, and we see these themes as key drivers of the compounding effect on the underlying fundamentals in the sector. • **Industrials & Materials – Theme Playing:** The larger themes in the economy that we see as driving a secular growth pattern right now are related to re-shoring (or near-shoring) reduced carbon (renewable energy, electric vehicles), and the advent of artificial intelligence (AI). Today, AI is early-stage and, as a theme, mostly affects the technology sector. Eventually though, it will move out of the development stage and to a point where applications are developed that will change aspects of manufacturing and logistics. • **International Equity and Emerging Markets – The Case for Diversifying:** U.S. stocks outperformed international and emerging-market stocks in Q2/23 due to the strong performance of tech stocks, which account for a sizeable part of U.S. equity benchmarks. The S&P 500 rose 8.5% during the quarter, while international and EM stocks were roughly flat.

■ **Alternatives | Real estate:** Commercial real estate continued to correct through the first half of the year, returning -3% across all property types. Higher interest rates and tighter lending conditions have weighed on asset values. • **Residential:** Average Canadian asking rents rose to a record-setting \$2,042 in June, driven by record population growth, strong employment and reluctant homebuyers. We believe residential sector is well positioned in both the near and long term given secular tailwinds affecting the sector. • **Industrial.** The industrial sector in Canada continues to tilt towards a balanced market, with new supply outpacing market absorptions or leases, edging vacancies higher to 2.1%. Vacancies, however, remain well below the 15-year historical average of 4.8%. • **Office:** The office sector in Canada continues to see vacancies rise. Average class A office net rental rate fell slightly to \$25.43 per square feet nationally, reflecting landlord's continued reluctance to lower rents. • **Infrastructure:** Private infrastructure returned approximately 2% in Q1 2023, with falling equity risk premiums and higher cash flow forecasts offsetting interest-rate impacts. • **Private debt:** We believe the asset class is well positioned for the current macroeconomic environment.

■ **Currencies | USD:** The U.S. dollar looks overvalued and most indicators are pointing to weakness ahead. The end of the Fed cycle is normally quite bearish for USD for the first few months after the last hike. In addition, U.S. data momentum is lagging the rest of world, which also points to a lower U.S. dollar. • **CAD:** The outlook for Canadian dollar is more positive, given that it is likely to catch the tailwinds of broader USD weakness. The Bank of Canada delivered a 25-bp hike in July, helping to provide a positive catalyst for the loonie.

■ **Commodities |** Droughts across North and South America following three successive years of La-Nina have heightened commodity-market sensitivity to weather patterns. With La-Nina conditions finally subsiding, focus is now turning to the likelihood, timing and severity of El-Nino. • **Mixed impact on agricultural commodities:** Every El-Nino/La-Nina event is unique in its timing, severity and locality. Historically we can generalize the favourable/unfavourable impact of El-Nino and La-Nina on major crops in various areas. • **Constructive on energy:** The overhang of inventories that built up in Q1, due to an extremely warm winter in Europe and the front-loading of supply from Russia as it tried to get ahead of sanctions, have been drawn down over Q2 and we see a tight balance through H2. • **Demand stabilizing for metals:** Base metals found a floor in Q2 as Chinese demand slowly recovers, albeit at a slower than expected pace. Weakening manufacturing activity combined with deleveraging in the real estate sector has sent some base metal (zinc and aluminum) prices down into their cost curves, which has stimulated buying activity in China. • **Bull cycle on the horizon:** In the short term, macro concerns continue to mask the reasonably constructive micro-fundamentals as evidenced by tight inventories across many commodities.

What's the frequency?

Brad Simpson, Chief Wealth Strategist | TD Wealth

I have spilled a lot of ink in these pages over the past few years trying my best to shed light on the impact of the experimental monetary and fiscal measures that have been used by policymakers to manage modern financial markets. A byproduct of this trial-and-error method is the havoc it often wreaks to the relevance of past data that portfolio managers use as part of their decision-making process — a cautionary tale for anyone who thinks that just “crunching the numbers” is enough to make decisions in the age of “Big Data.”

It's easy to be skeptical of arguments that suggest “this time it's different,” but we need to be open-minded and honest about our level of foresight. No one should underestimate the unusual dynamics at play. The measures taken to manage the inflationary aftermath of a global economic lockdown and a war-induced oil shock have generated a lot of distortion, and there's a good chance that central banks will overshoot again in their quest to bring inflation down to earth, as has been the case historically.

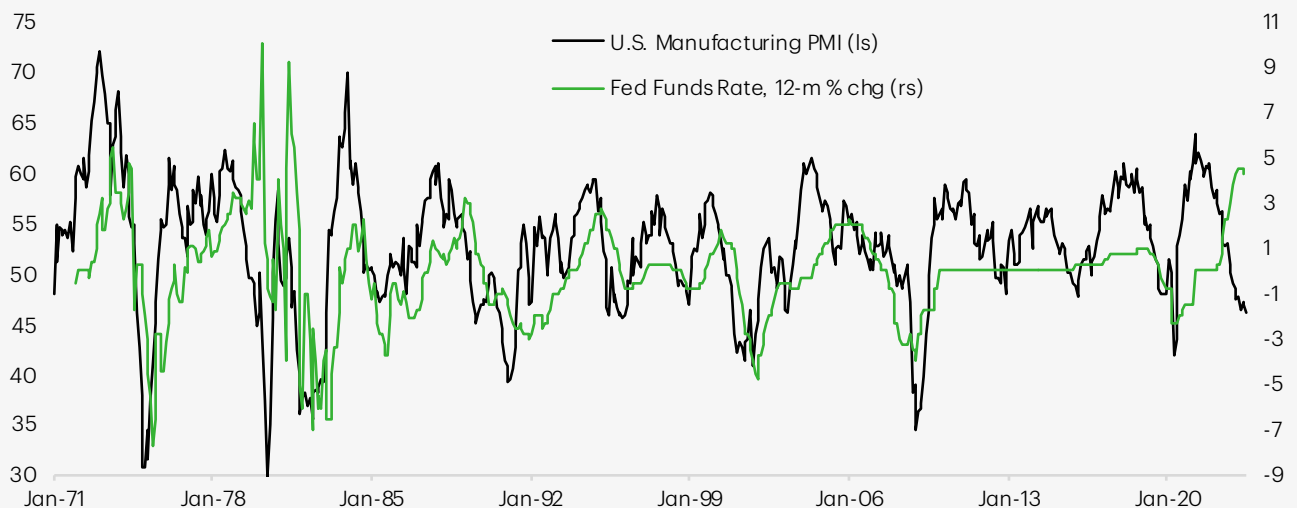
That being said, there's at least one data set that may still be of some use. Markets do still seem to move with the pull and push of monetary and fiscal policy. This relationship creates a beautiful pattern over a long period of time, eerily reminiscent of soundwaves generating various levels of vibration as frequency and amplitude oscillate like strings on a violin (Figure 1). After all, we used to call former Fed Chair Alan Greenspan “The Maestro.”

When economic growth is slowing and the market is depressed, the central bank acts as conductor, directing an uplifting tune by loosening its strings. When the market is hyperactive, it orchestrates a calming tune and tightens them. This is evident in the way the U.S. manufacturing PMI — a proxy for business confidence — has historically moved in lockstep with monetary policy. When business confidence wanes, the Fed cuts; when confidence rises, it does the opposite. In fact, the only exception over the past four decades to this beautiful harmony occurred in 1978, during the oil shock induced by the Iranian Revolution, when inflation was soaring into double digits.

As you can imagine, those were some stressful years. Now, I want you to picture the Fed getting nervous, thinking that perhaps that its worst fears can come true. The lesson from the 1970s is clear. From early 1978 (when the Iranian revolution began) to November 1979, the Fed raised its rates from around 6.5% to 15.5%, while CPI inflation in the U.S. rose from 6.7% to 12.6%. The S&P 500 index rose roughly 10% during the same period, but in February it turned sharply, plunging 20% in just one month.

The Fed might have paused its rate hikes here, but because monetary policy hadn't yet filtered into the economy, inflation was still going up. It took another four months before inflation finally peaked at 14.8%, and by then the policy rate in the U.S. was at 20% — a level that was highly restrictive even at the time.

Figure 1: Business and monetary cycles move in lockstep



By July 1980 the Fed had cut interest rates to 9.5%, causing the stock market to rally, but then decided to raise them again, back up to 20% by the end of the year, even as inflation continued to trend lower. This example of high-amplitude, high-frequency monetary policy led the U.S. economy to fall into a double-dip recession that did not end until the second quarter of 1982.

I confess, I was 13 at the time and was for the most part blessedly unaware of the crisis unfolding, except for the look of worry on my dad's face when he came home. (He was a portfolio manager at the time and still is, I'm proud to say.) These were tough times, and no one who lived or worked through the inflation crisis wanted to ever experience it again. Since this time, the haunting memory has been handed down to each succeeding generation of central banker and investment professional, with an unspoken but understood promise to avoid repeating it at all costs. In 2022, former chair of the U.S. Federal Reserve Ben Bernanke wrote extensively on this subject in his book *21st Century Monetary Policy: The Federal Reserve from the Great Inflation to COVID-19*:

"As a childhood trauma shapes an adult's personality, the Great Inflation shaped the theory and practice of monetary policy for years to come, both in the United States and around the world. Critically, central banks incorporated the lessons of the period in a policy framework focused on controlling inflation and managing inflation expectations - a framework that remained highly influential, even as inflation receded. The experience of the Great Inflation, which showed how political pressure can distort monetary policy, also convinced many that monetary policymakers should make their decisions, to the extent possible, independently, based on objective analysis and in the long-run interest of the economy."

I don't think it's a stretch to suggest that the current chair, Jerome Powell, has been shaped by similar traumas, at least if some of his recent comments are any indication:

"The Federal Open Market Committee's (FOMC) overarching focus right now is to bring inflation back down to our 2% goal,"..."Price stability is the responsibility of the Federal Reserve and serves as the bedrock of our economy. Without price stability, the economy does not work for anyone."

Over the past three or so decades, central banks have managed to keep that promise. The past few years, however, have provided a shock to the system that's reminiscent of those in the early 1980s, with the

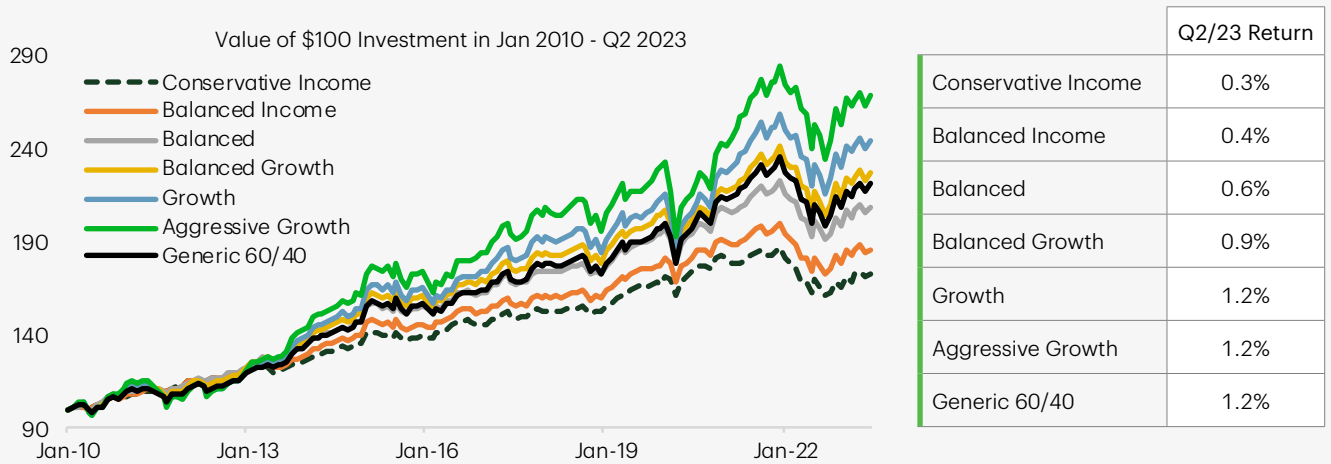
pandemic followed closely by the oil shock stemming from the Russo-Ukrainian war. The inflation challenges facing global central banks today have increased the amplitude of monetary policy in the current cycle. This has led to the most accommodative period in American history, with emergency fiscal and monetary policy both playing their parts.

Now, to be fair, it was hard to be critical of these measures at the time, but in hindsight we know that policy was kept too loose for too long. The zero-rate loans and pandemic benefits of 2020 and 2021 artificially amplified the economic boom we've seen over the past two years. Unlike normal periods when the Fed works to counteract spikes and plunges in business confidence, this time around monetary policy has reinforced those excesses. The trouble with that is, by reinforcing the pendulum swing in one direction, central bankers now have to work even harder to counteract the backswing. If the fear of entrenched inflation leads policymakers to overtighten, it could mean a more violent transition of boom to bust.

For proof of the global market's tendency to follow central bankers' overreactions, we need only look at our current environment of extremes — with investors earlier in the year stampeding into guaranteed short-term deposits; followed more recently by bullish investors pouring their wealth into richly valued tech stocks in the hopes that the latest trend (AI) will become self-sustaining. Assets held in money-market funds rose from US\$4.7 trillion at the beginning of 2023 to \$5.5 trillion by the first week of July, while valuation premiums for the info-tech sector have more recently reached the 98th percentile of their historical range. The extent and speed of this shift in risk sentiment is like soundwaves being pulled into higher amplitude and squeezed into higher frequency. This creates something that science calls "destructive resonance," which incidentally, can also warp the metallic structures in bridges, buildings and even trains. R.E.M. has a song called "What's the Frequency Kenneth?" that I recommend; the guitar track perfectly accentuates the distortion of this market: It's high.

Figure 2 shows returns for six passively managed portfolios since 2010, with Q1 2023 pulled out. I share this because it highlights the theoretical returns between the most conservative benchmarked portfolio and the most aggressive, plus the generic returns of a traditional 60/40 benchmark portfolio — all of which were roughly flat in the quarter, as the push and pull of positive and negative economic data left diversified investors directionless.

Figure 2: Data leaves investors directionless in Q2



Source: FactSet, Wealth Investment Office as of July 10, 2023

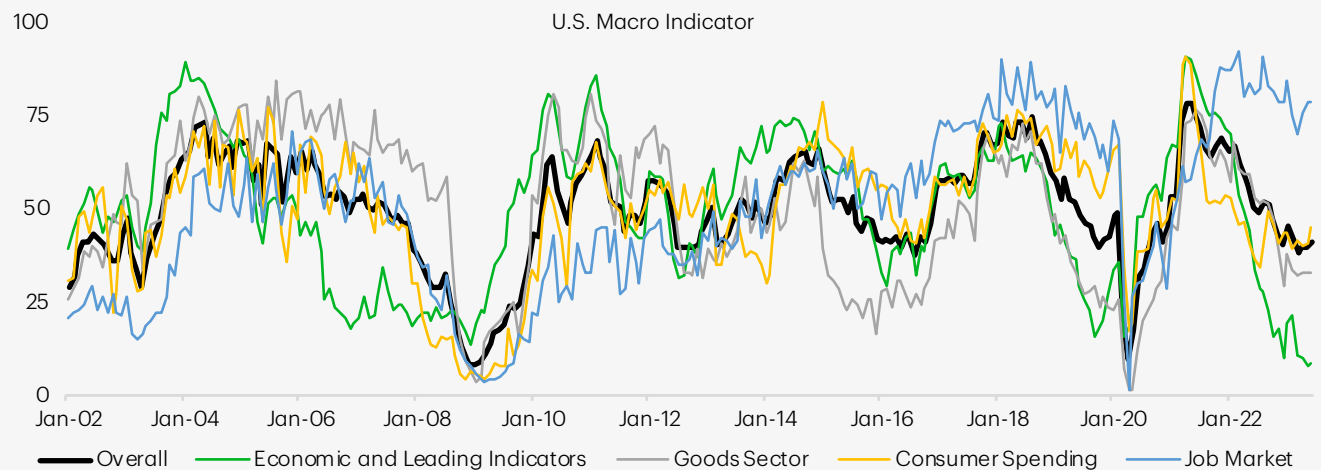
These are precisely the times when I like to fall back on a well-worn adage of mine: It's not what you think, but *how* you think. Investors far too often try to make decisions in the heat of the moment when the distortion is most extreme, by cobbling together whatever information they can quickly grasp — an approach that's bound to fail over time. Our approach, by contrast, is to quantify our decision-making processes, so that when we get into an environment like this one, we're prepared for it. We do this in a very structured way, by looking at the indicators for four areas: (1) the economy; (2) the industrial manufacturing sector; (3) consumer spending; and (4) the jobs market.

Let's start by considering the biggest and most important player in the global economy, the United States. Now, among these indicators, the economic and goods manufacturing data are viewed as leading indicators, while the jobs market and consumer spending are viewed as lagging indicators.

In Figure 3, we can start to see the trajectory of the economy. While the jobs market remains strong and consumer spending has been resilient, we need to stress again that these are lagging indicators. Overall economic growth, meanwhile, has been slowing consistently, and purchasing managers indices (PMIs) for the manufacturing side of the economy are already in contractionary territory, having fallen for eight months in a row.

It's true that, according to the same PMIs, the services side of the U.S. economy is still expanding — and the services side is much larger than the manufacturing side — but the outlook for a softer labour market amid tight monetary policy should lead service spending to also slow. Debt-servicing costs, which may have seemed light when interest rates were at rock bottom, will start to feel onerous, and that has an effect on consumer confidence more generally.

Figure 3: Employment is the last man standing



Source: FactSet, Wealth Investment Office as of July 10, 2023

Another potential headwind in the U.S. is the resumption of student loan payments in October. As part of the debt-ceiling deal, Congress ended the three-year moratorium on student debt repayment. As a result, an estimated 27 million borrowers, out of a total 46 million student loans, will need to resume making regular payments by October. Based on a TD Economics estimate, the average monthly payment for the Direct Loan borrowers is around \$350 per-month. The hit to household consumption overall could be as much 0.3 percentage points by mid-2024.

How about the rest of the world?

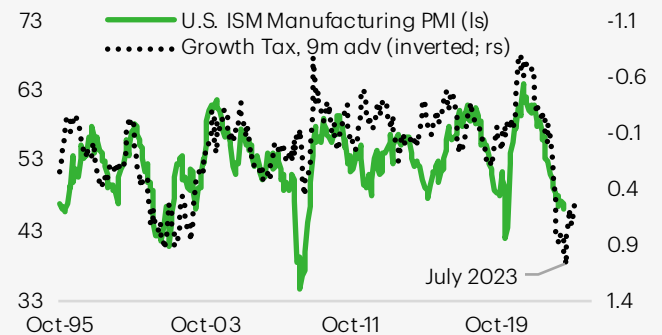
After the Fed's "hawkish pause" in June, it now appears that the major global central banks are, once again, getting ready to stamp out excess inflation. The Bank of Canada, which has been a first mover in this latest cycle, unexpectedly raised its policy rate by 25 bps. Yields across the developed world surged following the BoC's decision, with investors learning that, even after a well-telegraphed pause, central banks can still change their mind and tighten the screw. Consider the Bank of England's surprise 50-bp hike, a move which signalled heightened concern around the UK's inflation outlook. With the potential for stagflation lurking in Europe, the jury is still out on the next ECB move, but so far it has matched every move by the BoE. The big question is whether the Fed has already overtightened. It's impossible to say for certain, but what we can say is that there are strong arguments that the U.S. central bank has tightened enough. And there are a few somewhat weaker arguments to the contrary.

Some of our indicators are indeed pointing to a bottoming in manufacturing activity. For instance, our growth tax indicator — the average of the dollar, oil price and 10-year yield, all standardized — has been pointing to a potential bottom in the U.S. manufacturing PMI sometime between July and

October 2023 (Figure 4). The problem today is that the market has been front-running the potential recovery in the goods sector rather aggressively. Although we agree that a bottom is likely, the probability of a sharp rebound is low given that tight monetary policy is still in place (Figure 5).

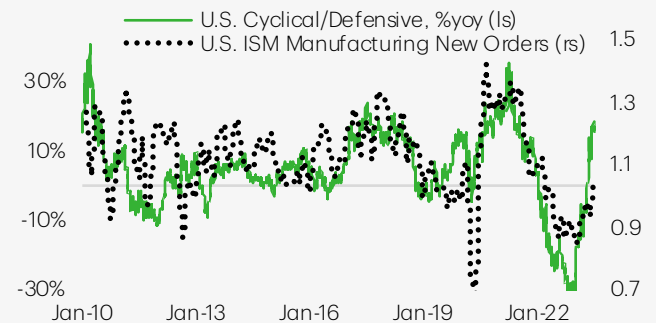
We can also see some mixed messaging in other U.S. economic figures. More recently, U.S. gross domestic income — another measure of economic output — fell for the second consecutive quarter in Q1/23, although GDP growth remained positive (Figure 6).

Figure 4: Growth tax indicator points to a bottom in manufacturing activity ...



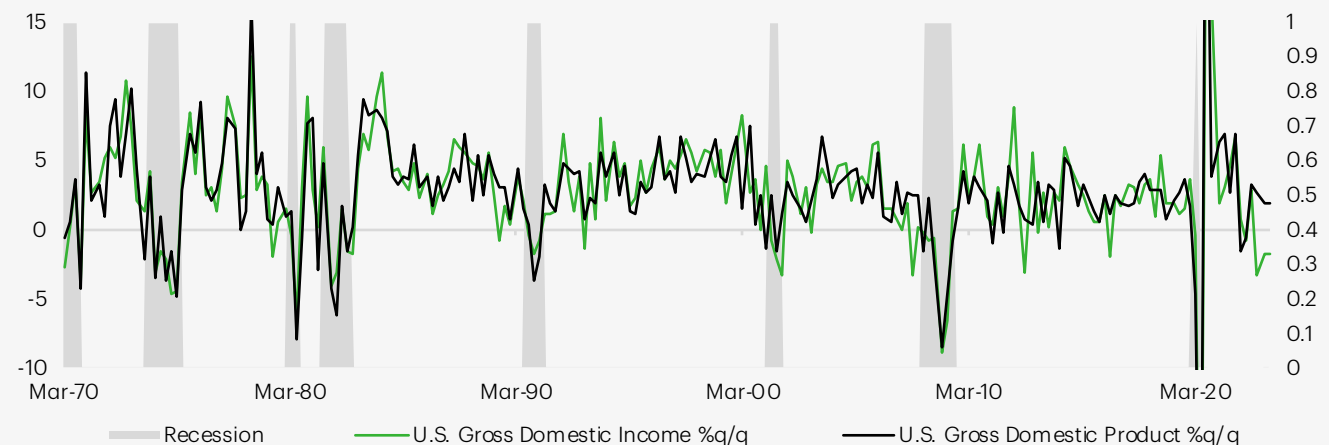
Source: FactSet, Wealth Investment Office as of July 10, 2023

Figure 5: ... but the equity market has been pricing this aggressively



Source: FactSet, Wealth Investment Office as of July 10, 2023

Figure 6: U.S. GDI has contracted for two consecutive quarters



Source: FactSet, Wealth Investment Office as of July 10, 2023

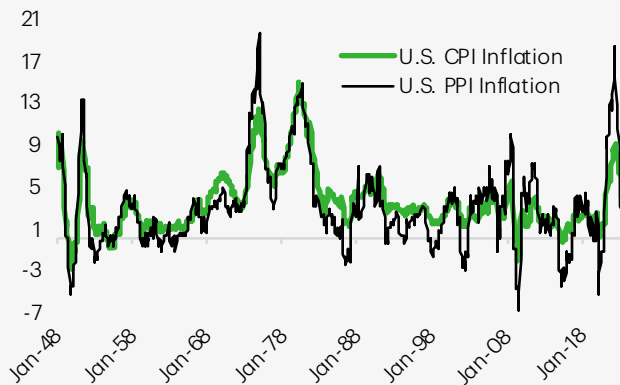
One good argument against further hikes is the commodities weakness we've seen recently. Despite rounds of supply cuts by OPEC and its allies, oil prices are trading at only around US\$75 per barrel, while the economic recovery in China has yet to drive base metal prices higher. Low commodity prices are good news for the fight against inflation, but the risk is that, by tightening into weakness, central banks may create a *deflationary* slump next year, especially given that producer price indices (PPIs) in many countries have already fallen into outright deflation. History shows that it does not take long for CPI inflation to fall alongside producer prices (Figure 7).

On the other side of the world, meanwhile, the world's second largest economy has stumbled under the weight of expectations (Figure 8). Demand for Chinese manufactured goods is slow, and the service sector cannot sustain the economy. There are a few thoughts to consider here (other than the obvious conclusion that this is a negative surprise for global growth).

The first is that, while the weak recovery is bad news for global growth, it actually helps alleviate inflation pressure for the developed world. Previous boom-bust commodity cycles, especially for industrial metals,

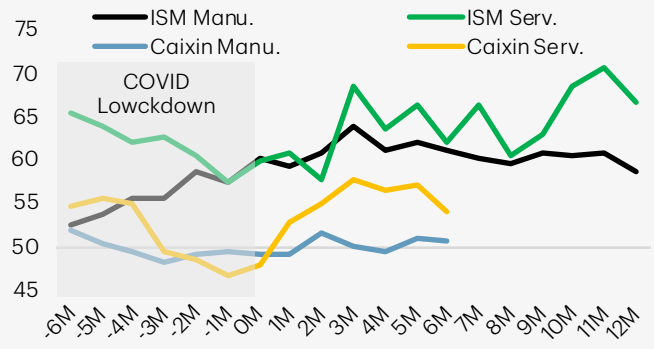
largely depended on the investment-led economic cycles in China. This time around, China has not stoked its economy by gobbling up commodities, which helps keep prices lower. In China, the leadership is well aware of the experience following the financial crisis at the turn of the century, when an outsized fiscal package was launched to boost growth and upgrade domestic infrastructure. It led to a commodity boom cycle, which pushed U.S. inflation up over its 2% target by the early 2010s. It also created an oversupply imbalance in China. This is why China's leadership is so hesitant about overstimulating, and why China's current economic recovery has fallen below market expectations. Further, China is facing long-term structural challenges from declining demographic growth, a weak property sector and issues surrounding elevated local government debt. Forget about inflation, deflation may be the bigger concern with the GDP deflator falling into contraction in the second quarter, a -1.5% yoy decline something not seen since the GFC in 2008 (Figure 9). China's issues are deep. The longer and more persistent the economic underperformance, the more attention it will get from the top, which could nudge their policymakers in the right direction.

Figure 7: CPI historically follows decline in PPI



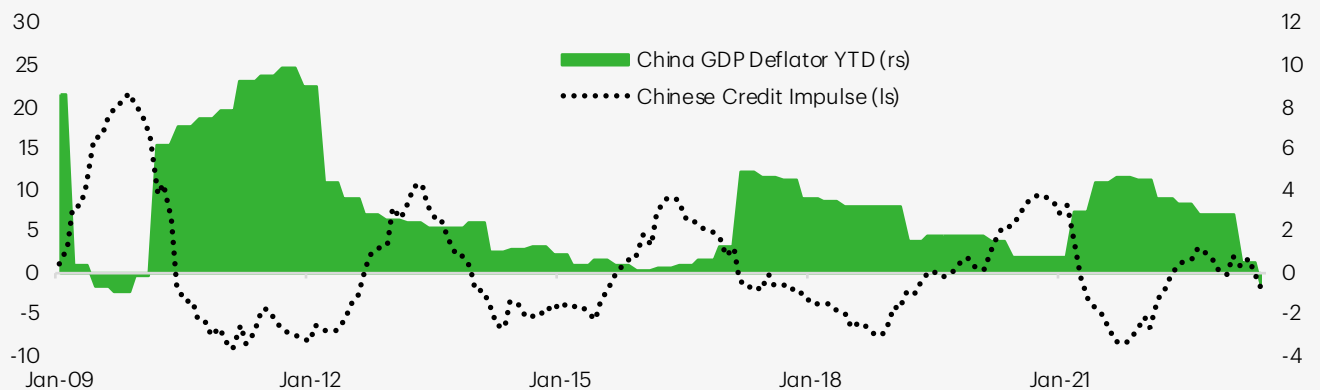
Source: FactSet, Wealth Investment Office as of July 10, 2023

Figure 8: China's Reopening Lagging Expectations



Source: FactSet, Wealth Investment Office as of July 10, 2023

Figure 9: China is facing deflationary forces



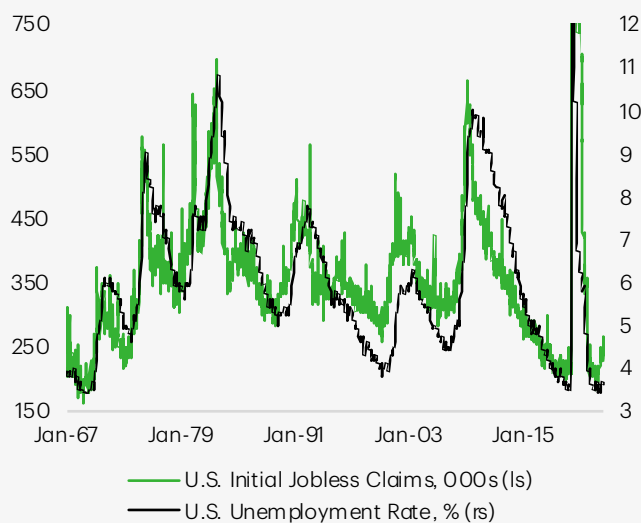
Source: China National Bureau of Statistics, Wealth Investment Office, as of July 25, 2023.

Another good reason for the Fed to stand pat is the fact that many economies have already entered a recession (or at least one definition of it). The final reading of first-quarter GDP numbers, released in May and June, reveal that Europe, New Zealand and several other developed countries have already recorded “technical” recessions — defined as two consecutive quarters of contraction. Our worry is that, unlike previous growth slowdowns, where fiscal and monetary policy turned looser, currently global central banks are still determined to tighten the screw further. The Fed, for instance, is expected to raise its policy rate by at least another 25 bps, whereas the European Central Bank is priced in for another 50 bps worth of rate hikes, along with other global central banks (Bank of England +125 bps, Australia +50 bps, Canada +25 bps). There is increasing risk of policymakers becoming a “fool in the shower” by cranking monetary policy too far and too fast, without waiting to gauge the impact of their initial actions.

There’s also inflation itself, which has been steadily trending down, along with the breakeven rate (a proxy for expected inflation). Headline and core CPI figures should continue to fall over the coming months, supported by the lower housing inflation that has started to show up in the official CPI data.

While the labour market remains very tight, with annual wage growth over 4%, it’s also true that jobless claims are once again beginning to rise (Figure 10). That’s consistent with the 12 to 18 months it normally takes for monetary policy to be reflected in macroeconomic data. There is now a high likelihood that the U.S. unemployment rate will increase closer to 5% in the coming quarters. After a much stronger labour market

Figure 10: Rise in jobless claims herald weaker labour market ahead



Source: FactSet, Wealth Investment Office, as of July 10, 2023

than expected, and robust consumer spending in the first half, risks for these two intertwined variables will only grow in the second half.

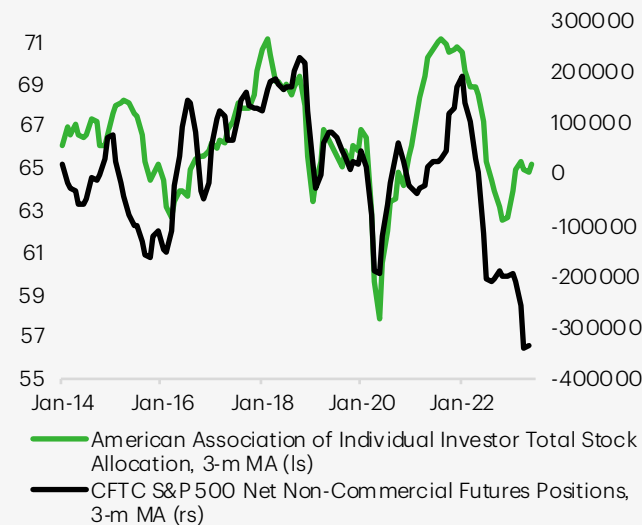
The other argument — that more tightening is needed to bring down inflation — is less compelling in our view, but it’s valid nonetheless. Monetary hawks argue that the workers who left their jobs during the pandemic may never re-enter the workforce, leading to persistent labour shortages and much stickier wage growth. If that’s the case, then policymakers would be better off tilting the balance to overtightening than risk a wage-price spiral and years of chronic inflation.

Consumer spending has also proven to be remarkably resilient in this tight labour market. Demand for services remains, if not robust, then at least expansionary, with the U.S. PMI even accelerating to 53.9 in June from 50.3 the previous month. Higher wages could keep consumer spending elevated and even support homebuyers — a possibility that may already be reflected in the improvements we’ve seen for the housing sector, with prices again on the rise and sales and homebuilding activities accelerating, despite the shock of higher mortgage rates.

Turning down the volume

Last October, when the S&P 500 was trading at 3,600, risk sentiment was at rock bottom. Retail investors were extremely bearish and institutional investors were shorting the market at record levels (Figure 11). Both sides were expecting a global recession to come sooner rather than later. The surprising resilience of the U.S. economy and lack of marginal sellers in the market meant the bar was low for stock prices to stage a rebound.

Figure 11: Retail sentiment shifted from extreme bearish to bullish, pros stayed the same



Source: FactSet, Wealth Investment Office, as of July 17, 2023

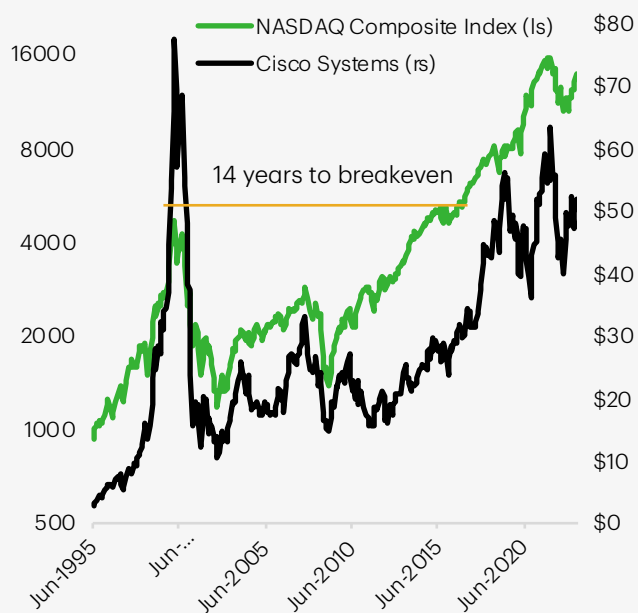
Throw in the AI-driven tech rally and you get a pretty good picture of what happened over the first two quarters of 2023. During this time, we, like many professional investors, have maintained a more cautious view towards risk assets (picking up pennies in front of a steamroller comes to mind).

After a 20% rise from its October low, the S&P 500 is at the end of June back to trading at 20x forward earnings, driven by the mega-cap tech stocks that account for fully 28% of the index. Investors should be cautious of chasing the rally in tech stocks, despite their promising outlook and the fact that they have been winners over the past decade. In the investment world, overpaying for growth could cost you dearly. Take, for example, the case of Cisco Systems during the dot-com bubble of 2000. Although the internet and its potential applications have grown beyond our wildest imagination, investors who bought and held Cisco stock at the height of the internet bubble would have yet to break even on their investment — even after more than two decades. It's a similar story for the Nasdaq index, which is a great proxy for overpriced tech companies — it took this index over 14 years to get back to even after the collapse in 2000 (Figure 12).

What does AI think?

Ironically, even AI agrees with me on this. The following is the response to my query to ChatGPT on the wisdom of chasing valuation-stretched tech stocks:

Figure 12: Long Way Back



Source: FactSet, Wealth Investment Office, as of July 17, 2023

As an AI language model, I don't have personal opinions, but I can provide some general insights. Chasing after investments in expensive technology companies can be both rewarding and risky.

On the positive side, some technology companies with high valuations may have significant growth potential, innovative products, and a strong market presence. Investing in such companies early on could lead to substantial returns if they continue to thrive and expand.

However, it's crucial to be cautious when investing in expensive technology companies. High valuations can also carry greater risks, including the possibility of overvaluation, market fluctuations, or changes in technology trends. Investors should conduct thorough research, assess the company's fundamentals, and consider their own risk tolerance before making any investment decisions.

Diversification is another key aspect of investment strategy. Allocating funds across a variety of assets, including different industries and risk levels, can help mitigate risks associated with investing in individual companies.

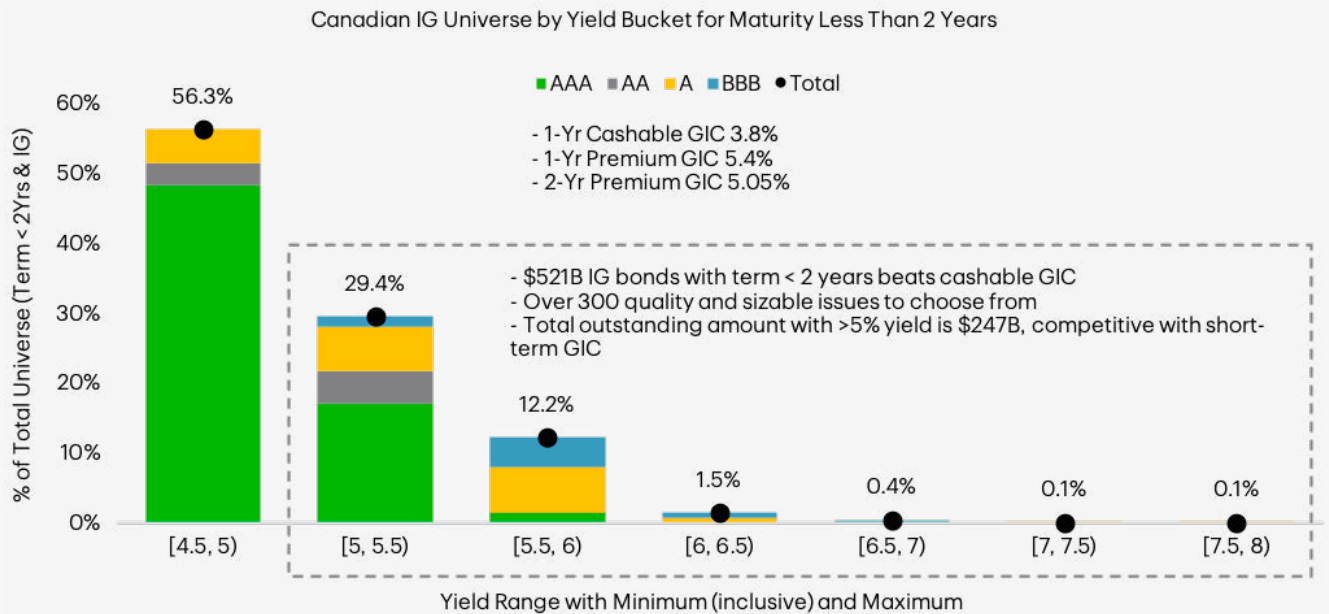
In summary, chasing investments in expensive technology companies can be profitable, but it requires careful analysis and a well-thought-out investment strategy to balance potential gains with potential risks. Always consult with a financial advisor or professional before making any investment decisions.

Last track

A distorted market environment like the one we're in leads to constant second-guessing. Investors appear to be highly confident of one outcome (bearish: a recession is coming); and then a month later highly confident of the opposite (bullish: a new economic cycle has begun). This is not how you craft and execute an investment strategy. Rather, you need to assess the probabilities of various scenarios and construct a portfolio that takes advantage of likely scenarios while taking into account unlikely scenarios (because those can happen too). Here is some of our clearest thinking on the matter:

- With inflation continuing to normalize, we maintain our positive view on government bond duration and expect yields to trend lower in time.
- Short-term yields are very attractive. The total universe of Canadian investment-grade credit yields at least 5.5%, beating the posted cashable one-year GIC of 3.8%.

Figure 13: Bonds aplenty, yields galore

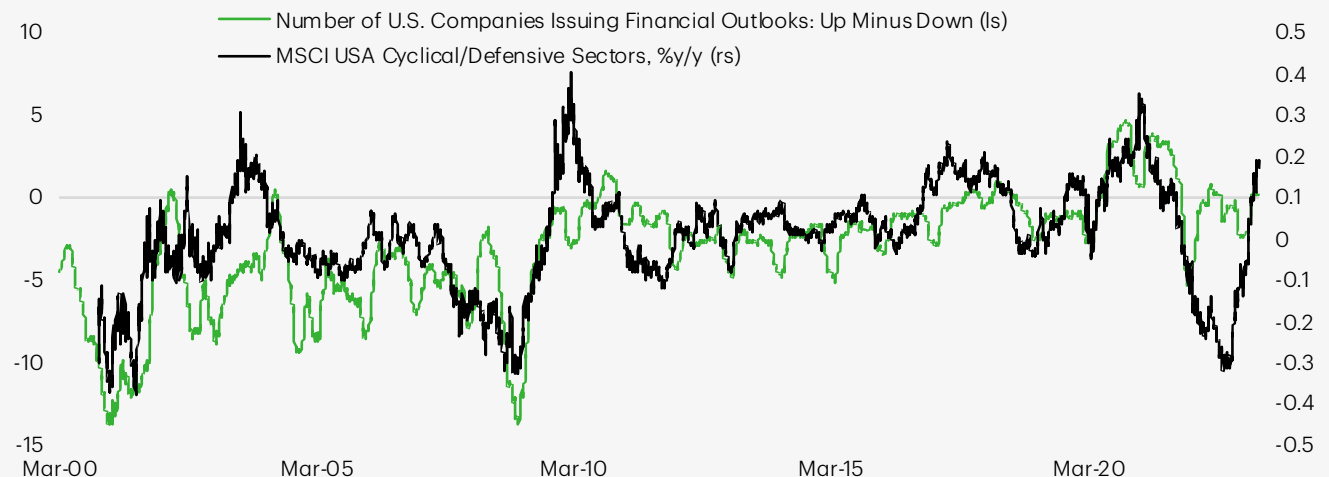


Source: FactSet, Wealth Investment Office, as of July 17, 2023

- In Canada, we have a neutral view for Canadian equities given that we expect inflation to continue to decline in 2023 and rate hikes to stall. The full effect of higher rates on the consumer and real estate market remains to be seen. As such, we anticipate that the Canadian economy will slow in 2023.
- The Canadian energy sector, however, presents attractive opportunities, due to strong free cash flows, attractive valuation levels and growing dividends. In addition, the relatively inexpensive financial sector offers attractive dividend yields and may present opportunities.
- In the U.S., Government stimulus programs remain in effect: the U.S. Inflation Reduction Act and the Chips & Science Act; the EU Recovery Plan; China's "1+N" Policy Framework

- Consumer sentiment has improved recently. The University of Michigan index of consumer sentiment was up to 72.6 for July (its highest since September 2021).
- The worst of the PMI contractions appear to be behind us. The PMI Composite has been in expansionary territory for five months in a row, coming in at 53.2 in June 2023 after being in contraction for the prior seven months, from July 2022 to January 2023.
- Downward revisions to earnings estimates appear to have slowed, or possibly ended, and estimates are flattening out. There hasn't been a meaningful downgrade to 2023 estimates in several quarters.
- The number of U.S. companies issuing positive versus negative outlooks is improving, and cyclicals continue to outperform defensives (Figure 14):

Figure 14: More positive, less negative



Source: FactSet, Wealth Investment Office, as of July 17, 2023

Figure 15: The rest of the index

	2024e Price/Earnings Ratio
S&P 500 Index	18.6x
Big 7 (MSFT, AAPL, GOOG, AMZN, NVDA, META, TSLA)	29.9x
S&P 500 excluding "Big 7"	16.3x

Source: FactSet

- If you strip out the "Big 7" tech-related mega-caps, the S&P 500 is trading around 16.3 times its estimated 2024 earnings versus 16.9x and 16.5x for its 10-year and 25-year averages respectively. Stay invested in a well-diversified portfolio throughout the cycle.
- Apple's valuation is now greater than the entire Russell 2000. We think that investors will think back to this time and say to themselves, "I wish I had the foresight to have owned some of the best small-caps in the United States."
- M&A activity is beginning to come to life, with more than US\$2.6 trillion sitting on company balance sheets.
- Stagflation is lurking in Europe, and tight monetary policy remains a headwind, while the monetary cycle in emerging markets has likely commenced anew. We continue to favour emerging markets over international equities.

• When it comes to monetary policy we are close to the end of interest rates hikes which tends to be a positive for financial markets.

• We continue to be committed to enhanced diversification, by building and managing portfolios that blend the best of traditional and alternative asset classes. We employ a broader spectrum of strategies including: fixed-income absolute return, equity absolute return, private capital and real assets.

Regardless of what happens over the short term, a well-constructed portfolio is designed to navigate extreme scenarios. A good investment strategy is low-conviction over the short term and high-conviction over the long term. It navigates destructive resonance by taking the mid-range where it's more quiet. That's how you, as an individual, can move away from the high-amplitude, high-frequency distortion that's afflicting the markets.

Figure 16 : Financial Markets tend to rally around central bank pauses

	S&P 500 Index	S&P/TSX Composite Index	MSCI World Index	U.S. 10 Year Bond Yield	U.S. 2 Year Bond Yield	10/2 Year Yield Curve	High Yield Credit Spread	U.S. Unemployment Rate
Fed Pause (pre-recession)								
Prior 3 months	3.1%	2.2%	1.0%	0.13%	0.39%	-0.26%	0.65%	-0.1
First 3 months	8.3%	9.2%	2.4%	-0.58%	-0.55%	-0.03%	0.06%	0.0
Following 6 months	-0.2%	-2.7%	1.4%	0.13%	0.39%	-0.26%	0.65%	0.2
Fed Pause (re-acceleration)								
Prior 3 months	7.9%	1.9%	4.2%	-0.24%	-0.10%	-0.14%	0.06%	0.0
First 3 months	6.9%	5.0%	4.8%	-0.78%	-0.92%	0.14%	-0.04%	0.0
Following 6 months	12.5%	9.1%	8.2%	-0.71%	-0.66%	-0.05%	-0.32%	-0.1

Source: Bloomberg, Picton Mahoney Asset Management Research, Wealth Investment Office. From June 1982 to June 2023
 * Fed pause is defined as the last hike of a continuous hiking cycle

Leading Macro Indicators

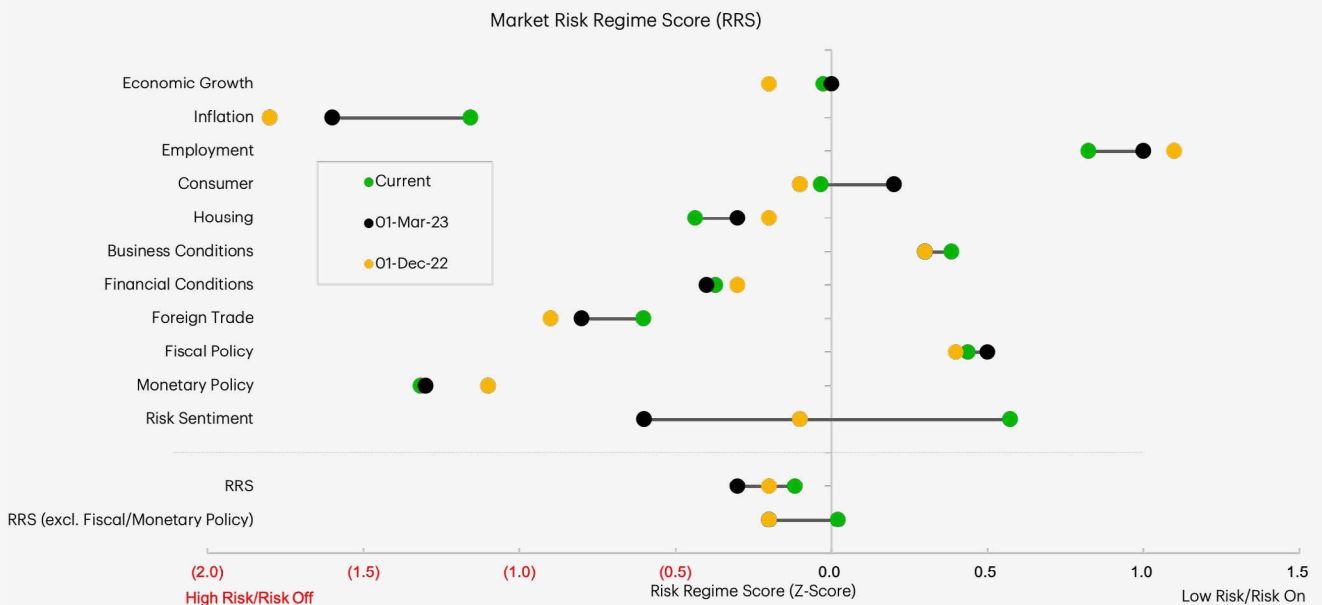
Overall risk regime score improves, but still negative on mixed economic data

As part of our process-driven approach to investment management, we monitor key variables that inform our understanding of the risk and macroeconomic environment. For each indicator, we calculate current values and compare them against recent trends and long-term data using a standardized approach that makes it possible to aggregate across indicators. Figures 1 and 2 summarize the overall condition and aggregate score of the indicators.

Figure 1: Market risk regime scores

Indicator	Overall Condition	Current	Mar-23	Dec-22	Sep-22
Economic Growth	Neutral	0.0	0.0	(0.2)	(0.2)
Inflation	Weak	(1.2)	(1.6)	(1.8)	(2.1)
Employment	Strong	0.8	1.0	1.1	1.2
Consumer	Neutral	0.0	0.2	(0.1)	(0.2)
Housing	Weak	(0.4)	(0.3)	(0.2)	0.7
Business Conditions	Neutral	0.4	0.3	0.3	0.4
Financial Conditions	Weak	(0.4)	(0.4)	(0.3)	(0.2)
Foreign Trade	Weak	(0.6)	(0.8)	(0.9)	(1.2)
Fiscal Policy	Neutral	0.4	0.5	0.4	0.3
Monetary Policy	Weak	(1.3)	(1.3)	(1.1)	(0.6)
Risk Sentiment	Strong	0.6	(0.6)	(0.1)	(1.2)
Risk Regime Score (RRS)	Weak	(0.1)	(0.3)	(0.2)	(0.3)
RRS (excl. Fiscal/Monetary Policy)	Weak	0.0	(0.2)	(0.2)	(0.4)

Figure 2: Movement in market risk regime scores



Scores represent number of standard deviations away from long-term average. Source: Wealth Investment Office, as of June 30, 2023

Risk conditions stabilized in Q2 and our risk regime score improved but remained weak on mixed economic data. Overall, the market risk regime score moved to -0.1 at the end of Q2, up from -0.3 at the end of Q1.

While equities and bond yields rose on the back of the resilient U.S. economy and expectations for further rate hikes from the Federal Reserve (Fed), financial conditions and monetary policy are keeping the overall risk score in negative territory. However, employment, business conditions, and risk sentiment remained relatively robust. Risk sentiment jumped to strong this quarter buoyed by the sharp rebound in U.S. stocks and reduced volatility across all asset classes. Below are some notable changes compared to Q1:

- Financial conditions, housing, and monetary policy remained weak in Q2 with housing deteriorating over the quarter. The score for financial conditions remains below the long-term norm and sits unchanged at -0.4; yield curves which are still inverted at record lows, and higher net-debt-to-income ratios for U.S. firms translated into a weak credit environment. The score for housing slipped from -0.3 to -0.4 amid falling house prices and slightly weaker homebuilder sentiment. More recent data, however, is pointing to an acceleration in the sector driven by rising housing starts and higher new home sales. Monetary policy—the rising policy rate and contraction of various money supply measures—continues to weigh on the risk regime score. The score for monetary policy remains at the depressed level of -1.3.
- The score for inflation continued its steady progression to end Q2 at -1.2, up from -1.6 in Q1. While both headline and core CPI have declined, they are still above the Fed's 2% target and core CPI remains stickier than previously expected. We will need to see more progress on this front before monetary policy and financial conditions improve. The foreign trade score ticked up from -0.8 to -0.6 standard deviation below the long-term norm as the U.S. trade and current account deficit narrowed.
- The scores for employment, fiscal policy, consumer, and economic growth all remained at or above zero despite weakening. Compared to Q1, initial jobless claims and the unemployment rate rose while wage growth moderated, driving the score for employment down from 1.0 to 0.8 at the end of Q2. Meanwhile, the rising deficit in the U.S. sent the score for fiscal policy from 0.5 in Q1 down to 0.4 in Q2. The consumer score slipped from 0.2 to 0.0 in Q2 amid weak consumer sentiment and higher borrowing rates that pushed up the debt service ratio. Economic growth sits at 0.0, firmly in neutral territory, reflecting expectations

that GDP growth will remain in line with the long-term historical norm.

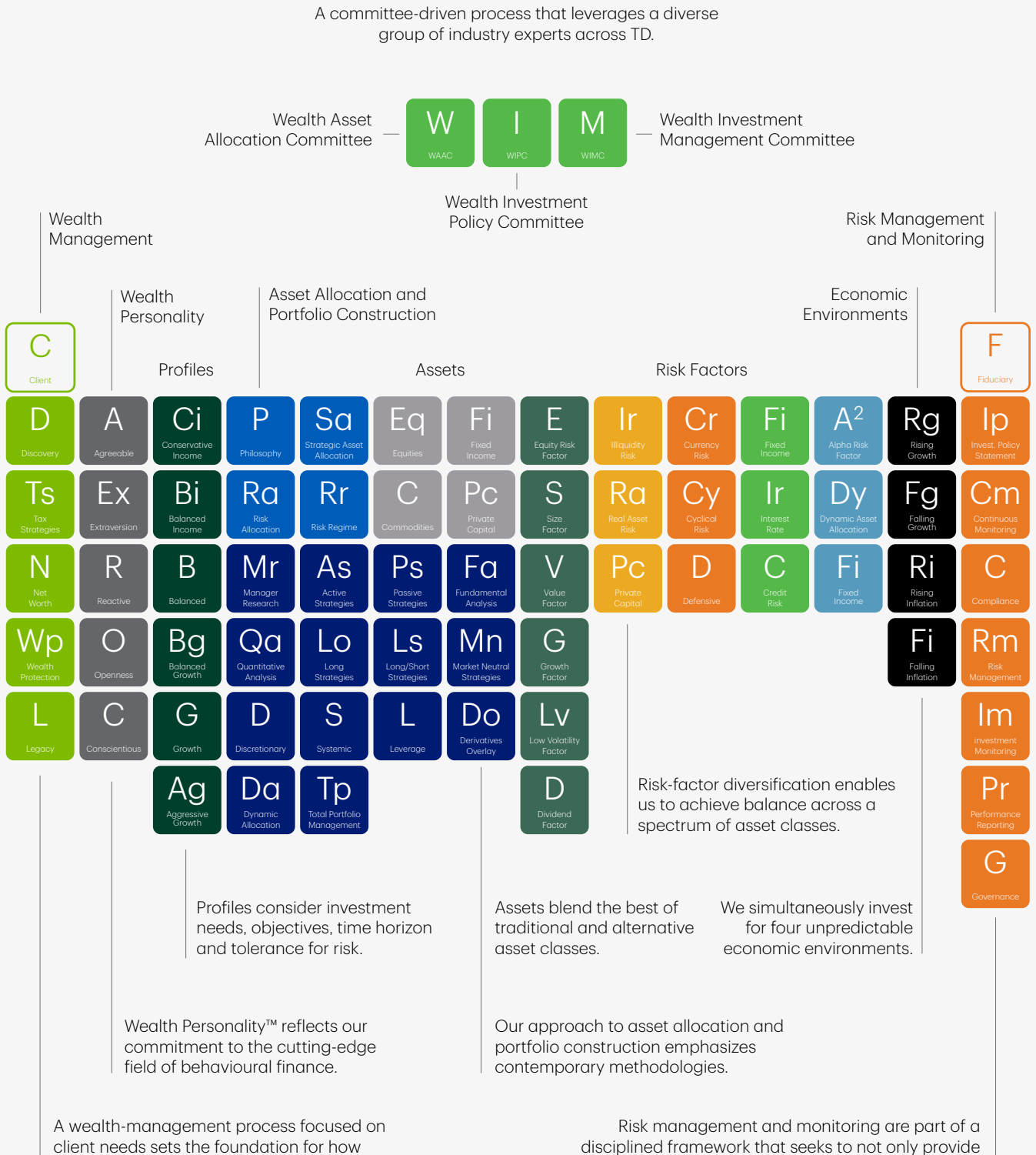
- On the bright side, risk sentiment swung into strong territory and business conditions inched ahead. Risk sentiment soared from -0.6 in Q1 to +0.6 in Q2 as equity market volatility collapsed and retail investors became increasingly bullish. The score for business conditions crept up to 0.4 in Q2 (from 0.3 in Q1) as strong service sector expansion supported growth and despite the material slowdown in U.S. manufacturing activity.

Overall, conditions for risk assets improved slightly in Q2 as stronger risk sentiment and business conditions offset weak financial conditions, housing, and monetary policy. The consensus outlook is for slower economic growth in Q3, which is also supported by lower leading economic indicators. We expect markets will remain very focused on labour and consumer data which remains surprisingly resilient.

Elements of Wealth Management

Investors are often left to make decisions without any formal process. Our solution? Follow an investment philosophy — a guiding set of principles designed to work in a world that’s constantly changing, often with dramatic impact on financial markets. At TD Wealth, we call that philosophy “Risk Priority Management,” and it provides the foundation for our decision-making process. That process is then broken down into its most basic components, similar to a periodic table of elements, as illustrated below, with groupings and weights. These components comprise our entire process, from wealth management to risk management to monitoring. All in all, there are 72 “elements” that fall into eight categories.

Figure 1: Elements

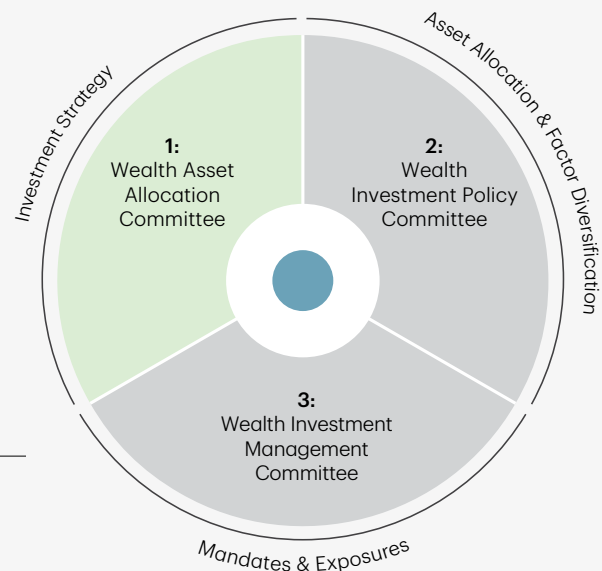


Wealth Asset Allocation Committee

The TD Wealth Asset Allocation Committee (WAAC) is composed of a diverse group of TD investment professionals. WAAC's mandate is to consider the financial-market environment and provide direction and themes for equities, fixed income, real assets and sub-classes for the next six to 18 months.

Considers the financial-market environment and provides direction and themes

Utilizing risk factors to manage exposures, we build and manage portfolios that blend the best of traditional and alternative asset classes.



Committee members:

- David Sykes, CFA Chief Investment Officer, TD Asset Management Inc (Chair)
- Michael Craig, CFA Managing Director & Head of Asset Allocation & Derivatives, TD Asset Management Inc.
- Anna Castro Managing Director, TD Asset Management Inc.
- Justin Flowerday, CFA Head of Public Equities, TD Asset Management Inc.
- Jennifer Nowski, CFA Vice President & Director, TD Asset Management Inc.
- Michael Augustine CFA Managing Director & Head of Fixed Income, TD Asset Management Inc.
- Alex Gorewicz Vice President and Director, TD Asset Management Inc.
- Jeffrey Trip, CFA Managing Director and Head of Alternative Investments, TD Asset Management Inc.
- Colin Lynch Managing Director and Head of Global Real Estate, TD Asset Management Inc.
- Kevin Hebner, Ph.D. Managing Director, Epoch Investment Partners, Inc.
- William Booth, CFA. Managing Director, Epoch Investment Partners, Inc.
- Brad Simpson, CIM, FCSI Chief Wealth Strategist, Wealth Investment Office, TDW
- Sid Vaidya, CFA, CAIA U.S. Wealth Investment Strategist, TD Wealth USA
- Bryan Lee, CFA Vice President & Director, TD Asset Management Inc.

Direction from WAAC

Core Asset Class Allocations

	Positioning	Rationale
Cash & Equivalents	<p>Modest Underweight</p> <p>▲ Previous Month</p>	<p>We prefer allocating to fixed income versus cash and equivalents. While cash returns have become more attractive based on the current rate environment, fixed income total returns should outperform over next 12 months.</p>
Fixed Income	<p>Maximum Overweight</p> <p>▲ Previous Month</p>	<p>We maintain a maximum overweight to fixed income as yields across the asset class remain well above the lows of the past decade and offer attractive, risk-adjusted potential returns. We believe fixed income will outperform equities over the next 12 months. Bonds can also provide diversification benefits, reduce overall portfolio volatility and preserve capital.</p>
Equity	<p>Modest Underweight</p> <p>▲ Previous Month</p>	<p>Our outlook for equities remains cautious over the short term. The MSCI World Index, which represents approximately 3000 global companies, is up 11% year-to-date, resulting in a notable \$6 trillion (US\$) increase in market capitalization. However, a rally of the largest seven U.S. megacap Technology stocks alone accounted for \$4 trillion of the global market capitalization increase. From a valuation perspective, the recent upswing in global equities has caused the equity risk premium to tighten, suggesting limited potential returns in the near future, unless earnings growth reaccelerates. Although headline inflation has shown signs of improvement, core inflation, the preferred gauge of enduring inflationary pressure by central banks, may remain stickier. Consequently, central banks may still choose to sustain their upward adjustments of interest rates and prolong the higher short-term interest rate environment. Over time, we expect higher-quality companies to overcome current headwinds, but we still expect further market volatility to create better entry points.</p>
Alternatives	<p>Neutral</p> <p>▲ Previous Month</p>	<p>We believe that an allocation to alternative assets such as commercial mortgages and infrastructure can benefit client portfolios. Alternative assets can provide inflation protection and attractive absolute returns, while acting as long-term portfolio stabilizers via their diversification benefits and less correlated income streams.</p>



Fixed Income - Maximum Overweight

	Positioning	Rationale
Domestic Government Bonds	Modest Overweight	Given the Bank of Canada's (BoC) recent decision to tighten monetary policy further, Canadian government bonds have underperformed global peers. However, despite the fact that government bond yields are now higher than they were at the start of this year, the income return they have generated has more than offset the negative price return. In other words, nominal total returns for government bonds remain positive. Better than expected economic data may have compelled the BoC to come off pause, however, the momentum in economic data is slowing. Therefore, over the longer term, government bonds continue to remain appealing due to their potential to generate positive nominal returns.
Investment Grade Corporate Credit	Neutral	Investment grade credit spreads have tightened and become less attractive, particularly in the U.S. relative to Canada and Europe. We continue to see the best opportunities in lower duration (5 year and under maturities) corporate bonds given their appealing all-in yields. We remain more cautious on longer duration corporate bonds due to the uncertain global economic outlook.
High Yield Credit	Modest Underweight	Risk sentiment has improved in recent months, causing credit spreads for high yield bonds to tighten and become less attractive. All-in yields remain high, indicating strong potential returns, but we continue to expect financial conditions to tighten and drive a deterioration of corporate credit fundamentals. This may create a particularly challenging backdrop for corporations with elevated debt loads, increasing overall volatility and downside risk.
Global Bonds Developed Markets	Neutral	Amidst stronger than expected inflation data, central banks continue to tighten monetary policy. Although investor expectations for rate cuts by the end of the year have moderated, investors continue to expect global monetary policy to shift into easing mode within the next two to three quarters
Global Bonds Emerging Markets	Neutral	The dispersion of returns within emerging markets has presented some opportunities. We are comfortable maintaining a neutral outlook as yields are attractive in some regions where central banks have proactively hiked interest rates, while bond returns will likely decline in other regions where central banks are still early in normalizing monetary policy.

Equities - Modest Underweight

	Positioning	Rationale
Canadian Equities	Neutral	The full effect of higher rates on the consumer and real estate market remains to be seen. As such, we anticipate that the Canadian economy will slow in 2023. However, strong free cash flows within the Energy sector, and relatively inexpensive Financials stocks, may present attractive opportunities.
U.S. Equities	Neutral	We remain concerned that U.S. earnings growth could be challenged as U.S. Federal Reserve rate hikes slow economic growth. The year-to-date returns on U.S. equities have been led by a few mega cap stocks. Valuations for the rest of the U.S. equity market are reasonable, which offers some potential support for the stock market, even in a modest economic slowdown.
International Equities	Modest Underweight	International equity markets have rebounded strongly since the fall of 2022. International stocks face similar concerns regarding corporate profits, rising rates, and slowing macroeconomic conditions. Given this view, we feel that further gains will be more limited.
Chinese Equities	Modest Overweight	As China resumes its reopening plan, we expect to see an increase in demand for travel and leisure, luxury goods as well as energy and commodities. China is focused on economic growth this year and appears to be looking to implement modest stimulus measures. We believe global supply chains will return to some sense of normalcy. Chinese equities could see relative outperformance over the next 12-18 months.
Emerging Market Equities (excluding China)	Neutral	Emerging markets equities continue to be challenged by persistently high inflation, concerns over global central bank monetary tightening, and the prospect of recession in many western economies. Our outlook for emerging markets remains cautious while recognizing that low relative valuations may provide a good entry point in the coming months.

Alternatives - Neutral

	Positioning	Rationale
Commercial Mortgages	Maximum Overweight	Commercial mortgages continue to provide accretive income while insulating investor returns from the increased volatility in interest rates.
Private Debt (Universe)	Modest Overweight	High credit quality and global diversification provides safety in a potentially recessionary environment. Incremental income and potential capital appreciation from interest rate moderation provide upside.
Domestic Real Estate	Maximum Underweight	Canada's growing demographic profile continues to be supportive of domestic real estate, particularly multi-unit residential. Office properties continue to experience leasing and valuation headwinds and a flight to quality, while fundamentals remain sound across the other property types.
Global Real Estate	Maximum Underweight	We believe that high quality assets, with low leverage and portfolios that are globally diversified, should outperform in the current environment. Office fundamentals are stronger in the Asia Pacific than in North America. Multi-unit residential, alternative real estate and a tilt to the Asia Pacific can provide global real estate portfolios with enhanced risk adjusted returns.
Infrastructure	Modest Overweight	Increases in cash flow from higher-than-expected inflation is buffering rising interest rates. Investor appetite remains strong, particularly for energy transition investments and critical infrastructure sectors that generate stable, growing cash flows.

Sub-Asset Classes

	Positioning	Rationale
U.S. Dollar	Maximum Underweight	We continue to expect USD weakness as interest rate differentials peaked several months ago. Following a very strong 2022, we believe that the USD's fundamental valuation, whether looking at historical averages, interest rate differentials, or U.S. growth versus global growth, remains overvalued.
Commodities (Gold, Energy, Metals, Agriculture, Carbon)	Modest Overweight	We are constructive on commodities as key markets such as oil and copper remain finely balanced and are supported by limited inventories, producer discipline and/or supply shortfalls, with demand potentially benefitting from a China recovery or stimulus measures. Gold has benefited from a flight-to-safety that may reverse as confidence in the banking system is restored. A weaker USD would also be a tailwind for the commodities complex.

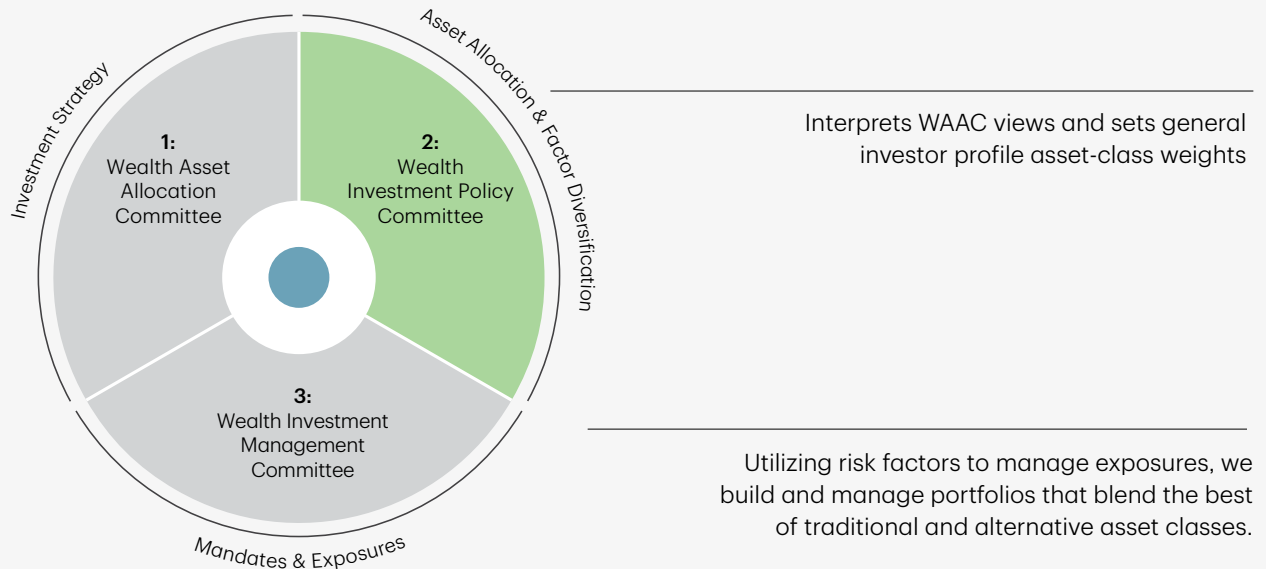
Figure 1: Direction from WAAC: strategic positioning

	Asset Class	Underweight		Neutral		Overweight
Fixed Income Maximum Overweight	Domestic Government Bonds				●	
	Investment Grade Corp. Credit			●		
	High Yield Credit		●			
	Global Bonds - Developed			●		
	Global Bonds - Emerging			●		
Equities Modest Underweight	Canadian			●		
	U.S.			●		
	International		●			
	China				●	
Alternative / Real Assets Neutral	Commercial Mortgages					●
	Private Debt				●	
	Domestic Real Estate	●				
	Global Real Estate	●				
	Infrastructure					●
Sub-Classes	U.S. Dollar	●				
	Commodities				●	

Source: Wealth Asset Allocation Committee, as of July 13, 2023.

Wealth Investment Policy Committee

The Wealth Investment Policy Committee is composed of a diverse group of TD investment professionals. WIPC's mandate is to interpret WAAC views and set general asset-class weights for each investor profile.



Committee members:

- Brad Simpson, CIM, FCSI** **Chief Wealth Strategist, Wealth Investment Office (WIO), TD Wealth (Chair)**
- Michael Craig, CFA Managing Director, Head of the Asset Allocation & Derivatives, TDAM
- Anna Castro, CFA Managing Director, TDAM
- Jafer Naqvi VP & Director, TDAM
- Christopher Lo, CFA Senior Portfolio Manager, Head of Managed Investments, WIO, TD Wealth
- Fred Wang, CFA Senior Portfolio Manager, WIO, TD Wealth
- Aurav Ghai, CFA Senior Fixed Income Analyst & Portfolio Manager, WIO, TD Wealth
- Mansi Desai, CFA Senior Equity Analyst & Portfolio Manager, WIO, TD Wealth

The Wealth Investment Policy Committee (WIPC) made no changes to its dynamic asset allocation in July. At the top asset-class-allocation tier, WIPC maintained an underweight position in equities, an overweight position in fixed income, and a neutral position in real assets as well as cash. This is closely aligned with WAAC's core asset-class-allocation view. Within equities, WIPC continues to be 1 percentage point (pp) underweight Canadian and U.S. equities, 2-pp underweight International equities and 1-pp overweight emerging-market equities.

Within fixed income, WIPC continues to hold a 2- to 4-pp overweight position in domestic government bonds, and a neutral or a modest 1-pp overweight position in investment-grade corporate bonds. WIPC's current positioning is aligned to emphasize the higher-quality end of the fixed income spectrum. WIPC also maintained a modest 1- to 2-pp underweight position in high-yield bonds. The allocation to both developed and emerging markets global bonds remains neutral.

Within real assets, WIPC maintains the overall positioning at neutral with a modest 1-pp overweight position in mortgages, a neutral position in private debt, a modest 1- to 2-pp underweight position in real estate, and a neutral to 1-pp overweight position in infrastructure. The positioning is directionally aligned with the WAAC guideline. Moreover, WIPC notes that our clients primarily invest in publicly traded real assets names, which are trading at discount valuations comparing to their net asset value.

Factor Exposure

Asset Classes	Fixed Income Factor	Equity Risk Factor	Currency Risk Factor	Illiquidity Risk Factor	Alpha
Factor Positioning	Overweight	Underweight	Underweight	Overweight	Dynamic
Cash	●				●
Fixed Income					
Domestic Government Bonds	●				●
Investment Grade Corp. Credit	●	●	●		●
High Yield Credit	●	●	●	●	●
Global Bonds - Developed	●		●		●
Global Bonds - Emerging	●		●	●	●
Equity					
Canadian		●			●
U.S.		●	●		●
International		●	●		●
China		●	●		●
Emerging Markets ex China		●	●		●
Alternatives					
Mortgages	●	●	●	●	●
Private Debt	●	●	●	●	●
Real Estate	●	●	●	●	●
Infrastructure	●	●	●	●	●
Real Estate/Infrastructure	●	●	●	●	●

Strategic and dynamic asset-class weights by investor profile (Condensed view)

Asset Class	Balanced Income		Balanced		Balanced Growth		Growth		Aggressive Growth	
	Strategic	Dynamic	Strategic	Dynamic	Strategic	Dynamic	Strategic	Dynamic	Strategic	Dynamic
Cash	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%
Public Fixed Income	63.0%	66.0%	48.0%	51.0%	33.0%	36.0%	23.0%	26.0%	0.0%	2.0%
Government	32.0%	35.0%	24.0%	27.0%	17.0%	20.0%	11.0%	14.0%	0.0%	2.0%
Corporate	31.0%	31.0%	24.0%	24.0%	16.0%	16.0%	12.0%	12.0%	0.0%	0.0%
Public Equities	35.0%	32.0%	50.0%	47.0%	65.0%	62.0%	75.0%	72.0%	98.0%	96.0%
Canadian	11.0%	10.0%	15.0%	14.0%	20.0%	19.0%	23.0%	22.0%	29.0%	29.0%
U.S.	14.0%	13.0%	20.0%	19.0%	26.0%	25.0%	30.0%	29.0%	40.0%	39.0%
International	7.0%	5.0%	10.0%	8.0%	13.0%	11.0%	15.0%	13.0%	19.0%	17.0%
China/Emerging Markets	3.0%	4.0%	5.0%	6.0%	6.0%	7.0%	7.0%	8.0%	10.0%	11.0%

Strat: Wealth Investment Policy Committee, as of July 13, 2023.

Strategic and dynamic asset-class weights by investor profile (Expanded view)

Asset Class	Balanced Income		Balanced		Balanced Growth		Growth		Aggressive Growth	
	Strategic	Dynamic	Strategic	Dynamic	Strategic	Dynamic	Strategic	Dynamic	Strategic	Dynamic
Cash	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%
Public Fixed Income	56.0%	59.0%	41.0%	44.0%	26.0%	29.0%	16.0%	19.0%	0.0%	2.0%
Domestic Government Bonds	24.0%	28.0%	17.0%	21.0%	11.0%	15.0%	6.0%	10.0%	0.0%	2.0%
Invest. Grade Corp Bonds	19.0%	20.0%	14.0%	15.0%	9.0%	9.0%	6.0%	6.0%	0.0%	0.0%
High Yield Bonds	4.0%	2.0%	3.0%	1.0%	2.0%	1.0%	1.0%	0.0%	0.0%	0.0%
Global Bonds - Developed	6.0%	6.0%	5.0%	5.0%	3.0%	3.0%	2.0%	2.0%	0.0%	0.0%
Global Bonds - Emerging	3.0%	3.0%	2.0%	2.0%	1.0%	1.0%	1.0%	1.0%	0.0%	0.0%
Public Equities	32.0%	29.0%	42.0%	39.0%	57.0%	54.0%	67.0%	64.0%	85.0%	83.0%
Canadian	10.0%	9.0%	12.0%	11.0%	17.0%	16.0%	20.0%	19.0%	25.0%	25.0%
U.S.	13.0%	12.0%	17.0%	16.0%	23.0%	22.0%	27.0%	26.0%	35.0%	34.0%
International	6.0%	4.0%	8.0%	6.0%	11.0%	9.0%	13.0%	11.0%	15.0%	13.0%
China/Emerging Markets	3.0%	4.0%	5.0%	6.0%	6.0%	7.0%	7.0%	8.0%	10.0%	11.0%
Alternatives	10.0%	10.0%	15.0%	15.0%	15.0%	15.0%	15.0%	15.0%	13.0%	13.0%
Commercial Mortgages	4.0%	5.0%	4.0%	5.0%	4.0%	5.0%	4.0%	5.0%	0.0%	0.0%
Private Debt	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	0.0%	0.0%
Real Estate	1.0%	0.0%	3.0%	1.0%	3.0%	1.0%	3.0%	1.0%	4.0%	3.0%
Infrastructure	2.0%	2.0%	5.0%	6.0%	5.0%	6.0%	5.0%	6.0%	9.0%	10.0%
Fixed Income	58.0%	61.0%	43.0%	46.0%	28.0%	31.0%	18.0%	21.0%	2.0%	4.0%
Equity	32.0%	29.0%	42.0%	39.0%	57.0%	54.0%	67.0%	64.0%	85.0%	83.0%
Alternatives	10.0%	10.0%	15.0%	15.0%	15.0%	15.0%	15.0%	15.0%	13.0%	13.0%

Strat: Wealth Investment Policy Committee, as of July 13, 2023.

Economic Outlook

Central Banks: Learning to Skip

Beata Caranci, SVP & Chief Economist and James Orlando, CFA, Director & Senior Economist | TD Economics

Highlights

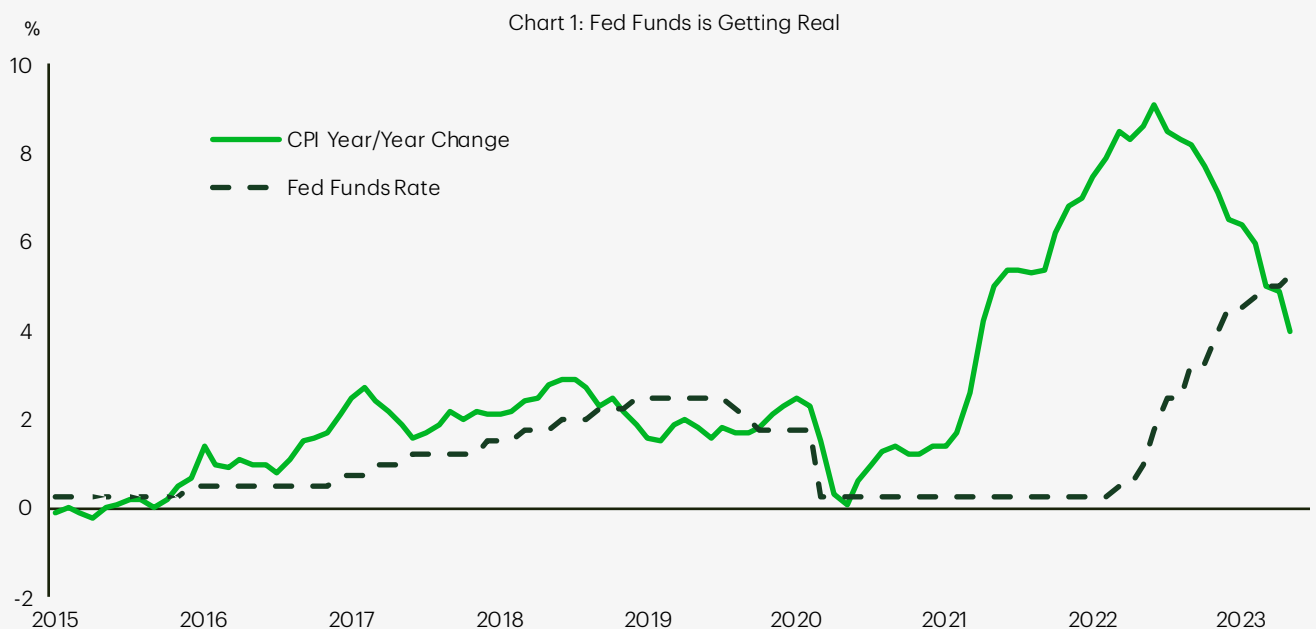
- The Federal Reserve has moved to a meeting-by-meeting approach as it explores the stopping point on interest rates.
- We think that occurs at 5.50%, but even in that case, the Fed will need to ensure communication jawbones the market to prevent a drop in yields.
- The Bank of Canada has already jumped back in with another hike after pausing in January. The population surge poses a challenge for a central bank that would prefer to remain on the sidelines but cannot ignore the demand shock.

Was it truly an innocent slip when Federal Reserve Chair Powell referred to the decision to not hike rates in June as a “skip” in the meeting cadence? Probably not. The Fed is treating every meeting as a live decision of “go” or “no go”. This is a shift from the previously telegraphed path of continuous rate hikes, where only the magnitude was the point of discussion. And this is a good thing.

With 500 basis points in rate hikes in the rear-view mirror and inflation decelerating, there is no longer a need for speed. The real policy rate is officially in restrictive territory and presses deeper with every month that inflation decelerates (Figure 1). This is the stage where a central bank’s true skills on inflation management are tested. By creating longer gaps between rate decisions to observe a larger subset of data, it should limit the risk of a policy overshoot, or

at least the magnitude of any overshoot. At the same time, there is strategic design behind the central bank’s intent to keep markets guessing. If the Fed had stated an outright pause, yields would likely have fallen. The market’s mindset would have shifted to the belief that the next most probable move is a rate cut. This is precisely what occurred north of the border when the Bank of Canada explicitly noted a pause in January. Central banks are now at the stage of fine-tuning policy, and this includes the art of jawboning markets to prevent a counterproductive easing in monetary policy expectations when the inflation fight has not yet been won. And jawboning required credibility with action when core inflation metrics prove stubbornly slow to decelerate. With this framework in mind, we view one more rate hike as a high probability over the summer months.

Figure 1: Business sentiment dropping as rates rise



Source: BLS, FRB, TD Economics.

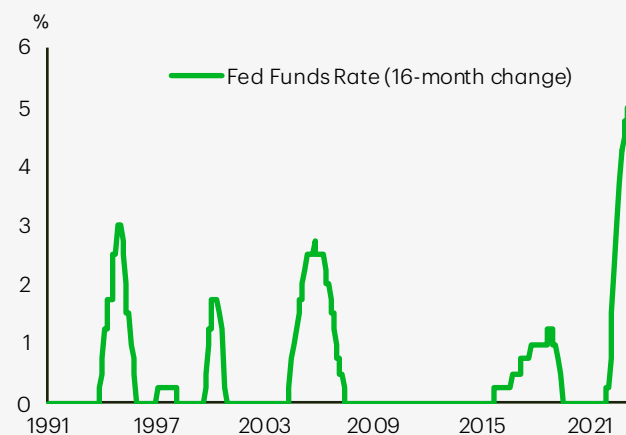
The Art of Inflation War

The current rate hike cycle has been the most aggressive since the Fed began targeting inflation in the 1990s (Figure 2) but doesn't deviate from how the path on policy adjustments typically occur. Chair Powell highlighted the three stages of the Fed's hiking strategy as: "The speed of tightening, the level to which rates need to go, and then a period of time over which we'd need to keep policy restrictive." The matter of speed is done. After 15 months of rate hikes, including four meetings of 75 basis point adjustments, the Fed slowed to smaller increments before skipping the decision to hike in June. With the policy rate now at 5.25% and inflation having fallen to 4%, the real rate is already at a level that is historically consistent with a slow economic growth trajectory. This takes pressure off the Fed to remain aggressive.

However, history is only a guide. This business cycle has not followed the typical rules of thumb, making many economists question whether economic relationships have become permanently muted or just require more patience due to longer lags. Consumer sensitivity to interest rates is being tested by excess household savings, past generous government transfers, and abnormally strong and persistent labor demand. The Fed's decision to skip a meeting to observe the evolution of the data doesn't necessarily mean an end to the rate hike cycle. It just means that they're in the pocket of being close to peak levels and moving at a more cautious pace helps avoid overshooting that mark.

The best way to describe the Fed's next meeting is 'live'. The Fed could easily justify another skip to buy more time to observe inflation, given that it has started to ease in a convincing manner. Or, it could hike again, given inflation is still far off the 2%-mark and economic data confirm strength and resilience.

Figure 2: The Fed's rapid rate hikes

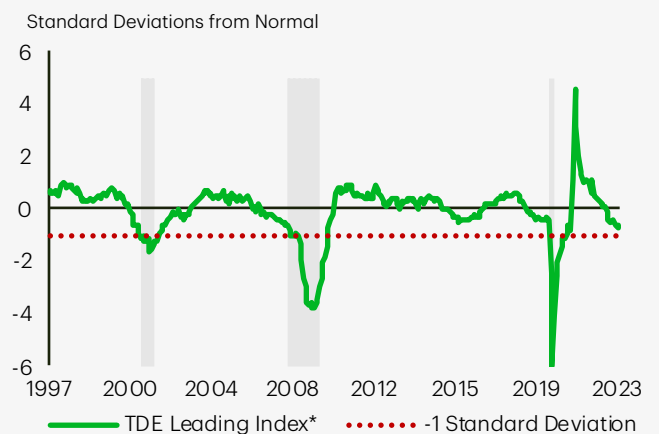


Source: FRB, TD Economics.

We are in the camp that another hike in July still makes sense in striking the right balance. Although consumer spending has recently wobbled, more convincing is needed that this is not a head-fake with consumers oscillating between blow-out months followed by temporary breathers. Consumer confidence improved in June, financial market sentiment has pushed stocks higher and the job market is still producing jobs above a long-term sustainable pace. There's reason to believe another quarter-point hike won't upset the apple cart, but at the same time, the Fed must remain attuned to the potential for a re-emergence of financial risks — a harsh reality that already played out within the regional banking sector in March. There's a fine balance in trying to tap down the credit and consumer cycle versus triggering unintended financial turmoil. High interest rates have already exposed the banking system to a strong impulse on deposit outflows, with the financial environment made more difficult by a sustained inverted yield curve.

As a result of these cross currents, we have pencilled in July's rate hike as the final tweak, but this requires a broader set of consumer and inflation metrics to manifest the signals already coming from other indicators. July would mark 18 months since the Fed started raising rates — right around the maximum lag for when interest rates start to hit the labor market. After this point, we would have to assess whether this business cycle is truly a reflection of longer lags or testing economic relationships all together. At present, our economic leading indicator has been flashing yellow for some time, moving sideways over 2023 on the threshold that predicts a significant slowdown in economic momentum, and in some cases, a recession within the next three-to-six months. Basically, it's right on the bubble (Figure 3).

Figure 3: Leading index on the bubble



* Index is comprised of eight leading economic indicators. Readings of 0 are consistent with historical average (1995-present) points in the business cycle, while readings of -0.4 or +0.4 should be interpreted as one standard deviation below/above average, respectively. Source: TD Economics.

However, as previously noted, every meeting is live. If the economy and core inflation metrics continue to show tenacity, we can't rule out further moves. In that instance, the central bank may also stretch out the time period between those decisions in order to better evaluate the totality of the data.

Finding the right level of interest rates is only the first order of tasks. The next becomes how long to hold at that level. Over the last three cycles, the Fed held the policy rate at the peak for an average of 9 months before starting to cut rates, but the range is wide at 7 to 14 months. The longest period occurred in 2006 and 2007. Then too, consumer spending was surprising resilient in the face of falling house prices, before a wave of poorly underwritten mortgages tipped the scales.

If July is indeed going to mark the final hike, than history's guide would imply the Fed would see sufficient data to prompt a rate cut as early as January 2024. We deem that outcome to be a long shot and have instead penciled the first rate cut in the second quarter as the earliest timing. This is when our core inflation metric finally cracks below 3% alongside sputtering job demand, hopefully offering sufficient comfort to the Fed that inflation is on a sustained trajectory towards its 2% target. In that environment, if the Fed does not cut interest rates, a real (inflation-adjusted) interest rate north of 3% would materialize. This would be a significant development. In all historical instances of recessions, monetary policy settings were left at this level or higher, indicating that the cost of capital became too crippling for too long.

Bank of Canada Dives Back In

The Bank of Canada (BoC) has already deployed a stop-and-go strategy, following up on a pause in January with a quarter-point rate hike in June. This was likely not its initial intention. At the time, the BoC's conditional pause made sense. The economy had absorbed 400 basis points in rapid-fire succession, making many economists squeamish given the disproportionate risks related to household leverage. Canadian households spend roughly 6 percentage points more of their after-tax income on servicing debt relative to their American counterparts. This should have translated into increased interest rate sensitivity, but the exact opposite played out.

Consumer spending clocked in at nearly 6% (annualized) in the first quarter, the fastest pace among peer countries. Housing demand also came roaring back. Sales jumped 20% in just two short

months despite a modest 15 bps drop in 5-year posted mortgage rates. The U.S. saw less of a reaction in housing demand with more than four times the drop in their preferred mortgage rate term.

The wrinkle in the BoC's plan and overall analysis came via population statistics. At the time of the announced pause, it was not readily observable that Canada was experiencing a massive demand shock. It turns out that the population expanded by 1.2 million persons over the last year, creating a demand force not seen since the 1950s. Despite a permanent immigration target of 431k in 2022, the total population swelled due to a less transparent surge in non-permanent residents. This puts the central bank into a bind. Even though spending per capita has softened, the whole matters more than the parts and the BoC must set policy for economy-wide inflationary forces that are pressing on capacity. At the same time, employer demand for workers is consistent with historical periods of ongoing economic expansions, averaging 28k jobs over the past three months. Momentum is even stronger within full time positions and among the core working age group (25-54 year olds).

The BoC highlighted this consumer/labour market/housing trio as sufficient reason to raise interest rates again. This was made more compelling by a bad-news inflation report in April, revealing stickier price pressures than expected. At least on this front, daylight has re-emerged. Inflation in May was surprisingly cooperative, easing to 3.4% year-on-year (from 4.4% in April), the lowest level since June 2021. Much of this was thanks to lower energy prices compared to last year. By comparison, the deceleration in the BoC's core inflation metrics are occurring at a slower pace, averaging 3.9%. Likewise, on a three-month annualized basis, core inflation has been stuck at around 3.5% for almost a year. For a central bank trying to anchor inflation back at 2%, there is plenty of reason to consider another interest rate adjustment.

This is why we view another rate hike by the BoC as a likely outcome. The population surge and strong labour markets point to more spending. In turn, this would limit the degree to which inflation can cool, ultimately posing a risk of entrenching higher inflation expectations. Something has to break in this chain to build confidence that inflation will not just move back to target, but be sustained there. That moment has not yet come. Like the Fed, the BoC will have to probe and find its cruising speed on the right level of interest rates.

Asset Class Analysis

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Quarter in Review

In Soft Landings We Trust

Fred Wang, Senior Portfolio Manager, Asset Allocation | TD Wealth

The second quarter was marked by strong equity market performance. A few mega cap growth stocks rallied and outperformed other names to drive the entire equity market higher. Artificial intelligence (AI) became one of the most mentioned words during the earning season, and names directly exposed to the theme benefited significantly.

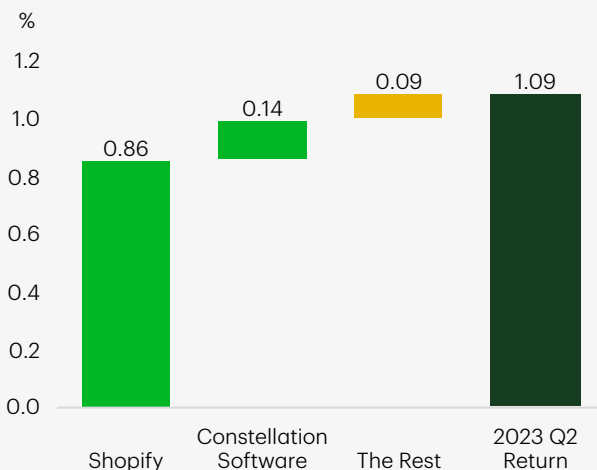
As a result, the market became more concentrated, and the valuation of broad market capitalization weighted indices were heavily influenced by the small group of expensive stocks: it was widely reported that Apple, Amazon, Google, Meta, Microsoft, NVIDIA and Tesla accounted for almost all the return of S&P 500 in the second quarter. Missing the few winners resulted in underperformance.

On the flipside, the rest of the market, collectively, is more reasonably priced and might be due for a catch-up if sentiment continues to improve.

Outside of the U.S., where the technology sector is smaller and not as exposed to the AI theme, equity performance is still solid, just not as great.

- The Canadian market was even narrower: Shopify and Constellation Software contributed almost all S&P/TSX Composite's quarterly return.
- European equities return was also strong, but much broader based.
- Japanese equities continued to be favoured by investors. Favourable monetary environment, weaker Yen and robust economic fundamentals helped.

Figure 1: S&P/TSX Composite second quarter return contribution from two tech names vs the rest



Source: FactSet, Wealth Investment Office, as of June 30, 2023

- The MSCI Emerging Markets (EM) index was slightly negative in the second quarter. The large tech names are the darlings of the developed world, but we see a huge performance bifurcation of tech names in EM. Chinese e-commerce and internet-related technology names were the worst performers, suffering from weak economic fundamentals and negative sentiment. But hardware and semiconductor-related tech names were the top contributors.

Although the equity market was under the spotlight, global macro uncertainty stayed elevated. Inflation, which was front and centre to the future monetary policy path, had a pronounced diversion across different regions.

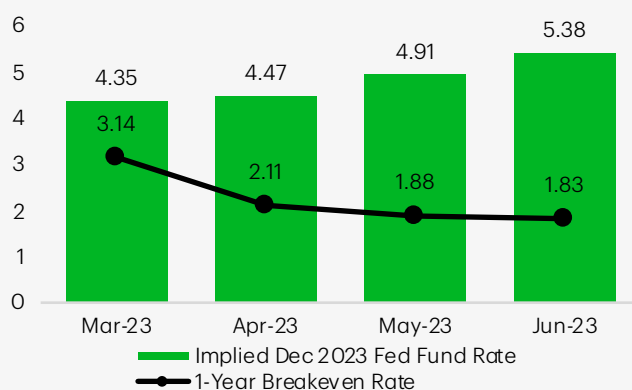
In North America, CPI inflation year-on-year peaked in the second quarter 2022. Due to large base effect, the U.S. YoY inflation saw a three handle at the end of the second quarter of 2023, and Canadian CPI even hit 2.8%. However, this does not mean the fight against inflation is over. When the volatile components are removed, the core CPI and PCE inflation is likely staying well above 4%. As a result, monetary policy remained tight. In the U.S., the Federal Reserve raised its policy rate by 25bps in May and signalled more possible hikes until the 2% inflation target is achieved. The Fed fund futures market priced in a much more hawkish policy path forward. Fig 2 shows that while the 1-year breakeven inflation eased, the year-end implied Fed Funds Rate moved up by 103bps. The amount of hawkishness without an increase in inflation expectations is worrisome.

The Bank of Canada also hiked policy rate by 25bps in June, walking back the previously announced halt and hinting at more hikes until inflation is under control.

Inflation in the Eurozone and the UK has moved lower from its peak in the fourth quarter last year, but the running rate of inflation continues to be a concern. The UK is seeing a YoY CPI inflation of 8.7% and Eurozone inflation stood at 6.1% in May. Stubborn inflation left the Bank of England (BOE) and European Central Bank (ECB) with no choice but to hike interest rate higher. The ECB hiked its policy rate in May by 25bps and again in June by 25bps, bringing it to 3.5%, while the BOE hiked its policy rate in May by 25bps and again in June by 50bps, bringing it to 5%.

If central banks in the West are all conducting a textbook tightening cycle to bring inflation back to target, the Bank of Japan (BoJ) is taking a more patient approach. With a new governor, the BoJ surprisingly did not change its monetary policy, even facing higher inflation. After peaking at 4.3% in January, Japan's inflation has been slowly trending down to 3.2% as of May 2023. The above target but not run-away inflation represented a sweet spot for Japan's economy, which was high enough for the unions to negotiate a modest salary increase for its members but not high enough for the monetary hawks to act.

Figure 2: Market prices in a hawkish Fed without a move up in inflation expectation



Source: FactSet. As of June 30, 2023

China continued to be a sour spot. Contrary to the rest of the world, leading indicators are deteriorating while the economy is on the verge of deflation. The RMB is weakening against the USD, breaking the important 7.2 level. Despite continued currency depreciation, the central bank cut the policy rate by 10bps in June to support faltering growth. It showed the government's concern over the Chinese economy not living up to the widely shared expectation that it would roar back with strong consumer spending and job markets after COVID lockdowns.

Performance through a macroeconomic lens

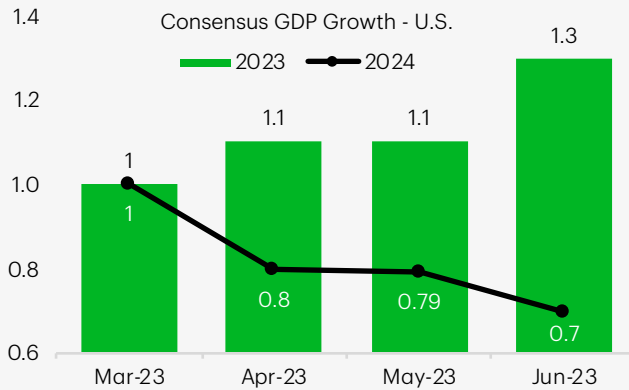
Looking at multi-asset performance from the perspective of four broad macroeconomic regimes (Table 1), although the framework has served us well for establishing relationships between macro narratives and asset returns, the results from the second quarter were very nuanced. Strong performance in equities is normally associated with falling inflation and higher growth. While both actual inflation and inflation expectation did trend down, the market merely pushed their expected economic slowdown further into the future. Figures 3 and 4 show the consensus GDP growth of U.S. and Canada went up for 2023 but went down for 2024.

Table 1: Asset-class performance by macroeconomic environment

Economic Environment	Falling Inflation					Rising Inflation					
			MTD	QTD	1 Year			MTD	QTD	1 Year	
Rising Growth	Equities	Global	5.4%	6.6%	16.5%	Commodities	GSCI		4.4%	-2.7%	-14.2%
		US	6.6%	8.7%	19.6%		Energy	6.0%	-3.2%	-23.0%	
		Canada	3.4%	1.1%	10.4%		Oil	3.7%	-6.6%	-33.2%	
		EAFE	3.6%	4.3%	17.5%		Natural Gas	19.1%	19.3%	-61.5%	
		EM ex. China	3.7%	6.0%	12.0%		Copper	3.4%	-6.3%	5.8%	
		China	2.1%	-4.0%	-12.2%		Agriculture	2.1%	-3.0%	-3.5%	
		US Small Cap.	8.1%	5.2%	12.3%		Industrial Metals	0.5%	-9.1%	-3.8%	
		Global REIT	3.3%	1.0%	-1.9%						
		Global Infra.	3.0%	-0.1%	4.2%						
	Corporate Bonds	Global IG	0.1%	0.0%	1.8%	Emerging Market Debt	Hard		1.9%	1.5%	6.8%
Global HY		2.1%	2.0%	10.1%	Local			2.8%	2.7%	11.1%	
Private Debt		2.3%	3.1%	10.7%							
Falling Growth	Nominal Gov't Bonds	Global	-0.1%	0.0%	0.1%	Inflation-Linked Gov't Bonds	Global		0.5%	-2.0%	-3.7%
		US	-0.8%	-1.4%	-2.1%		US		-0.3%	-1.4%	-1.4%
		Eurozone	-0.3%	0.0%	-4.7%		UK		3.2%	-6.9%	-17.6%
		Japan	0.3%	0.5%	0.3%		Canada		0.1%	0.0%	3.4%
		Canada	0.0%	-1.0%	2.8%		Commodities	GSCI		4.4%	-2.7%
				Energy		6.0%		-3.2%	-23.0%		
				Gold		-2.2%		-2.5%	6.20%		

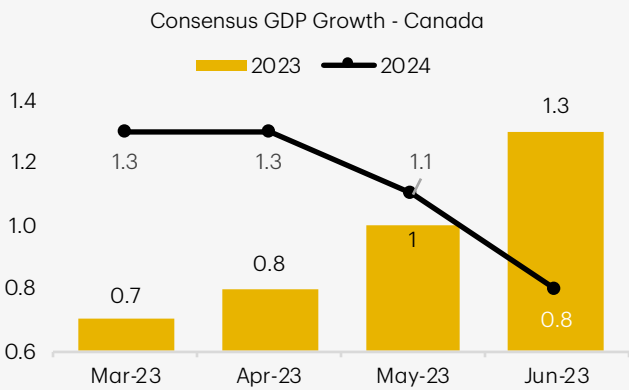
Source: FactSet as of June 30, 2023. Note: All returns are in local currency unless indicated otherwise.

Figure 3: The expected economic slowdown in the U.S. is shifted from 2023 to 2024



Source: FactSet, Wealth Investment Office, As of June 30, 2023

Figure 4: The expected economic slowdown in Canada is shifted from 2023 to 2024



Source: FactSet, Wealth Investment Office, As of June 30, 2023

Short term, this fits with the prevailing soft-landing narrative. But as the economists kick the can down the road, the implication is that it will take longer for the economy to finally feel the pain.

The concern resulting from this is that the economy holding up to higher interest rates could lead to a harder landing.

In March, the rates market experienced extreme price volatility, reflecting the market's increased expectation of recession. During the second quarter, as growth expectations for 2023 improved, yields moved moderately higher, giving back some of the gain in March for bonds. Government bonds and investment-grade corporate bonds, both highly sensitive to interest rate moves, underperformed. The riskier part of the fixed income market did better.

As short-term recession risk receded and inflation eased, commodities underperformed broadly. Lower commodity prices also reflected China failing to meet growth expectations. The outlier among commodities was natural gas, where the price bottomed below \$2/mmbtu (the lowest price since 2021) and then rebounded strongly during the quarter.

The EM debts robust performance was not driven by a typical upswing of the commodity cycle or rising inflation. Rather, many EM countries have either front run the Fed's tightening cycle to manage the capital outflow and now offer peak carry or, in China's case, at the verge of seeing the dawn of an easing cycle. The de-synchronized global growth, as part of the secular deglobalization trend, is unique and worth paying close attention going forward.

The silver lining around the underperformance of gold and bonds linked to global inflation aligns with the narrative that the probability of hard landing and global stagflation is fading.

The U.S. Debt Ceiling

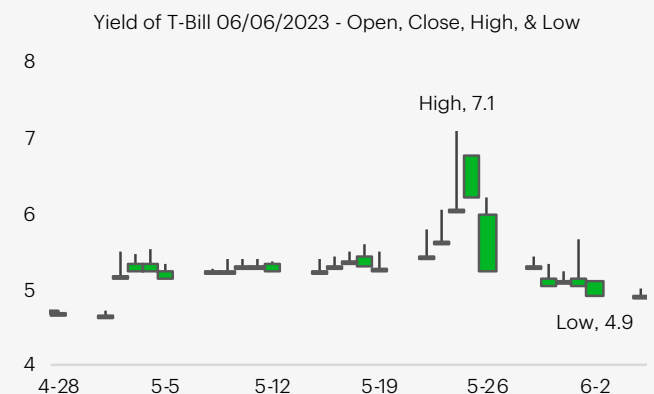
The resolution of the U.S. debt ceiling situation in June led to some outsized dislocations in the market, especially for treasury bills, which has turned out to be a tactical opportunity.

The event resembled the plot of a typical Hollywood movie:

It started with a potential crisis where the treasury could run out of money in early June if there was no deal between the parties to raise the arbitrary debt ceiling. With rounds of negotiation and meetings between the Democratic White House and the Republican Congress, a deal was finalized in the 59th minute of the eleventh hour.

However, the market reaction was extreme before the deal was announced. On May 24th, when a deal was still in question, the yield on the U.S. treasury bill maturing June 6th jumped to over 7% before normalizing to below 5% in a week. This reflected the overblown concerns of an impasse in Washington. This kind of market dislocation is rarely seen, but created great entry point to make a large profit even with the safest cash instrument. This is another anecdote of today's fast-moving market, where taking an active approach could benefit.

Figure 5: Yield on U.S. treasury bill maturing in early June moved two percentage points in a week



Source: FactSet, Wealth Investment Office, as of June 30, 2023

Investor Sentiment Revived

As markets rallied, fuelled by renewed opportunism over AI, a resolution to the debt ceiling and banking crisis, investor sentiment improved significantly. The American Association of Individual Investment survey saw material increase in bullish response over the quarter. Money market inflows started to fade and inflows to equity funds became positive in June. VIX (a.k.a., the fear gauge) hit the lowest level since the onset of the pandemic. The Commodity Futures Trading Commission's weekly reports also showed significant increase in the net long position on S&P 500 futures. The poster child of the semiconductor industry, NVIDIA hit a new high.

Figure 6 shows that skew dropped since NVIDIA's blockbuster quarterly result. The significant demand for call options to participate in the rally pushed implied volatility for the 1-month call with 0.25 delta 8% higher than the 0.25 delta put with the same expiry. This level of skew was only seen during the peak of the pandemic.

It might be early to tell if the market will enter the fear of missing out (FOMO) phase again, five percentage points of hike later. However, this opportunism could become exuberance, and when the exuberance becomes irrational, opportunities for a contrarian view will emerge.

This is the classic and time-tested Hollywood plot for the market.

Geopolitical Risks

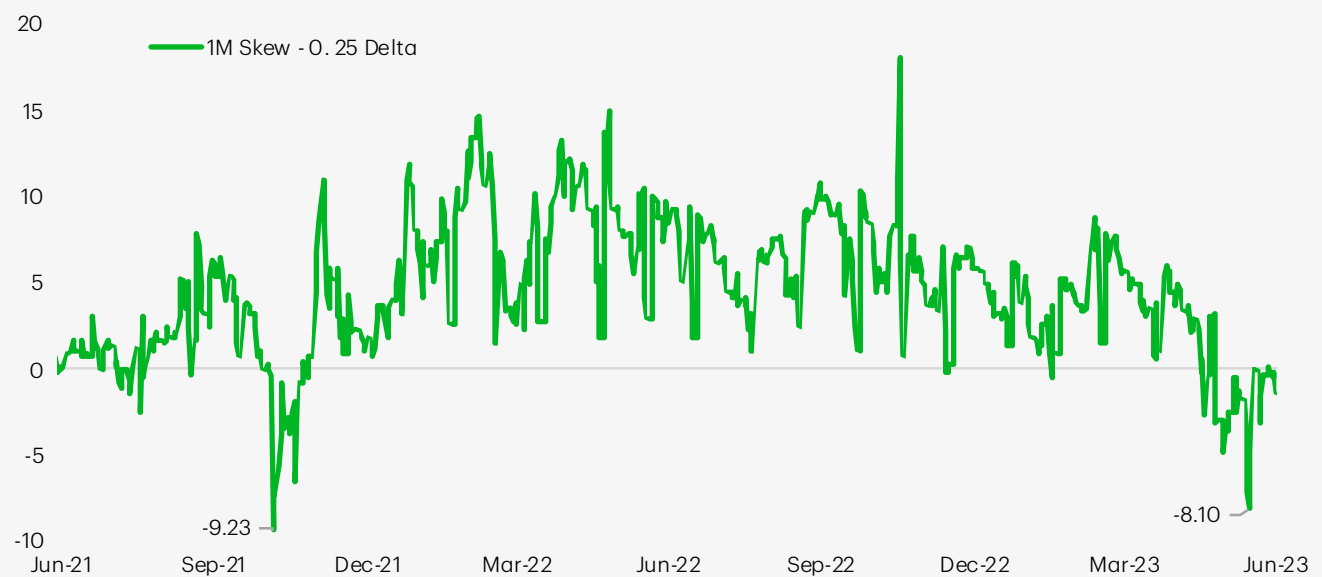
The structural changes on the geopolitical front continue to play out, with the most important being deglobalization and China/U.S. relations.

After several months of delay, both U.S. Secretary of State Antony Blinken and Secretary of the Treasury Janet Yellen visited Beijing. Both sides stayed firm on their positions on many issues. The main takeaways from the U.S. State Department's statement include keeping bilateral communication open, managing competition to avoid conflict and partnering where necessary on global issues like climate change and global economic stability.

However, it is clear the two largest economies will continue growing apart as the global supply chain shifts away from China. The recent declining trade numbers from China are anecdotal evidence of this trend.

The most surprising development during the quarter was probably the failed mutiny of the front-line Russian mercenary group Wagner, led by its leader Yevgeny Prigozhin. From its surprising start to the sudden ending, a lot of questions remain unanswered, and the impact on Putin's regime as well as the war is still to be seen. It clearly showed the internal struggle and challenges Putin is facing after 17 months since the invasion started. Now Ukraine has started a counter-offensive campaign with broad-based support from NATO and many other countries. The war is still going but the balance appears to be tipping, and the end might be close.

Figure 6: 1-month 25-delta skew signifies the exuberant revival of investor sentiment



Source: FactSet, Wealth Investment Office, as of June 30, 2023

Outlook on Fixed Income

The Allure of Yield

Aurav Ghai, Senior Fixed Income Analyst | TD Wealth

After a decade or more on the back bench, bonds are coming into their own. In fact, it's not just bonds. Investors can tap into attractive yields in almost all segments of fixed income.

But there is a caveat. Despite stronger than expected macro-economic data, the bifurcated U.S. economy could still upend our fixed income revival. While inflation has been difficult to tame, it appears the biggest contributor, housing, has finally peaked. However, payroll growth is still slowing and companies are cutting hours which will test labour market resiliency.

The market pricing of terminal rates and the efforts of global central banks to contain inflation combined with the resilience of the economy appear to have finally converged. As we noted in previous editions of PSQ, central banks will still face difficult trade-offs. The effects of tighter monetary policy will continue to weaken economic growth before fully suppressing inflation. That said, we believe we're looking at the finish line of this hiking cycle but whether it's a pause or a full stop, it's hard to tell. Central banks are full of surprises: just look at the Bank of Canada (BoC) which hiked rates in June and July after a five-month hiatus.

Government bond yields remain volatile making it crucial for anyone expecting a windfall from declining yields to take a risk-managed and risk-measured approach to duration or interest rate sensitive assets.

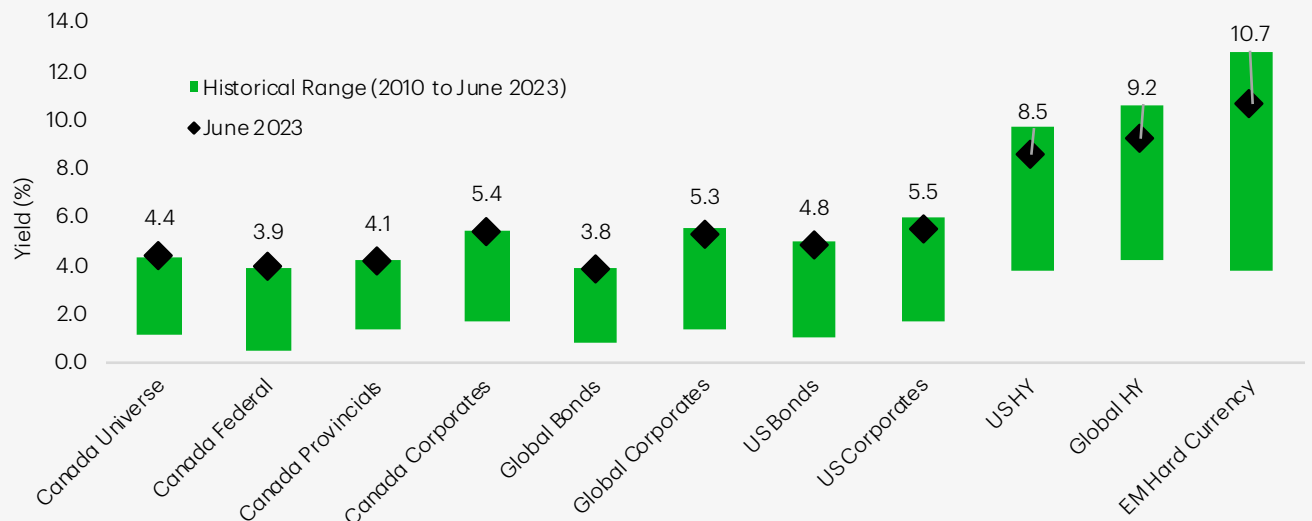
We believe the correction in global bond markets has ended for the most part and the negative correlation between risk and government yields should return.

Looking forward, the income and diversification on offer from bonds is far more enticing. Today's starting yields provide attractive entry points and yields across fixed income sectors are at levels not seen in over a decade offering real potential for future returns (Figure 1). This healthy yield cushion also implies bonds will be able to deliver positive returns and offset losses from other riskier investments.

While investors shouldn't throw caution to the wind, we believe the investment outlook and conviction for bonds remains strong:

- We remain maximum overweight fixed income investments in general and modest overweight domestic government bonds. Canadian and U.S. government bonds are more attractive at current yields and offer opportunities for income generation and downside protection. Yields have remained elevated and, historically, higher starting yields have been associated with higher total returns. We expect price/yield volatility to decline in coming months as forward guidance from central banks and the extent of economic slowdown becomes clearer.
- We remain neutral investment grade (IG) credit as we expect the challenging economic conditions to

Figure 1: Yields, the key valuation metric for fixed income, remain near 12-year highs



Source: FactSet, Wealth Investment Office, as of June 30, 2023

widen spreads but not to the same extent as past recessionary levels. We are mindful of the resilience offered by robust balance sheets in high quality credit and we expect technicals to remain supportive and the healthy yield cushion to offset losses. We continue to focus on fundamentals and valuations amid varying drivers of future performance.

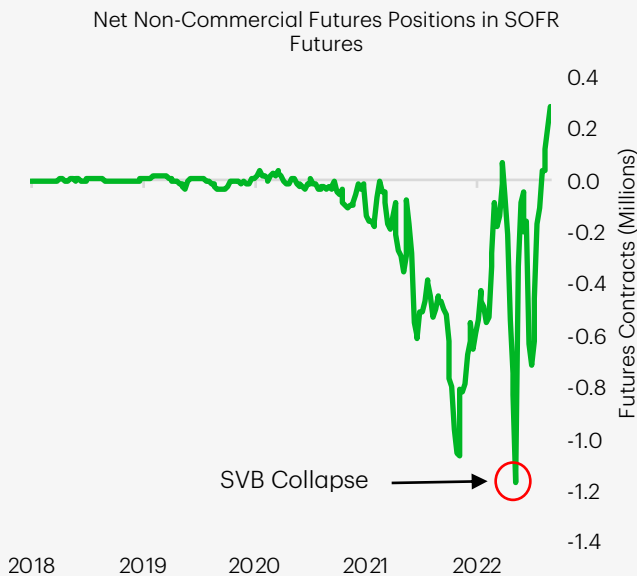
- We maintain our modest underweight view on high yield (HY) credit. The HY credit market remains in its unique cycle with changing characteristics that have improved overall quality and tightened spreads. This should keep spreads from returning to previous recessionary levels, but they will widen if the growth outlook deteriorates.

Government bonds

We maintain our modest overweight view on government bonds: yields remain range bound at high levels and starting yields historically have had a powerful correlation with bond returns. Today's yields offer investors more opportunities for income generation and downside protection.

We believe the slower than expected decline in inflation and economic growth will keep the Fed on its toes. While we may be hovering around peak government bond yields, we'll likely continue to experience data-dependent bouts of volatility as long as we lack clear forward guidance from central banks and fixed income investors remain opportunistic which will keep yields range bound for even longer (Figure 2). We don't expect yields to plummet unless markets experience a severe systematic event.

Figure 2: Opportunistic repricing of shorter maturity government yields



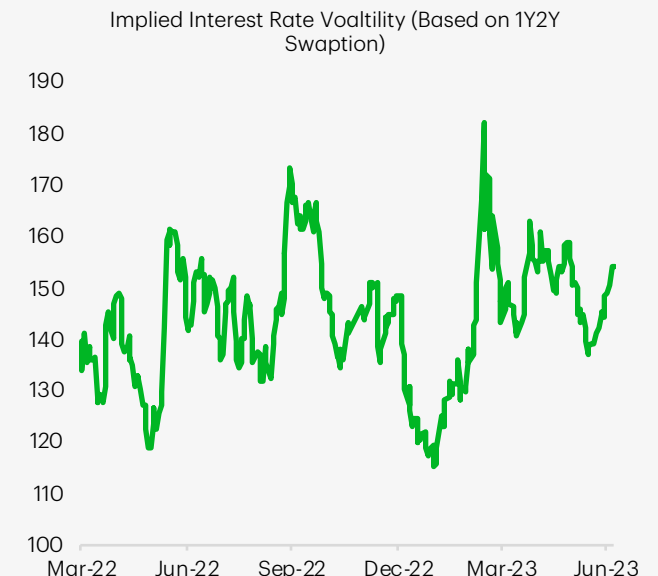
Source: FactSet, Wealth Investment Office, as of June 30, 2023.

It's important to take a balanced view of government yields and avoid very bullish or bearish outlooks. Inflation should keep slowing in coming months. Severe economic downturn is not our base case scenario and it has been gradually priced out by markets as well. If central banks have to deal with a liquidity crunch, they have the deep pockets and a variety of tools to do so. They can also use more targeted remedial methods instead of policy rate cuts. At the other end of the spectrum, we're wary of any over-exuberance pertaining to economic resiliency as the sentiment pendulum will always swing back.

Our key themes for government bonds are:

1. Continued, but moderating, government bond yield volatility. Near the end of Q2, market participants pushed expected policy rate cuts further into the future, partly because they're now anticipating another rate hike or two and because of the robust economy. As a result, shorter maturity yields rose relative to the rest of the curve but with volatility well below levels of February-March. Implied volatility at the front end of the curve has pulled back from elevated levels and conditions are in place for further moderation for two reasons (Figure 3). First, tail risk from bank stress continues to recede. Despite some residual uncertainty, our base case for an orderly labour market rebalancing and a gradual decline in inflation seems increasingly likely. This is reflected in the declining dispersion of growth, inflation and policy rate forecasts by the economists. Second, a slower pace of Fed tightening should reduce the risk of over-tightening and narrow the distribution of policy rates around the modal case.

Figure 3: Volatile interest rate markets



Source: FactSet, Wealth Investment Office, as of June 30, 2023.

Fed Chair Jerome Powell's semi-annual testimony to congress and his comments at the June conference in Sintra, Portugal yielded little additional insight regarding the path of Fed policy in 2023. He reiterated the need for further policy tightening albeit at a slower pace. The bar for a higher terminal policy rate will be raised if the slowdown in inflation holds for coming months alongside a moderating but healthy labour market. If the Fed wanted estimates from its Summary of Economic Projections (SEP) to persuade markets to price out near-term policy rate cuts, then it has clearly achieved it.

In Canada, and according to TD Securities, easing capacity pressures and softer consumer inflation expectations will be welcome news for the BoC. However, it's also keeping an eye on the rebound in house price expectations and possibly the fading impact of the policy rate hikes. This data along with expectations for softer inflation didn't deter the BoC from hiking the policy rate in June and July and it does make us wonder whether the bank will hike again, but the bar for that is higher than before.

In the last PSQ we suggested that elevated volatility was unlikely to persist for long and that economic fundamentals warranted a lower rate regime. We believe government yield volatility will continue to abate and we'd like to remind readers that with volatility comes opportunity; given that government bond yields are expected to remain range bound, astute and active fixed income managers could log attractive returns with tactical duration adjustments to their portfolios.

2. A prolonged yield curve inversion.

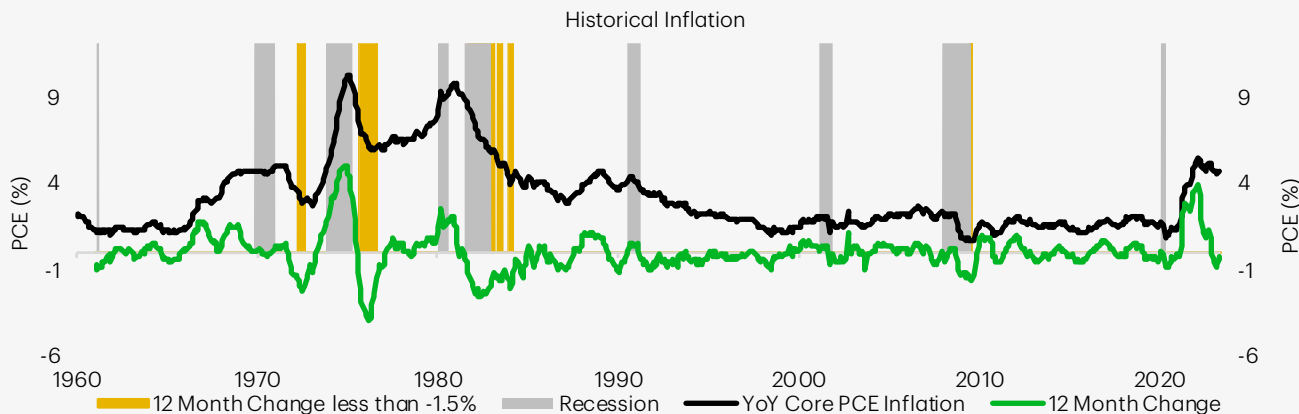
We believe the U.S. government yield curve inversion will persist over coming quarters if we continue to avoid a recession. Though we could also argue that the short- and intermediate-maturity curves are too inverted relative to underlying economic fundamentals.

We believe this mostly stems from investors responding to economic resilience by pushing central bank easing further into the future rather than changing their perception of the real neutral rate. What does this mean? The real neutral rate is the short-term interest rate expected when inflation is stable and an economy is working at full strength, according to the Fed. So this means that investors aren't yet willing to let go of the very low real neutral rates post Global Financial Crisis (GFC) and still expect to return to them. It would take a lot of data showing that the economy is resilient during higher policy rates before investors would reassess their position. This, combined with a Fed unlikely to ease in the near term, will keep yield curves inverted for some time. Over the shorter term—unless economic data signals a clear deterioration or the Fed keeps rates higher for longer leading to a rebuilding of term premium in longer maturity bonds—we don't expect any curve steepening. Over a longer horizon, we expect curve inversion to fade through a combination of policy easing and an upward repricing of both medium-to-long term real rates and inflation risk premia.

3. Inflation is slowing, but let's not get carried away.

Recent U.S. inflation data confirmed the ongoing cooling of price pressures. We expect further declines in inflation but markets appear more optimistic than we are about the pace of moderation. There could be a few reasons for this. First, investors might be expecting growth, and therefore price pressures, to decelerate faster than we do. We believe inflation will maintain its gradual slowdown because of strong consumer spending, robust income gains, and tight labour markets. Second, markets and investors may be mispricing components like healthcare that could experience delayed onset inflation. Third, with futures pointing to weaker energy prices, it's possible that investors are even more bearish on energy prices than commodities futures. (Figure 4).

Figure 4: Historically only a deep recession has sent core PCE inflation down as much as consensus forecasts in 12 months



Source: FactSet, National Bureau of Economic Research (NBER), Wealth Investment Office, as of June 30, 2023

Key risks to our views:

- **Stickier than expected inflation.** While housing inflation should slow in coming months, ongoing strength in core services ex-shelter and core goods inflation remains a risk. In fact, core goods disinflation was previously expected to pull overall inflation lower, but strong demand has prevented any decline.

- **Resilient labour markets and consumers.** In the post-Covid recovery world, workers became scarce and demand for goods and services skyrocketed which prompted employers to start labour hoarding, reflected in the low 3.7% unemployment rate. Corporate profit margins, although running at historically high levels, have come under pressure in the past several quarters and this pressure might lead to layoffs but for now labour markets seem to be in a good shape and will support shallow economic moderation.

Credit: investment grade and sub-investment grade

Given softening economic growth, we maintain our long-held view of modestly wider spreads in coming quarters, however technicals will likely remain positive and peak spreads should be lower than previously anticipated.

We are neutral on IG credit and maintain our defensive stance on HY credit. We believe the value proposition of owning short-dated IG bonds as a total return product is attractive; they now offer close to the highest all-in yield since the late 1990s, excluding the 2008/2009 recession (Figure 5). Higher yield offers greater protection if spreads widen but higher quality credit will widen less than others. We expect HY spreads to widen more relative to IG because they

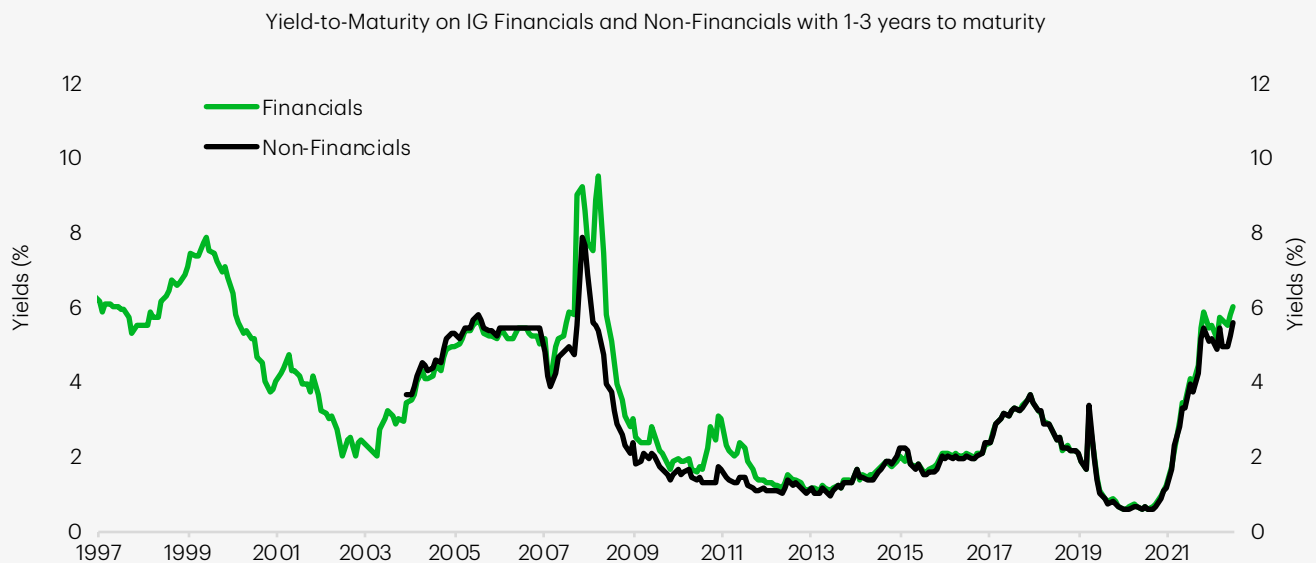
are more sensitive to deteriorating fundamentals and tighter credit conditions. We're more comfortable owning IG over HY, despite the potential for spread widening, because of the yield cushion and balance sheet strength offered by IG.

Overall, we maintain our cautious view on credit spreads in the near term due to: 1) weakening credit fundamentals and, 2) their strong correlation with government bond yield volatility that we expect will gradually moderate. With yield volatility set to decline in coming quarters, we continue to focus on fundamentals and relative value.

Our key themes for IG and HY credit are:

1. Fundamentals are mixed. IG credit fundamentals look solid, but trends are deteriorating as economic growth slows and input costs, particularly wages, grow faster than revenue. Many companies have indicated an increased focus on costs and headcount given these margin pressures and we expect these trends to continue though they should subside in coming months as labour markets and inflation cool. Companies are reacting to the challenging economic environment with slower debt growth and by re-evaluating capital returns to shareholders - particularly share re-purchases. These are positive trends for creditors or bond investors. Overall, the gradual moderation of economic growth has allowed companies the time to adapt to the more challenging environment. In the current environment IG issuers are in a better place than HY and leverage loan credit borrowers particularly because most IG debt has relatively longer maturities and a fixed coupon.

Figure 5: Shorter maturity IG offers yields not seen in over a decade



Source: FactSet, Wealth Investment Office, as of June 30, 2023.

2. Technicals are moving in the right direction, but valuations aren't.

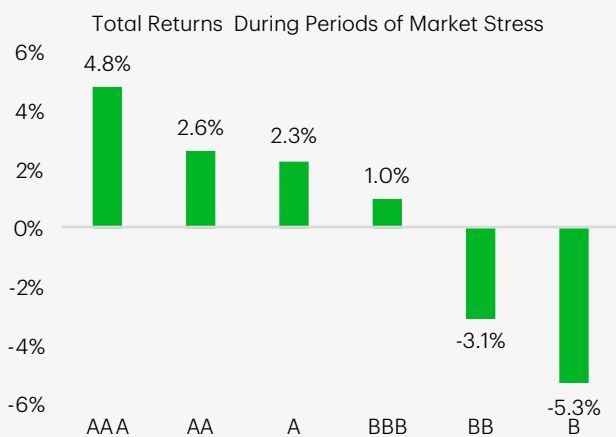
The bulk of demand for corporate bonds is driven by yields so the most positive and supportive technical component is that yields are high. One counter argument is that some other IG bond markets are cheaper (Mortgage-Backed Securities, Commercial Mortgage-Backed Securities) and offer higher excess yield, or spread, over U.S. government bonds (or Treasuries). This partially explains why IG credit spreads have lagged the spread compression (driven by the rally in prices) in other IG markets. Very high foreign exchange hedging costs are another negative technical weighing on overseas demand for IG credit and other U.S. assets. On the positive side, demand for IG credit from individual investors is robust: inflows totaled US\$110 billion (bln) so far this year, unwinding 67% of the US\$164 bln of outflows in 2022. We believe this trend will continue as the 'bonds are

back' theme builds momentum. Finally, pension fund demand for IG credit remains a supportive technical. The 100 largest corporate pension plans have an average funding status of more than 100%. which means they will be increasing their allocations to fixed income, particularly IG credit, to reduce portfolio risk.

3. Quality is still key. During periods of market stress, investors run to more secure debt meaning government bond prices tend to increase, yields decline and credit spreads widen hurting total returns for lower rated credit. For example, IG credit has posted positive total returns during the three market downturns since 2010 (European sovereign debt crisis in 2011, the commodities crash of 2015, and the Fed's aggressive rate hiking cycle in 2018) while returns for HY bonds were negative (Figure 6). If we focus on BBB-rated bonds, only the low-BBB lost money on total returns, while returns for mid-BBB and high-BBB were positive.

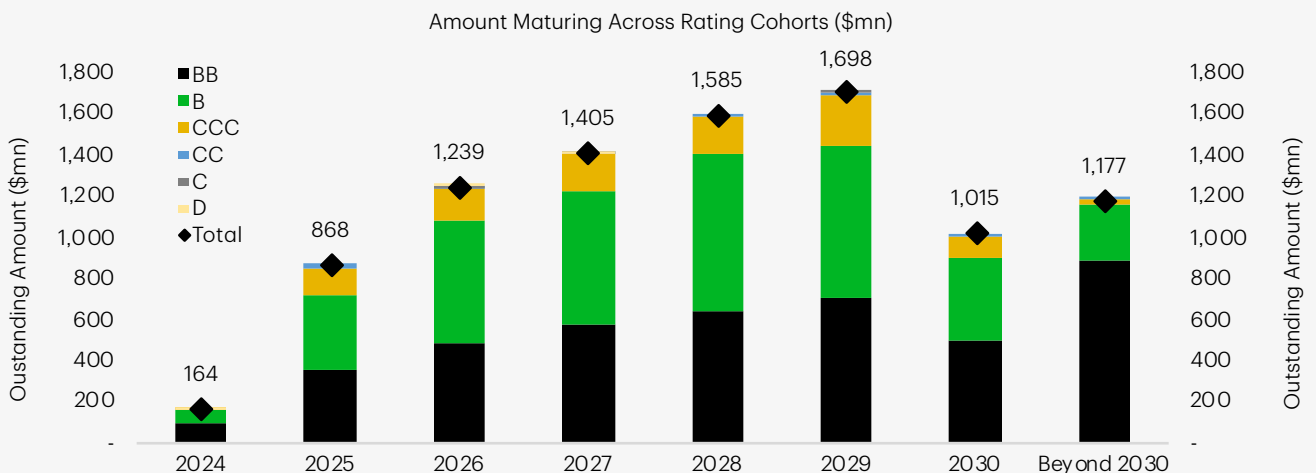
4. Maturity walls are distant but looming. So far, HY companies have weathered the sharp increase in borrowing costs for the most part by limiting new issuance or staying on the sidelines. That is a luxury they may not have if economic growth, the central bank stance, and the earnings environment persists unchanged into 2024. For context, the amount of U.S. HY bonds and leveraged loans entering the 18-month refinancing window jumps from US\$164 million in 2024 to US\$868 mln by 2025 end. With the coupon versus current yield gap for most single B and CCC rated corporate bonds in the area of 4-5 percentage points, these companies will either have to deliver better operational performance and improve their ratings or rely on secured debt capacity to reduce the cost of borrowing. Otherwise, the potential for more adverse outcomes will increase if borrowers continue to wait to refinance (Figure 7).

Figure 6: Positive average total returns for IG credit in periods of market stress



Source: FactSet, Wealth Investment Office, as of June 30, 2023. Past market stress periods considered for the analysis are European sovereign debt crisis in 2011, the commodity crisis in 2015 and the Fed rate hiking cycle in 2018.

Figure 7: Maturity wall for lower quality credit ramps up in 2025



Source: FactSet, Wealth Investment Office, as of June 30, 2023.

Higher yields and diversification

The income on offer from bonds is clearly much more enticing. Yields for the global government bond benchmark jumped about 266 bps in the past 18 months and HY bond yields are in the high single digits. Valuations in inflation-adjusted terms also look more attractive—while the roughly 1.5% real yield on global government bonds may not sound particularly exciting, it's a post GFC high and close to long-term averages.

The potential for bonds to support a portfolio amid the most challenging conditions—including a deep recession or escalating geopolitical tensions—is perhaps most important for multi-asset investors. If, for example, 10-year U.S. Treasury bond yields fell from 4% to 3% over the next 12-months, it still represents a total return of approximately 7% which should help offset any downside in riskier investments. Such diversification properties simply weren't available for much of the past decade.

We are maximum overweight for the fixed income market overall because we believe fixed income has once again earned its place in the multi-asset toolkit providing investors with the best opportunity in over a decade to build diversified portfolios. In the current investment landscape, an astute active fixed income manager who is versed in long/short credit strategies and able to make tactical duration adjustments when government bond yield moves are overstretched, could realize strong returns.

A final note on fixed income

With yields finally reaching attractive levels, the income component of fixed income is back. The inherent short-term volatility in yields will likely persist as markets try to price in central bank cuts (driven by the varying probability of severe stress events) and this will drive market participants to constantly reprice the future of policy rates and economic growth. The attractive income cushion should provide a buffer to these bouts of volatility. For example, a 3.8% yield for a U.S. government bond (as of June end) will need a 55 bp increase in yield to post 0% return over the next 12-months. On top of that, during economic

downturns, bonds are once again able to fulfill their traditional role as risk diversifier. We reiterate the key aspects of fixed income investing:

1. Fixed income portfolios are not meant to capture upside risk.
2. Fixed income is more than just government bonds. The current environment calls for a flexible approach to building resilient fixed income portfolios, including diversifying sources of return within fixed income and emphasizing relative-value opportunities when generic beta exposures don't look compelling.
3. Maybe the most important aspect is that duration, or interest rate risk, still has a role to play in portfolios. Duration tends to have a negative correlation to other risk assets and the role of duration and the fixed income asset class, as a whole, has been challenged in the high inflation environment but we need to remember that higher yields translate into enhanced downside protection if markets sell off. Importantly, this long-term negative correlation with risk assets tends to act a hedge and this is unlikely to change. With low convictions around the direction of government bond yields, we don't suggest investors offload all duration-heavy solutions or core bonds. Rather, we encourage tactical adjustments because we firmly believe there is an appropriate place for duration as a hedge in portfolios.

If investors move towards lower duration and riskier credit solutions in the fixed income sleeve, they must remain vigilant of the inherent drawdown risks as losses in the riskier parts of fixed income can be severe. Importantly, with higher yield on offer within high quality fixed income, the need to dive into riskier fixed income components might be unnecessary. Finally, investors must monitor potential total return losses, and they should not overlook the attractive levels of all-in yield or the income that fixed income investments can deliver from now on.

Consider the drawdown risks acceptable to clients who are investing heavily in fixed income and evaluate probable income versus probable drawdowns instead of probable returns versus probable volatility.

Outlook on Equities

Diversify and Hold On

David Beasley, Senior Portfolio Manager; Chris Blake, Senior Portfolio Manager; and Kevin Yulianto, Portfolio Manager; Chadi Richa, Manager, North American Equities; Andrej Knreta, North American Equities | TD Wealth

Following a challenging 2022, global stock markets are trading sharply higher in the first half of this year with U.S. equities leading the pack. But the breadth of this rally is the narrowest on record for the S&P 500: seven large-cap technology companies — Apple, Microsoft, Amazon, Alphabet, Meta, NVIDIA and Tesla — have accounted for close to 100% of the returns so far in 2023.

The valuation expansion of the S&P 500 to 20x forward earnings at the end of Q2, and the sharp outperformance of cyclical to defensive stocks, suggest the stock market is pricing in a new business cycle. But new business cycles rarely begin with a record-low unemployment rate, above-potential GDP growth and tight monetary policy, which makes economic growth unlikely. In addition, economists are expecting weak, if not recessionary, GDP growth for the third and fourth quarters of 2023, which is also seen in leading economic indicators.

Overall, our outlook for global equities remains cautious as we expect corporate earnings growth to face headwinds as nominal economic growth slows. Over time, we expect higher-quality companies to overcome these headwinds, while market volatility can create attractive entry points. We continue to favour a “barbell strategy” for equity portfolios, with exposure to high-quality tech leadership companies alongside defensive, value and income stocks.

Equity Sector Focus by Theme and Style

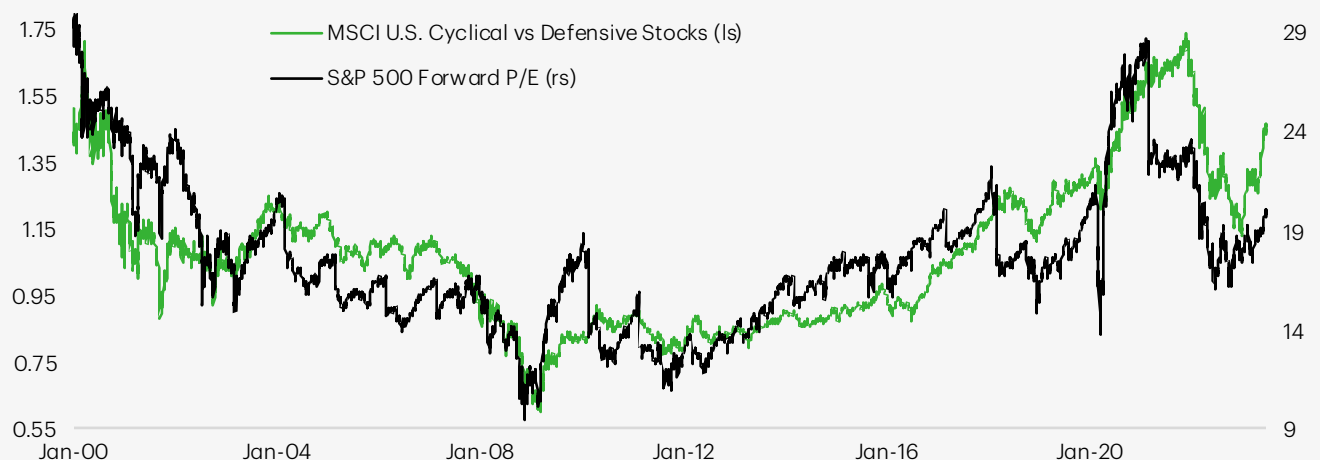
In any economic cycle, active equity managers can invest in “themes” (i.e., popular sectors or new ideas) garnering a disproportionately large share of spending, or they can rotate through styles as the market favours stock characteristics like dividend-paying stocks (income), stocks trading at relatively attractive valuation levels (value) or stocks expected to see accelerated compounding of capital when the economy swings up (growth).

The economic themes we are leaning into include reshoring manufacturing, electric transportation and artificial intelligence. Regarding styles, we believe well diversified portfolios can benefit from value and income in energy, income in finance, and growth in information technology.

Energy: Value and Income

Oil and gas is typically a highly cyclical industry, with energy stocks rising and falling with economic expansion and contraction. While industrial activity drives much of the demand for energy, the supply-demand balance has tightened structurally. At the same time, company management teams have generally moved their capital allocation framework away from investments in growth (like new rig deployments) and towards shareholder returns in the form of dividends and stock buybacks. These factors have turned oil and gas into a late-stage target of value and income investors this cycle.

Figure 1: Rising valuation and outperformance of cyclical to defensive suggest the beginning of a new business cycle



Source: FactSet, Wealth Investment Office, as of June 29, 2023

While the U.S. Department of Energy's release of approximately 200 million barrels of oil from the Strategic Petroleum Reserve has provided temporary supply to offset the lack of investment in discovering new sources of oil, it has also driven inventory to a 40-year low. The necessary refilling of the SPR should reverse those effects and further tighten supply.

Other factors affecting supply include Saudi Arabia's recently announced unilateral cut of a million barrels per day of production, and the ongoing (presumed) below market transactions between Russia and its oil trading partners. On the demand side, in spite of China's risky economic outlook, the International Energy Agency recently projected an increase in global oil demand of 2.2 million barrels per day. The projected increase in supply of 1.2 million barrels per day suggests the supply-demand balance is sufficiently tight to support prices at current levels.

Turning to energy equities, oil and gas stocks continue to trade at deep value. The sector is trading at a 3.7x multiple of Enterprise Value (EV) to consensus estimated 2023 EBITDA versus the 20-year average just above 6.0x (Figure 2).

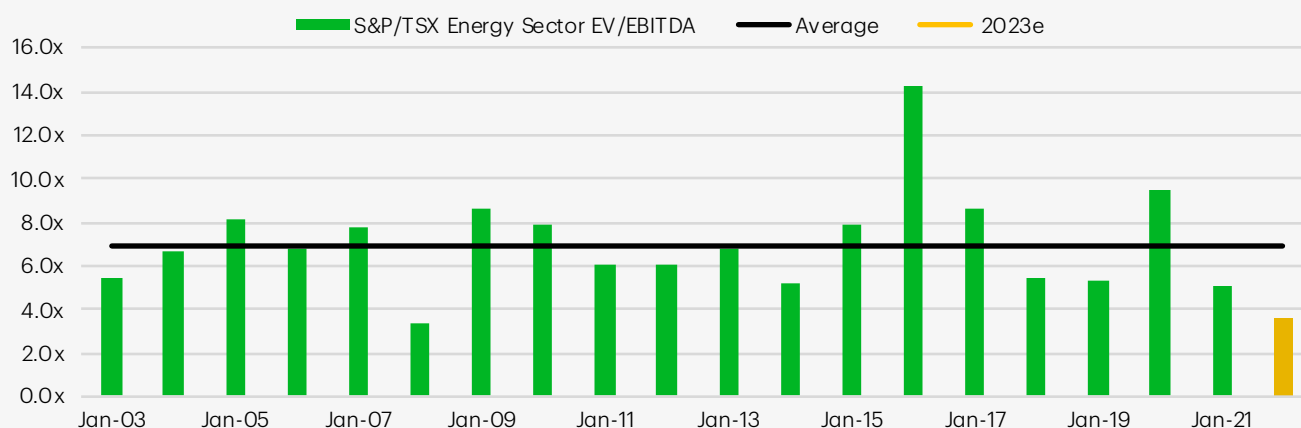
For reference, this metric has only traded below 4.0x once over this 20-year period. That was in 2008, which was a much worse economic environment than the current economic cycle's most bearish data shows.

We also see an attractive income component to the group, as current yields are healthy and easily sustainable in the 2.5% to 5% range and are expected to go up significantly in the coming quarters as free cash flow yield is expected to average over 10% for the group. This free cash flow is due to be returned at 50% to 100% (compared to current payouts of 30% to 40% at the higher end of the range) once these companies hit the deleveraging targets explicitly pledged by most management teams, likely in the coming few quarters.

When adjusting implied stock prices with that level of free cash flow payouts and priced at a 5% dividend yield, there appears to be significant value remaining in energy equities.

The group of companies shown in Figure 3 are examples of Canadian energy companies that we own across our enterprise that offer a combination of strong free cash flow yields, attractive dividend yields and discounted valuations.

Figure 2: Energy sector trading at deep value levels versus historical average



Source: FactSet, Wealth Investment Office, as of June 29, 2023

Figure 3: Canadian Energy Equity Holdings Valuation and Yields

Ticker	Company Name	Price	EV/ EBITDA 2023E	Dividend Yield	Free Cash Flow Yield 2023e	Indicated Dividend Payout as % of FCF'23e	Implied Dividend Yield at 75% FCF'23e Payout
SU	Suncor Energy Inc.	\$38.63	4.0x	5.4%	11.4%	35.5%	11.4%
CVE	Cenovus Energy Inc.	\$22.16	4.6x	2.6%	11.2%	18.2%	10.6%
WCP	Whitecap Resources Inc.	\$9.19	3.5x	6.3%	14.0%	36.3%	13.0%
ARX	ARC Resources Ltd.	\$17.66	3.9x	3.9%	6.9%	46.5%	6.2%
VET	Vermilion Energy Inc.	\$16.43	2.5x	2.2%	19.7%	8.3%	19.8%
CNQ	Canadian Natural Resources Ltd.	\$73.73	5.5x	4.9%	9.3%	45.7%	8.0%
TOU	Tourmaline Oil Corp.	\$61.91	5.0x	1.7%	9.2%	17.7%	7.1%
	Group Average	-	4.1x	3.8%	11.7%	29.7%	10.9%
	Sector Average	-	3.7x	3.7%	9.1%	-	-

Source: FactSet, Wealth Investment Office, as of June 29, 2023

Banks: Income Opportunity

Similar to bonds, investing in banks is a negative art that emphasizes exclusion rather than searching for the stock with the highest upside. This is especially important due to the significance of banks, particularly Canadian banks, as income-generating investments.

The banking industry is highly regulated and competitive; both factors can limit earnings growth, and during times of crisis and economic environments characterized by negative growth, holding the wrong bank stocks could prove to be detrimental to portfolio returns, with losses potentially taking years to recover. We focus on regulated large banks that benefit from scale, a diversified business model and, more importantly, a strong balance sheet.

This is important because we foresee challenges in the mid-term, primarily due to three main headwinds that are impacting earnings growth.

The first is restrictive monetary policy driving deposit outflows from the banking system and into higher yielding products, such as money market funds. This trend is more pronounced in the U.S., where it is expected to continue at a slower pace than what banks experienced since the beginning of the rate hiking cycle. As a consequence, banks' balance sheet growth is expected to slow compared to the previous decade, and we saw that play out in the second fiscal quarter for the Canadian banks, while deposits in the U.S. dropped 5% y/y at the end of May — the fastest pace on record.

To mitigate this risk, we focus on banks that have either completed or announced an acquisition, which would enable them to deliver above-peers earnings growth. These include Royal Bank of Canada, Bank of Montreal and JPMorgan Chase & Co. Furthermore, given recent comments from U.S. regulators in favour

of consolidation in the banking industry, banks with excess capital are also well-positioned to benefit from attractive opportunities.

The second headwind is rising deposit costs, which leads us to believe that net interest margins (NIM) have peaked and will stay under pressure during the second half of the year. Here again, banks that are completing an acquisition will be able to, at least partially, offset the negative impact of NIM contraction through balance sheet growth.

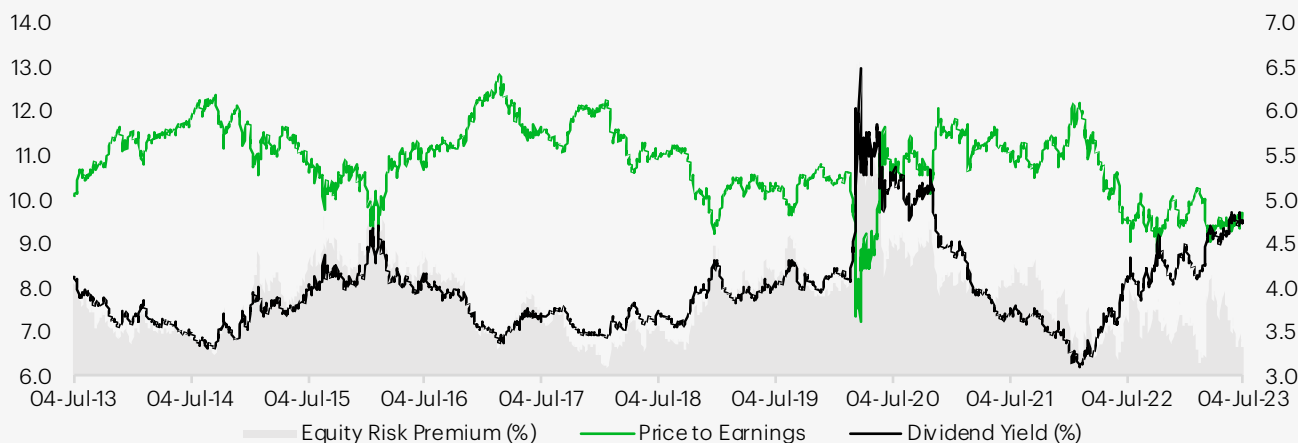
The third headwind is normalization in credit losses, a trend following record-low levels during the pandemic.

While the strong labour market should continue to support gradual normalization as opposed to rapid deterioration during recessionary periods, the situation for Canadian banks is somewhat more complicated due to the high exposure to residential mortgages (43% of loans). This is where the outlook is less clear and will depend on (a) the state of the economy over the next two years, when mortgages underwritten at extremely low rates during the pandemic come up for renewal, and (b) interest rates.

On the positive side, Canadian banks are well capitalized to weather the next credit cycle, should it materialize, and this is maybe the most important factor in our positioning, because the higher excess capital a bank has the more downside protection for investors.

Canadian banks are trading at a forward price-to-earnings multiple of 9.7x, which is at the low end of the historical range. Barring a credit cycle, we believe this valuation is appropriate, since it is difficult to justify a higher valuation multiple considering the level of interest rates and low earnings growth outlook. In the meantime, investors can earn a 4.7% dividend yield, at the high end of the historical range, if we exclude severe market downturns.

Figure 4: Fair valuation given earnings headwinds



Source: FactSet; Wealth Investment Office. As of July 4, 2023.

Technology: Multiple Paths to Growth

While navigating through the post-pandemic demand normalization, we remain focused on the macroeconomic trends that will help grow earnings, and we see these themes as key drivers of the compounding effect on the underlying fundamentals in our sector:

- i. investment in infrastructure,
- ii. complexity of managing the semiconductor supply chains
- iii. next generation productivity-driving technologies
- iv. cloud adoption as software development becomes a strategic functional unit at enterprises.

Recent initiatives to upgrade national infrastructure, including the energy grid and transportation networks, are set to drive the demand for technology that enables automation and energy efficiency. Microchip Technology (MCHP), another example of a quality company, supplies components with novel compound materials, such as Silicon Carbide, that are more energy efficient than Silicon and will be key in enabling the adoption of the electric vehicle charging infrastructure. Also, the company's dominant position in microcontrollers lets them supply deployment-ready reference designs for factory automation. As a result, their customers can ship faster across end markets, accelerating the timeline of reaching the productivity goals and economic gains to enable onshore manufacturing.

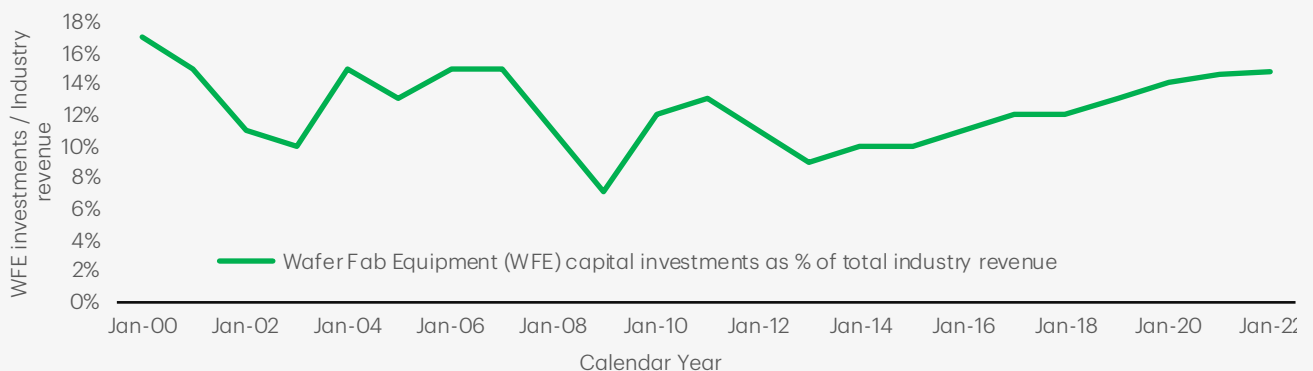
In the semiconductor space we are focused on the de-risking of the supply chains and the growing complexity of chip production. In both regards, KLA Corp (KLAC), a semiconductor equipment supplier, is well positioned to capitalize on the demand for chip fabricators to achieve economically viable high-volume production faster, a need resulting from new fab expansions in geographies with lower geopolitical risks.

Producing smaller more performant chips depends on the ability of firms like KLAC to deliver the equipment that facilitates the process. This is driving higher capital investments in the chipmaking equipment at semiconductor manufacturers.

Microsoft (MSFT) provides exposure to the impact Generative AI (Gen AI) may have on economic productivity this decade. As one of only a few providers of relevant computing infrastructure for foundation models or their LLMs (large language models) variations, MSFT has gained an early mover's advantage since it integrated the Co-pilot feature into the Office 365 suite. The product automates administrative tasks and, in turn, creates meaningful productivity gains for the end user. Although it is still early days, the emerging results are encouraging. And with the infrastructure buildout intensifying because of the technology from Nvidia (NVDA), many more points of validation of Gen AI as a key productivity driver are likely to come.

Finally, we see a multi-year demand for Cloud services, which will let enterprises across industry establish internal software teams. Regardless of the industry, organizations cannot afford to outsource the product-related software procurement, especially if it is a part of competitive differentiation. For example, automotive companies are ill-advised to cede the development and, in turn the control, of its autonomous driving technology to a third-party. As a source of competitive differentiation, software will have to be developed natively by internal talent. As a result, we expect continued demand from enterprises for cloud-native development platforms, including workload hosting in the public cloud as well as at the network edge for mission-critical applications.

Figure 5: A rise in the capital intensity of spending on fabrication equipment suggest a sustainably higher demand



Source: Wealth Investment Office, as of July 5, 2023.

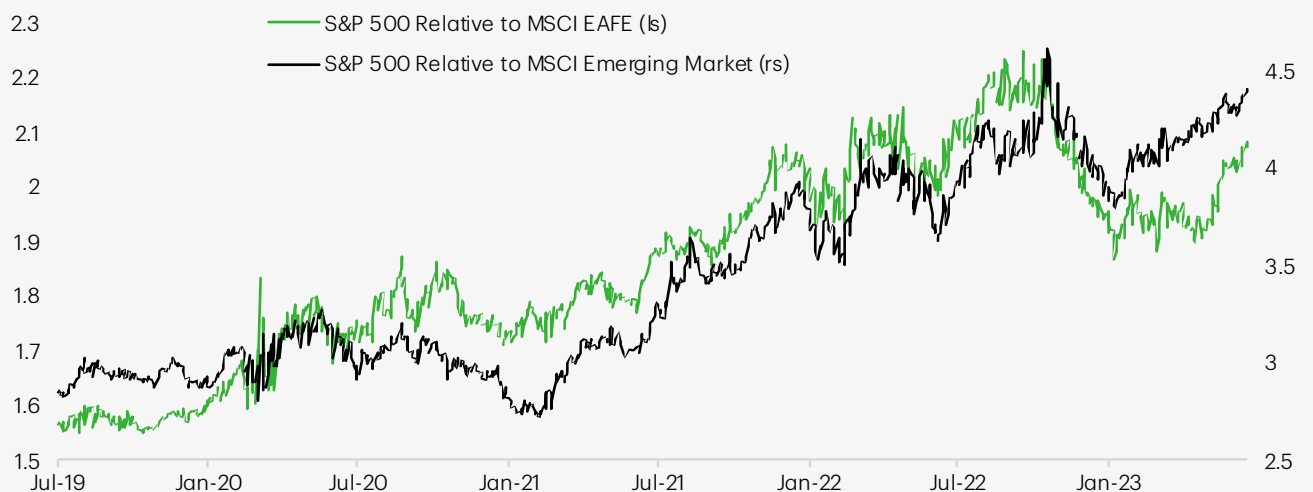
Industrials & Materials: Theme Playing

At times, when we step back from the market to look at some of the big picture drivers of the economy, it becomes apparent that there are large forces at play driving individual or corporate spending. These can be demographic (such as the aging population) or investment driven (spending on cloud infrastructure outlined above), and they tend to play out irrespective of near term macro-economic vacillations. The larger themes in the economy that we see as driving a secular growth pattern right now are related to re-shoring (or near-shoring) reduced carbon (renewable energy, electric vehicles), and the advent of artificial intelligence (AI). Today, AI is early stage and, as a theme, mostly affects the technology sector. Eventually though, it will move out of the development stage and to a point where applications are developed that will change aspects of manufacturing and logistics.

Reshoring and carbon reduction are already playing out, and are now being helped with government spending around the world.

- The United States has put a number of significant spending programs in place, like the Inflation Reduction Act that funds onshoring the manufacturing of electric vehicles, batteries and renewable energy adoption, the CHIPS and Science Act that provides significant incentives to onshore semiconductor manufacturing, and the US Infrastructure Investment and Jobs Act that targets power grid updates and electric vehicle charging networks.
- Europe recently put in place a US\$240-billion plan to target energy transition.

Figure 6: U.S. stocks outperformed international and EM stocks in Q2/23



Source: FactSet, Wealth Investment Office, as of June 29, 2023

- China has its "1+N" policy framework with large investments in renewable energy, electric vehicle charging infrastructure and electric grid upgrades.

Within the industrial space, we expect to see these programs enhance the fortunes of companies that provide electrical infrastructure. And we see other companies that can benefit from the construction of manufacturing facilities that emphasize efficiency. Companies like WSP Global, General Electric Co., Eaton Corp and ATS Corporation are all examples of quality businesses that provide exposure to some of these areas. Similar to other companies mentioned in this article, we are highlighting these companies as examples of quality businesses that are well positioned to benefit from the themes that we believe will play out over the next few years. Our sharing them should not be deemed as an investment recommendation to go out and purchase.

This spending will affect the need for a variety of commodities as well. Copper, one of the major electric conductors, is likely to see growth in demand and is a commodity that has seen little investment in production over the past decade.

Of course, in the event of an economic slowdown, the companies expressing these themes will also likely see business slow to some extent, however we hope that any slowdown will be moderated to at least some extent by the secular forces underlying the demand.

International Equity and Emerging Markets: The Case for Diversifying

U.S. stocks outperformed international and emerging market (EM) stocks in Q2/23 due to the strong performance of tech stocks, which account for a sizeable part of U.S. equity benchmarks. The S&P 500 rose 8.5% during the quarter, while international and EM stocks were roughly flat (Figure 6).

In our last edition of the PSQ, we highlighted the difference in sector exposures between the three indices and the potential implication for investors.

“EM and international stocks remain attractive relative to the U.S., but because foreign stocks are more exposed to these cyclical sectors, that relative appeal is in decline. Financials, consumer discretionary, industrials, energy and materials account for 39% of the U.S. equity universe, compared to 57% and 54% for international and EM stocks, respectively. Moreover, the potential for further decline in long-term yields amid recession fears is also supporting the performance of long-duration stocks, which are commonly found in the info tech sector and account for a quarter of the U.S. benchmark.”

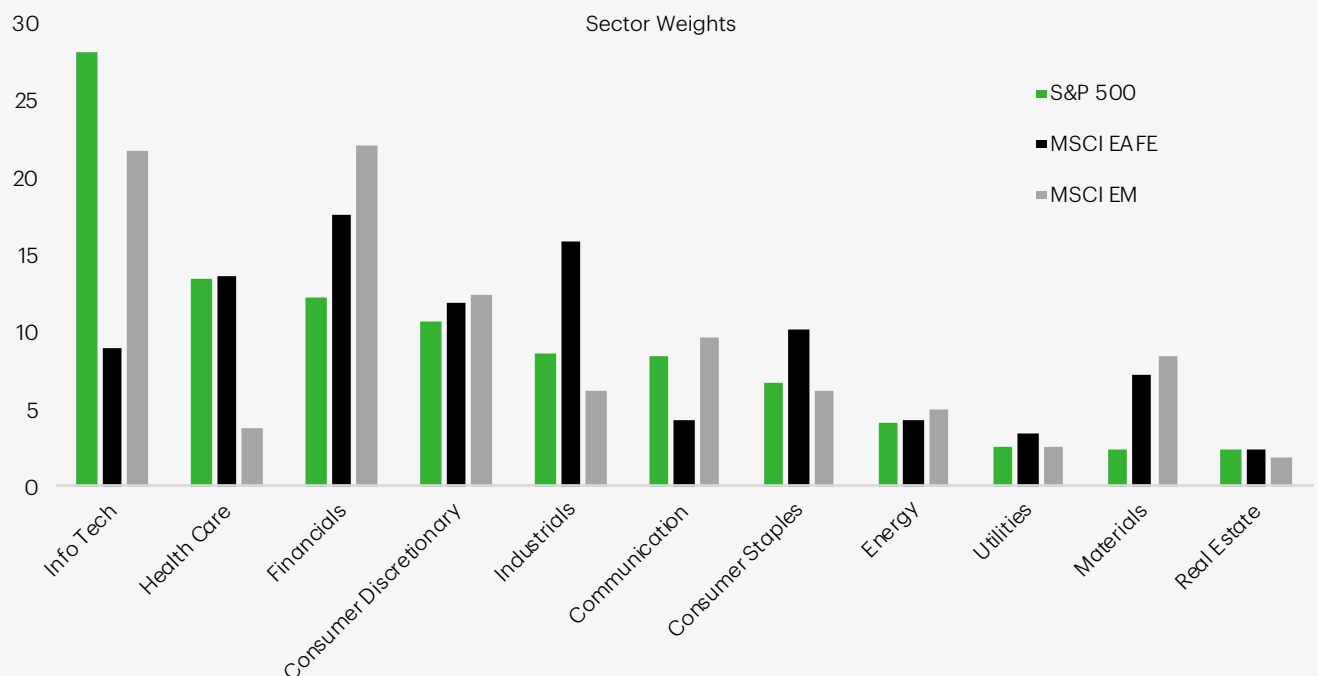
As it turns out, U.S. equities did outperform, driven by the seven largest technology companies – Apple, Microsoft, Amazon, Google, Meta, Nvidia, and Tesla. Tech stocks rallied on the back of positive news on AI development while many cyclical sectors lagged. This weighed on international and EM markets. At the end of Q2, the weight of the info tech sector in the U.S. benchmark has risen to 28% while its exposure to cyclical sectors fell slightly to 38% (Figure 7). International and emerging market benchmark cyclical weights remained unchanged at 57% and 54%, respectively.

Valuation levels remain quite attractive for EM and international equities, as many of these markets trade at attractive discounts to U.S. equities. However, we believe performance will diverge over the near term due to idiosyncratic factors.

In aggregate, international stocks are trading at a forward P/E of 13.4x (28th percentile) and EM stocks are trading at 13.3x (65th percentile). This compares to the forward P/E of 20x (80th percentile) for the S&P 500 at the end of Q2. From a valuation perspective, international and EM markets continue to look relatively attractive. However, historically, a backdrop of tightening global monetary policy and lower global growth outlook has led to relative underperformance in international markets in the coming quarters.

The outlook for monetary policy for developed and emerging countries are also starting to diverge. Whereas central banks in the U.S., U.K. and Europe are still expected to hike policy rates and hold rates at higher levels for some time, emerging markets’ central banks are either already cutting rates or are expected to do so very soon. For example, People’s Bank of China lowered its one-year loan prime rate by 10 bps in June while the Brazilian central bank is expected to cut its policy rate in August, as inflation there plummeted from 12% in June 2022 to below 4% as of early July 2023.

Figure 7: Cyclical sector accounts for greater share of international and EM equity benchmark



Source: Company reports, Wealth Investment Office, as of June 29, 2023

This divergence between developed and emerging market's central bank policy could mean greater support for the valuation of EM stocks. At the same time, it will allow EM countries to resume the upswing in their respective business cycles, which will further bolster the earnings outlook of EM stocks.

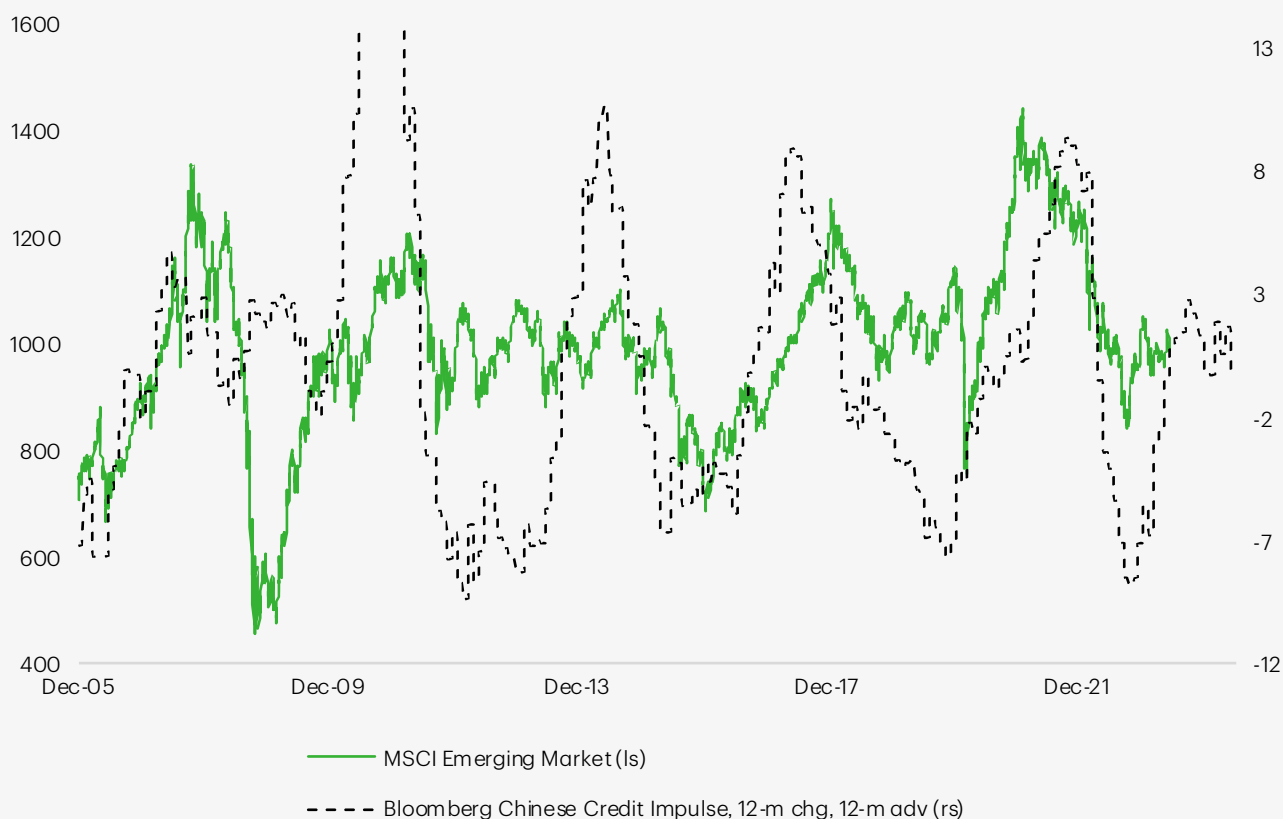
An important factor in the recovery of EM economies and hence their asset prices relates to the Chinese authorities' efforts to reflate the world's second largest economy (Figure 8).

Given their shifting priorities towards "quality growth" and the expectation for a consumer-led recovery, Chinese growth may not be as commodity-intensive as has historically been the case. However, the structural demand of certain base metals for renewable energy infrastructure, electric cars and electronics could more than offset the weaker Chinese commodity demand growth. A higher contribution of energy, materials, industrials and financials in the international and EM equity benchmark means they

should reap greater benefit from the coming upswing in the global business cycle. Although the commodity prices may be challenged in the near term, especially if a recession materializes, the long-term outlook for energy and select base metal producers remains attractive given the tight structural supply-demand picture in the coming decade.

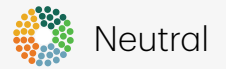
We believe investors will benefit from a well-diversified portfolio across different equity markets. Given the domination of the top 10 stocks in the S&P 500, diversification could be achieved by broadening portfolio exposure towards international and EM stocks. But this approach is fraught with risks like threats of currency depreciation against the U.S. dollar, geopolitical concerns and less shareholder-friendly governance, so it's important to be selective. But the increasing dependence of global growth on emerging Asian economies means some of the most attractive investment opportunities can be found there.

Figure 8: Chinese reflation effort is important driver for the recovery in EM economies and stock prices



Source: Company reports, Wealth Investment Office, as of June 29, 2023

Outlook on Alternative Assets



Pockets of opportunities for the savvy investor

Kenneth Sue, Senior Alternative Investments Analyst; Mitesh Agrawal, Managed Investments | TD Wealth

TD Wealth has a neutral recommendation on Alternative Assets. An allocation to alternative assets such as Commercial Mortgages and Infrastructure could benefit specific portfolios. Overall, alternative assets provide inflation protection and attractive absolute returns, while acting as long-term portfolio stabilizers through their diversification benefits and less correlated income streams.

Within the Alternative Assets group, TD Wealth is maximum underweight Domestic Real Estate and Global Real Estate. However, even with that maximum underweight recommendation, there are compelling opportunities in real estate, but investors must take a very intentional and nuanced approach to the asset class. We remain focused on high quality assets and broad diversification that enhances portfolio quality through value-add and build-to-core strategies.

TD Wealth holds a modest overweight view on Infrastructure as increases in cash flow from higher-than-expected inflation is buffering the asset class from rising interest rates. Investor appetite remains strong, particularly for energy transition investments and critical infrastructure sectors that generate stable, growing cash flows.

We hold a modest overweight view on Private Debt: high credit quality and global diversification offers a safety net in the event of recession. Incremental income and potential capital appreciation from interest rate moderation provide upside.

Real Estate [Maximum Underweight]

Commercial real estate continued to correct in the first half of 2023, losing 3% across all property types based on the CoStar Commercial Repeat-Sale Index, which measures actual commercial real estate transaction prices in the U.S. (Figure 1). Higher interest rates and tighter lending conditions have weighed on asset values.

According to the most recent senior loan officer survey, 67% of banks—the second highest percentage since 2014—have tightened commercial real estate lending standards because of the uncertain economic outlook, reduced risk tolerance, and liquidity concerns. More specifically, banks have widened the credit spread on loans, making loans more expensive, and cut loan-to-value ratios and maximum loan sizes which requires borrowers to inject more equity into a deal.

Unsurprisingly, global investment volumes for Q1 slumped 50% year-over-year (y/y) to US\$131 billion (bln) as buyers and sellers continued to spar over valuations amid growing financial difficulties.

The news isn't all bad however, Real Estate Investment Trusts (REITs), which are public entities that invest in private real estate, have been resilient. For the last three years REITs have focused on keeping debt lower for longer: the average maturity of REIT debt is seven years, while the weighted average interest rate on REIT debt is 3.9% and 87% of that debt is fixed rate.

Figure 1: Real Estate Returns Hurt by Rising Rates



Source: Nareit, CoStar, Wealth Investment Office, as of June 2023.

Overall, REIT net operating income (NOI) grew 2.2% y/y but real estate contains many subsectors. NOI for office REITs rose 4.6% y/y, while industrial and residential continued to show strength as the increasing adoption of e-commerce and population growth more than offset higher interest rates. NOI for industrial REITs jumped 15% y/y.

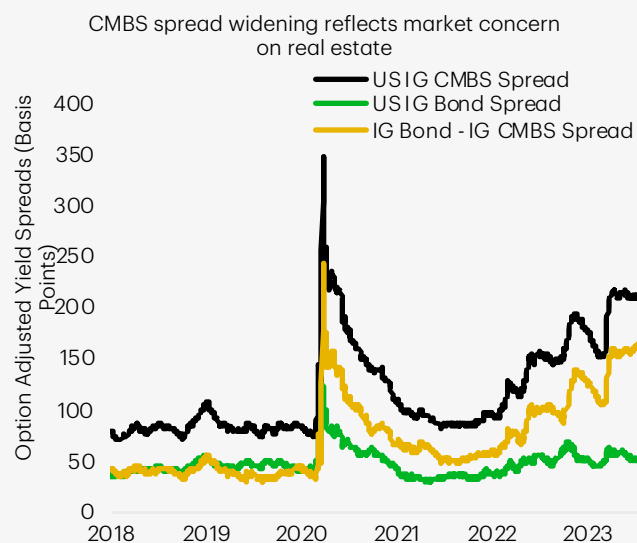
CMBS Debt Crunch

Commercial Mortgage-Backed Securities (CMBS) are at the forefront of a fast approaching maturity wall with US\$150 bln due this year. (For more information, please see “The Kite,” our Q2/2023 edition of PSQ.) Market participants continue to fret over the effects of higher interest rates on both valuations and the ability of companies to service debt. In fact, investment grade CMBS credit spreads over treasuries have not surpassed 200 basis points (bps) since 2012 (excluding the pandemic). Moreover, the spread between non-investment grade CMBS bonds and investment grade CMBS bonds has widened to 167 bps, about three times the pre-pandemic five-year historic average of 57 bps (Figure 2).

Indeed, concerns about the impact of higher rates on real estate valuations and debt may be warranted as CMBS delinquencies and special servicing rates continue their steady march upwards, primarily driven by the office sector which saw special servicing rates almost double since the start of 2023 (Figure 3).

In 2022 CMBS loans associated with office properties that went into default and resulted in a loss recorded an average loss rate of 63.9% because the original amount underwritten was far more than liquidation value, according to Fitch Ratings Inc.

Figure 2: CMBS Spreads Widen Dramatically in 2023



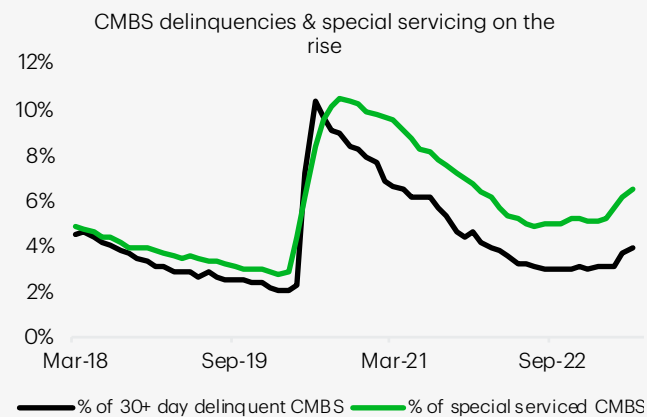
Source: Wealth Investment Office as of July 2023. U.S. IG CMBS Spread – U.S. IG Non-Agency CMBS, eligible for Aggregate Bond Index TR; U.S. IG Bond Spread – U.S. Aggregate Bond Index TR.

However, while we expect delinquency rates and losses to increase as valuations are adjusted downwards, loan losses thus far have been minimal. Despite US\$1.3 billion in CMBS losses last year—representing an average loss of 48.4% per loan that resulted in a loss—this figure represents less than 20 bps of a CMBS market that is more than US\$670 bln in size. When considering all default resolutions, including ones without losses, the average loss rate is 25.5%.

Residential: Opportunity Abounds in Canada

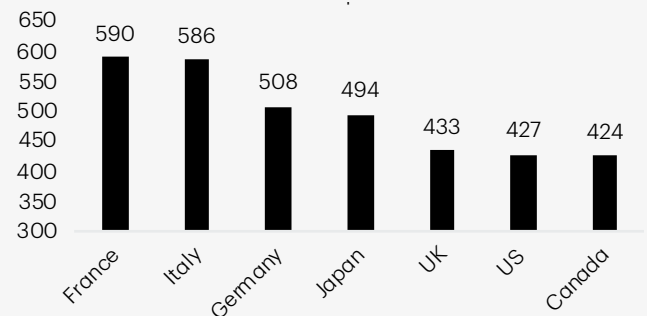
Average asking rents in Canada hit a new high of C\$2,042 in June driven by record population growth, strong employment, and once-prospective homebuyers sidelined by interest rates and housing prices. We believe the residential sector is well positioned in both the near and the long term as Canada's population—which grew by over a million people in 2022—continues to mount, exacerbating an already chronic housing shortage. In fact, Canada ranks last among G7 countries in housing per capita at 424 units per 1,000 people (Figure 4). To reach today's average G7 housing ratio, Canada needs an additional 1.8 million homes.

Figure 3: Rising CMBS Delinquency and Special Servicing Rates



Source: Trepp, Wealth Investment Office, as of July 2023.

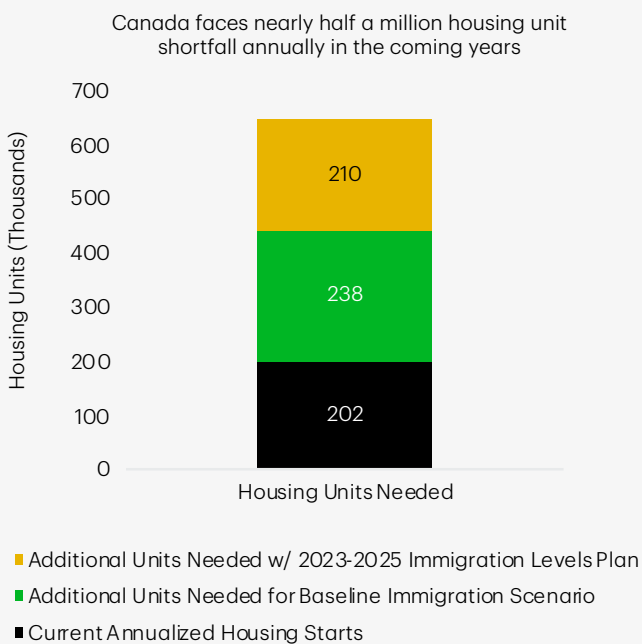
Figure 4: Canada has Lowest Number of Housing Units Per Capita in G7



Source: Eurostat, Organization for Economic Co-operation and Development (OECD), Cushman & Wakefield, as of 2020 the most recent available stats.

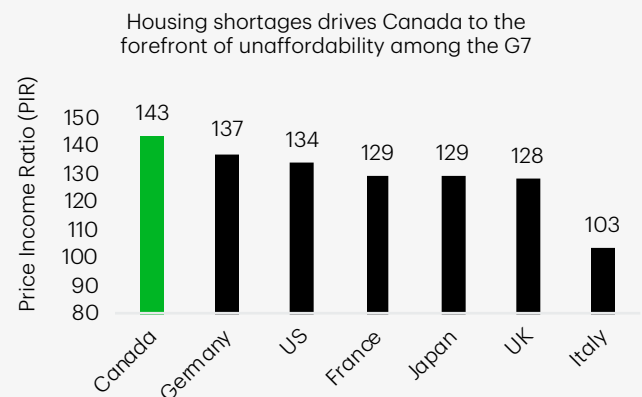
According to the Canada Mortgage and Housing Corporation (CMHC), Canada needs to build 3.5 million housing units by 2030—more than double the current annual rate of housing starts which is 202,000—to meet the shortage. When we factor in Canada's 2023-2025 immigration targets of almost 1.5 million new people, the additional units required surges to 210,000 (Figure 5).

Figure 5: Canada's Housing Shortfall Escalating



Source: CMHC, Desjardins Economic Studies, as of February 2023.

Figure 6: Canada is Least Affordable G7 Country



Source: OECD, as of Q1/2023.

Given this shortage, it's no surprise Canada ranks first within the G7 nations in terms of price to income ratio (PIR), or the ratio between house prices and disposable income, meaning it is the least affordable country among its peers (Figure 6).

PIR is an important figure because home ownership is a direct alternative to renting so higher house prices push some potential buyers out of the market

and increase demand for lower cost rental housing. Add to this the fact that most new immigrants tend to rent and we see continued opportunity for investment in this sector.

Industrial: Rent Growth Strong but Still Moderating

The industrial sector in Canada continues to move towards a balanced market as new supply outpaces market absorptions or leases, edging vacancies up to 2.1%, but still less than half the 15-year historical average of 4.8%. Rent growth remains strong but moderating at C\$16.35 per square foot (psf) nationally, representing 19.3% y/y growth. We expect the industrials market to moderate further as more than 27 million square feet of new construction is expected in H2 of this year. More importantly, this new supply has relatively lower preleasing levels of 38%, meaning over 60% or 16 million square feet will hit the market as new supply. By contrast, 73% of new construction delivered in the current quarter was preleased meaning only 27% of deliveries hit the market as new supply.

Office: Valuation Concerns Persist

With average office occupancy sitting at an estimated 50% across North America, vacancies in the office sector in Canada continues to rise, moving 40 bps to 18.1%. The average class A office net rental rate slipped to C\$25.43 psf nationally reflecting landlord's continued reluctance to lower rents, preferring rather to offer tenants inducements such as rent holidays, improving amenities, renovation and moving expense credits. We continue to see a flight to quality—both downtown and suburban class A rents surpassed 2020 levels at the expense of downtown class B properties. Increasingly tenants are opting for high quality office buildings with strong amenities that are close to transportation nodes to minimize commute times.

Valuation concerns persist as office landlords face higher interest costs for refinancing and potentially lower revenue from tenants occupying less space as companies integrate a hybrid working mode. Indeed, 49% of corporates now balance between remote and in-office work with the national average at three days in the office, according to a Q4 2022 Colliers survey.

There is a silver lining. Final projects from the 2018-2019 construction boom are set to be delivered by end 2023, reducing projects under construction to 4.2 million square feet, or 1% of existing office stock, the lowest level since 2005. New office supply, or construction, has been dwindling—developers have for the most part refrained from starting any new projects because of the current environment—and the lack of new supply will help rebalance the market going forward.

Infrastructure: Modest Overweight

Private infrastructure returned about 2% in Q1 2023 as falling equity risk premiums and higher cashflow forecasts offset the impact of rising interest rates. Energy and renewables represented the bulk of the dealmaking in Q1, with the focus on natural gas distribution deals.

Despite the positive outlook for infrastructure, fundraising remains well below historic norms, raising US\$5 billion in Q1, representing a 95% drop y/y. Much of this can be attributed to the denominator effect on institutional portfolios: public markets experienced significant drawdowns in 2022, resulting in an overallocation to private markets (which had been relatively stable) and heightened scrutiny when allocating capital.

We expect fundraising to recover. Infrastructure remains an attractive asset class because of its relatively lower volatility of returns and ability to pass through inflation. Unlike real estate, refinancing risk is low. Only 8% of unlisted infrastructure debt is due in the next three years, according to EDHEC Infrastructure & Private Assets Research Institute.

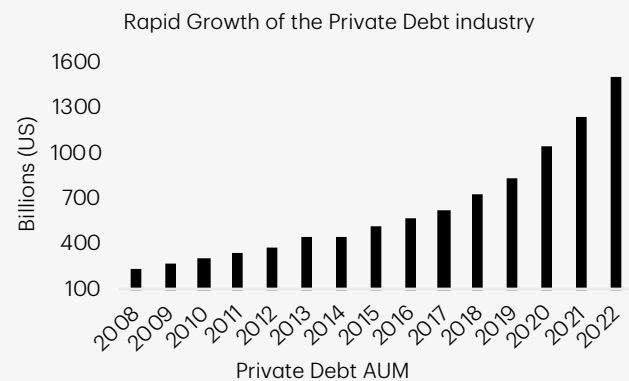
Private Debt: Modest Overweight

The private debt market was born out of the Global Financial Crisis (GFC) when global banking regulations tightened and banks and other traditional lenders shied away from approving riskier loans. Since then, the private debt market has grown more than six-fold, and stands at nearly US\$1.5 trillion, and growth is still accelerating filling the void left behind when banks retreated from the market. (Figure 7).

Private debt, also known as private credit, is an alternative institutional source of financing for businesses who want to raise debt. Private debt lenders are usually able to act much faster, offer tailor-made terms, and close financing deals quicker than banks (which often opt to syndicate larger loans thereby increasing the complexity of the loan). Private loans are often made to select middle-market companies; when economies deteriorate these companies face additional hurdles from banks and seek out the flexibility of private debt. They don't trade like public market high-yield fixed income securities, and like other private market asset classes, illiquidity is a defining characteristic of the private debt asset class.

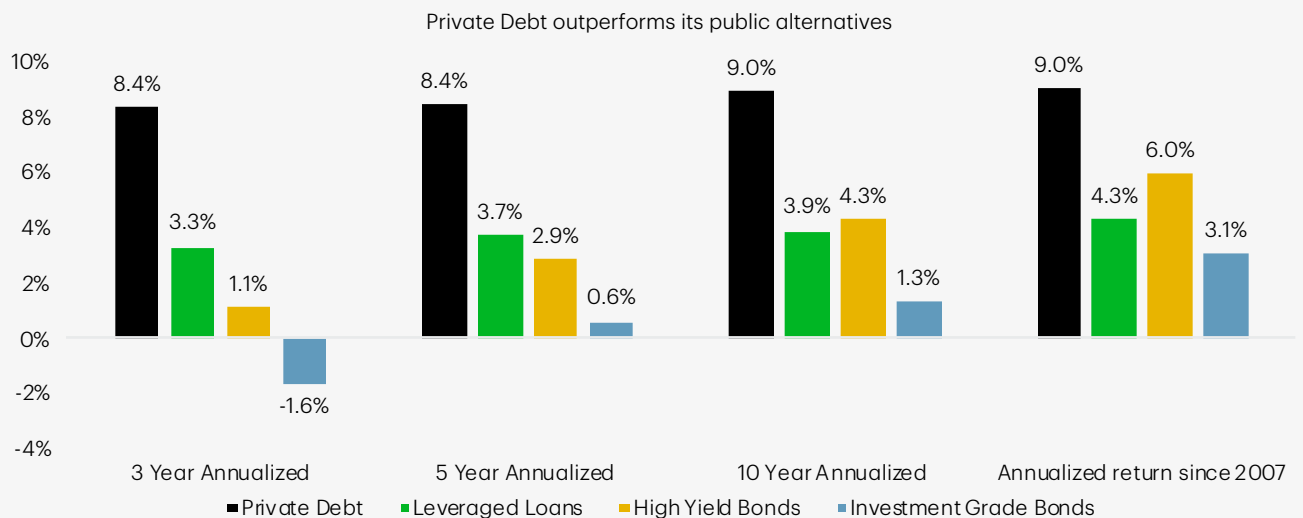
So how has this asset class fared so far? Private debt has provided an equity-like 9% annual return since 2007 and has outperformed investment grade bonds as well as high yield bonds and leveraged loans (sub-investment grade secured loans) in every time frame back to before the GFC, as measured by the Cliffwater Direct Lending Index (Figure 8).

Figure 7: Private Debt Assets Under Management



Source: Preqin, as of Q1/2023.

Figure 8: Private Debt Provides Equity-like Return from Fixed Income Source



Source: Cliffwater LLC, Morningstar, Wealth Investment Office as of Q1/2023. Indices: Private Debt: Cliffwater Direct Lending Index; Leveraged Loans: Morningstar LSTA US Leveraged Loan Index TR; High Yield Bonds: Bloomberg US Corporate High Yield Bond Index TR; Investment Grade Bonds: Bloomberg US Aggregate Bond Index TR. All figures in U.S. dollars.

Not only has private debt outperformed its higher yielding public alternatives but it has also recorded credit loss rates (losses in the event of defaults) at the lower end of the scale (Figure 9).

That said however, it is important to note that risk and reward goes hand in hand, private debt is speculative grade or high yield debt which would serve to complement a portfolio's existing investment grade bond exposure rather than replacing it, much like publicly traded high yield debt. We believe private debt is well positioned for the current macroeconomic

environment. As with 2008, we've seen banks pull back on lending driven by their own liquidity concerns and lower risk appetite after the regional banking crisis in Q1. Private debt also provides a measure of protection against inflation as most of the direct lending deals are essentially floating rate loans which have been rising with the current rate hiking cycle. Given the shortage of credit available to firms, private debt managers are able to be very selective on the deals they participate in and are able to extract better terms and covenants from borrowers.

Figure 9: Private Debt Credit Loss Rates

As of Q1 2023	Last 10 Years	Since 2005
High Yield Bonds	1.5%	1.5%
Leveraged Loans	0.8%	0.9%
Private Debt	0.9%	1.0%
US Bank Commercial & Industrial Business Loans	1.2%	2.3%

Source: Cliffwater LLC, Wealth Investment Office as of Q1/2023. Indices: Private Debt: Cliffwater Direct Lending Index Middle Market Debt; Leveraged Loans: Morningstar LSTA US Leveraged Loan Index TR; High Yield Bonds: Bloomberg US Corporate High Yield Bond Index TR. All figures in U.S. dollars.

Outlook on Currencies

Global Market's Summer of Discontent

Mark McCormick, Global Head of FX and EM Strategy | TD Securities

Markets seem stuck in holding patterns, watching in awe the inconsistencies between risk sentiment, yield curves, data surprises and inflation. There are three big market themes in currency markets; carry, global disinflation and macro volatility.

For the U.S., disinflation is the main driver and sending the strongest directional cue for the U.S. dollar in H2: choppy but lower. The main foreign exchange (FX) theme centres on the outperformance of global carry, which has been the single best FX strategy this year. As of mid-July, U.S. disinflation is strong enough for the Fed to deliver its last hike in July, which would bring an end to the hiking cycle, which would reinforce lower macro volatility, late-cycle growth dynamics and boost carry. There is also the China stimulus in the background which won't necessarily kick-start a new global growth cycle, but could extend late-cycle dynamics a bit longer. It could also revive sentiment and provide a cushion for the slowdown we expect in the U.S. in H2.

U.S. Dollar Can't Keep up with Carry

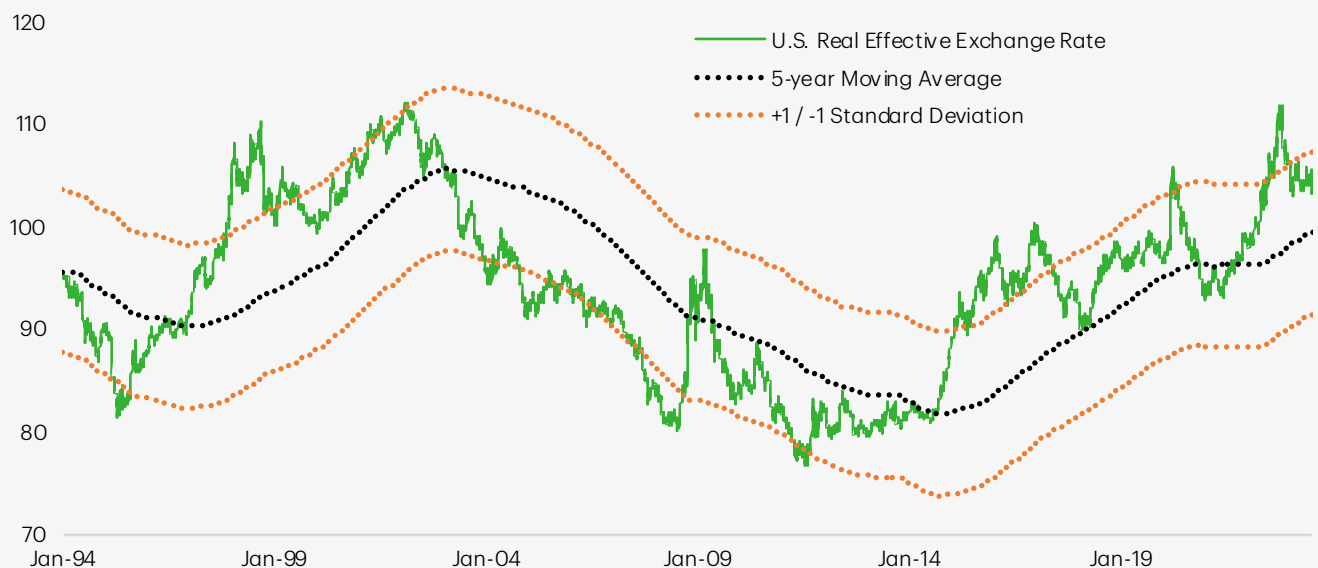
Two themes continue to dominate markets: China stimulus and central banks. This is simplifying the evolving narrative around global growth, inflation, and

rates. Carry has been the single best Forex strategy this year, and TD Securities notes that it will continue to be important. While the Sharpe ratio might start to ebb, peak Fed, late-cycle growth, and lower macro volatility should provide a buffer. Emerging Markets (EM) central banks will start to ease in H2 but we don't expect to see an immediate shift to easing through the summer.

Global Disinflation is a Thing

Disinflation is one of the most important drivers behind the price action. While G10 central banks are still tinkering with terminal rates, the tightening campaign is mostly over. Equally important, TD Securities thinks the Fed will likely deliver the last hike of the current cycle at the July FOMC meeting followed by a pause. That means the next move is downward, although data so far and comments from the Fed have pushed rate cuts further into the future with the consensus view of the first rate cut in May 2024 (as of July 20). Our global inflation indicators are showing broad-based signs of cooling inflation. It might not be cooling fast enough but the direction of travel is key. There is also less of a global factor driving inflation, suggesting that local stories are more relevant now.

Figure 1: U.S. Dollar Still Expensive



Source: Wealth Investment Office, as of April 5, 2023

Macro Volatility has Collapsed

We also think the economy is late cycle, remaining there for a bit longer rather than expecting a hard landing. The U.S. economy is likely to slow more than the rest of the world (ROW) in H2, while targeted China stimulus could boost sentiment. Still, we have likely reached peaked pessimism in China, suggesting that global data surprises should bottom out. U.S. data trends continue to underperform the ROW while the U.S. dollar is running at a 5% premium to global macro volatility. We're also on the cusp of a transition to curve steepeners, which is a poor regime for the USD.

Overall, the U.S. dollar looks overvalued and most indicators are pointing to weakness ahead. The end of the Fed cycle is normally quite bearish for the U.S. dollar for the first few months after the final hike. In addition, U.S. data momentum is lagging the rest of world, which also points to a lower U.S. dollar. TD Securities believes that the global growth outlook will probably set the tone for H2, especially if disinflation persists.

Positive Outlook for Canadian Dollar

The outlook for the Canadian dollar is more positive, as it is likely to benefit from broader U.S. dollar weakness. The Bank of Canada (BoC) delivered a 25 bp hike in July, as we expected, helping to provide two positive catalysts for the loonie. The market wasn't fully priced for a hike—with the consensus outlook leaning towards no change—so the increase provided some support to the loonie. The second positive is the soft U.S. inflation data.

While the Canadian dollar is likely to benefit from U.S. dollar weakness, keep in mind that BoC will maintain adherence to data dependency like other central banks. In turn, they are unlikely to commit to another hike, leaving the door open for this to be the last. With that in mind, we also believe the Canadian dollar could lose some of its appeal on the crosses, given our outlook for slowing U.S. growth in H2, which is likely to have secondary impacts.

Figure 2: Foreign exchange forecasts for G10 currencies

Summary G10 FX Forecasts							
	Spot	2023		2024			
	Jul 11, 2023	Q3 F	Q4 F	Q1 F	Q2 F	Q3 F	Q4 F
USD/JPY	144	137	134	130	125	120	115
EUR/USD	1.09	1.10	1.13	1.15	1.15	1.13	1.15
GBP/USD	1.27	1.27	1.30	1.32	1.34	1.34	1.36
USD/CHF	0.89	0.88	0.88	0.88	0.87	0.87	0.87
USD/CAD	1.32	1.32	1.30	1.29	1.27	1.26	1.25
AUD/USD	0.67	0.68	0.70	0.71	72.00	0.73	0.74
NZD/USD	0.62	0.62	0.62	0.63	0.64	0.65	0.67
EUR/NOK	10.35	10.73	10.62	10.00	9.57	9.74	9.39
EUR/SEK	10.67	10.64	10.44	10.00	9.57	9.47	9.57
BBDXY	1220.00	1207.00	1176.00	1158.00	1147.00	1151.00	1132.00

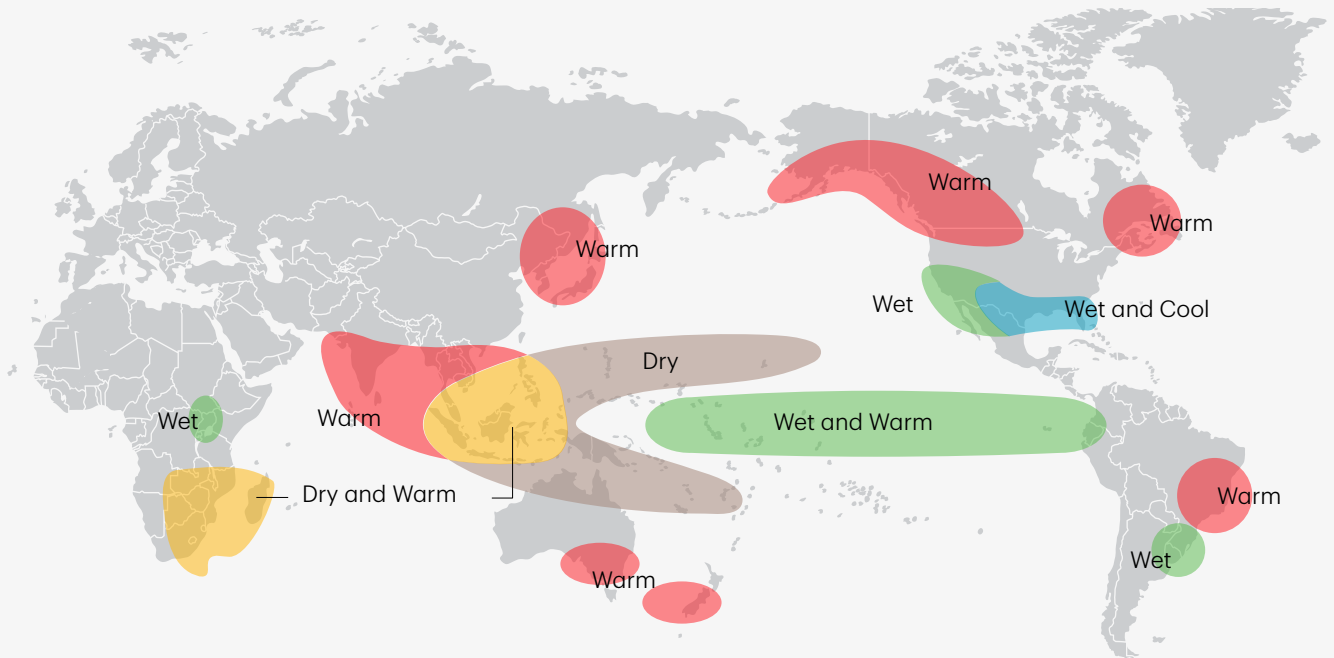
Source: TD Securities as of July 11, 2023

Outlook on Commodities

Weathering El-Nino: Cloudy but the sun is coming

Hussein Allidina, Managing Director and Head of Commodities | TD Asset Management

Figure 1: El Nino effects from December through February



Source: The National Oceanic and Atmospheric Administration https://www.noaa.gov/jetstream/enso_impacts

Droughts across North and South America following three successive years of La-Nina have heightened commodity market sensitivity to weather patterns. With La-Nina conditions finally subsiding, focus is now turning to the likelihood, timing, and severity of El-Nino, with every change in expectation grabbing headlines.

The National Oceanic and Atmospheric Administration (NOAA) recently declared the presence of El-Nino conditions. Much can change over the next few months, but agricultural commodity prices exhibited

heightened volatility around the end of Q2 on the heels of changing weather expectations. Although El-Nino has varying influences at regional levels, globally it affects the supply and demand of many commodities.

Mixed Impact on Agricultural Commodities

In regard to agricultural commodities, every El-Nino/La-Nina event is unique in its timing, severity, and locality. Historically we can generalize the favourable/unfavourable impact of El-Nino and La-Nina on major crops in various areas (Figure 2).

Figure 2: The impact of El-Nino and La-Nina on countries and crops

	Favourable	Unfavourable
EL-Nino	Brazil: Corn, Soybeans, Rice	USA: Corn, Wheat
	Argentina: Corn, Soybeans	India: Soybeans
	USA: Soybeans	Australia: Wheat
	Canadian Prairies: Wheat	China: Rice
	Russia: Wheat	
La-Nina		Brazil: Corn, Soybeans
	South/East Africa: Corn, Soybeans, Rice, Wheat	Mexico: Corn
		Russia: Wheat
		Australia: Wheat

Source : TD Asset Management, as of July 7, 2023

Figure 3: The impact of El-Nino and La-Nina on main global crops

	Favourable	Neutral	Unfavourable
EL-Nino	Soybeans		Corn, Rice, Wheat
La-Nina		Soybeans	Corn, Rice, Wheat

Source: TD Asset Management as of July 7, 2023

While some areas benefit from an El-Nino or La-Nina events, other suffer. Historical observations suggest that El-Nino conditions materially enhance global soybean yields but impair the yields from corn and wheat harvests. None of the four global crops (corn, soybean, wheat, rice) seem to benefit from La-Nina conditions with wheat being the most negatively affected.

El-Nino and La-Nina will have varying effects on crops depending on where they are grown and the impact on production at a local level can be negative or positive. Sugar, coffee, wheat, cotton, soybeans, and corn are most sensitive to this weather phenomena. Although it is not clear at this point, some climatological studies suggests climate change could intensify the severity of weather events during periods of El-Nino/La-Nina.

Constructive on Energy

In the energy complex, we remain constructive over the second half of the year. The overhang of inventories that built up in Q1, due to an extremely warm winter in Europe and the front loading of supply from Russia as it tried to get ahead of sanctions, have been drawn down over Q2 and we see a tight balance through H2. Adding confidence to our view is that OPEC+ has been proactively protecting the downside in prices, making cuts when they see any slack in demand. The weight of Strategic Petroleum Reserve releases has also been lifted and speculators have continued to sit on the sidelines, waiting until they have more clarity on the impacts of the Fed's aggressive rate hikes.

The risk of El-Nino adds some conviction to our view and introduces some upside risk. El-Nino could provide upside risk to energy prices through the winter as a moderate El-Nino has historically resulted in a colder winter across the U.S. northeast and northern Europe. Natural gas would be very sensitive to such an outcome given how depressed prices have become. El-Nino also tends to result in weaker monsoon rains and warmer temperatures across Southeast Asia, which could leave reservoirs dry and temper hydro generation across the region, increasing reliance on diesel, LNG, and coal.

Demand Stabilizing for Metals

Base metals found a floor in Q2 as China demand slowly recovers, albeit at a slower than expected pace. Weakening manufacturing activity combined with deleveraging in the real estate sector has sent some base metal (zinc and aluminum) prices down into their cost curves which has stimulated buying activity in China. Production restraint from smelters trying to turnaround negative profit margins, combined with expectations for policy support from China, has helped to arrest the bearish pressure on base metals for now.

Looking forward, targeted policy support, continued focus on housing completions and growth in energy transition demand sectors should continue to support an ongoing recovery in Chinese metals demand in 2023. Outside of China, a mild recession in the U.S. should mean the restocking of industrial metals will start. More stable demand over H2, should refocus attention on the dearth of global visible metals inventory which could drive the Industrial Metal index higher.

Bull Cycle on the Horizon

In the short term, macro concerns continue to mask the reasonably constructive micro fundamentals as evidenced by tight inventories across many commodities. These low prices further challenge the needed capital expenditure cycle which means when the world does look beyond the next recession it will see the tightest supply picture in 15 years. We firmly believe that we are in the early innings of a commodity bull cycle.

Market Performance

		(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)
Canadian Indices (\$CA) Return	Index	1 Month	3 Months	YTD	1 Year	3 Years	5 Years	10 Years	20 Years
S&P/TSX Composite (TR)	77,738	1.08	-1.13	3.37	8.00	11.59	7.14	8.19	8.30
S&P/TSX Composite (PR)	19,733	0.82	-1.82	1.80	4.62	8.35	3.93	4.99	5.33
S&P/TSX 60 (TR)	3,820	1.34	-0.64	3.44	7.30	11.83	7.66	8.83	8.63
S&P/TSX SmallCap (TR)	1,173	-2.04	-7.11	-2.93	2.59	11.72	2.87	4.65	4.60
S&P/TSX Preferred Share(TR)	1,592	0.86	-2.48	-0.26	-9.36	5.24	-0.41	0.66	2.05
U.S. Indices (\$US) Return									
S&P 500 (TR)	9,404	4.87	6.97	14.99	17.64	13.97	11.94	12.68	9.95
S&P 500 (PR)	4,378	4.75	6.55	14.04	15.67	12.19	10.00	10.55	7.80
Dow Jones Industrial (PR)	33,927	3.09	1.96	2.35	10.24	9.54	6.93	8.57	6.87
NASDAQ Composite (PR)	13,556	4.80	10.91	29.52	22.91	10.46	12.54	14.82	11.20
Russell 2000 (TR)	9,784	5.85	2.98	5.80	9.93	10.04	3.76	8.03	8.77
U.S. Indices (\$CA) Return									
S&P 500 (TR)	12,450	2.06	4.64	12.40	20.87	12.88	12.06	15.31	9.83
S&P 500 (PR)	5,797	1.95	4.24	11.47	18.84	11.12	10.12	13.13	7.68
Dow Jones Industrial (PR)	44,918	0.34	-0.25	0.05	13.26	8.49	7.04	11.10	6.74
NASDAQ Composite (PR)	17,947	1.99	8.50	26.60	26.28	9.40	12.66	17.50	11.07
Russell 2000 (TR)	12,953	3.02	0.75	3.42	12.95	8.98	3.88	10.55	8.65
MSCI Indices (\$US) Total Return									
World	13,296	4.43	5.33	13.63	17.27	12.12	9.28	9.92	8.86
EAFE (Europe, Australasia, Far East)	9,951	3.16	1.82	10.60	17.78	8.98	4.61	5.76	6.95
EM (Emerging Markets)	2,527	4.29	1.42	5.50	2.60	2.85	1.39	3.37	8.56
MSCI Indices (\$CA) Total Return									
World	17,603	1.64	3.05	11.07	20.48	11.05	9.40	12.48	8.74
EAFE (Europe, Australasia, Far East)	13,174	0.40	-0.39	8.11	21.01	7.93	4.73	8.23	6.83
EM (Emerging Markets)	3,345	1.50	-0.78	3.12	5.42	1.86	1.50	5.78	8.44
Currency									
Canadian Dollar (\$US/\$CA)	75.53	2.75	2.22	2.30	-2.67	0.97	-0.11	-2.28	0.12
Regional Indices (Native Currency, PR)									
London FTSE 100 (UK)	7,461	0.21	-2.23	0.13	4.08	6.54	-0.46	1.84	3.13
Hang Seng (Hong Kong)	19,148	5.01	-6.14	-3.20	-12.40	-7.80	-7.94	-0.83	3.52
Nikkei 225 (Japan)	32,699	5.86	16.61	25.31	23.89	13.63	7.95	9.11	6.61
Benchmark Bond Yields		3 Months		5 Yrs		10 Yrs		30 Yrs	
Government of Canada Yields		4.92		3.69		3.27		3.09	
U.S. Treasury Yields		5.31		4.16		3.84		3.86	
Bond Indices (\$CA Hedged) Total Return	Index	1 Mo (%)	3 Mo (%)	YTD (%)	1 Yr (%)	3 Yrs (%)	5 Yrs (%)	10 Yrs (%)	
FTSE TMX Canada 91-day Treasury Bill Index	439	0.34	1.01	2.14	3.70	1.40	1.48	1.11	
FTSE TMX Canada Universe Bond Index	1,078	0.04	-0.69	2.51	3.15	-3.75	0.63	2.06	
FTSE TMX Canada All Government Bond Index	1,021	-0.02	-0.98	2.35	2.77	-4.41	0.30	1.83	
FTSE TMX Canada All Corporate Bond Index	1,279	0.21	0.18	2.97	4.24	-1.88	1.52	2.70	
Bloomberg U.S. Corporate High Yield Bond Index	263	1.56	1.52	4.99	8.24	2.66	2.57	4.00	
Bloomberg Global Aggregate Bond Index	244	-0.13	-0.12	2.64	-0.11	-3.13	0.54	2.01	
JPM EMBI Global Core Bond Index	474	2.05	1.62	3.39	6.05	-3.94	-0.30	2.24	
HFRI Indices (\$US) Total Return									
HFRI Fund Weighted Composite Index	18,073	2.20	2.24	3.45	5.09	8.16	4.98	4.71	
HFRI Fund of Funds Composite Index	7,276	1.16	1.52	2.27	3.67	5.04	3.32	3.39	
HFRI Event-Driven (Total) Index	20,435	2.78	1.59	2.99	5.81	8.67	4.42	4.58	
HFRI Equity Hedge Index	28,039	2.94	2.97	5.55	7.49	8.91	5.44	5.64	
HFRI Equity Market Neutral Index	6,234	2.05	1.45	2.23	3.75	4.35	2.14	2.96	
HFRI Macro (Total) Index	18,821	1.47	2.02	-0.47	-0.05	7.42	5.07	3.13	
HFRI Relative Value (Total) Index	14,382	0.90	1.31	2.66	4.17	5.94	3.60	4.00	
HFRI Indices (\$CA) Total Return									
HFRI Fund Weighted Composite Index	23,909	-0.62	0.02	1.15	8.01	7.12	5.11	7.13	
HFRI Fund of Funds Composite Index	9,625	-1.63	-0.69	0.00	6.55	4.04	3.45	5.78	
HFRI Event-Driven (Total) Index	27,034	-0.05	-0.62	0.70	8.74	7.63	4.56	7.00	
HFRI Equity Hedge Index	37,092	0.10	0.73	3.20	10.47	7.86	5.58	8.08	
HFRI Equity Market Neutral Index	8,247	-0.76	-0.76	-0.05	6.63	3.36	2.27	5.34	
HFRI Macro (Total) Index	24,898	-1.33	-0.20	-2.69	2.72	6.40	5.20	5.51	
HFRI Relative Value (Total) Index	19,026	-1.88	-0.90	0.38	7.06	4.92	3.73	6.41	

Sources: TD Securities Inc., Bloomberg Finance L.P. TR: total return, PR: price return, as of June 30, 2023.

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