TD Asset Management

Market Perspectives 10 Minutes

Market Perspectives
The Year Ahead 2023

TD Wealth Asset Allocation Committee (WAAC) Overview

- Global equity markets may experience headwinds as economic conditions deteriorate into 2023. We feel that market expectations are still not sufficiently pricing in a recessionary scenario, as leading growth indicators and employment remain neutral to strong. Forward earnings estimates have been reduced broadly, but further declines in forecasts are expected. Global equities are likely to remain rangebound through to mid-2023.
- The historically unprecedented pace of central banks' rate hiking cycle, amid the backdrop of high global debt, may have unintended consequences for various asset classes. Additionally, the rapid rise in rates to combat persistently high inflation and wage pressures continues to drive concerns around a global recession. The war in Ukraine, among other ongoing geopolitical turbulence, also remains a risk to the market outlook.
- For investors looking beyond near-term volatility, yields across fixed income sectors are well above the lows of the past decade and now offer higher potential returns. We believe fixed income may outperform equities over the next 12-month period. Fixed income can also help to provide diversification benefits, reduce overall portfolio volatility and preserve capital over the longer term.
- Given that high equity volatility is likely to persist for risk assets, investors may benefit from an allocation to alternative assets to help manage portfolio volatility. Assets like mortgages, infrastructure and real estate may also provide some long-term inflation protection and attractive absolute returns. Alternatives could also help portfolios through either transitory or more structural inflation outcomes.

The Year in Review

Market turbulence dominated the economic landscape in 2022. Geopolitical conflict, rising interest rates and record inflation heightened recessionary risks for many economies as financial conditions became increasingly constrained. As a result, we witnessed significant repricing in fixed income and public equity markets. Real estate valuations have also cooled.

While the current uncertain macroeconomic backdrop may imply continued market volatility entering 2023, at TD Asset Management Inc. ("TDAM"), we believe that underlying market fundamentals remain relatively sound as corporations, particularly in North America, remain generally well capitalized. We are also beginning to see signs that inflation levels may be moderating in some economic categories, such as used cars, shelter, and commodity prices, which may suggest less hawkish global central banks in the coming months.

In broad terms, earnings for North American companies have been relatively positive, though most sectors continue to face challenges and we anticipate overall softer demand in 2023. Within equity markets, current forward estimates for earnings and revenues will likely need to be revised lower in the coming quarters and this may put added pressure on stocks globally in 2023. If markets trend lower in the coming quarters, our perspective remains that market drawdowns can provide opportunities. Broad selloffs often create dislocations within equity markets, where quality companies begin trading at valuation discounts, making them attractive long-term investments.

While bond markets also saw broad declines in 2022, as rapidly rising yields drove bond prices down, today's starting yields offer attractive entry points for those able to look beyond near-term volatility. Yields across fixed income sectors are well above the lows of the past decade and offer solid potential for quality future returns. Additionally, we maintain a positive outlook for alternative assets which can provide long-term inflation protection and attractive absolute returns.

Chart 1: Global Equity Index Returns (Based in CAD)

Name	1M	3M	12M	3Y	5Y	10Y
S&P 500 Index (Large Cap)	-5.51%	6.29%	-12.51%	9.18%	11.11%	16.09%
S&P/TSX Composite Index	-4.90%	5.96%	-5.84%	7.54%	6.85%	7.74%
MSCI EAFE Index (Europe, Australasia, Far East)	0.38%	16.02%	-8.13%	2.76%	3.61%	8.46%
MSCI Emerging Markets Index (Emerging Markets)	-1.08%	8.50%	-14.25%	-0.97%	0.50%	5.00%

Source: TD Asset Management Inc. ("TDAM"). As at December 31, 2022.

The Year Ahead – Asset Class Assumptions

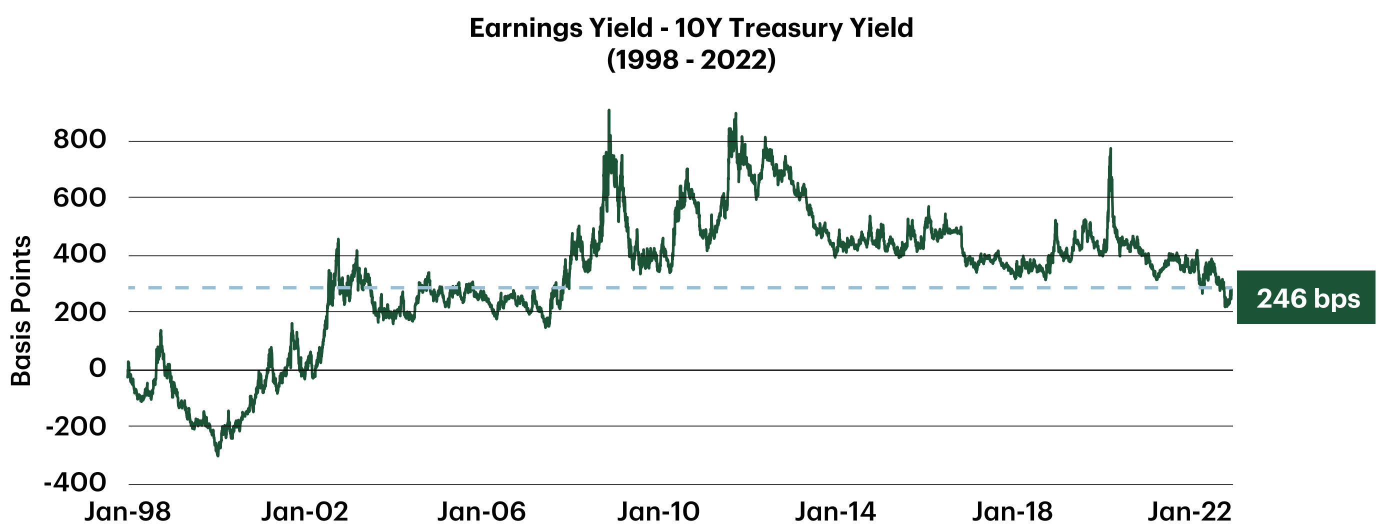
Overall, entering 2023 we are maximum overweight fixed income, neutral equities and modestly overweight to alternative assets. The Committee meets monthly and will make necessary strategic adjustments to asset class views as the environment unfolds. At TDAM, we remain active in evaluating long-run return expectations for key asset classes, while relying on our multi-asset investment philosophy, and input from our network of experienced investment teams to deliver informed strategic views. The following provides more comprehensive assumptions for what we believe are optimal portfolio allocations for the upcoming year.

Equities – Neutral Overall

	Maximum Underweight	Modest Underweight	Neutral	Modest Overweight	Maximum Overweight
U.S. Equities			●		
Canadian Equities			●		
International Equities			●		
Chinese Equities			●		
Emerging Markets Equities – excluding China			●		

Investors experienced broad declines in global equity markets in 2022 and we believe that there are some clouds on the horizon that will continue to weigh on markets in the first half of 2023. Earnings, valuations and weakening economic conditions combined with stubbornly high inflation are all examples of such ongoing concerns. One measure, among many data points we use in our analysis to help determine the attractiveness of equity valuations, is the Equity Risk Premium ("ERP") **(Chart 2)**.

Chart 2: Equity Risk Premium



Source: TD Asset Management Inc. ("TDAM"), Bloomberg Finance L.P., as of December 15, 2022.

The ERP is the spread between the S&P 500 Index's 12- month forward earnings yield and the 10 Year U.S. Treasury yield. It is intended to show how well investors are being compensated for taking on equity risk.

As at December 15, 2022, the forecasted earnings for the S&P 500 Index for 2023 was $230. The earnings yield is calculated by taking the $230 estimate and dividing it by the S&P 500 Index level of 3860 (230/3860), which gives us an earnings yield ("EY") of 5.95%. If we then subtract the risk-free rate of return of the 10 Year U.S. Treasury from the EY (5.96%- 3.5%), our ERP would be 246 basis points ("bps"), below the long-term trend **(Chart 2)**.

The long-term average since 1998 is an ERP of 283 bps. This is represented by the horizontal dotted line in the chart. Since the 2008 Financial Crisis, we can see that the ERP has been above the long-term average and that investors have been adequately compensated for taking on equity risk by getting a minimum of ~280 bps of equity risk premium. This in part informed the WAAC's decision to maintain a predominately overweight bias toward stocks and underweight to fixed income over this period. Today however, we remain neutral overall equities because the ERP is below the trend line. A neutral outlook allows us to remain strategic in our allocation views while emphasizing quality in the market.

One last consideration when looking at the current ERP level is that this number is based on forecasted earnings for the S&P 500 Index. Given expectations for an economic slowdown, we believe earnings estimates will likely need to be revised lower, resulting in a lower ERP.

Geographic Equity Market Views

For most of 2022 we were overweight **Canadian Equities**. This view proved effective as the S&P/TSX Composite Index outperformed many global counterparts. However, today there are headwinds that may make continued outperformance more challenging as we enter 2023. For the Canadian Financials sector, while net interest margins may still have room to grow, we do not expect the magnitude of this tailwind to persist. Additionally, provisions for credit losses may need to be higher across the banks' balance sheets, which could act as a modest earnings headwind. Further, following significant outperformance by the Energy sector in 2022, we expect a more balanced energy market and moderate performance for the sector going forward.

Forward earnings estimates have been lowered in most sectors, but further deterioration in forecasts is expected. However, many blue-chip **U.S. equities** have seen sharp compression of valuation multiples and are trading close to long-term historical averages. Any further market weakness could be viewed as an opportunity to incrementally add to high quality compounders. We remain focused on quality in the market, specifically on companies with robust fundamentals, access to growth and sustainable free cash flow generation.

While inflationary pressures and geopolitical risks continue to cloud the outlook for global equities, we see some opportunity within **International (European)** markets as they appear inexpensive on a forward price-to-earnings basis relative to their history and in comparison, to U.S. equities. A weakening U.S. dollar ("USD") may also provide a tailwind for international stocks over the next 12-18 months.

In our view, **China**'s outlook remains weak, however, we are hopeful that 2023 could see a sentiment reversal in China triggered by the government's possible easing of certain detrimental policies. These include the Zero-COVID-19 policy, the property-market crackdown, anti-trust campaigns over the Technology sector, and geopolitical tensions with the U.S. and Taiwan. Depressed valuations in select sectors may provide long term opportunity.

Emerging markets equities, similar to many global counterparts, are being 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 valuations may provide a good entry point.

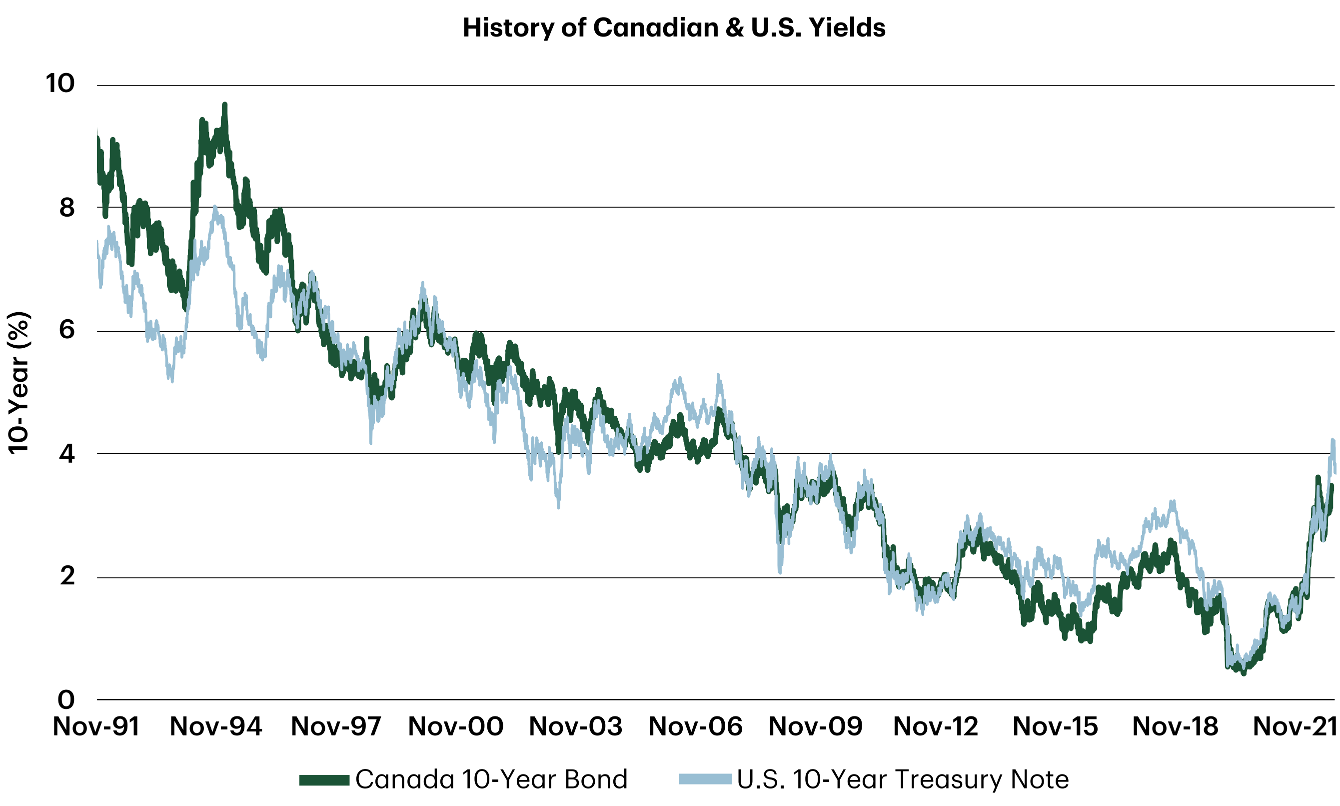
Equities

Fixed Income – Maximum Overweight Overall

	Maximum Underweight	Modest Underweight	Neutral	Modest Overweight	Maximum Overweight
Investment Grade Corporate Bonds				●	
Inflation Linked Notes			●		
High Yield Bonds		●			
Domestic Government Bonds					●
Global Bonds - Developed Markets		●			
Global Bonds - Emerging Markets			●		

Despite poor 2022 returns, we believe a fixed income allocation has become an increasingly important component of a multi-asset portfolio. For investors looking beyond near-term volatility, yields across fixed income sectors and geographies are well above the lows of the past decade and now offer attractive potential returns comprised of capital gains and income. When comparing current rates to about a year ago, interest rates in the United States and Canada were effectively at zero. Today 10-year government bonds in North America range from 4.25-4.50% **(Chart 3)**, a significant move to the upside by historical standards. We believe the current environment presents a great opportunity to construct a high-quality portfolio of fixed income assets with yields in the 4% to 5% range. When considering some of the concerns around the economic outlook, we believe this is a very attractive opportunity and a primary reason why the WAAC is more optimistic on fixed income versus equities over the next 12-months. From a historical perspective, bonds have also been effective at acting as a portfolio ballast in volatile markets, while helping to preserve capital over the longer term.

Chart 3: Bond Yield are Looking Attractive



Source: Bloomberg Finance L.P., as of November 30, 2022.

Fixed Income Sub-Class Views

North American central banks are beginning to slow the pace of policy rate hikes as inflation pressures show signs of easing at the margins. As a result, yields have stabilized at multi-year highs and **government bonds** remain appealing due to their potential to generate positive nominal returns over the longer term.

With a slowing global economic outlook, we prefer investing in higher quality **corporate bonds**. Credit fundamentals are robust and all-in yields are attractive, although there is limited upside from any further spread tightening in the near term. While their respective economies are more vulnerable to a downturn, corporate bond opportunities in Canada and Europe are modestly more compelling than U.S. opportunities due to a more attractive valuation.

Higher interest rates and a deteriorating economic backdrop will likely cause default rates for **high yield bonds** to rise from current low levels. This could result in further volatility and downside risk for credit spreads, despite the high potential return in the sector. However, solid credit fundamentals should prevent high yield bonds from experiencing the extreme dislocations seen in some prior recessionary periods.

Investors are increasingly paying attention to the global economic slowdown narrative, so we are starting to see some reversal of the extreme bearish sentiment and positioning in the **global bond market**. As bond yields have risen considerably year-to-date ("YTD"), some markets now offer attractive incremental yields, net of currency hedges. Non-USD denominated bonds may also benefit from a potentially weakening U.S. currency.

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.

Fixed Income

Alternatives/Real Assets – Modest Overweight Overall

	Maximum Underweight	Modest Underweight	Neutral	Modest Overweight	Maximum Overweight
Domestic Real Estate			●		
Global Real Estate			●		
Commercial Mortgages				●	
Infrastructure				●	

We maintain a modest overweight to commercial mortgages. **Commercial mortgages** continue to provide accretive income while insulating investor returns from the increased volatility in interest rates. Income collection via scheduled principal and interest payments remains resilient while demonstrating less volatility than observed in other corners of the fixed income markets.

We maintain a neutral weight to **Canadian Real Estate**. Aggressive interest rate hikes over the second half of 2022 are driving upward pressure on capitalization rates across property types. However, property fundamentals remain sound with supply/demand imbalances persisting within industrial and multi-family assets. This results in continued rental rate growth. High quality, transit-linked properties are exhibiting robust leasing activity.

We maintain a neutral weight to **Global Real Estate**. Rising inflation and interest rates remain the primary risks globally. Markets with strong institutional sponsorship, positive real estate fundamentals (i.e., low vacancy rates, rental rate growth), moderate development activity and conservative leverage ratios are long-term structural elements that may help support the broader Real Estate sector. We believe that being globally diversified within major cities and high-quality assets should help navigate through economic turbulence.

We maintain a modest overweight to **Infrastructure**. We believe infrastructure is well positioned to outperform relative to other asset classes through this interest rate cycle, even though rising interest rates will increase risk-free rates used to price private asset classes. Increases in cash flow from higher-than-expected inflation is buffering the rising rates and we anticipate core-plus portfolios may be best positioned given the embedded growth in revenue from value-add and opportunistic assets.

Real Assets

TD Wealth Asset Allocation Committee

The **TD Wealth Asset Allocation Committee** was established to deliver a consistent asset allocation message and be the source for active asset allocation advice across TD Wealth.

The committee has three prime objectives:

1. Articulate broad market themes
2. Provide macro-level asset allocation
3. Identify the major risks on the horizon

Committee Members

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