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# SPECIAL REPORT

TD Economics



January 5, 2016

## CANADIAN LONG-TERM FINANCIAL ASSET RETURNS: AN ECONOMIC PERSPECTIVE

### Highlights

- The impact of Fed tightening on asset returns is likely to be meaningful but not dramatic. The BoC is not expected to begin raising its policy rate until late-2017, while both the ECB and the BoJ are likely to continue swelling their balance sheets, helping maintain accommodative conditions globally.
- As such, cash returns in both Canada and the U.S. over the next four years are projected to rise, but only moderately, and remain lower on average compared to levels prevailing prior to the recession.
- The gradually increasing rate environment will trigger some capital losses which will be barely offset by negligible coupon returns on fixed income assets more broadly.
- While the near-term landscape remains filled with potholes, Canadian equities are expected to post a decent recovery over the 2016-19 period. Canadian equities should outperform U.S. stock returns, benefiting from firming commodity prices, robust U.S. growth and a still-low Canadian dollar.
- All told, a theoretical portfolio should between 2016 and 2019 return between 2.5% (income-focused) and 5% (growth-focused), with a balanced portfolio expected to return about 3.5% per year.
- Given our projections of long-term fundamental factors, returns on cash of 3%, fixed income of 3.5-5% and equities of 7% are viewed as sustainable in the period of equilibrium economic growth.

In this report, we provide an updated perspective on the most likely path of Canadian dollar financial asset returns over the coming decade. There is no shortage of factors that will ultimately drive asset returns. Chief among them are important structural factors such as growth, inflation and demographics. However, another key influence that will substantially affect investment returns going forward will be more cyclical in nature. Currently, U.S. monetary policy is at an inflection point, with the Federal Reserve, after seven years of zero interest rate policy (ZIRP), embarking on what will likely be a very gradual tightening cycle. Once rate normalization gets well underway, the Fed will also likely begin reducing the size of its balance sheet. Removal of the proverbial “punch bowl” could put a damper on asset returns in the coming years both in North America and globally, just as quantitative easing and ultra-low rates helped boost asset prices since the recession.

In our assessment, the impact of Fed tightening on cash, fixed income and equity returns is likely to be meaningful but not dramatic. The Federal Reserve is expected to be slow to take rates higher. Other major central banks will lag the Fed in rate hikes. The Bank of England (BoE) is not expected to follow until mid-2016 while the Bank of Canada (BoC) is unlikely to begin raising its overnight rate target until late-2017. Others may ease further still, with both the European Central Bank (ECB) and the Bank of Japan (BoJ) likely to continue swelling their balance sheets. These actions will help offset the impact of any Fed tightening and maintain accommodative conditions globally.

In this environment, cash returns in both Canada and the U.S. over the next four years are projected

**TABLE 1: LONG TERM FINANCIAL ASSET RETURNS (CAD)**

Returns for specific assets	History	Forecast	Forecast details	
	2005-2015 (past 10 years)	2015-2025 (next 10 years)	2015-2019 (next 4 years)	2019-2025 (6 years thereafter)
	Cash	1.6%	2.0%	1.0%
GoC	4.5%	2.0%	0.0%	3.5%
Provincials	5.2%	3.0%	0.5%	4.0%
Corporates	5.5%	3.5%	2.0%	5.0%
S&P/TSX Composite	4.3%	7.0%	6.5%	7.0%
S&P500	8.6%	4.5%	2.0%	7.0%
MSCI EAFE	4.9%	7.0%	7.5%	7.0%
<b>Income</b>	<b>4.9%</b>	<b>4.0%</b>	<b>2.5%</b>	<b>5.0%</b>
<b>Balanced</b>	<b>5.1%</b>	<b>4.5%</b>	<b>3.0%</b>	<b>5.5%</b>
<b>Growth</b>	<b>5.3%</b>	<b>5.5%</b>	<b>4.5%</b>	<b>6.5%</b>

Note: Figures are total annual returns rounded to the nearest half of a percentage point. Returns on international indices are converted to CAD.  
Source: Bank of Canada, Bloomberg, TD Economics

to rise, but only moderately, and remain below levels prevailing prior to the recession. The gradually increasing rate environment will trigger some capital losses amid still negligible coupon returns on fixed income assets more broadly. This is especially true in Canada, where coupon rates on medium- and longer term bonds are poised to nudge higher by more than those in the United States. On the flip side, we see a strong likelihood that Canadian equities manage to end their recent losing streak and outperform U.S. stock returns in the 2016-19 period. Part of the story of outperformance rests on our assumption of gradual firming of commodity prices, which will deliver a relative boost to the resource-heavy S&P/TSX Composite later this decade. Summing it up, a theoretical portfolio should during the 2016-19 period, on average, return between 2.5% (income-focused) and 5% (growth-focused), with a balanced portfolio expected to return an average of 3.0% per year in the next four years.

Looking further out, once U.S. and Canadian central bank policies stabilize around their respective terminal rates, which we expect will happen towards the end of this decade, longer-term structural factors will move into the driver's seat. Given our projections of long-term fundamental factors, returns on cash of 3%, fixed income of 3.5-5% and equities of 7% are viewed as sustainable.

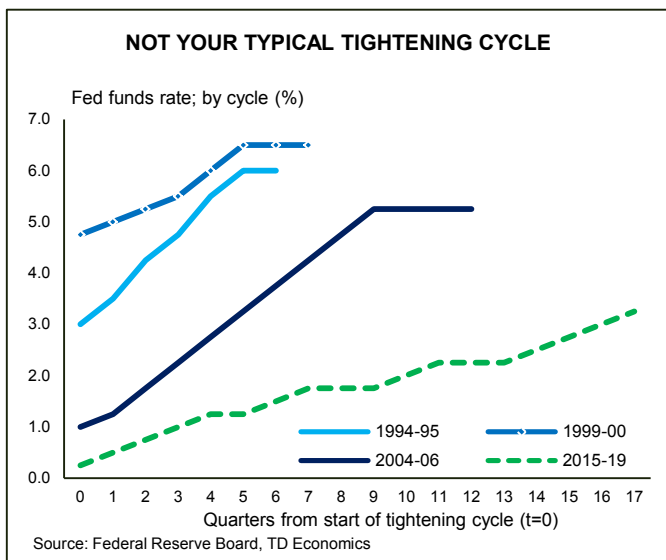
For the entire ten year period, a balanced portfolio made up of 5% cash, 45% fixed income and 50% equities should yield an average of about 4.5% per year. This is only slightly below the 5.1% average total return such a portfolio generated over the past decade. However, it is important to remember that these are average projections and returns will likely vary substantially from year to year within the forecast horizon.

### **Medium-term: 2016 through 2019**

#### **Fed to begin gradual normalization**

The overarching investment theme heading into 2016 is the divergence of global monetary policies among major central banks. Ultra-low interest rates alongside substantial amounts of quantitative easing by the Fed, BoE, BoJ, and ECB have driven strong and broad based returns in financial markets since the recovery. This was particularly the case for risk assets. This was the precise aim of stimulative conventional and unconventional monetary policies, designed to push investors further out the risk frontier. As such, the safest investments returned little, with cash in Canada yielding a mere 0.7% per year over the past seven years. Returns on Government of Canada (GoC) bonds were higher, averaging around 3% annually, boosted by capital gains on longer-duration bonds which benefitted from falling interest rates. The more risky corporate and provincial bonds fared better still, yielding between 5% and 7.5% per year, as spread compression vis-à-vis government bonds boosted capital gains further. Lastly, Canadian and international equities yielded an annual return of about 9%, while the U.S. benchmark rose by 14.5% per year between 2009 and 2015, and 16.5% in Canadian dollar terms.

At this point, the Federal Reserve is no longer adding to its balance sheet, and only maintaining its enlarged size for the time being. Still, with nearly \$3 trillion in excess liquidity, the Fed is expected to begin normalizing its balance sheet over the medium-term. This will be a passive process, at least at first, with the Fed unlikely to sell securities outright, instead letting them run-off as they mature. Moreover, balance sheet normalization won't begin until "normalization



of the level of the federal funds rate is well under way.” As such, we don’t expect the Fed to begin shrinking its balance sheet until at least late-2016, with the current tightening cycle likely to be very gradual. Still, these moves will mark the first time the Fed tightens monetary policy in more than a decade. Tightening monetary policy typically benefits cash returns, but could saddle fixed income investors with capital losses. At the same time, it could create a headwind for equity prices in the form of higher discount rates on future earnings.

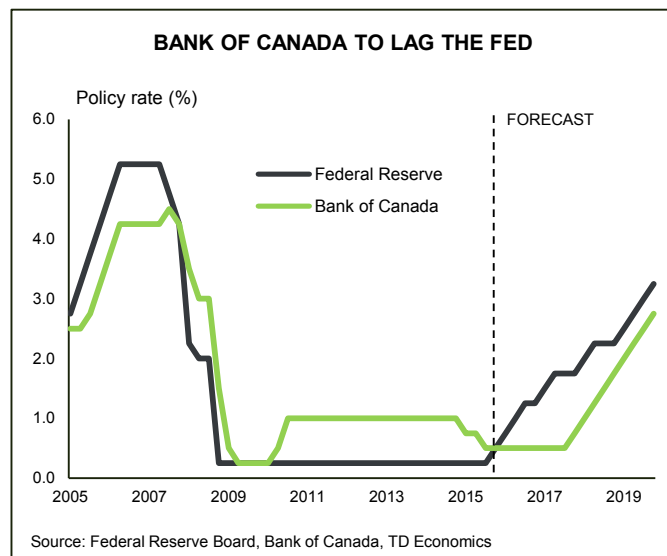
### This tightening cycle is different

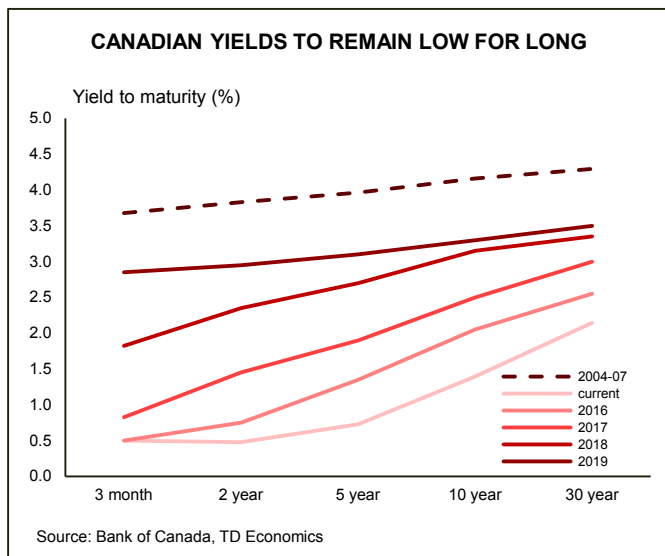
Still, there are a number of features of this tightening cycle that will make it different from those of one and two decades ago. For one, the Fed is expected to move slowly given the long-lasting legacies of the Great Recession. We expect only three 25 basis point hikes during 2016 and just eight more over the subsequent three years. This equates to about 68 basis points of hikes per year between 2016 and 2019, or about one-third the pace of the most recent tightening cycles which saw at least eight quarter-point increases per year. The idea of a very gradual, or even glacial, pace of hikes is also supported by the notion that the terminal, or long-term policy rate, is now lower than it has been traditionally. In light of demographic factors and trend productivity growth, the U.S. economy is projected to grow by only 2% in real terms once the cyclical boost runs its course in the coming years. Given this slower cruising speed of the economy, a real policy rate of 1.25% (or 3.25% in nominal terms) should be enough to keep it from overheating. A comparable nominal neutral rate in the past has

been estimated closer to a range between 4.0% and 4.5%.

### Global monetary policies to diverge

A rising policy rate in the U.S. should correspond with a one-to-one increase in short-term borrowing costs in USD denominated loans. But, increases in the mid- and long-end segments of the yield curve should be relatively less pronounced for two reasons. Firstly, since the Fed wants to keep long-term borrowing costs relatively low, so as to shield the housing market and the consumption-led recovery, it will likely delay normalization of its balance sheet. Moreover, when balance sheet normalization does begin, it will most likely remain passive with the Fed holding on to the Treasury- and agency-securities until they mature, instead of selling outright some of its \$4.5 trillion bond holdings. A passive run-off will necessarily result in a protracted balance sheet normalization process, with the Fed’s Treasury holdings unlikely to return to “conventional” levels until around 2022. Secondly, Fed liftoff will be taking place as both the European Central Bank and the Bank of Japan continue to buy assets to stimulate their economies and support inflation expectations. The ECB is currently buying about €60 billion per month (about \$65 billion), while the BoJ continues to purchase at a pace of ¥6.7 trillion per month (about \$56 billion). Both of these programs are expected to last for some time still, with the \$120 billion per month more than offsetting any Fed balance sheet run-off. Thus, on net central banks will still be increasing liquidity in the global financial system. This should help support values of longer-term government fixed-income securities as well as risk assets, keeping global bond yields relatively subdued.





### Bank of Canada to lag the Fed

Unlike the ECB and BoJ, the Bank of Canada is not expected to increase the amount of monetary policy stimulus. However, the BoC will still lag the Fed substantially as far as any tightening of monetary policy is concerned. The weakness in the oil-producing regions, brought about by the recent slump in oil prices manifested in the Canadian economy undergoing a technical recession in the first half of 2015. This has widened the output gap, likely delaying any rise in underlying inflation back to the central bank's target of 2%. Moreover, by allowing Canadian short-term rates to fall below their U.S. counterparts, the Canadian export sector has benefitted from consequent declines in the value of the loonie.

In order to shield the economy, the BoC is unlikely to tighten policy until at least mid-2017. When it finally does move, it will raise rates somewhat faster than the Fed. But, at about 100 basis points per year, the pace of hikes will also be relatively slow, at about half the previous cycles. Moreover, just as will be the case south of the border, the Canadian economy will be subject to a slower cruising speed as cyclical factors dissipate, with the neutral overnight rate unlikely to rise above 3%. In light of this muted profile for the policy rate, investing in three-month T-bills – which we use as a proxy for cash – will yield barely above 1.0% per year between 2016 and 2019.

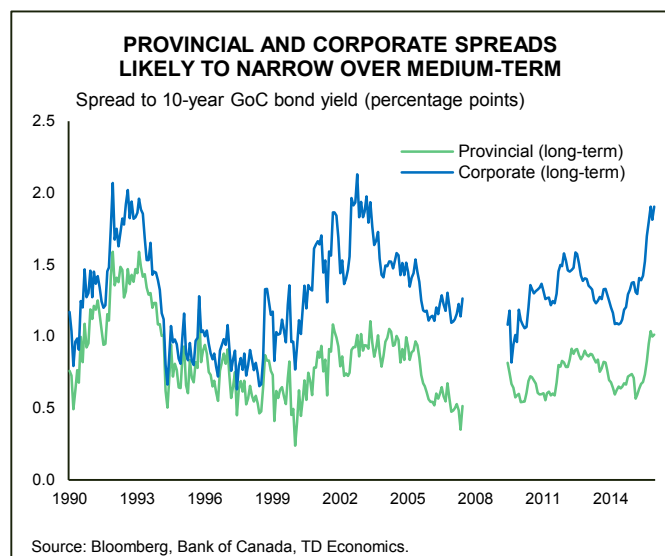
### Canadian yields to remain below U.S.

In light of the lagged tightening cycle, a lower terminal rate, and a lack of a risk premium vis-à-vis the U.S., Canadian sovereign yields have fallen below their U.S.

equivalents. This trend has already been nearly three years in the making, with the spread turning the most negative on record in recent months. Still, these large differentials do not appear sustainable over the medium term, especially as the adverse oil shock dissipates and the growth profile of the two economies converges over the next few years. A modestly faster increase in Canadian yields will result in larger capital losses that will more than offset the slightly higher coupon return. In all, returns across the entire yield curve are expected to fall short of cash. And while notes with maturities shorter than ten years should manage a meagre positive return capital losses, which are most pronounced on longer-duration bonds, will result in holders of those securities losing money over the coming years. All in all, the return on a portfolio made up of various maturity bonds, reflecting the makeup of outstanding Government of Canada debt, will average around zero over the next four years, with capital losses concentrated over the near-term horizon.

### Corporate bonds to also suffer from capital losses

Since provincial and corporate bonds tend to trade off of their sovereign cousins of corresponding maturity, these bonds too will also see their yields rise over the coming years. The degree to which provincial and corporate yields rise above their sovereign counterparts will depend on how spreads evolve going forward. Typically, stimulative monetary policy causes these spreads to narrow, while the opposite is true when financial conditions are tightening. However, at this point in the cycle we believe that much of the widening of spreads has already occurred. Long-term provincial spreads fell to as low as 50 to 60 basis points in

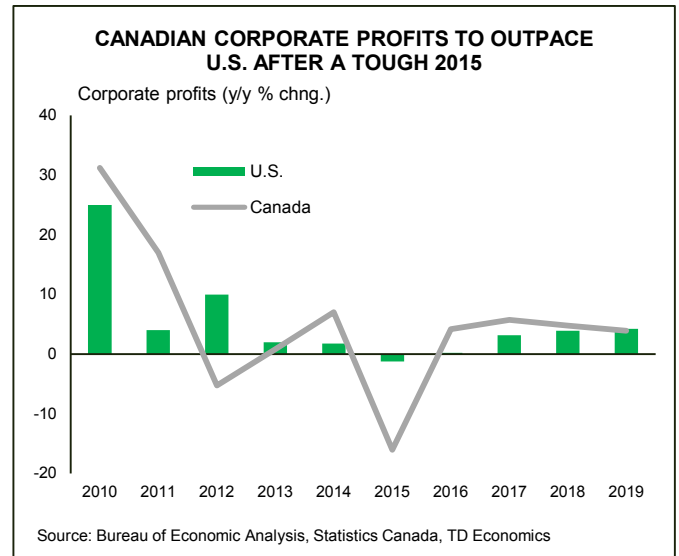


recent years, but have recently rebalanced to about 100 basis points – well above the 80 basis points that has been the average since 1977. Ditto for corporate spreads, which are between 50 and 60 basis points above their average levels. Much of the spread widening vis-à-vis GoC yields is likely a result of additional risk given weak resource prices and concerns surrounding the economic outlook for Canada. But, as the economy improves in the coming years, these spreads should normalize, ensuring still robust coupon gains, while shielding investors somewhat from capital losses. All in all, we expect provincial and investment grade corporate bonds to return between 1% and 2% over the coming four years with weakness, once again, concentrated in the near-term.

**Canadian equities likely to outperform**

Perhaps the most encouraging medium-term prospects for Canadian investors are to be had in the equity space. Canadian equities, as proxied by the S&P/TSX Composite index, have been battered by the global commodity rout. They remain 17% below their peak, with some near-term weakness still conceivable. However, over the medium-term we see scope for a rebound, with Canadian equities expected to outperform their U.S. counterparts over the next four years, with most of the strength back loaded. And, despite a relatively subdued economic outlook, Canadian corporate profits are likely to put in a comparatively strong showing.

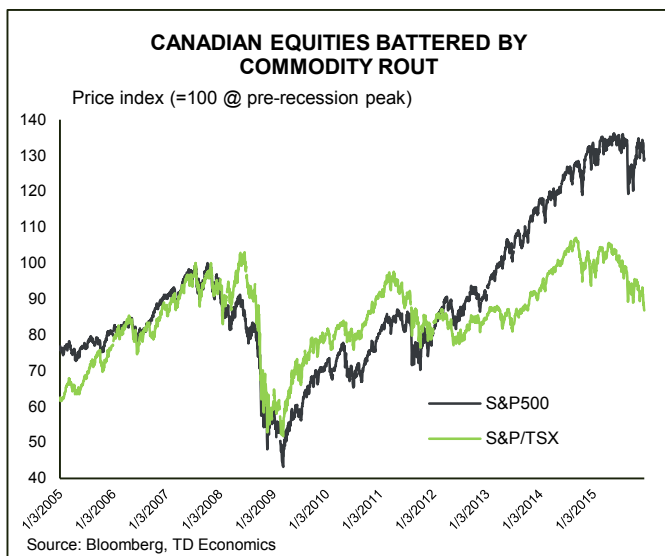
This view largely hinges on three factors: a low Canadian dollar vis-à-vis the greenback, strong U.S. growth, and some improvement in commodity prices. A low Canadian dollar – which we expect to decline even further through early-2016 before beginning a gradual ascent – will increase



competitiveness of Canadian businesses abroad. This boost, alongside robust U.S. growth, should lead to higher revenues for Canadian firms. A relatively low CAD will also serve to raise the value of U.S. earnings of Canadian companies that have operations south of the border. Lastly, we expect oil and other commodity prices to pull off their lows in the coming quarters, as reduced investment manifests on supply and alongside a moderate improvement in demand leads to more balanced market conditions. All these factors should allow Canadian equities, as proxied by the S&P/TSX Composite, to return about 6.5% over the 2016-19 period.

International equities should also fare well. The MSCI EAFE Index – consisting of developed market equities from Europe, Australasia, and the Far East – is still some 10 percent off last year’s peak despite some recent gains, with potential for outperformance. Equities across many of these developed markets will be supported by ultra-stimulative policies of the ECB and BoJ, low currencies vis-à-vis the U.S. dollar, and corporate profits that should benefit from cyclical recoveries. Moreover, Australian and Norwegian equities should be supported by firming commodity prices. On the whole, we expect the MSCI EAFE Index to return about 7% over the next four years, with additional 0.5% return per annum related to favorable foreign exchange dynamics – with the loonie expected to slip slightly vis-à-vis the EAFE currency basket by the end of the decade.

On the other hand, we expect equity returns south of the border to underperform despite the robust growth prospects. Broad U.S. benchmarks are within earshot of their record peaks, and are by some metrics mildly overvalued. Corporate profits, at 11.4% in 2015Q3, remain highly el-



evated relative to economic output, and are poised to grow slower than nominal GDP over the coming years. Profits of U.S. multinationals will also be suppressed by the elevated greenback, with one-third of S&P500 company revenues generated outside the U.S. As such, we expect total return on the S&P500 to average about 5% in local currency terms over the next four years. However, Canadian investors need to also take heed of the likely currency movements. Although the Canadian dollar will likely remain relatively low, we see scope for an appreciation of more than 10% vis-à-vis the greenback over the medium term, which will reduce the return on U.S. equities by nearly 3% per year when converted to Canadian dollars.

All told, after adjusting for currency conversions, investing in a mix of domestic, U.S., and international equities should return about 6% when weighted equally. While this return is above those of fixed income and cash, it is important to remember that it is associated with a significantly higher risk profile given the inherently higher volatility of equity prices and exchange rates.

#### Long-term: 2020 through 2025

We expect the Federal Reserve and the Bank of Canada to both reach their equilibrium levels in their respective policy rates by the end of the decade. These levels are assumed to be maintained for the remainder of the holding period horizon which runs through the end of 2025. This is done as a matter of simplicity, as forecasting macroeconomic and financial variables that far in advance with any certainty is challenging at best. However, investors need to be cognizant of the fact that a chance of a recession during that period is not insignificant. Still, the simplification offers a view into what returns would look like during a period where growth is at potential, resources are fully utilized, and price pressures are as intended.

Our assumption on the Bank of Canada equilibrium rate is predicated on expectations for potential growth of the Canadian economy during the coming decade. Lower growth relative to history should require lower interest rates to keep the economy in balance, all things considered. As

such, we expect the equilibrium overnight target rate to remain at 3.00%. Given this policy rate and continued strong demand for T-bills, cash should yield just shy of 3% – nearly double the return over the past decade. Government bonds of varying maturities should yield a slightly higher 3.5%, with long-bonds expected to yield about 3.75% – both well below their returns over the past ten years. This relatively modest return assumes no capital gains or losses. Still, long-term bond yields are likely to remain below nominal GDP growth – a golden rule of sorts – due to a depressed term-premium. Term-premia on high-quality sovereign bonds have been falling for decades and are unlikely to rise much, with the success of central banks in anchoring inflation as well as rising demand for long-term assets by global investors key contributing factors. To achieve additional yield, investors may need to move further out the fixed income risk frontier. Assuming spreads over government debt consistent with periods of stability, provincial and corporate bonds should return between 4% and 5% during the next decade. This is about a percentage point below the gain during the past decade, but still a significant premium over GoC bonds. Lastly, to estimate long-term returns on equities, we utilize Gordon’s dividend growth model. Assuming a constant region-specific dividend yield and profits growing in line with potential output across the Canadian, U.S. and international economies, equities across these regions should return approximately 7% over the long haul – slightly more than their returns over the past decade.

#### Bottom line

In the above paragraphs we outlined our expectations for financial asset returns from a perspective of a Canadian investor. Investment returns will be impacted by macroeconomic factors, monetary policy, and exchange rates both home and abroad. We expect the impact of Fed tightening on Canadian returns to be significant despite the Bank of Canada remaining on the sidelines until late 2017. Given this scenario, over the next four years cash returns in Canada are projected to rise, but only moderately, and remain lower on average compared to returns prevailing over the past de-

**TABLE 2: PORTFOLIO WEIGHTS**

	Cash	Fixed income			Equities		
		GoC	Provincials	Corporates	S&P/TSX	S&P500	MSCI EAFE
Income	10.0%	20.0%	20.0%	20.0%	15.0%	7.5%	7.5%
Balanced	5.0%	15.0%	15.0%	15.0%	25.0%	12.5%	12.5%
Growth	5.0%	5.0%	5.0%	5.0%	40.0%	20.0%	20.0%

Source: TD Economics.

cade. Moreover, the gradually increasing rate environment will trigger some capital losses amid negligible returns on Canadian fixed income assets. On the other hand, we expect there is a good chance that Canadian equities will outperform other asset classes as well as U.S. and international benchmarks over the next four years. This outperformance will be driven by a gradual rise in world commodity prices, robust U.S. growth and a weaker Canadian dollar. Looking further out, once U.S. and Canadian central bank policies stabilize around their respective terminal rates, which we expect will happen towards the end of this decade, longer-

term structural factors will instead drive returns. In light of our long-term fundamental factor assumptions, returns on cash of 3%, fixed income of 3.5-5% and equities of 7% are viewed as sustainable. As such, on the whole over the coming decade, a theoretical portfolio are expected to return between 4% (income-focused) and 5.5% (growth-focused), with a balanced portfolio expected to return 4.5% – only slightly below the 5.1% generated over the past decade. However, we would like to stress that these figures are averages only, and actual returns should be expected to vary substantially from one year to the next.

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