TD Wealth

Investment Outlook

TD Wealth Private Investment Counsel

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Central banks' undeclared war on savers

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Speak with any group of investors and it soon becomes apparent that one of their greatest frustrations is the extremely low rate of interest paid on cash balances. While improving financial markets in recent years have alleviated the anxiety of many investors, uncertainty remains. That uncertainty has been manifested in extremely high levels of bank deposits, where savers can park cash "until the coast clears," as one reader recently put it, and feel confident enough to make longer-term investments.

The problem with waiting "until the coast clears" is that those cash balances pay very modest rates of interest — 1.25% at the high end. To make matters worse, these funds are typically taxable, which, depending on one's province and tax bracket, can reduce the after-tax return to perhaps 0.75% or so.

Finally, the impact of inflation has to be considered to determine how savings are growing or shrinking in "real" inflation-adjusted terms. As of mid-March 2013, Canada's Consumer Price Index (CPI) has risen 0.5% over the past year — a figure that many Canadians would argue understates their own experience. At best then, the after-tax, net-of-inflation return on savings is perhaps 0.25%, which is negligible.

The impact of monetary policy

Short-term interest rates are so low today because of central banks' monetary policies in the wake of the 2008-2009 credit crisis. The global economy was in a fragile state and both the U.S. Federal Reserve Board ("the Fed") and the Bank of Canada cut interest rates sharply to lighten the load of borrowers and stimulate the economy. The trouble is that these low rates apply equally to borrowers and savers. While borrowers have been the beneficiaries of monetary policy, savers have suffered and represent the collateral damage of

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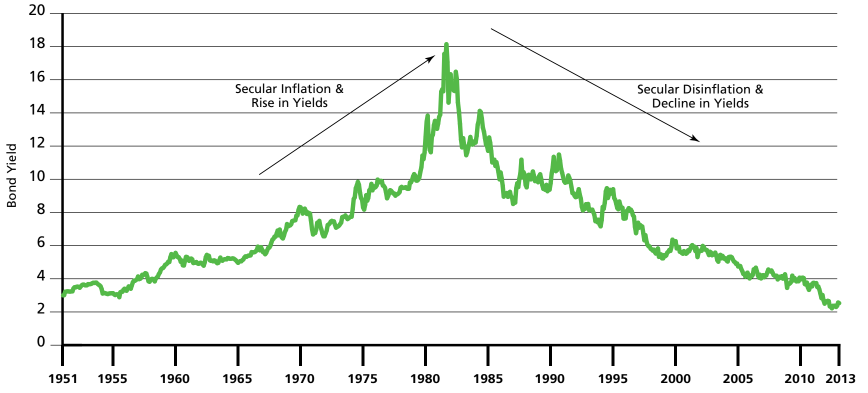
stimulative interest rates. Put another way, there has been a transfer of wealth from savers to borrowers.

Fed Chairman Ben Bernanke, a student of the Great Depression, has stated — quite often — that the premature withdrawal of monetary stimulus could derail the economic recovery and that the benefits of such stimulus outweigh the risks. The translation — don't expect savings rates to go up any time soon.

The rise and fall of the Government of Canada bond yield*

Bond yields — and interest rates — have been steadily declining since 1981, making it better for borrowers but more challenging for savers.



Source: Bank of Canada
*Modified: +10 Year Average (used for early history)

The end of an era

How, then, do Canadians holding substantial cash improve their returns?

The first inclination is to pick up yield by purchasing fixed-income investments such as bonds. Today, however, this presents a problem. Long-time readers will recall that our Fall 2011 column, entitled "The end of an era," outlined what we felt was the impending end of what had been a long and very favourable period for bond investors. As the accompanying chart illustrates, the yield on Government of Canada (GOC) bonds peaked in the mid-teens in 1981. Today, it is about 2%. During this 30-year period, bond investors enjoyed both a good stream of income and capital appreciation as their bonds rose in value. Going forward, we thought that bond returns would be much lower, providing investors with modest income and perhaps capital preservation. This point warrants some further explanation.

Bond math made easy

The topic of bond prices is a mystery to most investors. "Why would bond prices go down if interest rates go up?" is a question I hear quite often. At the risk of oversimplifying, here is an illustration that will shed some light on that question.

Suppose you had purchased a newly issued Government of Canada bond some years ago with an interest rate, or coupon, of 5%. Years pass, interest rates fall and another investor wishes to purchase a newly issued GOC bond but finds that its coupon is only 2%. Given a choice between buying the new GOC issue paying 2% and buying your bond with its coupon of 5% (assuming you are willing to sell), the second investor would clearly prefer your bond and would happily pay a higher price, or premium, to receive its higher stream of income. Thus, your bond has risen in value as interest rates have fallen. This is essentially what has happened over the past 30 years, with bond prices going up as interest rates have fallen.

The converse is also true. It is quite possible that bond yields will rise in the coming years and that bonds bought at today's yields will be less attractive than bonds issued with higher coupons in the years ahead. So, to answer the initial question, bond prices will go down as longer-term interest rates rise. Therefore, bond investors would receive modest streams of income along with the possibility those bonds could slip in value.

The dawn of a new era

For investors holding cash, bonds provide some incremental yield plus relative stability, and most investors benefit from a balanced portfolio that includes a bond component. However, as outlined above, it is likely that bonds will not generate the strong returns exhibited over the past generation and instead will offer modest income and, at best, capital preservation.

If bonds are not the complete answer for Canadians currently holding high cash balances, where should they turn? As detailed in past columns, we believe most investors will benefit from some allotment to dividend growth stocks — shares with substantial dividends that have a good track record of regularly increasing those dividends.

At present, it is not uncommon for such a portfolio to have a current yield of over 3% — which is roughly equivalent to receiving interest of 4%, owing to the impact of the Dividend Tax Credit on Canadian dividends. This obviously compares favourably with the 1% or so earned on cash today. Even more important, dividend growth of 4% to 6% per year provides your income with a hedge against inflation and typically establishes a rising floor under share prices, so you may benefit from any capital appreciation. Finally, while there is no escaping some degree of market volatility, our experience has been that the risk of holding dividend growth stocks is muted by the high quality of the underlying investments.

In sum, Canadians need not be collateral damage of central bank policies and should look to alternatives. Speak to your Portfolio Manager for more information.

The Canadian housing market: Too much of a good thing?

Traditionally, a home has been the most important and largest investment an individual could make. But over the past decade, household wealth has become even more tied to the value of one's home. Between 2002 and 2011, houses provided Canadians an average annual return of 7%.

During that time, homeownership rates surged, the number of second homes owned by Canadians rose and investment dollars flowed into the housing market from both Canadian and foreign investors.

A greater share of wealth

Today, housing accounts for almost 40% of an average household's total assets, compared with just 30% in 2002. Canadians also count on their homes as a source of wealth, drawing on their home equity to fund consumption. As a result, homeowners' equity is now at its lowest point in a decade.

As is often the case, too much of a good thing is never a good thing. The robust gains realized over the past decade now appear to be unsustainable, as home prices have grown much faster than income and rents. As a result, housing affordability has deteriorated in many markets despite record-low interest rates. All of this suggests that home prices are moderately overvalued — by roughly 10% — especially in urban condo markets like Toronto, Vancouver and Montreal.

U.S.-style crash unlikely

The word overvaluation often rings alarm bells, especially with the recent U.S. experience lingering on the minds of many. However, there are a number of reasons to believe that a U.S.-style housing correction is not in the cards for Canada. For one, the risky lending practices in the U.S., together with complicated mortgage-backed securities, helped inflate a financing-led bubble. As such, U.S. home prices appreciated much more sharply (and thus had farther to fall) than in Canada.

While Canada's housing market continued to advance when the U.S. market was sinking, more prudent lending practices and stronger mortgage regulations are expected to mitigate the risk of a hard landing here at home. Absent a negative external economic shock, a relatively stable unemployment rate in Canada together with a low interest-rate environment should support a more gradual unwinding of the excesses in the Canadian market.

New name, same commitment to you

We have changed our name from TD Waterhouse Private Client Services to **TD Wealth Private Client Group**. While our name has changed, our commitment to helping you reach your goals has not.

We will continue to provide you with the peace of mind and confidence that all of your financial resources are working together to help you achieve your long-term goals. We value your business and look forward to serving you under our new name.

Soft landing for Canada

The U.S. experience, however, does underscore the view that home prices cannot continue to rise rapidly forever. Indeed, it is widely believed that the Canadian housing market is currently undergoing a mild correction, or what many analysts are describing as a "soft landing." Existing home sales fell 17% year-over-year in December 2012, while for the year as a whole the average price of a Canadian existing home grew by just 0.2%.

Over the next few years, high levels of household debt along with tighter mortgage insurance rules and lending regulations are likely to keep housing demand in check. Rising interest rates in 2014 and 2015 are expected to be the catalyst for a gradual unwinding of imbalances in the Canadian housing market. In addition, some of the momentum from foreign buyers is likely to subside, especially as global equity returns improve and provide a competitive source of investment income.

More modest housing gains

From the prospects of a longer-term investment, housing is still expected to provide positive returns. However, double-digit home price gains appear to be a thing of the past. Even as the imbalances in the market clear, an aging population and modest economic growth are likely to cap home-price appreciation at an annual rate of 3.5% from 2015 to 2020 — about half the pace of returns experienced over the last decade.

In light of the near-term cooling expected in the Canadian existing housing market, other forms of investments, such as equities, may provide investors with a more lucrative return on their money over the next decade.

Current Private Investment Counsel strategy

Portfolio weighting

- Overweight in equities, excluding gold position
- Position in gold where appropriate within client portfolios
- Underweight in bonds, with a somewhat shorter term than benchmarks
- Overweight corporate bonds, where mandates permit
- Overweight emerging markets and Northern European large caps within international holdings

Percentage return for indices[1]

(For the period December 15, 2012 – March 15, 2013)

DEX Universe Bond Index	0.3%
S&P/TSX Composite Index	4.3%
S&P 500 Index	10.4%
MSCI EAFE Index*	8.0%

*Morgan Stanley Capital International Europe, Australasia and Far East Index

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TD's new Cross-Border Banking offers the following suite of services to customers:

- Easily transfer money between your Canadian and U.S.-based bank accounts, with free "Me-to-Me" wires of up to $25,000 per day.
- Apply for a U.S. mortgage[2] and/or a U.S. credit card[3] based on your Canadian assets, income and credit history.
- Review your TD Canada Trust and TD Bank, *America's Most Convenient Bank* accounts through online banking from a single web page.
- Use your TD Access Card in the U.S. to withdraw cash from more than 1,800 TD Bank® ATMs without paying additional system fees (foreign exchange fees still apply).

For more information, advice or support on your U.S. banking needs, please call the TD Cross-Border Banking Support Line[4] at 1-877-700-2913 or visit **tdcanadatrust.com/crossborderbanking**

Wealth Asset Allocation Committee Message

The TD Wealth Asset Allocation Committee (WAAC) is comprised of highly experienced TD investment professionals. WAAC meets at least once per month and works with Private Investment Counsel (PIC) to determine how its views should be implemented in order to both enhance returns and most effectively control risk for PIC clients.

WAAC's stance was largely unchanged in the first quarter of 2013, with its current views summarized below:

- Significantly overweight equities, emphasizing large-cap stocks with both a history and prospects of increasing their substantial dividends. From a geographic standpoint, overweight the U.S. and emerging markets, with neutral positions in Canada and major international markets.
- Continue to maintain a position in the SPDR Gold Trust ETF, as a hedge against extreme outcomes.
- Maintain a sharp underweight in bonds, as the modest potential rewards offered by bonds are not commensurate with their risk. Among bonds, investment-grade corporate issues are favoured over government securities, as the former offer higher yields and less risk in the event that bond yields rise.
- Underweight high-yield debt, which looks increasingly expensive by historical measures.

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