TD Waterhouse

Investment Outlook

Private Investment Counsel

Winter 2013

In this issue

Looking ahead to 2013

By Robert J. Gorman, CFA, Chief Portfolio Strategist, TD Waterhouse

With 2012 behind us, now is an appropriate time to review what transpired over the past year and discuss what we expect to unfold in 2013. What events will shape the year ahead? What are the key risks and positive factors we need to weigh, and how will financial markets and your portfolio fare?

A glance in the rear-view mirror

To put the road ahead in proper context, let's first examine the events of 2012.

❶ **We stated that U.S. stocks would rise for a fourth successive year and post a high single-digit return in 2012.** Our expectation was based on a number of factors, including: moderate economic and corporate earnings growth, reasonable valuations, relatively attractive and growing dividends, strong corporate balance sheets, and rising merger and acquisition activity. For the most part, this has unfolded on script, and at the time of writing, the S&P 500 Index was several percentage points ahead of forecast.

❷ **U.S. large-cap stocks were expected to lead their smaller-capitalization peers for the second successive year in 2012.** After outpacing the small-cap Russell 2000 Index by 545 basis points in 2011, the large-capitalization S&P 500 Index again led by a substantial, though reduced, margin in 2012.

Our short list of recommended names included **Oracle** and **IBM** from the information technology sector, with the former notching a strong double-digit advance as of late 2012 and the latter recording a solid total return. The more prosaic dividend growth stocks that we cited, **Johnson & Johnson** and **PepsiCo**, have both registered substantial total returns as of December 2012.

U.S. housing appears to have begun a sustainable recovery.

Within the financial sector, both **J.P. Morgan** and **Goldman Sachs** registered robust double-digit gains as of early December. **Exxon-Mobil** was the group laggard but had still posted an upper single-digit total return at the time of writing.

❸ **We thought that Canadian equities would resume their advance and post a high single-digit return in 2012.** The S&P/TSX Composite Index has indeed risen, but is likely to

Continued on Page 2

tdwaterhouse.ca
1-866-280-2022

Looking ahead to 2013

Continued from Page 1

fall short of forecast. That said, the less economically sensitive dividend growth stocks favoured have generally fared substantially better than the overall market.

The banks seemed inordinately cheap a year ago and top selection **Royal Bank** had posted a low double-digit return at the time of writing while the **Bank of Nova Scotia** also posted a strong return. Within the communications sector, **Shaw Communications** posted a solid return. **Thomson Reuters**' turnaround was fitful, but its total return was still respectable, courtesy of its substantial dividend.

Among resource stocks, **Suncor** had posted a high single-digit return as of early December, handily outperforming the Energy sub-index, which fell a similar amount. **Canadian Oil Sands**, however, lost ground.

Gold, employed as an insurance policy where appropriate for clients, rose in 2012, with the **SPDR Gold Trust ETF** registering a return in the upper single digits. Gold producers **Goldcorp** and **Barrick Gold** did not fare as well, with both companies losing ground as of December 2012.

❹ **We anticipated bond returns would be modest, in the range of 1% to 3%.** This has generally been the case, with year-to-date returns at the upper end of this range. Corporate issues, which we favour over government bonds, outperformed on the strength of higher coupons and shorter durations.

❺ **Northern Europe was expected to again be the best region among major international stock markets.** We continued to favour large-capitalization stocks with global reach in defensive industries, particularly those paying substantial and growing dividends. Indices either met or exceeded expectations, with consumer names **Diageo** and **Nestle** registering double-digit total returns, **Novartis** and **Standard Chartered Bank PLC** gaining ground, and **BP** and **Vodafone** posting small losses.

❻ **Emerging markets were to begin their recovery in 2012 after a dismal 2011.** This has worked out, with the MSCI Emerging Market Index posting a high single-digit return at the time of writing. Of the BRIC countries, India exceeded our expectations, Russia and Brazil were in line with our expectations, and China fell short.

The next 12 months

Readers of past years' forecasts will recall our thesis that 2009 would represent the first year of a four-year recovery in U.S. equities. Both 2009 and 2010 were generally in line with expectations, 2011 was below our estimate and 2012 has slightly exceeded forecast. In aggregate, the S&P 500 Index has returned to its 2008 pre-crash level. Going forward, we continue to favour equities over bonds.

❶ **We expect U.S. stocks to rise for a fifth successive year in 2013**, despite some notable macroeconomic and political risks, detailed below.

Risk 1: Fiscal cliff. The much-discussed fiscal cliff has the potential to derail the U.S. economy and stock market. The term "fiscal cliff" was coined by U.S. Federal Reserve Chairman Ben Bernanke to describe the dire effects of two possible events.

First, income and other tax cuts, largely initiated by Mr. Obama's predecessor, President George W. Bush, were scheduled to expire at the end of 2012. In the absence of congressional intervention, income tax rates are set to revert to Clinton-era levels in 2013, which could reduce U.S. GDP growth by two percentage points.

Second, to resolve the debt ceiling debate of 2011, President Obama signed the Budget Control Act, which created a bi-partisan committee to address the U.S. federal deficit and debt issues. Under the terms of this Act, if the committee's recommendations were not approved by Congress, automatic defense and non-defense spending cuts would kick in on January 1, 2013 — a process termed "sequestration." Since Congress has not adopted the committee proposals, the stage is set for these spending cuts, which could shave U.S. growth by another 1.5% to 2%, unless Congress intervenes. In combination, tax increases and reduced spending could cut growth by 4% and trigger a recession — hence the term "fiscal cliff."

Will the U.S. go over the fiscal cliff? It's possible but not probable. While the gulf between Republicans and Democrats is wide, the consequences of inaction are well known and severe. While much drama will doubtless unfold, we expect some accommodation with respect to tax revenue and spending. The result, as suggested by our colleagues at TD Economics, could be fiscal drag that has the potential to reduce growth by 1.5%. We are not expecting the U.S. to go over the proverbial fiscal cliff.

Risk 2: New presidential term. The first year of a new presidential term historically poses challenges for the stock market. Since 1928, when the S&P 500 Index was initiated, the first half of the presidential term — years 1 and 2 — have generated a combined return of 8.45%. This contrasts with a combined return in the second half — years 3 and 4 — of 20.15%. This sharp distinction is no accident and reflects fiscal and/or monetary policy. Specifically, a newly elected president typically doles out the harsh medicine — tax hikes and program cuts — early in his term and well before the next election. As detailed above, this is likely to happen in 2013, which will reduce economic growth and weigh on the stock market.

Risk 3: External factors — Europe, China and Iran. Southern Europe's current recession and tepid growth in the north is likely to dampen growth in North America but is not likely to induce recession in the U.S., as less than 15% of U.S. exports go to Europe. Sovereign debt, however, remains a major issue, which will drag on with the attendant pain. Nonetheless, Germany, acting out of enlightened self-interest, is increasingly accommodative toward its southern neighbours and we deem it improbable this issue will have a major, negative impact on U.S. stocks in 2013.

We believe China will experience a moderation in growth rather than the hard landing many anticipate.

Finally, military intervention in Iran is a possibility and with it, closure of the Strait of Hormuz and 20% of world oil shipments. While not a high-probability event, the possibility dictates the prudent oil exposure we maintain in equity portfolios.

The positives for U.S. stocks. Meanwhile, six key positive factors for U.S. stocks should be noted. We believe that:

- **Housing has begun a sustainable recovery** thanks to sharply lower conventional and "shadow inventories" (the current supply of pending foreclosures), excellent affordability and ongoing (albeit modest) job growth. Historically, housing has accounted for about 13% of U.S. economic growth when the economy has been recovering from recession, but housing has not yet contributed to this cycle. We believe that will change in 2013, and that housing will act as a significant offset to the fiscal drag cited above.
- **The auto sector will continue its recovery** in 2013, as discussed in prior issues of *Investment Outlook*. With the average car on the America road now 11.1 years old, according to Polk auto analysts, we are in the early stages of a major replacement cycle, which has positive implications for GDP growth, employment and retail sales.
- **The revitalization of U.S. manufacturing is under way.** The skilled labour wage gap with China has narrowed, even as the Chinese renminbi has risen 23% against the greenback since 2005. In addition, transportation costs for Chinese exports have increased while lower American natural gas prices have reduced U.S. input costs. The result has been outsized growth in U.S. manufacturing employment in recent years — a development that augurs well for the economy.
- **America's energy outlook is brightening.** From 2005 to the present, daily oil consumption in the U.S. has declined from 21 to 19 million barrels while American oil production has risen from five to seven million barrels. As a result, imported oil, as a percentage of consumption, has declined from 60% to under 49% today. This, along with soaring natural gas production, has major positive implications for U.S. growth.
- **Valuations are reasonable.** The S&P 500 Index is currently trading at around 13x our $104 estimate for 2012 earnings and 12.8x our $110 estimate for 2013 earnings. Both multiples are below historical averages. Meanwhile, stocks' earnings yield (earnings per share/share price) of 7% handily exceeds the 10-year Treasury bond yield of less than 2% — one of the widest such gaps on record.
- **Monetary policy remains accommodative.** Extraordinarily low short-term interest rates plus continued quantitative easing will continue to support equities.

Overall, while fiscal drag should limit equity market gains, we expect the S&P 500 Index to rise 6% to 7% in 2013 — for its fifth successive advance.

❷ **We expect U.S. large caps to outperform for a third successive year in 2013**, reflecting more attractive valuations relative to small caps, substantially higher dividend yields plus more consistent sales, earnings, and dividend growth.

Within the tech sector, we believe that **Oracle** and **IBM**, with their focus on software and services, remain a relatively low-risk way to participate in an otherwise volatile sector. Among dividend growth stocks, **Johnson & Johnson** and **Home Depot** are attractive, the latter benefiting from the recovery in housing and renovation activity. Among financials, we favour **J.P. Morgan** and **Wells Fargo**, with the latter's commanding market share in mortgage lending boosting earnings. In more economically sensitive sectors, **ExxonMobil** could generate a solid total return and **Freeport-McMorran**, after an early December sell-off, provides robust copper, gold and energy exposure.

❸ **Canadian stocks could advance again, with the S&P/TSX Composite Index rising 5% to 6%.** This reflects reasonable valuations and solid earnings growth. We expect the less economically sensitive sectors, which have outperformed in recent years, to do so once again in 2013, led by the stocks that exhibit substantial and growing dividends.

The banks face challenges in the form of compressed margins, slowing loan growth and a housing headwind but should advance along with moderate earnings improvements. **Bank of Nova Scotia** and **Royal Bank** remain our top two selections. **Shaw Communications** should again generate a solid total return, as should **Brookfield Asset Management**, which should see improved operating performance from its high-calibre portfolio of office buildings. Among resource stocks, we again favour **Suncor** and will add **Teck Resources**, which could benefit from any improvement in metallurgical coal prices.

In the current environment, gold represents a hedge against extreme outcomes. As a result, we are maintaining, where client mandates warrant, positions in either the **SPDR Gold Trust ETF**, **Barrick Gold** or **Goldcorp**.

Important information regarding leverage risk

Using borrowed money to finance the purchase of securities involves greater risk than a purchase using cash resources only.

If you borrow money to purchase securities, your responsibility to repay the loan and pay interest as required by its terms remains the same, even if the value of the securities purchased declines.

❹ **Bond returns will likely be modest again in 2013, with gains ranging from 0% to 2%.** After a 30-year bull market, the outlook for bonds is not favourable, as current low yields are likely to rise going forward — especially for government issues. We continue to overweight investment-grade corporate bonds for their higher coupons and shorter durations.

❺ **Northern Europe could once again be the best-performing region among the major international markets in 2013.** While Europe's economy will struggle in 2013, the large caps in defensive industries — based in the north and characterized by global reach, attractive valuations plus substantial and rising dividends — are expected to generate positive returns in 2013. We continue to favour **Diageo, Nestle, Novartis, Vodafone, BP,** and **Standard Chartered Bank**.

❻ **Emerging markets are expected to generate respectable returns and continue their recovery in 2013.** As outlined earlier, we expect China will orchestrate a soft landing, which is beneficial for both the global economy in general and emerging markets in particular. While the BRIC countries of Brazil, Russia, India and China remain the centre of emerging market attention, we are looking for the smaller, well-positioned MIST countries of Mexico, Indonesia, South Korea and Turkey to garner increasing investor attention in 2013.

In sum, we expect 2013 to be another year in which stocks advance and outperform bonds. We anticipate large caps will again outperform small caps. We continue to favour less economically sensitive sectors and stocks with substantial and rising dividends. ■

Current TD Waterhouse 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 September 15, 2012 – December 15, 2012)

DEX Universe Bond Index	1.5%
S&P/TSX Composite Index	-1.6%
S&P 500 Index	-3.6%
MSCI EAFE Index*	1.0%

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

3 retirement challenges and how to prepare for them

If you're approaching retirement, it's important to start thinking about how your savings and investments will last.

This is especially important today, as Canadians are facing new retirement realities. Capital preservation, of course, will be a key consideration as you move into retirement. But you may also need some investment growth to help your savings.

1 **Longer lives and the new retirement.** Statistics Canada data show that Canadians today are living longer, healthier lives. In 2007, life expectancy stood at 83 years for women and 79 for men. What's more, the latest figures show that more than half a million Canadians are 85 or older — twice the number as in 1981. And there are more than 1.2 million people in Canada over 80.

What does this mean for you? In a nutshell, your portfolio will need to finance many years of active retirement. Twenty to thirty years of retirement is becoming the norm, meaning you'll need a larger nest egg to fund this next chapter in your life.

That means you might want to consider having a growth component in your plan, in line with your risk tolerance and objectives. It also means working with your Portfolio Manager to ensure that your investments are structured tax-efficiently so you have more money left in your hands at the end of the day.

2 **Prepare for inflation.** Many Canadians have benefitted from low inflation over the past decade. As measured by the Consumer Price Index (CPI), inflation has averaged about 2% since 2000. But prices have been moving higher lately, spurred by higher energy prices.

The costs for services such as healthcare and leisure are rising at an even faster rate than the CPI.

Rising prices can eat away at the purchasing power of your savings over time. For example, Bank of Canada data show that inflation has averaged about 2.3% annually over the past 25 years. If your investment returns did not earn at least that much, you would be falling behind — and that's not even taking into account the effect of taxes.

In our opinion, equities and equity mutual funds can provide the growth needed to stay ahead of inflation.

3 **Plan for rising health care costs.** With longer life spans and rising medical costs managing healthcare costs may be a challenge for those in retirement. For Canadians transitioning out of full-time employment, this takes on even greater importance, as extended healthcare benefits — such as dental and physiotherapy — may no longer be available to them. You may need to plan for healthcare costs no longer covered by employment benefits. Indeed, the 2012 Sanofi Canada Healthcare Survey found that 51% of Canadians expect they will continue to have access to extended benefits after they retire — which may not be the case for many Canadians working in the private sector in non-unionized positions.

As you enter retirement, it's also important to take a longer view. For instance, long-term care insurance can be an important tool that can provide financial security for you and your family. Long-term care protection can be used to cover the cost of your care if you're no longer able to look after yourself and require the services of a long-term care facility or professional help in your home.

Your Portfolio Manager can help you plan and prepare for the new retirement realities, as well as challenges specific to your unique situation. Schedule an appointment today. ■

Notice to unitholders of TD Funds

The 2012 annual report for investment funds managed by TD Asset Management Inc. ("TD Funds") will be available at the end of March 2013. Unitholders are entitled to receive an investment fund's annual and interim financial statements and management reports of fund performance, available at the end of March 2013 and August 2013, respectively. These documents are available directly at **tdassetmanagement.com**, **sedar.com** or by contacting your *Portfolio Manager*. Delivery of such documents is based on instructions provided by the unitholder. Please contact your Portfolio Manager to change delivery instructions.

Message from Kevin Shubley

Vice-President, Head of Private Investment Counsel

Thank you for choosing to collaborate with TD Waterhouse Private Investment Counsel. We appreciate the trust you place in us as we work together to help you achieve your financial goals.

Uncertainty in the global economy continued to affect the investment markets in 2012, as volatility was a concern once again. The good news is there are reasons to be optimistic about the global economy in 2013. There are also reasons for caution, however, as we are in a low-return climate for fixed income.

Enhanced investment solutions

In response to today's more challenging climate for fixed income, we want to help ensure that our investors are not vulnerable to inflation eroding their savings. For clients who want, lower volatility and a potential for long-term capital appreciation, we have launched the **TD Private Global Low Volatility Fund**.

We have also enhanced our investment options with the recently launched **TD Private Bond Capital Yield Fund**, which seeks to provide the total return of an income fund, but in a more tax-efficient structure.

A holistic approach to wealth

We understand that your investments are just one part of your overall wealth management plan. That's why we believe in incorporating your values into an all-inclusive strategy focused on helping you achieve your personal and family goals.

The depth and breadth of specialization within TD enables us to offer services to help meet your needs beyond investment management. We can help you accumulate and manage your wealth, preserve it and transition it to your chosen successors.

Talk to your Portfolio Manager about your goals to help ensure that your wealth management plan reflects what is important to you and addresses these key wealth considerations.

We feel honoured that you have chosen TD Waterhouse Private Investment Counsel. We wish you and your family all the best in 2013! ■

Wealth Asset Allocation Committee message

The TD Wealth Asset Allocation Committee (WAAC) is made up of highly experienced TD investment professionals. The Committee, which meets at least once a month, works with TD Waterhouse Private Investment Counsel (PIC) to establish an asset mix with a view to enhancing returns and mitigating risk for PIC clients.

During the fourth quarter of 2012, the WAAC made two changes to target asset mix:

1. We raised the U.S. equity position to overweight from neutral. This reflects the view that reasonable valuations, corporate earnings growth and a solid economic backdrop could help U.S. stocks to outperform. To fund the increased U.S. exposure, we are reducing our tactical overweight in the SPDR Gold Trust ETF, which has risen substantially since its adoption in early 2010. We are maintaining a reduced position in gold, where appropriate for clients, as a hedge against extreme outcomes.

2. Reduced the position in high-yield bonds to neutral from overweight. After a period of strong relative performance from high-yield bonds, we believe their valuation is no longer as attractive. The proceeds have been directed into investment-grade corporate bonds, increasing the overweight position in that category.

Overall, we are overweight stocks and underweight bonds, with the equity overweight comprising U.S. and emerging market positions while, among bonds, we prefer corporate over government securities. We maintain a position in gold as portfolio insurance.