TD Asset Management

Market Perspectives + 15 Minutes
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Market Perspectives Q2 2021

Global Equities Advance Despite Rising Yields

Inflation Talk Heats Up, but is it Just Hot Air?

TD Wealth Asset Allocation Committee (WAAC) Overview

- Our strategic overweight to equities is underpinned by expectations for a sharp rebound in corporate profitability growth in 2021. Amid dislocations resulting from potential episodic volatility, we will seek to adjust equity weightings to optimize growth opportunities.
- Rates have risen in recent months, driven by pro-cyclical trends and expectations that economic conditions will see robust expansion. While higher inflation and rates are implied by the current environment, we do not foresee a significant surge in rates that would be materially negative for risk assets, but we are monitoring closely as we see some pockets of inflationary pressures developing.
- The COVID-19 vaccine rollout has been uneven in certain regions of the world but remains a significant driver of improved risk sentiment in markets. We expect increased efficiency in vaccine distribution over the coming weeks; however, the implications of emerging variants still pose a moderate risk to markets.
- We maintain a fixed income underweight overall, but with an overweight to investment grade corporate bonds. Corporate credit provides positive real returns and a yield advantage over government bonds, which are still offering negative real yields despite the recent rise in rates.
- We expect our strategic overweight tilt to alternative assets, such as mortgages, infrastructure and real estate to increase overall portfolio returns, add diversification, and act as a hedge against inflationary risks.

First Quarter in Review

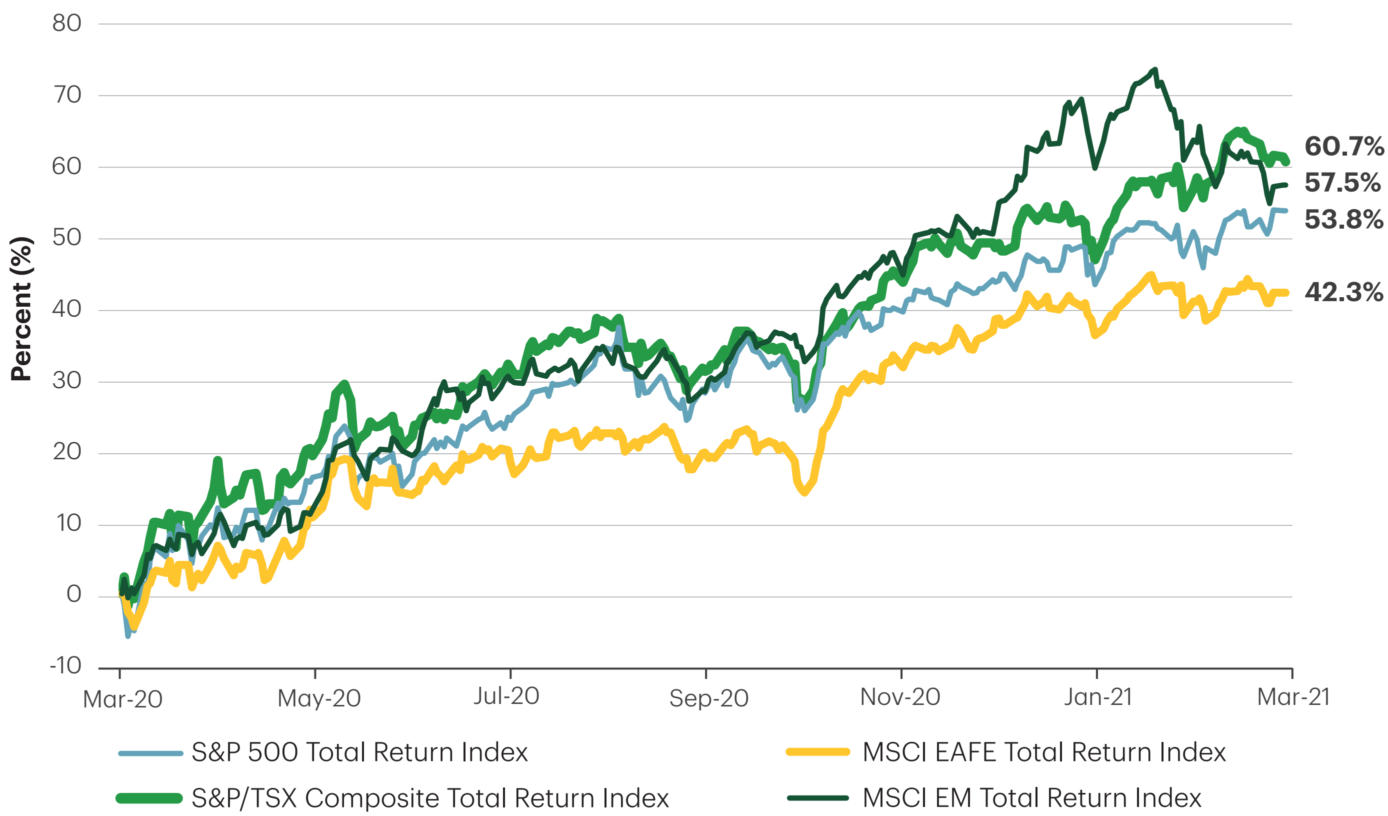
It was just a little over a year ago, back in early March of 2020, that the potential economic and societal implications of a global health crisis began to seize our collective awareness. Major market indices plunged at record velocity. Then, in mere months, those same markets staged a dramatic recovery, faster than any market rally in history (see **Chart 1**).

Though we are not completely beyond the health crisis, North American and other global equity markets are at or flirting with all time highs, and the focus is shifting from the pain of the COVID-19 pandemic to the eventual return to normalcy. Global central banks and governments provided critical support during the pandemic through highly responsive and effective monetary and fiscal policies. This and the remarkably rapid development of high efficacy vaccines were the primary catalysts behind the resiliency in markets and what has been a V-shaped economic recovery. To that we layer on lockdowns that are now easing in parts of the world and labour markets that are gradually improving. Economic indicators are pointing to robust global gross domestic product (GDP) growth (the U.S. Federal Reserve is forecasting as much as 6.5% growth in 2021 for example) and corporate fundamentals are stronger than most would have predicted.

We would argue that the 'wall of worry' has now shifted abruptly from concern over economic growth to concern over inflation. Our optimism and the expected swift pace of the economic recovery may come at the price of rising costs for the goods and services that we rely on every day. The significant increase in government spending that helped maintain financial stability for many during the pandemic has contributed to a sharp increase in money supply in the economy. Combine this with protracted low interest rates and markets are grappling with whether this will be the precursor to uncontrolled inflation.

Recently, these inflation concerns have found their way into both equity and fixed income markets in the form of rising bond yields and risk asset volatility. Inflation anxiety has increased, and many are worried about what an unexpected surge in rates and inflation could mean for their investments and capital markets. The TD Wealth Asset Allocation Committee ("we", "us", "our") understands these concerns. In this edition of Market Perspectives, we will provide our insights on inflation along with our asset class outlook over the next 12-18 months.

Chart 1: Index returns over the past 12 months (based in USD)



Source: Bloomberg Finance L.P. as of March 30, 2021.

Inflation Risk: Real or Inflated?

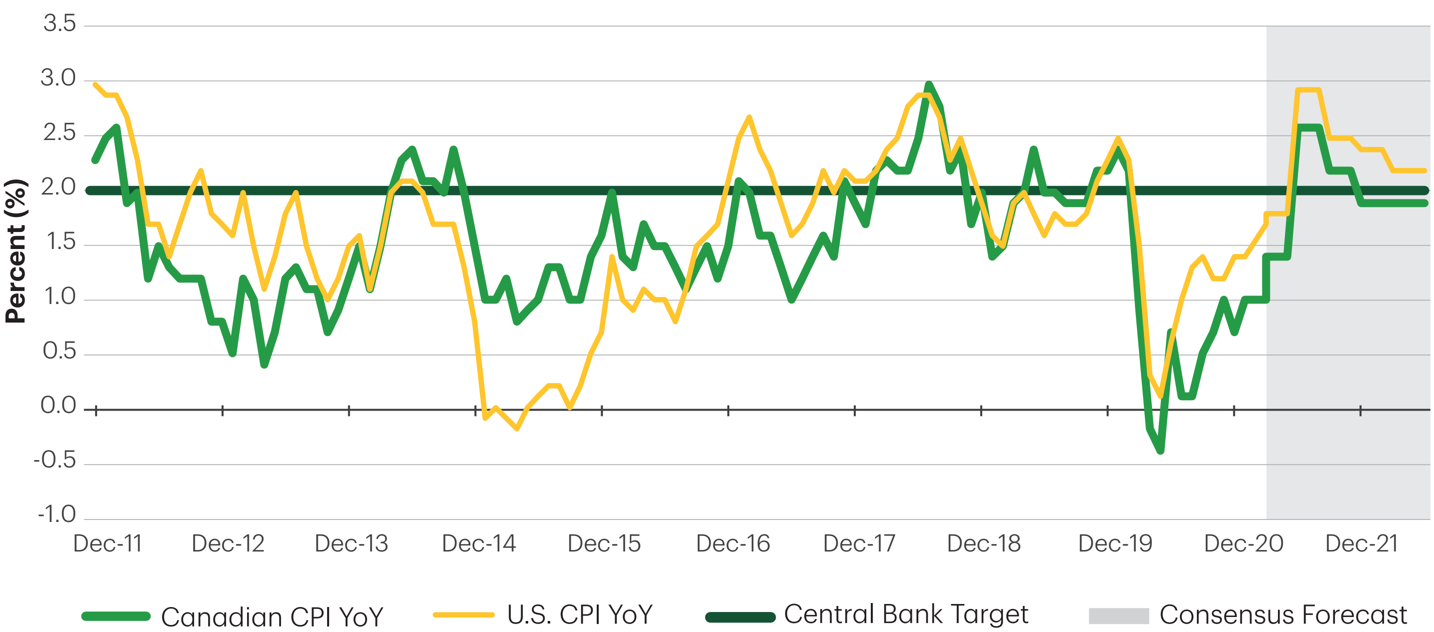
As the global economy emerges out of the deepest recession in recent history, investors have become increasingly focused on the prospect of rising inflation. The recovery has been highly dependent on massive amounts of government and central bank stimulus which have propped up household and corporate balance sheets, as well as generated incentives for private consumption and investment. As a result, broad money supply has sky-rocketed, growing at annual rates of an estimated 20% recently in Canada and the U.S., compared to long-term growth rates of around 7-8%. Historically, such monetary expansions have often led to periods of above-average inflation, which can hurt both savers and consumers.

Money supply in the economy is typically measured by what economists term "M2". M2 is comprised of cash and highly liquid investments like savings deposits and money market securities.

Near-term inflation to remain low but volatile

For now, concerns around rampant inflation are mostly speculative and rooted in economic theory. At a practical level, year-over-year (YoY) inflation growth rates in Canada and the U.S., as measured by the Consumer Price Index (CPI), are expected to stay in the 1-2% range during the first quarter of 2021, having risen from near-zero levels during the peak of the COVID-19 crisis (see **Chart 2**). In the second quarter of the year, we expect meaningful volatility in headline CPI data, which may come as a shock to some consumers and market participants. U.S. CPI, in particular, is expected to increase by 3% (YoY) in the second quarter, well above the U.S. Federal Reserve's (the Fed) target of 2%. This will be mostly a statistical phenomenon, however, as the "base effect" of comparing current prices to the depressed price levels experienced in the second quarter of 2020 will temporarily overstate headline inflation. Early in the pandemic, many economies were in the midst of heightened restrictions and lockdowns, and spending was severely curtailed, most notably in service related industries. As this effect subsides, we will likely see CPI rates closer to 2% in both Canada and the U.S. toward the end of 2021.

Chart 2: Inflation forecast to spike and then stabilize



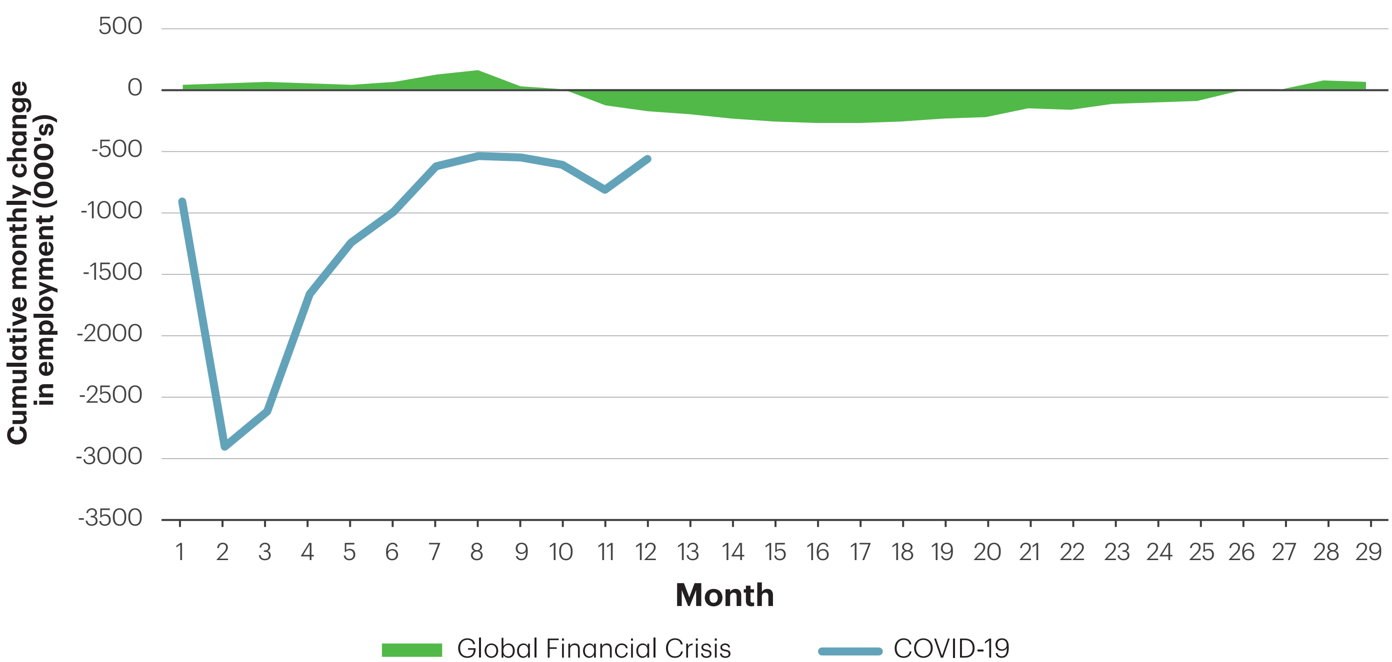
Source: Bloomberg Financial L.P. As of March 12, 2021.

Slack labour markets may cool inflationary pressures

Although near-term inflation dynamics may cause volatility in financial markets, we believe that inflation *expectations* are a more important input when thinking through medium-term investment outcomes. The primary driver for gradually rising inflation is the recovery in aggregate demand over the next few years, bolstered by the end of the global pandemic, significant fiscal stimulus programs and easy financial conditions. Indeed, forecasted real GDP growth rates have been trending higher. Based on recent forecasts, Canada and the U.S. are expected to grow over 5% in 2021 and approximately 4% in 2022, YoY. Furthermore, central banks (led by the Fed) are increasingly incorporating the concept of "average inflation targeting" (AIT) into their policy frameworks. This would mean that rate hikes will not occur until inflation is trending above 2% for a considerable period of time, in order to make up for past inflation undershoots. In Canada, there has been relatively less guidance on formally shifting to AIT but given the strong linkages between Canadian and U.S. monetary policy, we expect this to be a de facto framework for the Bank of Canada. While this is supportive for a recovery in aggregate demand, the supply side of the economy still exhibits significant slack, most particularly in labour markets. The COVID-19 recession was short, but it was significantly deeper in terms of employment than the global financial crisis (GFC) in 2008 (see **Chart 3**), and thus it will take time for labour markets to recover. In theory, for inflation to sustainably rise, economies would need to be closer to full employment with an accompanying rise in wages, pressuring consumer prices. We expect this is some time away for most global economies.

AIT is a central bank policy which seeks to achieve an average target level of inflation over time as opposed to the more conventional fixed target level. In a fixed target policy, a central bank would raise rates once the level of inflation exceeds the target and vice versa, in a set formulaic approach.

Chart 3: Canadian labour market yet to recover from pandemic lows



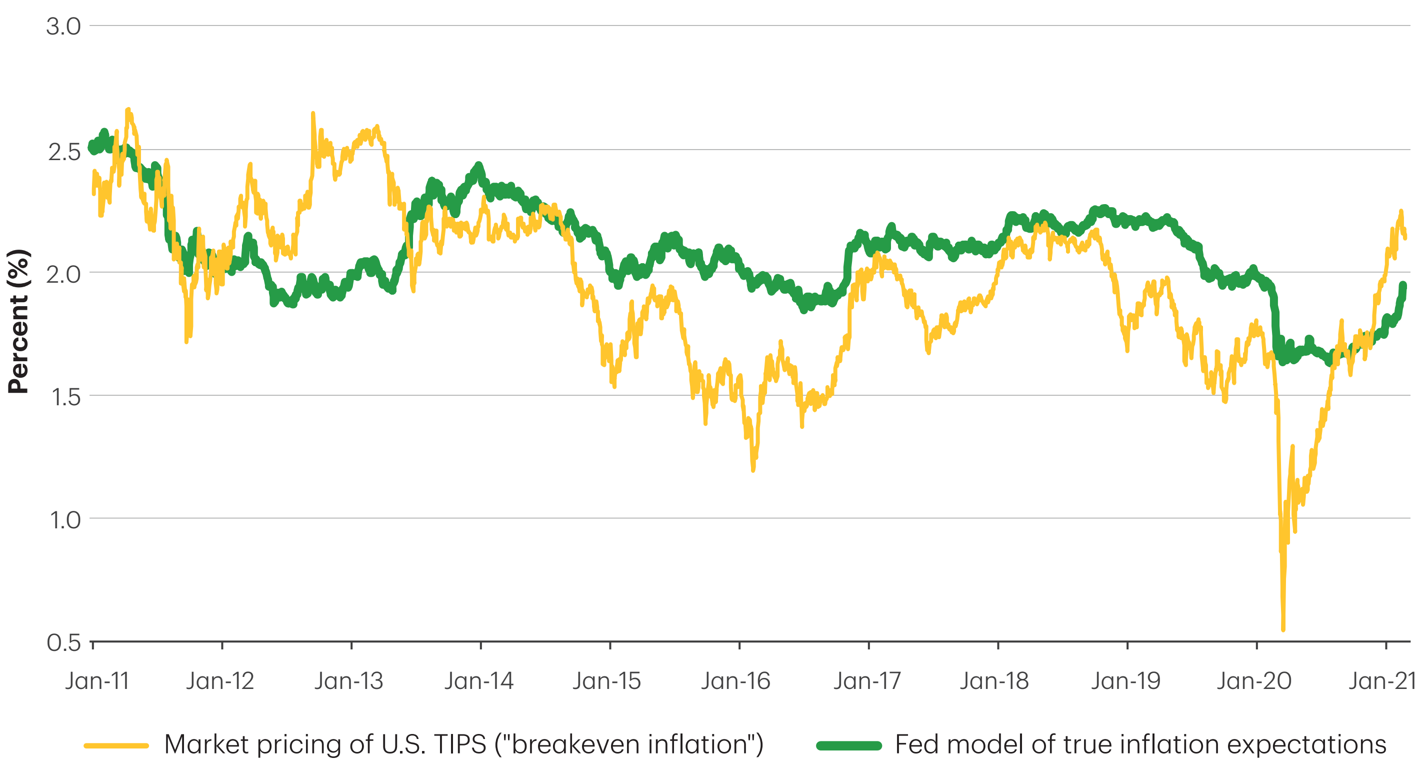
Source: StatCan. As of February 26, 2021.

Markets optimistic on inflation

Market-based measures of inflation expectations, however, appear to be more constructive. Breakeven inflation rates have rebounded significantly and surpassed pre-COVID-19 levels. We particularly focus on signals derived from U.S. Treasury Inflation-Protected Securities (TIPS), given the superior liquidity of this market compared to Canadian Real Return Bonds (RRB). U.S. TIPS currently imply that CPI will average 2.3% over the next 10 years. While this could be attributed to the market taking a forward-looking view on the global recovery and the efforts of the Fed to let inflation run hot, a deeper analysis shows that there is a significant liquidity premium embedded in breakevens. More specifically, the net supply of TIPS in 2020 and 2021 is actually negative, as the Fed is buying more of these bonds than are being issued by the U.S. government (the same phenomenon is evident in RRB markets as the federal government has reduced issuance while the Bank of Canada continues to conduct reverse auctions). After adjusting for this quantitative easing effect, we observe that true inflation expectations implied by TIPS breakevens are in line with historical average inflation rates of 2% (see **Chart 4**). In other words, runaway inflation is still not a concern for the market. The main risk to this view is that inflation manifests in an unexpected way, such as through a protracted increase in food or commodity prices, or through a breakdown of global supply chains due to another trade war. Regardless of the shock, we believe that it is important to look at whether price increases are a result of a structural shift in economic forces or simply transitory in nature. Understanding the varied policies of central banks and how they intend to control inflation and limit its impact on the economy is also key.

Breakeven inflation is derived from inflation-linked bonds. It's the difference between the yield of a nominal government bond and an inflation-linked bond. For example, if the yield on a 30-year treasury bond is 1.5% and the yield on an inflation-linked bond of the same maturity is 0.1%, the implied expected inflation is then 1.4%.

Chart 4: Runaway inflation not in the cards



Source: U.S. Federal Reserve. As of February 26, 2021.

WAAC Positioning and Outlook

As we enter the second quarter of 2021, we remain underweight fixed income, overweight equities and alternative assets and will continue to make necessary strategic adjustments to our views as the environment unfolds. We remain active in evaluating long-run return expectations for key asset classes, while relying on the input from our network of experienced investment teams to deliver informed strategic views.

Equities

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

While elevated bouts of volatility should be expected for equities over the coming months, we do not anticipate adverse shifts in the improving corporate and economic landscape, even should rates rise modestly higher from current levels. Intermittent declines in equity prices over the quarter were not associated with negative economic or corporate news, but by positive trends in data that have triggered inflationary pressures, which we expect to moderate over the intermediate term.

We anticipate more ubiquitous market participation compared to 2020, as the reopening trade gathers steam. Cyclical and value-oriented sectors (i.e. Financials, Energy and Industrials) should outperform as the pent-up spending surge and inventory rebuild is likely to contribute to an extended growth cycle for these sectors.

We are optimistic that the upturn in economic activity will gain momentum throughout the year, underpinned by a combination of accelerated vaccine rollouts, accommodative financial and monetary conditions, strong household balance sheets, and eventual job recovery in sectors of the economy that are still being hit hard by the pandemic. With the S&P 500 Index around all-time highs, some indicators point to stretched valuations. In our view, U.S. stocks are within fair value ranges and since corporate earnings have exceeded expectations and continue to be revised upward, this should validate current valuations and provide a supportive backdrop for U.S. markets to trend higher. Our expectation is for earnings growth to exceed current estimates and be a primary driver of U.S. equity returns over the next 12-18 months.

We continue to see strengthening fundamentals in the Canadian economy, with business activity accelerating in the second half of last year and into the first quarter of 2021. The resilient residential real estate market, stabilizing employment picture, and improving conditions within Energy, Materials and particularly the Financials sectors, should drive earnings growth more rapidly than most developed markets and relative Canadian equity outperformance over the year. The S&P/TSX Composite Index has experienced an extended period of underperformance versus other markets, including the U.S. We believe that Canadian equities are attractively valued and well positioned to narrow this performance gap, and therefore have raised Canadian stocks to maximum overweight to reflect this view.

The recovery in commodities has been constructive for many emerging markets and international economies. Increasing demand from western countries has led to rising exports, particularly in the Asia Pacific region. Additionally, emerging and international markets offer compelling valuations, and are home to higher yielding assets, relative to markets that are starved for yield. We maintain an overweight to emerging and international markets and continue to believe that China will deliver solid performance despite elevated short-term valuations, and some recent evidence of moderating growth levels, notably in manufacturing and services. However, these effects are likely to be transitory. In Europe, growth will remain challenged in the near-term, as countries grapple with resurgent COVID-19 cases and a slow vaccine rollout. Longer-term, growth is expected to pick up meaningfully towards the end of the year and into 2022.

Alternatives/Real Assets

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

We remain modest overweight infrastructure as the asset class continues to offer stable returns and low correlation to other asset classes. Strategies focused on contracted revenue provided stronger returns relative to those with exposure to GDP-linked or usage-based revenue. Pent-up demand for new infrastructure projects is now being realized as major transactions are being completed in a very competitive environment. We anticipate significant opportunity for growth in the infrastructure market given government spending initiatives. In addition, we expect that growth in digital infrastructure and a renewed global focus on building a low-carbon economy will continue to highlight the benefits of infrastructure within multi-asset portfolios.

Commercial mortgages have been relatively well insulated from the recent interest rate volatility, as they continue to provide incremental yield over other fixed income assets. On an absolute and duration adjusted basis, the yield advantage offered through commercial mortgages versus publicly traded bonds is near an all-time high. Additionally, income collection remains resilient, with principal and interest collection over the fourth quarter of 2020 and year-to-date not seeing any negative impacts. We continue to prefer property types with defensive income profiles, such as multi-unit residential and industrial/logistics.

Despite the pandemic, Canadian real estate transaction activity across property types has continued to rebound from 2020. Many investors are constructive on multi-family assets and logistics real estate given their resilience over the past year and positive outlook. While questions remain about office demand, cautious optimism around vaccination timelines has resulted in a slight pick-up in leasing activity. Greater transaction activity has helped stabilize valuations across most property types and rent collection remains stable. Retail assets remain vulnerable to on-going lockdown measures in certain regions.

Despite a relatively slow start to 2021, increasing vaccination rollouts, fiscal stimulus and accommodative monetary policy should be positive for global real estate. With global growth rates expected to rebound in the second half of 2021, we expect a supportive environment for commercial real estate, albeit with some challenges along the way. The logistics sector has shown to be one of the more resilient segments due to strong tenant demand driven by e-commerce growth. Industrial values and rents in several markets across Europe are at record highs due to occupiers competing for well-located modern facilities.

In early 2021, certain developed Asia Pacific countries have demonstrated their ability to contain the COVID-19 virus and are thus exhibiting a stronger pace of recovery compared to other regions across the world. While work-from-home will likely continue to some extent post pandemic, it is encouraging to see increasing signs of workers returning to the office. While challenges do persist in the retail sector, pent-up consumption and successful roll out of the vaccines should act as positive catalysts. The impacts of COVID-19 on economies worldwide have varied widely and as such, we believe that investments in high quality real estate strategically diversified across multiple regions, countries and cities will be a driver to risk-adjusted returns over the long-term.

Alternatives

Fixed Income

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

Bond yields have climbed due to rising inflation expectations driven by positive global economic developments. We expect government bond yields to be volatile near-term but believe rates will remain subdued around current or modestly higher levels over a longer horizon. Ultimately if rates continue to rise, we expect this to occur in an orderly fashion. This view is supported by global central banks affirming continued ultra-accommodative policy and backed by the Fed's aggressive bond-buying program that should help keep rates relatively contained. Over the longer term, on an inflation-adjusted basis, we believe government bonds will continue to deliver very low or negative real returns and therefore maintain our maximum underweight outlook.

Credit spreads remain narrow as market liquidity provided by unprecedented monetary and fiscal support has clearly benefited the corporate bond market. The improving economic outlook has also been positive for corporate creditworthiness and companies' ability to service debt. However, while the turnaround in the economy continues to be supportive of corporate credit, some volatility can be expected, and we witnessed signs of this with modest spread widening recently. This is a natural response to higher yielding government bonds, and while we do expect some bumps in the road, we do not anticipate dramatic negative consequences for the credit market. We remain constructive on investment grade corporate bonds as credit continues to offer relative value over government bonds. Within our allocation preferences, we maintain a modest overweight to investment grade corporate bonds, while emphasizing liquidity and quality within portfolios.

High yield spreads have also narrowed considerably since coming under significant pressure during the height of the pandemic. However, further gains from spread compression is unlikely going forward as markets seem to have priced in the recovery. We remain selective with a neutral outlook for high yield bonds as some headwinds continue to persist in certain segments of the economy.

We continue to maintain a maximum underweight view for global developed market bonds. While the global macroeconomic outlook has shown notable signs of improvement, real yields are likely to remain broadly low or negative. Despite the rise in rates, global bonds remain uncompelling from an opportunity perspective. We also remain neutral on emerging market bonds as opportunities offering attractive valuations and incremental real yields do exist, but some continued economic risks remain from the potential of an uneven global recovery.

Fixed Income

Sub Classes

	Maximum Underweight	Modest Underweight	Neutral	Modest Overweight	Maximum Overweight
Gold			●		
Canadian dollar vs. the U.S. dollar				●	
U.S. dollar versus a basket of currencies		●			

Over the quarter, we adjusted our strategic outlook for gold from modest overweight to neutral. In mid-2020, prices of the precious metal soared to all-time highs, driven by concerns over the economic fallout from the pandemic. The safe-haven characteristics of the asset supported higher valuations as there were still many prevailing uncertainties and the severity of the recession was still unknown. The subsequent stabilization of economies, combined with a steadily improving outlook, has diminished gold's attractiveness over the longer term. Additionally, our expectations for modest levels of inflation for the foreseeable future has minimized gold's appeal as an inflationary hedge in investment portfolios.

Relative to other global currencies, we maintain an underweight outlook for the U.S. dollar. While there has been recent strength in the currency driven by the brighter outlook for the U.S. economy, relative to other countries, burgeoning government debt may weigh on the currency longer term. On that same token, we maintain an overweight outlook for the Canadian dollar driven by stronger commodity prices, cyclical and financial sectors, and improving foreign demand for investments.

Outlook

TD Wealth Asset Allocation Committee

The TD Wealth Asset Allocation Committee (WAAC) was established to deliver a consistent asset allocation message and be the source for strategic 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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