TD Asset Management

Market Perspectives + 15 Minutes
= Current Insights

Market Perspectives Q4 2021

Navigating the Shifting Undercurrents

TD Wealth Asset Allocation Committee (WAAC) Overview

- Over the strategic horizon, the macroeconomic outlook remains favorable for equities. However, the pace of gains for global stocks will likely moderate markedly relative to the previous 12 months. While we remain positive on equities, we are more cautious in our outlook compared to the past year. Defensive positioning with an emphasis on quality may be warranted, as potential headwinds could drive episodic volatility.
- Inflationary pressures have persisted in segments of the economy due to global supply chain backlogs, high consumer demand, and rapidly tightening labour markets. While we continue to view many of these pressures as transitory, the impacts could linger longer than initially thought; however, prices should begin to normalize from current levels.
- Aside from inflationary risks, a mix of headwinds could impact global markets over the next 12-18 months. These include disruptions to the labour market recovery, peaking economic and corporate earnings growth, and the longer-term implications of COVID-19 variants.
- While we maintain an overall modest underweight to fixed income, we believe fixed income exposure within portfolios remains important. Fixed income can provide quality income, diversification benefits and can insulate portfolios during periods of elevated volatility.
- Where appropriate, portfolio exposure to alternative assets may take on greater importance in diversifying sources of income and achieving higher relative returns at more acceptable volatility levels. Alternative assets, such as mortgages, infrastructure and real estate can also act as a hedge against inflationary risks.

Third Quarter in Review

The first three quarters of 2021 have not disappointed investors with an appetite for riskier assets. Both the S&P 500 Index and S&P/TSX Composite Index have gained over 15% for the year, while global markets have surged off of the March 2020 collapse; the nadir of this health crisis (**Chart 1**). As the pandemic continues to impact many regions across the globe, the abundance of market liquidity provided by governments and central banks, which have kept the pedal to the metal on stimulus, has not only supported individuals and business, but has also fueled the tremendous equity market rally. Low real yields also remain a significant catalyst for global risk asset growth.

For most of the year equity markets have had a nice run with the S&P 500 Index delivering consecutive monthly gains, hitting 53 record closes before the end of August. However, volatility returned in September and drove the index lower by 5% from its all-time closing high. As North American stocks remain near their all-time highs, and while economic and corporate growth indicators are still positive, they are showing signs of slowing, and many are ringing alarm bells over the potential for a more significant correction.

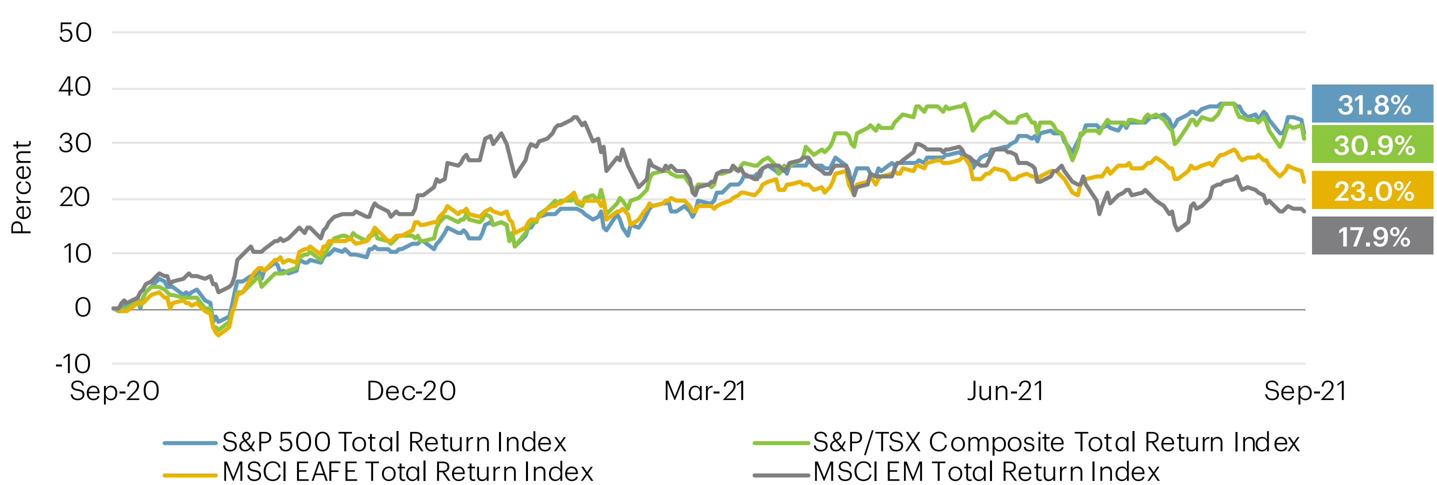
In addition to worries over lofty valuations, the chorus of concern centres on many of the themes that have dominated markets for much of the year. Inflation pressures have persisted in market segments and are lingering longer than initially thought. Central banks appear to be turning less dovish, and fiscal impulses are waning. The Delta and other emerging variants remain a concern, particularly as we enter the fall and winter seasons. Additionally, in the latter part of September, the risk of a possible Evergrande Group led real estate meltdown in China triggered a brief but sharp global selloff in equities, as investors feared the potential trickledown effects on global markets.

That's a lot to contemplate, and while the TD Wealth Asset Allocation Committee ("we", "our") is cognizant of headwinds, our focus remains on longer-term portfolio positioning and the factors that counterbalance these shorter-term risks. We expect corporate balance sheets and profitability to remain strong, and while the pace of economic growth may be moderating, slowing growth does not mean negative or no growth. The underlying economic undercurrents are strong as global Manufacturing and Services PMI data remains broadly expansionary across the globe, despite coming off the boil in recent months. The pandemic, while a major concern, should not lead to broad based shutdowns. We believe that policy makers are also at the ready to do whatever it takes to mitigate market shocks and keep the economy humming.

The bottom line: we continue to favour equities over fixed income longer term. Predicting when or how severe a correction might be is in near impossible. Keep in mind that selloffs help to clear market excesses, and any significant market weakness could present attractive buying opportunities, given the strong constructive macroeconomic and fundamental backdrop.

In the following section, we provide our thoughts on what may lie ahead for the investment landscape and look to an important market gauge for insights. For an in-depth perspective on our current views on key asset classes, as well as our strategic outlook over the next 12-18 months, please review the WAAC Positioning and Outlook section of this report.

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



Source: Bloomberg Finance L.P. As of September 28, 2021.

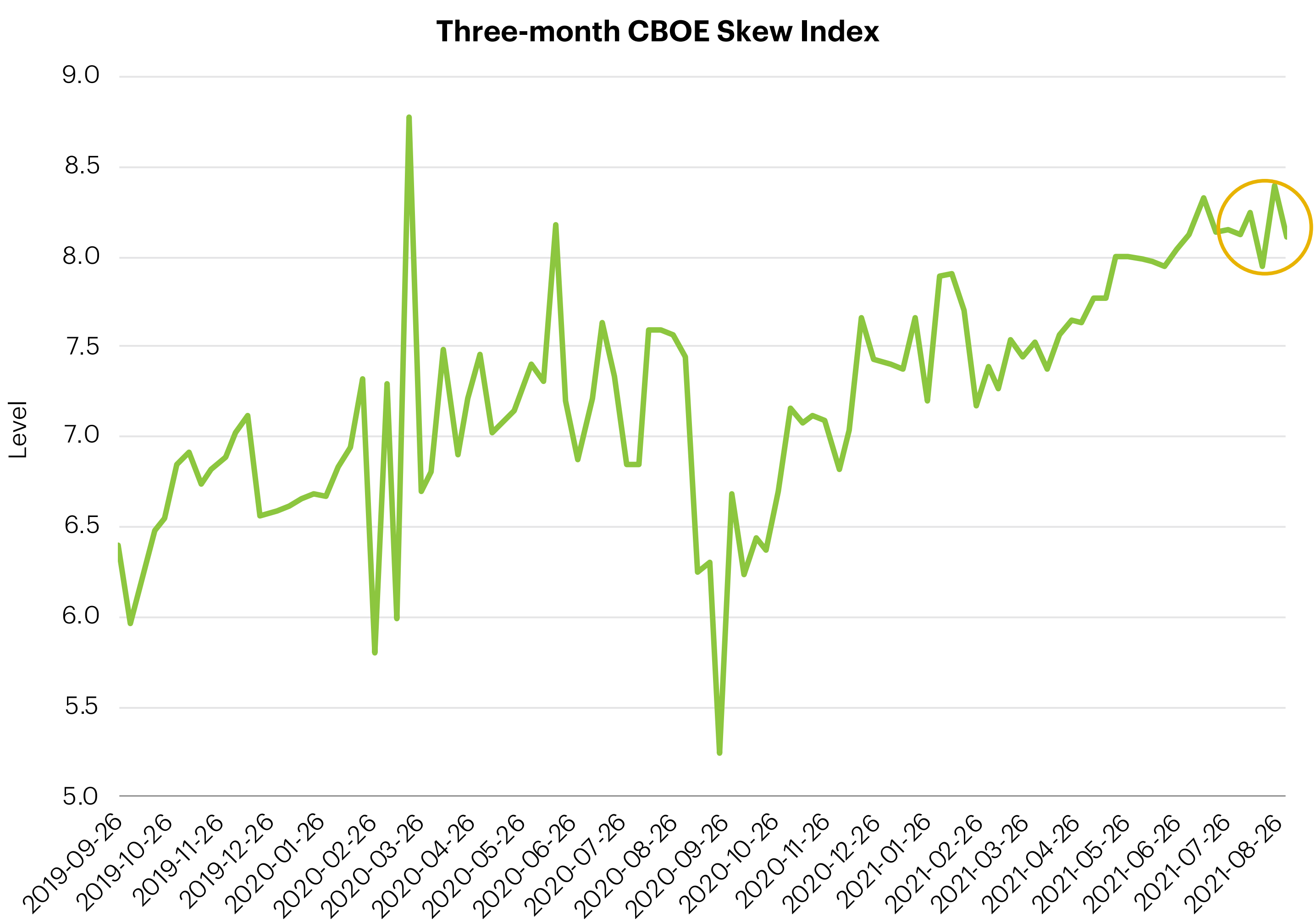
Markets Signal a More Cautious Outlook

On the surface, market sentiment remains broadly optimistic about the future state of the economy as global indices hover around all-time highs. The question on the minds of many is "how long can these good times last?" Some prognosticate that the markets may be overdue for a significant correction (10% or more), based on rich multiples and peak earnings, weaker economic data and elevated COVID-19 cases in certain regions.

One way to measure the risk of a potential market downturn, is to look at certain indicators like the CBOE Volatility Index (VIX). This index captures volatility, or fear in equity markets, as measured by S&P 500 Index options. The VIX is currently trading at historical averages, which suggests that investors' perception of risk is neither higher nor lower than average. Despite the VIX's popularity as a fear index, it may not tell the whole story.

Another measure of volatility, the CBOE Skew Index (Skew), paints a different picture. The Skew specifically measures investor demand for protection to extreme events through options on the S&P 500 Index. A higher Skew level means that investors are increasingly worried about an eventual negative shock to the equity market. **Chart 2** shows the Skew over a three-month time horizon. According to the data, the Skew is at a level not seen since the depths of the pandemic. This phenomenon is occurring despite the fact that there is arguably more certainty about the pandemic and the path of the economic recovery now than there was last year. The elevated three-month Skew is signalling that sentiment may be shifting and investors are seeking protection as a result. Why is this the case in the midst of the recovery, with markets near all-time highs and volatility at low levels?

Chart 2: High Skew may be a signal of shifting sentiment for U.S. stocks

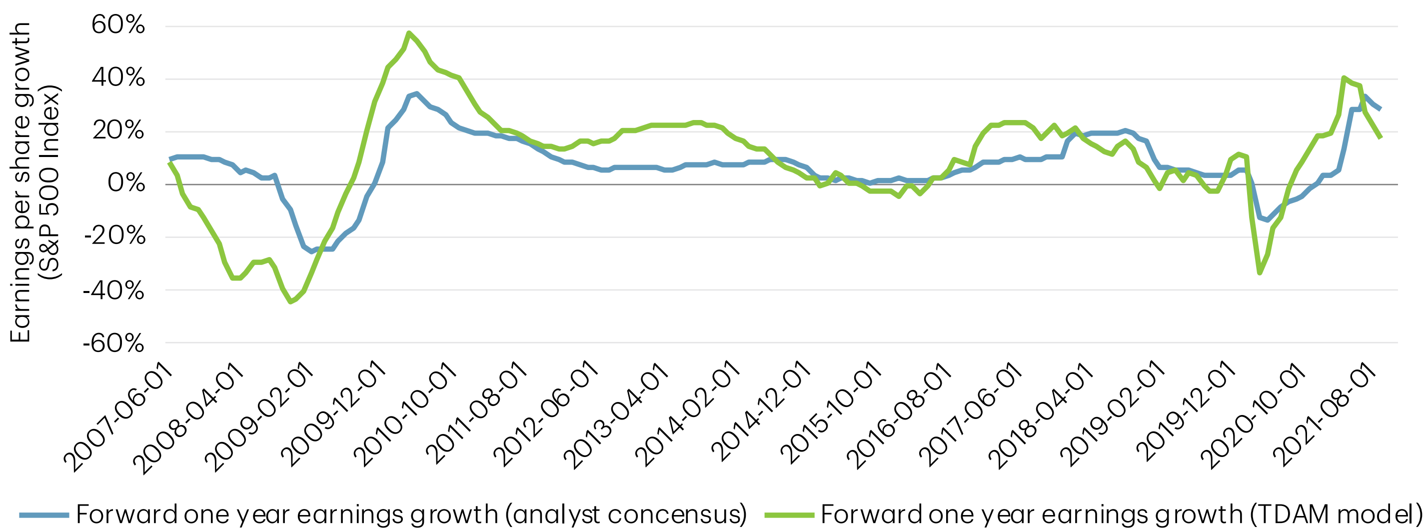


Source: Bloomberg Financial L.P. As of August 31, 2021.

Let's look at a few key factors that could be contributing to the increasing levels of cautiousness.

1. **Slower earnings growth**: Earnings ultimately drive equity prices. In our view, the economy is currently in the mid-cycle of its recovery. Earnings growth is slowing and likely past its peak growth rate (**Chart 3**), and many stocks may be fully valued relative to historical norms. News of companies pulling back on their forward guidance for earnings is emerging, and while earnings surprises and revisions remain positive, they are less positive than earlier in the recovery. Year-over-year comparisons are becoming increasingly difficult to beat, providing less of a tailwind for stock prices to go higher. We believe we are entering an era of lower equity returns compared to the previous 12 months.

Chart 3: Earnings growth appears to be decelerating



Source: Bloomberg Financial L.P. As of August 31, 2021.

2. **Tapering of stimulus programs**: We believe the U.S. Federal Reserve (the Fed) will begin tapering its bond-purchase program later this year, but how aggressively and what this could mean for interest rates is still uncertain. The Fed recently signalled that it could start raising interest rates by late 2022 or early 2023, but also stressed that it won't start raising rates until the tapering is complete and substantial progress has been made towards maximum employment. Employment has improved markedly this year but is still below pre-pandemic levels. Inflation remains a concern and may linger longer than initially thought in certain areas of the economy. Transportation challenges, a rapidly tightening labour market and heightened consumer inflation expectations are raising the floor on what may be transitory versus longer-term inflation. An unexpected policy move by the Fed could jolt markets and lead to increased volatility.

3. **Delta variant**: Another wave of COVID-19 infections in many countries around the world is causing a great deal of concern, and negatively impacting mobility and consumer confidence, especially in those countries with low vaccination rates. This is quickly becoming a pandemic of the unvaccinated, and countries are now ramping up efforts to inoculate more of their citizens. The emergence of new variants that are more resistant to current vaccines is also a concern. If rising case counts continue into the fall and winter, it could stall the economic recovery in certain countries and adversely impact equity markets.

4. **Political risks**: With the results of the Federal election in Canada as well as with legislative efforts in the U.S., there is a risk of corporate tax hikes in both countries which could have an impact on economic growth. Massive spending bills in the U.S., Canada and other countries have created record deficits for governments that will need to be dealt with at some point. New spending on infrastructure and social programs may provide a boost to the U.S. economy but will continue to add to the debt burden. Concerns over a potential U.S. government shutdown, if Congress does not raise the debt ceiling, poses some near-term risks to the economy, and could lead to higher market volatility. On the international front, China's crackdown on technology companies, data usage and anti-monopolistic behaviour, not to mention recent issues within its real estate sector, has rattled markets. This political and financial uncertainty could lead to further volatility in equity markets in the months ahead.

As a result of these perceived risks, investors are using options to cushion their portfolios from a possible correction, which is evident in the high level of the Skew. While we do not anticipate a market meltdown, we do acknowledge that equities may pull back, which is normal and healthy for markets. As we have entered the middle stage of this economic recovery, investors may want to keep the following in mind:

1. Focus on risk management and a holistic approach to preserving capital. Stay invested as markets rise more than they fall over the long term and diversify across sectors and asset classes.
2. Within equities, in our view and based on the current backdrop, focus on quality, earnings and dividend growers, over cyclical companies. Defensive positioning may be warranted while seeking to generate income from diversified sources.
3. In the current environment, some actively managed funds can use options to help reduce portfolio volatility and risk or generate additional income.

Portfolio diversification is particularly important during times of economic instability and an evolving market environment. You may want to consider working with an advisor to review your portfolio to ensure that it's not exposed to excessive risk. This can help insulate your portfolio from corrections when they occur. At TDAM, we offer a number of well-diversified solutions, across multiple geographic regions, asset classes and sectors that can help provide stable returns while also mitigating risks during periods of uncertainty through tactical asset allocation. For more information, visit our website at tdassetmanagement.com or speak to an advisor.

WAAC Positioning and Outlook

The WAAC believes that global economic growth will continue above its potential, but at a slower pace than the early part of the recovery, with much of the developed world appearing to have reached the peak rate of growth. Returns are likely to moderate considerably as markets appear to be pricing-in full earnings and economic growth potential.

Equities

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

Overall, we maintain a moderate risk-on stance for equities; however, we have become more cautious in our outlook. While equity prices are at the high end of historical ranges, we do not view valuations as excessive given the pace of earnings growth and revisions. As markets have risen, driven by stronger than expected earnings growth, forward price-to-earnings multiples have contracted, making equities more reasonably valued. Long-term structural trends remain intact and supportive of stocks; however, market pullbacks in more expensive areas could fuel broader volatility.

In the U.S., S&P 500 Index companies remain underpinned by strong earnings and revenue growth, although the pace of growth is showing signs of slowing. As the economic recovery continues to unfold, we expect quality secular growth companies to outperform, as they may be less susceptible to near-term disruptions in economic conditions.

In Canada, a cooling housing market and ongoing supply chain disruptions, dampened recent market activity. However, high frequency data suggests that the economy remains healthy and will continue to recover. Our strategic outlook remains constructive for Canadian equities; however, potential weakness within economically sensitive sectors (i.e. Materials, Energy) could weigh on broader market returns as a result of slowing recovery demand. Low rates may weigh on the Financials sector, the largest component of the S&P/TSX Composite Index; however, Canadian banks are well capitalized, continue to deliver quality earnings and offer solid dividend yields, which may be on the rise should the Office of the Superintendent of Financial Institutions remove restrictions. The sector could offer attractive longer-term growth opportunities. At the time of writing, Canadian stocks also appeared to be discounting any major policy changes that could have material impacts on the market and economy, regardless of the outcome of the Federal election.

In the third quarter, our outlook for emerging markets, excluding China, had shifted to neutral from a modest overweight stance. Continued fiscal stimulus and a recovery in commodities had been positive for emerging markets, but virus outbreaks, vaccine distribution that is lagging developed markets, and rising inflationary pressures in some countries, could act as headwinds.

In international markets, business confidence in Europe remains high, and economic activity is accelerating. We remain optimistic toward European economically sensitive countries (U.K., Germany, France), which continue to benefit from reopenings. As consumer activity continues to rebound, this should be supportive for corporate fundamentals and drive equity returns higher. However, recent virus outbreaks in parts of Europe remain a concern. We maintain a modest overweight outlook as we believe equity valuations do not fully reflect the Eurozone's growth potential.

Chinese equities have been a relative underperformer this year, due in part to broad regulatory crackdowns, and more recently fears over China's troubled property market drove investors to the sidelines. However, our longer-term bullish thesis remains intact as fundamentals remain relatively sound and valuations reasonable. Economic growth should stabilize later this year and into next, with authorities suggesting supportive policy intervention if needed.

Alternatives/Real Assets

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

Commercial mortgages continue to provide incremental income in a market where yield is scarce. In our view, accretive coupon payments are accompanied with lower interest rate risk, augmenting the attractiveness of private commercial mortgages in today's flat and low yield curve environment. Income collection has been resilient, with our exposure experiencing zero impairments or defaults throughout the pandemic while currently collecting 100% of scheduled principal and interest payments. Despite commercial mortgage spreads trading at pre-COVID-19 levels, the yield advantage offered through commercial mortgages versus corporate and universe bonds is still near all-time highs on a duration adjusted basis.

As certain regions of the world improve their efforts in vaccination rollouts, certain countries have witnessed broader economic activity in the first half of the year. However, investors still remain cautious over the resurgence of COVID-19 cases, particularly associated with newer variants and its potential impediments on full reopening plans. Globally, industrial real estate has continued to lead the way in performance as fundamentals remain strong. Industrial demand from investors and users have remained robust, driven by the ongoing expansion of e-commerce supply chains. Demand for traditional office space has remained dynamic as work-from-home is still a reality for many companies. While office capacity has grown over the summer months, expectations for continued re-occupancy has slightly detracted as employers rethink return-to-office plans. On the other hand, alternative real estate, including the lab office sector in the U.S., has seen tremendous growth over the past year driven by continued research & development, venture capital funding and demand for specialized life sciences real estate space. Long-term demographic trends and health care needs are expected to persist and fuel growth in the U.S. lab office sector.

Based on first half transaction volume trends, some forecasts suggest that Canadian commercial real estate market transaction activity could approach $50 billion for 2021, exceeding the previous record set in 2018. Investors continue to have a strong appetite for industrial assets given their attractive fundamentals and strong performance outlook. Even in Alberta, industrial activity and leasing demand have been active, with industrial vacancy in Calgary falling below 5%. The last time vacancy was this low was before the oil and gas recession in 2015. Multi-family and land holdings for mixed-use development have also experienced robust transaction volumes by all investor types including a growing interest from foreign buyers looking to diversify their domestic portfolios. Within the office and retail property types, there continues to be uncertainty around long-term impacts caused by the pandemic; however, valuations have stabilized across most sub-types and geographies. Sub-lease activity has tapered off in the office market, while certain retailers are looking to expand or re-enter the market as consumer confidence and shopping sales recover. Importantly, new supply under construction within both of these property types remain at healthy levels for the market to absorb over time.

Infrastructure continues to offer a healthy premium to fixed income with stable returns, low correlation to other asset classes, and inflation protected revenues. We anticipate significant activity in the infrastructure market as investors continue to consider increasing allocations to this asset class and as restrictions are lifted, allowing for transaction teams to travel once again. We anticipate that the energy transition underway will provide the largest opportunity set for private infrastructure investing. Investors with access to established platforms in renewable energy that can drive higher returns through exposure to greenfield assets will continue to be able to deliver higher risk-adjusted returns than other areas of the infrastructure market.

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			●		

We expect U.S. growth, as measured by real GDP, to moderate during the remainder of the year and into 2022, as the massive flows of capital into the economy recedes. The U.S. labor market continues to improve as pandemic-related restrictions have eased, although higher unemployment, combined with the difficulty employers are having filling vacancies, are adding to wage pressures and fueling the inflation debate.

The bond market will likely be subject to volatility from an uneven recovery, the varying speed of vaccinations globally, and the impact of additional fiscal stimulus. We believe interest rates will remain near historic lows as the Fed and other central banks continue to incorporate an accommodative stance with respect to interest rates and their balance sheets. The yield curve may become modestly steeper, with intermediate and long-term rates climbing due to positive economic prospects.

We remain constructive on corporate credit and comfortable with our strategic modest overweight in corporate bonds. Corporate credit continues to offer relative value and a yield advantage over government bonds. Our outlook also emphasizes a focus on liquidity and quality, and we expect the continued strength in corporate revenues and earnings to remain supportive of credit markets.

High yield bonds have rallied significantly over the past year and while they remain a consideration for a diversified fixed income portfolio, valuations and extremely tight spreads have made high yield less compelling. Strong corporate fundamentals combined with constructive credit conditions suggest that some areas of the high yield market can still offer adequate compensation for risk, but we remain highly selective at this time.

We are modestly overweight inflation linked bonds. We believe the recent weakness in the asset class may present an attractive entry point, particularly on a relative basis. Inflation linked bonds can also act as a hedge against increasing inflation and provides portfolio diversification benefits due to their low correlation to traditional fixed income and equities.

We maintain a maximum underweight to developed markets bonds due to their negative real returns and uncompelling value prospects.

Fixed Income

Sub-Classes

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

While the U.S. dollar (USD) has been rangebound, broadening concerns over the Delta variant and a modest rebound in yields have provided support and driven recent positive performance. Additional support could come from higher inflation, tapering prospects and the performance of the U.S. economy versus its counterparts. We maintain our neutral outlook.

Gold's underperformance in 2021 has been driven by investor concern that an improving U.S. economy and higher inflation will motivate the Fed to ease its unprecedented economic support. Low rates have historically helped gold's appeal versus assets that offer yields. The stronger USD and the relative outperformance of risk assets have also diminished demand for gold.

We remain optimistic over the long-term prospects for the Canadian dollar and economic growth, versus the USD, despite the recent negative Canadian GDP print. The combination of strong progress in vaccinations and labour market recovery bode well for the currency as Canada continues to emerge from pandemic-related restrictions. In addition, the certainty around the Federal election results should also provide a boost to the loonie.

Outlook

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 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

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