Market Perspectives Q4 2020

A Recovery in Progress: Economy Stabilizes Ahead of Historic U.S. Election

TD Wealth Asset Allocation Committee (WAAC) Overview

- We are bullish on equities over a 12-18 month horizon. The improving fundamental outlook and low rate environment are providing a supportive backdrop for a broad appreciation in equity valuations.
- Our expectation is for protracted low interest rates and inflation to remain at historically low levels. Aggressive monetary and fiscal policy measures continue to underpin economic stabilization, but may become a long-term drag on economies. We maintain a modest fixed income underweight due to the continuation of low expected returns and negative real yields.
- We remain modestly overweight investment grade corporate credit. Wider spreads of earlier this year have narrowed significantly, but still represent a yield advantage over government bonds.
- Corporate earnings, employment, and economic activity are improving globally; however, COVID-19 treatment/vaccine progress and the effectiveness of policy response will largely dictate the speed of recovery.
- We view alternatives assets favourably within the strategic asset mix of portfolios due to their yield and relatively stable income resiliency.

Conditions Improving Despite Choppy Quarter End

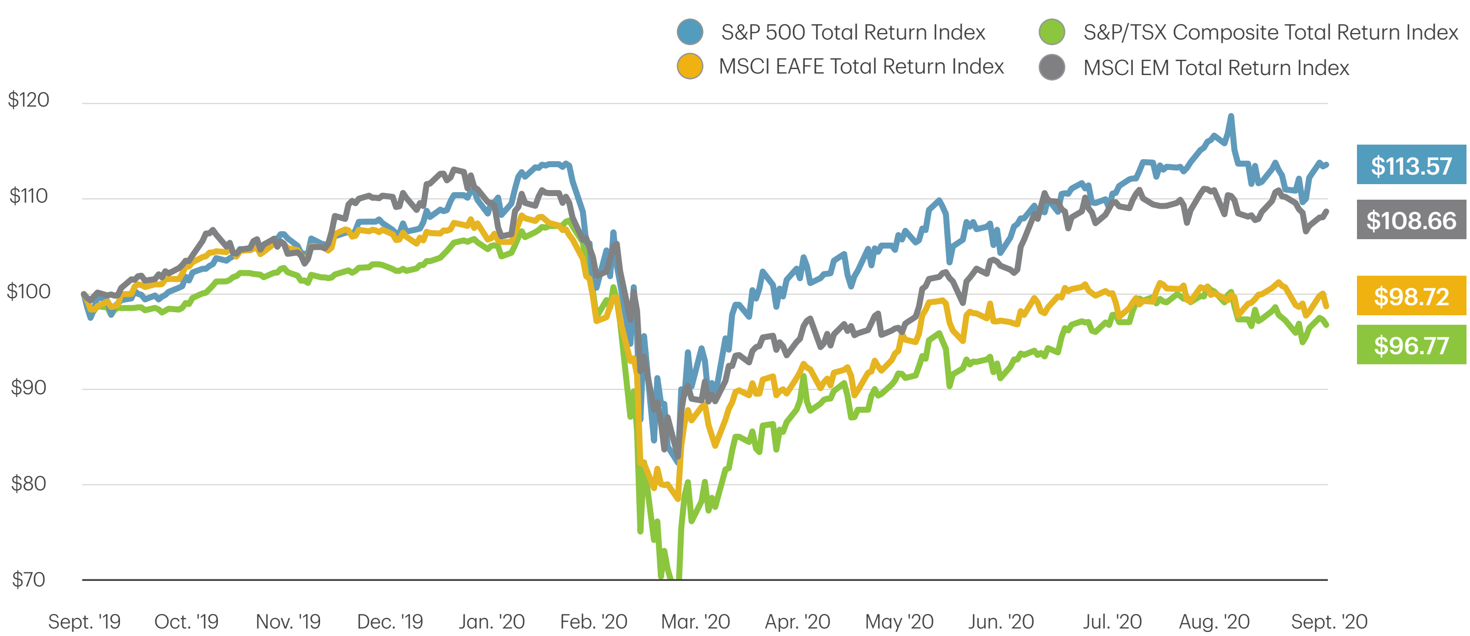
Over the third quarter, the TD Wealth Asset Allocation Committee ('the Committee', 'we', 'our') remained active in monitoring a cross section of economic indicators, asset valuations and fiscal/monetary policy actions, to assess the strategic investment quality of various asset classes. On aggregate, our measures indicate a continuation of current trends that point to a global economic recovery from the pandemic driven recession.

In the U.S., while new COVID-19 cases remain elevated, we are witnessing moderating levels in a number of states. Globally, cases ebb and flow by country but sentiment may be improving as several pharmaceutical companies are in late stage large scale human vaccine trials, and many are hopeful that public inoculation against the virus can begin within the next few months.

Global equities lost some of their steam to close out the quarter as volatility returned in September particularly within the Technology sector (**Chart 1**). Investors took some profits on U.S. mega-cap technology stocks that appeared overextended after having delivered exceptional price gains since the March lows. As the selloff broadened to other sectors, we viewed the pull-back as normal market volatility, and used the opportunity to add to equities at more attractive levels. The excessive bullishness in some parts of the market may be unwinding, which has the potential to give legs to the bull market and extend the breadth as market participants diversify and look more closely at underlying fundamentals.

Positive revisions to earnings estimates are usually constructive for equities and we have seen marginal improvement in the 12-month forward earnings estimates on a year-over-year basis. Though still negative for the global equity market, the trend is less negative and moving in the right direction. Overall, second quarter earnings season came in largely ahead of expectations for S&P 500 Index companies, which is a favourable indicator for the recovery and health of both debt and equity markets. In addition, global industrial activity is rebounding as measured by Purchasing Managers' Indices (PMIs) and Leading Economic Indicators, which continue to validate improvements in the productive capacity of the economy.

Chart 1: Index Returns Over the Past 12 Months — The Growth of $100



Source: Bloomberg Finance L.P. As of September 30, 2020.

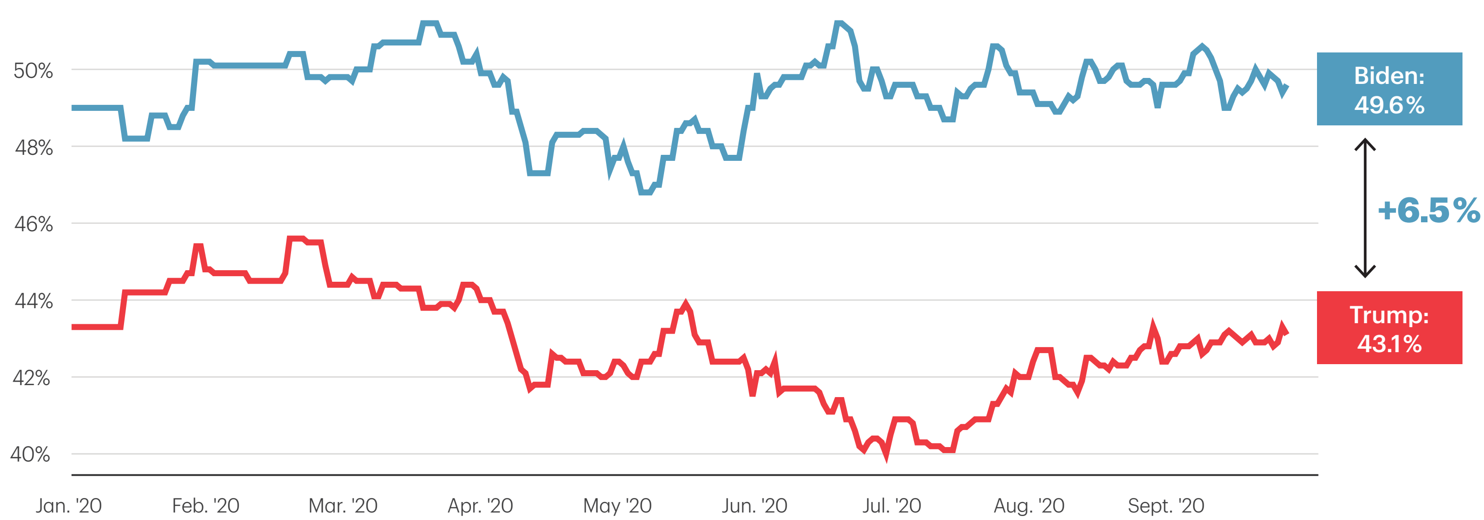
Stimulus remains a key driver of markets, and protracted low rates combined with a weak U.S. dollar have provided an additional boost to riskier assets. While we recognize that near-term volatility could be driven by a slowing recovery in global growth due to the pandemic, lagging consumer activity, and a potentially tumultuous U.S. election cycle, we remain optimistic towards a strengthening global financial environment over a 12-18-month horizon. We prefer equities over fixed income and absent material shifts in the fundamental outlook, we will seek to exploit significant periods of consolidation by increasing allocations to high quality assets, across our managed solutions. We also see opportunity in alternative asset classes due to their relatively stable income resiliency and return advantage they can provide in the persistent low yield environment.

The Battle for 1600 Pennsylvania Ave. — "It's the Economy Stupid"

"*It's the economy stupid*", the adage coined by political commentator James Carville during Bill Clinton's 1992 successful presidential run against incumbent George H. W. Bush, emphasizes a key issue that typically dominates the discourse during election periods. As with any U.S. Presidential election, people's issue preferences, opinions about candidates or views of the campaign are often trumped by economic considerations. The economy always seems to take center stage, and the U.S. election on November 3 will likely be no exception. This year may present an even more complicated dichotomy when adding a global health crisis into the mix.

The pandemic and the economy are inextricably linked, and this has been reflected by shifts in the President Trump vs. Joe Biden national election poll data over the past couple of quarters (**Chart 2**). Through the February to mid-May period, amid the height of global lockdowns, and the start of a painful recession, that resulted in millions of job losses, Trump's poll numbers saw a notable decline. The rising rate of infections, mortality rate, and the overall handling of the pandemic by the administration was not viewed favourably by segments of the population. Despite an uptick in May, overall support declined further through mid-July. Many Americans continue to speculate if a more centralized and unified effort across the U.S. to confront COVID-19, could have reduced the negative impacts to the economy and jobs market, and most importantly, saved more lives.

Chart 2: RCP Poll Average General Election: Trump vs. Biden

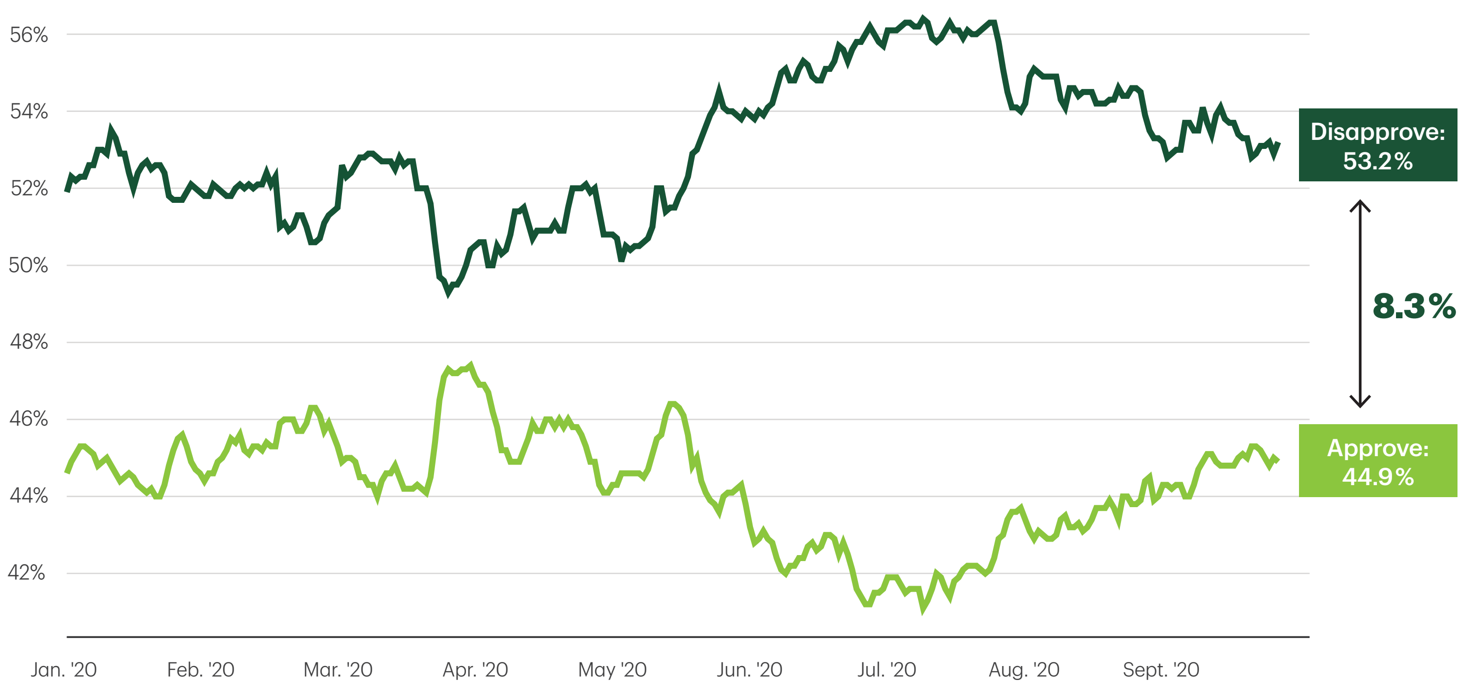


Source: REALCLEARPOLITICS. As of September 30, 2020.

As employment steadily improved and equity markets continued to gain steam, support levels for Trump rose. Improving capital market trends and stabilizing cases of new infections also translated to a rise in Trump's overall job approval rating (**Chart 3**). While these trends may be improving for Trump, certain ongoing factors like civil and social unrest, combined with still-elevated infection rates, have kept his approval and re-election support below peak levels — despite firming economic conditions.

Meanwhile, Biden has maintained a stable lead in the polls, but his margin has narrowed as the election draws closer. Growing concerns about how his proposed tax policies could impact the fragile economic recovery is likely a factor. Biden is seeking to reverse Trump's tax cuts, but not entirely. Trump brought the corporate tax rate down significantly from 35% to 21% and Biden has indicated he will attempt to raise it back to the 28% level. This may hurt corporate profitability but to a lesser extent than many may have originally feared. Regardless of who wins the election, it is important to note that if employment and the economy remain lackluster, the immediate responsibility of the president is to sustain the recovery. As a result, tax increase proposals, or any policies considered prohibitive to growth, may be delayed or implemented over time.

Chart 3: RCP Poll Average President Trump Job Approval



Source: REALCLEARPOLITICS. As of September 30, 2020.

What's on the Agenda?

Having touched briefly on policy implications, let's take a high-level view of what each candidate is proposing. While both will try to convince the electorate that their policies are pro-growth, their paths to achieving this goal differ vastly.

Policy Overviews

Joe Biden and Kamala Harris

Democratic Party Platform

- Tax hikes for corporations and high-income earners
- Healthcare reform
- Greater focus on green infrastructure and renewable energy, and increased regulation

President Donald Trump and Mike Pence

Republican Party Platform

- America first foreign policy — end U.S. reliance on China
- More tax cuts
- Deregulation

President Trump is proposing lower tax policies which could help create new jobs and increase labour participation, while driving real wage growth. For businesses, tax savings could be reinvested in technology and innovation to improve productivity. While Trump's tax agenda is more stimulative for domestic growth, his trade wars with China and allied nations could weigh on the global outlook if these relationships are permitted to deteriorate further. Bringing back manufacturing jobs to the U.S. has also been a goal of the Trump administration. While capital did begin to return to the U.S. in certain sectors, and provided a boost to business spending and investment, any progress was derailed by the pandemic. Trump has pledged to keep this a priority during a second term.

On the other hand, while Biden's higher tax plan could hinder domestic profitability, his less restrictive immigration policies and globalist approach to international trade, could increase and diversify the labour market and reduce trade barriers respectively, while contributing to a more balanced expansion of the global economy. A Biden administration would also look to implement changes that benefit environmental sustainability. "Greening of the economy", a Biden focus, would seek U.S. re-entry into the Paris Agreement. His administration would also commit to spending approximately $2 trillion over four years on a green energy plan. The plan includes infrastructure initiatives that cover higher efficiency buildings, sustainable housing and agriculture and carbon free power infrastructure, possibly creating jobs in these emerging sectors of the economy.

What Does it Mean for Markets?

Will markets fall if the Biden/Harris ticket win the election? Critics argue that their tax policies are prohibitive to growth and will send markets lower.

Does Trump's pro-business, America first agenda and low tax environment bode better for higher stock valuations? Most Americans know what to expect from a second Trump term, and many would argue that his policies have been and will continue to be supportive of markets.

Congress Composition Key to Policy Success

While the presidential race garners the lion's share of election coverage, U.S. voters can't overlook that the House of Representatives and Senate seats which comprise Congress are also up for grabs on November 3. Without getting too into the weeds on the potential implications of composition, policy implementation for either candidate will largely depend on whether their affiliated parties are able to capture full or partial control of Congress. Executive and full Congress control means a clearer path to successful policy realization. A split Congress means more gridlock, significant hurdles to policy achievement, and more executive orders.

Industries Usually Have Time to Adapt

One thing for investors to consider is that companies and economies usually have time to adapt to change. While certain policy measures could alter the corporate landscape and impact spending, legislative changes are rarely if ever implemented overnight. Affected sectors of the economy will typically have months or longer to adapt to the impending changes to their industries, which should help minimize potential negative implications. The smart money is to not react emotionally to a potentially volatile election cycle — and the uncertainty that might lie ahead. Rather than predicting which sectors will outperform others based on a candidate's policy positions, we believe that focusing on longer-term secular trends, while maintaining well diversified portfolios is the key to achieving financial success.

Implications of a Contested Outcome

A significant risk that may still be underestimated and could lead to market turbulence in the shorter term, is a contested outcome. Markets abhor uncertainty and any significant delays to the final results, or if the outcome is contested, would likely lead to a risk off climate until resolved. This scenario could occur in the case of a too close to call result, or where either candidate refuses to recognize the legitimacy of the outcome. The risk of this scenario has increased due to COVID-19 and the potential for a higher proportion of mail-in ballots. Given possible local administrative challenges and state by state rules, large portions of mailed-in votes could be counted after the November 3 election. If the results are still too close or disputed, then there may be court challenges, leading to a longer period of uncertainty for markets.

At TDAM, our investment teams don't believe that positioning portfolios based on polls, policy objectives, candidate hyperbole, and even election outcomes — contested or otherwise — is a sustainable investment process. That is not to say that we don't monitor the potential implications of policy changes on economic growth, capital markets and the impact on companies. Ultimately, our goal is to ensure we are allocated to geographies, sectors, and asset classes that are best positioned to drive outperformance well beyond the election.

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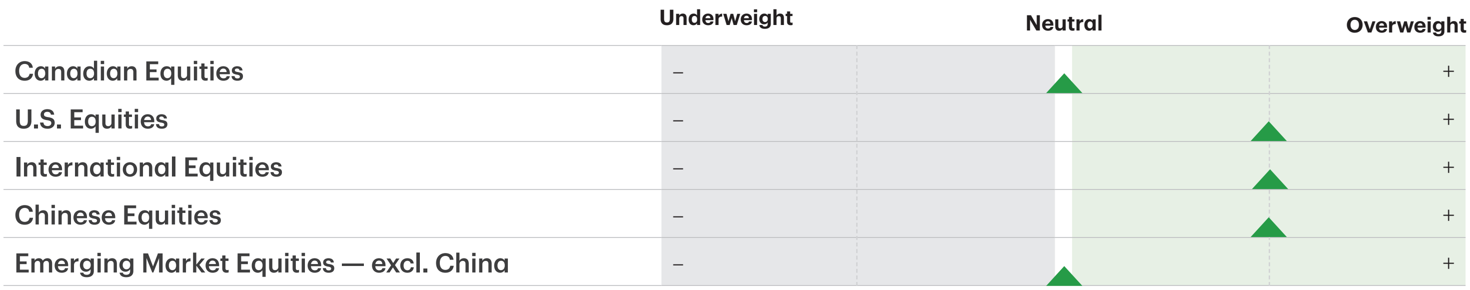
WAAC Positioning and Outlook

Equities



We are bullish longer-term on equities. While acknowledging the potential for near-term macroeconomic, geopolitical and pandemic driven disruptions, the protracted low rate return environment, combined with an improving fundamental backdrop for many global economies, reinforces our optimistic outlook.

Economic indicators including expansionary trends in global manufacturing PMI data, and policy coordination between central banks and governments, have been key drivers of the recovery from recession. These factors should also help drive longer-term equity outperformance over fixed income. During any significant drawdown periods, we will seek to increase exposures to well capitalized businesses, sectors and geographies that represent attractive long-term potential.

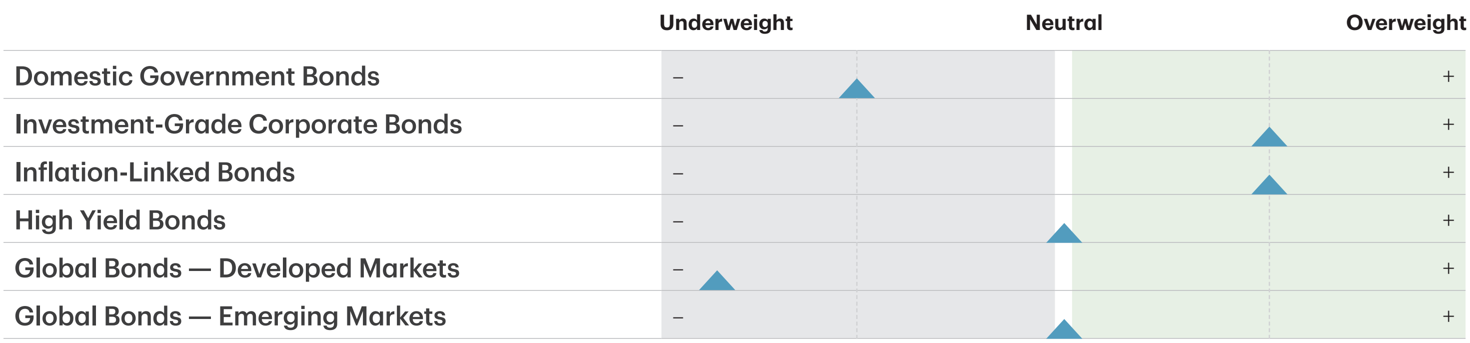
We are seeing some encouraging signs in the Canadian economy with an uptick in overall business activity following widespread shutdowns. A robust residential real estate market, a modestly improving employment picture, and stabilizing Financials sector, should underpin positive equity returns over the next 12-18 months. Canadian banks capped off a strong third quarter as earnings improved and many met or exceeded profit expectations led by capital markets divisions. However, margin compression and consumer credit remain an ongoing concern. Prolonged Energy sector weakness may also create a challenging environment for Canadian stocks.

U.S. equities continue to offer compelling longer-term opportunity. Prolonged low interest rates, a resilient consumer, expanding business productivity, and the rapid rate of growth of U.S. technology innovation has provided a supportive backdrop for U.S. stocks. However, fractured U.S./China relations remain a headwind for markets as the countries battle over a growing list of issues, including the origins of the coronavirus pandemic, human rights concerns and control over technology.

We believe Chinese equities remain attractive given favorable relative valuations. Supportive fiscal and monetary policies and an accelerating rebound in external consumption demand are driving growth. China's business activity may see a faster rate of expansion relative to other emerging economies still grappling with the pandemic, despite the simmering tensions with the U.S. that could weigh on the outlook.

Most international equity markets had a relatively solid quarter; however, concerns remain as a number of countries have seen an increase in COVID-19 cases. European risk assets have benefitted from the European Council's agreement in July to establish an unprecedented recovery fund which boosted investor confidence. The eurozone's bounce back in manufacturing and services activity, as well as strength in the euro, is providing evidence that international markets are healing from the deep contraction caused by the pandemic. International stocks may offer a period of outperformance under these improving conditions; however, prevailing structural challenges remain.

Fixed Income



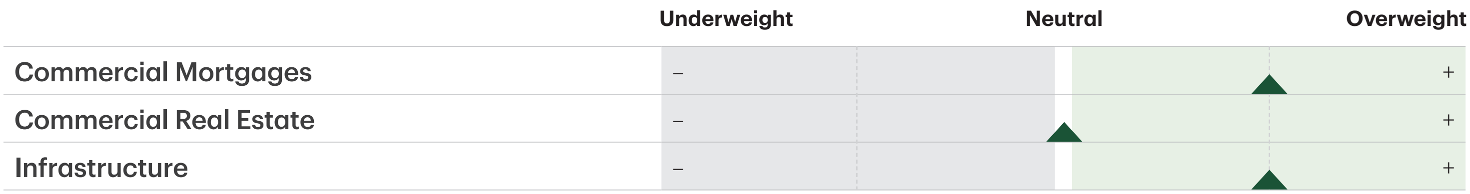
Despite significant tightening since the March market collapse, and with investment grade corporate bond spreads reverting to near their longer-term averages, we retain a modest overweight view on corporate credit due to the relative yield advantage over government debt. Given the spread compression in corporate credit, our teams are actively leveraging their strong credit management capabilities, looking to uncover relative value opportunities which we believe still exists in today's markets. We remain disciplined in our selection process.

One of the most notable market updates for fixed income investors over the quarter was the updated policy framework from the U.S. Federal Reserve (the Fed). On August 27, the Fed unveiled a shift in inflation targeting, with the new policy essentially allowing the Fed to overshoot their inflation target after economic downturns. In short, we believe the shift indicates that the Fed will maintain ultra-accommodative policy rates for quite some time, with the most recent Fed projections implying essentially no rate hikes through the end of 2023. We continue to expect the lower for longer, and low yield environment to remain a core theme in the market. In fact, since September 1, negative yielding debt around the world has increased by $1.2 trillion to a total of $14.2 trillion, providing additional rationale for exploring yield enhancement opportunities. Given that other central banks may adopt a similar approach to policy, including the Bank of Canada that has stated its own objectives for keeping rates low for the foreseeable future, we remain modestly underweight government bonds as we believe yields will remain range bound near record low levels indefinitely.

High yield spreads have also narrowed considerably from late March, but there may be room for further tightening, particularly if the economic rebound gains momentum. We remain highly selective with a neutral position in high yield bonds as economic headwinds continue to cloud the outlook for many sectors of the economy.

While a rise in inflation is not in the Committee's forecast, inflation linked bonds offer inexpensive insurance for those seeking protection against a rise in interest rates, driven by an unexpected shift in expectations.

Alternative Assets



Canadian Real Estate: Transaction activity within the Canadian real estate market is gradually returning in the second half the year. The majority of the activity is related to industrial and multi-unit residential properties, while office and retail remain quiet.

The office sector has seen softening of leasing supply fundamentals, partly due to the restrictions implemented during the pandemic. As regions across Canada re-open, retail assets are experiencing improved rent collections. Traffic counts at enclosed shopping centres are slowly rising; now at around 50%-60% compared to traffic last year.

The more resilient property types have been industrial and multi-unit residential. The growth of e-commerce has fueled the demand for industrial assets particularly for distribution, warehousing and fulfillment centres. The shift in consumer behavior will lead to retailers to further expand their distribution sites in order to quickly reach consumers. The multi-unit residential sector has been stable with strong rental collection across Canada. The job market has seen a rebound in the past few months which is expected to further support multi-unit residential properties.

Global Real Estate: COVID-19 had a major impact on Asia Pacific economies as physical distancing efforts were implemented to slow the spread of the virus. Real estate transaction activity slowed due to uncertainties and wider pricing expectations between buyers and sellers. However, as economies are now starting to re-open in a phased approach (with certain exceptions), the situation has improved.

As the lockdown measures across Europe ease, commercial real estate investment markets are beginning to show signs of a recovery. Deal-flow is approximately 20% - 30% of what would be generally expected, but coming from a "standing start" in April and early May, the current level of activity is promising. Given the low levels of activity, the commercial leasing markets in Europe are still challenging to evaluate. Over the coming months, the leasing markets will provide evidence of what the long-term impact of this crisis is likely to be on asset pricing.

The U.S. commercial real estate market continues to be an evolving story in which some cities will be impacted more than others. As the disease has spread across the U.S., the west coast has been impacted but these areas are generally less dense than NYC. Some tech hubs, including the San Francisco Bay Area and Boston will potentially be more insulated. Major tourism hubs, such as Orlando, Las Vegas and Miami could see the greatest downgrades, and key airline hubs including Atlanta, Charlotte and Chicago are expected to also feel the negative impact of COVID-19 on the travel industry.

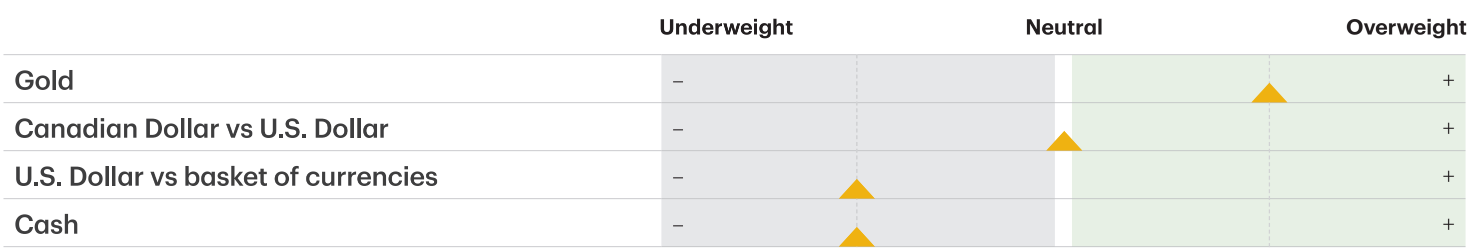
Commercial Mortgages: Commercial mortgages witnessed strong returns over the third quarter as income remained resilient and commercial mortgage spreads tightened considerably. Falling spreads coincided with steady transaction volume as the commercial real estate market began to find its footing and idle capital was put to work for mortgage investors.

Following subdued commercial mortgage transaction activity in April and March, the market has witnessed a material pick-up in originations with the summer months being more active than typical. Increasing transaction volumes has been met with growing competition for high-quality commercial mortgages investments as the relative premium of commercial mortgages versus public fixed income markets remains attractive.

Infrastructure: Infrastructure transaction activity has continued to be muted through the second quarter and into the summer as quarantine measures reached their peaks across the globe. We anticipate a significant increase in deal activity in the final months of the year as managers return to suspended deals and asset sales and development activity resumes.

As global economies have begun lifting quarantine measures, and economies are showing evidence of rebounding, we expect an uneven recovery in infrastructure, with some assets bouncing back quickly such as toll-roads that will benefit from domestic travel, while passenger air traffic may take years to return to previous levels. Ultimately, the essential nature of infrastructure ensures the relatively stable cash flows from these assets, and we expect demand for these assets to be robust in the coming years, compounded by the low interest rate environment.

Sub Classes



We believe that gold will continue to outperform in an environment of economic uncertainty, low real yields, and a weaker U.S. currency. The combination of unprecedented monetary policy (keeping rates low) and concern around the strength of the global recovery may continue to drive the outperformance of gold over a 12-month horizon.

Our expectations for a weakening U.S. currency, and overall firming of Canadian economic conditions, underpin our view that the Canadian dollar may outperform its U.S. counterpart over the next 12 months.

We are gradually reducing cash levels and deploying this capital to better represent our views in other asset classes where we can achieve higher potential returns for investors.

We are modestly underweight the U.S. dollar. The Fed's commitment to remaining accommodative for the extended term, continued pandemic risks, and the potential for a slower than expected recovery, have put pressure on the currency. An environment of improving economic conditions and a clearer domestic political climate could aid in the stabilization of the U.S. dollar.

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 active 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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