TD Asset Management

Market Perspectives + 15 Minutes
= Current Insights

Market Perspectives Q3 2022

The Impacts of High Inflation on Markets

Managing Through the Volatility

TD Wealth Asset Allocation Committee (WAAC) Overview

- We maintain an overall cautious view on global equities due to increasing recessionary risks and the potential for broad economic deceleration. While equity valuations have become more reasonable, contractionary financial conditions may impact earnings and revenue growth over the next 12-18 months, resulting in further valuation compression.
- Additional risks to the growth outlook that may contribute to bouts of episodic volatility include: protracted geopolitical instability, tightening monetary conditions due to elevated inflationary pressures, COVID-19 restrictions in China and tight labor markets.
- With the significant rise in rates, we believe fixed income exposure has become an increasingly important component of a diversified portfolio. Fixed income can provide capital preservation and liquidity, with the potential for generating positive total returns comprised of capital gains and income. Following the asset class' dramatic repricing this year, opportunity is being restored in several segments of the market.
- We continue to maintain a quality bias toward U.S. stocks for their potential resiliency to a broad range of economic outcomes.

First Half of 2022 in Review and Market Outlook

After closing 2021 at all-time highs, global equity and bond markets have faced a tumultuous first half of 2022 (**Chart 1**). Financial markets have plunged, with several major market indexes entering bear market territory during the quarter (bear markets are defined as a decline of more than 20%). Speculative assets like cryptocurrencies have also been decimated, with Bitcoin plunging to less than a third of its peak value, leaving investors with little place to hide from the market mauling.

The global macroeconomic outlook remains challenging. Economic growth is being restrained and the Russia/Ukraine war has driven substantial commodity price increases, fueled sizzling hot inflation, and exacerbated already tight supply chains. Additionally, North American labor markets have become incredibly strained, resulting in significant wage growth acceleration. As a result, central banks have been forced by inflation to raise rates aggressively despite growth uncertainty and the ongoing war in Ukraine.

We are undoubtedly facing a tough road ahead. Inflation is at levels not seen in decades. Interest rates are gapping higher, putting the health of an already fragile economy into question and increasing the risks of recession. With all this doom and gloom it is natural for investors to feel uneasy. However, assuming financial markets are not permanently impaired, this bear market could prove to be the beginning of a bottoming out process despite the expected high levels of volatility.

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

Name	1M	3M	12M	3Y	5Y	10Y
S&P 500 Index (LargeCap)	-8.25%	-16.10%	-10.62%	10.60%	11.31%	12.96%
MSCI EAFE Index (Europe, Australasia, Far East)	-9.26%	-14.29%	-17.33%	1.54%	2.69%	5.89%
MSCI Emerging Markets Index (Emerging Markets)	-6.56%	-11.34%	-25.00%	0.92%	2.55%	3.43%

Source: TDAM. As at June 30, 2022.

During times of uncertainty, it is important for investors to remain focused on the basics by remembering the fundamentals behind investing. As distressing as these markets can be, bear markets can also provide the opportunity for investors to better position portfolios for future gains. After all, stock market corrections are when quality companies become more attractively priced, and the goal of any investor should be to buy low and sell high. Investors may not want to discount the role of fixed income based on current circumstances either. Following the asset class' dramatic repricing this year, fixed income remains a key diversifier with increased opportunities to generate positive real returns.

While past performance does not guarantee future performance, the past can give us an idea of what is possible. **Using the S&P 500 Index as a proxy, we can see that historically, investing on the first day entering a bear market, an investor would have earned a positive return 70% of the time after 1 year, 89% of the time after 3 years, 78% of the time after 5 years, and 100% of the time after 10 years.**

In the following section, we provide insights into the current market environment with a spotlight on inflation, and what it all could mean from an investment standpoint. For an in-depth perspective on the WAAC's current views on key asset classes, as well as our strategic positioning views over the next 12-18 months, please review the WAAC Positioning and Outlook section of this report.

Red Hot Inflation Remains Top of Mind for Investors

Over the past year investors have seen food prices jump nearly 8% while gasoline prices are up over 50%. The cost of shelter is likewise up significantly and may get worse as mortgage rates rise. Against this backdrop investors have been aggressively pulling out of both equity and bond markets.

Over the quarter, TD Wealth assembled an all-star team of thought leaders that included TD Chief Economist Beata Caranci and two WAAC committee members, Canadian Chief Wealth Strategist Brad Simpson and Chief Investment Officer of TD Asset Management (TDAM), David Sykes to discuss inflation and the current market environment. They covered a diverse range of questions including, how long will the elevated inflationary environment last, how bad is it going to get and what are the implications for markets?

Here are some highlights from the discussion:

Are current inflationary pressures expected to subside anytime soon?

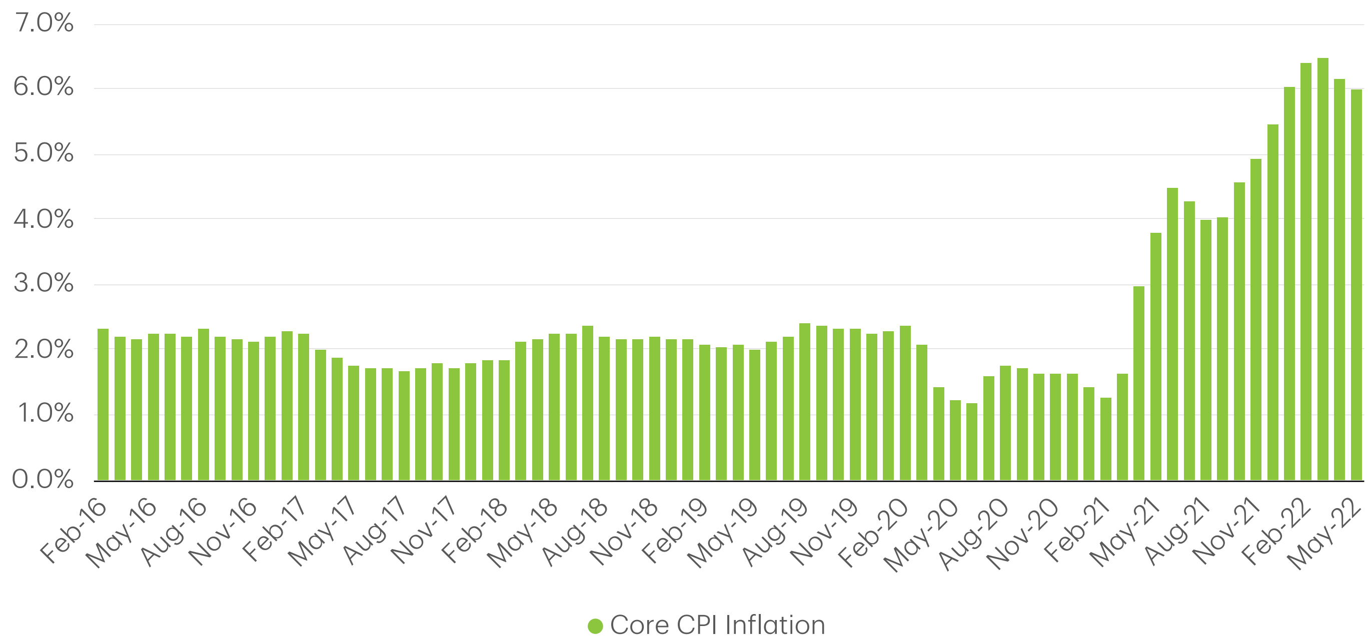
Caranci: While core inflation data may be showing some signs of peaking (**Chart 2**), price growth may still hover at a painful 5% at the end of the year. Returning to the central-bank target is probably more of a late 2023 story. The trouble is, the supply-side issues were not fully resolved before the dual shocks in Ukraine and China renewed the threat to global economic linkages. This has created more localized and nuanced pressures and is perpetuating the stickiness in overall consumer prices. As a result, we have raised our inflation forecast for 2022 and 2023, despite central banks accelerating the interest-rate cycle to slow demand.

Simpson: A recent TD Wealth survey revealed that inflation is the primary personal finance concern for many investors. Those under the age of 35 are significantly more likely to be worried about inflation than older generations (80% vs. 54%). Add a two-and-a-half-year pandemic, the Russian/Ukraine war, rising costs of everything from groceries to gas — along with the seemingly diminished prospects of owning a home — and it is little wonder that people are climbing the wall of worry about the persistence of high inflation, which may remain elevated for the foreseeable future.

Sykes: Supply-chain bottlenecks were temporary and pandemic-induced. As supply chains normalize — people go back to work, production lines restart, containers get offloaded at congested ports, etc. — price pressure should alleviate. You are already seeing this in used cars, where prices are now rolling over. We don't think inflation will be going away anytime soon, but believe it is going to settle at levels below where we are today— however, still higher than the Federal Reserve's (the Fed) tolerance band of around 2%.

Inflation

Chart 2: Core CPI Inflation may be peaking



Source: Bloomberg L.P. as of May 31, 2022.

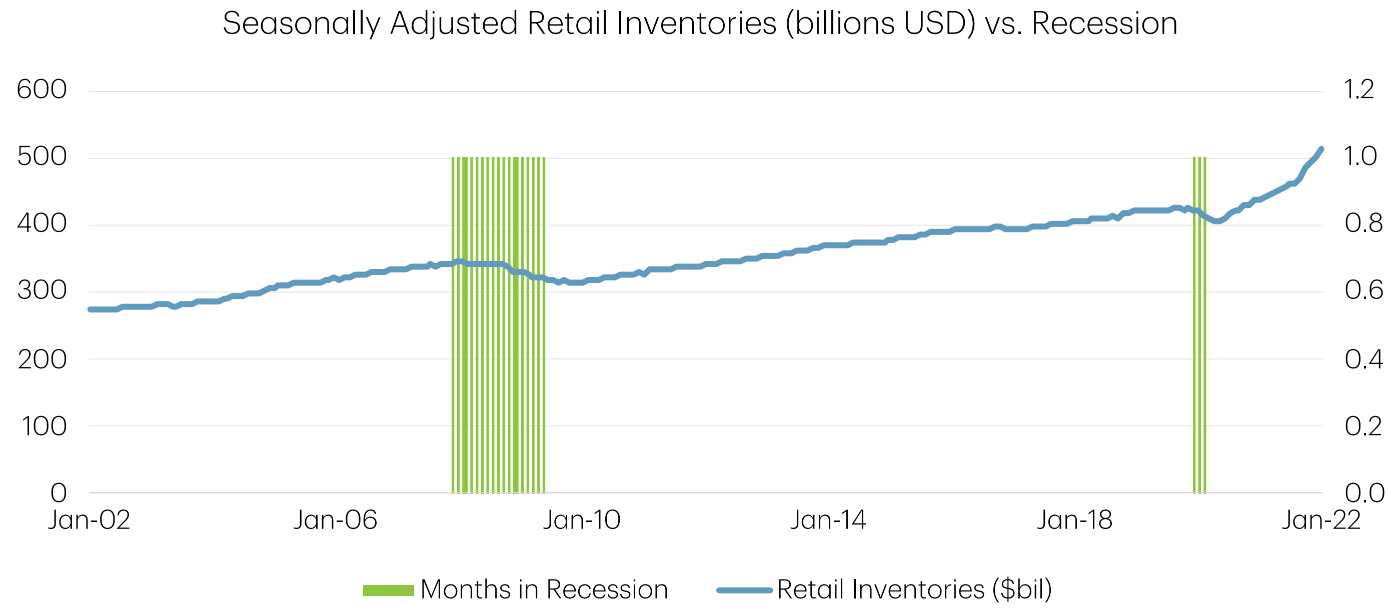
What, aside from central bank tightening, may help deflate prices?

Sykes: One thing that may help is this structural shift in spending from goods — which exploded during the pandemic because everyone was quarantined at home — to services. We have seen this in the commentary from management at companies like Amazon.com, Inc. and Shopify Inc., and in data like the Personal Consumption Expenditure (PCE) index, which is growing faster than retail sales. This shift is taking place even as inventories become elevated (**Chart 3**). So, the question is, what happens when these retailers, which are sitting with full warehouses, are faced with a consumer that is reallocating their spending to services? Structural demand-supply imbalances in global commodities, food and energy prices are expected to remain sticky. This poses a challenge for households, as a greater portion of income goes towards necessities, which decreases discretionary spending. If discretionary consumption falls faster than expected, that could put downward pressure on core inflation. My view is that we continue to see goods deflation as we progress through the year.

Simpson: Year-to-date major North American and global indices are down materially. The Nasdaq Composite Index and S&P 500 Index officially entered bear market territory during the quarter. Additionally more than an estimated $1 trillion in cryptocurrency value has been lost during the first quarter.

People like to call this the "wealth effect," which is the notion that, when households become wealthier as a result of the increase in their asset values, their sense of confidence increases, and so does their willingness to spend. The bad news is, the wealth effect works both ways, meaning spending contracts as asset values decrease. This has the potential to be a headwind for inflation as we move forward.

Chart 3: Inventories rise as spending shifts to services



Source: Bloomberg L.P. as of March 31, 2022.

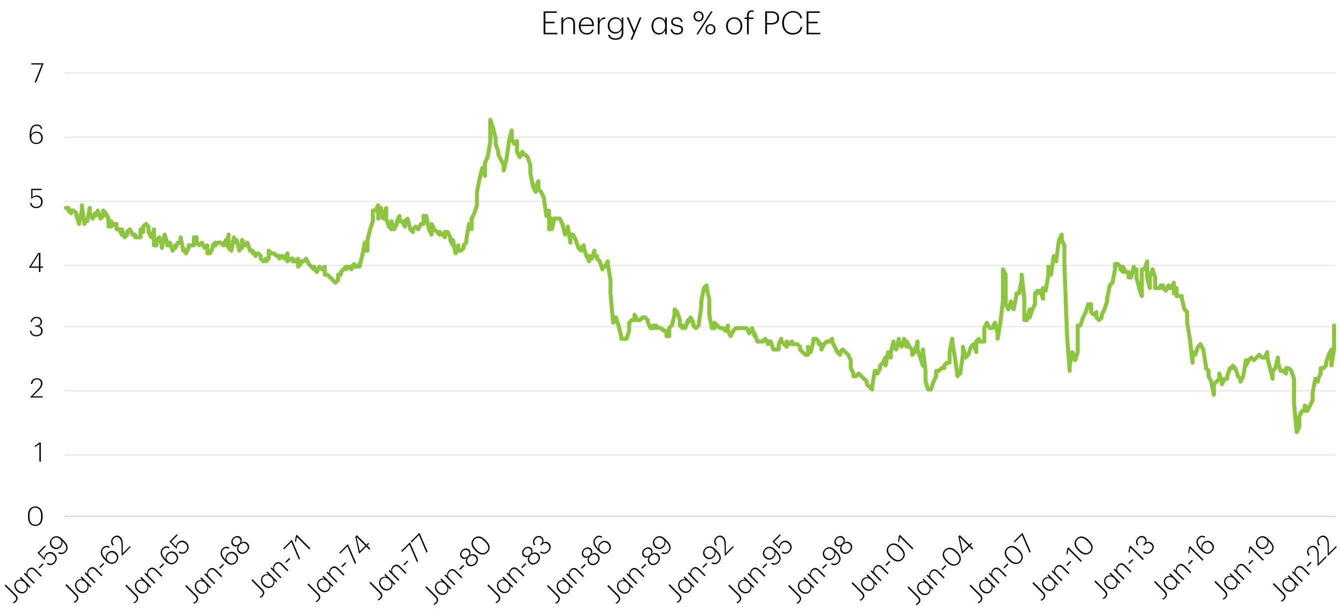
> ***We are now facing fears that we're entering a potentially persistent "stagflationary" environment similar to what was experienced in the 1970s period. How is today similar to those times, and how is it different?***

Caranci: Our forecast infers that inflation will be more persistent, but it also indicates that we're not headed for a 1970s redux. While some drivers are similar, there are a couple of important differences. For one, current inflation is nowhere near the rates from that period. Two, central banks are acting more aggressively earlier in the cycle to help pin down long-term inflation expectations and three, the labor market is far too strong to meet the definition of a "stagnant" economy. We would need to see a significant upward move in the unemployment rate to perpetuate stagnation in the business cycle.

To be fair, however, there are a few worrisome similarities between now and the 1970s. The drivers of inflation over the past two years — commodities, shelter, transportation — are the same as those in the 1970s and 1980s. But central banks today have a history of anchoring inflation towards 2% and remain committed to doing so in both rhetoric and action. For this reason, even though businesses and consumers see inflation above 3% over the next year, they still think it will come closer to the 2% target within the next three years. However, that is a long time period, which means households and businesses will have to demonstrate patience. There is a real possibility that further upside misses on inflation will chip away at the central bank's credibility. This dynamic would accelerate if there were to be an unexpected parallel weakening in the labor market.

Sykes: It was only with Volker, who was nominated in August 1979, that the Fed really took the hatchet to inflation by significantly raising interest rates above the Consumer Price Index (CPI) to force a recession and collapse demand. It is unlikely that we're going into a '70s style persistent stagflationary backdrop because the composition of U.S. gross domestic product (GDP) is so different. In the '70s, goods consumption and energy costs were a much larger component of GDP. So, rising goods prices and the Organization of the Petroleum Exporting Countries (OPEC) embargoes both had a meaningful impact on pushing up inflation. Those conditions are not applicable today. Service consumption is the largest component of the Personal Consumption Expenditure index (PCE) and is much more stable in terms of pricing — not to mention the deflationary impact from technological adoption. The energy contribution, moreover, is half of what it was in the '70s. Energy spending as a percentage of total PCE was 5% to 6% in the '70s. Over the past year, energy prices have doubled and they are still only 3% of PCE (**Chart 4**). In other words, energy prices would have to double from here to have the equivalent impact on consumer wallets.

Chart 4: Energy not as important to inflation as in the 1970s



Source: Bloomberg Finance L.P. as of March 31, 2022.

Simpson: The global economy and monetary policy have changed almost beyond recognition since the 1970s. Central banks have more tools and flexibility to achieve their goals, and they have a more informed idea of what those goals are. Quantitative easing didn't even exist until around 2001, when the Bank of Japan first tried it. Recent developments may have challenged the underlying drivers of deflation — the decline of organized labor as well as globalization and the technological boom — but these continue to operate on a broad level. On top of that, debt has reached record levels, and debt is deflationary because it means governments, corporations and individuals will have less to spend.

Do you think the first quarter contraction — or perhaps instability within the financial markets — will dissuade central banks from hiking rates and stamping out inflation?

Caranci: Real GDP in the U.S. contracted by 1.5% in the first quarter (quarter over quarter), whereas consensus estimates were looking for +1.0%. Either of these results essentially represents a flat performance — but only after a growth spike of 7% in the fourth quarter 2021 that had already nudged the U.S. economy into an excess-demand position. The ostensible "miss" on the quarter was related to inventories and imports, not consumer spending and business investment. These both performed better than expected and don't signal weakness in the domestic economy, so that is unlikely to dissuade the central bank.

Sykes: The goal of the Fed and other central bankers at this point in the cycle is to slow growth. Remember, higher rates on their own do not lead to lower inflation. The transmission mechanism is that higher rates lead to reduced demand, which should in turn lead to lower inflation. Given how behind the ball the Fed was in acknowledging and reacting to inflation, and the fact that rising costs are now a political issue — and that the Fed is trying to re-establish its inflation-fighting credibility — I don't think they are going to get dovish anytime soon.

Simpson: One of the big challenges for investors here is to overcome learned behavior. When I first started at TD, I wrote an article where I said that investors today look at the Fed as the Lone Ranger, and every time there is a market downturn, investors wait to hear the fourth movement of the William Tell Overture with the Fed riding in to save the day. This time, though, the orchestra's not playing. This is a great example of "anchoring bias" at work. I'm not saying the "Fed put" is dead, but relying on central banks to consider equity and bond markets — which may be down, but only from all-time highs — that's a tall order, especially when their great menace, inflation, is at work. When push comes to shove, the Fed's role is to regulate the money supply, keep inflation low and promote balanced employment.

What Investors Should Focus on to Stay on Track

Investors should never lose sight of their plan or their investment goals, even in challenging market conditions. Panic selling, momentum chasing or investing in highly speculative areas of the market are moves which are unlikely to deliver consistent portfolio success, and there are unique and sometimes disproportionate risks that come with investing in asset classes that are not well defined or understood.

Shortened time horizons and the compulsion to "do something" can tempt investors to act contrary to their investment plan, but this could be a miss-step as compounding returns is a slow process that takes time. History has shown that remaining invested is typically the most prudent approach to meeting goals, and that simply missing out on the top gaining days over the course of a calendar year can have a material impact on long-term return performance.

Investment Goals

WAAC Positioning and Outlook

Equities

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

Against the current inflationary backdrop, we expect global equity markets to remain volatile and returns muted. Multiples for long-duration stocks (securities valued based on future forecasted cash flows), also known as growth stocks, may continue to come under pressure, while shorter-duration or value stocks should be more resilient in the rising rate environment.

We prefer exposure to profitable growth companies that have a solid track record of compounding profits, generating cash flows and maintain strong balance sheets. These companies are typically better at delivering more consistent performance.

We maintain a neutral view to U.S. equities due to expectations for continued positive earnings by U.S. companies, though earnings growth expectations may be on the aggressive side in certain sectors and could materially slow in future quarters. We continue to favor quality areas of the market for their potential resiliency to a broad range of economic outcomes, while avoiding speculative growth sectors.

International markets have seen an acceleration in wage growth, but with inflation very high, real wages remain negative. A contraction in gross domestic product ("GDP") readings, low business and consumer confidence, as well as regional geopolitical instability, lead us to believe international equities will continue to face significant headwinds in the coming months.

China's continued restrictive COVID-19 policies have been hugely disruptive to economic activity and have put additional stress on consumption in China, as well as on global supply chains. We believe China's growth outlook may be materially impacted as a result but maintain a neutral outlook based on relative valuation opportunities.

Fixed Income

	Maximum Underweight	Modest Underweight	Neutral	Modest Overweight	Maximum Overweight
Short-Term Bonds	●				
Intermediate Treasury Bonds				●	
Intermediate Corporate Bonds				●	
Municipals			●		
TIPS		●			
High Yield Bonds		●			

Investors may not want to discount the role of fixed income based on current circumstances of rapidly rising rates. Bonds have historically been a hedge against equity risk and if the economy weakens to stall speed, we expect bonds to perform well as central banks may have to pivot to accommodation from the current aggressive tightening cycle. Markets are typically forward looking, and this shift will likely start being priced in before it happens. This may imply that current fixed income investors will be able to realize higher income levels moving forward. However, the price return of fixed income, which results from changes in bond yields, will still likely be a drag on total returns as long as inflation remains elevated and central banks react with tightening measures.

We believe that following the asset class' dramatic repricing this year, opportunity is being restored in several segments of the fixed income market. As a result, all-in yields for fixed income have risen significantly and now are beginning to look historically attractive.

Domestic government bond yields have increased significantly as North American central banks hike rates to curb the impacts of persistent inflation and wage pressures in labor markets. Yields are at multi-year highs. Government bond yields have become more appealing due to their potential to generate stable and positive real returns over the longer term.

Credit spreads have widened materially this year and while volatility in spreads will likely persist in the near-term, we believe maintaining exposure to companies with strong ratings is prudent and over time will contribute to favorable long-term total returns. At this stage of the economic cycle, we believe a conservative allocation to high quality investment grade corporate credit over high yield is warranted as financial conditions continue to tighten.

Sub-classes

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

High inflation readings from around the globe, combined with ongoing concerns surrounding Russia's invasion of Ukraine, had sent gold rallying earlier this year due to its safety characteristics. Gold has since struggled and has declined alongside global risk assets. Despite this weakness, gold may appreciate against a potentially weaker U.S. dollar and continued economic uncertainty.

The U.S. dollar has benefited from the Fed's tightening campaign. Safe haven buying and higher interest rates have driven investment into the U.S dollar. The USD may see continued support versus most currencies as a result of a flight to quality combined with the potential for the Fed to intensify its monetary policy tightening to combat elevated inflation.

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

Committee Members

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TD Asset Management Inc.

Robert Vanderhooft, CFA
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Michael Craig, CFA
Managing Director and Head of Asset Allocation & Derivatives,
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