TD Asset Management

Market Perspectives + 15 Minutes = Current Insights

Market Perspectives Q4 2022

A 3-Dimensional View

TD Wealth Asset Allocation Committee (WAAC) Overview

1. Global equity markets are likely to remain volatile due to persistent pressures from rising interest rates (to combat high inflation), geopolitical instability and macro headwinds. As a result, recessionary risks remain elevated for many economies as financial conditions become increasingly constrained.

2. Our expectation is that equity valuations will continue to compress as earnings growth declines. While earnings and revenue estimates have been broadly reduced, we believe a more meaningful reduction will occur given decelerating economic activity and continued central bank interest rate hikes. We believe that quality, well capitalized companies will be less sensitive to a slowing economic environment and provide the best breadth of opportunity amid the uncertain outlook.

3. Despite central bank policy tightening, we believe a fixed income allocation remains an important component of a diversified portfolio. From a strategic perspective, bonds can provide investors with capital preservation, liquidity, help reduce overall portfolio volatility, and provide the potential to generate positive total returns comprised of capital gains and income.

4. During uncertain market environments active asset management can play a key role in helping investors position portfolios to manage risk, reduce volatility and provide the potential to deliver attractive returns.

Quarter in Review and Market Outlook

Market turbulence continued to dominate over the third quarter of 2022, fueled by rapidly rising interest rates, fears of decelerating economic growth, the probability of corporate earnings erosion, and rising recessionary risks globally. While July delivered solid equity upside, volatility ensued as the Federal Reserve (the Fed) confirmed that it was not yet ready to pivot from its aggressive interest rate hiking cycle to curb stubbornly high inflation, despite the market's optimistic view that price pressures were ebbing.

Chart 1: Global Equity Index Returns (based in USD)

Name	1M	3M	12M	3Y	5Y	10Y
S&P 500 Index (LargeCap)	-9.21%	-4.88%	-15.47%	8.16%	9.24%	11.70%
MSCI EAFE Index (Europe, Australasia, Far East)	-9.31%	-9.29%	-24.75%	-1.38%	-0.36%	4.15%
MSCI Emerging Markets Index (Emerging Markets)	-11.67%	-11.42%	-27.80%	-1.71%	-1.44%	1.42%

Source: TD Asset Management as of September 30, 2022.

While we are seeing signs that inflation levels are moderating aggressive monetary tightening by hawkish central banks have yet to significantly dent resilient demand. However, as interest rates rise, economic data is pointing to a slowdown in economic activity. Global Purchasing Managers' Index (PMI) surveys have turned broadly contractionary and are continuing to deteriorate, particularly within the services side of the economy. Global Gross Domestic Product (GDP) figures have been weakening, with construction and government spending only partly offsetting modest increases in trade and consumption. While labor has remained strong, with tight jobs markets driving wage growth, when factoring in high inflation, real wage growth remains negative.

Within equity markets, while valuations have become more reasonable, we believe that current forward estimates for earnings and revenues will need to be revised lower. This may put added pressure on stocks globally over the next 6-12 months. The environment for bonds has not been any rosier, as rapidly rising yields have driven bond prices down, leading to materially lower returns for fixed income investors.

While the current economic backdrop may appear gloomy for most asset classes, we believe that underlying market fundamentals remain sound as corporations, particularly in North America, remain generally well capitalized. Our perspective remains that market drawdowns can provide opportunity. Broad selloffs often create dislocations within equity markets, where quality companies begin trading at valuation discounts, making them attractive long-term investments. This can also apply to fixed income assets. While bonds have sold off and have delivered disappointing performance in 2022, we believe this may be a good entry point to generate positive all-in returns over the strategic term in both government and high-quality corporate bonds.

During uncertain market environments, active asset management can play a key role in helping investors position portfolios to manage risk, reduce volatility, and provide the potential to deliver attractive returns. Our experienced investment teams at TD Wealth continue to focus on how to appropriately allocate assets within portfolios, while zeroing in on companies that can generate consistent profits and provide the best opportunity for outperformance.

In the following section, we provide our thoughts on the current macro outlook and the potential future impacts of three important structural forces. For an in-depth perspective on our 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.

The 3-Ds: Debt, Demographics & Disinflation

In the last few years, markets have had to wrestle with the upheaval of the COVID-19 global health crisis, a halt in economic activity to suppress the spread of the virus, broken supply chains, shortages in everything from key inputs like semiconductors to agricultural commodities, and now, geopolitical fissures between China and the U.S. and the Russia – Ukraine war. At the same time central banks have provided significant fiscal stimulus (as a percentage of GDP, this stimulus rivalled what was spent in World War II) and ultra-accommodative monetary policies. To say that economic activity, and market returns, have been volatile would be an understatement.

Some investors may believe that the unique confluence of macro factors witnessed in the last few years could be the new steady state. Inflation being more persistent than expected, higher nominal activity levels, increased and more permanent volatility are all being highlighted as potential end states. However, one alternative scenario is that conditions could become more similar to those that existed prior to the pandemic.

Take for example that the last time the U.S. 10-year Treasury bond was trading at or above the 3% level was in 2018. With the 10-year yield once again breaking above 3% in the first half of 2022, it really took us 'back in time' to those major debates for the direction of risk assets. One of the biggest themes debated in 2018 was regarding economic stability and the impact from the structural forces of **Debt, Demographics, and Disinflation (the three Ds)** and how these forces would lead to slower growth and a depressed interest rate environment.

Our belief is that the **three Ds** have never gone away, they have been lurking below the surface all this time and are ready to reassert themselves when COVID-19 becomes endemic, and the near-term inflationary cycle abates. Let us review the **three Ds** and how these forces have grown stronger since the onset of the economic shift in 2020.

Debt

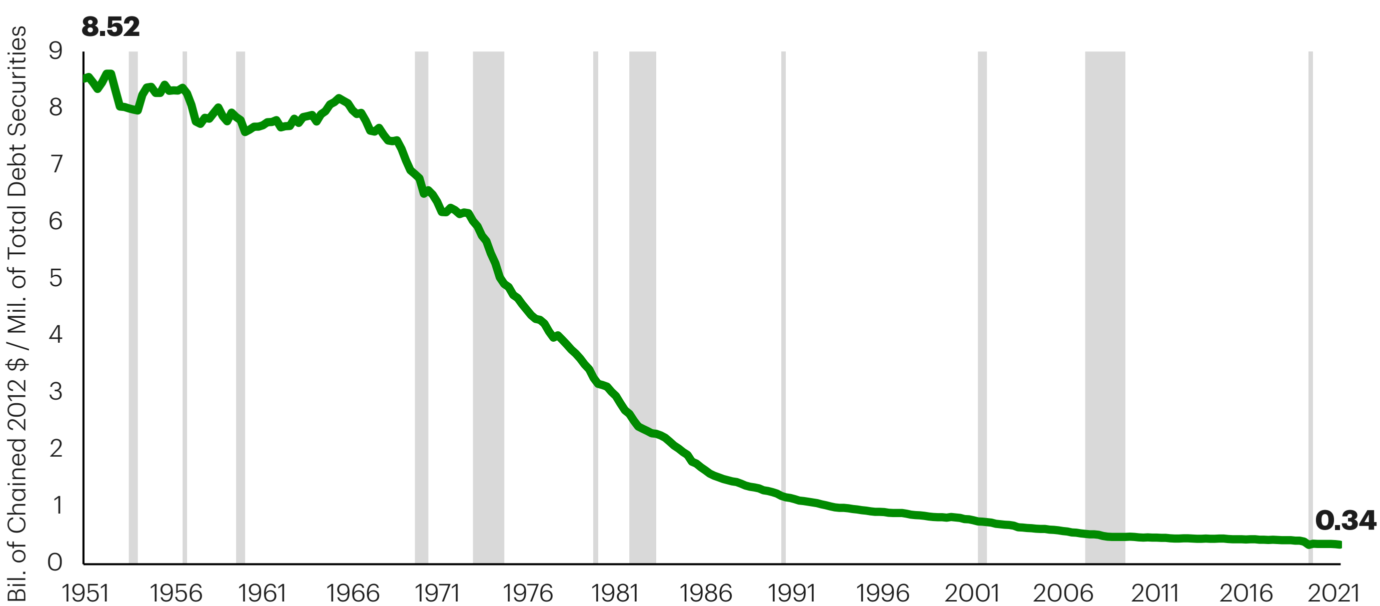
The use of debt in financing assets is a common and economically sound tool to increase future investment returns. As seen in **Chart 2**, prior to the 1990s, debt had a multiplier effect on real GDP. When debt is used to finance assets like infrastructure and education, it leads to value creation for the economy. However, as debt has been increased, that multiplier effect has diminished over time, as either productive investment opportunities have become harder to find or governments have redirected capital to items that have minimal economic returns. In recent times, as a society, we continue to use debt as a tool to bridge us through tough economic times. However, debt always comes at a cost. Recently, many governments and central banks took on significant sums of debt to create a bridge for their economies while they halted physical commerce to contain the spread of COVID-19.

As shown in **Chart 2** a marginal dollar of debt today only created 34 cents of real GDP compared to over eight dollars sixty years ago. Yet we continue to look to debt to solve many of our financial problems, indifferent to the limits it places on potential future growth.

Moreover, debt must be serviced with interest payments and these debt service amounts will rise with interest rates, and can act as brakes on the economy, as funds intended for other goods and services must be redirected to service the debt created. At present for the U.S., the level of debt as a percentage of GDP is at record highs (when combining public and private sector obligations). What is concerning is that the interest rate on that debt is increasing (as central banks move away from emergency levels of monetary accommodation) and the productivity of that debt in generating future growth is diminished, the result is a limit to how much an economy can grow. The implication is that investment and consumer spending that would have resulted in larger amounts of GDP growth (or economic value-added) must now be diverted to debt-financing and debt reduction.

Chart 2: Real GDP to Debt

Marginal gains from debt spending diminished



Note: Shaded areas indicate U.S. Recessions.

Source: St. Louis Federal Reserve, BEA, TD Asset Management. As of January 31, 2022.

Debt

Demographics

A healthy growing economy benefits from an expanding labor force and an increase in capital and technology allocated to workers to increase their productivity. However, the global labor force is currently facing challenges. Firstly, the growth rate of the global population has peaked and is now decelerating, and secondly, the general lifespan of the population has increased while the retirement age has remained constant.

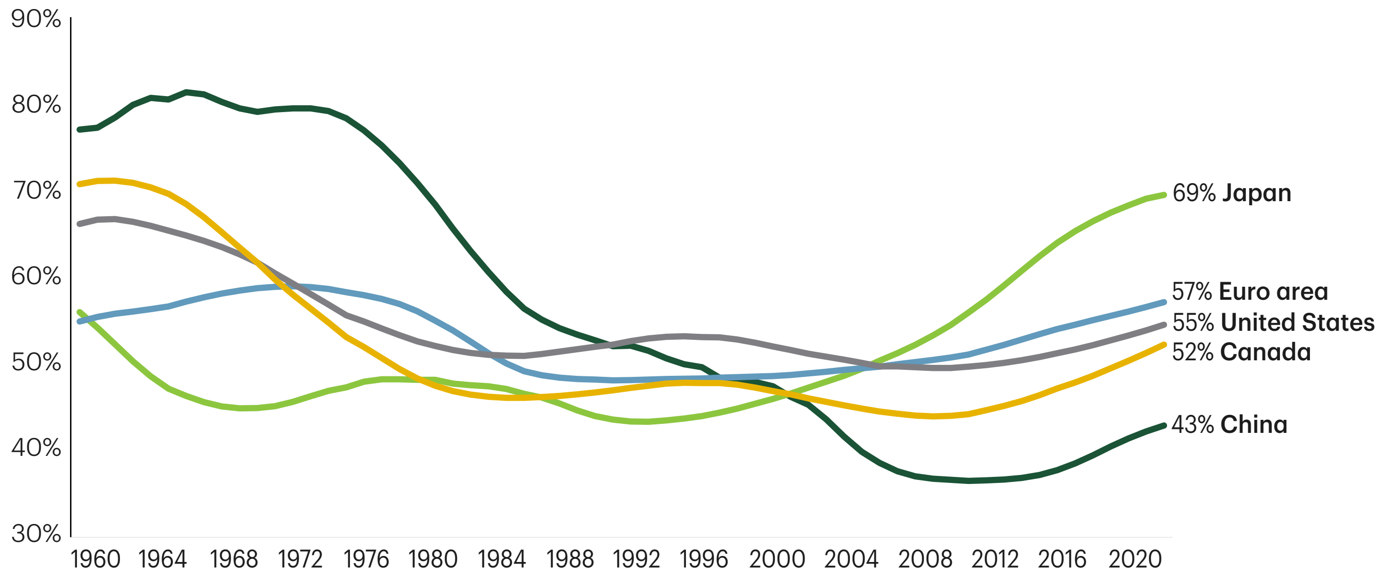
A reduction in the growth rate of labor markets will likely lead to slower economic growth, as less capital and equipment will be allocated to each worker. A smaller labor force could also decrease the demand for housing, which has been an important economic growth engine and could be a headwind on the value of real estate.

The latter issue of a longer lifespan could also be a headwind to economic growth. Workers typically save a portion of their salary to spend in their retirement. Now that we are living longer, this increases longevity risk (the risk that you outlive your assets) and, as such, both workers and retirees must save more to manage this risk. Higher savings translates into lower demand and as a result, lower interest rates.

Combined, these two forces create a dependency ratio issue, which gives insight into the number of people who are of working and non-working age. This ratio is calculated by taking the non-working age group (dependents), those who are under the age of 15 and over 65 and dividing it by the labor force. A higher ratio indicates a higher proportion of the population that are dependent on the rest of the population. As you can see in **Chart 3** below, Japan and its economy have already been dealing with this issue for quite some time, but this is becoming a growing concern for other developed countries and even emerging market economies like China.

Chart 3: Participation rate by region: Dependency Ratio

(calculated as <15yr & over-65yr divided by the labor force)



Source: https://ourworldindata.org/world-population-update-2022.

Disinflation

Inflation remains a topical subject today as it directly impacts consumer spending, can weigh on profitability if it persists (for example, if companies start hoarding inventories), and negatively impacts asset class returns by eroding future purchasing power. However, much of the inflation we are seeing today is driven by cyclical factors that should reverse.

For example, Energy represents 8.8% of the Consumer Price Index (CPI) basket and its index series has grown 24% year-of-year (YoY), in large part due to the geopolitical tensions in Europe. Energy itself contributed over 2% of the 8.3% YoY CPI number reported in August. To expect this growth rate to persist and have the same impact on the headline number, you would need energy prices to increase an additional 25% from here. Not impossible, but less likely.

Moreover, factories and corporations have been in a scramble to build inventories for the past two years as they tried to satisfy the well above trend consumer demand for goods and at the same time overcome supply chain pressures and input shortages. However, goods inflation has receded as consumer preferences quickly shifted to services (for example travel) when COVID-19 pandemic restrictions eased, and many companies are now burdened with excess level of inventories. These corporations will need to discount and or run pricing promotions to reduce these excesses and this will help ease some of the inflationary pressures we are seeing today, but questions remain about how high and how long services inflation will persist (i.e. wages) amid the current environment.

It may seem odd to discuss disinflationary forces in the economy while prices for food and gasoline are negatively impacting consumer pocketbooks.

However, one important way that society may be able to soften the impact of the dependency ratio issue (see **Demographics**) will be to allocate more capital to technology to increase productivity.

Technology has brought incredible innovations to our fingertips, such as microchips, and unleashed powerful disinflationary forces in the form of creative destruction. For example, TVs today are larger in size and a fraction of the cost of what they were 20 years ago. Our smartphones are mobile super computers and have completely displaced many other common appliances, products and services.

As shown in **Chart 4**, semiconductor companies design their microchips on the expectation that they can double the number of transistors every two years (this is commonly known as Moore's Law) and the outcome is that the speed and capability of these microchips will increase while their prices fall.

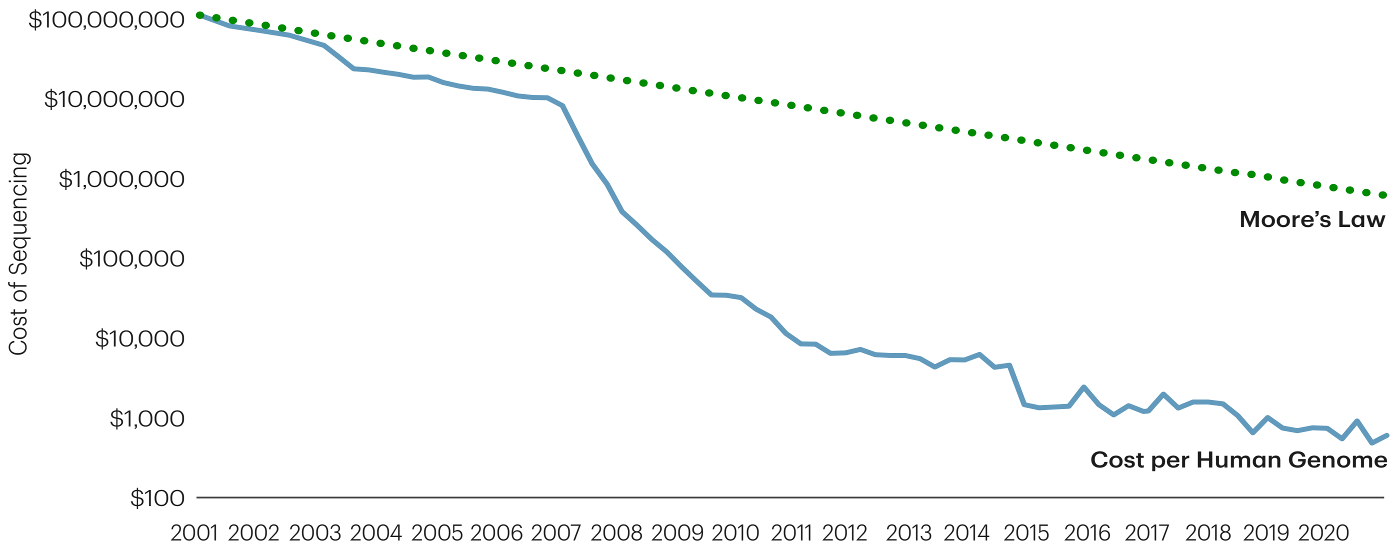
We have also been observing the incredible drop in the cost of sequencing the human genome, a lower sequencing cost will lower the barriers of entry for new startups to enter the Healthcare industry. We are at the forefront of a new wave of innovations and applications for the Healthcare industry. Medical Care is a material weight in the CPI basket and healthcare costs have been continuously compounding for years and this places a burden on both governments and individuals.

These new innovations could help to contain the rising costs or lower them if they can solve chronic illnesses with new technologies such as gene therapies.

Disinflation

Chart 4: Deflationary Force of Technology

Cost of Sequencing Human Genome has declined exponentially



Source: https://www.genome.gov/about-genomics/fact-sheets/DNA-Sequencing-Costs-Data/. Data as of August 2021.

What this Means for Portfolios/Investors Seeking Income

As countries emerge from the COVID-19 pandemic, we may expect to find ourselves traveling back in time to discover that the long-term forces of **Debt, Demographics and Disinflation** have been quietly waiting to reemerge all along. More concerning is that these forces have grown larger, and it is our view that the **three D's** will slow economic growth and thus sustain a low interest yielding environment over the longer term. While we should see the current inflationary pressures moderate, perhaps even a recession, investors may then begin to feel the same pressures they experienced over the course of the decade prior to the COVID-19 pandemic. As was the solution in the past, dividend growth remains a relevant and credible source for income and growth. In order for companies to maintain and grow their dividends year after year, they need to have enduring competitive advantages, solid balance sheets and multiple avenues to grow revenues. We prefer to focus on companies that benefit from secular growth trends such as digitization, decarbonization, health and defense, as we expect these areas will grow faster than the overall economy.

TD Wealth can help you achieve your investment objectives through a number of dividend and income focused investment solutions, that offer the potential for longer term sustainable portfolio growth. Contact your investment advisor or relationship manager for more information.

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WAAC Positioning and Outlook

Equities - Neutral

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

Economic data is showing evidence of a slowing U.S. economy. Below trend growth is forecasted for this year with an increasing likelihood of a recession in 2023 as the Federal Reserve (the Fed) tightens financial conditions. Consumer demand is likely to wane as unemployment rises with higher interest rates, and business investment may decline along with corporate profits. While recent economic data has been mixed, in our view, the U.S. economy and corporate balance sheets continue to show relatively solid underlying fundamentals. Though at a current forward price-to-earnings (PEs) multiple of ~17.5 for S&P 500 Index companies, valuations may still be elevated considering the uncertain economic backdrop.

Continued contraction in economic activity, low business and consumer confidence, as well as regional geopolitical instability remain significant headwinds for international equities. Growth estimates may also be on the high end for many international markets and will likely need to be revised lower. However, forward PEs remain near multi-year lows, and present select relative valuation opportunities.

The Chinese government has shown some commitment to spurring economic growth through monetary easing which could provide some support. However, present regional geopolitical risks, China's struggling real estate market, historically high youth unemployment, as well as the continuation of highly restrictive COVID-19 containment measures, could continue to weigh on equity performance for several quarters as its economic production is shut down.

Emerging market equities, similar to most regions of the world, have endured an extended period of elevated inflation, concerns over global central bank monetary tightening, and the prospect of recession in many western markets. Our outlook for emerging markets remains cautious as a result, while recognizing that low relative strategic valuations may still present quality growth opportunities.

Fixed Income – Modest Overweight

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

Despite some widening in corporate spreads over the quarter, we remain constructive, and selective toward corporate credit and are comfortable with our strategic overweight view. We maintain a preference for high-quality investment grade corporate bonds over high yield bonds. Corporate fundamentals remain relatively solid as we enter an economic slowdown and financial conditions should remain supportive of the corporate sector.

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

Credit fundamentals for high-yield issuers remain reasonably supportive of positive long-term returns after a prolonged period of balance sheet discipline.

However, high yield spreads have become more elevated recently, and appear to be fairly priced at current levels. High yield bonds may not currently provide adequate risk/reward compensation as increased volatility is expected for the asset class.

Elevated global inflation readings in developed markets are driving expectations for higher short-term rates, via interest rate hikes over the next several quarters. Global bond markets will be subject to heightened volatility due to tighter financial conditions, geopolitical events, and COVID-19 pandemic-related uncertainties.

With the expectation that high inflation levels may be starting to peak and slowly normalize, inflation insurance through TIPS have become moderately attractive for those looking to protect against a market that may be underappreciating current inflationary pressures.

Sub-classes

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

We maintain a modest overweight strategic view for Gold which typically acts as a defensive measure against extreme events and higher inflation.

The persistence of high inflation readings leveling off may lead to a less aggressive interest rate hiking cycle by the Fed in the coming quarters. However, we do not currently expect a pivot in the Fed's policy objectives to combat inflation until a meaningful decline in inflationary pressures are realized. We believe that the U.S. dollar may be at peak value, and as interest rate differentials narrow globally, this could limit further upside from current levels.

Maintaining neutral cash positioning allows for strategic deployment to other asset classes as opportunities arise. Cash can also provide flexibility to navigate the short-term outlook and uncertainties.

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 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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TD Asset Management Inc.

Michael Craig, CFA
Managing Director and Head of Asset Allocation & Derivatives,
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Justin Flowerday, CFA
Head of Public Equities,
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Jeff Tripp, CFA
Managing Director and Head of Alternative Investments,
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Kevin Hebner, PhD
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