TD Asset Management

Market Perspectives 10 Minutes

Market Perspectives
Q2 2024

TD Wealth Asset Allocation Committee (“WAAC”) Positioning Overview

Equity (Neutral Overall)	We believe that the equity market has a balanced return outlook. While earnings growth is in positive territory globally (as represented by the MSCI All Country World Index), this has been partially captured by the market in expanding valuations and elevated investor sentiment.
Fixed Income (Modest Overweight Overall)	The Bank of Canada has seen better-than-expected inflation prints over the past two months, increasing the likelihood that it will begin to reduce its policy rate in the summer. In previous easing cycles, bonds have generated positive returns as interest rates have fallen in the months leading up to the first rate cut. Given the modest rise in interest rates year-to-date, we anticipate that the lead-up to the Bank of Canada’s first policy rate cut later this year will exhibit similar patterns to historical easing cycles. Although uncertainty around the future evolution of domestic and global macroeconomic data remains elevated, we continue to expect that fixed income will generate positive returns over the next 12 months and that bonds can still provide diversification benefits, reduce overall portfolio volatility and preserve capital.
Alternatives (Neutral Overall)	We believe that an allocation to alternative assets can benefit diversified portfolios especially when implemented over the long-term. Alternative assets can provide inflation protection and attractive absolute returns, while acting as long-term portfolio stabilizers via their diversification benefits and less correlated income streams.
Cash & Cash Equivalents (Modest Underweight Overall)	We anticipate that the high yield we are currently seeing in cash may be temporary and we would expect a reduction in yields as the BoC and the U.S. Federal Reserve move towards easing measures. Overall, cash may not be as attractive as other asset classes in the medium term.

Quarter In Review

Inflation has made notable progress in recent months in many economies, enabling central banks to shift their warnings of potential interest rate hikes to a dialogue around the timing for highly anticipated cuts. Despite investors eagerly awaiting the start of these rate cuts, both the U.S. Federal Reserve ("the Fed") and Bank of Canada ("BoC") have been preaching patience on timing as economic data has come in stronger than expected so far this year.

On the economic front, the U.S. remains a stark outperformer to peers. Through geopolitical risks and high borrowing costs, the U.S. continues to impress, buoyed by remarkable productivity. This is out of step with other countries where growth has cooled markedly. Canada is no exception to this pattern, but domestic inflation has not capitulated as much as other regions, creating a challenge for the BoC. Global supply chains are also elongating due to ongoing geopolitical tensions, which could put further pressure on prices.

Through January, the annual change in the Consumer Price Index ("CPI") was 3.1% in the U.S., 2.9% in Canada, and 2.8% in the Eurozone. However, these annual readings mask important nuances. Momentum in price gains has evaporated in Europe, while the same degree of deceleration has yet to be observed in North America. In the Eurozone, both goods and services inflation have cooled substantially. The European economy has stalled since the third quarter of 2022 and traditional economic dynamics have settled in to rebalance demand and supply, and to restore price stability.

Although Canadian economic growth has steadily evaporated, decades-long housing shortages are coming home to roost. Through January, CPI inflation excluding housing-related costs (rent, mortgage interest costs, and replacement costs) has already returned to 1.8% year-over-year ("YoY") and is at an even lower 0.6% (annualized) on a quarterly basis. Strip out the same housing factors from the classic core CPI (excluding food and energy) and we see virtually no growth in the quarter ending in January. The picture that emerges is of an economy with accumulating slack.

In the U.S., a resilient economy continues to defy gravity, raising hopes for disinflation. Services inflation has been less cooperative, as it continues to chug along, running north of 4% on a quarterly basis. Stripping out the effects of rent and homeownership reveals a quarterly clip of price gains of 5.5% (annualized) through January. Outright deflation in core goods sets the U.S. apart as well, where January prices were down by 1.9% (annualized) on a rolling quarterly basis. Moreover, this print is not out of the ordinary, in the decade before the COVID-19 pandemic (January 2010 to January 2020) the annual average price growth for core goods was zero. This means that if the downward pressure on goods prices begins to stall in the face of strong domestic demand and an economy that remains in excess demand, the U.S. is at risk of a re-acceleration of inflation.

China's economic challenges linger despite fiscal stimulus introduced towards the end of last year. The current economic situation is best characterized by the lingering ripple effects from the overhang in the housing market. This malaise is leading to an adjustment in households' appetite for debt and has materialized at a much slower pace of debt accumulation since the COVID-19 pandemic. The retreat in credit demand is emblematic of downbeat consumer expectations and the effect of deflation, which exacerbates debt servicing costs in real terms.

Chart 1: Global Equity Index Returns

Name	1M	3M	12M	3Y	5Y	10Y
S&P 500 Index (Large Cap)	3.06%	13.27%	30.04%	14.30%	15.37%	15.28%
S&P/TSX Composite Index	4.14%	6.62%	13.96%	9.11%	9.96%	7.67%
MSCI EAFE Index (Europe, Australasia, Far East)	3.25%	8.52%	16.04%	7.97%	8.15%	7.47%
MSCI Emerging Markets Index (Emerging Markets)	2.37%	4.95%	8.72%	-2.27%	2.90%	5.46%

Source: TD Asset Management Inc. ("TDAM"). As of March 31, 2024.

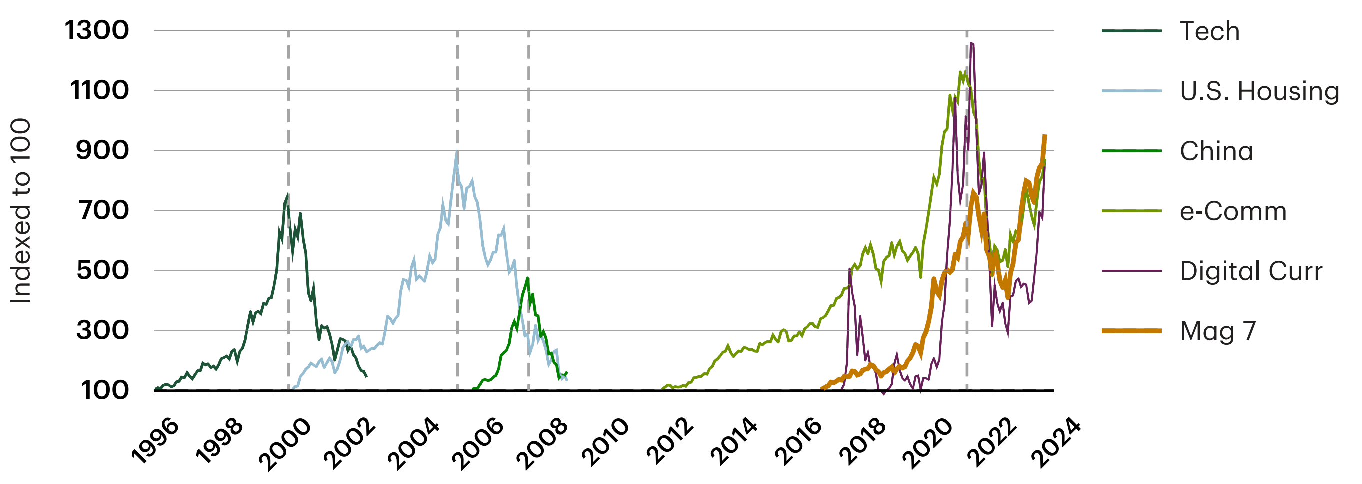
The Magnificent Seven:

Are AI Expectations creating a Bubble?

In finance, bubbles occur when euphoria, market momentum and price action race far ahead of fundamentals, particularly free cash flow ("FCF") generation. Such bubbles are fragile and can hit an air pocket when exuberant expectations finally catch up to earnings reality. In recent memory, we at TD Asset Management Inc. ("TDAM", "we", "our") have seen a number of bubble-like conditions rise and fall (**Chart 2**), and although we do not believe that artificial intelligence ("AI") is just another overhyped fad, we can also see that much of the euphoric commentary around AI is reminiscent of previous episodes of speculative frenzy.

Further, a notable amount of earnings growth has already been priced into several big technology names, particularly among the so-called **Magnificent Seven** (namely Alphabet Inc., Apple Inc., Amazon.com, Inc., Meta Platforms, Inc., Microsoft Corporation, NVIDIA Corporation and Tesla Inc.) and it is not at all clear that all of the prevalent rife optimism will be proven justified. For example, one of the Magnificent Seven names would need to grow earnings by 20% annually for the next 18 years to justify its euphoric multiple. This is unprecedented for a firm of its size, so some skepticism must be applied in that specific case.

Chart 2: Bubbles and Hype Cycles of Recent Memory (1996-2024)



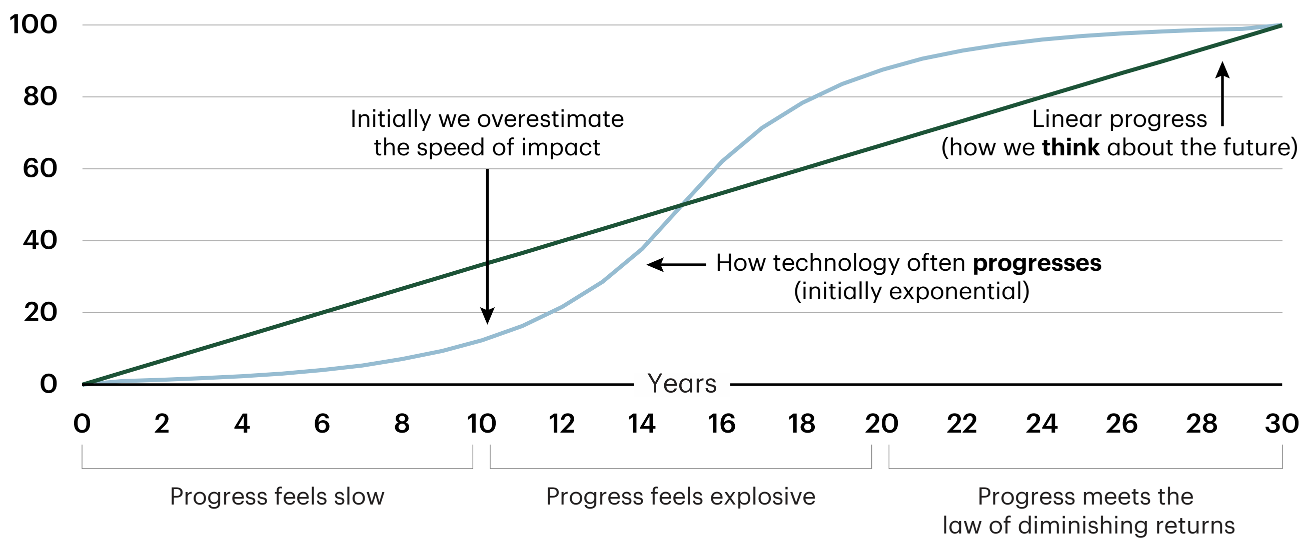
Source: Bloomberg Finance L.P., as at January 31, 2024.
Note: Each asset class is indexed to 100. China: Shanghai Stock Exchange Index, e-Comm: e-Commerce, Digital Curr: Digital currencies, Mag 7: Magnificent Seven

Is the Magnificent Seven phenomenon just another bubble waiting to burst?

In most of the bubblish cases illustrated in **Chart 2**, the underlying asset classes were essentially sound (the jury is still out regarding Chinese equities and digital currencies), but market momentum and price action raced too far ahead of fundamentals. This is especially common with new technologies. Many of us saw this phenomenon with the internet in the mid-1990s, though it was present all the way back to railways in the 1840s. As a society we can expect progress to be linear, but digital technology is more likely to proceed exponentially (**Chart 3**) and this can lead investors to swiftly pivot from euphoria to disillusionment when progress is perceived as occurring too slowly.

Chart 3: The Path to Progress

Investors can overestimate the speed of new technologies, especially in the digital economy

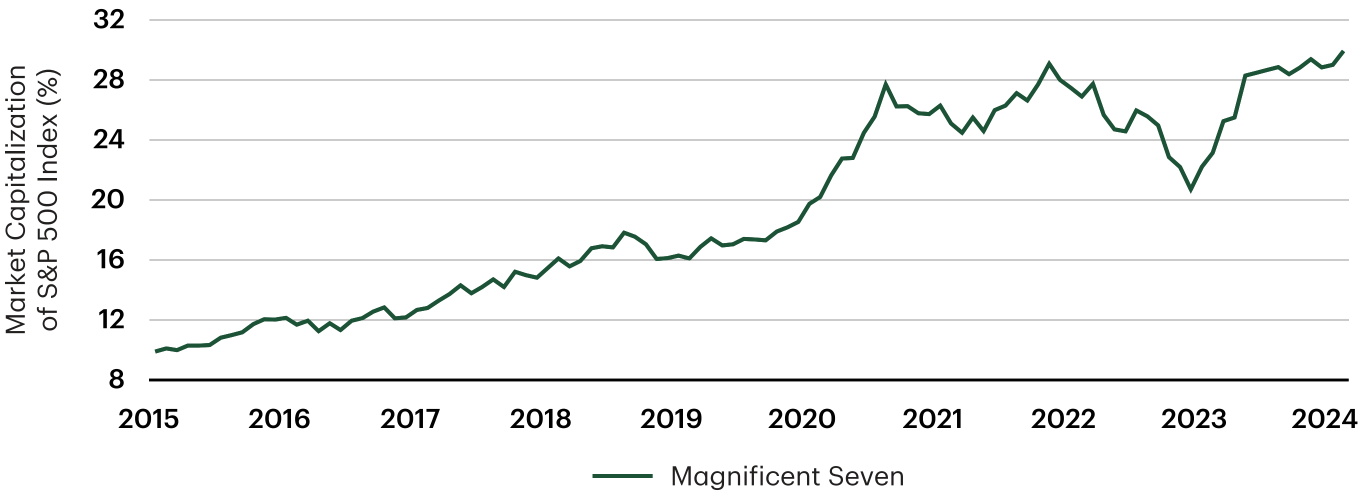


> **I am all-in on a fundamental bet that AI will drive substantial value creation, but this is a decade plus transition [...] investors will need to be patient.**
>
> **– Sa ah Guo, founder of Conviction, 2023**

The next three charts aim to look back on the ways in which the current economic situation is historically reminiscent of other high-hype periods and will demonstrate why a vocal minority of commentators are still arguing that we are entering a bubble. For a start, the enormous appreciation of the Magnificent Seven represented 44% of the S&P 500 Index's market capitalization gain since January 2015 and 62% since January 2023 (**Chart 4**). The U.S. equity market has only been similarly concentrated two times before, in the late-1920s and the late-1990s, and those are not periods investors remember fondly.

Chart 4: High Concentration (2015-2024)

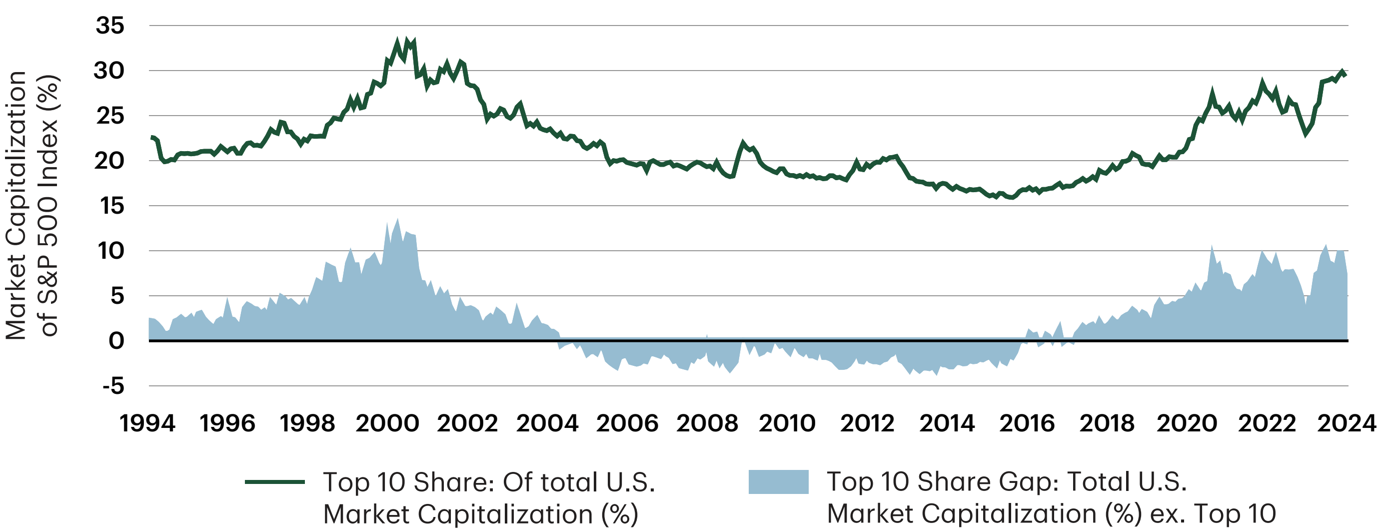
The Magnificent Seven now represent over 30% of S&P 500 Index's market capitalization



Source: Bloomberg Finance L.P., as at December 31, 2023.

Chart 5: Historical Market Capitalization (1994 -2024)

The top 10 stocks in MSCI USA Index represent 29% of the total market capitalization. That is the highest point since the technology bubble collapsed in 2000-2001 and notably above the historical average of 21%

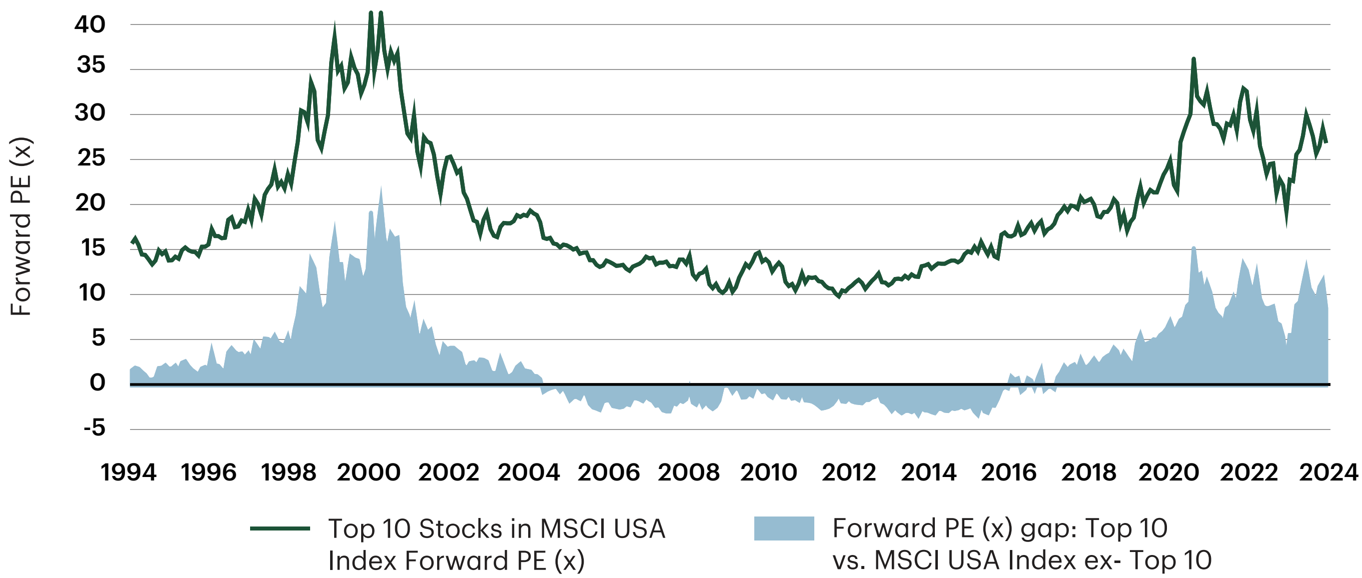


Source: JP Morgan, as at January 31, 2024.

A second sign of potentially bubblish behaviour can be seen by looking at the weight of the top 10 stocks in MSCI USA Index over the last thirty years (**Chart 5**). They currently represent around 29% of total market capitalization, which is the highest attained since 2001. Further, the top 10 stocks only represent 22% of forward earnings per share ("EPS"), which is just slightly above the 30-year mean of 20%. Moreover, the gap between the market capitalization and EPS, as illustrated by the gray shaded area, is the largest since the 2000s era technology bubble and four times the historical norm.

Chart 6: Forward Price to Earnings (PE) at Another Peak (1994-2024)

Top 10 stocks in MSCI USA Index have a forward PE of 27x, which is far above the historical median of 17x



Source: JP Morgan, as at January 31, 2024.

With respect to valuations, the top 10 stocks in the MSCI USA Index have a dizzying forward PE of 27x, while the remaining 599 names possess a multiple of 18x (only slightly above the 30-year mean of 16x) (**Chart 6**). Further, the gap between the PEs of the top 10 and the bottom 599 (gray shaded area) is stretched at four times the historical norm (or the 92nd percentile).

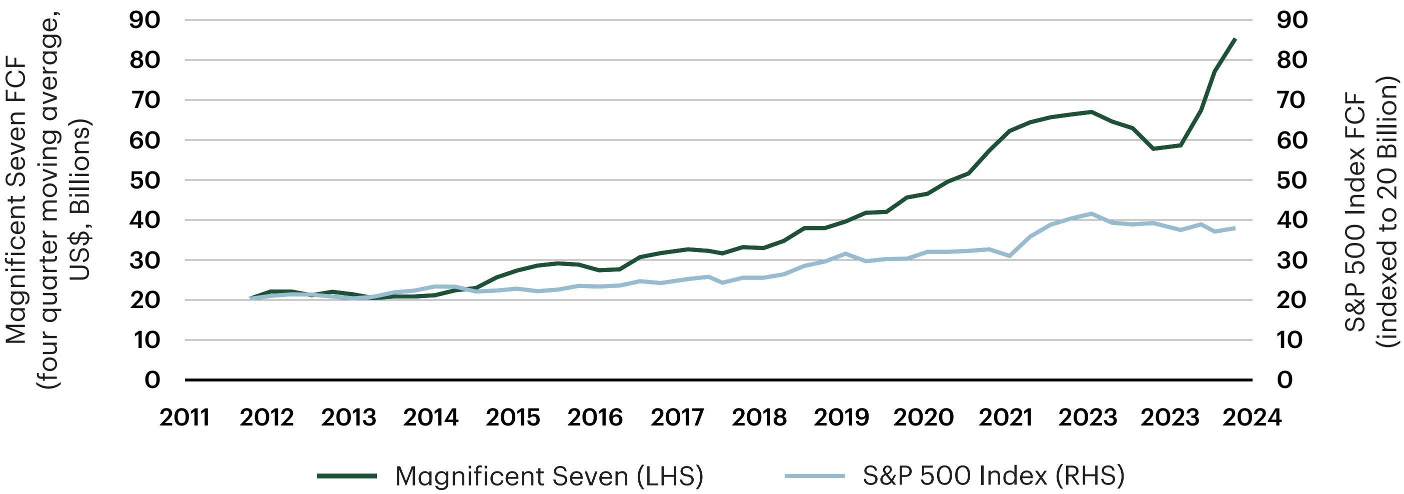
Winner-Takes-Most: Leading Firms Generate 15% Free Cash Flow Growth, 26% Operating Margins ("OPM") and 22% Return on Invested Capital ("ROIC")

The above charts could be used to make the case that we are in late stages of an AI bubble. However, this assessment implicitly assumes that AI does not represent a structural change in the distribution of FCF, margins and returns. This is where our thinking diverges. As has been written about extensively over the last eight years, digital technology and the substitution of bits for atoms invokes powerful, capital-light business models that exploit formidable economies of scale and network effects. One key feature is that the pursuit of market dominance leads technology firms to invest massively in intangible rather than tangible capital, which involves huge fixed costs but drastically lowers marginal costs. This is what drives winner-takes-most dynamics and produces a small number of so called superstar firms.

The next three charts will demonstrate this powerful impulse which we believe is still in early innings. For a start, the Magnificent Seven have produced an average annual FCF growth of 15% over the last decade and 17.5% over the past five years (**Chart 7**). By contrast, the S&P 500 Index has delivered only 5% growth, roughly in line with nominal GDP (gross domestic product). Moreover, the S&P 493 (that is, the constituents of the S&P 500 Index excluding the Magnificent Seven) have generated only 3% FCF growth over the last decade, well below that of the overall economy. This dichotomy can also be seen in consensus expectations for 2024 EPS growth, which is 12% for the overall S&P 500 Index. However, underneath lies an extreme bifurcation, with the Magnificent Seven at a staggering 55% and the S&P 493 a paltry 5%.

Chart 7: FCF (2011-2024)

The Magnificent Seven leads the overall S&P 500 Index

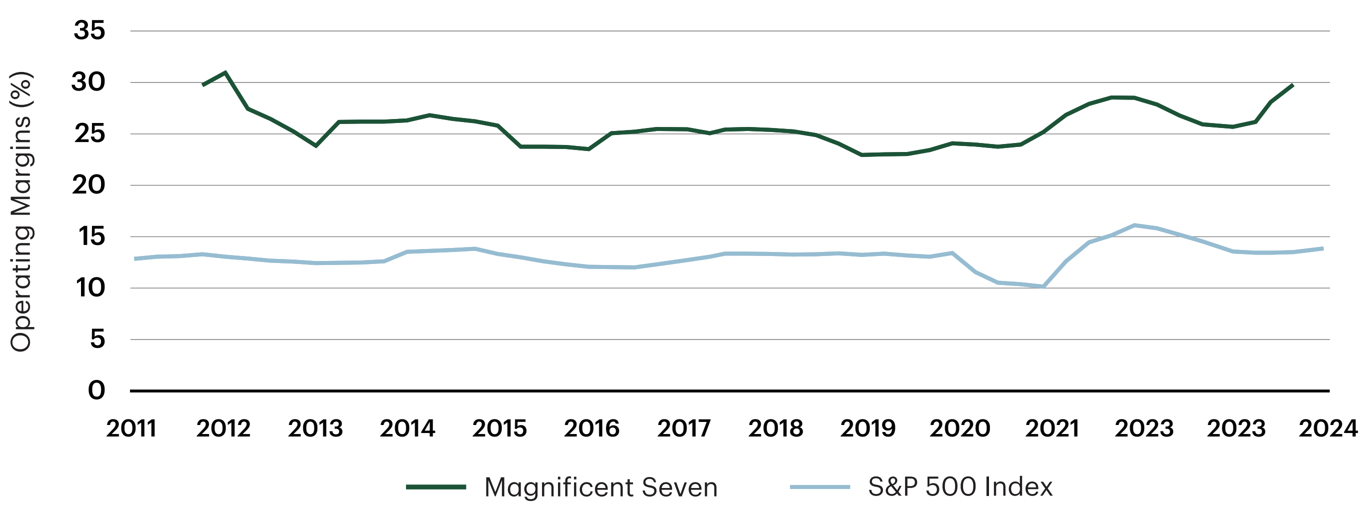


Source: Bloomberg L.P., TD Epoch as at December 31, 2023.
Note: Magnificent Seven FCF (four quarter moving average, US dollar, billions), S&P 500 Index (indexed to 20).

Next, we will take a look at operating margins (**Chart 8**), most importantly noting that the Magnificent Seven's impressive margin shows no sign of normalizing toward that of the S&P 493, which has averaged only 9.9% over the last decade.

Chart 8: Operating Margins

The Magnificent Seven's OPM has averaged 26% over the last decade, double that of the overall S&P 500 Index

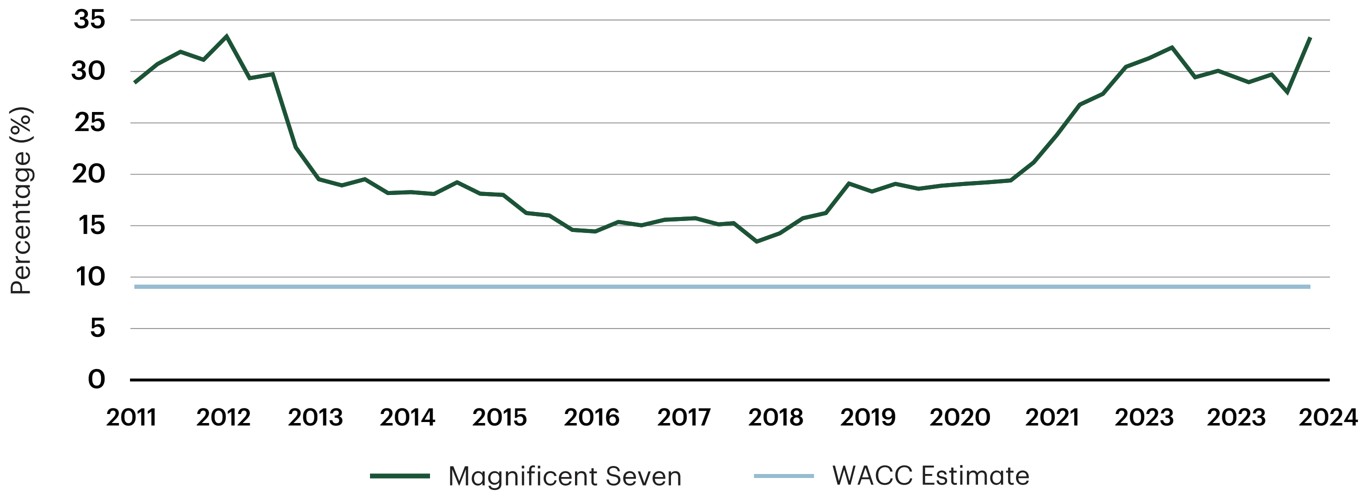


Source: Bloomberg L.P., TD Epoch as at December 31, 2023.
Note: Magnificent Seven OPM (four quarter moving average).

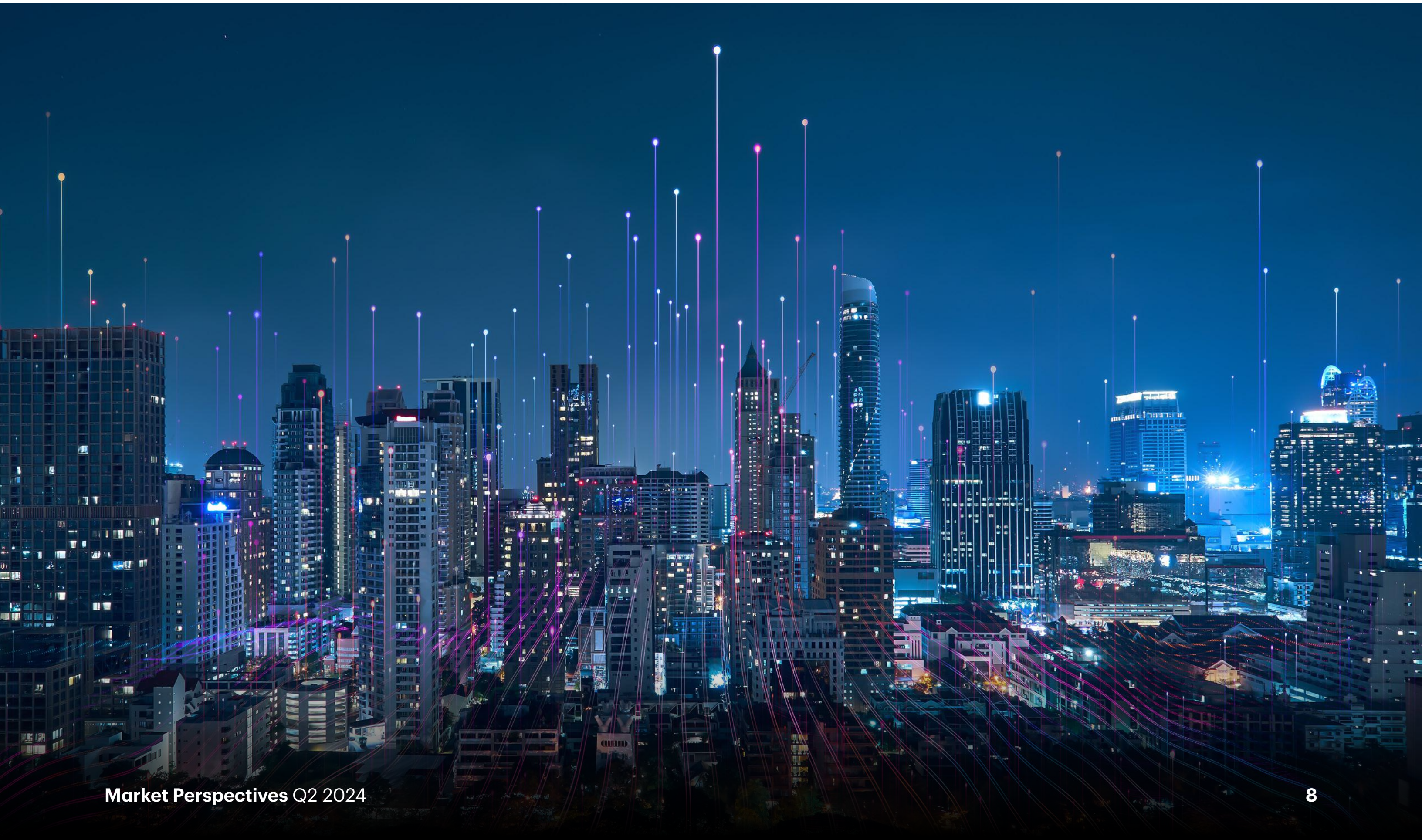
Third, the Magnificent Seven's ROIC is not only leagues above its estimated weighted average cost of capital ("WACC") but has actually accelerated during the last five years (**Chart 9**). By contrast, the S&P 500 Index overall has averaged a ROIC of 7-9%. Moreover, the S&P 493 has generated a meager 5-7%, which means the vast majority of companies require a low WACC, similar to that experienced last decade, to create value. We believe that the impressive ROIC is a key indicator to focus on when considering whether we are seeing bubblish conditions. It is important for a number of reasons including that a higher ROIC results in a loftier PE ratio and for many technology companies, their seemingly expensive PE can be entirely attributed to their elevated ROIC.

Chart 9: ROIC

The Magnificent Seven has produced an average ROIC of 22%, well above the estimated WACC



Source: Bloomberg L.P., TD Epoch, as at December 31, 2023.



Are We Really Seeing Echoes of the Late-1990s Tech Boom?

The above analysis we have completed in this piece has three key take aways, the last of which may be the most important:

1. We see a lot of earnings growth currently priced into the Technology sector.
2. Investors can swiftly pivot from euphoria to disillusionment when progress, especially in FCF growth, is perceived as too slow relative to what is priced in.
3. We believe that AI is not just another overhyped fad, as demonstrated by an impressive track record in generating FCF, OPM and ROIC.

The first two takeaways would have been equally applicable to the internet boom of the late-1990s (or even the railway boom of the 1840s). However, the third takeaway is different: investors in the internet boom were not sufficiently skeptical of hype stocks that promised future earnings somewhere far down the road but remained negative FCF at the time.

This time, in sharp contrast, the Magnificent Seven is generating impressive FCF, and consensus expectations are that the group should be able to grow earnings by an eye-popping 55% in 2024.

Much of this immediate impact represents revenue from infrastructure build, including blitz-scaling AI platforms. Additionally, some companies are reaping early returns from the use of AI to reduce labour costs and create process innovations: that is, making existing business processes more efficient by lowering operating costs.

However, the vast majority of the value added from general purpose technologies ("GPTs") like AI (as well as the internet, electricity and steam engine) have historically come from product innovation. That is, entirely novel goods and services that were not foreseen when the GPT was first commercialized.

The good news is that this really moves the needle on earnings, creating the potential for enormous value. The bad news is no one knows when or how it will play out and, in sharp contrast to process innovations, it can take years and even decades to be realized.

Infrastructure

For these reasons, we believe AI enthusiasm will likely be rewarded for the next year or two, despite lofty valuations, as earnings growth proves robust and meets expectations for some period of time. However, this is also a long term trend and investors will need to be patient and calm as the initial operational efficiencies wane. The 1990s boom ended after newspaper headlines began warning that many technology darlings were burning buckets of cash and had only a few months of liquidity remaining. There is some reason to be concerned that we might see a similar reversal in headlines here: after technology companies have spent tens of billions building out AI infrastructure, the news may begin a cycle of warning investors that the highly anticipated product innovation remain years away. Such a retracement might be averted if AI proves its value, in terms of FCF generation beyond the technology sector, more quickly than previous technologies have done.

The Bottom Line

Beyond the next year or two lies enormous uncertainty regarding how AI will evolve. As a result, we believe investors need to be cautious regarding speculative growth or hope stocks, which offer an enticing narrative and promises of future earnings that may or may not be realized. Instead, we at TDAM will continue to monitor the market trends but favour companies with a demonstrated track record of FCF generation, as well as high and sustainable OPMs and ROIC. We believe such companies are most likely to create value and reward investors during this period of extraordinary innovation and disruption.

WAAC Positioning And Outlook

Asset Class Assumptions

To close out the quarter, we were neutral on equities and alternatives, with a modest overweight to fixed income and a modest underweight to cash & cash equivalents. The TD Wealth Asset Allocation Committee meets monthly and will make necessary strategic adjustments to asset class views as the environment unfolds.

Equities – Neutral Overall Outlook

Maximum Underweight | **Underweight** | **Neutral** | **Overweight** | **Maximum Overweight**

Canadian Equities	Neutral	Canadian gross domestic product growth has slowed, but with the full effect of higher rates on the consumer and real estate market yet to be seen, the Canadian economy could remain weak. That said, strong free cash flows within the Energy sector, and relatively inexpensive Financials stocks, may present attractive opportunities.
U.S. Equities	Modest Overweight	The U.S. labour market and gross domestic product growth have remained robust. The S&P 500 Index has resumed year-over-year earnings growth, which has contributed to rising valuations and positive investor sentiment. The S&P 500 Index commands a premium valuation due to its higher technology exposure.
International Equities	Modest Underweight	International stocks remain challenged by weaker corporate returns and slowing macroeconomic conditions, particularly in Europe. Overall we feel that this may limit further gains, however Japanese equities look attractive on a relative basis, with momentum building behind a corporate reform agenda aimed at boosting profitability and valuation multiples.
Chinese Equities	Neutral	The Chinese economy is showing signs of stabilization and the government remains focused on supporting growth, but challenges remain in the property sector.
Emerging Markets ex. China	Neutral	Some emerging market central banks appear to have paused their rate hiking cycle, with Brazil and Chile cutting rates. While this is supportive of better domestic growth in these countries, it might be partially offset by the impact weaker global growth could have on exports.

Fixed Income – Modest Overweight Overall Outlook

Maximum Underweight | Underweight | Neutral | Overweight | Maximum Overweight

Domestic Government Bonds	Modest Overweight	The BoC remains patient in its monetary policy stance, waiting on continued evidence of decelerating inflation. Similar to the bond market, we expect the first rate cut to emerge at the BoC's June meeting. Based on yield patterns observed in historical easing cycles, we anticipate bond yields to decline over the next three months, or sooner if weakness in the labour market emerges. Over the longer term, we believe government bonds continue to remain appealing due to their potential to generate positive nominal returns.
Investment Grade Corporate Credit	Neutral	Investment grade spreads have tightened in recent months and continue to reflect a very modest softening of the global economic backdrop. We continue to see the best opportunities in lower duration corporate bonds given their appealing all-in yields and are more cautious on longer duration corporate bonds due to the uncertain global economic outlook.
Global Bonds-Developed Markets	Neutral	While the Bank of Japan has finally ended yield curve control and negative policy rates, it has not dropped its accommodative monetary policy stance. Other central banks have decisively shifted to policy easing, with the Swiss National Bank being the first among developed markets to lower its policy rate. Leading central banks, including the U.S. Federal Reserve, are expected to follow suit in the summer. However, each market faces large idiosyncratic risk factors, so the future evolution of each central bank's easing cycle is not a foregone conclusion. Therefore, we expect opportunities across developed market bonds to vary over the next 12 to 18 months.
Global Bonds-Emerging Markets	Neutral	The dispersion of returns within emerging markets continues to present some opportunities. We continue to maintain a neutral outlook as yields are attractive in some regions where central banks had proactively hiked interest rates before the U.S. Federal Reserve. Bond returns will likely underperform in other regions where central banks are still early in normalizing monetary policy.
High Yield Credit	Modest Underweight	All-in yields remain elevated, but have declined in recent months, indicating strong potential returns. However, we continue to expect financial conditions to tighten and drive a deterioration of corporate credit fundamentals. This may create a particularly challenging backdrop for corporations with elevated debt loads, increasing overall volatility and downside risk.

Alternatives – Neutral Overall Outlook

Maximum Underweight | **Underweight** | **Neutral** | **Overweight** | **Maximum Overweight**

Commercial Mortgages	Maximum Overweight	Commercial mortgages continue to provide accretive income while insulating investor returns from the increased volatility in interest rates.
Private Debt (Universe)	Modest Overweight	High credit quality and global diversification provides an income ballast in an uncertain economic environment. Incremental income and potential capital appreciation from interest rate moderation provide upside.
Domestic Real Estate	Maximum Underweight	Canadian real estate transaction activity remains selective. Industrial, retail and multi-unit residential fundamentals remain sound, while office continues to experience leasing headwinds and a flight to quality.
Global Real Estate	Maximum Underweight	Certain regions across the globe have seen quicker downward adjustments to valuations but we are now seeing early signs that these adjustments may be slowing down. Multi-unit residential and a tilt to the Asia Pacific region may be able to provide global real estate portfolios with enhanced risk-adjusted returns.
Infrastructure	Modest Overweight	Increases in cash flow from higher-than-expected inflation is buffering rising interest rates. Investor appetite remains strong, particularly for energy transition investments and critical infrastructure sectors that generate stable, growing cash flows.

Alternatives

Sub-Asset Class	Maximum Underweight / Underweight / Neutral / Overweight / Maximum Overweight	
U.S. Dollar	Neutral	Relative growth differentials favor the U.S. economy and by extension the U.S. dollar. While U.S. growth may also decelerate, it is expected to remain stronger than in Canada or parts of Europe. This leaves room for relative strength in the U.S. Dollar.
Commodities (Gold, Energy, metals, agriculture, carbon)	Modest Overweight	Commodities can help to diversify portfolios as their returns have a low correlation to both stocks and bonds. Oil prices have become firm as producers remain disciplined. The copper price has rallied due to recent disruptions and downgrades to existing supply. A U.S. Federal Reserve shift to rate cuts would be supportive of gold.

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Market

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