TD Asset Management

Market Perspectives 10 Minutes

Market Perspectives
Q3 2023

TD Wealth Asset Allocation Committee (WAAC) Overview

- Our outlook for global equites remains cautious as corporate earnings continue to face headwinds as nominal growth slows. Over time, we expect higher-quality companies to overcome current headwinds, but we expect further market volatility to create better entry points. Despite the recent failure of three U.S. regional banks, we believe that the banking system overall is soundly capitalized, and liquid, and that the situation will stabilize.
- We maintain a maximum overweight to fixed income as yields across the asset class remain well above the lows of the past decade and offer attractive, risk-adjusted potential returns. We believe fixed income will outperform equities over the next 12 months. Bonds can also provide diversification benefits, reduce overall portfolio volatility and preserve capital.
- 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.
- We prefer allocating to fixed income versus cash and equivalents. While cash returns have become more attractive based on the current rate environment, fixed income total returns should outperform over next 12 months.

Quarter in Review

The global economy defied the odds and started 2023 with optimism, only to be hit by trouble in the U.S. banking sector. With financial markets on edge, expectations for the U.S. Federal Reserve ("Fed") funds rate recalibrated. This swapped one form of tightening for another, with tighter lending standards filtering throughout the economy. While the Fed chose not to raise rates in June, they affirmed their commitment to reducing inflation and suggested the possibility of further rate hikes this year if conditions do not improve. Developments in the labor market, where too much resilience is not necessarily a good thing with inflation far from the mark, may be a key factor in the Fed's decision making. The U.S. government was also able to reach an agreement on the debt ceiling over the quarter, which avoided the messy and uncharted waters of a default. However we could still see an impact in consumption and economic growth over the third quarter if we see an end to the moratorium on federal student loan repayments.

The Bank of Canada ("BoC") came off a pause and hiked interest rates by 25 basis points in June. The BoC stated that this was due to a stronger-than-expected first quarter, with housing market activity and services demand up, as well as broad-based consumption growth (even accounting for the boost from population gains). Inflation remains sticky and though full-time jobs numbers did contract for a second straight month in May, it may be too soon to be certain if this is a trend or just a small chip in an otherwise very tight labor market.

China's rebound, while strong in respect to consumer mobility and with PMI (Purchasing Manager's Index) activity reaching a ten year high, was still something of a disappointment and did not power global growth in the way that many were hoping it could. This was in part because we did not see the Chinese government stepping in with as significant a stimulus package as in the past. That said, in recent weeks we are seeing a slight shift in tone which could signal the potential for, if not modest support, then at least an increased level of attentiveness to consumer and business confidence.

Overall this quarter was characterized by dogged complexity in many leading market indicators. To help explore that complexity further the following section of this edition of Market Perspectives will highlight a number of scenarios for global economies and interest rates going forward, as well as offer our views on where the opportunities might arise.
For further insight into our views on key asset classes, as well as our strategic positioning outlook over the next 12-18 months, please review the WAAC Positioning and Outlook section of this report.

Chart 1: Global Equity Index Returns (Based in CAD)

Name	1M	3M	12M	3Y	5Y	10Y
S&P 500 Index (Large Cap)	2.06%	4.64%	20.87%	12.88%	12.06%	15.31%
S&P/TSX Composite Index	1.08%	-1.13%	8.00%	11.59%	7.14%	8.19%
MSCI EAFE Index (Europe, Australasia, Far East)	0.40%	-0.39%	21.01%	7.93%	4.73%	8.23%
MSCI Emerging Markets Index (Emerging Markets)	1.50%	-0.78%	5.42%	1.86%	1.50%	5.78%

Source: TD Asset Management Inc. ("TDAM"). As of June 30, 2023.

Global Interest Rates

From "lower for longer" to "higher for longer" and (eventually) back again?

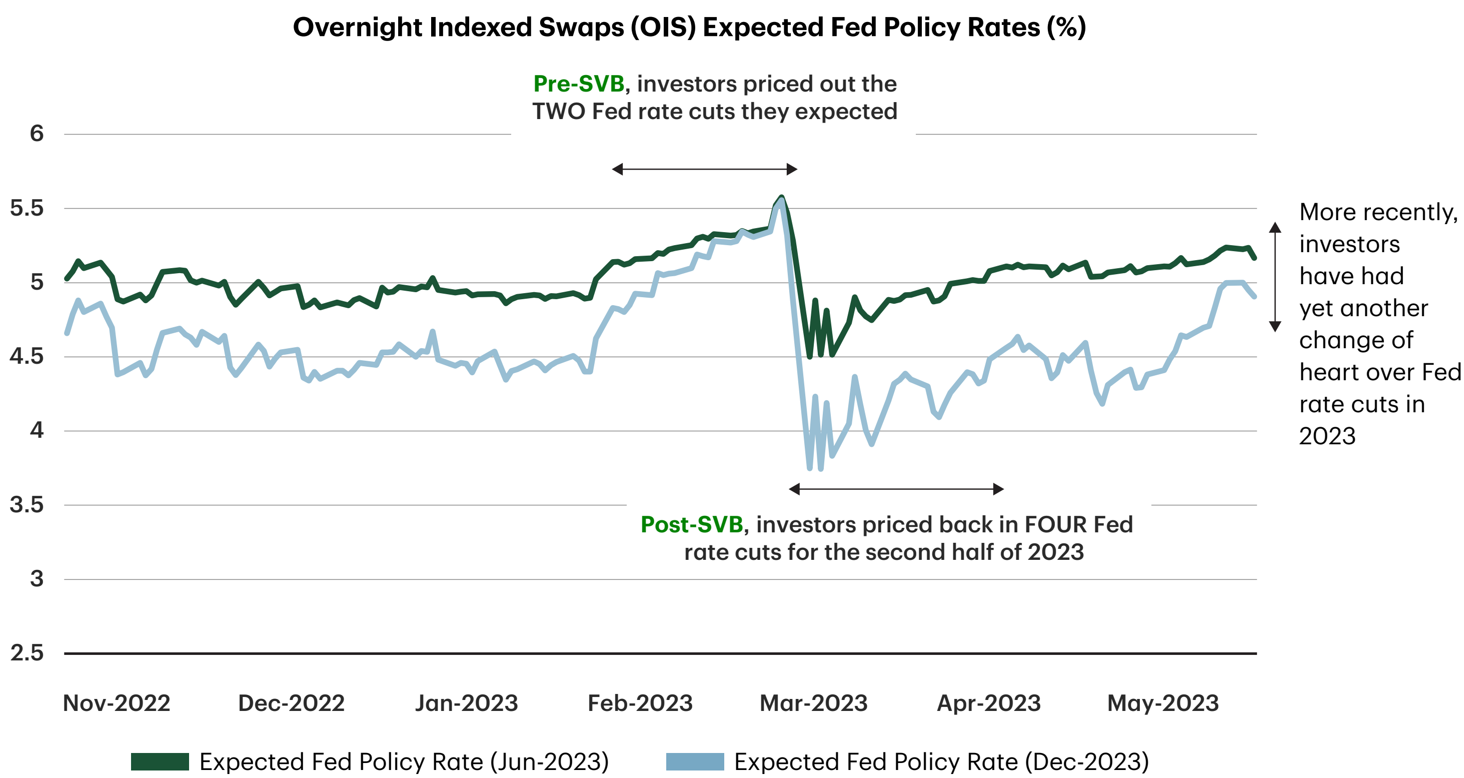
After one of the fastest global monetary policy tightening cycles on record, many global economies and, more importantly, labour markets, appear extremely resilient. Financial markets continue to march to the beat of their own drums as, broadly, financial conditions are looser today than they were in October 2022 when interest rates were at similar levels. As a result, most central banks continue to fret that inflation risks remain skewed to the upside. **Even central banks that have reached peak policy rate, which is the highest policy rate in a tightening cycle, have said that monetary policy easing is a long way away and that a pause could, in fact, be followed by more rate hikes.** Not what you wanted to hear? Don't worry; you are not alone.

Will we ever get back to target inflation?

The path from here seems long and winding, with a lot of uncertainty along the way. Up until this year, the bond market had expected the U.S. Federal Reserve ("Fed") to cut two times to a 4.5% policy rate by December 2023, after reaching a peak rate above 5% in June 2023. The Fed has consistently insisted that it would not cut rates this year, but the bond market ignored this message. With stellar jobs numbers in early 2023, however, investors had to concede that rate cuts may not happen until 2024. And, after several inflation releases showed "sticky inflation", investors began to worry that central banks may never again hit their 2% inflation targets and that we should instead brace for "higher for longer" rates.

Then, when Silicon Valley Bank (SVB) failed and Credit Suisse ran into governance-induced liquidity challenges, markets turned back to pricing in rate cuts for the second half of 2023 (specifically four cuts as seen in **Figure 1**). This was quickly followed up by some swift, policy-assisted regional bank takeovers, and as concerns over broader financial system contagion dissipated investors' heads were turned back by inflation that has defied expectations by normalizing at a "slower than expected" pace. If you are bewildered by these paradigm shifts around inflation and rates, just remember: "There is nothing either good or bad but thinking makes it so." Now replace "good or bad" with "lower or higher" and somehow, it all makes sense.

Figure 1: Expected Fed Policy Rates in June 2023 versus December 2023



Source: TDAM, Bloomberg Finance L.P. Data as of May 31, 2023. For Illustrative purposes only.

Today, investors are moving back to pricing out 2023 rate cuts as central banks continue to tighten monetary policy, albeit at a slower pace. Although the global financial system concerns that have emerged since March certainly add another layer of uncertainty around the future path of inflation, the continued tightening in global monetary policy may seem intuitive based on prevailing inflation levels. However, even before banking stresses came to the forefront, continued rate hikes were surprising when we consider that leading economic indicators having been signaling that a recession is coming. But is it?

The divergence between hard and soft data

Hard data shows that economic performance-to-date remains strong and continues to defy the gravity of the soft data, which shows that economic activity should contract in the future. Today's divergence between hard data, which includes metrics on employment and retail spending, and soft data, which includes financial market variables and survey-based business and consumer metrics, is at extreme levels. So, which set of data is right? **Will we finally realize the most anticipated recession ever? Or will we see financial markets and sentiment indicators rebound off low levels?** The answers to these questions will have massive implications for returns of all financial assets, but none more so than interest rates (yields on government bonds) due to the profoundly different monetary policy reactions we should expect depending on how the economy evolves from here.

Unfortunately, the extreme global disruptions since 2020 have made amateurs of even the most professional of forecasters: a massive build-up of excess savings for households and businesses thanks to wartime-like government stimulus, wildly oscillating demographic trends from rolling global lockdowns, labour retirements and resignations, and global supply chain disruptions. To this, we add overwhelming global challenges due to climate change, as well as the geopolitical conflicts between Russia-Ukraine and U.S.-China. These conflicts are no longer abstract thought exercises; they already have meaningful socioeconomic and policy implications. Now any of these socioeconomic or geopolitical issues alone could break the most robust of macroeconomic models. However, when they all occur simultaneously and we add financial system stresses, uncertainty is so high that models become less reliable. Instead, we have to rely on narratives to create a plausible distribution of expected returns for interest rates (government bonds).

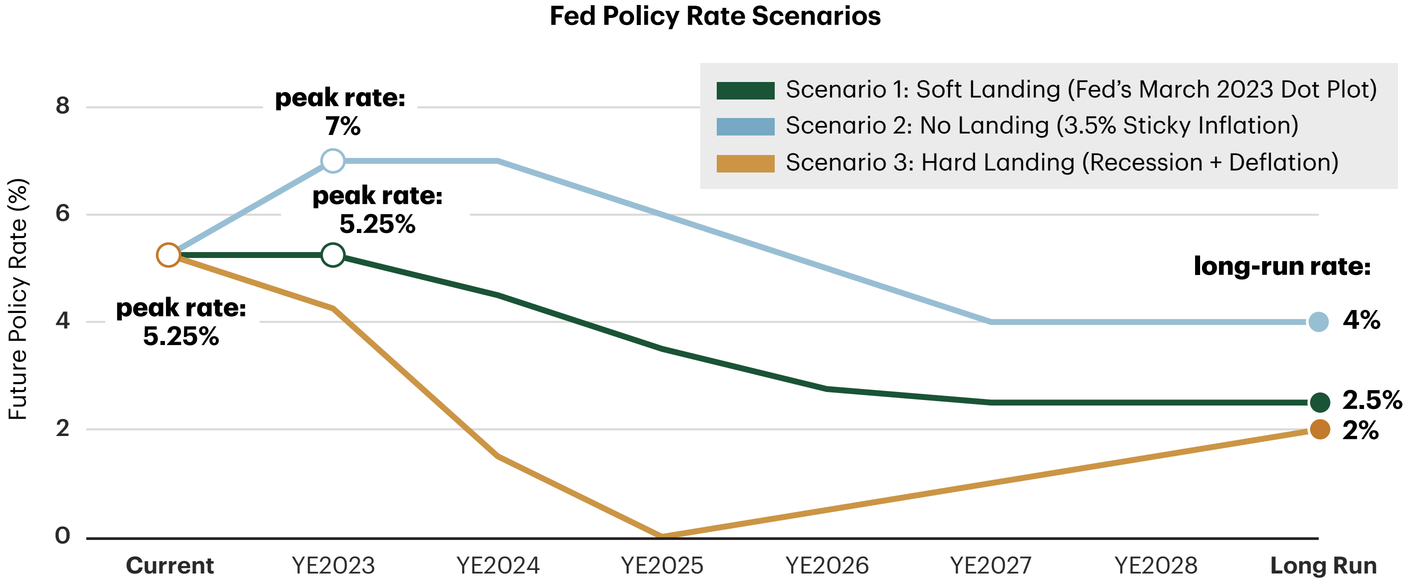
The significance of the new rate floor

When outlining the stages of the Fed's tightening cycle last year, Chairman Powell said there were three pivotal questions: how fast rate hikes would be delivered, where the Fed rate would peak, and how long it would remain at the peak. Unsurprisingly, investors continue to debate the latter two questions to this day. However, we believe that they should instead debate how low the policy rate will go once the cycle turns. And this was true even before we knew of U.S. regional banking stresses, which potentially indicate that the cycle is, in fact, already turning. Answering this question will matter a lot more in determining the present return potential of interest rates. Although, to be clear, this can only be said if we assume that we are closer to the end (or peak rate) of the hiking cycle than we are to the start or middle of it.

Fed policy rate scenarios

Interest rates have a number of complex risk factors that influence their returns; however, analyzing this asset class can be reduced to comparing longer-term rates to a compounded stream of short-term rates. That is, if you build a time series of where you believe the Fed policy rate will be in the future, you can calculate where bond yields should be today or in a year from now. When uncertainty is as high as it is currently, this exercise helps bring into focus what matters for the asset class and highlights potential returns even if we cannot confidently assign probabilities to the scenarios. In **Figure 2** below, we go through this exercise for three scenarios.

Figure 2: Three Scenarios for Fed Policy Rate Paths



Source: TD Asset Management Inc, Bloomberg Finance L.P. Data as of May 31, 2023.

1 **Scenario 1:** We assume the Fed's March 2023 economic projections are realized such that the policy rate remains at a peak of 5.25% for the remainder of 2023 and then is gradually reduced over the next few years to a long-run rate of 2.5% (median longer-term dot). **This is the soft landing scenario.**

2 **Scenario 2:** We assume that the Fed's 3.5% inflation forecast for the end of 2023 becomes sticky. That is, most of the disinflation occurs in 2023, but due to the overwhelming macroeconomic challenges in a geopolitically fragmented world, inflation cannot fall below 3.5%. **This is the no landing scenario.** Here, we assume the Fed hikes the policy rate to 7% over the next several months and keeps it there until the end of next year, but in time accepts 3.5% as its new inflation target and gradually normalizes the policy rate to 4% (just above its new 3.5% inflation target.)

3 **Scenario 3:** Something breaks in the economy and unemployment begins to rise very quickly. **This is the hard landing scenario.** As the economic contraction gains momentum and deflation appears, the Fed begins to cut the policy rate in the fourth quarter of 2023 and ultimately cuts to 0% by the end of 2025. Eventually, the policy rate gradually moves back up to 2%.

Drawing some conclusions

From Figures 3 and 4 below, we can draw several conclusions. First, significantly tighter monetary policy over several years, as per Scenario 2, can reduce interest rate returns due to price changes (i.e., capital loss). However, most of negative price impact is offset by income because government bonds now have meaningfully higher income than they did when the Fed started its rate hike cycle in the first half of 2022. This means that even if the Fed has to deliver more monetary policy tightening over the next 12 months, the distribution of government bond returns over the next 12 months is most likely positively skewed.

Furthermore, shorter 2-year and 5-year interest rates are greatly influenced by the peak policy rate, whereas longer 10-year and 30-year rates are anchored by the long-run Fed policy rate. This is extremely important because the interest rate sensitivity, which is known as duration, of most fixed income markets is very close to that of 10-year interest rates. **So, in order to assess the opportunity of investing in fixed income at this point in the cycle, we need to focus on where we think the Fed policy rate will be in the long run.** More specifically, we need to focus on how low we think the Fed will cut rates once the monetary policy easing cycle begins. Finally, and this is an extension of the second observation, any additional Fed policy rate hikes will simply further invert yield curves. Exhibit 3 shows that 2-year rates currently yield 0.75% more than 10-year rates. But in Scenario 2, where the peak policy rate is 7%, 2-year rates should yield 2% more than 10-year rates. This is noteworthy because the longer the yield curve remains inverted, the longer we expect credit conditions in the real economy to remain tight or tighten further, which would further stagnate or contract economic growth.

Figure 3: Expected Level of Interest Rates in 12 Months

Interest Rates	Current Yields	Expected Yields in 12 Months		
		Scenario 1	Scenario 2	Scenario 3
Peak Rate		5.25%	7%	5%
Long-Run Rate		2.5%	4%	2%
2-year	4.40%	4.0%	6.5%	0.7%
5-year	3.75%	2.9%	4.9%	0.9%
10-year	3.65%	2.7%	4.5%	1.5%
30-year	3.85%	2.5%	4.0%	1.9%

Source: TD Asset Management Inc, Bloomberg Finance L.P. Data as of May 31, 2023.

Figure 4: Hypothetical Government Bond Returns for the Next 12 Months Given Expected Yields in 12 Months

		Expected Yields in 12 Months		
		Scenario 1	Scenario 2	Scenario 3
2-year	Return Due to Price Changes	0.8%	-4.0%	6.9%
	Return Due to Income	4.2%	5.4%	2.6%
	Total Return	**5.0%**	**1.5%**	**9.5%**
5-year	Return Due to Price Changes	3.6%	-5.2%	12.6%
	Return Due to Income	3.3%	4.3%	2.3%
	Total Return	**7.0%**	**-0.8%**	**15.0%**
10-year	Return Due to Price Changes	7.6%	-6.8%	18.2%
	Return Due to Income	3.2%	4.1%	2.6%
	Total Return	**10.7%**	**-2.8%**	**20.7%**
30-year	Return Due to Price Changes	23.8%	-3.2%	34.7%
	Return Due to Income	3.2%	3.9%	2.9%
	Total Return	**27.0%**	**0.7%**	**37.5%**

Source: TD Asset Management Inc, Bloomberg Finance L.P. Data as of May 31, 2023.

The math highlights a compelling opportunity in the face of uncertainty

The math gives us comfort when so much uncertainty prevails, but how realistic are these scenarios and what do we actually expect to happen? Scenario 2 was designed to warrant extreme changes in the Fed's current monetary policy stance, but if this policy path were to come to pass, we expect that investors would respond more aggressively than what the math is showing in Figure 4. That is, we think that the yield curve would invert a lot more than what is shown in Figure 4. In fact, it is possible that long-term interest rates could even fall rather than rise from current levels. Why? Because in this scenario, investors will likely expect a very deep recession at some point in the future (a crash landing). As debt levels have continued to grow over the years, even the current 5.25% policy rate will seriously challenge debt sustainability in time, notwithstanding a 7% policy rate. This would be true for consumers, households, businesses and governments alike. Furthermore, greater yield curve inversion further pressures banking profitability, which, in turn, further tightens credit and lending conditions in the real economy. The harder or more expensive it is for the economy to access credit, the greater the likelihood that economic growth stalls or contracts. So, if the Fed is required to raise rates meaningfully above its current 5.25% policy rate, as per Scenario 2, investors will likely respond to a higher Fed peak rate by pricing a much lower long-run rate than the 4% that we have assumed for the scenario. As we have shown, a lower long-run rate should translate into lower 10-year and 30-year interest rates and, therefore, higher total returns than what we have calculated for Scenario 2.

Furthermore, in Scenario 3, we do not expect the Fed will cut the policy rate back to 0% so soon after the biggest inflationary episode in decades. They have repeatedly stated that history has taught them not to cut rates too soon or too low, as inflation can come in waves. We believe this stance is justified as we expect a greater level of volatility around inflation in the coming years than what we experienced in the years preceding the pandemic. **Inflation is never a straight line up and the opposite is also true: disinflation is never a straight line down. Patience and persistence in the monetary policy stance will be required.** However, should the Fed ignore history and slash the policy rate back to 0% in the next 12 to 24 months, we would worry that market-based inflation expectations will rise. We expect that this would put a floor under interest rates such that they would fall less than what we have calculated for Scenario 3 and, therefore, total returns would be lower than what we see in Figure 4.

While we acknowledge that inflation is proving to be stickier than we previously expected, in part because consumption in the economy has demonstrated greater resilience to higher interest rates we do believe that the current level of rates is restrictive for the real economy over the longer run. And despite the resilience, we can already see that growth is decelerating, which suggests that soft data has been a reliable predictor of the direction of travel for the economy. Worse still, soft data continues to point to weak or negative growth in the coming months and quarters. Therefore, even if inflation remains sticky around 3.5%, we do not expect that the Fed will respond by hiking the policy rate to 7%. Overall, this thought exercise highlights that regardless of how we assign probabilities across different monetary policy paths, we expect a positive skew in total returns for interest rates over the next 12 months. **In the face of so much uncertainty, this opportunity in government bonds is as compelling as it can possibly be.**

Opportunity

WAAC Positioning And Outlook

Asset Class Assumptions

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

Equities — Modest Underweight Overall

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

Canadian Equities: The full effect of higher rates on the consumer and real estate market remains to be seen. As such, we anticipate that the Canadian economy will slow in 2023. However, strong free cash flows within the Energy sector, and relatively inexpensive Financials stocks, may present attractive opportunities.

U.S. Equities: We remain concerned that U.S. earnings growth could be challenged as U.S. Federal Reserve rate hikes slow economic growth. The year-to-date returns on U.S. equities have been led by a few mega cap stocks. Valuations for the rest of the U.S. equity market are reasonable, which offers some potential support for the stock market, even in a modest economic slowdown.

International Equities: International equity markets have rebounded strongly since the fall of 2022. International stocks face similar concerns regarding corporate profits, rising rates, and slowing macroeconomic conditions. Given this view, we feel that further gains will be more limited.

Chinese Equities: As China resumes its reopening plan, we expect to see an increase in demand for travel and leisure, luxury goods as well as energy and commodities. China is focused on economic growth this year and appears to be looking to implement modest stimulus measures. We believe global supply chains will return to some sense of normalcy. Chinese equities could see relative outperformance over the next 12-18 months.

Emerging Markets ex. China: Emerging markets equities continue to be challenged by persistently high inflation, concerns over global central bank monetary tightening, and the prospect of recession in many western economies. Our outlook for emerging markets remains cautious while recognizing that low relative valuations may provide a good entry point in the coming months.

Fixed Income — Maximum Overweight Overall

	Maximum Underweight	Modest Underweight	Neutral	Modest Overweight	Maximum Overweight
Investment Grade Corporate Bonds			●		
High Yield Credit		●			
Domestic Government Bonds				●	
Global Bonds — Developed Markets			●		
Global Bonds — Emerging Markets			●		

Investment Grade Corporate Bonds: With the stress experienced in the banking sector, investment grade credit spreads have become more attractive across Canada, the U.S., and Europe. We see compelling investment opportunities for lower duration (5-years and shorter) corporate bonds given appealing all-in yields but remain more cautious on longer duration corporate bonds given the continued uncertainty around the global economic backdrop.

High Yield Credit: Higher interest rates and a deteriorating economic backdrop will likely cause default rates for high yield bonds to rise from currently low levels. Corporate earnings will likely continue to be under pressure in the near term, eroding credit fundamentals. This could result in further volatility and downside risk for credit spreads, despite the high potential returns in the sector.

Domestic Government Bonds: Given the Bank of Canada's (BoC) recent decision to tighten monetary policy further, Canadian government bonds have underperformed global peers. However, despite the fact that government bond yields are now higher than they were at the start of this year, the income return they have generated has more than offset the negative price return. In other words, nominal total returns for government bonds remain positive. Better than expected economic data may have compelled the BoC to come off pause, however, the momentum in economic data is slowing. Therefore, over the longer term, government bonds continue to remain appealing due to their potential to generate positive nominal returns.

Developed Markets Bonds: Amidst stronger than expected inflation data, central banks continue to tighten monetary policy. Although investor expectations for rate cuts by the end of the year have moderated, investors continue to expect global monetary policy to shift into easing mode within the next two to three quarters.

Emerging Market Bonds: The dispersion of returns within emerging markets has presented some opportunities. We are comfortable maintaining a neutral outlook as yields are attractive in some regions where central banks have proactively hiked interest rates, while bond returns will likely decline in other regions where central banks are still early in normalizing monetary policy.

Alternatives/Real Assets — Neutral Overall

	Maximum Underweight	Modest Underweight	Neutral	Modest Overweight	Maximum Overweight
Domestic Real Estate	●				
Global Real Estate	●				
Commercial Mortgages					●
Private Debt (Universe)				●	
Infrastructure				●	

Domestic Real Estate: Canada's growing demographic profile continues to be supportive of domestic real estate, particularly multi-unit residential. Office properties continue to experience leasing and valuation headwinds and a flight to quality, while fundamentals remain sound across the other property types.

Global Real Estate: We believe that high quality assets, with low leverage and portfolios that are globally diversified, should outperform in the current environment. Office fundamentals are stronger in the Asia Pacific than in North America. Multi-unit residential, alternative real estate and a tilt to Asia Pacific can provide global real estate portfolios with enhanced risk adjusted returns.

Commercial Mortgages: Commercial mortgages continue to provide accretive income while insulating investor returns from the increased volatility in interest rates.

Private Debt: High credit quality and global diversification provides safety in a potentially recessionary environment. Incremental income and potential capital appreciation from interest rate moderation provide upside.

Infrastructure: 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

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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