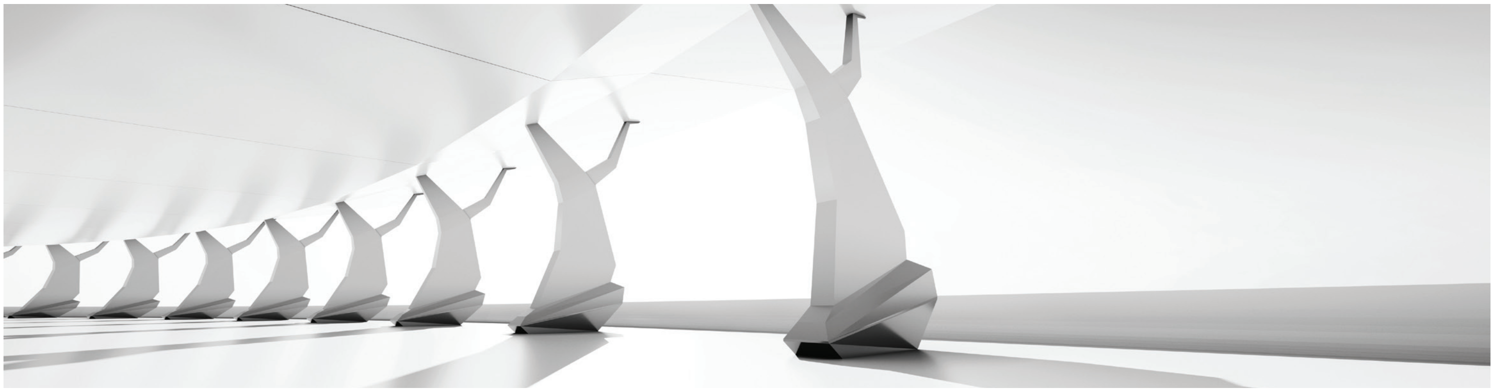
TD Wealth

Straight Forward

Winter 2017



Market outlook: the year ahead

Bruce Cooper, Chief Investment Officer, TD Asset Management Inc. and Senior Vice President, TD Bank Group

As we transition from 2016 to 2017, all eyes will be on Washington, where the transfer of power from Democrats to Republicans will take place. Donald Trump's election victory reflects a dissatisfaction with the current state of affairs, which we also witnessed with Brexit and the recent Italian referendum. The TD Wealth Asset Allocation Committee ("we") believes this rejection of the status quo will continue in 2017, particularly in Europe, and it may fuel further bouts of volatility.

Once he takes office, Mr. Trump plans to implement ambitious fiscal stimulus and tax reduction policies. These are expected to accelerate economic growth in the U.S., setting it apart from other developed markets, where growth is being restrained by elevated debt levels and demographics. We believe the move toward fiscal stimulus will be necessary elsewhere as well. The effectiveness of monetary policy appears to have peaked, meaning governments will need to reduce their reliance on it and instead embrace some of the fiscal policy tools available to them as they attempt to spark growth and inflation.

Broadly, increased growth and inflation bode well for U.S. equities, but they are likely to be headwinds for North American and global bonds as they may spur yields modestly higher. As a result, we are overweight U.S. equities and underweight bonds. Given the potential for volatility and the wide range of possible economic and market outcomes globally, we are also overweight cash as it provides stability and offers flexibility to take advantage of opportunities as they arise.

The following is our current positioning and some of our broad thoughts on what may unfold in financial markets during 2017.

Equities

We are overweight U.S. equities as stronger economic growth and higher inflation should be beneficial for revenue growth and the proposed corporate tax cuts would provide a meaningful boost to corporate earnings. The repatriation of offshore profits should also be a positive and may lead to shareholder friendly activities such as share buybacks and special dividends. Sectors that stand to benefit notably from Mr. Trump's proposed legislative changes include industrials, financials, consumer discretionary and information technology. While valuations are on the high side of fair from a historical perspective, we believe they are sustainable. We continue to prefer high quality dividend paying equities that offer a stable, gradually rising stream of income.

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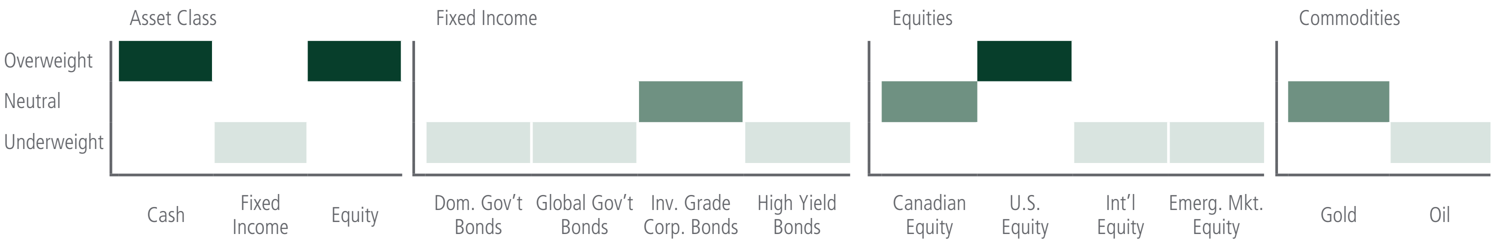
TD Wealth Asset Allocation Committee

Market outlook: the year ahead (cont'd)

Bruce Cooper, Chief Investment Officer, TD Asset Management Inc. and Senior Vice President, TD Bank Group

Asset Allocation Summary



Source: TD Wealth Asset Allocation Committee. For illustrative purposes only.

We are neutral Canadian equities, which are generally fairly valued, particularly after their strong run in 2016. A number of Canadian companies should benefit from the strengthening U.S. economy, and the industrials and financials sectors in particular are likely to benefit from Mr. Trump's policies. However, weak commodity prices are depressing earnings and with Canadian economic growth and inflation expected to remain modest, Canadian equities are likely to underperform their U.S. counterparts in 2017.

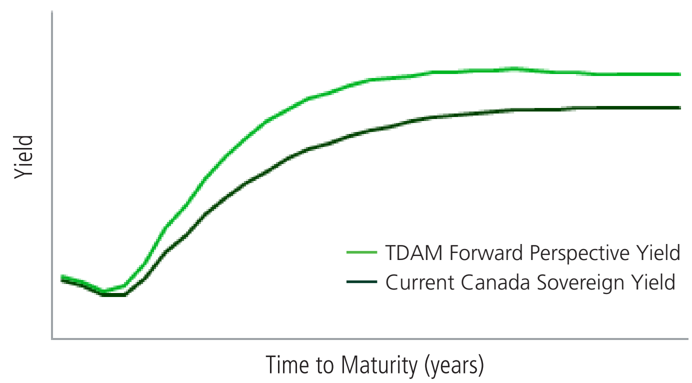
Equities in some European regions are attractively valued, but overall there are a number of threats to corporate earnings, including persistently low growth and inflation and stubbornly high unemployment. In addition, growing political uncertainty and doubt about the future of the euro all heighten risk, leading us to be underweight international equities. We are also underweight emerging markets as broad pockets of stress are evident due to high debt levels and slowing growth, and a strengthening U.S. dollar may increase risk.

Fixed Income

We remain overweight cash, which should provide stability in times of increased volatility. Domestic government bonds can also offer stability and they provide diversification benefits, but we are underweight the asset class as overall returns are expected to be low. Our neutral weighting in investment grade corporate bonds is based on the incremental yield advantage they offer over governments. We remain underweight high yield bonds as spreads are tight, and we are maximum underweight global government bonds as very low real and nominal yields make the risk/reward relationship unattractive.

Broadly, we believe the Bank of Canada will hold its key rate steady for some time to come, and while the U.S. Federal Reserve may increase the federal funds rate very modestly over 2017, we expect it to remain low both in real terms and from a historical perspective. This is likely to keep short-term rates anchored, but U.S. fiscal stimulus may push longer-term yields modestly higher as they are more sensitive to changes in economic growth and inflation. This creates what is known as a bear-steepener scenario, depicted in figure 1, which could lead to negative returns from some bonds.

Figure 1: Expected Yield Curve Movement



Source: TD Asset Management Inc. (TDAM). For illustrative purposes only.

Canadian/foreign currency exposure

We expect the Canadian dollar to remain low for an extended period. Conversely, higher growth and inflation in the U.S. combined with benefits from the repatriation of overseas assets should all drive the U.S. dollar higher relative to other global currencies. We believe the Canadian dollar will underperform the strengthening U.S. dollar.

Commodities

We believe an allocation to gold may provide insurance against the risk of extreme outcomes, and there are still meaningful risks globally. Our neutral weighting is a reflection of our optimism about U.S. equities and the potential for higher economic growth and inflation in the U.S.

Oil inventories remain high, and Mr. Trump's policies are likely to increase supply, which will restrain the price. While the recent OPEC deal appears to be a positive step, compliance with these quota agreements has been an issue in the past, and it is unclear whether this one will have a meaningful impact on inventory levels.

TD Economics

A foundation for uncertain times

Beata Caranci, Vice President and Chief Economist, TD Economics

There is no shortage of possible market-altering events on deck for 2017—from upcoming elections in Europe to Brexit negotiations to China's ongoing reform of its economy…and lest we forget the new kid on the block, U.S. policy under a new administration. The band of uncertainty around possible economic and financial outcomes has widened, but the world has not changed fundamentally. Here are five key macro themes to keep in mind for the new year:

Searching for growth

The post-crisis cyclical slowdown has been supplanted by a structural slowdown reflective of an aging population, slowing labour supply and disappointing productivity trends around the world. In other words, don't expect it to lift anytime soon. Canada has compounded the growth challenge with overheated housing markets and high household debt. Recent regulatory measures and an uptick in mortgage rates should help moderate the housing market. But this will leave the economy hard-pressed to reach outside of a 1.5-2.0% growth range in real terms on a sustainable basis, for the foreseeable future. These influences anchor the view that the Bank of Canada will be in no rush to raise rates, irrespective of the tactic taken by the U.S. Federal Reserve.

The pivot from monetary to fiscal policy

Central banks were the first line of attack to prop up growth and financial markets around the world, but that baton is increasingly being passed to government authorities. Structural rigidities in an economy require economic reforms to provide a longer term productivity bump. For the most part, this pivot will continue to occur gradually and highly accommodative monetary policy will remain in place within most countries, including Canada. But, there are exceptions to every rule. The U.S. was already on a path to tighten monetary policy in response to improving economic fundamentals, and there is a risk that the anticipated fiscal boost from the new administration may accelerate this pace. We think this is more likely to be a 2018 story, than 2017. There's no doubt that the incoming President will immediately work with Congress to implement an agenda of tax reform, infrastructure spending and deregulation. However, nothing is a slam dunk and some of this stimulus will necessarily require an offset in order to avoid an explosion in government expenditures. In addition, the pass-through of fiscal policy into economic impacts embeds lags. The implication being that U.S. interest rates will continue to rise at a measured pace. We are skeptical that fiscal policy will be a catalyst for dramatic moves by the U.S. Federal Reserve in 2017, particularly when benchmarked against the persistent potential for global event risk.

Higher yields, but not high yields

The Republican sweep of the U.S. chambers of government saw the 10-year Treasury yield jump from roughly 1.85% to 2.35% in the span of seven trading days. Entrenched market expectations for significant fiscal stimulus and the risk of higher government debt levels galvanize an upward trend that actually took root over the summer months. Investors around the globe were already stepping back from the notion that central banks would pursue additional aggressive monetary policy decisions. A higher global yield environment should persist in 2017, and the Canadian bond market will take its cue from U.S. movements. But, we are cautious in building too much upside to yields in the near term, as this would risk undermining the still-fragile state of the global economy, and Canada is certainly no exception.

U.S. dollar to dominate

Everything is relative, and with the U.S. likely to maintain a comparative advantage with higher yields and stronger economic growth, investor appetite for U.S. assets should remain strong. Even if U.S. 10-year yields stay comfortably below the 3% level recorded during the peak of the taper tantrum in 2013, those yields still offer a hefty premium against similar investments in Europe and Japan. The attractive fundamentals will keep the greenback supported at 13-year highs in 2017. Downside risks remain significant for the Canadian dollar. The loonie could fall to US$0.72 or lower if Canada is hit by the crossfire of a U.S. administration erecting trade barriers or intensifying threats that discourage trade flows. However, it's important to bear in mind that the loonie will also reflect dynamics occurring in the oil market, which offers a counterweight to any downside that materializes on the former. Hopes of supply reduction under the recent OPEC agreement should support oil prices in a US$50-$60 range.

Volatility remains the name of the game

It is a good bet that it will not be smooth sailing throughout 2017. Political event risk will remain at the forefront, particularly if negative U.S. rhetoric on immigration and trade turns into action. Meanwhile, a number of key elections (Germany, France, Norway, Netherlands) will be taking place, and now Italy is back on the table. Outcomes will further test the recent groundswell of populism that could heighten worries around the sustainability of the euro. Outside the political sphere, there are plenty of economic and financial triggers that can occur, including ongoing concern around Italy's banking sector. China's restructuring challenge and elevated debt in emerging markets both have the capacity to trigger volatility through a disorderly unwinding and sharp capital outflows.

TD Wealth

New principal residence exemption rules

Wealth Advisory Services, TD Wealth

Recent proposed tax measures announced in October 2016 by federal Finance Minister Bill Morneau, along with new administrative policies adopted by the Canada Revenue Agency (CRA), may have material implications for Canadian homeowners, non-residents immigrating to Canada, and trusts holding a principal residence as trust property.

What has changed?

1) More stringent tax reporting rules for individual homeowners

Starting in 2016, individuals must report the disposition (or deemed disposition) of their principal residence on Schedule 3 of their T1 Income Tax and Benefit Return for the year of disposition. Prior to the announcement, the CRA did not administratively require any tax reporting if an individual taxpayer was able to claim a full principal residence exemption to offset any capital gain arising on the disposition. Under the CRA's new administrative position, if the property was the individual taxpayer's principal residence for all years of ownership, the individual taxpayer would make a principal residence designation directly on Schedule 3, Capital Gains (or Losses). Otherwise, where an individual taxpayer is not able to designate a property as a principal residence for each year of ownership, the taxpayer would be required to file a prescribed form and report any capital gains on Schedule 3.

The new rules allow an individual taxpayer to file a late principal residence designation by paying a penalty of $100 for each complete month during the late period (up to a maximum of $8,000). Where a taxpayer amends a return to report a disposition of real property, the CRA may assess or reassess the return within three years of the date of filing of the amendment. The changes also allow the CRA to reassess outside of the normal reassessment period (generally, three years for individual taxpayers) if the taxpayer does not report the disposition of real property in the year disposed. Failure to report any real estate disposition, including a principal residence disposition, would expose a taxpayer to a reassessment indefinitely. In general, homeowners would be well-advised to maintain proper records to substantiate the adjusted cost base of their properties. The adjusted cost base includes the purchase price as well as any capital expenditures such as renovation costs to the properties. This is especially important given the reporting that is now required on the sale of a principal residence.

2) Changes to the principal residence exemption formula available to non-resident purchasers of Canadian real estate

An individual homeowner must be a Canadian resident in a particular year to claim the principal residence exemption for that year. The formula for calculating the exemption allows an extra year of exemption to accommodate homeowners who sell a property and buy a replacement property in the same year. Under the proposed amendments, for dispositions occurring after October 2, 2016, a purchaser who was a non-resident of Canada throughout the year in which the property was acquired will no longer be entitled to the additional year of exemption.

3) Limitation on which trusts qualify for the principal residence exemption

A trust must qualify as an "eligible trust" in order to designate a property as a principal residence after 2016. Eligible trusts include alter ego trusts, spousal and common-law partner trusts, joint spousal and common-law partner trusts, qualified disability trusts and certain testamentary trusts set up for minor children. Where a trust owns a property at the end of 2016, but is not able to make a principal residence designation after 2016 because it no longer qualifies as an eligible trust, a special transitional rule will allow the non-qualifying trust to claim the principal residence exemption to shelter accrued capital gains up to the end of 2016. The post-2016 accrued gains (if any) would be taxable to non-qualifying trusts on the disposition of the property.

In light of these changes, you are encouraged to speak with your tax advisor about how they may impact you.

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