



The Great Wide Open

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The Great Wide Open

Today, investors are like pilots. In the same way that pilots rely on numerous gauges and instruments to keep themselves in the air, investors rely on numerous data points to plot the path ahead, as well as the “altitude” of the business cycle and the direction the winds are blowing. Those indicators are harder to read today than they have been in a long time, with ongoing wars in the Middle East and Europe; the momentous elections looming around the world; and the rise of artificial intelligence.

Amid all this turbulence, what's remarkable is that financial markets remain calm, at least in the short to medium term. We're headed into "the great wide open," where the range of outcomes are numerous indeed — great opportunities but a lot of challenges, too. This makes it exceedingly difficult for investors to remain focused on their goals and objectives. In addition to the regular challenges we face during an economic transition, we're now faced with elevated geopolitical risks and the long-term consequences of deglobalization.

Whatever comes at us, we will continue to be committed to enhanced diversification, by building and managing portfolios that blend the best of traditional and alternative asset classes. We like to always remind ourselves that a good investment strategy is low conviction over the short term and high conviction over the long term. You just need to file the flight plan, adapt as the future unfolds, keep your seatbelt buckled ... and stick the landing.

Be well,

A handwritten signature in black ink, appearing to read 'Brad Simpson'.

Brad Simpson
Chief Wealth Strategist, TD Wealth

Cracking Complexity

Complexity

Stay buckled in

With U.S. inflation falling, GDP growth slowing and unemployment still below 4.1%, the Fed has forecasted an almost perfect soft landing. However, the full impact of the rate hikes is yet to be felt.

Can profits keep up?

Last year, the forward P/E ratio of the S&P 500 rose from 17.6x to 20X, accounting for all gains. Clearly, investors are expecting rapid earnings growth in 2024. Profit margins are expected to widen, but maybe not enough to account for slower revenue growth as the economy slows.

Bearish hedging

Bets against the current equity rally have been increasing. The top 10 options contracts for the SPDR S&P 500 ETF, as of January 19, are all put options with a total amount equal to 161% of the ETF's 30-day average daily volume. Strike prices are about 20% below the current price and expiration dates are mostly one or two months out.

Canada, attractive but narrow

While the multiple for the S&P/TSX Composite has also expanded, it remains attractive relative to historical levels. However, a discount to the U.S. is warranted given the dearth of technology stocks and more narrow stock market, with a concentration in energy, materials and financials. At the same time, the macroeconomic outlook for Canada is also less appealing, which may be another headwind to earnings growth for Canadian equities.

Lower growth = lower yields

Jobs and GDP data for the second half of 2023 have been downwardly revised, which bodes ill for equities, but the opposite is true for bonds. We anticipate four rate cuts this year, which would likely push yields lower and lift bond prices.

Powder galore

Total assets sitting in U.S. money-market funds hit a historic high of \$5.9 trillion at the end of 2023. As the Fed starts to cut rates, this pile of cash will look for greener pastures. Private-asset funds, meanwhile, are sitting on over \$2.3 trillion of dry powder — the highest the sector has ever seen.

1.25 million > 300,000

Canada is expected to see population growth of 1.25 million this year with less than 300,000 new housing completions. That will increase pent-up demand. We're forecasting single-digit growth for home prices this year, but it could be more than that.

30% > 42 years

Rapid rate hikes have lifted mortgage costs a whopping 30% this year. That blows past the previous y/y record of 25.4% in 1982, when the policy rate hit a high of 21%. Rents have also risen rapidly as a result.

Adaptation

Foursquare

There are four basic economic environments: rising growth, falling growth, rising inflation and falling inflation. Markets react as economies shift from one to another, but transitions are unpredictable and can be fraught. We don't predict the future, we invest in all four areas.

High-odds Proposition

Over the long term, it's been almost impossible to lose money on the broad market. The probability of making at least some money on the S&P 500 over a five-year period is 85%; over a 20-year period it's 100%.

Process Over Prediction

We manage investments based on a guiding set of principles designed to work in a world that's constantly changing. We focus on investor's goals and true diversification. We build resilient portfolios that aim to perform regardless of the environment.

Tactics on the Margins

Tactical or dynamic shifts should only be made at the margin, in an intentional and risk-controlled manner. Strategic asset allocation remains the principal driver of portfolio performance and is paramount in helping investors achieve their objectives.

True Diversification

To prosper in this new world, investors need a contemporary portfolio approach with true diversification, balancing: (1) broad asset allocation and (2) risk-factor diversification with (3) a deep understanding of financial behaviour.

Be Compensated

The goal of factor diversification is to reduce unintended risk exposures and target exposure to compensated factors while minimizing exposure to uncompensated factors.

Remember the 10/10/10 Rule

How are you likely to feel about this in 10 minutes vs. 10 months vs. 10 years? Be patient. There's a reason it's considered a virtue.

7 Years Bad Luck

Markets are awful at predicting central bank decisions. In 2008, investors were bracing for hikes, which didn't actually occur until seven years later. Then, in 2015, they vastly underestimated the speed of those hikes. Bottom line: The Fed responds to data, not sentiment.



PSQ1.2024 | Executive Summary

■ **House Views | Fixed Income, modest overweight:** As the normalization of inflation appears to be slowing alongside waning economic growth, the Bank of Canada continues to debate the need to maintain tight monetary policy and to reinforce its higher-for-longer policy-rate path. On the flip side, this may also imply higher-for-longer income returns within the asset class. We continue to believe that fixed income will outperform equities over the next 12 months and that bonds can still provide diversification benefits, reduce overall portfolio volatility and preserve capital. ● **Equity, neutral:** We believe that the equity market has a balanced return outlook. Earnings growth has been challenged year-over-year, but we believe that it is now starting to stabilize and show signs of positive momentum. Valuations in many geographies are reasonable, with the U.S. commanding a premium largely due to its exposure to higher-growth technology companies. ● **Alternatives, neutral:** 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.

■ **Quarter in Review |** Investors rushed back in to Treasuries in late October, prompting yields to fall and mega-cap growth names to rise. Lower real yields pushed gold to historic highs. ● **Yield environment lifts all boats.** In the U.S., the economy grew 4.9% in Q3, exceeding expectations. The Canadian economy, on the other hand, experienced a modest contraction of 0.3%. Improving inflation numbers are giving policymakers reason to soften their rhetoric. ● **Anomalies in the goldilocks scenario.** Commodities underperformed due to falling oil prices, despite a rise in base and precious metals. Another anomaly during the quarter was the stubbornly positive correlation between equities and bonds, due to the focus investors have put on the direction of interest rates. ● **A lot of dry powder.** Higher rates are enticing investors to move money into more conservative vehicles. Total assets sitting in U.S. money-market funds hit a historic high of \$5.9 trillion at the end of 2023. In addition, private-asset funds are sitting on over \$2.3 trillion of dry powder — the highest ever. ● **Geopolitics poses significant risk.** The biggest risk on the geopolitical front was the breakout of the Israel-Hamas war, which is a catalyst that could destabilize the entire region. Markets were also bracing for Taiwan's presidential election, on January 13. (The race was won by the incumbent vice-president, Lai Ching-te, who is favoured by Taiwanese nationalists.)

■ **Economy |** The Bank of Canada is expected to start cutting its policy rate this spring, despite inflation remaining above the target, and shelter inflation likely still running hot. This will create a communication challenge in anchoring household inflation expectations, which are already elevated and tend to overweight housing cost pressures. There is already evidence that the inflation-cooling process is widening to more products. The share of products where inflation is less than 3% has grown, and the share in outright deflation territory is also on the high side relative to the pre-pandemic period. The Bank of Canada will need to convincingly pivot its public communication to emphasize that shelter costs do not define broader inflation trends in Canada. To neglect to do so runs the risk of leaving rates too high for too long and sacrificing too much economic growth. At the same time, the central bank will have to trade off this risk with the risk that persistent growth in shelter costs limits its ability to re-anchor consumer inflation expectations.

■ **Fixed Income |** Calling 2023 challenging would be an understatement, but it looks like the worst is behind us. It likely will not be a smooth ride, but fixed income stands to benefit from an attractive longer-term outlook — set in motion by yields near two-decade highs — that comes with the price tag of shorter-term volatility. Fixed income should flourish at current yields. Returns may be volatile over the short term but will accrue for those with longer time horizons. ● **We remain modest overweight fixed income investments in general and modest overweight domestic government bonds.** Canadian and U.S. government bonds are attractive at current yields and offer opportunities for income generation and downside protection. Despite volatility in 2023, it was still a good year for bond investors and the future looks promising. We expect price/yield volatility to decline in coming quarters as the severity of economic slowdown becomes clearer and market participants stop second-guessing the timing and the size of policy rate cuts. ● **We remain neutral investment-grade credit.** We expect the challenging economic conditions to widen spreads (which indicates the market is pricing in more risk) but not to the same extent as past recessionary levels.

We prefer to focus on high-quality credit — companies with robust balance sheets — and we expect technicals to remain supportive and healthy yields to mitigate losses from price volatility. ● **We maintain our modest underweight view on high-yield credit.** High-yield credit performed well in general last year, but we don't expect

this to continue. The HY credit market has seen an overall improvement in quality. This should keep spreads from returning to previous recessionary levels, although they will widen if the growth outlook deteriorates.

■ **Equities** | Many of the weakest performers of 2022 had strong performances in 2023. If we start to see the broader economy weaken, we could see investment flows rotate from cyclical and growth sectors like information technology — which has become fundamentally expensive and technically overbought — into health care, staples and other defensive sectors. However, we are in an environment where there is a wide range of outcomes, as such we are inclined to take a cautious approach. ● **United States:** Slowing top-line growth, margin expansion. For the U.S. equity index, the gains in 2023 can be attributed to heightened risk sentiment, with the forward P/E ratio of the S&P 500 rising from 17.6x to slightly above 20x. We believe the potential for further multiple expansion this year is limited. History shows that it is too early to be “all-in” and take an aggressive stance on equities, given that the bulk of the lagged impact of monetary-policy tightening is still ahead. In the current environment, we favour overlooked stocks in the consumer staples, health-care and utilities sectors. At the same time, while the risk/reward profile of growth stocks has deteriorated given the significant rally in 2023, there is a fundamental reason for the strong performance; they are the most levered to AI, and they generate strong earnings growth and cash flow. As such, we continue to maintain a barbell approach to equities exposure. ● **Canada:** Tech-starved but affordable. Similar to the U.S. experience, there has been an increase in sentiment ascribed to the index. That said, Canadian equity valuations are not as rich as those in the U.S. reflecting the dearth of technology growth leaders. For the near term, we are staying balanced — employing a “barbell” approach that holds quality growth names on one side and, on the opposite, defensive income-focused companies. ● **International and EM:** Poised for a rebound? The dramatic correction in earnings across developing countries could mean their economies will also be first into the new business cycle, with the potential for faster earnings growth. International and EM equity valuations are attractive after underperforming through 2023, which could lead to attractive returns as central banks across the world shift towards looser monetary policy. However, it's important to watch corporate earnings trends as many regions continue to face macro-economic headwinds.

■ **Alternatives** | TD Wealth maintains a neutral weight on alternative assets. ● **Private debt, modest overweight:** We expect varying performance across private-credit strategies. Most private credit lenders today are hunting for recession-agnostic businesses, namely within the health-care, business-services and enterprise-software sectors. Meanwhile, private-equity sponsors are sitting on record amounts of dry powder and are eager to use it after a difficult year. ● **Infrastructure, modest overweight:** The energy transition and expansion of digital infrastructure should support infrastructure investment in the decades ahead. Supply chains are also being decoupled and rewired as geopolitical fragmentation accelerates, driving fresh investment in key logistics infrastructure. ● **Domestic real estate, maximum underweight; global real estate, modest underweight:** Commercial real estate fundamentals remain under pressure from lofty interest rates, tighter lending conditions, muted transaction markets, escalating refinancing risks and macroeconomic challenges. We expect demand for industrial and data centre real estate to grow in 2024. On the other hand, retail and office real estate fundamentals aren't expected to fare as well in 2024 and will likely remain under pressure from muted demand and limited rent growth.

■ **Currencies** | TD Securities has seen its global growth indicators improve for 2024, suggesting further downside for the U.S. dollar. Geopolitics, however, will feature heavily in the market calendar. ● **USD:** The U.S. slowdown is now gathering a bit more steam. Credit and labour markets will be two key indicators to watch. TDSI believes a repricing in line with more aggressive rate-cut expectations will bring USD weakness in the medium term. ● **Best of the rest:** Housing dynamics suggest that the loonie is vulnerable; however, CAD may appreciate into next year relative to the USD. The yen is the top-ranked currency in the G10 by a wide margin.

■ **Commodities** | Commodity prices lagged in 2023. This year should be better as we move through the investment phase of the commodity cycle — characterized by tight inventories, a challenged supply outlook and growing demand. ● **Energy:** While oil demand increased, the supply side surprised bearishly. Consensus expectations for 2024 imply a small aggregate build in inventories, but tight inventories should support prices. Further, geopolitical risk is only ratcheting higher. ● **Metals:** Inventories for many base metals are at or near record lows. Uncertainty around forward supply has also come into focus, with disruptions tightening current and forward balances. Demand for metals from EVs and renewable energy continues to provide support, and looser monetary conditions could also be a tailwind. ● **Grains, Softs:** We are modestly bearish on grains into 2024, given that weather is still conducive to high yields. Softs, on the other hand, moved meaningfully higher in 2023 — led by coffee and sugar, which have longer growing cycles.

Flight Plan Filed

Brad Simpson, Chief Wealth Strategist | TD Wealth

As we enter the first quarter of 2024, rarely have we flown into an environment where the stakes seem so high:

First, the ongoing wars in the Middle East and Europe:

Missile and drone attacks have disrupted shipping lanes within the Red Sea, and Ukrainian forces are under pressure along the front lines.

Second, the momentous elections looming around the world:

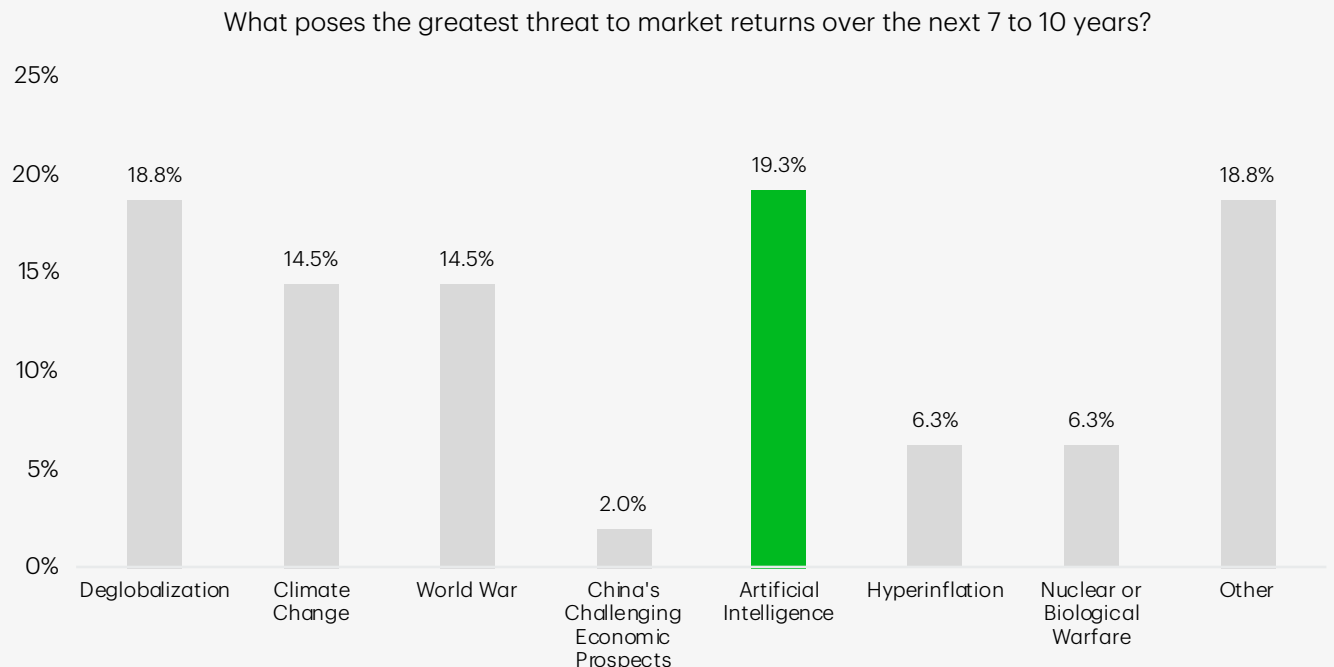
One-third of the global population will go to the polls this year, with the big one of course being in the United States in November. The result of this election will have an impact well beyond the borders of the world's biggest superpower. At risk of hyperbole, it seems like equality, rule of law and even representative democracy are on the ballot. For those who hold the American experiment as sacrosanct, this will be a pivotal moment. And it goes without saying, the election will have considerable ramifications for financial markets, given that the U.S. currency and capital markets are granted a premium thanks to the benefits afforded by these principles.

Third, the rise of artificial intelligence: The first quarter will see another chapter in the rapid advancement of AI, whose capabilities are set to double roughly every six months — three times faster than Moore's Law. Never has a technology offered such simultaneous promise and risk. It brings to mind Paul Simon's 1986 song "Boy in the Bubble," where he wrote about being in an "age of wonder" — so fitting then, and somehow it seems so small now when thinking about this new era we have entered.

We at the Wealth Investment Office do indeed sense some trepidation as we enter this new year. In the second week of January, we polled our advisors (Figure 1), asking them to share their clients' biggest investment fear for the next decade, what we called the "Grey Rhino" — a metaphor, from Michelle Wucker's book of the same name, for the major threats that we can anticipate and yet do little to avoid.

It's no surprise that AI, deglobalization, world war and climate change topped the list. What's remarkable is the fact that, in the short to medium term at any rate, financial markets remain incredibly calm and, dare I say, confident that these concerns are still far away, and that the concerns of the past couple of years (namely Covid-19 and inflation) may be behind us.

Figure 1: Biggest risks for the next decade?

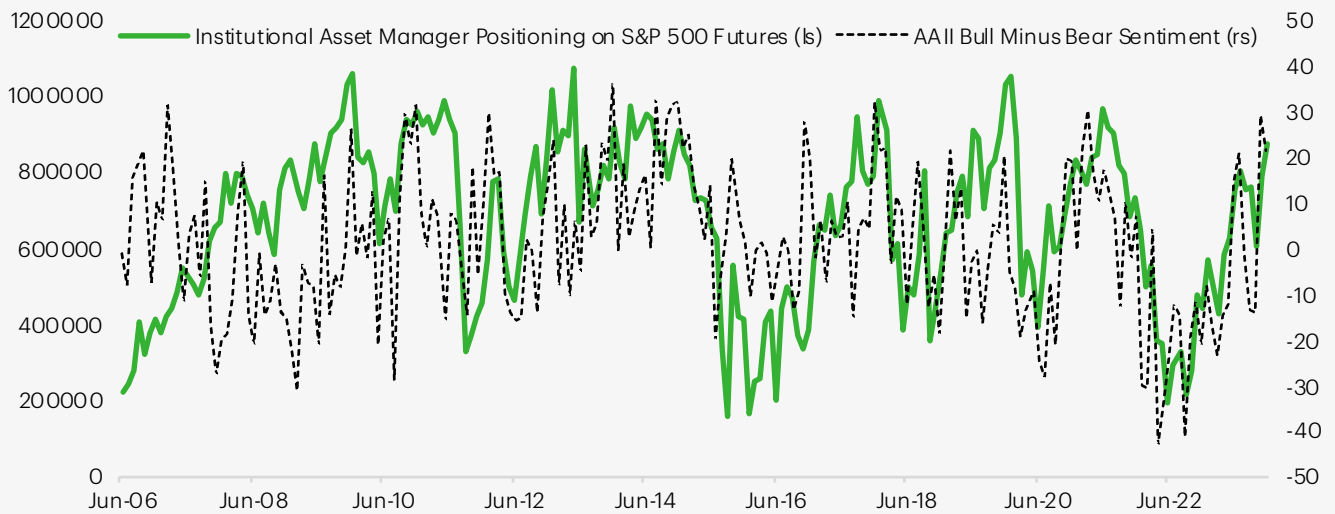


Source: Wealth Investment Office (Survey Monkey) as of January 10, 2024.

This seems to be true for both individual and institutional investors. Two years ago, when inflation started to accelerate across the developed world and central banks were expected to hike policy rates, investors saw dark clouds on the economic horizon. The last time inflation went out of control was in the late 1970s, which coincided with aggressive tightening by the Fed and a hard landing of the U.S. economy. With this in the back of their minds, investors proceeded cautiously and turned sour on both bond and equity markets. Today, that kind of pessimism is nowhere to be found. Sentiment has improved markedly, arguably to a euphoric level (Figure 2).

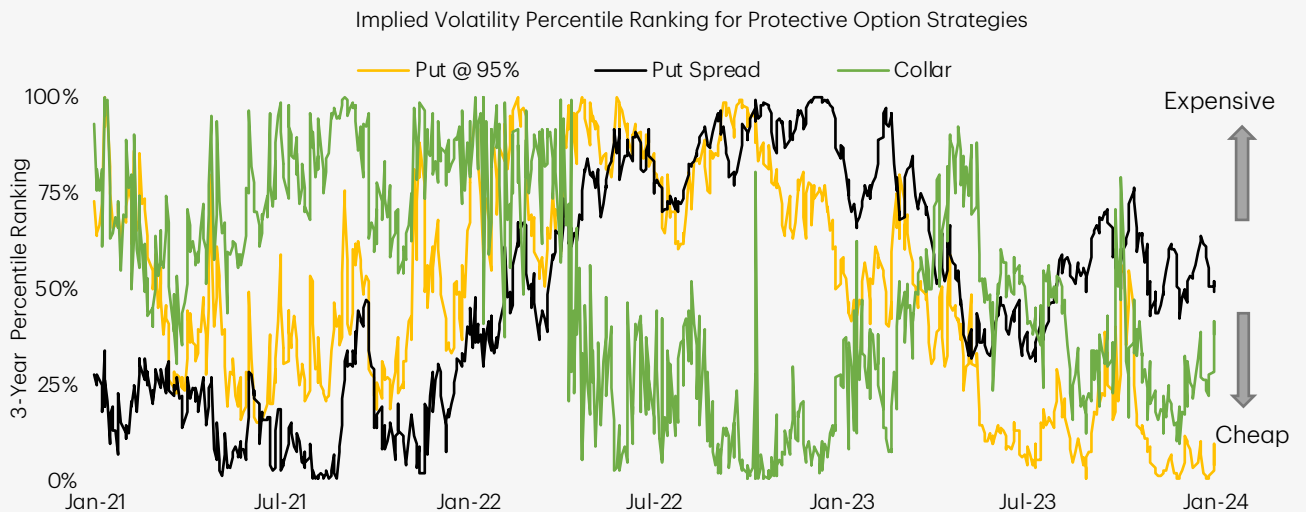
To dig a little deeper, let's explore what happens when institutional investors become euphoric. For this kind of investor, concern is reflected in the deployment of option-based hedges, such as put options, put spreads or collars. When pessimism is rampant, demand for these hedging mechanisms rise, and so do their prices, measured by implied volatility and implied volatility spread. Well, the opposite is also true: When pessimism is low, as is currently the case, these hedges become relatively cheap, as we can see in Figure 3.

Figure 2: Euphoria amid soft landing expectations



Source: FactSet, Wealth Investment Office, as of January 20, 2024

Figure 3: Institutional cheer pulls down hedging costs



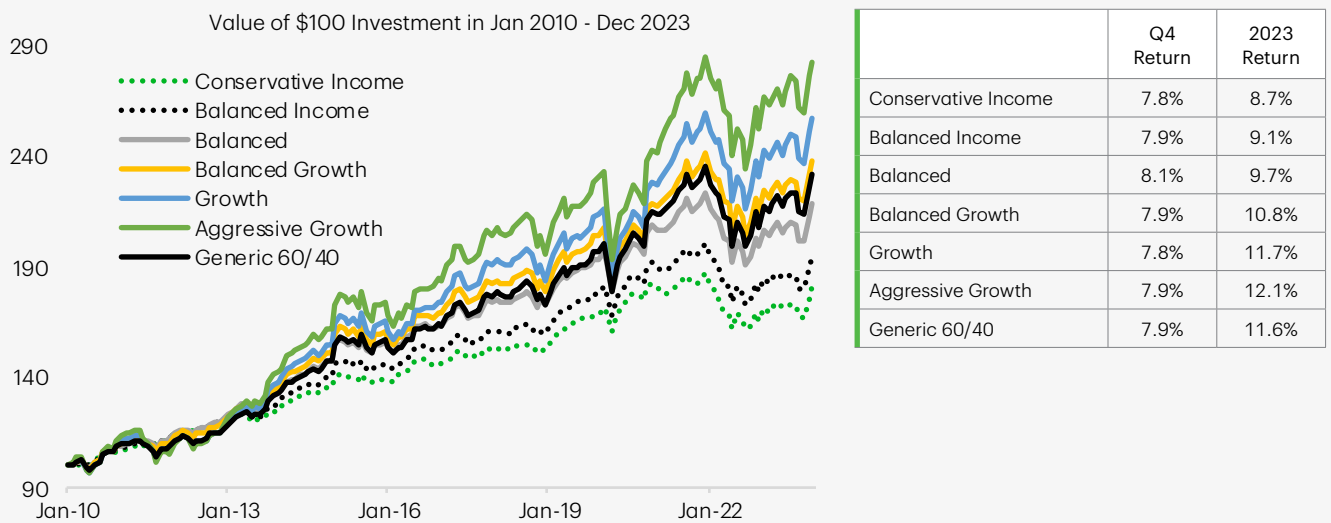
Source: FactSet, Wealth Investment Office, as of January 20, 2024

As investors gradually moved through 2023, the path forward started to look better, which is evident in the robust rally delivered over the last three months of 2023. Figure 4 plots the allocations for six investor profiles: from the very conservative to the aggressive as well as the traditional balanced 60/40 portfolio. While everyone's results will vary, most investors ended the year with quite a bit more in their pockets than they did at the beginning.

So, where do we go from here? To quote another famous songwriter (Tom Petty this time), from here the playing field is wide. We're headed "into the great wide open," where the range of outcomes are numerous indeed.

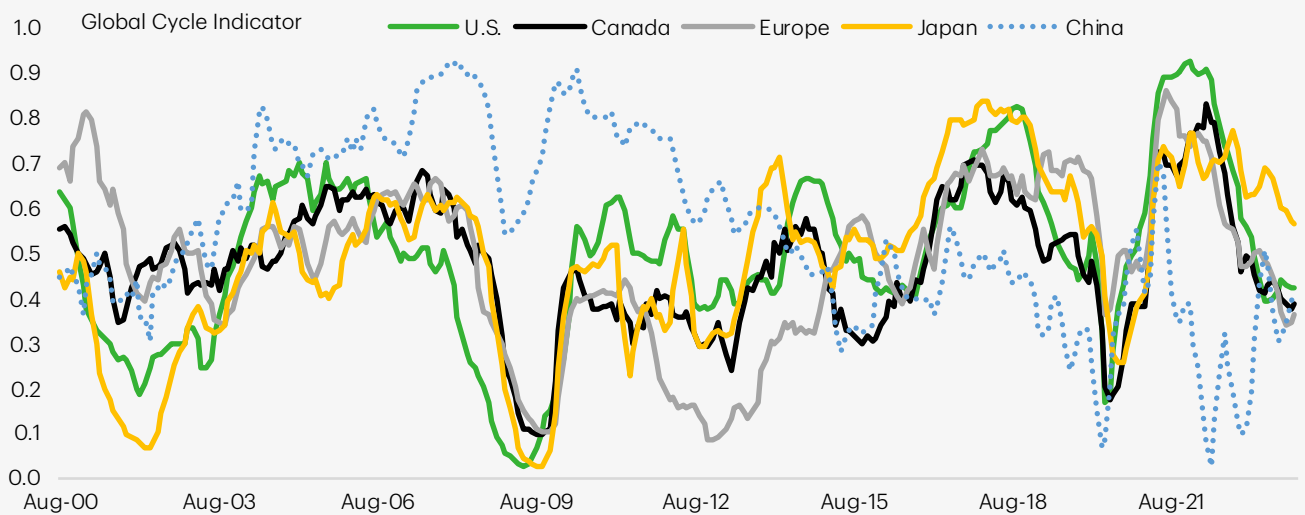
Today, investors are like pilots. In the same way that pilots rely on numerous gauges and instruments to keep themselves in the air, investors rely on numerous data points to plot the path ahead, as well as the "altitude" of the business cycle and the direction the winds are blowing. Figure 5 shows that business activity across developed economies is still falling, led by Europe and Canada, with the business cycle potentially ending sometime this year. At that point, activity should begin to pick up once again as a new cycle starts. The Chinese economy, meanwhile, is having trouble pulling out of a tailspin, after a prolonged zero-covid policy and a subsequent lack of stimulus.

Figure 4: Last year ended on a high note



Source: FactSet, Wealth Investment Office, as of December 31, 2023

Figure 5: Business cycle nearing an end



Source: FactSet, Wealth Investment Office, as of January 20, 2024

The forecast from TD Economics is that the U.S. economy will grow 1.5% this year, lower than the 2.4% real GDP growth in 2023. Canada is expected to grow only 0.5% — a step down from 1.1% last year — while euro zone economic growth is forecasted to expand 0.3%, slightly lower than the 0.5% last year (Figure 6).

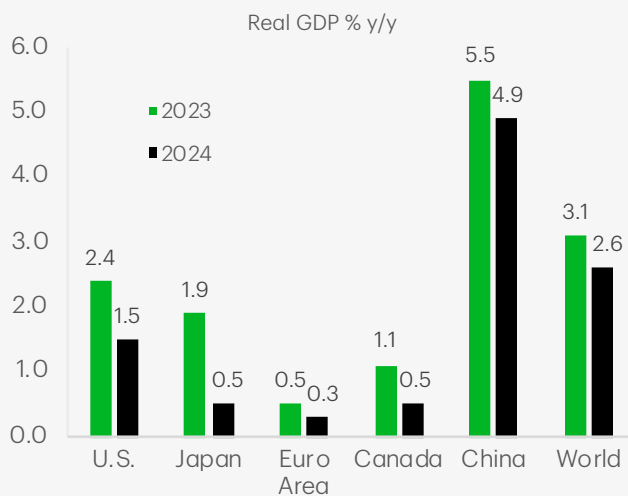
The U.S. economy, as it usually does in the late stages of the cycle, has outperformed other developed economies. Several European economies are already in recession, with Germany in particularly bad shape due to weakened demand for its manufacturing sector, which is closely tied to the Chinese economic outlook and has been hit hard by higher energy prices amid the Ukraine-Russia war.

Meanwhile, the Canadian economy is already nearing a recession (Figure 7), due in part to significant differences in the way mortgages are structured north

of the border. Unlike the long-term fixed mortgage structures in the U.S., Canadian mortgage borrowing is fixed for only a few years (typically five), which allows rate hikes to hit the economy faster, raising mortgage costs and dragging down consumer spending (Figure 8). Canada's larger proportion of commodities companies also gives the economy more of a cyclical structure than in the U.S., which leads to higher growth volatility — all of which is to say that, compared to its southern neighbour, the Canadian economy faces greater risks.

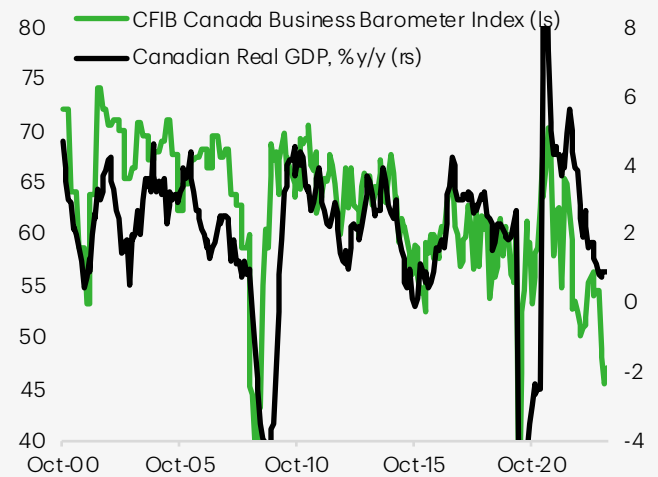
But despite the weaker growth outlook this year, there are reasons to be optimistic. After experiencing some turbulence over the past two years — due to Russia's invasion of Ukraine, the U.S. regional banking crisis and the Israel-Hamas war — the American economy remains in a relatively good shape:

Figure 6: Global Economic Outlook



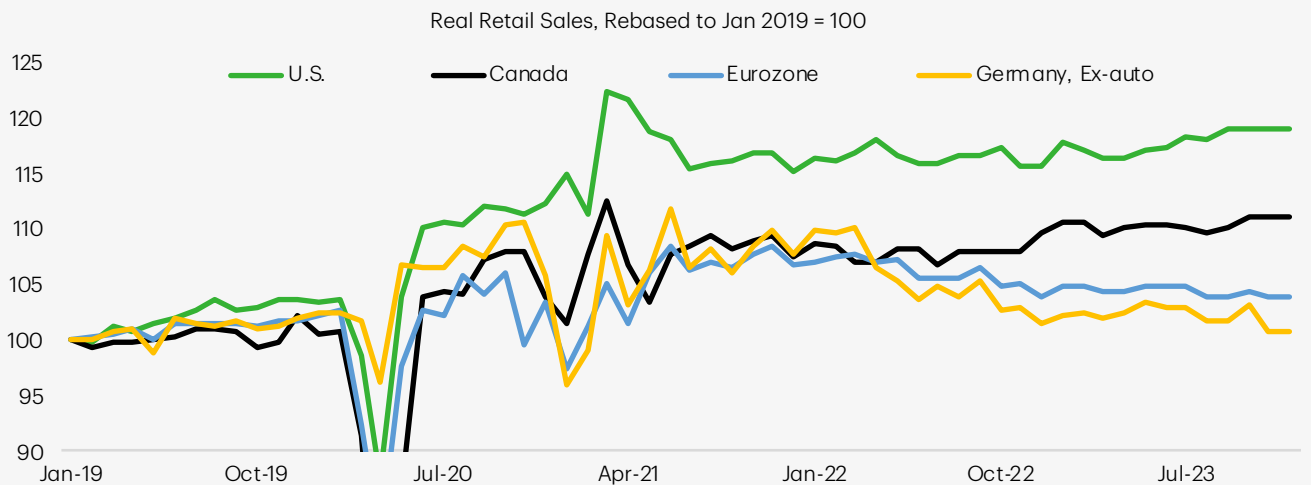
Source: IMF and TD Economics, as of December 2023.
* China CPI data is the IMF forecast

Figure 7: Canadian economy set to contract



Source: FactSet, Wealth Investment Office, as of January 20, 2024

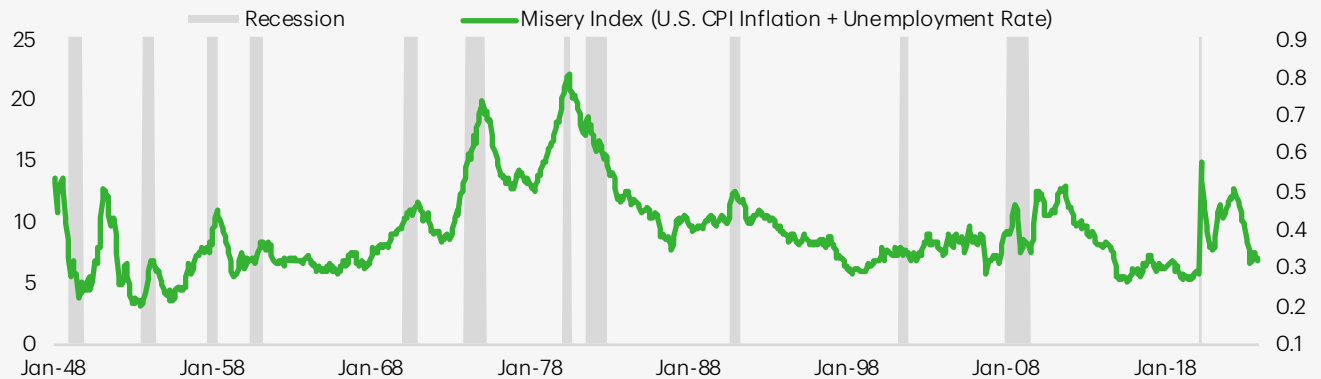
Figure 8: Lower U.S. mortgage costs prop up spending



Source: FactSet, Wealth Investment Office, as of January 20, 2024

First, the risk of U.S. stagflation is remote. The U.S. “misery index” (the unemployment rate plus CPI inflation) has fallen drastically over the past year, while the U.S. economy has yet to show signs of recession (Figure 9). Such a drastic decline in the misery index historically coincides with an exit from recessionary periods, not a lead-up.

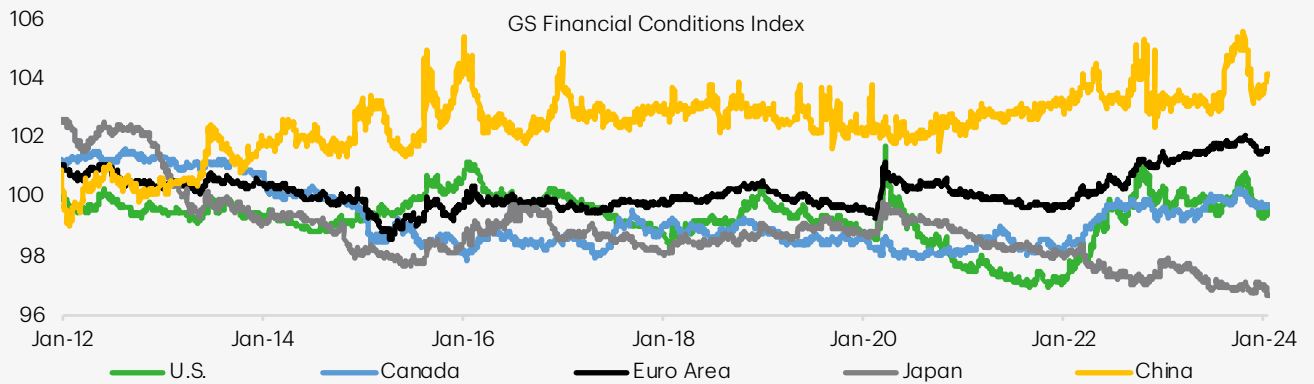
Figure 9: Misery index has fallen significantly



Source: FactSet, Wealth Investment Office, as of January 20, 2024

Second, yields have finally come down. Although financial conditions tightened in the second half of 2023, the Fed’s dovish pivot in December has pulled yields and the greenback much lower, blunting the impact of monetary-policy tightening to the real economy (Figure 10).

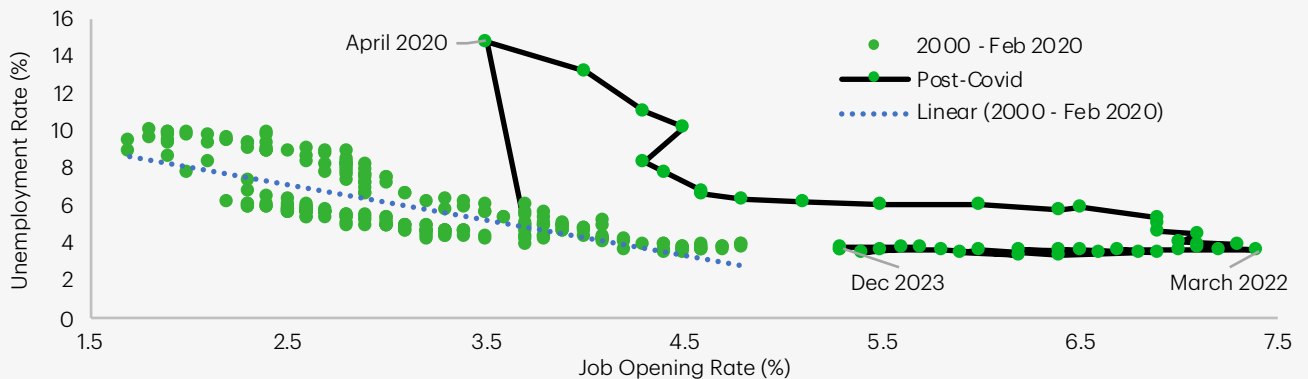
Figure 10: Global financial conditions have eased



Source: FactSet, Wealth Investment Office, as of January 20, 2024

Third, U.S. consumers are doing okay. Although jobs gains are decelerating and job openings are falling, the unemployment rate remains at historic lows, below 4%. A healthy labour market is supporting consumer spending, the backbone of the U.S. economy, and increasing the prospect of a soft landing (Figure 11).

Figure 11: Still heading towards a soft landing



Source: FactSet, Wealth Investment Office, as of January 20, 2024

Fourth, rate hikes are unlikely. The risk of a policy mistake by the Fed has been reduced following the central bank's acknowledgement that monetary conditions are already tight, which should cool growth and pull inflation lower.

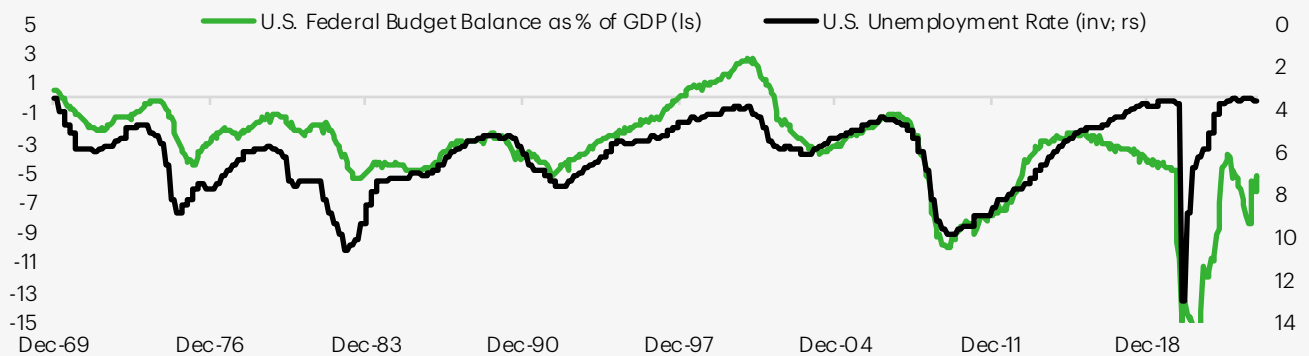
In our opinion, though, the rise in risk assets has been too far and too fast. It's like the passengers are congratulating the pilot for a smooth landing when in fact the plane is still in the air. Sure, the pilot may be confident — indeed, the Fed has forecasted an almost perfect landing, with lower inflation and GDP growth in 2024 and 2025, and unemployment still below 4.1% — but maybe we shouldn't be unbuckling the seat belt just yet, especially after a sharp rally in equity prices and tightening of credit spreads. We are seeing several risks on the horizon that could disrupt the soft-landing consensus among market participants and policymakers:

First, the full impact of rate hikes has not yet been felt. History has shown that it takes 12 to 24 months for the changes in monetary policy to be transmitted to the broader economy. This suggests that some of the impact of policy-rate tightening and quantitative tightening that began in March 2022 is still ahead of us.

Second, fiscal stimulus is slowing. The boost that has been supporting growth this year will likely become a drag in 2024. Figure 12 shows that the U.S. government was a positive contributor to spending in the economy in 2023. Although election years tend to coincide with largesse in fiscal spending, the current Republican control of the House will likely block any additional spending that could be proffered by the White House.

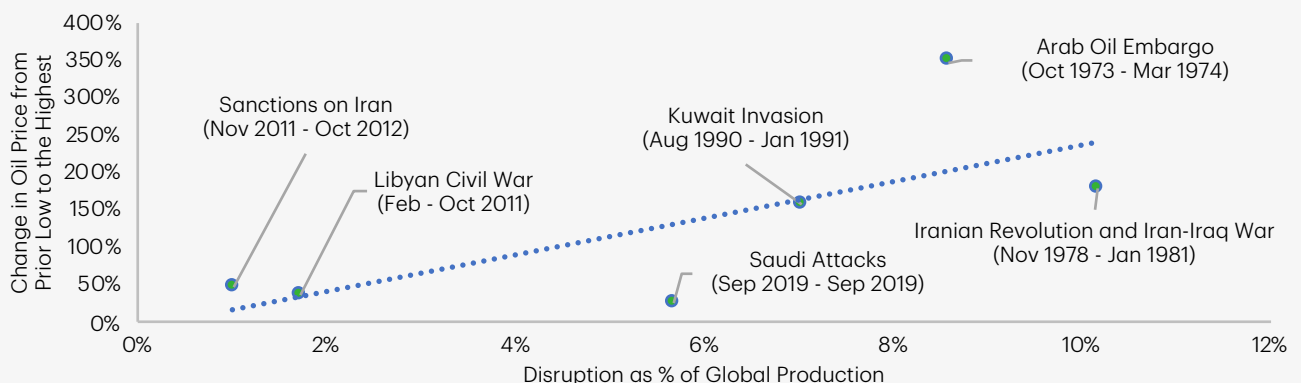
Third, the geopolitical landscape may prove disruptive. In a multipolar world, geopolitical considerations will increasingly interrupt the flow of trade and investment between economies, altering the profile of various investment opportunities. For instance, Russian assets are now deemed not investable by most money managers, while foreign direct investment to China has turned negative in 2023 due to stifling policies imposed by Beijing on the private sector. Meanwhile, the impact of war on the commodity supply chain, mostly on agriculture and energy prices, will influence global central banks. It's hard to estimate the impact of oil-supply disruption, but an Iranian oil export curb would likely push oil prices higher (Figure 13), possibly by as much as 20%, although this is not factored into our expectations. With the Russia-Ukraine and Israel-Hamas war still ongoing, rising geopolitical uncertainty could increase market's risk premium from currently tight levels.

Figure 12: Fiscal thrust set to become a drag



Source: FactSet, Wealth Investment Office, as of January 20, 2024

Figure 13: Oil disruptions may lead to double-digit price hike



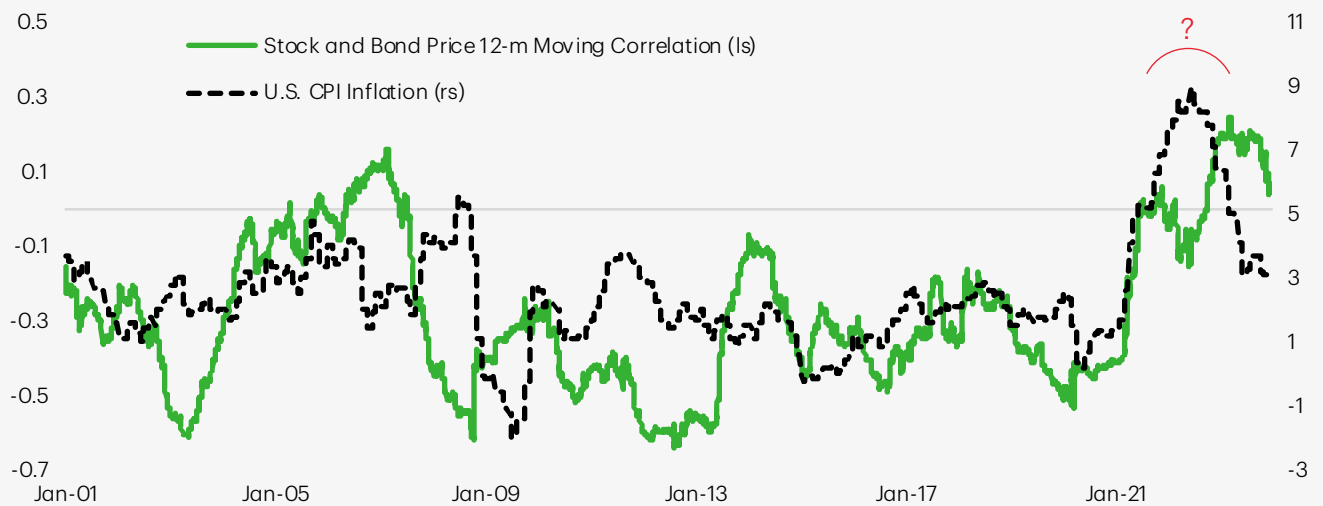
Source: FactSet, Wealth Investment Office, as of January 20, 2024

The Flightpath from Here

Basic Diversification. First, the path forward seems positive for basic diversification strategies. If we (and the consensus) are right that the U.S. and global economy will see lower growth and inflation this year, bonds are — and have been in recent quarters — an attractive asset to hold in a balanced portfolio. On top of its diversification benefit through negative correlation with equities and other risk assets, yields are now much higher than over the past decade (Figure 14).

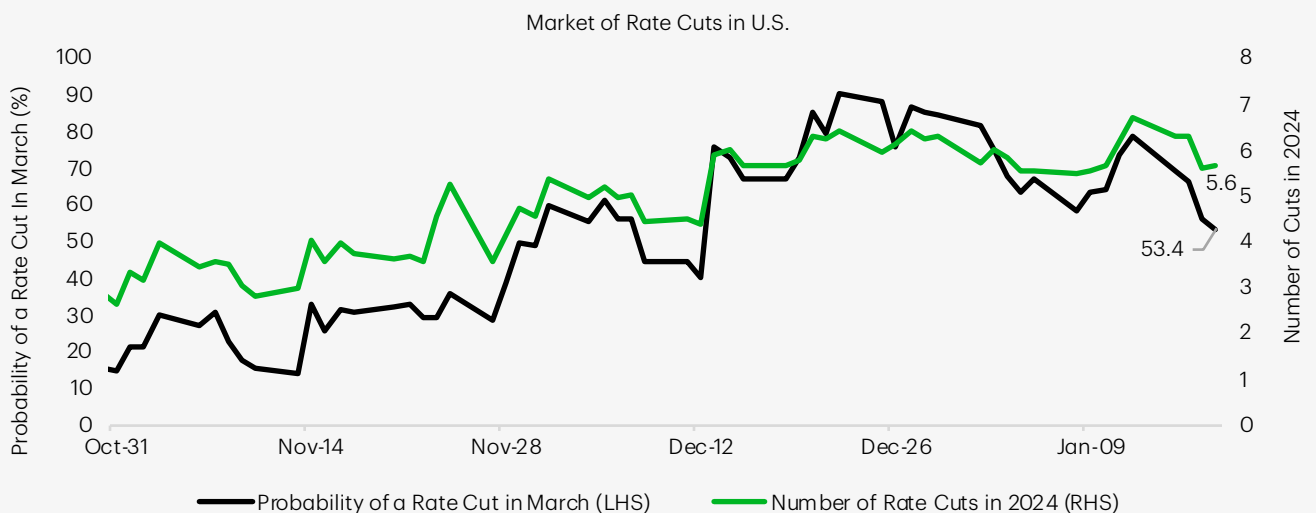
Fixed income. The case for being overweight bonds is even stronger when we consider the macroeconomic backdrop. After better-than-expected growth throughout the first half of 2023, the economic surprise index has been rolling over. The data for jobs and economic growth in Q3 and Q4 of 2023 have been revised lower. A continuation of the downward trend in economic surprises should be a tailwind for bonds. In sum, lower growth this year should translate to lower bond yields. Earlier this year, the consensus had six 25-bp policy-rate cuts in the U.S. — we think four cuts is more likely. As of mid-January, this view is being priced into the market (Figure 15).

Figure 14: Traditional diversification looks solid



Source: FactSet, Wealth Investment Office, as of January 20, 2024

Figure 15: Market pulling back rate cut expectations



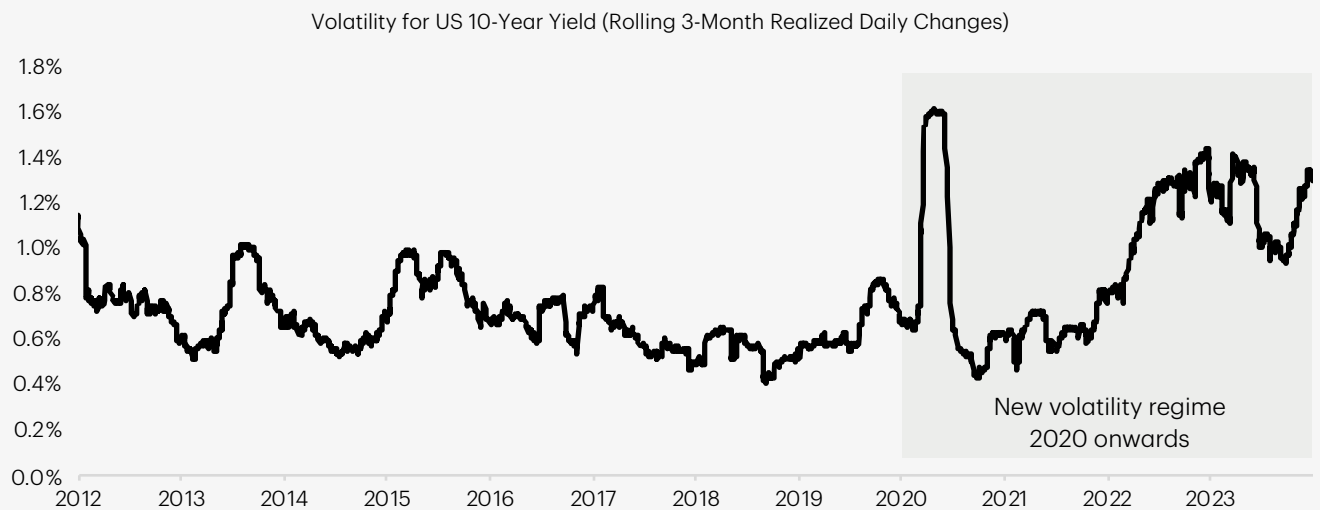
Source: FactSet, Wealth Investment Office as of January 18, 2024

Lastly, the volatility regime for government yields has clearly changed post-2020, and daily wild swings in yields are quickly becoming common (Figure 16). Armed with this knowledge, investors can profit. As GI Joe used to remind us, “Knowing is half the battle.” The other half is being prepared to act when opportunities present themselves.

We are modest overweight fixed income in general and modest overweight domestic government bonds. Canadian and U.S. government bonds are attractive at current yields and offer opportunities for income generation and protection from downturns in the equity market.

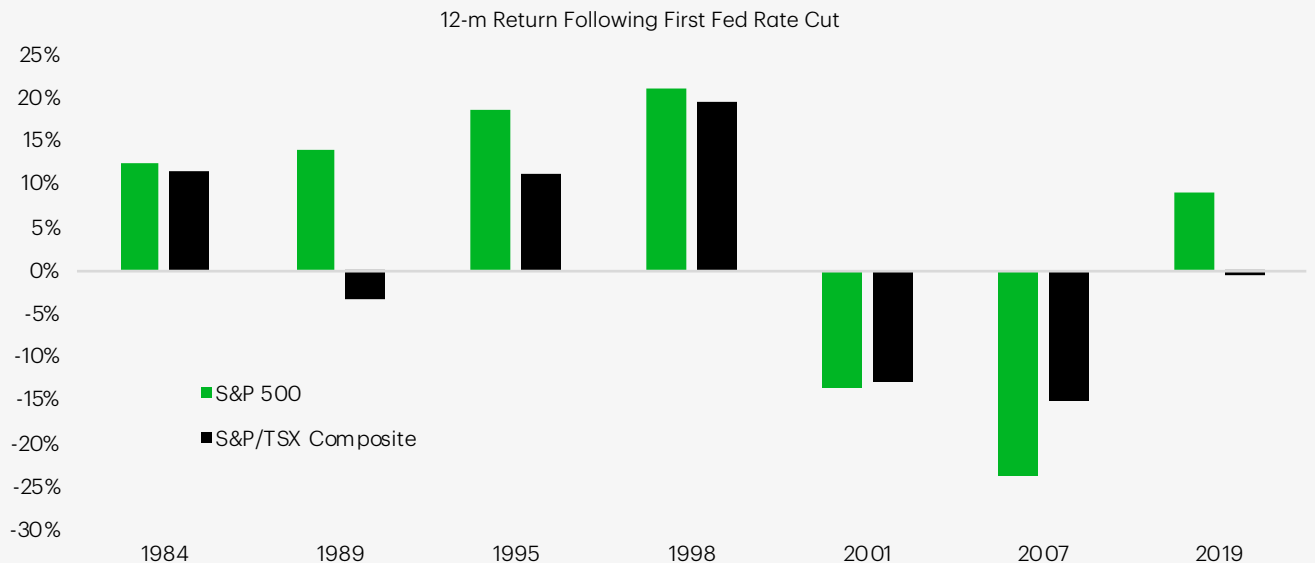
Equities. The good news, from a positioning perspective, is that we’re beginning 2024 with a constructive view, given the tailwind from improving macro data: EPS revisions, the manufacturing PMI, capacity utilization and high-yield credit spreads. There is also the gust from potential rate cuts in the coming months, with markets historically producing a positive return following the first Fed rate cut, barring some unforeseen event as in 2000 (tech wreck) and 2007 (financial crisis) (Figure 17).

Figure 16: Yield volatility may continue



Source: FactSet, Wealth Investment Office as of January 1, 2024

Figure 17: Stocks tend to rise on first cut



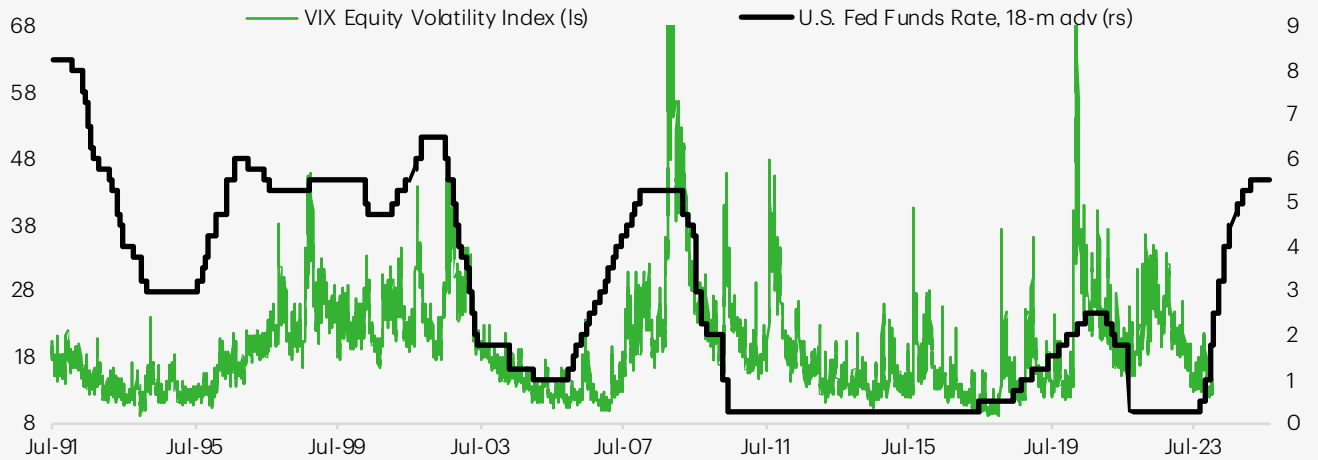
Source: FactSet, Wealth Investment Office as of December 29, 2023

The bad news is, we think the path ahead will be more volatile (Figure 18). When we look at 2023, markets had incredibly low volatility. We don't think that will be the case in 2024, but we can manage these risks with hedging strategies and, as discussed above, the price for doing so has become remarkably inexpensive.

That won't always be the case, however. Figure 19 shows that the top 10 option contracts for the SPDR S&P 500 ETF, as of January 19, are all put options — bearish bets, in other words — with a total notional amount equal to a staggering 161% of the ETF's 30-day average daily volume, strike prices about 20% below the current price and expiration dates mostly one or two months out. This tells us that large hedging activities are already in action to take advantage of the low cost.

We continue to be neutral Canadian equities. Strong free cash flows within the energy sector and relatively inexpensive financial stocks may present attractive opportunities. In the fall of 2023, we increased our allocation to modest overweight U.S. equities and that continues to be our position. We like overlooked defensive stocks in the consumer staples, health care, and utility space due to their attractive valuation profile and defensive characteristics. Many of the names in these sectors offer higher dividend yields over cash. These sectors' performances have significantly lagged their growth counterparts as the narrative swung from recession to soft landing throughout 2023. Meanwhile, the risk/reward of chasing growth stocks has deteriorated following the sharp rally last year. These growth stocks now trade at elevated multiples with the potential for rising equity volatility this year (Figure 20).

Figure 18: Equity volatility set to rise



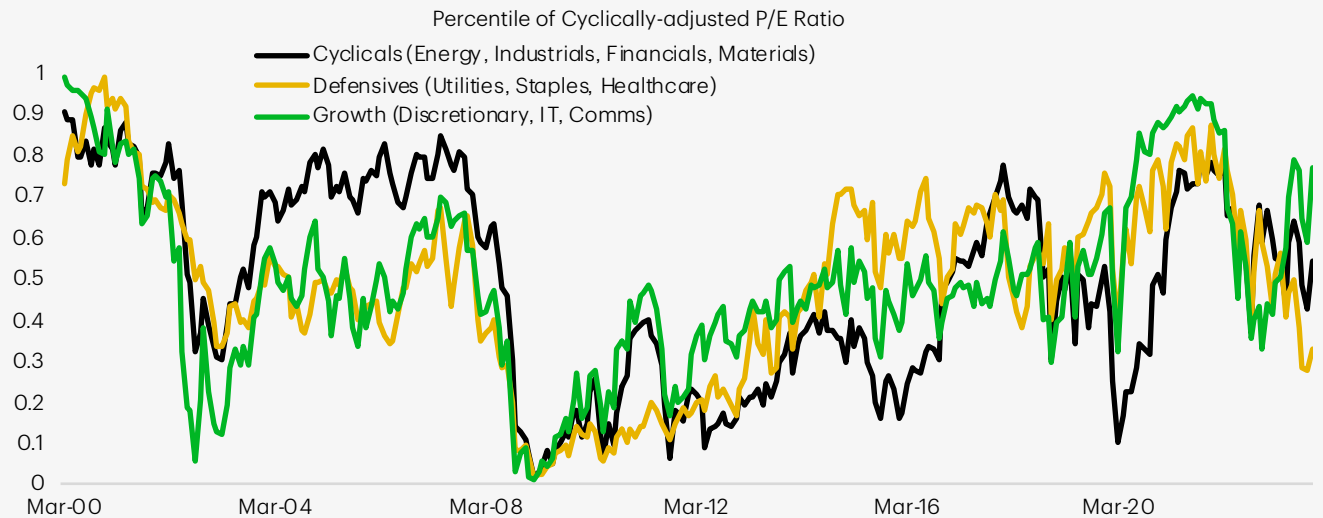
Source: FactSet, Wealth Investment Office, as of January 20, 2024

Figure 19: Bearish hedges on the rise



Source: FactSet, Wealth Investment Office, as of January 20, 2024

Figure 20: Defensive sectors are cheap



Source: FactSet, Wealth Investment Office, as of January 20, 2024

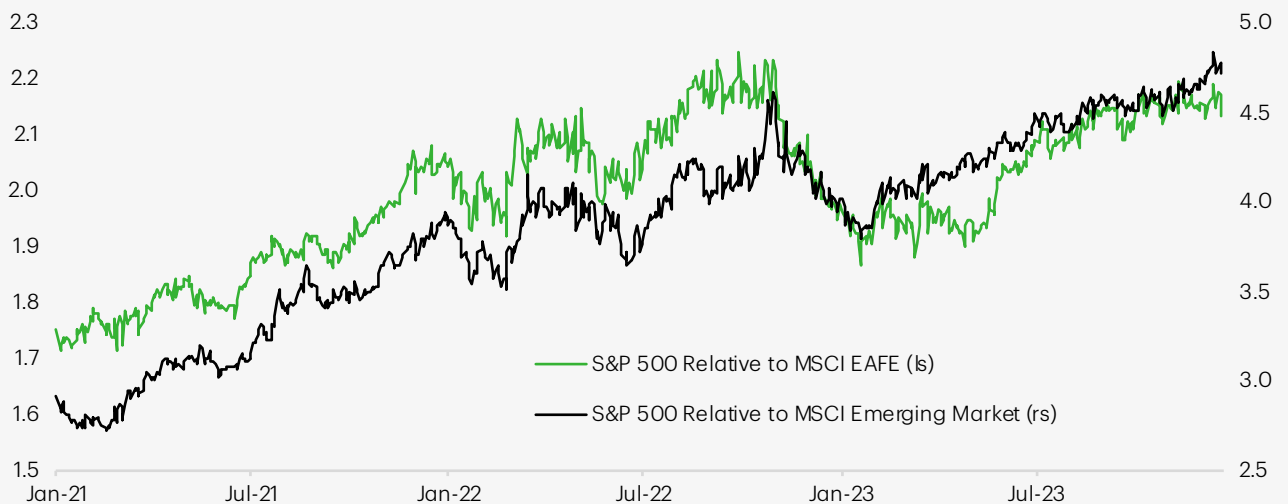
International and emerging-market equities. U.S. stocks outperformed the rest of world in 2023 (Figure 21), with the S&P 500 gaining roughly 25%, significantly above international equities (MSCI EAFE) at 15% and emerging-market equities (MSCI Emerging Market) at around 6%. Valuations for global equity indices rose throughout the year, with the forward earnings multiple for the S&P 500, MSCI EAFE and MSCI EM expanding 26%, 11% and 22%, respectively.

We continue to be modest underweight international equities given they are challenged by weaker corporate returns and slowing macroeconomic conditions, particularly in Europe. As such, we feel that further gains will be limited. On Chinese equities we are neutral. A floor for property markets, an escape plan for deflation and better policy implementation are all

required to jump-start equity markets that are sitting at generational lows. On emerging markets in general, we are neutral and believe a rethink is warranted.

“Friend-shoring,” for example, is one major theme that we’re homing in on. Rising tensions between the U.S. and China have allowed for the integration of emerging and frontier economies into the global supply chain. Several emerging-market nations stand to benefit from the “China plus one” strategy. Vietnam, for example, has been gaining market share as a destination for Chinese and global exports. Other Asian countries and Mexico could also benefit from this trend, either through the establishment of manufacturing bases by foreign companies, or as a location where Chinese goods pass through before being re-exported to the West.

Figure 21: International, EM equities lagged in 2023



Source: FactSet, Wealth Investment Office, as of January 20, 2024

Private equity. In our year-ahead document, we suggested that private assets present opportunities amid higher rates. Since the depths of the global financial crisis (GFC), privates have enjoyed the strong tailwinds of low interest rates, easy credit and the opportunities that are always present in an uncharted market. Today that market has changed. The cost of capital has increased, and what drove returns in the past likely won't going forward. However, private equity has a couple of major tailwinds.

First, private-equity funds are sitting on record levels of cash (Figure 22). One of the legacies of the pandemic is that, as many parts of the real economy came to a halt, private managers kept working, amassing a historical amount of capital. This capital was intended to be put to work on the other side of the pandemic by funding big ideas in energy transition, AI, biotech, fin-tech, etc.

However, things did not go as planned. After Covid, we witnessed the most aggressive rate-hiking campaign in 40 years, which created an extremely uncertain environment. The math changed, and some of the long-term private investments that made sense when discounted at a much higher rate, no longer did. Exit options also became limited. Private equity managers (the general partner) had to delay the deployment of capital they had just raised. In our opinion, the amount of dry powder today will act as a solid support for the private-equity market. As bargains start to emerge, this return-seeking capital will be put to work.

Second, there's the fact that the largest strategy within private equity, corporate buyout, tends to boom when the Fed starts cutting rates, thanks to the strategy's heightened rate sensitivity. It's a bit like wine production — the best weather produces the best vintages. Figure 23 compares the 10-year internal rate of return (IRR) to the public-market equivalent (excess return of private equity investment over public equity investment).

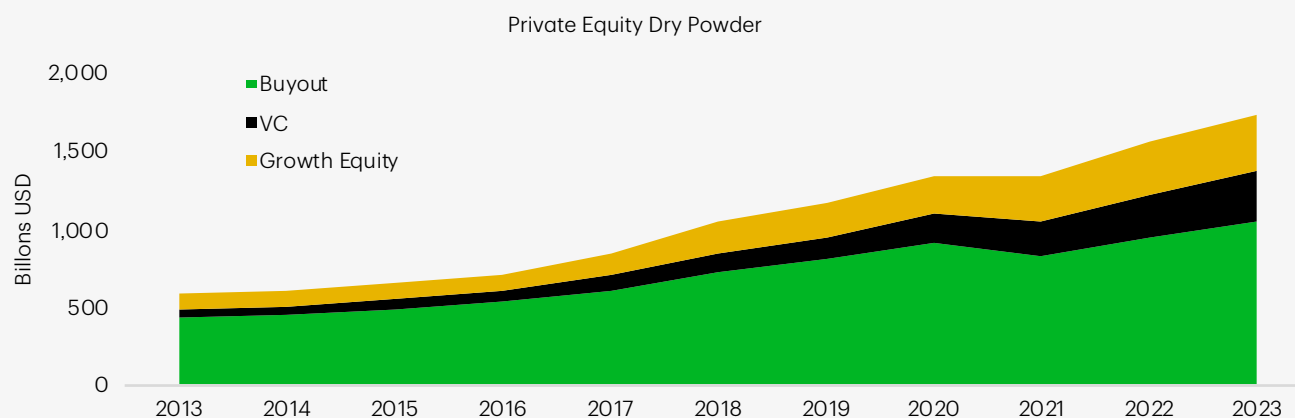
The 2001/2002 rate-cutting campaign comprised some of the best vintages, despite the fact that the 10-year horizon included the global financial crisis, which impacted vintages from 2003 to 2006 greatly. During the GFC, a clear direction for monetary policy allowed private-equity managers to deploy capital and achieve performance on par with the subsequent era of quantitative easing.

Where we are headed, with rate cuts in sight, private equity managers are similarly encouraged to deploy capital. Meanwhile, great businesses that survived the funding drought over the past two years may finally be up for grabs, often at more reasonable prices. History may be on the verge of repeating itself.

Although we do not tactically position private equity, we believe that the asset class exemplifies many of the things that we are looking for when allocating to equities. It's the ultimate active management because you are always investing in the company rather than the market. Many private managers exert control over their portfolio companies, which also adds value. The long holding period ensures discipline and removes short-term speculation. We believe investors should use some of their equity allocation to gain exposure to private equity if they can manage the illiquidity, which can be considerable.

Alternatives. Our current weight for alternatives is neutral. We continue to be cautious within real estate and think it's all about picking your spots — namely logistics, warehouses and data centres. We are modest underweight global real estate and maximum underweight domestic. Infrastructure continues to be a long-term theme, and we are modest overweight. We are also modest overweight private debt. Current bank lending and corporate-credit issuance has slowed, creating a structural opportunity for private lenders to not only fill the void but to pick the best borrowers, thanks to less competition.

Figure 22: Record cash levels in private equity



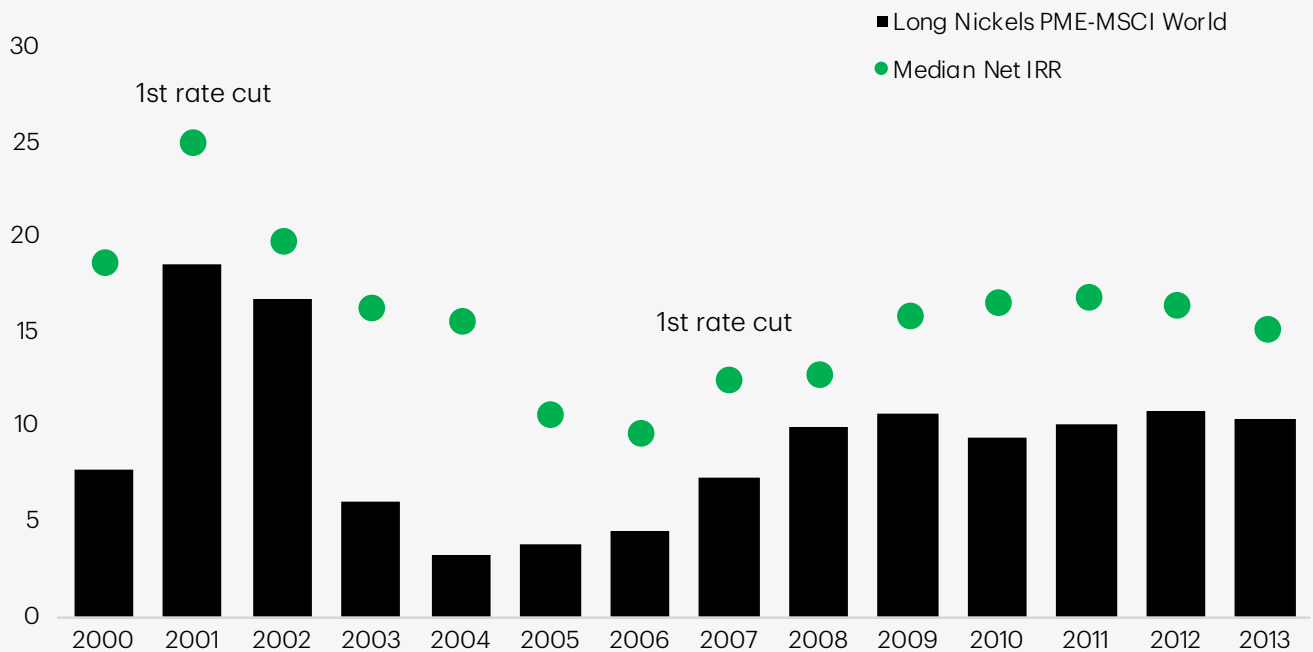
Source: Preqin as of December 31, 2023

Landing

My father is a pilot and a portfolio manager, and I am sure a psychologist would tell me that subconsciously he helped me write this article. I have always marvelled at his technical skill and have taken for granted how simple it all seemed whenever we've landed. I'm no pilot, but a lifetime in airplanes has taught me that the initial flight path often faces challenges as the plane flies from A to B. Over the past few years, markets have faced two big crosswinds: the pandemic and inflation. In 2024 we have flown into a new environment, into the great wide open.

There are a lot of great opportunities going forward and a lot of challenges, too. This makes it challenging for investors to remain focused on their goals and objectives. And now, in addition to the regular challenges we face during an economic transition, we're faced with elevated geopolitical risks and the long-term consequences of deglobalization. Whatever comes at us, we will continue to be committed to enhanced diversification, by building and managing portfolios that blend the best of traditional and alternative asset classes. We like to always remind ourselves that a good investment strategy is often low conviction over the short term and high conviction over the long term. To summarize: file the flight plan, adapt as the future unfolds, keep your seatbelt buckled and stick the landing.

Figure 23: PE outperforms as rates fall



Source: Prequin as of December 31, 2023. PME = Public Market Equivalent

Leading Macro Indicators

Overall risk regime score improved but still weak

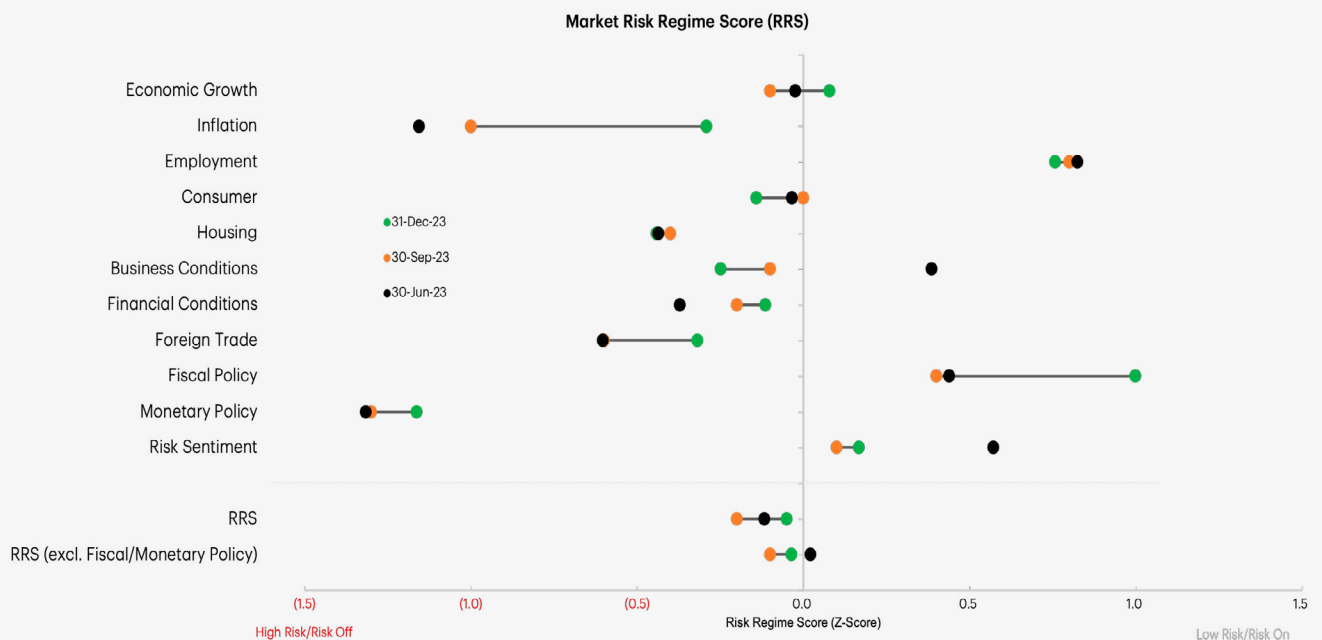
As part of our process-driven approach to investment management, we monitor key U.S. variables that inform our understanding of the risk and macroeconomic environment. For each indicator, we calculate current values and compare them against recent trends and long-term data using a standardized approach that makes it possible to aggregate across indicators. Figures 1 and 2 summarize the overall condition and aggregate score of the indicators.

Figure 1: Market risk regime scores

Indicator	Overall Condition	Current	Sep-23	Jun-23	Mar-23
Economic Growth	Neutral	0.1	(0.1)	0.0	0.0
Inflation	Weak	(0.3)	(1.0)	(1.2)	(1.6)
Employment	Strong	0.8	0.8	0.8	1.0
Consumer	Neutral	(0.1)	0.0	0.0	0.2
Housing	Weak	(0.4)	(0.4)	(0.4)	(0.3)
Business Conditions	Neutral	(0.2)	(0.1)	0.4	0.3
Financial Conditions	Neutral	(0.1)	(0.2)	(0.4)	(0.4)
Foreign Trade	Weak	(0.3)	(0.6)	(0.6)	(0.8)
Fiscal Policy	Strong	1.0	0.4	0.4	0.5
Monetary Policy	Weak	(1.2)	(1.3)	(1.3)	(1.3)
Risk Sentiment	Neutral	0.2	0.1	0.6	(0.6)
Risk Regime Score (RRS)	Neutral	0.0	(0.2)	(0.1)	(0.3)
RRS (excl. Fiscal/Monetary Policy)	Neutral	0.0	(0.1)	0.0	(0.2)

Source: FactSet, WIO as of December 31, 2023.

Figure 2: Movement in market risk regime scores



Scores represent number of standard deviations away from long-term average.
Source: FactSet, WIO as of December 31, 2023.

Our risk regime score improved in the last quarter of 2023 on the back of resilient growth and declining inflation. The overall market risk regime score nudged up to 0.0 at the end of Q4, from -0.2 at the end of Q3. U.S. equities rose sharply while bond yields tumbled as market participants priced in a higher probability of a soft landing and looser monetary policy in 2024.

Monetary policy continues to put the biggest drag on the overall risk score; the Federal Reserve (Fed) is still trying to bring inflation to its 2% target by keeping the policy rate at the highest level in 23 years, and broad money supply is contracting at a record pace. Employment and fiscal policy remained strong, while business conditions and consumer deteriorated slightly. The following are notable changes for Q4 compared to Q3:

- Monetary policy, foreign trade, and inflation were still weak in Q4, although scores for the three categories improved. Inflation posted the biggest positive surprise with a faster-than-expected decline throughout the quarter that lifted the score to -0.3 at the end of Q4 from -1.0. Continued progress on this front will likely translate into an improved score for monetary policy in the coming quarter. The monetary policy score ticked up to -1.2 at the end of Q4 from -1.3 amid the continued contraction in money supply and the elevated policy rate. The foreign trade score rose to -0.3 from -0.6 in Q3 bolstered by the greenback (which weakened on growing expectations for a policy rate cut in H1) and a narrower current account deficit.
- The scores for risk sentiment, economic growth, and financial conditions all improved slightly while remaining around neutral. Volatility for both equity and government bond markets fell compared to the previous quarter and retail investors turned bullish, which pushed the score for risk sentiment up to +0.2 from +0.1 at the end of Q3. Meanwhile, the upward revision in consensus GDP growth forecast for the next 12 months sent the economic growth score to +0.1 from -0.1 in Q3. The financial conditions score ticked higher to -0.1 from -0.2 standard deviation below the long-term norm as bond spreads compressed and the yield curve steepened but remained at a level historically linked to impending recession.
- Sentiment among homebuilders remained negative despite the decline in mortgage rates which translated into a flat score for housing (-0.4 at the end of Q4). The score for consumer slipped to -0.1 from 0.0 in Q3 after the slowdown in consumer spending which is forecast to extend even further.

And business conditions deteriorated—hurt by expectations for a further slowdown in manufacturing and services activity—pushing the score down to -0.2 from -0.1 at the end of Q3.

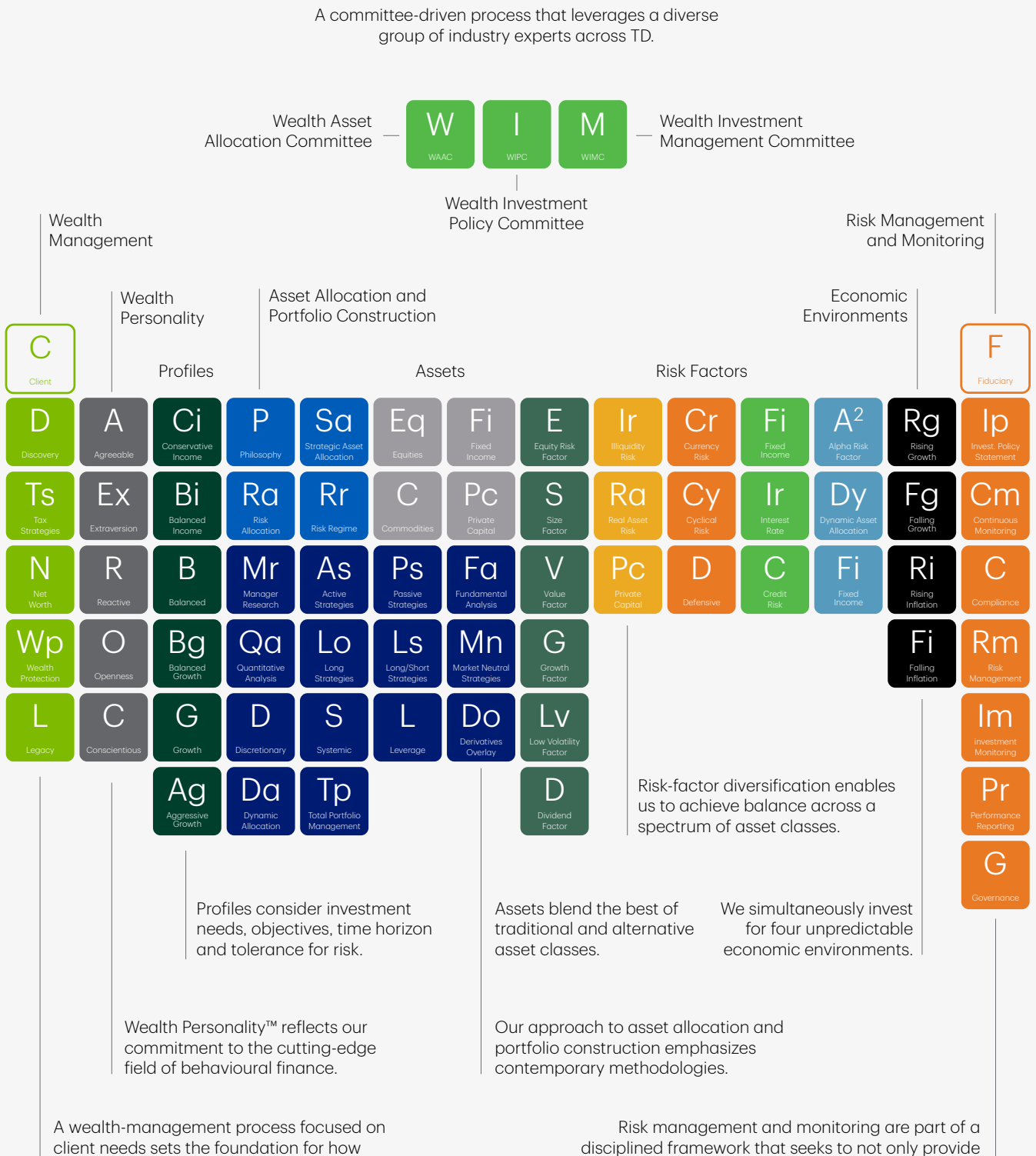
- Bucking the trend, employment and fiscal policy remained in healthy territory. The near-record low unemployment rate, depressed initial jobless claims, and strong wage growth are underpinning the resilient labour market. The score for employment sat unchanged at +0.8 in the quarter. Our fiscal policy score rose to +1.0 from +0.4 at the end of Q3 as government spending is expected to support economic growth.

Overall broad conditions for risk assets improved in Q4: monetary policy remained tight but inflation, risk sentiment, economic growth, and foreign trade improved. Market consensus is now pointing to a soft landing and, as such, we expect participants will be watching for any further signs of weakness in employment, consumer, and business conditions that could hint at potential downside risks to the U.S. economy.

Elements of Wealth Management

Investors are often left to make decisions without any formal process. Our solution? Follow an investment philosophy — a guiding set of principles designed to work in a world that’s constantly changing, often with dramatic impact on financial markets. At TD Wealth, we call that philosophy “Risk Priority Management,” and it provides the foundation for our decision-making process. That process is then broken down into its most basic components, similar to a periodic table of elements, as illustrated below, with groupings and weights. These components comprise our entire process, from wealth management to risk management to monitoring. All in all, there are 72 “elements” that fall into eight categories.

Figure 1: Elements

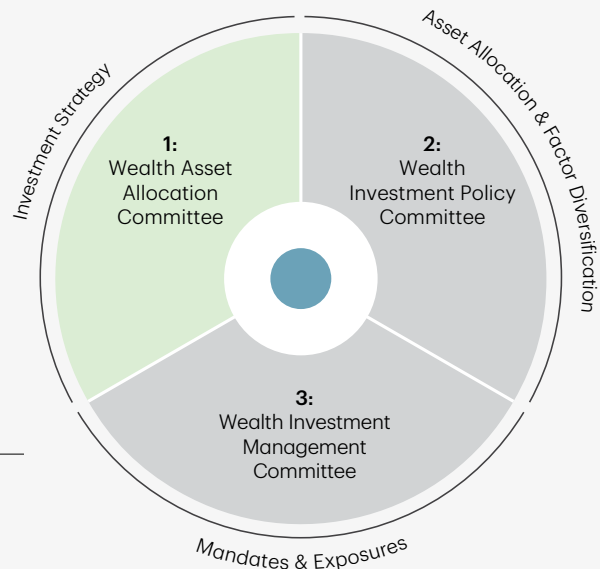


Wealth Asset Allocation Committee

The TD Wealth Asset Allocation Committee (WAAC) is composed of a diverse group of TD investment professionals. WAAC's mandate is to consider the financial-market environment and provide direction and themes for equities, fixed income, real assets and sub-classes for the next six to 18 months.

Considers the financial-market environment and provides direction and themes

Utilizing risk factors to manage exposures, we build and manage portfolios that blend the best of traditional and alternative asset classes.



Committee members:

- David Sykes, CFA** **Chief Investment Officer, TD Asset Management Inc (Chair)**
- Michael Craig, CFA Managing Director & Head of Asset Allocation & Derivatives, TD Asset Management Inc.
- Anna Castro Managing Director, TD Asset Management Inc.
- Justin Flowerday, CFA Head of Public Equities, TD Asset Management Inc.
- Jennifer Nowski, CFA Vice President & Director, TD Asset Management Inc.
- Michael Augustine CFA Managing Director & Head of Fixed Income, TD Asset Management Inc.
- Alex Gorewicz Vice President and Director, TD Asset Management Inc.
- Jeffrey Trip, CFA Managing Director and Head of Alternative Investments, TD Asset Management Inc.
- Colin Lynch Managing Director and Head of Global Real Estate, TD Asset Management Inc.
- Kevin Hebner, Ph.D. Managing Director, Epoch Investment Partners, Inc.
- William Booth, CFA. Managing Director, Epoch Investment Partners, Inc.
- Brad Simpson, CIM, FCSI Chief Wealth Strategist, Wealth Investment Office, TDW
- Sid Vaidya, CFA, CAIA U.S. Wealth Investment Strategist, TD Wealth USA
- Bryan Lee, CFA Vice President & Director, TD Asset Management Inc.

Direction from WAAC

Core Asset Class Allocations

	Positioning	Rationale
Cash & Equivalents	<p>Modest Underweight</p> <p>Previous Month</p>	<p>In recent months, the yield on cash and equivalents has risen alongside further rate hikes from the Bank of Canada. As key economic data continues to normalize, the risks of additional monetary policy tightening are now more balanced. We believe that the other asset classes may present better opportunities for long-term returns.</p>
Fixed Income	<p>Modest Overweight</p> <p>Previous Month</p>	<p>As the normalization of inflation appears to be slowing alongside waning economic growth, the Bank of Canada continues to debate the need to maintain tight monetary policy and to reinforce its higher-for-longer policy rate path. On the flipside, this may also imply higher for longer income returns within the asset class. We continue to believe that fixed income will outperform equities over the next 12 months and that bonds can still provide diversification benefits, reduce overall portfolio volatility and preserve capital.</p>
Equity	<p>Neutral</p> <p>Previous Month</p>	<p>We believe that the recent pullback has created a more balanced return outlook. Earnings growth has been negative year-over-year, but we believe that it is now starting to stabilize/show signs of positive momentum. Valuations have contracted somewhat, particularly in sectors that could face challenges, which may offer a better risk/reward outlook.</p>
Alternatives	<p>Neutral</p> <p>Previous Month</p>	<p>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.</p>



Fixed Income - Modest Overweight

	Positioning	Rationale
Domestic Government Bonds	Modest Overweight	As inflation continues to normalize and economic data decelerates, the Bank of Canada ("BoC") may feel that patience is required in maintaining tight monetary policy. After the recent decline in bond yields, we do not anticipate a consistent decline in yields going forward until there is visible weakness in the labour market. Over the longer term, 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.
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.
Global Bonds Developed Markets	Neutral	Despite firmer-than-expected inflation across markets, economic growth indicators continue to broadly decelerate, leading central banks to shift focus from policy tightening to policy easing in the next 12 months. We anticipate some divergence in monetary policy in 2024 across developed economies. The Bank of Japan has yet to tighten monetary policy, although it is expected to pivot soon. Other central banks that are expected to ease monetary policy in 2024, such as the U.S. Federal Reserve or Bank of England, have made varying progress on their inflation mandates so rate cuts will likely come sooner from some central banks than others. This will likely result in less positively correlated returns in global bonds 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.

Equities - Neutral

	Positioning	Rationale
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. We believe that earnings growth is starting to stabilize/show signs of positive momentum. This is supportive of multiples, which we view as fair in consideration of the higher technology exposure of the U.S. market.
International Equities	Modest Underweight	International stocks are challenged by weaker corporate returns and slowing macroeconomic conditions, particularly in Europe. Given this view, we feel that further gains will be more limited.
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 Market Equities (excluding 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.

Alternatives - Neutral

	Positioning	Rationale
Commercial Mortgages	Modest 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	Modest Underweight	Certain regions across the globe have seen quicker adjustments to valuations and are now starting to see early signs of slowing down. Multi-unit residential and a tilt to the Asia Pacific 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.

Asset Sub-Classes

	Positioning	Rationale
U.S. Dollar	Neutral	Relative growth differentials favor the U.S. economy and by extension the U.S. dollar. We believe that the U.S. Federal Reserve may be nearing the end of its interest hiking cycle, though this could be challenged if the economy continues to respectively outperform. Both European and UK economies are facing a tough reality of stagnating inflation while recent Canadian gross domestic product growth has been negative on a quarter over quarter basis. 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. While energy and some material prices have weakened, they could find some support as inventories are reasonable and producers have been disciplined. The copper market could see further tightness due to recent disruptions and downgrades to existing supply. The potential of the U.S. Federal Reserve shifting to rate cuts would be supportive of gold.

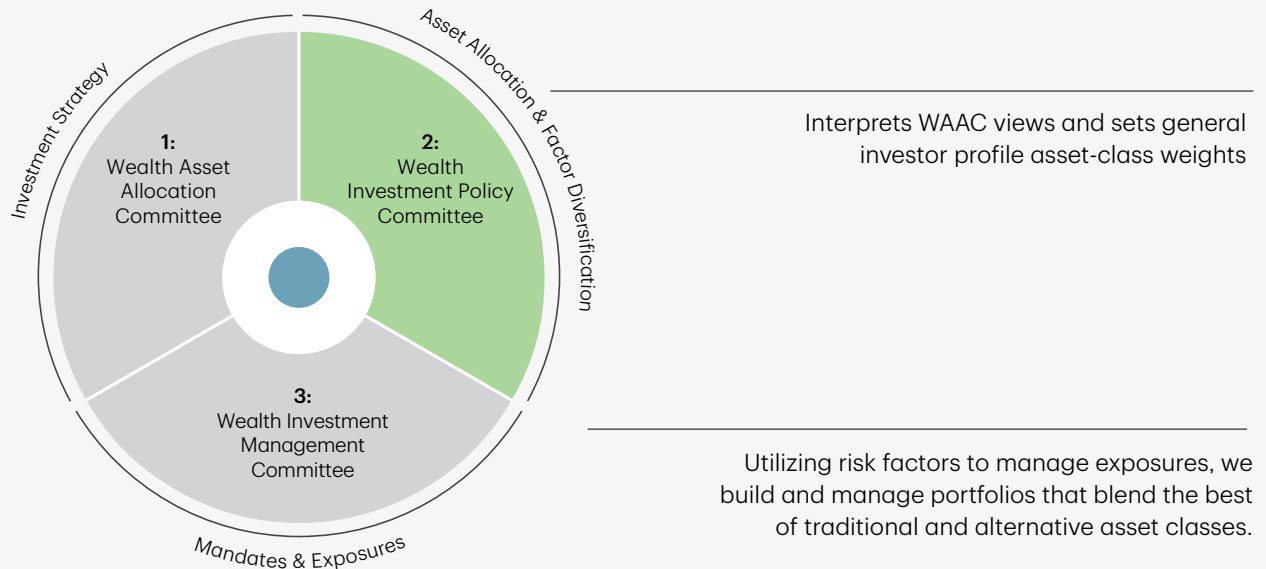
Figure 1: Direction from WAAC: strategic positioning

	Asset Class	Underweight		Neutral		Overweight
Fixed Income Modest Overweight	Domestic Government Bonds				●	
	Investment Grade Corp. Credit			●		
	High Yield Credit		●			
	Global Bonds - Developed			●		
	Global Bonds - Emerging			●		
Equities Neutral	Canadian			●		
	U.S.				●	
	International		●			
	China			●		
Alternative /Real Assets Neutral	Emerging Markets excl. China			●		
	Commercial Mortgages				●	
	Private Debt				●	
	Domestic Real Estate	●				
	Global Real Estate		●			
Sub-Classes	Infrastructure				●	
	U.S. Dollar			●		
Cash & Equivalents Modest Underweight	Commodities				●	
			●			

Source: Wealth Asset Allocation Committee, as of January 18, 2024.

Wealth Investment Policy Committee

The Wealth Investment Policy Committee is composed of a diverse group of TD investment professionals. WIPC's mandate is to interpret WAAC views and set general asset-class weights for each investor profile.



Committee members:

- Brad Simpson, CIM, FCSI** **Chief Wealth Strategist, Wealth Investment Office (WIO), TD Wealth (Chair)**
- Michael Craig, CFA Managing Director, Head of the Asset Allocation & Derivatives, TDAM
- Anna Castro, CFA Managing Director, TDAM
- Jafer Naqvi VP & Director, TDAM
- Christopher Lo, CFA Senior Portfolio Manager, Head of Managed Investments, WIO, TD Wealth
- Fred Wang, CFA Senior Portfolio Manager, WIO, TD Wealth
- Aurav Ghai, CFA Senior Fixed Income Analyst & Portfolio Manager, WIO, TD Wealth
- Mansi Desai, CFA Senior Equity Analyst & Portfolio Manager, WIO, TD Wealth

The Wealth Investment Policy Committee (WIPC) did not make any changes to the dynamic asset allocation table in January. At the top asset class allocation tier, WIPC maintains a modest overweight position in fixed income, a neutral position in equities, alternatives/real assets, and a modest underweight position in cash & equivalents. This aligns with WAAC's core asset class allocation view.

Within equities, WIPC has maintained a neutral allocation to Canada and a modest overweight allocation to U.S. equities in all of the risk profiles. Elsewhere, the allocation to international equities remains underweight by 2 pp while the allocation to China/Emerging Markets remains neutral.

Within fixed income, WIPC has maintained the overweight allocation to domestic government bonds by 2 pp in all profiles except Aggressive Growth, which is 1 pp overweight. The allocation to investment grade corporate bonds is neutral to modest overweight while the allocation to high yield bonds is underweight by 1 to 2 pp. The allocation to global bonds remains neutral for Developed Markets and Emerging Markets.

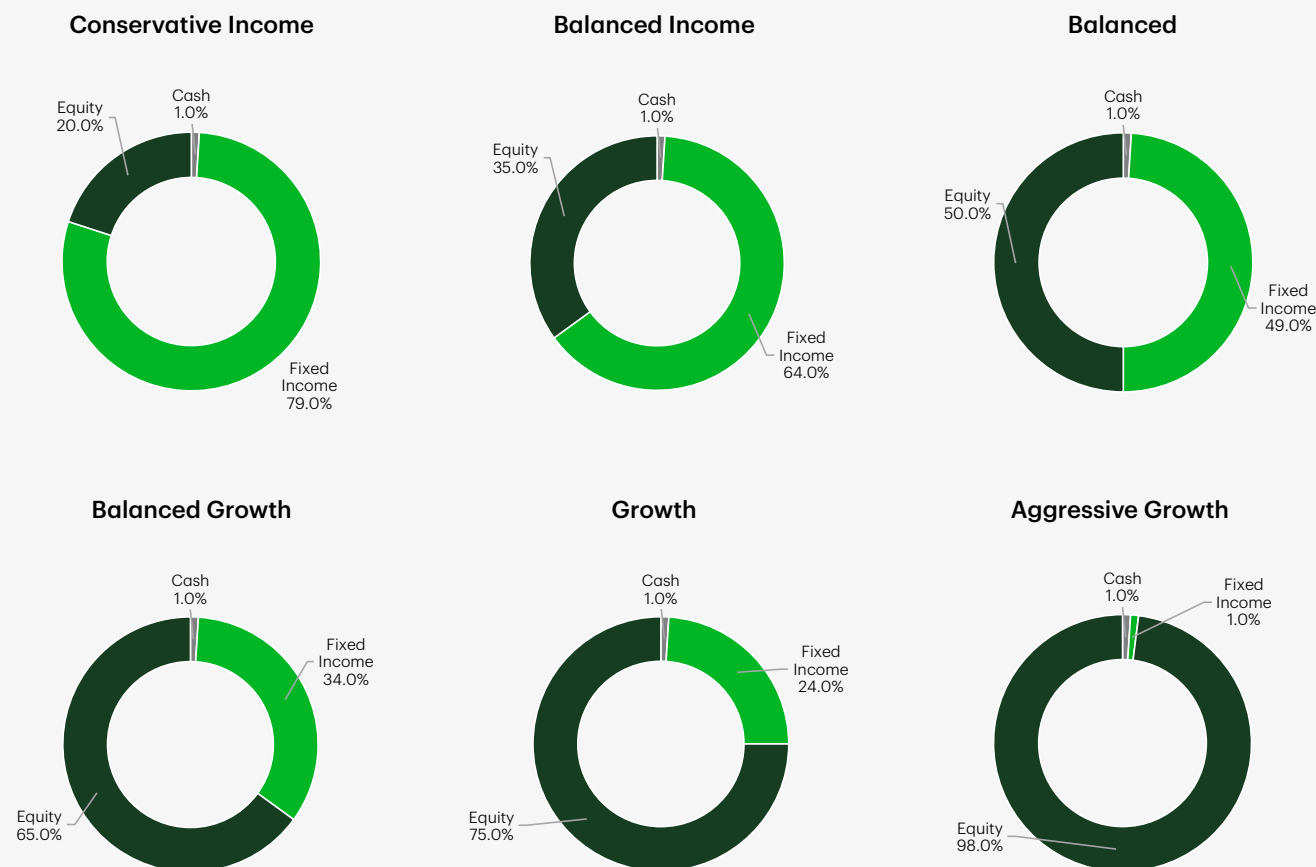
WIPC has also maintained an overall neutral allocation to alternatives. At the subclass level the allocation to commercial mortgages remains overweight by 1 pp in all investor profiles, with the exception of Conservative Income which is neutral. The allocation to private debt is neutral, and real estate is underweight by 1 – 2 pp. The allocation to infrastructure is neutral for the Conservative and Balanced Income investor profiles, and 1 pp overweight for all other profiles.

Factor Exposure

Asset Classes	Fixed Income Factor	Equity Risk Factor	Currency Risk Factor	Illiquidity Risk Factor	Alpha
Factor Positioning	Overweight	Neutral	Neutral	Overweight	Dynamic
Cash	•				•
Fixed Income					
Domestic Government Bonds	•				•
Investment Grade Corp. Credit	•	•	•		•
High Yield Credit	•	•	•	•	•
Global Bonds - Developed	•		•		•
Global Bonds - Emerging	•		•	•	•
Equity					
Canadian		•			•
U.S.		•	•		•
International		•	•		•
China		•	•		•
Emerging Markets ex China		•	•		•
Alternatives					
Mortgages	•	•	•	•	•
Private Debt	•	•	•	•	•
Real Estate	•	•	•	•	•
Infrastructure	•	•	•	•	•

Source: Wealth Investment Policy Committee, as of January 18, 2024.

Dynamic asset-class weights by investor profile (Condensed)

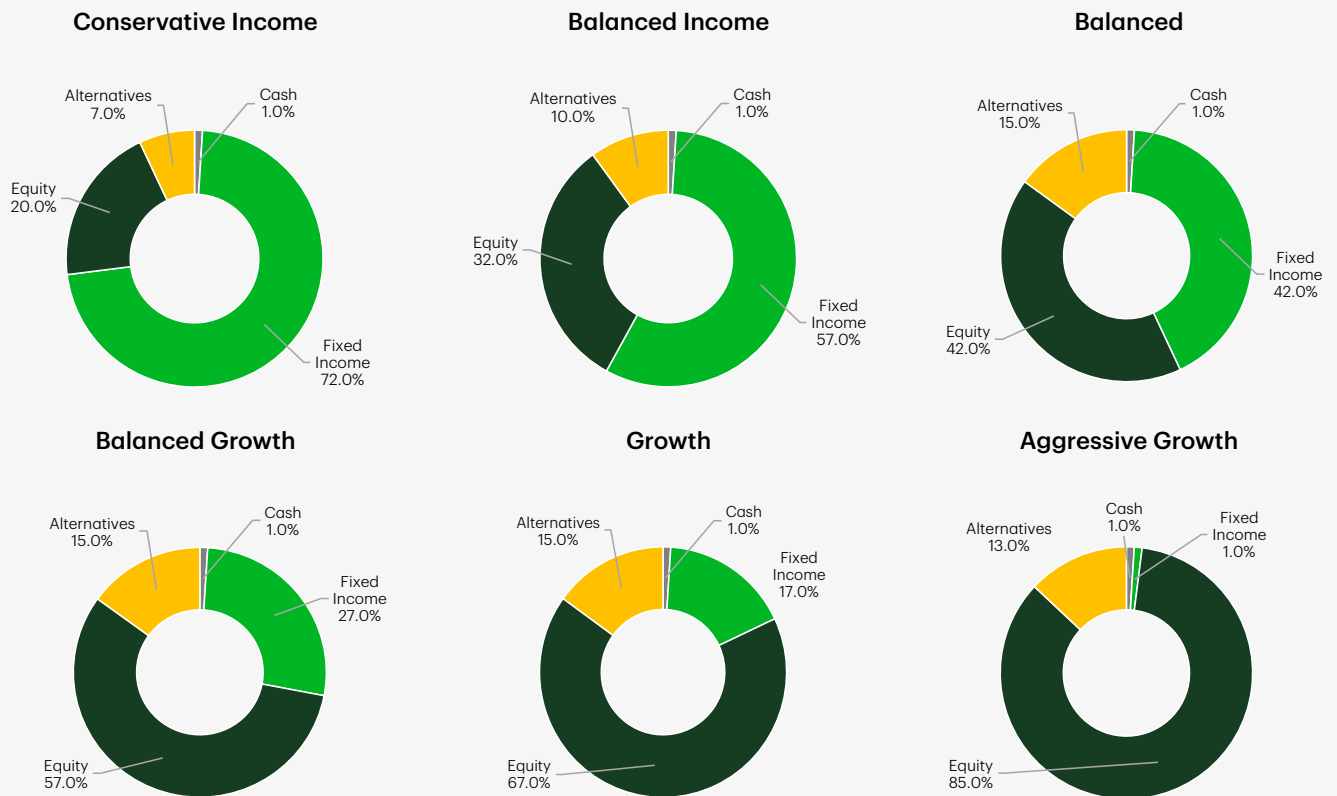


Strategic and dynamic asset-class weights by investor profile (Condensed)

Asset Class	Conservative Income		Balanced Income		Balanced		Balanced Growth		Growth		Aggressive Growth	
	Strat.	Dyn.	Strat.	Dyn.	Strat.	Dyn.	Strat.	Dyn.	Strat.	Dyn.	Strat.	Dyn.
Cash	2.0%	1.0%	2.0%	1.0%	2.0%	1.0%	2.0%	1.0%	2.0%	1.0%	2.0%	1.0%
Public Fixed Income	78.0%	79.0%	63.0%	64.0%	48.0%	49.0%	33.0%	34.0%	23.0%	24.0%	0.0%	1.0%
Government	39.0%	40.0%	32.0%	33.0%	24.0%	25.0%	17.0%	18.0%	11.0%	12.0%	0.0%	1.0%
Corporate	39.0%	39.0%	31.0%	31.0%	24.0%	24.0%	16.0%	16.0%	12.0%	12.0%	0.0%	0.0%
Public Equities	20.0%	20.0%	35.0%	35.0%	50.0%	50.0%	65.0%	65.0%	75.0%	75.0%	98.0%	98.0%
Canadian	6.0%	6.0%	11.0%	11.0%	15.0%	15.0%	20.0%	20.0%	23.0%	23.0%	29.0%	29.0%
U.S.	8.0%	10.0%	14.0%	16.0%	20.0%	22.0%	26.0%	28.0%	30.0%	32.0%	40.0%	42.0%
International	4.0%	2.0%	7.0%	5.0%	10.0%	8.0%	13.0%	11.0%	15.0%	13.0%	19.0%	17.0%
China/ Emerging Markets	2.0%	2.0%	3.0%	3.0%	5.0%	5.0%	6.0%	6.0%	7.0%	7.0%	10.0%	10.0%

Strat: Strategic, Dyn: Dynamic. Source: Wealth Investment Policy Committee, as of January 18, 2024.

Dynamic asset-class weights by investor profile (Expanded)



Strategic and dynamic asset-class weights by investor profile (Expanded)

Asset Class	Conservative Income		Balanced Income		Balanced		Balanced Growth		Growth		Aggressive Growth	
	Strat.	Dyn.	Strat.	Dyn.	Strat.	Dyn.	Strat.	Dyn.	Strat.	Dyn.	Strat.	Dyn.
Cash	2.0%	1.0%	2.0%	1.0%	2.0%	1.0%	2.0%	1.0%	2.0%	1.0%	2.0%	1.0%
Public Fixed Income	71.0%	72.0%	56.0%	57.0%	41.0%	42.0%	26.0%	27.0%	16.0%	17.0%	0.0%	1.0%
Domestic Government Bonds	30.0%	32.0%	24.0%	26.0%	17.0%	19.0%	11.0%	13.0%	6.0%	8.0%	0.0%	1.0%
Invest. Grade Corp Bonds	24.0%	25.0%	19.0%	20.0%	14.0%	15.0%	9.0%	9.0%	6.0%	6.0%	0.0%	0.0%
High Yield Bonds	5.0%	3.0%	4.0%	2.0%	3.0%	1.0%	2.0%	1.0%	1.0%	0.0%	0.0%	0.0%
Global Bonds - Developed	8.0%	8.0%	6.0%	6.0%	5.0%	5.0%	3.0%	3.0%	2.0%	2.0%	0.0%	0.0%
Global Bonds - Emerging	4.0%	4.0%	3.0%	3.0%	2.0%	2.0%	1.0%	1.0%	1.0%	1.0%	0.0%	0.0%
Public Equities	20.0%	20.0%	32.0%	32.0%	42.0%	42.0%	57.0%	57.0%	67.0%	67.0%	85.0%	85.0%
Canadian	6.0%	6.0%	10.0%	10.0%	12.0%	12.0%	17.0%	17.0%	20.0%	20.0%	25.0%	25.0%
U.S.	8.0%	10.0%	13.0%	15.0%	17.0%	19.0%	23.0%	25.0%	27.0%	29.0%	35.0%	37.0%
International	4.0%	2.0%	6.0%	4.0%	8.0%	6.0%	11.0%	9.0%	13.0%	11.0%	15.0%	13.0%
China/Emerging Markets	2.0%	2.0%	3.0%	3.0%	5.0%	5.0%	6.0%	6.0%	7.0%	7.0%	10.0%	10.0%
Alternatives	7.0%	7.0%	10.0%	10.0%	15.0%	15.0%	15.0%	15.0%	15.0%	15.0%	13.0%	13.0%
Commercial Mortgages	4.0%	4.0%	4.0%	5.0%	4.0%	5.0%	4.0%	5.0%	4.0%	5.0%	0.0%	0.0%
Private Debt	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	0.0%	0.0%
Real Estate	0.0%	0.0%	1.0%	0.0%	3.0%	1.0%	3.0%	1.0%	3.0%	1.0%	4.0%	3.0%
Infrastructure	0.0%	0.0%	2.0%	2.0%	5.0%	6.0%	5.0%	6.0%	5.0%	6.0%	9.0%	10.0%
Fixed Income	73.0%	73.0%	58.0%	58.0%	43.0%	43.0%	28.0%	28.0%	18.0%	18.0%	2.0%	2.0%
Equity	20.0%	20.0%	32.0%	32.0%	42.0%	42.0%	57.0%	57.0%	67.0%	67.0%	85.0%	85.0%
Alternatives	7.0%	7.0%	10.0%	10.0%	15.0%	15.0%	15.0%	15.0%	15.0%	15.0%	13.0%	13.0%

Strat: Strategic, Dyn: Dynamic. Source: Wealth Investment Policy Committee, as of January 18, 2024.

Economic Outlook

That First Canuck-cut Will Be a Doozie

Beata Caranci, SVP & Chief Economist and James Orlando, CFA, Director & Senior Economist | TD Economics

Be it markets or media, nobody is questioning that 2024 will mark the year of the rate cut. However, it's going to be a tricky communication exercise for the Bank of Canada. That first step will be a doozie in anchoring household inflation expectations.

The central bank will have to cut interest rates in the face of stubbornly high shelter costs because to neglect to do so risks running the economy aground. In turn, this could amplify household inflation expectations, which are sensitive to developments in home prices and perceptions of affordability. Currently, CPI shelter costs are running at 5.9% year-on-year (y/y) and account for just over half the growth in headline inflation. Shelter costs will maintain a magnified influence when the Bank of Canada starts cutting its policy rate in the spring, potentially accounting for upwards of two-thirds of overall inflation.

And we may be shy on this estimation. Canada can't meet annual population growth of 1.25 million with less than 300,000 new housing completions without creating serious structural shortages and increasing pent-up demand. While we currently forecast home price growth to be in the single digits this year and next due to the deterioration in affordability, there is upside risk to this forecast once interest-rate cuts get underway, which would put upward pressure on shelter inflation.

There's not much the Bank of Canada can do to address a structural shortage of housing supply. The responsibility falls into the lap of governments to ensure specific policies related to population growth have parallel housing supports. But the Bank of Canada is charged with anchoring inflation expectations around its 2% target, which is made more difficult by this challenge.

There are three key reasons why that first interest-rate cut will need to occur while the annual rate of inflation is still at the upper end of the central bank's targeted range. First, the real interest rate is already in restrictive territory. Duration and level will come under the microscope with each passing month. A real policy rate of 2% (adjusted for the neutral rate) is consistent with past recessionary periods and will only push higher as inflation continues to ease.

Second, aside from rising economic risks, financial risks could also become magnified. Last year, in a client note entitled "To Err Is Human," we observed

that, while the Bank of Canada does not manage the supply-demand imbalance of housing, it still needs to consider whether its interest-rate setting contributes to amplifying financial risks. Leaving interest rates at the effective lower bound for too long following the pandemic fuelled a high uptake in variable-rate mortgages and an escalation in household mortgage debt. Now the central bank must keep those risks top-of-mind at the other end of the spectrum in leaving rates too high for too long. This is definitely not an argument for a return to low interest rates. But it is an argument to adjust the braking force on the economy, by gradually easing the foot off the pedal.

Lastly, although the Bank's preferred core metrics of inflation won't yet be at a desirable level when that first interest-rate cut occurs, the breadth of consumer items driving the pressure should be narrowing. This trend started 18 months ago. Inflation, by its very nature, is a matter of breadth. It's always the case that aggregate figures on inflation can be propped up by outsized moves in a small number of components, but that does not speak to the overall condition of consumer demand across the entire economy. "No problem," you say, "the central bank's preferred trimmed inflation metric takes care of this issue with the removal of shelter costs that are driving the upper end." Not so. Even here, shelter carries an influence.

This three-pronged thought framework sounds simple enough as a basic overview, but not so if you're a central banker, which will be one of the toughest jobs within the financial industry this year. The stars won't be perfectly aligned on the inflation front relative to the timing of when interest-rate cuts will need to commence. And this could create a huge communication challenge for a central bank that may already have a credibility problem on its inflation-fighting credentials on Main Street.

That's the short version; now let's get into the nitty gritty of the analysis behind our argument.

How much pain can the BoC take?

Laying out the Bank of Canada's dilemma boils down to two decision paths. If shelter remains a prominent driver of inflation, as we think it will, any monetary policy response that does not pivot to focus on other drivers of inflation would mean that policy rates would likely stay higher for longer. This would result in weaker economic growth than our baseline forecast.

A recession would be fairly certain in that scenario. Alternatively, a communication pivot away from the influence of shelter could risk maintaining elevated inflation expectations among households, taking longer for the Bank of Canada to restore its credibility. It is a matter of which type of risk the central bank can live with.

Let's look at the breadth of inflation. Back in 2022, high inflation was everywhere. Supply-chain bottlenecks and a commodity price shock hit everything from everyday items like food and gasoline to longer-lasting products like washing machines. Price gains were broad-based, with approximately 60% of items increasing more than 4% in Canada and the U.S. (Figure 1). That was a toxic combination of both breadth and magnitude, especially when compared to periods of stable inflation or recent rate-hiking cycles. For instance, between 2017 and 2019, when the Bank of Canada started to get nervous about inflation risks and ultimately raised interest rates to a peak of 1.75%, the number of CPI items increasing by more than 4% amounted to just 8% of the basket in Canada (and 4% in the U.S.).

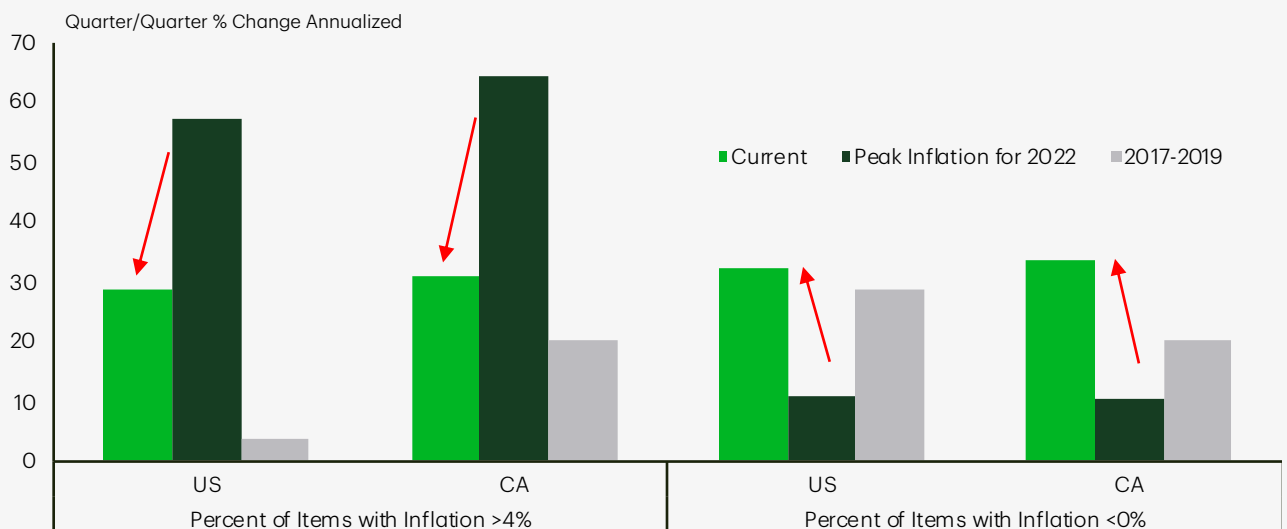
The good news is that the share of items comprising price growth of more than 4% has already halved within the CPI basket. Unfortunately, the breadth is still too high given the magnitude of gains occurring within the heavy-hitting shelter component. This is apparent considering that core inflation is running at 3.5% despite a tripling in the share of items with outright price declines relative to the peak period — a representation that's even greater than prior periods of stable inflation.

This phenomenon is not unique to Canada, but the interpretation differs slightly depending on where you look. In the U.S., Fed Chair Powell has been encouraged that inflation is moving decisively in the right direction, while BoC Governor Tiff Macklem has emphasized that many items are still rising at a pace that is “not normal.” Macklem highlighted high inflation for food, non-durable goods and shelter prices.

In both the U.S. and Canada, shelter prices show close to 6% growth. But U.S. rent prices have already decelerated two percentage points from a peak of nearly 9% y/y in early 2023. Given the decline in market-based rents over the past few months (a leading indicator), this trend should continue to push overall shelter inflation lower. The same story cannot be said for Canadian inflation. For one, rent prices are not easing. Rents have been growing at around 8% y/y. Worse, incredibly low vacancy rates in major city centres have caused the three-month annualized rate of rent growth to top 11%! That means about 9% of the core CPI basket is running at double-digit rates.

Rents are increasing not just due to the population-growth impulse, but because the higher cost of carrying a mortgage is implicitly passed into rents. And then there's a second direct influence of monetary policy within the shelter-inflation metric. The rise in the BoC's policy rate has pushed up mortgage interest costs (5% of the core CPI basket) a whopping 30% y/y. That compares to the previous peak of 25.4% y/y in 1982. In that case, the BoC policy interest rate hit a high of 21%. Today's lower rate of 5% has been no match for the speed of adjustment and the impact of moving off the zero lower bound.

Figure 1: Fewer Products Seeing Price Surges



Source: Statistics Canada, Bureau of Labor Statistics, TD Economics.

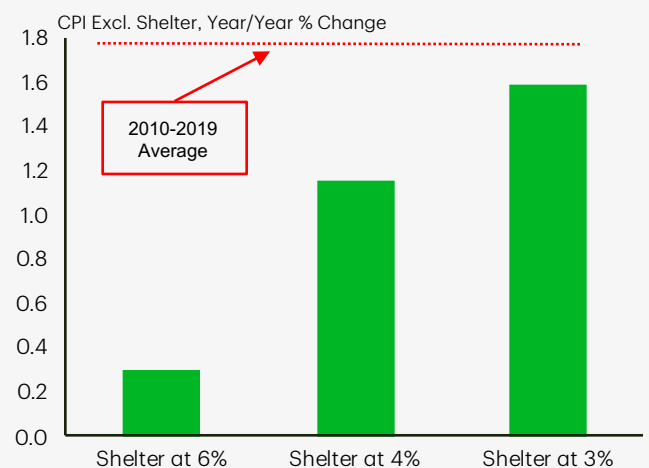
Half of the contribution to products with inflation above 4% in Canada comes from shelter. Now, some may say that the BoC's trimmed mean and median core inflation metrics will neutralize this influence by stripping out high shelter prices. But this is not so straightforward. In the November reading, shelter prices remained in the trimmed mean metric due to its disproportionate weighting. Indeed, rent prices and non-core items like restaurant meals were included in the trimmed mean measure for November, even though their prices rose by more than 5% annualized on the month. It's important to note that the combination of shelter plus food and energy accounted for 56% of the trimmed mean basket in November.

If the BoC wants to get core inflation down to 2% while shelter prices remain high, it will need to sacrifice more economic growth. Calculating a counterfactual with shelter inflation holding at 6% requires the rest of the inflation basket to decelerate to approximately 0.5% in order to sustain inflation at 2%. To get that outcome requires a large build-up of economic slack within every other area of the economy.

Comparatively, CPI excluding shelter averaged 1.75% during the "low-inflation" period of 2010 to 2019, which goes to show this would be no easy task to achieve absent a recession. Within Figure 2, two other more conservative scenarios for shelter price growth are captured, and these too speak to the difficult task ahead for the consumer basket making up the rest of household expenditures.

This is where the magnitude of economic sacrifice comes into play. The current 5% policy rate is 200 basis points above the BoC's top-end range for the neutral (neither accommodative nor restrictive) rate and nearly 300 basis points above our view. This is already

Figure 2: Focusing on Shelter Will Require More Disinflation Elsewhere



Source: TD Economics.

impacting the economy through weak consumer spending, which is only going to get worse in 2024 as more homeowners reset at higher mortgage rates. Should the Bank keep the policy rate high for too long, the amount of money households will dedicate to paying their debts will continue to rise beyond its current all-time high. With less money for people to spend elsewhere, the BoC's "growth sacrifice" becomes magnified.

This may well require a leap of faith by easing interest rates before the ideal backdrop on inflation. Our GDP forecast of a meagre 0.5% rate of growth in 2024 could easily turn into no growth at all if interest rates are held too high for too long.

And Behind Door No. 2 — Anchoring Inflation Expectations

The BoC is mandated to keep inflation stable at around 2%. Would cutting interest rates prevent the Bank from achieving this goal in the short run? Possibly. If interest-rate cuts, even modest, spur housing demand and strong price growth, it may be harder to re-anchor consumer expectations for a few reasons.

First, there's plenty of research to show that households anchor their inflation expectations to personal experiences, and following home prices is practically a sport in Canada. High leverage and home-ownership rates, alongside non-stop media attention, keep housing developments at the centre of casual conversations. Empirically, one study in the U.S. showed that a one-percentage-point increase in house-price expectations led to a 0.24-percentage-point increase in household inflation expectations. This was outsized relative to the benchmark and reinforced how house price expectations were overweighted in setting inflation expectations.

Second, households also show a tendency to overweight inflation expectations towards experiences or items that reflect more extreme moves, even when those items make up a smaller share of their expenditures. Clearly housing doesn't make up a small share of household expenditures, making this a higher risk. The fact that extreme price movements have been a trademark of CPI over the past three years further complicates this. Household expectations may have been conditioned to be even more sensitive to upside shifts in prices than the decade prior to the pandemic, when inflation was a boring affair.

So, the challenge for the Bank of Canada will be twofold. It will need to trust the process and start cutting interest rates before inflation is comfortably at target, while also successfully convincing the public that it knows what it's doing. The first will encompass a leap of faith, because there's always embedded forecast

error with the combination of known and unforeseen events. The second will require a convincing pivot in communication on why shelter costs do not define the inflation universe for Canada.

It's possible the Bank of Canada is already starting to prepare the public for this understanding. Within the December Summary of Deliberations, members noted concern over a premature easing in financial conditions that could spark a rebound in the housing market and fuel shelter price pressures. At the same time, they agreed that monetary policy cannot solve for the structural shortage of housing supply, with specific mention that members would monitor closely the evolution of shelter price inflation and its contribution to core inflation and total CPI. In central-bank-speak, this may be their way of saying that they need to think about isolating this sector's influence from broader demand trends within the economy.

We think this pivot is necessary for the BoC to strike the right balance between exerting too much pressure on the economy versus stoking inflationary pressures again. Consumer inflation expectations generally run higher than the inflation target, so some deviation is not cause for alarm. But the gap is holding particularly wide this time around, even as consumers look two years ahead (Figure 3). This is partly related to a phenomenon known as adaptive expectations, where people view the future based on what has happened in the recent past. The effects can be long-lasting. Ever talk with someone who took out a mortgage in the 1980s and hear them comment that the current generation doesn't even know what high rates are?

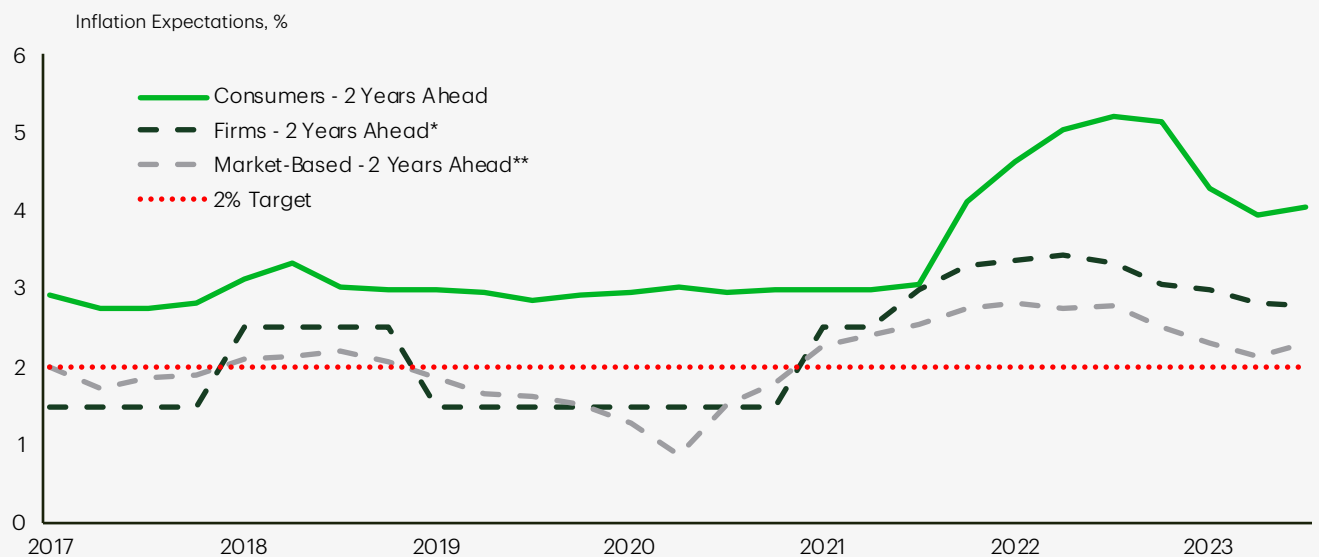
Breaking this psychology is what raises the possibility that the Bank of Canada will opt to leave interest rates high for longer. Although many might view this outcome as a miscalculation that could drive the economy more deeply into recession, it could also be thought of as a tactical manoeuvre that's required to reset household inflation expectations.

Bottom Line

This year is already shaping up to be a difficult one for the Bank of Canada. With the economy having flatlined in the second half of 2023 and annual core inflation rates still at uncomfortable levels, the BoC will be forced down one of two paths: Fight shelter-fuelled inflation until the bitter end, or recognize that growth/inflation dynamics will warrant rate cuts sooner rather than later.

Luckily for the BoC, recent inflation readings have been more convincing to allow for a communication pivot. CPI excluding shelter now sits just above the BoC's 2% target (y/y), and even its preferred indicators are averaging just 2.4% on a three-month annualized basis. This signals that annual core inflation rates are heading in the right direction. Consumers have already pulled back spending and more are likely to join the fray as homeowners continue to renew at higher rates. Less spending will create greater downward pressure on inflation going forward, but the Bank of Canada won't be able to wait until all the stars align before starting the process of normalizing interest rates.

Figure 3: Has the BoC Lost Its Inflation-fighting Credibility With Main Street?



*Quarterly Consensus (2017 - 2022), Quarterly Average of Monthly Data (2022 - Current). **Quarterly Average of Daily Data. Source: Bank of Canada, Statistics Canada, TD Economics.

Asset Class Analysis

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Quarter in Review

All's Well that Ends Well

Fred Wang, Senior Portfolio Manager, Asset Allocation | TD Wealth

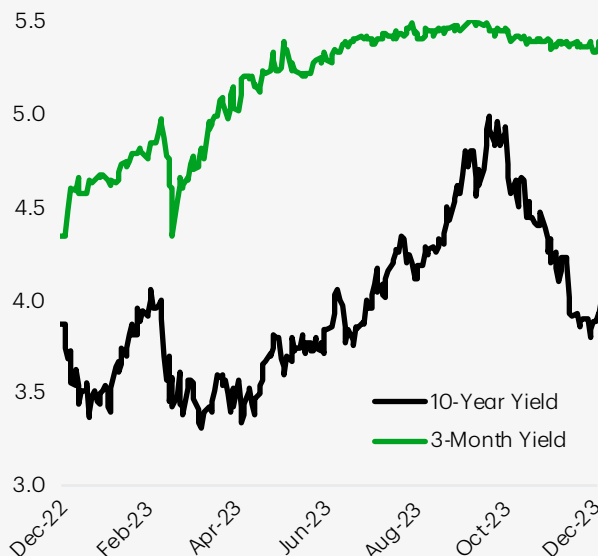
The global market in the fourth quarter was characterized by a strong rally, leading to solid annual returns both for equities and bonds. The macro environment — peppered with geopolitical events and monetary-policy pivots — continued to evolve rapidly, with shifting narratives tugging at market sentiment. Investors had to be nimble to navigate the environment, particularly as asset-class correlations turned increasingly positive.

Sharp Reversal of Stocks and Bonds

Entering the quarter, the market was not in great shape. Long-end Treasury yields continued their ascent, while short-end yields were anchored to the Fed's hawkish "higher-for-longer" stance (Figure 1). As a result, the yield curve steepened, with both 10-year real yields and term premiums peaking in late October. (See our previous edition of PSQ: "We" for a deeper dive into the factors that lifted Treasury yields.) This higher yield, in turn, tightened financial conditions significantly, hurting stocks and bonds simultaneously. The S&P 500 had fallen 10% from its July peak, and credit spreads also widened in October.

Indeed, prices were cut to such an extent that various asset classes became much more attractive. Treasuries hadn't been so cheap since the financial crisis, with 10-year Treasuries boasting a term premium close to 0.5%, a real yield of 2.5% and a nominal yield of 5%.

Figure 1: 10-year Treasury volatile; 3-month anchored

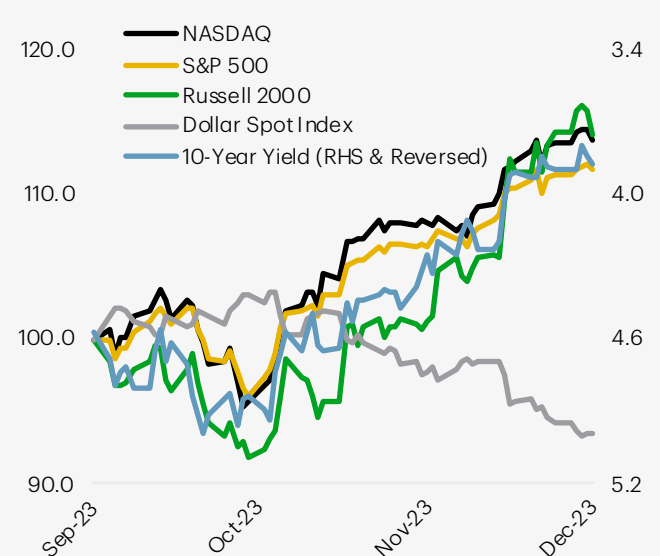


Source: FactSet, WIO as of December 31, 2023

In Canada, the 10-year real yield also rose to an attractive 2.4% in early October — a level that would allow some of the nation's largest pension plans to hit their long-term real return targets by simply buying government paper. We believe these pensions — powerful, liability-sensitive pools of investment — provide a natural demand for Canadian government bonds, especially on the long end. When yield becomes attractive, these buyers tend to step in, which essentially puts a cap on government yields in Canada.

Then, in late October, the tension broke. Investors rushed back in to Treasuries, prompting yields to fall. There are three implications for such a speedy reversal in yields. First, mega-cap growth names, especially within the technology sector, recovered significantly due to their heightened sensitivity to interest rates. As shown in Figure 2, equity markets rallied on lower yields, led by the Nasdaq Composite Index. Then, after a dovish Fed committee meeting in December, small-caps joined the party, ending the quarter up more than 14%. The second implication is that the reversal in interest rates since October also reversed the U.S. dollar trend. The dollar spot index finished the quarter down 6.6%. Last, but not least, the weaker USD and lower real yields also pushed gold, which can be viewed as a currency in the commodities complex, to historical highs.

Figure 2: Multi-asset moves were driven by Treasury yields



Source: FactSet, WIO as of December 31, 2023

Yield Environment Lifts All Boats

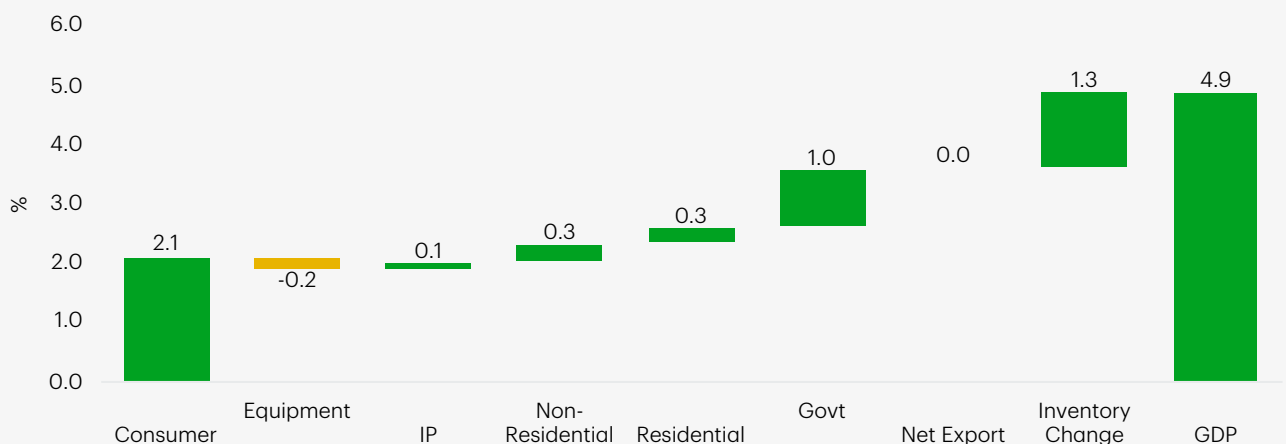
In previous editions of PSQ, we have pointed out that the U.S. economy has been exceptionally strong throughout the tightening phase, supported by a robust labour market and healthy consumers. Of course, the economic data are backward-looking whereas investors are forward-looking. So, if strength in the economy drives rates higher, which was the case up until October, those higher rates will be a headwind to stock prices. However, if the economy stays in the goldilocks zone — not too cold, not too hot — it should allow the Fed to begin to ease financial conditions without spurring inflation. This is what we believe is now happening.

In the United States, real GDP grew 4.9% in Q3 (q/q annualized), exceeding expectations and solidifying the soft-landing narrative. Personal consumption was the most significant factor, contributing 2.1 percentage points (Figure 3). Demand for new inventory added 1.3 points — not surprising given the rise in consumption.

Although, interest rates are typically a headwind for fixed assets, these remained positive. Investment in equipment was the only detractor among the eight components. Strong economic fundamentals reinforced the belief that U.S. recession risk is subdued, which in turn provided confidence to investors to embrace risk assets in Q4.

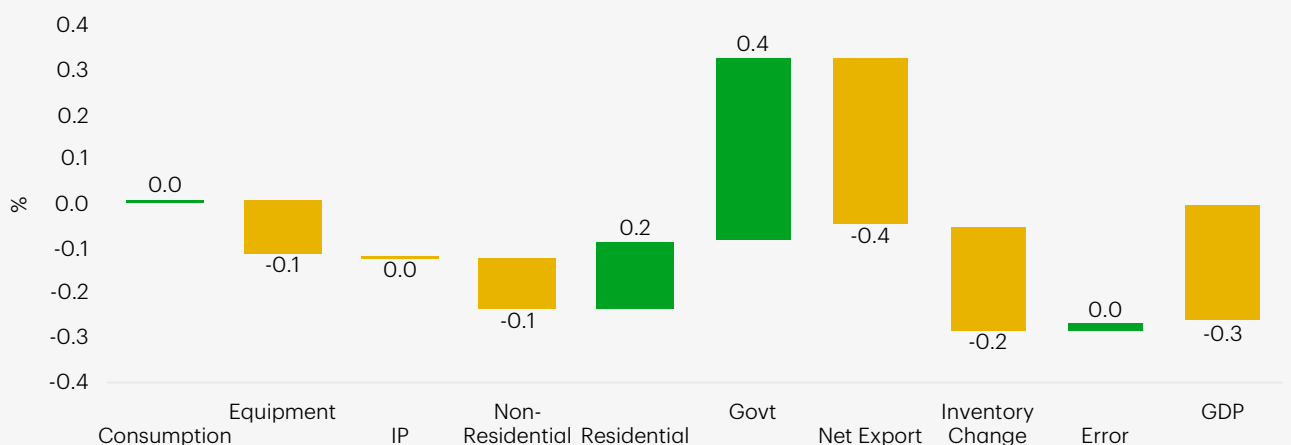
The Canadian economy, on the other hand, experienced a modest contraction of 0.3%. Figure 4 shows that the contribution by Canadian consumers to economic growth was flat during the quarter. Although residential investments contributed positively, higher rates weighed on non-residential and equipment investments. Government spending was the largest contributor. This economic performance stands in sharp contrast to that of the United States. Given that Canada is inherently more sensitive to interest rates, in part because of upcoming residential mortgage renewals, the Bank of Canada might need to act earlier than other central banks to manage the risk to the economy.

Figure 3: U.S. enjoys blockbuster Q3 on consumers, inventory replenishment



Source: FactSet, WIO as of December 31, 2023

Figure 4: Canada suffers Q3 contraction

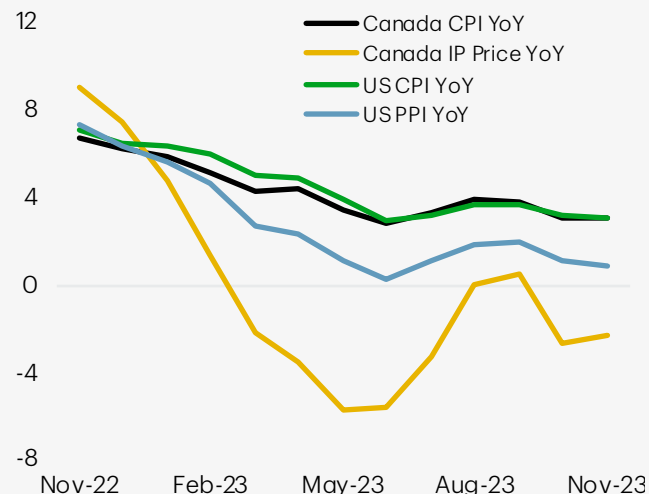


Source: FactSet, WIO as of December 31, 2023

On the inflation front, things continued to improve in Q4. As of November 2023, headline inflation figures in the U.S. and Canada both stood at 3.1%, a significant decline over the past year. The goods sector continued to be disinflationary, with input prices on the producer price index (PPI) rising just 0.9% y/y in the U.S. and down 2.3% in Canada (Figure 5). However, service-sector inflation pressures remain. The Fed's preferred "super-core" service CPI, defined as service CPI excluding volatile energy services and shelter, increased 0.4% in November from the previous month, or 3.9% y/y. Average hourly earnings from the December non-farm payrolls release also showed a 4.1% increase from a year ago.

The improving, albeit above-target, inflation numbers are definitely playing into the central bank's calculations, giving them reason to soften their rhetoric by starting to talk about a possible end to the hiking campaign and even a future path for lower rates. This was the case at the December Federal Open Market Committee (FOMC) meeting. As anticipated, the Fed held the upper bound of the federal funds rate at 5.5% but also noted a slowdown in economic activity since the strong third quarter. The latest fed funds rate projection (aka, the "dot plot") now predicts three rate cuts by the end of 2024. This shows that the committee may be more careful when considering recessionary risks, which was well received by the market.

Figure 5: Goods inflation well below CPI on weak producer prices



Source: FactSet, WIO as of December 31, 2023

After the meeting, small-cap and heavily shorted equities started to outperform, benefiting from the anticipated loosening of monetary policy and financial conditions.

Anomalies in the Goldilocks Scenario

At the Wealth Investment Office, we always look at multi-asset performance through a macroeconomic regime framework. Figure 6 shows the performance of different asset classes based on the framework.

Figure 6: Asset-class performance by macroeconomic environment

Economic Environment	Falling Inflation					Rising Inflation					
			MTD	QTD	1 Year			MTD	QTD	1 Year	
Rising Growth	Equities	Global	4.1%	9.4%	21.6%	Commodities	GSCI		-3.3%	-10.7%	-4.3%
		US	4.5%	11.7%	26.3%		Energy	-5.2%	-16.7%	-5.2%	
		Canada	3.9%	8.1%	11.8%		Oil	-5.7%	-21.1%	-10.7%	
		EAFE	2.9%	5.0%	16.2%		Natural Gas	-6.4%	-4.8%	-26.2%	
		EM ex. China	6.4%	13.0%	20.0%		Copper	1.2%	3.8%	5.9%	
		China	-1.8%	-6.8%	-9.1%		Agriculture	-3.3%	-0.7%	-8.3%	
		US Small Cap.	12.2%	14.0%	16.9%		Industrial Metals	3.8%	0.8%	-4.5%	
		Global REIT	9.7%	15.8%	11.5%						
	Global Infra.	4.2%	10.9%	6.8%							
	Corporate Bonds	Global IG	3.8%	7.5%	9.1%	Emerging Market Debt	Hard		4.8%	9.3%	10.4%
Global HY		3.8%	7.8%	13.7%	Local			2.3%	6.9%	10.9%	
Private Debt		1.6%	2.9%	13.3%							
Falling Growth	Nominal Gov't Bonds	Global	2.9%	5.5%	6.7%	Inflation-Linked Gov't Bonds	Global		3.6%	6.1%	4.5%
		US	3.4%	5.7%	4.1%		US		2.7%	4.7%	3.9%
		Eurozone	3.7%	7.2%	7.1%		UK		7.0%	9.4%	0.6%
		Japan	0.5%	1.0%	0.5%		Canada		3.7%	10.5%	2.0%
		Canada	3.5%	8.5%	6.1%						
					Commodities	GSCI	-3.3%	-10.7%	-4.3%		
						Energy	-5.2%	-16.7%	-5.2%		
						Gold		1.3%	11.6%	13.10%	

Source: FactSet as of December 31, 2023. Note: All returns are in local currency unless indicated otherwise.

Commodities did not do well during the quarter, due mainly to the underperformance of oil and gas, despite a rise in base and precious metals. This suggests that, even though a soft landing might be in the cards, it may not lead to the kind of cyclical expansion that would benefit energy, given soft growth expectations. Gold, however, may benefit from slower growth alongside an increasingly dovish Fed, especially since gold also acts as a hedge against geopolitical risk and a diversifier in the reserve currency basket for many emerging-market central banks.

Another anomaly during the quarter was the stubbornly positive correlation between equities and bonds. From Figure 6, we observe that both equities and bonds delivered strong performance, not only for the quarter but also for the year.

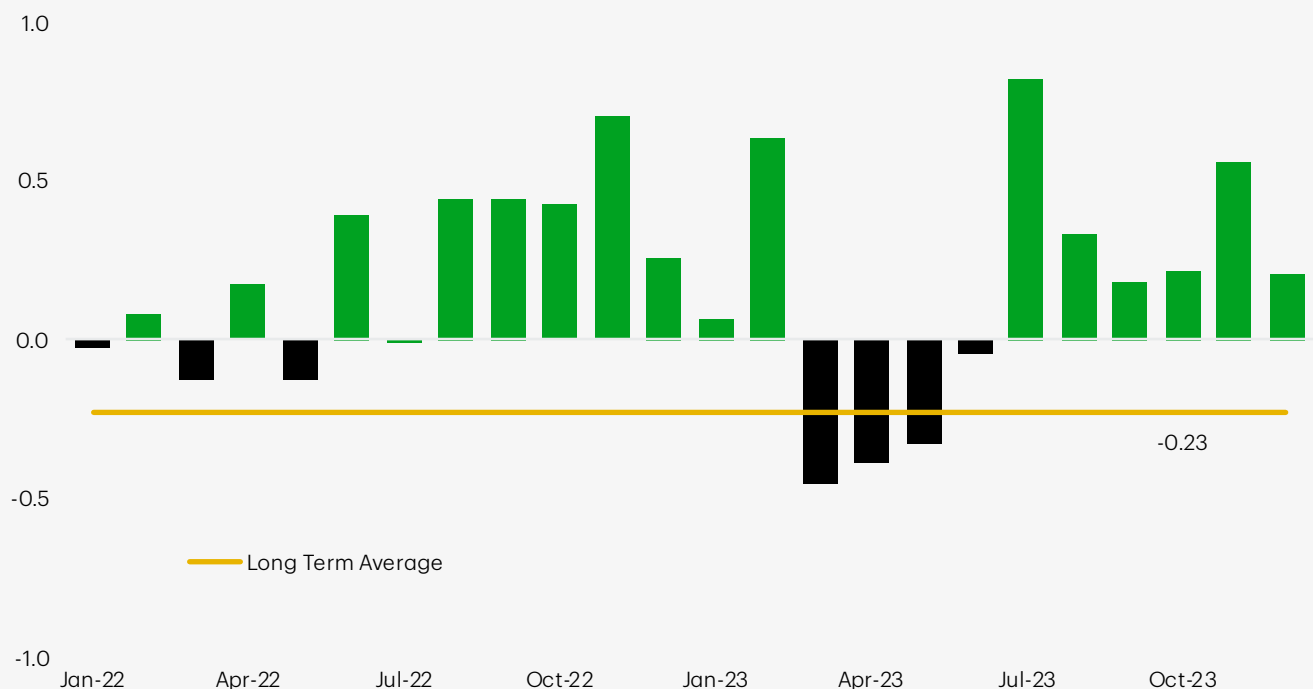
Figure 7 reveals that the correlation between U.S. equities and bonds since 2021 has only been negative coming out of the crisis stemming from the failure of Silicon Valley Bank (SVB). For most of the year, the two asset classes have remained positively correlated, due to the overwhelming focus investors have put on the direction of interest rates and monetary policy.

This positive correlation significantly reduced the diversification benefit and the risk-adjusted return of a balanced portfolio. This, of course, can lead to positive or negative outcomes. In 2022, equity and bond returns were both negative, leading to an investor exodus from the market. Unfortunately, when equity and bond returns both landed on the positive side in 2023, many investors were on the sidelines, unable to participate.

A Lot of Dry Powder

Over the past two years, as investors have tried to adjust to tighter credit conditions, a couple of interesting dynamics have emerged. First, as the Fed winds down its “balance sheet” of securities purchased during its stimulative campaign of “quantitative easing,” the bond market is missing the buyer of last resort that used to vacuum up all the supply, keeping prices high and long-term rates low. Now, retail and institutional investors are stepping in to fill the void, but they are more price-sensitive and would prefer higher yield. To cater to these investors, Treasury issuance has been concentrated on the short end offering yield north of 5%, which is much more attractive than long-term Treasuries on both yield and risk-adjusted basis.

Figure 7: A year of weird correlations, as stocks and bonds converge



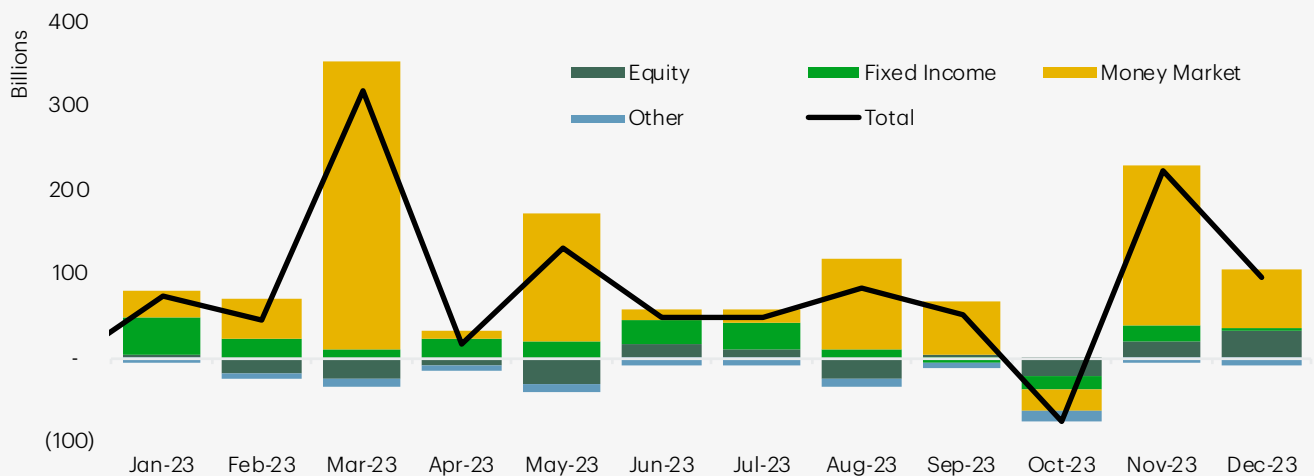
This can be observed in the persistent, outsized inflow into money-market and fixed income funds (Figure 8). Higher rates, in other words, are enticing investors to move money into more conservative vehicles from bank deposits. This dynamic was highlighted by many during the SVB crisis last year. However, it has continued since then. Data from the Investment Company Institute show that total assets sitting in U.S. money-market funds hit a historic high of \$5.9 trillion at the end of 2023. This pool of money is helping finance U.S. fiscal spending as well as the existing debt pile right now. However, in the future, as the Federal Reserve starts to cut interest rates, this pile of cash will have to leave to earn higher returns.

Second, the rapid and unpredictable rate-hike cycle has discouraged investors from putting their money to work, due to higher financing costs and fewer exit options. After raising a historic amount of capital

from investors globally, private-market investors are sitting on a large pile of cash while being hesitant to invest. Figure 9 shows that across private equity (buyout, growth equity, venture capital), private debt (senior direct lending), real estate and infrastructure, investment funds collectively are sitting on over \$2.3 trillion of dry powder — the highest the sector has ever seen. This capital could be deployed, however, if the concern around monetary policy wanes.

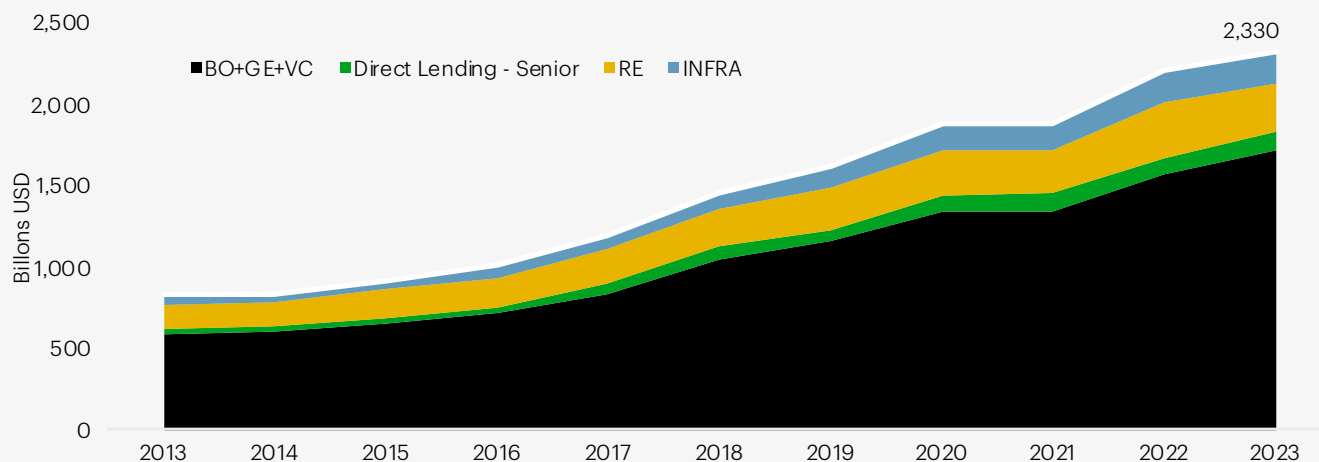
As the world adjusts to the new post-Covid reality, certain investment dynamics may have changed permanently. Although the unconventional Covid-era monetary and fiscal policies are already behind us, investors still have to deal with the legacy of many long-lasting implications. Cash sitting on the sidelines may not jump in to shore up asset prices every time, but the return-seeking nature of this pool of cash will certainly strike for the right opportunities.

Figure 8: Investors flood into money-market, fixed income funds



Source: FactSet, WIO as of December 31, 2023

Figure 9: Private asset managers sitting on piles of cash



Source: Preqin, WIO as of December 31, 2023; BO = Buyout, GE = Growth Equity, VC = Venture Capital, RE = Real Estate, INFRA = Infrastructure

Geopolitics Poses Significant Risk

The biggest risk on the geopolitical front was the breakout of Israel's war in Gaza against Hamas, after the militant group's attack on Israeli soil on October 7. Since then, the Israel Defense Forces have launched a military campaign to neutralize Hamas's threat in Gaza. The war is not only an escalation of the prolonged Israel-Hamas conflict, but also a catalyst that could destabilize the entire region.

In an attempt to cut off support to Israel, Houthi militants have been attacking merchant ships entering the Red Sea from the Gulf of Aden, given that the Red Sea connects to one of the most important global shipping choke-points: the Suez Canal. Instability in the area increases pressure on the global supply chain. Euro-bound container ships are being diverted around the Cape of Good Hope, at the southern tip of the Africa, in order to avoid the shorter but more dangerous Red Sea trading route. This significantly increases shipping costs. According to the World Container Index, as of early January, shipping rates from Shanghai to Rotterdam have tripled since the end of November. This poses risk to the disinflationary forces emanating from Europe and North America.

Another highly watched geopolitical event this quarter was the meeting between U.S. president Joe Biden and Chinese president Xi Jinping at the APEC Summit in San Francisco. This meeting somewhat alleviated market concern over the strategic rivalry between the world's largest economies. Leading up to the meeting, a number of high-profile deals between prominent U.S. and Chinese companies were announced.

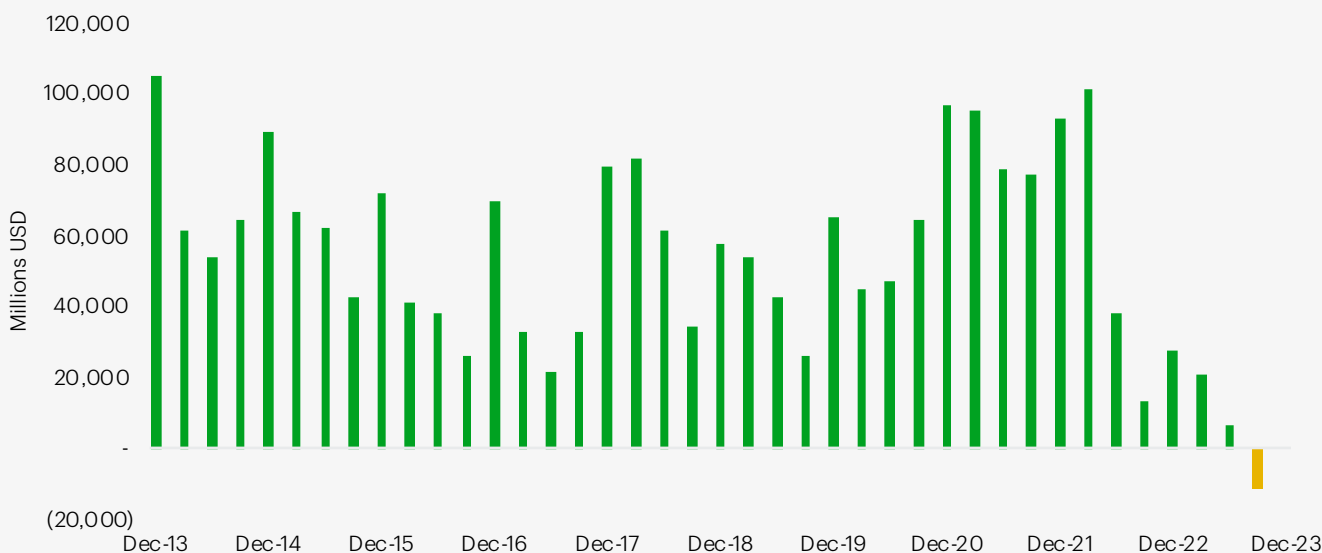
For example, Meta struck a deal with Chinese technology giant Tencent to distribute Meta's VR headsets in China, marking a celebrated comeback since Facebook's exit from China in 2009.

In the end, however, the meeting did not amount to much more than a commitment from the two nations' leadership to continue high-level, official dialogue, especially within the military ranks. There is no indication that the strategic rivalry will revert anytime soon. This clearly hurts businesses. Figure 10 shows that, during the third quarter of 2023, foreign direct investment into China turned negative for the first time since the inception of the data series in 1998.

By the time this article is published, we will also have witnessed the first important geopolitical event of the year: Taiwan's presidential election, on January 13. At time of writing, the race was led by the incumbent vice-president, Lai Ching-te. He is favoured by Taiwanese nationalists who support the island's sovereignty and independent government. This, needless to say, conflicts with the China's vision of "inevitable reunification" of Taiwan with China.

The election outcome may become a flashpoint, even though the new president will not be inaugurated until May. The probability of military conflict due to the election is low; however, if China intensifies its military drills and incursions by its fighter jets or navy fleet around Taiwan, it could heighten the tension and the risk of misfire. One worrisome scenario could involve a blockade of Taiwan, which could deal another blow to the global supply chain, on top of the damage to the region's economy.

Figure 10: Quarterly foreign direct investment turns negative for the first time



Source: FactSet, WIO as of December 31, 2023

Outlook on Fixed Income

Turning on the Charm

Aurav Ghai, Senior Fixed Income Analyst | TD Wealth

Beleaguered fixed income markets certainly had a tough time finding direction last year. In fact, calling 2023 challenging would be an understatement. But don't give up because it looks like the worst is behind us and this asset class is set to turn on the charm and take off.

Few of us expected the gains delivered by some fixed income segments in 2023 and, if we look at top performers over the past, it's unlikely last year's highfliers will manage to do the same in 2024 (Figure 1). Whatever this year brings, it definitely won't be a smooth ride because the turbulence surrounding

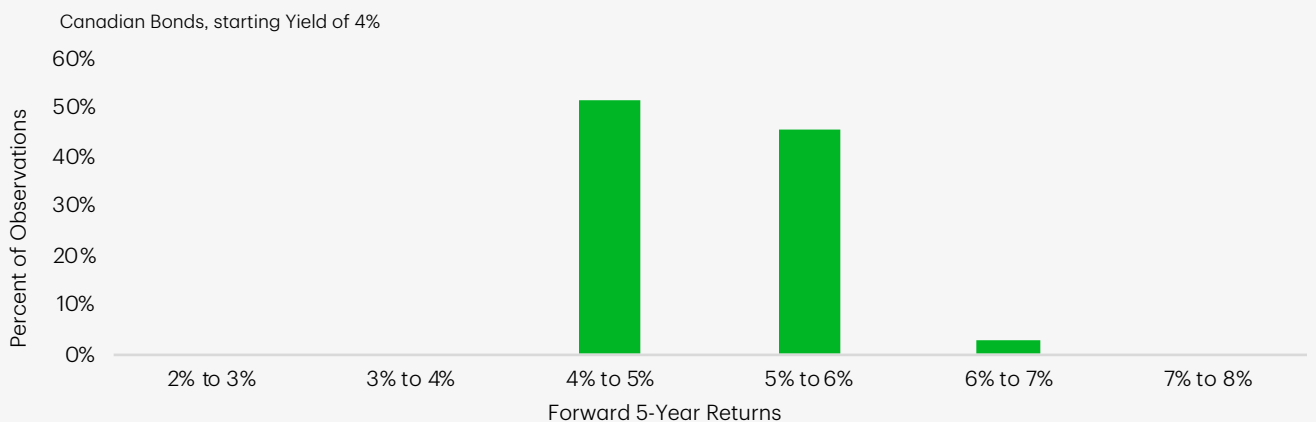
global economic growth hasn't disappeared. What you can expect, however, is an attractive longer term outlook for bonds—set in motion by yields near two-decade highs—that comes with the price tag of shorter term volatility (Figure 2). Yes, it would be fabulous if yields slipped a little further, like they did in the last two months of 2023, and pushed prices higher, adding capital gains to total returns. But even without, fixed income should flourish at current yields. As 2023 performance demonstrates, returns may be volatile over the short term but will accrue for those with longer time horizons.

Figure 1: Fixed Income Returns

Canada Gov	Canada IG	Canada HY	Canada RRB	US Gov	US IG	US HY	US IL	US Loans	Global Gov	Global IG	Global HY	Global IL	EMD (USD)
2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
22.0%	18.3%	19.2%	8.3%	13.2%	3.8%	16.6%	10.0%	2.1%	14.9%	13.0%	6.0%	-0.9%	12.6%
15.0%	14.0%	19.0%	8.2%	10.4%	2.8%	16.1%	8.5%	2.0%	13.6%	11.5%	5.4%	-6.2%	12.5%
14.9%	11.7%	16.5%	6.2%	9.3%	2.7%	15.1%	7.4%	1.5%	13.2%	9.0%	5.2%	-9.9%	12.1%
12.3%	11.0%	15.9%	5.8%	9.2%	2.0%	10.3%	7.0%	1.1%	13.2%	9.0%	5.1%	-11.1%	9.7%
11.1%	10.2%	11.7%	0.8%	8.6%	1.5%	9.9%	5.9%	0.2%	11.6%	8.7%	4.7%	-11.2%	8.8%
10.1%	8.9%	10.6%	0.8%	8.4%	0.9%	9.7%	5.2%	0.0%	10.4%	8.7%	3.6%	-11.7%	8.4%
9.4%	8.3%	10.4%	0.8%	8.2%	0.3%	5.9%	3.6%	-0.4%	8.8%	8.3%	1.8%	-12.3%	8.2%
7.6%	8.2%	7.6%	-0.9%	7.6%	0.1%	5.7%	3.4%	-0.5%	8.1%	8.1%	-0.8%	-12.6%	7.5%
7.3%	6.5%	7.3%	-2.0%	6.0%	-0.1%	4.8%	3.3%	-1.5%	8.0%	7.5%	-1.1%	-12.8%	6.1%
6.5%	5.4%	6.2%	-2.0%	4.4%	-0.5%	3.7%	2.8%	-1.8%	7.7%	5.7%	-1.3%	-14.3%	5.9%
6.5%	5.1%	5.3%	-3.6%	3.7%	-1.7%	3.7%	2.2%	-2.8%	7.5%	5.2%	-1.8%	-14.6%	3.8%
6.3%	3.2%	2.9%	-6.0%	3.2%	-2.4%	2.9%	1.8%	-3.0%	6.5%	5.0%	-2.2%	-16.3%	3.8%
5.2%	2.4%	2.8%	-9.3%	2.5%	-2.8%	0.9%	1.7%	-3.3%	6.4%	4.2%	-2.3%	-17.9%	3.2%
4.1%	2.1%	2.6%	-13.1%	1.2%	-4.5%	0.8%	0.7%	-6.1%	6.1%	1.8%	-3.0%	-19.0%	2.0%

Source: MorningStar, Wealth Investment Office (WIO), as of December 31, 2023.

Figure 2: Higher Bond Yields Point to Increased Returns



Source: MorningStar, Wealth Investment Office (WIO), as of December 31, 2023. Canadian bonds = FTSE Canada Universe Bond Index. Total 35 instances of starting yield of above 4% for FTSE Canada Universe Bond Index between 2006 and 2023.

- We remain modest overweight fixed income investments in general and modest overweight domestic government bonds. Canadian and U.S. government bonds are attractive at current yields and offer opportunities for income generation and downside protection. Despite volatility in 2023, it was still a good year for bond investors and the future looks promising: we expect price/yield volatility to decline in coming quarters as the severity of economic slowdown becomes clearer and market participants stop second-guessing the timing and the size of policy rate cuts.

- We remain neutral investment grade (IG) credit. We expect the challenging economic conditions to widen spreads (which indicates the market is pricing in more risk) but not to the same extent as past recessionary levels. We prefer to focus on high quality credit—companies with robust balance sheets—and we expect technicals to remain supportive and healthy yields to mitigate losses from price volatility.

- We maintain our modest underweight view on high yield (HY) credit. High Yield credit performed well in general last year but we don't expect this to continue. The HY credit market has seen an overall improvement in quality. This should keep spreads from returning to previous recessionary levels, although they will widen if the growth outlook deteriorates.

Government bonds

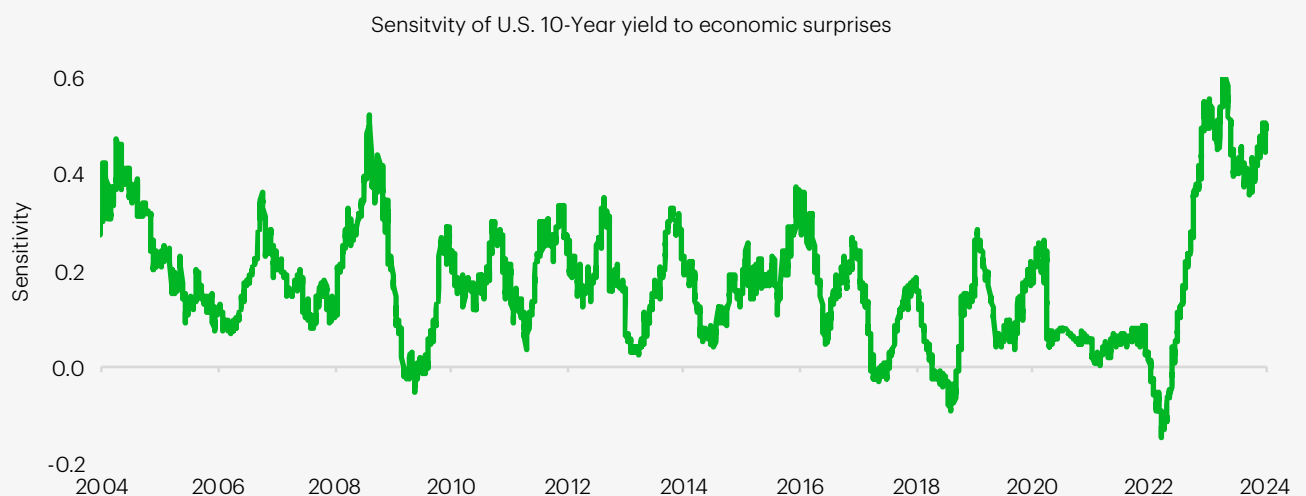
New year, same question. Soft landing or recession? Market participants have flip-flopped between the two as they digested higher policy rates and volatility in government yields (Figure 3). Despite the increased implied volatility in yields, our view on government

bonds hasn't changed. We believe volatility can be managed with a proper framework based on each portfolio's investment risk guidelines. Current yields continue to offer investors opportunities for income generation with downside protection. We maintain our modest overweight view on government bonds.

Central bankers are still in the hot seat: to avert a resurgence of inflation they'll have to keep policy tight for longer even though the weaker outlook for economic growth warrants lower rates. Unless we tip into a full-blown recession, we believe policy rates will settle well above pre-pandemic norms. We could even see central banks loosening the reigns on inflation targets to accommodate hefty government spending and other structural changes in the economy. If that's the case, we may end up in a regime of slower economic growth and higher inflation and interest rates than we had after the Global Financial Crisis (GFC). And if that happens, macroeconomic data and financial asset prices will both be more volatile. As a result, we believe yields will be range bound and expect significant declines to be limited—bar any unexpected events—but buckle up because we're not out of the volatility turbulence yet.

We encourage everyone to take a balanced and risk-managed view of government bonds and to avoid either a very bullish or bearish outlook on government yields or interest rate duration. We don't expect a severe economic downturn and neither do market participants. If central banks have to deal with a liquidity crunch, they don't have to rely on policy rate cuts alone because they have deep pockets and other tools they can use. On the other hand, let's not overestimate the resilience of the economy.

Figure 3: Government Yield Sensitivity to Short-Term Economic Surprises



Source: FactSet, Wealth Investment Office (WIO), as of December 31, 2023. Sensitivity is calculated using rolling 6-month regression between daily changes in U.S. 10-year government yield and U.S. Citigroup Economic Surprise Index.

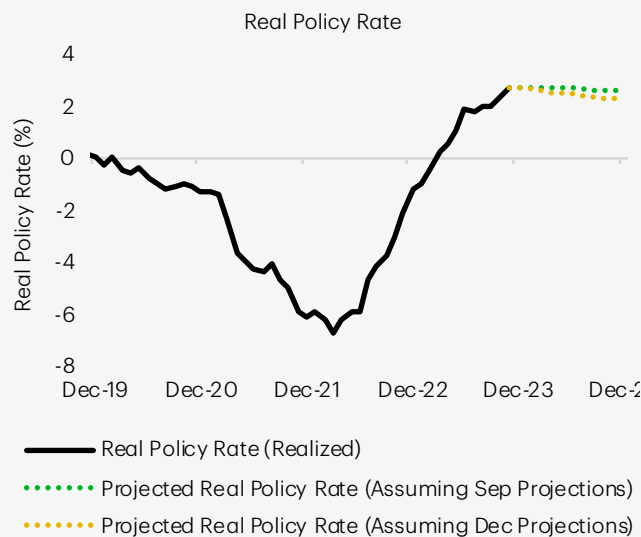
Key Themes for Government Bonds

1. Sizing the Rate Cuts. While we anticipated the dovish guidance provided by Federal Reserve (Fed) officials at the December meeting, the lack of firm pushback from Chair Jerome Powell took us by surprise. Fed speakers tried to walk back some of the market's post-meeting repricing but to little avail. Fed officials, while divided about the finer details of potential rate cuts, appear convinced that near-term inflation forecasts warrant the pivot.

The pressing question is: would rate cuts change anything? Practically speaking, if the Fed aims to hold the Fed funds rate 2% above inflation, the slowdown in inflation means there is room to lower policy rates. However, the policy stance in inflation-adjusted terms would remain largely unchanged. For example, if we see three policy cuts (or 75 bps as suggested by the Fed's 2024 projection), monetary policy would stay in restrictive territory that is only slightly less punishing than it is now. (Figure 4).

According to the Federal Open Market Committee (FOMC), the policy stance has already “slowed [growth] substantially from the outsized pace seen in the third quarter.” In our view, the Fed is trying to stay out of the way of a soft landing and the improving outlook for inflation allows the FOMC to now focus more on employment/growth conditions.

Figure 4: Fed's Dec. Projections Suggest Policy Posture Little Changed



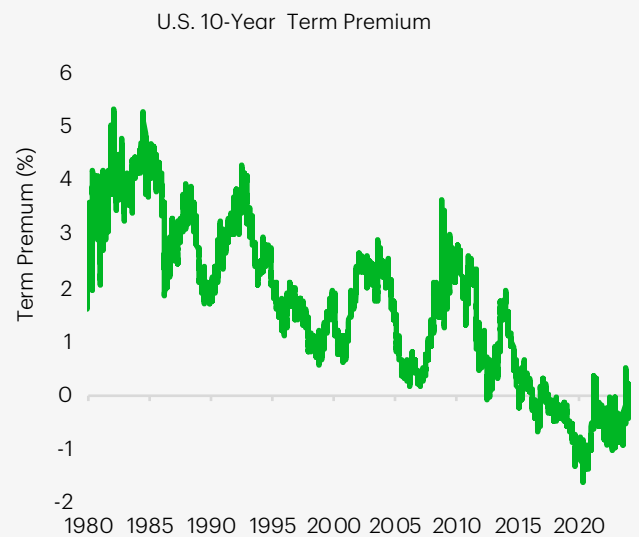
Source: FactSet, Federal Reserve, Wealth Investment Office (WIO), as of December 31, 2023. Real Policy Rate = Difference between U.S. Federal funds effective rate (average of lower and upper level) and Headline PCE Chain Type y/y seasonally adjusted.

In Canada, market participants are pricing in aggressive policy rate cuts for the Bank of Canada but we believe the BoC would like to see more progress on core inflation and other underlying measures (particularly services related) and more sustainable normalization of inflation toward the 2% objective before it pivots. An important risk remains: even with an earlier-than-expected easing, policy might still be too restrictive and trigger a drastic economic slowdown currently not priced by the investors.

2. The Return of Term Premium. Term premium (the extra compensation expected from investors who buy longer maturity government bonds and are therefore exposed to more risk) atrophied for three decades and bottomed out in 2020 around the time quantitative easing peaked (Figure 5). Going forward, we expect term premium to be in a higher range than at any point since 2011.

Higher term premium is being driven by three key factors: 1) The recent volatility in government yields which we expect to continue as uncertainty around economic outlook and monetary policy persists. 2) An increase in government bond supply without a commensurate improvement in liquidity. 3) Continued quantitative tightening (as the Fed unwinds its swollen balance sheet) through 2024.

Figure 5: Term Premium Pulls Out of 30-year Nosedive



Source: Federal Reserve, Wealth Investment Office (WIO), as of January 8, 2024.

The pandemic era of quantitative easing stands out as a clear break point for term premium; quantitative tightening and expansionary U.S. fiscal policy is expected to push term premium higher.

3. Challenges for Government Bond Supply/Demand.

U.S. government bond data confirms our view that households/individual investors and mutual funds were key to clearing U.S. government bond supply in 2023 (Figure 6). Mutual funds and households each absorbed over US\$700 billion (bln) of the roughly US\$1.2 trillion (tln) in net new government bonds issued to the public in the first three quarters of 2023. Despite fears of a lack of interest, foreigners bought about US\$200 bln in the same period. While this might suggest there isn't a foreign demand problem, we can't assume there will be the same interest this year. What if mutual funds are less active net buyers? So far, the Fed has been a net seller—demand from pensions has been lacklustre and is unlikely to change drastically in 2024. Banks were also net sellers in 2023 although as government bond yields stabilized, banks stopped shrinking securities portfolios and started adding to positions.

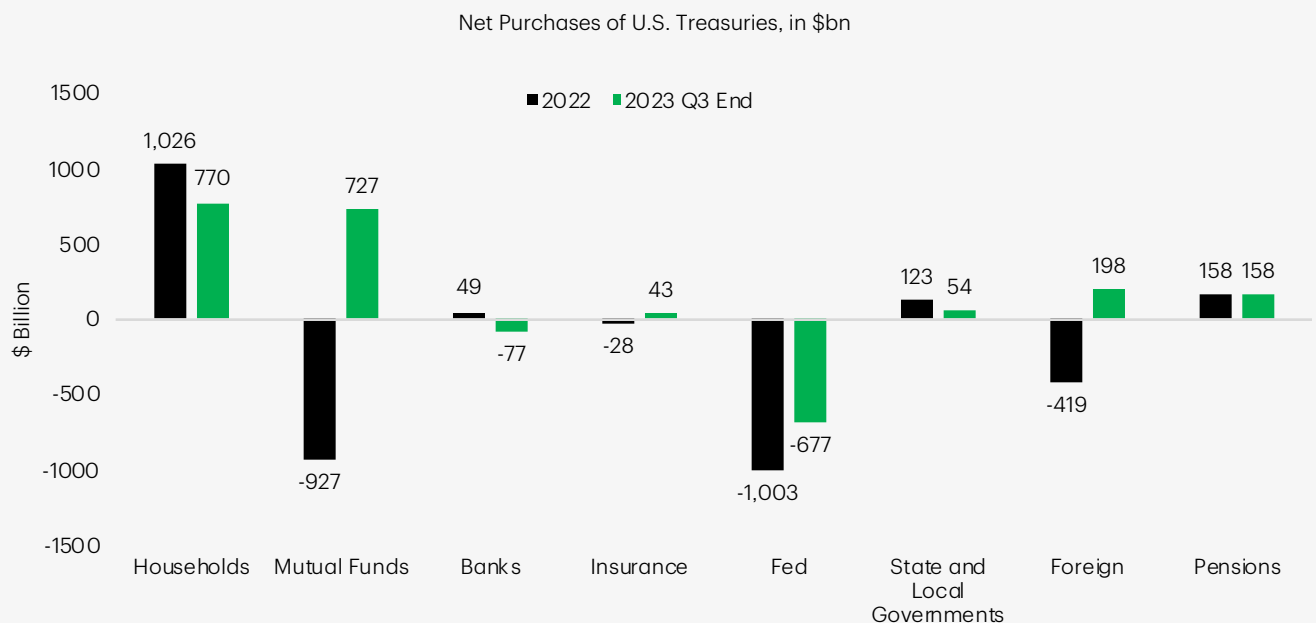
The situation will become even more challenging this year because U.S. government bond issuance is expected to almost double compared to 2023. This supply surge could be easily absorbed in a weaker growth environment, but in a more robust growth environment, where the case for policy rate cuts is

less compelling, longer duration U.S. treasuries could face some challenges. Any lack of buying interest will have an adverse effect on bond prices and push yields higher—something worth monitoring.

4. Government Bond Yield Volatility Wanes. While government yields aren't in the clear yet, the trend for overall volatility seems to be calming. Much of this can be attributed to declining yields, reduced macro uncertainty and central banks' shift to the sidelines. We expect volatility to normalize further in the coming quarters—even with rate cuts. If this seems to run counter to past data it's because, historically, policy rate cuts have coincided with a deteriorating growth outlook and macro uncertainty, which increased volatility. Any adjustment cuts this year will reduce the risk of slowing growth in the near term although this could change over the longer term. The chaotic repricing of term premium and concerns about demand/supply will also add to volatility.

No Straight Forward Path for Government Bond Yields. Let's face it, government bonds have been all over the place: U.S. Government 10-year yield surged 165 basis points between May and October, reaching the 5% level, and fell 100 bps in the last two months. Most of the move lower in government yields was driven by lower expected inflation. The end-of-2023 decrease in yields has made understanding their future path even more challenging from a valuation perspective. Given the Fed's dovish communication,

Figure 6: Households, Mutual Funds Top Buyers of U.S. Treasuries (2022, 2023)



Source: SIFMA, Wealth Investment Office (WIO), as of December 31, 2023.

the market is justified in expecting a gradual decline in policy rates in the coming months. However, even with the continued grab for duration (investors buying to lock in higher current yields or expected future returns for years) the investment risks arising from the return of positive term premium, increased bond supply and the higher neutral rate of interest will continue to exert push and pull on government yields, making it difficult for yields to sustain the pace of reduction seen at the end of 2023. Therefore, barring any unexpected events, we believe yields will be range bound and declines will be limited.

When it comes to government yields, there's no straight path forward. We believe central banks will err on the side of caution, limiting the size of rate cuts or delaying them altogether while investors try to pinpoint the likelihood of a soft landing. Policy rates are likely to remain in restrictive territory and while markets may be biased towards a soft landing, a more difficult one shouldn't be ruled out. If this cycle has taught us anything it's that change can come about very quickly and the wise investor would avoid taking a short-term view on government yields. We believe that the outcome over the medium- to long-term investment horizon is relatively clearer as moderating government bond yield volatility along with potential policy cuts have improved the outlook for interest rate duration or government bonds.

Credit: Investment-grade and sub-investment grade

Given the softening economic growth we reaffirm our long-held view of modestly wider spreads (risk premium over a government bond of similar maturity) in coming quarters—although sustained demand for yield and dwindling fears of a a full-blown recession will likely

offset higher supply keeping spreads narrower than previously anticipated. Our references to spreads may feel a little foreign but they're just a way of measuring risk premium: a wider spread means the market is pricing in more risk, narrower spreads, less risk.

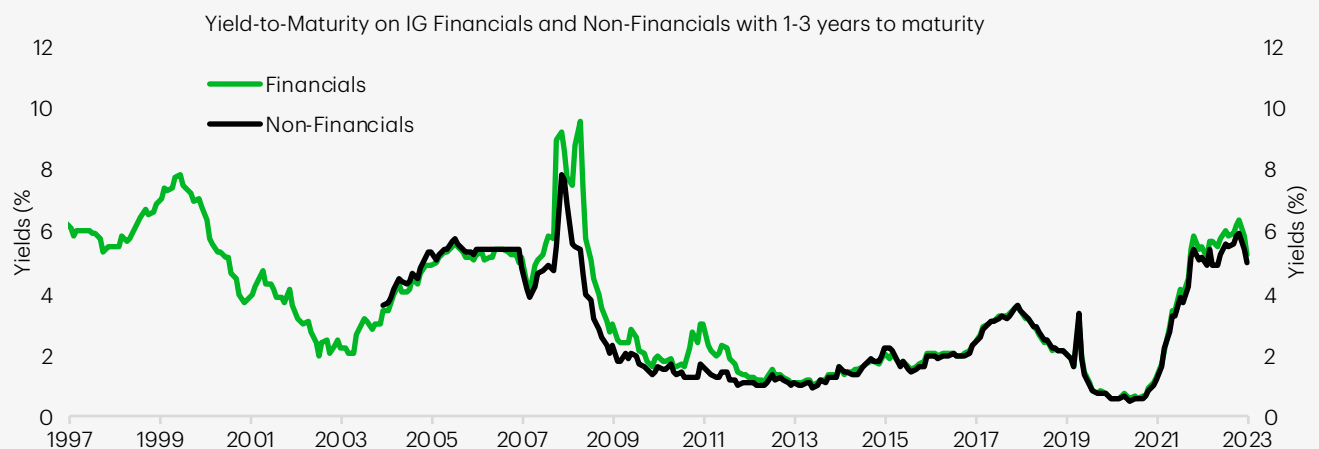
We are neutral on Investment Grade (IG) credit and maintain our modest underweight stance on High Yield (HY) credit. Our neutral stance on IG credit is based on the attractive yields for short-maturity IG: short-dated IG bonds as a total return product now offer close to the highest all-in yield since the late 1990s (Figure 7). Higher yield provides more protection if spreads widen (risk premium increases) and, importantly, higher quality shorter maturity credit will widen less than the broad IG index.

We expect HY spreads to widen more relative to IG because they're more sensitive to deteriorating fundamentals and tight credit conditions. We're more comfortable owning IG over HY because of the yield cushion and balance sheet strength offered by IG.

The rally in corporate credit last year may have caught some investors by surprise, but the bullish macro view, driven by robust labour markets, declining inflation and resilient consumer confidence, has pushed any threat of recession further out. A more cautious view suggests tight monetary policy, albeit with a few policy rate cuts, will eventually slow growth and widen spreads.

Given the wide range of views on the economic outlook, credit investors should rely on active management and keep an eye on the drivers behind spread tightening, the potential timing and magnitude of spread-widening, and sectoral trends.

Figure 7: Decade-High Yields for Shorter-Maturity IG Credit



Source: FactSet, WIO, as of December 31, 2023.

Key Themes for Credit or Corporate Bonds:

- **Narrower Range, Tighter Levels.** Slowing but resilient economic growth, disinflation and easier policy will continue to bolster investor confidence, reduce government yield volatility and keep credit spreads within a tight range similar to 2023. Our message for 2024 remains the same: focus on high quality shorter maturity credit and rely on active management.

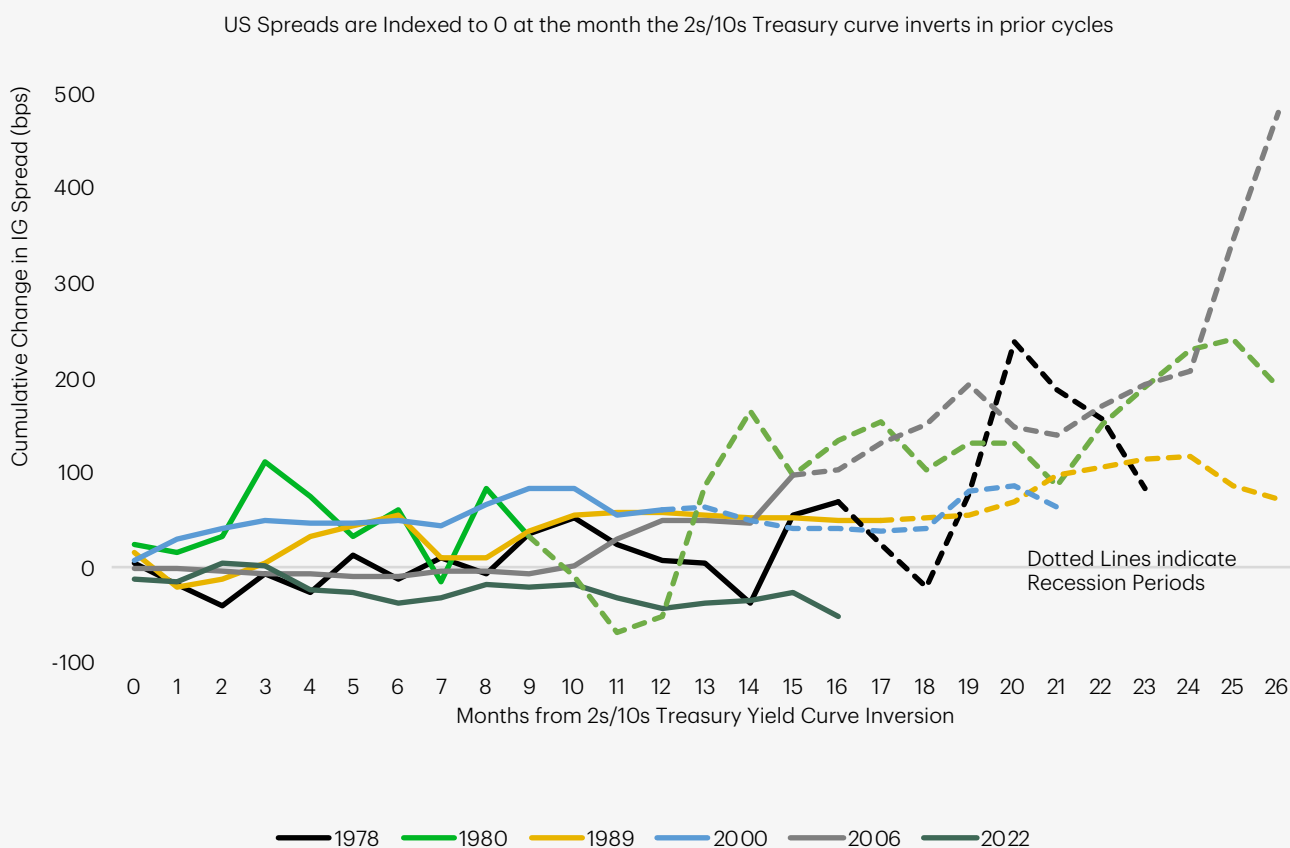
- **More M&A, Increased Supply.** The Fed's dovish pivot should boost M&A appetite. As mentioned in recent publications, 2023 was the weakest year for mergers and acquisitions since 2013: announcement volumes for leveraged buyouts (LBO) tumbled 40% year-over-year (y/y) while M&A fell 15% y/y. Until recently, corporate board rooms took a cautious approach which, coupled with the surge in funding costs and an uncertain outlook for monetary policy, limited activity and skewed M&A towards cash-rich and high-quality sectors. We expect corporate management to gain more confidence in the longevity of the current economic expansion, encouraging them to strengthen and diversify via acquisitions. In fact, lower funding costs could reignite appetite for debt-funded acquisitions for some high-quality issuers.

Lower quality issuers will wait for more funding relief before ramping up debt-funded M&A, which should keep M&A from hurting leverage and balance sheet quality. Overall, more debt-financed M&A will result in more corporate bond issuance or supply.

- **Strong Demand.** Conversations with IG credit investors indicate that demand (inflows) for corporate credit should remain robust in the near term and be supported by a range of buyers. The traditional heavyweights—pensions and insurance—will continue to drive demand for U.S. IG, although some will come from new clients. Demand will come from pension funds rebalancing portfolios away from equity and life insurance companies which recorded large fixed-annuity sales of more than US\$260 bln in the last 12 months.

These trends will support IG credit spreads in the near term but slowing economic growth could upend them. For this reason, we prefer short-maturity, high-quality IG credit. Our overall neutral stance on IG credit is underpinned by historical data which shows credit spreads (risk premium) don't widen until much later in the business cycle and, in some cases, not until recession arrives (Figure 8).

Figure 8: Spreads Widen Late in Business Cycle



Source: FactSet, WIO, as of December 31, 2023.

Rather than waiting to see where IG spreads peak, take a look at certain IG sectors (finance companies, REITs, banks) which have much wider spreads than the broad market and present attractive opportunities. Other sectors have less cushion and more risk if the economy comes under pressure. Active management is the best approach for the IG credit space and we prefer shorter maturity and sectoral tilts based on valuations.

Higher yields and diversification

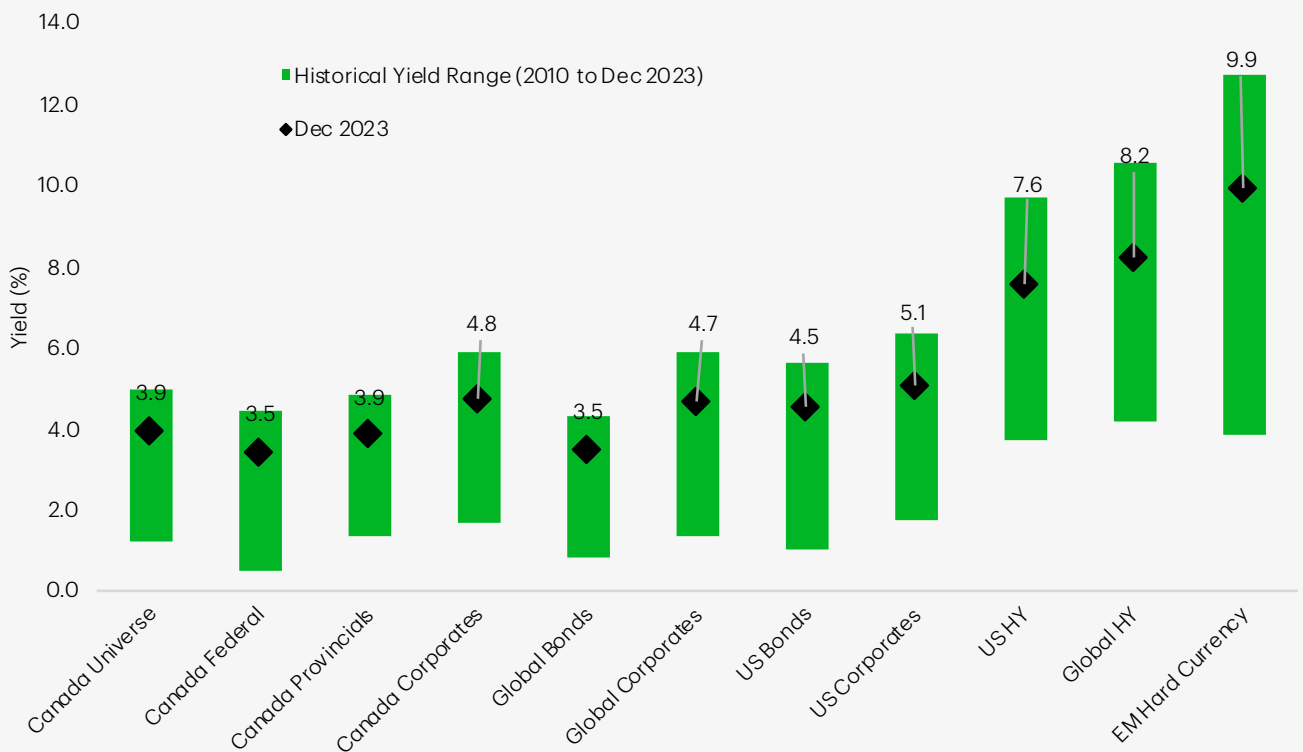
While we see growing signs of the U.S. and Canada coming in for a soft landing, we remain concerned about the economy and believe maintaining a balanced and diversified portfolio is key. With yields at historically attractive levels, the income component of fixed income is back and will act as a buffer against volatility. We believe the outlook for government bonds and duration is attractive for investors looking for a slightly longer investment horizon.

Investors can earn attractive yields in almost all segments of the fixed income market (Figure 9). Keep in mind that higher yields are a good indicator of future returns and provide cushion for investors as the market refocuses on fundamentals. Buying opportunities can arise quickly in periods of uncertainty so stay informed and manage your portfolios actively to balance both duration and credit exposure.

Bonds vs. GICs. A final word on the difference between bonds and term deposits like GICs. Traditional GICs tend to lock investments in until maturity and limit investor flexibility. GICs may be useful for investors who want zero price volatility, but for those who can tolerate price fluctuations, the bonds or fixed income investments we've outlined here are better options because they allow investors to switch to more attractive opportunities while earning similar yields. When investors buy a shorter maturity GIC with a higher yield, they're also taking on re-investment risk: GICs maturing now offer a higher yield than those that matured a year ago and the yield on offer when GICs mature in a year will likely be less than it is now. Bonds are much more flexible: when yields fall, prices increase, adding capital gains over and above any GIC-equivalent yield. So, the best way to mitigate re-investment risk is to extend the maturity profile by locking in the higher yields on offer in bonds.

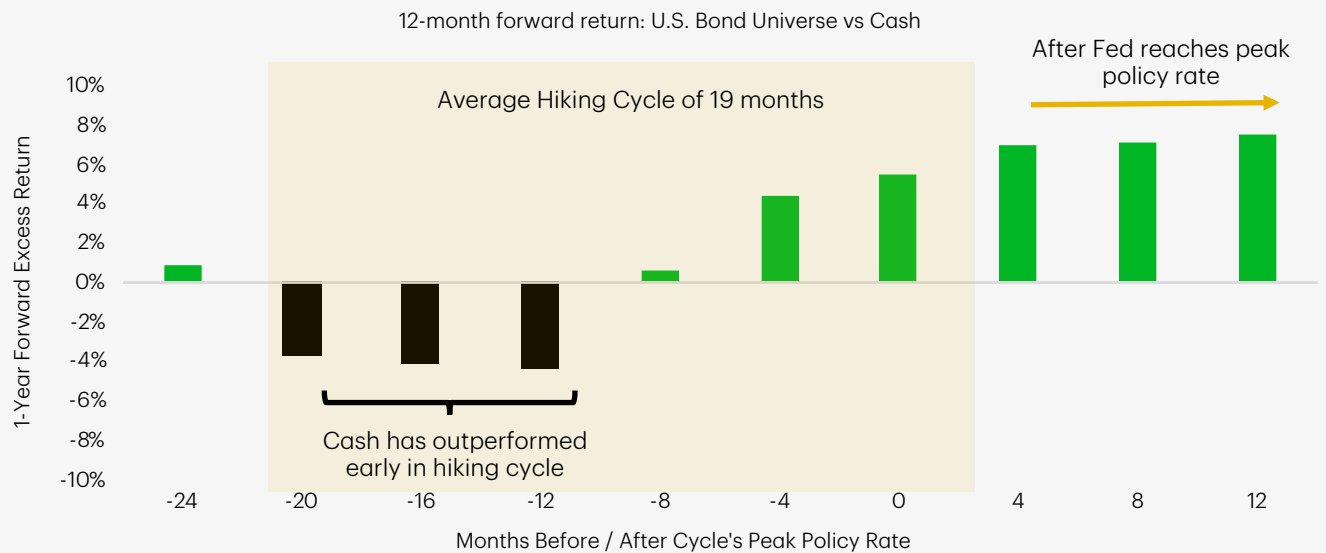
Cash yields are also attractive right now but won't remain so. As soon as central banks show signs of policy rate cuts, the simple interest on cash drops while the value of bond or fixed income investments appreciates (because prices rise as yields fall). This explains why, historically, cash has underperformed fixed income in periods following peak policy rates (Figure 10).

Figure 9: Yields High Across the Board



Source: FactSet, Wealth Investment Office (WIO), as of December 31, 2023

Figure 10: Fixed Income Outperforms Cash Ahead of Peak Policy Rate



Source: FactSet, Wealth Investment Office (WIO), as of December 31, 2023. U.S. Bonds are proxied by Bloomberg U.S. Aggregate Bond Index and Cash is Proxied by ICE BofA U.S. 3-month Treasury Bill Index. Hiking cycles are defined as periods where the Fed embarks on a sustained path of increasing the target Fed Funds rate and/or target range. We define the end of a hiking cycle as the month where the Fed reaches its peak policy rate for that cycle (i.e., it either pauses rate hikes or cuts). Hiking cycles include (start to peak), 1980 (Jul '80 to May '81), 1983 (Feb '83 to Aug '84), May 1988 (Feb '88 to Mar '89), 1994 (Jan '94 to Feb '95), 1999 (May '99 to May '00), 2004 (May '04 to Jun '06) and 2015 (Nov '15 to Dec '18).

We maintain our modest overweight view on fixed income. We believe it's providing investors with the best opportunity in over a decade to build diversified portfolios. After the turbulence of high inflation and rising rates, and even if growth is problematic, the bond market looks set to return to more conventional behaviour. Our base case for fixed income is to earn attractive income without expecting substantial capital gains from falling government bond yields and we suggest investors keep expectations realistic. In the current landscape, an astute active fixed income manager versed in long/short credit strategies and able to make tactical duration adjustments when government bond yield moves are overstretched, could realize strong returns.

A final note on fixed income

With yields finally reaching attractive levels, the income component of fixed income is back. However, short-term volatility will persist as markets reprice future policy rates and economic growth. Bonds also, during economic downturns, fulfill their traditional role as risk diversifier. We reiterate the key aspects of fixed income investing:

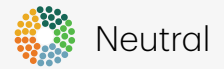
1. Fixed income portfolios are not meant to capture upside risk.
2. Fixed income is more than just government bonds. The current environment calls for a flexible approach to building resilient fixed income portfolios, including diversifying sources of return within fixed income and emphasizing relative-value opportunities.

3. Maybe the most important aspect is that duration, or interest rate risk, still has a role to play in portfolios. Duration tends to have a negative correlation to other risk assets. The role of fixed income has been challenged in the high inflation environment but we need to remember that higher yields translate into enhanced downside protection if markets sell off. Importantly, this negative correlation with risk assets tends to be strongest during economic shocks therefore we don't suggest investors offload all duration-heavy solutions or core bonds because they're afraid of increased volatility. Rather, we encourage tactical adjustments because we firmly believe there is an appropriate place for duration as a hedge in portfolios.

Investors who move towards riskier credit solutions in the fixed income sleeve must remain vigilant of the inherent drawdown risks which can be severe. Importantly, with higher yield on offer in high quality fixed income, the need to dive into riskier fixed income components might be unnecessary. Finally, investors must monitor potential total return losses, and they should not overlook the attractive levels of all-in yield or the income that fixed income investments can deliver from now on.

Consider the drawdown risks acceptable to clients who are investing heavily in fixed income and evaluate probable income versus probable drawdowns instead of probable returns versus probable volatility.

Outlook on Equities



Ready for a reversion?

David Beasley, Senior Portfolio Manager; Chris Blake, Senior Portfolio Manager; Kevin Yulianto, Portfolio Manager; Chadi Richa, Manager, North American Equities; Andrej Krneta, Senior Equity Analyst; Neelarjo Rakshit, Senior Equity Analyst | TD Wealth

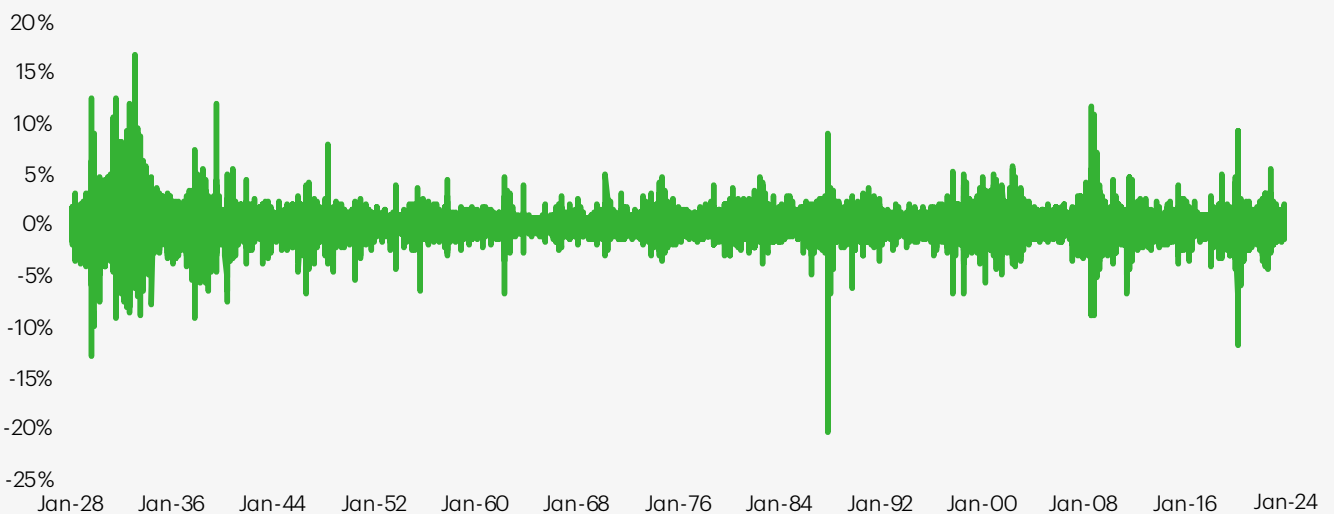
A fundamental principle of our investment philosophy, Risk Priority Management, is that markets are complex adaptive systems, more akin to biological ecosystems where individual agents adapt to the environment while the environment adapts to them. In a system like this, things often seem explainable in hindsight but are nearly impossible to predict. Actions of investors matter. Is the S&P 500 overvalued? Have I missed the opportunity to get returns from AI? What about bitcoin?

In the short term, the correct answer is impossible to predict because markets are not being driven by a calculator but by a human who is prone to making decisions based on “gut feeling” or an appealing narrative or a rule of thumb that has worked before in one’s memory, which is the same memory that conveniently forgets all the times it didn’t work. This explains why markets are in a constant state of change, swinging between one extreme to the other and spending very little time in the middle where financial academics will tell you is where they should be. Figure 1 highlights how information that is unsubstantiated and broadly disseminated can have an unforeseen impact on returns. In the short term, equity prices change due to new information. This may result in price volatility and lower return predictability.

In a system that is open and complex, reversion to the mean is incredibly important — meaning periods of above-average returns tend to be followed by periods of below-average returns and vice versa as the swings occur.

Let’s consider this way of thinking with an old school way of looking at markets: The Dogs of the Dow. This is an investment strategy that is predicated on reversion to the mean. It involves building a portfolio, at year’s end, of the 10 highest-dividend-yielding stocks on the Dow Jones 30 Index and selling the opposite. The implication is that these stock prices have not kept up with the dividend, leading to a value strategy that’s concentrated in blue-chip income stocks. For an added twist, to account for price volatility, we also considered the Dogs of the Dow from a pure price-return basis. High-quality stocks that underperform the market to a large extent can become oversold, making them candidates for a mean-reversion rally — that is, they are poised to bounce back and “play catch up” to the rest of the market as value-hunting investors rotate towards them.

Figure 1: Volatility in S&P 500 daily closing price



Source: FactSet, Wealth Investment Office, as of January 26, 2024

The accompanying tables (Figures 2 and 3) show the performance of the Dogs of the Dow entering 2023 using two methodologies: (1) the traditional approach, with top dividend-yielding stocks; and (2) an alternative approach that comprises stocks with the lowest price returns for 2022. As we can see, it was not the dividend leaders that had strong stock price recoveries during 2023 but rather many of the weakest performers of 2022. Growth and cyclical sectors (highlighted) dominated the list, while performance was clearly led by information technology, which saw a strong sector-rotation inflow during 2023.

Figure 3 shows the 2024 Dogs of the Dow stocks on a price-return basis. In this case, many of the stocks also have attractive dividend yields, which provides

a margin of safety as investors hold the stock in anticipation of a price recovery — a “pay as you wait” proposition. In terms of sectors, whereas the 2023 list was dominated by growth and cyclical stocks, the 2024 list is much more defensive in nature.

Defensive sectors were a significant detractor to the performance of diversified U.S. equity portfolios during 2023. The year started with concern the economy would be going into a recession, but when employment and consumer spending remained resilient, investors rotated out of defensive sectors and into growth and cyclical sectors. The underperformance of defensive sectors in 2023 is also evident in the S&P 500 and S&P/TSX Composite on an equal-weighted-sector basis, as shown in Figures 4 and 5.

Figure 2: 2023 return for the Dogs of the Dow strategy

Dow Component Company	Sector	2022 Return	2023 Return	2022-end yield
Intel Corp	Information Technology	-48.7%	90.1%	2.8%
Salesforce Inc	Information Technology	-47.8%	98.5%	0.0%
Disney (Walt) Co	Communication Services	-43.9%	3.9%	0.0%
3m Co	Industrials	-32.5%	-8.8%	3.4%
Nike Inc -CI B	Consumer Discretionary	-29.8%	-7.2%	0.7%
Microsoft Corp	Information Technology	-28.7%	56.8%	0.7%
Walgreens Boots Alliance Inc	Consumer Staples	-28.4%	-30.1%	3.7%
Apple Inc	Information Technology	-26.8%	48.2%	0.5%
Cisco Systems Inc	Information Technology	-24.8%	6.0%	2.4%
Verizon Communications Inc	Communication Services	-24.2%	-4.3%	5.0%
Average		-33.6%	25.3%	1.9%

Source: FactSet, Wealth Investment Office as of December 29, 2023

Figure 3: Dogs of the Dow strategy for 2024

Dow Component Company	Sector	2023 Return	Dividend Yield
Walgreens Boots Alliance Inc	Consumer Staples	-30.1%	7.2%
Chevron Corp	Energy	-16.9%	4.0%
Johnson & Johnson	Health Care	-11.3%	2.9%
3m Co	Industrials	-8.8%	5.5%
Coca-Cola Co	Consumer Staples	-7.4%	3.1%
Nike Inc -CI B	Consumer Discretionary	-7.2%	1.4%
Verizon Communications Inc	Communication Services	-4.3%	6.8%
Procter & Gamble Co	Consumer Staples	-3.3%	2.5%
Honeywell International Inc	Industrials	-2.1%	2.1%
Merck & Co	Health Care	-1.7%	2.7%
Average		-9.3%	3.8%

Source: FactSet, Wealth Investment Office as of December 29, 2023

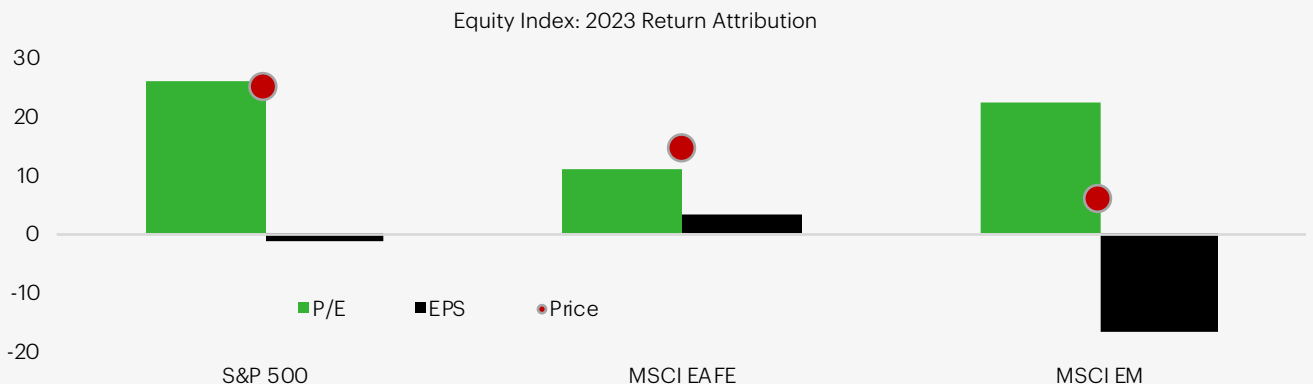
Figure 4: Dogs of the S&P 500

S&P 500 Sector	2023 Return
Consumer Staples	-7.1%
Utilities	-5.6%
Energy	1.0%
Health Care	2.6%
Real Estate	7.8%
Materials	8.4%
Financials	10.2%
Industrials	24.7%
Communication Services	26.9%
Consumer Discretionary	27.7%
Information Technology	43.2%

Source: FactSet, Wealth Investment Office as of December 29, 2023

The big question is whether there will be a reversion to the mean in 2024. Will the slowing economy, as desired by central banks, facilitate investment flows from cyclical and growth sectors like information technology — which has become fundamentally expensive and technically overbought — into health care, staples and other defensive sectors? Will the outperformers this year be the defensive “dogs” of 2023? We think there is potential here, but because we are in an environment where there is a wide range of outcomes, we are inclined to take a cautious approach. The job of a good portfolio manager is to be approximately right; seeking absolutes can lead to big gains but also big losses.

Figure 6: Return Attribution (U.S., international, EM)



Source: FactSet, Wealth Investment Office as of December 31, 2023

Figure 5: Dogs of the S&P/TSX Composite

S&P/TSX Sector	2023 Return
Utilities	-9.0%
Communication Services	-8.5%
Consumer Discretionary	-2.5%
Real Estate	0.2%
Consumer Staples	1.8%
Gold	3.0%
Energy	4.1%
Materials	4.9%
Financials	15.2%
Health Care	15.8%
Industrials	20.1%
Information Technology	45.3%

Source: FactSet, Wealth Investment Office as of December 29, 2023

U.S. Equities – Modest Overweight

Slowing top-line growth, margin expansion

Against the bearish narrative held at the beginning of 2023, global stock markets closed the year significantly higher, with U.S. equities outperforming the rest of world. On a price-return basis, the S&P 500 Index gained roughly 25%, higher than international equities (MSCI EAFE) at 14% and emerging-market equities (MSCI Emerging Market) at 6%. Will reversion to the mean occur here?

The factors driving these returns vary widely, however (Figure 6). For the U.S. equity index, all the gains can be attributed to heightened risk sentiment, with the forward P/E ratio of the S&P 500 rising from 17.6x at the beginning of 2023 to slightly above 20x at the end of year. Clearly, investors are expecting rapid earnings growth in 2024 following lacklustre growth in 2023.

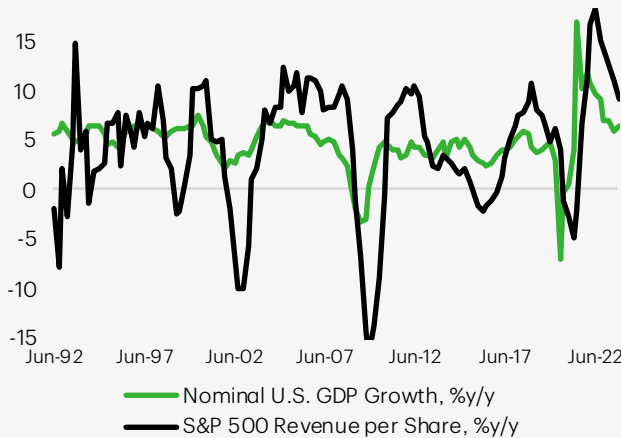
This year, U.S. real GDP growth and inflation are expected to slow to 1.2% and 2.6%, respectively, which should lead to lower top-line growth for companies (Figure 7). By comparison, the U.S. economy grew 2.4% in 2023, while inflation ended the year at 4.1%. The good news is that slower, but positive, revenue growth for U.S. public companies will likely coincide with profit-margin expansion, boosting the outlook for stocks.

Profit margin for the aggregate U.S. stock index has fallen in 2023 alongside a deceleration in top-line growth, lingering cost pressures from the supply-chain disruption and still elevated, albeit softening, wage demands. However, given falling material prices and better cost discipline, the outlook for profit margin has markedly improved. Figure 8 shows that the gap between CPI and PPI inflation — a proxy of what companies could charge for their products minus their input costs — points to a margin expansion over the next 18 months or so.

Given the elevated U.S. equity multiple (20x 2024 earnings), we believe the potential for further multiple expansion this year is limited, which means U.S. stock performance will be more reliant on earnings growth. The consensus estimate for 2024 EPS on the S&P 500 is currently \$243, implying y/y growth of 10%. Taking this forecast and applying a 16x to 20x forward earnings multiple gives us a range of 3,900 to 4,860 for the S&P 500 this year.

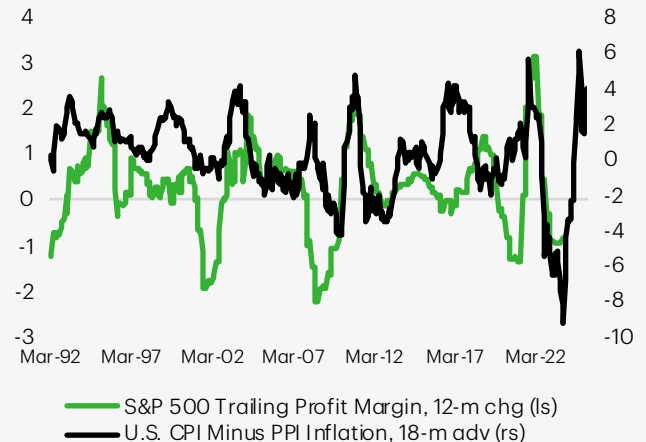
From a positioning perspective, investors have started the year on a bullish note. Positioning among asset managers and leveraged funds is above its historical average, while retail investors' net positioning is as optimistic as it's been since the start of the pandemic. This bullish setup stands in contrast to last year, when recession in the U.S. was a consensus view. History suggests, however, that it may still be too early to be "all-in" and take an aggressive stance on equities, given that the bulk of the lagged impact of monetary-policy tightening may still be ahead.

Figure 7: Slowing top-line growth ...



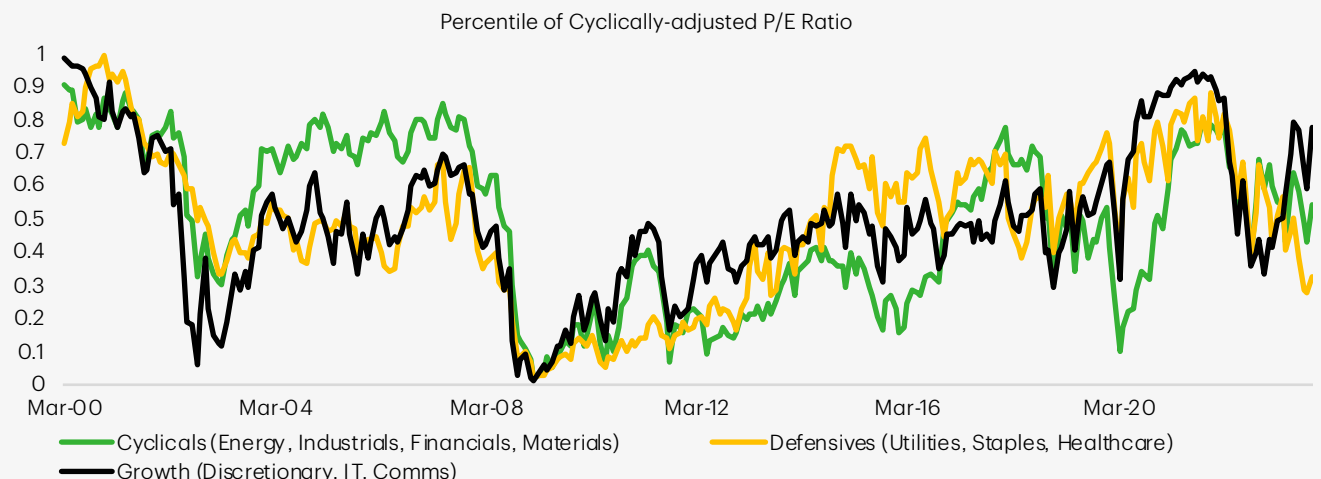
Source: FactSet and Wealth Investment Office, as of December 29, 2023

Figure 8: ... with margin expansion



Source: FactSet and Wealth Investment Office, as of December 29, 2023

Figure 9: Defensive sectors are cheap



Source: FactSet and Wealth Investment Office, as of December 29, 2023

In the current environment, we favour overlooked stocks, the so-called dogs of 2023: the consumer staples, health-care and utilities sectors due to their attractive valuation profile and defensive characteristics. These sectors significantly lagged their growth counterparts in 2023 as the narrative swung from recession to soft landing. Meanwhile, the risk/reward profile of growth stocks has deteriorated following the sharp rally last year, which led these stocks to trade at elevated multiples. However, there is also a fundamental reason for their outperformance: they are most levered to AI, whose capabilities are set to double roughly every six months – three times faster than Moore’s Law. Further, they generate enormous amounts of cash flow and earnings growth.

Let’s dig into this a little bit because it is so important to the direction of U.S. equities in the years ahead. To allocate in the current environment, we employ a quantitative system, with some of attributes of the Dogs of the Dow, but with the computing power and methodologies possible in the 21st century.

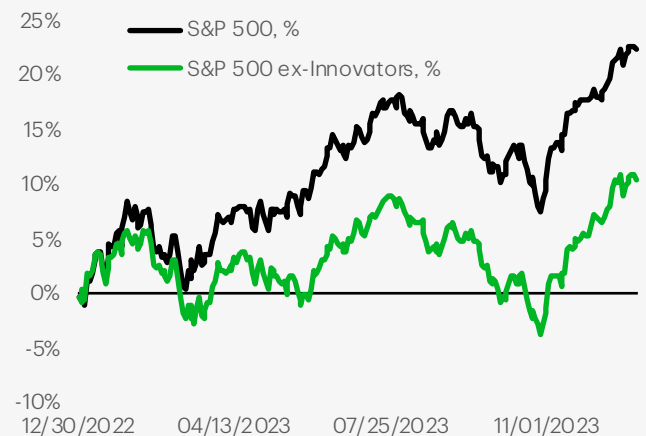
Currently in our quantitative equity work, we employ a proprietary trend-momentum quant model to analyze the price behaviour of stocks in terms of market flows, sector rotations and other insights left by the footprints of market participants on the broader equity landscape. This model takes over 700 North American equities (the constituents of the S&P 500 Index and S&P/TSX Composite Index), examines their price movements over time through a number of variables describing trend (long-term directional trajectory) and momentum (short-term cycles along trends), and applies a scoring algorithm to rank each name in the universe on an equal-weighted basis. When we want to examine where sector strength and weakness is shifting throughout the market, we use this as a magnifying glass: ranking each sector by

their components’ average quant ranking, along with how those sectors are shifting in real time. Figure 10 highlights our sector quant rankings.

It is likely no surprise that the information technology sector sits at the top of rankings, as it did for most of 2023. Also, notice that other growth-dependent sectors dominated the upper rankings as well, while more defensive and value-oriented sectors lagged. Whether it is a very strong bear-market rally or a new bull cycle, there is always a leading sector and leading theme within that sector. In 2023, that theme was inarguably artificial-intelligence-focused technology companies.

A popular talking point during the market’s technology-led rally of 2023 was the leadership of the “Magnificent Seven,” (Apple, Microsoft, NVIDIA, Alphabet, Meta, Amazon and Tesla). Looking at this equity leadership another way, five of these seven companies are major players in the AI infrastructure buildout – let’s call them the “Innovators.” Figure 11 shows just how much the AI theme lead the return of the S&P 500 in 2023.

Figure 11: S&P 500 Performance vs. Innovators



Source: FactSet, WIO as of December 31, 2023.

Figure 10: Quant Equity Sector Ratings

Sector Rank by Average Equity Quant Score	S&P GICS Sector	Average Change in in Momentum Rank	Average Change in in Trend Rank
1	Information Technology	14%	12%
2	Industrials		
3	Financials		
4	Consumer Discretionary		
5	Real Estate		
6	Materials		
7	Communication Services		
8	Health Care		
9	Energy		
10	Utilities		
11	Consumer Staples		

Legend: Overweight (Green), Modest Overweight (Light Green), Modest Underweight (Light Red), Underweight (Red)

Source: FactSet, WIO as of December 29, 2023

Now that we've seen this impact in the rear-view mirror, the next question to ask is, "How will the future of AI impact equity-market growth?" We are starting to get a picture in early 2024 that these innovators, in providing the equipment required to build AI infrastructure, should be very bullish as far out as 2027. However, there is a hitch to this secular growth view: an overbuilding period during 2023 will need to be drawn down during 2024 to 2025 before growth reaccelerates from 2025 to 2026. This year there is a potential "air pocket" in demand, which could lead to weaker financial quarterly results and guidance, and correspondingly weaker stock prices for some in the group. We think this would likely serve as an opportunity to accumulate these innovators at a much more reasonable price versus current valuations.

Remember, you don't have to own them all. Be patient. There could be air pockets ahead. Lastly, if the soft-landing narrative becomes reality — a possibility we are sympathetic to — this will benefit cyclicals relative to defensives longer-term. We want to be positioned for that and are overweight energy and communications while being underweight info-tech, but it's important to be ready to be selective and buy the dips to get to overweight.

Canada – Neutral

Tech-starved but affordable

If there is a market that Canadians, with their domestic bias, wish there could be a mean reversion, it's the S&P/TSX Composite. In 2023 the S&P/TSX Composite produced a price return of 8.1%, and dividends brought that to a total return of 11.8%. In terms of valuation, meanwhile, the index ended 2023 at 12.2x forward earnings and started 2024 at 13.7x. Similar to the U.S. experience, there has been an increase in risk sentiment ascribed to the index, which appears to have driven most if not all the return in 2023.

That said, Canadian equity valuations are not as rich as those in the United States and are more in line with what has been seen in Europe, reflecting the dearth of technology growth leaders in the rest of the world. Arguably, valuations are particularly good in Canada when considering historical averages. As with the United States, inflation as measured by the consumer price index is on its way down from a peak of 5.6% in 2022 to a consensus forecast of 3.8% in 2023, and 2.6% in 2024. Real GDP growth is also expected to slow in 2024 from 3.8% in 2022 to just 0.5% in 2024, according to TD Economics.

It is likely that relatively low valuations in Canada reflect a discount from the forthcoming growth slowdown. TD Economics anticipates the first rate cut from the Bank of Canada (BoC) to come in the spring, as the Bank attempts to counter that slower economic growth. The communications exercise around the cuts will be difficult, though, given that inflation is expected to remain above the 2% target, with population growth driving shelter costs up. On balance, however, the risk to the economy may outweigh the risk of population-driven inflation, leading the BoC to cut sooner rather than wait until inflation is at target.

We expect some volatility in Canadian equities as the economy approaches its bottom, although the second half of 2024 will likely be easier sailing than the first. For the near term, we are staying balanced — employing a "barbell" approach that holds quality growth names on one side and, on the opposite, defensive income-focused companies.

As for the CAD/USD exchange rate, TD Economics is forecasting a low point in the second quarter of 0.73, climbing back to 0.74 by year end. In 2025, the Canadian dollar is expected to strengthen, finishing around 0.80. Domestic companies tilted to foreign earnings should perform better. This bolsters our tilt to materials and energy, given that benchmark commodity prices are all priced in U.S. dollars.

We also see tightness in the supply of commodities. Oil and gas producers are declining to invest in new production, as the world turns increasingly to renewable sources of energy, and are instead opting to return cash to shareholders. We expect that cash returns to shareholders, whether through ordinary dividends, special dividends or share buybacks, will grow as operations ultimately face a wind-down. This should support higher energy share prices over the medium term.

On the other side of that equation are metals, which stand to benefit as economies move away from oil and gas and towards electrification. Current electrical grids are not built to supply the demand that fully electric houses and transportation will demand. Thus, metals and in particular copper will stay in high demand. The shortage of metal supply has been exacerbated by the dearth of investment in new mines, after investors were burned by the peak in the commodity cycle in 2009. It will likely take a couple of years before new production can restore balance, given the timelines required for mine development.

International Equities and EM – Modest Underweight/Neutral

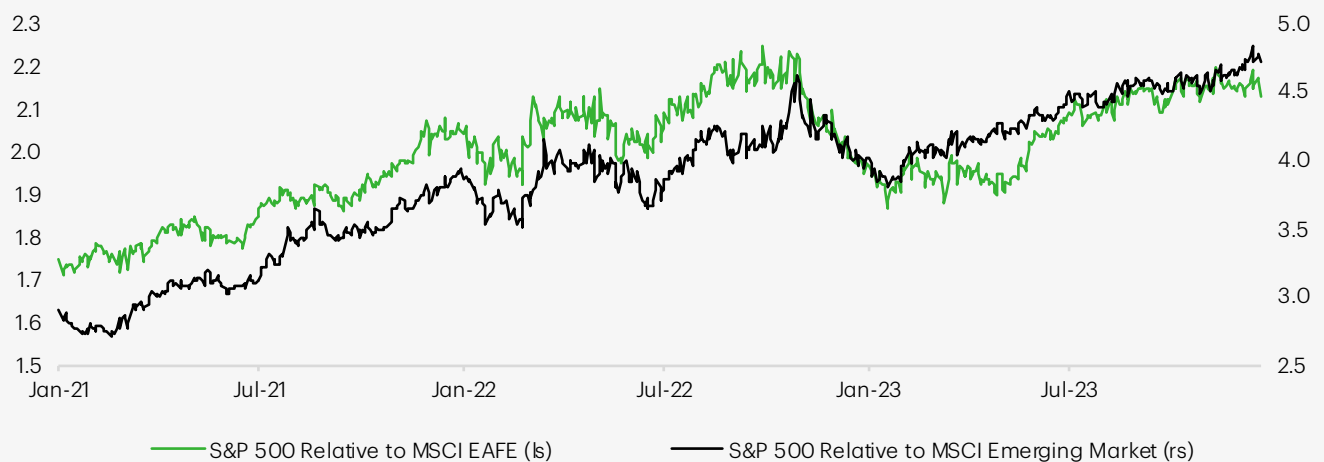
Poised for a rebound?

Valuations for global equity indices rose throughout the year, with the forward earnings multiple for the S&P 500, MSCI EAFE and MSCI EM expanding 26%, 11% and 22%, respectively, compared to the beginning of the year. More bullish investors would correctly point to the domination of U.S. tech giants in their respective areas. However, the case for reversion to the mean and diversification into international and EM equities is attractive, especially as prices for U.S. growth stocks get stretched.

In the long run, the bulk of equity returns is driven by earnings growth, and a portfolio manager's job is to allocate capital to companies that could deliver above-average earnings growth without overpaying and it is here where allocating capital outside of North America that is intriguing.

Last year, international stocks saw earnings grew only 3.2% during the year, while EM stocks experienced an eye-watering 16% decline in earnings due to the Chinese downturn, as well as the early headwind generated by EM central banks, which tightened monetary policy almost a full year before the Federal Reserve and European Central Bank.

Figure 12: International, EM lag U.S. stocks



Source: FactSet, Wealth Investment Office as of December 31, 2023

Figure 13: Valuation percentile across equity indices

	Trailing P/E	Percentile	Forward P/E	Percentile	P/B Ratio	Percentile	Average Percentile
India	26.6	89%	24.1	91%	3.4	61%	80%
U.S.	22.6	77%	21.4	77%	4.3	86%	80%
Taiwan	19.3	67%	18.1	88%	2.3	78%	78%
Developed World	18.7	57%	17.8	85%	2.7	78%	73%
South Korea	18.7	93%	17.4	94%	1.0	23%	70%
Emerging Markets	14.8	63%	13.5	74%	1.6	28%	55%
Japan	16.6	32%	16.0	57%	1.4	50%	46%
Europe	13.2	20%	13.2	35%	1.8	52%	36%
Developed Markets Ex. U.S and Canada	14.2	19%	13.9	36%	1.7	44%	33%
China	11.9	34%	10.7	28%	1.2	15%	26%
Canada	15.6	17%	14.4	19%	1.9	37%	24%
Brazil	8.2	10%	8.3	15%	1.6	26%	17%
Chile	8.0	5%	9.5	8%	1.2	6%	6%

Source: FactSet, Wealth Investment Office as of December 31, 2023

In the coming quarters, an expected deceleration in global growth bodes ill for earnings growth. However, the dramatic correction in earnings across developing countries could mean their economies will also be first into the new business cycle. If recession in the developed world is avoided, EM equities could see faster earnings growth relative to their U.S. counterparts. When allocating here we will remain mindful of our “friend-shoring” theme and tilt towards India, Indonesia, Vietnam and Mexico.

Risk sentiment abroad could also see a boost, given that EM central banks have already started to cut their policy rate over the past six months (Figure 14), whereas the Fed and ECB are forecasted to cut their policy rates only by the end of this quarter, or into the second quarter. The bottom line is that international and EM equity valuations are attractive and could be re-rated as central banks across the world shift towards looser monetary policy this year. However, it’s important to watch corporate earnings trends as many regions continue to face slowing macroeconomic conditions, which will weigh on corporate earnings.

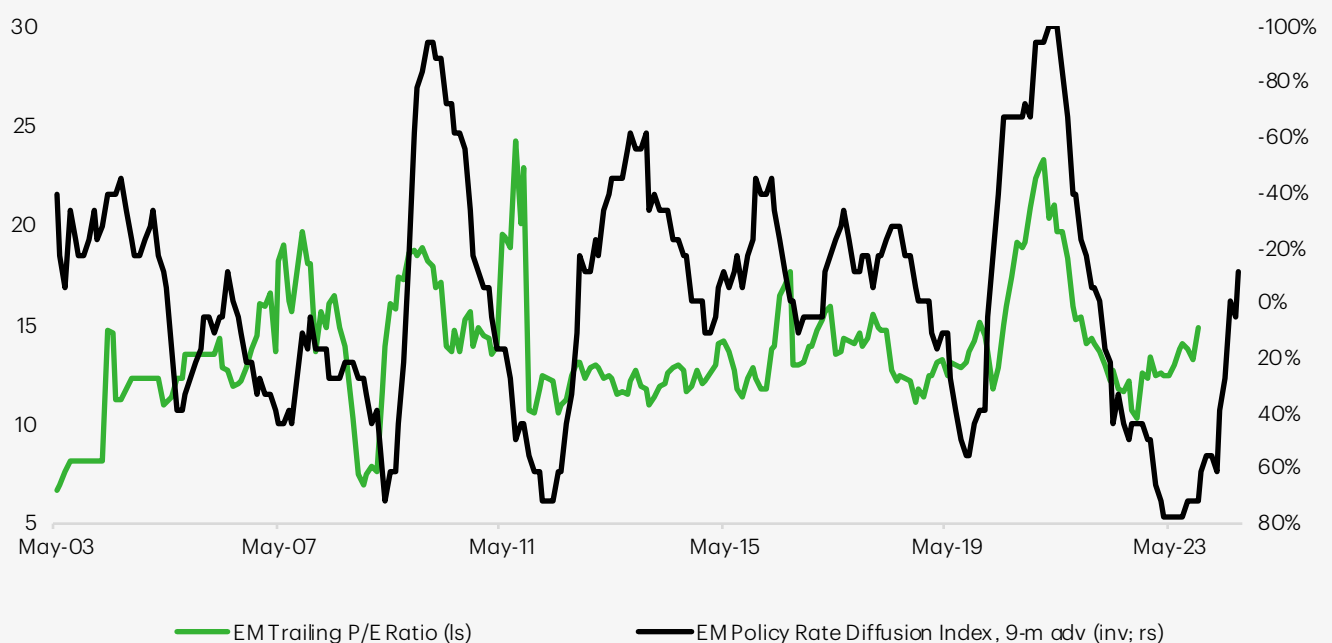
Conclusion: Keep the long term in mind

The market is continuously evolving as new information comes in, which colours sentiment, risk and future expectations. This constant re-evaluation means that market valuations over the short term are always in flux. Although today’s markets are generally deemed to be efficient, information that is unsubstantiated and broadly disseminated can have an unforeseen impact on returns. In the short term, equity prices change due to new information. This may result in price volatility.

Medium-term investments differ from shorter-term ones, however, in that they can also be highly influenced by changes to the economic environment. Medium-term economic growth is never stationary and can be subject to significant fluctuation as the economy moves through different parts of the cycle. That’s why the soft- versus hard-landing debate right now is so important. Over time, the economy and equity markets tend to converge to their long-term potential of increased economic growth and higher equity returns.

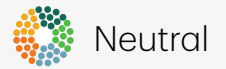
Over the long term, returns are largely driven by earnings growth, which is more influenced by economic growth than sentiment or cyclical volatility. In the short term, in a world where there are numerous outcomes — the “great wide open,” so to speak — we think this is the most important thing to keep in mind.

Figure 14: Valuation percentile across equity indices



Source: : FactSet, Wealth Investment Office as of December 31, 2023

Outlook on Alternative Assets



Private Credit, Infrastructure Still Resilient

Neelarjo Rakshit, Senior Equity Analyst, North American Equities | TD Wealth

An allocation to alternative assets such as private real estate, infrastructure, and private debt, can benefit long-term-oriented diversified portfolios. Alternative assets provide inflation protection and attractive absolute returns while helping to stabilize portfolios through diversification and less correlated income streams relative to public equities and fixed income. TD Wealth maintains a neutral weight on Alternative Assets.

Private Credit: Modest Overweight

TD Wealth has a modest overweight on private debt. In environments with increased risk of recession, private debt offers the safety net of high credit quality, global diversification, and strong risk adjusted returns.

After more than a year and half of rate hikes, the private credit industry has held up relatively well. The floating rate nature of private credit means every rate increase from central banks has strengthened absolute returns, and lenders are now pocketing a greater share of corporate cash flow. Private credit fundraising remained subdued recording just over US\$150 billion (bln) for the first three quarters of 2023—that's the lowest amount since 2016. Subordinated strategies (also known as junior debt strategies which have a lower priority for repayment) increased in popularity in 2023, particularly after yields rose for public market debt products. Fundraising for senior debt strategies remained solid through 2023, in line with post-pandemic ranges.

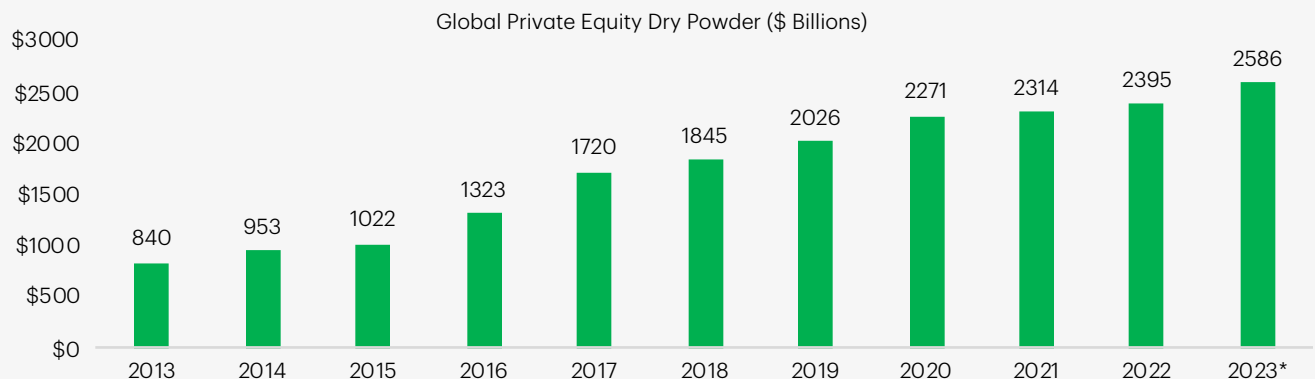
Private credit has historically outperformed public loans because of its premium for illiquidity, its securitized nature against borrower assets that enables

higher recovery values, the ability for funds to deliver operational value, and flexibility across the capital structure and with covenants (which limit borrower actions). On top of that, private credit's higher ranking in the capital structure means that the asset class has a lower risk profile relative to private equity and public equities. As a result, private credit presents a valuable diversification opportunity for investors seeking higher credit-profile risk and return.

We expect varying performance across private credit strategies regardless of whether central banks hold rates stable or trim them as market participants expect. Higher-for-longer policy rates could cause problems for borrowers: rising debt costs will further deteriorate credit metrics like the interest coverage ratio (which measures the ability of a company to pay interest on outstanding debt). If policy rates decline in response to a weakening economic backdrop, falling revenue and operating incomes for businesses could be offset by lower refinancing risk (i.e. lower interest costs on outstanding debt). In either scenario, the higher-for-longer cost of capital affects sectors and companies differently—because of their pricing power, business strength, and capital structure management—which will increase the range of performance across private credit strategies.

Nevertheless, private credit remains resilient for several reasons. 1) Private equity sponsors are sitting on record amounts of dry powder (capital committed to private equity but unallocated)—estimated at US\$2.6 trillion (tn) globally as of December 2023—and are eager to use it after a difficult year (Figure 1). North American

Figure 1: Record Capital Committed but not Allocated



*Year to date through Dec. 1, 2023. Source: S&P Global, WIO. Data as of December 31, 2023

and European general partners have demonstrated their willingness and ability to use this cash to support their portfolio companies. 2) Senior secured loans, particularly those in direct lending portfolios, are positioned at the very top of the capital structure. As a result, they typically experience lower default rates and higher recovery rates because they're backed by collateral. Most private credit lenders today are hunting for recession-agnostic businesses, namely within the healthcare, business services, and enterprise software sectors.

Infrastructure: Modest Overweight

TD Wealth holds a modest overweight view on infrastructure. Private infrastructure remains well positioned in a macro cycle defined by stagnating economies and structurally higher inflation.

Long-term structural trends should support infrastructure investment in the decades ahead. The world is in transition to decarbonize, requiring a reconfigured energy system and investment across all sectors. Digital infrastructure is expanding across the globe, increasing demand for fiber broadband, cell towers, and data centres. Supply chains are also being decoupled and rewired as geopolitical fragmentation accelerates ongoing trends toward onshoring, nearshoring (hiring third-party services) and friend-shoring (shifting towards allies), driving fresh investment in key logistics infrastructure such as railways and ports.

Investor appetite for private infrastructure remains strong, particularly for energy transition investments and critical infrastructure sectors. Expectations for increasing decarbonization have accelerated globally, particularly in power generation and clean energy

security, supported by government incentives and investment tax credits through the Inflation Reduction Act (IRA) in the U.S. and REPowerEU in Europe. The IRA has proved a powerful catalyst, attracting US\$350 bln of capital flows into U.S. utility-scale clean energy projects since August 2022. Lucrative tax credits and funding schemes also drove strong growth in third-quarter deal values for hydrogen (+451%), electric vehicle infrastructure (+248%), and battery storage (+46%). Europe is working towards decarbonization to fulfil energy security requirements, particularly as Europe transitions away from its dependency on Russian gas, creating an opportunity for new developments and brownfield sites (vacant or underutilized properties due to pollution from industrial use).

Fundraising for the first three quarters of last year remained sluggish, largely driven by the sizable decline in global mergers and acquisitions in 2023. Moreover, limited opportunities to exit investments, rapidly increasing capital costs, supply chain disruptions, and raw material price inflation have reduced asset managers' appetite to invest in new capital raising and develop new infrastructure projects.

Fundraising volumes ticked up quarter-over-quarter with US\$19.7 bln raised in the third quarter of 2023, (US\$27.3 bln in the first three quarters of 2023) but were still much lower than the US\$175 bln recorded in 2022 (Figure 2). Deal activity also remained subdued in the first three quarter of 2023: deal values tightened 24% and deal volume tumbled 20%. Dealmaking continues to centre around U.S. and Europe, particularly the renewables, electric and natural gas utilities, and digital infrastructure sectors.

Figure 2: Infrastructure Fundraising

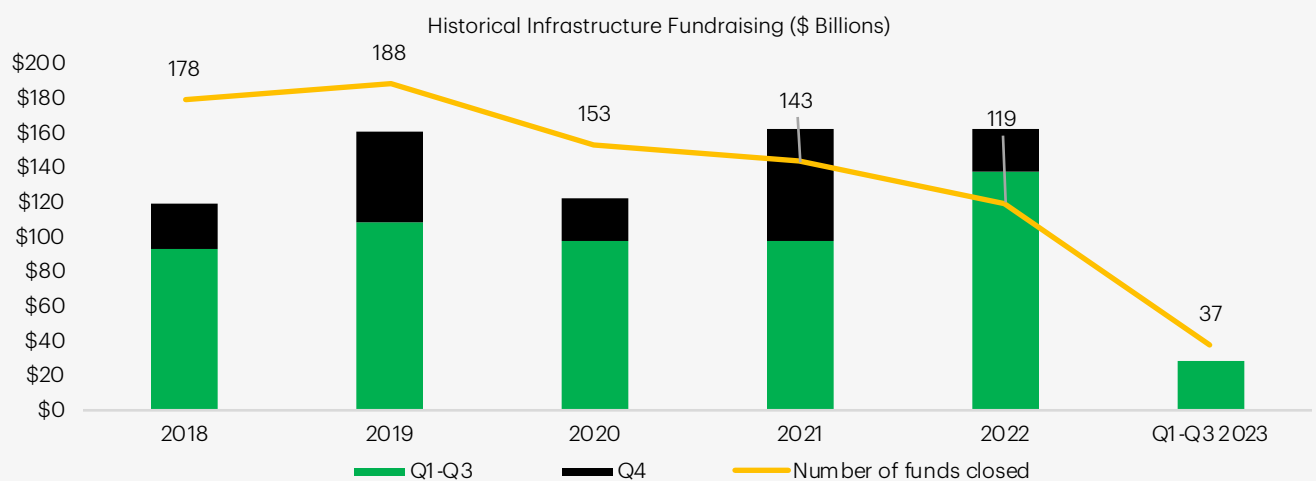
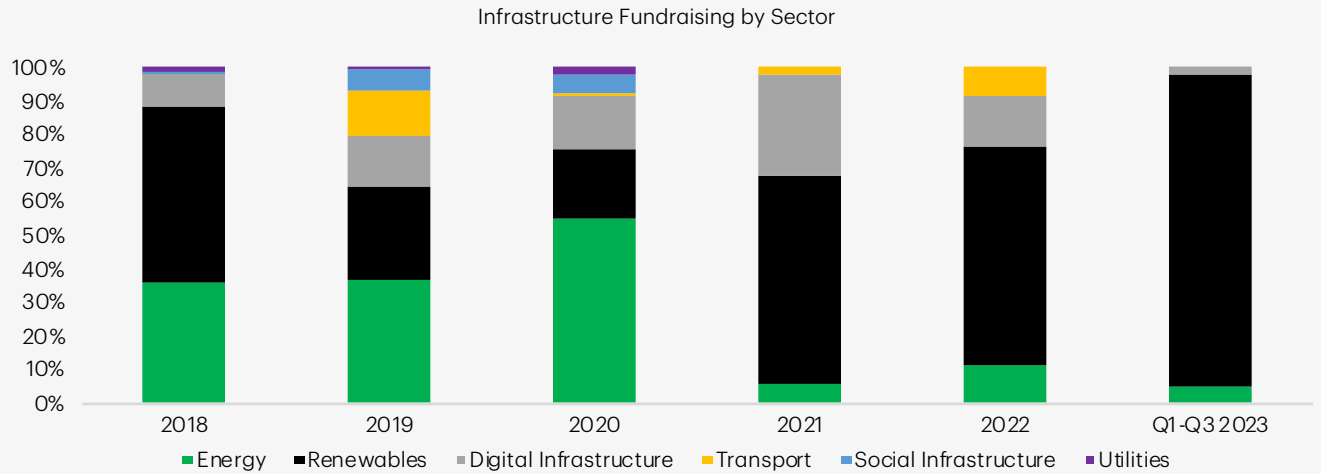


Figure 3: Breakdown of Infrastructure Fundraising

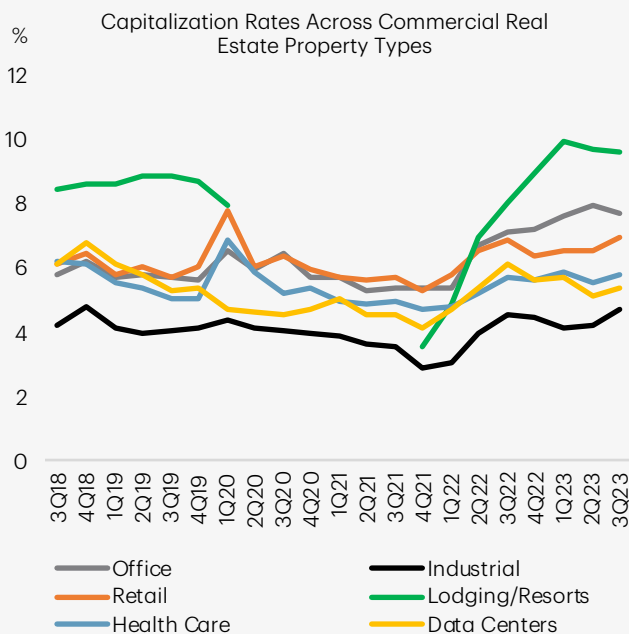


Source: Infrastructure Investor Fundraising Report 3Q23

Commercial Real Estate: Domestic (Maximum Underweight), Global (Modest Underweight)

TD Wealth holds a maximum underweight view on domestic real estate and a modest underweight view on global real estate. Commercial real estate fundamentals—and valuations—remain under pressure from lofty interest rates (which are pushing capitalization rates up, indicating higher risk), tighter lending conditions, muted transaction markets, escalating refinancing risks, and macroeconomic challenges such as inflation and supply chain concerns (Figure 4).

Figure 4: Commercial Real Estate Capitalization Rates



Source: NAREIT T-Tracker, 3Q23: <https://www.reit.com/data-research/reit-market-data/nareit-t-tracker-quarterly-operating-performance-series>

In 2023, the commercial real estate sector performance dramatically diverged across property types, sectors, and tenant types. Lending conditions are expected to remain tight throughout the first half of 2024 with property values declining further before activity rebounds in the second half.

We expect demand for industrial and data centre real estate to grow in 2024. Industrial real estate continues to benefit from the onshoring of manufacturing, increased e-commerce penetration, and the focus on last mile delivery networks (to fulfill consumer expectations for quicker deliveries). Demand for data centre real estate will benefit from internet adoption, mobile data usage, 5G infrastructure deployments, and increased adoption and use of technologies like artificial intelligence and machine learning.

On the other hand, retail and office real estate fundamentals aren't expected to fare as well in 2024 and will likely remain under pressure from muted demand and limited rent growth. The growth of necessity-based retailers—like grocery stores and pharmacies—is underpinned by immigration, high urban densification, and the trade-down effects (where consumers purchase similar but cheaper items) of high inflation. Shopping centres and experiential retail (which allow customers to try out products), however, may have to deal with increased recessionary risks which could hurt retail sales and slow future rent growth. We believe North American office real estate will continue its slower-than-expected recovery in occupancy rates with muted property-level rent growth. The U.S. and Canada are market economies where record tight labour markets, high suburban sprawl, and long commute times dictate the work-from-home frequency.

Outlook on Currencies

Central Bank Paparazzi Doves in 2024

TD Securities, Global Rates, FX & Commodites Strategy

Currencies and fixed income made a massive pivot in the final months of 2023, underscoring a shift to the other side of the central-bank cycle. It's now time for cuts, but global growth expectations don't point to a global recession. TD Securities (TDSI) has seen its global growth indicators improve for 2024, suggesting further downside for the U.S. dollar through the first half of the year. However, the currency strategists at TDSI note that it won't be a straight line, given that geopolitics will feature heavily in the market calendar this year and markets remain very data-dependent.

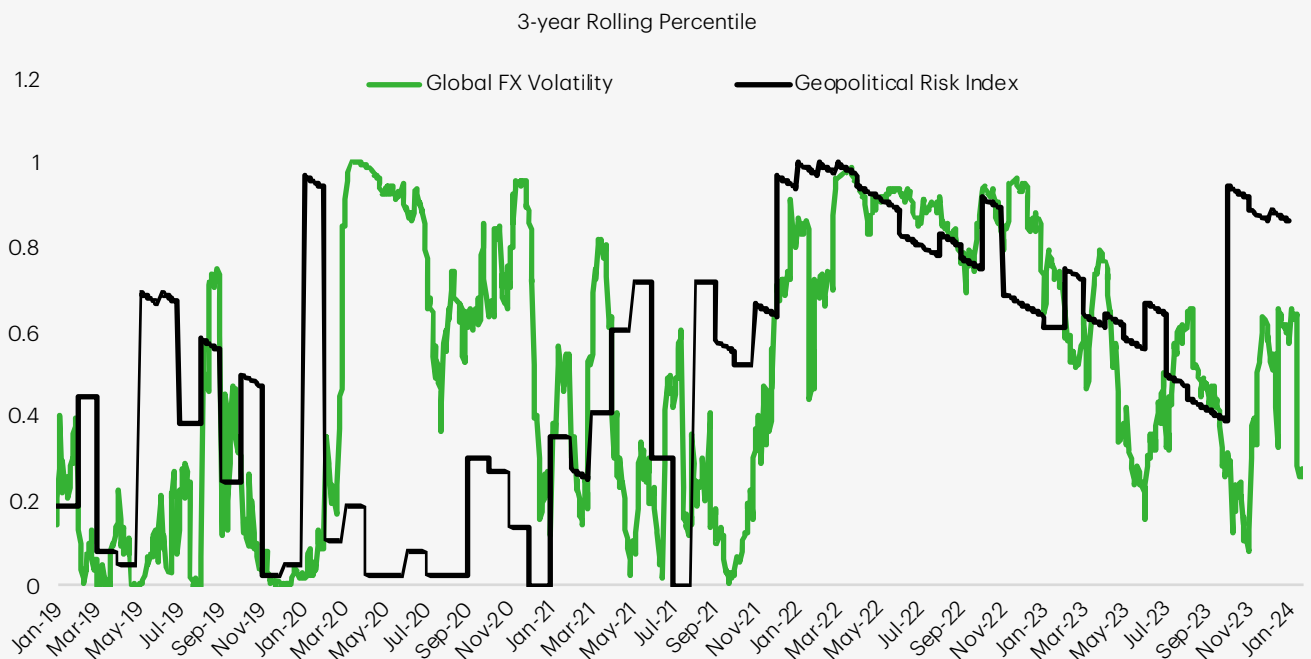
Market Themes for 2024: Bring on the cuts, better growth, heavy geopolitics

The market regime is pivoting again. Inflation was the focus of 2022, while 2023 brought the recession that never happened. Market returns were quite good to close the year, leaving markets to wonder whether to fade or to follow? TDSI believes peak rates are behind us, but the key question to start the year is really more tactical in nature. It appears things have moved a bit too far too fast, even if the direction of travel is clear for central banks.

Another key feature of the market dynamics is that, while global growth isn't super strong, it's muddling along. TDSI's leading indicators also show signs that things have improved recently, especially in Asia. Also, tracking of global growth upgrades/downgrades over the coming year skews in favour of upgrades. That could pose some near-term risks to inflation, but we still think supply-side factors should reinforce the broad disinflation theme, allowing central banks to cut rates and boost the outlook for 2025.

A big focus of 2024 will also be the impact of geopolitics. There are critical elections around the world, with 54% of the global population getting a chance to the vote. The U.S. election is already gathering market interest, underscoring the fact that investors see a big risk event. Elsewhere, markets will closely watch the outcome of Mexico's elections in June, especially as it relates to energy and foreign-investment policies. Also, market volatility is low relative to geopolitical uncertainty (Figure 1), so we don't expect a clean and linear story to play out in the price action. That said, it's also clear that elections will meet more bond supply, especially in the U.S.

Figure 1: Busy geopolitical calendar this year



Source: FactSet, Macrobond, TD Securities

U.S. slowing into “softish” recession this year

Last year was all about the recession that never happened, with asset markets and the U.S. economy holding up well. However, the U.S. slowdown is now gathering a bit more steam. Credit and labour markets will be two key indicators to watch for signs of a deeper setback (Figure 2).

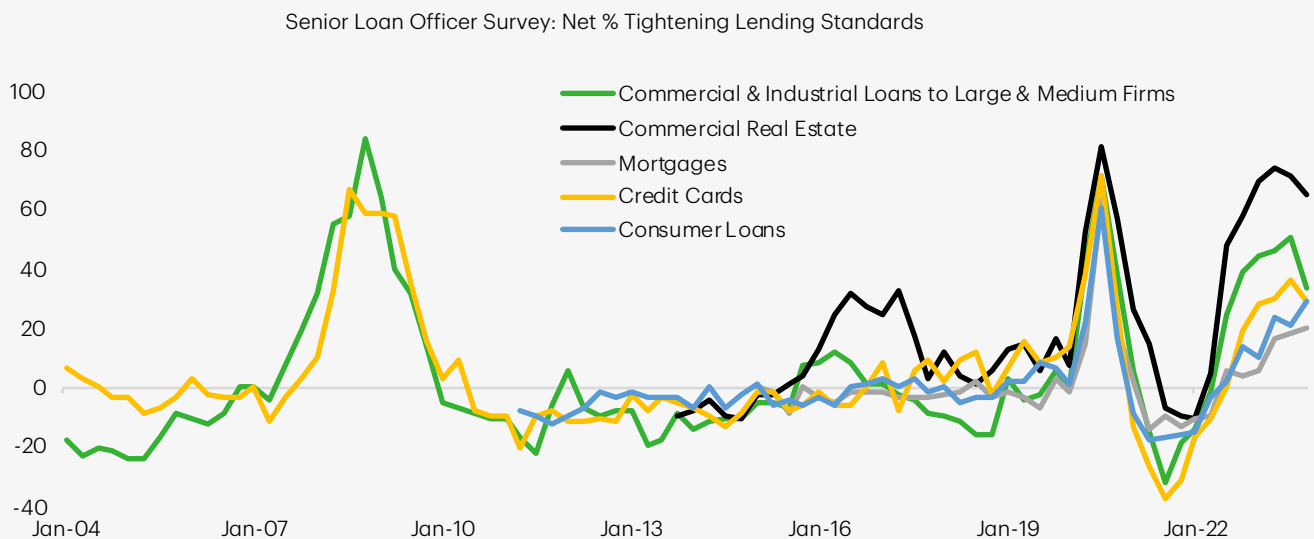
The U.S. dollar cares most about how the U.S. compares to the rest of the world (ROW). A key trend has been a steady, if less than spectacular, global growth outlook. Given the U.S. dollar’s perky valuations and surging deficits, the USD needs a global recession or clear growth leadership. The market has had a rough time making sense of data dependence, as if everyone is watching everything, increasing the noise-to-signal ratio. TDSI believes a repricing in line with more aggressive rate-cut expectations will bring U.S. dollar weakness in the medium term.

Best of the rest: Yen top-ranking, loonie less so

There is a shift in growth expectations over the coming year. The setup is interesting, underscoring the lack of global leadership in the G10, especially for Canada. The pass-through of higher rates to the domestic economy will be a key feature of the 2024 growth story. There we think housing will play a powerful role, where the Canadian dollar will lag on crosses. A look at housing dynamics — like household debt and debt-service ratios, and the large mortgage reset calendar in 2024/2025 — suggests that the loonie is vulnerable to weakness on crosses. However, the Canadian dollar may appreciate into next year relative to our broad U.S. dollar outlook.

As for the Japanese yen, our multi-factor approach highlights that the yen is the top-ranked currency in the G10 by a wide margin, underscoring value, terms-of-trade tailwinds, current account, growth and technical momentum.

Figure 2: Credit cycle has tightened in the U.S.



Source: FactSet, Macrobond, TD Securities

Figure 3: Foreign Exchange Forecasts for G10 Currencies

	2024			
	Q1 F	Q2 F	Q3 F	Q4 F
USD/JPY	143	140	138	135
EUR/USD	1.10	1.13	1.13	1.15
GBP/USD	1.28	1.29	1.30	1.32
USD/CHF	0.86	0.87	0.86	0.85
USD/CAD	1.33	1.32	1.31	1.29
AUD/USD	0.68	0.69	0.70	0.72
NZD/USD	0.62	0.64	0.64	0.66
BBDXY	1217	1195	1185	1163

Source: TD Securities as of January 9, 2024

Outlook on Commodities

A promising setup for the year

Hussein Allidina, Managing Director and Head of Commodities | TD Asset Management

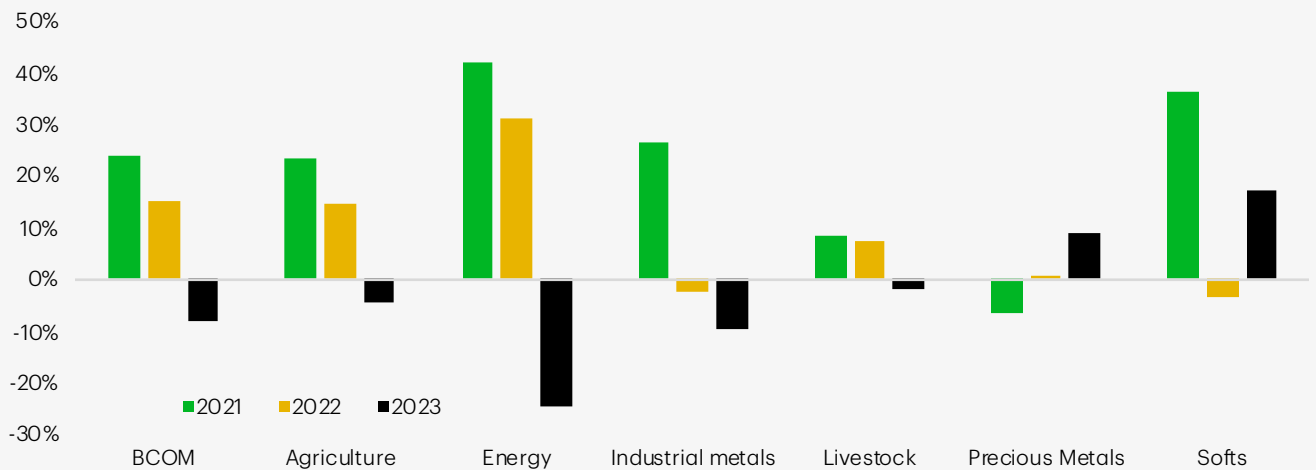
After posting double-digit total returns in both 2021 (+24%) and 2022 (+15%), commodity prices, as measured by the Bloomberg Commodities (BCOM) Total Return Index, lagged in 2023, shedding just over 8%. This weakness was broad-based, with all commodities in the index, except precious metals and soft commodities, weaker on the year (Figure 1). Important for commodity investors, BCOM total returns exceeded the change in spot prices, reflecting the collateral yield and positive carry earned through most of the year.

Performance in 2024 should be more favourable as we progress through the early innings of the investment phase of the commodity cycle – characterized by tight inventories, a challenged supply outlook (particularly for longer-lead-time commodities like oil and metals)

and growing demand. Energy transition, the reshoring of supply chains and heightened geopolitical risk are themes that we expect will remain in focus throughout the year. In contrast to 2023, easing financial conditions and a weaker U.S. dollar could prove a tailwind for the asset class.

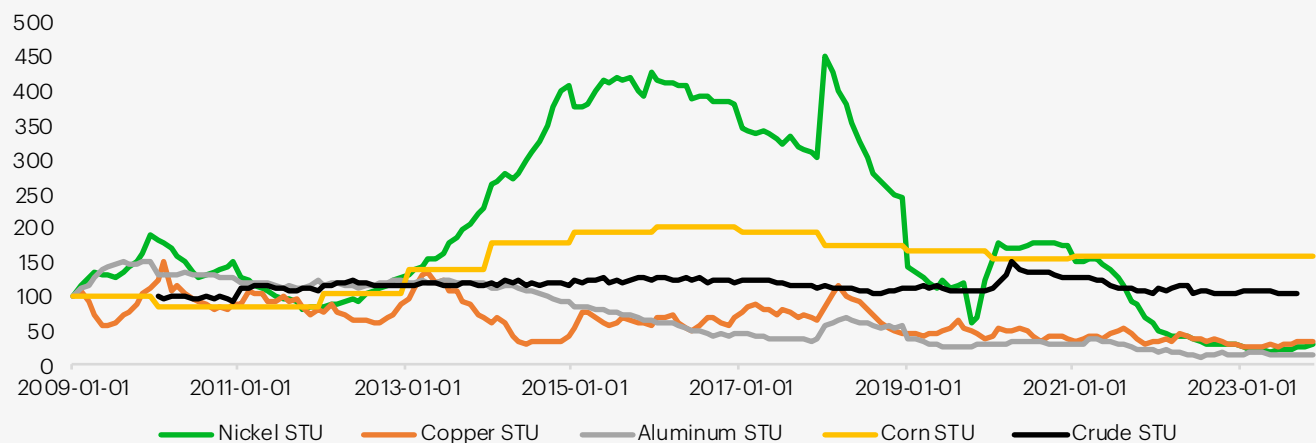
We think the commodity market broadly is pricing a material amount of pessimism around economic growth – pessimism that doesn't appear to be priced in other risk markets, including equities, and importantly pessimism that is yet to be reflected in higher-frequency demand data. Demand growth will slow into 2024, as the post-Covid rebound tempers, but we expect higher aggregate demand and see inventories remaining broadly constrained (Figure 2).

Figure 1: Commodities pulled back in 2023



Source: TD Asset Management, as of December 31, 2023

Figure 2: Inventories remain extremely low



Source: TD Asset Management as of December 31, 2023

Although growth rates are important for commodities, the aggregate level of supply and demand dictates whether inventories draw or build, and although 2024 may see inventories grow for some commodities, inventories broadly are expected to remain tight, especially when adjusted for demand.

Weakness in energy was the largest detractor to BCOM returns in 2023, despite the fact that global crude oil demand grew by some 2.2 million barrels per day (b/d), reaching a record high 101.7 million b/d. While oil demand increased above-trend, the supply-side surprised bearishly due to supply management by both OPEC and non-OPEC countries, which prevented the inventory draws expected when we started 2023. Within OPEC, Iranian production in particular saw an increase of more than 500,000 b/d and is now averaging levels not seen since 2018. We are skeptical, however, that Iran will be able to muster the same growth in 2024, and if sanctions are enforced, production could retreat.

Shale production in the U.S. also surprised late in 2023, raising concern that OPEC may flood the market to preserve market share as they did in 2014. We expect continued production growth in the U.S. but see that growth slowing to around 550,000 b/d, and we believe OPEC will continue to temper their production to keep the market balanced.

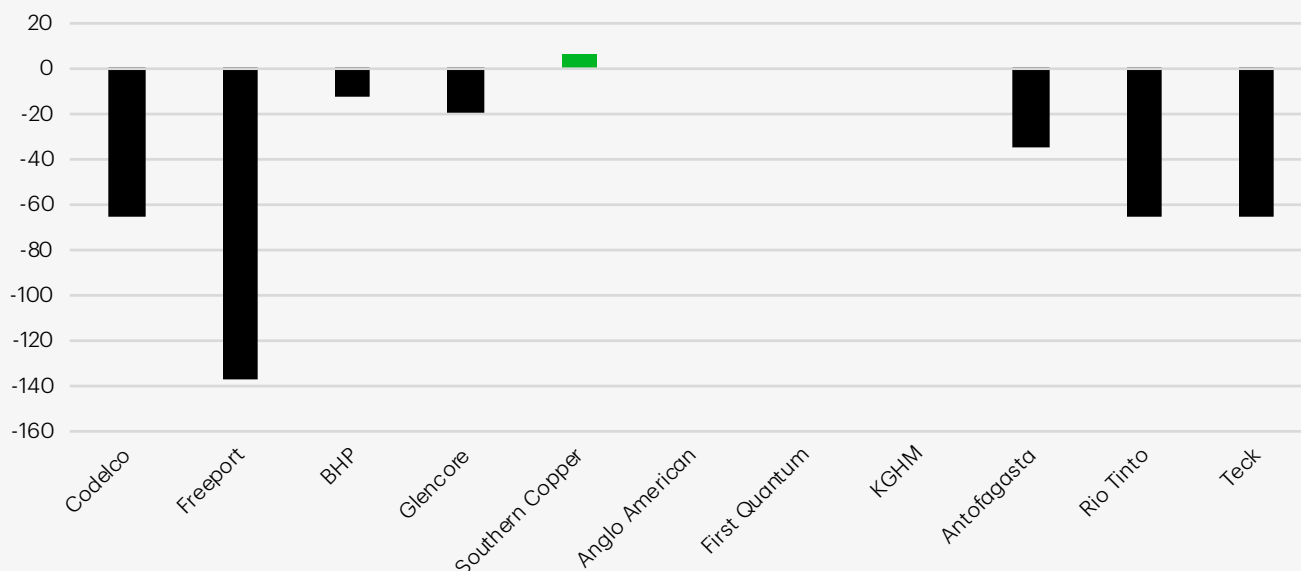
Consensus expectations for 2024 show global demand higher by a below-trend 1.2 to 1.4 million b/d, with non-OPEC supply seen growing by 1.2 to 1.5 million b/d — implying a small aggregate build in total inventories over the course of the year. While this is not bullish, especially with OPEC believed to hold some

3 to 4 million b/d of spare capacity, tight inventories, especially when adjusted for demand, should support prices and keep curves backward (positive carry) on average throughout the year. Further, geopolitical risk is only ratcheting higher, and although production has yet to see an impact, supply could still be constrained if shipping lanes continue to come under attack.

The outlook for metals is favourable, in our view. Not dissimilar to the oil market, years of underinvestment have left the cupboard bare, with inventories for many base metals at or near record lows (Figure 3). Uncertainty around forward supply has also come into focus, with disruptions in Guinea, Panama and elsewhere tightening current and forward balances. Demand for metals from EVs and renewable energy continues to provide support. Looser monetary conditions should ultimately prove supportive for industrial production and a rebuild of finished goods inventories, which could be a tailwind for metals demand throughout the year.

Grains and soft commodity performance diverged in 2023, with the former shedding 14% and the latter up by 17%. Corn, soybean and wheat supply has benefited from a few years of higher prices and synchronized favourable weather in the U.S. and South America. We are modestly bearish on grains into 2024, given that weather is still favourable, which should allow for further inventory builds. Softs, on the other hand, moved meaningfully higher in 2023 — led by coffee and sugar, which have longer growing cycles (versus crops like corn, wheat and beans). Soft markets are still tight and the evolving El Nino will keep markets on edge.

Figure 3: Copper supply falling as miners shave guidance



Source: TD Asset Management and Company Reports as of December 2023

Market Performance

		(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)	
Canadian Indices (\$CA) Return		Index	1 Month	3 Months	YTD	1 Year	3 Years	5 Years	10 Years	20 Years
S&P/TSX Composite (TR)	84,037	3.91	8.10	11.75	11.75	9.59	11.30	7.62	7.79	
S&P/TSX Composite (PR)	20,958	3.57	7.25	8.12	8.12	6.33	7.91	4.40	4.79	
S&P/TSX 60 (TR)	4,138	4.06	8.76	12.05	12.05	10.39	11.60	8.24	8.20	
S&P/TSX SmallCap (TR)	1,267	3.76	5.98	4.79	4.79	4.57	8.37	3.95	3.67	
S&P/TSX Preferred Share(TR)	1,690	0.82	7.28	5.90	5.90	1.17	2.61	1.46	2.13	
U.S. Indices (\$US) Return										
S&P 500 (TR)	10,328	4.54	11.69	26.29	26.29	10.00	15.69	12.03	9.69	
S&P 500 (PR)	4,770	4.42	11.24	24.23	24.23	8.29	13.73	9.94	7.55	
Dow Jones Industrial (PR)	37,690	4.84	12.48	13.70	13.70	7.19	10.07	8.56	6.62	
NASDAQ Composite (PR)	15,011	5.52	13.56	43.42	43.42	5.21	17.74	13.65	10.59	
Russell 2000 (TR)	10,813	12.22	14.03	16.93	16.93	2.22	9.97	7.16	8.11	
U.S. Indices (\$CA) Return										
S&P 500 (TR)	13,659	1.81	9.25	23.31	23.31	11.40	14.97	14.50	9.82	
S&P 500 (PR)	6,308	1.69	8.81	21.31	21.31	9.67	13.03	12.37	7.68	
Dow Jones Industrial (PR)	49,847	2.09	10.03	11.03	11.03	8.55	9.39	10.95	6.75	
NASDAQ Composite (PR)	19,854	2.76	11.08	40.05	40.05	6.56	17.01	16.15	10.72	
Russell 2000 (TR)	14,300	9.28	11.54	14.18	14.18	3.53	9.29	9.52	8.23	
MSCI Indices (\$US) Total Return										
World	14,558	4.94	11.53	24.42	24.42	7.79	13.37	9.18	8.37	
EAFE (Europe, Australasia, Far East)	10,693	5.33	10.47	18.85	18.85	4.53	8.69	4.78	6.08	
EM (Emerging Markets)	2,641	3.95	7.93	10.27	10.27	-4.71	4.08	3.05	7.20	
MSCI Indices (\$CA) Total Return										
World	19,254	2.20	9.10	21.49	21.49	9.16	12.67	11.59	8.49	
EAFE (Europe, Australasia, Far East)	14,142	2.57	8.06	16.05	16.05	5.87	8.02	7.09	6.20	
EM (Emerging Markets)	3,493	1.22	5.58	7.67	7.67	-3.49	3.43	5.32	7.32	
Currency										
Canadian Dollar (\$US/\$CA)	75.61	2.69	2.23	2.41	2.41	-1.26	0.62	-2.16	-0.12	
Regional Indices (Native Currency, PR)										
London FTSE 100 (UK)	7,733	3.75	1.65	3.78	3.78	6.18	2.82	1.37	2.77	
Hang Seng (Hong Kong)	17,047	0.03	-4.28	-13.82	-13.82	-14.45	-7.99	-3.08	1.53	
Nikkei 225 (Japan)	33,464	-0.07	5.04	28.24	28.24	6.83	10.83	7.46	5.88	
Benchmark Bond Yields			3 Months	5 Yrs	10 Yrs	30 Yrs				
Government of Canada Yields		5.05		3.18		3.11		3.03		
U.S. Treasury Yields		5.36		3.85		3.88		4.03		
Bond Indices (\$CA Hedged) Total Return		Index	1 Mo (%)	3 Mo (%)	YTD (%)	1 Yr (%)	3 Yrs (%)	5 Yrs (%)	10 Yrs (%)	
FTSE TMX Canada 91-day Treasury Bill Index	450	0.39	1.28	4.71	4.71	2.22	1.83	1.31		
FTSE TMX Canada Universe Bond Index	1,121	3.43	8.27	6.69	6.69	-2.80	1.30	2.42		
FTSE TMX Canada All Government Bond Index	1,059	3.48	8.49	6.11	6.11	-3.36	0.86	2.18		
FTSE TMX Canada All Corporate Bond Index	1,346	3.27	7.63	8.37	8.37	-1.23	2.51	3.10		
U.S. Corporate High Yield Bond Index	282	3.59	6.79	12.48	12.48	1.45	4.56	4.07		
Global Aggregate Bond Index	253	3.07	5.67	6.33	6.33	-2.47	0.97	2.22		
JPM EMBI Global Core Bond Index	503	4.81	9.23	9.69	9.69	-4.58	0.80	2.56		
S&P/TSX Preferred Total Return Index	1,690	0.82	7.28	5.90	5.90	1.17	2.61	1.46		
Credit Suisse (\$US) Total Return		Index	1 Month	3 Month	YTD	1 Year	3 Year	5 Year	10 Year	
Credit Suisse Equity Market Neutral USD	315	0.51	3.04	6.73	6.73	4.84	3.55	1.63		
Credit Suisse Event Driven USD	828	2.53	3.38	9.30	9.30	4.78	5.89	2.88		
Credit Suisse Global Macro USD	1,324	1.37	0.96	-5.19	-5.19	6.39	7.21	4.45		
Credit Suisse Hedge Fund USD	777	0.70	2.05	5.83	5.83	5.00	6.12	3.86		
Credit Suisse Long/Short Equity TR USD	970	0.84	4.17	10.93	10.93	4.24	6.50	4.58		
Credit Suisse Managed Futures USD	396	-0.49	-3.38	-2.78	-2.78	7.81	6.83	3.89		

Source: TD Securities Inc., Morningstar®, TR: total return, PR: price return, as of December 29, 2023.

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