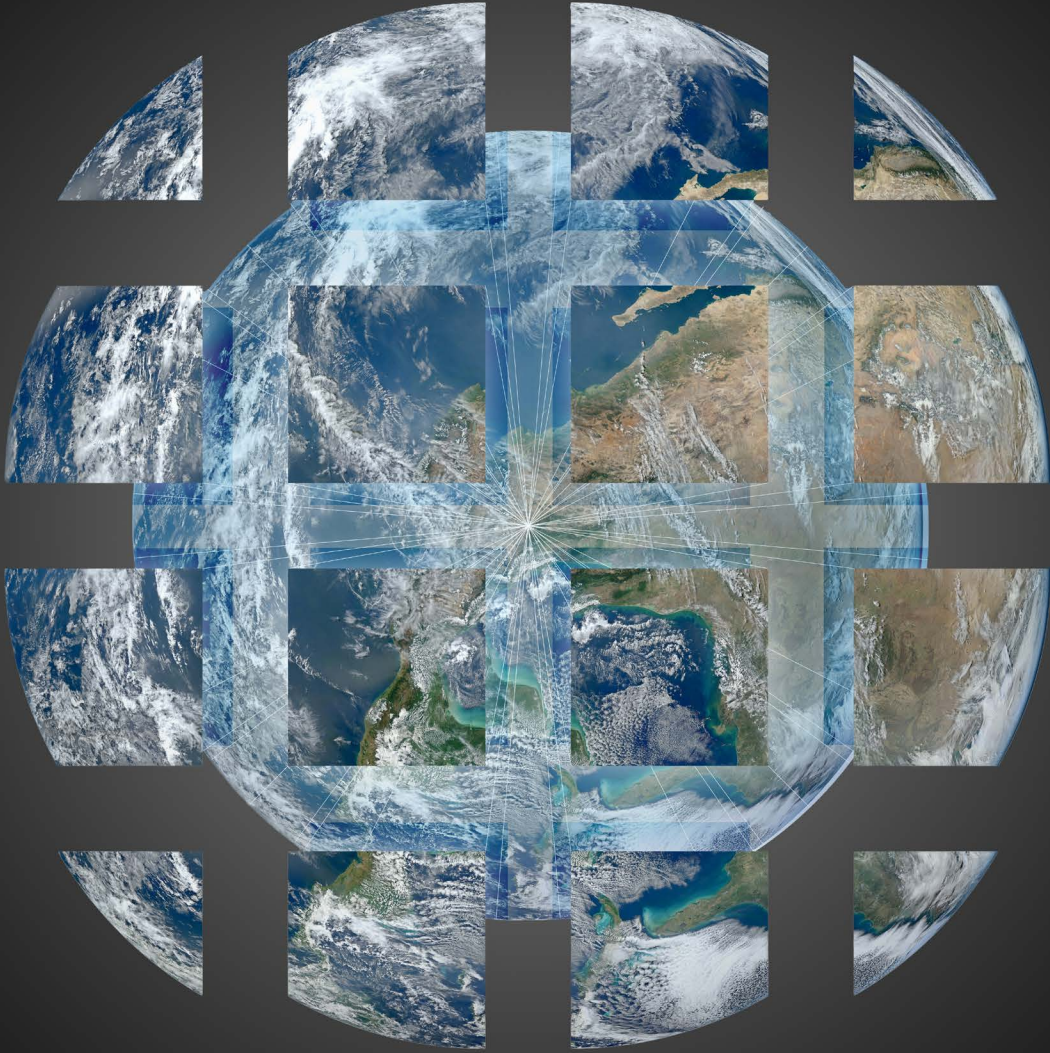




# "We"

Portfolio Strategy Quarterly | Q4 2023

October 27, 2023



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## “We”

There is more that unites us than divides. This has been said by many but remembered by few. In the decade between the global financial crisis and the Great Recession, we witnessed the longest economic expansion in American history. Old news, I know, but it's worth noting that those 12 years or so also represented the longest economic expansion in global history — because it was a global economy, where far-flung businesses and regional leaders worked together in pursuit of mutual prosperity. Now, with the rise of populism, protectionism and even war, those days seem to be a quaint memory. Political leaders are no longer working in furtherance of a globalized economy, and it's getting harder and harder to say "We."

History has shown that nations that trade freely with one another, more often than not, figure out how to live together. Back in early 2022, we were trying to come to terms with the Russia-Ukraine War, and now we're trying to process the war in the middle east. Let's all unite in support of those directly impacted and hope and pray for peace in the region. The human cost is incalculable. Nevertheless, professional responsibility also demands that we consider what this war will mean for financial markets.

In this, the fall edition of PSQ, we will, as always, endeavour to frame current conditions and provide a glimpse into the next few months, how we think they will unfold and how we will make decisions in pursuit of the growth and protection of investment capital.

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Be well,

A handwritten signature in black ink, appearing to read 'Brad Simpson', written in a cursive style.

Brad Simpson  
Chief Wealth Strategist, TD Wealth

# Cracking Complexity

## Complexity

### 49 = Soft?

The U.S. economy may be en route to a soft landing, if manager surveys are any indication. Service-sector PMIs have remained expansionary, stopping just short of the 50 threshold. Manufacturing PMIs, meanwhile, shocked the markets in October, rising from 47.6 to 49. If the U.S. avoids recession, broader U.S. equities should perform well.

### 15 = Hard?

On the other hand, the U.S. Conference Board's Leading Economic Indicators Index, which precedes turning points in the business cycle by six to eight months, has declined for 15 consecutive months — the longest streak since 2008 — and is negative year-over-year. Mixed signals abound.

### Heavyweight Knockdown

How tech-heavy is the S&P? In September, the Chinese government announced that it would ban employees from using the iPhone. Apple's stock took an almost 10% hit over three days, making it one of the index's largest detractors for the month.

### 14.5x < 16x < 21x

While the market-cap-weighted S&P 500 trades at 21x forward earnings, the equal-weighted version trades at a mere 16x, indicating value outside the "Magnificent Seven" mega-caps. The S&P/TSX Composite, meanwhile, is trading at 14.5x and is 78% composed of cyclicals.

### Quarter Century

U.S. investment-grade bonds now offer their highest all-in yield, at 5.5%, since the late 1990s — and the fundamentals look strong. Trailing 12-month debt/EBITDA is down to 2.5x from 2.8x in 2019, and there were four and a half times as many upgrades as downgrades in H1 2023.

### 33rd percentile

The energy sector is trading at 12 times forward earnings. That represents the 33rd percentile of its historical range and a 41% discount to the S&P 500. With oil supply tight and average dividend yields of 3.7%, energy may be readying for a rally.

### 50% Fewer

Existing home sales in Canada had a peak-to-trough decline of over 50% since the Bank of Canada first started hiking in 2022, with the average home sale price falling 20% over that time.

### 4% < 20%

Real estate has fallen out of favour post-pandemic, but nuance is everything in the sector. Vacancy rates for traditional offices are above 20%, but areas like logistics are enjoying vacancy rates of 4% in the U.S. Demand for data centres, meanwhile, is being driven by cloud computing, content creation and the AI revolution.

## Adaptation

### 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.

### 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.

### 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.

### 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.

### 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%.

### 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.

### 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.





# PSQ4.2023 | Executive Summary

■ **House Views | Fixed Income, modest overweight:** As resilience in the labour market persists and inflation continues to normalize in line with the expectations of the Bank of Canada, we believe monetary policy pivoting to rate cuts over the next nine to 12 months is less likely than is currently priced by investors. This may translate into a slower decline in interest rates. 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 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 and even show signs of positive momentum. Valuations have contracted somewhat, particularly in sectors that could face challenges, which may offer a better risk/reward outlook.
- **Alternatives and Real Assets, neutral:** We believe that an allocation to alternative assets can benefit diversified portfolios 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 |** At the beginning of the year many were calling for the U.S., Canadian and global economy to already be in a recession, which hasn't happened, at least not yet. The U.S. and Japanese economies are still strong, labour markets remain tight, inflation is still above central bank targets, and importantly, interest rates are likely to remain higher for longer than expected. Importantly, the higher for longer outlook for rates has led to broad-based weakness across global asset classes. While there have been a few exceptions, namely commodity markets, broadly speaking, there were few places to hide in Q3 2023.

- **Sunshine in the U.S, clouds in Canada:** The U.S. economy has proven to be more resilient than expected. Here in the north, however, it was a different story. The Canadian economy reported a 0.2% y/y decline for Q2 GDP, far worse than expected. Higher interest rates have begun to weigh on the Canadian consumer and the housing sector.
- **Keep a lookout for some thunder and lightning:** We have witnessed a surge in geopolitical tensions, with the war in the Middle East resulting in the tragic loss of life. The Sino-American divide became deeper in Q3, with each side rallying support from existing and newfound allies. In August, leaders from Japan, Korea and the U.S. met at Camp David to inaugurate a new trilateral partnership. On the other side of the world, leaders of BRICS also convened around the same time. Two important takeaways: the bloc is extending invitation to six more countries to join, including Saudi Arabia, Iran, UAE, Argentina, Egypt and Ethiopia; second, some BRICS leaders expressed a desire to create a bloc-wide currency to de-dollarize the global economy.

■ **Economy |** We tackle two questions this quarter: (1) How can an interest rate that's supposed to be rooted in long-term concepts of economic fundamentals and dynamics change by such a large magnitude? And (2) is that thinking about to migrate towards a higher neutral rate.

- **A paradigm shift in the (R-) stars.** Over the past 30 years, several large forces have caused analysts to mark down estimates of the neutral rate. All these theories and observations pointed in the same direction: too much money chasing too few assets, leading to a fall in world interest rates. The question is how much these conditions still hold today? We think the odds lean toward the neutral rate being slightly higher than the past decade. The resilience of the U.S. economy is giving some signals on this front. It's early days, but we think roughly a 25-bp nudge (and perhaps even as much as 50 bps) is a reasonable possibility.
- **Canadian economy slowing, but inflation remains stubborn.** The same forces impacting R-star in the U.S. are at work in Canada, but there is one key distinction on the domestic front. Canada's elevated household debt levels place the country at risk for a drawn-out deleveraging cycle, and this typically pushes down the resting place on interest rates.

■ **Fixed Income |** We believe the investment outlook and conviction for bonds remain strong. Yields are back around levels not seen since the early 2000s and the bond market is well positioned to deliver attractive returns in the years ahead driven simply by yield. Investors can earn attractive yields in almost all segments of the fixed income market. It would be fabulous if a drop in yields and higher prices helped capital gains boost total returns, but even without, fixed income is expected to flourish at current yields. As third-quarter performance demonstrates, returns may be volatile over the short term but will accrue for those with longer term time horizons.

- **We are modest overweight fixed income investments in general** and modest overweight domestic government bonds. Canadian and U.S. government bonds are more attractive at current yields and offer opportunities for

income generation and downside protection. While it has been another challenging year for bond investors, higher starting yields have historically been associated with higher total returns. We also expect price/yield volatility to decline in coming quarters as the rate hiking cycle nears an end and forward guidance from central banks as well as the severity of economic slowdown becomes clearer. • **We remain neutral investment grade (IG) credit.** We expect the challenging economic conditions to weigh on corporate bonds, 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.** The HY credit market has seen an overall improvement in quality. This should keep spreads from returning to previous recessionary levels, however, they will widen if the growth outlook deteriorates.

■ **Equities** | The S&P/TSX Composite Index is now trading at 12.4x, which is a discount to the median of 15.1 over the past 10 years. We believe the discount valuation reflects the risk that the full effect of higher rates on the consumer remains to be seen in Canada. Roughly two-thirds of the gain in the S&P 500 this year, meanwhile, has been driven by seven names. Following a sharp rally in cyclical and growth sectors, valuations for defensive sectors are becoming more attractive, while info-tech and consumer discretionary are becoming less appealing. Consumer staples and utilities, for instance, have flipped from two of the most expensive sectors early this year to a relative bargain. Energy and materials continue to screen positively, while financials and industrials now look more attractive relative to the broader benchmark. • **Energy: Tight market supports oil over \$80.** The decision by OPEC and its allies to extend their supply curbs has boosted the outlook for operating margins, which should continue to support valuations. We remain cautiously bullish on energy prices. • **Utilities: Under pressure from higher yields.** With borrowing costs on the rise, the high-leverage nature of utility operators may present a headwind for earnings growth in the sector. • **Consumer Discretionary: Cautious consumers bode ill.** Valuations within the consumer discretionary sector remain rich, with the index heavily tilted towards Amazon (30% of the sector) and Tesla (17%). We remain underweight the sector. • **International and Emerging Markets:** The growth outlook for European economies is bleak. The German composite PMI has been in contraction since July. The outlook for Japanese stocks, meanwhile, is more optimistic. The near term outlook for EM stocks is uncertain. An improving growth outlook should boost earnings growth, but overall economic activity in developed markets and foreign currency both play an important role and could present challenges for EM markets in the near term.

■ **Alternatives** | **Real Estate:** Values have continued to normalize as long-term interest rates march higher on stubborn inflation numbers and an increasingly hawkish Fed. Deal-making remains sluggish. • **Office and Industrial:** The national vacancy rate for office edged up 10 basis points to 18.2%. The industrial sector is moving toward equilibrium as vacancy rates rebound from all-time lows. We expect vacancy rates and rental growth to move further towards a balanced market as more supply comes online. • **Infrastructure:** Infrastructure returned 2% in Q2, bringing YTD returns to 3.8%. Deal-making continues to centre around Europe, the U.S. and the energy industry. • **Private Credit:** After peaking in January 2023, banks have essentially flatlined new loan growth in the face of uncertain economic prospects and regulatory scrutiny. This creates more opportunities for private credit managers to step into the void as borrowers remain resilient.

■ **Currencies** | The handover to fall includes uncertainty around China's outlook, a sharp tightening of financial conditions and an unexpected aggressive bear-steepening of the U.S. yield curve. • **USD:** We continue to expect medium-term USD depreciation. We see the rest of the world stabilizing in 2024, aided by China, while the U.S. may slow into 2024. • **CAD:** We believe the Bank of Canada will stay the course. The key issue will be how the Bank attempts to reconcile a significant downgrade to its growth outlook with signs of more persistent inflation. We look for the Bank to maintain a hawkish tone.

■ **Commodities** | The three major global economies are following their own paths, as a manufacturing recession continues to grip the EU. The U.S. continues to be the strongest economy on almost all fronts. • **Metals:** Demand has been supported by Chinese residential completion activity; however, this source of demand is expected to thin out on China's more structural real estate challenges. • **Oil:** Chinese demand continued to recover through the summer, hitting a new record high as travel returned to pre-Covid levels. • **Agriculture:** Data hints at the larger domestic challenges facing China, given that protein consumption peaked a few years ago and has since started to trend lower. • **Geopolitics:** Conflict is providing a tailwind for commodities as the risk for significant supply disruptions rises in step with tensions.

# There is no “We”

Brad Simpson, Chief Wealth Strategist | TD Wealth

There is more that unites us than divides. This has been said by many but remembered by few. Back in the spring of 2022, the *Portfolio Strategy Quarterly* we produced for Q2 bore the title “The Uncertainty Trinity.” In it, I made the case that, when it comes to investing, uncertainty comes in threes: (1) economic uncertainty; (2) policy uncertainty; and (3) geopolitical uncertainty. I then made the argument that, after being relatively dormant for decades, geopolitical uncertainty would have greater impact on financial markets due in no small part to the disturbing trend towards deglobalization.

This prediction has played out, unfortunately. After nearly three decades spent espousing the positive virtues of free trade, interconnectedness and the spread of democratic ideals, global leaders have increasingly pushed their nations toward protectionism and adversarial regionalism — a world where it’s about us and them.

History has shown that nations that trade freely with one another, more often than not, figure out how to live together. Let’s hope that Figure 1, which charts current global trade, indicates a cyclical trend and not a secular one, although I fear the latter may be true. The following questions are ones I’ve heard frequently over the past few months, and deglobalization is at the root of all of them:

1. Where are we in the business cycle?
2. Is the outlook for inflation getting any better?
3. What’s happening with the 10-year Treasury and why haven’t I done well in bonds?
4. If equity markets and the economy are still disconnected, will they eventually converge?
5. Where do we go from here?

Back in early 2022, we were trying to come to terms with the Russia-Ukraine War, and now we’re trying to process the war in the middle east. Let’s all unite in support of those directly impacted and hope and pray for peace in the region. The human cost is incalculable. Nevertheless, professional responsibility also demands that we consider what this war will mean for financial markets.

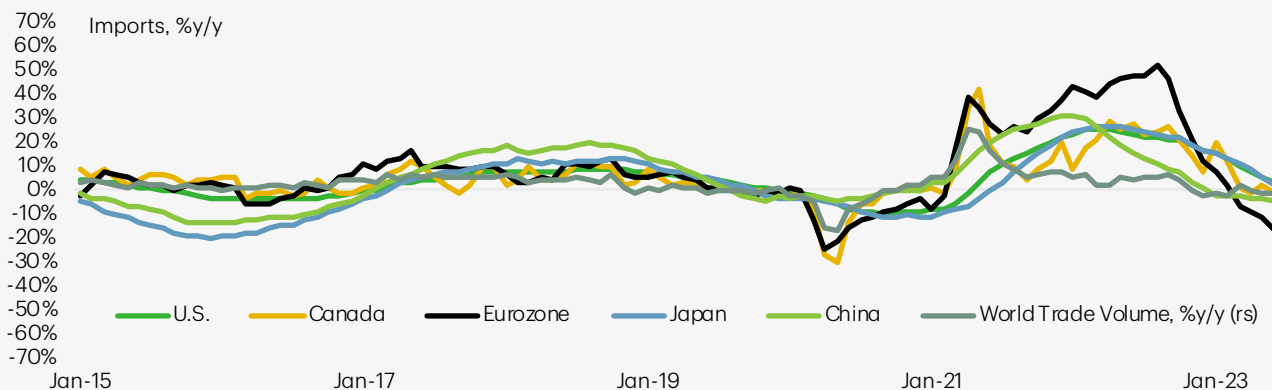
In this, the fall edition of *PSQ*, I will, as always, endeavour to frame current conditions and provide a glimpse into the next few months, how we think they will unfold and how we will make decisions in pursuit of the growth and protection of investment capital. Let’s start with the most daunting question:

## What does the Israel-Hamas war mean for financial markets?

The global economy hasn’t been this volatile since the 1970s. In just a few years we’ve seen a pandemic, Russia’s invasion of Ukraine, deterioration in U.S.-China relations, and now an outbreak of war in the Middle East. Geopolitical uncertainty is on the rise, and that plays heavily into the theme of deglobalization we wrote about last year. Global financial markets — that great mechanism for aligning interests in the pursuit of mutual prosperity — are feeling the strain. The tragic return of war in the Middle East only underscores the pattern of rising geopolitical risk.

Difficult as it is, our professional responsibility is to acknowledge the unspeakable human cost of war and then to define it in terms of its expected impact on financial markets. To do so we must begin by considering the trajectory of oil prices and its potential impact on inflation and interest rates — the two biggest factors in the economy today.

Figure 1: Is the decline of world trade a cyclical or secular trend?



Source: Factset, Wealth Investment Office (WIO) as of September 30, 2023.



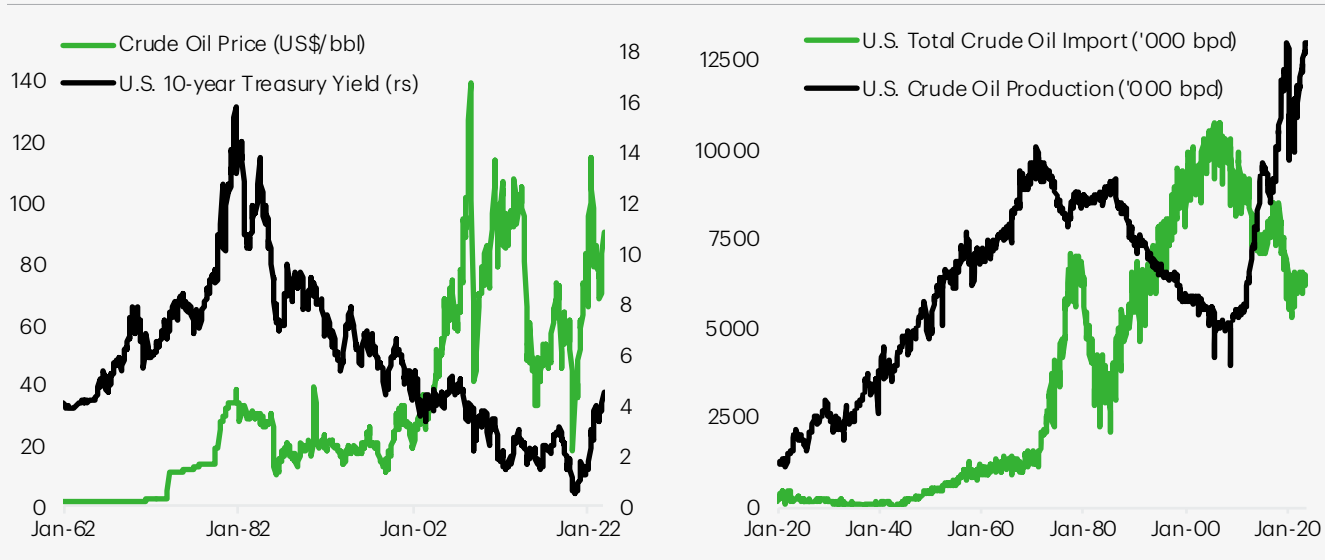
As I write this, we are still in the first days of this war. Oil prices have responded moderately to the crisis, which illustrates how much the world has changed since the Yom Kippur War in 1973. Figure 2 compares what happened to oil prices then compared to today.

Back then, the U.S. was highly reliant on oil imports to meet its consumption demand, with domestic production in decline. Over the past 15 years, however, U.S. oil imports have fallen from a peak of 10.4 million barrels per day (bpd) to 6.3 million bpd currently. Meanwhile, domestic production has risen from 4 million bpd to 13 million bpd, thanks to the U.S. shale revolution. The bottom line is that U.S. energy security today is less sensitive to geopolitical volatility in the Middle East.

That being said, it's worth noting that Israel is not a major oil producer, and it remains to be seen how oil prices will respond should the regional instability spreads — notably with respect to the regionally intertwined powers of Iran and Saudi Arabia. If Iranian intelligence is linked to the Hamas attack, supply and exports out of the region could face significant risks.

In the meantime, even as fears around US\$100 oil percolate, current prices don't look nearly as alarming. Figure 3 illustrates that, when adjusted for inflation, today's prices are around 50% less than their peak in 2008, and about 20% lower than the average real price from 2011 to 2015. This suggests that the world economy is better positioned to tolerate US\$100 crude than in past run-ups. This is a real positive in the current environment, where policymakers and investors, sitting on pins and needles, are parsing every data point and Fed utterance to determine the next move for inflation and interest rates.

Figure 2: This time it's different

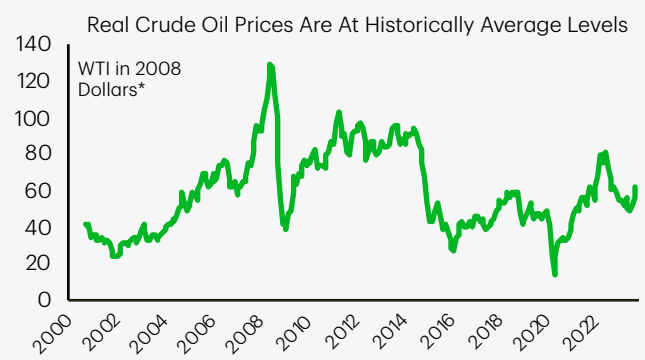


Source: FactSet, WIO as of October 12, 2023.

Ultimately, these are early days, and there are just too many variables to consider long-term outcomes. However, given the history of the region and the scope of the conflict, the muted response from oil may have staying power. Financial markets don't have a great track record of pricing geopolitical risk; in fact, they're often more influenced by the threat of a geopolitical event than the event itself. Further, a lifetime of studying war informs me that the kind of urban warfare being contemplated in Gaza is often long and painful, which may in time lead to market desensitization, troubling as that may be.

As is our practice, we will expect the best and plan for the worst. We believe the best way to navigate the "uncertainty trinity" is to have a well-thought-out wealth plan and a portfolio with true diversification — balancing asset and risk-factor diversification with the tenets of behavioural finance — which can have an incredible impact on our investment success. By doing this, we will considerably increase the likelihood that we will prosperously navigate these trying times. On to the next big question:

Figure 3: Less global oil dependency than in the past

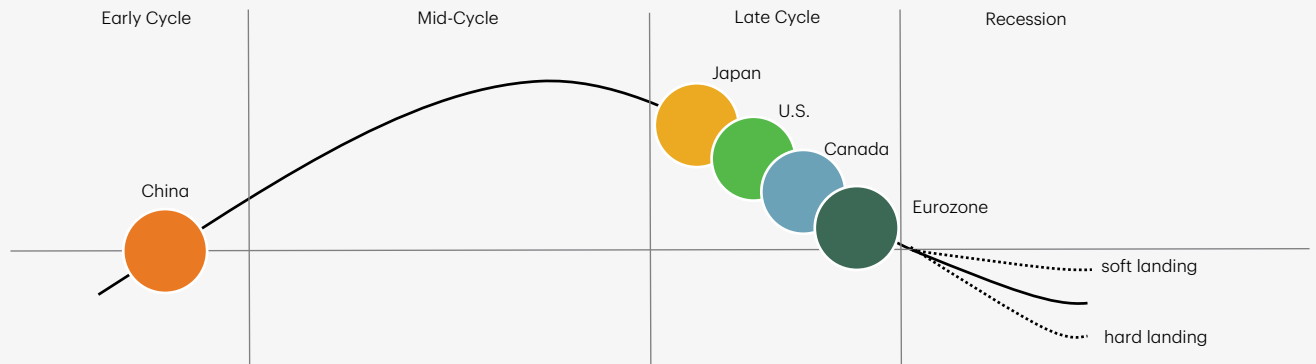


\*Oil prices adjusted for US consumer-price inflation using January 2008 as the baseline. Source: TD Economics, as of October 1, 2023.

## Where are we in the business cycle?

For clarity, in a world that is deglobalizing right before our eyes, there is no “we.” Instead, for the first time in a generation, we have a global economy that is less and less synchronized. The differing pace of economic recovery post-pandemic for each nation state, and differing policy measures in response to resurgent inflation, means that economies today are at different stages of the business cycle. Figure 4 shows a stylized economic cycle and where the economies of Europe, Japan, the United States, Canada and China are today, based on the composite percentile of various economic indicators we tracked on Figures 5 and 6. Clearly each region is dealing with a different reality.

Figure 4: Economies at different stages of the cycle



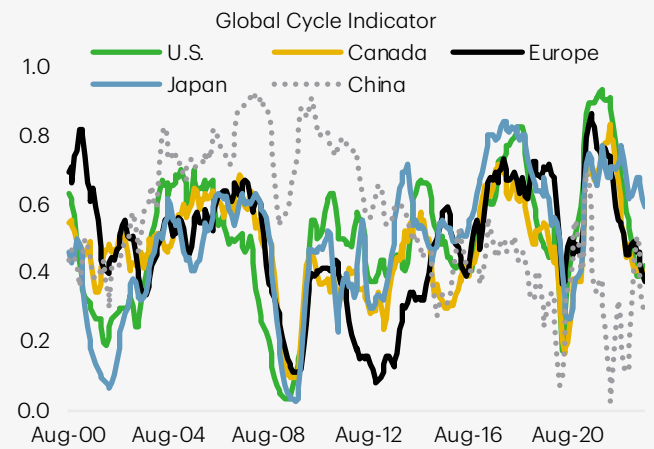
Source: WIO, as of October 19, 2023.

Figure 6: De-synchronization of economic indicators

		Aug-22	Sep-22	Oct-22	Nov-22	Dec-22	Jan-23	Feb-23	Mar-23	Apr-23	May-23	Jun-23	Jul-23	Aug-23	Sep-23	1-year Change
U.S.	Manufacturing PMI	0.483	0.315	0.247	0.186	0.15	0.114	0.129	0.086	0.107	0.103	0.075	0.1	0.121	0.185	↓ -0.13
	Non-manufacturing PMI	0.591	0.562	0.39	0.508	0.082	0.44	0.433	0.15	0.172	0.129	0.336	0.225	0.39	0.303	↓ -0.26
	Industrial Production, %y/y	0.752	0.928	0.749	0.48	0.344	0.419	0.358	0.318	0.326	0.304	0.29	0.297	0.318	0.317	↓ -0.61
	Retail Sales, %y/y	0.953	0.946	0.928	0.749	0.738	0.867	0.67	0.164	0.082	0.154	0.093	0.222	0.2	0.2	↓ -0.75
	Unemployment Rate	0.922	0.993	0.922	0.965	0.993	1	0.965	0.993	1	0.922	0.965	0.993	0.897	0.897	↓ -0.1
	Job Vacancies, %y/y	0.219	0.338	0.207	0.273	0.257	0.203	0.146	0.111	0.165	0.13	0.126	0.096	0.246	0.168	↓ -0.17
Canada	Manufacturing PMI	0.078	0.263	0.105	0.21	0.184	0.315	0.342	0.052	0.289	0.157	0.105	0.21	0.026	0	↓ -0.26
	Economic Mood Index	0.072	0.065	0.028	0.014	0.036	0.043	0.05	0.086	0.101	0.188	0.202	0.159	0.173	0.122	↑ 0.06
	Industrial Production, %y/y	0.837	0.93	0.215	0.43	0.235	0.735	0.26	0.097	0.325	0.715	0.186	0.8	0.439	0.368	↓ -0.56
	Retail Sales, %y/y	0.767	0.792	0.741	0.551	0.684	0.566	0.354	0.154	0.222	0.071	0.053	0.132	0.132	0.132	↓ -0.66
	Unemployment Rate	0.979	0.979	0.979	0.979	0.99	0.99	0.99	1	1	1	0.957	0.957	0.957	0.957	↓ -0.02
	Job Vacancies, %y/y	0.386	0.318	0.272	0.238	0.079	0.17	0.125	0.068	0.045	0	0.034	0	0.011	0.011	↓ -0.31
Europe	Manufacturing PMI	0.342	0.263	0.131	0.157	0.236	0.315	0.289	0.184	0.105	0.078	0.026	0	0.052	0.025	↓ -0.24
	Non-manufacturing PMI	0.333	0.282	0.256	0.23	0.333	0.435	0.564	0.692	0.871	0.717	0.538	0.461	0.153	0.275	↓ -0.01
	Industrial Production, %y/y	0.853	0.917	0.835	0.756	0.154	0.422	0.544	0.2	0.333	0.136	0.229	0.143	0.143	0.142	↓ -0.78
	Retail Sales, %y/y	0.175	0.311	0.057	0.06	0.039	0.136	0.075	0.021	0.039	0.075	0.204	0.189	0.096	0.096	↓ -0.22
	Unemployment Rate	0.99	0.99	0.99	0.99	0.957	0.957	0.957	0.968	0.968	0.968	1	1	1	1	↑ 0.01
	Job Vacancies Rate	0.651	0.651	0.651	0.651	0.651	0.651	0.651	0.651	0.651	0.651	0.651	0.651	0.651	0.648	↓ -0
Japan	Manufacturing PMI	0.552	0.5	0.473	0.21	0.157	0.157	0.078	0.263	0.289	0.447	0.368	0.315	0.315	0.128	↓ -0.37
	Non-manufacturing PMI	0.487	0.692	0.794	0.538	0.641	0.717	0.846	0.948	0.974	1	0.846	0.82	0.923	0.8	↑ 0.11
	Industrial Production, %y/y	0.784	0.946	0.741	0.347	0.365	0.197	0.297	0.347	0.448	0.652	0.433	0.243	0.197	0.196	↓ -0.75
	Retail Sales, %y/y	0.971	0.967	0.91	0.842	0.82	0.67	0.82	0.677	0.569	0.677	0.483	0.584	0.612	0.61	↓ -0.36
	Unemployment Rate	0.887	0.842	0.887	0.959	0.993	0.959	0.921	0.804	0.842	0.842	0.887	0.887	0.846	0.846	↑ 0
	Jobs to Applicants Ratio	0.788	0.802	0.817	0.824	0.835	0.824	0.817	0.802	0.802	0.788	0.781	0.77	0.77	0.767	↓ -0.04
China	Manufacturing PMI	0.289	0.026	0.157	0.263	0.105	0.157	0.763	0.368	0.289	0.578	0.5	0.157	0.657	0.512	↑ 0.49
	Non-manufacturing PMI	0.692	0.179	0.153	0.076	0.128	0.384	0.692	0.948	0.871	0.923	0.487	0.538	0.307	0.2	↑ 0.02
	Industrial Production, %y/y	0.068	0.283	0.107	0.021	0.01	0.01	0.01	0.057	0.132	0.035	0.078	0.043	0.089	0.089	↓ -0.19
	Retail Sales, %y/y	0.121	0.06	0.043	0.014	0.025	0.025	0.025	0.422	0.91	0.594	0.075	0.06	0.1	0.1	↑ 0.04
	Unemployment Rate	0.352	0.198	0.198	0.099	0.198	0.198	0.121	0.352	0.55	0.55	0.55	0.341	0.55	0.555	↑ 0.36

Source: FactSet, WIO as of September 30, 2023.

Figure 5: De-synchronization of cycle indicator



Source: Factset, WIO as of September 30, 2023.

**China:** The world's second-largest economy is still in recovery mode. Both manufacturing and non-manufacturing sectors are picking up, as are retail sales, although the rate of recovery is still tepid. Softer consumer inflation figures suggest the economy is already operating with excess capacity. Further, China's credit impulse (the measured change in new credit issued as a percentage of GDP) is turning higher amid Chinese policymakers' efforts to revive growth. While this is a good sign, the total stimulus has been much more measured than in the past (Figure 7). How consumer and business sentiment respond in the months ahead will be a critical determinant of whether the economy steadies itself or whether a weaker scenario plays out.

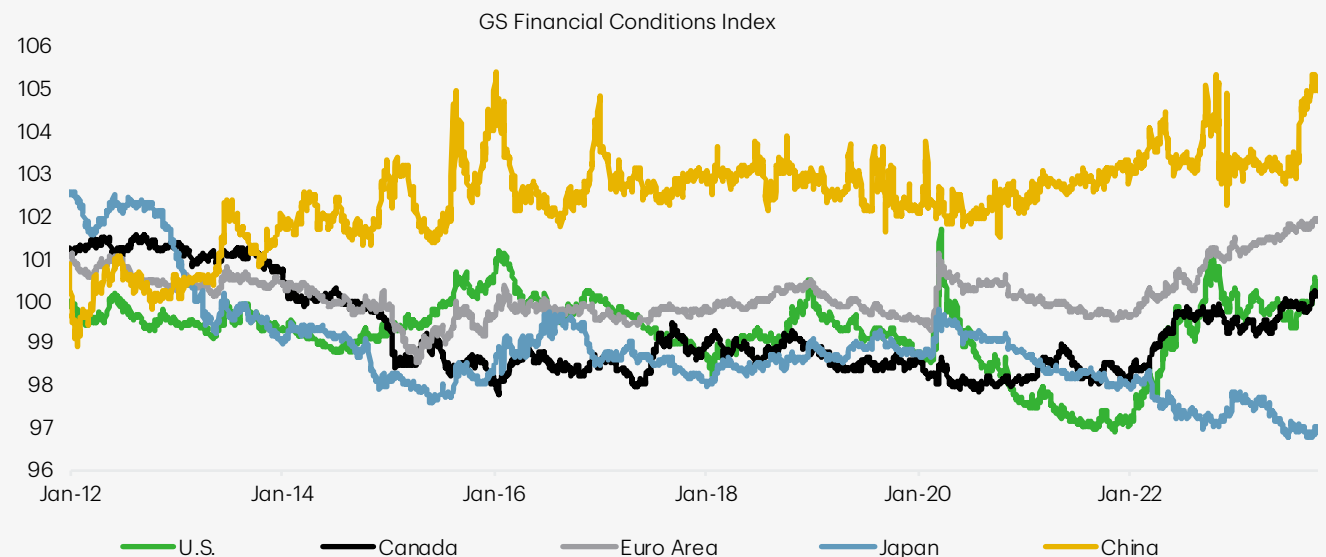
**Japan:** Growth is decelerating, although Japan's economic cycle remains close to peak, supported by extremely loose monetary policy by the Bank of Japan (BoJ). Indeed, monetary conditions are still easing due to Japan's low-rate policy, whereas in China monetary conditions are considered tight despite efforts from policymakers to ease amid the property crisis and credit crunch. Financial conditions in Japan, however, are beginning to change as the BoJ signals an intent to move away from its interventionist "yield curve control" policy (where long-term rates are kept under 1%) and to end, by April 2024, its short-term negative-interest-rate policy (Figure 8).

Figure 7: China has been stingier with stimulus



Source: FactSet, WIO as of September 30, 2023.

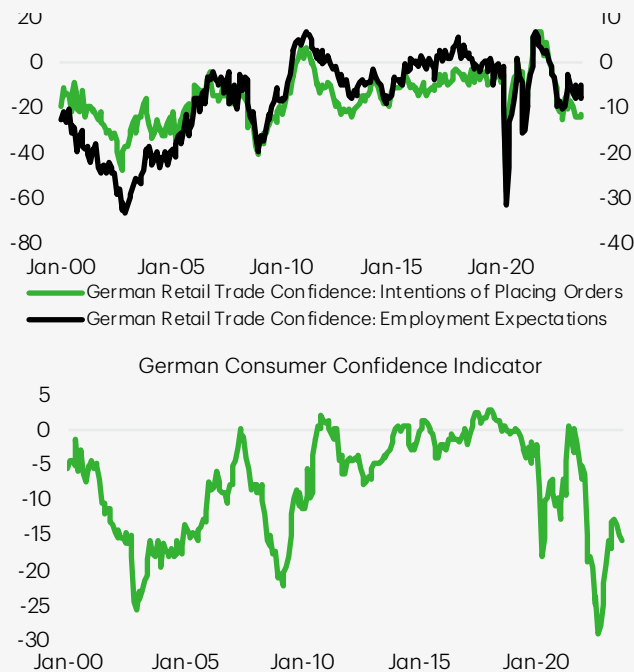
Figure 8: Different countries, different conditions



Source: FactSet, WIO as of September 30, 2023.

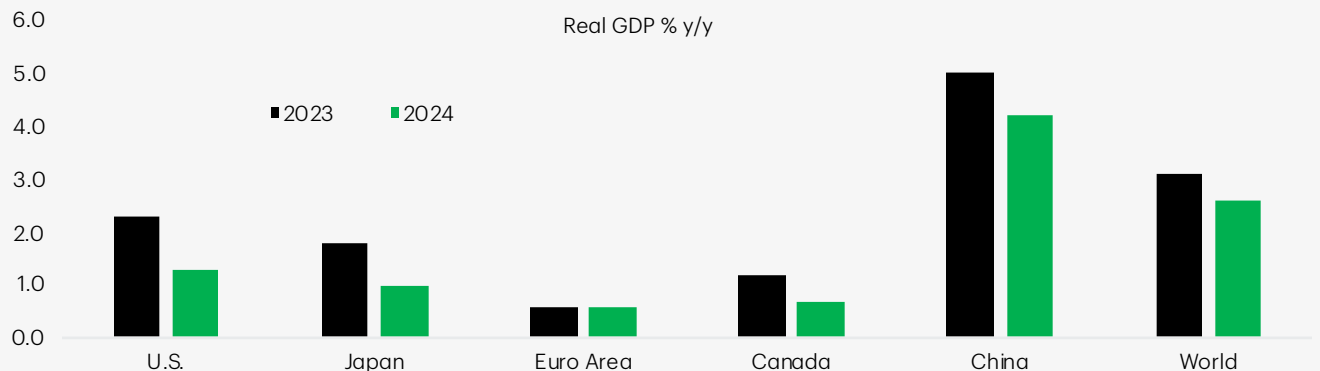
**Europe:** The third quarter brought further, increasingly compelling evidence that the 10 interest-rate hikes by the European Central Bank (ECB) are having the desired impact: Inflation is falling as economies are cooling. That's the good news. The bad news is that the European economy is beginning to really slow, with both manufacturing and services PMIs in contraction. Retail sales have also slowed, including the high-end retailers if the performance of LVMH (Louis Vuitton, Dior, Tiffany and Bvlgari) is any indicator. The luxury giant cited slower demand in its third-quarter earnings report. Of particular concern is the current situation in Germany — the engine of Europe. The Russia-Ukraine War, China's slow recovery, energy costs and inflation have exacted a toll on German business and consumer confidence (Figure 9). Further, faced with higher credit and material costs, the German real estate construction sector is in crisis.

Figure 9: Plenty of angst in Germany



Source: FactSet, WIO as of September 30, 2023.

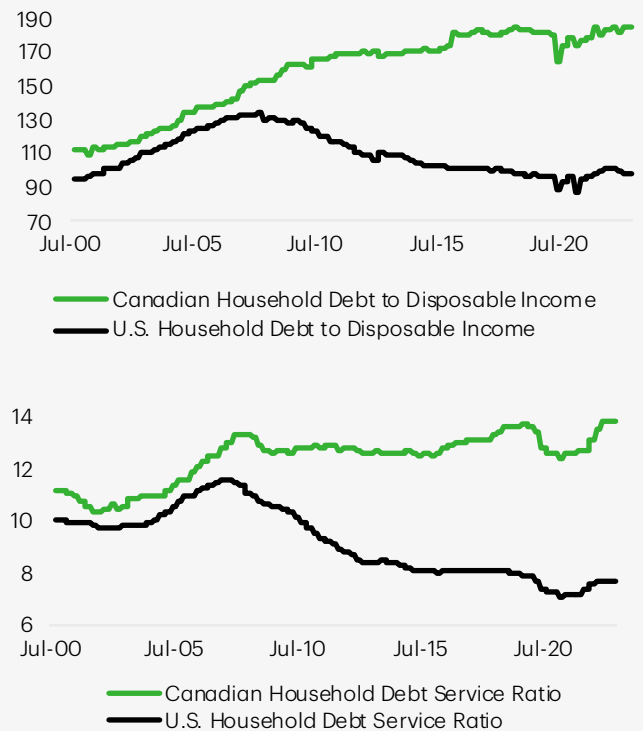
Figure 10: And now ... the hard part



Source: Statistics Canada, Bureau of Economic Analysis, TD Economics

**Canada:** After a strong start to the year, Canada's economy contracted in the second quarter. True, it was barely a contraction (-0.2% annualized) and there were a litany of special factors — strikes and wildfires — but this likely marks the start of a prolonged period of lacklustre growth. Real GDP growth is expected to slow from a modest 1.2% pace this year to only 0.7% next year (Figure 10). Unemployment has also risen faster than we expected a quarter ago, and a continuation of this trend will weigh on consumer confidence and spending. Further, the Canadian household balance sheet is much more leveraged than in the U.S., with a higher debt-to-income ratio and therefore a higher portion of income going to service their debt (Figure 11).

Figure 11: Canadian consumers getting stretched

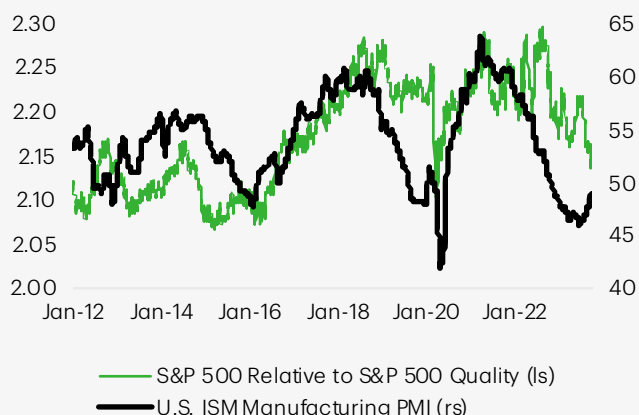


Source: FactSet, WIO as of September 30, 2023.

### United States: Surprising resilience

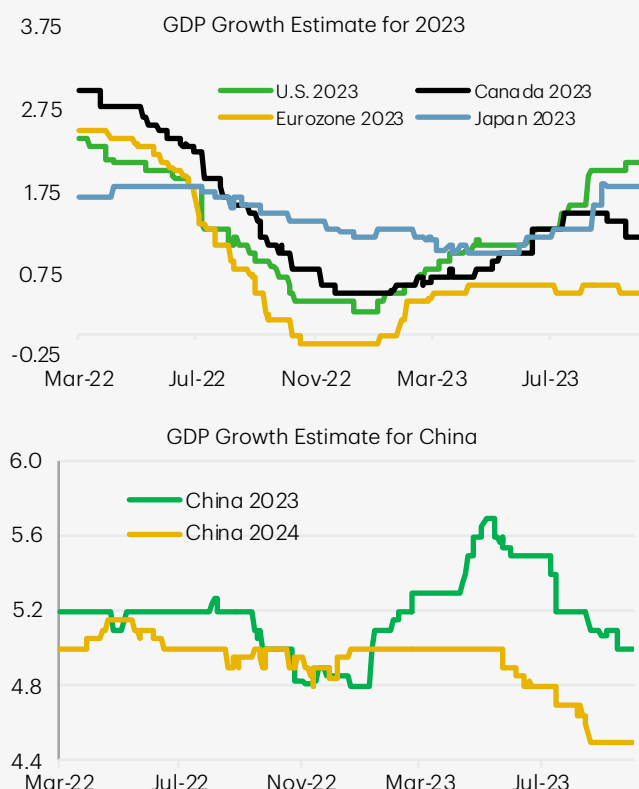
The resurgence of yields back to the highs of October 2022 has puzzled many strategists and investors — including me, I confess. Last year, CPI inflation was at 8.3% and the Fed was barely halfway through its tightening program. Today, inflation has fallen to around 3.7%. The 12-month change now sits at a two-year low, while the more recent three-month annualized inflation trend is running at 3.1%, just a notch above the long-term targeted range of 1% to 3%. The main reason attributed for the rise in long-term yields is the

Figure 12: Does manufacturing uptick signal outflow from quality mega-caps?



Source: FactSet, WIO as of October 12, 2023

Figure 13: We are not all in this together



Source: FactSet, WIO as of September 30, 2023.

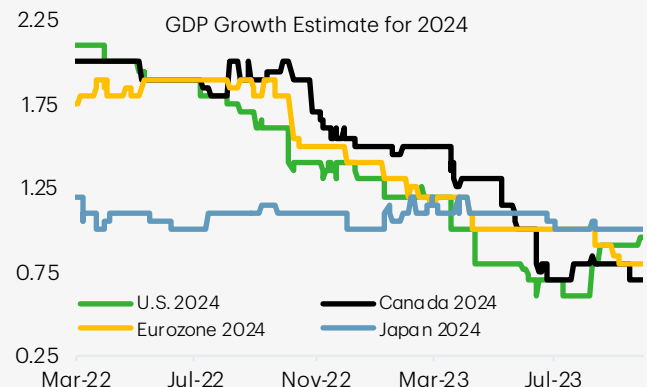
renewed optimism on economic growth in the U.S., with the consensus now pricing in a low probability of recession over the next 12 months.

Neither the U.S. equity markets nor the bond markets are pricing in recession — a sharp reversal compared to the beginning of the year. In fact, leading PMIs, particularly on the manufacturing side, have begun to turn. In September, the ISM Manufacturing PMI took the markets aback, nearly breaking out of contraction with a rise from 47.6 to 49. Looking at the m/m breakdown, only delivery times detracted. All other components had positive changes.

This has the potential to awaken the part of the market that has been aslumber of late, with buyers instead focused on the “Magnificent Seven” mega-cap tech stocks (Figure 12). Cyclical companies are now beginning to outperform defensives as ISM new orders also begin to pick up. A near record-low unemployment rate, depressed initial jobless claims and strong wage growth all point to a resilient labour market. Fiscal policy, and the U.S. consumer all remain in healthy territory.

Economists’ consensus estimates for 2023 highlight just how disparate the current economic cycles have become across regions, with the United States defying expectations (Figure 13). While economists are downwardly revising 2024 GDP growth estimates to below 1% for four of the five major economies we’re tracking (U.S., Canada, China, Japan and the euro zone), and China’s expected growth is anemic relative to recent norms, the downcast mood still does not call for recession (Figure 14). We may not be out of the woods yet, but what’s clear is that all five regions are on a different path, and this variance can provide opportunities for an active allocation strategy. In the United States in particular, whispers of soft landing are yet to reflect a chorus, but a chord has certainly been struck.

Figure 14: Slow but no recession



Source: FactSet, WIO as of September 30, 2023.



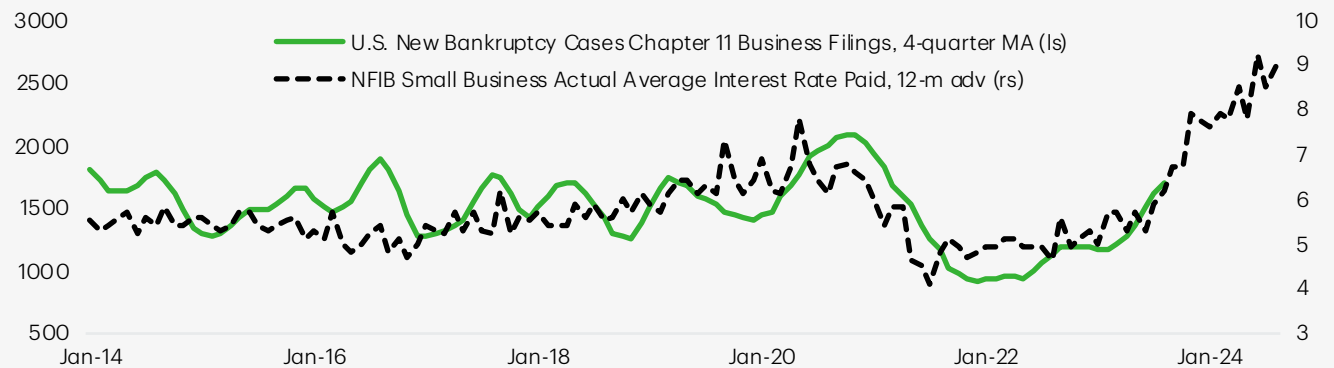
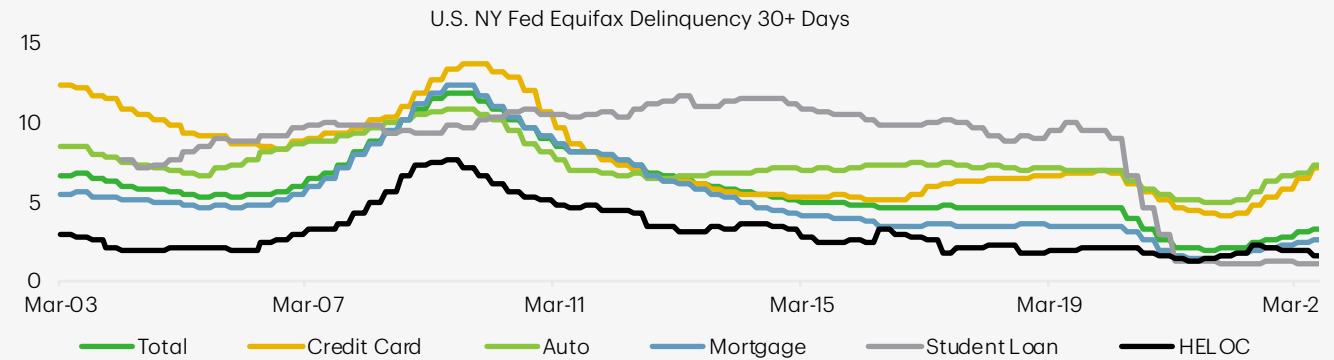
Of course, there are still headwinds in the U.S. — the spectre of a government shutdown in November, labour unrest and the myriad of geopolitical crises discussed above. There's also the all-important American consumer, whose ability and willingness to spend are being tested by numerous discouraging factors. Drained excess savings and resumption of student loan payments could slow discretionary spending. And U.S. consumers and businesses are also seeing higher delinquency rates as borrowing cost moves higher (Figure 15).

Labour market tightness also continues to be a thorn in the side of the Fed, but there are signs that the market is beginning to ease, with job openings and hiring continuing to soften (Figure 16). Total job

demand, proxied by the sum of jobs vacancy and total non-farm payrolls, peaked in the Spring of 2023 and has marginally softened since.

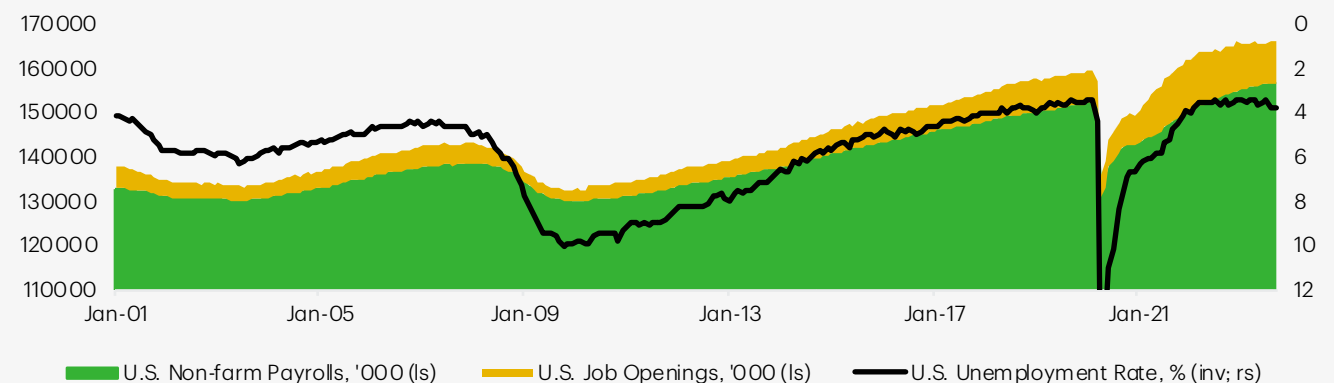
To reiterate, there is no “we” in the current business cycle. While I am wary of allusions to American exceptionalism, in terms of opportunity and safety of return, the United States presents the best opportunity. The U.S. economy — which has been a standout in terms of resilience this year — is forecast to grow 2.3% in 2023. While we see that slowing to 1.3% in 2024, a lot can happen between now and then as we have seen this year. With this in mind, we have decreased our allocation to cash and equivalents and moved from underweight equity to neutral, with an overweight in U.S. equities.

Figure 15: Credit beginning to crunch?



Source: FactSet, WIO as of September 30, 2023.

Figure 16: Softer Jobs



Source: FactSet, WIO as of September 30, 2023.

### What about inflation?

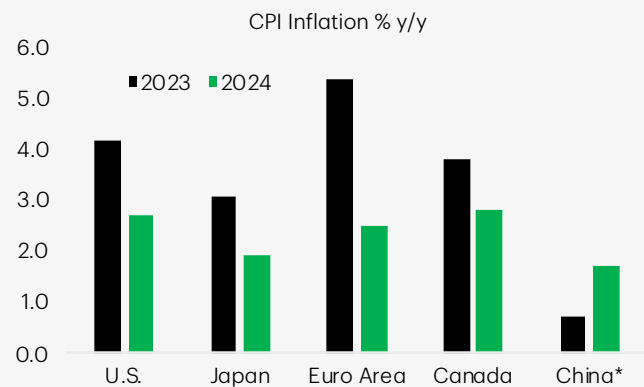
As for inflation, there is no one answer because, again, there is no “we.” In Canada, the United States and Europe, the trend is good, but progress on core inflation (excluding volatile energy and food prices) has proven to be more difficult (Figure 17). In Canada, evidence is beginning to mount that the economy is bending under the weight of higher interest rates. This is even more true for Europe, which is only barely treading above recession. As for China, deflation is the bigger concern. Our baseline view is that the economy will expand by 5% in 2023 and just north of 4% in 2024. However, as bad news accumulates, we recognize the growing risks to this forecast. And now, the final question we’ll tackle in this edition:

### What does this late stage in the cycle mean for investment strategy?

**Fixed Income:** No change to report, we are currently modest overweight.

From 1980 to the outset of the pandemic, long-term yields have conducted a marathon race to zero. That means that, while investors were frustrated to see their yield chipped away over that time, they were also consistently consoled by the fact that the coupon, and the capital gain derived by ever lower rates,

Figure 17: Stubborn inflation begins to come into range



Source: IMF, TD Economics as of September 2023. Note: China CPI data is the IMF forecast

Figure 18: Rates present a historic opportunity



Source: FactSet, WIO as of September 30, 2023.

worked with almost clock-like precision. Over the past 18 months, however, those same investors have been nursing losses on their fixed income portfolio amid the sharp increase in global inflation and policy rates. It’s understandable, given the elevated market uncertainty, that investors would now prefer to put their money into short-term deposits — which are now yielding over 5% — and shy away from duration risk, but the bond market is now providing investors with the opportunity to lock in long-term returns at levels not seen for 16 years (Figure 18).

Given that yields are now at their highest levels since the global financial crisis (GFC), the relevant question is whether factors that had been driving yields lower over the past four decades have reversed. Arguably, global population growth is still slowing, with the share of the population aged 65 years and older growing materially. Meanwhile, technological advancement continues to encourage, as highlighted by recent developments in artificial intelligence. AI could revolutionize medical diagnosis and treatment, advanced computing and even the way in which future technological breakthroughs are achieved. Both trends are deflationary in the long run.

If, after 18 months of being disappointed by bond returns, that sounds too pie-in-the-sky for you, take into consideration this simple, hard fact: The biggest determinant for fixed income return is the current yield, and right now the yield is good to great (Figure 19).

Figure 19: Future returns will likely be driven by current good to great yields

Periods	1992 - 2002	2002 - 2012	2012 - 2022	2023 Sept-
Total Return	7.45	5.29	1.27	?
	↑	↑	↑	↑
Starting Yield	6.76	4.38	1.75	5.39

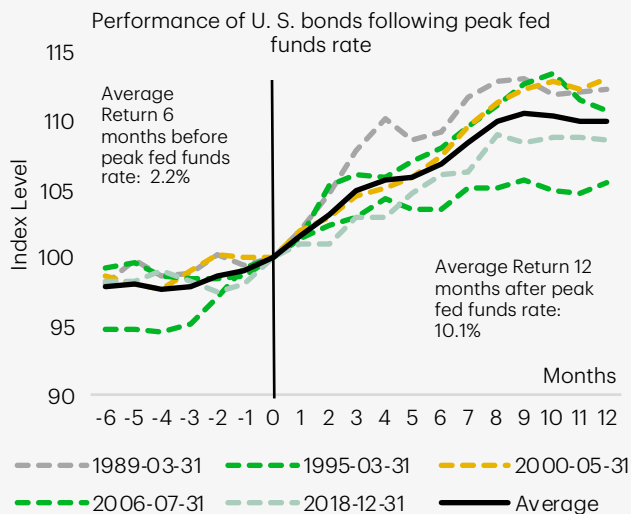
Source: FactSet, WIO as of September 30, 2023. Note: Yields and annualized returns shown for Bloomberg U.S. Aggregate Bond Index

Further, Figure 20 highlights performance of the universe of U.S. bonds during the past five instances of peak fed funds rates. These instances are shown by the dotted lines, while the solid line represents the average returns. Historically, 12 months after rates peak, returns have been very attractive for bond investors.

**Equity:** We've decreased our allocation to cash and equivalents and moved from underweight equity to neutral, with an overweight in U.S. equities.

It's been well documented in previous editions of *PSQ*, and in our other publications, that about two-thirds of the gain in the S&P 500 this year has been driven by seven names that account for about 30% of the index — the so-called "Magnificent Seven." The other 496 stocks (yes, there are 503 companies on the S&P 500), or the TO 496 for short, have delivered mainly mid-single-digit returns. This is consistent with historical periods of Fed tightening, when investors gravitate towards quality names.

Figure 20: Bond returns one year after peak rate

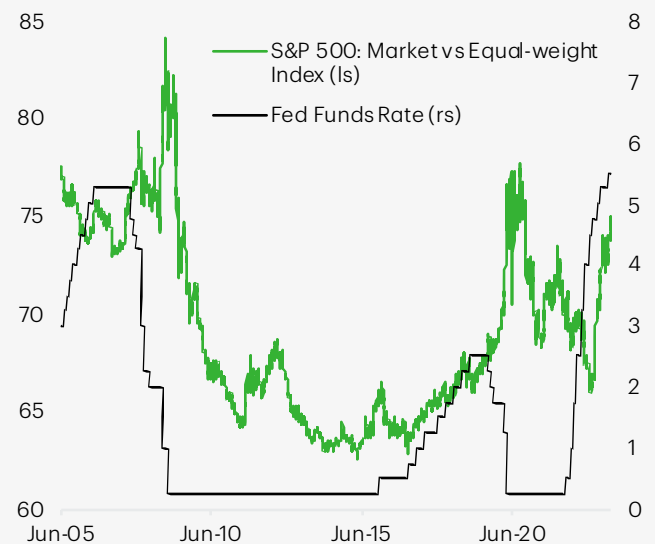


Source: FactSet, WIO as of September 30, 2023.

This imaginary TO 496 Index really represents the forgotten businesses — lost in the monetary- and fiscal-policy binge of liquidity and the ensuing debate between soft and hard landings. Consumer staples and utilities, for instance, have flipped from two of the most expensive sectors early this year to a relative bargain today. Energy and materials continue to offer discounted valuations, while financials and industrials now look more attractive relative to the broader benchmark.

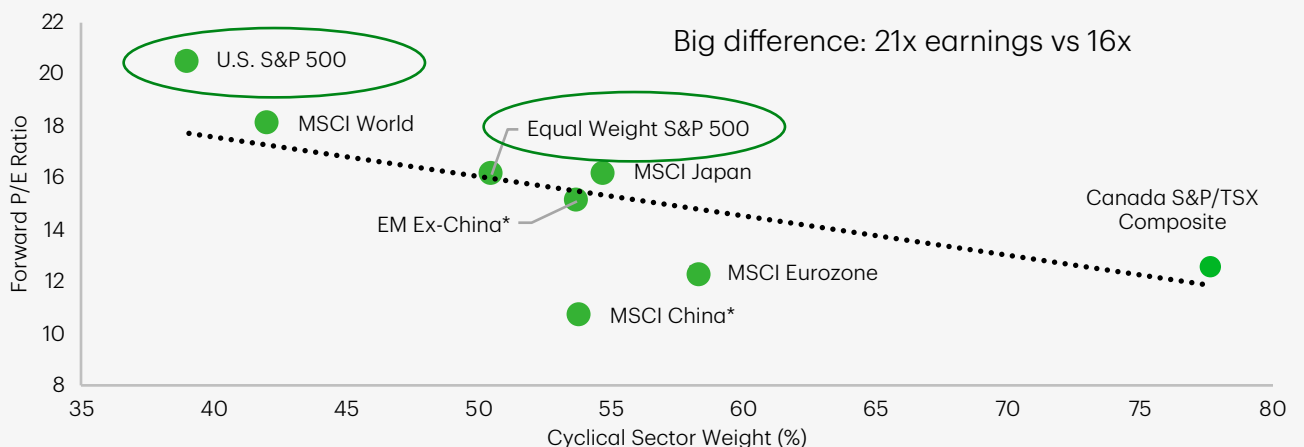
The gap between top- and bottom-end valuations is considerable, with the market-cap-weighted S&P 500 trading at 21x while the equal-weighted S&P 500 trades at 16x (Figure 21). Further, the equal-weighted S&P 500 has historically outperformed, particularly when there is peak interest-rate policy, such as now (Figure 22).

Figure 22: Flight to big names as policy tightens



Source: FactSet, WIO as of September 30, 2023.

Figure 21: Excluding mega-caps, the S&P is not expensive



Source: FactSet, WIO as of September 30, 2023.

### Alternatives: We're neutral on alternative assets.

Within the real estate allocation, we are maximum underweight, both domestic and global. However, I would use some discretion here. When it come to this sector, nuance is everything. Vacancy rates for U.S. traditional offices are above 20% and rents are under pressure. I think many investors are quick to attribute office towers in major urban centres as a catch-all for real estate, but there are many other areas in the sector that have appeal. Logistics, for example, is enjoying vacancy rates at only 4% in the U.S. and rent growth that materially exceeds inflation, driven by e-commerce and onshoring of manufacturing. In the same way that e-commerce drove demand for warehouses, demand for data centres is being driven by cloud computing, content creation and the AI revolution (Figure 23). The same lack of “we” applies here as well. In the United Kingdom and the Nordic countries, much of the repricing in commercial real estate has been done. In Germany less so, and in the United States it's about two-thirds done. Meanwhile, in Canada, I think it would be hard to argue that the pension funds have been quick, or prudent, in pricing their assets in the space.

### “You”

In the decade between the global financial crisis and the Great Recession, we witnessed the longest economic expansion in American history. Old news, I know, but it's worth noting as well that those 12 years or so also represented the longest economic expansion in global history — because it was a *global* economy, where far-flung businesses and regional leaders worked together in pursuit of that mutual prosperity.

Volatility was low and the equity markets were good to great, and the same was true for bond markets. Now, with the rise of populism, protectionism and

even war, those days seem to be a quaint memory. Political leaders are no longer working in furtherance of a globalized economy, and it's getting harder and harder to say “We”.

### But there is a “You”

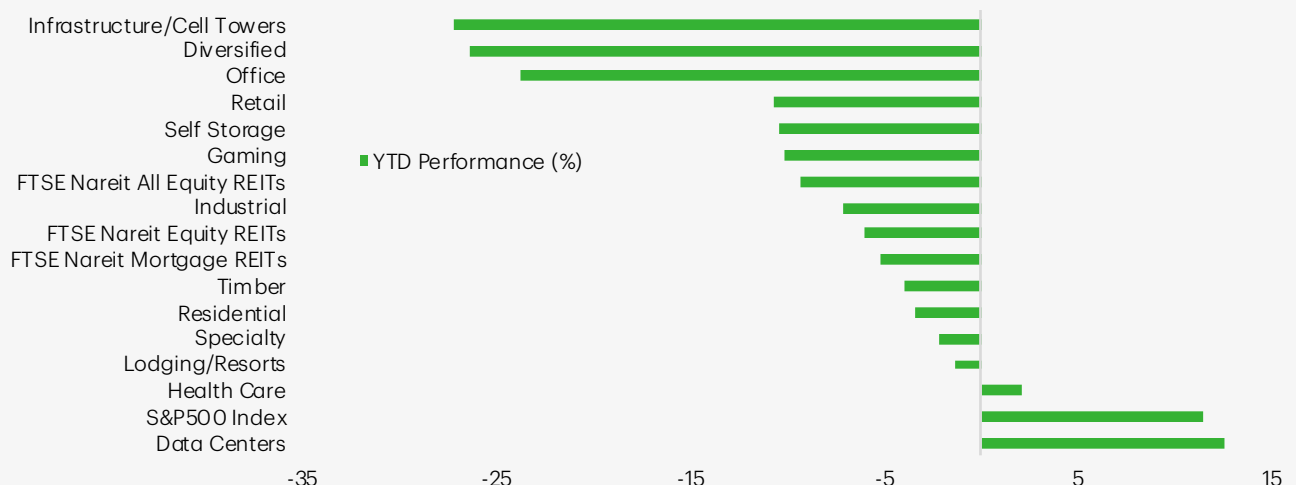
... as in, you, the individual investor with unique personality traits and a goal-based financial plan. And if you're reading this, there's also likely a wealth manager standing right beside you — someone equipped to navigate these difficult waters by tapping into the top institutional investment minds in the country, all of whom understand that now is not the time to sit back and rely on the rising tide — now is the time to hold fast and ride the currents.

Now is the time for tactical allocations that seek to exploit opportunities in the volatility and price discrepancies that are so evident in markets around the world. That being said, while tactical investing has undoubtedly become more important, we have to remind ourselves that we're in this for the long haul. We are first and foremost strategic investors — low-conviction over the short term and high-conviction over the long term.

We continue to be committed to enhanced diversification, by building and managing portfolios that blend the best of traditional and alternative asset classes, employing a broader spectrum of strategies including fixed income absolute return, equity absolute return, private capital and real assets. We're also committed to goal-based plans that prioritize absolute client objectives over relative returns.

Regardless of what happens over the short term, a well-constructed portfolio is designed to navigate extreme scenarios, as well as the more benign ones. May “we” all be committed to less of the first and more of the latter. □

Figure 23: A lot more to real estate than commercial



Source: Nareit, Factset, WIO as of October 20, 2023.

# Leading Macro Indicators

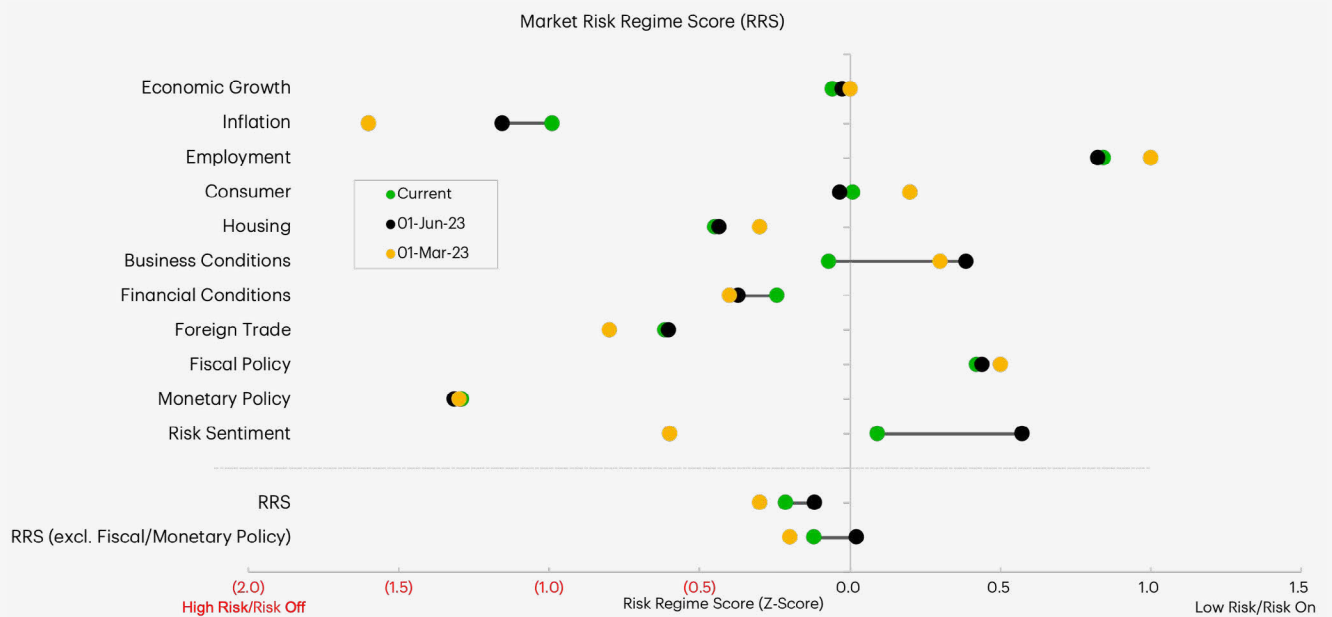
## Overall risk regime score remains weak, macroeconomic conditions deteriorate

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	Jun-23	Mar-23	Dec-22
Economic Growth	Neutral	(0.1)	0.0	0.0	(0.2)
Inflation	Weak	(1.0)	(1.2)	(1.6)	(1.8)
Employment	Strong	0.8	0.8	1.0	1.1
Consumer	Neutral	0.0	0.0	0.2	(0.1)
Housing	Weak	(0.4)	(0.4)	(0.3)	(0.2)
Business Conditions	Neutral	(0.1)	0.4	0.3	0.3
Financial Conditions	Weak	(0.2)	(0.4)	(0.4)	(0.3)
Foreign Trade	Weak	(0.6)	(0.6)	(0.8)	(0.9)
Fiscal Policy	Neutral	0.4	0.4	0.5	0.4
Monetary Policy	Weak	(1.3)	(1.3)	(1.3)	(1.1)
Risk Sentiment	Neutral	0.1	0.6	(0.6)	(0.1)
<b>Risk Regime Score (RRS)</b>	<b>Weak</b>	<b>(0.2)</b>	<b>(0.1)</b>	<b>(0.3)</b>	<b>(0.2)</b>
<b>RRS (excl. Fiscal/Monetary Policy)</b>	<b>Weak</b>	<b>(0.1)</b>	<b>0.0</b>	<b>(0.2)</b>	<b>(0.2)</b>

Figure 2: Movement in market risk regime scores



Scores represent number of standard deviations away from long-term average. Source: FactSet, WIO as of September 30, 2023.



Our risk regime score deteriorated slightly over the quarter. The overall market risk regime score inched down to -0.2 at the end of Q3, from -0.1 in Q2. U.S. equities finished Q3 lower and bond yields rose as market participants priced in a higher-for-longer policy rate.

Monetary policy is still putting the biggest drag on the overall risk score; the Federal Reserve (Fed) continues to hold the policy rate at its highest level in 23 years in an attempt to reduce inflation and broad money supply is contracting at a record pace. Employment, and—to a lesser extent—fiscal policy and risk sentiment, remained relatively strong, although risk sentiment did deteriorate amid higher asset volatility and increased pessimism about risk assets. Below are some notable changes compared to Q2:

- Monetary policy, foreign trade, and housing remained weak in Q3, although scores for the three categories stopped short of deteriorating. The score for monetary policy sat at a depressed level of -1.3 amid the continued contraction in money supply and the elevated policy rate. The U.S. dollar strengthened but the current account deficit narrowed slightly, which helped to stabilize the score for foreign trade at -0.6. Higher mortgage rates in the quarter and the associated deterioration in housing affordability drove down homebuilder sentiment and kept the score for housing unchanged at -0.4.
- The score for inflation rose to -1.0 at the end of Q3 from -1.2 in Q2. Both headline and core CPI have slipped—the core measure declined at a slower pace—but remain above the Fed's 2% target. More progress on this front will likely be necessary before monetary policy will improve. The financial conditions score ticked higher from -0.4 to -0.2 standard deviations below the long-term norm as the yield curve steepened but remained at a level historically linked to impending recession.
- The scores for risk sentiment, economic growth, and business conditions all deteriorated but hovered around neutral. Compared to the previous quarter, volatility for both equity and government bond markets increased which pushed the score for risk sentiment down from +0.6 to +0.1 at the end of Q3. Meanwhile, the deterioration in consensus GDP growth forecast for the next 12 months sent the economic growth score from 0.0 in Q2 to -0.1. The business conditions score—hurt by depressed manufacturing activity and slower service sector activity—slipped from +0.4 to -0.1 in Q3.

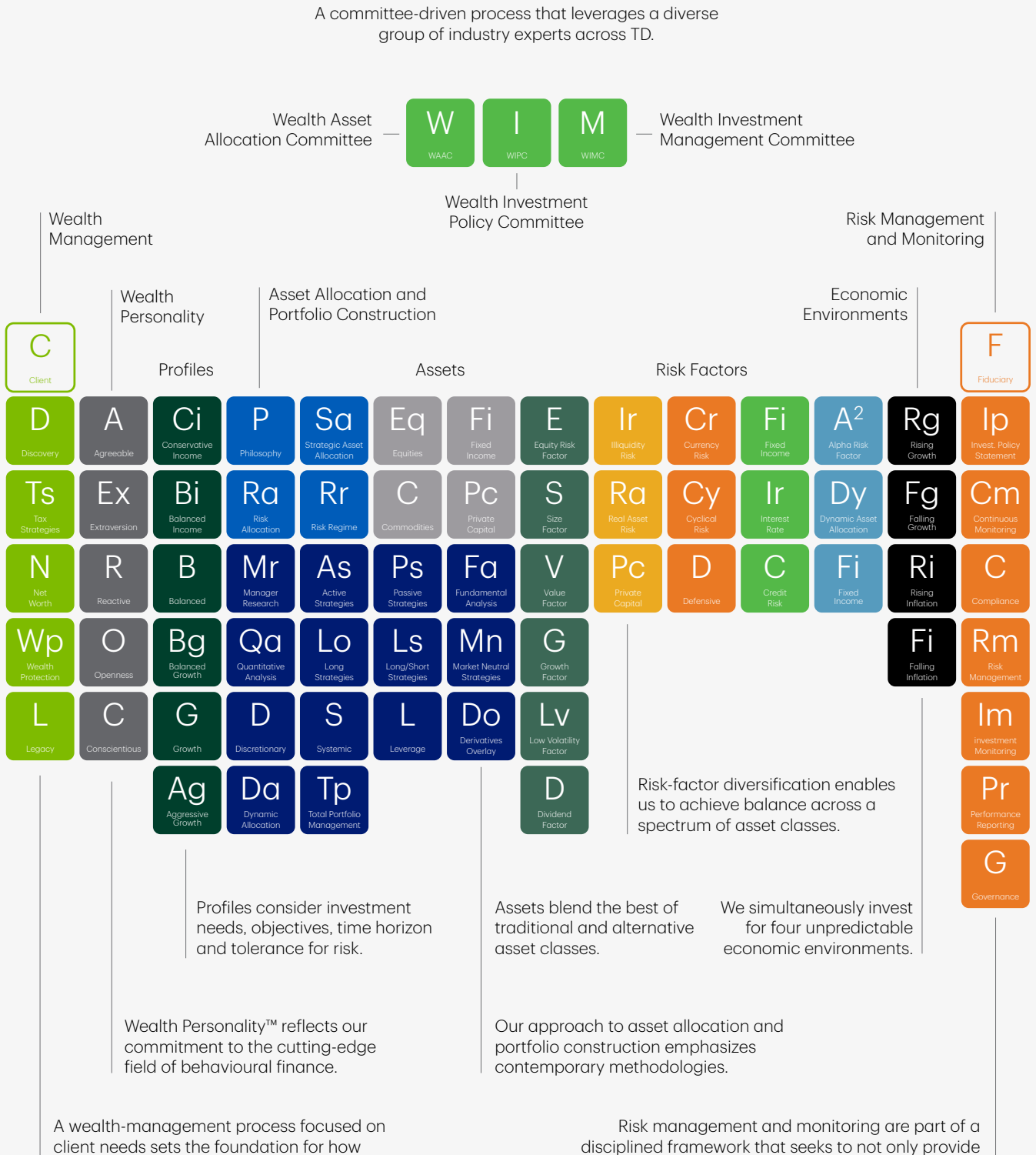
- On the bright side, employment, fiscal policy, and consumer remained in healthy territory. A near-record low unemployment rate, depressed initial jobless claims, and strong wage growth all point to a resilient labour market. The score for employment was unchanged at +0.8 during the quarter. Our fiscal policy score remained at +0.4 at the end of Q3—the decline in debt as a percentage of GDP offset the widening U.S. government fiscal deficit. The score for consumer also remained unchanged at 0.0 in Q3; U.S. consumer spending increased despite signs of some households paring back spending.

Overall broad conditions for risk assets deteriorated slightly in Q3 as monetary policy remained tight and risk sentiment, economic growth, and business conditions all deteriorated slightly over the quarter. Economic growth will likely continue to decelerate in Q4 and the market will focus on further signs of weakness in employment and consumer. □

# 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



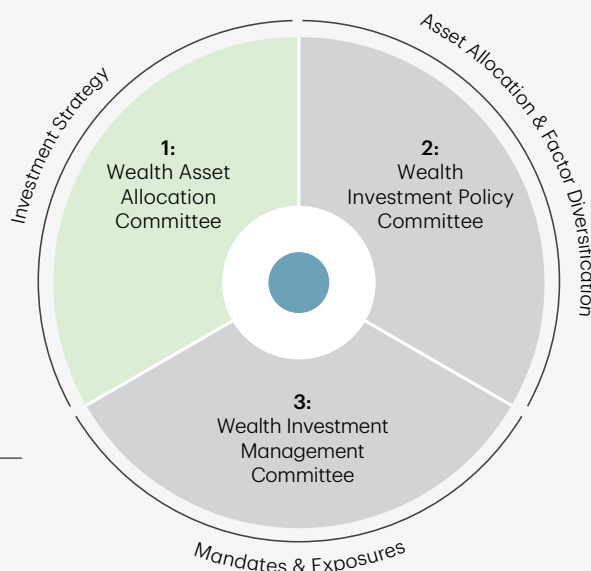
# Wealth Asset Allocation Committee

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><b>Modest Underweight</b></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 equity markets may present a stronger opportunity over the long-run.</p>
Fixed Income	<p><b>Modest Overweight</b></p> <p>Previous Month</p>	<p>As resilience in the labour market persists and inflation continues to normalize in line with the expectations of the Bank of Canada, we believe monetary policy pivoting to rate cuts over the next nine to 12 months is less likely than is currently priced by investors. This may translate into a slower decline in interest rates. 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><b>Neutral</b></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><b>Neutral</b></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 its policy. However, an additional BoC rate hike before the end of the year is still on the table and this hike would still result in lower government bond yields if the economy continues to slow. That said, we do not anticipate a consistent decline in yields 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 credit spreads have tightened and become less attractive, particularly in the U.S. relative to Canada and Europe. We continue to see the best opportunities in lower duration (5 year and under maturities) corporate bonds given their appealing all-in yields. We remain more cautious on longer duration corporate bonds due to the uncertain global economic outlook.
High Yield Credit	Modest Underweight	Risk sentiment has improved in recent months, causing credit spreads for high yield bonds to tighten and become less attractive. All-in yields remain high, indicating strong potential returns, but 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	Economic data across markets has been mixed. While the UK and European economies are visibly slowing or contracting, other economies like the U.S. and Japan remain resilient and continue to exhibit above-potential growth rates. While soft data points to broad-based headwinds for global economic growth and investors continue to expect global monetary policy to shift into easing mode in the next 12 to 18 months, the economic and inflation dynamics of each region will ultimately dictate how quickly each central bank will cut policy rates.
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 have proactively hiked interest rates. Bond returns will likely decline in other regions where central banks are still early in normalizing monetary policy. However, the rise in real yields over the past month across developed markets, particularly in the U.S., and the strength of the U.S. Dollar pose increasing headwinds for emerging markets.

## Equities - Neutral

	Positioning	Rationale
Canadian Equities	Neutral	The full effect of higher rates on the consumer and real estate market remains to be seen. As such, we anticipate that the Canadian economy will slow in 2023. However, strong free cash flows within the Energy sector, and relatively inexpensive Financials stocks, may present attractive opportunities.
U.S. Equities	Modest Overweight (from Neutral)	We believe that earnings growth is starting to stabilize/show signs of positive momentum and that valuations are more consistent with a slowing growth environment. The year-to-date returns on U.S. equities have been led by a few mega cap stocks. Valuations for the rest of the U.S. equity market are reasonable, which offers some potential support for the stock market, even in a modest economic slowdown.
International Equities	Modest Underweight	International equity markets have rebounded strongly since the fall of 2022. International stocks continue to face similar concerns regarding corporate profits, rising rates, and slowing macroeconomic conditions, particularly in Europe. Given this view, we feel that further gains will be more limited.
Chinese Equities	Neutral	China continues to reopen its economy and the Chinese government remains focused on supporting growth but is challenged by the continued struggles in its property sector. We feel that the reopening is largely reflected in markets at this point, as such, we maintain a neutral view on China.
Emerging Market Equities (excluding China)	Neutral (from Modest Overweight)	Some emerging market central banks appear to have paused their rate hiking cycle, with Brazil and Chile recently cutting rates. We believe that there is potential for this to generate better economic growth along with relatively low equity valuations, and this increases the appeal of these markets. However, a stronger U.S. Dollar, a sustained period of higher rates, and more moderate global growth could be a headwind to emerging market equities.



## Alternatives - Neutral

	Positioning	Rationale
Commercial Mortgages	Maximum Overweight	Commercial mortgages continue to provide accretive income while insulating investor returns from the increased volatility in interest rates.
Private Debt (Universe)	Modest Overweight	High credit quality and global diversification provides safety in a potentially recessionary environment. Incremental income and potential capital appreciation from interest rate moderation provide upside.
Domestic Real Estate	Maximum Underweight	Canada's growing demographic profile continues to be supportive of domestic real estate, particularly multi-unit residential. Office properties continue to experience leasing and valuation headwinds and a flight to quality, while fundamentals remain sound across the other property types.
Global Real Estate	Maximum Underweight	We believe that high quality assets, with low leverage and portfolios that are globally diversified, should outperform in the current environment. Office fundamentals are faring better in the Asia Pacific than in North America. Multi-unit residential, alternative real estate and a tilt to the Asia Pacific can 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	We are constructive on commodities as key markets such as oil and copper remain finely balanced and are supported by limited inventories, producer discipline and/or supply shortfalls, with demand potentially benefitting from a China recovery or stimulus measures. Gold has been facing headwinds from rising real rates and physical gold exchange-traded fund ("ETF") outflows.

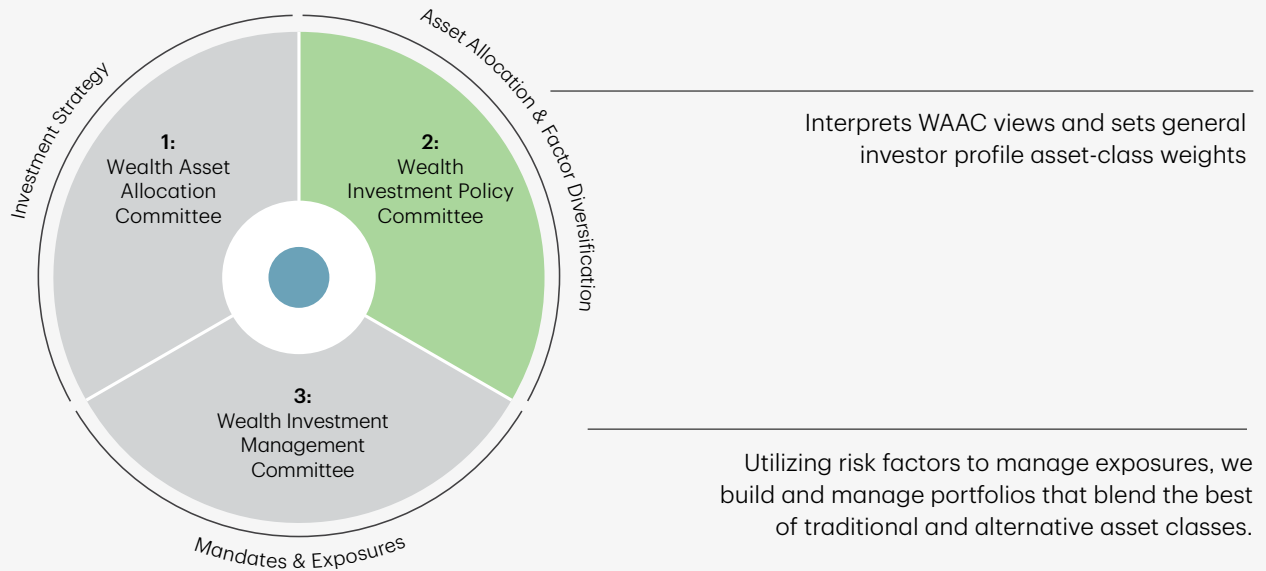
Figure 1: Direction from WAAC: strategic positioning

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

Source: Wealth Asset Allocation Committee, as of October 13, 2023.

# 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) made a number of changes to the dynamic asset allocation table in October. At the top asset class allocation tier, WIPC reduced the allocation to both cash and fixed income by 1 percentage point (pp) each in all profiles. Meanwhile, the allocation to equities was increased by 2 pp across the board. The proposed changes brought equities positioning from underweight to neutral, and cash positioning from neutral to 1 pp underweight. Fixed income's overweight position was reduced to 1pp and real assets positioning remained at neutral for all risk profiles. This is aligned with the guidance from Wealth Asset Allocation Committee (WAAC).

Within equities, WIPC increased the allocation to Canada and U.S. by 0.5 pp and 2.5 pp to neutral and 2 pp overweight in all risk profiles. The committee also reduced the allocation to emerging markets by 1 pp to neutral in all risk profiles. International equities positioning is maintained at 2 pp underweight across the board.

Within fixed income, WIPC reduced the overweight positioning in domestic government bonds by 1 pp, resulting in 1 to 2 pp overweight in all risk profiles. The committee maintained a modest 1 to 2 pp underweight position in high yield bonds and a neutral to 1 pp overweight in investment grade corporate bonds. Positioning to global bonds for developed and emerging markets remained neutral.

Within real assets, WIPC maintained a modest 1 pp overweight position in mortgage in four of the risk profiles. It continued to hold a neutral position in private debt. The committee also maintained a modest 1 to 2 pp underweight position in real estate in five of the risk profiles, and a 1 pp overweight in infrastructure in four of the risk profiles.

### Factor Exposure

Asset Classes	Fixed Income Factor	Equity Risk Factor	Currency Risk Factor	Illiquidity Risk Factor	Alpha
Factor Positioning	Overweight	Neutral	Underweight	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 October 13, 2023.

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

Asset Class	Balanced Income		Balanced		Balanced Growth		Growth		Aggressive Growth	
	Strategic	Dynamic	Strategic	Dynamic	Strategic	Dynamic	Strategic	Dynamic	Strategic	Dynamic
Cash	2.0%	1.0%	2.0%	1.0%	2.0%	1.0%	2.0%	1.0%	2.0%	1.0%
Public Fixed Income	63.0%	64.0%	48.0%	49.0%	33.0%	34.0%	23.0%	24.0%	0.0%	1.0%
Government	32.0%	33.0%	24.0%	25.0%	17.0%	18.0%	11.0%	12.0%	0.0%	1.0%
Corporate	31.0%	31.0%	24.0%	24.0%	16.0%	16.0%	12.0%	12.0%	0.0%	0.0%
Public Equities	35.0%	35.0%	50.0%	50.0%	65.0%	65.0%	75.0%	75.0%	98.0%	98.0%
Canadian	11.0%	11.0%	15.0%	15.0%	20.0%	20.0%	23.0%	23.0%	29.0%	29.0%
U.S.	14.0%	16.0%	20.0%	22.0%	26.0%	28.0%	30.0%	32.0%	40.0%	42.0%
International	7.0%	5.0%	10.0%	8.0%	13.0%	11.0%	15.0%	13.0%	19.0%	17.0%
China/Emerging Markets	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 October 13, 2023.

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

Asset Class	Balanced Income		Balanced		Balanced Growth		Growth		Aggressive Growth	
	Strategic	Dynamic	Strategic	Dynamic	Strategic	Dynamic	Strategic	Dynamic	Strategic	Dynamic
Cash	2.0%	1.0%	2.0%	1.0%	2.0%	1.0%	2.0%	1.0%	2.0%	1.0%
Public Fixed Income	56.0%	57.0%	41.0%	42.0%	26.0%	27.0%	16.0%	17.0%	0.0%	1.0%
Domestic Government Bonds	24.0%	26.0%	17.0%	19.0%	11.0%	13.0%	6.0%	8.0%	0.0%	1.0%
Invest. Grade Corp Bonds	19.0%	20.0%	14.0%	15.0%	9.0%	9.0%	6.0%	6.0%	0.0%	0.0%
High Yield Bonds	4.0%	2.0%	3.0%	1.0%	2.0%	1.0%	1.0%	0.0%	0.0%	0.0%
Global Bonds - Developed	6.0%	6.0%	5.0%	5.0%	3.0%	3.0%	2.0%	2.0%	0.0%	0.0%
Global Bonds - Emerging	3.0%	3.0%	2.0%	2.0%	1.0%	1.0%	1.0%	1.0%	0.0%	0.0%
Public Equities	32.0%	32.0%	42.0%	42.0%	57.0%	57.0%	67.0%	67.0%	85.0%	85.0%
Canadian	10.0%	10.0%	12.0%	12.0%	17.0%	17.0%	20.0%	20.0%	25.0%	25.0%
U.S.	13.0%	15.0%	17.0%	19.0%	23.0%	25.0%	27.0%	29.0%	35.0%	37.0%
International	6.0%	4.0%	8.0%	6.0%	11.0%	9.0%	13.0%	11.0%	15.0%	13.0%
China/Emerging Markets	3.0%	3.0%	5.0%	5.0%	6.0%	6.0%	7.0%	7.0%	10.0%	10.0%
Alternatives	10.0%	10.0%	15.0%	15.0%	15.0%	15.0%	15.0%	15.0%	13.0%	13.0%
Commercial Mortgages	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%	0.0%	0.0%
Real Estate	1.0%	0.0%	3.0%	1.0%	3.0%	1.0%	3.0%	1.0%	4.0%	3.0%
Infrastructure	2.0%	2.0%	5.0%	6.0%	5.0%	6.0%	5.0%	6.0%	9.0%	10.0%
Fixed Income	58.0%	58.0%	43.0%	43.0%	28.0%	28.0%	18.0%	18.0%	2.0%	2.0%
Equity	32.0%	32.0%	42.0%	42.0%	57.0%	57.0%	67.0%	67.0%	85.0%	85.0%
Alternatives	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 October 13, 2023.

# Economic Outlook

## Chasing the (R-) Stars

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

### Highlights

- The strength of the U.S. economy is fueling the debate on whether the Federal Reserve needs to continue raising interest rates. This debate revolves around whether the current policy rate is sufficiently restrictive relative to estimate of the neutral rate of interest (R-Star).
- We believe the neutral rate is on the rise due to the surge in climate change investment, the rewriting of global supply chains, and widening government deficits. A higher neutral rate means that the current policy rate may not be as restrictive as the Fed thinks.
- While the conditions for a higher R-Star are also in place for Canada, a major difference is the highly indebted household. This factor will restrict growth, justifying a lower R-Star in Canada relative to the U.S.

The Federal Reserve indicated in September that one more rate hike this year was still in the cards. That means the end is now at hand for this rate hiking cycle...or is it?

Investors have watched the Fed repeatedly revise up expectations for how high they will need to raise interest rates over the past year and a half (Figure 1) in the face of stubborn inflation and surprising economic momentum. Although interest rates are finally high enough to be in “restrictive territory”, the question of how restrictive is debatable. The answer depends on where the neutral rate is believed to rest, and that answer varies through history.

In this report, we tackle how an interest rate that’s supposed to be rooted in long-term concepts of economic fundamentals and dynamics can change by such a large magnitude, and whether that thinking is about to migrate towards a higher neutral rate.

Even a slightly higher neutral rate would imply that the current fed funds rate at 5.50% is not sufficiently restrictive to re-anchor and sustain inflation at the 2% target.

Figure 1: Fed policy path is rising



Source: Bloomberg Finance L.P., TD Economics.

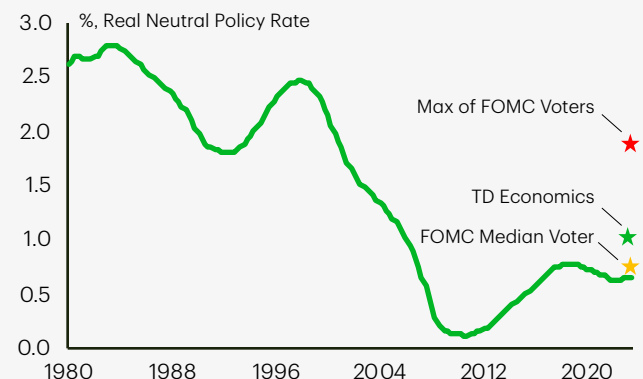
### A paradigm shift in the (R-) stars

The evolution of the neutral rate of interest or, in economics jargon, R-star, is the federal funds policy rate (net of inflation) that neither stokes nor chokes off economic growth. It can also be thought of as the “clearing rate” that keeps savings and investment in equilibrium. It is in the depths of this concept where the debate on R-star estimates rage on.

Over the last 30 years, several large forces have caused analysts to mark down estimates of the neutral rate (Figure 2). Two key ones were when the tech bubble popped in 2001 and the real estate market collapse in 2008. Both caused lengthy deleveraging cycles by corporations (in the case of the tech bubble) and consumers (following the real estate bubble). The net effect of each was to restrain the willingness to spend and invest, weighing down the neutral rate.

Two other phenomena were thought to lead to a lower neutral rate: a global savings glut and secular stagnation. In 2005, former Fed Chair, Ben Bernanke, noted that the rise of developing nations with higher

Figure 2: The evolution of R-Star



Source: FOMC, HLW, TD Economics.



savings rates, led by China, in combination with oil producing countries in the Middle East and North Africa created a supply of available global savings that was not matched by investment. Simultaneously, secular stagnation pulled on many threads, including one view that the dearth of investment was accentuated by the rise of the digital economy that required less capital, leading to slower employment and output growth.

All these theories and observations pointed in the same direction: too much money chasing too few assets, leading to a fall in world interest rates. And this seemed to be true over the period of 2001 to 2020, where inflation remained anchored near the 2% mark despite an average policy rate of only 1.5%.

Now the question is how much of these conditions still hold today?

The first catalyst of change is that the digital economy (and soon-to-be A.I. economy) is intersecting with government policies on clean energy and supply chain security. This has lit a fire under traditional investment in U.S. manufacturing facilities despite high interest rates.

The second catalyst is that the pandemic caused government debt (globally) to skyrocket, and many countries are keeping debt loads higher. This is causing greater competition by sovereign debt for global savings. This has the potential to crowd out private sector debt. In the case of the U.S., the Congressional Budget Office (CBO) projects that the (gross) federal debt-to-GDP ratio is slated to rise over eight percentage points by 2027 and by 22 percentage points (to 119%) by 2033. Deficits ranging between five and six percent of GDP are expected to persist – and ultimately widen. This would occur under a continual economic expansion, let alone a cycle that encompasses a downturn.

The third catalyst is that China’s contribution to the global savings glut is diminishing. Advanced countries

are actively limiting supply chain exposure to China, while the country is slowing materially under the weight of aging demographics and strong structural economic forces related to their financial and property sectors. Long gone are the days of double-digit economic growth when China’s entry into the World Trade Organization propelled a rapid expansion of globalization. Economic growth is expected to trend towards 3.5% by 2028. By extension, this will slow the pace of global savings creation as the pendulum starts swinging to the other side.

Diversifying supply chains away from China should help to bring down the risk of future large economic disruptions, but it could come at the expense of productivity. Lower global productivity reduces global income and available savings in turn. Even absent productivity losses, the shift of production to countries with lower savings rates could work to thin out the global savings pool.

Ultimately the coming years could see a normalization in the flow of savings, and this can raise the marginal cost of capital...i.e. the equilibrium interest rate.

### Stellar collision

This collision of forces is causing a rethink of R-star. Unfortunately, the answer is only ever known in hindsight. Even so, we think the odds lean toward it being slightly higher than the past decade. The resilience of the U.S. economy is giving some signals on this front, as laid out in Table 1. Of course, this doesn’t answer the crucial question of how high that R-star has risen. It is early days, but we think roughly a 25bps (and perhaps even as much as a 50bps) nudge is a reasonable possibility.

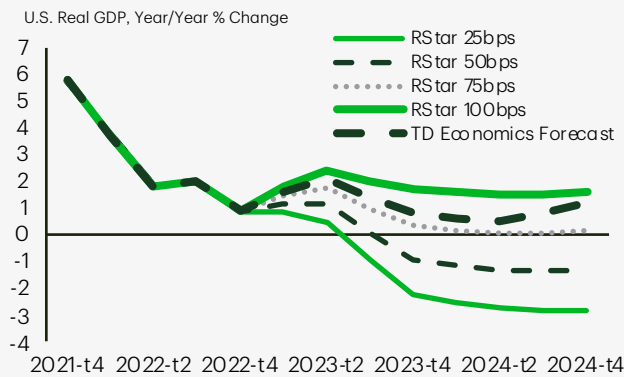
To help ground this perspective, we conducted a thought experiment. Applying different assumptions for R-star, we can test with our models what GDP growth would have been over the first three quarters of 2023 and through 2024 (Figure 3).

Table 1: Drivers of R-Star

	Prior Cycle	Current Cycle
Productivity Growth	Falling productivity and low investment (-)	Supply chain investment and potential of generative AI (+)
Demographic Trends	Falling birth rate, lower immigration, low labor force participation (-)	Same as prior but notable increases in labor force participation (+)
Fiscal Policy/Investment	High government borrowing offsetting consumer deleveraging (+)	Still high government borrowing plus climate change investment (+)
International Flow	Emergence of China led to significant investment (+)	A changing world trade order may spark new investment (+)
Scarcity of Safe Assets	Rising Emerging Market growth and commodity demand caused increased demand for USD and scarce USD assets (+)	Continuation of prior trend with no alternative to the USD (+)

Source: TD Economics.

Figure 3: U.S. economy validating a higher R-Star



Source: TD Economics. Note: Actual to 2023Q2.

If the post-Global Financial Crisis (GFC) level of R-star was maintained, the U.S. economy would have already been on a path towards recession. Instead, GDP growth over the first three quarters of 2023 reveals that R-star is tracking between 0.75% and 1.0% (compared to the Fed's view of 0.5%). This is consistent with our recently published economic forecast.

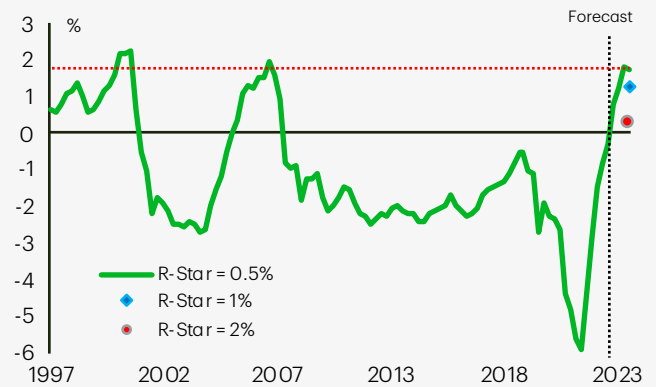
Now is this enough to slow the economy down and bring inflation back to 2%? Our monetary conditions index that takes the Fed's policy rate and adjusts it for inflation and R-star helps to answer this (Figure 4). It shows that if the Fed is right and R-star hasn't changed since the post-GFC time period, the monetary conditions index is set to reach the same level of restrictiveness that preceded the 2001 and 2008 recessions. But if R-star has migrated higher, the current level of policy is less restrictive than the Fed thinks. Our view of R-star between 0.75% to 1.0% (nominal neutral rate of 2.75% to 3.00%) validates our view that the U.S. economy is mostly likely headed for a soft landing.

**Canadian economy slowing, but inflation remains stubborn**

The same forces impacting R-star in the U.S. are at work in Canada, but there is one key distinction on the domestic front. Canada's elevated household debt levels place the country at risk for a drawn-out deleveraging cycle, and this typically pushes down the resting place on interest rates.

Already, signs are coming through on this front. Even though the Bank of Canada (BoC) has hiked its policy rate by 50 bps less than the Fed, economic momentum is already downshifting – a sign that R-star in Canada may be lower than in the U.S. Just look at real estate. Existing home sales had a peak-to-trough decline of over 50% since the BoC first started hiking in 2022, with the average home sale price falling 20% over that time. And even though the market started to heat up

Figure 4: Monetary policy might not be as tight as it seems



Source: HLW (Adjusted), TD Economics.

in the spring following the BoC's January pause, back-to-back hikes in June and July once again sent home sales plummeting.

While it is clear the BoC's actions have teeth when it comes to real estate, the impact on the consumer has been less immediate. In fact, consumer spending was the main driver of growth for the economy through the first quarter of 2023. But since then, there has been a notable shift. Retail sales have gradually turned lower, with the three-month figure showing a decisively negative trend since March. This is happening alongside a cooling in the job market. We have seen the number of job postings drop by 25% from the peak, while the number of unemployed workers has risen to a high of 138k, alongside a drop in the job switching rate to 0.4% - lower than in the pre-pandemic period. Workers are feeling less confident, and with more Canadians facing mortgage renewals, consumers have been adjusting their spending behaviour. This helps guide our view of R-star for Canada. With the economy having responded to past rate hikes so clearly, this has been a signal that the neutral rate is likely lower in Canada than in the U.S.

While this implies that the BoC can maintain a lower policy rate compared to the Fed, it doesn't mean the inflation fight is over. Lags, combined with the impulse of prior economic strength, has Canadian inflation remaining elevated. The CPI reading for August showed a reacceleration to 4.0% year-on-year (y/y). Worse, core readings of inflation have accelerated, also reaching 4.0% y/y in August (up from 3.8% the month prior). The BoC will find none of this encouraging as more time is needed for the very recent downshift in economic momentum to feed through to end-user prices. As shown in our recent economic forecast, evidence of easing inflationary pressures is expected to materialize in the first half of 2024. In the meantime, the Bank of Canada has little choice but to ensure communication remains firmly in the hawkish camp. □

## Asset Class Analysis

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# Quarter in Review

## Expecting rain clouds, investors awaken to sunshine

Fred Wang, Senior Portfolio Manager, Asset Allocation, Nadeem Kassam, Senior Equity Analyst | TD Wealth

It always takes some time to adjust to rain clouds in the morning when the forecast from the night before had been calling for sunshine, but it's usually viewed as a pleasant surprise when the opposite happens. Over the past quarter, most investors have awakened to sunshine, despite the forecast calling for a high probability for rain and thunder for the U.S. and Canadian economies.

At the beginning of the year most strategists and economists were calling for the U.S., Canadian and the global economy to already be in a recession by this time of year. This hasn't happened, at least not quite yet. At the end of Q3, the U.S and Japanese economies are still running strong, labour markets remain tight, inflation is still above central-bank targets (despite a gradual decline) and, most importantly, interest rates are likely to remain high for longer than expected, after the record pace of hikes over the past 12 to 18 months.

This new economic reality has had a ripple effect on global financial markets, as investors recalibrate their expectations for interest rates, inflation, economic growth, etc., resulting in broad-based weakness across global asset classes. While there have been a few exceptions, namely commodity markets, broadly speaking there were few places to hide in Q3.

As this new reality sets in for investors, it's worth highlighting that the single biggest variable for investors during the past quarter has been the outlook on interest rates, which are expected to stay higher for longer. The impact of this change was a material negative for equity-market returns (especially U.S. small-caps) in the third quarter and is best illustrated with an example.

Figure 1: Asset-class performance

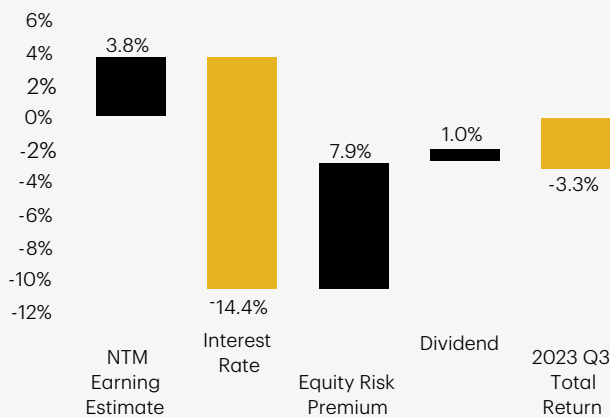
		MTD	QTD	YTD	1YR
Equities	US	-4.8%	-3.3%	13.1%	21.6%
	Canada	-3.3%	-2.2%	3.4%	9.5%
	EAFE	-1.1%	-1.3%	10.7%	20.3%
	EM ex China	-2.6%	-3.3%	6.2%	14.7%
	China	-2.0%	-2.9%	-2.5%	-0.5%
	US Small Cap	-5.9%	-5.1%	2.5%	8.9%
Government Bonds	US	-2.2%	-3.1%	-1.5%	-0.8%
	Eurozone	-2.7%	-2.5%	-0.1%	-2.2%
	Japan	-0.8%	-4.1%	-0.5%	-2.9%
	Canada	-2.9%	-4.4%	-2.2%	-2.4%
	EM Debt	-2.8%	-2.6%	1.1%	8.6%
Inflation-Linked Government Bonds	Global	-2.4%	-3.1%	-1.5%	-1.2%
	US	-1.8%	-2.6%	-0.8%	1.2%
	UK	-3.5%	-5.2%	-8.0%	-13.5%
	Canada	-3.6%	-7.4%	-7.7%	-5.1%
Corporate Bonds	Global IG	-1.9%	-1.6%	1.5%	4.6%
	Global HY	-1.1%	0.5%	5.5%	12.2%
	Leverage Loans	1.0%	3.5%	10.2%	13.1%
Commodities	Oil	8.6%	28.5%	13.1%	14.2%
	Natural Gas	4.3%	8.1%	-22.5%	-57.5%
	Copper	-1.5%	0.4%	2.1%	13.6%
	Gold	-4.7%	-3.7%	1.3%	11.3%
	Agriculture	-3.3%	-4.3%	-7.6%	-8.9%
	Industrial Metals	1.5%	3.5%	-5.2%	7.6%

Source: FactSet as of September 30, 2023. Note: All returns are in local currency unless indicated otherwise.

In the accompanying charts (Figures 2 and 3), we break down the Q3 returns for the S&P 500 and the S&P/TSX Composite indices into their components, the sum of which approximates the return for the index over a given period, in this case Q3. These components include: (1) the next 12 months of earnings growth; (2) the change in valuation multiple (i.e., the price/earnings ratio), which can be further broken down into the change in interest rates and the equity risk premium commanded by investors; and finally (3) the dividend yield.

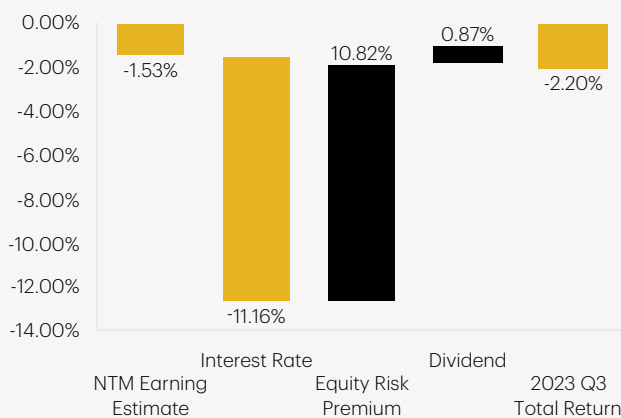
As we demonstrate, the single biggest contributor to weakness across U.S. and Canadian equity markets in Q3 was the change in interest rates, followed by a lower equity risk premium, which is the excess return, over the risk-free rate, that investors demand for incurring the risk inherent in the stock market. Should interest rates continue to move higher, or stay higher for longer, we expect interest rates to remain a critical contributor to equity-market returns.

Figure 2: The negative performance for S&P 500 in Q3 was driven by higher interest rates



Source: FactSet, WIO as of September 29, 2023

Figure 3: The negative performance for S&P/TSX in Q3 was driven by higher interest rates



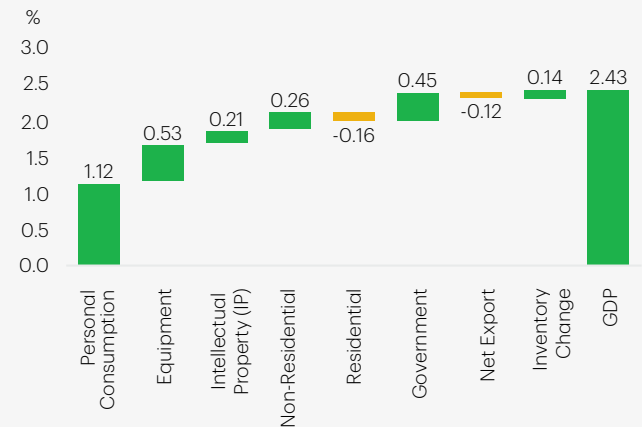
Source: FactSet, WIO as of September 29, 2023

Global fixed income markets also experienced broad-based weakness over the past quarter, alongside rising yields, as investors command higher real yields and term premiums. Commodity markets, in particular energy, were broadly higher due to ongoing supply/demand imbalances and idiosyncratic factors.

### Sunshine in the U.S, while clouds begin to emerge in Canada

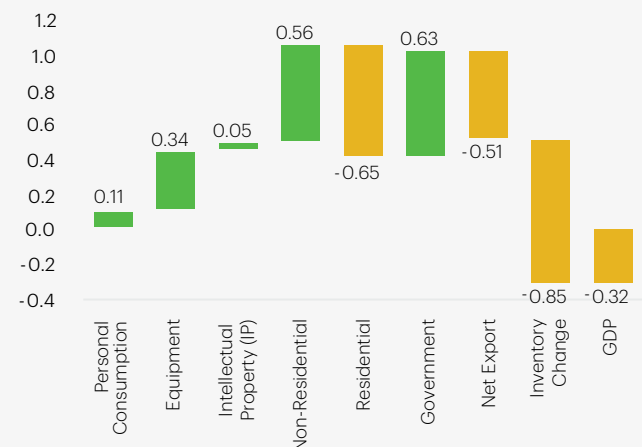
The U.S. economy, which as a reminder, is the largest in the world and often looked to as a barometer for the health of the global economy, has proven to be more resilient than expected, even in the face of higher rates. However, while the sun is still shining bright for the U.S. economy (Figure 4), with second-quarter gross domestic product (GDP) rising 2.4% year-over-year (y/y), here in the north, it was a different story (Figure 5). The Canadian economy reported a 0.2% y/y decline for Q2 GDP, which was far worse than expected. The main headwind for Canadian Q2 GDP was higher interest rates, which have begun to weigh on the Canadian consumer and the housing sector.

Figure 4: U.S. GDP growth in Q2 remained robust, with strong contribution from consumers



Source: FactSet, WIO as of June 30, 2023

Figure 5: Canada's GDP growth disappointed, with weak consumer spending and residential investment



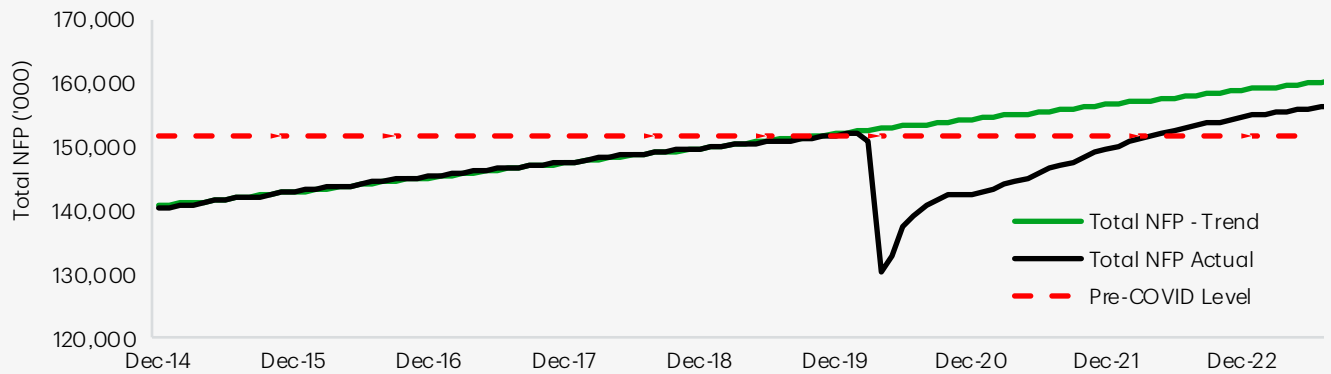
Source: FactSet, WIO as of June 30, 2023

Another bright spot stateside are labour markets. A strong labour market (low unemployment, strong job creation) is a good thing all else equal, but the impact of this persistent level of tightness in labour conditions has resulted in sustained wage pressures and has increased the risk of long-term inflation. In (Figure 6) we show how the U.S. labour market continues to pump out new jobs, albeit below the long-term trend, while the U.S. unemployment rate hovers at 3.8% (as of September), slightly above the 50-year low of 3.4%. Taking a closer look at the labour situation in the U.S. provides insight into the drivers of the tightness and pressures of wage inflation. For example, the hospitality and construction sectors, which have historically fulfilled a sizable portion of their labour needs with immigrant workers from the southern

border, are now faced with tougher immigration rules, which has significantly reduced the supply of migrant workers entering the U.S.

Manufacturing and health care are other sectors still experiencing structural labour shortages, due to: demand and supply factors, including the re-shoring of manufacturing operations; higher baby boomer retirement rates; and covid burnout within the health-care sector. It's also worth mentioning that these sectors have historically been more unionized than others, resulting in labour unrest and inflationary wage growth (Figure 7). The recent United Auto Workers (UAW) strike by health-care workers at Kaiser Permanente was just one recent development suggesting that sticky inflation is not so easily cured by high rates.

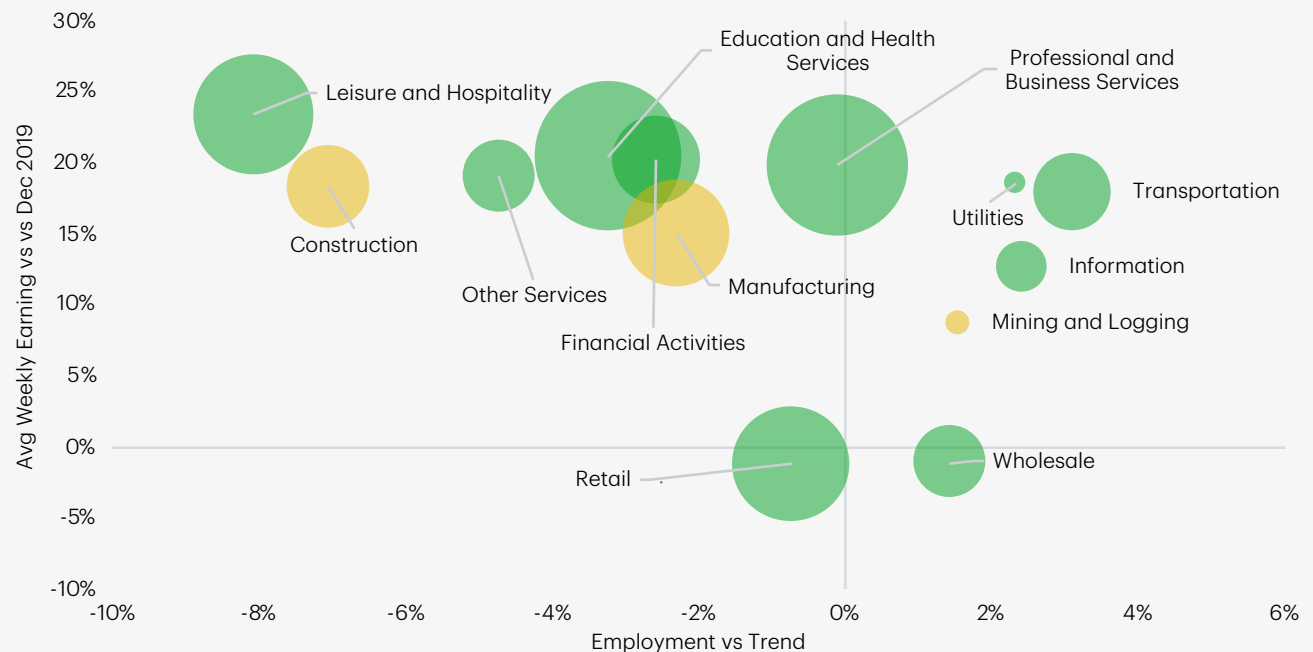
Figure 6: U.S. workforce is currently under pre-COVID trend, resulting in tight labour market



Source: FactSet as of August 31, 2023

Figure 7: Employment sectors with the largest shortages see the largest salary increases

Bubble size indicates employment size of the sector; green bubbles represent service sectors and orange bubbles represent manufacturing sectors



Source: FactSet as of September 30, 2023



## Investors revising their weather forecast heading into Q4

The expectation of higher-for-longer rates has led long-term yields on government bonds to begin to reprice higher (Figure 8). The yields on 10-year government bonds in major developed markets (apart from the UK) have shown themselves to be positively correlated (less of a diversifier in multi-asset portfolios) with one another.

There are two ways to break down bond yields. The first includes two components: (1) inflation expectations (aka, “breakeven” inflation), which is implied from the inflation-linked and nominal bonds; and (2) real yield, the reward investors demand for taking on inflation risk, since higher inflation erodes the purchasing power of the fixed coupon and principal payment of a bond.

Over the past quarter, inflation expectations have remained mostly unchanged, while real yields have risen, forcing bond prices to fall. As a reminder, bond prices move inversely to yields. That is, as yields rise bond prices fall, and vice versa. In addition to higher real yields, we have also seen investors demand higher term premiums, which for the first time since beginning of the covid crisis in early 2020, have turned positive.

The second way that bond yields can be broken down also comprises two components: (1) future short-term interest-rate expectations; and (2) term premium, the additional reward that bond investors demand for taking on short-term interest-rate risk over a period of time, say 10 years. Estimating term premium is difficult, but economists at the Fed have come up with a few ways.

The recent rise in yield, for instance, was clearly driven by higher term premiums. In Figure 9, we can see that, since the onset of the first quantitative easing, the term premium has been compressed all the way into the negative territory. The term premium has stayed negative until recently. If anything, this is the bond market waking up to the new reality of higher-for-longer rates, feeling all of a sudden that inflation, and thus hawkish central banks, are here to stay.

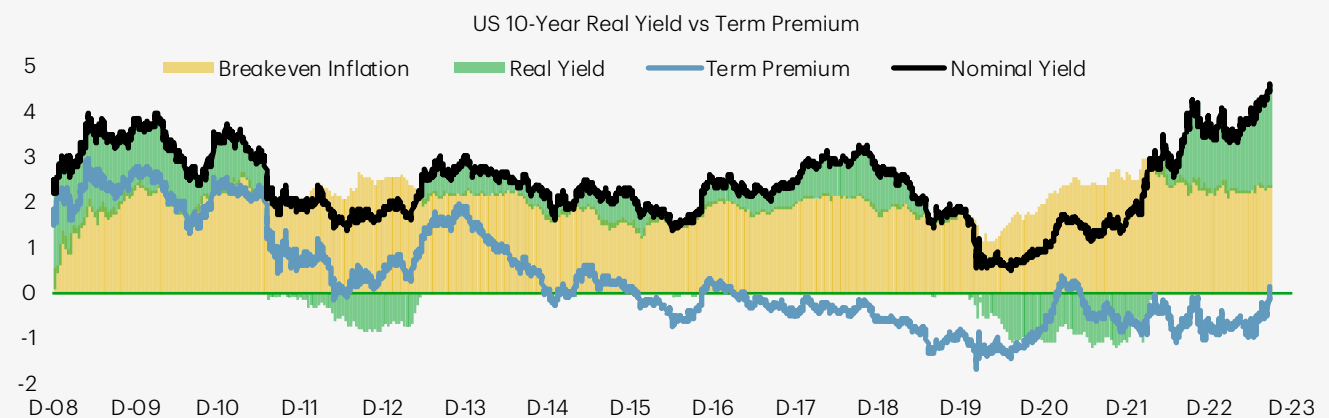
All this is to say that, for the real economy, higher interest rates — short- and long-term, controlled by the central banks and repriced by the markets — will be here for some time. The market is likely to respond with higher volatility, tighter financial conditions and lower liquidity.

Figure 8: Global yield increase during Q3

		U.S.	Canada	U.K.	Germany	Japan
<b>2023 Q3 Yield Change</b>	Breakeven Inflation Change (bps)	11.9	3.0	-1.0	0.2	14.4
	Real Yield Change (bps)	72.8	72.7	18.6	52.8	20.9
	Total Yield Change (bps)	84.6	75.7	17.6	53.0	35.3
<b>2023 Q3 Correlation</b>	U.S.	1.00				
	Canada	0.96	1.00			
	U.K.	0.12	0.05	1.00		
	Germany	0.88	0.89	0.27	1.00	
	Japan	0.89	0.85	-0.06	0.71	1.00

Source: FactSet as of September 30, 2023

Figure 9: 10-Year U.S. Treasury yield has hit the highest level since 2008



Source: FactSet as of September 30, 2023

### **Keep a lookout for some thunder and lightning**

At the time of writing, we have witnessed a surge in geopolitical tensions in the Middle East, resulting in the tragic loss of life. Our thoughts and prayers are with those impacted by these tragic events. While difficult to anticipate and price into expectations for markets, geopolitical uncertainties remain an ongoing risk.

Ultimately, understanding market dynamics requires a broad scope, not only covering the economic fundamentals and policies, but also the slow-moving but persistent cloud of activities on the horizon. Geopolitical risk is one such force, which continues to intensify.

Front and centre is the U.S.-China relationship. The divide became deeper in Q3, with each side rallying support from existing and newfound allies. In August, leaders from Japan, Korea and the U.S. met at Camp David to inaugurate a new trilateral partnership. The joint statement declared wide-ranging collaboration to develop technology and economic ties, to promote democratic value and human rights, and to ensure regional security.

The partnership will play an important role in the U.S. Indo-Pacific strategy and was viewed as a counter to the growing threat from North Korea and an assertive China. The timing is also important, given that the pact was formed before the highly sensitive presidential election in Taiwan next January, in which the candidate from the nationalist Democratic Progressive Party has been leading the polls.

On the other side of the world, leaders of BRICS (Brazil, Russia, India, China, and South Africa) also convened in Johannesburg around the same time. Although these five countries have drastically diverse interests, they have a shared goal of creating new economic and trade systems that are less tied to U.S.-led Western systems. Two important takeaways: first, the bloc is extending invitation to six more countries to join, including Saudi Arabia, Iran, UAE, Argentina, Egypt and Ethiopia; second, some BRICS leaders expressed a desire to create a bloc-wide currency to de-dollarize the global economy, although there's not much that's tangible from the official statement of the summit.

If all of these postures and joint statements stay in the political arena, investment portfolios will be much easier to manage. Unfortunately, these undercurrents could lead to higher volatility. After four years of export sanctions on advanced chipmaking equipment, Chinese smartphone company Huawei debuted its new 5G phone using a domestically manufactured mobile chip. This breakthrough, on one hand, revived

the smartphone maker's business, which was hindered by the sanction put in place in 2019. On the other hand, this development surprised the U.S. government, which in turn launched investigations into whether any companies were helping Huawei and violating the sanction.

Also in September, just a couple of weeks before Apple's iPhone 15 was released, it was reported that the Chinese government was banning its employees from using the iPhone. Given China's large state-owned sector, which is also considered quasi-government, the impact could be meaningful. Apple's stock fell close to 10% over three days, making it one of the largest detractors in the S&P 500 for September.

The next major trade scuffle for China is around the EU's investigation on the suspected government subsidy on Chinese EV imports into the economic bloc. If the trade dispute escalates, many high-margin, European-made SUV and luxury cars could be subject to retaliation. This could hurt the fragile European manufacturing sector significantly. In a deglobalizing economy, protectionism and trade disputes could take a toll on multinationals. □

# Outlook on Fixed Income

## Yielding Opportunities

Aurav Ghai, Senior Fixed Income Analyst | TD Wealth

Fixed income investors may be grumbling when they look at performance so far this year but if you've been reading PSQ regularly you'll know that no one should be evaluating these investments based on performance alone.

If we look at fixed income from the point of view of yield and the capacity for higher yields to offset capital losses then it's not doing too badly. Take, for example, the Canada 10-year government bond. The yield jumped more than 180 basis points (bps) in 2022 and another 70 bps this year while the FTSE Canadian Universe Bond Total Return index lost only 1.5% this year versus a hefty 11.7% loss in 2022. No one enjoys waiting out volatility and negative performance but wait it out we must.

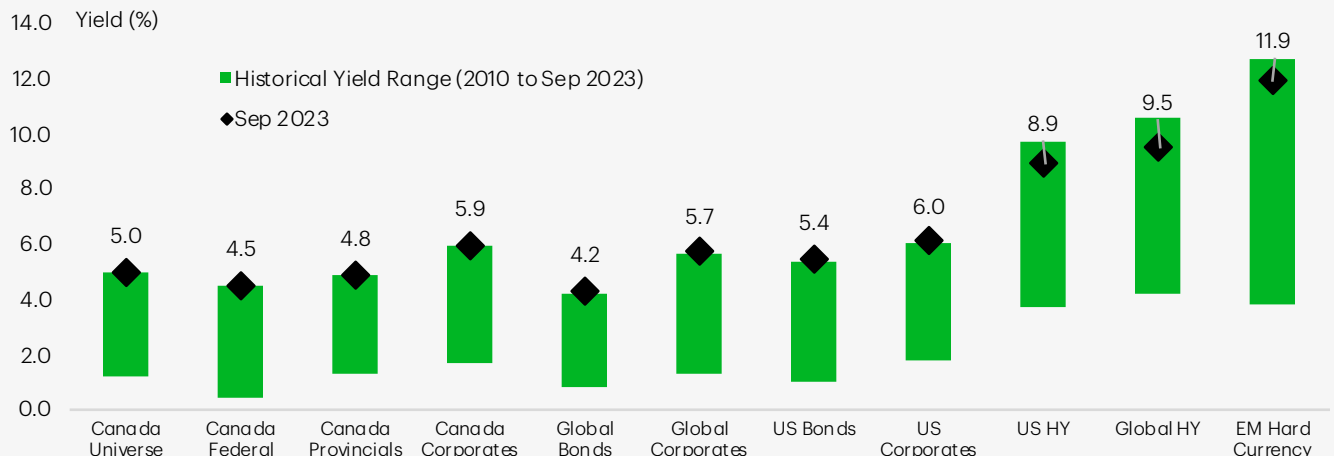
We believe the investment outlook and conviction for bonds remain strong. Yields are back around levels not seen since the early 2000s and the bond market is well positioned to deliver attractive returns in the years ahead driven simply by yield. Investors can earn attractive yields in almost all segments of the fixed income market (Figure 2).

Figure 1: Future returns driven by yield

Periods	1992 - 2002	2002 - 2012	2012 - 2022	2023 Sept-
Total Return	7.45	5.29	1.27	?
	↑	↑	↑	↑
Starting Yield	6.76	4.38	1.75	5.39

Source: FactSet, WIO as of September 30, 2023. Yields and annualized returns shown for Bloomberg U.S. Aggregate Bond Index

Figure 2: Yields still near 12-year highs



Source: FactSet, WIO as of September 30, 2023

It would be fabulous if a drop in yields and higher prices helped capital gains boost total returns, but even without, fixed income is expected to flourish at current yields. As third-quarter performance demonstrates, returns may be volatile over the short term but will accrue for those with longer term time horizons.

- We are modest overweight fixed income investments in general and modest overweight domestic government bonds. Canadian and U.S. government bonds are more attractive at current yields and offer opportunities for income generation and downside protection. While it has been another challenging year for bond investors, higher starting yields have historically been associated with higher total returns. We also expect price/yield volatility to decline in coming quarters as the rate hiking cycle nears an end and forward guidance from central banks as well as the severity of economic slowdown becomes clearer.
- We remain neutral investment grade (IG) credit. We expect the challenging economic conditions to widen spreads 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. The HY credit market has seen an overall improvement in quality. This should keep spreads from returning to previous recessionary levels, however, they will widen if the growth outlook deteriorates.

## Government bonds

Since last year macroeconomic risks have made us wary of increased volatility and, given that the market appears to lack near-term conviction, our view hasn't changed. Current yields offer investors opportunities for income generation and downside protection and as such we maintain our modest overweight view on government bonds.

We believe the slower than expected decline in inflation and economic growth will keep the Federal Reserve (Fed) on its toes and we'll likely keep experiencing bouts of volatility. As a result, we believe yields will be range bound for even longer and we also believe any decline in yields will be limited, barring any unexpected events.

As we've pointed out before it's important 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 it has been gradually priced out by markets as well. If central banks have to deal with a liquidity crunch, they have the deep pockets and a variety of tools so they don't always have to rely on policy rate cuts. At the other end of the spectrum, let's not get too excited about economic resiliency because the sentiment pendulum will always swing back.

### Key themes for government bonds

**1. Higher policy rates for longer.** 'Higher rates for longer' is one of the most discussed topics right now and it's supported by the Fed's projection for two fewer policy rate cuts in 2024 and stronger economic

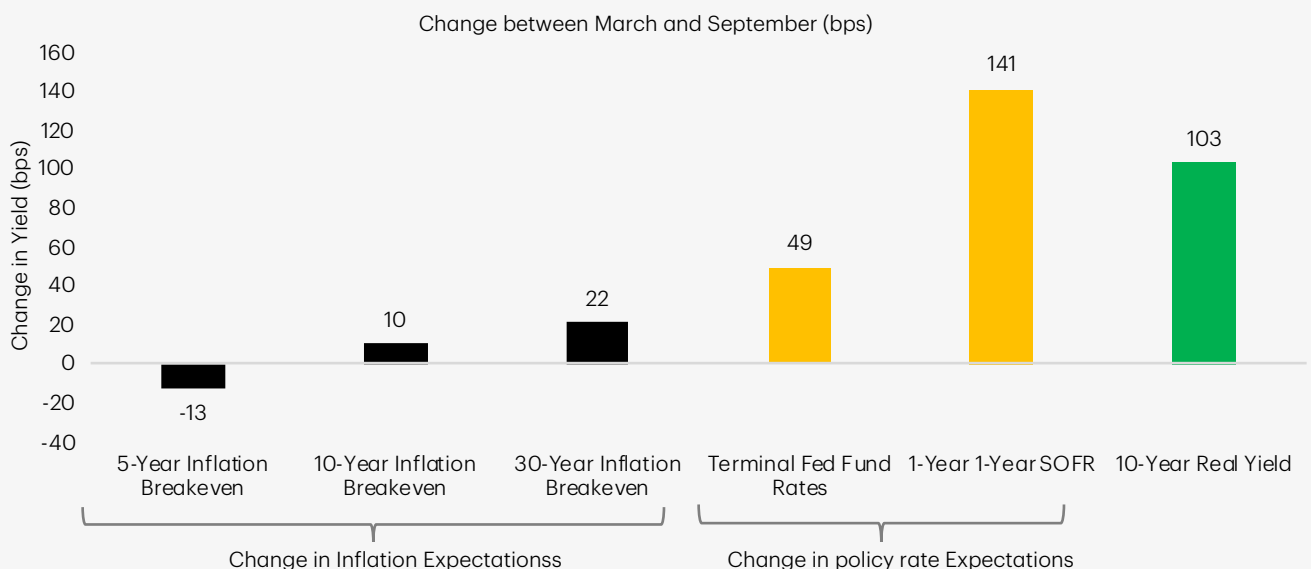
growth in 2023 and 2024. 'Higher' doesn't mean more policy rate hikes from here, though the Fed's projection (or dot plot) does suggest one more hike.

Ontopofthat, inflation expected by market participants (also called breakeven inflation) has drifted up by just a few basis points for 5-yr, 10-yr and 30-yr Treasuries, while the expected peak (or terminal) policy rate has risen by 49 bps since the start of April (Figure 3). This confirms the recent increase in government bond yields is driven by market expectations of 'higher for longer' rates, not by a shift in long-term inflation expectations.

**2. Economic data robust, macro outlook mixed.** Even though most leading indicators still point to recession, strong labour markets and resilient consumer data have increased the probability of a soft landing. The U.S. Conference Board's Leading Economic Indicators Index, which precedes turning points in the business cycle by six to eight months, has declined for 15 consecutive months—the longest streak since 2008—and is negative year-over-year (y/y). This presents us with a mixed macroeconomic outlook and weak fourth quarter data could further muddy the outlook.

**3. U.S. Treasury supply, deficit impacts yields.** The U.S. Treasury boosted its estimate for federal borrowing for Q3 to US\$1 trillion and Q4 to US\$852 billion, bringing additional supply to the market. The Treasury is also targeting a higher cash balance for the Treasury General Account (TGA) by end of 2023. On a short-term basis, supply concerns can evaporate (as evidenced by the relatively stable long-term U.S. and European government bond yields

Figure 3: Market expectations push yields higher



Source: FactSet, WIO as of September 30, 2023

over the past year) despite heavy issuance and quantitative tightening. But Fitch's recent decision to cut the U.S. credit rating from AAA to AA+ suggests that indebtedness does matter to the rating agencies. The downgrade also reflected Fitch's concern that the U.S. government would be unable to manage the debt load because of acute political divisions. The U.S. deficit is already quite large and, despite a decline in 2021-22, is surging again and could keep building. A rising deficit will put upward pressure on government bond yields. Back in the 1990s and early 2000s, large swings into surplus and back to deficit was mirrored by large swings in government bond yields. Specifically, from 1993 to 2001, as the massive deficit turned to surplus, the U.S. government bond curve flattened (as longer maturity yields declined) and then when the deficit surged in 2002-03, long-term yields rose and the curve steepened (Figure 4).

**4. Bank of Japan and North American bond markets.**

Since 2016, the Bank of Japan (BoJ) has intervened in public bond markets to control long-term government yields by using a policy known as 'yield curve control' (YCC). This all changed at the end of July when it loosened the YCC which could, theoretically weaken foreign demand for U.S. government bonds. Even slightly higher Japanese government bond yields make these bonds more attractive to certain Japanese investors like pension funds and insurance, which puts pressure on U.S. bond prices and pushes U.S. yields higher. Higher U.S. real yields will likely put pressure on the yen, and combined with rising domestic inflation, could speed up the BoJ's decision to exit accommodative monetary policy.

**Government bond yields to remain range bound.**

We're swimming in a grey area—with slowing growth and inflation, and central bankers near peak policy rates—where change can happen very quickly and

spur unexpected shocks. (Just look at the recent U.S. regional bank mini crisis). As such, central banks will take a cautious approach and future policy rate hikes, if any, will be limited. Policy rates are likely to stay on hold, which should keep shorter maturity government yields around current levels.

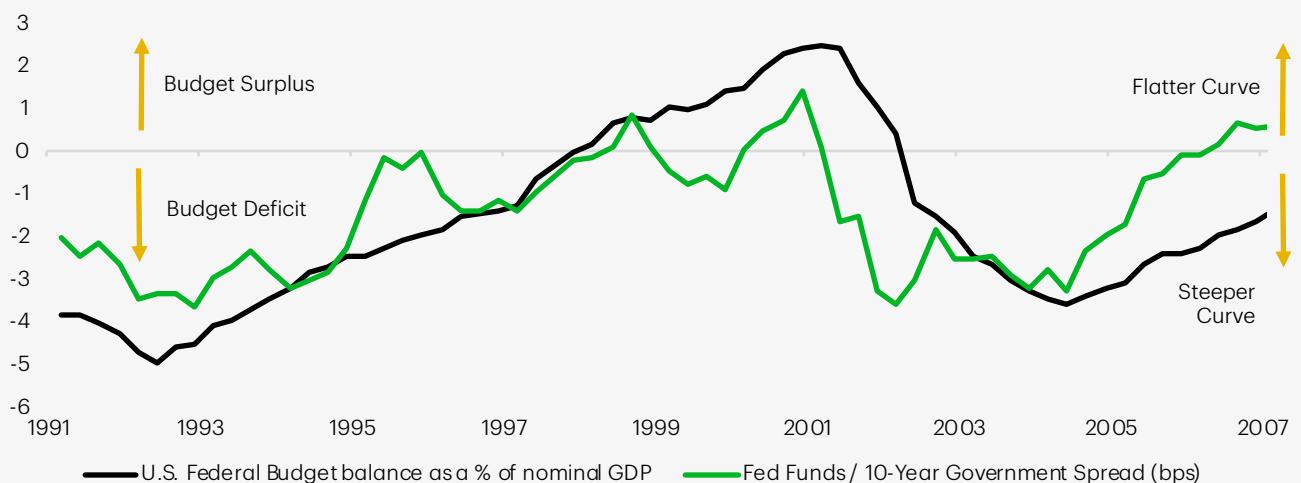
To top it all off, unemployment is at record lows, labour bargaining power is pressuring wages, and inflation is tenaciously high. No central bank wants to repeat the mistakes of the 1970s and cut rates before inflation is firmly under control. As a result, we believe central bankers are unlikely to cut rates aggressively any time soon.

**Soft landing, not deep recession, and government yields.**

One could argue that policy rate hikes don't cause hard landings. Rather, it's the hidden icebergs of excess built up during expansions that come to the fore after rate hikes depress economic growth. For example: the 1989 policy hiking cycle exposed the financial excesses of the leveraged buyout boom and the Savings and Loan crisis; the 1999-2000 rate hikes revealed accounting fraud at major companies and popped a stock market bubble; the 2004-2006 rate-hike cycle ran into inflated assets in housing, with aggressive leverage, illiquidity, and an opaque bond market.

On the other hand, the rate peaks in 1995 and 2018 resulted in soft landings. Since both rate-hike cycles followed fairly dramatic recessions there wasn't the same excesses so economic growth resumed and the hiking cycles ended on a soft landing. Clearer central bank communication also reduces the odds of recession; investors are always looking ahead so transparency around the future course of policy rates limits excesses from accumulating during expansions which tends to reduce the severity of downturns and limit any sharp downturn in government bond yields.

Figure 4: The impact of budget deficit/surplus on long-term government bond yields



Source: FactSet, WIO as of September 30, 2023.

Overall, we expect continued but moderating government bond yield volatility over the medium term along with slowing inflation which could prove stickier than expected.

**Credit: investment grade and sub-investment grade**

Given softening economic growth, we maintain our long-held view of modestly wider spreads (risk premium over a government bond of similar maturity) in coming quarters, however technicals (low issuance and sustained demand for yield) will likely remain positive keeping spreads narrower than previously anticipated. We talk a lot about spreads here but don't be put off reading further. The spread between two products is 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 rooted in the attractive yields for short-maturity IG. We believe the value proposition of owning short-dated IG bonds as a total return product is attractive as they now offer close to the highest all-in yield since the late 1990s (Figure 5). 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 are more sensitive to deteriorating fundamentals and tighter credit conditions. We're more comfortable owning IG over HY because of the yield cushion and balance sheet strength offered by IG.

The year-to-date rally in corporate credit may have caught some investors by surprise given fears of a recession—historically a bad environment for credit spreads. But the bullish macro view, stemming from robust labour markets, declining inflation and resilient consumer confidence, has pushed the threat of recession farther out or perhaps eliminated it entirely (as in a soft landing). A more cautious view suggests tight monetary policy will help to slow growth and widen spreads.

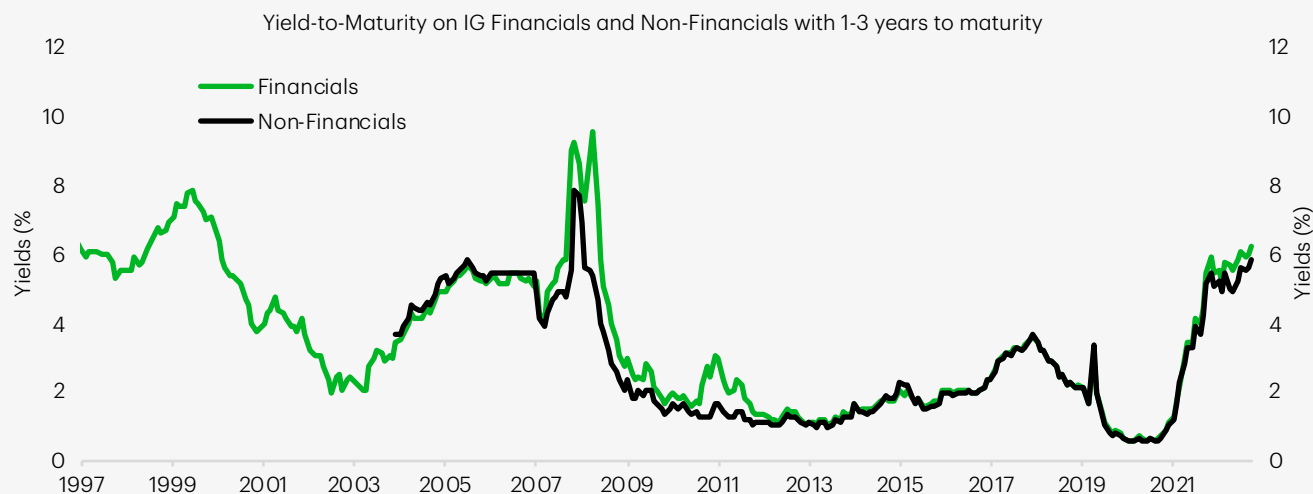
Given the wide range of views on the direction of the economy, credit investors should consider the driving forces behind spread tightening this year, the potential timing and magnitude of spread-widening, and sectoral trends. All of which suggests active management will work best going forward.

Both technical and fundamental dynamics have supported IG credit this year:

**Fundamentals:** While Q2 profits were much lower than mid-2021 peaks, debt levels are manageable, and this could improve credit metrics. In fact, debt ratios are declining for U.S. IG credit and lower debt ratios suggests better financial health. (The trailing 12-month total debt/EBITDA ratio for the U.S. IG universe sat at 2.5x over the past four consecutive quarters, down from a peak of 3.3x in Q2 2020 and lower than 2.8x in Q4 2019.) Moreover, about 8% of IG debt was upgraded in the first half of this year, almost four and a half times the amount of debt that was downgraded.

**Technicals:** Corporate bond issuance has been generally on par with issuance trends over the past two years and institutional and foreign investor demand has remained strong. While spreads remain tight—accounting for around 25% of the yield on IG bonds—the overall yield of about 5.5% remains attractive to pension funds and foreigners given the perceived low risk of default.

Figure 5: Decade-high yields for shorter-maturity IG credit



Source: FactSet, WIO as of September 30, 2023.



We expect these trends to support IG credit spreads in the near term but a growth slowdown could upend this. For this reason, we prefer short-maturity, high-quality IG credit. Our overall neutral stance on IG credit is supported by historical data which shows credit spreads don't widen until much later in the business cycle and, in some cases, not until recession arrives (Figure 6).

We aren't in the game of trying to guess where the peak in IG spreads will land, but certain sectors in IG (finance companies, REITs, banks) have much wider spreads than the broad market and present attractive opportunities. Other segments have less cushion and more risk if the economy comes under pressure. We recommend an active management approach in the IG credit space and prefer shorter maturity and sectoral tilts based on valuations.

### Higher yields and diversification

Only time will tell whether we have a recession in the coming quarters or not, but we can't dispute the clear signs of economic slowdown. Therefore, maintaining a balanced and diversified portfolio is important. With yields reaching attractive levels, the income component of fixed income is back. Short-term volatility in yields will likely persist as markets try to second-guess when central banks will begin to cut policy rates and the extent of economic slowdown. This will drive market participants to reprice future policy rates and economic growth constantly and the timeline for this might be longer than most of us anticipate.

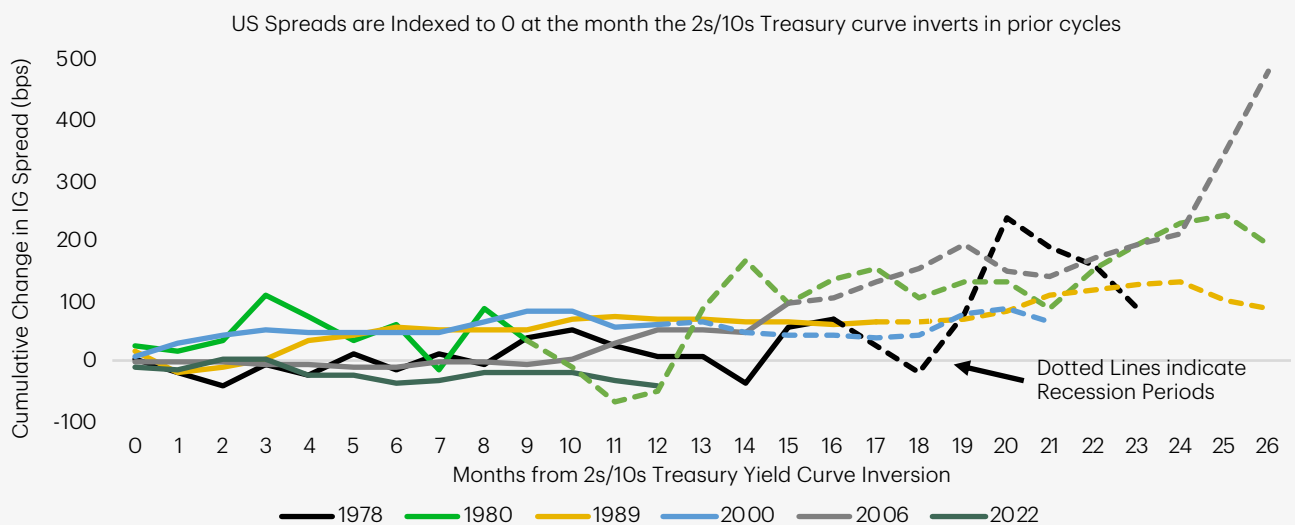
While government bond yields could still rise further (and prices drop), we maintain the current dynamics are driven mainly by technical factors, not fundamentals.

As such, we believe the recent bond sell-off provides an even more attractive risk/reward tradeoff with real yields (nominal yields adjusted for expected inflation) at multi-decade highs.

Keep in mind that higher yields are a good indicator of future returns and provide more cushion for investors as the market refocuses on fundamentals. The 'income' component of fixed income is at historically attractive levels and will provide a buffer against volatility. Good buying opportunities can arise quickly during periods of heightened uncertainty so it's important to maintain an active management approach that can balance both duration and credit exposure.

**Bonds vs. GICs.** A final word on the difference between bonds and term deposits like GICs. Because traditional GICs tend to lock the investment in until maturity they limit investor flexibility. GICs may be useful for investors who want zero price volatility, but for investors 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 yields similar to locked-in GICs. Investors are also taking on re-investment risk when they buy a shorter maturity GIC with a higher yield: for example, the GICs maturing now offer a much more attractive yield than those that matured a year ago and the yield on offer when GICs mature in a year time will most likely be less than it is now. Under the same assumption of falling yield in coming months, bonds will appreciate in price adding capital gains to any GIC-equivalent yield. The best way to mitigate this re-investment risk is to extend the maturity profile of the investments by locking in the higher yields on offer in bonds.

Figure 6: Spreads tend to widen later in the business cycle



Source: FactSet, WIO as of September 30, 2023.

If we compare fixed income to cash, which currently offers an attractive yield, the simple cash yield will drop when central banks start talking about cutting policy rates, while the value of bond or fixed income investments would appreciate because prices go up as yields decline. This explains why, historically, cash has underperformed fixed income in periods following peak policy rates (Figure 7).

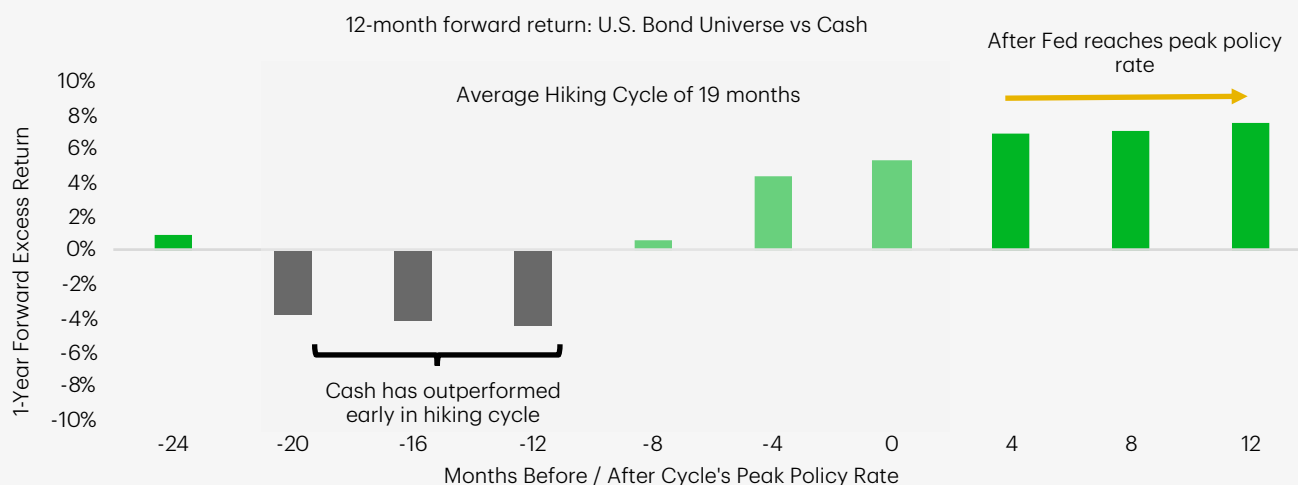
We remain modest overweight the fixed income market overall because we believe fixed income has once again earned its place in the multi-asset toolkit providing investors with the best opportunity in over a decade to build diversified portfolios. Our base case for fixed income is to earn attractive income without getting too ambitious about any substantial capital gains from falling government bond yields. We urge investors to maintain realistic expectations from the asset class. In the current investment landscape, an astute active fixed income manager who is 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 likely persist as markets keep repricing 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.

Figure 7: Fixed income outperforms cash ahead of Fed peak policy rate



Source: FactSet, WIO as of September 30, 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).

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 long-term negative correlation with risk assets tends to act as a hedge and this is unlikely to change. With low convictions around the direction of government bond yields, we don't suggest investors offload all duration-heavy solutions or core bonds. Rather, we encourage tactical adjustments because we firmly believe there is an appropriate place for duration as a hedge in portfolios.

If investors move towards riskier credit solutions in the fixed income sleeve, they must remain vigilant of the inherent drawdown risks as losses in the riskier parts of fixed income can be severe. Importantly, with higher yield on offer within 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

## Waiting on Earnings ... and Santa

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

The rally in global equity markets took a breather in Q3 as investors priced in the probability of higher-for-longer policy rates and struggled with the impact that those rates may have on growth in 2024. The S&P/TSX Composite Index retreated 3.0% while the S&P 500 fell 3.7% during the quarter. Global markets outside Canada and the United States corrected 4.7% and emerging markets declined 3.7%. The rally in seven mega-cap tech stocks continued to lead the S&P 500 to outperform the rest of world year-to-date.

In Canada, the broad index was pushed and pulled by mixed inflation data, higher interest rates, and strong energy prices. The price of oil rose 28.5% through the quarter, allowing the energy-heavy index to outperform the S&P 500 in Q3, but only slightly. Canadian equity investors seemed focussed rather on the outlook for persistently high rates and the struggling Chinese economy. An uptick in July inflation, after a solid June report, also created some consternation in the markets, with wage growth proving stickier than expected.

The Canadian economy seems to have entered a prolonged period of sluggishness. Second-quarter GDP contracted a marginal 0.2% (q/q annualized) – well under the already tepid 1.1% forecast from TD Economics last quarter. The contraction came amid a steep drop-off in consumption growth and a host of extreme events. While consumer spending was essentially flat, rising 0.2% in the second quarter, striking workers and a horrific fire season provided a counterweight, bringing the economy to a standstill.

The TSX is now trading at 12.4 times the 12-month forward earnings estimate, which is a discount to the median of 15.1 over the past 10 years. In fact, over that 10-year period, the forward earnings multiple has been lower only a few times: during the fall of 2022, as the market braced for a possible recession; in March 2020, during the pandemic low; and in late 2018, during a period of waning economic growth (Figure 1).

Over the past 12 months, the earnings estimates for the S&P/TSX Composite have declined 13.8% for calendar 2023 and 5.7% for calendar 2024. The numbers do still suggest that earnings growth from 2023 to the end of 2024 will come in at 11.0%; however, falling prices of late may be an indication that the market does not believe that earnings growth will be as high as 11.0%.

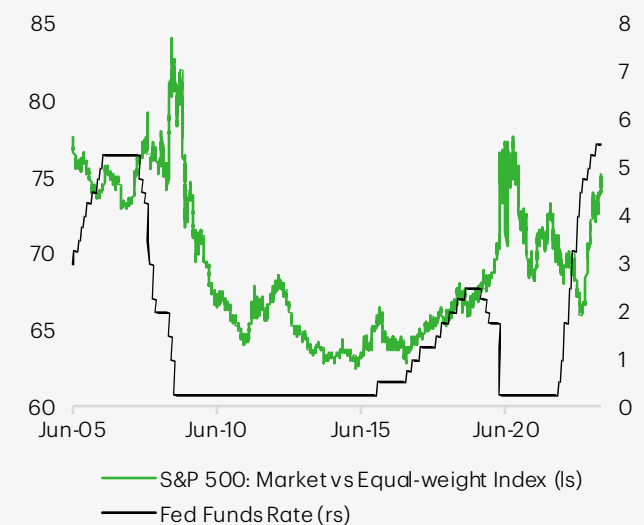
Roughly two-thirds of the gain in S&P 500 this year has been driven by seven names that account for about 30% of the index, while the remaining 70% of the index has delivered mainly mid-single-digit returns. This is consistent with historical periods of Fed tightening, where quality and growth companies tend to outperform smaller and riskier names. In fact, this outperformance could extend further if a recession occurs and investors move to companies with strong balance sheets and defensible earnings growth, which happened during the global financial crisis and the covid-19 pandemic (Figure 2).

Figure 1: Canadian equities trading at a discount



Source: FactSet, WIO as of September 30, 2023

Figure 2: Flight to quality leads to concentration

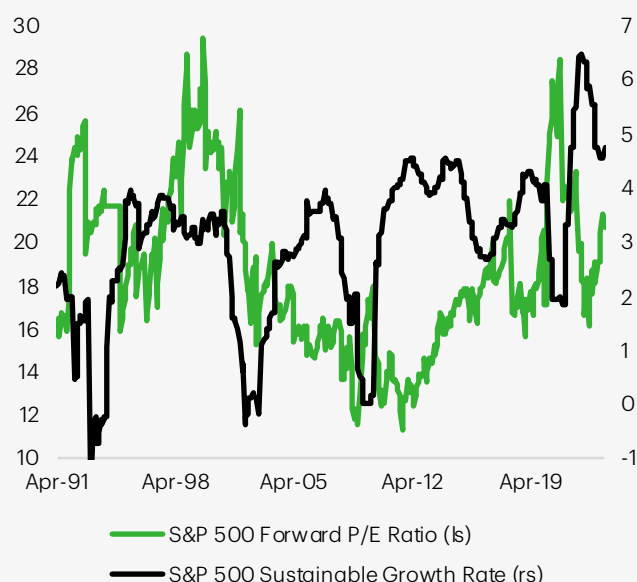


Source: FactSet, WIO as of September 30, 2023

While valuations on the S&P 500, remain somewhat elevated, it is influenced by the large contribution from high-growth, large-cap names in the technology space. This is an instance where it's crucial to look beneath the surface - the domination of the global internet advertising space by Google and Meta, and of the e-commerce space by Amazon, the cloud space by Microsoft and Google, and smartphones by Apple — all of which drive higher earnings growth and may justify a premium valuation.

Given the current payout ratio and return on capital for U.S. stocks, we estimate sustainable growth to be around 4.7% — slightly above the nominal GDP growth trend and roughly 100 bps higher than the historical average (Figure 3). This could be partially explained by the excess margin earned after the pandemic, as U.S. consumers spent their excess savings, and the fact that wage growth has only barely caught up with inflation.

Figure 3: Prices elevated despite middling growth rate

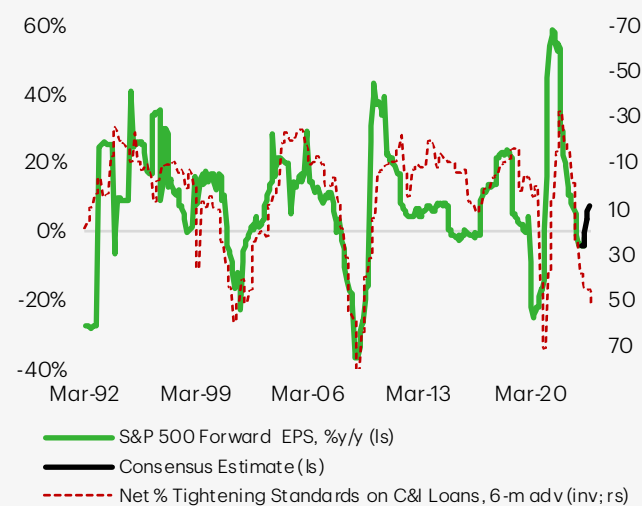


Source: FactSet, WIO as of September 30, 2023

Most analysts expect earnings for U.S. stocks to move higher by mid-single digits in the coming quarters. While earnings estimates for 2024 may be too high as the economic picture remains uncertain, the outlook for the U.S. economy is improving and consensus is shifting to a higher likelihood of a soft landing as the U.S. diverges from the rest of the world, most of which is more challenged for a variety of reasons. We believe U.S. equities will benefit in this environment, particularly companies with positive growth profiles, strong balance sheets and reasonable valuations, 'growth at a reasonable price'.

Following a sharp rally in cyclical and growth sectors, valuations for defensive sectors are becoming more attractive, while info-tech and consumer discretionary are becoming less appealing (Figure 5). Consumer staples and utilities, for instance, have flipped from two of the most expensive sectors early this year to a relative bargain. Energy and materials continue to screen positively, while financials and industrials now look more attractive relative to the broader benchmark.

Figure 4: Earnings estimates defy tightening trend



Source: FactSet, WIO as of September 30, 2023

Figure 5: Defensive sectors flip to bargain levels

	Current		Jan-23	
	Relative Forward P/E (rs)	Percentile	Relative Forward P/E (rs)	Percentile
Info Tech	1.43	93%	1.28	72%
Consumer Discretionary	1.26	70%	1.33	77%
Communications	0.92	47%	0.82	27%
Healthcare	0.92	43%	0.96	56%
Financials	0.72	18%	0.78	40%
Materials	0.89	18%	0.79	7%
Industrials	0.95	16%	1.17	85%
Utilities	0.85	15%	1.12	92%
Consumer Staples	0.99	15%	1.26	97%
Energy	0.59	7%	0.47	2%

Source: FactSet, WIO as of September 30, 2023

## Seasonality: Investors looking for Santa

“Seasonality” refers to the tendency for markets to perform better or worse over specific times during a calendar year. There are several drivers of investor behaviour that generate seasonal patterns in the market. These include quarterly reporting expectations, registered account contribution deadlines, tax season, and even self-reinforcing beliefs such as “Sell in May and go away.” This old saying was popularized by the *Stock Trader’s Almanac*, which promoted a “best six months” trading strategy that says the best time to be invested in the market is November to April.

The fourth quarter of the year has perhaps the most famous (and festive!) seasonal pattern: the Santa Claus Rally, which suggests markets have a positive bias during the holiday season. In the accompanying charts, we examined the realized monthly performance over the past 16 years — since and including the depths of the global financial crisis — for four major stock-market indices (Figure 6).

We looked at four stock-market indices: the Nasdaq Composite; the broader (but still tech-heavy) S&P 500; the Wilshire 4500 index, which includes virtually all companies trading in the U.S. *other than* the S&P 500; and the S&P/TSX Composite Index. The charts show the percentage of time each index closed positively during each calendar month over the time series, with the fourth quarter outlined in red.

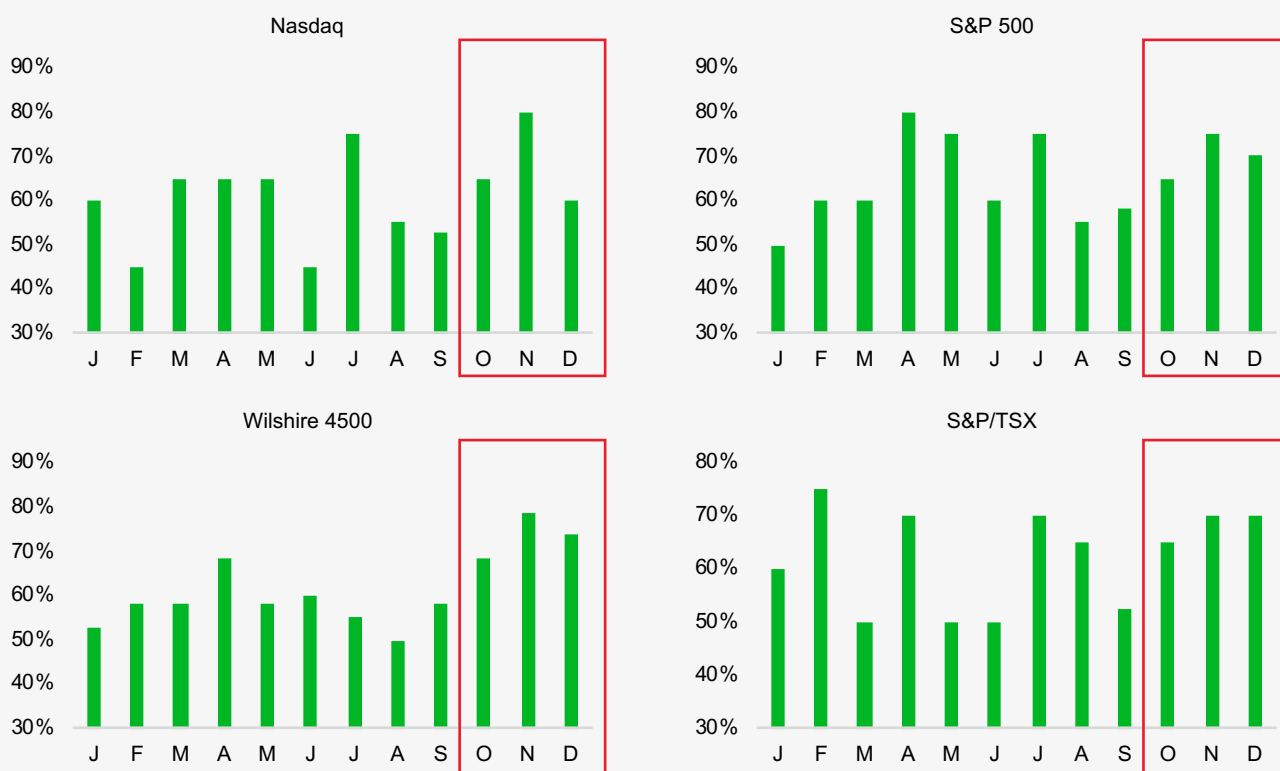
In each case, the seasonal trading patterns show relative weakness later in the third quarter, with September weak across the board. After September, however, markets have done better through the end of the year. November has been the strongest for U.S. stocks and this follows through to December for the broader U.S. market, although technology stocks tend not to participate as much.

Canadian stocks appear to be gearing up for a strong finish, going from a 50/50 proposition in September into a fourth quarter that has won around 70% of the time. Depending on the timing and impact of expected tax-loss selling, Canadian investors will be looking for a visit from Santa to end what has been a challenging yet profitable year (so far) for North American equities.

## Sector Analysis

Energy: Tight market supports oil over \$80. Our overweight energy strategy, having dragged for most of the year, has worked out well since the end of June. The decision by OPEC and its allies to extend their supply curbs, along with relatively strong Chinese demand, lifted the price of WTI back above US\$85 per barrel in the third quarter. This boosted the outlook for operating margins in the coming year, which should continue to support valuations for energy stocks.

Figure 6: Percentage of times stock index has closed higher in the month than it opened (since 2008)



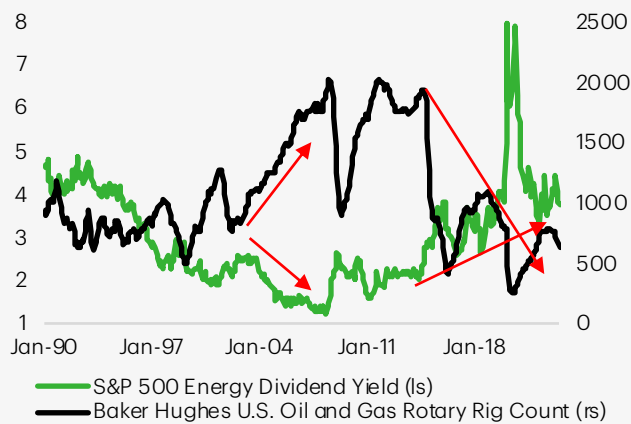
Source: FactSet, WIO as of September 30, 2023.

The sector is trading at 12 times forward earnings (at the 33rd percentile of the historical range), a 41% discount to the S&P 500. Meanwhile, North American operators remain disciplined in their capital allocation (Figure 7), preferring to focus on returning cash to shareholders (sector dividend yield of 3.1% as of September 2023) rather than capital expenditures for suboptimal returns.

There are signs, however, that the elevated oil price is accelerating the transition towards electric vehicles and green energy infrastructure, which could bring forward the timeline for peak oil demand. In the shorter term, we remain cautiously bullish on energy prices.

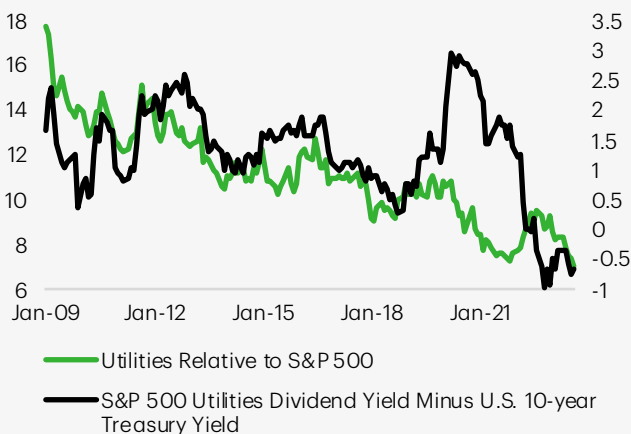
Utilities: Under pressure from higher yields. Utilities are among the worst performers this year, and we have been underweight. With borrowing costs on the rise, the high-leverage nature of utility operators will present a headwind for earnings in the sector. Not only have they seen a dramatic increase in their debt/asset ratio, but their dividend yields remain uncompetitive for investors needing income. For example, the average utilities dividend yield, at 3.5%, is well below the U.S. 10-year Treasury yield, at 4.4% (Figure 8).

Figure 7: Energy companies raise dividends, not capex



Source: FactSet, WIO as of September 30, 2023

Figure 8: Utilities fall as rates rise



Source: FactSet, WIO as of September 30, 2023

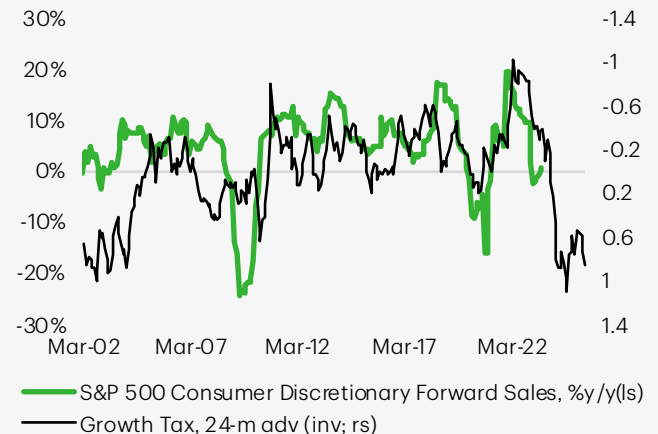
We could, however, turn more positive on the sector, if the dividend yield became more attractive and if growth conditions began to deteriorate at a faster pace. On a positive note, valuations for the sector have improved materially compared to the beginning of 2023, with the forward earnings multiple falling from 19.7x (89th percentile) to 17.3x (66th percentile).

Consumer Discretionary: Cautious consumers. Valuations within the consumer discretionary sector remain rich, with the market-cap-weighted index heavily tilted towards Amazon (30% of the sector) and Tesla (17%). The rest of the sector is much weaker, with Home Depot and homebuilders rolling over after a strong start to the year. Meanwhile, the rest of the sector is tightly linked to the health of consumers (Figure 9). While the hard data confirms a still healthy US consumer, we are cautious on the sector given the elevated valuations and risk of slower consumer spending amid the drain in excess savings, student-loan repayments in October and impact of significantly higher interest rates over the past 18 months.

### International and Emerging Markets

The growth outlook for European economies is particularly bleak. The German composite PMI has been in contraction since July, with manufacturing activity contracting for 15 consecutive months and the service sector falling into contraction in August and September. Tighter monetary and fiscal policy, the war in Ukraine and high trade dependency with China — whose economic recovery this year has been disappointing given the crisis in its property sector and depressed consumer confidence — have all weighed on the region's economy. Within international equity, the outlook for Japanese stocks is much more optimistic. The Bank of Japan has maintained its ultra-loose monetary policy, despite inflation levels that have crept above target, and the country's growth profile remains robust.

Figure 9: Difficult business climate could impact sales



Source: FactSet, WIO as of September 30, 2023



All these factors are reflected in the divergence of performance and valuations across regional equity indices. Indices with more exposure to high-growing info-tech names, such as the S&P 500, saw higher valuations. Meanwhile, indices with more exposure to cyclical sectors (financials, discretionary industrials, energy, materials) are trading at a significant discount (Figure 10). For example, Canada's S&P/TSX Composite Index — 78% of which is composed of cyclicals — is being valued at only 12.4 times forward earnings.

In our last edition of the *PSQ*, we highlighted the way monetary policy in developed and emerging economies have diverged:

*“Whereas central banks in the U.S., U.K. and Europe are still expected to hike policy rates and hold rates at higher levels for some time, emerging markets’ central banks are either already cutting rates or are expected to do so very soon. For example, People’s Bank of China (PBoC) lowered its one-year loan prime rate by 10 bps in June while the Brazilian central bank is expected to cut its policy rate in August, as inflation there plummeted from 12% in June 2022 to below 4% as of early July 2023.”*

This theme has played out in the third quarter and will likely continue into the first half of next year. The PBoC cut its one-year loan prime rate by another 10 bps in August to 3.45%. The Brazilian policy rate has fallen 50 bps, from the peak of 13.25% to 12.75%. And other countries have followed suit — including Chile, which cut its policy rate by 175 bps to 9.5% in the third quarter. The easing of policy rates should help EM countries bolster their economic activity. This will likely lead the recovery in the current cycle, bolstered by Chinese policymakers’ efforts to reflate their economy (Figure 11).

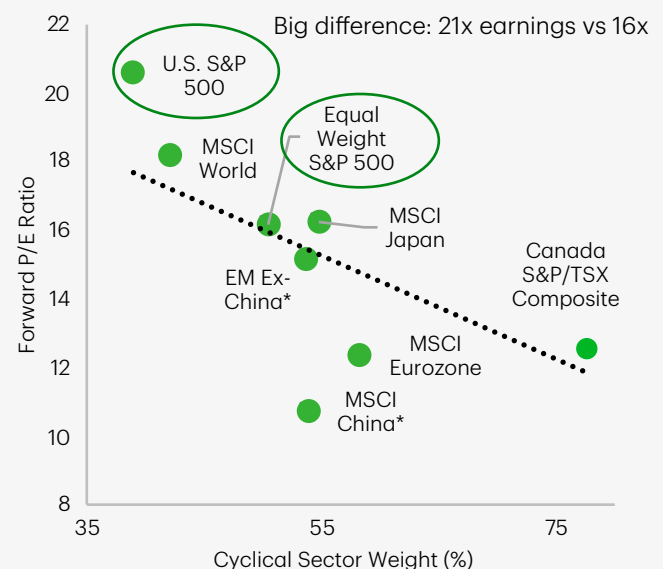
The near term outlook of EM stocks, however, is less straightforward. On one hand, the improving growth outlook should be a tailwind for equity earnings, while valuations could be re-rated as domestic policy rates continues to decline. On the other hand, weaker developed-market economies could mean less demand for raw material and goods sourced from EM countries, especially if a recession materializes.

Foreign exchange also plays an important role in emerging-market equity returns. Historically, the late stage of the economic cycle and tight global monetary policy have led to a stronger U.S. dollar, which is generally a headwind for EM countries. As such we have shifted to a neutral view of EM stocks over the near term.

## A final note on equities

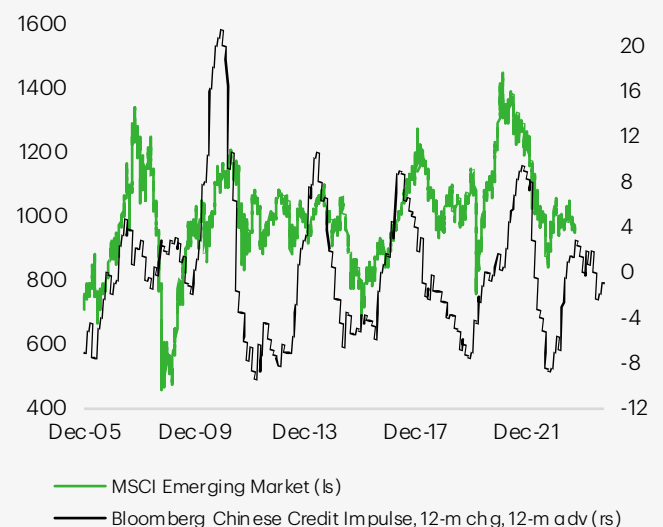
We believe that the recent pullback in equity markets has created a more balanced return outlook, particularly in the U.S. While earnings estimates for 2024 may be too high as the economic picture remains uncertain, the outlook for the U.S. economy is improving and consensus is shifting to a higher likelihood of a soft landing as the U.S. diverges from the rest of the world, most of which is more challenged for a variety of reasons. As such, we have recently moved from underweight equity to neutral, with an overweight in U.S. equities. □

Figure 10: Cyclical exposure has brought down multiples



Source: FactSet, WIO, as of September 30, 2023

Figure 11: Chinese stimulus could lead EM higher



Source: FactSet, WIO as of September 30, 2023.

# Outlook on Alternative Assets

## Infrastructure, Private Credit Still Interesting

Kenneth Sue, Senior Alternative Investments Analyst; Nadeem Kassam, Senior Equity Analyst | TD Wealth

We currently hold a neutral allocation to Alternative Assets. Overall, alternative assets provide inflation protection and attractive absolute returns, while acting as long-term portfolio stabilizers through their diversification benefits and less correlated income streams. Infrastructure continues to look interesting and could benefit specific portfolios.

Within the allocation, we are maximum underweight Domestic and Global Real Estate, although the attributes within different real estate sectors are quite mixed. Canada's growing demographic profile continues to support domestic residential real estate, particularly multiunit residential. Office properties however still face headwinds from leasing and valuation challenges as well as a flight to quality. Fundamentals remain sound across other property types.

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

As for infrastructure, we are modest overweight. Increases in cash flow from higher-than- expected inflation is protecting the asset class from rising interest rates. Investor appetite remains strong, particularly for energy transition investments and critical infrastructure sectors that generate stable, growing cash flows.

Our current allocation to Private Debt is modest overweight. High credit quality and global diversification offer a safety net in the event of recession. Incremental income and potential capital appreciation from interest rate moderation provide upside.

Figure 1: Real estate returns



Source: Nareit, CoStar, WIO as of September 2023.

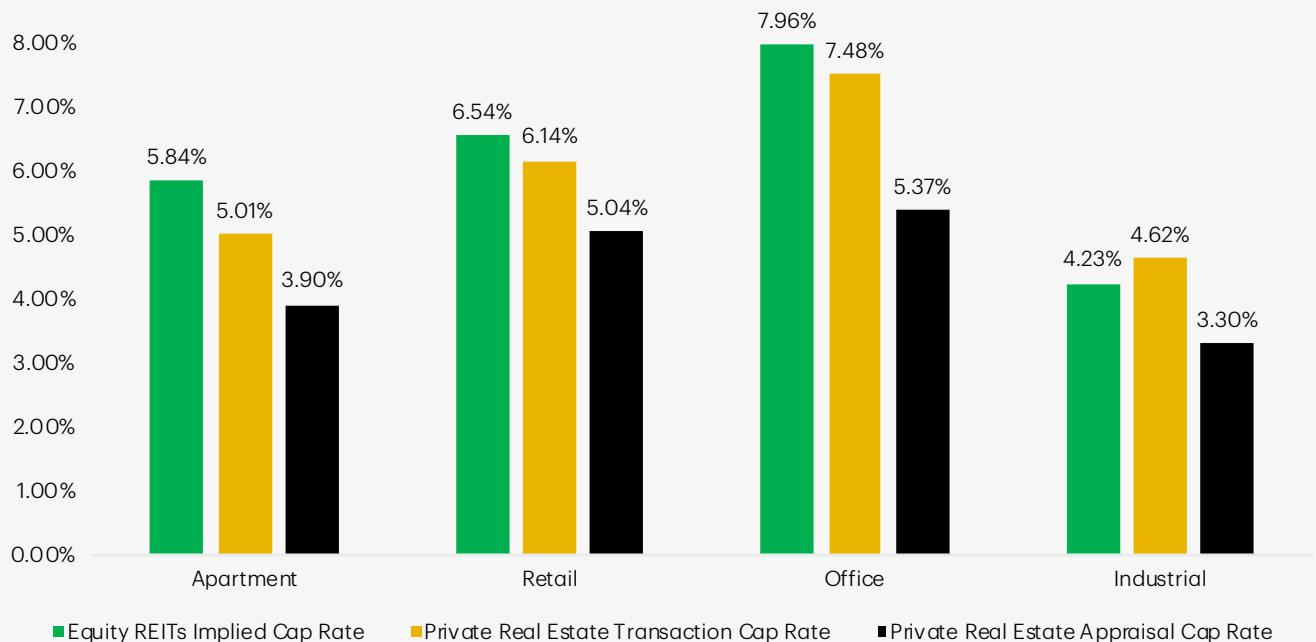
## Real Estate: Maximum Underweight

Within real estate, we are maximum underweight, both domestic and global. However, we would caution against the tendency to lump the sector into one big bucket. Instead, there are numerous differing categories that make up the sector. There is also the difference between public and private to consider (Figure 2). For instance, a comparison of public (REIT-implied) and private (transaction and appraisal) U.S. real estate cap rates at Q2 2023 for the four traditional property types — apartment, retail, office and industrial — demonstrates the great divide that exists between public and private real estate valuations. The gap between REIT-implied and transaction cap rates has closed in recent quarters due to changes in both REIT and private-market valuations. However, the spreads between REIT-implied and appraisal cap rates remain wide because property appraisals have been slow to adjust to current market conditions. Of the four property types, office has the largest differential at 259 bps. The differences for apartment, retail and industrial are 194, 150 and 93 bps respectively. Further material write-downs for the private real estate market are likely given that appraisal cap rates could rise. Closing the gap between REIT-implied and appraisal cap rates would require private valuation write-downs of 33%, 23%, 33% and 22% for the apartment, retail, office and industrial sectors respectively.

## Commercial Real Estate

The most influential factor for commercial real estate values, the U.S. 10-year Treasury bond, has seen rates rise above 4.5%, which is more than eight times higher than at the start of the hiking cycle and the highest level since before the Global Financial Crisis (GFC). Accordingly, deal making remains sluggish, with global investment volumes falling another 5% quarter-over-quarter (q/q) to US\$140 billion (bln), as per MSCI, marking a decade low in volume. With economists divided on the probability of a recession over the next 12 months, we anticipate a swift repricing of assets in the event of recession but if a recession is averted, the pace is likely to be more gradual. This expectation arises from the impact of higher interest rates on terminal values. While valuations have remained stable due to robust revenue growth—REITs have seen a 4.2% year-over-year (y/y) increase in funds from operations, according to Nareit—this pillar of support could start to show cracks if we go into recession. Within North America, the office sector remains under pressure. Vacancies averaged about 18-20% both in Canada and the U.S. as employers struggled to convince workers to return to the office. Europe and Japan remain bright spots, European vacancy rates remain below prepandemic levels and, in Japan, vacancies for major cities such as Tokyo came in at 4.9% and Osaka at 3.7%.

Figure 2: The difference between public and private cap rates

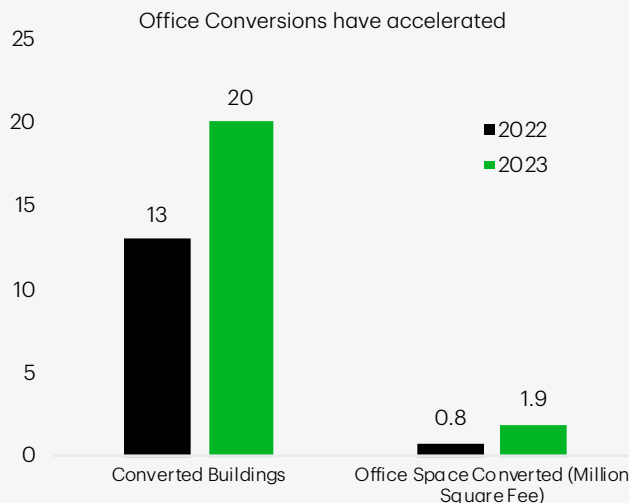


Source: Nareit, NCREIF ODCE Appraisal and Transaction Indices, WIO. Data as of 2Q23.

## Office and Industrial (Canada)

The national vacancy rate for Office edged up 10 basis points (bps) to 18.2%, aided by lower office deliveries and an increase in office conversions. About 2.8 million square feet (msqf) of office space has been removed from inventories since 2022, representing 0.6% of total supply. Conversions accelerated in 2023; in the first three quarters alone conversions were already double the total amount for 2022 (Figure 3). Most conversions have been centered around adapting older, less competitive buildings to residential use. Conversions are often difficult, as feasible buildings are limited, but government subsidies have played an important role. The city of Calgary for example provides incentives of up to C\$75 per square foot to convert office buildings. Class A office buildings were the exception and remained relatively sheltered; vacancies remained stable or even decreased for 9 out of 10 Class A office markets.

Figure 3: Office conversions in Canada on the rise



Source: CBRE, WIO September 2023

The Industrial sector in Canada is moving towards equilibrium with vacancy rates rebounding from all-time lows—they hit 2.5% in Q3 but remain below the 4.7% average rate of the past 15 years. The amount of new supply hitting the market is driving this rebound: 11 msqf was delivered in Q3, on pace to set a record-breaking year of 48 msqf of new industrial supply. Accordingly, rental growth has slowed, rising 11.8% year-over-year (y/y) to C\$16.36/sqf nationally, in line with growth rates prior to the pandemic. We expect vacancy rates and rental growth to move towards equilibrium as more supply comes online over the next 12 months.

## Infrastructure: Modest Overweight

Infrastructure returned 2% in Q2, bring returns to 3.8% by the end of H1 this year. Dealmaking continues to centre around Europe, the U.S., and the energy industry with the bulk of deals completed for less than US\$250 million. Interest rates remain an impediment to new core projects with investors favouring a higher yielding Core Plus strategy, or opportunistic projects. Fundraising—at US\$4.5 billion (bln) in Q2 compared with a US\$36 bln quarterly average over the past five years—is having trouble leaving the sluggish zone. Fundraising has declined to a pace not seen in a decade or so because investor appetite for infrastructure (which raised a record breaking US\$175 bln in 2022 when all other asset classes were in retreat) has largely been satiated.

## Private Credit: Modest Overweight

After peaking in January, banks have essentially flatlined new loan growth in the face of the uncertain economic outlook and regulatory scrutiny. The Federal Reserve, the Federal Deposit Insurance Corporation, (FDIC) and the Options Clearing Corporation (OCC) drafted a new regulation to address issues in the banking system exposed by the collapse of Silicon Valley Bank (SVB). The new proposal, which could take years to implement, expands regulations to cover banks with over US\$100 billion in assets, up from the previous lower limit of US\$250 bln. For reference SVB had US\$210 bln in assets before its collapse. According to industry estimates other regulatory changes are likely to affect risk weightings on bank capital: banks with US\$250 bln of assets or more could need 20% more capital and banks with assets of US\$100 bln to US\$250 bln may be required to hold 25% more capital. All of this means that banks are likely to continue to de-risk, creating more opportunities for private credit managers to step into the void, either by purchasing bank loans at a discount or stepping in as a lender creating a conducive environment, similar to post-GFC, for private credit to accelerate. Private Credit returned 2.81% in Q2, bringing total returns so far this year to 5.57%, according to the Cliffwater Direct Lending Index. Borrowers remain resilient: private middle market companies outpaced the S&P 500 revenue and earnings growth year to date. They expanded revenues by 8% and earnings by 13% y/y in Q3, based on the Golub Capital Altman Index. Given the continued retreat of banks and the resilience of borrowers, we believe Private Credit is well positioned for the future environment.

# Outlook on Currencies

## The higher they are, the harder they fall

TD Securities, Global Rates, FX & Commodities Strategy

Global markets are climbing the wall of worry again. What started as a conventional macro shift over the summer has morphed into a period of elevated uncertainty. Indeed, the handover to fall includes uncertainty around China's outlook, a sharp tightening of financial conditions and an unexpected aggressive bear-steepening of the U.S. yield curve. (Bear-steepening occurs when long-term rates increase at a faster rate than the short-term rates because investors want more compensation for increasing their term.)

Fixed income markets saw increased volatility, particularly in long rates. This oozed its way into other asset classes as well, part of which reflects the rise in term premia, helping to undermine the well-populated carry trades. And now geopolitical flashpoints have put the world on edge.

The rise of term premia has been a key driver of the malaise, likely reflecting Bank of Japan normalization, increased supply, inflation and central-bank dynamics. Barring a few outliers, like the Bank of Canada potentially, we think most of the major central banks are done hiking. Cuts are the next focus.

Our factor-based framework highlights the importance of relative terms of trade, carry, equities and fair value over the past few months. We think these factors should continue to drive currency markets, especially as U.S. data surprises ease in Q4 and the risks of a narrative disruptor grow.

**U.S. Dollar:** The USD has had a solid run in the past few months. Curve-steepening, and the backup in long-end rates have been a key ingredient. The market has repriced a higher-for-longer Fed.

While much of our macro-based quant framework remains long for the U.S. dollar, we're wary of projecting

that too far into the future. For starters, despite the near-term reaction to the tragic events unfolding in parts of the world, it's unclear that these flashpoints will have global macro implications. Oil remains relatively well contained now, but 2022 also showed us that emerging-market currencies can be the winners of a global terms-of-trade shock. What's more, the accumulation of shocks since the summer has shifted the Fed to the sidelines, directing us back to the data. Our leading indicators highlight some convergence of the U.S. and rest of world (ROW) story. Other tools show that the USD is a well-populated trade, which has also overshot the global macro backdrop. Much needs to go right for the U.S. or wrong for the rest of the world to validate pricing.

In turn, we continue to expect medium-term USD depreciation, highlighting some rebalancing of the global outlook and a shift in U.S. curve dynamics. We see the ROW stabilizing in 2024, aided by China, while the U.S. may slow into 2024.

### Positive Outlook for the Canadian Dollar?

The U.S. dollar performance and risk sentiment are the biggest factors driving the Canadian dollar. As noted above, we expect medium term U.S. dollar depreciation, dovetailing with some lift to the Canadian dollar, albeit any rally may be limited by more attractive alternatives within the dollar bloc currencies.

We believe the Bank of Canada will stay the course and hold the overnight rate at 5.0%. The key issue will be how the Bank attempts to reconcile a significant downgrade to its growth outlook with signs of more persistent inflation, which should preclude any change in tone. We look for the Bank to maintain a hawkish tone, with an emphasis on persistence of inflation / wage pressures and no change to forward guidance. □

Figure 1: Foreign exchange forecasts for G10 currencies

	Spot	2023	2024			
	October 17, 2023	Q4 F	Q1 F	Q2 F	Q3 F	Q4 F
USD/JPY	150	144	140	138	135	130
EUR/USD	1.06	1.08	1.10	1.12	1.15	1.18
GBP/USD	1.22	1.24	1.26	1.27	1.28	1.29
USD/CHF	0.90	0.91	0.89	0.89	0.88	0.88
USD/CAD	1.36	1.33	1.30	1.29	1.27	1.25
AUD/USD	0.63	0.65	0.67	0.68	0.69	0.72
NZD/USD	0.59	0.62	0.63	0.64	0.65	0.66
EUR/NOK	1270	1240	1214	1195	1166	1132
EUR/SEK	10.67	10.64	10.44	10.00	9.57	9.47
BBDXY	1220.00	1207.00	1176.00	1158.00	1147.00	1151.00

Source: TD Securities as of October 17, 2023

# Outlook on Commodities

## China pushes through headwinds

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

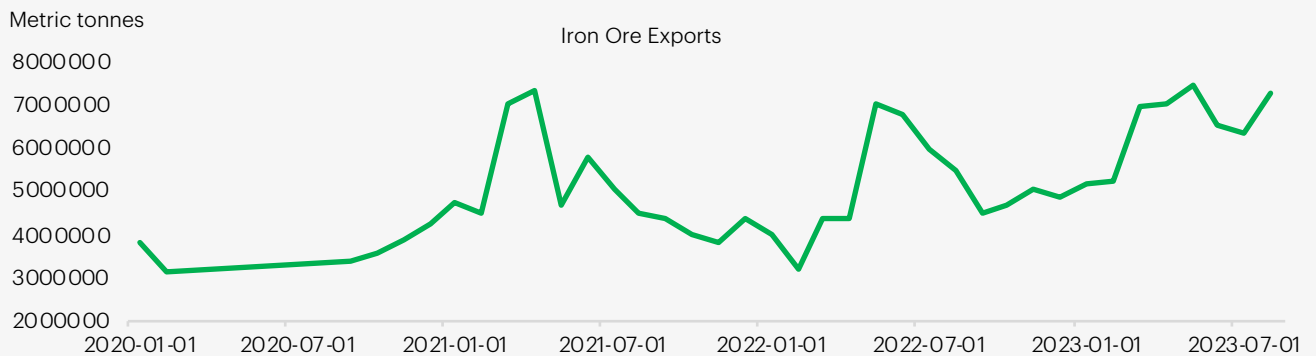
With the U.S. economy remaining more resilient than expected and Chinese activity and sentiment seemingly having bottomed in the middle of the year, commodities had a strong Q3 performance, gaining 4.7% (Bloomberg Commodities Index), while a traditional 60/40 portfolio (Blackrock 60/40 Target Allocation Fund) was down 3.6% over the same period — a significant outperformance of 8.3% and a demonstration of the value of commodities as a diversifying asset class.

At the macro level, the three major global economies are following their own paths, as a manufacturing recession continues to grip the EU while the broader economy does well, with gasoline demand hitting four-year highs and unemployment at record lows. The U.S. continues to be the strongest economy on almost all fronts, with employment firm, manufacturing resilient and fiscal stimulus continuing to work its way through the economy, most visibly through the record levels of factory construction planned and under progress across the country.

The unclear path that China has followed since its reopening continues to add uncertainty to commodity markets. At a broad level, Chinese activity and sentiment hit their lows around mid-year and have since improved to a more tepid level (Figure 1). Metals demand has followed along, supported by residential completion activity; however, this source of demand is expected to thin out on China's more structural real estate challenges. Focused policy support for EV manufacturing and grid infrastructure has helped to offset some of the lost metals demand from the residential sector. Declining metals prices through the first half of the year also helped to spur export demand from the region, especially India, providing a tailwind for the Chinese refining industry and helping to offset weaker domestic demand. High energy prices in the EU have also been to the benefit of China as EU domestic capacity is curtailed, substituted by imports from China.

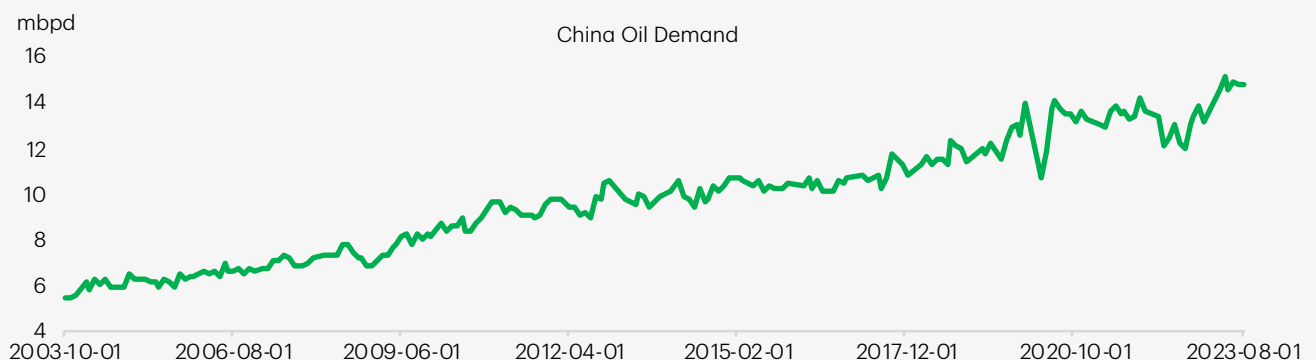
Energy demand has been on a much steadier recovery path than metals and manufacturing. Chinese oil demand continued to recover through the summer, hitting a new record high as travel returned to pre-Covid levels (Figure 2).

Figure 1: Chinese metal exports recover to tepid levels



Source: China Customs, TD Asset Management as of August 31, 2023

Figure 2: Chinese energy demand rises steadily



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



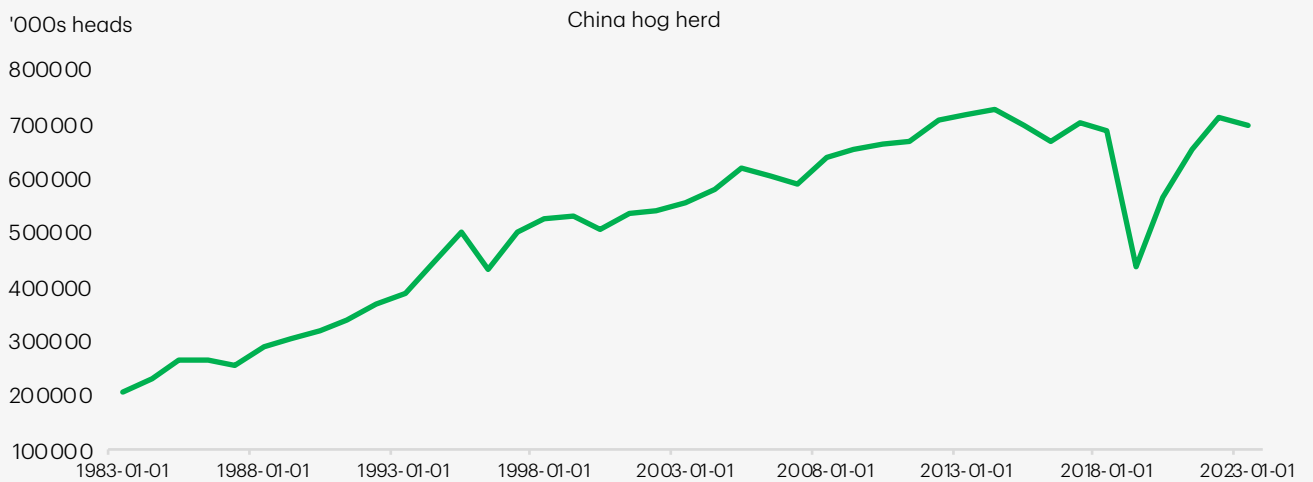
Agricultural data hints at the larger domestic challenges facing China, given that protein consumption — which is highly correlated with income and population growth — peaked a few years ago and has since started to trend lower (Figure 3).

Commodities were down through the first half of the year and, although they performed well in Q3, are still down 4.4% year-to-date (YTD) as the exuberance of the China reopening trade was met with a disappointing reality. The weakness has been mostly concentrated in the metals market, with the metal subindex down 13.8% YTD. Post-Covid economies have been characterized by an increased demand for services versus durable goods. Still, across commodity markets, the balance of supply and demand remains constrained, as evidenced by the number of commodities in “backwardation” (i.e., with a spot price greater than its future price, reflecting the market’s willingness to pay a scarcity premium for immediate delivery, Figure 4).

Weaker-than-expected demand, particularly in the manufacturing economy, and concerns about the forward growth outlook have proven to be headwinds for commodity prices, although the market structure has remained tight. Any improvement or synchronization in growth across the three major economies would be supportive for prices.

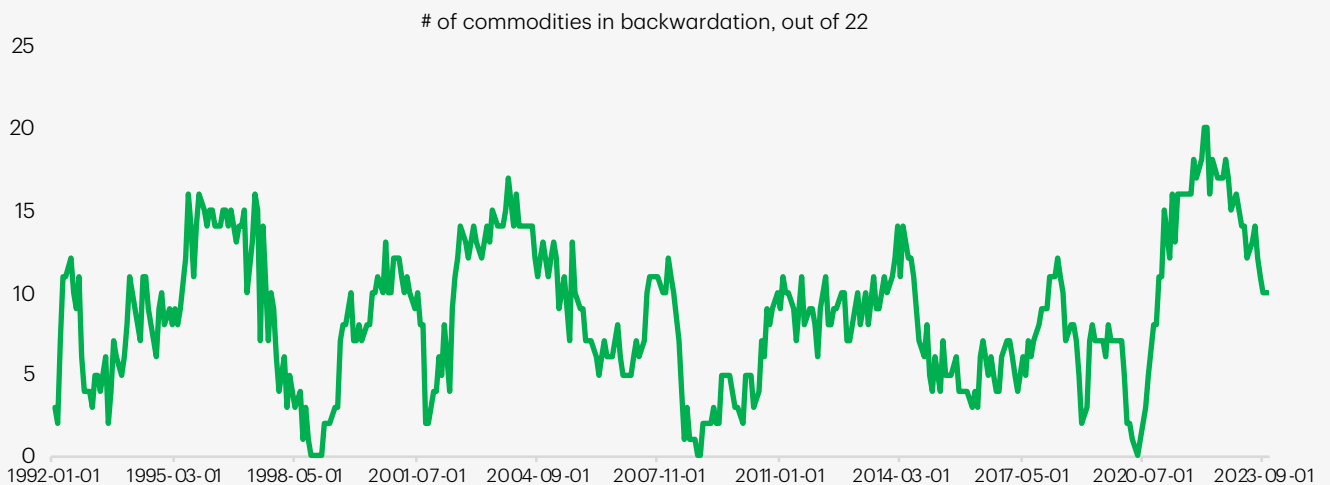
Geopolitics provides another tailwind for commodities as the risk for significant supply disruptions rises in step with tensions. Russia’s recent ban of diesel exports, albeit temporary, is evidence of not only the elevated geopolitical risks but also of the sensitivity to such risks as we navigate a world of tight balances. Oil also jumped sharply as the conflict between Israel and Hamas broke out, with the market having to price in various new risks, including crude trade-route disruptions, a conflagration in neighboring countries, or ideas that a softening stance on Iran, which has allowed Iran to increase crude production and exports, could all be undone. □

Figure 3: Chinese protein consumption peaks



Source: USDA, TD Asset Management as of September 30, 2023

Figure 4: High spot prices indicate tight supply



Source: TD Asset Management as of September 30, 2023

## Market Performance

		(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)
<b>Canadian Indices (\$CA) Return</b>	<b>Index</b>	<b>1 Month</b>	<b>3 Months</b>	<b>YTD</b>	<b>1 Year</b>	<b>3 Years</b>	<b>5 Years</b>	<b>10 Years</b>	<b>20 Years</b>
S&P/TSX Composite (TR)	77,738	-3.33	-2.20	3.38	9.54	9.88	7.27	7.54	7.95
S&P/TSX Composite (PR)	19,541	-3.70	-3.05	0.81	5.95	6.62	3.98	4.33	4.96
S&P/TSX 60 (TR)	3,805	-3.19	-2.55	3.03	8.75	10.08	7.71	8.14	8.29
S&P/TSX SmallCap (TR)	1,195	-5.24	-0.79	-1.11	7.17	10.03	3.85	4.04	4.06
S&P/TSX Preferred Share(TR)	1,576	1.44	-1.43	-1.28	-4.47	1.18	-0.93	0.72	1.89
<b>U.S. Indices (\$US) Return</b>									
S&P 500 (TR)	9,247	-4.77	-3.27	13.07	21.62	10.15	9.92	11.91	9.72
S&P 500 (PR)	4,288	-4.87	-3.65	11.68	19.59	8.44	8.03	9.81	7.57
Dow Jones Industrial (PR)	33,508	-3.50	-2.62	1.09	16.65	6.45	4.84	8.28	6.63
NASDAQ Composite (PR)	13,219	-5.81	-4.12	26.30	25.00	5.78	10.44	13.36	10.52
Russell 2000 (TR)	9,482	-5.89	-5.13	2.54	8.93	7.16	2.40	6.65	8.13
<b>U.S. Indices (\$CA) Return</b>									
S&P 500 (TR)	12,502	-4.85	-1.22	12.87	19.97	10.65	10.88	15.02	9.73
S&P 500 (PR)	5,798	-4.95	-1.60	11.49	17.97	8.93	8.98	12.86	7.58
Dow Jones Industrial (PR)	45,305	-3.58	-0.55	0.91	15.07	6.93	5.75	11.28	6.64
NASDAQ Composite (PR)	17,874	-5.89	-2.09	26.08	23.31	6.26	11.40	16.51	10.53
Russell 2000 (TR)	12,821	-5.96	-3.11	2.36	7.46	7.65	3.29	9.60	8.14
<b>MSCI Indices (\$US) Total Return</b>									
World	13,053	-4.28	-3.36	11.55	22.58	8.60	7.80	8.84	8.50
EAFE (Europe, Australasia, Far East)	9,679	-3.37	-4.05	7.59	26.31	6.28	3.74	4.32	6.39
EM (Emerging Markets)	2,447	-2.57	-2.79	2.16	12.17	-1.34	0.94	2.45	7.67
<b>MSCI Indices (\$CA) Total Return</b>									
World	17,648	-4.36	-1.31	11.36	20.92	9.09	8.74	11.86	8.51
EAFE (Europe, Australasia, Far East)	13,087	-3.45	-2.01	7.40	24.60	6.76	4.65	7.21	6.39
EM (Emerging Markets)	3,308	-2.65	-0.73	1.98	10.65	-0.89	1.82	5.29	7.68
<b>Currency</b>									
Canadian Dollar (\$US/\$CA)	73.96	0.08	-2.08	0.18	1.37	-0.45	-0.87	-2.70	-0.01
<b>Regional Indices (Native Currency, PR)</b>									
London FTSE 100 (UK)	7,608	2.27	1.02	2.10	10.36	9.05	0.26	1.65	3.15
Hang Seng (Hong Kong)	17,810	-3.11	-5.85	-9.97	3.41	-8.77	-8.51	-2.47	2.33
Nikkei 225 (Japan)	31,858	-2.34	-4.01	22.09	22.83	11.17	5.72	8.22	5.85
<b>Benchmark Bond Yields</b>		<b>3 Months</b>		<b>5 Yrs</b>		<b>10 Yrs</b>		<b>30 Yrs</b>	
Government of Canada Yields		5.13		4.25		4.03		3.81	
U.S. Treasury Yields		5.46		4.61		4.57		4.70	
<b>Bond Indices (\$CA Hedged) Total Return</b>	<b>Index</b>	<b>1 Mo (%)</b>	<b>3 Mo (%)</b>	<b>YTD (%)</b>	<b>1 Yr (%)</b>	<b>3 Yrs (%)</b>	<b>5 Yrs (%)</b>	<b>10 Yrs (%)</b>	
FTSE TMX Canada 91-day Treasury Bill Index	444	0.42	1.22	3.39	4.43	1.79	1.66	1.21	
FTSE TMX Canada Universe Bond Index	1,036	-2.62	-3.87	-1.46	-1.36	-5.14	0.05	1.64	
FTSE TMX Canada All Government Bond Index	976	-2.91	-4.44	-2.19	-2.40	-5.88	-0.35	1.36	
FTSE TMX Canada All Corporate Bond Index	1,250	-1.77	-2.22	0.69	1.69	-3.05	1.19	2.43	
Bloomberg U.S. Corporate High Yield Bond Index	264	-1.23	0.32	5.32	9.82	1.28	2.17	3.78	
Bloomberg Global Aggregate Bond Index	239	-1.77	-1.95	0.63	1.54	-3.99	0.18	1.71	
JPM EMBI Global Core Bond Index	460	-2.97	-2.87	0.42	8.91	-5.55	-1.34	1.82	
<b>Credit Suisse (\$US) Total Return</b>	<b>Index</b>	<b>1 Month</b>	<b>3 Month</b>	<b>YTD</b>	<b>1 Year</b>	<b>3 Year</b>	<b>5 Year</b>	<b>10 Year</b>	
Credit Suisse Equity Market Neutral USD	306	0.67	0.52	3.58	7.69	4.05	1.91	1.84	
Credit Suisse Event Driven USD	800	0.10	1.46	5.72	7.55	7.10	3.86	3.02	
Credit Suisse Global Macro USD	1,311	1.44	0.15	-6.10	-12.45	8.12	6.63	4.64	
Credit Suisse Hedge Fund USD	762	0.33	1.81	3.71	4.66	6.47	4.77	4.08	
Credit Suisse Long/Short Equity TR USD	931	-0.88	0.36	6.49	12.46	5.38	4.19	4.79	
Credit Suisse Managed Futures USD	409	3.77	2.77	0.62	-2.83	11.15	6.76	4.78	

Source: TD Securities Inc., Morningstar®, TR: total return, PR: price return, as of September 30, 2023.

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