

## TD Wealth Asset Allocation Committee (WAAC) Overview

- Volatility likely to rise, driven by central bank tightening, a closed output gap, fear of rising inflation and heightened trade frictions
- Central banks transitioning policies from emergency to neutral, but expect lower for longer rate environment to continue
- Neutral rating in equities reflects strong corporate fundamentals offset by quantitative tightening in the U.S. and slowing growth globally
- We anticipate protracted conflict between China and the U.S. on issues of trade and technology leadership
- Cautious on the Canadian dollar due to elevated household debt and the risk of slower rate increases from the Bank of Canada versus the U.S. Federal Reserve

Over the past quarter, investors experienced a "tale of two markets". North American markets experienced strong performance, while international, particularly emerging markets and China, have retreated. The uptick of volatility in international markets has been largely attributable to developments out of Turkey, signs of economic deceleration in China and Europe and ongoing trade frictions between the U.S. and China, and the U.S. and Europe.

The Turkish lost more than 35% of its value against the U.S. dollar this year after U.S. President Donald Trump announced a doubling of steel and aluminum tariffs on Turkey. In response, Turkey retaliated with their own increased tariffs on some imports from the U.S. including passenger cars, alcohol and tobacco. This has prompted concerns that Turkey's economy, which is heavily reliant on foreign currency loans, could affect other emerging markets. Markets have calmed since the initial tariff announcement. We believe the risk of contagion from Turkey is low as its



challenges, including very high current account deficits; low foreign exchange reserves, a weak central bank and erratic policy making are not widespread.

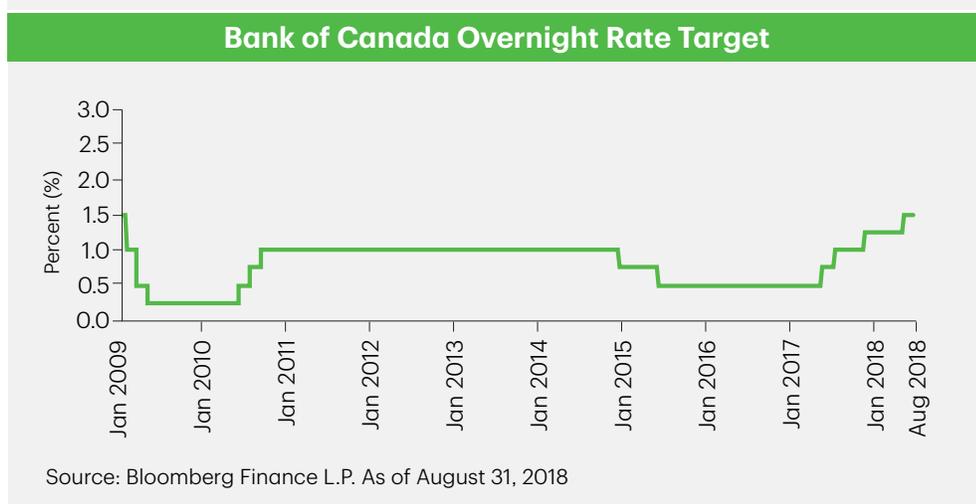
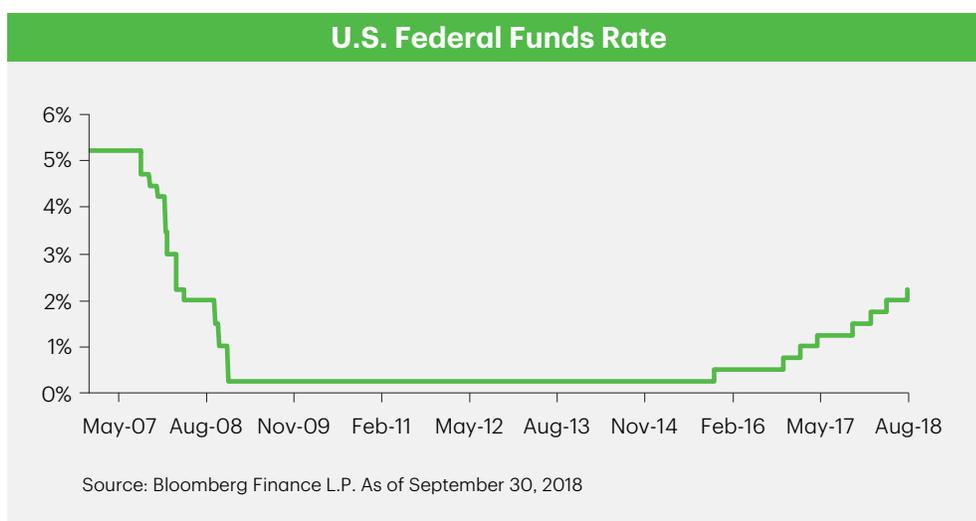
In North America, Canada and the U.S. have ended weeks of intense negotiations and announced a tentative new trilateral trade deal with Mexico that includes some key concessions on issues of import to both countries — and also a reworked name: the United States-Mexico-Canada Agreement (USMCA). Initial reports say the new deal gives U.S.

farmers new access to the dairy market in Canada, but preserves a dispute-resolution system the United States wanted removed. This is positive news for Canada and, assuming ratification, removes one of the overhangs that has led to the significant underperformance of Canadian equities versus U.S. equities of the past two years. Although trade frictions in North America may be subsiding, we expect these frictions between the U.S. and China to be elevated for some time and remain a concern.

The U.S. Federal Reserve (Fed) raised rates during its June and September policy meetings and signaled that they continue to view gradual interest rate increases as appropriate provided the economy evolves in line with its expectations which include a strong economy and labour market. For now this continues to be the case. Outside of North America, markets are gradually pricing in reduced stimulus from central banks in both Japan and Europe, but at a later date.

In Canada, the Bank of Canada increased its target for the overnight rate to 1.5% in July. The central bank has raised its rate 4 times since last summer with the economy heating up, the job market doing well, and inflation inching higher. Poloz has emphasized that he remains unworried about inflation, even though the Consumer Price Index jumped to the outer limit of the Bank of Canada's comfort zone in July.

Overall, the economic picture in North America is stronger than the global outlook. The U.S. economy is proving stronger than expected, and has started to show a divergence in growth versus the rest of the world. Global Purchasing Manager Indices (PMIs) remain in positive territory, but are deteriorating. Capacity utilization in the U.S. and Canada continues to edge higher with the output gap closed and these nations performing above their potential. A robust U.S. economy is reinforcing market expectations of higher policy rates and an increase in the value of the U.S. dollar. This is also contributing to financial stresses in some emerging market economies.



## WAAC Positioning

On the whole, global growth still looks healthy and corporate earnings are performing strongly. We continue to believe that the themes of rising yields, central bank tightening, and fears over heightened trade frictions are likely to persist, potentially leading to greater volatility in the coming months.

Overall, we retain our neutral mix between fixed income and equities, however, we have made several changes to this mix over the past quarter which is included in the commentary below.

We believe a balanced approach is warranted and favour a diversified portfolio that includes:

1. High quality equities that may have the ability to increase their earnings and dividends in a low-growth environment, thereby helping to protect the real value of investors' savings
2. An allocation to cash to help provide stability and safety of capital
3. An allocation to high quality domestic government bonds and investment-grade corporate bonds to help provide some income, diversification and stability

## Equities

- Neutral Canadian equities
- Modest overweight U.S. equities
- Modest underweight international equities
- Neutral emerging market equities

Over the past quarter, global equity markets were mixed with U.S. markets posting gains and international markets retreating, particularly in China and emerging economies. U.S. equities hit an all-time high in August 2018 as strong economic growth continues on the back of the Trump administration's fiscal stimulus. Headwinds such as potential missteps by the Fed, inflation spikes and trade frictions still remain key risks that we will continue to monitor.

Within equities we have moved U.S. equities from neutral to modest overweight. Continued strong earnings growth, stagnant wage inflation and improved valuations are all contributing to a positive outlook for performance. We have also moved international equities from neutral to modest underweight. Ongoing trade frictions and the risks of more tariffs with China remain headwinds, and a strong U.S. dollar continues to place pressure on emerging market equities.

We remain neutral within Canadian equities. Despite strong Canadian equity market returns over the past 12 months, concerns around ongoing trade tensions and their impact on the growth of the Canadian economy still remain. Presently, household spending is being dampened by higher interest rates and tighter mortgage lending guidelines. Canada's reliance on cyclical, capital intensive sectors compared to high growth businesses in the Health Care

and Technology sectors also remains an ongoing challenge. Rising oil prices, however, can provide a boost in returns.

## Fixed Income

- Neutral cash, domestic government bonds, investment grade corporate bonds and inflation-linked bonds
- Modest underweight high yield bonds
- Maximum underweight global developed market bonds
- Modest underweight global emerging market bonds

Overall, our outlook for bonds hasn't changed and coupon-like returns are anticipated in the low single digits. We are neutral domestic government bonds as they can offer diversification, stability and modest income. Our view is also neutral for investment grade corporate bonds. Spreads have narrowed, but may still offer a yield advantage over government bonds and the economic backdrop is supportive for corporate health. Break-even rates, the difference between nominal and inflation-linked bonds, have been gradually rising, but are still reasonable from a historical perspective. Thus, our neutral rating has been maintained for inflation-linked bonds.

We have moved from maximum underweight to modest underweight in high yield bonds. With central banks tightening monetary policy and yields on government bonds on the rise, high yield bonds have benefited. Within the global developed bond space, we are currently maximum underweight, as low nominal and real yields in Europe and Japan are not very compelling. We have downgraded our position to modest underweight in the

global emerging market bond space. Emerging market debt has been hit by issues including rising interest rates, a stronger U.S. dollar, higher oil prices and the threat of a global trade war, and we feel that these factors will continue to weigh on these assets.

## Canadian/U.S. currency exposure

- Modest underweight the Canadian dollar vs. the U.S. dollar
- Neutral the U.S. dollar

The Canadian dollar has weakened recently, and we still expect it to underperform the U.S. dollar in 2018, driven primarily by differences in central bank policy rates and economic growth prospects. U.S. economic strength supported by fiscal policy, an easing regulatory framework, the Fed's continuous march to neutral interest rates and quantitative tightening generally provide a more muted bias towards the U.S. dollar trade weighted basket.

## Gold

- Neutral gold

We believe an allocation to gold can provide insurance in a portfolio against the risk of extreme outcomes. However, we do not currently believe that this insurance is currently required. ■

## TD Wealth Asset Allocation Committee

The TD Wealth Asset Allocation Committee (WAAC) was established to deliver a consistent asset allocation message and be the originating source for active asset allocation advice across TD Wealth. The committee has three prime objectives: articulate broad market themes, seek to provide macro-level asset allocation direction and help identify the major risks on the horizon.

### Committee Members:

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CEO & CIO, TD Asset Management Inc. and SVP, TD Bank Group

**Michael Craig**, CFA  
Vice President & Director, TD Asset Management Inc.

**Glenn Davis**, CFA  
Managing Director, TDAM USA

**Kevin Hebner**, PhD  
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U.S. Wealth Investment Strategist, TD Wealth

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