currentPERSPECTIVES

Emerging Markets Update

During recent weeks, news about emerging market ("EM") countries has dominated headlines. On January 22nd, weak Chinese manufacturing data triggered concern about growth in the world's largest emerging economy. One day later, Argentina announced its decision to let its currency slide, reflecting its weak fiscal status and low foreign exchange reserves. On January 28th, the Reserve Bank of India unexpectedly raised its policy rate by 25 basis points to fight persistent inflation. And on January 29th, the central banks of both Turkey and South Africa raised their policy rates to curb steep declines in their currencies. These events caused a setback in many EM equity markets (which were down 11% year to date through February 3, 2014, and down 15% from their highs last October).[1] In addition, they have led some investors to worry about contagion effects, similar to those experienced in the 1997-1998 EM crisis. While the recent slide in these EM markets has been notable and volatility may continue, we do not believe that there is a high risk of contagion as the greatest weakness has come from relatively small EM countries.

Fundamentally, the EM pressure we have witnessed to date has been confined to a small group of countries with glaring weaknesses, namely high inflation, high budget deficits and quite often weak government institutions. Collectively, the weakest EM countries (Argentina, Turkey, South Africa, Indonesia, India, Hungary and Poland) have large current account deficits, on average 3.2% of gross domestic product ("GDP"),[2] and represent only 7% of total global GDP. This is in stark contrast to the strongest EM countries (China, Taiwan, South Korea, Malaysia and the Philippines), which collectively have current account surpluses that average 5.7% of GDP and together account for 14% of global GDP. China, the largest EM country, has been slowing, but it's important to remember that it is slowing from elevated levels. The International Monetary Fund projects Chinese GDP growth of more than 7% in both 2014 and 2015, which are still strong levels, relatively speaking. In addition, in contrast to the mid-1990s, EM countries are supported by massive foreign exchange reserves (in aggregate a total of $7.7 trillion U.S.)[3] which provide a lot of ammunition with which to potentially stave off a crisis.

In our opinion, the main reason for the recent volatility in EM financial markets is changing monetary policy in the U.S. Since the financial crisis in 2008, several rounds of Quantitative Easing ("QE") programs caused sharp declines in EM interest rates, resulting in large increases in credit growth and strong domestic demand. Indeed, the abundant liquidity provided by the U.S. Federal Reserve (the "Fed") led EM currencies and equities higher as global investors sought yield, which was still relatively attractive. However, QE liquidity also resulted in significantly higher inflation in weaker EM countries. Today, the combination of a U.S. economic recovery and subsequent reductions in the Fed's QE program has started to pressure both EM currencies and equities. For now, the weaker EM countries are being forced to react by raising interest rates, either to support a falling currency (and attract foreign capital) or to tackle persistent high inflation and financial imbalances, which we believe will mean ongoing volatility in some EM equity markets and which contributes to TD Asset Management's low direct exposure to EM countries.

The modest amount of QE tapering in the U.S. ("decelerating easing" as we like to call it) has been more than offset by the continued highly accommodative policies in both Japan and Europe. In aggregate, global central bank balance sheets are still moving higher, currently approaching $9 trillion U.S., providing an enormous amount of liquidity support to the global economy and financial markets. In addition, the fundamentals of many developed economies, including North America and Europe, continue to improve. In light of these improving fundamentals and ongoing central bank liquidity, on balance we believe that developed markets will weather the gyrations in the weakest EM markets. As such, we maintain our long-held preference for equities relative to fixed income and for high quality North American equities over international and emerging market equities to help protect investors' real savings and income.

We continue to monitor and evaluate the risks and rewards around the globe and to assess conditions with the objectives and best interests of our clients in mind.

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[1]Source: Bloomberg Finance L.P. [2]Source for all GDP data: The World Bank. [3]Source: CIA World Factbook.