TD Asset Management

forward PERSPECTIVES

Risks from Abroad

Bruce Cooper, CFA
Chief Investment Officer, TD Asset Management
Chair, TD Wealth Asset Allocation Committee

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Risks from Abroad

In recent *forward Perspectives*, I've talked about the potential for lower investment returns and increased volatility. Since then, volatility has increased in currency and fixed income markets. In addition, as many equity investors felt first-hand during August, it also returned to stock markets after a notable absence, with the VIX index (a measure of implied volatility) at one point spiking to its highest level since February 2009. We at TD Asset Management (TDAM) expect bouts of higher volatility to continue, which may be a challenging turn of events for investors who have grown accustomed to the unusually low levels enjoyed over the past few years.

China and Europe have both contributed to the increase in financial market volatility, and we believe they will continue to contribute significantly in the future. In China, economic growth has slowed. In fact, with growth rates in electricity consumption, railway freight volume and fixed asset investment all decelerating, we believe that the economy has slowed meaningfully (in spite of the official figures released, which paint a rosier picture than we believe to be the case). We expect that growth in China will continue to slow as it confronts a series of structural and cyclical headwinds. Slowing growth in China is likely to have a number of side effects, including lower global growth (it has long been a key contributor), weaker commodity prices and volatility in currency markets.

While economic data out of Europe indicates a nascent recovery may be underway, the union of countries within the euro zone is showing signs of stress, most recently demonstrated when a Greek tragedy almost unfolded as the country struggled under its onerous debt load and its exit from the partnership seemed imminent. We think the euro zone is a potential source of volatility whether it stays together or not. If the union is to remain intact, significant reforms and adjustments will be required to correct imbalances between member countries, which could result in more volatility as changes are implemented and consequences realized. And if it fractures, then volatility will likely increase as officials determine how to unwind the partnerships and establish new trade regulations and currencies.

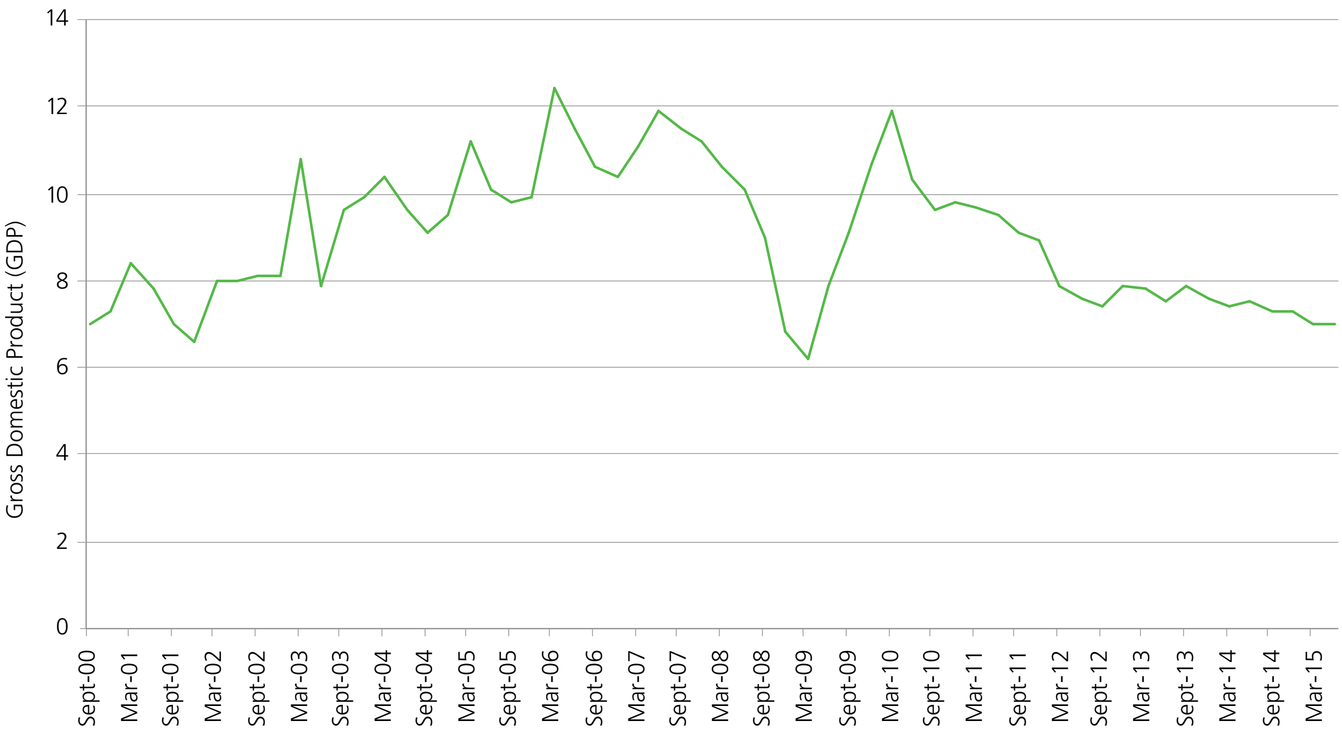
With global growth restrained by the effects of a Chinese slowdown as well as persistent sluggishness in Europe and the rest of the world, and with volatility re-entering financial markets, we continue to anticipate a period of more muted returns from financial assets along with higher volatility than we've experienced in recent years. We believe a diversified portfolio of high quality investments can help investors navigate these more turbulent waters, and continue to encourage investors to take a long-term view of their investments.

China: The growth engine is losing steam

China's economy has grown markedly during recent decades, driven most importantly by capital spending. Massive investment in infrastructure projects, real estate development and manufacturing caused the economy to boom, growing at an average rate of 10% in the 1990s and 2000s. China was a key engine of global growth during this period and accounted for roughly 25% of global growth since 2000[1].

Figure 1: Chinese Economic Growth

September 2000 - March 2015



Source: TDAM, Bloomberg Finance L.P.
As at September 1, 2015

Today, however, a combination of structural and cyclical headwinds have slowed growth significantly, and it is likely that these lower growth rates are here to stay. Demographics mean that China's working age population has peaked and will eventually start to decline. Very high levels of debt will likely depress growth, as they have elsewhere. Many industries, including the banking industry, are dominated by inefficient state-owned enterprises, and the pace of reform is likely to be glacial. Real estate markets, especially outside the largest cities, are oversupplied, and it may take considerable time for inventory to be worked off. Finally, the export sector faces the challenge of weakened markets in Europe as well as elsewhere in Asia.

Because of China's importance to the world economy, this slowdown will impact other countries as well as investors. Lower growth everywhere is likely to keep interest rates at unusually low levels for a prolonged period — a theme we have returned to repeatedly in recent years. Lower investment in China will likely reduce Chinese demand for raw materials, significantly impacting a range of commodities and the countries that produce them. Finally, an increase in currency volatility is possible if China continues to lower the value of the yuan, as it did recently in an effort to stimulate its economy.

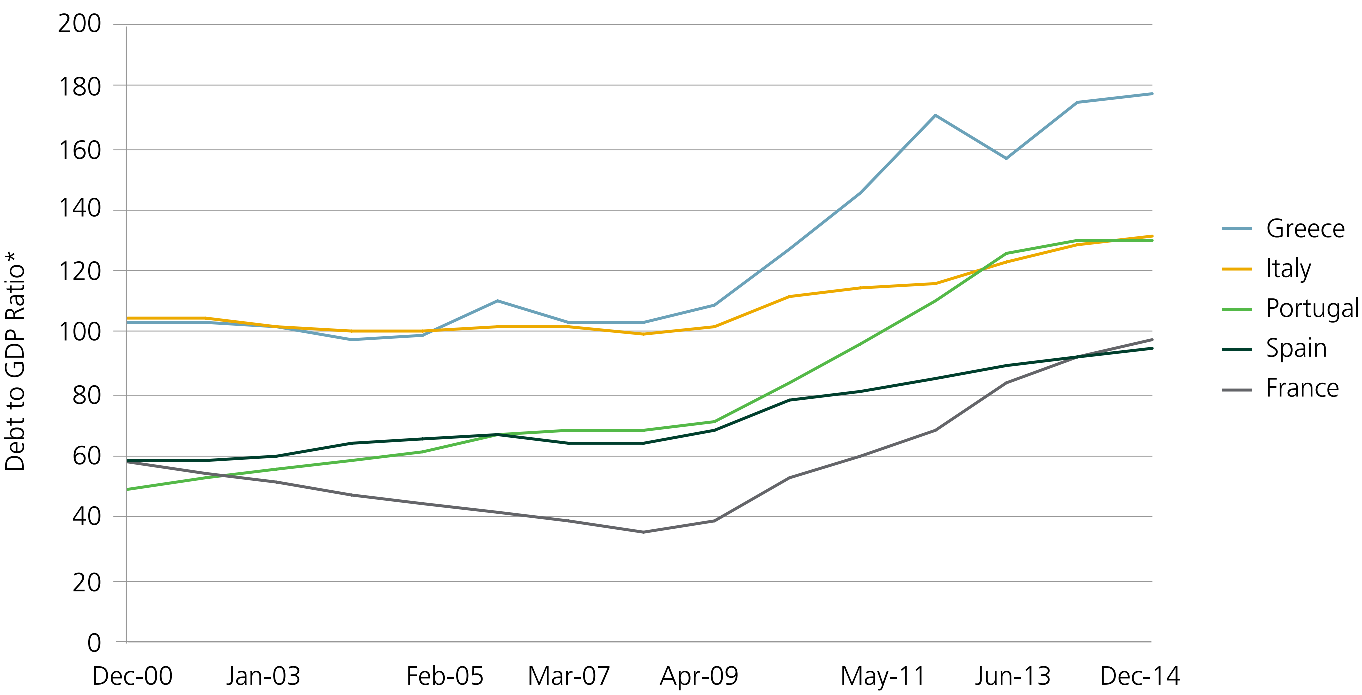
Euro zone: Unresolved imbalances

The euro zone comprises 17 countries, and growth rates, productivity levels and sources of political and economic stress vary widely among them. In 2015, some euro-zone countries, such as Germany and the Netherlands, showed signs of becoming impatient with the weaker ones. For example, as Greece tried to reach a deal with its European creditors, the Dutch Prime Minister (who had claimed during his election bid that he would provide "not one more cent for Greece") faced a non-confidence vote when he asked parliament to support another Greek bailout. In the end, he survived; the Netherlands agreed to support the bailout, as did other euro-zone countries; onlookers breathed a sigh of relief and some may even have shouted opa! (perhaps Greeks who had been limited to meagre ATM withdrawals while capital controls were in place). However, we believe it's premature for celebrations as a number of unresolved imbalances remain within Greece and the broader euro zone, creating the potential for further, and possibly long-term, volatility.

Greece is just one example of stresses that also exist in other euro-zone countries, including Spain, Portugal, Italy and France. Each of these countries has taken on substantial debt over the past few years, and while Greece's small size meant that its debt could have been absorbed by its creditors if a deal hadn't been reached, the other peripheral countries are much larger, and defaults in one or more of these countries would have significant detrimental effects.

Figure 2: Debt to GDP in peripheral Europe

December 2000 - December 2014



Source: TDAM, Bloomberg Finance L.P.
As at September 3, 2015
*Government debt as a percentage of GDP

Dealing with the imbalances within the euro zone is likely to be difficult. For example, while the European Commission bills the euro zone's single currency as a benefit, "eliminating fluctuation risks and exchange costs," eliminating 17 individual currencies and replacing them with the euro has rendered currency adjustment, a key economic rebalancing tool, obsolete. Usually when imbalances arise, the stronger country's currency will rise in value, making its goods and services more expensive, and the weaker country's currency will decline in value, making its goods and services cheaper. The market then adjusts accordingly, increasing the competitiveness of the weaker country, and the imbalance is rectified. However, because the euro zone uses a single currency, this is not an option.

Instead, the weaker country must take on more debt or restructure. Taking on additional debt allows the country to continue operating, but can slow economic growth and is not a sustainable solution over the long term as it will eventually lead the country into a debt spiral. Restructuring, on the other hand, can take a long time and can be politically challenging. Countries can reduce labour costs to improve competitiveness. However, lower wages would weigh on economic growth and could create political unrest — asking workers to accept lower wages is likely to lead to dissatisfaction and might spur the rise of left-wing political parties. If one of these parties came to power, they might choose to raise wages again, which would reduce the country's competitiveness and lead to the need to incur further debt, or they might choose to exit the euro zone, which would cause a great deal of disruption and markedly increase volatility, at least in the short term.

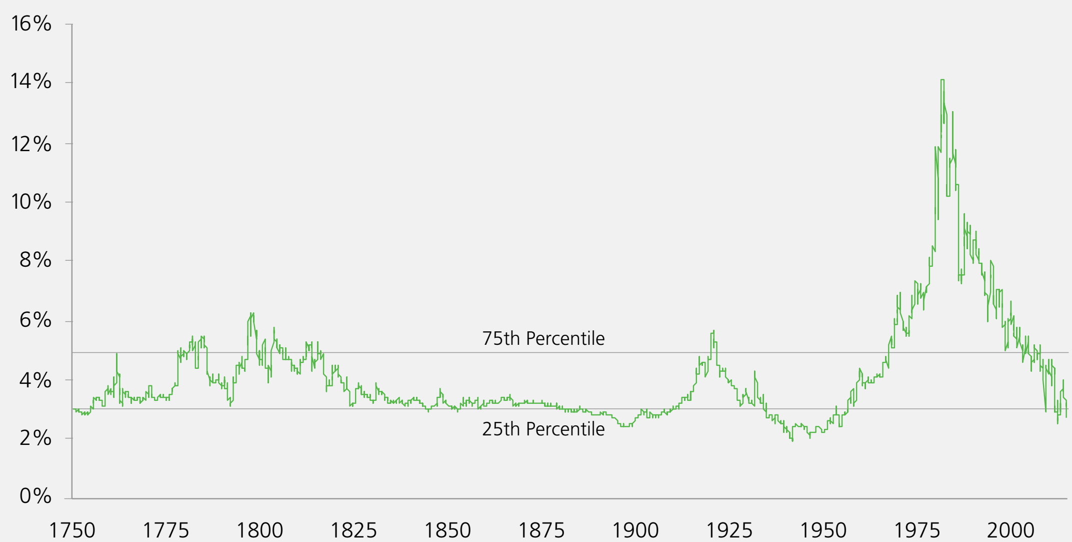
In addition, stronger countries within the euro zone may lose patience with the peripheral countries. As witnessed in both Germany and the Netherlands when the most recent Greek bailout was being debated, some within these stronger nations are growing weary of aiding weaker euro-zone members. If discontent expands, it is possible that the stronger nations may be less inclined to offer assistance and more inclined to agree to the exit of one or more of the weaker countries.

Our View

So what does all this mean for investors? For the past several years, one of the foundational beliefs behind our investment thesis has been that economic growth would be low, which has been the case. With Chinese demand for commodities diminishing, we anticipate that growth in commodity-producing countries (such as Canada, Australia and many emerging markets) will face their own growth challenges. With this, plus a number of other factors, weighing on already weak global growth, we anticipate a low-growth environment will persist for a prolonged period, and may well be exacerbated by the deflationary effects of elevated global debt levels, changing demographics and abundant supply. As a result, we also anticipate that the current low-yield environment will persist for a prolonged period. In fact, while investors may be hoping for a return to the heady yields of the past 30 years, there is a case to be made that those yields were exceptional and low yields can be expected for the long term as they are the norm (see figure 3 below).

Figure 3: Historical Interest Rates**

January 1750 - December 2014



Source: Bank of England, Federal Reserve Bank of New York. Data to December 31, 2014.
**Long-term bond yields; U.S. yields after World War I, U.K. yields prior.

With yields so low, many investors have broadened their portfolios, moved away from government bonds and turned to alternatives such as corporate bonds and equities to help them meet their needs. However, with volatility increasing and the landscape in both China and Europe likely to fuel further volatility, investors may be faced with a more uncomfortable journey than they've been used to. In this environment, we remain cautious — but not negative. We continue to encourage investors to take a long-term approach and believe that they can be well served by a diversified portfolio of high quality investments, including investment-grade fixed income (for stability and some income) and global equities (for currency diversification), and a focus on companies that pay consistent dividends and can increase their dividends over time. As always, 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.

About the author

Bruce Cooper, CFA
Chief Investment Officer, TD Asset Management
Chair, TD Wealth Asset Allocation Committee

About TD Asset Management (TDAM)

TD Asset Management (TDAM), is a North American investment management firm. Operating through TD Asset Management Inc. in Canada and TDAM USA Inc. in the U.S., TDAM manages over C$288 billion in assets as at June 30, 2015. TDAM offers investment solutions to corporations, pension funds, endowments, foundations and high net worth individuals. A cornerstone of the success of TDAM's investment strategies has been the firm's disciplined and risk-controlled approach to investing, along with its ability to innovate progressive solutions that help meet clients' changing needs and objectives.

In addition, under the TD Mutual Funds name, TDAM offers a diverse range of over 120 investment solutions including mutual funds, professionally managed portfolios and corporate class funds. TDAM manages retail mutual fund assets on behalf of more than 1.9 million investors and offers one of the most broadly diversified fund families in Canada, and its funds are available through authorized dealers. As of July 31, 2015, TDAM was the fourth largest mutual fund company in Canada,[2] with C$106 billion invested in TD Mutual Funds.

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