TD Asset Management

forward PERSPECTIVES

The Next Chapter: Lower Returns and Higher Volatility

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December 2014

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In the five years since the end of the financial crisis, economic growth in the developed world has been sluggish, with the U.S. posting real growth averaging around 2% and Europe frequently flirting with recession. Despite this persistent low growth environment, TD Asset Management (TDAM) has had a consistently positive outlook for equities, particularly versus fixed income. This outlook has rested on three key pillars: corporate earnings, monetary policy and equity valuations. As we look ahead to 2015, each of these pillars needs to be re-examined.

Past Expectations	Future Expectations
Strong corporate earnings growth	Modest corporate earnings growth
Favourable global monetary policy backdrop, particularly in the U.S.	Favourable global monetary policy backdrop, pause in the U.S.
Attractive equity valuations, particularly versus bonds	Reasonable equity valuations, particularly versus bonds

In terms of earnings, we anticipate that companies will continue to post gains, although we believe the pace of growth will slow. On the monetary policy front, the U.S. Federal Reserve (the Fed) recently announced the end of its third QE program, concluding the monetary regime we dubbed "decelerating easing" in the August 2013 edition of *forward Perspectives* ("Inflection Point"). We anticipate that the Fed will now pause for a considerable time until it is confident that the economic recovery has firmly taken hold. Finally, valuations remain reasonable, although not nearly as attractive as they were in the 2009-2013 period when multiples in the equity market were low as a result of the significant market decline during the great financial crisis.

All of this sets the stage for a period of more modest returns from financial assets. Investors have enjoyed a low volatility environment and robust returns over the past few years as bond yields declined to historical lows and stocks moved up from very low levels following the financial crisis. However, we would caution that returns going forward are likely to be more muted and volatility is likely to be more pronounced.

Increasing Volatility

Volatility – it's back, which is no surprise to investors who experienced October's market correction. Over the past five years, accommodative central bank policies and abundant liquidity helped to moderate volatility. For example, as of September 30, 2014, the Chicago Board Options Exchange Volatility Index (VIX) was 36% lower than on September 30, 2009. This means that over the past five years many equity investors were able to enjoy robust gains with relatively little volatility.

However, with the Fed pausing its accommodation, we expect overall volatility will increase. We don't expect it will return to the extreme levels witnessed during the financial crisis, but rather we expect it will normalize.

This means that while we do expect equities will provide positive mid-single digit returns over the long term, higher volatility is likely to make achieving those returns a bumpier ride than many investors have become used to.

In fact, increased volatility may mean negative returns from equities for short periods. In this environment, we believe that dividends will become a more important component of return, and we encourage investors to focus on long-term outcomes and to maintain a well diversified portfolio.

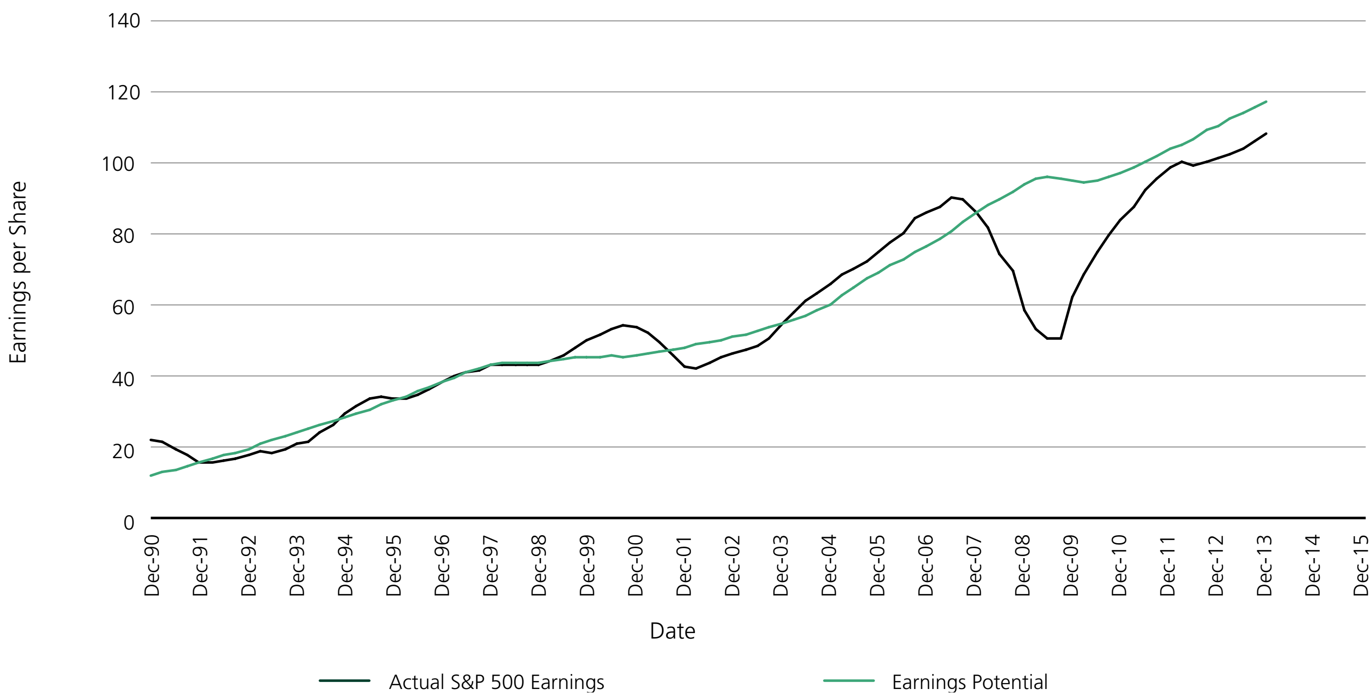
Pillar 1: Corporate Earnings

During the past five years, earnings have been strong in spite of weak economic growth. From their 2009 low to their anticipated 2014 level, earnings for the S&P 500 Index (S&P 500) have grown at a compound annual growth rate of 12%. In Canada, earnings on the S&P/TSX Composite Index (S&P/TSX) grew at a compound annual growth rate of 11% over the same period. Earnings were driven by a combination of modest revenue growth and impressive cost controls that took margins close to record highs, as well as lower financing costs and declining effective tax rates.

Over the long term, corporate earnings tend to grow in line with the economy, although they are much more volatile than economic growth. It is our view that, having fallen well below trend during the financial crisis, earnings have now almost fully recovered (as noted in Figure 1). In addition, the U.S. dollar has risen notably in recent months, and we believe that relative economic growth and structural advantages will continue to favour the U.S. dollar. This is likely to create a headwind for U.S. corporate earnings as the stronger dollar will have a negative effect on earnings that are generated outside of the U.S. (approximately 30% of S&P 500 earnings). Therefore, we expect that the earnings growth rate is likely to slow to the mid-single digits, tracking closer to revenues, which in turn are driven by the growth of the economy (represented by nominal gross domestic product, or "GDP").

Figure 1: Earnings Growth Trend

December 1990 - December 2013



Source: TDAM, Bloomberg Finance L.P.

Pillar 2: Monetary Policy

Despite record low interest rates, global economic growth has been slowing recently, particularly in Europe and the emerging markets, and forecasts for future growth have been revised downward. However, the U.S. economy, which continues to march toward recovery, is a relative bright spot. Recent notable data points there include strong third quarter GDP, rising durable goods orders and falling jobless claims.

Amid these improvements, monetary policy in the U.S. is largely unfolding as we expected, with the Fed gradually decelerating its QE program during the year and recently ending it. Now that QE has ended, we expect the Fed willpause and monitor economic progress without making changes to its monetary policy. Once the Fed is convinced that the economy is self-sustaining and no longer requires the support of the current emergency-level low rates, it may begin to very modestly raise the federal funds rate.1 However, we do not believe that it will move rates substantially higher in the near term. Over the past 15 years there have been two rate hike cycles; during these, on average, the federal funds rate rose 300 basis points over the course of 18 months. However, we believe that the Fed is likely to continue to hold rates at lower levels than in previous cycles because:

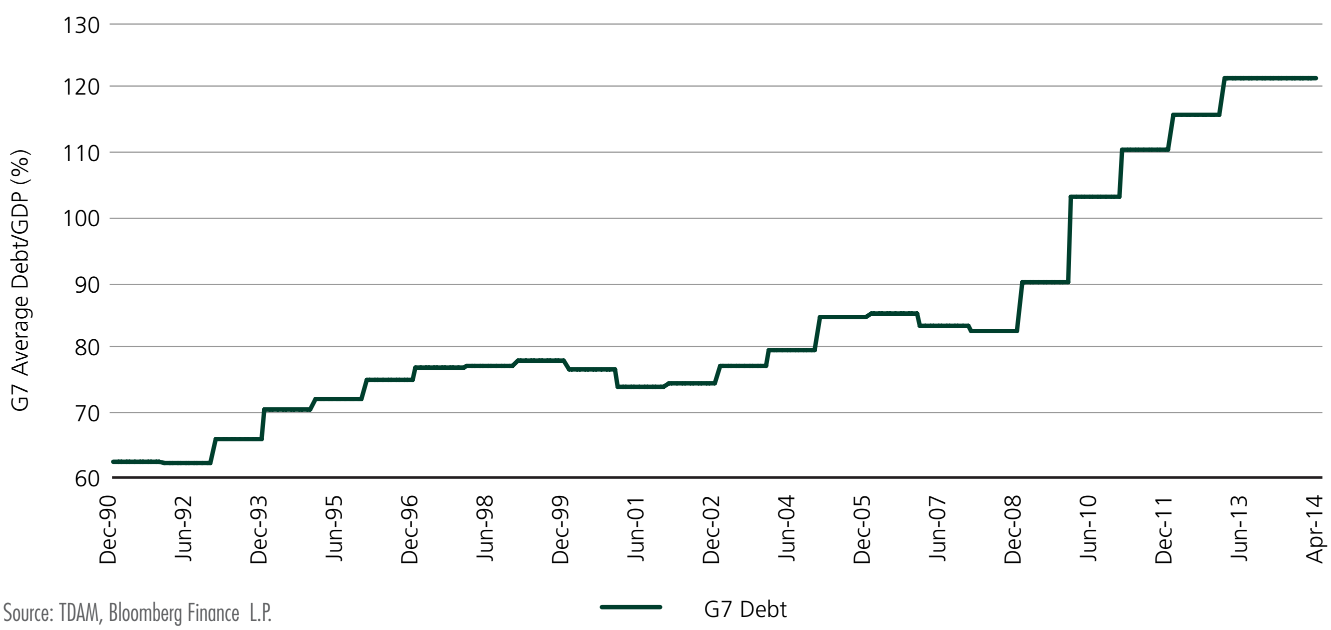
- debt levels are elevated
- the U.S. economy is not operating at full capacity
- the U.S. dollar is rising

Debt Levels

In the aftermath of the financial crisis, overall debt levels remain very high in spite of some household deleveraging in the U.S. (see Figure 2 for an illustration of government debt levels as measured by debt/GDP). If rates rose significantly, both governments and households would have to divert funds from other areas or raise deficit levels, which would slow the economy. This would likely lead to a self-correcting cycle in which the Fed would have to lower rates again in order to re-stimulate the economy. Therefore, we believe that these high debt levels will continue to restrain interest rate increases.

Figure 2: High Global Debt Levels

December 1990 - April 2014



Source: TDAM, Bloomberg Finance L.P.

Major Central Banks include the U.S. Federal Reserve, European Central Bank, Bank of Japan, Bank of England, Swiss National Bank, Bank of Canada, and Reserve Bank of Australia. Balance sheet assets converted to US$ at market prices.

Economic Capacity

While the U.S. economy and labour market are both improving, neither is operating at full capacity. TDAM estimates that the economy is operating below potential, and while we expect this output gap to narrow, we don't expect it to reach its historical average for some time. And while the unemployment rate in the U.S. has dropped significantly, the current 5.8% unemployment rate remains above what the Fed considers the normal range of between 5.2% and 5.5%. The Congressional Budget Office expects that it will be the final quarter of 2017 before this labour market slack is absorbed. As we argued in the last edition of forward Perspectives ("Inflation Trends", July 2014), with both the economy and the labour market operating below full potential, inflation should remain contained. This will allow the Fed to keep rates lower for longer.

U.S. Dollar

As we mentioned previously, the U.S. dollar has been rising recently, bolstered by a number of factors, including the U.S.' relatively strong economy, concern over deflation in Europe and, in the face of a variety of geo-political events, the greenback's safe-haven status, and we expect this strength to continue. Generally, a high U.S. dollar mimics the effects of rising interest rates – the cost of exports increases, the cost of imports decreases, and the economy often slows as a result. Therefore, with its focus on maintaining economic momentum, the Fed is unlikely to raise rates as much as it might if the dollar were weaker.

While the Fed will not be adding stimulus to the system now that it has ended QE, with it maintaining very low rates and the European Central Bank and Bank of Japan both firmly committed to accommodative policies, including asset purchase programs, we believe that monetary policy will continue to provide some support for equities.

Pillar 3: Valuations

In March 2009, the S&P 500 bottomed at 666. Given that earnings per share were $62, the market was trading at approximately 11x earnings at its bottom. Today, the S&P 500 is trading at roughly 16x estimated 2014 earnings while Canada's S&P/TSX is trading at roughly 15x. This multiple expansion from 11x to 15-16x has been a significant tailwind for equity investors. These current valuation levels are close to the long-term average and also close to what TDAM considers to be a reasonable level. Valuations are certainly not stretched, but we do not believe that investors should count on further multiple expansion. Rather, we expect that equity returns will be driven by earnings growth, which, as noted above, we expect to be in the mid-single digits.

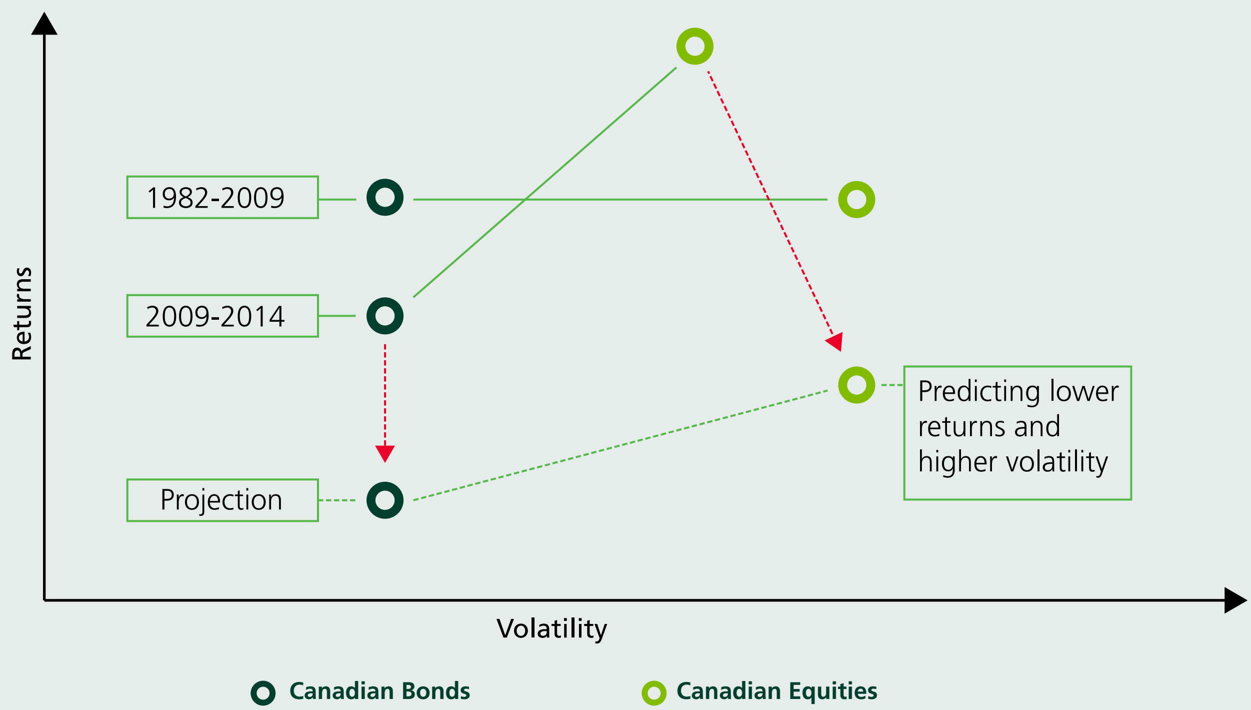
Our View

We expect that equities will outperform fixed income in 2015, and we believe equities will continue to provide positive long-term returns supported by mid-single digit earnings growth and stable valuations. The massive levels of liquidity being provided by global central banks and the rising economic activity in North America should continue to support the growth of company earnings and dividends. Overall, we anticipate that bonds will provide coupon-like returns. Therefore, we maintain our preference for an overweight allocation to equities over fixed income. However, equity investors should be aware that the period from 2009 to 2014 was characterized by higher returns and lower volatility than has been normal over longer periods. As illustrated in Figure 3 below, going forward we would expect returns to be more modest and volatility to rise to more normal longer-term levels. In this environment, investors will likely benefit from absorbing increases in volatility and looking through any potential pull backs with a focus on longer-term returns.

We remain watchful of slow global growth and the potential for deflation in Europe, and concern over these issues partially drives our geographic preference for North American equities over international equities. As always, we will 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.

Figure 3: Projected Return/Volatility Paradigm

Predicting lower returns and higher volatility



For Illustrative purposes only. Canadian equities represented by the S&P/TSX Composite Index. Canadian Bonds represented by the FTSE TMX Universe Bond Index. “DEX” bond indices have been re-branded to “FTSE TMX Canada”

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All data contained within this document is sourced from Bloomberg Finance L.P. unless otherwise stated. [1]If depository institutions hold excess funds at the Fed, they can lend them to other depository institutions. The federal funds rate is the interest rate the lender charges for these overnight loans, which is determined by the Fed's Federal Open Market Committee and is considered a key interest rate. The information has been drawn from sources believed to be reliable. Where such statements are based in whole or in part on information provided by third parties, they are not guaranteed to be accurate or complete. Graphs and charts are used for illustrative purposes only and do not reflect future values or future performance of any investment. The index returns are shown for comparative purposes only. Indexes are unmanaged and their returns do not include any sales charges or fees as such costs would lower performance. It is not possible to invest directly in an index. 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