TD Wealth

The Best and Worst of Times

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Wealth Investment Office

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The Best and Worst of Times

Consider how Dickens' A Tale of Two Cities so perfectly captures the spirit of our times. Hope versus gloom, stability versus disorder, prosperity versus suffering — such duality also captures the spirit of today's financial markets.

North American equities posted strong performance in 2023, but within that bull market we saw a meaningful pullback in the major indices from their summer highs into late October lows, with the S&P 500 and S&P/TSX Composite both falling over 8% before a strong rally into year-end, which continued through the first quarter. From the trough in late October to the end of the first quarter, the S&P 500 and S&P/TSX were up 25.3% and 17.5%, respectively. Fear, as an emotion, is not only powerful — it's also persistent. Although we've seen strong performance from North American equity markets, it's easy for investors to find reasons to fear the worst. For investors who are prone to constant worry, it's only natural to avoid risk-taking, and that's also what we saw in the first quarter, with a historic amount of capital moving into GICs and money-market funds.

Perhaps the most interesting dichotomy right now is found in the range between real economic data, often referred to as "hard data" and surveys about what respondents think and feel, which is often referred to as "soft data." The considerable spread is telling — it really hits home the difference right now between evidence-based reason and irrational intuition.

That split between our rational and irrational beliefs also well explains some of the flawed thinking around the world's second-largest economy: China. The differences between the headline news coming out of the U.S. and China is stark. Many market pundits, analysts and portfolio managers are waiting for China to get back to their ways of the last 30 years. Many of these folks are simply unable, or unwilling, to adapt to the new environment in China.

In his book Thinking, Fast and Slow, the renowned (and recently departed) economist Daniel Kahneman explains that people use two methods of thinking: System 1 and System 2. System 1 is fast, automatic and context-oriented. It accepts as true whatever seems to be your world view at the moment. If you're worried about the economy and your groceries are more expensive than they were a couple of years ago, System 1 will tell you that the economy is worse. If your social-media app reinforces that, it's doubly true.

System 2 is slower, deliberative and analytical. System 2 would tell you that inflation has indeed gone up a lot in the past two years but that much of it is behind you. Further, it would tell you that you can't use just one input to determine the state of the economy and financial markets. You need many to come to a disciplined conclusion.

This publication, our commitment to a disciplined process for allocating capital, is all about profitably navigating the best and worst of times. Things are rarely, at first blush, as good or bad as you think. We think that's true for where we are right now in financial markets.

Be well,

Brad Simpson
Chief Wealth Strategist, TD Wealth

Complexity

Perception ≠ Reality

The so-called "Misery Index" (the sum of inflation and unemployment rates) stands at 7.1%. At this level, the Michigan Consumer Sentiment Index usually hovers around 92. But it's at 77. Why the disconnect between consumer sentiment and economic data? Likely a combination of factors; impacts of inflation, high interest rates, and deep-rooted concerns about the general social, cultural and geopolitical climate.

It's a bull. No bull

The S&P has risen over 25% in a span of less than six months, defying forecasts of a recession. In fact, according to the Atlanta Fed's "GDP Now" tracker, economic growth has been rising since Q2 2022.

150 bps = Six fewer

At the start of the year, the market had priced in a 10% chance that the U.S. policy rate would end 2024 below 2%. By the end of Q1, that number had risen by 150 bps, implying a year-end rate of 3.5% (or six fewer 25-bp cuts).

Strong expectations

The S&P 500 was trading at 21 times forward earnings at the end of Q1, driven by great expectations for AI and mega-cap tech stocks. Currently, sell-side analysts are expecting EPS for the S&P to rise 9.7% in 2024 and 12.2% in 2025. That compares to a post-2008 annualized average of 6.5%.

Delectable Differentials

A comparison of mean and median valuations within each sector reveals opportunistic price differentials for stock-pickers. In the S&P 500 consumer staples sector, for instance, while sector valuations are in the 71st percentile of their historical average, the median stock in the sector is trading below the 50th percentile.

Security > Economy

In 2012, use of the word "economy" in China's congress was about double that of "security." Ten years later, the script has flipped, with "security" about double that of "economy." With the U.S. election campaign underway and continue conflict in Europe and the Middle East, geopolitics are likely to feature heavily this year.

Gold vs. Green

The price of gold (and the U.S. dollar) is typically driven by the U.S inflation-adjusted policy rate. This year, however, gold prices are getting a lift from central banks trying to break the dominance of the greenback. Central banks have roughly doubled their purchases of gold versus the past 10 years.

A New Phase

We believe it's a markedly different environment for commodities when it comes to demand, supply and collateral yield. Expect the next decade to be more supportive for the asset class than prior two decades.

Adaptation

Reason Over Intuition

Propagandists have long used headlines to influence the populace. Now social media is reinforcing that influence a hundred-fold, and it's interfering with investment decisions. Trust the numbers, not the media.

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%.

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.

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.

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.

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

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.

PSQ2.2024 | Executive Summary

■ **House Views | Fixed Income, modest overweight:** We anticipate that the lead-up to the BoC's first policy rate cut later this year will exhibit similar patterns to historical easing cycles, where bonds have generated positive returns in the months leading up to and following the first rate cut. Although uncertainty remains elevated, we still expect that fixed income will generate positive returns over the next 12 months, will provide diversification benefits, reduce overall portfolio volatility and preserve capital. ● **Equity, neutral:** Markets appear to be taking a step back this month as they digest the headwinds from higher bond yields and ongoing geopolitical uncertainty. We believe that the equity market has a balanced return outlook. Attractive earnings growth has been partially captured by the market in valuations and elevated investor sentiment. ● **Alternatives, neutral:** 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.

■ **Quarter in Review |** A number of seemingly unrelated market drivers interacted to create interesting opportunities in Q1. ● **Fear is not a verb.** We saw a lot of risk avoidance, with a historic amount of capital moving into GICs and money-market funds. What's more, there have been fewer IPOs, fewer issuances of corporate debt, fewer private-asset deals, and less M&A activity, leaving the markets with a lot of dry powder. But economic data have been strengthening since Q2 2022. ● **Impact of hawkish surprises has been smaller.** The impact of surprises and the uncertainty around CPI data is much lower than it was during the 2022 peak. This is important because more clarity around future rate policy makes it easier to price corporate buyouts or to evaluate public companies. Although deal count and value are still tepid, average deal size year-to-date has increased significantly. ● **Fear of bank failure might be overblown.** The vast majority of banks in the U.S. are small, so it's not hard for a small bank failure to catch media attention. But since Q2 last year, there has only been a brief episode of moderate banking stress. ● **Opportunities grew out of fear in Q1**. As sideline money pours in to well-known companies, price differentials for individual stocks widen, creating attractive opportunities for stock-pickers.

■ **Economy |** The U.S. is outperforming most other developed countries on many indicators of economic health. Despite this, U.S. consumers are still reporting levels of sentiment more consistent with an economy emerging from a recession, rather than one that has consistently outperformed. Several explanations have been suggested to account for the discrepancy. These generally revolve around inflation, interest rates and consumer's internalized anxiety about the current social and geopolitical climate. While the current strength in consumer spending may contradict their self-reported sour mood, if historical relationships reassert themselves, consumer spending may be headed for a soft patch.

■ **Fixed Income |** The U.S. economy continues to confound; inflation remains stubborn and growth resilient. This has forced market participants to unwind their expectations for a series of rate cuts later this year and has made fixed income markets give up some of their Q4 gains. Yields, however, are still near two-decade highs, and higher yields historically translate into higher returns meaning the longer-term outlook for bonds is still attractive. At current levels fixed income continues to offer the best opportunity in a decade to build diversified portfolios. ● **We remain modest overweight fixed income investments in general and modest overweight domestic government bonds**. Canadian government bonds are attractive at current yields and offer opportunities for income generation and downside protection. We expect price/yield volatility to decline in coming quarters as the economic outlook in Canada becomes clearer and market participants stop second-guessing future policy rate cuts. ● **We have increased our view for investment grade (IG) credit to Modest Overweight**. We expect challenging economic conditions to widen spreads (which indicates the market is pricing in more risk) but not to the same extent as previous recessionary levels. We continue to focus on high quality credit — companies with robust balance sheets — and we expect technicals will remain supportive and healthy yields will mitigate losses from price volatility. ● **We maintain our modest underweight view on high yield (HY) credit.** We don't expect high yield credit to repeat its 2023 performance. The overall improved quality of the HY credit market should keep spreads from returning to previous recessionary levels, but they will widen if the growth outlook deteriorates.

■ **Equities |** We're beginning to see some rotation away from the AI-driven tech names that have led this bull market. ● **North America: Stay active.** The outperformance of mega-caps is translating into a significantly higher concentration in the U.S. equity index. Revenue and earnings for the Magnificent Seven stocks is expected to grow at a higher rate than the rest of the index. While valuation across U.S. sectors appears expensive, the median stock's valuation in each sector may not be as expensive. In Canada, we continue to maintain a neutral

view given concerns about further economic weakness in Canada, which will be a headwind for earnings growth. Strong free cash flow in the energy sector and relatively inexpensive financial stocks may present select attractive opportunities. ● **Quant Analysis: Rotating along the barbell.** The "barbell" strategy continued to underperform. However, we noticed an apparent rotation out of those leaders as the first quarter started. On an equal-weighted basis, the information technology sector went from the strongest leader to the top laggard in the final month of the quarter. ● **Info-tech:** There still appears to be enough business momentum on the AI infrastructure spending side to keep the rally humming for now. ● **Financials**: The Big Six banks had seven consecutive quarters of negative EPS growth, but there has been a positive shift in investor sentiment recently. ● **Energy:** Energy equities have become an area of value and income over the past few years as companies have opted to shift their capital-allocation strategy toward dividends and buybacks. ● **Gold:** The strength in gold likely due to a combination of geopolitical as well as inflation and fiat currency concerns by investors, central banks and retail buyers. Gold equities, however, have underperformed. ● **International**: **Varied growth trajectories.** the European and British recovery has been slow and uneven. Japanese equities are benefitting from structural tailwinds, with signs that Japan could end its deflationary regime. Except for Japan, developed-market international equities are expected to record negative earnings growth. ● **Emerging Markets: While the dragon descends, other EMs could rise**. EM equities recorded subdued performance, owing to lacklustre Chinese equities and muted growth elsewhere. In China, slumping property values have severely weakened confidence. Taiwan and South Korea are benefitting from the strength in AI. India has been brought into the limelight as the next potential engine of global growth. Finally, South American nations, especially Brazil, are further ahead in the economic cycle, with inflation falling closer to target.

■ **Alternatives** | Investors with a long-term time horizon could benefit from adding alternative assets—such as private equity, private credit, unlisted real estate, and unlisted infrastructure—to their portfolios. Alternative assets can enhance portfolio risk-adjusted returns through inflation-linked cash flows and income streams that are different in nature to the dividends and interest payments received from holding public equity and fixed income securities. They also help to reduce portfolio volatility because they're less influenced by the noise in public markets. ● **Opportunities in Private Equity.** We believe exposure to value-oriented buyouts and secondaries remains compelling. We also view opportunities in thematic investing favourably, especially with managers who have high conviction and strong expertise in specific areas. We are seeing the democratization of private markets with growing popularity of perpetual capital, or evergreen funds. This new fund structure in Privates has an indefinite line, is designed to address the needs of clients who want immediate capital deployment, lower minimums, no capital calls, periodic liquidity windows, and simplified tax reporting.

■ **Real Estate** | High base rates, tight lending conditions, a refinancing maturity wall and limited transaction activity are keeping commercial real estate under pressure; however, disinflation, easing supply-chain bottlenecks and normalizing cap rates could provide relief in the second half of 2024.

■ **Currencies** | The key shift for currency markets recently has been the USD's shift to inflation, capturing the USD's new smile. ● **Market Themes for 2024: Carry, growth and risk.** TD Securities (TDSI) now expects the first Fed cut to be in September, with the ECB and BoE more likely to cut in the summer. Policymakers will need to juggle geopolitical risks against their desire to cut rates. TDSI believes the USD rally has limits and will remain somewhat rangebound through the rest of 2024. ● **Meanwhile, in Canada.** The pass-through of higher rates to the domestic economy will be key in 2024. While economic growth has been weak, the bottom hasn't fallen out. This has left the loonie at its lowest level since late 2023, where it may remain over the near term.

■ **Commodities** | Commodities have had a good start to the year after entering the investment phase of the new commodities cycle in early 2020. We believe we are in a markedly different environment for commodities when it comes to demand, supply and collateral yield. ● **On Demand.** Balance sheets have been repaired, U.S. consumers are holding a healthy level of cash, and U.S. government spending has been profligate. We also see better EM growth, while much of the world embarks on plans to electrify, which bodes well for base metals. ● **On Supply.** Spare capacity is limited, especially in commodities with a long lead time. On the energy side, U.S. shale has matured and consolidated, with producers far more fiscally disciplined. ● **On inflation and interest rates.** We believe there are many forces that will support inflation structurally in the coming years: carbon pricing, increasingly erratic weather, the reshoring and parallelization of supply chains, and demographics across the developed world. ● **On the ascendancy of gold**. Gold has found support from central banks, which doubled their gold-buying pace versus the previous 10 years.

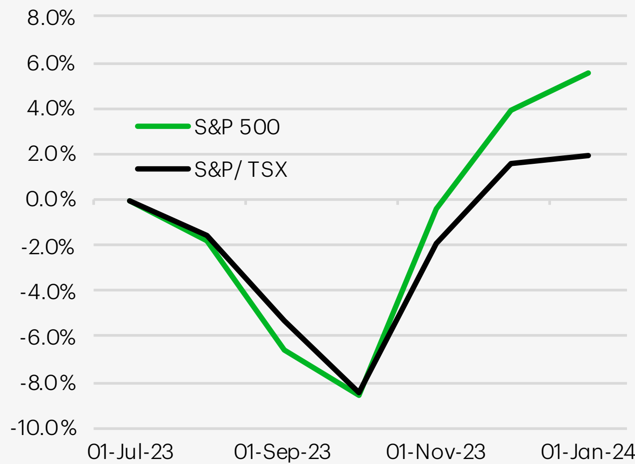
A Tale of Two …

Brad Simpson, Chief Wealth Strategist | TD Wealth

"It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair, we had everything before us, we had nothing before us …" – *Charles Dickens, A Tale of Two Cities*

Great literature transcends time and space. For evidence of this, consider how Dickens' *A Tale of Two Cities* so perfectly captures the spirit of our times, while writing about the lives of those living in London and Paris in the 18th century. Hope versus gloom, stability versus disorder and prosperity versus suffering — such duality runs just as much through this 18th century novel as it does today.

Figure 1: North American Equites Price Action Summer 2023 – Q1 2024

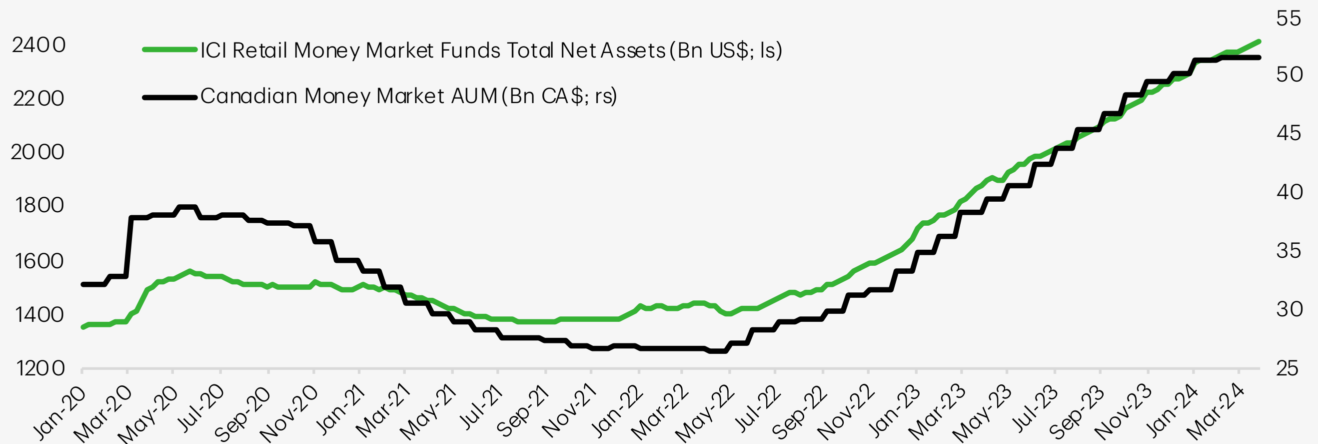


Source: FactSet and Wealth Investment Office as of March 31, 2024

Duality also captures the spirit of today's financial markets. For instance, North American equities posted strong performance in 2023, but within that bull market we saw a meaningful pullback in the major indices from their summer highs into late October lows, with the S&P 500 and S&P/TSX Composite both falling over 8% before a strong rally into year-end, which continued through the first quarter. From the trough in late October to the end of the first quarter, the S&P 500 and S&P/TSX were up 25.3% and 17.5%, respectively (Figure 1). Fear, as an emotion, is not only powerful — it's also persistent. Although we've seen strong performance from North American equity markets, it's easy for investors to find reasons to fear the worst. For investors who are prone to constant worry, it's only natural to avoid risk-taking, and that's also what we saw in the first quarter, with a historic amount of capital moving into cash (Figure 2).

The theme of duality, runs through our commentary this quarter, which also serves as a follow-up to our most recent *Monthly Perspectives* (March, "Just the Facts"), where we wrote about the surprisingly negative views being held by many investors about the state of the U.S. economy, despite its relatively good health when taking into account objective, quantifiable measures, such as inflation, economic growth, employment and the state of the consumer.

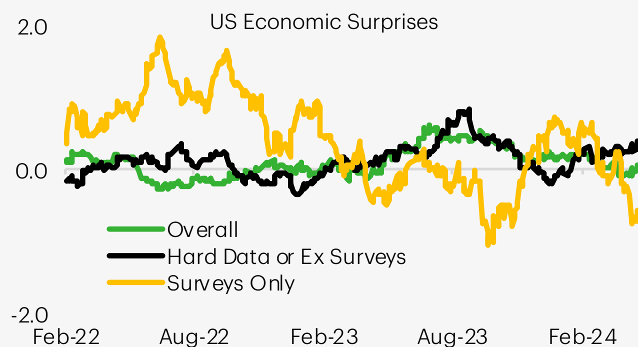
Figure 2: The Rise of North American Individual Investor Cash



Source: ICI, MorningStar, Wealth Investment Office, as of April 25, 2024

Perhaps the most interesting dichotomy right now is found in the range between real economic data, often referred to as "hard data" and surveys about what respondents think and feel, which is often referred to as "soft data." This gulf really jumps out at you when you look at Figure 3, which considers the hard data — inputs such as home sales (pending, new, existing), the industrial sector (durable goods orders, production, inventories) labour (unemployment rate, initial jobless claims, change in non-farm payrolls) and the consumer's health (credit, income, spending) — and compares it to "soft data" surveys, such as the purchasing managers' indices, the U. of Michigan Consumer Sentiment Survey and the Conference Board Consumer Leading index. The considerable spread is telling — it really hits home the difference right now between evidence-based reason and irrational intuition.

Figure 3: 'Hard' vs. 'Soft' Data



Source: FactSet and Wealth Investment Office, as of March 31, 2024

So, what gives? In "Just the Facts" we placed much of the blame for negativity on U.S. politics and the rising use of social media. Our colleague at TD Economics, Shernette McLeod, published an excellent piece, "Why So Glum? The Disconnect Between Consumer Sentiment and Economic Data," where she ascribed a number of reasons behind the cognitive dissonance including:

1. Reminders of high inflation (Individuals are heavily influenced by the prices of frequently bought items).
2. Consumer purchasing power has not yet regained lost ground.
3. Higher debt payments due to higher interest rates.
4. Geopolitics: the ongoing devastation brought by the wars in Ukraine and Gaza.

We would be remiss if we did not mention the behavioural economics angle of this. So much of what we produce here at the Wealth Investment Office is guided by the study of behavioural economics, first conceived by economist Daniel Kahneman, who passed away on April 4, 2024. Dr.Kahneman's research was best known for debunking the notion of "homo economicus," the "economic man," who since the epoch of Adam Smith was considered a rational being who acts out of self-interest. Instead, Dr. Kahneman found, people rely on intellectual shortcuts that often lead to wrongheaded decisions that go against their own best interest — what we call at this organization "blind spots" that drive our Wealth Personality™. We will be forever in his debt for his remarkable contributions to our profession and what we do here on a daily basis. Dr Kahneman said that humans "are much too influenced by recent events. … They are much too quick to jump to conclusions under some conditions and, under other conditions, they are much too slow to change."

That split between our rational and irrational beliefs also well explains some of the flawed thinking around the world's second-largest economy: China. Recently at one of our research meetings, WIO portfolio manager Kevin Yulianto pointed out the stark differences between the headline news coming out of the U.S. and China. Whereas inflation has been top-of-mind in the U.S., *deflation* is what's worrying businesses and government across the Pacific Ocean. And as the tight post-pandemic labour market in the U.S. allows workers to negotiate higher wages and look for better opportunities, workers in China are taking pay cuts across both public and private sectors.

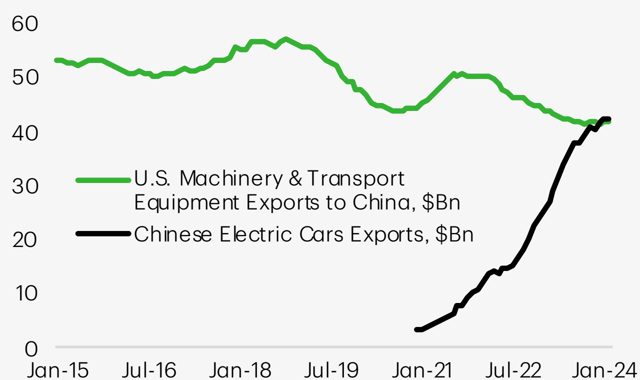
The respective trajectories of economic recovery in the U.S. and China could not be more different. Whereas consumer and government spending in the U.S. roared back to life following the easing of lockdown restrictions, the extended lockdown and inadequate fiscal supports in the Middle Kingdom have sapped the willingness of consumers and private sectors to spend. In fact, spending growth for Chinese households has been below that of the U.S. following the pandemic (Figure 4). Is the shock to China from the pandemic equivalent to what Japan experienced in the 1990s, just before it entered a very low growth and deflationary regime?

Figure 4: U.S. consumer spending outpaces China

Source: FactSet and Wealth Investment Office, as of March 31, 2024

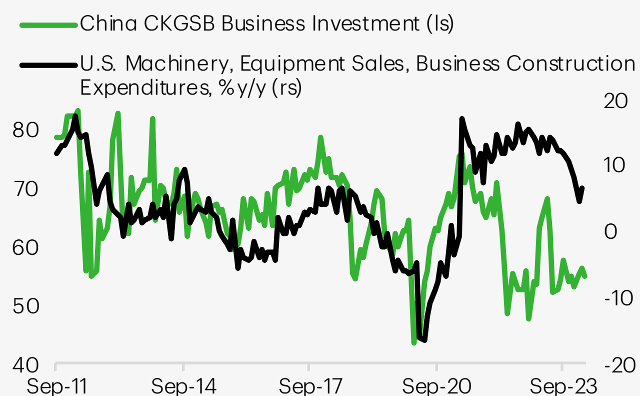
It is becoming evident that China will have a difficult time maintaining its 5% growth target going forward amid the domestic property-sector crisis and increasingly unfavourable geopolitical environment. As tensions between the U.S. and China intensify, Beijing's focus on developing a domestic high-tech industry and growing its exports market are facing a backlash from the U.S. and European governments. The U.S. is expanding its restrictions on advanced chip exports to China, hampering the government's efforts to move higher in the value chain, while the European Commission is opening an anti-subsidy investigation into Chinese electric vehicles (Figure 5). Western governments have been re-evaluating their supply chain's dependency on China and incentivizing companies to diversify their production base. On an ideological basis, the U.S. and China are also on polar opposites when it comes to many issues, including Russia's invasion of Ukraine, the future of Taiwan, and basic values such as human rights and the rule of law. The bottom line is that the benign geopolitical environment that had supported rapid Chinese GDP growth since it joined the WTO in 2001 is now reversing.

Figure 5: China faces headwinds moving up the value chain



Source: FactSet and Wealth Investment Office, as of March 31, 2024

Figure 6: Many factors have dampened investment demand in China



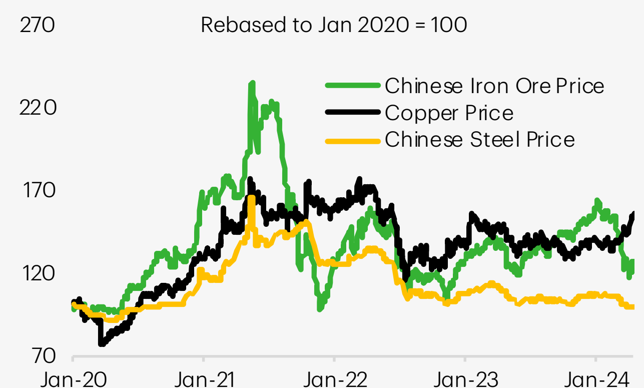
Source: FactSet and Wealth Investment Office, as of March 31, 2024

To make matters worse, China's professed goal of becoming a dominant exporter of high-tech goods has been stymied by its own counterproductive policies. Lack of stimulus has failed to lift consumer demand, which in turn has discouraged private businesses from reinvesting their profits and expand operations. Furthermore, repeated government crackdowns on sectors that are deemed to create instability and increase inequality have targeted the tech sector (Figure 6), discouraging the innovators that China will need to become a high-tech hub. Contrast this with the U.S. government's efforts to rejuvenate its physical infrastructure and provide subsidies for the advanced manufacturing industry (i.e., semiconductors) via the CHIPS and Science Act.

Given the limited foreign ownership of Chinese assets and capital-flow restrictions, the global financial linkage to the rest of the world should be relatively limited. The largest impacts of a slowing Chinese economy and its property-sector crisis are most visible in the trade channel and the commodity market, in which China is a major consumer. Over the past two years, Chinese goods export prices have been falling sharply, and the prices of select base metals have been sluggish despite the above-trend economic growth across developed countries (Figure 7).

Following decades of booming economic growth and a significant increase in both public- and private-sector leverage, Beijing is certainly aware of the risk arising from a prolonged slump in the real estate sector, insolvent local governments, and the need to stimulate growth. However, the fiscal support provided so far has mainly focused on putting a floor on growth and containing the crisis, rather than outright net new stimulus. In contrast to the infrastructure building seen in previous fiscal stimulus packages (2008, 2015, 2018),

Figure 7: Commodity prices have waned amid weak Chinese demand



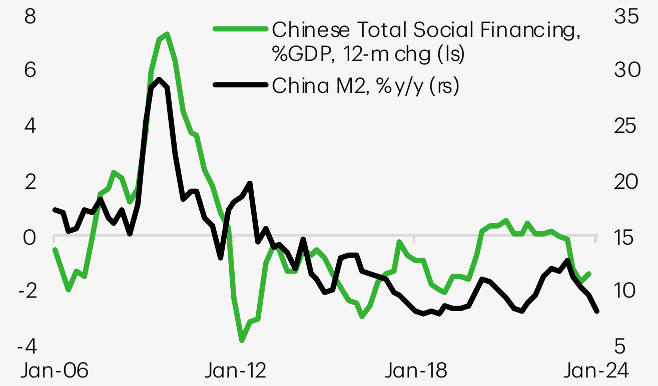
Source: FactSet and Wealth Investment Office, as of March 31, 2024

today the central government has instead told indebted provinces to scrap select infrastructure projects to save money, which should translate to lower growth in both the near and long term (Figure 8). Given that real estate and infrastructure investment is unlikely to be the primary driver for growth, China's ability to meet its growth target of 5% this year will require a strong recovery in consumer demand (Figure 9).

But just as Chinese businesses have been discouraged from reinvesting in their operations, Chinese consumers too have been disinclined to spend as they watch their household wealth decline. This is related to the fact that real estate accounts for 41% of Chinese household wealth compared to a much lower 26% in the U.S. In many large Chinese cities, the price of houses and apartments are estimated to have fallen 20% to 30% from their peak. In a recent survey by the People's Bank of China (PBoC), 58% of Chinese households said they intend to save more, with only 17% and 25%, respectively, looking to invest and spend more. Barring additional stimulus or an improvement in the growth outlook, this reality could prolong the deflationary forces in the Chinese economy.

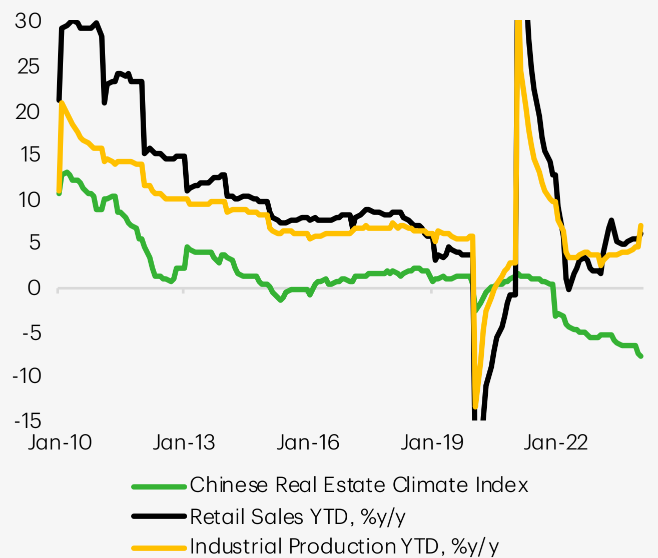
To stimulate the economy, Chinese policymakers have rolled out several rounds of fiscal and monetary stimulus over the past two years, starting from the issuance of special government bonds; rounds of cuts to the medium-term lending facility rate and the required reserve ratio for banks. The central government has also urged banks to lend to credit-starved sectors. For this year, China's augmented fiscal deficit is expected to be around 8.2% of GDP, 1.2 percentage points higher than in 2023 (Figure 10).

Figure 8: Chinese stimulus not reflationary enough



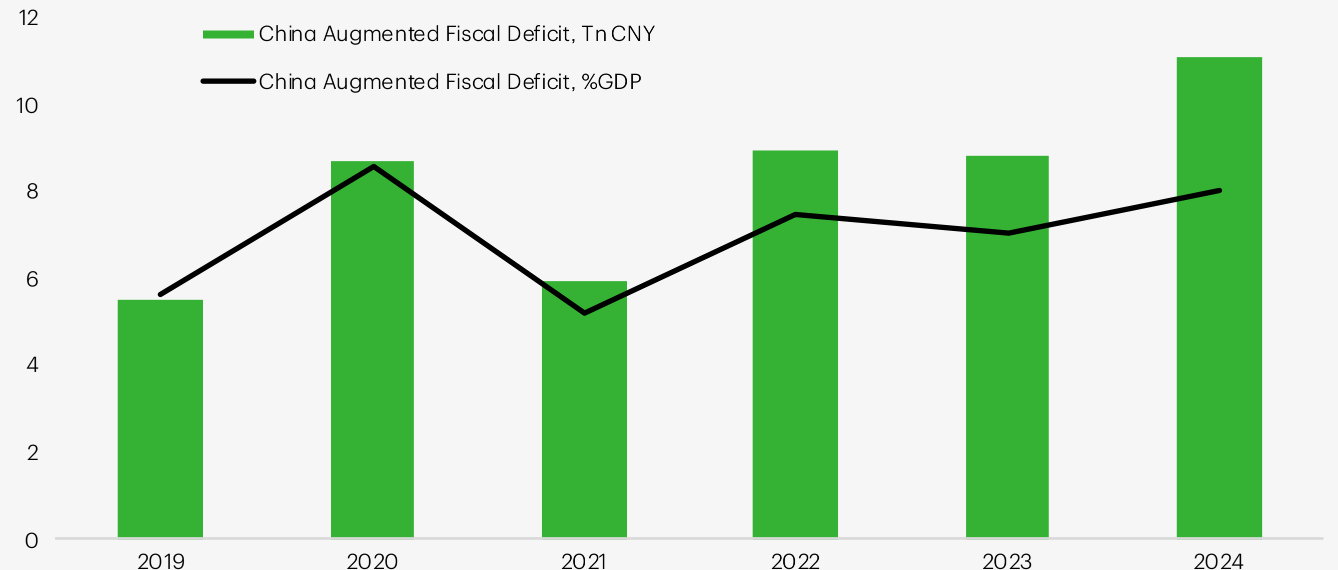
Source: FactSet and Wealth Investment Office, as of March 31, 2024

Figure 9: Meeting growth target will require consumer spending



Source: FactSet and Wealth Investment Office, as of March 31, 2024

Figure 10: China's deficit as a % of GDP to rise in 2024



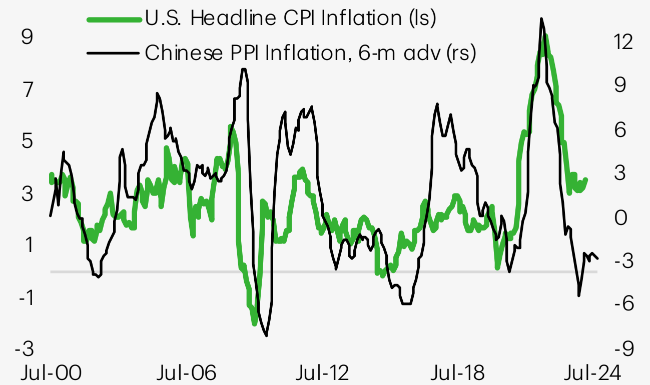
Source: FactSet and Wealth Investment Office, as of March 31, 2024

The majority of economists, however, deem this to be inadequate to bolster growth above the 5% mark. Meanwhile, the U.S. is running a 6% deficit despite healthy GDP growth and a tight employment backdrop (Figure 11). So it's not surprising that financial conditions in the U.S. have been significantly looser than in China and the euro area.

The deflationary forces in the Chinese economy, however, are not all bad for the rest of the world. Disinflation in China should translate to lower prices for net importers of manufactured goods, helping policymakers' effort to bring inflation back to target (Figure 12). Over the past 18 months, we have seen Chinese goods producers taking market share in North America, with Temu (China's version of Amazon) and Shein (a clothing retailer) reportedly accounting for a chunk of online advertising spending in the U.S.

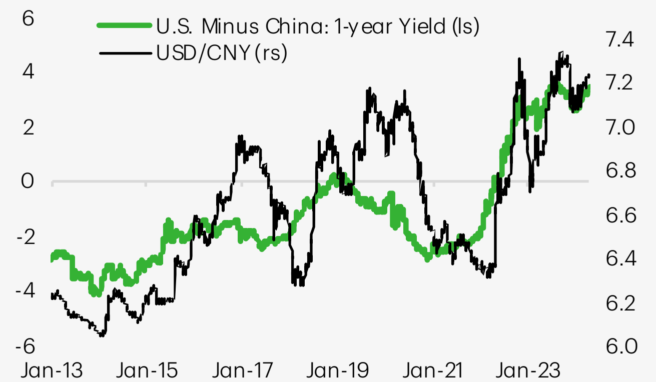
The weaker Chinese growth outlook versus the U.S. means that, barring an (increasingly unlikely) aggressive rate cut in the U.S., monetary-policy divergence should continue. The possibility of dovish Chinese policy alongside "higher for longer" U.S. policy should tilt the bias in favour of a stronger USD/CNY (Figure 13). Consider that, as the U.S. 10-year government bond yield rose from 0.5% during the depths of the pandemic to 4.5% currently, the Chinese 10-year yield has fallen further from the pandemic low of 2.48% to 2.29% currently. From the perspective of a Chinese investor, this divergence increases the attractiveness of foreign assets, minding the restriction on capital flow.

Figure 12: Lower Chinese prices bode well for global inflation



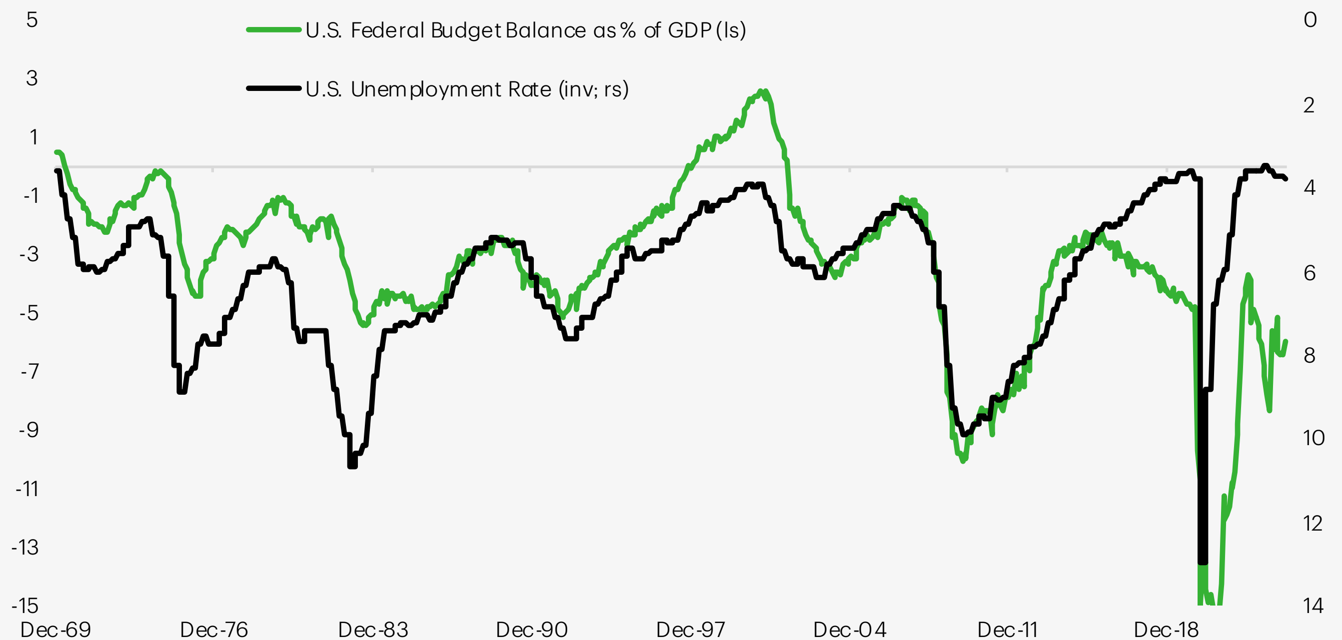
Source: FactSet and Wealth Investment Office, as of March 31, 2024

Figure 13: Diverging monetary policy bodes ill for the yuan



Source: FactSet and Wealth Investment Office, as of March 31, 2024

Figure 1: U.S. running big deficit despite hot economy



Source: FactSet and Wealth Investment Office, as of March 31, 2024

From a geopolitical perspective, moreover, the Chinese government's greater focus on its domestic economy could also potentially translate to a more cordial relationship with the West in the near term.

Many market pundits, analysts and portfolio managers are waiting for China to get back to their ways of the last 30 years. This only serves to illustrate Daniel Kahneman's contention that we are too slow to change. Many of these folks are simply unable, or unwilling, to adapt to the new environment in China.

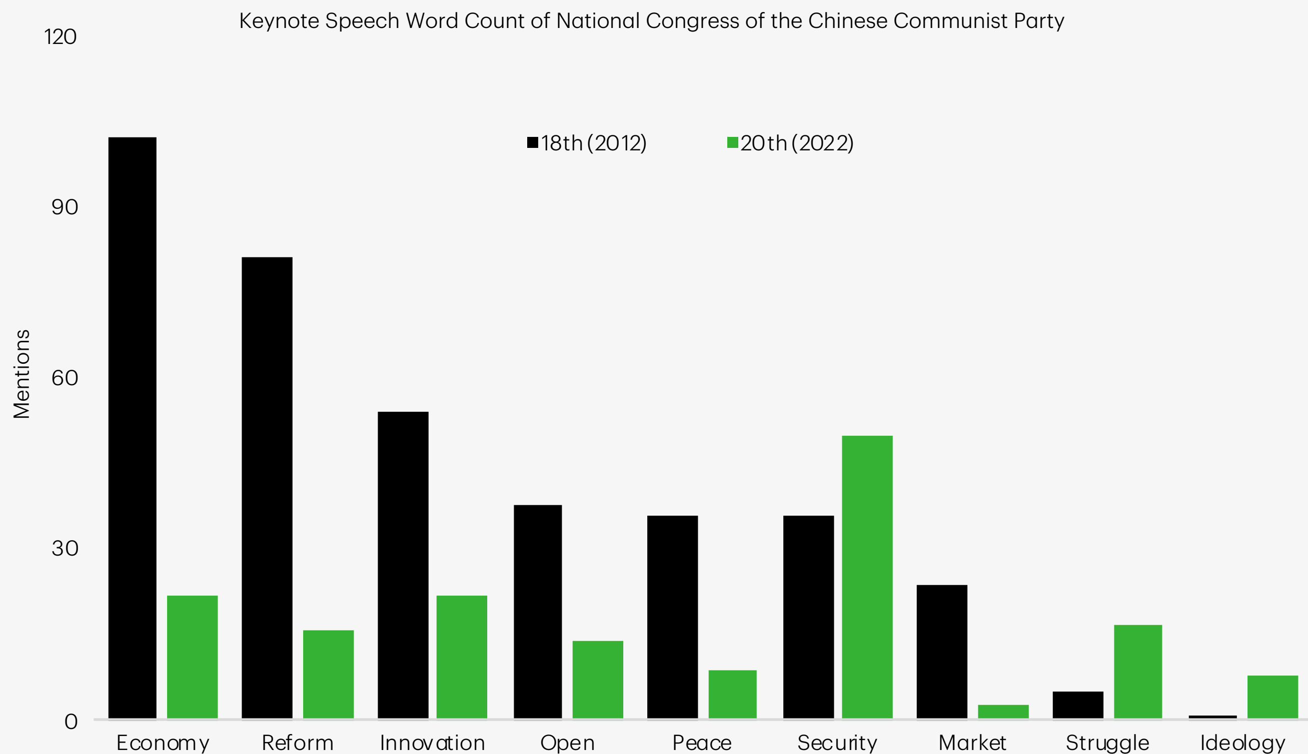
Figure 14 charts the word count for various words spoken at the National People's Congress of the Chinese Communist Party over the past decade, which provides some insight into how Chinese policymakers have shifted the focus of their speeches. The count for words like economy, innovation and market have all dropped significantly. Words such as security and ideology, meanwhile, were used many more times in the 2022 speeches as compared to those in 2012. This is a dramatic change in priority for the Chinese government, with major impacts across sectors.

We believe that the facts warrant a considerable change in approach to how we think about China, and how to allocate — something we are incredibly comfortable with given our adaptive markets approach. Let's consider our thoughts on allocating capital as we move ahead:

Fixed Income: Our view is unchanged at **modest overweight**. We continue to have a positive outlook for fixed income and believe it will generate attractive returns for investors over the next 12 months. Bonds can also still provide diversification benefits, reduce overall portfolio volatility and preserve capital. However, as we've seen over the past year, fixed income markets can also be volatile (Figure 15), and we believe that volatility will continue in the near term as expectations around rate cuts evolve. With that in mind, investors can lock in attractive yields today. Although predicting the exact timing of rate cuts is a challenge, there's no doubt that they are coming.

Equities: We maintain a **neutral** outlook for equities overall. Within the asset class, we also continue to prefer U.S. equities given the attractive earnings outlook for U.S. companies. Asset selection, however, is important in this market. While the "Magnificent Seven" has become the "Fab Four" (Nvidia, Meta Platforms, Microsoft and Amazon.com) and continue to lead the rally in U.S. equities, other segments — especially the cyclical sectors, such as industrials — are currently benefiting from a recovery trade based on hopes of a soft- or no-landing scenario. The earnings outlook for industrials is also quite attractive. Another indicator of widening breadth in equities is the reduction in performance dispersion between the cap-weighted S&P 500 and its equal-weighted counterpart.

Figure 14: Speeches highlight shift to geopolitics



Source: Wealth Investment Office, as of March 31, 2024

Alternatives / Real Assets: For alternatives, we are currently at **neutral**. Private equity offers attractive opportunities, especially exposure to value-oriented buyouts and late-stage growth equity. Private-credit yields remain attractive, with investors likely to earn equity-like returns. In real estate, asset selection is key. Our focus is on high-growth sectors (logistics, multi-family residential, etc.)

Commodities: We are currently **modest overweight** overall. Energy markets have seen oil prices (Brent) nearing US$91 for the first time since October 2023. In base metals, we are bullish on copper given hard-to-resolve supply challenges. And in precious metals, we see further upside ahead for gold, driven by strong physical demand from central banks and falling real yields.

Worth the Effort

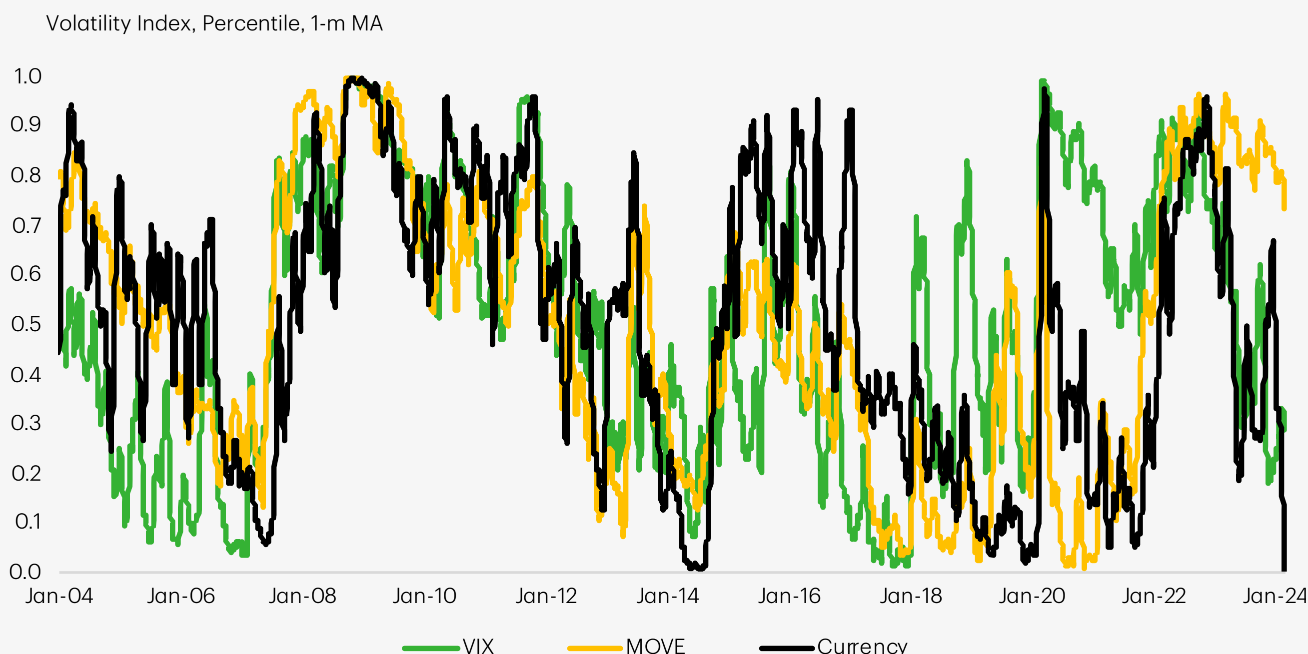
In his book *Thinking, Fast and Slow,* Daniel Kahneman explains that people use two methods of thinking: System 1 and System 2. System 1 is fast, automatic and context-oriented. System 1 thinking is a near-instantaneous process; it happens automatically, intuitively, and with little effort. It's driven by instinct. It's prone to accepting as true whatever seems to be your world view at the moment. If you're worried about the economy and your groceries are more expensive than they were a couple of years ago, for instance, System 1 will tell you that the economy is worse. If your social-media app reinforces that while you are addictively checking your phone in the checkout aisle a minute later, it's doubly true.

System 2 is slower, deliberative and analytical. It's the part of your brain that says, "let's stop and work this out". System 2 would tell you that inflation has indeed gone up a lot in the past two years but that much of it is behind you. Further, it would tell you that you can't use just one input to determine the state of the economy and financial markets. You need many to come to a disciplined conclusion. It will also help you construct thoughts in an orderly series of steps.

Watching a 30-second clip on Instagram is a System 1 activity, it's designed to trigger your impulses. Reading this publication is a System 2 activity meant to trigger your intellect – the part of the brain you want participating in decisions about your life savings. The key is understanding how System 1 and 2 work. This publication, our commitment to a disciplined process for allocating capital, is all about profitably navigating the best and worst of times. Things are rarely, at first blush, as good or bad as you think. We think that's true for where we are right now in financial markets.

The key to managing in times like these is establishing an investment approach that is designed to adapt to the ever-changing environment — one that employs a well-thought-out wealth plan and a contemporary portfolio approach with true diversification, balancing broad asset allocation and risk-factor diversification from specialists who have a deep understanding of financial behaviour.

Figure 15: Rate volatility remains high, diverging from equity and currency volatility



Source: Macrobond and Wealth Investment Office, as of March 31, 2024

Leading Macro Indicators

Overall risk regime score firmly in neutral territory, for now

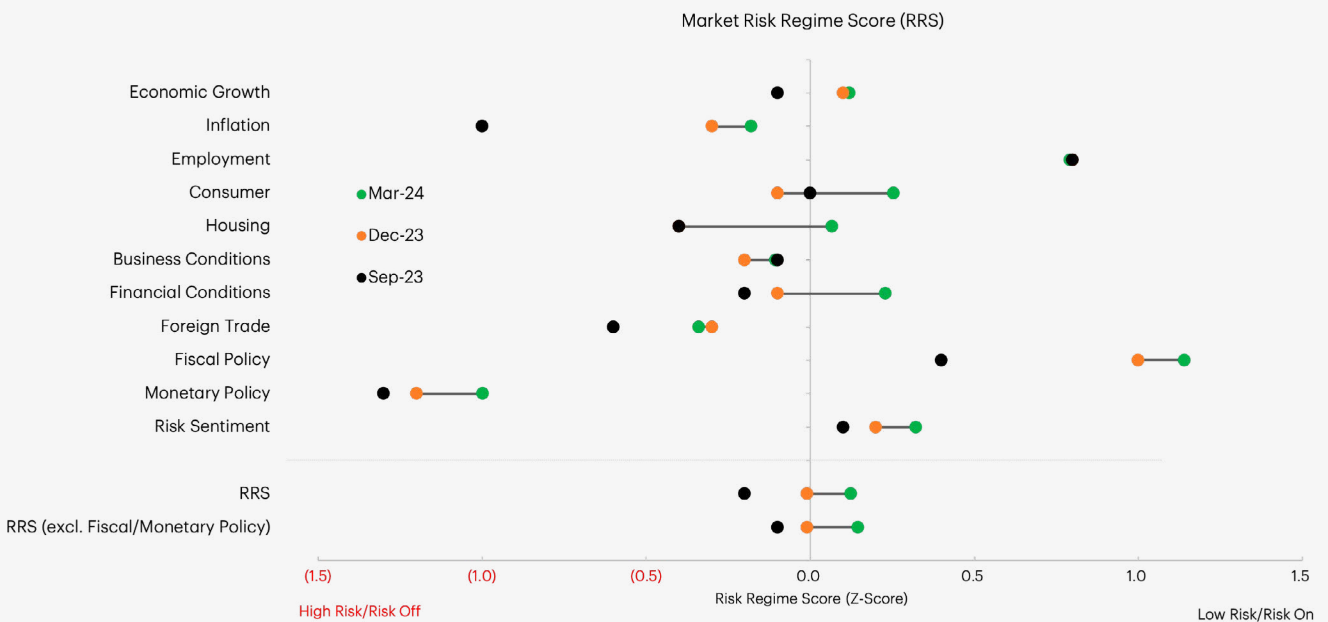
As part of our process-driven approach to investment management, we monitor key U.S. variables that inform our understanding of the risk and macroeconomic environment. For each indicator we calculate current values and compare them against recent trends and long-term data using a standardized approach that makes it possible to form an aggregate score. Figures 1 and 2 summarize the overall condition and aggregate score of the indicators.

Figure 1: Market risk regime scores

Indicator	Overall Condition	Current	Dec-23	Sep-23	Jun-23
Economic Growth	Neutral	0.1	0.1	(0.1)	0.0
Inflation	Weak	(0.2)	(0.3)	(1.0)	(1.2)
Employment	Strong	0.8	0.8	0.8	0.8
Consumer	Neutral	0.3	(0.1)	0.0	0.0
Housing	Neutral	0.1	(0.4)	(0.4)	(0.4)
Business Conditions	Neutral	(0.1)	(0.2)	(0.1)	0.4
Financial Conditions	Neutral	0.2	(0.1)	(0.2)	(0.4)
Foreign Trade	Weak	(0.3)	(0.3)	(0.6)	(0.6)
Fiscal Policy	Strong	1.1	1.0	0.4	0.4
Monetary Policy	Weak	(1.0)	(1.2)	(1.3)	(1.3)
Risk Sentiment	Neutral	0.3	0.2	0.1	0.6
Risk Regime Score (RRS)	**Neutral**	**0.1**	**0.0**	**(0.2)**	**(0.1)**
RRS (excl. Fiscal/Monetary Policy)	**Neutral**	**0.1**	**0.0**	**(0.1)**	**0.0**

Source: FactSet, WIO as of March 31, 2024.

Figure 2: Change in market risk regime scores



Scores represent number of standard deviations away from long-term average.
Source: FactSet, WIO as of March 31, 2024.

Our risk regime score improved in the first quarter buoyed by consumer and housing. The overall market risk regime score nudged up to 0.1 at the end of Q1, from 0 at the end of Q4. U.S. equities rose alongside bond yields. Investors were more optimistic about the probability of an economic soft landing and higher earnings growth, making stock prices less sensitive to changes in monetary policy.

Monetary policy is still the biggest drag on the overall risk score; although inflation has declined, it remains above the Federal Reserve's (Fed) target of 2%. The Fed continues to hold the policy rate at the highest level in 23 years while broad money supply contracts. Employment and fiscal policy remained strong, and the scores for consumer, financial conditions and housing all moved up into positive territory. The following are notable changes for Q1 compared to Q4 last year:

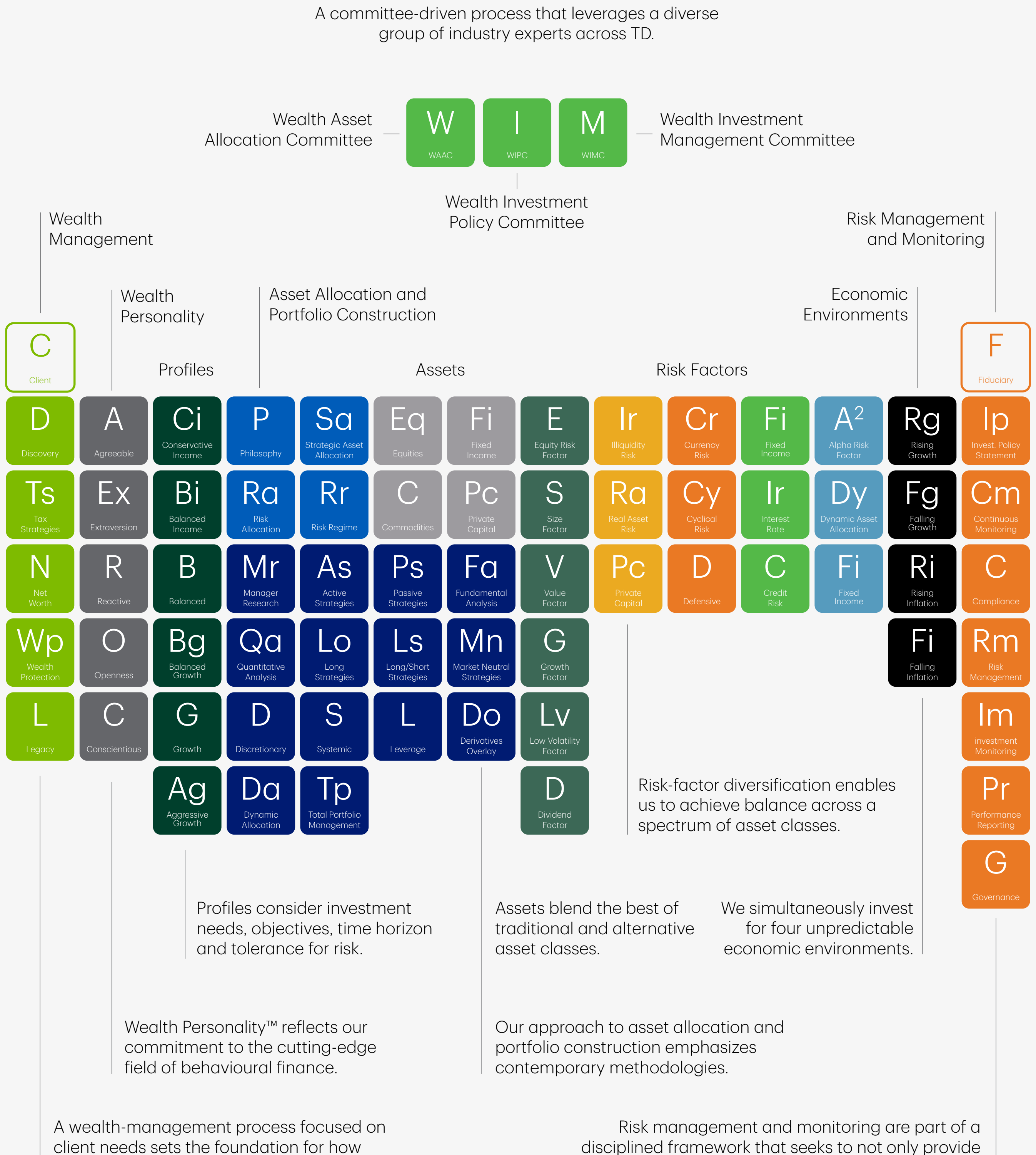
- Monetary policy, foreign trade, and inflation were still weak in Q1 although scores for inflation and monetary policy improved. Inflation fell at a slower-than-expected pace throughout the quarter and the score for inflation rose to -0.2 standard deviation away from the long-term norm at the end of Q1 from -0.3 in Q4. The outlook for monetary policy hinges on whether inflation can be contained around 2% and whether the labour market keeps softening. The monetary policy score ticked up to -1.0 at the end of Q1 from -1.2 amid an improvement in money supply growth. The current account deficit remains high, keeping the foreign trade score unchanged at -0.3 in Q1.
- Risk sentiment and economic growth remained in neutral overall condition with scores in positive territory. Volatility across various asset classes declined in the quarter and investors turned bullish on equities, helping to nudge the score for risk sentiment up to +0.3 at end Q1 from +0.2 in Q4. Stabilizing real GDP growth at a level slightly above the historical average kept the score for economic growth neutral at +0.1 at the end of Q1.
- Scores for business conditions, consumer, financial conditions, and housing all improved—the last three indicators moved into positive territory in Q1. U.S. manufacturing grew for the first time in 18 months bumping the score for business conditions up to -0.1 from -0.2 at the end of Q4. Consumer confidence rose throughout the quarter: the healthy job market and strong spending pushed the score for consumer up to +0.3 in Q1 from -0.1. The score for financial conditions jumped to +0.2 from -0.1 as bond spreads compressed further, suggesting a decline in the perception of overall risk. The overall condition for housing moved from weak to neutral and the score sprung to +0.1 from -0.4 in Q4 amid rising house prices and an improvement in U.S. homebuilder sentiment.
- Employment and fiscal policy remained in healthy territory. The resilient labour market is underpinned by low initial jobless claims, strong wage growth and unemployment that continues to hover just above the record low. The score for employment was unchanged at +0.8 in Q1. Our fiscal policy score rose to +1.1 from +1.0 at the end of Q4—U.S. government spending supports economic growth and the government fiscal deficit is forecast to stay elevated.

Overall, broad conditions for risk assets improved slightly in Q1: monetary policy remained tight while consumer, financial conditions, and housing all improved. Market consensus is now pointing towards a soft landing in the U.S. and, as such, any signs of weakness in employment, consumer, or business conditions that could hint at potential downside risks to the U.S. economy could set off a painful adjustment.

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

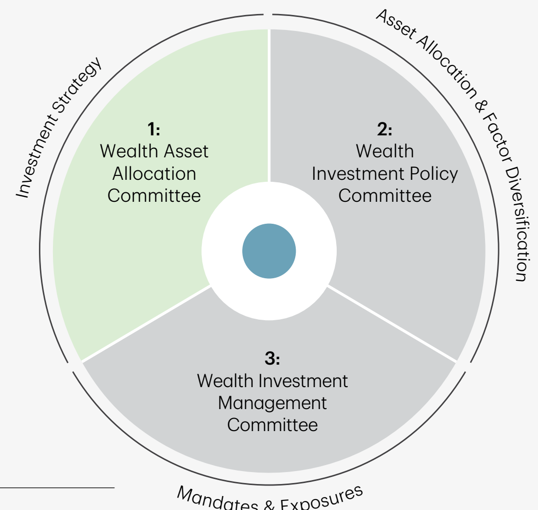


Wealth Asset Allocation Committee

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.

Colin Lynch ....Managing Director and Head of Global Real Estate, TD Asset Management Inc.

Bruce MacKinnon .. Managing Director, Head of Private Debt Research & Origination, 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	**Modest Underweight** Previous Month	We anticipate that the high yield we are currently seeing in cash may be temporary and we would expect a reduction in yields as the BoC and the U.S. Federal Reserve move towards easing measures. Overall, cash may not be as attractive as other asset classes in the medium term.
Fixed Income	**Modest Overweight** Previous Month	The Bank of Canada ("BoC") has seen better-than-expected inflation prints over the past three months, increasing the likelihood that it may begin to reduce its policy rate in the summer. In previous easing cycles bonds have generated positive returns as interest rates have fallen in the months leading up to the first rate cut. Given the modest rise in interest rates year-to-date, we anticipate that the lead-up to the BoC's first policy rate cut later this year will exhibit similar patterns to historical easing cycles. Although uncertainty remains elevated around the future evolution of domestic and global macroeconomic data, we would still expect that fixed income will generate positive returns over the next 12 months and that bonds can still provide diversification benefits, reduce overall portfolio volatility and preserve capital.
Equity	**Neutral** Previous Month	While equity market returns remain positive year-to-date, markets appear to be taking a step back this month as they digest the headwinds from higher bond yields and ongoing geopolitical uncertainty. We believe that the equity market has a balanced return outlook. While earnings growth is in positive territory globally (as represented by the MSCI All Country World Index), this has been partially captured by the market in valuations and elevated investor sentiment.
Alternatives	**Neutral** Previous Month	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.

Fixed Income - Modest Overweight

	Positioning	Rationale
Domestic Government Bonds	**Modest Overweight**	The BoC remains patient in its monetary policy stance, waiting on continued evidence of decelerating inflation. Similar to the bond market, we expect the first rate cut to emerge at the BoC's June meeting. Based on yield patterns observed in historical easing cycles, we anticipate bond yields to decline over the next three months, or sooner if weakness in the labour market emerges. Over the longer term, we believe government bonds continue to remain appealing due to their potential to generate positive nominal returns.
Investment Grade Corporate Credit	**Modest Overweight** (From Neutral)	Investment grade spreads remain tight overall and reflect a modest softening of the global economic backdrop. We see Canadian investment grade corporate bonds as more attractive than U.S. investment grade corporates as spreads in Canada continue to be meaningfully wider.
High Yield Credit	**Modest Underweight**	All-in yields remain elevated, but have declined in recent months, indicating strong potential returns. However, 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**	While the Bank of Japan has finally ended yield curve control and negative policy rates, it has not dropped its accommodative monetary policy stance. Other central banks have decisively shifted to policy easing, with the Swiss National Bank being the first among developed markets to lower its policy rate. Leading central banks, including the U.S. Federal Reserve, are expected to follow suit in the summer. However, each market faces large idiosyncratic risk factors, so the future evolution of each central bank's easing cycle is not a foregone conclusion. Therefore, we expect opportunities across developed market bonds to vary over the next 12 to 18 months.
Global Bonds Emerging Markets	**Modest Underweight** (From Neutral)	The dispersion of returns within emerging markets continues to present opportunities on a tactical basis. While yields remain attractive in some regions, local-currency government bonds in many emerging market countries have already priced-in significant rate cutting cycles and therefore there is reduced potential for emerging market bonds to outperform developed market bonds. A strengthening U.S. dollar and persistent volatility in U.S. government bond yields may also be a headwind for emerging market countries with high levels of U.S. dollar liabilities.

Equities - Neutral

	Positioning	Rationale
Canadian Equities	**Neutral**	Canadian gross domestic product growth has slowed, but with the full effect of higher rates on the consumer and real estate market yet to be seen, the Canadian economy could remain weak. That said, strong free cash flows within the Energy sector, and relatively inexpensive Financials stocks, may present attractive opportunities.
U.S. Equities	**Modest Overweight**	The U.S. labour market and gross domestic product growth have remained robust. The S&P 500 Index has resumed year-over-year earnings growth, which has supported valuations and positive investor sentiment. The S&P 500 Index commands a premium valuation due to its higher technology exposure.
International Equities	**Modest Underweight**	International stocks remain challenged by weaker corporate returns and slowing macroeconomic conditions, particularly in Europe. Overall we feel that this may limit further gains, however Japanese equities look attractive on a relative basis, with momentum building behind a corporate reform agenda aimed at boosting profitability and valuation multiples.
Chinese Equities	**Neutral**	The Chinese economy is showing signs of stabilization and the government remains focused on supporting growth, but challenges remain in the property sector.
Emerging Market Equities (excluding China)	**Neutral**	Some emerging market central banks appear to have paused their rate hiking cycle, with Brazil and Chile cutting rates. While this is supportive of better domestic growth in these countries, it might be partially offset by the impact weaker global growth could have on exports.

Alternatives - Neutral

	Positioning	Rationale
Commercial Mortgages	**Modest Overweight**	Commercial mortgages continue to provide accretive income while insulating investor returns from the increased volatility in interest rates.
Private Debt (Universe)	**Neutral** **(From Modest Overweight)**	High credit quality and global diversification provides an income ballast in an uncertain economic environment. Incremental income and potential capital appreciation from interest rate moderation provide upside.
Domestic Real Estate	**Modest Underweight** **(From Max. Underweight)**	Canadian real estate transaction activity remains selective. Industrial, retail and multi-unit residential fundamentals remain sound, while office continues to experience leasing headwinds and a flight to quality.
Global Real Estate	**Modest Underweight**	Certain regions across the globe have seen quicker downward adjustments to valuations but we are now seeing early signs that these adjustments may be slowing down. Multi-unit residential and a tilt to the Asia Pacific region may be able to 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. While U.S. growth may also decelerate, it is expected to remain stronger than in Canada or parts of Europe. This leaves room for relative strength in the U.S. Dollar.
Commodities (Gold, Energy, Metals, Agriculture, Carbon)	**Modest Overweight**	Commodities can help to diversify portfolios as their returns have a low correlation to both stocks and bonds. Underlying fundamentals remain supportive for key commodities (e.g. oil or copper), as supply remains either disciplined or restricted. Geopolitical uncertainty furthered the rally in oil and gold. This, along with central bank buying and demand from China, has supported the gold price despite the headwind from the recent rise in real yields and the U.S. dollar.

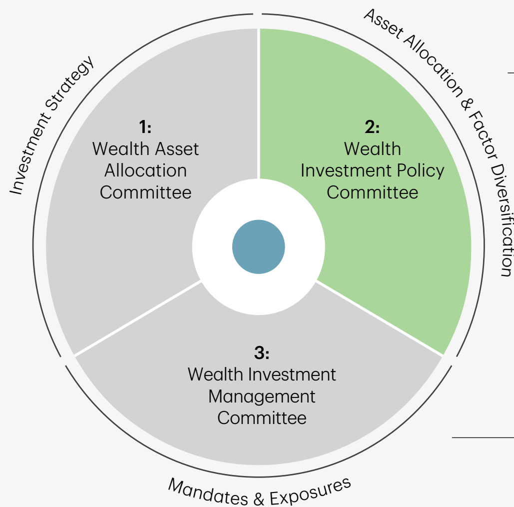
Figure 1: Direction from WAAC: strategic positioning

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

Source: Wealth Asset Allocation Committee, as of April 18, 2024.

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.



Interprets WAAC views and sets general investor profile asset-class weights

Utilizing risk factors to manage exposures, we build and manage portfolios that blend the best of traditional and alternative asset classes.

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

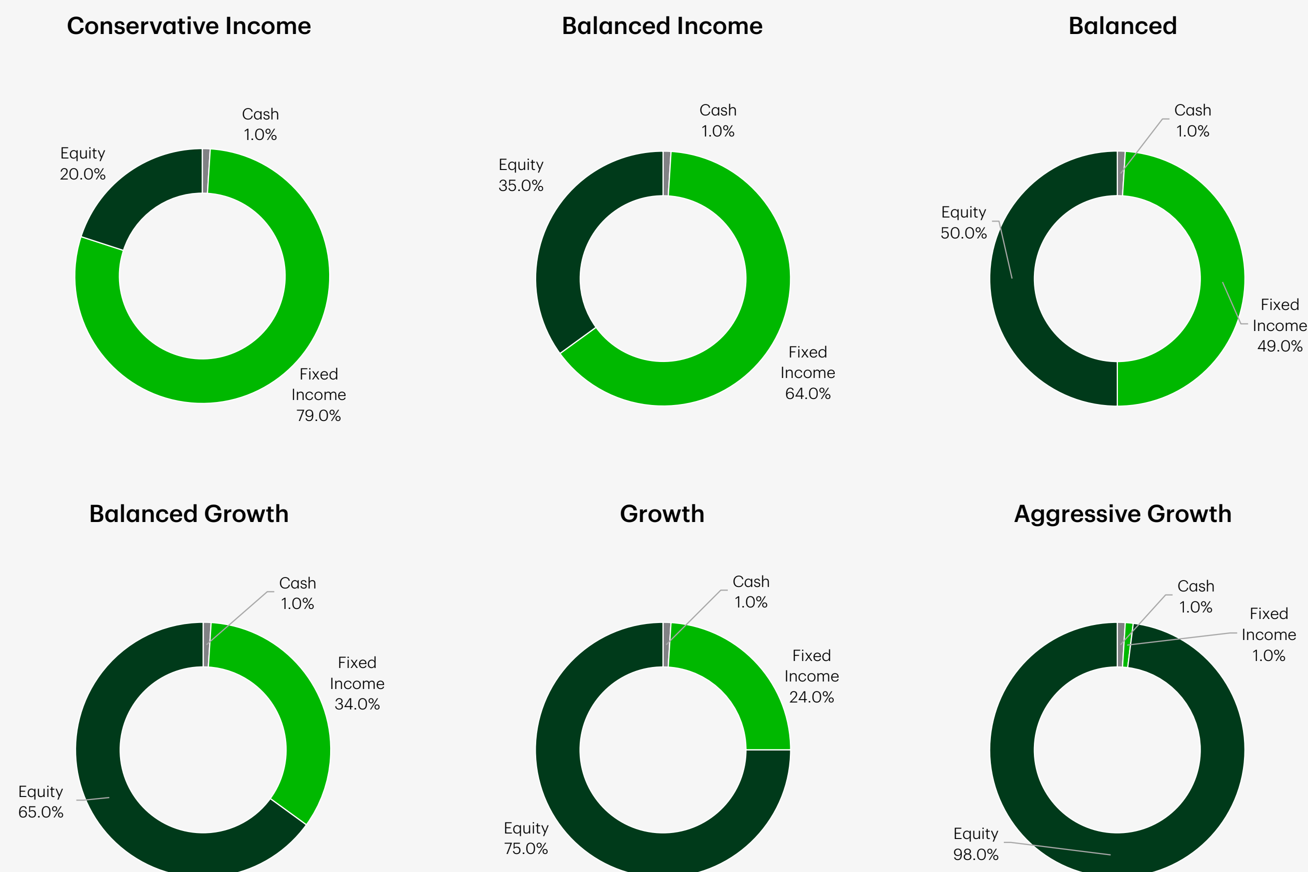
While WAAC made some adjustments to the sub-asset classes, the Wealth Investment Policy Committee (WIPC) did not make any changes to the strategic and dynamic asset allocation tables as the allocations are currently aligned with the new WAAC recommendations. Overall, at the top asset class allocation tier, WIPC maintains a modest overweight position in fixed income, a neutral position in equities, alternatives/ real assets, and a modest underweight position in cash & equivalents. This aligns with WAAC's core asset class allocation view.

Within equities, WIPC has maintained a neutral allocation to Canada and a modest overweight allocation to U.S. equities in all of the risk profiles. Elsewhere, the allocation to international equities remains underweight by 2 pp while the allocation to China/Emerging Markets remains neutral.

Within fixed income, WIPC has maintained the overweight allocation to domestic government bonds by 2 pp in all profiles except Aggressive Growth, which is 1 pp overweight. The allocation to investment grade corporate bonds is neutral to modest overweight while the allocation to high yield bonds is underweight by 1 to 2 pp. The allocation to global bonds remains neutral for Developed Markets and Emerging Markets.

WIPC has also maintained an overall neutral allocation to alternatives. At the subclass level the allocation to commercial mortgages remains overweight by 1 pp in all investor profiles, with the exception of Conservative Income which is neutral. The allocation to private debt is neutral, and real estate is underweight by 1 – 2 pp. The allocation to infrastructure is neutral for the Conservative and Balanced Income investor profiles, and 1 pp overweight for all other profiles.

Dynamic asset-class weights by investor profile (Condensed)

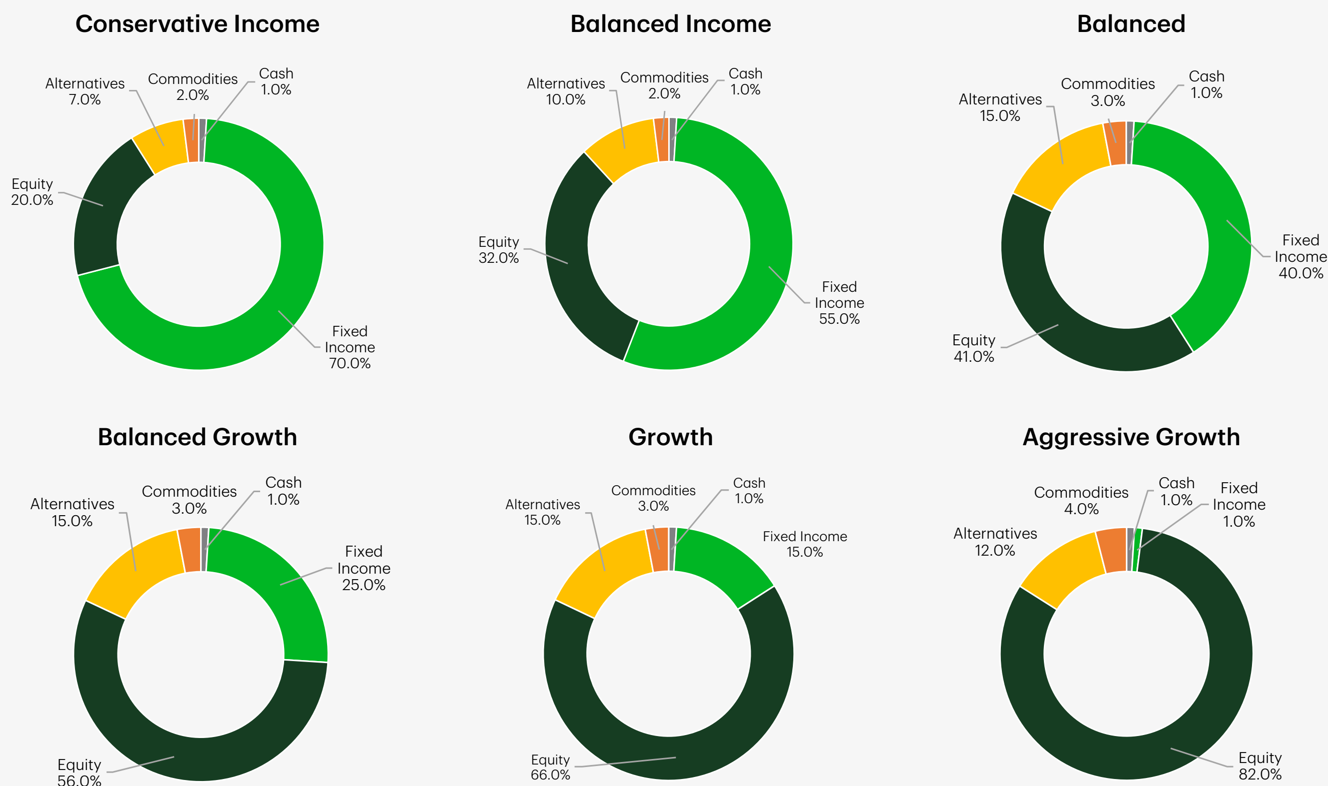


Strategic and dynamic asset-class weights by investor profile (Condensed)

Asset Class	Conservative Income		Balanced Income		Balanced		Balanced Growth		Growth		Aggressive Growth	
	Strat.	Dyn.	Strat.	Dyn.	Strat.	Dyn.	Strat.	Dyn.	Strat.	Dyn.	Strat.	Dyn.
Cash	2.0%	1.0%	2.0%	1.0%	2.0%	1.0%	2.0%	1.0%	2.0%	1.0%	2.0%	1.0%
Public Fixed Income	78.0%	79.0%	63.0%	64.0%	48.0%	49.0%	33.0%	34.0%	23.0%	24.0%	0.0%	1.0%
Government	39.0%	40.0%	32.0%	33.0%	24.0%	25.0%	17.0%	18.0%	11.0%	12.0%	0.0%	1.0%
Corporate	39.0%	39.0%	31.0%	31.0%	24.0%	24.0%	16.0%	16.0%	12.0%	12.0%	0.0%	0.0%
Public Equities	20.0%	20.0%	35.0%	35.0%	50.0%	50.0%	65.0%	65.0%	75.0%	75.0%	98.0%	98.0%
Canadian	6.0%	6.0%	11.0%	11.0%	15.0%	15.0%	20.0%	20.0%	23.0%	23.0%	29.0%	29.0%
U.S.	8.0%	10.0%	14.0%	16.0%	20.0%	22.0%	26.0%	28.0%	30.0%	32.0%	40.0%	42.0%
International	4.0%	2.0%	7.0%	5.0%	10.0%	8.0%	13.0%	11.0%	15.0%	13.0%	19.0%	17.0%
China/ Emerging Markets	2.0%	2.0%	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 April 18, 2024.

Dynamic asset-class weights by investor profile (Expanded)



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

Asset Class	Conservative Income		Balanced Income		Balanced		Balanced Growth		Growth		Aggressive Growth	
	Strat.	Dyn.	Strat.	Dyn.	Strat.	Dyn.	Strat.	Dyn.	Strat.	Dyn.	Strat.	Dyn.
Cash	2.0%	1.0%	2.0%	1.0%	2.0%	1.0%	2.0%	1.0%	2.0%	1.0%	2.0%	1.0%
Public Fixed Income	69.0%	70.0%	54.0%	55.0%	39.0%	40.0%	24.0%	25.0%	14.0%	15.0%	0.0%	1.0%
Domestic Government Bonds	28.0%	30.0%	22.0%	24.0%	15.0%	17.0%	9.0%	11.0%	5.0%	7.0%	0.0%	1.0%
Invest. Grade Corp Bonds	24.0%	25.0%	19.0%	20.0%	14.0%	15.0%	9.0%	9.0%	5.0%	5.0%	0.0%	0.0%
High Yield Bonds	5.0%	3.0%	4.0%	2.0%	3.0%	1.0%	2.0%	1.0%	1.0%	0.0%	0.0%	0.0%
Global Bonds - Developed	8.0%	8.0%	6.0%	6.0%	5.0%	5.0%	3.0%	3.0%	2.0%	2.0%	0.0%	0.0%
Global Bonds - Emerging	4.0%	4.0%	3.0%	3.0%	2.0%	2.0%	1.0%	1.0%	1.0%	1.0%	0.0%	0.0%
Public Equities	20.0%	20.0%	32.0%	32.0%	41.0%	41.0%	56.0%	56.0%	66.0%	66.0%	82.0%	82.0%
Canadian	6.0%	6.0%	10.0%	10.0%	11.0%	11.0%	16.0%	16.0%	19.0%	19.0%	22.0%	22.0%
U.S.	8.0%	10.0%	13.0%	15.0%	17.0%	19.0%	23.0%	25.0%	27.0%	29.0%	35.0%	37.0%
International	4.0%	2.0%	6.0%	4.0%	8.0%	6.0%	11.0%	9.0%	13.0%	11.0%	15.0%	13.0%
China/Emerging Markets	2.0%	2.0%	3.0%	3.0%	5.0%	5.0%	6.0%	6.0%	7.0%	7.0%	10.0%	10.0%
Alternatives	7.0%	7.0%	10.0%	10.0%	15.0%	15.0%	15.0%	15.0%	15.0%	15.0%	12.0%	12.0%
Commercial Mortgages	4.0%	4.0%	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%	3.0%	3.0%	0.0%	0.0%
Real Estate	0.0%	0.0%	1.0%	0.0%	3.0%	1.0%	3.0%	1.0%	3.0%	1.0%	3.0%	2.0%
Infrastructure	0.0%	0.0%	2.0%	2.0%	5.0%	6.0%	5.0%	6.0%	5.0%	6.0%	9.0%	10.0%
Commodities	2.0%	2.0%	2.0%	2.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	4.0%	4.0%
Fixed Income	71.0%	71.0%	56.0%	56.0%	41.0%	41.0%	26.0%	26.0%	16.0%	16.0%	2.0%	2.0%
Equity	20.0%	20.0%	32.0%	32.0%	41.0%	41.0%	56.0%	56.0%	66.0%	66.0%	82.0%	82.0%
Alternatives	7.0%	7.0%	10.0%	10.0%	15.0%	15.0%	15.0%	15.0%	15.0%	15.0%	12.0%	12.0%
Commodities	2.0%	2.0%	2.0%	2.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	4.0%	4.0%

Strat: Strategic, Dyn: Dynamic. Source: Wealth Investment Policy Committee, as of April 18, 2024.

Economic Outlook

Why So Glum? The Disconnect Between Consumer Sentiment and Economic Data

Shernette McLeod, Economist | TD Economics

Highlights

- The U.S. is outperforming most other developed countries on many indicators of economic health. Despite this, U.S. consumers are still reporting levels of sentiment more consistent with an economy emerging from a recession, rather than one that has consistently outperformed.
- Several explanations have been suggested to account for the discrepancy. These generally revolve around inflation, interest rates and consumer's internalized anxiety about the current social and geopolitical climate.
- While the current strength in consumer spending may contradict their self-reported sour mood, if historical relationships reassert themselves, consumer spending may be headed for a soft patch.

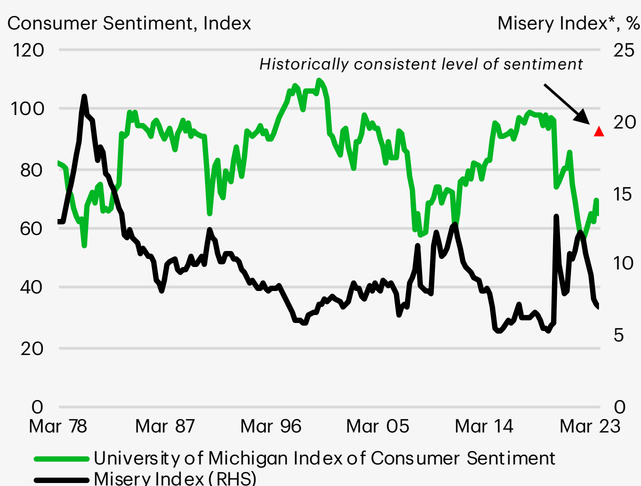
According to official data, the U.S. economy is performing exceptionally well and is outperforming many of its G7 peers (see here). Inflation has come down from near double-digit highs, unemployment is historically low, employment growth is strong, real wages are starting to rise and GDP is growing at a healthy clip (see TD forecasts). The problem – consumers remain relatively glum.

Measures of consumer sentiment have been notably lower than what such strong economic data would normally merit. Historically, moderate inflation and low unemployment would result in a rather elevated level of consumer sentiment. Take for example the misery index, which is the sum of the unemployment and inflation rates. It currently stands at 7.1%. Historically, when the misery index is that low, consumer sentiment, as measured by the University of Michigan's Index of consumer sentiment, is generally around 92 points (Figure 1). The most recent sentiment measure of 76.5 however is notably below that mark. The same is true of the Conference Board's consumer confidence measure, which at 104.7 is also below its historically consistent value of around 113. Thus, despite recent upticks, consumer sentiment is still significantly below the level normally associated with such robust economic data. In short, there appears to be a general disconnect between consumer mood and U.S. economic performance in the hard data.

The Interplay Between Sentiment and Spending

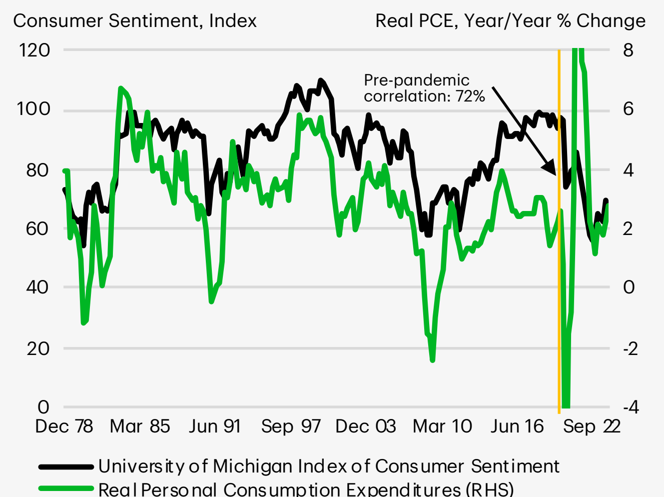
First off, previous research has shown that there is a correlation between consumer spending and consumer sentiment.[1] In fact, the correlation between the Michigan consumer sentiment index and growth in total personal consumption expenditure was more than 70% prior to the pandemic (Figure 2).[2] This historically strong link between the two variables suggests that confidence may be helpful in predicting consumer spending.

Figure 1: Sentiment is much lower than current economic data would warrant



*The Misery Index is the sum of the unemployment rate and the year-over-year % change in the CPI-U. Source: BLS, University of Michigan, TD Economics.

Figure 2: Correlation between spending and sentiment has weakened since the pandemic



Source: Bureau of Economic Analysis, Univesrity of Michigan, TD Economics.

To delve deeper, the question of whether or not consumer sentiment provides meaningful information about future consumer spending beyond that already contained in other economic data has already been examined in the economic literature. The general finding is that it does, but with caveats. Earlier studies found a direct link between sentiment and spending such that movements in sentiment could directly help to forecast movements in consumer spending.[3] The relationship was small but significant. More recent authors have found, however, that controlling for variables omitted in these earlier studies, sentiment affects spending, but only indirectly.[4] In this view, sentiment simply foreshadows the overall outlook for the economy, by between one to four quarters ahead. It's a reflection of emerging economic conditions. When consumers are optimistic about the economic outlook, they give positive responses to interviewers. On average, those expectations are validated and spending eventually increases as sentiment suggested it would.

Reasons for the Disconnect Between Sentiment and Economic Data

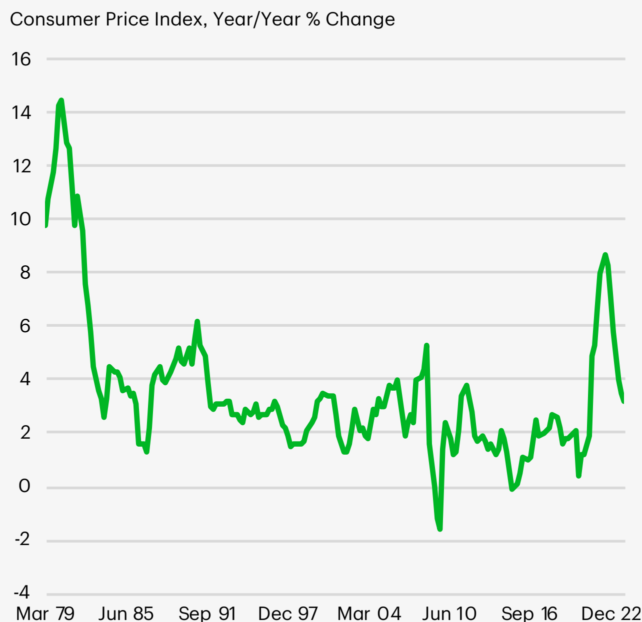
Given the historical and empirical connection between sentiment and economic data, the current divergence between the two is even more interesting. There are several reasons that have been proposed and they fall into three broad categories relating to inflation, interest rates and consumer's internalization of external non-economic factors (aka "referred pain").

Price Changes and Levels

Firstly, high inflation coming out of the pandemic likely dampened consumer's mood. Many consumers have not experienced inflation as high as 9.1% in their lifetime. The last time inflation exceeded 9.1% was over 40 years ago (Figure 3). The memory and shock of it may still be lingering and affecting sentiment. Consumers tend to have long memories when they experience a negative shock such as rapidly rising prices, and it will take a sustained period of much lower price increases to counteract that effect.

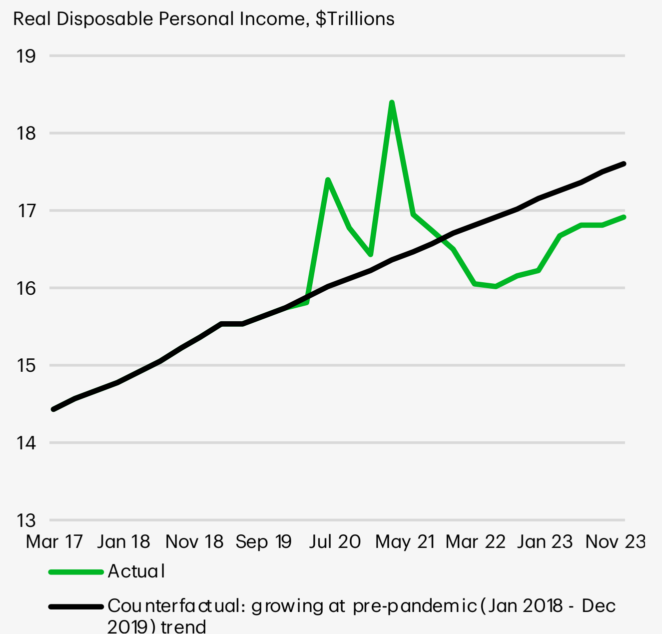
Adding to the negative feelings associated with inflation is the fact that while the rate of inflation might have cooled, price levels are still elevated. Prices are especially high relative to before the pandemic with prices growing 20% in the most recent four years compared with growth of just 9.1% in the prior four. These steep price increases are particularly evident for things people purchase often, such as grocery[5] and research has shown that individuals are heavily influenced by the prices of frequently bought items.[6] Early in the surge in inflation– between April 2021 and February 2023 – real wages declined. Even though real wages and incomes are now on the rise again, consumer's purchasing power has not regained all the ground lost during that period (Figure 4). The cumulative loss in purchasing power combined with the still high prices for frequently purchased items may help explain why the drop in inflation thus far has yet to improve consumers' moods.

Figure 3: The most recent period of high inflation prior to the pandemic was in the 1980s



Source: Bureau of Labor Statistics, TD Economics.

Figure 4: Consumers' purchasing power has not yet regained ground lost during the inflation surge



Source: Bureau of Economic Analysis, TD Economics.

Inflation (Mis)Calculation

Another aspect to the inflation-induced malaise is one recently suggested by former Treasury Secretary Larry Summers and co-authors[7] – inflation is still high. They argue that if interest rates, or "the cost of money", was included in the prices used to measure inflation, inflation would be a lot higher. The current CPI basket does not account for interest expenses. Consequently, it is likely to understate the pain that many consumers feel as rising rates make it more expensive to undertake major purchases that are typically done on credit, such as homes and vehicles (Figure 5). This is how inflation was measured at the turn of the century, and using a reconstructed CPI measure, Summers et al (2024) estimate that homeownership costs in the CPI would have more than doubled since the pandemic. If interest costs associated with mortgages were directly included in the CPI, then inflation would have peaked at 18% not 9.1%, and current inflation would be measuring closer to 8%, not 3%.[8] Their calculations suggest that consumers are experiencing a higher rate of inflation than what is measured in the official numbers, and this is dampening their moods.

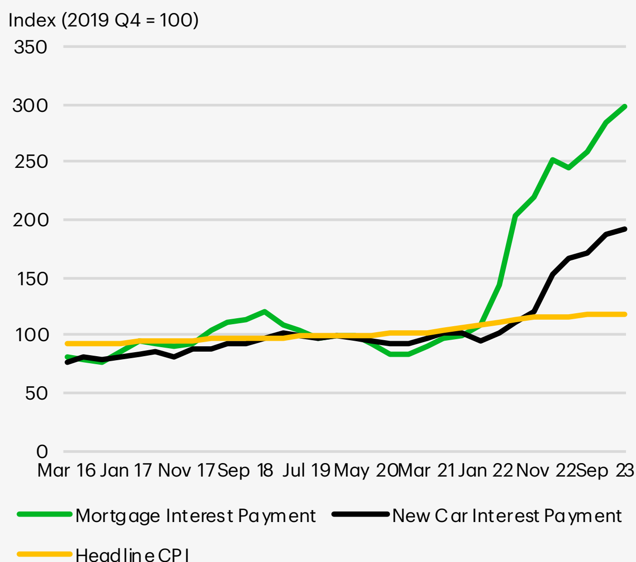
Referred Pain

Another thesis attempting to explain unusually low consumer sentiment amidst such robust economic data is the "referred pain" hypothesis.[9] This hypothesis suggests that non-economic concerns now drive economic sentiment such that consumers' gloomy mood is due to increases in political distrust, rising cultural conflict and general dissatisfaction with institutions (Figure 6). In essence, pessimism about the economy may reflect dissatisfaction with other elements in the country or even the wider world. There is a general sense among some Americans of tenuous long-term financial stability susceptible to upheavals from wide-ranging social and political actions.[10] This is perhaps understandable given that in the past 15 years many adults have lived through major life altering events such as the global financial crisis and U.S. housing collapse (2007/2008) and the Covid-19 pandemic, which significantly altered many aspects of everyday life. This general sense of living through precarious and unpredictable times, with little support from the social and cultural institutions meant to offer it, has left many feeling weighed down under a general sense of pessimism, divorced from seemingly good economic times.

Bottom Line

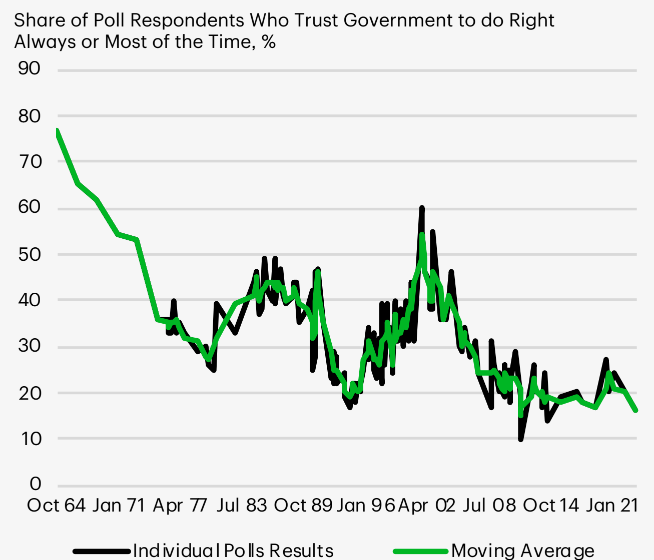
Despite low unemployment, strong GDP growth, declining inflation and solid wage gains, many Americans are still feeling less optimistic than the data would suggest. The reasons proffered for the widespread malaise have largely centered around the various impacts of inflation, high interest rates and deep-rooted concerns about the general social, cultural and geopolitical climate. While consumer spending has so far defied the downbeat mood reported on sentiment surveys, it may be just a matter of time before spending also retreats as previous analysis has shown a high correlation between the two. A cooling in spending, while lending an assist to the Fed's inflation fighting regime, does remove one of the major divers of America's current strong economic performance.

Figure 5: Skyrocketing debt payments may contribute to sour mood



Source: BLS, WSJ, S&P Case-Shiller, Federal Reserve Board, TD Economics.

Figure 6: Trust in government near historic lows



Source: Pew Research Center, TD Economics.

Asset Class Analysis

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Quarter in Review

Fear, momentum, diversion and reversal

Fred Wang, Senior Portfolio Manager, Asset Allocation | TD Wealth

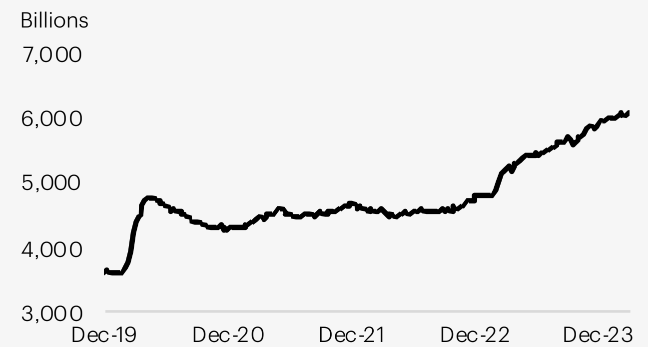
In the first quarter, a number of seemingly unrelated market drivers somehow interacted to create many interesting dynamics and opportunities. Let's switch things up and take a look at the action-packed quarter through these lenses.

Fear is not a verb

Fear, as an emotion, is not only powerful — it's also persistent. Although we've seen strong performance for most risky assets, it's easy for investors to find reasons to fear the worst. For investors who are prone to constant worry, it's only natural to avoid risk-taking, and that's precisely what we saw in the first quarter, with a historic amount of capital moving into GICs and money-market funds (Figure 1). What's more, there have been fewer IPOs, fewer issuances of corporate debt, fewer private-asset deals, and less M&A activity in general, leaving the markets with a significant amount of dry powder (Figure 2). In short, fear discourages all activities in financial markets.

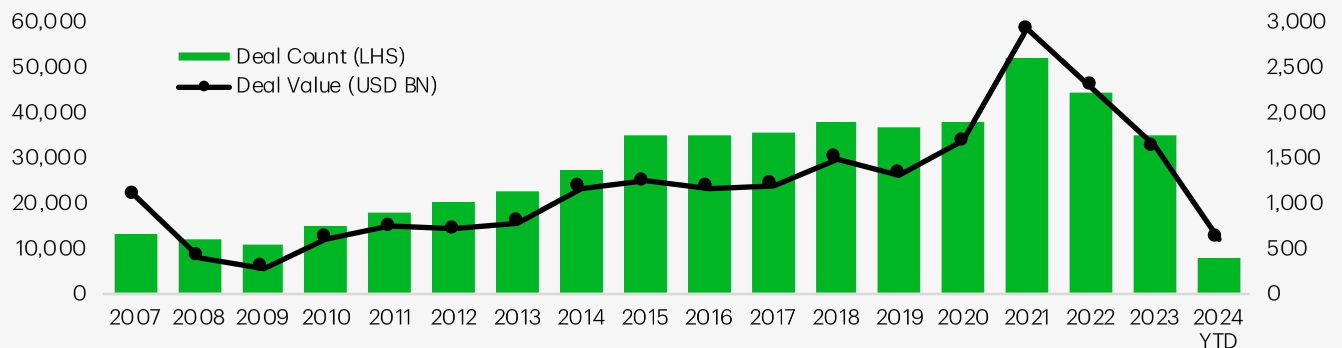
So, what's at the root of all this fear, and is it justified? For one, there continues to be a strongly inverted yield curve, which has been signalling a probability of recession for a long time now (Figure 3). While there have been many suggestions that "this time is different," it's wise to keep track of real-time data to gauge whether the U.S. economy is inching closer to contraction.

Figure 1: U.S. Money Market Fund Assets



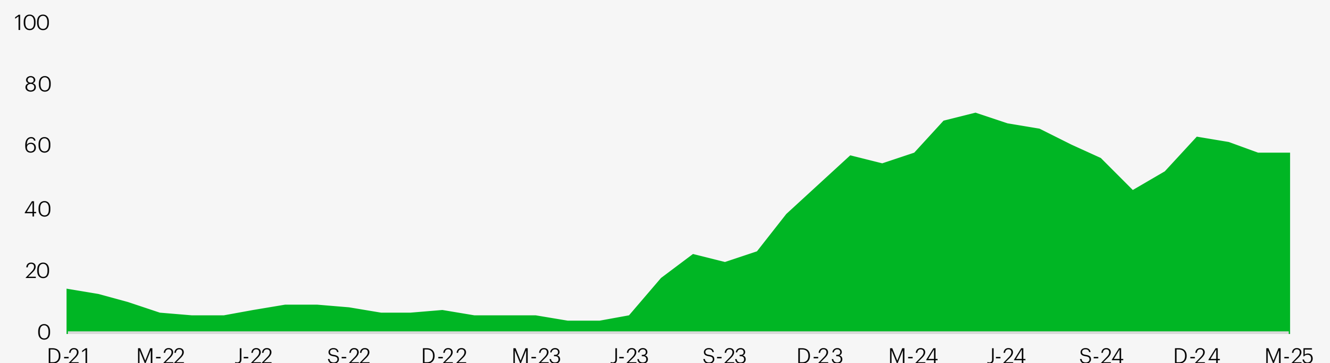
Source: Macrobond, WIO as of April 3, 2024

Figure 2: Private Equity Deal Count vs Value by Calendar Year



Source: Preqin, WIO as of March 31, 2024

Figure 3: Recession Probability from New York Fed based on Yield Curve Shape



Source: FactSet, WIO as of December 31, 2023

The Atlanta Fed's GDP Now breakdown (Figure 4) is one of our favourite high-frequency measures of U.S. economic growth. It incorporates all economic data, released in real time, to form an estimate of the current quarter's annualized growth rate. We believe, it's an indicator that keeps everyone honest, since the growth estimate is based on each hard data point's contribution to the final GDP growth, avoiding the common bias to emphasize one data point over another. The tracker bottomed in Q2 2022 and has been rising swiftly since then. Digging deeper, the breakdown shows that robust consumption continues to be the primary driver of the U.S. economy, contributing 2.1 percentage points of the 2.4% estimated GDP growth for Q1 2024.

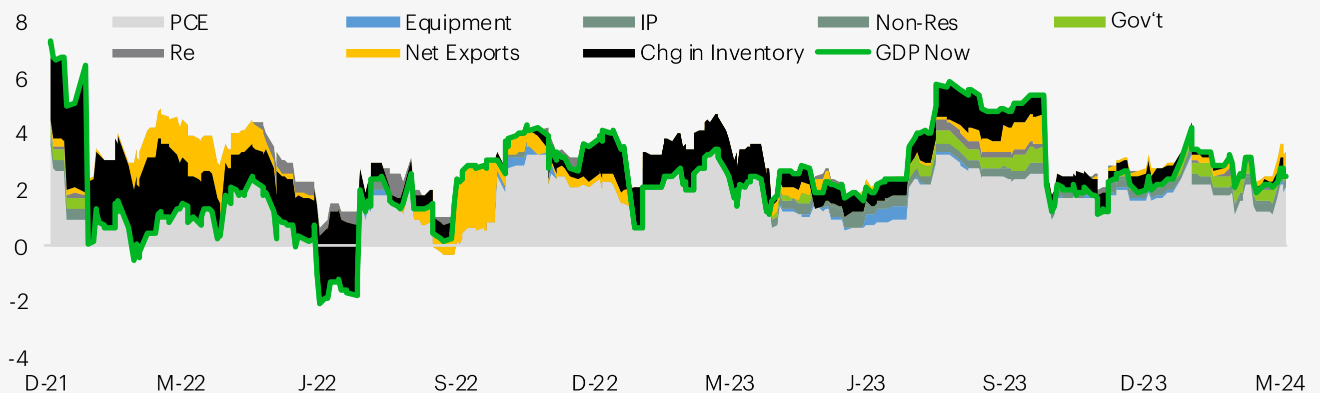
Impact of hawkish surprises have been smaller

Another fear revolves around stubborn inflation. This one can be more or less justified by looking at the data. Figure 5 shows that recent CPI releases have been hotter than expected, driving the one-year breakeven higher. This shift in the inflation narrative has been met with a more hawkish tone from Federal Reserve officials. As a result, the futures market for the fed funds rate has priced in fewer cuts for 2024, and Treasury yields are moving higher.

However, even with hotter CPI data unravelling the bond market, there is no doubt that the impact of this surprise and the uncertainty around CPI data is much lower than it was during the 2022 peak. This has begun to translate into increased clarity around the future path of the policy rate, and lower interest-rate volatility, as shown in Figure 6. Less uncertainty about future rate policy is important because it makes it much easier to price corporate buyouts or for analysts to evaluate public companies. This should be a positive development for the market and empirically one of the reasons why risk assets perform well after the last rate hike.

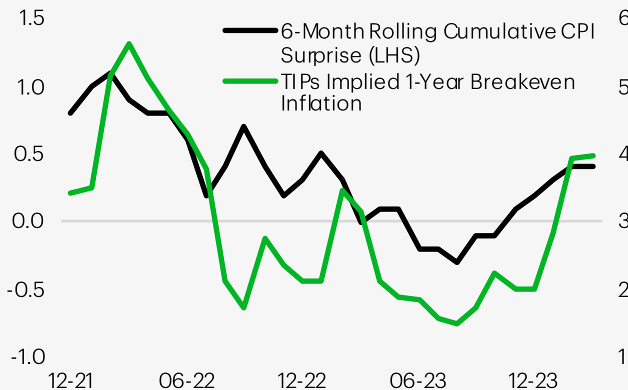
Over the past quarter, we have observed some of the largest private-market investors put money to work. Although deal count and value are still tepid, one thing to notice is that the average deal size year-to-date has increased significantly — to over US$155 million, compared to only US$92 million over 2022 and 2023. This echoes what happened after the global financial crisis. Our interpretation is that now may be an opportune time for marquee players in the private-equity space, with the ability to pursue larger companies while most of their smaller competitors are still stuck in fear.

Figure 4: Atlanta Fed 'GDP Now' Breakdown



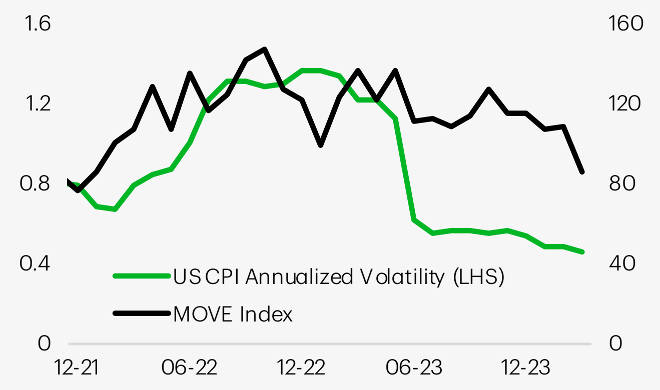
Source: Macrobond, WIO as of April 4, 2024

Figure 5: Positive Inflation Surprise vs 1-Year Breakeven Inflation



Source: Macrobond, WIO as of April 4, 2024

Figure 6: Annualized Volatility of U.S. CPI Inflation vs MOVE Index



Source: Macrobond, WIO as of April 4, 2024

Fear of bank failure might be overblown

Every week we see news stories about problems in the commercial real estate sector, which in turn could jeopardize the financial stability of the banking system. To some extent, this fear is warranted given that we just had a major bank failure one year ago. However, we should be mindful of the context here. Compared to most countries in the world, the U.S. is over-banked with thousands of regional and community banks, in addition to a few major national players. Given that the vast majority of banks in the U.S. are small, it's not hard for a small bank failure to catch media attention.

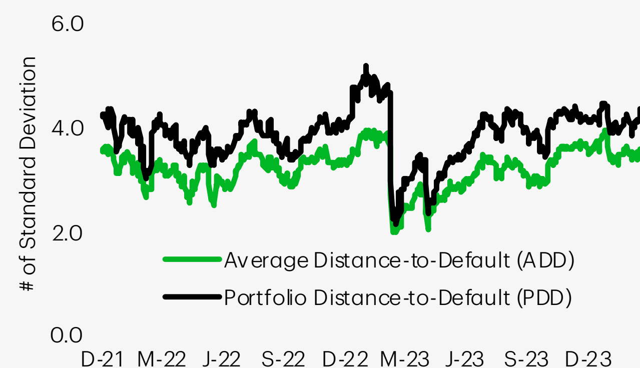
Figure 7 shows the Cleveland Fed's average distance-to-default (ADD) and portfolio distance-to-default (PDD) measures, which uses the options market to quantify perceived and actual banking-sector stress. The lower the gauges are, the more banking stress there is. The ADD essentially measures banking stress by giving each bank the same weight, which means small community banks could be treated equally as the large money-centre banks. If the number of bank failures increases, even if they are small banks, the ADD will decrease.

The PDD, on the other hand, takes into account the relative size of each bank. In the event that we see small bank failures, the PDD may not go down meaningfully, as long as the more important money-centre banks are holding up well. Both measures have been improving significantly since the Silicon Valley Bank (SVB) failure in March last year. The Cleveland Fed has defined the systematic risk indicator as the difference in PDD and ADD in order to quantify the actual banking stress and provided the threshold for mild and severe banking stress. Figure 8 shows that since Q2 last year, there has only been a brief episode of moderate banking stress. So, bottom line, the banking system is safe and sound.

Opportunities grew out of fear in Q1

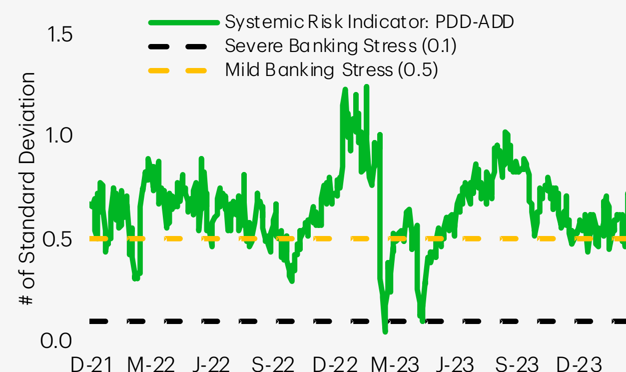
How financial markets operate is simple: fear leads to hoarding cash which can lead to dislocation; and dislocation leads to opportunity. As we enter 2024, we observed the emergence of plenty of opportunities that have served investors well.

Figure 7: Cleveland Fed Average Distance-to-Default vs Portfolio Distance-to-Default



Source: Macrobond, WIO as of March 27, 2024

Figure 8: Cleveland Fed Systematic Risk Indicator



Source: Macrobond, WIO as of March 27, 2024

After a strong rally for both stocks and bonds over the last quarter of 2023, investors got excited. Sentiment quickly shifted from "gloom and doom forever" amid stubborn Fed hawkishness to quickly embrace the narrative that we will see a decisive dovish pivot in 2024. Investors that had already put money in the market were happy with the Q4 rally, but for those on the sidelines, a fear of missing out (aka FOMO) became apparent. During the first quarter, more than US$150 billion flowed into mutual funds and ETFs in the U.S. These FOMO-driven fund flows helped sustain the price momentum in equities, which in turn could beget more FOMO flow and momentum (Figure 9).

Figure 9: Excess Return of Style Indices Against Core Indices in Different Regions

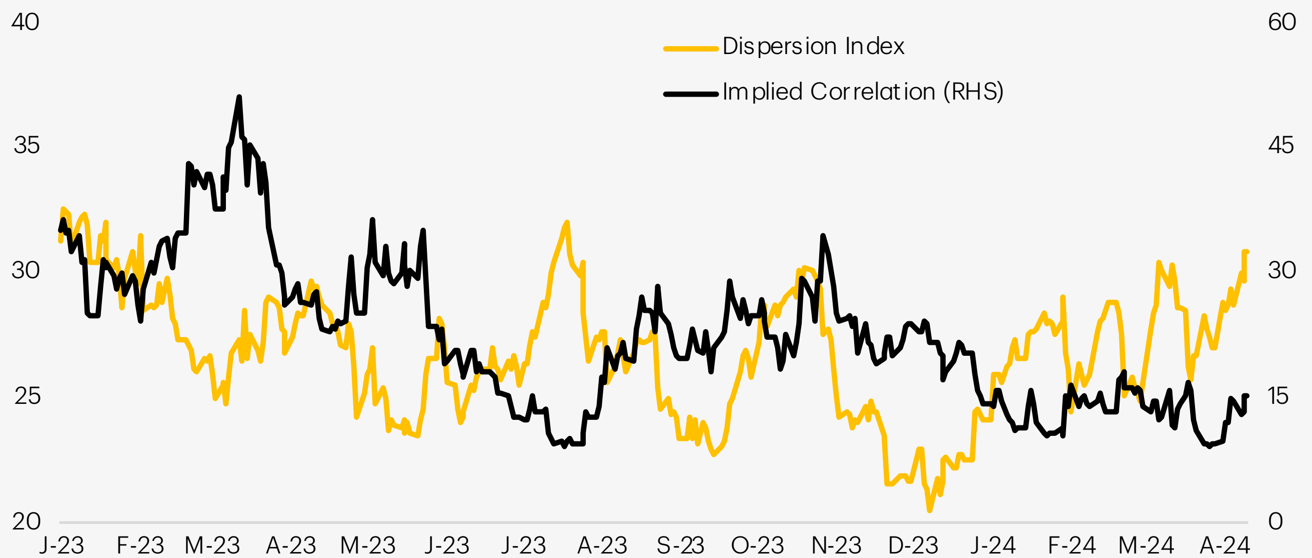
2024 YTD Excess Return	Value	Dividend	Low Vol	Growth	Momentum	Quality
US	-1.42%	-2.40%	-2.76%	1.39%	9.96%	2.52%
Canada	-1.95%	-1.75%	-0.72%	1.97%	3.78%	3.53%
EAFE	-1.30%	-4.97%	-3.55%	1.25%	9.21%	-1.43%
EM	-1.05%	-0.19%	-0.59%	0.98%	4.83%	-3.02%

Source: Macrobond, WIO as of March 31, 2024

As sideline money pours in to companies that are already well-known, price differentials for individual stocks widen, creating attractive opportunities for stock-pickers. Figure 10 shows two measures that support this verdict. First, the implied correlation derived from individual stocks as well as index options has been at its lowest level since 2023. This is in sharp contrast to 2022, when large macro forces such as inflation and monetary policy could drive the performance of all stocks. The second measure is the S&P 500 Dispersion Index, which measures how volatile individual stocks are relative to the index, implied from the options market. Higher dispersion indicates that the options market is pricing in potentially larger moves in individual stocks, providing higher reward for active strategies that successfully pick winner over losers.

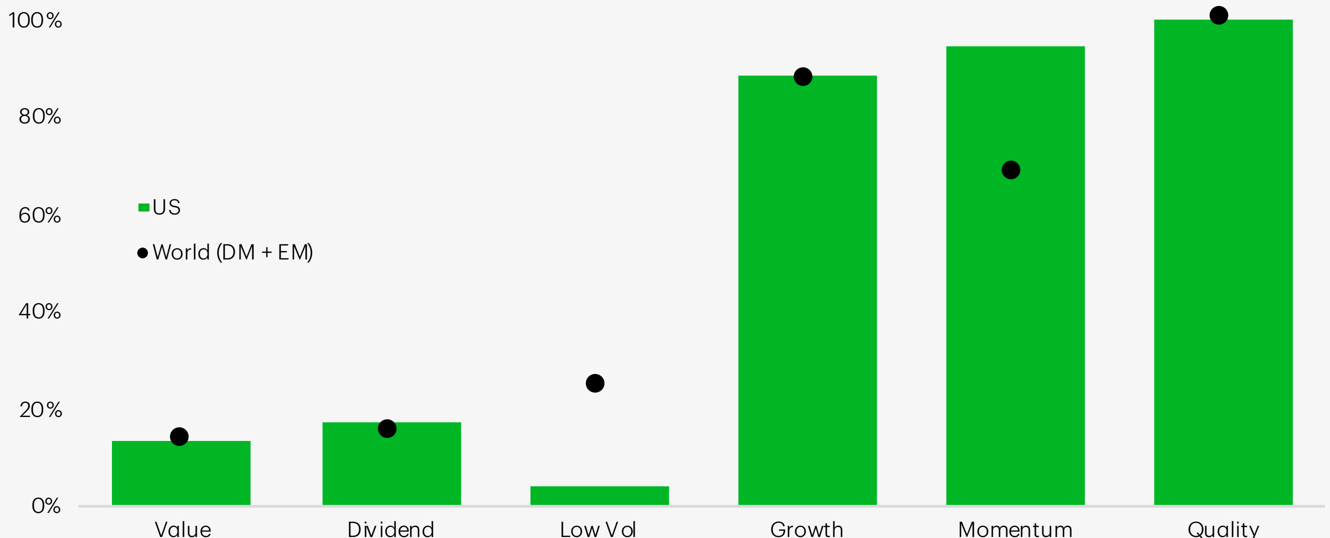
Styles that are still out of favour, such as value, dividend and low-volatility, have seen their valuation hover below the bottom quintile over a 10-year range (Figure 11). To be clear, valuation spread is never meant to be a timing tool for style rotation, and the spread can stay wide for a long time. What we know, however, is that valuation spread cannot continue to widen indefinitely and can provide an indication of what the potential payoff could be when valuation spreads normalize.

Figure 10: CBOE S&P 500 Implied Correlation Index vs Dispersion Index



Source: Macrobond, WIO as of March 31, 2024

Figure 11: 10-year Valuation Spread Percentile Between Different Equity Style vs Core Indices

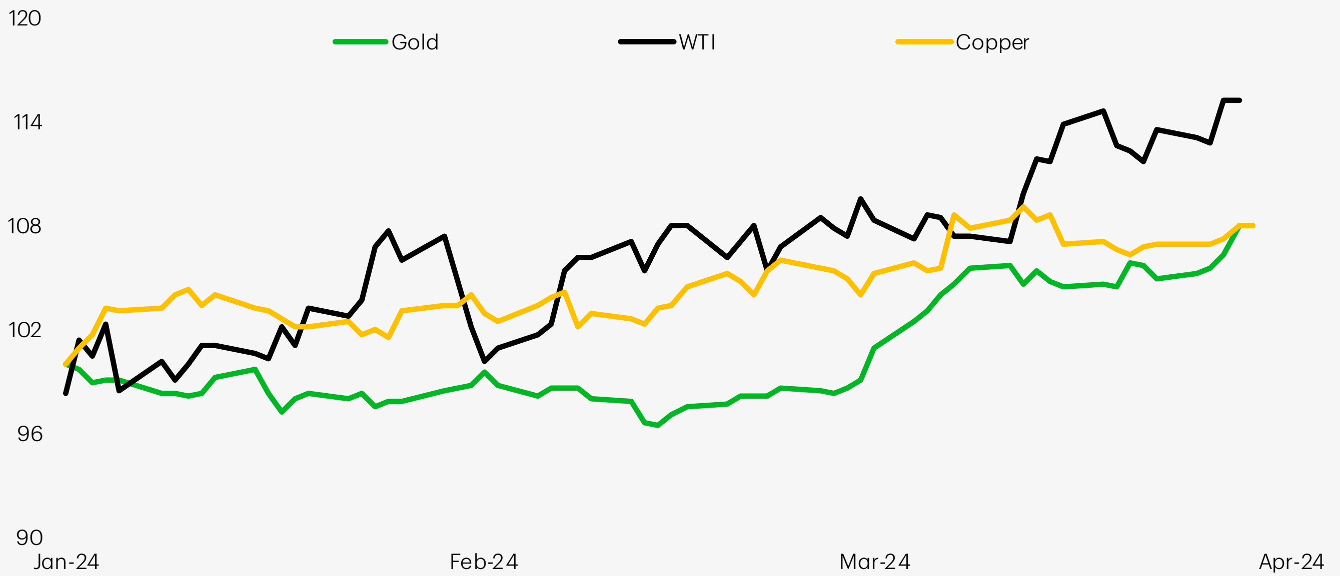


Source: Macrobond, WIO as of March 31, 2024

During the quarter, the Wealth Investment Policy Committee (WIPC) added commodities to the strategic asset mix. It's great to see that, subsequently, the commodities complex delivered positive returns for investors (Figure 12). A number of drivers of the strong performance were inline with our rationale to add commodities. First, we expected the asset class to do well amid economic expansion and upside inflation surprises, which is what happened during the quarter.

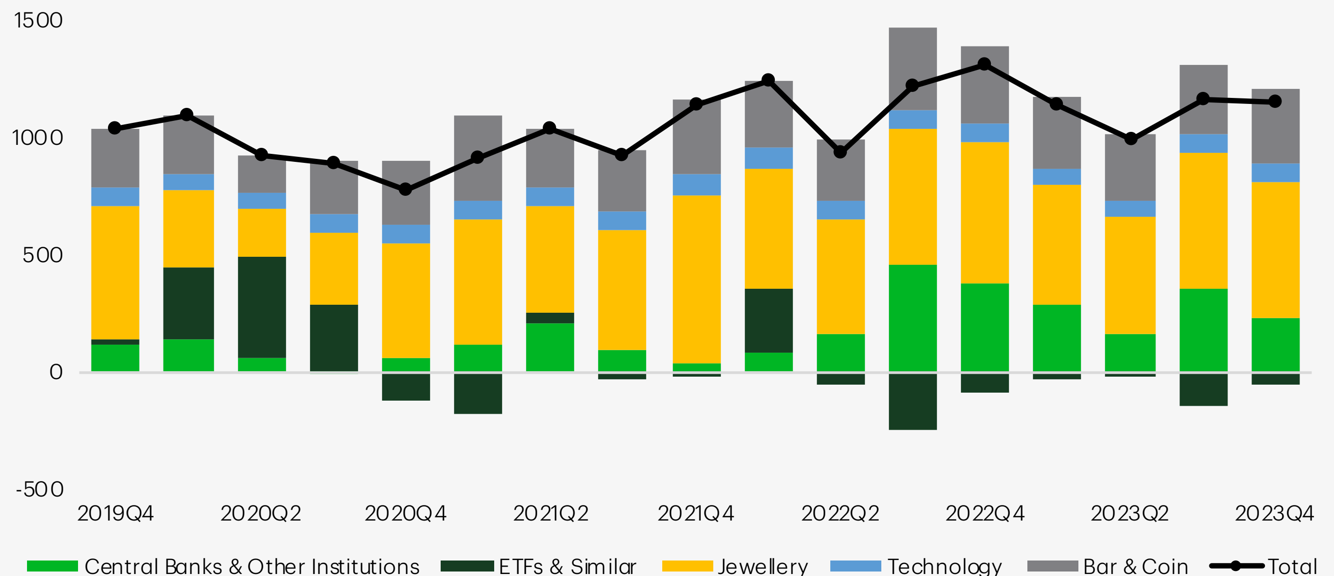
Second, the ongoing military conflict in middle east, as well as the attacks on container ships near the Red Sea highlight increasing geopolitical risk. This concern often leads to disruption in oil markets and higher oil prices. Last but not least, as the geopolitical landscape continues to bifurcate since the war broke out in Ukraine, the demand for gold from global central banks has increased, primarily driven by China as the second largest economy seeks to diversify the reserves away from the U.S. dollar. Increase in gold in the central bank reserves around the globe added to already strong global demand (Figure 13).

Figure 12: YTD Return for Gold, WTI and Copper



Source: Macrobond, WIO as of March 31, 2024

Figure 13: Global Gold Demand Breakdown



Source: Macrobond, WIO as of March 31, 2024

Outlook on Fixed Income

Modest Overweight

Stay the Course

Aurav Ghai, Senior Fixed Income Analyst | TD Wealth

The U.S. economy continues to confound. Despite the Federal Reserve (Fed) rate hikes, inflation remains stubborn and growth just won't come in for a soft landing. This has forced market participants to unwind their expectations for a series of rate cuts later this year and has made fixed income markets give up some of their Q4 gains.

If we can zoom out for a moment and look beyond the turbulence—after all economic growth and geopolitics aren't going to resolve themselves overnight—we'll remember that yields are still near two-decade highs. Higher yields historically translate into higher returns meaning the longer-term outlook for bonds is still attractive. At current levels fixed income should flourish. In fact, fixed income continues to offer the best opportunity in a decade to build diversified portfolios. And if yields slide any further, they'll push up prices and add capital gains to total returns.

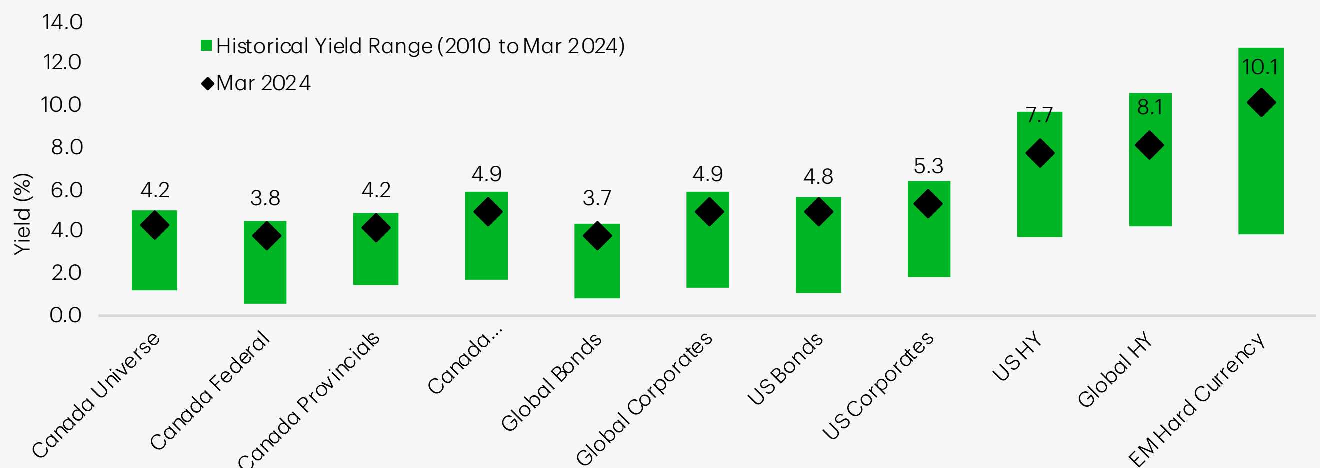
Returns may be volatile over the short term but they will accrue for those with longer time horizons—especially if fixed income portfolios are managed actively.

- We remain modest overweight fixed income investments in general and modest overweight domestic government bonds. Canadian government bonds are attractive at current yields and offer opportunities for income generation and downside protection. We expect price/yield volatility to decline in coming quarters as the economic outlook in Canada becomes clearer and market participants stop second-guessing future policy rate cuts.
- We have recently upgraded our view on investment grade (IG) credit to modest overweight. We expect Canadian IG to fare better than U.S. IG as spreads for Canadian IG credit are tight but still have some room to perform. We continue to focus on high quality credit—companies with robust balance sheets—and we expect technicals will remain supportive and healthy yields will mitigate losses from price volatility.
- We maintain our modest underweight view on high yield (HY) credit. We don't expect high yield credit to repeat the strong performance of 2023. The overall improved quality of the HY credit market should keep spreads from returning to previous recessionary levels, but they will widen if the growth outlook deteriorates.

Government bonds

In our previous Portfolio Strategy Quarterly (Q1 2024), we said it would be difficult for yields to sustain the end-2023 rate of reduction. Government bonds have extended their erratic path: the U.S. Government 10-year yield surged 165 basis points (bps) to 5% from May to October, fell 100 bps in the last two months of 2023 and jumped by 32 bps in the first quarter of this year. Unexpected economic data and the repricing of policy rates have been driving government yields for months now and will continue to do so in coming quarters. If we take a closer look at the recent repricing of the Fed policy rate path, market participants are now indicating that they believe the probability of steep policy rates cuts, or a recessionary environment, has declined.

Figure 1: Yields high across the board



Source: FactSet, Wealth Investment Office (WIO), as of March 31, 2024

At the start of the year, the market was pricing in a 10% probability that the policy rate would end 2024 below 2%. At the end of Q1, there is only a 10% probability the policy rate will be less than 3.5%. This implies the consensus range for the Fed policy path is narrowing and it supports our thesis: we expect government bonds to remain range-bound, with limited price declines and less-volatile yields in coming quarters.

When it comes to government yields, there's still no straight path forward. We believe central banks will err on the side of caution, limiting the size of rate cuts or delaying them or possibly both. Policy rates are likely to remain in restrictive territory and even though Canada may cut rates before the U.S. the divergence will be limited. Canada and other non-U.S. developed markets still can't rule out a more difficult landing than currently anticipated. This could happen very quickly so it's best to take a longer term view on government yields. We believe moderating government bond yield volatility along with potential rate cuts have improved the outcome for Canadian government bonds, or interest rate duration, over the medium to long term. From a valuation perspective, government bond yields are undeniably higher than the recent past and therefore offer more cushion (Figure 2).

We maintain our modest overweight view on Canadian government bonds. We encourage everyone to avoid the extremes: take a balanced and risk-managed view of government bonds and yields (or interest rate duration). We strongly favour actively managed government bonds or interest rate duration that taps into tactical opportunities on offer given the large trading range for yields.

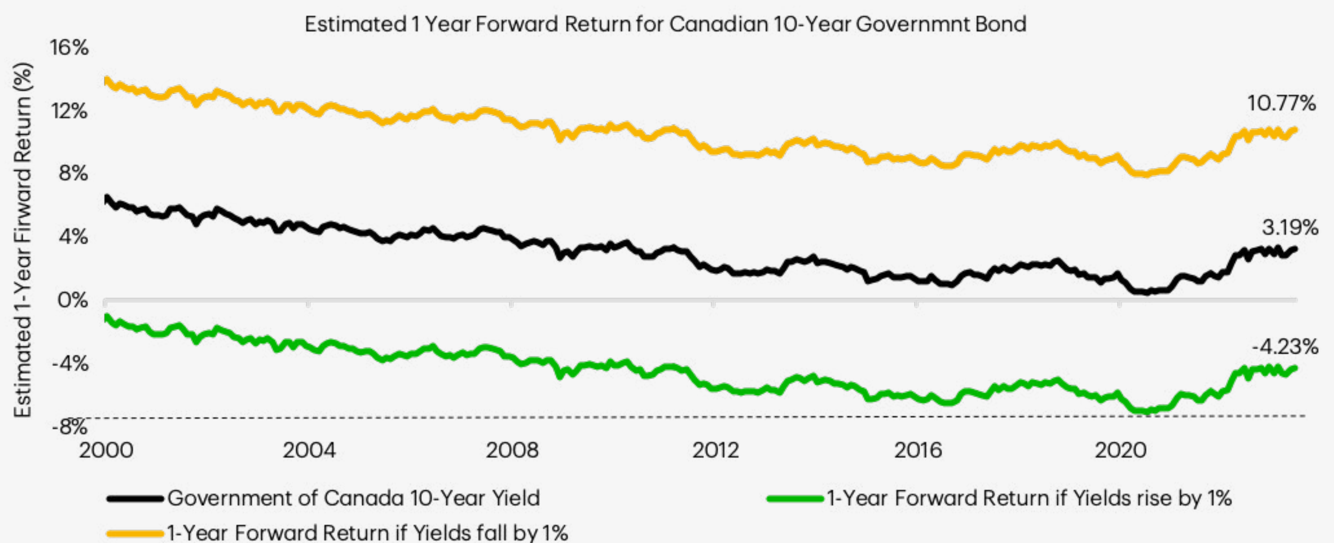
Key Themes for Government Bonds

1. Central Banks Diverging. The global investment landscape is ever evolving and we believe it will be transformed in the months ahead as the trajectories of major economies diverge. Central banks tightened policy in unison to curb the pandemic inflationary spike and will likely now follow a variety of paths when cutting rates. While almost every developed market economy is slowing, the U.S. has maintained its surprisingly strong momentum and it looks set to continue.

U.S. Federal Reserve Chair Jerome Powell's confident tone at recent press conferences coupled with the revised Fed projections suggests officials are determined to cut interest rates this year. Fed officials have signaled that it would take a dramatic turn of events to knock them off this course. The Fed's persistently strong guidance towards rate cuts makes us wonder whether these cuts would signal the beginning of a prolonged series smoothing rates back towards neutral, or nothing more than a mid-cycle adjustment aimed at sticky inflation. We'll be watching for any signs of rising or persistent inflation that could derail the series of cuts indicated in the Fed's latest projections.

On the Canadian side, we expect the Bank of Canada (BcC) to start reducing policy rates over the Northern Hemisphere summer, as inflation slows towards its target. Declining inflation, stagnant economic growth, and further softening of the labour market will give the BoC the confidence it needs to begin trimming rates. Investors and market participants are pricing in a

Figure 2: Risk/reward skewed favourably for Canadian government bonds



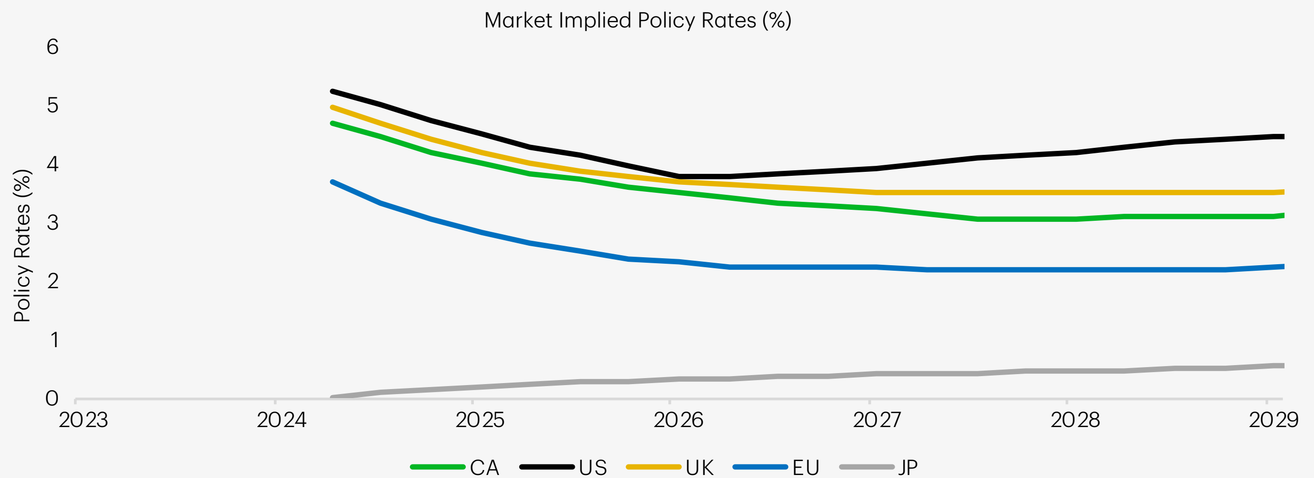
Source: FactSet, Wealth Investment Office (WIO), as of April 11, 2024.

similar trajectory for the BoC and the Fed policy rate cuts but we believe the pace of easing will be faster in Canada because of its weaker economy. Three main factors are hurting the Canadian economy: faster mortgage renewals, a slowdown in immigration, and weaker labour market dynamics. The pace of cuts isn't nearly as crucial as the end point and whether the BoC eventually trims rates more than the Fed.

With policy rates at cyclical peaks, developed market central banks (minus Japan) are broadly signaling a mid-year start to their easing cycles. We believe the pace of subsequent cuts could be faster than investors expect, that policy rates will diverge during the trimming cycle and that the year-end 2025 destination rate outside of the U.S. could be lower than anticipated. Market implied forward policy paths seem to agree with us on divergence and, importantly, they are not projecting a return to near-zero policy rates (Figure 3). All of this is subject to changing economic strength and the amount of tolerance central banks have for inflation levels that exceed their targets.

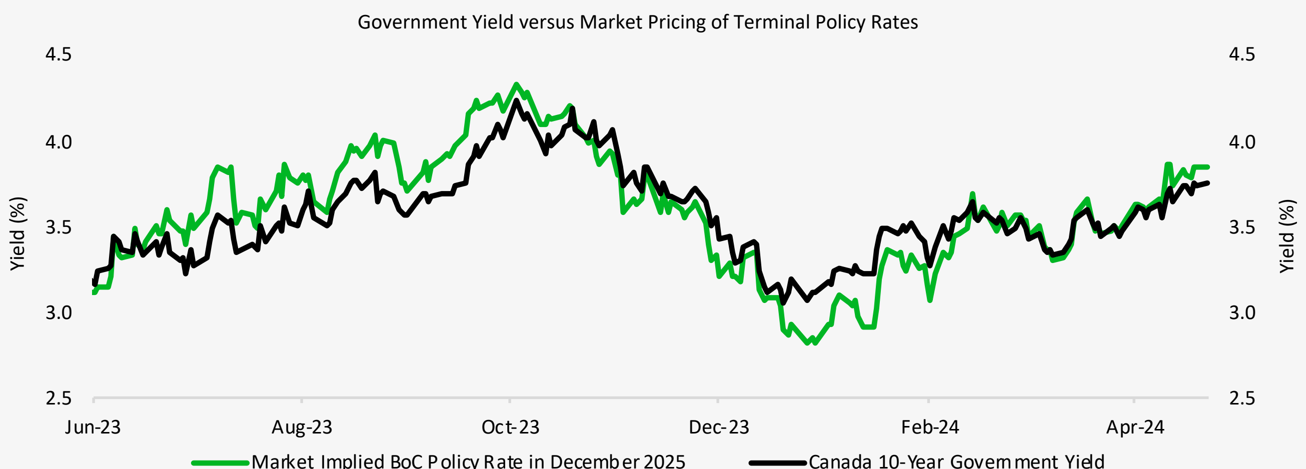
2. Number of Policy Rate Cuts Key, Not Start Date. Over past quarters, the U.S. economy has surprised to the upside time and again—despite the higher rates. We need to pay attention to the magnitude of the Fed's rate cuts not the start date. For now, market indicators are pointing towards a Goldilocks economy where unemployment is low and growth is stable. But any long-term economic weakness could change that view and pump up the number of rate cuts expected in 2025. This implies that U.S. and Canadian longer maturity government yields will remain closely tied to the market pricing of the overall cuts, keeping the yield curve inverted throughout 2024 (Figure 4).

Figure 3: Market-implied policy rates diverge



Source: FactSet, Wealth Investment Office (WIO), as of April 11, 2024.

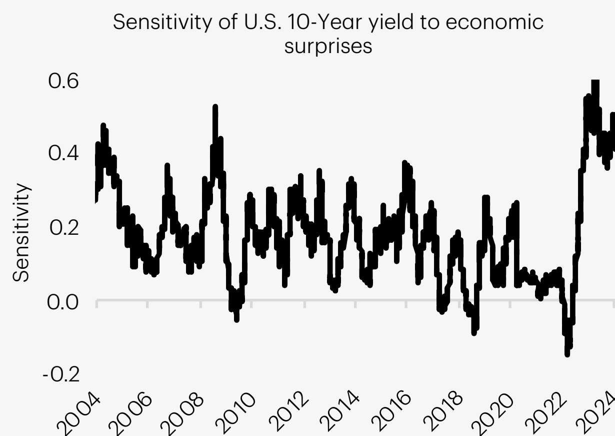
Figure 4: Implied terminal policy rate and longer-maturity government yields closely linked



Source: FactSet, Wealth Investment Office (WIO), as of April 11, 2024.

3. Government Bond Yield Volatility Waning. Over the first quarter, government yields proved they aren't in the clear yet and remained highly volatile. We expect the trend for overall volatility to calm in coming quarters and range-bound yields to hold a downward pattern over the medium term as large parts of the economy continue to show signs of stability—based on the U.S. Citigroup Economic Surprise Index—even amid the aggressive monetary policy tightening since 2021 (Figure 5). This economic resilience in the U.S. has prompted market participants to revise their expectations for inflation from a swift decline towards something a little stickier and more appropriately priced: inflation swaps (derivative contracts linked to the Consumer Price Index) are now suggesting about 2.5% inflation in the near term. Unless recent economic trends shift unexpectedly, government yields will be range-trading over the next few months.

Figure 5: Government yield sensitivity to short-term economic surprises



Source: Federal Reserve, U.S. Citigroup Economic Surprise Index, Wealth Investment Office (WIO), as of April 11, 2024.

Credit: investment grade and sub-investment grade

Let's talk about risk and spreads. If you remember, spreads are simply a way of measuring risk premium: a wider spread means the market is pricing in more risk, narrower spreads, less risk. Given the softening Canadian economic growth and tight valuations, we maintain our long-held view of modestly wider spreads (or a larger risk premium over a government bond of similar maturity) in coming quarters—although sustained demand for yield and dwindling fears of a full-blown recession will likely offset higher supply and keep spreads from widening significantly.

We are modest overweight on Investment Grade (IG) credit and maintain our modest underweight stance on High Yield (HY) credit. We expect Canadian IG to fare better than U.S. IG (based on historical periods of spread levels similar to or less than current valuations) because spreads for Canadian IG credit are tight but still have some room to perform (Figure 6). Canadian IG spreads have ended lower than current levels for about 134 months in the past 20 years, or 56 percent of the time, and forward excess returns (returns over similar maturity government bonds) were positive and relatively more attractive than U.S. IG. U.S. IG spreads have ended below current levels for 25 months out of the last 20 years, or 10 percent of the time, and more importantly, forward excess returns were, on average, negative for those 25 months.

Within the broader IG complex, we prefer short-dated IG bonds because they continue to offer close to the highest all-in yield since the late 1990s. 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.

Figure 6: Canadian excess returns better than U.S.

		Forward Total Return				Forward Excess Return		
		12-Month	24-Month	36-Month		12-Month	24-Month	36-Month
CAD IG Credit	Average	4.68%	4.49%	4.32%		0.22%	0.04%	0.46%
	Median	4.90%	4.49%	4.71%		0.73%	0.73%	0.94%
	Max	12.34%	9.24%	8.02%		3.11%	2.02%	2.04%
	Min	-4.44%	-5.50%	-1.94%		-9.32%	-7.75%	-4.94%
US IG Credit	Average	3.30%	2.86%	3.38%		-1.48%	-3.66%	-3.17%
	Median	3.40%	3.31%	3.54%		-0.48%	-1.96%	-2.64%
	Max	8.27%	7.42%	6.94%		1.29%	0.90%	1.04%
	Min	-2.22%	-3.97%	0.04%		-8.60%	-13.48%	-8.02%
US HY Credit	Average	2.83%	-2.03%	4.13%		-5.29%	-9.69%	-1.00%
	Median	1.87%	-2.33%	5.60%		-7.77%	-11.15%	0.38%
	Max	13.19%	7.82%	7.02%		7.27%	4.45%	4.49%
	Min	-3.74%	-13.27%	-4.66%		-16.82%	-23.04%	-12.42%

Source: FactSet, Wealth Investment Office (WIO), as of March 31, 2024. Using historical month-end spreads since 2003 from periods when spread levels were tighter than current conditions.

We expect HY spreads to widen more relative to IG because they're more sensitive to deteriorating fundamentals and tight credit conditions. Moreover, given their current valuations (Figure 6), forward excess returns are not attractive at all. We're more comfortable owning IG over HY given the relatively better performance outlook and the balance sheet strength offered by IG. Importantly, given the wide range of views on the economic outlook, credit investors should rely on active management and sectoral trends.

Key Themes for Credit or Corporate Bonds:

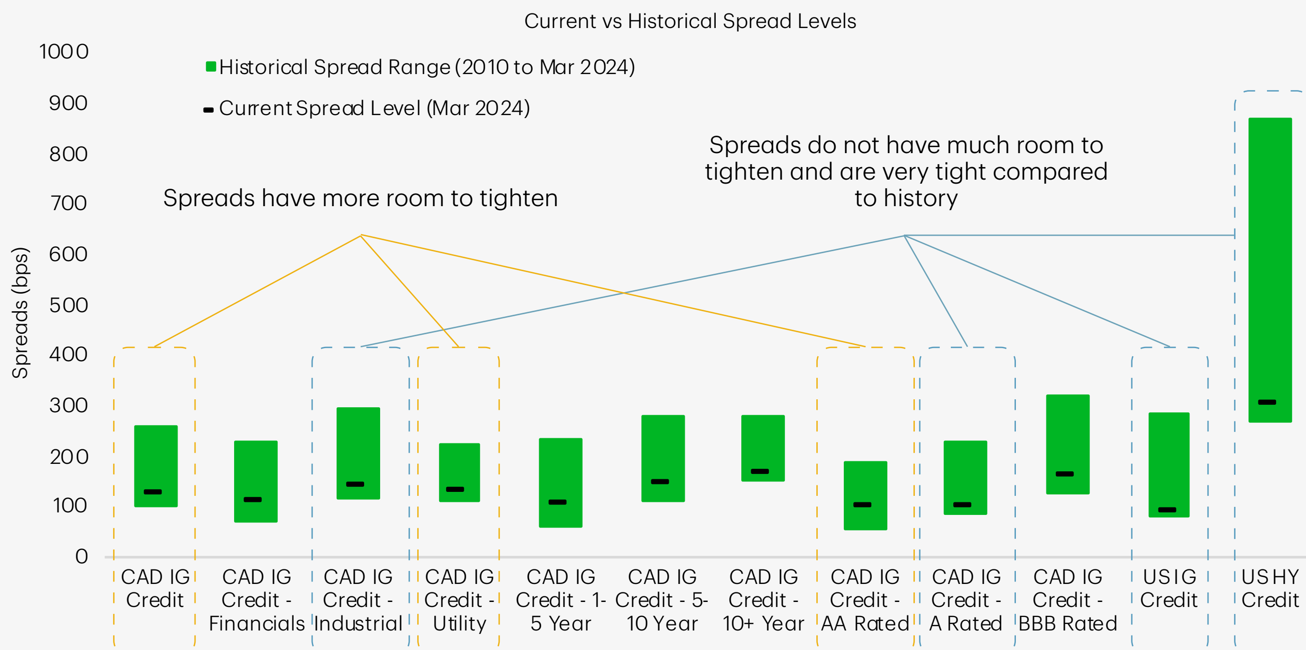
1. Narrower Range, Tighter Levels. Slowing but still resilient U.S. economic growth and easier policy will continue to bolster investor confidence, reduce government yield volatility and keep credit spreads within a tight range similar to 2023. Our message for coming quarters remains the same: focus on high quality shorter maturity credit and rely on active management.

2. High Gross Issuance but Net Negative. Issuance was abundant in the U.S. in Q1, driven mainly by refinancing needs and elevated merger and acquisition (M&A) activity. However, net issuance for Investment Grade rated corporate bonds is expected to turn negative for the rest of 2024. This means the volume of coupon maturities and payments is expected to be greater than the volume of new bonds issued. This, combined with strong inflows into fixed income, should help to buoy IG credit spreads.

3. Strong Demand. Conversations with IG credit investors indicate that demand (inflows) for corporate credit should remain robust in the near term and be supported by a range of buyers. The traditional heavyweights—pensions and insurance—will continue to drive demand for U.S. IG, although some will come from new clients. Pension funds are expected to keep rebalancing portfolios away from equity, and life insurance companies will likely keep recording large fixed-annuity sales.

4. Active Management. Active management is the best approach for IG credit. We prefer shorter maturity and sectoral tilts based on valuations. We believe investors will benefit most from a bottom-up approach: look for sectors or maturities within IG credit with relatively attractive spreads compared to the broad market (Figure 7). For example, the Big Six Canadian banks flooded the domestic market with C$61.7 billion in new corporate bond issuance in 2022, more than doubling their annual issuance volume of the prior two years, and driving spreads wider. Issuance returned to normal in 2023 when the Big Six issued C$33.5 billion but spreads remained wider. (The Silicon Valley Bank collapse in March 2023 didn't help spreads much either.) At the same time, pure corporate issuance posted a year-over-year increase of around 33%, or almost C$70 billion. Canadian bank bond spreads are still wider than the rest of the market offering attractive valuations (compared to other sectors) and they have a bias towards higher quality (only about 20% of IG credit issued is BBB-rated while almost 60% of the credit issued by non-financial sectors is BBB-rated).

Figure 7: Tight valuations call for active management



Source: FactSet, Wealth Investment Office (WIO), as of March 31, 2024

Higher yields and diversification

Given the economic uncertainties and diverging economic outlooks, we continue to urge investors to hold a balanced and diversified portfolio. Yields are still at attractive levels, acting as a buffer against volatility and adding the income component of fixed income back into the mix. Government bonds and duration will be attractive to those investors with a slightly longer time horizon. Active management and tactical adjustments will help investors sort through the wide range of government yields and capture strong returns.

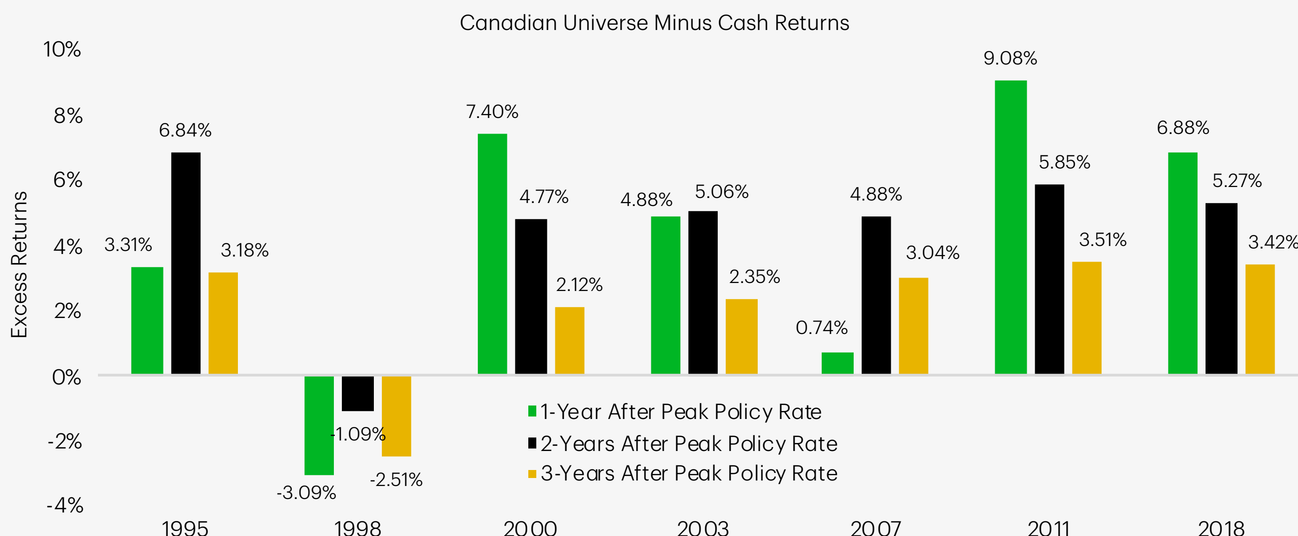
It's possible to earn attractive yields in almost all segments of the fixed income market. Higher yields are a good indicator of future returns and provide a buffer while markets refocus on fundamentals. Buying opportunities can arise quickly in periods of uncertainty so stay informed and manage your portfolios actively to balance duration and credit exposure.

Bonds vs. GICs. A final word on the difference between bonds and term deposits like GICs. Traditional GICs tend to lock investments in until maturity and limit investor flexibility. GICs may be useful for investors who want zero price volatility, but for those who can tolerate price fluctuations, the fixed income or bond investments we've outlined here are better options because they allow investors to switch to more attractive opportunities while earning similar yields. When investors buy a shorter maturity GIC with a higher yield, they're also taking on re-investment risk: GICs maturing now offer a higher yield than those that matured a year ago and the yield on offer when GICs mature in a year will likely be less than it is now. Bonds are much more flexible: when yields fall, prices increase, adding capital gains over and above any GIC-equivalent yield. So, the best way to mitigate re-investment risk is to lock in the higher yields on offer in bonds.

Cash yields are also attractive right now but won't remain so. As soon as central banks show signs of policy rate cuts, the simple interest on cash drops while the value of bond or fixed income investments appreciates (because prices rise as yields fall). This explains why, historically, cash has underperformed fixed income in periods following peak policy rates (Figure 8).

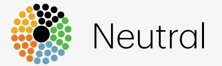
We maintain our modest overweight view on fixed income. Fixed income is offering the best opportunity in over a decade to build diversified portfolios. After the turbulence of high inflation and rising rates, and even if growth remains problematic, the bond market looks set to return to more conventional behaviour. Our base case for fixed income is to earn attractive income without expecting substantial capital gains from falling government bond yields. We all need to keep our expectations realistic. In the current landscape, an astute active fixed income manager versed in long/short credit strategies and able to make tactical duration adjustments when government bond yield moves are overstretched, could realize strong returns.

Figure 8: Fixed income outperforms cash ahead of peak policy rate



Source: FactSet, Wealth Investment Office (WIO), as of March 31, 2024. FTSE Canada Universe Bond Index acts as proxy for the Canadian Universe and the FTSE Canada 91-Day T-Bill Index acts as a proxy for cash.

Outlook on Equities



Taking a Breather

David Beasley, Senior Quantitative Portfolio Manager; Christopher Blake, Senior Portfolio Manager; Mansi Desai, Senior Equity Analyst; Kevin Yulianto, Portfolio Manager, | TD Wealth

If the first quarter was that moment in the party where guests put their hands in the air (like they just don't care), the beginning of the second feels more like the dance floor thinning out as exhausted partygoers retreat to less crowded spaces. That's the gist, at least, as we begin to see some early rotation away from the AI-driven tech names that have led this bull market, towards the more defensive end of the spectrum.

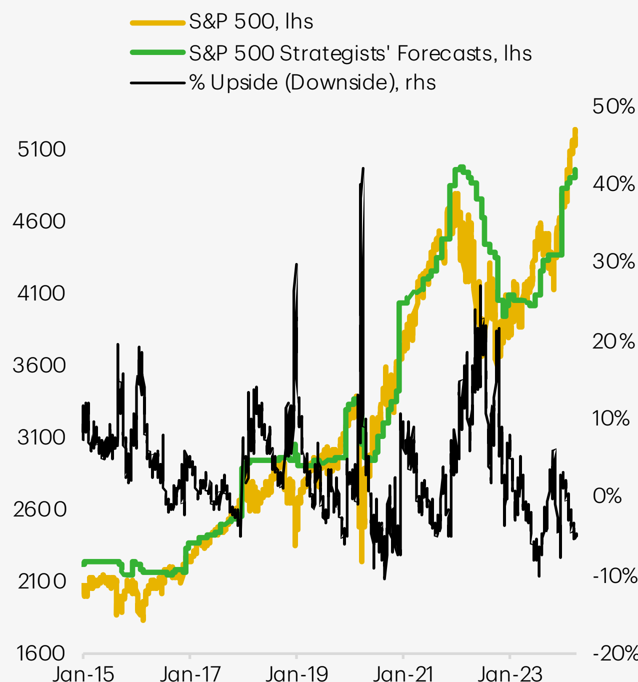
So far, though, there's no sign of any egregious tech bubble or supply glut, with plenty of value to be found in less crowded spaces. All in all, not a bad set-up for the coming quarter.

North America: Stay active

Following the bottom in October 2023, the S&P 500 has entered another bull market as it rose over 25% in a span of less than six months, outperforming almost all other global equity markets. The steady climb higher in equities has also been relatively painless, with pace and volatility that surprised many. Sell-side strategists were forced to raise their year-end targets higher as the S&P 500 surpassed most targets even before the quarter ended (Figure 1), while the VIX volatility index stayed below 16 in Q1/24.

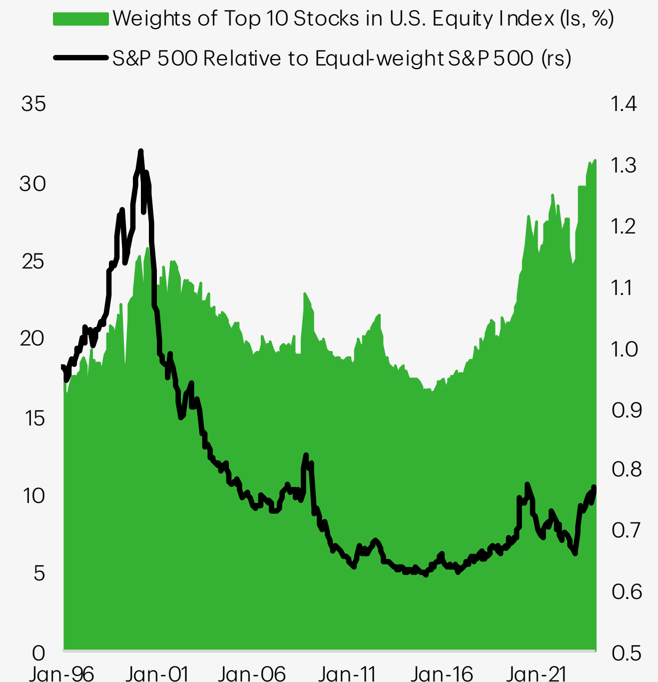
With GDP growth upwardly revised and the labour market doing better than expected, it is perhaps unsurprising that investors turned bullish on stocks and bid market darlings higher. The leaders in the year-to-date equity rally have not changed much from the past year. The tailwind from AI continues to benefit the semiconductor hardware and software/services industries, with these sub-sectors significantly outperforming the broader benchmark. Given that the AI tailwinds are benefitting incumbents with the largest troves of user data and infrastructure, the outperformance of mega-cap tech stocks is translating into a significantly higher concentration in the U.S. equity index (Figure 2). And it may be here to stay, given that revenue for the Magnificent Seven stocks (Microsoft, Apple, Alphabet, Amazon, NVIDIA, Meta and Tesla) is expected to grow at a higher rate compared to the rest of the S&P 500 index, with the former expected to grow 12% annually over the next two years versus 3% for the latter.

Figure 1: U.S. equities beat forecasts in Q1



Source: FactSet and Wealth Investment Office as of March 31, 2024

Figure 2: Concentration in big names the highest in decades



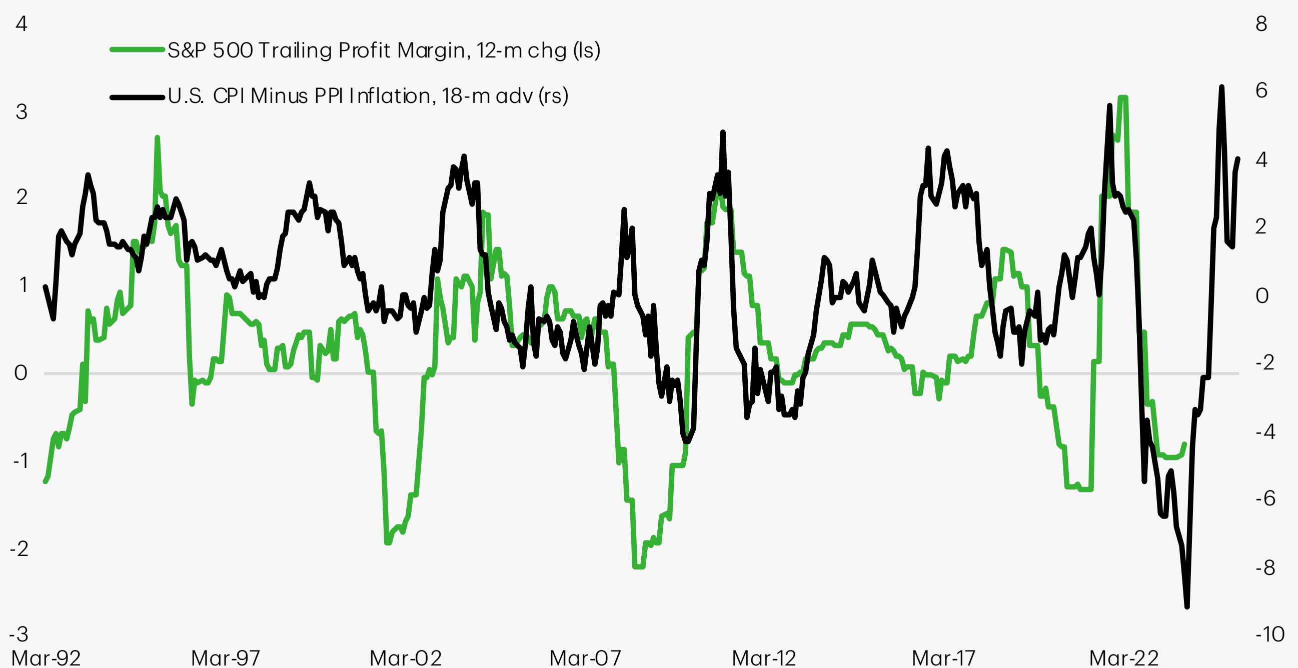
Source: FactSet and Wealth Investment Office as of March 31, 2024

With the S&P 500 trading at 21 times forward earnings at the end of the first quarter and multiple expansion contributing to 21% of the 37% gain in S&P 500 since January 2023, earnings growth expectations are high. During the previous earnings season, companies that missed estimates saw their stock price fall by more while those that beat were less rewarded. Currently, sell-side analysts are expecting earnings per share for the S&P 500 to rise to $242.94 at the end of 2024 — a 9.7% increase from 2023 — followed by another 12.2% increase in 2025. This compares to a historical average of 6.5% annualized earnings growth (post the global financial crisis).

Meanwhile, the S&P/TSX Composite Index ended the quarter trading at 15.2x 2024 earnings, which compares to a five-year median of 14.5x and a 10 year median of 15.0x. Total return for the S&P/TSX Composite was 6.62% while the S&P/TSX 60 returned a total 6.33%. In the broader S&P/TSX Composite the price returns of individual equities ranged from -57.6% to +56.8% indicating a broad range and one in which active management can perform well. In terms of the sector returns, the strongest sector was healthcare with a 18.4% total return on the back of one stock Tilray, a marijuana company, that rallied on the news that Germany was examining legalization of their product. The lowest sector return came from the communication services sector where there was weak performance from all major telecom providers.

There are, however, reasons to be optimistic. First, raw material costs and wage inflation have been declining, which should translate to lower input and operational costs for many companies. Second, companies have been proactive in improving operational efficiencies through cost-cutting efforts, including headcount reduction, which is also a tailwind for profit margins (Figure 3). Third, price hikes over the past three years have not translated to a material reduction in volume. There are a few main reasons for this: (1) wages have risen alongside inflation; (2) excess savings have been drained only among the lower half of income earners; and (3) the overall job market remains healthy. In addition, the improving outlook for the manufacturing sector could mean that, even if consumer spending weakens, the cyclical part of U.S. economy could start to pick up — translating to rotation into sectors that experienced significant slowdown and have lagged over the past two years. And as the probability of a soft landing in the U.S. has increased significantly over the past year, the outlook for stocks outside the AI beneficiaries is also improving. For instance, many stocks in the energy, utilities and consumer staples sectors are trading at valuations below their historical averages and provide an attractive dividend and buyback yield.

Figure 3: Margins set to grow on cost-cutting, disinflation



Source: FactSet and Wealth Investment Office as of March 31, 2024

And while valuation levels across U.S. sectors appear expensive on a market-cap-weighted basis, with seven out of 10 sectors' (excluding real estate) forward P/E ratio trading above the 80th percentile, the median stock's valuation in each sector may not be as expensive (Figure 4). This is most prominent in the consumer staples sector, where the market-cap-weighted sector's P/E valuation is trading at the 71st percentile, but the median stock valuation is below the 50th percentile (inexpensive).

The bottom line is that U.S. equities may continue to perform well if the current high expectations on earnings growth is met. Given that economic growth has been much more resilient than previously thought, the outlook for stocks outside the technology sector is also improving, which may translate to the broadening of the current equity rally. Lastly, the valuation gap between the largest stocks in a given sector and their peers is providing opportunities for active managers to be more selective in their trades and diversify their portfolios.

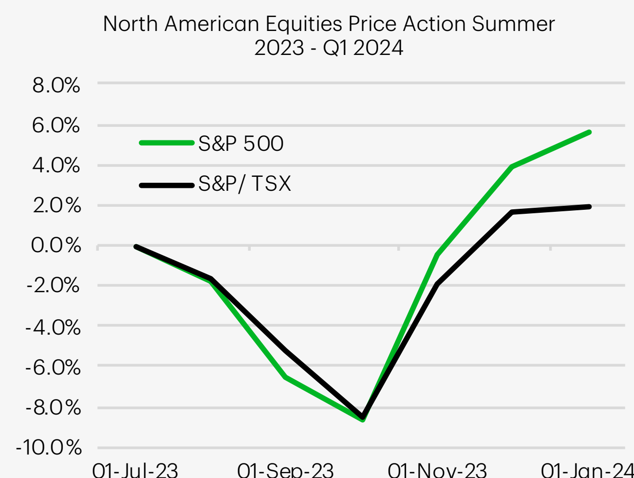
For Canada, we continue to be neutral Canadian equities. With the indebted consumer and the full impact of higher rates yet to be fully reflected, the Canadian economy could remain weak in the near term, which could limit earnings growth for corporations. Having said that, the recent Federal Budget has provided additional fiscal spending and the Bank of Canada could deliver a rate cut as early as June, both of which should provide economic support. Within Canadian equities, strong free cash flows from the energy sector and relatively inexpensive financial stocks may present select attractive opportunities. Overall, we believe the risk/reward profile at present warrants a neutral position.

Quant Analysis: Rotating Along the Barbell

In addition to the fundamental characteristics of current North American equity markets summarized above, we also consider price behaviour of stock groups for what insights they may provide with respect to sector rotation, sentiment and other indicators of investor flows that may help guide positioning going forward.

North American equities posted strong performance in 2023, but within that bull market we saw a meaningful pullback in the major indices from their summer highs into late October lows, with the S&P 500 and S&P/ TSX Composite both falling over 8% before a strong rally into year-end, which continued through the first quarter (Figure 5). From the trough in late October to the end of the first quarter, the S&P 500 and S&P/TSX were up 25.3% and 17.5%, respectively.

Figure 5: Deep pullback followed by a sharp rally



Source: FactSet and Wealth Investment Office as of March 31, 2024

Figure 4: Opportunities abound outside mega-caps

S&P 500	Sector Forward P/E Ratio	Percentile	Median Stock P/E Ratio	Percentile	3-5 Year EPS CAGR Estimate (%)
Info Tech	37.9	100%	31.1	93%	12.8
Healthcare	19.4	96%	22.8	86%	10.2
Industrials	21.5	88%	23.9	98%	12.0
Financials	15.9	87%	16.2	88%	9.9
Communications	18.9	85%	19.0	79%	8.3
Materials	22.1	83%	21.0	85%	14.2
Consumer Discretionary	24.6	81%	21.9	96%	16.5
Consumer Staples	20.4	71%	19.1	46%	11.0
Energy	12.7	45%	12.8	25%	40.6
Utilities	15.7	36%	16.6	59%	7.2

Source: FactSet and Wealth Investment Office as of March 31, 2024

When we look under the hood at the leading stocks and sectors of this revitalized bull market, it was clear the "barbell" strategy continued to underperform with growth/cyclicals sectors leading and the more defensive sectors lagging as they had done throughout 2023, while the energy sector significantly underperformed. However, as the momentum in the market continued through year-end and into the first quarter, we noticed an apparent rotation out of those leaders and into energy and materials as the first quarter started, and then the defensive areas of the market, such as utilities and consumer staples, started to show relative strength. On an equal-weighted basis, the information technology sector went from the strongest leader to the top laggard in the final month of the quarter, as energy, materials and utilities became the top three (Figure 6).

In Canada, meanwhile, we similarly saw the growth-dependent sectors lead us out of the pullback into year-end before shifting over to energy, materials (led by gold) and improvement in defensives. (Figure 7). We have excluded health care and added gold as a sub-sector given relative relevance for investors. The S&P/TSX Composite has a significant weight in energy and materials (30% versus around 6% for the S&P 500), so the strong performance of energy, gold and other materials represents meaningful flow, likely including U.S. funds seeking exposure in cross-listed, large-cap Canadian resource equities.

Figure 6: Rotation in S&P 500 Sector Leadership (Q4 rally vs. Q1 vs. March 2024)

S&P500 Sector (equal weighted)	Oct 31 - Dec 31, 2023
Information Technology	32.4%
Consumer Discretionary	31.2%
Industrials	30.9%
Financials	30.7%
Health Care	25.7%
Materials	23.4%
Real Estate	19.4%
Communication Services	17.3%
Consumer Staples	13.4%
Utilities	11.1%
Energy	10.8%

S&P500 Sector (equal weighted)	Q1 Average Performance
Energy	12.5%
Industrials	10.7%
Financials	9.8%
Information Technology	8.1%
Materials	8.0%
Consumer Discretionary	7.5%
Health Care	6.8%
Consumer Staples	4.9%
Communication Services	4.3%
Utilities	3.5%
Real Estate	-1.2%

S&P500 Sector (equal weighted)	March 2024 Average Performance
Energy	11.0%
Materials	7.0%
Utilities	6.0%
Financials	5.6%
Industrials	4.2%
Consumer Staples	4.1%
Consumer Discretionary	3.1%
Health Care	3.1%
Communication Services	3.0%
Real Estate	2.6%
Information Technology	2.2%

Source: FactSet and Wealth Investment Office as of March 31, 2024

Figure 7: Rotation in S&P/TSX Sector Leadership (Q4 Rally vs. Q1 vs. March 2024)

S&P/TSX Sector (equal weighted)	Oct 31 - Dec 31, 2023
Information Technology	20.5%
Financials	19.2%
Real Estate	16.9%
Industrials	16.2%
Utilities	13.3%
Materials	10.5%
Consumer Discretionary	10.0%
Communication Services	9.3%
Gold	6.3%
Consumer Staples	6.2%
Energy	-7.1%

S&P/TSX Sector (equal weighted)	Q1 Average Performance
Energy	11.9%
Materials	7.7%
Gold	7.0%
Financials	6.8%
Consumer Discretionary	6.3%
Industrials	5.3%
Information Technology	2.0%
Consumer Staples	1.5%
Real Estate	1.0%
Utilities	-4.2%
Communication Services	-7.0%

S&P/TSX Sector (equal weighted)	March 2024 Average Performance
Gold	23.0%
Materials	17.3%
Energy	6.7%
Real Estate	2.5%
Industrials	2.4%
Consumer Discretionary	1.9%
Financials	1.9%
Utilities	0.8%
Information Technology	-0.1%
Consumer Staples	-1.8%
Communication Services	-6.1%

Source: FactSet and Wealth Investment Office as of March 31, 2024
Note: We have excluded health care and added gold as a sub-sector given relative relevance for investors.

What does this mean?

On the one hand, we could interpret the year-end leadership and new-year fade of growth/cyclicals and financials as the harbinger of a blowoff top to the AI/tech-driven bull market. The move into energy, gold, other materials and defensives could correspondingly be seen as a rotation towards a more risk-off stance as well as an inflation hedge. To parse this theory, we examined each of the key sectors of information technology (specifically the semiconductor and AI-related aspects), financials (Canadian banks), energy and gold equities.

Information Technology: So far in 2024, the semiconductor sector has led the rally in technology stocks. Specifically, exiting 2023 and for much of 2024, it was a handful of AI-related names that led the semiconductor index (SOX). Yet, over the last 30 days of the quarter, the semis stalled, with the AI-related winners retreating from their highs. One reason is the stretched valuations, with the SOX next-12-months (NTM) price/earnings multiple now trading at a 45% premium to the S&P 500. That led investors to scrutinize the drivers behind such lofty expectations. Many of those depend on enterprise workloads filling the newly built AI infrastructure capacity. For that to happen, our software names must find the demand for their newly launched AI productivity tools. Only then can we expect the follow-up demand for more AI chips.

So far, incremental AI revenue has not been included in the fiscal 2024 outlook for our software names. For example, at 4.1% YTD the iShares Expanded Tech-Software Sector ETF (IGV) trails the performance of the overall market, with the laggards within the index being some vendors with early AI product launches. It appears that we are in a kind of holding pattern, and the longer it takes for the end customer to emerge, the closer we will come to the proverbial "air pocket" in the AI-induced rally. However, there still appears to be enough business momentum on the AI infrastructure spending side to keep the AI-driven bull market humming for now.

Financials: The six largest Canadian banks (Big Six) had seven consecutive quarters of negative EPS growth, driven by low revenue growth, reserve-building against a challenging economic backdrop, rising expenses and lower return on equity from higher capital requirements. Those factors have weighed on valuations, driving the forward P/E ratio below 10x. Historically, the Big Six have traded within the 10x-to-12x range about two-thirds of the time, trading below 10x P/E typically when there were concerns over a recession and rising delinquencies (Figure 8). However, there has been a positive shift in investor sentiment, driven by expectations of reversal in some of the aforementioned factors that pressured earnings, reflecting a moderation of expense growth, a rebound in capital-markets revenue and easing of credit losses. This led to a re-rating in valuations to slightly above 10x, which is expected to continue if those expectations materialize.

Figure 8: Big Six trading at the low end of their P/E range

Source: FactSet and Wealth Investment Office, as of April 9, 2024

Energy: Energy equities have become an area of value and income over the past few years as companies have opted to shift their capital allocation strategy towards issuing dividends and buybacks rather than investing in capital expenditures for growth projects. As deleveraging targets are hit, and free cash flow is increasingly returned to shareholders, stock prices should naturally re-rate to normalize dividend yields. Much of this process is expected to play out during 2024 and 2025, likely accelerating later this year. With double-digit free-cash-flow yields and dividends sustainable at the lower end of the trading range for the oil price, we expect investors will look to energy stocks to participate in the realization of value and income.

Gold: The price of gold hit new all-time highs, up nearly 23% since the start of 2023, including 8% in the first quarter of 2024. This historic move in the commodity price has not been driven by traditional factors, such as falling real interest rates and a weaker U.S. dollar (both of which have been relatively firm). Rather, it appears to have been due to a combination of geopolitical as well as inflation and fiat currency concerns by investors, central banks and retail buyers. China imports of gold have been particularly robust, with People's Bank of China's increasing their gold reserves by approximately 10% during 2023 and the country's imports rising by 30% in 2023 including demand from individuals.

Gold equities on the other hand have been mixed, with the weighted S&P/TSX Global Golds Index up only 2.1%. The equal-weighted average of precious-metals equities on the S&P/TSX Composite Index, meanwhile, averaged 7.0% in the first quarter. This suggests relatively broad buying across market capitalization, which often corresponds more to gold equity specialists investing rather than large-cap generalist fund managers and retail investors. All in all, we would take the underperformance of the gold index as a sign that flows should continue to gold stocks as strong prices persist for the foreseeable future.

International: Varied growth trajectories

The growth trajectory for international equities looks very different depending on the region. While the worst of the economic contraction for Europe could be behind us, the recovery has been slow and uneven. Europe's manufacturing PMI continues to come in below 50, while industrial production has declined to -6.0% from an earlier recovery to +0.2% in December 2023. Germany, one of the EU's key contributors, has also been struggling with a slump in the manufacturing activity; it recorded a 4.9% decline in industrial production in January 2024, and its manufacturing PMI stood at 42 in March 2024.

The European Central Bank might be pushed to cut rates earlier than the Fed given the sluggish state of the economic recovery. However, interest-rate differentials between Europe and the U.S. could further depreciate the euro, boosting exports while also possibly lifting inflation as imports get more expensive with a depreciating domestic currency. In addition, although inflation has come down to 2.4% in Europe, wage growth has been consistently strong, over 3.0% since December 2021. We believe the ECB will be limited on how far it can go in cutting rates, and hence we believe that it will take some time to confirm an economic recovery in Europe.

In recent weeks we have seen a strong rally in European cyclicals, leading to strong outperformance over defensive sectors. However, for the reasons mentioned above, we don't anticipate a strong cyclical rally to last in Europe unless we see a strong and sustained revival in the economy.

The UK is also struggling with a challenging macro environment. The difference here is that inflation is relatively high, at 3.5%, against the backdrop of the stubbornly high rent inflation alongside consistently strong wage growth of over 4.0% since December 2020. While manufacturing activity has recovered relatively well, given that PMIs and industrial production have both climbed into positive territory, projected earnings growth for UK equities remains challenged due to high inflationary pressures. We believe once the ongoing cost-of-living pressure subsides for the UK consumer, the outlook for UK equities could turn positive.

Japanese equities, on the other hand, are benefitting — despite the weak overall economic recovery — from a few structural tailwinds. After a decades-long deflationary period, there are signs that Japan could end its deflationary regime and enter an inflationary world supported by a rising labour participation rate and strong wage growth. In order to exit the deflationary environment, however, corporations will need to evolve by allowing wages to rise around 2% a year. Another key development has been the regulatory push for public issuers to increase their return to shareholders. Corporations are now focused on dividend payments and stock buybacks, which reached a record 9 trillion yen in 2023. For companies on the Nikkei 225 Stock Average, the ratio of cash to total assets is now 20%, compared to 12% for the S&P 500. Equity investors are eyeing this excessive cash, which if returned to shareholders could translate into a higher return-on-equity ratio for Japanese equities. Currently, return on equity for the Nikkei 225 stands at 8.0%, significantly lower than its global and U.S. counterparts, whose ROE stands at 13% and 18%, respectively.

With respect to valuation at an index level, international equities are trading at an excessively low premium to historical valuations — 4% as of March 24 — compared to 24% of the S&P 500 (Figure 9). This discount is not as attractive, however, once we take into account the expected earnings growth for international equities. Except for Japan, developed-market international equities are expected to record negative earnings growth due to weakness in the macro outlook and consumer spending.

That said, for bottom-up investors, the region can boast of some very strong businesses that offer growth opportunities equal to their U.S. counterparts while trading at lower premiums. This is especially true for Europe. We do believe that the relative macro weakness has led to a structural discount in valuations, but in that comes an opportunity set with an attractive reward to risk ratio. As Figure 10 shows, the P/E-to-growth (PEG) ratio — which measures how much the market is willing to pay for each percentage point of growth — for companies in sectors like technology, consumer discretionary and industrials is significantly lower outside the U.S. This means that an investor is paying much more for growth in the U.S. At present, this premium is supported by the resilience of the U.S. economy and greater confidence in the ability of U.S. companies to deliver on growth expectations.

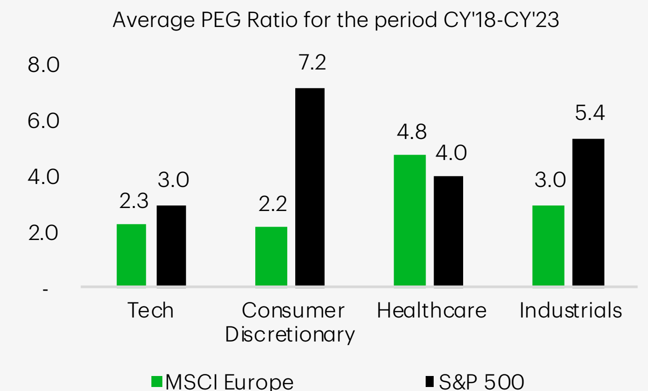
Emerging Markets: While the dragon descends, other EMs expected to rise

During the first quarter, emerging-market equities recorded subdued performance of 4.0%, owing to the lacklustre performance of Chinese equities and muted growth recorded by other regional equities. After consistently outperforming the MSCI EM Index since 2019, Chinese equities have been on a downward spiral since May 2023 and we don't see a respite in the interim period.

Despite certain underwhelming measures taken by the Chinese government to revive real estate, the sector continues to struggle, leading to a lack of confidence in the economy. The credit impulse ratio has stagnated in the range of +/-2.0% — far below the historic average growth of around 5%, last recorded in 2020. New construction for residential and commercial buildings has been at an all-time low, with a decline of more than 10% in February 2024, compared to average growth over 10%, since 2010. This has severely weakened confidence in the economy, given that a significant amount of family assets in China are tied up in property. Apart from the measures already taken, a much larger stimulus package is needed to revive the real estate sector and boost investor confidence. So far, however, the government has been hesitant in announcing a large stimulus package given the already onerous debt situation in China.

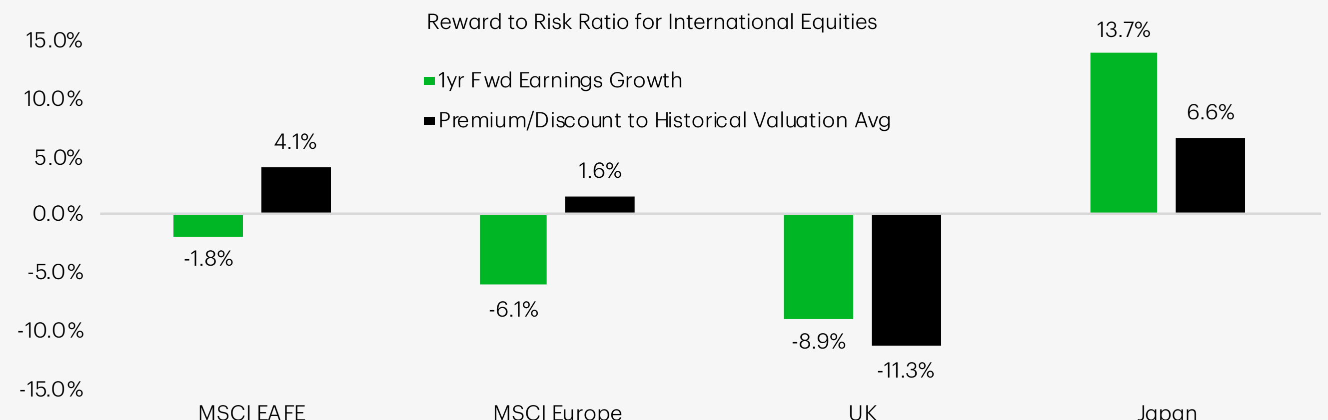
On the other hand, besides real estate, the rest of the Chinese economy is on track to recovery with the manufacturing PMI now above 50.0 and y/y growth in industrial production at 7.0%. Despite the fact that the consumer confidence index in China has declined to its lowest level in the past three decades, retail sales growth has been up 8.0% since 2022.

Figure 10: Growth is still cheaper in Europe



Source: FactSet and Wealth Investment Office as of March 31, 2024

Figure 9: Bleak international outlook offsets attractive valuations



Source: Factset and Wealth Investment Office as of March 31, 2024

Although offshoring from China is accelerating, it's important to note that China has reduced its dependence on exports. The export to GDP ratio for China has declined to 20% as of 2022, from 36% in 2006. In addition, China is also reorienting itself towards investment in advanced industries ranging from renewables to industrial robotics and automation. China is slowly graduating towards a more innovation-driven growth model and is moving away from its capital-intensive (property and infrastructure), debt-dependent growth model.

It remains to be seen whether the former can replace the growth provided by the latter. Moreover, there could be a challenge if developed markets continue to discourage high-tech driven imports from China given the recent ban placed on Chinese electric vehicles by the U.S. It's certain that China's historical economic growth of around 8% to 10%, driven primarily by government debt, is not sustainable. Long-term growth in China is expected to come down between 4% and 5%. The key question is, how much of a drag will China's newfound debt aversion and the ongoing slump in real estate have on its economy?

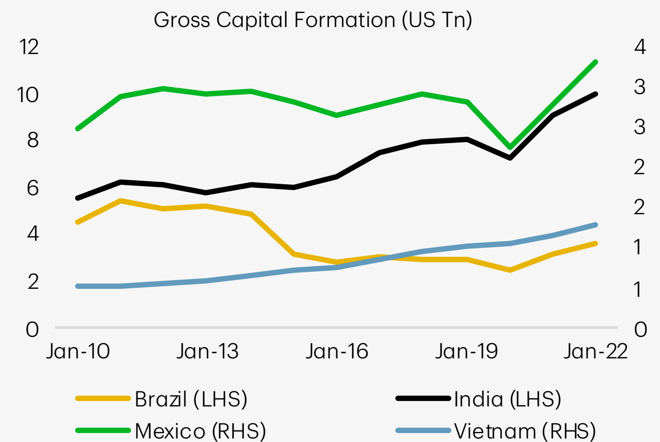
Taiwan and South Korea, meanwhile, are benefitting mightily from the strength in AI, given that a large part of the technology supply chain — ranging from leading-edge chips to handsets — passes through these countries. Given that AI technology is still in its infancy, we believe the soaring demand for hardware will be a strong tailwind for equities in these regions. Tech and tech hardware represent over 70% of the index in Taiwan and South Korea.

And while real estate woes have plagued China, India has been brought into the limelight as the next potential engine of global growth. India's young demographics, business-friendly policies and democratically elected government are now gathering global investors' attention. The country is benefitting, as is Mexico, from the ongoing trend of offshoring manufacturing from China, which has led to a massive rise in gross capital formation in these countries (Figure 12).

Finally, South American nations, especially Brazil, are further ahead in the economic cycle, with inflation falling closer to target. Brazil's central bank, for instance, has already begun to cut rates and has more room if needed. Moreover, the Latin American region is benefitting from rising foreign investment into critical sectors like mining, renewables and hydrocarbons, which are expected to benefit from the growing surge in infrastructure spending in developed markets, especially in the U.S. However, equities in this region will be impacted by a slowdown in infrastructure activity in China given that the latter contributes over 30% of their exports.

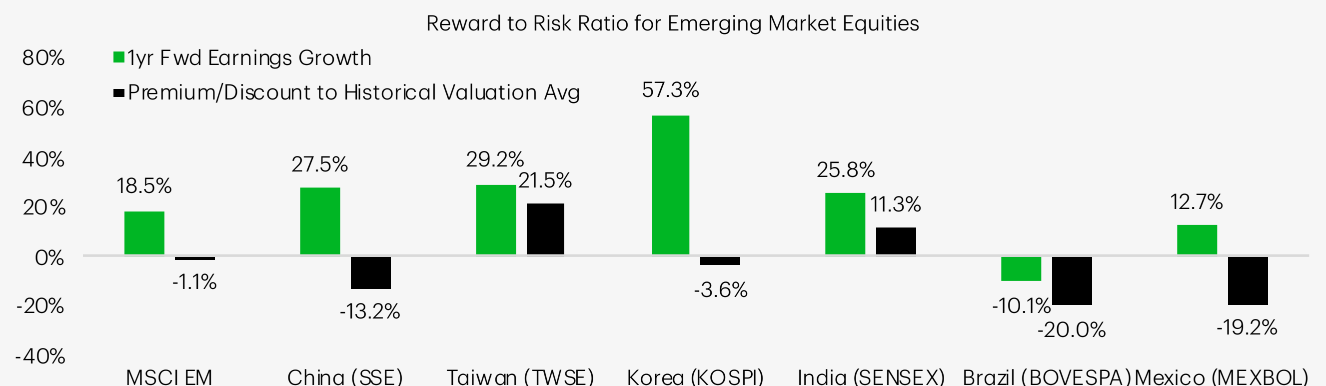
While there are signs of stabilization and improvement in some Emerging Markets, overall, there remain headwinds that we expect will challenge earnings growth. As such, we believe the reward-to-risk ratio is balanced for emerging-market equities, and hence we maintain a neutral outlook.

Figure 12: Beneficiaries of Chinese offshoring



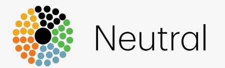
Source: Factset and Wealth Investment Office, as of March 31, 2024

Figure 11: Earnings growth for many EMs at risk if China remains weak



Source: Factset and Wealth Investment Office, as of March 31, 2024

Outlook on Alternative Assets



Pockets of Private Equity and Commercial Real Estate Remain Resilient

Shezhan Shariff, Senior Alternative Investments Analyst, Managed Investments | TD Wealth
Neelarjo Rakshit, Senior Equity Analyst, North American Equities | TD Wealth

Investors with a long-term time horizon could benefit from adding alternative assets—such as private equity, private credit, unlisted real estate, and unlisted infrastructure—to their portfolios. Alternative assets can enhance portfolio risk-adjusted returns through inflation-linked cash flows and income streams that are different in nature to the dividends and interest payments received from holding public equity and fixed income securities. They also help to reduce portfolio volatility because they're less influenced by the noise in public markets. Control-oriented investments, such as those found in private equity and unlisted infrastructure, provide exposure to potential gains from corporate restructuring, operational intervention, and recapitalization. Less efficient markets, trading illiquidity, and active ownership offer greater opportunities to capture a premium and generate attractive absolute returns. TD Wealth maintains a neutral weight on alternative assets.

Opportunities in Private Equity

While TD Wealth doesn't officially prescribe an asset allocation weight in private equity, we believe certain categories are worth pursuing for the sophisticated investor. Given compressed valuations and limited partner (LP) liquidity needs brought forth by a higher cost of capital, we believe exposure to value-oriented buyouts and secondaries remains compelling. A value-oriented buyout is a type of private equity strategy that focuses on acquiring undervalued or underperforming companies with the potential for growth and improvement. Secondaries are a niche market offering ways for third parties to invest in private equity. They can be LP-led, where an LP sells its primary stake in a fund to a third party, or initiated by a general partner (GP). In the GP-led instance, a GP typically transfers the most valuable assets of an existing fund to a continuation vehicle in the face of less promising exit pathways. We also view opportunities in thematic investing favourably, especially with managers who have high conviction and strong expertise in specific areas. Current themes we like include horizontal application software, technology services, life sciences, and energy transition.

Performance

U.S. private equity (PE) rose 0.6% and U.S. venture capital (VC) fell 2.5% in Q3 of 2023, according to benchmarks compiled by Cambridge Associates. On a one-year basis, these prints were 7.3% and -10.4% respectively. Higher base rates, recession concerns, geopolitical tensions, and a focus on U.S. regional bank balance sheets have made exiting investments challenging. This has lengthened the holding period for both PE and VC and dragged down measures of return such as internal rate of return (IRR) and multiples on invested capital (MOICs). Performance for Q4 2023 won't be available until late May; as a proxy, the six publicly traded U.S. PE managers (Blackstone, Apollo, KKR, TPG, Carlyle, and Ares) recorded a median gross IRR of 2.8% in Q4, which may point towards more resilient industry-wide results.

The Deal Making Environment

Higher interest rates have changed the deal-making environment: in particular, entry valuations for new portfolio companies have compressed to pre-COVID averages, improving the sourcing pipeline. Managers are prioritizing operational intervention over financial engineering and multiple arbitrage strategies to drive revenue and EBITDA (earnings before interest, taxes, depreciation, and amortization) growth. Given that LP distributions are expected to remain low in 2024, traditional fundraising activity continues to be muted. As a result, many large fund managers have pivoted to perpetual capital or evergreen funds.

In 2023, U.S. PE deal volume totaled US$645 billion (bln), in line with the average between 2018 and 2020, but down significantly from US$1,185 bln in 2021 and US$915 bln in 2022, according to Pitchbook. Pent-up deal flow could be unlocked in the second half of this year if the macro backdrop stabilizes with respect to normalizing inflation and clarity around monetary policy. Buyers may pursue mergers and acquisitions (M&A) more confidently with pricing between buyers and sellers clearing more easily. Public multiples are currently trading higher than private multiples, providing a favourable window for IPOs, after a near-frozen market for the better part of two years.

Valuations

Looking into 2024, with public markets expensive, we expect large take-private transactions to slow while smaller deals may continue to perform well. Valuations for leveraged buyouts (LBOs) increased in lockstep with pandemic-induced central bank policy rate cuts, but have since fallen. The U.S. LBO entry multiple was 8.9x on an enterprise value (EV) to EBITDA basis in Q4 last year, down from 11.4x in Q1 2023, according to Pitchbook. The average was 10.4x for full-year 2023, down from 11.5x in 2022 and 11.0x in 2021. Existing portfolio companies traded down 32% from a peak of 2.8x EV/revenue in 2021 to 1.9x in 2023; by sector, financial and consumer companies have seen the largest peak-to-trough declines, falling 38% and 57% respectively, as per Pitchbook. Technology valuations held up well until early 2023, but have since tumbled 19%. Relative to mega buyout deals, smaller add-on acquisitions and carve outs held up better, given that they are less dependent on new debt. Growth equity has filled some of the void left by large platform LBOs; these all-equity, minority interests are more palatable when monetary and fiscal conditions are tight. In 2023, growth equity accounted for 13% of total U.S. PE deal volume.

Buyout strategies raised about US$300 bln in 2023, according to Preqin, proving to be more resilient than venture capital. Established managers were able to secure capital more easily with mega funds accounting for over 50% of dollars raised. Within the buyout space, middle-market funds (US$100 mln to US$5 bln) attracted the highest interest, accounting for over 50% of all private equity fund closings in 2023, according to Pitchbook.

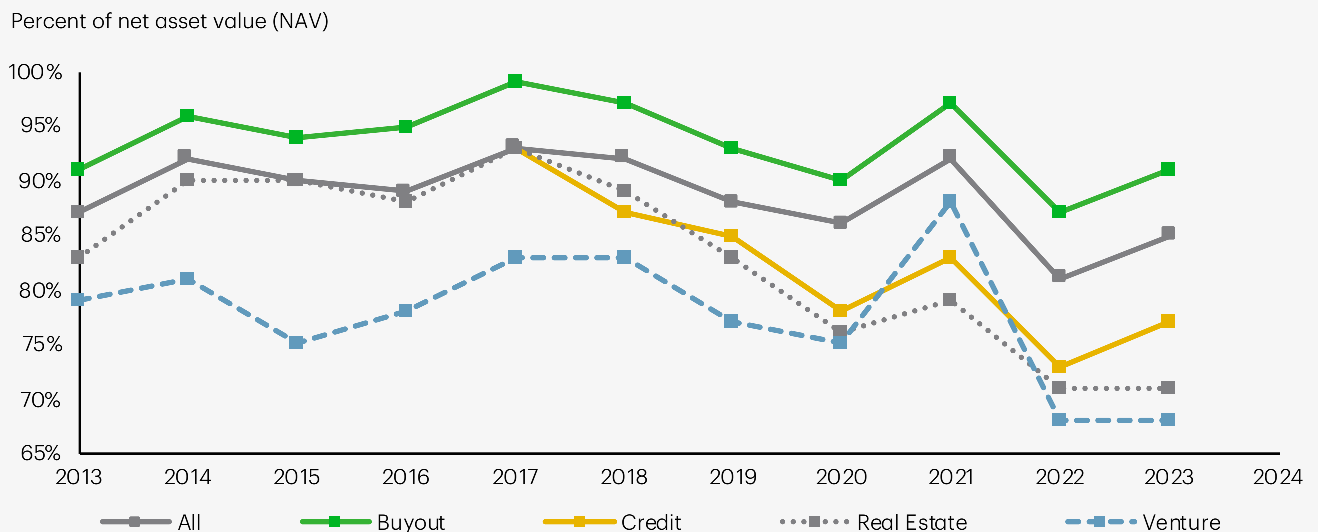
Perpetual Capital or Evergreen Funds

Perpetual capital, or evergreen funds, are growing in popularity. This new fund structure, which has an indefinite life, is designed to address the needs of private wealth clients who want immediate capital deployment, lower minimums, no capital calls, periodic liquidity windows, and simplified tax reporting. These features represent the democratization of private markets when compared to traditional closed-end drawdown funds. At the end of 2023, publicly traded alternative managers had US$1.4 tln of assets under management in perpetual capital or evergreen vehicles across private equity and private debt, representing growth of 16% year-over-year (y/y), as per Pitchbook.

Secondaries

Activity surged and pricing improved for private equity secondaries near the end of 2023. Overall volume increased 60% to US$69 bln in the second half of 2023, from US$43 bln in the first half. This was primarily fueled by LPs seeking to generate liquidity and de-risk their portfolios, coupled with narrowing bid-ask spreads supported by strong public markets. The average pricing for LP portfolios was 85% of Net Asset Value (NAV) at the end of 2023—an improvement of approximately 400 basis points from the end of 2022. While buyout strategies were also repriced higher, buyers remained concerned about the outlook for real estate and venture capital, which translated into steeper discounts (Figure 1). Regionally, North America dominates, with about 70% of the secondaries market, and while LP stakes in the Asia Pacific saw a moderate increase in demand, these changed hands at steep discounts approaching 40% of NAV. Secondaries remain below 10% of total private equity assets under management, according to Preqin.

Figure 1: Secondary Pricing of LP Portfolios



Source: Wealth Investment Office, Preqin, PEI, Hamilton Lane and Dealogic as of Q4 2023

Real Estate: Modest Underweight

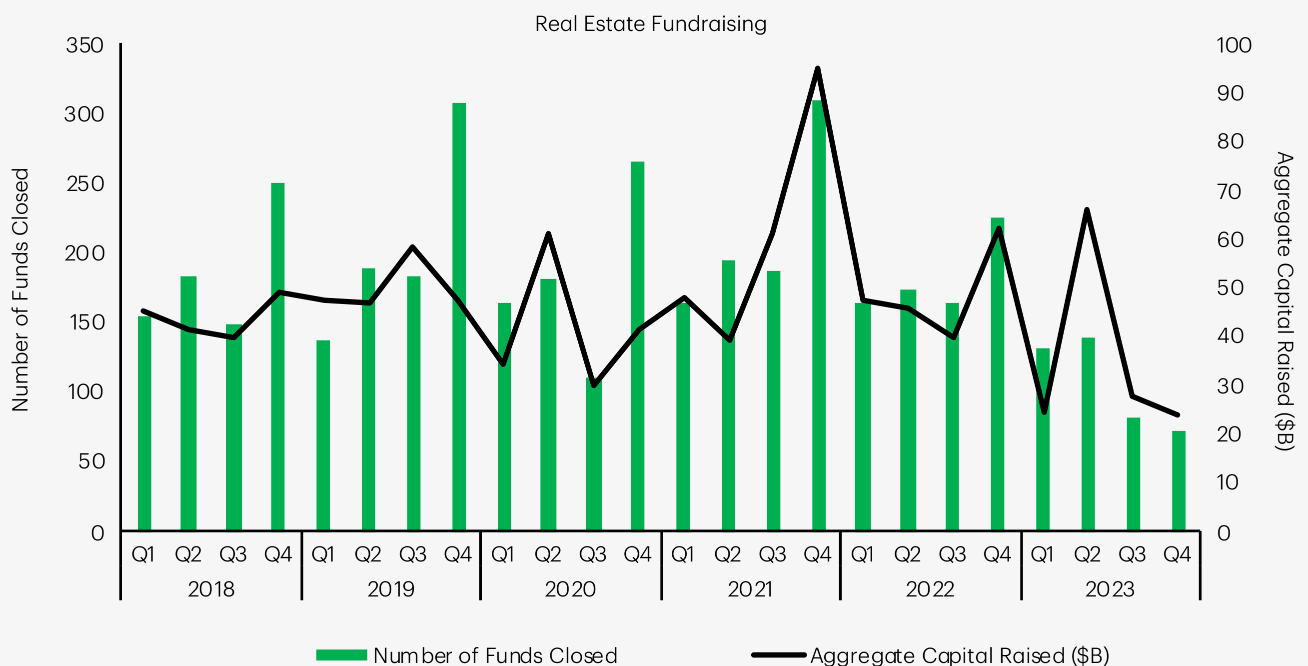
TD Wealth holds a modest underweight on both domestic and global real estate. High base rates, tight lending conditions, a refinancing maturity wall, and limited transaction activity are keeping commercial real estate (CRE) under pressure; however, moderating inflation, easing supply chain bottlenecks, and normalizing capitalization (cap) rates could provide relief in the second half of 2024.

Demand uncertainty, slowing rent growth, and elevated financing costs drove cap rates higher and made price discovery challenging, all of which weighed on deal volume, fundraising, and investment performance in Q4 2023 and Q1 2024. Fundraising momentum in private real estate remained weak in Q4 2023: 73 funds closed, raising US$28 bln (Figure 2). In 2023, private real estate fundraising totaled US$139 bln, down 41% from the 2021 peak of US$236 bln. Rising interest rates widened bid-ask spreads and impaired deal volume across most property types, including in well-performing areas such as multifamily housing and industrial. Investors sought liquidity via redemptions in open-end vehicles, with capital moving away from core and core-plus strategies. On a positive note, opportunistic strategies benefited, with investors focusing on capital appreciation over income generation.

The fundamentals of real estate investing are likely to return as market participants recalibrate their expectations for a higher-for-longer term structure of interest rates, compressed valuations, and significant debt refinancing needs. Location, property type, and occupancy levels will remain key drivers of performance for investors seeking high-quality assets that hold their value through market cycles. Hotel, retail, and industrial properties, with their durable fundamentals and less volatile historical underwriting, have been standout performers for real estate owners such as Real Estate Investment Trusts (REITs).

With returns declining in core property types such as regional malls and offices located in central business districts, niche assets may attract capital from private debt and opportunistic equity investors. Examples include data centres, seniors housing, purpose-built medical offices, self-storage, and suburban single-family rental housing. Such assets remain well positioned to benefit from the ongoing structural shift in lending; in particular, PE investors are building exposure across the capital stack within CRE in order to mitigate equity downside risk given that cap rates remain higher than historical levels.

Figure 2: Downturn in Private Real Estate Fundraising



Source: Wealth Investmment Office, Preqin as of 4Q23

Outlook on Commodities

Modest Overweight

All the ingredients are here

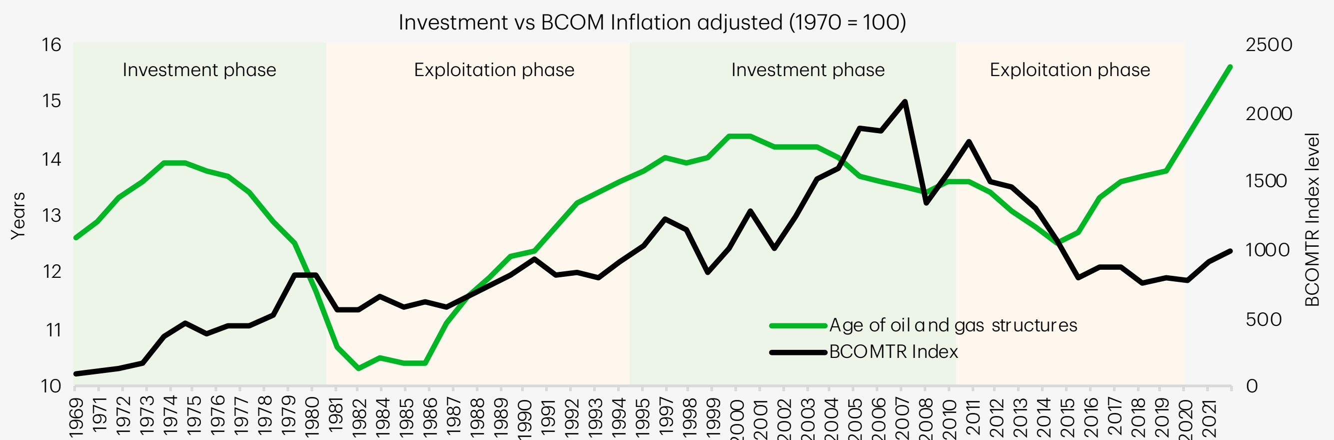
Hussein Allidina, Managing Director and Head of Commodities | TD Asset Management
Humza Hussain, VP & Director, Commodities | TD Asset Management

Commodities have had a good start to the year, up 2.2% in Q1 and higher since, continuing a strong performance since entering the investment phase of the new commodities cycle in early 2020 (Figure 1). The prior phase of the cycle, which we call the exploitation phase, was not friendly to commodities; the Bloomberg Commodity Total Return Index returned an annualized -6.9% per annum from 2011 to 2020 (Figure 2). Poor performance and little concern for inflation led to tepid interest and minimal allocation to commodities. Things seem to be changing, however, and it's worth noting that in the last commodity investment phase, from 1994 to 2008, commodities returned 7.4% annually.

Following the global financial crisis, commodities fared poorly as investments made over the prior investment phase led to a new greenfield commodity supply just as the world was entering a decade of deleveraging and slow economic growth. Energy was the biggest deterrent, owing primarily to the shale revolution in the United States, which unlocked a trove of crude and gas production. Metals and agriculture fared slightly better, although they still weakened alongside slowing Chinese and EM growth. The best performing sector was precious metals, but even that was down over the period.

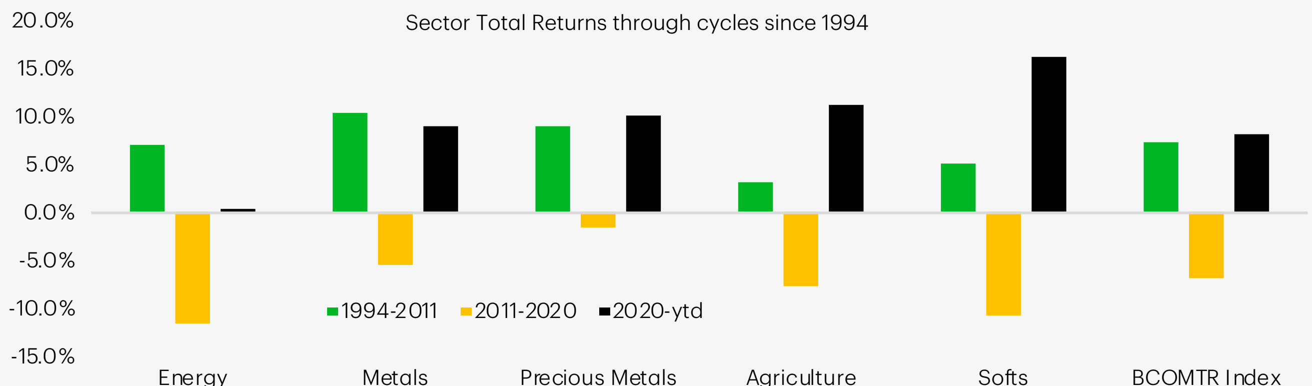
We believe we are in a markedly different environment for commodities when it comes to demand, supply and collateral yield. From a more macro, portfolio-construction perspective, we also see the next decade as being more supportive for the asset class than the prior two decades, given that inflation is likely to remain volatile, increasing the appeal for diversifying and inflation-protecting assets like commodities.

Figure 1: Early in the investment phase



Source: Bloomberg and TD Asset Management as of March 31, 2024. BCOM = Bloomberg Commodity Index, BCOMTR = Bloomberg Commodity Total Return Index

Figure 2: Returns correlated with past phases



Source: Source: Bloomberg and TD Asset Management as of March 31, 2024. BCOMTR = Bloomberg Commodity Total Return Index

On Demand

Balance sheets have been repaired, with U.S. consumers holding a healthy level of cash and a renewed ability to add leverage. Consumer demand is also being supported by a profligate U.S. government that looks likely to run large deficits well into the foreseeable future. We also see better emerging-markets growth, especially in India, as crude and steel imports surprise to the upside. Despite a property sector that continues to be a drag in China, copper consumption was still higher by 3.6% y/y, helped along by investments in the electrical grid, renewable energy and EV manufacturing as the government reorients its policy supports away from real estate and towards the energy transition and manufacturing sectors. That energy transition, moreover, is not confined to China. The developed world is embarking on its own plans to electrify, which bodes well for base metals demand.

On Supply

More than a decade of underinvestment has now put us in an environment where spare capacity is limited, especially in commodities with a long lead time, like energy and metals. Despite expected growth in copper demand, owing to energy transition, mine output continues to disappoint as expansion plans, especially in Chile, are continually delayed. This has made the market highly sensitive to any disruptions, as witnessed in 2024 with the challenges faced by First Quantum in Panama. On the energy side, the engine of global oil-supply growth over the past decade — namely, U.S. shale — has undergone structural changes. The shale industry has matured and consolidated, with producers far more fiscally disciplined. This results in a very different environment for oil, with the marginal supply capacity now sitting with OPEC and its allies, which are demonstrating much better discipline than shale producers did in the prior era.

On Inflation and Interest Rates

The focus of central banks has shifted in recent years. Gone are the years of incredibly easy monetary conditions that were aimed at stimulating tepid growth and low inflation. Instead, central bankers are now focused on reducing inflation.

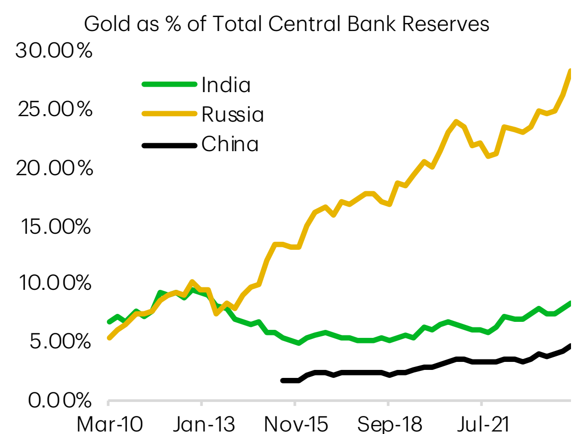
We believe there are many forces that will support inflation structurally in the coming years. We've discussed issues of constrained commodity supply as poor return on capital employed (ROCE) discouraged producers from investing in commodity supply. And there are a myriad of other factors that we see as supportive of inflation: carbon pricing, increasingly volatile weather, the reshoring and parallelization of supply chains, and demographics across the developed world.

Demographic trends have received some interest of late as they are exacerbating labour tightness and supporting higher wage growth. An aging population will also increase the burden on governments, which will necessitate increased spending and larger deficits. Commodities tend to perform well in higher-inflation environments and will also benefit from improved collateral yields that come in such periods.

On the Ascendancy of Gold

Gold has made a material move late in the first quarter, having rallied 13% year to date. We believe the reason is twofold and has little to do with discussions around real rates. The opportunity cost of holding gold has most definitely increased with alternatives offering greater returns (i.e., interest rates and equity markets), and this is evident in the continued decreases in gold ETF open interest (sitting near five-year lows). Instead, gold has found support from robust demand from central banks, which doubled their gold-buying pace in 2022 and 2023 versus the previous 10 years. This is partially motivated by the U.S. confiscating Russian reserves and, on the margin, by decaying confidence in fiat currencies as many nations in the developed world run profligate deficit programs. Although central banks have supported prices over the past two years, we think this recent move higher was driven by the fund community, which is starting to trade on ideas of monetary debasement, along with a Fed that may have turned dovish too soon.

Figure 3: Central banks gobble up gold



Source: Bloomberg and TD Asset Management as of March 31, 2024

Commodity returns are based on the Bloomberg Commodity Total Return Index.

Outlook on Currencies

More of the same, for now

TD Securities, Global Rates, FX & Commodites Strategy

The newish macro regime is starting to take shape, though a theme for much of this year will be transition. Inflation was the theme for 2022, while 2023 was all about the recession that never happened. We have been focused on macro drivers but note that the importance of the U.S. election will start to take shape after the conventions this summer.

However, it's important to note that the complexity and uncertainty in the market is rising, not falling.

Our Macro Ranking Scorecard Index shows carry, growth and risk driving performance this year, dovetailing with the improving global growth outlook, easing financial conditions and depressed macro volatility. The key shift for currency markets recently has been the U.S. dollar's (USD) shift to inflation, capturing the USD's new smile.

Market Themes for 2024: Carry, growth and risk

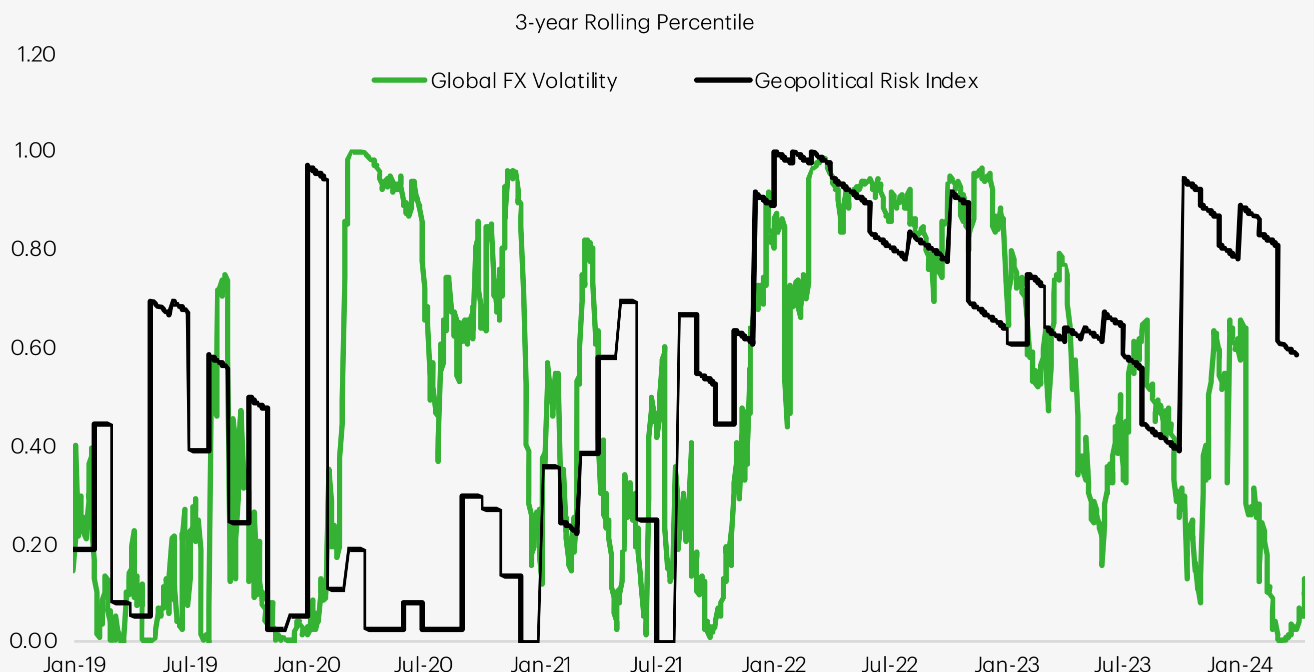
The market regime is beginning to take shape, although the pace and path will likely remain non-linear.

The macro backdrop has undergone another shift. For one thing, the things that have worked over the past two years are no longer working — particularly terms of trade and G10 inflation.

In the U.S., economic data have continued to surprise to the upside, particularly on inflation. Markets have priced out imminent Fed cuts, but the timing and pace have been reduced since the start of the year, with expectations now looking for fewer rate cuts, and timing continues to shift out to later in the year. We now expect the first Fed cut to be in September, with the ECB and BoE more likely to cut in the summer.

Currencies where central banks have been more hawkish have outperformed. Risk assets have performed well despite swings in data, with gold and bitcoin outperforming with elevated tensions in the Middle East and Ukraine, and potential trade issues with the US with elections approaching. There are growing geopolitical risks the world over. Tensions in Ukraine, the Middle East and Southeast Asia, with over half the population voting this year, mean that by the end of the year, there's a good chance the world won't look the same as we expect today. Policymakers will need to juggle these risks against their desire to cut rates, and the optimal path of policy is uncertain. Data will continue to lead central banks down their cutting path, but events may well get in the way.

Figure 1: Busy geopolitical calendar this year



Source: Macrobond, TD Securities as of March 31, 2024

Even though TD Securities (TDSI) recently upgraded the forecast profile for the USD over the very near term, it also believes the USD rally has limits and will remain somewhat rangebound through the rest of 2024. Consensus herding has migrated to the U.S. dollar, and the rest of world (ROW) growth story is converging with the U.S.

We are wary of chasing the USD higher from here, especially if moderation in core PCE allows the Fed to cut rates this year. However, we also expect that downside risk is quite limited given that growth is holding up well, as well as momentum and increased risk-off sentiment in markets.

A big focus of 2024 will also be the impact of geopolitics. There are critical elections around the world, with 54% of the global population getting a chance to the vote. The U.S. election is already gathering market interest, underscoring the fact that investors see a big risk event. Elsewhere, markets will closely watch the outcome of Mexico's elections in June, especially as it relates to energy and foreign-investment policies.

Meanwhile, in Canada

There remains some lack of global leadership in the G10 for macro growth, especially for Canada. The pass-through of higher rates to the domestic economy will be a key feature of the 2024 growth story. There we think housing will play a powerful role. A look at housing dynamics — like household debt, debt-service ratios and the large mortgage reset calendar in 2024/2025 — suggests that the loonie will remain vulnerable. On the inflation picture, the average of the Bank of Canada's (BoC) core inflation measures came in at 3.0% y/y, down 10 bps and in line with expectations. On a three-month basis, these are averaging just above 1%, a signal that the annual numbers will continue to decelerate in the coming months. This opens the door further for the BoC to cut rates in June, although we expect it will take a patient approach. While economic growth has been weak, the bottom hasn't fallen out of the economy. This has left the loonie at its lowest level since late 2023 against the USD, which we expect will remain over the near term.

Figure 2: Foreign Exchange Forecasts for G10 Currencies

	2024				
	19-Apr-24	**Q1 A**	**Q2 F**	**Q3 F**	**Q4 F**
USD/JPY	154	151	149	142	138
EUR/USD	1.06	1.08	1.09	1.11	1.08
GBP/USD	1.24	1.26	1.27	1.30	1.27
USD/CHF	0.91	0.90	0.91	0.90	0.89
USD/CAD	1.38	1.36	1.35	1.32	1.33
AUD/USD	0.64	0.65	0.66	0.68	0.66
NZD/USD	0.59	0.60	0.61	0.63	0.61
BBDXY	1266	1244	1235	1205	1222

Source: TD Securities as of April 19, 2024

Market Performance

Canadian Indices ($CA) Return	Index	(%) 1 Month	(%) 3 Months	(%) YTD	(%) 1 Year	(%) 3 Years	(%) 5 Years	(%) 10 Years	(%) 20 Years
S&P/TSX Composite (TR)	89,602	4.14	6.62	6.62	13.96	9.11	9.96	7.67	7.88
S&P/TSX Composite (PR)	22,167	3.76	5.77	5.77	10.28	5.83	6.60	4.46	4.86
S&P/TSX 60 (TR)	4,400	3.74	6.33	6.33	14.44	9.55	10.35	8.33	8.31
S&P/TSX SmallCap (TR)	1,367	7.49	7.92	7.92	8.22	3.99	7.82	3.95	3.84
S&P/TSX Preferred Share(TR)	1,853	3.47	9.62	9.62	13.52	1.41	4.28	2.13	2.44
U.S. Indices ($US) Return									
S&P 500 (TR)	11,418	3.22	10.56	10.56	29.88	11.49	15.05	12.96	10.15
S&P 500 (PR)	5,254	3.10	10.16	10.16	27.86	9.77	13.14	10.87	8.01
Dow Jones Industrial (PR)	39,807	2.08	5.62	5.62	19.63	6.47	8.95	9.23	6.96
NASDAQ Composite (PR)	18,255	1.17	8.49	8.49	38.49	11.72	19.86	17.64	13.55
Russell 2000 (TR)	10,077	2.80	7.58	7.58	20.35	-2.68	7.38	7.89	8.38
U.S. Indices ($CA) Return									
S&P 500 (TR)	15,472	3.06	13.27	13.27	30.04	14.30	15.37	15.28	10.34
S&P 500 (PR)	7,120	2.95	12.86	12.86	28.02	12.53	13.45	13.15	8.19
Dow Jones Industrial (PR)	53,940	1.93	8.21	8.21	19.78	9.15	9.25	11.48	7.14
NASDAQ Composite (PR)	24,735	1.02	11.15	11.15	38.66	14.53	20.19	20.06	13.74
Russell 2000 (TR)	13,655	2.64	10.22	10.22	20.49	-0.23	7.68	10.11	8.56
MSCI Indices ($US) Total Return									
World	10,763	3.21	8.88	8.88	25.11	8.60	12.07	9.39	8.11
EAFE (Europe, Australasia, Far East)	8,234	3.29	5.78	5.78	15.32	4.78	7.33	4.80	5.66
EM (Emerging Markets)	8,963	1.09	-3.90	-3.90	23.35	11.04	4.14	2.06	7.88
MSCI Indices ($CA) Total Return									
World	14,584	3.06	11.55	11.55	25.26	11.34	12.38	11.64	8.29
EAFE (Europe, Australasia, Far East)	11,158	3.14	8.38	8.38	15.46	7.42	7.62	6.95	5.84
EM (Emerging Markets)	12,145	0.94	-1.54	-1.54	23.51	13.83	4.43	4.16	8.06

Currency									
Canadian Dollar ($US/$CA)	73.80	0.15	-2.39	-2.39	-0.12	-2.46	-0.28	-2.02	-0.17
Regional Indices (Native Currency, PR)									
London FTSE 100 (UK)	7,293	4.61	10.02	10.02	14.49	4.05	6.70	3.77	4.95
Hang Seng (Hong Kong)	3,041	0.86	2.23	2.23	-7.08	-4.04	-0.32	4.11	2.83
Nikkei 225 (Japan)	16,541	0.18	-2.97	-2.97	-18.92	-16.47	-10.65	-2.88	1.34

Benchmark Bond Yields	3 Months	5 Yrs	10 Yrs	30 Yrs
Government of Canada Yields	5.01	3.53	3.47	3.36
U.S. Treasury Yields	5.38	4.21	4.20	4.34

Bond Indices ($CA Hedged) Total Return	Index	1 Mo (%)	3 Mo (%)	YTD (%)	1 Yr (%)	3 Yrs (%)	5 Yrs (%)	10 Yrs (%)
FTSE TMX Canada 91-day Treasury Bill Index	455	0.37	1.24	1.24	4.84	2.63	2.00	1.41
FTSE TMX Canada Universe Bond Index	1,108	0.49	-1.22	-1.22	2.10	-1.45	0.28	2.01
FTSE TMX Canada All Government Bond Index	1,041	0.48	-1.66	-1.66	0.95	-1.96	-0.23	1.74
FTSE TMX Canada All Corporate Bond Index	1,347	0.54	0.07	0.07	5.50	0.01	1.72	2.80
U.S. Corporate High Yield Bond Index	286	1.14	1.34	1.34	10.22	1.69	3.45	3.88
Global Aggregate Bond Index	252	0.86	-0.13	-0.13	3.34	-1.72	0.40	1.97
JPM EMBI Global Core Bond Index	511	2.04	1.68	1.68	9.63	-2.37	-0.24	2.33
S&P/TSX Preferred Total Return Index	1,853	3.47	9.62	9.62	13.52	1.41	4.28	2.13

Credit Suisse ($US) Total Return	Index	1 Month	3 Month	YTD	1 Year	3 Year	5 Year	10 Year
Credit Suisse Equity Market Neutral USD	325	1.37	3.14	3.14	8.59	5.61	3.67	1.97
Credit Suisse Event Driven USD	862	1.67	4.19	4.19	12.41	4.08	5.74	3.01
Credit Suisse Global Macro USD	1,409	3.64	6.45	6.45	8.92	7.65	8.00	5.17
Credit Suisse Hedge Fund USD	818	1.74	5.30	5.30	11.27	5.83	6.39	4.31
Credit Suisse Long/Short Equity TR USD	1,035	1.15	6.72	6.72	13.79	5.69	6.78	5.09
Credit Suisse Managed Futures USD	436	3.58	10.12	10.12	15.01	10.51	8.22	5.36

Source: TD Securities Inc., Morningstar®, TR: total return, PR: price return, as of March 31, 2024.

Endnotes

1. See Bram, Jason, and Sydney Ludvigson. 1998. "Does Consumer Confidence Forecast Household Expenditure? A Sentiment Index Horse Race." Federal Reserve Bank of New York Economic Policy Review 4 (June): 59-78.
2. The pre-pandemic correlation between the Conference Board's consumer confidence index and consumption growth was slightly lower at almost 60%. The analysis in the paper does not change regardless of the measure of confidence used. For brevity and consistency, we will refer to the Michigan Index of Consumer Sentiment throughout.
3. See Carroll, Christopher D., Jeffrey C. Fuhrer, and David W. Wilcox. 1994. "Does Consumer Sentiment Forecast Household Spending? If So, Why?" American Economic Review 84 (December): 1397–1408.
4. Mehra, Yash P. and Elliot Martin 2003. "Why Does Consumer Sentiment Predict Household Spending?" Federal Reserve Bank of Richmond Economic Quarterly Volume 89/4 (Fall).
5. The U.S. Department of Agriculture has in fact reported that the portion of Americans' income spent on food has reached a three-decade high. In 1991, U.S. consumers spent approximately 11.4% of their disposable personal income on food. After falling notably in the intervening years, by 2022 (the most recently available USDA data), the figure was back up to 11.3%.
6. See Ulrike Malmendier, F. D'Acunto, J. Ospina and M. Weber 2021. Exposure to Grocery Prices and Inflation Expectations. Journal of Political Economy, May 2021, vol. 129 (5), pp. 1615-1639.
7. See Larry Summers et al 2024. The Cost of Money is Part of the Cost of Living: New Evidence on the Consumer Sentiment Anomaly. NBER.
8. The authors used actual home ownership costs (such as home prices and mortgage rates) instead of the currently used owner equivalent rent in the official index to recreate a CPI index which accounted for the actual cost of this major purchase to a prospective buyer.
9. See Greg Ip 2023. The Economy Is Great. Why Are Americans in Such a Rotten Mood?
10. See Aaron Zitner et al 2024. Why Americans Are So Down on a Strong Economy.

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