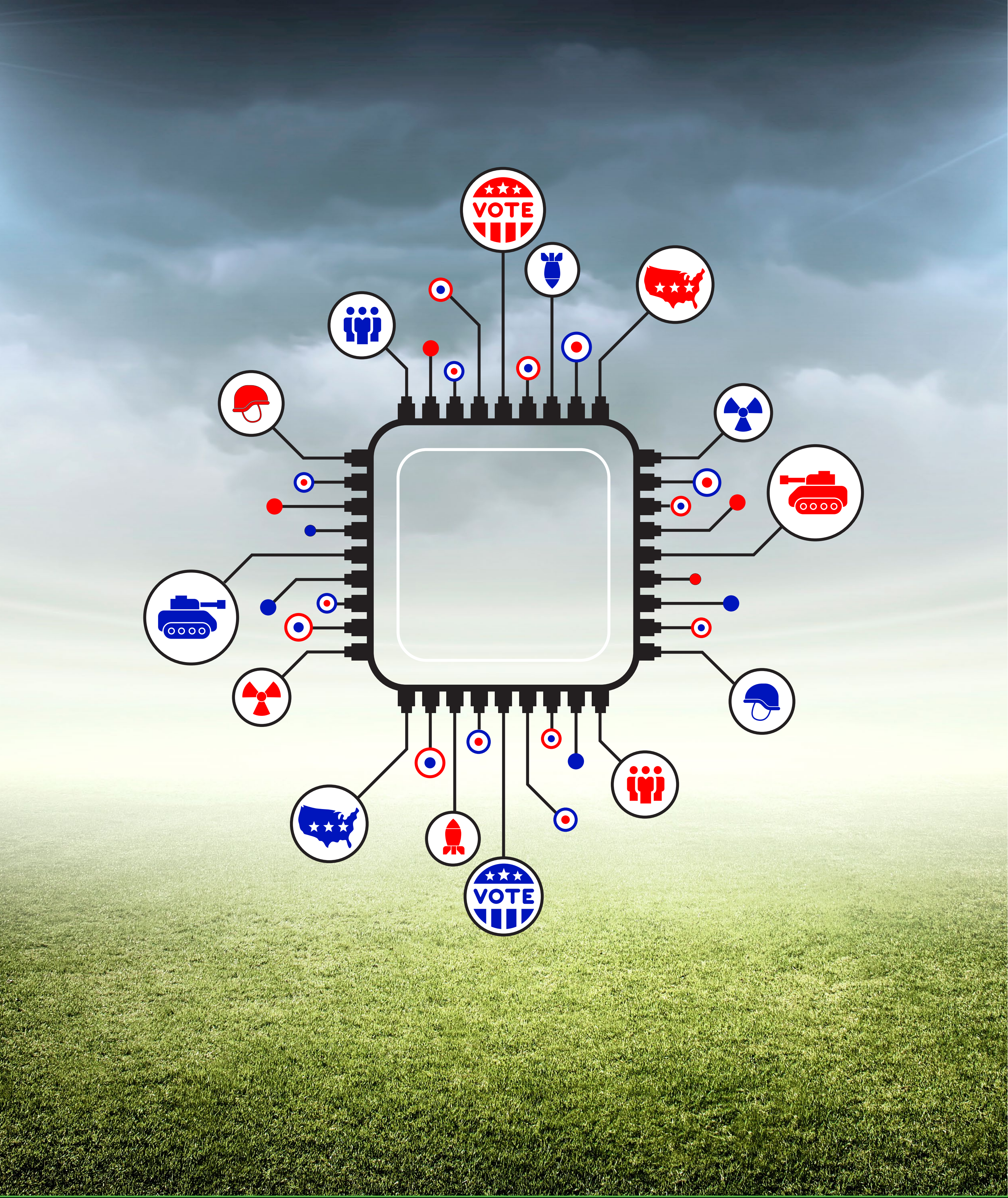
TD Wealth

All is Quiet?

Portfolio Strategy Quarterly | Q3 2024

July 30, 2024


VOTE
VOTE

In this issue

All is quiet?

With hostilities rising in the Middle East and Europe, uncertainty around artificial intelligence, and political upheaval in some of the world's largest democracies, financial markets must be in in turmoil, right? Simply put, no. In fact, the first half of 2024 will go down as one of the calmest in history — at least insofar as markets are concerned. If we look at last quarter, as of the end of June 2024, volatility for the S&P was at 12.4, well below the historical range of 15 to 20. Consider this: in twenty-three days we witnessed a U.S. presidential debate for the ages, followed by an assassination attempt on former President Donald Trump and finally an announcement from current President Joe Biden that he was not going to seek reelection, instead he endorsed Kamala Harris to be the Democratic Party nominee for U.S. President. Even with all this political turmoil in the country with the world's largest economy, financial markets were relatively stable, reacting with little more than a short-lived spike in volatility and factor (size and style) rotation.

In the Q1 edition of PSQ, we wrote that there would be a "wide range of outcomes" early in the year, but I confess I would have assigned a rather low probability that financial markets would be tranquil. However, as we sit at the halfway point of the year, this indeed is the case. All is quiet on the market front, and as I gaze at these peaceful financial markets, I think the big three questions are: (1) Why is market volatility so low? (2) How long will it last? (3) What are the implications for portfolios?

There are a number of reasons why the current calm and the strong performance of risk assets could continue for a while. A recession in the United States is still nowhere in sight, even after two years of relatively high rates, and financial conditions remain loose in much of the developed world. But experience tells me that periods like this will not last forever. They almost always end with a reality check that's reflected in the equity market volatility index (VIX), the bond market volatility index (MOVE) and the currency market volatility index (CVIX).

Peace time doesn't last forever. Being mindful of that, sticking to your process, staying diversified and adapting to the environment around you is always the best course of action.

Be well,

Brad Simpson
Chief Wealth Strategist, TD Wealth

Cracking Complexity

Complexity

Peak Dispersion

The difference in risk sentiment between U.S. and international equities is at a 17-year high. Small-caps are lagging large-caps by the most in 23 years. The S&P 500 is lagging the Nasdaq 100 by the most in 30 years. Growth has outperformed value by a large margin YTD — 23.1% vs 4.6%.

Trough Volatility

Ironically, dispersion within the S&P 500 has led to one of the calmest quarters in history. Volatility for the index was at 12.4, well below the historical range of 15 to 20, as Mag 7 stocks (35% of the index) move inversely to the rest of the index.

10 of 20

The massive outperformance of U.S. stocks would have you believe that no other region is worth looking at — but this is just not true. Despite what appears to be American tech hegemony, about half of the top 20 stocks globally come from outside America.

Four of 10

While the world waits for the Fed to act, four of the G10 central banks have already cut rates. The headliner may not have taken the stage yet, but the concert is well underway.

A Shallow Cycle?

After 500 bps worth of rate hikes, investors are expecting the Fed, eventually, to make borrowing much cheaper. But with little chance of a recession, it's more likely that rate cuts will be slow, steady and shallow.

50x = Electric

North American utilities and power generators may have been overlooked, given the need for massive amounts of electricity to power data centres and EVs. The U.S. Department of Energy estimates that a data centre can use 10 to 50 times the energy of a typical commercial building.

1 of 2

Elections have already made their mark on the geopolitical risk premium, with fears of nationalism dampening the mood in Europe, and elections in Mexico and India influencing emerging markets. Fully 54% of the world's population will get to vote this year.

Populists ≠ Prudent

The most important election in terms of global financial markets will take place in November, of course. Ultimately, over-spending and under-taxing ultimately lead to the same thing: massive U.S. deficits.

Adaptation

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.

Calm Before the Storm

Extended periods of market calm can breed complacency. Remember, peace time doesn't last forever. Being mindful of that, sticking to your process, staying diversified and adapting to the environment around you is always the best course of action.

Be Compensated

The goal of factor diversification is to reduce unintended risk exposures and target exposure to compensated factors while minimizing exposure to uncompensated factors.

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.

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.

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.

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.

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.

PSQ3.2024 | Executive Summary

■ **House Views | Fixed Income, neutral:** We have shifted fixed income to neutral. We continue to have a positive outlook for fixed income, particularly in the shorter end of the universe and believe it will generate attractive returns for investors over the next 12 months. However, we expect ongoing volatility and yields have declined recently, as such we believe it is prudent to move to a Neutral view overall. Bonds can still provide diversification benefits, reduce overall portfolio volatility, and preserve capital. ● **Equity, neutral:** 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 |** The second quarter of 2024 continued to be action-packed. It started with a tough April, with both equities and bonds down, followed by a healthy recovery for both asset classes, with U.S. equities hitting new highs. ● **Brace for turbulence on final approach.** In the U.S., as high rates continue to burden consumers and corporations alike, the economy is slowing. The labour market is more balanced now, but we're still far from a recessionary level. All in all, the soft-landing narrative is still intact in the U.S., although it might get a little bumpy ● **Central banks on the move**. The Bank of Canada started its rate-cutting campaign on June 5. This move was well anticipated and justified. Among G10 central banks, four have pulled the trigger on rate cuts. Although a few, including the Federal Reserve, have passed the 12-month mark since the last hike, the exact timing still depends on inflation data. ● **Myopic bond market vs. hyperopic equity market.** So far this year, government bonds have been struggling as data-dependent central banks leave investors at the mercy of uncertain economic data like inflation. In sharp contrast, equity-market investors have an entirely different focus, rallying on their conviction that the AI trend will give the mega-cap tech companies a very long runway for top- and bottom-line growth.

■ **Economy | High debt loads are common but the U.S. is unique in the size of it's ongoing deficits.** The United States, like other major economies, has seen a large increase in its debt and deficits in recent years. Most major economies have a need to reduce their deficits to prevent their debt from becoming unsustainable. The difference between the U.S. and its peers is in the trajectory of debt and deficits. Smaller deficits are expected to reduce the debt to GDP ratio in most other advanced economies, but not in the U.S.

■ **Fixed Income |** A global shift toward easing by central banks has historically rewarded fixed income investors. In the first half of 2024, however, this tailwind weakened as robust economic data tempered rate-cut expectations. At the start of the year, many anticipated significant rate cuts from the Fed to mitigate growth risks, with futures markets pricing in 150 bps of cuts by year end. As we enter the second half of 2024, only about 50 bps are expected, amid persistent inflation and resilient consumer spending. This uncertainty, combined with geopolitical tensions and the upcoming U.S. elections, may lead to market volatility along with opportunities for actively managed fixed income portfolios. Higher yields historically translate into higher returns, meaning the longer-term outlook for bonds is still attractive. ● **We are neutral fixed income overall 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 volatility to decline in coming quarters as the economic outlook and path of policy rate cuts in Canada becomes clearer. ● **We are modest overweight investment grade credit**. Investment-grade spreads remain tight overall and reflect a modest softening of the global economic backdrop. We see Canadian IG corporate bonds as more attractive than U.S. IG corporates because spreads in Canada continue to be meaningfully wider. While we expect softening economic conditions to widen spreads, we believe it will be manageable given the expectations of a soft landing. We continue to focus on high-quality credit and believe technicals will remain supportive and healthy yields will mitigate losses from price volatility. ● **We maintain our modest underweight view on high-yield credit**. The 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. We continue to favour the higher-quality cohort of the HY credit market.

■ **Equities** | Breadth continued to be narrow, with the market overwhelmingly led by U.S. tech mega-caps. Now, at the midway point of the year, investors are asking themselves two questions: (1) Is it too late to put money to work in growth stocks? (2) Is it too early to invest in value and income stocks? In this article, we provide insights on investing at both ends of the equity "barbell" positioning strategy. ● **The Growth End: U.S. info-tech.** The semiconductor index is demanding its highest premium of the cycle relative to that of the S&P 500. However, when we exclude the names with high exposure to AI, the semiconductors valuations are more reasonable. Another pocket that offers attractive pricing is software. Although software stocks participated in much of 2023's bull market, they essentially flattened out since their peak earlier this year. As a result, valuations have improved versus the sector, providing a "growth at a reasonable price" proposition. ● **The Value/Income End: Canadian Banks.** We saw a positive inflection point in operating leverage, which was driven by improving revenue growth and slowing expense growth. Capital markets were also a bright spot, as an acceleration in the segment's revenue growth boosted top-line growth. Although there remains an overhang from mortgage renewals and some deterioration in domestic personal loans, Canadian banks maintain a healthy capital position. ● **The Value/Income End: North American Utilities**. The increasing demand for power generation, transmission and distribution to support new technology has made utilities interesting, and they should benefit from a shift in the power demand landscape across North America on the back of three key demand drivers: energy-intensive data centres, electric vehicles and manufacturing on-/re-shoring. ● **International: Discount reflects sluggish economies.** In the near term, the weaker economic environment will be a drag on earnings growth, but as we move towards economic recovery, we believe dispersion between U.S. and international equities will reduce, offering potential for equities outside the U.S. ● **Emerging Markets: Some allocation is worth the risk.** There are political risks across the board for EM equities if Republicans in the U.S. win a strong mandate in November 2024. However, we maintain a neutral view given the emergence of powerful companies across the EM regions, improved balance sheets of key EM countries, the EM's importance as an engine of global growth and attractive valuations. However, investors must be selective within the EM bucket.

■ **Alternatives** | Investors with a long-term time horizon could benefit from adding alternative assets to their portfolios, namely private equity, private credit and unlisted real assets. ● **Infrastructure makes sense across market cycles**. Infrastructure is remarkably diverse, encompassing a range of facilities and projects that provide the essential services underpinning the global economy. Absent black swan events, demand for core infrastructure is typically inelastic with mitigated volume risk. ● **Unlisted Real Estate: The long game.** We hold a modest underweight view on domestic real estate and global real estate. High-for-longer interest rates, tight lending conditions, a refinancing maturity wall, and limited transaction activity are keeping commercial real estate under pressure. Positively, however, normalizing capitalization (cap) rates, moderating inflation, and easing supply chain bottlenecks could provide relief in the second half of 2024.

■ **Currencies** | The U.S. election will turn into the main driver in the months ahead. Recent events in other countries confirm the importance of local politics on markets. They connect to a larger meta-theme, linking geopolitics, globalization and financial markets. This rise in geopolitical uncertainty may challenge the Goldilocks narrative, especially if markets begin to price in a Trump risk premium. ● **Meanwhile, in Canada**. A look at housing dynamics suggests that the loonie will remain vulnerable. Decelerating inflation, moreover, opens the door further for the BoC to cut rates. This has left the loonie at its lowest level since late 2023 against the USD, which we expect will remain over the near term..

■ **Commodities** | We believe the second half of the year will be driven by steady demand growth and tight inventories in energy; tightening forward balances and heightened investor attention on industrial metals; a revived recognition of the importance of gold in investor and central-bank portfolios; and a well-supplied agricultural market. ● **Prices likely to rise on uncertainty.** A world where inflation is more volatile, where geopolitical competition is rising, and where energy transition is ongoing, amongst other factors — that is a world wherein commodities should fare well.

All Quiet on the Market Front?

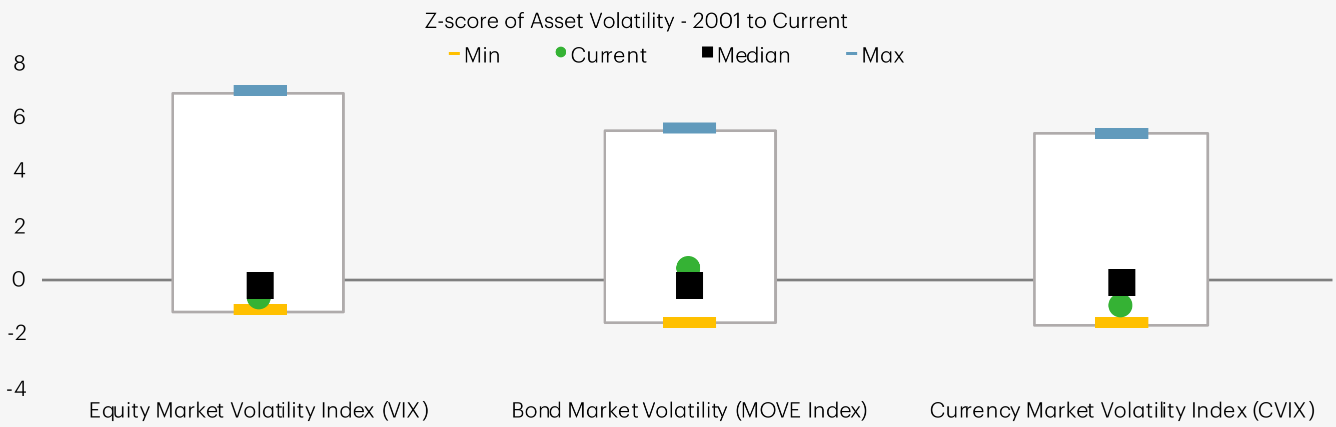
Brad Simpson, Chief Wealth Strategist | TD Wealth

In our first-quarter *Portfolio Strategy Quarterly*, “The Great Wide Open,” we wrote that the environment we would be navigating in 2024 would likely be dominated by three headlines: (1) the ongoing wars in the Middle East and Europe; (2) the momentous elections looming around the globe; and (3) the rise of artificial intelligence. As it turns out, this trio has been the stick stirring the proverbial drink. Surely then, with hostilities rising in two major theatres, uncertainty around AI, and political upheaval in some of the world’s largest democracies, financial markets must be in in turmoil, right?

Simply put, no. In fact, the first half of 2024 will go down in the books as one of the calmest in history — at least insofar as markets are concerned. If we look at last quarter, as of the end of June 2024, volatility for the S&P was at 12.4, well below the historical range of 15 to 20. Currency volatility is also below its long-term average (Figure 1). While there has been some interest-rate volatility, this too has been quite low.

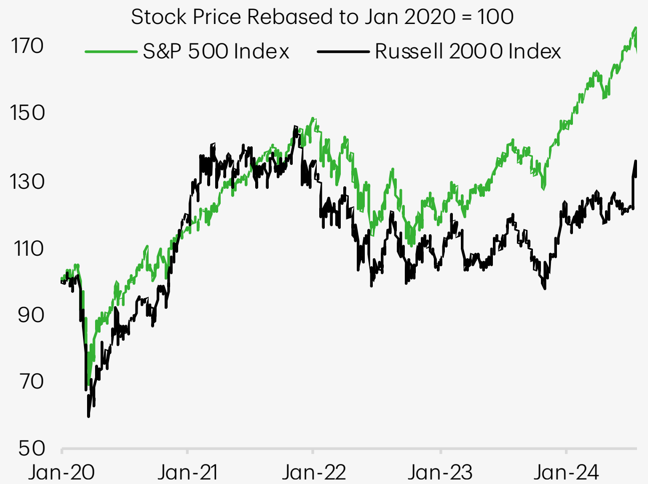
Consider this: in twenty-three days we witnessed a U.S. presidential debate for the ages, followed by an assassination attempt on former President Donald Trump and finally an announcement from current President Joe Biden that he was not going to seek reelection, instead he endorsed Kamala Harris to be the Democratic Party nominee for U.S. President. Even with all this political turmoil in the country with the world's largest economy, financial markets were relatively stable. Sure, volatility increased a little and a rotation from the tech mega-cap growth stocks towards value and smaller-cap equities has begun, but as we have written about a lot over the past year, we think both were long overue (Figure 2).

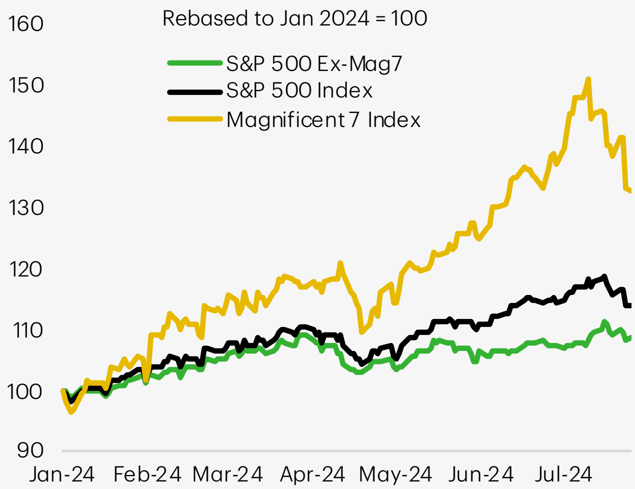
Figure 1: Volatilities muted across equity and currency markets



Source: Macrobond, Wealth Investment Office, as of July 12, 2024

Figure 2: Overdue rotation





Source: Macrobond, Wealth Investment Office, as of July 25, 2024

Risk asset returns have been terrific (Figure 3). U.S. equity valuations are high by almost any traditional measure, and North American credit spreads have remained very tight, near all-time lows. In that Q1 edition of *PSQ*, we also wrote that there would be a "wide range of outcomes," but I confess I would have assigned a rather low probability that financial markets would be tranquil. As we sit at the halfway point of the year, this indeed is the case: All is quiet on the market front.

As I gaze at these markets, I think the big three questions are:

1. **Why is market volatility so low?**
2. **How long will it last?**
3. **What are the implications for portfolios?**

Experience tells me that periods like this will not last forever, especially considering the current backdrop, but before we consider these three questions let's frame the state of play:

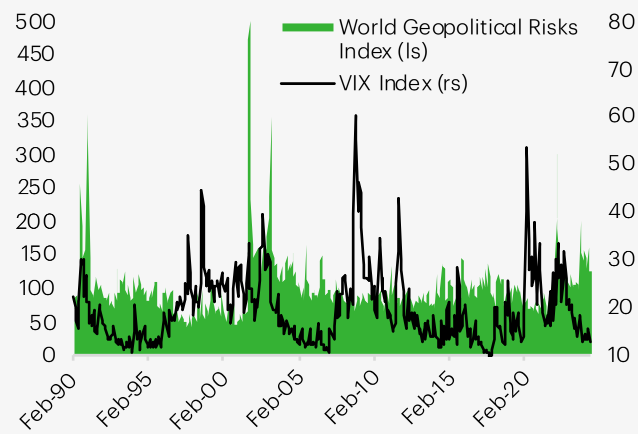
Geopolitical Risks

Global geopolitical risk has been elevated (Figure 4). The ground offensive in Gaza and its southern city, Rafah, continues as Hamas militants and Israeli soldiers attack each other's position. For Israel's government, which has been heavily criticized for the mounting civilian casualties, the conflict has expanded with the involvement of Hezbollah militants in the southern part of Lebanon, which have been attacking Israelis living along the northern border.

In Ukraine, meanwhile, Russia's military forces continue to destroy that country's infrastructure. Russia has also taken increasingly bold actions against NATO countries, including cyber-attacks, cognitive warfare, sabotage and even weaponized migration. And there's been little progress on peace talks, given Russia's insistence on the full control of four Ukrainian regions annexed in 2022 but only partially controlled by Russia, as well as the cancellation of Western sanctions — a proposal immediately rejected by Kyiv and its Western backers.

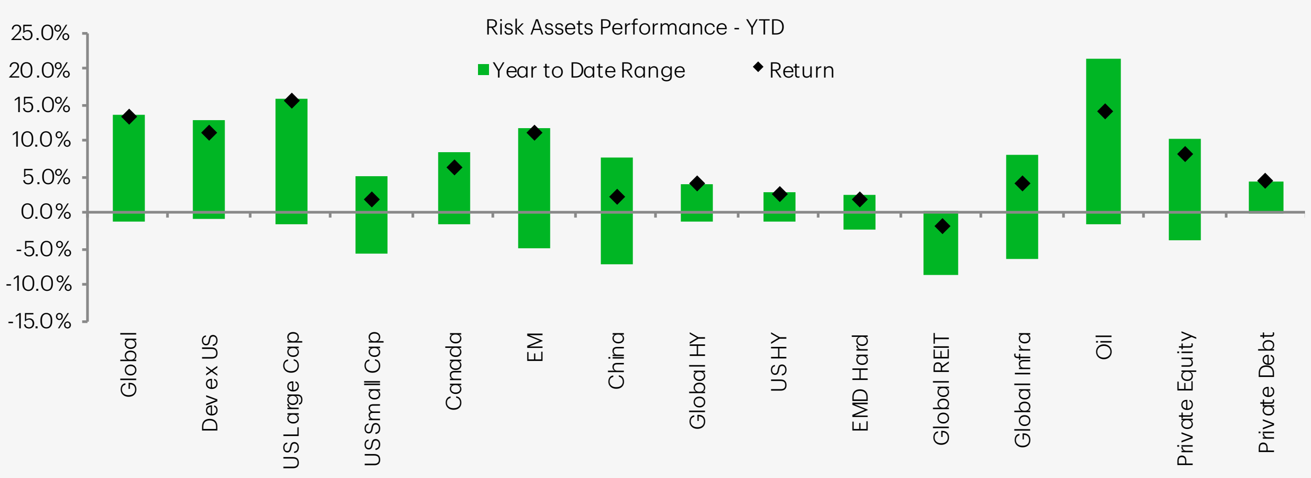
Looming in the background is the threat of a larger escalation between the U.S. and China. In the second quarter this year, the U.S. and European Union proposed tariffs on imports of Chinese electric vehicles and solar panels, among others, in order to protect their domestic industries from unfair competition, and for domestic security reasons. Meanwhile, the U.S. is cancelling several export licences for sensitive chip technology to China to slow the country's progress in building its own domestic chip industry. Closer to Taiwan, Chinese coastguards have also taken a more aggressive posture in the Southern China Sea, which is why we're hearing more news about Taiwanese and Filipino fishermen. The bottom line is that the relationship between Western governments and China continues to be fraught and complex, something that may escalate as we get closer to the U.S. election.

Figure 4: Geopolitical risks elevated despite market calm



Source: Macrobond, Wealth Investment Office, as of July 12, 2024

Figure 3: Risk returns have been terrific



Source: FactSet, Wealth Investment Office as of July 12, 2024

Global Elections

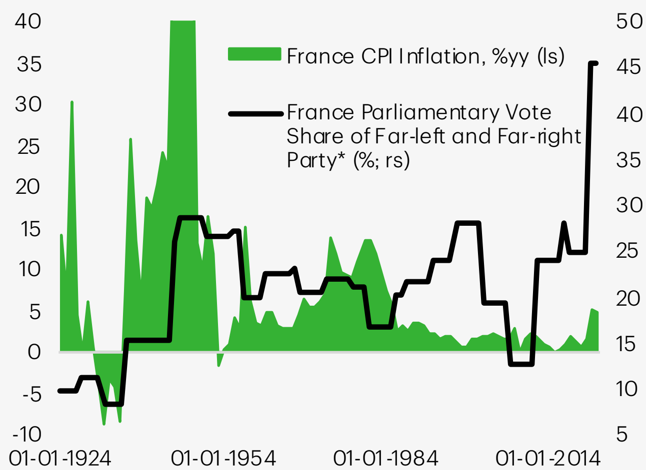
In a record year that will see approximately half of the world's population going to the polls, elections in the first half of 2024 have yielded some surprising results, which we believe could have important policy and market implications. First, voters are increasingly leaning towards parties of the far-right or far-left, making the political centre an increasingly lonely place for moderates.

While concerning, this development is consistent with historical trends. Polarization tends to rise following periods of war, inflation or geopolitical upheaval. Figure 5 considers 100 years of French history, but the implications hold true for other democracies over the same period. To put it simply, the higher-inflation era that followed the Covid-19 pandemic has made it difficult for incumbents. Meanwhile, populist candidates, promising seemingly better alternatives, have the potential down the road to wreak havoc on fiscal and debt sustainability in the world's democratic states.

Again, let's consider France, where the recent election saw both far-left and far-right parties propose an unwinding of President Macron's efforts to reduce that country's fiscal deficit. The increased likelihood that the extreme left or right could gain power triggered a spike in French long-term bond yields (Figure 6). Currently, bond markets are putting a higher country risk premium for France relative to Portugal — a country that just a decade ago was classified as one of the most fragile economies in the euro zone. Our view on French assets remains cautious; continued uncertainty warrants a higher risk premium.

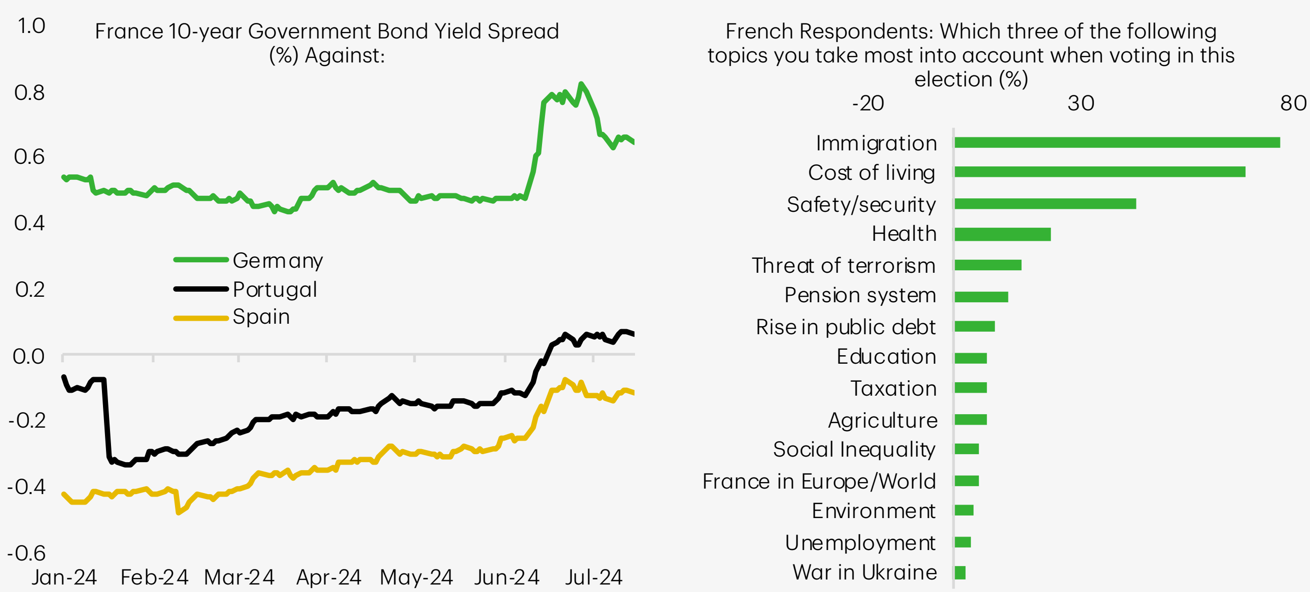
Another example can be found in the UK, where voters also rejected the incumbent government. Chaotic policy, high inflation, the pandemic and slower growth following Brexit all contributed greatly to a landslide Labour win over the Conservatives. This Labour victory will likely be a market positive given the party's well thought out, centrist economic plan focused on economic growth, fiscal stability and policy certainty. Closer to home, U.S. Republican presidential candidate Donald Trump is also pushing an agenda that includes more protectionism, stronger border policy and tax cuts that will likely worsen the trajectory of U.S. public debt and could be potentially inflationary. Alternatively, it also has the potential to provide a tailwind for U.S. public companies (Figure 7). Vice President Harris has a short window to garner support for her campaign, but seems well on track to lead the Democratic ticket. Vice President Harris's policy stance is largely unknown,

Figure 5: Extreme parties tend to benefit from upheaval



*Far-left: Unbowed France, France Communist Party, other far-left; far-right: National Rally, other far-right. Source: Macrobond, French National Institute of Statistics and Economic Studies

Figure 6: Fiscal and debt sustainability rank low among voter priorities



Source: Macrobond, Ipsos, Wealth Investment Office, as of July 12, 2024 but continuity with the Biden administration on most economic policies seems likely. Initial market reaction to her candidacy saw large caps and the NASDAQ rally, which may be telling. Interestingly, her views on trade may be an area to watch and an area of strength in a country where protectionism is supported by both sides of the aisle. Specifically, Harris voted against the United States-Mexico-Canada Agreement (USMCA) and opposed the Trans-Pacific Partnership (TPP), whereas Biden supported both.

Rise of AI

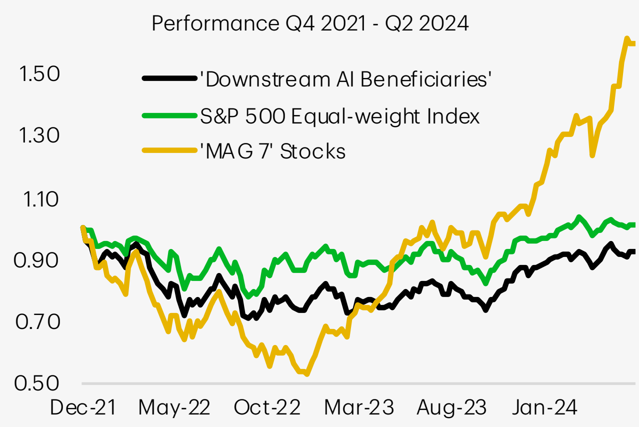
The biggest story in financial markets this year has been the continued influence, and outperformance, of "AI beneficiaries" on equity markets. The main beneficiaries so far have been those involved in the buildout of AI infrastructure. In the first stages, this was driven primarily by the data-centre and semiconductor leaders, such as Nvidia, which is up nearly eight-fold since the start of 2023. Investors then also turned to the equity groups that use (software) and feed (electricity generation and transmission) this infrastructure. Most of these direct AI plays have seen their stock prices and valuations reach new all-time highs, leading investors to look further down the AI evolution path. Now, they're turning their attention to the companies expected to see productivity gains from implementing AI to boost earnings.

Goldman Sachs recently published a report on companies they believe stand to gain significantly from the use of AI. They refer to "AI beneficiaries," but we think a better naming convention would be "Downstream AI Beneficiaries" given that the study examined how AI would allow companies to either cut labour costs by replacing worker tasks with automation, or boost revenue by providing workers with productivity-enhancing tools. The firm then took a basket of the 50 highest-scoring companies in their evaluation and formed an equal-weighted index. We replicated this index and compared its performance to the equal-weighted S&P 500 from the end of 2021 through the end of the second quarter of 2024 (Figure 8).

The performance of this basket has significantly trailed that of the equal-weighted S&P 500 over this period. The implication is that these companies have not shown the profit gains from AI that may have been expected.

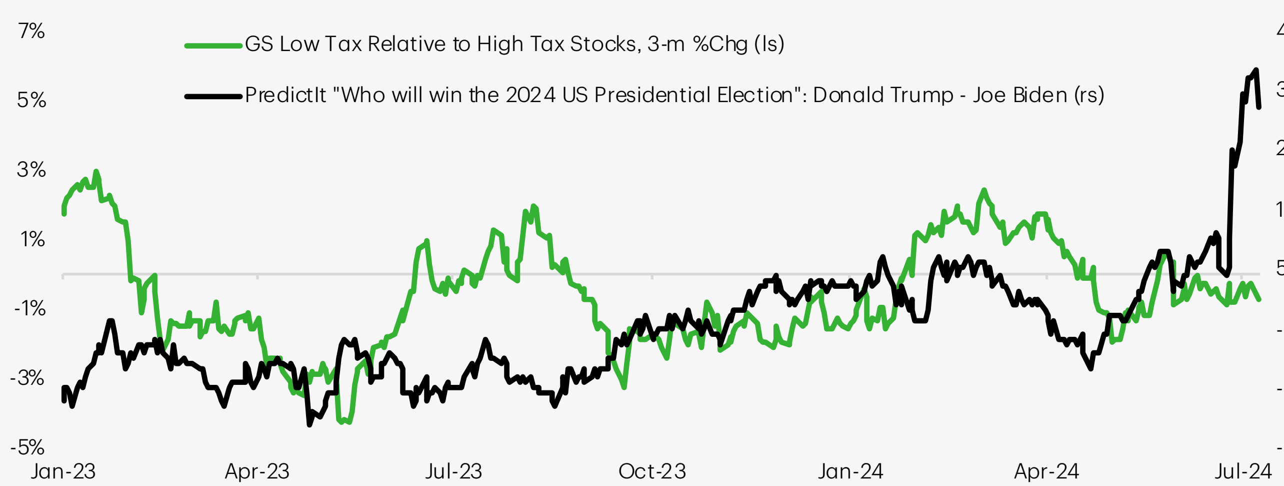
There are two takeaways here. First, the business benefits from AI are going to take time. It's reminiscent in some ways of the late 1990s, in that many of the espoused benefits of the internet came true, but not as quickly as the tech jingoists and frothy markets thought. The financial benefits of AI will accrue to businesses and shareholders alike — and probably faster than most people think, but slower than what speculators are currently betting on.

Figure 8: Downstream AI beneficiaries have lagged the market



Source is FactSet, Wealth Investment Office as of June 30, 2024

Figure 7: Rising probability of Trump win bodes well for companies that would get a tax cut



Source: Macrobond, Wealth Investment Office, as of July 12, 2024

Second, the performance of this broader group of "Downstream AI Beneficiaries" must be considered in the context of current investment flows. The U.S. equity market has been dominated by high-quality, large-cap stocks, and the group of equities in the downstream basket includes a handful of household names and other lower-quality, smaller-cap names, which may also have contributed to the performance lag.

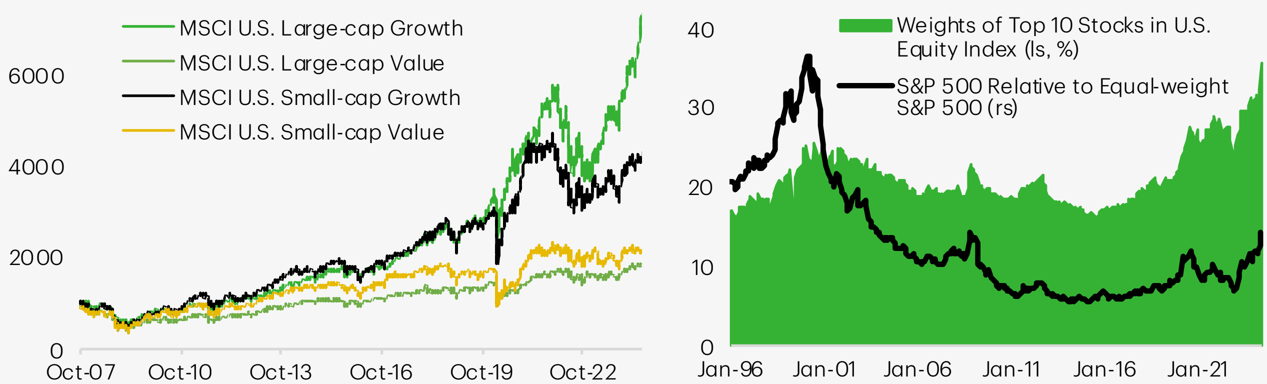
In recent months, we have seen a rising tide that is not lifting all boats. The mega-cap tech stocks now account for 35% of the S&P 500 (Figure 9). We are seeing an increasingly narrow leadership in the U.S. equity rally, with Magnificent Seven stocks driving two-thirds of the gain in the first half of 2024. Meanwhile, if we take a look at indices with less exposure to the Mag 7, they have been lagging badly. As of early July, the Russell 2000 — a proxy of small-cap stocks — had lagged the S&P 500 by the largest margin since January 2001. On the other hand, the tech-heavy Nasdaq 100 was outperforming the S&P 500 by the largest margin in the past 30 years — surpassing the peak of the dot-com bubble.

The divergent performance between large-cap growth stocks and the rest raises the question of how long and how far such outperformance could be sustained, especially as valuations for the former become expensive. Equity indices from other areas, such as the euro zone, China and Canada, have lagged badly due to limited exposure to AI beneficiaries, raising the possibility that they could start to outperform as the increasingly high earnings bar for Mag 7 leaves them more prone to disappointment (Figure 10), which is what we have seen in the latter half of July. Moreover, as the long-term impacts of AI benefit a greater number of companies downstream, these global indices should start to profit as well.

Why is market volatility so low?

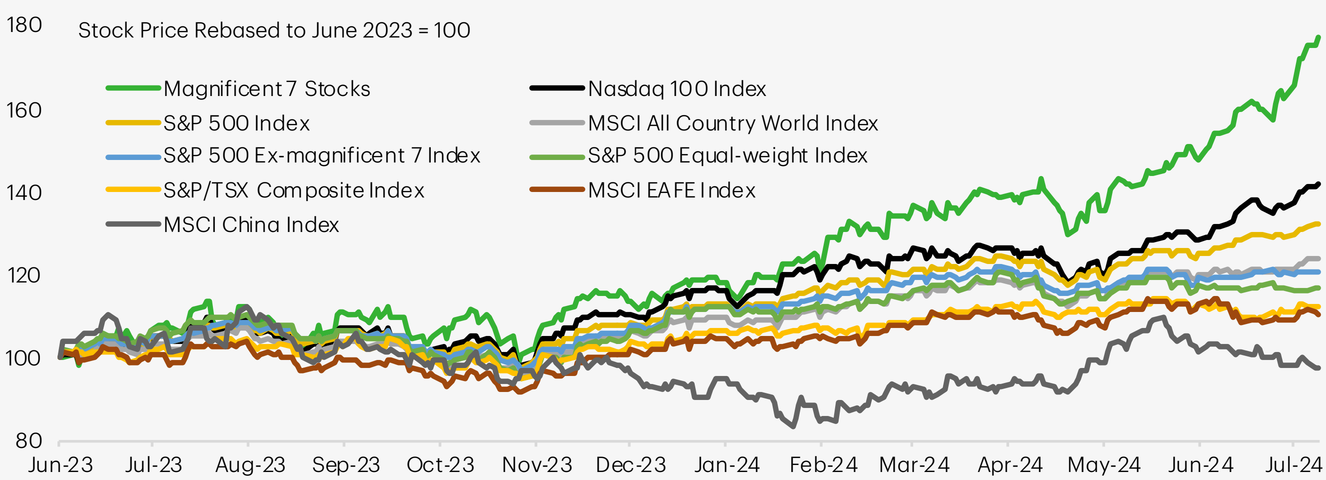
So, now that we understand the headline risks, we must answer the question that has investors scratching their heads: Why has volatility been so low? Understanding this will help us identify potential catalysts for a reversal and make the appropriate adjustments to portfolios. Knowing is half the battle.

Figure 9: Outperformance of AI-related stocks has resulted in dense concentration



Source: Macrobond, Wealth Investment Office, as of July 12, 2024

Figure 10: Performances diverge on outsized Mag 7 contribution



Source: Macrobond, Wealth Investment Office, as of July 12, 2024

Let's start by considering volatility itself. Within a portfolio of equities, volatility is a function of: (1) the allocation across its holdings; (2) the volatility of those holdings (their movement up and down); and (3) the correlation of those holdings (do they move together in a synchronized way or not). Given the fairly static composition of a market-cap-weighted equity index, it is the volatility and correlation.

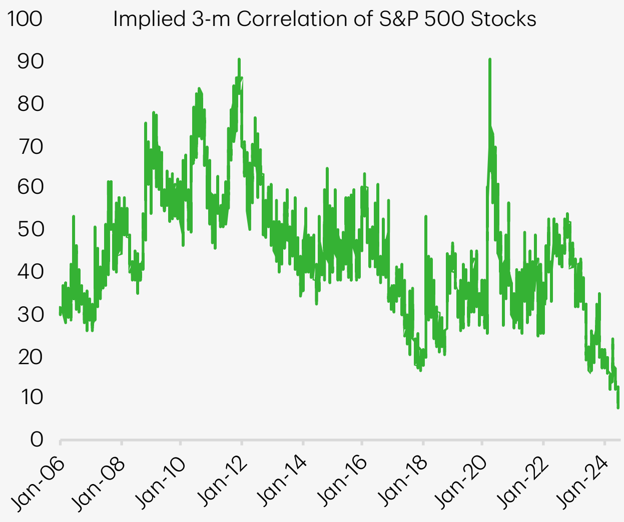
In Figure 11, using the S&P 500 as a proxy for a portfolio of equities, we show the average pairwise correlation among S&P 500 stocks, which by the end of Q2 had dropped to 0.09, and the distribution of the correlation since 2006. The takeaway here is that correlation between stocks within the S&P 500 index has fallen to a rare, historical low. This very low correlation, or movement, within the stocks inside the S&P 500 brought down volatility of the index as a whole (Figure 12).

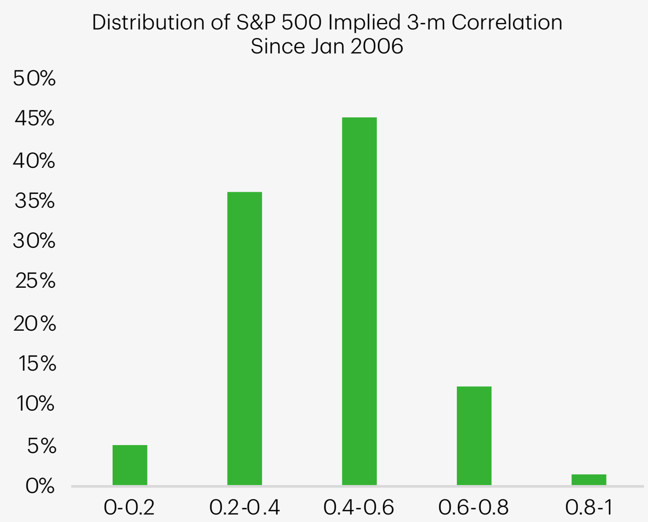
As a reminder, when this period of relative calm ended, volatility roared back to life, forcing the Fed to end its policy of monetary tightening at the time. We are not suggesting that this is imminent — periods of low volatility can last longer than you think — but expecting the current calm to last indefinitely, and allocating accordingly, is unwise for investors who want to grow *and* protect capital.

How long will it last?

There are a number of reasons why the current calm and the strong performance of risk assets could continue for a while. First, a recession in the United States is still nowhere in sight, even after two years of relatively high rates. Bank of America's Fund Managers Survey shows most market participants believe a no-landing or soft-landing scenario is the most likely

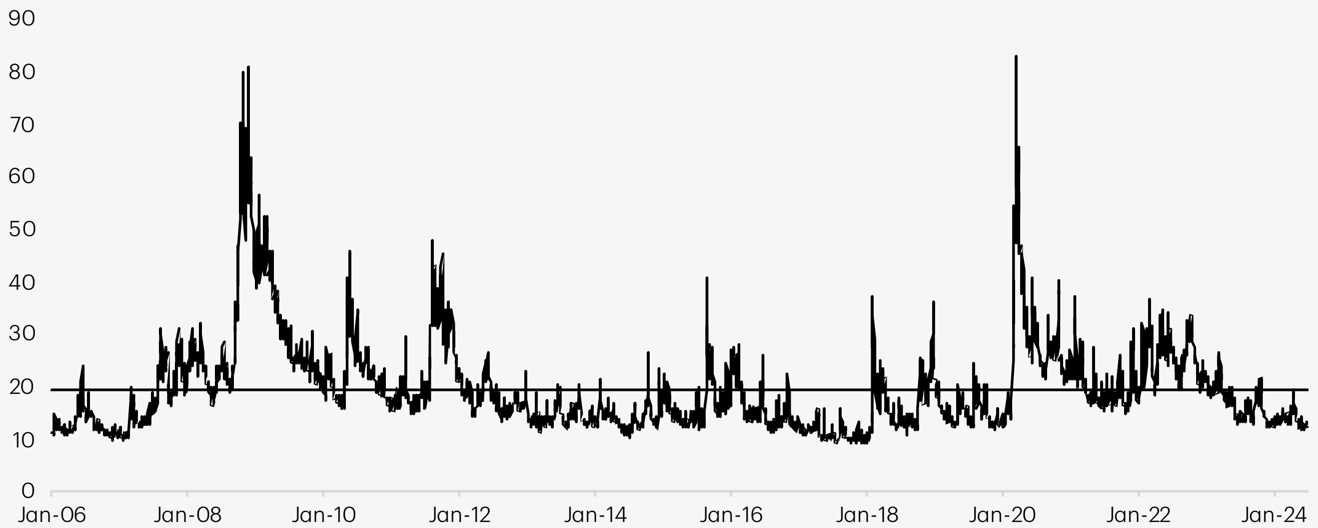
Figure 11: Implied correlation in the S&P 500 has fallen to historic lows ...





Source: Macrobond, Wealth Investment Office, as of July 12, 2024

Figure 12: ... contributing to muted volatility



Source: Macrobond, Wealth Investment Office, as of July 12, 2024

in the coming 12 months (Figure 13). For Q3 2024, TD Economics estimates a slight acceleration in the U.S. economy (1.7%), a continued decrease in core inflation (3.2%) and a relatively strong job market despite the softening trend, with unemployment still at historical lows (4.1%).

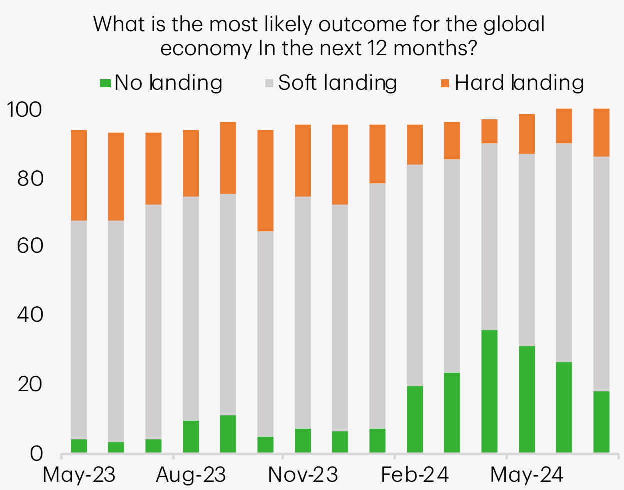
Second, financial conditions remain loose in much of the developed world, including in the U.S. Investor sentiment has been positive given the rally in stocks, and positioning is bullish. The clamour around potential AI applications are fuelling the market's animal spirit, especially for companies in the vertical that are seeing growing earnings and valuation. Large and sustained fiscal deficits in the U.S. are also boosting investment and capex in the technology and industrial space. And although there have been pockets of weakness among low- and middle-income consumers, spending overall remains in good shape. Unless the labour market weakens dramatically from here, the U.S. economy will likely enter a new business cycle as monetary policy eases.

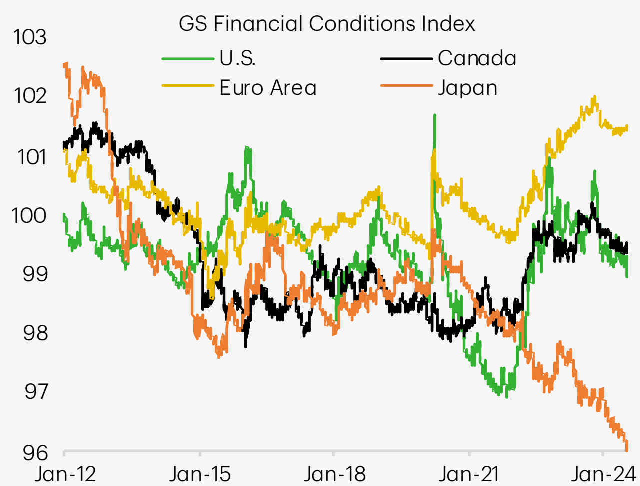
Lastly, many of the risk-taking activities have moved from the public to private markets. This means it is becoming increasingly difficult to assess the underlying health of U.S. corporations. With the banking system increasingly constrained by capital and liquidity rules, lending to the private sector is increasingly dominated by specialized non-bank firms (Figure 14). While banks are actively trying to repackage loans and transfer their risk to institutional buyers, pension funds, family offices and endowments have all increased their allocation to private-credit managers, who are then able to attract deal flows from middle-market companies. Sometimes, these players also borrow from the banking system to increase their leverage, making it difficult for the Fed and regulators to monitor risks in the financial market.

What are the implications for portfolios?

While we don't see this current calm turning into something more sinister in the immediate term, when it comes to risk, it's the things that you don't see that usually hit you. With that in mind, the relevant question now is, how volatile will it get when equity correlation

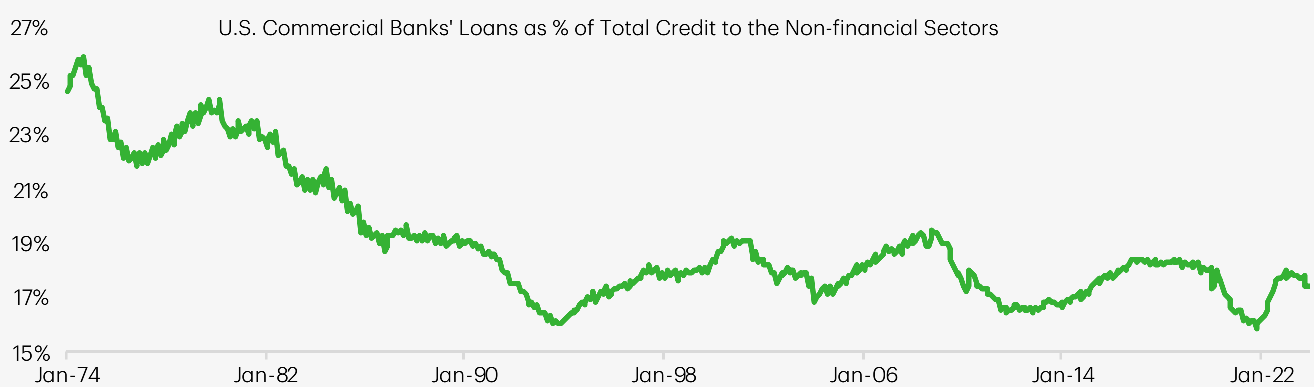
Figure 13: Soft-landing remains the consensus among fund managers





Source: BofA Global Fund Manager Survey, Wealth Investment Office, as of July 16, 2024

Figure 14: Regs force banks to cede ground to private-credit managers



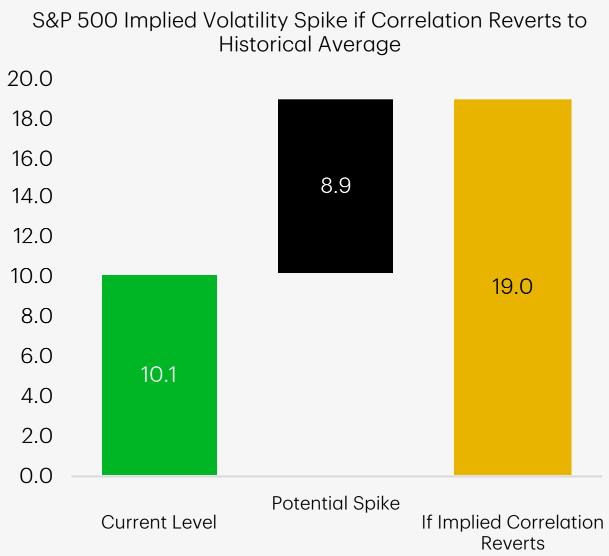
Source: Macrobond, Wealth Investment Office, as of July 12, 2024

reverts to its historical average from the current level? Figure 15 shows that this would amount to the equity volatility index (VIX) jumping by nine percentage points, or an 80% increase from the current level, which is a dramatic increase. Worse, this rise in volatility could trigger program selling in the derivatives market, potentially taking volatility higher and markets lower.

For active equity managers, this risk can be hedged by using a combination of option strategies or by shorting index futures. Tilting an equity portfolio to selectivity could also help to mitigate the downside risk.

Figure 16 outlines the annualized excess return for five major factors in a scenario where volatility jumps by 80% in the next three months. The result shows that low-volatility and quality will outperform. This supports our strategic allocation to low-vol and quality mandates across our portfolios.

Figure 15: VIX would rise if correlations were to normalize



Source: Wealth Investment Office as of June 30, 2024

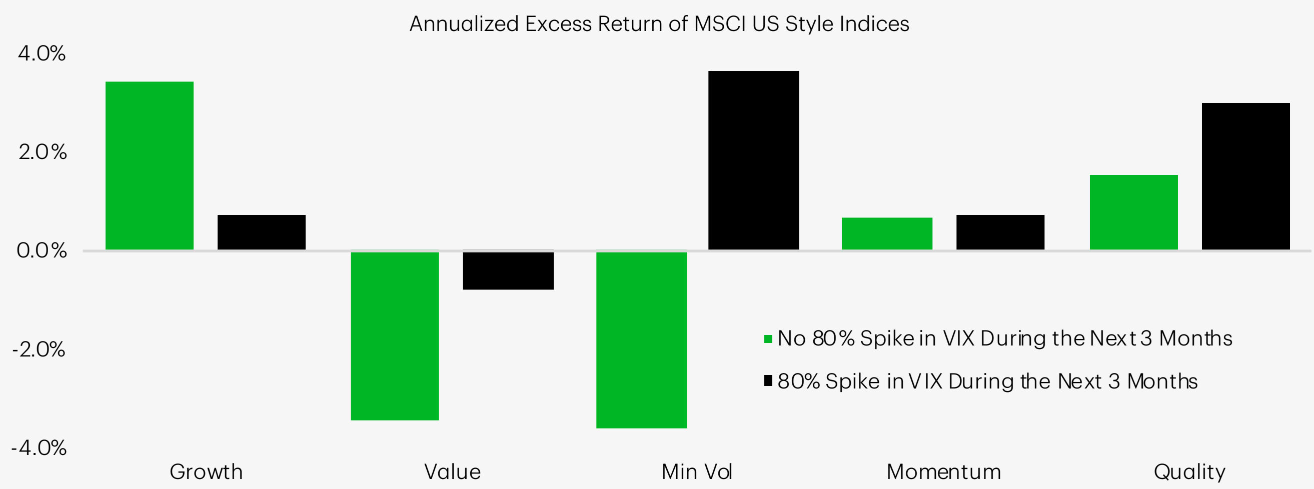
There are several other concrete actions an investor could take to protect capital and reduce overall portfolio volatility. The first is to revisit their investment policy statement or their wealth plan to evaluate whether the current portfolio is still appropriate for their risk profile. Significant gains in equities and the poor performance of bonds over the past three years may have led investors to become overallocated to equities and underallocated to bonds — at a time when valuation for the former skewed expensive while the latter offers the highest yield seen in the past decade (Figure 17).

It is prudent for investors to rebalance their portfolios to target weights following the massive shift in allocation across asset classes and within each asset class. Investors should also ask whether the current portfolio is truly diversified, especially given the heavy influence of Magnificent Seven stocks in U.S. equity indices. While we have shifted to a neutral view for fixed income, we continue to believe that bonds will perform well when the Fed finally cuts its policy rate, particularly the shorter end of the universe (Figure 18).

The second step is to implement a hedging strategy. Other than traditional hedging strategies, such as buying put options or shorting index futures, investors could also consider allocating to long/short or market-neutral equity strategies to mitigate risk in broad equity indices. In essence, this is analogous to trading market beta (dependent on market sentiment) for manager's alpha (dependent on security selection).

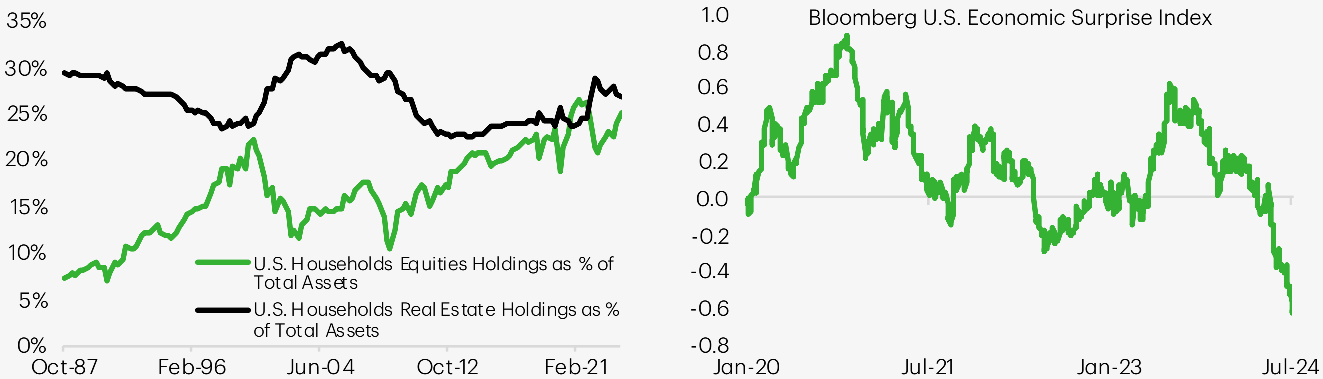
So far this year, long/short managers have been able to keep up with the equity market despite taking only a moderate beta exposure. A multi-strategy hedge fund is also an attractive option to lower volatility for the overall portfolio given its very low correlation to both equity and bond markets.

Figure 16: Low-vol, quality tend to outperform during volatility spikes



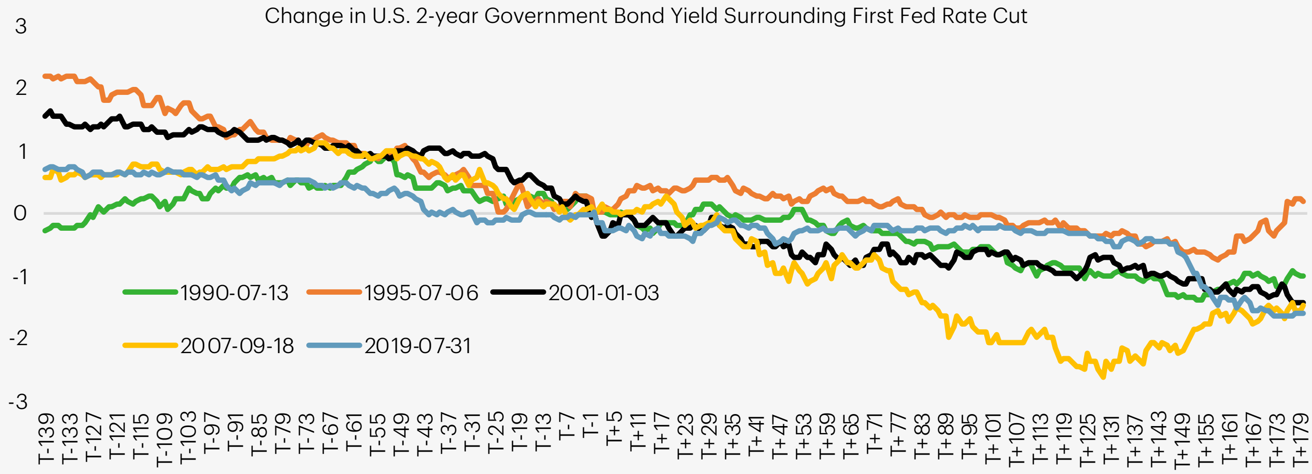
Source: Wealth Investment Office as of June 30, 2024

Figure 17: Equity holdings among U.S. households are near record highs



Source: Macrobond, Wealth Investment Office, as of July 12, 2024

Figure 18: Bond yields tend to fall on first Fed cut



Source: Macrobond, Wealth Investment Office as of June 30, 2024

Third, given that some of the best opportunities are increasingly moving to the private market, its importance cannot be overstated. In the private-equity space, the best managers — with access to deal flow and the ability to guide companies in their portfolio — should provide investors with greater returns than in the public markets, which has been the case over the past decade. Meanwhile, better alignment of incentives between managers and owners in the private market should also mitigate the short-termism in decision-making often seen among publicly listed companies. In the credit space, where both investment-grade and high-yield bond spreads are near all-time lows, investors may also benefit from access to the rapidly evolving private-credit space, which has grown into a $2.1-trillion industry.

Outlook by Asset Class

We are neutral, which is an asset allocators' way of saying we are cautious across the board.

Cash: Our most recent change is to upgrade cash from modest underweight to neutral and downgrade fixed income from modest overweight to neutral. This will have little impact on our actual allocations but it captures the tone of our thinking - cautious.

Fixed Income: Shift to neutral. We continue to have a positive outlook for fixed income, particularly in the shorter end of the universe and believe it will generate attractive returns for investors over the next 12 months. However, we expect ongoing volatility given the uncertainty related to fiscal policy and yields have declined recently, as such we believe it is prudent to move to a Neutral view overall. Bonds can still provide diversification benefits, reduce overall portfolio volatility and preserve capital. With that in mind, investors can lock in attractive yields today; we know rate cuts are coming, although trying to predict exact timing is a challenge.

Equities: We continue to maintain a neutral outlook for equities overall. We also continue to prefer U.S. equities given the attractive earnings outlook for U.S. companies. However, it's important to note that we are selective in this market.

For instance, we continue to believe a barbell approach makes a lot of sense. While the Magnificent Seven (or maybe now the Fab Four?) continue to lead the rally in U.S. equities, other segments — especially in the cyclical sectors, such as industrials — are currently benefiting from a recovery trade based on expectations of a soft landing. Following significant underperformance over the past two years, small-caps and value stocks should perform better as monetary policy eases and a new business cycle potentially starts.

Alternatives / Real Assets: We are currently neutral, but this is a diverse asset class where we are employing risk-mitigation strategies, such as market neutral, long/short, commodities. Private equity offers attractive opportunities, especially exposure to value-oriented buyouts and late-stage growth equity. Private-credit yields remain attractive, and are expected to generate equity-like returns. In real estate, asset selection is key, and we're focusing on high-growth sectors like logistics and multi-family residential.

Commodities: We are currently modest overweight. Our general view continues to be tied to the fact that commodities in general provide strong diversification benefits to a portfolio, particularly in times of extreme change. Commodity returns have a low correlation to both stocks and bonds, and the underlying fundamentals remain attractive for key commodities, such as oil and copper, given that supply remains either disciplined or restricted. Elsewhere, gold continues to be supported by central-bank buying as well as demand from China.

Final thoughts during a period of relative quiet

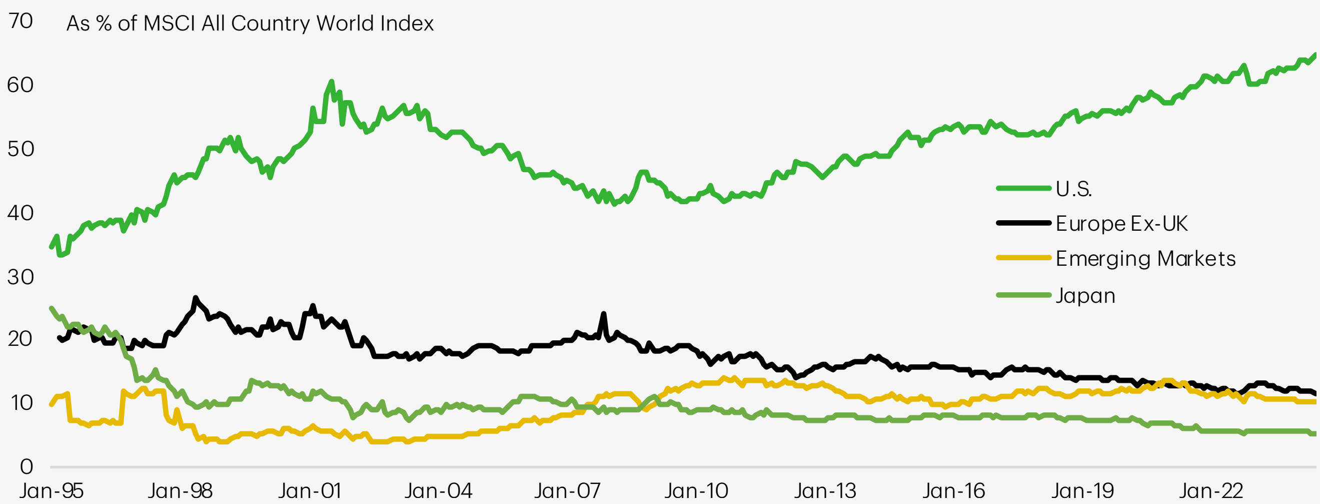
We spend a lot of time writing and speaking about the importance of implementing a process-driven investment-management strategy and ensuring you have a properly diversified portfolio that is structured to meet your individual goals and fit your constraints. That is always important, in every type of environment, but it's especially important now, when market enthusiasm can lead to complacency.

After the stellar performance of the Mag 7, and relatively lacklustre performance in other regions, the U.S. weighting within the MSCI All Countries World Index has grown to all-time highs, as seen in Figure 19. We continue to believe U.S. equity markets offer attractive prospects, with strong earnings expectations. However, it's important to be mindful of asset allocation, given that many portfolios may have developed outsized U.S. weightings, similar to the ACWI. Basic mean reversion would suggest that this U.S. outperformance will even out over time, and there are more than enough signals within the S&P 500 that demand higher diversification within the asset class and outside.

For clarity, we are not delivering a negative message on U.S. markets — we are overweight U.S. equites — but the kind of concentration we're seeing on the S&P 500 can lead to exposure that exceeds a traditional overweight position.

Extended periods of market calm often end with a reality check that will be reflected in the equity market volatility index (VIX), the bond market volatility index (MOVE) and the currency market volatility index (CVIX). Peace time doesn't last forever. Being mindful of that, sticking to your process, staying diversified and adapting to the environment around you is always the best course of action.

Figure 19: U.S. proportion of global equity value has risen to all-time highs



Source: Macrobond, Wealth Investment Office, as of July 12, 2024

Leading Macro Indicators

Overall risk regime score remains firmly in neutral territory

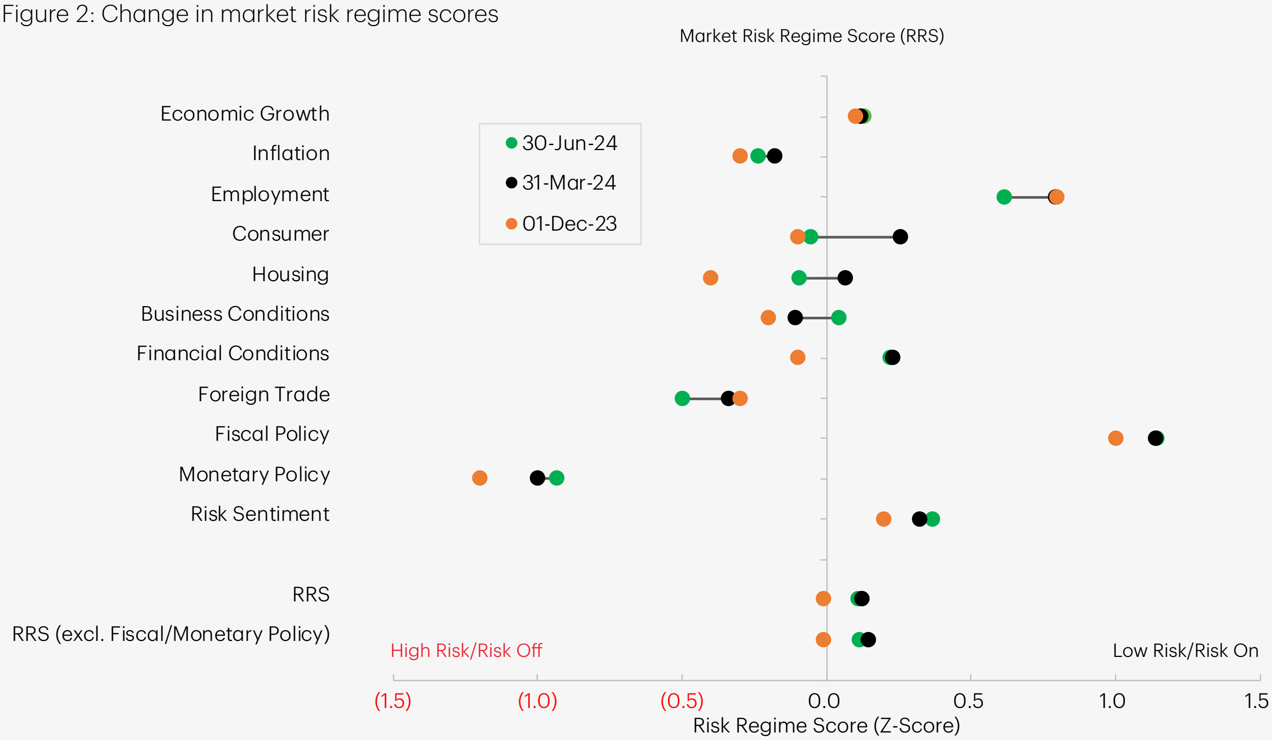
As part of our process-driven approach to investment management, we monitor key U.S. variables that inform our understanding of the risk and macroeconomic environment. For each indicator we calculate current values and compare them against recent trends and long-term data using a standardized approach 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	Mar-24	Dec-23	Sep-23
Economic Growth	Neutral	0.1	0.1	0.1	(0.1)
Inflation	Weak	(0.2)	(0.2)	(0.3)	(1.0)
Employment	Strong	0.6	0.8	0.8	0.8
Consumer	Neutral	(0.1)	0.3	(0.1)	0.0
Housing	Neutral	(0.1)	0.1	(0.4)	(0.4)
Business Conditions	Neutral	0.0	(0.1)	(0.2)	(0.1)
Financial Conditions	Neutral	0.2	0.2	(0.1)	(0.2)
Foreign Trade	Weak	(0.5)	(0.3)	(0.3)	(0.6)
Fiscal Policy	Strong	1.1	1.1	1.0	0.4
Monetary Policy	Weak	(0.9)	(1.0)	(1.2)	(1.3)
Risk Sentiment	Strong	0.4	0.3	0.2	0.1
Risk Regime Score (RRS)	**Neutral**	**0.1**	**0.1**	**(0.0)**	**(0.2)**
RRS (excl. Fiscal/Monetary Policy)	**Neutral**	**0.1**	**0.1**	**(0.0)**	**(0.1)**

Source: FactSet, Wealth Investment Office, as of June 30, 2024.

Figure 2: Change in market risk regime scores



Scores represent number of standard deviations away from long-term average. Source: FactSet, Wealth Investment Office, as of June 30, 2024.

Unchanged is the key word for our Q2 risk regime scores as a slight improvement in risk sentiment and business conditions offset the weaker consumer sector. The overall market risk regime score remained at 0.1 at the end of Q2. U.S. equities rose, driven mainly by several mega-cap technology stocks, while bond yields ticked up. Investors remained optimistic about the probability of an economic soft landing and higher earnings growth.

Monetary policy continues to exert the biggest drag on the overall risk score. Although inflation has declined, it remains above the Federal Reserve's (Fed) 2% target. 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, but the score for consumer deteriorated again after a slight bounce in Q1. The following are notable changes for Q2 compared to Q1:

- Monetary policy, foreign trade, and inflation were still weak in Q2. Several components of services inflation, including housing services, proved to be stickier-than-expected and the score for inflation at the end of Q2 sat unchanged at -0.2 standard deviation away from the long-term norm. The outlook for monetary policy hinges on whether inflation can be contained around 2% and whether the labour market will keep softening. The monetary policy score rose to -0.9 at the end of Q2 from -1.0 amid improved money supply growth. The stronger dollar in Q2 weighed on the outlook for foreign trade and the score slid to -0.5 in Q2 from -0.3 at the end of Q1.

- Scores for employment and fiscal policy remained in positive territory. The labour market continued to soften but remained healthy, supported by robust job creation amid a moderating quit rate, wage growth, and rising jobless claims. The score for employment fell to +0.6 in Q2. Our fiscal policy score remained unchanged at +1.1 at the end of Q2 as U.S. government spending continues to support economic growth and the government fiscal deficit is forecast to stay elevated.

- Risk sentiment was the only indicator this quarter to see a change in its Overall Condition from neutral to strong. Volatility across various asset classes remained at very low levels in the quarter and investors were bullish on equities, helping to nudge the score for risk sentiment up to +0.4 at end Q2 from +0.3 in Q1. Economic growth, financial conditions, housing, and business conditions were all relatively unchanged and remained in neutral Overall Condition. 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 Q2. The score for financial conditions was unchanged at +0.2 as bond spreads stayed tight suggesting investors were not worried about default risk. The overall condition for housing fell slightly to -0.1 from +0.1 in Q1 amid deterioration in U.S. homebuilder sentiment. U.S. services were upbeat during the quarter, bumping the score for business conditions up to 0.0 from -0.1 at the end of Q1.

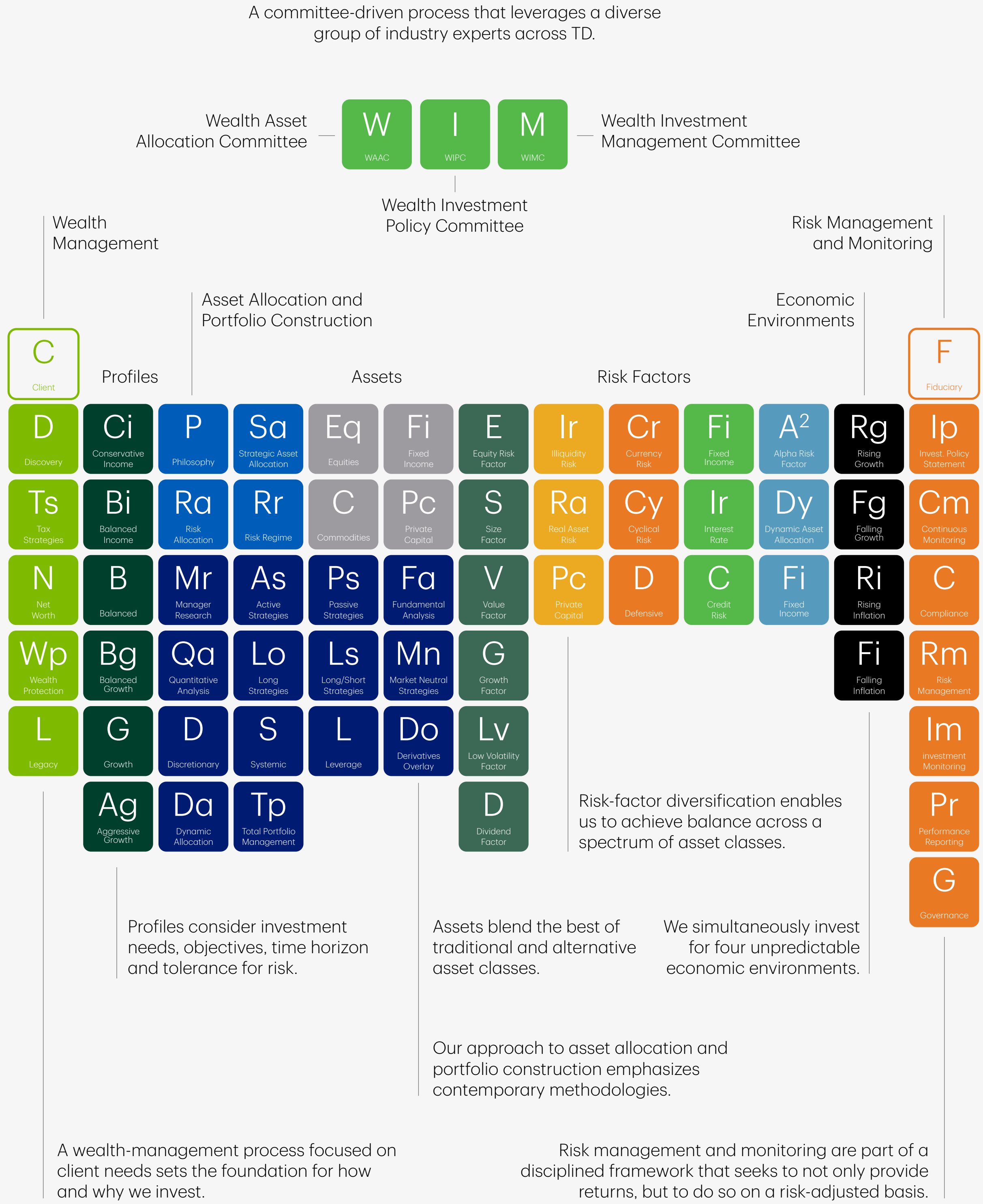
- The score for consumer deteriorated the most during the quarter—sliding to -0.1 in Q2 from +0.3—as consumer confidence fell and consumer spending slowed. The household debt service ratio, which fell to a record low during the pandemic, normalized to its pre-pandemic level in Q2 amid the combination of rising consumer loans and a higher borrowing rate.

- Overall, broad conditions for risk assets in Q2 were quite similar to Q1. Monetary policy remained tight and the uptick in business conditions offset the deterioration in consumer. Market consensus is still pointing towards a soft landing in the U.S. and, as such, further signs of weakness in employment and consumer could disrupt the very low volatility environment for risk assets seen during the quarter.

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.

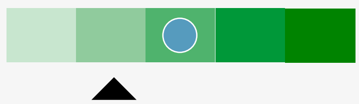
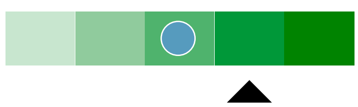
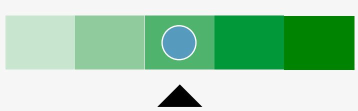
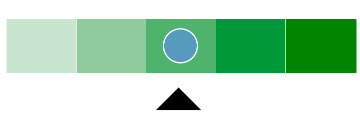
Brad Simpson, CIM, FCSI .... Chief Wealth Strategist, Wealth Investment Office, TDW

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	**Neutral** **(From Modest Underweight)**  Previous Month	U.S. pre-election and policy uncertainty may cause episodic spikes in volatility as we approach the fall. Additionally, recent economic trends suggest an increasing chance of transitory below trend growth. Considering this, we are raising cash to enhance liquidity and provide optionality to capitalize on better valuation opportunities that may emerge. Cash rates are expected to ease as short term rates fall, but declines should be gradual.
Fixed Income	**Neutral** **(From Modest Overweight)**  Previous Month	Given the evolution of domestic inflation, we expect the Bank of Canada ("BoC") to continue cutting its policy rate this year. However, barring a swift weakening of the economy, the BoC has stressed that rate cuts will materialize at a slower pace than the hikes they delivered in 2022 and 2023. This means that bond yields should not fall quickly, but this bodes well for the income component of bond returns and, therefore, we continue to expect fixed income will generate positive returns over the next 12 months. Furthermore, with the turn in the monetary policy cycle, we expect that bonds will provide diversification benefits, reduce overall portfolio volatility and preserve capital.
Equity	**Neutral**  Previous Month	Equity market returns remain positive year-to-date. While the U.S. market, and in particular technology-related names, are among the leaders, all S&P 500 Index sectors and many major equity markets are up this year. We believe that the equity market has a balanced return outlook. While earnings are growing (as represented by the MSCI All Country World Index), this has been partially captured by the market in valuations.
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. Given the nature of private asset classes as well as the present phase of value adjustment in several markets and asset classes, we believe that this may be an attractive time to increase or consider an allocation to alternative assets.

Maximum Underweight | Underweight | Neural | Overweight | Maximum Overweight

Fixed Income - Neutral

	Positioning	Rationale
Domestic Government Bonds	Modest Overweight	If the Canadian economy continues to evolve as it has in the first half of 2024, we anticipate that the BoC will deliver more rate cuts this year. Bond yields have continued to trend lower after the BoC delivered the first cut, and there is room for them to fall further if the BoC can continue to reduce its restrictive monetary policy stance. As the easing cycle progresses, we expect yields on shorter government bonds, which are more sensitive to the monetary policy cycle, to fall faster than that of longer government bonds. Over the long term, we believe government bonds will remain appealing due to their potential to generate positive nominal returns.
Investment Grade Corporate Credit	Modest Overweight	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 attractive, but high yield spreads continue to be expensive and not reflective of potential challenges within the sector. While the majority of high yield companies are performing well, many of the riskier high yield issuers are struggling with heavy debt loads and slowing growth. As a result, we remain cautious at current valuations and favour the higher quality cohort of the market.
Global Bonds Developed Markets	Neutral	As more leading central banks are beginning to cut policy rates, investor attention is turning to the uncertainty emanating from global elections. As election-induced, idiosyncratic policy risks weigh on markets, we believe the evolution of each central bank's easing cycle and bond returns are not foregone conclusions. For example, we anticipate the Fed will be in a position to cut its policy rate as early as September, which should have positive implications for U.S. bond market returns. On the other hand, sustained momentum in underlying inflation trends is giving more confidence to the Bank of Japan ("BoJ") to consider raising interest rates further and reduce the degree of policy accommodation over the coming months. Therefore, we expect opportunities across developed market bonds to vary over the next 12 to 18-months.
Global Bonds Emerging Markets	Modest Underweight	While yields remain attractive in some regions, many emerging market countries have either cut policy rates meaningfully this year, or have significant rate cut expectations already priced in bond yields. As a result, there is now a lower potential for emerging market bonds to outperform developed market bonds from capital appreciation alone. However, there are tactical opportunities in some emerging market countries where fiscal policy and growth fundamentals remain stable.

Equities - Neutral

	Positioning	Rationale
Canadian Equities	Neutral	Canadian gross domestic product ("GDP") growth has slowed and inflation has subsided. As a result, the BoC announced a 25 basis points reduction to its policy rate. The indication that rates have peaked and potential for further reductions is supportive for the economy. The TSX Composite Index offers some attractive opportunities with strong free cash flows within the Energy sector, relatively inexpensive Financials sector stocks, and reasonable overall valuation.
U.S. Equities	Modest Overweight	S&P 500 Index returns this year have been driven by both multiple expansion and earnings growth. While mega cap technology firms are a significant contributor to returns, partly driven by AI opportunities, all sectors are in positive territory. Signs of a softening labour market and lower inflation could result in the U.S. Federal Reserve ("the Fed") starting to cut rates. A lower rate environment combined with earnings growth is supportive of a broadening of equity market performance. The S&P 500 index may command a premium valuation due to its higher technology exposure.
International Equities	Neutral	While macroeconomic conditions are sluggish, particularly in Europe, international equity valuations may be overly discounted and that future returns may be more inline with global markets. 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	Modest Underweight	We believe the Chinese equity market may lag its global peers as the country continues to work through the challenges in its 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**	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**	We believe a significant portion of the value adjustments in the Canadian commercial real estate space have been taken. Moving forward we see more reason for confidence in the multi-unit residential, retail and industrial spaces.
Global Real Estate	**Modest Underweight**	We believe the majority of the value adjustments have occurred in the U.S., UK and Nordic countries, while other regions, such as Australia, are in the midst of value adjustments.
Infrastructure	**Modest Overweight**	Increases in cash flow from higher-than-expected inflation is buffering rising interest rates. Investor appetite is particularly focused on energy transition investments and critical infrastructure sectors that generate stable, growing cash flows.

Asset Sub-Classes

	Positioning	Rationale
U.S. Dollar	**Neutral**	The USD has remained strong against global currencies as relative growth differentials still favour the U.S. economy, and by extension the USD. Some USD weakness may be expected in the near term, however, currency risk is not expected to be a major factor affecting returns as any USD softness is expected to be modest. The USD provides diversification in portfolios considering the range of risks in the near term.
Commodities (Gold, Energy, Metals, Agriculture, Carbon)	**Modest Overweight**	Economic data has started to underwhelm, and this is showing up with recent softness in industrial production and ISM manufacturing. However, long term underlying fundamentals remain supportive for key commodities such as oil and copper as supply remains disciplined or restricted. Geopolitical risks could also exacerbate supply concerns which could provide a short term boost. Commodities remain a source of diversification in this environment.

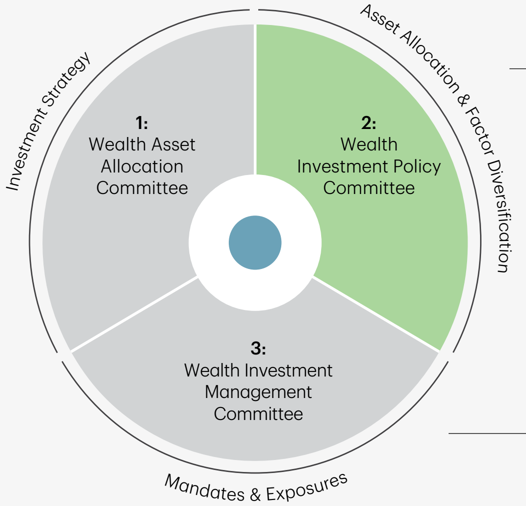
Figure 1: Direction from WAAC: strategic positioning

	Asset Class	Underweight		Neutral		Overweight
Fixed Income Neutral	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 Neutral	Cash			●		
Sub-Classes	U.S. Dollar vs Basket of Currencies			●		

Source: Wealth Asset Allocation Committee, as of July 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

In accordance with the Wealth Asset Allocation Committee's (WAAC) changes to Fixed Income, which was downgraded from Modest Overweight to Neutral, and Cash, which was upgraded from Modest Underweight to Neutral, the Wealth Investment Policy Committee (WIPC) reduced the overall allocation to Fixed Income by 1pp and added 1pp to Cash across all investor profiles. Overall, at the top asset class allocation tier, WIPC now has a Neutral position in all asset classes; fixed income, equities, alternatives/real assets, and cash & equivalents. This aligns with WAAC's core asset class allocation view.

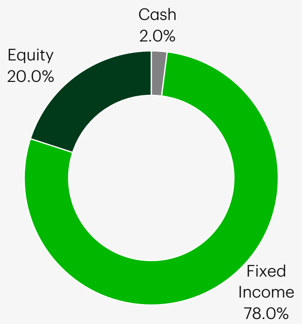
Within equities, WIPC has maintained a neutral allocation to Canada and a modest overweight allocation to U.S. equities in all of the investor risk profiles. Elsewhere, the allocation to international equities remains underweight by 1 pp as does the allocation to China/Emerging Markets remain 1pp underweight.

Within fixed income, WIPC has reduced the allocation to domestic government bonds by 1pp in all profiles except Aggressive Growth. Overall, WIPC still maintains the overweight allocation to domestic government bonds, now by 1 pp in all profiles . The allocation to investment grade corporate bonds remains 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.

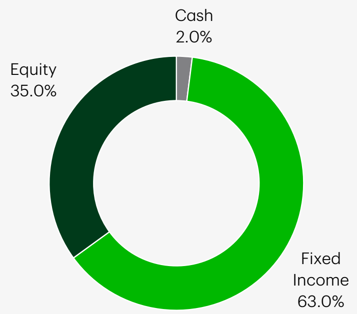
WIPC has also maintained an overall neutral allocation to alternatives. At the subclass level, the allocation to commercial mortgages remains overweight by 1 pp in all investor profiles, with the exception of Conservative Income which is neutral. The allocation to private debt is neutral, and real estate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

Dynamic asset-class weights by investor profile (Condensed)

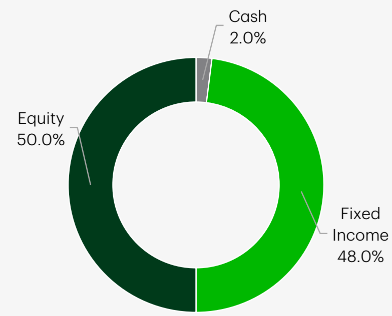
Conservative Income



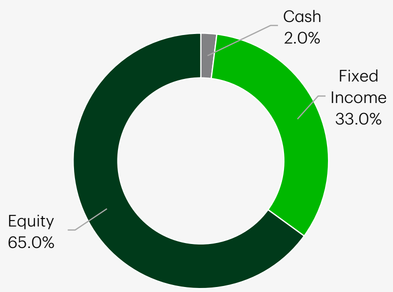
Balanced Income



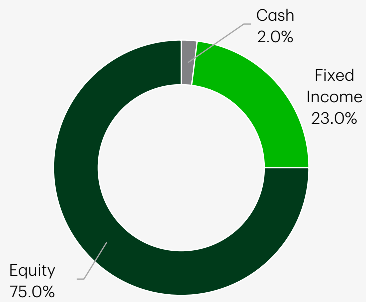
Balanced



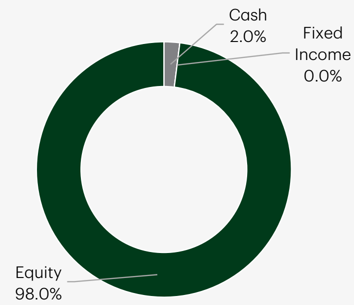
Balanced Growth



Growth



Aggressive Growth

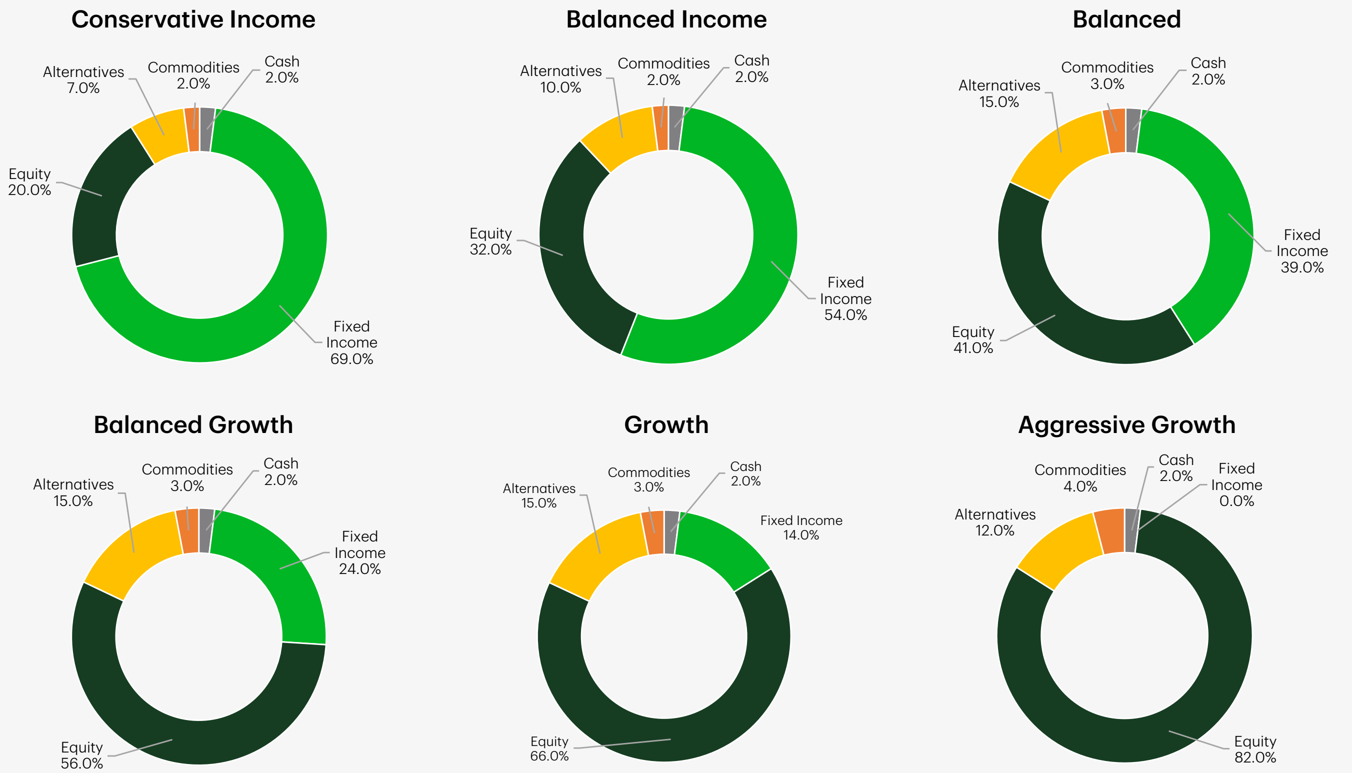


Strategic and dynamic asset-class weights by investor profile (Condensed)

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%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%
Public Fixed Income	78.0%	78.0%	63.0%	63.0%	48.0%	48.0%	33.0%	33.0%	23.0%	23.0%	0.0%	0.0%
Government	39.0%	39.0%	32.0%	32.0%	24.0%	24.0%	17.0%	17.0%	11.0%	11.0%	0.0%	0.0%
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%	3.0%	7.0%	6.0%	10.0%	9.0%	13.0%	12.0%	15.0%	14.0%	19.0%	18.0%
China/ Emerging Markets	2.0%	1.0%	3.0%	2.0%	5.0%	4.0%	6.0%	5.0%	7.0%	6.0%	10.0%	9.0%

Strat: Strategic, Dyn: Dynamic. Source: Wealth Investment Policy Committee, as of July 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%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%
Public Fixed Income	69.0%	69.0%	54.0%	54.0%	39.0%	39.0%	24.0%	24.0%	14.0%	14.0%	0.0%	0.0%
Domestic Government Bonds	28.0%	29.0%	22.0%	23.0%	15.0%	16.0%	9.0%	10.0%	5.0%	6.0%	0.0%	0.0%
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%	3.0%	6.0%	5.0%	8.0%	7.0%	11.0%	10.0%	13.0%	12.0%	15.0%	14.0%
China/Emerging Markets	2.0%	1.0%	3.0%	2.0%	5.0%	4.0%	6.0%	5.0%	7.0%	6.0%	10.0%	9.0%
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 July 18, 2024.

Economic Outlook

High Debt Loads Are Common but U.S. Unique in Size of Ongoing Deficits

Vikram Rai, Senior Economist; Andrew Hencic, Senior Economist | TD Economics

Highlights

- The United States, like other major economies, has seen a large increase in its debt and deficits in recent years.
- Most major economies have a need to reduce their deficits to prevent their debt from becoming unsustainable.
- The difference between the US and its peers is in the trajectory of debt and deficits. Smaller deficits are expected to reduce the debt to GDP ratio in most other advanced economies, but not in the U.S.

One of the more common questions we get asked is, 'How sustainable is U.S. government debt?' Our report on the topic last month highlighted that, in addition to a high debt load, the U.S. is currently running large deficits that are expected to remain in place for the next several years. Deficits of this size cannot continue indefinitely as the interest charged on the debt will eventually eat up all tax revenues, leaving nothing left to pay for other government initiatives.

Another popular query is how other countries compare to the U.S. It's a fair question – current U.S. deficits are, to some extent, a function of events impacting other countries as well – the global pandemic, heightened inflation, climate change, and rising geopolitical threats. Ageing demographics (and the resulting pressure on public pensions and healthcare systems) is another common challenge across advanced economies.

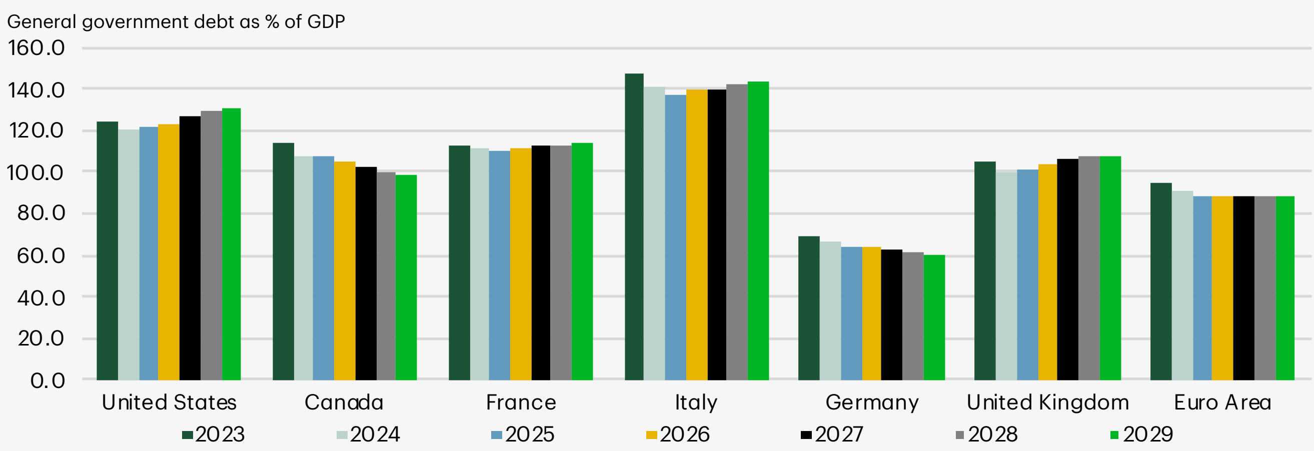
In terms of the level of government debt relative to the size of its economy, the U.S. is near the top, but it is not far off its rich country peers. The U.S. is also ahead in terms of the size of its current budget deficit, though it is certainly not alone. France, Italy and the United Kingdom are in similar positions. Where the U.S. stands out most is in the relative lack of improvement in its deficit over the next several years. Where most other countries have a plan to bring down deficits, there appears little on the horizon to the change the size of the gap between spending and revenues in the United States.

The U.S. is not alone in carrying a high debt burden

The starting point of this comparison is how much debt economies have, and whether it is on an increasing or decreasing trajectory. To put countries of different sizes on the same playing field, a common measure of the relative level of debt is the debt-to-GDP ratio – the ratio of outstanding government debt to annual economic output.

Here, we rely on official data and the latest forecasts from the IMF, which apply a consistent methodology for projecting government fiscal policies and their impact on borrowing[1]. Figure 1 shows that the U.S. debt-to-GDP ratio is comparable to its peers. While only Italy has a noticeably higher ratio, the U.S. is not much higher than Canada, France, or the United Kingdom. The debt-to-GDP ratio is forecast to increase in the U.S. the UK, and in France. It is flat or decreasing in other major economies.

Figure 1: Gross debt as a % of GDP



Source: International Monetary Fund, TD Economics

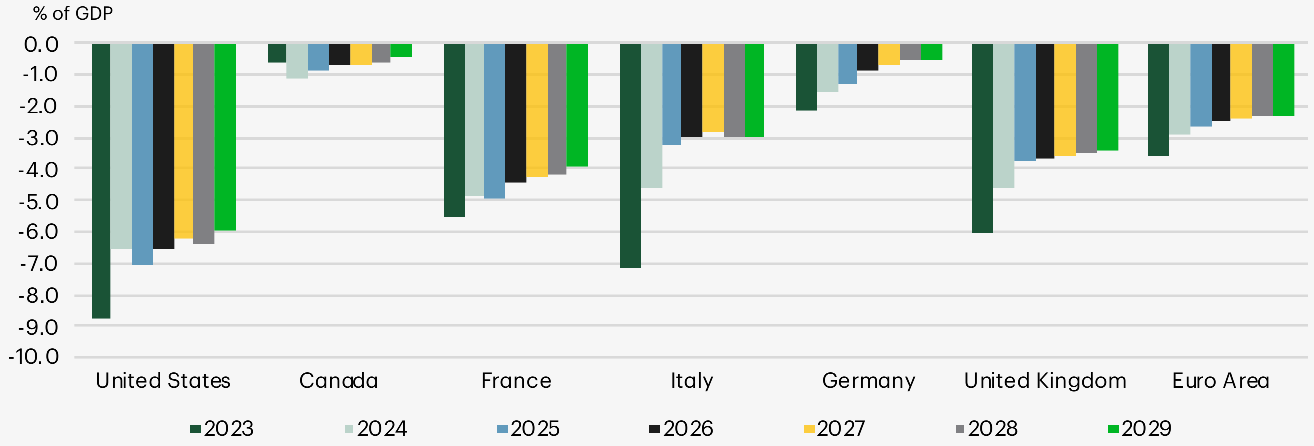
U.S. deficits are more exceptional

On the deficit front, the picture is similar. The U.S. deficit in 2024 is the highest, but it is not too far off deficits in France, Italy and the United Kingdom.

The U.S. stands out in the expected evolution of deficits. In other countries deficits are expected to continue to improve after 2024 (figure 2).

The comparison to the euro area is helpful here as it encompasses an economic block similar in size to the U.S. and smooths out the idiosyncrasies of particular countries. Euro area shortfalls are smaller to begin with and are expected to shrink steadily from their current levels. Canada does even better, with much smaller deficits in 2024 and continued, albeit modest, improvement over the next several years.

Figure 2: Government Balance as a % of GDP



Source: International Monetary Fund, TD Economics.

Enforceable Fiscal Rules Helpful in Keeping Policy on Sustainable Track

While deficits can arise due to unforeseeable events, countries have tried to increase investor confidence by putting in place fiscal rules for righting the ship after the storm. The European Union leads on this front. The EU treaty sets out fiscal rules for total debt and deficit spending. The historical reason for this rule is to prevent free-riding, as the European Union has mechanisms for fiscal transfers between countries, and some members are also on a common currency. This degree of economic and financial integration would be compromised if EU members' shared fates were jeopardized by the deficits of a single member.

Targets for EU countries, updated in 2024, are to maintain general government debt below 60% of GDP and a deficit of less than 3% of GDP.[2] These rules were temporarily suspended during the pandemic and in the aftermath of the energy crisis brought on by the Russian invasion of Ukraine. Beginning in 2024, countries will once again need to begin adhering to the common rules regarding debt and deficits.

In 2024, seven member states, including France and Italy, have been identified as being in breach of these conditions and will have new Excessive Deficit Procedures put in place.[3] They have until September to provide plans to the European Commission outlining how deficits will be reduced in the coming years.[4] In general, the new rules will require that the structural deficit shrinks by 0.5 percent of GDP per year.[5]

The United Kingdom also has a set of self-imposed but more easily alterable fiscal rules. In its current form, U.K. fiscal rules require the ratio of government debt-to-GDP (measured in net terms) to be falling five years out. The recently elected Labour party proposes to modify these rules, requiring the current budget – used to fund day-to-day operations – to be brought back into balance at some point in the future, but would allow deficit spending if it is used for investment.

In Canada, the federal government budgetary targets form one set of fiscal rules, while the provinces have jurisdiction over their own finances. Canada's federal fiscal anchors mirror those of the UK in setting a target for the deficit and debt relative to the economy.[6] Not all provinces have explicit fiscal targets, however the country's largest, Ontario, employs a three-pronged approach, targeting the ratios of net debt-to-GDP and revenues, and the interest on debt to revenues.[7]

Combining debt and deficit for an overall view

Clearly, a country's debt level, its current deficit, and its future deficits are all necessary for assessing whether its fiscal policy is sustainable. If debt and deficits are both elevated, then there is a definite need to reduce the deficit in the future.

Figure 3 combines these metrics over time to place economies relative to each other. Generally speaking, the closer you are to the bottom right quadrant of this ranking, the greater the need to reduce the deficit from current levels. Many of the economies closest to the bottom-right quadrant may still have time and space to stabilize their fiscal policy; Japan, for example, is not pictured but is further out in that direction. Still, it is clear that from a comparative point of view, the U.S. is in an unenviable position of having both high debt and deficits. As the issuer of the world's reserve currency, the U.S. is able to maintain relatively lower borrowing costs than other countries, but the longer it remains in this position, the more untenable this reality will become.

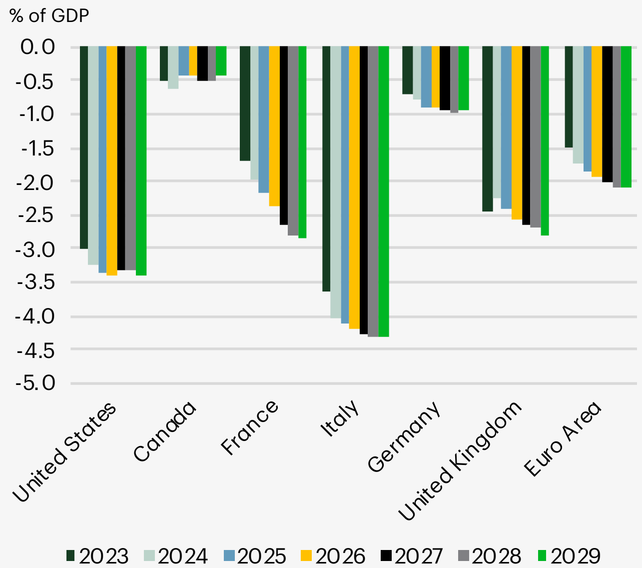
Bottom Line

Concerns about budget deficits, government debt, and debt sustainability are not merely academic. Interest is charged on government debt, and these interest payments are expenditures funded by tax revenue that do not go to paying for government initiatives. Figure 4 shows that for several major economies, these costs are already significant budget expenditures. The U.S., Italy, the UK, and France all must devote considerable portions of annual output to the cost of the debt they carry. With the exception of the U.S., all are expected to see debt service costs rise considerably over the next several years. The U.S. has an advantage over its peers in this area, as it is able to borrow at favourable rates despite high debt and deficits. The average deficit in the euro area at the end of this forecast period is mostly interest expense on its debt. This is why European authorities may ultimately feel more urgency to address their public debt.

A second matter is that deficits affect economic growth. Barring rare circumstances, reducing the deficit will typically also reduce growth. The forecasts for most major advanced economies currently build in some deficit reduction, as this is planned in most economies. This is not the case in the U.S. – the projected deficit in 2024 is similar to the projections for the following five years.

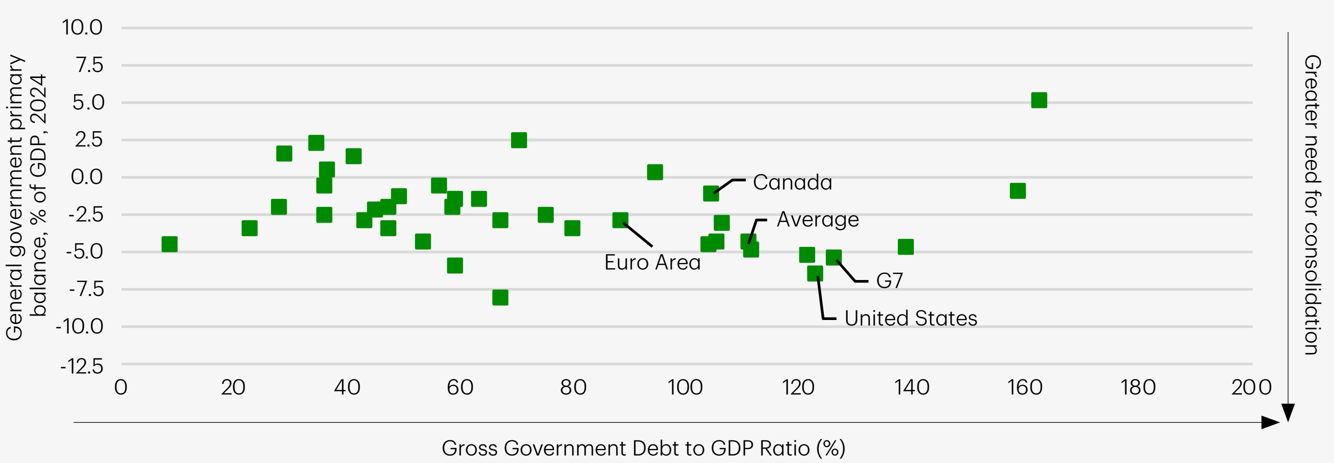
Compared to the rest of the world, the U.S. is exceptional: it is the only high-debt country not expected to make an adjustment to deficit reduction in the coming years. Fortunately, it is not expected to pay significantly for this in terms of higher debt service costs, but this may not last forever.

Figure 4: Debt service cost as a % of GDP



Source: International Monetary Fund, TD Economics.

Figure 3: Many advanced economies have high debt-to-GDP ratios and deficits in 2024



Source: TD Economics, International Monetary Fund

Asset Class Analysis

Contributors

Christopher Lo, CFA...Head of Managed Assets, WIO, TD Wealth

Mansi Desai, CFA .... Senior Equity Analyst, Managed Investments, WIO, TD Wealth

Aurav Ghai, CFA ....Senior Fixed Income Analyst, Managed Investments, WIO, TD Wealth

Fred Wang, CFA, FSA, FRM...................... Senior Portfolio Manager, Asset Allocation, WIO, TD Wealth

Christopher Blake, MBA, CFA................................ Senior Portfolio Manager, Equities, WIO, TD Wealth

Chadi Richa, MBA, CFA .... Senior Equity Analyst, WIO, TD Wealth

David Beasley, CFA, CMT................ Senior Quantitative Portfolio Manager, Equities, WIO, TD Wealth

Kevin Yulianto, CFA..Portfolio Manager, Equities, WIO, TD Wealth

Andrej Knreta, MBA, CFA .... Senior Equity Analyst, WIO, TD Wealth

Neelarjo Rakshit, CFA, CAIA... Senior Equity Analyst, WIO, TD Wealth

Shezhan Shariff, MBA, CFA .... Senior Alternative Investments Analyst, WIO, TD Wealth

Quarter in Review

Elections loom as rate cuts beckon

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

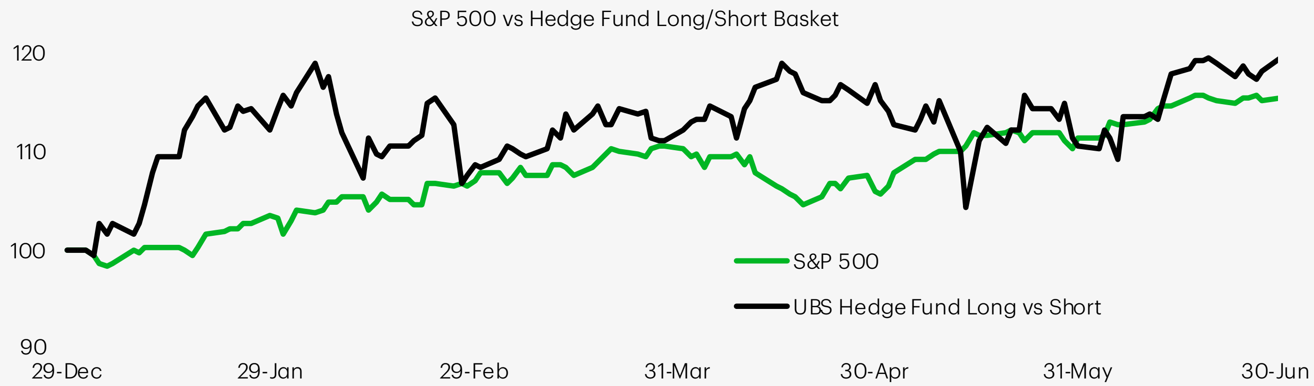
The second quarter of 2024 continued to be action-packed. It started with a tough April, with both equities and bonds down, followed by a healthy recovery for both asset classes, with U.S. equities hitting new highs. The case for a soft landing is still intact, although the global economy has slowed. On one hand, we've seen the rate-cutting phase of the policy cycle begin at a few major central banks; on the other hand, the Federal Reserve is still holding its policy rate, waiting for more signs of cooling inflation. As bonds were being priced in real time, with the ebbs and flows of incoming data, equity investors doubled down on the long-term case for AI, pushing a few related stocks higher, as well as market concentration.

A few themes identified in previous publications persisted. The positive inter-asset-class correlation between equities and bonds continued to present a challenge for the 60/40 portfolio. Meanwhile, *intra*-asset-class correlations (i.e., among individual stocks within S&P 500 index implied by index and stock level implied volatilities) hit a historical low, offering greater diversification benefits to lure investors away from the few mega-cap tech names driving the entire market higher YTD. This year has also been a great year for hedge-fund strategies (Figure 1). In this banner year for global elections, we witnessed volatility driven by election outcomes ripping through several countries, which served as a reminder of the uncertainties ahead of us.

Brace for turbulence on final approach

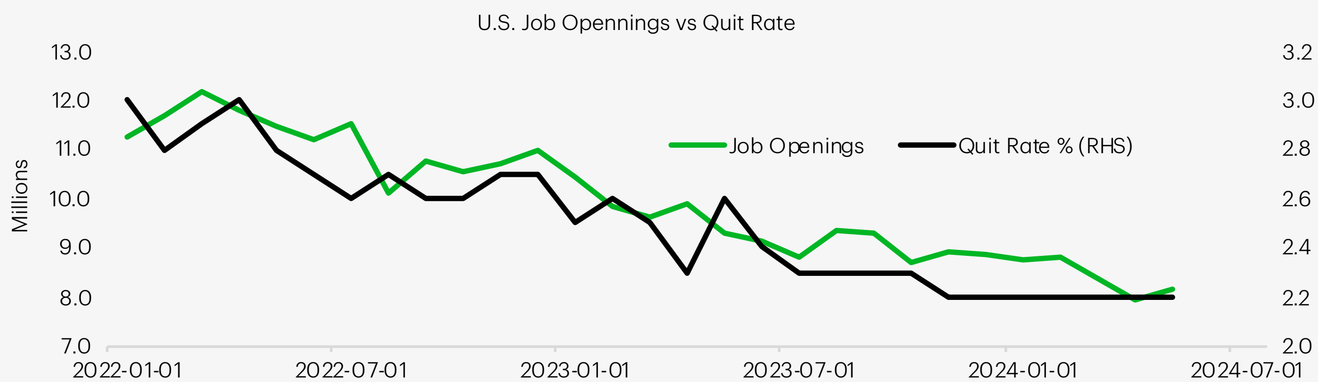
In the U.S., as high interest rates continue to burden consumers and corporations alike, the economy continues to slow. The labour market is more balanced now. As shown in Figure 2, a smaller percentage of employed people are leaving their jobs voluntarily, indicating a tougher environment to switch jobs or start a business. This is also confirmed by the gradual decrease in job openings since the beginning of the rate-hiking campaign. Both data points are deteriorating, but we're still far from a recessionary level.

Figure 1: Hedge fund long/short basket outperforms



Source: Macrobond, Wealth Investment Office as of June 28, 2024

Figure 2: Cooler job market in the U.S.



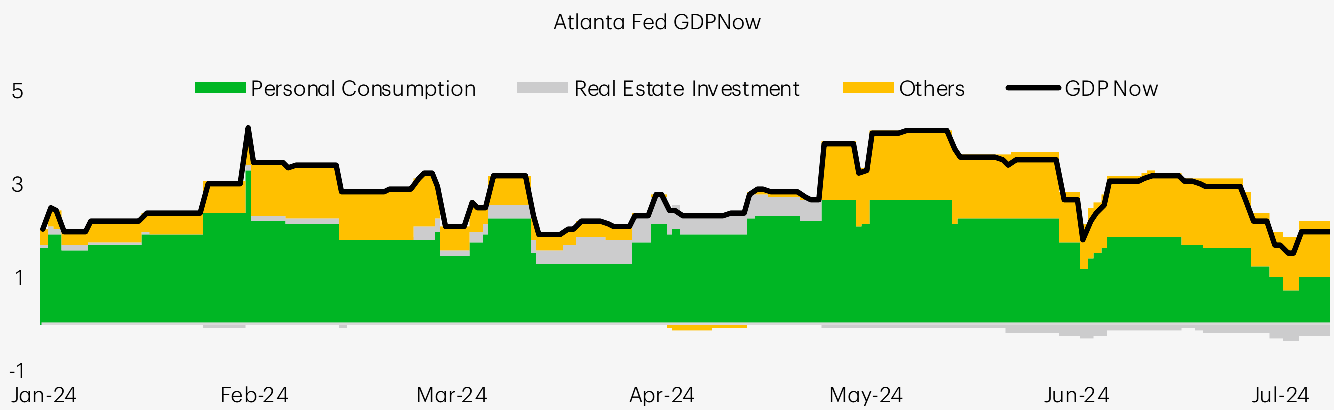
Source: Macrobond, Wealth Investment Office as of May 31, 2024

On the growth front, we are seeing the negative impact of higher interest rates and an early sign of fatigue on behalf of consumers. The most rate-sensitive sector — real estate investment, which includes both the cooling residential market and the struggling commercial market — started to weigh on GDP growth during the second quarter. In Figure 3, the GDPNow indicator from the Atlanta Fed shows that the top-line estimate for the second-quarter annualized GDP growth rate slowed from above 4% in April to around 2% as of July 10, 2024. The contribution from personal consumption slowed from above 2.5% to around 1%. We saw deteriorating retail sales, as well as consumer confidence. Consumers are becoming more stretched, with the credit card delinquency rate growing from around 3% at the beginning of the hiking cycle in Q1 2022 to 6.9% in Q1 2024 — a level that's higher than before the pandemic but still far from the 11% high seen during the global financial crisis.

Although things may look somewhat grim on employment and growth, the softening numbers are exactly what's needed to bring inflation down. Figure 4 shows how the broad contribution of the Federal Reserve's preferred measure, PCE inflation, has cooled to 2.6% during Q2. The most interest-rate-sensitive components of the consumer basket, durable goods, have become a drag on overall inflation. Within the category, the weakest have been housing-related durable goods and vehicles.

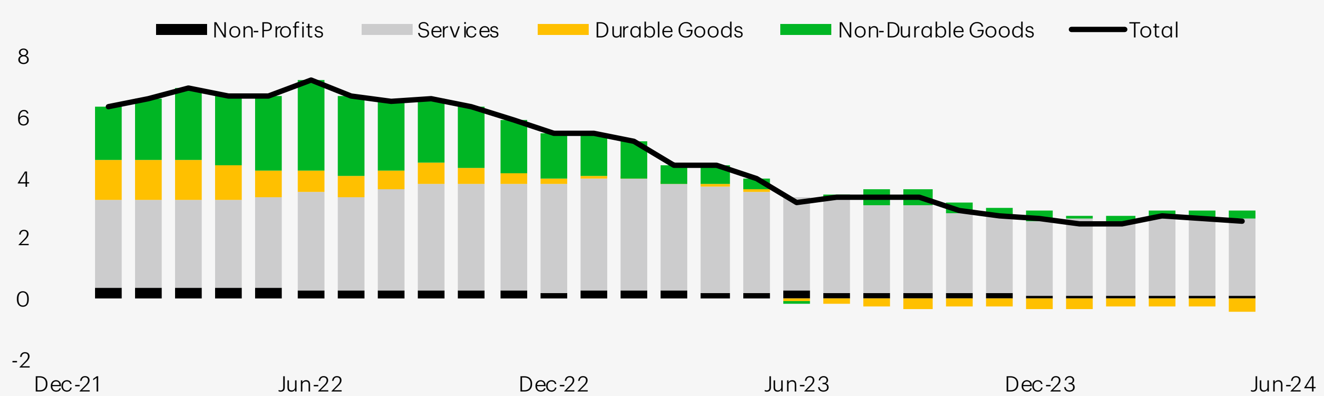
Tight monetary policy is designed to slow the rate-sensitive part of the economy in order to cool inflation. This mechanism is clearly working. Meanwhile, stubborn service inflation is still holding the headline inflation figure above the 2% target. Within the service segment, many have discussed the slow but sure decline of shelter inflation. We are aligned with that view, although we're also keenly aware of persistent health-care inflation due to the structural shift in demographics. All in all, the soft-landing narrative is still intact in the U.S. It might get a little bumpy as the plane makes its final approach to runway, but the cooling inflation, slowing labour market and economic growth do make the Fed's first cut more and more visible.

Figure 3: Consumption slows, real estate drags in the U.S



Source: Macrobond, Wealth Investment Office as of July 10, 2024

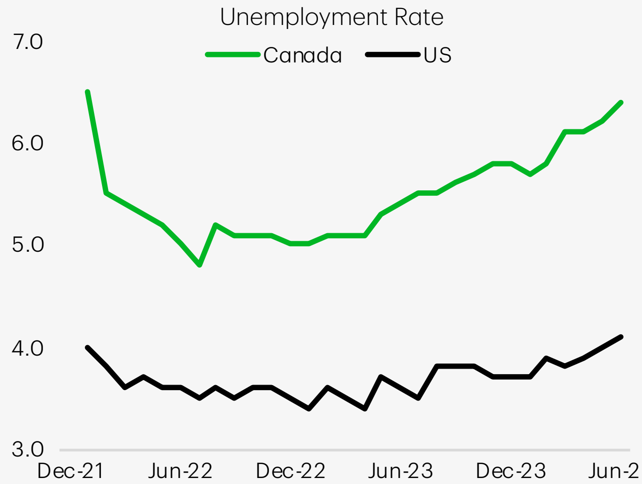
Figure 4: Inflation slowing, but service prices remain stubborn



Source: Macrobond, Wealth Investment Office as of May 31, 2024

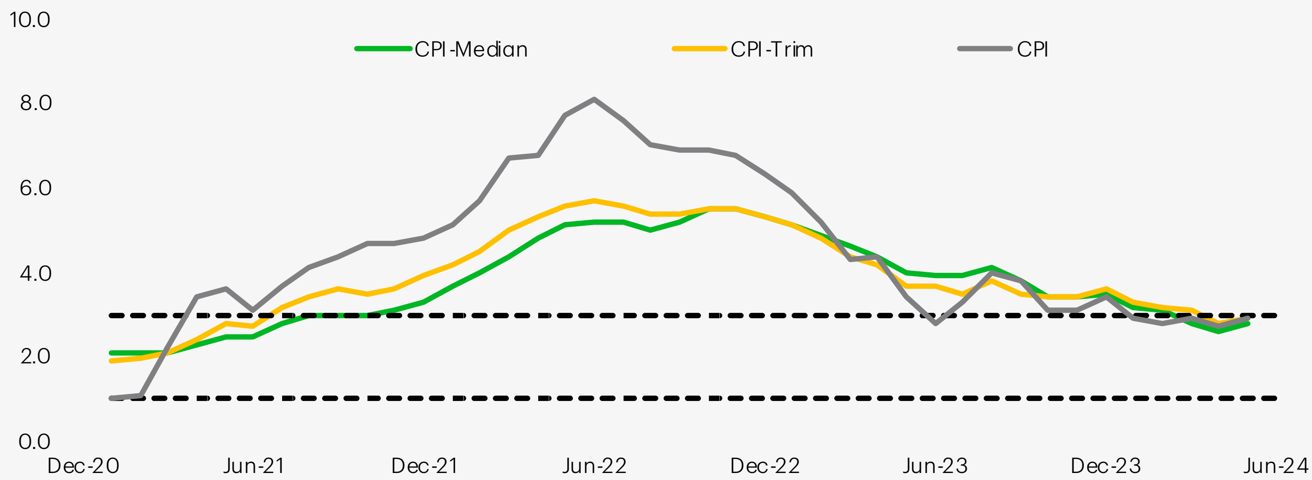
In contrast, the economic slowdown in Canada is more severe. As shown in Figures 5 and 6, Canada's inflation and labour market have also cooled gradually, as the impact of higher interest rates reverberates through the economy. But there are two major distinctions here. First, Canada's economy is more interest-rate-sensitive, given the significant role of the housing sector, high household debt, and the capital-intensive resources sector. As a result, the Canadian economy was slowing faster than the U.S. The second distinction is that Canada has the highest population growth rate within the developed world. Combined with the tight monetary policy, a lack of innovation and investment has led to lower productivity growth. Consequently, although headline GDP growth remained positive, on a per capita basis, Canada is actually already in recession, as shown in Figure 7, prompting the Bank of Canada to cut rates earlier.

Figure 6: Employment in Canada deteriorates faster than the U.S.



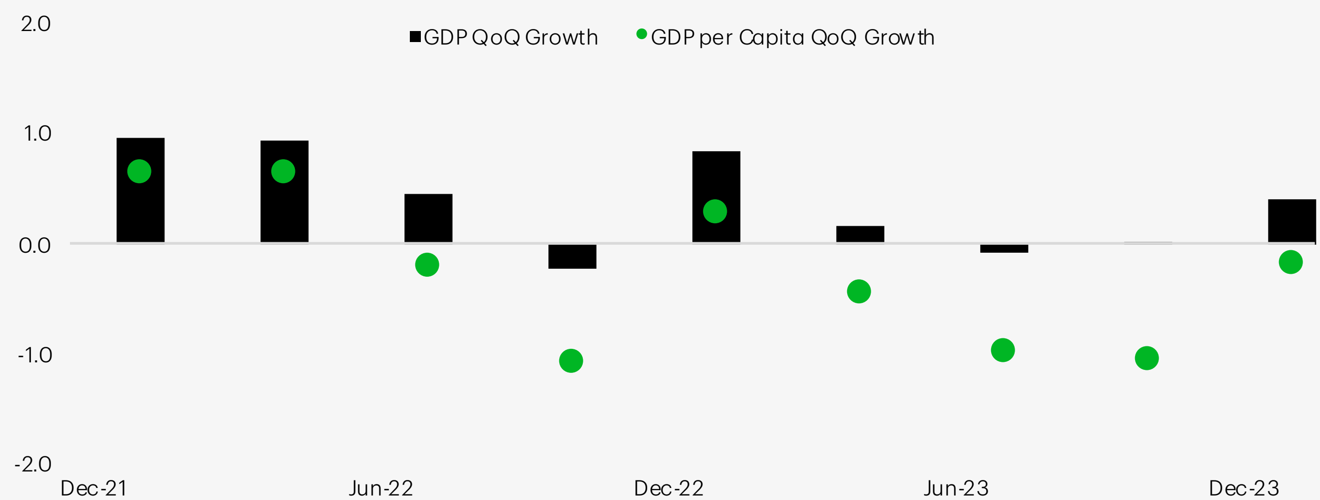
Source: Macrobond, Wealth Investment Office as of May 31, 2024

Figure 5: Canada's inflation enters target range



Source: Macrobond, Wealth Investment Office as of May 31, 2024

Figure 7: Canada's economy, per capita, already in recession



Source: Macrobond, Wealth Investment Office as of Q1, 2024

Central Banks on the Move

The Bank of Canada started its rate-cutting campaign on June 5. This move was well anticipated and justified. Figure 8 shows that, among G10 central banks, four have pulled the trigger on rate cuts. The time required for an economy to respond to monetary policy is debatable, and while we believe the right answer is the classic "it depends," most economists are somewhere between six and 18 months. The chart shows the latest inflation reading and the number of months each central bank took to cut its rate since the last hike.

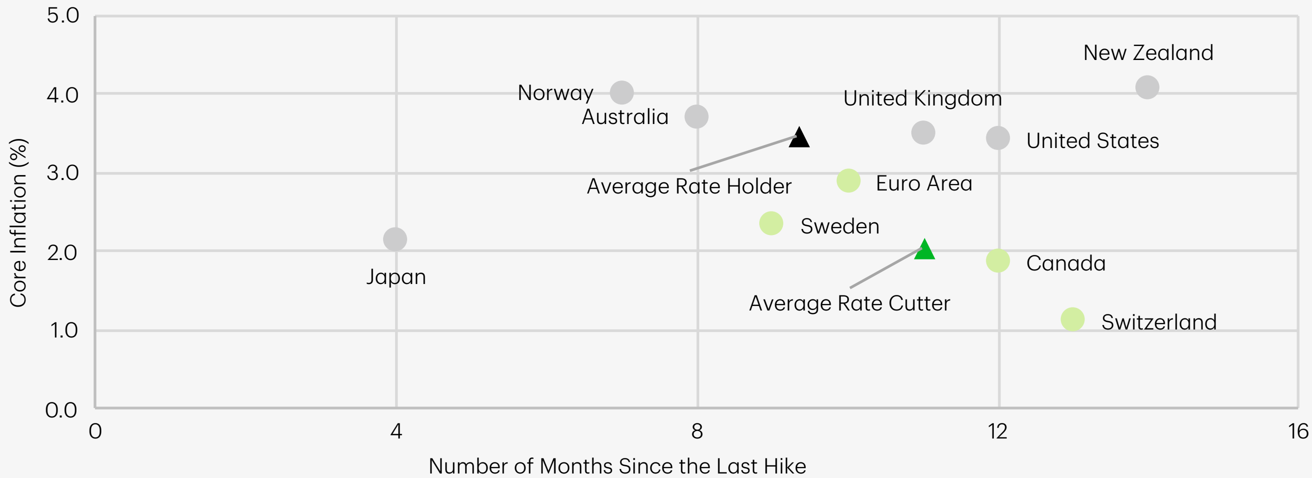
The chart also shows the average inflation level for rate-holders versus the rate-cutters. First, it's obvious that inflation is the most important determinant here, with rate-cutters on average having lower inflation. Although a few rate holders, including the Federal Reserve, have passed the 12-month mark since the last hike, the exact timing still depends on the incoming inflation data. And as discussed earlier, we do see less uncertainty around the timing of the first cut, which could gradually tame the rate-market volatility and finally bring some upside for bonds.

Myopic Bond Market vs. Hyperopic Equity Market

So far this year, government bonds have been struggling as data-dependent central banks leave investors at the mercy of uncertain economic data like inflation. Figure 9 shows a table of one-day yield changes as well as the difference between actual and estimated CPI data — that is, the extent of the surprise.

It's amazing that, during the first six months of 2024, a 0.1% higher-than-expected inflation release pushed the 10-year yield higher by 16 basis points (bps) on average. On the flip side, a slightly lower-than-expected inflation release moved the yield 9 bps lower. Day to day, the bonds were swayed significantly by incoming data, as fast money quickly shifts positions for the policy implications. This myopic focus could quickly fade, however, as we enter the rate-cutting phase of the cycle, bringing the market's attention back to long-term fundamentals, such as elections and debt sustainability.

Figure 8: G10 Rate-cutters vs. Rate-holders



Source: Macrobond, Wealth Investment Office as of June 28, 2024

Figure 9: How the 10-year Treasury moves against CPI surprises

MoM CPI Change Actual vs Consensus

	<-0.2	-0.2	-0.1	0	0.1	0.2	>0.2
2021	N/A	N/A	-0.04	-0.03	-0.05	-0.02	0.06
2022	N/A	0.00	-0.17	-0.04	-0.04	0.02	N/A
2023	N/A	N/A	-0.06	0.00	0.14	-0.03	N/A
2024	N/A	-0.07	-0.09	0.05	0.16	N/A	N/A

Source: Macrobond, Wealth Investment Office as of June 28, 2024

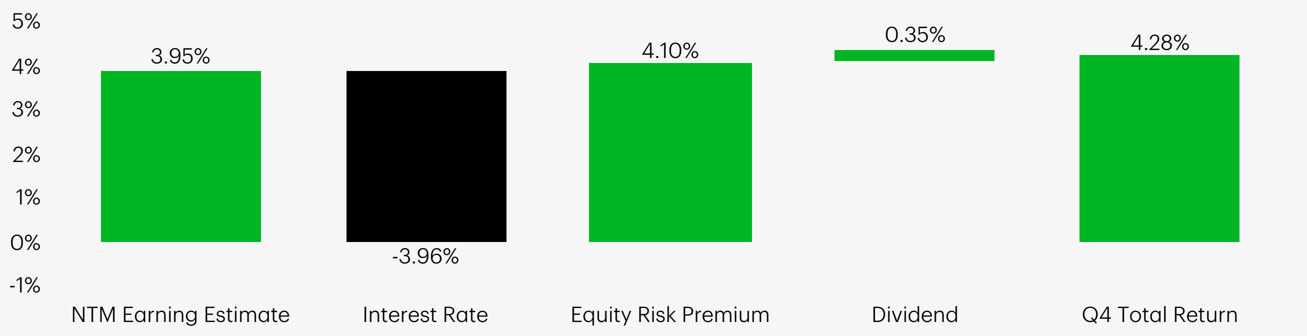
In sharp contrast, the equity-market investors have an entirely different focus, rallying on their conviction that the AI trend will give the mega-cap tech companies a very long runway for top- and bottom-line growth. As discussed in the opening section, equity-market concentration has already hit a new high. In Q2, the S&P 500 returned a total (including dividends) of 4.28% in USD terms. Figure 10 shows that the positive earnings growth and lower equity risk premium added to the total return — or, to frame it another way, investors are now willing to accept a lower equity risk premium under the belief that hefty earnings growth will be realized down the road. Another point from the graph is that higher bond yields presented a headwind for equities, which is consistent with equities and bonds having a positive correlation today.

As the poster child of the Q2 market rally, it's hard not to mention Nvidia (NVDA). From the options market, we observe that investors have turned more opportunistic. For most of 2024, the implied volatility for the one-month 0.25-delta NVDA call is higher than the implied volatility for the one-month put with same delta, or stock price sensitivity. This is rarely the case in the options market, where most investors are risk-averse and would value the downside protecting put options higher with higher implied volatility. In other words, NVDA is a stock for risk-seeking investors rather than the risk-averse types.

Figure 11 also shows something interesting about the NVDA options traders. In 2020, before NVDA's historic run, when the stock was down more than 3% on a given day, the strong demand for downside would kick in and push the implied volatility of the put contract higher by 9 volatility points. However, as the stock advanced over the years, on an equally bad day, the implied volatility on the same put would only go up 1 volatility point.

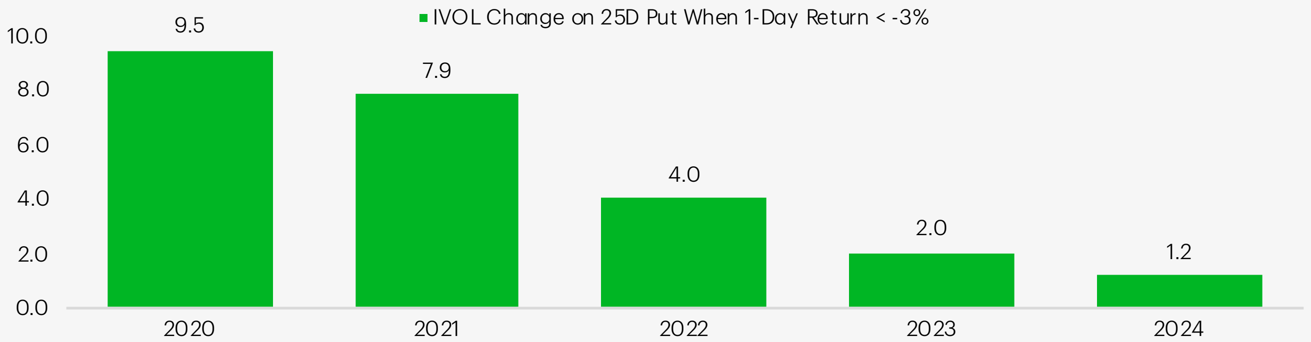
One explanation might be that, as the stock sells off today, suitors on the sidelines jump at the opportunity to pick up the stock at a cheaper price. They may buy the dip or simply sell put options for a chance to catch the stock eventually. There are so many such suitors that the insurance buyers are outnumbered, thus there is a muted spike in put implied volatility. This might be counter-intuitive, but to look at this another way, strong momentum in a stock can make investors rich, it can also make them irrational sometimes. We know that NVDA has a real competitive advantage in the chip business, but as with many valuation/momentum runs, the stretched valuation and ultimate "animal spirit" of the market could lead to significant casualties on the elevator ride down.

Figure 10: S&P 500 Q2 Total Return Breakdown



Source: Macrobond, Wealth Investment Office as of June 28, 2024

Figure 11: Average implied volatility change on 1-Month NVDIA put with 0.25 delta on days when daily return is less than -3%



Source: Macrobond, Wealth Investment Office as of June 28, 2024

Outlook on Fixed Income

Neutral

Uncertainty offers up opportunity

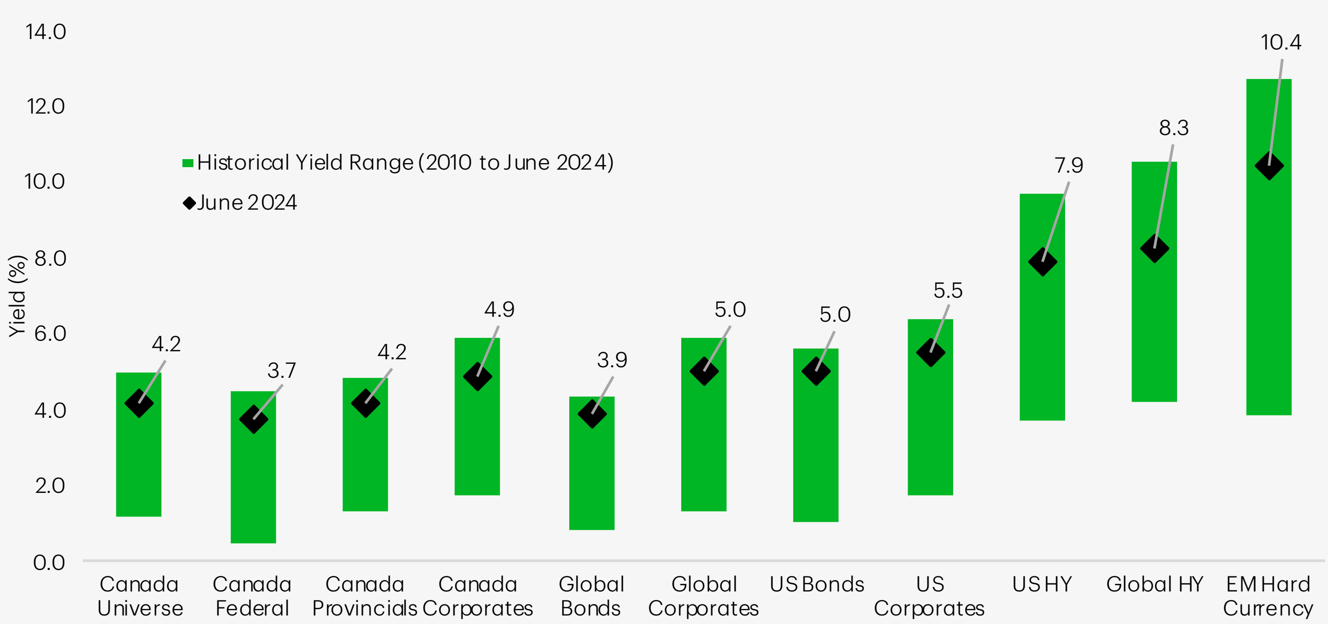
Aurav Ghai, Senior Fixed Income Analyst | TD Wealth

A global shift towards easing by central banks has historically rewarded fixed income investors. However, in the first half of 2024, robust economic data tempered rate-cut expectations. At the start of the year, many anticipated significant rate cuts from the U.S. Federal Reserve (Fed) to mitigate growth risks, with futures markets pricing in 150 basis points (bps) of easing by year end. As we enter the second half of 2024, that number has dropped to 60 bps, amid persistent inflation and resilient consumer spending. All of the uncertainty surrounding monetary policy, geopolitical tensions, and the U.S. elections, may give rise to persistent market volatility and opportunities for actively managed fixed income portfolios.

The longer term outlook for bonds is still attractive. Higher yields historically translate into higher returns and at current levels fixed income is expected to deliver positive returns, albeit with ongoing volatility through the second half of the year.

- We are neutral in fixed income overall and modest overweight domestic government bonds. Canadian government bonds are attractive at current yields and offer opportunities for income generation and downside protection. While we expect price/yield volatility to continue, we believe it will gradually subside as the economic outlook and the path of policy rate cuts in Canada becomes clearer.
- We are modest overweight investment grade (IG) credit. Investment grade spreads remain tight overall and reflect a modest softening of the global economic backdrop. We view Canadian investment grade corporate bonds, with their modestly wider spreads, as more attractive than U.S. investment grade. While we expect softening economic conditions to widen spreads further (indicating the market is pricing in more risk), we believe any widening will be modest given expectations for a soft landing. We continue to focus on high quality credit—companies with robust balance sheets—and we expect technicals to remain supportive and healthy yields to mitigate losses from price volatility.
- We maintain our modest underweight view on high yield (HY) credit. HY spreads remain too tight, reflecting their rich corporate valuations, and have little room to tighten from here. Importantly, we expect HY spreads to widen if the growth outlook deteriorates although the improved quality of the HY universe should keep spreads from returning to previous recessionary levels. We continue to favour the higher quality cohort of the HY credit market.

Figure 1: Yields Remain High



Source: FactSet, Wealth Investment Office as of June 30, 2024

Government Bonds

Over the first six months of 2024, U.S. treasury yields rose by 40-60 bps. At the start of the year, market participants had fully embraced immaculate disinflation: core inflation measures had returned to 2% on a 6-month annualized basis and Chair Jerome Powell's dovish tone at the December 2023 Federal Open Market Committee (FOMC) meeting made investors think the Fed would ease earlier and more aggressively than other developed market central banks. This thesis was derailed by strong inflation and labour market reports in the first quarter, and as of mid-July markets are pricing a 25bp ease by the September meeting. However, in the final weeks of Q2 government yields retreated from their local peaks after U.S. economic data tempered the worst fears around accelerating inflation, retail sales indicated consumption is slowing and the labour market is softening.

Delivering on the central bank divergence that we talked about in our Q2/2024 Portfolio Strategy Quarterly, Bank of Canada (BoC) was among the first developed market central bank to ease policy rates in June. Despite this move, Canadian government bond yields still increased 30-40 bps over the first six months of the year, mostly due to their sensitivity to U.S. government yields. We expect this relationship to weaken over the rate cut cycle if the Canadian economic growth outlook remains materially weaker than that of U.S. (Figure 2).

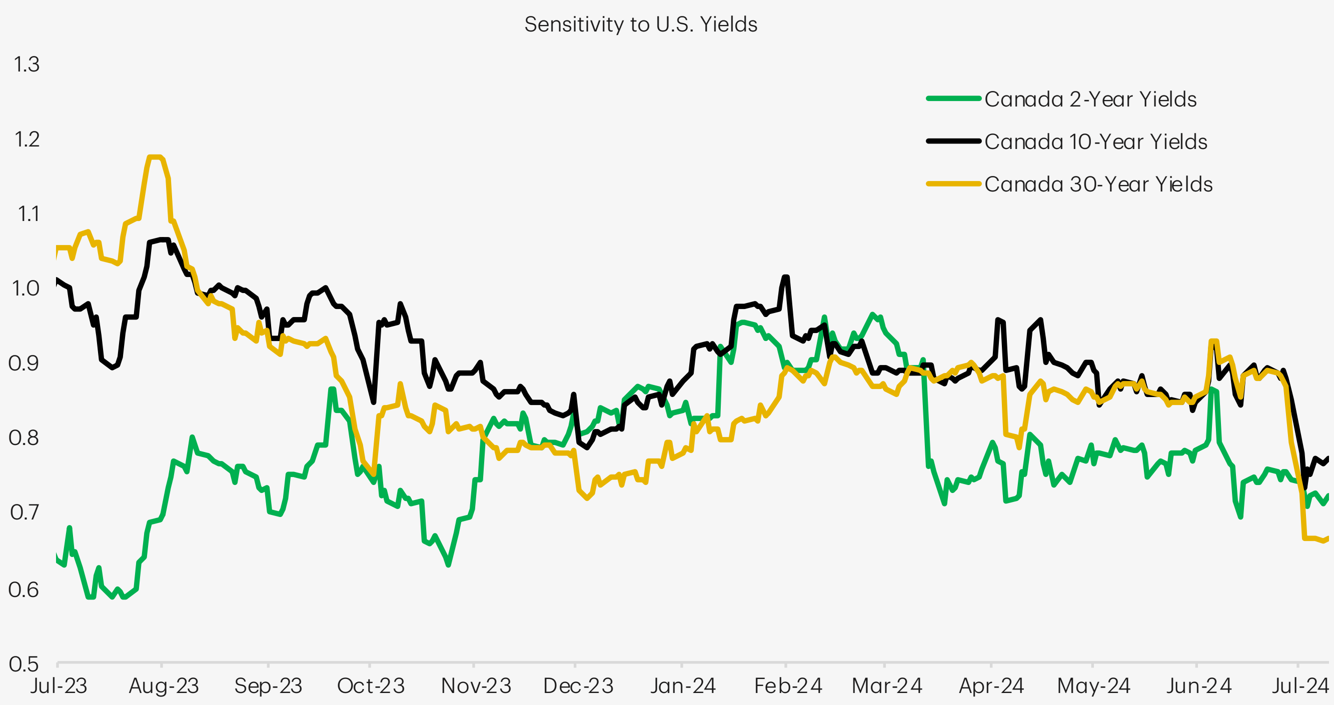
When it comes to government yields, we continue to expect central banks to limit the size of rate cuts, delay them, or possibly both. Even though Canada may deliver the follow-up cuts faster and reach the final policy rate sooner than the Fed, the extent of divergence on the neutral, or final policy rate will be limited. Canada and other non-U.S. developed markets could still face more difficult landings than anticipated and this could happen abruptly so it's best to take a longer term view on government yields. We believe moderating government bond yield volatility along with future rate cuts have improved the outlook for Canadian government bonds over the medium to long term. From a valuation perspective, government bond yields are higher than the recent past and offer more cushion.

We maintain our modest overweight view on Canadian government bonds. We encourage everyone to 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. Shallow Rate Cuts Expected. All eyes are on the Fed and expectations around rates remain the dominant driver of U.S. Treasury yields, something we expect to continue in the second half of 2024.

Figure 2: Canadian Government Yields Less Sensitive to U.S. Equivalents



Source: FactSet, Wealth Investment Office as of June 30, 2024

As of mid-July, market participants anticipated a first policy rate cut in September, followed by a quarterly cadence after that. We don't expect severe recession in the U.S., meaning this cycle will be shallower, and perhaps more closely resemble the 1995 and 2019 easing cycles rather than the aggressive cycle of the 2001 recession and the Global Financial Crisis of 2007-2008. Even if the Fed and BoC opt for shallow cuts, there is still room for government yields to decline.

2. Economic Surprises Trending Down. Government bond yields have remained highly sensitive to economic surprises and persistent negative economic surprises have been driving government yields lower over the second quarter, according to the Economic Surprise Index. So far this year, the market has largely ignored broadly weak surveys. The downward trend in "hard data" economic surprises, and particularly the deterioration in growth-related data since mid-April, has sent yields lower (Figure 3).

With broad inflation measures slowly approaching 2% for the BoC and the Fed, any sensitivities towards a risk-management approach to policy may be amplified at future meetings. If restrictive policy remains in place for much longer, additional cuts in 2025 and 2026 may be priced in alongside a deterioration in the economic growth outlook.

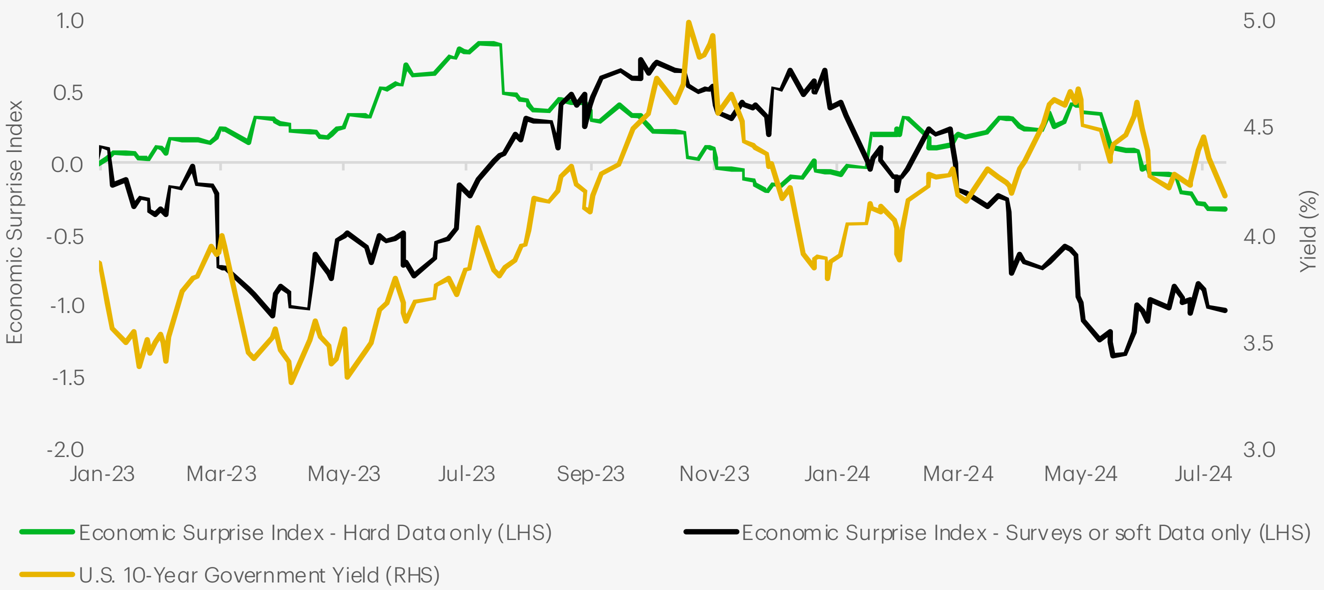
3. Central Banks Diverge. The global investment landscape is ever evolving and it will continue to transform in the months ahead as major economies converge towards soft-landings and central banks ease monetary policy. However, we expect the pace of policy easing to differ.

June's Consumer Price Index (CPI) report was good news for the Fed. The month over month (m/m) core dynamics are still moving in the right direction, particularly for the services segment (which is supported by the normalization in housing inflation). We believe this trend will continue over the coming months.

While it's still too early to announce "mission accomplished," we expect Fed officials will keep acknowledging the progress made to trim inflation since Q1 and start shifting their attention towards employment while preparing the markets for the coming easing cycle.

On the Canadian side, the July report displayed a rare combination of stronger wage growth and an unexpected reduction in headline employment. While the acceleration in wages could stoke concerns about core services inflation, BoC has suggested it is looking past the recent wage growth and another modest increase to the unemployment rate should bolster BoC's conviction that wages will soften going forward. We expect the BoC to follow its policy easing path in the coming months, though the pace and timing will be data dependent. While market participants are pricing in a similar trajectory for BoC and Fed policy rate cuts, we believe the pace of easing will be faster in Canada because of its weaker economy. Three main factors are weighing on 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.

Figure 3: Government Yields Sensitive to Hard Data Economic Surprises



Source: FactSet, Wealth Investment Office as of June 30, 2024

4. Watch Overall Magnitude of Rate Cuts. The magnitude of the Fed's rate cuts—not the start date—is key. Over the 2022-2023 rate hiking cycle, the U.S. economy surprised to the upside time and again. For now, market indicators are pointing towards a Goldilocks economy where unemployment is low, although trending higher, and growth is softening though broadly stable. But any long-term economic weakness could upend that view and pump up the number of rate cuts expected in 2025. As such, U.S. and Canadian longer maturity government yields will remain closely tied to the market pricing of the overall cuts (Figure 4).

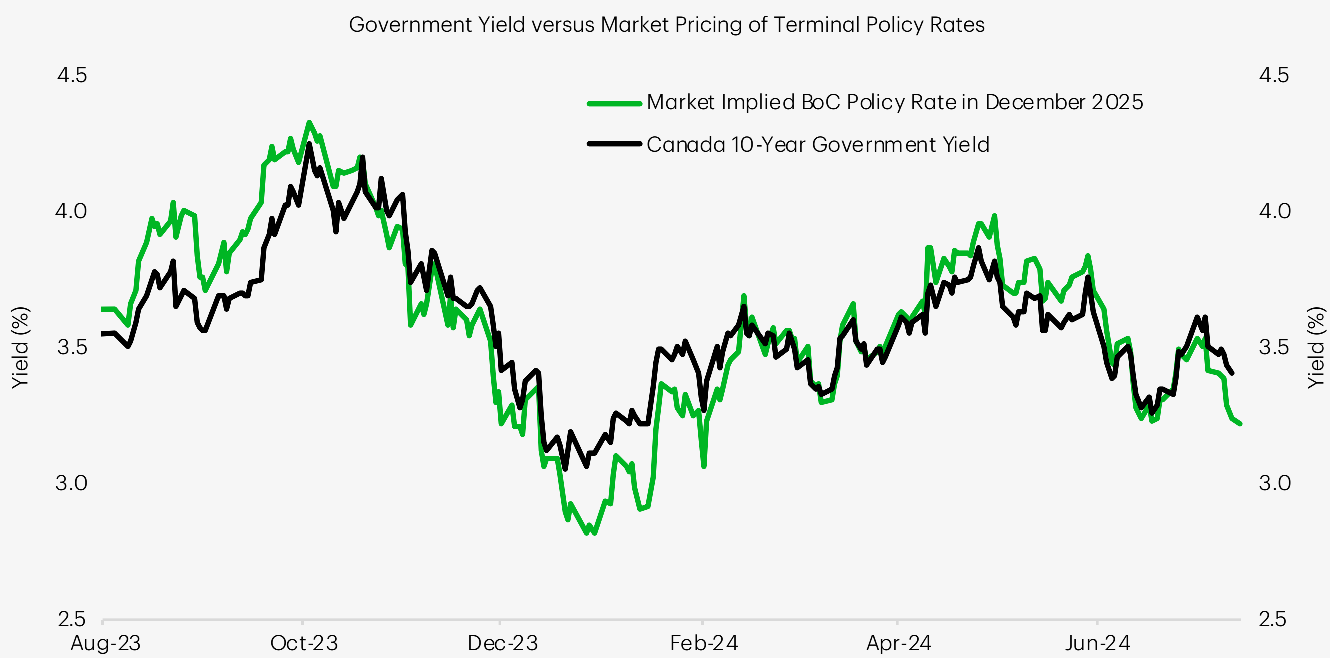
5. U.S. Election. In their first presidential terms, neither Joe Biden nor Donald Trump could be lauded for fiscal prudence. Biden's 2021 fiscal plan and the 2022 Inflation Reduction Act as well as Trump's tax cuts came amid strong economic growth contributing to today's deficits of almost US$2 trillion. The new democratic presidential candidate will most likely extend Biden's economy policy direction. Given that both republicans and democrats have exhibited a lack of fiscal restraint in their most recent presidential tenure, the outcome of November's vote may not bold well for longer term government yields. Market participants might expect higher yields as compensation for absorbing the increased government bond issuance needed to sustain fiscal spending. The next U.S. president will have much influence over the path of the domestic and global economy. Spending priorities, tax policy and international trade can all affect the growth and inflation trajectory. Equally important is the appointment of the next chair of the Fed's Board of Governors, and potentially several other board governors. Jerome Powell said in mid-July he will be staying until his term ends in 2026.

Credit: Investment Grade And Sub-Investment Grade

Given softening Canadian economic growth and tight valuations, we maintain our long-held view of modestly wider spreads in coming quarters. Sustained demand for yield and dwindling fears of recession will likely offset higher supply and keep spreads from widening significantly. (Spreads are a way of measuring risk premium over a government bond of similar maturity: a wider spread means the market is pricing in more risk, narrower spreads, less risk.)

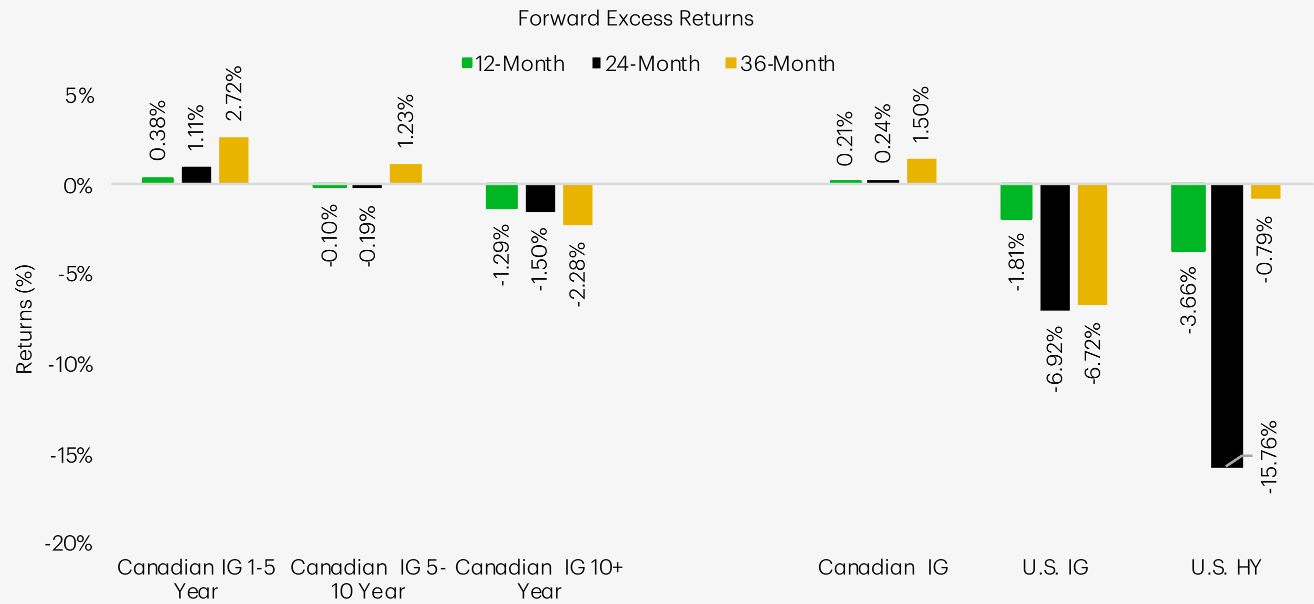
We are modest overweight on Investment Grade (IG) credit and maintain our modest underweight stance on High Yield (HY) credit. We expect Canadian IG to fare better than U.S. IG (based on historical periods when spread levels were similar to or less than current valuations) because spreads for Canadian IG credit are tight but still have some room to perform (Figure 5). Over the past 20 years, Canadian IG spreads have ended below current levels 54% of the time, and importantly forward excess returns (returns over similar maturity government bonds) were positive and relatively more attractive than U.S. IG. On the other hand, U.S. IG spreads have ended below current levels and forward excess returns were on average negative 12% of the time over the past 20 years.

Figure 4: Implied Terminal Policy Rate, Longer Maturity Government Yields Linked



Source: FactSet, Wealth Investment Office as of July 11, 2024

Figure 5: Forward Excess Returns Favour 1-5Yr Canadian IG



Source: FactSet, Wealth Investment Office as of June 30, 2024. Using historical month-end spreads since 2003 from periods when spread levels were tighter than current conditions.

Within the broader IG complex, we prefer short-dated IG bonds as a total return investment because they continue to offer close to the highest all-in yield since the late 1990s and are expected to keep offering better forward excess returns than the longer maturity corporates (Figure 5). 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.

We expect U.S. 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, forward excess returns are not attractive. We're more comfortable owning IG over HY given the relatively better outlook and the balance sheet strength offered by IG. 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:

• Credit Spreads in Tight Range. 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. Positive and negative scenarios exist which could move spreads more meaningfully than our base case forecast. If the Fed cuts rates and U.S. IG supply remains light while corporate earnings are strong, we could see heavy demand for IG bonds; insufficient supply of U.S. IG could lead to modestly tighter spreads, especially if the U.S. election outcome is viewed as market friendly. Spreads could widen if IG bond yields move significantly lower, reducing demand while increasing supply, or if yields rise on the back of political developments that undermine market confidence in fiscal discipline or Fed independence.

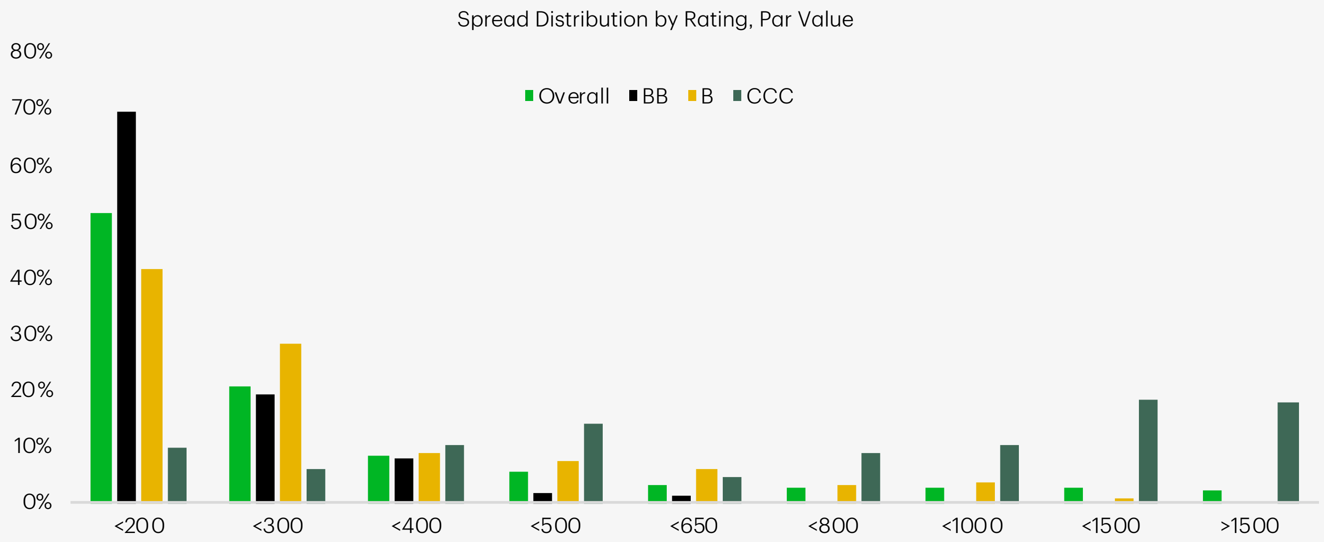
• Expect Net Negative Issuance H2/2024. Issuance was abundant in the U.S. in Q1, driven mainly by refinancing needs and elevated merger and acquisition (M&A) activity and then it slowed in Q2. We expect net issuance for IG-rated corporate bonds to turn negative for the rest of 2024 leaving the entire year issuance closer to the long-term trend. 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.

• Demand Remains Robust. 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. Pension funds are expected to keep rebalancing portfolios away from equity and life insurance companies will likely keep recording large fixed-annuity sales.

• Super Tight U.S. HY Corporate Valuations. Valuations in the HY universe are priced for perfection and leave little safety net for embedded risk. For example, 50% of the market capitalization of the U.S. HY Index trades inside of 200 bps, including almost 70% of all BB-rated HY (Figure 6). At 177 bps (as of June 28), the BB tier's option-adjusted spread has seldom been tighter (more expensive). Within B-rated HY credit, 40% trade inside 200 bps. At the other end of the spectrum, just 5% of the Index trades at least 1,000 bps over Treasuries, the threshold for distressed.

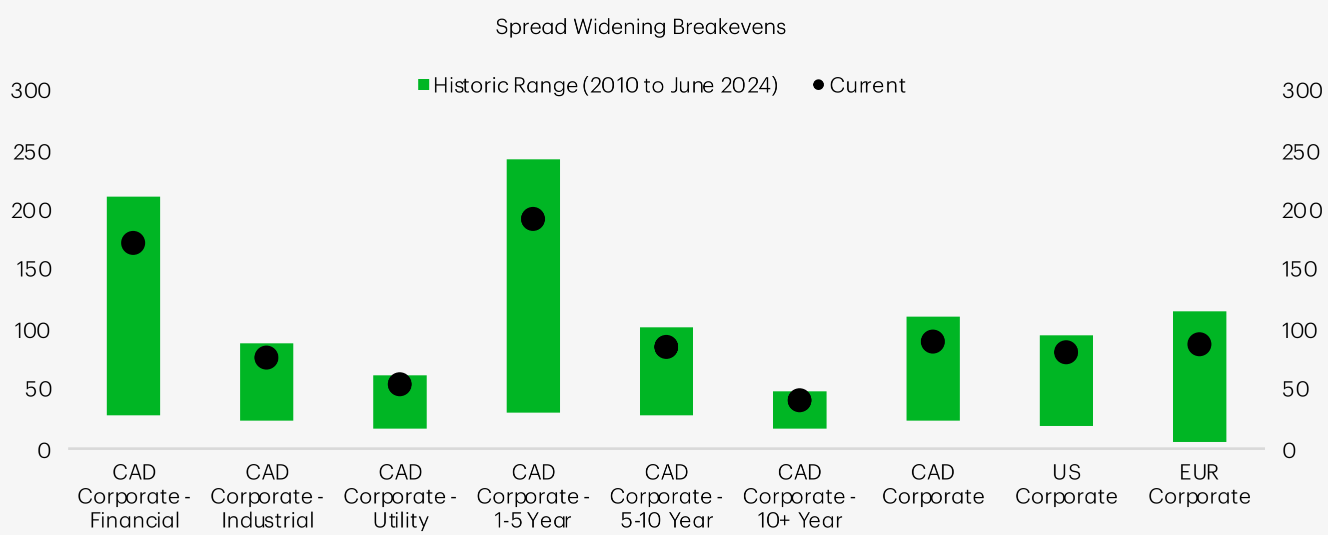
• Active Management. We believe active management is the best approach for IG credit and we prefer shorter maturity and sectoral tilts based on valuations. We believe investors will benefit most from a bottom-up approach: look for sectors or maturities within IG credit with relatively attractive spread breakevens compared to the broad market (Figure 7). Breakevens estimate the amount that spreads or yields can rise before a year's worth of total returns are offset. Higher breakevens imply more cushion. For example, after higher than usual issuance in 2022, bond spreads and breakevens for the Big Six Canadian banks are still attractive compared to the rest of the market plus they have a bias towards higher quality. Canadian 1yr-5yr credit offers higher breakevens than the longer maturity credit hence our preference for shorter maturities, followed by, broadly, Canadian and European credits which are currently offering higher breakevens than U.S. credit (Figure 7).

Figure 6: HY Credit Valuations Flashing Caution



Source: FactSet, Wealth Investment Office as of June 30, 2024. Universe referred is Bloomberg U.S. Corporate High Yield Index.

Figure 7: Yield Breakevens Compare Credit Subsegments



Source: FactSet, Wealth Investment Office as of June 30, 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.

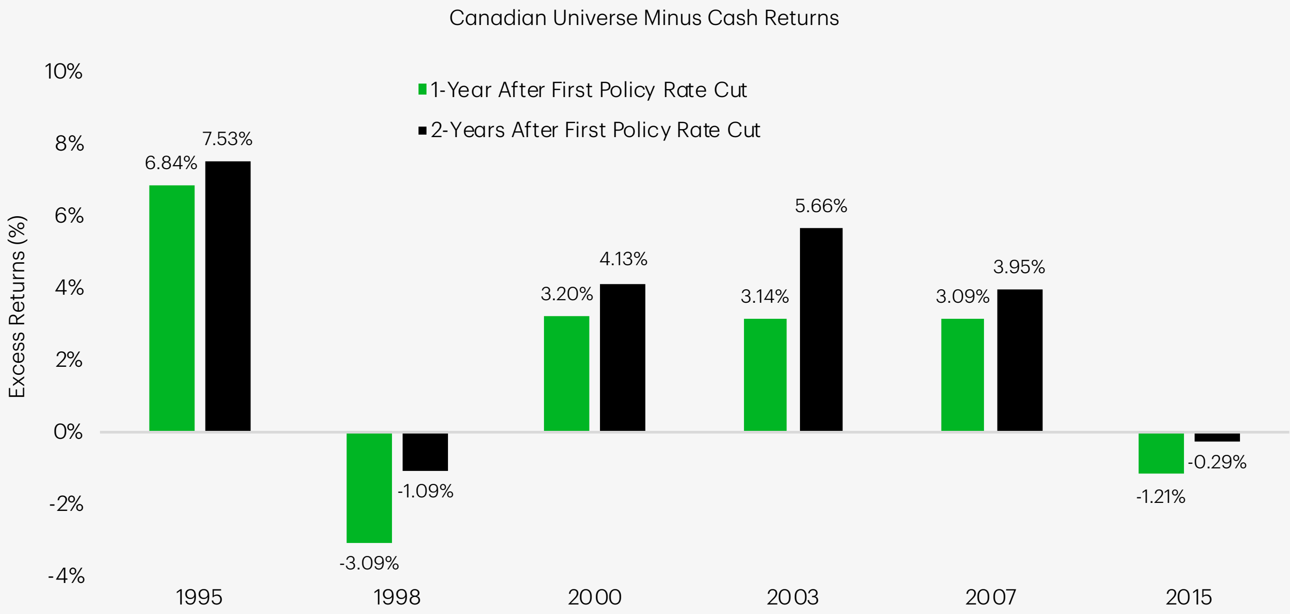
It's possible to earn attractive yields in almost all segments of the fixed income market. Higher yields are a good indicator of future returns and provide a buffer while markets refocus on fundamentals. Buying opportunities can arise quickly in periods of uncertainty so stay informed and manage your 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 lower 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 less attractive than they were a few months ago and are expected to fall further with the follow-up rate cuts because 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 the policy rate cut periods (Figure 8).

We hold a neutral view on fixed income. Fixed income continues to offer an attractive opportunity 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. 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 During Policy Rate Cuts



Source: FactSet, Wealth Investment Office as of June 30, 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

Neutral

Never too early, never too late

David Beasley, Senior Portfolio Manager; Christopher Blake, Senior Portfolio Manager; Mansi Desai, Senior Equities Analyst; Chadi Richa, Senior Equities Analyst; Andrej Krneta, Senior Equities Analyst; Neelarjo Rakshit, Senior Equities Analyst; Kevin Yulianto, Portfolio Manager | TD Wealth

North American equity markets finished the second quarter muted following an exceptional start to the year. So-called "breadth" — that is, the proportion of stocks that are participating in the rally — continued to be narrow, with the market being overwhelmingly led by U.S. tech "mega-caps," and particularly those associated with the artificial intelligence (AI) investing theme.

Consider the Nasdaq 100 Index, where these mega-cap stocks are concentrated. The index was up 7.8% in the quarter (on a price-return basis), while the S&P 500 was up half that, at 3.9%, and the equal-weight S&P 500 was actually down -3.1%. Drilling down on a style basis, the bias is even more pronounced. The S&P 500 growth index outperformed the S&P 500 value index +9.4% to -2.7% in the second quarter and 23.1% versus 4.6% year-to-date.

In the Canadian market, the S&P/TSX Composite Index was up 4.4% through the first half of the year, despite giving up 1.3% in the second quarter, which puts it about on pace with its 8.1% gain in 2023. Canadian technology growth names did not follow their American counterparts; rather, they detracted from performance, with the sector down 3.9% during the second quarter. The most heavily weighted sector in the index, financials, was also down, at -2.2%.

Other dividend-paying sectors also underperformed. Both utilities and real estate sectors were down low- to mid-single digits in the first half and second quarter — a surprise, given that the Bank of Canada began what is likely a fresh rate-cutting cycle. For Canadian investors, the best performing sectors through the first half of the year have been energy and materials, up 17.1% and 12.6% year-to-date, with gold miners in the materials sector doing the heavy lifting, with a gain of 4.4% in Q2, while energy stocks digested prior gains.

Now, at the midway point of the year, given the ups and downs of this volatile market, many equity investors are asking themselves two questions:

1. Is it too late to put money to work in growth stocks?

2. Is it too early to invest in value and income stocks?

As legendary mutual fund manager Peter Lynch once said, "Far more money has been lost by investors in preparing for corrections ... than has been lost in the corrections themselves." By the same token, we believe the answer to those questions is "no" — it is never too late or too early to put money to work towards long-term equity growth and income strategies.

In the following pages, we provide further insights on investing at both ends of the equity "barbell" positioning strategy — specifically, U.S. information technology on the growth end, and Canadian financials and North American utilities on the value/income end.

The Growth End: U.S. Information Technology Sector

During the second quarter, technology indices reached new all-time highs. Continued gains driven by a broader expansion in valuation multiples (i.e., increased risk-taking) tends to create a "wall of worry" given that this kind of rally typically precedes a sharp correction. For many investors, as optimism bubbles into enthusiasm and exuberance, an equal and opposite foreboding starts to occur — a kind of "waiting" as more conservative investors brace for the impact of a pullback.

For the past 18 months or so, many of the stocks leading the rally have been the semiconductors, a notoriously cyclical industry. This semiconductor cycle, like all that have come before, will likely end under the weight of oversupply, when the business cycle turns and spending on capital expenditures is cut. And yet, the anticipation of a negative event should not stop us from positioning for an optimal risk-return outcome. That is why we continue to apply our defensive growth strategy: positioning portfolios to protect from the downside while participating in structural investment themes that will play out over multiple macro cycles.

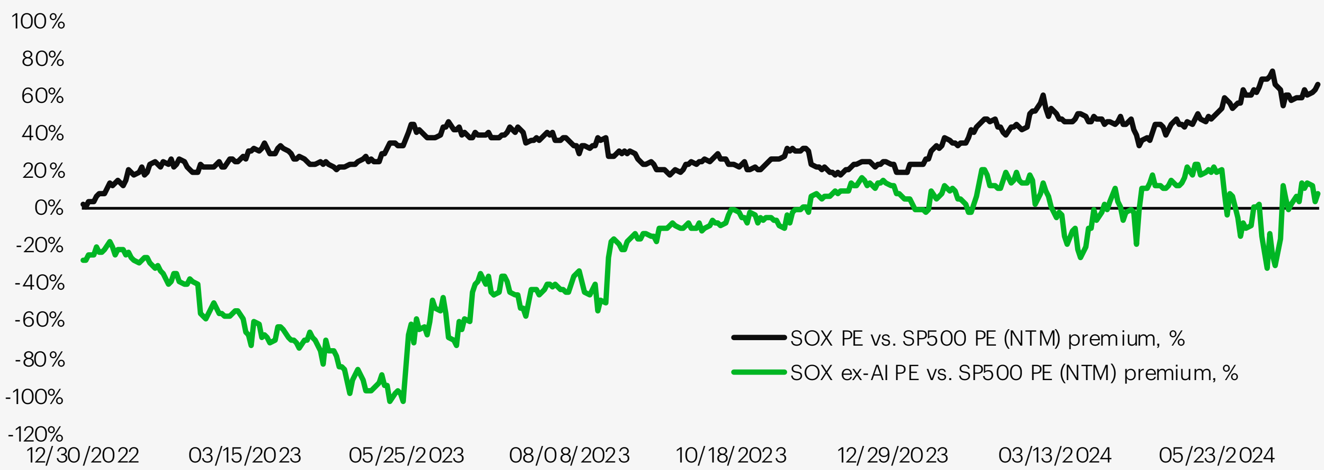
This strategy helps us to avoid excessive drawdowns in a market correction. We do so by avoiding positions where a valuation multiple contraction from lofty levels could be compounded by a negative earnings revision on the ground level. It's likely impossible to completely avert the impact of both, but it is possible to limit the magnitude of the effect.

This strategy requires us, ultimately, to select securities that are fairly priced. As shown in the accompanying chart (Figure 1), the Philadelphia Semiconductor Index (SOX) is demanding its highest premium of the cycle relative to that of the S&P 500. However, when we exclude the names in the SOX with high exposure to AI (defined as a minimum of $1 billion of annual revenue), the semiconductors look more attractively priced relative to the market.

Another pocket of the technology space that offers attractive pricing is software. In 2024 the market lowered its expectations for software companies after guidance failed to reveal an AI-related revenue bump. Investors' impatience with the timing of AI revenue led to deteriorating sentiment and valuation multiple contraction. Our proxy for the software subsector is the iShares Expanded Tech-Software Sector ETF (IGV). Although software stocks participated in much of 2023's bull market in technology, with similar multiple expansion to other subsectors, the accompanying chart (Figure 2) shows the lost momentum in software multiples, with stocks essentially flattening out since their peak earlier this year. As a result, their relative valuations have improved versus the sector, providing a "growth at a reasonable price" proposition ahead of presumed eventual monetization of their AI functionality.

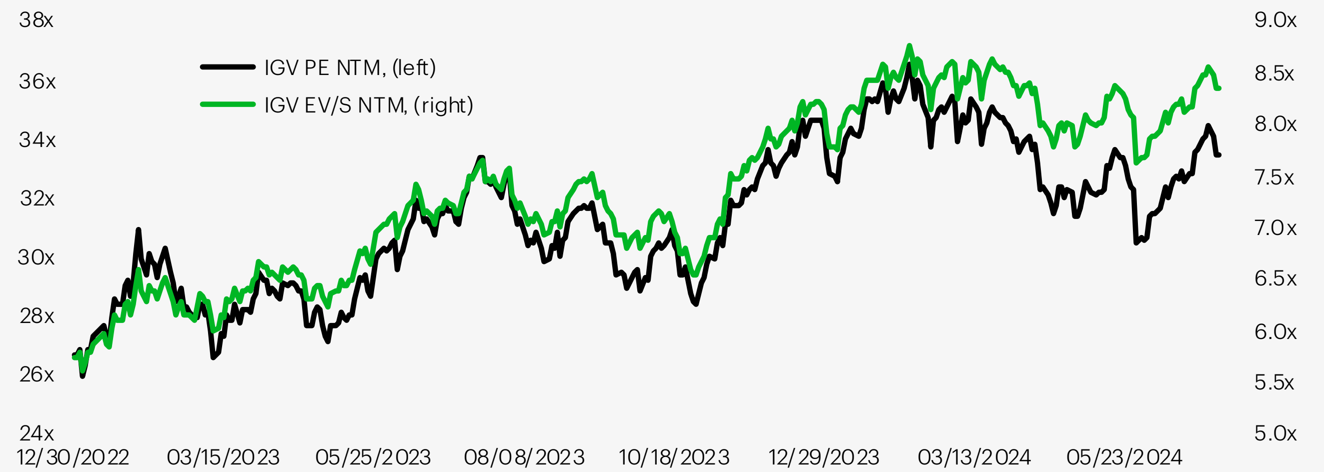
Waiting is the hardest part. Investors are anxious to know the rest of the story of this tech-led rally. We doubt that anyone knows exactly how this story ends. Instead of idly waiting for the resolution, we can limit our exposure by adding somewhat more defensive growth, those names which have high growth potential but have lagged the leading stocks with lower valuations and thus appear poised to play catch up.

Figure 1: Semiconductor premium limited to AI stocks



Source: FactSet, Wealth Investment Office. As of June 28, 2024

Figure 2: Software multiples have moderated



Source: FactSet, Wealth Investment Office as of June 28, 2024

The Value/Income End: Canadian Banks

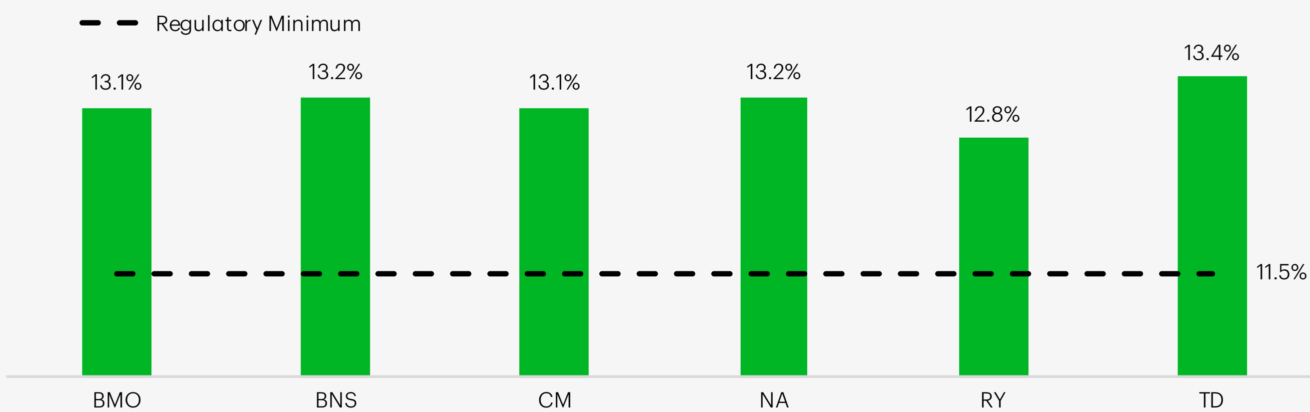
Canadian banks have had weak fundamentals for the past two years, with the benefit of rising rates offset by high expense growth and lower capital-markets-related revenue (CMRR). The result was several quarters of negative operating leverage that, combined with normalization in credit losses, weighed on Canadian banks. However, in the second quarter we saw a positive inflection point in operating leverage, which was driven by improving revenue growth and slowing expense growth, as the banks reaped the benefits of cost initiatives implemented last year.

Capital markets were also a bright spot for the quarter, as an acceleration in the segment's revenue growth boosted top-line growth. Capital-market conditions are expected to remain healthy in 2024, with industry players in the U.S. forecasting a sizeable recovery driven by increased participation from private-equity companies looking to exit investments and exploit pent-up demand following decades-low activity in 2022 and 2023. This bodes well for Canadian banks with U.S. capital-markets businesses, such as Bank of Montreal and Royal Bank.

On the risk side, although there remains an overhang from mortgage renewals and some deterioration in domestic personal loans, Canadian banks maintain a healthy capital position (Figure 3) to help fend off any potential stress in the sector. The average CET 1 ratio came in at 13.1%, which is well above the regulatory minimum of 11.5%. Following its semi-annual review, OSFI has decided to maintain the Domestic Stability Buffer (DSB) at 3.5% of total risk-weighted assets.

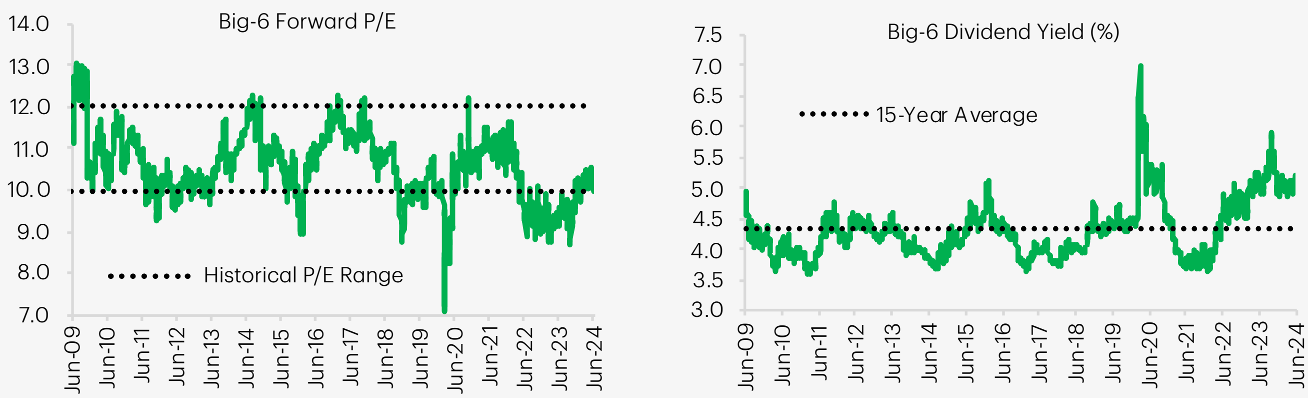
Turning to valuation, Canadian banks usually trade between 10x and 12x forward earnings. Currently, the group is trading at the bottom of that range, at around 10.1x. Meanwhile, with the average dividend at 5.2%, they are yielding well above their historical average of 4.3% (Figure 4). While some would argue that, in an environment where short-term interest rates are yielding around 4%, such a dividend yield doesn't seem very attractive. We would counter that dividends grow with earnings, which is close to a certainty for Canadian banks. The same cannot be said about interest income earned on a savings account or GIC, which carry reinvestment risk, especially when the Bank of Canada has delivered two rate cuts.

Figure 3: Canadian banks maintain a healthy capital position



Source: Bank of Canada, Wealth Investment Office as of June 14, 2024

Figure 4: Value and Income – Bank stocks are 'cheaper' and dividends are 'richer'



Source: FactSet, Wealth Investment Office as of June 28, 2024

The Value/Income End: North American Utilities

The increasing demand for power generation, transmission and distribution to support new technology has made utilities interesting, and they should benefit from a shift in the power demand landscape across North America on the back of three key demand drivers: energy-intensive data centres, electric vehicles and manufacturing on-/re-shoring.

First, the development of AI technology requires data centres, which are extremely energy intensive. The U.S. Department of Energy estimates that a data centre can use 10 to 50 times the energy of a typical commercial building. Second, many countries, including the U.S., provide tax credits to customers who buy electric vehicles, and certain states like California and New Jersey have passed laws that will ban the sale of ICE (internal combustion engine) vehicles beyond 2035. We expect EV adoption to remain fairly muted in the 2020s, but it should ramp up significantly in the 2030s. This will have a material impact on power demand in the future, but utilities should have plenty of time to prepare the grid for the increased load.

Finally, onshoring/reshoring has generated economic development opportunities, with multiple utilities citing growth in electric transportation, manufacturing and its supporting supplier base. These factors are all drivers of secular growth for the supply side of power, which will likely translate into massive investment and revenue growth, and corresponding dividend growth for utilities over the coming years.

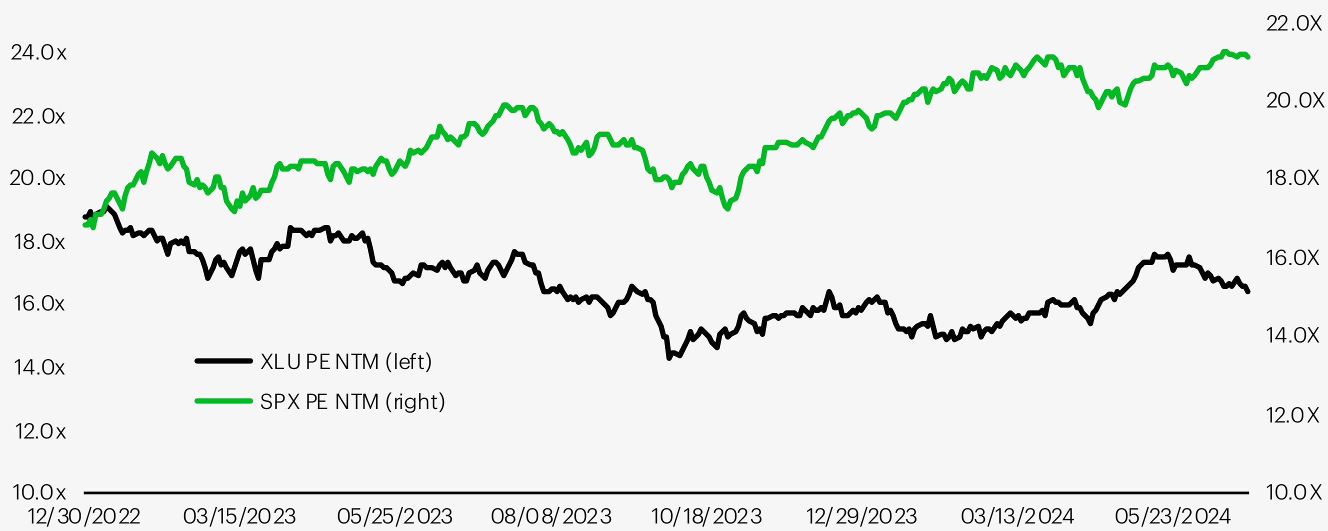
Similar to Canadian banks, North American utilities are currently offering an attractive value and income proposition. The accompanying chart (Figure 5) shows the Select Sector SPDR ETF (XLU) price-earnings (next twelve months) ratio versus that of the broader market (S&P 500). Since the start of the technology-driven bull market in late 2022, the multiple has compressed meaningfully, trailing the market by over 5-turns versus trading at a slight premium at the start of the move. That premium multiple was last seen at the end of the 2022 bear market, reflecting the defensive nature of utilities stocks which see relative inflows when equity markets are weak. If the economy were to slow down and growth equities pull back, we would expect the utilities stocks to similarly see defensive rotation-driven flows and their prices to rerate higher and narrow the valuation gap with the broader market. The income component is a key feature of utility stocks. Using XLU as a general proxy for sector yields, the 3.2% as of the end of the second quarter is more than double the S&P 500 yield.

International: Discount reflects sluggish economies

International equities recorded a subdued performance of -0.1% in the second quarter amid persistent economic weakness. While the economic contraction in Europe appears to have bottomed in October 2023, the composite PMI in Europe shrank in June to 50.9 from 52.2 in May. Industrial production in Europe also deteriorated from -1.2% to -3.0%. Europe continues to struggle with slow demand, with continued weakness in the growth in new orders.

The recovery in Europe has been slower due to structural challenges in the region. While the ECB announced its first rate cut in June, at 25bps, Strong wage growth in Europe, over 4.5%, will likely deter the ECB from announcing aggressive rate cuts.

Figure 5: The valuation of the utilities sector has diverged from the S&P 500 since late 2022



Source: FactSet, Wealth Investment Office as of June 28, 2024

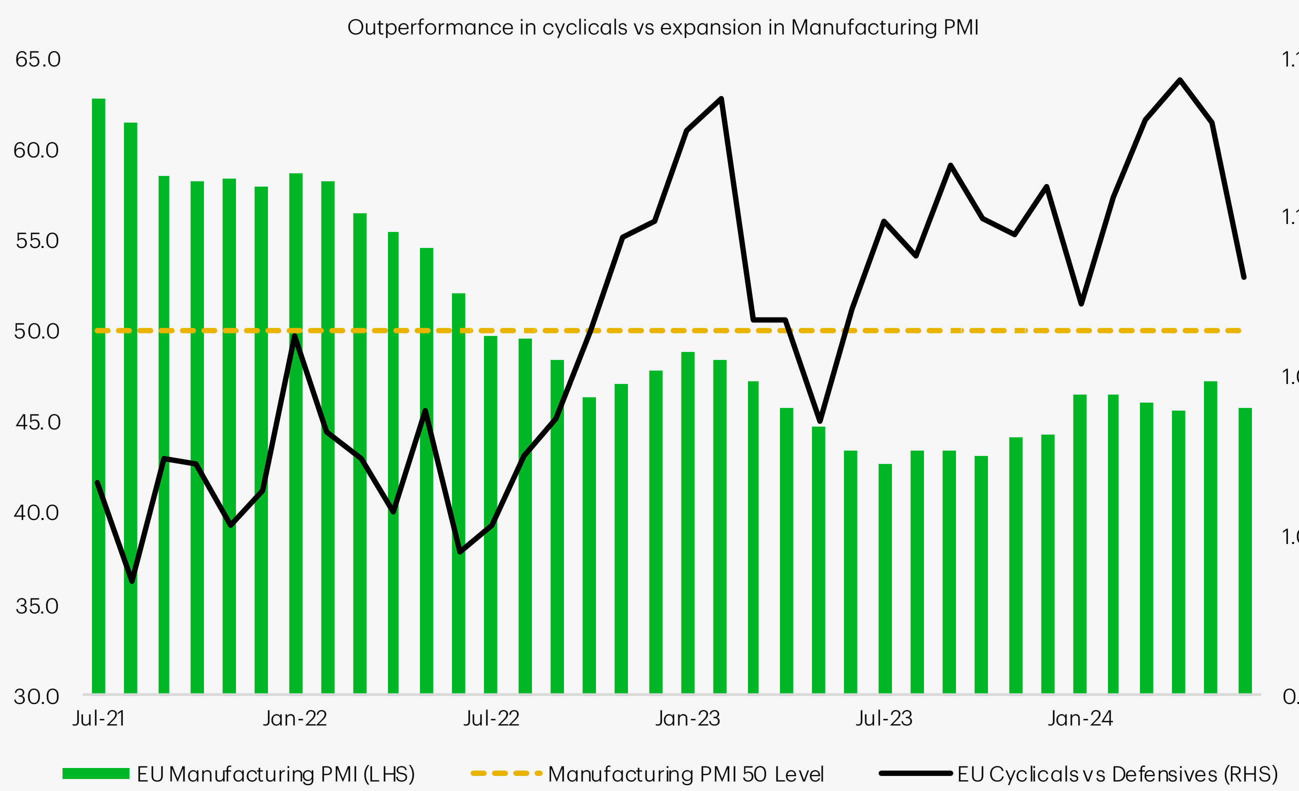
We noted in the previous edition of *PSQ* that the rally in EU cyclicals might not be sustainable, given that the surge in prices was stronger than the expansion in the EU manufacturing PMI. Despite the 25-bp rate cut announced by the ECB in early June, the rally in EU cyclicals lost steam given the weak PMI levels recorded in Q2 2024 (Figure 6). In addition, the rally in EU cyclicals so far has been concentrated in financial stocks. While the economic backdrop remains weak, we believe the discounted valuation levels provide support and that there is potential in some cyclical pockets of industrials and materials as the EU progresses towards a sustained economic recovery.

UK equities, after a dismal run in 2023 and Q1 2024, had a better Q2 as inflation came down to the target rate of 2.0%. There are also early signs of house prices stabilizing, and after recording rent inflation of 7.2% in March 2024, it seems that rent inflation has also peaked in UK, which should help to alleviate the crisis in housing affordability. Economic recovery now appears to be on track for the UK, with the composite PMI above 50 since December 2023. This, combined with attractive valuations and positive real income growth, bodes reasonably well for UK equities. However, it's important to note that the economic recovery will likely be bumpy, and as such, equity market performance may be volatile.

This quarter, the rally in Japanese equities came to a pause after surging by 17% in Q1 2024. Continued weakness in the yen, weakening growth in China (Japan's largest export market, at around 20%) and negative real income growth can be blamed for the pause in the equity rally. A prolonged period of negative income growth has led to weakness in consumer spending, which has largely impacted the services sector: the services PMI fell to 49.4 in June 2024 from 53.8 in May 2024.

We noted in the previous edition of *PSQ* that, for the inflationary environment to persist in Japan, it will be important for corporations to maintain wage growth over 2%, which in turn would support consumer spending. Since the asset bubble in Japan collapsed in 1990, wage growth has been stagnant at around 0%, one of the lowest among developed economies. However, we continue to believe that Japanese equities look attractive on a relative basis given improved capital-allocation policies for corporations and a renewed focus on generating higher returns for equity shareholders.

Figure 6: EU cyclicals stall after outpacing PMIs



Source: FactSet; Wealth Investment Office as of June 30, 2024

It's important to note that the valuation dispersion among U.S., international and emerging-market equities has reached a 17-year peak (Figure 7). We believe this abnormally large discount is not warranted in an environment where both Europe and Japan are seeing a rise in real rates (compared to the negative rate regime in place after the global financial crisis), along with an improved fiscal deficit for Europe and structural tailwinds for Japan. In the near term, the weaker economic environment will be a drag on earnings growth, but as we move towards economic recovery, we believe dispersion between U.S. and international equities will decline, offering potential for equities outside the U.S.

Moreover, when we look beneath the surface of the MSCI All Country World Index, we find that not all great investment returns come from the U.S. As you can see in Figure 8, every year around 10 of the top 20 companies on the MSCI ACWI are outside the U.S. While we do not question the quality of dominant U.S. corporations and their ability to record consistently high earnings growth, the index has become very concentrated. Some constituents appear to be trading at lofty valuations, leading to asymmetric risk for an equity portfolio that is not diversified.

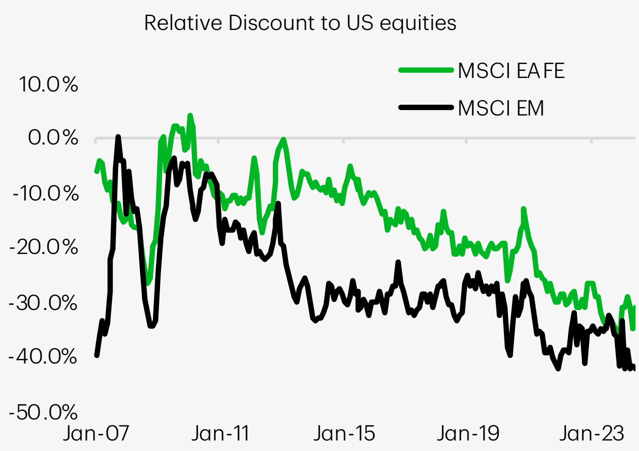
Emerging Markets: Some allocation is worth the risk

Emerging-market equities outperformed many in developed market this quarter, due to a strong run in Taiwan and India. Chinese equities got off to a good start in Q2 after the government announcement that it would borrow a trillion yuan as part of a stimulus package. However, as the markets recognized the need for additional stimulus that would rejuvenate the real estate market, the strong momentum dissipated. Chinese equities closed the quarter with -2.4% return.

More than half of Chinese household net wealth is tied to real estate, so if the housing downturn persists, consumer spending is expected to be curtailed further, leading to a deflationary environment. Historically, China's economy has managed to get out of deflation on the back of population growth, urbanization, investment and a rebound in exports. Given that growth in population and urbanization appear to have peaked, the Chinese economy is now quite dependent on growth in investments and exports.

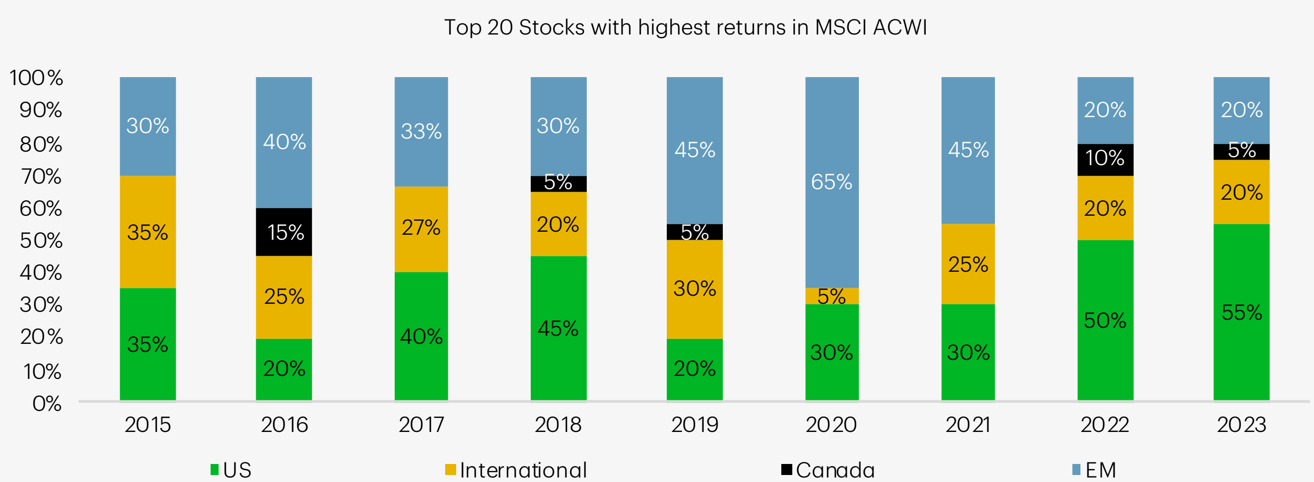
Although China has made significant progress in its "new three" pillars of growth drivers — electric vehicles, batteries and solar panels — its growing dominance is not welcomed by developed nations, especially the U.S. Hence, we believe it is crucial for the Chinese government to announce measures that will help to revive consumer spending. China's 53% consumption share of GDP is lower than many of the leading global economies (U.S., Germany, Japan), which hovers between 70% and 82%.

Figure 7: EAFE, EM discount at 17-year high



Source: FactSet; Wealth Investment Office as of June 30, 2024

Figure 8: About half of the MSCI ACWI's top 20 investment returns are outside of U.S.



Source: FactSet; Wealth Investment Office as of June 30, 2024. Note: companies with below 0.01% share in MSCI ACWI have been eliminated from the ranking.

Given these headwinds for China, valuations appear reasonable; Chinese equities are trading at a discount of -8.5%. China continues to be a leading trading partner to many developed economies, such as the U.S., Europe and Japan, and offshoring from China will take time. In addition, over the years strong multinationals have emerged in China (e.g., Alibaba, PDD Holdings, Meituan), which have all recorded annual earnings growth over 15% since 2017, similar to what mega-cap tech stocks in the U.S. have delivered. Structural headwinds will take some time to work through, however. As such, we continue to take a cautious view on Chinese equities.

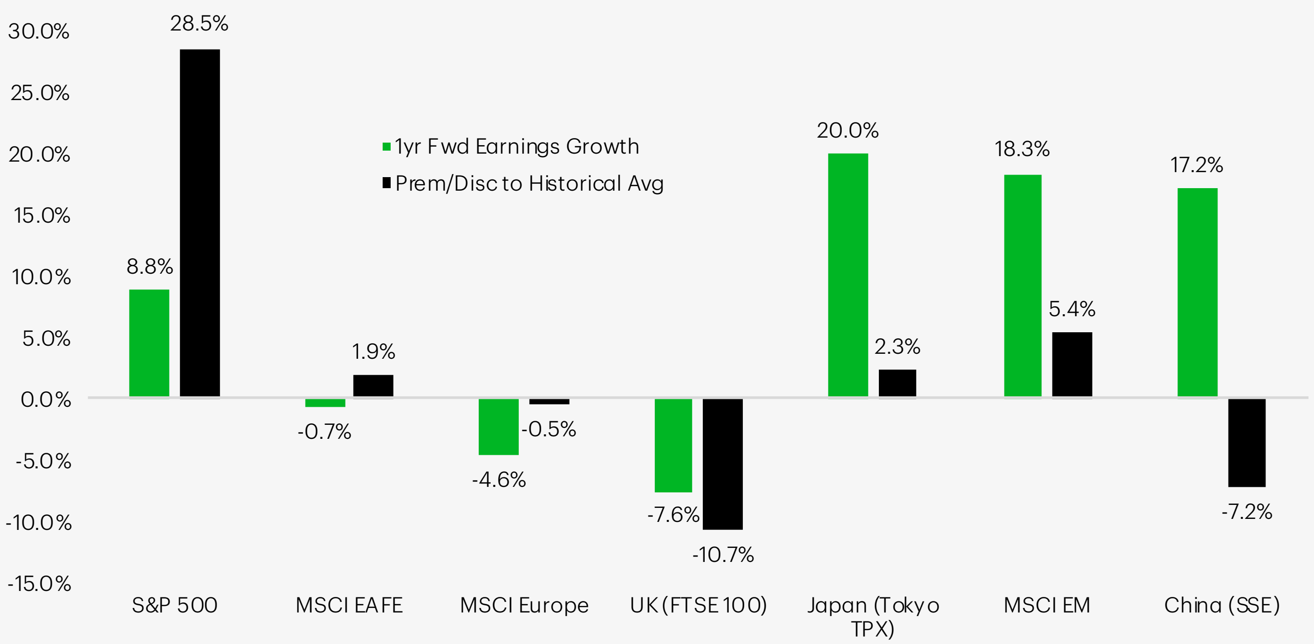
Taiwanese equities continued to outperform in Q2, owing to the AI semiconductor rally. We believe this trend will continue to benefit all the EM nations that are a critical part of the AI supply chain (Taiwan, South Korea). Indian equities also recorded a healthy run of 7.3% after the current ruling party secured victory, albeit without strengthening its mandate. Indian markets expect a continued push towards business-friendly policies, improvement in infrastructure, a quickly evolving tech sector and measures to re-establish a supply chain out of China. In addition, the decline in inflation to 4.8% (closer to the target rate of 4.0%) and the reduction in fiscal deficit to 5.6% bodes well for Indian equities.

Equities in South Korea, Brazil and Mexico underperformed owing to the political risks in these countries. In Brazil, increasing signs of intervention from the leftist administration, concerns over expansion of the fiscal deficit and the higher-for-longer environment in the U.S. impacted the performance of Brazilian equities. Over the long term, however, many Latin American equities are well positioned to benefit from growing foreign investment into critical sectors like mining, renewables and hydrocarbons, which are crucial for growth in infrastructure (including the green transition) in developed markets, especially in the U.S.

In Mexico, the incumbent Morena party won a landslide victory, but there are fears that if the new president, Claudia Sheinbaum, wins a supermajority, the party will be able to make constitutional changes that could overburden the economy. For South Korea, meanwhile, another landslide victory, this time for the opposition group, came as a blow to the ruling party's president, Yoon Suk Yoel. Investors were concerned about whether Yoon's "corporate value-up" program, which encourages corporations to improve their governance and increase shareholder returns, will be supported by the opposition party.

There are further political risks across the board for EM equities if Republicans in the U.S. win a strong mandate in November 2024. However, we maintain a Neutral view given the emergence of powerful companies across the EM regions, improved balance sheets of key EM countries, the EM's importance as an engine of global growth and attractive valuations (Figure 9).

Figure 9: Risk/reward for global equities



Source: FactSet; Wealth Investment Office as of June 30, 2024

Outlook on Alternative Assets

Neutral

Investing in infrastructure makes sense in all market cycles

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 horizon could benefit from adding alternative assets to their portfolios, namely private equity, private credit, and unlisted real assets such as real estate and infrastructure. Alternative investments 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 by virtue of relatively muted drawdowns. because they're less influenced by the noise that occasionally causes dislocations in public markets. Inefficient markets, trading illiquidity, and active ownership offer a target rich environment to capture a premium and generate attractive absolute returns. TD Wealth maintains a neutral weight on alternative assets.

Infrastructure: Modest Overweight

Infrastructure is remarkably diverse, encompassing a range of facilities and projects that provide the essential services underpinning the global economy, moving people, goods, commodities, and data to where they are needed most. Examples can be found across transport, energy transition, utilities, midstream, and data (Figure 1). These durable assets with multi-decade operational lives provide stable, inflation-protected cash flows and enjoy dominant market positions, often natural monopolies. There are four main strategies for investing in infrastructure, each carrying different risk levels: core, core-plus (also known as value-add), opportunistic, which are all equity-based investments, and debt.

Infrastructure debt entails lending to other asset owners to finance construction, fund maintenance and growth capital expenditures, roll maturities, enable recapitalizations, or provide acquisition financing. Analogous to other types of debt financing, creditors can target specific parts of the capital structure – such as senior secured, senior unsecured, subordinated, junior, and mezzanine positions – to refine portfolio positioning.

Within the infrastructure equity bucket, core assets are the most conservative from a risk-return perspective. Examples include regulated utilities and contracted pipelines. Such investments target mature, lower-risk, operational assets with predictable revenues that are primarily located in developed markets. Demand for core infrastructure, absent black swan events, is typically inelastic with mitigated volume risk. Revenues may be further bolstered by constructive regulation or purchase agreements, where rising costs can be passed through to end users. Once built, such assets typically have high operating margins due to relatively low running costs that are predominantly fixed. High cash flow visibility is underpinned by constructive regulatory regimes or long-term contracts, such as those with a take-or-pay or cost-of-service basis. As a result, this space appeals to investors who prioritize distributions over capital gains.

Figure 1: From railways that transport raw agricultural commodities to data centers that house graphics processing units, infrastructure forms the backbone of the global economy

Transport	Energy Transition	Utilities	Midstream	Data
Rail & mass transit	Wind, solar, hydro, & nuclear generation	Water transmission & distribution	Pipelines	Telecom towers
Ports & terminals	Distributed generation including small modular reactors	Electricity transmission & distribution	Tank Farms	Data centers
Airports	Carbon capture, storage, & sequestration		Processing	Fiber networks
Toll roads & managed lanes				

Core-plus, or value-add infrastructure, entails moderate risk with the goal of growing cash flows and enhancing valuations. Examples of core-plus or value-add infrastructure include a toll road that is being expanded to handle more traffic, a power plant that is being retrofitted to use lower emitting fuel sources, a port that is being modernized to handle larger ships, or a data center that is upsizing its processing power. Core-plus assets require operational intervention and thus seek to provide investors with more capital appreciation. Revenues may still be regulated or contracted, but there is typically capacity for improved terms or counterparties. To further enhance value, asset owners may seek to optimize capital structures or undertake major works.

Opportunistic infrastructure is the riskiest investment type. It includes, by way of example, a greenfield toll bridge that is yet to be constructed in a region with a growing population, or an oil well that requires rehabilitation and carries a significant asset retirement obligation. These projects involve significant development or restructuring, whereby revenues are yet to emerge, or are very sensitive to shifts in demand and involve price and/or volume variability. Such assets may be located in emerging or frontier markets.

Real Estate: Modest Underweight

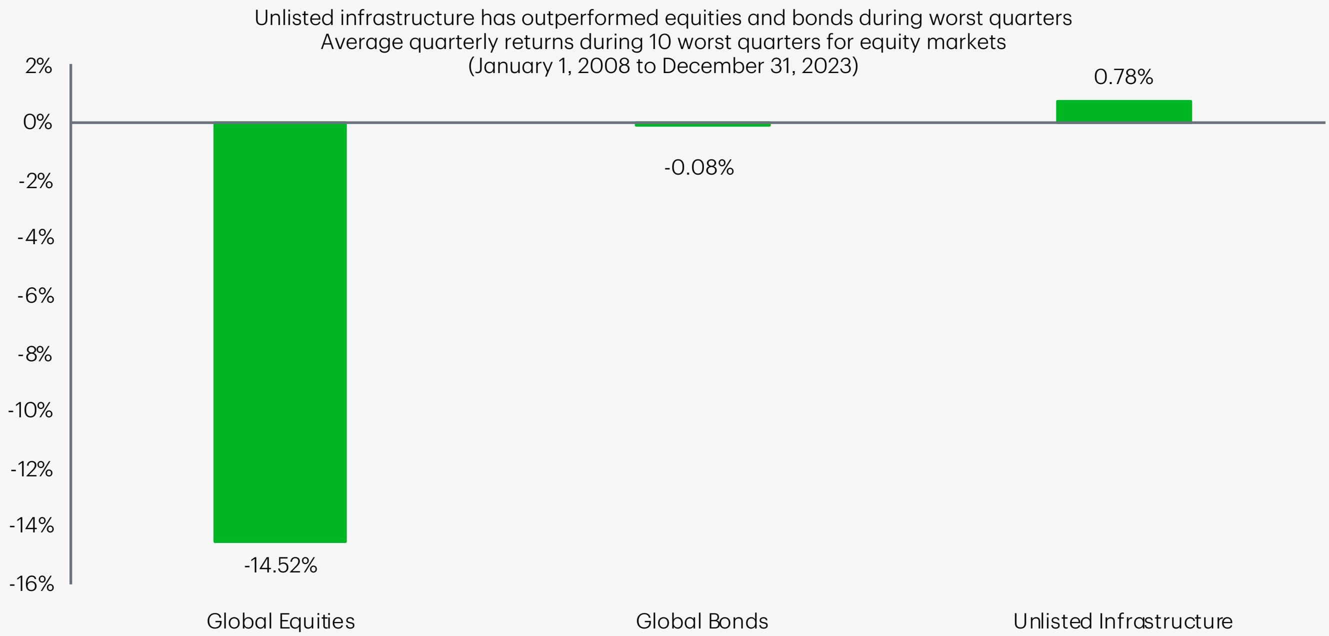
TD Wealth holds a modest underweight view on domestic real estate and on global real estate. High-for-longer interest rates, tight lending conditions, a refinancing maturity wall, and limited transaction activity are keeping commercial real estate (CRE) under pressure. Positively, however, normalizing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

In it for the Long Game

Private real estate fundraising in Q1/24 halved from Q4/23 levels, with aggregate capital raised declining from US$30.8 billion (bln) to US$28.5 bln. Negative sentiment across private real estate has persisted since mid-2022 due to limited transaction markets, investors' desire for liquidity in an illiquid asset class, high leverage for real estate companies relative to other corporate sectors, and limited access to debt capital markets.

While we acknowledge the reasons for negative sentiment and their impact on real estate landlords in a higher-for-longer cost of capital environment, we continue to believe that CRE (which includes property types such as Industrial, Healthcare, Hospitality, and Data Centres) offers a plethora of opportunities. The industrial sector, for instance, could continue to perform well through 2024: rent growth remains high and vacancy rates are below 5% in most markets as tenants aggressively compete for space. Aggregate industrial real estate demand continues to be driven by a combination of e-commerce growth, on/re-shoring and sustained just-in-case inventory management.

Figure 2: Unlisted infrastructure may provide downside protection during market downturns



Source: Wealth Investment Office, Preqin, Brookfield Oaktree as of December 31, 2023. Global Equities represented by MSCI World Index. Global Bonds represented by Bloomberg Global Aggregate Index. Unlisted Infrastructure represented by the Preqin Infrastructure Index

Healthcare real estate—particularly those focused on medical office, life science, and senior housing—remain well positioned over the long term to benefit from multi-decade demand drivers. These include an aging senior population, growing global demand for medication, supportive regulatory environments, a favourable supply backdrop, and shifts in the provision of care to non-hospital and outpatient settings.

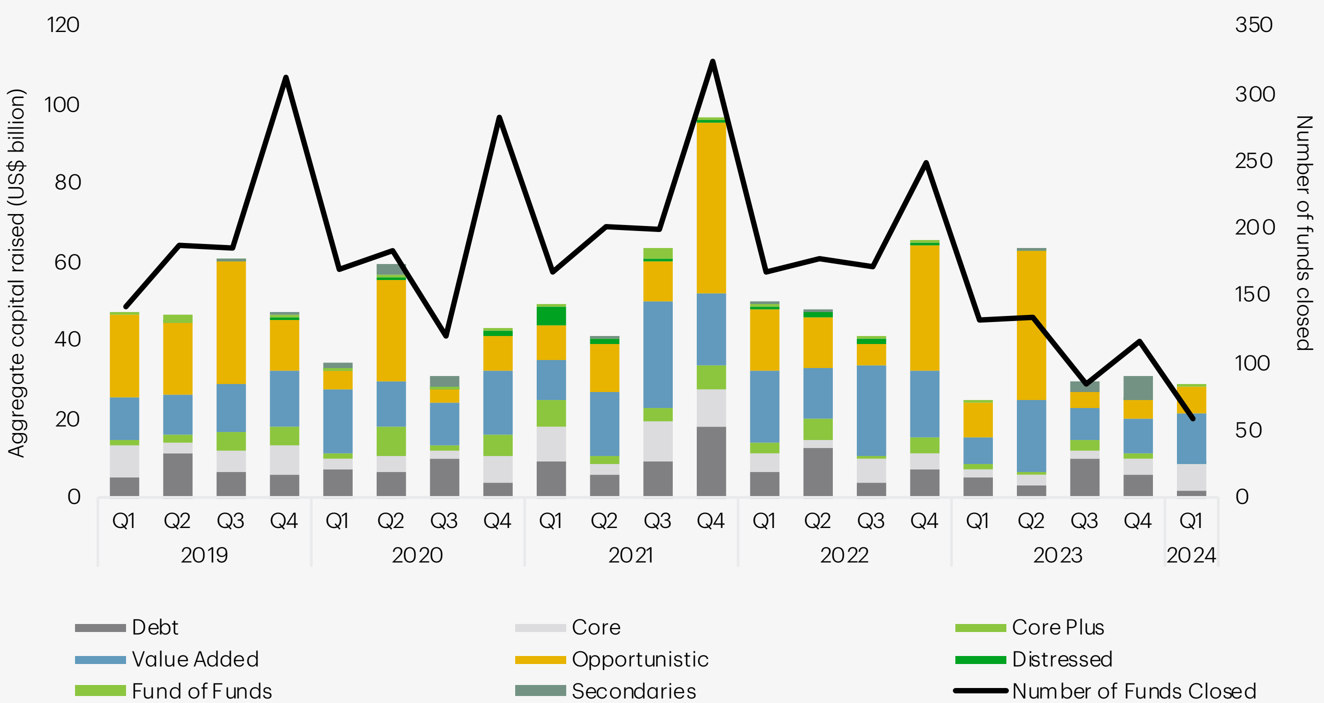
Growth in the data centre property type is expected to be sustained through 2030 buoyed by Generative AI, ubiquitous internet adoption and mobile data usage, deployment of 5G networks, cloud storage, IT outsourcing, and migration away from hosting servers on-premises.

Lodging and hospitality real estate should also continue to perform well through 2024 due to sustained demand for post-pandemic travel, both domestically and internationally, as people continue to prioritize travel over other discretionary spending. Stronger than expected group and corporate travel, normalizing labour costs, and the possibility of lower interest rates could further improve hotel real estate cash flows and compress capitalization rates. Lastly, greenfield land – which has recently seen an uptick in transactions in the Asia Pacific region – could insulate real estate owners from prevailing market-wide weakness and provide future opportunities for development. The latter could make way for tenants in manufacturing, warehousing, and logistics.

So, what now? Is it reasonable to accept the current range of interest rates as normal? Perhaps this is a good place to start, given that the federal funds rate averaged 4.78% over the 30-year period prior to the Global Financial Crisis (GFC). Accounting for the impacts of the pandemic and the GFC, rates above 5% may make sense. However, what really matters more than ever are property-level fundamentals. Indeed, when investors set aside expectations about interest rates, they are left with a clearer picture of private real estate.

Commercial real estate has never been a short game. In recent years, the investor mindset has all but yielded to cheap, easy money. But real estate investments weren't built for quick wins or near-zero rates. Sure, interest rates will go down, and they'll also go up again. But when and by how much remains to be seen. These questions are likely better left to economists. Mark Twain introduced us to the notion that history doesn't repeat itself, but it often rhymes. Perhaps at this precipice of expensive capital and muted valuations, investors will heed this cadence.

Figure 3: Global Real Estate Fundraising by Strategy



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

Outlook on Commodities

Modest Overweight

A promising environment

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

Commodities have had a strong start to the year, up 5.1% on broad strength. Energy, industrials and precious metals all contributed, with agricultural commodities the sole detractor. We believe the second half of the year will be driven by similar themes: steady demand growth and tight inventories in energy; tightening forward balances and heightened investor attention on industrial metals; a revived recognition of the importance of gold in investor and central-bank portfolios; and a well-supplied agricultural market. From a broader macro perspective, softer CPI prints in the U.S. should allow for some policy easing and a weaker U.S. dollar — a possible tailwind for commodities.

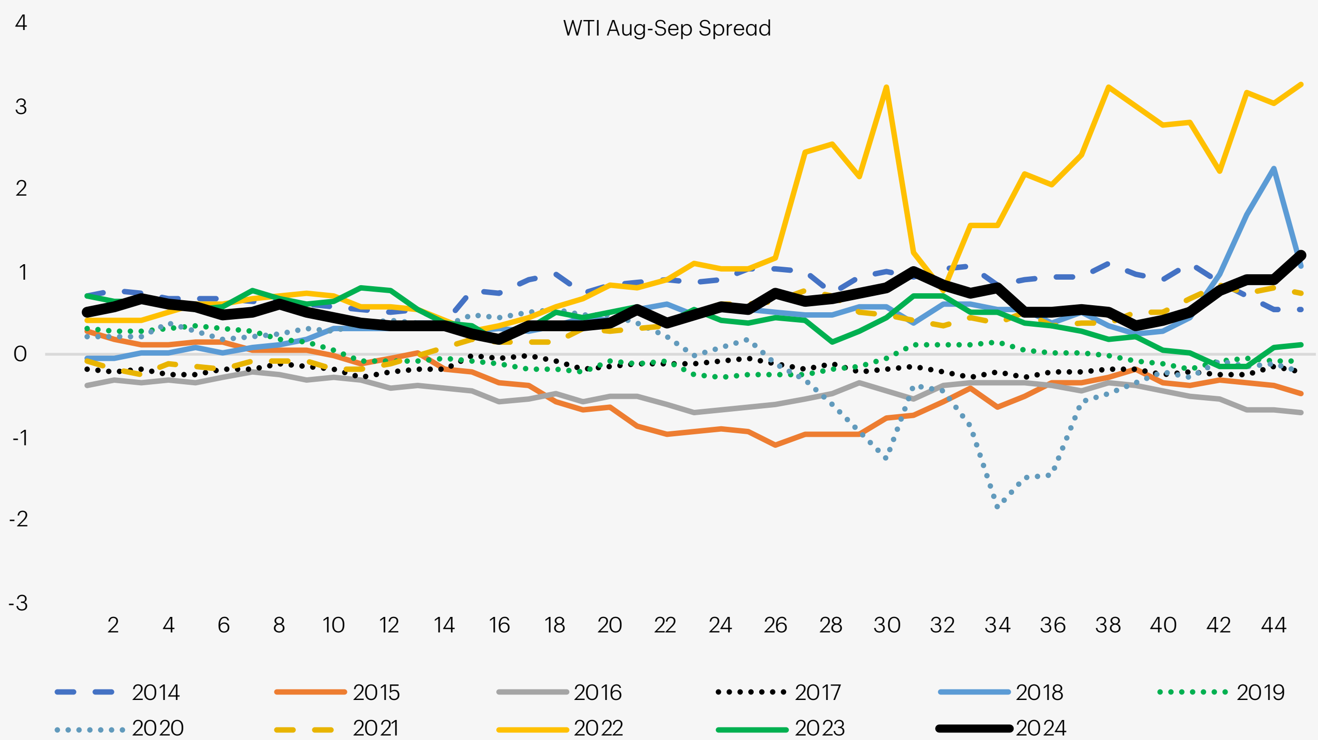
Agriculture: Bumper crops weaken prices

As mentioned, agriculture was the sole drag across the commodities complex, down 6.3% in the first half of the year. Elevated prices following Russia's invasion of Ukraine have resulted in a supply response across the main-row crops of corn, wheat and soybeans. Favourable weather across South America and the U.S. has added further pressure to prices, likely leading to a second year of surpluses, which should continue to rebuild global stocks and dissipate the risk premia that were priced into markets. We remain bearish on the agricultural complex. The upcoming U.S. harvests of corn and soybeans should register above-trend, something that is already being seen in the wheat harvest. Although agricultural prices broadly should continue to see pressure into the Northern Hemisphere harvests, we prefer to take a more nuanced approach, incorporating commodity-specific fundamentals. We see corn closer to fair value, with rather limited downside, but see further downside in wheat (around 5%), and are most bearish on soybeans (and soymeal) with price targets that are still 5% to 10% lower than current values.

Metals: AI euphoria lifts copper

Industrial metals had a strong first half, up 9%. The rally was led by copper, up almost 15% as AI euphoria spills into the metals space; investors expect a jump in demand that will result from increased electricity usage, grid improvements and data-centre buildouts. We remain broadly overweight the sector and constructive in the medium to long term.

Figure 1: Futures curve indicates inventories remain tight



Source: FactSet and TD Asset Management, as of July 5, 2024

We believe that copper prices did get ahead of current fundamentals, but we see inventories tightening into the end of the year, which should provide support. Our stronger conviction is in aluminum, where we believe strong demand growth will exhaust smelting capacity in China by year's end, with little capacity growth expected globally in the short to medium term.

We also remain constructive on gold. We believe the drivers behind the recent gold rally — monetary debasement, deficits and central-bank buying — are long-term trends that will continue to be tailwinds. A weaker U.S. dollar could also present additional upside.

Energy: Rangebound on disciplined supply management

Energy was up 8% through the first half as crude oil prices bounced off the lower end of their recent trading range. We continue to believe that oil prices will be rangebound (US$70 to US$90 per barrel). Jet fuel and gasoline demand has been strong in the U.S. and are expected to remain so through the summer travel season. Strong demand combined with a tighter inventory balance has led to tightness in the market, with backwardation (where current prices are higher than futures) yielding an annual roll yield of near 10%. Although OPEC does hold spare capacity, we see them returning volumes to the market in a measured manner, which should keep structure and price supported through 2024.

Commodities Complex: Prices likely to rise on uncertainty

Although each commodity is driven by its own idiosyncratic factors, there is a broad theme playing out across the complex — that the exploitation phase has come to an end and the lack of capital investment over that time period is now being reflected in tightening supply. As we move into the early stages of the investment cycle, which has been slow to start due to producer discipline and a regulatory environment that remains difficult, to put it mildly, for extractive industries, we note that commodities have other tailwinds. A world where inflation is more volatile, where geopolitical competition is rising, and where energy transition is ongoing, amongst other factors — that is a world wherein commodities should fare well.

Outlook on Currencies

Politics and implications

TD Securities, Global Rates, FX & Commodites Strategy

Since June 27, market and media discussions have shifted to the U.S. election and associated policy implications. Harris stepping up as Democrat's Presidential nominee has lowered the odds of a Red sweep. Yet, many are wondering if the Trump trade has started to hit markets and what are the signs. We believe that currency markets have not fully priced in a potential Trump presidency but the contours are clear.

Recent events in other countries confirm the importance of local politics on markets; South Africa, India, Mexico and France are not isolated events. They connect to a larger meta-theme, linking geopolitics, globalization, and financial markets. This rise in geopolitical uncertainty may challenge the Goldilocks narrative, which we believe is living on borrowed time.

In our last quarterly update, we noted that the next macro regime was starting to take shape, although the 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 dominate this year.

Having said that, most recently, markets have been keen to enjoy the slide in US data surprises, especially the latest CPI reading. Our factor performance shows a recent pickup in carry, but the clear trend in the past few months has been the pivot towards mean-reversion.

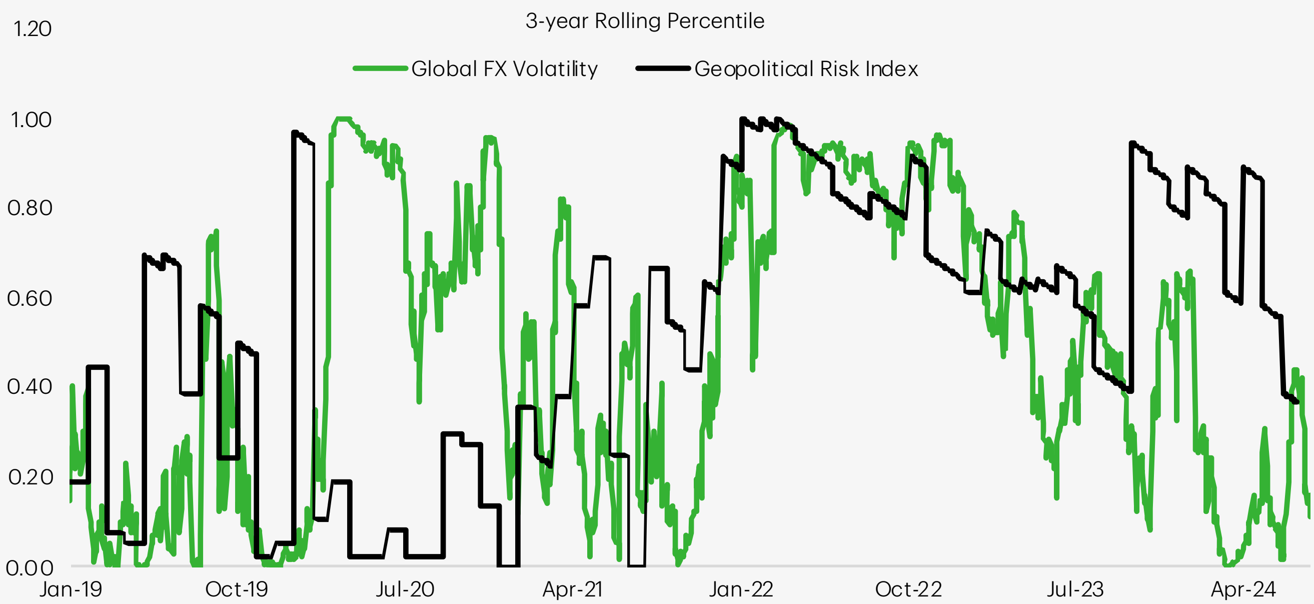
Market Euphoria: What Could Go Wrong?

Performance in currency markets over the past few months has been inconsistent. Terms of trade was the best performing strategy for a few weeks in June/July, but the key story has been the importance of mean-reversion. This tells us again that markets lack conviction and are plagued by uncertainty, leaving markets in a trading range. As we noted last quarter, the pace and path in currency markets will likely remain non-linear.

Global data surprises are negative for the first time in a year. With a market that lacks patience, the slower-moving political economy narrative favours a strong USD and higher volatility through the fall.

Political and economic uncertainty should start to weigh on sentiment again, underscoring risks to the Goldilocks backdrop. In the very near term, the softening economic data in the U.S. could create some volatility in the greenback. While it may be too early to have an outright bullish view on the U.S. dollar through the next month, we continue to believe any dips will be temporary and the U.S. dollar will recover through 2H of the year on the growing importance of the political economy backdrop. Overall, we remain bullish the US dollar versus G10 and most of the EM world, reflecting the carry unwind and a rising risk premium.

Figure 1: Busy geopolitical calendar this year



Source: Macrobond, Wealth Investment Office as of July 23, 2024

At the same time, we are watching market expectations as convictions are low, there are simply too many offsetting and game-changing forces operating at the same moment for investors to have strong conviction in any scenario.

The world is on edge and hoping that something doesn't break in the next six months that undermines the Goldilocks phase, shifting markets into a new phase. We could have a few more weeks of calm, but we don't think it will last for the remainder of the year.

Bank of Canada: Back to Back

The Bank of Canada's second policy rate cut on July 24 was well telegraphed and largely expected. Not surprising, it has pushed the Loonie a bit lower, but overall the moves are in-line with expectations. We didn't expect to see any major discrepancies to positioning or short-term valuation that would have generated more significant moves.

The Bank has been adamant that it will take its policy decisions one at a time after stepping off the fence in June, but it also has a well established history of back-to-back moves to begin a cycle. However, the recent uptick in core inflation momentum may result in a more balanced tone from the Bank from here.

Given our view that volatility will increase through the fall as we approach the U.S. federal election, we believe that the U.S. dollar will be the beneficiary of that volatility while the Canadian dollar may be vulnerable to underperformance.

Figure 2: Foreign Exchange Forecasts for G10 Currencies

	2024			2025	
	23-Jul-24	**Q3 F**	**Q4 F**	**Q1 F**	**Q2 F**
USD/JPY	156	155	150	140	137
EUR/USD	1.09	1.05	1.03	1.02	1.04
GBP/USD	1.29	1.25	1.22	1.20	1.22
USD/CHF	0.89	0.92	0.93	0.92	0.91
USD/CAD	1.38	1.40	1.41	1.42	1.40
AUD/USD	0.66	0.64	0.62	0.61	0.62
NZD/USD	0.60	0.59	0.58	0.57	0.58
BBDXY	1257	1283	1294	1294	1274

Source: TD Securities as of July 23, 2024

Market Performance

		(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)
Canadian Indices ($CA) Return	**Index**	**1 Month**	**3 Months**	**YTD**	**1 Year**	**3 Years**	**5 Years**	**10 Years**	**20 Years**
S&P/TSX Composite (TR)	89,125	-1.42	-0.53	6.05	12.13	5.98	9.28	6.95	7.86
S&P/TSX Composite (PR)	21,876	-1.77	-1.31	4.38	8.54	2.75	5.95	3.74	4.81
S&P/TSX 60 (TR)	4,341	-1.77	-1.34	4.90	11.18	5.97	9.40	7.52	8.24
S&P/TSX SmallCap (TR)	1,378	-1.93	0.85	8.83	14.42	1.28	8.06	3.11	4.11
S&P/TSX Preferred Share(TR)	1930	-0.02	4.17	14.19	20.75	1.14	5.57	2.28	2.79
U.S. Indices ($US) Return									
S&P 500 (TR)	11,907	3.59	4.28	15.29	24.56	10.01	15.05	12.86	10.29
S&P 500 (PR)	5,460	3.47	3.92	14.48	22.70	8.31	13.17	10.79	8.14
Dow Jones Industrial (PR)	39,119	1.12	-1.73	3.79	13.69	4.27	8.02	8.80	6.83
NASDAQ Composite (PR)	17,733	5.96	8.26	18.13	28.61	6.93	17.24	14.93	11.40
Russell 2000 (TR)	11,000	-0.93	-3.28	1.73	10.06	-2.58	6.94	7.00	7.85
U.S. Indices ($CA) Return									
S&P 500 (TR)	16,283	3.83	5.35	19.38	28.76	13.64	16.05	15.70	10.42
S&P 500 (PR)	7,467	3.71	4.98	18.54	26.83	11.88	14.16	13.58	8.27
Dow Jones Industrial (PR)	53,495	1.36	-0.73	7.47	17.53	7.71	8.96	11.54	6.95
NASDAQ Composite (PR)	24,249	6.21	9.36	22.31	32.95	10.45	18.26	17.83	11.52
Russell 2000 (TR)	15,042	-0.69	-2.29	5.34	13.77	0.63	7.88	9.70	7.97
MSCI Indices ($US) Total Return									
World	16,310	2.07	2.78	12.04	20.75	7.38	12.32	9.73	8.78
EAFE (Europe, Australasia, Far East)	11,307	-1.59	-0.17	5.75	12.09	3.43	6.98	4.84	6.12
EM (Emerging Markets)	2,844	4.01	5.12	7.68	12.97	-4.68	3.49	3.18	7.64
MSCI Indices ($CA) Total Return									
World	22,304	2.31	3.79	16.01	24.82	10.91	13.30	12.49	8.90
EAFE (Europe, Australasia, Far East)	15,463	-1.36	0.81	9.50	15.87	6.84	7.91	7.48	6.24
EM (Emerging Markets)	3,889	4.25	6.15	11.49	16.78	-1.54	4.39	5.77	7.76

Currency									
Canadian Dollar ($US/$CA)	1.37	0.37	1.03	3.29	3.30	3.33	0.88	2.51	0.13
Regional Indices (Native Currency, PR)									
London FTSE 100 (UK)	8,164	-1.34	2.66	5.57	8.40	5.07	1.91	1.93	3.06
Hang Seng (Hong Kong)	17,719	-2.00	7.12	3.94	-6.33	-14.98	-9.10	-2.66	1.85
Nikkei 225 (Japan)	39,583	2.85	-1.95	18.28	19.27	11.19	13.22	10.07	6.21

Benchmark Bond Yields	3 Months	5 Yrs	10 Yrs	30 Yrs
Government of Canada Yields	4.66	3.51	3.50	3.39
U.S. Treasury Yields	5.36	4.38	4.40	4.56

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	461	0.38	1.30	2.55	5.13	3.06	2.18	1.52
FTSE TMX Canada Universe Bond Index	1,117	1.13	0.86	-0.38	3.69	-1.78	-0.05	1.90
FTSE TMX Canada All Government Bond Index	1,049	1.18	0.78	-0.89	2.75	-2.36	-0.56	1.60
FTSE TMX Canada All Corporate Bond Index	1,361	0.96	1.09	1.16	6.46	-0.09	1.40	2.73
U.S. Corporate High Yield Bond Index	289	0.89	0.92	2.26	9.56	1.02	3.19	3.71
Global Aggregate Bond Index	252	0.81	-0.07	-0.20	3.39	-2.03	-0.14	1.74
JPM EMBI Global Core Bond Index	512	0.61	0.10	1.78	7.99	-3.67	-0.97	1.82
S&P/TSX Preferred Total Return Index	1,930	-0.02	4.17	14.19	20.75	1.14	5.57	2.28

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	335	1.36	2.98	6.22	10.02	5.93	4.33	2.30
Credit Suisse Event Driven USD	876	0.52	1.55	5.81	10.98	3.38	5.57	2.89
Credit Suisse Global Macro USD	1,375	-0.93	-2.41	3.89	5.04	5.62	6.52	4.75
Credit Suisse Hedge Fund USD	831	0.62	1.48	6.86	11.02	5.29	6.21	4.26
Credit Suisse Long/Short Equity TR USD	1,071	1.54	3.51	10.46	15.48	5.91	7.25	5.30
Credit Suisse Managed Futures USD	426	-1.38	-2.30	7.59	6.84	8.26	6.73	4.59

Source: TD Securities Inc., Morningstar®, TR: total return, PR: price return, as of June 30, 2024

Endnotes

1. These forecasts tend to be fairly similar to others recognized as authoritative for the country at hand, such as the Congressional Budget Office for the U.S., or the European Commission for Europe. Using the IMF's figures means we can be more confident this is an apples-to-apples comparison.
2. European Council, (April 29, 2024) "Economic Governance Review: Council Adopts Reform of Fiscal Rules" https://www.consilium.europa.eu/en/press/press-releases/2024/04/29/economic-governance-review-council-adopts-reform-of-fiscal-rules/
3. European Commission. "Excessive Deficit Procedures – Overview": https://economy-finance.ec.europa.eu/economic-and-fiscal-governance/stability-and-growth-pact/corrective-arm-excessive-deficit-procedure/excessive-deficit-procedures-overview_en
4. EUR-Lex "Excessive Deficit Procedure (EDP): https://eur-lex.europa.eu/EN/legal-content/glossary/excessive-deficit-procedure-edp.html#:~:text=The%20aim%20of%20the%20excessive,of%20EU%20countries'%20fiscal%20policies
5. European Council, (April 29, 2024) "Economic Governance Review: Council Adopts Reform of Fiscal Rules" https://www.consilium.europa.eu/en/press/press-releases/2024/04/29/economic-governance-review-council-adopts-reform-of-fiscal-rules/
6. The objective is for the federal net debt-to-GDP ratio to be falling and a budget deficit no greater than 1% of GDP in the future.
7. "Building a Better Ontario: 2024 Ontario Budget" Page 13, https://budget.ontario.ca/2024/pdf/2024-ontario-budget-en.pdf