TD Wealth

U-Turns

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U-Turns.

What a journey! Returns so far in 2024, for both risk assets and risk-control assets, are set to be among some of the best in recent years. For many, it's the mirror image of 2022, when both equity and bond prices fell amid aggressive rate hikes.

This year's rally, on the other hand, comes compliments of a sharp policy U-turn that saw the Bank of Canada and European Central Bank begin to drop interest rates in June, followed soon thereafter by the U.S. Federal Reserve, which got aggressive with a 50-bp cut in September. As history shows, there are few things financial assets like more than falling interest rates, and this time has been no exception with both stocks and bonds performing well.

Another potential U-turn is the U.S. election, which could be a big one. It's interesting to see how docile markets have been in what we believe can be described as a generational election. While there are deep policy differences between the two parties and candidates, this election is about so much more than policy. This may be the most divisive U.S. election in modern history.

As such, it's a good time to revisit your portfolio allocation and ensure it remains appropriate to reach your long-term goals. An equity long/short and market-neutral strategy could help de-risk investors' equity allocations, and allocation to bonds and private assets could help cushion a portfolio's volatility should the risk of a "left-tail" event increase. Investors are cautioned against extrapolating forward from returns seen over the past two years.

Be well,

Brad Simpson
Chief Wealth Strategist, TD Wealth

Cracking Complexity

Complexity

Heads = Tails

The U.S. election could have enormous implications for international trade and corporate tax policy. The contrast between the two candidates couldn't be clearer, and yet the electorate is split down the middle. A true coin-toss election.

A/B = Higher Yields

Perhaps the only commonality between the candidates is their lack of concern for ballooning debt levels. Whether Trump cuts taxes or Harris raises spending, the result is the same when it comes to federal debt — and consequently long-term Treasury yields.

Beijing Bump

In late September, the Chinese government announced stimulus measures that included rate cuts and a spending package worth nearly US$300 billion. Chinese stocks surged over 20% on the news, but investors are likely still underweight Chinese stocks. Beijing has been reluctant to stoke speculation.

Trump Trade

Emerging markets, and China in particular, could be hit hard if the Republicans win the White House. Trump has vowed to raise tariffs and penalize offshoring. Given that 32% of U.S. imports come from China and Mexico, the imposition of trade barriers would be painful on both sides.

Surprising Strength

The U.S. economy is in much better shape than it has been at other points when the Fed began cutting rates. Wage growth is around 6% and the economy is still adding upwards of 180,000 jobs per month. Overall, the U.S. economy remains on solid ground with a soft-landing still the most likely outcome.

Too Many Doves?

The market has priced in approximately 150 bps of rate cuts over the next 12 months, but given continued economic strength, high wage growth and above-target core inflation, this may just be wishful thinking.

AI Arms Race

For investors worried about the AI boom petering out, consider the words of Alphabet's CEO, Sundar Pichai: "The risk of underinvesting is dramatically greater than the risk of overinvesting for us here." Cash-rich and forward-thinking tech giants are likely to keep this ball rolling

Santa, Baby

Since the global financial crisis, North American equities have risen more than 80% of the time in Q4. The Nasdaq has done so 87% of the time. This has been a tech-driven rally, so ... jingle jingle?

Adaptation

Adaptive Approach

The large majority of assets in any good investment portfolio should be allocated strategically, not tactically. That means adapting to challenges as they emerge, not positioning for challenges before they emerge.

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.

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.

Process Over Prediction

We manage investments based on a guiding set of principles designed to work in a world that's constantly changing. We focus on investor's goals and true diversification. We build resilient portfolios that aim to perform regardless of the environment.

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.

High-odds Proposition

Over the long term, it's been almost impossible to lose money on the broad market. The probability of making at least some money on the S&P 500 over a five-year period is 85%; over a 20-year period it's 100%.

PSQ4.2024 | Executive Summary

■ **House Views | Fixed Income, modest underweight (from neutral):** We believe that the forward path for the BoC is fairly reflected in Canadian interest rates, we expect modest low-to-mid single digit total returns for the bond market over the next 12 to 18 months. Nevertheless, against a backdrop of continued monetary policy easing, we expect that bonds will continue to provide diversification benefits, reduce overall portfolio volatility and preserve capital. ● **Equities, modest overweight (from neutral):** We expect positive earnings growth to continue to drive attractive relative returns over the medium term. While the U.S. market has been among the leaders year-to-date, equity returns have been broadly positive across many geographies and sectors. We believe current valuations are justified given the backdrop of modest economic growth and declining rates. ● **Alternatives, modest overweight (from neutral):** We believe that an allocation to alternative assets can benefit diversified portfolios especially when implemented over the long-term. 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.

■ **Quarter in Review |** In July, we warned that low market volatility was unjustified amid economic and geopolitical uncertainty, leading to investor complacency. ● **When the crowd turns.** By mid-year, U.S. equity market concentration was well documented, especially in tech. A semiconductor sell-off and geopolitical events triggered volatility, leading to a sharp market reaction. The yen carry trade and Japanese stocks also faced significant disruptions, causing notable market shifts. ● **Small cracks in the economy can be sealed**. Despite some weaknesses, the U.S. economy remains robust with GDP growing at or even slightly above the long-term trend. Employment data shows slowing growth, but public sectors are strong job generators. Inflation is normalizing, though risks remain from geopolitical events and policy decisions. Overall, a soft landing is still anticipated. ● **A segment of the population is suffering.** Monetary policy is a blunt tool for inflation. While a U.S. soft landing is likely, higher interest rates disproportionately impact lower-income households, necessitating careful policymaker action to avoid exacerbating wealth disparity. ● **Here comes the cut.** The Fed's 50-bp rate cut on September 18 was welcomed by investors, easing economic risks and providing relief for spending and investment. ● **Could a policy pivot finally happen in China?** In late September, China introduced significant monetary and fiscal policies to stimulate the economy and boost investor confidence. These measures included rate cuts, a reduction in down payments for second properties and liquidity support for share buybacks. Additionally, a US$300-billion fiscal package is expected to support the property market. These actions led to a rally in Chinese equities, despite ongoing geopolitical risks and investor caution.

■ **Economy |** The Bureau of Economic Analysis recently made annual benchmark revisions to its National Income & Product Accounts, which showed a stronger pace of economic and income growth in recent years, with a notable upgrade to personal income in H1/24. As a result, we now estimate that there's roughly US$350 billion of remaining excess savings — up from our prior estimate of US$100 billion. The larger cushion of savings alongside the upward income revision and September's surprisingly strong employment report suggests some upside to the consumer spending outlook, which is now expected to run closer to 2% in 2025.

■ **Fixed Income |** With the start of the rate-cutting cycle firmly in hand in Canada and the U.S., fixed income markets have delivered relatively attractive returns year to date, at around 4.27% for FTSE Canada Universe Bond Index. We have downgraded the overall asset class from neutral to modest underweight because we believe returns going forward will be largely in line with the historical average in the mid-single digits, largely composed of the coupon. ● **Within fixed income, we maintain our modest overweight view on domestic government bonds.** Canadian government bonds are attractive at current yields and offer opportunities for income generation and downside protection. We expect volatility in Canadian yields to subside as the outlook for the economy, the pace of policy rate cuts and the end point becomes clearer. ● **We remain modest overweight on investment-grade credit.** Investment-grade spreads are still tight overall and reflect a gradual softening of the global economic backdrop. We view Canadian investment-grade corporate bonds, with their slightly wider spreads, as more attractive than U.S. investment-grade. We expect softening economic conditions to widen spreads further (indicating that the market is pricing in more risk) but only by a modest amount given continued expectations for a soft landing. We remain focused 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 credit.** HY spreads are tight, reflecting their rich corporate valuations, and have little room to tighten further. We expect HY spreads to widen if the growth outlook deteriorates, although the improved quality of this universe should keep spreads from returning to previous recessionary levels. We continue to favour the higher-quality cohort of the HY credit market.

■ **Equities** | After a volatile third quarter in 2024, sparked by the unwinding of the yen carry trade, North American equities ended the quarter in positive territory, with the S&P 500 and S&P/TSX Composite gaining 5.5% and 9.5%, respectively. By the time the long-awaited U.S. Federal Reserve rate cut was announced on September 18, the S&P 500 had shot back to just below its all time high. The rally was further supported by new stimulus measures from the Chinese government and growing confidence of a soft-landing in the U.S. ● **Fourth-quarter outlook.** U.S. technology growth stocks have been driving this bull market cycle and they are likely to continue to do so if seasonal tailwinds persist. ● **The AI trade: Counter-cyclical spending drives revenue for semiconductor supply chain.** Developing generative AI models is costly, requiring significant capex for semiconductor-based infrastructure. Hyper-scalers like AWS, Microsoft Azure and Google Cloud are driving this spending, benefiting chipmakers like Nvidia. Despite volatility, counter-cyclical capex and seasonal tailwinds suggest continued market momentum, with semiconductor stocks poised for growth. ● **In Canada,** the significant rate cuts appear to be having the intended impact with signs of stabilization in the economy. Canadian equities are also attractive from a valuation perspective ● **International and EM equities: Economic stagnation, political crisis weigh on international equities.** International equities saw a subdued 0.3% performance in Q3, impacted by Europe's sluggish economy and Japan's yen carry trade reversal. Germany's manufacturing and auto sectors face structural challenges. Japanese equities are attractive long-term but face yen volatility. Global rate cuts may rejuvenate economies, but international equities remain underweight due to slow recovery. ● **Emerging markets: Will China sustain the equity rally?** Emerging-market equities, led by China, saw strong growth in Q3 2024, driven by significant stimulus measures. The People's Bank of China cut lending and mortgage rates, boosting liquidity and real estate confidence. Despite these gains, structural issues in China's real estate sector and political risks in Brazil and Mexico pose challenges. India continues to show strong performance, driven by ambitious growth plans.

■ **Alternatives** | High capital costs have reduced liquidity for private-market buyouts, lowering prices and creating opportunities for specialized managers. Despite tight monetary conditions, North American buyouts have shown strong returns. Higher interest rates have led to more secondary-market transactions. The IPO market is recovering, and successful private-equity investments, like Blackstone's acquisition of AirTrunk, highlight the sector's potential. ● **Private credit.** Strong capital inflows and investment bank reengagement have tightened spreads for sponsor-backed direct lending, with new issuances at multi-year highs. Leveraged finance issuance in 2024 is expected to exceed $1 trillion, driven by refinancing and repricing. Despite tighter spreads, returns remain strong, with North American direct lending outperforming public markets. Refinancings have surged, and private-equity firms are extracting cash from portfolio companies amid sluggish exit activity.

■ **Currencies** | The market's 2024 memes have been disrupted by data, emphasizing unexpected trends, volatility and U.S. election risks. **The World in a Nutshell.** Investors are confused about currency markets, focusing on mean reversion due to a changing macro regime. The U.S. election and economic data are key factors, with inflation and volatility surprising markets. The U.S. dollar is expected to rally short-term, but the market faces uncertainty, especially with potential political changes. The past straightforward FX performance regime is likely over, shifting focus to new dynamics. **Bank of Canada: Further cuts coming.** The Bank of Canada cut rates by 50 bps on October 23, aligning with expectations despite mixed economic signals.

■ **Commodities** | The Bloomberg Commodity Index rallied nearly 10% due to rebounding oil, metals and gold prices, driven by monetary easing and geopolitical tensions. ● **Energy: Geopolitics keep oil bubbling.** Oil was in a downtrend due to anticipated 2025 balances, but geopolitical risks and tight inventories could drive prices higher. ● **Metals:** Gold rises on structural shift, base metals riding high. Gold prices hit all-time highs due to Fed cuts and central-bank easing. Emerging-market central banks' gold buying supports demand. Base metals rebounded in Q3, driven by improved fundamentals and economic stimulus. ● **Grains and softs:** Poor weather outside U.S. lift softs. Corn, soybeans and wheat hit four-year lows due to record U.S. harvests. Dry weather in Brazil and Vietnam raised coffee and sugar prices to multi-year highs.

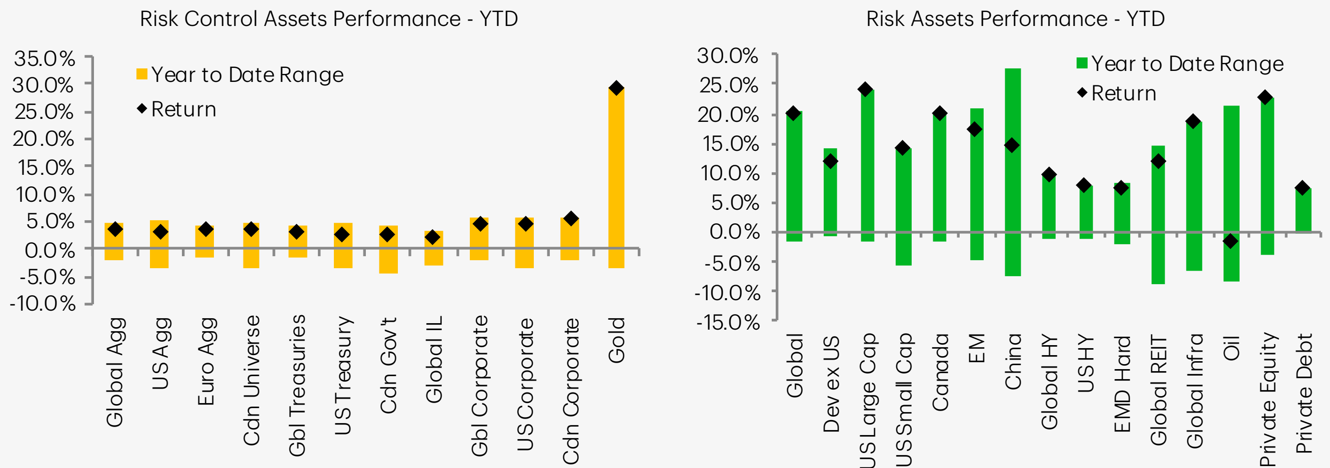
U-Turns

Brad Simpson, Chief Wealth Strategist | TD Wealth

What a journey! With less than three months to the end of the year, returns so far in 2024, for both risk assets and risk-control assets, are set to be among some of the best in recent years. For many, it's the mirror image of 2022, when both equity and bond prices fell amid aggressive rate hikes.

This year's rally comes compliments of a sharp policy U-turn that saw the Bank of Canada and European Central Bank begin to drop interest rates in June, followed soon thereafter by the U.S. Federal Reserve, which got aggressive with a 50-bp cut in September. As history shows, there are few things financial assets like more than falling interest rates, and this time has been no exception with both stocks and bonds performing well (Figure 1). And the same can be said, incidentally, for our Wealth Strategy portfolios (Figure 2).

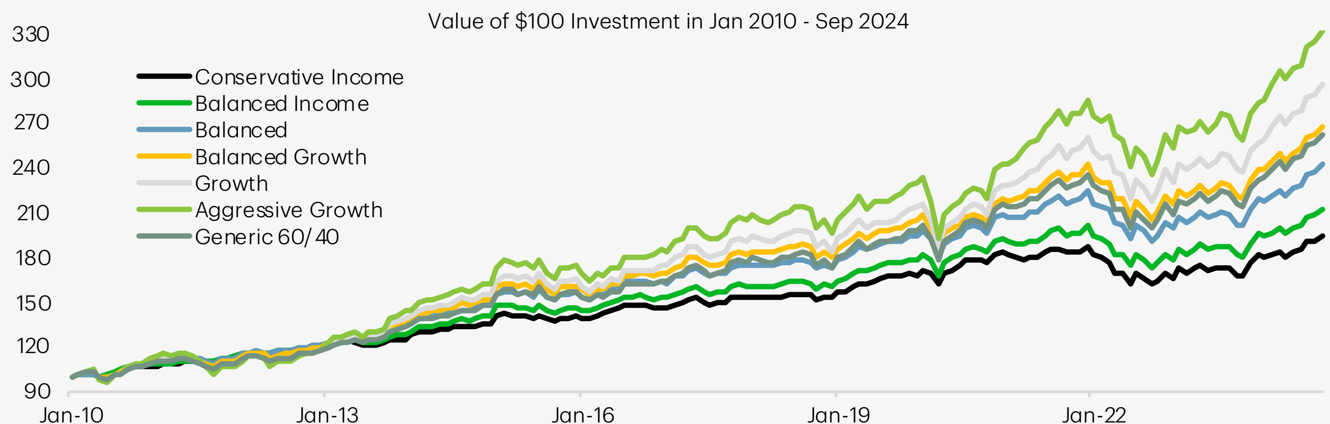
Figure 1: Both risk assets and risk-control assets have outperformed



Source: FactSet and Wealth Investment Office as of September 30, 2024

Figure 2: Wealth Strategy Process Returns (Q3, YTD)

	Q3/24	Q1-Q3/2024
Conservative Income	5.2%	7.6%
Balanced Income	5.5%	8.7%
Balanced	5.9%	10.6%
Balanced Growth	6.2%	12.5%
Growth	6.5%	14.9%
Aggressive Growth	7.2%	17.0%
Generic 60/40	5.5%	12.6%



Source: FactSet and Wealth Investment Office as of September 30, 2024

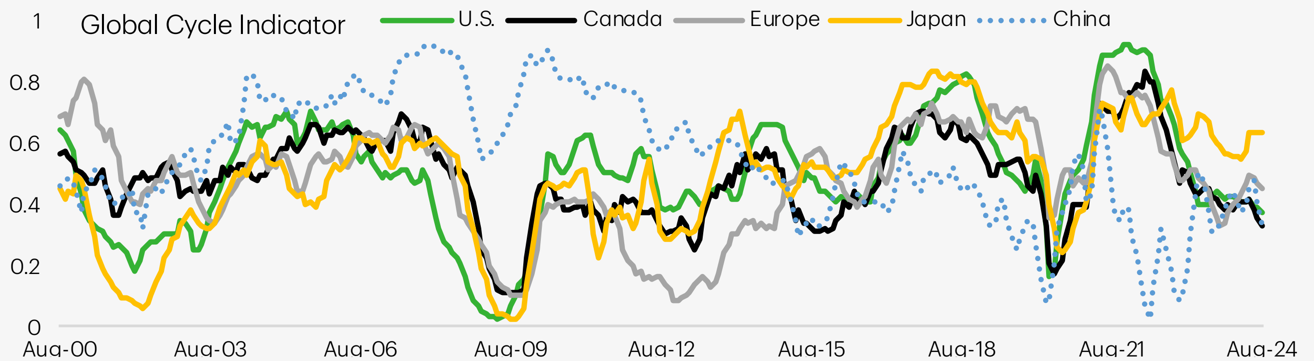
To really understand what drove this policy U-turn we begin by looking at our Global Business Cycle Indicator, which is a summary of numerous economic gauges (Figure 3). Recent readings indicate that the U.S., Canadian and European business cycles, after stabilizing around the historical median in Q4/23, resumed a downward trend in the past quarter. In Europe, PMIs are falling again, with manufacturing activity muted and the service sector starting to slow.

The overall economic picture in Canada is a bit more mixed, with Q3 growth still tracking below the BoC's forecast and the latest inflation data well below target. On the positive side, the most recent S&P Global Canada manufacturing PMI rose to just above the expansionary 50 threshold in September, signalling the first improvement in operating conditions since April 2023. There is also some strength coming from the jobs market, with wage growth running above inflation, which should be supportive of consumer spending.

Including its recent cut of its overnight rate by 50 basis points, to 3.75%, the Bank of Canada has telegraphed further cuts, and with the shifting economic data, they have room to deliver. European economic data is also softening, with inflation at target, so we expect the ECB to deliver another 25-bp cut at its meeting in December. Japan is the outlier, where growth and the labour market remains strong, although the country's inflation, after hovering above target for much of 2024, also fell in September. The strong domestic Japanese economy vis-à-vis the rest of the world is the reason we are seeing monetary policy divergence between the Bank of Japan and other developed countries' central banks. With recession nowhere in sight and bond yields trending lower, analysts expect valuations in U.S. equity markets to remain steady and earnings to grow around 13% next year.

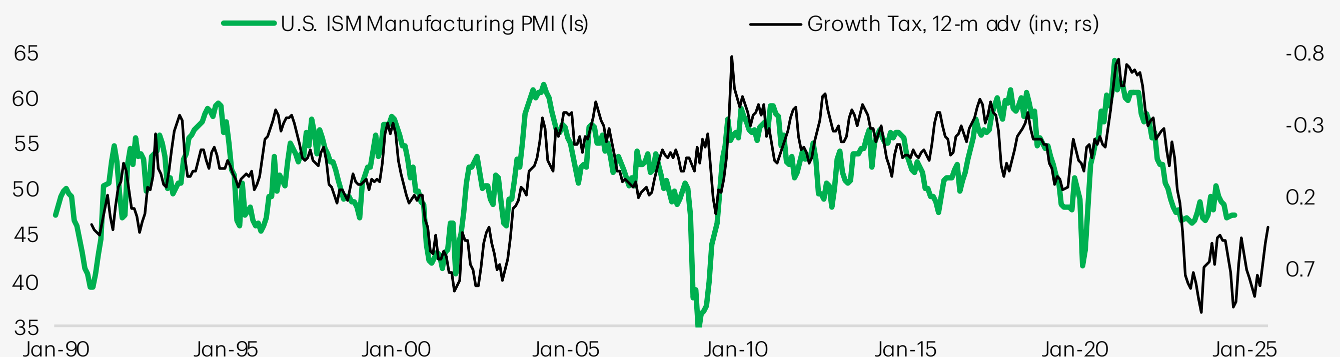
The U-turn in monetary policy also has implications for the real economy, potentially bolstering activity in the more cyclical and rate-sensitive sectors. Activity in the manufacturing and housing sectors is still weak but have been improving since the beginning of this year. Following the pandemic-associated lockdown, the manufacturing sector has been experiencing a dramatic boom/bust cycle that has led to an overbuilding of inventory and hence weak new orders. This excess inventory has been unwinding since H2/23. If economic activity firms up in China and across Europe, we could see stronger goods demand next year, which would benefit the industrial sector. In addition, our growth tax indicator — the average of the WTI oil price, the DXY dollar index and the U.S. 10-year yield — is improving, and points to a potential rebound in manufacturing activity (Figure 4).

Figure 3: Business cycle resuming its downward trend (ex Japan)



Source: Macrobond and Wealth Investment Office as of September 30, 2024

Figure 4: Manufacturing set to rebound next year amid monetary easing



Source: Macrobond and Wealth Investment Office as of September 30, 2024

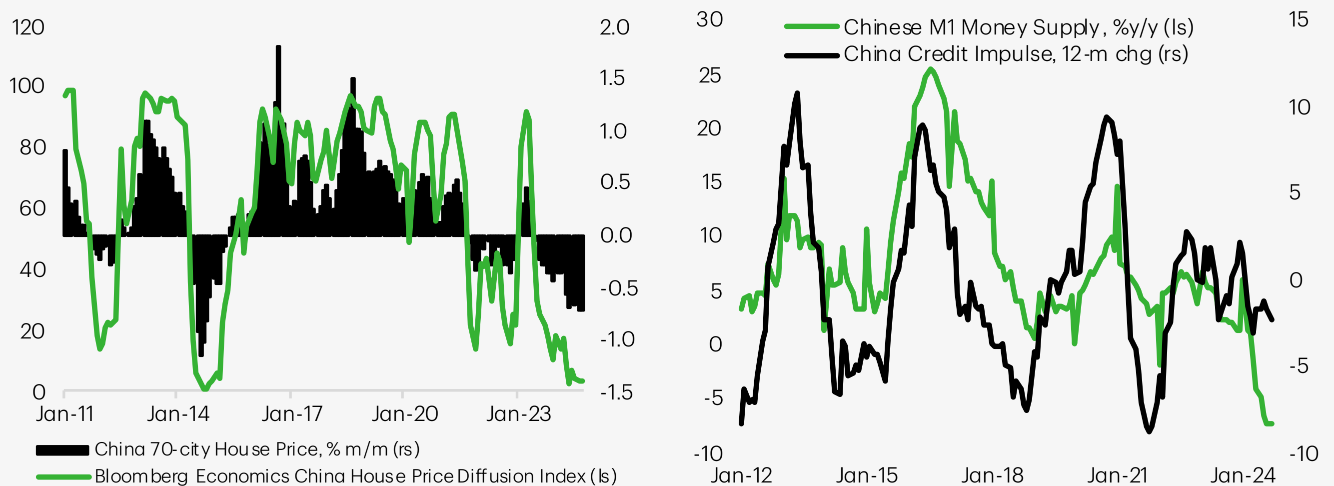
The case for a cyclical rebound in the global economy is even stronger following the announced policy stimulus out of China in early October, which essentially is a policy U-turn from Beijing's relatively passive stance over the past two years in dealing with the domestic property-sector crisis and weak consumer demand. The backdrop of rising youth unemployment, falling property prices and weak credit growth is forcing policymakers to act with greater urgency (Figure 5).

Although the specifics remain unclear, Chinese policymakers aim to further reduce the bank reserve requirement ratio, mortgage borrowing rate and medium-term loan rate — all of which should stimulate credit growth and lower the interest-rate burden for both companies and households. Policymakers said that the central government has more room to borrow and raise its fiscal deficit if necessary, and the government is also recapitalizing state-owned banks, which have suffered from compressing net interest margin and rising loan delinquency. Importantly, China's ministry of finance is said to be planning the issuance of special sovereign bonds worth 2 trillion yuan (US$284 billion, or 1.6% of China's GDP) this year to stimulate consumption and help local governments tackle debt problems, on top of the 1 trillion yuan pledged earlier this year. After two years of disappointment, the world's second largest economy is potentially at a turning point.

Focus on the U.S. Landscape

Among all these sharp turns, we think the biggest and most important thing to watch is the direction of the United States. Let's start with the economy. There are many reasons to believe that the U.S. economy will continue to travel towards a soft landing. To help map this out, consider Figure 6. This visualization tracks changes in employment, inflation, leading indicators, cyclical-sector activity, consumer spending, housing sector and credit growth. Each data point is converted into a percentile range starting in 1990 or the earliest measure possible after 1990, with higher percentiles denoting better performance. Simply put, the further the lines are to the outside of the circle, the better.

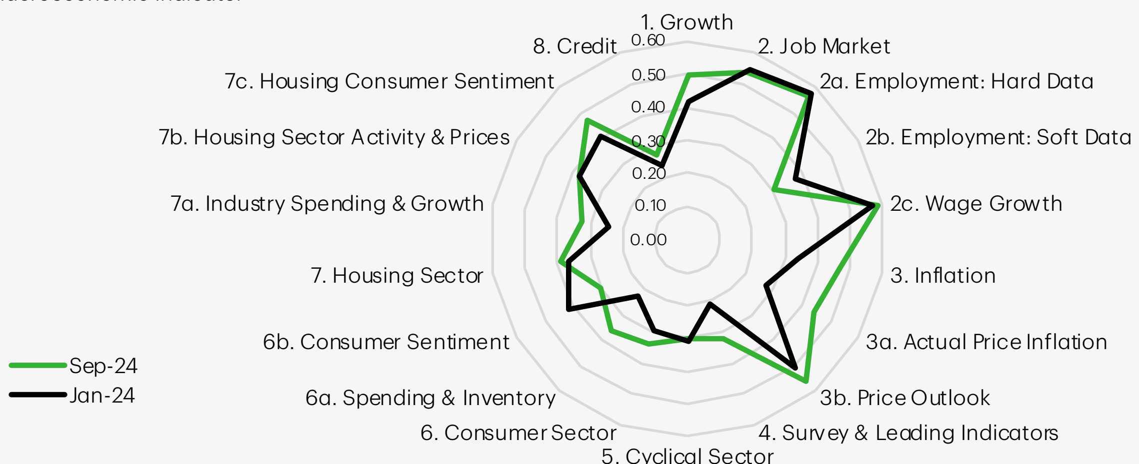
Figure 5: Chinese property-sector crisis still severe, credit impulse muted



Source: Macrobond and Wealth Investment Office as of September 30, 2024

Figure 6: Most U.S. macro indicators have improved

U.S. Macroeconomic Indicator

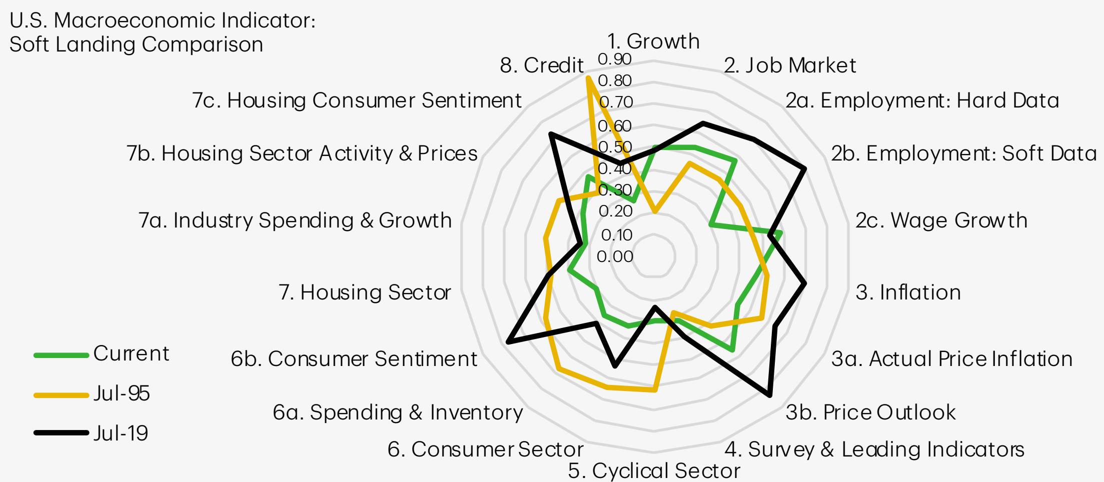


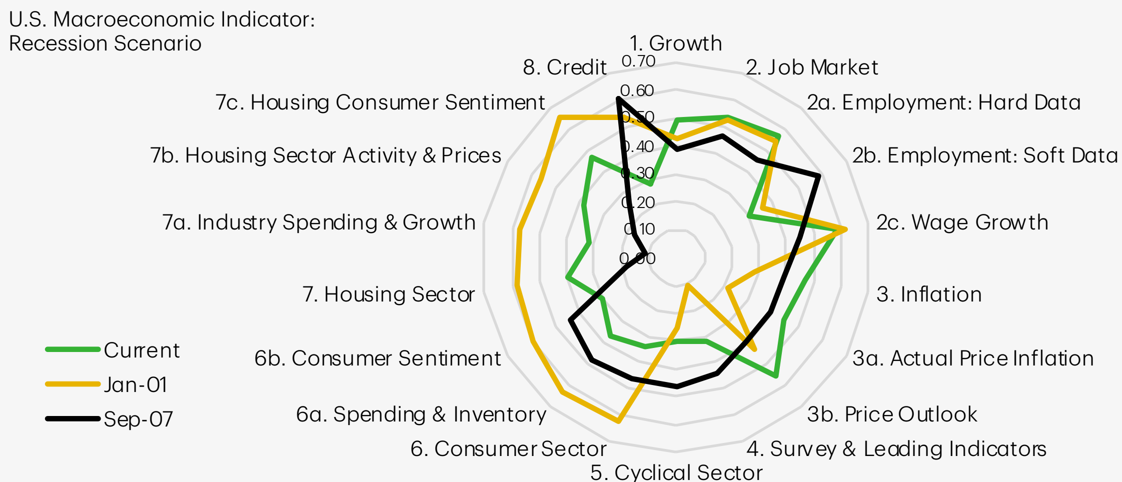
Source: Macrobond and Wealth Investment Office as of September 30, 2024

Compared to the beginning of the year, most indicators have seen slight improvement, with inflation seeing the largest positive change (currently in the 44th percentile from the 28th in January 2024). The score for employment fell slightly, with the outlook for employment declining to the 30th percentile from the 37th. Now, in this case, the decline is positive, in the sense that the prior overheated labour market has begun to cool. (As you can see, reading of these gauges takes some nuance, which I think bodes well for my future employment).

For context let's compare the current easing cycle to the previous easing cycles in 1995, 2001, 2007 and 2019 (Figure 7). To do this we divided these cycles into two scenarios: (1) soft-landing scenario (July 1995 and July 2019 cycle); and (2) hard-landing scenario (recession, January 2001 and September 2007 cycle).

Figure 7: Macro Indicators at the Start of Prior Easing Cycles





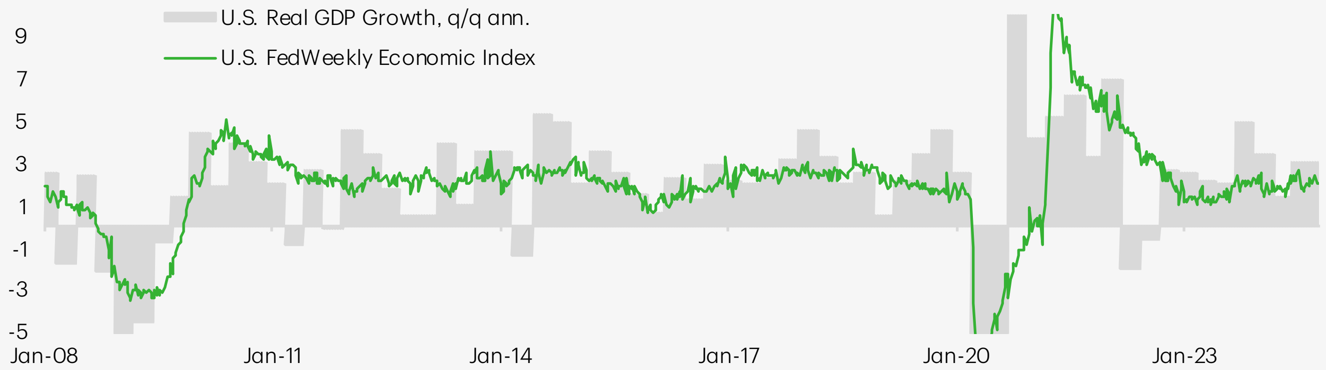
Source: Macrobond and Wealth Investment Office as of September 30, 2024

Consideration 1: Growth and Job Market

Growth conditions today are in a much better spot compared to the beginning of the four previous monetary easing cycles. Our growth indicator currently stands in the 50th percentile, supported by strong economic growth in Q2 (3.0%, q/q annualized) and the Dallas Fed's Weekly Economic Index at 2.1% (Figure 8). Given that both indicators are still above the 2% growth rate considered to be trend, a majority of economists and investors think the risk of recession is low. This view is also shared by TD Economics.

As for employment, the data show that we are currently in a decent spot — better than during the easing-cycle kick-offs that occurred in July 1995 and September 2007, but very similar to the one that started in January 2001. It should be noted, however, that "decent" is in the eye of the beholder. Much of the political debate (and dare I say, vitriol) in the U.S. has been about the state of the economy and in particular the jobs market.

Figure 8: Weekly Economic Index points to growth above 2%



Source: Macrobond and Wealth Investment Office as of September 30, 2024

While there's a lot of rhetoric, the devil is often in the details and the details are often one of the first casualties in any political campaign.

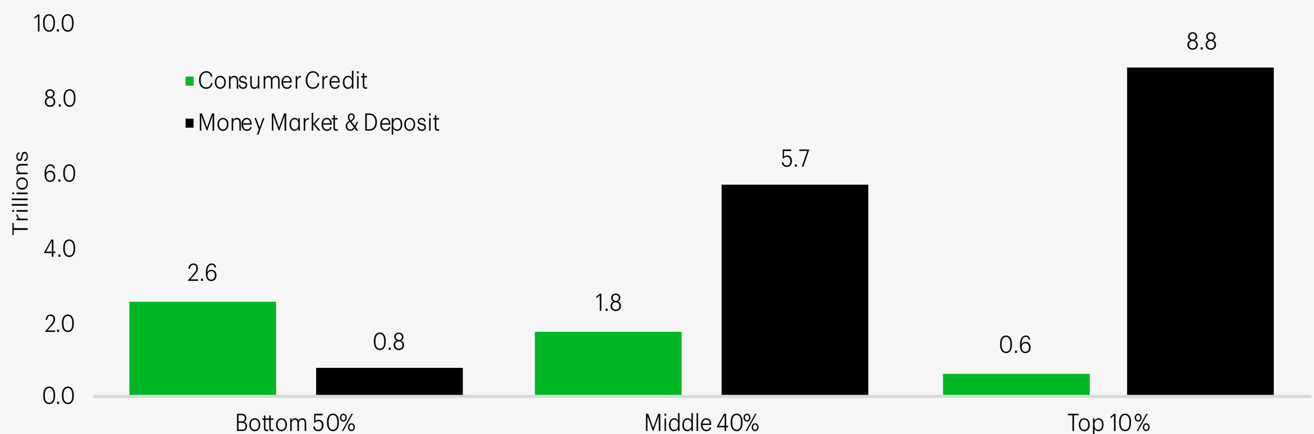
Although a soft landing is the most likely scenario in the U.S., that doesn't mean there will be no collateral damage in the economy. Monetary policy, after all, is a blunt tool for addressing inflation. We know on aggregate that growth and employment is slowing, but who among the general population are most negatively impacted by higher interest rates? The answer is important not only to investors, but also to policymakers, who could take such considerations into account when determining the best path forward.

Figure 9 shows the amount of cash and consumer credit held by U.S. households in Q2/24 based on Fed data. Despite higher interest rates, the wealthiest 10% of the U.S. households continued to do well, with more cash in the bank to earn higher interest while carrying a relatively small amount of consumer debt. On aggregate, they are likely better off with the higher interest rates. This is probably why we saw luxury and experiential spending skyrocket during the latest rate-hiking cycle.

The bottom half of U.S. households, meanwhile, have struggled with very low cash levels and much higher consumer credit. And aside from the impact to their balance sheet, higher inflation over the past couple of years has meant that grocery and gas bills, the essentials, were higher. Purchasing power is diminished by inflation, while debt-servicing costs are raised. While there's no doubt that inflation had to be stopped, the unprecedented speed of rate hikes has come at a price. In the long term, credit restriction was the lesser of two evils, even for those who felt more pain, but it's hard to explain that kind of nuance on a campaign sign or in a sound bite.

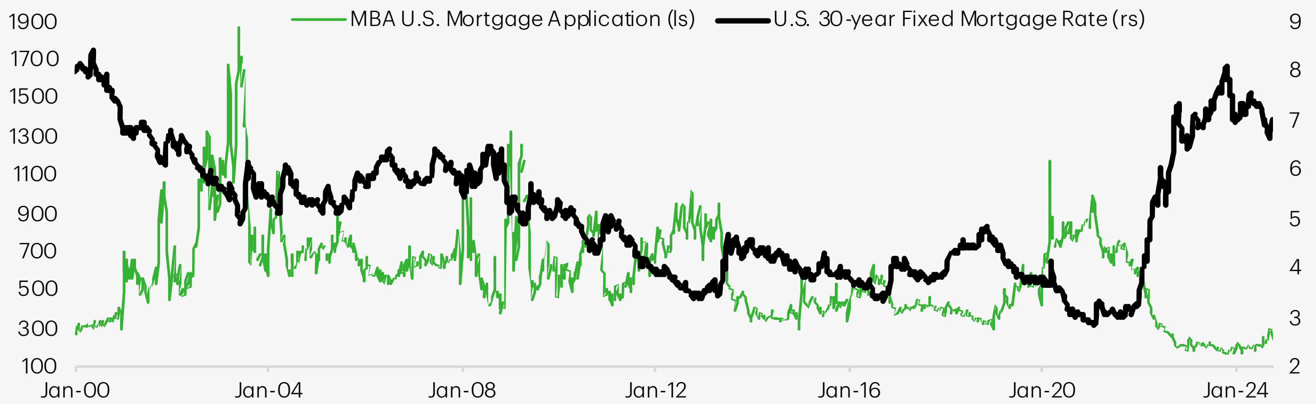
Lastly, it's interesting to note that the 2001 easing cycle coincided with the bursting of the tech bubble and ended with a shallow recession. Hard data on employment, which includes actual job gains and job openings, is currently in the 57th percentile, as it was in 2001. Soft data is around the 30th percentile and wage growth is around the 58th percentile. The cyclical sector is a tad stronger today, but the consumer and housing sector is in worse shape compared to the 2001 easing cycle (Figure 7).

Figure 9: Consumer Cash vs. Credit by Wealth Percentile



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

Figure 10: Lower mortgage rates could stoke activity in the housing sector



Source: Macrobond, Wealth Investment Office as of October 2024

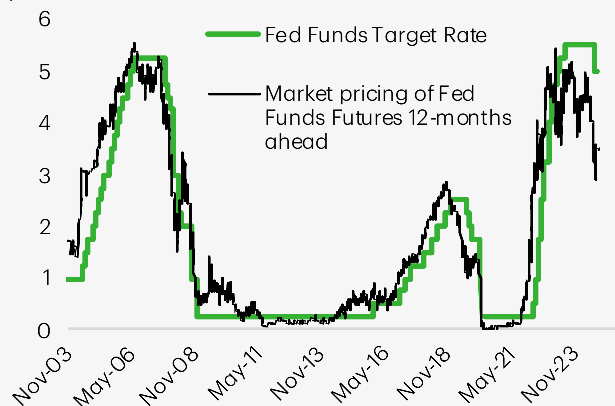
Consideration 2: Cyclical and Housing Sectors

Compared to the past four rate-cutting cycles, the score for the cyclical sector today is in between. As for the all-important U.S. housing sector, we are looking for the market to improve. The impact of 550 bps of rate hikes and elevated property prices following the pandemic boom are clearly visible across our indicators. Compared to September 2007, though, the housing sector is in better shape (39th percentile today versus 18th). Mortgage applications and housing transactions have fallen over 70% since the Fed started hiking in 2022, but U.S. house prices have been holding up. Lower rates and a resilient labour market could lead to a rebound in activity (Figure 10).

Consideration 3: Leading Indicators and Consumer Credit

Among the worries plaguing the market today are the manager and consumer surveys and the leading indicators, which have worsened significantly over the past two years even as the economy stayed strong. The aggregate of leading indicators is currently in the 32nd percentile, higher than at the start of easing cycles in 1995 and 2001. The consumer sector, currently in the 34th percentile, is also notably weaker compared to the outset of the past four rate-cutting cycles — weighed down by slower retail spending on goods. However, services spending has been holding up, which has supported personal consumption expenditure growth. With core PCE inflation running around 2%, nominal income growth at 5.6% and personal consumption growth at 5.2%, this implies consumer spending of around 3% — not far from the Atlanta Fed's GDPNow estimate. Finally, credit growth has been weak, with consumer credit growing only 2.3% y/y and commercial/industrial loan growth slightly negative. The ongoing easing cycle should boost this metric going forward.

Figure 11: Bond market is pricing an aggressive easing cycle



Source: Macrobond and Wealth Investment Office as of September 30, 2024

All in all, however, these are prosperous times in the United States. The U.S. economy continues to grow at an above-trend rate, and central bankers are confident that inflation will continue to move towards its target. In September, the market was pricing in as much as 250 bps in cuts over the next 10 Fed meetings (Figure 11). While many investors, including me, remain skeptical that the Fed will do so, it did start with a bang — lowering the upper bound of the federal funds target rate by 50 bps versus an expectation of 25 bps at the beginning of July. The good news is that lower rates will be a tailwind. Add to this the fact that there is greater urgency by Chinese policymakers to reflate its economy, and the case becomes even stronger for a rebound in the coming quarters of the more cyclical parts of the economy.

What about the U.S. election?

If you are looking for another potential U-turn, the upcoming U.S. election has to be a big one. I confess I have been amazed by how docile markets have been in what can only be described as a generational election. We all know there are deep policy differences between the two parties and candidates (Figure 12). This election, however, is about so much more than policy.

Figure 12: Trump and Harris Policy Agenda

	Trump	Harris
Tax Policy	Trump proposes extending the 2017 Tax Cuts and Jobs Act (TCJA) and implementing additional tax cuts. His key initiatives include:	In contrast, Harris supports:
	Extending individual income tax provisions of TCJA	Raising taxes on corporations and high-income earners
	Eliminating taxes on Social Security benefits	Expanding tax deductions for small businesses
	Lowering the corporate income tax rate to 15% for corporations that make their products in America.	Restoring and expanding the earned income tax credit and child tax credit, including a $6,000 child tax credit for newborns
Economic Approach	Trump emphasizes deregulation and fossil fuel production to stimulate economic growth. He promises to:	Harris focuses on government investment and targeted support for specific groups:
	Increase domestic oil and gas production	Building 3 million affordable new homes and rentals
	Implement tariffs on imported goods	Providing down-payment assistance for first-time homebuyers
		Supporting a federal ban on corporate price gouging in grocery and food industries

	Healthcare Policy	
Affordable Care Act (ACA)	Trump's stance on the ACA is somewhat ambiguous. While he has previously sought to repeal and replace it, he now claims he wants to:	Harris strongly supports the ACA and aims to:
	Build and improve on the existing law by making it less expensive and more efficient	Extend enhanced ACA marketplace subsidies
		Expand access to affordable coverage
Medicare and Prescription Drugs	Reviving the "most favored nation" rule for pharmaceutical pricing	Allowing Medicare to accelerate negotiations on prescription drug prices
	Addressing chronic illness through a Presidential Commission	Expanding the $35 monthly cap on insulin and $2,000 annual limit on out-of-pocket costs to all Americans

	Environmental and Energy Policy	
Climate Change Approach	Calls climate change a "hoax" and downplays its threats	Considers climate change an "urgent matter" and existential threat
	Promises to exit the Paris Climate Agreement again	Supports the goals of the Paris Climate Agreement
Energy Production	Trump advocates for increased fossil fuel production:	Harris supports a transition to clean energy while maintaining some fossil fuel production:
	Unlocking new lands for drilling	Advocating for a "clean energy economy"
	Expediting drilling permits and natural gas pipeline approvals	Not banning fracking, but supporting clean energy initiatives

	Immigration and World Defense	
Immigration Policy	Launching the largest deportation operation in American history	Reviving the bipartisan border security deal that collapsed in Congress
	Ending birthright citizenship for children of unauthorized immigrants	Supporting an "earned" path to citizenship for undocumented immigrants- Expanding legal immigration
	Implementing a "Trump Reciprocal Trade Act", under which if any foreign country imposes a tariff on American-made goods that is higher than the tariff imposed by the U.S., President Trump will have the authority to impose a reciprocal tariff on that country's goods.	
Stance on NATO and Allies	Trump has been more critical of NATO, urging allies to increase their defense spending. He has taken a more transactional approach to alliances, often questioning their value to the United States.	Harris strongly supports NATO, describing it as the "greatest military alliance the world has ever known" . She emphasizes the importance of maintaining and strengthening relationships with traditional allies.
Ukraine Conflict	Trump has suggested he could end the war quickly, potentially by pressuring Ukraine to cede territory to Russia. He has been more skeptical of continued aid to Ukraine, arguing it unnecessarily prolongs the conflict.	Harris pledges continued support for Ukraine against Russian aggression, emphasizing the importance of backing Ukraine's sovereignty. She supports ongoing military and financial aid to Ukraine.

For one thing, it underscores just how polarized the United States electorate has become. Figure 13 traces the divisive path the two major parties have been on since the mid-1960s. In a healthy political environment, differences remain small and on the margins as political parties adjust their policies to attract the majority of voters. In the United States today, however, there is very little common ground, due in part to a gerrymandered districting system that rewards extreme partisanship.

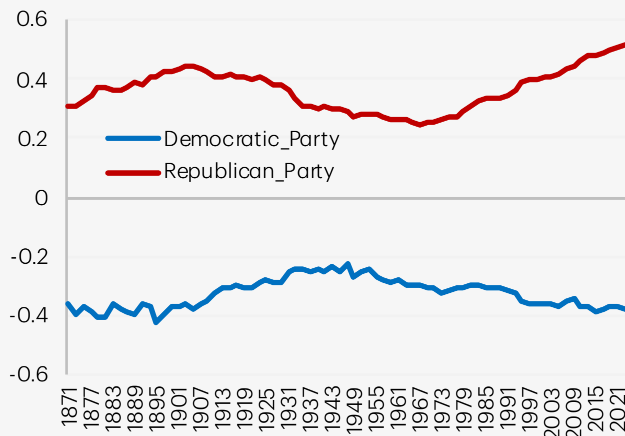
To provide context of this division, we have created the Partisan Division Index (Figure 14). The PDI quantifies the ideological distance between the two major U.S. political parties over time. Using NOMINATE (Nominal three-step estimation) scores — a system developed in the early 1980s by political scientists Keith Poole and Howard Rosenthal to measure legislators' ideological positions on a scale from -1.0 (liberal) to +1.0 (conservative) based on their voting records — we calculate the average ideological position for each party in each Congressional session.

For each session, we measure the ideological distance between the parties by finding the difference between their average NOMINATE scores. The PDI is then normalized to a scale of 0 to 1, where 0 represents minimal division and 1 represents maximum division. This normalized index allows us to track how partisan polarization has fluctuated across U.S. history, providing insights into periods of high or low division in Congress.

In simple terms, think of the PDI as a thermometer for U.S. political division: low PDI (closer to 0) indicates that the major parties are ideologically similar, suggesting bipartisan cooperation; high PDI (closer to 1) indicates significant ideological differences, reflecting greater partisan division.

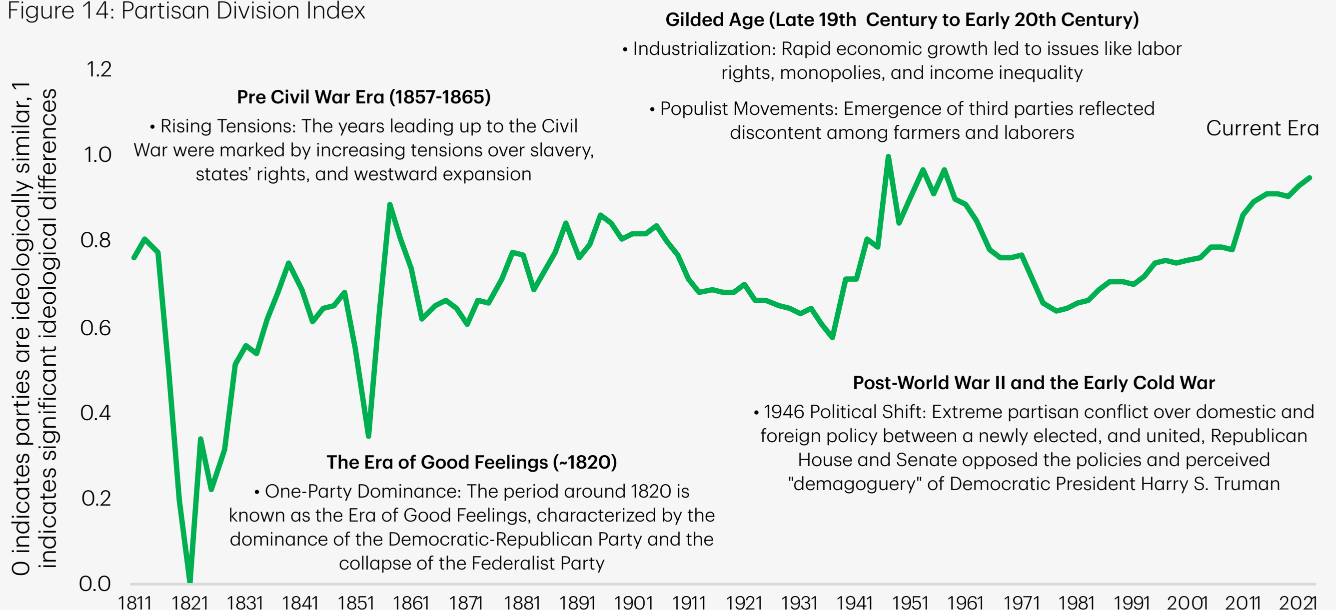
The current division is at levels typically reserved for periods of crisis like the Civil War, the Gilded Age and after the Second World War. In all three instances, the nation persevered and remained whole, and it will likely remain so after this period. I think it's fair to say, however, that while the States are a lot of things right now, "united" isn't one of them. This is important to investors because the U.S. is home to the world's largest economy and reserve currency, and its equity markets make up almost 70% of the global share (Figure 15).

Figure 13: Drifting Apart: Both parties drift from the centre



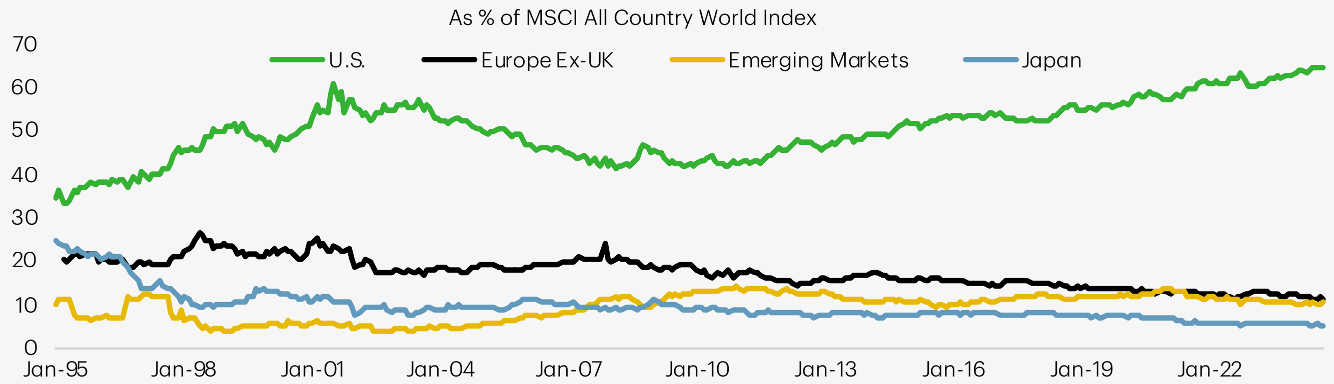
Source: Wealth Investment Office and Lewis, Jeffrey B., Keight Poole, Howard Rosenthal, Adam Boche, Aaron Rudkin, and Luke Sonnet 2024. Voteview: Congressional Roll-Call Votes Database - voteview.com as of October 16, 2024

Figure 14: Partisan Division Index



Source: Wealth Investment Office and Lewis, Jeffrey B., Keight Poole, Howard Rosenthal, Adam Boche, Aaron Rudkin, and Luke Sonnet 2024. Voteview: Congressional Roll-Call Votes Database - voteview.com as of October 16, 2024

Figure 15: U.S. proportion of global equity value has risen to all-time highs

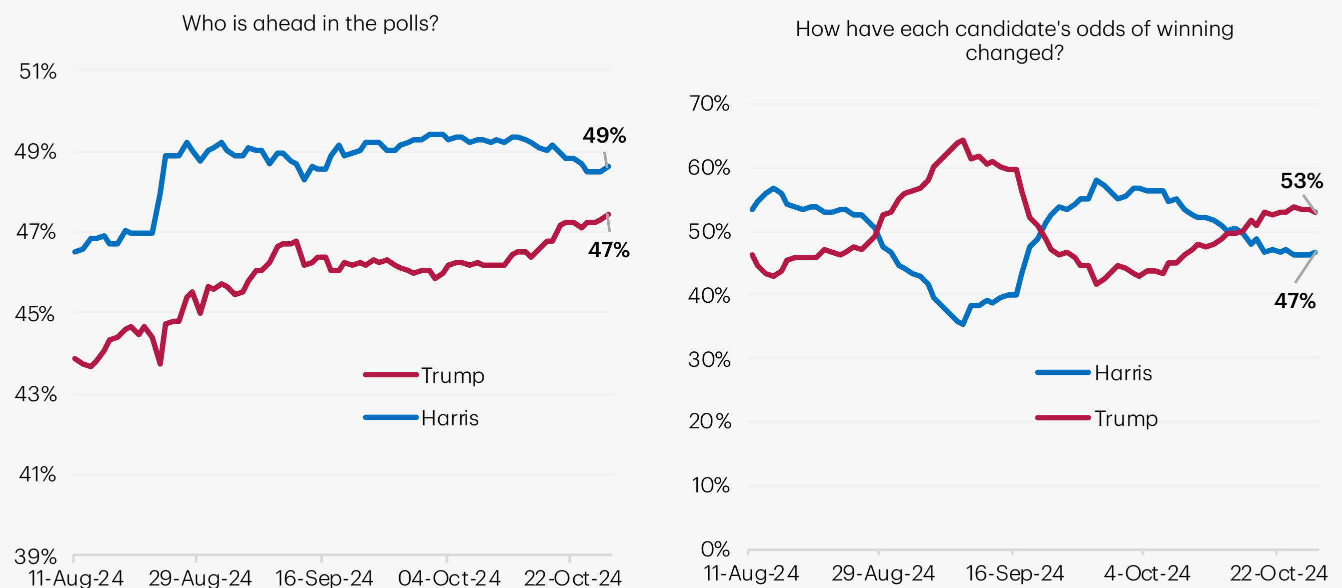


Source: FactSet and Wealth Investment Office as of September 30, 2024

What's more, the U.S. is the land of commerce, whose markets are backed by its constitution and rule of law. The rule of law, as opposed to the discretionary rule of politicians and bureaucrats, gives investors confidence that their capital is safe. Failure to maintain the rule of law can undermine the institutions that drive economic growth and prosperity. Taxation, fiscal policy, regulation, courts, the police and militaries are all beholden to the rule of law. This is the importance of this election. These are the things that make U.S. capital markets safe and its currency the foundation of trade around the world. The ramifications from events like January 6 and difficulties around the peaceful transfer of power all have an impact on financial markets. Markets like certainty, and this is certainly uncertain.

This election is a coin toss. Figure 16 utilizes Nate Silver's data to consider overall pools and the odds of winning based on the electoral college. As of October 27, 49% Harris, 47% Trump — it doesn't get closer than that. Investors can expect elevated uncertainty and market volatility as we approach election day. Both the Democratic and Republican candidates have run on the promise of ignoring fiscal discipline, although the fiscal deficit is expected to be larger under the latter. On the issue of taxation, who wins the election matters for the equity market because certain companies and sectors will see larger tax increases if the statutory corporate tax rate increases. There is, moreover, much to debate on each candidate's view regarding the wars in Ukraine and the Middle East, but both are expected to maintain their current hawkish stance on China. Despite all the political noise, however, we think the financial market will likely continue to be driven mainly by what happens to the U.S. economy — unless, of course, we encounter another U-turn during the transfer of power.

Figure 16: Probability of Winning the Presidential Election Based on Electoral College Math



Source: FiveThirtyEight, natesilver.net, Wealth Investment Office as of October 27, 2024

What to do about it? What we need to learn from 2016 is that we didn't know who was going to win. None of us knew. Initially markets fell, but then rose as areas of the market benefitted from the election of President Trump. Here at TD Wealth, we went overweight U.S. markets shortly following that election. We believe in adaptive markets, and we will make the decision on how to allocate the days around this election, as the outcome becomes clear. If there is a dramatic U-turn, we think the best way to manage for this potential is to stick to your process, adapt to what's in front of you, and make sure you own a well-diversified investment portfolio. We do expect to see ongoing spikes in volatility, though, over the next few months.

Closing Thoughts

The bottom line is that, so far, growth has remained resilient, and the job market, although softening, has yet to flash a warning sign. With policy-rate cutting underway and a greater urgency by Chinese policymakers to reflate its economy, we expect that the more cyclical manufacturing and housing sectors to rebound in the coming quarters. However, a faster-than-expected deterioration in the U.S. labour market continues to pose a risk to the U.S. and global economy, which to an extent depends on the ability of U.S. consumers to keep spending.

Gains in the equity market have been considerable over the past two years, especially in the U.S., and expectations are high, which is dependent on an economic soft landing. Equity valuations are above historical average levels. Meanwhile, spreads across fixed income products are also tight, and returns in the bond markets this year have been strong. Investors are cautioned against extrapolating the returns seen over the past two years.

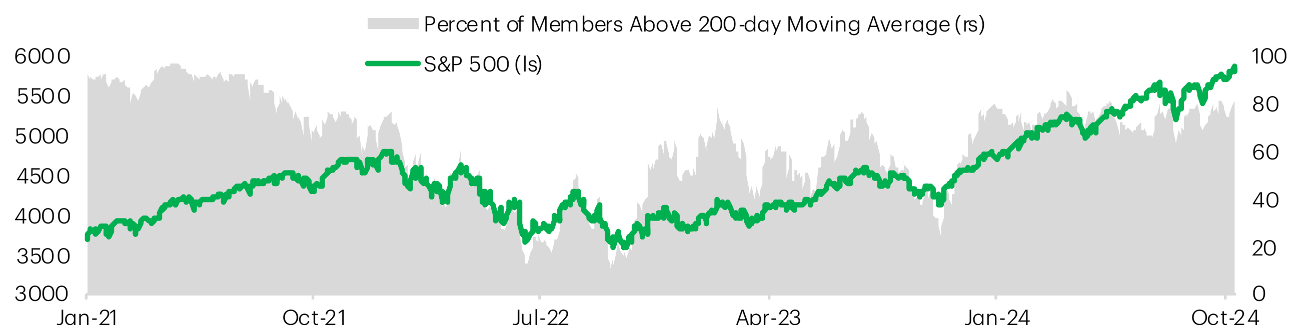
It is a good time to revisit your portfolio allocation and ensure it remains appropriate to reach your long-term goals. An equity long/short and market-neutral strategy could help de-risk investors' equity allocation, and allocation to bonds and private assets could help cushion a portfolio's volatility should the risk of a "left-tail" event increase. Finally, a multi-strategy hedge mandate is a good diversifier to which many investors have little exposure and is worth due consideration.

Positioning & Mandates

Fixed income (modest underweight). With the start of the rate-cutting cycle firmly underway in Canada and the U.S., fixed income markets have delivered relatively attractive returns year-to-date. As such, we have shifted our fixed income position to modest underweight. We believe returns going forward will be closely aligned to current yields in the mid-single digits. At the same time, the risk of a more severe economic slowdown looks less and less likely, which may keep returns in the fixed income market more rangebound over the next 12 months. Overall, we believe bonds will continue to provide the benefits of diversification, reduce overall portfolio volatility and preserve capital. However, interest rate volatility will likely continue to be a factor in rates, which keeps us actively managing our fixed income exposure.

Equities (modest overweight). In keeping with the downgrade to fixed income, we have upgraded equities to modest overweight as the risk of a more severe economic slowdown declines, providing greater confidence in the attractive earnings-growth outlook in the U.S. and Canada. While current valuations are fair to modestly elevated, we believe they are justified given this backdrop of positive economic growth and declining rates. If there's been a U-turn in equity markets, it's that leaders can now be found outside the Magnificent Seven. Contributing to our continued modest overweight position in the U.S. is the fact that breadth has been improving as this bull market extends, with shifts in leadership towards cyclical growth with a particular focus on the semiconductor space in the AI value chain as well as Industrials more broadly (Figure 17).

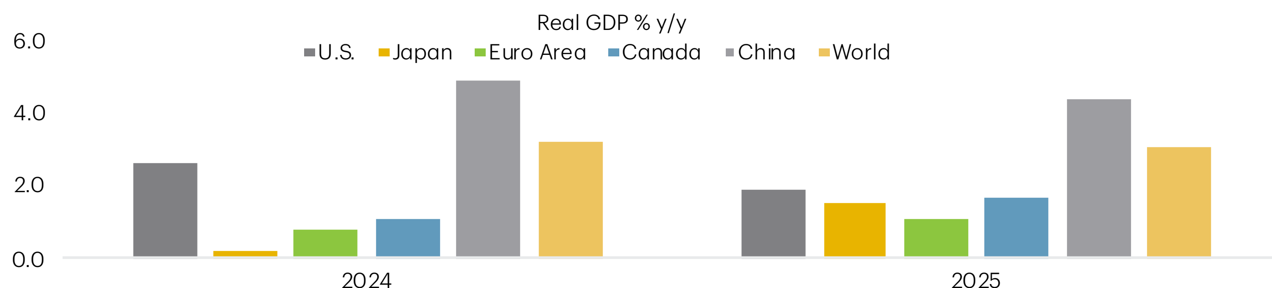
Figure 17: Equity market rally broadening, rotation in play



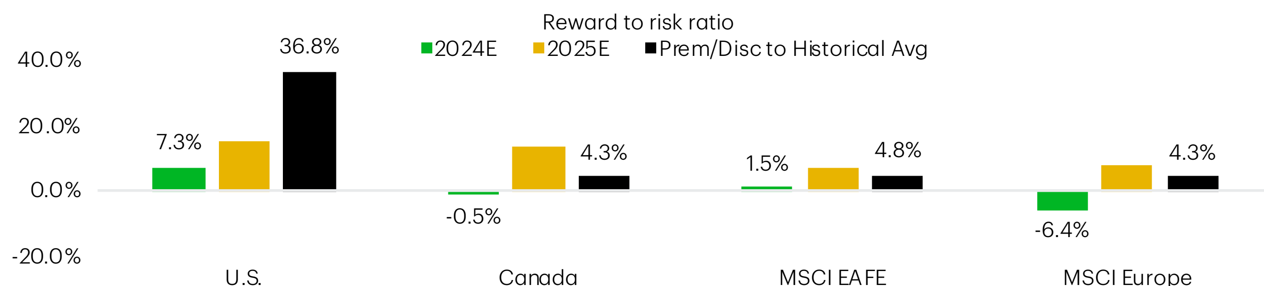
Source: FactSet and Wealth Investment Office as of October 16, 2024

Of the latter, we prefer to tilt towards companies that benefit from the Build Back Better Act, Inflation Reduction Act and The Chips Act, which is to say from infrastructure building as well as the near-shoring /reshoring of manufacturing. The Bank of Canada's significant rate cuts appear to be having the intended effect, with the economy showing signs of stabilizing. Canadian equities are attractive from a valuation perspective, which combined with an improving economic backdrop and attractive earnings outlook, warrant a modest overweight position in Canadian equities (Figure 18). In Canada, we are focusing on dividend growth companies in the Energy sector, and gold mining leaders within Materials. Elsewhere, we also favour Industrials with a focus on Engineering, Procurement and Construction companies and Insurance companies within the Financials sector.

Figure 18: Equity market rally broadening, rotation in play



* China CPI data is the IMF forecast. Source: TD Economics, IMF and WIO, as of September 2024



Source: FactSet and Wealth Investment Office as of October 18, 2024

While valuations remain attractive in international and emerging-market equities, we continue to maintain a modest underweight position given the elevated economic risks in many of those regions.

Alternatives (modest overweight). We have also increased our overall alternatives allocation to modest overweight. As we noted last quarter, this is a diverse asset class where we are employing risk-mitigation strategies and sub-classes, such as market-neutral, long/short, private assets and commodities. Private-equity exposure offers attractive risk-adjusted returns, and an allocation here provides ballast in a portfolio. We have downgraded private credit to neutral. This largely reflects the tight spreads in many thinly-traded project finance bonds, such as those issued by public private partnerships (P3s), as well as securities privately placed among qualified institutional buyers under SEC Rule 144A or Regulation S. Many of these issues are at levels where we believe the reward for illiquidity risk is too low, (tighter spreads relative to risk-equivalent publicly-traded bonds). There are still many attractive opportunities in global private-credit in areas such as floating-rate, senior secured loans and direct lending. Our position in domestic real estate has moved to neutral given that there are pockets of unlisted real assets that offer secular growth tailwinds.

Commodities (modest overweight). We live in a world where inflation is more volatile, where geopolitical competition is rising, and where energy transition is ongoing — that is, a world where commodities should fare well. At the same time, commodities provide strong diversification benefits to a portfolio, which is even more attractive in this ever-changing environment. Commodity returns tend to have low correlation to either stocks or bonds. The outlook for gold also remains attractive, supported by lower real rates, heightened geopolitical risk and central-bank buying.

Cash (modest underweight). In order to facilitate the increased exposure to equities and alternatives, cash has been downgraded to modest underweight. In an environment where rates are declining, the outlook for equities and alternatives is much more attractive than cash.

Leading Macro Indicators

Overall risk regime score logs six quarters in neutral territory

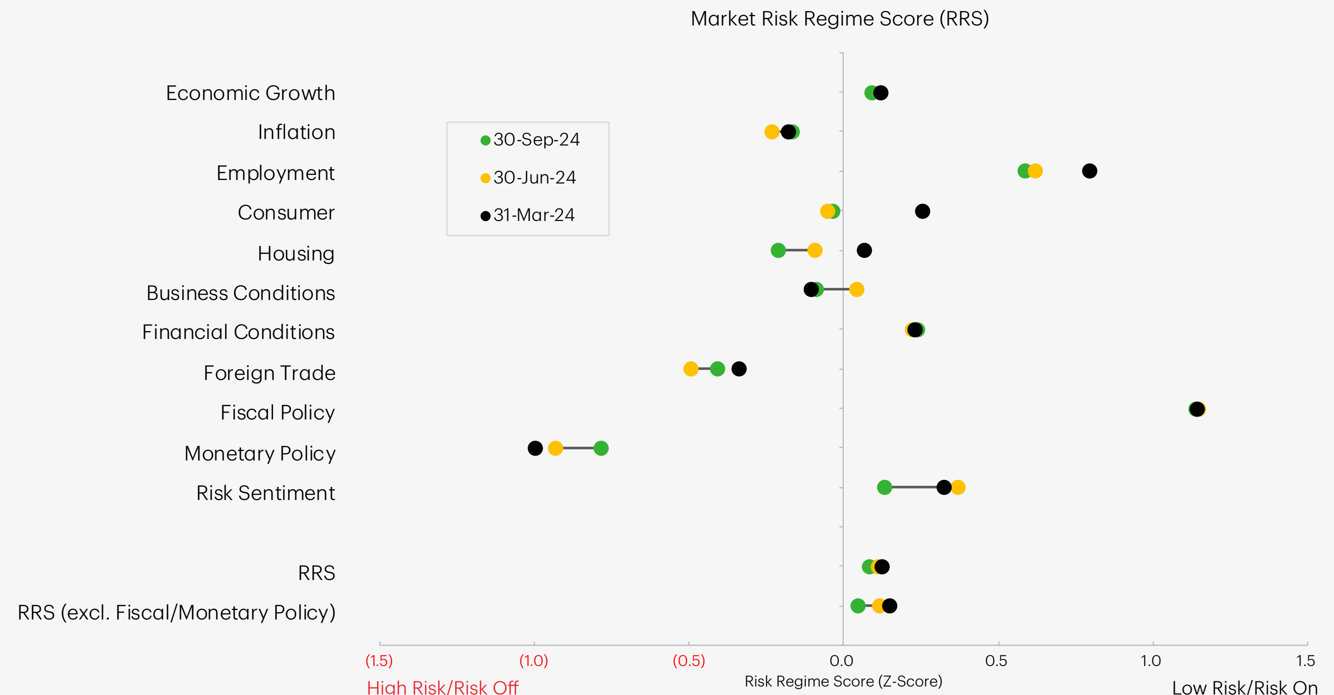
As part of our process-driven approach to investment management, we monitor key U.S. variables that inform our understanding of the risk and macroeconomic environment. For each indicator we calculate current values and compare them against recent trends and long-term data using a standardized approach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

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

At the end of Q3 the overall market risk regime score remained unchanged around zero for the sixth consecutive quarter, as cyclical sectors continued to consolidate while the consumer sector softened but spending remained healthy. U.S. equities rose and bond yields tumbled as the Fed began its monetary easing cycle. Investors remained optimistic about the probability of an economic soft landing and higher earnings growth next year.

Monetary policy continues to exert the biggest drag on the overall risk score, although the score improved slightly after the Fed cut the policy rate by 50 basis points (bps) at the September meeting. Employment and fiscal policy remained strong in Q3, but the score for risk sentiment deteriorated as volatility spiked and investors turned more cautious following the August unwinding of the Japanese yen carry trade which sparked a sell-off in global markets. (Carry trades are a foreign exchange strategy where investors borrow in a currency with lower rates like the yen and reinvest the proceeds in other assets.) The following are notable changes for Q3 compared to Q2:

• Monetary policy and foreign trade remained weak in Q3. The Fed is expected to cut the policy rate by 25 bps in each of the upcoming meetings, taking it to about 3% by the end of 2025. This should improve the monetary policy score, which currently stands at -0.8. The score for foreign trade ticked up from -0.5 to -0.4 at the end of Q3, on the back of the weaker U.S. dollar. The current account deficit remained elevated.

• Scores for employment and fiscal policy remained in positive territory. The labour market softened further while remaining healthy amid a moderating quit rate, wage growth, and rising jobless claims. The hiring rate has fallen to below the pre-pandemic level, but there is little sign that companies are actively laying off workers. The score for employment is unchanged at +0.6 in Q3. Our fiscal policy score also sat unchanged at +1.1 at the end of Q3: 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 major change: the score slipped to +0.1 at the end of Q3 from +0.4 in Q2 and its overall condition returned to neutral from strong. Volatility across various asset classes has risen and although investors remain bullish on equities, positionings have moderated.

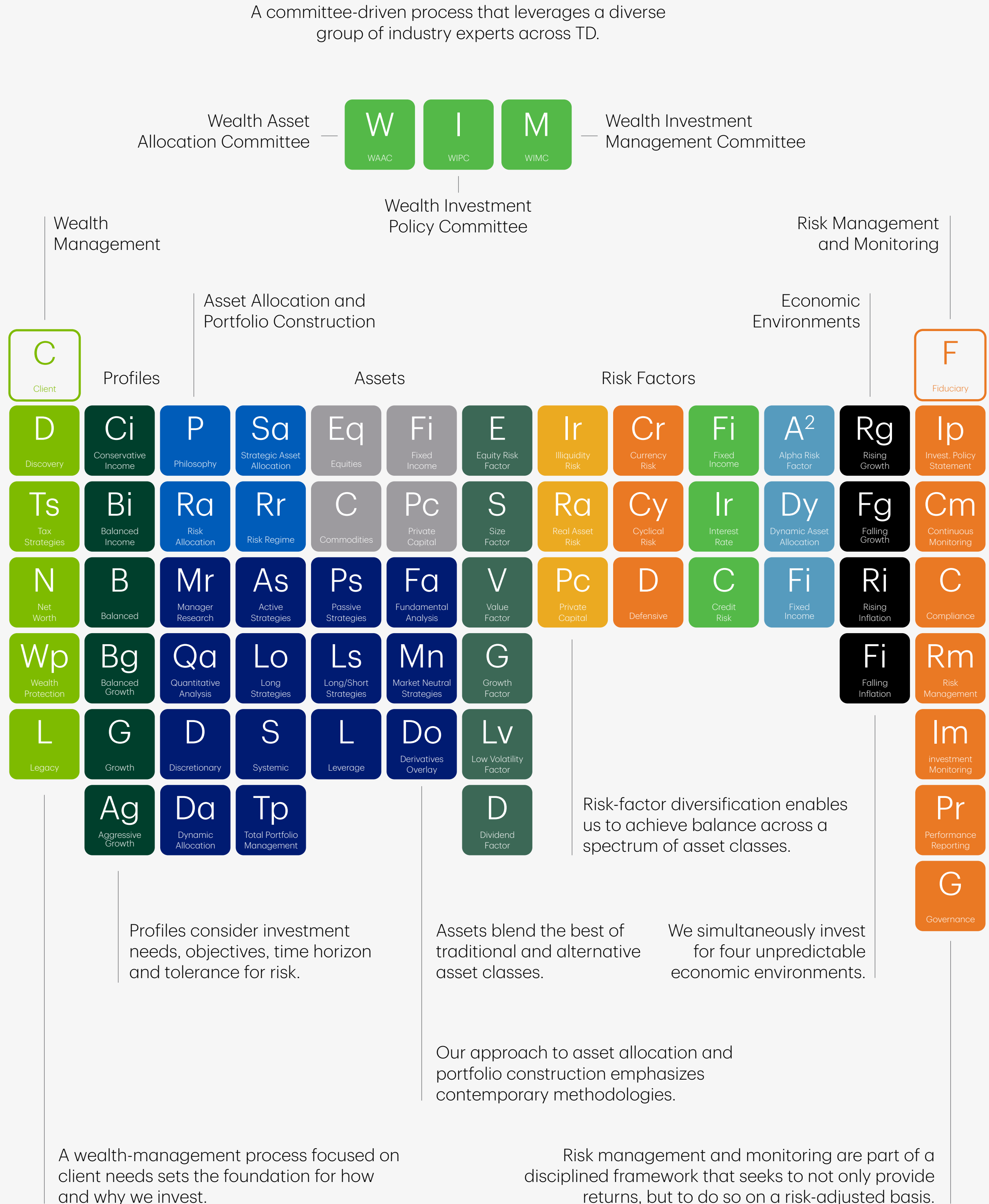
• Economic growth, financial conditions, housing, inflation, consumer, and business conditions were all relatively unchanged and remained in neutral overall condition in Q3. The real GDP growth forecast is still above the 2% level, supporting the +0.1 score for economic growth. The score for inflation was -0.2, and given the positive trajectory for inflation, we have returned it to an overall condition of neutral. Inflation fell during the quarter, but elevated shelter cost helped to keep the headline index above the Fed's 2% target. Policymakers and investors believe the upside risk to inflation has fallen significantly and shelter cost should keep declining going forward. The score for financial conditions was unchanged at +0.2 as bond spreads stayed tight amid limited signs of stress in the market. The overall condition for housing fell slightly to -0.2 from -0.1 in Q2 amid deterioration in U.S. homebuilder sentiment. The score for consumer improved slightly during the quarter to 0 from -0.1 in Q2.

There was little change in broad conditions for risk assets in Q3. Monetary policy is tight but should ease further in the coming quarters and economic growth is expected to stay robust. The scores for various sectors of the economy are currently near zero (historical trend), and the ongoing monetary policy easing should support the recovery of cyclical industries. However, downside risk remains—if the U.S. labour market deteriorates more than consensus expectations—amid current valuation levels and high earnings growth expectations of U.S. equities.

Elements of Wealth Management

Investors are often left to make decisions without any formal process. Our solution? Follow an investment philosophy — a guiding set of principles designed to work in a world that's constantly changing, often with dramatic impact on financial markets. At TD Wealth, we call that philosophy "Risk Priority Management," and it provides the foundation for our decision-making process. That process is then broken down into its most basic components, similar to a periodic table of elements, as illustrated below, with groupings and weights. These components comprise our entire process, from wealth management to risk management to monitoring. All in all, there are 72 "elements" that fall into eight categories.

Figure 1: Elements

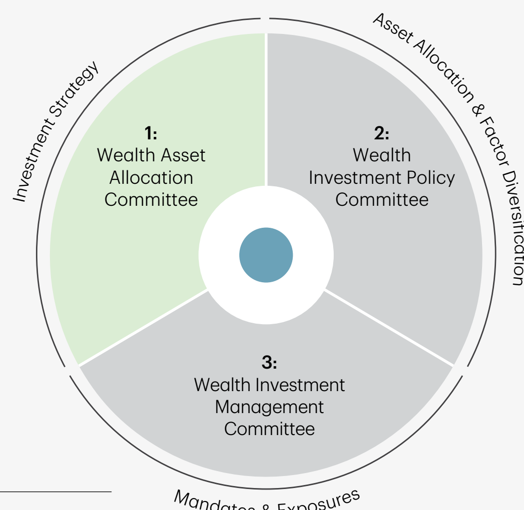


Wealth Asset Allocation Committee

The TD Wealth Asset Allocation Committee (WAAC) is composed of a diverse group of TD investment professionals. WAAC's mandate is to consider the financial-market environment and provide direction and themes for equities, fixed income, real assets and sub-classes for the next six to 18 months.

Considers the financial-market environment and provides direction and themes

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



Committee members:

David Sykes, CFA .... Chief Investment Officer, TD Asset Management Inc (Chair)

Michael Craig, CFA .... Managing Director & Head of Asset Allocation & Derivatives, TD Asset Management Inc.

Anna Castro .... Managing Director, TD Asset Management Inc.

Justin Flowerday, CFA .... Head of Public Equities, TD Asset Management Inc.

Jennifer Nowski, CFA .... Vice President & Director, TD Asset Management Inc.

Michael Augustine CFA .... Managing Director & Head of Fixed Income, TD Asset Management Inc.

Alex Gorewicz .... Vice President and Director, TD Asset Management Inc.

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

Bruce MacKinnon .. Managing Director, Head of Private Debt Research & Origination, TD Asset Management Inc.

Kevin Hebner, Ph.D. .... Managing Director, Epoch Investment Partners, Inc.

William Booth, CFA. .... Managing Director, Epoch Investment Partners, Inc.

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

Sid Vaidya, CFA, CAIA .... U.S. Wealth Investment Strategist, TD Wealth USA

Bryan Lee, CFA .... Vice President & Director, TD Asset Management Inc.

Direction from WAAC

Core Asset Class Allocations

	Positioning	Rationale
Cash & Equivalents	**Modest Underweight** (Previous Month)	We are downgrading Cash to increase our allocation to Equities and Alternatives as in a declining rate environment these asset classes should provide more attractive returns relative to Cash.
Fixed Income	**Modest Underweight** (Previous Month)	As the Bank of Canada ("BoC") considers the speed with which to remove its restrictive policy stance, the bond market has already pre-empted a change of pace by pricing an aggressive easing cycle over the coming year. As a result, the Canadian bond market has outperformed other bond markets over the past 12 months with a total return of almost 13% due to a combination of capital gains as well as income. As we agree with the bond market and believe that the forward path for the BoC is fairly reflected in Canadian interest rates, we expect modest low-to-mid single digit total returns for the bond market over the next 12 to 18 months. Nevertheless, against a backdrop of continued monetary policy easing, we expect that bonds will continue to provide diversification benefits, reduce overall portfolio volatility and preserve capital.
Equity	**Modest Overweight** (Previous Month)	We are upgrading Equities to overweight as we expect positive earnings growth to continue to drive attractive relative returns over the medium term. While the U.S. market, and in particular technology-related names, are among the leaders year-to-date ("YTD"), equity returns have been broadly positive across many geographies and sectors. Earnings growth (as represented by the MSCI All Country World Index) has been partially captured by the market in valuations, and we believe current valuations are justified given the backdrop of modest economic growth and declining rates. The U.S. election and fiscal policy implications, or uncertainty on the magnitude and pace of rate cuts, may cause episodic spikes in equity volatility, but we believe the fundamental drivers of the market will remain supportive.
Alternatives	**Modest Overweight** (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.

Fixed Income - Modest Underweight

	Positioning	Rationale
Domestic Government Bonds	**Modest Overweight**	We anticipate that the BoC will ramp up its rate cuts before the end of 2024 and agree with the bond market's assessment that the BoC policy rate will reach a neutral level before the end of 2025. That said, in our view, it remains prudent to continue to overweight Canadian bonds versus other markets as Canadian inflation has normalized much faster. Therefore, we remain patient and await a clear catalyst that could reverse the outperformance of the Canadian bond market. 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.
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 new economic data in the U.S. calls into question the Federal Reserve's (the Fed) aggressive start to the policy rate cutting cycle, investors continue to expect the Fed to lower the policy rate in the coming months. However, uncertainties emanating from the upcoming U.S. federal election are beginning to weigh on global bond markets as concerns rise around fiscal and global trade policy implications. The outcome of the election is expected to have different consequences for different countries and regions. 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 - Modest Overweight

	Positioning	Rationale
Canadian Equities	**Modest Overweight**	The Bank of Canada ("BoC") has cut rates significantly since the spring as inflation has subsided and the economy is showing signs of slowing. We believe that these cuts are supportive of the consumer and businesses, which should allow for credit to stabilize at Canadian Banks. The Energy sector has strong balance sheets and is returning its significant free cash flow to shareholders. Additionally, the high dividend yielding stocks can benefit from the declining interest rate environment.
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 YTD. We remain constructive on the earnings outlook for the U.S. as lower rates could support more broad-based growth. The S&P 500 index commands a premium valuation due to its higher technology exposure.
International Equities	**Modest Underweight**	International Equities returns might lag due to weakening industrial activity and slower earnings per share growth in Europe. Japanese equities look attractive on a relative basis, with momentum building behind a corporate reform agenda aimed at boosting profitability and valuation multiples. The Japanese stock market and yen might experience additional volatility depending on how the Bank of Japan continues with its process of raising rates versus the Fed potentially cutting rates further.
Emerging Market Equities	**Modest Underweight**	Emerging Markets central banks, including China, Brazil, Chile and Mexico, have been cutting rates. China continues to struggle with challenges in its property sector but has recently announced monetary stimulus that could provide some stabilization for its economy.

Alternatives - Modest Overweight

	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)	**Modest Underweight (From 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	**Neutral (From 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**	Metals prices rallied recently in response to the Chinese monetary stimulus announcements, but further gains could be limited as this initial stimulus has a less direct impact on commodity demand. Long term underlying fundamentals remain supportive for key commodities such as oil and copper as supply remains disciplined or restricted. Gold continues to rally in anticipation lower interest rates, as well as heightened instability in the Middle East.

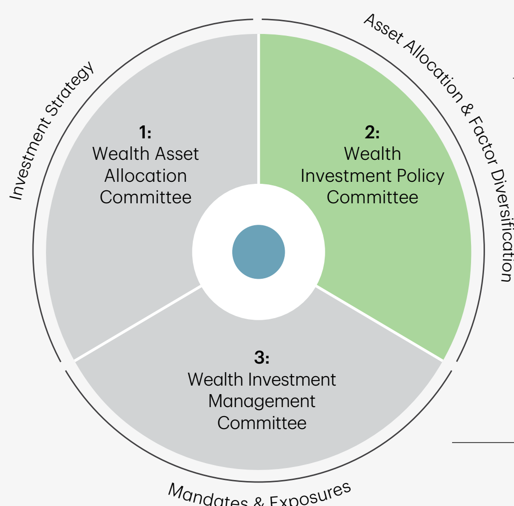
Figure 1: Direction from WAAC: strategic positioning

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

Source: Wealth Asset Allocation Committee, as of October 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

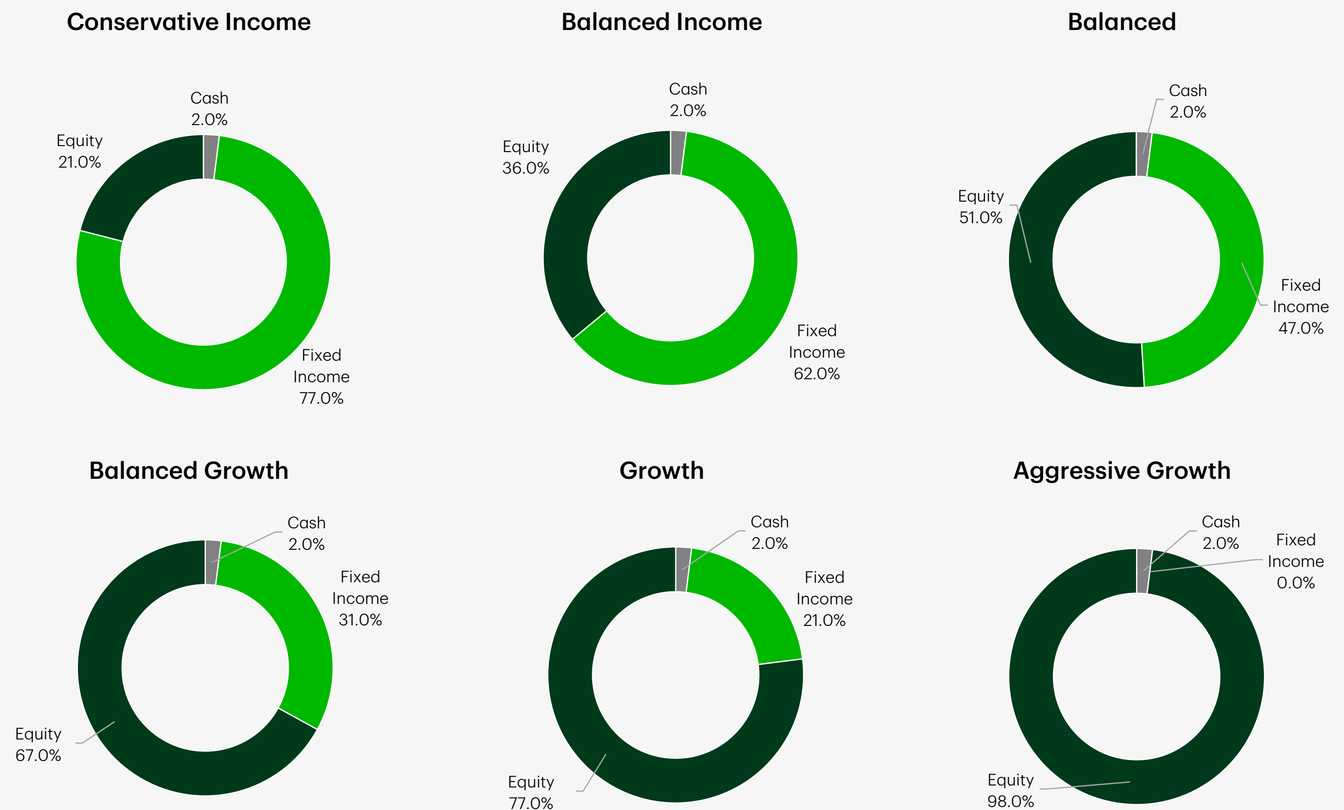
In accordance with the Wealth Asset Allocation Committee's (WAAC) changes to Fixed Income, which was downgraded from Modest Overweight to Neutral, and Cash, which was upgraded from Modest Underweight to Neutral, the Wealth Investment Policy Committee (WIPC) reduced the overall allocation to Fixed Income 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)

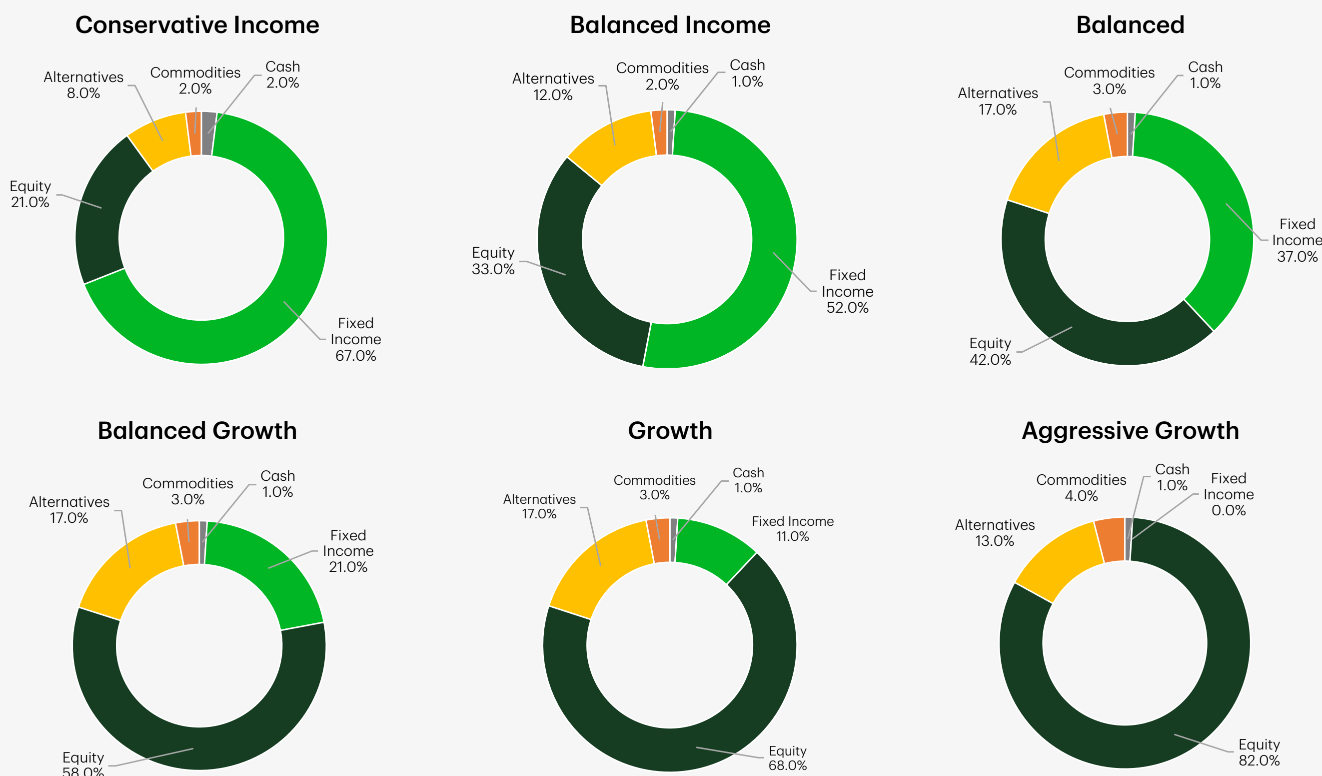


Strategic and dynamic asset-class weights by investor profile (Condensed)

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%	77.0%	63.0%	62.0%	48.0%	47.0%	33.0%	31.0%	23.0%	21.0%	0.0%	0.0%
Government	39.0%	38.0%	32.0%	31.0%	24.0%	23.0%	17.0%	16.0%	11.0%	10.0%	0.0%	0.0%
Corporate	39.0%	39.0%	31.0%	31.0%	24.0%	24.0%	16.0%	15.0%	12.0%	11.0%	0.0%	0.0%
Public Equities	20.0%	21.0%	35.0%	36.0%	50.0%	51.0%	65.0%	67.0%	75.0%	77.0%	98.0%	98.0%
Canadian	6.0%	7.0%	11.0%	12.0%	15.0%	16.0%	20.0%	22.0%	23.0%	25.0%	29.0%	31.0%
U.S.	8.0%	10.0%	14.0%	16.0%	20.0%	22.0%	26.0%	29.0%	30.0%	33.0%	40.0%	42.0%
International	4.0%	3.0%	7.0%	6.0%	10.0%	9.0%	13.0%	11.0%	15.0%	13.0%	19.0%	17.0%
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%	8.0%

Strat: Strategic, Dyn: Dynamic. Source: Wealth Investment Policy Committee, as of October 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%	1.0%	2.0%	1.0%	2.0%	1.0%	2.0%	1.0%	2.0%	1.0%
Public Fixed Income	69.0%	67.0%	54.0%	52.0%	39.0%	37.0%	24.0%	21.0%	14.0%	11.0%	0.0%	0.0%
Domestic Government Bonds	28.0%	28.0%	22.0%	22.0%	15.0%	15.0%	9.0%	8.0%	5.0%	4.0%	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%	3.0%	3.0%	2.0%	2.0%	1.0%	1.0%	0.0%	1.0%	0.0%	0.0%	0.0%
Public Equities	20.0%	21.0%	32.0%	33.0%	41.0%	42.0%	56.0%	58.0%	66.0%	68.0%	82.0%	82.0%
Canadian	6.0%	7.0%	10.0%	11.0%	11.0%	12.0%	16.0%	18.0%	19.0%	21.0%	22.0%	24.0%
U.S.	8.0%	10.0%	13.0%	15.0%	17.0%	19.0%	23.0%	26.0%	27.0%	30.0%	35.0%	37.0%
International	4.0%	3.0%	6.0%	5.0%	8.0%	7.0%	11.0%	9.0%	13.0%	11.0%	15.0%	13.0%
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%	8.0%
Alternatives	7.0%	8.0%	10.0%	12.0%	15.0%	17.0%	15.0%	17.0%	15.0%	17.0%	12.0%	13.0%
Commercial Mortgages	4.0%	5.0%	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%	1.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%
Infrastructure	0.0%	0.0%	2.0%	3.0%	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%	69.0%	56.0%	53.0%	41.0%	38.0%	26.0%	22.0%	16.0%	12.0%	2.0%	1.0%
Equity	20.0%	21.0%	32.0%	33.0%	41.0%	42.0%	56.0%	58.0%	66.0%	68.0%	82.0%	82.0%
Alternatives	7.0%	8.0%	10.0%	12.0%	15.0%	17.0%	15.0%	17.0%	15.0%	17.0%	12.0%	13.0%
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 October 18, 2024

Economic Outlook

Can't Hold Me Down: U.S. Consumer Spending to See an Upgrade

Thomas Feltmate, Director & Senior Economist; Shernette McLeod, Economist | TD Economics

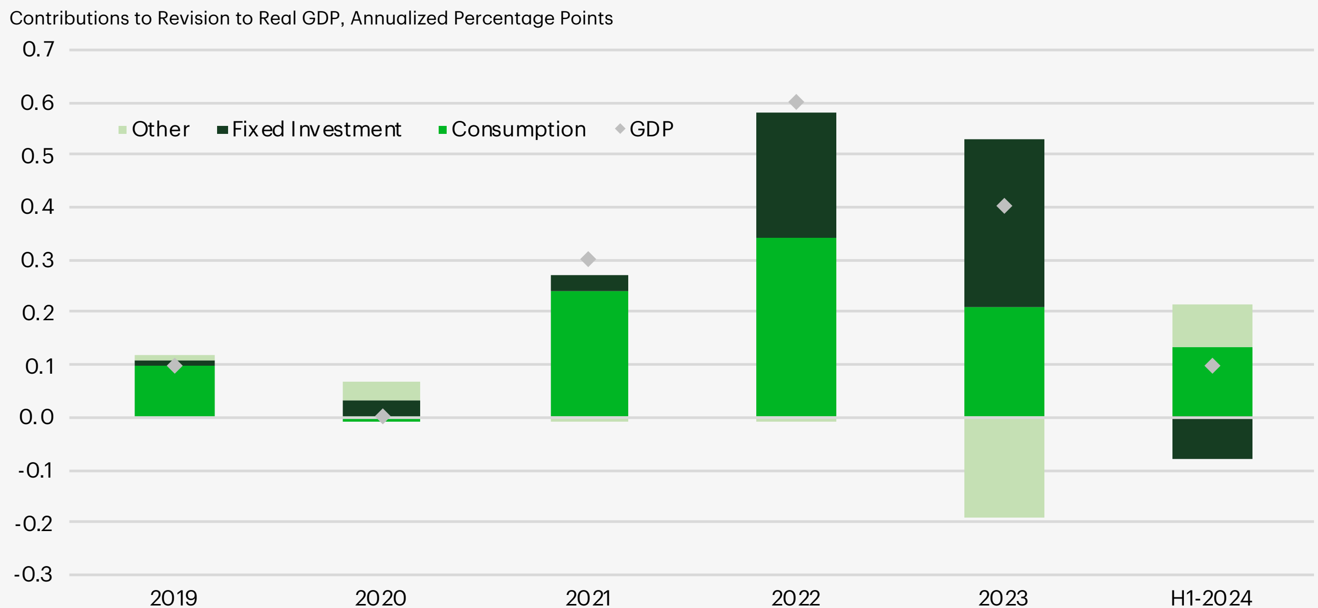
We have long thought that consumer spending was ripe for at least a few quarters of below-average growth. But time and time again, we've pushed out the timing of when that would occur due to an exceptionally resilient consumer. Our most recent forecast assumed spending would slow in H1/25, largely predicated on the fact that the job market was quickly cooling, consumer delinquencies were trending higher and households' savings had dipped to a multi-year low. But since then, the backdrop is looking more positive for a couple of reasons. Personal income was revised higher and shows a larger cushion of remaining excess savings, while September's employment report suggests healthy income gains continued into the third quarter. While consumer spending is still expected to cool from its breakneck pace of over 3% annualized in Q3, we now expect somewhere closer to 2% spending growth through 2025.

Benchmark revisions support stronger consumer balance sheets

Since we published our last forecast, the Bureau of Economic Analysis released its annual comprehensive revisions to its National Income & Product Accounts. Overall, the revisions showed that U.S. economic growth was higher than previously reported, with annual GDP growth between 2021 and 2023 revised higher by 0.5 percentage points to an average annual growth rate of 2.7%. Much of that revision was due to a stronger pace of domestic spending, particularly for consumer spending and business investment (Figure 1).

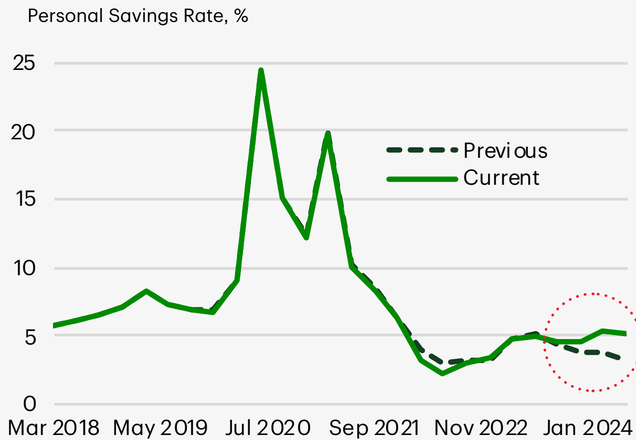
Real gross domestic income (GDI, an alternative measure of economic output) was revised up even higher, with average growth revised from 1.3% to 2.2% between 2021 and 2023. The revision was even larger over the first half of 2024, where first-quarter GDI was revised from 1.3% quarter-on-quarter annualized to 3.0% and for Q2 from 1.3% to 3.4%. Most of the additional strength was the result of stronger employee compensation, which is now running about $200 billion higher than previously estimated. This has lifted real disposable income growth from a relatively benign 1.1% annualized rate of expansion in H1/24 to 4.2%. Because the 2024 income revisions were far greater than the revisions to consumer spending, the household savings rate was revised meaningfully higher, from 3.3% to 5.2% in the second quarter. And while the revised series still shows a downward trend in the savings rate, the slope is far less severe than what was previously reported (Figure 2).

Figure 1: Benchmark revisions show upgrade to post-pandemic growth



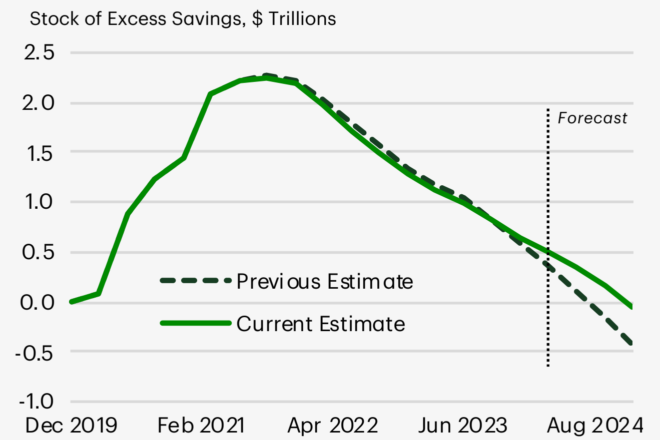
Source: Bureau of Economic Analysis, TD Economics

Figure 2: Benchmark revisions remove the downtrend in the savings rate



Source: Bureau of Economic Analysis, TD Economics

Figure 3: Revisions result in a higher estimated stock of excess savings



Source: Bureau of Economic Analysis, TD Economics

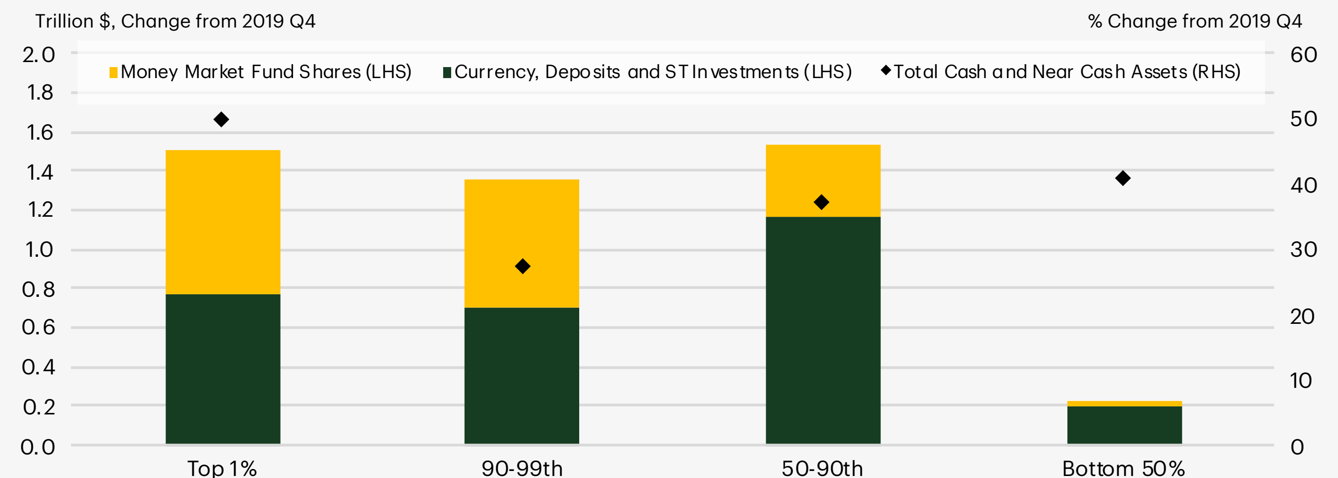
The income revisions have also resulted in an upward revision to our estimate of excess savings, which now appear to be closer to $350 billion as of Q2/24, up from our prior estimate of $100 billion (Figure 3). Using households' available liquid funds, most of the excess savings (over 60%) are held by households in the top 10% of the wealth distribution with very little (less than 5%) remaining in the hands of those in the bottom 50% (Figure 4), who tend to spend a higher share of their income. This could mean that the remaining drawdown of excess savings is happening more slowly than it has in the past or maybe not at all. But either way, we would be remiss if were not at least highlighting the revision as a potential tailwind for spending over the coming quarters.

Stronger job gains add to consumer upside

Moreover, growth in employee compensation is likely to accelerate above the already strong 6% annualized pace seen in the second quarter. This is due to a combination of healthy wage gains and an uptick in job creation. While the surge in job creation in September likely overstates the degree of strength still present in the labour market, smoothing through recent volatility still shows that the economy added a healthy 186,000 jobs per month over the past three months, up from 147,000 per month averaged in the second quarter.

More so than the savings revisions, this poses some upside risk to our current spending forecast. Indeed, there will be some near-term distortions coming through in the fourth quarter spending data, largely due to the devasting impacts from Hurricanes Helene and Milton — making it very difficult to infer a monthly pattern with any degree of confidence. However, it's now looking more likely that, once those impacts fall out, consumer spending can continue to run closer to 2% through all of 2025, as opposed to our prior thinking of a few quarters of sub-2% spending growth.

Figure 4: Higher income groups have most of the remaining liquidity



Source: Federal Reserve Board, TD Economics. *Data for 2024 Q2

Greater spending unlikely to undo inflation progress

From an inflation standpoint, the modest upgrade to spending is unlikely to pose any meaningful upside risk to the inflation outlook. For starters, much of the additional strength on spending is likely to come from areas of discretionary spending like durable goods (excluding autos), recreational services and food services / travel, where we had previously assumed most of the cooling would be concentrated. However, price pressures across most of these discretionary categories have already returned to or are running below their respective pre-pandemic rates of price growth. This suggests that a modest upgrade to spending is unlikely to meaningfully move the needle on inflation. Moreover, the discretionary service categories where we see the most upside only account for a little over 13% of core PCE inflation. So even if prices were to jump by over 1% annualized, it would only add slightly more than a tenth of a percentage point to the Fed's preferred inflation gauge.

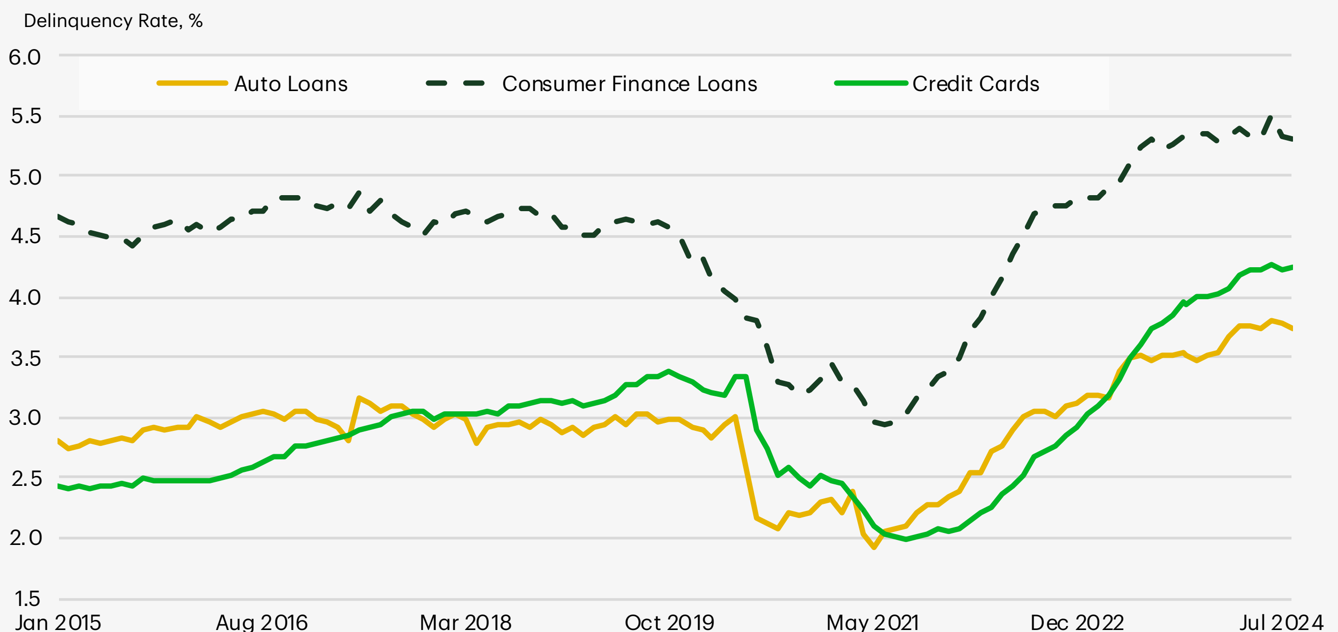
Headwinds from delinquencies have possibly peaked

At this point, what's happening on the delinquency-rate front remains a wild card. Clearly, some borrowers have come under pressure, as evidenced by delinquencies for most consumer credit products now above pre-pandemic levels (Figure 5). We suspect a lot of this is driven by the "credit score inflation" that happened during the pandemic, which ultimately unlocked more available credit for borrowers and likely resulted in some overextending. The problem has been particularly acute for some lower-income borrowers, who would've benefited the most from loan forbearance programs during the pandemic, and thus the "credit score inflation" phenomenon. They were also the most vulnerable during the recent bout of higher inflation and among the first to draw down their excess savings. Consequently, delinquency rates across this sub-group have seen the largest increases in recent years and have been a major contributor to the uptick in the aggregate measures. However, with the Fed's easing cycle underway, the job market still appearing healthy and prices for things like autos and essentials easing, we should soon see consumer delinquencies cresting.

Bottom Line: Consumers may have more gas in the tank

All in all, the recent revisions to the income and spending accounts reveal that consumers may in fact have more gas in the tank than previously expected. This has resulted in an upward revision to not only our estimate of excess savings but also our expectations for consumer spending. While rising consumer delinquency rates remain a potential headwind for spending, we suspect the forces are already in place to lead to a leveling off over the near term. Should this not be the case, we could again be revisiting our consumer-spending outlook. But for now, the labour market remains healthy and still supportive of ongoing income gains, which taken alongside the larger cushion of savings, should help to keep spending running around 2% over the coming year.

Figure 5: Consumer loan delinquency rates levelling off above pre-pandemic levels



Source: Equifax, TD Economics. *Last data point is September 2024

Asset Class Analysis

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Quarter in Review

Quiet No More

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

In our last PSQ, published in July, we cautioned that the low volatility we were seeing in the equity market was not justified in a year filled with economic and geopolitical uncertainty. The implied correlation among stocks in the U.S. hit its historical low on July 12, creating an environment where macro risks that could have broad market impact were ignored — leading to complacency among investors.

Indeed, the complacency priced into the largest risk market in the world was daunting. We were of the view at the time that there were a lot of extremes in the market as a result of strong and persistent momentum from certain trades that had been working for a long time. These included the yen carry trade, long exposure to U.S. equity and mega-cap tech names, as well as short exposure to Chinese equity and U.S. small-caps.

The crowding in the market was high and had come to a point where a sharp reversal could be just a catalyst away. This line of thinking provides a fairly good framework to help us understand what happened during the third quarter. To sum it up, the quiet market got noisy.

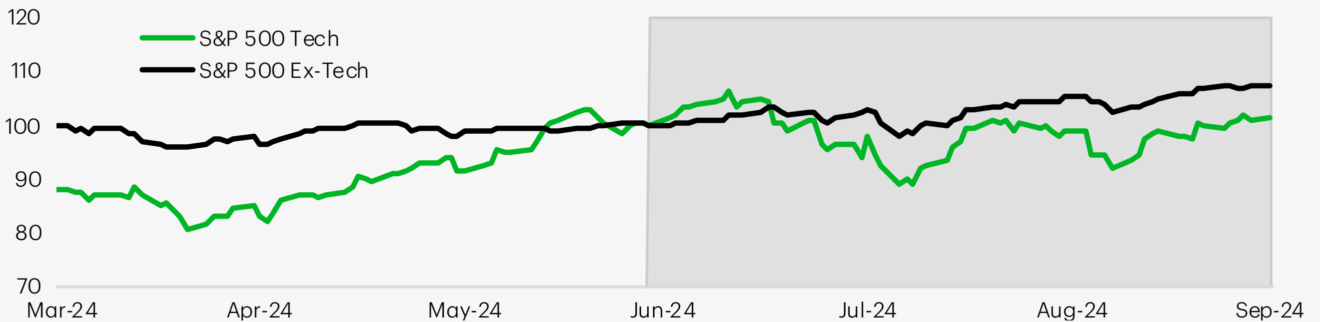
When the Crowd Turns

By the end of the first half, the U.S. equity market's growing concentration had been well documented. The concentration was not only obvious among the top seven stocks that dominate the U.S. equity market (the "Magnificent Seven") but was also readily apparent when we looked at the technology sector as a whole versus other sectors, large-caps versus small-caps, the U.S. versus the rest of the world and growth versus value (Figures 1 and 2).

Although we all know that no trend can persist indefinitely, the exact timing of a reversal is still difficult to predict. The first crack did come in the hottest area in tech: semiconductors. In the third quarter, economic data disappointed and the U.S. government tightened the export ban on advanced chip technology to China. This double whammy caused certain semiconductor names to sell off.

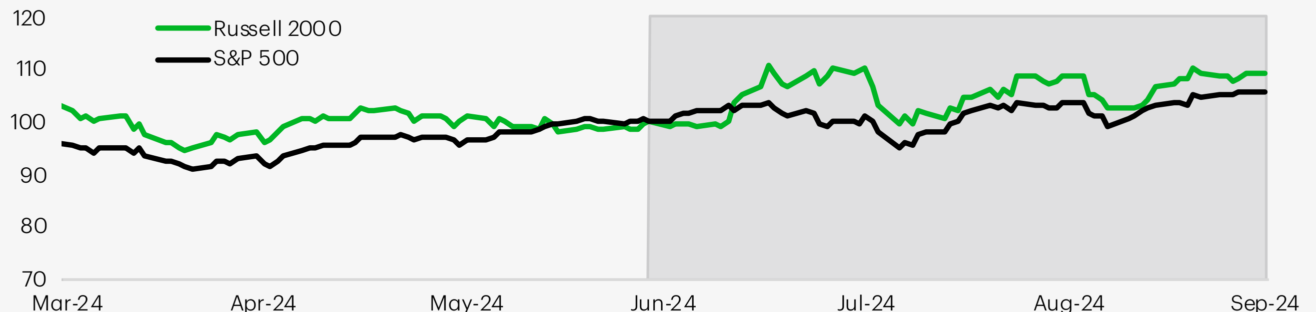
Meanwhile, the failed assassination attempt of the former U.S. president only boosted his popularity. The market reacted with a sharp "Trump rally," with cyclical and small-cap stocks significantly outperforming the large-cap index. That led investors who had crowded into large-cap growth and tech stocks to start heading for the exits, especially in July (Figures 1 and 2).

Figure 1: S&P 500 Tech vs. S&P 500 Ex Tech



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

Figure 2: S&P 500 vs. Russell 2000



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

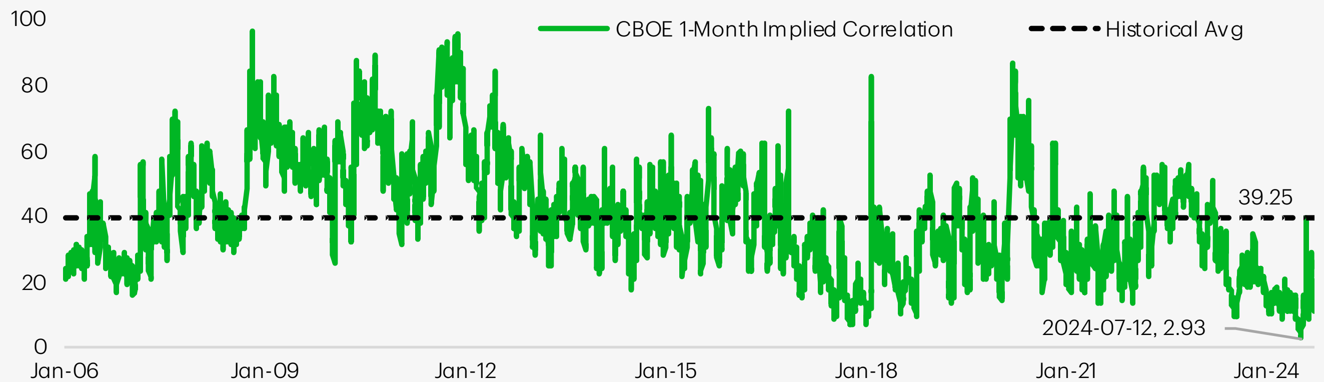
Looking at the options market, a similar dynamic has played out. Figure 3 shows the implied correlation among S&P 500 constituents, which hit a historical low on July 12. In our last PSQ, we suggested that this implied correlation was too low, in that it failed to price in heightened geopolitical, policy and economic uncertainty (aka, the "uncertainty trinity"). As we noted, the severity of an implied volatility spike could be high if the equity market were to wake up to a macro catalyst, and the implied correlation were to normalize from historical lows.

Well, it didn't take long for such a catalyst to emerge. Almost immediately after we wrote those words, the July U.S. labour-market data came out, showing that hiring prospects had dimmed significantly. Then, almost simultaneously, the Bank of Japan (BoJ) surprised investors by hiking rates in a bid to move away from its ultra-dovish monetary policy. That led the implied correlation in Figure 3 to quickly rise to its historical average on August 5, less than one month after hitting a new low. As a result, the implied volatility on the S&P 500 also spiked. Figure 4 shows the normalization of implied correlation was the main driver of higher implied volatility.

Crowding can also be seen in the currency market. Before the BoJ's surprise pivot, the rate-hiking cycle in the U.S. had offered global investors a profitable carry trade, where they could borrow yen cheaply and convert it to the U.S. dollar to earn higher interest. This trade led to a stronger dollar and depreciating yen. Many investors made money on this carry trade, which attracted even more investors, dragging the yen down to 30-year lows against the U.S. dollar in Q3. When the BoJ pivoted, however, this carry trade was disrupted and profit quickly became loss. As a result, investors started to unwind their positions, purchasing yen to repay their debts, which caused a short squeeze in the yen against the U.S. dollar and led the Japanese currency to rise an astonishing 12.9% for the quarter.

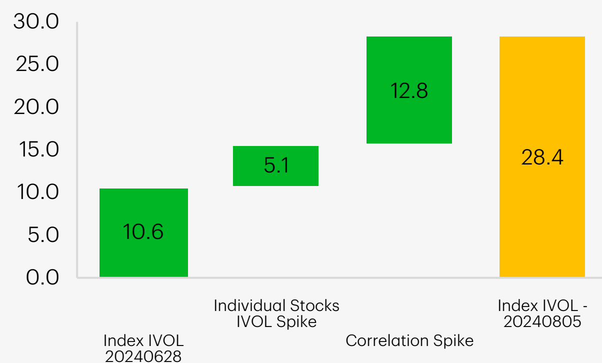
Another crowded position at the time was long exposure to Japanese stocks, given that the export-oriented Japanese economy was benefiting at the time from the weakened yen. As a result, when the yen began to spike, Japanese equity markets tumbled. On August 5, the Nikkei 225 plunged 12.4%, suffering its worst day since Black Monday in 1987, as shown in Figure 5. The enormous selling pressure was a clear sign of the unwinding of levered and crowded positions. This is a classic example of what can happen when a catalyst impacts vulnerable positioning.

Figure 3: Reversal of Implied Correlation



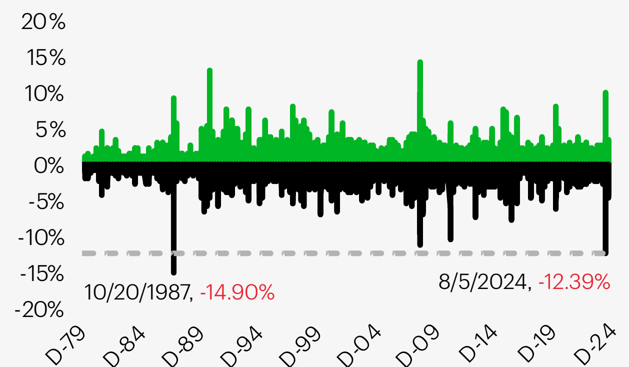
Source: Macrobond, Wealth Investment Office as of September 30, 2024

Figure 4: Breakdown of Implied Volatility (IVOL) Spike on August 5



Source: Macrobond, Wealth Investment Office as of August 5, 2024

Figure 5: Daily Returns of Nikkei 225 Index



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

Small cracks in the economy can be sealed

Turning our attention to the economy, we remain constructive and stand firmly behind our soft-landing call for the U.S., even though we do acknowledge weakness in a few areas. Even after a large 50-bp cut to kick off the easing cycle in September, the effective federal funds rate remains significantly above inflation. Certainly, the economy is feeling stress, but the good news is that this stress is not evenly distributed and is highly dependent on where you look. Overall, the U.S. economy remains robust, with GDP growing at or even slightly above the long-term trend.

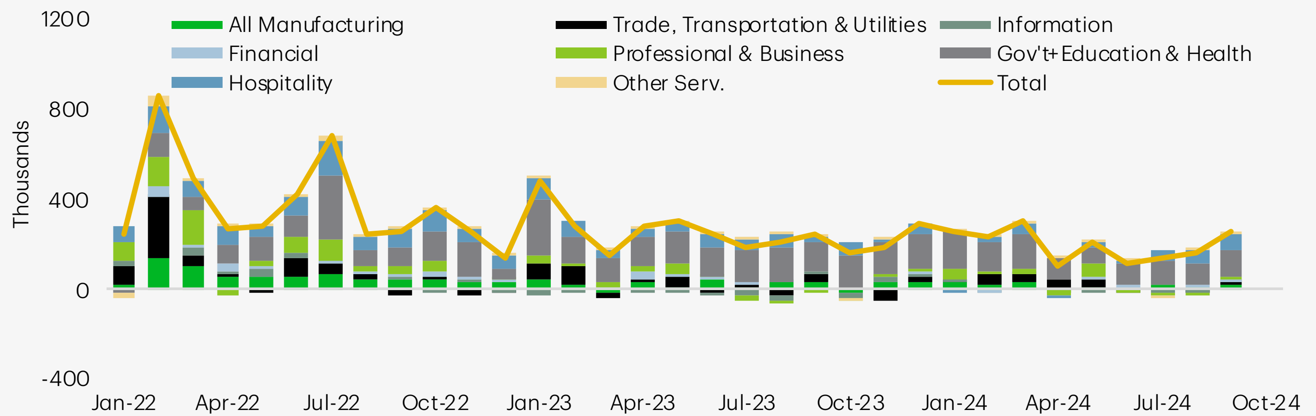
While the employment data has weakened, there are many nuances within that data — most of which can be broken down into three themes. First, headline employment has been declining, as shown in Figure 6. Non-farm payrolls reported an average of 370,000 and 250,000 jobs added per month in 2022 and 2023 respectively; as of September, the 2024 monthly average has fallen to 180,000.

Although the labour market is still growing at a healthy clip, we are seeing signs of slowing. More importantly, public and heavily regulated sectors like health care, education and government remain the top job generators. This means that the jobs created today are mostly medium-income and provide little productivity boost to the economy, which is not great in the long run.

The second theme is that, in the post-Covid era, people are approaching their work differently. Remote working, for instance, makes it easier to take on multiple jobs, which could result in double-counting in the establishment survey. This could explain the growing gap between the household survey and the establishment survey.

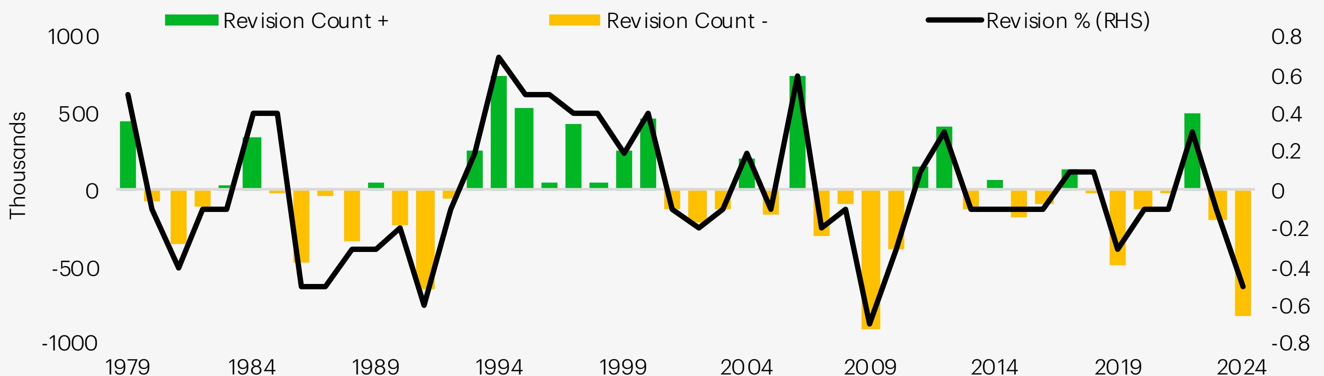
Also, revisions to the data have become larger. Every year, the U.S. Bureau of Labor Statistics does a revision to true up the comprehensive employment count, as of March, based on more granular state-level data. The preliminary revision for 2024, however, was one of the largest negative revisions ever, as shown in Figure 7. This raises concerns over the credibility of the data and the policy decisions that rely on it — and greater uncertainty inevitably leads to more volatility.

Figure 6: U.S. Non-Farm Payroll Breakdown



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

Figure 7: Employment Data Revisions since 1979



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

The third key theme is that, while the U.S. unemployment rate is higher today, a significant part of that unemployment is not due to layoffs but rather higher labour supply, given an influx of people re-entering job market. Given the context, the higher unemployment is not great, but probably better than what the headline suggests.

Inflation is also making good progress towards that much anticipated soft landing. As Figure 8 shows, the consumer price index and core CPI, which excludes volatile food and energy prices, are normalizing. This should not surprise anyone, given that shortages experienced post-Covid have now also normalized. Higher interest rates, meanwhile, are weighing on business investment, durable goods and housing, which in turn slow the economy and suppress aggregate demand. Finally, rent inflation, while still close to 5%, is also expected to follow a consistent downward trend, given that the methodology for incorporating rent inflation in the CPI has a lag.

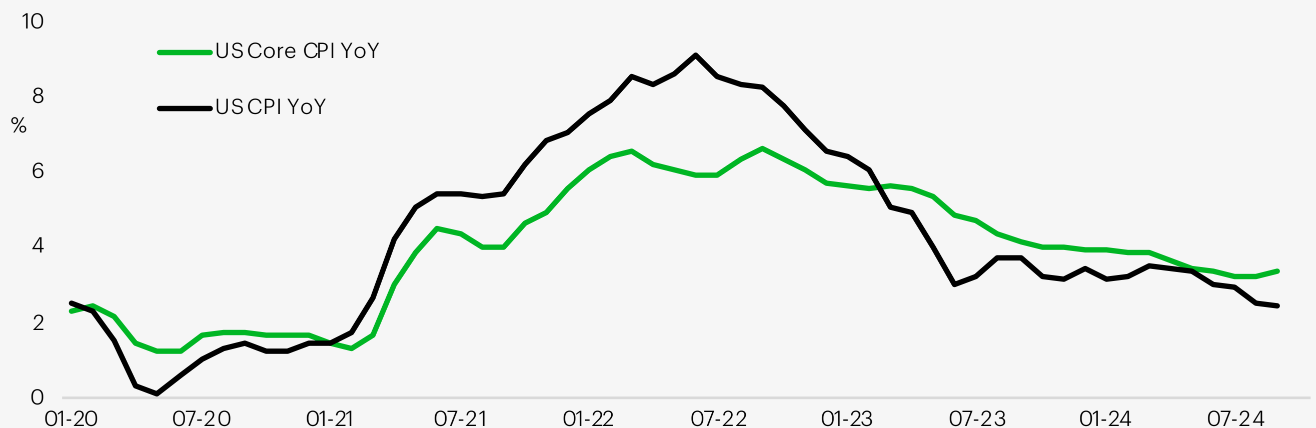
This does not mean that inflation risk is out of the picture. Labour strikes, intensifying regional military conflicts in the Middle East, and the upcoming U.S. presidential election all present risks to inflation. However, the delicate balance to slow the economy just enough to stem inflationary forces, while avoiding recession, is well on its way to being achieved.

A segment of the population is suffering

Monetary policy, in our opinion, is a rather blunt tool for addressing the inflation problem. Although a soft landing is most likely to be achieved in the U.S., that doesn't mean there will be no collateral damage in the economy. We know that growth and employment is slowing; the question is, who among the general population are bearing the unproportional weight of higher interest? The answer is important not only for investors, but also for policymakers trying to determine the best path forward.

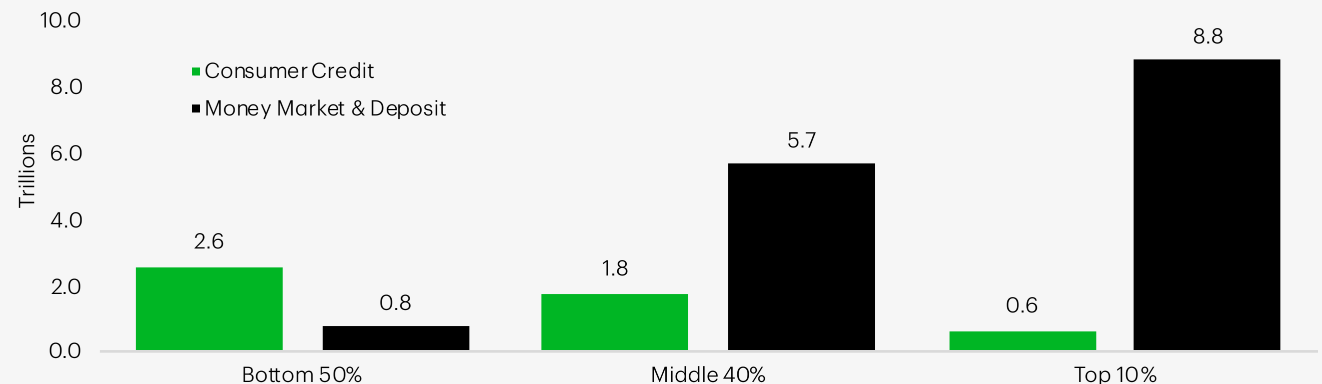
Figure 9 shows the amount of cash and credit held by U.S. households by wealth percentile in Q2, based on Fed data. With higher interest rates, the wealthiest 10% of U.S. households continue to do well, with more cash in the bank to earn more interest while carrying a relatively small amount of consumer debt. On the whole, they are likely better off with higher interest rate than lower rates. This is probably why we are seeing luxury and recreational spending grow off the chart during this rate-hiking cycle.

Figure 8: Inflation Normalization



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

Figure 9: U.S. Household Cash vs Consumer Credit by Wealth Percentile



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

On the other end, the bottom half of U.S. households by net worth is struggling with very low cash levels and much higher consumer credit. Higher inflation, moreover, means that their grocery and gas bills are also higher. If they're not part of a union with bargaining power to demand strong wage increases, this cohort could feel squeezed on both ends — with their purchasing power diminished by inflation, and debt-servicing costs boosted by higher rates.

That forces policymakers to take a nuanced approach when attacking the inflation problem today. It might be justified to take decisive action to control runaway inflation, but they also need to be careful to pivot quickly once inflation is under control. Otherwise, over-restrictive monetary policy could exacerbate wealth disparity and lead to social unrest, which could also have political implications during an election year.

Here comes the cut

On September 18, the Fed announced a 50-bp cut to the U.S. policy rate. It was modestly more dovish than what the market had been anticipating. Investors welcomed the move, since it largely alleviated the downside risk in U.S. economy and provided relief for consumers and corporations, whose ability to spend and invest had been hindered by high interest rates.

Having said that, at time of writing (October 11), the market is still expecting relatively dovish policy from the Fed. As shown in Figure 10, even with tepid growth expected next year (1.8%), the U.S. still has one of the fastest-growing economies in the developed world. Nevertheless, the fed funds rate is expected to go down by another 154 bps over the next 12 months — second only to the European Central Bank. To put things into context, the euro zone economy is currently on the verge of recession, with growth expected to rebound to 1.2% over the next year. In other words, the current policy rate pricing in the U.S. might be too dovish if the soft landing goes according to plan.

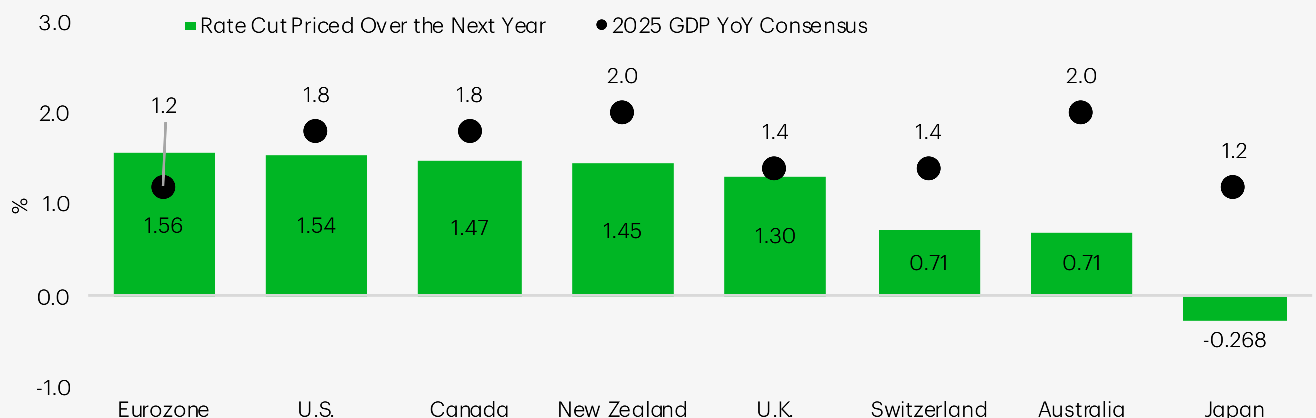
Could a policy pivot finally happen in China?

Over the last week of September, policy in China seemed to take a significant turn. It started on September 24, when the People's Bank of China (PBoC) announced three positive policies. First, the PBoC cut both the policy rate as well as the required reserve ratio for commercial banks. The moves were meant to provide liquidity to the real economy and stimulate banks to lend. Second, the down payment required for households to purchase a second property was lowered to 15% from 25%. Third, the central bank announced that it will provide liquidity to public companies and their owners to buy back shares. These policies not only provided monetary stimulus to the economy but were also designed to prop up the equity market and investor confidence.

This time, however, the stimulus measures did not stop with monetary policy. Two days after, the state news agency reported on a politburo meeting that recognized the importance of fiscal stimulus as means to save the ailing economy and property market. It's now widely expected that Beijing will announce a fiscal package close to US$300 billion in the form of a special government bond issuance, dedicated to prop up the property market and restore consumer confidence.

The plan still lacks details, but investors in Chinese assets have been hungry for a silver bullet like this. The Chinese government historically has shied away from using fiscal policy to backstop struggling businesses and consumers post-Covid. This news signals a potential regime shift that could change the status quo and lead to a turnaround in the Chinese equity market.

Figure 10: Implied Rate Cut over the Next 12 Months vs. 2025 GDP Growth Consensus



Source: Macrobond, Wealth Investment Office as of October 11, 2024

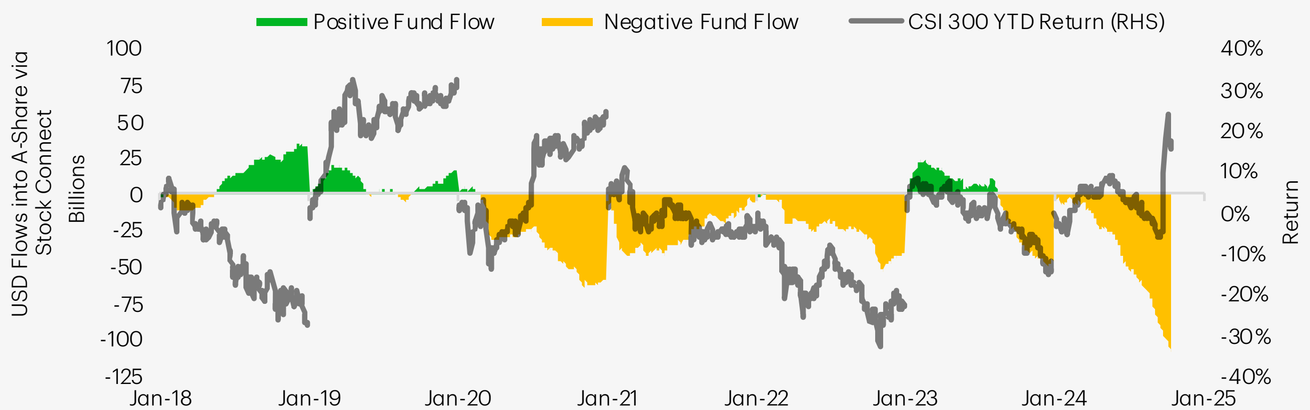
Chinese equities rallied significantly on the news, adding to the sharp sentiment reversals we've seen recently in the global market. Consistent outflows and capitulation have rendered the Chinese market un-investable to many. Indeed, given the geopolitical risks, many institutional investors have even closed their operations in China for good. This has resulted in a significant underweight and extreme bearish views toward China. Year-to-date, we have witnessed the largest outflow ever from Chinese onshore equities, via the Hong Kong Stock Exchange connect program (Figure 11). When a large outflow is met with an equity rally, however, the flow has tended to reverse.

History provides some context for the current situation. In 2015, the red-hot equity market in China seemed to make the government and regulators there uneasy, which eventually resulted in its downfall. The Chinese government is known to be cautious about the accumulation of financial risk in the system and will not shy away from tightening regulations to end excessive speculation. As such, investors in China need to be careful.

One measure of speculation, for instance, is the turnover as a percentage of total market capitalization. When this ratio shoots up, it means that the churning in the equity market has increased significantly. As we can see in Figure 12, when the ratio approached 10% in 2014 and 2015, the securities regulator in China started to crack down on speculative and leveraged trading. As a result, the equity market crashed. However, this ratio today is only around 2% and change, which means the same kind of speculation may not be present, leaving the risk of a regulatory crackdown low.

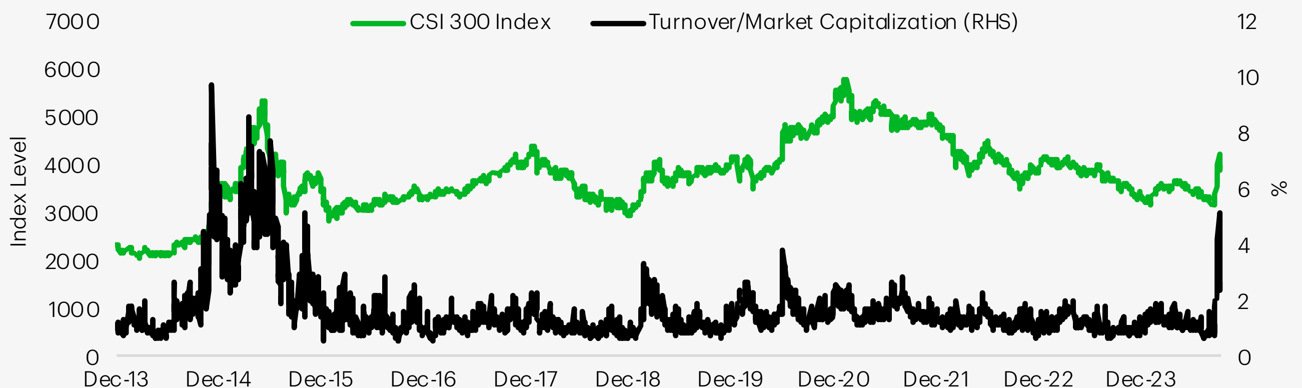
Last but not least, the unique geopolitical risks today are something we have to pay close attention to. While global investors have become more enthusiastic about China and believe the index has broken out like a rocket, we would like to point out that there was a rocket launch into the South China Sea that should catch everyone's attention. China conducted an intercontinental ballistic missile test on September 25 — the first time in 44 years. Given the new government in Taiwan's pro-independence stance, the risk continues to simmer in the narrow strait between the mainland and Taiwan, as well as in the islands scattered around the South China Sea.

Figure 11: China CSI 300 vs. Foreign Flows via Hong Kong



Source: Macrobond, Wealth Investment Office as of October 14, 2024

Figure 12: Market Turnover Ratio vs. China's CSI 300 Index



Source: Macrobond, Wealth Investment Office as of October 14, 2024

Outlook on Fixed Income

Modest Underweight

Turning in Opportunities

Aurav Ghai, Senior Fixed Income Analyst | TD Wealth

Most developed market central banks have shifted towards easing policy rates and fixed income investors are finally reaping the rewards with government yields drifting lower and corporate bonds sustaining historically rich valuation levels. With inflation seemingly under control and expected to return to target, all eyes have turned to economic growth and employment. While we may have finally entered the long-awaited rate-cutting cycle, be prepared for surprises. No two central bank easing cycles are ever alike and we're still digesting uncertainties surrounding the slowing labour market, geopolitical risks, the U.S. elections, and the pace of future rate cuts. This means that volatility will persist providing opportunities for actively managed fixed income portfolios.

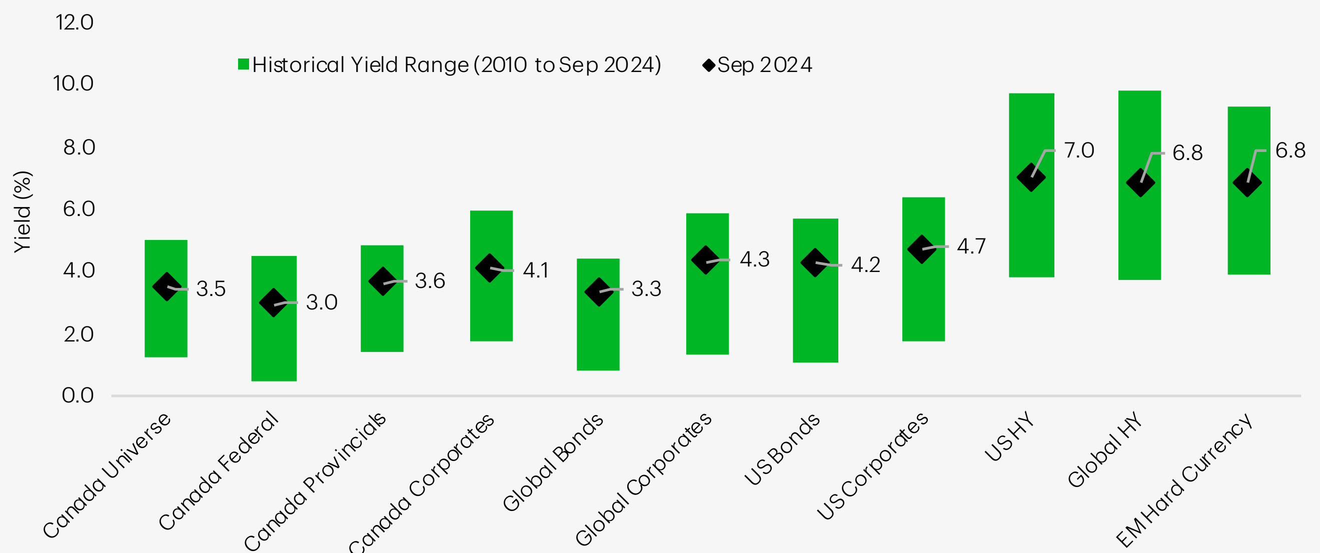
Even with the global move towards easing, government yields are likely to remain higher than pre-COVID levels and for longer than expected. This isn't necessarily a negative for fixed income investors. Given the overwhelming uncertainty, bonds are still offering yields on the higher side of the historic range (Figure 1). We believe that higher yields reinforce the positive role of fixed income in a broadly diversified portfolio, delivering ongoing income as well as downside protection.

- With the start of the rate cutting cycle firmly in hand in Canada and the U.S., fixed income markets have delivered relatively attractive returns year to date, at around 4.27% for FTSE Canada Universe Bond Index. We have downgraded the overall asset class from Neutral to Modest Underweight as we believe returns going forward will be largely in-line with historical average levels in the mid single digit range, largely composed of the coupon.

- Within fixed income, we maintain our modest overweight view on domestic government bonds. Canadian government bonds are attractive at current yields and offer opportunities for income generation and downside protection. We expect volatility in Canadian yields to subside as the outlook for the economy, the pace of policy rate cuts and the end point becomes clearer.

- We remain modest overweight on investment grade (IG) credit. Investment grade spreads are still tight overall and reflect a gradual softening of the global economic backdrop. We view Canadian investment grade corporate bonds, with their slightly wider spreads, as more attractive than U.S. investment grade. We expect softening economic conditions to widen spreads further (indicating the market is pricing in more risk) but only by a modest amount given continued expectations for a soft landing. We remain focussed 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.

Figure 1: Attractive Yields



Source: FactSet, Wealth Investment Office as of Sep 30, 2024. Global HY = Bloomberg Global High Yield Hedged to CAD, EM Hard Currency = JP Morgan EMBI Global Core Hedged to CAD

- We maintain our modest underweight view on high yield (HY) credit. HY spreads are tight, reflecting their rich corporate valuations, and have little room to tighten further. We expect HY spreads to widen if the growth outlook deteriorates although the improved quality of this universe should keep spreads from returning to previous recessionary levels. We continue to favour the higher quality cohort of the HY credit market.

Government bonds

The U.S. Federal Open Market Committee (FOMC) started its easing cycle in September by slashing the federal funds rate by 50 basis points (bps), taking the target range to 4.75%-5.00%. The size of this policy rate cut—the largest one since the Global Financial Crisis in 2008—took many by surprise.

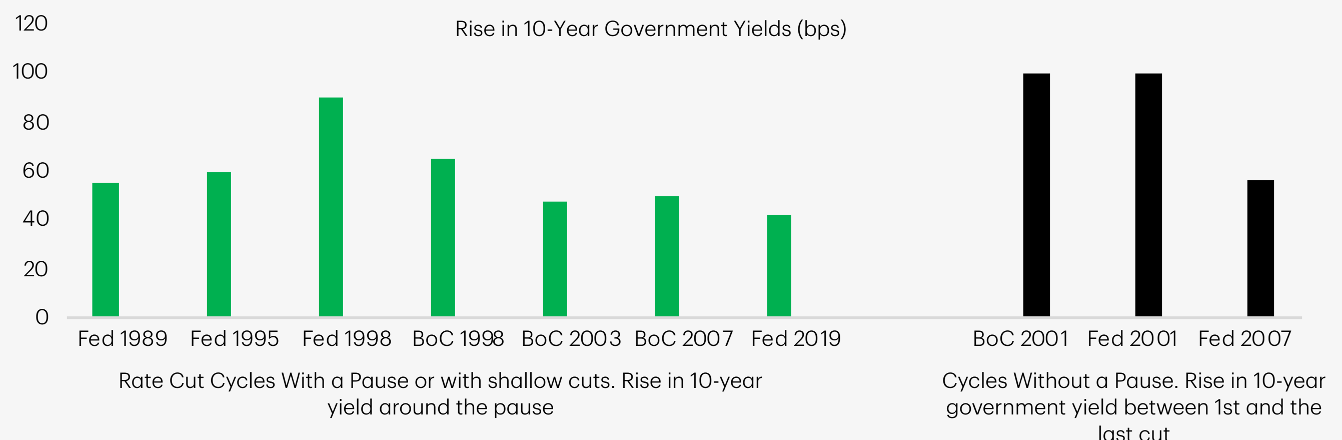
We do not believe the U.S. economy is currently in recession: consumer spending is resilient, and investment growth appears to be accelerating. However, with inflationary pressures subsiding, and with hiring and real GDP growth both slowing down, the Fed appears more focussed on keeping the economy strong. We believe this aligns with the faster path towards neutral policy rates implied in the latest interest rate projections from Fed officials (the dot plot). This new rate trajectory depends on continued U.S. economic resilience. Median Fed forecasts indicate consistently solid 2% growth, with the unemployment rate stabilizing just 20 bps above current levels. Government yields have priced in an easing cycle typical of a soft landing (no recession), but this could change to steeper cuts if recession risks increase materially. We believe the Fed's baseline path is to ease policy by 25-bp increments at each upcoming meeting. Since the Fed is data dependent when it comes to rates, government bond markets will likely react to any economic surprises, pricing in more and less aggressive cuts accordingly.

The Bank of Canada (BoC) delivered two additional 25 bps policy rate cuts at the July and September meetings following its first cut in June. Broad market expectations are looking for the BoC to ease policy by 25 bps at each of its upcoming meetings until it reaches neutral policy and that seems reasonable, but the BoC is likely to remain data dependent. Economic activity data since the September meeting do not justify increasing the pace of rate cuts but the momentum could change. We believe the slack in the economy justifies a policy rate modestly below the long-term neutral, but this is conditional on inflation remaining around the 2% target.

We maintain our modest overweight view on Canadian government bonds. We continue to expect the BoC and the Fed to diverge when it comes to the size and pace of cuts. However, even though the BoC may deliver follow-up cuts faster than the Fed and reach the final policy rate sooner, the extent of divergence on the neutral, or final policy rate, will be limited. We believe it's still best to take a longer-term view on government yields because Canada and other non-U.S. developed economies could still experience more difficult and abrupt landings. We maintain that moderating government bond yield volatility along with future rate cuts have improved the outlook for Canadian government bonds over the medium to long term, but investors need to be mindful of overstretched valuations as long-term government yields have fallen very quickly. We encourage everyone to take a balanced and risk-managed view of government bonds and yields (or interest rate duration).

Given expected volatility for yields, we strongly favour actively managed government bonds or interest rate duration that taps into tactical opportunities. If we look at past easing cycles for the BoC and the Fed, most had a "soft landing" narrative heading into the first cut (Figure 2).

Figure 2: Volatile Government Yields in Past Easing Cycles



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

As the cuts progressed, however, the narrative began to change. Sometimes initial cuts reignited economic growth and led to a central bank pause. In the seven cases where the central bank paused after a handful of initial cuts, bondholders suffered painful drawdowns around the pause. On the other hand, when there was no pause in the cutting cycle, government yields jumped between the first and last cut. In a few cases, cuts were unable to prevent a hard landing.

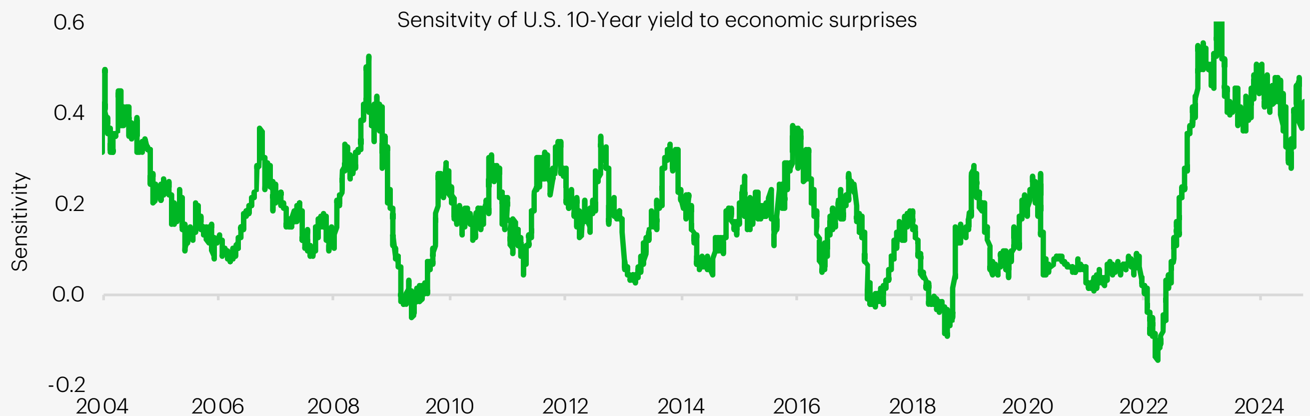
Any investor who commits to a particular outcome this early in the cutting cycle is merely rolling the dice. Successfully navigating this period requires someone with an adaptable approach and flexible framework capable of adjusting on the fly as the economy reacts to policy changes and shocks.

Key Themes for Government Bonds:

1. Economic Surprises Still Driving Government Yields. While a slew of negative economic surprises led to an increase in expected policy cuts and drove government yields lower from May to mid-September, the dynamic has flipped in the past few weeks. It is difficult to believe that the U.S. 10-year government bond yield is higher at the end of September than at the start of 2024 and remains so despite the significant policy rate cut and the clear messaging from the Fed that there are more policy cuts on the way. Government bond yields have been highly volatile and sensitive to economic surprises (Figure 3) and this relationship is still relevant and is expected to remain so in the coming months, according to the U.S. Citigroup Economic Surprise Index.

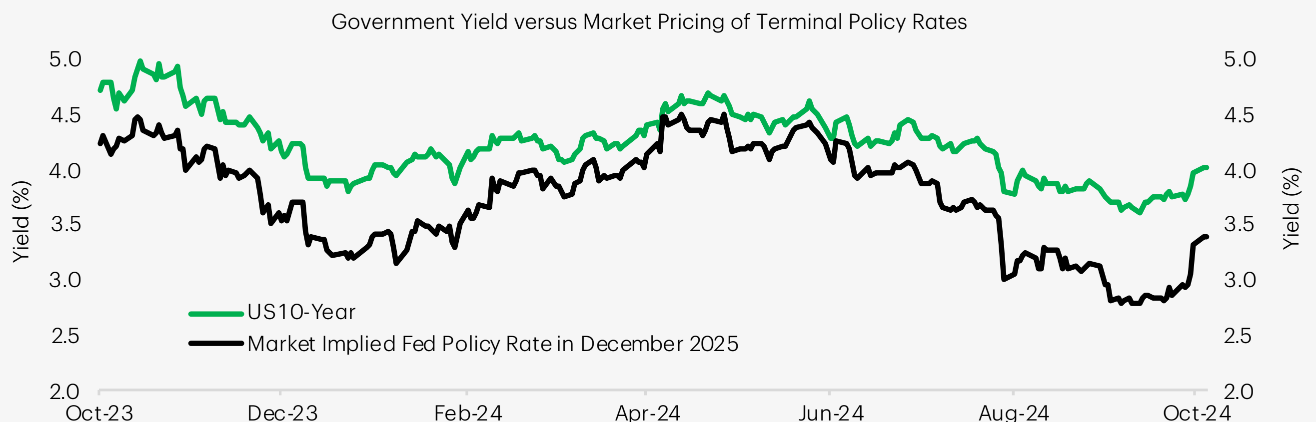
2. Watch Central Bank Terminal Rate. The overall Fed rate cuts—not timing—remain key. Over the 2022-2023 rate hiking cycle, the U.S. economy surprised to the upside time and again. For now, market indicators are pointing towards a Goldilocks economy where unemployment is low, although trending higher, and growth is softening though broadly stable. Any long-term economic weakness could upend this 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).

Figure 3: Government Yields Still Sensitive to Economic Surprises



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

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



Source: FactSet, Wealth Investment Office as of October 4, 2024.

3. U.S. Election. Given that both Republicans and Democrats have shown a lack of fiscal restraint recently, the outcome of November's vote may not bode well for longer term government yields. Joe Biden's 2021 fiscal plan and the 2022 Inflation Reduction Act as well as Donald Trump's tax cuts came amid strong economic growth and contributed to today's deficit of almost US$2 trillion. We believe Kamala Harris will probably broadly follow Biden's economic policy. 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 trajectories for growth and inflation. Equally important is the appointment of the next chair of the Fed's Board of Governors, and potentially several other board governors. Jerome Powell has said he will be staying until his term ends in 2026.

Credit: investment grade and sub-investment grade

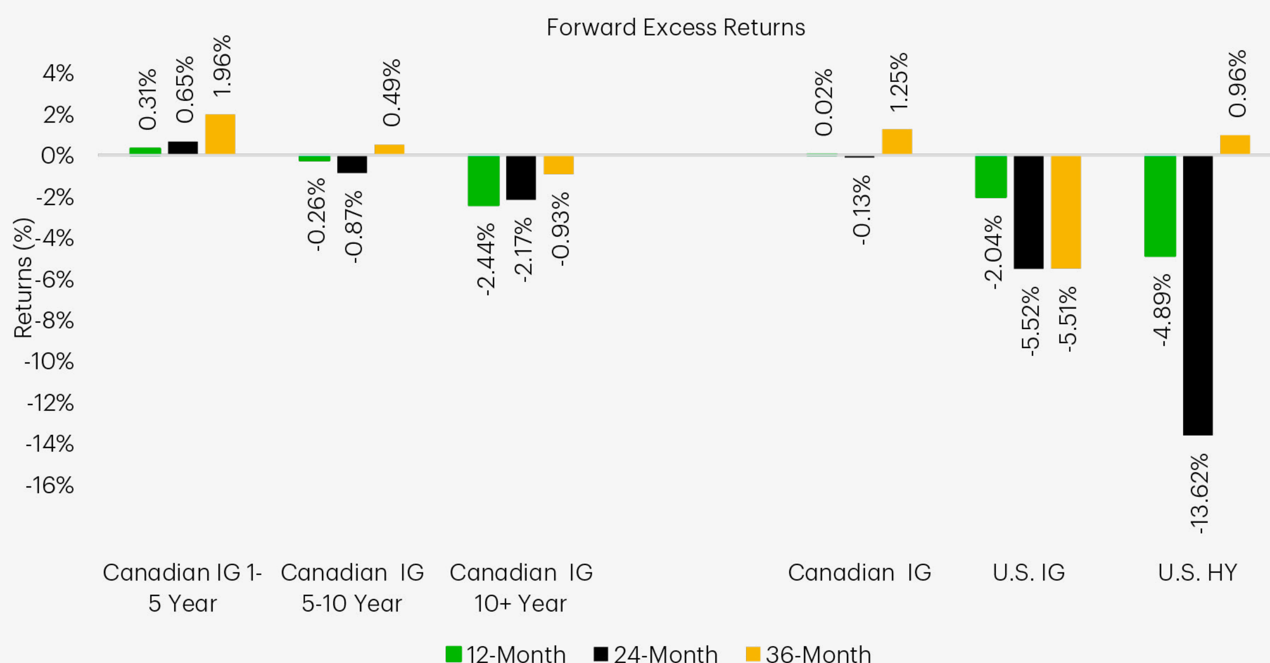
Given softening economic growth in Canada and tight valuations, we maintain our long-held view of modestly wider spreads in coming quarters. Spreads are expected to stay range bound because of sustained demand for yield, dwindling fears of recession and lower supply in coming months. (Spreads are a way of measuring risk premium over a government bond of similar maturity: a wider spread means the market is pricing in more risk, and narrower spreads, less risk.)

We maintain our modest overweight view on Investment Grade (IG) credit and 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). Spreads for Canadian IG credit are tight but still have room to perform (Figure 5). Looking over the past 20 years, the forward excess returns (returns over similar maturity government bonds), and therefore the potential, for the Canadian IG credit is relatively more attractive than U.S. IG.

Within the broader IG complex, we prefer short-dated Canadian IG bonds as a total return investment because they continue to offer very attractive all-in yield with lower interest rate sensitivity 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. Based on their current valuations, forward excess returns are not attractive. We're more comfortable owning IG, with its better outlook and balance sheet strength, over HY. Given the wide range of views on the economic outlook, credit investors should rely on active management and sectoral trends.

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

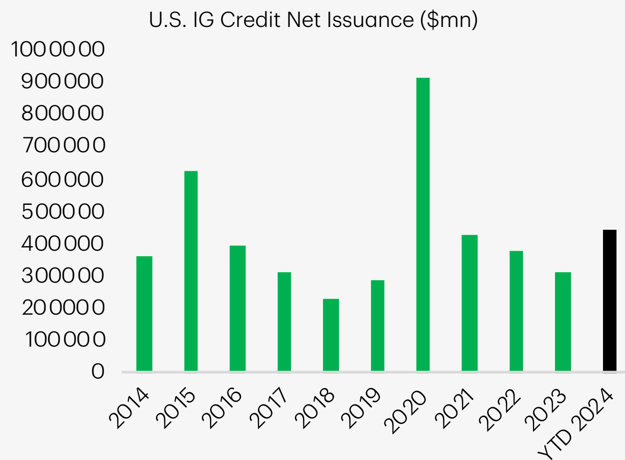


Source: FactSet, Wealth Investment Office as of September 30, 2024. Using historical month-end spreads since 2003 from periods when spread levels were tighter than current conditions

Key Themes for Credit or Corporate Bonds:

- **Credit Spreads in Tight Range.** Rate cuts on top of slowing but still resilient U.S. economic growth will continue to bolster investor confidence, keep government yield volatility subdued and hold credit spreads within a tight range similar to 2023. Given this situation we reiterate our view that investors manage portfolios actively and focus on high quality shorter maturity credit. Scenarios exist which could move spreads much more than our base case forecast. If the Fed delivers the remaining projected rate cuts 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. However, spreads could widen if IG bond yields tumble (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.

Figure 6: Record Issuance Has Not Dented Tight Spread Levels



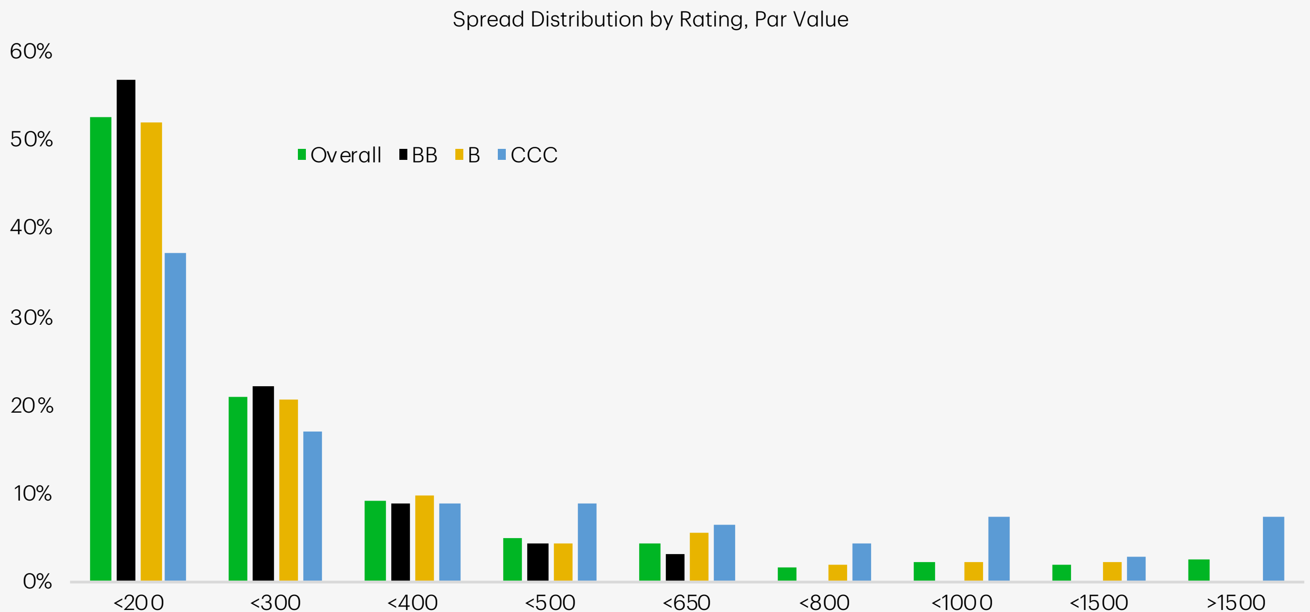
Source: FactSet, Wealth Investment Office as of September 30, 2024.

- **Net New Issuance Good for Credit Spreads.** Total bond issuance across IG credit ended the quarter with the third-largest year-to-date supply in the past ten years. Higher new issuance is led by companies refinancing ahead of maturity walls while strengthening balance sheets. But demand has also been high. In coming quarters, the lower expected issuance to replenish maturing bonds will likely send net issuance (issuance minus bonds maturing) for both IG and HY into negative territory, which could result in positive technicals for credit spreads in future quarters.

- **Robust Demand.** Conversations with IG credit investors indicate that demand 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.

- **Tight U.S. HY Corporate Valuations.** Valuations in the overall 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 50% of all BB-rated HY (Figure 7).

Figure 7: HY Credit Valuations Expensive



Source: FactSet, Wealth Investment Office as of October 4, 2024. Universe referred to is Bloomberg U.S. Corporate High Yield Index.

At 180 bps (as of September 30), the BB tier's option-adjusted spread has seldom been tighter (more expensive). Within B-rated HY credit, 50% trade inside 200 bps. At the other end of the spectrum, 12% of the index trades at least 1,000 bps over Treasuries, the threshold for distressed.

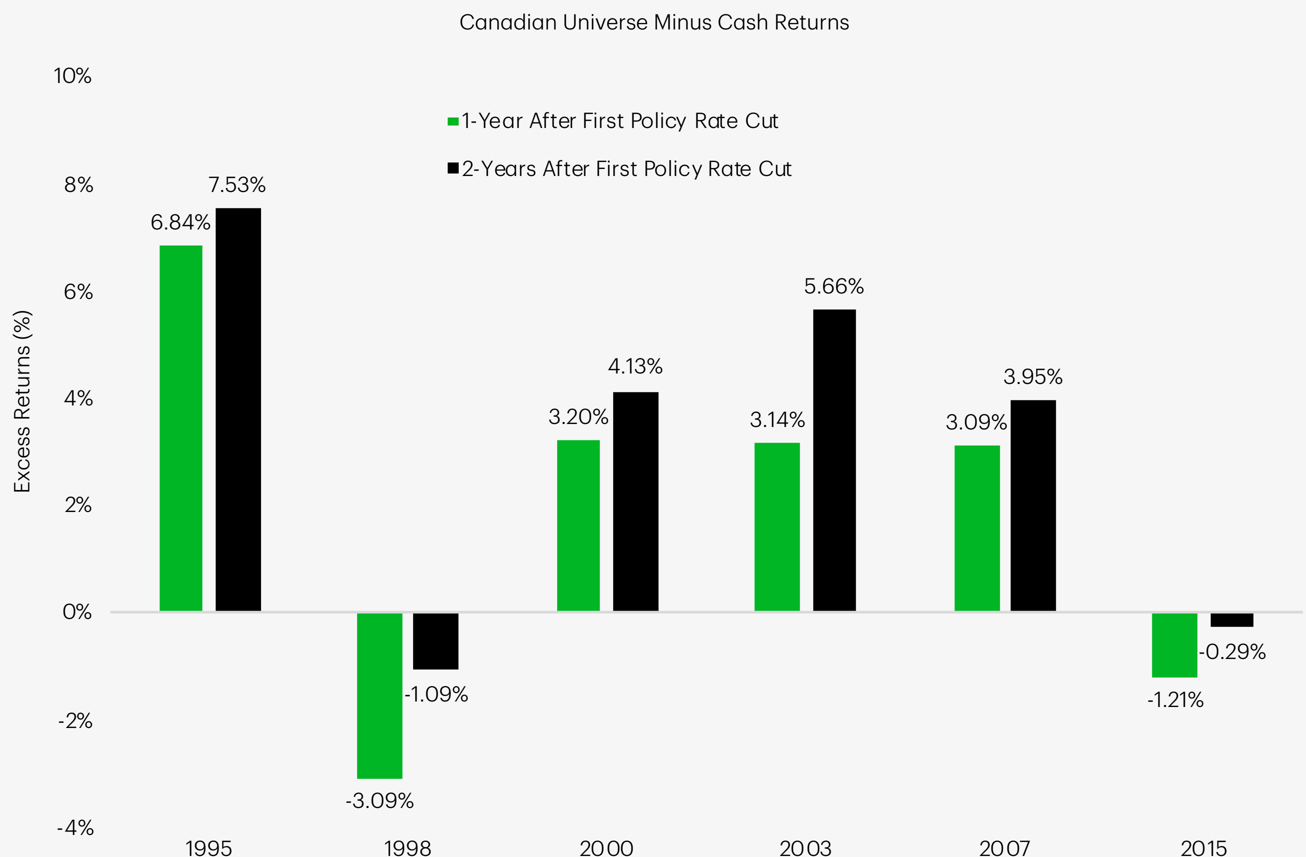
Higher yields and diversification

We urge investors to hold a balanced and diversified portfolio. While we believe returns over the next 12 months will be lower than what has been delivered in 2024, it's still possible to earn attractive yields in most segments of the fixed income market right now. Current yields are still at attractive levels, providing a buffer against volatility and adding the income back into the fixed income mix. Government bonds and duration will be attractive to those investors with a slightly longer time horizon. Buying opportunities can arise quickly in periods of uncertainty. Active management focussed on balancing duration and credit exposure, and tactical adjustments will help investors sort through the wide range of government yields and capture strong returns.

Historically, cash has underperformed fixed income during easing cycles (Figure 8). Cash yields are already less attractive than they were a few months ago and are expected to fall on further rate cuts because the simple interest on cash drops. Overall, bonds offer comparable yield and potential for price gains over cash and GICs.

We have shifted to a modest underweight view on fixed income overall. However, it's important to note that 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 is showing signs of returning to more conventional behaviour. Our base case for fixed income is to earn attractive income without 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 more attractive returns.

Figure 8: Fixed Income Outperforms Cash During Policy Rate Cuts



Source: FactSet, Wealth Investment Office as of September 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

Maintaining Momentum

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

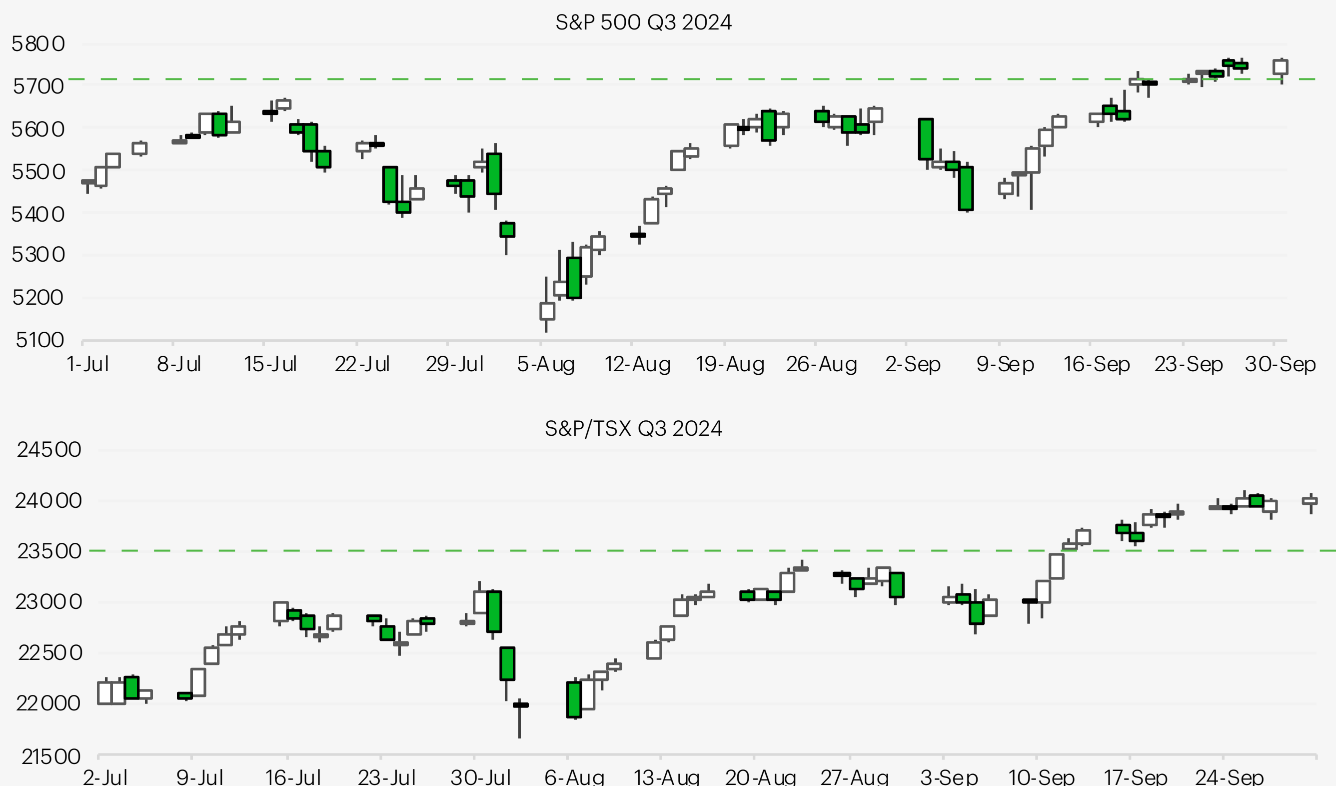
After steady gains and muted volatility in the first half of 2024, the third quarter turned into a wild ride for North American equity markets. It started in July. The yen carry trade unwind sparked a violent selloff in global equity markets and particularly in the tech-heavy U.S. market. Global traders had borrowed yen at low rates to make levered bets on U.S. growth stocks but when the Bank of Japan (BoJ) hiked interest rates and the yen rallied they were suddenly forced to reverse the trade and sell U.S. stocks to pay back yen loans. The leading NASDAQ 100 index tumbled 15% from its record high in mid-July to an early August low–losing almost two thirds of its year-to-date return in a matter of weeks. The CBOE volatility index, or VIX, spiked to levels not seen since the March 2020 panic, illustrating just how much equity managers were scrambling to secure portfolio insurance.

Yet, as we've seen time and again during this bull market cycle, equities remained resilient. By the time the long-awaited U.S. Federal Open Market Committee (FOMC) policy decision came on September 18, the S&P 500 had shot back to just below its all-time high. A day after the dovish 50 basis point (bp) cut was announced, the index broke out to new highs.

The week following the FOMC-driven boost, the Chinese government initiated a broad stimulus package including reduced reserve requirements for banks and liquidity support for the stock market. Again, risk markets reacted positively, particularly China-listed equities, but also the commodity complex. This proved to be a boon to resource-dominated Canadian equities and added to their post-FOMC breakout gains.

By the time the dust settled at the end of the third quarter, the breakout in the S&P 500 had closed with a gain of 5.5% and the S&P/TSX Composite Index was 9.5% higher on a price return basis (Figure 1). This reaction to easing policies suggests the market had already begun to price in the Fed successfully engineering a soft landing. Whether or not this turns out to be true, it has given the market momentum that should help during the typically strong fourth quarter.

Figure 1: Equity Markets Climb After FOMC and China Stimulus



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

We have upgraded our outlook on equities from neutral to modest overweight overall to reflect increased confidence in a soft-landing scenario which will support attractive earnings growth, particularly for U.S. and Canadian companies. As such, we maintain a modest overweight both U.S. and Canadian equities.

In the United States, we are attracted to an economy which is a leading light in scientific innovation and development and a leader in the development of Artificial Intelligence (AI). Within that theme, we continue to tilt towards companies with a particular focus on the semiconductor space in the AI value chain. In addition, Industrial companies more broadly continue to offer attractive opportunities, particularly those that are exposed to the benefits of the Build Back Better Act, the Inflation Reduction Act and the Chips Act, which is to say infrastructure building as well as the near-shoring/reshoring of manufacturing. The soft landing that the Federal Reserve appears to be achieving will, we feel, allow a continuance of the attractive earnings growth seen over the last decade.

In Canada, the significant rate cuts appear to be having the intended impact with signs of stabilization in the economy. Canadian equities are attractive from a valuation perspective as well. We see potential for better performance from the financial sector and particularly banks which should be able to bring down provisions for credit losses as a worst-case economic outcome is avoided. At the same time, the materials sector should continue to benefit from stable to increasing metals prices and energy companies should continue to return cash to shareholders by both dividend and share re-purchases as strong free cash-flows continue with the capital discipline producers have shown.

Fourth Quarter Outlook

Since the Global Financial Crisis (GFC), North American equity markets have performed well in the fourth quarter at least 80% of the time. In the fourth quarter the S&P/TSX has been positive 80% of the time and S&P 500, 87% of the time since 2009 (Figure 2). In the last 15 years, there have only been three times that the S&P/TSX, and two times that the S&P 500, did not record a positive fourth quarter. At the time of writing, as we march towards the end of 2024, both indices are sitting on five-year Q4 winning streaks.

This year we entered the fourth quarter with strong year-to-date momentum: both leading Canadian and U.S. equity markets are posting double-digit price gains.

U.S. technology growth stocks have been driving this bull market cycle and they are likely to continue to do so if seasonal tailwinds persist. Historically, the NASDAQ Composite, the broad technology index, has recorded one of its strongest months of the year in November; it's been positive 87% of time in the post-GFC era, including 12 positive returns in a row, with an average return of over 3% (Figure 3).

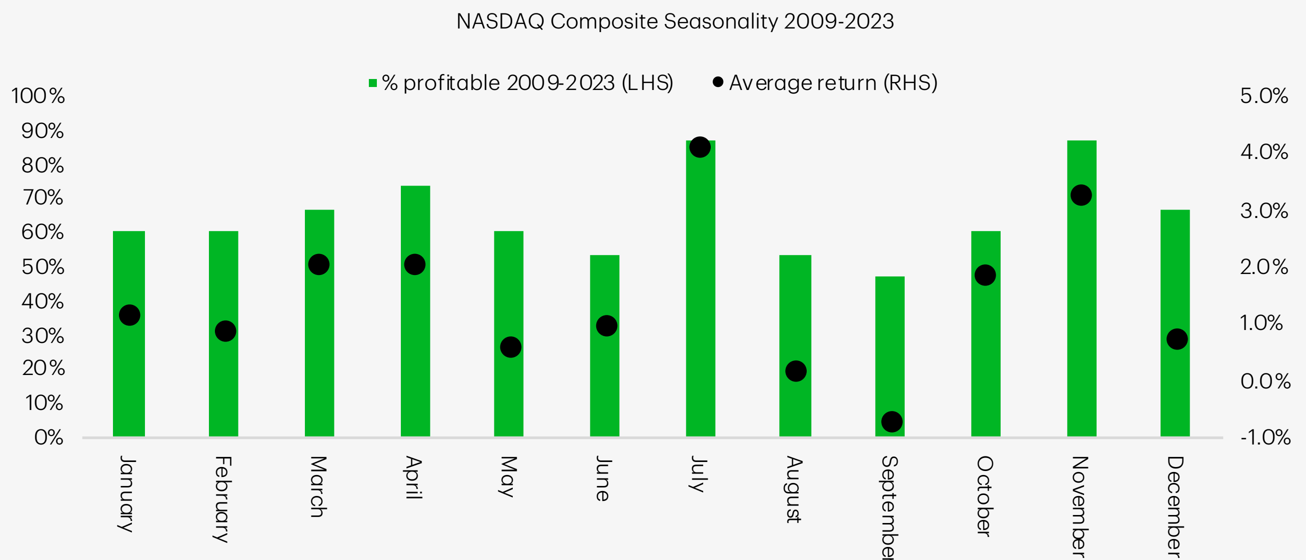
Given this backdrop, the next question is: In a strong "up" year driven by the AI trade, will this equity investing theme continue to lead the market into year-end?

Figure 2: S&P/TSX and S&P500 Q4 Performance (2009-2023)

Year	S&P/TSX		S&P 500	
	Q1-Q3	Q4	Q1-Q3	Q4
2009	26.8%	3.1%	17.0%	5.5%
2010	5.3%	8.7%	2.3%	10.2%
2011	-13.5%	2.8%	-10.0%	11.2%
2012	3.0%	0.9%	14.6%	-1.0%
2013	2.8%	6.5%	17.9%	9.9%
2014	9.8%	-2.2%	6.7%	4.4%
2015	-9.1%	-2.2%	-6.7%	6.5%
2016	13.2%	3.8%	6.1%	3.3%
2017	2.3%	3.7%	12.5%	6.1%
2018	-0.8%	-10.9%	9.0%	-14.0%
2019	16.3%	2.4%	18.7%	8.5%
2020	-5.5%	8.1%	4.1%	11.7%
2021	15.1%	5.7%	14.7%	10.6%
2022	-13.1%	5.1%	-24.8%	7.1%
2023	0.8%	7.3%	11.7%	11.2%
2024	14.5%	?	20.8%	?
Percent positive	69%	80%	81%	87%
Average in all years	4.2%	2.9%	7.2%	6.1%
Average in 'up' Q1-Q3	10.0%	4.0%	12.0%	5.5%
Average in 'down' Q1-Q3	-8.4%	0.6%	-13.9%	8.2%

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

Figure 3: Q4 Historically Strong for NASDAQ Composite



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

The AI trade: Counter-cyclical spending drives revenue for semiconductor supply chain

The cost of developing and/or training the models that will drive generative AI functionality is very expensive, and it requires large capital expenditures (CapEx) to build the computing infrastructure required to do the training. Building this infrastructure—where the primary components are semiconductor chips—has turned into a race. The annual CapEx run rate is likely approaching US$200 billion, and is expected to grow in 2025, driven by leading hyperscaler companies such as Amazon Web Services, Microsoft Azure, and Google Cloud. On a July earnings call, Alphabet CEO Sundar Pichai talked about the company's heavy spending on AI infrastructure, highlighting: "the risk of underinvesting is dramatically greater than the risk of overinvesting for us here." Similarly, META CEO Mark Zuckerberg said in a Bloomberg podcast that "the downside of being behind is that you're out of position for like the most important technology for the next 10 to 15 years." These aggressive build strategies have spawned a type of counter-cyclical CapEx that will support the AI supply chain regardless of a potential economic slowdown.

This hyperscaler CapEx becomes revenue for chipmakers at the forefront of the AI value chain. Revenue growth is expected to remain strong as this buildout cycle continues, with NVIDIA leading the way. Its revenue is forecast to more than double, from US$61 billion in fiscal 2024 to over US$125 billion in 2025, and it's expected to grow another 43% in 2026. Semiconductor industry revenue is expected to surpass US$1 trillion in 2030. Hence, the outlook for semiconductor stocks as core long-run holdings in the secular growth trend, is positive going into the end of the year and beyond.

Let's zoom out from the chipmakers to the semiconductor capital equipment makers, the companies that provide the machinery to produce the components. Equipment vendors are at the start of the supply chain and therefore poised to see revenue growth continue: as semiconductor production expands, their capital expenditures must follow suit to increase production capacity and maintain existing capital. Wafer fabrication equipment is currently about 15% of semiconductor revenue and tracking higher, making this group another near-term and secular growth opportunity in the expansion of AI.

We've seen some recent volatility in this space, but as long as hyperscalers continue their infrastructure buildout unabated, we expect the semiconductor value chain to keep driving the market in the near term.

As we begin the fourth quarter, the market appears more buoyed by tailwinds than battered by headwinds. Like Newton's first law of motion, we expect momentum to continue, barring an opposing force or catalyst. Volatility is to be expected, but the counter-cyclical spending and seasonal tailwinds typical at year-end suggest the market will hold its year-to-date gains, if not add to them. We may even see another Santa Claus rally to close out 2024 and open 2025.

International and Emerging Market equities

Economic stagnation, political crisis weigh on international equities

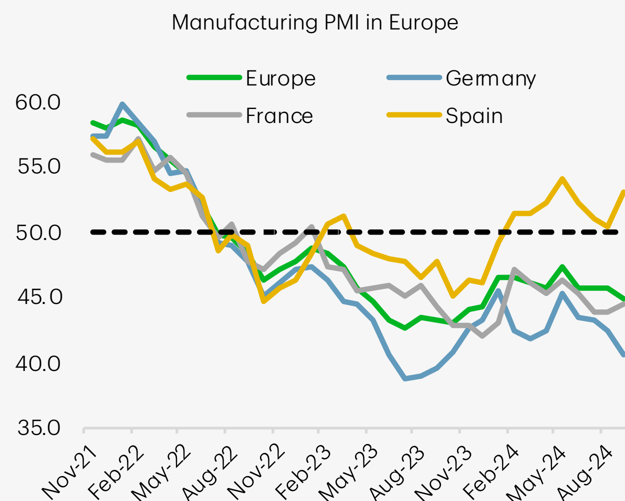
Performance for international equities, at 0.3%, remained subdued in the third quarter, hampered by sluggish economic activity in Europe and the impact of the reversal in the yen carry trade on Japan equities. Industrial production in Europe is still negative with Manufacturing PMI levels since June close to 45 and lower than the historical average of 50. Germany which accounts for 25% of Europe's GDP is battling structural headwinds in its manufacturing sector. Germany's once renowned auto industry is struggling with declining demand amid growing competition from other global auto players. It is also losing market share in China—its largest auto export market—to lower cost and heavily government-subsidized domestic players. This has limited the ability of the German auto players to fully monetize their hefty investments in electric car production. Germany's real estate market which has a close alliance with Chinese investors is also being hurt by China's liquidity crisis and problems in its real estate sector. Therefore, although early signs of economic recovery exist in other regions like Spain and France, sluggish recovery in Germany is weighing on the outlook for European equities (Figure 4).

Economic activity in the U.K., on the other hand, has made decent progress; both Manufacturing and Services PMI levels have been higher than 50 since July 2024 and December 2023, respectively. Housing prices, consumer and business confidence have all begun to recover. However, the U.K. continues to struggle with the affordability crisis and rental inflation has remained entrenched above 6% since December 2023. Despite the decline in inflation from 6.7% in September 2023 to 2.2% in August 2024, the Bank of England (BoE) has maintained a cautious stance, indicating it will cut rates at a slower pace as compared to the European Central Bank (ECB). Higher borrowing costs has impacted both top- and bottom-line growth for U.K. equities resulting in lackluster earnings growth of 1.0% in 2023 and a negative forecast (-10%) for full-year 2024.

The long-term story for Japanese equities continues to be attractive because of the government's corporate governance reforms and its push to increase returns to equity shareholders, but yen volatility could cap upside potential by year end. After the Bank of Japan (BoJ) hiked interest rates by 25 bps—sending investors into panic-reversing the yen carry trade which led to the massive appreciation of the yen—Japanese equities lost 12% in one day. It was not just the BoJ's move which impacted the yen. The devaluation of the yen was already stretched because markets focused on the "higher for longer policy rate scenario" in the U.S. We don't expect a similar event to happen in the near future. However, with the Fed clearly into an easing cycle, the yen could appreciate from now until year end, which would limit upside potential for Japanese equities. (Japan's GDP depends on exports and the appreciating yen makes exports more expensive, and companies lose their cost advantage). Another important factor for Japan is that corporates should continue to be encouraged to maintain nominal wage growth of over 3.0% which would ensure the real wage growth would be in positive territory (unlike the past two decades) and boost consumer spending. Consistent positive real wage growth and increased consumer spending are essential elements for Japan to sustain an inflationary environment.

We believe the global (ex Japan) move to reduce rates will help rejuvenate economies in international regions given their higher sensitivity to interest rates compared to the U.S. At the same time, the growing political crisis in the Middle East continues to add volatility to oil prices which could, in turn, hurt equities in Europe which relies on energy imports. We believe these macro risks are priced into current valuations. Given the slow pace of economic recovery, earnings growth for international equities is expected to be muted in 2025, according to an analyst survey by Bloomberg. We maintain a modest underweight stance for international equities.

Figure 4: Sluggish recovery in Germany adds to economic stagnation in Europe



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

Emerging Markets: Will China Sustain the Equity Rally?

In the third quarter, emerging market (EM) equities recorded the strongest growth of 2024, with China leading the pack. Chinese equities, which had lagged since June 2023, posted a 12% return after its central bank announced a series of monetary, fiscal, and financial measures which amount to the largest stimulus package since 2015. These measures are expected to benefit the following aspects of the economy:

- **Monetary Support:** People's Bank of China (PBOC) cut lending rates for seven-day repo rates, medium-term facility, and loan prime rates by 20-30 bps. It also lowered the reserve requirement ratio by 50 bps, all of which is expected to boost liquidity in the financial system.

- **Property Sector:** PBOC cut mortgage rates by 50 bps, reduced the minimum downpayment to 15% from 25%, and local governments eased restrictions on second home purchases which helped to boost confidence in the real estate sector.

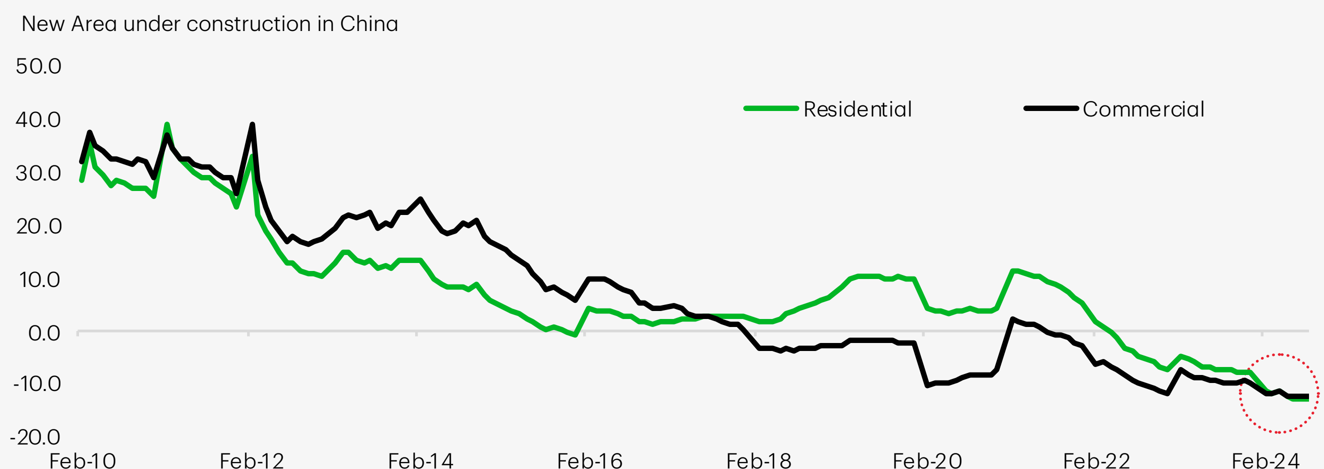
- **Financial Markets:** PBOC created a swap facility open to securities brokers, asset managers and insurance companies to get easier access to funding for stock purchases. It initiated a study of a specialized refinancing facility for listed companies to buy back shares.

After these measures were announced, the dwindling confidence of global investors in China turned around and the CSI 300 Index ended September with a 21% return compared with a 2.0% return from the MSCI ACWI.

The key question is: What now? Will these initiatives resolve the structural issues China is facing in its real estate sector and the huge debt burden of local governments? China announced multiple measures in May 2024 and August 2023, but they failed to translate into a sustainable rally in China equities. These stimuli, however, are different from past attempts because of the magnitude of the fiscal support they offer combined with government regulatory efforts. Moreover, both the PBOC and the government have expressed intentions to announce additional monetary and fiscal support to rejuvenate the real estate sector and boost consumer spending.

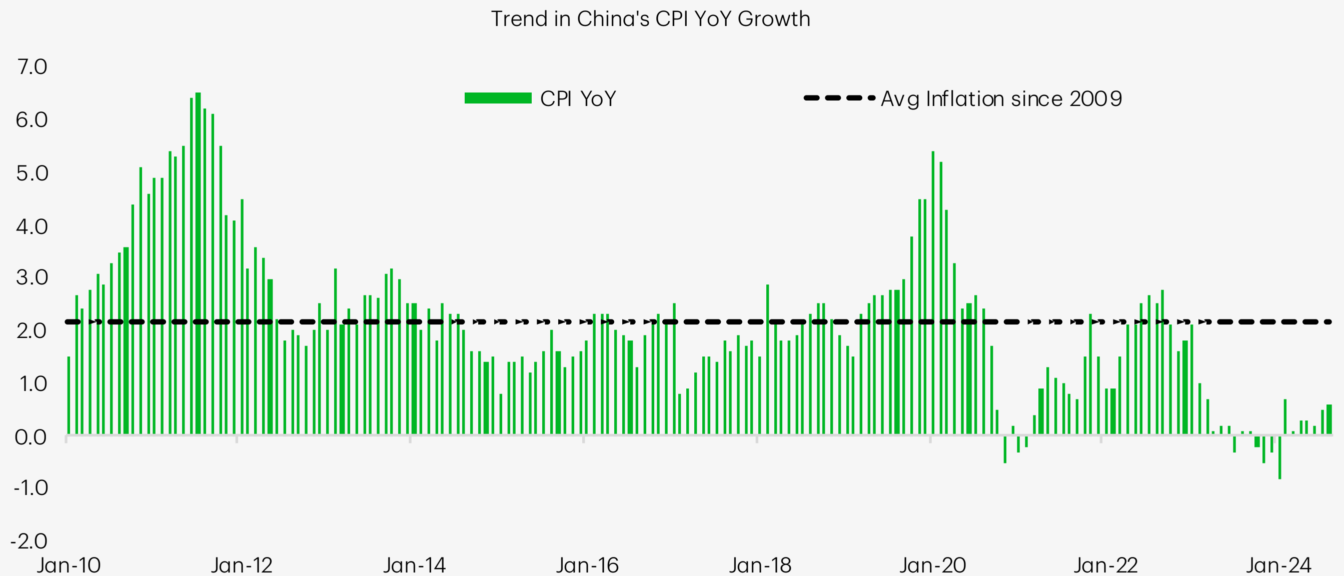
How China implements this stimulus package is crucial for sustaining the equity rally. So far, these measures, which address supply-side issues, have shifted global investor sentiment towards hopeful and positive. However, more fiscal support is needed to lift confidence and secure additional investment in the real estate sector (Figure 5). More importantly, we need to see more confidence within China to buoy domestic consumption and corporate spending (the demand side of the economy). The latest CPI trend suggests the economy could shift towards a deflationary environment if consumers continue to hoard savings because they don't believe the government will be able to stimulate the economy (Figure 6). While the measures announced so far are in the right direction, implementation and continued fiscal support is now key. Hence, we maintain our modest underweight stance for China equities.

Figure 5: Real Estate Sector Growth Languishing



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

Figure 6: Inflation in China Around 0% Since April 2023



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

When it comes to year-to-date performance, India equities continue to deliver strong and steady gains and record the second-highest returns after Taiwan equities. Global investors don't seem phased by the coalition government and are still eyeing up Indian equities mainly because of the government's ambitious plans to turn the country into a global manufacturing hub by 2047 and a supply chain alternative to China. Manufacturing comprises less than 20% of India's GDP and this number has been flat over the last decade. Hence, it has aimed to focus on exports with an ambitious target of growing it to $1 trillion annually by 2030 as compared to the $780bln in exports so far in 2024. The country is also gearing up its infrastructure spend by announcing a US$1.4 trillion investment in pipelines over the next five years; it has also built 75 new airports, doubled its railway capacity by launching semi-high speed trains, and has 111 National Waterways. However, these growth targets are already priced into equities in India, which are trading at peak premium (since 2010) of 24%. Despite these stretched valuations, momentum could continue for some time.

Equities in Brazil and Mexico—the forefront of the EM equities bull run in 2023—have been overshadowed by rising political risks clouding growth prospects. In Brazil, President Luiz Inacio Lula da Silva replaced the CEO of Petrobras (Jean-Paul Prate) with the former head of the country's oil and gas regulator making investors nervous about the accelerating shift towards economic interventionism. Similar risks hold true for Mexico equities, which tumbled mainly on election results. Claudia Sheinbaum and the Morena party's almost supermajority in Congress has raised concerns about power concentration and a potential weakening of judicial independence.

When it comes to politics, we are also concerned about the potential risks for EM equities if Republicans win the U.S. election in November. In such a scenario, China equities will get hit hardest but other EM equities like Mexico might also feel the squeeze if Republicans impose restrictions on imports and offshore production. However, we expect pragmatism to win out because 32% of the U.S.'s total imports come from China and Mexico so the country will be greatly affected by any price increases.

Unless we see signs of robust economic recovery for Europe and China and a sustained pick up in global demand, we retain our modest underweight stance for China and emerging market equities.

Outlook on Alternative Assets

Modest Overweight

What rate cuts mean for private assets

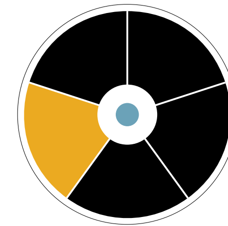
Shezhan Shariff, P.Eng., CFA | Senior Alternative Investments Analyst | TD Wealth

When the cost of capital is high, as it has been over the past two years, the liquidity that supports private-market buyouts tends to dry up, which naturally drags down prices. From an investment perspective, though, this kind of restrictive rate environment is the best time to allocate long-term capital to managers with specialized expertise in large-scale, control-oriented buyouts. Why? Because lower entry valuations over the short term create a target-rich environment for buyout specialists with proven track records of successfully executing business transformations that unlock value.

Recall that in the decade following the global financial crisis (GFC) — when monetary policy in Western developed markets was ultra-accommodative — there was too much capital chasing too few deals, resulting in a stymied and frustrated environment for value investors. One example of this was the large cash pile sitting on Berkshire Hathaway's balance sheet during this period, eagerly awaiting deployment at rational prices. It's also important to note that, when capital is tight, returns tend to be generated from operational intervention that drives free cash flow growth, as opposed to leverage-induced multiple expansion. This is where it pays to be discerning in selecting a general partner (GP) with proven expertise, because there is no rising tide to lift all boats.

The first half of 2024 demonstrated the kinds of returns possible in a tight monetary environment. As of June 30, North American buyouts returned 6.6%, 9.5%, 17.0%, and 15.5% annualized over one-, three-, five- and 10-year periods respectively, according to the Preqin Quarterly Index. Despite lagging the whopping 24.3% one-year return for the S&P 500, North American buyouts outperformed by 219 basis points (bps) and 266 bps annualized over five- and 10-year periods. When compared to the small-cap Russell 2000 (which more closely resembles the private-equity opportunity set), North American buyouts outperformed by 10.3 and 8.6 percentage points annualized over five and 10 years. These risk premiums were even higher for top-quartile managers, such as those available in both traditional drawdown and contemporary perpetual-capital fund types on the TD Wealth platform.

On the other hand, higher interest rates subdue exit options for portfolio companies, leading GPs to pursue secondary-market transactions as a path to liquidity. Limited partners (LPs) are accustomed to regular



Why consider adding alternatives to your portfolio?

Investors with a long-term horizon could benefit from including private-market assets in their portfolios — namely, private equity, private credit and unlisted real assets such as real estate and infrastructure. Alternative investments can enhance risk-adjusted returns by taking advantage of cash flows and valuation drivers that are different in nature than those found in companies that issue publicly traded equity and fixed income securities. Additionally, unlisted real assets provide investors with income streams that rise and fall with inflation, unlike the nominal dividends and interest payments that are typically received from stocks and bonds.

Privately held assets in general help to reduce portfolio volatility, due to relatively muted drawdowns across market cycles because they're less influenced by the noise that sometimes causes dislocations in public markets. Beyond exposure to a wider cross-section of systematic risk factors, private markets provide opportunities to capture additional skill-based risk premiums and generate attractive absolute returns. This is by virtue of lower information efficiency that rewards specialized origination capabilities; active ownership that requires operational intervention and capital structure optimization; and trading illiquidity that enables long-term compounding of capital. We have a Modest Overweight outlook for Alternatives.

distributions from their closed-end allocations as these traditional drawdown funds mature into their harvesting phases. Additionally, because GPs are averse to letting go of crown jewel assets on the cheap at contractual fund termination dates, they seek transfers into continuation vehicles with new LPs with reset fund lives.

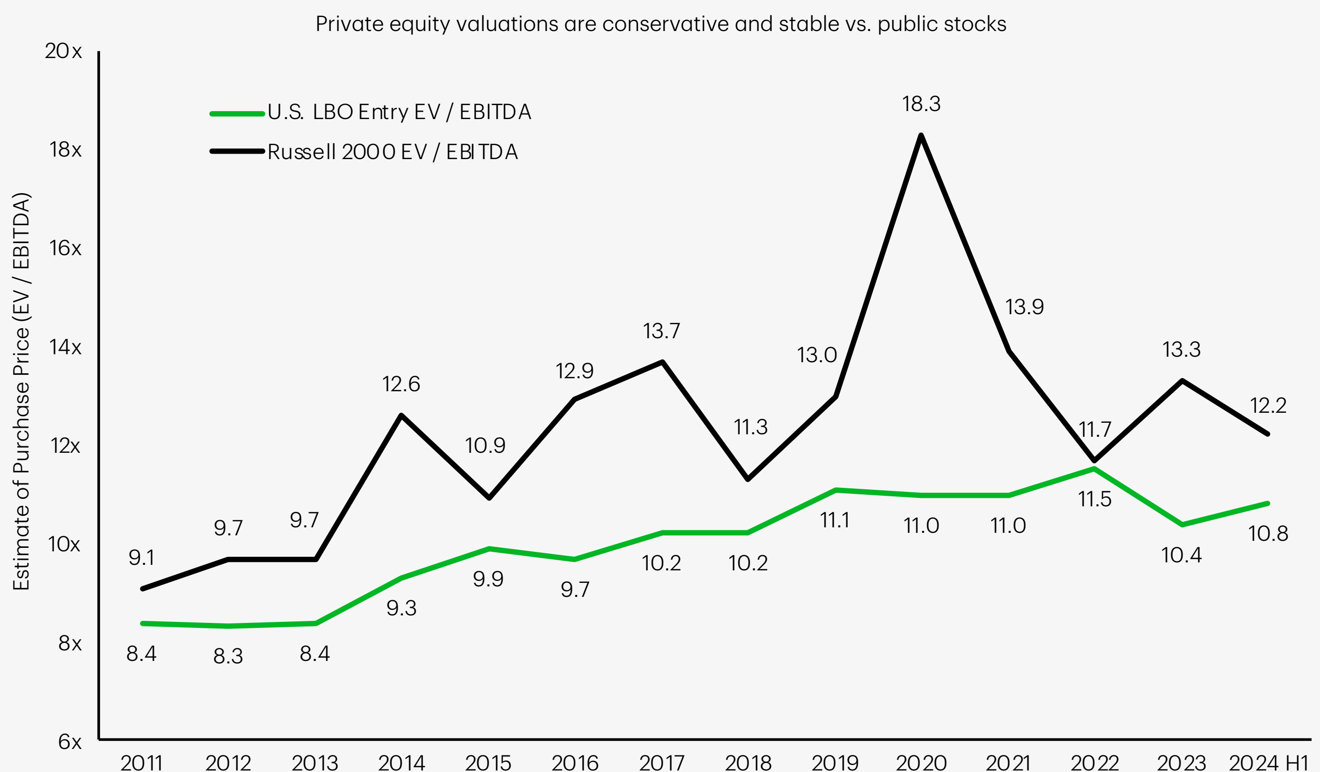
It's no surprise, then, that there was a spike in LP-led and GP-led secondary transactions over the past two years. UBS Asset Management data show that during the depths of the mergers and acquisitions (M&A) and initial public offering (IPO) freeze of 2022, primary LPs were willing to let go of units in seasoned buyout funds for about 85 cents on the dollar. For portfolios of real estate holdings, this value was closer to 75 cents, and for venture-capital funds, 70 cents. Such bargains for performing assets were available to opportunistic liquidity providers.

Meanwhile, transaction costs for U.S. leveraged buyouts (LBOs) have been conservative relative to public-market equivalents for over a decade, due in part to illiquidity and a disciplined valuation process, which ameliorates return volatility. Figure 1 shows the ratio of U.S. LBO entry enterprise value (EV) to pre-tax, pre-financing cash operating profits (proxied by earnings before interest, taxes, depreciation and amortization, or EBITDA, and ignoring working capital adjustments) compared to prevailing valuations for the aforementioned Russell 2000 index using the same EV-to-EBITDA valuation metric. At the midpoint of 2024, private-market multiples averaged 10.8x compared to 12.2x for publicly traded companies. These measures were respectively 10.4x and 13.3x last year.

Another data point of note that may provide reassurance on the private-equity landscape is the approximately US$150 billion of global LBO transactions announced by GPs in the third quarter of 2024, an eye-popping 42% increase year-over-year (y/y), per Carlyle data. Through the first nine months of the year, financial sponsors have accounted for 18% of global M&A volumes, almost nine percentage points higher than average since the financial crisis.

Although headlines about IPOs are most alluring to financial-market participants, most portfolio companies owned by private-equity firms are exited through trade sales. These have been relatively weak since the first quarter of 2022, as the countervailing forces of elevated base rates and robust run-rate profit growth made price discovery impossible and sidelined strategic buyers. The decline in trade sales delivered a negative liquidity shock in that capital calls exceeded distributions for LPs in buyout funds for eight consecutive quarters — the longest stretch of net negative distributions since the GFC. That finally ended in the third quarter of 2024.

Figure 1: Conservative and stable vs. stocks



Source: Wealth Investment Office, Preqin, UBS Asset Management as of June 30, 2024

In the wake of the Fed's 50-bp rate cut in September, the IPO market is seeing green shoots of recovery. Excluding special-purpose acquisition companies (SPACs, aka "blank cheque" entities), 119 U.S. exchange-listed IPOs raised US$26.2 billion in the first nine months of 2024. These represent 30% and 50% y/y increases in listings and proceeds respectively. The figures remain subdued relative to white-hot 2021 levels, but follow-on transactions have seen an uptick from their trough in the first quarter of 2023. These transactions typically serve as a leading indicator for IPO sentiment and may portend a new liquidity window going into 2025.

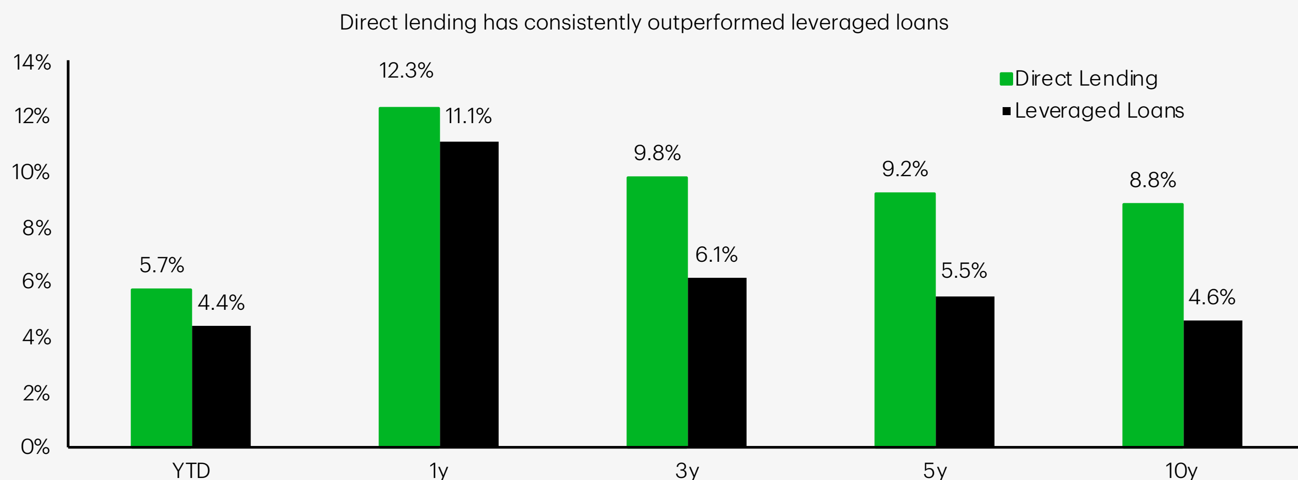
One great example of a successful private-equity investment was Blackstone's US$16-billion acquisition of AirTrunk, the Asia-Pacific region's largest data-centre platform. Blackstone's basis set up to a 20x run-rate EBITDA multiple, which stacked up favourably to comparable transactions in the public markets trading at 26x. This deal included a co-investment from CPP Investments and contributes to Blackstone's US$55-billion global data-centre portfolio. Since 2010, data created, consumed and stored has grown 90-fold, from two zettabytes in 2010 to 180 zettabytes today. Partnering with GPs capable of originating, executing and operating such assets is one way to participate in the AI boom.

Private Credit

Strong capital inflows and reengagement from investment banks (following last year's banking crisis) have led GPs to compete on price, which has significantly tightened spreads for sponsor-backed direct lending. New issuances, moreover, have risen to their highest level in several years. Carlyle estimates that full-year 2024 leveraged finance issuance, inclusive of high-yield bonds, is likely to exceed US$1 trillion for only the third time in history — the main driver being the boom in refinancing and repricing transactions, comprising 72% of all institutional loan activity this year through September. According to J.P. Morgan Asset Management, private-credit transactions at the end of June closed approximately 100 bps wide to B-minus-rated broadly syndicated loans, close to the average over the past 18 months but down from close to 190 bps at the end of 2023. Despite tighter spreads, carry remains ample, defaults low and dry powder abundant. Prevailing high-single- to double-digit yields are a tailwind to total return as monetary policy eases.

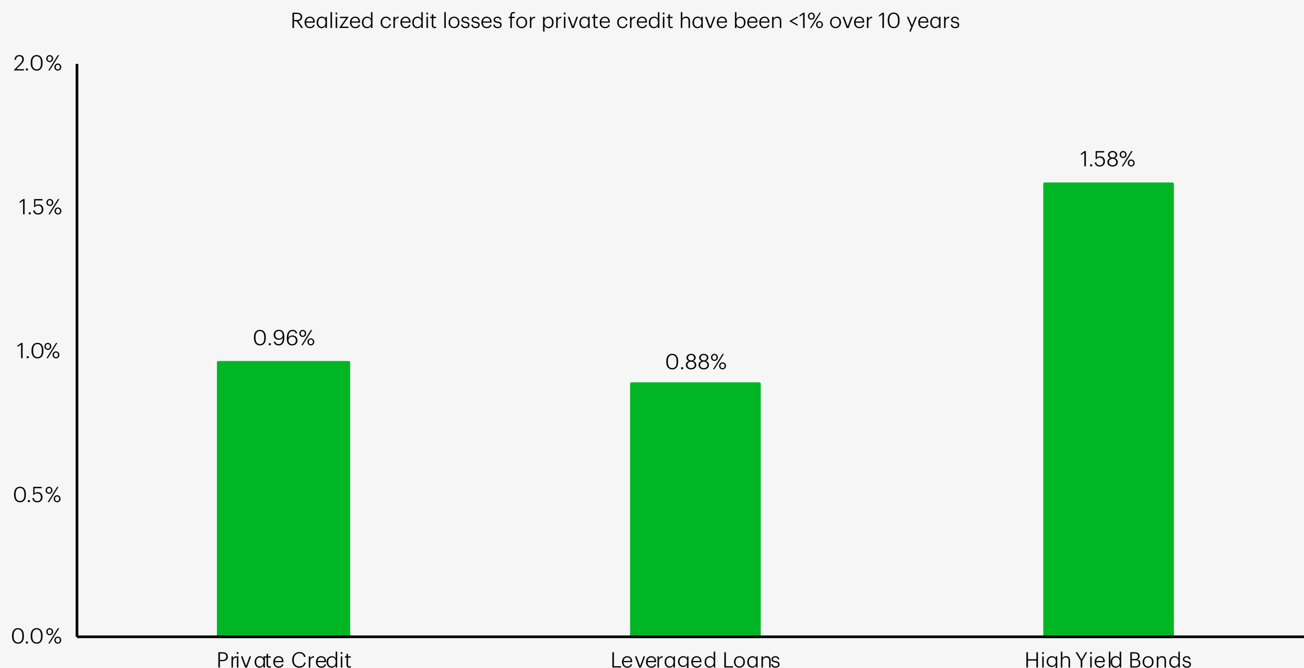
As of June 30, North American direct lending returned 9.9%, 10.3%, 10.6% and 8.5% annualized over one-, three-, five- and 10-year periods respectively, as per the Preqin Quarterly Index. This represents outperformance of 4.2, 5.1 and 3.9 percentage points (pp) annualized over three-, five- and 10-year periods respectively compared to the Morningstar LSTA U.S. Leveraged Loan Index. This delta was even larger relative to the ICE BofA U.S. High Yield Bond Index at 8.7, 6.9 and 4.3 pp over the same time horizons. These outcomes demonstrate the illiquidity and skill-based risk premiums on offer from best-in-class private lenders, such as those available in evergreen vehicles on the TD Wealth platform. We continue to advocate for exposure to direct lending: in particular, first-lien, senior-secured, sponsor-backed private loans — with strict structural protections — made to companies in the upper-middle market through time-tested and robust underwriting processes. Figure 2 showcases the outperformance of private credit and Figure 3 emphasizes that the total credit loss for private transactions remains relatively contained due to lower defaults and higher recoveries.

Figure 2: Direct lending has consistently outperformed leveraged loans



Source: Wealth Investment Office, Morningstar, UBS Asset Management as of June 30, 2024

Figure 3: Global Real Estate Fundraising by Strategy



Source: Wealth Investment Office, Brookfield, Morningstar as of August 2024. *Data represent past 10 years ending December 31, 2023

Refinancings have also spiked, comprising 71% of high-yield bond issuance from October 2023 to September 2024 — the highest in a 12-month period since 2016. The volume of leveraged loans backing dividend recapitalizations (where a company borrows from creditors to finance dividends to owners) hit a record of more than US$17 billion in September, contributing to the highest quarterly volume in three years.

At a time when exit activity remains sluggish, private-equity firms are keen to extract cash from portfolio companies, and GPs may feel pressure to put capital to work. High-yield bond spreads are below 300 bps for the first time since the GFC, and net leveraged loan supply in September hit negative US$6.2 billion, the largest deficit since 2022, per Fitch Ratings. Differentiated origination capabilities from top asset managers are put on display during such environments.

One recent refinancing that's emblematic of the times was Belron Group's 8.1-billion-euro private-debt issuance, financing a 4.4-billion-euro dividend to shareholders, the largest such deal on record. Belron, the owner of windscreen repair companies in the U.S. and UK, nearly doubled its gross debt from under 5 billion euros to almost 9 billion. Despite having their rating slashed into junk territory by Moody's and S&P, the deal was massively oversubscribed, with a bid-to-cover ratio in excess of 7x.

We prioritize manager selection in private markets. In addition to conservative practices and the capacity to anchor and lead deals, we like to see private-credit GPs lend to companies with stable and growing free cash flow, fortress balance sheets, robust competitive advantages and top management teams. This matters when cycles roll over. Several pundits have argued that, with the rise in rates, more borrowers are opting to service their debts through payment-in-kind (PIK) or non-cash interest, where coupons are tacked on to principal for a fee. According to Pitchbook, PIK loans comprise 17% of the portfolios of business-development companies (BDCs), up from 10% in early 2022. A BDC is one type of legal structure for a private-credit fund and is distinct from a collateralized loan obligation (CLO), which is a security invested in tradeable bank debt. CLOs have a strict regulatory 5% upper limit for PIK loans, whereby a borrower's election to accrue non-cash interest is considered a default. It is therefore imperative to invest in portfolios composed of performing loans with low non-accruals; otherwise confidence in reported net asset values (NAVs) may waver such that public BDCs may trade at a discount to their unlisted counterparts.

Outlook on Commodities

Modest Overweight

It's the climate, geopolitical and otherwise

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

The Bloomberg Commodity Index (BCOM), since hitting a low just before Labour Day on growth-related concerns, has rallied by nearly 10% (CAD, daily hedged) — driven by rebounding oil and metals prices and continued strength in gold and silver, with the yellow metal continuing to make new all-time highs. Catalysts have included monetary easing, with both the Fed and China cutting rates. China, in particular, recently announced some of its most stimulative measures in years. In addition, the risk premium for oil has grown, following Israel's ground invasion into Lebanon and Iran's ballistic response.

The U.S. election remains a focal point — and we anticipate significant volatility depending on who wins (and how long it takes to determine the winner). A Trump win could result in a knee-jerk bearish reaction on increased tariff expectations. Regardless of who wins, however, in the medium to long term either candidate would drive the U.S. deficit higher through increased spending, which is ultimately constructive for commodities.

We continue to believe that commodities are in the early innings of an investment supercycle, which should lead to above-normal returns. Continued economic growth should keep inventory balances tight as the lagged impact of inadequate capex over the past decade highlights supply challenges. Further, while demand for commodities as an inflation hedge is likely to suffer in the near term, more accommodative monetary policy and a weaker USD should prove supportive.

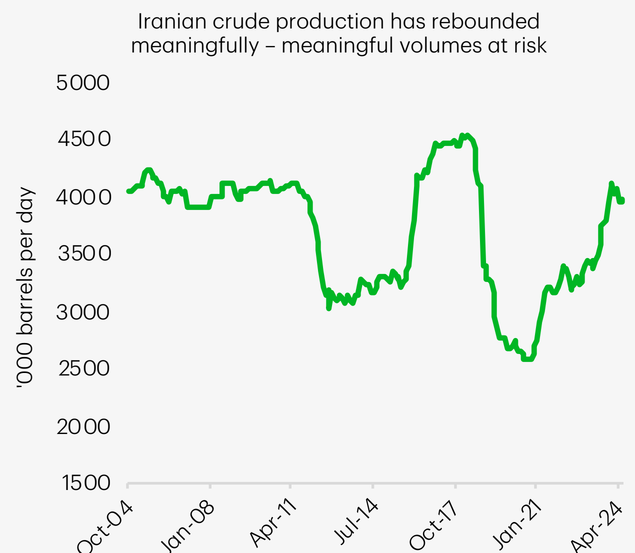
Energy: Geopolitics keep oil bubbling

Prior to the increase in geopolitical risk, oil had been in a downtrend, on anticipation of weaker balances in 2025, despite very tight current fundamentals. Inventories remain tight as evidenced by backwardated oil (when the current price is trading above futures contracts) and product forward curves. While we are of the view that balances in 2025 will soften, we're not in the growing camp of analysts forecasting prices at US$50 to US$60 per barrel. Current tightness is not being recognized, positioning is very short, and although spare capacity exists, little supply risk is (was) being priced. Neither do we believe that OPEC (nor Saudi Arabia in particular) will flood the market as they did in the 2014 market-share battle. We are constructive on oil at current prices but appreciate that, if geopolitical risk fades, the market will revert to being over-focused on softer 2025 balances. In the short term, oil could move materially higher from here if the situation between Israel and Iran continues to intensify — and oil infrastructure is targeted. Iran is a large producer and has been growing its production and exports to the world over the past several years.

Figure 1: BCOM rebounds 10%

Source: TD Asset Management as of October 11, 2024

Figure 2: Focus on Iran as production rebounds



Source: TD Asset Management as of October 11, 2024

Metals: Gold rises on structural shift, base metals riding high

Gold prices have continued their run, trading to all-time nominal highs. We remain constructive on gold. Tactically, our view has been that Fed cuts and central-bank easing broadly should be positive for gold, as it lowers the opportunity cost of holding gold and on the tailwind of a weaker USD. Structurally and more importantly, emerging-market central banks are buying gold and have been a major driver of demand. Although their appetite ebbs and flows inversely with price, their reserves are still meaningfully skewed to fiat (U.S. dollars and some euros) versus their "developed" world peers, which have far more of their holdings in gold. We believe this buying is an ongoing structural change, and the increased chaotic global order only lends to further support. ETF demand for gold (a proxy for retail and some institutional funds) has been relatively muted, although it has started to turn. Any turbulence in equity markets will increase retail demand for gold ETFs, which could be significant.

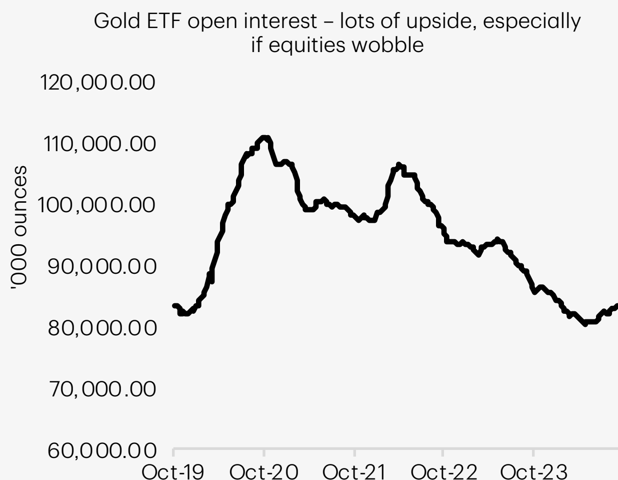
Base metals experienced a significant turnaround in Q3, hitting a low in late July before rebounding impressively over the past two months, driven by improved fundamentals and an improving macroeconomic environment. The Federal Reserve initiated its rate-cutting cycle in September, and China introduced a large reflationary stimulus package to stabilize its economy. A notable appreciation of the renminbi against the USD coincided with industrial restocking activities and import arbitrage, while downstream orders improved due to energy-transition efforts and increased grid spending in August. Additionally, Chinese exports surged ahead of potential U.S. tariffs. Although we remain optimistic about metals in Q4, with a 15% price rally since July, prices may be slightly ahead of fundamentals. Given possible upcoming U.S. election risk, we have shifted to a more neutral stance and will look to opportunistically add back on weakness, with copper and aluminum remaining top picks due to their roles in the energy transition.

Grains and softs: Poor weather outside U.S. lift softs

The main agricultural commodities of corn, soybeans and wheat hit four-year lows in Q3, driven by the prospect of record harvests in the U.S. With those prospects currently being realized and speculators having established the largest short positions on record, markets have since staged a slight recovery as we now look forward to the next slew of harvests in South America, where weather has not been as co-operative as it was in the U.S. Dry weather across the major growing regions of Brazil has encouraged speculators to take profits on their short positions and price in some risk that the dry weather may continue. Although no alarms are being raised yet, if the rains do not arrive by the end of October, this recent rally could have legs.

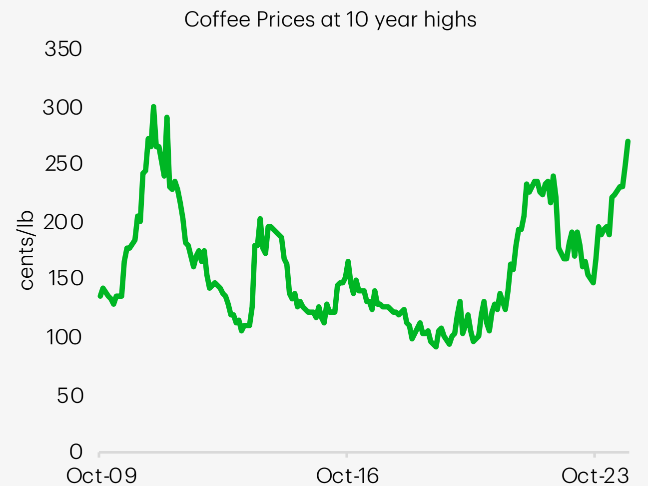
The story across soft agricultural commodities is more constructive. Too dry weather in Brazil and too wet weather in Vietnam, two of the largest coffee growers globally, has resulted in 10-year highs for coffee prices. The dry weather in Brazil has also resulted in significant fires across cane fields, raising concerns about the end of the current harvest and potential damage to the fields for next year's harvest. Sugar prices have jumped 30% over the past two months. This is the commodity cycle in action as the tightness being exhibited in coffee and sugar underscores years of weak prices and underinvestment, which has left balances exposed to any disruption. As prices rise and stay elevated, it should encourage investment, weather permitting.

Figure 3: Lots of upside in gold, especially if equities wobble



Source: TD Asset Management as of October 11, 2024

Figure 4: Coffee prices at 10-year highs



Source: TD Asset Management as of October 11, 2024

Outlook on Currencies

U.S. election joins the Island of Misfits memes

TD Securities, Global Rates, FX & Commodites Strategy

The market has been obsessed with the memes of 2024: soft, no, hard landing (when does the plane arrive, exactly?) The rub has been that each of these memes has ultimately been disrupted by data dependence, underscoring the surprise factor and the importance of positioning around these plot lines. The market gets excited about potential trends that are seemingly undermined by the data.

Our strongest view for H2 has been to expect the unexpected, undermining the Goldilocks narrative with further underperformance of carry, higher volatility and a stronger U.S. dollar. Mean reversion is king. These pieces are coming together nicely and continue to hold these views, especially as U.S. data have improved.

Data from the rest of world (ROW), mostly the euro zone and China, are getting worse, reinforcing the adjustment in market positioning and central-bank pricing. U.S. dollar positioning is cleaner now but not for long. With weeks to go, the market can no longer ignore the U.S. election risks. It's a binary outcome with sizeable tail risks to markets. What could go wrong?

The World in a Nutshell

In conversations with investors around the globe, a universal theme appears to be one of confusion, at least as it pertains to currency markets. The major talking point has not been central banks, although, of course, that has been a key feature in all discussions. Instead, the number-one talking point has been how markets are in a state of transition. The macro regime is in flux. And as a result, mean reversion remains the key to understanding currency market dynamics now.

Indeed, the best performing strategies in our Global FX overlay portfolio are not macro factors but rather mean-reverting factors. They work well when the market isn't trending — in other words, they are the mirror image of momentum. This is not a strategy that has performed well over the past five, 10 and 20 years. What gives? The market regime is changing. The past five years were quite straightforward, at least for FX performance. Carry, terms of trade and G10 inflation dominated. That means FX performance was primarily driven by relative rate dispersion, a wedge between commodity importers and exporters, mostly favouring exporters, and high inflation in the G10. This regime is likely finished.

The challenge for markets is to figure out what is next. Given that markets have the tendency to focus on only one theme at a time, they can no longer ignore the U.S. election. For the past few months, the focus has been on slowing U.S. economic data and the Fed repricing story. Now, it's an old and tired narrative, especially as U.S. data look to be recovering, ROW is sliding, and the Fed looks less dovish than its peers. It's too soon to trade China stimulus, since we expect the data will get worse before it gets better. Plus, we believe China stimulus efforts will continue to take a back seat to the evolving U.S. election outlook.

Our highest-conviction views have barely changed in the past few months. We continue to believe that: (1) macro vol remains underpriced; (2) U.S./ROW data doesn't jibe with neutral-rate pricing; and (3) positioning, while adjusted recently, provides the U.S. dollar with more runway to rally in the short term. Indeed, one of the surprising takeaways in our client discussions over the past few months has been the complacency around inflation. Many feel that inflation is of second-order importance, given that central banks have shifted to growth.

That's why we think markets will be surprised by inflation. It's also another source of macro vol, given that market pricing has simply provided a nice smooth profile for central-bank cuts. It's never that easy. So again, another market narrative is getting disrupted as a string of hot U.S. data undermines the soft-landing meme, instead potentially shifting back to higher-for-longer. The Atlanta Fed's GDPNOW sits above 3%, while their sticky core inflation index sits above 4%. Even if the Fed could get inflation back to 2%, which is very unlikely in our view, the GDPNOW indicator has been averaging around 2.4% for the past few years.

A very simple back-of-the-envelope terminal-rate bean count points to 4% to 5%, reflecting 2.4% growth and 2.0% to 2.5% inflation based on current trends. That's a far cry from market pricing. More important, Trump could disrupt all this. Fed pricing, non-U.S. growth, equity markets — he would also usher in a higher level of uncertainty. The knee-jerk reaction is likely bullish for the U.S. dollar. A Harris presidency is likely status quo, where markets will go back to trading global macro data. In that scenario, we think the U.S. dollar will also remain on solid ground, but strength will be limited on global macro uncertainty and U.S. resilience.

Bank of Canada: Further cuts coming

The Bank of Canada continues on its rate-cutting path, which has been well telegraphed and largely expected. The 50-bp cut announced on October 23 was in line with recently revised consensus expectations. It was a coin toss as to whether the BoC would cut 25 bps or 50 bps, with the September CPI of 1.6% allowing for a 50-bp cut, while at the same time, when you dig into the details of that lower-than-expected CPI print, the overall inflation data that the BoC focuses on was largely as expected, just north of 2%. Also, on the positive column and supportive of a 25-bp cut, the job market has shown some signs of strengthening, and wage growth remains solid. Canadians are not showing signs of financial stress, despite some regional variation. The coin toss landed in the 50-bp square for the BoC.

While we expect the loonie to remain under some pressure relative to the U.S. dollar in the near term as markets price in a rising Trump premium and potential for accelerated BoC cuts, we believe that pressure will be limited.

Figure 1: Foreign Exchange Forecasts for G10 Currencies

	2024		2025			
	21-Oct-24	**Q4 F**	**Q1 F**	**Q2 F**	**Q3 F**	**Q4 F**
USD/JPY	150	142	140	138	137	135
EUR/USD	1.09	1.07	1.06	1.08	1.09	1.11
GBP/USD	1.30	1.28	1.27	1.30	1.33	1.36
USD/CHF	0.86	0.86	0.86	0.87	0.87	0.88
USD/CAD	1.38	1.39	1.39	1.38	1.36	1.35
AUD/USD	0.67	0.67	0.67	0.69	0.70	0.72
NZD/USD	0.61	0.61	0.60	0.61	0.63	0.64
BBDXY	1255	1255	1258	1240	1221	1202

Source: TD Securities as of October 21, 2024

Market Performance

Canadian Indices ($CA) Return	Index	(%) 1 Month	(%) 3 Months	(%) YTD	(%) 1 Year	(%) 3 Years	(%) 5 Years	(%) 10 Years	(%) 20 Years
S&P/TSX Composite (TR)	98,523	3.15	10.54	17.24	26.74	9.52	10.95	8.09	8.30
S&P/TSX Composite (PR)	24,000	2.80	9.71	14.51	22.82	6.14	7.58	4.84	5.22
S&P/TSX 60 (TR)	4,826	3.05	11.16	16.61	26.83	9.70	11.15	8.62	8.68
S&P/TSX SmallCap (TR)	1,495	3.80	8.44	18.02	25.07	4.95	10.09	4.98	4.55
S&P/TSX Preferred Share(TR)	2,037	0.48	5.52	20.49	29.26	2.03	6.59	2.79	2.96
U.S. Indices ($US) Return									
S&P 500 (TR)	12608	2.14	5.89	22.08	36.35	11.91	15.98	13.38	10.71
S&P 500 (PR)	5762	2.02	5.53	20.81	34.38	10.19	14.12	11.32	8.56
Dow Jones Industrial (PR)	42330	1.85	8.21	12.31	26.33	7.74	9.48	9.52	7.44
NASDAQ Composite (PR)	18189	2.68	2.57	21.17	37.60	7.98	17.86	15.01	11.97
Russell 2000 (TR)	12020	0.70	9.27	11.17	26.76	1.84	9.39	8.78	8.49
U.S. Indices ($CA) Return									
S&P 500 (TR)	17030	2.17	4.59	24.85	35.97	14.28	16.44	15.51	11.10
S&P 500 (PR)	7783	2.06	4.23	23.56	34.01	12.51	14.58	13.41	8.94
Dow Jones Industrial (PR)	57175	1.88	6.88	14.86	25.98	10.02	9.91	11.59	7.81
NASDAQ Composite (PR)	24568	2.72	1.31	23.92	37.21	10.25	18.33	17.17	12.36
Russell 2000 (TR)	16235	0.74	7.93	13.69	26.41	3.99	9.82	10.83	8.86
MSCI Indices ($US) Total Return									
World	17364	1.87	6.46	19.28	33.03	9.61	13.59	10.65	9.17
EAFE (Europe, Australasia, Far East)	12136	0.97	7.33	13.50	25.38	6.02	8.72	6.22	6.51
EM (Emerging Markets)	3096	6.72	8.88	17.24	26.54	0.82	6.15	4.41	7.67
MSCI Indices ($CA) Total Return									
World	23454	1.91	5.16	21.99	32.66	11.92	14.04	12.74	9.55
EAFE (Europe, Australasia, Far East)	16393	1.00	6.01	16.08	25.03	8.26	9.16	8.22	6.88
EM (Emerging Markets)	4182	6.76	7.54	19.90	26.18	2.94	6.57	6.38	8.05

Currency									
Canadian Dollar ($US/$CA)	1.35	0.24	-1.13	2.13	-0.38	2.17	0.43	1.91	0.35
Regional Indices (Native Currency, PR)									
London FTSE 100 (UK)	8237	-1.67	0.89	6.51	8.27	5.14	2.14	2.21	2.99
Hang Seng (Hong Kong)	21134	17.48	19.27	23.97	18.66	-4.91	-4.13	-0.81	2.41
Nikkei 225 (Japan)	37920	-1.88	-4.20	13.31	19.03	8.79	11.75	8.89	6.47

Benchmark Bond Yields	3 Months	5 Yrs	10 Yrs	30 Yrs
Government of Canada Yields	4.22	2.74	2.96	3.14
U.S. Treasury Yields	4.64	3.56	3.78	4.12

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	467	0.35	1.22	3.80	5.13	3.45	2.34	1.62
FTSE TMX Canada Universe Bond Index	1169	1.90	4.66	4.27	12.89	-0.10	0.63	2.25
FTSE TMX Canada All Government Bond Index	1098	1.83	4.66	3.72	12.53	-0.66	0.11	1.95
FTSE TMX Canada All Corporate Bond Index	1425	2.12	4.67	5.88	13.96	1.49	2.11	3.12
U.S. Corporate High Yield Bond Index	303	1.51	5.00	7.37	14.67	2.35	3.96	4.40
Global Aggregate Bond Index	263	1.20	4.11	3.91	9.79	-0.76	0.19	2.02
JPM EMBI Global Core Bond Index	543	1.73	6.11	8.00	17.97	-1.51	-0.07	2.51
S&P/TSX Preferred Total Return Index	2023	-0.21	4.80	19.67	28.38	1.83	6.45	2.72

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

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