WAAC Perspectives

2023 FEB

TD Wealth Asset Allocation Committee (WAAC)

Key Themes

1. Expectations for corporate earnings continue to decline, however, in our view, earnings growth projections for North American equities remain too optimistic given the deteriorating economic backdrop. We expect further downward earnings revisions to be a headwind to equity markets in the coming quarters.
2. We expect the trend of economic normalization that started in 2022 will continue in 2023. Global growth is showing clear signs of slowing, and capital markets remain uncertain and volatile. The risk of recession remains elevated, and while the recent deceleration in inflation may have widened the path toward a "soft landing", it is unlikely to prompt a complete policy pivot or rate cuts in the near term. Interest rates may remain higher for longer which could keep financial conditions restrictive.
3. Over the next 12-18 months, we continue to see a broad range of opportunities in fixed income markets, with the potential for accretive returns in the form of income as well as capital gains. We believe fixed income may outperform equities over this period. Bonds can also provide diversification benefits, reduce overall portfolio volatility and preserve capital.
4. We believe that an allocation to alternative assets such as commercial mortgages and infrastructure can benefit client portfolios. 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.

Positioning Changes

Asset	From	To	Rationale
Investment Grade (IG) Corporate Bonds	Modest Overweight	Neutral	Canadian IG spreads appear more attractive than U.S. and global markets but have rallied materially year-to-date. We still see compelling investment opportunities for lower duration (5-years and shorter) corporate bonds given that all-in yields remain elevated relative to historical levels. However, U.S., European, and Canadian corporate bond spreads with higher durations have all become less attractive, causing us to see modestly more downside risk than upside opportunities.
Gold	Modest Overweight	Neutral	Gold has been trading near the high end of its current range due to seasonality, central bank buying, and U.S. Dollar weakness. Central banks' purchases of gold were well above historical averages in 2022 and if this returns to more normalized levels, it could be a headwind for the price of gold. It appears that gold is factoring in the current elevated levels of inflation, and we have concerns that if inflation subsides, and interest rates remain near current levels, this could hinder the price of gold.

Equities

Modest Underweight

Canadian Equities

Modest Underweight

- We expect earnings estimates to be revised downwards amid high rates and the resulting slowing economy. We also expect rate hikes to stall in 2023 if inflation continues to trend lower. The effects of higher rates remain to be seen, but we anticipate that Canada could see a mild recession in 2023. That said, the Canadian economy has proven resilient so far, with employment numbers remaining strong and financial system solid. High consumer debt levels and a weak domestic real estate market remain as headwinds for the Canadian economy.

U.S. Equities

Modest Underweight

- Well into the current earnings season, S&P 500 Index companies have reported modest topline growth, however, earnings-per-share have shown mid-single digit declines, which is evidence of margin degradation. Additionally, the U.S. economic outlook for 2023 remains weak and could weigh on company earnings. There is also some uncertainty over the U.S. Federal Reserve's policy actions and whether the economy will escape recession. We maintain a modest underweight outlook for U.S. equities as a result.

International Equities

Neutral

- While the market is more comfortable now that inflation is trending down, investors remain concerned with slowing corporate profit growth. Uncertainty also remains with the magnitude and duration of a potential recession in 2023 if policy mistakes by developed central banks make financial conditions too restrictive for too long. We believe quality and valuation will be desirable attributes to weather market volatility in international equity markets.

Chinese Equities

Modest Overweight

- As China begins its reopening plan, we expect to see an increase in demand for travel and leisure, luxury goods, energy and commodities, and we expect global supply chains to return to some sense of normalcy. Chinese equities could see relative outperformance over the next 12-18 months. However, the reopening is unlikely to proceed in a straight line, so investors should expect some choppiness along the way.

Emerging Market Equities (excluding China)

Neutral

- Emerging markets equities, like many of their global counterparts, are being challenged by persistently high inflation, concerns over global central bank monetary tightening, and the prospect of recession in many western economies. Our outlook for emerging markets remains cautious while recognizing that low relative valuations may provide a good entry point in the coming months.

Fixed Income

Maximum Overweight Overall

Domestic Government Bonds

Maximum Overweight

- North American central banks are beginning to slow the pace of policy rate hikes as inflation pressures show signs of easing at the margins. As a result, yields have stabilized at multi-year highs and government bonds remain appealing due to their potential to generate positive nominal returns over the longer term.

Investment Grade Corporate Bonds

Neutral

- Canadian IG spreads appear more attractive than U.S. and global markets but have rallied materially year-to-date. We still see compelling investment opportunities for lower duration (5-years and shorter) corporate bonds given all-in yields remain elevated versus historical levels. However, U.S., European, and Canadian corporate bond spreads with higher durations have all become less attractive, causing us to see modestly more downside risk than upside opportunities.

Inflation-Linked Bonds

Neutral

- With the expectation that high inflation levels may be starting to peak and beginning to normalize, inflation insurance is moderately attractive for investors.

High Yield Bonds

Modest Underweight

- Higher interest rates and a deteriorating economic backdrop will likely cause default rates for high yield bonds to rise from currently low levels. Corporate earnings will likely continue to be under pressure in the near term, eroding credit fundamentals. This could result in further volatility and downside risk for credit spreads, despite the high potential return in the sector. We expect strong credit quality to prevent high yield bonds from experiencing the extreme dislocations seen in some prior recessionary periods.

Global Bonds-Developed Markets

Neutral

- Investors are increasingly paying attention to the global economic slowdown narrative, and we are starting to see some reversal of the extreme bearish sentiment and positioning in the global bond market. As bond yields have risen considerably year-to-date, some markets now offer attractive incremental yields, net of currency hedges. Non-USD-denominated bonds may also benefit from a potentially weakening U.S. currency.

Global Bonds-Emerging Markets

Neutral

- The dispersion of returns within emerging markets has presented some opportunities. We are comfortable maintaining a neutral outlook as yields are attractive in some regions where central banks have proactively hiked interest rates, while bond returns will likely decline in other regions where central banks are still early in normalizing monetary policy.

Alternatives
Modest Overweight Overall

Commercial Mortgages

Maximum Overweight

- Commercial mortgages continue to provide accretive income while insulating investor returns from the increased volatility in interest rates. Income collection via scheduled principal and interest payments remains resilient while demonstrating less volatility than observed in other corners of the fixed income markets.

Domestic Real Estate

Modest Underweight

- High inflation, rising financing costs, and mounting recessionary fears are driving flight-to-quality within the market. However, real estate fundamentals remain sound with supply/demand imbalances persisting within industrial and multi-family assets. Investors that are broadly diversified and able to generate income growth will be better positioned to navigate the current environment.

Global Real Estate

Neutral

- We maintain a neutral weight to global real estate. Rising inflation and interest rates remain the primary risks globally. Strong institutional sponsorship, positive real estate fundamentals (i.e., low vacancy rates, rental rate growth), moderate development activity and conservative leverage ratios are all long-term structural elements that may help support the broader real estate sector. We believe that being globally diversified within major cities and in high quality assets should help navigate through economic turbulence.

Infrastructure

Modest Overweight

- We maintain a modest overweight to infrastructure. We believe infrastructure is well positioned to outperform relative to other asset classes through this interest rate cycle, even though rising interest rates will increase risk-free rates used to price private asset classes. Increases in cash flow from higher-than-expected inflation is buffering the rising rates and we anticipate core-plus portfolios may be best positioned given the embedded growth in revenue from value-add and opportunistic assets.

Real Assets

Sub classes

Gold

Neutral

- Gold has been trading near the high end of its current range due to seasonality, central bank buying, and U.S. Dollar weakness. Central banks' purchases of gold were well above historical averages in 2022 and if this returns to more normalized levels, it could be a headwind for the price of gold. It appears that gold is factoring in the current elevated levels of inflation. We have concerns that if inflation subsides, and interest rates remain near current levels, that this could hinder the price of gold.

Canadian vs. U.S. Dollar

Neutral

- The Canadian Dollar's performance versus the USD will be largely dependent on the path of rate hikes by the Bank of Canada, the strength of the Canadian economy and commodity prices.

U.S. Dollar (USD) vs. basket of currencies

Maximum Underweight

- We continue to expect USD weakness as interest rate differentials peaked around three months ago. The USD and 10-year Treasury yields are positively correlated, meaning lower bond yields (which we expect) typically result in a declining USD. Following a very strong 2022, we believe that the USD's fundamental valuation, whether looking at historical averages, interest rate differentials, or U.S. growth versus global growth, remains overvalued.

Cash

Neutral

- We maintain neutral cash positioning to allow for strategic deployment to other asset classes as opportunities arise. Cash can also provide flexibility to navigate the short-term outlook and uncertainties.

We are always monitoring important economic and market themes and believe that maintaining a portfolio of high-quality assets is critical to long-term investment success. While there is always potential for market volatility, we encourage investors to remain focused on the long-term. We consider periods of higher volatility to be normal market behaviour that can help clear excesses and create investment opportunities.

Summary of Positioning

	Asset Class	Maximum Underweight	Underweight	Neutral	Overweight	Maximum Overweight
Fixed Income	**Maximum Overweight Overall**					
	Domestic Government Bonds					●
	Investment Grade Corporate Bonds			●		
	Inflation-Linked Bonds			●		
	High Yield Bonds		●			
	Global Bonds — Developed Markets			●		
	Global Bonds — Emerging Markets			●		
Equities	**Modest Underweight Overall**					
	Canadian Equities		●			
	U.S. Equities		●			
	International Equities			●		
	Chinese Equities				●	
	Emerging Markets Equities – excl. China			●		
Alternatives/ Real Assets	**Modest Overweight Overall**					
	Commercial Mortgages					●
	Domestic Real Estate		●			
	Global Real Estate			●		
	Infrastructure				●	
Sub Classes	**Overall Rating N/A**					
	Gold			●		
	Canadian Dollar vs U.S. Dollar			●		
	U.S. Dollar vs. basket of currencies	●				
	Cash			●		

For more information please contact your **investment professional.**