TD Greystone Asset Management

Quarterly Market Update

Winter Overview
(Q4-2018)

CIO *View*Point

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It is fascinating to observe the difference that three months can make on market sentiment and outlook. Last quarter our concern was around investor complacency given the lack of discernable headline risks to global growth. Over the course of the fourth quarter we saw a reversal of sentiment with the implied probability of a recession rising. Slowing global growth and tighter monetary conditions appear to be the primary culprits, driving higher risk premiums and lower valuations across equity markets.

While we do not claim to have a crystal ball with respect to timing of future outcomes, we have believed in the potential for an equity correction of 10-20% within the framework of a growing global economy.

Finding ourselves in the midst of the sell-off, we are challenging our thesis to determine if this is simply a market correction or if the sell-off is an indicator that the economic cycle is nearing an end. The distinction is important, as a correction would lead us to “buy the dip” and return multi-asset portfolios to equity targets. In contrast, a view towards the end of the cycle would lead us to shift our asset allocation into a fixed income overweight.

In this assessment, our highest point of conviction is that the U.S. consumer remains in a very healthy position and is now supported by falling inflation and energy prices in addition to rising wages, falling debt levels and low unemployment rates. This is also important, as the U.S. consumer is the single largest component of global GDP and, on its own, larger than any other single country.[1] Despite the fact that lending rates are rising, real rates are significantly lower in the U.S. than they were in 2006, while the U.S. consumer is currently carrying lower debt levels and may therefore be able to manage through higher overnight interest rates.

Consumer risks appear greater in Canada; however, low unemployment rates should continue to provide support to the economy until the next downturn. The federal government also has a strong balance sheet, which can potentially provide stability to the economy when needed. In our opinion, the housing and energy sectors are areas of concern and weaken the fundamental outlook for Canada relative to the U.S. Our view on energy is that global prices will stabilize, while Canadian oil prices will start to find support later in 2019 as takeaway capacity comes online.

While the global economy outside of North America is stalling, valuations appear to be pricing in the bad news. Price-to-earnings ratios outside of the United States are in low double digits, which is attractive relative to history. Absent a global recession, modest earnings per share growth should create an attractive environment for foreign equities.

[1] WorldBank.

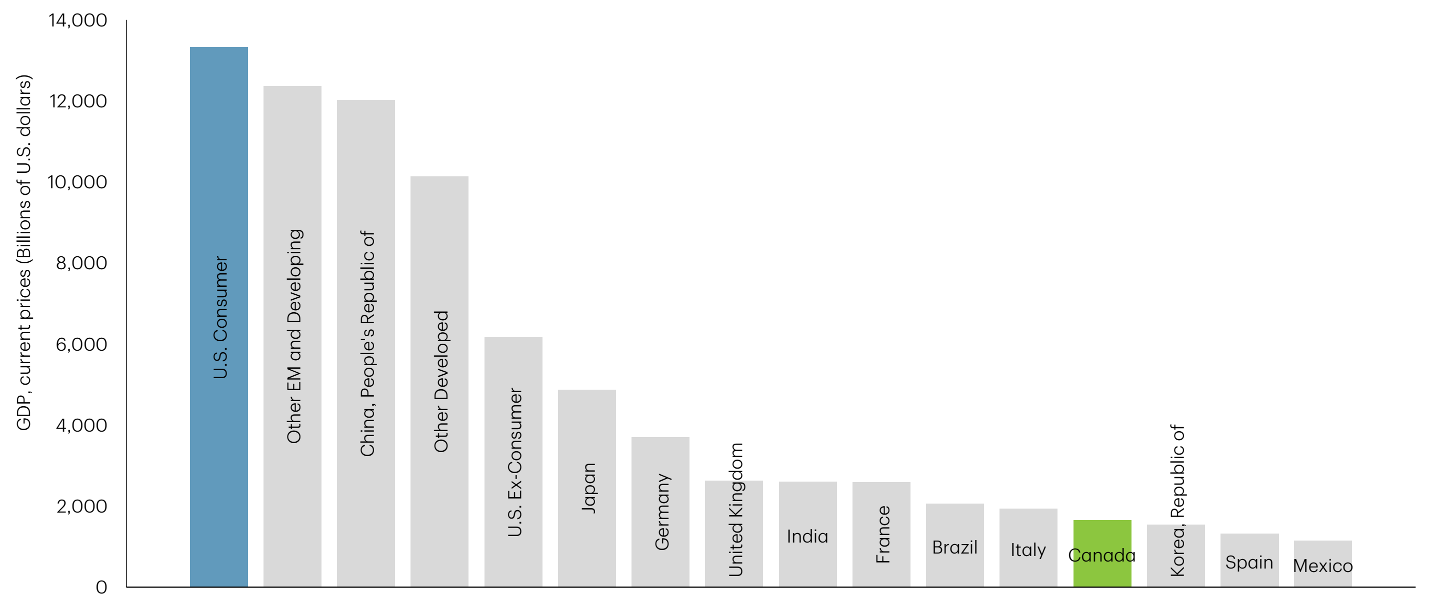
Our asset mix positioning retains an equity overweight versus the benchmark and we will look to buy back towards equity targets. While we do believe the global economy will stay out of a recession over the coming year, we have trimmed our equity overweight in response to growing risks. Trade tensions, earnings margins (particularly in the technology sector), commodity prices and non-U.S. PMIs all warrant monitoring for further signs of stress. Our bias will be towards U.S. and non-North American equities with benchmark targets to Canadian equities.

Despite forecasts for growth, we have held duration close to benchmarks within fixed income portfolios, as this economic cycle has shown yields can fall precipitously with deflation fears. We believe yields may have fallen further if not for supply and demand imbalances in the U.S. treasury market. In our view, forecasts looking at the yield curve for a recession are premature, as historically a broader inversion across the curve is required.

Given our outlook for low but positive economic growth, we believe that interest rates will likely trade between current levels and the peak in yields may be established in the summer of 2019. Portfolios that allow private commercial mortgage debt to replace corporate credit have performed very well, as corporate spreads have widened with the equity sell-off. Corporate bond valuations appear more attractive relative to history, but the negative backdrop of corporate indebtedness remains a concern.

Private real assets, such as real estate and infrastructure, have demonstrated their stabilizing benefits through the fourth quarter. Year to date, portfolios holding real estate and infrastructure have outperformed multi-asset programs that are only exposed to public equities and fixed income. We believe that market volatility will continue for the remainder of this cycle and investors should continue to right-size liquidity needs in order to optimize private market exposures.

U.S. Consumer is Largest Component of Global Economy



Source: World Bank.

Asset Class Total Returns

Calendar Year						Q4-2018
2013	2014	2015	2016	2017	2018	3-month
Glo. Eq 35.2	Long Bonds 17.5	Glo. Eq 18.9	Cdn. Eq 21.1	EM Eq 28.3	Infrastructure 7.8	Mortgages 1.9
Cdn. Eq 13.0	Glo. Eq 14.4	Infrastructure 11.5	Infrastructure 8.6	Glo. Eq 14.4	Real Estate 6.6	Long Bonds 1.9
Infrastructure 12.9	Infrastructure 10.6	Real Estate 7.8	EM Eq 7.3	Infrastructure 10.1	Mortgages 2.4	Bonds 1.8
Real Estate 10.6	Cdn. Eq 10.6	Mortgages 4.0	Real Estate 6.1	Cdn. Eq 9.1	Bonds 1.4	Real Estate 1.4
EM Eq 3.9	Bonds 8.8	Long Bonds 3.8	Glo. Eq 3.8	Real Estate 7.2	Cash 1.4	Infrastructure 0.8
Mortgages 1.3	Real Estate 7.0	Bonds 3.5	Long Bonds 2.5	Long Bonds 7.0	Long Bonds 0.3	Cash 0.5
Cash 1.0	EM Eq 6.6	EM Eq 2.0	Mortgages 1.8	Bonds 2.5	Glo. Eq -0.5	EM Eq -2.2
Bonds -1.2	Mortgages 6.0	Cash 0.6	Bonds 1.7	Mortgages 0.9	EM Eq -6.9	Glo. Eq -8.5
Long Bonds -6.2	Cash 0.9	Cdn. Eq -8.3	Cash 0.5	Cash 0.6	Cdn. Eq -8.9	Cdn. Eq -10.1
Market Portfolio[5]						
			4.9	10.4	-0.3	-4.0

Benchmarks

- S&P/TSX Composite Index
- MSCI World (Net)[1]
- MSCI Emerging Markets (Net)[1]
- Infrastructure[2]
- MSCI/REALpac Canada Annual Property Index - All[3]
- Custom Mortgage Benchmark[4]
- FTSE TMX Cda 91 day T-bill
- FTSE TMX Cda Universe
- FTSE TMX Cda LT Overall

Source: TD Greystone Asset Management, FactSet, Preqin. As at December 31, 2018. Returns in Canadian dollars, excluding Infrastructure (U.S. dollars). Gross of investment management fees. May be subject to rounding. Past performance is not indicative of future performance.

1 MSCI, net of foreign dividend withholding taxes.

2 Infrastructure returns are the Preqin Infrastructure Quarterly Index up to its most recent publication, Q2 2018 and are Greystone Infrastructure Fund (Canada) LP returns thereafter.

3 Real estate returns are the MSCI/REALpac Canada Annual Property Index - All Assets up to its most recent publication, Q3 2018 and are Greystone Real Estate Fund Inc. returns thereafter.

4 Custom Mortgage Benchmark: FTSE TMX Cda Short Term Overall 60%, FTSE TMX Cda Mid Term Overall 40% + 0.5% per annum.

5 The Market Portfolio is the Greystone Balanced Plus fund.

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