



# Market Perspectives



## The Year Ahead 2022 Global Economic Outlook

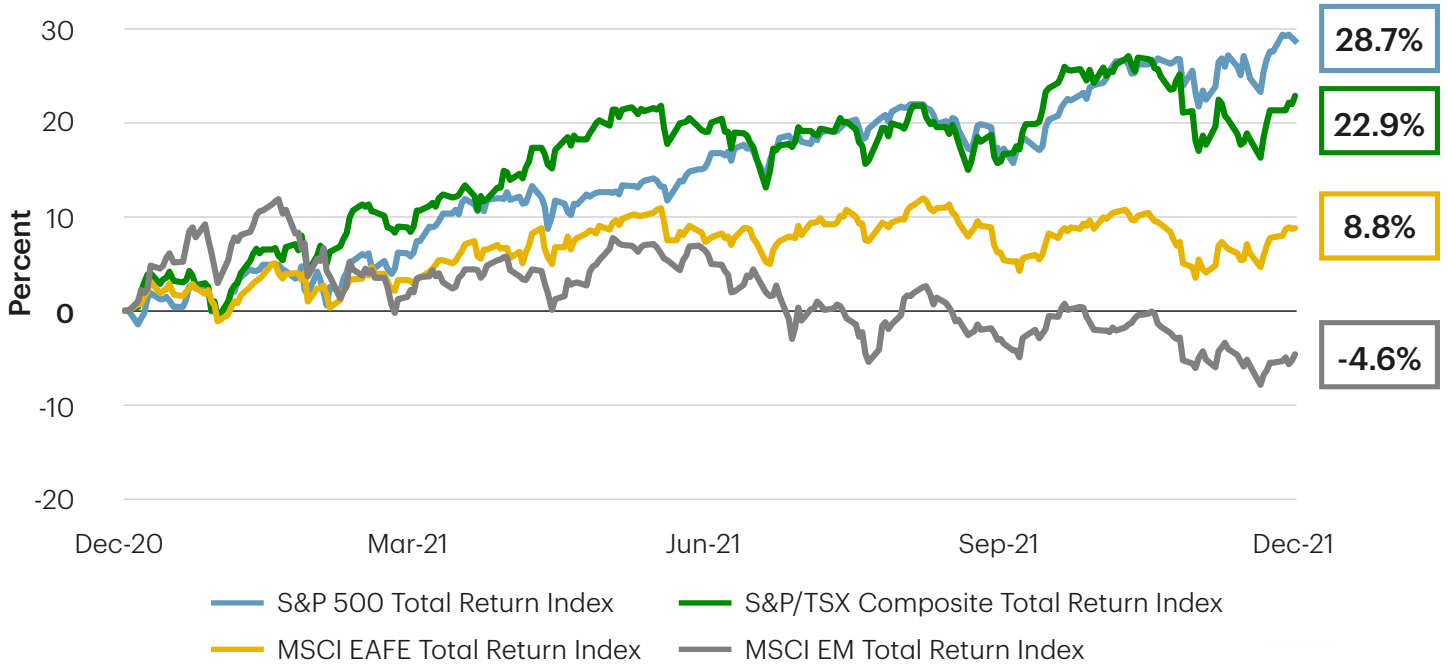
### TD Wealth Asset Allocation Committee (WAAC) Overview

- 1 We expect global equities to deliver positive performance in 2022; however, gains are likely to moderate significantly from 2021 levels. Markets should be driven higher by positive economic and earnings growth and strong corporate fundamentals.
- 2 We maintain our core strategic preference for equities relative to fixed income. The protracted low-rate environment is likely to persist even as central bank policies shift from accommodation to stabilization.
- 3 Primary risks to the outlook include elevated and more persistent inflation, tight labour markets/wage pressures, monetary policy missteps, and new virus variants, which could all lead to elevated market volatility and impact global growth.
- 4 While we maintain an overall modest underweight to fixed income, due to low real returns, we believe fixed income exposure within portfolios remains important. Bonds can provide investors with consistent income, diversification benefits and insulate portfolios during periods of elevated volatility.
- 5 With low fixed income yields and the potential moderation of equity returns, an allocation to alternative assets should continue to be beneficial in managing portfolio volatility, providing some long-term inflation protection and attractive absolute returns. We believe alternative assets can help portfolios under either transitory or more structural inflation outcomes.

# The Year in Review

2021 did not disappoint investors with an appetite for riskier assets. The performance of North American equity markets has been impressive, driven by the strength and resilience of the U.S. and Canadian economies (Chart 1). Low interest rates and aggressive government support benefited individuals and corporations, helping to ease some of the pressures experienced during the ongoing global health crisis. International markets were mixed, as optimism over the economic recovery wavered throughout much of the year.

**Chart 1: Index returns over the past 12 months (based in USD)**



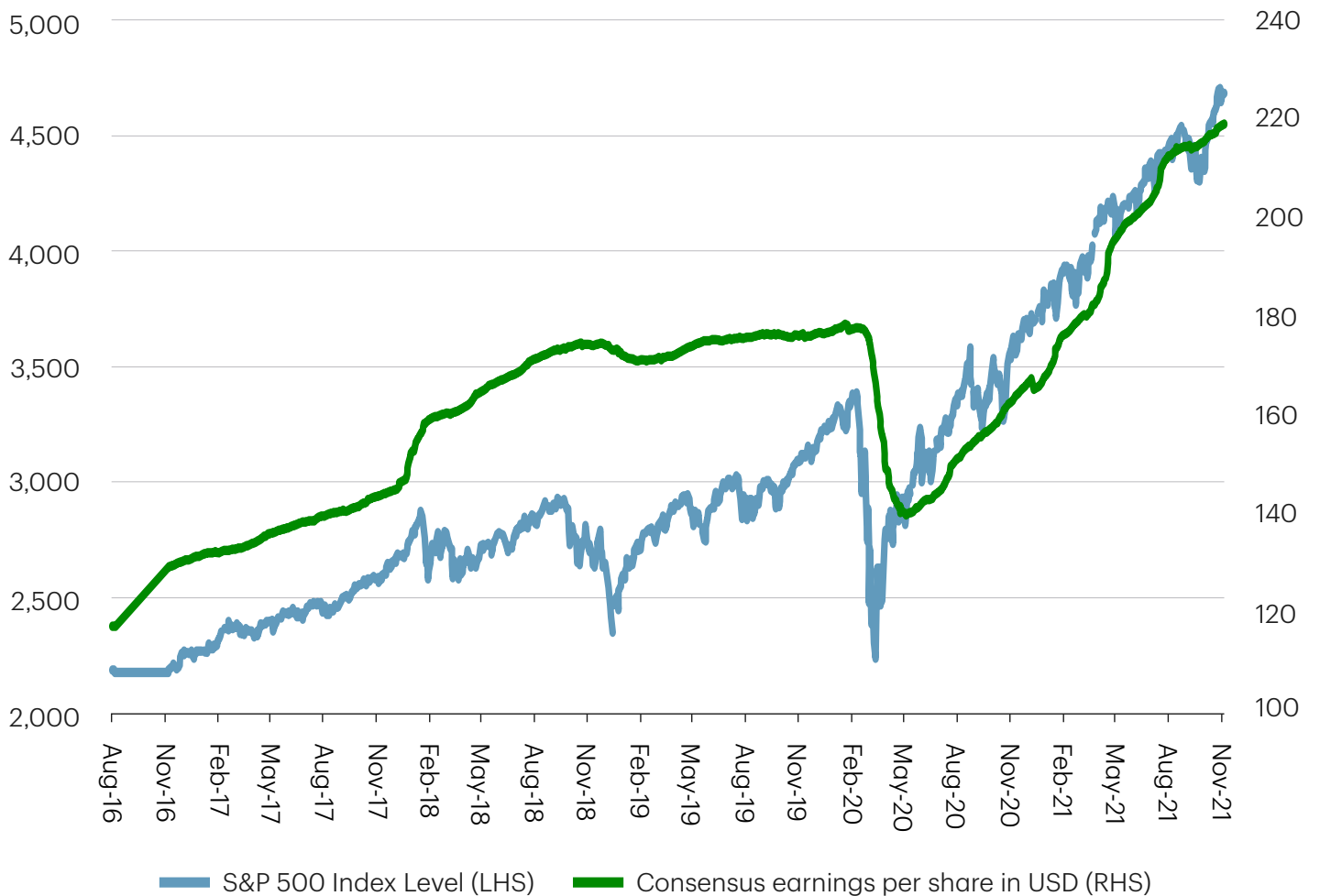
Source: TDAM. As of December 31, 2021.



The TD Wealth Asset Allocation Committee ("we", "our") remained bullish on equities throughout 2021 as record earnings growth, positive earnings surprises and revisions drove share prices higher (Chart 2). Corporate balance sheets remained resilient during the pandemic, save for companies in hard hit sectors like tourism and hospitality. Record low yields and strong demand have led to significant margin expansion, driving the profitability of companies higher in most sectors. In fixed income, it was a different story. Our underweight fixed income positioning throughout the past year was reflective of

low yields, negative real returns, and the expectation of higher yields. However, we saw opportunities within the high yield and corporate bond space to add incremental income. Alternative assets like real estate, infrastructure, and private debt performed well in 2021, despite the challenges imposed by the pandemic. Industrial real estate for example was a positive contributor to returns, driven by the expansion of e-commerce and the increased need for warehousing and logistics to meet surging consumer demand.

**Chart 2: The strong earnings recovery drove U.S. stocks to record highs in 2021**



Note: LHS= Left hand side. RHS= Right hand side.  
Source: TDAM. As of November 15, 2021.

Opportunities



## The Year Ahead

WAAC members were recently asked to share their thoughts on the current market environment, economic challenges looming ahead, and their investment outlook for key asset classes. Below are some of their responses.



**Robert Vanderhooft, CFA**  
CIO of TDAM, SVP of TD Bank Group

### What is your macro view of markets right now?

Overall, the committee is positive. If you look at some of the recent economic data, global purchasing managers indices, despite some recent weaknesses, are still in expansionary territory. Growth in the U.S. is accelerating, and fourth quarter GDP [Gross Domestic Product] is expected to come in above 8%. We are seeing quite a few economic forecasts in this order of magnitude. The positive backdrop for the U.S. economy has been supported by very robust employment numbers. Unemployment rates are very low, particularly in North America. Job openings in the U.S. have been very impressive. With respect to the Omicron variant, though highly transmissible, there is still some uncertainty over the severity of illness it causes. If it ultimately proves to be less serious and manageable, we expect global growth to continue and be reasonably positive in 2022.

### What is the WAAC's asset class outlook for 2022?

We believe that global economic growth will continue into 2022, but unsurprisingly at a slower and more moderate pace than the remarkable recovery experienced over the previous twelve months. We maintain a modest risk-on perspective as transitional inflationary pressures, pandemic uncertainties, geopolitical instability, and the potential for central bank missteps could all cause disruptions to growth and increase market volatility against a backdrop of lower expected returns. We are still underweight fixed income overall. We expect yields to move modestly higher in 2022 from current levels as central banks tighten, which should cause the yield curve to flatten as shorter-term rates rise faster than longer-term rates. As a result, fixed income returns will be challenged for most of the year. However, we do see some opportunities in the higher yielding credit sectors of the market. On the equities side, we maintain our bullish stance. We recently upgraded Canadian equities given attractive valuations and positive fundamentals, like rising commodity prices. We are also constructive on the Canadian dollar as the Bank of Canada is expected to raise rates at a faster pace than many other developed markets. Within the alternatives space, we are also overweight and see a lot of compelling opportunities going forward given the increased focus on ESG [Environmental, Social and Governance] factors and decarbonization.



## With respect to inflation, are you in the transitory or permanent camp?

We have been, and continue to be, more negative on the outlook for inflation as compared to the Fed [U.S. Federal Reserve] and other central bankers, and have expressed serious doubts on the transitory inflation narrative that the Fed has recently backed away from. The U.S. has now registered the fastest rise in consumer prices in nearly four decades, and it is a similar story in Canada. While we do expect inflation to moderate from these elevated levels, we are concerned that there may be a more persistent element. We are seeing increasing wage pressures here and in the U.S. as the number of job openings surpass the number of people looking for work. Once employers increase wages lowering them becomes more difficult, and when employees see what the level of wage inflation is in the market that becomes the new floor for contract negotiations. This can lead to a wage-price spiral further exacerbating the rise in prices for consumers. Energy has also been a huge contributor to inflationary pressures due to supply/demand imbalances and an underinvestment in capital by oil producers. Nowadays, it is more difficult to get new projects approved and investors are shying away from fossil fuels due to environmental and social concerns. A similar situation is occurring for mining companies as demand increases for copper, nickel, and other metals not just as a result of growing economies, but also as a result of electrification to build and support electrical vehicles and the charging infrastructure. At the same time, getting permits for new mines is cumbersome and difficult in today's environment. All that being said, we do not believe we are in a hyper inflationary environment similar to what we experienced in the 1970s.



**David Sykes, CFA**

Managing Director, Head of Public Equities, TDAM

## Are stock prices too high?

We continue to see what we have seen for the last two quarters, revenues and earnings in excess of what the market has been expecting. If there has been a trend in 2021, it has been the habitual underestimation of earnings by the analyst community, particularly in the U.S. The reason why equity markets have done so well has been because of positive earnings surprises. If there is one thing I have learned in my 24 years of investing is that as earnings go, so goes the market. S&P 500 Index earnings have had an amazing rebound from the depths of the shutdown and are up almost 50% from the bottom. Sure enough, the market has followed that higher. There can be arguments made whether the markets are undervalued or overvalued. The notion that we are in this bubble territory and markets are disconnected from reality is not correct in my opinion. I believe that current prices, based on the S&P 500 Index, are largely justified based on strong corporate fundamentals.

## Companies are growing earnings. What do you expect them to do with it?

If we look at the pre-COVID-19 payout ratio for the S&P 500 Index, that is, how much as a percentage of earnings was being paid out in the form of a dividend, half of every dollar earned by an S&P 500 Index corporation was returned to investors. Now, thanks to COVID-19, you have seen a collapse of that ratio to around 35%. Many companies cut their dividends during the pandemic and are now hanging on to excess capital. As the economy re-opens and gets back on track, barring any major setbacks, with strong earnings numbers we expect dividends to increase substantially as the payout ratio reverts to the mean. We have already started to see this with the large Canadian banks. I believe we will see steady and consistent dividend increases in 2022 on both sides of the border as corporations look to return their excess capital. If interest rates are staying lower for longer, this is a really attractive proposition for investors.

## What is your preference right now: Canadian large-cap or U.S. large cap stocks?

By looking at the equity risk premium, how much extra compensation you're getting for owning equities over fixed income, Canada looks very attractive right now. Valuations on financials and energy companies are compelling, given the free cash flow yields and the strength of corporate balance sheets. However, this will depend on what happens with Omicron and any other variant that may come along. If the recovery continues, you will see a pickup in aggregate demand in the world, not just North America. This puts Canada in a good place as we have the resources that the world needs. Valuations are a little bit richer in the U.S., but it all depends on where the world is headed.



**Robert Pemberton, CFA**

Managing Director, Head of Fixed Income, TDAM

## What do you see for interest rates going forward?

Most central banks have done a good job of communicating their plans with respect to quantitative easing and rate hikes. Currently, a number of rate hikes are expected for 2022 from the Bank of Canada and the Fed. The market is pricing in up to six hikes for the Bank of Canada and up to three for the Fed, and fewer for the ECB [European Central Bank] and Bank of England. What we are focused in on is what that terminal rate looks like, that is, where does the market see the long-term overnight rate getting to over time. 10-year yields in Canada and the U.S. are about 1.5% and we could see modest increases from here. It may be helpful to remember that when central banks start their hiking process, longer-term yields tend to be less volatile than shorter-term yields. When thinking through that, we see that as an opportunity to position ourselves appropriately across the yield curve to help protect clients' capital amid the rising interest rate environment.

## Does lower for longer still hold?

It really goes to how high interest rates can rise in an environment where there is so much debt, whether at the government level, corporate level, or the consumer level. Consumers are in better shape than they were prior to the global financial crisis. A debt transfer has occurred as governments have become the debtor of last resort as they have supported thousands of individuals and businesses throughout the pandemic. As a result, to lessen the financial burden of increasing interest payments, we believe longer-term interest rates will remain lower than they have traditionally been after interest rate hiking cycles.

## How are you positioning fixed income portfolios in 2022?

I think 2022 will be a little more positive for fixed income investors. If we look back a couple of years, fixed income returns in 2019 and 2020 were really strong and we spent time building capital for clients. 2021, on the other hand, was more about protecting capital during the uncertainties brought on by the pandemic. This was something the fixed income team was extremely focused on and they were able to deliver some strong performance. In 2022, we should see income-like returns, driven by the idea that we will see less volatility in longer-term interest rates. We don't see yields moving materially higher from here. From our thinking, to help protect clients' capital and deliver more income, our focus will be around corporate credit, high yield credit and private debt. These should continue to drive returns and provide elevated levels of income in the fixed income space for 2022.



## **Michael Craig, CFA**

Managing Director, Head of Asset Allocation and Derivatives, TDAM

### **With markets at all time highs, what are the chances of a crash in 2022?**

A crash can be viewed as a significant event that no one saw coming. We are talking about a 20% to 30% correction in the markets. The magnitude of a crash would largely depend on the type of event that preceded it. I don't see this happening in 2022. Perhaps if you had a resurgence of a variant that was vaccine resistant and had a higher mortality rate, or a military conflict in Eastern Europe, these could all possibly cause crashes. Something like the Fed raising rates I don't believe would lead to a market crash. If the Fed gets too far ahead of itself and over hikes, a 10% to 15% drawdown in equity markets is possible. From an investment perspective, a short duration shock is an opportunity to buy on the dip whereas for something longer lasting, you are probably better off waiting until the dust settles before making any investment decisions.

### **What are your thoughts on the crypto craze?**

Crypto is still a very speculative asset. As an investor, you are betting on a completely different financial system that we may inherit in the not-too-distant future. Whether that pans out or not, no one really knows. However, it's certainly a possibility. In terms of an asset class, it is challenging because it is difficult to get a good feel for what the drivers of growth are. Right now, momentum has been behind the large increases we have seen. You are buying on the belief that someone will pay more for your crypto assets down the road. The ultimate litmus test for the crypto currency markets will be the tightening of financial conditions. Back in 2017 and 2018, Bitcoin fell after rates rose. It will be interesting to see what happens in today's environment. I would be cautious on crypto going into 2022 and longer-term. As the asset matures, it is certainly something we are looking at in terms of investment opportunities. Personally, I don't like the idea of allocating funds to an asset that might drop 90% in the short term and then trying to explain this to clients when I don't have a good handle on it myself.

### **What should we expect for markets going forward?**

It's important to look at the bigger picture. Looking back, the 2010s were an interesting decade. You had a period with steady monetary policy that was very loose and with fiscal policy that was very tight. It was an era of relatively low meandering market growth, marked by the rise of passive investing. Economic volatility was low and so was inflation. Fast forward to 2020, and both metrics have broken out. We are now in a decade where I believe we will have materially higher volatility in inflation and growth. Some of the drivers of inflation are transitory while others are longer term. For instance, we are setting up for some real problems with energy because there are no new capital expenditures or supply coming on board to meet growing demand. So, we can probably expect more ups and downs in the markets as a result. We view this as a positive as there will be more opportunity to add value for clients. Risks may also get ratcheted up, requiring us to be on high alert. With respect to governments, I believe the concept of fiscal conservatism is dead. Most developed countries are now running large budget deficits which may not only lead to higher growth, but higher volatility in growth as well. As we all know, markets are sensitive to what goes on in the economy.

# Outlook





**Jeff Tripp, CFA**

Managing Director, Head of Alternative Investments, TDAM

## **Where do you see opportunities in the alternative assets space?**

Infrastructure returns in 2021 were strong given rebounding economies and loosening quarantine measures. We see significant opportunity looking forward as the need for new infrastructure intensifies. Renewed government commitments to decarbonizing economies has highlighted the opportunity in renewable energy and power infrastructure as over \$140 trillion dollars [USD] will be needed to reach current net zero targets globally. As electricity becomes the core of the energy system, this new demand will create an opportunity for investment. Electrical generation capacity is expected to nearly triple by 2050 and 80% of that growth is expected to come from wind and solar. Portfolios positioned to capitalize on that growth with proven development capabilities will see excess returns over the coming years.

## **Will the global real estate market cooldown in 2022?**

Global real estate returns saw a rebound in 2021, and in 2022 we expect more of the same. In the U.S., we believe that the Sun Belt region will continue to be a driver of growth given favourable in-migration patterns which are expected to benefit the multi-unit residential sector. The economic recovery across Europe has improved, largely driven by pent-up domestic demand leading to increased consumer spending. A focus on logistic assets and essential retail within Europe will be contributors of strong capital preservation and income predictability. Finally, we believe having a strategic allocation in the developed Asia Pacific region will be beneficial over the long-term, particularly within the industrial sector as large-scale third-party logistics and e-commerce occupiers continue to expand their networks to meet the rapidly growing needs of consumers.

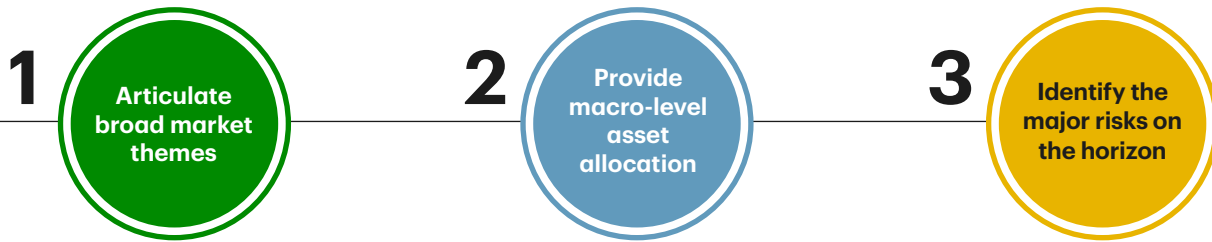




# TD Wealth Asset Allocation Committee

The **TD Wealth Asset Allocation Committee** was established to deliver a consistent asset allocation message and be the source for active asset allocation advice across TD Wealth.

The committee has three prime objectives:



## Committee Members

**Robert Vanderhooft, CFA**  
Chief Investment Officer,  
TD Asset Management Inc.

**Michael Craig, CFA**  
Managing Director,  
TD Asset Management Inc.

**David Sykes, CFA**  
Managing Director,  
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**Robert Pemberton, CFA**  
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**Glenn Davis, CFA**  
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