That hum you heard in the background throughout 2013? That was emanating from the U.S. Treasury’s printing presses, which were running at full throttle to keep up with the $85 billion the U.S. Federal Reserve (the Fed) was spending on long-term securities each month (“QE3”).

Other global central banks, most notably the Bank of Japan and European Central Bank, were also fully committed to expanding their balance sheets and together provided trillions of dollars of easy money to spur growth. Approximately two thirds of this excess liquidity ended up in financial markets, which meant they were well supported through the year.

Indeed, this support allowed equity markets to easily shrug off a variety of concerns during 2013, including potential sovereign defaults in Cyprus and the U.S., political uncertainty in Europe, slowing growth in China, sequester-related cutbacks in the U.S., a partial shutdown of the U.S. federal government and the possibility of an end to QE3, which led to a brief “taper tantrum.” In spite of some short-term volatility associated with these concerns, 2013 was a good year for equity markets, particularly those in the U.S., Japan and Europe – where equity markets produced double digit returns.

Moving into 2014, you might feel a sense of déjà vu, as we at TD Asset Management Inc. expect this accommodation from central banks to continue, which should support both financial markets and the global economy. With the U.S. economy showing signs that it is becoming self-sustaining and employment continuing to improve, the Fed recently announced that it will reduce QE3 to $75 billion per month, beginning in January 2014. However, it’s important to remember that tapering is not the same as tightening. When QE3 eventually ends, the Fed will no longer be adding to its balance sheet each month, but the balance sheet will remain enlarged because the Fed won’t immediately begin selling the assets it purchased. This means the liquidity that QE1, 2 and 3 provided will remain in the financial system until the Fed determines the timing is appropriate to begin reducing the size of its balance sheet.

We expect central banks will keep short-term rates low for a considerable time. This will likely keep investors further out on the risk spectrum, where many have moved in an effort to protect the real value of their savings. This, combined with ongoing high levels of liquidity, should be positive for equities in 2014.

In addition, officials from the Fed and other global central banks have repeatedly committed to remaining accommodative for as long as they deem necessary. While we believe that economic growth will accelerate in 2014, we think it will still be low compared to historical levels and relative to previous recoveries, which implies the need for continued support from central banks.
The Year Ahead

With this backdrop, what follows are our thoughts on what might be expected from financial markets over the year ahead.

Equities

We believe equities will generate positive returns in 2014, but expect they’ll be more modest than in 2013. We continue to favour equities over bonds. However, following a strong 2013, there is potential for equities to pull back from current high levels, particularly if company earnings or revenues disappoint.

Gains were widespread in 2013, but we expect that investors will likely become more focused on company-specific factors in 2014 and it may no longer be a case of the “rising tide lifting all boats.” In fact, the liquidity provided by central banks not only supported equity valuations, in some cases it distorted them. Therefore, gains in some areas will likely not be sustainable.

In general, we believe companies with strong balance sheets, low payout ratios and a commitment to returning capital to shareholders should do well in the coming year while highly leveraged companies with high payout ratios and low earnings growth are likely to face challenges.

Geographically, we continue to favour the U.S., which should benefit from improvements in the housing, automobile, manufacturing and energy sectors, plus higher consumer spending. In addition, the U.S. has a very broad and deep selection of quality companies, many of which operate globally and are poised to potentially benefit from improvements in domestic or global growth.

Fixed Income

Overall, fixed income returns were muted in 2013, reflecting improving economic growth and investor anticipation that the Fed would taper QE3. Although yields rose over the year, they are still near all-time lows, and corporate and high yield spreads have narrowed considerably.

Moving forward, we expect short-term yields to remain low throughout 2014 as central banks are likely to keep their policy rates low. We think that mid- and long-term yields will likely rise during 2014, although we expect them to remain low in absolute terms. In particular, long-term yields should rise as the Fed begins to taper its monthly purchases, which are largely made up of long-term bonds.

We still prefer corporate bonds to government bonds because of the yield advantage, but would caution that fixed income returns are likely to be very low, and potentially negative in real terms, again in 2014.

Commodities

Commodities were hit hard in 2013. The price of gold declined substantially as demand waned amid low levels of inflation, reduced risk of extreme outcomes, and speculation that the Fed would reduce its bond purchases. In addition, infrastructure development in emerging markets slowed, lessening demand for other key commodities. We expect gold will likely continue to face headwinds in 2014, and we think that demand for commodities should broadly move in tandem with global GDP growth.

Currency

Over 2013, the Canadian dollar declined against its U.S. counterpart and dropped below parity. We believe that the Canadian dollar may dip further in 2014, as relative economic growth and structural advantages favour the U.S. and the U.S. dollar will likely become more valuable when the Fed ends QE3. While snowbirds and cross-border shoppers may be unhappy with the lower loonie, it should provide a net benefit to Canadians, as the export sector and Canadian businesses with operations in the U.S. will both improve materially.

Overall, while being aware of factors that are likely to influence markets and investments is important, it’s equally important not to get caught up in the headlines or to overemphasize short-term events and market movements.

At TD Asset Management, we prefer to focus on high quality investments with solid fundamentals that will serve investors well for years to come. We believe this focus on quality, coupled with our commitment to excellence and our determination to deliver the best possible solutions, will continue to serve our clients well through the next year and long into the future.

As we head into the new year, all of us here extend our best wishes to you for a happy, healthy and prosperous 2014!

For more information, contact your Financial Advisor.

The statements contained herein are based on material believed to be reliable. Where such statements are based in whole or in part on information provided by third parties, they are not guaranteed to be accurate or complete. The article does not provide individual financial, legal, tax or investment advice and is for information purposes only. Particular investment or trading strategies should be evaluated relative to each individual’s objectives and risk tolerance. TD Asset Management Inc. (“TDAM”), The Toronto-Dominion Bank and its affiliates and related entities are not liable for any errors or omissions in the information or for any loss or damage suffered. Certain statements in this commentary may contain forward-looking statements (“FLS”) that are predictive in nature and may include words such as “expects”, “anticipates”, “intends”, “plans”, “believes”, “estimates” and similar forward-looking expressions or negative versions thereof. FLS are based on current expectations and projections about future general economic, political and relevant market factors, such as interest and foreign exchange rates, equity and capital markets, and the general business environment, in each case assuming no changes to applicable tax or other laws or government regulation. Expectations and projections about future events are inherently subject to, among other things, risks and uncertainties, some of which may be unforeseeable and, accordingly, may prove to be incorrect at a future date. FLS are not guarantees of future performance, and actual events could differ materially from those expressed or implied in any FLS. A number of important factors can contribute to these digressions, including, but not limited to, general economic, political and market factors in North America and internationally, interest and foreign exchange rates, global equity and capital markets, business competition and catastrophic events. You should avoid placing any undue reliance on FLS. Further, there is no specific intention of updating any FLS whether as a result of new information, future events or otherwise. TD Asset Management Inc., The Toronto-Dominion Bank and its affiliates and related entities are not liable for any errors or omissions in the information or for any loss or damage suffered. ©/The TD logo and other trade-marks are the property of The Toronto-Dominion Bank.