TD Asset Management

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The Year Ahead 2015

"I'm delighted to be writing the first of what I hope will be many *Year Ahead* commentaries. As you may well be aware, I've recently taken over as Chief Investment Officer at TD Asset Management Inc. (TDAM), and I'm excited to have the opportunity to guide our talented team as we continue TDAM's long-standing tradition of investment excellence."

After a period of relative calm in financial markets, volatility returned in 2014, bookending the year and reminding investors that investing is not always a smooth journey. While many are hoping this volatility was just an anomaly, we at TDAM believe that it offers a preview of what investors can expect for 2015.

Over the past year, economic growth outside of North America was disappointing. Chinese growth, which is a significant contributor to global gross domestic product (GDP), has slowed considerably and is likely to continue to slow. In Europe, progress appears to have stalled and the euro zone continues to wrestle with the spectre of deflation, and in Japan, Abenomics has not yet lived up to expectations, with the country recently slipping into a technical recession. The central banks in all three regions have pledged to expand their accommodative monetary policies in order to stimulate and support the waning economies. However, we believe that despite the best efforts of global central banks, most of the world is in for a long period of persistent low growth — the hangover from a long period of debt accumulation.

On the other hand, the U.S. has emerged as an economic bright spot. On a relative basis, the U.S. economy began to shine in 2014 as employment improved notably, GDP surpassed expectations and both consumer credit and business investment increased. With these economic improvements, monetary policy in the U.S. began to diverge from the global trend of increasing accommodation. After several years of very accommodative policies, the U.S. Federal Reserve started to move toward a more neutral stance by reducing and then ending its massive monthly asset purchase program. While the unified accommodative efforts of global central banks have provided abundant liquidity and suppressed financial market volatility over the past few years, with the U.S. no longer increasing its accommodation, volatility is likely to increase to more normal levels, such as we've witnessed over the final quarter of 2014.

New Year, New Reality

As the new year begins, we believe that investors will face a new reality – more modest returns from their financial assets and heightened volatility. Below I share some of our broad thoughts of what you might expect in 2015.

Equities: As 2014 unfolded, equity markets were jarred by concerns over high inflation and budget deficits in some emerging market countries, geopolitical conflict between Russia and Ukraine, and weak economic data out of China and the U.S. However, investors quickly shook off their fears and equity markets resumed their upward trajectory, aided in large part by strong support from a variety of global central banks. North American markets were particularly robust, with Canadian and U.S. indices reaching numerous all-time highs. Volatility re-emerged in the final quarter of the year though, spurred by further geopolitical conflicts, speculation over potential changes to monetary policies in the U.S., slower international economic growth and a steep decline in the price of oil. Nonetheless, global equities were positive for the year.

Slowing growth in the emerging markets and disinflationary pressures in Europe make us cautious about international equities, and we continue to prefer North American equities, many of which offer strong balance sheets and good cash flows. For 2015, we expect North American equities will generate positive returns, but we believe they will be lower than they have been over the past few years, when they were spurred by a number of tailwinds associated with the recovery from the financial crisis (including very attractive valuations, strong earnings growth and highly accommodative monetary policies). As these tailwinds abate, equity returns should moderate. For example, in the U.S., valuations are now reasonable from a historical perspective, and we anticipate that the improving U.S. economy will help support modest earnings and dividend growth. However, we also believe that earnings growth will slow to the mid-single digits and companies with operations outside of the U.S. may face headwinds associated with the strong U.S. dollar, both of which are likely to moderate returns. In Canada, valuations are attractive, particularly after the recent pullback, but slowing global growth may continue to weigh on demand for commodities, which make up a large part of the Canadian equity market.

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Bonds: Amid the geopolitical skirmishes and slower-than-expected economic growth of 2014, fixed income did well, generating positive returns as many investors opted to move to the relative security of bonds. Bond returns were also aided by the ongoing accommodative central bank policies globally, which helped to keep yields low. However, with yields at such low levels, we expect that bond returns will be low in 2015. In fact, while bonds continue to offer stability within portfolios, we would caution that investors may find it difficult to generate positive after-inflation returns from their fixed income holdings. We continue to favour investment grade corporate bonds over government bonds as the incremental yield is attractive in light of strong corporate balance sheets.

Commodities: For commodities, 2014 was a tale of two halves. The year started off well, but things got tough in the second half as global economic growth slowed markedly, which weakened demand for commodities. Gold and oil were particularly hard hit, with gold declining against the strength of the U.S. dollar and oil prices dropping hard and fast amid excess supply and slowing demand growth.

On balance, lower oil prices are a negative for Canada. While drivers have been enjoying the benefits of lower prices at the pumps, Canadian investors have been feeling the negative effects of the energy sector's large weighting in the S&P/TSX Composite Index, and Canadian economic growth is likely to moderate as oil producers slow their operations. However, oil prices are now below the long-term marginal cost of production, so we do not believe they will remain depressed for a prolonged period.

Currency: The Canadian dollar was mixed over 2014, rising against a number of major currencies, including the euro and Japanese yen. However, it declined significantly against the U.S. dollar, which was notably strong. While the loonie's weakness against the U.S. dollar hurts Canadian snowbirds, it should benefit investors with unhedged U.S. holdings as well as Canadian businesses that export to the U.S. and/or have operations in the U.S. We believe that the Canadian dollar is fairly valued.

The U.S. dollar was universally strong against other global currencies as uncertainty over various geopolitical incidents and slowing growth in regions outside of the U.S. led many to take advantage of its safe-haven status. Overall, we believe that the U.S. dollar will continue to be strong in 2015 as relative economic and structural advantages favour the U.S. over other geographies.

Our view

In spite of our more cautious outlook, we continue to prefer equities over fixed income as we believe real returns from bonds will be low. However, we expect that the differential between fixed income and equity returns will be smaller than it has been over the past few years. Overall, we expect higher volatility and more modest returns from financial assets in the year ahead. In this environment, we encourage investors to maintain focus on their long-term objectives and to avoid being distracted by short-term market movements. At TDAM, we will maintain our focus on investment excellence, continue to invest in high quality companies and remain committed to creating and delivering innovative low volatility and risk-mitigation solutions to help our clients achieve their goals.

As we head into the new year, all of us here at TDAM extend our best wishes to you for a happy, healthy and prosperous 2015.

For more information, contact your Financial Advisor.

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