TD Greystone Asset Management

Public Equities Monthly Macro-to-Micro

April 2019

Feature:
No April Showers in the U.S. Equity Market

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Fund Performance Highlights:

Performance (%)

As at April 30, 2019	3-Month	1 Yr	3 Yrs	5 Yrs
Global Equity	**12.8**	**11.1**	**16.0**	**14.9**
MSCI World-ND	10.7	11.7	14.1	11.8
Difference	**2.1**	-0.6	**1.9**	**3.1**
U.S. Equity	**14.2**	**22.8**	**21.1**	**18.9**
S&P 500	12.1	19.1	17.6	16.3
Difference	**2.1**	**3.7**	**3.5**	**2.6**
U.S. Income & Growth	**14.2**	**26.1**	**20.0**	**18.6**
S&P 500	12.1	19.1	17.6	16.3
Difference	**2.1**	**7.0**	**2.4**	**2.3**
International Equity*	**11.0**	**2.0**	**12.7**	**10.4**
MSCI EAFE-ND	8.7	1.5	9.8	6.9
Difference	**2.3**	**0.5**	**2.9**	**3.5**
China Income & Growth	**19.9**	**9.0**	**27.0**	**n/a**
CSI 300 (Net)	24.6	4.6	10.7	n/a
Difference	-4.7	**4.4**	**16.3**	**n/a**
Canadian Equity	**8.4**	**8.2**	**8.2**	**4.9**
S&P/TSX Composite	7.5	9.6	9.1	5.6
Difference	**0.9**	-1.4	-0.9	-0.7

* International funds and MSCI EAFE performance is net of foreign dividend withholding taxes. This figure shows the performance in Canadian dollars, including cash; net of custodial fees, audit fees, transfer agent fees and administrative expenses; gross of investment management fees.

No April Showers in the U.S. Equity Market

New all-time highs: While our investment process is bottom-up and focused on the long-term outlook for growth at the individual company level, it's important to note that there are underlying rumblings going on in equity markets. Developed markets generally performed well in April. The S&P 500 wrapped up the month at a new all-time high on the back of generally strong corporate earnings. Emerging markets were left somewhat flat in the month as the U.S. dollar rallied further. Historically, U.S. dollar gains are associated with lower inflation/growth expectations, which is consistent with the broad-based decline in G10 inflation expectations. Declining G10 inflation expectations have forced global central bankers to adopt a more dovish stance.

Focusing on the micro, not the macro: Still, among all of the macro and geopolitical noise that continues to dominate headlines, global investors are turning their focus to more micro drivers and business fundamentals as we get into the heart of corporate earnings season. So far, it hasn't paid to overthink earnings this quarter. Stocks that raise or point to short cycle signs of improvement are rallying, while companies that miss or do little to instill confidence in their outlooks are sold. We continue to favour software names in the Greystone U.S. Equity Fund as demand trends for cloud solutions remain strong and businesses continue to invest heavily into software to better compete in a digital economy. Microsoft and ServiceNow showed that there is positive business momentum in the sector, despite a very high bar.

It's a stock picking environment: More importantly, we are starting to see signs of real dispersion and differentiation within sectors. This is particularly the case in the Consumer Staples, Consumer Discretionary, Health Care, Energy and Information Technology sectors, as shown in Figure 1.

Figure 1: S&P 500 Price Dispersion (Max-Min Total Return) YTD 2019 and April 2019

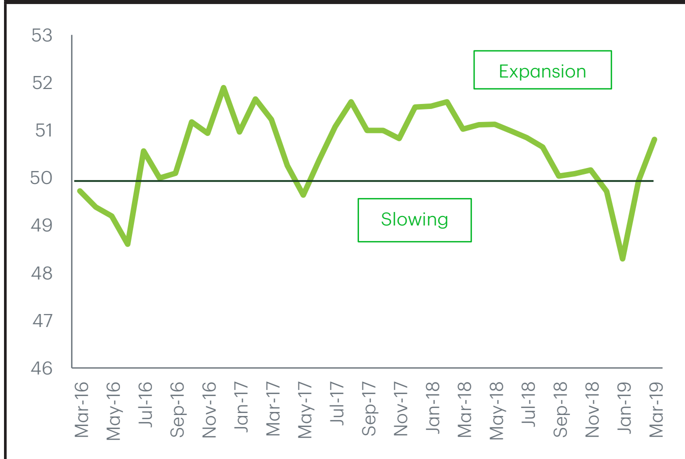
Source: FactSet.

China - Green Shoots Continue to Appear

After a slow start, Chinese policy makers have "flooded the fields with fertilizer" and, as a result, green shoots have been proliferating the last few months. Strong data for March included a reported 8.5% year-over-year increase in industrial output, a 6.5% surge in fixed investment, and an 8.7% rebound in retail sales, according to the National Bureau of Statistics of China. There was also strong growth in money and credit. While some of the strength in March is likely due to the timing of the Chinese New Year, it is hard to completely dismiss the strong data. It may still take the rest of this year to see signs of further stabilization in the data as, according to Cornerstone Macro LLC, over 70 stimulus measures have been applied to the economy since June 2018.

In April, Chinese Manufacturing and Non-Manufacturing PMIs, and new yuan loan growth figures supported a stabilization view. Global investors need to take note of this given that China generates close to one-third of global GDP growth. The latest cluster of Chinese PMIs all managed to increase, following the prior month when only one of the four PMIs rose.

Figure 2: China Caixin Manufacturing Purchasing Managers Index (PMI)



Source: FactSet.

The Bottom Line:

A linear recovery/stabilization trend should not be expected in China: After three consecutive months of sub-50 readings, the manufacturing PMI rebounded to 50.8 in March from 49.9 in February (see Figure 2). It exceeded market expectations and is the first material monthly improvement since 2017. However, the early indications for April suggest the rate of recovery is not going to be in a straight and smooth line with official manufacturing PMI sliding to 50.1 in April from the six-month high seen in March, according to data from the National Bureau of Statistics. Despite the broadly lower readings, the index managed to stay above the 50 mark separating expansion from contraction for two straight months.

Early green shoots in China have yet to show in the European data: It seems green shoots in China didn't make their way into the European data this month. However, according to Morgan Stanley, China's PMI leads Euro Area PMI by about three months, so the recent positive Chinese data may support a positive outlook for Europe in the near term. While the PMIs remain in flux, other surveys have been painting a more positive picture for some time. ZEW expectations (a monthly economic sentiment indicator used as an indicator of the economic outlook for Germany), have risen for the past six months and the German Ifo has shown signs of improving. That being said, it's not off to the races just yet. Continued risks include Brexit, potential Trump auto tariffs and rising energy costs.

Potential green shoots for Japan are less clear than for Europe. On the one hand, if the Chinese economy is stabilizing, the Japanese manufacturing sector should benefit. On the other hand, Japan is vulnerable to a stronger yen and yet another poorly timed consumption tax hike coming this fall.

Medicare for All – All for One and None for All?

Shedding light on industry developments and sharing our thoughts on Health Care stocks

Since the end of 2018, the U.S. Health Care sector has been under pressure following a general shift to more cyclical sectors from defensive ones, and a series of industry-specific developments that have turned into headwinds. One subsector in particular, Managed Care in the Health Care Providers and Services subsector, has been particularly weak after peaking in early December 2018 (see Figure 3).

Several reasons have been cited for the relative share price weakness including:

- **Election uncertainty** – The Democrats "Medicare for All" plan submitted by presidential candidate, Senator Bernie Sanders.
- **Drug pricing reform** - U.S. Department of Health and Human Services proposed a rebate rule to lower drug prices by mandating manufacturers to pass discounts directly on to patients, as well as requiring new transparency in prescription drug markets.
- **Medicare Final Part D rule overhang** – In early April, the Centers for Medicare & Medicaid Services issued a final rule that updates the Medicare Advantage (MA or Part C) and Medicare Prescription Drug Benefit (Part D) programs by promoting innovative plan designs, improved quality, and choices for patients.
- **A crowded group:** Managed Care stocks were a crowded group in Health Care, which created additional selling pressure on these names as news came out.

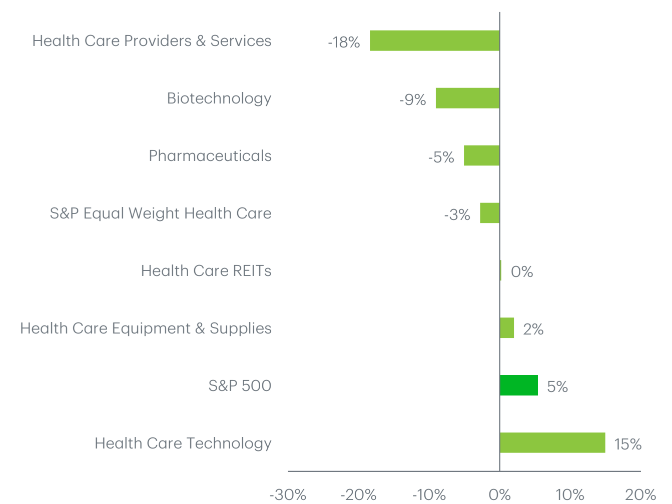
The Bottom Line:

In the Greystone Global Equity Fund and the Greystone U.S. Equity Fund, our exposure to the Managed Care stocks rests with our long-time holding, UnitedHealth Group Inc. ("UNH"). We have held UNH in the Greystone U.S. Equity Fund since 2010 and it has consistently contributed to excess returns above the S&P 500. Year to date, UNH shares have underperformed given the perception that it will be negatively impacted from both the introduction of the Medicare for All bill and an increase in perceived pharmacological pricing pressures from continued political changes and the 2020 election.

Our team believes that the risks of a dramatic change in pricing or regulatory environment remain low. This view is based on the challenges of actually passing any material legislative changes through the U.S. House and Senate with an election pending in 18 months. Nonetheless, headline risks are likely to remain in the Managed Care group, and possibly for UNH. Health care is likely to be one of the most fiercely debated topics during the upcoming 2020 presidential election, as President Trump pushes Congress to repeal Obamacare and Democrats increasingly call for a move to government-backed insurance.

That being said, any changes that happen are likely to be on the margin and should be manageable for the strong team at UNH. Looking at the fundamentals of the recent earnings report, we see the outlook for growth at UNH as quite attractive in light of the stock's compressed value relative to the index since December 2018. And finally, in the last few weeks, stocks in the Managed Care sector have rebounded relative to their global Health Care peers.

Figure 3: S&P 500, S&P 500 Health Care sub sector price return (%) Dec 3/18-Apr 30/19



Source: FactSet.

Around The Bend – A Look Ahead and a Halloween Brexit Deadline

Upcoming Events

Date	Event	Comment
May 15, 2019	U.S. Autos Tariff deadline	Trump decision on whether to impose tariffs on auto imports
May 23-26, 2019	European parliamentary elections	Includes U.K. EU elections under Article 50 extension
June 8-9, 2019	G20 Finance Min. Summitt (Japan)	
June 20-21, 2019	EU Summit (Brussels)	A successor to Draghi could be determined at this event
June 26-27, 2019	Democrat Debate (Miami)	First Democratic primary debate
June 28-29, 2019	G20 Leader's Summit (Japan)	
2H2019?	USMCA vote	Likely congress to vote yes but debated
1-Oct-2019	Japan sales tax increase	Japanese sales tax is scheduled to rise from 8% to 10%
21-Oct-2019	Canadian Federal Elections	
October 31, 2019	Brexit Deadline	Article 50 extension deadline

Source: FactSet. TD Greystone Asset Management.

It seems as though the Brexit issue continues with the European Union ("EU") leaders granting an extension of the U.K.'s EU membership under Article 50 TEU ("A50 extension") until October 31, 2019. There are conditions with this A50 extension, including (1) there will be EU elections in the U.K. in May, (2) there can be no U.K. obstruction of EU decisions on personnel and other matters, (3) there will be no renegotiation of the Withdrawal Agreement. The extension can be used to change the political declaration on future relations and can be cut short if the Withdrawal Agreement is ratified.

The Bottom Line:

Taking a no-deal Brexit or hard Brexit off the table for now: the extension takes a no-deal Brexit off the table for now, but successive short extensions are not great for business confidence and investment on either side of the deal. Our exposure in the U.K. is tilted to companies with a strong global footprint, with the majority of their revenues coming from outside of the U.K. **We believe our direct exposure to the U.K. has been minimized and our exposure through U.K. listings is not material.** There are many moving parts to the U.K./EU negotiations and, as such, we do not believe that adding exposure at this time is favorable on a risk/reward basis.

Each month, we feature some of the work coming from our public equities team. We feature two interesting pieces from our team this month.

Iron Ore Rally – What's the fuss?

Implications for our Holdings

This month, we highlight the strong rally in iron ore prices and how our exposure to Rio Tinto PLC ("RIO"), which is held in the Greystone International Equity Fund, the Greystone International Income & Growth Fund, and the Greystone Global Income & Growth Fund, has benefited from this rally. As of the end of April, iron ore prices rallied approximately 34% since the beginning of the year, which has come from a series of supply distributions. RIO has appreciated by over 21% (in Canadian dollar terms) year to date, as well.

Heather Greenman, TD Greystone's global materials analyst, noted that while iron ore prices will likely come down over the back half of 2019, the macro trends from China and RIO's own corporate strategy of disciplined capital allocation should continue to support Rio, even if we get an initial dip in the stock when iron ore prices start to normalize. In the near-term, any increase in iron ore price should benefit RIO's cash flow leverage to the commodity. While our long-term thesis is based on seeing stable underlying demand backed by steel and environmental reform in China paired with sound capital discipline.

The Bottom Line:

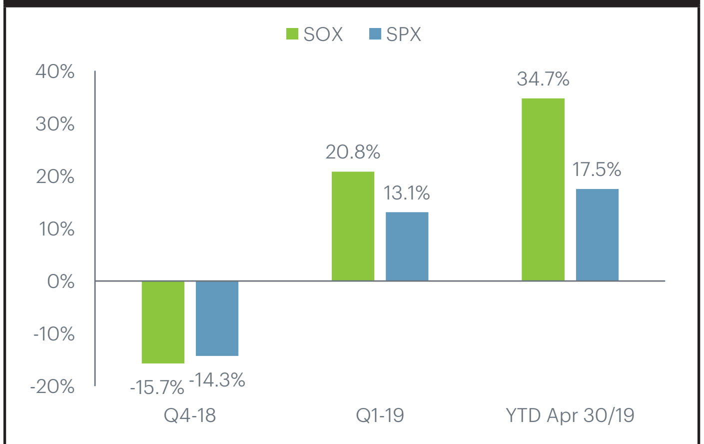
We have owned Rio in our funds since November 2018 and continue to like the company and stock given the combination of capital discipline, healthy balance sheet, and low cost tier-1 assets, which we believe will support peer-leading capital returns. Our proprietary quantitative screening tool continues to assign top-decile rank to RIO given its robust Return on Invested Capital, strong historical earnings growth, positive business momentum, high dividend yield, and valuation.

Semiconductors – Where to from here?

Our information technology analysts, Andrew McKendry and Jared Ablass, presented to the wider team in April on the robust rally in the Semiconductor sector year to date (see Figure 4). The rally from the December 24, 2018 lows has been impressive, and it has all been on the back of multiple expansion rather than on earnings growth. Given the highly cyclical nature of the sector, this sort of dynamic between the price-to-earnings ratio and earnings per share growth in the short term is to be expected.

For instance, in Q4-2018 the PHLX / Semiconductor ("SOX"), which is a Philadelphia Stock Exchange capitalization-weighted index that is composed of companies primarily involved in the design, distribution, manufacture, and sale of semiconductors, declined by 15.7% and underperformed the S&P 500 by 140 basis points. This was mostly due to fears of further tightening of financial conditions and slowing global growth. Enter Q1-2019, with the U.S. Federal Reserve signalling a dovish tone in their outlook for monetary policy and global growth fears easing, and the SOX is up +35% year to date, which is almost double the S&P 500 index gain this year. The price-to-earnings ratio expansion was +40% and earnings per share growth was -5% for the SOX index.

Figure 4: S&P 500 (SPX), PHLX / Semiconductor (SOX) price change (%)



Source: FactSet.

After going through the earnings updates in April from semiconductor companies that have reported results, our fundamental team pointed out that none of the indicators to watch in this subsector are improving. These include the guidance and beats/misses ratio worsening since December 2018, days inventory still very high across the sector, and expectations for a second half 2019 recovery in demand seeming less likely at this point. From a stock perspective, it would seem that the price-to-earnings ratio appreciation year to date already reflects expectations for a better second half, which we see as less likely today based on our fundamental work. Weighing in on this, our Asia information technology analyst, Solo Zhang, notes that seeing the multiple expansion simultaneously with earnings bottoming out isn't uncommon.

The Bottom Line:

Fundamentals for Semiconductor companies continue to look negative, yet valuations are implying a recovery near-term. Under our disciplined investment process, we constantly evaluate our holdings for near-term price changes relative to changes in ranking based on our proprietary quantitative screening tool. In conjunction with our fundamental work on the semiconductor industry, our macroeconomic indicators continue to point to late stage business cycle positioning. Combining all the data, we have moved our portfolios to be more balanced between defensive and cyclical exposures. In particular, we have somewhat reduced our exposure to the Semiconductor sector in our International, Global and U.S. funds over the last few months. We continue to have exposure to the sector through the global industry leaders with higher-quality balance sheets and reasonable valuations.

Our Team is Growing!

Welcoming New Additions to Our Team

The TD Greystone Public Equities team continues to grow following the acquisition by TD in November 2018. As a firm, we are investing in the team to ensure that we continue to deliver investment excellence to our clients.

Since November 2018, we have added five new members to our team bringing our total team resources for TD Greystone Public Equities to 29, including Public Equities Trading, and Client Portfolio Management.

- **Jared Ablass**, Analyst, joined in 2018 with generalist responsibilities as well as covering a portion of the Global Information Technology sector.
- **Andrew McKendry**, Vice President, joined in 2019 and is covering Global Information Technology and Communication Services.
- **Brandon Merkosky**, Analyst, joined in 2019 and will be covering a portion of the Global Communication Services and Global Utilities sectors.
- **Leila Kulbayeva**, Associate, joined in 2019 and will be covering Consumer Staples with Paula Brinton on parental leave.
- **Shawn Unger**, Analyst, Quantitative Research / Risk Management, Public Equities, will be working with the Quantitative Research team on projects related to the measurement of quantitative factor efficacy and risk for the global equity team, as well as assisting in the development of tools for data analytics within TD Greystone's equity portfolios.

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