TD Greystone Asset Management

Quarterly Market Update

Summer Overview (Q2-2019)

CIO *View*Point

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The primary question for our current outlook is whether upcoming interest rate cuts from the U.S. Federal Reserve are in response to a potential recession occurring or an attempt to prevent one. This is of great importance given divergence in financial asset outlooks. Sovereign rates are reflecting a significant slowdown, while risk premiums for credit remain low. Equities are close to all-time highs; however, defensive sectors are trading at a greater premium relative to their history. Inflation expectations are falling while gold appears to be breaking to the upside. Where we are in the economic cycle will inform which asset classes are more likely to be dislocated from underlying fundamentals.

When risk budgeting for asset allocation, our outlook relative to consensus, along with implied asset pricing, play an important role. Our global outlook is for a slowing expansion but not a recession. As yields have fallen, they provide natural stimulus and increasingly accommodative financial conditions. Equity earnings and margins, while slowing, remain at strong absolute levels. Labour markets remain extremely strong in the U.S. and Canada with positive real wage growth.

Consensus in the market appears to be reflecting a similar view for a late cycle slowdown with central banks easing as a precautionary measure. We have observed that U.S. employment figures, purchasing managers' indices (PMIs), housing permits and credit spreads all reflect trends that preceded non-recessionary cuts (1987, 1995, 1998) versus recessionary ones (1989, 2001, 2007).

With equities near all-time highs and tight credit spreads, risk assets already reflect our outlook. Our focus for asset allocation is where the balance of risks lie versus our consensus view. Europe faces headwinds and the European Central Bank is running short on stimulus options. Tariffs appear to be biting as the slowdown in global PMIs appears to coincide with escalating trade tensions. If trade tensions persist, there is potential for greater damage to global economic growth. Fiscal stimulus in the U.S. is also likely to wear off in upcoming quarters, removing a recent tailwind to economic growth. Finally, we do recognize that consensus views missed recessions in both 2001 and 2007 despite anticipating interest rate cuts.

As active managers, we recognize that knowing when to scale down asset allocation risk is a key component of long-term value add. Given our view reflects market consensus, and appears to be priced in, we maintain a neutral posture with respect to active equity exposure. While equities traditionally perform well after an "insurance cut," markets may be disappointed if the three cuts priced in by year-end are not delivered. As we noted and witnessed in 2018, equity markets can also experience significant drawdowns even in periods of expansion.

In our estimation, the collapse in sovereign bond yields appears to be overdone, and we believe that with money market rates above 10-year Government of Canada bond yields, a short-term bias is appropriate. High yield and corporate bonds can provide return enhancement, but we counsel our clients that upside potential is limited at current spread levels. Default expectations also remain historically low despite high levels of leverage for corporations.

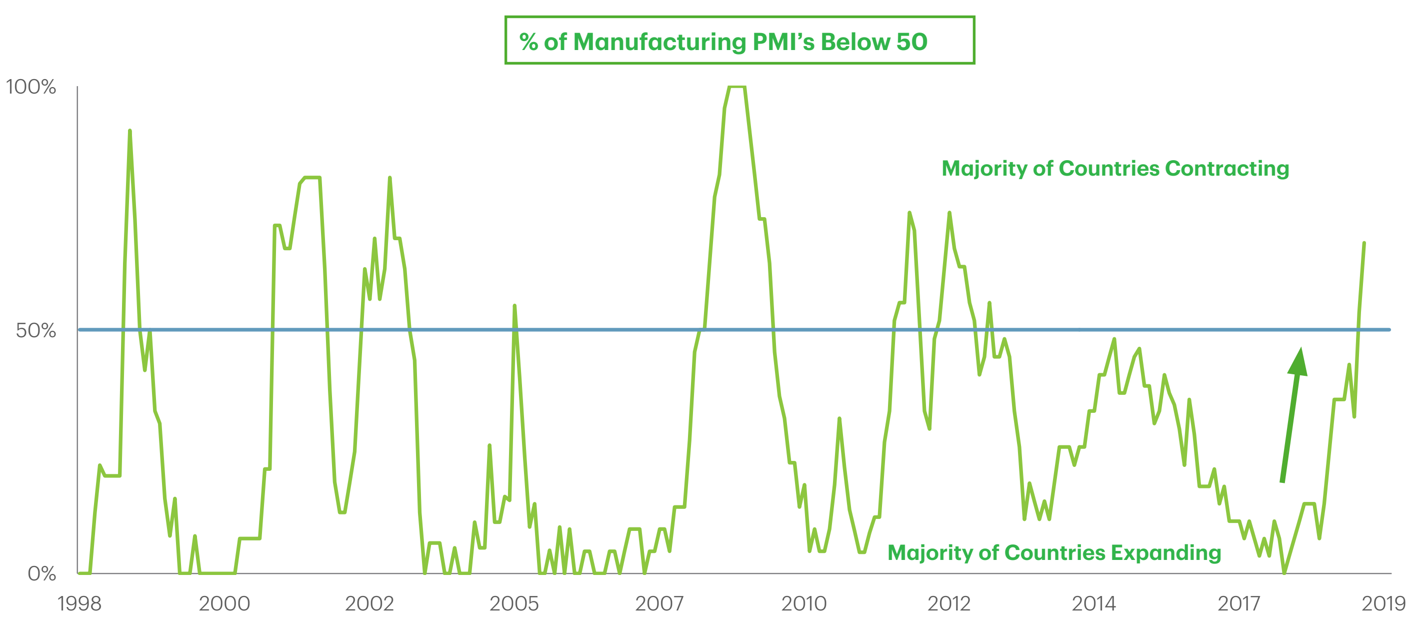
Within equities, we do not see tremendous divergence in the trajectory for profitability by region. Pricing shows some dislocation from historic relative value, with defensive and interest rate sensitive sectors trading at a greater premium to five-year averages. Sustainable earnings profiles tend to outperform when growth becomes scarce and remains a focus in our stock selection.

With strong equity and fixed income returns, balanced investors have witnessed close to double-digit returns, recovering losses from 2018. Real assets and private commercial mortgages have continued to demonstrate their diversifying return profile with lower but more stable returns through the first half of 2019.

Within infrastructure, we are seeing deal opportunities broaden again outside of renewables. While valuations are rising, we still believe that premiums relative to equities and bonds remain strong.

After a slowdown in activity through the first quarter, real estate deal volumes recovered in the second quarter. Fundamentals remain strong across Canadian commercial real estate sectors with low vacancy rates. Real estate asset prices will likely benefit going forward as cap rates tend to follow sovereign yields with a lag. Commercial mortgages should also perform well as spread premiums relative to corporate bonds are near five-year highs.

Manufacturing PMI's Reflect Risks in Global Economy



Source: Cornerstone Macro.

Asset Class Total Returns

Calendar Year						Q2-2019
2014	2015	2016	2017	2018	YTD	3-Month
Long Bonds 17.5	Glo. Eq 18.9	Cdn. Eq 21.1	EM Eq 25.8	Real Estate 7.8	Cdn. Eq 16.2	Long Bonds 4.8
Glo. Eq 14.4	Infrastructure 11.5	Infrastructure 8.6	Glo. Eq 14.4	Infrastructure 6.3	Long Bonds 12.1	Infrastructure 2.8
Infrastructure 10.6	Real Estate 7.8	EM Eq 7.3	Infrastructure 10.1	Mortgages 2.4	Glo. Eq 11.9	Cdn. Eq 2.6
Cdn. Eq 10.6	Mortgages 4.0	Real Estate 6.1	Cdn. Eq 9.1	Bonds 1.4	Bonds 6.5	Bonds 2.5
Bonds 8.8	Long Bonds 3.8	Glo. Eq 3.8	Real Estate 7.2	Cash 1.4	EM Eq 5.8	Real Estate 1.9
Real Estate 7.0	Bonds 3.5	Long Bonds 2.5	Long Bonds 7.0	Long Bonds 0.3	Mortgages 4.2	Glo. Eq 1.7
EM Eq 6.6	EM Eq 2.0	Mortgages 1.8	Bonds 2.5	Glo. Eq -0.5	Infrastructure 3.5	Mortgages 1.5
Mortgages 6.0	Cash 0.6	Bonds 1.7	Mortgages 0.9	EM Eq -6.9	Real Estate 3.3	Cash 0.4
Cash 0.9	Cdn. Eq -8.3	Cash 0.5	Cash 0.6	Cdn. Eq -8.9	Cash 0.8	EM Eq -1.6
Market Portfolio[5]						
		4.9	10.4	-0.3	9.3	1.9

Asset Class Proxies

- S&P/TSX
- MSCI World (Net)[1]
- MSCI Emerging Markets (Net)[1]
- Infrastructure[2]
- Real Estate[3]
- Custom Mortgage Benchmark[4]
- FTSE Cda 91 day T-bill
- FTSE Cda Universe
- FTSE Cda LT Overall

Source: TD Greystone Asset Management, FactSet, Preqin. As at June 30, 2019. 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, Q3 2018, and are Greystone Infrastructure Fund (Canada) LP returns thereafter. Infrastructure returns are presented in US$.

[3] Real estate returns are the MSCI/REALpac Canada Annual Property Index - All Assets up to its most recent publication, Q1 2019, and are Greystone Real Estate Fund Inc. returns thereafter.

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

[5] The Market Portfolio is the Greystone Balanced Plus fund.

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