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The Enduring Economic Expansion
A Cycle Of Resilience

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

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It's official. The U.S. economic recovery from the devastating Great Recession (2007-2009) made history in July 2019, as the 121-month expansion officially became the longest on record. In December the cycle extended to the 126-month mark, and continues to roll along. According to the National Bureau of Economic Research, the previous record spanned 120-months (1991-2001) and many will recall the dotcom implosion that punctuated its calamitous end.

The current cycle has endured despite many market pundits claiming that an economic slowdown or recession is inevitably looming on the horizon. What has been the key driver behind the unprecedented run in business activity? What has it meant for equity market performance, bond yields and central bank policy?

Central banks to the rescue

Following a relatively shallow rate hiking cycle, the U.S. Federal Reserve (the Fed) swiftly pivoted from hawkish to dovish and cut interest rates three times in 2019, responding to subdued inflation expectations, slowing global economic growth rates, and negative repercussions from trade wars. While there has been no shortage of criticism directed at the Fed, history may prove that a "soft landing"—the best possible outcome of central bank policy—may have been achieved in this cycle.

Central banks from around the world are using monetary policy to help manage and support the economy. As growth has moderated, central banks have lowered rates or utilized expansionary monetary policy measures to boost spending and investment.

At home, the Bank of Canada (BoC) has not been shy about expressing concerns regarding the domestic picture and has cited the global deceleration in economic activity and unpredictability of the U.S./China trade relationship as potential risks to future growth. As a result, the BoC maintained its already low benchmark rate at 1.75% throughout 2019, while cutting its outlook for economic growth in 2020.

How have equity markets responded?

By the end of 2018, equity returns—most notably in North America—were at levels often witnessed after sharp drawdowns, corrections or recessions. Markets recovered in 2019, delivering double digit gains globally and above 20% in the U.S. and Canada (in Canadian dollar terms). Since September, we have also seen value stocks recover, and more recently emerging markets equities have risen, an asset class where we have maintained an overweight view throughout the year.

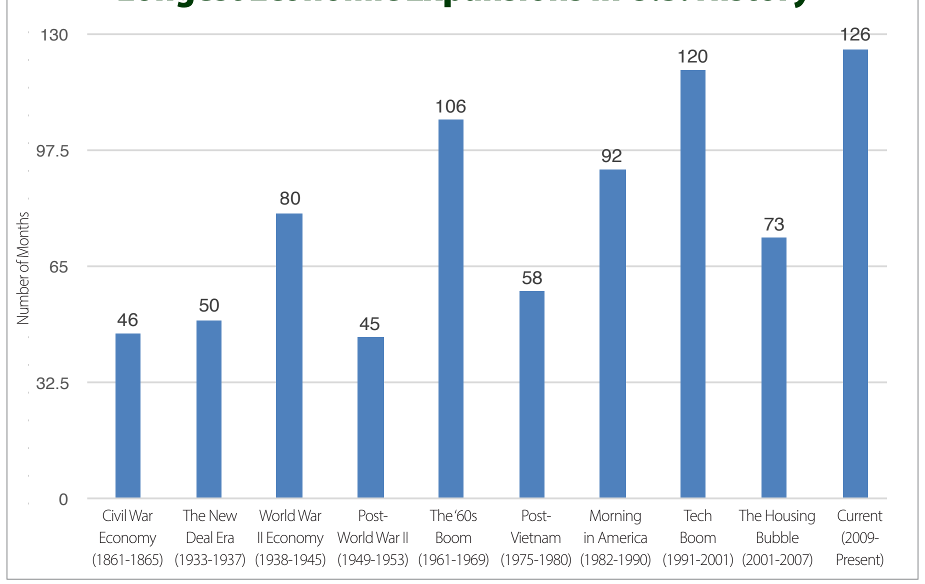
The late stages of the economic cycle are historically noteworthy as they often bring high potential market returns but are also associated with a wall of worry that prevailing risk factors will eventually bring pain when the music stops.

What seems more probable at this point is that we are enduring the third mini slowdown within a very long cycle. While the cycle has been long, the amplitude of the growth has been relatively shallower than typical cycles. As a result, we have seen fewer excesses, and it is excesses that have often ended cycles. Encouragingly we are seeing some early economic indicators bottom out or turn up from their recent lows.

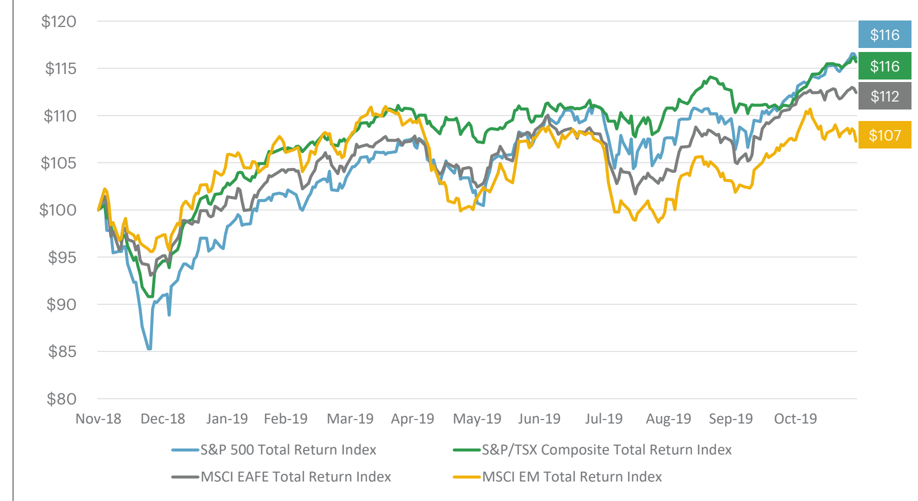
Unyielding to the curve

If market concerns were a popularity contest, the yield curve would have been second only to trade wars in 2019. Flat to inverted yield curves have been prevalent around the world, and typically follow a central bank tightening cycle or precede a recession or slowdown. A yield curve inversion is often considered a warning signal for financial markets, however, significant time can elapse before a possible economic downturn or major market decline occurs.

Longest Economic Expansions in U.S. History



Index Returns Over The Past 12 Months
The Growth of $100



Source: Bloomberg Finance L.P. As of November 30, 2019

Fueling recession concerns is the fact that we are in the longest economic expansion on record, but expansionary cycles do not end abruptly without reason. While moderating growth and geopolitical concerns continue to weigh, the North American economy and corporate health remain strong and central bank policies appear to be delivering the intended outcomes.

Since the global financial crisis and subsequent recession, the economy has witnessed a prolonged yet steady recovery at the lowest growth rates on record. Combined with low inflation, this moderate growth rate has provided central banks latitude to deploy stimulative measures for longer periods to help maintain a steady economic course, with relatively fewer interest rate hikes in between. This central bank balancing act has helped extend the current cycle and may propel equity markets even higher in 2020.

Our view for 2020?

Looking ahead, we continue to be cognizant of a convergence of macroeconomic factors that may influence the performance of financial markets. While some factors are supportive of continued economic growth, any optimism should be tempered with potential risks clouding the horizon, namely geopolitical developments, trade protectionism, and potential for central bank missteps. However, the recent cooperation between the U.S. and China on trade, the UK's retreat from the brink of a no-deal Brexit, and global central banks commitment to accommodation—are all positive developments for markets.

The spread of expected returns between equities and fixed income reinforces our preference for equities. Yields declined throughout 2019, driven by a wave of easing and dovish central bank policies across the globe. Policy makers have become increasingly data dependent and stated an almost unified commitment to using accommodation to sustain the economic expansion. We expect bond yields to remain in a range near current low levels, as global growth expectations continue to be subdued and markets price in rate cuts for the coming years.

The U.S. economy remains the world's largest, and while it may show signs of slowing, labour markets are still quite strong, with healthy consumer spending. We do not anticipate a near-term recession and are seeing signs of a resumption in growth. We expect corporate earnings growth to remain broadly positive but at more moderate levels compared to 2019. Companies are generating positive free cash flows and are expected to continue to boost dividends and repurchase shares. Market valuations for higher-risk assets appear to be reasonably valued, despite being at the higher end of the valuation range from a historical perspective. The persistence of low interest rates may also bode well for U.S. stocks in 2020, despite their elevated levels.

Although Canadian economic growth is expected to lag the U.S., we believe opportunities exist for Canadian equities. The labour market, despite a recent negative print on payrolls, continues to look reasonable with wage growth over 4% and quality Canadian companies continue to generate increasing free cash flows and improved fundamentals. Canadian financial stocks may also offer good value, as fundamentals remain relatively positive and dividend yields attractive.

We maintain a modest underweight stance on international equities as the eurozone continues to grapple with sluggish growth. Global trade tensions have weighed on the region, particularly in Germany, due to its large reliance on international trade compared to its international counterparts. Eurozone economies are fragile as Manufacturing Purchasing Manager's Indices (PMI) remain in contractionary territory across the region. The European Central Bank has shown a commitment to accommodative monetary policy and keeping bond yields contained through its stimulus measures, however our outlook remains cautious for the eurozone.

We maintain an optimistic outlook for emerging market equities. A combination of continued easing and fiscal stimulus by global central banks, and a temporary truce or possible phase 1 trade deal between the U.S. and China, reinforce our view. Forward Price-to-Earnings ratios for emerging markets stocks are considerably lower than many developed Markets. These lower equity valuations, coupled with China's commitment to fiscal stimulus, suggest that we may see stronger market performance over the long term.

Within alternatives, we maintain a modest overweight to Canadian real estate, commercial mortgages and global infrastructure. Sound fundamentals across Canadian property types has allowed for year over year net operating income growth, particularly in assets located in transit-linked nodes in major urban areas. Our strategy for commercial mortgages heading into 2020 is focused on combining value-add opportunities within floating prime rate loans with stable high-quality term loans. We believe this pairing can provide higher risk-adjusted returns, facilitate less duration risk and more nimble capital deployment. For global infrastructure, despite solid gains across all asset classes this year, the last twelve months have seen increasing volatility given global macro-economic headwinds, highlighting the benefits of private infrastructure exposure in portfolios.