

# Investment Outlook

An exclusive quarterly report from TD Waterhouse® Private Investment Counsel Inc.<sup>1</sup>

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## What are credit markets telling us?

BY ROBERT J. GORMAN, CFA, CHIEF PORTFOLIO STRATEGIST, TD WATERHOUSE

**W**ith a tumultuous first half of 2009 under our belts, it is time to evaluate what has happened year-to-date and what likely lies ahead. In our January 2009 forecast, we cited improving credit conditions as a positive factor entering the New Year. This has proven very important and is well worth understanding.

Here are four clear signals being sent by the credit markets:

**1. THE LIBOR RATE.** First, consider LIBOR, the London Interbank Offered Rate, an interest rate between large institutions which can be thought of as a gauge of fear in credit markets — the higher the rate, the greater the fear of not being repaid. From its peak of about 4.8% in late 2008, the three-month LIBOR rate has fallen to 0.6% as of early June — one measure of diminishing fear in the system.

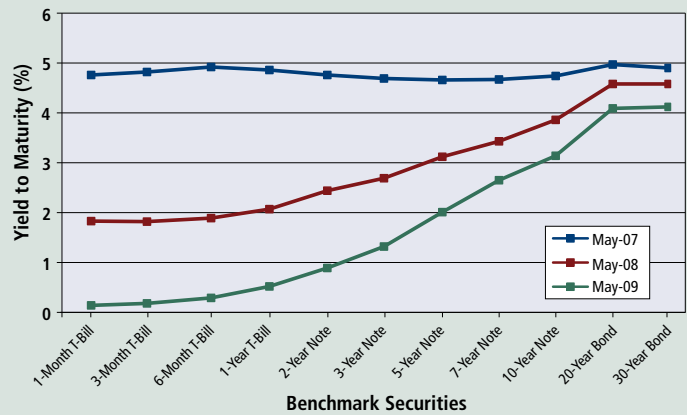
**2. THE TED SPREAD.** Next, examine what's termed the TED Spread. The "T" in TED stands for Treasury Bill — the yield of which is generally regarded as the risk-free rate of return. The "ED" in TED refers to Eurodollar, a reference to short-term corporate investments with some credit risk. The difference, or TED Spread, between the risk-free T-Bill rate and the Eurodollar rate is another measure of fear — that the investor in

the Eurodollar instrument will not be repaid. After rising to over 4.6% last fall, the TED Spread has retreated to 0.5%, signaling a reduction of fear in the credit markets.

**3. THE YIELD CURVE.** Third is the yield curve, the line or curve depicting the relationship between short- and long-term interest rates. Generally, short-term rates are lower than long-term rates (see chart, "A positive economic indicator," above), a state called a normal or positive yield curve.

### A positive economic indicator

The steepening yield curve should lead to wider profit margins for the U.S. banking sector.



Source: The U.S. Federal Reserve

# Mid-year portfolio report

BY ROBERT J. GORMAN, CFA, CHIEF PORTFOLIO STRATEGIST, TD WATERHOUSE

Our January forecast outlined six dominant investment themes for 2009. Let's examine what has transpired so far this year, why, and what lies ahead.

**THEME ONE** was that the U.S. stock market would begin to recover and potentially generate high single- or low double-digit returns in 2009. In support of our case, we cited low stock valuations in terms of the Price/Earnings ratio and more attractive valuations relative to bonds. Monetary and fiscal policies were also deemed to be very supportive, as short-term interest rates were extremely low and the U.S. federal government was injecting large sums into the economy.

Meanwhile, cash on the sidelines in the form of money market funds was an exceptionally high US\$3.6 trillion, serving as a source of latent buying power if investors chose to move into stocks. Finally, purchases of stock by corporate management were very high, another positive portent.

After a difficult start to 2009, which saw the S&P 500 Index fall as much as 25% from January 1 to the equity market's March 9 low, U.S. stocks have rebounded sharply and are now in positive territory.

**THEME TWO** was that while smaller companies' shares might be the stron-

gest performers coming out of the recession, shares of larger, high-calibre companies would post high risk-adjusted returns. So far this year, this has been the case. Small-cap stocks have led the pack, but higher-quality companies have participated in the rally, albeit with less risk.

**THEME THREE** was that the Canadian equity market, like its U.S. counterpart, would enter the first leg of its recovery with high single- or low double-digit returns. We identified short-term weakness in commodities as a hurdle for the S&P/TSX, something we did in fact encounter in the first two months of the year. After declining 16% from December 31 through March 6, the S&P/TSX Composite Index has recouped that loss and is slightly ahead of forecast.

**THEME FOUR** stated that last year's flight to quality in the bond market, which had seen government issues generally outperform corporate bonds, would reverse with corporate bonds outdistancing government issues in 2009. In anticipation of these events, we increased clients' corporate bond weight where mandates permitted (see "The view from our Chief Portfolio Strategist" on Page 3), which has proven highly beneficial as bond markets have generally acted as anticipated.

## Asset allocation

While portfolios will differ due to each client's unique needs, we generally entered 2009 with a roughly even split between stocks and bonds. Where client mandates permitted, we rebalanced client portfolios in the mid-January to mid-March period, which took advantage of low prices.

In the succeeding months, we have not rebalanced client accounts, so portfolios benefited from the stock markets' recent rally. Going forward, we shall rebalance client accounts to a higher equity weight of 58%, which could enhance returns in the coming year.

**THEME FIVE** was that European and Japanese stock markets would also advance in 2009, based partly on low valuations and, in the case of Europe, a decline in short-term interest rates. So far, both regions have advanced as expected in the year-to-date. Whether they underperform U.S. stocks for the year is too early to determine.

**THEME SIX** was near-term caution in emerging markets and, ultimately, a strong recovery. Our concern in the short term was a sharp slowdown in growth within those countries, which did prove problematic in the initial months of 2009. Our worries dissipated several months ago and we have added some direct exposure to China in international mandates, and more cyclical indirect exposure as well. Emerging markets, while volatile, could do well for the year as a whole. ■

## Current Private Investment Counsel strategy

### Portfolio weighting

- Modest overweight in equities
- Slight underweight in bonds, with a somewhat shorter term than benchmarks
- Overweight corporate bonds, where mandates permit
- Overweight European industrial stocks and underweight financials within international equities

### Percentage return for indices

(For the period March 15, 2009 – June 15, 2009)

DEX Universe Bond Index	1.2%
S&P/TSX Composite Index	26.3%
S&P 500 Index	9.4%
MSCI EAFE Index*	21.1%

\* Morgan Stanley Capital International Europe, Australasia and Far East Index

## Transferring recreational property to your heirs

In many families, recreational properties are used by several generations. However, difficulties may arise when the actual ownership of the property passes from one generation to the next. The transfer may be subject to capital gains tax if the property passes to a child or grandchild. Your heirs could be forced to sell the property just to pay the taxes.

If you will be in a position to transfer property to the next generation, it's important to start planning today. Here are some things to consider.



It's important to plan ahead if you anticipate transferring ownership of recreational property.

**OPEN THE DISCUSSION.** Speak to your children about whether they want to keep the property and share in its upkeep. Involve them in discussions about sharing it and potential upgrades that may be needed. This is a very important step, as the lifestyles and financial resources of your children may differ.

**EXPANDED ESTATE PLANNING.** If one child is not interested in the property, you may want to think about equalizing that child's share of your overall estate with other assets.

**HOLD THE PROPERTY IN TRUST.**

One way to possibly save on tax and retain control of the property is to create a testamentary trust in your Will, to hold the property in trust for your children. Be sure to advise your children of your decision.

**CHOOSE YOUR TRUSTEE**

**CAREFULLY.** Given the complex nature of a trust, think carefully about the selection of an experienced trustee to administer the trust.

### Beneficiary designations now permitted in TFSA plan

Did you know that you can now designate a beneficiary and a successor holder in the Tax-Free Savings Account (TFSA) plan documentation itself in a number of provinces? The eligible provinces include British Columbia, Alberta, Saskatchewan, New Brunswick, Ontario, Nova Scotia, Prince Edward Island and Northwest Territories.

The ability to make these designations in the TFSA plan itself may provide certain estate-planning advantages. Speak to your Private Investment Counsel Portfolio Manager for more information.

Your Private Investment Counsel Portfolio Manager can put you in touch with a Private Trust<sup>2</sup> Specialist, who can assist you with keeping the recreational property in the family and other estate planning needs you may have. ■

## The view from our Chief Portfolio Strategist

*Financial markets have performed much better through the first four months of 2009 after a challenging year. However, volatility remains high and our clients have many questions about their portfolios. Robert J. Gorman, CFA, Chief Portfolio Strategist, TD Waterhouse, answers one of the more common questions below.*

**Q** Last year, you sold some government bonds from my portfolio and bought more of the TD Private Canadian Corporate Bond Fund. Why did you make this move when government bonds were one of the best-performing investments last year?

**A** You are correct in pointing out that government bonds were one of the few bright spots for investors in 2008. Due to the extreme pressure on credit and financial markets in the final third of

2008, investors were naturally very fearful and poured money into the perceived safe haven of government bonds.

This had the effect of pushing bond prices up and pushing bond yields down. Generally, these higher bond prices boosted returns for investors, while government bond yields were driven down to very low levels, with the 10-year Government of Canada (GOC) bond yielding a paltry 2.5% or so by late last year.

With GOC prices high and yields low, we elected, where mandates permitted, to sell a portion of government bonds and to buy high-quality corporate bonds issued by Canada's most creditworthy companies. The principal advantage of these investment-grade corporate bonds is their potentially higher stream of income, which is currently in the 5% range, versus about 2% to 3% for most GOC issues.

In addition, the corporate bonds we buy have, on average, a relatively short term to maturity which — coupled with their above-average stream of income — makes them less susceptible to the adverse effects of any increase in interest rates.

Very importantly, we buy only top-quality, investment-grade corporate bonds in the TD Private Canadian Corporate Bond Fund to seek to protect your capital. We generally use certain of the TD Private Funds for gaining exposure to corporate bonds as they allow us to both diversify holdings and reduce trading costs, boosting potential yields for our clients. So far, this switch into corporate bonds has been beneficial as clients have been earning a higher stream of income and these bonds have been generating higher returns overall than the government bonds that were sold.

## What are credit markets telling us?

Continued from Page 1

The shape of the yield curve is very important for the U.S. banking system in particular as American banks tend to borrow “short,” taking in short-term deposits (such as savings accounts), and lend “long” (in the form of 30-year mortgages, for instance). The difference between the short- and long-term rates is the banks’ “spread” or profit margin. After having been relatively flat in 2007, the yield curve has steepened over the past two years, meaning wider profit margins for the beleaguered banking sector and, typically, an improving economy.

#### 4. INVESTMENT-GRADE BONDS.

The fourth signal is investment-grade corporate bonds — those issued by

North America’s most creditworthy corporations. In 2008, the dominant theme in the bond market was a flight to quality, with investors flocking to government issues and generally avoiding corporate bonds, fearful the issuers might default on their interest payments.

In January, we stated this would change, with a reversal of the flight to quality and greater interest in higher-yielding corporate bonds. So far, this has taken place (see “The view from our Chief Portfolio Strategist” on Page 3). Indeed, new U.S. corporate bond issuance topped US\$824 billion in the first quarter of 2009 — more than double the count in the same period a year ago. Meanwhile, the incremental yield on

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### Leverage risk disclosure

Using borrowed money to finance the purchase of securities involves greater risk than a purchase using cash resources only. If you borrow money to purchase securities, your responsibility to repay the loan and pay interest as required by its terms remains the same, even if the value of the securities purchased declines.

corporate bonds versus Treasury issues is shrinking, yet another display of improving confidence among investors.

While tight credit, foreclosures, credit card default rates and other woes continue to weigh on credit markets, the trends cited above are positive and are key reasons for financial markets’ improvement in recent months. ■

## Making a difference together

During this period of economic uncertainty, Canadians are rightfully asking if our leading corporate citizens have been doing their part to improve Canada’s social, economic and environmental conditions.

To address this question, The Toronto-Dominion Bank has recently published its 2008 Corporate Responsibility Report, now available online for your review at [www.td.com/corporateresponsibility/crr2008](http://www.td.com/corporateresponsibility/crr2008)

#### ► COMMUNITY BUILDING.

This report provides an update on specific social issues, such as TD community

investments in health care and children’s literacy, along with the bank’s ranking among Canada’s best employers overall and as an employer recognized for supporting diversity.

#### ► CORPORATE STRENGTHS.

The report also provides key business details, such as the growth of the TD workforce to more than 70,000 worldwide and the bank’s industry-leading construction of 30 new branches in Canada in 2008.

#### ► ENVIRONMENTAL EFFORTS.

On the environmental front, learn how TD plans to be Canada’s first major

carbon-neutral bank in 2010, how our 2,600 ABMs are now powered by renewable energy and how 63,000 Canadians collected 135 tonnes of refuse from our lakes and rivers as part of last year’s TD Great Canadian Shoreline Cleanup.

Visit the new, engaging TD Friends of the Environment Foundation® (TD FEF) website at [www.tdfef.com](http://www.tdfef.com); you’ll find details on how you can get involved in one of the 90-plus TD FEF Chapters that have directed \$49 million into more than 18,000 grassroots projects since 1990.

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