Economic and Capital Market Review

Year-to-date as at November 30, 2017

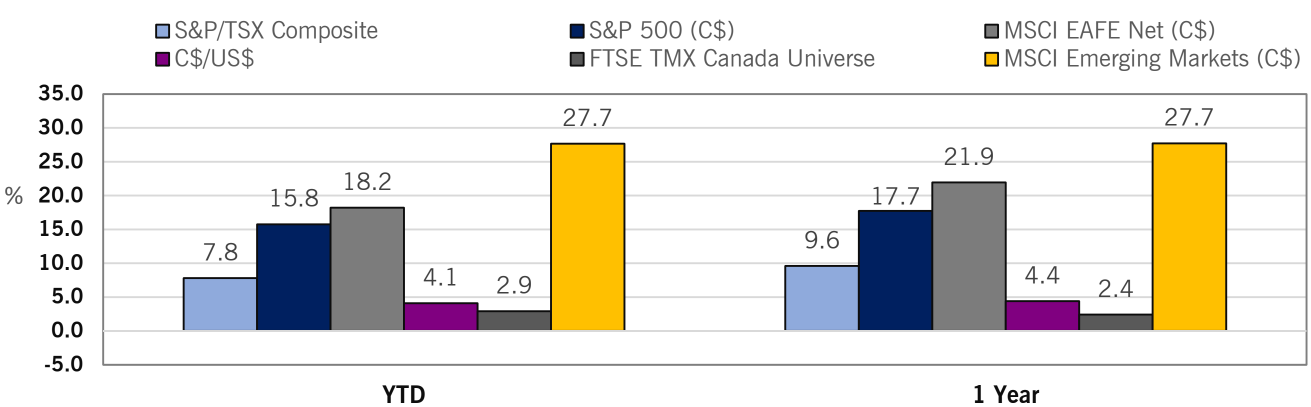
Global equity markets have posted strong returns on a year-to-date basis. Strong momentum in technology stocks and banks contributed to above average gains in the U.S. while the Canadian market lagged with the relative weakness in energy stocks. Financial conditions remain easy despite interest rate increases by both the U.S. Federal Reserve (three hikes of 25 bps to 1.25%) and the Bank of Canada (two hikes of 25 bps to 1%). Stock market strength and an improvement in corporate credit spreads more than offset the tightening in monetary policy. International markets also recorded strong returns. The extreme policy accommodation provided by the European Central Bank and Bank of Japan has helped to maintain the positive tone. Emerging markets also benefitted from the strong performance of the technology sector which now represents 25% of the benchmark. Bond market returns were weak for most of the year although they improved towards the end of the period as muted inflation kept long rates down while central bank tightening impacted mainly the short term interest rates.

In September, the Bank of Canada stayed true to its word, raising once again the overnight interest rate to 1%. Essentially it took back the 0.5% of rate cuts from 2015 that were in response to the extreme weakness in the energy sector. The U.S. Federal Reserve held the overnight interest rate steady in the third quarter but announced that the process for the “normalization” of its $4.5 trillion balance sheet will begin in October. We do not believe the impact on financial markets will be significant as the process involves keeping bonds held until maturity rather than a more disruptive sale of bonds into the open market. This should limit the impact on interest rates and therefore the stock market as well. Reducing its holdings of mortgage-backed securities may have an impact on mortgage rates and consequently the economy, although again, we don’t expect the impact to be significant.

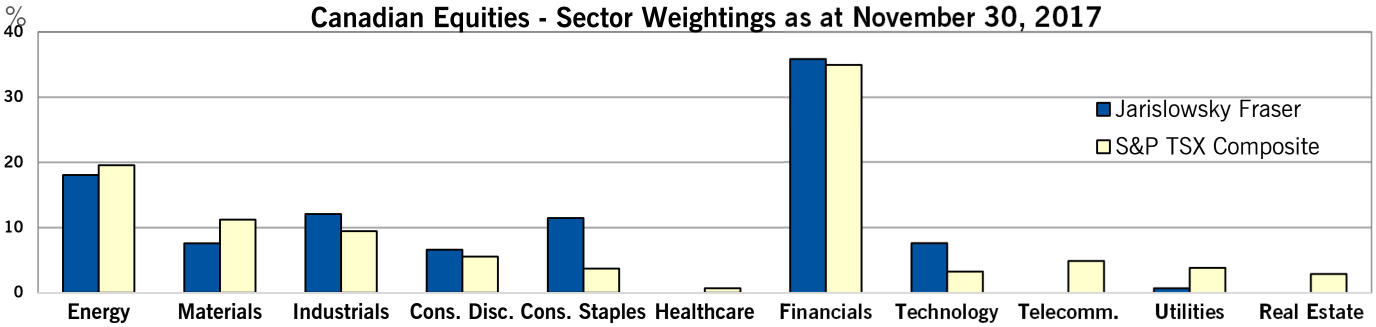
Economic growth continues to support financial markets with the synchronized global expansion very much intact. What is notable about the expansion is that while growth has been recovering for over eight years, inflation pressures have remain muted. The sluggish pace of growth, around 2% in developed economies, is in large part the reason for this, and given the structural demographic and debt headwinds, we doubt that these modest growth rates will strengthen any time soon. This is the best of all possible environments for financial markets, particularly with the added fuel of exceptionally low interest rates (although that stimulus has peaked for now).

Global markets continued to trend upwards during November, despite more talk of expensive valuations and new market highs. The U.S. senate passed President Trump’s $1.5 trillion package of tax reforms during the month, allowing investors to look past one of the few potential “bumps in the road” and giving the President his first major policy win. In addition, tensions in Saudi Arabia and production cuts of 300,000 barrels per day led to price increases of both oil and natural gas. West Texas Intermediate ended November at US$57.40, up 5.6% for the month.

Market Performance (Periods Ending November 30, 2017)



Canadian Equity - Portfolio Review



The Canadian equity portfolio lagged the S&P/TSX Composite on a year-to-date basis, generating a return of 5.8% against 7.8% for the index. The underperformance can be explained by three main causes. The first, which is not recoverable, is the broad-based decline in the Energy sector as a result of the lower price of oil and more specifically Cenovus Energy Inc. (a cost of 90bps in terms of relative performance), which we sold following the buyout of their 50% partner Conoco Phillips in their key asset, FCCL. We became uncomfortable with what we considered being an overpriced acquisition and a balance sheet that was now at risk and depended on asset sales. The second cause involves what we consider high-quality stocks that we have owned for many years and have performed very strongly in the past, especially in 2016, but underperformed the index in 2017 for no particular reason. This includes stocks such as Open Text Corporation, Potash Corp., Enbridge, SNC-Lavalin Group, CGI Group and Saputo; we used this opportunity to add to a few of them. Finally, the third impact is the rate sensitive sectors that benefited from the fact that long-term rates did not move up the way the market had expected at the beginning of the year. As a result telecoms, REITs and utilities continued their move upwards, which cost the portfolio over 60bps. We are not able to find any companies in those sectors that fit our valuation metrics and think that this performance will reverse.

Market Outlook and Portfolio Strategy

Global economic momentum remains robust with broad-based strength, although we would single out the eurozone as a notable standout in terms of a positive change in momentum along with being the largest economy in the world. Economic strength with subdued inflation has allowed risk markets, particularly stocks and corporate bonds, to set aside geopolitical concerns such as the threat of a war between the United States and North Korea. For Canada, the shorter-term economic outlook is much less certain despite two quarters of robust growth. In particular, business investment faces two potential uncertainties that are dependent on U.S. policy. The first is from the NAFTA renegotiations that could reduce Canadian companies' trade advantage with the U.S. The second is the recently passed tax reform in the U.S. that could dramatically narrow the current tax advantage of Canadian corporations, creating further uncertainty for future corporate spending plans. Add in the largest quarterly gain in the Canadian dollar against the U.S. dollar since 2004 and the continuation of the strong pace of business investment becomes challenging. The Bank of Canada is cognizant of the risks that record high household debt levels pose for consumer spending, so we expect it to be very cautious in raising interest rates from this point. Globally, interest rates should remain near long-term lows as we believe inflation rates will stay muted. Ultimately, a significant expansion in federal fiscal spending may be what can fuel the inflation fire.

The economic backdrop always has uncertainties surrounding it but well-managed companies can and will succeed in most types of environments. Canada has a number of global success stories that have withstood competition from abroad and have been successful competitors beyond our borders. We rely on our deep in-house research to identify these "Canadian champions" based on key criteria such as industry fundamentals, quality management, company financials and valuations. We also continue to look for opportunities connected to higher growth regions. Financial markets have experienced a lengthy period with muted volatility so it would be natural to expect volatility to increase, particularly as accommodation from central banks is peaking. The global economic trend is still positive, which will continue to support markets as they are buffeted by the inevitable shocks.