INVESTMENT OUTLOOK
Q1 2015

EXECUTIVE SUMMARY

Economic Review

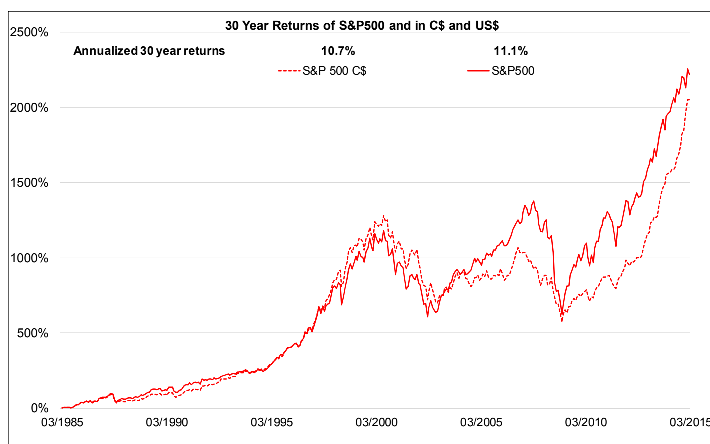
- *Facing negative pressures from the economy, specifically related to the drop in oil prices, the Bank of Canada cut the overnight rate by 0.25%.*
- *The Canadian dollar depreciated as the Bank of Canada, among more than 20 other central banks, provided additional stimulus to economies.*
- *The U.S. Federal Reserve (Fed) in contrast moved one step closer to raising interest rates. Such divergence contributed to extreme currency volatility during the quarter.*

Investment Outlook

- *More global economic instability may be experienced due to diverging global currency policies.*
- *Sluggish long-term growth and low inflation rates continue.*
- *Our stance remains unchanged: Overweight equities in balanced portfolios and overweight corporate bonds in fixed income portfolios.*

ECONOMIC OUTLOOK

Fluctuations in currency markets were the most significant contributor to investment returns for Canadian investors during the first quarter. The 8.6% depreciation of the Canadian dollar versus the U.S. dollar turned an average 4.9% international equity market return into an extraordinary 14.7% return for the quarter. As the chart below shows, this is not something an investor can count on repeatedly as the impact from the fluctuations tends to normalize or cancel out over time. The decline in the Canadian dollar was part of a broader trend of U.S. dollar appreciation, as the Bank of Canada, as well as more than 20 other central banks, provided additional stimulus to economies. Global excess capacity relative to demand is still the order of the day.



The long-term themes have not changed, central banks continue to implement less and less productive policies in their unilateral attempt to revive economic growth to previous, and ultimately, unsustainable levels. These growth levels were unsustainable because they were fueled by excessive debt growth which almost bankrupted the world financial system. As a result of monetary policy doing the heavy lifting, nominal interest rates through to 10-year maturities are now negative in some European countries. In addition, we have witnessed exceptional growth in money supply and currency market volatility. With every country operating in its own self-interest by intentionally or inadvertently depreciating its own currency, more global economic instability is likely.

The Bank of Canada lowered the overnight rate by 0.25% to 0.75% in January. They pointed to a number of negative impacts including declining capital expenditures from the energy sector and a record high household debt/income ratio that will only get worse if incomes decline. The manufacturing sector has also shrunk by 3.5% (to 10.5%) over the last ten years and the economy lacks the fiscal policy spending to offset these negative impacts. By itself the move was not that significant, but when combined with the subsequent currency weakness it may be enough to help stabilize the economy. In contrast, the Fed inched forward on its journey to raise interest rates, effectively removing the extraordinary level of accommodation that it has provided over the past seven years. With the exception of the United Kingdom, the U.S. policy direction is diverging from that of most other countries. This divergence contributed to the extreme currency moves during the quarter with the euro, in particular, declining by 11.3% against the US dollar.

BOND MARKETS

The FTSE TMX Canada Universe Index posted a robust 4.2% return for the quarter. There was a dramatic decline in yields, over 50bps, during January as the European Central Bank unleashed its own version of Quantitative Easing. In its attempt to achieve a 2% inflation target over the medium term, it plans to buy over €1trillion of eurobonds through to the third quarter of 2016. These actions prompted a wave of central bank interest rate cuts as each affected country's currency rate jumped higher against the euro. The Canadian bond market outperformed the U.S. as the Bank of Canada lowered the overnight interest rate, while the Fed laid the groundwork for an increase in interest rates later this year. It is important to note that when the Fed does move to raise interest rates, the magnitude of the increase is unlikely to be anywhere near the 400bps of previous cycles. In addition, with the global economic outlook still modest, and other central banks keeping interest rates exceptionally low, moving short-term interest rates higher may not translate into a proportional rise in long-term rates. Within the Canadian bond market, provincial bonds outperformed both federal government and corporate bonds. Some of the performance is recognition of the potential for improvement in the

economic prospects of the two largest provincial borrowers (Ontario and Quebec) due to the weakened Canadian dollar and relatively attractive valuations. Superior long-term prospects in a persistently low interest rate environment are more apparent with corporate bonds.

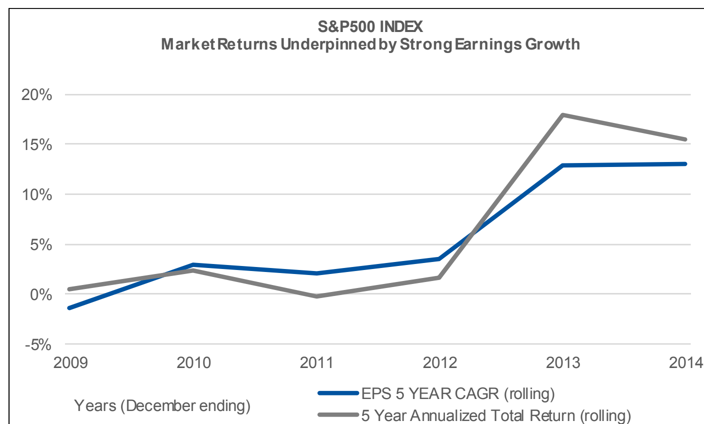
EQUITY MARKETS

Market Returns - Periods ending March 31, 2015

(%)	3M	1 Yr	5 Yrs	10 Yrs	15 Yrs
S&P/TSX	2.6	6.9	7.4	7.4	5.6
S&P 500 (C$)	10.4	29.4	19.7	8.5	3.2
S&P 500 (US$)	1.0	12.7	14.5	8.0	4.1
Russell 2000 (US$)	4.3	8.2	14.6	8.8	7.2
DJIA (C$)	9.1	23.9	15.4	5.9	2.4
DJIA (US$)	-0.3	8.0	10.4	5.4	3.3
MSCI EAFE Net (C$)	14.7	13.7	11.0	5.4	1.9
MSCI EAFE Net (US$)	4.9	-0.9	6.2	4.9	2.9
Nikkei 225 (US$) Japan	10.2	12.9	8.1	5.6	0.0
Shanghai (US$) China	16.0	90.8	8.5	17.9	8.9
BSE Sensex (US$) India	3.4	21.9	4.5	13.3	11.3
EAFE Emerging Mkts (US$)	2.3	0.8	2.1	8.8	7.4
FTSE TMX Canada Universe	4.2	10.3	6.0	5.6	6.3
FTSE TMX Canada 91 Day T-Bills	0.2	0.9	0.9	1.9	2.4
C$/US$	-8.6	-12.9	-4.3	-0.5	0.9

Converted to Canadian funds using London 4PM rates.
Returns are annualized for periods greater than 1 year.

Equity markets produced reasonable quarterly returns in local currency terms; however, non-Canadian equities delivered exceptional returns when translated back into Canadian dollars. Much of the weakness in the Canadian dollar is attributable to the strength of the U.S. dollar. We view this strength as cyclical rather than the start of a secular trend. The outperformance of the U.S. economy typically ebbs and flows, as does the divergence in monetary policy globally. Despite the shale oil export boom and a 40% decline in the trade-weighted dollar from the previous highs, the U.S. still has a substantial current account deficit which pushes its dollars out to the international markets. This contrasts with the euro zone, which has a current account surplus and a stronger balance sheet, and thus argues that investors positioned for a stronger U.S. dollar and weaker euro may be starting to overstay their welcome. The outperformance in the Canadian equity market was concentrated in Valeant, a pharmaceutical company with an aggressive growth by acquisition strategy. The banks underperformed the market as the decline in interest rates lowered their net interest margin while concerns of mortgage related weakness from the energy cycle downturn also contributed to investor caution. Frequent calls for a plunge in stock markets based on valuation concerns are not supported by the performance of earnings growth, as the following chart shows. Mergers and acquisitions activity has heated up but is not at historical extremes, signaling more of a healthy market as opposed to a late in the cycle type of environment.



INVESTMENT STRATEGY

The exceptionally low level of interest rates globally— even negative rates in some countries— have most investors shaking their heads. This situation will obviously not last but there is a substantial probability that low rates could still be present for a number of years. Most central banks seem committed to keeping interest rates low even if inflation starts creeping higher. Even the Fed, which is the closest to raising rates, is unlikely to mimic previous tightening cycles. In addition, given the sluggish trend growth, low global inflation and the USD strength, interest rate increases could be as little as half of that seen in previous cycles, i.e. a 2% terminal rate as opposed to 4%. To adjust our outlook to a heightened inflation risk environment we would likely need to see the end of fiscal austerity, debt write-offs, the acceptance of the need for structural reforms and a move to consumer-oriented growth among emerging economies such that they draw resources from the world rather than supply them.

The long-term outlook for sluggish growth and low inflation rates persists. Interest rates can remain low in this environment; consequently, we see no reason to change our equity overweight in balanced portfolios, and continue to overweight corporate bonds in fixed income portfolios. Our cyclical outlook continues to support this stance as well. It has been a lengthy economic recovery, which can persist as long as excesses do not build. Risks abound that increase this likelihood: the currency wars; the political mishandling of the situation in Greece; dealing with the implications of a weakened Russian economy; the extraordinary accumulation of debt in China (which we think is manageable); emerging economy funding pressures as the US dollar rises; and finally, whether even small increases in U.S. interest rates would upset asset markets (public and private). With so many risks it is difficult to see how excesses in financial assets can build to extreme levels as we “climb the wall of worry”.

Sources: TD Securities, S&P, BIS and Bloomberg. The yen and euro currency conversion are based on Bank of Canada noon rates.

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