INVESTMENT OUTLOOK Q3 2016

EXECUTIVE SUMMARY

Economic Review

- *Equity markets continued to edge higher in the third quarter of 2016 as central bank stimulus continues.*
- *The continued central bank support was key to the improvement in market sentiment in the face of persistent economic weakness.*
- *We continue to monitor the decreasing appetite for global trade in the long term, largely in developed economies where the middle and lower class face wage pressures from emerging economies.*

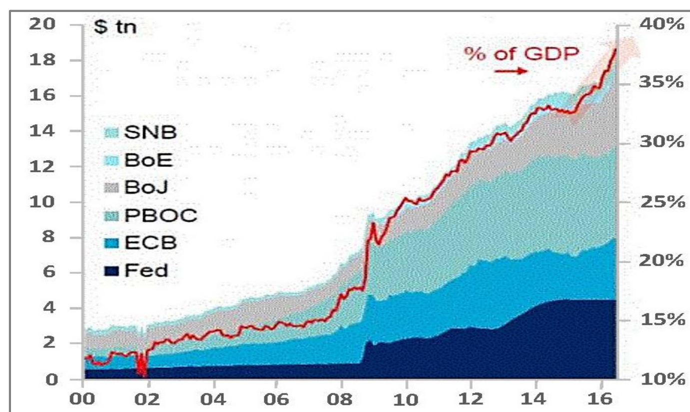
Investment Outlook

- *We believe the global economic growth trend will continue on its modest path of the last few years.*
- *We do not view the various predictions calling for another financial crisis as an immediate threat, if only because a precursor to such an event is often market deregulation.*
- *The risks of inflation and deflation are currently viewed as being more balanced.*
- *Market valuations, particularly in the U.S, are viewed above average, but not at excessive levels.*

ECONOMIC OUTLOOK

Equity markets continued their march higher during the third quarter, while bond markets put in a more mixed performance. The economic backdrop disappointed yet again as the improvement that the global economy had shown from the February lows faded in the latter part of the quarter. The song remains the same though; financial markets in the post-crisis world continue to be aided by extreme central bank policy. When the economic momentum wanes and market volatility rises, the central banks come out with more support. The below chart shows that central bank involvement in the global economy has tripled in the past ten years.

Aggregate balance sheet of large central banks, $Tn & % of GDP



Central banks have bought not only government bonds but also corporate bonds and equities (the Swiss National Bank owns over US$61 Billion in U.S. equities alone). The latest actions by the Bank of Japan include setting a 0% yield target for 10-year Japanese government bonds. They also broke new ground by implementing a policy allowing inflation to move above target for whatever length of time necessary to make up for the previous years when it was below target (over 23 years for those who are counting). Bond yields were rising ahead of the announcement but have reversed since, not only in Japan but globally. The U.S. Federal Reserve did their part with another delay in their drawn-out process to raise interest rates from historical lows.

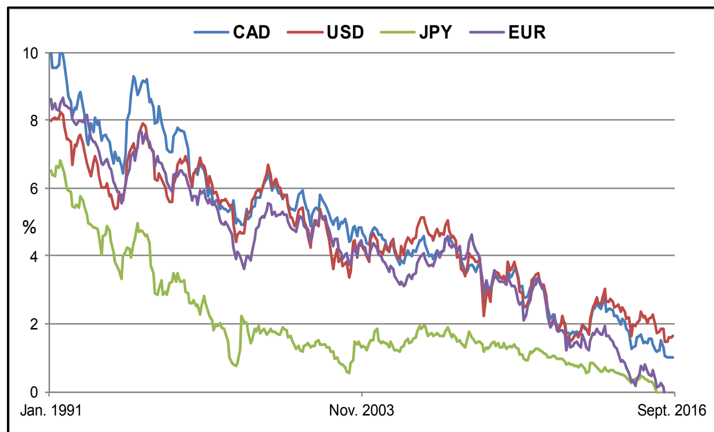
Some of this central bank balance sheet expansion might be construed as necessary and justified, and we would agree—up to a point. Ensuring the "oil" in the economic machine flows is important, but at some point one has to wonder if flooding the engine does more harm than good. We do not know what the long term impact will be, nor do the central bankers for that matter. But we do think that they will need to exercise some caution now that asset prices have reached high levels relative to the income producing potential of the underlying economies. It is clear that asset prices are much more important to the business cycle and we cannot help but wonder if central bank actions are pushing the envelope too far in their quest to boost inflation through economic growth. Ultimately, the most effective way for policymakers to stimulate economic growth is through fiscal policy measures. We have addressed these in previous Investment Outlooks but would note that the political attitude towards deficit spending seems to be changing at the margin. A few more votes like "Brexit" or extremists being elected may be enough to force the current political establishment to change their strategies. The Federal Reserve continues to lower their long-term growth rate, the latest being 1.8%. In addition, the World Trade Organization (WTO) estimated that global growth in trade will decline from 2.8% to 1.7%. If the WTO is correct, it will be the first time in 15 years that trade growth has been below overall economic growth. Declining growth expectations may also help shift the political momentum.

BOND MARKETS

Bond market returns were mixed in the quarter. The Canadian bond market posted a 1.2% return, with corporate bonds outperforming government bonds. The weakness that corporate bonds experienced during the first quarter, on the back of weaker oil prices, now seems a distant memory with the energy and pipeline sectors rallying the strongest. The 10-year government bond yield declined 6bps, while the equivalent U.S. Treasury bond yield rose by 12bps, with softening Canadian economic momentum contributing to the divergence in yield changes. Much like in the equity markets, emerging markets were the strongest performers in this risk-on environment. We have recently written about inflation risks rising with the decline in energy prices

eventually filtering out of the yearly measures. Longer term we do take note of the decreasing appetite for global trade, particularly from developed economies where the middle and lower income earners have faced competitive wage pressures from the emerging economies. We see the risks of inflation and deflation as currently more balanced despite the minor increase in recession risk.

Rates on 10-Year Bonds



EQUITY MARKETS

Returns ranged from modest to strong in global equity markets with the U.S. market at the low end of the spectrum and emerging markets at the high end. This is typical of what we would expect in a “risk-on” environment. Much of the strength reflects a relief rally after the weakness seen at the beginning of the year. Continued central bank support was key to the improvement in market sentiment in the face of continued economic weakness and little in the way of earnings growth.

Market Returns (as at September 30, 2016)

(%)	3M	1 Yr	5 Yrs	10 Yrs	15 Yrs
S&P/TSX	5.5	14.2	8.1	5.3	8.0
S&P 500 (C$)	5.1	13.2	21.9	9.0	5.8
S&P 500 (US$)	3.9	15.4	16.4	7.2	7.2
Russell 2000 (US$)	8.7	13.7	14.2	5.6	7.8
DJIA (C$)	3.3	10.2	16.2	6.3	3.7
DJIA (US$)	2.1	12.4	10.9	4.6	5.0
MSCI EAFE Net (C$)	7.7	4.4	12.5	3.5	4.5
MSCI EAFE Net (US$)	6.4	6.5	7.4	1.8	5.8
Nikkei 225 (US$) Japan	8.2	13.7	6.7	3.6	6.2
Shanghai (US$) China	3.6	-4.2	9.5	9.5	7.1
BSE Sensex (US$) India	5.0	6.4	6.1	5.9	15.8
EAFE Emerging Mkts (US$)	8.3	14.1	0.5	1.5	8.9
FTSE TMX Canada Universe	1.2	6.3	4.4	5.2	5.8
FTSE TMX Canada 91 Day T-Bills	0.1	0.5	0.8	1.5	1.9
C$/US$	-1.2	2.0	-4.5	-1.6	1.2

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

The strongest sectors were Materials, IT, Consumer Discretionary and Financials. The more interest-rate sensitive sectors and energy stocks lagged the market. Companies with smaller market capitalizations generally outperformed ones with larger capitalizations. Market valuations, particularly in the United States, currently sit above long-term averages but are not at extreme levels. It is difficult, if not impossible, to time the moment when the turn in valuations occurs. But at this point we continue to believe that the risk/return outlook generally remains attractive for equities.

INVESTMENT STRATEGY

In the long run, pricing of stocks and bonds is based on the historical ability of the issuing entity to produce a steady cash flow, the quality and ethics of management and the industry dynamics. We spend the bulk of our time diligently examining these factors before we invest. Underlying all markets, however, is an element of confidence and trust in the institutions that regulate and intervene in those financial markets. We do not support the opinion of the various prognosticators who are calling for another financial crisis, if only because a typical precursor to such an event is market deregulation. Currently, the regulators are tightening the rules rather than relaxing them. What does concern us is the heavy intervention of central banks in the price-setting mechanism of financial markets and what the outcome will be if and when market participants lose faith in their central bankers. Strong fiscal policy support could be a large offset to such a potential situation, effectively boosting growth and inflation prospects. We are confident a portfolio of carefully selected securities from quality companies will be able to withstand such a potential environment.

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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