EXECUTIVE SUMMARY

Economic Review

- *Equity markets rebounded in response to corporate optimism following the U.S. election and the continued recovery in energy and material prices.*
- *Overall earnings growth has improved along with economic momentum.*
- *The U.S. Federal Reserve declared a broadly expected interest rate hike, increasing the overnight rate by 25 bps to 0.75%.*
- *In the long term, equity markets should become more discriminating as interest rates begin their long road back to normal levels.*

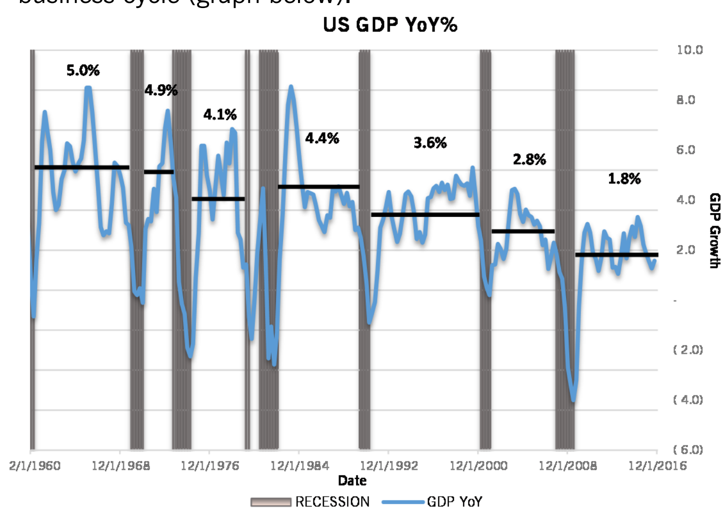
Investment Outlook

- *We believe the global economic growth trend will continue on its current modest path.*
- *Most developed economies, including China, will face weaker working age population growth as baby boomers move into retirement.*
- *Global productivity growth continues to decline, however we remain optimistic in the private sector's ability to innovate.*
- *Market valuations, particularly in the U.S., are viewed above average, but still not at extreme levels.*

ECONOMIC OUTLOOK

Volatility during the quarter centered on the election of Donald Trump as the U.S. President. With the benefit of hindsight the outcome should not have been too surprising given the context of growing disillusion with government leadership after over a decade of sluggish growth and stagnant incomes for the average person or, if you will, the "forgotten man" that President Roosevelt referred to in his speech during the 1930's depression. People in developed economies are frustrated with policies that seem to only favour the ruling class. Despite the execution risks, which are substantial, President-elect Trump's policies can be mainly characterized as pro-business. Markets are if anything "discounting mechanisms" and the difference in approach to economic policy between President Obama and President-elect Trump was quickly priced in by the U.S. stock market (S&P 500), gaining 4.1% ($C) after the election. This stronger growth, higher inflation theme, however, was detrimental to global bond markets. The Canadian bond market experienced less downside due to our weaker growth outlook. The U.S. Federal Reserve (the FED) announced a widely anticipated interest rate increase of 25 bps, bringing its overnight interest rate to 0.75%. The FED's action suggests that it believes labour markets are tight enough to produce wage pressures, meaning that further declines in the unemployment rate will likely be met with interest rate increases. The European Central Bank adjusted its asset buying program, extending it for three months longer than expected, but reducing the monthly purchases from €80B to €60B. Not to be overlooked was the Bank of Japan maintaining its 0% ten-year government bond target rate, an important anchor for global interest rates.

Economic momentum improved in the quarter, reflecting the stimulus from central banks earlier this year, particularly outside North America. Earnings growth has also improved, with most of the energy sector weakness behind us. The strong improvement in commodity prices suggests increasing confidence in the economic outlook. Financial conditions have become slightly more restrictive, given the increase in interest rates and the U.S. dollar, but overall they still remain supportive for growth. The extent of the potential policy changes in the U.S. including tax cuts, infrastructure spending, decreasing regulation and protectionist trade policies, makes the outlook more uncertain. It may be useful to consider whether these new policy initiatives can alter the declining "trend" in economic growth that typically occurs during expansion periods of the business cycle (graph below).



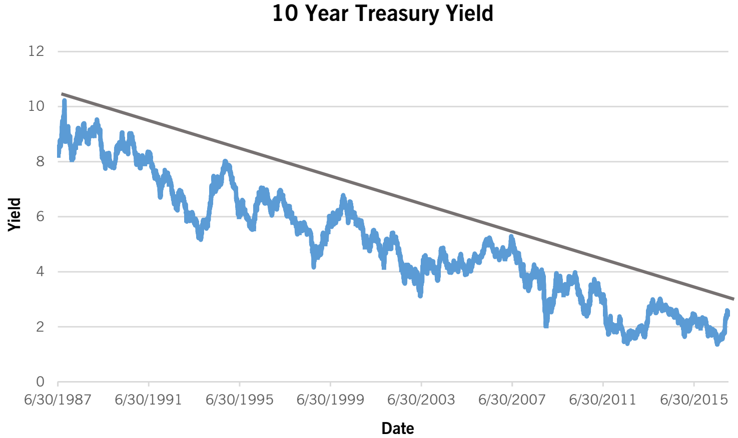
As mentioned in previous quarters, trend growth is comprised of population growth and productivity. As baby boomers move into their retirement years, the decline in the growth rate of the working age population (i.e.15-64 year old group) will depress the trend economic growth rate. The effect will be much stronger in Europe than in North America, but in general all developed economies as well as China are facing weaker working age population growth. Productivity growth has been declining as well although we would not discount the private sector's ability to innovate. During this period of declining economic trend growth, debt burdens have increased as private and public sectors tried to offset weaker income growth with increased borrowing. What we are left with is unfavourable demographic trends, potential for improvements in productivity and historically elevated levels of debt globally. We doubt that President-elect Trump can sustainably alter these dynamics and at worst, his protectionist leanings could contribute to growing trends to anti-globalization sentiment.

BOND MARKETS

The Canadian bond market posted a -3.4% return in the quarter as yields increased post-election (i.e. ten-year yields moved from 1.0% to 1.7%) bringing the calendar year's gain down to 1.7%. Corporate bonds continued to outperform government bonds. The fourth quarter performance was the complete opposite of the first quarter, a remarkable turnaround. Improving economic prospects were largely responsible for the dichotomy of performance. The impact was particularly favourable for energy industry bonds. Inflation-linked bonds posted very strong relative returns as inflation expectations rose with the improving growth outlook.

With the dramatic increase in interest rates there are no shortage of commentators calling for the end of the 35-year bull market in bonds (graph below). We would refer to our discussion above concerning trend growth. Yes, interest rates reached historical lows, but for the long-term trend to change we would need higher trend economic growth rates. We doubt that President-elect Trump alone can do that. If there is a move higher we suggest it will come about because of higher inflation rather than real growth. Inflation expectations reached historical lows earlier this year when central banks went to the extreme in setting policy rates at negative levels. Such a distortion in policy can only be executed in an environment of rampant deflation expectations. We believe that inflation expectations have reached a secular low but with the Bank of Japan still targeting a 0% ten-year yield, the ability of U.S. ten-year yields to rise above the 3% mark, seems limited. In the end, much higher rates would damage growth prospects due to the heavy debt burden in most developed economies.

10 Year Treasury Yield



Market Returns (as at December 31, 2016)

(%)	3M	1 Yr	5 Yrs	10 Yrs	15 Yrs
S&P/TSX	4.5	21.1	8.3	4.7	7.4
S&P 500 (C$)	5.9	8.1	21.2	8.5	5.5
S&P 500 (US$)	3.8	12.0	14.7	7.0	6.7
Russell 2000 (US$)	8.4	19.5	12.9	5.6	7.1
DJIA (C$)	10.2	9.5	16.3	6.2	3.4
DJIA (US$)	7.9	13.4	10.1	4.7	4.6
MSCI EAFE Net (C$)	1.3	-2.5	12.6	2.2	4.1
MSCI EAFE Net (US$)	-0.7	1.0	6.5	0.8	5.3
Nikkei 225 (US$) Japan	1.2	5.8	10.3	3.1	6.5
Shanghai (US$) China	-0.8	-17.1	7.7	4.7	7.5
BSE Sensex (US$) India	-6.2	1.8	7.8	3.8	14.2
MSCI Emerging Mkts (US$)	-4.6	8.6	-1.2	-0.6	6.9
FTSE TMX Canada Universe	-3.4	1.7	5.2	4.8	5.4
FTSE TMX Canada 91 Day T-Bills	0.1	0.5	0.8	1.4	1.9
C$/US$	-2.0	3.6	-5.4	-1.4	1.2

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

EQUITY MARKETS

Robust returns in the stock market were driven mainly by the improving earnings growth outlook as economic prospects improved, continued corporate optimism following the U.S. election results, and the long anticipated increase in interest rates. There was a notable divergence in industry performance as the rising interest rates benefited the banking and insurance sectors while negatively impacting the utility and REIT sectors which had performed strongly while interest rates were declining. The continued rebound in energy and material prices contributed to the strong finish for stock markets globally. Canada posted extremely strong returns for the quarter and the year as it was a particular beneficiary of the rebound in the financial and resource sectors. Emerging markets underperformed as the strengthening U.S. dollar resurrected concerns around excessive U.S. dollar-denominated debt.

INVESTMENT STRATEGY

Equity markets should become more discriminating as interest rates begin their long road back to more normal levels. The shift from unanimous and increasingly stimulative monetary policy to divergences amongst the major central banks signals the end of liquidity induced gains for financial markets. Now we turn to the economic and company fundamentals, which have more recently improved. Potential positives include the global spread of pro-business policies which could encourage corporate capital spending that has been lacking in this recovery. There are obvious risks to the ability of politicians to execute on populist policies, with the potential disappointment of voters leading to increased instability. Valuations are neither at extreme highs nor are they at historical lows so we are being more attentive to their influence on potential long-term returns.

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