EXECUTIVE SUMMARY

Economic Review

- *Early in the quarter, the U.S. Federal Reserve initiated its third interest rate hike since late 2015.*
- *The Bank of Canada seems to have found enough evidence to start the process of reducing accommodation, after seeing the best quarter for retail sales in almost seven years, more evidence of U.S. export growth and continued job gains.*
- *Economic fundamentals continue to be supportive, with recession risks at very low levels, regardless of the historically long period of expansion.*

Investment Outlook

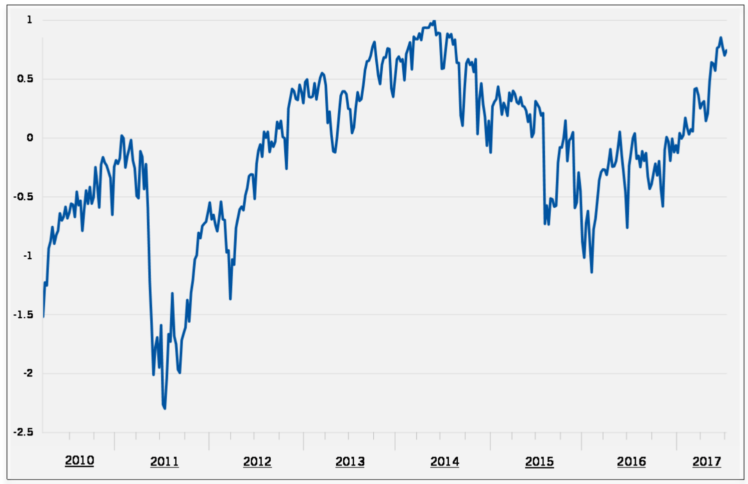
- *We anticipate economies will be able to muddle through this modest growth environment, however it is financial markets that are more vulnerable to swings in liquidity from central banks.*
- *The outlook will become more uncertain as the long-term headwinds of weak growth in the working-age population and record debt levels weigh more clearly on the economy.*
- *The increased use of indexed strategies expands the opportunity for active managers to take advantage of discrepancies between the underlying valuation of businesses and market prices.*

ECONOMIC OUTLOOK

Financial markets performed well during the quarter until nervousness surrounding support of central bank liquidity surfaced late in the period. The end result was mixed returns in equities. Energy-concentrated markets, such as Canada's, slid slightly while international markets recorded modest gains. Bond markets overall were marginally stronger. The Canadian dollar was stronger against the U.S. dollar and the yen, offsetting much of the gains for Canadian investors in those markets. The euro strengthened against the Canadian dollar and, as a result, brought European stock market gains to decent mid-single digit levels for Canadian investors. In aggregate, returns were muted.

Economic fundamentals remain broadly supportive as recession risks are at very low levels despite the historically long expansion. Typically, recessionary periods are preceded by overheating cyclical sectors and surging commodity prices, which contribute to wage pressures and, ultimately, a tough, anti-inflation fighting stance from central bankers. None of these elements are currently present. With another interest rate increase of 25 basis points (bps) by the U.S. Federal Reserve (Fed) in the quarter, financial markets continue to debate whether the interest rate increases are actually a full-fledged tightening or a reduction of accommodation (i.e. still easy, just less so). It is important to keep in mind that even with recent interest rate increases overall financial conditions are still stimulative for growth. Financial conditions include not only interest rates, but also currencies, corporate borrowing costs and equity markets. Thematically, markets spent much of the quarter ratcheting down expectations for stimulative fiscal policy as the Trump administration's ability to deliver on tax cuts diminished.

United States Financial Conditions Index



Notes: The Bloomberg U.S. Financial Conditions Index tracks the overall level of financial stress in the U.S. money, bond, and equity markets to help assess the availability and cost of credit. A positive value indicates accommodative financial conditions, while a negative value indicates tighter financial conditions relative to pre-crisis norms.

Source: Bloomberg

BOND MARKETS

Returns in the Canadian bond market were relatively robust until late in the quarter when the Bank of Canada (BoC) made another dramatic announcement to alter its policy bias. In the last Investment Outlook we questioned the extent of the BoC's elevated concerns of slow economic growth. After the best quarter for retail sales in almost seven years, more evidence of U.S. export growth and continued job gains, the BoC seems to have found enough proof of strong growth to start the process of reducing accommodation. The Bank could have easily kept the focus on the soft inflation numbers, weak oil prices and debt levels that are still at record highs – all factors that are even more evident today than when interest rates were last lowered in 2015. Perhaps, however, the Bank is more concerned about credit excesses in the housing market. Whatever the rationale, the impact was felt immediately in the currency, bond and equity markets. Shorter-term bonds suffered the most as their yield increased 0.3% while long bond yields were down almost 0.2%. Corporate and provincial bonds continued their strong performance relative to federal bonds as investors sought the extra yield. The bond market closed the quarter with a 1.1% return.

Also weighing down on the markets was the trend toward less accommodation from central banks globally. The Fed raised its short-term interest rate and outlined the likely path to winding down its $4.5 trillion balance sheet. There was also the realization that the European Central Bank (ECB) will not continue to buy assets as economic growth and inflation improve. The growth part has been realized while the inflation outlook is still cloudy, which is evidence enough for markets to start pricing in the eventual end of the ECB's asset purchase program. The shift to a less accommodative environment also reflects the desire of central banks to avoid fueling any speculative excesses within financial markets. The unwinding of these extraordinary interventions should be applauded as a sign of the return to a more normal economic environment. Some investor trepidation, however, is understandable given the dubious track record of heavy-handed central bank policy actions.

Market Returns (as at June 30, 2017)

(%)	3M	1 Yr	5 Yrs	10 Yrs	15 Yrs
S&P/TSX	-1.6	11.1	8.7	3.9	8.0
S&P 500 (C$)	0.4	17.9	20.3	9.3	7.2
S&P 500 (US$)	3.1	17.9	14.6	7.2	8.3
Russell 2000 (US$)	2.1	22.9	12.1	5.4	7.7
DJIA (C$)	0.6	19.1	16.1	6.9	4.6
DJIA (US$)	3.3	19.1	10.6	4.8	5.7
MSCI EAFE Net (C$)	3.3	20.3	14.1	3.1	5.2
MSCI EAFE Net (US$)	6.1	20.3	8.7	1.0	6.3
MSCI Emerging Mkts (US$)	6.4	24.2	4.3	2.3	11.0
FTSE TMX Canada Universe	1.1	0.0	3.3	5.1	5.4
FTSE TMX Canada 91 Day T-Bills	0.1	0.5	0.8	1.2	1.8
C$/US$	2.7	0.0	-4.7	-2.0	1.1

Converted to CAD using London 4pm rates. Returns are annualized for periods greater than one year.

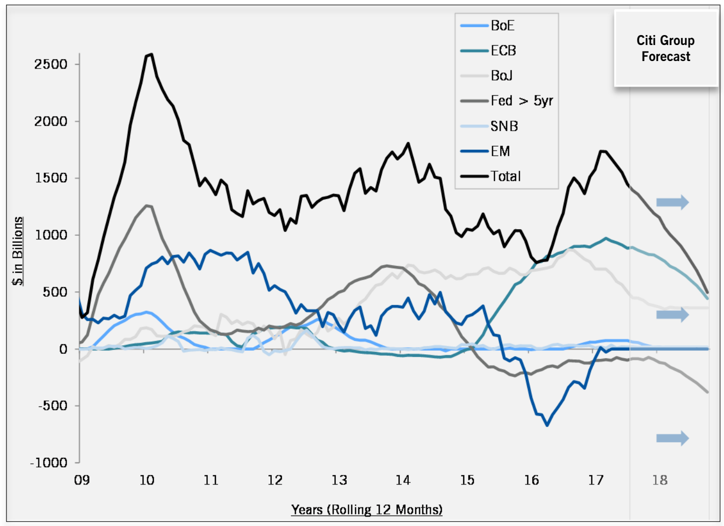
EQUITY MARKETS

Canadian equity markets continued to lag their international counterparts as oil prices declined to a low of $42 before recovering to $47 by quarter-end. Other commodities also lost ground with gold stocks weaker. The financial sector struggled as uncertainty in the mortgage market, related to the near demise of Home Capital Group, weighed on sentiment. In the U.S., the Technology sector experienced near-term exhaustion with the technology heavy NASDAQ Index up over 7% at one point in the quarter before losing momentum to close with a 3.9% gain. The Retail sector continued to suffer from the Amazon effect. This time it was the Consumer Staples sector that was impacted as Amazon announced its buyout of Whole Foods with the goal of boosting its online grocery presence. This also has an impact on the commercial real estate market where valuations are falling after having recently surpassed its pre-crisis peak. Emerging markets posted the strongest equity results in local currency terms. Unlike developed markets, returns were boosted by a strong increase in Technology stocks like Tencent, Baidu and Alibaba.

INVESTMENT STRATEGY

The recovery in global growth in the past year largely reflects a bounce back from the collapse in capital expenditures following the energy sector selloff in late 2014. The rebound was aided by stimulative policy initiatives in China, Europe and Japan. As mentioned above, financial conditions are supportive and low inflation rates should keep the central banks from tightening aggressively. In fact, the ECB in particular is unlikely to raise interest rates for a few years, thus allowing real interest rates to decline as inflation rises. Even Japan has posted relatively strong growth and is not expected to tighten for many years. In this environment earnings growth can continue at a healthy pace. The liquidity impulse from central banks is starting to fade and with it the outlook has become more uncertain as the long-term headwinds of weak growth in the working-age population and record debt levels weigh more clearly on the economy. Of course the possibility, however small, of significant tax cuts in the U.S. exist. This could extend the cyclical upturn, but at this point the chances look slim.

Total Central Bank Purchases



Notes: Expect markets to flounder as Central Banks try to exit.

Source: National central banks, Citi Research, EMFX reserve changes are FX-adjusted

In our opinion, economies will be able to muddle through this modest growth environment while it is financial markets that are more vulnerable to the swings in liquidity from central banks. Within the equity markets there is enough rotation such that pockets of undervaluation are appearing alongside overvaluation. Over long periods of time, active management will always have the edge over passive, as the passive mandates blindly buy what is going up or sell what is going down without regard for valuation or business fundamentals. Ultimately, the increased use of indexed strategies only expands the opportunity set for managers such as ourselves who do extensive research into determining the underlying valuation of the businesses we purchase.

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