EXECUTIVE SUMMARY

Economic Review

- *The Bank of Canada raised the overnight interest rate twice to 1.0% during the quarter.*
- *Economic growth continues to support financial markets with the synchronized global expansion still intact.*
- *The improved pace of growth helped corporate bonds outperform government counterparts. Equity markets continued to move upward with support from earnings growth.*

Investment Outlook

- *We anticipate the Bank of Canada will be very cautious in raising interest rates as it is cognizant of the risk that record high household debt levels pose on consumer spending.*
- *Proposed tax reform in the U.S. would dramatically narrow the current tax advantage of Canadian corporations increasing uncertainty for future corporate spending plans.*
- *Economic momentum is still positive which should lead to further gains in stocks.*

ECONOMIC OUTLOOK

Stock markets posted reasonable returns in the third quarter, although the Canadian market still lags foreign stock markets, particularly the top-performing emerging markets. It was a similar case for the bond markets, where Canadian performance was negative while foreign markets recorded positive returns. 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 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).

The U.S. Federal Reserve held the overnight interest rate steady in the 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.

The Bank of Canada stayed true to its word, raising the overnight interest rate twice 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 European Central Bank remains committed to its -0.4% interest rate target and asset purchases, however, this may change as a result of the stronger economic growth that Europe is experiencing. The Bank of Japan continues to maintain a 0.1% target for its 10-year government bond yield. Prime Minister Abe is committed to maintaining the fiscal and monetary stimulus, however there is the possibility of a change in government with a serious contender emerging for the October 22 election.

Economic growth in Canada has exceeded expectations, with second quarter annualized growth at 4.5% — the strongest growth rate of the G7 countries – and surpassing the first quarter’s growth of 3.7%. Many, including ourselves, doubt that this pace of growth can be sustained as the main drivers arose from the bounce back in energy sector business spending and double-digit increases in house prices, both of which are unlikely to be repeated to the same degree. Furthermore, the Canadian dollar’s strength could hinder export growth and business investment is vulnerable to an unfavourable turn in the NAFTA negotiations. Finally, the lowering of U.S. corporate tax rates to levels that are more competitive with Canada may also hurt business spending. Housing demand hinges on low interest rates and the willingness of lenders to expand their loan book, both of which are cyclical. Ontario appears to be the most exposed, particularly as government finances are unlikely to be able to absorb a significant downturn in one of the province’s major economic drivers.

Market Returns (as at September 30, 2017)

(%)	3M	1 Yr	5 Yrs	10 Yrs	15 Yrs
S&P/TSX	3.7	9.2	8.1	4.1	9.2
S&P 500 (C$)	0.6	12.9	19.8	9.9	8.3
S&P 500 (US$)	4.5	18.6	14.2	7.4	10.0
Russell 2000 (US$)	5.3	19.1	12.2	6.4	9.9
DJIA (C$)	1.1	16.5	16.2	7.3	5.8
DJIA (US$)	4.9	22.4	10.8	4.9	7.5
MSCI EAFE Net (C$)	1.5	13.3	13.7	3.7	6.6
MSCI EAFE Net (US$)	5.4	19.1	8.4	1.3	8.3
MSCI Emerging Mkts (US$)	8.0	22.9	4.4	1.7	12.9
FTSE TMX Canada Universe	-1.8	-3.0	2.7	4.7	5.0
FTSE TMX Canada 91 Day T-Bills	0.1	0.5	0.7	1.1	1.8
C$/US$	3.8	5.1	-4.7	-2.3	1.6

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

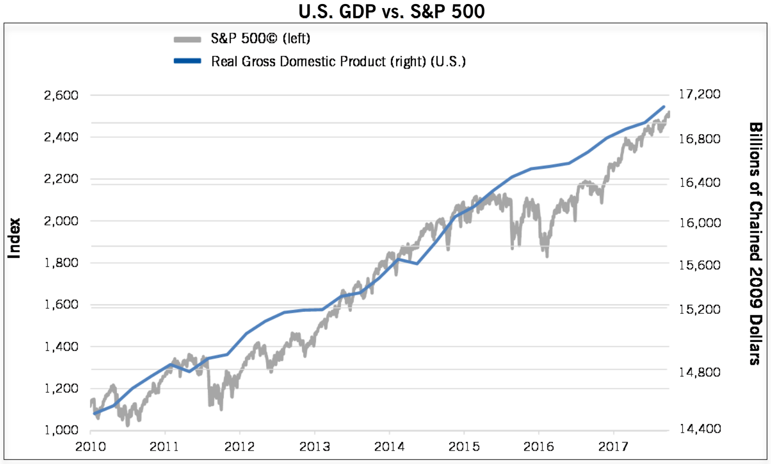
BOND MARKETS

Most bond markets gained while the Canadian bond market was one of the worst performing, a result of its relatively stronger economic growth. The market declined by 1.8% in the third quarter and the Bank of Canada’s two interest rate increases of 0.25% helped push bond yields up by almost 0.4% with the shorter maturities bearing the brunt of the increase. The improved pace of growth helped corporate bonds to outperform their government counterparts. Demand for corporate bonds was robust with Apple able to issue a record-setting $2.5 billion Canadian-dollar seven-year bond at a similar yield premium that Canadian banks pay to borrow in the bond market. This is another sign that the corporate bond market is in the late stages of its bull run, reminiscent of equity IPOs that coalesce at the top of a bull market in stocks. Longer term, we believe that a substantial weighting in high quality corporate bonds would be beneficial; however, valuations are currently reaching historical extremes so caution is warranted.

EQUITY MARKETS

Equity markets continued to move higher with earnings growth supporting the positive momentum. The Canadian market has been a laggard this year with the Energy sector under pressure; however, in the third quarter many of these stocks bounced back. In addition, Materials (excluding gold stocks) performed well as did Financials stocks. The foreign markets outperformed domestic markets once again although, for Canadian investors, the gains were offset by the appreciation of the Canadian dollar. Emerging markets posted another strong quarter in local currency terms as they are benefitting from a 28% weighting in technology stocks, which are currently the darlings of the bull market. Market valuations remain above average, particularly in the U.S., however economic momentum is still positive which should lead to further gains barring a tremendous geopolitical shock or policy error.

U.S. GDP vs. S&P 500



Source. S&P Dow Jones Indices LLC, U.S. Bureau of Economic Analysis, and the Federal Reserve Bank of St. Louis

INVESTMENT STRATEGY

Global economic momentum remains robust with the strength broad-based, 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. While we recognize that the desired outcome is to modernize the deal, the U.S. President needs a political win and tearing up the deal may "play" better with his support base. The second is the proposed 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. Perhaps if a substantial portion of the proposed U.S. tax package passes, we will see the start of a trend; however, that seems to have a low probability at this time.

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.

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