EXECUTIVE SUMMARY

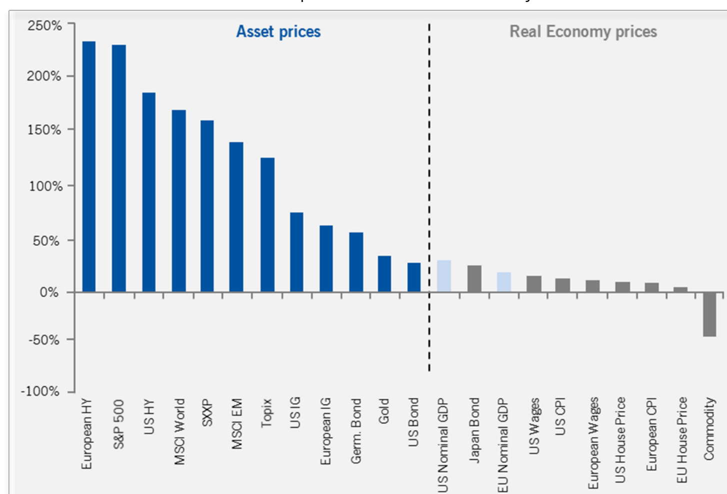
Economic Review

- *The Bank of Canada shifted to a more cautious policy stance following two interest rate increases in the third quarter.*
- *Equity markets continued their upward climb thanks to continued support from economic growth and accommodative financial conditions.*
- *Globally, yield curves have flattened substantially as central banks raised short-term interest rates while long-term rates remain low.*

Investment Outlook

- *Near-term, the risk of recession is quite low and therefore a significant market downturn does not look to be imminent.*
- *The recently-passed tax bill in the United States should also provide some near-term upside to the economy.*
- *Technological advancements in cryptocurrencies may ultimately reduce costs and improve security, however, we doubt that governments will allow other "currencies" to challenge their own.*

Asset Price Inflation & Real Economy Inflation
Total return performance in local currency



Notes: Total return in local currency from January 2009 to September 2017
Source: Goldman Sachs Global Investment Research

ECONOMIC REVIEW

The goldilocks environment is alive and well as inflation remains low despite the pickup in economic growth. This has allowed central banks to either raise interest rates very gradually, as the U.S. Federal Reserve did this quarter, or maintain record low interest rates and continue with billions of dollars of monthly asset purchases, as the European Central Bank (ECB) and Bank of Japan did. The Bank of Canada shifted to a cautious stance following its two interest rate increases in the third quarter. This caution stems from uncertainty related to the housing sector's adjustment to more stringent mortgage qualification rules that come into play in the New Year, NAFTA negotiations, and the impact of the recent increase in interest rates on elevated levels of household debt. We expect these impacts to be softened by the stimulative fiscal policies of both the federal and provincial governments as well as strong employment and immigration flows. Once the uncertainties fade, the Bank of Canada will be able to resume its push to normalizing interest rates. Globally, investors are assessing the timing of an eventual return to less accommodative central bank policy.

One of the features of this bull market has been the exceptional asset price gains relative to prices in the real economy. This is not unheard of as valuations can fluctuate meaningfully throughout a cycle. What is unusual is for markets to run ahead of economic fundamentals. For that we can thank the central banks and their ultra-low, and in some cases negative, interest rate policies. Manifestation of this easy money environment is seen in the cryptocurrency craze. Although this technological leap should ultimately reduce costs and improve security in the financial system, we doubt that governments will allow other "currencies" to challenge their own. In fact, in a recent speech the Governor of the Bank of Canada stated that it is working on its own, true, cryptocurrency as are other central banks. Ultimately the "true" currency is the one that is accepted for payment of taxes.

BOND MARKETS

Global bond markets posted modest returns during the quarter; however, the Canadian bond market outperformed most developed markets. Yield curves have substantially flattened globally this year as central banks raised short-term interest rates while long term rates stayed low (or even declined in Canada's case). Long term interest rate movements are more sensitive to inflation expectations which have remained subdued despite central banks' efforts to raise them, even within an environment of stronger economic growth. Low inflation expectations are not the only reason for the behaviour of long term interest rates. There is also an element of investors wanting safe, long-term bonds to insure against equity market downside. Provincial bonds were notable outperformers in the quarter, besting both federal and corporate bonds. They remain one of the most liquid, high-quality global bonds in the world that offer incremental yield.

Market Returns (as at December 31, 2017)

(%)	3M	1 Yr	5 Yrs	10 Yrs	15 Yrs
S&P/TSX	4.5	9.1	8.6	4.7	9.0
S&P 500 (C$)	6.8	13.8	21.2	11.1	8.2
S&P 500 (US$)	6.6	21.8	15.8	8.5	9.9
Russell 2000 (US$)	3.0	13.1	12.6	7.2	9.7
DJIA (C$)	10.5	16.9	18.9	9.0	5.9
DJIA (US$)	10.3	25.1	13.5	6.4	7.5
MSCI EAFE Net (C$)	4.4	16.8	13.0	4.4	6.5
MSCI EAFE Net (US$)	4.2	25.0	7.9	1.9	8.1
MSCI Emerging Mkts (US$)	7.5	37.8	4.7	2.0	12.7
FTSE TMX Canada Universe	2.0	2.5	3.0	4.7	5.0
FTSE TMX Canada 91 Day T-Bills	0.2	0.6	0.7	1.0	1.8
C$/US$	-0.2	7.0	-4.5	-2.4	1.6

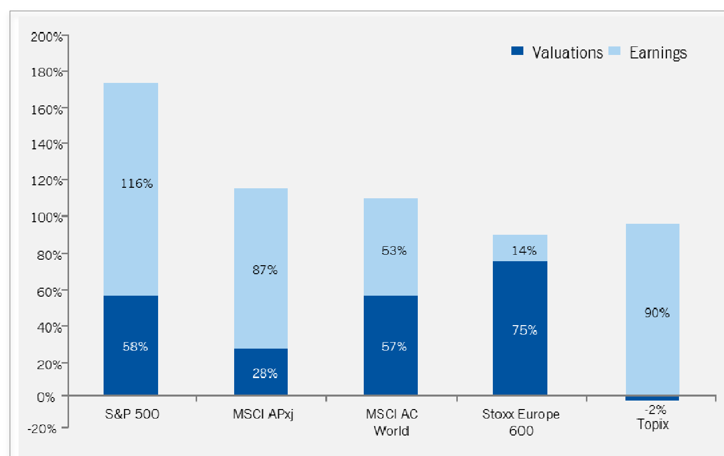
Converted to CAD using London 4pm rates. Returns are annualized for periods greater than one year.

EQUITY MARKETS

Global equity markets continued their upward climb thanks to continued support from economic growth and accommodative financial conditions. Canada essentially matched the average global return during the quarter in local currency terms, partly owing to the rise of cannabis company valuations and a bounce back in beaten-down companies such as Valeant and Home Capital Group. International equity markets gave back some of their relative gains from earlier this year as they underperformed the U.S. market in the last quarter.

The Canadian equity market lagged most markets during the first three quarters of the year. A large part of the underperformance was attributable to energy stocks which remain weak as Canadian oil prices have lagged the rise in international oil prices due mainly to the lack of access to external markets. European stocks were also relative laggards after the previous periods of outperformance. The persistence of an accommodative posture by the ECB weighed on the performance of the financial sector as higher interest rates typically benefit their margins while lower rates are a hindrance. Asian and U.S. stock markets were relatively strong, benefitting from their heavier technology sector weights. Japan was one of the stronger markets as signs point to its recent growth improvement being more sustainable than in the past. For the first time in years, Japan is seeing companies raise prices. For instance, according to the Wall Street Journal, for the first time in 30 years Torikizoku Company, a restaurant chain, raised prices after being forced to increase wages due to a shortage of part-time labour. It is interesting to note that since 2009, returns in the Japanese stock market (Topix) have been much more influenced by earnings growth, which suggests more sustainable performance.

Contributions to Returns, Valuation Re-Rating vs. Earnings



Notes: Returns have been driven by a mix of re-rating and earnings from Jan. 2009 to Sept. 2017.
Source: Datastream, Company data, Goldman Sachs Global Investment Research

INVESTMENT STRATEGY

As global economic growth continues to expand and equity markets rise, there is no shortage of warnings that the positive environment will soon end. Absolute valuations, particularly for the U.S. market, are above long-term averages even accounting for the impact of the extraordinary performance of the technology sector and its offshoots.

What has consistently eluded most investors is optimizing the timing of investment decisions, with some eventually deciding that it is best to ignore market cycles and hold to a long term plan—which would be our recommendation. There are three types of bear markets: event-driven, which cannot be anticipated; cyclical bear markets, which investors can mostly monitor as they are associated with the business cycle; and structural corrections where there is typically a recession combined with an asset bubble burst.[1] Historically, event-driven bear markets produce the mildest corrections; cyclical bear markets produce average corrections of 30%; and structural corrections are the largest, averaging 50%. From a risk management perspective, when valuations are elevated and a shock occurs, there is typically a larger market correction. We would add that downside risk is more elevated today due to the fact that the extraordinary central bank liquidity—which some markets have come to depend on—will eventually be withdrawn.

Currently, the signposts for a recession are not evident. Normally we would see a period of three months where short-term interest rates are above long-term rates (i.e. an inverted yield curve), which squeezes the profitability of lenders, dissuading them from lending. A rise in the unemployment rate by a third of one percent has always preceded U.S. recessions. We would also typically see a decline in manufacturing activity as measured by the purchasing managers' index. None of these signposts are currently in evidence, which suggests that the near-term risk of recession is quite low and therefore a significant market downturn is not imminent. The recently-passed tax bill in the United States should also provide some near-term upside to the economy.

[1] Goldman Sachs Global Investment Research.

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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