INVESTMENT OUTLOOK
Q1 2018

HIGHLIGHTS

Economic Review

- Investor confidence was shaken by talk of trade wars, the return of inflation, interest rate increases, and the potential regulatory clampdown on the use of online users' data.
- Recent leading indicators are still not pointing to elevated recession risks, and earnings momentum is positive which suggests a resumption in market gains.
- The U.S. Federal Reserve has essentially been matching the rise in economic growth with equivalent increases in interest rates.

Investment Outlook

- We anticipate that this period of uncertainty will subside over the next quarter as solid economic fundamentals reassure investors.
- Near term, a continuation of the bull market for equities is expected; however, longer-term concerns are building.
- Our strength in selecting high-quality businesses at historically reasonable valuations should provide portfolios with the ability to withstand the inevitable market shocks.

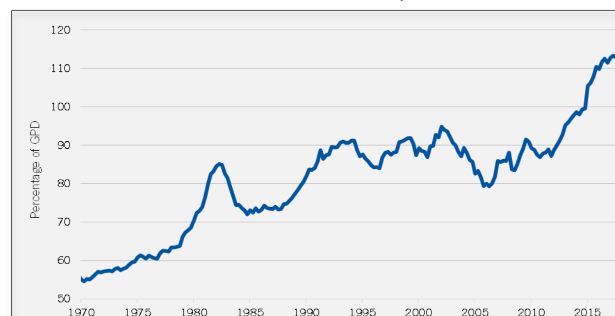
ECONOMIC REVIEW

If the first quarter of 2018 is any indication, financial markets have waved goodbye to the record low volatility that they enjoyed over the last few years. Many of the world's stock markets gave back some of last year's gains, with most posting negative returns in the quarter, while bond markets were essentially unchanged. For the first time in a number of years the much maligned cash, or money market investments, were the superior performer in the short term.

Stock prices were more volatile than warranted by any underlying change in valuations or fundamentals. Last quarter, investor confidence was shaken by talk of trade wars, the return of inflation, central bank interest rate increases and the potential regulatory clampdown on the handling of online users' data. It is worth noting that changes to investments' fundamental cash flow prospects impact long-term valuations while investor confidence typically affects prices. So what is the current reality? Earnings growth has been generally rising at a double digit pace while prospects for a recession seem remote. Since the 1960s, growth in international trade has been on an upward trajectory, with the pace accelerating upon the creation of the World Trade Organization in 1995 and China's entry in 2001. We believe that the recent tariff proposals are trade skirmishes, and are unlikely to develop into a full-blown war. The main target of the U.S. populist trade angst is China and, given the latter's desire to move to a more consumption-oriented growth profile, it is unlikely that it will walk away from trade discussions. The U.S. is already a consumer-based economy and, as such, would be hurt by a trade war because the resulting increase in prices would act as a tax on consumer spending. Fighting for more fair trade has been a key component of President Trump's platform but once he has a "win" on trade we doubt he would push much further on a path that is ultimately negative for global growth.

Inflation has only been inching up, despite record stimulus by central banks and generally low levels of global unemployment. It is a wonder that inflation problems have not already intensified to a greater extent. However, if we take into account the continued deflationary impact of aging demographics and extended private sector indebtedness, this long period of low inflation becomes more understandable. Even though central banks have been raising interest rates—the U.S. Federal Reserve (the Fed) did so again in the quarter—the pace has been very measured. The Fed has essentially been matching the rise in economic growth with equivalent increases in interest rates. The Bank of Canada has clearly adopted a more cautious stance, bypassing the opportunity to raise interest rates in its last two meetings in the quarter. The European Central Bank and the Bank of Japan have shown no inclination to raise interest rates any time soon.

Total Debt Issued to Non-Financial Corporations in Canada



Source: Bank for International Settlements and FRED Economic Data, Adjusted for breaks

BOND MARKETS

The Canadian bond market continued to be one of the better performers, eking out a minor gain in contrast to mild losses in the U.S. market. The contrast between the Bank of Canada's cautious stance and the Fed's methodical process of raising interest rates to a more neutral level contributed to the Canadian market's outperformance. Economic prospects for Canada are notably weaker than for the U.S., and Canada faces heavily indebted household and corporate sectors, making it more vulnerable to higher interest rates. In addition, Canada does not have the benefits of significant tax cuts and fiscal spending that the U.S. is experiencing. Trade uncertainty is also somewhat of an overhang; however, we expect that a resolution that will not disadvantage Canada to any great extent will be announced in the near future. European bond markets were relatively strong, following leading economic indicators that suggest growth will slow down in the near term from the strong pace of late.

Similar to equity markets, corporate bonds had a relatively strong start before investor confidence softened. This, and a wave of supply, led them to end the quarter on a weak note and underperforming federal government bonds. Economic momentum is still positive, albeit subdued, and is supporting the valuation of riskier corporate and provincial bonds relative to federal government bonds. However, if that support diminishes, there is increasing risk of underperformance as weak corporate fundamentals will be exposed. Corporate leverage in Canada is at record highs and the credit quality of the corporate bond market is the weakest ever: the portion of BBB-rated bonds within the corporate bond market has increased from 17% just 10 years ago to 38% today. In addition, the index now includes hybrid securities which allow the bonds to be converted into equity under stressed circumstances, essentially withdrawing creditors' traditional asset protection when it is needed most. Reduced credit quality overall and the extended nature of the business cycle have caused us to take a more cautious approach with our allocation to corporate bonds.

Market Returns (as at March 31, 2018)

(%)	3M	1 Yr	5 Yrs	10 Yrs	15 Yrs
S&P/TSX	-4.5	1.7	6.9	4.5	9.0
S&P 500 (C$)	2.1	10.2	18.8	12.0	9.1
S&P 500 (US$)	-0.8	14.0	13.3	9.5	10.1
Russell 2000 (US$)	-0.4	10.4	10.0	8.3	10.0
DJIA (C$)	0.3	12.8	16.0	9.4	6.7
DJIA (US$)	-2.5	16.7	10.6	7.0	7.6
MSCI EAFE Net (C$)	1.3	11.0	11.7	5.1	7.7
MSCI EAFE Net (US$)	-1.5	14.8	6.5	2.7	8.6
MSCI Emerging Mkts (US$)	1.5	25.4	5.4	3.4	13.3
FTSE TMX Canada Universe	0.1	1.4	2.9	4.4	5.0
FTSE TMX Canada 91 Day T-Bills	0.3	0.8	0.7	0.9	1.7
C$/US$	-2.8	3.4	-4.7	-2.3	0.9

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

EQUITY MARKETS

Global equity markets were weaker in the quarter after a period in which expectations for future gains became excessive. After a number of years of steady growth and subdued inflation it is not surprising to see prices stumble whenever doubt is introduced. Although it is not our expected scenario, rising inflation with falling growth amid rising rates is a negative environment for stock markets. The historically high prices relative to growth prospects also increase the potential downside, should underlying fundamentals deteriorate. We anticipate that this period of uncertainty will subside over the next quarter as solid economic fundamentals reassure investors.

International markets, particularly emerging economies, continue to be the strongest performers. At one point, the MSCI Emerging Markets Index was up 12% in the quarter before settling at a gain of 4.4%. Superior growth prospects and valuations imply a long period of outperformance. With China now the second largest economy in the world, the label of "emerging market" seems out of place. The technology sector continued to be the strongest performer while energy stocks, particularly pipelines, were the weakest. Given the heavier weighting in energy, Canada continues to be a relatively weak market. The weakness in the Canadian dollar, however, boosted foreign market returns for Canadian investors.

INVESTMENT STRATEGY

In the past nine years, financial markets have enjoyed the helping hand of central bank-induced record low interest rates. Bouts of volatility that we experienced in the past quarter were not unusual, although the record low volatility of 2017 may have lulled some investors into believing in a new era of steady market advances. Prospects for continued market expansion actually improve when markets are instilled with some uncertainty as market peaks tend to coincide with environments where investor confidence is high rather than low. In last quarter's Investment Outlook, we outlined some of the warning signs for economic recessions, such as an inverted yield curve or rising unemployment rates. Recent leading indicators are still not pointing to elevated recession risks, and earnings momentum is positive which suggests a resumption in market gains.

Investors tend to extrapolate short-term trends and end up positioning their portfolios too aggressively, or too conservatively, at turning points. While the prospects for further market gains are good, we acknowledge that the investment environment is not as favourable as it was nine years ago when valuations were near historical lows and economic prospects could only improve, absent a depression. Inflation is now rising and, even if it is a more temporary or cyclical increase, in our opinion, it contributes to a less benign environment. Central banks are no longer as friendly towards financial markets, since they no longer need to stabilize the global financial system and fears of deflation are no longer prevalent. If the axiom that markets stop panicking when central banks start panicking is true, then the reverse might also hold and we should now be more vigilant. These are some of the more macro influences on investment portfolios that suggest a more cautious approach to portfolio construction. Continuation of the bull market for equities is expected in the near term but the longer-term prospects are developing some uncertainties. As always, our strength in selecting high-quality businesses, and purchasing them at historically reasonable valuations, should help our clients' portfolios withstand the inevitable shocks that financial markets face from time to time.

All returns are expressed in Canadian dollars unless otherwise indicated.

Sources: TD Securities, S&P and Bloomberg. This document is prepared for general circulation to clients of Jarislowsky, Fraser Limited (JFL) and is provided for information purposes only, it is not intended to convey investment, legal, tax or individually tailored investment advice. All opinions and estimates contained in this report constitute JFL's judgment as of the time of writing and are provided in good faith. All data, facts and opinions presented in this document may change without notification. This is not a solicitation for business. Past performance is not a guide to future performance. Future returns are not guaranteed. No use of the Jarislowsky, Fraser Limited name or any information contained in this report may be copied or redistributed without the prior written approval of JFL.