HIGHLIGHTS

Economic Review

- Global financial markets showed mixed results in the third quarter with equity markets generally positive.
- U.S. economic growth will likely continue based on another quarter of above trend growth. We expect the gap in growth rates between North America and the rest of the world to close as the fiscal policy stimulus in the U.S. fades.

Investment Outlook

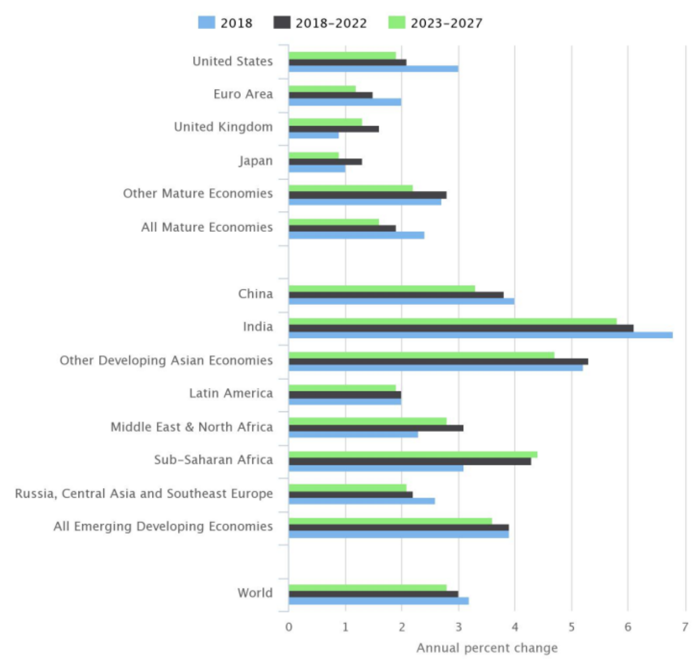
- As valuations rise to historical extremes, it is imprudent to take on too much risk.
- Valuations will be subject to significant volatility if the liquidity withdrawal is not executed perfectly.

ECONOMIC REVIEW

Global financial markets showed mixed results in the third quarter with equity markets generally positive, while bond markets suffered from continued central bank pressure to raise interest rates. At the end of the quarter, the U.S. equity market led returns, the Chinese market once again lagged, and the Canadian equity market gained slightly as weak results from energy and gold stocks offset gains from bank and cannabis stocks.

U.S. economic growth will likely continue based on another quarter of above trend growth approaching 4% on a real basis, in comparison to the average trend of just 2% over the past 10 years. Strong corporate earnings and supportive fiscal and monetary policies have contributed to the favourable economic environment. Canada has also posted upside surprises in growth with positive contributions from exports and housing starts. In contrast, growth in the eurozone has softened slightly and emerging markets are still struggling with the weakness in China. We expect the gap in growth rates between North America and the rest of the world to close as the fiscal policy stimulus in the U.S. fades. Based on history, global economic weakness will eventually filter into the U.S. economy. The risk to supercharging the U.S. economy with fiscal stimulus this late in the business cycle is that the economy can overheat, making the U.S. Federal Reserve's (the Fed) attempts to orchestrate a soft landing more difficult. The current U.S. expansion has been the second longest on record, due mainly to its low volatility explained by the following longer-term factors: 1) the evolution of the U.S. into a service-based economy, which implies less impact from swings in industrial activity; 2) weak labour force growth; 3) better anchored inflation expectations; and 4) the development of a global supply chain for production which has shifted some volatility overseas. Unique to this cycle is the added influence of the 2008 financial crisis.

Overseas, the political environment in Italy continued to cause concern in the European markets. The electoral success of more extreme parties has magnified uncertainties around budget deficits and overall government debt levels. The relationship between Italy and the European Union (EU) has been intense as risk of an Italian departure from the EU and the euro is rising. This situation highlights the inconsistency of having a monetary union without a fiscal union. Meanwhile, international trade tensions between the U.S. and China continue to escalate. For now, the U.S. markets are taking it in stride, perhaps expecting the negative growth impact to only hit the rest of the world. We are hearing from companies in emerging markets that they are holding back on investment intensions until the air is cleared around trade negotiations. Expectations are biased following the recent NAFTA (now called USMCA) deal being reached between the U.S. and Canada.



Source: Conference Board Global Economic Outlook 2018, May 2018

BOND MARKETS

The third quarter showed a rise in global interest rates in response to decent economic growth and continued central bank interest rate increases in both Canada and the U.S. After lagging the Fed in its program to normalize interest rates, the Bank of Canada raised its target interest rate by 0.25% to 1.5%, matching the Fed's 0.25% increase. Given the right opportunity, the European Central Bank (ECB) will likely increase rates which remain stuck in negative territory (-0.4%). The Bank of Japan has allowed more flexibility around its yield control target, and as a result its 10-year government bond yield rose from 0.02% to 0.12%. Altogether, it is clear that central banks are unwinding the unprecedented liquidity expansion of the past decade. The FTSE TMX Canada

Universe Bond Index posted one of its weakest quarters in recent years, declining by -1.0%.

Canadian and U.S. 10-year government yields rose approximately 0.3% in the quarter. Most of the interest rate increases were attributable to the rise in real yields, which reflected increased expectations for economic growth rather than rising inflation expectations. Overall, growth expectations for Canada remain subdued due to the extreme leverage in the household sector and the concomitant sensitivity to higher interest rates. Markets have priced in some of this divergence in growth expectations with the U.S. as the real yields in Canada are almost 0.3% lower. Meanwhile, corporate bonds recovered some of their underperformance from earlier in the year. Their recovery was consistent with the improved growth scenario and some late-in-the-quarter stability in the emerging markets. Quality remains weak, as is expected late in the credit cycle, with loan covenants favouring the borrower over the lender.

EQUITY MARKETS

Despite ongoing rhetoric around trade-making headlines, equity markets were generally positive in the quarter. The U.S. market led the way, with fairly broad-based participation inclusive of an ongoing recovery in the health care sector. At the other end of the spectrum, emerging markets were weaker, driven to a large extent by China, which comprises nearly a third of the MSCI Emerging Markets Index. Within the Chinese market, key equities in the technology sector were notable laggards after strong absolute returns over the recent past. The Canadian market was essentially flat for the quarter, as outsized strength in cannabis-related stocks offset declines in gold-related equities. Other global equity markets were also marginally positive, with pockets of softness in those markets as well as equities with higher exposure to global trade flows. Negative returns in both the UK and Hong Kong equity markets could be seen as emblematic of this trend.

Market Returns (as at September 30, 2018)

(%)	3M	1 Yr	5 Yrs	10 Yrs	15 Yrs
S&P/TSX	-0.6	5.9	7.8	6.3	8.2
S&P 500 (C$)	6.0	22.0	19.3	14.2	9.3
S&P 500 (US$)	7.7	17.9	13.9	12.0	9.7
Russell 2000 (US$)	3.6	15.2	11.1	11.1	10.1
DJIA (C$)	7.3	22.2	17.1	11.5	6.9
DJIA (US$)	9.0	18.1	11.8	9.3	7.2
MSCI EAFE Net (C$)	-0.2	6.3	9.3	7.5	6.5
MSCI EAFE Net (US$)	1.4	2.7	4.4	5.4	6.8
MSCI Emerging Mkts (US$)	-0.9	-0.4	4.0	5.8	10.0
FTSE TMX Canada Universe	-1.0	1.7	3.3	4.4	4.6
FTSE TMX Canada 91 Day T-Bills	0.3	1.2	0.8	0.8	1.7
C$/US$	1.8	-3.2	-4.5	-1.9	0.3

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

INVESTMENT OUTLOOK

In five easing cycles since 1981, the Fed has cut the fed funds rate by an average of 6.17% (range of 5.5%-6.75%). Currently, the rate is 2% and likely to rise to 3% in the next year. Clearly, the Fed and all developed country central banks, for that matter, will have less capacity to stimulate borrowing appetites through lower interest rates in the next recession. Over the last couple of decades, the returns from the relationship between lower interest rates and increased debt-financed consumer spending have diminished as households have shown less appetite for increased borrowing. This explains the central banks having resorted to the extraordinary measures of asset purchases, otherwise known as quantitative easing.

Leaning excessively on monetary policy has created financial excesses: the tech/telecom boom and bust 20 years ago; the U.S. housing/subprime mortgage bubble that preceded the great financial crisis of 2008; and now the quantitative easing bubble with its excesses in long duration assets. These excesses are evident in the record valuations for private equity investments, venture capital with their unicorns (i.e.: start-up tech companies with $1B+ valuations despite negative cash flows), the frenzy for cannabis stocks and the rage for Bitcoin—which peaked late last year. In terms of fiscal policy, these are also extraordinary times, as it is extremely rare to have an exploding federal government debt and deficit profile during a time of relative peace and prosperity. By expanding the debt and deficits, the U.S. Administration has made it politically more difficult to continue to use those remedies when the economy ultimately heads into recessionary times.

To maintain belief in overextended assets, one must hope that interest rates will stay near record lows (or a productivity-led boom which allows a "good" rise in real interest rates), that monetary and fiscal policy stimulus will effectively mitigate any economic downturns, that foreigners will keep financing US deficits, that inflation expectations will remain anchored, and that the global political order remains in place. Not impossible, but as valuations rise to historical extremes, we feel it imprudent to take on too much risk. It is late in the financial and business cycle, and liquidity is being withdrawn. While the economic profile for most companies may not change dramatically, we expect that valuations will be subject to significant volatility if the liquidity withdrawal process is not executed perfectly. For the next few quarters, positive economic momentum should support markets; however we are mindful that this trend may not continue into 2019 and beyond.