CONNECTED WEALTH™

2018 Market Outlook

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Stars Remain Aligned

Market returns in 2017 were rather stellar. Canada enjoyed a strong second half while many global markets saw steady positive returns throughout the year. The TSX finished up 9.1% on the year, and the S&P 500 was up 21.8%, albeit only 13.8% in Canadian dollar terms. Global markets were also strong from Europe to Asia to emerging markets. We remain in a sweet spot, with improving global economic growth and very limited signs of inflationary pressures.

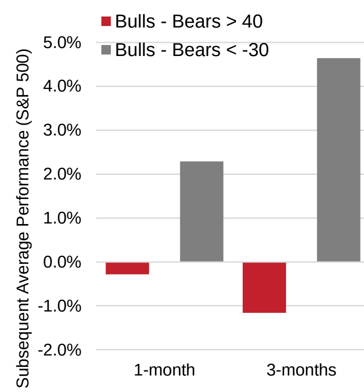
The global economy is really doing well and should carry this positive momentum in 2018. Europe is growing at its best pace since 2011, thanks in part to the region's greater sensitivity to global growth relative to the U.S. Most emerging economies are expanding handsomely, although there are policy rumblings in China. The U.S. economy, which led the global economy out of its funk, is seeing estimate revision to the upside for the first time in years. Most years the consensus forecast for the U.S. economy starts out too optimistic and then gets revised down as time passes. Consensus forecasts for 2018 are actually moving higher. Tax reform may garner more media attention, but the underlying U.S. economy continues to be quite strong.

Add this all up and you have consumers and corporations more confident and spending more. Earnings and sales growth are strong. Commodity prices have moved higher on the back of improving global demand and a softer U.S. dollar. Credit spreads have compressed. It is a full risk-on environment. How sweet it is.

As 2018 begins, we are optimistic for the markets based on the fundamental data and on our market cycle analysis (next section); we remain of the view that this bull cycle has more room to run. However, we have two caveats. The first is simply that sentiment is extremely bullish at the moment, with 60% of investors bullish and only 16% bearish. Typically, when the spread is greater than 20 (60-16=44), equity market returns over the next few months are tepid. Clearly a lot of the good news is already reflected in stock prices and it has been a very long time since we saw a correction.

The other caveat is we are seeing more signs of an extended cycle. The U.S. Federal Reserve (the Fed) is raising rates, the U.S. output gap has closed, and leadership in equity markets is narrowing with fewer companies doing most of the lifting of the S&P 500. These signals are longer term and often precede a bear market by a year or two, but they are starting to show up nonetheless.

Chart 1: Extremely Bullish Sentiment



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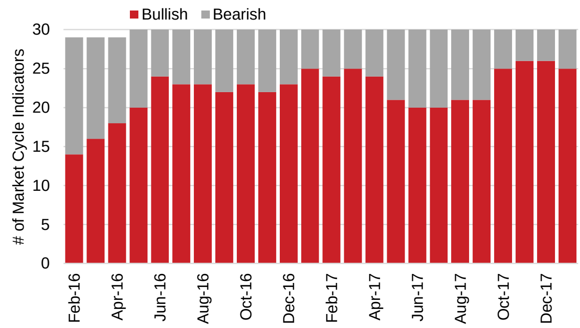
Market Cycle – Another Good Checkup

The current market cycle started in early 2009 and is now over eight years old. Based on either global economic growth or duration in between bear markets for the S&P 500 Index or S&P/TSX Composite Index, the current cycle is one of the longest on record. In our view, there is little doubt, based on our analysis, that this is a late-cycle environment. Most of the characteristics of a late cycle are now clearly evident. The examples are many – elevated valuations in the equity markets, low unemployment, synchronized global economic growth, and narrowing leadership in equity markets – to name a few. In addition, the Fed appears set to raise rates three times next year, and the output of the U.S. has just joined Germany and Japan as major economies producing above potential. We are also starting to see some signs of animal spirits in rising confidence and investor behaviours. One of the late-cycle characteristics missing is inflationary pressure, which may hold the key to how long this cycle continues to run and what might signal the end.

Chart 2: Market Cycle - Old but still healthy



The good news is, based on our proprietary Market Cycle framework, we see limited signs that the end of the cycle is near. This framework is multi-disciplinary, incorporating yields, economic data, company fundamentals, valuations and technical indicators. There are 30 key inputs, and each have been historically accurate, to varying degrees, in signaling turning points in the market cycle. Our view is none will work every time, but using a basket, we have a better chance of positioning the portfolio for the most probable next move. The good news is 25 of the 30 remain bullish for the continuation of the current cycle (Chart 2). Historically that is high and healthy. We don't really get concerned unless the number of bullish signals drops down into the low teens.

Chart 3: U.S. Output gap is gone, which often precedes a recession by a year or two

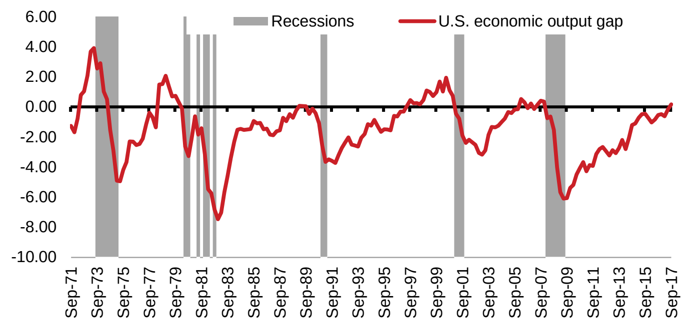


Chart 2 & 3 Source: Connected Wealth, Bloomberg

How do we see the cycle playing out? Our base case scenario remains relatively traditional: Global economic growth continues to improve gradually, and this finally begins to translate into inflationary pressure and/or upward pressure on bond yields. Then, given that so much asset price inflation has occurred over the past decade thanks to low yields, this asset price inflation partially reverses and causes a recession.

The timing of this scenario is not imminent, but there are signs it may be coming. The German and Japanese economies have both been producing above their potential, which causes inflationary pressures. The U.S. has just passed over this threshold as well (Chart 3). Historically, this precedes recessions by a year or two.

Adding to this base case, the Fed, as mentioned above, is now expected to raise rates three times in 2018, which would put the upper band of the Fed Funds rate at 2.25%. How and when this begins to impact longer-term yields will be critical and could begin multiple compression, not just in the equity markets but also in real estate cap rates.

For now, we are in the sweet spot: a healthy economy and low inflation. We will be watching inflation for a potential early warning signal that things may change. If the current relatively low inflation expectations begin to creep higher, this would likely trigger a surprise reaction in the bond markets, causing higher-than-expected yields. Some surprises are welcome, but this development would certainly be an unwelcome one. But for now, enjoy the good times!

Geographic Outlook

Our geographic outlook remains consistent with last year, overweighting Asia and Europe at the expense of Canadian equity and roughly neutral on America. Europe was one of the best performing regions last year and we expect another year of outperformance. After a strong year of equity returns, supplemented by appreciation of the Euro, overweighting the region was a big benefit to unhedged Canadian investors. We are less bullish on the Euro rally continuing as it is beginning to appear over extended, our conviction in the equity rally remains high. These comments could be echoed for Japan. Both economies are in a much earlier phase of the economic recovery when compared to North American equities, particularly on the U.S. side. The differentiation amongst the central banks should further dislocate in the first half of the year, as the ECB and BoJ continue their asset purchase programs, where paradoxically North American central banks are undergoing monetary tightening regimes and expected to raise rates several times over the course of 2018. Much of the tailwind from tax reform appeared to be quickly priced into U.S. equities, further extending valuations. We remained cautious adding to Canada because of the inherent cyclicality in our economy. If we do enter a recession cyclical economies like Canada and the Emerging Markets, could be some of the hardest hit, thus our zero weight in EM. If green shoots of inflation start to percolate in Canada or the U.S., we could see the Central Bank accelerate their pace of rate hikes, which likely would not be good for equity markets.

Chart 4: Global Market Valuations

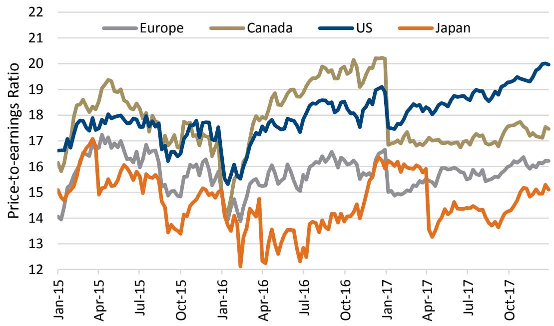
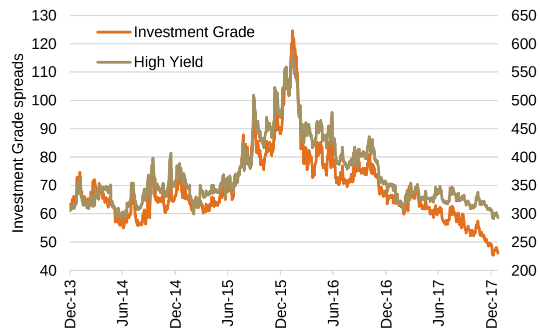


Chart 5: Investment Grade Credit spreads are under 50bps over governments. High Yield is a mere 296bps over.



Fixed Income

We continue to recommend underweighting fixed income, for now. Central banks around the world either are already raising rates or are cutting back on quantitative easing. Later this year we'll find ourselves in a rather uncomfortable situation, one where central banks will no longer be the buyers of last resort. Meanwhile the Fed will continue to shrink its $4 trillion balance sheet. We expect both the U.S. and Canadian bond yields to continue their steady rise through 2018. The 30-year bond bull market may very well be over, but we'll not make such a bold prediction, for now. But it's important to remember why we own bonds – safety. Investors tend to have short memories, but the diversification benefits from having a defensive component of your portfolio are undeniable. High quality bonds remain our diversifier of choice against unexpected shocks to reduce overall portfolio volatility.

We remain cautious of the relative price of corporate credit, which is historically expensive at the moment. Credit spreads for both investment grade and high yield are the narrowest they have been in in many years. While this long bull market has pushed default rates to well below average, investors are not getting paid suitably for the added levels of risk.

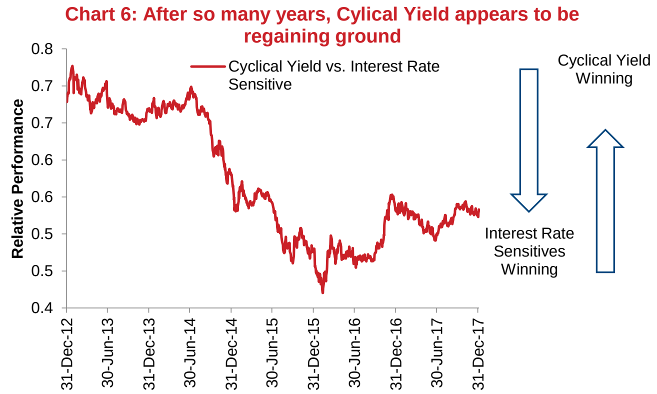
Key Themes

The following are a number of key themes that are based on our macro view of the world today. These themes are put into action through our relative sector/industry over and under weights, and our stock-selection process.

Cyclical yield hitting its stride

Not all dividend-paying companies are the same, and the differences may become increasingly noticeable in 2018. Many dividend-paying companies can be found in industries that are more interest-rate sensitive, such as Utilities, Telecommunications, Real Estate and Consumer Staples. These companies benefit from falling yields, and are at risk should yields move higher. Other dividend-paying companies are what we often refer to as cyclical yield. These types of companies are more sensitive to the economic cycle, benefiting from strong economic activity and less from movements in bond yields. Cyclical yield companies are predominantly in the Industrials, Energy, Information Technology and Financials sectors.

For the past couple years, we have leaned more towards cyclical yield dividend-paying companies and less so on the interest-rate sensitives in the Fund. This has been the right call, as the performance of cyclical yield has been better than interest-rate sensitives over the past couple years. Chart 6 is the relative performance of cyclical yield industries vs interest-rate-sensitive industries, based on each industry's historical correlation to changes in bond yields. When the line is falling, the more interest-rate-sensitive payers are outperforming. When the line is rising, cyclical yield industries are outperforming the interest-rate sensitives.



When things change, the winners and losers often switch positions. From 2010 to 2015, the interest-rate sensitives were outperforming cyclical yield thanks to soft global economic growth and falling bond yields. The bond yields were declining in part due to unprecedented quantitative easing (QE) around the globe. QE is central banks buying bonds to put downward pressure on bond yields. There is some debate as to how much of an economic impact QE had in trying to foster growth. However, there is virtually no doubt that QE inflated asset prices, from bonds to – more notably for us – the 'bond proxies' (i.e., the more interest-rate-sensitive stocks). As QE is now fading across the globe, with the Fed leading by reducing the amount of bonds they hold on their balance sheet, how yields react will likely dictate which types of dividend-paying stocks win in 2018. Declining or even reversing QE around the globe, the Fed raising interest rates, and the strongest synchronized global economic growth we have seen this economic cycle are all in favour of the cyclical yields continuing their recent trend of outperformance vs. the interest-rate sensitives.

Given this view, we will continue to focus more on companies that are less interest-rate sensitive in 2018, and focus more on those that are more levered to the economy.

U.S. dollar

OK, we were wrong on the U.S. dollar in 2017: We remained too bullish with the Fund's allocation near the maximum-allowable U.S. exposure and only used a partial hedge for a portion of the year. Currency detracted approximately 2.3% from performance over the year after going on a wild ride that saw the loonie at 73 cents in May and over 82 cents in September.

The earlier weakness was mainly on the back of Home Capital's troubles and market speculation on cracks in the Canadian housing market. As these near-term fears passed, the Canadian economic data really took a turn to the positive. Meanwhile the U.S. administration's failure to repeal the *Affordable Care Act* injected uncertainty regarding their other initiatives, including fiscal stimulus and tax reform. Better global growth (good for C$), less turmoil in Europe (bad for US$) also contributed to the swings over the year.

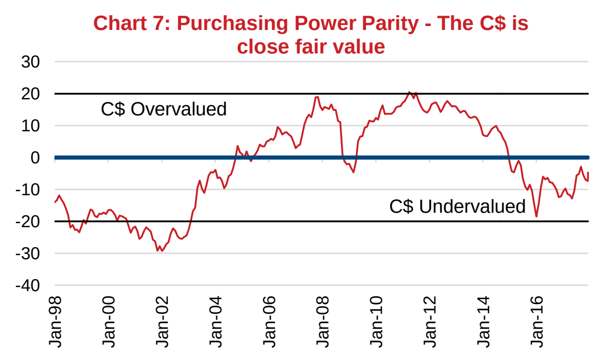


Chart 6 & 7 Source: Connected Wealth, Bloomberg

Now at 80 cents, where do we go from here? In contrast to 2017, when speculators were net short the loonie and net long the U.S. dollar, the reverse is now true. Also from a valuation perspective, based on purchasing power parity (chart 7), the C$ is closer to fair value today than it was a year ago. We could see some more near-term Canadian dollar strength as the Bank of Canada raises rates, but would expect the data to cool as 2018 progresses and comparables become tougher and NAFTA fears to weigh on the loonie. We expect the U.S. dollar to strengthen during the year, or at the very least, additional downside will likely be harder to come by. As we head into 2018, we remain in favour of U.S. dollar exposure.

Final thoughts

We think this year will tell two very different stories. Better economic growth, tax reform, and optimism have this year starting on the right foot, extending the momentum from 2017. This will likely keep equity markets in an upward trajectory, keep a decent bid under commodity prices and lead to some continued softness in the U.S. dollar. However, at some point this narrative may change. The better economic growth will begin showing up in the inflationary data. When it does, expect the Fed to be more active on tightening and other global central banks to really take their respective feet off the QE gas pedals. Higher bond yields would inject volatility back into the market and impact some assets much more than others. We will be sticking more with our cyclical yield theme in the portfolio and reducing interest-rate sensitivity in the coming months.

It should be a good year, with few signs the bull cycle end is near. But it probably won't be the layup 2017 was.

Charts are sourced to Bloomberg unless otherwise noted.