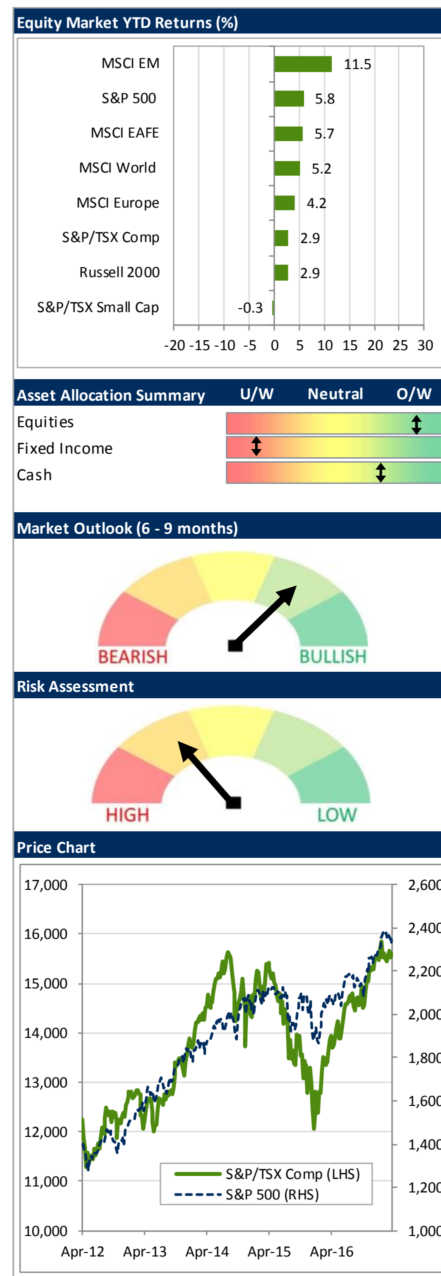
Asset Allocation

PRIVATE CLIENT SOLUTIONS

July 20, 2017

Q3/17 Outlook

- At the beginning and halfway through the year, we survey each member of the IASG to facilitate discussion among the group and to take the pulse of each member. The mid-year survey was consistent with the last survey results in that members continue to anticipate economic conditions to be supportive of equity market gains.
- Political risks and uncertainty continues to grab headlines, although the spotlight shifted from European populism to the political drama/risks playing out in the US. Despite this uncertainty, the market and corporate managers were able to look past the lingering possibilities Congress may fail to enact the pro-growth agenda that was promised with the election of Donald Trump. For all the noise in the marketplace, it was easy to overlook the positives. Globally, purchasing managers' indices (PMI) continue to point to steady economic growth and a recovery in US economic data suggests a reacceleration in H2/17.
- The second quarter was disappointing for the average Canadian equity investor, as our market lagged compared to its developed country peers. The S&P/TSX slipped 2.4% (price return) in Q2/17. One of the more interesting dynamics in the Canadian market last quarter was the performance of almost every sector other than the "Big Three" - financials, energy and materials. Excluding these sectors, which make up 2/3rd of the index weight, the return profile looked completely different as the S&P/TSX would have posted a positive return
- Following our most recent IASG meeting, the group did not change the current asset allocation or regional mix. For a moderate investor we continue to recommend being overweight equities, overweight cash and underweight bonds. As for our regional mix, we continue to see great value in Canadian equities relative to the US. This view is not only predicated on attractive relative valuation, but based on our view that the Big Three sectors are poised to perform well in H2/17. From a relative value perspective, Canadian versus US equities trade more than 2-standard deviations below the 5-year average. In fact, the last time Canadian equities were this cheap relative to the US was in 2008. Further, given the S&P/TSX allocation to energy, the importance of the commodity to the Canadian economy in conjunction with our view that WTI will achieve our year-end average price assumption, we see energy acting as a tailwind for the index. These factors lead the IASG to believe the S&P/TSX, at current levels, will outperform the S&P 500.



Source: Bloomberg, Raymond James Ltd.

Please read domestic and foreign disclosure/risk information beginning on page 6

Raymond James Ltd. 5300-40 King St W. | Toronto ON Canada M5H 3Y2.
2200-925 West Georgia Street | Vancouver BC Canada V6C 3L2.

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Mid-year Survey Results

At the beginning and halfway through the year, we survey each member of the IASG to facilitate discussion among the group and to take the pulse of each member. The mid-year survey was consistent with the last survey results in that members continue to anticipate economic conditions to be supportive of equity market gains. The main takeaways from the mid-year survey include:

- Members anticipate US and global growth to evolve in-line with the consensus view. US 2017 GDP growth is forecast at 2.2% and global growth 3.3%.
- US and Canadian markets will post positive returns in 2017; however, Canadian equities will outperform from current levels.
- Commodity prices will trend higher. In particular, oil price gains will further support earnings growth in H2/17.
- Members believe a moderate investor should remain overweight equities and cash, underweight bonds. Within bonds, there was preference for corporates over governments with a short- to medium-term duration.

In our Q2/17 Outlook publication, the IASG recommended increasing exposure to Canada at the expense of US equities. This recommendation was based on the relative attractiveness of Canada and on the view oil prices would continue to recover. This call has yet to pay off, as Canadian equities underperformed US equities in Q2, although the strength in the Canadian dollar was an unexpected tailwind to this call. We remain committed to the view that Canadian equities will stage a recovery in H2/17 and, thus, outperform the US market.

Q2/17 Asset Returns (in CAD) Total Return

US Equities (S&P 500)	+0.7%
Canadian Equities (S&P/TSX)	-1.6%
International Equities (MSCI EAFE)	+3.8%
Cdn Corporate Bonds	+1.0%
Cdn Government Bonds	+1.1%
Canadian Dollar vs $USD	+2.7%

Source: Bloomberg; Returns as of June 30, 2017

Global Economic Activity

US economic activity during the second quarter was broadly disappointing, but the US Federal Reserve remained steadfast in reducing accommodative monetary stimulus. Despite four consecutive months of disappointing inflation data and a softening in wage gains, US employment trends continue to point to an economy that is approaching full capacity, albeit at a growth rate that is much slower than in past cycles. The temporary slowdown in the US, which has become typical during the first half of the year, appears to have bottomed out early in Q3/17 and leading economic indicators point to a reacceleration in H2/17. The Fed appears increasingly concerned about financial stability and that financial conditions by some measure continue to ease despite a higher Fed funds rate. The Fed's hawkish path remains intact and will only be paused if the outlook changes significantly.

Political risks and uncertainty continues to grab headlines, although the spotlight shifted from European populism to the political drama/risks playing out in the US. Despite this uncertainty, the market and corporate managers were able to look past the lingering possibilities Congress may fail to enact the pro-growth agenda that was promised with the election of Donald Trump. For all the noise in the marketplace, it was easy to overlook the positives. Globally, purchasing managers' indices (PMI) continue to point to steady economic growth and a recovery in US economic data suggests a reacceleration in H2/17.

In Asia, the world's second largest economy showed signs of improvement. Chinese Q2/17 GDP rose 6.9% y-o-y, topping expectations of 6.8% and industrial production also printed better than expected. Credit conditions eased in Q2 as total social financing, an indicator of activity in shadow banking, rose much higher than forecast, inferring that demand for credit remains strong despite efforts to dampening activity in off-balance sheet products. In the near term, the data suggests economic growth momentum remains resilient in the face of government curbs on leveraging, real estate investment, and stricter financial regulations. This is a positive for export economies, particularly those who rely on commodities.

Global PMIs Remain Supportive of Growth

Global PMIs	Current	1 Month Ago	3 Months Ago	6 Months Ago
Global	52.6	52.6	53.0	52.7
U.S.	57.8	54.9	57.2	54.5
Canada	54.7	55.1	55.5	51.8
Japan	52.4	53.1	52.4	52.4
U.K.	54.3	56.3	54.0	55.9
Euro zone	57.4	57.0	56.2	54.9
Germany	59.6	59.5	58.3	55.6
France	54.8	53.8	53.3	53.5
Italy	55.2	55.1	55.7	53.2
Brazil	50.5	52.0	49.6	45.2
China	50.4	49.6	51.2	51.9
Note	<= 50	52 to 50	>= 52	

Source: Bloomberg, Raymond James Ltd.

Canada

The second quarter was disappointing for the average Canadian equity investor, as our market lagged compared to its developed country peers. The S&P/TSX slipped 2.4% (price return) in Q2/17. One of the more interesting dynamics in the Canadian market last quarter was the performance of almost every sector other than the "Big Three" - financials, energy and materials. Excluding these sectors, which make up 2/3rd of the index weight, the return profile looked completely different as the S&P/TSX would have posted a positive return. We attribute this performance divergence largely to weakness in the energy sector given its weight in the index and influence on the broader Canadian economy, a lack of foreign investment interest given potential US trade protectionism measures and the recent issues facing one of Canada's largest alternative lenders which flashed a spotlight on Canada's frothy housing market.

S&P/TSX Sector Returns

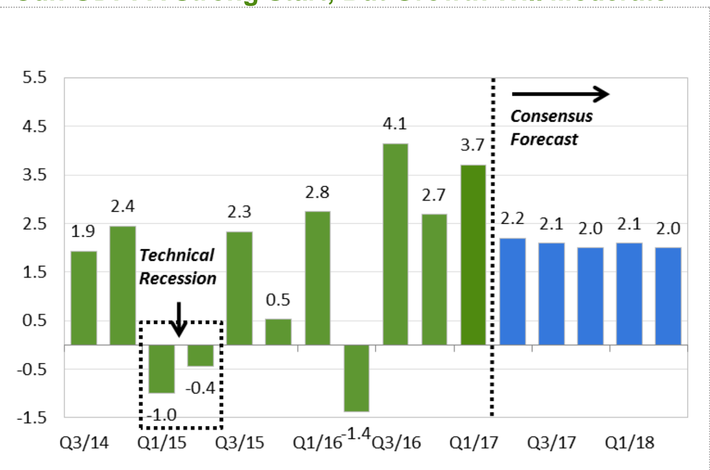
Sector	3-mth Return	1-yr Return	3-mth EPS Change
Consumer Discretionary	4.3%	21.5%	-2%
Consumer Staples	1.4%	7.8%	6%
Energy	-9.1%	-4.5%	-6%
Financials	-1.8%	16.8%	1%
Health Care	13.0%	-21.5%	-34%
Industrials	5.7%	28.2%	2%
Information Technology	2.1%	21.2%	-14%
Materials	-6.7%	-9.0%	-7%
Real Estate	0.0%	-0.7%	NA
Telecom Services	1.4%	2.9%	-1%
Utilities	1.5%	5.8%	-1%
S&P/TSX	-2.4%	7.9%	-1%

Source: Blomberg; Price returns as of June 30, 2017

While these issues may have negatively impacted equity market returns, economic conditions continued to improve during the quarter and were generally much stronger than anticipated. A modest recovery in oil and gas spending, strong consumption growth and residential investment lifted GDP growth to 3.7% in Q1/17, the strongest growth in the OECD. Following two consecutive quarters of strong economic output it understandably became difficult for the Bank of Canada (BoC) to reiterate its cautious outlook on the economy. Toward the end of the quarter, the BoC offered a more hawkish view (in fact we observed subtle shifts from the ECB, BoE, BoC and Fed in what seemed to be a coordinated effort to remove monetary stimulus) signalling the two "insurance" rate cuts that were taken out in 2015 could be reversed in short order. The central bank did indeed raise its benchmark lending rate 25 bps to 0.75% on July 12th citing "robust" household spending which has helped absorb "a significant amount of economic slack".

The BoC, however, must walk a fine line between tightening monetary policy and maintaining the existing accommodative policy to ensure it does not contribute to the very event it wishes to avoid. With higher borrowing costs and recent attempts to cool the housing market, these measures come at a time when there are indications housing is softening. In addition, consumer debt levels are elevated, which will complicate the BoC's forecast for household consumption to significant contribution to GDP growth in 2017. While the BoC is forecast to raise another 25 bps in October there are many headwinds to consider that may derail the rate hike expectations.

Cdn GDP: A Strong Start, But Growth Will Moderate



Source: Bloomberg, Raymond James Ltd.

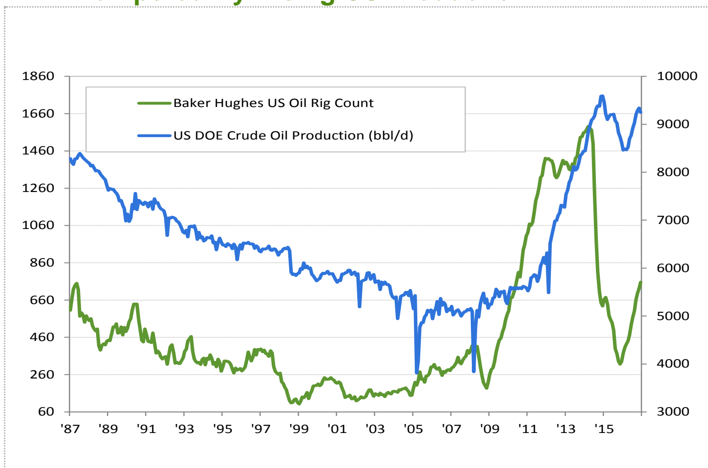
Canadian corporate earnings have remained robust in H1/17 helped largely by the recovery in oil and gas spending, which bounced off of very depressed levels. However, a pullback in commodity prices in Q2/17 resulted in analysts' revisions for the S&P/TSX earnings slipping 1.5% over the past 4-week period. Despite the Big Three sectors' poor performance in H1/17 there are indications of a reversal of fortunes in H2/17. The BoC's recent rate hike will be a positive for financials, particularly the banks' net interest margins. In addition, long-dated yields have also been on the rise, which will benefit insurance operators. As for energy and materials, commodity prices appeared to have bottomed in Q2/17 and if our forecast is correct this will be supportive of earnings growth over the coming quarters.

Commodities

An important driver for Canadian equities is the direction of commodities, in particular oil prices. In our *2017 Outlook Reigniting Growth* we guesstimated that WTI would trade in a

range of US$50-US$60/bbl, with the midpoint obviously being US$55/bbl. WTI averaged US$51.70/bbl in Q1/17 and US$48.18/bbl in Q2/17. We had anticipated larger US inventory drawdowns to occur as we approached summer driving season; however, this behaviour occurred later than we had anticipated. There are many headwinds for oil, including rising US production and the potential for OPEC members failing to adhere to their production agreement; however we continue to forecast WTI prices to move towards the mid-point of the forecast range by year end.

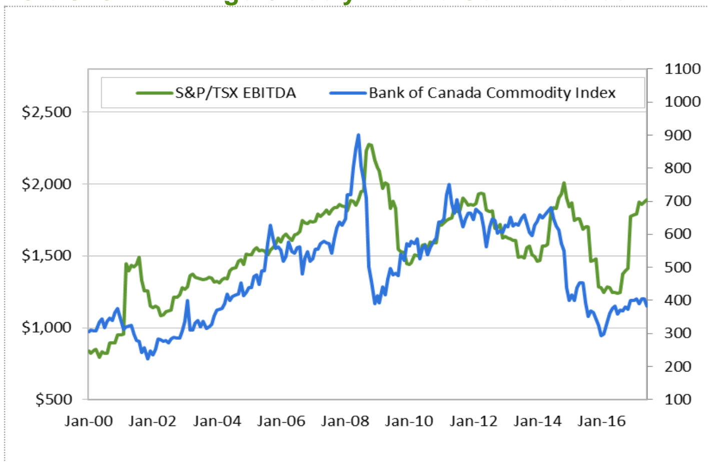
WTI Hampered By Rising US Production



Source: Bloomberg, Raymond James Ltd.

Base metal prices have improved on the back of data coming out of China, as mentioned above. The recent data is supportive of metal prices and given the S&P/TSX's high correlation to commodities we anticipate analysts will begin to markup their earnings estimates. Further, from a sentiment perspective the S&P/TSX may experience multiple expansion amid the improved outlook for commodities.

S&P/TSX Earnings Closely Tied to Commodities



Source: Bloomberg, Raymond James Ltd.

US Recession Check List

We have created a "US Recession Checklist" in the following table that looks at six economic indicators: manufacturing data, unemployment, high-yield spreads, the yield curve, housing starts and consumer confidence. The checklist indicates whether the indicator was in expansionary, recessionary or neutral territory at the onset of the past five recessions. We also illustrate the current readings for each indicator. We believe one of the best indicators at predicting a recession is the yield curve (US 10-year yield minus US 2-year yield). Dating back to 1950 (with the exception of 1967), the yield curve has inverted prior to every recession. As the chart illustrates, the yield curve is currently positively sloping and remains well above the zero bound. We believe the US will continue to experience growth at least into early 2018 and believe the yield curve will remain positively sloping over that period. The risk to our outlook remains geopolitical events, monetary policy and corporate earnings. We believe corporate earnings have been a significant contributor to the market's resilience and we see risks to both the up and downside. The risk to the upside may result from Congress successfully passing a pro-growth agenda, while on the downside rising interest rates and wages may detract from corporate margins. We believe these risks have a greater probability of occurring in 2018.

Overall, while there remains uncertainty in the market, economic activity points to continued expansion. With five of our six indicators in positive territory, we believe the probability of a US-led recession remains low in 2017. Predicting a recession is a difficult game to play; however, our base case is for the fiscal "carrot" that Trump is waving in front of corporate America to sustain economic momentum and equity market returns.

Positively Sloping Yield Curve (US 10-Yr Minus 2-Yr)

Source: Bloomberg, Raymond James Ltd.

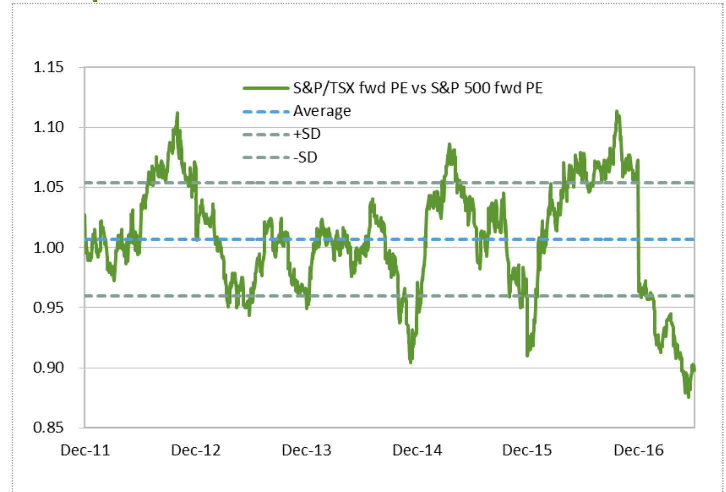
Asset Allocation

Following our most recent IASG meeting, the group did not change the current asset allocation or regional mix. For a moderate investor we continue to recommend being:

- Overweight equities
- Overweight cash
- Underweight bonds

As for our regional mix, we continue to see great value in Canadian equities relative to the US. This view is not only predicated on attractive relative valuation, but based on our view that the Big Three sectors are poised to perform well in H2/17. From a relative value perspective, Canadian versus US equities trade more than 2-standard deviations below the 5-year average. In fact, the last time Canadian equities were this cheap relative to the US was in 2008. Further, given the S&P/TSX allocation to energy, the importance of the commodity to the Canadian economy in conjunction with our view that WTI will achieve our year-end average price assumption, we see energy acting as a tailwind for the index. These factors lead the IASG to believe the S&P/TSX, at current levels, will outperform the S&P 500.

S&P/TSX fwd P/E vs S&P 500 fwd P/E - Canada Cheap Relative to the US



Source: Bloomberg, Raymond James Ltd.

US Recession Checklist	Indicators					
Start of Recession	Manufacturing	Unemployment	HY Spread	Yield Curve	Housing Starts	Cons. Confidence
January 1980	☒	☒	☒	☒	☒	☒
July 1981	☒	☒	☒	☒	☒	☒
July 1990	☒	☒	☒	☒	☒	▤
March 2001	☒	☒	☒	☒	▤	☒
December 2007	☒	☒	☒	☒	☒	☒
Current	☑	☑	▤	☑	☑	☑

☒Recessionary territory; ☑ Expansionary territory; ▤Neutral

Investor Profiles and Asset Class Weightings

Recommended Asset Allocation	Capital Preservation	Conservative	Moderate	Growth	Aggressive Growth
Cash	7%	7%	7%	7%	7%
Bonds	70%	60%	35%	15%	0%
Can Equities	20%	23%	23%	23%	28%
US Equities	3%	10%	20%	33%	35%
Intl Equities	0%	0%	15%	22%	30%
Tactical Asset Mix (Bonds include cash)					
Bonds | Equities	77 | 23	67 | 33	42 | 58	22 | 78	7 | 93
Strategic Asset Mix (Bonds include cash)					
Bonds | Equities	80 | 20	70 | 30	50 | 50	30 | 70	10 | 90
Asset Ranges					
Cash	0-20	0-20	0-20	0-20	0-20
Bonds	60-100	50-90	20-70	10-50	0-30
Equities	0-30	10-50	30-75	50-90	70-100
Description	May be appropriate for investors with long-term income distribution needs who are sensitive to short-term losses. The equity portion of this portfolio generates capital appreciation, which is appropriate for investors who are sensitive to the effects of market fluctuation but need to sustain purchasing power. This portfolio, which invests primarily in fixed-income securities, seeks to keep investors ahead of the effects of inflation with an eye toward maintaining principal stability.	May be appropriate for investors with intermediate-term time horizons who are sensitive to short-term losses yet want to participate in the long-term growth of financial markets. The portfolio, which fixed-income securities tend to make up the largest proportion of holdings, seeks to keep investors well ahead of the effects of inflation with an eye toward maintaining principal stability. The portfolio has characteristics that may deliver returns lower than that of the broader market with lower levels of risk and volatility.	May be appropriate for investors seeking a balance between capital preservation and capital growth. This portfolio, which is a split between fixed-income securities and equities, seeks to keep investors well ahead of the effects of inflation with an eye toward maintaining principal stability. With roughly half of the portfolio invested in a diversified mix of Canadian and international equities, investors should be comfortable with moderate fluctuations in the portfolios.	May be appropriate for investors with long-term time horizons who are not sensitive to short-term losses and want to participate in the long-term growth of the financial markets. This portfolio, which has a higher weighting in equities, seeks to keep investors well ahead of the effects of inflation with principal stability as a secondary consideration.	May be appropriate for investors with long-term time horizons who are not sensitive to short-term losses and want to participate in the long-term growth of the financial markets. This portfolio, which is primarily invested in equities, seeks to keep investors well ahead of the effects of inflation with little regard for maintaining principal stability. The portfolio may deliver returns comparable to those of the broader equity market with similar levels of risk and volatility.

Investment Advisory Strategy Group Members

Jason Castelli, CFA (Chair)
VP and Head of Investment Strategy

Seth Allen
SVP and Portfolio Manager
Private Client Group

Ryan Lewenza, CFA, CMT
SVP and Portfolio Manager
Private Client Group

Andrew Clee, CFA
Mutual Fund/ETF Specialist & Portfolio Manager
Investment Strategy

Patrick Carrington, CFA
VP, Asset Management Services

Rob Mark, CFA
Portfolio Manager
Investment Strategy

Michael Gibbs
Managing Director, Portfolio & Technical Strategy
Raymond James Financial

Phil Kwon
Fixed Income Specialist
Fixed Income & Currencies

Jacob Leibel
VP, Private Investment Management Group

Peter Matter
VP, Product Compliance
Compliance

Harvey Libby
Manager
Fixed Income & Currencies

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