Asset Allocation

PRIVATE CLIENT SOLUTIONS

Investment Advisory Strategy Group (IASG)

October 18, 2018

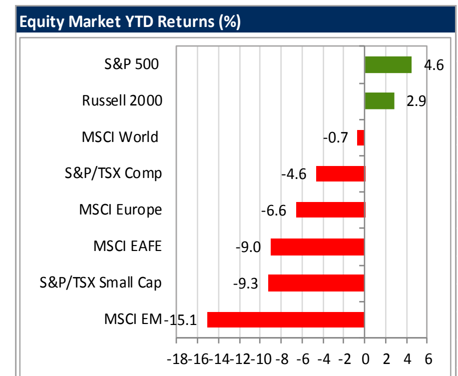
Q4/18 Outlook

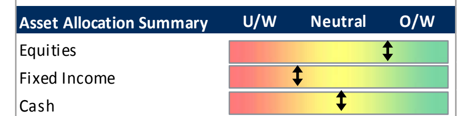
- Global economic activity clearly peaked six months ago as evident by the deceleration in the level of global PMIs, which currently stand at 52.2 versus 53.3 six months prior. The world's largest economy, the US, remained a bright spot despite a modest deceleration in global growth. US employment trends continue to point to an economy moving towards full employment. Over the past nine months, non-farm payrolls gained 205k on average and unemployment rates touched a cycle low of 3.8%. Average hourly wages are trending higher, suggesting inflationary pressures are building within the broader economy.

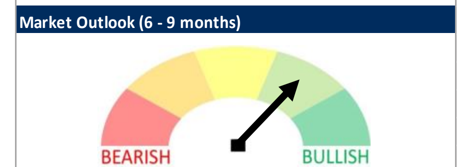
- Ironically, the strength of the US economy has created difficulties for emerging markets. As the US Federal Reserve continues on it path of normalizing interest rates, the US dollar has strengthened creating headwinds for countries that have dollar-denominated debt. Over US$200bln of USD-denominated bonds and loans, issued by emerging market governments and companies will come due during the remainder of 2018, and about US$500bln will come due in 2019. The stronger dollar makes it harder to service the debt and puts additional strain on government finances.

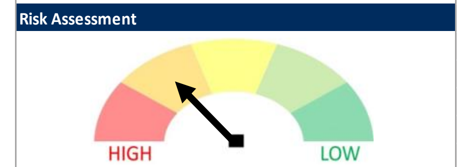
- The S&P/TSX struggled during the third quarter amid a selloff in base metals such as copper, which weighed on our commodity sensitive index. Copper slipped 23% from peak to trough due to concerns China was not doing enough to combat its economic slowdown. The risks to the global outlook also intensified with emerging market economies experiencing additional strain from the strong US dollar and uncertainty from trade protectionist measures. We believe the S&P/TSX has discounted a lot of the bad news we've highlighted in this report. The S&P/TSX trades at 15.0x estimated earnings, a discount to its 10-year average of 15.8x. Despite the headwinds, earnings estimates have held up relatively well.

- The members believe investors should remain overweight equities, but anticipate greater volatility as credit conditions continue to tighten. From this perspective, we believe investors can mitigate this risk by rotating from growth to value and focusing on quality and/or companies with low earnings variability.









Source: Bloomberg, Raymond James Ltd.

Note: U/W = underweight, O/W = overweight

Please read domestic and foreign disclosure/risk information beginning on page 7

Q3/18 Asset Returns (in CAD) Total Return

Asset	Return
US Equities (S&P 500)	+6.0%
Canadian Equities (S&P/TSX)	-0.6%
International Equities (MSCI EAFE)	-0.2%
Cdn Corporate Bonds	-0.5%
Cdn Government Bonds	-1.2%
Canadian Dollar vs $USD	+1.7%

Source: Bloomberg; Returns as of September 30, 2018

Global economic activity clearly peaked six months ago as evident by the deceleration in the level of global PMIs, which currently stand at 52.2 versus 53.3 six months prior. The world's largest economy, the US, remained a bright spot despite a modest deceleration in global growth. US employment trends continue to point to an economy moving towards full employment. Over the past nine months, non-farm payrolls gained 205k on average and unemployment rates touched a cycle low of 3.8%. Average hourly wages are trending higher, suggesting inflationary pressures are building within the broader economy.

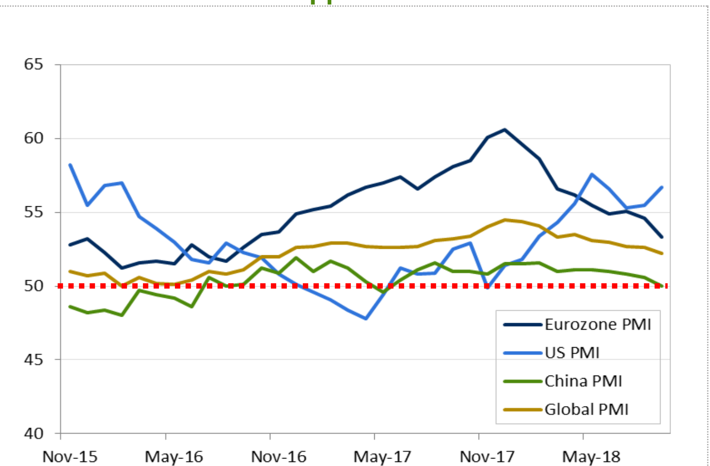
The US Federal Reserve continued on its path to reduce monetary stimulus raising the fed funds rate by 25 bps to 2.25% in September. The Fed also signalled further rate hikes will be warranted; Federal Reserve Chairman Jerome Powell commented that "interest rates are still accommodative, but we're gradually moving to a place where they will be neutral…we may go past neutral, but we're a long way from neutral at this point, probably." The comments imply rates may increase faster than the market had anticipated.

Ironically, the strength of the US economy has created difficulties for emerging markets. As the US Federal Reserve continues on it path of normalizing interest rates, the US dollar has strengthened creating headwinds for countries that have dollar-denominated debt. Over US$200bln of USD-denominated bonds and loans, issued by emerging market governments and companies will come due during the remainder of 2018, and about US$500bln will come due in 2019. The stronger dollar makes it harder to service the debt and puts additional strain on government finances.

Additionally, upward pressure on US interest rates has forced other central banks around the world to follow the Fed. This tightening cycle is occurring at a time when the world's second largest economy, China, is experiencing an economic slowdown. The Chinese government has taken small steps to spur growth, but has yet to act more aggressively. The Shanghai Composite index entered bear market territory in Q2 and continued to slide during Q3. The last time China experienced a material slowdown was in 2015, which caused a ripple effect across global equities. However, the slowdown this year is unlikely to mirror 2015 in our view, assuming trade protectionism measures do not escalate further. There is also the potential that policy makers will react to the slowing economy by announcing additional measures at the Annual Economic Work Conference held in December.

Despite the slower pace of growth, global economic activity remains on a firm footing as PMIs remain in expansionary territory. Recognizing the headwinds to growth, the IMF recently trimmed its global growth forecast for 2018 to 3.7% from 3.9%, while maintaining the outlook for the US at 2.9% in 2018 and reducing the 2019 growth forecast for the US by 0.2% to 2.5% due to the potentially negative implication from trade.

Global PMIs Remain Supportive of Growth



Global PMIs	Current	1 Month Ago	3 Months Ago	6 Months Ago	1 Year Ago
Global	***52.2***	***52.6***	***53.0***	***53.3***	***53.2***
U.S.	59.8	61.3	60.2	59.3	60.2
Canada	54.8	56.8	57.1	55.7	55.0
Japan	52.5	52.5	53.0	53.1	52.9
U.K.	53.8	53.0	54.2	54.9	55.6
Euro zone	53.2	54.6	54.9	56.6	58.1
Germany	53.7	55.9	55.9	58.2	60.6
France	52.5	53.5	52.5	53.7	56.1
Italy	50.0	50.1	53.3	55.1	56.3
Brazil	50.9	51.1	49.8	53.4	50.9
China	50.0	50.6	51.0	51.0	51.0

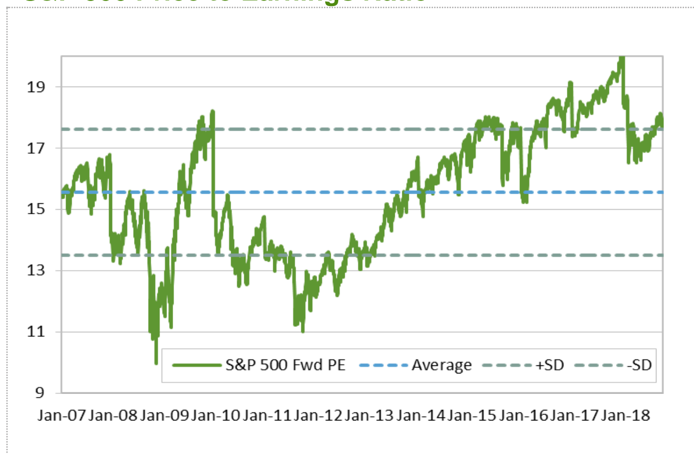
Source: Bloomberg, Raymond James Ltd.

S&P 500 earnings are anticipated to grow 19.2% year-over-year (yoy) for the third quarter. Earnings estimates through Q3 have remained relatively stable, as we typically see earnings revised lower by 3-5%. However, since June 30th, S&P 500 earnings have been revised lower by only 1.1%, even though the number of companies providing negative guidance this quarter has been higher than usual.

As we progress through the quarter, based on historical earnings surprise data, the actual Q3 growth rate will likely be closer to 23% yoy. If the index achieves earnings growth of greater than 20% it will mark the third straight quarter of 20% plus growth, an achievement that typically only occurred as the economy exited the depths of a recession. Obviously, the US corporate tax cuts from 35% to 21%, which were the largest in a generation, has had a meaningful impact on 2018 corporate earnings. While growth will level off in 2019, the regulatory changes implemented in the US may have an even bigger long-term impact on future economic growth and will help to sustain equity markets in the coming quarters.

For the full year 2018, bottom up earnings growth is 20.3% on revenue growth of 8.1%. Looking at calendar year 2019, analysts project earnings growth of 10.4% on revenue growth of 5.3%. From a valuation perspective, the S&P 500 is trading at 17.7x this years estimated earnings, one full standard deviation above its 10-year average. On a forward 12-month basis, the PE ratio is 16.7x, which is above the 5-year average of 16.3x and 10-year average of 14.5x.

S&P 500 Price to Earnings Ratio



Source: Bloomberg, Raymond James Ltd.

Canada

The S&P/TSX struggled during the third quarter amid a selloff in base metals such as copper, which weighed on our commodity sensitive index. Copper slipped 23% from peak to trough due to concerns China was not doing enough to combat its economic slowdown. The risks to the global outlook also intensified with emerging market economies experiencing additional strain from the strong US dollar and uncertainty from trade protectionist measures. On the trade front, the Trump administration followed through with slapping tariffs on an additional US$200 billion of Chinese imports. China responded with its own duties on US$60 billion of US imports. The cumulative impacts of the tariffs still represent a small direct drag on GDP growth, but the back-and-forth nonetheless did little to support global risk appetite. While the S&P/TSX closed the quarter in the red, there were pockets of strength. The best performing sectors, which have had a meaningful impact on the broader index, have been industrials and financials, with minor contributions from heath care, technology, real estate and telecom.

S&P/TSX Sector Price Returns

Sector	3-mth Return	1-yr Return	3-mth EPS Change
Consumer Discretionary	-8.4%	-2.4%	-2%
Consumer Staples	-1.3%	1.0%	-
Energy	-6.6%	-4.2%	-1%
Financials	3.0%	4.4%	1%
Health Care	31.2%	88.9%	-20%
Industrials	5.2%	15.7%	2%
Information Technology	2.9%	29.8%	1%
Materials	-13.2%	-6.9%	-8%
Real Estate	2.6%	10.5%	-
Telecom Services	1.2%	-3.1%	-1%
Utilities	-2.9%	-9.7%	-9%
S&P/TSX	-1.3%	2.8%	-1%

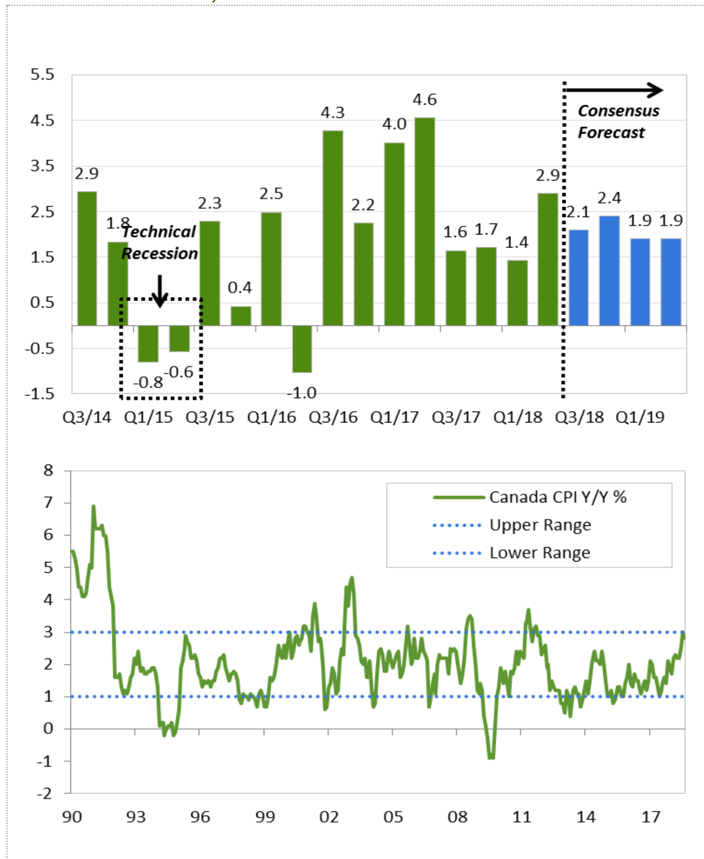
Source: Bloomberg; Price returns as of September 30, 2018

Meanwhile, crude oil prices swung 14% peak to trough during the quarter, averaging US$69.68/bbl; a level which allows many producers to be profitable. However, for Canadian E&Ps, the reality facing the sector was not as rosy. In late August, the appeal court ruled that the Trans Mountain expansion project needed further review by the National Energy Board (NEB). In turn, the federal government has given the NEB a 22-week deadline to reconsider the proposed project in order to take into account the increased marine traffic. The delay further depressed sentiment amid an environment where Canadian heavy crude traded at more than a US$30/bbl discount to WTI and Brent, meaning Canadians are realizing only half the value of our nation's resources. Edmonton Par blend – a benchmark for lighter crude – was selling at just a few dollars less than WTI last year but that differential widened to US$17/bbl. The widening differentials, global growth concerns and ongoing uncertainty over NAFTA weighed on the S&P/TSX Index, which slipped 1.3%, vastly underperforming other developed markets.

Besides the widening differentials, the Canadian economy faces headwinds from a slowing housing market (residential investment currently contributes ~8% of overall GDP, compared to an average of ~6%), weaker consumption growth, higher interest rates and a lack of fiscal policy response to address the growing divergence between Canada and the US. Without clear action to address these growth headwinds, the Canadian

economy runs the risk of slower economic output while experiencing higher inflation. Canadian headline inflation is bumping up against the Bank of Canada's (BoC) upper range and its core measure is hovering at the target level. The BoC anticipates inflation to subside in 2019 as temporary factors owing to higher gasoline prices, the impact of minimum wage increases, newly imposed tariffs and exchange rate pass-through fade. However, we believe the BoC is in a very difficult position of attempting to support growth while at the same time dealing with the inflation outlook. We'll be watching this dynamic closely over the coming months as it may have implications for our investment positioning.

Slower Growth; Inflation on the Rise



Source: Bloomberg, Raymond James Ltd.

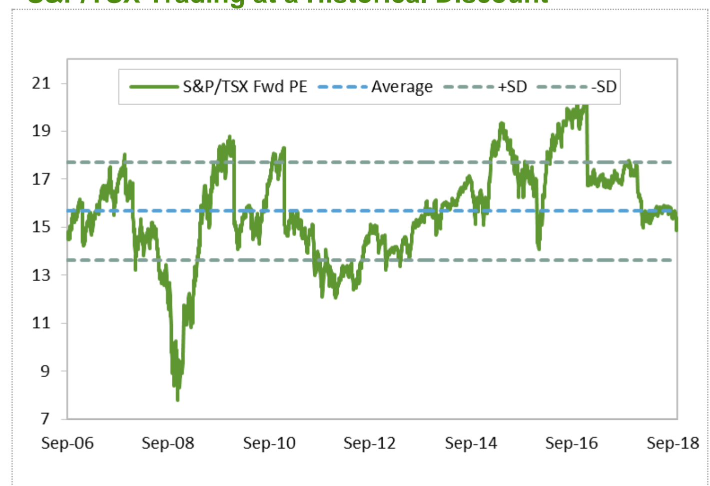
Looking Ahead

The fourth quarter has started on a rather sour note. October has historically been the most volatile month of the year, but the good news is we have entered the seasonally strong period for equities that runs from late October to late spring.

From a historical perspective, following a negative Q3 return, the probability of a positive fourth quarter is 73%, which is slightly better than the average for all Q4s. Interestingly, while the probability of a positive return improves, the average Q4 return following a negative Q3 is +1.9%, which is slightly lower than the average for all Q4s.

We believe the S&P/TSX has discounted a lot of the bad news we've highlighted in this report. The S&P/TSX trades at 15.0x estimated earnings, a discount to its 10-year average of 15.8x. Despite the headwinds, earnings estimates have held up relatively well. According to Bloomberg, for the calendar year 2019 earnings growth rate for the S&P/TSX is 13.1%. So if we assume no multiple expansion and the earnings estimate remains stable, we can foresee the S&P/TSX trading towards 17,400 over the next 12 months. We'll explore this and other forecasts in more detail in our 2019 Outlook.

S&P/TSX Trading at a Historical Discount



Source: Bloomberg, Raymond James Ltd.

US Recession Check List

Our "US Recession Checklist" in the table on the following page shows six key economic indicators: manufacturing data, unemployment, high-yield spreads, the yield curve, housing starts and consumer confidence. The checklist indicates whether the gauges were in expansionary, recessionary or neutral territory at the onset of the past five recessions.

Since the beginning of this year, three indicators have moved from positive to a neutral level – yield curve, inflation and most recently housing. The yield curve has receive a lot of attention given it has flattened 8 bps over the past 3 months. Some have made the argument, including former Federal Reserve head Janet Yellen, that we should not worry about a yield curve inversion. During the Mortgage Bankers Association's Annual Conference & Expo, she said, "I do think there is a reasonable chance that the yield curve may invert as the Fed raises rates…Should the Fed absolutely stop before the curve inverts? I might say this time is different."

The yield curve has been one of the more reliable indicators of an impending US recession. In conjunction with other indicators we believe it would not be wise to ignore the importance of this indicator.

At this pace, the curve may invert in 2019 increasing US recession risks in 2020. However, the timing between the inversion and the end of an economic cycle vary significantly. Since the 1960's the timing between the initial inversion of the yield curve and a recession is between 6 and 24 months, with an average period of just under a year. But, going back to 1978, the S&P 500 has risen ~16% in the 18 months following an inversion of the curve.

Asset Allocation

While IASG members believe a US recession is not a near-term concern, we are cognizant of the fact that some of the indicators we monitor are approaching levels that should warrant more scrutiny. As such, during the quarterly meeting, members discussed the current economic environment within the context of our recession checklist. The members believe investors should remain overweight equities, but anticipate greater volatility as credit conditions continue to tighten. From this perspective, we believe investors can mitigate this risk by rotating from growth to value and focusing on quality and/or companies with low earnings variability. We foresee a change in sector leadership as part of the rotation that will play out over the next few quarters.

Following the IASG's quarterly asset allocation meeting, we maintained the moderate investor profile as follows:

- Overweight equities at 58% (8% overweight)
- Neutral cash at 5%
- Underweight bonds at 37% (8% underweight)

US Recession Checklist

Start of Recession	Indicators: Manufacturing	Unemployment	HY Spread	Yield Curve	Housing Starts	Cons. Confidence	Inflation
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	5%	5%	5%	5%	5%
Bonds	72%	62%	37%	17%	2%
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.

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