

Investment Playbook

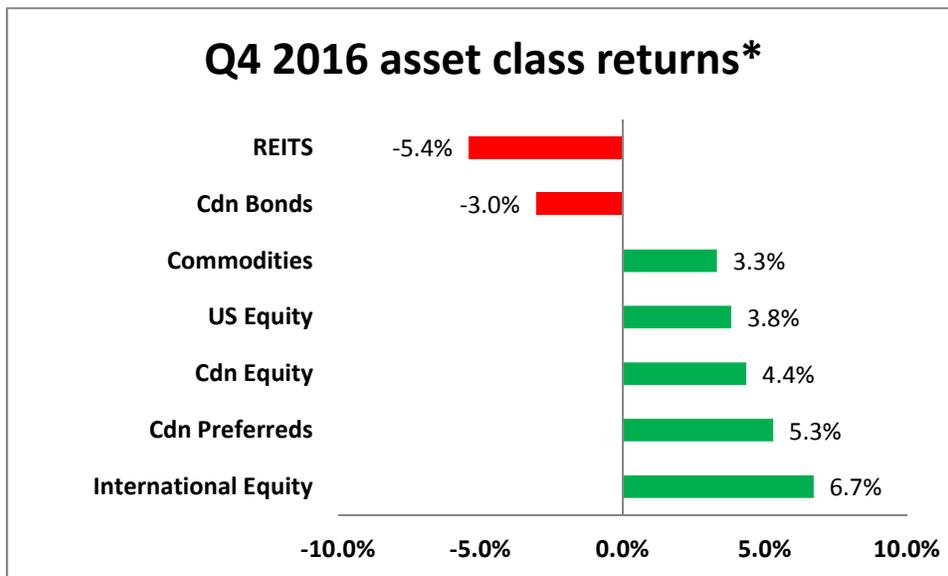


Active Balanced portfolios – Q1 2017

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Source: Bloomberg, as of 12/30/2016

*Commodities = Thomson Reuters/Core Commodity Index, Cdn Preferred shares = S&P/TSX Preferred TR Index, International Equity = MSCI EAFE Index, US Equity = S&P 500 Total Return Index, Cdn Bonds = Bloomberg Canada Sovereign and Corporate Composite Bond Index, REITS = FTSE NAREIT Developed Total Return Index

Global economic outlook (Neutral)

- We expect the US economy to expand by 2.7% in 2017, driven by the consumer. Fiscal spending could disappoint current market expectations and will likely be funded by more government debt.
- Upside inflation risks in the US are driven by Trump's pro-growth policies and potential protectionist measures (border taxes) which could have the Fed hike rates at a faster pace than what is currently priced in.
- Protectionism is the biggest risk to US growth in 2017. If Trump does, in fact, pursue extreme protectionist measures it could derail the US economy in a material way.
- Our outlook for Canadian growth is marginally below average analyst estimates of 1.90%, although we remain more bullish on Canadian business investment and the government sector. Our bullishness for Canadian business investment growth comes in part from improved business sentiment and a bottoming of the resource sector.
- Across the European region, there is uniform improvement in domestic demand. Inflation appears to be gaining traction across core regions. This is especially evident in the UK given the 15% devaluation of the pound since the Brexit referendum. Wages are at risk of lagging broader inflationary measures which poses a risk to the domestic demand driven recovery. Trade remains weak and fiscal policy is seen as relatively neutral across the region.
- In Japan, we see GDP likely to grow at a moderate 1.4% pace, with the assistance of fiscal stimulus and a ramp up in investment ahead of the 2020 Olympics. Inflation will remain in positive territory, but will struggle to even reach the 1% mark unless wage inflation can pick up. Additional monetary stimulus is unlikely over 2017, unless GDP growth or inflation fall below zero.

**Asset class outlook****Government bonds (Neutral)**

- Yields will continue to move up over the coming year, pulled higher by US treasuries due to stronger fundamentals, rising inflation and less accommodative monetary policy.
- After starting Q4'16 near all-time lows, rates rebounded substantially to levels not seen in 18 months and have room to move marginally higher.
- Government driven economic stimulus will likely shift from monetary policy to fiscal policy. US fiscal policy is in the pipeline but could underwhelm market expectations for 2017.
- Investors are less concerned about North American deflation; this is based on commodities rebounding, a weaker dollar (in Canada), and possible protectionist trade policies. We also see upside risks to US inflation with potential offset from a stronger US dollar.
- The risk environment is quiet with markets optimistic in global reflation; however trade protectionism remains a big risk and the new administration in the US will need to be closely watched.
- Divergent Canadian/US monetary policy is topical. The Fed continues along path of gradual tightening with risk of faster pace, BoC on hold for prolonged period. Sovereign yields in both markets continue to look attractive from a global perspective.
- Global monetary policy is likely to be less accommodative: ECB continues to stimulate at a slower pace, BoJ to continue to push aggressive monetary policy, BoE faces dilemma of higher inflation coupled with lower growth.
- Developed world deleveraging and demographic backdrop will continue to keep a lid on interest rates, making it unlikely we will return to the previous cycle highs unless we see a trade war that stimulates inflation, or Trump pushes through a much larger than expected fiscal program at the expense of the budget deficit.
- Trade and protectionist policies from the new US administration remain a large risk to the Canadian economy and the outlook for North American rates. The global follow-through from a trade war could lead to an increase in downside volatility and a subsequent flight to quality, pulling rates lower. It could also lead to a strong increase in inflation resulting in an opposite effect. Additionally, if Trump is able to get his full fiscal program through, it would blow a large hole in the US deficit which lends itself to higher yields. The incoming administration's policy agenda has added a large degree of ambiguity to the annual strategy, however the baseline outlook and the majority of the risks support higher yields.

Corporate bonds (Positive)

- Our investment grade corporate bond recommendation is overweight over the coming 12 months as fundamentals and credit metrics in North American corporations appear to be becoming more stable.
- Credit profiles are improving in the energy sector and non-energy corporations are generally moderating.
- Credit event risk is a key consideration as funding rates remain low. Interest rates moving up too quickly could negatively impact the economy leading to the next credit cycle downturn.



- While the macro global environment continues to be supported by central banks, albeit at a gradually slowing pace, there is a growing emphasis on fiscal stimulus. This along with improved business sentiment in both Canada and the US is expected to be credit positive.
- Credit spreads are expected to continue to be constructive as sentiment continues to lean towards positive technicals.
- The market continues to be very responsive to the supply of corporate bonds.
- The Canadian credit market is benefiting from the impact of low yields in European credit markets.
- Price performance is unlikely to be as broad based in 2017 as it was in 2016. It will be important to be opportunistic in this type of environment.

Equities (Neutral)

- The environment for 2017 will likely be challenged by slower than expected demand. This will lead to flat returns for the year and an increase in equity market volatility. The increase in volatility will help shorter-term tactical trades but makes the strategic outlook on equities more of a challenge.
- Trump's pro-growth policies represent a potential positive change for the US economy and therefore an opportunity for positive equity performance. Consensus views on the impacts of Trump's fiscal stimulus plans are for an increase in GDP growth of approximately 2.2%/2.3% in 2017/2018 in the US.
- Our base case is for Trump's policies to be generally positive although less than consensus. We are closely monitoring signs of positive or negative development in Trump's tax and trade reform, and the potential impacts on US corporations. Should his policies come with little resistance, our earnings growth estimates could be conservative leading to greater upside risk.
- Monetary policy is on a renormalization pathway as rates head higher in many global developed nations, namely the US and the EU, which could be a risk for equities. Still, the pathway will likely be slow going which will help P/E multiples maintain current elevated levels of approximately 17 times.
- After leading global markets higher in 2016, returns on the TSX will likely be somewhat restrained in 2017. The Canadian banking industry offers a potential source of stability while the energy industry continues to struggle with adapting to the new environment of lower energy prices on increased levels of supply. Provided Trump's trade policies do not interfere with Canada's development, TSX performance should benefit.
- In Europe, improving economies could add value to client portfolios as multiples catch up with North American markets. 2016 geopolitical risk helped European equity markets in 2016. This could change suddenly going forward as we view the political landscape as a continued material risk ahead of Germany's and France's national elections.



REITS (Positive)

- Fundamentals remain favourable, however Canadian real estate is nearing a peak and going forward, growth while still reasonable, is not necessarily as bullish for REITs as it was.
- If we see stronger than expected growth in the economy driven by fiscal spending and tax reform we could see higher rates, and an increase in inflation. , In this case the price performance on REITs would lag the broader index, but with a solid income distribution, 1.6% above 10 year treasuries and 2.0% above the S&P500 dividend yield, we are optimistic on the total return and view the return as likely to outperform in our base scenario, while providing more stable returns and lower downside risk.
- Occupancy rates continue to improve, and are now at their highest levels since 2000. While growth is not as robust as it once was, with the exception of industrial properties, increased supply has not been an issue, which has continued to permit rental inflation and net operating income growth.
- Supply may continue to be modest, and fiscal stimulus could lead to increased construction costs.
- Capitalization rates may reach their trough in 2017 given the potential for rising rates, higher inflation, a stronger US dollar, and conservative underwriting given the real estate cycle is in advanced stages. Analyst consensus view higher cap rates as priced into the market, however, which could therefore limit downside risk.
- There is risk that the strengthening USD will curb foreign investment which has been a driver of increased property prices in the past year.
- Since REITs are not taxed as corporations, a decline in the corporate tax rate is of no real benefit. Leading to a potential underperformance on better than expected corporate tax changes.
- REITs have stabilized since their sell-off and offer reasonable upside, although they may lag the 10.8% total return that they have provided between 2002 and 2016.

Portfolio positioning

Asset class	12/31/2016	9/30/2016
Cash	Neutral	Overweight
Government bonds	Neutral	Overweight
Corporate bonds	Overweight	Underweight
Equity	Neutral	Underweight
<i>Canada</i>	Neutral	Underweight
<i>US</i>	Neutral	Underweight
<i>International</i>	Neutral	Neutral
Global Real Estate	Neutral	Underweight

**EAMG Investment philosophy**

The Equitable Asset Management Group investment philosophy follows an asset allocation model, which differs from the more prevalent stock selection approach to asset management. To guide us in our asset class decisions, we employ a macro-driven, top-down investment philosophy which we believe minimizes risk and maximizing returns across the entire asset class spectrum. Our insurance based background offers a conservative and measured approach to return generation that seeks to grow client wealth in a safe and responsible manner.

*Negative, neutral and positive ratings indicate current, not full year views

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