Equitable
Asset Management Group

Investment Playbook

Active Balanced Portfolios – Q4 2017

Content

Economic outlook
Asset class outlook

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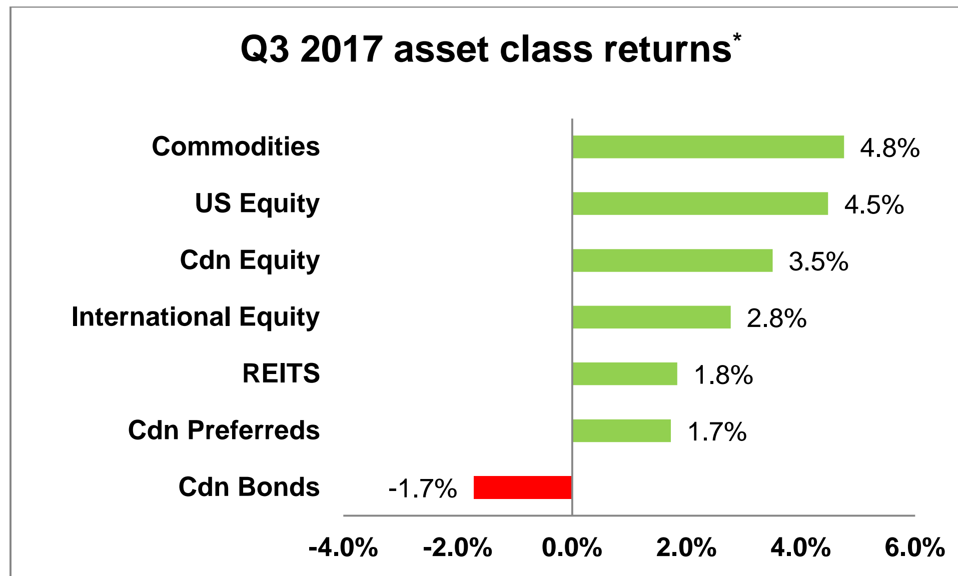

Source: Bloomberg, as of 09/29/2017
*Commodities = Thomson Reuters/Core Commodity Index, Cdn Preferred shares = S&P/TSX Preferred TR Index, International Equity = MSCI EAFE Index, US Equity = S&P 500 Total Return Index, Cdn Bonds = Bloomberg Canada Sovereign and Corporate Composite Bond Index, REITs = FTSE NAREIT Developed Total Return Index

Economic Outlook

- Our outlook for growth is relatively unchanged. Since the last strategy we've seen very strong Canadian growth, with momentum across the board including sizeable contributions from the consumer, trade and business investment, despite a pull-back in housing with the new measures implemented.
- While the strong growth has been encouraging, it is difficult to see the Q2 pace of GDP growth continue over the next four quarters (August GDP print was 4.5%). The Bank of Canada (BoC) has begun its tightening cycle and, with interest rates rising, it is expected to dampen the consumer's enthusiasm.
- Business investment and trade are expected to continue to contribute but it is not yet clear that their contributions are sustainable. The risks are mainly to the downside as debt levels remain at or near historical highs. The outlook assumes that the BoC will remain cautious and move gradually.
- The outlook is also predicated on our oil & gas analysis which suggests oil will remain range bound in the $41-54 range over the next 12 months.
- In the US we had a good Q2 GDP (3.0%) result after a couple of quarters of weakness. The underlying trend hasn't changed though, and we continue to expect growth of 2.25%, with increasing downside risks as we believe we are late in the economic cycle.
- Even though monetary policy is tightening it is from a very accommodative stance. The labour market continues to expand, and solid wage growth and consumer confidence should help support personal consumption.
- Growth has been improving in both Japan and the EU. In Europe, growth continues to be driven by domestic demand with household consumption the largest contributor. Looking forward, we expect strong business investment and personal consumption to drive growth as the economy improves and, with it,

consumer and business sentiment. The strength in the Euro will hurt trade, with no contribution expected over the coming quarters.

- Japanese GDP is likely to grow at a moderate 1% pace, with broad based contributions. The consumer is supported by a solid labour market, and there is continued strength in business investment and trade. Government spending should contribute over time ahead of the 2020 Olympics.
- The risks to growth across the globe are relatively balanced. The emerging markets, including China, have been experiencing stable growth. China has been undergoing a transition towards a consumer based economy less reliant on credit.
- Other emerging markets have seen improving corporate profit margins, strong economic data including PMIs, and reduced expectations of monetary tightening in the US, all of which have contributed to improved stability in these regions. The political environment has created some headline risk, but has not weighed strongly on the markets.
- As discussed previously, the Trump administration presents both upside and downside risks. The downside risks are primarily around protectionism and are of largest impact to the US's major trading partners. Overall this will take time, likely more than previously anticipated.
- Tax reform provides some upside risk to our expectations, largely via increased business investment due to business tax cuts and the potential for a repatriation tax holiday.

Asset Class Outlook

Government bonds (Negative)

- GDP is likely to continue on its 2% annual growth trend, while inflation has likely bottomed and will move up towards the 2% target gradually.
- Both the BoC and Fed are poised to normalize policy. The Fed continues along a path of gradual tightening with the risk of a faster pace. The BoC has removed the 'insurance rate cuts' from 2015 and will look to remove more stimulus.
- Global monetary policy is less accommodative; the ECB continues to stimulate at a slower pace, and the BoJ continues to push aggressive monetary policy, although the BoE is moving towards a tightening bias.
- North American deflation risks are abating; the underlying core inflation picture has been weak for much of 2017 in part driven by temporary factors and central banks are largely looking through the weakness. Wage gains are picking up and market expectations of inflation have room to move higher in the US.
- The risk environment remains benign; trade protectionism is the biggest risk and North Korea remains a wild card.
- While there are multiple fundamental reasons for yields to move higher, there remain arguments that support yields from rising too quickly which include:
    - Sovereign yields in North American markets continue to look attractive from a global perspective.
    - Flows into Canadian sovereign debt markets continue to show strength.
    - Developed world deleveraging and demographic backdrop will continue to put downward pressure on interest rates.

- The resulting Canadian fixed income environment will see yields pulled higher by US Treasury bonds on the back of stronger fundamentals, rising inflation and less accommodative monetary policy.

Corporate bonds (Positive)

- Similar to the last strategy, our credit recommendation is overweight over the long term as global growth, firmer commodity prices and higher bond yields will provide support for spreads to continue to compress, albeit at a slower pace.
- The fundamental backdrop for credit remains largely supportive, given the carry and spread support from an improving macro backdrop and higher government yields.
- These positives are offset by a prolonged credit cycle, consumer risk in a rising rate environment, and nominal spreads near multi-year lows.
- Yields remain sufficiently low that investors need to find extra yield where possible and, absent an external shock, a key source of that extra yield lies within corporates. It continues to be important to be selective in this market, and therefore we favour higher quality credit in this environment.
- Short term technical support will remain, as an overweight position from domestic investors and elevated purchases of Canadian bonds in foreign currencies by international investors will keep spreads lower for the foreseeable future.
- Demand for credit remains strong, but issuance expectations have risen looking toward year-end. As we've highlighted in the past, the same features should continue to play well in the current global macro context; that is, Canada provides a relatively predictable investment landscape, adequate liquidity, large issuers with dominant competitive positions in their markets, and a breadth of investable sectors and issuers across the credit spectrum.

Equities (positive)

- Equity fundamentals remain positive – revenue growth and margin expansion will help support forward views of EPS growth in Canada, the US and Europe. This is generally supported by manufacturing indicators, although export indicators are weak, and retail/consumer indicators are fairly neutral. Economic sentiment is good, especially in Europe.
- Margins in the US accelerated to 9.3% in Q2. Forward expectations of margins are for continued expansion. Capacity utilization and interest rates are supportive of this, although there are signs wage growth is accelerating, especially in Canada.
- Valuations, outside of the low BBB spreads relative to the forward earnings yield, remain expensive, and markets remain highly complacent. Valuation is cheaper in the EU and Canada than for the S&P.
- This, in addition to improving international economies, influences our preference for equities in the EAFE benchmark.
- Overall equities should continue to perform with high single digit returns, making Equities our preferred asset class.

Real Estate Investment Trusts – REITs (Neutral)

- REITs have been one of the best performing sectors since the IPO bubble, registering annual returns of 10.8% between 2002 and 2016 with only two years of negative returns (2007 and 2008).
- REITS have also outperformed the S&P 500 in 11 of those 15 years which highlights the strength of the sector. Dividend yields of 4% remain a key selling point for owning the sector in portfolios.
- Despite the positive past performance, our long-term bias remains neutral as retail REITs struggle amidst concern for some "Anchor" tenants (e.g. Macy's, Sears, etc.).
- While the commercial real estate recovery continues, vacancy rates and rent growth remain reasonable. New construction activity continues to remain below average levels seen during 1993-2008, and may be starting to decline. Overall, lenders are tightening lending conditions for commercial real estate which bodes well for keeping new supply in check.
- While REIT fundamentals remain reasonable, considering the later stage of the commercial real estate cycle we believe we are in keeps us from going overweight the sector.

Portfolio positioning

Asset class	Current view	Previous view
Cash	**Neutral**	**Negative**
Government bonds	**Underweight**	**Neutral**
Corporate bonds	**Positive**	**Positive**
Equity	**Positive**	**Positive**
Canada	**Positive**	**Neutral**
US	**Positive**	**Neutral**
International	**Positive**	**Positive**
Global Real Estate	**Neutral**	**Neutral**

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 maximizes 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.

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