Q4 2015 MARKET OUTLOOK QUARTERLY

The Great Reset

Global equity markets, including Canada and the U.S., ran into a correction over the past couple months that has clearly heightened investor concerns. Continued deceleration of economic growth across emerging markets and the subsequent hit to commodity prices is a big contributor, as is the continued uncertainly around when the Fed will begin to raise interest rates. This correction, while painful, is helping reset valuations and address some of the excesses in the market place.

Given that the majority of economic data continues to point to expansion, albeit slow, this reset may lay a foundation to help markets move higher in the coming quarters.

Key themes

- **Correction, or the start of a bear market?** – This bull market is in year seven, raising concerns the end may be near. Given the majority of our market cycle indicators continue to favor a continuation of the bull, we believe this correction is a buying opportunity.
- **Divergence in the Late Bull stage** – Emerging market economic growth is slowing, this is raising the divergence of economies, monetary policies and markets. At this point we are favoring developed markets over emerging.
- **The crude awakening** – Oil is down below $50/bbl, what are the medium and long term implications across various industries of this dramatic change?
- **Outlook for the Loonie** – Has the C$ reversed or is this a relief rally? We share our views on the Canadian to US exchange rate.
- **Investment implications heading into Q4** – How our analysis impacts our recommendations on asset allocation and portfolio strategies.

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The Great Reset

The third quarter is in the history books and it was anything but a good one for investors. The TSX Composite dropped 8%, the S&P 500 lost 6% while global equities, as measured by the MSCI World Index, declined 8%. Volatility, which had been trending below historical levels for a number of years, spiked higher. Unfortunately, bonds did not come to the rescue of portfolios as widening credit spreads muted the benefits of declining interest rates. The broad bond universe rose a paltry 0.1% during the quarter, which masks wide divergence between the positive performance for government bonds and the negative performance for investment grade and high yield.

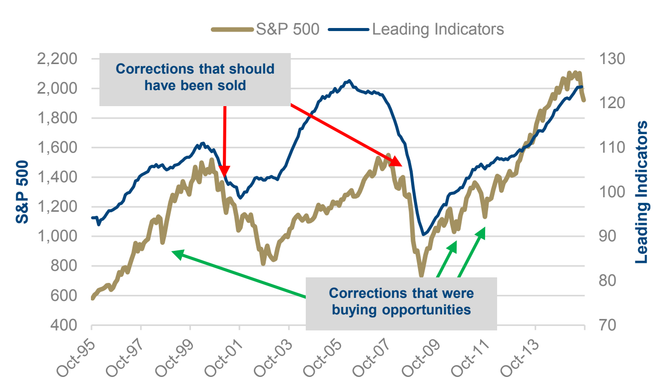
The markets suffered a number of woes both domestically and internationally. The bursting of China's equity bubble has weighed on emerging markets coupled with declining growth prospects for their economies. This did not help commodity prices. Closer to home, the market wrestles with the uncertainty of when, or if, the U.S. Federal Reserve will end ZIRP (zero interest-rate policy) and raise rates for the first time in almost a decade.

The bad news is that the market volatility is not over. Global markets are in correction territory with the vast majority down more than 10% from their recent highs. The good news is the market is sowing the seed for a late bull run. We believe the market moves of Q3 will go down as the great reset. Resetting valuations, expectations and addressing many of the excesses built up during the ZIRP and quantitative easing of the past few years. While painful, and potentially not over, this should create a more sustainable base for a move higher in the markets.

Correction, or the start of a bear market?

First, let's define the difference between a correction and a bear market. Corrections are easy, it is a 10% decline or more in the market from its recent high. A bear market is an event that is obviously a worse outcome for investors. In our view, these are market declines coinciding with an end to the business cycle. Aka a recession. For investing, the simple rule of thumb is if it is a correction then it's a buying opportunity, if a bear market it is not. Telling the difference is the hard part.

Leading indicators support the view the current market weakness is a buying opportunity



Source: Bloomberg

The big differentiator clearly comes down to the economy, the pace of the expansion and, just as important, changing momentum. This is where investors may begin to feel a bit better after the pain of Q3. While economic momentum has softened over the past few months, the data remains largely on the positive side, including many forward looking measures of activity. Plus, at the time of writing the IMF just lowered its global growth forecast. That is actually good potential news as they tend to be rather late to the party when it comes to revisions.

One reassuring indicator is the U.S. Leading Economic Indicators index, which is a basket of ten or so economic and market indicators that tend to move ahead of the economy. This index is still positive and we would highlight how reliable it has been in the past for differentiating between corrections and bear markets (chart). While no rule is perfect, it is best to sell during market corrections when the leading indicators have rolled over and are moving down (red arrows). If they are not or are just a little weaker then it may be an opportunity to buy (green arrows). Clearly the latest data points, with leading indicators still positive, would appear to be lining up like a 'green arrow' scenario.

Based on our market cycle framework, we feel confident the current market is still in the Late Bull phase of the cycle, supporting the view this is a correction, not anything more nefarious. This stage tends to be a difficult, yet rewarding period for investors. Difficult as volatility is higher than normal, and we are betting few would disagree with this assertion given the past quarter. This volatility is driven by greater divergence or variability in economic growth around the world, plus the resulting divergence in yields, currencies and monetary policies. Nevertheless, this phase also tends to have some of the best returns for investors.

Divergence in the Late Bull stage

We are living in diverging world as the much sought after synchronized global recovery remains elusive. There are areas of strength and areas of weakness, which is adding to the volatility across multiple regions and asset classes.

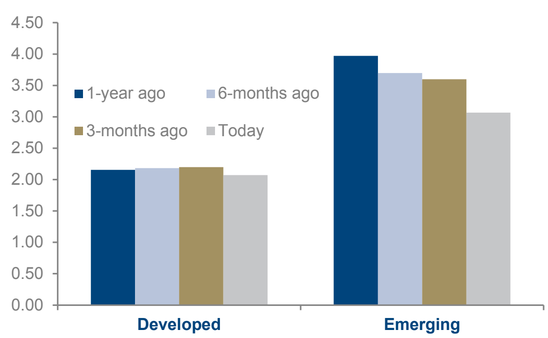
On the strong side, and we are using the world 'strong' loosely, the U.S. economy is perhaps the leader. Growing 0.6% in Q1 and 3.9% in Q2 for an average of 2.2%, the U.S. economy has grown roughly in line with the last five years. Not too exciting until you add in a few additional factors. Consumers have largely delevered their balance sheets, housing represents a historically low portion of GDP growth and employment continues to improve. It is simply a healthier economy. Add to this the benefit of low oil prices, which we believe are slowly making their way through the U.S. and global economies, it certainly appears that gradual growth should remain sustainable for some time, or dare we say even accelerate.

Behind the U.S., things get a little less impressive. The general trend is that most developed economies, including Europe, Japan and Canada, are growing at muted paces. Still, growth is growth. The negatives are primarily coming from emerging economies. Russia and Brazil dropped into recession in 2015. The bigger drag on the global economy likely comes from China, which is still forecast to grow by 6.5% in 2016, but this has been declining. Given the size of their economy and how much they contributed to global growth in years past, the markets tend to be super sensitive to Chinese data.

It really comes down to momentum. Developed economies are growing slower but steadily. Emerging markets are growing faster but tiring.

Despite dramatic underperformance of emerging markets compared to developed markets, there is likely more pain ahead, both absolute and relative. Economic momentum continues to wane, structural problems are on the rise in many economies, and the inevitable rate hikes by the Fed may increase capital outflows. This heightens the risk of a negative tail event for some emerging markets. While valuations are attractive and the long term demographic trends encouraging, we believe investors will see much better entry points down the road. The time to be long emerging markets tends to be early in a bull cycle for the global economy, not in year six.

Emerging growth is fading



Source: Bloomberg

New Reality: Falling oil prices present both short and long-term opportunities

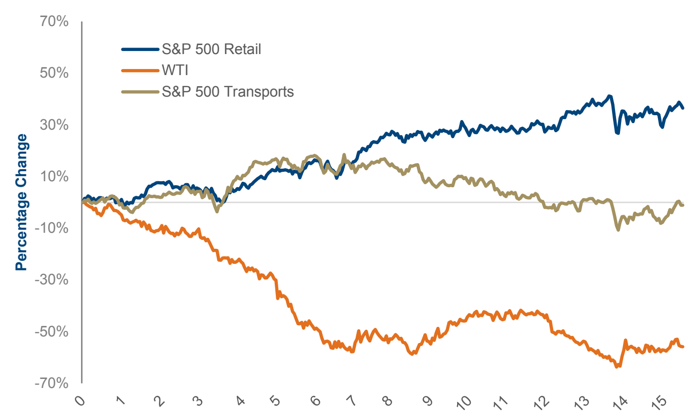
A lot has been written on the new reality facing the global energy market. Gone are the days of 'peak oil', instead producers are facing an unprecedented oil glut. It's a reflection of how technology can reinvent an industry which has been established for over 100 years. Though long-term demand remains in place, the balancing act in the short-term has many moving parts.

Negative returns for energy stocks have weighed heavily on financial markets, something Canadians know only too well. While near-term conditions point to a renewed sense of equilibrium, given the 30% increase in the price of West Texas Intermediate since late August. The market balances primarily by supply adjusting downward toward demand, and this is exactly what has occurred. Due to a 62% reduction in the amount of oil rigs in operation, the U.S. supply levels have fallen to roughly the same level as last December. Demand growth may not rise as fast as previously forecasted as China continues to discover what a soft landing actually means. The outlook of the price remains uncertain, however it is widely viewed that prices should remain *lower for longer*.

The crude awakening

There are far reaching effects of lower oil. Close to sixteen months after the collapse began last July many of the initial opportunities have played through as expected. Consumers have been the big winner, benefiting directly from the oil dividend, a term for the additional disposable income from a reduction in household energy costs. Retailers have been big winners, rising 36.4% in the U.S. For the most part transportation companies have not seen dramatic increases in their stock price over this time. The U.S. Transportation sector is actually down -1.0%. This is the result of two primary factors; 1) revenue loss from transporting less oil (crude by rail) and the fact that many have simply passed along the reduction to their end customers.

Initial demand responses have largely leveled out



Source: Bloomberg

We mentioned in our Jerk report earlier this year "*But we would say the real jerk could potentially be the drop in oil, feeding lower inflation that triggers the market to become concerned about a global economic growth scare, or slowdown. We don't think it would materialize but there certainly could be a brief growth scare.*" Well inflation pressures have certainly eased, bringing down bond yields in the process, and the growth scare is a reality. China received its fair share of the blame, but weakening inflation data did not help either. The U.S. dollar appreciated by over 20%, but has been flat since the end of January.

We've seen a modest improvement in the oil price as the supply side tightens. Though lower demand growth remains a major downside risk to the price forecast, we anticipate demand growth to remain steady compared to current expectations. Given the typical lag in rig count changes in production, we expect production to curtail given that the rig count in the U.S. continues to make new lows.

So now what…

Investors should be pragmatic and focus on what is in their control. You can control your investments to benefit from the spin-off implications of lower oil price for longer. Let's shift our attention to what lower oil price means for your portfolio past short term uncertainty to the long term opportunities.

As mentioned above, the oil dividend acts as a stimulus to the global economy helping to boost growth. We're still digesting the deflationary fears of the impact, and due to time delay we have yet to see the true benefits. Here are some specific thoughts on both real and probable portfolio implications.

Consumers have been the big winner with greater flexibility in personal budgets thanks to the 17% fall in energy expenditures for the average household. Oil price gains and losses across producers and consumers is a zero sum game, the net effect on global activity is a positive.

- **Retailers** have benefited from increased discretionary spending, the easy money has been had, and we anticipate this coming Christmas season will have tougher YoY comps.
- **Restaurants** have and will continue to benefit, particularly fast food chains as it is their customers who feel the biggest impact from cheaper gas prices.
- **Technology**, mainly those who are consumer centric will benefit.
- **Telecoms** will benefit from increased discretionary spending. Rather than goods, consumers may decide to up their service packages
- **Leisure and Lifestyle**, cruise operators, theme parks are positively impacted.
- **Processed food manufacturers** will continue to see a boost to margins, as much of the cost of their goods is devoted to freight and fuel. Cheaper oil leads consumers to spend on discretionary food items. Reduced F/X volatility should also help the multinationals.
- Modestly positive for **car makers**, increased demand for larger, higher margin vehicles.

The oil industry was the second largest payer of dividends after financials. With the challenging commodity space, dividends for some companies cannot be fully funded from free cash flow. Dividend safety is a real and ongoing concern, and yield hungry investors face a real income conundrum. For stability, look to large integrated oil companies and those with proven capital discipline. Also, worth noting that bonds issued by oil and gas producers have slumped, pulling both investment grade and junk bonds lower.

Consolidation, in particular, would present attractive opportunities as higher quality oil and gas companies begin to acquire smaller, more leveraged competitors who need high oil prices to survive. We're starting to see this with the Suncor bid for Canadian Oil Sands. Too early to say if this is the beginning of an M&A push, but it looks to have already added a slight premium to takeover candidates.

By the end of the fourth quarter, the year over year deflationary effects of lower oil and the stronger dollar should dispel the ongoing global deflation fears. If the Fed hasn't hiked rates by that point, we expect the chatter only to increase come January. Inflation pressures will build, and perhaps this is the time when we will see higher bond yields. Financials, particularly insurance companies followed by the banks will be direct beneficiaries of higher rates. Also come 2016, retailers and those who have benefited over the past year will be facing tougher comparables from the year earlier, just as the year-over-year numbers for energy companies might start to look better. Apathy is not a strategy, actively positioning your portfolio to take advantage of opportunities ahead is.

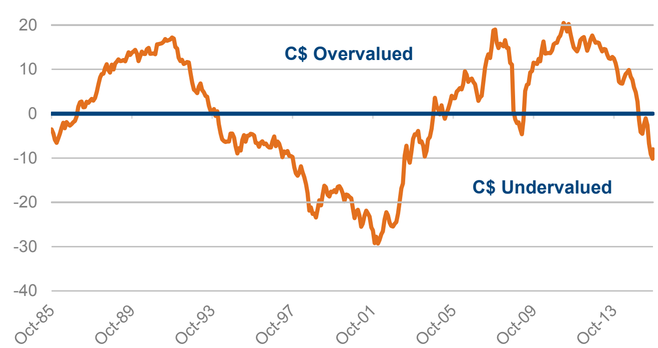
Outlook for the Loonie

The Canadian dollar has lost roughly 20% of its value versus the greenback over the past 12 months as divergence in monetary and GDP growth have weighed on the value of our local currency. The Canadian economy slipped into a technical recession in September after posting two consecutive quarters of negative growth. Low energy prices and a struggling Materials sector have meaningfully slowed the microcosms of mining and drilling communities in Western Canada. Those woes have begun to percolate eastward causing concern for economists and the Bank of Canada. Earlier this year there were hopes that lower gasoline prices for consumers and cheaper feedstock for the Manufacturing sector would offset the downturn in the Commodity complex, so far this has not come to fruition.

In response to the slowing economic growth, Bank of Canada Governor Stephen Poloz made two cuts to the policy rate bringing it down to 0.50%, he has also given future guidance that further cuts are a possibility. This is a dichotomy to expectations for the direction of U.S. monetary policy. Market pundits have long believed that Janet Yellen will hike rates at some point this year. However, softening U.S. economic data, weaker than expected job growth and a struggling Chinese economy have been pushing out the likelihood of this happening. The jobs report on October 2nd seems to have been the tipping point for investors who now believe that there is roughly only a 36% chance of a rate cut at the December FOMC meeting.

This has bucked the trend of a weakening Canadian dollar with the loonie making up nearly a nickel in the first few weeks of October. We have long been overweight U.S. dollar denominated securities in our flex mandates maintaining nearly a maximum weight for the past few years. The overvaluation was evident back in late 2011 with Purchasing Power Parity (PPP) indicating the Canadian dollar was 20% overvalued, this is around the time it was trading above par. The PPP model is now indicating that the loonie is modestly undervalued, however it typically takes time for the actual currency trend to reverse.

We remain near the upper corridor of U.S. exposure despite believing the easy money has already been made. From a medium term perspective, we think there is still another 10% of weakness in the loonie but it could take some time to get back below $0.70 and maintain that level. We continue to overweight U.S. corporations, where allowed, in our Canadian mandates. We also have substantial investments in Canadian corporations with U.S. operations, which benefit twofold from stronger economic growth south of the boarder and higher translated profits.



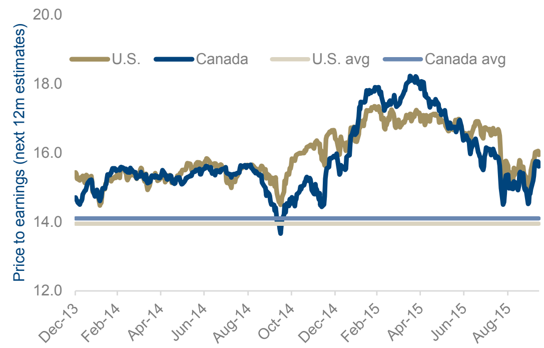
Source: Bloomberg

Investment Implications

Given our economic modeling, we believe this period of market weakness is a healthy correction that is resetting valuations and addressing some of the small excesses that have developed in the markets. A few of these excesses include biotechs, higher momentum industries and growth via acquisition strategies. The valuations are becoming more reasonable, with the S&P 500 price-to-earnings ratio declining from 17.3x in February to 15.5x today. The TSX has followed a similar path with valuations declining from 18.2x to 14.5x. Not cheap but certainly more constructive and potentially more durable to weather soft emerging markets and a Fed hike or two.

Asset Allocation – We continue to be overweight equities and underweight bonds/cash in the current environment as we believe this bull market has more room to run. That being said, our investor profiles have a much greater emphasis on international developed equity markets. The U.S. equity market remains our biggest overweight, currency unhedged as we believe the US dollar has more gains ahead. We also have healthy developed market Asia and European allocations. Canada is a mild underweight given the exposure to commodities and emerging markets.

Valuations have come down



Source: Bloomberg

On the bond side, we remain steadfast and wrong so far, opting to focus on shorter duration and some credit risk exposure. Bond yields have failed to move higher but we also do not buy the deflationary fears that are currently suppressing yields. The drop in oil is having a cascading effect on global inflation, removing previous pressures that were building. As the price drop in oil nears its one year anniversary, we believe this deflationary pressure will soften and some small inflationary pressures may arise. Nothing to get too excited about, but certainly enough to lift bond yields half a point or so. In the meantime, we will remain lower duration.

Adding to Quality - There is a time to own quality and a time to own lower quality. Year six of a bull market, following a correction that lowered valuations across the board makes for a time to focus on quality. While there are a multitude of metrics to decipher quality, in this instance we are highlighting dividend payers relative to the broader market (contrasting the Dow Jones Canada & U.S. Dividend indices with the broader market). It may come as a surprise to some investors, but dividend strategies have been lagging the broader market during the past year in both Canada and the U.S. In the U.S. market, the dividend space has been under pressure of potential higher interest rates and getting hurt by the rising US dollar given greater international operational exposure relative to the broader market. Meanwhile, the market was very momentum driven, including high growth technology and biotechs. The trend has been evident in Canada as well, albeit different factors.

With this relative underperformance, we have added to dividend strategies in our profiles. Relative valuations now favor the dividend payers, with historically less volatility. We believe in the U.S. the currency impact is largely reflected. In Canada, the dividend paying universe is more challenging given many companies are higher risk. However, there are quality dividend payers as well, which we believe are trading at depressed valuations.