Equitable
Asset Management Group

Investment Playbook

Active Balanced portfolios – Q4 2018

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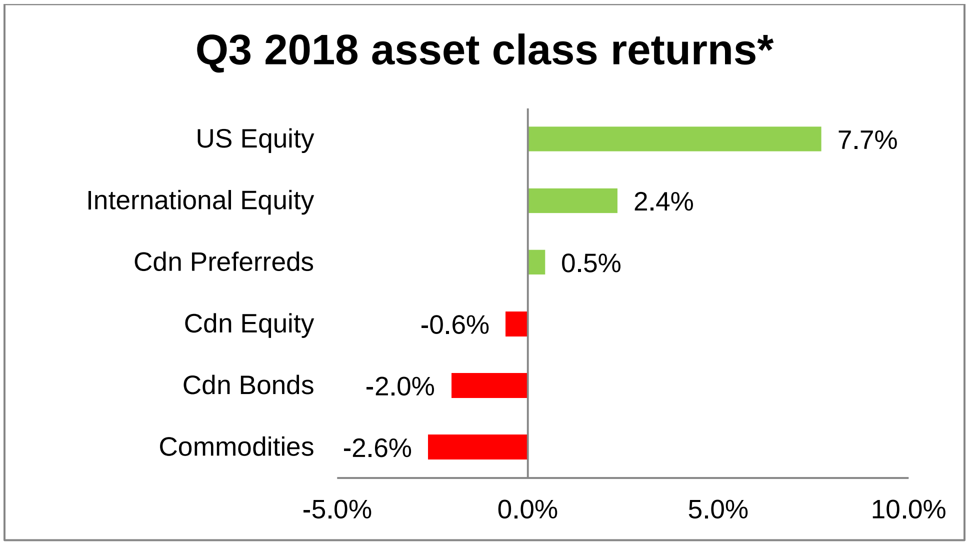

Source: Bloomberg, as of 09/28/2018
*Commodities = Thomson Reuters/Core Commodity Index, Cdn Preferred shares = S&P/TSX Preferred TR Index, International Equity = MSCI EAFE Index, US Equity = S&P 500 Total Return Index, Cdn Bonds = Bloomberg Canada Sovereign and Corporate Composite Bond Index

Economic Outlook:

CANADA:

- The newly announced USMCA (rebranded NAFTA) will undoubtedly help decrease the uncertainty that has been lingering over Canadian businesses and trade over the last year-and-a-half. The Bank of Canada (BoC) is still expected to show its dedication towards a gradual approach to raising rates, but if the data remains strong into the year-end, the BoC may hike more aggressively than previously expected in 2019.
- Despite trade uncertainty, consumer and business confidence has remained decent. The consumer will continue to underpin the expansion, although spending growth will slow markedly from 2017's 3.5% pace.
- Global oil prices have continued to trade in a relatively tight range over the past couple of months as lower demand fears from trade wars have been offset by Iran's supply coming offline. Canadian oil prices trade near historical lows versus WTI due to pipeline constraints and expectations for little relief in the future.
- Overall, GDP is projected to rise over the next four quarters to 2.30%. The drivers of Canada's economy during this time are expected to be the consumer, trade and, potentially, business investment. There are risks to the downside that could affect these drivers including the high leverage of consumers and businesses, US protectionism, US tax cuts hurting Canadian business competitiveness and infrastructure issues around the oil sands projects.

US:

- Our outlook for four quarter forward growth is basically unchanged since the last strategy at 2.5%, with improved expectations from business spending offset by weaker trade expectations. Inflation will continue to tick up, driven by rising wages and input costs but will remain in the 2.3-2.5% range, within the range that will allow the Fed to continue on its gradual hiking path.
- Downside risks continue to increase as business leverage is high, tit-for-tat trade disruptions have the potential to escalate impacting inflation and/or growth, and if consumer confidence deteriorates we could see the savings rate tick up materially as many US consumers remain impacted by the '08 great recession. Our downside scenario would have growth flat line, but this would include solid growth over the coming two quarters offset by negative 2019 GDP as we see the probability that GDP falls off a cliff in the coming quarter as highly unlikely.
- We view the probability of a recession over the coming 12 months as less than 20%, but with each passing quarter this probability is likely to continue to increase.
- The upside could see growth maintain at Q2's 4% pace, and would be driven by very strong business spending, personal consumption and more stable than expected trade.

Asset Class Outlook

Government bonds (Negative)

- Short rates remain poised to move higher, buoyed by central bank policy, while the increase in long rates is likely to be contained by concerns about the sustainability of the economic cycle.
- Central banks are expected to continue tightening over the coming year, with the Canadian economy at or near capacity, reduced trade policy uncertainties and a growing number of firms citing difficulties in hiring in the US market.
- Wage inflation is likely to move up moderately over the coming year further supporting tightening by central banks.
- The cycle is getting late and is one of the longest in recorded history. Further central bank tightening will likely have a much greater impact on the front end of the curve. And while the base case is that the front end of curve will not invert over the coming year, there is a relatively high, and growing, probability that this is not far off, providing support that we are late in the business cycle.
- Resolution regarding NAFTA was welcomed by investors, however trade policy concerns remain between the US and China.

- Periodic flare ups of risk out of Europe around the sustainability of the European Monetary Union continue to worry investors. This is a situation that is likely to continue to crop up and die down over the coming year.
- Large US deficits, and the unwind of the Fed's balance sheet present a further risk that interest rates move higher as supply outpaces demand. Markets are too confident in the Fed's ability to quietly unwind the balance sheet and risk of a policy mistake here will become greater in 2019 as the program unwind increases.
- Markets seem overly optimistic that this cycle will continue. There has been very positive data out of both Canada and the US, while trade policy concerns diminish somewhat and inflation remains contained at the BoC's target. Rates have sold off considerably since the announcement of the USMCA and there is a chance that rates will continue to move higher over the next year as the Fed unwinds its balance sheet.

Corporate bonds (Neutral)

- We believe that the risks continue to increase on a number of different levels. Globally, risks are rising with the ramping up of trade wars, threatening growth and adding inflationary pressure. It is becoming more difficult to have a positive view on corporate spreads over the medium term as the expected excess returns are likely to be low. As further spread widening is likely before the cycle turns.
- Canadian corporate credit has fared better than other credit markets, despite more primary issuance vs last year. More recently, supply has slowed, providing spreads the chance to recover and tighten slightly.
- Over the short term, we remain cautious as corporate leverage remains very high. Defaults are expected to remain relatively low but could quickly change if a catalyst occurs.
- We remain selective with new investments in this type of environment and are moving towards higher quality credit as the end of the credit cycle approaches.

Equities (Neutral)

- With global growth slowing and the US approaching 3.5% on the 10 year yield, equities will remain challenged to generate double digit returns. Demand indicators look supportive of fundamentals but there are risks with respect to strengthening inflation, in particular wages increasing corporate costs. Valuations remain expensive, but are still cheaper relative to bonds. Based on this, we will likely see equities offer a better return profile than bonds, despite the length of this bull market, with mid-single digit returns expected.
- S&P/TSX Composite Index has been hampered by energy stocks as well as a strong US dollar which has created financial stress in emerging markets. Canada also has significant capacity constraints with respect to

pipelines, which accounts for the significant discount in the energy sector. Sentiment toward the energy sector is beginning to improve, however, as some investors, including institutions, are beginning to see greater value in the energy patch.

- The bank sector also has well known challenges, namely real estate and consumer debt, which both continue to elude quarterly financial results as bank business lines continue to post impressive results. For the time being, the fundamentals on the banks look attractive but appear to be priced into their stocks.
- International equities are now in their 10th year of underperformance vs the US and will most likely continue to underperform until we see a new cycle of global growth emerge. Contributing to the underperformance are continued European banking and political woes which will likely remain a headwind for international investors.

Portfolio positioning

Asset class	9/30/2018	6/30/2018
Cash	**Overweight**	**Neutral**
Government bonds	**Underweight**	**Underweight**
Corporate bonds	**Neutral**	**Neutral**
Equity	**Neutral**	**Overweight**
Canada	**Overweight**	**Overweight**
US	**Overweight**	**Overweight**
International	**Underweight**	**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.

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

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