TACTICAL ASSET ALLOCATION COMMITTEE MONTHLY COMMENTARY

JANUARY 2019

FIERA CAPITAL

Global financial markets ended 2018 on a sour note and sentiment remained fragile as deepening pessimism on the state of the global economy and the prospect for a drawn-out US government shutdown overshadowed some signs of optimism regarding US-China trade discussions. In stark contrast to the calm and rewarding market conditions witnessed in 2017, volatility reasserted itself throughout 2018 amid a myriad of global economic and geopolitical developments that stifled risk appetite – with most major asset classes ending the year in negative terrain.

FINANCIAL MARKET DASHBOARD

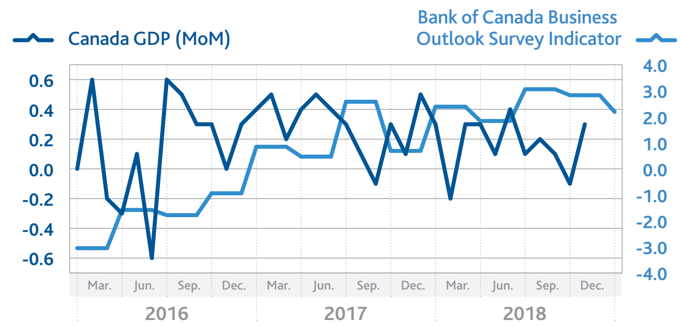
	DEC. 31 2018	DEC.	YTD	1 YEAR
EQUITY MARKETS		% PRICE CHANGE (LC)		
S&P 500	2,507	-9.18%	-6.24%	-6.24%
S&P/TSX	14,323	-5.76%	-11.64%	-11.64%
MSCI EAFE	1,720	-4.96%	-16.14%	-16.14%
MSCI EM	966	-2.92%	-16.64%	-16.64%
FIXED INCOME (%)		BASIS POINT CHANGE		
US 10 Year Bond Yield	2.68	-30.4	27.9	27.9
US 2 Year Bond Yield	2.49	-29.9	60.5	60.5
CA 10 Year Bond Yield	1.97	-30.1	-7.8	-7.8
CA 2 Year Bond Yield	1.86	-29.7	17.4	17.4
CURRENCIES		% PRICE CHANGE		
CAD/USD	0.73	-2.54%	-7.83%	-7.83%
EUR/USD	1.15	1.33%	-4.48%	-4.48%
USD/JPY	109.69	-3.42%	-2.66%	-2.66%
COMMODITIES		% PRICE CHANGE		
WTI Oil (USD/bbl)	45.41	-10.84%	-24.84%	-24.84%
Copper (USD/pound)	2.63	-5.27%	-20.28%	-20.28%
Gold (USD/oz)	1,281.30	5.01%	-2.14%	-2.14%

Global equity markets were hit particularly hard in December. The S&P 500 led the monthly rout and erased its gains for 2018, marking its first negative annual return since 2015 – while the S&P/TSX declined alongside the steep drop in crude prices. The monthly retreat also extended to overseas markets, with political and economic anxieties roiling European bourses, while Japanese equities breached bear market territory as the strengthening yen and global trade anxieties pushed the nation's exporters lower. Finally, emerging market stocks ended December on the defensive but managed to outperform their global peers as attractive valuations and a weaker US dollar lent some support during the month.

Not surprisingly, North American fixed income markets received a safe-haven bid in the otherwise tumultuous trading environment. Global bond yields slid lower as global growth concerns and the precipitous slide in oil prices weighed on inflation expectations. The flight to bond markets was amplified further by the slump in equities, which prompted investors to reduce their wagers for policy normalization in the coming year. Notably, US markets are now expecting that the Fed has all but completed its tightening for this cycle, while Canadian markets are pricing only a 20% chance of a rate hike during the first half of 2019.

In currency markets, the greenback ended the month lower amid reduced wagers for fed fund rate hikes, political strife in Washington, and as President Trump scrutinized Fed Chair Powell for raising interest rates. In contrast, the euro gained after Italy's populist government succeeded in obtaining parliamentary approval for its 2019 budget after several months of intense negotiations, while the Japanese yen was bolstered in the environment of heightened risk aversion.

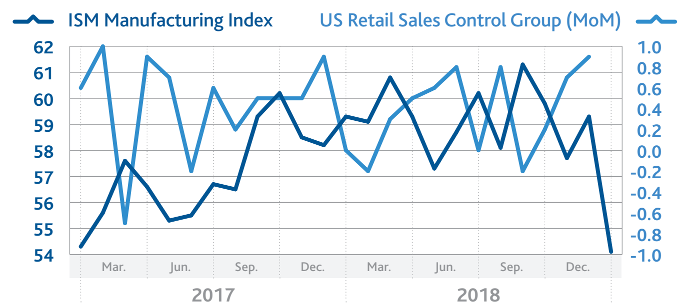
In commodity markets, crude prices slumped even after OPEC and its allies agreed to a larger-than-expected production cut in 2019. Instead, fears of a global supply glut resurfaced on the back of record pumping from American drillers and a corresponding surge in US stockpiles. And after hitting record lows in November, Western Canadian Select prices soared higher thanks to mandated production cuts from the Alberta government, which helped to close the heavy oil differential. Meanwhile, gold thrived in December as turbulent trading conditions stoked demand for the metal as a haven, while copper extended its latest slump as fears of slowing growth in China weighed on the outlook for demand.



The Canadian economy demonstrated some decent momentum heading into year-end, with gross domestic product advancing at a respectable 0.3% pace in October. Meanwhile, the Bank of Canada's Business Outlook Survey overall measure of activity dipped only marginally to a still-elevated 2.19 (from 2.82) and revealed an optimistic sentiment from corporations heading into the new year.

CANADA

The Canadian economy got off to a healthy start to the fourth quarter, with output growing at its fastest pace in five months in October. Encouragingly, gains were fairly broad based across both the goods and services sectors, with 15 out of 20 industries expanding during the month. According to the Business Outlook Survey, corporations remained fairly upbeat at the close of 2018. While indeed acknowledging uncertainty around the impacts of protectionism, expectations for future investment and hiring remained reasonably bright heading into the new year. With mandated crude production curbs in Alberta set to temporarily weigh on growth in 2019 and a non-threatening inflation backdrop, the Bank of Canada is likely to adopt a cautious approach to policy normalization in the coming year.



In the US, renewed strength in the consumer space was met with some worrisome results in the factory sector at year-end. The ISM Manufacturing Index tumbled by the most since October 2008 as factories contend with the trade war, a stronger USD, and softer foreign demand. The good news is that the consumer (70% of US GDP) remains resilient thanks to a solid labor market and healthy fundamentals overall – helping to overshadow lingering headwinds on the factory side.

USA

The US economy revealed some mixed results at the end of 2018. The factory sector lost some momentum in December as manufacturers began to feel the pressures from a softer foreign demand backdrop and the ongoing global trade debacle. Encouragingly, the consumer remains in resilient shape heading into 2019 and should help to compensate for near-term headwinds in the factory space. As widely expected, the Federal Reserve raised interest rates for a fourth time in 2018 – though softened the blow by acknowledging the volatile financial climate and lowered its forecast for 2019 rate hikes. Instead, the Fed opted to take a more data-dependent approach to future normalization, essentially allowing for a pause in 2019 should the global macroeconomic outlook deteriorate further.

While the Chinese economy has indeed slowed over the course of 2018, the good news is that policymakers have ratcheted-up stimulative measures to support growth – with China's central bank cutting the required reserve ratio (RRR) for banks 4 times through 2018. And early activity indicators for December suggest that the downturn is worsening. In response, China's central bank announced yet another reduction in the RRR in early January.

INTERNATIONAL

Economic prospects in China remain highly uncertain heading into 2019. The official manufacturing gauge fell back into contraction territory in December amid persistent trade tensions between the US and China – though the services gauge actually pushed higher. These mixed results suggest that stimulus measures may be taking root on the domestic side of the economy, though some sort of trade deal between the US and China will be needed to alleviate lingering anxieties in the factory space. Indeed, both US and Chinese authorities have cited progress heading into the formal trade discussions in January, while China has also made some important concessions to placate the US (such as pledging to purchase US agriculture products and dropping the retaliatory tariff on US autos).

Our current scenarios are for a synchronized global expansion (60%), which is a continuation of the current environment that benefits equities, trade protectionism (15%), which would be negative for equities and positive for bonds, stagflation (15%) which would be detrimental for both bonds and equities, and finally, geopolitical instability (10%) that would introduce significant financial market volatility.

MAIN SCENARIO
SYNCHRONIZED GLOBAL EXPANSION

PROBABILITY 60%

The global economy continues to grind higher in a synchronous manner, with all major regions contributing to the advance. The US leads the global charge, thanks to widespread momentum across both the consumer and manufacturing space, while the double-dose of fiscal stimulus boosts an already-buoyant economy. Meanwhile, the Canadian economy moderates towards a more sustainable, albeit still above-trend pace. Finally, policymakers in Europe and Japan ultimately prove successful in reflating growth, while emerging market economies prosper in the environment of improving global demand, ample liquidity, and rising commodity prices. Taken together, the lucrative combination of synchronized global growth and a revival in commodity prices should bolster inflation expectations across the world, though not to levels that would threaten the status of the economic recovery. This reflationary backdrop bodes well for equities and commodities (ex-gold) at the expense of fixed income and the US dollar.

SCENARIO 2
TRADE PROTECTIONISM

PROBABILITY 15%

The biggest risk to our base case scenario is a rise in protectionism stemming from the US and the threat of a trade war that would derail the synchronous global expansion. Specifically, President Trump's rhetoric on protectionism has translated into action ahead of the midterm elections, with the US imposing tariffs on a variety of imports including solar panels, washing machines, steel, and aluminum – which have been met with retaliatory measures from some of America's closest allies in response. Mr. Trump has since upped the ante by imposing tariffs on a total of $250 billion worth of Chinese goods (of which China has retaliated), while threatening to slap tariffs on an additional $267 billion of imports as well as levies on global auto imports – which would be detrimental for trade flows and the global economy alike. In this scenario, anti-trade rhetoric in the US becomes a reality and results in tariffs being imposed on economies such as China, Canada, Europe, Japan and Mexico, with further retaliation igniting a full-blown global trade war.

SCENARIO 3
STAGFLATION

PROBABILITY 15%

After an extended period of undershooting central bank inflation targets, policymakers tolerate higher inflation (overshoot) and monetize inflation by letting the economy run hot. As a result, inflation expectations start to de-anchor from current subdued levels and surge higher. This would come at the same time that fiscal stimulus is being reigned-in (2020) in the later stages of the economic expansion, causing growth to moderate to well below potential levels in response. In the Stagflation scenario, a stagnation in growth occurs concurrently with an acceleration in inflation as a result of previous excessive monetary stimulation and an exhaustion of productive capacity - creating a tumultuous financial market landscape whereby both equities and bonds experience broad based declines.

SCENARIO 4
GEOPOLITICAL INSTABILITY

PROBABILITY 10%

Political upheaval in Europe and vulnerabilities in the emerging world could ignite a crisis in confidence – disrupting the global economy and financial markets alike. Specifically in Italy, the Five Star and League parties have formed a coalition government with Eurosceptic tendencies, with plans to expand fiscal policy that would go against the fiscal rules and threaten the relationship with the European Union – which risks throwing the region into political disarray at the same inopportune time that a lack of progress in Brexit negotiations has raised the odds of a "hard Brexit" scenario. Meanwhile, emerging market economies remain susceptible to a strengthening greenback, particularly those countries with high levels of external debt. An increase in debt-servicing costs raises default risks and capital outflows for the weaker links, with the potential for contagion to spread more broadly across the developing world.

FORECASTS FOR THE NEXT 12 MONTHS

SCENARIOS	DECEMBER 31, 2018	SYNCHRONIZED GLOBAL EXPANSION	TRADE PROTECTIONISM	STAGFLATION	GEOPOLITICAL INSTABILITY
PROBABILITY		60%	15%	15%	10%
GDP GROWTH (Y/Y)					
Global	3.50%	4.00%	2.00%	2.75%	3.00%
Canada	2.20%	3.00%	0.50%	2.75%	1.00%
U.S.	3.00%	3.50%	1.00%	2.75%	1.00%
INFLATION (HEADLINE Y/Y)					
Canada	1.70%	2.50%	1.50%	3.00%	1.50%
U.S.	2.20%	2.50%	2.00%	3.00%	1.75%
SHORT-TERM RATES					
Bank of Canada	1.75%	2.25%	1.00%	2.00%	1.25%
Federal Reserve	2.50%	3.00%	2.00%	2.75%	2.25%
10-YEAR RATES					
Canada Government	1.97%	3.00%	1.40%	3.80%	1.70%
US Government	2.68%	3.40%	2.25%	4.25%	2.00%
PROFIT GROWTH (12 MONTHS FORWARD)					
Canada	12.6%	8.4%	-17.7%	6.4%	-12.9%
U.S.	7.6%	8.6%	-11.3%	-0.7%	-10.0%
EAFE	5.5%	3.7%	-14.8%	-11.1%	-18.5%
EM	10.0%	20.3%	-21.8%	-9.8%	-21.8%
P/E (FORWARD 12 MONTHS)					
Canada	12.3X	15.0X	15.0X	13.0X	14.0X
U.S.	14.4X	16.5X	16.5X	16.0X	16.0X
EAFE	12.1X	15.0X	13.0X	13.0X	13.5X
EM	10.6X	13.0X	11.0X	11.0X	11.5X
CURRENCIES					
CAD/USD	0.73	0.80	0.70	0.80	0.72
EUR/USD	1.15	1.20	1.10	1.10	1.00
USD/JPY	109.69	110.00	100.00	120.00	100.00
COMMODITIES					
Oil (WTI, USD/barrel)	45.41	75.00	40.00	80.00	45.00

MATRIX OF EXPECTED RETURNS

SCENARIOS	SYNCHRONIZED GLOBAL EXPANSION	TRADE PROTECTIONISM	STAGFLATION	GEOPOLITICAL INSTABILITY
PROBABILITY	60%	15%	15%	10%
Money Market	2.0%	1.4%	1.9%	1.5%
Canadian Bonds	-3.4%	7.1%	-9.4%	5.4%
Canadian Equity	17.3%	-11.0%	-0.2%	-12.0%
U.S. Equity	5.6%	-1.4%	-6.4%	-5.8%
International Equity	11.9%	-9.0%	-16.9%	-12.1%
Emerging Market Equity	23.4%	-22.4%	-21.7%	-21.2%
Real Assets	7.0%	5.0%	5.3%	5.5%

CURRENT STRATEGY[1]

	MINIMUM	BENCHMARK	MAXIMUM	STRATEGY	ALLOCATION	RELATIVE
Money Market	0.0%	5.0%	25.0%	Underweight	0.0%	-5.0%
Canadian Bonds	5.0%	25.0%	45.0%	Underweight	5.0%	-20.0%
Canadian Equity	10.0%	20.0%	30.0%	Overweight	25.0%	+5.0%
U.S. Equity	0.0%	10.0%	20.0%	Underweight	5.0%	-5.0%
International Equity	0.0%	10.0%	20.0%	Underweight	5.0%	-5.0%
Emerging Markets Equity	5.0%	5.0%	15.0%	Overweight	15.0%	+10.0%
Real Assets	5.0%	25.0%	45.0%	Overweight	45.0%	+20.0%

[1] Based on a 100 basis point value added objective. The benchmark employed here is based on a model portfolio and for illustrative purposes only. Individual client benchmarks are employed in the management of their respective portfolios.

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EVOLUTION OF STRATEGY[1]

	MONEY MARKET	CANADIAN BONDS	CANADIAN EQUITY	U.S. EQUITY	INTERNATIONAL EQUITY	EMERGING MARKETS EQUITY	REAL ASSETS
October 5, 2011	+7.0%	-15.0%	+8.0%	0.0%	0.0%	0.0%	0.0%
October 12, 2011	+6.0%	-10.0%	+4.0%	0.0%	0.0%	0.0%	0.0%
November 11, 2011	+5.0%	0.0%	0.0%	0.0%	-5.0%	0.0%	0.0%
December 7, 2011	0.0%	0.0%	+5.0%	0.0%	-5.0%	0.0%	0.0%
April 20, 2012	+15.0%	-20.0%	+10.0%	0.0%	-5.0%	0.0%	0.0%
July 31, 2012	+20.0%	-15.0%	0.0%	0.0%	-5.0%	0.0%	0.0%
November 9, 2012	+10.0%	-15.0%	+10.0%	0.0%	-5.0%	0.0%	0.0%
February 19, 2013	+5.0%	-15.0%	+10.0%	0.0%	0.0%	0.0%	0.0%
August 6, 2013	0.0%	-15.0%	+10.0%	+5.0%	0.0%	0.0%	0.0%
December 3, 2013	+10.0%	-15.0%	+5.0%	0.0%	0.0%	0.0%	0.0%
February 5, 2014	0.0%	-15.0%	+10.0%	+10.0%	-5.0%	0.0%	0.0%
October 14, 2014	0.0%	-20.0%	+5.0%	+10.0%	+5.0%	0.0%	0.0%
November 14, 2014	+10.0%	-20.0%	+2.5%	+2.5%	+5.0%	0.0%	0.0%
July 13, 2015	0.0%	-20.0%	+7.0%	+4.0%	+9.0%	0.0%	0.0%
October 19, 2015	0.0%	-20.0%	+11.0%	+0.0%	+9.0%	0.0%	0.0%
June 24, 2016	+9.0%	-20.0%	+11.0%	+0.0%	+0.0%	0.0%	0.0%
July 12, 2016	0.0%	-20.0%	+15.0%	+0.0%	+0.0%	+5.0%	0.0%
July 27, 2016	+5.0%	-20.0%	+12.5%	+0.0%	+0.0%	+2.5%	0.0%
October 31, 2016	0.0%	-20.0%	+12.5%	0.0%	0.0%	+7.5%	0.0%
April 5, 2017	+5.0%	-15.0%	+7.5%	0.0%	-5.0%	+7.5%	0.0%
December 6, 2017	+15.0%	-15.0%	+5.0%	-5.0%	-5.0%	+5.0%	0.0%
October 9, 2018	+15.0%	-15.0%	+5.0%	-10.0%	-5.0%	+10.0%	0.0%
November 9, 2018	0.0%	-20%	+5%	-10%	-5%	+10%	+20%
December 17, 2018	-5.0%	-20%	+5%	-5%	-5%	+10%	+20%

[1] Based on a 100 basis point value added objective.

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