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ECONOMIC & GEO-POLITICAL BACKDROP | GLOBAL GROWTH OUTLOOK REMAINS SOLID

Canadian economic growth has returned to a more sustainable pace, growing a reported 2.1% in Q3 and an estimated 1.9% in Q4. Personal consumption in Q3 moderated due to higher interest rates and a diminishing wealth effect from a slowdown in house price appreciation, coupled with lackluster stock market returns. In fact, a good portion of the economic expansion in Q3 came from a reduction of imports (lower imports boosts net exports, raising GDP growth). Residential housing remains a drag on growth, but net exports, government spending, and business investment have been solid contributors.

The unemployment rate in Canada remains near the lowest on record at 5.9%, while the low labour participation rate leaves room for more people to enter the work force. Wage growth this year has been distorted by the large minimum wage increase in Ontario that began in January. Wage growth peaked at 3.9% in May and has moderated each month to just 1.5% in November. The strong economy and low unemployment rate has not resulted in the rate of wage growth that would ordinarily be expected. Retail sales, excluding volatile auto and gas purchases, for the most recently reported month of October was lower than back in July.

Core inflation has been consistent at 1.9% over the past few months. **With the economy performing well, the Bank of Canada (BoC) raised its administered overnight interest rate to 1.75% in October, its third hike of 2018.** Raising the administered rate at this point prevents the economy and inflation from overheating and moves the BoC closer to the long-term neutral level of 2.5% to 3.5%. This gives the BoC more room to cut and stimulate growth in the next downturn. Canada has its challenges heading into 2019, including energy-price headwinds and slowing housing markets in Vancouver and Toronto. However, the new year will see the start of construction of the Canada LNG (liquified natural gas) project, completion of Enbridge's Line 3 replacement project, expected strong economic growth in the United States, and a Federal election in October.

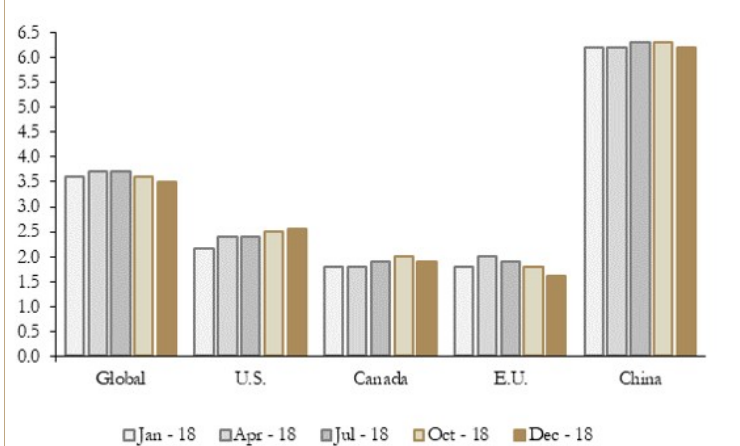
U.S. ECONOMY

The United States economy is performing well, with reported Q3 growth of 3.0% and forecasted Q4 GDP growth of 3.1%. The tax changes that took effect at the start of the year have boosted economic growth, but are one-time in nature. As this stimulus fades, economic growth should return to natural levels closer to 2%. The growth forecast for 2019 is a healthy 2.6%.

The U.S. labor market remains tight, with nonfarm payrolls adding an average of 170,000 jobs in each of the past three months. Adding 150,000 jobs per month will help keep the cycle going, while adding over 200,000 would be a very rapid pace. The unemployment rate continues lower, with the most recently reported number of 3.7% at the end of November. Participation in the job market for working age individuals is still low, leaving room for more people to enter the workforce, likely encouraged by higher wages. **Most recently, U.S. wages have grown 3.1% year-over-year, the highest level since before the financial crisis.**

The U.S. consumer price index (CPI) is above the Federal Reserve's 2% target, as is the core, ex-food and energy, measure. However, the Fed's preferred measure of inflation, the personal consumption expenditure (PCE) core price index, declined in Q4 to 1.85%, from a peak of 2.04% in July. The U.S. Fed raised its administered interest rates for a fourth time this year in December, with the upper bound now at 2.50%. The Fed has reached a goal of being at the bottom end of the estimated long-term neutral rate of 2.5% to 3.5%. We believe the U.S. economy will continue to perform well, with further interest rate hikes likely.

FIGURE 1: EVOLVING 2019 GROWTH GDP FORECASTS



Source: Bloomberg

The U.S. political environment will continue to be noisy in 2019. With the change of control in the House of Representatives, the Democrats will have more power to oppose Republican President Trump. Funding the Federal budget and the debt ceiling will be key issues, in addition to foreign trade and legal investigations, as the political parties ramp-up for the 2020 Presidential election.

EUROPE & CHINA

The economic growth environment in Europe has slowed with forecasted Q4 growth of 1.4%, following 1.6% in Q3. Growth in 2019 is forecasted to be 1.6%, but with considerable uncertainty. Positively, the labor market continues to improve, with the unemployment rate declining to 8.1% at the end of October. Most recent data for wage growth in Q3 was 2.4%, the highest since 2009. **The European Central Bank (ECB) finished its quantitative easing (QE) program of buying long bonds as of December 31st, ending a multi-year policy.** The ECB remains far from raising interest rates, which sit below zero, and forecasts the first hike in the summer of 2019. Core inflation remains weak around 1%, below the 2% target.

The Chinese economy has been in flux recently, with the government taking steps to stimulate growth to reach targeted levels. Q4 GDP growth is forecasted at 6.4% down marginally from Q3 reported at 6.5%. Strained trade activity with the U.S. has hurt the economy, but China has been making adjustments to improve relations.

While expectations for 2019 global economic growth have moderated slightly this year (Figure 1), we remain confident that growth will remain solid.

EQUITY MARKETS | SENTIMENT OVERSHADOWS FUNDAMENTALS

A modest softening of global economic growth expectations, and increasing uncertainty related to both U.S.-China trade and broader U.S. government policy, led to a repricing of global equity markets. Fourth quarter equity benchmark returns were in the red, with Canadian and Global indices returning –10.1% and –8.7% (-13.3% in USD terms), leading to full year prints of –8.9% and –0.2% (-8.2% in USD), respectively.

While the aforementioned concerns regarding growth and political uncertainties may lead to a tempering of corporate earnings outlooks, we note that the U.S. market has already priced in some reduction in future earnings potential. Forward twelve-month consensus earnings estimates remained essentially flat through the fourth quarter of 2018 (a minor disappointment as estimate revisions ideally should trend higher as the quarter rolls forward). However, the valuation multiple assigned to those forward earnings fell by about 14% from the start of the quarter (Figure 2). Consensus earnings expectations do not adjust in real-time and some revisions are to be expected in the new year. Still, we do not see any broad fundamental reasons for estimates to retrace to levels that would indicate an unattractive risk/reward scenario for equities.

Recently released corporate outlooks acknowledge the near-term macro challenges, but so far most are only modestly tweaking medium-term growth expectations. For example, 3M, a multi-national company with wide exposure across the industrial, healthcare and consumer end-markets, hosted an investor day in mid-November and provided medium-term growth outlooks that were consistent with growth in 2018. This signaled that the company does not yet see a significant deterioration in fundamentals.

Another illustration of the risk-off nature of the quarter was captured by the performance of the various industry sectors of the global equity markets (Figure 3). Generally, non-cyclical sectors outperformed the cyclicals, with valuations contracting to multi-year lows for the cyclicals in some instances. Outside of company specific catalysts, any one of concrete progress on the U.S.-China trade file, a lack of further yield curve flattening or a less fractious political environment may serve to unlock the fundamental value in equities.

GLOBAL MARKETS

As previously noted, Global equity markets performed poorly in the quarter with defensive sectors outperforming, in part due to concerns over a deceleration in earnings growth. Geographically, the trade-exposed countries such as the U.S., Germany, and Japan lagged the broader index. **Although there are several factors that contributed to recent growth concerns, it's important to note that a deceleration in growth is not the same as negative growth.** The global economy experienced a very strong acceleration in growth expectations through early-2018, which proved difficult to sustain. However, as previously indicated, corporate outlooks remain optimistic, and in general hiring intentions and capital expenditure plans are broadly unchanged. In addition, interest rates for long-dated government bonds declined meaningfully during the quarter, providing some tailwinds for 2019. Furthermore, valuations have become very compelling, which bodes well for equities in 2019, especially if the trade and political environment improves.

CANADIAN MARKET

Financials and Energy remain the two largest sectors in the Canadian index and both have been impacted by the weak market sentiment.

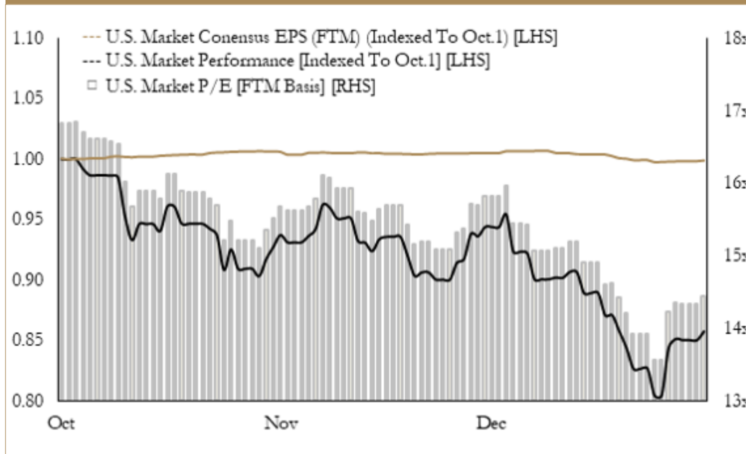
Canadian banks remain highly profitable, have strong capital bases and are positioned for modest growth even with slowing residential mortgage activity. Dividend payout ratios remain near the low-end of company target ranges, notable given that the banks now yield well over 4%. Any mean reversion from currently discounted valuations would augment the attractive total return opportunity.

Heavily discounted Canadian crude oil pricing due to infrastructure bottlenecks, in tandem with lobbying by members of the oil patch, pushed the Alberta government to institute production caps for 2019. This initiative helps to de-risk the pricing differential picture for Canadian crude in the upcoming year (assuming the timely completion of Enbridge Line 3 and a continued ramp-up of crude-by-rail). However, securing incremental oil pipeline expansions remains a critical focus given the growth ambitions of the oil sands players for 2020 and beyond.

PORTFOLIO INSIGHTS

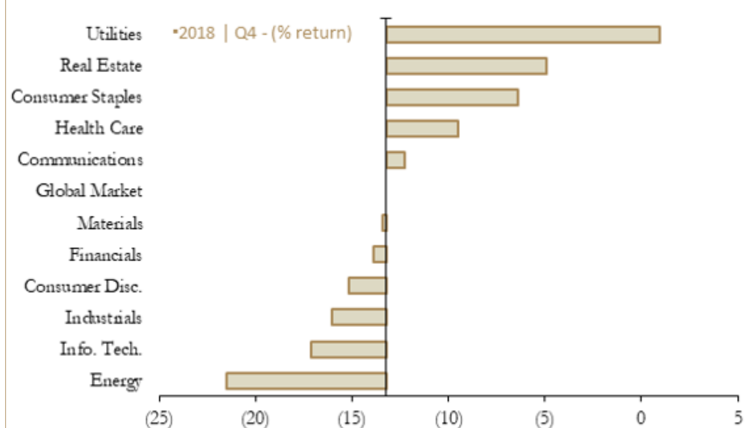
In Canadian portfolios, we continue to own Boyd Group Income Fund, one of largest collision repair center operators in North America, with most of its facilities located in the U.S. **Boyd is an example of a company whose share price has been impacted by recent poor market sentiment, but has limited exposure to global trade and benefits from a solid U.S. economy, as well as lower oil/gasoline prices (likely a near-term boost for vehicle miles travelled).** The company has less than 5% mar-

FIGURE 2: U.S. VALUATIONS DROPPED IN Q4



Source: Bloomberg | Note FTM = Forward Twelve Months

FIGURE 3: GLOBAL Q4/18 PERFORMANCE BY SECTOR



Source: Bloomberg

ket share in North America, leaving significant runway for Boyd to consolidate a fragmented industry. Boyd extracts synergies from its acquisitions by implementing best practices and also boosts the productivity of the acquired repair shops by leveraging its strong relationships with insurance companies. Organic growth is a key focus and Boyd has averaged around 4% annual same-store-sales growth over the past ten years.

In Global portfolios, we continue to hold McDonald's. **With an iconic foodservice brand and a franchisor model (over 90% of its worldwide restaurants are franchised), McDonald's generates high margins and ROIC (returns on invested capital) throughout the various stages of the economic cycle.** The company is currently undergoing a remodel program across the majority of its U.S. restaurants, incorporating a new layout, self-order kiosks and digital screens. After seeing its remodel investments in Canada, Australia, and parts of Europe bear fruit, we are confident that the U.S. remodel program will drive solid multi-year sales growth. Once the U.S. remodel program is fully completed, a reduction in capital expenditures will lead to robust free cash flow generation for the company. Lastly, McDonald's is a leader in driving technological change (mobile app and in-store self-order kiosks) and food delivery in the industry. These characteristics are particularly important in today's environment of wage inflation, rapid digital penetration and home delivery uptake.

FIXED INCOME MARKETS | GROWTH CONCERNS LEAD INTEREST RATES LOWER

Canadian interest rates declined in the fourth quarter over concerns of the economy slowing down after the strong pace earlier in 2018. Short-term interest rates declined from around 2.25% in September to roughly 1.90% at the end of December. With the Bank of Canada (BoC or Bank) overnight rate at 1.75%, the market is currently pricing-in slightly less than one more hike from the BoC this cycle. The Canada 10-year rate finished the quarter at just under 2%, not leaving much room between it and the Bank of Canada rate.

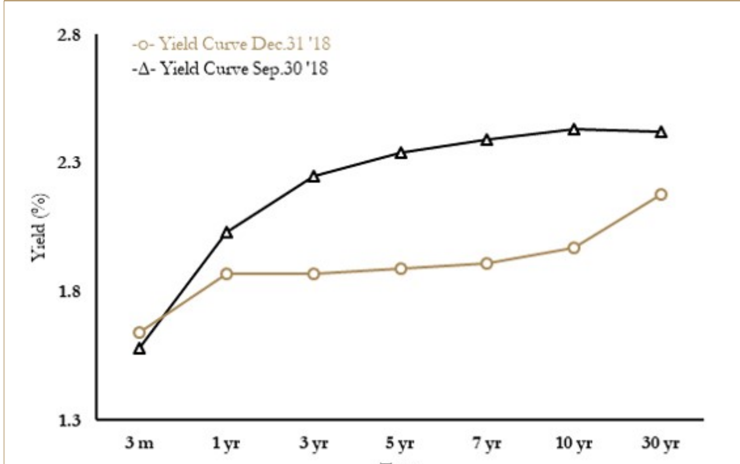
The flattening yield curve has received a lot of attention recently. In our view, the key measure to watch is the difference between 3-month treasury bill rate and the 10-year rate, which is still about 30bps above zero. Historically, only after this difference becomes negative has a recession ensued. The current positive 30bps difference remains wide and the length of time before the gap narrows is uncertain. The recent flattening has been the result of higher overnight interest rates from the BoC, which hiked by 25bps in October. The 10-year rate declined 45bps this quarter (Figure 4), but was only lower by 7bps in 2018. Should the market regain confidence in the economy and reverse some of the recent move lower in the 10-year rate, the 3-month to 10-year difference will increase further above zero. Of course, should the Bank of Canada increase interest rates again this would narrow the gap.

The Bank of Canada will likely take an extended pause before raising administered interest rate again. The Bank hiked in January 2018, paused for six months, hiking in July, and again three months later in October. The Bank of Canada has always communicated its data dependence and this is truer than ever today. The BoC will likely wait to see if there is strength in the economic numbers for Q4-2018 and Q1-2019 before considering hiking again. Currently, the Bank sees room for the economy to grow from higher capacity utilization and employment, without causing overheating inflation. The BoC's measures of core inflation sit comfortably under 2%. Additionally, with energy prices now lower, holding off on raising interest rates will give some welcome relief to energy-producing regions within Canada, as well as the national housing market.

Credit spreads, the difference between the interest rate on Federal government of Canada debt and any other bond issuer, increased significantly during the fourth quarter. The Province of Ontario must now pay an additional 20bps, compared to the end of September, when borrowing money for 10-years (its credit spread increased from 65bps to 85bps). Bell Canada, a good indicator for BBB-rated corporate bonds, saw its credit spread increase by 50bps in the quarter to 198bps.

Post-financial crisis, credit spreads in Canada were widest in early-2016, after the steep downturn in oil prices, and tightest in early-February 2018. Today's

FIGURE 4: CANADIAN YIELD CURVE (%)



Source: Bloomberg

spreads are about 60% back to that widest point. As cooler heads prevail and confidence in the economy returns, credit spreads should tighten.

PORTFOLIO INSIGHTS

Bonds from the Federal Government of Canada outperformed respective maturity dates this quarter, and the longer the maturity the better. Provincial and corporate bond performance suffered as credit spreads increased as mentioned. Bond issuers with direct exposure to energy prices saw spreads increase more than others, for example the Province of Alberta and Alberta utility, AltaLink.

No portfolio holdings experienced significant changes to credit fundamentals other than North West Redwater Partnership. The entity saw its spread widen after announcing a delay in ramping to full capacity at its new refinery facility by one quarter to Q1-2019.

Only one portfolio change was made during the quarter. In December, as interest rates reached low levels, Government of Canada bonds (5-year and 10-year maturities) were sold. These bonds performed very well with declining interest rates, providing an opportune time to exit. The proceeds are waiting to be reinvested at higher, more attractive yields.

With a low duration, the portfolio currently remains far less sensitive to changes in interest rates than the overall bond market. Since it is later in the economic cycle, should interest rates increase to attractive levels we would look to increase duration. We remain confident that the economy will continue to perform well and that bond prices will eventually reflect this strength.

Barrantagh {manx gaelic} trustworthy *adj.*, dependable *adj.*

We are dedicated to preserving our clients' capital while generating growth through consistent application of our value-based fundamental investment philosophy

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