Second Quarter Commentary

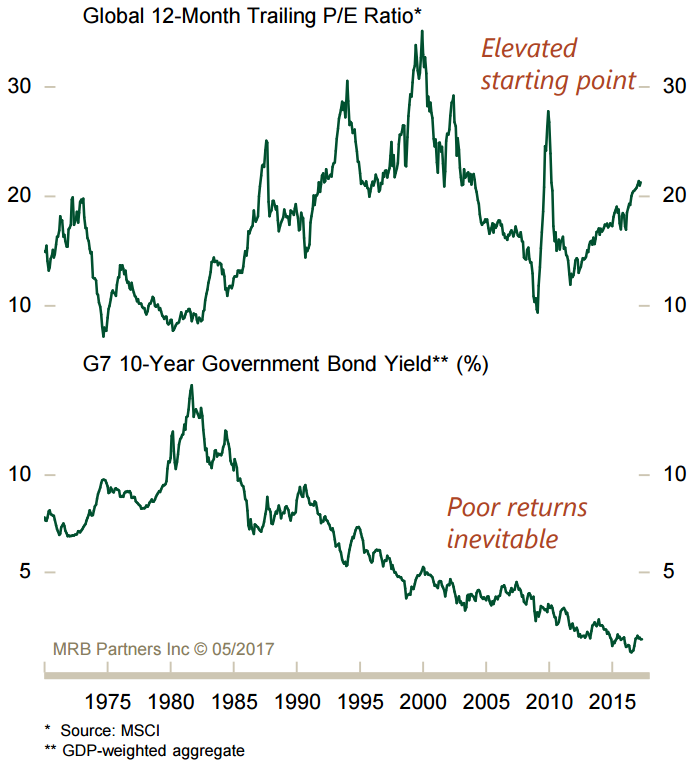
July | 2017

Long term return expectations – an update

"The main asset classes are poised to deliver modest real total returns (after inflation) by historical standards over the next 10 years, primarily because of subdued economic growth and elevated valuations. Returns for balanced portfolios will be particularly hampered by the poor starting point for bonds, with yields destined to march higher in the coming decade. While we classify ourselves as mildly constructive, investors likely face a period of significant challenges in the coming decade, with modest rewards." – MRB Partners, May 2017

Last year, in our commentary titled "Game plan for a low return decade", we discussed the long term challenges facing investors given the low yields in bonds and GICs, and resulting low contribution to portfolio returns by these necessary components of a diversified balanced portfolio. This is particularly relevant for those in retirement, approaching retirement, or those who simply do not want to assume too much risk in their investment portfolios. For millennials, this is less of a challenge given their longer term investment time horizon, ability to assume more stock market exposure and in general a greater tolerance to withstand short term market corrections or setbacks.

Chart 1: High valuations imply lower returns in the coming decade



Source: MRB Partners

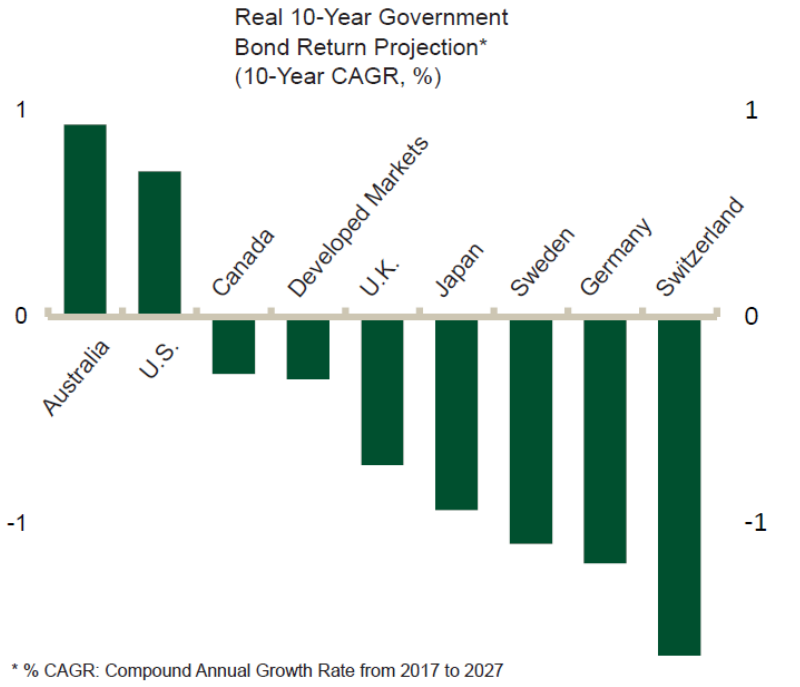
Over the long term, returns are primarily driven by three main factors: economic growth rates, interest rates (inflation), and the starting valuations for both stocks and bonds. These factors are fairly intertwined, particularly when it comes to stock and bond pricing, and the expectations of future economic growth and interest rate direction. In our previous commentary, we mentioned that while short term stock market performance is driven more by whether conditions are getting better or worse, rather than on an absolute valuation basis, long term returns are largely determined by valuations. Current elevated stock valuations and low bond yields imply that the returns in a multi asset class portfolio in the coming decade will be lower than those of the decade past.

The biggest challenge to long term returns is valuation (Chart 1). The top chart shows the current price to earnings ratio (P/E ratio) of the MSCI World Index (higher P/E ratio meaning stocks are more highly priced). Outside of the dot com boom at the

turn of the century, as a starting point, the current valuation of stocks is towards the higher range within this forty seven year time frame. Prices are high and with good reason. Corporate profits are expanding at a healthy clip, real returns (after inflation) on fixed income investments are providing little if any return, and the global economy is improving. This elevated starting point has little bearing on short term returns, but limits return potential over the longer term period of economic expansion and contraction that encompasses a business cycle.

The bottom graph in Chart 1 shows the GDP weighted average 10 year government bond yields of the G7 countries. Bond yields are inversely related to price - as bond prices rise, the bond yields falls. Given the very low current yields for government bonds (i.e. higher bond prices), the prospects for returns in bonds are poor, particularly when we factor in inflation (Chart 2).

Chart 2: Negligible returns from Government bonds



Source: MRB Partners

Don't believe the hype

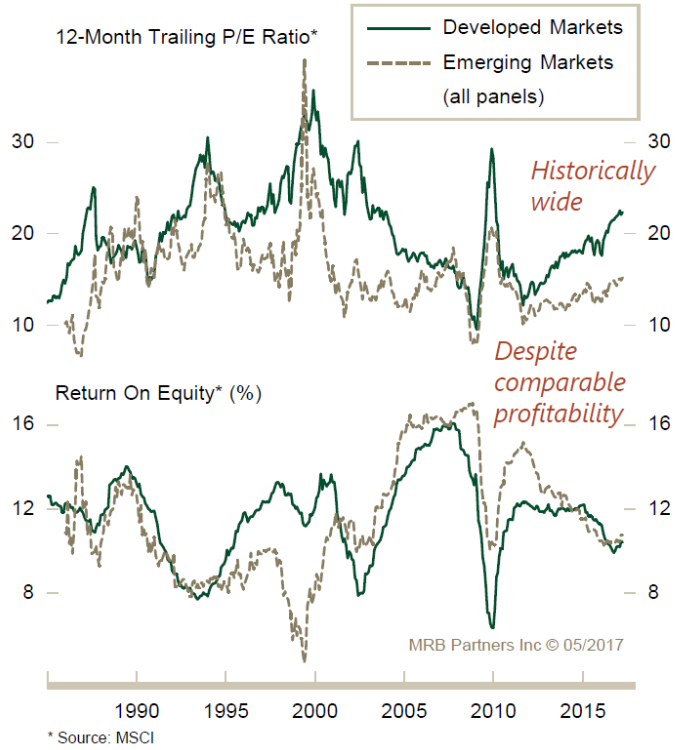
Given the challenges facing investors in the coming decade, there is likely to be a greater push by those within the wealth management industry to steer investors towards investment strategies that offer the prospects of both higher than market returns, with similar investment risk to that of traditional asset allocation portfolios (cash, bonds, stocks). Although such alternative strategies may perform well in a given year, on a relative basis, the likelihood of them adding value to an investment portfolio over the long term is doubtful. Fee structures that are typically quite profitable to the issuer of the product exacerbate the issue.

Other investment products such as "low volatility" or "minimum volatility" stock strategies need to be regarded as stock investments that are not any lower risk than other stock market investments. The multi-decades long decline in interest rates has benefitted these so called bond proxy investments, stocks in primarily slow growth or no growth industries, which pay out the bulk of their net earnings in the form of a higher dividend to attract investors. The long term decline in bond yields, has resulted in investor willingness to pay a higher price for higher dividend yielding, but low growth stocks, and leaves this pricey group vulnerable to a prolonged period of underperformance should bond yields tick higher in the coming years. Stocks in the utilities sector, telecom stocks, or real estate investment trusts would be included in this category. The consensus viewpoint is for interest rates to begin an up cycle and investment strategy must change.

The importance of emerging market exposure

Economic growth is a key factor impacting long term returns. Projections for the next decade are for much higher annual real GDP growth in emerging market (EM) economies compared to what is anticipated for developed market (DM) economies. Although growth in the EM region is likely to moderate from the prior decade, the estimated real growth rate (net of inflation) of 4.6% is much stronger than the 1.5% expected in the more mature DM economies. The world is changing as there is likely to be a growing reliance on EM to drive the global economy. EM's contribution to global growth and as a percentage of total global output is increasing, and as a result over the long term cannot be ignored from an investment perspective. In addition,

Chart 3: EM stocks are cheaper, and companies are just as profitable



Source: MRB Partners

Given the relative underperformance of the Canadian economy over that time, the five year benchmark Canada yield hit a low point only as recently as last summer (shortly after the Fort McMurray wildfires). Since then, the yield has more than doubled (and bond prices declined). A continuation of this trend will benefit reset rate preferred shares which have lagged in performance up until 2016. As the Canada benchmark five year yield now begins to climb, the reset rates have since been leading the way in preferred share performance. Consensus expectations are for the five year Canada benchmark yield to rise from current levels through 2018 (Table 1).

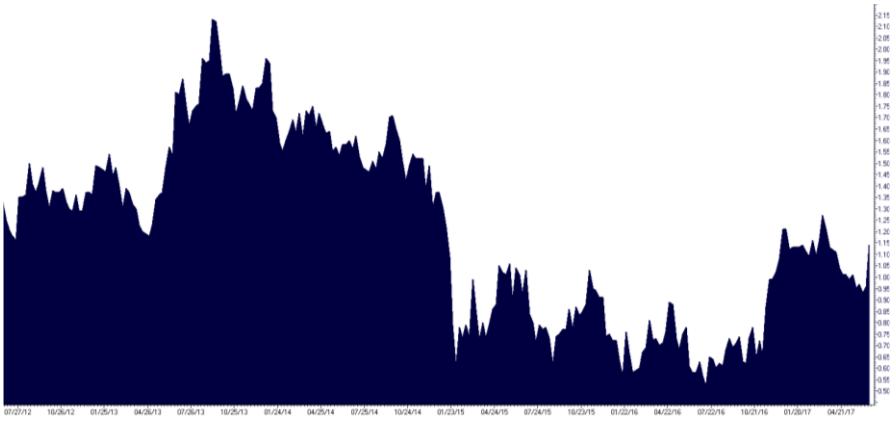
the current valuations of EM stocks are much lower than DM stocks (Chart 3). Within DM, U.S. stock market returns are likely to be hampered by high valuations relative to other markets. European stock market returns are likely to be better than those in the U.S. due to better earnings growth potential (from a depressed level). Canadian stock market returns are likely to be similar to the returns in the U.S., with both upside and downside risk to this viewpoint largely dependent on the commodity cycle. Our bias is towards exposure to EM non-commodity related exposure, given that as Canadians, we have sufficient commodity sector investment opportunities domestically.

Revisiting reset rate preferred shares

Unlike bonds and perpetual preferred shares whose prices decline when interest rates increase, reset rate preferred shares actually benefit as interest rates rise. After thirty five years of declining interest rates which benefitted bonds, perpetual preferreds, and so called “low volatility” equity investments, we are now entering a rising interest rate environment where they will suffer. Reset rate preferreds will be the better choice going forward.

With the U.S. Federal Reserve leading the way in terms of interest rate hikes, there has been a definite change in the long term direction of U.S. five year government bond yields which bottomed in 2012 at about 0.55% (currently at 1.75%).

Chart 4: Are Canada five year yields on a longer term uptrend?



Source: Thomson Reuters

Table 1: Consensus rates forecasts

	Current	2017 4th Quarter	2018 2nd Quarter	2018 4th Quarter
Bank of Canada Rate	0.50%	0.50%	0.75%	1.00%
2 Year Gov't Bond Yield (Canada)	1.10%	1.01%	1.31%	1.58%
5 Year Gov't Bond Yield (Canada)	1.39%	1.50%	1.95%	2.23%
10 Year Gov't Bond Yield (Canada)	1.77%	1.92%	2.25%	2.49%
CAD USD	$0.77	$0.74	$0.75	$0.76

Bank of Canada consensus forecasts are the median averages. Government of Canada bond yield and CAD USD exchange rate consensus forecasts are the mean averages. Forecasts are from BMO Economics, Scotiabank Economics, CIBC Economics, RBC Economics, and TD Economics, as of June 2017.

Game plan for the coming decade, the new normal

We are at a major inflection point in the interest rate cycle, commodity prices are trending back to the long term normal following the end of the "super-cycle" in late 2014, Europe economic growth is recovering with about a four year lag to U.S., Japan continues to pull itself out of its long disinflationary slump, China has become the world's second largest economy, and global growth is recovering slowly with the emerging markets (especially commodity importers) becoming more and more important. Ignoring these major trend changes could lead to longer term disappointment.

Investors wanting to generate competitive returns over the next ten years must adapt to this new environment. To meet these challenges, changes within our managed portfolios reflect this new investment landscape, and this new normal will continue to have a bearing on the portfolios going forward.

Worth Allaye-Chan Investment Counsel | www.worthallayechan.com | worthallayechan@raymondjames.ca
Suite 2100-925 West Georgia Street, Vancouver, B.C., Canada V6C 3L2 | T: 604.659.8066 TF: 1.855.659.8066 F: 604.659.8449