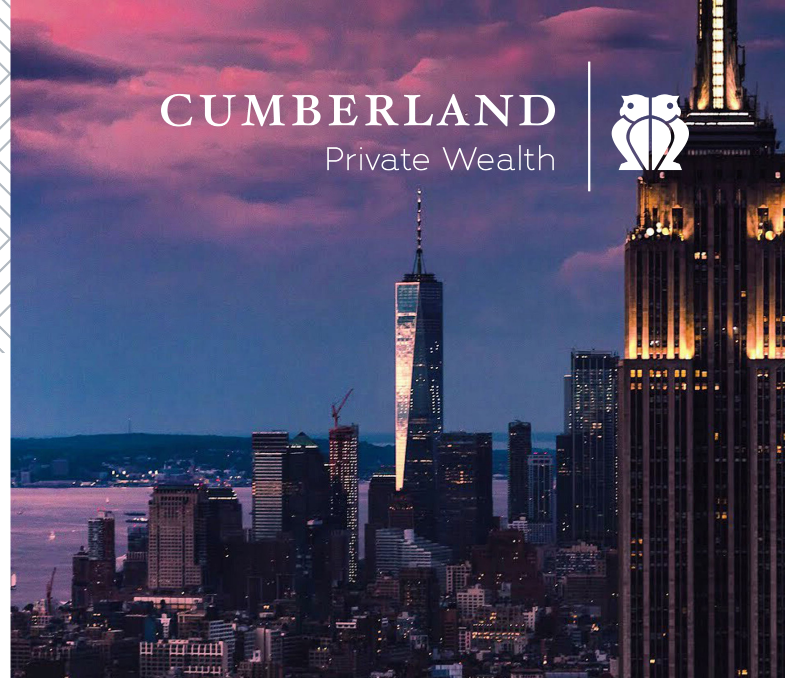

Investment Insights from our CIO

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Is the volatility we've seen in the market so far this fall set to continue? A closer look at key indicators will help determine what can happen.

Following the FED rate hike on September 26th market volatility began to accelerate, however the S&P 500 index remains at less than 6% off its all-time highs, the TSX is looking attractive from a valuation perspective and there has been little impact on corporate bond spreads.

Volatility

One measure of volatility (fear) we monitor is the VIX, which recently jumped from about 12 to 25 commensurate with the sell-off in the market in early October. Currently the VIX is in line with its long term average at around 19. The low levels of 12 we experienced in 2017 and a good part of 2018 were the anomaly. Therefore, we are just back to normal volatility and market gyrations like this should be expected especially given we are in a later part of the economic cycle.

FED

In late September the FED removed the wording "that the stance of monetary policy remains accommodative" and outlined a continuing path of one more hike in 2018 and three in 2019. This would take the overnight lending rate slightly above neutral, which is regarded as the level where rates are neither simulative nor restrictive. However, when you put this in the context of what the FED's assumptions are behind their rate forecast, gradually rising rates should probably be somewhat expected.

If the FED is even close in its projections, we think the US economy will continue to prosper for quite a while even with slightly higher rates:

- GDP forecast for 2018 from 2.8% moves up to 3.1%
- GDP forecast for 2020 and 2021, 2% declining to 1.8% in 2021
- Unemployment rate in 2020 and 2021 of 3.5% and 3.7%, respectively
- Core inflation rises to 2.1% from the current 2% level.

We will get our first read on Q3 GDP this Friday, which might be a big number influenced by higher stockpiling going into the tariff hikes introduced in September. And presumably, if the FED is too aggressive in its assumptions, it can adjust down the rate path which would no doubt be well received by the market.

Trade

The other concern is the impact trade tensions could have on global growth and in this context, on October 9th the IMF cut its forecast for 2018 and 2019. However, they reduced their forecast from an already high level of 3.9% to 3.7%, which is still respectable. And as Gerry Connor and I reviewed in our recent quarterly updates, the tariff impact on $250bn of imported goods in a $20 trillion US economy likely won't have too dampening an effect.

TSX

The TSX is currently looking more attractive from a valuation perspective versus the S&P 500. Other than a brief period during the financial crisis, this 2.4x multiple gap is the largest Price Earnings (P/E) valuation gap since the early 2000's. Also, if you compare the TSX at 13.6x and the S&P 500 at 16.0x, to their long-term average P/E multiple valuations of 14.6x and 14.7x, statistically the TSX is about half a standard deviation below the long-term average while the S&P500 is about half a standard deviation above its average. Finally, when we compare the outlook for earnings growth into next year over 2018, the TSX earnings growth rate is estimated at 13% as compared to 10% for the S&P500.

Corporate Bond Spreads

Another thing one would expect to see when volatility jumps like this and stocks trade down, is a change in the level of corporate bond spreads. If there were genuine concerns of weakening economic fundamentals, these would begin to show up in the corporate bond market as well in widening credit spreads. However, so far corporate bond spreads have barely reacted to the increased equity volatility.

Investment Strategy

From an asset mix perspective, we are just under 90% invested in equities for 100% Capital Appreciation portfolios such that there are some cash reserves to deploy if the market pulls back further. Lately we have also been adding equities that are more earnings durable (less reliant on the economic cycle) for growth such as Healthcare and Communication Services, although we have also maintained some late cycle exposure to rising commodity prices and interest rates through our exposure to the Financials and Energy sectors. Looking out into 2019 these sectors are experiencing some of the highest earnings growth rates and are generally regarded as being the more "value-oriented" sectors. We have been reducing our exposure or weight in Technology which favours growth.

Market breadth this past week improved over the previous week and there are noticeably fewer new 'lows' being made in stocks this week versus last. So when we put it all together, taking into account the level of volatility which has more or less just normalized, the FED actions relative to their assumptions about continual economic growth, easing concerns on trade wars, attractive valuations and earnings growth and consistent credit spreads, this suggests, at least for now, that we should stay the course in equities.

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