MACKENZIE Investments

LBC FINANCIAL SERVICES

Expect Global Momentum in 2018

Alain Bergeron,
Head of Mackenzie Asset Allocation Team

Todd Mattina,
Chief Economist and Strategist on the Mackenzie Asset Allocation Team

Despite a stormy political year, most major economies shared in the broad cyclical upturn in world GDP in 2017 with low inflation. Investors were rewarded for taking risk as the 'Goldilocks' backdrop supported high returns in equities and credit markets with low volatility. We expect the broad cyclical expansion to continue in 2018, favouring pro-cyclical assets and investment strategies. Key tactical views include an overweight in global stocks relative to government bonds, an overweight in Emerging Market (EM) stocks and an underweight in the US dollar relative to the loonie.

Global Investment Committee: Asset Allocation Views, 2018 Q1

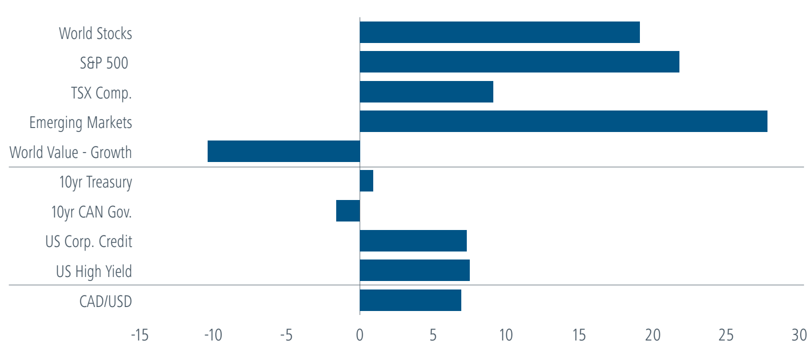
	Underweight				Overweight		
	Strong	Moderate	Slight	Neutral	Slight	Moderate	Strong
Asset Allocation							
Equities vs Fixed Income						•	
Relative Equity*							
U.S.				•			
Canada			•				
Europe				•			
U.K.				•			
Japan				•			
Emerging Markets						•	
Currencies (vs CAD)							
USD			•				
EUR						•	
GBP					•		
JPY			•				

*Refers to local currency index; Emerging is MSCI Emerging Markets

2017 – A Stellar Year for Investors

Markets delivered a stellar year for investors in 2017, shrugging off initial concerns about geopolitical risks. Many asset classes performed strongly despite political uncertainties ranging from the turbulent presidency of Donald Trump, growing anti-establishment sentiment in Europe and the threat of a conflict with North Korea. Stock markets in developed economies delivered a return of about 19% (local currency terms) led by the technology sector while world growth stocks over-performed value stocks by about 10% based on the MSCI definition. High yield and EM debt also rallied strongly while the 10-year US Treasury yield at about 2.4% ended the year almost unchanged.

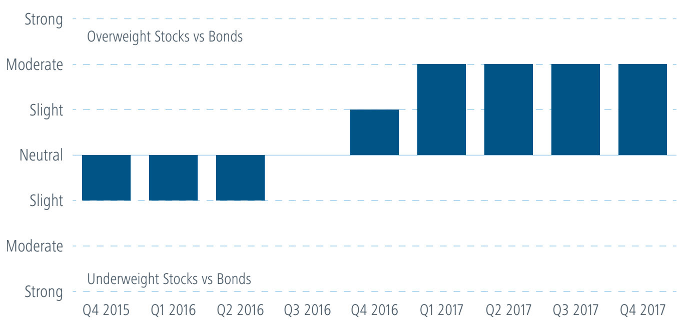
Total Returns of Selected Asset Classes in 2017*



*Total returns for World Stocks, Emerging Markets and World Value – Growth stocks are based on MSCI indexes in local currency. Returns for the S&P500 and TSX Composite are expressed in local currency. Fixed income returns are also expressed in local currency terms. Returns in US corporate credit and high yield are based on the iBoxx liquid universe of investment grade credits and the Bank of America Merrill Lynch High Yield Master II indexes, respectively.

During all of 2017, we were overweight global stocks relative to bonds. Given the impressive performance of global stocks last year, this benefited our investors. We initiated our equity overweight heading into Q3 2016 and increased the conviction going into 2017, which we kept all year.

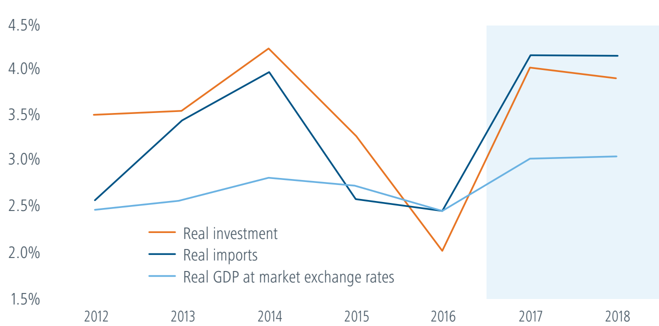
Global Investment Committee: Tactical View in Global Stocks vs. Government Bonds



Source: Mackenzie Global Investment Committee.

Many economic factors combined to set the stage for a surprisingly synchronized cyclical expansion that rewarded globally-diversified investors. Global manufacturing activity strengthened as capital spending showed signs of revival, supporting firmer commodity prices and a rebound in world trade. Global monetary conditions also remained supportive overall as direct asset purchases and negative policy rates of the ECB and Bank of Japan (BoJ) offset rate hikes by other major central banks and the announced unwinding of Quantitative Easing (QE) by the US Federal Reserve to reduce its bloated balance sheet of US$4.5 trillion. Inflation remained low in most major economies; this kept a lid on interest rates and supported equity markets, even as major economies rapidly absorbed spare capacity.

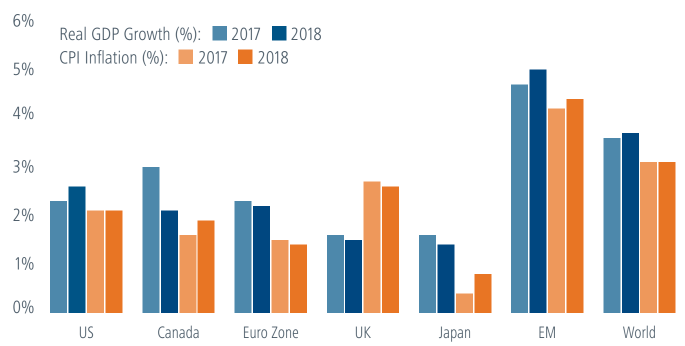
Rebound in Global Growth, Trade and Investment Following the 2016 Slowdown



Note: Shaded area contains IMF projections. Source: IMF Staff calculations.
https://blogs.imf.org/2017/12/17/the-year-in-review-global-economy-in-5-charts/

In Canada, the surprisingly robust economic recovery in 2017 after the oil price shock failed to translate into an equally impressive year for the TSX compared to other major markets. In the first half of 2017, the annualized pace of real GDP growth was about 4%, well above Canada's sustainable growth rate at full capacity. With declining economic slack and growing concerns of inflationary pressure, the Bank of Canada hiked interest rates twice, catching markets by surprise and leading to a rapid surge in the loonie by over 10% from May to the peak in September. With the economy rapidly absorbing spare capacity, real GDP growth slowed in the second half of 2017, leading markets to scale back expectations of more rate hikes. The TSX underperformed other major stock markets, partly due to the stronger loonie. However, the TSX had stronger momentum beginning in September as the Canadian dollar reversed some of its earlier gains and oil prices rallied by about a third.

Most major economies shared in the broad cyclical expansion. In the US, the economy approached full employment in 2017 with growth in real GDP of about 2.25%, exceeding its full capacity rate. The economies in Europe and Japan also grew above their sustainable long-term trends, although remaining slack in those economies provides room for a sustained period of rapid growth. EM economies shared in the global upswing, rebounding from a multi-year slowdown given stabilizing commodity prices, stronger trade growth and loose global financial conditions, easing concerns about high levels of dollar-denominated debt.



*Forecasts by Mackenzie's Asset Allocation and Alternatives team based on forecast surveys produced by Consensus Economics and Bloomberg.

2018 – Another Strong Year Ahead

Economic Outlook for 2018

Many of the economic factors that supported pro-cyclical assets are expected to persist in 2018. Economic growth rates in the US and China – the two main engines of the global economy – are expected to remain strong. Tax cuts in the US will stimulate business investment and consumer spending, providing a short-term boost in economic growth, but at the cost of adding over US$1 trillion over 10 years in public debt. As the US economy continues growing faster than its sustainable trend, and employment surpasses non-inflationary levels, the additional stimulus from tax cuts could lead to inflationary pressure. The Fed is expected to respond by increasing interest rates about three times in 2018 while it steadily reduces its balance sheet. However, we expect the ECB and BoJ to continue expanding their balance sheets in 2018 with direct asset purchases, maintaining supportive global monetary and financial conditions.

Economic momentum is expected to continue globally. In Europe and Japan, slack resources provide room to continue growing above the sustainable long-term trends as they catch up to the more advanced stage of the US business cycle. We also expect China to engineer a gradual transition to a lower sustainable growth rate as it focuses on structural reforms to reduce excess industrial capacity, restrain housing excesses and reduce debt. EM economies are expected to continue rebounding after a multi-year slowdown as commodity prices stabilize, trade growth remains strong and global financial conditions remain accommodative. The UK is an outlier as it deals with higher inflation and slower economic growth, while investors remain uncertain about the UK's post-Brexit prospects.

In Canada, we expect the economy will continue growing above its sustainable long-term trend in 2018. Canadian real GDP is expected to grow by about 2.2% in 2018 compared to about 3% in 2017. Household spending may slow as the pace of house price gains continues cooling. Canadian household debt exceeds 170% of disposable income compared to about 90% in 1990. Further upside surprises in employment gains and real GDP growth could also trigger a faster pace of rate hikes by the Bank of Canada to address potential inflationary pressures. Gradually rising interest rates are expected to lead to a gradual increase in debt-service costs for highly indebted households. This could begin to crowd out spending on goods and services and slow residential investment. However, solid commodity prices, strengthening business investment, scaled up infrastructure spending and stronger exports should cushion the impact.

Investment Views for 2018 Q1

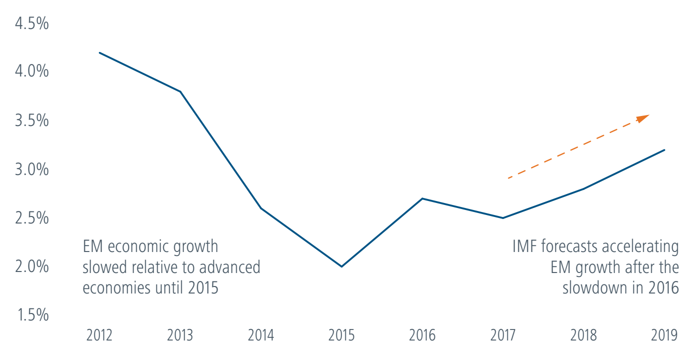
The positive global economic backdrop supports our tactical overweight in a number of pro-cyclical asset classes and strategies. Our key tactical views include the following:

- Overweight in stocks relative to government bonds
- Overweight in EM equities and underweight in Canadian stocks
- Slightly underweight in the US dollar relative to the Canadian dollar

We have maintained an overweight in global equities relative to bonds since Q4 2016 to the benefit of our multi-asset portfolios, given the equity market rally after the surprise election of Donald Trump. Our overweight in global stocks reflects three key factors. First, stocks appear expensive on an absolute basis compared to their own history but are still relatively attractive compared to government bonds given today's low yields. Second, we expect a continuing economic upswing in the global business cycle with little indication of a global slowdown in the next year. Upward cyclical pressure on long-term interest rates should be gradual and limited by structural downward factors, such as a glut of global savings, population aging and the slowdown in productivity. Third, our behavioural sentiment models indicate that investors remain enthusiastic about equities relative to bonds as the "fear of missing out" in the powerful equity rally attracts outflows from bonds and inflows to stocks.

Within the equity sleeve of our portfolios, we expect EM stocks to outperform and Canadian stocks to underperform (in local currency terms). Following a strong 2017, Canadian economic activity is expected to continue slowing in 2018, providing a headwind to the Canadian stock market. At the same time, the spread in the economic growth rates of EM and developed markets in 2018 is expected to reach its widest point since 2013, supporting local EM stock markets. Domestic economic fundamentals have also improved in many EM economies with firming commodity prices and loose financial conditions providing an attractive backdrop for investors seeking yield. EM equity valuations relative to long-term fundamentals are also relatively attractive.

Spread in Real GDP Growth Rate Between Emerging and Advanced Economies (in %)



Source: Real GDP growth rates obtained from the IMF World Economic Outlook database (Oct. 2017). Spread in growth rates calculated by Mackenzie's Asset Allocation and Alternatives team.

We are slightly underweight the US dollar relative to the loonie. While the US dollar weakened in 2017, it remains over-valued based on our models following a multi-year rally. The still strong US dollar reflects the more advanced stage of the US business cycle and the Fed's divergent monetary policy in recent years compared to the ultra-loose policy stance of other major central banks. In the longer term, we anticipate fair value of the Canadian dollar at about US$0.84.

Key risks in our bullish scenario for pro-cyclical assets include higher-than-expected increases in inflation and interest rates, or a 'policy accident' by a major central bank or government. Fiscal stimulus in the US threatens to increase inflationary pressure, which could lead the Fed to hike rates faster than expected. Higher rates would affect the valuation of other asset classes that embed low discount rates. In 2018, policymakers' decisions could also disrupt the cyclical expansion. For instance, major central banks could tighten liquidity conditions faster than desired, especially if inflation picks up, slowing the pace of economic expansion. For Canada, more aggressive US trade policies could negatively impact confidence in Canadian exporters. Geopolitical shocks also remain a risk. Just as in early 2017, there are many potential risks. However, our baseline view of continued strong and synchronized global growth is expected to support many pro-cyclical asset classes.

Watching Monetary Policy in 2018

Steve Locke,
Head of
Mackenzie Fixed Income Team

The focus for markets through much of the fourth quarter was the political drama surrounding the US tax bill and, of course, the price of Bitcoin. The US tax bill was debated and passed by both the House and Senate, and signed by President Trump before year-end.

The tax bill is likely to provide some boost to the US economy in 2018. This expectation was factored into the Federal Reserve's December rate hike, and into the Governors' most recent projections (the "dot plot") of the path of the Fed Funds rate in 2018. The median estimate is at three hikes of 0.25% each. Equity and corporate credit markets embraced the growth-is-good forecast, and inflation expectations rose as 2017 came to a close.

In December, the Bank of Canada left its policy rate unchanged. Further comments by Governor Poloz indicated that the Bank may let the economy run for a bit. Given their recent history of sudden shifts in monetary policy bias, and with the economy producing jobs at a rapid pace in both November and December, there is no guarantee that the Bank will refrain from hiking rates.

2018 could be a more interesting year with regard to global monetary policy. The Fed will likely follow through with two to three hikes while continuing to reduce the size of its balance sheet, but this will happen under the guidance of new Chairman Jerome Powell. The European Central Bank will taper its bond purchases, and EU growth is expected to be stronger than it has been in years. The Bank of England faces some inflation pressures but must also navigate an uncertain domestic political scene and the Brexit process.

As with past monetary policy tightening cycles, developed market yield curves have now been flattening over many quarters. The accelerated flattening of the US curve over Q4 caught much attention. Most often in past tightening cycles, the curve flattens as rate hikes pressure the front end higher, while the back end rises by less, or sometimes falls. These curve movements have happened over many quarters in previous cycles. Consider that since the 2013 "taper tantrum", the Fed Funds rate has been increased five times totaling 1.25%, with the US 10-year yield having increased by about 0.85%. Over this timeframe, the US 30-year yield is roughly flat.

Recent concerns over the curve flattening are due to the fear that it portends a recession around the corner. While economic growth may come under pressure from rising yields due to tighter monetary policy, as it usually does every cycle, there is no immediate evidence this is happening at the start of 2018. In fact, short bursts of steepening aside, the yield curve will probably continue to flatten this year while growth continues. Eventually, we could see a completely flat curve that stays with us for a while, as was the case in the mid-2000s.

Potential upward pressure exerted on short- and mid-term yields by the Fed in 2018 will eventually have a negative effect on the economy. It remains likely that this cycle will end at a lower terminal Fed Funds rate and yield curve than was the case in 2007, before the last recession. Back then, Fed Funds was 5.25%. If the Fed follows through on its dot plot projection, then in about 18 months the rate will be about 2.75%, or pretty close to today's 30-year US Treasury yield. Given the rising amount of government and non-financial corporate debt in the post-Financial Crisis global economy, it may not take much more than that to reduce prospects for greater economic growth.

In the near term, we continue to look for the best risk-adjusted bond and loan investments. As 2018 kicks off, we are maintaining shorter durations than our benchmarks, and have been reducing areas of corporate holdings that are fully valued. ■

Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments and the use of an asset allocation service. Please read the prospectus of the mutual funds in which investment may be made under the asset allocation service before investing. The indicated rates of return are the historical annual compounded total returns assuming the investment strategy recommended by the asset allocation service is used and after deduction of the fees and charges in respect of the service. The returns are based on the historical annual compounded total returns of the participating funds including changes in unit value and reinvestment of all distributions and does not take into account sales, redemption, distribution or optional charges or income taxes payable by any security holder in respect of a participating fund that would have reduced returns. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated.

This document includes forward-looking information that is based on forecasts of future events as of December 31, 2017. Mackenzie Financial Corporation will not necessarily update the information to reflect changes after that date. Forward-looking statements are not guarantees of future performance and risks and uncertainties often cause actual results to differ materially from forward-looking information or expectations. Some of these risks are changes to or volatility in the economy, politics, securities markets, interest rates, currency exchange rates, business competition, capital markets, technology, laws, or when catastrophic events occur. Do not place undue reliance on forward-looking information. In addition, any statement about companies is not an endorsement or recommendation to buy or sell any security.

The content of this magazine (including facts, views, opinions, recommendations, descriptions of or references to, products or securities) is not to be used or construed as investment advice, as an offer to sell or the solicitation of an offer to buy, or an endorsement, recommendation or sponsorship of any entity or security cited. Although we endeavour to ensure its accuracy and completeness, we assume no responsibility for any reliance upon it.

Index performance does not include the impact of fees, commissions, and expenses that would be payable by investors in the investment products that seek to track an index.

Unlike mutual funds, the returns and principal of GICs are guaranteed.

LBC Financial Services Inc. (LBCFS) is a wholly owned subsidiary of Laurentian Bank of Canada and is a corporate entity separate from Laurentian Bank, B2B Trustco, and from Mackenzie Investments. The registered LBCFS representative is also a Laurentian Bank employee.