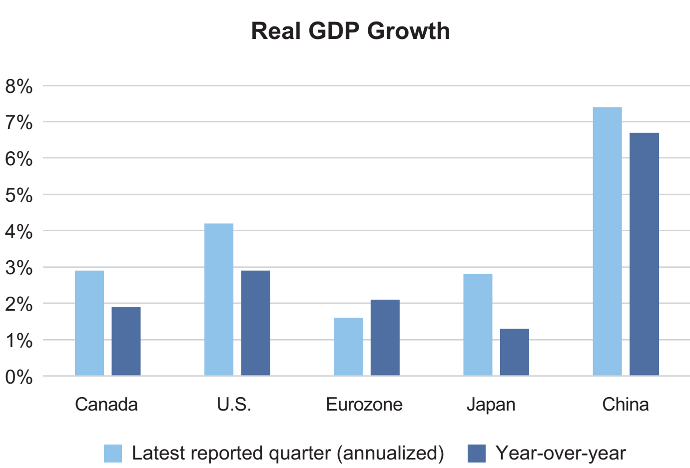
ECONOMIC OVERVIEW

September 30, 2018

Global economic growth continued to be strong in the third quarter of 2018, with some trend differences among countries. The U.S. economy continued to experience strong GDP growth mostly as a result of reduced tax rates. However, the strengthening U.S. dollar, central bank monetary tightening and related interest rate increases as well as trade tensions (especially U.S./China) weighed on business sentiment. The settlement of the new NAFTA trade agreement (now called USMCA) brought some market relief. However, economic dynamics are slowing in China and the Eurozone, while Japan is countering this trend due to rising consumption growth, increased capital expenditures, and continued monetary easing.

Overall, estimates of 12-month global growth, while still strong, have been softening to 3.3% from the previously expected forecast of 3.9%. The IMF has recently warned that "ultra-low interest rates and growing public debt are contributing to the buildup of financial vulnerabilities." These concerns have also been echoed by the World Bank noting "global trade has lost momentum and financial market pressures have intensified in some key emerging market economies."



Source: Bloomberg

Canada

As the third quarter concluded, so did months of negotiations that led to an agreement on a revamped trade deal between Canada, the United States and Mexico. In short, Canada did preserve tariff-free market access to the U.S. and the impartial arbitration panel for dispute resolution. On the other hand, Canada had to accept a cap on auto exports, increased access for U.S. dairy farmers to Canadian consumers, and a sunset clause allowing the trade pact to be cancelled in 16 years following 10-years' notice.

Arguably, Canada did have to make some concessions but this was expected given the export-dependent nature of the domestic economy – 75% of our exports go to the U.S while only 20% of U.S. exports come to Canada. Canadians had much more to lose if the threat of higher tariffs became a reality.

There are some positives. This agreement removes some of the uncertainty regarding business investment as capacity utilization rates are quite high in several industries, a situation which has led, historically, to increased capital spending. Also, the federal government can now turn its attention to levelling the playing field with the U.S. in terms of tax cuts for business and the introduction of new productivity-boosting measures.

The announcement of the trade deal resolved a major uncertainty which should allow the normalization of monetary policy by the Bank of Canada (BoC). Reduced concern over tariffs and trade barriers should allow the BoC to focus on inflationary pressures building within an expanding economy – core inflation in August was the highest since 2012. The BoC did raise rates in July and is now expected to do so again in October and in January, 2019.

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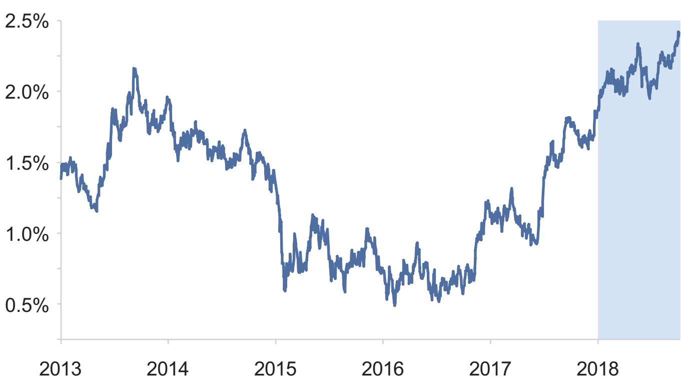
Following the direction of interest rates in the U.S., yields in the Canadian domestic bond market rose across the curve throughout the quarter. Short-end yields rose at a slightly faster pace than long-end yields, thus flattening the yield curve to a level not seen since 2007. The yield curve remains positively sloped, but only marginally, with just 20 basis points of yield separating two-year and thirty-year maturities. The flattening trend matched the pace south of the border, with both the U.S. Federal Reserve (the Fed) and the BoC continuing to tighten monetary policy.

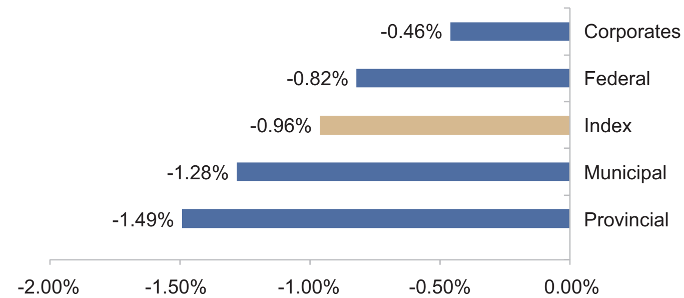
Five-year Government of Canada Bond Yield
(2013 to 2018)

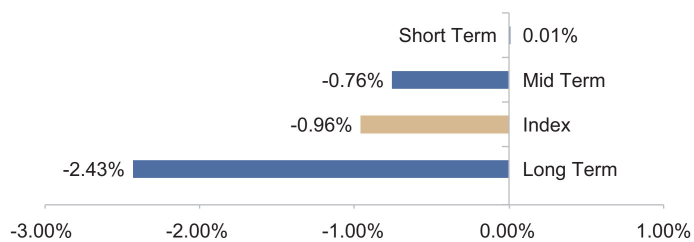


Source: Bloomberg

Corporate bond markets were relatively stable once again this quarter as corporate yield spreads remained in a tight range, continuing a trend that began in the first quarter of 2017. High yield bonds again outperformed investment grade bonds. By sector, and on a duration-adjusted basis, there was not much dispersion in returns although financial and energy issues performed the best while infrastructure and communication issues lagged.

Performance of FTSE TMX Canada Universe Bond Index Sectors and Term Structure
(Three months ending September 30, 2018)





Source for both graphs: FTSE Canada

U.S.

The U.S. economy continued to fire on all cylinders, but as the quarter ended there were signs of some slowing in private consumption and capital goods orders. It appears that the stimulative effects of the tax cuts and increased government spending may be starting to wane slightly. With near record low unemployment levels, labour market shortages are resulting in rising wages – 3% wage growth, the highest level since 2009 – which could have a negative effect on GDP growth. Additionally, the U.S. Federal Reserve (the Fed) is signaling that it will most likely continue with its restrictive monetary policies. The escalating trade war between the U.S. and China, if unresolved, would have a negative effect on U.S. consumer spending, business investment and overall economic momentum. The trade situation remains uncertain but the signing of the USMCA appears to be at least one positive.

Europe

European economic sentiment declined for the eighth consecutive month. Overall economic growth has declined from 2.7% last year to approximately 1.5% in the second quarter as exports declined amid the slump in global trade. Lower Purchasing Managers' (PMI) surveys and slowing industrial production combined with uncertainty over the Eurozone's trade relationship with the U.S. suggest growing unutilized industrial capacity. The European Central Bank (ECB) announced in September it would continue its monetary policy tapering by cutting its asset purchases further to 15 billion euros per month and potentially ending the program in December. Meanwhile, like the U.S., with wage growth at 3.9%, the ECB has been encouraged to proceed with their monetary plans.

Populism is still on the rise and the Brexit negotiations continue to deteriorate as an informal summit in Austria had the delegates rejecting some of the U.K.'s proposals as unworkable. However, there is some optimism that progress can be made prior to a formal EU summit on October 18, just months before the U.K. leaves the EU in March 2019.

Japan

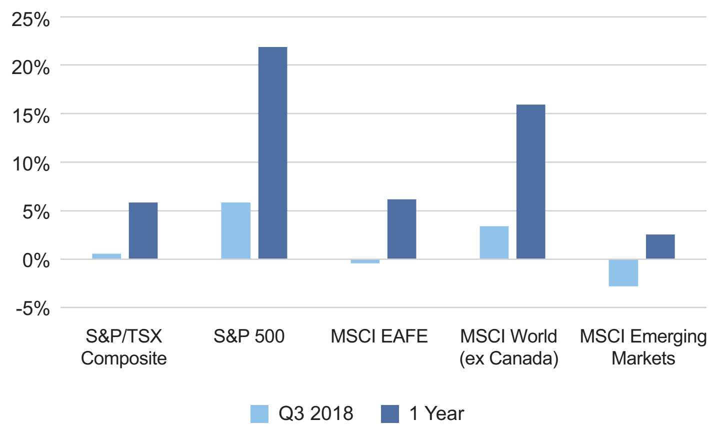
Surprisingly, Japanese real GDP growth rebounded to 3% quarter-over-quarter in the second quarter of 2018 after a first quarter decline. The main contributors to this growth were an increase in consumption and capital spending. As inflation remains stubbornly low, the Bank of Japan (BOJ) has signaled that its current accommodative monetary policy would remain in place until early 2020. This policy should support growth despite a contradictory rise in the value of the yen relative to the U.S. dollar.

In September, Prime Minister Shinzo Abe was re-elected to head of the ruling party in a landslide, leading the way for him to be reappointed prime minister for another three-year term. This may cause some friction with the U.S. if Abe proceeds with possible plans to reform Japan's pacifist constitution.

Emerging Markets

Despite strong growth in the second quarter of 2018, recent incoming economic data in China have been mixed. China/U.S. trade wrangling have overwhelmingly increased downside risks, as Chinese stocks declined to their lowest levels in several years. However, China has shifted towards more accommodative fiscal and monetary policies which should aid consumption demand. The government has also brought in new tax breaks for financial institutions' lending to small firms and removed restrictions to encourage banks to buy more local bonds.

Equity Index Performance (CAD) at September 30, 2018



Source: TD Securities, MSCI

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