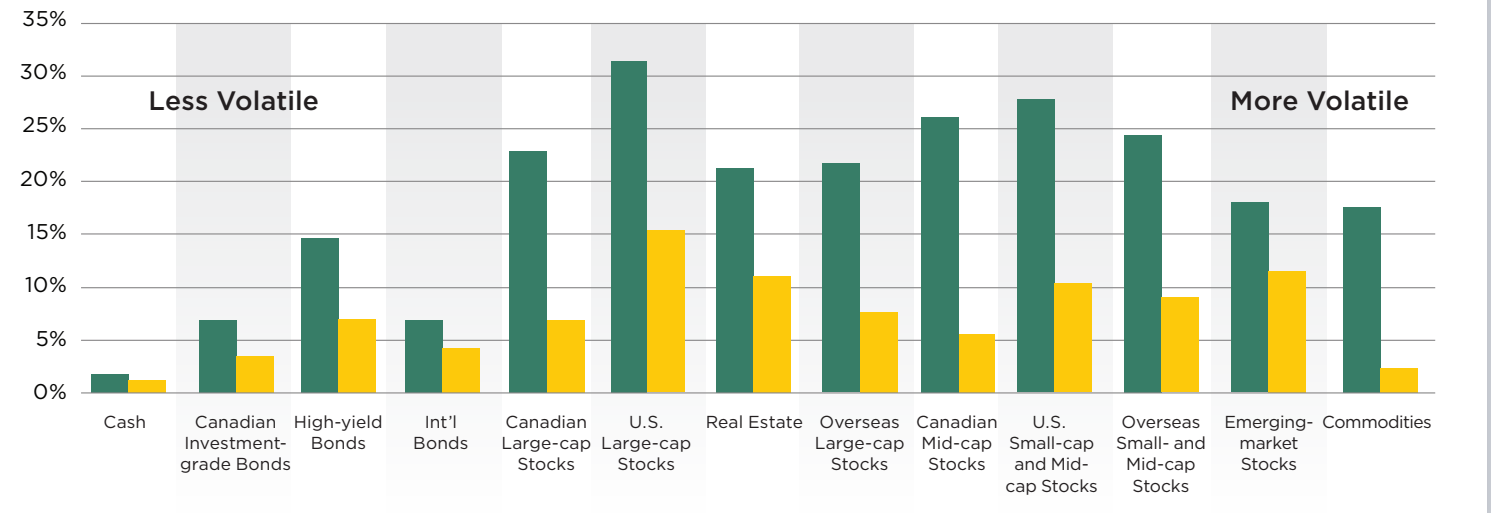
## Asset Class Performance




Source: Morningstar Direct, 12/31/2019. Representative indexes are: Real Estate: S&P Canada REIT Index, High Yield Bonds: Barclays High Yield Canadians Index, Canada Large-cap Stocks: S&P/TSX Composite Index, U.S. Small- and Mid-cap Stocks: Russell 2500 Index, International Bonds: Barclays Global Aggregate Bond Index , Canada Bonds: FTSE TMX Canada Universe Bond Index, U.S. Large-cap Stocks: S&P 500 Index, Emerging Market Stocks: MSCI EM Index, Overseas Large-cap Stocks: MSCI EAFE Index, Canadian Mid-cap Stocks: S&P/TSX Completion, Commodities: S&P GSCI, Cash: FTSE TMX Canada Cdn Trsy Bill 91 Day. Past performance is not a guarantee of how the market will perform in the future. Indexes are unmanaged and are not available for direct investment. All returns expressed in local currency and include reinvested dividends.

QUARTERLY MARKET OUTLOOK: **FIRST QUARTER 2020**

# Year in Review

Last year's equities' performance was the best since 2010. Investment-grade bonds also posted strong returns for the year. While uncertainty loomed, last year's market was calm by historical measures. We don't think 2019's outsized performance will be duplicated in 2020. But, equities' outperformance over bonds is likely to be repeated this year.

**Rocky start, strong finish for equities.** Canadian and U.S. large-cap stocks entered 2019 with the most attractive valuations in several years. All told, in 2019, large cap equities returned 22.9% and 31.5% in Canada and the U.S., respectively, powered in large part by the high-growth tech sector (up 65% in Canada). Overseas stocks lagged large-cap performance in North America, facing stronger headwinds from slowing economic fundamentals and trade uncertainty.

**Federal Reserve rate cuts boosts bond returns.** Last year, the U.S. Federal Reserve (the Fed) cut rates three times. And while the Bank of Canada (BoC) maintained policy rates at just 1.75% for the year, central banks in other major economies also provided monetary stimulus, leading to $11 trillion in negative yielding-debt worldwide and increasing demand for positive-yielding Canadian and U.S. bonds. The total effect of coordinated monetary stimulus lifted Canadian investment-grade bond returns by 6.8% even as equities – which tend to respond differently than bonds – soared.

**Recession fears came and went –** In March 2019, the gap between short and long-term interest rates in the U.S., known as the yield curve, inverted for the first time in over a decade. Cuts to short-term interest rates by the Fed helped the curve steepen back closer to its normal shape, signalling a modestly growing economy. In Canada, a healthy labour market, solid consumer spending and recovering housing market eased recession fears and underpinned strong positive returns for every asset class.

### ▶ *Action for Investors*

Asset classes tend to perform differently from each other so that economic and corporate conditions that produce declines in one asset class may lead to smaller declines or even gains in other asset classes. Since we expect lower returns and higher volatility in 2020, we recommend broadly diversifying across asset classes to help buffer your portfolio from market swings in the year ahead.

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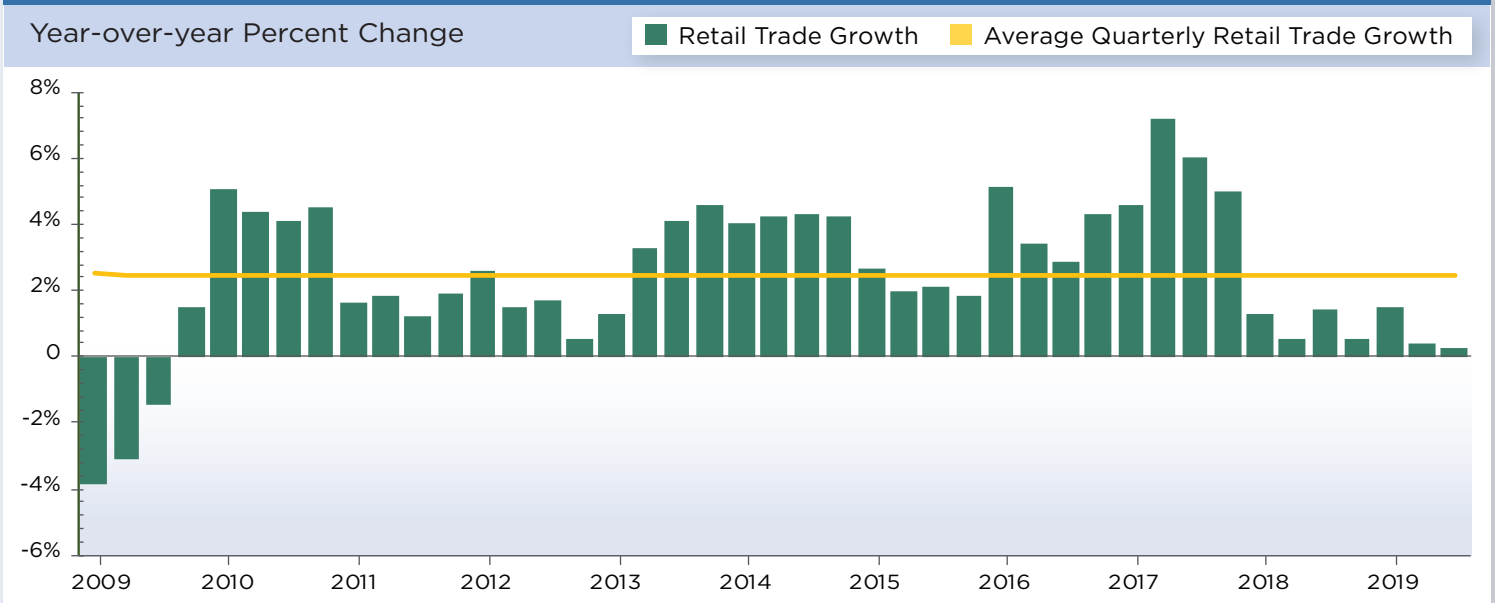
## Quarterly Canadian Retail Trade Growth




Source: Organization for Economic Co-operation and Development, Total Retail Trade in Canada.

QUARTERLY MARKET OUTLOOK: **FIRST QUARTER 2020**

# Economic Outlook

Similar to last year, the Canadian economy is likely to grow between 1.5% and 1.8% in 2020. We expect consumers to fuel the economic expansion, and business investment and exports to be somewhat restrained. Accommodative central bank policy should continue to provide modest support to the economy.

**Consumers key to growth this year –** A combination of a positive labour market and low interest rates will keep the Canadian economy growing at about last year's pace. As shown in the chart, Canadian retail sales in the first 11 months of 2019 were mostly flat compared to 2018. Though monthly job gains are levelling-off, we expect the unemployment rate to stay near a four-decade low and wages should continue to grow faster than inflation. Interest rates will likely rise modestly from the rock-bottom levels of 2019, and population growth should extend the recovery in the housing market in 2020.

**Weak business investment faces headwinds from geopolitical concerns and ongoing tariff woes –** Although there's promising progress on the trade front between the U.S. and China – and the likely ratification of a trade agreement between Canada and its major trading partners, we don't expect a comprehensive trade deal between the U.S. and China this year. Additionally, new tariffs recently announced by the White House late last year against handful of countries could signal that the trade overhang on business investment will continue in 2020. However, we expect the global economy to rebound this year, which should increase demand for Canadian goods and services.

**Central Bank policy, the oil that greases the wheel.** We expect the Bank of Canada (BoC) to maintain the current target of benchmark interest rates at 1.75%, unless there is a downward shift in economic conditions. We expect additional stimulus measures in the U.S. (and other central banks) to help ease the frictions from geopolitical headwinds and help Canada avoid a recession this year.

### ▶ *Action for Investors*

Though slowing, economic fundamentals are solid enough to support rising share prices this year, but we expect lower returns and more volatility than last year. We recommend reviewing your portfolio to ensure that after a year of soaring equity returns your equity/bond mix still reflects your risk tolerance, and add bonds to stabilize returns, if appropriate.

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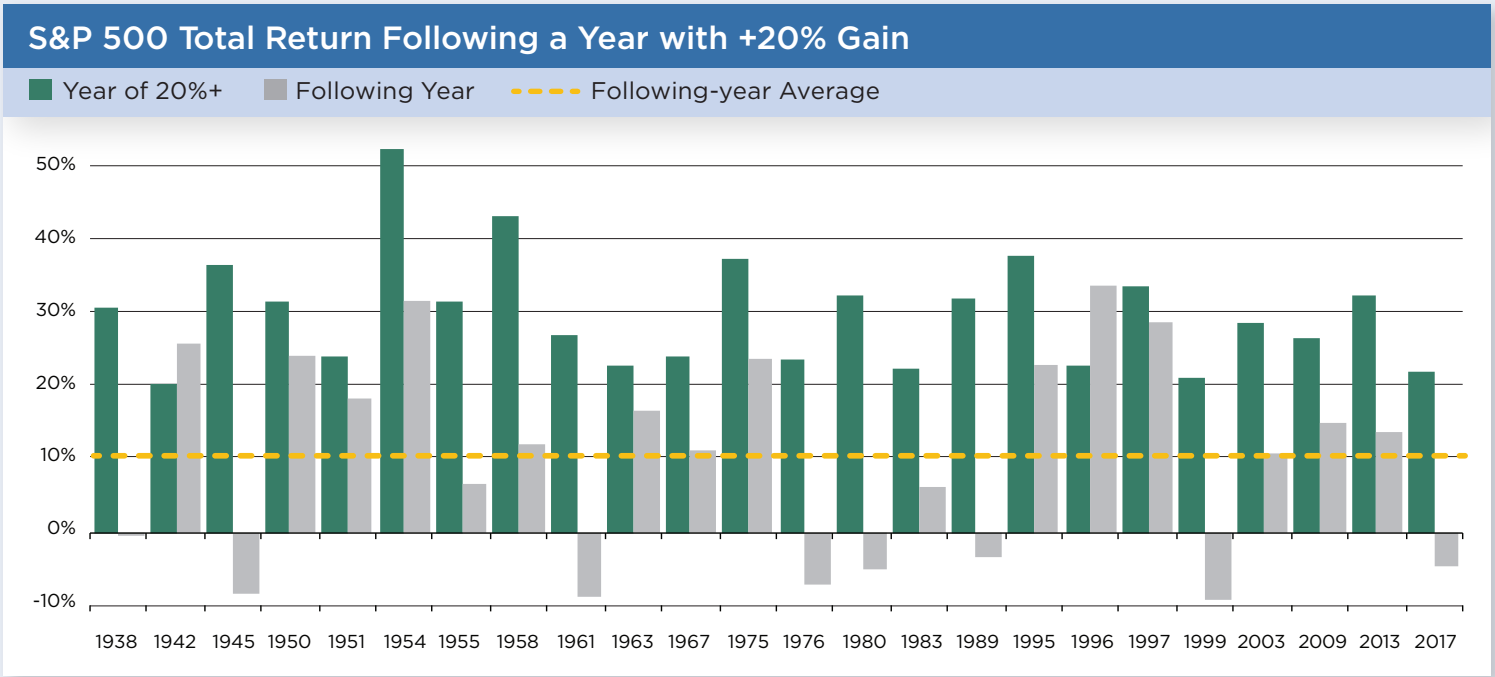


Source: FactSet.

QUARTERLY MARKET OUTLOOK: **FIRST QUARTER 2020**

# Equity Outlook

2019's gains were among the strongest of the 2000s and well outpaced our expectations. We don't think this exhausts the bull market's tank heading into 2020, but it does temper our expected return for the coming year. Modest earnings growth and full valuations should drive more moderate gains this year, but the strong year-end rally sets the stage for a potentially rockier start.

**Market may take a breather –** Stocks rallied sharply heading into this year, and we think there is now an air of complacency in the market. We think an uptick in volatility, and a short-term pullback, is a reasonable expectation. And, we think 2020 is likely to endure more frequent swings, as was the case in 2016 and 2018, when election and trade uncertainties rose.

**The bull isn't exhausted –** We don't think pullbacks will give way to a bear market, as the conditions that are historically associated with a bear market are not in place. Economic growth should continue to offer support to the market. Unemployment in Canada enters 2020 below 6%, a position experienced in eight different years since 1960. The TSX posted a return of 6.9% in the following year. In the 16 years since 1950 in which U.S. unemployment was below 4.5% heading into year end (currently 3.5%), the average S&P 500 return in the following year was 9.9%.

**More moderate gains ahead –** 2019's sizeable returns won't likely be replicated this year, in our view, but since 1950, when the S&P 500 rose by more than 20%, the average return in the next year was 11.27%, indicating great years don't have to be followed by bad ones. Stocks enter 2020 with valuations slightly above long-term averages. But to us, there is limited potential for material expansion in the price-to-earnings ratio from here, meaning the pace of market gains will be set by the pace of earnings growth.

### ▶ *Action for Investors*

Sharp stock gains offer a timely opportunity to rebalance to your long-term target weight in equities. Pullbacks would offer a compelling buying opportunity. We maintain our underweight recommendation to Canadian equity, favouring U.S. large- and small-caps while a slightly better global outlook and discounted valuations support our ongoing favourable view of international equities.

 

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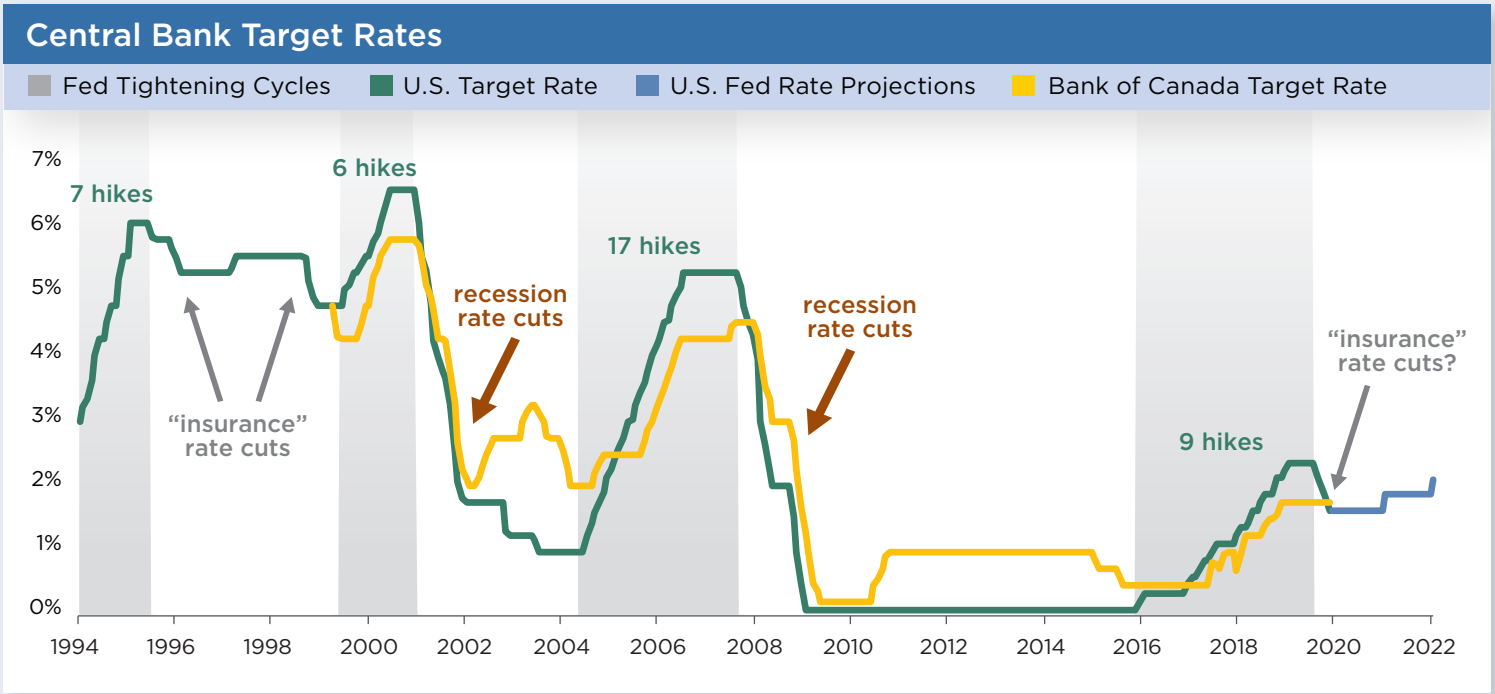


Source: St. Louis Federal Reserve, Edward Jones, FOMC projections 12/31/2019.

QUARTERLY MARKET OUTLOOK: **FIRST QUARTER 2020**

# Fixed-income Outlook

We expect equities to outperform bonds this year as moderate economic growth continues, with no recession imminent, in our view. However, geopolitical uncertainties could drive volatility higher, highlighting the stabilizing role fixed-income investments typically play during market pullbacks.

**Long-term rates to rise modestly –** Last year's sizeable decline in long-term global interest rates reflected fears of recession, a slowdown in global growth and expectations of a policy shift from central banks. With global growth showing signs of stabilization, trade tensions easing and major central banks providing stimulus, the 10-year government bond yield is not likely to fall materially below 1.5% in Canada and 2% in the U.S. in our view. We think bond yields will rise modestly.

**Fed and BoC on pause through 2020 –** Last year, the U.S. Federal Reserve (Fed) cut interest rates three times as insurance against recession risks, consistent with the non-recessionary easing cycles of 1995 and 1998. We believe the bar for the Fed to either lower or raise interest rates is very high leading up to the 2020 U.S. election. Improving economic data and lower risk of a further slowdown in global growth imply no further rate cuts are needed. In Canada, while the same threats to the domestic outlook exist, the Bank of Canada (BoC) will be less inclined to proceed in "insurance" rate cuts as the potential benefit from easing could be offset by the side effect of further stoking the already frothy housing market.

**Policy still a tailwind –** While the BoC didn't follow other major central banks in cutting interest rates, Canadian consumers and businesses benefited from low global rates that suppressed domestic ones. We expect the markets and economy to continue to benefit from last year's easing as monetary policy changes typically impact the real economy with a lag (typically six to nine months).

### ▶ *Action for Investors*

Despite ongoing low yields, we still think fixed-income investments play an important part in helping stabilize portfolios when stocks drop. We recommend an appropriate allocation to bonds, including Canadian investment-grade, high-yield and international bonds.

 

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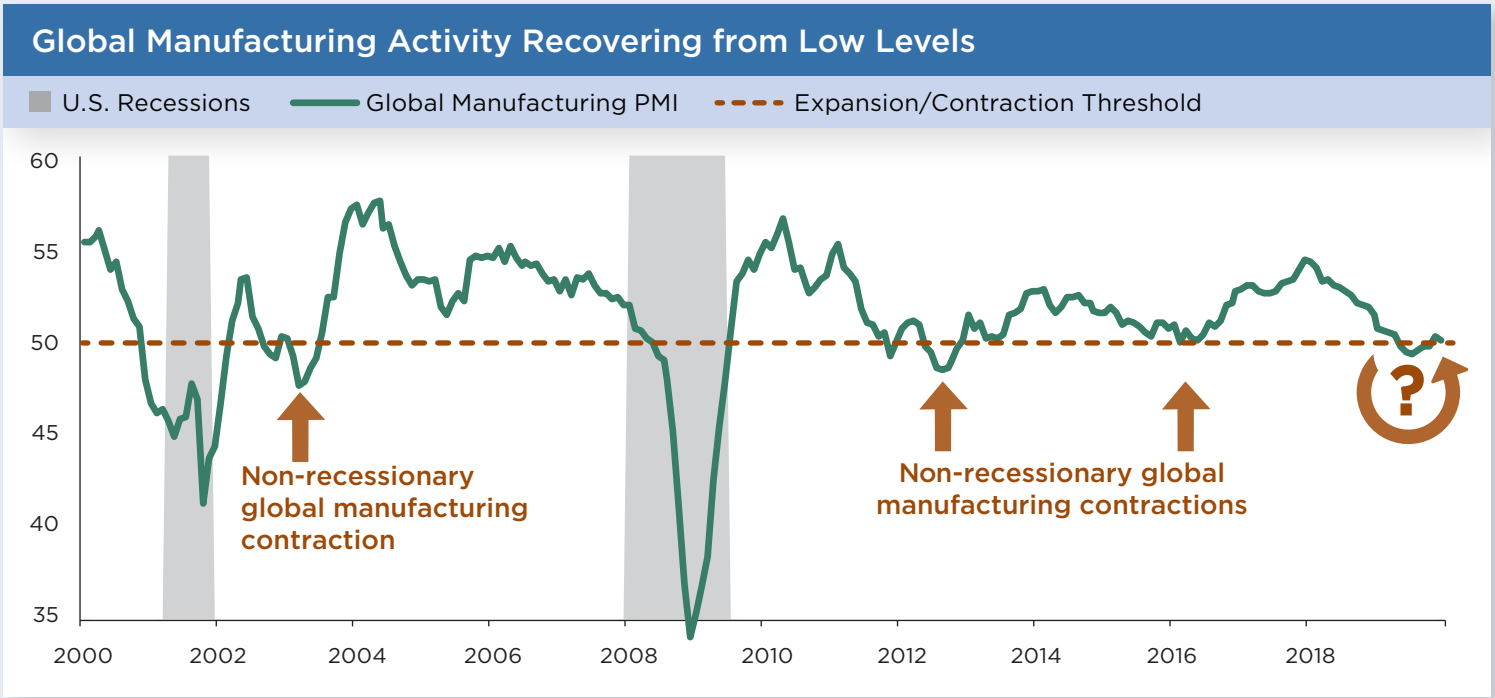


Source: Bloomberg, 12/31/2019.

QUARTERLY MARKET OUTLOOK: **FIRST QUARTER 2020**

# International Outlook

Overseas stocks performed well in 2019, but still trailed Canadian and U.S. stocks. Challenges remain, but there are signs that global manufacturing may be stabilizing. We expect a modest re-acceleration in global growth, which, together with depressed valuations and a likely rangebound Canadian dollar, could position international investments to outperform in 2020.

**Manufacturing activity is recovering –** Global manufacturing activity contracted last year as growth fizzled. Entering 2020, forward-looking business surveys have shown signs of bottoming in economic activity in both emerging and developed markets and are consistent with a still soft but improving demand environment. Activity in the services part of most major economies remains relatively robust and central bank policies are likely to stay accommodative until growth or inflation pick up.

**Valuations reflect pessimism –** Even with last year's rally, international developed stocks are priced at a 20% discount to U.S. stocks, with emerging-market stocks at a 30% discount.* Valuations have historically been a good predictor of long-term returns, and we believe higher dividend yields and better valuations support the possibility of above-average long-term returns for overseas equities positioning them to outperform U.S. large-cap stocks over time.

**Currency likely not a major obstacle –** The Canadian dollar (CAD) has been largely rangebound against major currencies - including the U.S. dollar – over the last four years. While the CAD modestly reduced returns for international investments in 2019, we don't expect a major breakout in either direction in 2020 as oil and interest rates could be relatively neutral influences.

## ▶ *Action for Investors*

We recommend investors add overseas equity investments, as appropriate, to take advantage of the likely re-acceleration in global growth. In contrast, the very low rates in the rest of the world keep us cautious about international fixed income, and we recommend reducing international bond investments.

*Source: Forward price-to-earnings ratio, MSCI EAFE and MSCI Emerging Market relative to S&P 500.

 

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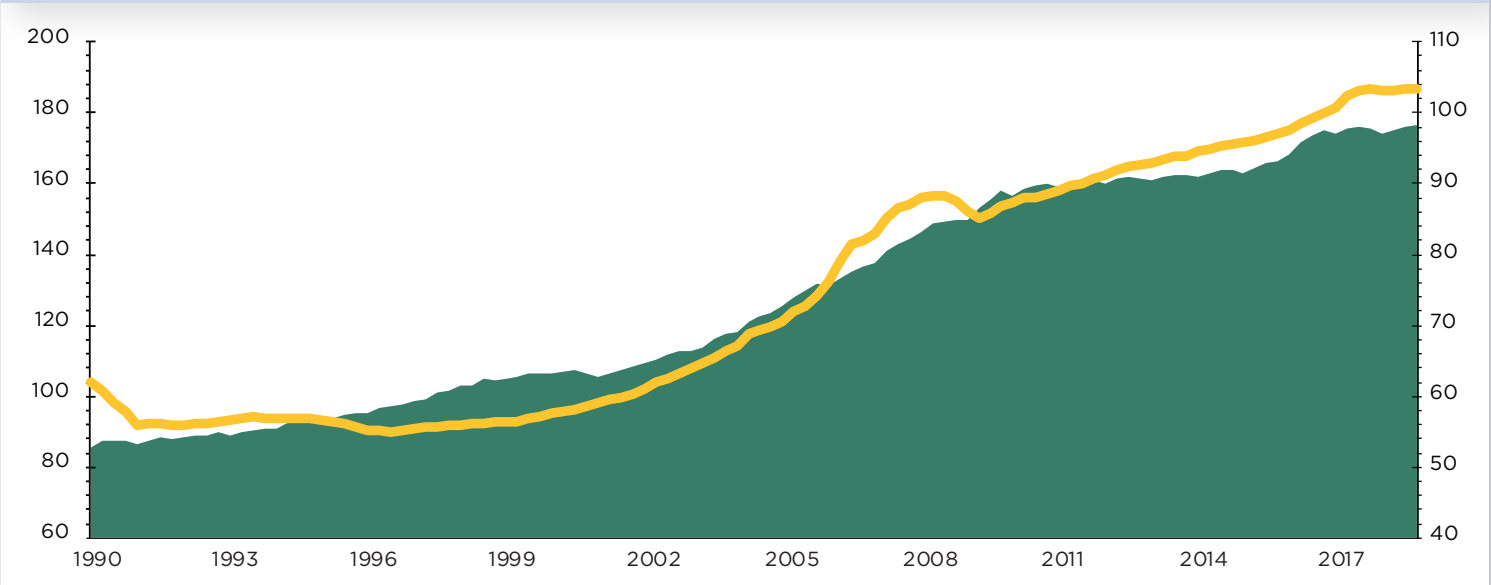
## Household Debt to Disposable Income vs. New Home Price Housing Index




Source: Statistics Canada, Table 38-10-0235-01 Financial indicators of households and non profit-institutions serving households, national balance sheet accounts.

QUARTERLY MARKET OUTLOOK: **FIRST QUARTER 2020**

# Rising Debt: A Looming Risk?

There has been no shortage of risks in the market lately, but these have been countered by a growing economy, allowing markets to climb the wall of worry. We think this investment dynamic will continue, but rising debt levels are a risk we're watching. We think domestic household debt will have a more immediate impact, while corporate and government debt loads are likely to play a role in economic and investment conditions longer term.

**Household debt remains elevated –** The Canadian consumer debt-to-disposable-income ratio has reached a new high of 176%. While we don't think this will spark a wave of defaults, we do expect this to curb future household consumption in an already tepid economy. A weakening housing boom and slower consumer lending growth will be a key headwind for economic growth this year.

**Corporate borrowing at record highs –** In Canada, corporate debt has more than doubled over the past decade while U.S. corporate debt levels have risen to a record $10.1 trillion, or 47% of GDP[1], now exceeding the peaks of the '80s and '90s. Rising corporate debt is not surprising, nor completely unreasonable, as debt has been a cheap source of financing amid low rates. Further, debt as a percentage of corporate equity is roughly half its level before the financial crisis and reflecting strong earnings and stock market values.

**Government debt: large but longer-term –** At less than 40%, the Canadian federal debt-to-GDP level remains in a relatively favourable condition. U.S. federal debt, however, has surpassed $23 trillion, with persistent annual budget deficits set to add to that figure moving forward. This is not a pot set to boil over immediately, however, as U.S. debt-to-GDP[2] is slightly under 80% – still well below levels that portend financial stress or insolvency. Nevertheless, shifting demographics and ongoing deficits are likely to make rising government debt a more prominent risk further down the road.

### ▶ *Action for Investors*

Ensure appropriate diversification within fixed income portfolios, with the majority allocated to investment-grade bonds. To address corporate debt risks, we favour high-quality companies with sound financial positions and stable earnings. To address long-term government debt/interest rate risks, ensure a proper allocation to global equities and domestic equities with rising dividend potential.

1 Source: Bloomberg and Ned Davis Research, non-financial corporate debt.

2 Source: St. Louis Federal Reserve, federal debt held by the public as a percent of GDP.

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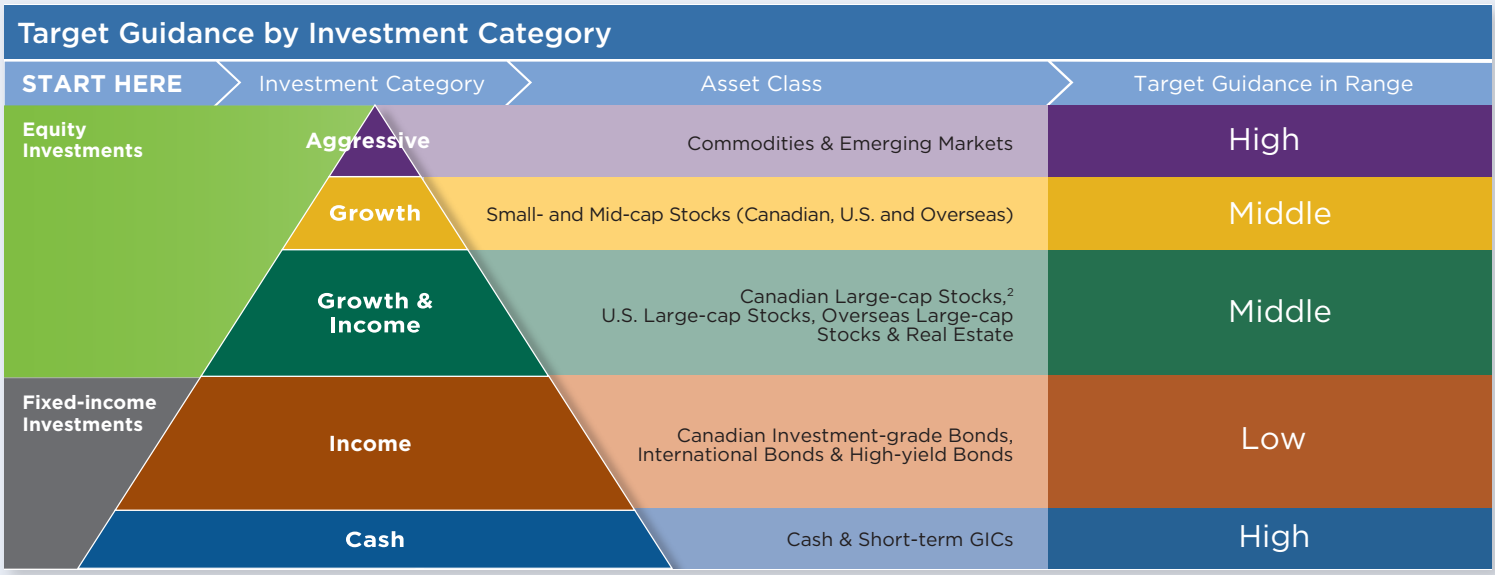


1 Alternative Investments and Stocks trading less than $4 align with the aggressive investment category, but they are not recommended.
2 Large-cap stocks that do not pay a dividend are in the Growth investment category.
Asset classes we don't recommend separately include alternative investments, micro-cap equities and international high-yield bonds.

QUARTERLY MARKET OUTLOOK: **FIRST QUARTER 2020**

# Asset Class Outlook

We believe well-diversified portfolios should be built by first identifying a targeted mix of equity and fixed-income investments based on your goals and comfort with risk, and then gaining exposure to a broad mix of the asset classes highlighted below.

**Equity Versus Fixed Income (Equity target = Middle) –** We think the bull market in stocks can continue, supported by modest economic and earnings growth. Interest rates remain low but are likely to rise slowly. A laddered bond portfolio and an above-average amount in cash may help provide downside protection for portfolios as volatility picks up.

**Domestic Versus International (International target = High) –** We recommend overweighting international equities and underweighting international fixed income as global growth starts to improve. Expectations appear too pessimistic and equity valuations have improved.

## Asset Class Diversification

**Aggressive (Target = High):** We recommend adding emerging-market equities, which we think are attractively valued, don't reflect early signs of improving global growth and could benefit if trade tensions ease. We remain cautious on commodity investments and don't think investors need additional investments beyond the TSX.

**Growth (Target = Middle):** Opportunities and risks appear balanced for U.S. small- and mid-cap stocks and international small-cap stocks as concerns about slower global economic growth are offset by low interest rates and easing monetary policy worldwide.

**Growth & Income (Target = Middle):** We recommend overweighting overseas and U.S. equities due to the sector composition of the TSX and our expectations for slower Canadian economic growth ahead. Overseas equities are attractive because expectations are low, dividend yields are high and early signs of improving economic growth should support better earnings growth as well. U.S. large-cap stock are attractive due to near-average valuations and support from modest U.S. economic and earnings growth.

**Income (Target = Low):** Long-term interest rates tend to move with inflation, which could rise slightly as labour markets tighten. Rates on high-yield bonds compensate for their additional risk, but we think international fixed income looks relatively unattractive due to very low foreign interest rates.

**Cash (Target = High):** We recommend overweighting cash, having enough to cover short-term expenses and invest during pullbacks.

Investors should understand the risks involved in owning investments, including interest rate risk, credit risk and market risk. The value of investments fluctuates, and investors can lose some or all of their principal. The prices of small-cap, mid-cap and emerging-market stocks are generally more volatile than those of large company stocks. Special risks are inherent to international investing, including those related to currency fluctuations and foreign political and economic events.

 

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# Investment Performance Benchmarks

It's natural to compare your portfolio's performance to market performance benchmarks, but it's important to put this information in the right context and understand the mix of investments you own. Talk with your advisor about any next steps for your portfolio to help you stay on track toward your long-term goals.

## *As of December 31, 2019*

| Benchmarks for Investment Categories | | | |
|---|---|---|---|
| **Total Return** | **1-Year** | **3-Year** | **5-Year** |
| Cash | 1.7% | 1.3% | 1.0% |
| Canadian Bonds | 6.8% | 3.5% | 3.0% |
| High-yield Bonds | 14.7% | 6.9% | 8.0% |
| International Bonds | 6.8% | 4.3% | 2.3% |
| Canadian Large-cap Stocks | 22.9% | 6.9% | 6.3% |
| U.S. Large-cap Stocks | 31.5% | 15.3% | 11.7% |
| Real Estate | 21.3% | 11.1% | 8.8% |
| Overseas Large-cap Stocks | 21.7% | 7.7% | 6.7% |
| Canadian Mid-cap Stocks | 26.1% | 5.6% | 5.0% |
| U.S. Small- and Mid-cap Stocks | 27.8% | 10.3% | 8.9% |
| Overseas Small-cap Stocks | 24.4% | 9.0% | 9.7% |
| Emerging-market Stocks | 18.1% | 11.5% | 7.5% |
| Commodities | 17.6% | 2.4% | -4.3% |

| Canadian Equity Sector Performance | | | |
|---|---|---|---|
| **Total Return** | **1-Year** | **3-Year** | **5-Year** |
| Basic Materials | 23.8% | 6.5% | 6.2% |
| Communication Services | 13.0% | 8.7% | 8.8% |
| Consumer Discretionary | 15.3% | 5.9% | 5.3% |
| Consumer Staples | 14.4% | 7.9% | 8.7% |
| Energy | 21.7% | -2.6% | -0.7% |
| Financials | 21.4% | 7.6% | 8.8% |
| Health Care | -10.9% | 0.2% | -28.8% |
| Industrials | 25.5% | 13.6% | 9.9% |
| Technology | 64.9% | 29.6% | 21.5% |
| Utilities | 37.5% | 11.5% | 9.5% |
| **TSX Index** | **22.9%** | **6.9%** | **6.3%** |

Source: Morningstar Direct, 12/31/2019. All returns expressed in local currency and include reinvested dividends. Performance represented by: Emerging Market Stocks: MSCI EM Index, Canadian Mid-cap Stocks: S&P/TSX Completion Index, U.S. Small- and Mid-cap Stocks: Russell 2500 Index, Overseas Small- and Mid-cap Stocks: MSCI EAFE Small Cap Index, Canadian Large-cap Stocks: S&P/TSX Composite Index, Real Estate: S&P Canada REIT Index, U.S. Large-cap Stocks: S&P 500 Index, Overseas Large-cap Stocks: MSCI EAFE Index, High Yield Bonds: Barclays HY Canadians Index, Canadian Bonds: FTSE TMX Canada Universe Bond Index, International Bonds: Barclays Global Aggregate Index. Past performance is not a guarantee of how the market will perform in the future. Indexes are unmanaged and are not available for direct investment.

 

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