INDUSTRIAL ALLIANCE INVESTMENT MANAGEMENT INC.

Market Commentaries

January 7, 2019

Economy and investment strategies in 2019
Recession unlikely and an expected increase in stock prices!

Comments from our Chief Economist, Clément Gignac

Highlights

Economy: Despite the recent flattening of the yield curve and the drop in stock prices last quarter, we estimate that the likelihood of seeing the U.S. economy sink into a recession in 2019-2020 is less than 25%. Strong economic fundamentals, combined with expansionist fiscal policy and far from restrictive monetary policy, should pave the way for a prolonged US business expansion and above trend growth in 2019 (+2.4% expected versus about 3% seen in 2018). Regarding the global economy, a deceleration of economic growth (around 3.3% in 2019 versus a projected 3.7% in 2018) is likely given the deceleration underway in China and geopolitical uncertainties (Brexit in Europe, tension between the White House and the Democrat-led Congress, etc.).

Interest rates: Due to the recent tightening of financial conditions (drop in equities and corporate bonds), the Federal Reserve (Fed) should take a pause in the first half of 2019, even more so as its current leading rate has basically moved back close to the “neutral” zone and inflationary pressures remain muted. The Bank of Canada should be more active given the delay in its interest rate normalization process.

Bonds: The Fed’s “wait and see” attitude should pave the way for a more “risk-on” mood. In such circumstances, high-yield corporate bonds and emerging market bonds are now more attractive than same time last year for investors with a higher risk tolerance.

Stock markets: Assuming there are positive developments in negotiations with China and a more pragmatic Fed, the significant volatility observed since early October should gradually reduce in the first half of 2019. History has shown that in the absence of a recession, Wall Street should recover a significant portion of the recorded losses (-19.8% since its peak) within a reasonable period (between 9 and 12 months).

Currencies: With the Fed temporarily taking to the sidelines and given the scope of budget and foreign imbalances (close to 8% of the U.S. GDP), downward pressure on the greenback should gradually increase in 2019. At the same time, the Canadian dollar should rebound closer to 80 cents U.S., even more so because the Bank of Canada should continue to normalize its rates.

Investment strategies: In the absence of a recession, equities should outperform government bonds in 2019. At current valuation levels, the Canadian and overseas markets (emerging markets) offer a better risk-return ratio than the U.S. market.

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Post-mortem 2018: The worst stock market performance in 10 years

Economically speaking, 2018 was marked by continued economic expansion south of the border for a ninth consecutive year. GDP growth was nearly 3% and the unemployment rate is at its lowest in almost 50 years.

However, the year was markedly less favourable for financial markets. Despite an exceptional rise in U.S. business profits, the Fed's decision to continue normalizing its monetary policy and the escalation in U.S.-China trade tensions have created a highly volatile environment on Wall Street. In fact, there were more than 80 sessions showing daily fluctuations exceeding 1% compared to barely eight in 2017. The risk premium on corporate bonds also increased substantially last quarter from an unusually low level.

This wore away at investors' patience, as near-record cash outflows (bonds and equities) of more than $45 billion were recorded in the third week of December, the highest since 2008.

This resulted in the S&P 500 index recording a drop of nearly 15% in the last quarter of 2018, its worst quarterly performance in a decade. Furthermore, December was particularly painful with a drop of 9.2%, the worst December since the 1930s! As Christmas approached, the S&P 500 index even approached the psychological barrier of a bear market with a downturn of 19.8% since it peaked in early October. In Canada, the story was relatively the same, with declines of 10% in the S&P/TSX in the last quarter of 2018 (around -10% for the year). It is worth noting that the contraction of the price/earnings ratio of nearly 20% seen on Wall Street in 2018 was among the top three observed in 40 years.

Bottom line: The severe decline of the stock markets and return of volatility in the last quarter led some observers to raise the possibility of an imminent recession and the end of the bull-market that started in 2009. What is our view on these two issues?

What's in store for 2019?

Prolonged business cycle and expected rebound in stock prices!

As we have often said, economic and stock market cycles do not die of old age. Regarding Wall Street's predictive ability, distinguished economist Paul Samuelson said as early as 1966 that Wall Street had predicted nine of the last five recessions! To this, we should add recent experiences from 1987 (Black Monday stock market crash) and 1997-1998 (Asian financial crisis) where the S&P 500 posted declines of nearly 33% ad 19% respectively without being a prelude to a recession of any kind the following year. In fact, as illustrated in the appendix, we have seen over the last 50 years more than seven major corrections (declines of about 20% or more) that were not accompanied or followed by a recession.

No recession in sight until at least 2021? Why?

Despite certain risk factors, we believe that economic fundamentals remain stable in the U.S. It is our position that 2019 will instead be the theatre for a soft landing of the U.S. economy (and not a recession) with projected GDP growth of 2.4% (compared to nearly 3% in 2018).

Here are a few reasons to explain our optimism:

1. Following the tax reform enacted in December 2017, the U.S. budgetary policy will remain expansionist in 2019 and add approximately 0.2% to the GDP. Additionally, with the 2020 presidential election, it would not be surprising to see an ambitious infrastructure program to gain support from a Democrat-led Congress.

2. Despite nine rate hikes by the Fed so far since late 2015, it is difficult to label the monetary policy as restrictive. The Fed's real policy rate (leading rate minus the inflation rate) is barely 50 basis points and since 1960, recessions were not recorded unless real rates exceeded 2%.

3. Unlike previous bull-market cycles, American households have continued to soundly manage their personal finances since the crisis of 2008, as demonstrated by the maintenance of their savings rate around 6%. If, as we anticipate, we see continued strong performance of the labour market in 2019, the level of confidence and behaviour of American households should not change too much despite the drastic drop in stock prices in the fourth quarter.

4. Unlike previous economic cycles, banks remained very conservative during this cycle and are clearly better capitalized than in previous cycles, due to the strict rules adopted following the last financial crisis. Historically, remember that financial institutions have often been accused of amplifying economic cycles by yo-yoing credit-access rules.

5. Although at a more moderate pace, emerging countries growth (responsible for nearly 50% of global growth) should continue in 2019. In China, the possible adoption of a more expansionist budget policy to deal with the uncertainty regrading the trade negotiations with the United States should facilitate a soft landing. In Brazil, the change in government is giving people hope and may stimulate consumer spending and business investment projects.

Given that the Canadian economy is highly integrated in the U.S. economy, the economic cycle should also continue in Canada in 2019. We expect a Canadian GDP growth of 1.9% in 2019, a level similar to the 2.1% observed in 2018. Even though the residential real estate sector slowed down considerably in 2018 in reaction to macro-prudential measures adopted in 2017, the rebound in Canadian business investment intentions following the new tripartite free trade agreement (USCMA) and the many infrastructure projects at different levels of government will help stimulate economic activity.

Interest rates: A more pragmatic Federal Reserve and a renewed Bank of Canada

With a relatively stable inflation rate of around 2% and the significant widening of corporate credit interest rate gaps, we see the Fed making a pause with its leading rate in the first half of 2019. Why? At the current level of 2.5%, the U.S. leading rate has finally reached the lower end of the "neutral" range (monetary policy is neither restrictive nor accommodating) of 2.5% to 3.5%. Moreover, the Fed's desire to continue to reduce the size of the balance sheet (at a pace of $50 billion per month) will also help tighten financial conditions. Thus, given the huge risk premium increase on equities and corporate bonds during the last quarter and the projected

deceleration of the American economy, we should expect the Fed to be more “patient and pragmatic” in 2019. It should seek to better communicate its orientations… while preserving its independence and credibility!

As for the Bank of Canada, several uncertainties raised in 2018 were resolved or are in the process of being resolved. For example, the trade agreement concluded on September 30th by the United States, Mexico and Canada, the significant rise in Canadian heavy oil prices and the soft landing in the real estate sector. In this respect, we believe that the Bank of Canada should continue to normalize its monetary policy while raising its key interest rate by 75 basis points to reach 2.5% by the end of 2019!

With respect to currencies, this type of scenario should translate into downward pressure on the greenback while considering major budget and foreign imbalances totalling close to 8% of the U.S. GDP. Conversely, this should pave the way to a gradual increase for the Canadian dollar, supported by the Bank of Canada’s desire to restore positive real rates. The target for the loonie by the end of 2019 is 80 cents U.S.

Stock markets: Expect more volatility…but with higher returns!

As trade negotiations with China will probably continue past March, we will undoubtedly still have to deal with volatile markets in the first half of 2019. Nonetheless, we believe that the recent correction of stock market prices offers excellent opportunities for investors whose investment horizon is 18 to 24 months. Here are a few arguments to support our optimism regarding the improvement of stock prices in 2019:

1. Contrary to the negative sentiment currently prevailing on Wall Street, we believe that profits for U.S. corporations should still show growth in 2019 (around 5%) even if this constitutes a deceleration when compared to an unsustainable pace of around 20% in 2018.

2. Currently, the U.S. market is trading at 14 times projected profits, which is less than the historic average of nearly 15 times over the last 10 years, and of approximately 16 times over the last 25 years. Given significantly lower interest rates than in the past, equities are even more attractive than bonds on a relative basis.

3. Based on historical data, the U.S. stock market recorded an average return of 23% in the 12 months following a market correction between 15% and 20%...if not followed by a recession.

4. A clear sign of investor capitulation, the pessimist (bear) ratio currently exceeds the optimist (bull) ratio. Historically, this level of capitulation is often associated with a market trough and is followed by a recovery in the following three to six months.

5. Another sign of investor capitulation: the dollar cash outflow observed on the bond and stock markets in the third week of December was similar to the colossal amounts observed at the low point of the 2008 financial crisis.

6. A reflection of disproportionate fear is that the percentage of stocks in the U.S. financial sector trading at their lowest point over the last 52 weeks exceeds the percentage recorded during the financial crisis of 2008-2009, whereas they are clearly more disciplined and better capitalized!

Recommended investment strategies

Even if the current environment of high volatility naturally leads investors to seek refuge in GICs or Treasury bonds, we do not believe that this is the best strategy, especially if investors have an investment horizon of 18, 36 or even 60 months.

1. Based on historical data, stock markets tend to recover losses incurred from a (even major) correction quickly (about 9 to 12 months), especially if not followed by a recession (see chart in appendix). In such a context, we recommend an overweighting of equites in balanced portfolios.

2. Overseas markets (particularly emerging markets) trade at a high discount with respect to their historical average, offer a better risk-return ratio and should benefit from a lower greenback.

3. History shows that leaders in the previous bull market are rarely leaders in the next bull market. Even if the recent correction of 19.8% does not correspond to the definition of a bear market in the strict sense, we believe the expectations with respect to the earnings growth of FAANG stocks are too high (13.8%) and unrealistic considering stiffer regulatory constraints and slower global growth.

4. At about 12 times its expected earnings, the Canadian market is trading at a high discount relative to the U.S. market. If leadership moves away from growth stocks to value stocks (banks, energy etc.), Canadian equities should outperform U.S. equities.

5. In the absence of a recession and considering a potential stock market recovery, the yield curve should increase through long-term rates as confidence is restored. In bond portfolios, we recommend lower duration and an overweight position in emerging-market and high-yield corporate bonds for investors with higher risk tolerance.

Risk factors

1. **Rising inflation:** Our basic scenario assumes a more pragmatic Fed committing to not compromising the continuation of the current economic cycle, especially since inflation is low and stable. However, an upturn in inflation expectations could lead the Fed to further tighten its monetary conditions and would increase the risk of a recession.

2. **U.S.-China trade tensions:** We assume that China and the U.S. will come to some sort of agreement by the end of March. Even if trade between both countries is not as significant once expressed as a percentage of their respective GDP, failed negotiations would create fear of an escalation in protectionism and further retaliation.

3. **Brexit:** At the time of writing, the outcome is still difficult to determine. In any event, we believe that the economic and financial losses of Brexit will be limited to England. Other European countries would suffer little collateral damage and be unwilling to follow in England's footsteps and leave the European Union.

4. **Trump's relationship with Congress:** Following the recent mid-term elections, President Trump should deal with a Democrat-led Congress. Given the president's style, it may be more difficult for the White House and the leaders in Congress to achieve compromise on some key issues.

Clément Gignac, M.E.Sc.
Senior Vice-President and Chief Economist

About Industrial Alliance Investment Management Inc. ("iAIM")

iAIM is a wholly owned subsidiary of IA Financial Group ("iA"). Its responsibilities include the portfolio management of iA's general funds, segregated funds and mutual funds including external manager oversight. Its assets under management exceed 78B$ and employs close to 140 resources including more than 100 investment professionals.

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Appendices:

Post-mortem 2018: A difficult year for global assets

Asset Class Total Return by Year (USD)

Ranking	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	
1- Highest	MSCI EM	MSCI China	MSCI China	Gold	MSCI EM	Gold	US TIPS	Global REITs	Russell 2000	US REITs	MSCI Japan	Russell 2000	MSCI China	US T-bills	1.8%
2	MSCI Japan	Global REITs	MSCI EM	US Agg. Bond	MSCI China	US REITs	Gold	MSCI China	S&P 500	Global REITs	US REITs	US HY	MSCI EM	US Agg. Bond	0.0%
3	MSCI China	US REITs	Gold	Global Agg. Bond	Global HY	Russell 2000	US Agg. Bond	Global HY	MSCI World SC	S&P 500	S&P 500	Global HY	MSCI Europe	Global Agg. Bond	-1.2%
4	Gold	MSCI Europe	MSCI Europe	US T-bills	US HY	MSCI World SC	US REITs	MSCI Europe	MSCI Japan	MSCI China	Global REITs	MSCI World SC	MSCI Japan	US TIPS	-1.3%
5	Commodities	MSCI EM	US TIPS	US TIPS	MSCI World SC	Global REITs	Global Agg. Bond	MSCI EM	MSCI Europe	US Agg. Bond	US Agg. Bond	S&P 500	MSCI World SC	Gold	-1.6%
6	MSCI World SC	Gold	Commodities	US HY	MSCI Europe	MSCI EM	US HY	MSCI World SC	US HY	Russell 2000	US T-bills	MSCI EM	S&P 500	US HY	-2.1%
7	US REITs	MSCI World SC	Global Agg. Bond	Global HY	Global REITs	Commodities	Global HY	US REITs	Global HY	US TIPS	MSCI World SC	Commodities	Russell 2000	US REITs	-3.4%
8	Global REITs	Russell 2000	MSCI World SC	MSCI Japan	US REITs	MSCI Japan	S&P 500	Russell 2000	MSCI China	US HY	US TIPS	Gold	Gold	Global HY	-4.1%
9	MSCI Europe	S&P 500	US Agg. Bond	Russell 2000	Russell 2000	US HY	Global REITs	S&P 500	Global REITs	MSCI World SC	Global HY	US REITs	Global HY	S&P 500	-4.4%
10	S&P 500	Global HY	S&P 500	Commodities	S&P 500	S&P 500	US T-bills	US HY	US REITs	Global Agg. Bond	MSCI Europe	Global REITs	Global REITs	Global REITs	-4.8%
11	Russell 2000	US HY	US T-bills	S&P 500	Gold	Global HY	Russell 2000	MSCI Japan	US T-bills	US T-bills	Global Agg. Bond	US TIPS	US HY	Russell 2000	-11.0%
12	Global HY	Global Agg. Bond	Global HY	US REITs	Commodities	US Agg. Bond	MSCI World SC	Gold	US Agg. Bond	Global HY	Russell 2000	MSCI Japan	Global Agg. Bond	MSCI Japan	-12.6%
13	US T-bills	MSCI Japan	US HY	MSCI World SC	US TIPS	US TIPS	MSCI Europe	US TIPS	MSCI EM	Gold	US HY	US Agg. Bond	US REITs	Commodities	-13.0%
14	US TIPS	US T-bills	Russell 2000	Global REITs	Global Agg. Bond	Global Agg. Bond	Commodities	Global Agg. Bond	Global Agg. Bond	MSCI EM	MSCI China	Global Agg. Bond	US Agg. Bond	MSCI World SC	-14.0%
15	US HY	US Agg. Bond	MSCI Japan	MSCI Europe	MSCI Japan	MSCI China	MSCI Japan	US Agg. Bond	US TIPS	MSCI Japan	Gold	MSCI China	US TIPS	MSCI EM	-14.2%
16	US Agg. Bond	US TIPS	Global REITs	MSCI China	US Agg. Bond	MSCI Europe	MSCI EM	US T-bills	Commodities	MSCI Europe	MSCI EM	US T-bills	US T-bills	MSCI Europe	-14.9%
17- Lowest	Global Agg. Bond	Commodities	US REITs	MSCI EM	US T-bills	US T-bills	MSCI China	Commodities	Gold	Commodities	Commodities	MSCI Europe	Commodities	MSCI China	-18.8%

Source: Scotiabank GBM Portfolio Strategy, Bloomberg.

Source: Scotiabank GBM Portfolio Strategy, Bloomberg, December 31, 2018

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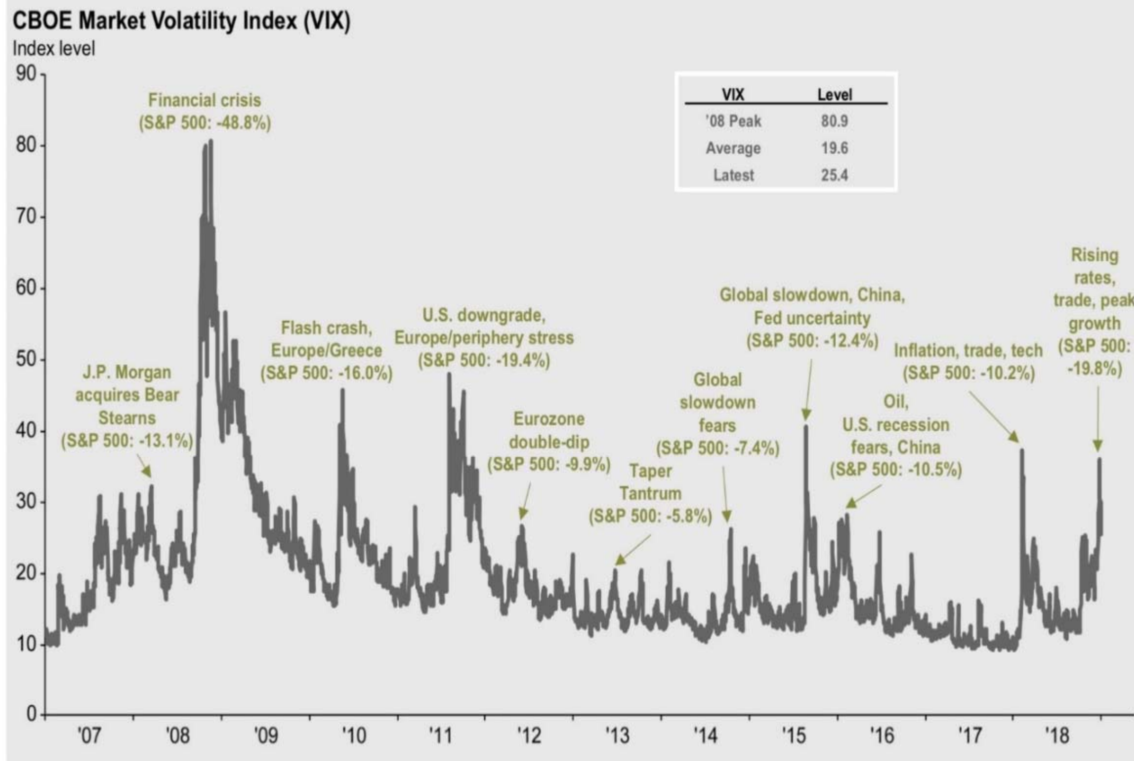
Post-mortem 2018: Volatility is back on Wall Street



Sources: CBOE, FactSet, J.P. Morgan Asset Management.
Stock market returns are based on calendar year peak to trough declines experienced during VIX spike, except for J.P. Morgan acquires Bear Stearns, which is based on the calendar year peak to the acquisition date. Average is based on the period shown from 12/31/2006 to 12/31/2018.
Guide to the Markets – U.S. Data are as of December 31, 2018.

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Daily Market Moves

	# of Trading Days		
Year	**1 - 2 %**	**> 2 %**	**All-Time Highs**
2013	38	4	45
2014	38	6	53
2015	72	10	10
2016	48	9	18
2017	8	0	62
4Q18	28	12	0
2018	64	20	19
Annual Avg	**52**	**11**	**26**
2013-17 Avg	**41**	**6**	**38**

Source : Credit Suisse, January 2019

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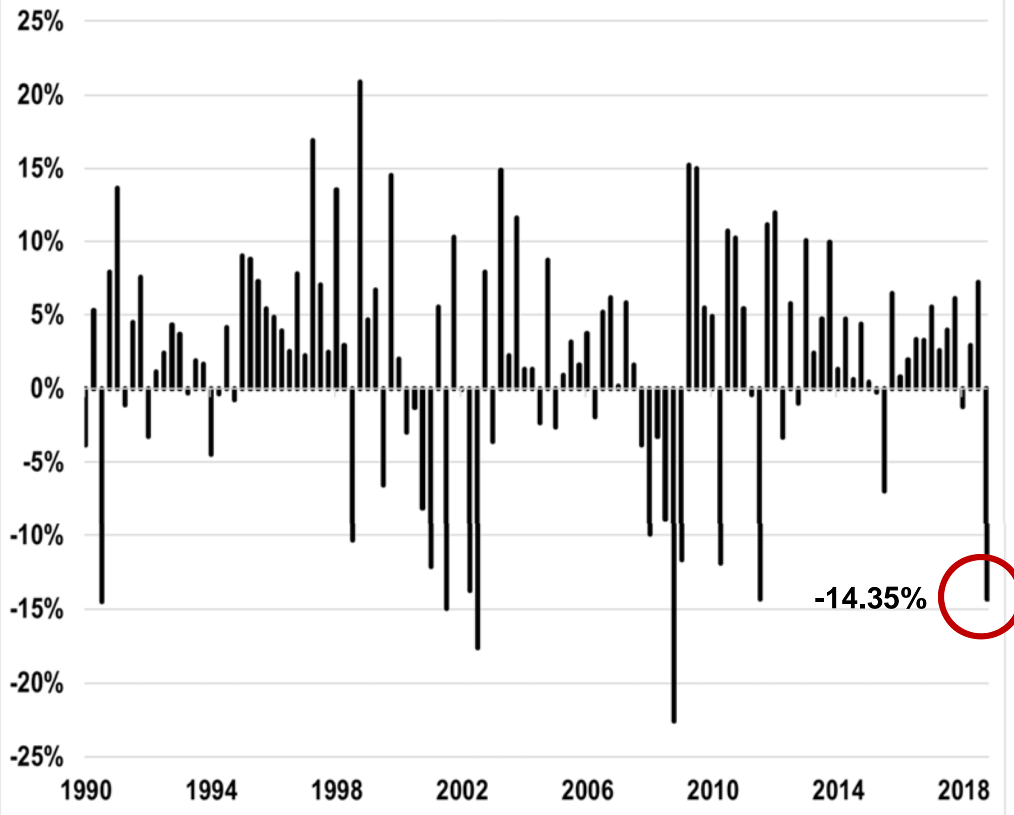
Q4 2018: A messy quarter to forget!



Source : Bloomberg, iAGP, December 31, 2018

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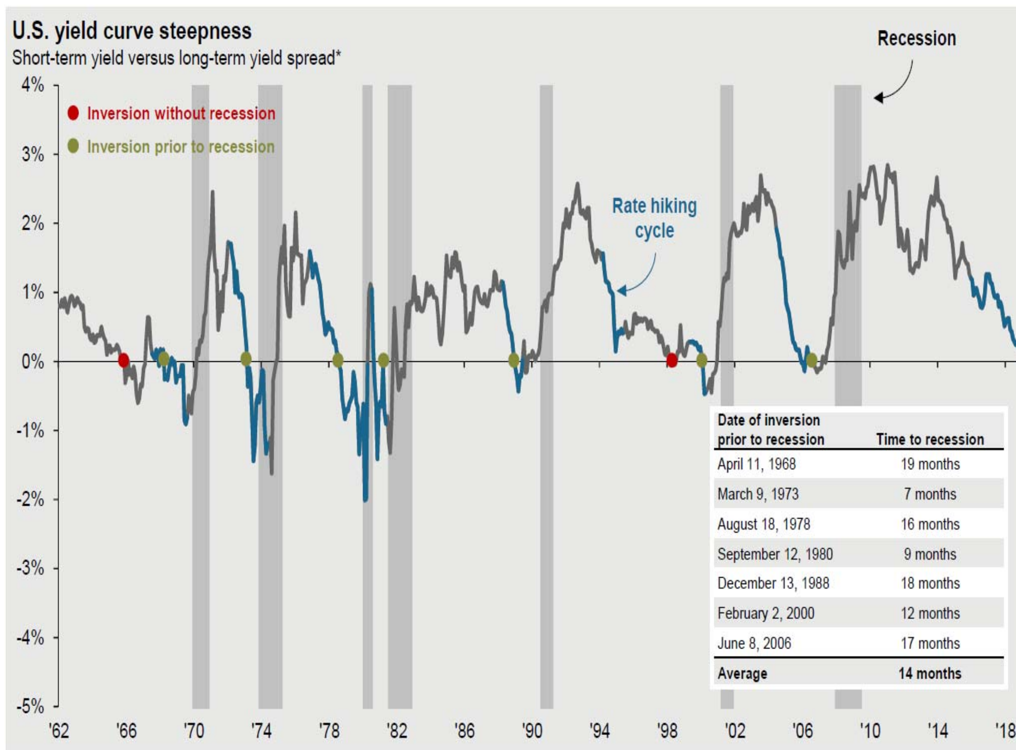
Wall Street's main concern for 2019:
Is the U.S. heading into a recession or not?



Date of inversion prior to recession	Time to recession
April 11, 1968	19 months
March 9, 1973	7 months
August 18, 1978	16 months
September 12, 1980	9 months
December 13, 1988	18 months
February 2, 2000	12 months
June 8, 2006	17 months
Average	**14 months**

Source: FactSet, Federal Reserve, J.P. Morgan Asset Management. *From January 1962 to May 1976 short-term bond is U.S. 1-year bond. Short-dated bond is 2-year from June 1976. Time to recession is calculated as the time between the final sustained inversion of the yield curve prior to recession, and the onset of recession.

S&P 500 Index Bear Markets Since WWII

Month of Peak	Month of Trough	% Decline	Recession?
05/1946	05/1947	-29%	No
08/1956	10/1957	-22%	Yes
12/1961	06/1962	-28%	No
02/1966	10/1966	-22%	No
12/1968	05/1970	-36%	Yes
01/1973	10/1974	-48%	Yes
09/1976	03/1978	-19%	No
11/1980	08/1982	-27%	Yes
08/1987	12/1987	-34%	No
07/1990	10/1990	-20%	Yes
07/1998	08/1998	-19%	No
03/2000	10/2002	-49%	Yes
10/2007	03/2009	-56%	Yes
04/2011	10/2011	-19%	No
	Avg (All)	-31%	
	Avg (Recessions)	-37%	
	Avg (No Recession)	-24%	

Source : iAGP, LPL Research, Factset

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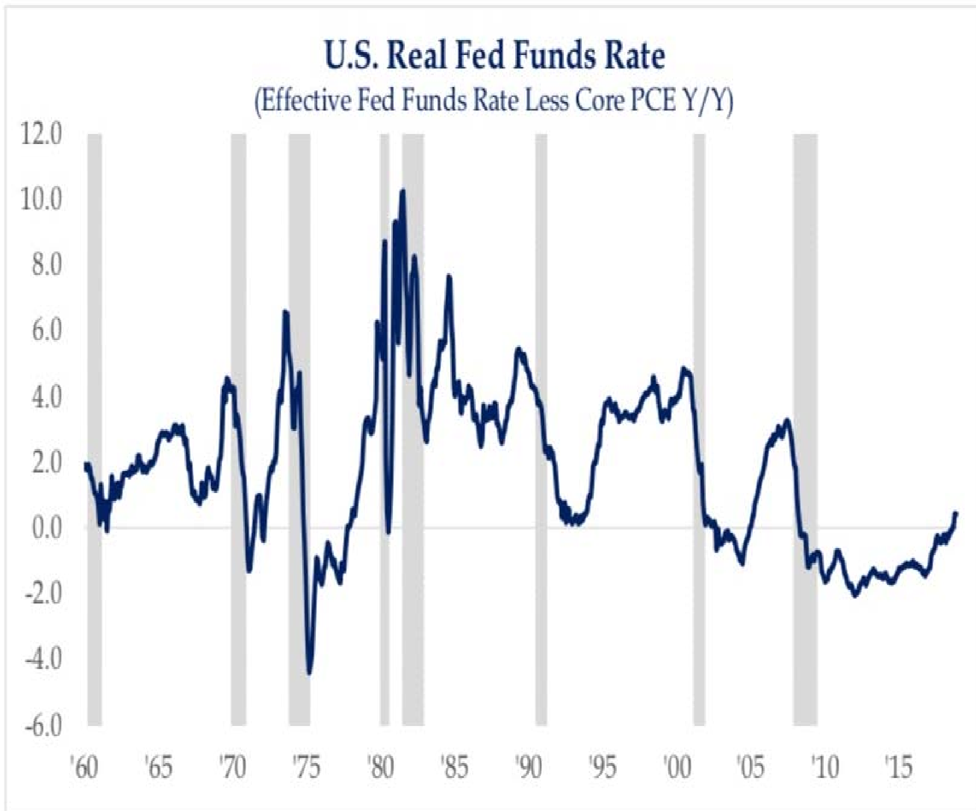
Real Fed funds rate near zero:
Recession unlikely at these low levels



Recession Dashboard

Start of Recession	Yield Curve	Inflation Trends	Job Creation	Credit Perform	ISM Mfg.	Earnings Quality	Housing Market
Nov-73	↓	↓	↓	↓	↓	--	↓
Jan-80	↓	↓	↓	↓	↓	--	↓
Jul-81	↓	↑	↑	↓	↓	--	↓
Jul-90	↓	↓	↓	↓	↓	↓	↓
Mar-01	↓	↓	↓	↓	↓	↓	↔
Dec-07	↓	↓	↔	↓	↓	↓	↓
Present	↑	↔	↑	↑	↑	↑	↔

Key: ↓ Recessionary ↑ Expansionary ↔ Neutral

Source: Standard & Poor's, Federal Reserve, BLS, National Statistical Agencies, NBER, ISM, Census Bureau, Haver Analytics®, Credit Suisse

Source : Strategas, December 2018

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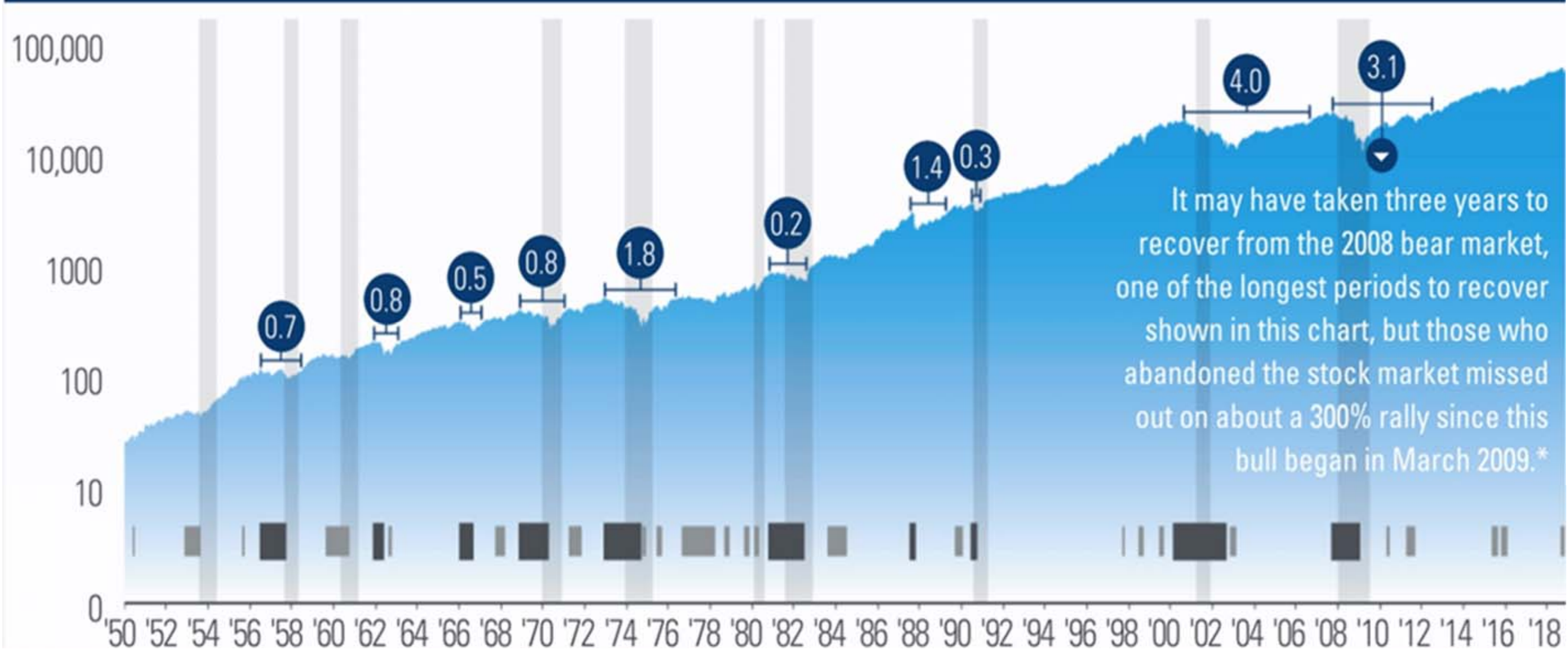
In the absence of a recession, the market tends to recover its losses faster



Source : LPL Financial

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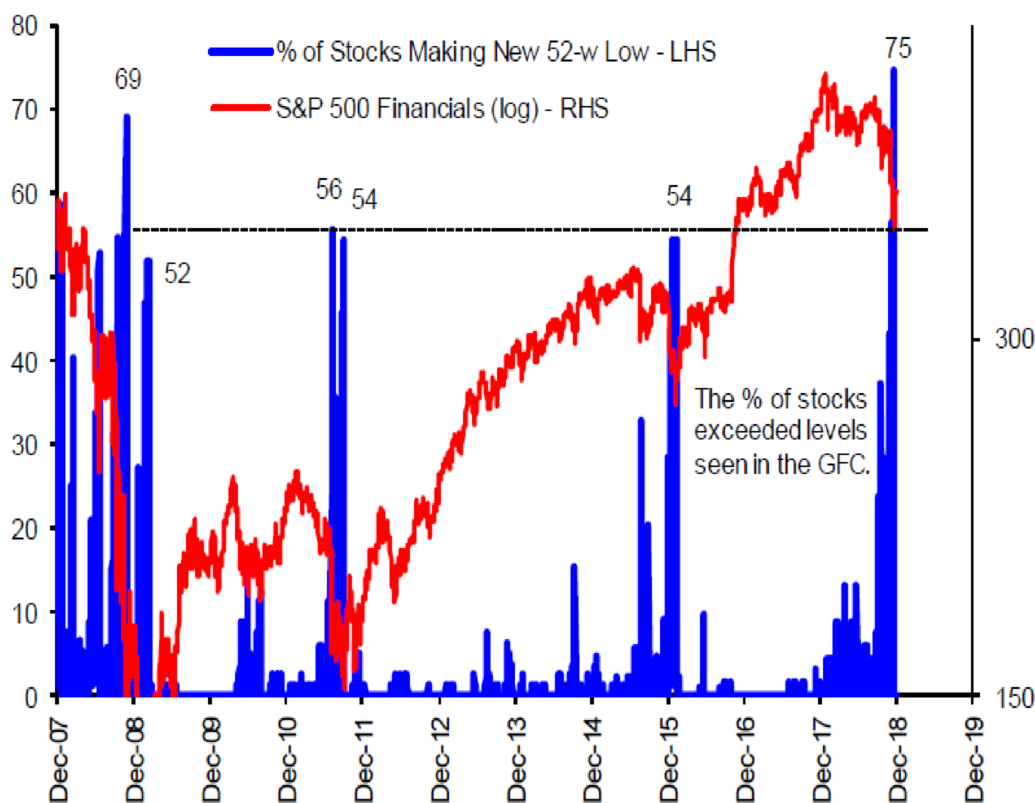
Some investment themes in 2019:
U.S. financials and overseas markets

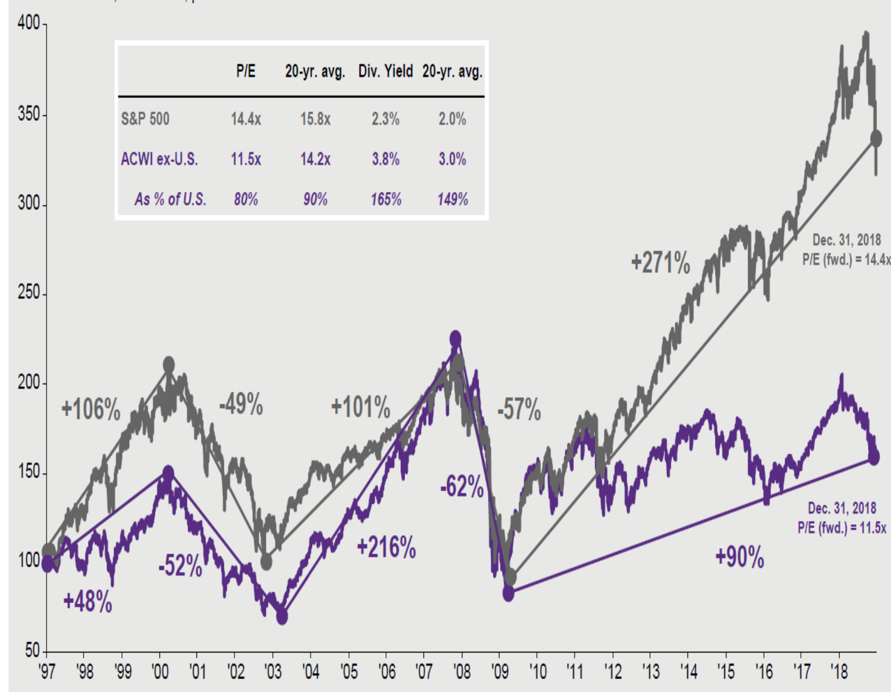
US Financials - % of Stocks Making New 52-w Lows



Source: Scotiabank GBM Portfolio Strategy, Bloomberg

MSCI All Country World ex-U.S. and S&P 500 Indices

Dec. 1996 = 100, U.S. dollar, price return



	P/E	20-yr. avg.	Div. Yield	20-yr. avg.
S&P 500	14.4x	15.8x	2.3%	2.0%
ACWI ex-U.S.	11.5x	14.2x	3.8%	3.0%
As % of U.S.	*80%*	*90%*	*165%*	*149%*

Source: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management.
Forward price to earnings ratio is a bottom-up calculation based on the most recent index price, divided by consensus estimates for earnings in the next 12 months (NTM), and is provided by FactSet Market Aggregates. Returns are cumulative and based on price movement only, and do not include the reinvestment of dividends. Dividend yield is calculated as consensus estimates of dividends for the next 12 months, divided by most recent price, as provided by FactSet Market Aggregates. Past performance is not a reliable indicator of current and future results.
Guide to the Markets – U.S. Data are as of December 31, 2018.

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The rate of return is used to illustrate the effects of the compound growth rate only and is not intended to reflect the future values of the investment fund or the return on an investment in the investment funds.

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