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AVIVA INVESTORS CANADA INC.
FIXED INCOME QUARTERLY COMMENTARY
Stone & Co.
FLAGSHIP GROWTH & INCOME FUND CANADA

GLOBAL ECONOMIC REVIEW AND OUTLOOK

(As of December 31, 2016)

The global economy appeared to reach an inflection point in Q4 2016 as fears of deflation were replaced by expectations of reflation. This coincided with a modest uptick in the performance of the major economies, albeit against the backdrop of potentially seismic political events in the form of the election of Donald Trump as US president and the rejection of constitutional reform in the Italian referendum. The oil price strengthened, with a structural recovery looking more likely after OPEC and non-OPEC members agreed to cut production.

US economic activity strengthened in H2 2016 following a disappointing H1 2016. GDP growth was estimated to have risen to 3.5% in Q3 2016, the fastest pace of increase in over two years and more than three times the H1 2016 average. The improvement in growth reflected continued robust household consumption growth, alongside a turnaround in net trade and inventories. Business investment growth remained sluggish, although the drag from mining investment largely came to an end. The acceleration in growth mainly reflected the waning impact of the previous tightening in financial conditions and the correction in oil prices at the end of 2014.

From a macro-economic point of view, the Eurozone seems to have finished 2016 on a stronger note. Having weathered the storms of Brexit, Trump and the Italian referendum, sentiment has remained elevated and a number of indicators even picked up towards the end of the year. Q4 2016 growth should be at an annualized pace of 2% and 1.7% for the year overall looks likely, slightly down on 2015, but an above-trend rate nonetheless. The more optimistic pundits have suggested that Eurozone growth could finally reach or exceed 2% in 2017.

For the UK, fears of a serious downturn, recession even, in the immediate wake of the referendum have proved unfounded, although many forward-looking indicators fell sharply at the time. Most subsequently rebounded and the UK economy has been extremely resilient in the period since the vote. Indeed, growth in Q3 2016 came in at a very reasonable 0.6%[1], with all components except inventories contributing.

Japan's economy was reported to have expanded at an annualized pace of 1.3% in Q3 2016[1]. Growth was supported by a strong rebound in exports, thanks to a number of one-off factors, including shipments of smartphones. Despite the absence of these factors in Q4 2016, exporters have been helped by a sharp depreciation in the Yen. Domestic demand was weak despite the disbursement of cash payments to low-income households. However, there was a solid pickup in residential investment. Business investment contracted, with concerns over global uncertainties weighing on sentiment.

Although we acknowledge the potential for heightened volatility given numerous geopolitical uncertainties, we believe that, in an inflationary environment, equity markets will benefit in the short to medium term from improving growth across the global economy.

Within equities, we favour a diverse exposure to North America, Europe and emerging markets. North America should continue to benefit from the US growth story together with the potential cut in corporation tax and other tax reforms, and in particular the domestically-focused companies and financials would be beneficiaries of Trump's policies.

We expect that US bond yields will head higher in 2017, creating an increasingly differentiated outlook with the euro area and Japan, where central bank policies continue to suppress yields. Central bank purchases in the UK and the Eurozone should continue to support corporate bonds in these markets, where spreads remain attractive relative to valuations in other asset classes. In emerging market debt, improving fundamentals have been challenged by the risk of increased protectionism and investor outflows. Such an environment increases the importance of focusing on risk-adjusted returns and taking a longer-term perspective.

[1] Source: Bloomberg

CANADIAN FIXED INCOME MARKET REVIEW AND OUTLOOK

In the fourth quarter of 2016 the FTSE TMX Canada Universe Bond Index generated a return of -3.44%. The weakness was driven by rising Government of Canada yields across the yield curve partially offset by running yield and credit spread tightening in the corporate sector.

We remain constructive on the Canadian investment grade bond market for the following reasons:

- credit spreads remain above historical averages
- stronger balance sheets in the energy sector following improved commodity prices
- Bank of Canada remains accommodative and has the tools to support the economy further if necessary
- The Canadian dollar remains significantly lower than the much stronger levels of the previous five years. This should help to offset expenditure challenges across the central provinces by bolstering non-energy exports

These factors are partially tempered by the following:

- credit spreads have tightened significantly since their early-2016 levels.
- the stretched balance sheet of the average Canadian household
- concerns around geopolitical events, and in particular, the impact of a protectionist Trump agenda for Canada
- the potential for weak North American growth

Aviva Investors Canada Inc., December 31, 2016