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AVIVA INVESTORS CANADA INC.
FIXED INCOME QUARTERLY COMMENTARY
STONE GLOBAL BALANCED FUND

GLOBAL ECONOMIC REVIEW AND OUTLOOK

Economic Review Q3

Global growth rates remained robust in the September quarter, helping to support sentiment towards risk assets globally. Encouragingly, there is no reason to suggest that buoyant growth rates cannot persist for some time yet. We expect global GDP to rise by close to 4% in both 2018 and 2019, similar to projections made by the IMF in July. This comprises growth in the developed world of around 2.25% and in emerging nations of close to 5%.

Alongside sustained inflationary pressures, this has required central banks to move interest rates higher or signal an intention to do so. Sensibly, policy makers are adjusting interest rates slowly, allowing the growth cycle to be extended. While the global expansion remains widespread, it has become less synchronized; the US continues to accelerate, while Europe and Japan have slowed slightly. Growth has also become less even in some emerging and developing economies.

In the US, the boost provided by President Trump's fiscal stimulus is ensuring growth remains well above long-term averages at a time when the economy is operating close to full capacity. The result is ongoing but, as yet, modest inflation in product and labour markets. In fact, inflation rates are now at or above target – typically around 2% – in most developed markets.

As a result, we expect most central banks around the world to follow the lead of the US Federal Reserve and slowly remove exceptionally loose monetary policy over the next few years. 'Unconventional' policies (including quantitative easing programs) have already been wound down or stopped in several nations and others are using 'forward guidance' to indicate that they will be removed in due course. Nevertheless, an era of gently rising interest rates is set to characterise the investment backdrop over the next two or three years – that is a very different environment to the one that has prevailed on and off since 2008 and it will be interesting to see how markets respond.

Specifically, we expect the Federal Reserve to raise US interest rates once more this year and three more times in 2019. The European Central Bank plans to stop asset purchases by the end of this year, but is not expected to raise rates until the autumn of next year. Normalisation in Japan may take longer, but an upward bias over the medium-term remains likely.

Market Review Q3

Global equities performed reasonably well in the third quarter of 2018, with the MSCI World Index adding 5.10% in US dollar terms. On the whole, global shares were supported by another period of very solid earnings growth from US-listed companies. Economic growth in the US accelerated to an annual pace of 4.2% in the June quarter, providing a supportive background for company profitability. Manufacturing data and other important economic statistics also suggested the US economy has not yet been adversely affected by 'trade war' concerns following the bilateral introduction of import tariffs between the US and China. These concerns did, however, affect sentiment towards Asian stocks. The Chinese share market, for example, lost further ground over the quarter. UK and European stocks were affected by ongoing Brexit uncertainties. In spite of some more conciliatory comments from both sides, British and European lawmakers have still not been able to agree on terms of the UK's proposed withdrawal from the European Union.

Government bonds suffered negative returns as investors were concerned that rising inflationary pressures would force central banks into more rapid monetary tightening. Although excess returns for good-quality corporate bonds increased, total returns were also negative. Prices for high-yield bonds nevertheless rose as they are more correlated to equities and are less sensitive to interest rate changes.

Outlook

The global economy remains on track for another year of solid growth, likely to be a little under 4%. However, while that would be a similar growth rate to that achieved in 2017, growth across countries and regions has become more uneven. In the US, for example, tax cuts earlier in the year have boosted household and business spending, pushing already robust growth even higher. Domestic demand growth has remained above average in Europe and Japan. There has been a slower rate of growth in China and some other emerging market economies too. We do not ascribe this to the imposition of tariffs by the US and China, which up to this point have not been large enough to have a material impact on global trade volumes.

While growth has become more uneven, the above-trend pace has seen spare capacity continue to be eroded in all the major economies. In the US, Japan and the UK, unemployment has fallen and is being reflected in wage growth. Combined with continued employment gains, this should underpin consumption growth across the major economies.

While fundamentals remain encouraging, the main risk to the outlook is a further intensification in the trade dispute between the US and China. The threat of both increased rates and a further broadening in the coverage of tariffs by the US (to potentially include all Chinese imports), and the potential for China to retaliate, could move the direct impact on growth and inflation to something more economically significant. Further, our growth outlook would have to be revised materially lower and inflation moderately higher if the dispute broadens and becomes more global in nature.

With growth expected to remain above trend this year and next in most of the major economies, and with inflation moving back towards central bank targets, accommodative monetary policy settings will gradually be removed. The US has already raised interest rates several times in this cycle and will continue to do so. Other countries have halted or reduced the extent of unconventional monetary policies or announced an intention to do so. Looking ahead, markets are priced for interest rate increases across the developed market economies over the next two years.

Periods of rising interest rates (or tighter monetary policy more generally) can be challenging for financial markets. This must be especially true after the extended period of ultra-low interest rates that has prevailed since 2008/09. While it is true that policy settings are being tightened because economic conditions have improved, it remains the case that the era of 'easy money' is ending. That is a headwind that financial assets must face.

Portfolio Commentary

In the third quarter the portfolio generated a return of -0.69% which was 27bps higher than the FTSE Canada Universe Bond Index. The positive return was driven by performance by our position in US corporate bonds that tightened meaningfully during the quarter. Sector allocation also benefitted performance, specifically the overweight in the pipelines, utility and telecommunications sectors. This benefit was partially offset by our underweight position in provincial bonds where spreads tightened. The structure of the portfolio did not change meaningfully in the quarter with our overweight corporate position primarily concentrated in the shorter end of the credit curve with higher weightings in holdings in Government of Canada and provincial bonds in longer-term maturities.

During the quarter the combination of economic growth, unemployment levels near 40-year lows and signs of increasing inflation in the Canadian economy led to rising bond yields. The performance detraction of rising yields was partially offset by a combination of yield, roll down and tighter corporate and provincial spreads. Progress in North American trade negotiations and still-healthy corporate earnings led to an improving market tone and the tighter spreads throughout much of the fixed income market.

The global economy remains on track for another year of solid growth, yet more uneven than in 2018 and with domestic factors playing a more important role. In the US, tax cuts have boosted spending and are pushing already robust growth even higher. Growth in Europe has been slower impacted by political risks in

the UK and Italy while some emerging markets have been negatively impacted by tightening financial conditions. In the remainder of this year and into 2019, the Canadian economy should benefit from US growth and pent-up business investment that had been delayed due to uncertainty around trade agreements with the US. Due to this pent-up demand, still-accommodative monetary policy and US growth, we expect corporate earnings to continue to be strong and the Bank of Canada to continue hiking prudently.

Although Aviva Investor's forecast for Canadian GDP growth in 2019 is slightly above 2%, there are risks on the horizon. First, trade tensions between the US and China have increased recently. Based on measures so far announced, we estimate that global growth may be lower by perhaps 0.25 percentage points and inflation higher by a similar amount. But there is the risk of further escalation of the trade dispute and the potential that this could spill over more significantly to global growth. Second, while wage inflation is rising, it is extremely tame in the context of unemployment at 40-year lows. An upward trend could cause rates to sell off substantially more which could hurt household balance sheets, credit spreads, and other risk assets