January 2020

AVIVA INVESTORS CANADA INC. FIXED INCOME QUARTERLY COMMENTARY

STONE GLOBAL BALANCED FUND

Q4 2019 GLOBAL ECONOMIC REVIEW AND OUTLOOK

Economic Review Q4

Having decelerated for the past 18 months, the pace of global growth is expected to trough at the end of 2019 and gradually pick up during 2020. We do not expect growth to rise above potential, but the outlook for the year ahead is nonetheless somewhat better than we had previously expected. This is significant for asset markets, as the probability of a severe downturn or recession in 2020 appears to have receded.

The brighter outlook is partly due to the agreement of a 'Phase 1' trade deal between US and Chinese officials in December. A moderation of tensions between the two superpowers should help reverse the sharp slowdown in business investment we saw in 2019 in many major economies. It should also prevent weakness in manufacturing sectors (which are sensitive to developments in international trade) spreading into much larger services sectors.

Alongside the recent de-escalation in trade tensions, 2019 saw a material easing in policy settings in key regions. In the US, the Federal Reserve lowered interest rates by 75 bps in the second half of 2019 and global monetary conditions are back to their loosest in several years. This should help boost global growth by between a quarter and half a percentage point in 2020, offsetting some of the effect of the increase in import tariffs during 2019.

Inflationary pressures remained muted in key regions during the quarter and are expected to remain contained. That makes it highly unlikely we will see major central banks tightening policy settings in the year ahead. That said, the likelihood of further easing also appears limited. In our central scenario, we expect the Federal Reserve and other major central banks to maintain existing policy settings in 2020. But with growth below potential, inflation below target and the risks remaining tilted to the downside, most are likely to maintain an easing bias.

Market Review Q4

Global equities continued their strong run of performance in the fourth quarter, making further progress and adding to gains made earlier in 2019. The MSCI World Index rose 8.7% during the period, extending its advance to more than 28% in the calendar year.

During December in particular, sentiment was supported by an apparent moderation in geopolitical risk. US and Chinese officials reportedly agreed to terms of an initial trade deal, removing the prospect of further tariffs being applied on imports and exports to one another. The brighter prospects for world trade boosted emerging markets in particular, with MSCI EM (Emerging Markets) Index rallying by 11.9%.

In Europe, the European Central Bank recommenced an asset purchase program, injecting €20 billion per month into the financial system in an effort to boost activity levels in the region. This helped the MSCI Europe index rise by 8.8% in USD terms.

Following further gains in the fourth quarter, global equity valuations are generally around or above their long-run averages, but we see scope for them to edge higher given the high equity risk premia implied by historically low discount rates. Moreover, equity funds saw substantial outflows in 2019, with bond and money market funds seeing significant inflows. Any reversal of this trend in the early part of 2020, particularly from retail accounts, could be a material catalyst for a move higher in equities. We do not expect re-rating to do all the heavy lifting; earnings growth is expected to improve following a very weak 2019.

Bonds struggled in the final quarter of 2019, having made solid progress in the first nine months of the year. The slowdown in global economic growth and resulting cuts to interest rates in key regions pushed bond yields significantly lower over the year. Improved prospects during the December quarter, however, saw yields retrace some of their earlier downward movement. Growth trends remained subdued globally, but the tentative agreement of a trade deal between the US and China brightened investors' mood. With the accord potentially removing a headwind to global economic growth in 2020, investors started to suggest that interest rates might not be lowered as aggressively as had earlier been anticipated. This focus on geopolitical developments was the key driver of sentiment during the quarter, with mixed economic data not appearing to have a significant influence on yields.

Outlook

The outlook for global economic growth in 2020 has improved, partly due to a temporary de-escalation in the trade war between the US and China. The probability of a global recession appears to have diminished and portfolios have been tilted in favour of growth assets. Combined with improving economic prospects, the current momentum in equity markets appears strong enough to support overweight exposure to equities.

Overall, we believe equity returns over the next 12 months will be driven by fundamental factors. We are expecting annual earnings growth, which was roughly flat in year-on-year terms in 2019, to return to positive territory. At the same time, moderating geopolitical risks and an improvement in the economic growth outlook could result in higher valuations during 2020.

That said, we are hesitant to take on significant risk. Equity valuations already reflect an improved economic outlook and we still consider the trade conflict between the US and China as unresolved, despite news of a "Phase 1" deal being agreed to in December. We are also cognisant of potential risks associated with the US presidential election in November, which could hamper US equities, in particular.

A reduction in duration exposure has funded the increased allocation to risk assets. Developed market bond yields moved significantly lower during 2019, making the risk-return trade-off of fixed income less attractive. Yields drifted higher in the December quarter, but remain well below their end-2018 levels in most key regions. With interest rates close to historic lows, monetary policy in many G10 economies approaching the lower bound, and with the worst of the economic slowdown seemingly behind us, the scope for a further bond market rally in 2020 appears limited.

PORTFOLIO COMMENTARY

Performance summary: Outperformed the index by 17bp for the fourth quarter, bringing year-to-date performance to +64bp versus the index.

Contributors: The strong relative performance of the portfolio in the quarter was driven overwhelmingly by security selection, with sector allocation also adding value. The strongest security-specific contributions were made by Enbridge, Capital Power and Videotron. At the strategic level, the overweighting of corporates was positive.

Detractors: The underweight position in provincials – a risk-reducing position – detracted from performance.

Outlook/positioning: We are currently positioned more conservatively relative to the index until such time that valuations warrant an escalation in the overall risk profile of the portfolio. Over the quarter, we have reduced our corporate positioning across the curve while increasing our Federal exposure across the curve. We also remain invested in a few key convicted US dollar issues.

Performance summary

Canadian credit spreads narrowed over the period as investors became more constructive on the outlook for the global economy. Sentiment received a boost from indications that the US and China were moving closer towards a deal on trade. Data releases, including strong payroll numbers, also suggested that the US economy was stabilizing after a summer dip in performance. From a technical perspective, corporate bond spreads were supported by strong investor demand against a backdrop of relatively high issuance. Yields in both the US and Canada rose and dragged total returns in negative territory, a reflection of the market pricing in a less dovish rhetoric from central banks with a lower probability of interest rate cuts expected in 2020.

For the quarter, the portfolio outperformed the index by 17bp, gross of fees, as a result of strong security selection and helpful sector allocation.

Attribution commentary

In the fourth quarter of 2019, security selection was the dominant driver of the portfolio's outperformance, with the majority of value being added in December. The strongest contributions were made by Canadian dollar investment-grade credits, notably Enbridge, Capital Power, GE, Hydro One and Ford. US investment-grade issuers, notably Energy Transfer Partners, also boosted returns. Within the high-yield exposure, the Canadian issuer Videotron performed well, while our US high yield bond exposure was neutral to performance but added a fair amount of portfolio volatility.

Sector allocation also contributed to performance, mainly due to our overweight position in corporate bonds given the tightening in credit spreads, in particular our overweight exposure to communications and pipelines. This more than offset our underweight position in provincials, a risk-reducing position, which detracted from performance.

Positioning commentary

Since the end of the third quarter, our overall credit risk positioning slightly decreased and remains below the index. Our corporate positioning has slightly decreased across the curve, reflecting in part our exit from our US health care positions in HCA and Cigna given the volatility caused by Medicare for all in the US and the impact on our original investment thesis. Additionally, we have closed our Vikings Cruises position within US high yield as we believed it had reached its full value.

The risk positioning of the portfolio has been facilitated by an ongoing underweight in provincial paper in the short and long parts of the curve. While provincial spreads have substantially lower volatility than corporate bonds, we believe they are, at current valuations, a particularly inefficient allocation to credit as we move further out the curve given (1) the very small amount of incremental credit spread pickup for added term and (2) other fundamental and technical factors-related considerations respecting provincial budgetary finances and vulnerability to a plausible Canadian macroeconomic downside scenario.

With respect to portfolio composition, within Canadian banks, we are only overweight short-term bonds for carry and roll down with a shorter duration than the index and predominantly in legacy deposit notes. We take a more cautious approach on bail-in and NVCC as their valuations do not adequately reflect the potential for substantially more issuance amidst a backdrop of a highly leveraged Canadian consumer and greater fiscal restraint being sought in the provincial credit space (and ultimate implications for bank asset quality). Our other key overweights remain in select pipeline exposure, communications, infrastructure, auto finance and power generation. Given the poor diversity of the Canadian market, we also remain invested in a few key convicted US dollar issues, mainly Energy Transfer Partners and Genesis Energy. Our high yield exposure is currently rather modest – about 2%. We are cognisant that these allocations come at a cost of somewhat-elevated volatility and susceptibility to risk-on, risk-off swings motivated by global macro market sentiments – especially as the Canadian credit market exhibits substantially less volatility than the US. Notwithstanding this cost of 'importing' idiosyncratic opportunities from other markets, our portfolio construction efforts are aimed at dampening such volatility, being less reliant on spread directionality and rather focusing on efficiently allocating risk across sectors and term buckets.

Outlook

We believe that credit markets are on the tighter end of the spectrum reflecting strong appetite for credit – especially as government yields renewed their path lower over the past year. As such, we are positioned conservatively until such time that valuations warrant an escalation in the overall risk profile of the portfolio. In fact, current market conditions offer little upside and we are looking to place a greater emphasis on downside protection. Therefore, given current market conditions, our portfolio construction process looks to emphasize carry, roll-down and idiosyncratic opportunities as opposed to spread directionality. Additionally, the risks associated with Canadian financials and provincials, while highly contained for now given the renewed low rate environment, remain an area of close focus for us for potential future deterioration from current valuation levels.