STONE ASSET MANAGEMENT LIMITED

March 2019

AVIVA INVESTORS CANADA INC. FIXED INCOME QUARTERLY COMMENTARY

STONE GLOBAL BALANCED FUND

GLOBAL ECONOMIC REVIEW AND OUTLOOK

Economic Review Q1

After three years of upgrades to global growth projections, the past few months saw modest downgrades from influential organisations such as the IMF and the OECD. These amendments coincided with data that confirmed the slowdown in sequential growth rates over the course of 2018. Across the G20 group of economies (which account for around 85% of global output), quarterly annualized growth slowed from around 4% at the end of 2017 to just over 3% by the end of 2018. That slowdown reflected a weakening in global manufacturing and trade, partly due to the introduction of tariffs on goods imported into the US.

Even more importantly, central banks amended their policy outlook due to a benign outlook for inflation. Most significantly, the Federal Reserve suggested US interest rates are unlikely to be raised in 2019, moving away from previous guidance for two rate hikes this year. Expectations for interest rate hikes in Europe have also been pushed out from this year to next, while the Japanese and Chinese economies continue to be supported by fiscal stimulus measures.

Collectively, policy makers appear to be increasingly wary of downside risks to both economic growth and inflation. Accordingly, the removal of extreme levels of monetary accommodation will now take place at an even more gradual pace. An expectation that interest rates will remain lower for longer enabled risk assets to perform well during the March quarter. The sharp sell-off in equity and credit markets in late 2018 quickly reversed in the first quarter of 2019.

Developments in trade negotiations between the US and China were also encouraging and helped support the rally in risk assets. The US delayed the introduction of additional tariffs due to commence in March, citing progress in the dialogue. Tariffs that have already been implemented have had an adverse impact on trade volumes and activity levels in exporting regions; a favourable resolution to the ongoing dispute would therefore augur well for the growth outlook and would be well received by investors.

Market Review Q1

Equity markets performed well, rebounding from weakness in late 2018. All major global share markets

registered solid gains, supported by a change in interest outlook in the US.

Federal Reserve officials suggested borrowing costs in the US are unlikely to rise in 2019. This was an important change in stance, as two increases in interest rates this year had previously been forecast.

Investors were also reassured by some encouraging developments in trade negotiations between the US and China. There was optimism that the two countries were nearing an accord, alleviating the risk of additional tariffs being introduced and thereby improving the outlook for exporting regions.

US equities performed particularly well, adding more than 13% in dollar terms. As well as the amended interest rate outlook, sentiment was buoyed by another solid set of quarterly earnings announcements from listed companies. While the pace of growth in the US has slowed, economic conditions remain more buoyant than elsewhere.

Shares in other regions also advanced, although Europe (11%), Japan (7%) and emerging markets (10%) lagged the US as economic data disappointed. Trade-related concerns also remained front of mind for investors given the export-oriented nature of these economies.

Bond markets had a solid quarter. The prospect of global interest rates remaining lower for longer pushed bond yields lower and supported prices. US Treasuries appreciated by 2.2%, for example, with a sharp rally in longer-dated issues causing the yield curve to invert. This was seen by some as an indicator of a looming recession.

Investors' healthy risk appetite also enabled corporate bonds to perform well. Although there remain concerns about the high-indebtedness of companies, most corporates are comfortably able to meet their debt repayment obligations and default rates remain low.

OUTLOOK

Having performed well in the first quarter of 2019, the big question for markets is whether global growth decelerates to a cyclical low-point in early 2019 and then picks up again, or whether the recent slowdown in economic activity is indicative of a more prolonged downturn.

We believe global growth will slow this year by more than we had previously anticipated, to around 3.4%. The impact of slower growth in China is expected to persist until at least the middle of this year, affecting activity levels globally. In the US, the fading boost from the fiscal expansion in 2018 will likely act as a further drag on growth this year.

While we have revised down growth expectations for 2019, we continue to see only a modest risk of recession in the major economies. Recessions typically result from a set of imbalances e.g. excessive household debt or corporate balance sheets becoming too stretched, central banks raising interest rates aggressively, or due to exogenous shocks. The risk from the first two of these appears to remain contained. The third is rather less predictable; we believe the most significant exogenous risk to the global economy is an inability for authorities to shore up growth in China.

Overall, we expect the global growth cycle to extend beyond this year supported by a pause in the global monetary tightening cycle. We are not expecting to see interest rates lowered; rather the Federal Reserve may need to consider raising rates again towards the end of 2019, or in early 2020. Such a move will be dependent on inflation and not just growth. This represents quite a significant change from our house view at the end of 2018 – disappointing growth data and subdued inflation suggests the Federal Reserve's policy normalisation program is likely now largely complete.

While market volatility will likely moderate as central banks support markets and growth stabilizes, changes to the regulatory environment and market structure mean we could see more shocks within what otherwise appears to be a lower volatility environment. Political risks remain high in some regions, for example, with several emerging market countries due to hold elections in the remainder of 2019.

PORTFOLIO COMMENTARY

In the first quarter the portfolio generated a return of 4.11% which was 20bps higher than the FTSE Canada Universe Bond Index. Sector allocation positively impacted performance, specifically the overweight in the pipelines and telecommunications sectors. This was partially offset by our underweight position in provincial bonds where spreads tightened. Security selection also contributed to performance with Energy Transfer Operating LP merging their holding

company and operating company and seeing a credit upgrade on the holding company's debt and spread tightening due to a simplified operating model. Teva Pharmaceutical also contributed on the back of spread tightening. Finally, Canada Housing Trust bonds also contributed to performance. The structure of the portfolio did not change meaningfully in the quarter, but we have reduced our Federal agency exposure to increase our provincial and corporate exposure. Our overweight corporate position is primarily concentrated in the shorter-end of the credit curve and our underweight position in provincial bonds is across most of the credit curve.

The sharp equity and credit market sell-off in Q4 2018 was quickly reversed at the start of 2019. That came on back of a pivot from the Federal Reserve and other central banks away from further rate hikes. As such, we saw both the Canadian and US bond markets rally as interest rates fell across the curves. Additionally, tighter corporate credit spreads in Canada also contributed to performance.

According to the IMF, global growth was estimated to be 3.7% in 2018, a similar rate of increase to that seen in 2017. When taken together, the past two years represent the strongest period of global growth since the start of the decade. However, the stability of calendar-year average growth masked a marked slowdown in sequential growth rates over the course of 2018. Across the G20 group of economies, quarterly annualized growth slowed from around 4% at the end of 2017 to just over 3% per cent by the end of 2018. That slowdown reflected a weakening in global manufacturing and trade, with the earlier policy-driven tightening in credit conditions in China resulting in weaker external demand across the major trading nations in Europe and Asia. In our central scenario we expect the global growth cycle to extend beyond this year, supported by a pause in global monetary tightening. However, central bank decisions will be contingent on higher inflation and not just growth. If global growth does not stabilize and pick up over the course of this year, then the case for lower rates in the US would become stronger.

While a slowdown in Canadian growth in late 2018 and early 2019 was anticipated, the decline has been sharper and broader than expected. Looking ahead this implies that growth in early 2019 will be slower than the Bank of Canada's ("BoC") forecast from their January monetary policy report. At the same time, macro concerns around US-China trade policy have impacted global confidence and economic activity. The combination of weaker-than-expected domestic growth and a disappointing global backdrop has led the BoC to take a more cautious stance to monetary policy tightening and therefore we expect rates to be kept on hold for now. On the inflation front, the headline rate has fallen due to lower fuel prices, but core inflation measures remain near target. Going forward, price pressures will be muted by the slower growth outlook. In particular, the BoC will be watching household spending closely to guide expectations about domestically driven growth and inflation pressures.

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