Market Commentary

Second Quarter 2017

CI Multi-Asset™ Management

Portfolio Series and Portfolio Select Series
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Market performance

The positive momentum in Canadian financial markets carried over to the second quarter. However, the tone changed when Bank of Canada officials hinted in June that they would soon be hiking rates. The Bank then increased its benchmark rate by 25 basis points after quarter-end, on July 12. It marked the first increase since 2010, despite some tough talk over the years.

The intention, as described by Governor Stephen Poloz, is to remove the stimulus that was initiated in 2015 when the world unexpectedly experienced a dramatic decline in oil prices. The sudden change from forever dovish to hawkish shocked investors, with the result that government bonds were re-priced lower with higher yields, the Canadian dollar rallied against major foreign currencies, and some stocks retraced earlier gains. Canadian investors who own bonds and domestic stocks and are exposed to foreign currencies experienced negative impacts.

Since Mr. Poloz was appointed governor, he has surprised investors twice with a cut in 2015 and a hike in 2017. Poloz's style is quite different than that of his predecessor, Mark Carney, and U.S. Federal Reserve Chair Janet Yellen and former chair Ben Bernanke – all of whom would give markets ample of time and hints before changing course. While a change of 25 basis points is not a significant event, investors have yet to learn our governor's style and its implications for the markets, particularly concerning volatility.

Returns in % at June 30, 2017	3 mo	1 yr	3 yr	5 yr	10 yr
S&P/TSX Composite Index	-1.6	11.0	3.1	8.7	3.9
S&P 500 Index (C$)	0.7	18.0	17.0	20.3	9.4
MSCI World Index (C$)	1.7	19.0	13.1	17.6	6.7
FTSE/TMX Canada Universe Bond Index	1.1	0.0	3.8	3.3	5.1

Source: Bloomberg, FTSE/TMX

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A valuation premium was accorded to growth-sensitive asset classes such as stocks and corporate bonds in the wake of President Trump's election, reflecting his plans for generous infrastructure spending. However, nothing has been done after six months in office. Talk can move valuations but not earnings. We remain skeptical and are positioning our portfolios defensively until either real money is spent or until after a market correction.

The quarter was more difficult for Canadian investors for the reasons highlighted previously. All of our portfolios finished the quarter with a modest gain and very attractive results on a year-to-date and one-year basis. Defensive positioning hurts performance but decisions on currency management, an overweight position in foreign markets and stock selection in the international portion added value.

Class F returns in % at June 30, 2017	**3 mo**	**1 yr**	**3 yr**	**5 yr**	**10 yr**
Portfolio Series Income Fund	0.7	5.3	5.2	6.8	5.9
Portfolio Series Conservative Fund	0.8	7.0	5.3	7.7	5.2
Portfolio Series Conservative Balanced Fund	1.0	8.7	5.8	8.7	5.3
Portfolio Series Balanced Fund	1.1	10.4	6.4	9.6	5.3
Portfolio Series Balanced Growth Fund	1.2	12.8	6.6	10.5	5.3
Portfolio Series Growth Fund	1.1	13.7	6.7	11.3	5.1
Portfolio Series Maximum Growth Fund	1.2	16.6	7.6	12.8	4.9
Select Income Managed Corporate Class	0.6	2.6	3.4	4.4	n/a*
Select 80i20e Managed Portfolio Corporate Class	0.7	5.1	4.1	6.1	5.0
Select 70i30e Managed Portfolio Corporate Class	0.6	6.0	4.3	6.8	3.8
Select 60i40e Managed Portfolio Corporate Class	0.7	7.0	4.6	7.5	5.0
Select 50i50e Managed Portfolio Corporate Class	0.7	8.2	4.9	8.3	5.0
Select 40i60e Managed Portfolio Corporate Class	0.7	9.6	5.3	9.2	5.0
Select 30i70e Managed Portfolio Corporate Class	0.7	10.9	5.6	9.9	5.0
Select 20i80e Managed Portfolio Corporate Class	0.9	12.8	6.3	11.0	5.1
Select 100e Managed Portfolio	0.8	15.5	6.9	12.5	5.5

**Since inception: 4.5% (Sept. 2010).*

Select Income Managed Corporate Class

The Bank of Canada started to prepare investors for a rate hike only a few weeks before it raised its overnight rate by 25 basis points to 0.75% on July 12. We wouldn't go so far as to call the increase a policy mistake as: 1) It is only 25 basis points. It may slow growth, particularly in the housing markets, but it is not significant enough to change the overall course of the economy; 2) We have waited seven years for the first

hike despite all the talk; and 3) There were concerns that monetary policy has been exhausted, so central bank are reloading "bullets" for the next economic problem.

Mr. Poloz surprised markets with his hawkish tone, which largely ignored low inflation and the recent strength in the Canadian dollar. The markets are now expecting and pricing in rising rates, rather than just the removal of the 50 basis point cut in 2015 to offset lower oil prices. This could be a mistake as domestic and global fundamentals remain fragile. Some issues in Canada that are not going away in the short term include:

- High household debt, which means high interest rate sensitivity, resulting in a larger impact on consumption
- Canadian mortgages are generally repriced at least every five years, so the additional cost of interest will increase many homeowners' expenses
- At the same time, productivity is not increasing, putting a lid on wages
- Canada is hiking when other central banks are relatively dovish, causing the Canadian dollar to appreciate and creating more headwinds for the manufacturing sector.

In her recent testimony, Yellen described the current U.S. rate (which is 100-125 basis points) as not being far from the neutral level, even though it is much lower by historical standards. If this is the case, then the ceiling for Canadian interest rates is not very high. A stronger Canadian dollar will likely reduce inflation and exports. This is not too different from 2011 when the Bank of Canada's hawkish talk drove up the Canadian dollar, and contributed to lower economic growth. Is the bank repeating this error?

The Canadian bond markets held up on the day of the hike, with most of the negative impact felt in the short end of the curve. The two-year yield rose 6.8 bps, the five-year was up 5.2 bps, and the 10-year increased 1.8 bps, while the 30-year yield actually declined 1.4%. (Note there is an inverse relationship between yields and prices.) However, elsewhere in the world, bonds were rallying on the more dovish tone in Yellen's testimony.

We believe there is no justification for a series of rate hikes in Canada given the challenges in our economy. If the Bank of Canada pursues this policy, there may be more short-term downside in fixed income and foreign exchange rates. We are optimistic about the longer-term performance of long-dated government bonds but are concerned that the markets may be swayed by central bank comments and not the fundamentals. In Select Income Managed Corporate Class, Portfolio Series Income Fund, CI Income Fund, and CI U.S. Income US$ Pool, the duration (a measurement of interest rate sensitivity) is less than the index and the portfolios are diversified with assets that are generally negatively correlated to rates. Our ability to withstand rising interest rates does not rely on any single factor or a rebound of any one asset class. We also have various tools to help us manage interest rate risk, currency risk and equity risk; they will be deployed on a proactive basis if necessary. Recently, we have reduced our fixed-rate high-yield bonds in exchange for exposure to floating-rate securities.

Is it time to give up on fixed income? Probably not. We have experienced one of the longest stretches of economic growth in history, increasing the likelihood of a recession within the next five years. We would

expect the overnight rate to average no more than 100 basis points for the next decade. The current yield of 1.925% (as of July 13) for a Government of Canada 10-year bond seems very reasonably priced. Investors receive a premium of about 90 basis points to lend for the long term.

Outlook and positioning

Given that the timing of the next recession or crisis is unknown, we believe it makes sense to continue with our portfolio management and risk management process. Even if results lag in the short term, in an environment that encourages persistent risk taking, our process has been proven over the long term.