Q3 2018 Commentary

Sentry Asset Allocation and Market Outlook

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EXECUTIVE SUMMARY

	Under-weight	Neutral	Over-weight	Our view
Fixed income				Expect a modest increase in interest rates and inflation, and maintain a short duration
Core fixed income				Modestly Increased allocation as we anticipate higher volatility for risky assets
High-yield fixed income				Underweight high yield bond market, maintain a bias to high quality (B – BB)
Equity				Overweight supported by U.S. growth, monetary policy should normalize gradually
Canada				Slight overweight as business sentiment should improve, however, headwinds remain with slowing credit growth and cooling household sector
U.S.				U.S. economy has been positively impacted by fiscal stimulus and low unemployment rate; economy seems to be entering self-reinforcing stage of the growth cycle
International				Major regions in the world are contributing to global economic growth. We are monitoring leading indicators for signs of economy softening.
Real assets				Neutral exposure to energy, real estate, infrastructure with a slight underweight to precious metals

ASSET ALLOCATION

- Our solutions are tactical, goals oriented and objective-based. Our asset allocation decisions are shaped by the opinions of our portfolio managers, which give us an opportunity to maximize the benefits of diversification and mitigate the impact of a correction as we strive to deliver strong risk-adjusted returns. We continue to anticipate positive global growth, albeit at a slower pace than that of first half of 2018 as trade disputes remain the biggest risk to the global synchronized expansion. Trade wars are inherently negative to economic prosperity for most people. Certain industries will naturally be on the right side of any tariffs, but overall population suffers higher prices, weaker business spending and confidence is eroded.

- While some central banks have a more hawkish tone, we remain confident that monetary policy will normalize gradually, and remain data dependent. The U.S. Federal Reserve (the Fed) and the Bank of Canada (the BOC) will likely raise interest rates once more in December 2018. The European Central Bank (ECB) is expected to end its quantitative easing program in December 2018, with rates markets starting to price in ECB rate hikes in 2H 2019, despite the confrontation between the Italy and the European Commission and waning data momentum.

- We believe that diversification is a prudent way to mitigate geopolitical, policy and valuation risk, which could be amplified during the next few quarters. We remain overweight equities versus fixed income, but we have begun

to narrow that difference, as the global economy may plateau in 2019 due to trade disputes and higher rates.

- Our equity exposure remains heavily concentrated in the U.S. and Canada where equity risk premiums, reflecting the difference between cyclically adjusted earnings yields and the risk-free rate, remain attractive. Meanwhile, Europe represents more than half of our international equity exposure. In the North American equity component, we believe that the U.S. economy is better positioned versus the Canadian economy for the coming period, but both should continue to grow. In Canada, we prefer to invest in companies that are exposed to improving energy prices and with exposure to the United States. Due to rising inflation, we are looking to invest in companies with pricing power that can pass on the cost of inflation to customers. We attempt to avoid investing in companies with high debt levels, which we believe will be negatively impacted by rising interest rates upon refinancing. U.S. equities continue to offer investors compelling risk-adjusted returns, while Canadian and European equities should provide capital appreciation potential as these equities are trading at better valuations.

- We believe fixed income exposure should provide investors downside protection as volatility picks up, and reasonable risk-adjusted returns, notwithstanding the recent increase in interest rates. We will keep the portfolio's duration (interest rate sensitivity) moderately shorter than that of the benchmark, and will maintain an overweight exposure to credit assets, although not as aggressively as in previous years. As monetary tightening filters through the market, generous returns may be tough to reproduce. We continue to believe that the U.S. dollar remains firm and have kept our foreign exchange hedges at a neutral level.

MARKET OUTLOOK

- **U.S. –** With growth accelerating and a very low unemployment rate, we are starting to the see the benefit of tax reform in consumer spending and business investment. The U.S. administration's goal of reducing trade deficits with other countries should spur domestic production, and result in higher gross domestic product growth. We believe that inflation will pick up as a result of low unemployment, rising raw material costs and the potential for further tariffs. With rising inflation, we are looking to invest in companies with pricing power (companies that can pass on the cost of inflation to customers). We are conscious of rising interest rates, which could result in a higher cost of capital, and will try to avoid highly indebted companies and those that we believe could be most negatively impacted by higher interest rates.

- **Canada –** We remain cautious on the domestic economy given slowing job and GDP growth. That said, there are bright spots following the resolution of North American Free Trade Agreement negotiations and Canada LNG announcement. With Shell moving forward with Canada LNG there will be C$40b of spending over the next 4 years – an opportunity for investors. The initial spend will benefit companies in logistics management, such as trucking businesses and companies that provide services to construction sites and camps. In this environment, we continue to prefer Canadian companies with exposure to the U.S. market, which is experiencing accelerating growth enhanced by improved business conditions. Additionally, we will remain disciplined in selection of primarily domestic Canadian companies that generate strong free cash flows and have low leverage.

- **International –** Despite the headlines of U.S. markets hitting new highs, most other markets were in a negative territory during the year. The emerging markets have been negatively impacted by several factors. The first is the strength of the U.S. dollar. The Fed's steady and consistent approach to raising interest rates, faster than other central banks, has resulted in a continued strengthening of the USD. Rising interest rates were also negatively impacting emerging markets given the debt levels and the fact that a majority of the debt is dollar denominated – thus making repayments more expensive from both a borrowing and currency perspective. Finally, global trade wars have the potential of disrupting global trade flow, much of which involved emerging economies. The combination of these activities has weighed heavily on emerging market equities, some of which are approaching bear market territory. We would likely need to see some combination of easing rates, a weaker U.S. dollar and resolution of trade disputes before investors feel more comfortable re-allocating capital to emerging markets.

- **Infrastructure –** In aggregate, while infrastructure securities faded with the rising rate/risk-off environment at the end of Q3, the underlying cash flows for companies in the sector generally – and the portfolio specifically – remained strong. Within utilities, we have seen good valuation opportunities emerge in US and international names, and we have added to this sector, largely replacing some more consumer focused names. Attractive entry points for names we know is the upside of the recent selloff, and we are comfortable reducing the beta of the portfolio with solid single stock upside potential. Transportation infrastructure such as airports and toll roads

continue to see positive, if decelerating, growth. In midstream energy infrastructure, while we have trimmed our positions, we feel comfortable that growing North American volumes of oil and gas production will continue to support accretive investments and growing cash flows for midstreamers.

- **Real estate –** We are at a stage in the cycle where we believe the strong companies will continue to separate themselves from the pack. Those with solid balance sheets, conservative payout ratios, and a culture of thinking forward will position themselves to capture growth and stability of cash flows in a low risk manner. The rise in interest rates has sent REIT pricing down and we are seeing opportunities in these types of companies beginning to emerge. We have a number of real estate companies on our radar and will look to deploy if we see further weakness. We continue to like Industrial, Multi Family, Single Family, and select Office subsectors throughout many developed markets.

- **Energy –** Energy sector had a tough quarter, especially in Canada given a higher than normal refinery maintenance schedule and rail not able to move crude out of the basin as quickly as expected. We remain constructive on the crude market as the demand is still relatively robust, inventory at normal levels and global spare capacity is at historical lows due to outages in Venezuela and Iran sanction. Valuation is at the low-end of the historical range. Most companies have free cash flow and return capital in form. Given the infrastructure issues in Canada and the Permian, we have rotated some our positions to international names such as Saipem.

- **Precious metals –** The manager believes that gold prices bottomed in the last quarter. However, in the short term, gold is expected to trade within the current range of US$1200-$1250 per ounce. One potential catalyst to lift gold prices beyond this current range would be a correction in the U.S. dollar and equity markets, further resolutions in trade uncertainties or a reversal in the extremely low COMEX gold speculative positioning.

Fixed-income markets

- **Investment grade bonds –** We anticipate that North American interest rates will continue to reset towards higher levels in the coming quarters, and we will watch corporate financing rates closely. We expect the ECB to end its quantitative easing program in December 2018, but interest rates are not likely to rise until the second half of 2019. We expect the U.S. economy to be positively impacted by fiscal stimulus in the short-to-intermediate term. The U.S. Federal Reserve will likely raise interest rates once more in 2018. The corporate bond cycle is entering its latter stages and any shock to the system could put significant pressure on corporate bond spreads (the difference in yield between bonds of similar maturity but different credit quality). The continued repatriation of overseas cash by U.S. corporations after recent U.S. tax reform legislation could also put pressure on corporate bond spreads, as much of the cash was invested in short-term corporate bonds. With this in mind, we have upgraded the fund's credit quality, and we have also increased its exposure to floating-rate bonds over the last few quarters. This shift should help us to take advantage of rising U.S. interest rates in the later part of 2018 and 2019.

- **High yield bonds –** Our base case assumes U.S.-centric growth persists and earnings growth moderates but stays positive. In this environment, credit should outperform duration. A bout of volatility, or policy uncertainty, could be healthy, if it tames the animal spirits in the markets. Until then, many markets, corporate bonds included, lack identifiable positive or negative catalysts and will be subject to broader risk sentiment. Merger and acquisition activity feels like it will continue and generally be credit negative for investment-grade issuers and positive for high yield companies. Investors looking for a market turn signal from the high yield bond market, traditionally reliable as the 'canary in the coal mine' may be disappointed. Credit quality there is relatively high, issuance low, and outflows are stable, in stark contrast to the emerging market bond, investment-grade bond, and leverage loan markets. Cognizant that deterioration in those markets will pressure our core markets we are gradually de-risking our high-yield exposure.

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