Greystone Quarterly Market Update

Q2-2018

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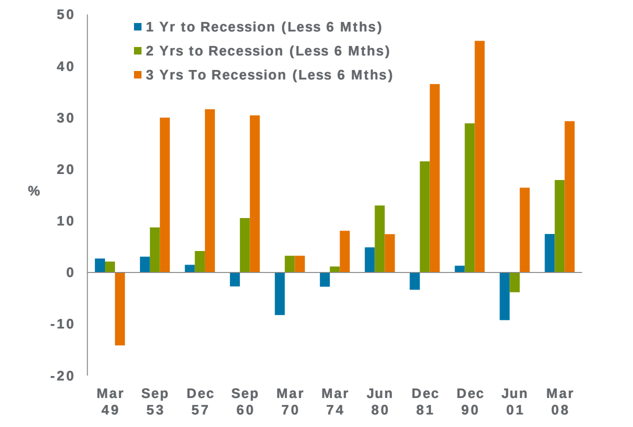
Commonly used terms within economic outlooks can often be more impactful through the emotions they induce versus their true meaning. For example, the phrase "late cycle" is increasingly common in the outlooks we read and hear about. The challenge for investors is to check the meaning of late cycle against loss-aversion instincts associated with the end of the cycle, which follows. We remind ourselves of two key points when setting Greystone's current outlook. First, late cycle does not equate to end of cycle, and it is historically a period of strong market returns until roughly six months before a recession. Second, debate around late cycle growth is focused on the United States with the rest of the world in the earlier stages of a recovery.

We see signs of continued growth around the world, albeit at a moderating pace. Financial conditions are generally accommodative with low long-term interest rates and tight corporate bond spreads. The United States is healthy with very strong expected real GDP growth in Q2, rising consumer sentiment and modest but accelerating wage growth. Productivity and capital expenditures are also showing signs of improving, which are to a degree offsetting and will continue to be needed to offset rising labour costs. The European Central Bank is likely to keep rates low well into the future and leading manufacturing indicators in Europe remain in expansionary territory.

Figure 1: S&P 500 Cumulative Returns Prior To Cycle End (Six Months Before Recession)



Source: Bloomberg. The National Bureau of Economic Research. US$ Returns.

Corporations have sustained their progress with revenue and earnings growth, albeit at a moderating pace. An area of increasing focus for us is inflationary and cost pressures that companies are increasingly facing. Tight labour markets, climbing commodity prices and protectionist policies are beginning to impact margins for companies that are unable to pass through costs. These pressures will likely persist as unemployment rates progress lower.

The Canadian outlook is stable but more cautious. Higher debt loads and mortgage rates may be resulting in consumer fatigue. A lower Canadian dollar has also failed to translate into an acceleration of exports reflecting a lower structural potential for the export sector. Stability, however, is provided to the domestic economy through higher commodity prices, low unemployment rates and population growth. If the global economy continues to grow, we believe Canada may be able to rebalance while maintaining positive economic growth. For investors, it is also important to note that the Canadian equity market is exposed to forces outside the domestic economy and will also perform well if global growth continues.

Interest rates remain close to but still below our assessment of fair value. In our view, 10-year yields will peak at modestly higher levels of between 3-3.5% in the United States and 2.5-3% in Canada. We view the flattening of yield curves as a normal function of tighter monetary policy.

Fears that the yield curve may be signalling a recession appear premature, particularly as long-term rates remain above shorter-term rates and there is a historical lag between flat curves and recessions.

Our outlook is not dismissive of risks that build up as the economic cycle progresses. We recognize that continued growth is discounted into prices across many public and private asset classes. Volatility and periodic sell-offs will likely also be a fixture for investors over the coming quarters. While we are less concerned about absolute equity valuations, rising corporate debt levels are a preliminary symptom of prolonged growth.

Geopolitically, the second quarter of 2018 shifted the stakes as well. On the positive side of the ledger, a historic meeting between the United States and North Korea reduces the risk of conflict between nuclear powers. That risk has been exchanged with the rise of Euroscepticism in Italy and the escalation of trade rhetoric between the U.S. and almost every other economic power in the world. While the economic impact of trade barriers is negative, we do not believe it is a catalyst for a global recession. An area of risk we are keeping an eye on is emerging markets where currency, interest rate and stock market indicators are flashing signs of caution. If financial conditions continue to deteriorate, the risk of a negative feedback loop into developed markets will also rise.

In light of the current environment, we would require high conviction in above consensus growth in order to increase risk in our portfolios. In aggregate this is not the case as our outlook for growth is similar to that of the markets. As a result, our active asset mix decision remains biased towards equities but with only a modest tilt. Regionally, we favour U.S. and international equity exposure over Canadian equities. The U.S. represents the strongest economic fundamentals, while international markets benefit from a very accommodative monetary policy.

Within debt markets, we are underweight duration and continue to see strong opportunities in private commercial real estate debt. Spreads available remain attractive when compared to investment grade and high yield bonds. Strong underwriting and strong security from underlying real estate can create strong fundamentals relative to elevated levels of corporate debt.

In client discussions around real assets, we are increasingly hearing questions regarding capital inflows to private real estate and direct infrastructure. Real asset valuations have risen in recent years, which may reduce expected returns; however, this challenge exists with public markets as well. In a multi-asset framework, the absolute returns nature of real assets can potentially add value while adding diversification to a balanced portfolio of stocks and bonds. In our view, the inaccessibility of real assets by many retail investors and the private nature of these investments preserves this strong relative investment and diversification case.

Effective deployment of capital is crucial at this phase of the economic cycle in order to maintain healthy risk-adjusted returns for real assets. Investors should focus on finding additional pockets of inaccessibility in order to reduce the competition for their capital, for example, deploying capital in direct infrastructure and real estate investments on an off-market basis.

We advocate for modest portfolio tilts towards return seeking assets as our economic assessment sees continued growth beyond the next 12-18 months. Through the maturation of the cycle we do believe that strong asset selection will play an increasingly important role for participating in growth.

Multi-Asset Returns

Calendar Year						Q2-2018
2013	2014	2015	2016	2017	YTD	3-Month
Glo. Eq 35.2	Long Bonds 17.5	Glo. Eq 18.9	Cdn. Eq 21.1	EM Eq 28.3	Glo. Eq 5.4	Cdn. Eq 6.8
Cdn. Eq 13.0	Glo. Eq 14.4	Infrastructure 11.5	Infrastructure 8.6	Infrastructure 17.6	Real Estate 3.9	Glo. Eq 3.8
Infrastructure 12.9	Infrastructure 10.6	Real Estate 7.8	EM Eq 7.3	Glo. Eq 14.4	Infrastructure 2.3	Infrastructure 2.8
Real Estate 10.6	Cdn. Eq 10.6	Mortgages 4.0	Real Estate 6.1	Cdn. Eq 9.1	Cdn. Eq 2.0	Real Estate 2.5
EM Eq 3.9	Bonds 8.8	Long Bonds 3.8	Glo. Eq 3.8	Real Estate 7.2	Long Bonds 0.9	Long Bonds 0.9
Mortgages 1.3	Real Estate 7.0	Bonds 3.5	Long Bonds 2.5	Long Bonds 7.0	Mortgages 0.7	Bonds 0.5
Cash 1.0	EM Eq 6.6	EM Eq 2.0	Mortgages 1.8	Bonds 2.5	Bonds 0.6	Mortgages 0.4
Bonds -1.2	Mortgages 6.0	Cash 0.6	Bonds 1.7	Mortgages 0.9	Cash 0.6	Cash 0.3
Long Bonds -6.2	Cash 0.9	Cdn. Eq -8.3	Cash 0.5	Cash 0.6	EM Eq -2.0	EM Eq -6.1

Benchmarks

- S&P/TSX
- MSCI World (Net)[1]
- MSCI Emerging Markets (Net)
- Infrastructure[2]
- IPD All Property[3]
- Custom Mortgage Benchmark[4]
- FTSE TMX Cda 91 day T-bill
- FTSE TMX Cda Universe
- FTSE TMX Cda LT Overall

Source: FactSet, Preqin, Greystone. As at Jun 30, 2018.
Returns in Canadian dollars, excluding Infrastructure (U.S. dollars). Gross of investment management fees. May be subject to rounding. Past performance is not necessarily a guide to future results.
[1] MSCI, net of foreign dividend withholding taxes.
[2] Infrastructure returns are the Preqin Infrastructure Quarterly Index up to Q4 2017 and are Greystone Infrastructure Fund (Canada) LP returns thereafter.
[3] Real estate returns are the IPD All Property Index up to its most recent publication, Q1 2018 and are Greystone Real Estate Fund Inc. returns thereafter.
[4] Custom Mortgage Benchmark: FTSE TMX Cda Short Term Overall 60%, FTSE TMX Cda Mid Term Overall 40% + 0.5% per annum.

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[1] As at Jun 30, 2018.
[2] An eligible employee is defined as contributing one or more years of service to Greystone.
[3] The Greystone Alternative Plus Solution is an integrated open-ended alternatives mandate where a client invests in the Greystone Infrastructure Fund (Canada) LP, the Greystone Mortgage Fund and the Greystone Real Estate Fund Inc. or the Greystone Real Estate LP Fund. Greystone holistically manages the underlying cash flows and liquidity of the allocation as well as the asset mix between the underlying strategies.

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