AS AT SEPTEMBER 30, 2015

From Greece to China to the Fed!

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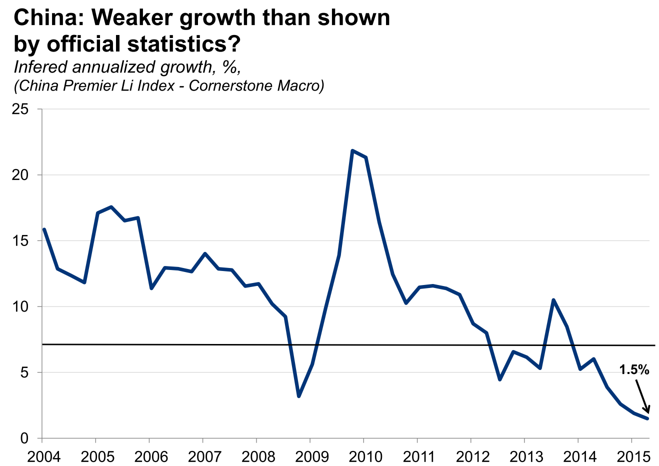
A number of significant developments took place in the third quarter of 2015, whether it was the resolution of the Greek political saga, the Chinese situation finally appearing on investors' radar screens, or the U.S. Federal Reserve (the Fed) injecting more uncertainty into the markets with its contradictory messages. For the Canadian investor, the role played by the Fed is probably the most important, given the deep interconnection between the United States and Canada, both economically and financially. Janet Yellen, chair of the committee that determines U.S. monetary policy, centred her speech on her concerns over the slowdown in China and the potential negative side effects on U.S. soil. The markets did not appreciate the Fed's uncertainty, and are now wondering if the Fed will find sufficient information in the data published between now and the end of the year to be convinced of the validity of raising its key policy rate for the first time in nearly ten years. This increase would have a rather symbolic impact, announcing that the effects of the crisis are well and truly behind us and that the U.S. economy no longer needs to rely on an ultra-accommodating monetary policy. Ms. Yellen made an additional appearance toward the end of the quarter where she reiterated that she (as well as the majority of governors) still expects to see conditions favourable to a rate hike before the end of the year. It now remains to be seen whether the fourth quarter will take place in a more or less volatile environment than the one we have just experienced.

World: China rocks the markets

All eyes were riveted on China in the third quarter, as it took centre stage to replace the political crisis in Greece, which has been resolved, at least for the time being.

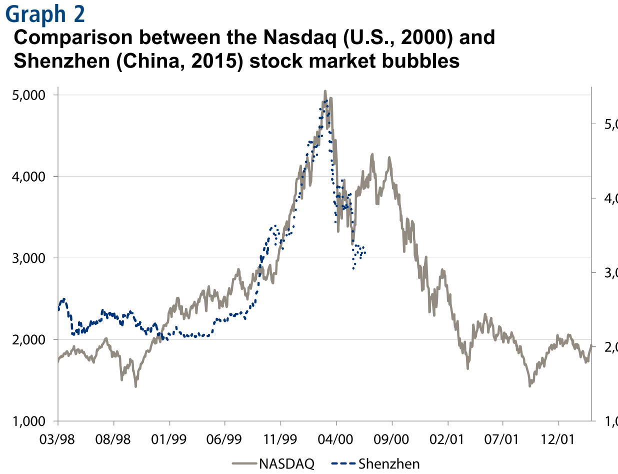
The Chinese economy is clearly in the middle of a slowdown, as has been repeated each quarter, and the signs of fragility are still clear. Official statistics are reporting annual growth of 7%, but some implicit indicators based on real economic activity (rail transport, electricity consumption, loans issued by banks) suggest a much lower growth rate of 1.5% (Graph 1). In August, China took a step toward liberalizing its currency, the yuan, which quickly awakened the ghosts of the late 1990s Asian crisis. At that time, several emerging countries found themselves forced to abandon the practice of pegging their currency to the U.S. dollar, which immediately caused an exodus of capital and the rapid devaluation of several currencies, primarily in Asia. Although for the moment there are no catastrophes in view within the emerging countries, which now represent nearly 70% of annual world economic growth, the risks are tangible given that a large portion of their debts are held in U.S. dollars and that their capacity to pay is therefore hindered by the relative strength of the greenback.

Graph 1



Source: IA

Graph 2



Source: IA

China has denied having wanted to purposely weaken its currency in order to stimulate its economy (thus dismissing fears of a currency war) and seems instead to be working to satisfy the requirements of the International Monetary Fund (IMF), which is pressuring China to liberalize its currency before including the yuan in its list of currencies making up special drawing rights, that is, the basket of major currencies that are widely recognized and used for world trade and the financial markets. China has not hidden its desire to see its currency recognized as such and, since the beginning of the year, has been gradually moving toward the liberalization of its capital markets.

All these steps, taking place at the same time as China is undertaking a very ambitious program of economic and social reforms, have caused Chinese markets to swing up and down in the last year. In fact, similar to the behaviour of the NASDAQ at the turn of the millennium, the Chinese stock market posted a return of 150% in the year preceding its June 2015 peak. The stock market has since deflated just as quickly, with the Shenzen index losing more than 40% over the summer (Graph 2). History tells us that we can typically expect a drop of 60% when a financial bubble bursts, so the decline is probably not yet over.

The economic and financial difficulties of the second world economy have obviously had visible consequences on the international markets, but it is essential to reiterate the importance of the situation for the natural resources market (Graph 3). To mention only a few examples, China alone consumes more than 45% of the world's production of aluminium, nickel, copper, zinc, tin and steel. As for oil, the United States and Europe remain the larger consumers, while China's share is smaller, at 12%. In short, for economies based in large part on natural resources (such as Canada!), the Chinese economic situation merits close attention.

Europe: Greek settlement (for the moment)

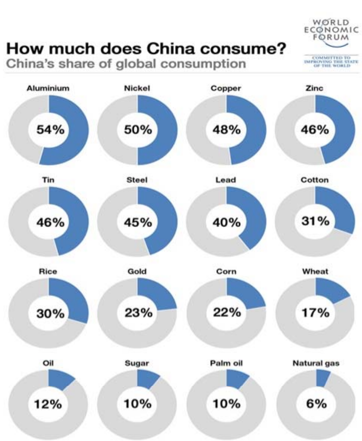
The political crisis in Greece seems behind us for the moment, but now the reforms imposed on the Greek government by the European authorities will have to be implemented.

An agreement was finally reached between Greek leaders and the European Union, the European Central Bank (ECB) and the IMF in order to ensure that Greece retains its place within the euro zone. This agreement contains by far the strictest austerity measures that Greece has had to accept over the last few years and was finally ratified by the Greek parliament at a special vote on July 23. The Syriza party, in power only since the beginning of the year, then launched a snap election, seeking a strong mandate to implement the reform measures imposed by the agreement. With the Tsipras government re-elected in mid-September, the way seems clear for a return to stability.

The international community appears to have lost interest in the situation since the end of July, but the game is not over yet. The IMF, the major player in this story, still does not seem convinced of the viability of the agreement reached, which does not include any debt relief for the Greek people. We will have a better idea of the IMF's participation in the fourth quarter, at the same time as Spain enters into its own election, where the subject of austerity is likely to be a key issue…

Elsewhere in Europe, economic data continue to show modest improvement (Graph 4), although we are still far from enviable levels of growth. In fact, the ECB has suggested it may extend its quantitative easing (QE) program and even

Graph 3



Source: World Economic Forum

Chart 1
Returns of the Canadian Bond Market as at September 30, 2015

Index	Returns (%) 3 months	YTD
FTSE TMX Canada Universe Bond Index	0.1	2.5
FTSE TMX Canada Short Term Bond Index	0.0	2.1
FTSE TMX Canada Mid Term Bond Index	0.8	3.8
FTSE TMX Canada Long Term Bond Index	(0.1)	2.1
FTSE TMX Canada Federal	0.9	3.0
FTSE TMX Canada Provincial	(0.3)	2.5
FTSE TMX Canada Municipal	(0.4)	2.1
FTSE TMX Canada Corporate	(0.2)	2.1

Source: Scotia Capital Debt Market Indices

increase the sums injected into the markets each month. The U.S. Federal Reserve's decision not to raise its key policy rate in September had caused a number of observers to speculate that the ECB could react by bolstering its QE program in order to avoid an undesirable appreciation of the euro. The ECB quashed this idea the following week, but the markets will in all likelihood continue to study the signals sent by the central bank over the next few months regarding the direction of its monetary policy.

United States: Strong domestic economy, despite the Fed

In the third quarter, we witnessed the magic of economic data revisions once again: U.S growth for the first quarter was revised into positive territory, to 0.6% (versus the previous estimate of -0.2%) and second-quarter growth was raised to 3.9%, placing the U.S. economy on excellent footing for the second half of the year.

Indeed, there are positive signs wherever we look.

The job market has made substantial progress in the last few years, and some leading indicators, such as the number of unfilled job openings, are at their highest in 15 years and are even at more attractive levels than at the previous economic peak in 2007. Other related indicators, such as monthly job creation, are also in much better shape than in 2007. It is mostly in labour utilization—for example, the number of people working part-time for economic reasons, long-term unemployment, and the labour force participation rate—where progress is still needed in order to return to the desirable pre-crisis level, but significant strides have still been made.

We are also seeing a rebirth in the manufacturing sector, where the theme of "reshoring," or moving production back onto U.S. soil, is playing an important role. The number of hours worked per employee in this sector is at a peak not seen since 1950, and job growth is at a 40-year high (Graph 5).

U.S. household confidence, at a peak since the financial crisis, is feeding sales of high-priced goods, such as automobiles and real estate, two sectors on which a

Chart 2
Market Returns as at September 30, 2015

Index	Returns (%)	
	3 months	YTD
FTSE TMX Canada 91 day T-bill Index	0.1	0.5
FTSE TMX Canada Universe Bond Index	0.1	2.5
S&P/TSX Composite Index	(7.9)	(7.0)
S&P 500 (Can. $)	0.5	9.4
MSCI - EAFE (Can. $)	(3.6)	9.4
MSCI - World (Can. $)	(1.7)	8.5
Exchange Rate (Can. $/US $)	7.4	15.5

Chart 3
Market Returns as at September 30, 2015

Index	Returns (%)	
	3 months	YTD
S&P/TSX Sector Returns		
Energy	(17.2)	(21.6)
Materials	(24.5)	(23.9)
Industrials	(2.1)	(10.0)
Consumer Discretionary	(3.6)	3.9
Consumer Staples	8.0	11.5
Health Care	(15.6)	33.7
Financials	(3.1)	(3.3)
Information Technology	2.8	4.7
Telecommunication Services	2.7	5.3
Utilities	2.4	(2.2)
S&P/TSX Composite Index	(7.9)	(7.0)

whole range of related sectors depend and which are playing a significant role in stimulating economic growth. On the real estate front, there has been a considerable increase in construction starts, building permits and, especially, builders' confidence, which is back to its 2005 level. Automobile sales are also at a 10-year high, with nearly 18 million vehicle sales per year. The average age of vehicles circulating on U.S. roads is now at a record 11.5 years, an encouraging factor for the continued stimulation of demand in the coming years.

Despite all this, the Fed opted on September 17 to maintain its ultra-accommodating monetary policy.

In its press release, the Federal Open Market Committee (FOMC), in charge of determining U.S. monetary policy, recognized the progress in the domestic economy and the job market, but saw a softening of exports (caused by the strong U.S. dollar and global economic weakness) and expressed concern over the weakness in inflation as well as the decline in inflation expectations.

The most important section of the press release, however, and the section over which much ink has been spilled, refers directly to recent developments on the world economic scene (weakness in China) and in the financial markets (bursting of the Chinese stock market bubble and global market turbulence in August and September), stating that U.S. economic activity could be adversely impacted.

This statement as well as the press conference given by Chair Janet Yellen injected a strong dose of uncertainty into the markets, for several reasons.

Firstly, even though the markets had mixed expectations regarding a potential rate hike in September, many people were surprised by the Chair's rather "dovish" tone.

Secondly, a number of observers were caught off guard by the press release's explicit reference to the international situation. The slowdown in China will not subside in just a few months, and if the Fed is concerned about it enough to delay its decision, it is difficult to see how it could feel comfortable initiating its monetary policy normalization between now and the end of 2015.

Thirdly, despite all this, Ms. Yellen reiterated that the committee still expects the data to militate in favour of a first increase between now and the end of the year, and the forecasts of the individual committee members, published along with the press release, still show that 13 of the 17 committee members expect to begin raising the key interest rate by the end of 2015. Moreover, following the decision, several committee members spoke out in support of the thesis of an increase in 2015, further adding to the confusion.

In short, rather than calming the uncertainty that had prevailed in the markets over the last few weeks, the Fed merely fuelled the confusion, leaving the markets scrambling to find their own points of reference. Chances are that the U.S. economy will remain robust in 2016 and that the first world economy is sturdy enough to support a first increase in rates, which would be symbolic because it would acknowledge the progress made since the worst recession of our generation. But for the moment, cutting through the confusion, we see a Fed that is sufficiently concerned over the low inflation outlook to exercise caution.

Canada: Truly in recession?

After two consecutive quarters of declining GDP, Canada is officially in a technical recession. However, we believe the word "contraction" would be more appropriate to describe the economy at the Canada-wide level, and that the word "recession" should be reserved for Alberta and other oil-producing provinces, where up to 24% of the economic activity depends directly on the oil and gas industry (Graph 6).

The Canadian economy has well and truly been hit by an oil shock and the slowdown of the Chinese economy, which have in turn slowed revenue growth

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Chart 4
Asset mix: Diversified Fund (040)

	Min.	Neutral	Max.	Actual Weight	Over Weight (+)/ Under Weight (-)	Change in quarter
Money Market	**0**	**5**	**25**	**12.5%**	**+7.5%**	**-10.5%**
Canadian Bonds	20	45	70	24.0%	-21.0%	-1.0%
International Bonds	0	0	15	0.0%	0.0%	0.0%
Total – Bonds	**20**	**45**	**70**	**24.0%**	**-21.0%**	**-1.0%**
Canadian Equities	**5**	**25**	**45**	**30.5%**	**+5.5%**	**+2.5%**
U.S. Equities	5	12.5	45	20.0%	+7.5%	+9.0%
International Equities	5	12.5	45	10.5%	-2.0%	+0.5%
Emerging Markets	0	0	45	2.5%	+2.5%	-0.5%
Total – Foreign Equities	**10**	**25**	**45**	**33.0%**	**+8.0%**	**+9.0%**
Total – Portfolio		**100**		**100.0%**		

and, to an even greater degree, business investment, in resource-related sectors. The situation is likely to remain this way for several quarters to come, if we are to judge from the major international agencies, which aren't expecting the current imbalance in the oil market to shift until the fourth quarter of 2016. And with the Chinese slowdown likely to continue, the backdrop is not very favourable for the prices of our main export goods.

One important observation is that, despite the five consecutive months of contraction in Canada's monthly GDP at the start of the year, the total number of hours worked has continued to rise (Graph 7). Recessions are typically characterized initially by a decline in the number of hours worked as companies gradually reduce the use of their factors of production (the same trend can usually be seen in the machinery usage rate), and the current behaviour of the job market indicates that the unease in concentrated in the resource sectors (geographically, in western Canada).

While in 2014, the large majority of jobs were created in the west, in 2015, although healthy job creation continues, the distribution has migrated toward the centre of the country, to Ontario and Quebec (Graph 8). We're still waiting for a clear sign that the manufacturing sector is taking up the torch of growth, so for the moment we will have to content ourselves with a few early signs of a recovery in non-energy exports, which are reacting tentatively to the weakness of the Canadian dollar.

The loonie is still a "petrocurrency" and continues to be rather faithfully tied to movements in the price of oil. On a longer term horizon, the loonie's weakness could persist in an environment of downward structural pressure on resource prices. Looking at the behaviour of the loonie over the last 40 years, we see that the Canadian dollar trades under its equilibrium value (typically called, in economic jargon, "purchasing power parity," or PPP) in periods where resource prices have depreciated, and above the equilibrium when resource prices are high (Graph 9). These periods of disequilibrium can last several years, for example from 1994 to 2005 or from 2009 to 2015. Our pessimistic outlook for resource prices therefore leads us to believe that it is reasonable to expect the loonie to remain below its equilibrium value for some time.

Financial markets: Waiting for the Fed and spotlight on Greece

A number of events shook the financial markets in this third quarter.

First off, the political crisis in Greece generated uncertainty at the beginning of the quarter, but its resolution in July quickly calmed things down. Then the situation in China took centre stage, precipitated by the bursting of the stock market bubble that had been inflating since mid-2014. The announcement of a controlled devaluation of the yuan in mid-August sent shock waves across world markets, which had become fragile after a prolonged period of low volatility. Combined with uncertain expectations as to whether or not the Fed would decide to raise its key rate in September for the first time since 2006, all the ingredients were there for a return to volatility (Graph 10).

Indeed, volatility was back with a vengeance at the end of August, as the U.S. stock market experienced its first technical correction (that is, a drop of more than 10% since its peak in May) in four years. As we regularly repeat in these lines, we consider that it is recessions that cause bear markets, and our radar screens are not showing any "recessionist" signs on the horizon.

One positive point emerging from this correction is that the valuation of the U.S. market quickly returned to a level in keeping with the average valuation observed over the last 25 years (Graph 11). Whether we look at the price/earnings ratio (15.4 vs. an average of 15.7), the price-to-book ratio (2.5 vs. an average of 2.9), or the price/cash flow ratio (10.9 vs. an average of 11.4), the U.S. market is back at a level where we can consider that it offers an "acceptable" valuation.

The Canadian S&P/TSX Composite Index, meanwhile, had already briefly entered a correction phase in July 2015, after having dropped more than 10% from its September 2014 peak. In the turmoil of August and September 2015, the index once again fell to extend the scope of its correction to nearly 17% since its 2014 peak. Canadian investors who invested outside the country can at least console themselves with the fact that the loonie's decline since the start

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Chart 5
Estimated Gross Returns for the Next 12 Months Starting on September 30, 2015

Market indicators	Interest or dividend	+	Capital gains	=	Total estimated gross return
FTSE TMX Canada 91 Day T-Bill Index	0.45%	+	0.00%	=	0.45%
FTSE TMX Canada Universe Bond Index	3.20%	+	(1.50%)	=	1.70%
Canadian stocks (S&P/TSX Composite Index) including dividends					8% to 10%

of the year completely erased the negative return of the S&P 500 (the return of the U.S. market in Canadian dollars is still above 5% for the year to date)!

Historically, just like the behaviour of the loonie described above, the Canadian stock market has tended to outperform only when natural resource prices are high (Graph 12). Since 1950, there have only been two periods when the S&P/TSX has offered a better performance than the S&P 500 over a period of a few years: from 1976 to 1980 (arrival of OPEC and run-up in the price of oil) and from 1999 to 2010 (rapid urbanization of China and overall increase in natural resource prices). Outside of these two periods, the Canadian stock market has offered at best, in local currencies, a return similar to that of the U.S. market.

Of course, over shorter periods (a few months or quarters), the Canadian market may offer more attractive returns, especially when an environment conducive to risk-taking takes hold for the short term. A seasoned investor must therefore remain attentive to market sentiment when choosing the relative weight to be attributed to each North American stock market.

The Canadian bond market started to rise again in the third quarter, as volatility took hold of the stock markets. The FTSE TMX Canada Universe Bond Index was up 0.1% in the third quarter of the year. Short-term bonds were relatively stable with a slight gain of 0.0%, and long-term bonds posted a meagre loss of 0.1%.

A first correction in four years hit the S&P 500, which fell 6.4% during the quarter. However, the loonie's depreciation cushioned the fall for Canadian investors, translating into a total return of 0.5% for the index in Canadian dollars. The Canadian stock market was also hit with a drop of 7.9%, led by significant declines in the materials, health and energy sectors. The Canadian S&P/TSX Small Cap index did not escape unscathed either, plummeting 15.2%.

Stock markets in Europe, Asia and the emerging markets carried over into another negative quarter. The European market, represented by the MSCI - Europe Index, fell 8.7% (-1.9% in Canadian dollars), the MSCI - EAFE lost 9.0% (-3.6% in Canadian dollars) and the MSCI - World was down 7.7% (-1.7% in Canadian dollars). Finally, the MSCI - Emerging Markets Index fell 12.0% (-11.7% in Canadian dollars).

Strategy: Time to be opportunistic

As in the summer of 2014, when low volatility in the markets made us skeptical, we once again maintained our exposure to equities at a lower level than usual, to the point of being basically neutral in equities. Our strategy described in the previous quarter of increasing the cash position and protecting the portfolio while positioning it to take advantage of market opportunities paid off once again as we were well positioned to take advantage of the decline in the markets.

The correction that took place during the quarter therefore opened the door for us to increase our weighting in equities. While panic was taking hold and the stock market was offering very attractive prices, we took the opportunity to use a portion of the accumulated cash to make some choice purchases.

Our strategy consisted primarily in increasing the weight of international equities and re-establishing a neutral weight in Canadian equities (which had been underweight until then). We also introduced targeted exposures to some sectors of the S&P 500, such as banks and real estate builders, which should both benefit from the momentum of the U.S. real estate sector.

With U.S. growth settling in, we continue to think that the bond market is expensive and that a decline in the market is more likely than an increase. We are therefore staying underweight in bonds within the portfolios.

The depreciation of the Canadian dollar continued throughout the quarter. The loonie went from US$0.80 to US$0.75 since the end of July, once again favouring the returns of our foreign investments. At the current level, it is difficult to formulate specific expectations for the loonie for the rest of the year; therefore, at the end of the third quarter, we were no longer holding positions on the U.S. monetary market.

Our wave of equity purchases at the end of the quarter brought the Diversified Fund's exposure to equities above the neutral targets dictated by the investment policy. Canadian equities now represent more than 30% of the Diversified Fund, of which 9% are in small-cap stocks. Foreign equities once again account for nearly 30% of the assets, including a 2.5% exposure to the emerging markets by means of a position in an exchange-traded fund (ETF) replicating the MSCI - Mexico index.

The weight of bonds remains below the target, at 24% against a target of 45%, due to our lack of conviction with respect to this asset class, and the caution warranted by an imminent increase in the Fed's key policy rate.

Finally, the Money Market balance now represents about 13% of the fund's assets, and we no longer hold any direct exposure to the U.S. dollar. At the loonie's current level (below 75 cents U.S. at the end of the quarter), we are no longer as convinced about the future movements of our currency.

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Chart 6
Economic and financial scenarios

Economic scenario

		2013	2014	2015	2016	2017	Change since June 30, 2015 2015	Change since June 30, 2015 2016
United States	Real GDP	2.2%	2.4%	2.8%	2.9%	2.8%	-0.5%	---
	Inflation rate	1.5%	1.6%	0.2%	1.9%	2.0%	-0.3%	+0.2%
	Unemployment rate	7.4%	6.2%	5.3%	4.9%	4.8%	-0.1%	-0.1%
Canada	Real GDP	2.0%	2.5%	1.2%	2.0%	2.2%	+0.1%	+0.1%
	Inflation rate	0.9%	1.9%	1.2%	1.7%	1.8%	+0.6%	+0.2%
	Unemployment rate	7.1%	6.9%	6.8%	6.7%	6.6%	+0.1%	+0.2%

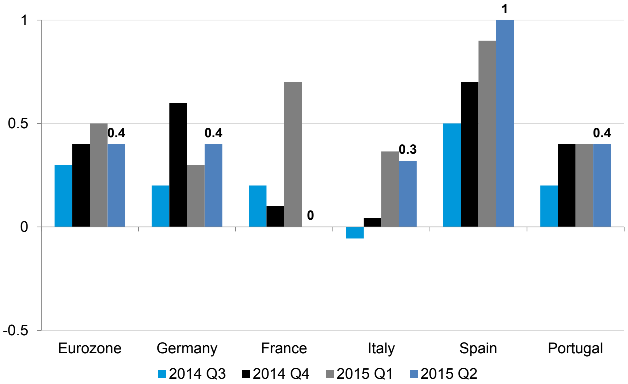
Financial scenario*

	Actual	Targets Dec. 2015	Targets June 2016	Targets Dec. 2016	Change since June 30, 2015 Dec. 2015	Change since June 30, 2015 June 2016
Interest rate						
U.S. 10-year rates	2.04%	2.30%	2.90%	3.20%	-0.25%	---
Canada 10-year rates	1.43%	1.70%	2.10%	2.40%	-0.20%	-0.20%
Exchange rates						
$US/$CAD	0.75	0.78	0.80	0.80	+0.03	+0.02
$US/Euro	1.12	1.1	1.05	1.05	+0.05	---
Oil price (WTI), $US	45.09	47	52	55	-3	-3
S&P 500	1,920	2,050	2,100	2,200	-75	-100
S&P/TSX	13,307	14,200	15,000	15,500	-800	-300

* end of period

Graph 4

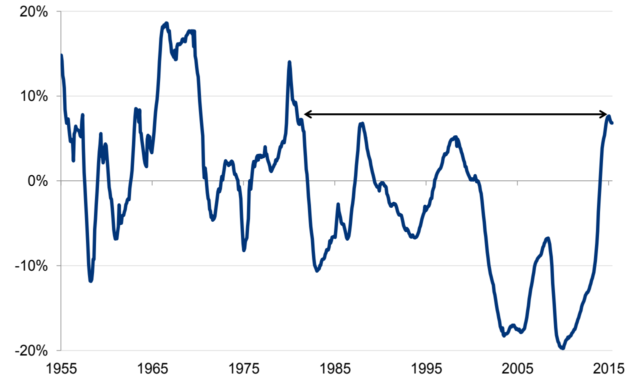
Euro zone: Growth is gaining breadth and momentum
Quarterly growth



Source: IA

Graph 5

U.S.: Growth in manufacturing sector employment
Change in % on 60 months



Source: IA

Graph 6

Contribution of oil and gas industry to economic activity

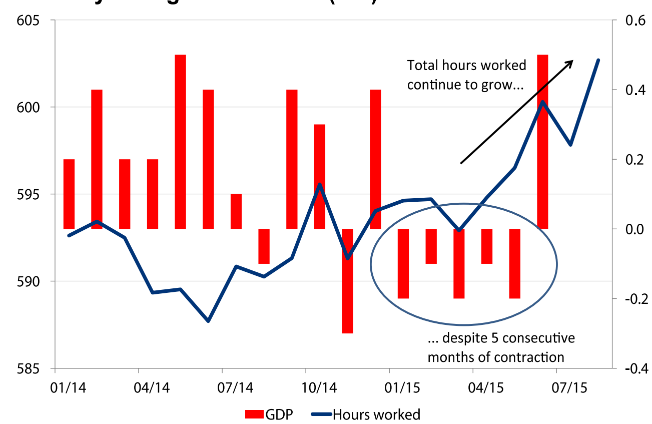
(As a share of total, 2014, %)

Region	GDP	Employment	Capital spending
Canada	6.2	2.2	34.0
Alberta	24.0	7.4	64.0
Saskatchewan	15.0	5.0	30.0
N.-F.-and-Labrador	22.0	7.1	23.0
United States	1.7	0.7	8.0

Source: IA

Graph 7

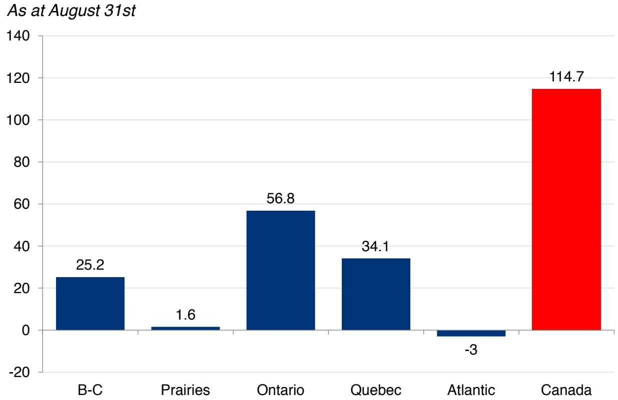
Total hours worked (lhs) and monthly change in real GDP (rhs)



Source: IA

Graph 8

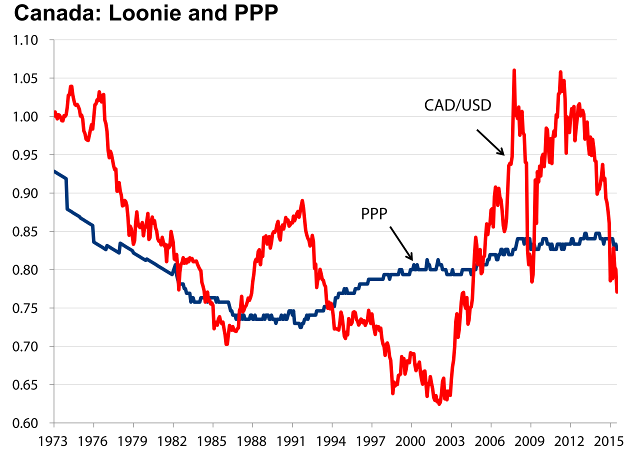
Jobs creation in Canada in 2015
As at August 31st



Source: IA

Graph 9

Canada: Loonie and PPP

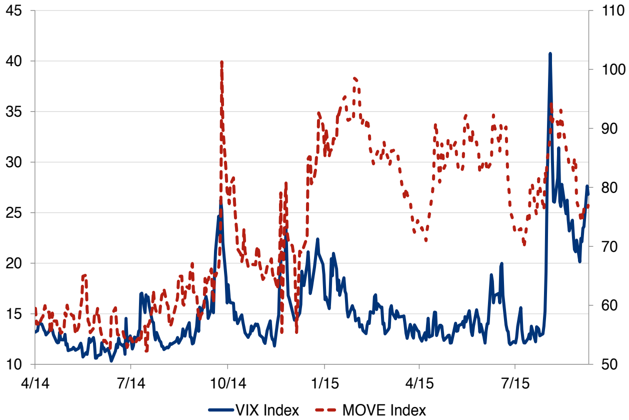


Source: IA

Graph 10

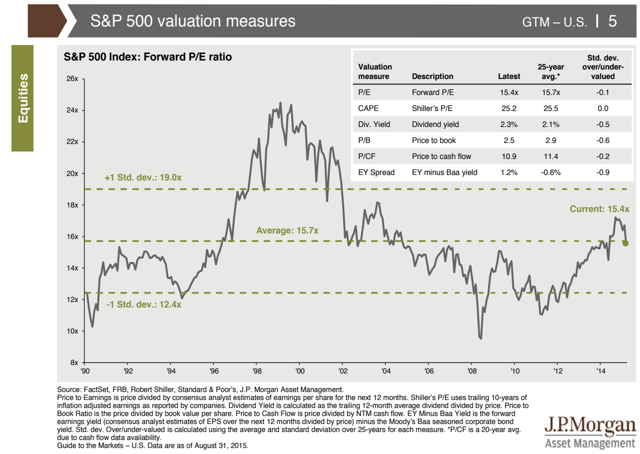
U.S. : Financial market volatility

Stocks (VIX) and Bonds (MOVE) comparaison



Source: IA

Graph 11



Valuation measure	Description	Latest	25-year avg.*	Std. dev. over/under-valued
P/E	Forward P/E	15.4x	15.7x	-0.1
CAPE	Shiller's P/E	25.2	25.5	0.0
Div. Yield	Dividend yield	2.3%	2.1%	-0.5
P/B	Price to book	2.5	2.9	-0.6
P/CF	Price to cash flow	10.9	11.4	-0.2
EY Spread	EY minus Baa yield	1.2%	-0.6%	-0.9

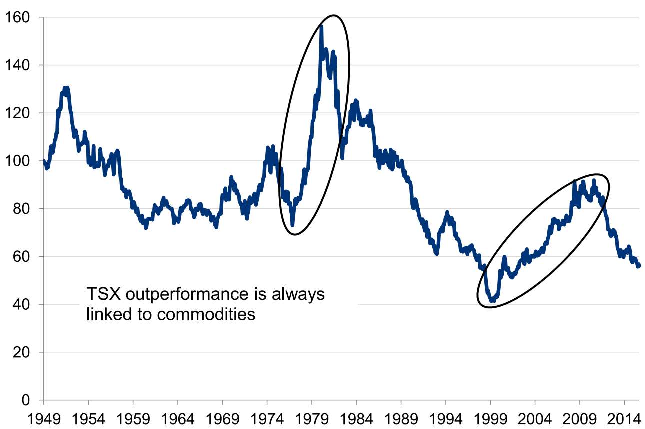
Source: FactSet, FRB, Robert Shiller, Standard & Poor's, J.P. Morgan Asset Management.
Price to Earnings is price divided by consensus analyst estimates of earnings per share for the next 12 months. Shiller's P/E uses trailing 10-years of inflation adjusted earnings as reported by companies. Dividend Yield is calculated as the trailing 12-month average dividend divided by price. Price to Book Ratio is the price divided by book value per share. Price to Cash Flow is price divided by NTM cash flow. EY Minus Baa Yield is the forward earnings yield (consensus analyst estimates of EPS over the next 12 months divided by price) minus the Moody's Baa seasoned corporate bond yield. Std. dev. Over/under-valued is calculated using the average and standard deviation over 25-years for each measure. *P/CF is a 20-year avg. due to cash flow data availability.
Guide to the Markets – U.S. Data are as of August 31, 2015.

Source: J.P. Morgan

Graph 12

Relative performance, S&P/TSX vs S&P 500

1949 = 100



Source: IA