## Goodbye NAFTA, welcome USMCA!


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A difficult trade war was avoided in North America with an eleventh hour pact on the NAFTA renegotiation. The new agreement, once officially approved by the three governments (probably by the end of the year), will replace the current agreement, which has been in effect since 1994, and bear the name of USMCA (United States, Mexico and Canada Agreement).

Since the August 31 announcement of a bilateral agreement between Mexico and the United States, Canada was forced into a race against time to find its place in what would replace the most important trade agreement in the world. American law requires the full text detailing the agreement negotiated to be submitted to the American Congress a month, at the very latest, after the announcement of the agreement and no modification to the text is possible after the deadline. So, this gave Canada until September 30 at midnight to reach an agreement with its main trading partners.

In spite of perceptions, the heat was not just on the Canadian delegation. Several members of the U.S. Congress, including Republicans, had already announced that they would not vote favourably on any bilateral agreement, putting President Trump at risk of suffering yet another political defeat at the hands of Congress (the failure to repeal Obamacare must still be fresh in his memory!).

All this culminated in a blitz of negotiations at the end of the month and an agreement was hammered out on the night of Sunday, September 30, just a little before midnight.

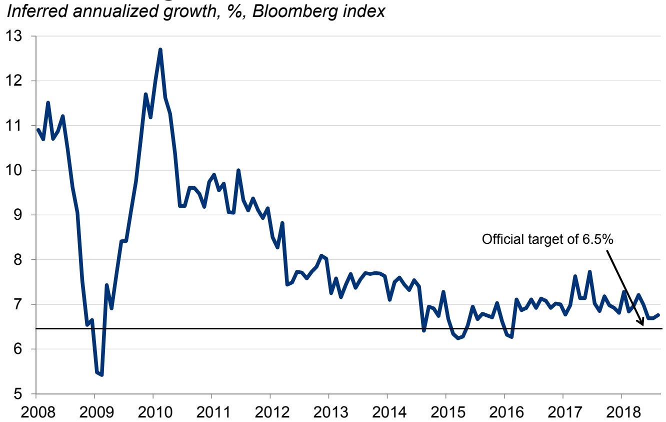
The details of the agreement are described in the Canadian section of this text, but a few key observations can be made from them.

Firstly, despite his cavalier strategies, President Trump seems to be open to genuine trade agreements benefiting all parties. The positive reaction of the markets following the agreement effectively signals that investors are more optimistic with regard to averting the possibility of a generalized trade war.

Graph 2

**China: Economic growth remains above the official target**

*Inferred annualized growth, %, Bloomberg index*




Graph 1

**Emerging markets currencies selling off**

*MSCI emerging markets currencies index*


Secondly, with this uncertainty retreating and the Canadian economy performing well, we now expect the Bank of Canada to look sharp and proceed with two rate hikes by the end of the year (October and December), followed by three to four hikes in 2019.

Finally, the signal will probably be given for a good performance of Canadian assets by the end of the year.

### World: Must we worry for emerging markets?

The third quarter of the year was marked by a series of negative surprises in emerging markets.

We first saw the Turkish lira, Turkey's currency, crash by nearly 40% in August as it suffered a concerted attack from investors who had lost confidence in the independence of the country's Central Bank under President Erdoğan. Turkey was not the only country to see its currency attacked. The MSCI Emerging Markets Index posted a decline of more than 5.0% for 2018 and more than 8.0% since reaching its peak in April (graph 1).

Add to this the situations in Argentina (unbearable burden of government debt necessitating an emergency loan from the International Monetary Fund) and Venezuela (deep recession and hyperinflation due to the fall in oil prices since 2014), without forgetting South Africa, which just entered recession. Neither must we forget Indonesia, where the fall of the currency has delayed major public infrastructure projects due to a steep rise in the cost of production.

Even if the list is long, we are of the belief that the contagion is not very likely to spread completely in emerging markets, even in the event of a real trade war, for as long as the Chinese economy holds steady. We must not forget that emerging markets trade a lot among themselves and China is by far the most important trading partner for many of them.

This brings us to a closer look at China's economic fundamentals and we have to say that for the moment, there is nothing to worry about. Even if it is attacked daily by the Trump administration and the spectre of a trade war is looming over it, the Chinese economy continues to show stable and enviable growth (graph 2). One of our preferred indicators, published by Bloomberg, illustrates that China continues to show a growth rate between 6.5% and 7.0%, which is slightly above the official target of the Chinese government.

Data on Chinese international trade also sends the same signal. The annual growth of exports has remained strong at a rate of approximately 10% per year since mid-2017 and imports recently stepped up to an annual rate of 20%, showing a robust internal demand (graphs 3 and 4).

We also notice that the transition of the Chinese economic model, moving progressively from an economy dependent on the export of processed goods ("old economy") to a model based on domestic consumption and high-tech industries ("new economy") is taking place smoothly (graph 5). Not only do we notice that the new economy now seems to have taken over as the main engine of growth, but we also see a new impetus to the "old economy" and this shows good potential for the general growth of the Chinese economy.

An obvious reason for the resilience of the Chinese economy is certainly the recent depreciation of the yuan against the American dollar in relation to a trade-weighted basket (graph 6). This pullback, orchestrated in large part by the central bank of China (People's Bank of China) in reaction to President Trump's trade threats, seems to have attained the target and brought a stabilizing influence to China during a period of uncertainty. The recent stabilization finally calmed the markets, suggesting that China will not try to counterattack in the currency war.

In brief, this is the state of affairs with China and the emerging markets. Nothing guarantees that an eventual trade conflict between the two leading economies in the world will not create a domino effect in emerging markets. Contrary to what President Trump will have us believe, the decline of the Chinese stock market since the beginning of 2018 does not in any way indicate that the American threats are already inflicting damage on the Chinese economy.

## Europe: slight improvement

Things are improving slowly but surely in Europe. The European index of economic surprises is back to neutral in the third quarter, after having hit rock bottom in the second quarter of 2011.

Graph 3

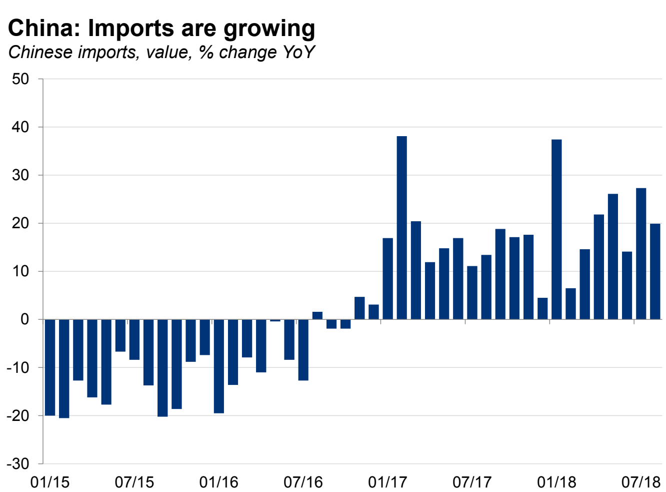



**Chart 1**
**Returns of the Canadian Bond Market as at September 30, 2018**

| Index | Returns (%) 3 months | YTD |
|---|---|---|
| FTSE TMX Canada Universe Bond Index | (1.0) | (0.4) |
| | | |
| FTSE TMX Canada Short Term Bond Index | 0.0 | 0.5 |
| FTSE TMX Canada Mid Term Bond Index | (0.8) | (0.5) |
| FTSE TMX Canada Long Term Bond Index | (2.4) | (1.5) |
| | | |
| FTSE TMX Canada Federal | (0.8) | (0.2) |
| FTSE TMX Canada Provincial | (1.5) | (1.0) |
| FTSE TMX Canada Municipal | (1.3) | (0.7) |
| FTSE TMX Canada Corporate | (0.5) | 0.2 |

As we have mentioned several times during the last few quarters, it has been a long and perilous journey for the European economy after the financial crisis, but the path now seems to have been charted for a return to sustainable growth.

The most telling indicator is probably consumer and business confidence levels, both at their peaks in more than 10 years despite the slowdown of economic data in 2018.

Consumers benefit from a healthy job market, with the unemployment rate returning to pre-recession levels in 28 of the largest economies in the European Union. Businesses, although exposed to the risk of a trade conflict with the United States, continue to show a high level of optimism close to historical peaks.

The combination of this generalized optimism and a very accommodating monetary policy continue to speed up the credit cycle, which is a vital driving force of the economic cycle (graph 7).

In this context, we are not surprised to see the European Central Bank (ECB) maintain a positive, though cautious, tone. Remember that the ECB showed its colours earlier this year by announcing in black and white in one of its press releases that it will not raise its key interest rate until at least the summer of 2019, but will halt the process of winding down its quantitative easing program by the end of 2018. The course is set for the end of its monthly bond purchases from the stock market in December 2018 and it would take a major negative surprise to change the ECB's plans.

Even if these policy intentions have already been announced, the ECB continues to influence the markets by the tone of its communications and economic forecasts. In the press conference following the decision to maintain the status quo in September, ECB President Mario Draghi reiterated that the risks to the Eurozone would remain balanced, but external demand could slow down over the next few years if a trade conflict with the United States actually materialized. The risks inherent in emerging markets were also mentioned, leading the ECB to slightly revise its expectations downward for economic growth in 2018 and 2019 to 2.0% and 1.7% respectively.

In brief, even if the American economy, which is strong from its recent tax reform, risks outperforming the European economy in 2018, our optimism about the old continent's prospects remains unshaken by the recent slowdown.

**Chart 2**
**Market Returns as at September 30, 2018**

| Index | Returns (%) 3 months | YTD |
|---|---|---|
| FTSE TMX Canada 91 Day T-Bill Index | 0.3 | 0.9 |
| FTSE TMX Canada Universe Bond Index | (1.0) | (0.4) |
| S&P/TSX Composite Index | (0.6) | 1.4 |
| S&P 500 (Can. $) | 5.8 | 14.1 |
| MSCI - EAFE (Can. $) | (0.4) | 1.7 |
| MSCI - World (Can. $) | 3.2 | 8.8 |
| | | |
| Exchange Rate (Can. $ / US $) | (1.7) | 3.2 |

**Chart 3**
**Market Returns as at September 30, 2018**

| Index | Returns (%) 3 months | YTD |
|---|---|---|
| **S&P/TSX Sector returns** | | |
| Energy | (5.8) | (1.2) |
| Materials | (12.9) | (10.8) |
| Industrials | 5.6 | 12.6 |
| Consumer Discretionary | (7.9) | (4.6) |
| Consumer Staples | (0.9) | (3.5) |
| Health Care | 31.4 | 29.9 |
| Financials | 3.8 | 2.2 |
| Information Technology | 3.0 | 25.9 |
| Telecommunication Services | 2.4 | (2.9) |
| Utilities | (1.5) | (7.6) |
| Real Estate | 3.9 | 9.3 |
| | | |
| S&P/TSX Composite Index | (0.6) | 1.4 |

## United States: officially the longest economic expansion recorded!

It is official. We are currently in the longest period of uninterrupted economic growth recorded in American history (that is, since World War II). This is not all that surprising because history clearly shows that expansions after financial crises have a tendency to be long and not very energetic. It is consistent with the current cycle, which was characterized by consumers and businesses having a poor appetite for risk, thereby creating fewer risks of excess which typically cause the end of high economic cycles.

September 2018 is in fact the 129th month since the last recession and everything leads us to believe that the current cycle could last a few more years, at least until 2020. Our dashboards indicate that the factors typically associated with periods of recession always show signs of expansion.

Firstly, even if the American yield curve continues to flatten, it remains well anchored in the positive. Besides, we are of the opinion that from a purely economic viewpoint, the 3-month to 10 year curve is the one that must be followed most closely (and not the 2-year to 10 year curve, which generally attracts investors' attention) and it will likely remain in the positive until the second half of 2019. Although it is true that recession is generally not seen without the yield curve first inverting, the inversion can, however, take place a few years before the start of a recession!

Secondly, inflation remains elusive, which means major central banks can barely start tightening their monetary policies. The typical end of an economic cycle usually spells increasingly restrictive monetary policies. The fact that the American Federal Reserve's key interest rate is now just slightly above the U.S. core inflation rate, a first in more than 10 years, makes us feel safe.

Thirdly, a robust job market is contributing briskly to the economic expansion. The American economy continues to create nearly 200,000 jobs per month and businesses indicate that their biggest challenge is labour shortage. A telling statistic to this effect is that at the moment, there are 11 jobs available in the U.S. for 10 jobseekers, which is by far a record since this information was started to be compiled in 2001 (graph 8). In short, a picture of anything but a recession!

The list of arguments could go on: the benefits of businesses posting strong growth, even when excluding the effects of the tax reform, the real estate market slowing down, but continuing to show growth, etc.

But because we must always be cautious, we are aware of the fact that an economic cycle can end abruptly in the event of an economic policy mistake or financial shock.

One possibility is that the deterioration in the American budget deficit from a tax reform coming at a time when the economy has already growing to its full potential (a first in recorded history!) may cause overheating followed by a slump in a few years. Any economic stimulus financed by a debt increase is in fact just advance future spending, which eventually means lower growth and incidentally, a greater vulnerability of the American economy to external shocks down the line.

The second possibility is a breakdown in trade relations between the United States and China, which would lead to a spike in inflation and a slowdown of economic growth in two of the world's most powerful economies. According to an Oxford Economics analysis, the imposition of customs tariffs on all the trade flow between these two countries could whittle away 1% of the American GDP, more than 1.2% of the Chinese GDP and 0.7% of the global GDP by 2020 (graph 9).

In short, we are of the opinion that the economic cycle may last for a few more quarters, but we have to watch out for the possible deterioration of advanced economic indicators… and a bad turn in U.S.-China relations.

## Canada: NAFTA settlement finally reached!

After several months of, let us say, turmoil, the NAFTA renegotiation process finally resulted in a new trilateral agreement just a few hours before the October 1 deadline.

The terms of the agreement were revealed and are, all things considered, somewhat positive for the Canadian economy.

Firstly, a significant proportion (between 40% to 45%) of the content of cars produced in North America must come from jurisdictions where the average salary is above $16 per hour, a measure clearly targeting Mexico and favouring both Canadian and American manufacturers so that fewer jobs will now go to low-cost Mexican plants.

**Chart 4**
**Asset mix: Diversified Fund (040)**

| | Min. | Neutral | Max. | Actual Weight | Over Weight (+)/ Under Weight (-) | Change in quarter |
|---|---|---|---|---|---|---|
| **Money Market** | **0** | **5** | **25** | **8.0%** | **+3.0%** | **+1.5%** |
| **Gold (ingot)** | | **0** | | **3.0%** | **+3.0%** | **+1.5%** |
| Canadian Bonds | 20 | 45 | 70 | 27.0% | -18.0% | +1.0% |
| International Bonds | 0 | 0 | 15 | 0.0% | 0.0% | 0,0% |
| **Total – Bonds** | **20** | **45** | **70** | **27.0%** | **-18.0%** | **+1.0%** |
| **Canadian Equities** | **5** | **25** | **45** | **35.5%** | **+10.5%** | **-4.5%** |
| U.S. Equities | 0 | 12,5 | 45 | 11.0% | -1,5% | +0.5% |
| International Equities | 0 | 12,5 | 45 | 13.0% | +0.5% | -1.0% |
| Emerging Markets | 0 | 0 | 45 | 2.5% | +2.5% | +1.0% |
| **Total – Foreign Equities** | **5** | **25** | **45** | **26.5%** | **+1.5%** | **+0.5%** |
| **Total – Portfolio** | | **100** | | **100.0%** | | |

Still on the subject of cars, Canada and Mexico both agreed to a quota on exports to the U.S. of cars and parts (some exceptions apply, for instance for light trucks) of 2.6 million units annually, with an imposition of customs tariffs by the Americans beyond this. This leaves room for growth because right now, Canada and Mexico each export less than 2 million vehicles per year to the U.S.. In this way, Canada avoids the catastrophic scenario of customs tariffs, which would have pushed the Ontario economy into recession in 2019.

Secondly, the dispute settlement mechanism (chapter 19) remains intact. This issue was crucial for the Canadian delegation, which had stated that it was nothing less than the red line in negotiations.

In return, Canada will give American dairy farmers access to 3.5% of its domestic market, a concession similar to that in the Trans-Pacific Partnership negotiation. A financial compensation for Canadian dairy farmers is already being discussed.

Thirdly, customs tariffs on steel and aluminum remain in force and will be dealt with later. Given the limited impact of this issue on the Canadian economy, we think that this could be reasonably excluded from the negotiations.

Finally, the agreement will be officially revised after six years and the amendment process could be spread out over a period of 10 years (thereby giving it a potential lifespan of 16 years).

Even through all this uncertainty and political turmoil, the Canadian economy has continued to show a good growth profile in the third quarter and even cuts a fine figure as one of the countries where economic surprises are the most positive among developed countries (graph 10).

According to Senior Deputy Governor Carolyn Wilkins of the Bank of Canada, this good economic performance even leads the institution to evaluate whether it should speed up the process for its monetary policy normalization. We anticipate that the Bank of Canada will raise its key interest rate at the end of October, which would be the third hike in 2018. Given the advantageous resolution of the NAFTA issue, we now anticipate a fourth hike in December.

## Markets: Must we fear contagion from emerging markets?

The composite index of emerging markets officially entered a bear market in September with a drop of more than 20% since its peak on January 26. Its divergence from the American stock market has been rather astounding since spring, reminiscent of a certain striking episode 20 years ago: the 1997-1998 Asian crisis.

Many reasons today explain this marked loss of appetite for emerging market assets.

There is, of course, the spectre of a trade war between the United States and China, which could create waves in emerging markets that are an integral part of the global supply chain.

To this is added the fact that several emerging markets have benefited from an environment of low interest rates and the relative stability of their currencies over the past few years to borrow significant sums in foreign currency for better sources of financing at better rates. So, in 2018, several countries find themselves with a large chunk of their debt in American dollars, which exposes them to an increase in their debt ratio should there be a marked depreciation of their currency.

History does not necessarily repeat itself, but it often rhymes. So, there are interesting parallels to be drawn between the current economic and financial environment and that of 1997-98, when the world witnessed the "Asian crisis."

Let us recall the facts first. Over the decades that preceded this episode, massive flow of global capital was directed to Asia, where the fast pace of industrialization allowed investors to enjoy high yields from their investments. To maintain, and even encourage the interest of foreign investors, several Asian countries decided along the way to create a fixed exchange rate regime, that is, to have their currencies pegged to the American dollar. Such an exchange rate regime contributes to investor confidence because currency fluctuations no longer need to be taken into account in investment return calculations.

The meltdown began in 1997 when the massive movement of capital created financial bubbles in certain emerging markets – firstly Thailand – which burst and caused the flight of foreign capital. The Thailand economy suddenly found itself

**Chart 5**
**Estimated Gross Returns for the Next 12 Months Starting on September 30, 2018**

| Market indicators | Interest or dividend | + | Capital gains | = | Total estimated gross return |
|---|---|---|---|---|---|
| FTSE TMX Canada 91 Day T-Bill Index | 2.60% | + | (1.30)% | = | (1.30)% |
| FTSE TMX Canada Universe Bond Index | 3.35% | + | (3.35)% | = | 0.00% |
| Canadian stocks (S&P/TSX Composite Index) including dividends | | | | | 13.8% |

with an overvalued currency and was forced to give up its fixed exchange rate regime, automatically speeding up the flight of capital and precipitating the steep fall of its currency, the Thai baht. Facing a crisis of confidence, investors started speculating on the next domino that would fall, thereby generalizing the crisis across all of Asia's emerging markets. The net result was the end of many fixed exchange rate regimes and a sharp decline of emerging market valuations on stock market listings.

On reading these lines, we realize that the foundation is different. Emerging markets now represent nearly 60% of the global economy (graph 11) and nearly 75% of global economic growth. In addition, emerging market economies are currently in a good position, making the spread of isolated problems in Argentina, Venezuela, South Africa and Turkey very improbable for the time being.

For instance, the current account aggregate deficit as a percentage of the GDP of emerging economies is expected to be less than 0.5% in 2019 and this deficit remains entirely financed by foreign investments. The debt to export ratios are also not higher by historical standards and data shows that the accumulation of foreign debt in emerging markets these past few years comes more from Chinese public companies, which are well supported by the government.

In short, even if we can imagine a scenario where several isolated cases worsen simultaneously and create a real crisis in emerging markets, history suggests that these problems become systemic when global growth weakens and exports from emerging markets contract.

For the moment, we are of the opinion that it is the strength of the American dollar, buoyed by a combination of the Fed's hawkish tone and the movement towards safe investment in periods with a risk of trade tensions, which largely explains the decline in emerging market assets. In fact, emerging market currencies were the first to be under pressure, which drove the stock and bond markets downward.

Despite all this, one thing has not changed since the Asian crisis: human nature. The causes of market movements change over time, but investors' reaction to these is surprisingly timeless.

Let us take a look at the behaviour of markets in 1997-98 to guide us to what could be in store for markets over the next few quarters. Graph 12 illustrates the behaviour of several financial indices in 1997 and 1998: American shares (S&P 500), emerging market shares (MSCI EM), American key interest rate (Fed funds) and the American 2-year yield rate.

The first observation is that despite the slump in emerging stock markets from mid-1997, American shares continued their upward trend until mid-1998. The psychology of investors at the time was that the storm which hit emerging markets would never reach the large ocean liner that the American economy was and they did not have to worry. This even pushed former Fed chairman, Alan Greenspan, to warn (rightly): "It is just not credible that the United States can remain an oasis of prosperity unaffected by a world that is experiencing greatly increased stress."

The analysis of graph 12 interestingly illustrates that bond investors had already started worrying much earlier about the impact this crisis could have on the American economy.

Remember that the Fed ended a cycle of tightening its monetary policy which it had started a few years before. The 2-year American yield rates were higher than the key interest rate by nearly 30 points at the end of the first quarter before beginning a steady decline in reaction to negative news. At the beginning of 1998, the 2-year yield rates reached parity with the key interest rate and then quickly fell below this rate when clear signals started to suggest a slowdown in the demand for American exports (as illustrated in graph 13, where we see the high yield spreads' reaction as soon as the ISM Manufacturing Index moved into the contraction zone).

Therefore, it is when tangible signs of the contagion spreading to the American economy were felt that investors started to react, pushing the S&P 500 into a correction of nearly 20% and the 2-year American yield rates into a drop of nearly 50 basis points. The Fed, faced with the contagion which was spreading to the American economy, was finally forced to cut its key interest rate, which ultimately coincided with a trough in the stock market.

What are the lessons to be learned from all this?

Firstly, that the American economy is never completely safe from a slowdown elsewhere in the world. This is probably even truer today considering that emerging markets have more economic importance now than twenty years ago.

Secondly, economic data must be monitored to identify signs of contagion. But if history repeats itself, it is too early to reduce American stock exposure for as long as these signs have not appeared.

Thirdly, the Fed's communications must be monitored. Back then, it made cuts to its key interest rate. Today, the Fed is more in the process of tightening its policy, which makes cuts rather unlikely. We recommend watching for signals sent by the Fed that it is worried about the economic situation abroad, which could slow down or even halt the normalization of its monetary policy.

In the third quarter, the Canadian bond market, measured by the FTSE TMX Canada Universe Bond Index, showed a pullback of 1.0%. The FTSE TMX Canada Short-Term Bond Index posted a zero yield (of 0.0%). Finally, the FTSE TMX Canada Long-Term Bond Index fell by 2.4%.

The American stock market, measured by the S&P 500 index, offered a total return of 7.7% in the third quarter (+ 5.9% in Canadian dollars). The Canadian stock market registered a decline of 0.6%.

**As at September 30, 2018**

**Group savings and retirement**

**Chart 6**
**Economic and financial scenarios**

**Economic scenario**

| | | | | | | | Change since September 30, 2018 | |
|---|---|---|---|---|---|---|---|---|
| | | 2017 | 2018 | 2019 | 2020 | 2021 | 2018 | 2019 |
| **United States** | Real GDP | 2.2% | 2.9% | 2.5% | 1.9% | 1.5% | -- | -0.1% |
| | Inflation rate | 2.1% | 2.5% | 2.3% | 2.2% | 2.0% | -0.1% | -- |
| | Unemployment rate | 4.4% | 3.9% | 3.6% | 3.7% | 3.8% | -- | -- |
| **Canada** | Real GDP | 3.1% | 2.1% | 2.0% | 1.9% | 1.8% | -- | +0.1% |
| | Inflation rate | 1.6% | 2.4% | 2.0% | 2.0% | 2.0% | +0.1% | -- |
| | Unemployment rate | 6.3% | 5.8% | 5.7% | 5.7% | 5.7% | -- | -- |

**Financial scenario***

| | | | Targets | | | Change since September 30, 2018 | |
|---|---|---|---|---|---|---|---|
| | | Actual | Dec. 2018 | June 2019 | Dec. 2019 | Dec. 2018 | June 2019 |
| **Interest rate** | | | | | | | |
| | U.S. 10-year rates | 3,06% | 3,20% | 3,45% | 3,70% | +0.20 | +0.30 |
| | Canada 10-year rates | 2,43% | 2,60% | 2,85% | 3,10% | +0.30 | +0.40 |
| **Exchange rates** | | | | | | | |
| | US $/Can. $ | 0,77 | 0.8 | 0.82 | 0.84 | +0.02 | +0.02 |
| | US $/Euro | 1.16 | 1.2 | 1.23 | 1.25 | -- | -- |
| | Oil price (WTI), US $ | 73.5 | 75 | 77 | 80 | +5 | +12 |
| | S&P 500 | 2913 | 2100 | 3090 | 3185 | +200 | +230 |
| | S&P/TSX | 16075 | 16800 | 17600 | 18060 | -400 | -- |

* end of period

The European market, represented by the MSCI – Europe index, gained 0.8% (- 0.9% in Canadian dollars), the MSCI – EAFE index rose 1.4% (- 0.4% in Canadian dollars) and the MSCI – World index went up 5.0% (+3.2% in Canadian dollars). Emerging markets, measured by the MSCI – Emerging Markets index, once again fell, this time 1.0% (-2.6% in Canadian dollars).

## Strategy

Calm came back to the American stock market in the third quarter with the VIX index returning to a 12 to 15 bracket after crossing the 35 level at the beginning of February.

Global stock markets have had a quarter that is positive overall with the American market far ahead once again. Since the month of February, there has been a sharp divergence between the S&P 500 and the rest of the world, which makes it difficult to seek high returns outside the United States. This outperformance is largely due to the impact of the recent tax reform, which propelled the growth of benefits for American businesses to nearly 25%.

The result is that, relatively speaking, the majority of global stock market indices have ended up with good valuations. It is still difficult to predict when market trends will change direction, but it is very likely that investors will eventually take advantage of profits from their gains on American soil to go in pursuit of opportunities elsewhere in the world.

In this context, we recommend gradually reducing American stock market exposure and progressively staking out positions on the European and Japanese stock markets (EAFE index). Emerging markets are also showing an attractive valuation, but caution is always advised because it is very risky to try to predict when the market will bottom out!

A factor to watch closely is the strength of the American dollar, which, as explained in the previous section, largely dictates the trends of emerging market indices.

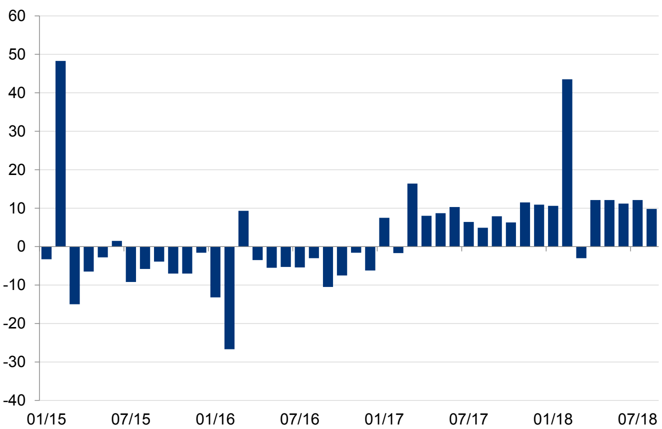
As we are forecasting that the Bank of Canada will step up the progressive tightening of its monetary policy over the next few years, we recommend underweighting bonds. Same thing for American bonds as the movement of interest rates went back up again recently in response to robust economic data.

Finally, because of the loonie's sensitivity to geopolitical developments, we continue to recommend a dynamic management of exposure to foreign currencies. At the end of this quarter, because of the successful NAFTA renegotiation, we have almost fully covered American dollar and euro exposure.

Graph 4

**China: Growth in exports remains stable**

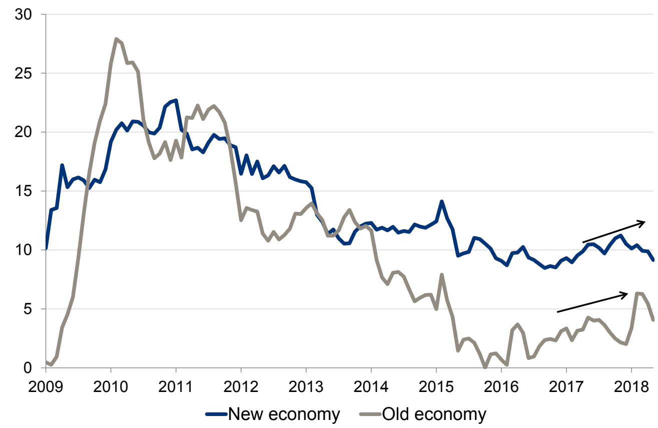
*Chinese exports, value, % change YoY*




Graph 5

**China: The economic transition is bearing fruit**

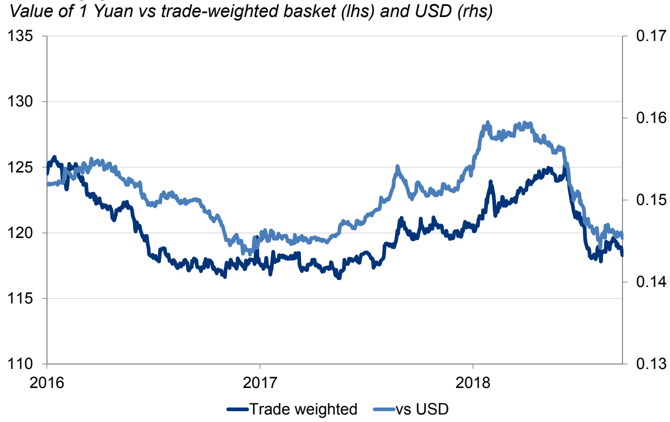
*% change in growth, YoY*




Graph 6

**Yuan: Recent stabilization following a sharp pullback**

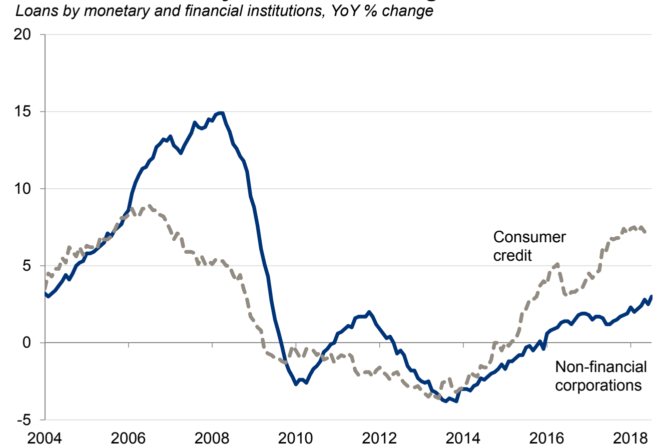
*Value of 1 Yuan vs trade-weighted basket (lhs) and USD (rhs)*




Graph 7

**Eurozone: credit cycle is accelerating**

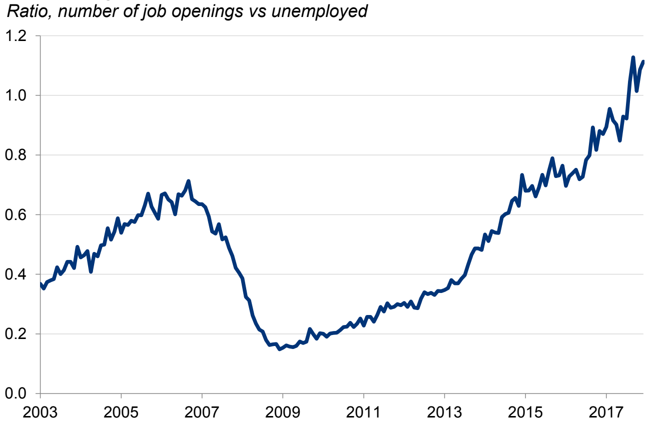
*Loans by monetary and financial institutions, YoY % change*




Graph 8

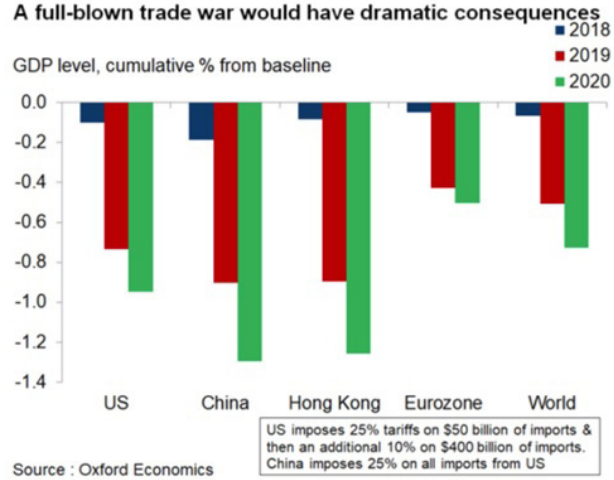
**U.S.: More than one job available per unemployed american!**

*Ratio, number of job openings vs unemployed*




Graph 9

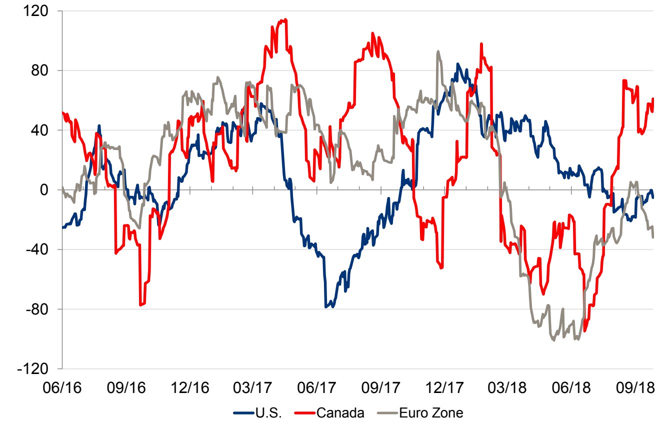
**A full-blown trade war would have dramatic consequences**



Graph 10

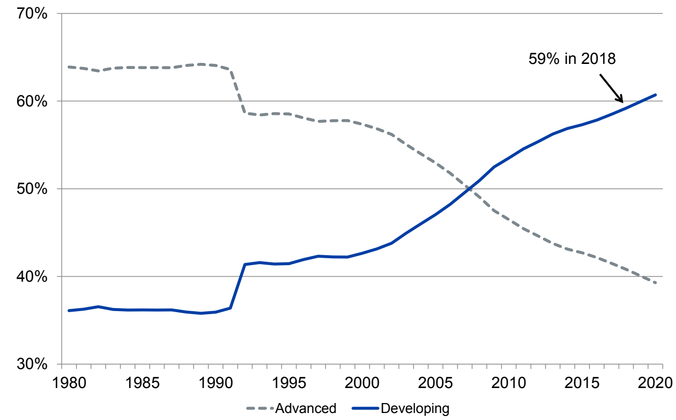
**Economic surprise indices**

*Citigroup indices*




Graph 11

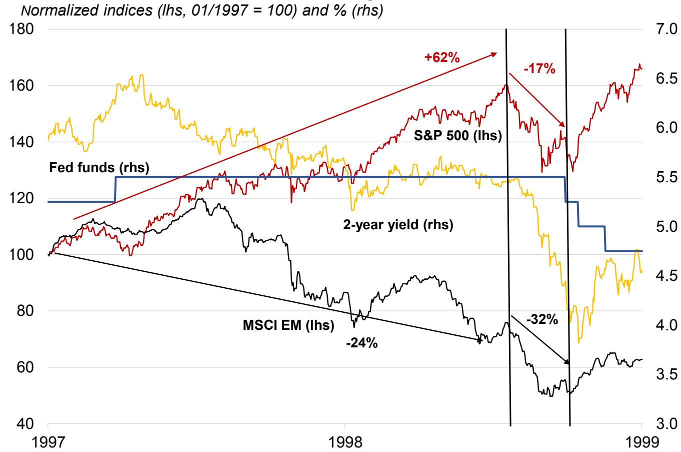
**Emerging countries now represent the lion's share of the global economy**




Graph 12

**Financial Markets: 1997-1998 episode**

*Normalized indices (lhs, 01/1997 = 100) and % (rhs)*




Graph 13

**Financial markets: 1998 episode**

***ISM manufacturing index and high-yield spreads, %***