CONNOR, CLARK & LUNN
PRIVATE CAPITAL

Financial Markets Summary

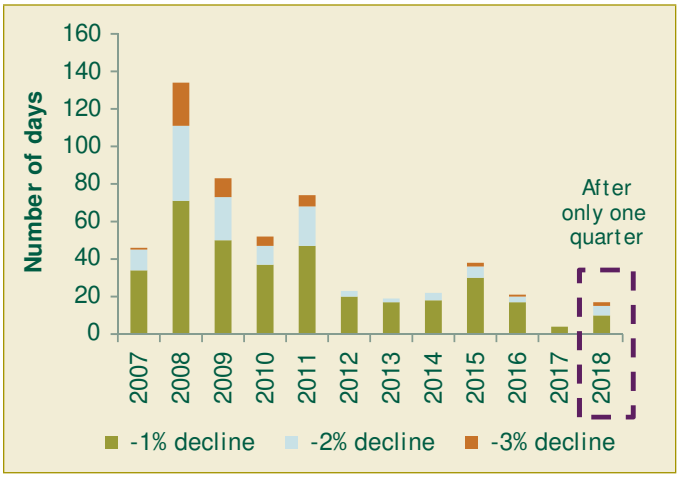
March 31, 2018

PORTFOLIO MARKETS SUMMARY

2018 got off to an impressive start as global equities reached new highs in January, but investors' New Year cheer came to an abrupt end after an aggressive equity sell-off at the end of January and into early February. Higher volatility was evidenced by the S&P 500 falling more than 1% in a day on eleven separate occasions (below left), compared to just four instances in all of 2017. The imposition of trade tariffs and the seemingly never-ending personnel changes in US President Trump's administration were the most commonly cited reasons for the escalated volatility. While these sound plausible, we believe peaking economic growth momentum—as indicated by data on the economic health of the manufacturing sector—is a larger determining factor. A function of the monetary tightening that began in 2016, the decline in growth momentum is showing the typical 18-month lag that monetary conditions have on economic growth. It makes sense that the change in direction of the interest rates in the summer of 2016 is resulting in a change in the direction of economic growth today.

The US Federal Reserve plans to increase interest rates at least once more in 2018, and there is evidence that higher rates are beginning to negatively affect some consumers and corporations—higher rates become a hindrance to risk assets when the cost of borrowing exceeds the return on capital. This is why we have been paring back risk as our investment thesis develops. As we receive more confirmation from our process, our level of conviction will grow and we will adjust portfolios accordingly.

Volatility increases:
annual number of S&P 500 daily declines



Source: Thomson Reuters Datastream

US Corporate BBB credit spreads

Source: Thomson Reuters Datastream

PORTFOLIO STRATEGY

Our tactical process continues to flag peaking economic growth momentum and high asset valuations as reasons to maintain a neutral balance between stocks and bonds. We trimmed our equity exposure twice during the period; first, we sold Canadian equities ahead of the pickup in volatility and put the proceeds into bonds and global small caps. Second, at the end of the quarter we reduced our exposure to global equities and increased the allocation to core bonds. We will continue to take advantage of periods of equity strength to reduce risk. As a typical business cycle matures, interest rates rise and credit conditions deteriorate, resulting in the balance of risk and reward swinging in favour of bonds. We are watching these factors very closely for any signs of a negative reaction in the credit market.

We continue to favour global equities over Canadian equities due to a weakening Canadian dollar, higher growth momentum abroad and easier monetary policy outside North America. Our overweight allocation to global equities was rewarded again this quarter, as they outperformed Canadian stocks by more than 7%. The benefit of this position is that it does not add to the absolute level of risk but it still has the potential to add value.

In fixed income we have an overweight allocation to government bonds relative to cash and high yield credit. In addition, we've included an allocation to short-term bonds, which are less affected by rising rates. This relatively defensive position stems from our view that interest rates will rise further and investors will continue to price-in greater corporate risk, leaving bond prices in danger of falling. We continue to find alternative asset classes such as commercial real estate, infrastructure, private loans and hedge strategies attractive.

CONNOR, CLARK & LUNN
PRIVATE CAPITAL