2017 was a year of high returns and low volatility. The Canadian and U.S. markets reached record highs, and stocks solidly outperformed bonds as rebounding global growth, low rates and rising sentiment helped produce above-average gains across global equity markets. Some pockets of euphoria showed up as Bitcoin and marijuana stocks grabbed headlines and big gains.

Historically calm stock markets – The Canadian market drifted lower by 6% mid-year, but had just six days with a move greater than 1%. The S&P 500 went the entire year without a 3% decline as the Volatility Index (VIX) reached an all-time low.

Domestic stocks were good, not great – The 9% return from the TSX was solid, but appears somewhat disappointing when compared to international gains. Although the domestic market spent the first half of 2017 treading water, strong Canadian GDP growth supported earnings and showed up in the leadership of the consumer discretionary, financial services and industrial sectors. Overall market gains were limited, as the heavyweight energy sector fell 7% on the year despite a 12% rise in oil prices.

International markets surged higher – Overseas stock markets produced strong gains on the year, driven by a healthy rebound in economic growth. European economies were among the brightest spot, with Eurozone GDP expanding at the fastest pace in a decade. China’s economy posted its first uptick since 2010, leading emerging-market equities to a 30% gain. U.S. equities also delivered their second-best gain since 2010, as economic activity steadily improved and enthusiasm around tax reform spurred a 22% return for the S&P 500.

2017 in Review

Source: Morningstar Direct, 12/31/2017. All returns in local currency and total return. Representative indexes are: Real Estate: S&P Canada REIT Index, High Yield Bonds: Barclays High Yield Canadians Index, Canada Large-cap Stocks: S&P/TSX Composite Index, U.S. Small- and Mid-cap Stocks: Russell 2500 Index, International Bonds: Barclays Global Aggregate Bond Index, Canada Bonds: FTSE TMX Canada Universe Bond Index, U.S. Large-cap Stocks: S&P 500 Index, Emerging Market Stocks: MSCI EM Index, Overseas Large-cap Stocks: MSCI EAFE Index. Past performance is not a guarantee of how the market will perform in the future. Indexes are unmanaged and are not available for direct investment. All returns expressed in local currency and include reinvested dividends.

QUARTERLY MARKET OUTLOOK: FIRST QUARTER 2018

Action for Investors

We don’t expect the magnitude of last year’s equity returns to be repeated, nor do we think this historically low level of volatility will persist. Investors with appropriate expectations will be better positioned to react – and not overreact – when swings occur. We think investors should prepare for more average-looking gains ahead, traveling a bumpier path that includes the rising potential for a 5-10% correction.

Past performance of the markets is not a guarantee of what will happen in the future. Equity investments carry risk, including the loss of principal. There are special risks inherent in international investing, including currency, withholding taxes and high levels of taxation, political, social and economic risks.
We think the domestic economy will downshift from last year’s pace, with growth slowing as improved business investment and exports fail to offset slower household spending. We don’t think a recession is impending, but economic imbalances are likely to hold back the pace of growth in this latter stage of the cycle.

Labour and business conditions offer support – The unemployment rate has fallen below 6% for the first time since 2008, which should begin to lift wage growth from recent weak levels. Business investment rebounded in 2017, and though flattish oil prices may restrain capital expenditures in the oil patch, overall spending should benefit from higher corporate profits and rising sentiment.

Housing headwinds – The red-hot housing market’s halo benefit on household spending (the largest share of GDP) is likely to cool this year. Home sales activity relative to new listings has fallen recently, which has historically signaled a slowdown in housing price appreciation. Meanwhile, the debt-to-income ratio is at record highs and the domestic savings rate has fallen by half since mid-2015, leaving less gas in the tank for consumers.

NAFTA renegotiations are a risk – Export activity is poised to contribute more to GDP this year, helped principally by faster growth in the U.S. We don’t think NAFTA will be completely scrapped, but we anticipate negotiations to ultimately involve some concessions from Canada that could result in a modest -- not dramatic -- impact on domestic GDP.

Action for Investors

Given our view for sustained but slower economic growth, we think neutral allocations between equities and fixed income are appropriate. We maintain our recommended underweight allocation to Canadian equities. International equities (U.S. and overseas) and domestic sectors with less earnings sensitivity to domestic headwinds offer potential opportunities for rebalancing.

Equity investments carry risk, including the loss of principal. There are special risks inherent in international investing, including currency, withholding taxes and high levels of taxation, political, social and economic risks.
The foundation of economic growth and rising corporate profits will, in our view, extend the bull market. That said, we think this cycle’s largest gains are behind it, and in the latter stages of this expansion we expect more moderate returns, with an increasing probability of a temporary pullback this year.

A bumpier ride ahead – As central banks – especially the U.S. Federal Reserve (Fed) – gradually withdraw stimulus, we believe stocks may be more prone to knee-jerk reactions to disappointing news, including weak economic readings (particularly in the U.S. or China), a drop in oil prices, a downturn in China or increased conflict with North Korea. Since 1980, in years when the Fed raised rates three times or more, U.S. stocks experienced an average of four 5% pullbacks and one 10% correction.\footnote{Bloomberg, 12/31/2017.}

Earnings in the driver’s seat – S&P 500 revenue growth is forecast to double for the second straight year in 2018. We expect profit margins to compress as labour and investment expenses rise, meaning revenue gains will be increasingly important for ongoing corporate earnings growth – the most powerful driver of market performance over time.\footnote{Bloomberg, 12/31/2017.} We believe domestic profits and performance will be particularly sensitive to commodity prices and bank results, warranting a modest valuation discount to the S&P 500. Broadly, we think earnings can rise at a mid- to upper-single digit rate, setting the pace for equity returns.

Modest returns – The TSX and S&P 500 delivered average annual returns of 15% and 17%, respectively, in the past two years. Over the past 40 years, when two-year gains exceeded 15%, the following two years saw average returns of 10.4% for the TSX and 15.8% for the S&P 500.\footnote{Bloomberg, 12/31/2017.} Above-average valuations already price-in some future improvement, so we expect positive, but more modest stock market returns ahead.

\textbf{Action for Investors}

We recommend a neutral allocation to equities, and as appropriate, suggest buying on dips as they occur. We maintain our reduced allocation to Canadian equities and recommend sector rebalancing, noting our cautious view of domestic financials and our more positive outlook for energy, materials, industrials and technology.

\textbf{Healthy Fundamentals Make Pullbacks a Buying Opportunity}

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{s&p_500_return.png}
\caption{S&P 500 Calendar Year Return and Largest Intra-Year Decline}
\end{figure}

Source: Bloomberg, 12/31/2017.
We expect interest rates to rise only modestly this year. Inflation pressures remain fairly contained and the Bank of Canada (BoC) is likely to take a slower approach to further rate hikes. While rates remain sufficiently low to support economic growth, central banks are pivoting toward tighter policy, which we expect to stoke episodes of equity market volatility, making the case for appropriate bond allocations despite continued low yields.

BoC taps the brakes – We believe it would be prudent for the BoC to evaluate the impact of its recent rate hikes and shifts in the domestic and global economic landscape before tightening policy further. While an early 2018 rate hike is reasonable, we think the BoC will move to the sidelines as slower Canadian growth emerges. We think high consumer debt and a cooling housing market amplify the rate headwinds to consumers, supporting a cautious approach from the BoC.

Less help for the C$ – The loonie’s 2017 mid-year surge reflected overly optimistic expectations for growth and persistent BoC rate hikes. We expect a more level loonie ahead amid a more cautious BoC and steadier policy tightening from the U.S. Fed (multiple rate hikes and a reduction in its balance sheet stimulus). With NAFTA negotiations continuing and the potential adverse impact on exports from a rising C$, we think there is additional support for the BoC to avoid exerting upward pressure on the loonie.

Bonds: more value than meets the eye – Bonds have underperformed stocks in seven of the past nine years, as expected during an equity bull market and a trend we think will continue this year. That said, though bonds have delivered low returns in recent years, their average return during the past five stock market pullbacks was 1.6%, compared to -17.8% for equities.

**Action for Investors**

Bond returns are likely to remain modest amid low yields. However, we recommend a neutral weight to fixed income, including an increased cash allocation to help stabilize portfolios during periods of rising market volatility. Consider short- and intermediate-term investment-grade bonds, and, internationally, we favour U.S. bonds over global. We recommend reducing high-yield bond allocations as spreads have compressed to unattractive levels.

Past performance is not a guarantee of what will happen in the future. Bond investments are subject to interest rate risk such that when interest rates rise, the prices of bonds can decrease, and the investor can lose principal value.
Global stocks outpaced the TSX last year, a trend we believe can continue. In our view the U.S. is poised for stronger growth on the back of a healthy labour market and rising business investment, while other advanced economies continue to demonstrate persistent improvement in key economic indicators and earnings-growth prospects.

**U.S. growth picks up** - The U.S. economy has added traction heading into 2018, including posting back-to-back quarters above 3% GDP growth for the first time in three years. We believe the unemployment rate - already at a 17-year low - will fall below 4%, with little slack in the labour market spurring wage growth and consumer spending. Newly minted tax reform should also add a modest boost to growth, providing an incremental lift to disposable income and corporate profits. We think U.S. growth will move up to the 2.5%-3.0% range this year.

**Global equities maintain their lead** - Slower domestic economic growth and the lack of a breakout in oil prices will, in our view, restrain TSX earnings growth. Persistent signals of rebounding output in Europe and Japan (which are earlier in their economic cycles) bode well for sustained earnings growth, which, combined with discounted valuations, offer a compelling outlook for global allocations.

**Policy uncertainties likely to drive volatility** - Aggressive monetary stimulus from influential global central banks is in the early stages of winding down. Along with U.S. tax reform moving from expectation to reality, we expect key policy tailwinds will be less prominent this year. Additionally, China’s economy may be sensitive to policy decisions seeking to balance growth with real estate risks, and geopolitical uncertainties related to OPEC, Brexit and North Korea remain. We don’t expect these risks to derail global markets, but instead are likely to stoke periodic volatility, presenting opportunities to buy on dips.

**Action for Investors**

We recommend an increased international equity allocation, as overseas developed-market large-cap equities remain attractive, while better growth in the U.S. would support an allocation to U.S. small- and mid-cap equities.

**Source:** Morningstar Direct, 12/31/2017. Canadian stocks represented by the S&P TSX Composite. International stocks represented by an equal mix of the S&P 500 and the MSCI EAFE Index. All returns are in local currency and assume dividend reinvestment.
<table>
<thead>
<tr>
<th>Asset Class</th>
<th>1-Year</th>
<th>3-Year</th>
<th>5-Year</th>
<th>10-Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commodities</td>
<td>5.8%</td>
<td>-7.5%</td>
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<td>-10.2%</td>
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<tr>
<td>Emerging-market Stocks</td>
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<td>10.5%</td>
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<tr>
<td>Canadian Small/Mid-cap Stocks</td>
<td>7.0%</td>
<td>5.1%</td>
<td>6.6%</td>
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<tr>
<td>U.S. Small/Mid-cap Stocks</td>
<td>16.8%</td>
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<td>14.3%</td>
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<tr>
<td>Overseas Small-cap Stocks</td>
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<td>14.7%</td>
<td>16.8%</td>
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<td>Canadian Large-cap Stocks</td>
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<tr>
<td>Real Estate</td>
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<td>U.S. Large-cap Stocks</td>
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<tr>
<td>Overseas Large-cap Stocks</td>
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<tr>
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<td>Canadian Investment-grade Bonds</td>
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<td>International Bonds</td>
<td>7.4%</td>
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<td>0.8%</td>
<td>3.1%</td>
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</tbody>
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QUARTERLY MARKET OUTLOOK: FIRST QUARTER 2018

Investment Performance Benchmarks as of 12/31/2017
Target Guidance by Investment Category

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>START HERE</th>
<th>Investment Category</th>
<th>Target Guidance in Range</th>
</tr>
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<tr>
<td>Cash</td>
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<tr>
<td>Income</td>
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<td>Low</td>
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<td>Growth</td>
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<td>Aggressive</td>
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<td>Equities</td>
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<tr>
<td>Fixed-income Investments</td>
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</tr>
</tbody>
</table>

1 Alternative investments and Stocks trading less than $4 align with the aggressive investment category, but they are not recommended.
2 Large-cap stocks that do not pay a dividend are in the Growth investment category.
Asset classes we don’t recommend separately include alternative investments, micro-cap equities and international high-yield bonds.

QUARTERLY MARKET OUTLOOK: FIRST QUARTER 2018

Asset Class Outlook

We believe well-diversified portfolios should be built by first identifying a targeted mix of equity and fixed-income investments based on your goals and comfort with risk, and then gaining exposure to a broad mix of the asset classes highlighted below.

- **Equity versus Fixed Income (Target = Middle)** – We recommend a neutral position to equity and fixed income. We believe the bull market in stocks will continue, supported by economic expansion and rising corporate earnings. However, above-average valuations and policy uncertainties increase the risk of a short-term pullback.

- **Domestic Versus International (International target = High)** – We maintain our overweight international allocation. Faster growth in the U.S. and sustained signs of a synchronized global rebound offer support for continued international outperformance. We expect domestic investments to deliver positive returns, but recommend a reduced allocation given economic challenges and domestic sector imbalances.

- **Asset Class Diversification:**
  - **Income (Cash target = High, Income Target = Low)** – Yields are rising, but from a historically low base. We suggest reducing the average maturity of bond portfolios as a way to lessen interest rate risk. We recommend a higher weighting with your cash range to position for increased volatility. Our low target allocation for income investments includes our recommendation to reduce exposure to high yield bonds (aggressive income).
  - **Growth & Income (Target = Middle)** – We recommend underweight positions in Canadian large-cap equities and real estate, which we believe each face headwinds from the domestic economic backdrop. We maintain our suggested overweight allocation to overseas developed-market large-cap equities.
  - **Growth (Target = Middle)** – Reduce allocations to domestic small- and mid-cap stocks, as we favour U.S. small- and mid-cap equities, which would benefit from tax changes and the improving U.S. economy.
  - **Aggressive (Target = Middle)** – Emerging-market equities warrant a modest allocation, balancing improving global growth with policy challenges in China. We continue to be cautious toward direct commodity investments.

Investing in equities involves risks. The values of your shares will fluctuate and you may lose principal. Special risks are inherent to international and emerging-markets investing, including those related to currency fluctuations and foreign political and economic events.
Building Your Portfolio – Actions for Investors

1. **Overall Economic Outlook**: Given our view for sustained but slower economic growth, we think neutral allocations between equities and fixed income are appropriate. We maintain our recommended underweight allocation to Canadian equities. International equities (U.S. and overseas) and domestic sectors with less earnings sensitivity to domestic headwinds offer opportunities for rebalancing.

2. **Equities**: We recommend a neutral allocation to equities, and suggest buying on dips as they occur. We maintain our reduced allocation to Canadian equities and recommend sector rebalancing, noting our cautious view of domestic financials and our more positive outlook for energy, materials, industrials and technology.

3. **Fixed-income Investments**: Bond returns are likely to remain modest amid low yields. However, we recommend a neutral weight to fixed income, including an increased cash allocation as a portfolio cushion against rising market volatility. Consider short- and intermediate-term investment-grade bonds, and, internationally, we favour U.S. bonds over global. We recommend reducing high-yield bond allocations, as spreads have compressed to unattractive levels.

4. **International Investments**: We recommend an increased international equity allocation, as overseas developed-market large-cap equities remain attractive, while better growth in the U.S. would support an allocation to U.S. small- and mid-cap equities.

Past performance may not be repeated.
Diversification does not guarantee a profit or protect against loss.
The TSX and S&P 500 are unmanaged indexes and are not meant to depict actual investments.
There are special risks inherent in international and emerging markets investing, including currency, withholding taxes and high levels of taxation, and political, social and economic risks.
Before investing in bonds, you should understand the risks involved, including credit risk and market risk. Bond investments are also subject to interest rate risk such that when interest rates rise, the prices of bonds can decrease, and the investor can lose principal value if the investment is sold prior to maturity. Equity investments carry risk, including the loss of principal. The prices of small- and mid-cap stocks are generally more volatile than large company stocks.

Expected Return: Based on our long-term annual return expectations for Canadian and U.S. equity (6-8%), overseas equity (7.5%-10%) and fixed-income investments (3-4.5%), this describes the average expected return for this Portfolio Objective based on the asset allocation illustrated. This does not factor in potential fees and taxes that could reduce your actual return. There is no guarantee that you will earn this return if you hold investments in line with this Portfolio Objective. Expected Returns source: Edward Jones calculations, September 2015.