

AGF INSIGHTS
OUTLOOK 2019

Policy, Politics and Prospects of a Recession

The Year Ahead

The background image shows a modern architectural structure with a curved glass facade and a steel frame, set against a city skyline at sunset. The sky is filled with warm orange and yellow hues. In the foreground, there's a road with a white dashed line and some greenery.

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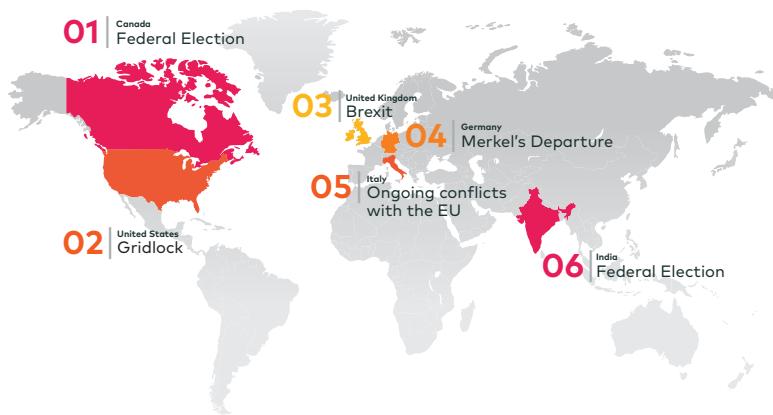
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Policy, Politics and Prospects of a Recession

The Year Ahead

By Kevin McCreadie

Chief Executive Officer and Chief Investment Officer
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Investors should avoid a recession next year, but not the threat of it as higher interest rates and growing geopolitical risk continue to weigh on the global economy and markets in 2019.

This shouldn't come as a surprise. Over the past few months, stocks, bonds and other asset classes have become more volatile in a potential sign of what's to come. That doesn't mean opportunities for gains have vanished, but a more selective approach will be a key ingredient for returns moving forward.

With that in mind, all eyes should be on the future direction of interest rates and, in particular, the U.S. Federal Reserve (Fed)'s next few

moves. More than two years into the Fed's tightening cycle, investors have become increasingly leery of the prospects for a central bank misstep and whether less accommodative policy will cool the world's largest economy too quickly, becoming a drain on corporate profits.

This may very well prove true. In the past, when inflationary pressures have increased like wage growth has now, it has been very difficult for central banks to "thread the needle"

and find the right balance between rate hikes and sustained economic expansion.

To complicate matters further, corporations are starting to feel the bite of ongoing trade tensions between the U.S. and China. And if tariff rates increase in March as threatened by U.S. President Trump's administration, the impact on future earnings – especially U.S. companies with manufacturing in China – could be severe.

Will cooler heads prevail? More than likely, but getting the world's two biggest economies to reach a new agreement on trade will involve further brinksmanship along the way. At the same time, the "handshake" trade deal between the U.S. and European Union (EU) isn't a sure thing yet and more noise on that front should be anticipated.

Just how noisy may depend on the new political landscape in Washington, D.C. With the

Ultimately, we believe a recession is unlikely over the next 12 months and that equity markets are poised to grind higher in a highly charged environment marked by low returns, higher volatility and the potential for big selloffs.

Democrats now in control of the U.S. House of Representatives, Trump's hardline approach towards trade may be tempered if it becomes necessary to steady equity markets, an important pre-requisite of his re-election.

A gridlocked U.S. Congress could also put a dent in some parts of the Republican's pro-market agenda and raises the spectre of a campaign to turf the U.S. President from office. While actual impeachment is highly unlikely given the Republican lock on the U.S. Senate, any attempt by the Democrats to kickstart the process would be unsettling for investors.

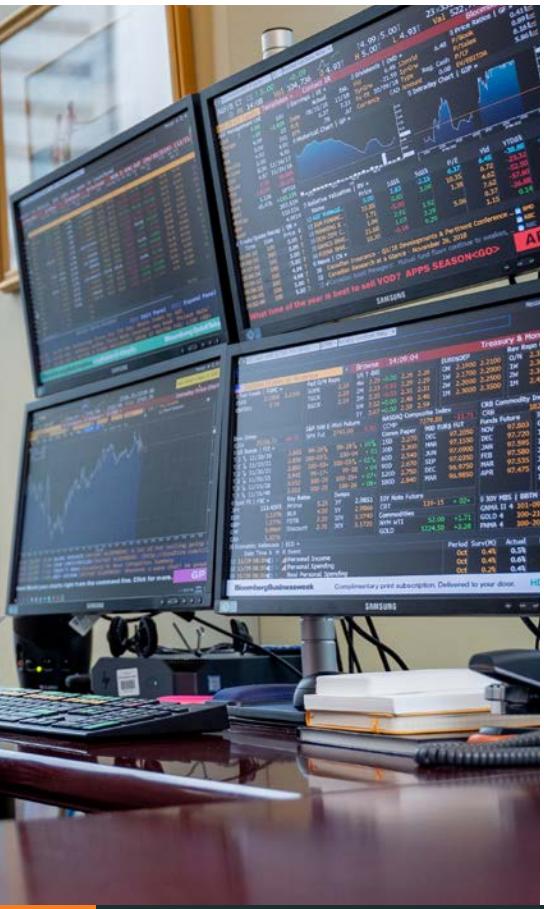
But U.S. politics aren't the only game to watch. In Europe, Italy's budget fight with the European Union remains ongoing and Angela Merkel's decision to step down as Germany's

Chancellor leaves a vacuum near the very top of the EU's political hierarchy.

And then there's Brexit. The United Kingdom's (UK)'s decision to leave the European Union has become a vicious game of chicken and will hang over markets at least until the deadline to reach a separation agreement at the end of March – if not longer.

While all of these political events have the potential to undermine stock markets next year (and give bond prices a boost), the satisfactory resolution of one or all of them could do just the opposite and act as a catalyst that keeps the bull market alive. And even if markets do retreat, a major pullback would very likely put the brakes on further rate hikes and be a silver lining for investors.

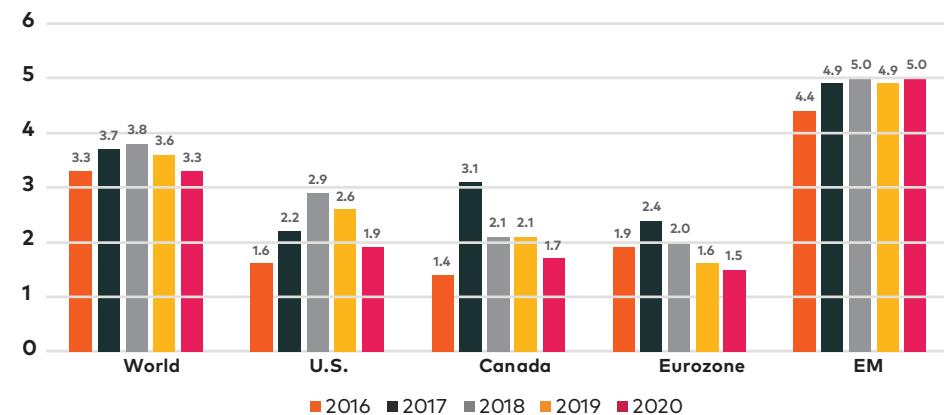




Ultimately, we believe a recession is unlikely over the next 12 months and that equity markets are poised to grind higher in a highly charged environment marked by low returns, higher volatility and the potential for big selloffs.

In particular, we remain positive on U.S. equity markets and see opportunities in emerging markets, which, after a challenging 2018, are more attractively valued. And while we head into the year favouring stocks over bonds from an asset allocation standpoint, we think the worst may be over for the latter and see more opportunities to put money to work in this much-maligned asset class as the year progresses.

GDP Growth Expectations



Source: Bloomberg, November 27, 2018. Real GDP (YoY%), 2018 to 2020 are consensus forecasts.

Geopolitical hotspots

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Federal Election



02 | United States
Gridlock

03 | United Kingdom
Brexit

04 | Germany
Merkel's Departure

05 | Italy
Ongoing conflicts
with the EU

06 | India
Federal Election

01

Canada: Federal Election

Among the contentious issues Canadians will be considering as they head to the ballot box this fall are the oil patch's woes and climate change. Tensions are rising for Justin Trudeau's Liberals over pipeline capacity, regulatory hurdles, and oil prices. Meanwhile, Trudeau has demanded that the provinces put a price on carbon emissions, or vowed to do it for them. The cap-and-trade program is already being challenged provincially, and will be the key issue put forward by the Progressive Conservative Party in the fall election.

02

United States: Gridlock

Following November's mid-term election outcome, there are a number of wildcards that could create uncertainty once Congress resumes sitting in January. With the Democrats now in control of the House of Representatives, they could potentially push impeachment proceedings, although they are likely to be thwarted by a Republican-led Senate. More uncertainty could also be created by ongoing trade tensions with China, and the spectre of a government showdown over the debt ceiling.

03

United Kingdom: Brexit

Much of the focus of the United Kingdom's departure from the European Union has been on the economic impact of Britain leaving. However, the effect on global supply chains will be significant, potentially precipitating a move to more local sourcing, as the UK will be required to establish new trading arrangements with the EU.

04

Germany: Merkel's Departure

Often hailed as the de facto leader of Europe, Angela Merkel is stepping down as leader of Germany's Christian Democratic Union, and has also announced she will not seek another term as Germany's Chancellor in the next federal elections, slated for 2021. With the rise of populism in Europe, questions have been raised about whether Merkel's departure opens up the region to more extremes in the EU.

05

Italy: Ongoing conflicts with the EU

With continued tension between the European Commission and the Italian government over its budget, there are not only immediate concerns about credit yields, but ongoing concerns over Italy's participation in the EU as well. Having emerged from the Greek debt debacle that nearly destroyed the single currency, the EU is concerned about another possible crisis if debt-laden Italy were to lose market trust—or even leave the Eurozone. There are already concerns that the new populist government could adopt a more confrontational stance on issues such as migrants.

06

India: Federal Election

Although it's thought that the Bharatiya Janata Party (BJP) is likely to remain in power in India's 2019 election, slow wage growth in the agricultural sector has given rise to growing disenchantment among the country's large rural farming community. However, if India's fragmented opposition manages to coordinate their efforts and defeat the BJP, it could hinder the progress of economic reform.

Asset Class Roundup



EQUITIES



FIXED
INCOME



CURRENCY



COMMODITIES



Bottoms up: Is EM ready to rebound?

By Regina Chi

While there's reason to be optimistic about an emerging market (EM) rebound in 2019, pinpointing market bottom is often elusive. Investors are more likely to capture a full recovery by implementing a long-term strategy.

The year that was

After a strong start to 2018, the MSCI Emerging Markets Index lost 13.32% year-to-date through late November, according to Bloomberg data. Ongoing global trade tensions and concerns about monetary tightening by the U.S. Federal Reserve (Fed) weighed on emerging markets. At the same time, the Fed's tightening caused a rally in the U.S. dollar relative to EM currencies, and many EM countries felt the shock of a higher cost of borrowing, while those countries that had better current account deficits fared better in the face of the strengthening greenback.

A rebound in the making?

There's no question all of these headwinds could have an impact as we move into the New Year, but it may well be that much of this is already priced into the market. Consider that EM equities are currently trading at considerable double digit discounts to Canadian and U.S. equities. In other words, we believe this may be the time to buy. Longer term, there are reasons for optimism, too. Many EM countries have vibrant domestic economies, driven by a growing middle class, especially in Asia Pacific countries. EM economies are also leading developed market (DM) economies in

terms of productivity rates. In fact, productivity in EM is improving at double the rate of DM. If anything, ongoing trade tensions are a wake-up call because U.S. tariffs promise to make selling low-cost goods to American consumers less profitable. Companies are being forced to rethink their operations and products in the next wave of manufacturing. China, in particular, is moving from imitator to innovator, and up the value-chain as an advanced manufacturer to stay relevant.

For all of these reasons, we're bullish both in the near term and over the long term.

EM markets have recently traded at a

1.5

standard deviation below their five-year average trailing P/E ratio.

Source: Bloomberg, as of October 24, 2018



Why the bear market in bonds is getting long in the tooth

By Jean Charbonneau, Tristan Sones, Andy Kocher and David Stonehouse

It hasn't been an easy stretch for fixed income investors, but more than two years into the current bear market for bonds, the worst may soon be over.

Much, of course, depends on the future state of the economy. Decelerating economic growth, global trade tensions and disinflationary forces could force central banks to rethink their plans for further tightening. If so, this would support a relatively better environment for fixed income next year.

More specifically, from a **rates** perspective, the correction of the past two years is likely closer to an end than a beginning and government yields aren't expected to move materially higher in the near to mid-term. To that end, The U.S. Federal Reserve has taken a more pragmatic

stance in recent weeks and may not maintain its steadfast pace of hikes if fears of an economic slowdown persist in the weeks ahead. The Bank of Canada could also slow its pace of rate hikes as it contemplates the impact of lower oil prices, while others, including the European Central Bank, could fall even further behind.

As for **credit**, the recent repricing in the market has made it relatively more attractive heading into the new year and, with the worst of the tightening cycle now likely behind us, rising rates have largely been priced in. A return to the "goldilocks" period of modest economic growth is also a potential positive for credit as is the fact that yields, following their gradual rise, are near their most recent upper bounds. And while overly aggressive central bankers and further weakness in commodity prices remain risks, the corporate sector continues to de-lever, resulting

in healthier fundamentals compared to prior years. Any further repricing in the market should be an opportunity to acquire select oversold securities.

Emerging market (EM) bonds, meanwhile, faced a number of major challenges in 2018, but could regain momentum as some headwinds – most notably, a strong U.S. dollar – start to subside. While a swift and immediate turnaround is not expected, the growing divergence within EM will lead to opportunities for specific countries over others in the mid-to-long-term. At the same time, government issued debt is preferred to corporate issues, while both local and external market issues look more fairly valued.

All in all, investors can anticipate a greater divergence between winners and losers in this environment, which should bode well for those who take a more active approach in their portfolio.

Cyclical bear markets in 10-yr U.S. treasuries

Length of current bear market:

28 months

Avg length of past bears since 1954:

23 months

Source: Bloomberg LP, AGF Investments as of November 30, 2018



Will the U.S. Dollar reign supreme again?

By Tom Nakamura

Buoyed by a strong economy, higher interest rates and growth concerns elsewhere, the U.S. dollar had a strong 2018. We believe many of the tailwinds that the USD has enjoyed will dissipate and fill the sails of other currencies.

The economic outperformance of the United States relative to the rest of the world should start to fade as monetary and fiscal tightening start to dampen growth. Other central banks have been slower to normalize policy, most notably the European Central Bank and the Bank of Japan.

In Europe, while economic data has been disappointing, the central bank is staying the course in guiding the market to normalizing interest rates

in the second half of 2019. Despite this, the Euro has been weak against the USD as Italian sovereign risk and Brexit uncertainty has weighed on the single currency. The United Kingdom's Bank of England has held a cautious stance in light of Brexit uncertainty, but they have indicated that absent this risk that rates would be higher.

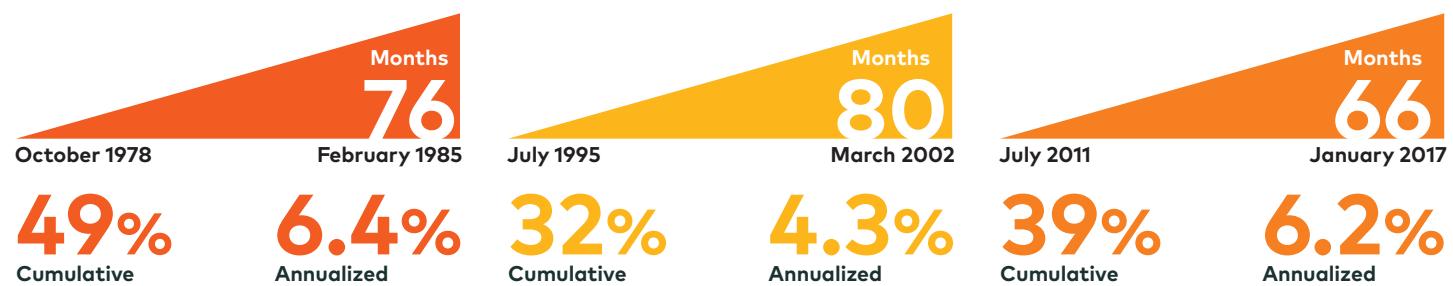
In Canada, the Bank of Canada has been firmly in a normalization path. While rate hikes have been priced in by the market, the Canadian dollar has failed to stage a significant rally. While trade uncertainty is part of

the equation, the wide differentials between Canadian and U.S. oil have caused deterioration in Canada's terms of trade (the difference between the price of exports and the price of imports) and there is concern that the economy is not well equipped to handle further hikes. One of our preferred measures to assess long-term valuation is the Bank of International Settlement (BIS) Real Effective Exchange Rates (REER). REERs measure a currency's valuation against a trade-weighted basket, adjusted for differences in

inflation. The BIS USD REER has had three major rallies over the past five decades.

While the most recent rally has been shorter in duration, the magnitude of the move is akin to what we saw in the late 70s through the mid-80s. This suggests to us that the strength of the USD will start to bite into the competitiveness of the U.S. economy and that long term investors should enjoy currency gains from exposure to global and emerging market portfolios.

Major rallies in USD



Source: Bloomberg LP, as of November 30, 2018. Bank of International Settlement (BIS) Real Effective Exchange Rates (REER)



Mind the gap: Oil's shifting dynamics

By Steve Bonnyman

The oil market has been on a rollercoaster ride for most of the past dozen years with traditional factors like supply and demand, foreign exchange rates and geopolitical risks fueling oil's price volatility.

However, as production growth moves to newer regions, these factors, as well as the logistics challenge of getting raw crude to market are creating more uncertainty in the sector.

North America is the hub of the logistics glitch, evidenced by the volatility of price differentials across and within regions. The explosive growth of production in West Texas Intermediate (WTI) crude has outpaced pipeline capacity in the region, resulting in US\$10 price per barrel differentials even within a few hundred miles. We believe these price differentials should narrow over the next year as new pipelines come on stream. But supply has currently

crowded transportation capacity to the key Gulf Coast demand/export center, creating price differentials throughout North America and record price discounts for Canadian oil production in recent months..

Beyond this ongoing headwind, the most recent price decline is a clear example of a combination of market balances as well as geopolitical risk, which is expected to continue to drive variability in oil prices. The existing low US\$60 Brent price for oil is not adequate for Saudi Arabia to balance their budget, suggesting a strong incentive to encourage OPEC to manage production for higher prices. Additionally, provided that the Trump administration's policy regarding

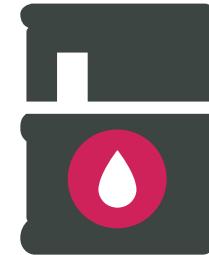
the Middle East is unchanged, the Iran sanctions will be enforced and another 800,000+ barrels per day of production will be taken off the market. Either of these factors could tighten the market substantially, supporting higher prices. With the continued production risks in fragile economies like Venezuela, Libya or Nigeria, the market has little room for error before swinging into deficit.

Barring a major slump in demand, oil prices will only drop to a point in which "swing" producers in the Continental U.S., and notably in West Texas, remain profitable. What the market will lack going forward is the easily accessible idled capacity which used to reside in OPEC but has been replaced with short cycle unconventional production from the U.S., which is expected to result in continued high levels of price volatility.

What's the Difference?



Canadian oil
\$39
Barrel



U.S. oil
\$52
Barrel

Source: Bloomberg LP, December 11, 2018.
U.S. Oil represented by WTI and Canadian Oil represented by WCS in U.S. Dollars.

What to watch in factors



Differential of average 12-month return of stocks in the top and bottom quintiles of MSCI ACWI ordered by the respective factor values from November 30, 2017, through November 30, 2018.

Source: AGFiQ, FactSetFactors used (respective factor group's shown above): Price to Book Ratio (Value), Market Capitalization (Size), 300 Day Volatility (Volatility), Return on Equity (Quality), 12-month Price Change (Momentum).

Low volatility and momentum have been two of the best performing factors in most regions around the world so far this year, but returns have been volatile in recent months and the potential for new leadership is significant heading into 2019.

In recent weeks, we've seen a broad shift in tactical, shorter-term factor performance that has coincided with higher market volatility, rising interest rates, and various bouts of geopolitical uncertainty, despite strong company earnings and solid economic growth.

The result has been a much stronger showing for quality of late and a rebound in value, which hit historical lows in some regions earlier in the year. Low volatility, meanwhile, has maintained its strength, with growth and momentum (particularly longer-term momentum) experiencing weakness across all regions.

Going forward, we expect to see some moderation in factors that have done well recently, but remain committed to a multi-factor approach that ensures we both mitigate risk and have diversified alpha drivers that carry over through different market cycles.

– The AGFiQ team



Is the market its own worst enemy?

The structural transformation of markets and trade dynamics in recent years could add fuel to the next big selloff in stocks.

By John Christofilos

Equity markets have been anything but dull this year. After a long stretch of unusual calm in 2017, volatility has spiked and a number of hair-raising pullbacks have occurred, leaving the bull run in stocks bent but not quite broken.

While growing fears about rising interest rates and trade wars are largely to blame for the turbulence over the past 12 months, this alone does not explain the full risk now facing investors.

Exacerbating current macro threats is the vast transformation in market structure and daily trading practices, which, combined, have proven their potential to accentuate losses and may be what ultimately fuels the next big selloff when it happens.

Chief among these structural changes is the rise of trading algorithms and increasing influence of high frequency traders (HFTs) and quantitative models that can now buy and sell securities in nanoseconds.

This facet of the market's ongoing technological innovation has helped improve the speed and accuracy of trade execution, while also supporting the interconnectivity of

the numerous exchanges and trading platforms now operating around the world. But their prevalence has also created new challenges in areas such as liquidity and they have been linked to a number of so-called "flash crashes" this decade including the first and most famous which occurred on May 6, 2010, resulting in a loss and recovery in the Dow Jones Industrial Average of over 1,000 points in about 15 minutes.

More recently, algorithmic trading played a large role in the Dow's steep drop in early February of this year. Precipitated by a strong U.S. jobs report, the correction was driven by several contributing factors beginning with a necessary rebalancing by many large pension funds following an abnormally strong rally in stocks the previous month.

From there, algorithms triggered even more selling from trend-following strategies that trade strictly on market technicals

without considering the context of the greater economic backdrop. And as losses continued to mount, panic set in – particularly among self-directed retail investors – only leading to further losses.

This type of scenario is only bound to repeat – especially given some estimates that show algorithmic trading accounts for more than 50% of all trades that take place in certain marketplaces. But what's being traded may have just as big of an impact on future stock prices

as does the changing ways in which trades are being executed.

The rise of passive investing, for example, is being increasingly scrutinized as it continues to eat up market share. Index funds and ETFs that track market-weighted indices and portfolios have ballooned to US\$7.4 trillion in assets under management globally, according to JPMorgan Chase & Co., and are being held more accountable for an uptick in concentrated last-minute trading that is resulting in steep

end-of-day volatility with growing frequency.

This stems, in part, from the fact that many passive ETFs are benchmarked to the close, which forces most of the buying and selling required to target benchmarks toward the final moments of the day. And because passive investing tends to be trend following, this may lead to wild price swings in the last hour of trading.

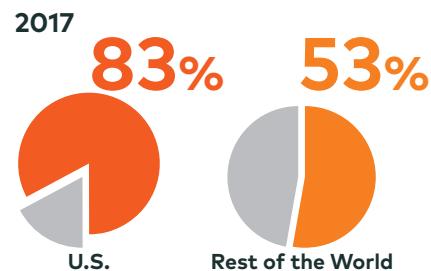
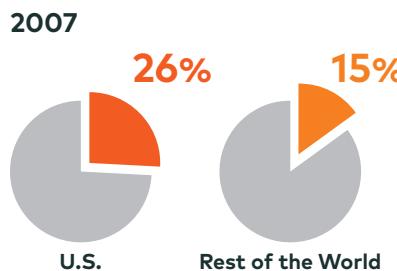
Granted, many ETFs are incredibly useful tools in certain circumstances,

but the tendency of passive funds to push equity prices higher during rallies and magnify losses during pullbacks is particularly alarming at this late stage of the economic cycle.

Similar worries apply to the possibility of another flash crash as the result of algorithmic trading. While neither of these risks will likely cause the next bear market, they could easily reduce the ability of the market to prevent and recover from its impact, while potentially eroding investor confidence over time.

BY THE NUMBERS

In 2007, passive investing's overall size amounted to about 26% of actively managed large and all-cap funds' assets under management (AUM) in the U.S., and about 15% outside of the U.S. Eleven years later, those figures have jumped to 83% and 53%, respectively.



Source: Bloomberg LP and JPMorgan Chase & Co.

Last-minute trading spurs have hit record levels. This year on the New York Stock Exchange and the NASDAQ, 22% of trades were concluded in the final half hour of each day, on average, up from 19% in 2014.



Source: Bloomberg LP and Investment Technology Group.



Quality from quantity

Members of our fundamental, quantitative and risk management teams discuss the ins and outs of utilizing data to improve investment outcomes in the digital age.

By Rune Sollihaug, Mark Stacey and Stephen Way

Why is data becoming more important to investment management?

Stephen Way: Data simplifies our investable universe and has helped us create a more disciplined, systematic process over the years. The key is how you analyze the data and the judgment you apply to it.

Mark Stacey: What's most important is the story within the data that tells us how companies are doing. To make thoughtful decisions, you need to be able to harness this information.

How has data changed your job?

Rune Sollihaug: Data has become more granular, and there is now more focus on shorter term data. In the past, there was very little focus on factor exposures, for instance. Systems have become more sophisticated as well, resulting in the benefit of more detailed reports.

MS: More and better data now provides so many different perspectives on the market beyond traditional financial statement analysis.

SW: We've been using data related to factors to inform our country allocation since 1995, but back then we relied solely on a third party provider. Now we get a lot of it from Mark's quantitative team and we have more ways to slice it to come up with new approaches.

Does utilizing data represent any specific challenges for asset managers?

RS: Both accuracy and getting timely data are crucial. Without a proper quality assurance process in place there is a risk that the data quality

could end up being poor.

MS: Whether it's financial statements or an earnings call transcript, it's crucial to get the right data source. You also have to be able to understand the data, "scrub" it, organize it and maintain it. It's easy to become overloaded with too much data if you don't have a proper process for handling it in place.

SW: Figuring out what is not worth knowing is just as critical. Otherwise, you can spend months crunching data in a so-called analysis paralysis.

What data sources do you use/trust?

RS: There are no data sources that I trust 100%. Those I trust most have a solid quality assurance process in place in order to scrub and validate the data.

MS: Trust can become a bit of an issue when you get into Artificial Intelligence (AI) and unstructured data that is being scraped from the Internet. As data moves away from just financial statement analysis, it's important to note whether the information is audited or self-reported as it tends to be in a lot of environmental, social and governance (ESG) factor data.

SW: Because ESG scores are put together by third parties from a culmination of data, you never know if they are misinterpreting the information unless you do the fundamental analysis and identify the key issues yourself. So, it's important to triangulate and validate through multiple sources.

Is harnessing proprietary data important?

MS: It's more the way you use the data that's important. For our quant team, that means making sure all

the inputs for the models we build are proprietary as well as the models themselves. That way, we understand them and are not relying on someone else if something goes wrong.

RS: If you have data or models that give you a competitive advantage, it would certainly be beneficial.

How does a quant use data differently than a fundamental manager? How can they learn from each other?

SW: From a fundamental perspective, we use the quantitative data to help us narrow the universe of stocks down from around 600 names to something more manageable. We can also use data to help capture "red flags" in our investment thesis, allowing us to prioritize our attention to potential risks that fundamental analysis, by itself, might have been slow to recognize.

MS: As quants, we're analyzing many of the same things that Steve does, like discounted cash flow, for example. But we do it differently. Our heavy lifting is up front when we are creating our models based on the data. Steve's heavy lifting is after the data has helped him narrow down his universe.

RS: I believe both should be used in both processes, the question is to what degree.

How does data help from a risk management perspective?

RS: It's become crucial for someone

rest of the portfolio and scenario analysis.

MS: Data is helping us learn far more about the contributors to risk in a portfolio. Because of that, we are able to identify and get the exposures we want, but also control

AGFiQ's proprietary database has

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>4.5 Billion
rows of data

= 800
= Gigabytes

or equal to
 80
Wikipedias

Source: Wikipedia, "Size of Wikipedia", October 1, 2018 and AGFiQ Analytics

like me who is helping manage risk across a number of strategies. But it has to be accurate. Even small variances in input data can cause significant inaccuracies in any report.

SW: Data is becoming a key enabler of risk management. It provides key insights in terms of active risk contribution, correlations with the

the exposures we don't want.

SW: I'm not sure terms like active risk and tracking error were even in my parlance 10 years ago. The bar has been raised and it's now expected you'll use this data to help understand, manage and communicate the various risk exposures in your portfolio.



The growing reward of being a responsible investor

Building a more sustainable economy is creating opportunities while bestowing new powers on investors

By Martin Grosskopf and David Stonehouse

Responsible investing has reached a critical juncture. A number of shifts are currently underway as the once nascent trend goes mainstream, including demands for better data and measurement to thwart "greenwashing," and the creation of more customized products as a growing chorus of investors call for progress on environmental, social and governance (ESG) issues.

Looking ahead, we believe investors will be keeping a watchful eye as the rise of populism in developed markets undermines the drive to find global consensus on issues like

climate change, and governments retreat to focus on local concerns. Still, there's no denying that the velocity of growth over these past few years is nothing short of staggering. What began as a niche desire by investors to put their money where their heart was, has matured into growing agreement that the integration of ESG risks into investment strategies can improve the planet as well as social outcomes, while driving long-term value. In fact, ESG integration is increasingly seen as a fiduciary duty.

The United Nations-supported

Principles for Responsible Investment, an international network representing some US\$80-trillion worth of investment (according to its own 2018 data) has helped lend credibility to the investment strategy, helping to build trust with everyone from foundations and endowments, to retail investors. In Canada alone, there are now \$2.1 trillion in responsible assets under management, representing 42% growth over the past two years and 51% of Canada's investment industry, according to the Responsible Investment Association's 2018 Trends Report.

Populism's overhang

While geopolitics has traditionally been the preserve of emerging markets, the sweep of populism, arising from growing social fissures, has resulted in Brexit, turmoil in countries like Italy, and the election of U.S. President Donald Trump, and is likely to shift ESG considerations in the coming years. Because many large environmental initiatives are undertaken at a national level, both political support and important subsidies could be at risk in some countries that have helped fuel global action on issues like climate change.

81%

Sponsored by AGF, the 2018 RIA Investor Opinion Survey is based on an Ipsos poll of 800 individual investors in Canada which found:

of respondents expressed concern about climate change and ranked environmental issues as the most important factor among E, S, and G issues.

70%

of respondents believe climate change will have negative financial impacts on companies in some industries in the next five years; this number rises to 79% over the next twenty years.

66%

of respondents would like a portion of their portfolio to be invested in companies providing solutions to climate change and environmental challenges.

Consider that the U.S. government has opted out of the Paris Agreement, largely dismantled the EPA, and rolled back environmental regulations. In Canada, meanwhile, Ontario is pulling out of the cap-and-trade plan with Quebec and California and is now also challenging the Canadian federal government's jurisdiction to impose a carbon tax on provinces. The federal Conservative Party has also not only vowed to fight cap-and-trade, but to dismantle the carbon tax should the party win the election next fall.

What does this mean for investors? In the wake of less concerted action on a global level, we believe many will

increasingly be looking to solve their ESG concerns closer to home.

The need for verification: no small measure

Just as the organic industry faced growing scorn over "greenwashing" with consumers demanding both better standards and labelling to protect the integrity of the organic designation, there has also been increasing scrutiny over ESG investment measurement. While corporate disclosure on ESG issues has steadily improved since the launch of the Global Reporting Initiative (GRI) in 2000, measurement and the verification of outcomes is still

evolving. Big data and machine learning will undoubtedly help to improve ratings methodology, but there will be costs associated with improved measurement and they will either have to be borne by investors or companies themselves. Still, we know there's good reason to do so. A growing body of academic evidence shows that companies that effectively manage and integrate sustainability issues reap a range of reputational and competitive advantages – including better governance and positive social impact, resource and cost efficiencies, productivity gains, as well as new revenue and product opportunities.

Custom-designed versus off-the-rack

As the industry matures, more investors are likely to be clamouring for customized products. The objectives of one major pension fund, for example, may be quite different from another's. One may focus more on air quality or energy use, while another could be more focused on health, safety and workers' rights.

Sophisticated asset managers will continue to innovate, finding new ways for investors to satisfy both their ESG and financial goals.

The folly of forecasts

Forecasting investment performance can be a huge challenge. Here's what investors need to know.

By David Stonehouse

Predicting the percentage returns of stocks and other asset classes is a staple in many investment outlooks this time of year, but history shows the numbers don't often add up.

Indeed, as Yogi Berra said, "It's tough to make predictions, especially about the future." Based on our research of various sell side reports over the past two decades, a high proportion of predictions play it safe and call for upper-single digit equity increases most years. Since average annual equity price returns over the long term have been approximately 7.5%, this approach seems reasonable. Actual annual returns are highly variable, however. The S&P 500, for

instance, has only delivered mid- to upper-single digit price returns (4 – 10%) about 8% of the time since 1927, according to Bloomberg data.

So far this century, strategist forecasts have typically missed the actual outcome by an enormous margin of 13.1% on average (see accompanying graphic for source). In fact, in one third of the past 18 years, the realized return of the S&P 500 has been outside the range of every forecast, either coming in higher than all estimates or lower than every estimate. In addition, the average forecast ended up being within 5% of the actual return in only five out of 18 cases.

These inaccuracies don't just apply to equity forecasts. There is also evidence of the difficulty in predicting the future returns of other asset classes such as sovereign bonds. But that's not to say the analysis accompanying these forecasts isn't sound – in fact it can provide valuable insights to investors.

Rather, it's a reflection of how dynamic markets can be and a reminder to all of the importance of being prepared for any kind of eventuality to unfold. So instead of trying to make a precise forecast of returns next year, an investor could focus on potential upside and downside risks to the consensus

forecast. After all, if returns only end up being in the mid- to upper-single digits a small percentage of the time, that means that returns in most years will either be up double digits or flat-to-negative.

Therefore, investors could try to consider whether a strongly positive outcome is more likely, or whether negative risks will prevail. To put it another way, if one assumes that consensus is wrong in any given year, the question to ponder is whether reality will be better (a very good year for stocks) or worse (a flat to down year).



**Taking a closer look
at S&P 500 forecasts
since 2000.**

The **mean S&P 500 forecast**
ranged between

4% and 10%

in 12 of the past 18 years.

18 Positive price return
forecasts since 2000.

12 Years with actual
positive price returns.

8 Years of positive double
digit price returns.

Actual price returns within
the same range happened
just twice.

2004 9.0%

2015 9.5%

The **realized return** of the
S&P 500 fell outside the
range of strategist forecasts

1/3 of the time.

The **average forecast**
ended being within

5% of the actual
return in just **five of 18** cases.

Contributors

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Shared Intelligence



Measured Approach



Active Accountability



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