

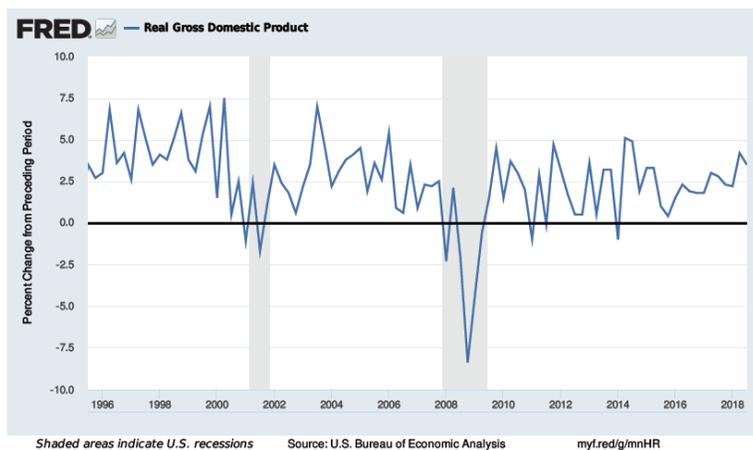
Capital Markets Review and Outlook

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Economy and Outlook

While the U.S. jobs report for the month of November showed a lower than expected increase (with revisions) of 143,000, real GDP growth of 3.5% for the third quarter following a 4% print in the second quarter underscores the strength of the U.S. economy.



The November unemployment rate of 3.7% for the third consecutive month remains close to a 50-year low. Consumer and business confidence readings are at multi-year highs.

The relief rally in the equity markets that followed the 90-day trade tariffs

truce between the U.S. and China was cut short by fears that the arrest of a prominent Chinese business leader in Canada (at the request of the U.S.) for alleged violations of Iran sanctions would not only derail the truce but worsen the conflict between the two countries. The volatility index (VIX) which had dropped 15% in November, rose sharply by 28% by the end of the first week in December. Other concerns for investors include the problems in Europe arising from the uncertainties with the Brexit negotiations, the budget deficit issues in Italy and social unrest in France. Slowing global economic growth is an additional worry for investors. In this climate of uncertainty and fear, there has been a flight to safety that has pushed Treasury yields down. After remaining above 3% for the past two months, 10-year Treasury yields are back below 3% in December.

Inflation in the United States is likely to be further restrained as the sharp drop in energy prices spills into core inflation. This, in turn, may spell a nearer end to the Fed's interest rate tightening cycle. If this is the case, a slowdown in economic growth next year from the 3+% print expected for 2018 may not be a significant headwind for risk markets. Also, the tax cuts and interest rate cuts enacted in China are likely to be positive for global economic growth. An additional supportive factor for the markets would be a more lasting trade agreement with China beyond the current 90-day truce. However, in the process of reaching the political end-game, market volatility is likely to continue.

Equity Markets

After a shaky start well into the third week of the month, global equity markets rebounded in November following the sharp selloff the previous month. An easing of trade tensions with China combined with less hawkish comments from the Fed were the primary factors for the relief rally. The broad domestic equity market was up 2% for the month. The middle of the capitalization spectrum was the best performer as the Mid Cap segment outperformed both Large Cap and Small Cap sectors. However, Large Cap Value was the standout across both capitalization and style with a 3% return for the month. The move by investors to a more defensive positioning as the last quarter of the year unfolded has cut into Growth's outperformance over Value, but the margin of Growth's outperformance year-to-date remains substantial at +500 bp. International equity markets were mixed; developed markets were down fractionally, while the renewed risk-on climate was reflected in the 4.1% return for emerging markets.

Fixed Income Markets

Despite the rebound in equity markets, Treasury yields declined reflecting expectations for fewer additional interest rate hikes by the Federal Reserve. The belly of the Treasury curve benefited the most as 5-year and 10-year yields dropped by 14 bp, while yields on longer and shorter maturities declined by about half as much. The usual positive correlation between corporate bonds and equities broke down in November. Credit spreads widened despite the rally in stocks. The credit curve was unchanged as intermediate and long maturity credit spreads both widened by 17 bp. However, the quality curve steepened with single-A credit spreads increasing by 13 bp, while BBB spreads widened by twice as much. The flight out of lower quality corporates was especially pronounced in the high yield market which weakened noticeably with spreads widening by 47 bp in November. For the first 11 months of the year, high yield spreads widened 75 bp. Non-U.S. global fixed income markets managed to post a small positive return of 0.3% for the month as foreign exchange rates stabilized versus the U.S. dollar. Year-to-date, the over 7% rise in the Federal Reserve's broad trade-weighted dollar index has weighed on the non-dollar bond market resulting in a -4.3% return.

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