VESTCOR

QUARTERLY MARKET UPDATE

AS AT SEPTEMBER 30, 2018

The following information is being provided as an overview of Vestcor Inc.'s (Vestcor) investment activities and the general financial market conditions experienced during the noted reporting period.

Please note that the following material is specific to Vestcor activities and is presented for information purposes only. It does not constitute investment advice in any way, and no guarantee is provided as to its completeness or appropriateness. We recommend that readers consult a professional advisor with respect to their own specific financial matters.

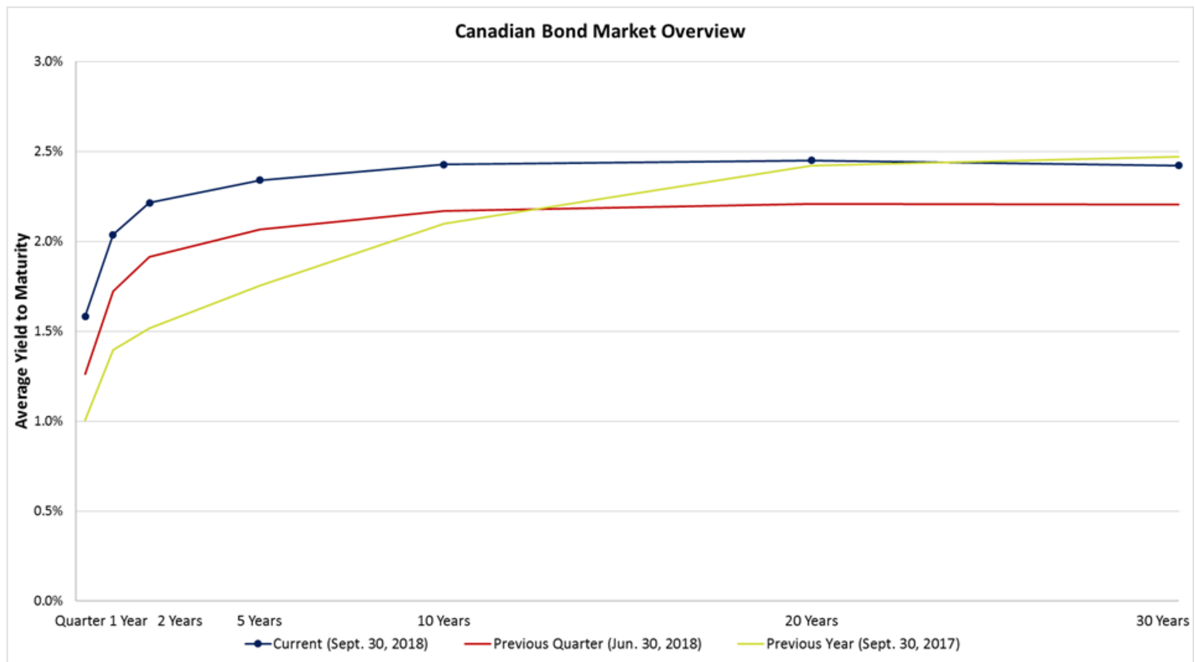
Performance Overview

- Performance was mixed in the quarter both between and within asset classes. While most interest rate sensitive allocations fell, equity performance was differentiated and therefore did not provide levels of diversification witnessed in prior periods.

- During the quarter, active management activities were flat. The Absolute Return program, along with various fixed income and real estate portfolios outperformed their respective benchmarks while equity portfolios (both market capitalization-weighted and low volatility) had a more challenging environment.

- The Canadian yield curve shifted higher over the past quarter leading to negative returns for fixed income portfolios. Short-term yields increased as the Bank of Canada hiked interest rates another 25 bps in July. Yields for longer term bonds also rose in recent months with Canadian fixed income following the U.S., where the benchmark U.S. 10-year yield increased approx. 20 bps. The Corporate Bond Index outperformed due to its lower exposure to yield changes. Credit spreads were roughly flat over the quarter and therefore did not contribute to the outperformance.

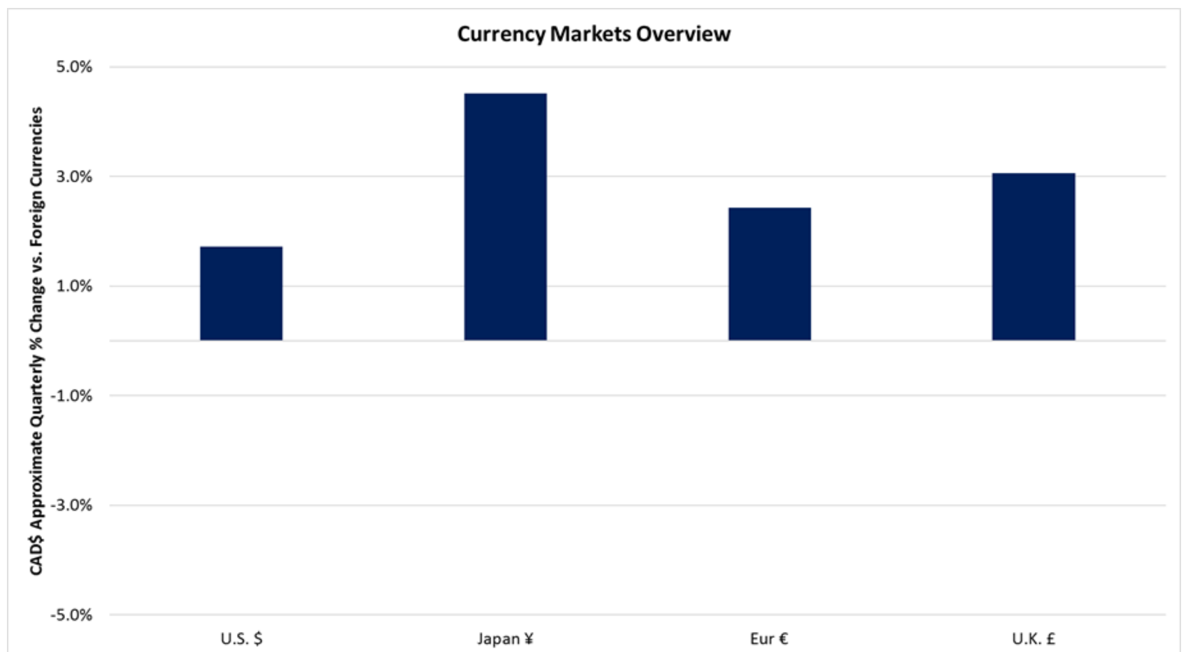
- The Real Return Bond Index showed weaker performance than nominal bonds due to having a higher sensitivity to yield changes. Increases in yields were not explained by higher inflation expectations and therefore did not provide protection to bonds in this space.



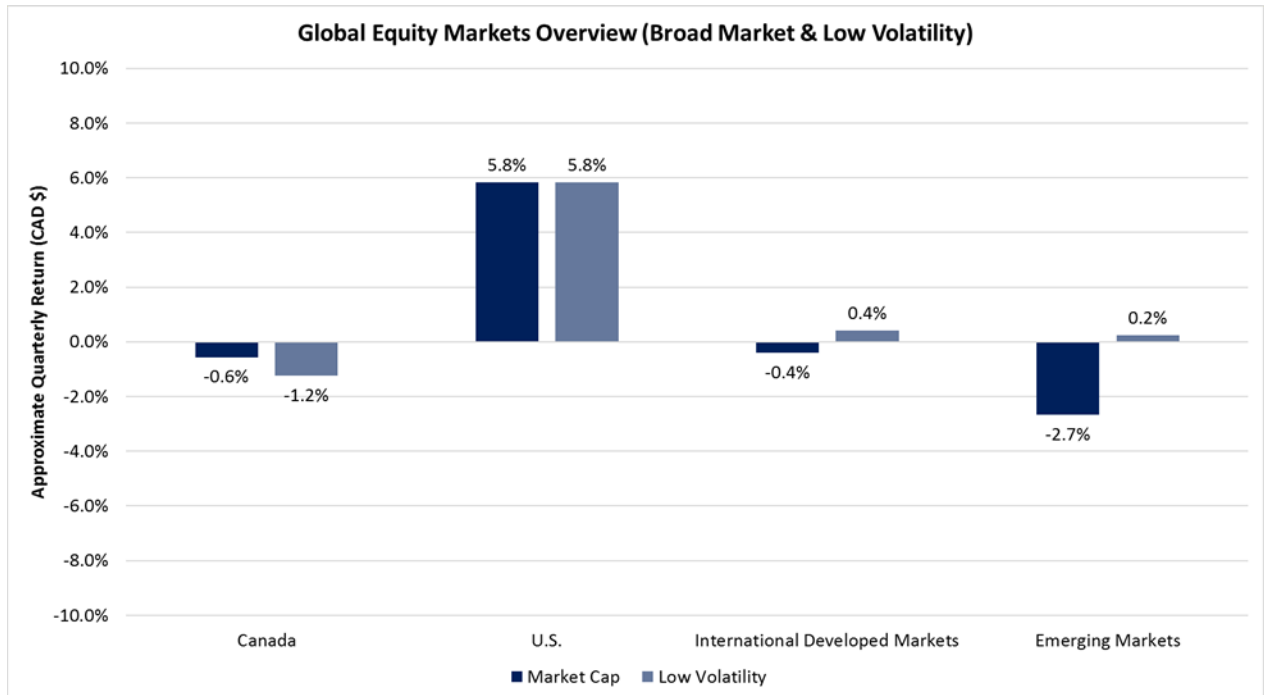
- Total Real Estate performance was strongest among Canadian assets where Canadian Public Market Real Estate (REIT) outperformed other real estate categories while U.S Public Market Real Estate (REIT) lagged other categories.

- Total Infrastructure performance was flat in the most recent quarter.

- In currency markets, the Canadian dollar gained versus all major currencies, thus contributing to lower Canadian dollar returns for unhedged international equity investors when compared with local currency returns:



- Equity markets showed mixed performance in the quarter with the U.S. market advancing while other regions were either flat or slightly lower. Canadian dollar appreciation was a major contributor to the lagging performance of international equities. An allocation to low volatility emerging market equities, instead of weaker performing market-capitalization weighted emerging market exposure, kept returns within that market segment positive:



Market Environment and Outlook

Economic and corporate earnings growth remained strong in the third quarter backed up by solid retail sales and consumer confidence survey results. With a 7.7% return in USD terms, the U.S. market continued to provide the strongest results, while international economies were impacted negatively by tariff threats and European Union challenges. In particular, ex-North America developed markets (EAFE) produced a slightly positive return in U.S. dollar terms (slightly negative in Canadian dollar terms), while emerging markets were down -1%/-2.5% respectively in $USD/$CAD. Canadian markets were also negative in the quarter, with particularly negative contributions from the Energy and Materials sectors offsetting gains in Financials. Benchmark interest rates in the U.S. and Canada were mostly stable through the majority of the quarter before beginning a move higher in September that carried forward into the beginning of the fourth quarter.

The month of October resulted in the second substantial drawdown of the 2018 calendar year for equity markets, as the S&P 500 fell from a high of 2925 to a low of 2728 (a drop of more than 6%) in the first half of the month. Global markets experienced similar losses, with the Canadian S&P/TSX Composite Index down about 5% over a similar period and the global MSCI ACWI Index dropping nearly 7% over the same period. Overall measures of volatility increased significantly as well, with the benchmark VIX Index spiking from 11 to a high of nearly 24 during the peak, before settling back at a still elevated level (relative to recent experience) of approximately 18.

While the October volatility can be partially explained by the accumulation of geopolitical risk (U.S.-China trade concerns and the risk of delays and downside in Brexit negotiations, among other concerns), the increasing market concern around tightening Federal Reserve policy and the associated rise in interest rates (the U.S. 10-year yield has increased about 0.8% so far in 2018), it is important to place the recent market volatility in the context of historical evidence. Over the past 50+ years of market history, the S&P 500 has experienced intra month drawdowns of more than 5% approximately 15% of all months (just under 2 times per year). The experience so far in 2018 with two such drawdowns is not outside the normal functioning of equity markets in general, and probably reflects normal levels of volatility experienced in a late cycle, monetary tightening environment.

Overall, the global economy remains on generally solid footing, although market participants do expect some further late cycle slowdowns in growth in certain areas. The U.S. employment picture remains extremely strong with a low unemployment rate (although somewhat low increases in wages overall), and the U.S. central bank remains committed to a continuation of its monetary tightening path, reflecting their view of the underlying strength in the U.S. economy. That being said, risks to the outlook continue to revolve around geopolitical risk, with downside risk should trade tensions between the U.S. and China continue to expand in the form of higher tariffs or wider application of trade restrictions in general.

The market volatility manifested itself in the standard outcomes of low volatility strategies outperforming broad markets (generic U.S. low volatility equity strategies outperformed the broad market by more than 1% during the October drawdown) and commodity prices remaining stable, with oil maintaining a price around $70 per barrel. As is sometimes the case during negative market events, precious metals such as gold and silver both saw price stabilization (and in fact slight price increases), with gold in particular providing diversification when compared to equity markets.

In Canada, the apparent resolution of trade concerns with the U.S. should help remove uncertainty going forward (although the bullish market response to the deal was short lived), thus improving the outlook

somewhat. The Canadian equity market has underperformed global markets in recent years (lagging significantly behind the S&P 500 over the trailing 12-month period) due to trade concerns and dramatic widening in the price spread between Western Canadian Select oil vs. the U.S. benchmark price continuing to weigh on commodity sensitive companies on the Toronto Exchange.

Market valuations, after reaching fairly elevated levels in late 2017, have now retreated to less extreme values. The 12-month forward Price-Earnings ratio on the S&P 500 is now just over 17x (still above long run average, but well below the 19-20x levels achieved 12 months ago). For bonds, government interest rates have increased significantly thus far in 2018, thereby improving somewhat the expected return for fixed income investors on a go-forward basis.

Our medium-term outlook remains unchanged from the previous quarter. An improved valuation condition likely improves medium to long-horizon expected returns for policy asset mixes, but geopolitical risk remains front and center, likely to provide further volatility in markets from a month-to-month perspective. Consequently, we remain biased slightly toward risk assets for return-seeking portfolios, although with a strong risk-managed stance. In the shorter term, our tactical positioning has shifted to a slightly more bearish stance in recent weeks, although market dislocations will hopefully provide opportunities for additional returns if markets return to normal conditions.