PORTFOLIO MANAGERS

SHARE INSIGHTS ON MARKET DIRECTION FOR 2018

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2017 WAS A GREAT YEAR FOR MOST INVESTORS.

Almost every asset class and major market index finished the year with positive returns. Much of this performance was due to a strong comeback in the global economy as most major industrial and developing economies also saw a big upturn in economic growth. Central banks worldwide began to raise interest rates, and finally, reduced a decade-long era of quantitative easing. Many see this as a true indication that the woes of the credit crisis of 2008 and its aftermath are behind us. While global monetary stimulus tightening may have been thought of as a headwind, financial markets not only survived, but thrived. For instance, valuations in U.S. markets have reached new levels with somewhat low interest rates.

What surprises will 2018 have in store? How much higher can valuations go? We asked portfolio managers representing some of our top ETF mandates to give us their outlook on where they believe markets will be headed over the next 12 months.
The Portfolio Managers Are:

**Tyler Mordy**

Tyler Mordy is President and CIO of Forstrong Global. Since joining the firm in 2003, Tyler has become a recognized innovator in the design and application of “global macro” ETF portfolios. He is widely quoted and interviewed by the financial media for his views on global investment strategies and ETF trends. Forstrong Global is the sub-advisor of the Horizons Global Managed Opportunities ETF (HGM).

**Fiona Wilson**

Fiona Wilson is a Portfolio Manager, Systematic Strategies for Guardian Capital LP (GCLP). She joined GCLP in 2011 in her current role. Prior to joining Guardian, Fiona was Portfolio Manager, Global Derivative Instruments with Ontario Municipal Employees Retirement System (OMERS). Guardian Capital is sub-advisor for the Horizons ETFs’ active dividend ETFs.

**Candice Bangsund**

Candice Bangsund is a member of the Asset Allocation committee for Fiera Capital, focusing on central banks and fundamental macro analysis. She also actively participates in the development and communication of the Asset Allocation strategy. Fiera Capital is the sub-advisor of Horizons ETFs’ active fixed income ETFs.

**Nicolas Normandeau**

Nicolas Normandeau is Vice-President and Portfolio Manager, Fixed Income for Fiera Capital. Nicolas is a member of the Integrated Fixed Income team and is a portfolio manager for the Integrated Fixed Income strategies, including the team’s preferred shares portfolios. Fiera Capital is the sub-advisor of Horizons ETFs’ active fixed income ETFs.
What do you consider big investment themes for 2018?

Mordy:
This year marks the 10th anniversary since the onset of the global financial crisis, the credit crunch that changed the world and, in many ways, serves as a demarcation line in reshaping economies, financial markets, politics and even our culture.

History shows that post-crisis periods, like the one since 2009, tend to be protracted affairs. This episode has been no different. Many global economic engines are just starting to rumble.

Europe and emerging Asia are becoming the beneficiaries of the next phase of outperformance (moving away from America). These regions, which have relatively inexpensive currencies, are showing signs of earnings and economic acceleration and trade on much more favorable valuations.

Last year, we called for an “emerging market boom”. That was quite prescient. Although 2018 will be more volatile than the last few years, the broad fundamentals in emerging markets remain excellent and we believe they are primed for multi-year outperformance. This continues to be our biggest macro theme (that we are investing in).

Wilson:
A shift in federal interest rate policy is one that will overshadow 2018. In the past, we have seen an accommodative U.S. Federal Reserve (“Fed”) policy that fueled stock returns. Now that the Fed has changed its stance, we should no longer see a rising tide lifting all boats.

With this, we are seeing single stock dispersion increase and this should lead to increased volatility in 2018. This lends itself to a stock-pickers market and one in which an active management style usually outperforms passive investing.

Another theme is synchronized global growth, and this should continue for 2018. Earnings growth remains firm globally amidst a backdrop of strong economic growth numbers.

In recent years, growth stocks have outperformed significantly. With the Fed embarking in a tightening cycle and volatility due to increase, income investing should return to favour. With overall gains harder to come by, there should be an increased emphasis on income investing. In addition, with demographics shifting towards an older population in the developed markets, the demand for yield will only get stronger.

Bangsund:
As we look ahead into 2018, the favourable conditions that have underpinned the stock market rally in 2017 remain largely intact. The global economic expansion has become increasingly entrenched, with all major regions of the world contributing positively to the acceleration. As a result, we are favouring equities over bonds.

While the economy has been strong enough to keep recession fears at bay, it has yet to generate much in the way of inflationary pressures and we see no imminent danger of overheating conditions over our 12-month horizon. Central banks can take their time in paring-back stimulative policies and leaving the global liquidity backdrop supportive in general. Moreover, as central banks have yet to become outright restrictive, the global economic recovery may continue uninterrupted well into 2018.

We are indeed in the later stages of the economic expansion. We remain in the early stages of the central bank tightening cycle and don’t foresee recessionary conditions starting to take hold until three to four years from now. Meanwhile, the stronger global growth and corporate earnings trajectory should lend support to equity markets and compensate for rising interest rates in the coming year.

Regionally speaking, we anticipate that the reflationaly, pro-growth environment should favour the cyclically-biased, commodity-levered regions of the world such as Canada. We believe that a revival in the commodity space should provide a lift to the S&P/TSX, while financial stocks should rebound alongside renewed inflation expectations and steeper yield curves.

Furthermore, extreme pessimism among Canadian stocks has resulted in a significant valuation discount, presenting a compelling opportunity for a potential reversal. We expect the glaring performance gap between oil prices and energy shares to close in 2018 (with energy shares playing catch-up – a boon for the energy-levered Canadian market).

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Almost every equity market was up in 2017. Are you concerned about how high global equity valuations have become?

Wilson:
There are fundamental reasons that support valuations. While these levels may constrain returns, they do not prevent them. Decent earnings growth and the macro backdrop suggest that, even if there is some compression, equities can still generate returns.

Again, this is a stock-pickers market, and as a result, we should see quality stocks gain momentum and some of the lower-quality equities may fall out of favour.

Bangsund:
While valuations appear stretched at current levels, we believe that these lofty levels are largely justified in the environment of still-low interest rates, subdued inflationary pressures, and most importantly, stronger earnings growth (the predominant driver of equity returns over the last year).

The synchronized global expansion and the corresponding resurgence in earnings growth should allow the equity markets to absorb a gradual increase in interest rates over the coming year.

Mordy:
On a composite valuation basis, the U.S. stock market is the most expensive it has been since 2007. By contrast, and perhaps surprising to some, many global markets currently showcase good value. Using the same composite value measure, developed Asia and Emerging Markets are sporting very reasonable valuations.
From a pure valuation basis, there is a strong incentive for investors to overweight stock markets outside of North America. Who can argue with rotating into cheaper markets, where business cycles have only just begun their expansion phases? And where profits have plenty of scope for improvement and where monetary policy is years away from any substantial tightening?

What is your outlook on interest rates in Canada for 2018, given the anticipation of rate hikes next April?

Bangsund:
We anticipate that the Bank of Canada will take a more tempered and cautious approach to rate normalization in 2018, as the bank monitors the impact of higher borrowing costs and new OSFI rules on the highly indebted consumer sector, as well as any progress (or lack thereof) on NAFTA negotiations. As such, we expect a total of three rate hikes from the Bank of Canada in 2018 (from 1.00% to 1.75%) as well as three rate hikes from the Federal Reserve (from 1.50% to 2.25%).

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Wilson:
Rates are likely to drift higher, but we don’t think that will happen to a significant degree. The market is currently pricing in 2.5% rate hikes by the Bank of Canada by 2018 year-end, which might be on the aggressive side.

Mordy:
The Bank of Canada’s rate-hiking cycle will be a glacial affair with a targeted short-rate that is much lower than in the past. However, the secular path is for higher real yields in Canada. In the same way that investors took more than a decade after 1980 to believe that inflation would not rise again into double digit figures, today’s investors – conditioned by at least 35 years of disinflation and declining interest rates – will take years to become convinced that the secular environment has changed.

While a spike in rates is clearly detrimental to fixed income investors, a slow-and-steady rise allows for a higher reinvestment rate without incurring large capital losses. This is wonderful news for retirees who have had considerable difficulty generating sufficient income in an abnormally low interest rate environment.

What is your outlook for the fixed income market for the next 12 months?

Normandeau:
We see rates rising slowly and steadily this year, with inflation being tame and under control. We don’t think rates will rise to hurt growth. We continue to be positive on the corporate bond market for 2018, as we think the excess return on corporate bonds will remain attractive, with a positive credit tone and strong credit demand continuing to underpin the sector. We see returns stemming mainly from the carry, and we especially like the one-to-seven-year sector in corporates.

We are also positive on the preferred share market – a large portion of preferred shares are still trading at a discount, and higher rates would be positive for many floating and rate-sensitive issues. Therefore, we still see a lot of value to be had in this asset class.

How will the Trump administration and the difficulties of NAFTA discussions impact markets in the year ahead?

Mordy:
Bond rallies will still present themselves. However, with the U.S. economy operating at near-full capacity, inflation will surprise us on the upside next year. We would remain short-duration and take on floating rate exposures where possible. Similar to equities, we are generally positive on emerging market debt, which offers higher yields and increasing credit quality, due to a combination of healthy structural reform, booming middle classes and earlier stage cycles.

Bangsund:
The risks to our central scenario are predominately political in nature. Namely, any sudden breakdown of NAFTA negotiations or U.S./China relations remain front-and-centre from a risk perspective. If anti-trade rhetoric in the U.S. becomes a reality and results in tariffs being imposed on economies such as China, Canada and Mexico, retaliatory measures could ignite a global trade war (though the risk of this scenario playing out remains fairly low, in our view).

Looking forward, the biggest impact of the ongoing NAFTA stalemate is through the uncertainty channel, as questions about the long-term viability of the free trade agreement remain a key issue and could potentially weigh on confidence and investment spending in the near-term.

The fact that the U.S. is running a small trade surplus with Canada is good news. Both Canada and the U.S. mutually benefit from North American trade, which leads us to believe that Canada is not a major target of Trump’s protectionist agenda. As such, we believe an abandonment of NAFTA is unlikely.

Wilson:
Uncertainty surrounding the NAFTA negotiations will continue to cloud Canada’s macro outlook and play into the Bank of Canada taking a very cautious approach to policy setting.
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What is your outlook on volatility for North American markets, given the historical lows of 2017?

Wilson:
We believe that volatility will pick up in the equity markets in 2018. The VIX has been trading at historical lows throughout 2017, but single stock dispersion is increasing. Rising rates in the context of policy tightening and indications of inflationary pressures should add to volatility across all markets. Impending U.S. midterm elections, policy uncertainty and the news flow leading up to them could spur volatility as well. Many investors have done well continually selling volatility and there are a lot of leveraged short volatility products in the market. This could lead to exaggerated moves in the VIX when we actually see volatility kick in.

Bangsund:
Volatility has the potential to play a larger role in financial markets in 2018, after remaining extremely subdued through 2017. The bar for economic and earnings surprises is much higher versus last year as buoyant expectations have largely been built into prices. Subdued levels of volatility suggest that investors remain vulnerable to disappointment and appear unprepared for a negative surprise. As a result, equity markets could be ripe for a near-term correction and some periodic episodes of volatility in 2018. However, any pullback would likely be short-lived and could result in some compelling trading opportunities within the cyclical bull market.

Mordy:
Perhaps the biggest consensus in markets is that world economic and inflation volatility will remain low. The Organisation for Economic Co-operation and Development (“OECD”) has even reported that variability in GDP growth across countries is the lowest in 50 years. What does this mean for investors? Tread cautiously. While equity volatility is very low, fixed income volatility is even lower (making it one of the most boring asset classes today). This also means it is vulnerable to a big surprise. If inflation steadily rises from here – as we believe it may – the bond market will be anything but boring.

Where do you see the best investment opportunities (equities or fixed income) outside of North America?

Mordy:
In 2017, we saw Canadians finally overcoming their home bias and new inflows skewed to international developed markets and emerging markets. While emerging market equities underperformed U.S. stocks for much of the 1990s, they outperformed the U.S. for 10 of the next 12 years. Could we see a similar path today? Absolutely! It is important to recognize that emerging markets already had a large slowdown between 2010 and 2016. Since then, currencies have weakened (boosting competitiveness), commodities have fallen (raising consumption) and policy has turned simulative (lowering the cost of capital). These benefits always show up with a lag.

Wilson:
European equities have been relatively cheap compared to the U.S. during the past few years. However, we weren’t seeing the earnings take hold in that region. Economic data has been quite strong lately and we are seeing earnings traction create many opportunities. The growth backdrop in both Eurozone and Japan has improved markedly and the economies are in relatively early stages of recovery when compared to the U.S. Earnings growth and momentum are favourable and equity markets in Europe and Japan provide better relative value from a valuation standpoint than can be found in the U.S.

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Bangsund:
Within equity, emerging market bourses remain best-positioned to benefit from the reflationary thrust in the marketplace and should ultimately prove resilient to a tighter Fed in the context of undemanding valuations versus their global peers. The broad improvement in global growth, firming commodity prices and robust earnings growth prospects also remain supportive. Similarly on the fixed income side, we also like emerging market debt due to the attractive yield enhancement opportunity and improving fundamentals (stronger emerging market finances/improved current account deficits). The environment of synchronized global growth, higher commodity prices and a weaker greenback should also lend support.
Oil prices have somewhat stabilized around $53 a barrel. Do you think prices will climb higher in 2018?

Mordy:
We remain steadfast that oil and commodities are in a “lower-for-longer” phase. Yes, stability may have arrived and a global cyclical upturn may help boost prices. However, a renewed bull market is unlikely any time soon. Prices went through a very typical secular phase – rising demand amidst constrained supply in the early 2000s was met with an enormous surge in capital spending. The resulting increase in supply will keep a ceiling on prices for years.

Looking ahead, global investors should learn to love low oil prices. Cheap oil is a very powerful stimulant for world growth. This will become more apparent as the positive impact on global consumption, investment and liquidity materializes over time. Falling oil prices have never correctly predicted an economic downturn. On all recent occasions when the oil price has at least halved, faster global growth followed. Conversely, every global recession in the past 50 years has been preceded by a sharp increase in oil prices.

Wilson:
Oil prices have room to move slightly higher with the extension of OPEC cuts and the synchronized/broad-based global growth demand.

We remain bullish on oil prices heading into 2018 and have a USD $65 target for WTI crude over the next 12 months. Notably, the synchronous global expansion should continue to bolster demand, while on the supply-side, inventory levels have stabilized and even receded towards more normal levels. OPEC’s decision to extend production curbs through 2018 has removed a key downside risk from the equation. All of these factors should help crude markets achieve a better balance and lend support to prices in the coming year.

The U.S. dollar fell in the latter half of 2017. What trends do you foresee for the Canadian dollar and the U.S. dollar throughout 2018?

Bangsund:
True portfolio management using artificial intelligence – being managed solely by A.I. with no human intervention – is in its infancy and will have no market impact for 2018. However, other forms of A.I. have been making inroads into the investment industry. A.I. has been helping to develop alternative factor-based benchmarks and quant strategies, which have seen increases in fund flows and will continue to do so. A.I. has also improved productivity, facilitating large outflows of active funds into passive funds. The risk is that this switch from active management, coupled with A.I. continuing to improve trading algorithms, may lead to an increase of momentum trades and mini-crashes.

Wilson:
The U.S. dollar has scope to firm against its currency pairings as the economy continues to perform and the Fed pushes on with tightening, while other regions maintain stimulus. With respect to the Canadian dollar, the U.S. dollar should remain firm into 2018. The market may be too aggressive when pricing in the Bank of Canada rate increases, which could see rate differentials widen which would put pressure on the Canadian dollar.

Artificial intelligence (“A.I.”) has been revolutionizing various sectors. How do you see it impacting markets and flows in 2018?

Bangsund:
While the Canadian dollar could indeed take a breather as the Fed prepares to raise interest rates several more times through 2018, we expect the Canadian dollar to remain well-supported over the coming year, particularly if our call for higher crude prices comes to fruition. Meanwhile, the convergence of global growth prospects and central bank normalization supports an allocation towards non-U.S. dollar currencies. Specifically, the synchronized global expansion should be bearish for the U.S. dollar as central banks tone down their ultra-dovish stances and begin to normalize in response to stronger global growth, compounded further by increased inflows into foreign markets.

Wilson:
There is an increased focus on the investment application of deep learning (multi-layered neural networks) that enable machines to think like humans.

In the investment industry, machine learning can be used to eliminate many mundane tasks. It is also used to analyze and evaluate alternative data sets to assist in the investment process. We expect this trend to continue and strengthen in 2018.
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