ETERNA FINANCIAL GROUP

MARKET REVIEW SEPTEMBER 2016

STATISTICS on 2016-09-30

CANADA

Unemployment rate	7.00%	↓
C.P.I. (August)	1.10%	↓
3 months treasury bills CDA	0.51%	↓
Bonds CDA 5 years	0.63%	↓
Bonds CDA 10 years	1.08%	↓
S&P/TSX	14 726	↑

UNITED STATES

Unemployment rate	5.00%	↑
C.P.I. (August)	1.10%	↑
3 mths treasury bills US	0.27%	↓
Bonds US 5 years	1.15%	↓
Bonds US 10 years	1.59%	↑
Dow Jones - Industrial	18 308	↓
S&P 500	2 168	↓

CURRENCY

$ USA / $ CAN	0.7618	↑
$ USA / € Euro	1.1235	↓
¥ Yen / $ USA	101.35	↑

The arrow indicates the trend since the publication of the last monthly data or end of the month..

ASSET SUMMARY AND ALLOCATION

Stock markets all generated positive returns over the past three months. The Canadian index (S&P/TSX) maintained its pace, producing a 5.45% yield over the last three months. During the same period, the U.S. S&P 500 and EAFE international offered yields of 4.96% and 7.57%, respectively. On the bond market, the FTSE-TMX index for Canadian bonds delivered a return of 1.19%, for a total yield of 5.28% since the beginning of the year. While the U.S. election has been the favoured topic in the mainstream media, current topics such as the FED's interest rate increase, the global economic situation and discussions between OPEC countries have been relegated to the background, despite their significant impact on global stock market trends.

- The world economy remains weak and interest rates continue to decline in many parts of the globe.
- Rate increases are once again postponed in Canada.
- Bond duration is neutral, but we will take advantage of any sudden and unjustified rise in interest rates to increase it.
- We slightly decreased equity investments in portfolios of our clients with high-risk profiles. Cash will temporarily be increased and we will take advantage of volatility to reinvest.
- North American stock markets are favoured in this uncertain climate.

Market Indices in Canadian Dollars as of September 30, 2016

	3 months	1 year	3 years *	5 years *
FTSE/TMX - 91 Day Tbill	0.11%	0.46%	0.72%	0.83%
Bonds				
FTSE/TMX - Universe	1.19%	6.31%	5.98%	4.38%
FTSE/TMX - Short term (1-5 years)	0.45%	2.03%	2.65%	2.29%
FTSE/TMX - Private wealth management [1]	0.64%	3.58%	4.16%	3.35%
FTSE/TMX - Mid term (5-10 years)	0.91%	5.91%	6.43%	4.94%
FTSE/TMX - Long term (10+ years)	2.38%	12.64%	10.47%	6.96%
North American Stock Indices				
Canada - S&P/TSX	5.45%	14.21%	8.00%	8.05%
USA - Standard & Poor's 500	4.96%	13.01%	20.51%	21.91%
USA - Dow Jones	3.87%	13.04%	18.41%	19.17%
International Stock Market Indices				
United Kingdom - FTSE-100	5.77%	-0.66%	6.78%	11.11%
France - CAC-40	7.58%	-1.85%	4.31%	9.45%
Germany - DAX	11.27%	6.96%	8.94%	15.00%
Japan - Nikkei-225	8.59%	9.28%	11.97%	12.65%
Hong Kong - Hang Seng	13.28%	9.34%	9.09%	10.89%
Australia - S&P/ASX 200	8.02%	15.79%	2.88%	6.15%
MSCI - EAFE [2]	7.57%	4.28%	8.92%	12.49%
Currencies				
$ CAN versus $ U.S.	-1.57%	1.40%	-8.39%	-4.56%

as of September 30, 2016

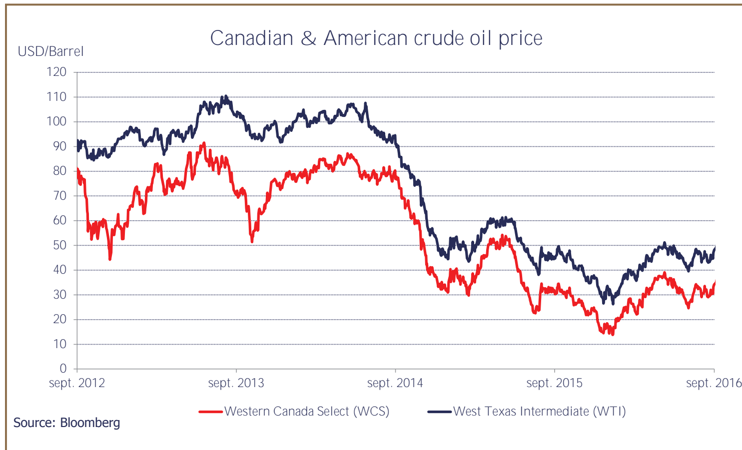
Source: Bloomberg
*Annualised return

1 FTSE/TMX Universe (60% short term & 40% mid term)

2 Morgan Stanley Capital Index - Europe, Australia & Far East

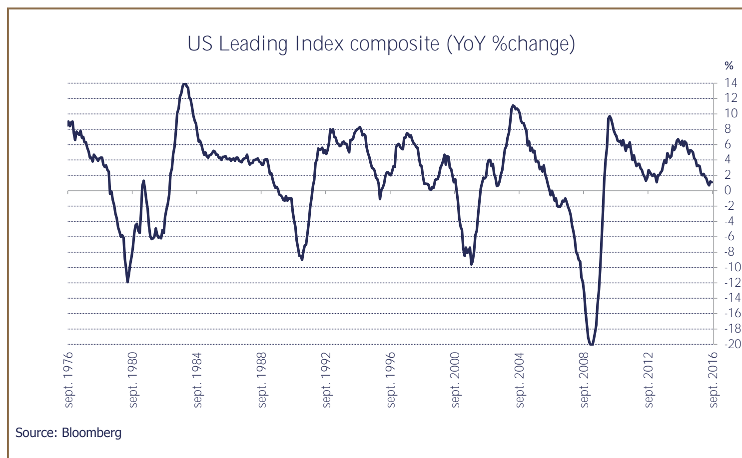
NORTH-AMERICAN ECONOMY AND FIXED-INCOME SECURITIES

The summer months proved to be eventful. However, a rebound could be expected in Canada, following a difficult start to the year, due to the fires in Alberta and their catastrophic consequences for the country's economic growth. There was a slight rebound in manufacturing shipments and exports, resulting in third-quarter GDP growth. However, growth distribution may be cause for concern, while business investments still show inferior overall profits. Oil prices (WTI) had climbed from their $26 low in February to $51 in June, but the constant reluctance of Saudi Arabia, prospects of oversupply and concerns about the global economy resulted in lower prices in July. A progressive increase may have since been settled. In September, oil prices closed at $48. OPEC countries reached an agreement in late September, suggesting a stabilization of prices.



Source: Bloomberg

Finally, there were momentary market expectations regarding rising interest rates in the U.S. The FOMC did not change its policy, although the committee recognizes, without much conviction, that conditions are favourable. The latest statistics published south of the border are not bad, but are not the best either. New manufacturing orders appear to be treading water, industrial production has stalled and job creation remains stable at 1.7% annual growth. In fact, the annual rate of the early composite index has decreased in recent months. In the context of relatively stable core inflation of approximately 2.3%, low-key interest rates are not impossible, but there are few factors that justify drastic changes in monetary policy.



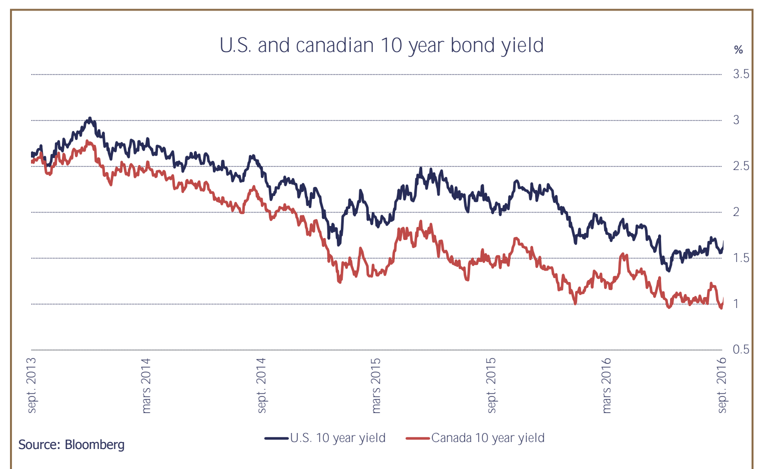
Source: Bloomberg

Elsewhere in the world, emerging markets are in the headlines. The central banks of these countries maintained their easing policy and there are early signs of improved economic conditions; their currencies depreciated, increasing competitiveness on world markets, while raw materials prices are higher than earlier in the year. There is concern regarding the European banking sector, especially in Italy, while the European Central Bank did not improve its easing measures, creating sudden market volatility. Bond rates increased, resulting in fewer bonds posting negative rates at the end of September. Meanwhile, Japanese authorities announced a new policy aimed at 10-year bond rates, hoping that a more positive yield curve will restore some normalcy to the bond market.

China published reassuring figures showing continued growth, but with larger domestic demand in terms of exports. The Chinese Central Bank is still accommodative in its desire to stimulate credit expansion. The fact remains that global trade is not growing. It is therefore difficult to predict stronger growth in the global economy in the coming months.

In this context, can we really consider that the U.S. FOMC will increase rates? While it is possible that an adjustment will follow the November election, another turn of the screw will have to wait until conditions improve, the overall environment is more favourable and corporate profits increase. Although polls and markets favour Senator Clinton in the presidential race, their reliability has been questionable on many occasions, which means that we may witness greater market volatility this fall.

In short, there has been little change in the situation. The most likely scenario remains that of low growth and, consequently, of low bond interest rates. We still watch for changes in labour costs, which have recently increased. This increase has generally resulted in lower profit margins for companies, since they have so far been unable to raise prices.



Source: Bloomberg

During the last quarter, 10-year bond rates fluctuated between 0.95% and 1.25%, while credit spreads on corporate bonds continued their decline. Provincial and municipal issuers also saw a decline in their risk premiums, but generally to a lesser extent than corporations. The FTSE-TMX index for Canadian bonds generated a 1.19% return, with the long-term component (10 years +) gaining 2.38%, while the short- and medium-term components advanced 0.45% and 0.91%, respectively. Corporate bonds recorded gains of 1.59%, followed by provincial (1.53%), municipal (1.36%) and federal (0.55%) securities.

As of September 30th, our active bond fund was yielding 1.09% over 3 months and 6.79% over 1 year, while our short- and medium-term bond fund was yielding 0.57% over 3 months and 3.88% over 1 year. In September, we reduced the duration of our active bond strategies from short to neutral. We intend to increase it slightly, should there be any sudden and unjustified rise in interest rates over the coming weeks. This upward movement could occur in the context of the November 8 U.S. election, which we believe will be preceded by temporary increased volatility. We also maintain sectoral positioning favouring Quebec municipal bonds that offer an attractive risk/yield profile. We remain underweight in the federal sector, neutral to slightly underweight in provincial and corporate sectors and continue to focus on issues with highest quality credits.

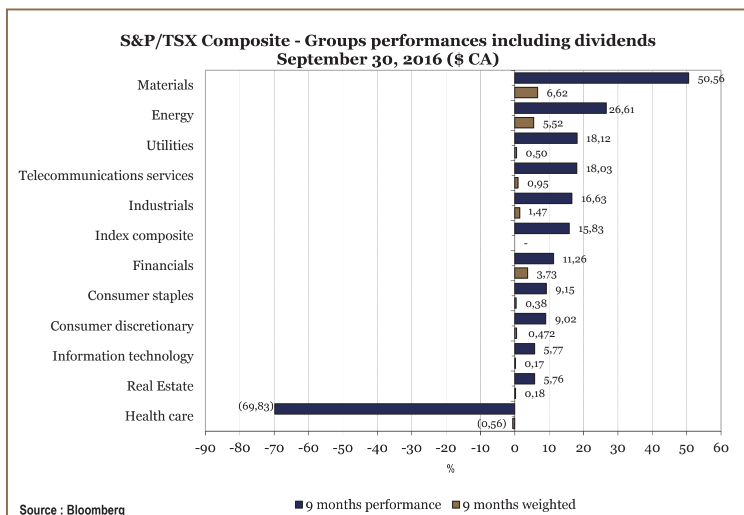
NORTH-AMERICAN EQUITIES

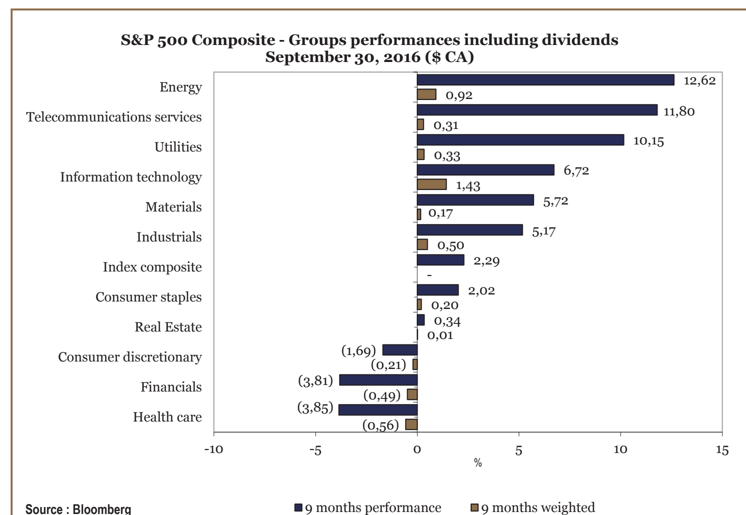
North American stock markets all delivered positive returns over the past three months. The S&P 500 and Dow Jones Industrials generated yields of 4.96% and 3.87%, respectively, in Canadian dollars. Meanwhile, the Canadian S&P/TSX generated a return of 5.45% over three months, for a total yield of 15.83% since the beginning of 2016. While all activity sectors, with the exception of basic materials and the new real estate sector ended the quarter with positive returns, the information technology and industrial sectors did the best, with respective yields of 12.14% and 10.75%. That said, the materials and energy sectors still have the most significant impact on the index performance in 2016, delivering returns of 50.56% and 26.61%, respectively. The health sector remains the only loser, with a 69.83% decrease over the same period. This sharp decline is still due to Valeant.

The financial sector, the most important of our Canadian index, gained 11.26% since the beginning of the year. This is a significant turnaround from last year's poor performance. The current interest rate level could put pressure on our banking institutions' profit margins. While consumer debt is excessively high, it is increasingly difficult to generate sustained growth in loan applications, even with very low rates. Profitability is likely to be weak in the coming quarters. This sector still presents interesting benefits, both in terms of dividends and relative valuation, which prompts us to maintain a slight overweight relative to the index.

As for raw materials sectors, we maintained our respective overweight and underweight in the energy and basic materials sectors throughout the summer. The September 28 agreement of a production freeze declared by OPEC countries resulted in a 5% same-day increase in oil prices. However, the immediate results arising from such news are often ephemeral and create short-term volatility, while core indicators are prioritized in order to justify longer-term trends. Oil prices seem to be heading towards an equilibrium level which will favour profitability growth for the domestic equities we hold. Conversely, the current global economic context leads us to doubt that there will be a sustained recovery in prices of basic materials, thus explaining our underweight in this sector, dominated by precious metals companies that we have always avoided.

Our valuation measures demonstrate high valuation in the U.S. market. Next month's elections, combined with a FED statement indicating openness to higher interest rates by year's end, may create increased volatility on short-term markets. However, investors throughout the world still favour the U.S. stock market's attractive risk/return profile. Short-term events should therefore serve as an investment opportunity. In the last quarter, we reduced our positions in the U.S. financial sector due to weak growth in the banking business and current interest rate levels.





INTERNATIONAL MARKET

It is now three years that your portfolio manager took full responsibility for both the global focused fund and the EAFE fund. This is a reasonable time span to look at the results so far (although we admit that a more adequate period would be five or even more years) and further explain our investment approach.

Over the last three years investors in the global focused fund realized an annualized gain of 18.7% versus a 14.7% return of the reference index. EAFE fund investors achieved an annual gain of 13.1% versus a 8.9% return of the reference index. We are pleased with these results, both on an absolute and on a relative basis but want to caution our clients that stock market investing is by definition subject to market volatility and there will be lapses of time (probably even extended periods of time) were returns will be inferior. We urge our clients to keep in mind that it is in these periods of high uncertainty that we more easily find attractive investment opportunities.

We take this opportunity to further explain the way we manage our portfolios. Here are some astonishing facts: Smucker makes jelly and instant coffee, its stock is up more than 1200% since 1995. McCormick makes spices, its stock is up more than 1400% since the same year. The stock price of IBM, the world's biggest information technology company in 1995 has barely changed since then. The lesson is that there is a lot of "excitement" in simple and boring businesses. While the newspapers and market pundits rave about the latest technological achievement, just think about self-driving cars, artificial intelligence etc. we focus our attention on companies that we understand and whose development we can predict with a high degree of confidence for the next five to ten years. In other words, we do not venture outside our circle of confidence. It is better to remember the obvious than to grasp the esoteric. As an example, although we have a background in computer science, we do not have the faintest idea which company (if any) will benefit the most from the emergence of artificial intelligence.

Conventional wisdom suggests that the more sophisticated and technically refined the products of a company are, the better its margins and profits should be. Nothing could be further from the truth. Just think of the eternal "arms races" between the various chip manufacturers resulting in companies that oftentimes do not even earn their cost of capital. We often notice that people who ask us for "good investment" advice really hope for "good sounding" advice. Your portfolio is not the place where life's excitement should come from, we stick with boring companies.

Another core principle is that we see ourselves as owners of a portfolio of businesses (as opposed to owners of stocks). While the value of a quality business follows a slow but constant progression the price of the stock can fluctuate widely as a function of investors' emotions.

While we cannot guarantee investment results, we can assure you that our investments will be chosen on the basis of value, not popularity. Successful investing is the marriage of a calculator with a contrarian streak (Seth Klarman). While our portfolio might look boring we are confident that the results will be better than that.

QUEBEC EQUITIES

The Eterna Quebec Equity Fund registered a net yield of 3.2% for the quarter, or 13.3% since the beginning of the year. The main positive contributor for the quarter was Alimentation Couche-Tard, which significantly increased following an announcement of the acquisition of CST Brands. The latter will add more than 2,000 locations to the Couche-Tard network in the U.S. and Canada, and now has the largest market share in the United States. With the successful integration of Couche-Tard's past acquisitions, investors are confident that the level of synergy expected for this acquisition will be attained. The second main contributor during the quarter was GDI Services aux immeubles, a position we initiated in the second quarter. The company announced more encouraging results in Canada, with an increased profit margin. Air Canada also contributed positively and continued its strong performance, despite economic difficulties in Alberta and an increased number of seats available in the industry. Negative contributions came from Héroux-Devtek, which fell back after a strong rise in previous months. Investors are concerned about a decline in Boeing 777 production, for which Héroux will soon begin producing landing gear. Canam also contributed negatively, with disappointing results in its large-project division. The company announced that it had concluded arrangements as part of construction of the new Atlanta Falcons stadium.

With increased valuation measures and unbridled optimism from investors, we maintained the fund's cash at about 8% at the end of September. In terms of portfolio transactions, we proportionately reinvested the sum collected from Ovivo's privatization (which boosted the equity) in different equities already held in the portfolio. We also decreased our positions in Richelieu, CN and Couche-Tard for increases in WSP, BRP and Lumenpulse, which were all trading at more attractive relative valuation measures.

NEWS RELEASE

Michel Pelletier joins Eterna Investment Management

Eterna Investment Management is pleased to welcome Mr. Michel Pelletier to its team, as Vice-President and Senior Manager, Fixed-Interest Securities. Based in our Montreal office, his duties will primarily consist of managing the fixed-interest security sector and participating in organizational development. Through this appointment, he also becomes a member of the company's investment committee.

An economist by training, Mr. Pelletier has had a successful career in the investment world. He has held executive positions with, among others, major investment management companies. His training, knowledge and experience will be assets to our company.