ETERNA FINANCIAL GROUP

MARKET REVIEW DECEMBER 2017

STATISTICS on 2017-12-31

CANADA

Unemployment rate (December)	5.70%	↓
C.P.I. (November)	2.10%	↑
3 months treasury bills CDA	1.05%	↑
Bonds CDA 5 years	1.87%	↑
Bonds CDA 10 years	2.05%	↑
S&P/TSX	16 209	↑

UNITED STATES

Unemployment rate (December)	4.10%	
C.P.I. (November)	2.20%	↑
3 mths treasury bills US	1.38%	↑
Bonds US 5 years	2.21%	↑
Bonds US 10 years	2.41%	↓
Dow Jones - Industrial	24 719	↑
S&P 500	2 674	↑

CURRENCY

$ USA / $ CAN	0.7955	↑
$ USA / € Euro	1.2005	↓
¥ Yen / $ USA	112.69	↑

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

ASSET SUMMARY AND ALLOCATION

The year 2017 provided positive returns. Virtually all markets are rising. The MSCI World Index rose by 16.3%, while the Emerging Markets Index gained 27.8%. Among major countries, the Japanese index advanced 19.1%, while Germany's increased by 12.5%. For Canadian investors, the good news was the Euro's rise of more than 6.4% against the Canadian dollar. North American markets also experienced a rise; S&P500, +21.8%, Nasdaq, +28.2%, Russell 2000, +13.1%, and the Dow Jones, +25.1%. The 6.8% increase in the Canadian dollar against the greenback resulted in a S&P500 total return of 13.5% for Canadian investors, compared to 9.1% for the Canadian S&P/TSX Composite Index. The Bond Universe Index also provided a positive total return of 2.5%, with the long-term component posting an unexpected 7.0% gain.

The passing of the Trump tax project stimulated the stock market last quarter, as U.S. corporate and household taxes will drop in January. In all markets, corporate profits are good and contribute to security valuation. The recent rise in rates administered by the Federal Reserve was not a surprise. As the year begins, we are confident that the bull cycle will continue despite its eight years of expansion. We see good prospects for quality stocks, while maintaining a certain margin of caution, given the prevailing optimism. Central banks are gradually adapting their policies to economic conditions and short-term rate increases are not complete. Maturity curves have already smoothed out. The year 2018 could be a transition year after which there could be a continuation of the cycle or a marked slowdown in 2019.

- Stock indices are reaching new heights, corporate profits are rising and taxes in the United States are decreasing.
- Global growth is accelerating, which should benefit stock markets.
- Although inflation is under control for the moment, it's becoming an underlying risk within this context.
- Central banks' policies are transitioning, as they seek to normalize interest rates.
- Market volatility is surprisingly low and the interest rate curve is flattening, as the year 2018 could be one of transition for the business cycle.

Market Indices in Canadian Dollars as of December 31, 2017

	3 months	1 year	3 years *	5 years *
FTSE/TMX - 91 Day Tbill	0.23%	0.56%	0.57%	0.72%
Bonds				
FTSE/TMX - Universe	2.02%	2.52%	2.56%	3.01%
FTSE/TMX - Short term (1-5 years)	0.28%	0.08%	1.23%	1.70%
FTSE/TMX - Private wealth management [1]	0.62%	0.43%	1.72%	2.27%
FTSE/TMX - Mid term (5-10 years)	1.12%	0.96%	2.46%	3.14%
FTSE/TMX - Long term (10+ years)	5.22%	7.03%	4.42%	4.65%
North American Stock Indices				
Canada - S&P/TSX	4.45%	9.10%	6.59%	8.63%
USA - Standard & Poor's 500	7.01%	13.47%	14.25%	21.25%
USA - Dow Jones	11.34%	19.32%	17.28%	21.86%
International Stock Market Indices				
United Kingdom - FTSE-100	6.40%	14.23%	7.19%	10.51%
France - CAC-40	1.88%	15.99%	10.04%	10.85%
Germany - DAX	2.91%	19.45%	12.04%	14.20%
Japan - Nikkei-225	12.26%	14.93%	14.33%	16.09%
Hong Kong - Hang Seng	8.95%	25.71%	10.71%	10.53%
Australia - S&P/ASX 200	6.72%	7.92%	4.97%	4.33%
MSCI - EAFE [2]	4.59%	16.45%	10.55%	12.99%
Currencies				
$ CAN versus $ U.S.	-0.79%	6.47%	-2.65%	-4.85%

as of December 31, 2017
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 two main events of the last quarter were the adoption of the tax reform law and increase in rates in the United States. The latter was no surprise, as it had been telegraphed for months and market stakeholders were more than prepared for one of the last measures implemented by Mrs. Yellen before leaving to her retirement. So, a new chair, along with new governors, should be appointed to the monetary policy decision board after February. Policy basis should, however, be no different. The U.S. Central Bank is seeking to "normalize" its key rates and economic conditions are favourable. The institution has already begun to reduce its bond purchases in the markets, an operation that will accelerate in the coming quarters and should last several years. Investors are braced for such measures.

Regarding the tax reform, markets oscillated between optimism and pessimism as negotiations continued in Congress; upon its adoption, some companies announced salary measures favourable to their employees, while others took the opportunity to confirm capital expenditure plans. In particular, the tax reform reduces corporate income tax from 35% to 21%, and also provides for companies to repatriate profits currently held by their foreign subsidiaries at 8% for illiquid assets and 15.5% for cash. Time will test the effectiveness of this measure. Most importantly, it will be interesting to see how U.S. corporations handle this liquidity and the new after-tax room for maneuver that the reform has just provided. Will we actually see new investment in capital and machinery to improve productivity and employment, or a new wave of mergers and acquisitions that will benefit market valuations? Repurchases of securities are also an option. One thing is certain, although this is temporary and will expire over time, lower personal income taxes will have its effect; consumption will be stimulated over the next few months. What has been surprising so far is the casual disregard of rising deficits and debt over the next ten years, representing a whopping $1.5 trillion dollars. Bond markets have traded without consideration of this element. We would have expected some tension on long-term interest rates under such circumstances, especially as the FED reduced its security purchases. As a result, there will soon be more outstanding bonds. Long-term rates, however, did not manage to rise and ended 2017 lower than the previous year. The 30-year U.S. Treasury bonds started the year at 3.07% and ended at 2.75%. What does this behaviour among long-term investors mean as rates have only gone up in the shortest maturities? The maturity curve experienced significant flattening in 2017, both in the United States and Canada. Canadian 2-year rates rose 87 basis points (bps), 5-year up 75 bps, but 30-year closed the year only 25 bps higher than twelve months ago.

Global growth is good, as precursor indices are rising almost everywhere. The unemployment rate is low both in the United States and Canada. Inflation should normally be rising under these conditions. We believe it will, but maybe not as much as some people think. There is still a surplus in global production capacity, both in terms of equipment and labour, and global trade is not dead, despite uncertainties in trade agreements since the arrival of the Trump administration. However, some jurisdictions announced significant increases in minimum wages, such as in Ontario. There should be wage pressures if good economic conditions continue. It remains to be seen whether this will translate into a capacity for companies to raise prices to consumers or into reduced profit margins.

All central banks are in transition mode or in the process of being transitioned. The Bank of Europe is aiming to implement its security purchase reduction plan, but significant tightening of its monetary policy could be premature, as inflation is low and the euro is appreciating. Moreover, it must consider political uncertainties related to Brexit and the Italian election, whose campaign has just started. The situation in Japan has not been this good for some time. China's growth, meanwhile, reached almost 7% according to official figures and exports have resumed despite the rising yuan. However, US-China trade relations could deteriorate and growth could moderate. The stability of the financial system remains a priority for Chinese authorities.

The Bank of Canada raised its discount rate twice in 2017, from 0.75% to 1.25%. After surprising growth in the first half of the year, the pace has slowed significantly since the summer and we have seen both upward and downward trends. Domestic demand is strong, but at the cost of a decline in the savings rate. Job creation is strong and wages seem to be rising faster on this side of the border. However, consumer indebtedness and strength of the real estate market should be monitored. Federal budget deficits and minimum wage increases in some provinces should support growth. The Bank is therefore on hold and U.S. economy will prove decisive. Growth acceleration will most likely mean an increase in short-term rates.

Economic conditions are still favourable to credit securities. In 2017, the corporate bond sector performed well in all maturities, with long maturities showing an 8.8% yield. There was a steady decline in the yield gaps in provincial and municipal sectors. Long-term provincials yielded a total return of 8.0%, while municipals returned 9.4%. Adequate provincial budgets and solid growth in the center of the country, particularly in Quebec, narrowed the gaps. We remain positive regarding provincial and municipal gaps, as they have not yet caught up to their pre-crisis levels, while lower-quality corporate credit spreads will reach theirs soon. We suggest focusing on higher quality securities in the corporate sector.

We maintained a cautious positioning in terms of durations during the last quarter, as well as an over-positioning in municipal short and medium terms. Given the economic conditions, we will maintain these positions in the next quarter. We continue to anticipate rate hikes in short-term securities. The trend towards a flattening maturity curve will remain in 2018, meaning that interest rates will rise faster in the short than in the long term. In our opinion, this reflects the fact that we have entered a cycle where restrictive actions of central banks reassure buyers of longer-term securities. The demand for long-term bonds is surprisingly strong at the institutional level and is boosted by higher rates. We would be extremely surprised if bond performance in 2018 was as good as in 2017. Therefore, there is no need for undue risks with this asset class. If 2018 were as good as 2017, it would reflect much weaker economic conditions than anticipated.

NORTH-AMERICAN EQUITIES

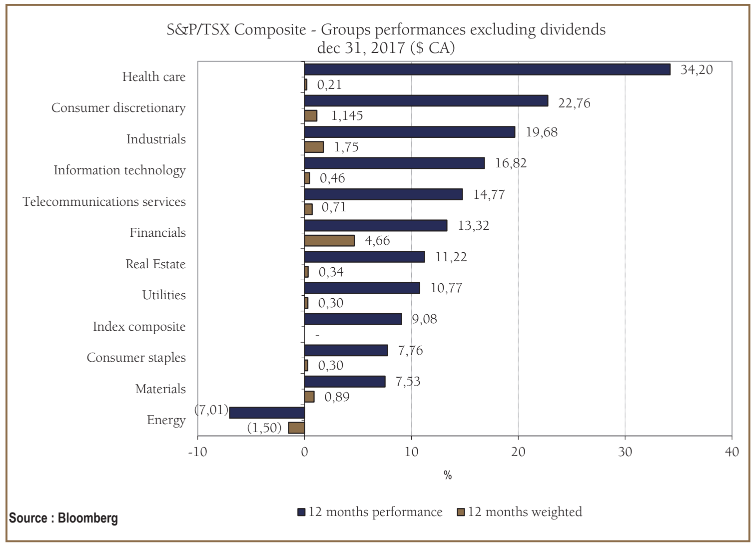
The significant increase of the last three weeks of September was not short-lived for the Canadian market. Indeed, it was the premise of an excellent quarter for the S&P/TSX, with a 4.45% return, almost half of the index's annual yield (9.10%). All sectors contributed to this positive performance. The health sector, representing less than 1% of the index, reversed its downtrend for the first nine months, delivering an impressive 46.67% yield in the last three months and generating a 34.2% annual return. The consumer staples (6.17%), real estate (6.02%) and financial services (5.74%) sectors all performed very well, while service companies (2.62%), and especially oil companies (0.66%), did not do as well. The scenario was similar on an annual basis—all other business segments provided positive returns, with the exception of the energy sector (-7.01%).

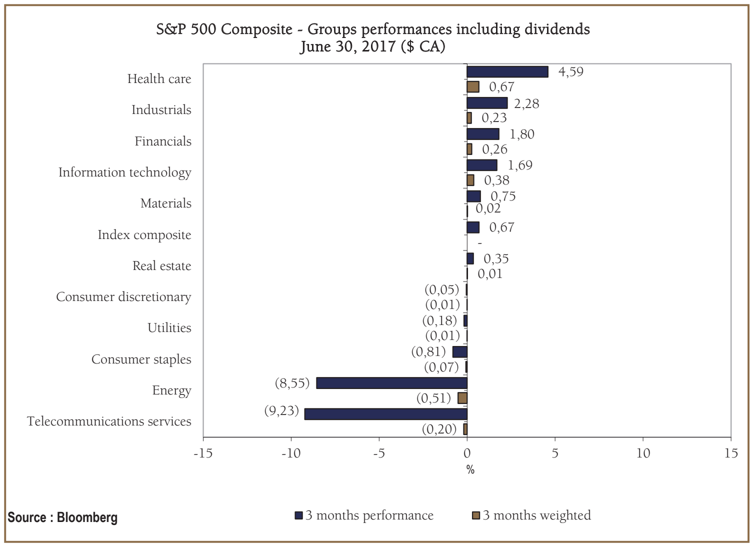
Our Canadian equity strategy generated returns close to 3% above the S&P/TSX benchmark. Once again, our stock selection delivered these results, while sector allocation produced virtually nothing. Since our sector weighting is very similar to that of the index, it goes without saying that the companies we target in each sector make the difference. In fact, nearly 75% of value added comes from our stock selection in energy and basic materials sectors. Our investments in companies such as First Quantum and Stella Jones in the basic materials sector, or Canadian Natural Resources and Parkland Fuel Corp. in the energy sector, are good examples of quality companies that have allowed us to deliver a better return than the market once again this year. The Canadian market performance in 2018 will strongly depend on the global economy and commodity prices. In a context of sustained global growth, the Canadian stock market could provide a very respectable performance, driven mainly by cyclical sectors. While we remain optimistic about the Canadian outlook for 2018, the NAFTA negotiations and high debt levels of Canadian consumers could affect future results.

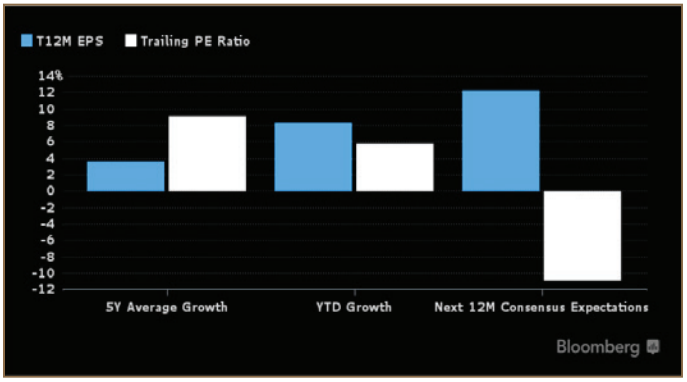
The U.S. market (S&P 500) continued to excel in 2017, with a quarterly performance of 7.00%, for annual total of 13.47% for Canadian investors. Note that without the currency effect, this return would have reached 21.83%. Unsurprisingly, technology stocks (9.38% over three months) played a leading role throughout the year, finishing with a 29.31% increase. Oil stocks, like their Canadian counterparts, posted a negative annual performance of 7.80%, while Telecommunications (-8.03%) was the only other sector to lose value.

Equity growth remains strong and is supported by better than expected earnings, which is critical, given the almost constant S&P 500 increase since 2009. In addition, the profit increase seems to be generalized to all stock markets. The year 2017 was very different from other years, since the rise in the U.S. index comes largely from profit growth, unlike in previous years when the increases in values came from the rise in the price-to-earnings multiple granted by investors in the stock market.

We believe that good corporate earnings performance will continue into 2018, as long as economic indicators continue to exceed expectations. Globally, the economic surprise index is at its highest for over a year, which offers the best prospects for several years. Analysts forecast U.S. earnings growth of more than 14%. This usual optimism on their part is partly based on significant tax cuts granted to our southern neighbours; the real impact remains to be seen. However, there could be disappointments during 2018 and slightly higher volatility than at the end of 2017. We remain cautious with our North American equities strategy, as we favour companies with lower volatility producing high dividend yields.







OUR INTERNATIONAL EQUITIES MANAGER COMMENTS

The gross return for 2017 of the global focused fund and EAFE fund respectively was 8.7% and 27.7% versus a return of 14.0% and 16.5% for their respective reference indices. Over the last for years investors in the global focused fund realized an annualized gross return of 14.3% versus a 12.7% return of the reference index. EAFE fund investors achieved an annual gross return of 12.8% versus 8.9% return of the reference index.

Although your portfolio manager knows more about Greek restaurants than Greek mythology, he remembers the essence of the famous Odysseus saga. Odysseus was warned by the Goddess Circe that he needed to pass an Island with Sirens on it. However, the song of the sirens was so seducing that the only way to avoid falling prey of it was to plug one's ears with wax or to bind oneself to a mast of the ship in order to be immobilized. Odysseus and his men followed the advice and stayed out of harms' way.

Our worst error of commission was to follow the advice of an industry analyst who thought he had identified an investment opportunity with lots of upside potential and virtually no downside. Reality turned out to be the polar opposite of that proposition. Luckily the position we took was too small to create noticeable damage. Subsequently we decided to renounce from all "outside help" and solely rely on our own research. There are things in life that cannot be reliably be outsourced, folding ones parachute and analyzing companies are part of them.

While it is very likely that these errors will be followed by many others, it is our duty toward our clients to make sure that we do not commit the same error twice. After all, insanity is sometimes defined as doing the same thing over and over again and expecting different results. Over many years in financial markets, we learned this lesson the hard way.

What does that have to do with investing?

Today's investment world is full of siren songs such as:

- The seemingly unstoppable FAANG (Facebook, Apple, Amazon, Google) stocks;
- The hype surrounding Bitcoin and Blockchain technology;
- So called financial gurus forecasting a melt-up (or melt-down) of the market;
- A "sure" stock tip form a self-proclaimed insider;
- Any attention grabbing headline appearing in financial media;
- Stock price movements following on a minute per minute basis.

As disciples of Odysseus we follow his example by plugging our ears with wax. When it comes to our financial media intake, we follow a very slender diet and restrict ourselves to annual reports, conference call transcripts and well researched books. Over the years we have learned that financial markets are highly complex systems and any prophecy reveals far more of the frailties of the prophet than it reveals of the future. This is why we avoid so called investment gurus, macro forecasters and sell analysts like the plague. It has the additional advantage that our clients do not have to pay for the services of these "helpers".

The Odysseus parallel does not stop here. We agree with Blaise Pascal who observed more than 300 years ago that "All of humanity's problems stem from man's inability to sit quietly in a room alone." There is no better characterization for the most challenging aspect of portfolio managing, i.e. the need to control the natural urge for action, especially when markets temporarily do not agree with his/her positioning. We "bind ourselves" symbolically to the mast by limiting our turnover to a maximum of 20% per annum (we add, with a sense of pride, that so far it has been significantly less than that). This self-imposed discipline prevents us from "flavor du jour" investing and significantly reduces transaction fees for our clients. While instinct is a very desirable attribute for artists, augurs and athletes we abhor "fast thinking" (Kahneman's System 1) when it comes to investing and prefer deliberate decision making (System 2).

We hope that our clients follow a similar approach, i.e. block out as much noise as possible and have a healthy and prosperous New Year.

QUEBEC EQUITIES

The Eterna Quebec Equity Fund registered a net yield of 3.1% for the fourth quarter, or 13.7% for the year 2017. For the eighth consecutive year, our Québec Portfolios outperformed the TSX Index, which ended 2017 with a 9.1% return. Alimentation Couche-Tard was a positive contributor this quarter, up 15% since the end of September. Following the company's result publication, the equity has seen an interesting progression. The latter bought back 4.4 million shares, with the sale of a block of shares held by Metro. The company is already reporting synergies from its acquisition of CST, which participated in the results for the first time. Other positive contributors were Bombardier, which announced new orders for the CSeries aircraft under the Airbus agreement, as well as Intertape Polymer, which rebounded following the release of better-than-expected results. Negative contributions came from Mediagrif Technology, which saw its results suffer following a recent acquisition that weighed on its profitability, and Air Canada, which is experiencing a decline after sharp increases in previous quarters. For the year 2017, the main positive contributors were Air Canada, Cogeco, 5N Plus and BRP.

Regarding portfolio movement, we decreased our position in Cogeco after a good stock performance and increased valuation measures. In return, we increased our position in BCE, which was trading to more attractive relative valuation measures. We also decreased our position in BRP, for reasons similar to those of Cogeco, and increased our position in Uni-Select and SNC Lavalin. We also participated in the financing of Mason Graphite. The funding will allow the company to proceed with development of the Lac Guérêt graphite mine and its mill project in Baie Comeau. As we remain optimistic towards the stock market, our strategy remains the same and we maintain a higher than normal level of cash on hand. Our medium- and long-term economic outlook remains positive, but we will expect a market correction before reinvesting cash.

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