ETERNA FINANCIAL GROUP

MARKET REVIEW SEPTEMBER 2017

STATISTICS on 2017-09-30

CANADA		
Unemployment rate (August)	6.20%	↓
C.P.I. (August)	1.40%	↑
3 months treasury bills CDA	0.99%	↑
Bonds CDA 5 years	1.75%	↑
Bonds CDA 10 years	2.10%	↑
S&P/TSX	15 635	↑

UNITED STATES		
Unemployment rate (August)	4.40%	↑
C.P.I. (August)	1.90%	↑
3 mths treasury bills US	1.04%	↑
Bonds US 5 years	1.94%	↑
Bonds US 10 years	2.33%	↑
Dow Jones - Industrial	22 405	↑
S&P 500	2 519	↑

CURRENCY		
$ USA / $ CAN	0.8019	↓
$ USA / € Euro	1.1814	↑
¥ Yen / $ USA	112.51	↓

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

ASSET SUMMARY AND ALLOCATION

Stock markets showed a strong finish for the third quarter 2017. The S&P TSX closed September at less than 300 points from its February peak and delivered a total return of 3.7% for the quarter, or 4.4% for the year, with energy as the best-performing sector. The U.S. S&P 500 reached record highs and yielded a year-to-date return of 14.2%, which translated into a 6.0% return for Canadian investors, taking into account the appreciation of the Canadian dollar. Emerging markets provided the best returns. Bonds performed poorly, with the TMX Canadian Universe gaining only 0.48% since the beginning of the year, losing 1.84% in the last three months. The Canadian bond market surprised many, while Canadian short-term rate increases flattened the yield curve. Only long-term maturities generated positive returns.

Current issues include greater synchronization of the global business cycle, overperformance of cyclical sectors, and a more evident change in monetary policies. There is a sectoral rotation taking place. While inflation's weakness continues to surprise, many investors are now expecting a rise in prices. We believe the economy will remain good, but the bull cycle is growing old and a cautious approach to economic policies is appropriate.

- Global expansion continues and the cycle seems to be synchronizing;
- Central banks are becoming less accommodating and a change of tone is taking place;
- Although inflation is lagging behind, investors expect higher prices;
- We still prefer equities in this context;
- There has been little volatility in recent weeks, prompting some caution in the short term.

Market Indices in Canadian Dollars as of September 30, 2017

	3 months	1 year	3 years *	5 years *
FTSE/TMX - 91 Day Tbill	0.13%	0.47%	0.57%	0.74%
Bonds				
FTSE/TMX - Universe	-1.84%	-2.97%	2.79%	2.66%
FTSE/TMX - Short term (1-5 years)	-0.45%	-0.70%	1.44%	1.71%
FTSE/TMX - Private wealth management [1]	-0.86%	-1.73%	2.06%	2.22%
FTSE/TMX - Mid term (5-10 years)	-1.48%	-3.27%	2.99%	2.99%
FTSE/TMX - Long term (10+ years)	-4.09%	-5.95%	4.43%	3.62%
North American Stock Indices				
Canada - S&P/TSX	3.68%	9.18%	4.54%	8.06%
USA - Standard & Poor's 500	0.40%	12.89%	14.87%	19.80%
USA - Dow Jones	1.46%	19.40%	16.46%	19.12%
International Stock Market Indices				
United Kingdom - FTSE-100	0.76%	9.30%	4.75%	10.25%
France - CAC-40	3.44%	19.88%	7.90%	13.07%
Germany - DAX	3.44%	22.11%	12.12%	15.64%
Japan - Nikkei-225	-2.59%	6.07%	10.93%	15.04%
Hong Kong - Hang Seng	2.70%	11.76%	9.98%	10.74%
Australia - S&P/ASX 200	-2.55%	1.79%	2.37%	4.41%
MSCI - EAFE [2]	1.29%	13.36%	8.88%	13.67%
Currencies				
$ CAN versus $ U.S.	3.80%	4.99%	-3.66%	-4.86%

as of September 30, 2017
Source: Bloomberg
*Annualised return

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

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

The global economy continues to expand. The last recession, the so-called "Great Recession", is already over eight years old. The current cycle is therefore aging, but there is no sign of a marked deterioration in conditions. Of course, expansion has been uneven, both geographically and sectorally. Europe has had its "Greek crisis", Canada its "oil crisis", and China has seen an almost constant decrease in its growth rate in recent years. However, growth never seemed to be as synchronized as in this autumn of 2017.

The situation only improved in Europe over the last year. Uncertainties over the political situation at the beginning of the year have faded. The Brexit remains an issue and will remain so for a long time, but the risks related to the French and German elections have passed. We will discuss Italy next year. Trust, as measured by the IFO index, is at its highest and growth in loans to households and businesses has picked up. Even though the euro has rebounded, inflation remains low and rates administered by the central bank are still negative. In fact, the European Central Bank (ECB) is still trying to determine when and how it can begin to reduce its financial position. It is certainly not ready to raise its rates. The ECB cannot proceed too rapidly with the withdrawal of the monetary stimulus, because it must ensure that expansion does not derail because no fiscal stimulus can take over. The end of austerity programs is not synonymous with expansionary fiscal policy.

Japan's growth has impressed recently. The labour market is strong and the unemployment rate has returned to the 1995 level of 2.8%. Prime Minister Abe took advantage of this upturn to launch premature elections.

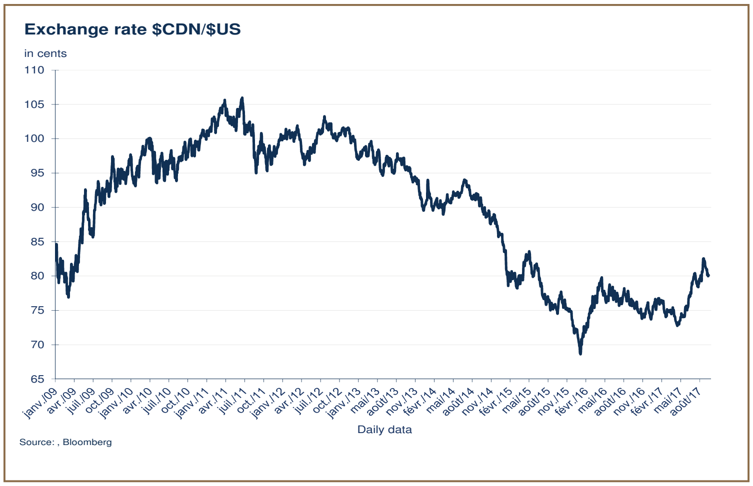
In China, the pace is good, but seems to be slowing down. Monetary indicators point to a more marked slowdown in the coming quarters. The Chinese economy is controlled and making any forecast is a fool's game. However, we know the Chinese conundrum: debt keeps growing and has now reached over 250% of GDP, whereas it was lower than 150% in 2008. The issue remains an orderly reduction in financial leverage.

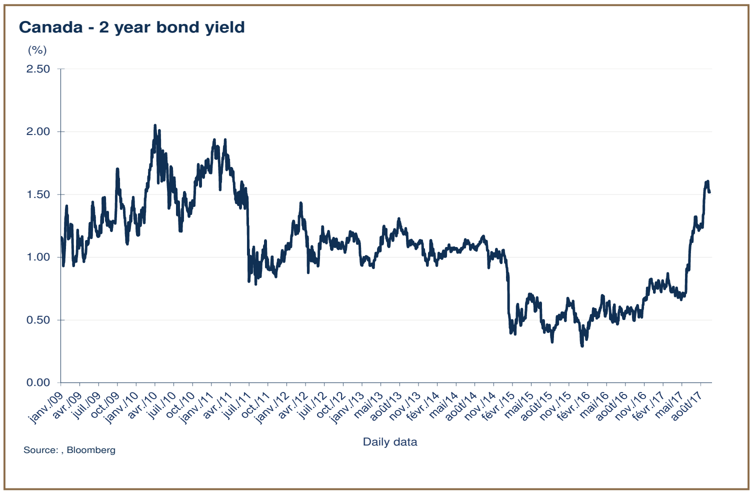
In the United States, the tax reform announced by the new administration was finally proposed at the end of September. Just as with the Obama-care reform, there is no certainty as to its realization, as the American political context remains volatile and the Trump administration's ability to vote on its bills remains unclear. Several market stakeholders are beginning to detach political issues from their investment decisions—the fundamentals are taking over. Things have not really changed at this level, as overall growth remains good, but statistics are somewhat volatile from month to month. As a result, during the summer months, job creation slowed, new manufacturing orders shrank, and housing starts dropped. Hurricanes that hit Texas and Florida will certainly have short-term effects. However, history tells us that activity usually rebounds as quickly, and that on average, effects on growth are marginal after a few months. The conditions in the United States are sufficient for the Federal Reserve to implement its program of gradual reduction of its financial position. Moreover, the FED announced that, in October, it will begin to reduce the amount of income reinvestment and maturities of bonds it holds. Many investors are concerned about the effects on the economic conditions of the end of monetary accommodation, especially as there are expected increases in administered rates. At the moment, changes are minimal and the FED still seems very cautious. Nevertheless, it is clear that the major period of monetary easing has ended and that markets will now have to focus on fundamentals such as inflation, profit margins and household income growth. Without additional stimulus, perhaps through tax cuts, the pace of growth is likely to remain similar.

In Canada, consumers are very active and housing starts are increasing. Industrial production was boosted by the resumption of operations in Western Canada, particularly in the oil sector. Real estate prices continue to rise. The second quarter showed strong and surprising growth. Faced with this remarkable dynamism, the Bank of Canada raised its key policy rate in response. The Canadian dollar, up as the euro and the yen against the U.S. dollar since the beginning of the year, enjoyed a bounce. The combination of a strong loonie and higher short-term interest rates will certainly have repercussions over the coming months. Thus, the summer period seems to show a slowdown: the July GDP was nil with marked declines in several sectors and new manufacturing orders recorded three months of decline in late July. Not surprisingly, at the end of September, Governor Poloz stated that the Bank is closely monitoring developments in the Canadian economy. The Bank of Canada cannot "go it alone" in a good global economy, which could weaken if central banks around the world tighten monetary policy.

The rise in Canadian rates has attracted attention. The movement of Canada-U.S. spreads has been such that Canadian 2-year rates are now higher than their U.S. counterparts. Earlier this year, they were lower by 60 basis points. As a result, short- and medium-term bond indices have had negative returns so far in 2017. While the FTSE-TMX index for Canadian bonds is up 0.48%, only long maturities rewarded investors with a performance of 1.73%; the short-term index was -0.2% and the medium-term -0.16%. These performances reflect the major flattening of the Canadian yield curve since January. Long-term corporate bonds delivered the best return with 3.67%. All maturities and sectors were negative during the third quarter. Corporate, provincial and municipal credit spreads were somewhat more volatile in August, but ended the quarter, as a whole, where they were in June. They are low compared to their development during this cycle but, given the economic situation, are not under pressure. In addition, provincial budgets are improving more quickly than anticipated. As for corporations, growth "without too much inflation" continues, but a certain caution is necessary given the aging of the cycle.

In short, we favour provincial and municipal sectors in our portfolios, and neutral risks of duration at the beginning of autumn. We made little change in our strategy during the quarter. Bond yields are likely to be disappointing within the current environment.

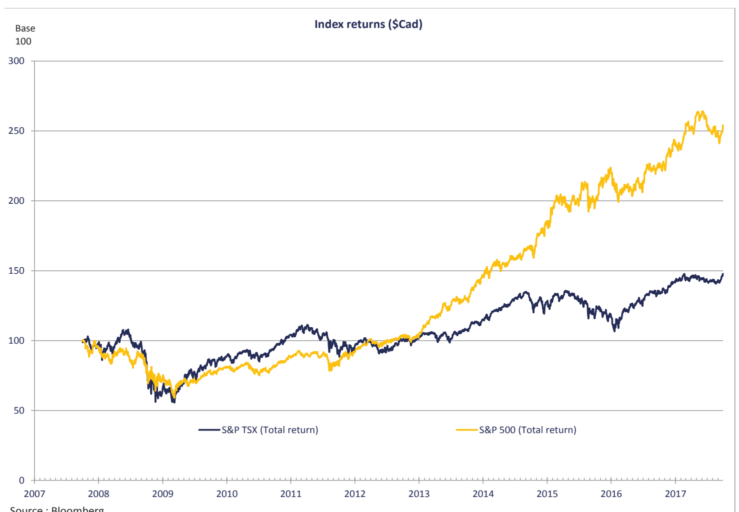




NORTH-AMERICAN EQUITIES

Throughout the quarter, the Canadian stock market continued its downward trend from the previous quarter, but the last three weeks of September saw a sharp increase in the S&P/TSX index, ultimately generating a 3.7% quarterly growth. However, Canadian markets have remained well below global markets since the beginning of the year, generating a low return of 2.3%. While the health sector, which represented a slight weighting of the overall index, lost 10.3%, the sectors that performed well were those that had suffered the most in the first six months. The energy (6.6%), financial (4.5%) and materials (3.2%) sectors had the biggest impact on the overall performance of our stock market. Higher oil prices (+12.3%), over $50 a barrel, and industrial metals, as well as the decline of the Canadian dollar, are certainly not unrelated to the rebound of the last few weeks. In addition to a slight increase in our investments in oil companies, our sector positioning has changed very little over the last few months, favouring a cautious approach given the current duration of the bull cycle and the tightening of North American economic policies.

South of the border, the S&P 500 delivered an excellent 4.5% return, bringing its total to 14.2% in 2017. Unfortunately, the greenback's weakness against our currency amputated the vast majority of it for Canadian investors. All sectors, with the exception of consumer staples (-1.4%), delivered positive returns. Like their Canadian counterparts, oil companies performed well, but technology companies continued to steal the spotlight during the summer with a performance of 8.7%, or more than 27% since the beginning of the year. The group of companies called "FAANG" (Facebook, Amazon, Apple, Netflix and Google) alone contributed more than 20% of the S&P 500's return in 2017, despite a significant decline of these securities at the end of September. Although there are significant expectations for future growth, these securities, apart from Apple, trade at excessively high price/earnings multiples and do not fit into our investment criteria, which focus on "value-type" companies. Regarding our strategy, slight weighting reductions in the consumer staples, energy and information technology sectors allowed us to increase our investment in industrial companies and add Clorox, a company specializing in the sale of household products, to our basic consumer securities.



Source : Bloomberg

.OUR INTERNATIONAL EQUITIES MANAGER COMMENTS

It is now four 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 explain some of the lessons learned.

Over the last four years investors in the global focused fund realized an annualized gain of 15.4% versus a 14.2% return of the reference index. EAFE fund investors achieved an annual gain of 11.8% versus a 10.0% return of the reference index. It is important to understand that the reference index is not an easy push-over. According to a recent study from S&P Dow Jones, less than 15% of US stock fund managers succeeded in beating their benchmarks in the last 15 years. 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 (Bernard Madoff is the only investor we know with consistent results and he is in jail).

Although we left school almost 35 years ago, we still have the ambition to be the equivalent of a constant learning machine. To that end we found it more useful to rub our nose in past errors than to celebrate successful moves (especially if they happened by chance). It is important to distinguish between errors of commission (the ones actively committed by us) and errors of omission (opportunities we failed to seize). The latter is more devious because it usually goes unnoticed by the public and thus gets easily swept under the rug.

Our worst error of omission is Amazon. As students of the ".com-bubble" in the early parts of this century, we are very skeptical whenever we hear of a company that pretends to fundamentally disrupt the existing structure of its industry. While this is generally a healthy approach, it prevented us from seeing that Amazon is a true revolutionary as illustrated by 24 bankruptcies in the US retail space so far this year alone. Consequently, we missed the opportunity. To add insult to injury, we should mention that we are a regular client of this company and fully appreciate the convenience and customer service that comes with it. We are guilty as accused.

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.

QUEBEC EQUITIES

The Eterna Quebec Equity Fund registered a net yield of 2.8% for the quarter, or 10.3% since the beginning of the year. Year-to-date returns are higher than those of the TSX (4.4%) and in line with the Morningstar National Bank Quebec Index (9.4%). Air Canada was one of the main positive contributors during the quarter, remaining one of the largest positions in the portfolio. The stock has grown by 51% since the end of June, following the announcement of results above expectations for its second quarter. The company also met with investors, with executives sharing the company's new long-term goals. With its free cash flow expected to increase, Air Canada anticipates a significant reduction in its indebtedness over the next three years. The valuation measures, which remain low, have increased in light of these new objectives. Another contributor was Cogeco, which announced its acquisition of Metrocast, a cable operator with 236,000 subscribers on the U.S. East Coast. In conjunction with the acquisition, Cogeco announced that the CDPQ is investing $315 million for a 21% interest in its U.S. subsidiary, highlighting the value of this business segment of Cogeco.

In terms of portfolio movements, we took advantage of the weakness of Intertape Polymer's equity to add to the position. Although medium-term results were below expectations and coupled with increased competition in Europe and higher raw material costs, the company's long-term outlook remains positive, with expected production growth and several opportunities for consolidation in the industry. We also increased our position in Innergex, a renewable energy producer, with a relatively attractive return on free cash flow.

As we remain optimistic towards the stock market, 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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