Q3 2016 MARKET OUTLOOK QUARTERLY

Changing tides

2016 has been a year of surprises. Oil traded at $26 a barrel, the Canadian dollar touched 68 cents. China weakness sidelined the Fed, the UK voted to leave the EU. Oh, and Trump is actually running for President. Sure, lots of bumps along the way but as we transition through the summer doldrums, markets have actually been rather kind. It has been nearly impossible to lose money in bonds, equities are a bit mixed but have been rather pleasant in North America. With a little less than half a year to go in 2016, let's share our thoughts on what might surprise us in the coming quarters.

Highlights

2016 - The year of surprises – a closer look at the first half of 2016 and what transpired.

Monetary Policy, I would like to introduce you to Fiscal Policy – after years of just monetary efforts to foster growth, we are now seeing fiscal stimulus. This has implications.

Risk of a taper tantrum – low yields have increased interest rate risk to unprecedented levels in some pockets of the bond and equity markets.

Return of earnings growth – after almost two years, earnings growth has returned.

How low can you go? A look at negative yields around the world and policy implications.

Currency implications – big headwinds for the Canadian Dollar.

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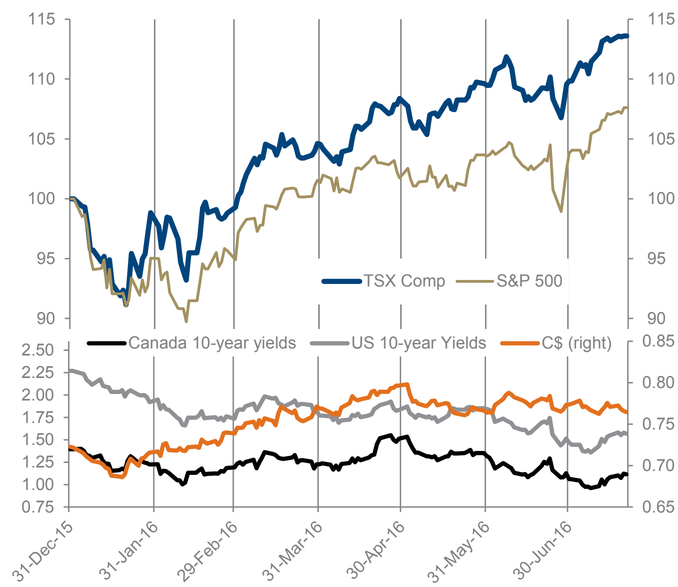
2016 – The year of surprises

As we start the 2nd half of the year, 2016 has so far been full of surprises. The year started with the U.S. 10-year Treasury yielding 2.25%, a level viewed as already low by most, including us. Recently this bond benchmark traded at a historical low of 1.37% (higher now though). The Fed raised rates last December for the first time since 2006, and market participants waited with baited breath to see the impact of this change in monetary policy direction. The Canadian dollar was 72 cents and about to embark on a six-month roller coaster ride that would see a low of 68 cents and a high of 80 cents. Oil traded down to $26/barrel and also traded as high as $52. China stumbled and then unleashed a credit expansion not seen since 2009. England voted to leave the EU. Despicable terrorist acts have become much too common. There was chatter of a U.S. recession followed by chatter the Fed had reacted too slowly, given U.S. economic strength. This market has been like the weather in London, just wait a few minutes and it will change.

The first half of 2016 had three big drivers of performance – low quality, currency and yields. The first was a rally in low quality or more cyclical sectors namely Energy and Materials. After multiyear bear markets for these sectors, they saw a very strong bounce in 2016. Some of this was driven by China expanding credit, some by better supply/demand balances in oil, some for the desire for a "safe haven" in gold, yet much was driven by the US dollar weakening after so many years of just going up. Currency was a big driver of performance in the 1st half as it subtracted more than 6% off U.S. denominated returns. This brings us to number three, yields. 10-year bond yields have turned negative in a number of countries which has put further downward pressure on yields in North America. The 10-year Canada government bond yield sits at about 1.0%. This obviously led to strong bond market returns and helped lift the more interest rate sensitive sectors such as Utilities and Telcos to even higher levels.

Rough ride, but nice finish



Source: Bloomberg

Equity markets have certainly seen a volatile 2016 and returns have been extremely divergent. Just about every market fell into correction territory in January and February, but globally markets have rebounded nicely. This has the S&P 500 up 6% so far this year and making new all-time highs. The news gets better closer to home as the TSX is leading global developed markets, up 11.6% before dividends. Energy and gold shares have done the lion's share of the lifting. Outside North America things were not so good. Even with recent strength Europe is still down 10% this year and Japan down 12%.

Still, most stocks are up, bonds are up, commodities are up, 2016 has been a good year so far.

"Monetary Policy, I would like to introduce you to Fiscal Policy"

We may be on the verge of something big, something that could have a profound impact not only on markets but economies as well. For the past seven or so years, we have watched central banks use monetary policy levers to try to stave off the impacts of a credit driven financial crisis and to foster economic growth. ZIRP led to NIRP (ZIRP = Zero Interest Rate Policy, NIRP = Negative Interest Rate Policy), QE was followed by QE2 then QE3 (QE = Quantitative Easing). The ECB has expanded its QE mandate to include purchases of government bonds and investment grade corporate bonds. The BOJ has moved to buying equities. If monetary policy is akin to a lever that can be pulled and pushed to impact asset prices and the economy then central banks have pulled and pushed to the extreme. There is no doubt that it has had an impact. The moves helped to inflate asset prices for equities, bonds, commodities and real estate. This has created imbalances and has led to the misallocation of capital. Germany just issued 10-year bonds with a negative interest rate, so buyers will pay more than they receive over the 10-year life of the bond. Sign me up!

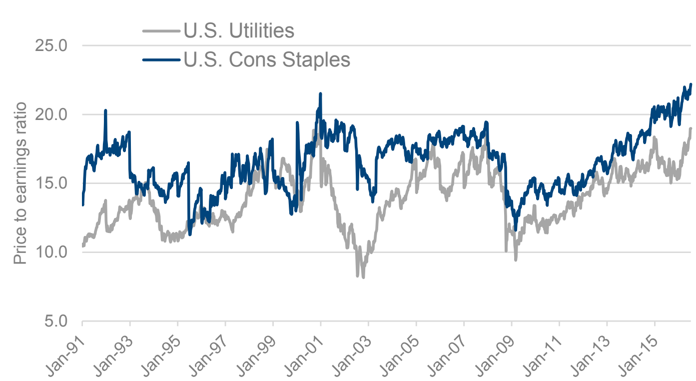
While the monetary policy lever has been moving in the right direction, the fiscal one has been moving against it. How much of the monetary policy's impact was negated by restrictive government spending? We will leave that for the economists to try to measure. But something has started to change. Canada was an early mover, electing a new government that plainly stated that it will run deficits to invest and foster growth. Others are starting to do the same. The Brexit vote has the newly formed UK government committed to spending more. Voters across many democracies are becoming disenchanted and want change. If policymakers want to keep their jobs then you can bet that more of them will increase spending to promote economic growth. Both U.S. candidates have platforms that would see government spending as a positive for GDP and not a negative. If investors will give money to Germany for ten years for no cost then shouldn't the government take advantage?

If fiscal spending starts to contribute more to economic growth, then investors should take notice. Expansionary monetary and fiscal policy would be a powerful combination. It won't happen overnight, but it could certainly lead to higher earnings growth, increased capital spending and ultimately higher bond yields. Not materially higher, as there are still lots of savers and demographic forces to keep a lid on yields, but higher than current levels.

The risk of a taper tantrum

The move lower in bond yields has skewed the risk / return trade-off for duration and interest rate sensitive assets. The bond market, with a duration of over seven years, is at risk should we see yields normalize even partially. Moreover, the low yields have lifted interest rate sensitive sectors to valuations not seen in over a decade. In some cases, valuations are higher than they ever have been. Bond proxy equities such as Utilities and Consumer staples are valued at well over 20x earnings. With limited revenue or earnings growth, these valuations are

Equity bond proxy valuations highest in over 25 years



Source: Bloomberg

completely dependent on yields staying ultralow, which is a risky bet.

The drop in bond yields has had a positive impact on sectors of the market that are more interest rate sensitive, often referred to as bond proxies. Given our view that, from these depressed levels, the greater likelihood is for yields to rise somewhat, harvesting some gains in the bond proxies, including Utilities and Telcos may prove prudent.

The return of earnings growth

Q2 earnings season has started and it is the kind of season that we have not seen in a while. This earnings season is special because it marks the first positive earnings growth for the S&P 500 since way back in Q3 of 2014. Yes, we have gone through an earnings recession in America with six quarters or a year and a half of negative earnings growth. It is rare to have an earnings recession that doesn't coincide with an economic recession, but it does happen. Last time was in 1998, and then the market rocketed higher. Based on current consensus estimates, earnings are expected to be 7.4% higher than in Q2 of 2015. Results tend to surprise, and more often the surprises are to the upside, so earnings growth could come in even higher than 7.4%.

The reasons behind the earnings recession are plain to see. Global and U.S. growth have been ok, but not great. The collapse of the resource sector had a significant impact on earnings in that sector. Then there was the strong U.S. dollar that sapped the value of overseas earnings. As these drags fade, earnings growth returns. This could help lift the S&P 500 out of its trading range, dating back to when the earnings recession started.

Good earnings in the U.S. will be good for Canadian earnings as well. A significant portion of many Canadian companies' operations are either U.S. based or sensitive to what is going on south of the border.

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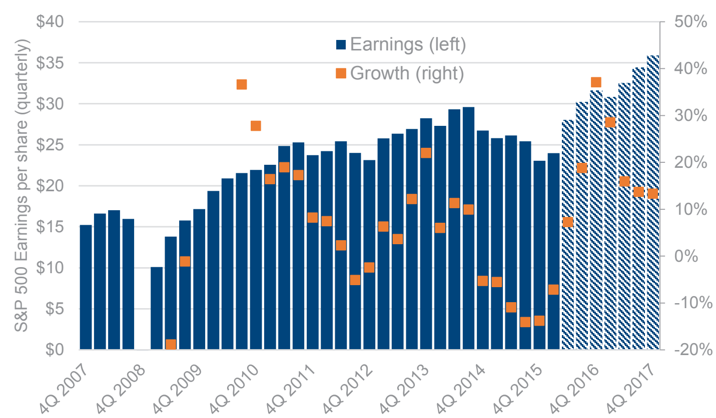


Source: S&P

How low can you (yields, that is) go?

Perhaps one of the greatest persisting trends we saw in the first half of the year, and no doubt a big driver for markets in the latter half, is that of negative interest rates. With the implications far greater than simply the prospect of losing money during the course of one's investment, negative risk-free rates can call into question entire pricing and valuation models that have been used for decades in finance.

With about U$13 trillion of debt worldwide now having a negative yield, it poses significant problems to savers and conservative investors alike. When there is a glut of savings like we are seeing now, the competition for safe yield will be fierce.

Canada, with its central bank set overnight rate at just 0.50%, is actually one of the high-yielders in the developed world, and investors need to extend their maturities to ten years simply to see 1% yields. This makes the duration of the Canada government bond index a risk measure that shows the price sensitivity to changes in interest rates at all-time highs. In fact, the Canada government bond index, which monitors federal and provincial debt, now has a duration of 8.3 and a yield of just 1.55% – a terrible risk reward measure by any stretch. Canada, with its 1.10% yielding 10-year bond, would decline in price by almost 10% if the yield were to rise to just 2.10%. I think we would all agree that even at 2.1%, we would describe the yield on the 10-year "low"

This is what has caused some to call developed world bond markets "insurance, not investing". Should there be a shock to the global "risk" markets like equities and high yield bonds, investors would surely jump into AAA and AA rates sovereign bonds, regardless of the yield. In that way, bonds can still act as a portfolio diversifier. However, with miniscule nominal yields, and negative real (after inflation) yields, this is hardly somewhere to test the power of compounding.

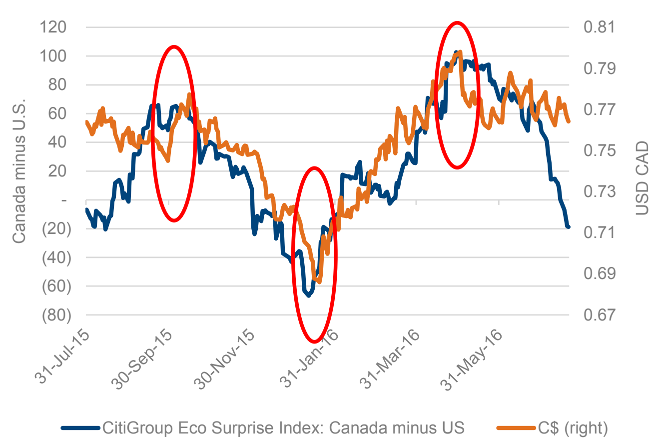
Currency implications

In a world with institutions free to seek investments almost anywhere, we are seeing yields being dragged lower in areas that may not deserve it. The United States, for example, with GDP growth stable between 2 and 3%, and core inflation now above 2%, surely should command a 10-year yield of more than 1.5%. Either global investors are pushing this lower than fundamentals would suggest, or the bond market is predicting a negative growth shock. We think it's the former.

This has major implications for the currency markets, and forces us to keep a close eye on the relative yields between U.S. and Canadian 2-year bonds. The higher the U.S. goes relative to Canada, the more weakness we will see in the loonie. While crude oil is a great barometer as well (albeit with its own currency-related fluctuations), we find the yield spread equally instructive.

In 2016, the loonie went from a dead duck to a, well, a rising duck. From late January until the start of May there was 15%+ increase in the loonie versus the dollar following the swift decline in the fourth quarter of last year. We have been longtime U.S. dollar bulls and remain such, benefiting from the prolific fall in our local currency since 2011 when it was trading above par. However, the strength during the first four months of the year was a drag on performance. U.S. dollar exposure is starting to pay dividends again as the loonie has lost some ground since the May highs. While we are not expecting as much currency lift as years past, given the dichotomy between our economies we continue to think the medium term move leans to further dollar appreciation.

Economic data momentum points to a softer C$



Source: Bloomberg

Policy

While we believe that the amount a bond can go negative is limited by an investor's willingness to finally pull out money and go to cash, this would change should the banks ever start to really enforce negative cash deposit rates as well. With the right kind of policy, that could happen again. This is where we start to explore policy implications.

The most immediate and apparent would be what has become known as "helicopter money", after Milton Friedman (and later Ben Bernanke) suggested flying over the people and dropping $1,000 bills to spark some kind of consumer spending and inflation (Of course they would have to bring back the $1,000 bill first!). There are many who believe the current course of central banks will lead us there. If easing by monetary policy has not had the desired effect, easing by fiscal policy just might – and we are seeing many political changes around the world that may lead us in that direction.

Final Thoughts

Now half way through the year, markets are at or near all-time highs which is nice. But given our view, we are in a more volatile time for the market. Perhaps the 2nd half of the year will contain fewer surprises, but we doubt it. More importantly is to keep a cool head, assess the situation with limited emotion and make sound, well researched investment decisions.

Economic indicators in Canada suggest relative weakness to those in the U.S., but U.S. numbers remain fairly constructive. The extent to which markets are reflecting that is the big question. While all markets look "fully valued", we would suggest that continued decent (but not hot) numbers for the economy can mean the earnings recession can end.

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