Economic and Financial Environment

As at December 31, 2015

The Fed (finally) makes its move

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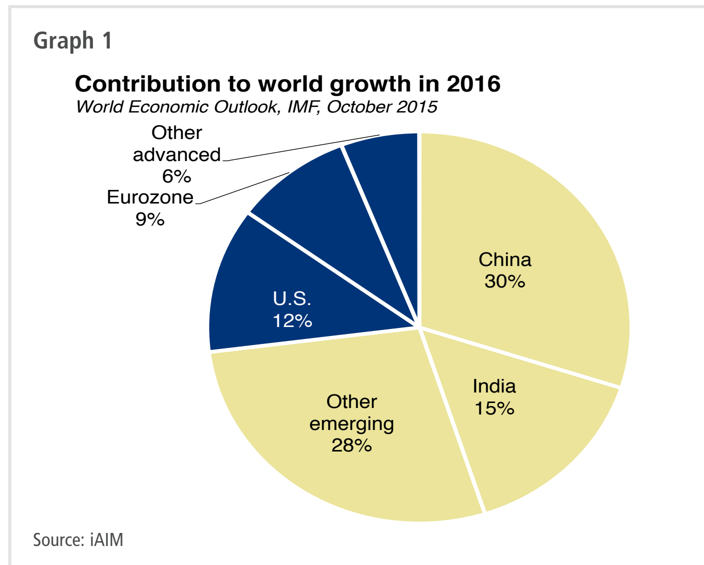
The fourth quarter of 2015 was marked by volatility, reversals, and ends. Following its first correction of more than 10% in four years, the U.S. market made a comeback in October, erasing almost all the losses recorded over the summer. The emerging economies, after having been responsible for a large part of the year's uncertainty, saw their situation reverse itself and are now exceeding expectations at a pace not seen in nearly three years. Closer to home, the U.S. Federal Reserve (Fed) finally raised its key rate by 0.25%, a gesture symbolizing the start of monetary policy normalization in the United States. It should be said that the Fed's governors had been preparing the ground since their September meeting, when many observers accused the Fed of having injected a strong dose of uncertainty and confusion into the markets. It now remains to be seen whether the beginning of a monetary tightening cycle will ultimately be well received by the markets, which seem to have had a rather mixed reaction in the days following the announcement.

Graph 1



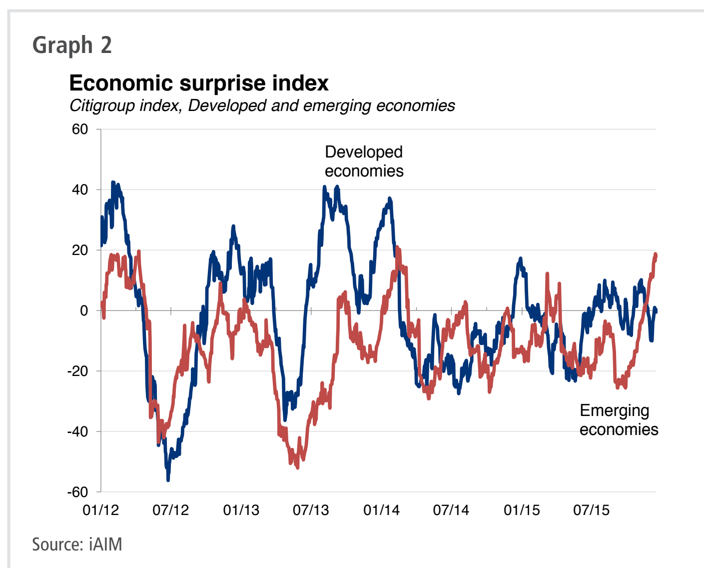
Source: iAIM

World: Emerging economies are back

After having been the primary source of concern on the macroeconomic scene since the summer, the emerging countries, which represent more than 50% of the world economy and which will be responsible for nearly 75% of the planet's growth in 2016 (graph 1), picked up again in the fourth quarter. The economic surprise index for emerging markets, which measures the average surprise of published economic indicators compared to experts' expectations, has entered positive territory and even ended the year near a four-year high (graph 2).

The tone is improving in Asia in particular, led by China, where the indicators are pointing to a recovery in exports in 2016. The global manufacturing index suggests an expansion for the year to come, bolstered by the accumulation of multiple quantitative easing programs and ultra-accommodating monetary policies in various countries over the last few years. This should boost trade between emerging countries and with developed countries, stimulating an appreciation in exporting countries' currencies and, in so doing, putting some downward pressure on the U.S. dollar.

Graph 2



Source: iAIM

Europe: A calmer year in store?

Europe regained some of its economic calm in the fourth quarter, despite the fact that this was clearly not the case on the geopolitical front.

European economic performance is lukewarm, with growth rates that are just high enough to leave behind the spectre of deflation but just low enough to justify continued monetary support by the European Central Bank (ECB), which has extended its quantitative easing program until March 2017.

The ECB's efforts are starting to produce tentative results, with the credit cycle moving into positive territory over the last few months (graph 3).

We expect 2016 to continue in the same vein as the end of 2015, that is, with economic data slowly improving, a central bank that remains largely accommodating, and general calm on the economic front. There could still be some surprises on the political front, with Spain just removed from an election which leaves the country in political limbo, but resolution of the Greek situation seems to have quelled the fervour of the anti-austerity movement, at least for the moment.

United States: More expansion ahead

Economic growth continues for our southern neighbours, despite a slight slowing in the manufacturing sector since the summer, which has made some observers skeptical about the outlook for 2016.

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We continue to maintain a very positive outlook for the U.S. economy. The main reason lies in households, whose consumption represents 70% of the GDP and which will continue to benefit from the strength of the job market as well as the overall increase in household wealth. The next step should be an increase in wages, which could occur in 2016 if we are to believe the intentions of small and medium-sized enterprises which have leapt in this direction over the last few months (graph 4).

Another major element, in our opinion, is the beneficial effects of the significant drop in energy prices, both for gasoline and natural gas, which will result in the average household enjoying several hundred dollars more in disposable income in 2016. At the moment, we've seen that most households have chosen to put away their savings earned at the pump; however, the already high level of savings means we may now see families start to spend the additional amounts saved.

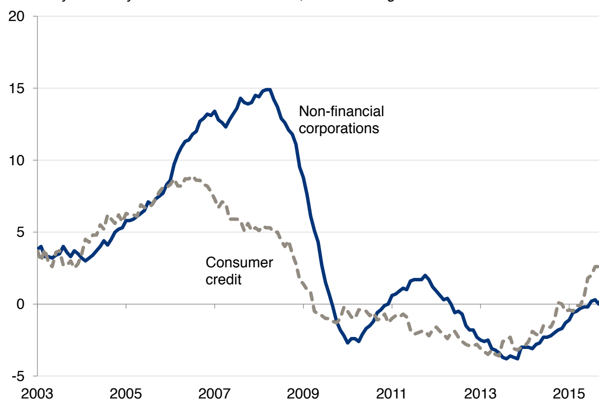
As for the general economic picture in 2016, we are forecasting continued growth, with sustained vigour in the domestic economy, driven by consumption and, possibly, a new wave of business investments. The strength in exports will depend on the strength of the U.S. dollar (which could put a brake on sales outside the country) and of emerging markets.

Canada: Cautious optimism

The general improvement in Canadian data in the second half of the year leads us to display cautious optimism.

After a difficult first half of the year, marked by a contraction that was concentrated in the oil-producing provinces, economic growth rebounded to such a degree that Canadian GDP in August had already regained what it had lost at the beginning of the year. The Bank of Canada therefore was in part correct: the negative effects of the oil price collapse had a rapid effect on the Canadian economy, and the cuts orchestrated by the Bank at the beginning of the year may have accomplished their purpose.

Graph 3



Source: iAIM

Chart 1
Returns of the Canadian Bond Market as at December 31, 2015

Index	Returns (%)	
	3 months	YTD
FTSE TMX Canada Universe Bond Index	1.0	3.5
FTSE TMX Canada Short Term Bond Index	0.5	2.6
FTSE TMX Canada Mid Term Bond Index	1.0	4.9
FTSE TMX Canada Long Term Bond Index	1.6	3.8
FTSE TMX Canada Federal	0.7	3.7
FTSE TMX Canada Provincial	1.6	4.1
FTSE TMX Canada Municipal	1.1	3.2
FTSE TMX Canada Corporate	0.6	2.7

Source: Scotia Capital Debt Market Indices

A significant number of jobs were created in 2015 and, to our great surprise, the western provinces continued to put their shoulders to the wheel. The majority of jobs were created in central Canada (Ontario and Quebec), where consumers enjoy the lowest energy costs and where the negative effects of the oil price collapse were limited.

The decline of the Canadian dollar, which has dipped even further since the summer, also played an important role. We are of course expecting that a weaker loonie will stimulate the manufacturing sector, given the importance of exports to the U.S. market in this sector, and there again we have reasons to be cautiously optimistic.

Job creation in the manufacturing sector was its second highest in 13 years (graph 5) this year, a sign that some of the production capacity lost in the years when the loonie was trading at parity with the greenback is being restored. However, export volumes of non-energy good are still disappointing: it seems that Canadian exporters are no longer able to play their game as well in the U.S. market, at least if we are to judge from the level of U.S. imports which is rising faster than that of our exports (graph 6).

The real estate market still seems balanced, despite headlines claiming that prices are skyrocketing. On this front, it is important to distinguish between the situation in the areas of Vancouver and Greater Toronto, where prices are up nearly 10% year over year as a result of intense demographic inflows (international and interprovincial) that are fueling housing starts, and that of other regions where growth is more or less zero given the absence of demographic pressures. The new Trudeau government has already announced new measures aiming to contain the rise in real estate prices (and primarily speculation), by raising the down payment requirements for homes selling between $500,000 and $1,000,000. This is a laudable but relatively timid measure, in that it primarily targets the markets of Vancouver and Toronto (where 40% of transactions are in that price range) and, to some degree, Calgary, but it is not likely to have a significant impact on the country as a whole.

As at December 31, 2015

Chart 2
Market Returns as at December 31, 2015

Index	Returns (%)	
	3 months	YTD
FTSE TMX Canada 91 day T-bill Index	0.1	0.6
FTSE TMX Canada Universe Bond Index	1.0	3.5
S&P/TSX Composite Index	(1.4)	(8.3)
S&P 500 (Can. $)	10.6	21.0
MSCI - EAFE (Can. $)	8.2	18.3
MSCI - World (Can. $)	9.0	18.3
Exchange Rate (Can. $/US $)	3.3	19.3

Chart 3
Market Returns as at December 31, 2015

Index	Returns (%)	
	3 months	YTD
S&P/TSX Sector Returns		
Energy	(1.6)	(22.9)
Materials	3.8	(21.0)
Industrials	(1.2)	(11.1)
Consumer Discretionary	(5.2)	(1.5)
Consumer Staples	0.8	12.4
Health Care	(36.9)	(15.6)
Financials	1.7	(1.7)
Information Technology	10.5	15.6
Telecommunication Services	(1.7)	3.6
Utilities	(1.3)	(3.5)
S&P/TSX Composite Index	(1.4)	(8.3)

The year 2016 should be marked by the return of the fiscal tool, as Canada, which has the lowest indebtedness ratio of the G-7, deliberately goes into deficit in order to stimulate economic growth. We welcome the infrastructure spending proposed by the new federal government, as it will enable Canada to boost its growth potential and help overcome the national infrastructure deficit, which some estimate at above 700 billion dollars.

Financial markets: Market recovery and the Fed finally moves

Volatility was back and remained centre stage in the fourth quarter of 2015.

The quarter was initially off to a flying start, with the U.S. stock market delivering a superb performance. Following last August's correction, the market had ended the month of September near the year's lowest point; however, it then recovered almost all the ground lost with a gain of 8.4% in October (5.9% in Canadian dollars). Several observers expressed doubt during the quarter over the strength and sustainability of this recovery, given that the market had been pushed up by just a few dozen high-growth stocks, but a good share of the gains still held at the end of the quarter.

The month of December finally brought us the first rate hike by the U.S. Federal Reserve since 2006. The Fed says it is now much more confident in the U.S. economic outlook and notes that the job market is quickly approaching full employment, although there is still excess capacity due to historically low participation rates. The press release accompanying the decision clearly states that inflation pressures and inflation expectations will be closely monitored and will determine future adjustments to the Fed's monetary policy.

Initial market reaction was mixed but orderly, showing that the Fed had succeeded in managing expectations and preparing investors for this possibility. The bond market remained more or less stable, even showing some slight gains, which is encouraging because the worst scenario would have been a wave of panic leading to a disorderly correction in the world's biggest market. Which goes to show that markets prefer certainty to uncertainty!

The Canadian bond market ended the year with another positive quarter and, despite our expectations conveyed several times here, posted another year of gains. The FTSE TMX Canada Universe Bond Index was up 1.0% in the fourth quarter, for a total gain of 3.5% in 2015. Short-term bonds grew 2.6% and long-term bonds posted a gain of 3.8% in 2015.

The U.S. stock market held on to some of the gains recorded in October and ended the quarter up 7.0% (10.6% in Canadian dollars). The Canadian stock market was down again with a 1.4% contraction in the S&P/TSX Composite Index compared to a gain of 1.1% in the small-cap index. In 2015, the Canadian stock market lost 8.3%, underperforming the U.S. market for a fifth consecutive year.

The stock markets of Europe, Asia and the emerging markets entered positive territory in the fourth quarter. The European market, represented by the MSCI - Europe Index, was up 5.2% (+5.9% in Canadian dollars), while the MSCI - EAFE Index gained 6.3% (+8.2% in Canadian dollars) and the MSCI - World Index grew 6.2% (+9.0% in Canadian dollars). Finally, the MSCI - Emerging Markets Index posted a slight gain of 1.6% (+4.1% in Canadian dollars).

Strategy: Time to go back to Canadian equities?

Our strategy within the diversified funds was similar to that of the last quarter of 2014. After the stock market correction in August, when we took advantage of the situation to significantly increase the weight of equities over cash, we gradually reduced our exposure to equities in light of the scope and speed of the recovery.

The result is that we ended the quarter slightly overweight in equities, but with a small difference: we now have a stronger weighting of Canadian equities than U.S. equities.

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Chart 4
Asset mix: Diversified Fund (040)

	Min.	Neutral	Max.	Actual Weight	Over Weight (+)/ Under Weight (-)	Change in quarter
Money Market	**0**	**5**	**25**	**13.0%**	**+8.0%**	**+0.5%**
Canadian Bonds	20	45	70	24.0%	-21.0%	0.0%
International Bonds	0	0	15	0.0%	0.0%	0.0%
Total – Bonds	**20**	**45**	**70**	**24.0%**	**-21.0%**	**0.0%**
Canadian Equities	**5**	**25**	**45**	**37.5%**	**+12.5%**	**+7.0%**
U.S. Equities	0	12.5	45	11.5%	-1.0%	-8.5%
International Equities	0	12.5	45	11.5%	-1.0%	+1.0%
Emerging Markets	0	0	45	2.5%	+2.5%	0.0%
Total – Foreign Equities	**5**	**25**	**45**	**25.5%**	**+0.5%**	**-7.5%**
Total – Portfolio		**100**		**100.0%**		

In terms of market valuation, we believe that U.S. equities are properly valued (graph 7) (therefore no overvaluation, according to our estimates) and that the return outlooks, although modest, are positive for the next few years (graph 8). The main factor that causes us to remain cautious is the fact that the profit margins of U.S. firms are perched close to a 60-year high, meaning that impending wage pressures, as well as the eventual need to step up investments, should slow profit growth for U.S. firms.

On the Canadian stock market, we deem that the time has come to take advantage of the fact that the S&P/TSX is at a two-year low to build a greater position within our diversified funds.

Several factors are pushing us in this direction.

First, 2015 was the fifth consecutive year where the Canadian market under-performed with respect to the U.S. market, and in all of history, such a sequence has never continued into a sixth year. Historically, after such a sequence, the Canadian market has outperformed the U.S. market by more than 20%. In a context where emerging markets are expanding and oil prices are stabilizing, we believe it probable that the ensuing context will favour commodities-linked assets as well as those that perform well in a "risk on" environment.

Second, during previous periods of Fed rate hikes, we saw that in the first six months following the first hike, the Canadian stock market performed better than the U.S. stock market, and that the Canadian dollar rose (graph 9).

Finally, the overall valuation of the energy sector, measured by the price-to-book ratio, shows that current levels correspond more or less to historic lows (graph 10). This observation leads us to believe that the worst of the collapse in energy-related stocks is behind us, and that it's time to direct a greater share of our asset allocation to the Canadian market.

The loonie fell further over the quarter, dipping below 72 cents U.S., pushed downward by another drop in oil prices and the divergence in monetary policies in North America. We took advantage of recent lows (corresponding in fact to an 11-year low!) to cover our exposure to the U.S. dollar, a new move which should reduce the volatility of our portfolios in an environment where the loonie could benefit from a rebound in the emerging economies and, possibly, from a slight increase in the price of oil in 2016.

Our wave of equity purchases at the end of the quarter brought the Diversified Fund's exposure to equities above the neutral targets dictated by the investment policy. Canadian stocks now account for more than 38% of the Diversified Fund, of which 9% are invested in small-cap stocks. International stocks once again account for 25% of assets, including over 2% exposure to emerging markets through a position within the MSCI - Mexico index.

The weight of bonds remains below the target, at 24% versus a target of 45%, at the same level as at the end of the previous quarter. Now that the Fed has begun the process of normalizing its monetary policy, we expect the bond market to remain under pressure.

Finally, the cash balance now accounts for nearly 13% of the fund's assets, and we no longer hold any direct exposure to the U.S. dollar. At the loonie's current levels (close to US$0.72 at the end of the quarter), we are no longer as convinced about the future movements of our currency.

Economic and Financial Environment (continued)

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Chart 5
Estimated Gross Returns for the Next 12 Months Starting on December 31, 2015

Market indicators	Interest or dividend	+	Capital gains	=	Total estimated gross return
FTSE TMX Canada 91 Day T-Bill Index	0.50%	+	0.00%	=	0.50%
FTSE TMX Canada Universe Bond Index	3.20%	+	(3.24%)	=	(0.04%)
Canadian stocks (S&P/TSX Composite Index) including dividends					8% to 11%

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Chart 6
Economic and financial scenarios

Economic scenario

							Change since September 30, 2015	
		2013	2014	2015	2016	2017	2015	2016
United States	Real GDP	1.5%	2.4%	2.4%	2.8%	2.6%	-0.1%	-0.1%
	Inflation rate	1.5%	1.6%	0.1%	1.6%	2.0%	-0.1%	-0.3%
	Unemployment rate	7.4%	6.2%	5.3%	4.8%	4.7%	---	-0.1%
Canada	Real GDP	2.2%	2.5%	1.2%	1.8%	2.1%	---	-0.2%
	Inflation rate	0.9%	1.9%	1.2%	1.9%	2.0%	---	+0.2%
	Unemployment rate	7.1%	6.9%	6.9%	6.9%	6.7%	+0.1%	+0.2%

Financial scenario*

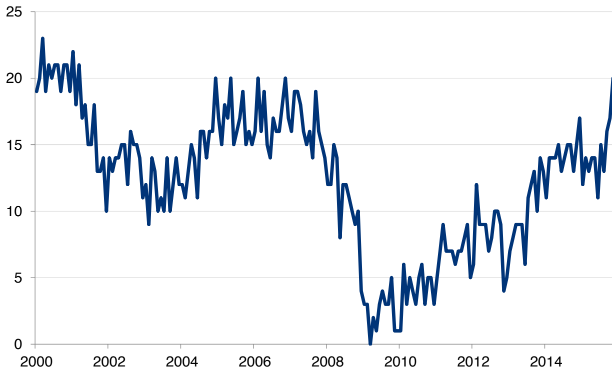
			Targets			Change since September 30, 2015	
		Actual	June 16	Dec. 2016	June 2017	June 2016	Dec. 2016
Interest rate							
	U.S. 10-year rates	2.27%	2.50%	2.70%	3.20%	-0.40%	-0.50%
	Canada 10-year rates	1.39%	1.70%	1.90%	2.20%	-0.40%	-0.50%
Exchange rates							
	$US/$CAD	0.72	0.72	0.75	0.77	-0.08	-0.05
	$US/Euro	1.09	1.05	1.05	1.05	---	---
	Oil price (WTI), $US	37.04	35	40	45	-17	-15
	S&P 500	2,043	2,000	2,100	2,200	-100	-100
	S&P/TSX	13,010	13,000	14,050	15,200	-2,000	-1,450

* end of period

Economic and Financial Environment (continued)

Graph 4

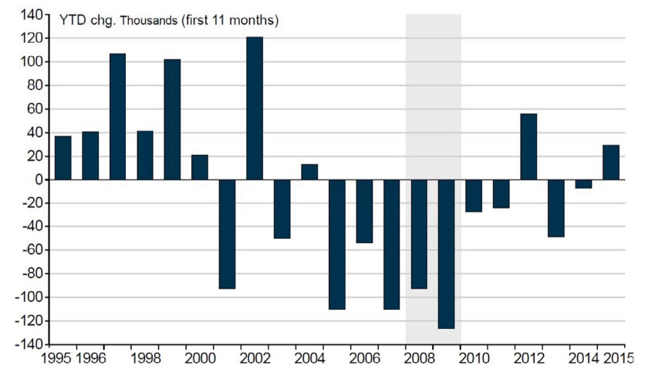
U.S.: Small businesses intend to raise wages in 2016
NFIB Compensation plans index



Source: IAIM

Graph 5

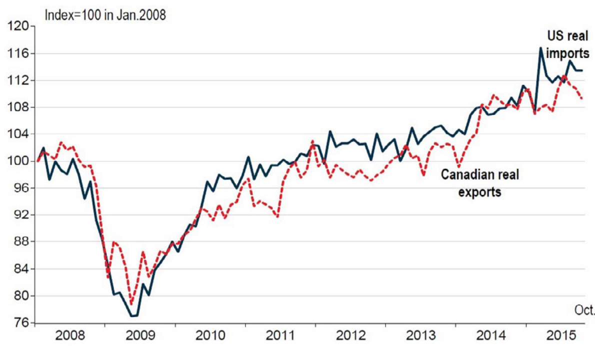
Manufacturing : second best performance in 13 years
Manufacturing employment



Source: NBF Economics and Strategy (data via Statistics Canada)

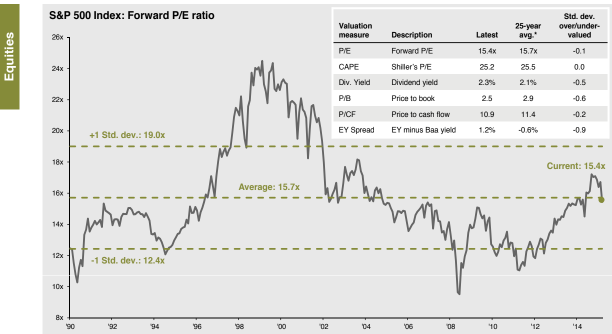
Graph 6

Canada: Exports underperformed considering US demand
Real US imports of goods versus real Canadian merchandise exports



Source: NBF Economics and Strategy (data via Statistics Canada)

Graph 7



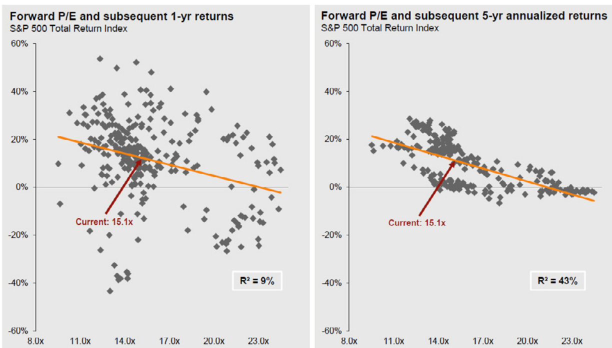
Valuation measure	Description	Latest	25-year avg.*	Std. dev. over/under-valued
P/E	Forward P/E	15.4x	15.7x	-0.1
CAPE	Shiller's P/E	25.2	25.5	0.0
Div. Yield	Dividend yield	2.3%	2.1%	-0.5
P/B	Price to book	2.5	2.9	-0.6
P/CF	Price to cash flow	10.9	11.4	-0.2
EY Spread	EY minus Baa yield	1.2%	-0.6%	-0.9

Source: FactSet, FRB, Robert Shiller, Standard & Poor's, J.P. Morgan Asset Management.
Price to Earnings is price divided by consensus analyst estimates of earnings per share for the next 12 months. Shiller's P/E uses trailing 10-years of inflation adjusted earnings as reported by companies. Dividend Yield is calculated as the trailing 12-month average dividend divided by price. Price to Book Ratio is the price divided by book value per share. Price to Cash Flow is price divided by NTM cash flow. EY Minus Baa Yield is the forward earnings yield (consensus analyst estimates of EPS over the next 12 months divided by price) minus the Moody's Baa seasoned corporate bond yield. Std. dev. Over/under-valued is calculated using the average and standard deviation over 25-years for each measure. *P/CF is a 20-year avg. due to cash flow data availability.
Guide to the Markets – U.S. Data are as of August 31, 2015.

J.P.Morgan Asset Management

Source: J.P. Morgan Asset Management

Graph 8



Source: FactSet, Reuters, Standard & Poor's, J.P. Morgan Asset Management.
Returns are 12-month and 60-month annualized total returns, measured monthly, beginning September 30, 1990. R^2 represents the percent of total variation in total returns that can be explained by forward P/E ratios.
Guide to the Markets – U.S. Data are as of September 30, 2015.

J.P.Morgan Asset Management

Source: J.P. Morgan Asset Management

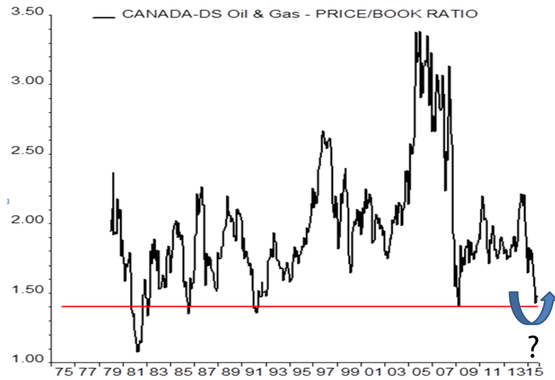
Graph 9

Asset class performance following a first rate hike from the Fed

	Consecutive Rate Hikes 1994, 1999 and 2004 Average		Gradual Rate Hikes 1986 Episode	
Asset Class	Previous 6 Months	Following 6 Months	Previous 6 Months	Following 6 Months
S&P/TSX	8.2%	7.6%	-0.7%	21.3%
S&P 500	6.3%	3.5%	3.7%	16.6%
U.S. 10-Yr Yields (bps)	51.6	47.1	-137.7	157.4
Canadian Dollar	-0.6%	2.9%	0.8%	2.8%
U.S. Dollar (DXY)	4.4%	-5.7%	-7.2%	-8.8%
Gold	-5.9%	6.6%	13.6%	16.6%

Source: Canaccord

Graph 10



Source: Canaccord