Economic and Financial Environment

As at June 30, 2016

Brexit, the Fed, and forest fires

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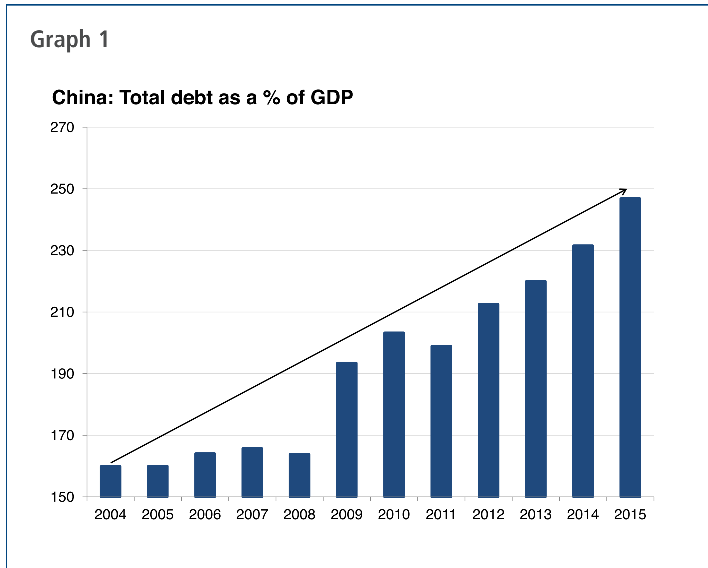
Three main topics dominated headlines and the markets in the second quarter. In chronological order, the first was the Fort McMurray wildfire, which generated infernal images in the media and brought a quarter of Canada's oil production, our primary export, to a halt. The Bank of Canada immediately revised its estimate for second-quarter GDP growth downward, while expecting the impact on the year 2016 as a whole to be zero. Then in May, it was the turn of the U.S. Federal Reserve's governors (the Fed), in concerted fashion, to take the spotlight by preparing the markets for the possibility of two or three rate hikes by the end of 2016. The strong negative surprise caused by the weak jobs report in May, however, forced the Fed to remain patient, throwing a new dose of uncertainty onto the markets. But it was without a doubt the British vote on June 23 that garnered the most attention worldwide: the government of the United Kingdom now holds the results of a referendum in which the people rallied behind the refusal to ratify an improved agreement on conditions for belonging to the European Union. The new government, to be led by whoever succeeds David Cameron, will therefore have to launch a process for the country to exit the European Union, commonly referred to as "Brexit." The third quarter now beginning is therefore likely to be coloured by volatility on the markets and political upheaval.

World: IMF issues another warning on China

For the umpteenth time, the International Monetary Fund (IMF) has issued a warning to China concerning its high level of corporate debt. According to the IMF, rising corporate debt constitutes "a key fault line in the Chinese economy." The IMF did not mince words, estimating that corporate debt problems today could become systemic debt problems tomorrow, leading to much lower growth for China's economy (and therefore for the world economy, given that China alone currently accounts for 33% of world economic growth), or even a banking crisis.

Graph 1



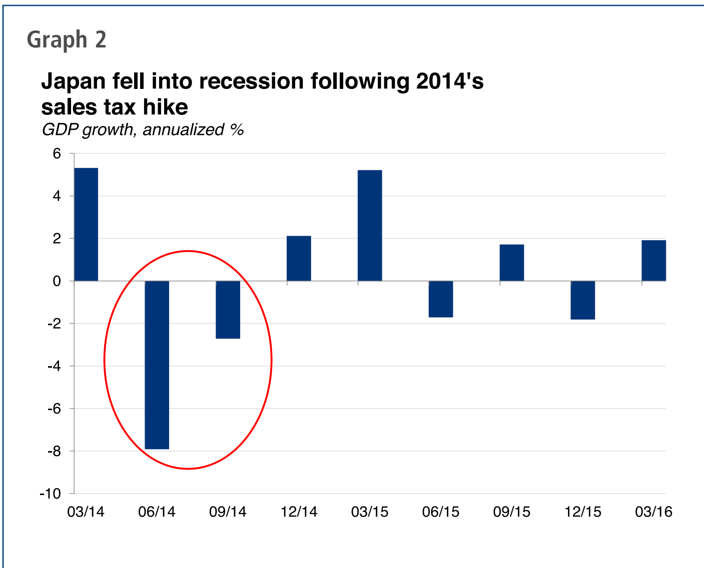
There is frequent mention of the weight of Chinese corporate debt, which represents close to 145% of the country's GDP, and total debt, which is now around 250% of GDP (Graph 1). It remains difficult to take a stand on the level of debt that could be considered excessive and that could set off a credit crisis in the second world economy. For example, we see that 55% of Chinese corporate debt is on the balance books of public companies (a strong over-representation, since these companies contribute only 22% to the country's production). Given that the Chinese banks are controlled by the government, are the risks of a financial system collapse really imminent, considering that the lenders and most of the borrowers are under direct control of the state?

This question has been asked by several reliable observers and, as yet, has no clear answer. One thing is certain, however: since anything that cannot last forever will eventually come to an end, the balance sheets of Chinese companies cannot continue to grow heavy in this way. From this perspective, the IMF advice is probably very wise and arrives at a time when the Chinese authorities still have the tools to avoid a banking crisis, rather than coming too late.

Meanwhile, still in Asia, Japan continues to wage its battle against weak economic growth and deflation, not too successfully, despite all the money printed by the Bank of Japan and the well-meaning intentions of the Abe government.

The Japanese government had announced its plan to reform its mode of financing by raising the sales tax for a second time, in order to reduce its dependency on debt as a means of financing public programs. This increase was planned for spring 2017, coming on the heels of the first increase in April 2014, which had pushed the rate of taxation from 5% to 8% but, more importantly, plunged the country into a new recession (Graph 2). Given the timid results obtained to date by this grand, three-pronged plan (monetary and fiscal stimulus and structural reforms), the government deemed it prudent to delay the next tax increase, from 8% to 10%, for another two and a half years, that is, until October 2019.

Graph 2



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Japan is often cited as the laboratory of the industrialized world, given its difficult demographic situation heralding a reality that could extend to Europe and North America in a few decades. Decision-makers around the world are probably taking note that it will eventually become very hard to counter the effects of an ageing population, which will weigh heavily on the size of the population of working age and, directly, on the economic growth outlook that is so important for the continued financing of social programs, through monetary and fiscal simulation.

Elsewhere in the world, the oil market moved toward a rebalancing of supply and demand in the second quarter, with temporary but notable production stoppages in Alberta, Iraq and Nigeria. In its June report, the International Energy Agency stated that the strong growth in oil demand in Asia, stimulated by low prices, will also be a factor in restoring equilibrium to the oil market by the end of 2016, that is, a few quarters sooner than previously hoped.

The strategy of the Organization of the Petroleum Exporting Countries (OPEC) seems to be bearing fruit, since the sharp drop in prices since the end of 2014 has been placing pressure on the production of non-OPEC countries (which, one will recall, were the primary source of growth in world oil production over the last decade, see graph 3). They have already seen their production fall to 56.8 million barrels per day, which is 900,000 barrels per day less than the same time last year. Global demand, meanwhile, is expected to increase by 1.3 million barrels per day in the coming year, which should be enough to sustain price levels. In light of these estimates, we are maintaining a target range of $50 to $60 per barrel for the price of oil in the coming year, which is above the current price.

Europe: Brexit

The English people created a shockwave when they voted 52% against the proposal to remain within the European Union, in the historic referendum held on June 23, 2016. This result pushed British Prime Minister David Cameron to resign and propose a new election for October, then wreaked havoc on the opposition party, which was hit with several sudden resignations of elected representatives who were unhappy with their leader's performance during the campaign.

Graph 3

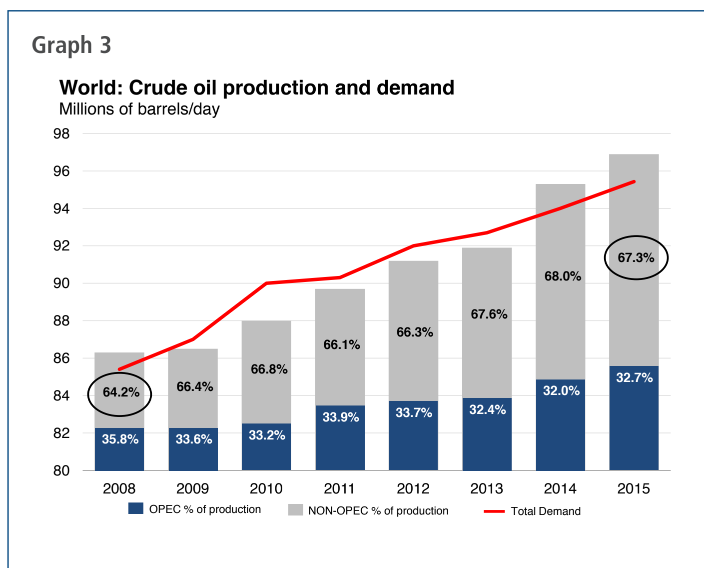

Chart 1
Returns of the Canadian Bond Market as at June 30, 2016

Index	Returns (%) 3 months	YTD
FTSE TMX Canada Universe Bond Index	2.6	4.1
FTSE TMX Canada Short Term Bond Index	0.7	1.1
FTSE TMX Canada Mid Term Bond Index	2.4	3.9
FTSE TMX Canada Long Term Bond Index	5.5	8.3
FTSE TMX Canada Federal	1.7	2.8
FTSE TMX Canada Provincial	3.6	5.3
FTSE TMX Canada Municipal	3.3	4.6
FTSE TMX Canada Corporate	2.5	4.0

Source: Scotia Capital Debt Market Indices

The political implications of this event should not be underestimated: there is no doubt that it represents a major change in the cards. For the first time since the Second World War, a developed country belonging to the Organisation for Economic Co-operation and Development (OECD) has decided to take a clear step backwards on the issues of opening borders and labour mobility. That said, it is important to take a minute to grasp the underpinnings of this decision, the next steps that can be expected, and the impacts most likely to result.

The issue of staying in or leaving the European Union (EU) is not a new one for the English. Since the United Kingdom joined the big European family in 1973, politicians have been declaring their opposition to regulations, the loss of sovereignty, and the costs related to the administration of this entity. The topics of labour mobility and immigration were recently at the heart of the debates, in light of the rise in radicalization in the Middle East and the multiplication of terrorist acts in Europe. Nor can one ignore the increase in income inequality within the population, a widespread phenomenon in the developed countries that is helping to sow mistrust toward institutions (on this front, a parallel can easily be drawn with the rise in popularity of Donald Trump in the United States, who seduced a large part of the electorate with his protectionist discourse, sowing division). The subject had become a major electoral issue for Mr. Cameron during the 2015 election, leading him to promise a referendum on the issue if elected.

The result of the vote revealed significant divisions between the different age groups (older people preferring to leave, young people preferring to stay) and from one region to another. Scotland (which just had its own referendum on whether or not to stay in the United Kingdom) and Northern Ireland both voted massively in favour of staying in the EU, and are now considering consulting their respective populations on the idea of leaving the U.K. to remain in the EU! Scotland's first minister has even said her parliament could block the Brexit project by not giving its consent. In short, on the political front, we are entering a climate of great uncertainty that could last months, maybe even years.

The next logical steps that have to be taken are known, however. First, the United Kingdom will have to invoke, before the EU, article 50 of the Treaty of Lisbon, which calls for a two-year period of negotiations should a member country

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Chart 2
Market Returns as at June 30, 2016

Index	Returns (%)	
	3 months	YTD
FTSE TMX Canada 91 day Tbill Index	0.1	0.3
FTSE TMX Canada Universe Bond Index	2.6	4.1
S&P/TSX Composite Index	5.1	9.8
S&P 500 (Can. $)	2.8	(2.4)
MSCI - EAFE (Can. $)	(1.2)	(10.2)
MSCI - World (Can. $)	1.3	(5.4)
Exchange Rate (Can. $ / US $)	0.3	(6.0)

Chart 3
Market Returns as at June 30, 2016

Index	Returns (%)	
	3 months	YTD
S&P/TSX Sector Returns		
Energy	9.5	19.3
Materials	26.9	52.3
Industrials	1.2	5.3
Consumer Discretionary	(2.9)	0.1
Consumer Staples	(4.1)	2.7
Health Care	(15.3)	(72.3)
Financials	1.3	5.1
Information Technology	(5.9)	(5.7)
Telecommunication Services	3.0	14.8
Utilities	7.0	17.3
S&P/TSX Composite Index	5.1	9.8

request to leave the group. Yet the best time to trigger the exit process is still to be determined: some people are advocating to move quickly, others suggest waiting until the election of a new government in the fall, while still others want to wait even longer to carefully weigh all the ins and outs. Once the process is triggered, the United Kingdom and the European Union will have to agree on a (or several) new trade agreement(s), all depending on the willingness of the two parties to maintain close economic ties or not. Here again, it is difficult to anticipate the outcome. The possibilities run from an agreement very similar to the current one but including tougher measures on immigration, to a complete rupture of ties, forcing the United Kingdom to renegotiate its trade agreements one by one.

The biggest risk to consider is undoubtedly the spread of this nationalist movement across Europe, which is seeing the growth of more and more parties that are taking firm positions on closing borders and on protectionism. Spain, where these positions are relatively popular, held an election in the days following the English vote, and the result showed that the population did not stand behind the separatist leaders. The year 2017 will still be busy, with elections in the Netherlands (in March), in France (in April) and in Germany (in August), during which the issue of staying in the EU or not will likely be debated.

In terms of the economic and financial impacts, things are still uncertain, but we can make some assertions.

Firstly, this event is in no way comparable to the Lehman Brothers bankruptcy, which led to the financial crisis of 2008. Banks around the world are well capitalized and the credit transmission belt will continue to function fully.

Secondly, the risks of a correction similar to "Black Monday" are very low, since the stock markets did not boast high valuations during the event, but rather a certain complacency toward the results, despite the polls showing the two sides neck in neck.

Thirdly, the United Kingdom is probably heading into a recession, but its economic size represents only 2% of the world economy. Europe will likely experience a generalized lack of confidence and a decline in business investment, but it will probably avoid a recession.

Fourthly, North American exporters shouldn't suffer too much given that exports to the United Kingdom represent only 3% of total exports.

Lastly, the dynamics of the oil market should not in any way be affected seeing as the growth in demand will continue to come primarily from the emerging countries.

Our conclusion is that this event will undoubtedly take up a great deal of space in the news in the coming months and years, and that it is difficult to assess the consequences at this time. We are entering political territory as yet unexplored. It will probably be filled with new developments, keeping the markets on their toes; and the markets, as we saw the day after the vote, do not appreciate nasty surprises.

United States: Tightening of the labour market?

Despite a rather slow start to the year, the economic data generally improved in the second quarter. Consumers continued to do well, bolstered by a substantial increase in earnings in the last few years from the job market, the financial markets, and a rise in real estate prices. Of course, the issue of income inequality remains omnipresent, but consumer confidence ended the quarter at an eight-month high (Graph 4), and in April, household spending saw its sharpest month-over-month increase since 2009 (Graph 5).

The latest estimates point to rather low annualized growth of the GDP in the first quarter, at 1.1%, and roughly 2.5% in the second quarter, which is above the long-term growth rate.

Yet what unquestionably marked the quarter was job creation in May, which plummeted to 38,000 new jobs, well below the moving average of the last six

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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**	**7.5%**	**+2.5%**	**-1.0%**
Gold (ingot)		**0**		**4.0%**	**+4.0%**	**0.0%**
Canadian Bonds	20	45	70	23.0%	-22.0%	-0.5%
International Bonds	0	0	15	0.0%	0.0%	0.0%
Total – Bonds	**20**	**45**	**70**	**23.0%**	**-22.0%**	**-0.5%**
Canadian Equities	**5**	**25**	**45**	**36.5%**	**+11.5%**	**-2.5%**
U.S. Equities	0	12.5	45	12.5%	0.0%	-0.5%
International Equities	0	12.5	45	14.5%	+2.0%	+4.5%
Emerging Markets	0	0	45	2.0%	+2.0%	0.0%
Total – Foreign Equities	**5**	**25**	**45**	**29.0%**	**+4.0%**	**+4.0%**
Total – Portfolio		**100**		**100.0%**		

months of 170,000 jobs (Graph 6). This had a severe impact on the markets, suddenly reducing the chances of a rate hike by the Fed this summer, and even by the end of 2016.

It is important to note that May's survey took place during a large strike, now over, at Verizon, an American telecommunications company and major employer for our southern neighbours, subtracting some 35,000 to 40,000 jobs from the survey.

A few more months of data will be required before we can draw a conclusion about the current state of the job market. Is this a sudden and significant slowdown in job creation, or is it a statistical anomaly? Many people believe the job market will become tighter, as the unemployment rate is now below 5%, but we believe this slowdown occurred too quickly to jump to any alarmist conclusions.

Our concern instead is the weakness in business investment, which seems to be a reflection of the general lack of confidence in the economic outlook. Corporate profit margins reached a 60-year high over the last few years (Graph 7), but profits were returned to investors through dividends and stock redemptions rather than being invested in labour productivity. We are therefore now in a situation where profit margins are narrowing as a result of massive hiring over the last few years combined with small but constant hourly wage increases, while work productivity has slackened to its slowest pace in 65 years (Graph 8).

We can therefore expect the U.S. economy to grow at a slower pace in the coming years than in the previous decade if household consumption is to remain the only engine functioning at full throttle on this big ship.

Canada: Forest fires and loss of momentum

The second quarter of the year was a difficult one for the Canadian economy, with major forest fires in Fort McMurray, the heartland of the Canadian oil industry. At one point, 1.2 million barrels of daily production were offline, out of a total capacity of about 4 million barrels per day. The country's GDP growth will necessarily be negatively affected (the Bank of Canada estimates a negative impact of about 1.25% for the second quarter, bringing its previous forecast of 1% annualized growth down to a 0.25% contraction, see graph 9). However, the effects should reverse themselves in the second half of the year as oil producers make up for the lost time, resulting in an overall impact of close to zero for the year 2016 as a whole.

The main point to watch for the Canadian economy is, as we expressed in the last quarter, the economy's transition from the energy sector to the manufacturing sector. On this front, we remain cautious toward the success of this transition, while still being optimistic, in light of the loss of momentum in job creation in the manufacturing sector at the beginning of the year (Graph 10). In fact, a simple look at the data from Statistics Canada shows that all the gains made in 2015 were erased at the beginning of 2016 (optimists will note fresh gains in May, but it is too soon to identify a new upward trend).

The outlook for the Canadian economy is therefore positive, supported by a currency now 30% more affordable than it was in 2013 when it was trading at parity with the U.S. dollar. We will maintain a cautious attitude for as long as necessary until genuine momentum, including significant investments in production capacity in the manufacturing sector and a sustained increase in hiring in goods production, is clearly felt.

Financial markets: Positive returns sprinkled with volatility

The English vote on June 23 clearly stole the show on the financial markets in the second quarter, especially considering the violent reaction on world stock markets the day after the result: $2 trillion ($2,000 billion!) of stock market capitalization was erased in a single day, a historic record. Although this amount stuns the mind, especially since the reaction following the Lehman Brothers bankruptcy in 2008 was not as big in terms of dollars (global market capitalization being lower at the time), one must be cautious in drawing parallels between the two events.

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Chart 5
Estimated Gross Returns for the Next 12 Months Starting on June 30, 2016

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	3.04%	+	(4.55%)	=	(1.51%)
Canadian stocks (S&P/TSX Composite Index) including dividends					8% to 11%

In the first place, U.S., Canadian and European banks are much better capitalized today than in 2008, and the credit market continues to function smoothly. Anyone wishing to obtain a mortgage at the end of June could make the request to their bank, regardless of their location, and any company seeking to access the corporate credit market could do so according to modalities that remain highly favourable in historical terms.

Secondly, it has been often repeated that there has almost never been a bear market (decline of more than 20%) in the U.S. without there being a recession at the same time (the exception was "Black Monday" in 1987, when the 20% drop took place in a single day!). The result of the vote could cause a recession in England, but let us remember that this country accounts for only 2% of world GDP (Graph 11) and buys only 4% of North American exports (Graph 12). The potential effects of economic contagion, in the case of a catastrophe scenario, are therefore very limited.

The strong reaction of the markets in the days following the vote can be explained primarily by the level of complacency present in the days preceding the referendum, especially in Europe. In the first half of June, the "Leave" camp was gaining in the polls, causing markets to dip; then a slight comeback of the "Remain" camp in the last week propelled the markets to new heights—all this despite the fact that polls were still showing both sides neck-in-neck! Since the markets detest negative surprises, all the gains achieved were wiped out in just one session. Not to mention the pound sterling, which plunged 10% at the news and posted the worst daily decline in its long history (the Bank of England has been printing the banknotes since its foundation in 1694).

The impact was of course not limited to European stocks. Market reaction was also negative (to a lesser degree) in North America, Asia and the emerging countries, and safe-haven assets such as bonds, gold and the U.S. and Japanese currencies all posted very positive returns. Calm returned to all markets in the final days of the quarter, but it is still too soon to say whether the Brexit effect is behind us.

Brexit has taken up so much space that the Fed, which had held most of the markets' attention in April and May, is discussed here only at the end. The ideal time for the Fed to begin raising its key rate is still an important variable for portfolio managers, and the Fed had tried as much as possible to provide some clarity to markets by repeating, in a series of statements made by members of the Federal Open Market Committee (FOMC), the decision-making body, that it expected to implement two or three rate hikes in 2016 and then three or four rate hikes in 2017. The jobs report for May, with its 38,000 jobs added (the lowest increase in six years) compared to expectations of 160,000, changed the situation, basically forcing the Fed to wait a few more months in order to make sure the job slowdown is merely cyclical, not structural.

Now that we know the decision of the British, and given the political uncertainty this will cause in Europe (in addition to the official launch of the U.S. election campaign that is at our door), we expect the Fed to remain on the sidelines until December, at the very least.

The Canadian bond market, measured by the FTSE TMX Universe Bond Index, continued its momentum with a gain of 2.6% in the second quarter, and 4.1% for the year to date. Short-term bonds were up 0.7%, while long-term bonds were up 5.5% for the quarter.

The U.S. stock market posted another positive return, with a small gain of 2.5% (2.8% in Canadian dollars) for the quarter. The Canadian stock market again posted one of the best performances in the world, with the S&P/TSX Composite Index up 5.1% (9.8% for the year to date) and the small-cap index climbing 17.9% (28.0% for the year to date).

The stock markets of Europe and Asia were all down again in the second quarter, as were all the emerging markets. The European market, represented by the MSCI - Europe Index, gained 1.2% (-2.0% in Canadian dollars), the MSCI - EAFE lost 0.7% (-1.2% in Canadian dollars) and the MSCI - World Index was up 1.3% (1.3% in Canadian dollars). Finally, the MSCI - Emerging Markets Index posted a gain of 0.8% (1.1% in Canadian dollars).

Strategy: Is there still room for gold in our strategy?

The stock markets continue to offer some interesting prospects, especially after the decline observed at the end of the quarter. The European market is trading at highly attractive multiples (Graph 13), but the uncertainty we are very likely to face on the political scene this summer and fall causes us to exercise caution before forging ahead for the long term, although the tactical opportunities the situation presents may be interesting.

This is in fact the strategy we adopted in June, when European stock market prices were pointing to a "Leave" victory despite the narrow polls. Within our diversified funds, we temporarily increased the weight of European equities, then sold most at a profit, before the results of the vote and after a rapid climb of nearly 10%.

Economic and Financial Environment (continued)

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Chart 6
Economic and financial scenarios

Economic scenario

							Change since March 31, 2016	
		2014	2015	2016	2017	2018	2016	2017
United States	Real GDP	2.4%	2.4%	2.2%	2.3%	2.1%	-0.3%	-0.3%
	Inflation rate	1.6%	0.1%	1.3%	2.3%	2.3%	---	+0.1%
	Unemployment rate	6.2%	5.3%	4.8%	4.6%	4.6%	---	---
Canada	Real GDP	2.5%	1.1%	1.7%	2.0%	2.2%	-0.3%	-0.4%
	Inflation rate	1.8%	1.1%	1.6%	2.0%	2.0%	-0.4%	---
	Unemployment rate	6.9%	6.9%	7.2%	7.0%	6.7%	---	---

Financial scenario*

			Targets			Change since March 31, 2016	
		Actual	Dec. 2016	June 2017	Dec. 2017	Dec. 2016	June 2017
Interest rate							
	U.S. 10-year rates	1.47%	1.90%	2.20%	2.50%	-0.35%	-0.40%
	Canada 10-year rates	1.06%	1.45%	1.70%	1.90%	-0.20%	-0.20%
Exchange rates							
	$US/$CAD	0.77	0.80	0.81	0.81	---	---
	$US/Euro	1.11	1.08	1.05	1.05	---	---
	Oil price (WTI). $US	49.21	52	55	55	+7	+5
	S&P 500	2,099	2,200	2,250	2,300	---	---
	S&P/TSX	14,065	14,500	15,200	15,500	---	---

* end of period

Just before the vote, despite our belief in a "Remain" victory, we opted to protect the capital in our funds by adding substantial exposure to the gold ingot, an asset class that, according to our expectations, would heavily profit from any negative surprise in the case of a "Leave" victory. The reaction of the price of gold was as we expected, but is it still appropriate to hold gold within a diversified portfolio?

We are of the opinion that yes, the conditions are still in place to support the price of gold over the coming months, primarily for two reasons. Firstly, the price of gold usually benefits from climates of uncertainty. Secondly, the reaction of monetary and fiscal authorities, which could inject even more stimuli into the world economy, could have the effect of maintaining world interest rates at even lower levels, further reducing the opportunity cost of holding gold. In short, it is important to stay flexible and avoid falling in love with one asset class in particular, but we continue to see good reasons to keep gold within our diversified funds.

In addition, we are maintaining an active strategy of currency hedging, taking into account the close relationship that exists between the Canadian dollar and the price of oil.

We have again maintained a strategy of staying overweight in equities in the second quarter, and seized several opportunities provided by the markets' volatility. Canadian equities now make up 36.8% of the Diversified Fund, including 7.5% in small-cap stocks. International equities now represent 24.1% of the assets.

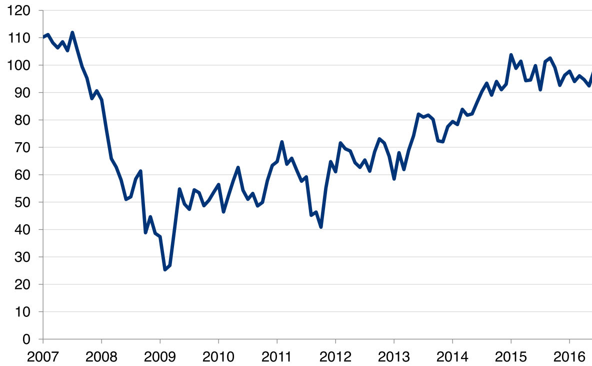
The weight of bonds remains below the target, at 23% versus a target of 45%, a level slightly below that of the previous quarter.

The cash balance now accounts for nearly 8.0% of the fund's assets, and we no longer hold any direct exposure to the U.S. dollar.

During the quarter, we maintained almost constant direct exposure to the price of gold, through forwards and futures contracts on the price of gold bullion and exchange-traded funds (ETFs) containing gold stocks. We also added a broader exposure to natural resources, through ETFs holding resource futures or stocks of companies operating in various resource sectors.

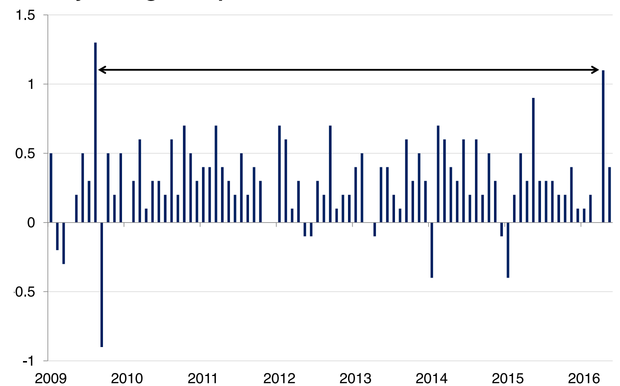
Graph 4

U.S.: Consumer confidence at an 8-month high in June
Conference Board survey



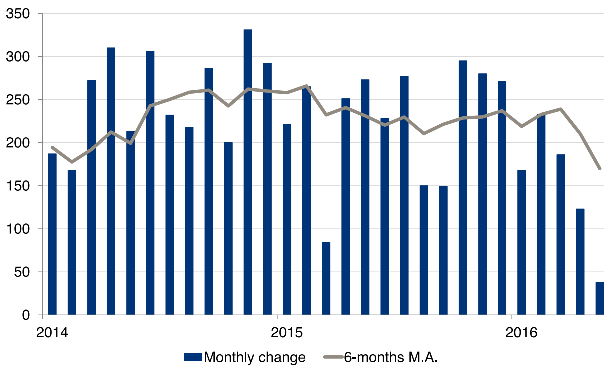
Graph 5

U.S.: Monthly growth in personal spending at a 7-year high in April



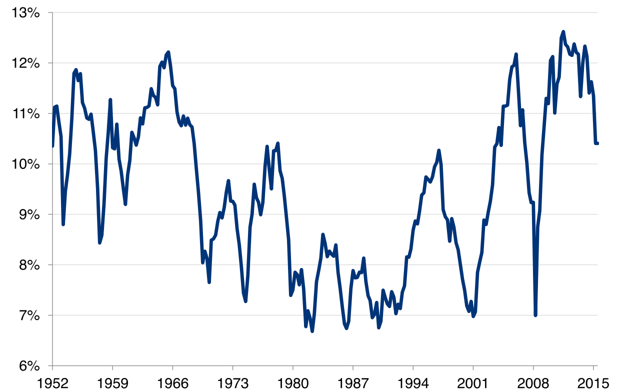
Graph 6

U.S.: Monthly change in Non-Farm Payroll Employment
000s



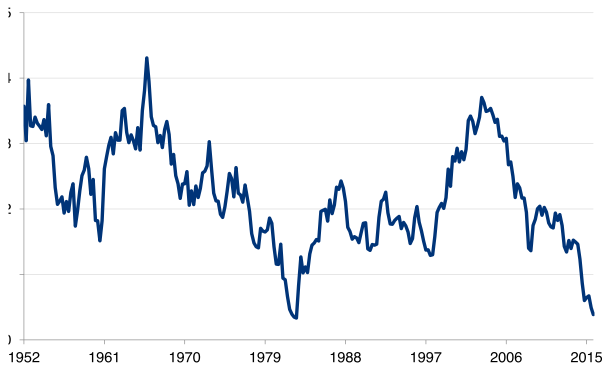
Graph 7

U.S.: Profit margins under pressure
Corporate profits as a % of GDP



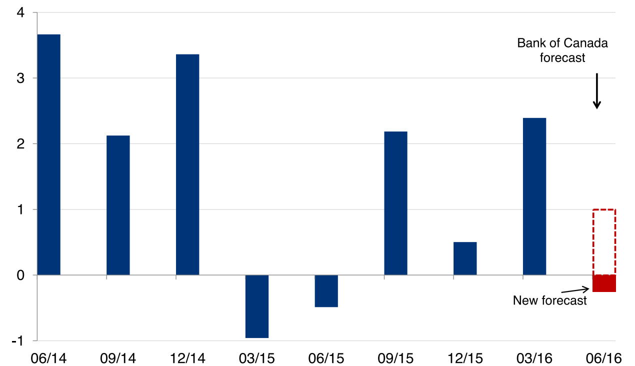
Graph 8

U.S.:
The lowest productivity growth in decades
Annual productivity growth (%), 5-year M.A.



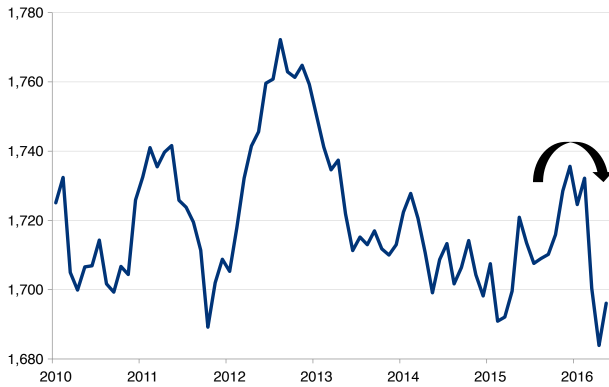
Graph 9

Canada: Impact of Fort McMurray wildfires on Q2 GDP growth
Quarterly GDP growth, SAAR, %



Graph 10

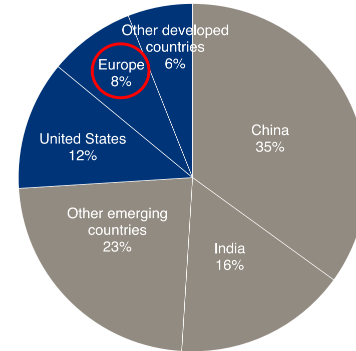
Canada: Manufacturing sector recently shed all the jobs gained in 2015



Graph 11

Europe's contribution to global economic growth is less than 10%

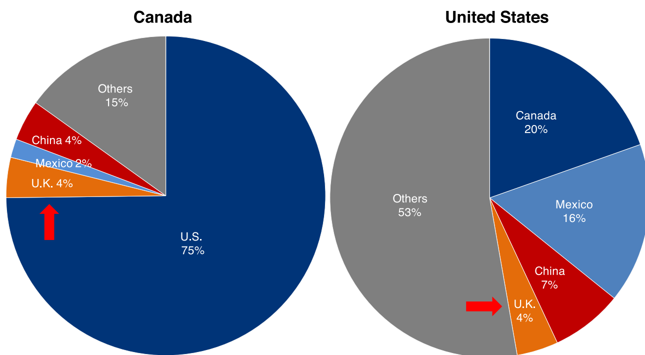
Estimated relative contribution of countries to global GDP growth in 2016



Graph 12

Brexit: The impact on North America's exports should be low

Exports by country, in % of total exports



Graph 13

Equities: The European stock market trades at a relative discount

Forward Price/Earnings ratios