Economic and Financial Environment

As at December 31, 2016

Dawn of the Trump era

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The year 2016 was one of political surprises. First, English citizens surprised the world by voting to leave the European Union, which remains one of the biggest socioeconomic projects of the modern era; then it was the Americans' turn, electing as their leader Donald Trump, a flashy billionaire with no political experience. Looking out to the next four years, a fair amount of economic uncertainty lies ahead, given the protectionist tone espoused by Donald Trump during his electoral campaign. Prosperity of the Canadian model depends largely on its commercial ties with the United States, and the fate of NAFTA (North American Free Trade Agreement), a significant driver of economic growth since 1994, is now at stake. Relations between the U.S. and China, the world's two largest economies, have been turned upside down even before the new president has taken office, foretelling a turbulent time on the geopolitical scene. And the potential for conflicts of interest for Mr. Trump, who holds a vast real estate empire spread over several countries, is making a number of political observers anxious.

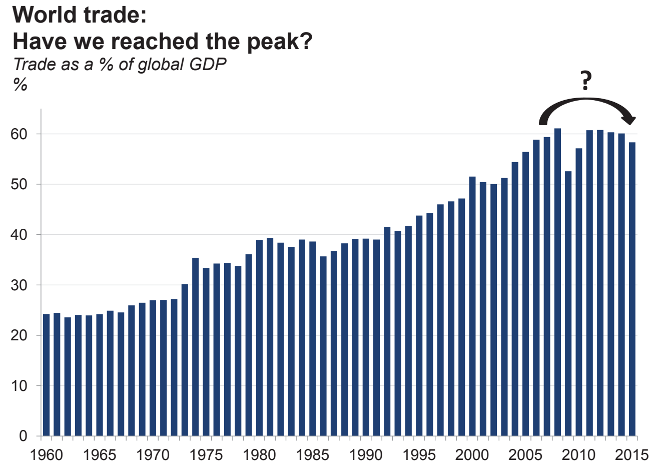
For the moment, the financial markets seem to be applauding the arrival of Mr. Trump. Some are even going so far as to say that his arrival will waken the appetite for risk and the enthusiasm of American entrepreneurs. For the moment, it is difficult to form a clear picture of what the next four years will look like; we therefore prefer to adopt a cautious attitude in the face of all this uncertainty.

World: A return to protectionism?

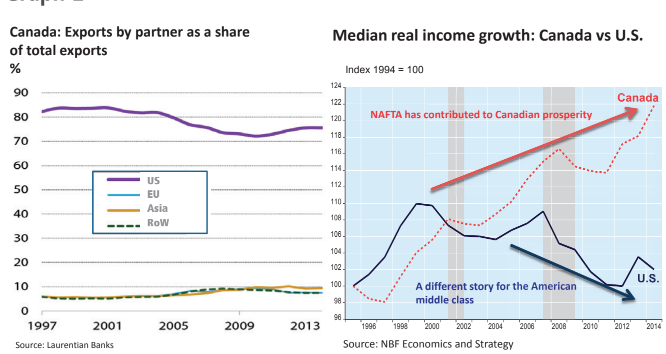
The election of Donald Trump to the White House will in all likelihood have repercussions on world trade, judging from the protectionist tone adopted by the president elect during his campaign.

The era of globalization began in the early 1970s, when the industrialized countries gradually migrated a large part of their goods production that was not capital intensive to developing countries (the classic example being the textile industry, which practically abandoned North America for Asia). Trade jumped from 25% of world GDP in 1965 to more than 60% at its peak in 2008 (Graph 1). In fact, trade links grew at such a speed that it became one of the main drivers of the world economy for the last 40 years, in conjunction with the arrival of baby-boomers on the job market and technological advances in computerization.

Graph 1



Graph 2



The major trade agreements of the past, including the NAFTA, brought significant changes to the industrial structures of the developed countries. China's accession to the World Trade Organization (WTO) in 2001, meanwhile, was a key factor in the dramatic rise of the importance of trade as a driver of growth. However, an analysis of the previous graph suggests that the importance of trade within the world economy has already peaked since the crisis of 2008, and that international trade now comprises a smaller portion of the economic pie.

Some observers suggest that we simply reached the limits of the integrated world assembly line, while others point to the political weight of the middle class which saw economic growth accelerate without having benefited from it (according to data compiled by French economist Thomas Piketty, the purchasing power of the American middle class is currently 8% *less* than what it was at the start of the 1970s). Yet one thing stands out from the English vote for Brexit in June and the U.S. election in November: the protectionist nerve of the middle class within the developed countries is increasingly sensitive, and this will naturally be reflected to a greater and greater degree in the economic policies of the industrialized countries.

Europe: At the dawn of a pivotal year

The referendum held at the beginning of December to modify the Italian Constitution ended in a victory of the "no" vote and the resignation of Matteo Renzi as Prime Minister. The referendum result was not really a surprise, given the polls that showed a clear advantage of the "no" side. The year 2016 was therefore the year of fruitless referendums in Europe, and the year 2017 is promising to be as loaded on the political scene, since both France and Germany, pillars of the European Union, will hold general elections.

As at December 31, 2016

First it will be France's turn to hold a presidential election in April and May, during which a new president will be elected, since outgoing president François Hollande will not be running again. While it is too soon to take opinion polls into account, the anti-European message put forth by the Front National, led by Marine Le Pen, presents a clear risk to the European project.

Then, it will be Germany's turn to go to the polls to elect its government in October. Angela Merkel, in power since 2005, will seek a new mandate despite a difficult year in 2016, marked by a drop in her popularity as well as several setbacks in the regional elections.

United States: The Trump era begins

We can say it was the event of the year 2016: Donald Trump was elected as the 45th president of the United States in the November 8 election, and will enter office on January 20, 2017. The result of the election came as a surprise, given that polls showed Hilary Clinton as the leading candidate right up until the end.

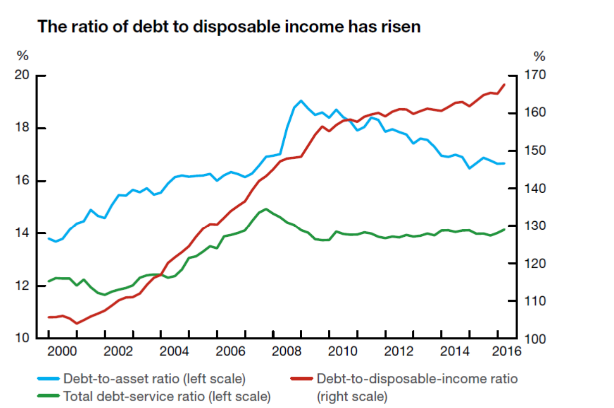
The United States (and the world!) is therefore getting ready to enter the Trump era, which will likely be anything but boring, given the unpredictable and impulsive nature of Mr. Trump, who does not hold back from commenting on the news, international relations, or even imitations by comedians on the U.S. TV show *Saturday Night Live* via his Twitter account.

But beyond the character, what matters to investors is the nature of the economic policies that the new administration intends to implement, and which consist of three main lines of action.

Firstly, the biggest action is aimed at tax rates. Mr. Trump proposes to reduce income taxes for individuals and businesses, which should very quickly have an expansionary effect on the U.S. economy. The most interesting proposal is that of reducing the corporate tax rate from 35% to 15%, thereby encouraging companies to invest and to hire more people.

In terms of individual tax rates, the picture is not as clear. The fiscal plan put forth by the Trump team aims to lower taxes for all tax brackets, but it would mostly be

Graph 3



Sources: Statistics Canada and Bank of Canada calculations

Last observation: 2016Q2

Chart 1
Returns of the Canadian Bond Market as at December 31, 2016

Index	Returns (%) 3 months	YTD
FTSE TMX Canada Universe Bond Index	(3.4)	1.7
FTSE TMX Canada Short Term Bond Index	(0.5)	1.0
FTSE TMX Canada Mid Term Bond Index	(3.1)	1.6
FTSE TMX Canada Long Term Bond Index	(7.5)	2.5
FTSE TMX Canada Federal	(3.3)	0.0
FTSE TMX Canada Provincial	(4.9)	1.8
FTSE TMX Canada Municipal	(3.9)	2.0
FTSE TMX Canada Corporate	(1.8)	3.7

Source: Scotia Capital Debt Market Indices

the (very) rich who would benefit from a substantial reduction in their tax bill. For some groups in the middle class, the elimination of deductions could even increase their tax burden. At the end of the day, more money will stay in U.S. taxpayers' pockets, which should stimulate consumption and, therefore, economic growth, but the impact could be less significant than expected.

Secondly, the Trump team proposes to invest in infrastructure, primarily in the sectors of transportation, drinking water, telecommunications and national security. The model put forth would be implemented through public-private partnerships, encouraging companies to assume responsibility for major portions of the projects. This policy will also be expansionary, but the benefits, as we are currently seeing in Canada, will likely take 12 to 18 months to manifest themselves.

Finally, the third major line of action is that of protectionism. While the first two lines of action are clearly of an expansionary nature, it is difficult to see how closing borders can stimulate economic growth.

True, some sectors of activity (primarily the manufacturing sector) could be rekindled from their ashes should the Trump administration decide to impose major customs tariffs on products coming from China and Mexico, but this creation of jobs would be offset by a direct and immediate increase in inflation, such that the gains would be financed by higher prices nationwide.

Moreover, it would be unrealistic to believe that an imposition of customs tariffs by the U.S. would not be met with reprisals from its trading partners, thereby harming other American exporting industries that depend on trade relations with these markets.

We will therefore be watching a game of tug-of-war over the next few years, as international relations management takes on a critical role in determining whether or not the Trump team's expansionary plan succeeds.

For our part, we have some reservations about the scope of the impact that this expansionary plan might have, even if all goes well. A number of observers have compared Donald Trump's arrival to that of Ronald Reagan, and although the

As at December 31, 2016

Chart 2
Market Returns as at December 31, 2016

Index	Returns (%) 3 months	YTD
FTSE TMX Canada 91 Day T-Bill Index	0.1	0.5
FTSE TMX Canada Universe Bond Index	(3.4)	1.7
S&P/TSX Composite Index	4.5	21.1
S&P 500 (Can. $)	6.3	8.6
MSCI - EAFE (Can. $)	1.6	(2.0)
MSCI - World (Can. $)	4.3	4.3
Exchange Rate (Can. $ / US $)	2.4	(3.0)

Chart 3
Market Returns as at December 31, 2016

Index	Returns (%) 3 months	YTD
S&P/TSX Sector Returns		
Energy	7.0	35.5
Materials	(6.2)	41.2
Industrials	5.3	22.8
Consumer Discretionary	1.5	10.7
Consumer Staples	(1.5)	7.5
Health Care	(28.6)	(78.5)
Financials	11.5	24.1
Information Technology	(0.5)	5.2
Telecommunication Services	(2.8)	14.7
Utilities	(0.4)	17.7
Real Estate	0.1	-
S&P/TSX Composite Index	4.5	21.1

latter did indeed succeed in relaunching economic growth in the early 1980s, in our view, the contexts, and the most likely results, are very different.

Mr. Reagan entered office on the heels of two short recessions that had pushed the unemployment rate up to nearly 8%. The debt-to-GDP ratio was 30%, the highest marginal tax rate was around 70%, and the first baby-boomers were just 34 years old.

Mr. Trump, however will be taking office after seven full years of economic expansion, with an unemployment rate below 5% (and probably below the level of full employment), a debt-to-GDP ratio exceeding 75%, an upper marginal tax rate below 40% and, a particularly aggravating factor, with baby-boomers now leaving the labour force in droves. In the current context, while the proposed policies appear similar, their potential to bolster growth is greatly reduced. With such a large part of excess capacities absorbed, the majority of the impact is likely to be felt mostly in terms of inflation.

Regardless, as we reported in the last quarter, the desire of Donald Trump to use the fiscal tool to support growth constitutes a major change in the cards for world central banks. After several years during which monetary policy bore the weight of supporting economic growth, and after several calls for help by the central banks to the world's leading governments, the first world economy is answering the call and getting ready to take up the relay of supporting growth. This acknowledgment alone has had a direct effect on the markets' expectations of world monetary policies and, incidentally, on interest rates.

Canada: What will become of NAFTA?

The U.S. election result will undoubtedly have significant ramifications for the Canadian economy, given the close trading ties between the two countries. Not only is the United States the primary destination for Canadian exports (about 75% of our exports go there), but Canada is also the primary destination for U.S. exports, accounting for nearly 20% of the market share.

That's why the protectionist discourse adopted by Donald Trump, who has repeated several times that he wants to renegotiate NAFTA, is attracting the attention of Canadians. Although his comments are clearly aimed at Mexico, a renegotiation of the most important trade agreement Canada has ever signed would nonetheless have a major impact on Canadian businesses and consumers, since it is hard to imagine our country ending up in a better position than it currently enjoys.

The reason why NAFTA is so important for Canadians is simple: Canada ranks as one of the top countries within the Organisation for Economic Co-operation and Development (OECD) when it comes to the redistribution of wealth. Therefore, unlike the United States, where the benefits of opening up borders were directed mostly toward the rich (holders of capital), our fiscal system is such that the average Canadian household has seen its purchasing power increase steadily since ratification of NAFTA in January 1994 (Graph 2). Consequently, it is in the interest of Canadian households that our businesses keep this privileged access to the largest consumer market on the planet.

Mr. Trump's team has stated that the protectionist shift will be one of its priorities within the first 100 days of its mandate. This means we will probably get a foretaste of the fate of NAFTA within the first quarter of 2017.

On the domestic front, the Vancouver and Toronto real estate markets continue to make the news, as well as household debt which, by some measurements, is worsening. In fact, in its December 2016 *Financial System Review*, the Bank of Canada (BoC) highlighted these two factors—high levels of indebtedness and housing market imbalance—as two key vulnerabilities in the Canadian financial system.

The fourth quarter also saw new macroprudential measures aiming to tighten home financing rules and to ensure Canadians' long-term security. In addition to measures imposed by federal and provincial authorities, the City of Vancouver went forward with an annual tax on unoccupied homes (non-principal residences) at a rate of 1% of the property's appraised value, to come into effect in 2017. For the moment, Vancouver's resale market seems to have lost some of its steam, but

As at December 31, 2016

Chart 4
Asset mix: Diversified Fund (040)

	Min.	Neutral	Max.	Actual Weight	Over Weight (+)/ Under Weight (-)	Change in quarter
Money Market	**0**	**5**	**25**	**6.0%**	**+1.0%**	**--**
Gold (ingot)		**0**		**0.0%**	**0.0%**	**-2.0%**
Canadian Bonds	20	45	70	28.0%	-17.0%	+3.0%
International Bonds	0	0	15	8.0%	+8.0%	-0.5%
Total – Bonds	**20**	**45**	**70**	**36.0%**	**-9.0%**	**+2.5%**
Canadian Equities	**5**	**25**	**45**	**34.0%**	**+9.0%**	**+2.0%**
U.S. Equities	0	12.5	45	10.0%	-2.5%	-7.0%
International Equities	0	12.5	45	14.0%	+1.5%	+4.5%
Emerging Markets	0	0	45	0.0%	0.0%	--
Total – Foreign Equities	**5**	**25**	**45**	**24.0%**	**+8.0%**	**-2.5%**
Total – Portfolio		**100**		**100.0%**		

the Torontonian market is still over-heating, reflecting an insatiable demand by immigrants converging on the Greater Toronto Area.

Household indebtedness, typically measured as the ratio of household debt to disposable income, continues to climb (Graph 3). Of increasing concern to the Bank of Canada, however, is the distribution of the debt, since the proportion of households considered heavily indebted (loan-to-income ratio exceeding 450%) continues to grow in many Canadian cities, especially west of Ottawa.

We believe that a more accurate picture of household debt is provided by the debt-to-asset ratio, which has in fact been declining steadily since its peak in 2008. Yet we must not become complacent, since the vulnerability of the most indebted households could be exacerbated by the recent increase in interest rates.

On the job front, the year 2016 was beneficial for Ontario, Quebec and British Columbia, where 71,500, 69,100 and 55,400 jobs were added, respectively, in the first 11 months of the year (Graph 4). The rest of the country, meanwhile, shed more than 35,000 jobs. As a result, in November, the province of Quebec recorded the lowest unemployment rate in its history, at 6.2%, just ahead of Ontario (6.3%) and just behind British Columbia (6.1%).

On the other hand, the reality is that all the jobs created were part-time, and that full-time employment actually shrank by more than 20,000 jobs over the same period. The number of jobs in the goods sector also fell, making service-related sectors the drivers of employment.

Thus, although the decline in the Canadian dollar since 2014 is still not being felt in the nature of jobs created in the country, the three provinces that we expected to benefit from the loonie's weakness saw significant growth in their labour markets this year.

Financial markets: Generalized absence of fear

The year 2016 unfolded in a state of relative calm, with the exception of course of the first six weeks of the year, when investors started to anticipate a world recession in reaction to the dramatic decline in the price of oil.

As in the third quarter after the Brexit vote, the stock market quickly absorbed the surprise shock caused by the election of Donald Trump. In fact, some like to say that the markets got over the news of the Brexit vote in just three days, and of the U.S. election in just three hours. This statement is close to the truth, since shortly after the markets opened on November 9, U.S. indexes began climbing again and did not look back until the end of December.

In fact, a major sectoral rotation took place the day after the vote (Graph 5), led by an upsurge in the sectors of finance (in reaction to deregulation expectations for banks), energy (expectations of deregulation for U.S. oil producers), industry and materials (infrastructure spending program). On the other end of the spectrum, defensive sectors such as utilities and consumer staples were down, given the increased appetite for risk and the upward revision of expectations of economic growth and inflation.

A notable collateral effect of this marked rotation in investors' positioning was that the VIX volatility index, a barometer for the level of market fear, once again fell to nearly historic lows. This meant that the cost of buying protection against a sudden drop in the markets, which for the moment seem to be integrating only the potential good news that will result from the Trump era, also fell to historically low levels.

But it was on the bond market that the reaction was most pronounced. Worldwide, November 8 came to be the breaking point for interest rates. In decomposing the interest rate levels (see the decomposition of U.S. 10-year rates in graph 6), we can see a general revision of expectations toward both inflation and the monetary policies of the major central banks, captured by the "term premium" factor, indicating that the markets now expect the U.S. Federal Reserve, among others, to tighten financial conditions.

As at December 31, 2016

Chart 5
Estimated Gross Returns for the Next 12 Months Starting on December 31, 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	3.10%	+	(0.90)%	=	2.20%
Canadian stocks (S&P/TSX Composite Index) including dividends					8% to 12%

What also emerges from this analysis, quite interestingly, is that expectations for economic growth over the next 10 years were not revised upward, despite the expansionary character of the policies proposed by Donald Trump.

Finally, the agreement signed by the Organization of the Petroleum Exporting Countries (OPEC) in November, to which some non-OPEC countries have also subscribed, including Russia, pushed the price of oil above $50 per barrel at the end of the year, and we now expect the price to move within a range of $50 to $60 in 2017. Restoration of the market balance should take place gradually during the year, and it is therefore likely that the price will move only very slowly toward the upper end of this range.

This of course has implications for the Canadian dollar, which could remain under pressure for the beginning of the year given the uncertainty surrounding the future of NAFTA and the discrepancy in the direction of Canada and U.S. interest rates, considering the message of the BoC, which has repeated that it does not intend to follow the Fed's lead but to stay on the sidelines for the coming year. We may therefore have to wait for the second half of 2017 before we see the Canadian dollar climb up toward 80 cents.

The Canadian bond market, measured by the FTSE TMX Universe Bond Index, took a major hit in the fourth quarter, down 3.4%, reducing the annual return to 1.7% for 2016. The FTSE TMX Canada Short Term Bond Index was down 0.5% (a 1.0% gain for 2016), while the FTSE TMX Canada Long Term Bond Index lost 7.5% during the quarter (a 2.5% gain in 2016).

The U.S. stock market, represented by the S&P 500 Index, posted a strong quarterly return, up 3.8% (+6.3% in Canadian dollars) bringing the total annual return to 12.0% (8.6% in Canadian dollars). The Canadian stock market also did well, with the S&P/TSX Composite Index gaining 4.5% (21.1% in 2016).

Stock markets in Europe and Asia also posted gains in the fourth quarter, unlike the emerging markets. The European market, represented by the MSCI - Europe Index, was up 5.4% (2.0% in Canadian dollars), the MSCI - EAFE Index climbed 7.1% (1.6% in Canadian dollars) and the MSCI - World Index gained 4.8% (4.3% in Canadian dollars). Finally, the MSCI - Emerging Markets Index fell 1.4% (-1.8% in Canadian dollars). Returns for the year 2016 were therefore 7.2% for the MSCI - Europe Index (-2.8% in Canadian dollars), 5.3% for the MSCI - EAFE Index (-2.0% in Canadian dollars), 9.0% for the MSCI - World Index (4.3% in Canadian dollars) and 10.1% for the MSCI - Emerging Markets Index (8.3% in Canadian dollars).

Strategy: First and foremost, protection of capital

For a second quarter in a row, we have adopted a strategy of protecting capital. The stock market's reaction following the presidential election in November took us by surprise, given the already high valuation of stock markets at the time and all the geopolitical risks that could arise following Donald Trump's entrance to the White House. The U.S. market seems to have already integrated all the potential good news while dismissing the risks (protectionist reprisals affecting American multinationals, political conflict between the U.S. and China, excessive strength of the U.S. dollar and failure in the implementation of the economic policies proposed by Mr. Trump, to name just a few).

Given this context of high stock market valuations combined with a historically low cost of protection, we have maintained a defensive investment strategy: a neutral to overweight position in the stock markets (so as not to watch the parade go by) while purchasing an insurance policy by means of index put options. In this way, our portfolios benefit from most of the upward movement of the markets, while being largely protected against any downward movements. The cost of this protection does affect fund returns, since the markets are still going up and showing low volatility, but it could become one of our best investments should the markets suddenly decline or volatility reappear.

As for the bond portion of our funds, we took advantage of the recent rise in interest rates to reduce our underweight position, while maintaining a bias toward provincial and high-quality corporate bonds. It is difficult to anticipate the short-term trajectory of interest rates; however, we believe they will go up in the long-term.

Finally, we are maintaining a downward outlook for the Canadian dollar for the first half of 2017, for the reasons explained above. However, should there be a sustained increase in the price of oil, we could reinstate an active Canadian currency hedging strategy in order to protect the assets of portfolios denominated in U.S. dollars.

We remained overweight in equities for the fourth quarter, reflecting our large holding of sales options on the major indexes in which the funds under our management are invested (in effect giving us an asymmetrical risk profile). At the end of the quarter, Canadian equities accounted for 33.8% of the Diversified Fund, including 6.0% in small-cap stocks. International equities account for 24.4% of the assets.

The weight of bonds remains below the target, at 35.6% against a target of 45%. We took advantage of the rise in long-term rates since the November election to slightly reduce this underweighting.

Cash currently accounts for 6.2% of the fund's assets.

As at December 31, 2016

Chart 6
Economic and financial scenarios

Economic scenario

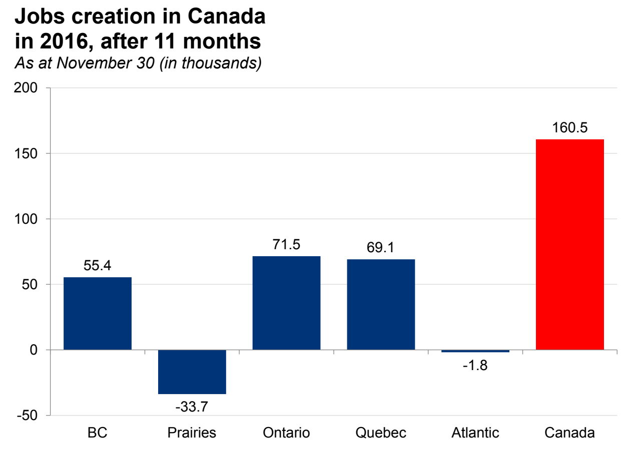
		2015	2016	2017	2018	2019	Change since September 30, 2016: 2017	Change since September 30, 2016: 2018
United States	Real GDP	2.6%	1.6%	2.2%	2.3%	2.2%	-0.1%	+0.2%
	Inflation rate	0.1%	1.3%	2.3%	2.4%	2.0%	+0.1%	+0.2%
	Unemployment rate	5.3%	4.9%	4.7%	4.6%	4.5%	+0.1%	--
Canada	Real GDP	0.9%	1.3%	1.8%	1.9%	2.0%	-0.1%	-0.1%
	Inflation rate	1.1%	1.5%	1.9%	1.9%	2.0%	-0.1%	--
	Unemployment rate	6.9%	7.0%	7.0%	6.9%	6.8%	+0.1%	+0.1%

Financial scenario*

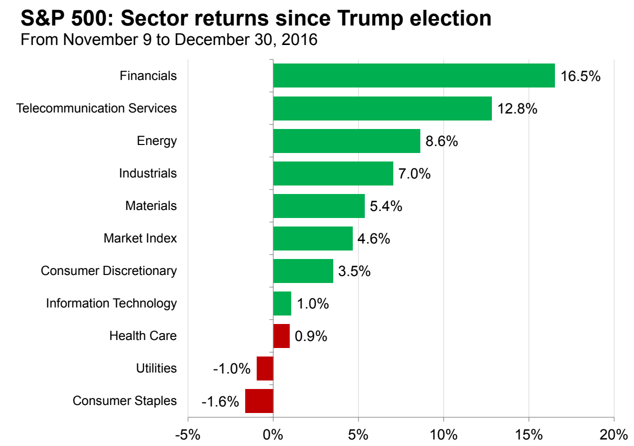
			Targets		Change since September 30, 2016	
	Actual	June 2017	Dec. 2017	June 2018	June 2017	Dec. 2017
Interest rate						
U.S. 10-year rates	2.45%	2.80%	3.00%	3.25%	+0.60%	+0.50%
Canada 10-year rates	1.72%	2.00%	2.20%	2.45%	+0.50%	+0.50%
Exchange rates						
US $/Can. $	0.74	0.72	0.77	0.8	-0.04	+0.01
US $/Euro	1.05	1.00	1.00	1.00	-0.10	-0.10
Oil price (WTI), US $	53.72	55	60	60	--	+5
S&P 500	2,239	2,300	2,355	2,425	+85	+95
S&P/TSX	15,288	15,950	16,580	17,225	+815	+1,110

* end of period

Graph 4



Graph 5



Graph 6