Economic and Financial Environment

As at June 30, 2017

Europe at the forefront

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The second quarter of 2017 is behind us, and stock markets are in a flat calm.

In the first six months of the year, the U.S. market, measured by the S&P 500 Index, posted a daily movement greater than 1% (either up or down) only four times, and no daily movement greater than 2% in absolute value (Graph 1). To illustrate the abnormality of this calm reigning over the financial world, consider that the average for the years 2009 to 2016 was 67 trading days with an upward or downward movement of more than 1% (with a peak of 117 in 2009), and 18 days of movements greater than 2% (with a peak of 55 in 2009).

The result of this subdued climate is that most of the world markets are posting positive returns, whether for stocks, bonds, gold, or other. Of course, the economic backdrop is quite positive, even ideal. There is economic growth worldwide, at moderate levels, and generally low inflation.

An air of predictability is therefore hovering above the asset classes, and good news is accumulating, especially in Europe and Canada.

The vigour of the Canadian economy is one of the big surprises of the year, and has pushed the Bank of Canada to revise its position: rate hikes are likely to be announced for the country very soon. Despite this positive backdrop, the Canadian stock market posted a return of nearly zero for the last six months. It should be said that the spectacular performance of the S&P/TSX Index in 2016 would be difficult to replicate, and that the Canadian market was probably ripe for a pause.

Our attention is currently directed toward Europe, where positive news abounds. The Old Continent's stock market delivered an enviable performance over the last six months, and we are of the opinion that considerable gains can be harvested by investing in Europe in the coming years.

Graph 1

Year	# of trading days > 1 %	# of trading days > 2 %
2009	117	55
2010	76	22
2011	96	35
2012	50	6
2013	38	4
2014	38	6
2015	72	10
2016	48	9
2017	4	0
Average 2009-2016	**67**	**18**

Source: RBC Capital Markets and iA Economics, as at June 30, 2017

World: The importance of China

China is continuing the gradual withdrawal of its massive fiscal stimulus plan, begun nearly two years ago. This vast plan aimed to stimulate credit (with China's major banks being mainly state-owned, it was easy for the Chinese administration to open the credit faucets to stimulate consumption and investment) and involved major infrastructure spending. Given the huge size of the Chinese economy, the plan resulted in a sharp increase in imports (Graph 2), drawing on the world supply chain. The effects are still being felt worldwide, with a synchronization of growth across all developed countries (Graph 3).

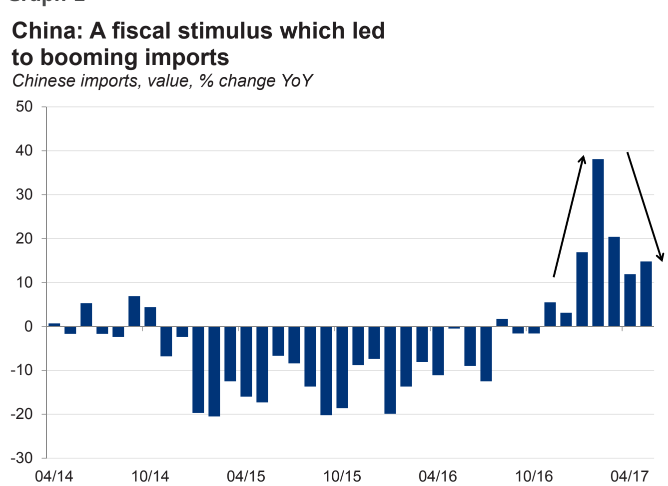
The Chinese administration's plan to stimulate short-term growth while attempting to limit excessive risk-taking appears to have born fruit. Following a strong boost at the end of 2016, the level of activity is gradually stabilizing at an enviable rate of growth. The real estate sector, which was recently a chief source of concern for observers of China, is also levelling off to a more sustainable pace.

The volatility of Chinese economic developments in large part explains the fluctuations in world interest rates, and in this respect, the world's second economy's recent stability in growth is welcome.

Meanwhile in Japan, which is still the world's third largest economy, growth remains slow and fragile. There is no need to look too far to explain the under-performance of the Japanese economy over the last two decades: the size of the working-age population has been dwindling for nearly 20 years (Graph 4), and there is nothing to suggest that these demographics will change in the medium term. We can therefore expect the words "Japan" and "slow growth" to go hand-in-hand for a while.

It is against this backdrop that the Bank of Japan is trying as best it can to stimulate economic growth and inflation, by maintaining a regime of negative interest rates, a quantitative easing program of monthly purchases of stock and bonds (in this regard, the Bank of Japan is straying into unknown territory, becoming in summer 2016 one of the 10 most important stockholders of 90% of companies listed on the Japanese stock market) and a target of 0% on interest rates for 10-year government bonds.

Graph 2



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For the moment, there is nothing indicating that these measures will succeed in sustainably stimulating inflation, which remains well below the 2% target. Core inflation, which excludes the more volatile components such as food and energy, is stuck in negative territory.

That's why the Bank of Japan is maintaining its course and continues to repeat—even as the U.S. Federal Reserve (the Fed) continues its monetary policy normalization plan and the European Central Bank slowly opens the door to normalization as well—that it's too early to even discuss the possibility of lifting its foot from the accelerator.

Europe: Encouraging outlooks

Good news is flourishing in Europe, where growth is now spreading convincingly to its periphery.

The performance of the European economy over the last 10 years has not been very convincing. In fact, The European Union (EU) slid back into recession in 2012 and 2013 and, at the time, it seemed like the German economy was the only engine. Like Japan, the EU is facing major demographic changes, with a contraction in the size of its working-age population since 2009, acting as a headwind to economic growth (Graph 5).

The EU was therefore in dire need of a spark to move it forward and provide some momentum.

The first spark came in fact from China, which trades a lot with the EU, allowing European companies to benefit from its fiscal stimulus plan. Fortunately, it was not only central European countries (France and Germany) that benefitted, but also the large majority of EU countries, thereby re-energizing the continent as a whole (Graph 6).

The second and perhaps even more significant spark may come from the political scene. The successive defeats of the populist parties in the Netherlands and France bode well, and suggest that the EU will avoid getting tangled in anti-European issues for the next few years. Just as importantly, Emmanuel Macron's resounding majority in the French election, accompanied by a strong majority of his En Marche party in June's legislative elections, will pave the way for future structural reforms in France.

Graph 3

Global PMIs

	May-17	Apr-17	Nov-16	May-16
Global	52.6	52.7	52.0	50.1
U.S.	54.9	54.8	53.5	51.0
Canada	55.1	55.9	51.5	52.1
Japan	53.1	52.7	51.3	47.7
U.K.	56.7	57.3	53.5	50.7
Euro Area	57.0	56.7	53.7	51.5
France	53.8	55.1	51.7	48.4
Germany	59.5	58.2	54.3	52.1
Italy	55.1	56.2	52.2	52.4
Spain	55.4	54.5	54.5	51.8

Expanding ≥ 52 52 > Neutral ≥ 50 Contracting < 50

Source: Markit, ISM, Haver, and RBC Capital Markets Note: U.S. ISM PMI, Markit PMI for all others; as of 6/1/17

Chart 1
Returns of the Canadian Bond Market as at June 30, 2017

Index	Returns (%) 3 months	YTD
FTSE TMX Canada Universe Bond Index	1.1	2.4
FTSE TMX Canada Short Term Bond Index	(0.4)	0.3
FTSE TMX Canada Mid Term Bond Index	(0.1)	1.3
FTSE TMX Canada Long Term Bond Index	4.1	6.1
FTSE TMX Canada Federal	0.2	0.9
FTSE TMX Canada Provincial	2.1	3.5
FTSE TMX Canada Municipal	1.9	3.6
FTSE TMX Canada Corporate	1.0	2.9

Source: Scotia Capital Debt Market Indices

One will recall that barely 20 years ago, Germany was considered the "sick child" of Europe and suffered from an inefficient labour market that greatly limited its growth perspectives. German politicians then implemented major job market reforms, primarily by limiting the power of the unions, and unleashed the economic potential of Europe's first economy.

In France, optimism over an ambitious reform agenda that would stimulate the economy is now high; this would in turn give the world economy another driver of growth to rely on in the coming years.

Finally, in England, Prime Minister Theresa May triggered legislative elections in May, when polls suggested this would shore up her majority in the British Parliament, which would give her a stronger position in negotiations with EU authorities.

However, Mrs. May's daring bet failed, as the British population chose to give some of its support to the Labour Party. The result: Mrs. May's Conservative Party is now reduced to a minority in parliament, putting it in an unfavourable position for the negotiations that began in June.

The negotiations promise to be long, and the process will likely take years. At the moment, it seems that England, and not the EU, has the most to lose.

United States: Back to reality

After several months where we saw a rise in optimism south of the border, the second quarter of 2017 brought a reality check.

Last quarter, we pointed out the wide gap between the results of household and business surveys compared to actual consumer and business spending. For example, despite the Conference Board's survey showing household confidence at a 15-year high in March, real consumer spending in the first quarter actually slowed to a pace of 0.6% on an annualized basis, the lowest growth rate in nearly 10 years (Graph 7).

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Chart 2
Market Returns as at June 30, 2017

Index	Returns (%) 3 months	YTD
FTSE TMX Canada 91 Day T-Bill Index	0.1	0.2
FTSE TMX Canada Universe Bond Index	1.1	2.4
S&P/TSX Composite Index	(1.6)	0.7
S&P 500 (Can. $)	0.4	5.8
MSCI - EAFE (Can. $)	3.3	10.1
MSCI - World (Can. $)	1.3	7.0
Exchange Rate (Can. $ / US $)	(2.6)	(3.2)

Chart 3
Market Returns as at June 30, 2017

Index	Returns (%) 3 months	YTD
S&P/TSX Sector returns		
Energy	(8.3)	(13.3)
Materials	(6.4)	(0.7)
Industrials	6.1	11.7
Consumer Discretionary	4.8	12.2
Consumer Staples	1.7	4.4
Health Care	13.4	2.0
Financials	(0.9)	2.6
Information Technology	2.2	9.4
Telecommunication Services	2.5	7.6
Utilities	2.6	10.1
Real Estate	1.2	6.0
S&P/TSX Composite Index	(1.6)	0.7

Disappointing surprises were not limited to consumption data. The U.S. economic surprise index posted one of the worst declines in the last 20 years in the second quarter (Graph 8), a finding which reflects the fact that 1) expectations for the U.S. economy had reached unrealistic levels following last November's elections, and 2) economic vigour dipped slightly in the second quarter, even though, in our opinion, the long-term outlook remains positive overall.

One aspect that causes us to be optimistic about the extension of the economic cycle is the small but seemingly well-anchored renewal in business investment.

The current economic cycle is already the third longest in recorded history (behind the bumper years of 1961 to 1969 and 1991 to 2001), yet despite everything, the factor missing from the current cycle has long been investment spending, which has remained elusive for several years. Since the last months of 2016, durable goods orders from companies (a good barometer of investment spending) have begun to climb, and the rise in optimism of leaders of small and medium-sized enterprises (Graph 9) points to continued momentum in this direction.

In this context, the importance of success for the Trump administration to deliver at least a few of the elements of the promised fiscal reform takes all its meaning. Should there by a reduction in the corporate tax rate and a tax exemption for profits made abroad and repatriated to the United States (two of Mr. Trump's key promises), we could see a marked acceleration in business spending and an extension of the economic cycle.

Politically, no new laws have been passed since Donald Trump's arrival, and doubt as to Washington's ability to implement the promised fiscal reform is slowly spreading among the population and business leaders. After the failure of Congress to move forward with a reform to the healthcare law (known as Obamacare) in March, elected officials now face considerable pressure to set out and move forward with concrete bills, and quickly, or there is a high risk of seeing a change in leadership take place in favour of the Democratic Party in the House of Representatives in the 2018 mid-term elections.

Canada: Bank of Canada changes its tone

The Canadian economy has shown a clear overperformance since mid-2016, pushing the Bank of Canada to drastically change its tone in June.

Following the near-technical recession in the middle of last year, the Canadian economy racked up three consecutive quarters of growth surpassing that of the United States (Graph 10), despite all the optimism that prevailed south of the border. The Bank of Canada had nonetheless maintained a cautious view of the Canadian economy during this period, hammering out the message that these positive factors were probably only transitory. It now appears that the accumulation of good news is sufficiently convincing for the Bank to reconsider its position.

It should be recalled that the Bank of Canada had, not long after the arrival of Governor Stephen Poloz, instituted an "insurance policy" by making two cuts to its benchmark rate in 2015, in order to protect the Canadian economy from contagion and prevent the effects of the oil shock from spreading to the rest of the country's economy.

The good news on this front is that this policy seems to have born fruit, since production in non-energy sectors (including non-energy natural resources) has not budged in the last few years, and has even increased (Graph 11).

The same observation holds on the regional level: the economic indicators have fallen considerably in Alberta since the end of 2014 (although there has been an improvement in the last 12 months) but the three other major provinces—British Columbia, Ontario and Quebec—do not seem to have been affected at all.

In short, we agree with the Bank of Canada that the 50 bps "insurance policy" for the key interest rate is probably no longer necessary, and that the central bank could comfortably raise its key rate once or twice within the next 9 to 12 months.

That said, a tightening of monetary policy would not be without risks, since the situation in the real estate sector, especially in the greater area of Toronto, is still a major risk factor for the Canadian economy.

On this front, we agree with the new macro-prudential measures being implemented by the Ontario government to limit excessive risk-taking in this overheating market. As we have explained in detail in the past, we do not believe the Canadian real estate market is currently experiencing a speculative bubble. Our rationale, in short, comes from the fact that growth of the Canadian

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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**	**6.0%**	**1.0%**	**-8.5%**
Gold (ingot)		**0**		**0.5%**	**0.5%**	**-1.0%**
Canadian Bonds	20	45	70	31.5%	-13.5%	+5.0%
International Bonds	0	0	15	0.0%	0.0%	-2.5%
Total – Bonds	**20**	**45**	**70**	**31.5%**	**-13.5%**	**+2.5%**
Canadian Equities	**5**	**25**	**45**	**32.0%**	**+7.0%**	**+3.5%**
U.S. Equities	0	12.5	45	17.0%	+4.5%	+5.5%
International Equities	0	12.5	45	13.0%	+0.5%	-2.0%
Emerging Markets	0	0	45	0.0%	0.0%	--
Total – Foreign Equities	**5**	**25**	**45**	**30.0%**	**+5.0%**	**+3.5%**
Total – Portfolio		**100**		**100.0%**		

population is 70% dependent on international immigration, and immigrants have good reason to settle in the areas of Toronto and Vancouver, where the majority of newcomer communities are located. These regions are therefore the object of a significant demand for new housing and, because space is a limited resource, the result is an increase in prices that is slowly spreading to the periphery of these major centres.

The current danger lies in the possibility that the measures recently taken by British Columbia and Ontario could prove to be too effective, causing a disorganized decline in the markets. For the moment, however, this is not what the data are showing: we are seeing a falling-off in the number of transactions and a new surge in sellers on the market (probably a matter of crystalizing the gains of the last few years) but no collapse in prices. For the moment, therefore, the measures seem to be calming the excess speculation in these two markets, without harming real demand for housing.

We will now monitor the possibility of these measures simply relocating the problem. We have in fact seen the beginning of such a phenomenon in the Montreal area, which has seen a curious jump in real estate prices over the last few months.

Despite all this, it is highly unlikely that a hike of 25 to 50 bps in the key policy interest rate would lead to a catastrophe in the Canadian real estate sector, but caution is still warranted.

In terms of international risk factors that could have an impact on the Canadian economy, we think the picture cleared considerably during the quarter.

First, the agreement reached by the Organization of Petroleum Exporting Countries (OPEC) (as well as a few non-OPEC producers, such as Russia) last May, aiming to extend the production cuts for another nine months, has reduced the risks of seeing a sharp drop in oil prices like we experienced in 2015 and early 2016. At the time of this quarter ending, however, it is true that the strategy of the oil oligopoly does not seem to be producing the desired results, since U.S. production continues to grow. Technological advances are forever the sworn enemy of natural resource prices, and once again, we're seeing a marked decrease in the costs of U.S. shale old production, leading us to believe that the long-term equilibrium price of oil is slowly heading toward $40, rather than the $60 hoped for by OPEC.

Second, Washington's tone with respect to Canada-U.S. relations has gradually softened over the last few months. The United States' trade deficit with Canada is now considered "blameless" because it is, rather, the result of the Unites States not being self-sufficient in energy.

Digging a bit deeper, we also note that it is in fact Canada that holds a trade deficit in the bilateral relationship, when trade in services is included in the equation (Graph 12). All this suggests that the risks of a difficult negotiation process are lower for the moment, and that the planet's biggest bilateral trade relationship should continue on good terms, despite the rhetoric of the Trump administration.

Financial markets: Trump effect has disappeared from the markets

The quarter just ended was once again characterized by a generally low level of volatility, on the majority of markets.

In Canada, the story that captured investors' attention the most was probably the fall of Home Capital Group, the troubled mortgage lender whose stock collapsed during the quarter in light of fraud allegations by the Ontario Securities Commission. The news helped fuel negative feelings toward Canadian assets, at the same time as investors were giving energy-sector stocks the cold shoulder, and added to fears that a breakdown in the real estate sector was imminent.

The Home Capital Group saga culminated at the end of the quarter with a major surprise: none other than the famous Warren Buffett, President and CEO of Berkshire Hathaway, came to the rescue by acquiring significant holdings (about 38% of the company's shares) and offering the company a loan. It is too early to say whether this transaction signals an opportunity to buy Canadian financial securities, but a vote of confidence by the world's biggest investor has certainly become a major asset for the Canadian lender.

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Chart 5
Estimated Gross Returns for the Next 12 Months Starting on June 30, 2017

Market indicators	Interest or dividend	+	Capital gains	=	Total estimated gross return
FTSE TMX Canada 91 Day T-Bill Index	0.85%	+	0.00%	=	0.85%
FTSE TMX Canada Universe Bond Index	2.95%	+	(2.95)%	=	0.00%
Canadian stocks (S&P/TSX Composite Index) including dividends					6% to 10%

As mentioned above, the energy sector remains under pressure worldwide, as investors seriously question the ability of OPEC to push oil prices up by means of production cuts.

Despite an agreement on production cuts signed in May by OPEC and some non-member producers, including Russia, and covering a period of nine months (rather than the six months expected), the strength of U.S. production and the high level of inventories of crude oil and gasoline being maintained are pushing prices downward, straight toward the threshold of $40 a barrel. Once again, it seems that technological innovation is at work, with an impressive drop in production costs for U.S. shale oil sustaining world production despite OPEC's cuts.

Meanwhile, the U.S. stock market seems to be posting an elevated but still attractive valuation for the short and medium term.

Our eyes are currently fixed on the technology sector: it has delivered a strong performance since the start of the year, which seems justified given the capacity of companies in the sector to generate liquidity. Despite the perceptions (resulting, understandably, from the stigma of the bursting of the tech bubble at the dawn of 2000), the U.S. technology sector is currently posting a valuation similar to the rest of the stock market, on a price/earnings ratio basis, and the business model of the sector's leaders is largely protected from macro-economic risks. In a context where few sectors are offering such attractive growth prospects, we are of the opinion that this sector could continue to outperform the rest of the market.

However, we believe the most promising returns are on the international front. We still see a discount within the European market, which is trading at a price/earnings ratio below the U.S. market, and which could benefit from an acceleration in European economic growth.

The highlight of the financial markets in 2017 is, in our opinion, the complete disappearance of "Trump trade," that is, the enthusiasm seen in both the equities and the bond markets following the election of Donald Trump. One will recall that the optimism resulting from the election manifested itself through a steepening of the U.S. yield curve (measured by the spread between rates at different maturities) as well as a marked overperformance of banking securities in the S&P 500 Index.

Since February, the yield curve has resumed a flatter shape (but at a higher level, given the Fed's tightening of the key rate), suggesting that the bond market does not foresee a accelerating of the economy as a result of the fiscal plan promised during the electoral campaign. Banking securities also lost a large part of their gains, signaling that investors also have reservations about whether deregulation of the financial sector will truly be carried out.

In this context, we believe the outlook remains positive for the stock markets for the second half of the year, and that the Trump factor could again become a positive one, should he succeed in implementing some of his electoral promises. As for bonds, the continued normalization of U.S. monetary policy as well as the change of tone by the Bank of Canada lead us to anticipate a retreat in the market, or very small gains at the least, in the second half of the year.

The Canadian bond market, measured by the FTSE TMX Canada Universe Bond Index, continued its momentum with a gain of 1.1% in the second quarter. The FTSE TMX Canada Short Term Bond Index was down 0.4%, and the FTSE TMX Canada Long Term Bond Index climbed 4.1%.

The U.S. stock market, measured by the S&P 500 Index, once again delivered a positive return for the quarter, up 3.1% (0.4% in Canadian dollars). The Canadian stock market, meanwhile, posted a negative return, with the S&P/TSX Composite Index down 1.6%.

Stock markets in Europe and Asia posted additional gains in the second quarter. The European market, represented by the MSCI - Europe Index, was up 1.8% (4.9% in Canadian dollars), the MSCI - EAFE Index climbed 2.7% (3.3% in Canadian dollars) and the MSCI - World Index gained 2.7% (1.3% in Canadian dollars). The best performance of the quarter once again came from the emerging markets, measured by the MSCI - Emerging Markets Index, which jumped 6.7% (3.6% in Canadian dollars).

Strategy: Cautious overweighting in equities

Our strategy of overweighting in equities was maintained throughout the second quarter of the year.

This overweighting was once again achieved through foreign equities, with an overweighting of European and Asian stocks, and through the U.S. banking and technology sectors.

We have a strong interest in sectors that offer good growth outlooks for earnings and that generally perform better than the market in environments where economic growth and inflation are positive but limited. This strategy translated into thematic investments in technology and in exchange-traded funds (ETF) specializing in companies with this characteristic.

Our current stock market strategy, however, hinges in large part on an overweighting in European equities, which could offer attractive returns in the coming quarters if economic and political trends evolve in the direction we anticipate.

As for bonds, we are still maintaining an underweighting in this asset class, given the low level of interest rates and the prospects of increases by the Bank of

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Chart 6
Economic and financial scenarios

Economic scenario

							Change since March 31, 2017	
		2015	2016	2017	2018	2019	2017	2018
United States	Real GDP	2.6%	1.6%	2.2%	2.3%	2.2%	--	--
	Inflation rate	0.1%	1.3%	2.3%	2.2%	2.2%	-0.2%	-0.2%
	Unemployment rate	5.3%	4.8%	4.4%	4.2%	4.2%	-0.2%	-0.3%
Canada	Real GDP	0.9%	1.5%	2.5%	2.0%	1.9%	+0.3%	--
	Inflation rate	1.1%	1.4%	1.9%	2.0%	2.0%	-0.1%	--
	Unemployment rate	6.9%	7.0%	6.6%	6.6%	6.6%	-0.2%	--

Financial scenario*

			Targets			Change since March 31, 2017	
		Actual	Dec. 2017	June 2018	Dec. 2018	Dec. 2017	June 2018
Interest rate							
	U.S. 10-year rates	2.31%	2.70%	2.90%	3.00%	-0.05%	+0.10%
	Canada 10-year rates	1.77%	2.00%	2.25%	2.45%	+0.05%	-0.20%
Exchange rates							
	US $/Can. $	0.77	0.80	0.81	0.83	+0.03	+0.03
	US $/Euro	1.14	1.17	1.18	1.18	+0.07	+0.08
	Oil price (WTI), US $	46.04	47	50	52	-8	-5
	S&P 500	2,423	2,580	2,750	2,840	+130	+150
	S&P/TSX	15,182	15,525	15,980	16,620	-1,055	-1,245

* end of period

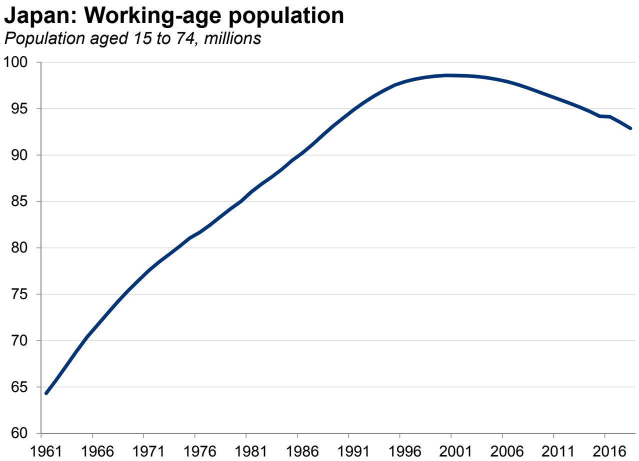
Canada and the Fed. We nonetheless implemented a strategy of neutralization during the quarter compared to our peers, by initiating long-term positions in U.S. bonds. We did this to protect portfolios in the case of a stock market decline and to benefit from a possible decrease in long-term U.S. rates, which we deemed elevated given the context where expectations of the Trump administration were gradually evaporating from the rest of the market.

At the end of the quarter, Canadian equities represented 32.0% of the Diversified Fund, while international equities accounted for 30.0% of the assets.

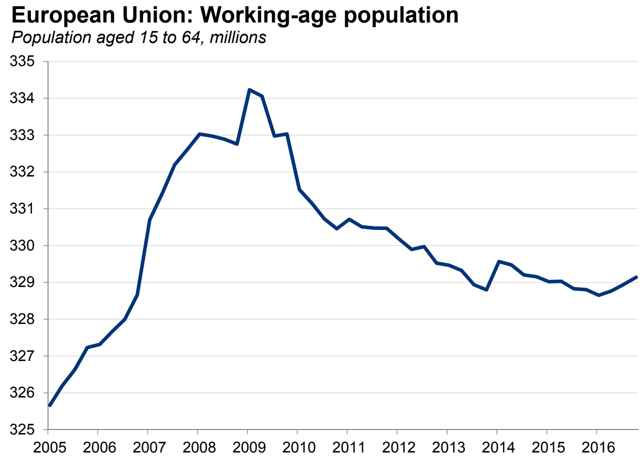
The weight of bonds remains below the target, at 31.5% compared to a target of 45%.

Cash now accounts for a rather neutral level of 6.0% of fund assets, a level providing sufficient flexibility to take advantage of any potential opportunities that arise on the stock markets.

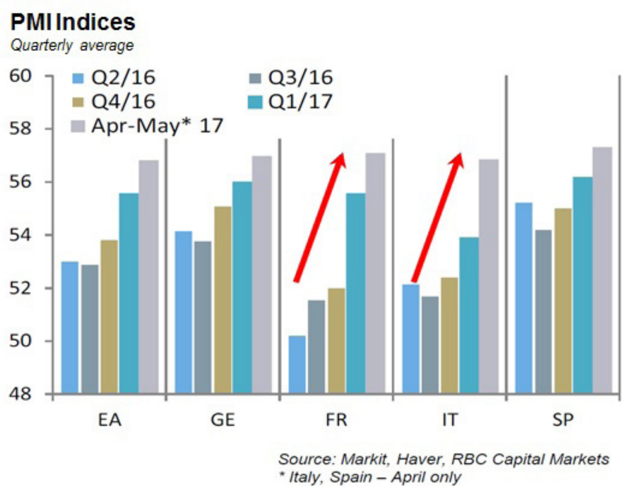
Graph 4



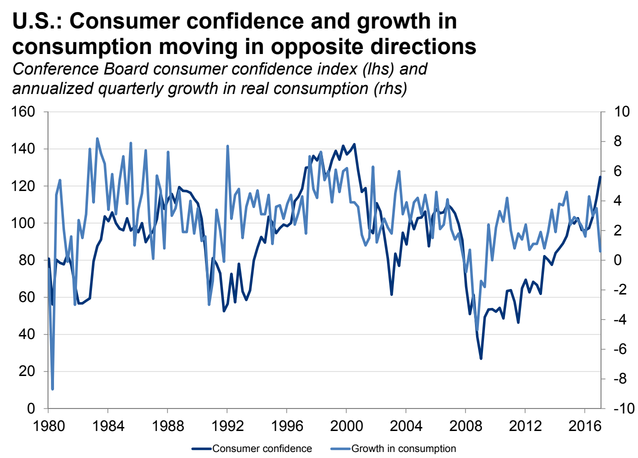
Graph 5



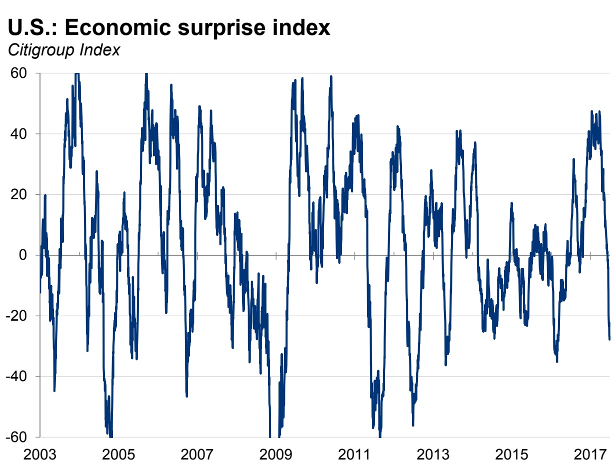
Graph 6



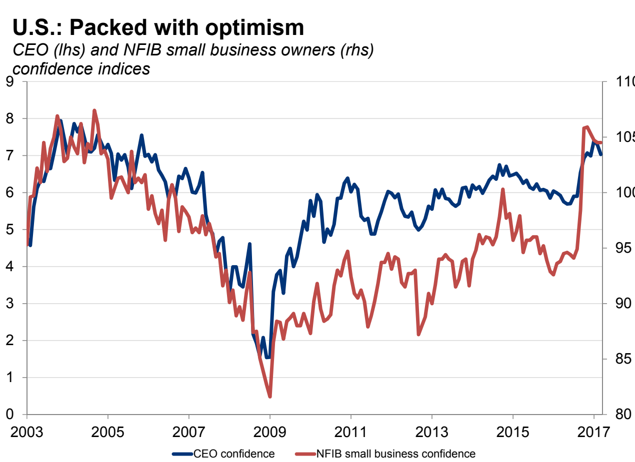
Graph 7



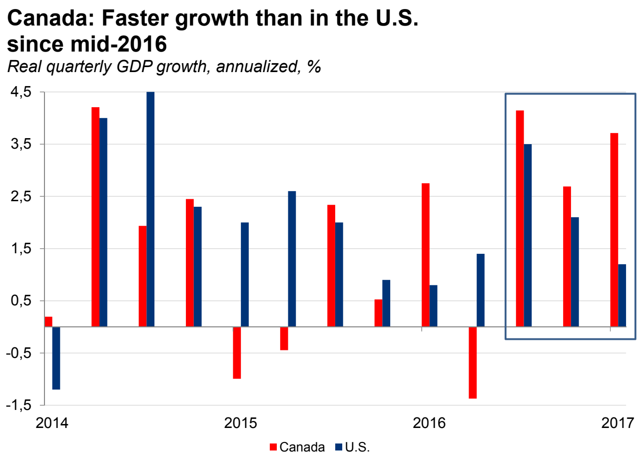
Graph 8



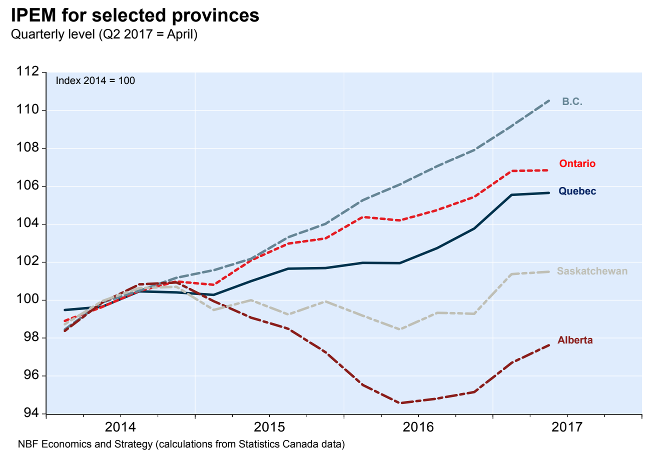
Graph 9



Graph 10



Graph 11



Graph 12