Economic and Financial Environment

As at September 30, 2017

Canadian economy steals the show

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The Canadian economy has been thriving in 2017, growing faster than its counterpart south of the border. Not only is job creation on the rise, but the investment intentions of businesses are approaching historic peaks.

Canada is currently benefitting from several desirable tailwinds. First of all, Canada is enjoying one of the fastest rates of population growth of countries in the Organisation for Economic Co-operation and Development (OECD), and immigrants landing in Canada are among the highest educated of all industrialized countries. Second, the loonie's decline since 2014 has stimulated the competitiveness of Canadian exporters, who are also profiting from the synchronized acceleration of the world economy. Third, the federal government's infrastructure spending program is starting to bear fruit. The combination of these factors, along with improved business confidence, suggests the Canadian economy will continue to hold its place as one of the top-performers in the world.

At the end of this third quarter, however, considerable uncertainty remained over the fate of Canada-U.S. trade relations. Several major components of the North American Free-Trade Agreement (NAFTA) are still to be negotiated, and a number of issues, such as Canadian milk quotas and subsidies to the aerospace industry, are sensitive points on both sides of the border.

While we cannot expect the Canadian economy's recent stellar performance to continue indefinitely, we believe the elements are in place for Canada to continue doing well on the economic scene for the next few years.

World: Good news

Despite the fact that events in North Korea dominated headlines over the summer, a very strong economic story was unfolding in the background: the world economy is in surprisingly decent shape.

The world economy has posted synchronized growth since the start of the year, a very positive sign for continuation of the economic cycle. In fact, for the first time in ten years, all OECD countries posted positive growth rates in the second quarter of 2017, led by China and India (Graph 1).

Graph 1

OECD Interim Economic Outlook real GDP growth projections
Year-on-year (%)

	2016	2017		2018	
		Interim projections	Difference from June Economic Outlook	Interim projections	Difference from June Economic Outlook
World	3.1	3.5	0.0	3.7	0.1
United States	1.5	2.1	0.0	2.4	0.0
Euro area	1.8	2.1	0.3	1.9	0.1
Germany	1.9	2.2	0.2	2.1	0.1
France	1.1	1.7	0.4	1.6	0.1
Italy	1.0	1.4	0.4	1.2	0.4
Japan	1.0	1.6	0.2	1.2	0.2
Canada	1.5	3.2	0.4	2.3	0.0
United Kingdom	1.8	1.6	0.0	1.0	0.0
China	6.7	6.8	0.2	6.6	0.2
India[1]	7.1	6.7	-0.6	7.2	-0.5
Brazil	-3.6	0.6	-0.1	1.6	0.0
Russia	-0.2	2.0	0.6	2.1	0.5
G20	3.2	3.7	0.1	3.8	0.0

Note: Difference in percentage points based on rounded figures.
1. Fiscal years starting in April.

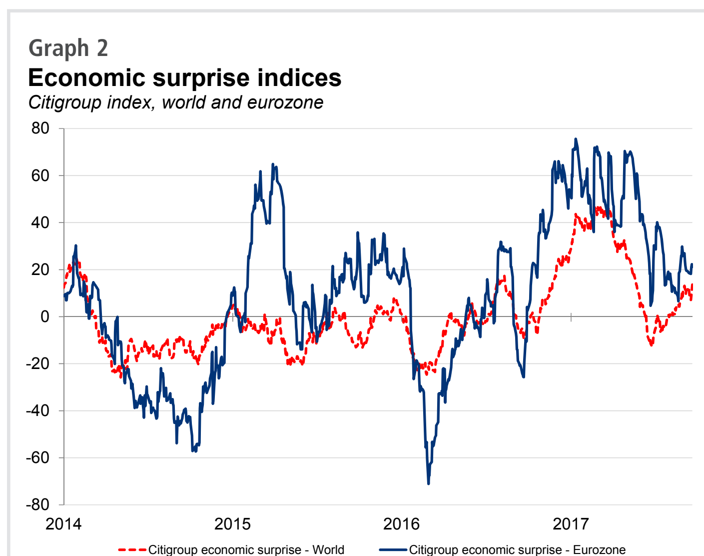
In September, it was precisely the OECD's turn to produce its economic growth forecasts. The organization is expecting real GDP to grow at a pace of 3.5% worldwide in 2017, with a further uptick to 3.7% in 2018.

China's economy is expected to pick up speed for the first time since 2010, with a growth forecast of 6.8% for 2017, compared to 6.7% in 2016, a very positive sign given the vital role China plays in international trade. Infrastructure investments rebounded in the last few quarters in the Middle Kingdom, and the increase in imports benefitted all its commercial partners.

India is still competing with China to head the list of countries with the strongest pace of growth (India's GDP is projected to rise to 7.2% in 2018 according to the OECD, against 6.6% for China), but the implementation of monetary and fiscal reforms is proving more arduous than expected.

Forecasts for the Japanese economy have also been revised upward, although projected growth remains weak at 1.6% for 2017 and 1.2% in 2018. Japan remains at the mercy of an unfavourable demography (the size of the working-age population is shrinking at a rate of 1 million individuals per year) and the major reforms carried out by the Abe administration over the last few years have yet to truly change the course of events: inflation remains weak, and growth is timid.

Indeed, the Japanese government generated surprise at the end of September when it announced the dissolution of the government and launched an election, to be held in October. The objectives are clear: obtain a strong mandate in the face of a tense situation with North Korea, and put forth a new economic plan focusing, among other things, on the integration of women into the workforce.



Europe: Populism rears its head in Germany

Economic surprises in Europe remained favourable over the summer (Graph 2), translating into a sharp rise of the euro against the U.S. dollar, up from 1.14 at June 30 to more than 1.20 in early September.

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The OECD revised its economic forecasts for the eurozone upward, projecting growth rates of 2.1% in 2017 and 1.9% in 2018 (on the heels of 1.8% growth in 2016). Moreover, these positive revisions extend to Europe's three largest economies (Germany, France and Italy) which are all experiencing renewed momentum.

On the political front, the honeymoon following the election of Emmanuel Macron to the Élysée Palace appears to be over, and the French population is now waiting for the implementation of genuine structural reforms. The young French president worked hard this summer to negotiate with the major French workers' unions to set up a plan aiming to significantly loosen regulations for hiring and laying off workers. Although protests over the labour-law overhaul continue, it appears the president is managing to convince a critical mass of unions of its merits.

After France in the spring, it was Germany's turn to hold elections in the fall. Although it came as no surprise that Angela Merkel's Christian Democrat Union won, with 33% of votes, the situation has become somewhat more complicated.

First, the Social Democrat Party, which came in second with 21% of the vote, had already made it known that it would no longer seek to form a governing coalition, as had been the case in the past few years, but that it would, instead, take on the role of opposition. Angela Merkel and her party will therefore have to forge alliances with other, less centrist parties to form a government, which could lead to more populist policies. The process could last several weeks, even months, but the Germans have the reputation of demonstrating pragmatism when it comes to politics.

Second, after the United Kingdom, the United States and France, it is Germany's turn to see its populist movement gaining ground. The far-right Alternative for Germany Party stunned the country by capturing 13% of votes (finishing third place in the popular vote), thereby securing itself a place in the German parliament for the first time in 60 years. Because Germany uses mixed-member proportional representation, this party will occupy 13%, or 94 of the 709 seats; given the party's drastic positions, this could influence the direction of German politics in the coming years.

Graph 3

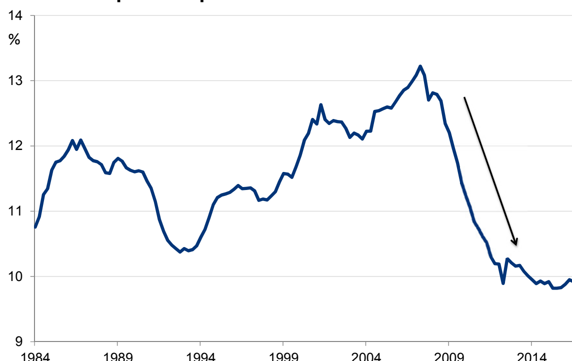

Chart 1
Returns of the Canadian Bond Market as at September 30, 2017

Index	Returns (%)	
	3 months	YTD
FTSE TMX Canada Universe Bond Index	(1.8)	0.5
FTSE TMX Canada Short Term Bond Index	(0.5)	(0.2)
FTSE TMX Canada Mid Term Bond Index	(1.5)	(0.2)
FTSE TMX Canada Long Term Bond Index	(4.1)	1.7
FTSE TMX Canada Federal	(1.6)	(0.7)
FTSE TMX Canada Provincial	(2.5)	0.9
FTSE TMX Canada Municipal	(1.9)	1.6
FTSE TMX Canada Corporate	(1.3)	1.5

Source: FTSE TMX Global Debt Capital Markets

United States: Fed maintains its course

The U.S. economy continues to demonstrate a robust pace of growth. The OECD is estimating growth of 2.1% for the U.S. economy in 2017, and 2.4% in 2018—a clear acceleration since the 1.5% recorded in 2016.

We have talked about it more than enough in the past: the current economic cycle has lasted for eight years and is the third longest in history. It is therefore natural to wonder how much longer this cycle will last and, especially, what each economic sector's contributions will be.

The American consumer, primary driver of the economy, remains in good health, with an increasingly improved balance sheet since the recession, as can be seen by the debt service ratio which is at its lowest in nearly 40 years (Graph 3).

Although labour market conditions remain favourable to continued growth in consumer spending, two reasons lead us to believe that it is natural, at this stage, to expect a slowing of pace.

First, the pace of job creation has been slowing for the last few years, which is entirely normal given that the unemployment rate recently dipped below the long-term equilibrium level, estimated at about 5%. Second, the household saving rate has declined dramatically over the last few quarters and is now near historic lows (Graph 4), suggesting that it is unlikely that U.S. households will have access to credit to increase their spending in the coming quarters.

In terms of business investment, the prognosis is positive. We are currently seeing a slight increase in investment spending, but surveys among business managers suggest the trend is fragile.

The arrival of some clarity to the Trump administration's fiscal reform plans at the end of the quarter will likely stimulate business spending, given the firm intention to reduce the corporate tax rate from 35% to 20%. On the other hand, other administrators seemed to indicate that the recent rise in interest rates will encourage them to first clean up their balance sheets rather than launch into investment projects. The current business investment to GDP ratio is around the historical average, which is not abnormal at this stage of the economic cycle, but still leaves room for an increase in spending (Graph 5).

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Chart 2
Market Returns as at September 30, 2017

Index	Returns (%)	
	3 months	YTD
FTSE TMX Canada 91 Day T-Bill Index	0.1	0.3
FTSE TMX Canada Universe Bond Index	(1.8)	0.5
S&P/TSX Composite Index	3.7	4.4
S&P 500 (Can. $)	0.6	6.4
MSCI - EAFE (Can. $)	1.5	11.7
MSCI - World (Can. $)	1.0	8.1
Exchange Rate (Can. $ / US $)	(3.7)	(6.7)

Chart 3
Market Returns as at September 30, 2017

Index	Returns (%)	
	3 months	YTD
S&P/TSX Sector returns		
Energy	6.6	(7.6)
Materials	3.3	2.5
Industrials	2.7	14.7
Consumer Discretionary	4.7	17.4
Consumer Staples	(2.7)	1.5
Health Care	(10.3)	(8.5)
Financials	4.5	7.2
Information Technology	3.2	12.9
Telecommunication Services	2.3	10.1
Utilities	(1.9)	7.9
Real Estate	(1.0)	4.9
S&P/TSX Composite Index	3.7	4.4

As for the government's potential contribution, we are still awaiting details of the infrastructure plan proposed by Donald Trump during his election campaign. Although it is impossible in the short term to anticipate the scope of the plan that will eventually be unveiled and voted on, it is highly likely that the U.S. federal government's spending will support some degree of economic growth in the coming years.

Finally, the component that is hardest to evaluate is that of exterior trade, which is caught between Washington's protectionist agenda and a synchronization of the world economy, the latter benefitting exporters.

In short, we deem it highly probable that the current economic cycle will continue for a few more years, and we estimate that the risks of a recession are very low for the next two to three years.

Meanwhile, the U.S. Federal Reserve (the Fed) has reiterated its intention of going ahead with the normalization of its monetary policy, signalling another increase in its key rate before the end of 2017 and three more in 2018, despite market skepticism. The Fed officially set October for the start of its plan to reduce the size of its balance sheet, a process that will likely extend over five years (barring, of course, any marked deterioration in the U.S. economy) and, according to some estimates, push 10-year interest rates up by no more than 10 basis points a year, a rather marginal impact.

The Fed also recognizes that the weakness of inflation remains a mystery, but Chair Janet Yellen has adopted a clear position, repeating that she expects inflation to gradually move up to its 2% target, thereby justifying the continued tightening of monetary policy.

Canada: 2017's economic celebrity

The Canadian economy stole the show in the second quarter, with a sharp increase in growth that pushed the Bank of Canada to go ahead with not one, but two increases in its benchmark interest rate.

Canada's economic performance since mid-2016 has been impressive. On average, over the last four quarters, the country's quarterly growth rate has exceeded that of the U.S. by 1.5% (Graph 6), thanks to the rebound in oil production in Alberta, the beneficial effects of the loonie's decline and the federal government's spending programs.

Given that the real rate of annual growth in May (that is, by comparing May 2016 and May 2017) reached 4.7%, a 17-year high, it is natural to expect a slowing of pace. Despite everything, the Canadian outlook is positive for the coming years.

First, recent robustness in employment (Graph 7) should continue to act as a tailwind for Canadian households. The wealth effect should continue to sustain the pace of household spending, even though households have recently demonstrated more cautious behaviour, as can be seen in their savings rate which increased in the last quarter to 4.6%.

Second, Canadian companies are increasingly optimistic. The Bank of Canada's most recent Business Outlook Survey shows that investment intentions have reached their highest levels on record, primarily in the oil and natural resource sectors (Graph 8).

Third, government spending should continue to boost the Canadian economy over the next few years as the infrastructure spending program is just beginning to be felt in the economic statistics. In light of the targets announced by the federal government in the latest Budget Plan, we are confident that the government contribution to the real economy's growth will remain positive in the coming years.

Finally, the contribution of foreign trade remains difficult to anticipate as long as NAFTA negotiations continue. As the quarter was drawing to a close, representatives from the three countries concerned were opening the discussion on the most sensitive points, such as maintaining an impartial tribunal with the role of settling trade disputes. One will recall that the United States would like to see this mechanism abolished, while Canada and Mexico are insisting that it be kept.

The recent strength of the Canadian dollar will likely cause some harm to the competitiveness of Canadian companies on the export market, but current levels remain relatively low compared to those observed from 2010 to 2014, greatly curbing our concerns.

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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**	**8.0%**	**3.0%**	**+2.0%**
Gold (ingot)		**0**		**2.0%**	**2.0%**	**+1.5%**
Canadian Bonds	20	45	70	30.0%	-15.0%	-1.5%
International Bonds	0	0	15	0.0%	0.0%	0.0%
Total – Bonds	**20**	**45**	**70**	**30.0%**	**-15.0%**	**-1.5%**
Canadian Equities	**5**	**25**	**45**	**30.0%**	**+5.0%**	**-2.0%**
U.S. Equities	0	12.5	45	18.0%	+5.5%	+1.0%
International Equities	0	12.5	45	12.0%	-0.5%	-1.0%
Emerging Markets	0	0	45	0.0%	0.0%	--
Total – Foreign Equities	**5**	**25**	**45**	**30.0%**	**+5.0%**	**0.0%**
Total – Portfolio		**100**		**100.0%**		

In short, with the absence of a recession south of the border, the stars are aligned for the continued healthy growth of the Canadian economy in the coming years.

In this context, the Bank of Canada deemed it time to change tack and reverse the two interest rate cuts made in 2015 as an “insurance policy” against the effects of falling oil prices spreading to other Canadian provinces. After proceeding with two consecutive rate hikes in July and September, the Bank of Canada indicated at the end of the quarter that it would now assess the impact of these changes on the Canadian economy and monitor the evolution of the various data published before taking any further action—comments which served to calm the rapid upward movement of interest rates and of the currency.

We nonetheless expect the Canadian dollar to continue its slow progress toward its long-term equilibrium level (commonly called “purchasing power parity” or PPP) estimated at about US$0.83 to US$0.85 (Graph 9).

Financial markets: Canadian markets not very generous since the start of 2017

The year 2017 is far from spectacular for Canadian investors: after nine months, the major Canadian stock and bond indices are delivering rather meagre returns compared to those of the last few years (Graph 10). Moreover, since the start of the year, the strength of the Canadian dollar has had the effect of erasing a large part of the returns that investors might have gained outside the country.

How can the performance of Canadian markets in 2017 be explained? Several factors are at work.

First, the Canadian stock market, represented by the S&P/TSX Composite Index, posted a very strong performance in 2016, with a total return exceeding 20%. One should probably have expected a slowdown after such a year, but the real explanation lies in the sectoral mix of the Canadian stock market.

At the end of the third quarter, financials accounted for 34% of the S&P/TSX Composite Index, energy accounted for 20%, and materials, 12%. Given foreign investors’ negative perception of the real estate market and Canadian household indebtedness, Canadian financial stocks have been left by the wayside since the start of the year, offering a return of about only 4.5%. The energy sector, meanwhile, is under pressure both in Canada and in the U.S. and has dropped nearly 10% in nine months as investors remain skeptical over the chances of success of the Organization of the Petroleum Exporting Countries’ (OPEC’s) current strategy. The Canadian materials sector has also been stagnating, up just 1.6% since the start of the year.

In short, it is hard for the Canadian stock market to deliver attractive returns when its three main sectors are having a rough year.

Second, the Canadian bond market had a two-part year. At a certain point at the beginning of June, rates on 10-year federal bonds were at a low of 1.4% and the FTSE TMX Canada Universe Bond Index was up nearly 4% for the year to date, in part because of comments by the Bank of Canada, which deemed that raising its benchmark rate could lead to a recession.

Following a marked change in the Bank of Canada’s tone in June, 10-year interest rates jumped to more than 2.1% in September and the returns of the FTSE TMX Canada Universe Bond Index evaporated.

Third, the rise of the Canadian dollar during the year, but especially since early May, had a major but unfortunately sometimes misunderstood impact on the portfolios of Canadian investors. Since the loonie has risen against the U.S. dollar, for example, by about 8% since the start of the year, investors who placed some of their assets in the U.S. stock market will not have been able to pocket all of the roughly 13% return on their investment, but will have had to content themselves with a slim 6%, unless they had set up a comprehensive currency hedging strategy.

In short, the only strategy that would have enabled a Canadian investor to achieve a 10% return on his or her portfolio since the start of 2017 would have been to be invested entirely outside the country, in equities, while covering exposure to the currency. In all likelihood, this strategy would not have been an obvious choice at the start of the year, when the Bank of Canada was maintaining a very cautious tone toward the Canadian economy and the U.S. market was already trading at a historically high valuation.

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

Market indicators	Interest or dividend	+	Capital gains	=	Total estimated gross return
FTSE TMX Canada 91 Day T-Bill Index	1.40%	+	0.00%	=	1.40%
FTSE TMX Canada Universe Bond Index	2.90%	+	(2.90)%	=	0.00%
Canadian stocks (S&P/TSX Composite Index) including dividends					6% to 8%

As the last quarter of the year gets under way, we remain of the opinion that valuation of the U.S. stock market is high, with several measures near historic peaks (Graph 11). We have also observed that the number of equities contributing to the S&P 500 Index's upward movement was limited in 2017, with the technology and health care sectors doing most of the work.

After three full quarters, the Canadian stock market, measured by the FTSE TMX Canada Universe Bond Index, was up a meagre 0.5% for the year to date. Meanwhile, the FTSE TMX Canada Short Term Bond Index lost ground once again in the third quarter, reducing its return to -0.2% for the year to date. The FTSE TMX Canada Long Term Bond Index was down 4.1% during the quarter but the return for the year to date remains positive at 1.7%.

The U.S. stock market, measured by the S&P 500 Index, had another positive quarter, up 4.5% in the third quarter (0.6% in Canadian dollars). The Canadian stock market also delivered a positive return in the third quarter, with the S&P/TSX Composite Index gaining 3.7%.

Stock markets in Europe and Asia once again posted gains in the third quarter. The European market, represented by the MSCI - Europe Index, was up 3.5% (2.5% in Canadian dollars), the MSCI - EAFE Index gained 3.4% (1.5% in Canadian dollars) and the MSCI - World Index climbed 3.9% (1.0% in Canadian dollars). The best performance of the quarter once again belonged to the emerging markets, measured by the MSCI - Emerging Markets Index, which jumped 7.7% (4.0% in Canadian dollars).

Strategy: Cautious overweighting in equities

Our strategy of overweighting in equities was maintained once again throughout the third quarter of the year.

This overweighting was achieved through foreign equities, with an overweighting of European and Asian stocks, and in so-called "growth" sectors such as information technology.

As the quarter was ending, we noted a shift on the markets, as "value" sectors, such as financials and energy, delivered a superior performance to those of the market in September. The tone adopted by the U.S. Federal Reserve could create fertile ground in the financials sector, as banks tend to benefit from an environment of interest rate hikes, and the reduction in oil stocks suggests that the trough is perhaps already behind us in terms of energy securities.

In this context, toward the end of the quarter, we began to reduce our funds' exposure to the U.S. stock market and to increase our exposure to the Canadian stock market. Although we remain overweight in the European and Asian stock markets, we have reduced that position as well in favour of the Canadian market.

This strategy of overweighting in equities remains accompanied by holdings of index put options in order to protect portfolios against any sudden drop in the markets.

In terms of bonds, we are remaining underweight in this asset class, given the international trend of tightening monetary policies and, especially, the new prospect of increases in the Canadian key interest rate in 2018. Despite all this, we maintained a dynamic management strategy for duration throughout the quarter with respect to our peers, taking positions in long-term U.S. bonds, both to protect portfolios in case of a stock market decline and to take advantage of the level of long-term U.S. rates, which appear well anchored for the moment.

At the end of the quarter, Canadian equities accounted for 30% of the Diversified Fund, holding the same weight as international equities.

The weight of bonds was reduced to 30%, a level below the 45% target, as interest rate hikes led us to further reduce the size of this position.

Cash is now at a rather neutral level, representing 8% of the Fund's assets. This gives us the flexibility to seize any new opportunities that present themselves on the stock markets.

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Chart 6
Economic and financial scenarios

Economic scenario

							Change since June 30, 2017	
		2015	**2016**	**2017**	**2018**	**2019**	**2017**	**2018**
United States	Real GDP	2.9%	1.5%	2.1%	2.3%	2.2%	-0.1%	--
	Inflation rate	0.1%	1.3%	2.0%	2.1%	2.2%	-0.3%	-0.1%
	Unemployment rate	5.3%	4.9%	4.4%	4.2%	4.2%	--	--
Canada	Real GDP	1.0%	1.5%	3.2%	2.2%	2.0%	+0.7%	+0.2%
	Inflation rate	1.1%	1.4%	1.6%	1.9%	2.0%	-0.3%	-0.1%
	Unemployment rate	6.9%	7.0%	6.5%	6.3%	6.3%	-0.1%	-0.3%

Financial scenario*

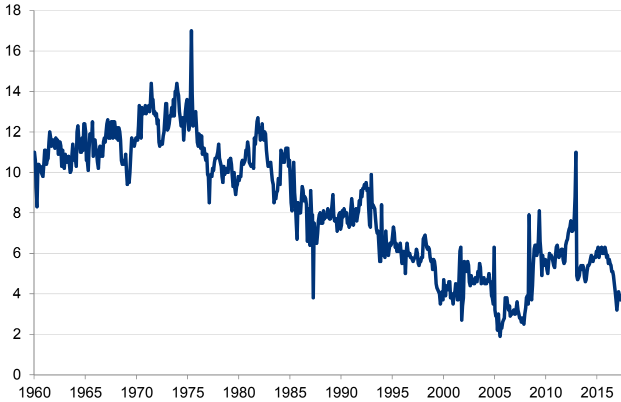
			Targets			Change since June 30, 2017	
		Actual	**Dec. 2017**	**June 2018**	**Dec. 2018**	**Dec. 2017**	**June 2018**
Interest rate							
	U.S. 10-year rates	2.33%	2.70%	2.90%	3.00%	--	--
	Canada 10-year rates	2.10%	2.20%	2.40%	2.60%	+0.20	+0.15
Exchange rates							
	US $/Can. $	0.8	0.83	0.85	0.85	+0.03	+0.04
	US $/Euro	1.18	1.20	1.22	1.25	+0.03	+0.04
	Oil price (WTI), US $	51.67	52	55	57	+5	+5
	S&P 500	2,519	2,580	2,750	2,840	+130	+150
	S&P/TSX	15,635	16,100	16,650	17,200	+575	+670

* end of period

Graph 4

U.S.: Personal saving rate

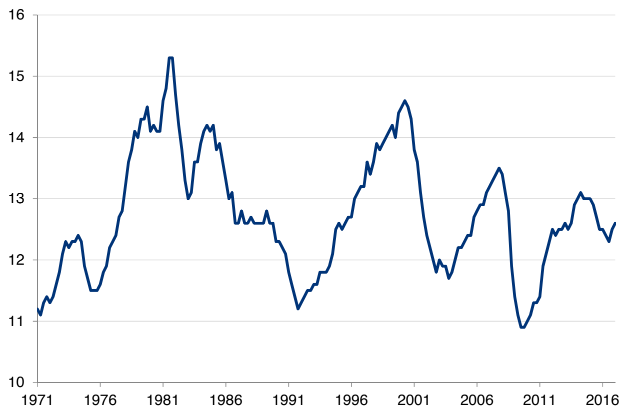
Personal saving as % of disposable income



Graph 5

U.S.: Business investment has room to run

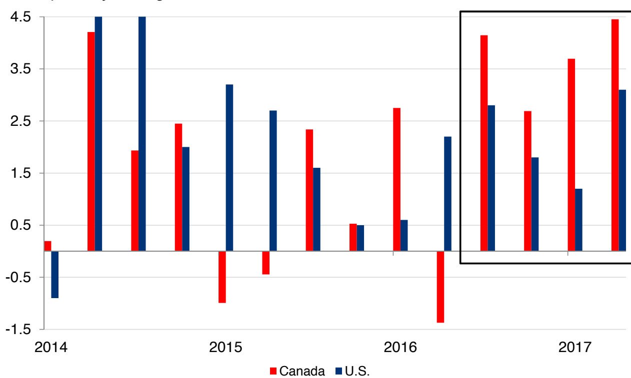
Nonresidential investment as % of GDP



Graph 6

Canada: Faster growth than in the U.S. since mid-2016

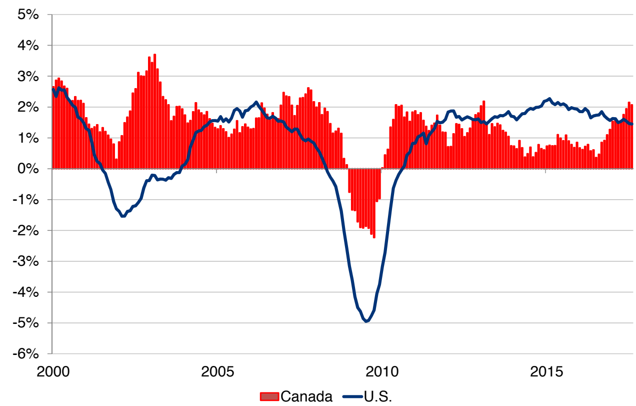
Real quarterly GDP growth, annualized, %



Graph 7

Canada & U.S.: Annual jobs creation

Jobs added to the labour market in last 12 months, %



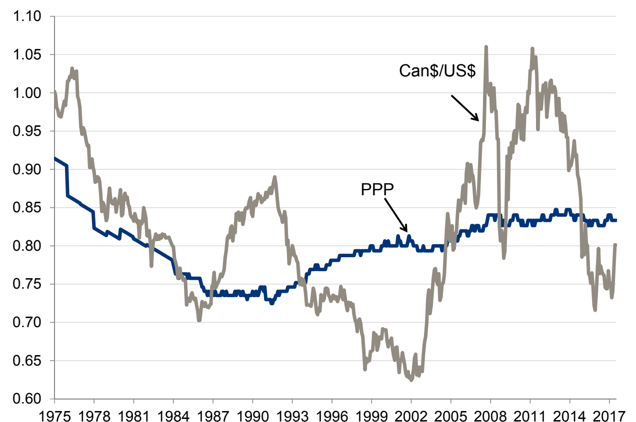
Graph 8

Canada: Balance of opinion on investment in machinery and equipment

Bank of Canada, Business Outlook Survey

Graph 9

Canada: Loonie and PPP



Economic and Financial Environment (continued)

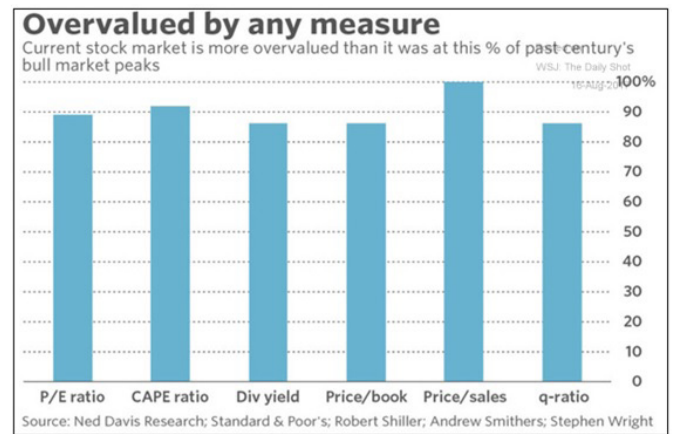
Graph 10

Total returns, Can$	2012	2013	2014	2015	2016	2017*
Canadian bonds	3.6%	-1.2%	8.8%	3.5%	1.7%	0.5%
Canadian equities	7.2%	13.0%	10.6%	-8.3%	21.1%	4.4%
U.S. equities	13.5%	41.4%	24.2%	20.7%	8.9%	6.0%
EAFE equities	14.8%	31.2%	3.9%	18.1%	-1.8%	11.3%
Balanced portfolio**	**7.0%**	**11.8%**	**10.1%**	**4.4%**	**6.9%**	**3.5%**

* YTD, as of 30/09/2017

** Theoretical gross returns based on a neutral positioning for a typical balanced portfolio, with weights of 5% cash, 45% Canadian bonds, 25% Canadian equities, 12.5% U.S. equities and 12.5% EAFE equities

Graph 11



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