Third Quarter Commentary

October | 2016

Canada – taking off the rose-colored glasses

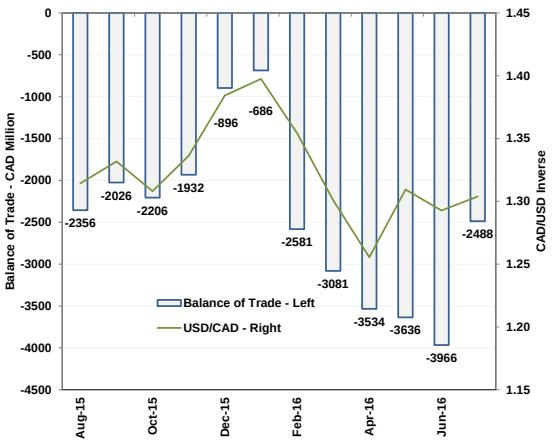
"The structural outlook for commodity-based economies continues to deteriorate, although this year's bounce in natural resource prices has provided some reprieve. The latter is driven in part by a pickup in Chinese demand, which will likely reverse next year. Fundamentals for crude oil prices are already deteriorating. In turn, our forecast is that recent strength in Canadian equities (energy, base metals and the banks) and the currency will soon fade." – MRB Partners, September 2016

Canadian assets including stocks, bonds and our Canadian Dollar have been among the best performers in the world in 2016. Leading the way has been investment within the resource sector, with shares in metals, mining, and oil stocks having outsized gains following a few years of steep declines. Foreign investors have taken notice of Canadian investment opportunities fueling these gains, with net foreign portfolio inflows totalling $80.4 billion in the first half of 2016, of which $26.2 billion flowed into stocks, the highest levels seen in 16 years. Canadian bonds saw even more demand, with net inflows of $48.7 billion during that period, as low yields did not hamper demand, particularly given that three quarters of global government bonds currently have negative yields. Given the uncertainties in many parts of the world (e.g. Brexit, political uncertainty), Canada is benefiting from the perception of being a relatively stable place to put money, but investor sentiment has driven equity markets beyond what we view as fundamentally justified.

A deeper dive into Canada's economic health however reveals a more challenging environment than shown by the performance of the Canadian equity market. Despite resilient economic data in the early part of this year, more recent numbers renew concerns about the vigor of the recovery beyond the Fort McMurray wildfire related impact.

Canada has long been an economy that is heavily dependent on its resource sector exports. Exports are important to the Canadian economy as they amount to more than 30% of our GDP. Of this, about half of our exports are tied to commodities. Despite the bounce back in commodity prices this year, energy and metals prices are still well below the levels seen in 2014. The weakness in commodities over the past few years has been mirrored by the relative weakness in the Canadian Dollar to the U.S. Dollar. Thus hope was for the non-energy exports to pick up the slack; essentially a lower Loonie would potentially stimulate demand for Canadian manufactured goods bound for the United States and abroad. Recent trade deficit figures have not been supportive of this thesis. Canada's trade deficit hit a record (revised) $3.97 billion in June of this year. Although some of that weakness can be attributed to disruption by the wildfires, the weakening trend had already been evident in the months prior. As chart 1 illustrates, there is a defined link between the Canadian dollar and Canada's balance of trade. Irrespective of the high correlation to oil prices, the Canadian dollar

Chart 1: Canada's Balance of Trade



Source: Statistics Canada

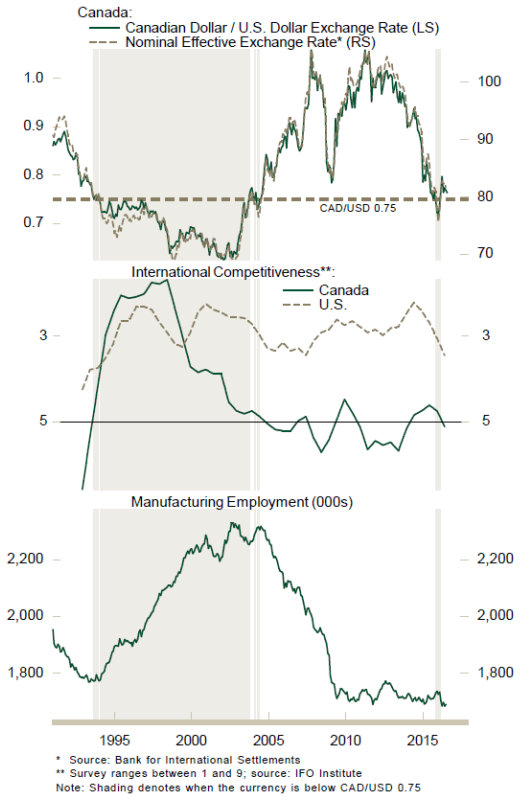
needs to weaken materially (note on the chart, it's the inverse of the CAD/USD rate) to narrow the trade deficits over the past year. Even if it's a tail wagging the dog scenario, the Canadian economy is not competitive in trade with our currency at the current levels. Export performance is the worst since 2009, but of greater concern is the disappointing non-energy export figure.

During the first half of the year, the Bank of Canada has maintained a more positive tone towards the economy than what the economic data would have suggested. The dramatic recovery in oil prices from the February lows also emboldened Canadian dollar bulls to speculate. Strong foreign capital flows into Canada have led to an overshoot of the Loonie to the upside. The latest Bank of Canada update however was decidedly more cautious, stating risks to the country's inflation profile having "tilted somewhat to the downside".

The year to date rally in the Canadian currency has further hurt cross border trade. The slowdown in the growth of the global economy and of global trade flows has also had an impact. Our dollar's rally versus the Mexican Peso has led to a decline in Canada's share of non-energy U.S. bound imports, and at the same time a rise of Mexico's share of U.S. imports, this is most evident in the automobile sector. This loss of competitiveness is troubling for the Canadian economy, and a weaker currency is required to regain the lost ground.

We acknowledge that commodity exports are cyclical, and will ebb and flow along with global commodity demand, but we focus this discussion on the structural challenges, specifically those of our manufacturing sector. The recent downgrade by the Bank of Canada on its outlook for growth is a bit of a return to reality. Trudeau's willingness to spend on stimulus will help, but the potential impact has likely been overstated. Middle income families could see a 0.5% lift to household disposable income through the new child care benefit program. The structural issues however trump (pardon the pun) the benefits when it comes to our economy. Our current lack of competitiveness means the Canadian dollar needs to weaken beyond its long term equilibrium pricing (US$0.75) to regain lost non-commodity export share. Chart 2 illustrates the importance of a weaker currency to spur our manufacturing sector. The extended period of a lower Canadian dollar beginning in the mid-1990s (grey on the chart) was stimulative, leading to jobs growth within the manufacturing sector. Note that this didn't occur until the Loonie fell below US$0.70, and remained at those levels for years. The subsequent rebound beyond US$0.75 in the mid-2000s essentially ended this expansion.

Chart 2: A weaker Canadian Dollar is needed



Source: MRB Partners

Debt continues to dominate any discussion about Canadian household finances, of which mortgages account for 65.6% of all outstanding debts. Low borrowing costs and rising home prices in Toronto and Vancouver continue to encourage more leverage. At the current five year fixed mortgage rate of 2.49%, a $500,000 mortgage with a 25 year amortization period equates to a monthly payment of only $2,237. Doubling those amounts means a $1,000,000 mortgage would cost only $4,474, thus the bidding wars in the hot property markets. Mortgage growth has slowed in recent months however on signs of cooling real estate activity. Accumulation of debt in the form of personal lines of credit and car loans has also contributed to overall household indebtedness. As of the second quarter, the debt to disposable income ratio rose to a new record of 167.6%, households owed $1.68 for every dollar in disposable income. Total household credit market debt now stands at $1.97 trillion, more than our Gross Domestic Product. Although car loans make up a small component of consumer credit, the

dramatic increase in such borrowings has prompted some warnings by the Bank of Canada. Upward pressure on mortgage delinquency rates have been well contained to this point with most provinces seeing few problems in this regard. Although some upward pressure could be expected in Atlantic Canada and the oil-producing provinces, the dramatic increase in household asset values and continuing low rates means that outside of a housing correction in the "hot" markets, the Bank of Canada will likely stand pat on the overnight policy rate. Should there be a larger than expected drop in housing prices in Vancouver or Toronto, a rate cut would moderate the downside, but that is not our base case scenario.

"Lies, Damned Lies, and Statistics (Raymond James Insights & Strategies, September 2016)

This year's U.S. election is one for the ages. America is set to elect their next president in November and the candidates offer two starkly different alternatives on how to steer the country to future prosperity. At the end of August, polling data pointed to a Democrat win, but as we recall ahead of the "Brexit" vote, polls and market expectations are not always accurate. As such, the race for the White House may be tighter than what most pundits and polls are suggesting. However, this doesn't stop us from attempting to guess the outcome by looking at historical patterns and using this guess to formulate potential investment decisions. If we believe polling data and equity market performance, the two are suggesting a Democratic win in the U.S. election. The fact that the U.S. equity markets are sitting at or near all-time highs, suggests the incumbent party (Democrats, Hillary Clinton) will win, if history is a predictor of future outcomes. In considering historical equity returns during an election year, stocks tend to perform well ahead of the incumbent party regaining the Oval Office. Looking at the economy, the fact that the U.S. economy is muddling through (and is not in recession) also points to an incumbent win. Former U.S. President Bill Clinton understood that economic conditions could have a significant impact on an election outcome as he famously said "It's the economy, stupid!" According to Ned Davis Research, the economy has been in recession five times on Election Day and in four of those times, the incumbent party lost. When the economy has not been in recession, the odds of the incumbent party winning is 71%. All these signs point to the Democrats retaining the White House, but Republicans can argue that economic conditions are not so rosy, as millions of Americans have been left behind during the recovery. They can also pull out stats like a third term for either party, Democrat or Republican, is a rare occurrence. With the adoption of the Twenty-second Amendment in 1948, which limited the term of a sitting president to two terms, an incumbent party has won a third term only once – in 1988, the year the Republican nominee Vice President George H.W. Bush, won the right to replace Ronald Reagan. With an eye on the election, we look broadly at each candidate's economic policies to better understand what impact their policies may have if elected.

Both Clinton and Trump have stressed the growing divide that continues to widen in the U.S., although their approaches to solving this issue differs dramatically. Clinton's agenda appears consistent with the previous administration's policies such that Clinton's economic policies are very much viewed as status quo. Trump's policies appear more growth oriented and are a departure from the last eight years, which brings both risk and opportunity. Regardless of the election outcome, both candidates have highlighted the need to invest in infrastructure as a way to kick start economic growth."

	Clinton	Trump
Job & Trade	▪ Supports raising the Federal minimum wage to US$12/hr, but states would be allowed to set a higher floor. Clinton wishes to rebuild the middle class by improving education and training. Proposes most students attend public colleges without having to pay tuition. Opposes the 12-nation Transatlantic Pacific Partnership (TPP). ▪ **Impact:** Higher minimum wage would be a negative for retailers and restaurants, which disproportionally employ low wage employees. However, higher wages would result in increased spending at retailers that focus on low- to mid-income families.	▪ Believes the individual states should determine the minimum wage, but later called for a $10/hr Federal minimum wage. Supports increased trade protectionism. Opposes TPP and wishes to renegotiate the two-decade old North American Free Trade Agreement (NAFTA). ▪ **Impact:** Protectionism would hurt large multinationals, but benefit US domestic producers (typically small- to mid-cap companies).

	Clinton	Trump
Taxes	▪ Increase taxes on estates, capital gains from investments, and on higher wage earners: a surtax of 4% on incomes above $5 million, so the top income bracket moves to 43.6% from 39.6%. Individuals earning above $1 million would be subject to a minimum 30% income tax. Clinton has also pledged business tax reforms to pay for infrastructure investment. ▪ **Impact:** Wealth transfer from the rich to poor. Increase in taxes would be directed to government spending.	▪ Tax reform and cut taxes across the board. Tax code would have 3 brackets, down from 7 existing brackets. Trump's initial plan called for the top tax rate to drop to 25% (later revised to 33%) from 39.6%; the remaining brackets at 12% and 25%. Tax on capital gains and dividends would be capped at 20% and taxes on large estates would be eliminated. The corporate tax rate would fall to 15% from 35%. Businesses would be allowed to immediately write off new investments. ▪ **Impact:** Generally positive for equity markets and capital investment. Increased capex would benefit many manufacturers and technology firms.
Infrastructure	▪ Proposed spending $275 billion to repair/build roads & bridges, expand public transit and high-speed internet access. Clinton's energy plan would spend on repairing aging infrastructure and reducing carbon emissions.	▪ No specific proposal, but Trump has promised a "trillion-dollar rebuilding program" to fix aging infrastructure. He also proposes lifting restrictions on energy production and use the resulting tax revenue to fund infrastructure spending.
	▪ **Impact:** Both Clinton and Trump agree on increased Infrastructure spending, although Trump offers few details.	
Regulatory Reform	▪ Clinton believes Dodd-Frank did not go far enough. She proposes a risk-fee levied on all banks with more than $50 billion in assets, high debt levels, or too much reliance on short-term funding. ▪ **Impact:** Clear negative for financials, particularly large banks.	▪ No new reforms. ▪ Impact: Clear positive for financials, particularly large banks.

Asset Allocation

Given the lack of attractive alternatives, equities remain the preferred asset class from a 12-18 month perspective, but a tactical approach is key. Economic data permitting, we are likely to see one rate hike in the U.S. in 2016, and should U.S. economic growth pick up as expected, possibly another two hikes in 2017. Such periods of monetary tightening usually mean lower valuation on equities as some monies flow back to fixed income due to an improvement in bond and GIC yields. The initial knee jerk market declines during such periods should be seen as entry points, as real returns on both cash and fixed income would remain negligible. Equity valuations are high relative to history, but potential pullbacks should be seen as opportunities to add to stock exposure. However, certain interest sensitive sectors which have clearly benefited from the flight to dividends should begin to underperform, on excessive valuation, and little to no growth prospects, as bond yields creep higher. Meanwhile, the Bank of Canada during this time is unlikely to make any changes to the policy rate, and would likely welcome a Canadian dollar decline to improve Canada's trade position. The divergence in this interest rate policy with the U.S. should exert negative pressures on the Canadian dollar, but stabilizing to rising oil prices over this period would act to counter some, but not all of that downside. U.S. equities should return to outperformance over Canadian equities over this time. Five to ten year fixed income yields should rise 70 - 80 bps (+0.70% to +0.80%) between now and the end of 2017. In spite of a possible slowdown in China growth, we see a return to modest global growth over the coming 12–18 months. Under this scenario, European and emerging market equities will also provide attractive opportunities relative to those in Canada.

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