

2017 Second Quarter Review

Central Banks On Guard

Most major equity markets continued their advance last quarter, even as they traded in a historically narrow range. Central banks helped with their generally positive messaging; they expect sustainable economic growth going forward. Canada's TSX was one exception, effectively giving back first-quarter gains due to weakness in our sizeable natural resources sector.

The price of crude oil remained low in spite of OPEC's recent agreement to reduce production. A worldwide supply glut is still a problem: current inventory is more than 25% above its five-year average. Yet in the face of soft oil prices, **Canada's economy has been surprisingly strong**, with six consecutive months of GDP growth. This fact prompted the Bank of Canada (BoC) to suggest conditions may be ripe for an increase in interest rates. The Canadian dollar strengthened in anticipation.

In the US, equities moved ahead mainly thanks to large-cap technology stocks, which continued to outperform the broader market. And **although political antics in Washington garnered frequent headlines, they were mostly ignored by Wall Street.** Likewise, stocks did not pull back when the Federal Reserve (the Fed), for the

second time this year, raised its benchmark rate by another ¼ percent. Their message was that US economic data, including a very low unemployment rate, warranted the move, even if inflation remains below target.

International stocks rose moderately, helped by the euro, which rallied on the suggestion that the European Central Bank's (ECB) program of government bond purchases - a measure taken following the global recession - may be nearing its end. National elections in France and the UK gave rise to a few unsettling headlines, but investors in European stocks focused more on corporate earnings and improving economic conditions. Japanese equities reached their highest point in two years. And emerging market stocks were roughly flat after a strong first quarter.

In fixed income markets, a basket of high-quality Canadian bonds (maturities of five years or less) advanced modestly for most of the quarter, only to reverse course towards the end of June when **the BoC implied they might raise Canadian interest rates sooner than previously expected.** As yields and prices move in opposite directions, bond prices softened.

Following are the returns for major indices for the period ended June 30th, 2017:

	2 nd quarter actual	1 year actual	3 year annualized	5 year annualized	10 year annualized
Canadian Short Term (FTSE 30-Day T Bill)	0.1	0.5	0.6	0.7	1.0
Canadian Bonds (FTSE Short Term Bond)	-0.4	0.2	1.7	1.9	3.5
Canadian Stocks (S&P/TSX Comp.)	-1.6	11.1	3.1	8.7	3.9
U.S. Stocks (S&P 500)	0.5	17.7	17.0	20.3	9.3
Non-North American Dev. Stocks (EAFE)	3.7	19.8	8.1	14.1	3.1
Emerging Markets Stocks (FTSE / MSCI Emerging)*	1.0	19.4	7.5	9.1	4.0

*Last quarter, 1 year, and 3 year returns are FTSE Emerging. Other periods are MSCI Emerging. All returns in Canadian dollars. Source: SS&C Technologies and Vanguard

Outlook

Looking for Inflation

Central banks around the world are managing interest-rate policy with two key objectives. The first is to achieve full employment. The second is to maintain low inflation. Maintaining low inflation will help with the first, as escalating inflation (not to mention deflation, or falling prices) typically jeopardizes job growth over time.

Improving job growth, led by the US, is now underway in other developed countries, including Canada, which has suffered a significant rout in its resource sector. Employment is improving in Europe too despite ongoing Brexit challenges and continuing drag in the south, particularly Greece. Even Japan, with its long battle against deflation, is seeing improvement. This data is encouraging and is allowing more central banks to finally shift away from long-standing easy monetary policy. For example, in order to foster a desirable “Goldilocks” scenario, i.e., an economy that is not too hot nor too cold, a key topic of ECB discussions is now about reducing stimulus, and the BoC is hinting Canadian interest rates may rise soon.

It is often touted that **the US has been leading the global economy, with its healthy recovery being supported by strong job growth and low unemployment** (4.3%), improving industrial activity, robust consumer spending and burgeoning private investment. This explains why the Fed has responded with four ¼ percent increases to its Fed-funds rate since December 2015 - and another is expected later this year. Now other countries are catching up and their long-awaited turnarounds should be noted as well.

As mentioned, **Canada - still hampered by depressed commodity prices - is nevertheless witnessing improving conditions:** consistent GDP growth, strong retail sales, decent employment and a hot housing

market. The BoC’s change in tone is raising expectations that its first interest rate increase since 2007 may be imminent. As a result, the CA\$ has bounced from the low “70s” (versus US\$) to the high “70s”.

Overseas, the broadening recovery in the euro zone is accelerating, leading the ECB to reverse its quantitative easing program (using bond purchases to keep long-term interest rates low). Investors are hopeful that the outcome of June’s French election bodes well for September’s German election, reducing the risk of further harm to the EU. Even the UK’s economy, coping with Brexit uncertainty and shaky post-election politics, is ticking along at about 2% GDP, forcing the Bank of England to adopt a more “hawkish” tone.

In Asia, Japan is also enjoying a stronger-than-expected recovery. The labour market is tightening, with rising exports and solid factory output driving the economy. Even so, **after decades of battling stubborn deflation, the Bank of Japan remains committed to its aggressive stimulus program,** including negative interest rates and quantitative easing. But that too could change if the global recovery continues its advance.

Among the emerging-markets countries, China is clipping along at close to 7% GDP growth, despite higher short-term interest rates and recent efforts to clamp down on risky lending. The global recovery is driving Chinese exports, up 16% from a year earlier. Brazil, India and Russia (the other BRIC nations) are also attracting capital thanks to their improving economic fundamentals and attractive valuations.

In this positive economic landscape, central banks are now on the watch for signs of inflationary trouble, such as undue wage pressures. So far, the data shows no evidence of it. Rather, **in most areas, inflation remains stubbornly lower than the standard 2% target rate set by all the central banks discussed above.** In Canada, the data is actually showing a decline in inflation, creating a tricky balancing act for the BoC. The conundrum is whether to pare back stimulus now when inflation is below target, or wait and run the risk of falling behind the curve, requiring more painful action later.

Globally, **we are clearly in an early stage of the monetary-tightening cycle**, with central banks making small, selective moves when/if their respective economies warrant it, and leaving room to delay/reverse tightening if growth falters. In this environment, it is difficult to envision a “classic” end of the cycle anytime soon. Typically, that would be indicated by a long string of interest-rate increases undertaken to curtail rampant inflationary pressures. High interest rates would finally trip an economy into a “soft landing” or recession. That seems far off because, at this point, economic uptrends are not only developing slowly but many are still giving mixed signals.

Our view is that, although this bull market in stocks is now in its eighth year and valuations are stretched by many historical measures, it is nevertheless hard to envision its imminent demise. Corporate profits and the global economy continue to improve. **That said, the low volatility we are currently experiencing is unusual by historical standards.**

Investors should expect market corrections to occur (defined as a 10% drop in stock prices from their highs). Frankly, we would view such an event as a beneficial restoration of stock-price valuations. Otherwise, short of some unpredictable shock, such as a clash with North Korea or a major terrorist event, a bear-market selloff à la 2000 to 2002 or 2008 to 2009 remains unlikely.

Portfolio Strategy

With many equity markets at or near all-time highs, **we continue to rebalance, as appropriate**, ensuring client portfolios remain within risk-tolerance thresholds. This entails selling stocks to add to fixed income because global equity returns have significantly outpaced bonds over the past year, or sometimes rebalancing the equity component to trim over-weighted asset classes.

In the fixed income portfolio, we continue to emphasize GICs over government bonds due to the attractive yield pick-up available. This is especially true in the case of Home Trust, a subsidiary of Home Capital. Being a higher-risk lender, they must offer higher yields, particularly in the past month. Three- to five-year Home Trust GICs currently yield more than double what is available on comparable Government of Canada bonds, yet deposits up to \$100,000 remain fully guaranteed by the Canada Deposit Insurance Corporation.

In closing, let’s remember that the current “calm” in stock markets is not normal and a price correction is overdue. However, let’s also remember that stocks are resilient. Smart investors are resilient too, knowing that **long-term success is tied to maintaining a sensible allocation to stocks in a diversified, global portfolio - through good times and bad.**