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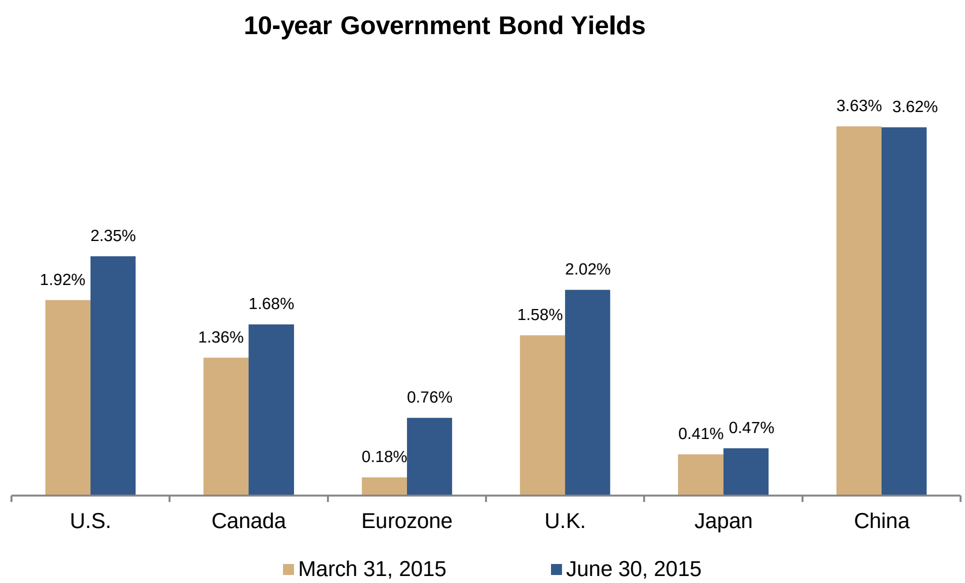
INVESTMENT COUNSEL

Q2 2015 Global Economics Overview

Even as Greece was at the top of everyone's mind as the quarter ended, some economies around the world continued to grow modestly, helped by several central banks which had increased their quantitative easing initiatives. Economic weakness at the beginning of 2015 gave way to improving performances coinciding with a rise in global interest rates from the extreme lows of the first quarter.



The U.S.

The U.S. economy rebounded from a weak first quarter.

The consumer side of the economy showed ever-increasing improvement, with employment gains, wage gains, household spending increases, more housing market activity, greater auto sales, and rising consumer confidence levels. All these indicators bode well for a potential 3.0% to 3.5% annualized GDP growth rate in the second quarter.

Offsetting some of this optimism, the appreciation of the U.S. dollar undermined exports and negatively impacted domestic companies' foreign earnings. Capital spending and factory conditions remained lacklustre with only a few bright spots. However, recent upswings in various purchasing manager surveys suggest some improvement in business activity. This optimism may slowly help lift capital spending out of the doldrums. Whereas past oil price declines caused oil companies to reduce their capital spending in the oil patch, capital expenditures may stabilize if recent oil price increases hold.

Inflation risks may be on the rise due to the recent employment and wage gains. Traditionally, the U.S. Federal Reserve (the Fed) would begin raising short term interest rates to counter any inflation above their target rate. However, Fed chair Janet Yellen has publically stated that she will not raise rates until the Fed is assured that the economy is on solid footing. Recent volatility in economic releases suggests that any monetary tightening may be delayed beyond the market's September expectation.

Canada

Canada's GDP in April shrank slightly, continuing the trend of economic growth moving in fits and starts. The recent rise in oil prices and a reduced discount on the price of heavy crude helped lift export earnings.

Future GDP growth will depend on the U.S economy and on a recovery in commodity prices. A strengthening production cycle in the U.S. may help Canadian non-energy exports.

Consumer spending has remained resilient, but some observers think consumer debt might become a problem. The International Monetary Fund (IMF) warned that Canadians are over-indebted and the housing market risks a downward price shock. This issue has been overblown by the press, and comparisons with the U.S. are not telling the whole story. Mortgage rates in Canada are much lower than they were in the U.S. at the time of the 2008 housing collapse. In addition, Canadians have more equity in their homes and employment has improved along with wage rates, making it easier for borrowers to service their mortgages.

While consumers appear to be doing well, the manufacturing sector is another story. Despite a considerable decline in the Canadian dollar over the past 18 months, Canadian manufacturers continue to struggle. A declining Canadian dollar used to help manufacturers increase their production and exports, but a southward transfer of automobile assembly jobs over the past two decades changed all that. Mexico now builds more cars than Canada. Any benefits of a lower dollar to the Canadian auto industry is less than it used to be because there are fewer car plants in Canada than previously.

On the other hand, a lower Canadian dollar helps Canadian resource companies as their products – oil, gas, timber, potash, to name a few - are priced in U.S. dollars. The lower dollar also helps companies that have U.S. dollar exposure, such as banks, and companies that sell their products abroad.

While the Canadian dollar may have some small interim rallies over the near term, it faces some headwinds, including the following:

- correlation with weak commodity prices
- lower Government of Canada bond yields than U.S. Treasury yields
- lagging growth versus the U.S.
- the Bank of Canada's (BoC) preoccupation with wanting an even lower exchange rate to stimulate exports, which means that the BoC would increase interest rates only some time after the Fed makes its move.

Europe

Unsettled but still relatively low interest rates are starting to bolster consumer spending in Europe. The United Kingdom remains one of the stronger economies in Europe. The country is benefitting from rising consumer spending, construction, industrial activity, and inflows of foreign capital. Despite the Greek economic situation, some “sprouts” of growth began to appear in select parts of the Eurozone. France, Germany and Spain all benefited from the export competitiveness that has been helped by a weaker euro, or, more precisely, by the massive quantitative easing introduced by the European Central Bank.

Japan

In Japan, the 2.4% annualised GDP growth in the first quarter was a pleasant surprise but looked like an inventory-induced bounce. Stagnant real wages crimped consumer spending and the export sector was affected by the effects of moderating growth in China. Japan certainly benefited from lower oil prices and a second big devaluation where the yen weakened by another 10% relative to the U.S. dollar over last nine months. This market appears to be challenged as stimulus in the form of massive bond buying failed to lift wages and shift income to households.

Emerging Markets

Overall, emerging market economies remain volatile. Currencies, with some exceptions, remain under pressure, and political uncertainty persists.

China remains a wildcard. The country is dealing with debt-fueled economic imbalances which present an underlying risk of a credit crisis. It’s hard to ascertain China’s true economic performance given the divergence between its GDP growth data and broader economic indicators. But given China’s weak commodity demand and other factors, its economic growth is moderating, a situation that is also spilling over into other emerging market countries.

In India, there is less investor optimism as the pace of economic reform has been slower than expected. Any new measures brought in by Prime Minister Narendra Modi will take a lot longer to revolutionize the economy than originally expected.

Many Latin America countries continue to have weak economic performance due to low commodity prices and the after-effects of high credit growth. The country with the largest economy in the region, Brazil, is still in recession as fiscal restraint continues and as interest rates remain high to combat inflation. President Dilma Rousseff’s unpopularity is making it difficult for her to implement the unpopular measures needed to turn around the economy and to preserve Brazil’s credit rating.