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INVESTMENT COUNSEL

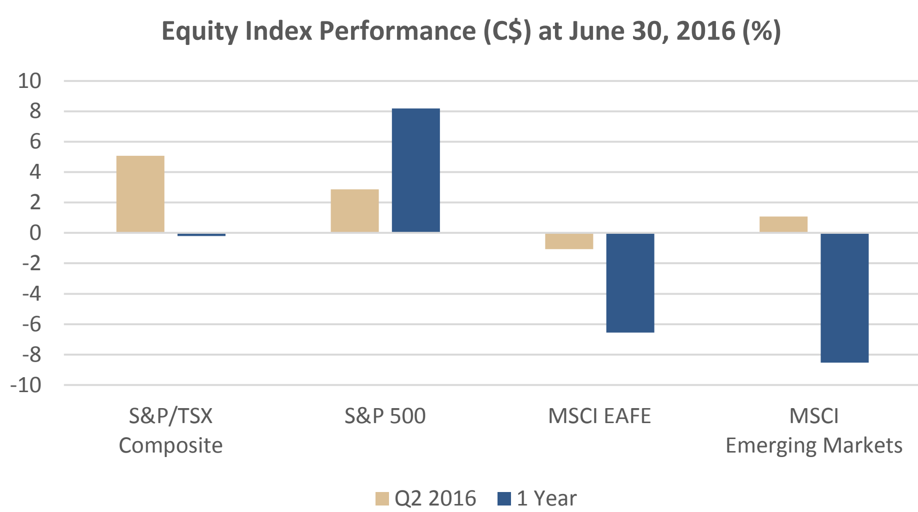
Q2 2016 Global Economics Overview

Economic Overview

Political events overshadowed macro-economic market fundamentals in the second quarter of 2016. World stock markets, after recovering from a first quarter sell-off, were faced with the continuing Trump / Clinton election saga in the U.S. and, more recently, the results of the U.K. Brexit vote to leave the European Union.

Concerns over potential fallout from the British vote initiated a strong initial market correction as investors fled risky assets such as stocks and corporate bonds in favour of U.S. and Canadian treasury bonds, the U.S. dollar, and gold. In the aftermath of the vote, we expect heightened market volatility to persist as Brexit headlines rattle markets in the coming months. However, longer term impacts on world economies are less clear and will hinge on the results of negotiations between the EU and Britain.

The MSCI World Index returned 1.6% in Canadian dollars over the quarter, or 1.2% in U.S. dollar terms. The Canadian equity market outperformed other major equity markets as commodity prices continued to improve and the Canadian dollar rose in overseas currency terms.



Source: Bloomberg

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Inflation and GDP Growth as of March 31, 2016	Canada	US	EAFE	EM
CPI (YoY)	1.70%*	2.20%*	0.46%	3.36%
Real GDP (YoY)	1.10%	2.10%	1.38%	2.91%

** Core Inflation*

Valuation Multiples as of June 30, 2016	S&P/TSX	S&P 500	EAFE	EM
P/B	1.77x	2.80x	1.51x	1.52x
P/E (Fwd)	19.1x	17.3x	14.8x	13.8x

Source: Bank of Canada, Statistics Canada, Bureau of Labor Statistics, Bloomberg, BNY Mellon

Canada

After the credit rating downgrade of the U.K., Canada remains one of only 12 developed market countries with a Triple A credit rating. This should benefit Canada's international capital inflows during the current period of global economic uncertainty. There are some shorter-term economic headwinds as growth has been impacted by the Alberta wild fires and a slowing in export growth as the Canadian dollar rallied from its lows in early 2016. Market-related growth forecasts have been reduced, with expectations of only 1% real GDP growth for the year as a whole. Canada's overall exposure to the Brexit problem is relatively minor compared with other developed markets as the U.K. accounts for less than 4% of Canada's overall trade. However, Canada will not be entirely immune to the impacts if the U.S. and other global economies are strongly affected. Interest rates are expected to stay lower in Canada but remain positive.

The U.S.

U.S. economic growth remains the strongest of the G7 countries, despite some weakness in a select number of growth indicators. The economy continues to be led by consumer spending and construction. Politics are expected to dominate the market's agenda over the coming months as the U.S. electorate remains concerned and puzzled by the platforms and rhetoric advanced in the Clinton and Trump presidential campaigns. The U.S. dollar continues to be the primary beneficiary of the Brexit result as the move away from risk remains in the marketplace.

Europe

Despite showing some signs of economic recovery in Europe earlier this year, as illustrated by rising industrial production and stabilizing unemployment levels, Brexit has cast a pall on the Eurozone's real GDP outlook. The Brexit resolution will not occur overnight as EU rules set out a two-year period for negotiating an exit. There is also the possibility of an extension once formal notice from Britain is received by Brussels.

The U.K.

The unprecedented vote on June 23 in favour of the U.K. leaving the European Union raised concerns about the future of the British economy. Stock markets initially sold off but the overall market effect was bifurcated. London's FTSE 100 Index benefited from the collapse in the British pound as its component companies earn the majority of their revenues from overseas countries. The domestically-dominated FTSE 250 remained approximately 10% below its pre-referendum level by quarter end. U.K. gilt yields continued to decline to record lows and may remain at risk if the depressed pound causes inflation to escalate. The Bank of England remains accommodative, with further initiatives expected if "conditions warrant". The contrarian view is that Britain may actually benefit from this decision over the long term given its strong underlying structural economy. Historically, compromise in inter-government dealings has also acted as a calming influence on longer term market expectations.

Japan

Japan showed only a modest improvement in economic growth thanks to higher private consumption. The Abe government decided to postpone its planned 2% increase in a controversial sales tax to avoid derailing the country's weak economic recovery. However, April's earthquakes, combined with the strong yen, are acting as short-term headwinds to continued growth improvement. On a longer-term basis, Japan must continue to address its need for further structural reform, excessive debt levels, and demographic challenges.

Emerging Markets

After a surge in the first quarter of 2016, economic indicators in China moderated in the second quarter. Growing signs that China will not easily pull the trigger on further economic stimulus drove expectations of continued Asian growth deceleration. An extended slowdown in emerging market capital inflows adds to this slower growth thesis.

Overall the macro economic environment in China remains muddled with a financial system burdened with bad loans and industry mired in overcapacity. At the same time, the government continues to periodically resort to short periods of stimulus to jump start economic activity.

The major story of the quarter happened not in emerging markets but rather in the U.K. with Brexit. The impact of Brexit on emerging markets remains uncertain but may arise from potential tightening of global financial liquidity. One offset could be further monetary easing by developed market central banks, particularly the U.S. Federal Reserve.

Bonds

Deflation remained a dominant theme in bond markets during the quarter, particularly in overseas economies. Over $12 trillion in sovereign bonds are now trading at negative interest rates. In fact, after quarter-end, a 50-year Swiss government bond traded at a small negative yield. The flight to safety, accentuated by the Brexit vote, strengthened this trend. North American bond yields remain in positive territory and are attracting interest from overseas investors. As a result, the consensus forecast for Canadian interest rates is “lower for longer”. However, with yields at near record lows, longer-term bond valuations are extremely expensive. Central banks’ excessive quantitative easing experiments have been the major contributors to this overvaluation. The bond risk/return trade-off is historically unattractive and warrants caution from a longer term perspective.

Canadian Bond Market Performance		
	Second Quarter 2016	1 Year
TMX Universe Bond Index	2.6%	5.2%
TMX Short Term Bond Index	0.7%	1.6%
TMX Long Term Bond Index	5.5%	9.9%
Canadas	1.7%	4.4%
Provincials	3.6%	6.7%
Investment Grade Corporate	2.5%	4.5%
High Yield Corporate	5.8%	-1.3%

Source: FTSE TMX

All returns shown in the Global Economics Overview are expressed in Canadian dollars unless otherwise stated.