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INVESTMENT COUNSEL

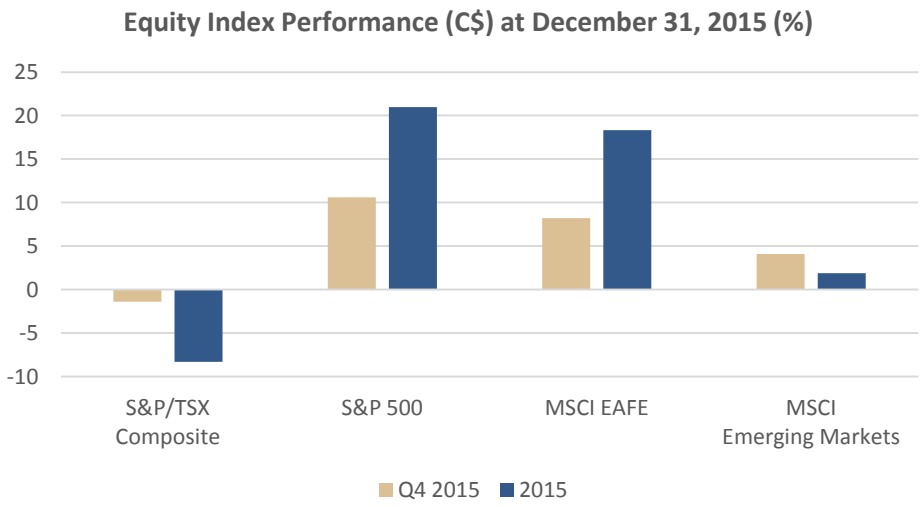
Q4 2015 Global Economics Overview

Economic Overview

The year was a challenging one for investors across all asset classes. China's economy experienced a significant slowdown after more than three decades of strong and consistent economic growth. The Chinese slowdown contributed to a sharp correction in resource stocks, which depressed returns in resource-heavy markets such as Canada and Australia. It also dealt a serious blow to resource-dependent emerging market economies, notably nudging Brazil into recession.

The Eurozone managed to avoid a meltdown related to continued instability in Greece, however the European economies continued to show uneven rates of growth. Investors expected 2015 to be the year that the U.S. economy closed the book on the hangover from the credit crisis. The U.S. Federal Reserve (the Fed) used this perceived economic strength as an opportunity to increase the Fed Funds rate. However, as the year closed, the U.S. economy continued to underperform expectations.

Despite the tailwind of falling interest rates, Canadian bonds provided low single digit returns as investor fears resulted in a flight to quality that favoured government bonds over risk-bearing bonds.



Source: Bloomberg

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Inflation and GDP Growth as of September 30, 2015				
	Canada	US	EAFE	EM
CPI (YoY)	1.00%	0.13%	0.20%	2.79%
GDP (YoY)	0.00%	2.20%	1.83%	3.09%

Valuation Multiples as of December 31, 2015				
	S&P/TSX	S&P 500	EAFE	EM
P/B	1.75x	2.76x	1.66x	1.50x
P/E (Fwd)	18.5x	16.6x	15.1x	12.7x

Source: Bloomberg, BNY Mellon

Canada

The Canadian economy registered two quarters of negative real GDP growth during the first half of 2015, resulting in a technical recession. However, these declines were not broad-based across all sectors of the economy. The strong resource reliance hurt the Canadian economy as commodity prices continued to fall as global demand for resources slowed, led by a significant slowing in the Chinese economy. In the face of this headwind, the S&P/TSX Composite Index lost 1.4% in the quarter, closing the year down 8.3%. Despite the benefit of a falling dollar, there was only a marginal improvement in the manufacturing sector. The TSX was the worst performing developed stock market in 2015.

The U.S.

The U.S. economy remains the strongest economy among developed nations, with a year-over-year GDP growth rate in the third quarter of 2.2%. U.S. unemployment is low (5.0%), and inflation remains low at 0.1% overall. Against this backdrop, the Fed increased its overnight lending rate by 0.25%, signaling an end to expansionary U.S. monetary policy. Additional rate hikes have been signaled for 2016, assuming economic fundamentals do not deteriorate.

The U.S. dollar appreciated significantly relative to the Canadian dollar and other major currencies over the year, hurting U.S. companies with significant foreign revenues. Despite this movement, the S&P 500 Index finished the year strongly, earning 10.9% in Canadian dollars in the quarter, or 7.0% in U.S. dollars. The index had a return of 21.6% in Canadian dollars in 2015; however the return in U.S. dollars was only 1.4%.

Europe

Quantitative easing (QE) is finally having an impact on continental Europe. Despite the slowdown of the Chinese economy, European economies appear to be slowly strengthening, even with inflation levels hovering just above zero. Increased QE is helping to keep interest rates low and is putting downward pressure on the euro, which, in turn, stimulates demand for European exports. These factors together with subdued inflation levels are acting to stimulate the European economy. European equities, as measured by the Euro Stoxx 50 Index, returned 6.6% in the quarter and 15.4% in 2015.

It is important to remember that the Greek debt problem has not been fully resolved, but has only been kicked further down the road. It is only a matter of time before talk of a “Grexit” reappears. This means further uncertainty and potential instability in the Eurozone in the future.

Japan

The Japanese economy benefited from continued quantitative easing and an improving labour market which has helped buoy consumer confidence. Despite weaker demand for Japanese exports, particularly from China, and slower progress in the implementation of much-needed pro-growth reforms, the Japanese economy grew by 1.6% in 2015. The Nikkei 225 Index capped off a strong year, returning 32.7% in 2015 and 13.1% in the quarter.

Emerging Markets

The emerging market economic story has been dominated by events in China. The continued Chinese economic slowdown and lingering fears related to the stability of the Chinese stock market following the summer stock market crash continue to erode confidence in other emerging market economies. Slower growth in China has continued to pressure the earnings of resource companies, which are an integral component of both the economies and stock markets of many emerging market geographies, including Brazil and Russia. At the same time, a rising U.S. dollar further eroded these economies, which carry significant U.S. dollar denominated debt balances.

While the Chinese stock market recovered its footing in the quarter, with the Hang Seng Index returning 9.2%, the broader MSCI Emerging Market Index earned only 4.3% in the quarter and just 2.0% in 2015.

Bonds

Fears during the quarter over the continued slowing of the Chinese economy, combined with concerns over the impact of eroding commodity prices on the solvency of resource companies and a severe slowdown in Western Canada, caused a flight to quality in the Canadian bond market. In this environment, the best performing sector was the provincial sector, followed by the Federal bond sector. High yield bonds were the worst performing sector as corporate yields relative to Government of Canada bond yields widened.

Unlike in the U.S., the Bank of Canada (BoC) lowered the overnight rate twice in 2015 and continues to signal that it has no plans to raise rates. The BoC recently floated the possibility of further interest rate cuts in 2016 and could experiment with negative interest rates if Canadian economic conditions deteriorate significantly. In this environment, interest rates fell, more at the shorter end of the Canadian yield curve, resulting in a steepening of the curve.

Canadian Bond Market Performance		
	Fourth Quarter	2015
TMX Universe Bond Index	1.0%	3.5%
TMX Short Term Bond Index	0.5%	2.6%
TMX Long Term Bond Index	1.6%	3.8%
Canadas	0.7%	3.7%
Provincials	1.6%	4.1%
Investment Grade Corporate	0.6%	2.7%
High Yield Corporate	-2.5%	-3.8%

Source: FTSE TMX