Quarterly Insights

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Economic & Investment Outlook

September 30, 2014

The global economy is experiencing an increasing divergence of growth rates among developed regions and this uneven recovery is influencing financial market returns and volatility.

Economic data continues to suggest that the Canadian and U.S. economies are accelerating, while the Eurozone and Japanese economies appear to be losing momentum.

Second quarter GDP growth in Canada rose by 3.1%, which was the strongest growth rate in nearly three years.

Consumers led the increase, with household consumption up by 0.9%. Exports increased by 4.2%, which was the strongest performance by the sector since late 2011 and also marked the eighth consecutive quarter of expansion.

Third quarter GDP growth appears to be expanding at a similar pace, as manufacturing sales rose 2.5% in July and have now surpassed the previous peak recorded in 2008.

Our economy continues to accelerate despite limited growth in employment. Canadian job creation has been slowing since 2011 when it initially recorded very strong gains after the global recession of 2008. This employment performance is consistent with a transition from growth led by housing and consumer related sectors, to growth led by export and business investment sectors.

US second quarter GDP growth rose by 4.6% and was supported by gains in personal spending, exports and construction.

In August, auto sales reached their highest level in over eight years and the manufacturing sector continued to expand with increases in both production and new orders. The continued rise in manufacturing output should produce stronger demand for capital goods and fuel business investment for the remainder of the year.

Unlike Canada, U.S. employment growth has been steady. Monthly gains of 200,000 or more have occurred for six straight months to July, which is the longest such streak since 1997. The jobless rate continues to decline. A move toward full-employment levels is possible next year, unless there is an increase in the historically low level of labour participation.

The Eurozone economic recovery continues to be weak. GDP growth for the second quarter was unchanged, with Germany, France and Italy all showing weakness. The uncertainty associated with political tensions in Russia and Ukraine may also act as a headwind to economic growth.

Faced with disappointing growth, the European Central Bank (ECB) cut its policy interest rate to 0.05% and announced an asset-backed securities and covered bond purchase program that will begin in October. The ECB also cut its deposit rate, which com-

Diverging

Growth

has

Consequences

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mercial banks pay to keep their funds at the central bank, to minus 0.2% from minus 0.1%. This greater negative rate is an impetus for banks to lend money by imposing a financial penalty for maintaining assets in the safety of the ECB's accounts.

Given the current macroeconomic backdrop, there is a good chance that the ECB may go beyond what it announced this week and embark on a broad quantitative easing program involving large scale purchases of private and public sector assets over the next few quarters. The ECB says it will keep its policy rate near zero for an extended time, even as other major market central banks are preparing to raise interest rates.

We would expect that broad quantitative easing will be less effective in Europe compared with the U.S. Bond yields are already low and the impact of asset price changes may be less powerful in a corporate sector that is more dependent on bank loans than on the capital markets.

Financial Markets

Global financial markets recorded a mixed performance in the third quarter, as investor concern about geopolitical issues and diverging economic growth placed downward pressure on equity prices in some markets. Third quarter 2014 returns in local currency terms for world equity markets were:

Country	Index	2014 Q3 Returns
Canada	S&P/TSX	-1.64%
United States	S&P 500	0.62%
United States	NASDAQ	1.93%
United Kingdom	FTSE 100	-1.80%
Japan	Nikkei	6.67%
France	CAC 40	-0.15%
Germany	DAX	-3.65%
Hong Kong	Hang Seng	-1.11%

Despite a weaker performance in the third quarter, the Canadian equity market (as represented by the S&P/TSX index) has been a solid performer over the past year. There have been several factors that have supported this performance:

- The Canadian dollar's 14% decline against the U.S. dollar since mid-2011 to near the .90 US level, has helped increase earnings for companies in the resource, industrial and manufacturing sectors.
- Non-residents have purchased almost $40 billion in Canadian equities over the past 12 months (to May 2014). This net inflow is the second largest on record.
- The S&P/ TSX index has a large relative weighting to cyclical sectors, with roughly 47% of the index concentrated in industrials, energy and materials compared to 25% for the S&P 500. As a result, Canadian equities tend to outperform as an economic cycle matures.

The Bottom Line

A key theme for the remainder of this year and 2015 will be accelerating growth in Canada and the US, slower growth in Europe and Japan, and the effect this divergence has on interest rate levels and relative currency values.

Historically, the best part of the economic cycle for equity prices has been the period between the end of central bank easing and early in the tightening cycle, as economic growth gains increasing momentum, but is not overly restrained by monetary policy.

As the process of normalizing monetary policy begins, we will continue to prepare the fixed income allocation in our client portfolios for a rising interest rate environment.

Interest Rates and Unintended Consequences

In response to the global financial crisis and recession that began in 2008, the central banks in most developed economies embarked upon an unprecedented effort to stabilize financial markets and inject liquidity into their banking systems.

More than six years later, central banks have reduced short-term interest rates to near zero, or in the case of the ECB, negative levels. They have also deployed unconventional strategies to provide liquidity and credit facilities to banks and have undertaken large-scale securities purchases in financial markets. These measures, along with a general lack of demand for credit due to slow economic growth, have contributed to a decline in interest rates to levels that have never previously been experienced by investors and lenders.

Country	2 Year Yield*	20 Year Yield*	30 Year Yield*
Canada	1.14%	2.20%	2.79%
United States	0.54%	2.55%	3.27%
Japan	0.06%	0.53%	1.67%
France	0.01%	1.34%	2.43%
Spain	0.33%	2.20%	3.51%
Germany	-0.07%	1.00%	1.93%

*Source; Bloomberg September 23/2014

In July 2012, the Spanish government received a 100-billion Euro loan from the ECB to rescue its banking system. The Spanish government also appeared to need financial assistance after the ECB pledged to do “whatever it takes” to save the Euro. However its borrowing rate began to decline prior to the introduction of economic reforms. Short-term Spanish fixed income yields are now lower than those of both Canada and the US. Do investors truly believe that Spanish bonds have less risk than North American bonds or have the actions by a central bank artificially lowered rates and distorted the perception of risk in markets?

Financial markets have clearly grown accustomed to the benefits of ongoing central bank intervention.

The U.S. Federal Reserve has provided three stages of quantitative easing since 2008. The final stage occurred in 2012 with the purchase of $85 billion per month of bond and mortgage-backed securities. When the Fed first indicated in May 2013 that it was prepared to scale back its purchases, the yield on the 10-year U.S. Treasury note nearly doubled from 1.66% to 3.04% by the end of the year. Since then, the 10-year Treasury yield has fallen back toward 2.50%.

Interest Rates and Unintended Consequences cont'd.

The Federal Reserve has gradually been reducing its fixed income purchases by $15 billion each month and the program will be fully wound down in October. The Fed now owns approximately one-third of all outstanding mortgage-backed securities issues. These securities are a major component of the fixed income marketplace. The withdrawal of this source of demand will impact market prices for debt and potentially interest rates that individuals pay to finance their homes.

While the exact timing of a Federal Reserve rate hike is still unknown, the U.S. will likely begin to tighten monetary policy next year. By contrast, in the Eurozone and Japan, the course of monetary policy will continue to be toward more stimulus in an effort to boost inflation and economic growth.

The effects of these differences in monetary policy emerging over the next several years are new risks for both the volatility of global financial markets and the returns that are generated by traditional fixed income securities. The unintended consequences of these quantitative easing programs may ultimately be a new set of issues for the global economy.

Are Media Opinions Helpful?

The media treatment of the recent Scottish independence vote had two things in common with similar coverage in the investment world. First, uncertainty changed to confusion because so much of the forecasting was hasty, volatile and unhelpful. Second, important long term issues were ignored as they were simplified into singular short-term questions.

Media forecasting frequently produces conflicting advice that turns out to be wrong when the facts are known. Polls regarding voting intentions in the Scottish referendum switched back and forth leading up to the vote, however in the end they underestimated how strong the margin of the vote would be. This is similar to the media forecasting that surrounds financial markets all the time.

Two major polls in the last week before the Scottish referendum indicated a six point lead for the 'Yes' vote, and also a seven point lead for the 'No' vote. This was not likely caused by wide fluctuations in public opinion as the two surveys were taken within a day of each other. The difference was probably the result of different sampling procedures, or from the normal ranges for statistical errors. However these types of errors are rarely discussed. In a similar manner, financial markets often react strongly to economic data that we know is likely to be revised significantly.

The point in time of the Scottish vote was made into an exciting and historic moment, when actually the issues that produced the desire for the referendum were long- term. Historically, Scotland has been consistently more socialist-leaning than England. After the vote it became clear that people younger than 55 voted overwhelmingly for independence. Those over 55 and pensioners voted overwhelmingly to stay part of the U.K. Even though these underlying issues are still unresolved, media coverage has now moved elsewhere. The financial media also shifts its focus frequently without resolving their previous coverage.

Most of the time, the media uses sources that have their own interests. It provides them with a platform to represent their own opinions as balanced advice. Viewers of political and investment discussions should be sceptical of the value of simplified, short-term forecasts. Complicated, longer-term issues need a more reliable basis for informed decisions.

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