Quarterly Insights

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Economic & Investment Outlook

December 31, 2015

Despite continued progress in most major developed economies, the pace of global growth decelerated this year as some key emerging market economies continued to slow. Europe, Japan and the US recorded at least a modest acceleration in economic growth in 2015, however that was offset by a slowdown in China and deep recessions in Brazil and Russia.

Driven by a record surge in exports, the Canadian economy rebounded in the third quarter from the declines that were recorded earlier in the year. Our economy grew at a 2.3% annualized rate.

The price of WTI crude oil has declined by nearly two-thirds from a high of $106 per barrel in June 2014 to a year- end price near $37, primarily as a result of a shift in Saudi Arabia's production strategy away from providing price-support to that of gaining market share.

Low oil prices have stimulated a notable increase in global demand for oil. However, this has been insufficient to match supply, resulting in inventories increasing to record levels. This environment has slowed annualized Canadian oil & gas capital spending by nearly 35%, causing a substantial drag on economic growth.

As the year drew to a close, growth in Canada appeared to be progressing at a more moderate pace. Consumer spending continued to advance despite high household debt levels, and exports were rising due to demand from the strengthening US economy. For the first time in several years, increases in government spending are expected to make a notable contribution to growth in the latter half of 2016. Consequently, we expect the Canadian economy to continue to expand next year.

The US economy grew at a 2% annualized rate in the third quarter, following a 3.9% advance in the previous quarter. Consumer spending continued to propel growth with auto sales on track for a record year.

The US unemployment rate has declined to a seven year-low of 5% while growth in wages appear to be accelerating after being dormant for an extended period. Accelerating pay suggests that any remaining slack in the labour market is close to disappearing.

Supported by growing payrolls, demand for housing has continued to strengthen over the past year. New home construction in the US rebounded in November as building permits for single-family homes

Diverging Policies

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Diverging Outlooks

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reached an eight-year high.

We expect that the US will have the highest growth rate of developed countries in 2016 as the economy builds on the momentum of this past year.

The Eurozone recovery is expanding and becoming more self- sustaining. After initially being led by consumer spending, a rebound in capital investment is beginning to underpin a steadier pace of growth. Companies are now hiring at the fastest pace in more than four years in a sign of confidence that the region's economy will gather momentum in the coming months.

In December, the European Central Bank reduced a key interest rate and extended a bond-buying program through to at least March 2017, which should add further stimulus to the Eurozone economic recovery.

Global Monetary Policies Begin to Diverge

On December 16th, the Federal Reserve announced a long awaited increase of 25 bps to the Federal funds rate. This is the first rate rise in nearly ten years as the previous increase occurred in June 2006. This marks what will likely be a multiyear normalization process of US monetary policy.

Expectations are that this rate hike cycle will be more gradual and longer than previous periods. The Federal Reserve's projections are for increases of 100 bps in 2016, 100 bps in 2017 and 85 bps in 2018. If this projected path occurs, it will be less than half of pace of the previous two rate increase cycles.

There could also be a prolonged divergence between interest rates levels in the US and other major markets. For example, while 2 and 5 year US Treasury bonds yield 1.00% and 1.70% respectively; German yields are negative from 1 to 6 years and Japan's yield curve is slightly negative from 1 to 3 years.

This yield divergence will continue to have implications for currency valuations as global investors seek US dollar denominated fixed income assets to increase investment returns. As expectations of interest rate increases have become more pronounced this past year, the US dollar rose at the fastest pace since the early 1980s.

Even though the Bank of Canada is expected to leave its overnight lending rate unchanged into the later part of next year, US interest rate increases will also have implications for Canadian bond yields. This is because the yield on Canadian bonds is influenced by both domestic and international sources. The Bank of Canada generally directs bonds yields with a maturity 2 years and less, while bond yields 5 years and longer tend to be influenced by comparable US yields. Over the last 25 years, the correlation between Canadian and US 5 year bond yields is very high. The two tend to move in the same direction more than nine times out of ten. Therefore it is likely that Canadian bond yields will be increasing even if the Bank of Canada remains on the sidelines for much of next year.

We expect that the normalization of US monetary policy will be an evolving process, with global central banks and investors adjusting to a new period of rising bond yields.

Financial Markets

Global financial markets partially rebounded in the final quarter of the year after posting significant losses in August and September. However, 2015 still proved to be one of the worst years for global equity markets since the financial crisis of 2008.

Fourth quarter and 2015 year-to-date returns in local currency terms for world equity markets were:

Country	Index	2015 Q4 Returns	2015 YTD Returns
Canada	S&P/TSX	-2.23%	-11.09%
United States	S&P 500	6.45%	-0.73%
United States	NASDAQ	8.38%	5.73%
United Kingdom	FTSE 100	2.98%	-4.93%
Japan	Nikkei	9.46%	9.07%
France	CAC 40	4.08%	8.53%
Germany	DAX	11.21%	9.56%
Hong Kong	Hang Seng	5.12%	-7.16%

Declining commodity prices had negative consequences for the equity markets of countries that have significant resource sectors. The TSX Composite Index experienced this effect and declined by 11% in 2015. Emerging markets performed significantly worse, declining by over 15%.

A contributing factor to commodity weakness was the strength of the US dollar, which closed the year by rising 9% compared to a weighted index of its major trading partners. Commodities are generally priced in US dollars, so as the dollar appreciates, commodity prices tend to fall. The Bloomberg Commodity Index which tracks 22 different commodities declined by 25% in 2015.

The strength of the US dollar also affected the value of the Canadian dollar. Our dollar declined by 16% this year, falling to reach an eleven year low. The weaker Canadian dollar will have significant implications for our inflation rate next year, as it will put upward pressure on a variety of imported goods prices. The most notable will be food prices, since 75% of fresh produce sold in Canada is imported from outside the country.

The Bottom Line

Since the financial crisis of 2008 central banks set the tone for financial market and economic performance with similar monetary policies. With a new divergence in global monetary policies now beginning, further gains in equity prices will be highly dependent on an increase in economic growth.

We expect that some of the hardest hit economies are likely to stabilize next year, while oil-consuming regions will more fully benefit from the decline in energy prices.

Rise of the Yuan

The International Monetary Fund (IMF) announced in November that the Chinese currency will now be part of the IMF's list of reserve currencies. A basket of these currencies is used to create its internal unit of accounting, called the special drawing rights (SDR). The SDR basket is a notional currency used as the standard for dealing with the IMF's 188 member governments. Until 1980, the basket held 16 currencies, but was subsequently reduced to just four: the US dollar, the euro, the pound, and the yen. This move now elevates the yuan into the same class as these major currencies, with implementation of the new basket taking place during the third quarter of 2016.

After a period of study, the IMF concluded that the yuan was "freely usable," meaning widely used for international transactions and broadly traded in foreign exchange markets. Over the past five years, China's exports have averaged 11% of the global total, which places it behind the Eurozone and the US, but ahead of Japan and Britain.

The yuan is the fourth largest currency for global trade, accounting for about 2.5% of the total value, according to the Organization for Interbank Financial transfers. However, China has historically pegged its currency to the dollar, giving it an advantage in exporting goods to the US and assisting its exporters to compete in other global marketplaces by eliminating the cost and risk of fluctuating exchange rates.

The yuan still remains far from replacing the US dollar as the top world currency. According to the Economist magazine, the US dollar accounts for 64% of global reserve currencies and nearly 90% of foreign exchange transactions. However, over the longer term the IMF decision will likely encourage central banks to hold more reserves in yuan.

The IMF decision will likely assist the Chinese government to continue reforms that will lead to the maturity of its capital markets and the relaxation of foreign exchange regulations. This will be a contributing factor to stabilizing the growth rate of the Chinese economy.

TFSA Update

The newly elected Federal Government fulfilled an election promise and announced that commencing January 1, 2016 and for all subsequent taxation years, the annual TFSA contribution amount will decrease from $10,000 to $5,500 and will also be subject to indexation.

For individuals who have never made a TFSA contribution, the maximum lifetime limit for 2016 will now be $46,500.

Since the TFSA contribution limit is a lifetime amount, for individuals who do not contribute to the maximum of $10,000 for 2015 year, this expanded amount will not be lost and can be made up with contributions in future years.

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