Quarterly Insights

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WEALTH MANAGEMENT
A DIVISION OF BELLWETHER INVESTMENT INC.

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US Economy Advances

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UK Vote Surprises

Economic & Investment Outlook

After a weak beginning for 2016, the global economy has been showing signs of uneven, but moderate expansion. Improving commodity prices and accelerating growth in the US, have underpinned the divergent economic advance. However, the vote in late June by the United Kingdom to leave the Eurozone has created a new risk for growth in the second half of the year.

The Canadian economy advanced by 2.4% in the first three months of this year which marked a significant improvement from the last quarter of 2015. The positive momentum slowed entering February and March as growth contracted from reductions in manufacturing, retail sales and wholesale trade.

Canadian retail sales advanced 0.9% in April and employment showed modest improvement in May by adding 14,000 jobs. The unemployment rate declined to 6.9%, which is the lowest level since July 2015.

The effects of the wildfires in northern Alberta and the evacuation of 90,000 people from Fort McMurray will result in economic data over the next several quarters being volatile. The two week shutdown of nearly half of the oil sands production will have a short term negative effect, while the rebuilding of the infrastructure in Fort McMurray will be an intermediate term addition to growth.

Canadian exports are expected to remain a key contributor to growth and are being supported by the low Canadian dollar and advancing US economic growth. As commodity prices continue to normalize business investment will likely stabilize in the second half of this year, although a significant increase is not expected until late 2017.

The Bank of Canada has now issued a similar warning to that from Canada Mortgage and Housing Corporation regarding home prices in the surging markets of Vancouver and Toronto. Both entities have indicated that prices are rising at an unsustainable pace, with valuations outpacing the local economic fundamentals of job creation, immigration and income growth. The annual price increase in the greater Vancouver area was 30% in May, up from 15% in December. In Toronto, prices increased by 15%, compared to 10% six months ago.

These markets have also seen an increase in the share of mortgages with high loan values relative to income. According to the Bank of Canada, the proportion of new mortgages with a loan-to-income ratio greater than 450% jumped from 12% to 15%. New borrowers are making payments more manageable by increasing amortization periods beyond 25 years. As a result, mortgage debt continues to rise among highly indebted households that have less capacity to cope financially with employment

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loss or an unexpected rise in interest rates.

Supply constraints in these markets make a meaningful decrease in home prices unlikely unless a significant economic downturn occurs. However, high debt loads will restrain household spending going forward, weighing on overall economic growth.

First quarter economic growth in the US rose 1.1%. It appears that second quarter growth is on track to more than double that pace as gains in employment and low borrowing costs are propelling consumer demand.

US personal spending rose 0.4% in May after an upwardly-revised 1.1% jump in April. Consumer spending, which accounts for about 70% of the economy, will rise 4% in the second quarter. This will be the fastest pace recorded since late 2014.

Business investment was weak during the six months ending in March, reflecting widespread setbacks in the energy sector. The US housing sector remains a bright spot as sales of new homes in April reached the highest level since early 2008.

Although the number of new jobs created in May was below expectations, average hourly earnings increased at the fastest pace in more than six years. This is a positive trend as a sustained acceleration in wages would provide further support for household demand and future employment.

Financial Markets

Global equities partially recovered in the second quarter from the declines that were recorded to start the year. However, market returns in local currency terms have been largely negative over the last year. The surprising result of the UK referendum on membership in the Eurozone sparked new volatility as the quarter drew to a close.

Second quarter returns in local currency terms for world equity markets were:

Country	Index	2016 Q2 Returns
Canada	S&P/TSX	4.23%
United States	S&P 500	1.90%
United States	NASDAQ	-0.56%
United Kingdom	FTSE 100	5.33%
Japan	Nikkei	-7.06%
France	CAC 40	-3.37%
Germany	DAX	-2.86%
Hong Kong	Hang Seng	0.09%

In the aftermath of the United Kingdom referendum vote, the yield on Germany's 10-year government bond fell below zero for the first time on record. The decline in global yields, which has been driven primarily by European and Japanese central bank negative interest rate policies and securities purchases, accelerated as financial market volatility intensified due to the result of the referendum.

The Federal Reserve owns over $4.4 trillion in bonds, an increase of $3.7 trillion in only eight years. The Bank of Japan holds $4.1 trillion in bonds compared to $1.3 trillion at the start of 2011 (US $ equivalent). This value is equivalent to 80% of Japan's GDP whereas the Federal Reserve current holdings represent only 20% of US GDP. Global central banks have become the largest buyers in the global bond markets. As supply is lessened, yields continue to be pushed lower.

Financial Markets Cont'd.

The maturity value of negative-yielding government debt has now risen above $10 trillion for the first time. According to CIBC, about one third of European government bond yields are now trading with a negative yield and, globally, about a quarter of European government bonds now pay a negative yield.

Investors who buy bonds with a negative yield and hold the security to maturity are assured to receive a dollar amount that is less than what they paid. In the current investment environment, borrowers are favoured and savers are penalized.

Negative interest rates are designed to reduce borrowing costs which should increase demand for loans. However, in practice it appears that banks are absorbing the cost of negative rates. This reduces the profit margin between their lending and deposit rates and may actually result in them being less willing to lend.

Fixed income securities are a global asset class and historically low interest rates have led foreign investors to seek the relative attractiveness of yields in the Canadian and US markets. This foreign demand is a contributing factor in supressing bond yields. For Canadian investors this means that the policy decisions of global central banks are producing indirect consequences that are affecting our investment returns.

Brexit Wounds

In a surprising referendum outcome, the United Kingdom (UK) voted to 52% to 48% to leave the European Union (EU) after forty three years of membership.

Only a simple majority was required to pass the referendum. With voter turnout at 72%, this resulted in the referendum being won with only 38% of eligible voters supporting it. There were also strong regional differences as Northern Ireland and Scotland voted strongly in favour of remaining, while England and Wales voted to leave.

Although the referendum was termed "non-binding and advisory", the result has produced a chaotic political landscape in the UK. The Prime Minister announced that he will step down by September, while Scotland's First Minister has indicated that a second referendum on Scottish independence is now a possibility. An election may also be called in the next several months to select a new government to ratify the results of the referendum into law and lead the exit negotiations with the EU.

The short-term economic impact of the vote is unquestionably negative. The credit rating of the UK was downgraded and bank share prices initially declined by over 30% as doubts were raised about London's future status as the second largest global financial center.

Global equity markets immediately produced sizeable declines and volatility in the foreign exchange markets increased, with the British Pound trading down to reach a 30 year low.

The longer-term impact is also uncertain as there will be at least a two year period of negotiating the country's exit. Its new relationship with the EU will regulate $575 billion of annual trade as well as the immigration status of over 2.5 million EU citizens who currently work in the UK.

According to Bank of Montreal, the direct impact on the North American economies will be modest, as the UK accounts for just 3% of US trade and 2.5% of Canadian trade. However, in terms of economic impact, the vote result will add further uncertainty to a global economy that is in need of increasing growth and also the long-term future of the EU as a cohesive entity.

The Bottom Line

The global economy continues to experience modest economic growth.

Equity, currency and fixed income markets continue to be volatile and remain highly influenced by central bank interventions. These increasingly experimental policies continue to underpin valuations, but are also encouraging the accumulation of increasing amounts of debt.

We will continue to use periods of volatility as opportunities to rebalance asset allocations in client portfolios.

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