Quarterly Insights

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Growth Expectations Increase

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Political Populism Rising

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Economic & Investment Outlook

The global economy disappointed during the first half of this year, as the U.S., Europe and Japan all recorded decelerations in growth. Many emerging market economies also retrenched with a slowing in China and ongoing deep recessions in Brazil and Russia. However, the U.S., Eurozone and China showed economic acceleration as the year drew to a close.

The outlook for some of the hardest hit economies appears poised to turn the corner in 2017, supported by a recovery in the prices for a broad variety of commodities.

Canadian economic growth increased by 3.5% in the third quarter, recovering from the previous quarter's decline of 1.3%. Exports led the advance by growing 8.9%, which largely reflected a resumption of energy product exports following the Fort McMurray wildfires.

Canadian home sales rose by 4.4% this year with average prices growing at a 9.5% pace. Consumer debt continues to rise at the same time that housing affordability is declining. According to the Royal Bank, owning a home in Canada is less affordable now than at any time in nearly eight years. Toronto has moved past Vancouver as the city with the most significant erosion in affordability. However, Metro Vancouver remains the market with the steepest ownership cost as a share of household income. With household debt reaching a new record high in the third quarter and recent changes to mortgage qualification rules beginning to take effect, we expect the housing sector will lose momentum as 2017 progresses.

In December, WTI benchmark crude oil prices increased to a 17 month high of over $53 as OPEC finalized a previously announced reduction in oil production. Once implementation begins in January, the agreement translates into a decrease of roughly 1.2 million barrels per day from October production levels. The accord is also supported by an understanding that some non-OPEC countries, including Russia, will also cut output by close to 600,000 barrels per day. These measures will assist in bringing the supply and demand dynamics of the oil market into balance. However, producing countries will need to change their historical record and actually follow through with their pledged reductions in order to have a lasting impact. If the rebound in oil prices holds, capital spending in the resource sector should stabilize and remove a substantial drag on Canadian economic growth.

Economic & Investment Outlook cont'd.

The combination of a recovery in commodity prices and an expectation for firmer U.S. growth sets a better backdrop for the Canadian economy next year. Stabilization in oil-producing provinces will provide more uniform economic growth, while construction outlays should receive some support from federal government infrastructure spending. Longer-term benefits will depend on how well the planned spending is allocated.

U.S. economic growth is closing the year on a strong note. Third quarter GDP advanced 3.5%. recovering from the weakness experienced earlier in the year. Leading the rebound was a large increase in exports and stronger commercial construction. Consumer spending also continued to advance, supported by increased employment and rising wages.

Fourth quarter growth is also on track as October retail sales grew at the fastest pace in over two years. The housing sector continues a steady recovery. In November, sales of previously owned U.S. homes reached the highest level since February 2007, while housing starts recorded a 9-year high.

The current U.S. economic expansion is now the fourth longest on record at 90 months.

Italy voted "no" in a December referendum on a series of constitutional reforms that were designed to reduce legislative gridlock, which has been a contributing factor to the country's poor economic performance since joining the Eurozone. The Italian Prime Minister resigned after the lost vote which will now require a new election to be held.

Italy is the third largest member of the Eurozone and shares extensive trade and financial linkages with the major Eurozone members. Given the recent rise of populist political parties, the upcoming election will introduce a degree of political uncertainty to both Italy and potentially the entire Eurozone.

Financial Markets

2016 was a noteworthy year for global financial markets as a series of political outcomes surprised the general market consensus. However, the UK referendum decision to leave the Eurozone and the election of Donald Trump as the U.S. president-elect produced only short-term volatility in global equity markets. The year finished with positive annual returns in most major markets.

Returns in local currency terms for world equity markets were:

Country	Index	2016 Q4 Returns
Canada	S&P/TSX	3.81%
United States	S&P 500	3.25%
United States	NASDAQ	1.34%
United Kingdom	FTSE 100	3.53%
Japan	Nikkei	16.20%
France	CAC 40	9.31%
Germany	DAX	9.23%
Hong Kong	Hang Seng	-5.57%

In December, the U.S. Federal Reserve increased its benchmark interest rate by 0.25%. It was the first rise in a year and only the second since June 2006. The increase comes as the prospects for the U.S. economy has improved to the point that no longer requires historically low interest rates. The Fed also caught markets off guard by predicting a faster pace of interest-rate increases next year. Their new forecast is now for three increases, as opposed to the previous plan of only two. The accelerated projection is significant and shows that the Fed is becoming more concerned about rising inflation.

In November core U.S. inflation was 2.1% and has maintained a steady 2.0% to 2.3% range over the past twelve months. Energy prices are now up 1.1% on a year-on-year basis and will continue to push headline inflation higher as the recovery in oil becomes incorporated into consumer prices.

Increased expectations for higher future inflation have triggered significant volatility in fixed income markets. November was the worst month ever for the Barclays Aggregate Total Return Bond Index, which declined 4%, as yields on U.S. 10-year Treasury bonds climbed from 1.8% to 2.4%.

Financial Markets cont'd.

Rising bond yields have been replicated in all global markets including Canada, even though there has not been a significant improvement in underlying economic fundamentals of most countries.

Since the financial crisis of 2008, global central banks have been utilizing quantitative easing programs to aggressively expanding their balance sheets to lower interest rates. Over the past nine years, the total assets of the four major global central banks - the U.S. Federal Reserve, the European Central Bank, the Bank of Japan and the People's Bank of China - have tripled from $6 trillion to nearly $18 trillion.

It now appears markets believe that central banks have reached a point where their ability to artificially suppress interest rates is waning. As a result, fixed income investors are once again requiring a premium to compensate for interest rate risk. We expect the global trend toward higher interest rates to continue throughout 2017.

The Bottom Line

November marked a decisive shift for global financial markets as equity prices rallied sharply while bond prices declined.

The potential for market volatility remains elevated as we enter the New Year. Political event risk will remain at the forefront, particularly if negative U.S. rhetoric on trade turns into policy. Meanwhile, a number of key European elections will be taking place. The outcomes may further support the recent groundswell of populist voting that was the hallmark of 2016.

Momentum may carry the markets higher in the short run, but from current valuation levels, equity prices in most markets cannot climb sustainably higher without a sustained acceleration in corporate earnings.

What to Expect From a Trump Presidency

Donald Trump astonished the world by winning the U.S. presidential election. In what was originally viewed as a nearly impossible result, the acrimonious and unconventional campaign concluded with Trump becoming the president-elect. He is very much an unknown when it comes to governing as he has never held an elected office or a high ranking public position.

Equally surprising was the Republican Party keeping control of both houses of Congress. The election campaign illustrated that there are differences of opinion between president-elect Trump and Congressional Republicans as many distanced themselves from his policies on key issues.

As his cabinet nominations were being announced, it is clear that the backgrounds of the individuals who are receiving the appointments are much different than previous cabinet choices. The selections include two billionaires, nine millionaires, and two former generals. Less than half of the nominees have any prior government experience.

Financial markets are now focused on understanding the potential implications of the policies that president-elect Trump and the Republican Party may put forward in 2017.

Although his campaign lacked a detailed policy platform, he did indicate he would like to enact tax reform and lower both corporate and personal taxes. He also proposed a one-time, reduced tax rate on cash balances that U.S. corporations repatriate to the U.S. He has also discussed repealing regulations such as the Dodd Frank Act in the financial sector, which has hampered a profit recovery for U.S. banks. The president-elect has also expressed a desire to boost fiscal stimulus by spending money on infrastructure projects and defense.

What to Expect From a Trump Presidency cont'd.

During his campaign, president-elect Trump was most vociferous against global trade. He has pledged to withdraw from the Trans Pacific Partnership and vowed to renegotiate NAFTA. It is unclear how a new NAFTA agreement would differ from the current one.

If a trade war was to develop with the U.S., the economic implications would be significant for both Canada and Mexico. According to the Bank of Montreal, Canadian exports to the U.S. account for 76% of our total foreign sales and one-fifth of GDP. A 10% drop in exports would reduce economic growth by 2%. Mexico would fare much worse, as exports to the U.S. account for four-fifths of Mexico's exports and 28% of its GDP. A 10% reduction in exports would reduce Mexican economic growth by nearly 3%.

While there are provisions within NAFTA to alter its terms, any renegotiation will take considerable time. However, a shift to a more protectionist trade stance by the U.S. would be a significant negative headwind for global economic growth. Additionally, multinational corporations that have created cross-border supply chains would be adversely affected by restrictions on trade.

Obamacare is also squarely in the sights of the president-elect and the Republican Party as they have contested the program since its inception. While details of a new healthcare plan are vague, we expect that the most likely outcome will be a restructuring rather than an outright cancellation as the program currently has close to 20 million participants.

The implications of these policies are difficult to determine in the near-term. Pro-growth economic policies (tax reform, infrastructure spending and deregulation) could be offset by more trade protectionism, possible higher import tariffs and increasing government debt levels.

The U.S. system of checks and balances between the legislative (Congress) and executive (the President) branches of government significantly limits the power of the Presidency. However, the volatile temperament that president-elect Trump displayed during the campaign and his continued use of social media to express his opinions will likely add a new degree of political risk, not only to the U.S., but also to the world.

Suite 300
1055 West Hastings Street
Vancouver, BC
V6E 2E9
T: 604.609.6177

2600 Sun Life Plaza
144-4th Avenue S.W.
Calgary, AB
T2P 3N4
T: 403.269.1375

Suite 1204
220 Portage Avenue
Winnipeg, MB
R3C 0A5
T: 204.989.6200

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