Quarterly Insights

Economic & Investment Outlook

March 31, 2017

Economies Solid

-

Politics Volatile

The pace of global economic expansion continues to improve as recovering commodity prices and more fiscal spending are broadening growth. Deflationary pressures are now dissipating as inflation continues to increase in many developed economies.

Canadian real GDP grew by 2.6% in the fourth quarter of 2016 fueled by gains in consumer spending, manufacturing and residential construction. Over the past four quarters, Canadian GDP has risen by 1.9% on a year over year basis, which equals the pace of US economic growth that was recorded last year.

The Canadian oil sector is once again contributing to economic output as shipments of energy products rose in December to the highest level since November 2014. The longer term outlook for the sector is also improving due to the approval of several new pipeline projects. Canada approved expansions for two existing crude oil export pipelines: Trans Mountain and Enbridge Line 3; while President Trump revived the approval process for the Keystone XL pipeline that was rejected by the previous US administration. According to estimates by the National Energy Board, the three pipelines represent a $20 billion combined total investment and will add sufficient capacity to accommodate 20 years of oil exports from western Canada.

The majority of Canadian economic data for the first three months of this year point toward an economy that is gathering momentum. Canada recorded its third straight trade surplus in January as export volumes started the year on a strong note, while wholesale trade rose to a new record high with the largest monthly percentage gain since November 2009.

January retail sales increased 2.2% reinforcing expectations for strong consumer spending growth in the first quarter.

Canada produced 48,300 new jobs in January, which was the sixth consecutive monthly gain. Over the past six months, the economy has added 239,000 new jobs, which is the best performance since 2002. The strength of the job market was further reinforced in February with more job gains and a decline in the unemployment rate to the lowest level in more than two years.

Housing starts reached 210,000 units in February, bringing the six-month moving average to the fastest pace since November 2015.

Inflation in Canada continues to move higher. Consumer prices rose again in February, recording an annual inflation rate of 2.0%. This marks the second consecutive monthly reading at or above the Bank of Canada's inflation

Inside this issue:

Economic & Investment Outlook cont'd.

target. Rising oil prices and new carbon taxes in Ontario and Alberta contributed to the increase. The introduction this year of additional new provincial carbon taxes will continue to add underlying pressure to the inflation rate.

US real GDP rose at a 2.1% annual rate in the final three months of 2016, as robust consumer spending was offset by downward revisions to business investment and government spending.

Retail sales rose by 0.4% in January, following an upwardly revised December report. Spending was strong and showed gains across almost all components of the retail sector.

Consumer confidence reached a 16-year high in March which bodes well for future personal spending.

US headline inflation in January was above 2% for the second consecutive month, largely as a result of rising energy prices.

US non-farm payrolls increased by 235,000 in February. Hiring was very broad, with a number of industries showing increases to the highest levels since December 2015. During the week of February 25th, the fewest Americans in 44 years filed applications to collect unemployment benefits.

Employers appear to be limiting layoffs as the labour market remains tight. The unemployment rate continues to be in the range that the US Federal Reserve considers to be full employment.

In March, the US Federal Reserve raised its benchmark interest rate by 0.25%. This was the second increase in three months and they now forecast two additional hikes this year.

The Eurozone's economic recovery continued as GDP grew by 1.6% in the final quarter of last year and leading indicators suggest that a faster recovery is already in place to start 2017. However, political uncertainty has the potential to add a strong headwind to the economic expansion with upcoming elections in France, Germany and Italy.

On March 29th, British Prime Minister officially triggered the process for the U.K. to leave the European Union. Further complicating the Brexit negotiations, Scotland has begun the legal process of preparing for a second independence referendum. Scotland's semi-autonomous government is seeking to retain access to the Eurozone even if the rest of the U.K. abandons it.

Financial Markets

As the global economic background continues to improve, many equity markets reached multi year highs during February and March. First quarter 2017 returns in local currency terms were:

Country	Index	2017 Q1 Returns
Canada	S&P/TSX	1.70%
United States	S&P 500	5.53%
United States	NASDAQ	9.82%
United Kingdom	FTSE 100	2.52%
Japan	Nikkei	-1.07%
France	CAC 40	5.35%
Germany	DAX	7.25%
Hong Kong	Hang Seng	9.60%

The Bottom Line

Improving economic growth and moderately escalating inflation have resulted in higher bond yields and rising equity prices. Although equity valuations have increased significantly in many major markets over the past six months, equities remain attractive relative to bonds in a rising interest rate environment.

We will continue to monitor relative valuations across all asset classes and rebalance client portfolios as required.

NAFTA: Tweak or New Tariff Wall?

The North American Free Trade Agreement (NAFTA) is a comprehensive trade agreement that sets the rules of trade and investment between Canada, the United States, and Mexico. Since the agreement came into effect on January 1, 1994, NAFTA has eliminated most tariff barriers to trade and investment between the three NAFTA countries.

The agreement requires each country to forego tariffs on imported goods that “originate” in the other NAFTA countries. Rules of origin determine which goods qualify for this preferential tariff treatment. Existing rules of origin are well-defined to provide certainty and to ensure benefits are not extended to goods imported from non-NAFTA countries, or to products that have undergone only minimal processing in North America.

The supply chains of companies that import and export goods under this agreement have grown increasing complex. During the manufacturing process, many products cross the borders between the three countries multiple times to create the lowest cost final product that is available for sale to consumers. According to Bloomberg, nearly 60% of the total goods that the US imports from Canada and Mexico have qualified under NAFTA origin rules.

A key component of President Trump’s campaign was to either renegotiate NAFTA with the goal of putting “America First” or to withdraw from the existing agreement if Canada and Mexico are not willing to renegotiate some of the terms. Any of the NAFTA participating countries can withdraw from the treaty by providing six months’ notice.

In a meeting with Prime Minister Trudeau in February, President Trump commented that he only expected to tweak the terms of NAFTA as they apply to Canada. However, in March the US Commerce Secretary has indicated that he expects substantive changes to be made to the agreement with negotiations starting later this year.

Canada has been laying the groundwork for formal talks by reinforcing the depth and the importance of the economic relationship between Canada and the United States. The bilateral trade between the two countries is the second largest in the world. Canada is the largest export market for 31 US states with $1.5 billion in merchandise trade crossing the Canada-US border on a daily basis.

Major revisions to NAFTA will require consultation and approval by both the US Congress and Canadian government. This means that the time horizon for potential changes becoming effective will not be until late 2018 or 2019 at the earliest. However, substantive changes to the agreement have the potential to disrupt the North American economics and the effectiveness of many existing supply chains. This would have significant consequences for corporate earnings and investments, trade flows and consumer goods prices.

Beginning Brexit

Brexit refers to the legal process for the U.K. to leave the European Union as defined by Article 50 of the Treaty on European Union. It allows for negotiations with a two-year time limit that can be extended only by unanimous agreement of all Eurozone governments.

The negotiations will redefine the trade relationship between the two regions and end decades of political integration. The process will focus on a number of important issues:

<u>Trade</u>

One of the most contentious issues will be how much tariff-reduced access to the Eurozone the U.K. will be allowed after leaving the union. The Eurozone is the U.K.’s largest export market, which is the destination for 45% of its exports.

<u>Immigration and Citizenship Rights</u>

The U.K. is seeking to regain control of immigration replacing the free movement of people throughout the Eurozone.

This will have consequences that affect the status and rights of both U.K. and Eurozone citizens. There are currently three million Eurozone citizens living in the U.K. and one million U.K. citizens living in Eurozone countries.

<u>Exit Payments</u>

The Eurozone has stated that past commitments and future financial obligations of the U.K., result in the U.K. owing as much as €60 billion to the Eurozone upon its withdrawal. The U.K. has countered with an estimate of only €3 billion.

Beginning Brexit cont'd.

The departure of the U.K. will impact future Eurozone budgets as it is the second largest contributing country. As a result, future budgets may require spending cuts or larger contributions by remaining member countries.

The complexity of these issues will mean that negotiating a new agreement within the next two years is a lofty goal, as trade agreements between the Eurozone and other nations have historically taken much longer. For example, Canada and the Eurozone began negotiations for a free trade agreement in 2009 with the final agreement only being ratified earlier this year.

The goal of the negotiations will be to balance the U.K.'s desire for a new trade deal against the Eurozone's view that the U.K. should not be able to benefit by withdrawing from the union. The Eurozone will also use the process as an example to discourage other of its members who may have aspirations to leave the union in the future.

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

INDEX
WEALTH MANAGEMENT
A DIVISION OF BELLWETHER INVESTMENT INC.