Quarterly Insights

June 30, 2017

Economic & Investment Outlook

Global economic growth is expanding. The International Monetary Fund has increased its forecast for world growth to 3.5% this year, up from the 3.1% advance that was recorded in 2016. All major economies are expected to grow this year, which is the first time this has occurred since 2010.

The Canadian economy roared ahead in the first quarter of the year, expanding by 3.7%. Growth was fuelled by household spending and a significant rebound in business investment.

The strong momentum from the beginning of the year is also continuing into the second quarter as the economy expanded for the sixth consecutive month in April, with both manufacturing output and retail sales exceeding expectations.

Canada added 54,500 jobs in May with gains spread across most sectors. A total of 316,000 new jobs have been created over the past year. This is the largest 12-month gain since February 2013.

Sources of growth are beginning to broaden which will allow the rotation of economic growth away from the increasingly overextended real estate sector. Since 2014, TD Bank estimates that almost 40% of Canadian economic growth has been produced from housing related activity.

The Bank of Canada's key interest rate target has been set at 0.5% since 2015. The recent revival of economic activity has created expectations in financial markets that interest rate increases will occur in the second half of this year.

A potential headwind to the resurging Canadian economy is the US administration beginning to act on some of its protectionist trade rhetoric. Over the past two months, the US has imposed tariffs and countervailing duties of up to 27% on Canadian softwood lumber.

The US Commerce Department contends that Canadian lumber producers receive unfair government subsidies related to the wood that is harvested on public lands. This is not a new issue, as the US has previously accused Canada four times of unfairly subsidizing the softwood lumber industry. In each of these disputes, Canada has prevailed against the accusations before the World Trade Organization or under the NAFTA dispute resolution process.

The overall impact of these tariffs is limited, as softwood lumber accounted for only 1.2% of Canada's total exports last year. However, a more serious threat to trade could arise from the renegotiation of NAFTA which will begin on August 16, 2017.

Growth Accelerating

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Trade Tension Rising

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Economic & Investment Outlook cont'd.

An orderly renegotiation and modernization of NAFTA could prove to be beneficial for all three North American economies. However, an elevated level of uncertainty regarding future trade policy could result in delays or cancellation of some business investment and pose a direct risk to economic growth.

The US economy got off to a slow start this year, producing only a 1.4% growth rate in the first quarter. Weakness was concentrated in personal consumption, defense spending and inventories. A bright spot continued to be residential construction with housing starts and sales reaching decade highs.

It appears that some of the recent headwinds on the US economy were the result of temporary factors that are now reversing. Consumer spending rebounded in March and April and although the pace of monthly job gains has moderated, the unemployment rate has fallen to a 16-year low of 4.3% in May. With consumer confidence and manufacturing output increasing in June, projections for second quarter growth are for more than double the pace recorded earlier in the year.

In June, the US Federal Reserve raised its key interest rate for the third time in six months. The Fed is projecting another rate hike by the end of this year.

The new US administration continues to be plagued by ongoing allegations of misconduct. These political missteps have the potential to delay the anticipated implementation of pro-growth policies such as tax reform and infrastructure spending. Even if these policies are eventually passed in the next several months, any economic benefits will not be experienced until later next year.

First quarter economic growth in the Eurozone surpassed expectations and continues on its strongest trajectory since the initial recovery from the 2009 financial crisis. Additionally, the expansion appears to be broadening from the core countries of France and Germany to many of the periphery countries.

Rising auto sales in March resulted in Europe surpassing the US as the world's second-largest car market. In April manufacturing sales grew at the fastest rate in six years, while the rate of job creation rose to one of the highest levels over the past decade. The improving labour market should continue to reinforce consumer spending.

However, the improving economic outlook will remain vulnerable to Britain's upcoming departure from the European Union. The Brexit negotiations officially began on June 19th and have a two year time limit. The European Union has established a tough negotiating position by reiterating its hard line on the amount of the UK's departure payment and by refusing to discuss a future trade arrangement until there is agreement on other key topics. Britain is the single biggest export market for Eurozone companies and a failure to conclude a new trade agreement could stoke uncertainty across the region.

Financial Markets

Global equity market performance was subdued in the second quarter, with Canada's S&P/TSX Composite Index posting a negative return as oil prices retreated on concerns about over-supply. Second quarter 2017 returns in both Canadian dollars and local currency terms were:

Country	Index	2017 Q2 Local	2017 Q2 In CAD$
Canada	S&P/TSX	-2.35%	-2.35%
United States	S&P 500	2.57%	0.09%
United Kingdom	FTSE 100	-0.14%	-2.56%
Japan	Nikkei	6.93%	4.34%
France	CAC 40	-0.04%	-2.46%
Germany	DAX	1.10%	2.32%
Hong Kong	Hang Seng	7.69%	5.08%

Financial Markets cont'd.

The US Federal Reserve has announced plans to begin reducing the size of its balance sheet, which consists of Treasury bonds and mortgage securities that were purchased during the 2009 – 2014 quantitative easing programs. During this period, the Fed injected liquidity into the financial markets by purchasing more than $4.5 trillion of these securities.

Later this year, the Fed will begin monthly reductions in Treasury bond holdings of no more than $6 billion and $4 billion in mortgage securities. These amounts will rise each quarter until they reach $30 billion in Treasuries and $20 billion in mortgages per month. The reductions will primarily occur by not replacing existing holdings as they mature, and not by outright sales into financial markets. This process will remove liquidity from the economy and gradually unwind the prior stimulus provided through quantitative easing.

In 2016 the Fed purchased $216 billion of Treasury bonds to replace its matured holdings and keep the size of its balance sheet uniform. These purchases financed nearly 40% of the US budget deficit. Therefore, as a consequence of the Fed unwinding its balance sheet, the US will also lose its largest source of deficit financing which will likely add more upward pressure to long-term borrowing rates.

The Bottom Line

With improving global economic growth, some central banks are now beginning the process of normalizing interest rates and removing extraordinary measures of monetary accommodation. Rising bond yields will be the result of these policy changes.

Bond prices have an inverse relationship with interest rates; when interest rates rise, bond prices fall, and vice-versa. All things being equal, the longer a bond's maturity the higher the price volatility. We have positioned client portfolios to mitigate the impact of rising bond yields by holding short term bonds where prices are affected less by rising interest rates.

Even in a rising interest rate environment, fixed income securities will continue to play an important role in portfolio asset allocation by providing: capital preservation, consistent income, and diversification through negative correlation with other investment types.

Although equity valuations have increased in most major markets, equities continue to 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.

Retail Evolution

Spending by consumers in North America has been advancing at a moderate pace since the recession of 2009; however the sales gains have not been distributed evenly throughout the retail industry. The rise of e-commerce combined with an overabundance of malls is producing a profound makeover of the retailing sector.

Traditional department stores and mall-located retailers are retrenching. In the US there have been nine retail bankruptcies so far in 2017, which already equals the total number experienced last year. Sports Authority has liquidated, while Payless Shoes and Gymboree have filed for bankruptcy. RadioShack, J.C. Penney, Macy's and Sears have each announced more than 100 store closures. In total retailers have pledged to close over 3,600 stores since the start of the year, which will exceed the closures of last year by a significant margin.

As stores close, jobs are lost. Employment with US retailers has fallen every month this year. Department stores have shed nearly 100,000 jobs since October 2016.

The Canadian marketplace is experiencing similar trends. Target closed all of its 133 Canadian stores in 2015 and Sears Canada applied this month for creditor protection and announced the closing of 59 stores. It also warned that it had "significant doubt" about its ability to keep operating beyond a twelve month horizon.

Retail Evolution cont'd.

The demise of traditional retail stores is a direct result of consumers continuing to shift a growing portion of their spending to online retailers. US online sales have produced 22nd consecutive months of gains compared to other retailing categories.

Amazon is the dominant online retailer in North America. From 2010 to 2016, the company's sales have quintupled from $16 billion to $80 billion. It is estimated that half of all US households are now Amazon Prime subscribers.

The US has nearly 1,200 operating retail malls. According to Cowen and Company, the number of malls has increased at a pace that is more than twice as fast as the growth in population over the last four decades. This has resulted in the US now having 40% more shopping space per capita than in Canada.

As large retail stores close, the negative consequences flow through to real estate developers and investors. Many leases have "co-tenancy" clauses that give a small mall store the option to break a lease and close if an anchor tenant is lost. As a result, the failure of one or more department stores can ultimately shutter an entire mall.

Many retailers are now developing marketing strategies that are based on the blending of online sales with a physical presence. The expectation is that web based availability will complement and expand the markets for brands that are already operating in their own retail locations.

While some companies are only beginning to evolve, Amazon is using its dominant market position to expand into new markets. In June, the company moved into the grocery business with the purchase of Whole Foods. The acquisition provides a network of more than 460 stores in North America and Britain that can be used as a platform to develop online grocery sales.

As consumer spending trends continue to evolve it is likely that the retail landscape will look much different in a decade than it does today.

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