MARKET OUTLOOK QUARTERLY

Q2 2016 MARKET OUTLOOK QUARTERLY

Is it safe to come out now?

The first quarter of 2016 may be worthy of an Oscar. It started with such high hopes after a dismal 2015. Those hopes were crushed early by the tragedy of oil falling to $26/barrel, which led to credit concerns spreading from the energy industry to the largest of banks. Yes, there was even chatter of the commonalities between the mortgage bust of 2007/8 and pending bust in energy debt. But instead of a bear emerging, like the one that tried to eat DiCaprio, something else happened. Softer economic data caused the Fed to back off on talking about additional rate hikes, leading to U.S. dollar weakness and a rise in the price of oil. After all that, credit concerns started to dissipate and the markets came roaring back.

The end.

Well, not really. Sorry but there is no 'end' to the market and in the pages that follow we will share our expectations going forward. Topics include:

Q1 in the rearview mirror – a look back at how we got here

Market Cycle still going – an update of our multiple discipline asset allocation models and what they are saying today.

Canada has a plan – as most developed economies rely on monetary stimulus, we are going the other way. Plus, where will bond yields and – more importantly – the dollar go after its wild ride.

America may not be great but it's steady – U.S. economic outlook and the politics

Market Outlook – Putting the volatility into perspective and what to expect next.

Investment Implications – How we've allocated our assets, plus one of our key portfolio themes: the U.S. Consumer.

RICHARDSON GMP

Contributors

Craig Basinger, CFA
Chief Investment Officer

James Price, CFA
Director, Capital Markets Products

Gareth Watson, CFA
Director, Investment Management Group

Derek Benedet, CMT
Research Analyst

Chris Kerlow, CFA
Research Analyst

Shane Obata
Investment Service Analyst

Joey Mack, CFA
Director, Fixed Income
GMP Securities L.P.

Q1 in the rear-view mirror

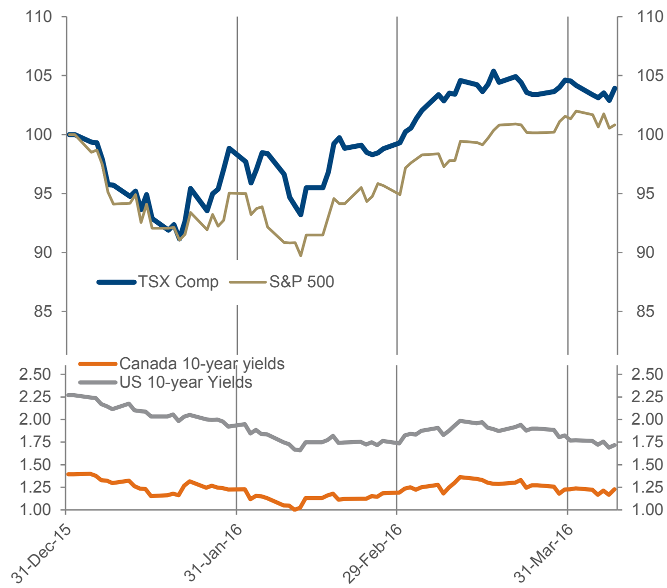
In our 1st quarter market outlook we posited that this is what late stage bull markets feel like. With the S&P 500 starting the quarter just 4% from its all-time high achieved in Q2 2015 (and again in Q3), there is no question the volatility we suggested would afflict the markets is here. After such an easy run higher for the major indices, the S&P500, the NASDAQ and even the small cap Russell 2000 continue their choppy trading. The TSX index of course, suffering from poor diversity, has felt it hard. We all know the story from energy, financials have stuttered since the beginning of 2015 and Valeant continues to make the healthcare sector of the TSX less and less significant.

It was not just equities though. The Loonie has gone for a volatile ride as well, hitting a 12 year low this quarter then staging a rapid recovery to claim back everything it had lost in this quarter and the previous one. The Bank of Canada got an assist from a Trudeau lead deficit spending program that exceed most expectations, and suddenly, more interest rate cuts weren't such a threat. And of interest rates, bond markets had a relatively flat quarter that masked some chop as well, particularly in the corporate space.

The surprise of the quarter was gold. Whether you blame a weaker US dollar, uncertainty in geopolitics, central banks or a hint of inflation, gold surged in January and February catching many off guard. Indeed, we didn't even mention it in our Q1 outlook. After hitting a 6 year low in December, gold posted a 16% return in Q1 after being as much as 20% higher. It seems, like in so many market cycles, once an asset class is forgotten, it is then free to perform again.

So with history out of the way, what can we see today that allows us to plan? Allow us to update some of our views from the first quarter Market Outlook…

Rough start, smooth finish to Q1



Source: Bloomberg

Market Cycle still going

Firstly, because of our Market Cycle approach to asset allocation, we will look at the health of our broad indicators as they closed out Q1.

Markets (positive)

As we noted, equities are now positive on the year, and have rebounded nicely.

Rates (mixed)

Rates are still a mixed picture. While Canada seems to have switched to neutral, the U.S. appears to be toying with a neutral stance as well. While easy money is good for equities, it could mean the Federal Open Market Committee (FOMC) sees weakness.

Fundamentals (mixed)

The rebound in markets has caused valuations to climb, and as with last year, optimistic earnings expectations at the start of the year are being pared back.

Global Economy (mixed)

While we were negative here last quarter, we have seen some signs of recovery out of Emerging Markets and the Eurozone growth has held steady at 1.6%.

North American Economy (positive)

We still believe this to be positive, especially now that Canada has surprised us. The U.S. may have had some disappointing data, but overall, it continues to grind along and grow.

Canada has a plan

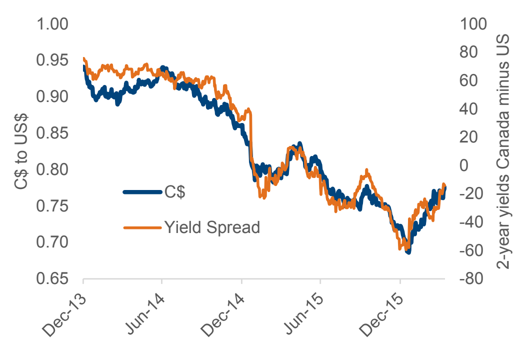
Let's start by looking at home. Canada's woes are now known worldwide. The target of short-sellers and pessimists, it seems that Canada can do little right. And with good reason. High household debt levels, the plunging prices of our biggest exports and big budget deficits are scary. Then January's initial read on Gross Domestic Product is released showing a whopping 0.6% month-over-month gain – the best month since July 2013. The Utilities sector surged, as did Manufacturing – as we would expect when the loonie weakens.

We aren't out of the woods though. The problems indicated above are real. Housing, for example, continues to pose risks to the industries related to them such as building and construction, financials services and household services. Oil continues to languish some 65% below where it was two years ago – and more when you measure the price of Alberta's heavy oil. The Liberal budget was well known to be a deficit budget, but they revealed not only its budget for the coming year, but also its vision over the next decade of increased spending and policies to help the middle class and eventually lead to higher growth. However, putting this plan into action will be a slow process which will likely do little to help growth prospects in 2016 and possibly next year as well.

Canadian Bonds and Loonies

Implications for the Canadian economy, loonie and bond markets are important. The budget has allowed the Bank of Canada to step to the sidelines, and also put our call of another rate cut in question. It now looks like the overnight rate will be static for the rest of the year. Bond yields should stay low as a result, with the two-year Canada bond trading just above the overnight rate, we don't see much action until the Bank starts to indicate a future direction. The longer ten-year bond has been dropping, causing the yield curve to flatten. Still within 15 basis point of where it started the year, yields are lower but not materially so. We continue to see this ten-year yield slowly creeping higher as the deficit spending both stimulates some growth and chips away at the perceived safety of a Canada Government Bond.

Don't expect this narrowing of spreads to last



Source: Bloomberg

Risks to that view are that at 1.25%, Canada is one of the higher yielding AAA sovereign credits out there, except for the juicy 2.4% yield down under in Australia. Should the world continue to be comfortable with our credit, global yield seekers could buy Canadas instead of, say, German ten-year bunds at 0.10%, and push yields lower.

Furthermore, if the silliness of the Vancouver real estate market ends badly, it could cause contagion through some of the financial institutions. With a 20% weighting in the Teranet National Bank national composite house price index, a composite based on resale prices in 11 Canadian cities, it carries enough weight to inflict some damage. While Toronto (35% weighting) has been flying as well, it has not nearly been to the same extent.

The Canadian dollar went too low, too fast. Few saw the speed and ferociousness of the selling, even knowing how low oil would go. Throw in a U.S. dollar that started to run out of steam as rate hike expectations there were pared back, and you had a recipe for a pretty good rebound, which we got through the quarter. We continue to believe that the best prospects for growth are in the U.S., and after this current soft patch plays out, the FOMC can raise rates – and the spread between their two-year bond and ours – renewing the pressure on the loonie.

United States may not be great, but it's steady

The U.S. economy should remain relatively robust in 2016 putting to rest some of the recessionary predictions made at the beginning of the year, even as the political environment provides us with more questions than answers.

U.S. growth continues to average just north of 2% over the past three years, the employment environment remains strong, wage growth is marginally improving, inflation is creeping higher and the U.S. Citi Economic Surprise Index has rebounded nicely in the second half of the first quarter. This data taken together suggests the U.S. saw a soft patch at the beginning of the year rather than a fundamental change which would put the economy into recession.

The likely candidates for President at this moment are Hillary Clinton and Donald Trump. While Clinton policies could impact isolated industries, for the most part the market will view a Clinton victory as a continuation of Democratic policies and thus provide little uncertainty. A Trump win will raise a number of policy questions namely because nobody knows exactly what the details of his economic policies are – he says he'll create jobs and grow the economy, but he hasn't explained how he'll accomplish these goals. Easier said than done. While much fodder will be made by the media about the influence of either a Trump or Clinton presidency, we believe that the overall impact on the economy will be marginal since a large majority of the U.S. budget focuses on Medicare and Social Security alone. The social and geopolitical impact of either candidate, mostly Trump, is another story.

While there may have been a few doubts about the U.S. economy at the beginning of the year, recent data would suggest that we can rule out a recession in 2016 and believe we should start to see U.S. yields move higher as the FOMC's very long, slow deliberate path to raising interest rates plays out.

This should give buoyancy to the U.S. dollar as well, and while quick part of the U.S. dollar bull cycle is played out, we believe there is more to run.

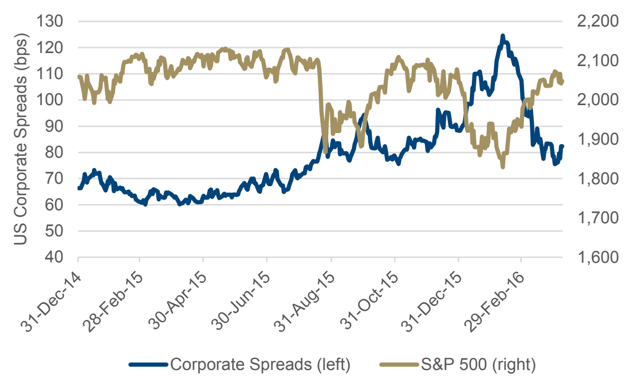
Gold

While this is an update of our Q1 Market Outlook and we did not mention gold, it is worth doing it now given the surprising run. We have yet to take positions here, but are looking closely. Credit Suisse is forecasting a supply deficit for 2016-2018. This should provide fundamental support for gold prices, and the current doubt on future rate hikes from the Fed has also helped. While we don't expect meaningful hikes in bond rates, we do expect them to grind higher, which would typically run contrary to being the best condition in which gold runs.

Market Outlook - Is it safe to come out now?

Markets have rallied hard from their Jan/Feb lows (TSX +13%, S&P +11%) bringing most indices back to break even on the year or even a little better. And while we welcome this rally (as we welcome all rallies), our jubilation is tempered by root of the advance. Softer economic data reduced fears the Fed would steadily raise rates as 2016 progressed. Fewer rate hikes led to the U.S. dollar falling back to earth, which sparked a rebound/bounce in commodity prices, also helped by some better global economic data. The rebound in oil from the mid $20s to $40/barrel was the big one. Higher oil alleviated credit concerns that had spread from the energy producers to encompass all high yield debt and the financials. As credit spreads narrowed (came down), markets took off. A dance we have been seeing for much of the past year.

Corporate spreads come back down, market goes back up



Source: Bloomberg

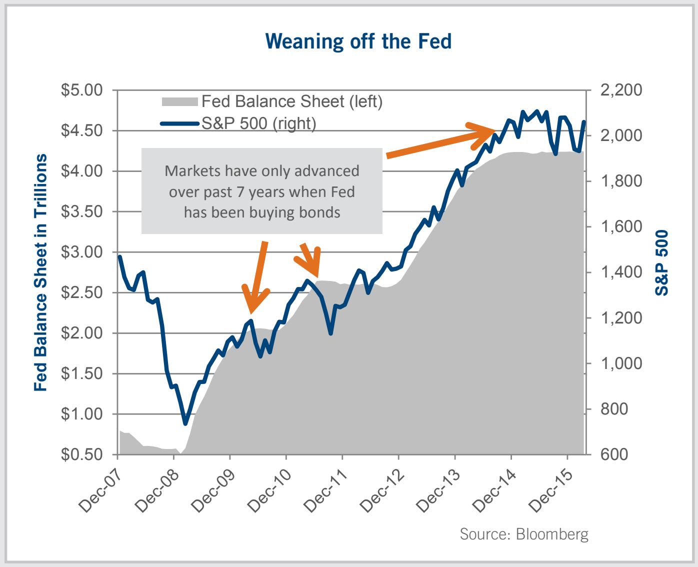
Our excitement over this recovery is tempered for a few reasons. First, it is a low quality rally among the most beaten down industries. In this instance we are using S&P high and low quality indices, which differentiate companies based on the volatility of earnings/dividends. The weakness in January and early February was most focused on lower quality companies and the rebound has been them as well. In other words, it is not as broad a market advance, and may be more of a relief rally after extreme selling pressure. This does raise the question of the rally's sustainability.

Our other concern is the confluence of factors that appear to be fuelling this rebound could very easily reverse. Remember, softer economic data begat lowered expectations of Fed hikes which lead to U.S. dollar weakness and oil strength, which reduced credit risk, and markets went higher. It does sadden us that after a bull market turned seven years old in March, there remains so much market attention and sensitivity on 'what the Fed will do next'.

BAD HABITS TAKE A LONG TIME TO KICK

The amount of monetary stimulus applied to the global markets/economies since 2008 is certain to add a few new chapters to economic text books in the years to come - ZIRP for zero interest rate policy, now NIRP for negative rates in Europe / Japan, QE for the open market bond buying of Quantitative Easing. And perhaps the most important, did it work? For that, we have to wait.

What we do know is the Fed expanding its balance sheet by almost $4 trillion since 2009 lifted asset prices including real estate, bonds and equity markets. One of our deep rooted concerns during this cycle has been how the markets/asset prices would react first to the end of Quantitative Easing (liquidity injection) then to a higher overnight Fed Funds rate. Every time the Fed stopped buying (QE), the equity markets stopped rising or declined. In fact, the last month the Fed purchased over $20 billion worth of bonds was in October of 2014, the S&P 500 was 2,018 right about where it is today a year and a half later.



Glass half full or half empty. The half empty take on this would be the markets can't seem to rise without more monetary policy being thrown into the mix. However, the half full view would be the removal of QE in 2014 and now one rate hike, with markets holding in, perhaps they are farther along weaning off monetary policy. Bad habits take a long time to kick.

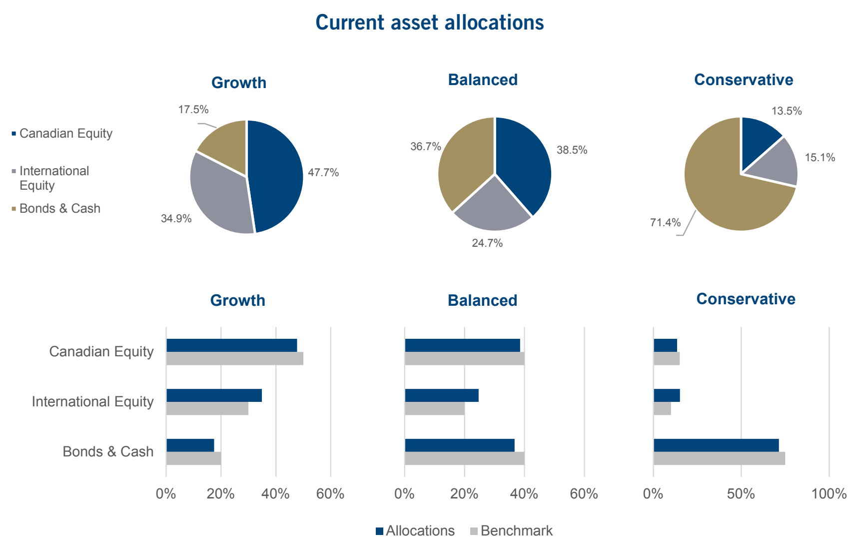
The market continues to wrestle with the big macro questions about the sustainability of the global economy, the impact of the high U.S. dollar, oil induced credit concerns and of course what and when will the Fed do something next.

This is all late market cycle characteristics that will continue to fuel above average market volatility, thankfully that volatility during the past couple of months has been the good kind, lifting markets higher.

Investment Implications

This phase of the market cycle, late bullish, will certainly continue to see heightened volatility. That being said, the majority of our market indicators continue to favour a continuation of this bullish phase. In fact, over the past couple months we have seen improvement in some of our indicators notably for the global economy and also in the U.S. data. Technicals are looking more encouraging and valuations remain a little elevated but not unreasonably so.

We did change our asset allocations during Q1. Across our investor profiles we added to the Canadian equity in early February and reduced the International equity weight. Given the currency and how far the TSX fell, we wanted to take advantage of an apparent market overreaction. This brought our Canadian equity allocation up to roughly market weight from underweight and reduced the overweight in International equities. Still maintaining a mild underweight in Bonds and Cash. Our allocations are now much closer to neutral than they have been in the past three years.



Key Investment Themes - U.S. Consumer

The U.S. consumer matters, not just for America but the world. This single group of individuals, with their spending ways, comprise 16-17% of the global economy. Which is why most global recessions have coincided with a declining U.S. consumer. The good news is at present the U.S. consumer appears to be in pretty good shape. Debt-to-disposable income has come down to levels not seen in over 15 years at 105%. By comparison the Canadian consumer is all levered up at 168%. Average gasoline prices across the U.S. are still low at $2/gallon, down 12% from this time last year. Unemployment is down to 5%, and we are starting to see early signs of wage growth.

This has the U.S. consumer sitting rather pretty and should benefit the broader consumer related industries. However there is one caveat, the consumer's tastes appear to be changing. It could be demographics, or changing priorities, but it seems the consumer is increasingly focused on experience spending as opposed to hard goods. The need to have the biggest plasma TV on the block appears gone, nor the fastest home PC. Now spending growth is increasingly being focused on travel, leisure, media, food/dining and health care.

One of our more prevalent overweights in portfolios is leverage to the U.S. consumer. This includes a tilt even within the sectors to more experience spending such as cruise operators, restaurants and media.

Final Thoughts

This is the late phase of a bull run that started back in 2009 and history tells us to expect added volatility, both up and down. Thankfully, this past quarter had both. The term "late bull" may sound alarming given its finality, but this phase can last a number of years. Based on the current readings of our Market Cycle models, we do believe it has at least a number of quarters, if not years, to go before the bear emerges.

Still, expect the volatility to be above average. And we recommend using periods of strength to gradually become more defensive. We would not be surprised to have our investor profiles back from overweight to neutral on the equity weighting in the next couple quarters. After all, nobody can call a market top or bottom, it is best to gradually manage the turns.