Summer 2017

While the political scene continues to provide an unsettling backdrop, the financial markets have continued to experience historically low levels of volatility with many indices marking and/or maintaining levels near historical highs. Many of the concerns expressed earlier this year remain unresolved. One that has been and proved to be a catalyst for global markets to extend their early-2017 gains was the victory of now French President Emmanuel Macron over the right-wing populist party National Front's presidential nominee Marine Le Pen. This bucking of the political populist trend that had emerged in 2016 resulted in perceived reduction of political risk across the European Union, which had become a growing concern. Despite global equities generally receiving a lift on the news, weak commodity prices prevented Canada from joining the party in the first half of 2017; S&P/TSX Composite Index (S&P/TSX) 0.74%, S&P 500 Index (S&P 500) 5.68%, U.K. London FTSE 6.44%, German DAX 12.14%, MSCI Japan 6.42%, China Shanghai Comp 1.82%, MSCI EAFE 10.4%, MSCI Emerging Markets 14.63%, and MSCI World Index ex-USA 9.44%. A late-quarter rally by the Canadian Dollar meaningfully narrowed that relative return, with the underperformance of the Canadian benchmark TSX/S&P Composite Index being more significant on an unadjusted basis. There was only a single Canadian sector with performance worse than -1% in the first half of 2017. Being that it was energy, which accounts for more than 20% of the index, it was enough to be a meaningful drag for the Canadian market. Whereas in the U.S., the negative contribution from energy was more than offset by double-digit gains in higher weighted information technology, health care, and consumer discretionary sectors.

Unlike 2016, the U.S. Federal Reserve Open Market Committee has stayed true to their forecasted rate hike trajectory. On June 15th, they increased the target federal funds rate by 0.25% for the second time this year. The new range is 1.00% to 1.25%. The U.S. Federal Reserve's (the Fed) current forecast is for one more hike this year, then three hikes in both 2018 and 2019. A bigger question than whether they hike by another 25 basis points this year, which the market expects to occur in December, is how and when they will start reducing the $4.5 trillion of debt they have accumulated since the financial crisis. While the Fed hasn't increased the size of its balance since they stopped their bond-buying program in 2014, they have been reinvesting the interest and maturities. Given what we've learned about Fed Chair Janet Yellen, we anticipate a delicate touch to the shift in policy with the end of their reinvestment policy being the first step. As that occurs, they will be monitoring the impact the policy change has on interest rates with keen interest. Another related item worth monitoring will be whether or not President Trump asks Janet Yellen to return for another term as chair of the Fed; her current term concludes at the end of February 2018.

Back home in Canada, the Bank of Canada (BoC) made the decision to increase the overnight target rate for the first time in almost seven years on July 12th. That 0.25% hike brings the BoC's benchmark rate to 0.75%. The commentary surrounding the move implied that the hike is viewed as a reversal of the emergency rate cuts enacted by the BoC in 2015 and therefore another hike is likely this year. We don't expect that this hike marks a fundamental change in policy and that the Bank of Canada is embarking on a multi-year rate hiking cycle yet. We believe another hike later this year followed by an evaluation period that lasts several meetings to be the most likely scenario.

The effect of the Bank of Canada's decision on interest rates resulted in a directional change, as rates had been trending lower since March. The reaction was unsurprisingly more significant on short-term rates as the two-year Canadian Treasury bond's

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yield jumped from 0.73% to 1.33%. At 0.60%, the change validates our expectation that the BoC is unlikely to be aggressive with the overnight rate in the near-term. While longer term rates moved higher, the move wasn't much beyond where they were trading earlier this year. The impact of those higher rates is that the year-over-year performance of the FTSE TMX Canada Universe Bond Index is in negative territory. Going forward, we expect rates will be relatively flat for the balance of the year. While the recent move in rates has modestly increased the number of bond issuances that fit our preferred search criteria, we continue to lean on tactical global fixed income strategies for our core fixed income allocations.

The Bank of Canada's impact was not limited to the fixed income market, as the Canadian dollar (CAD) rallied on the move as well. Since BoC governor Poloz indicated that a reversal of the emergency cuts was on the table in mid-June, the CAD has gained 7% relative to the U.S. dollar. At 1.245 per U.S. dollar, the Loonie is trading at its highest level since 2015. The Canadian dollar is not alone in that position, as the Euro is also trading at multi-year highs relative to the U.S. dollar. While the trend is surely in the CAD's favour, we believe that the policy change is now accounted for and the U.S. dollar should find support.

Beyond the change in BoC policy, a recovery rally in energy prices over the same period contributed to the Canadian dollar’s move. The rally brings the U.S. dollar price of a barrel of oil back to the high-40s and close to the mid-point of its range for the past 12-months. While demand is forecasted to be slightly higher in 2017, it’s the supply equation that’s dominating the narrative. The two sides in this equation are the Organization of the Petroleum Exporting Countries (OPEC) and the U.S. shale producers. The efficiency of new drilling technologies has effectively put a cap on energy prices, despite attempts by OPEC to cut supply and push prices higher. Such an environment leads us to prefer the movers of energy products rather than the extractors.

With populist political concerns in Europe abating and economic/fiscal situation earlier in the cycle than the U.S., we have become more positive on European equities. Of our neighbor to the south, we continue to be concerned that the tax and regulatory policy changes promised by an embattled U.S. Presidential Administration will take longer to pass than equity markets currently expect. Despite that, U.S. equities have continued to rally and we have maintained a position best described as neutral. Closer to home, the makeup of the Canadian equity markets is such that the growth we forecast from its largest sector (Financials) will be somewhat offset by the prospects of its second largest (Energy). All told, we expect equities to move higher over the balance of 2017, but with more volatility than what the market’s exhibited of late.

Sources:
Bloomberg Finance L.P. as at June 30, 2017. Total Index returns. Index returns calculated in C$.
International Energy Agency, *Oil Market Report,* July 13, 2017.

Interest Rates as of July 26, 2017

Fixed Income Securities	1 year	2 years	3 years	5 years	10 years	20 Years	30 Years
GICs**	1.42%	1.50%	1.60%	2.10%			
Canadian Treasury Bonds*	1.14%	1.33%	1.38%	1.63%	2.02%	2.33%	2.36%
U.S. Treasury Bonds*	1.22%	1.36%	1.55%	1.89%	2.34%	2.59%	2.92%

* Rates provided by TD Securities
** Rates provided by TD Wealth

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