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Economic and Capital Markets Outlook

September 2014

Summary

- The IMF forecasts global growth to rise from 3.3% to 3.8% in 2015, led by stronger growth in the U.S.
- The U.S. economy is supported by improvements in almost all major sectors. Housing, capital spending and trade are expected to drive growth forward in 2015. Canada will be a major beneficiary of stronger growth in the U.S.
- Europe is experiencing positive albeit slow growth. The ECB's actions to provide further monetary stimulus are key to the region's recovery.
- Emerging markets are positioned to grow at least twice as fast in real terms as the developed world, notwithstanding some dispersion across economies.
- The current stock market decline is being driven by concerns over temporary factors. A generally favourable backdrop for earnings growth, reasonable valuations and solid dividend yields will support equity prices over the longer-term.
- Equities will deliver superior returns over cash and bonds. Long-term bonds represent an unattractive investment.

Global economic growth has remained moderate in the aftermath of the Great Recession of 2008-09, as financial, fiscal and consumer excesses have been unwound. Our review of current economic conditions suggests that we are entering a period of accelerating economic activity, particularly in the U.S. where growth is supported by improvements in almost all sectors of the economy.

Canada will be a major beneficiary of increased U.S. economic activity. The transition away from growth based on residential investment and consumer spending will be led by trade as the demand for Canadian exports increases.

While Europe is still burdened by banks that have been reluctant to lend, recent announcements by the European Central Bank (ECB) offering banks generous credit terms are encouraging. Growth in the region, while modest, should continue to improve given further monetary stimulus.

The fundamental growth drivers remain strong in emerging markets. Economies in transition are bound to face occasional periods of instability, whether financial or political. The tremendous opportunities that these markets offer should result in solid returns over the long term.

An improving global economy provides a positive backdrop for a rise in corporate earnings and equity returns. In contrast, bond yields are expected to face upward pressure as they normalize. We therefore continue to favour equities over both cash and bonds over the medium-term.

U.S. economic growth is broad-based

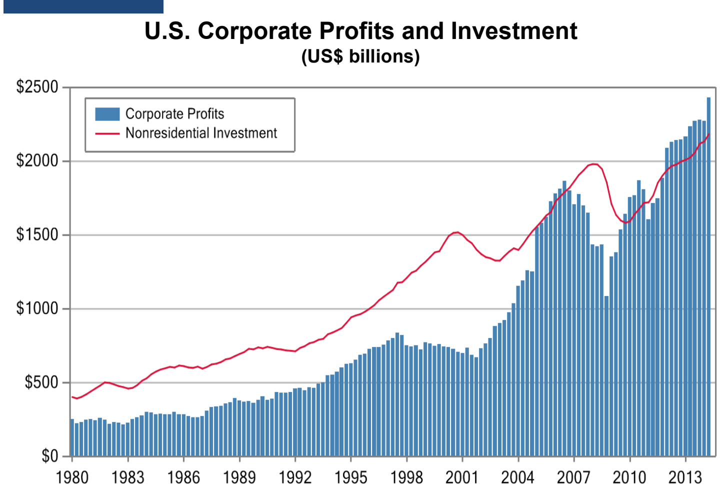
U.S. growth in the first quarter was unusually subdued due to difficult winter conditions. Looking past this temporary distortion, there are clear signs that the economy is re-accelerating. Nominal GDP expanded by more than $275 billion in Q2, representing a rise of 4.3% on an annual basis. Consumer spending accounts for the largest segment of the economy (69%), followed by government spending (18%), non-residential investment (13%), residential investment (3%) and the trade balance (-3%). Real GDP is now growing 2.6% year-over-year and is supported by improvements in almost all major sectors of the economy.

Household consumption is dependent on income growth which, in turn, is determined by employment and wage increases. Since the beginning of the year, employment growth has averaged 227,000 jobs per month, well above the rate of 161,000 per month seen during 2010-2013. There has been a pickup in both the number and quality of new jobs: 22% were professional & business-related while 14% were in construction & manufacturing. Wages are also rising consistently at a rate of 2.0% year-over-year. Even low paid sectors such as leisure and hospitality are experiencing the best growth in salaries since 2007 (+4.2%). These factors are driving a solid expansion in aggregate income and consumption.

The household sector's balance sheet adjustment appears to be over as American consumers have reduced their spending to 95% of their disposable income compared with a peak of 103% in 2005. Household net worth has climbed to an all-time high of $81.5 trillion. Going forward, we expect consumer spending to be in line with income, or even slightly better as there are signs that a new credit cycle is underway. The impact of rising incomes and consumer credit are stimulating car sales (+10%) and retail sales (+5.0%).

Turning to investment, capital spending tends to be driven by corporate profits and the expectation of healthy economic activity (Chart 1). While corporate profits rebounded significantly following the 2008-09 recession, companies remained reluctant to invest amid uncertainty about the recovery's sustainability, particularly given malaise over Europe in 2011 and political gridlock in the U.S. in 2012. During the second quarter, capital spending increased, with investment in structures up 12.4%, spending on equipment and machinery up 7.6% while spending on intellectual property and R&D was up 5.7% over last year. Manufacturing capacity utilization is now close to 80%, a level that is conducive to the construction of new plants. At this stage of the economic cycle, continued growth in activity should translate into more robust capital spending.

Chart 1



Source: Bureau of Economic Analysis

Housing investment has emerged from depression-like conditions and is approaching more normal levels. New housing starts rose from an average of 589,000 units during 2009-2011 to about 1 million new units per year. The current rate of construction remains below our estimate of normalized demand of around 1.5 million housing starts largely due to subdued household formation. With the jobs market picking up, household formation should increase and stimulate additional construction. Early signs of this demand can already be seen: the surplus in housing inventories hit a 15-year low during the summer months.

In tandem with the improving economy, headway has been made on reining in unsustainable fiscal deficits. The Congressional Budget Office (CBO) forecasts that the deficit will decline to 2.9% of GDP in 2014, a substantial reduction from 9.8% of GDP recorded in 2009. The government actually detracted from growth in recent years by cutting spending and raising taxes. We expect that fiscal policy will be neutral as no new spending initiatives or cuts are likely to be enacted in the lead up to the next election in 2016.

The trade deficit reached a trough of $615 billion in Q1 2012 and has since improved to $549 billion on the back of stronger exports. Reduced petroleum imports are also having a positive impact as U.S. domestic production of crude oil has risen by 64% in the past 5 years. Oil imports have fallen from a peak of 10 million barrels per day to less than 8 million barrels per day.

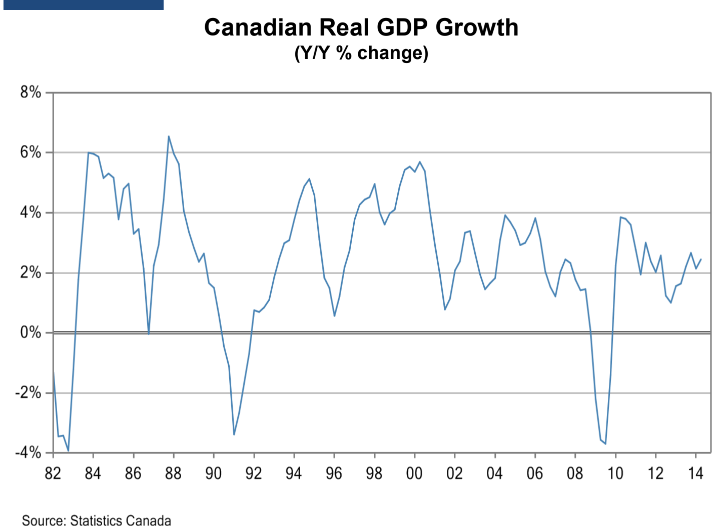
Our forecast for U.S. real GDP growth has been somewhat scaled back to 2.0%-2.5% for 2014 given the anomaly of Q1, although growth for the remaining quarters of the year are expected to rebound above 2.5%. Our central forecast for 2015 is for growth in the range of 2.5%-3.0%.

Canadian growth higher than expected yet headwinds remain

The improving U.S. economy will have a positive impact across the globe and Canada is set to be a major beneficiary. The U.S. accounts for 75% of Canada's merchandise trade and the volume of exports across the border has risen from $270 billion in 2009 to $359 billion in 2013. This level reached a record $398 billion annualized for the first eight months of 2014 as a result of a weaker Canadian dollar and firmer U.S. growth. All major export segments are rising including crude oil (+16% year-over-year), cars & light trucks (+5.9%), food and consumer goods (+14%) and mining and metal products (+16%). The increase in exports to the U.S. contributed 16% of the economy's 4.9% year-over-year expansion in nominal terms in the second quarter. In real terms, Canada's growth rate is 2.5%, one of the best rates of the last few years (Chart 2).

The key headwinds that the economy faces which are likely to hinder future growth have been covered in past reports (please see June and December 2013 issues of the LBA *Economic and Capital Markets Outlook*). Household indebtedness is reaching new highs at 162% of disposable income, driven in part by strong residential investment and rising home prices. Thus far, however, consumer balance sheets have not adjusted and the housing market has not cooled despite various government attempts to tighten mortgage credit. Consumption is still the main driver of the economy, growing 5.0% year-over-year, while housing starts are running at 197,000, leading to a rise of 3.7% in residential investment.

Chart 2



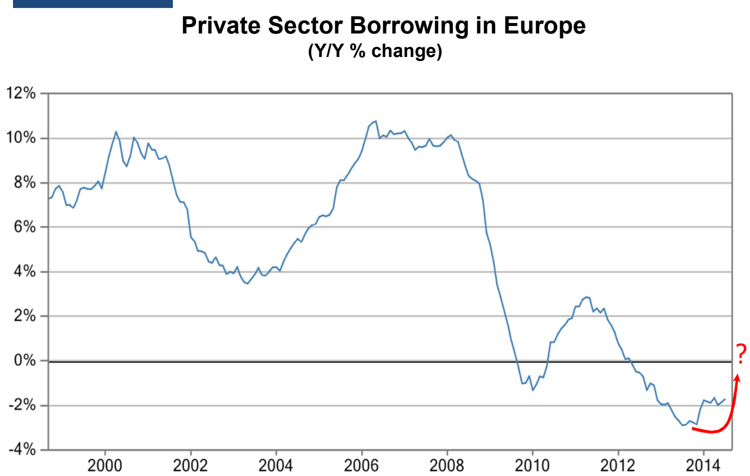
The Canadian economy will gradually transition away from consumer spending and housing. While investment has been modest, the improvement in exports is encouraging and reinforces our view that the transition should be smooth and enable the economy to deliver fair levels of growth. Our central forecast for the Canadian economy is 2.0%-2.5% real GDP growth in 2014-15.

Progress on easing Eurozone credit conditions key to recovery

Economic activity in the Eurozone remains sluggish. Real GDP growth during the second quarter was 0.7% versus a year ago. Spain (+1.2%), Netherlands (+0.9%) and Portugal (+0.8%) are seeing an improvement in growth rates while Germany (1.3%), France (0.1%) and Italy (–0.3%) are slowing. Spain and Portugal appear to be benefiting from structural reforms enacted during the past three years, an area in which Italy and France have lagged. Pressure is therefore building in these latter countries to tackle their structural rigidities more decisively.

Credit conditions remain tight in various Eurozone countries, particularly for small and medium-sized businesses (Chart 3). This together with geopolitical concerns remains a major headwind to growth. European corporations rely heavily on bank loans which fund on average 80% of their financing needs, whereas U.S. firms fund themselves primarily through corporate bond issuance and only source 30% of their financing through banks. Lending to the non-financial sector is down –7.9% in Spain, –1.4% in Italy, –0.5% in France and is only up +0.9% in Germany. Bank lending in the region is currently constrained by two factors. First, European banks are still reducing leverage and recapitalizing balance sheets. Second, an ECB-led assessment of the quality of banking assets ("Asset Quality Review") was launched in October 2013 and is expected to be completed by October of this year. Banks have been reluctant to extend credit ahead of the ECB's findings.

Chart 3



Source: ECB

This past June, the ECB announced a series of measures aimed at incentivizing banks to restart lending. These measures rested on 3 pillars: interest rates, liquidity and asset purchases or quantitative easing. In an attempt to direct excess bank funds into the real economy, the central bank both lowered the rate at which banks could borrow and started paying a negative interest rate on funds deposited at the ECB. On the liquidity front, the ECB extended the term of its loans to banks to 3 years, conditional on the funds being used to increase lending. In other words, banks will be able to secure medium-term funding at very low rates in exchange for new credit creation. The third pillar, while similar to the program which the U.S. Federal Reserve will soon exit, is different in scope. The ECB proposal involves outright central bank purchases of financial instruments underpinned by bank loans (corporate bonds backed by collateral and asset-backed securities). By bearing the credit risk, the central bank's aim is to encourage banks to increase lending to the private sector. More details on this latter program should be revealed in October.

Leverage in the European financial system has been substantially reduced. The banking sector's asset-to-equity ratio declined from 18 times in 2008 to 12.5 times in 2014. Banks are therefore in a better position to increase lending in line with the objectives of the ECB. Our forecast for European real GDP growth in 2014 is 0%-1.0%. Should the ECB's actions to unclog credit markets bear fruit, growth in 2015 should gradually pick up.

Our economic outlook in Europe is tempered by potential instability due to rising tensions between Ukraine and Russia. While Europe's share of exports to Russia is relatively small, varying from 1%-3% per country, several nations rely heavily on Russian imports, notably on the energy front. For example, Russia supplies 18% of Germany's oil and gas imports, 23% for the Netherlands and 24% for Italy. General business uncertainty arising from this conflict is detrimental to the nascent European recovery. Geopolitical events are notoriously difficult to analyze and forecast. However, successive rounds of sanctions against Russia could foster a change in attitude due to deteriorating economic conditions in the country. Overall inflation has increased to 7.5% while food inflation is running above 10%. The ruble has declined by about 10% versus the U.S. dollar since the onset of the military intervention and the central bank has been forced to raise rates. The Russian economy is clearly slowing and likely entering recession. Further deterioration will be increasingly difficult to bear and could lead to a softer stance on foreign policy.

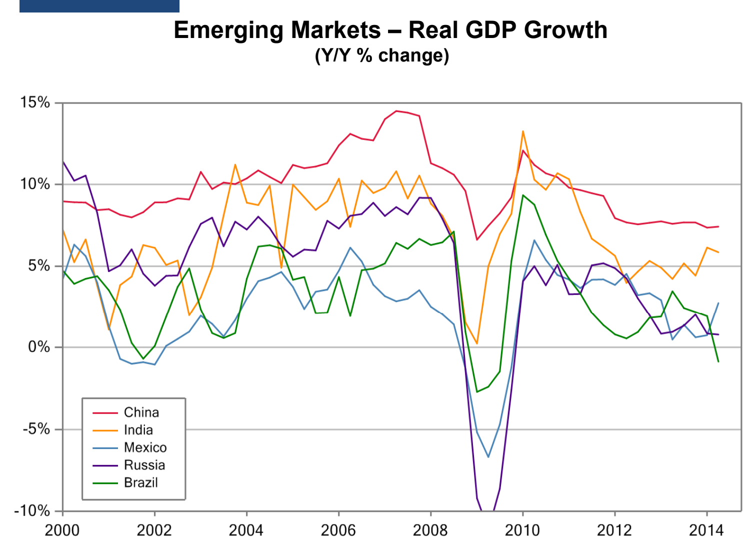
Emerging markets hitting a soft patch

Economic activity amongst emerging market countries is mixed. A cyclical slowdown is impacting certain developing countries while growth in others appears resilient (Chart 4). The IMF forecasts emerging markets to grow 4.4% in real terms in 2014, improving to 5.0% in 2015, more than twice the rate of developed markets' growth.

In our September 2013 *Economic and Capital Markets Outlook,* we outlined that a potential risk to a pickup in global activity included decelerating growth in developing markets. Facing foreign capital flight and high inflation, the central banks of several key emerging market countries raised interest rates at the expense of slower growth. Brazil, for example, hiked rates from 7.5% to 11% while inflation reached 6.5% and the country went into recession during the second quarter.

While the growth rate of several emerging countries is low due to cyclical factors, we remain of the view that the long-term fundamentals of these countries offer the potential for solid returns as their economies progressively develop and their standard of living continues to improve.

Chart 4



Investment conclusion: favour equities over bonds

The MSCI World Index is down around 4% in Canadian dollars between October 1st and October 15th although it remains up 4.2% on a year-to-date basis (expressed in U.S. dollars, the year-to-date return is –2%). The market's pullback in recent weeks should not be surprising given the cumulative 50% total return generated from January 2013 to September 2014. A number of factors have combined to erode investor confidence. Weak German industrial production has brought into question the recovery in Europe. A small decline in global oil consumption over the last 3 months, together with a moderate gain in capacity, has precipitated a sharp drop in crude oil prices. Finally, fears of a wider Ebola outbreak have added to investor concerns.

We are of the view that current negative sentiment is focussed on temporary factors. As noted above, we believe that global growth will improve, led by the U.S. Europe remains impacted by geopolitical tensions and lacklustre business confidence. However, monetary stimulus should alleviate tight credit conditions and improve growth prospects.

Our investment strategy remains unchanged. Corporate profits are set to increase, which will support equity prices in the future. Equity valuations are reasonable. Using Bloomberg estimates for 2015 profit growth in the U.S., the price-earnings (P/E) multiple for the S&P 500 Index is 13.9 times. Using similar estimates for profit growth in Canada, Europe and Asia, the S&P TSX trades at 13.3 times earnings, the Stoxx Europe 600 trades at 12.4 times and the MSCI Asia Pacific Index trades at 11.7 times. Our global equity portfolios, which are broadly invested across all economic sectors, are well valued at around 13 times 2015 earnings.

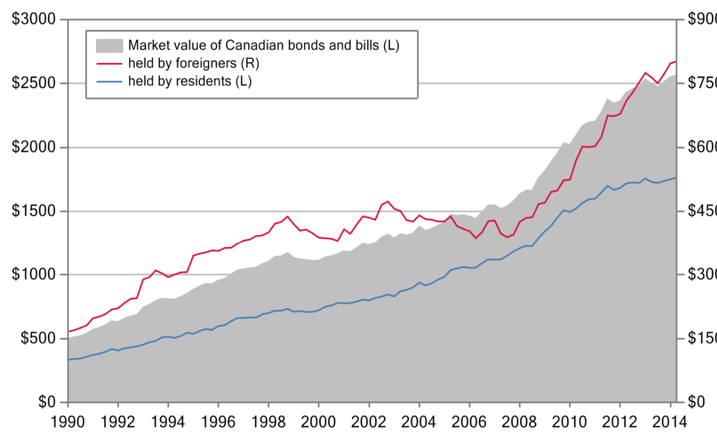
Canadian bond prices are up year-to-date and the FTSE TMX Universe Bond Index generated a total return of 5.9%. The 10-year government yield dropped from 2.77% at the beginning of the year to 2.10% at the end of September, an unusual occurrence given that the economy improved and inflation is running at 2.1%. At today's levels we are persuaded that bond prices are disconnected from their fundamentals, which raises the question: who is buying the bonds and why?

A breakdown of bond purchases by investor type shows that total holdings by domestic investors have remained broadly unchanged. However, foreigners have increased purchases of fixed income instruments since 2008. The pace of purchases slowed in 2013, coincident with rising yields, but picked up again in 2014. During the first half of this year alone, foreign investors bought 85% of the entire amount of Canadian bonds & bills that were purchased the prior year (Chart 5).

As we forecast the future direction of interest rates, it is extremely difficult to assess the direction, size and timing of foreign flows. This demand stems from the unavailability of better investment alternatives elsewhere or from factors other than an assessment of the fair value of the asset. We reiterate that the underlying drivers of bond yields are economic growth and expected inflation. Long-term yields in Canada will face upward pressure as they adjust to the expanding global economy. Should bonds continue to be supported by foreign inflows, their expected return will increasingly be eroded by inflation. The benchmark 10-year government bond yields 2.1%, roughly equivalent to the long-term expected inflation rate, which suggests that the gain in purchasing power from holding this bond for a decade is nil. Moreover, when foreign flows start to reverse, the negative impact on yields could be sudden and dramatic.

Chart 5

Canadian Bond Holdings – By Investor Type
(in $ billions)



Source: Statistics Canada

Bonds are an unattractive investment and warrant a short duration in our portfolios. We continue to favour high-quality instruments and are underweighting this asset class within balanced mandates.

All dollar references in the text are U.S. dollar unless otherwise indicated.

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