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Economic and Capital Markets Outlook

September 2013

Summary

- The structural imbalances linked to the financial crisis are being corrected. The need for extraordinary fiscal and monetary policy measures is receding.
- Economic activity is expected to pick up in 2014 in most regions of the world.
- Short term challenges in certain developing countries and the risks associated with tight oil markets are not expected to materially impact global growth.
- Bond yields remain below levels consistent with a growing economy. Interest rates are in the early stages of normalizing to higher levels.
- We are maintaining a short duration in our bond portfolios and are underweighting bonds within balanced mandates.
- Equity prices will be dictated more by an appreciation of direct business issues than macro risks. In such an environment, stock selection and price discipline will be of paramount importance.
- Equities remain our favourite asset class. We expect a higher return from owning stocks compared to both bonds and cash.

Over the past five years, the world economy has recovered from one of the deepest and longest recessions since the 1930s. Extraordinary fiscal and monetary policy measures have been undertaken to rebalance economic activity and reinstate the smooth functioning of credit markets. A review of global economic progress to date suggests that imbalances have been, or are on their way to being, corrected.

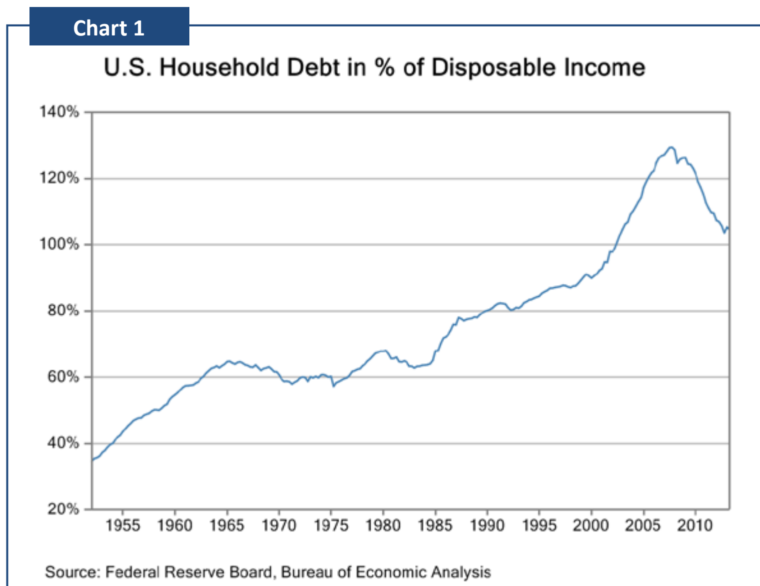
The global financial sector is both better capitalized and, with the possible exception of continental Europe, willing to extend credit again. U.S. consumers are now living within their means and the federal government has made significant headway in reining in budget deficits. The adjustment process required in the Canadian household sector is underway, and although it has further room to run, sound fiscal finances provide a positive backdrop. The large current account deficits and budget deficits of many southern European economies have decreased. Thanks to these adjustments, the world economy is now better balanced and structurally sounder. Economic activity is expected to pick up in 2014, and growth in the U.S. could surprise to the upside, although the outlook is tempered by potential instability in key developing economies and oil markets.

Throughout this turbulent period, macroeconomic concerns contributed to significant volatility in financial asset prices, which we believed were not reflecting their fundamental value. In the case of bonds, we have consistently argued that artificial manipulation of interest rates by major central banks was unsustainable and long-term bond prices were grossly overvalued. Bond prices are now normalizing as 10-year sovereign yields in the U.S. and Canada are up 65 bps and 75 bps since the beginning of the year. In our view, this process has further room to run. Meanwhile, global equity markets are up sharply in the past year and have benefited from a renewed focus on fundamentals. Equities are well supported by attractive dividend yields and reasonable valuations and will outperform both cash and bond investments in the medium-term.

U.S. growth led by thriving private sector

Recent U.S. data confirm our initial forecast of a fiscally-induced slowdown in 2013 as real GDP in the second quarter increased by 1.6% year-over-year. Government spending declined 1.5% and consumption grew only 3% in nominal terms, due to the impact of higher taxes. The economy is being sustained by three fundamental growth drivers: housing, capital spending and trade. Housing expanded 20.2%, while non-residential investment is up 3.5%. The trade deficit has shrunk from $558 billion in Q2 2012 to $506 billion currently, representing a 9.3% improvement.

The structural imbalances that led to the 2008 crisis are now being corrected and this adjustment is supporting U.S. growth in the medium-term. Household debt levels have declined by an aggregate $954 billion or 6.9% while disposable income has increased by $1,225 billion or 11%. As a result, the ratio of household debt-to-income has improved from 125% to 105% (Chart 1). The saving rate has adjusted upwards to 4.6% and consumer spending (including housing investment), which peaked at 102.9% of disposable income in Q3 2005, is now 96.1%, within its historical range of 95%-100%. This will allow households to spend in line with disposable income growth and we expect consumer spending to be a growth driver over the next several years.

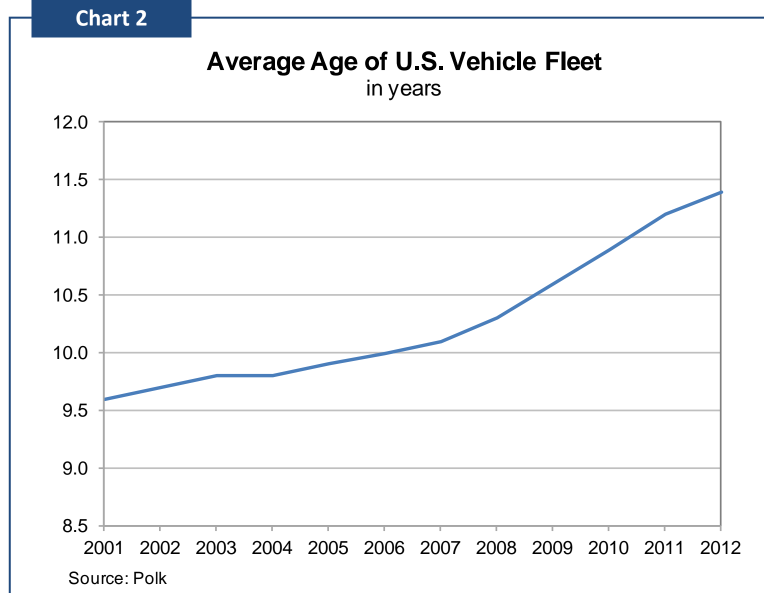


Corporations have also improved their financial profile over the past 5 years. After-tax profits have risen by an average annual rate of 8.9% and corporate debt (excluding the financial sector) remains at a low level as firms have been reluctant to borrow despite low financing rates. While business investment is growing at a slower pace than profits, we anticipate stronger capital expenditures as corporations take advantage of healthy balance sheets to exploit opportunities that are arising with the pick-up in economic activity. This should support continued improvement on the labour front. Private employment is up 2.1% over the past 12 months, representing 2.3 million new jobs, while hourly earnings are up 2.2%. Together, this is driving a solid expansion in private sector aggregate wages (4.6%), underpinning household income growth going forward.

While the private sector is thriving, the public sector is feeling the impact of spending cuts resulting from the stalemate in Washington over public finances. Federal government spending is down 3.2% compared with last year. Taking into account the impact of higher income taxes and the increase in social security taxes, these combined measures represent a significant adjustment to the government`s budgetary imbalances. In fact, improving revenues and spending restraint has led to a $519 billion reduction in the federal deficit over the past year. The adjusted budget deficit (including public sector investment) stands at 4.3% of GDP in Q2 2013, compared with a recession-era peak of 11% of GDP in Q2 2009. The public sector's drag on growth is therefore likely to abate in 2014 as the pace of fiscal contraction diminishes.

Given the positive backdrop of these major structural adjustments, we anticipate that economic growth will return to more normal levels next year. Our central forecast for U.S. real GDP growth in 2013 remains 1.5%, with stronger growth in the range of 2.5%-3.0%, expected in 2014.

It should be noted that an upside surprise to growth may occur if a stronger-than-expected cyclical rebound in the housing, energy and/or auto sector occurs. The auto industry in particular may benefit from an upswing due to pent-up demand. Auto sales have recovered to 16.4 million units, in line with average sales prevailing from 2000 to 2007, but the car fleet's average age has risen considerably to 11.4 years (Chart 2). Under a scenario where the average age of the car fleet declines to 10.8 years, auto sales could rise from 18 to 22 million units per year over the next three to four years.



Gradual rebalancing of Canadian economy implies below-trend growth

The Canadian economy has been weakening. Second quarter real GDP growth was 1.4% compared with 2.6% during the same period last year. The Canadian economy's rebalancing away from consumer spending and housing, the drag on the trade sector caused by the strong Canadian dollar and the slowdown in capital spending have been reviewed in our June *Economic and Capital Markets Outlook*. These factors continue to exert a negative impact on growth. Consumer spending was up a moderate 3.2% in nominal terms, driven by strong auto sales while most other sectors saw little growth.

Residential investment grew a paltry 0.2% compared with 11% last year. The trade balance remains in deficit with oil exports more than mitigated by a myriad of consumer goods imports. Capital spending in machinery and equipment was down 1.1% due to a slowdown in the oil & gas industry and manufacturing.

While adjustments in the U.S. economy are setting the foundations for a pick-up in activity, in Canada the process has much further to run. Household indebtedness stands at 167.4% of disposable income. Consumers are still spending beyond their means: total spending (including housing) as a share of disposable income remains high at 101.6%. An adjustment in both ratios to more normal levels implies slower consumption and recent data suggest this may be underway. While private sector wages increased 4.0% year-over-year during Q2, retail sales were up 2.7% (1.2% excluding automobiles).

We believe that these headwinds will hold growth back in Canada in the medium term. As a result, our baseline forecast for Canadian real GDP growth remains at 1.5% for both 2013 and 2014.

Europe: signs of a turnaround

For the first time since 2011, the Eurozone experienced positive real GDP growth on a quarter-over-quarter basis (+0.3%), a tentative sign that economic retrenchment is easing. On an annual basis real growth for the region was –0.5%, but Germany and France both returned to positive growth with GDP up 0.5% and 0.3% respectively. Other major countries were still contracting: Ireland –1.1%, Spain –1.6%, Netherlands –2.0% and Italy –2.1%. Outside the Eurozone, the U.K. economy expanded by 1.5%, and Switzerland grew 2.1%.

This improving economic environment is reflected in positive business expectations towards the future. The European Commission’s industrial confidence indicators are all pointing to an improvement in company order books and production expectations. The Purchasing Managers’ Index (PMI) for manufacturing is signalling an expansion in activity, with a reading of 51.1 in September. The trade sector has also been a positive contributor; the region`s trade surplus rose to 3.5% of economic output, versus 1.1% in 2011.

Despite a more positive corporate backdrop, the household sector is still in a slump. The unemployment rate remains high at 12.0%, which is directly affecting the ability of consumers to spend on goods and services. As a result, many industries are seeing a decline in their volume of goods sold. The car industry is one such example: in August car sales fell 5.0% year-over-year and were well below trend levels. From 2000 to 2007, car sales averaged 11.5 million units per year while the annualized level from January to August 2013 was 8.6 million units.

The softness in consumer spending is further exacerbated by tight credit conditions. As of August, Eurozone lending to households and non-financial corporations is down 2.8% year-over-year. Deutsche Bank estimates that European banks increased capital by €160 billion during 2007-2012 but need to raise an additional €45 billion in order to pass European Central Bank stress tests in 2014 and fulfill Basel 3 regulatory requirements. Although near the end of the process to rebuild their balance sheets, bank credit will remain subdued and act as a headwind to economic activity. This risk has been identified by Mario Draghi, the ECB governor, as one of the Eurozone’s main growth challenges. The ECB is weighing several new measures to ease the credit slump, including encouraging banks to lend to small businesses.

The adjustment in public finances is ongoing although consensus has emerged within the Eurozone to allow member countries more time to reach their deficit targets. Since government spending represents on average 48% of Eurozone GDP, an easing of austerity will be supportive of a gradual recovery in economic conditions.

On the structural front, reforms to liberalize labour markets and boost the productivity of European companies are progressing. Unit labour costs are improving, trade gaps between the different countries are shrinking and the region’s trade surplus is increasing. Past balance of payments imbalances have seen major improvements: a case in point is Spain which in Q2 recorded a current account surplus of 1.2% of GDP versus a deficit of 10% in 2007. While the adjustments are

structurally positive, we expect slow economic growth until credit conditions improve. We forecast that real GDP will grow in a range of 0% to 1.0% in 2014.

Global growth to reaccelerate in 2014

Growth in emerging market economies remains higher than that of developed markets. The IMF forecasts that advanced economies are expected to grow by 1.2% in 2013 and by 2.0% in 2014, compared with 4.5% and 5.1% for emerging markets. In the second quarter, real GDP increased by 7.6% in China, 3.3% in Brazil, 2.4% in India and 1.2% in Russia.

Growth in most developing markets is slowing compared with 2012. As of the second quarter, Mexico was growing 0.3% and Chile 4.1%. In Asia, Thailand is growing at 2.8%, Malaysia at 4.3% and South Korea at 2.3%. In Eastern Europe, growth remains moderate with Poland up 4.0% and Turkey at 4.4%.

The IMF forecasts real GDP growth of 2.9% in 2013 and 3.6% in 2014 for the global economy on the back of increased activity in the U.S. and Europe. Potential risks to a pickup in global activity include a pronounced slowdown of key developing markets and an oil price shock resulting from increased geopolitical tensions and international sanctions.

Risk to central forecast: disruption in emerging markets

Economies in a development phase typically require significant funding to finance investment (capital spending) and rising consumption (imports). Given that domestic capital is usually scarce and financial markets are much less developed, these countries often rely on foreign capital and consequently experience negative current account balances. Relying on external funds can help spur domestic growth when capital is flowing in, but it can be destabilizing when the flows reverse course.

Table 1 - Current account as a % of GDP

	2007	2008	2009	2010	2011	2012
Brazil	0.1%	-1.7%	-1.5%	-2.2%	-2.1%	-2.3%
India	-0.7%	-2.4%	-2.1%	-3.2%	-3.4%	-5.1%
Indonesia	1.6%	0.1%	2.0%	0.7%	0.2%	-2.8%
South Africa	-7.0%	-7.2%	-4.0%	-2.8%	-3.4%	-6.3%
Turkey	1.8%	1.6%	1.3%	0.1%	-1.7%	-1.5%

Note: the current account represents the net flow of current transactions, including goods, services and interest payments, among countries.
Source: IMF

In the aftermath of the financial crisis, central banks injected significant amounts of liquidity into the financial system, part of which found its way into emerging markets. In 2012, many major emerging economies recorded current account deficits (Table 1): South Africa (–6.3% of GDP), India (–5.1%), Indonesia (–2.8%), Brazil (–2.3%) and Turkey (–1.5%). In 2013, rising bond yields stimulated a repatriation of funds into developed markets. This has led to a painful adjustment process and growth has decelerated. Real GDP growth in Brazil slowed from 7.5% in 2010 to 3.3% during Q2 while Turkey's real growth declined from 9.2% to 4.4%, South Africa from 3.1% to 1.8%, India from

10.6% to 2.4% and Indonesia from 6.2% to 5.8%. Given that many of these countries have high inflation, monetary stimulus via lower interest rates is hardly feasible. On the contrary, several emerging market central banks have raised short-term rates to alleviate inflation risks.

Lower economic growth and foreign capital flight has had a sharp negative impact on exchange rates. Coincident with the rise in bond yields across developed markets, the decline versus the U.S. dollar from end-April to end-September is 15.6% for the Indonesian rupiah, 13.6% for the Indian rupee, 12.0% for the Turkish lira, 11.2% for the South African rand and 9.8% for the Brazilian real. Stock markets (in U.S. dollar terms) have also reacted sharply: Indonesia –31.4%, Turkey –23.2%, India –15.0%, Brazil –12.8% and South Africa 0%.

The adjustment process that these economies are experiencing is unsurprising. Growth led by sudden surges of foreign capital is rarely sustainable. While the correction of external imbalances may induce a cyclical slowdown in the economies cited above, the impact on global growth is likely to be relatively muted. We calculate that 10% of the rise in global real GDP in 2014 will be driven by these five countries. Using a scenario whereby growth in these five economies slows by a further 2% in real terms, world economic growth would be revised downwards by an estimated 0.2%. Moreover, as developed markets continue to recover, demand for goods will increase. In turn, this will support the export sector of emerging economies and help mitigate the negative repercussions of this adjustment process.

As we try to assess the long-term growth profile of these economies, we note that their fundamental growth drivers remain unchanged. Population growth, a gradual shift towards domestic consumption, infrastructure and other capital spending needs are structural factors which will sustain development and growth on a secular basis. These economies are still expected to expand more rapidly than the developed world and offer an enormous market of unmet needs. We continue to believe that taking advantage of these opportunities through a diversified portfolio in terms of countries, industries and companies will provide solid returns over the long term.

Risk to central forecast: disruption in oil markets

Notwithstanding some signs of a softening of attitudes in Iran and a step back from military confrontation with Syria, tensions in the Middle East remain. Concerns regarding a disruption of energy supplies has kept oil prices firm.

Although markets are well supplied around the world, spare capacity continues to be tight. World oil demand is around 91 million barrels/day and global excess capacity has been estimated at between 2-4 million barrels/day. Despite various geopolitical outbreaks since 2008, OPEC producers have maintained a stable contribution to oil supply of around 37% of world production. However, a closer look at the output of the different members reveals that 4 out of 12 countries are producing less oil per day compared with five years ago and 5 are at risk due to civil strife or sanctions (Table 2). The decline in production from these countries, estimated to be 1.9 to 2.4 million barrels/day, has been mitigated by increases by other OPEC and non-OPEC regions.

Table 2 – OPEC members with oil production declines or at risk for disruptions

OPEC Member	Oil Production in 2008 (million barrels/day)	Oil Production 2013 (million barrels/day)	Net gain/loss (million barrels/day)	Reason
Iran	3.9	2.7	-1.2	U.S. sanctions
Libya	1.7	0.5-1.0	-0.7-1.2	civil war
Algeria	1.4	1.1	-0.3	civil strife
Iraq	2.5	3.0	+0.5	civil strife
Nigeria	1.9	1.9	0	civil strife
Qatar	0.9	0.7	-0.2	Natural decline
Total	**12.3**	**9.9-10.4**	**-1.9-2.4**	

Sources: Petroleum Economist, OPEC, International Energy Agency

Smaller non-OPEC countries such as Syria, Yemen and Sudan collectively produce 0.8 million barrels/day and are also subject to fluctuating outages. Strife in Egypt has the potential to disrupt 2 million barrels/day in transit through the Suez Canal. In addition, Syria is close to the major oil port of Ceyhan, Turkey through which another 1.3 million barrels/day is transported onto tankers.

This potential for disruption is mitigated by the fact that the world's largest swing producer, Saudi Arabia, is not at full capacity. Saudi Arabia has stated publically that it is able to produce up to 12.5 million barrels/day, potentially adding 2.5 million barrels/day from current levels. Increases in the Canadian oil sands and oil shale production have contributed 3 million barrels/day. Production is expected to continue to grow, particularly from U.S. shale formations, thereby helping further balance the market.

Oil inventories are mostly located and monitored in developed countries and are not in short supply. As a result, transportation disruptions would delay, but not ultimately prevent, oil from reaching its markets. The International Energy Agency has estimated 58 days of cover, which is in line with the historical long-term average.

While we keep a watchful eye on developments in the Middle East, we believe it is premature to conclude that an oil price hike is imminent.

Financial assets: back to basics

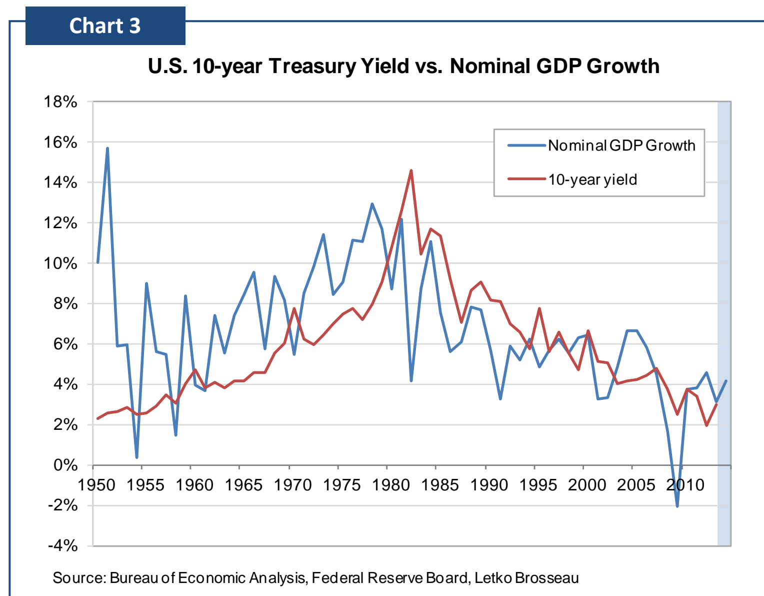
After a few years of macroeconomic concerns, the focus is gradually returning to business fundamentals. Investment opportunities will be dictated more by an appreciation of direct business issues than macro risks. We are returning to a more *normal* environment, and as such stock selection and price discipline will be of paramount importance.

The current pricing of financial assets is beginning to reflect this movement towards a more normal world. Stock markets are now trading at earnings multiples that are in line with their long-term averages and bond yields are starting to climb from historical lows.

Since the beginning of the year, the total return for the MSCI World Index is 21.3% while S&P 500 rose 23.8% and S&P/TSX is up 5.3%. In Europe, the DAX is up 19.8%, the FTSE 100 is up 15.8%,

and the CAC-40 is up 24.0%. Elsewhere, the Nikkei rose 28.9% while the return on the MSCI Emerging Markets Index is –0.9% (all returns expressed in Canadian dollars).

The two core drivers of medium and long-term sovereign bond yields are expected inflation and economic growth: over long periods, 10-year bond yields track the nominal growth rate of the economy (Chart 3). A year ago, bond yields diverged significantly from the level implied by this simplified measure of fair value. The 10-year Treasury yielded 2.0% while the U.S. economy was expected to grow at 1.5% in 2013. After adding 2.0% for inflation, a fair yield would have tended towards 3.5%.



Since the beginning of the second quarter, interest rates have begun to normalize and the 10-year yield has risen to 2.61% at end-September. However, given that we foresee a pick-up in U.S. growth to around 2.5%, the fair value for the 10-year U.S. Treasury has increased to around 4.5%. In other words, yields are still below our basic measure of fair value and will face upward pressure to reflect true fundamentals. In Canada, although the level of inflation is muted and economic growth is expected to remain moderate, the 10-year Canadian federal bond yield is 2.54%, still below its fair value of around 3.2%. As interest rates adjust to reflect underlying fundamentals, bond prices are expected to further decline in price.

Consequently, we are maintaining a very short duration in our bond portfolios and are underweighting bonds within balanced mandates. We continue to believe that a portfolio of high quality stocks will outperform cash and bonds.

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

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