



June 2018

SUMMARY

- Worldwide economic growth accelerated in both developed and developing economies during the first half of 2018. Global real GDP is expected to increase 3.9% in 2018, the most in seven years.
- Tax cuts added fuel to business investment in the United States, providing a boost to an already impressive economic expansion. Our 2018 forecast for U.S. real GDP growth is 2.5%-3.0%.
- Canada's economy is enjoying strong growth, aided by job creation. Despite trade uncertainties and a cooling housing market, the Canadian economy is expected to grow 2.0%-2.5% in 2018.
- The Eurozone is on track to expand 2.0%-2.5% as job gains continue to support consumer spending.
- Emerging market economies remain strong with some exceptions, including Brazil and Turkey, which face political challenges.
- Contentious trade talks between the United States and China, together with NAFTA's ongoing renegotiation, are creating uncertainty in the countries involved. While this presents a risk to our global growth forecast, we believe there exists a community of interests that suggests agreements supporting trade will eventually prevail.
- The investment landscape continues to favour equities, as an accelerating global economy will promote improving profits. Careful attention to valuations remains critical as we enter a more mature phase of the economic cycle.
- With inflationary pressures building, and central bank policies turning toward less accommodation, interest rates are primed to rise. Holders of long-term debt instruments, which are particularly sensitive to interest rate movements, face potentially significant capital losses as bond prices adjust to higher rates.

GLOBAL GROWTH MOMENTUM IS INCREASING

Global growth continues to gain momentum across both developed and developing economies. Unemployment rates in some developed countries have reached the lowest level in decades, and there are signs that wages are increasing. Industrial production growth is at a seven-year high (see Chart 1), while business investment is trending higher, thanks to strong corporate profits. The prospect of recession remains low for the near term. While we are entering the stage of the cycle in which risk of volatility and other disruptions are greater, there are no real impediments to the underlying forces of economic growth.

The International Monetary Fund expects global real GDP growth to reach 3.9% in 2018, slightly outpacing last year's 3.8%.

Chart 1: Global Industrial Production (Y/Y % change)



* 3-month moving average. Source: CPB Netherlands Bureau for Economic Policy Analysis

In the **United States**, real GDP expanded by 2.8% year-over-year during the first quarter of 2018 on the back of business spending. Non-residential corporate investment grew 8.4% in nominal terms against Q1 2017. Oil-and-gas-related investments expanded 44%, as the WTI oil price rose to \$65 per barrel in February 2018 from the low \$40s in the summer of 2017. Other industries also fared well, as non-energy capital spending increased 7.0%.

Employment growth continues to support consumer spending. Job creation averaged 179,000 per month



during the three months ended May 31, 2018, while the unemployment rate declined to 3.8% and hourly wages increased 2.7% from the same period a year earlier. With an additional boost to income from lower taxes, total household disposable income jumped 4.0% and spending rose 4.4% during Q1 from the same period a year earlier.

In May, an annualized 1.3 million homes were built. Given the pent-up demand from young households who delayed their purchase of a first home in recent years, new-home construction should move toward 1.3-1.5 million units in the coming quarters.

We believe U.S. economic momentum remains solid. Leading indicators of factory orders, consumer sentiment and building permits all suggest continued strong growth this year. Our 2018 forecast for U.S. real GDP expansion is 2.5%-3.0%.

Consumer spending and business investment also contributed to strong economic growth in **Canada**. Real GDP expanded 2.3% year-over-year in Q1. Consumption rose 4.0% in nominal terms, supported by strong job creation and steady wage increases. During the three months ended May 31, 2018, the Canadian economy created 238,000 jobs, while the unemployment rate fell to 5.8%, its lowest level since comparable data became available in 1976. Hourly wages increased 3.9%.

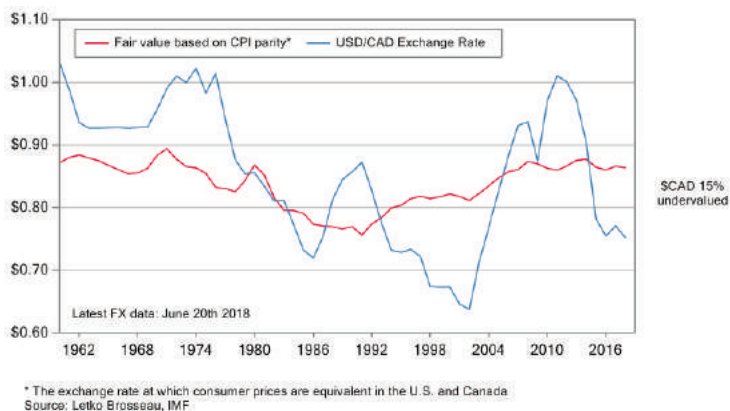
Business investment was up 8.3% in Q1 from the year earlier period. With plants and equipment operating at more than 85% of capacity, any increase in consumer demand is forcing companies to upgrade or expand their existing capital assets. As demand continues to grow and business sentiment remains strong, capital spending is expected to remain buoyant.

The housing sector cooled during Q1 after stricter mortgage qualification rules came into effect on January 1. Residential investment expanded by 2.1% year-over-year in Q1, significantly less than the 6.8% average of the past three years. During the three months ended May 31, 2018, new home construction slipped 3.4% from the same period a year ago,

although prices remained strong, rising 4.5%. While the new mortgage regulations were necessary to curb excesses in the housing market, this is likely to hinder economic growth over the short term. However, the strong employment picture makes a significant housing market correction unlikely.

An increase in Canada's trade deficit has held back economic growth in recent months. Exports increased 1.4% in Q1 against a year ago, but imports rose 4.7% and the trade deficit jumped to \$61 billion from \$37 billion. Uncertainty over NAFTA is likely to act as a near-term drag on growth. Over the medium term, however, we expect the trade balance to improve as Canadian exporters benefit from the lower value of the dollar, higher oil prices and the overall positive impact of global economic growth. The Canadian dollar is 15% undervalued against the U.S. dollar based on our purchasing power parity model (see Chart 2). While 15% is outside the long-term trend of +/-12%, it probably can be explained by the uncertainty surrounding NAFTA.

Chart 2:
U.S. Dollar vs. Canadian Dollar Exchange rate and fair value



We forecast Canada's real GDP will expand 2.0%-2.5% in 2018.

In **Europe**, real GDP rose 2.5% in Q1 against a year ago, led by the Netherlands (3.1%) and Spain (3.0%). The German and French economies grew 2.3% and 2.2% respectively, while Italy lagged at 1.4%. Higher



employment helped boost household spending, while rising corporate profits ultimately supported steady increases in industrial production. Meanwhile, with government deficits reined in and austerity measures being phased out, the drag on growth is diminishing. In 2018, the government deficit-to-GDP ratio in the Eurozone is forecasted by the OECD to be 0.6%, its lowest level since 2000.

While economies are expanding, political concerns are resurfacing. A new populist coalition government in Italy is planning to challenge EU deficit limits with a program of tax cuts and increased fiscal spending. The administration's fiscal unorthodoxy, along with the inclusion of anti-EU coalition ministers, has fueled speculation that a referendum may be held on a possible departure from the EU. Italian 10-year bond yields jumped to 3.1% in early June from 1.8% at the end of April, before pulling back to 2.7% at the end of Q2.

We do not believe an Italian exit from the EU is likely and we expect the current uncertainty will have no material impact on the European economy. Both parties in the coalition have recently stated that they have no intention of proposing a departure, preferring to focus on domestic economic policy and a renegotiation of fiscal and immigration rules with other EU members. Meantime, polls indicate fewer than 30% of Italians would vote to leave.

We expect the Eurozone's real GDP to rise 2.0%-2.5% in 2018.

Economic growth continues to slow in the **United Kingdom**, two years after the country voted to leave the EU. About 8% of the U.K.'s GDP is connected to Europe-bound exports, 7% is tied to the financial sector, and 13% is driven by investments in plant and equipment, all of which are somewhat at risk. As Brexit-related uncertainty lingers, real GDP growth decelerated to 1.2% year-over-year in Q1, compared with 1.3% in Q4 and 1.8% in Q1 2017. The IMF forecasts the U.K. economy will expand 1.6% in 2018.

Elsewhere, real GDP in Japan grew 1.1% in Q1 from the previous year, in line with our forecast of

1.0%-1.5% for 2018.

Among **emerging markets**, Turkey and Brazil recently encountered economic challenges. Turkey is struggling with rising double-digit inflation, a widening current account deficit and the fiscal and monetary uncertainty of an election year. Brazil is also facing an election with an unpredictable outcome. Furthermore, Brazil's economic recovery slowed in Q1, with real GDP expanding only 1.2% year-over-year, down from 2.1% in Q4. Growth will likely continue to be held back in Q2 due to a trucking strike that disrupted the country's supply chains.

While economic activity may be temporarily weaker in Turkey and Brazil, these challenges remain country-specific and are inconsistent with the developing markets' overall economic health. Growth is robust elsewhere as China's real GDP increased 6.8% in Q1 from a year earlier, while India gained 7.7%. These economies continue to be driven by population growth and increasing consumption, and offer tremendous investment opportunities.

TRADE ISSUES CAN BE OVERCOME

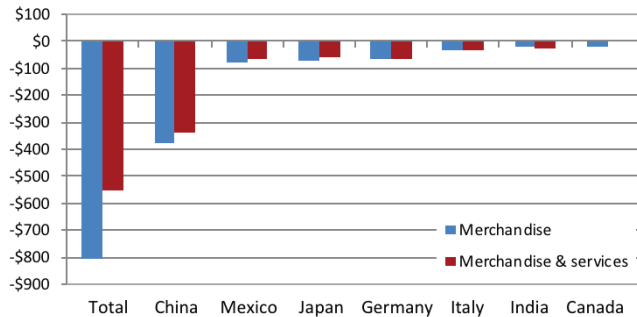
International trade has become a dominant topic in the past year as the United States started introducing protectionist measures to curtail imports. As discussed in the March 2018 issue of our *Economic and Capital Markets Outlook*, the U.S. administration's primary objective is to reduce its significant merchandise trade deficit, which reached \$807 billion in 2017.

To that end, the U.S. undertook bilateral negotiations with China, with which it has a merchandise trade deficit of \$376 billion. It also initiated the renegotiation of NAFTA even as the deficit with Canada and Mexico, at \$23 billion and \$76 billion respectively, together account for only 12% of the country's total (see Chart 3). Including services, the U.S. has a deficit of \$336 billion with China, \$69 billion with Mexico and a \$3 billion surplus with Canada.

Negotiations on both trade fronts this spring proved contentious. After three months of intense talks with China produced an impasse, the U.S. announced a



Chart 3: U.S. trade balance (in USD billions)



Source: U.S. Bureau of Economic Analysis

25% tariff on \$50 billion of Chinese imports. China responded with tariffs on an equivalent amount of U.S. imports, to which the U.S. retaliated with a threat of tariffs on an additional \$200 billion of imports.

On the NAFTA front, a temporary exemption granted by the U.S. to Canada and Mexico on previously announced tariffs was allowed to expire. Since June 1, exports of steel and aluminum from the two countries to the U.S. are subject to tariffs of 25% and 10% respectively. Canada and Mexico retaliated with dollar-for-dollar tariffs against a wide variety of U.S. goods.

These confirmed tariffs remain very modest for the time being. U.S.-China tariffs affect only 2% of the total exports from both countries, while the steel and aluminum tariffs involve 2% of total Canadian exports and less than 1% of those of Mexico. Nonetheless, these developments have created considerable uncertainty for all of the economies involved. The situation has also raised fears of an escalation of global protectionist policies.

As disconcerting as the present situation appears, we are of the view that these issues can be resolved. Political rhetoric aside, it is clear that trade integration has tremendously benefitted the U.S. economy and its citizens. Since NAFTA's implementation in 1994, there has been a significant increase in trade between the three countries. For example, U.S. exports to Mexico have risen 7% annually, a rate significantly faster than

nominal GDP growth. Similarly, over the same period, U.S. exports to China rose 12% per year.

On the other hand, increased imports have translated into cheaper goods for American consumers and consolidated the U.S.' position as the global liquidity provider and the U.S. dollar as the world's reserve currency. Despite the rise in imports, there are more people currently working in the U.S. than ever before. Unemployment is at 3.8%, a level not seen since 2000 and, before that, in 1969.

We continue to carefully monitor the developments on this front, but it is encouraging to see all countries appear willing to continue to negotiate. Whether the recently announced measures are part of a bargaining tactic or a harbinger of further trade restrictions, both the U.S. and its trading partners stand to lose if the conflict escalates and business conditions are adversely impacted. We believe all parties understand this, and, thus, we caution against embracing an excessively negative view on trade.

EQUITIES REMAIN FAVOURED OVER FIXED INCOME

Despite a volatile start to the year, global equity markets recorded positive total returns over the last six months, reflecting the strong macroeconomic backdrop. Volatility should not be surprising, as markets have been near their all-time highs. Longer term, equities have been decidedly positive. The MSCI World Index achieved a total return (in C\$) of 12.4% for the year ended June 30, 2018, while the S&P 500 Index rose 15.7% (in C\$) and the S&P/TSX Composite Index gained 10.4%.

Given our positive economic outlook, we believe equities will continue to provide attractive returns over the medium term. Earnings for MSCI World companies are forecasted by Bloomberg to increase 22.6% this year and the 2018 P/E multiple stands at a reasonable 15.8x.

As we enter the mature phase of the business cycle, we are aiming to shield our equity portfolios from global risks while profiting from a still attractive investment environment. For example, we have limited positions in Italy, Brazil and Turkey. We believe the

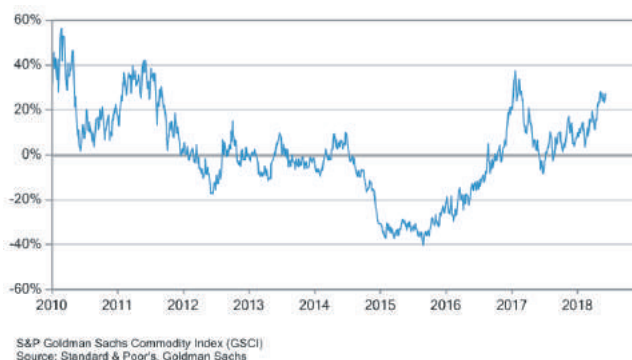


best way to limit equity market risk is to strictly abide by our investing principles of fundamental analysis and price sensitivity. Our portfolio is valued at an attractive 12.7x 2018 earnings and offers a 2.9% dividend yield. Meanwhile, our emerging markets portfolio trades at a reasonable 10.4x 2018 earnings, with a 1.5% dividend yield.

Within balanced mandates, we are also protecting our fixed income portfolios by significantly reducing the risk from rising interest rates. We are maintaining a short duration and are avoiding any exposure to bonds with maturities longer than 10 years

In both Canada and the U.S., wage pressures are becoming evident as the unemployment rate in both countries sits at a multi-decade low. In addition, commodity prices are rising, pressuring companies to increase selling prices (Chart 4). Over the last year to June, the price of oil (WTI) was up 61%, nickel 59%, steel 42%, Australian coking coal 41%, aluminum and cotton 13%, copper 9% and zinc 5%. In addition, the World Bank grains and fertilizers commodity indices were both up 13% during the year to May.

Chart 4: Commodity Price Index* (Y/Y % change)



As inflation increases – perhaps even significantly if additional tariffs are implemented – it will exert upward price pressure on bonds. In this environment, central banks will continue to normalize monetary policy, which will impact yields across the entire curve. Capital preservation remains our primary objective at a time of potential significant losses among fixed income investments.

Overall, we continue to believe that carefully selected equities will outperform both cash and bonds over the medium term.

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

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