Canada 2016:

Investment Review and Outlook

July 2016

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Brexit vote triggers uncertainty, but Canada expected to ride out volatility with help from the US

Q2 in Review

- Brexit roiled markets at quarter end.
- Canadian equities were up 5.07% in the second quarter.
- Canada's GDP edged up after two months of declines.
- Oil prices showed signs of improving.

Q3 Outlook at a Glance

- We expect the Fed to keep rates on hold this year.
- The Bank of England may add more stimulus this summer.
- Brexit will likely continue to drive moderate volatility.
- We remain cautiously optimistic heading into the second half of 2016.

The vote by the UK to leave the European Union means we can now expect to see a significant period of uncertainty as the UK moves into a transition period of renegotiating existing agreements. The political path ahead also is unclear. However, the UK accounts for only a small portion of Canadian trade.

The bigger question is what effect Brexit will have on the global economy and what that will mean for demand for key commodities produced in Canada, such as oil. The early signs are encouraging. Despite some short-term weakness, in the second quarter of this year commodities delivered their best quarterly performance since 2010.

Another key question to consider is the strength of the US economy. Canada's biggest trading partner continues to gain strength. A raft of US data released at quarter-end showed continuing positive momentum, with robust consumer spending data for May and a strong rebound in June's Institute for Supply Management (ISM) manufacturing index to 53.2, its highest level since February 2015.

On balance, we expect ongoing US growth combined with a weak Canadian dollar to continue to deliver better performance from Canada's export-oriented economy. HSBC forecasts US GDP growth of 1.8% for 2016. We expect Canada's economy to expand by 1.2% this year; the devastating Fort McMurray wildfires should have a muted impact on overall growth. The global economy is forecast to grow by 2.2% this year.

Pre-Brexit, in an early June speech, Janet Yellen, chair of the US Federal Reserve, gave a relatively positive assessment of the US economic outlook, saying: "I see good reasons to expect that the positive forces supporting employment growth and higher inflation will continue to outweigh the negative ones."

However, Yellen's remarks made no mention of when the Fed might raise rates. This, plus the potential for Brexit-related uncertainty to be drag on global growth, leads us to revise our forecast for US rate hikes. Last quarter we had expected the Fed to raise rates, likely twice, in 2016. But Brexit combined with the Fed's focus on the sputtering global economy could encourage the Fed to remain on the sidelines. It is possible the Fed could remain on hold until perhaps 2018, with the Bank of Canada also standing pat.

Market highlights

Despite the quarter-end spike in volatility post-Brexit, Canadian equities finished strongly. After posting successive monthly gains, Canadian equities, as measured by the S&P/TSX Composite Index, finished the quarter up 5.07%. Canadian bonds, as measured by the FTSE TMX Canada Universe Bond Index, finished the second quarter up 2.62%.

The ongoing firming of prices for oil, gold and other commodities was good news for Canada. At quarter-end, oil was trading around US$48 per barrel, up from US$38 per barrel at the end of the first quarter. The summer US driving season may also continue to help stoke demand.

Gold prices moved from about US$1,232 an ounce to more than US$1,322 an ounce over the quarter. Brexit was again partly behind the rise, with investors looking for traditional safe havens.

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On a sector-by-sector basis, there were broad gains in the three months ending June 30. Energy built on first-quarter gains and delivered a 9.50% return. Materials were also sharply higher for the second straight month, gaining 26.88%.

Other sectors fared less well. Consumer discretionary and consumer staples fell 2.86% and 4.05% respectively. Financials finished the quarter 1.32% higher. Health care continued to slide, but the downside was more limited this quarter. The sector was down 15.30% on the back of the ongoing struggles of one company.

Investment strategy highlights: Equities remain favoured over bonds

The well-diversified structure of our portfolios reflects our views on capital markets. Over the long term, our modest preference for equities relative to developed-market government bonds or cash remains unchanged, despite Brexit-related turmoil.

Within equities, we continue to find opportunities in Canada. Valuations are somewhat less attractive than in previous quarters but overall remain broadly neutral, and price premiums on equities versus government bonds are still reasonable.

We remain underweight, compared with the broader market, in our Canadian energy holdings. However, we are continuing to make some small additions to our energy holdings and are edging toward a neutral weighting. We are underweight materials and overweight consumer staples and consumer discretionary.

Within fixed income, we still prefer corporate bonds. Many good-quality corporate bonds are supported by healthy company balance sheets and an ongoing expectation for continued modest earnings growth in 2016. Within the government sector, we still prefer provincial bonds over Government of Canada bonds because of their higher return potential.

Canada's economy: April reverses negative growth trend

On June 30, Statistics Canada data showed that after decreasing in February and March, real gross domestic product edged up 0.1% in April. StatsCan pointed to widespread gains, notably in manufacturing, utilities and the public sector, that were largely offset by a significant decline in non-conventional oil extraction. The oil extraction slump was largely attributed to the Fort McMurray wildfires.

The Bank of Canada estimates that the Fort McMurray fires would cut annualized GDP by 1.25 percentage points. However, it's important to factor in maintenance slowdowns in April before the fires. This bolsters our view that the fires may not have reduced output by as much as some fear. This would mean the reduction in economic growth may end up being lower than more bearish analysts have predicted.

Other positive developments to note include that after declining in February and March, manufacturing output rose 0.4% in April. This was driven by non-durable goods manufacturing, which was up 0.9%, the third straight monthly gain. Gains were also recorded by utilities, but the agriculture and forestry sectors were softer.

Employment numbers remained flat in May, with unemployment standing at 6.9%, down 0.2 percentage points from April. Encouragingly, full-time employment rose in May.

The year ahead

As expected, central banks continue to provide reassuring messages post-Brexit. The Bank of England reassured markets again in its semi-annual financial stability report on July 5. Consensus expectations are for a UK interest rate cut this summer potentially combined with bond purchases and steps to spur bank lending aimed at stimulating the economy.

There will likely be some near-term weakness in the Canadian dollar as the turmoil linked to Brexit works its way through currency markets. Brexit has spurred currency flows to the US dollar, which is perceived as a safe haven in volatile times. The loonie hit an 11-month high of around 80 US cents at the end of April. In the first week of July, post-Brexit, it was trading around 77 US cents.

Overall, while there will undoubtedly be volatility to contend with, we remain cautiously optimistic heading into the second half of 2016.

Canada's Economy at a Glance:	Latest period		Year ago
Real GDP	April	0.1% m-o-m	1.5% y-o-y
Unemployment rate*	May	6.9%	7.1%
Housing starts (000s)*	May	188.6	183.3
New motor vehicle sales (000s)*	April	203.2	192.5
Retail sales	April	0.9% m-o-m	4.6% y-o-y
Current account balance (billions)*	Q1	$16.8 (deficit)	$17.0 (deficit)
Consumer price index	May	0.4% m-o-m	1.5% y-o-y

m-o-m = month-over-month; y-o-y = year-over-year
* Levels are shown for the latest period and the same period a year earlier
Sources: Statistics Canada and Canada Mortgage and Housing Corporation, as at June 30, 2016

Important Information:

All returns are total returns as at June 30, 2016 in Canadian dollars. Data sources include Bloomberg, FTSE TMX Global Debt Capital Markets Inc., Bank of Canada and HSBC Research.

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