Canada 2017:
Market Review and Outlook

April 2017

Governments have more room to use growth-oriented fiscal policies

Q1 in Review
- Government borrowing costs are low and debt-to-GDP ratios have stabilized
- The overall Canadian bond market finished up 1.2% on the quarter
- Canadian equities were 2.4% higher on the quarter
- Oil prices dropped by about 10% over the quarter

Q2 Outlook at a Glance
- The US Federal Reserve (Fed) could raise rates up to four times this year
- Canada’s GDP should continue to expand in the second quarter
- Globally, growth and inflation will be low but with an upward bias
- The environment remains constructive, but equity return expectations have been tempered

A lengthy period of austerity in most of the world’s major advanced economies came to an end in 2016. As 2017 moves toward the halfway point, many countries now have more room to loosen their fiscal straitjackets.

In fact, there is a strong case to be made for countries to lean on fiscal policy to support economic growth. Government borrowing costs are low, debt-to-GDP ratios have stabilized, and budget deficits are back to the levels before the financial crisis in 2008. Greater investment spending could also boost much needed productivity growth.

This view is supported by recent political signals that indicate a shift towards growth-enhancing fiscal policy, especially in Japan and the US. The Government of Canada remains committed to a growth agenda, although financial markets saw the March federal budget largely as a non-event. Contrary to what many analysts expected to see in Budget 2017, there were no increases to the capital gains inclusion rate. Only 50% of any realized capital gains will continue to be included in income.
The budget telegraphed a wait-and-see approach from the federal government. Canadian policymakers are waiting to see how the Trump administration weighs in on key questions surrounding trade and taxes before making any significant new moves to stimulate growth.

Canada’s energy sector is under some pressure; oil prices reversed some of their year-end gains in the first quarter. However, lower oil prices are one factor behind the weaker Canadian dollar, which is positive news for exporters.

**Market highlights: S&P/TSX Composite Index delivers five positive quarters in a row**

After finishing ahead of all other developed markets in 2016, the Canadian stock market delivered a less competitive performance in the first quarter of 2017. However, on a positive note, Canadian equities delivered their fifth-straight quarterly advance, the longest streak of gains since 2007.

Canadian equities, as measured by the S&P/TSX Composite Index, finished the first quarter up 2.4%. By contrast, the S&P 500 Index rose 5.2%, the MSCI Emerging Markets Index was up 10.6% and the MSCI Europe, Australasia and Far East (EAFE) Index was up 6.5%.

The driver for the TSX’s relative underperformance so far this year — and the outperformance in 2016 — was oil. The price of West Texas Intermediate crude has fallen about 10% from its high of US$56 per barrel in early January. Energy companies make up about a fifth of the market cap of S&P/TSX, which means their performance had a much greater influence than the Trump rally driving US stocks.

Every sector of the Canadian stock market finished the first quarter higher except energy, which was 5.5% lower on weaker oil prices, and health care, which was down 10.1%. Among the best-performing sectors were consumer discretionary, information technology, utilities and materials.

Canadian bonds, as measured by the FTSE TMX Canada Universe Bond Index, finished the first quarter up 1.2%. The FTSE TMX Canada Universe Corporate Bond Index was 1.8% higher on the year. (All returns in Canadian dollars).

**Investment strategy highlights: Harvesting equity gains in reaction to strong relative performance**

The well diversified structure of our portfolios reflects our views on capital markets. The first quarter offered attractive opportunities to harvest gains by trimming some Canadian equity positions. These profits were taken after realizing several years of robust equity returns. We feel it is prudent to continue to make some marginal moves to rebalance our positions back into bonds. After a number of years being overweight equities, portfolios are now neutral at the broad asset class level.

Bond valuations are looking better overall, and we are encouraged by what appears to be a return to a more normal market scenario where bonds have the potential to compete with equities. Within fixed income, we still prefer corporate bonds. Many good-quality corporate bonds are supported by solid company balance sheets. Within the government sector, we still prefer provincial bonds over Government of Canada bonds because of their higher return potential.

**Canada’s economy: Key economic data support a positive outlook**

We expect US economic growth to continue to drive performance from Canada’s export oriented economy. According to Bloomberg, the consensus for both US and Canadian growth in 2017 is 2.2%. Key economic data support this positive outlook. The latest releases of consumer prices, gross domestic product, retail and manufacturing sales all showed gains. Meanwhile, unemployment was little changed in March.

The Consumer Price Index (CPI) rose 2% on a year-over-year basis in February, following a 0.2% gain in February. Prices were up in seven of the eight major components in the 12 months to February, with the transportation and shelter indexes contributing the most to the year-over-year rise in the CPI.

The results of the Bank of Canada’s Business Outlook Survey – Spring 2017 showed signs of a further strengthening of domestic demand following overall subdued activity over the past two years. The Bank of Canada pointed to foreign demand and an expected rebound in activity in energy-producing regions to support its outlook.
The US Federal Reserve raised the federal funds rate to 1% from 0.75% on March 15 for the third time since the 2008 financial crisis. Markets view this as a vote of confidence in the growth prospects for the US economy as the Fed moves to stay ahead of inflation. We forecast two or potentially three more hikes from the Fed this year.

On March 1, the Bank of Canada maintained the target for its overnight rate at 0.5%. We do not expect the Bank of Canada to raise interest rates this year. Despite the positive signs emerging from the Canadian economy, there is still persistent economic slack in Canada, in contrast to the United States where economic momentum is building. The outlook is clouded further by uncertainty surrounding trade- and tax-related policy moves that could come from the Trump administration.

The year ahead: Guarded optimism as we head towards the end of the first half

Our view remains that our guarded optimism is on balance justified. However, we will be closely monitoring a number of potential headwinds and inflection points, including key European elections, the Brexit negotiations and ongoing economic reforms in China.

We expect the Trump administration to give markets the greatest uncertainties to contend with. After a post-election, Trump-driven rally, the realities of governing and delivering on election promises are beginning to set in. The administration’s defeat on health care reform was a sobering reminder that many investors had let bullish sentiment get ahead of reality when it comes to the complexity and difficulty of implementing policy.

Central banks are likely to maintain real rates at particularly low levels, even in the US. This will be supportive of the continued economic recovery over the long run. We also expect government policies to continue to become more central to economic growth strategies, and to complement very accommodative monetary policy.

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<th>Canada's economy at a glance:</th>
<th>Latest period</th>
<th>Year ago</th>
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<tbody>
<tr>
<td>Real GDP</td>
<td>January</td>
<td>0.6% m-o-m</td>
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<tr>
<td>Unemployment rate*</td>
<td>March</td>
<td>6.7%</td>
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<tr>
<td>Housing starts</td>
<td>February</td>
<td>210,207 units</td>
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<tr>
<td>New motor vehicle sales</td>
<td>January</td>
<td>112,996 vehicles</td>
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<tr>
<td>Retail sales</td>
<td>January</td>
<td>2.2% m-o-m</td>
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<tr>
<td>Current account balance (billions)*</td>
<td>Q4</td>
<td>$10.7 (deficit)</td>
</tr>
<tr>
<td>Consumer Price Index</td>
<td>February</td>
<td>0.2% m-o-m</td>
</tr>
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m-o-m = month-over-month change; y-o-y = year-over-year change
*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 April 7, 2017
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