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- A quarter packed with tense drama: the unexpected came to be with Donald Trump the presumptive Republican presidential candidate; the United Kingdom voting on Brexit and shocking much of the world with an unexpected 'yes' result; Turkey apologized to Russia for shooting down an errant fighter-bomber; government bonds in most major European and Asian countries began trading with negative yields; North Korea successfully launched a ballistic missile capable of carrying a bomb into space and had it return to a spot roughly 200 km from Japan; and last but not least, the U.S. Federal Reserve has not raised the Fed Funds target rate to pursue the expected and often discussed implementation of tightened monetary policy.
- The Brexit vote comes at a precarious time as many of the EU member states are only just starting to recover from the financial crisis. The ECB has pumped liquidity into the economy and stated it will continue to do so, most recently by purchasing Euro denominated investment grade debt.
- There is no obvious exit from this situation unless the EU member states assume an expansionary fiscal policy, which they have so far been reluctant to do. This continues to highlight the fundamentally different economic and social philosophies of the member states.
- In North America, both the Republicans and Democrats are struggling to formulate an approach to deal with Donald Trump and his strong appeal to otherwise disaffected voters. Trump appears to have tapped into a vein of anger and dissatisfaction in America. Trump has committed to canceling or renegotiating most of America's free trade agreements. The return to an era of protectionism and isolationist policies greatly concerns market participants. This is a potentially inflationary and corporate profit compressing path for any nation to follow.
- All through the second quarter, market participants have attempted to divine the Federal Reserve's next move as the signals from the Fed have been variable and uncertain. A prime worry for the central bank is the gradually increasing risk of inflation as slack in the job market falls and wages continue to rise.
- There remain a number of risks to the North American economies, but we believe that our base case of "lower for longer", on interest rates remains intact, and that growth will persist although at a less than optimal rate.
- While the U.K. referendum provided a mandate to leave the European Union, the longer term implications on the markets remain unclear. Given the large number of unknowns and range of outcomes, we expect news flow to impact probability expectations for the potential of Brexit actually occurring and, in the event of a withdrawal, the materiality of the disruption (orderly or disorderly) to result in higher than normal volatility. Within this backdrop, when evaluating new equities for inclusion to our portfolios, candidates with characteristics including stable demand drivers, real assets, or limited U.K./Euro exposure will take on increasing appeal.
- We remind our clients that we continue to have no direct exposure to gold mining stocks given our general difficulty in deriving a fundamental view on value and the spot price. At present, we have greater confidence in alternatives (such as infrastructure, REITS or utilities) when investigating ways to profit from the current low rate environment.
- We believe the surprising Brexit result has fundamentally changed the global growth outlook and put central banks on watch for potentially negative outcomes (real or not) for the foreseeable future. In this environment, it is highly unlikely that long term interest rates will go up.
- There remain a number of events that could drive interest rates lower and credit spreads wider. This includes Brexit, the U.S. Presidential campaign and Canada's economic outlook.

Economic Backdrop – Drama Driven Outlook

A quarter packed with tense drama: the unexpected came to be with Donald Trump the presumptive Republican presidential candidate; the United Kingdom voting on Brexit and shocking much of the world with an unexpected 'yes' result; Turkey apologized to Russia for shooting down an errant fighter-bomber; government bonds in most major European and Asian countries began trading with negative yields; North Korea successfully launched a ballistic missile capable of carrying a bomb into space and had it return to a spot roughly 200 km from Japan; and last but not least, the U.S. Federal Reserve has not raised the Fed Funds target rate to pursue the expected and often discussed implementation of tightened monetary policy.

The event that has had the greatest impact to date is the Brexit vote in the U.K. The "Remain" supporters ran a desultory campaign, acting more as if they would naturally win, and not appealing until the last minute to the hearts and minds of the people. Prime Minister Cameron has announced that he will resign in October, compelling the Conservatives to pick a new leader and Prime Minister. The Conservatives rarely seemed to grasp the real issues; immigration control, inequality and the apparent loss of sovereignty. Successive governments, Conservative or Labour, have often given the appearance of being uncommitted to the EU, and this time they were unprepared for the impact of the similar emotions that Donald Trump has been tapping into in the United States. There is little apparent leadership being shown by any of the principal players. The slogans of the Brexit campaign are fading away as they are slowly abandoned or refuted by impartial sources. Border control was one of the principal points, and now it appears that the programs proposed will have little impact, as they deal with future immigration and do not impact the existing legal residents. Meanwhile the EU has made it clear to everyone that there will be no negotiation before the official notice of intent to withdraw, as required in Article 50 of the Lisbon Treaty, and that admission to the single market will only be possible if free movement of EU citizens is permitted, quickly deflating claims to the contrary.

The Brexit vote comes at a precarious time as many of the EU member states are only just starting to recover from the financial crisis. The ECB has pumped liquidity into the economy and stated it will continue to do so, most recently by purchasing Euro denominated investment grade debt. The actions of the ECB have resulted in the decline of 10-year government debt yields to zero and beyond, with newly issued government debt now trading with negative yields. There is no obvious exit from this situation unless the EU member states assume an expansionary fiscal policy, which they have so far been reluctant to do. This continues to highlight the fundamentally different economic and social philosophies of the member states. Therefore, we expect rates, particularly in Europe, to remain low and possibly even push into more negative territory for a considerable time.

In North America, both the Republicans and Democrats are struggling to formulate an approach to deal with Donald Trump and his strong appeal to otherwise disaffected voters. Trump appears to have tapped into a vein of anger and dissatisfaction in America. Voters have become increasingly dissatisfied with what their governments are doing for them, particularly in regard to the loss of jobs to lower cost countries. Trump has committed to renegotiating most of America's free trade agreements. The return to an era of protectionism and isolationist policies greatly concern market participants. This is a potentially inflationary and corporate profit compressing path for any nation to follow. In parallel he is also proposing to tax or otherwise compel U.S. companies to repatriate cash held outside the U.S. to avoid taxation if the funds were returned to the U.S. He is also proposing to find ways to punish companies that relocate manufacturing outside the U.S. Whether any of these proposals survive the election campaign, the issues have been brought into focus.

It is quite possible that the market is responding to international events in an overly concerned manner.

All through the second quarter, market participants have attempted to divine the Federal Reserve's next move as the signals from the Fed have been variable and uncertain. Concern about the state of the employment picture and the less robust nature of job creation, now coupled with the fallout from Brexit, has held Yellen back. A prime worry for the central bank is the gradually increasing risk of inflation as slack in the job market falls and wages continue to rise. The Fed does not want to be caught stuck behind the curve, but at the same time does not want to choke off the sectors of the economy that are growing and creating new jobs.

It is quite possible that the market is responding to international events in an overly concerned manner, as the U.S. economy, while certainly not as robust as it was in Q4 2015, is still expanding, and expected to continue to do so at the Q1 level or better.

There remain a number of risks to the North American economies, but we believe that our base case of lower for longer on interest rates remains intact, and that growth will persist although at a less than optimal rate. Once the U.K. starts to move along whatever path they choose, the markets will adapt. The presidential election campaign in the U.S. should help to bring the risks and opportunities into focus.

Equity Markets – Brexit Uncertainty

Equity markets continued in a strong vein through the majority of the second quarter despite being blindsided by the release of the U.K. referendum results. The Canadian market was up 5.1% for the quarter, significantly outpacing the 1.2% Canadian dollar performance by the global markets. The outperformance was the result of very strong performance in the mining sector which is now a more significant part of the Canadian index.

While the referendum provided a mandate to leave the European Union, the longer term implications on the markets remain unclear. The Brexit result itself was not legally binding, and David Cameron has chosen to leave the decision to initiate a withdrawal (a complicated process when under way, could take up to two years to conclude) to a yet to be determined successor who will emerge from a conservative party convention this fall. This environment is not supportive of the European consumer or business confidence, and will most likely moderate expectations for growth. Furthermore, we would expect the potential for a dramatic rise in uncertainty and further curtailment of the economic outlook should formal divorce proceedings begin.

Given the large number of unknowns and range of outcomes, we expect increased market volatility; firstly, from news flow impacting expectations for the potential of Brexit actually occurring and, secondly, from the level of the disruption (orderly or disorderly) from the actual withdrawal process. Additionally, as mentioned previously, we expect an extended timeline for a resumption of U.S. federal reserve action (i.e. rates will likely continue to be lower for longer) due to Yellen's keen eye on the current geopolitical uncertainty. Within this backdrop, when evaluating new equities for inclusion to our portfolios, candidates with characteristics including stable demand drivers, real assets, or limited U.K./Euro exposure will take on increasing appeal.

One investment recently added to the portfolios that meets many of these criteria is Lowe's. The home improvement industry in the U.S. remains well positioned for continued growth. The housing recovery from the credit crisis remains in the middle innings and the low rate environment will continue to provide tailwinds for the housing and renovation sector. In addition, we expect Lowe's execution to improve over the coming years, with meaningful margin improvement to follow. They have become a very strong free cash flow generator with a focus on shareholder returns, and the recently completed Rona acquisition will be accretive to earnings.

As highlighted in our previous communication, we maintain a relatively optimistic view for crude oil prospects due to continuing improvements to the supply/demand balance. In the absence of a significant downturn in Europe (or meaningful appreciation of the U.S. dollar) we don't expect a material impact on demand. Supply side developments continue to be constructive as capital investment remains depressed, which is most evident in onshore U.S. production that remains in steady decline. Additionally, numerous unforeseen supply outages have helped to chip away at, what is admittedly, a still bloated inventory picture.

As we look to the second half of the year and the potential for increased uncertainty, we remain positively disposed to the equity markets.

In the energy complex, Seven Generations Energy is a liquids rich natural gas company, recently purchased for clients, that benefits from rising crude prices due to the significant amount of condensate (extremely light oil) produced at its operations. The asset base is focused in the Alberta Deep Basin, housing a deep inventory of prolific wells that return top quartile economics. Management exhibited great foresight by proactively securing significant takeaway capacity on the Alliance pipeline which has enabled the team to deliver to plan while select peers have suffered production curtailments due to transportation bottlenecks. We expect the company's strong track record of execution to continue given the recent completion of significant infrastructure projects that will further showcase the productive capacity of the operations.

As we look to the second half of the year and the potential for increased uncertainty, we remain positively disposed to the equity markets. Nonetheless, to remain vigilant, we continue to review clients' portfolios with a particular focus on names with more cyclical characteristics, to gauge our confidence that they can endure a period of potentially increased volatility (i.e. competitive positioning, balance sheet strength and valuation). Fortunately, the high quality stocks we own for clients and general bias to North America will help in this regard. Given the unprecedented nature of recent events, the upcoming earnings season will offer the first opportunity to gain a sense of how companies will navigate and adapt to the current political climate.

We remind our clients that we continue to have no direct exposure to gold mining stocks given our general difficulty in deriving a fundamental view on value and the spot price. At present, we have greater confidence in alternatives (such as infrastructure, REITS or utilities) when investigating ways to profit from the current low rate environment.

Fixed Income Markets – Positioned for Low Rates

The second quarter of 2016 was another good one for the fixed income market. Interest rates went lower with the largest change in the 30-year term which moved down almost 30 basis points (bps) and set a new all-time record. The Canada 3.5% June 2045 bond led the pack with a return of +6.50% for the quarter. Credit spreads, the difference between the interest rate on a bond and Government of Canada rate, were flat or lower for all sectors except for telecommunications.

During the quarter we sold 5-year General Electric (GE) bonds and bought new Bank of Montreal (BMO) senior 5-year bonds. GE is part of the way through its process to reduce its business activity in financial services and refocus on industrial production. Spreads have tightened as a result, and we took advantage to move into more stable BMO bonds. Look for GE to make a significant announcement over the coming months to redeploy its resources into new industrial related business activities.

Any expectations for global economic weakness will hurt corporate bond spreads over the coming months.

The only other significant change that was made to the portfolio during the quarter was a result of Brexit. The bond market seemed to be of two minds going into the vote, but ultimately when the results were known at the open on Friday, June 24th interest rates were 8bps to 13bps lower from the night before, and corporate credit spreads were about 10bps wider. We believe the surprising result has fundamentally changed the global growth outlook and put central banks on watch for potentially negative outcomes (real or not) for the foreseeable future. In this environment, it is highly unlikely that long term interest rates will go up. We have adjusted the portfolios to capture higher returns on long bonds and any price appreciation should those rates go lower. Any expectations for global economic weakness will hurt corporate bond spreads over the coming months as the full impact of this historic vote is realized in the fixed income market. We sold corporate and municipal bonds in the portfolio with the longest maturities as they will be the biggest underperformers should credit spreads increase. The longer the maturity, the larger the impact a +/- one basis point change will have on the price of a bond. We moved about 17% of the portfolio out of corporate and municipal bonds with maturities from Nov 2021 to 2024 and into the Government of Canada 5.75% June 2033 bond. This alteration significantly decreased the credit risk in the portfolio and is well position for negative economic surprises while maintaining a very high current yield. The longest corporate bond in the portfolio today has a maturity of August 2021. Duration increased 1.35 years to 6.85, still below the index at 7.70 years.

There remains a number of events in the coming months that could drive interest rates lower and credit spreads wider. One is the fallout from Brexit. Second, the U.S. Presidential campaign will heat up as the election date of November 8th draws closer. Hillary Clinton would like to raise taxes and Donald Trump would like to tear up many important trade agreements. The details of their policies will hopefully be clarified in time. Keep in mind the House of Representatives also stands for reelection, as well as one third of the Senate. It is expected that the Republicans will maintain control of the House, but the Senate is up for grabs. Control of Congress is important for any President to accomplish his or her agenda, as President Obama can attest having dealt with a split congress in his first term and an opposition Republican majority in his second term.

The third event is a domestic risk as the expectation is for Canada's economy to have shrunk in the second quarter. This is caused by the economy cooling from strong growth in the first quarter (+2.4%) and the impact from the forest fire in Fort McMurray. The Bank of Canada expects second quarter GDP growth to be slightly negative, while private sector forecasts are -1% or worse. However, there is confidence that the third quarter will offset this contraction and overall GDP growth for the year will be a calm +1.0% to +1.5%. As economic numbers come in for the second and third quarters, the market will be evaluating the details to see if that forecast will come true.

With these three events offering mostly negative economic risks, we are confident in our decision to reduce credit risk and position the portfolio for rates to stay the same or go lower.

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