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- While the third quarter played host to a wide variety of economic or geopolitical events and themes, nearly all began or grew most strongly in the second quarter, culminating with the selection of Donald Trump as the Republican presidential candidate, facing Hillary Clinton for the Democrats. As we leave the third quarter behind, it is disappointing to find that all the key issues remain, with the greatest concern in the marketplace continuing to center around the anticipated change in the Fed's monetary policy, and its impact on interest rates.
- The U.S. economy continues to provide mixed signals, perhaps explaining Yellen's lack of enthusiasm to pursue a tightening program. We are now in the countdown to the end of the year, with the remaining FOMC meetings on November 2nd and December 14th. The November date is less than a week before the U.S. presidential election, which further argues for a December hike to ensure the Fed is perceived to be politically neutral.
- No matter who wins in November, there is a definite undertone that the current focus on monetary policy (already wrung out like a dry sponge) will give way to fiscal stimulus. The hope is that this will support the economy, stoke inflation, and catalyze corporations into capital spending programs, which has been noted by its absence during this economic cycle.
- In Europe, the U.K. Brexit vote has triggered the announcement of a number of similar EU member votes. The pressure on Theresa May, the new Tory Prime Minister, is intense as she prepares to steer the U.K. out of the EU. She has announced her intention to trigger Article 50, leaving financial markets in the U.K. and elsewhere in flux trying to decide if this latest development is positive or negative.
- In Asia, Japan continues to struggle to bring its economy back from the abyss, and China continues to target economic growth of 6% to 7% while becoming more aggressive in establishing its zone of influence.
- The most recent earnings and conference season did provide some insight into how companies will navigate the current political climate, though certain management teams were more forthcoming with their intentions than others. For instance, Nissan CEO Carlos Ghosn was amongst the most outspoken in stating that major capital investments by the firm will not proceed in the U.K. We remain cautious, and therefore selective, with our stock exposures in Europe due to the region's structurally lower growth outlook versus other parts of the world.
- Crude oil markets continued to attract headline attention in the quarter leading up to and in the aftermath of the OPEC meeting at the end of September. While the meeting itself did not lead to any official changes in policy, we are optimistic that evidence of further co-operation amongst OPEC members, to manage the market, will help put a bottom in for crude oil.
- We continue to tilt the portfolios defensively in equities, not necessarily in the sector exposure but towards advantaged businesses that can prosper through economic cycles. We believe in buying sound businesses cheaply – not determined blindly by short-cut earnings or asset multiples screening "value" – but instead when our conservative estimate of future cash flows indicates shares are discounted attractively to intrinsic value.
- It was another solid quarter for the fixed income market. Interest rates up to the 7-year term were mostly unchanged, and beyond that rates were lower, leaving the overall yield curve flatter. Credit spreads also improved led by the Energy sector.
- If the Fed raises rates again we do not expect it to have much impact on Canadian interest rates and therefore we do not expect to make any changes to the portfolio as a result of the Feds actions.

Economic Backdrop – Key Issues Unresolved

While the third quarter played host to a wide variety of economic or geopolitical events and themes, nearly all began or grew most strongly in the second quarter, culminating with the selection of Donald Trump as the Republican presidential candidate, facing Hillary Clinton for the Democrats. The British people, by a narrow margin, chose to exit the EU, North Korea continues to "test" the capability of their nuclear tipped missiles, and in the Middle East, a horrible war continues to be waged. Battlegrounds have grown to cover Syria, Yemen, Libya, and parts of Iraq, while the Americans and Russians have continued to be drawn in.

Yellen has not developed one central strategy and compelled all the board members to fall in line.

As we leave the third quarter behind, it is disappointing to find that all the key issues remain, with the greatest concern in the marketplace continuing to center around the anticipated change in the Fed's monetary policy, and its impact on interest rates. Despite entering 2016 with expectations of four hikes during the year in the Federal Funds target rate, which could have amounted to a one percentage point rise in administered rates, we have seen the Fed hold back in every meeting this year. The confusion in the markets as to the FOMC's intentions has been made more pronounced because, unlike previous chairs, Yellen has not developed one central strategy and compelled all the board members to fall in line. As a result, we have witnessed each board member speak publically, and frequently contradict each other.

The U.S. economy continues to provide mixed signals, perhaps explaining Yellen's lack of enthusiasm to pursue a tightening program. Inflation measured at the core PCE level remains stubbornly below the Fed's target of 2%. There is also growing concern about the drop in productivity measures for the U.S. economy. We are now in the countdown to the end of the year, with the remaining FOMC meetings on November 2nd and December 14th. The November date is less than a week before the U.S. presidential election, which further argues for a December hike to ensure the Fed is perceived to be politically neutral in what is turning out to be a closer race than most expected, even following the presidential debate. No matter who wins in November, there is a definite undertone that the current focus on monetary policy (already wrung out like a dry sponge) will give way to fiscal stimulus. The hope is that this will support the economy, stoke inflation, and catalyze corporations into capital spending programs, which has been noted by its absence during this economic cycle. In Europe, the U.K. Brexit vote has triggered the announcement of a number of similar EU member votes. The pressure on Ms. May, the new Tory Prime Minister, is intense, as she prepares to steer the U.K. out of the EU. She has announced her intention to trigger Article 50, leaving financial markets in the U.K. and elsewhere in flux trying to decide if this latest development is positive or negative. The Pound has taken a beating in the forex market, falling from a worth of almost US$1.50 to nearly US$1.22.

Meanwhile, Italy has slowed its expansion and has moved to convince the EU to bailout what amounts to the key participants in its domestic banking sector. Effectively the entire sector (including the oldest bank in Italy, Banca Monte dei Paschi di Siena), was told by the ECB that they had to reduce their bad debts by 40 percent over three years. Italy was unwilling to trigger the bail-in feature of the debt (this would push the losses to the depositors and bond holders) due to political ramifications and the need to pass key legislation. Eventually, with the risks of Brexit hanging over the EU members, the ECB caved and the EU approved the bailout by the Italian government. Fortunately, this has occurred while the economic data for the stalwarts of the EU are taking on a much brighter outlook, and 10-year government bond yields have generally crept back into positive ground.

In Asia, Japan continues to struggle to bring their economy back from the abyss. Japanese Prime Minister, Shinzo Abe, has struggled to find an economic plan to stimulate the economy and jump start the rate of inflation. He has tried what has been dubbed QQE (Qualitative and Quantitative Easing). The latest plan is to try and reshape the yield curve by selling 10-year debt, the purchase of which had been the focus of the QQE program, and buying longer-term and shorter-term debt. Previous strategies have centred around buying the 10-ten year maturities, which only succeeded in driving down 10-year rates, proving ineffective. The new strategy may also stumble as it is inconsistent with Japan's currency policy.

China continues to target economic growth of 6% to 7% while becoming more aggressive in establishing its zone of influence. Having already taken the West by surprise, by establishing bases on artificial islands scattered around the perimeter of the South China Sea, the Chinese are now working on agreements with countries it has challenged over the legitimacy of the Law of the Sea ruling. Chinese naval ships have sailed into territorial waters of Indonesia, Vietnam, Philippines, and gone north towards the Bering Strait.

Little progress was made on any of the key issues in the world economies. However, economies are becoming more stable, and therefore, more resilient in meeting any future crises. The final quarter of 2016 should bring better clarity and stronger economic growth.

Equity Markets – OPEC About to Act

Canadian (+5.5%) and Global (+5.0% or +6.1% in C$ terms) markets produced strong performance in the quarter, extending the rebound post the Brexit sell off near June's end. Immediate concerns related to the U.K.'s potential departure from the European Union were alleviated somewhat by the prospects of further monetary easing and changing perceptions regarding the potential for an orderly Brexit process. At quarter end, expectations were for May to trigger Article 50 (i.e. to initiate the two-year process of withdrawal from the European Union) by the end of March 2017, so the proverbial can has been kicked down the road.

The most recent earnings and conference season did provide some insight into how companies will navigate the current political climate, though certain management teams were more forthcoming with their intentions than others. For instance, Nissan CEO Carlos Ghosn was amongst the most outspoken in stating that major capital investments by the firm will not proceed, in the U.K., without a guarantee of compensation, should Brexit related tariffs be imposed in the future (Nissan exports a large number of vehicles to Europe from an assembly plant in Sunderland, U.K.). It remains reasonable to assume that other companies with flexibility may choose to allocate capital away from the U.K. until more clarity on the future business environment and terms of trade are outlined.

Clients benefited from mergers and acquisitions, with record quarterly Canadian activity taking place.

We remain cautious, and therefore selective, with our stock exposures in Europe due to the region's structurally lower growth outlook versus other parts of the world. In addition to the remaining Brexit uncertainties, the European Central Bank's negative interest rate policy continues to dampen European bank profit margins and has raised balance sheet concerns for Deutsche Bank and Italy's Monte dei Paschi. Although these banks will be able to raise the required capital, it does highlight the difficulties faced by the banking industry to grow in this environment. As such, European stocks with a global footprint remain better positioned from a structural growth perspective. For instance, Adidas management has executed very well on its new premium brand offerings, which has allowed them to take market share and grow sales well in excess of expectations. In addition to strong earnings revisions, shareholders have also been rewarded with an expanded multiple. Although we expect Adidas to continue executing their turnaround plan, we decided to trim the weight, in client portfolios, as the stock price has moved closer to our target.

Crude oil markets continued to attract headline attention in the quarter leading up to and in the aftermath of the OPEC meeting in Algiers at the end of September. While the meeting itself did not lead to any official changes in policy, headlines were made related to the cartel having come to a collective production agreement in principal (lower than current output levels) to be ratified at the next meeting in November. While details regarding the potential proposal are sparse, and challenges relating to the re-imposition of individual country quotas are not trivial, we are optimistic that evidence of further co-operation amongst OPEC members (and potentially non-OPEC members), to manage the market will help put a bottom in for crude oil. Although there have been a few false starts on this front recently, we believe Saudi Arabia is more motivated to potentially change its strategy. Simply put, the strain of low prices over the past two years (which has successfully curtailed non-OPEC global energy related capital spending and production growth) is now also putting severe strain on Saudi finances. This is evident in announcements to scale back public sector salaries, reduced subsidization of water and electricity, a sovereign credit rating downgrade, and concerns regarding pricing for the planned Saudi Aramco initial public offering. All eyes will be on Vienna on November 30th given the heightened expectations for the next meeting.

Client portfolios benefited this quarter from merger and acquisition announcements, with record Canadian quarterly amounts of activity taking place. Alimentation Couche-Tard's purchase of CST Brands and related disposition of a portion of the acquired gas stations (sold to allay potential competition bureau concerns regarding the Quebec footprint) to Parkland Fuel Corporation generated significant value for both companies which clients own. Both companies pursue different businesses and strategies, though each has a retail fuel network and a demonstrated track record of profitable growth by acquisition. As investors, we appreciate the strong free cash flow generation capabilities of both companies, supporting the use of a prudent amount of leverage. When analyzing such transactions from an investor perspective, each company is now in a stronger competitive position, reinforcing our support of the actions undertaken.

In our search for equity returns, we continue to tilt the portfolios defensively, not necessarily in the sector exposure but towards advantaged businesses that can prosper through economic cycles. We believe in buying sound businesses cheaply – not determined blindly by shortcut earnings or asset multiples screening "value" – but instead when our conservative estimate of future cash flows indicates shares are discounted attractively to intrinsic value.

Fixed Income Markets – Positioning is Vital

It was another solid quarter for the fixed income market. Interest rates up to the 7-year term were mostly unchanged, and beyond that rates were lower, leaving the overall yield curve flatter. The 10-year term led the way decreasing 6.5bps, while Canada 3.5% 2045 bonds returned about 2% during the quarter. Credit spreads also improved led by the Energy sector, even though the price for oil finished roughly unchanged. Energy bonds are typically the most volatile, so when spreads tighten they often perform the best. Our investments in Veresen and Enbridge were standouts in their maturity dates.

Meanwhile, in September, Enbridge announced a merger with Spectra Energy, creating one of North America's largest pipeline and energy infrastructure companies. The merger was positive for bond holders as Enbridge issued stock to fund the acquisition, creating a company with little additional debt. The new entity will have billions more in assets producing cash to service the debt. Credit spreads on the holding of Enbridge Inc. 4.53% March 2020 tightened by 25bps on the news resulting in a final gain of 2.35% for the quarter.

The Communications sector had the second best return in the quarter, followed by Infrastructure with the exception of shorter-term securities. Earlier in the year there was a flight to safety where short maturity Infrastructure bonds outperformed. As a result, we identified this sector as expensive in late July. We sold two short-term infrastructure bonds, natural gas distributor Gaz Metro 5.45% July 2021 and Greater Toronto Airport Authority 1.51% February 2021, and added to the existing Canada 5.75% June 2033 position. This move has worked well, and we expect long term interest rates to decrease further. This was the only portfolio change we made during the quarter.

In late August, we learned that second quarter Canadian GDP shrank 1.6% (quarter-over-quarter annualized) after strong 2.5% growth in Q1. Second quarter exports contracted 5.4% and were the main culprit to the negative GDP print. The fire in Fort McMurray was largely responsible as oil production and pipelines were taken offline for several weeks. However, domestic demand remained strong after a good print in Q1 and was helped by business capital investments decreasing at a slower rate. The hope is that this six-month trend will continue and businesses, mainly in the oil patch, will begin to increase investments. In August, the WTI price of oil saw its first year-over-year positive change since prices started dropping two years ago. Hopefully this encourages companies to invest which should produce higher headline inflation numbers. So far, Q3 Canadian GDP looks good with July clocking in at 1.3%, which should allow the Bank of Canada to maintain its current overnight interest rate.

Historically, the Fed avoids taking action so close to an election for fear of causing political influence.

In the United States, the Federal Reserve decided to hold off on raising their overnight target rate until a later date. After a frightening payroll number for May, it looks like the job market down south will remain strong and the unemployment rate should hold near or below 5%. The Fed is waiting for the tight job market to result in higher wages, which will generate an increase in demand for goods and services, and inflation. Thus far, employers are hiring additional employees, but are having an increasingly difficult time finding skilled labour. However, wages have yet to rise. A few more people are re-entering the workforce and might be satisfying the increased demand for labour. As a result, the Fed has decided to stay on the sideline and see what the future has in store.

As mentioned previously, we don't think the Fed will have much new to say at the November 2nd meeting since the U.S. Presidential Election will be held less than a week later on November 8th. Historically, the Fed has avoided taking action so close to an election for fear of causing political influence. This leaves December 14th as the next opportunity to raise interest rates, which you may recall is the same meeting where the Fed initially hiked in 2015. However, before December 14th we will see more economic data that will certainly influence the Fed's decision, not to mention the outcome of the Presidential election.

If the Fed raises rates again we do not expect it to have much impact on Canadian interest rates. U.S. Treasury bonds with maturities of 0 to 18 months will see their rates go up, but longer-term 10- and 30-year bonds should be mostly unchanged. We do not expect to make any changes to the portfolio as a result of the Fed's actions.

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