The Bull Market in Everything:

Investment positioning for times that can't last forever.

glc asset management

2019 Mid-Year Capital Market Outlook

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Data as of June 21, 2019 unless otherwise stated.

The World at Large: The Bull Market in Everything

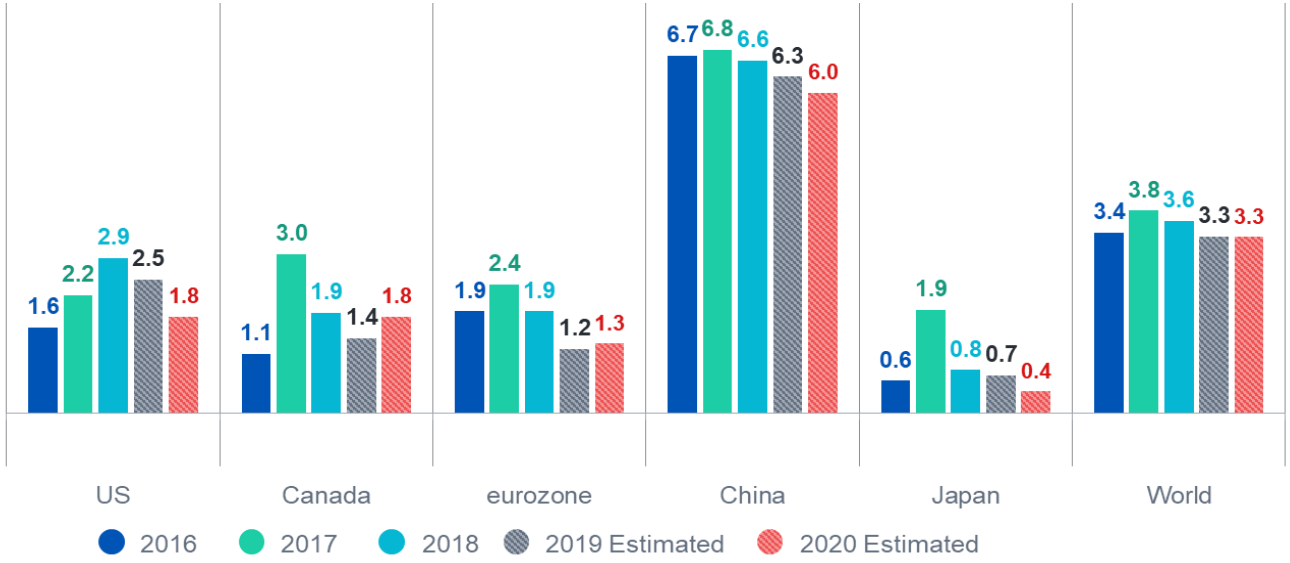
Investment positioning for times that can't last forever

We believe the global economy has enough positive momentum to exit the current global slowdown within the next two to four quarters. That's the good news. What's causing us concern are the sharp advances in equities, commodities and bonds. The 'bull market in everything' scenario is not one that can last for long. **We recommend investors take action to get back to neutral equity/fixed-income positions that address today's risks, while adjusting weightings within those asset classes to capture relative opportunities to enhance returns.**

Equity markets have quickly moved to price in a rosy scenario on trade and supportive global central banks. Furthermore, earnings expectations for 2020 remain overly optimistic. Fixed income has also moved aggressively, providing little attraction going forward as an alternative to stocks. Trade frictions and policy responses (both monetary and fiscal) present additional uncertainty for capital markets. While this sounds like a tempting invitation to overweight cash, outside of very tactical moves in the near term, we see a balanced and diversified asset mix that includes both equities and fixed income as most appropriate to navigate through our forecast horizon. Our 2019 mid-year Capital Market Outlook highlights adjusted weightings within equities and fixed income to reflect our view of relative opportunities.

1.1 | Global GDP Growth

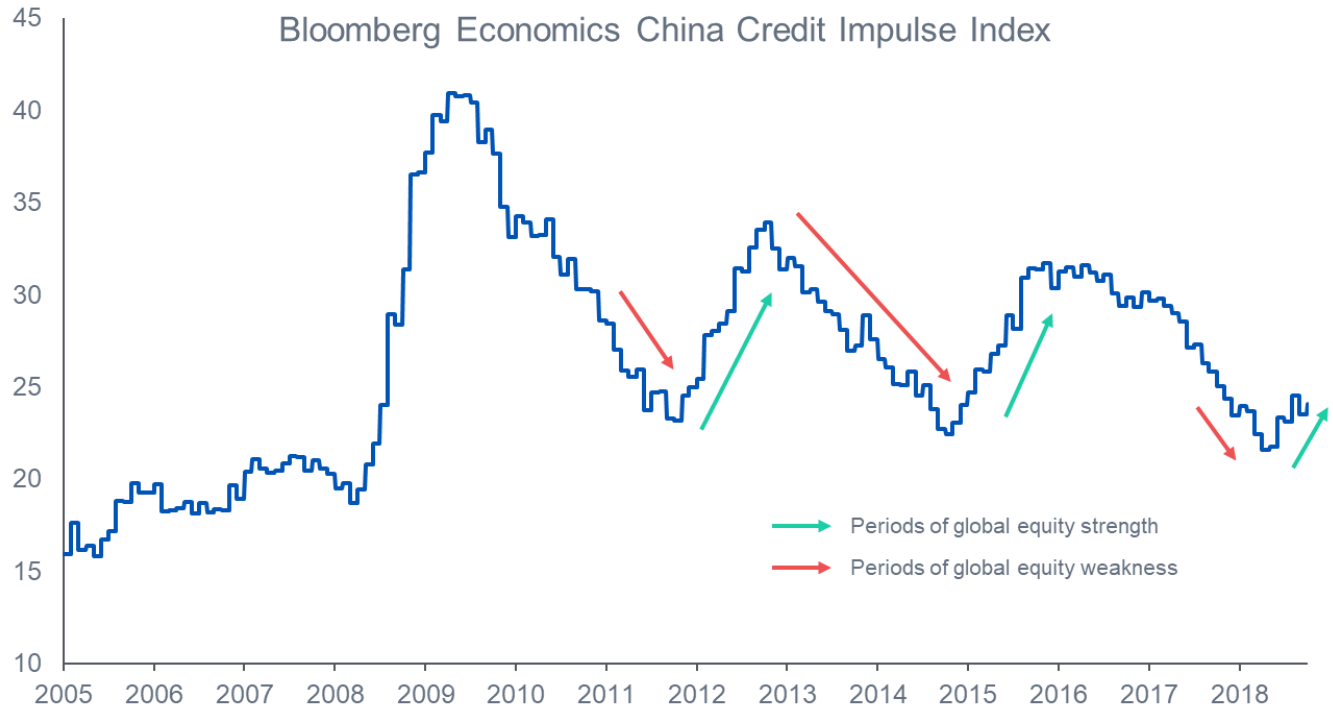
Global GDP growth remains solid, but peaking, reminiscent of 2016



Source: Bloomberg, June 21, 2019.

1.2 | China's Credit Impulse

Global equities are heavily influenced by China's flow of credit

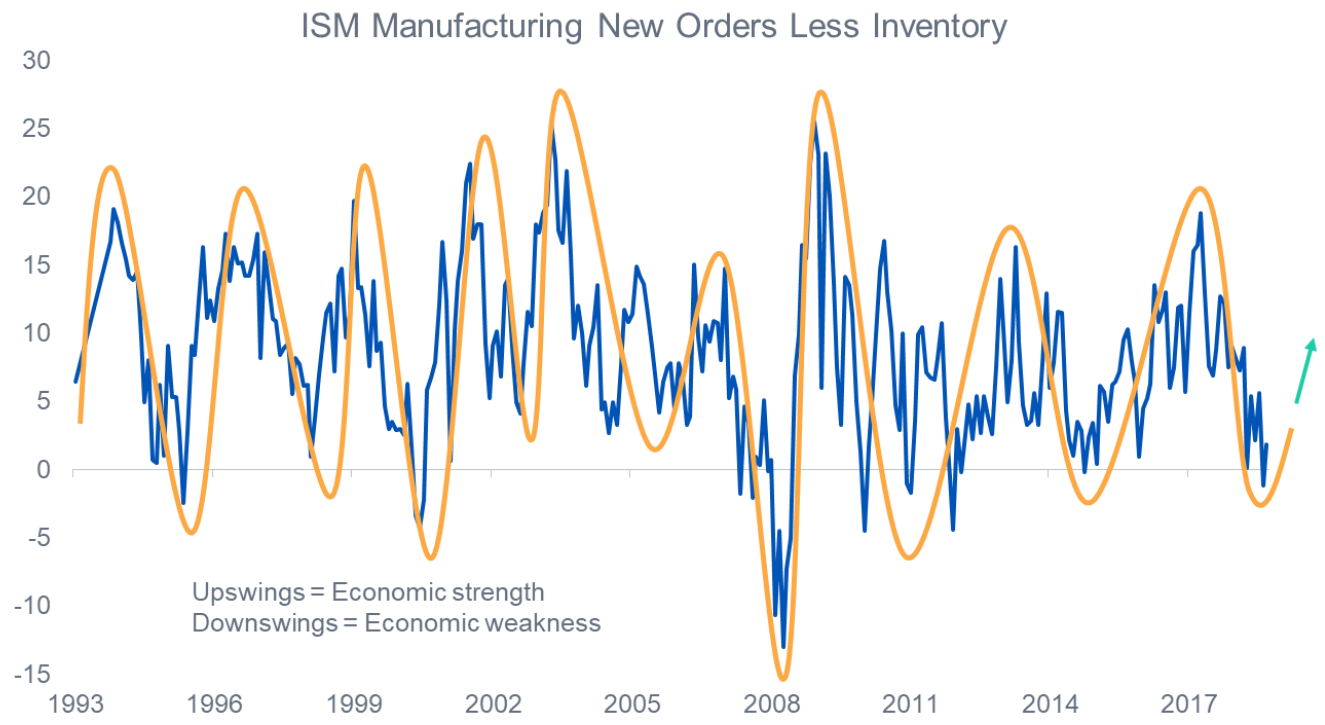


Source: Bloomberg, May 31, 2019.

The global economy has been slowing for a year (see exhibit 1.1). While the longevity of the U.S. business-cycle expansion garners much attention (see "Did you know?" section on page 9), this is the third global slowdown of the past 10 years. Trade frictions have exacerbated the slowdown and remain an unpredictable cloud dimming future growth expectations. This makes the question of whether we're closer to the end or the beginning of the current slowdown particularly challenging. When we dig deep and weigh out the evidence, we find ourselves tilting in favour of growth re-emerging late in 2019 or early in 2020. Our view is aided by economic metrics that signal future demand expectations, such as the Chinese credit cycle and U.S. inventory cycle turning positive (see exhibit 1.2 and exhibit 1.3), and the willingness of global policy makers to re-fuel the economy through fiscal policy, monetary policy or both. If six to twelve months seems like too long to wait, remember that capital markets are forward-looking 'predictors' of growth. **Even if economic data continues to weaken in the near term, that does not preclude stocks from beginning a march higher in anticipation of better days ahead – a scenario we've seen repeat itself many times.** At this juncture, equities are pricing in some of the more positive outcomes, despite there remaining great uncertainty with the outcome of the U.S. trade agenda and the magnitude and timing of central bank easing interventions.

1.3 | U.S. Inventory Cycle

The natural U.S. inventory cycle has been a large part of the slowing U.S. economy. This cycle is showing signs of turning; a headwind will shift to a tailwind.



Source: Bloomberg, May 31, 2019.

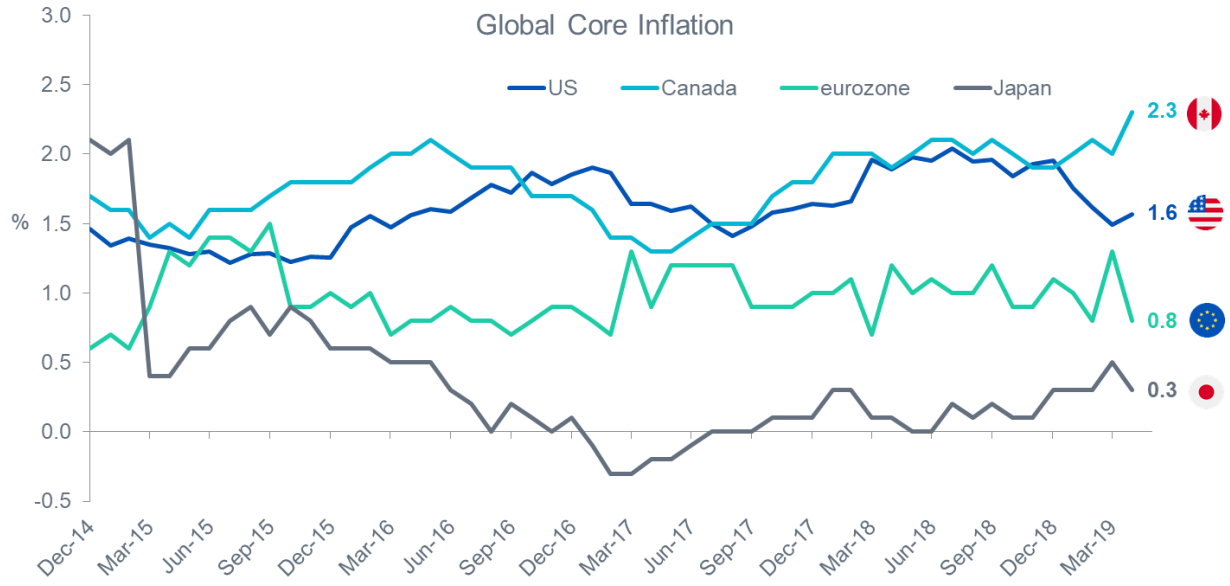
The Committees to save the world

Our base-case scenario highlights our expectation of a synchronized easing of financial conditions globally. The old adage, "Don't fight the Fed" has expanded to become "Don't fight the Fed, PBoC, ECB, BoE, BoJ, RBA, BoC, RBI…"[1] Just about every major central bank imaginable are now coined as the "Committees to Save the World". Each of these central banks has already loosened monetary policy (or are poised to), greenlighted by slowing economic growth, and despite historically low unemployment in most regions, a persistent lack of inflation. (see exhibit 1.4).

[1]Selected Global Central Banks: Fed = U.S. Federal Reserve, PBoC = People's Bank of China, ECB = European Central Bank, BoE = Bank of England, BoJ = Bank of Japan, RBA = Reserve Bank of Australia, BoC = Bank of Canada and RBI = Reserve Bank of India.

1.4 | Inflation Remains Low Globally

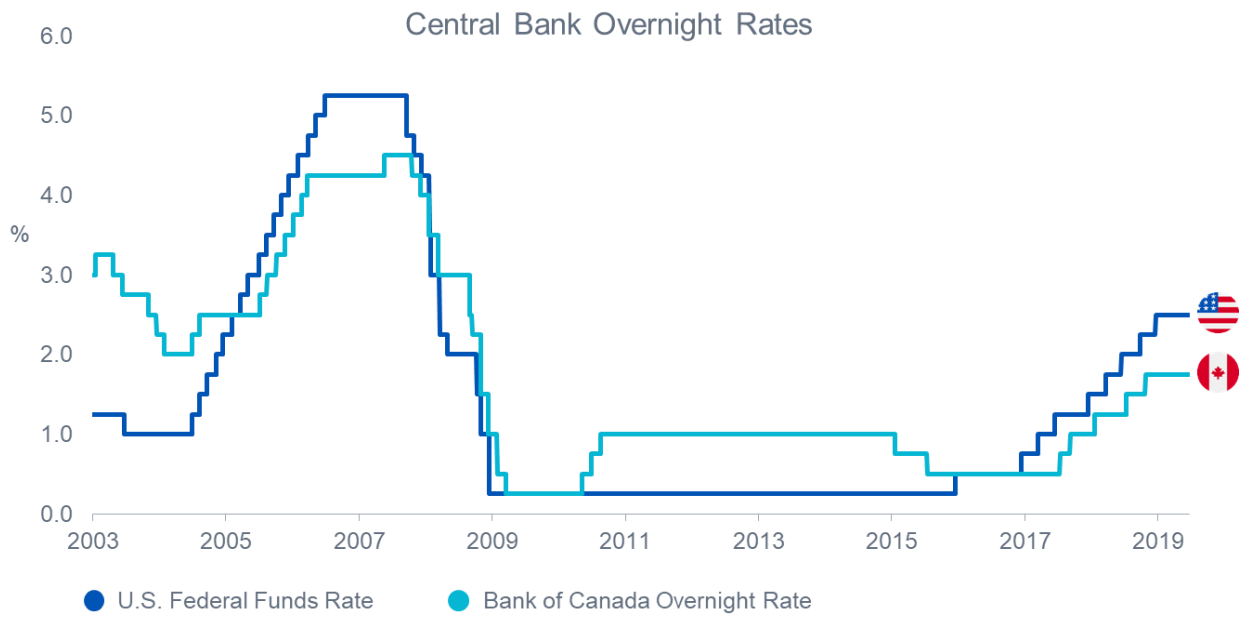
Contained and/or low inflation allows central banks to adopt a 'dovish' stance



Source: Bloomberg, April 2019.

China's fiscal and monetary policies and U.S. monetary policy are especially important given the dominant role of the world's two largest economies and the U.S. dollar as the global reserve currency. Each nation has pursued restrictive growth policies since the beginning of 2017 (as has Canadian monetary policy). As designed, these two full years of action to deliberately slow their economies has worked (see exhibit 1.5). These actions have now completed their cycle and we see them as set to reverse. Chinese authorities have already moved to stimulate their economy and the U.S. Federal Reserve (Fed) has spoken clearly about their consideration of rate cuts. **There's little doubt the conversation around the central bankers' table is now one of 'how can we re-ignite growth' after two years of debate around how to normalize from emergency policy rates.** We anticipate capital market volatility as these policy measures unfold. Both the Chinese authorities and the Fed are trying to "thread the needle" on policy. China would like to inject as little stimulus as possible, with a longer-term goal to generally decrease leverage. This leads to uncertainty and fear over whether their efforts to stimulate growth will be as effective as in the past. For the Fed, the trick will be to ease enough to meet the markets expectations without overdoing it. It's impossible to tell with the first couple of Fed rate cuts whether these are 'good' insurance cuts (that historically have worked to extend the cycle) or the start of 'bad' end of cycle cuts (that have preceded recessions). The bond market in particular will be looking for signs these are "insurance-style" rate cuts that are expected to be temporary with a pause and potential restart of a hiking cycle to come as economies respond and reaccelerate.

1.5 | Central Bank Tightening Has Naturally Led to Slower Growth for the Economy



Source: Bloomberg, June 21, 2019.

U.S., Canadian and global equity markets have gone sideways for 18 months

Those markets making new all-time highs are just now surpassing levels originally set in January 2018. This sideways move properly reflects the reality of the economic slowdown and the current near-flat, year-over-year earnings growth being reported by corporations. This experience is very similar to the equity market behaviour during the two other global slowdowns of the past 10 years in 2011/12 and 2015/16. However, this time, the overall growth environment that eventually emerges is likely to drive modest capital market returns.

We cannot avoid tempering this view somewhat by the recent escalation of trade concerns, so we've devoted a special 'Trading Tweets For Facts' section in our report to outline various scenarios and their possible impact on capital markets. However, as a base case, we believe China-U.S. tensions will linger enough to spark action from U.S. and Chinese monetary and fiscal authorities to support growth and equity valuations. Meanwhile, threatened trade disruptions (such as we've seen most recently with Mexico and the U.S.) will rattle markets with emotive responses. **Any escalation that results in actual implementation of trade barriers will need to be negatively factored in to an already tepid earnings growth outlook. This presents enough risk to warrant some defensive protection and diversification within investment portfolios.**

Defensive protection and diversification

We think a lot of the fear around the economy is already reflected in the substantial decline in bond yields witnessed thus far in 2019. Should stocks correct, fixed income is able to offer further gains. However, over our forecast horizon, we don't think bonds offer much further upside, unless a slowdown or recession scenario unfolds.

Bottom line: We're maintaining our asset allocation at neutral, aligned with one's own risk tolerance – a balance between exposure to participate in equity market growth without over-reaching for risk.

- **Our 2019 Mid-Year Capital Market Outlook generally calls for single-digit equity price gains between now and the end of the year. Bouts of trade-, political- and geopolitical-related volatility may be severe enough to present buying opportunities for those comfortable with a more pro-risk stance.**
- **Within equities, we recommend broad, diversified geographic and sector allocations – with a slight equity overweight toward Canada. We recommend neutral exposure to U.S. and EAFE equities and recommend a slight-underweight in Emerging Markets.**
- **For fixed-income investors, we recommend a neutral weight to sovereign bonds, offset by an overweight to investment-grade corporate bonds and an underweight in high-yield bonds. Overall, we forecast a 0.5% total fixed-income return for the back half of 2019. The main attraction in fixed income is, once again, as a risk-mitigation tool (a role it has repeatedly played well, most recently in Q4-2018 and May of 2019).**

Trading Tweets For Facts

Trade wars are neither good nor easy to win. Often events in financial markets are more emotive than they are material. Trade issues are both.

On the emotive side, when thinking about equity valuations under the constant threat of trade uncertainty, it's necessary to account for the hit to investor sentiment and assign lower-equity valuations as a result. Similarly, trade uncertainty leads to a dampening of business confidence that impacts business spending – a key ingredient to GDP growth, profitability and productivity. Consumer confidence may also face a similar, yet likely smaller impact, depending on the ultimate impact to the prices and availability of everyday goods.

Sentiment comes and goes

Investor sentiment comes and goes; what will be longer lasting are the material economic costs and impact to corporate earnings from various levels of any trade barriers implemented rather than threatened. Trade barriers would have a negative impact on economies, but the relatively closed nature of the U.S. economy (exports represent 12% of U.S. GDP, with exports to China <1% of GDP), and the fact that China has grown its domestic economy to such an extent that exports have shrunk to represent 18% of Chinese GDP (with exports to the U.S. at 3.5% of GDP), would limit this. Trade barriers would only impact a portion of the overall import/export picture. Corporations would respond with mitigating measures and product and supply chain substitution would take place – all are negative impacts, but not ones that we feel would be large enough to change our view that the global economy is sound enough to avoid a recession.

Where the impact would be more of a concern is not the economy but on those in the economy who will bear the heaviest toll, namely: the global multinational corporations. Multinational corporations have benefited the most from decades of globalization and it stands to reason they have the most to lose as globalization comes under attack.

Both the short- and long-term impact of tariffs on corporate profits, and outright bans on some commercial activity, is highly uncertain, but it's expected to be negative for those countries and companies impacted. **Tariffs are a tax that's paid by some combination of consumers and corporations. The longer and more significant trade disputes become, the more corporate profits will be eroded by rising costs due to tariffs, product realignment and decreased operating efficiencies through disrupted supply chains.** The decline in GDP, coupled with the hit to profitability, along with the potential for some of the world's largest companies to be barred from some of the world's largest markets, is likely enough disruption to drive a U.S. corporate earnings recession, even if it doesn't cause a "main street" recession.

Headaches in the world's two largest economies would likely materially dampen earnings growth globally. It's fair to note that the last global earnings recession experienced in the 2015-2016 global slowdown brought bear markets to Canadian, EAFE and Emerging Market equity indices. We do not believe equity markets globally are priced for these outcomes today. Should trade frictions escalate, equity markets would need to correct, and potentially sharply.

Bottom line: Trade frictions have the potential to wipe out modest corporate earnings growth estimates for 2019 and severely dampen the still-optimistic outlook for 2020 earnings growth. Should these negative scenarios unfold, the decline in earnings expectations will collide with an erosion of investor sentiment that will impact equity valuations, resulting in equity market declines. **The gravity of the situation is not lost on policy makers: falling equity markets and waning business sentiment are likely to pressure both sides to return to the table and find solutions.** We believe this is the most likely outcome; however, we also believe this outcome is largely priced into equity markets. Hence, a mis-step on trade in either timing or degree of détente has a higher probability to disappoint, which would bring near-term downward pressure on equity prices. This cycle has the potential to repeat more than once as the key-players balance jockeying for an upper hand, against domestic pressures from their capital markets, economies or political constituencies.

Did You Know?

The U.S. economic expansion is poised to become the longest on record this July, surpassing the previous 120-month expansion of the 1990s. As we cross this milestone, questions abound as to how long the current expansion and its attendant "bull" market will last. We've stated in the past that economic and market cycles do not come with any pre-ordained expiry dates. Lengthy expansions are not all that uncommon: Australia is enjoying 28 straight recession-free years. Canada, the U.K., Spain and Sweden all experienced expansions of 15 years or more between the early 1990s and 2008. According to the Economic Cycle Research Institute and a Wall Street Journal analysis of global growth data, France, Germany, the Netherlands, Norway, South Korea, Ireland and China have all experienced periods of economic growth that lasted 15 years or more at different points since World War II.

The key ingredients for economic growth are a growing labour force, combined with human and physical capital that drives productivity to keep the economy going. During this current expansion:

- *The U.S. has created more than 20 million jobs and the net worth of American households has risen by $47 trillion to $104 trillion.*
- *The GDP growth rate has been the lowest of any expansion on record; 'slow and steady' has meant 'better for longer'.*
- *The unemployment rate sits at a 50-year low, but wage growth has also been slow. However, when measured against low inflation, real wages have grown more robust than in other expansions.*

Source: "After Record-Long Expansion, Here's What Could Knock the Economy Off Course," by Jon Hilsenrath, Wall Street Journal, June 3, 2019.https://www.wsj.com/articles/after-record-long-expansion-heres-what-could-knock-the-economy-off-course-11559591043?mod=article_inline.

Canadian Equity

We continue to hold a positive view toward Canadian equities, maintaining a slight overweight recommendation. We believe it currently offers the best risk/reward outlook of the global equity allocations.

While on a fundamental basis (earnings and valuations) Canadian equities look attractive, we've previously written about the need for a catalyst to spark interest in Canadian equities. We now see those catalysts on the horizon. These 'green shoots' have the potential to grow and drive a high single-digit price return for the S&P/TSX Composite into year's end.

Green shoots on the horizon

Economy – The Canadian economy appears to be exiting its two-quarter soft patch, spurred by:

- Stabilizing housing markets;
- The narrowing Canadian oil price differential;
- A pickup in exports;
- Continued solid employment;
- An uptick in wage growth; and
- A positive turn in the inventory cycle.

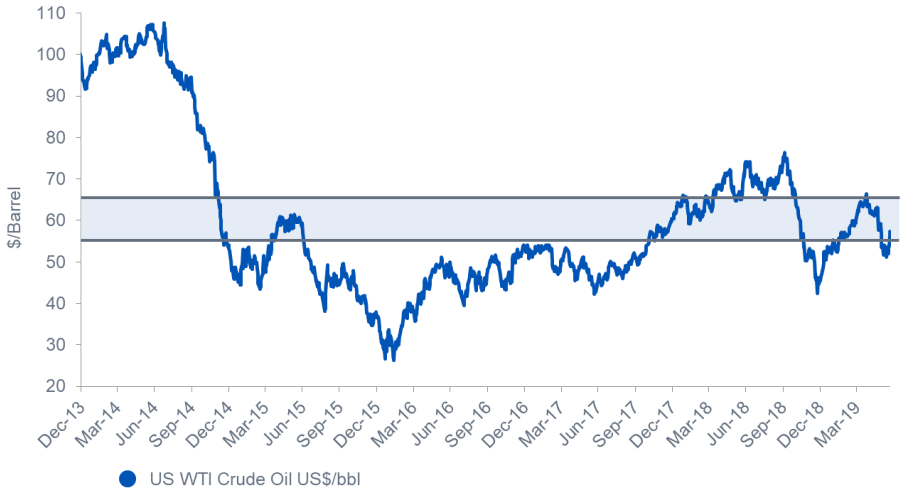
Debt levels – The debt outlook has improved. With bond yields doing an abrupt about-face since late 2018, the fears around rising borrowing costs have abated for now. What was looking like a severe headwind six to eight months ago is turning into a tailwind. Should borrowing costs rise, high household and corporate debt levels would remain areas of potential stress, but for now those risks remain at bay.

The banks – The Canadian banks are lagging the S&P/TSX Composite on a price-only basis in 2019, a rare bout of underperformance that has only happened in four of the past 18 full calendar years. Earnings growth for Canadian banks is slowing, likely to the mid-single-digit range. However, as an industry, cash operating earnings were $11.8 billion in the recent quarter, higher by 4% y/y with slower growth in Canadian banking but solid growth in U.S. and international segments. For the group, credit quality remains healthy, return on equity is solid at 15% and dividend growth continues to be a regular feature. All of this, coupled with attractive valuation levels, makes us constructive on the outlook for Canadian banks.

Energy sentiment – While little has changed on the ground for energy egress issues, sentiment has improved since late 2018. The scenarios that were once considered to be worst-case (i.e., no Trans Mountain Pipeline extension and burdensome regulatory reform) have not materialized. Trans Mountain is back on track (however opponents are not likely to abandon their efforts) and while bills C-69 and C-48 are set to become law, some energy industry recommendations were adopted. The Province of Alberta is considering a legal challenge of bill C-48 and there is always the possibility of revision or repeal depending on the outcome of the October Federal election. **The bottom-line is the most pessimistic views toward the energy patch are retreating.** Although oil prices reached our 2019 outlook level of US$65/barrel, they have not averaged at that pace. We see recent weakness as having more to do with the risk-off tone and global growth worries (that will abate) along with profit-taking after a 57% straight run-up from December 24 to the nearby peak on April 23. Our base-case scenario of holding pat and/or improving economic growth over the next six to twelve months implies reasonable demand growth for oil. **We also see supply being constrained by OPEC and partners to keep Brent crude prices in the US$60 to US$70/barrel range and WTI to range between US$55 and US$65/barrel (see exhibit 2.1).**

2.1 | WTI Oil US$55-$65

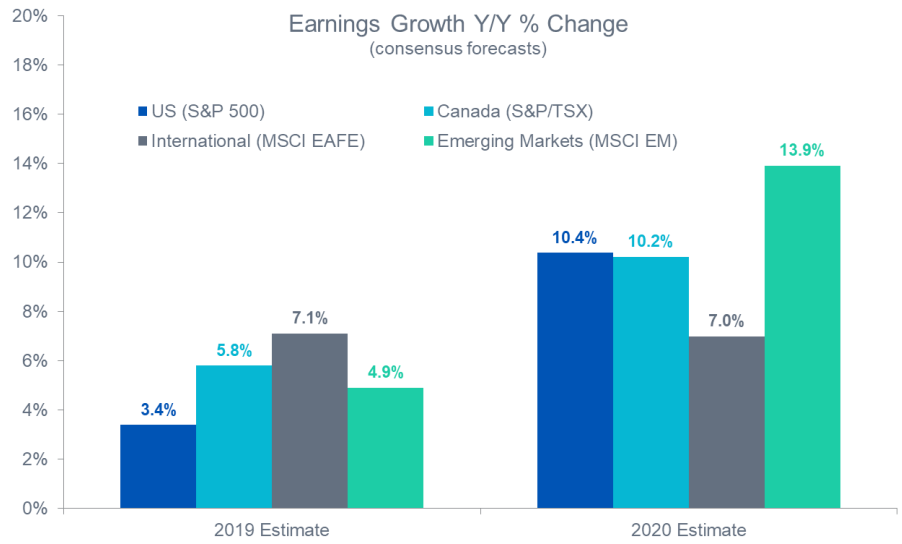
We forecast a H2 2019 average price for WTI of US$60/bbl



Source: Bloomberg, June 21, 2019.

Implications for the energy sector – The energy sub-index has recovered somewhat in 2019, but the index sits just 16% above the lows of early 2016 when oil prices were half of what they are today. Conversely, the sector sits 20% to 30% below levels of the past three years that corresponded with WTI oil prices between US$50 and US$70. **While many of the positives for the energy space remain uncertain, the good news is that share prices haven't yet fully bought into the 'green shoots' either; we see the opportunity for upside outweighing the downside.**

2.2 | Global Earnings Growth Expectations



Source: Bloomberg, JP Morgan, TD Securities; May 31, 2019.

Reasonable earnings and attractive valuations

Consensus earnings estimates for the S&P/TSX for 2019 look reasonable to us, but consistent with the rest of the world, they require a second-half acceleration (see exhibit 2.2). Earnings estimates were justifiably revised sharply lower to open 2019. We believe estimates then overshot on the downside to the point where consensus was expecting little to no growth for all of 2019. Earnings estimates have now crept back up to sit in the 5% to 6% range, in line with where our views were back in December and we continue to be comfortable with an earnings estimate in the $1,100 range for FY 2019 (see exhibit 2.3).

2.3 | S&P/TSX Composite Return Scenarios

Current trailing P/E multiple = 16X
Current dividend yield = 3.1%

2019 EPS Growth @ 6% = **$1,090**

Implied Trailing Multiple	S&P/TSX Composite	% change from June 21 level of 16,525
15X	16,347	-1%
base case → 16X	17,437	6%
16.5X	17,982	9%

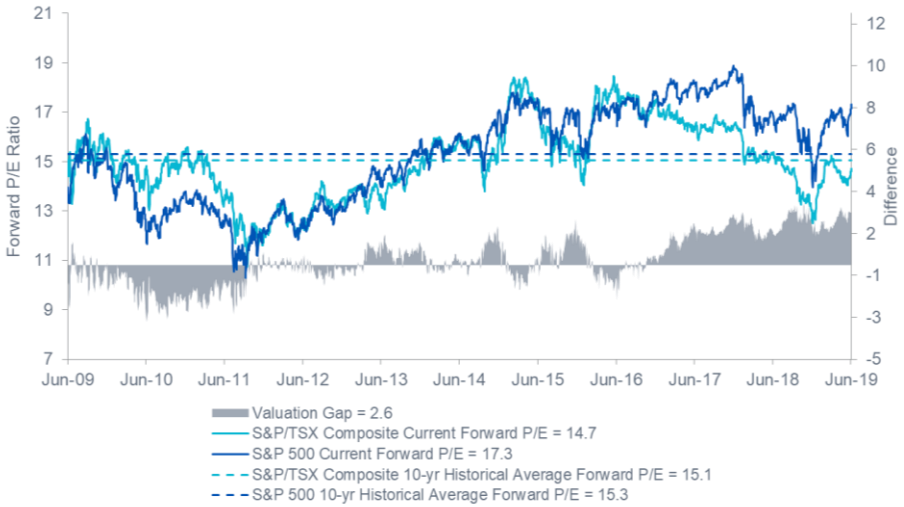
Source: Bloomberg, TD Securities; June 21, 2019, price only return.

On valuations, Canada continues to look attractive on both a relative basis to U.S. equities, and on an absolute basis (see exhibit 2.4). Our scenarios over the past couple of years have incorporated falling P/E multiples on the account of higher bond yields. Today, with the sharp reversal for bond yields, we see that as less of a risk. The current forward P/E multiple in Canada is slightly below the 10-year average – a level we see holding steady through the end of the year.

"On valuations, Canada continues to look attractive on both a relative basis to U.S. equities, and on an absolute basis."

– Brent Joyce

2.4 | North American Equity Valuations

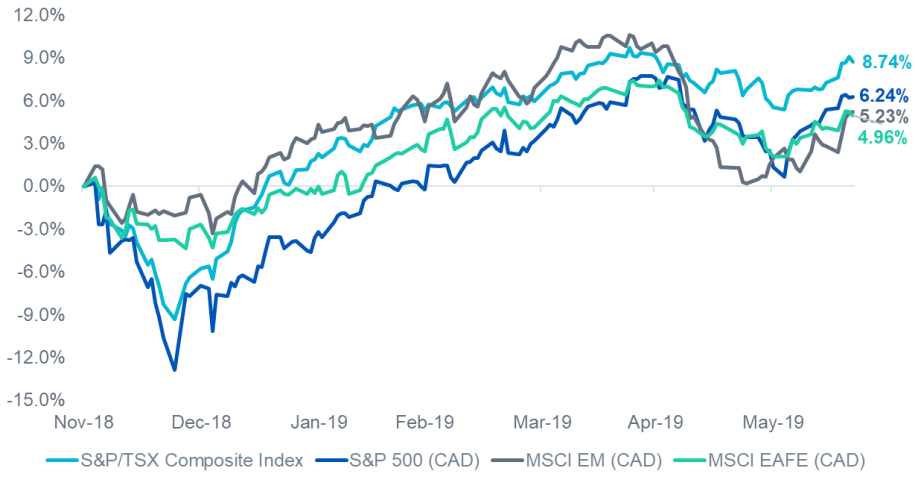


Source: Bloomberg, June 21, 2019.

Outside of P/E, other valuation metrics remain reasonable:

- Price-to-cash flow sits slightly below the 10-year average.
- Price-to-book is one-half standard deviation below the 10-year average.
- Cash flow and profitability remain favourable.
- EBIT interest coverage is sitting at the long-term historical average.[1]
- Return on equity has moved back above the 10-year average and sits at 10%.

2.5 | Canadian Equities Quietly Outperforming



Source: Bloomberg; price-only returns in Cdn dollars, from Nov. 30, 2018 to June 21, 2019.

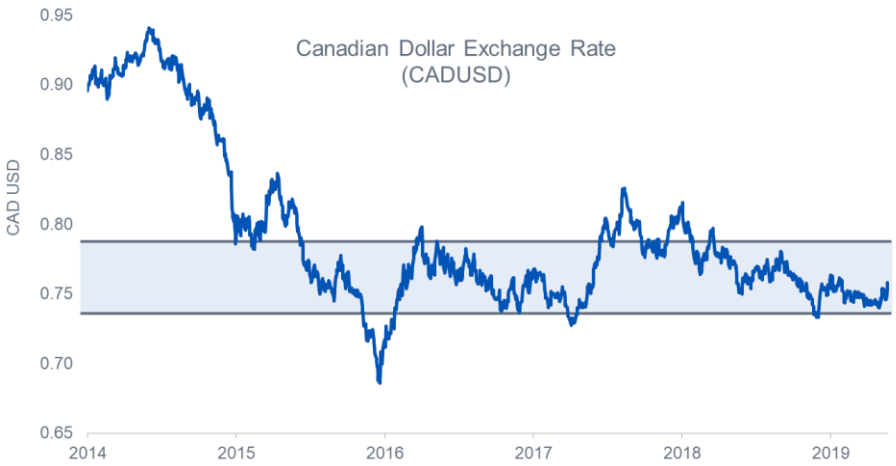
Canadian equities are outperforming

The S&P/TSX Composite Index (TSX) has quietly been outperforming the other major global markets (see exhibit 2.5). We have previously cited foreign fund flows into Canadian equity as a necessary catalyst for improvement, and in the first three months of 2019 those monthly flows have averaged more than twice the level ($5 billion) of the average monthly flows for 2018 (~$2.2 billion).

EV-to-EBITDA is signaling a more cautionary note as it is elevated at one standard deviation above the 10-year average.[2]

2.6 | Loonie Should Have Wings

Canadian dollar sees upward pressure from narrowing interest rate differentials and solid oil prices; range between US 74¢ - 78¢



Source: Bloomberg, June 21, 2019.

The loonie trade environment

A further reason for our overweight stance lies in the currency and trade backdrop. We expect tensions between the U.S. and China to simmer for several months. As long as these tensions exist, we believe Canada and other allies will remain out of the U.S. administration's gunsights on trade. Our view that the U.S. Federal Reserve is likely to cut interest rates, while the Bank of Canada stays on hold (see Fixed Income section for more), should result in upward movement for the Canadian dollar (see exhibit 2.6). This will be a slight negative for TSX earnings, but also makes U.S. dollar-denominated assets less attractive to a Canadian investor.

Bottom line: On a fundamental basis, Canadian equities continue to look attractive to us. 'Green shoots' for the Canadian economy, and improving sentiment toward Canada generally, lead us to upgrade our Canadian equity recommendation to a slight overweight. **Our base-case scenario for the S&P/TSX Composite is a 6% price return; when coupled with half of the annual 3.1% dividend yield, we expect a total return of 8% for the remainder of 2019.**

[1]EBIT = earnings before interest and taxes.
[2]EV= enterprise value; EBITDA = earnings before interest, taxes, depreciation and amortization.

"We believe Canadian equities currently offer the best risk/reward outlook of the global equity allocations."

– Brent Joyce

U.S. Equity

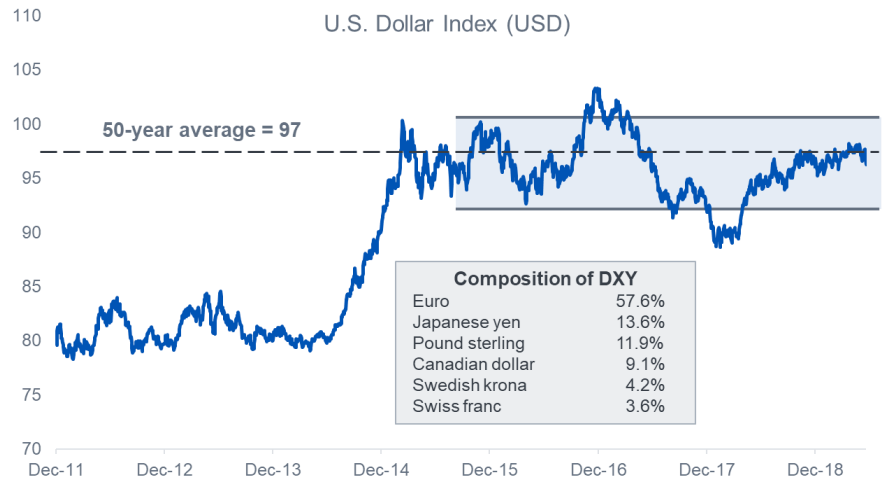
We have reduced optimism toward the outlook for U.S. equities, stepping back to a neutral positioning. The S&P 500 remains the most diversified equity market in our universe, and it contains some of the best secular growth opportunities around. However, it suffers from extreme popularity and, as such, it's the most expensive market on our list. Additionally, the S&P 500, with its earnings heavily exposed globally (often a benefit), sits at the epicenter of trade uncertainty.

We don't think the current S&P 500 valuations fully reflect the uncertainty the world faces today. Along with its popularity, U.S. equity valuations are also being propped up by the extraordinary decline in bond yields. If the U.S. Federal Reserve doesn't come through with interest rate cuts to the extent that the capital markets desire, this support for valuations is at risk. Additionally, the S&P 500 is home to other lurking issues that are also, unfortunately, political in nature. Health care, information technology and the revamped communications sector comprise 46% of the S&P 500. All these sectors face political headwinds heading into an election year. Populist politicians are typically keen to elicit electoral support and 'big business' has become an easy target given the large and growing share of the economic pie that corporations now command.

- **For the health care sector, politicians on all sides are taking aim at controlling drug costs, health care spending and efficiency in general.** The spectre of increased regulation looming over sentiment in this sector, along with any actual implementation, will most likely be a negative for shareholders.
- **For the information technology and communications sectors, two issues lurk: privacy and anti-trust.** Consumer protection through privacy issues and the promise of greater competition (leading to lower prices) are areas ripe for populist politicians to exploit. These two sectors are home to technologies at the forefront of the privacy debate. Privacy regulation may hinder the data and targeted advertising business models of these organizations. Their growing size and market dominance are leading to the perception that some of the larger players have become monopolies (Alphabet/Google, Amazon and Facebook in particular). This holds the prospect that governments in the U.S. or elsewhere launch campaigns to limit the size of these entities through anti-trust break-ups. There are only a few anti-trust cases to compare to over the past decades and the long-term impact to shareholders has been mixed. However, judicial proceedings of this nature have tended to be long, drawn-out affairs; during this period, the impact was largely negative and certainly came with an increase in volatility. Given growing public support for regulation, it may be a question of when, not if, the U.S. government and others clamp down on these companies.

We expect a simmering trade friction backdrop to persist whether it be between the U.S and China or others (for more see special section: Trading tweets for facts). **We perceive many of the trade-related risks to be U.S.-centric, meaning they have the potential to cut across U.S. equities more so than in other markets. It is U.S. multinationals that have benefitted the most from globalization, and it stands to reason they have the most to lose.** U.S. corporations will be paying the tariffs at the U.S. border, and it will be U.S. corporations that will have to try and pass those costs along to consumers. Trade frictions and economic growth disparity between the U.S. and the rest-of-the-world have strengthened the U.S dollar, an important input to S&P 500 earnings. We see the U.S. dollar's strength abating, and weakness here is a positive for S&P 500 earnings (see exhibit 3.1).

3.1 | U.S. Dollar Hitting a Peak?



Source: Bloomberg, June 21, 2019.

Earnings and valuations

We think current consensus earnings expectations for the S&P 500 are reasonable (see exhibit 2.2). Like in Canada, earnings estimates were justifiably revised sharply lower to open 2019. We believe estimate revisions then overshot on the downside to the point where consensus was expecting little to no growth. Earnings estimates have now crept back up to sit in the 3% to 4% range (see exhibit 3.2).

The current forward P/E for the S&P 500 is one-standard deviation above its 10-year average (see exhibit 2.4). While this is higher than other markets, it is not extreme, especially given the low level of bond yields. Return on equity is solid, in the 15% range. However, a one-turn reduction in the P/E multiple does translate into a 5 to 6% correction for the index. Other valuation metrics are more elevated with price-to-cash flow, price-to-book and EV-to-EBITDA all at one and a half standard deviations above their 10-year average.

3.2 | S&P 500 Return Scenarios

Current trailing P/E multiple = 17.7X
Current dividend yield = 1.9%

2019 EPS Growth @ 3% - 4% = **$167**

Implied Trailing Multiple	S&P 500	% change from June 21 level of 2,950
16X	2,679	- 9%
base case → 17.5X	2,930	- 1%
18X	3,014	2%

Source: Bloomberg, June 21, 2019, price only return.

Bottom line: U.S. equities remain relatively expensive compared to their global counterparts and outright expensive on most valuation measures outside of forward P/E. However, the decline in bond yields supports the P/E multiple. **Our base-case of a re-accelerating economy calls for the P/E multiple to hold steady, along with a range of 3% to 4% earnings growth. The current level (2950 on June 21) of the S&P 500 fully reflects this scenario.** Brace for continued volatility in the near-term. For Canadian investors, we see strength in the Canadian currency vis-à-vis the U.S. dollar tempering the overall results (see exhibit 2.6). **We recommend a neutral position in U.S. equities. Our base-case scenario for the S&P 500 is a 0% price return; when coupled with half of the annual 1.9% dividend yield, we expect a total return of 1% in U.S. dollars for the remainder of 2019.**

International Equity (EAFE)

We hold a neutral view on international equities [non-North American, developed market equities, commonly benchmarked against the MSCI Europe, Australasia and the Far East Index (MSCI EAFE Index)].[1] In aggregate, we don't expect EAFE equities to outperform Canadian and emerging market (EM) equites, but there's enough attraction to warrant a neutral view.

Cause to pause

Topping the list of negatives, Europe and Japan (making up a combined 87% of the index) are structurally challenged over the longer term. Japan has faced, and continues to face, decades of economic malaise and low inflation/deflation. Europe appears to be headed down a similar path. The largest constraint in both economies is poor demographics. **Europe's declining working-age population and its problematic dependency ratio (workers-to-retirees) are tracking a similar path to Japan's in the late 90s and early 00s. Immigration policies are one notable demographic difference: from very restrictive in Japan (a negative) to very open in Europe (a positive).**

Furthermore, the banking system in Europe is weak, and financials represent 23% of European equity markets. The negative interest-rate environment is especially painful for European lenders. Where once we had hope, we no longer see any relief from the weight of negative deposit rates in sight with the ECB recently extending its forward guidance (for the third time) to maintain negative deposit rates out to the middle of 2020.

Should the U.S. resolve its trade battle with China, there's a high likelihood the U.S. administration pivots toward Europe and Japan as their next trade foes (if Canada can avoid all of this, we stand to benefit on all fronts). We expect U.S. trade hostilities with China to continue to simmer and expect that this will restrain the U.S. from expanding its trade battles, but this does not preclude the Trump administration from turning its attention toward Europe and Japan and engaging in a multi-pronged trade war. The U.S. trade deficit with the European Union is at its largest level ever, averaging $155 billion/year over the last five years. By comparison, the deficit with China has averaged more than twice that at $373 billion/year for five years. **A tariff war between the U.S. and Europe and/or Japan would spell trouble for EAFE equities and the euro and yen currencies – all negatives for Canadian investors in EAFE assets.**

Of course, Europe doesn't need the U.S. to create headaches – its own political landscape provides ample. Italy is fighting with the EU over Italian government spending (and Italian elections are commonplace), Greek elections take place in July, the European Central Bank needs a new Chair by October and the current (but not set in stone) Brexit deadline is October.

Good value

On the positive side, EAFE equities are reasonably inexpensive, especially Japanese and European equities (see exhibit 4.1). Equity markets have accounted for some of the negatives the region faces. For instance, the Euro Stoxx Bank Index is trading at a 30-year low and shares of European automakers have been hard hit, trading at the lowest level relative to the EuroStoxx 600 Index in six years. It would not take much of a change in sentiment to spark a move higher. This change in sentiment is likely to be accompanied by a strengthening euro currency, a headwind for corporate earnings but offset somewhat as a positive for foreign investors – like Canadians.

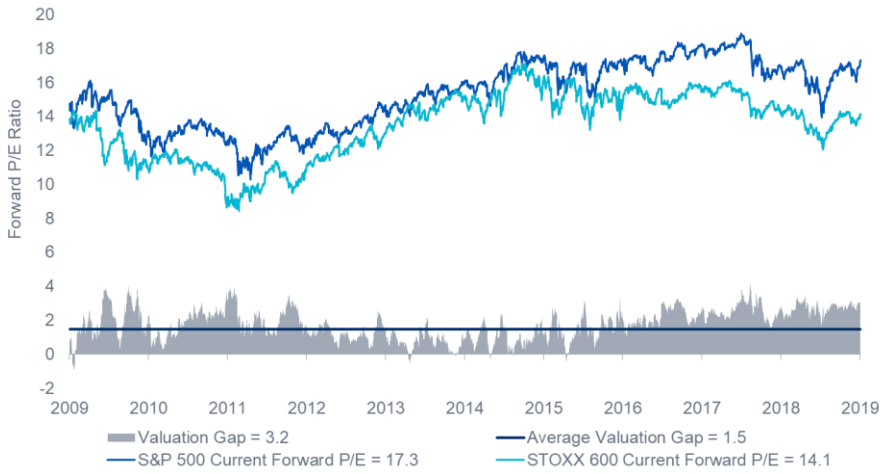
A re-acceleration in China should spark an upturn in Europe and Japan. They're heavily tied to China. Germany is one of the largest exporters in the world with exports making up 47% of German GDP and China is Germany's third largest export market. So, a significant part of the slowdown in Germany (and hence Europe more broadly) has been related to the slowdown the Chinese authorities deliberately orchestrated for China in 2017-18. Under a prolonged U.S. trade war with China, Europe stands to benefit from both Chinese import substitution away from the U.S., and U.S. import substitution away from China. **Herein lies an interesting dynamic: European and Japanese exporters benefit from U.S.-China trade frictions and would likely suffer under a thaw in them.**

EAFE equities are projected to have decent corporate earnings growth (see exhibit 2.2) and some of this growth is attributable to currently weak currencies (benefiting exporters). EAFE equities also sport a sizeable dividend yield advantage, with a dividend yield of 3.6%.

Bottom line: Given the mix of positives and negatives, and the uncertainties that face EAFE markets, we endorse a neutral weight to EAFE equities in our asset mix recommendation.

[1]The MSCI EAFE Index is an equity index that captures large and mid-cap representation across 21 developed market countries around the world, excluding the U.S. and Canada. Developed markets countries in the MSCI EAFE Index include: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the United Kingdom.

4.1 | Equity Valuations – U.S. versus Europe



Source: Bloomberg, June 21, 2019.

"A tariff war between the U.S. and Europe and/or Japan would spell trouble for EAFE equities and the euro and yen currencies – all negatives for Canadian investors in EAFE assets."

– Brent Joyce

Emerging Markets

We are upgrading our emerging market equities (EM) from underweight to low-neutral, proceeding with caution.

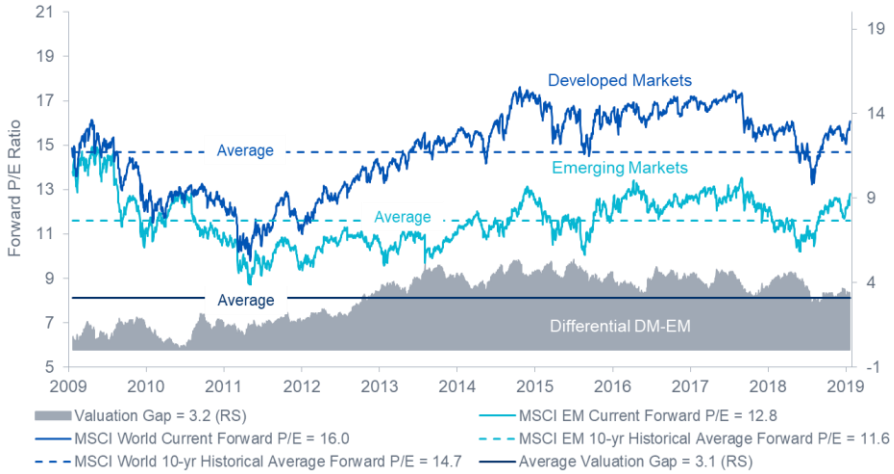
EM equities are most sensitive to the uncertainty stemming from trade and global growth concerns. As such, the risk/reward trade-off here is stark. Over the next six to twelve months, we see the most likely scenario as one of re-accelerating global growth and simmering trade tensions. We believe EM equities will outperform given they have exhibited the largest negative reaction to these same uncertainties. This small bet is in the context of our overall portfolio weights being moderately defensive with a nod to spending our risk budget wisely; being comfortable that the assets we look to for safety will deliver if needed and take risks where the upside is the greatest and risk is cheaper.

Financial conditions – Tightening global financial conditions and the value of the U.S. dollar are important metrics for emerging markets. Recent U.S. dollar strength has hurt emerging markets. However, with the end of tightening American monetary policy and the potential for U.S. rate cuts, further U.S. dollar strength requires a further global slowdown. We believe we're nearing the peak for the U.S. dollar (see exhibit 3.1) and expect it to level off or to weaken slightly – either will assist EM equities to rebound.

Earnings and valuations – Emerging markets offer respectable earnings growth estimates (see exhibit 2.2), the strongest 2020 estimates of our major markets, owing to the expectation that global reflation hits full stride by then. On a valuation basis, EM equities are cheap relative to their own history and to developed markets. The gap between forward P/E multiples for emerging and developed markets is sitting well above the historical average (see exhibit 5.1).

Emerging markets have faced a number of fundamental headwinds; while risks remain in each of these areas, our EM equity outlook has improved.

5.1 | Emerging Markets Valuations



Source: Bloomberg, June 21, 2019.

However, we reiterate that with our expectation for increased equity volatility, EM equities remain a riskier, high-beta asset class most appropriate for those with higher risk tolerance and longer time horizons.

Bottom line: Emerging markets come with an elevated risk profile. EM equites could suffer as much, or more, should trade frictions escalate, with slowing global growth (rather than it re-accelerating) and/or with U.S. and/or Chinese monetary/fiscal stimulus failing to arrive and work as planned. The risks and swing factors are many, but when we weigh these factors against the ability for EM equities to outperform developed market equities under a 'less bad than expected' or improving scenario, this leads us to **increase our weighting to low-neutral from our previous forecast of simply low.**

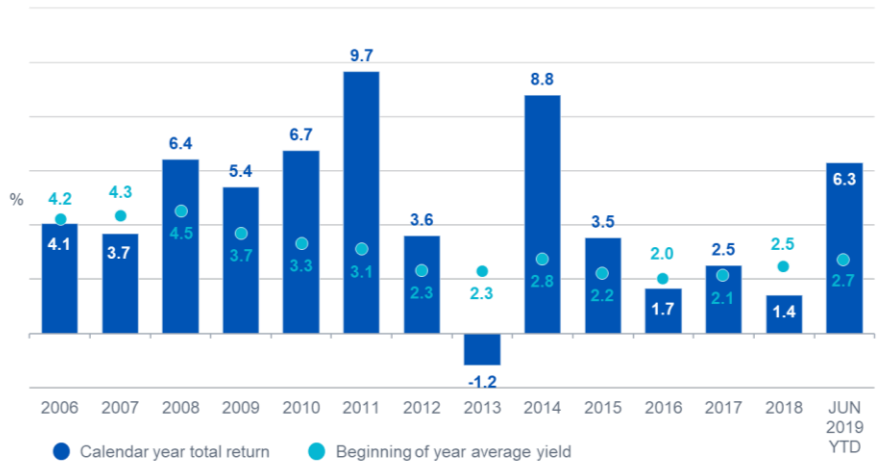
Fixed Income

The outlook for fixed-income returns remains very modest. Over the medium term, we don't think bonds offer much further upside, unless a slowdown or recession scenario unfolds. **Overall, we forecast a 0.5% total fixed-income return for the back half of 2019.**

We believe a lot of fear is already reflected in the substantial decline in bond yields witnessed thus far in 2019, the magnitude of which was surprising (see exhibit 6.1). It does reinforce the idea that **fixed income, regardless of the yield environment, continues to be a reliable risk-mitigation tool that provides substantial ballast to an overall portfolio.**

6.1 | FTSE Canada Universe Bond Index Returns

Proven valuable as a risk-mitigation tool



Source: Bloomberg, FTSE TMX Canada; June 21, 2019.

Should stocks correct, fixed income is able to provide further gains. However, we think returns are limited over the next six to twelve months as the worst-case trade scenarios are avoided and the economy shows resilience.

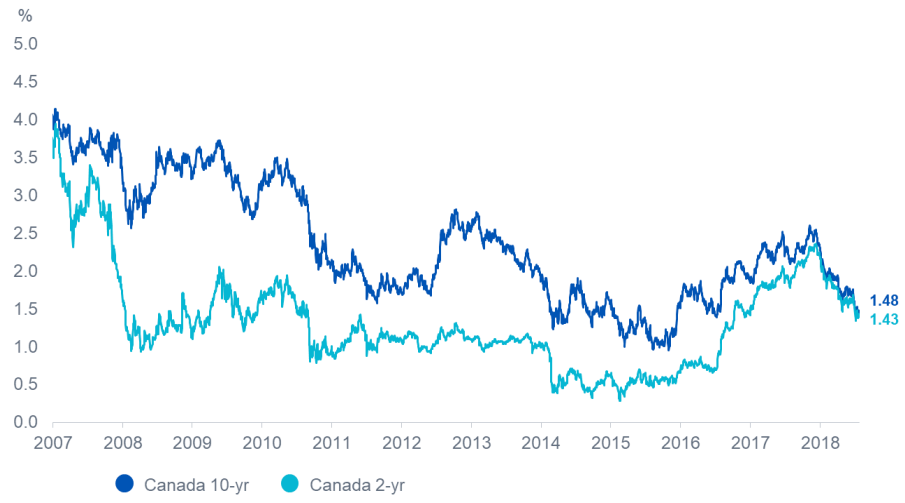
With central banks having pivoted 180 degrees from the fall of 2018, it's no longer necessary to incorporate a path of higher short-term yields into our forecast. The key question is whether central banks cut rates and, if so, by how much. U.S. bond yields carry significant sway over the Canadian yield environment, but the U.S. Fed Funds rate is currently 0.75% higher than the Bank of Canada (BoC) rate. We expect the U.S. Federal Reserve (Fed) to cut once or twice as an insurance policy against slowing growth. Three cuts, on the other hand, likely requires further evidence of trade tensions biting or the economy failing to exit its slowdown. We see the bond market as priced more toward a three-cut scenario; should the Fed cut less than three, the bond market will face disappointment and yields will need to rise. Notably, this scenario would also spell some disappointment for equities as well.

The situation in Canada is different. We're feeling collateral damage from the U.S.' trade war in the form of retaliatory actions from China (largely on agricultural exports), but the fallout from the trade woes are not as acute in Canada (notwithstanding remaining NAFTA uncertainty). The Canadian economy has recently shown better growth signs and a rate cut here would incent Canadian businesses and households to rack up further debts, something the Bank of Canada is reticent to see. **Combined with Canada's 0.75% buffer to the U.S. overnight rate, the BoC can take a more 'wait and see' approach and keep interest rates on hold for the remainder of 2019.**

We forecast an end of 2019 Canadian 10-year bond yield of 1.80% (versus a 1.49% yield on June 21) and our end of 2019 two-year yield forecast is 1.75% (versus 1.43% on June 21). This would bring two-year yields in line with the Bank of Canada rate, reflecting expectations that the BoC is on hold with no bias toward a hike or cut (see exhibit 6.2).

6.2 | Government of Canada 10- & 2-Year Bond Yield

Year-end targets: 10-year = 1.80%, 2-year = 1.75%



Source: Bloomberg, June 21, 2019.

Sensitivity to higher interest rates, owing to elevated debt levels across the board (i.e., household, corporate and public-sector debt), necessitates a lower overall yield environment in Canada. Canadian economic growth is expected to moderate from current levels. **Inflation pressures stemming from an overheating economy may be present in the U.S. but we do not see these being as acute an issue for Canada.** Canada's slowing housing market, productivity and competitiveness challenges and impediments to resource extraction that weigh on business investment are further reasons to believe interest rates and bond yields won't head much higher in Canada.

Bottom line: We see fixed income's risk-mitigating qualities as being their main attraction. Canadian bond yields still offer enough income that they can deliver a small positive return given the small yield increases we forecast. The majority of our fixed-income return scenarios continue to deliver a positive total return outcome into year's end. If yields move up by more than we expect (e.g., more than a 50-basis point parallel shift in the yield curve), the second-half of 2019 could deliver slightly negative returns. A risk-off environment (a parallel shift down by 50 basis points) in turn could deliver returns in the 3 to 4% range. **Our base-case scenario calls for a second half of 2019 total bond market return of 0.5%.**

Sector insights

a) Government bonds

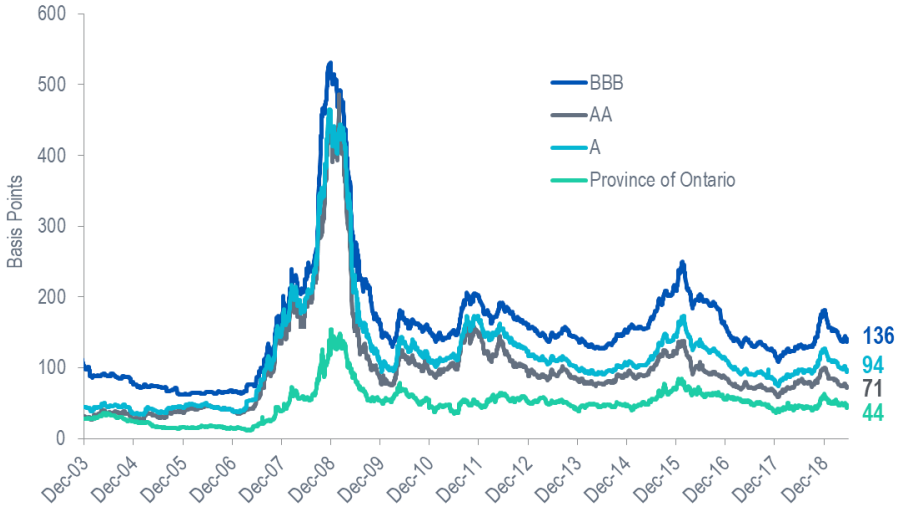
Government bonds are attractive for their superior risk-mitigation qualities. Sovereign bond yields have fallen precipitously, pricing in an overly fearful environment. They're likely to face headwinds through the remainder of the year. Their attraction lies in the ability to deliver the highest level of upside in the event of a risk-off scenario. **We have reduced our government bond recommendation to neutral.**

b) Investment-grade corporate bonds

We continue to see investment-grade corporate bonds as most attractive given their mix of yield pick-up and modest safety. Investment-grade corporate bond spreads remain narrow (see exhibit 6.3). We see little on offer in terms of further appreciation on this basis. Falling sovereign bond yields are pushing investors into corporate bonds (both investment grade and high yield) in search of better yield opportunities. This leaves the sector vulnerable to a near-term sell-off as the move has been sharp. Notwithstanding this possibility, over our forecast horizon of 6 to 12 months, we don't see spreads widening sufficiently, or for long enough, to negate the attraction of the higher running yield available from investment-grade corporate bonds, while maintaining a modicum of safety that we desire from our fixed-income positions generally. We have a bias toward shorter duration corporate bonds given the tight spread environment and our expectation for modestly higher yields. We continue to favour the higher credit-quality spectrum at the expense of the lowest BBB tranche. **We have returned investment-grade corporate bonds to the highest overweight available.**

6.3 | Investment Grade Corporate Bonds

Most attractive given their mix of yield and modest safety



Source: BMO Capital Markets, June 21, 2019.

6.4 | Canadian High Yield Bond Spreads

Very narrow spread levels and lack of risk-mitigation characteristics makes high yield unattractive

Source: Bloomberg, June 21, 2019.

c) **High-yield bonds**

Given the narrow-spread levels in high-yield bonds in aggregate (see exhibit 6.4), and their lack of risk-mitigation characteristics as an asset class (see exhibit 6.5), we see the risk/reward tradeoff in high yield as unattractive. High-yield bonds should not be relied upon for risk-mitigation as they generally experience negative returns in 'risk-off' environments. Their attraction lies in the higher yield and greater potential for capital appreciation as spreads decline. **At the asset class level, neither of these metrics (yield offered nor capital-appreciation potential) appear very attractive to us at present.** High-yield bond issuers are not a homogeneous group and our active fixed-income managers continue to uncover selected unique opportunities through individual security selection where the risk/return tradeoffs are appealing.

"Fixed income, regardless of the yield environment, continues to be a reliable risk-mitigation tool that provides substantial ballast to an overall portfolio."

– Brent Joyce

6.5 | What's Inside Your Bond Fund?

High ***quality*** bonds, not high ***yield*** bonds, should form the core component of a fixed income portfolio

Worst Decline Periods For Canadian equity	S&P/TSX Composite Index TR	FTSE TMX Canada Universe Bond Index TR	FTSE TMX Canada Corporate Bond Index TR	FTSE TMX Canada High Yield Bond Index TR
Sep 1, 2000 – Dec 21, 2000	-24.2%	3.1%	2.5%	1.9%
Jan 30, 2001 – Apr 4, 2001	-20.4%	1.3%	1.5%	2.0%
May 22, 2001 – Sep 21, 2001	-22.0%	5.0%	4.7%	4.2%
Mar 7, 2002 – Jul 23, 2002	-22.1%	4.5%	3.4%	3.9%
Jun 18, 2008 – Mar 9, 2009	-48.5%	4.7%	0.3%	-16.3%
Apr 5, 2011 – Oct 4, 2011	-20.6%	8.3%	6.5%	-7.8%
Apr 15, 2015 – Jan 20, 2016	-21.5%	0.1%	-0.3%	-6.6%

Source: Bloomberg, PC Bond.

"We recommend investors take action to get back to neutral equity/fixed-income positions that address today's risks, while adjusting weightings to capture relative opportunities to enhance returns."

– Brent Joyce

GLC Outlook Summary

	Change in view[1]	Under	Neutral	Over
Fixed income	=	○○○	○●○	○○○

Bond yields have declined to such an extent that incremental returns moving forward will be modest. Fixed income remains attractive as a risk-mitigation tool. We recommend a neutral weight to fixed income. Our base-case scenario calls for small enough increases in bond yields that we forecast a further total bond market return of 0.5% for the remainder of 2019.

Government bonds	▼	○○○	○●/	○○○

Government bonds are attractive for their superior risk-mitigation qualities. However, sovereign bond yields have seen a precipitous decline in 2019. Barring a recession (not our base-case scenario), we don't see room for yields to move materially lower from current levels and therefore see minimal return potential.

Investment-grade corporate bonds	▲	○○○	○○○	○/●

We see investment-grade corporate bonds as most attractive given their mix of yield pickup and modest safety. We expect them to outperform government bonds. On an absolute basis, investment-grade corporate bond spreads remain narrow, moderating any significant price appreciation from here. We anticipate periods of volatility in spreads, but don't expect the length or the severity of these to be significant enough to negate the benefits of the higher running yield.

High-yield corporate bonds	=	●○○	○○○	○○○

High-yield spreads remain low and narrow. When coupled with a lack of risk-mitigation characteristics, we see the risk/reward trade-off in high-yield bonds as unattractive.

Equity	=	○○○	○●○	○○○

We believe the global economy has enough momentum to exit the current global slowdown within the next six to 12 months. Trade frictions have weakened the outlook, but globally synchronized stimulative central bank policies support risk assets to keep our equity outlook constructive. On a risk-adjusted basis, a neutral stance is most appropriate.

Canada	=	○○○	○○●	○○○

Canada is a favoured market due to its leverage to global growth and attractive valuations. Sentiment is improving. Steady or improving global economic growth, coupled with a reasonable Canadian economic backdrop, supports mid-single digit earnings growth. Add in the solid dividend yield and we consider Canadian equities to offer the best risk/reward outlook.

U.S.	▼	○○○	○●/	○○○

U.S. equities are home to some of the best secular growth opportunities. However, given current earnings expectations, we see the S&P 500 as fully valued at the 3,000 level, leading us to pull back our positioning to neutral. U.S. equities sit at the epicenter of trade and policy uncertainty, so brace for volatility in the near term.

International	=	○○○	○●○	○○○

We hold a neutral view toward EAFE equities. The group offers reasonable valuations and decent earnings growth potential, along with a high dividend yield. However, Europe and Japan have longer-term structural issues, and heavily export-oriented EAFE corporations may face near-term trade challenges.

Emerging markets (EM)	▲	○○/	●○○	○○○

EM equities are most sensitive to trade and policy uncertainty, making their risk/reward trade-off stark. With steady or improving global economic growth, we expect EM equities to outperform. EM equities remain a riskier, high-beta asset class most appropriate for those with higher risk tolerance and longer time horizons.

● As at June 2019. / [1]From December 2018.

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