Global Asset Management

For more on our current view and outlook, consult **The Global Investment Outlook**.

Asset class commentary – Summer 2017

With modest growth in the economy and decent inflation, the outlook for sovereign fixed-income investments is unexciting. At current yields, prospective returns for bonds are extremely low or even negative. While prospective long-term returns are much better for equities than for bonds, key signals have prompted us to modify our degree of enthusiasm for stocks. Having harvested the stock market's outsized gains that resulted from the recent economic acceleration, we have begun to scale back our risk-taking by reducing our allocation to equities. This is further motivated by the ongoing maturation of the business cycle, equity valuations becoming less compelling and from concern that complacency is beginning to seep into markets. Nevertheless, the tweak leaves our equity overweight intact.

Fixed income

Global bond yields have drifted lower in the last quarter as enthusiasm about President Trump's pro-growth policies has receded. The resulting drop in nominal bond yields has reintroduced the valuation risk that had mostly evaporated during the initial run-up after Trump was elected. Although the trend so far this year has been towards lower bond yields, our models continue to suggest that the long-term direction of yields is higher. That said, a number of structural headwinds – aging populations, a limited capacity to take on debt, wealth inequality, globalization and a preference for safe assets – may limit the pace of the increase in bond yields. Our forecast for the U.S. 10-year yield is 2.50% a year out, and any deviation from our base case would likely be to the upside.

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Regional outlook for equities

Canada

Between January 1 and May 31 of 2017, the S&P/TSX delivered a 1.5% total return, lagging the S&P 500 by 720 basis points and the MSCI World by 900 basis points. Over the three-month period ended May 31, the index declined by 1.5%. This underperformance was primarily a result of the weakness in the Financials and Energy sectors, which together represent just over 50% of Canada's benchmark stock index. The Canadian dollar has been largely unchanged versus the U.S. dollar at $0.74 since the beginning of the year, mainly due to a better-than-expected Canadian economy. The Bank of Canada recently left the overnight rate unchanged, but also added a hawkish undertone with its belief that the economy will return to full potential sometime in the first half of 2018.

Our forecast for GDP growth in 2017 has increased to 2.0%. The Canadian economy has had a strong start to 2017, but the pace of growth may be difficult to maintain. We expect that Canada's path to higher interest rates will be longer and slower than in the U.S., with the Canadian economy's reliance on housing, consumer spending and energy projects remaining key points of discussion. We are also monitoring for the potential impact of any U.S. protectionist measures on Canadian trade. Negotiations for a reworked North American Free Trade Agreement could begin this summer.

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For the S&P/TSX, 2017 earnings estimates are now about $918, and for 2018 at about $1,044. These forecasts are a considerable uptick over 2016 and reflect returns on equity consistent with longer-term averages. The earnings generated in the Energy sector account for almost half of the 2017 profit-growth projection for the S&P/TSX and almost a third of the 2018 forecast increase. The recovery in oil prices from the severe collapse last year drives the earnings gains and assumes the price of oil makes its way from about US$45 now toward US$60 per barrel. Outside the commodity sectors, expectations for the remainder of the earnings pool are strong. Valuations for the S&P/ TSX are moderately lower than the S&P 500, a discount that seems justified given the energy-price forecast and the impact of financial earnings on the overall profit pool.

United States

The U.S. stock market made progress over the three-month period ended May 31, rising 2.6% in local currency terms as the economic expansion continued. Since Trump's election in November 2016, the S&P 500 has gained 13%. While the move higher was driven by anticipation of pro-growth policies, strong fundamentals have helped offset concern that President Trump and Congressional Republicans will struggle to pass those policies in the near term. Surveys of U.S. economic activity have stabilized near a six-year high and new-order and inventory components indicate that production should continue improving for at least several months.

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The pace of U.S. job growth is slowing, as is typical late in the business cycle, but the economy has still created an average of 240,000 new jobs per month this year. The unemployment rate rests at 4.3%, a 16-year low, and there is some upward pressure on wage growth.

Wage growth is currently about 2.5%-3.0% but could top 4% if economic activity continues to improve, perhaps leading to inflation becoming a problem. For now, our estimation is that the U.S. consumer remains in good health, as balance sheets are strong, debt levels are down and home equity is up substantially since the financial crisis.

Corporate fundamentals are also supporting the market. After three years of essentially flat earnings, we expect the companies in the S&P 500 to report 10% earnings growth in aggregate this year.

In the current quarter, profits could get a boost from an increase in corporate spending on technology and equipment, which have a disproportionate impact on the S&P 500 earnings pool given the size of the likely beneficiaries (Information Technology and Industrials sectors) and their leverage to rising revenues. In addition, slightly higher interest rates and a steeper yield curve would help the Financials sector.

Looking forward, our base case is the U.S. economy will continue to expand slowly and interest rates will rise gradually over the next year. Currently, the S&P 500 trades at roughly 17.7 times consensus earnings estimates for the next 12 months. While this is relatively expensive, we note that market valuations often rise in periods when economic growth is modest and sectors like Information Technology and Consumer Discretionary lead the way.

Europe

We continue to witness synchronized global growth, with the Chinese economy exhibiting unexpected resilience and the U.S. continuing to remain firm. This development creates a benign backdrop for continued economic recovery in much of Europe and is beginning to feed through to an uptick in corporate earnings for the first time in four years.

Equally important to understand is that Europe is at a much earlier stage of its economic recovery than the U.S. and therefore could have longer to go before it is likely to see another downturn. Political risk has been somewhat offset by last month's election of Emmanuel Macron as France's president. Macron is highly Eurocentric and, in many respects, represents the status quo. In this environment, the medium-term backdrop remains fairly constructive, even if we may be nearing some seasonal weakness.

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Asia

Asian stock indexes continued to perform strongly in the latest three-month period, outperforming other major global markets. Asian equities have benefited from a positive economic and political backdrop with Indonesia receiving a credit-ratings upgrade from Standard & Poor's, South Korea electing

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a new president and China easing monetary conditions. Japanese equities exhibited more volatility than many other markets over the past three months, reflecting fluctuations in the yen.

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Macroeconomic conditions are softening somewhat, and so we are becoming slightly more cautious about the outlook for equity markets. Economic statistics may disappoint amid weakening commodity prices and regional geopolitical risks led by North Korea's periodic missile tests. Economic data in Japan has been reasonably encouraging, offsetting some of the negative impact of the yen due to the safe-haven appreciation. We have raised our 2017 GDP forecasts for Japan from 0.75% to 1.25%, given an improvement in private consumption and an increase in capital expenditures.

Emerging markets

The gain in emerging-market stocks so far this year has been 16% – six percentage points more than in developed markets. Returns were driven primarily by macroeconomic and fundamental improvements that included a fragile but sustained global economic recovery, higher earnings and strong inflows.

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With economic momentum continuing into 2017, emerging-market purchasing managers' indexes rose for the sixth consecutive month, reaching their highest level in four years. Several models suggest that emerging-market credit spreads are also a significant driver of emerging markets' relative equity outperformance. As the creditworthiness of a sovereign improves (Brazil in 2016, for example, or Asia in the early 2000s), it typically leads to higher valuations for equities, a decline in the weighted average cost of capital and currency appreciation. While emerging-market credit spreads have already contracted by 50 basis points in aggregate so far this year, building on a 100-basis-point narrowing in 2016, they still don't appear stretched: yields on countries in the JPMorgan Emerging Market Bond Index are still more than double what they were relative to developed markets before the financial crisis.

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