2016 Capital Market Outlook
Executive Summary

Ron Hanson
CHIEF INVESTMENT OFFICER

A cautious tone, but not without opportunity

In thinking about what capital markets may have in store for investors in 2016, we note a number of critical tipping points within the current marketplace, each likely to shift sentiment, change outlooks and reveal opportunities for investors in 2016. Here's where we stand today:

Oil

The plunge in prices that followed the OPEC decision to maintain its production quota has certainly shaken the market. On a fundamental basis in the near term, OPEC's decision to maintain production quotas, the admission of Indonesia back into the cartel, and the rising production levels in Iran and Libya mean that high-cost non-OPEC production needs to adjust to the new low price environment to balance supply and demand.

Bottom Line **Our base case (assuming the International Energy Agency's forecast for supply and demand, a stable USD and no geopolitical shock) is for oil to lag the 2015 $49/year average but finish the year in the $55 to $60 range.**

Monetary policy

We consider the magnitude and unprecedented nature of quantitative easing, the lengthy period of time rates have been effectively zero, and the impact accommodative monetary policy had on risk asset prices, and we simply have no historical precedent for the type of monetary policy we have seen in place globally since the Great Financial Crisis.

Bottom Line **We see the possibility of a policy accident in the sense that risk assets could see significant downside volatility as investors adjust to the reality of rising interest rates, however we just do not know all the linkages these policies have, nor the extent to the potential for downside risk. In general, we think this is the biggest uncertainty as we move into 2016.**

Canadian equities

The key question: What are the conditions that will, at minimum, stabilize the energy and material sectors? In 2015 the earnings story in Canada was derailed by the collapse in energy prices. While today's data does not point to a sustainable catalyst to drive the commodity complex higher, we may be close to finding a bottom.

Bottom Line **As it stands today, without some stabilization in the commodities market, Canadian equities are unlikely to make much headway in 2016. It may in fact take further damage on the downside to balance the market out. Having said that, our scenario testing across reasonable expectations for earnings per share values and in various interest rate increases imply a base case of 6 to 8% return for 2016. We stay alert to the possibility that conditions could change quickly, particularly if the USD depreciates and/or the commodity market catches a bid. The duration of the underperformance of Canadian equities reflects how one-sided the trade has become, and a reversal of fortunes for the USD or commodities is a possibility.**

US equities

The key question: Will US equities respond to a shift in monetary policy? While energy prices weighed on index-level earnings in the U.S. as well, US equities fared better than Canadian equities, helped by a US consumer on solid footing and secular strength in the information technology and health care sectors. Notwithstanding historical evidence for strong returns post flat years on the S&P500, it is difficult to build a fundamental case for double digit returns in 2016.

Bottom Line **Although we are somewhat cautious as we move into 2016, we believe US equities will be supported by an improving economic backdrop. Having said that, we remain watchful of how capital markets react as the Fed increases interest rates. Given the difficulty in seeing a scenario where multiples push much higher than current levels, we see another low-to-mid single digit total return outlook for US equities.**

European equities

The key question: Can ECB policies be enough to drive sustainable economic growth? Earnings growth and positive sentiment towards equities in the region has been largely driven by easing monetary policy and a lower currency. The consensus forecast has earnings growth in 2016 close to 10%, which is likely on the high side in our view.

Bottom Line **Like the US, and in local currency terms, modest low-to-mid single digit returns are a reasonable expectation, and at this time European equities offer a similar risk and return profile to US equities.**

Emerging markets equities

The key question: What will mark a turning point for emerging market equities? For emerging markets 2015 was another difficult year. The constant debate about the direction of Chinese growth and the surprise devaluation of the Yuan played havoc on sentiment toward emerging markets in general. We remain cautious on emerging markets to start the year as Chinese growth moderates, low commodity prices weigh on commodity producers, and high debt levels add a layer of risk. In the event that US dollar strength moderates, we could see the risk to emerging markets emanating from high levels of US dollar denominated debt and current account deficits partially mitigated.

Bottom Line **Our stance on emerging markets remains unfavourable in the face of the challenges outlined above. Factors that would change that view include stabilization in China, commodity prices, and emerging market currencies strengthening vis-a-vis the USD.**

Fixed income markets

***The key question: Will rates finally rise across the curve in both Canada and the US*?** In 2015 Canadian interest rates fell modestly along the yield curve, and as a result long term bonds performed well. Corporate bonds lagged slightly as credit spreads widened (particularly at the low quality end of the scale). There is virtually zero probability the Bank of Canada (BofC) will raise rates in 2016, but still some risk if oil prices do not stabilize that the BofC could lower rates. However, on balance and with the influence from rising rates in the US, we anticipate upward pressure on yields in Canada.

Bottom Line **With historically low running yields and some upward pressure on rates, we remain of the view that investors should have (at best) low single digit returns in the bond market. Exposure to corporate credit should be limited to high-quality investment grade securities. We continue to see room for further weakness in the high yield market.**

How to position for 2016?

At a high level, our base case is to maintain a tilt in favour of equities. We would remain underweight bonds given our return outlook and the relative attractiveness of equities.

We know that the unprecedented nature of monetary stimulus post the Great Financial Crisis was a contributing factor in the inflation of asset prices. Therefore, it seems unreasonable to assume that the Fed can navigate a thoroughly smooth landing as it begins to tighten monetary policy. We expect volatility.

Although underlying economic trends, along with monetary and fiscal policy differences, argue for continued USD appreciation, in 2016 we do not anticipate the USD to appreciate as much as it did in 2015.

We believe it makes sense to take some profits on US and European equity positions, and hold modest levels of cash. We would do this with an eye to deploying the proceeds into Canadian equities (even possibly emerging markets) if and/or when we see some stabilization in commodity prices (particularly oil) and moderating strength in the US dollar. We maintain our view that within the Canadian equity landscape, Canadian banks continue to offer an attractive risk/reward.

Our recommendation for a modest cash allocation should also help to mitigate volatility against the possibility of a downward adjustment in risk assets as the Fed starts down its path to rate normalization.

OUTLOOK

Asset Class	Under-weight	Neutral weight	Over-weight	Change in view (from 2015)	
Fixed Income	○○●	○○○	○○○	▲	With historically low running yields and some upward pressure on rates, we remain of the view that investors should have (at best) low single digit returns in the bond market.
Investment Grade Corporate Bonds	○○○	○○◑	◐○○	▼	Exposure to corporate credit should be limited to high-quality investment grade securities.
High Yield Corporate Bonds	○●○	○○○	○○○	▼	We continue to see room for further weakness in the high yield market.
Equity	○○○	○○◑	◐○○	▼	We maintain a tilt in favour of equities given our return outlook and the relative attractiveness of equities over bonds.
Canadian Equity	○○○	○○●	○○○	▲	Without some stabilization in the commodities market, Canadian equities are unlikely to make much headway in 2016. We stay alert to the possibility that conditions could change quickly, particularly if the USD depreciates and/or the commodity market catches a bid.
U.S. Equity	○○○	○○◑	◐○○	▼	We believe US equities will be supported by an improving economic backdrop. Given the difficulty in seeing a scenario where multiples push much higher than current levels, we see another low-to-mid single digit total return outlook for US equities.
European Equities	○○○	○○◑	◐○○	▼	In local currency terms, modest low-to-mid single digit returns are a reasonable expectation, and at this time European equities offer a similar risk and return profile to US equities.
Emerging Market	○●○	○○○	○○○	=	Our stance on emerging markets remains unfavourable. Factors that would change that view include stabilization in China, commodity prices, and emerging market currencies strengthening vis-a-vis the USD.