Time to adjust the sails

glc asset management

2018 Mid-Year
Capital Market Outlook

Brent Joyce CFA
Chief Investment Strategist

Andrew O'Brien CFA
Manager, Investment Strategy

All data as of June 15, 2018 unless otherwise stated.

Publish date: June 26, 2018

The World At Large

The pessimist complains about the wind; the optimist expects it to change; the realist adjusts the sails.

William Arthur Ward, American writer (1921-1994)

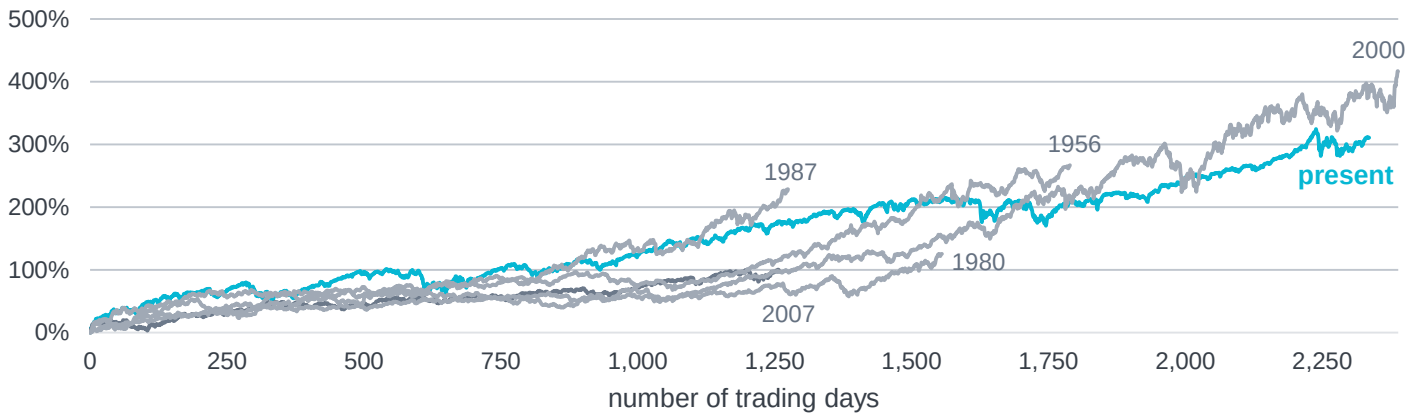
Time to adjust the sails.

The world economy and financial markets continue to progress through the later stage of the business cycle.

This is not the time to overreach with aggressive, growth cycle positioning in an attempt to squeeze out every last drop of the 'risk-on' trade, which can put years of rationed, prudent financial planning at risk (see exhibit 1.1). We caution against extrapolating the trends of the past several years in the 'darling' sectors – things like emerging markets, information technology, or high yield bonds.

1.1 | Second longest US equity bull market on record

Longest S&P 500 bull markets since WWII



Source: Bloomberg | 15-Jun-18

The late stage of the business cycle is often characterized by heightened volatility, the potential for sharp, short run-ups in equity prices, fast-moving price corrections, and rising bond yields. Any attempt to time each market gyration is a fool's game.

Although we see continued growth in corporate earnings, we expect the pace of earnings growth to slow. As such, **within equities, we recommend broad and diversified geographic and sector allocations – favouring Canadian and US equities over UK and emerging markets, and neutral exposure to Europe and Japan.**

Within fixed income we expect yields to move higher and continue to pressure overall bond returns. We anticipate the moves should take some time to unfold (4 to 6 quarters in our view), and will continue with the 'fits and starts' type of volatility we have seen thus far in 2018. As with equities, we see opportunities for investors to be selective in how they diversify their fixed income holdings. Given the mix of safety and yield enhancement, we recommend an overweight position in investment grade corporate bonds and alternative fixed income exposure (e.g. mortgages). High yield bonds as a whole do not look attractive to us and we suggest an underweight position. We view the current narrow level of high yield bond spreads (with very limited room for further tightening) and their lack of risk-mitigation characteristics as justification to avoid, or limit high yield bond exposure.

Bottom line **A neutral stance (risk tolerance aligned) is most appropriate for today's investors. A neutral stance provides exposure to participate in equity market growth without stretching one's risk tolerance. Our capital market outlook for the second half of 2018 calls for single digit equity price gains. For fixed income investors, we see flat to 1% total returns in the back half of the year.**

The pace of change

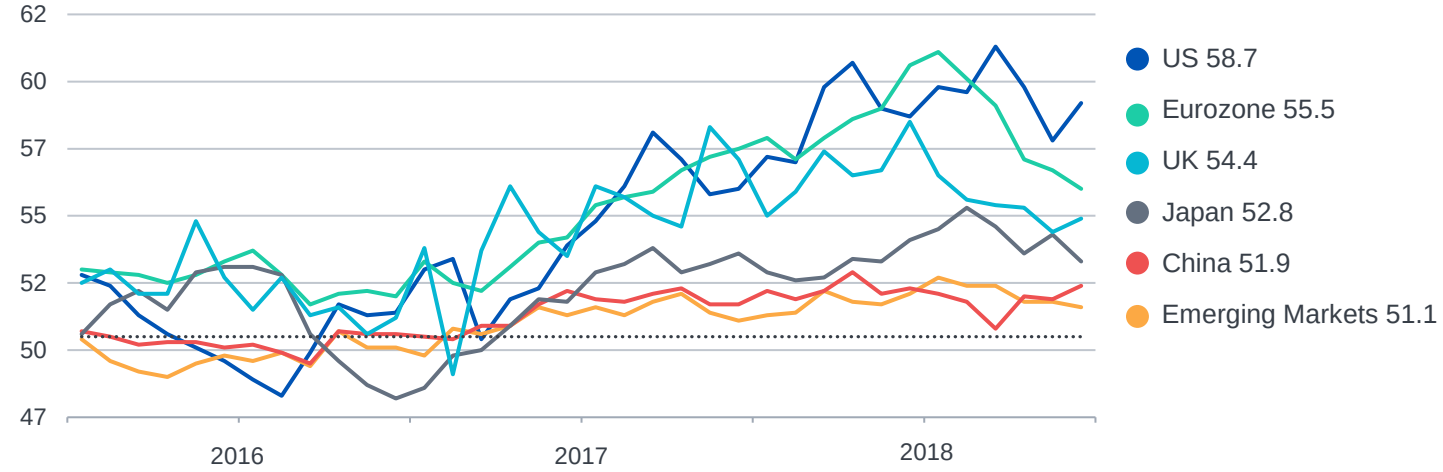
At the crux of our near-term capital market performance outlook lies the difference between good absolute levels for many fundamentals, and their go-forward rates of change. **Capital markets care about the absolute level of various fundamental economic and market metrics, but only insofar as they impact the outlook for future levels and the rate of change.**

The devil is in the details. Current absolute levels of key fundamental metrics remain supportive of corporate earnings and hence equity markets. We believe they also justify further central bank monetary policy tightening and with that, higher bond yields. However, unlike at the start of 2018, the rate of change for all of these variables is no longer globally synchronized, or accelerating (see exhibit 1.2).

The pace of inflation will follow disparate paths depending on geography (see exhibit 1.3). Broadly, the world remains in a situation of economic growth, with declining unemployment and closed and/or narrowing output gaps. Globally, we also see a bias toward monetary policy tightening. However, inflation expectations need to be put in the context of idiosyncratic country and regional backdrops that will result in divergent paths for monetary policy. In our view, the US will lead the pack with higher inflation and central bank tightening. Canada will follow, but at lower and more tempered levels. Europe will tread slowly and lightly with their monetary policy, while Japanese inflation and central bank tightening will remain the most benign.

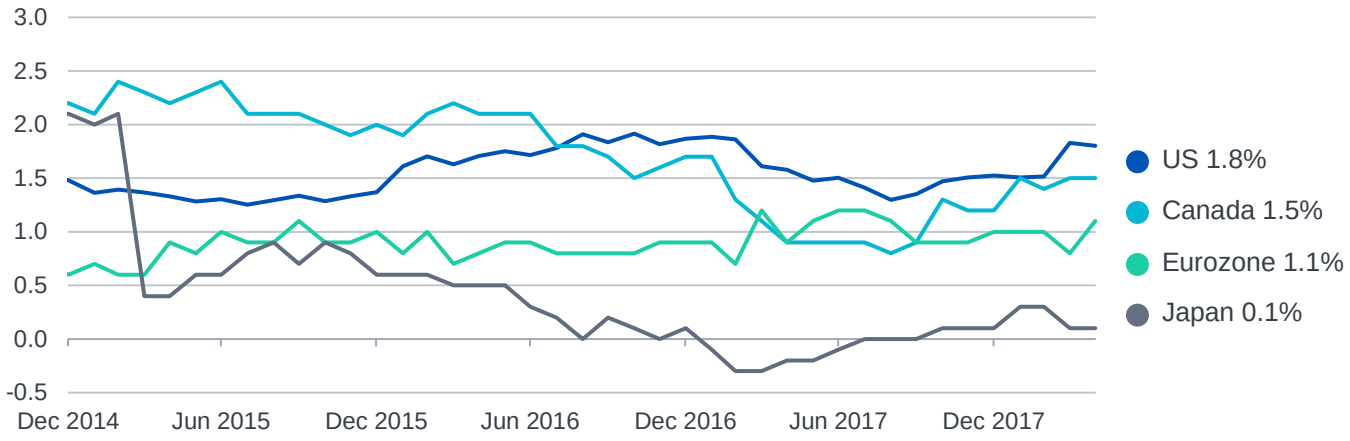
1.2 | Global economies on divergent paths

Global PMI surveys



1.3 | Inflation levels vary by region

Global core inflation rates



Source: Bloomberg | Chart 1 as of 31-May-18 | Chart 2 as of 30-Apr-18

The keystone for capital markets remains economic growth (see exhibit 1.4):

- Growth in the US economy is likely to remain above potential, continuing to feel the effects of the recent fiscal boost and a normal late cycle spurt of business investment.

- Canada, Europe and Japan are already showing signs that growth is moderating from 2017's above potential pace. Growth in these markets is simply downshifting to more sustainable levels.
- Chinese growth is also moderating, but only slightly. However, even small shifts from such a large contributor to global growth are important at the margin.
- A moderating growth path for China tempers the outlook for emerging market countries. These nations will also feel the weight of higher developed market bond yields and US dollar strength. We also factor in that certain emerging markets (e.g. Turkey, Russia, Brazil) face bespoke problems.

The two most significant changes to our capital market outlook from the beginning of the year stem from the move up in bond yields and the improvement in equity market valuations.

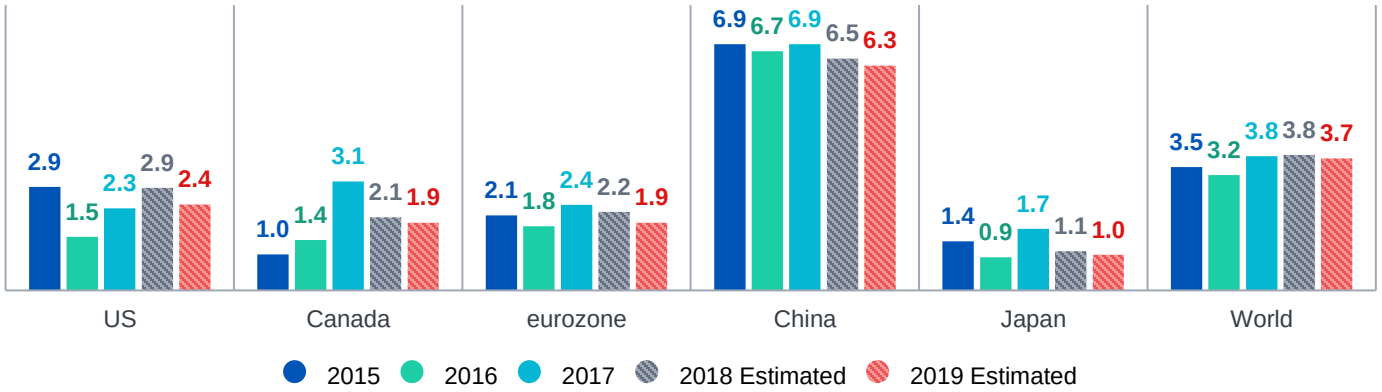
While we see yields continuing to rise, we believe a great deal of the move to higher yields is behind us. When coupled with our continued belief that the importance of fixed income as a risk-mitigation tool grows as yields rise and time passes, our recommended neutral stance for equity and fixed income positioning is reinforced.

Price-to-earnings multiples (P/E) have improved on both P and E. Globally, corporations have delivered very strong earnings growth, largely surpassing analyst expectations and, in many cases, prompting upward revisions to forward earnings guidance. In spite of this, major global markets have witnessed price corrections in the neighborhood of 10%. While some markets have rallied back modestly, very few have recouped their early 2018 highs.

The increase in bond yields and the equity market check-back are constructive moves that improve our outlook for both asset classes in the back half of 2018.

1.4 | Global GDP growth remains solid, but is peaking

Real GDP growth year-over-year percent change



Source: Bloomberg | 31-May-18

Canadian Equities

We hold a positive view toward Canadian equities. Canadian economic growth is settling down to a more sustainable pace. As a result, we expect domestically-focused equities in the S&P/TSX Composite Index (roughly 1/3 of the index weight) to have moderated growth expectations in-line with this reality. The other 2/3rds of Canada's equity benchmark exposure is more reliant on US and global factors, with a heavy tilt toward the US. Global commodity prices are an obvious driver, but so are export-oriented companies in other industries for which trade uncertainty will play a role. **It is also worth noting that financials, the largest S&P/TSX Composite sector, now derives significant earnings and earnings growth from substantial US and other international business units.** On average, the 'Big 5' Canadian banks and the 'Big 3' Canadian insurers generate 31% and a whopping 64%, respectively, of their earnings outside of Canada.

Financials, energy, materials and industrials sectors comprise 75% of the index (see exhibit 2.1). However, outside of these four sectors there are 25 notable Canadian businesses that comprise a further 8% of the benchmark. The fortunes of these businesses are heavily dependent on foreign revenues. Companies in the auto parts, apparel, food processing and retailing, drug distribution, and information technology sectors, such as Magna, Spin Master, Canada Goose, Saputo, Bausch Health, Shopify and CGI Group, are included in this group of notable Canadian businesses. All of the above-mentioned components of the Canadian equity market stand to continue to benefit from global growth, and especially the solid pace of US economic growth and business investment.

Consensus earnings growth estimates for the S&P/TSX Composite are solid and have been revised up since the start of the year, with 16% growth expected in FY2018 and 11% for FY2019. Despite the solid earnings growth, investors have generally been unwilling to pay up for broader Canadian equity market exposure (see exhibit 2.2). The lower P/E multiple reflects poor sentiment toward Canadian equities due to uncertainty on a number of fronts:

- **Debt:** High levels of indebtedness at the household, corporate and government levels;

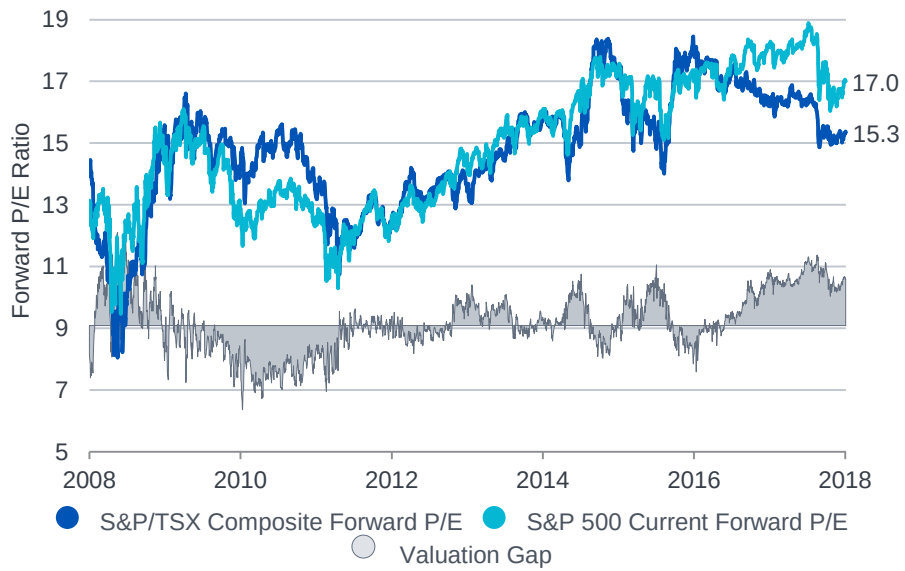
2.1 | Sector weights and characteristics

S&P/TSX Composite Index

Sector	Weight %	YTD Return %	Dividend Yield %
Financials	33.6	-1.7	3.5
Energy	19.2	-2.9	3.6
Materials	11.7	3.0	0.9
Industrials	10.2	8.7	1.4
Consumer Discretionary	5.8	7.1	1.8
Information Technology	4.2	29.0	0.3
Telecommunications	4.3	-6.3	4.6
Utilities	3.4	-9.2	4.7
Consumer Staples	3.4	-5.3	1.3
Real Estate	2.8	3.1	4.8
Health Care	1.3	3.6	0.7
S&P/TSX Composite Index	**100.0**	**0.6**	**2.8**

Source: Bloomberg, price only returns, local currency | 15-Jun-18

2.2 | North American equity valuations



Source: Bloomberg | 15-Jun-18

- **Housing:** Slowing housing markets;
- **Business competitiveness:** NAFTA uncertainties and a narrowing of US/Canadian tax rate differentials weighing on business investment;
- **Government intervention:** Carbon and other taxes, and provincial minimum wage legislation.

Out of risk, opportunity can be born! A lot of these uncertainties are reflected in the sluggish performance of the S&P/TSX Composite Index (sub 3% price only return since February of 2017 versus more than 18% for the S&P 500). The negative backdrop has valuations in Canada remaining attractive vis-a-vis solid corporate fundamentals. **Our base case return scenario (see exhibit 2.3) uses a valuation estimate that we feel reflects no improvement in sentiment.** Under that scenario, we see the potential for a 5% price return in the back half of 2018. Add the dividend yield of 2.8% annualized, and it brings total returns for the second half of 2018 in the neighborhood of 7%, which is largely unchanged from our previous full year estimate. Should sentiment improve in any of the above noted concerns, Canadian investments could become more appealing; a scenario in which we feel Canadian equities could add an additional 3% to 5% upside to our base case return figure.

Trade

Canada is better with NAFTA than without. However, notwithstanding near-term uncertainties around trade, it is important to differentiate the impact to the Canadian economy vs. Canadian equities. We do not see a scenario where it spells the end for Canada's premier companies. Bellwether Canadian businesses (often cross-listed on US exchanges) have diverse and successful franchises. Many have profitable operations outside of Canada, including on US soil, where their operations are welcomed and could receive a boost. These foreign operations flow earnings back to Canadian shareholders (earnings that would receive a currency boost under a weaker loonie as an outcome of no NAFTA deal).

2.3 | Canadian return scenarios

S&P/TSX Composite Index: 12-month return forecast

2018 EPS Estimate **$1,036**

Implied Trailing Multiple[1]	S&P/TSX Composite	% change from current level[2]
15.0x	15,540	-5%
16.5x	**17,094**	**5%**
17.0x	17,612	8%

● base case scenario

1. Current multiple 17.9x | 2. Current level 16,314

Source: Bloomberg, local currency, price only returns | 15-Jun-18

Sector insights

Financials

Financials are expected to account for 32% of index earnings growth in 2018 (in-line with its sector weighting). As the largest and most liquid sector of the Canadian market, the financials are currently bearing the full brunt of the current negative sentiment toward Canadian equities. Yet in spite of this, earnings growth expectations for the financial sector have been bumped up to 11% y/y from 6% at the beginning of 2018. While growth in the mortgage business of the Canadian banks is slowing, their earnings are being boosted by cost containment, improving foreign subsidiary revenue, increased business and commercial lending, and low loan loss provisions. Consider the following contributing factors to the positive outlook for Canadian financial companies:

- Recent earnings growth from the sector is running at 25% y/y, an upside surprise to the tune of around 4%.
- Return on equity continues to rise, sitting at 14%, above the 10-year average of 12.5%.

- Price-to-earnings and price-to-book ratios are essentially in-line with historical averages at 12x and 1.7x respectively.

Given the healthy dividend yield of 3.5%, financials only need to make modest price gains to deliver their expected total return contribution to our overall market return forecast.

Energy

We are sticking with our positive return forecast for the Canadian energy sector. Importantly, it is not solely predicated on oil prices continuing to climb. In fact, WTI prices north of $US55 should be enough to sustain current valuations. With prices around 20% above that level today, we continue to see a gap between the commodity and the share prices - a gap that we believe should narrow with energy share price gains (see exhibit 2.4). We forecast oil prices to hold above $US60 for WTI and price differentials for WCS to remain stable in the mid-teens (where they are now). If this is coupled with a benign-to-weaker Canadian dollar (also our view), we see potential for the energy sector to trade back up by another 10% in the second half of 2018.

Materials

The materials sector has become a smaller, but more diverse, component of the Canadian equity landscape over the last number of years. **Broadly speaking, global growth and firming commodity prices are a tailwind to the materials sector. However, the materials sector is far from homogeneous and no one metric clearly defines its fortunes.**

High expectations for earnings growth see the sector responsible for 14% of total expected index earnings growth in 2018. Full year earnings growth expectations sit at 26% y/y, led by an 80% earnings gain for lumber producers (lumber prices are up 75% y/y). More broadly, non-energy commodity prices have moved up. We note that strong commodity prices are a staple of the late stage of the business cycle. Yet, we don't need excessive price gains from current levels for the materials sector to perform. On a price basis, the materials sector has posted a small positive gain so far in 2018, and continues to sit within the sideways channel it has occupied for the last five years (see exhibit 2.5). On valuations, the sector is reasonably priced with price-to-earnings, EV-to-EBITDA[1], price-to-cash flow, and price-to-book ratios all below their 10-year averages. **We maintain our opening year outlook that the fundamentals are sufficient for the materials sector**

Oil prices face a mix of positive and negative influences for the remainder of 2018

On the plus side:

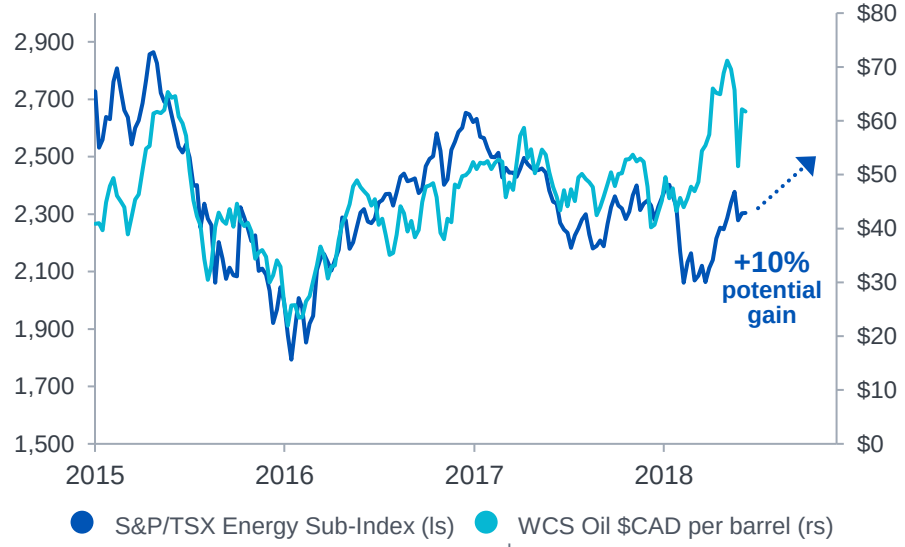
- Global oil demand is rising, consistent with solid global growth;
- Global inventories of crude oil have been brought down below their 5-year average;
- US oil production is back to previous peak levels, and further near-term gains in US oil production are showing early signs of being limited by rising costs, labour and input shortages, extraction capacity and egress issues.

On the negative side:

- Supply outages (or fears thereof) could abate in the likes of crisis-torn or embargoed producers in the middle east and Venezuela;
- The OPEC production deal could be wound down quickly (but they appear united to maintain prices at least above US$55);
- While OPEC and 'partners' compliance with the current quotas has been high. Historically, they have been renowned for cheating. The higher prices remain, the greater the incentive to sneak a few extra barrels of oil onto the market.

We forecast an average price for WTI of US$65/bbl ($US60 - $US70 range) over the remainder of 2018.

2.4 | Energy sector hasn't kept pace with oil prices



Source: Bloomberg, local currency, price only returns | 15-Jun-18

to trade back to the top-end of the 5-year trading range, representing a price move of approximately 8% from today's levels.

Gold

We expect the price of gold to stay range-bound, helped by simmering geopolitical tensions and rising inflation, but dampened by rising bond yields and a stabilizing-to-slightly stronger US dollar.

Industrials

The industrials sector has been one of the top performing sectors thus far in 2018. The sector has exceeded our modest expectations, and in doing so has further exacerbated our concerns around valuations in this sector. Companies in the industrial sector are highly levered to global growth. Given the extensive use of debt in the capital structure of industrial companies, they can deliver high rates of return on equity in a robust economic environment. However, return on equity is now at a cycle high and we expect rising input costs (wages, borrowing costs and fuel, to name a few) to become of greater significance. Earnings growth estimates for the industrials sector have moderated significantly to reflect this expected margin erosion. Full-year 2018 earnings growth expectations sit at 8%, half of 2017's 16% rate. Despite the sector's #4 rank in market weight, the earnings growth contribution is a mere 4% of the index's total earnings growth.

Earnings have been trending lower for two quarters with the y/y growth rate of the most recent quarter a paltry 1%. Currently, the 12-month forward price-to-earnings and price-to-cash flow ratios sit 1.75 standard deviations above the 10-year average, and EV-to-EBITDA[1] near 2 standard deviations above average. **Stretched valuations have us cautious in our outlook for the industrials sector**.

2.5 | Higher base metal prices should boost the materials sector

Source: Bloomberg, local currency, price only returns | 15-Jun-18

1. Enterprise value to earnings before interest, taxes, depreciation and amortization

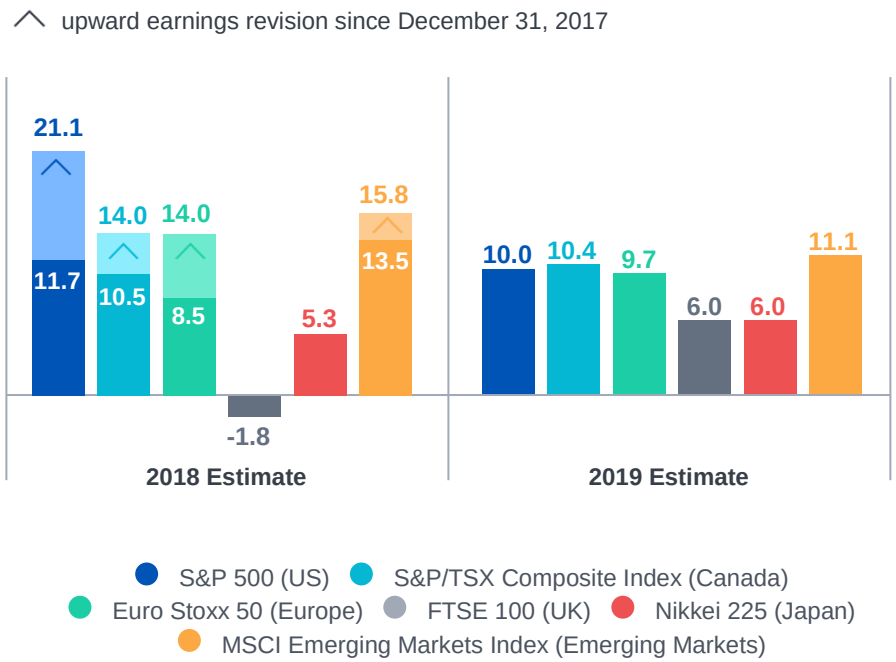
US Equities

We hold a more constructive view toward US equities than at the start of the year. We were very concerned in January when our entire year's best case scenario return arrived in 18 trading days. However, the 10% price correction, and subsequent 7.5% rebound, still leaves the S&P 500 around 4% below the early year high. This price action, coupled with substantial upward earnings revisions (see exhibit 3.1), has helped to improve (but not eliminate) the elevated valuations we were most concerned with at the end of 2017 (see exhibit 2.2). Looking toward the end of 2018, with a continuation of solid corporate earnings and market attention turning toward further (albeit more modest) 2019 earnings growth, we see potential for the S&P 500 to revisit the highs reached earlier this year; cresting above the 3,000 mark would not surprise us. **Our base case forecast calls for a 3% price return in the back half of 2018. When coupled with the YTD gain of 4% and near 2% annualized dividend yield, the total return for 2018 should come in around 8%.**

S&P 500 earnings are being boosted by the US economy growing at the fastest pace of any of the G7. US equities bring the highest earnings growth expectations of any of our covered markets. Economic growth is expected to peak in 2018, but 2019 growth remains above potential (a factor we see sowing the seeds for disappointment down the road). Beyond domestic strength, the global economy continues to offer a solid pace of growth, albeit moderating in many regions. Further enhancing the attraction of the S&P 500 is share price support from the elevated level of company share buyback initiatives. In spite of signs that the accelerating pace of mergers and acquisitions (M&A) activity has peaked, US M&A activity remains strong and business investment continues to power ahead. These are all market friendly developments that are typical at this stage of the business cycle. For the US, these developments are receiving an added boost from tax reform, a large fiscal spend, overseas cash repatriation, and the regulatory roll-back policies of the current administration. **As has often been the case in the late stages of a market cycle, increased volatility is to be expected.** Some of these positives are partially offset by uncertainty with respect to trade. The Trump administration remains focused on pushing forward with tariffs that hold the potential to spark trade wars with virtually all its major trade partners.

3.1 | Global earnings growth expectations

Year-over-year EPS growth (%)[1]



Source: Bloomberg. Local currency | 1. Consensus estimate | 31-May-18

Trade wars dampen economic growth and tariffs are a tax on consumers. While little actual economic damage has been inflicted thus far, tensions are causing uncertainty both in and out of the US. This uncertainty can weigh on business confidence; which in turn can lead to a dampening of business investment – a key component to extend the life of the current economic expansion.

While we see the level of rhetoric as largely a negotiating tactic, with potential outcomes less damaging than the threats, should worst-case scenarios unfold, it would be negative for equities and positive for fixed income. Ultimately, there remains a lot of ground to be covered on trade. **We expect trade to be a source of continued volatility for "risk" assets, and is therefore part of our decision to pursue a neutral asset allocation recommendation.**

An additional risk is posed by the US mid-term election. Mid-term election years typically see equity market gains. However, the size of the gain tends to be below those of other years. Given the extent of the boost to the fortunes of S&P 500 companies from government policies, this year's mid-terms bring heightened risk and uncertainty.

Lastly, we have concerns over the efficacy and longevity of the corporate tax cut that is responsible for some of the boost to corporate earnings. The tax cut is to be paid for by expanded economic activity. We are skeptical, as are many others, of the economic expansion being sufficient to pay for such a significant reduction to tax revenue. This leaves the current situation as unsustainable and projections for the US deficit are rising rapidly. The impact of this is not likely something markets will focus on in the near-term, preferring to "party-on", drinking in the tax cut boosted earnings growth. However, the consequences are real and will need to be addressed at some point. We believe it would be difficult to see the situation addressed without some upward adjustment to corporate taxes.

The S&P 500 continues to face elevated valuations and elevated investor sentiment. While valuations have improved, they remain high and we expect them to continue to contract under the weight of higher bond yields. Compared to the 10-year average level, the 12-month forward price-to-earnings ratio for the S&P 500 is now more reasonable, sitting less than one standard deviation above the average. The EV-to-EBITDA ratio remains 1.5 standard deviations above average, while the price-to-cash flow and price-to-book ratios are two standard deviations above average.

Valuation expansion in the current environment is unlikely to move US equities higher. In determining our US market outlook, we book-ended our base case with two opposing market scenarios:

1. Should the earnings number miss by around 5%, the return forecast drops to zero for the second half of 2018.
2. Alternatively, should earnings come through, and investor sentiment keep P/E multiples elevated, the result is an equity market run-up in the order of 10-15% (n.b. late stage equity markets have often been marked by strong returns prior to the onset of a bear market).

3.2 | US return scenarios

S&P 500 Index: 12-month return forecast

2018 EPS Estimate $159

Implied Trailing Multiple[1]	S&P 500	% change from current level[2]
17x	2,703	-3%
18x	**2,862**	**3%**
19x	3,021	9%

● base case scenario

1. Current multiple 21.1x | 2. Current Level 2,779

Source: Bloomberg. Local currency. Price only returns | 15-Jun-18

Our best line of sight is our current base case: We are calling for the current 21x trailing P/E multiple to fall to 18x (See exhibit 3.2) driving a 3% price return in the back half of 2018.

International Equities

Our views toward international equities (EAFE) are balanced on the whole, with regional distinctions guiding our outlook and recommended country positions. Global growth is solid, but the synchronicity of growth has peaked. The thrust of global growth is shifting toward the US, with moderating growth expected in Europe, the UK and Japan. Eurozone earnings growth underpins our favoured market rating for the region. In contrast, emerging markets (never a homogenous group) have certain countries facing idiosyncratic, largely political issues (e.g. Russia, Brazil, Turkey) and in aggregate the pace of growth is moderating. Likewise, the sharpest slowdown signals from forward-looking surveys of economic activity are in Europe, UK, Japan and emerging markets (see exhibit 1.2).

In terms of our outlook for international equities we would tilt toward Europe with a neutral stance on Japan and underweight UK and emerging markets.

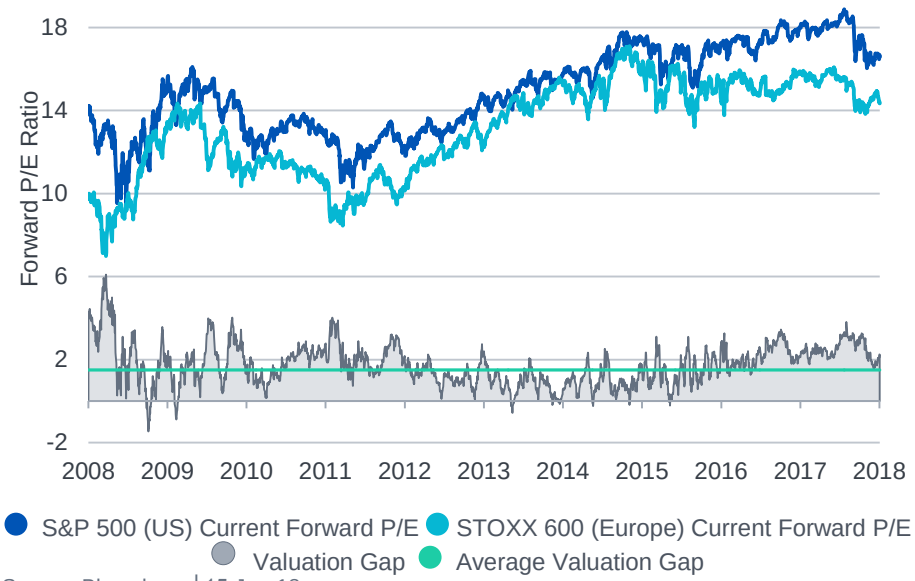
Regional insights

Europe

European equities are our favoured choice of the international markets. We caveat our view with the acknowledgement that Europe faces challenges. Lingering political risks (e.g. Italian government unrest and Brexit fall-out), along with valuations that offer little by way of discount over the norm to North American equities, tempers our enthusiasm. Likewise, even though the price-to-earnings multiple for Europe has come down, Europe has not experienced upward earnings revisions to the same extent as the US (see exhibit 4.1). To the positive side, even though European real GDP growth is slowing, the pace remains above potential. Eurozone central bank policy is set to remain accommodative, as the region has a longer runway for growth and inflation before reaching full potential. As such, European stocks will benefit from easier financial conditions for longer.

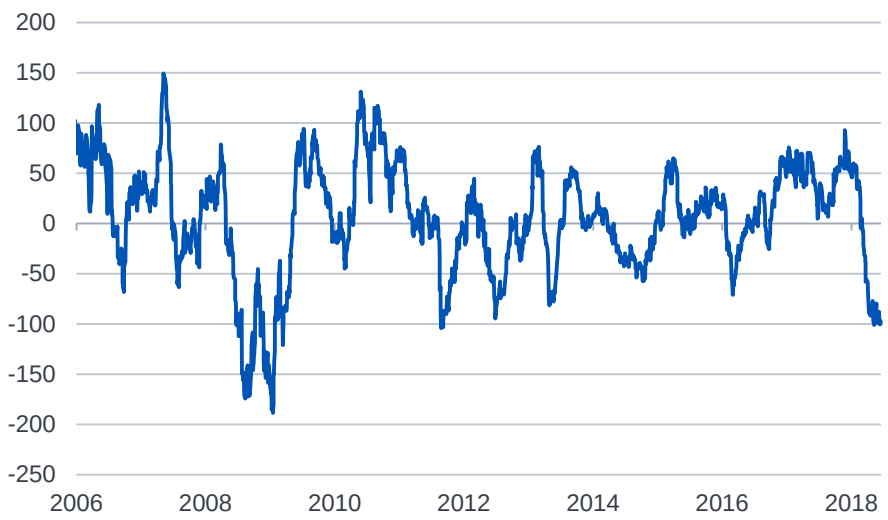
The first quarter slowdown in Europe was exacerbated by harsh winter weather, large labour stoppages in France and Germany, and a particularly severe flu season. The slowdown has pushed expectations for eurozone economic surprises to a seven-year low (see exhibit 4.2). Technical bottoms

4.1 | Gap between European and US equity valuations returning to normal



Source: Bloomberg | 15-Jun-18

4.2 | Eurozone Citigroup Economic Surprise Index



Source: Bloomberg | 15-Jun-18

in this metric have historically augured equity market rallies, adding to our positive expectations. We see a relatively stable (maybe slightly weaker) euro for the remainder of 2018 (see Currency section for more) and this factors into our modestly positive outlook. **Ultimately, our positive view on the eurozone is underpinned by the solid earnings' growth outlook (see exhibit 3.1).**

United Kingdom

We see UK equities as unattractive on weak earnings growth, elevated valuations, central bank tightening and Brexit risks. Yes, the robust dividend yield (the UK FTSE 100 index boasts a superior dividend yield north of 4%) does offer some attraction, but not enough to offset the risks and sway us from an underweight recommendation. Earnings growth expectations for UK equities have deteriorated (see exhibit 3.1). The FTSE 100 Index fully participated in the earlier year equity market sell-off, but is one of the few markets that fully recovered to new highs. As a result, valuations are elevated, and we see most of the near-term gains behind us.

UK equities will face tighter monetary policy. We expect the Bank of England to continue raising interest rates. Despite the fact that the UK and the European Union have agreed to a post-March 2019 Brexit transition deal, significant hurdles remain before a complete agreement is obtained.

Japan

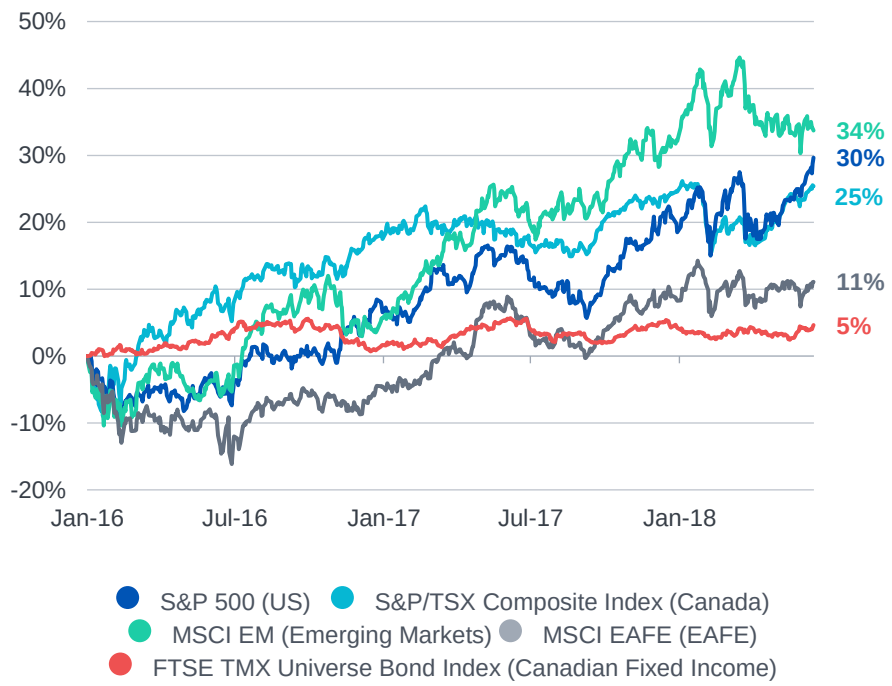
We take a neutral stance on Japanese equities. A large trade imbalance with the US means Japanese exporters could be the target of US trade action. Earnings growth estimates are modest (see exhibit 3.1), and there is an additional risk that Japanese companies are more levered to Chinese growth (which is moderating) and a downshift in Japanese economic growth. To the positive, Japanese equities are cheap. Forward price-to-earnings ratios are close to one standard deviation below their historical average. Japanese companies will be able to access some of the lowest borrowing costs on earth, given the incredibly low level of Japanese interest rates. Weighing all of these factors brings our outlook back to neutral for Japanese equities.

Emerging Markets

Emerging markets (EM) are highly levered to global synchronized growth and

4.3 | Asset class performance in the era of synchronized global growth

Cumulative returns in Canadian dollars



Source: Bloomberg | equity returns - price only, fixed income returns - total return | 15-Jun-18

have generated performance commensurate with the global growth path thus far (see exhibit 4.3). **However, today we see emerging markets facing a number of fundamental headwinds:**

1. Trade frictions with the United States remain an important risk to all global markets, but given their significant manufacturing export orientation, emerging market equities are particularly sensitive.
2. Emerging markets will struggle under higher US interest rates and a tightening bias across many other central banks.
3. The recent strength in the US dollar is forcing emerging market central banks to respond with higher interest rates to defend their weakening currencies, leading to tighter financial conditions in these markets. Additionally, the downdraft for emerging market currencies

removes what was a source of incremental gains for foreign investors in emerging market equities.

4. While commodity prices are rising (historically a positive for emerging markets), the energy and materials sectors now account for just 15% of the MSCI EM index combined, and these two sectors are modest performers YTD (3.6% and -0.6%, respectively). Furthermore, higher oil prices are a mixed blessing. While the index carries direct exposure, higher oil prices are not a benefit to heavily weighted emerging market countries like China, Taiwan and India - all net oil importers.

Emerging markets offer respectable earnings growth estimates, with small upward revisions from the beginning of the year, and the forward price-to-earnings ratio is slightly above its long-term average. The gap between EM and developed market P/Es remains slightly above average, but it has narrowed since our last outlook. Weighing all of these factors with their tilt to the negative, coupled with the elevated risk profile of emerging markets, **we feel most comfortable with an underweight asset allocation recommendation. This recommendation is reinforced by the expectation for a general increase in equity market volatility.**

Fixed Income

The outlook for fixed income total returns remains modest, but their attraction as a risk-mitigation tool has increased. We expect yields to move higher and continue to pressure overall bond returns. We anticipate the moves should take some time to unfold (4 to 6 quarters in our view), and with a continuation of the 'fits and starts' type volatility we've seen thus far in 2018.

Canadian and US 10-year bond yields have more than doubled from their 0.95% (Canada) and 1.36% (US) 2016 lows. We believe the move to higher bond yields from their recent ultra-low levels is well past the halfway point (see exhibit 5.1). Canadian yields are lower than, but keeping pace with, their rising US counterparts. US yields will continue to move higher on the back of rising inflation and solid growth. Canadian growth is forecast to trail the US owing to a variety of headwinds from high debt levels, the slowing housing sector, corporate competitiveness, and government policy action (see Canadian equity section).

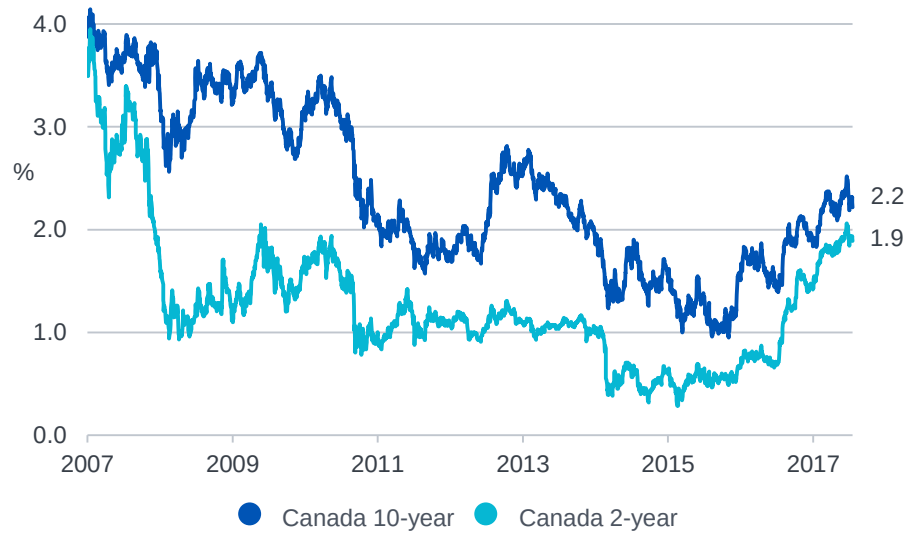
Under this backdrop, we see the Bank of Canada raising rates two more times in 2018, for a total of three 0.25% hikes, while the US Federal Reserve adds two more 0.25% hikes to the two they have already made. Beyond that horizon, we would expect the US to raise rates at a more aggressive pace than Canada. We maintain our end of 2018 Government of Canada 10-year bond yield forecast - unchanged at 2.5% versus the 2.22% yield today, while our end of 2018 2-year bond yield forecast is upped to 2.2% versus a current yield of 1.89%.

Near-term, we see the pace and magnitude of yield increases in the second half of 2018 to be similar to those witnessed in the first half. **Our base case scenario calls for bond yields to creep higher longer term. Fixed income investors should expect to see flat to 1% total returns for the remainder of 2018.**

Sector insights

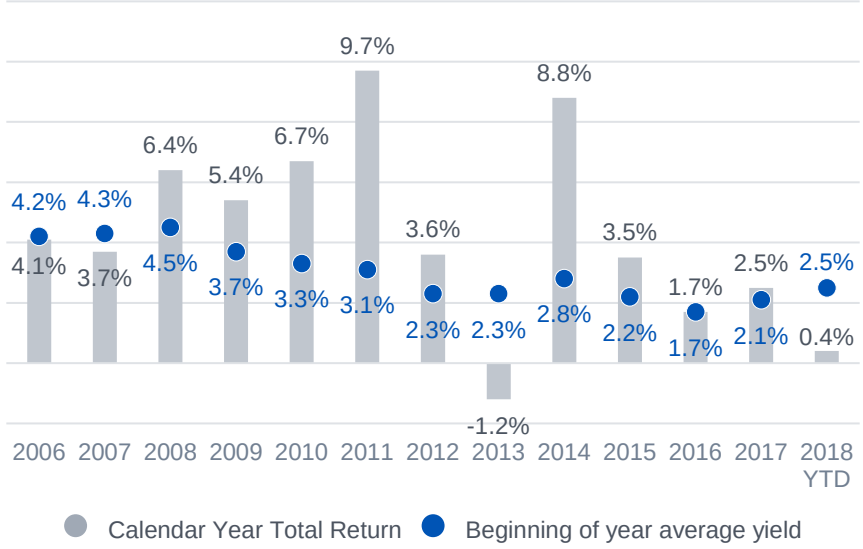
There remains yield pick-up in spread product (provincial, mortgages, investment grade and high yield corporate bonds) that can offset some of the

5.1 | Government of Canada 2 and 10 year bond yields



Source: Bloomberg | 15-Jun-18

5.2 | FTSE TMX Canada Universe Bond Index Returns



Source: Bloomberg | FTSE TMX Canada | 15-Jun-18

headwinds of rising yields. Spread compression has been an important feature in fixed income markets for the past several years, representing a valuable component of total return (see exhibit 5.2). We now see the benefits from spread product as coming primarily from the enhanced running yield; as we see little room for further gains on spread compression. **Given the lack of further spread compression, diversifying and allocating assets to account for the risk profile of various credit spread assets becomes important.** Provincial and investment grade corporate bonds, to varying degrees, deliver the risk-mitigation characteristics that we see as most valuable from fixed income today.

Government bonds

Government bonds are attractive for their superior risk-mitigation qualities, but will continue to face the headwind of a rising yield environment. Mid-term and longer duration sovereign bond yields have risen by a substantial amount. This provides additional income from today's starting point, and compared to where we started, the magnitude of the yield increases that lie ahead have diminished.

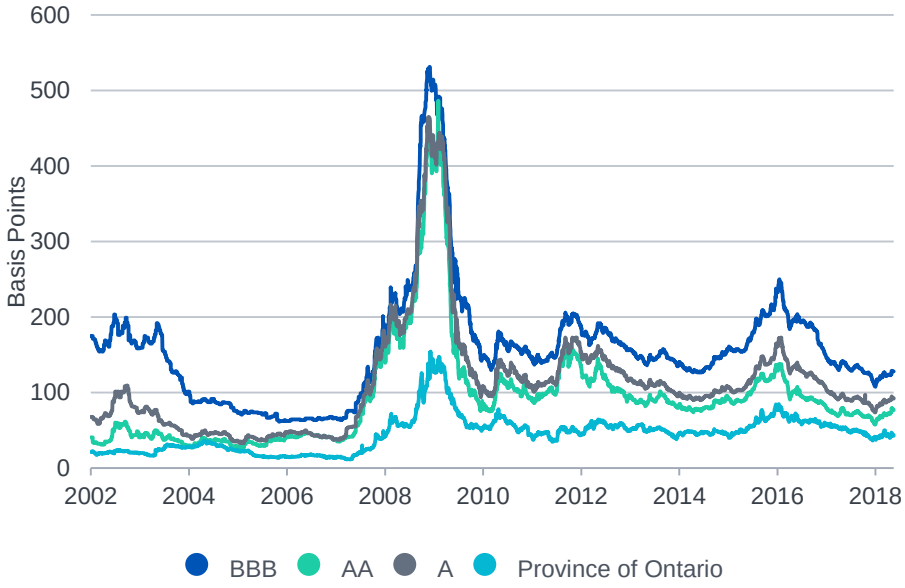
Investment grade corporate bonds

We see investment grade corporate bonds as most attractive given their mix of yield pick-up and modest safety. The main attraction of investment grade corporate bonds is their (generally) shorter duration and higher running yield that will help to mitigate losses as yields rise (see exhibit 5.3).

High yield bonds

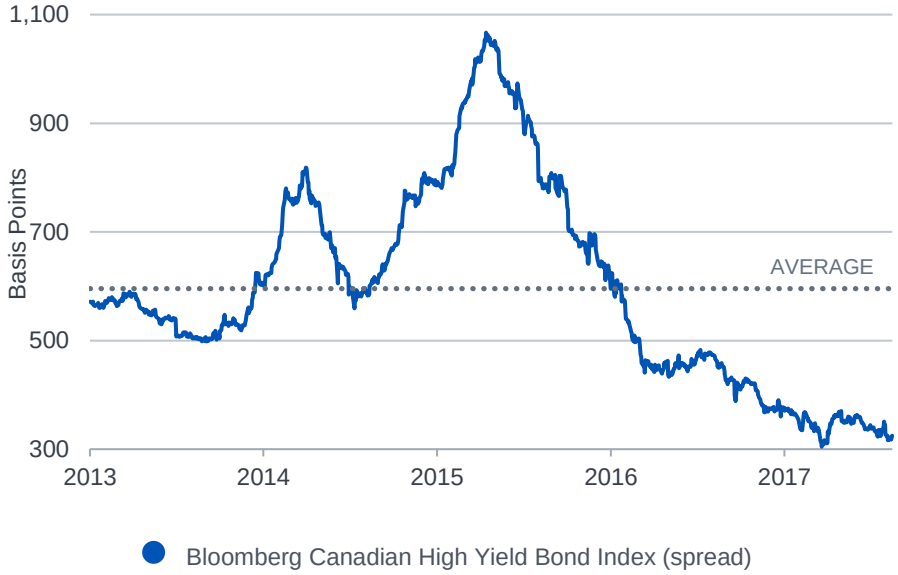
Given the very narrow spread levels of high yield bonds in aggregate (see exhibit 5.4), and the higher risks of this asset category (see exhibit 5.5), we see the risk/reward trade-off in high yield bonds as unattractive and would be generally underweight the group.

5.3 | Investment grade corporate bond spreads offer some attraction



Canadian Corporate Bonds Spreads | Source: BMO Capital Markets | 15-Jun-18

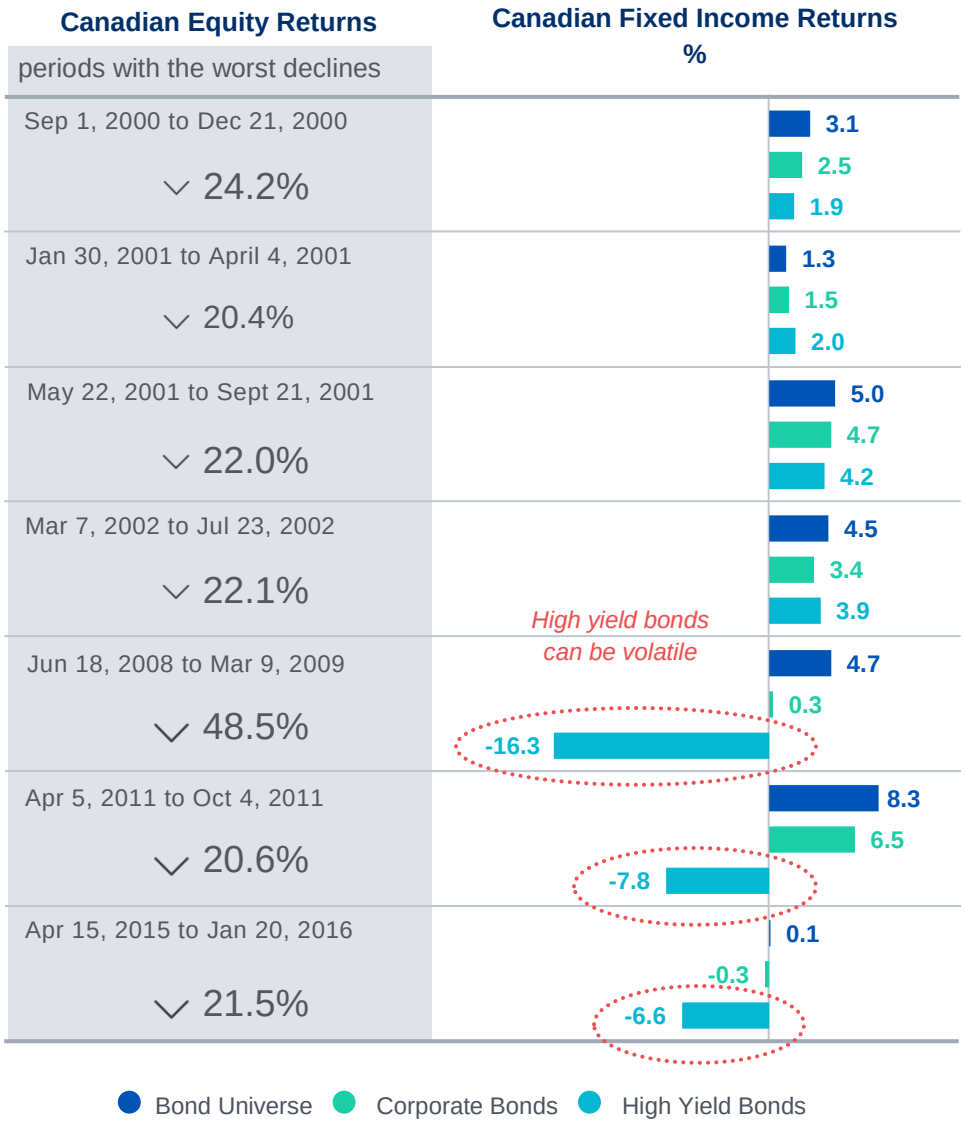
5.4 | Canadian high yield bond spreads



Source: Bloomberg | 15-Jun-18

5.5 | What's in your bond fund?

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



Source: Bloomberg, PC Bond | S&P/TSX Composite Index (total return) – Canadian equities, FTSE TMX Canada Universe Bond Index (total return) – Bond Universe, FTSE TMX Canada Corporate Bond Index – Corporate Bonds, FTSE TMX Canada High Yield Bond Index (total return) – High Yield Bonds | 15-Jun-18

Currencies

US Dollar

We forecast mild strengthening for the US Dollar Index by ~3%, expecting the US Dollar Index (DXY) to move toward 98.

Forces we expect to push the US dollar higher include:

- Higher US interest rates and inflation;
- Downward pressure on US trading partners' currencies due to tariffs and/or the threat thereof; and
- A stronger US economic growth picture versus other major economies.

Some offsetting forces causing us to moderate our forecast include:

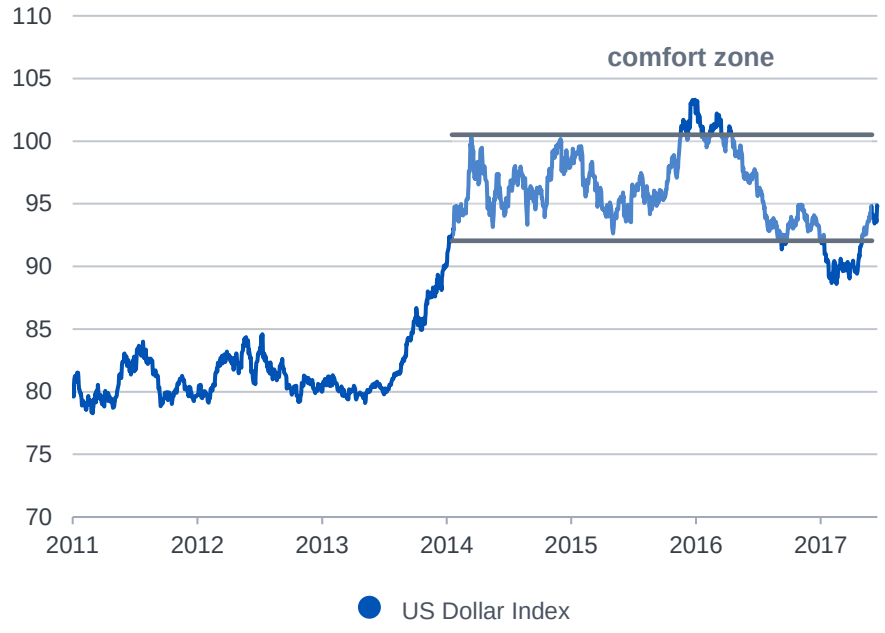
- A widening fiscal deficit under tax reform; and
- A continuation of a large trade deficit, despite efforts to the contrary.

This settles the US dollar in the middle of a band that we see as a natural "comfort zone" (between 92 and 100) (See exhibit 6.1). This is a "comfort zone'' level for the US dollar because within the zone it is not so strong as to upset S&P 500 earnings estimates and the broader global economy (especially commodity prices and emerging markets), and not too weak to raise concerns over the health of the US economy, or the US government's balance sheet. This is exactly the same forecast we held in December 2017; not surprising considering the DXY sits almost exactly at the same level today as it did then.

Canadian Dollar

The Canadian dollar is likely to remain weak. We currently see the fundamental factors that influence the Canadian dollar to be a mix of positives and negatives, set against a backdrop of poor investor sentiment toward Canada in general. We believe that trade frictions between the US and Canada currently represent a 'fear' discount in the order of roughly US3¢ - US5¢ (CADUSD). Should those fears dissipate (which we do not see happening in the near-term), we would expect the loonie to make up that ground.

6.1 | US Dollar Index: trading in a natural comfort zone



US Dollar Index Composition

Currency	Weight %
Euro	57.6
Japanese yen	13.6
Pound sterling	11.9
Canadian dollar	9.1
Swedish krona	4.2
Swiss franc	3.6

Source: Bloomberg | 15-Jun-18

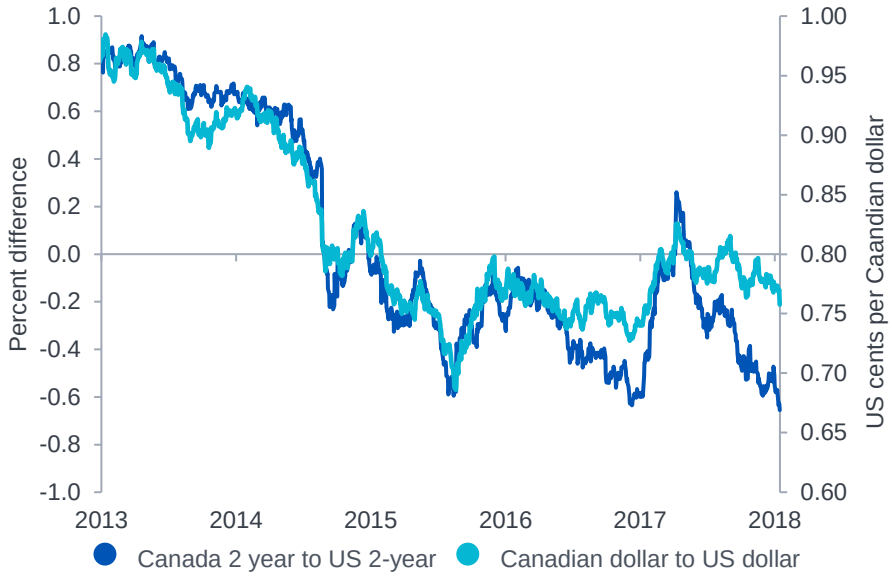
More fundamentally, the two primary drivers of the loonie (i.e. interest rate differentials and oil prices) sit at opposite ends of our forecast (See exhibit 6.2 and 6.4).

On Canada-US 2-year interest rate differentials, the current level suggests the Canadian dollar should be trading closer to US73¢. Our outlook for Bank of Canada and US Federal Reserve policy paths have the US raising rates at a more aggressive pace than Canada. This will result in the differential widening, putting downward pressure on the Canadian dollar.

Given oil prices alone, the loonie should be trading closer to US79¢. Given our view that oil prices have likely seen their best days for 2018, we expect this upward pressure for the currency to fade.

Weighing all of these factors, we call for the Canadian dollar to average US75¢, trading in a range between US72¢ and US77¢ through the remainder of 2018. (See exhibit 6.3).

6.2 | Canadian dollar versus Canada-US yield differential

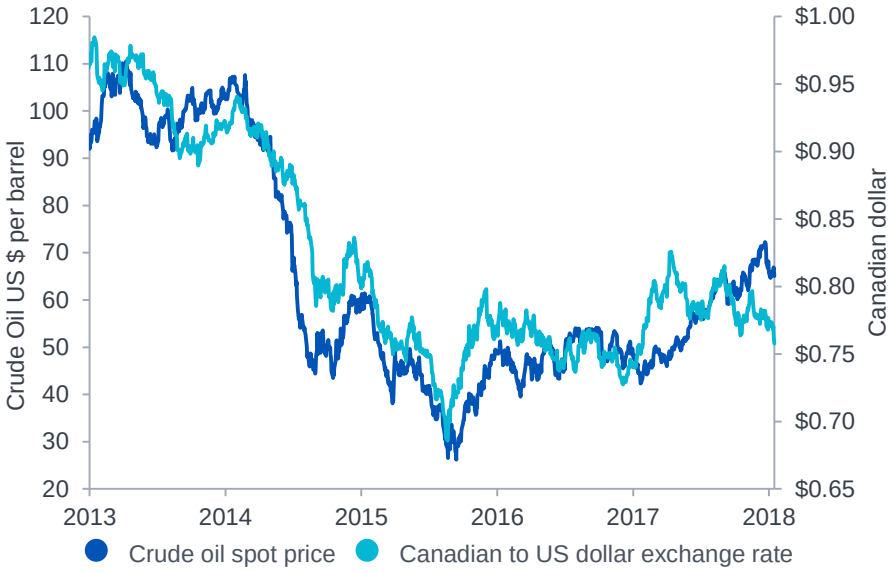


Source: Bloomberg | 15-Jun-18

6.3 | Canadian dollar to average US 75¢

Source: Bloomberg | 15-Jun-18

6.4 | Canadian dollar versus oil prices



Source: Bloomberg | 15-Jun-18

GLC Outlook Summary

1. From December 2017

	change in view[1]	Under	Neutral	Over
Fixed Income	▲	○○○	○●○	○○○

Fixed income investors face a sideways market as slowly rising (normalizing) yields grind against the time required for higher coupons to make a positive contribution. Active management to navigate the yield curve and pick-up additional yield through credit instruments (e.g. provincials, mortgages and investment grade corporates) provides the opportunity for small, single digit positive gross returns.

Government Bonds	▲	○○○	○●○	○○○

With rising yields, government bonds offer little upside, but their value as a risk-mitigation tool continues to rise the later in the market cycle we go.

Investment Grade Corporate Bonds	▲	○○○	○○○	○○●

We see investment grade corporate bonds as most attractive given their mix of yield pick-up and modest safety. We expect investment grade corporate bonds to outperform governments, with less volatility than high yield bonds. Spreads have limited room for further tightening. Their generally shorter duration and higher running yield is a benefit in a rising rate environment.

High yield Corporate Bonds	▼	●○○	○○○	○○○

High yield spreads have moved down and we see very limited room for further tightening. Given the very narrow spread levels and their lack of risk-mitigation characteristics, we see the risk/reward trade-off in high yield as unattractive.

Equity	▼	○○○	○●○	○○○

We believe that the global economy has enough momentum, and that inflation and financial conditions will remain accommodative long enough, that our near-term outlook for equities remains constructive. However, we believe we are in the late stage of the market cycle where increased volatility is to be expected and timing is extraordinarily tricky. On a risk-adjusted basis, a neutral stance is most appropriate.

Canada	=	○○○	○○●	○○○

Canada is a favoured market due to its greater sector leverage to global growth and firming commodity prices. Canada's valuations are more reasonable than their global peers. Trade, debt and sensitivity to higher interest rates remain risks.

US	▲	○○○	○○●	○○○

We hold a more constructive view on US equities on improved valuations and earnings growth potential, but optimism is moderated by a number of factors: Rising bond yields will continue to weigh on valuation multiples; while we see demand remaining solid, we see a tougher environment ahead for corporate earnings growth as rising borrowing costs, wages and input prices erode profit margins; and finally, trade frictions remain a risk.

International	▼	○○○	○●○	○○○

We hold a neutral view toward EAFE equities. With Europe (ex-UK) offering solid earnings growth, political risks linger and valuations offer little discount. UK equities are unattractive on earnings growth, valuations and Brexit risks. We hold a neutral view on Japan given muted earnings growth expectations and slowing economic growth in both Japan and China.

Emerging Markets	▼	○○●	○○○	○○○

We recommend an underweight to emerging markets as they face headwinds from a firmer US dollar, global bond yields trending higher and moderating Chinese growth. The risk profile reinforces this underweight, as increased volatility and delicate timing provide incentive to underweight riskier, high-beta assets.

Disclaimer

 This commentary represents GLC's views at the date of publication, which are subject to change without notice. Furthermore, there can be no assurance that any trends described in this material will continue or that forecasts will occur; economic and market conditions change frequently. This commentary is intended as a general source of information and is not intended to be a solicitation to buy or sell specific investments, nor tax or legal advice. Before making any investment decision, prospective investors should carefully review the relevant offering documents and seek input from their advisor.

glc asset management

www.glc-amgroup.com

99-7919