GLC 2015 Mid-Year update and outlook

Ron Hanson, Chief Investment Officer

As we move towards the second half of the year, we find capital markets to be on edge.

- Investors are fixated on when the U.S. Federal Reserve (Fed) will finally increase interest rates.
- As expected, the 50% drop in oil prices has weighed on Canada's economic growth in the first quarter. Canadian equities have been in a trading range since highs reached last September, managing to stay in positive territory so far this year.
- US equities, for the most part, have traded sideways and are up marginally for the year.
- Notwithstanding the ongoing Greek saga, aggressive policy action by the European Central Bank (ECB) has helped push equities in the region higher.
- Despite slowing economic growth, Chinese equities have gained 29.6% so far this year as retail investor activity increases on the back of promises of more stimulus.
- Bond markets have experienced increased volatility. With deflation fears abating and global growth expectations improving, investors have been abandoning the 'safety play' of government bonds. Yields have been on the move in 2015.

Going forward into the second half of 2015, we see the following key questions facing capital markets.

1. *When will the Fed raise rates?*
   [GLC] We think most likely in September.

2. *Can equity markets withstand higher interest rates?*
   [GLC] Yes, to a point.

3. *Will the US economy move back towards 3% trend growth?*
   [GLC] Yes, we think it will.

4. *Have we seen the lows in crude oil prices?*
   [GLC] A range of US$65 to US $75 seems reasonable for the next 6-12 months.

5. *What are the opportunities outside of North America?*
   [GLC] We prefer developed markets over emerging markets.

6. *Is the bull market in bonds over?*
   [GLC] The secular downward trend in bond yields has, in all likelihood, come to an end.

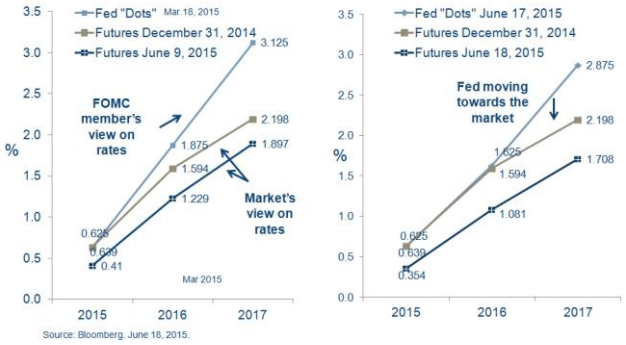
All data within is as of June 26, 2015 unless otherwise stated.

1. When will the Fed raise rates?

We believe the Fed is most likely to increase rates at its September meeting.

Although we acknowledge that economic growth has been below expectations this year, recent data is surprising to the upside and as slack in the labour market continues to erode, the Fed needs to start raising rates. The employment gap is now negative and history shows that on average this gap lasts for about 36 months before pressures build and tighter policy from the Fed is warranted. In the past, the Fed has also started hiking rates when the gap went negative and we firmly believe both the economy and capital markets need to be weaned-off zero interest rates.

Exhibit 1



In the press conference following the June 16th/17th meeting U.S. Federal Reserve Chair, Janet Yellen, went to great lengths to emphasize that the timing of the first hike is not as important as the pace of increases. To that end she also highlighted that the path of increases will be gradual. This is reflected in the new economic projections (a.k.a. the DOT plot of the committee - see Exhibit 1). Overall the message was slightly dovish relative to market expectations. The Federal Open Market Committee (FOMC) would like to see more decisive evidence that the moderate pace of economic activity can be sustained before increasing rates. The committee also lowered its forecast for 2015 GDP growth to 1.8% to 2.0% from 2.3% to 2.7%, but this is simply a function of factoring in the slowdown in the first quarter.

Implications

In our view, the risk of a policy "accident" grows the longer the Fed anchors rates at zero. The important factors for risk appetite over the next 6 to 12 months are the pace of rate hikes, and whether the economy will continue to expand with firming inflationary pressure. Economists' forecasts continue to suggest the rate hike cycle will be the most gradual in history, with median projections for 2016 and 2017 implying rate hikes of 1% per year.

As we wrote in May 2015's piece "Insights into Extraordinary Central Bank Policy," one of the biggest issues facing capital markets in the months and years ahead is the divergences in global monetary policy and the inevitable normalization of these extraordinary policies. We acknowledged then, and remain of the view that, ***as global economies improve, rate hikes are appropriate and should allow equities to remain within the primary trend.*** However, investors should moderate their expectations for returns in both equities and bonds over the next 12 months compared to what we have experienced over the past several years.

2. Can equity markets withstand higher interest rates?

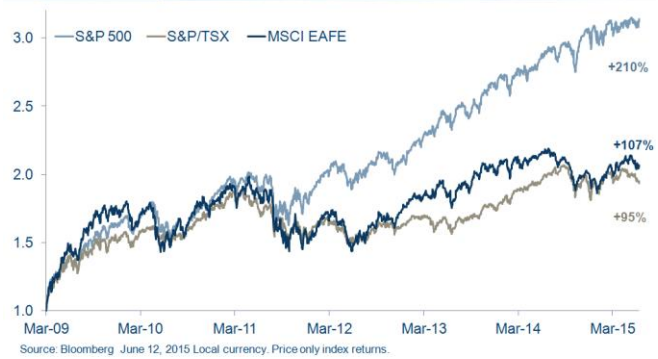
Yes, to a point.

Low interest rates and accommodative monetary policy have undoubtedly contributed to the rally we have seen in stock markets since the depths of the global financial crisis (see Exhibit 2).

Admittedly, we do not think the returns in Exhibit 2 are sustainable. As a result, investors should moderate their return expectations going forward.

Over longer time periods, investors should be targeting 7-9% as reasonable targets.

Exhibit 2



Historically, US equities peak when the 10 year Compound Annual Growth Rate (CAGR) gets into the high teens. The current 10 year CAGR is 5% (see Exhibit 3).

So far this year, stocks in the US and Canada have essentially been in a wide trading range, at times rallying on weak economic data and hopes of lower-for-longer monetary policy, and declining on fears the Fed may be getting ever closer to raising rates. More recently global bond yields have moved up significantly from their lows in April and global equity markets have responded with mixed results (see Exhibit 4).

Exhibit 3

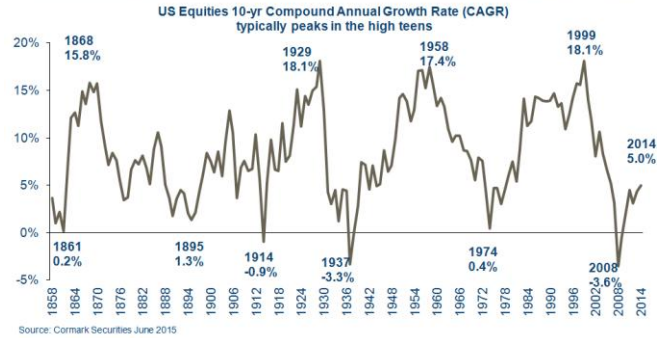
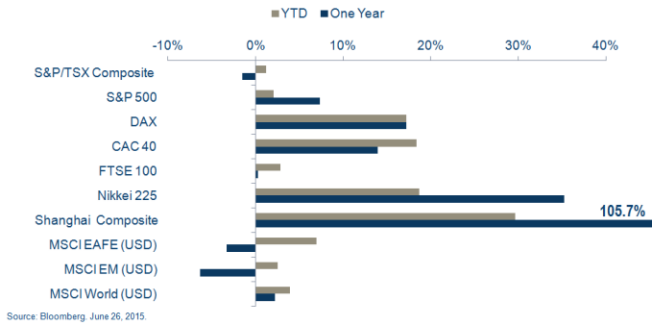


Exhibit 4



PAST PERSPECTIVES

As we face the prospect of a higher Fed Funds rate, historically US equities have responded well. Between 1950 and 2006, the Fed had 10 instances of initial rate hikes and, on average, the S&P500 gained 3.9% and 8.7% three and six months later, respectively (see Exhibit 5). Conventional wisdom would point to the fact that typically in a rising rate cycle the underlying economy is improving and earnings growth picks up.

Exhibit 5

	S&P 500 return to first Fed rate hikes			*...in any period on average*	
	3 mo. before Rate Hike	3 mo. after Rate Hike	6 mo. after Rate Hike	1950-2006 Rolling 3 mo.	1950-2006 Rolling 6 mo.
Mean	3.9%	3.9%	8.7%	2.0%	4.0%
Frequency of Up Markets	60.0%	80.0%	80.0%	65.0%	68.0%
Frequency of Down Markets	40.0%	20.0%	20.0%	35.0%	32.0%
# of Observations	10	10	10	675	672

Source: RenMac Research; 10 historical first rate hikes measured spanning 56 years(1950-2006)

How high can rates go before they become a problem for US equities?

To answer that question, we took various interest rate scenarios, combined with a range of outcomes for S&P 500 earnings, and assumed an equity risk premium (ERP) of 2.5. The analysis implies rising rates do not weigh on price returns until 10 year bond yields hit 3.25% - 3.5%. In Canada, using a similar methodology and setting the ERP just below current levels means 10 year rates can rise about 100 basis points before returns turn negative (See Exhibit 6 and 7).

Historically multiples do not increase when interest rates are rising. Given that on a price-to-earnings basis stocks in both Canada and the US are trading well above historical averages ***we know stocks are expensive. But this analysis highlights that bonds appear even more expensive.*** We believe in the current environment of extraordinary low rates and lofty valuations, the earnings side of the equation is going to have to drive higher equity prices.

Exhibit 6

S&P 500 Fair Value Using Various Earnings Per Share(EPS) and Interest Rate Assumptions

Equity Risk Premium(ERP)	2.75								
S&P 500	2121								
10-year Bond Yields	EPS	118	120	122	124	126	Average	S&P 500 on June 18, 2015	Return
	ERP	2.75	2.75	2.75	2.75	2.75			
2.25		2360	2400	2440	2480	2520	**2440**	2121	**15.0%**
2.50		2248	2286	2324	2362	2400	**2324**	2121	**9.5%**
2.75		2145	2182	2218	2255	2291	**2218**	2121	**4.6%**
3.00		2052	2087	2122	2157	2191	**2122**	2121	**0.0%**
3.25		1967	2000	2033	2067	2100	**2033**	2121	**-4.1%**
3.50		1888	1920	1952	1984	2016	**1952**	2121	**-8.0%**

Rates can rise by nearly 1.0% before pushing expected returns negative

Source: Bloomberg, GLC. June 18, 2015.

Exhibit 7

S&P/TSX Fair Value Using Various Earnings per Share(EPS) and Interest Rate Assumptions

Equity Risk Premium(ERP)	3.00								
S&P/TSX	14771								
10-year Bond Yields	EPS	795	810	825	840	855	Average	S&P/TSX on June 18, 2015	Return
	ERP	3.00	3.00	3.00	3.00	3.00			
1.50		17667	18000	18333	18667	19000	**18333**	14771	**24.1%**
1.75		16737	17053	17368	17684	18000	**17368**	14771	**17.6%**
2.00		15900	16200	16500	16800	17100	**16500**	14771	**11.7%**
2.25		15143	15429	15714	16000	16286	**15714**	14771	**6.4%**
2.50		14455	14727	15000	15273	15545	**15000**	14771	**1.6%**
2.75		13826	14087	14348	14609	14870	**14348**	14771	**-2.9%**

Rates can rise by nearly 1.0% before pushing expected returns negative

Source: Bloomberg, GLC. June 18, 2015.

Implications

We believe asset mixes within a diversified portfolio should remain tilted in favour of equities over bonds with specific risk tolerances.

Within that overall view, we see unique risks and opportunities within various markets.

GLC'S OUTLOOK FOR OVERALL ASSET MIX

Equity returns should outpace bonds

In spite of some risks and likely volatility, with yields still near historic lows, bonds do not present a particularly hard bogey.

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3. Will the US economy move back towards 3% trend growth?

Yes, we think so.

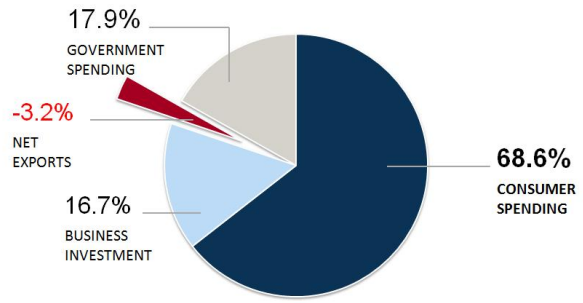
The softness seen in the first quarter from severe winter weather, West Coast port shutdown, strong US dollar, and low oil prices lingered to some extent into the second quarter. The second quarter is likely to come in sub-3% GDP growth, but more recent data is leading us to believe that the second half of the year should be much better. At the top of the list was the May employment report where the US added a much better-than-expected 282,000 jobs in May.

Housing starts have also regained some momentum with the last two months back above the 1 million mark. Some of this could be catch-up from a weak winter, but with an improving jobs market, rising wages, relatively low rates, and easing lending standards the conditions for further improvement are in place. In an additional sign that better days are ahead, May retail sales surprised to the upside gaining 1.3% compared to last year.

With the US consumer sitting on record net worth, reduced debt levels, improving job prospects, and relatively low rates, the conditions are in place for a consumer led recovery. At two thirds of the economy this is important (see Exhibit 8). By contrast, business investment has been lagging. Durable goods orders and industrial production are being held back by reduced investment in the energy sector and the uncertainty created by a strong US dollar. Some of these headwinds could persist as we expect the greenback to remain relatively strong. Offsetting that is the possibility of some relief in energy investment should oil prices find a new range, as we expect it will. The strong dollar will likely continue to weigh on net exports and GDP growth, while the final component of GDP (government spending) is set to increase later this year.

Exhibit 8

Consumer nearly 70% of the US economy (GDP)



Source: U.S. Bureau of Economic Analysis

PAST PERSPECTIVES

There have only been two recessions since 1970 when weekly jobless claims dipped below 300k - 1970 and 1973. But the total labor force in those periods was less than 80 million compared to today at 150 million. Currently, the unemployment rate rose marginally to 5.5% in May, but this was due to an increase in the labour participation rate to 62.9% from 62.8%. Jobless claims remain below 300k and are at their lowest level since March of 2000. Wage growth is also picking up, average hourly earnings advanced 2.3% compared to last year and are now up 3.5% year-to-date annualized.

Taken together we believe the US economy is moving in the right direction back towards a GDP growth rate of 3% in the second half of the year (see Exhibit 9).

Implications

Upward pressure on interest rates.

An improving US economy would mean upward pressure on interest rates and tighter monetary policy.

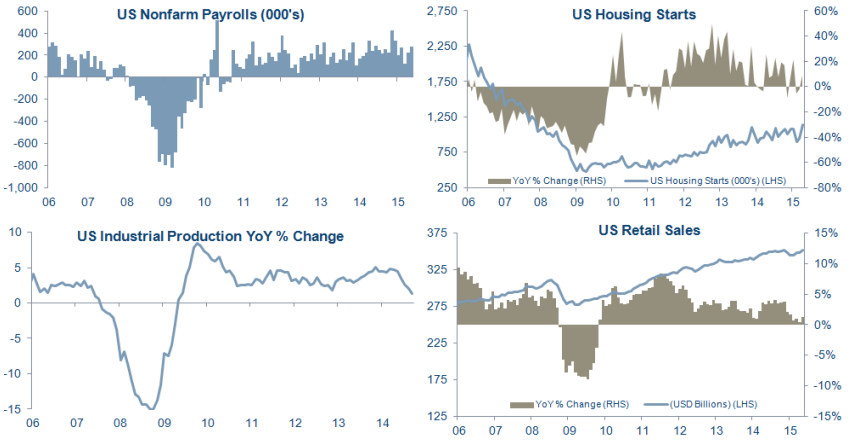
US dollar should remain well bid

In a scenario where we see limited downside to US interest rates, marginally tighter monetary policy and relative strength in economic growth, we find it hard to be bearish on the US dollar. Having said this, we do believe the Fed is wary of some of the negative impacts of a strong currency, and this could impact the timing of when they ultimately raise rates.

US corporate earnings stabilizing

Corporate earnings within the US would stand to improve and stabilize, with the greatest benefit being felt by domestically-focused companies.

Exhibit 9



Source: Bloomberg. June 18, 2015.

PAST PERSPECTIVES

We are mindful of the fact that we could see global growth improve in the second half of the year and historically the US dollar has depreciated in those conditions. However there are exceptions, consider the 90s when global growth accelerated, commodities were relatively flat and the USD was in fact up significantly during the decade.

GLC'S OUTLOOK FOR US EQUITIES[1]

US equities are on pace to post a fourth straight year of gains, but with only modest price upside from now into year-end. Buy the dips.

- *Valuations are elevated. Overall improving economic conditions support ongoing bull market.*
- *We would expect to see some added volatility in the markets as we move towards a rate hike.*

1. See appendix for additional US market insights

4. Have we seen the lows in crude oil prices?

"It would appear for now that a return to the low $40s or worse is not in the cards.

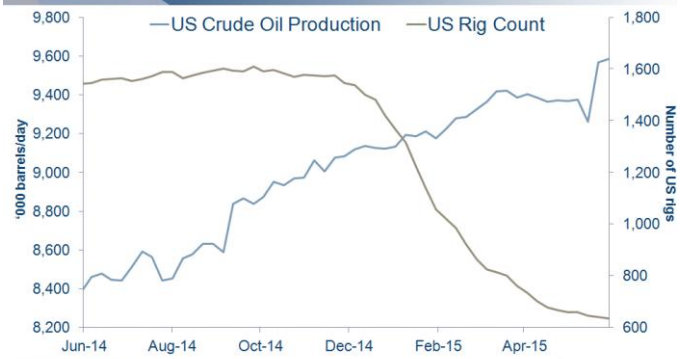
We believe that production in the higher cost basins of US shale and Canadian oil sands (i.e. key sources of supply growth) are not economical at oil prices much below US $60/bbl. At the same time we do not see $100 anytime soon either.

Over the next 6 to 12 months a range of $65 to $75 seems reasonable.

Much can change over time, but the bottom line is 'new' and 'projects currently under construction' did not contemplate sub $70 oil prices, and the economics simply do not work. We consider the following:

- OPEC recently confirmed its commitment to produce up to its 30 million barrel per day quota.
- US production has remained resilient thus far, despite a dramatic drop in number of active oil rigs (see Exhibit 10). We do expect to see some flattening in growth in US shale production, but with technological improvements and a focus on their best plays, US shale producers have stated their intention to increase activity should oil prices move toward US $70/bbl.

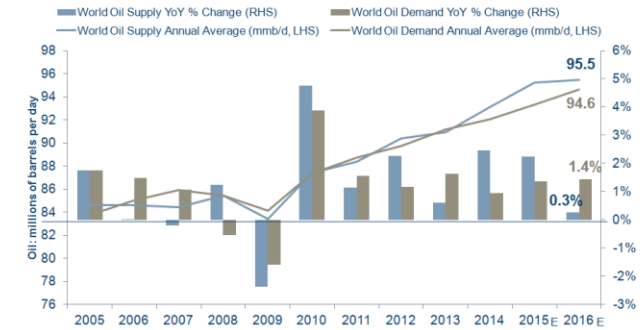
Exhibit 10



Source: Bloomberg. June 18, 2015.

- Due to the long tail nature of investment in Canadian oil sands growth, near-term production growth remains on track for about 6% per annum growth until 2020. Granted, at current prices, longer term growth will be slowed. The Canadian Association of Petroleum Producers (CAPP) reports that capital expenditure in the oil sands will fall by nearly a third to $23 billion in 2015. The industry association also cut its long-term growth forecast by 1 million bbls/day due to low oil prices.

Exhibit 11



Source: Bloomberg. June 18, 2015.

The oil market is currently oversupplied by roughly 2 million bbls/day but at current prices with supply growth expected to moderate and demand to increase, the supply surplus is forecast to decline to just under 1 million bbls/day by the end of next year (see Exhibit 11). As a result we think US $65 to $75 range is a reasonable range over the next six to twelve months.

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Implications

Positive for global economic growth

As we have pointed out in the past, all else being equal, a lower oil price should be positive for the global economy. As a percentage of GDP the largest importers of oil are also the world's largest economies: United States, China, Japan, and the eurozone.

A headwind for the Canadian economy

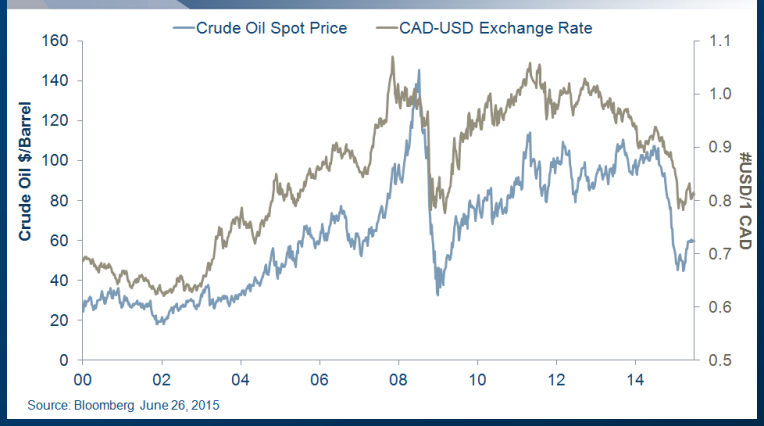
The dramatic drop in oil price has already had a significant negative impact on the Canadian economy. At $65 to $75 we could see stabilization in production and capital expenditures, but we are unlikely to see acceleration in either of those areas. It is also highly likely in oil producing regions like Alberta that housing and employment will continue to struggle. As the Bank of Canada recently highlighted, the risk is further compounded by the higher debt levels in Alberta. The offset for the Canadian economy would be a pick-up in regions like Ontario and British Columbia.

At the end of day, it would appear that the drop in consensus GDP growth forecasts to 1.6% for 2015 adequately account for these factors. This validates to a large extent the widely held view that the drop in oil price will cost the economy about 0.5% in growth in 2015. It also means the Bank of Canada is highly unlikely to raise rates until late 2016, and a rate cut is not out of the realm of possibilities.

HOW WILL OIL PRICES AND OUR MONETARY POLICY AFFECT THE CANADIAN DOLLAR?

Over the next six to twelve months, barring an unexpected spike in oil prices, the Canadian dollar is likely capped in the mid 80 cent range with downside into the mid 70 cents as monetary policies diverge and relative economic strength favours the US (see Exhibit 12). However, we anticipate limited weakness against the euro.

Exhibit 12



WHAT DOES THAT MEAN FOR INVESTORS?

US dollar denominated investments should continue to provide a modest tailwind for Canadian investors, while euro denominated investments will likely need to overcome a modest currency headwind.

PAST PERSPECTIVES

The benefits of lower fuel costs have historically occurred with a one year lag, and oil prices peaked in June of last year. If history holds we would expect the benefits to begin to accrue in the second half of this year. In the US it is estimated the combination of gasoline and heating oil savings amount to US$700 to $1000/household annually. Given there are approximately 115 million households in the US, that amounts to $80.5 to $115 billion in total otherwise available for spending or saving. To this point we have not yet seen spending accelerate and in fact the savings rate has increased to 5.6% from 4.5% late last year (see Exhibit 13). Perhaps the improvement in May's retail sales as well as personal spending data are early signs of improved consumer consumption, and in line with the timelines experienced in the past.

Exhibit 13

GLC'S OUTLOOK FOR CANADIAN EQUITIES[2]

2015 will likely result in low to mid single digit total returns for the broader Canadian index

- *Canadian equities face a resource headwind and high valuations in non-resource sectors pose a challenge as well.*
- *The financial sector looks attractive on a risk/reward basis and should provide some ballast for our resource-heavy market.*
- *Stock selection will be key and the value of active versus passive management will be reflected in the results for Canadian equity investors this year.*

2. See appendix for additional Canadian market insights

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5. What are the opportunities outside of North America?

We continue to prefer developed markets over emerging markets.

In Europe, equities have had a strong start to the year, undoubtedly helped by the ECB's aggressive monetary policy and the depreciation of the euro. More recently, worries about Greece have created some uncertainty. On June 26th Greece's Prime Minister called a July 5th referendum asking the Greek people to vote on the latest bail out offer from the IMF, ECB, and European Union. Keeping in mind that whatever the outcome, Greece's problems will not be solved and restructuring in Greece will be ongoing. In any event Greece is a relatively small economy representing approximately 0.3% of global GDP. There are some fears that a Greek default and exit from the euro would result in other periphery European countries to also choose default over austerity.

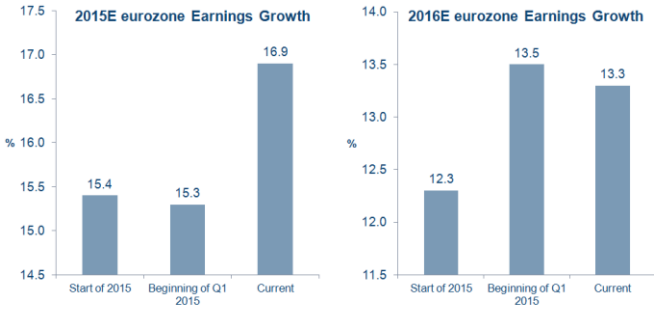
Although not out of the realm of possibility, the eurozone is much better equipped to handle a speed bump from Greece now than it was several years ago. More importantly, inflation fears have abated to some degree and growth is showing signs of improvement. From an equity perspective, fundamentals for European equities are improving.

Consensus expectations for 2015 earnings growth now sits at 16.9% (up from 15.3% to start the year) and 2016 earnings are expected to grow 13.3%. With 80% of companies in the STOXX600 having now reported Q1 2015 earnings, 58% beat expectations for earnings compared to a long-term average of 53%. This is the strongest result since Q3 2010. Earnings revisions are also improving (see Exhibit 14).

In Japan, although the economy has been slower to improve, accommodative monetary policy has put downward pressure on the currency and helped corporate earnings. Corporate governance standards are also aiding sentiment. With the government committed to maintaining an accommodative stance and a positive technical backdrop, the Nikkei looks poised for further gains.

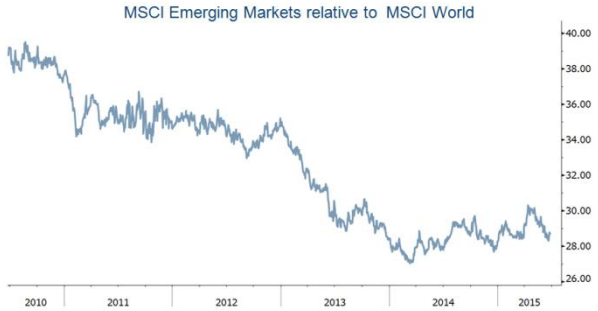
On the other hand we remain cautious on emerging markets. We believe that slowing growth in developing markets, coupled with the eventual tightening of US monetary policy, will serve as a headwind for this group (see Exhibit 15). It is important to note that emerging markets are not a homogenous group. In today's low-price commodity environment, commodity consuming nations (such as those in Southeast Asia) are benefitting, while the commodity producers (like Russia and Brazil) are not. China has been a big driver of emerging market returns, gaining 29.6% year-to-date and nearly 105.7% in the last year.

Exhibit 14



Source: BofA Merrill Lynch Global Research, European Quantitative Strategy, MSCI, IBES, May 15, 2015.

Exhibit 15



Source: Bloomberg. June 26, 2015.

The smaller cap-oriented Shenzen index has nearly tripled in the past year. These gains are occurring despite a clear downward step change in China's economic growth trajectory (see Exhibit 16). Rather the gains have been driven largely by retail investors speculating that Chinese authorities will continue to ease monetary and fiscal policy.

- The People's Bank of China has lowered rate three times since November and the Reserve Requirement Ratio twice.
- Retail investors only own 20% of the outstanding market cap, but have accounted for 80% of the trading volume.
- Brokerage accounts are being opened at a record pace with 4.5 million new accounts opened in the week ending May 29th (see Exhibit 16).
- Margin lending has increased by 120% this year alone (margin debt in the US is also at record levels but its rate of increase is 11%).
- Chinese equities have added US $6.5 trillion in value in the last year, exceeding the entire US $5 trillion value of Japanese equities.

We do not know when the surge in Chinese equities will end, but with so much based on investor speculation we have a hunch how (hint: Not well). As a result we recommend a heightened level of caution around Chinese equities.

Exhibit 16

Implications

International equity exposure should be tilted towards developed markets like Europe and Japan relative to emerging markets.

GLC'S OUTLOOK FOR INTERNATIONAL EQUITIES

Strategically we upgraded our outlook on Europe earlier in the year and we continue to hold that view.

- *European economy is improving at the margin.*
- *Underlying economic risks within the eurozone are still present but ECB QE program is driving equities higher*
- *Tactically we would be inclined to be more positive if uncertainty surrounding Greece creates further downward volatility, but would not chase any deal driven strength*

Japanese equities are likely to perform as well as European and US equities in local currency terms, and we believe some exposure is warranted.

- *The government appears committed to maintaining an accommodative stance, and from a technical perspective, the Nikkei Index looks poise for further gains.*

We remain cautious on emerging markets as they continue to struggle versus global equities

- *Gains in China look unsustainable and the region (while not a homogeneous group) faces currency and debt headwinds as well.*

6. Is the bull market in bonds over?

"The secular downward trend in bond yields that started in the early 80's has in all likelihood come to end.

With the benefit of hindsight, history will likely mark the secular low in rates as far back as July 2012, when the US 10 year Treasury hit 1.387%. Yields have dipped twice since, into the 1.6% range in May 2013 and February 2015, but we believe a new higher range has been established.

With the recent rise in yields globally, the US 10 year Treasury broke decisively above its 200 day moving average, which should now act as significant support. The 50 day moving average has now pushed through the 200 day moving average, which gives further confidence that the downward trend in yields has been broken (see Exhibit 17).

With unprecedented levels of monetary accommodation and a myriad of other factors (e.g. demographics, flight to safety, diminishing supply, and pension fund immunization) the relationship between nominal yields and nominal growth has broken down (see exhibit 18). We believe the combination of the diminishing fears of global deflation and a 2015 US rate lift-off, has turned the tide on falling yields.

The move has been most dramatic in Europe, and in particular Germany where 10 year Bund yields have gone from near-zero to as high 1% since mid-April (see Exhibit 19).

The pace of yield increases is likely to moderate from here, but rates should trend gradually higher over the next six to twelve months.

Admittedly we have held this stance for the better part of two years. We see US 10 year Treasuries at a minimum achieving the range we set out earlier in the year of 2.5% to 2.75%. ***Rate increases in Canada will likely lag the US given policy differences and a more modest recovery***, but we see Canadian yields also moving up in line with our view from 2.1% to 2.35% on Canadian 10 year bonds.

Exhibit 17

Exhibit 18

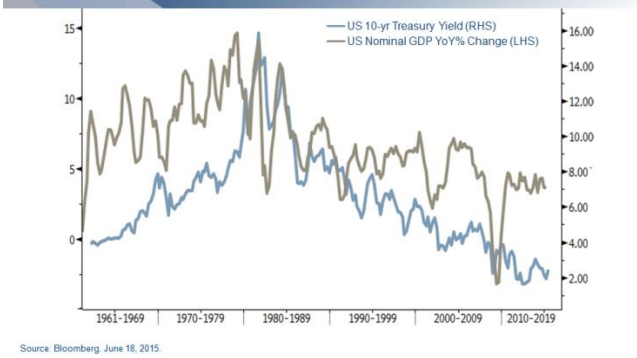
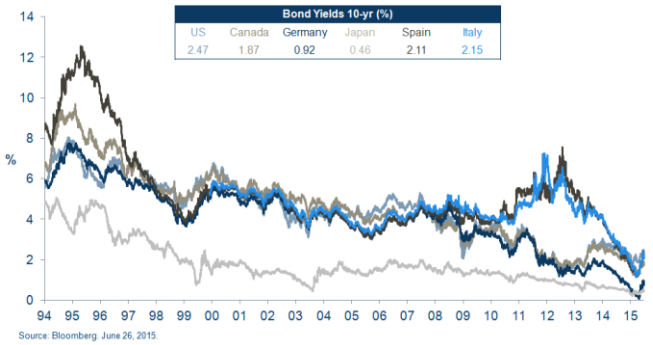


Exhibit 19



Implications

Bond investors should have modest total return expectations, recognizing that negative returns (as we have had since mid April) are a distinct possibility in 2015 (see Exhibit 20).

Exhibit 20

As a result ***we continue to advocate a bias to the shorter end of the curve and exposure to higher quality investment grade corporate bonds*****.** In line with our position, these are areas which have outperformed in the most recent yield back up.

We remain cautious on the high yield bond market and have identified this as one area where risk has been mispriced in investors' insatiable appetite for yield. To that end, we are starting to see high yield spreads in the US move up off their lows, putting downward pressure on returns for high-yield bond holders.

One of the key risks facing institutional bond investors is the apparent reduction in liquidity. Since the financial crisis, banking regulation (particularly in the US) has focused on increased capital and liquidity requirements. For example, banks in the US are no longer permitted to engage in "prop" trading (trading for their own account). The result of these regulations is that banks do not have the same flexibility to 'make markets' and liquidity has been reduced, especially in debt markets. It has been reported that dealer inventories of corporate bonds are down 90% since 2001, despite the amount of corporate debt outstanding having doubled. The lack of liquidity was cited as a factor in the 'flash crash' in yields last October, as well as this most recent sharp back-up in yields. ***Liquidity is something that doesn't matter until it is needed. As this old market axiom articulates "Liquidity is a coward. When you need it most, it runs away and hides."***

GLC'S OUTLOOK FOR YIELDS

We believe a higher trading range for yields has been established with a gradual upward bias.

- *We advocate a bias to the shorter end of the yield curve as rates rise with an improving global economy*

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Appendix

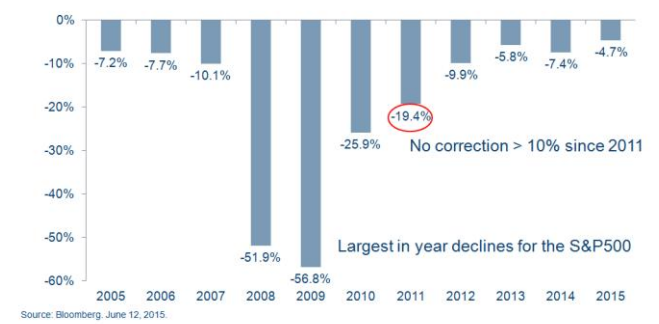
US EQUITIES

Given the market's reliance on lower-for-longer and diverging monetary policies globally, ***we expect to see some added volatility in the markets as we move towards a rate hike.***

Stocks have historically done reasonably well at the beginning of a rate hiking cycle. Large caps, technology, and health care have tended to outperform during past rate hikes. We would expect areas of the market that have been used as bond proxies (like telecoms, utilities and pipelines) to struggle in a rising rate environment. In the yield space, companies that have a strong record of growing their dividends would also be expected to do well in a rate hike cycle. The caveat being that there are always exceptions to history.

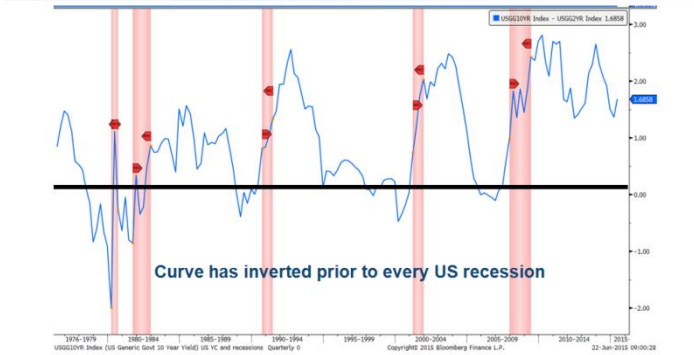
Although US equities have not had more than a 10% correction since the fall of 2011 (see Exhibit 21), bull markets do not typically die of old age. According to data from RBC Dominion Securities, the duration of the current bull run is not unprecedented. The October 1990 to October 1997 and March 2003 to October 2007 were both longer and produced higher returns.

Exhibit 21



We do not rule out a market correction and have been on record that a correction would be healthy. However, bull markets typically end due to recessions and we simply do not see the conditions present for a recession. The primary example is the steepness of the yield curve. The yield curve has inverted prior to every recession and we are long way from the curve inverting (Exhibit 22). Other economic indicators we follow (e.g. manufacturing surveys and labour market) are also not signalling a recession.

Exhibit 22



Earnings growth for the S&P500 has stalled due to several headwinds, not the least of which is the strong US dollar. It looks like analysts were overly punitive in their downward revisions for the first quarter as 72% of companies listed on the S&P500 beat analysts' earnings expectations. With valuation well above historical averages, earnings will be relied upon to drive stock value gains as multiple expansions are unlikely to do so. Current consensus is calling for approximately 4% earnings growth this year (see Exhibits 23 and 24).

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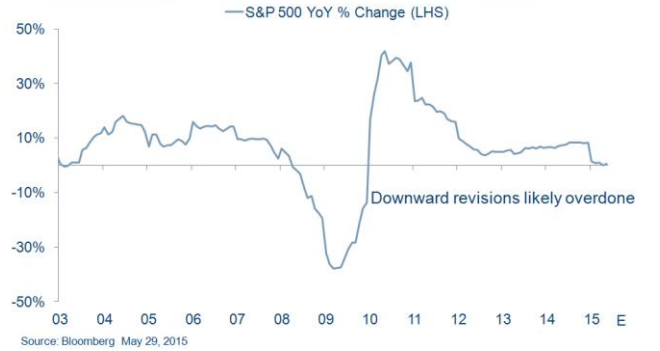
Exhibit 23

Exhibit 24



We believe in USD terms there is only modest price upside into year-end, but with some help from the currency and a 2% dividend yield, high single digit returns are likely achievable.

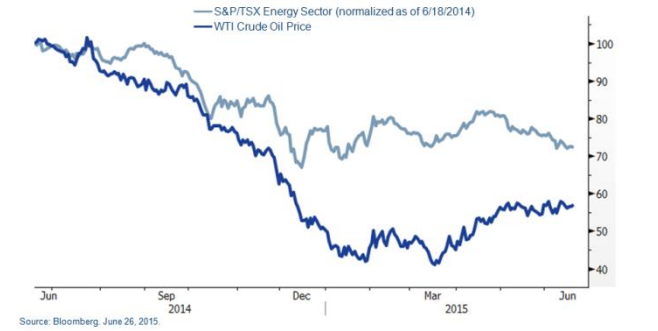
CANADIAN EQUITIES

In light of the fact that we do not expect the Bank of Canada to start raising rates until sometime later into 2016 at the earliest, the rate hike cycle may not be as big a factor for Canadian equities. We do however see a number of conditions that pose a challenge for Canadian equities in the months ahead.

- The drop in oil prices has hit the energy sector. Crude oil has rallied roughly 26% from the March lows, but at around US$60/bbl it is still off 43% from its July 2014 high. However, energy stocks have held in much better than crude oil prices (see Exhibit 25). The share prices of many oil producers indicate oil prices north of US $70/bbl are already being factored in**.**

If oil prices move up from here we would expect sentiment to lift stocks, but in our view upside is limited if oil trades in our assumed range of US$65-$75/bbl.

Exhibit 25



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- In the materials sector ***we do not see evidence that base metal or gold stocks are poised to rally.*** Neither technical nor fundamental indicators point to an imminent turn in the underlying commodity prices (e.g. the copper price remains in a well defined downtrend and the supply/demand balance is expected to remain in surplus for the next several years).
  - We see limited reasons for gold bullion to trade materially higher from current levels. Gold bugs would point to accommodative monetary policy, the diminishing faith in the fiat monetary system, and inevitable inflationary pressures from the monetary printing presses, as sure signs that the price of gold is headed much higher in the years to come. Maybe one day, but ***looking out 6 to 12 months, with higher interest rates, a higher US dollar, and moderate inflation, gold bullion's day to shine again remains beyond our forecast horizon.*** From a stock perspective, with limited upside from the commodity price, companies are going to have to prove they can consistently produce free cash flow and generate returns in excess of their cost of capital to coax generalists (as opposed to the gold bugs) back into the sector.
  - We would echo these comments for base metal producers as well. The metals and mining industries represent only 7% of the index today compared to 15% in June of 2011. But we do acknowledge that stock valuations are at the lower end of historical averages, and if global growth begins to accelerate into the 2016 (particularly in China) we would revisit our position.
- One area of the market that we think should provide some stabilization is the financial sector at 35% of the index. As a group they are trading at or below historical valuation metrics against a modest earnings outlook of mid-single digit growth. There are some headwinds (particularly with respect to Canadian banking operations) such as regional housing risks and the impact of low oil prices. But all in, we think these risks are quite manageable. Keep in mind the Big 5 Canadian banks all have operations outside of Canada. In addition, the Big 5 have an average dividend yield of 4%, and over the past 5 years have grown their dividend at a CAGR of 5.9%. Insurance companies will also benefit if longer-term interest rates continue to rise. While we may see some pressure on the REIT sector, ***we think financials are attractive on a risk/reward basis and globally financials are performing well on a relative basis (see Exhibit 26).***

Exhibit 26

Sector	Sector Weight	Dividend Yield	YTD Return	Forward P/E	Forward P/E 10-yr Avg.
Energy	20.2%	3.8%	-5.7%	62.8	19.2
Materials	10.9%	2.1%	1.8%	25.3	18.0
Industrials	8.0%	1.6%	-6.4%	15.6	16.0
Consumer Discretionary	6.7%	1.8%	6.0%	17.0	15.1
Info Technology	2.4%	0.7%	7.6%	20.5	21.1
Health Care	6.0%	0.1%	59.9%	20.4	17.7
Financials	35.2%	3.6%	-0.7%	12.4	12.6
Consumer Staples	3.8%	1.2%	3.1%	19.6	16.1
Telecom	4.7%	4.5%	-2.0%	15.7	15.1
Utilities	2.1%	4.4%	-5.4%	20.5	19.1
S&P/TSX Composite		**2.9%**	**0.7%**	**18.3**	**15.2**

Source: Bloomberg. June 12, 2015.

- If we look outside of financial and resource sectors to the consumer discretionary, consumer staples, industrials, health care and information technology sectors, the underlying fundamentals are solid, however valuations in many cases are above historical averages (see Exhibit 26).

In light of our varying sector views, we firmly believe that stock selection will be key and the value of active versus passive management will be reflected this year.

Overall we are sticking with our view that ***2015 will likely result in low to mid single digit total returns for the broader Canadian index.*** As we move through the year and earnings growth starts to stabilize from the current 10% year-over-year drop (see Exhibit 27), we think there is a good possibility that we can look forward to higher returns into 2016.

Exhibit 27