2017 Economic and Financial Outlook

(Executive Summary)

For most of 2016, until mid-Fall, the US$ retreated from the gains it had made in 2015. Following the late 2014 Fed's guidance that it would raise the Federal Funds rate eight times over the following two years, the US$ quickly appreciated against all major currencies. However, after having raised its policy rate only once by the end of 2015, the market discounted the Fed's guidance for more rate increases. Eventually, early in 2016, the Fed announced much more modest targets for the Federal funds rate for the rest of the year. As a result, in 2016, the U.S. dollar gave back some of the gains it had made in 2015. The strong dollar in 2015 had contributed to lower the U.S. growth outlook for 2016 and justified the Fed's less aggressive policy stance, going forward.

By the end of 2016, the U.S. dollar resumed its upward trajectory when it became clear that the Fed would finally tighten again. The removal of monetary accommodation and the greenback appreciation should continue in 2017. We expect the Fed to remain prudent in terms of the number of hikes it is anticipating for next year and beyond. The Fed will want to avoid provoking another disproportionate US$ appreciation which could force it, once again, to backtrack from its guidance. Depending on the fiscal measures Donald Trump and the U.S. Congress will agree on in early 2017, U.S. growth could surprise to the upside. Yet, we expect that, this time, the Fed will remain behind the curve to prevent another surge in the U.S. dollar.

Domestically, the Bank of Canada is likely to keep short term rates low and, potentially, even ease further if Canada's growth outlook deteriorates. Yet, Canadian long term rates will continue to face upward pressures. The Bank of Canada may have effective control on the very short end of the yield curve but the country remains largely a "price-taker" for longer term maturity bond instruments, for which prices are determined on the global bond market. In 2017, expansionary U.S. fiscal policy and a tampering of Quantitative Easing in Europe, will contribute to increasing long term interest rates globally and Canada will have a difficult time escaping it.

At the end of 2015, we turned neutral on equities and advised investors to proceed with caution in the near-term as our dashboard of financial and economic indicators pointed to a worrying set of signals. This recommendation proved profitable as global equities largely underperformed bonds early in 2016 as rising speculation of a possible U.S. recession, a deterioration in global economic prospects and market volatility all weighted on investors' outlook.

On the other hand, following the Brexit vote, we noted in late June that market sentiment had turned extremely bearish, with key indicators reaching levels similar to those achieved during past recessions and financial crises. With the economic backdrop then more positive than in 2008-09, for instance, and many leading economic indicators already on the upswing, we then recommended to overweight equities. This recommendation proved profitable, with equities largely outperforming bonds since late June.

We remain overweight equities as we expect earnings growth to continue to accelerate in the quarters ahead. The still-rising S&P 500 forward profit margins, steepening yield curve and the rebounds in both the ISM Manufacturing and the Global ZEW Current Conditions indices, are all supportive of a continued pick-up in earnings growth.

Moreover, despite the recent surge in bond yields, stocks still appear cheap relative to bonds as the S&P 500 earnings yield remains historically high relative to the effective yield of U.S. corporate high-yield issuers. Finally, market internals remain positive with corporate spreads still in tightening mode and capital market, transportation and weak balance sheet stocks, continuing to outperform.

In terms of regional allocation, U.S. and Canadian equities still figure as our favored regions since we decided to implement an overweight position in equities. This proved to be a profitable decision with both regions outperforming global equities during the period. Accelerating EPS growth and hopes for corporate tax reform and infrastructure spending should continue to stimulate U.S. outperformance. Also, late during the month of November, OPEC reached an agreement to cut oil production by 1.2 mb/d from October levels, which was the first cut in eight years. This deal should be supportive of higher oil prices and should contribute to the outperformance of Canadian equities.

For the most part, we believe that, in spite of the heightened uncertainty, global growth will pick up in 2017 and benefit equities.

- We expect the commodity rally to continue in 2017, especially in the oil sector. We forecast the WTI to reach $US68 per barrel by year-end. Our positive oil outlook for 2017 is, of course, conditional on OPEC members holding to the promised cuts as well as non-OPEC countries joining the agreement to reduce production, to swiftly reduce excess oil inventories.
- We expect gold prices to continue falling in 2017 with a mid-year target of US$1100. Yet, if the Fed remains behind the curve and inflation expectations start increasing, this trend could see a reversal in the second half.
- After another bad year, *forestry and agriculture stocks* (e.g. fertilizers) should recover in the U.S. and Canada amid the strong demand growth for such products, in emerging countries. A reversal should provide a good entry point.
- So far, with two weeks to go before year-end, the financial sector offered the second best performance in the S&P 500, beating the index by more than 10% and outperforming the return offered by the TSX (20.2% vs. 17.2%). The financial sector should continue its ascent in the new year.
- While we caution investors against the sector due to the rising rate environment, REITs are excellent hedges against inflation and their yield is expected to remain higher than that of long term government bonds. We recommend establishing positions in the REITS sector on weaknesses and as a diversifying strategy in a very volatile market.
- We expect consumer staples and discretionary to outperform in the U.S. and to underperform in Canada.
- The Canadian dollar, which regained some ground due to higher oil prices, but which remains weak compared to where it stood less than two years ago, should trade within a wide range during 2017. If the CA$ were to cross the 1.25 threshold, we think that the Bank of Canada would be inclined to lower rates.
- The bottom line is that while the Canadian dollar will be volatile next year, it should remain sufficiently weak to increasingly benefit large Canadian exporters at the expense of domestically oriented businesses.

Finally, as in previous years, we caution readers there are risks to the above economic perspectives and market forecasts. First, global growth could falter as China and the U.S. enter a trade war. And second, US$ borrowing in emerging markets to take advantage of low U.S. interest rates could cause havoc on the markets as the domestic value of these debts risks swelling to unstainable levels as the US$ appreciates.

2017 Economic and Financial Outlook

The rapidly appreciating US$ is back at the forefront of our preoccupations as its dynamics is dictated by developing financial market conditions and increased political uncertainty. Its evolution in 2017 will be crucial to the absolute and relative performance of financial markets and that of the different regional economies.

For most of 2016, until mid-Fall, the US$ retreated from the gains it had made in 2015. Following the Fed's guidance in late 2014 that it would raise the Federal Funds rate eight times over the following two years, the US$ quickly appreciated against all major currencies. However, after having raised its policy rate only once by the end of 2015, the market discounted the Fed's guidance for more rate increases. Eventually, early in 2016, the Fed announced much more modest targets for the Federal funds rate for the rest of the year. As a result, in 2016, the U.S. dollar gave back some of the gains it had made in 2015 as we had forecast in our 2016 outlook. We had written in December of last year: "In the short-run, … there is a probability that the CA$ will appreciate back to the 1.30 level on the dovish stand of the Fed early in the year". The strong dollar in 2015 had contributed to lower the U.S. growth outlook for 2016 and justified the Fed's less aggressive policy stance going forward.

We had also forecast that by the end of 2016, the U.S. dollar would pursue its upward trajectory when it would become clear that the Fed would finally tighten again. And indeed, as the U.S. growth outlook finally improved and the likelihood grew that the Fed would increase its policy rate at its FOMC meeting last week, on December 14th, the US$ strengthened.

The removal of monetary accommodation and the greenback appreciation should continue in 2017. But we expect the Fed to remain prudent in terms of the number of hikes it is anticipating for next year and beyond. The Fed will want to avoid provoking another disproportionate US$ appreciation which could force it, once again, to backtrack from its guidance and lose even more credibility. Depending on the fiscal measures Donald Trump and the U.S. Congress will be able to agree in early 2017, U.S. growth could surprise to the upside. Yet, we expect that, this time, the Fed will remain behind the curve to prevent another surge in the U.S. dollar; at least until it becomes clear that some fiscal measures have received the green light from Congress.

Domestically, the Bank of Canada is likely to keep short term rates low and, potentially, even ease further in the event of a deterioration of Canada's growth outlook. Yet, Canadian long term rates will continue to face upward pressures. The Bank of Canada may have effective control on the very short end of the yield curve but the country remains largely a "price-taker" for longer term maturity bond instruments, for which prices are determined on the global bond market. The evolution of long term global interest rates is mostly determined by what is happening on the American, European and Japanese bond markets. In 2017, expansionary U.S. fiscal policy and a tampering of Quantitative Easing in Europe (although Mario Draghi just announced that the BCE would extend its QE program beyond next April) will contribute to increasing long term interest rates globally and Canada will have a difficult time escaping it.

This will likely tighten financial conditions in our already highly-leveraged economy and provide further justifications for the Bank of Canada to lower its policy rate; even more so in the event that a rising Canadian dollar would threaten to further tighten such conditions.

At the end of 2015, we also turned neutral on equities and advised investors to proceed with caution in the near-term as our dashboard of financial and economic indicators pointed to a worrying set of signals. Negative contributors to our equity/fixed income call then included the indefatigable widening of credit spreads in the corporate bond market, the persistent decline in the ISM Manufacturing index and upward earnings revisions, the outperformance of strong balance sheet stocks and the increasing pressure on corporate profit margins. Combined, these indicators suggested potential headwinds for equities in the near term. This recommendation proved profitable as global equities largely underperformed bonds early in 2016 as rising speculation of a possible U.S. recession, a deterioration in global economic prospects and market volatility all weighted on investors' outlook.

On the other hand, following the Brexit vote, we noted in late June that market sentiment had turned extremely bearish with key indicators reaching levels similar to those achieved during past recessions and financial crises. With the economic backdrop then more positive than in 2008-09, for instance, and many leading economic indicators already on the upswing, we then advised investors that global equities probably hit a bottom and recommended to overweight equities for the first time since late 2015. This recommendation proved profitable, with equities largely outperforming bonds since late June.

We remain overweight equities as we expect earnings growth to continue to accelerate in the quarters ahead. As mentioned in our previous monthly asset allocation updates, accelerating earnings growth historically tends to coincide with rising equity prices. The still rising S&P 500 forward profit margins, steepening yield curve and the rebounds in both the ISM Manufacturing and the Global ZEW Current Conditions indices, are all supportive of a continued pick-up in earnings growth.

Moreover, despite the recent surge in bond yields, stocks still appear cheap relative to bonds as the S&P 500 earnings yield remains historically high relative to the effective yield of U.S. corporate high-yield issuers. Finally, market internals remain positive with corporate spreads still in tightening mode and capital market, transportation and weak balance sheet stocks, continuing to outperform. Another indicator signaling that the U.S. economy continues to move in the right direction is the current uptrend in the U.S. new home sales-to-initial jobless claims ratio. Historically speaking, peaks in this indicator historically tend to lead downturns in equity prices.

In terms of regional allocation, U.S. and Canadian equities still figure as our favored regions since we recommended last June decided to implement an overweight position in equities. This proved to be a profitable decision with both regions outperforming global equities during the period. Accelerating EPS growth and hopes for corporate tax reform and infrastructure spending should continue to stimulate U.S. outperformance. Also, late during the month of November, OPEC reached an agreement to cut oil production by 1.2 mb/d from October levels, which was the first cut in eight years. This deal should be supportive of higher oil prices and should contribute to the outperformance of Canadian equities.

As for our Canadian bond allocation, since we started to recommend investors to overweight corporate bonds against Canadian government back in late April, credit spreads have significantly tightened. We then turned constructive on corporate bonds on the back of attractive valuations and all-in yields, especially in the context of our expectations for a re-acceleration in earnings growth during the second half of 2016. A strong Q3 corporate earnings season reinforced our thesis as 76% of S&P 500 companies beat EPS estimates, surprising positively by 6%.

Companies in the S&P 500 also reported a positive year-over-year EPS growth rate for the first time since Q2 of 2015, basically ending the profits recession that lasted for five consecutive quarters. Our thesis for accelerating economic and earnings growth also received a major boost from Donald Trump's election on hopes that the new administration will be able to dramatically boost economic growth thanks to the prospect of deregulation, tax cuts and infrastructure spending.

Also, in early August, we noted that the large fall in inflation expectations was overdone in the absence of a recession and a coming pick-up in economic activity should lead to some firming in the inflation outlook, or at least an unwind of the deflation premium that is priced into inflation expectations. In other words, this represented an opportunity to take the other side of too pessimistic expectations by being long breakevens or short government bonds. This again proved to be a profitable call as inflation expectations and yields rebounded during the remainder of the year.

For the most part, we believe that, in spite of the heightened uncertainty, global growth is expected to pick up in 2017, mostly in the U.S. and Canada and in some EM economies. Like last year, **a switch from cyclical to more defensive sectors could be warranted later in the year if protectionism makes further inroads or if rising political risks in Europe lead to a new protracted period of financial market turbulence.**

- Last year, we expected the energy and mining sectors to rebound in the second part of the year. After collapsing in January more than anybody expected, they bounce back even earlier than we would have thought; energy and materials were indeed among the top performers in both Canada and the U.S. in 2016. **We expect the commodity rally to continue in 2017, especially in the oil sector. We forecast the WTI to reach $US68 per barrel by year-end** but remain worried about the oil market beyond 2018 as non-OPEC production is still increasing on the back of yet-to-be-completed projects initiated before 2014. Our positive oil outlook for 2017 is of course conditional on members of OPEC holding to the promised cuts as well as non-OPEC countries joining the agreement to reduce production to swiftly reduce excess oil inventories.

- We also expected that 2016 would see gold prices and gold producers to be under pressure as they usually underperform in a rising interest rate environment. Yet, as the Fed could not find an opportunity to raise its policy rates in 2016 before December 14th, gold over performed in the first half part of the year before giving back half of its gain in the second half. **We expect gold prices to continue falling in 2017 with a mid-year target of US$ 1100. Yet, if the Fed remains behind the curve and inflation expectations start increasing, this trend could see a reversal in the second half.**

- After another bad year, ***forestry and agriculture stocks*** (e.g. fertilizers) should recover in the U.S. and Canada amid the strong demand growth for such products in emerging countries. A reversal should provide a good entry point. However, the US-Canada lumber dispute poses a risk for forestry stocks.

- We had predicted in our 2016 outlook that the financial sector would over performed the overall market with a focus on US banks and insurance companies. So far, with two weeks to go before year-end, the sector offered the second best performance in the S&P 500, beating the index by more than 10% and outperforming the return offered by the TSX (20.2% vs. 17.2%). **The financial sector should continue its ascent in the new year.**

- We also had good calls with the REITS sector which performed well early in the year yet gave back some of its gain as interest rates started to rise in the summer. While we caution investors against the sector due to the rising rate environment, REITs are excellent hedges against inflation and their yield is expected to remain higher than that of long term government bonds. **We recommend establishing positions in the REITS sector on weaknesses and as a diversifying strategy in a very volatile market.**

- We were negative last year on the consumer sectors in Canada, less so in the U.S. **We maintain our call for 2017 as we expect consumer staples and discretionary to outperform in the U.S. and to underperform in Canada. This call is supported by record-high household debt and soft household income growth in Canada whereas the reverse conditions prevail south of the border.**

- The **Canadian dollar**, which regained some ground due to higher oil prices but which remains weak compared to where it stood less than two years ago, **should be range bound during 2017. We anticipate this range to be quite wide**: On the one hand, the loonie could revisit the 1.40 level on the back of the Fed raising rates while the Bank of Canada could potentially be lowering its discount rate within the next few quarters to fight a sluggish recovery. On the other hand, higher oil prices and potentially faster than expected growth south of the border could boost our exports and push the CA$ towards 1.25. However, in order to prevent a stronger Canadian dollar to derail a fragile recovery, the Bank of Canada could intervene to prevent the value of the currency to get ahead of itself. Again, like last year, if the CA$ were to cross the 1.25 threshold, we think that the Bank of Canada would be inclined to ease.

- The bottom line is that while the Canadian dollar will be volatile next year, it should remain sufficiently weak to increasingly benefit large Canadian exporters at the expense of domestically oriented businesses.

Finally, as in previous years, we caution readers there are risks to the above economic perspectives and market forecasts.

Global growth could falter as China and the U.S. enter a trade war. This could force a disorderly devaluation of the Yuan which already lost more 10% against the US$ since the PBOC effectively put an end of its peg in August on 2015.

The appreciation of the U.S. dollar in 2017 has many drawbacks aside from diming the U.S. growth outlook. First, a deteriorating trade deficit could incite Donald Trump to adopt more protectionist measures. Second, US$ borrowing in emerging markets to take advantage of low U.S. interest rates has grown considerably in recent years could cause havoc on the markets as the domestically value of these debts risks swelling to unstainable levels as the US$ appreciates; an event which could potential create financial instability as well as prolong the downturn in commodity-producing countries. Accordingly, investors need to monitor net capital flows to Emerging Market economies.

If such an outcome (or other geopolitical events) were to hamper world trade and the free flow of goods and services around the globe, a global recession could ensue. In almost all of these circumstances, although there would be no place to hide completely from the crisis, the American economy and the U.S. dollar would most likely represent the safest haven but recent stock market gains would vanish and interest rates would probably achieve new lows.

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	Performance (%)	
Sectors	YTD	Q4-to-date
S&P 500	10.5	4.1
Energy	25.6	8.2
Financials	20.8	21.2
Industrials	16.8	7.3
Materials	15.9	5.8
Telecommunication Services	15.7	1.7
Information Technology	13.0	1.7
Utilities	11.9	-1.0
Consumer Discretionnary	6.1	3.6
Consumer Staples	3.4	-1.9
Health Care	-3.3	-3.4

	Performance (%)	
Sectors	YTD	Q4-to-date
S&P/TSX Composite	17.2	3.6
Energy	32.8	7.6
Materials	31.3	-11.7
Industrials	20.6	4.8
Financials	20.2	11.4
Utilities	11.8	-2.2
Consumer Discretionnary	10.1	2.8
Telecommunication Services	8.6	-5.0
Consumer Staples	6.6	-1.4
Information Technology	3.5	-1.6
Health Care	-80.0	-33.3

Financial Forecasts

	14Q4	15Q1	15Q2	15Q3	15Q4	16Q1	16Q2	16Q3	16Q4	17Q1	17Q2	17Q3	17Q4
Canada													
Overnight Rate Target	1.00	0.75	0.75	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
3-Month Treasury Bills	0.91	0.55	0.58	0.43	0.51	0.45	0.50	0.52	0.50	0.50	0.50	0.50	0.60
2-Year Bond	1.01	0.51	0.49	0.53	0.48	0.54	0.52	0.54	0.80	0.65	0.70	0.75	0.80
5-Year Bond	1.34	0.77	0.81	0.81	0.73	0.68	0.57	0.61	1.20	1.10	1.15	1.20	1.10
10-Year Bond	1.79	1.36	1.68	1.45	1.39	1.23	1.06	1.19	1.80	1.65	1.75	1.80	1.85
30-Year Bond	2.33	1.99	2.31	2.21	2.15	2.00	1.71	1.85	2.40	2.30	2.45	2.50	2.55
United States													
Federal Funds Rate Target*	0.125	0.125	0.125	0.125	0.375	0.375	0.375	0.375	0.625	0.625	0.875	0.875	1.125
3-Month Treasury Bills	0.04	0.03	0.01	0.00	0.16	0.21	0.22	0.33	0.55	0.55	0.70	0.80	1.00
2-Year Bond	0.67	0.56	0.64	0.64	1.06	0.76	0.59	0.76	1.20	1.10	1.20	1.40	1.60
5-Year Bond	1.65	1.37	1.63	1.37	1.76	1.21	1.00	1.24	2.00	1.85	1.95	2.00	2.10
10-Year Bond	2.17	1.94	2.35	2.06	2.27	1.78	1.46	1.59	2.55	2.35	2.50	2.55	2.65
30-Year Bond	2.75	2.54	3.11	2.87	3.01	2.61	2.28	2.31	3.15	3.00	3.10	3.25	3.40
Canadian Dollar (US$/C$)	0.86	0.79	0.80	0.75	0.72	0.77	0.76	0.76	0.75	0.76	0.77	0.78	0.79
S&P 500 Index	2059	2068	2063	1920	2044	2060	2099	2168	2300	---	---	---	2500
TSX Index	14632	14902	14553	13307	13010	13494	14064	14726	15000	---	---	---	16500
Oil WTI (US$/barrel)	53.5	47.7	59.5	45.1	37.0	38.3	48.3	48	55	58	62	65	68

Quarter-end data and annual averages

Updated: December 2016 * midpoint of the target range for the Fed funds