

MARKET UPDATE

Q2 2017

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OPINIONS AS OF JUNE 30, 2017



HIGHLIGHTS

- Bank of Canada raises key interest rate by 0.25% to 0.75%
- Trump still unable to deliver stimulus
- New French president has European markets excited
- Crude prices continue to decline
- U.S. Federal Reserve continues path of raising interest rates
- Foreign equity markets higher, Canada lower
- Canadian dollar rises to almost US\$0.77

Trump unable to deliver stimulus thus far

Halfway through the year, U.S. President Donald Trump still has not been able to deliver the steep tax cuts and a massive economic stimulus program he had promised during his campaign. U.S. equity markets have shrugged off the delay, but how long will markets remain patient?

The good news is the U.S. economy has a strong footing with low unemployment, good consumer confidence and healthy consumer balance sheets. At its June meeting, the U.S. Federal Reserve raised the federal funds rate by 25 bps to 1.25%, as expected.

In European markets, all eyes were watching how the French elections played out. Emmanuel Macron was the winner, beating out far right candidate Marine Le Pen. This removed some uncertainty and risk, with markets wholeheartedly embracing the result.

Foreign equity markets continued to rally in the quarter, led by international and emerging equities, while Canadian equities headed lower (See chart 1).

Canadian economy: Trouble looms

Oil remains the big story for Canada. Though we have seen a slight bounce-back in oil prices recently, prices remain much lower than the start of the quarter.

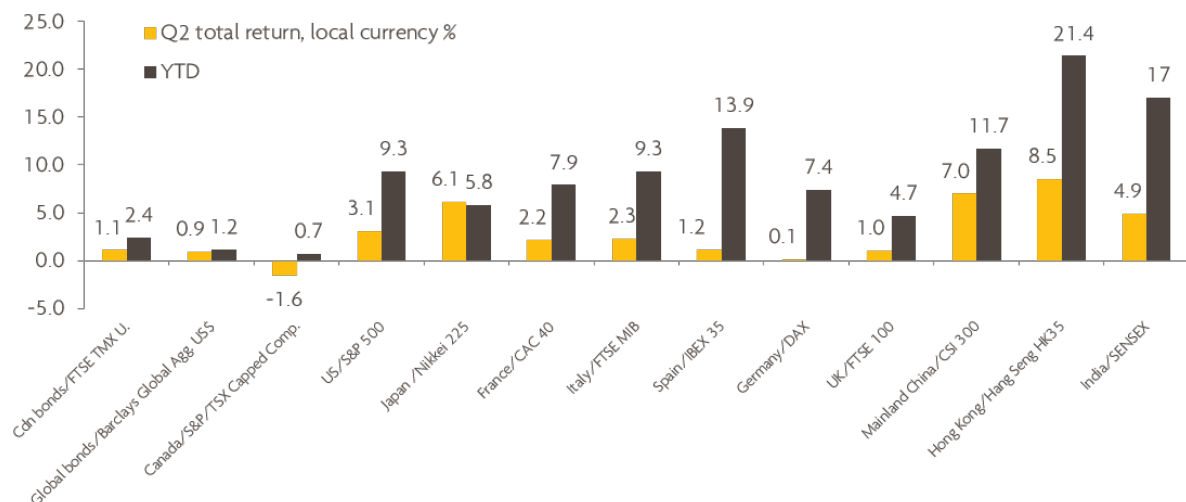
The worry continues to be that supply is not dropping fast enough with heightened concerns over increasing rig counts in the U.S. OPEC, however, continues to live up to its promise of lowering supply – but how long that lasts remains to be seen.

Though we still feel oil prices are undervalued, the upside potential for 2017 may have been truncated.

With continued concerns about Canada's real estate problems and the attention Home Capital brought to the alternative mortgage market, we have seen Canadian bank stocks drop, sending the financial sector into negative territory for the quarter (See chart 2). Given that, it's no surprise that the S&P/TSX Composite Index has once again lagged foreign equity markets.

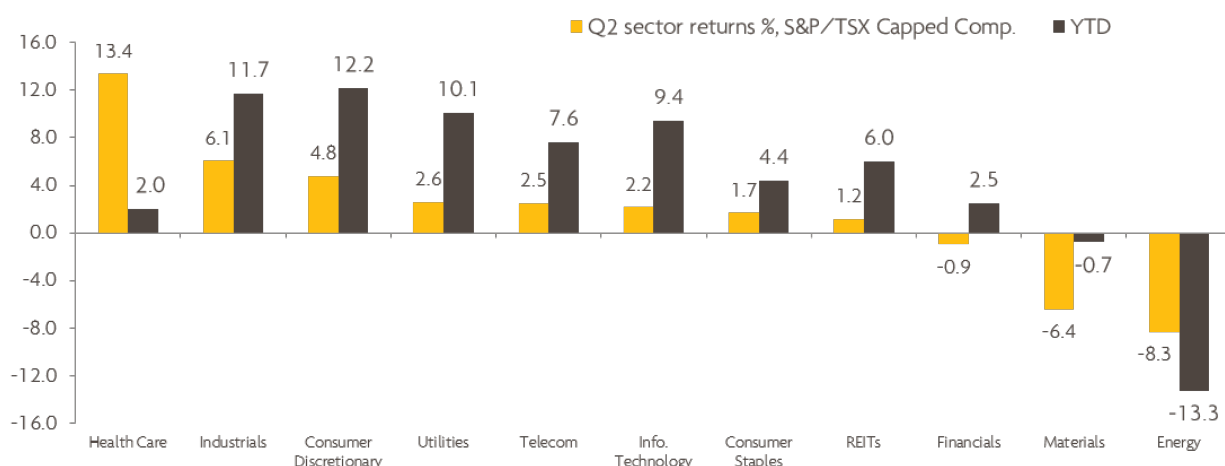
Looking ahead, the decision by Bank of Canada Governor Stephen Poloz to raise the bank's key lending rate by 0.25% to 0.75% may put additional pressure on the country's housing market and consumers, who are saddled with record levels of debt. We believe the BoC's move raises the likelihood of a hard landing in the housing market. We would have preferred a more patient strategy.

Chart 1: Foreign stock markets charge higher



SOURCE: BLOOMBERG

Chart 2: Biggest three sectors decline



SOURCE: BLOOMBERG

Canadian bond yields head higher

Bond yields rose in Q2, with the yield on Canadian 10-year bonds starting the quarter at 1.57% and ending at 1.76%. Similarly, yields on U.S. 10-year Treasuries rose from 2.32% to 2.39%. As the U.S. continues to push ahead on interest rates, and now with the potential of rising rates at home, we could still see Canadian and U.S. yields to move higher by year-end.

U.S. economy: Will Trump ever deliver?

There is no question that U.S. economic stimulus will be delayed significantly and the magnitude will likely be reduced. But with unemployment at low levels and consumers in a healthy position, we expect the economy to continue to grow. Furthermore, U.S. banks have been given a clean bill of health in the initial stress test results, which should cause an increase in dividends and share buybacks – all positive for markets and confidence.

There are two crucial questions about U.S. markets at this juncture. One, what happens if Trump does not deliver on his promises? And two, are equity valuations expensive? These are fair questions.

On stimulus, we think the market is giving less and less weight to the proposals, but the stimulus is at least partially priced into the markets. So it would be a disappointment to the markets if it never materializes as expected, but not necessarily a devastating one.

With regard to equity valuations, compared to historical standards and other geographies, the U.S. is looking expensive. The full opportunity set must always be considered when reviewing valuations. At this time, we feel the risk/reward trade-offs are diminishing; in other words, that U.S. stocks are becoming less attractive.

Political risk comes off international markets

Just like the U.S. elections last year, all eyes were glued to the presidential race in France. This one went as expected, with Emmanuel Macron beating Marine Le Pen, sending markets soaring. With this important election behind us, we feel a big risk has been removed. With valuations relatively cheap compared to other geographies, we are looking to deploy additional capital into Europe.

Emerging markets: It comes down to China

Emerging market equities continued to surge in Q2. As the world realizes more and more that lower global growth may be the status quo, emerging markets stand out with some of the best growth profiles.

There are still risks on the trade front with the U.S., particularly for Mexico and China, but those risks appear to be abating. Markets such as Russia and Brazil have had good turnaround stories but it is too early to say whether that will last. The focus for the rest of the year will likely be on how much China's growth slows, and the impact that could have on confidence levels for emerging markets in general.

Outlook: Not a bad time to be taking profits in some markets

With uncertainty about Trump's stimulus package, higher valuations and lower potential for employment growth, we are looking to take profits in U.S. equities – but gradually. As mentioned, we believe the economy is still in good shape and we don't see a major correction at this time, thus we remain slightly bullish.

Now that we have greater clarity on the European political front we are more optimistic and have started to deploy additional capital in that market. We would like to see lower unemployment and higher economic growth, but we think things are in place to get there. We have moved to a slightly bullish stance.

In Canada, we will watch the interest rate environment closely as any change could have a big impact on the economy. With NAFTA discussions still going on, cracks in Canadian housing and high debt levels, there is very little reason to feel optimistic about Canada's economy.

Emerging markets have had a great run as the best performing market year-to-date with valuations still looking decent. We have no major concerns at the moment.

The Canadian dollar remains within our predicted range of between US\$0.73 and US\$0.78. Though it's approaching the top of that range, we don't think it will stay there. The dollar has had a bit of a surge on the higher probability of an interest rate hike, but we think we are further away from that than the overall market is expecting.

We predict Canadian and U.S. bond yields will move higher by year-end, but not by much – unless major stimulus materializes in the U.S. We would not be surprised to see a negative return for bonds in Q3.

Overall, we remain slightly bullish on equities with a bias toward foreign markets.

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