2016 Economic & Investment Perspectives - Second Half Update

Recapping the first half: How did the year start?

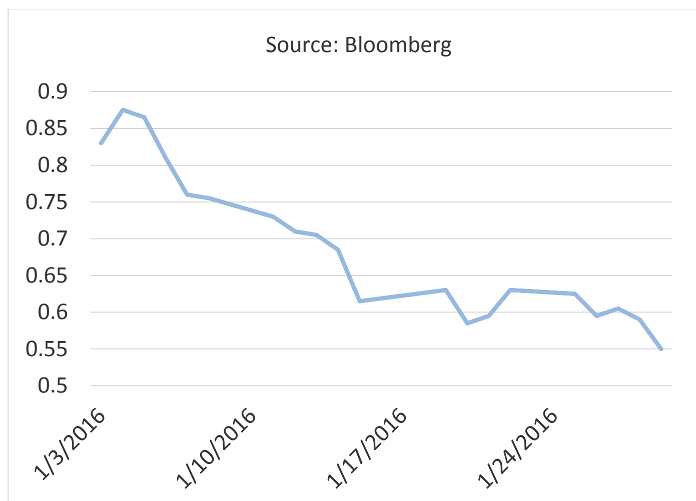
The global economy entered 2016 primarily concerned about Chinese growth, Brazilian political turmoil, continued Greece induced volatility and uncertainty in the E.U., the impacts of collapsing energy prices on the economies of Oil exporters (including Canada), and the potential inflationary and monetary policy impacts of a U.S. economy running at or close to full speed deep into its business cycle. Consensus however, remained that a resilient U.S. labor market and consumer, along with continued accommodative monetary policy globally would help keep corporate profits strong and clear the way for a healthy growth in corporate earnings in general and a rebound in many segments that lagged in 2015. Forecasts for rising interest rates, led the consensus to be very partial to equities over fixed income and continued outperformance for developed markets over emerging markets.

The combination of concerns however, overwhelmed the optimism and led the way for significant volatility in financial markets across the globe during the first quarter. The collapse in equity and energy markets eventually forced the hands of policy makers in the U.S., which led to a major repricing for the path of future short-term interest rate increases (see Chart 1) and an even stronger rally in long-term bond prices. By signaling to the markets that policy making is indeed short-term event sensitive, U.S. policymakers essentially removed roughly 50 bps of rate hikes which we believe became an important catalyst for the subsequent recovery in the equity markets of the U.S. into the end of the second quarter. Simultaneously around the globe; optimism over the new government in Brazil, the stabilization (admittedly somewhat) of data coming out of China (which along with a weaker USD was a catalyst for the recovery in global energy prices), led to a strong recovery in equity and bond markets in emerging markets and commodity sensitive markets as well.

Brexit

In December 2015 at the request of the British Prime Minister, the UK Parliament passed the "European Union Referendum Act 2015". Like most observers, we regarded the vote as a serious matter and one which regardless of the outcome could/would have repercussions across both side of the English Channel in the coming years.

Chart 1
January 2016 Twelve Month
Forward Fed Funds Rate



However, we heavily discounted the possibility of an out ("Leave") vote, and were as un pleasantly surprised as many were when the final results were made official. As expected when the markets don't anticipate the "un-expected", dislocations occur viciously. The Pound's collapse, equity market drops, and rallies in global bond and commodity markets in the first days were followed with continued declines in the Pound, but a sharp and quick reversal in equities just prior to the end of the quarter and first half of the year.

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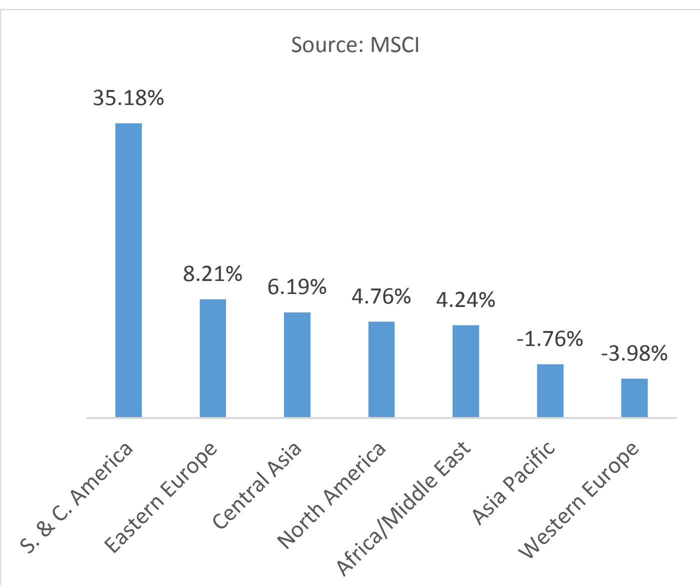
How were we positioned?

While we were not terribly excited about yields globally in fixed-income, given the aged cycle and our projected assessment for corporate earnings and what equity markets demanded for them, we preferred bonds over stocks and were rewarded for that call. As measured by our preferred global bond and equity indices; the PIMCO Global Advantaged Bond Index (GLADI) returned 6.9% vs the MSCI ACWI equity Index which returned 1.78% for the first half.

Chart 2

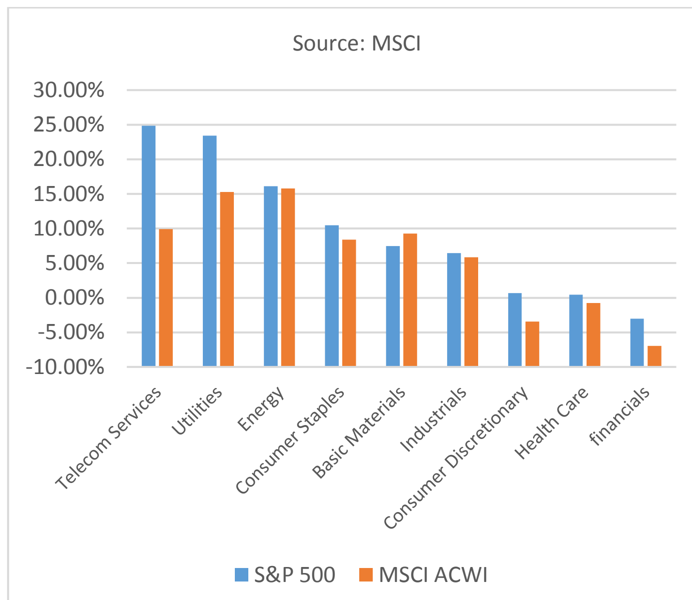
1st Half Regional Equity Market Performances



Within the equity space we preferred the emerging markets (with the exception of China) over developed markets and as far as Latin America, Eastern Europe, and Central Asian markets were concerned we were handsomely rewarded for it (see Chart 2 above), as those markets significantly outperformed North America and Western Europe. Asia in general (including Japan) remained a laggard for us and though outperforming Western Europe, it remained under water during the first half primarily due to Japanese market weakness which was down 7.34% (one of our over weights), and China which was down 4.7% (we started the year neutral). Within the developed markets we preferred Canada (up 20.86%), and Australia (up 1.18%) and were underweight the U.S. (up 3.95%).

Chart 3

1st Half Sector Performances in Equities



Within equities in general, we also preferred large-cap over mid and small-cap and within the MSCI ACWI Index observed global large cap stocks return 2.0%, while mid cap and small cap were down 5.8% and 1.03% respectively.

In equity sectors, we recommended being over-weight economically less sensitive sectors such as healthcare, and global commodity plays such as energy and materials, and underweight consumer cyclicals in the developed markets. We were neutral financials, technology, staples, and utilities. As seen in Chart 3, energy was the big outperformer globally, followed by utilities, telecom, and materials. While consumer discretionary, healthcare, and financials were the laggards. Within the U.S., the story wasn't too different with commodities, utility, telecom, and staples outperforming the economically sensitive discretionary and financial sectors. While our healthcare call has lagged year to date, we do believe that the structural and cyclical factors that have led us to this relative optimism, remain in place.

Within fixed-income, we also favored emerging markets over developed ones. Within the PIMCO GLADI index, the developed market sub index returned 7.34% while its emerging markets counterpart returned 6.55%.

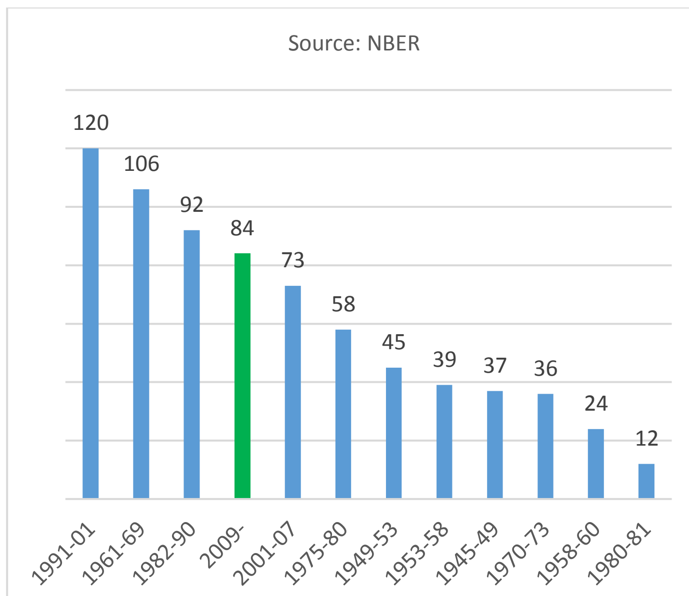
We also favored investment grade over high yield in developed markets in general and the U.S. in particular. In addition, we preferred the U.S. over other developed markets. As measured via the IBOXX U.S. investment grade and high yield indices, investment grade outperformed handsomely by returning 9.19% against 7.68% for its high yield equivalent. While in Europe the IBOXX investment grade Europe returned 7.65% in USD terms and its high yield counterpart returned 7.55%. and within Asia, Japanese investment grades returned 1.33% as measured by the Bloomberg indices.

Where do we go from here? What's in store?

We recently wrote that Brexit to us is a game changer, and more due to its "indirect" impacts on global banking and credit creation, corporate planning, and the "uncertainty" impacts on investor psychology, rather than its quantitative impacts on trade flows as most optimistic observers have pointed too. As the "divorce proceedings" get underway in the coming months and drag out well into 2018, the negative impacts of uncertainty will drive the U.K. into recession. The E.U. will have bouts of periodic negative political outcomes and periodic positive and negative internal economic data which will lead the markets and the economy into a wilderness of sorts for the coming several years with significant impacts on the growth profile of the continent. Whether it leads ultimately into a full blown recession in the E.U. or not, we place the odds at close to 60% over the coming 18 months.

Chart 4

Post WWII length of U.S. Business Cycles (Months)



While the direct trade impacts of a weaker U.K. and British Pound on the U.S. economy will be very small, the spillover from tighter credit and banking activities, weaker financial markets, and the ongoing uncertainty especially as it relates to corporate decision making will be impactful. And it couldn't have come at a worse time, with the U.S. economic cycle already aged,

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economic activity peaking in many segments, sectors and regions of the country, and Presidential elections just around the corner.
This past June marked the beginning of the eighth year of this cycle, making it the fourth longest since the end of WWII (see Chart 4). With employment at levels we consider "full", wage inflation will play a major role in increasing costs for American companies in the coming quarters. All the while with limited to no ability to raise prices, we see significant margin compression in the second half and into 2017.

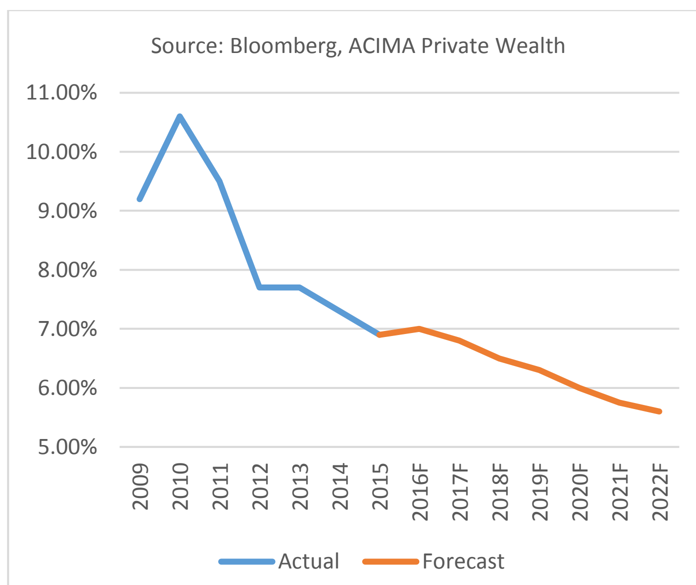
Our U.S. business cycle indicators continue to point us in the direction of a cycle that if not yet at its peak, is getting closer by the month. Along with margin compression, the fallout from Brexit and elections uncertainty will begin to impact business confidence in the second half. As a result, we see the potential for a meaningful slowdown in hiring impacting consumer confidence and spending into 2017. We place the odds of a recession over the coming twelve months at over 40% and rising marginally on a rolling basis. While we appreciate the fact that economic cycles just don't die of old age, we do believe that old cycles are much more sensitive to events and factors that in earlier stages would have marginally impacted the trend. The U.S. economy today is at an ever increasing risk of being tipped over by internal and external factors and or events that could and would be very disruptive to the financial markets initially and the general economy shortly thereafter.

While we are concerned about growth in Europe and the U.S., we believe the rest of the world will continue to be the beneficiary of the Chinese economic recovery. While by the traditional definitions, the Chinese economy did not experience a recession over the past 18 months, we believe a recessionary equivalent impact most certainly explains the facts on the ground in the world's third largest economy. In the meantime, leverage remains significant in many parts of the economy especially in the government and related sectors. However, accommodative monetary policy, along with stricter monitoring of the financial sector has in our opinion diffused the risks of a financial fallout.

On a relative basis, we believe the Chinese consumer remains in a strong position to expand the role of consumption and services in the economy over the coming years, and trade flows that are geared more towards the rest of Asia, the Middle East, Africa and Latin America will more than alleviate the negatives coming from Europe and North America. We expect business and consumer confidence to pick up in the second half mimicking the multi-year cyclical bounce typically seen elsewhere in the early stages of a recovery.

Chart 5

China Real GDP Growth



Going forward and in the coming 12 to 24 months, we believe "nominal" growth in China will pick up and average close to double digits, while "real" growth eventually converges to the 5.5%-6.0% range by 2022 (see Chart 5). While Asia including Japan will be the most positively impacted regions as result of the Chinese recovery, the emerging markets will follow closely behind.

Latin America in general and Brazil in particular remain a bright spot from our perspective. While Brazil has a long way to go before conditions normalize, the recent leadership change and financial market recovery are strong enough to induce further improvement in sentiment and psychology. We are much more optimistic about growth prospects than consensus and believe the economy will bottom in the second half of this year (if it hasn't already), with a multi-year recovery leading to a cyclical bounce in business investment, employment growth and consumption ahead of us in 2017 and beyond.

With China leading the way, we are also optimistic about the economic prospects of energy and commodity producers (both in developed and emerging markets) which will benefit from strong prices, stronger currencies, capital flows and credit creation in the coming years. While Canada will remain highly sensitive to U.S. prospects, it will be one of the main beneficiaries of the recovery in energy prices and trade with Asia. Real growth in the second half of 2016 could average close to 2.75% and slightly over 2.0% for 2017 (in comparison with 1.1% for 2015 and 1.4% for 2016). We are also optimistic about growth prospects in Australia and see a quicker return to 3.0% real growth than consensus (which presently doesn't see it happening until 2018). Australia's commodity sector remains highly sensitive to Chinese demand and growth and will likely ride the up wave well in 2016 and into 2018.

Energy producers in emerging markets including Russia and Mexico will benefit from continued strength in Oil prices which we see moving much higher as a result of Chinese demand. Oil prices in the U.S. peaked at slightly over $51/bbl. earlier in June and have corrected some $5/bbl. since then. We could see further downside possibilities limited to the very high $30's followed by a recovery into the $60-$70 range in late 2017.

Positioning ourselves for the second half

From an asset allocation stance, we continue to favor fixed-income over equities despite low global yields and the strong first half performance. We are however reducing the duration of our fixed-income call and are recommending an outright 10% allocation to cash and cash like instruments (low credit risk with durations less than 1.5 years). Within longer duration fixed-income, we continue to favor emerging markets over developed ones and with yields below or close to zero in many sovereign markets within the developed space (see chart 6), we are no longer recommending any positions within the government sub-sector. Any rationale for continued exposure would need to rely on positive returns coming from FX and or further drops in already extremely low yields, neither of which we favor.

We do recommend maintaining neutral exposures to corporate credit within developed markets but only within the investment grade arena as valuations within high yield and the pro cyclicality nature of that group will correlate with weaker growth in the coming quarters. Within the developed markets we are region neutral (based on our GDP weighted exposures).

We are also overall and region neutral within emerging markets bonds, but with a bias towards high yield as the economic recovery especially within Latin America and Asia-Pacific will provide spread compression and FX appreciation opportunities in the coming quarters and well into 2017.

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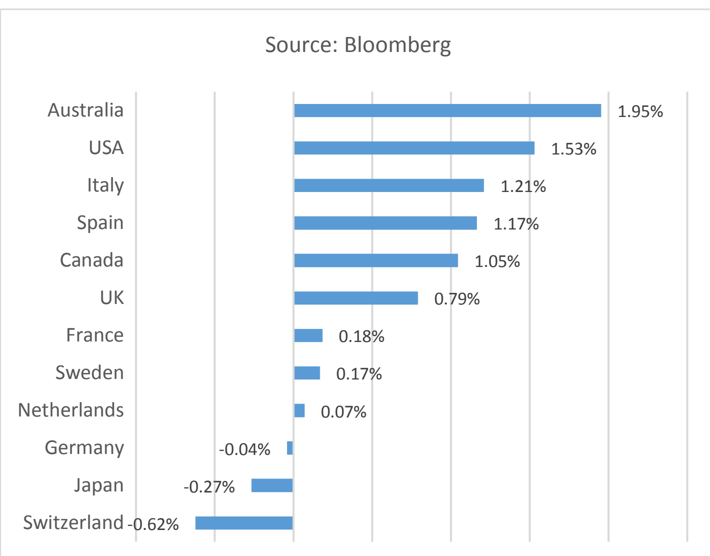
In equities, we continue to recommend an overall under-weight exposure especially in light of the recent Brexit fallout. We recently changed our overall allocation to 40% and remain biased towards emerging markets and commodity sensitive developed markets (i.e. Canada and Australia). Elevated valuations, peak earnings, aged economic cycle, and Brexit uncertainty lead us to recommend almost minimum exposure to the U.S. and Europe in general. While we believe opportunities will arise in the U.K. as the economic slowdown accelerates in the coming quarters, we believe better valuations are ahead and patience is necessary.

Chart 6

Ten year sovereign yields in select Developed Markets



Within developed markets, we recently increased our exposure recommendations to consumer staples, and reduced exposures to financials and technology. We continue to be over-weight healthcare, energy and materials and under-weight consumer. In emerging markets, we favor discretionary over staples, technology over industrials and generally neutral financials and healthcare.

We continue to favor large cap over small and mid-cap in the developed markets and vice versa in emerging markets.

While we believe the climate will remain favorable for industrial metals, energy and materials, we are not recommending allocations to hard assets at the moment and prefer the valuations and upside potentials of equity and fixed-income on a risk adjusted basis. We are also cautious real estate on a global basis as we continue to discern the fallout from Brexit and its impacts on this class.

The wild card for the second half!

Our wild card for the second half are the November U.S. elections of course which shouldn't be a surprise. This cycle we have the benefit of observing and quantifying to a great extent what markets are assuming and pricing.

Over the past decade or so we have seen the development, expansion, and evolution of "prediction markets", and in particular those concentrating on "political' outcomes. Prediction markets are publicly traded markets for "outcomes" which are primarily binary in nature (whether an event will occur by a specific date or not) and similar to other tradable securities or security like instruments are priced based on traditional supply and demand factors and with a significant amount of transparency. They are very much a "derivative" instrument such as an option with a specific event as its payoff (much like a strike price) within a specific time (with a stated expiration date). The payoff is typically "one" if the event occurs and "zero" if it does not, which therefore allows participants to discern the probability of the event occurring by observing its fractional price prior to the

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expiration date. While by no means a complete market, the level of transparency and volumes have expanded significantly and consistency with non-traded model forecasts raise the credibility of these markets. To what extent are the broader financial markets influenced and impacted by these prediction markets is as yet unknown and will need several more years and election cycles to analyze.

Having said that, these markets are forecasting election results generally favorable to the Democrats with odds at roughly 70% for the retention of the White House, at 60% for a Senate takeover and a small (though not negligible chance) of a takeover of the House of Representatives as well. While these markets were also forecasting a 65% chance of the U.K. remaining in the E.U. hours before the final results were known, the financial markets reaction post Brexit results were an indication of the consistency between the prediction markets and financial market assumptions.

So where does that leave us with U.S. elections? If there is consistency similar to that of Brexit, then an outcome favorable to the GOP can be considered a surprise for the financial markets and therefore in our opinion not properly discounted at the moment. Whether that leads to a rally or a drop relative to where we are election eve is of course anyone's guess.

Stay tuned;

Ardavan Mobasheri
Chief Investment Officer
July 14th, 2016

Asset Class Views – Mid-Year Update

Asset Class	Opportunity	Change	Positive	Neutral	Negative
Fixed Income		▼	○ ○ ○	🟡	○ ○ ○
U.S. Fixed Income	Government / Agency	▼	○ ○ ○	○	🔴 🔴 🔴
	Investment Grade Corporate		○ ○ 🟢	○	○ ○ ○
	High Yield		○ ○ ○	○	🔴 🔴 🔴
International	Government / Agency	▼	○ ○ ○	🟡	○ ○ ○
	Investment Grade Corporate		○ ○ ○	🟡	○ ○ ○
	High Yield		○ ○ ○	🟡	○ ○ ○
Equities		▼	○ ○ ○	○	🔴 ○ ○
	U.S.	▼	○ ○ ○	○	🔴 🔴 ○
	North America (Ex-U.S.)		○ 🟢 🟢	○	○ ○ ○
	Europe	▼	○ ○ ○	○	🔴 🔴 ○
	Asia		○ 🟢 🟢	○	○ ○ ○
	Latin America		○ 🟢 🟢	○	○ ○ ○
	Eastern Europe/Mid-East Africa		○ ○ 🟢	○	○ ○ ○
Cash	Cash and Cash Equivalents	▲	○ ○ 🟢	○	○ ○ ○

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