ECONOMIC VIEWPOINT

FOCUS ECONOMICS
ANALYST FORECAST AWARDS
2017
#1 BEST OVERALL FORECASTER - CANADA

2017 Has Been a Good Year for Investors Thus Far

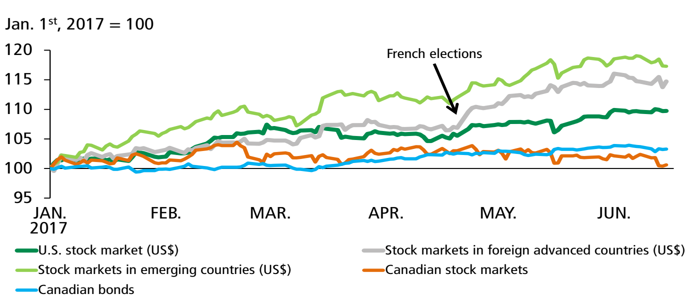
Major asset classes have posted solid performances since the start of 2017. Foreign stock markets did particularly well, having benefited from a weaker greenback. Strong growth in profits is promising for the stock market outlook. The Canadian stock market has underperformed in the last few months, but some catch-up now appears likely. The bond market continued to show remarkable resilience in the first half of 2017, but the next few months could be more difficult for this asset class.

Returns Are Still Strong

The first few months of 2017 were particularly eventful on the political front as the impact of Donald Trump's election continues to be felt in many sectors. A number of elections in Europe also attracted attention. While Emmanuel Macron's victory in France was welcomed by investors, the recent weakening of the British government could further complicate the upcoming Brexit negotiations. Geopolitical tensions have also intensified, particularly in the Middle East and Korea.

Despite all that, many asset classes have posted strong performances as we approach the year's halfway mark (graph 1). In particular, foreign stock markets shot up, with the MSCI EAFE posting a total return of close to 15% since the start of 2017. The U.S. stock market also continued to prove the pessimists wrong. The strong performance of the global economy, with the Organisation for Economic Co-operation and Development (OECD) forecasting the highest global GDP growth in six years for 2017, has resulted in solid growth in corporate profits. In this context, and with the Federal Reserve (Fed) pursuing its monetary tightening, the strong performance of the bond market is more difficult to explain.

GRAPH 1
Excellent performances for most asset classes



Sources: Datastream and Desjardins, Economic Studies

An Excellent First Half of the Year for Foreign Stock Markets

We weren't surprised to see the stock markets continue to grow in 2017, although the extent of the gains made by foreign stock markets exceeded our expectations. Unlike several analysts who have believed for a while now that the stock markets, particularly in the United States, had risen too much, we stated in September 2016 that the outlook remained relatively favourable for this asset class.[1]

Our optimistic outlook for stock markets primarily relied on two arguments. First, the outlook for profits was good as the highly damaging effects of the oil shock were beginning to wear off. Second, very low bond yields and their limited upside potential justified maintaining relatively high price/earnings ratio.

Movements of the U.S. stock market since last fall have been strongly influenced by Donald Trump's election and the difficulties of his administration. However, beyond the political

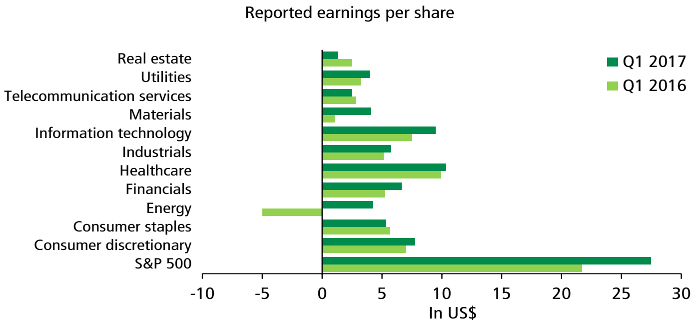
[1] Some optimism still seems appropriate regarding North America's stock markets, Desjardins, Economic Studies, *Economic Viewpoint*, September 26, 2016, 5 p.

François Dupuis, Vice-President and Chief Economist • Mathieu D'Anjou, Senior Economist
Desjardins, Economic Studies: 514-281-2336 or 1 866-866-7000, ext. 5552336 • desjardins.economics@desjardins.com • desjardins.com/economics

front, we should underscore the spectacular performance of S&P 500 companies in the first quarter of 2017. With more than 98% of companies having published their results, reported earnings and operating earnings were up by 26% and 20%, respectively, compared with the first quarter of 2016.

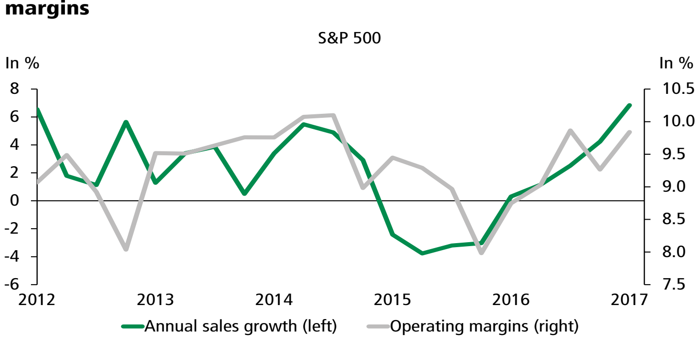
This remarkable performance is due in part to the energy sector's return to profitability, with reported earnings for the sector going from a loss of US$4.98 per share to a gain of US$4.25 between the winter of 2016 and the winter of 2017 (graph 2). Other sectors also posted excellent results as the simple average earnings of the other sectors rose 14% due, in part, to increases of over 25% in materials, financials and information technology. The sharp increase in profits over the course of last year was supported by growth of nearly 7% in sales and an upswing in profit margins (graph 3). Maintaining very low interest rates and limited wage growth despite low unemployment certainly favoured these higher margins.

GRAPH 2
A spectacular and relatively widespread surge in profits for S&P 500 companies in the last year



Sources: Standard & Poor's and Desjardins, Economic Studies

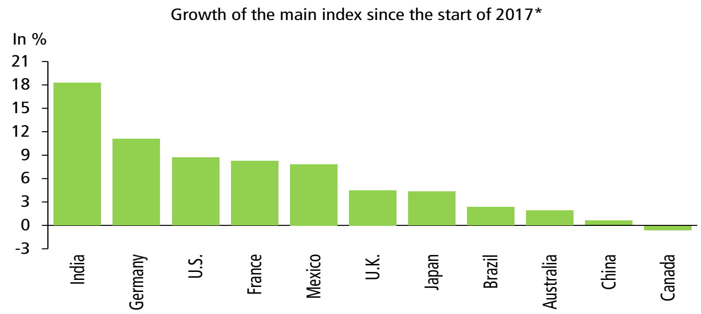
GRAPH 3
The rebound in earnings reflects a sharp rise in sales and profit margins



Sources: Standard & Poor's, Datastream and Desjardins, Economic Studies

On the international front, most of the stock markets in advanced countries posted growth similar to that of the S&P 500 when expressed in local currencies (graph 4). The outperformance of the MSCI EAFE index, which is expressed in U.S. dollars, was thus primarily due to the decline of the U.S. dollar in recent months. The yen and euro performed particularly well, appreciating over 5% against the greenback. Allayed concerns in Europe following the first round of elections in France also contributed to the excellent performance of foreign stock markets. Many emerging markets also benefited from a stronger currency to show an excellent return in U.S. dollar. In is notably the case for Mexico.

GRAPH 4
Several stock markets have posted strong growth since the start of the year



*As at June 15, 2017.
Sources: Datastream and Desjardins, Economic Studies

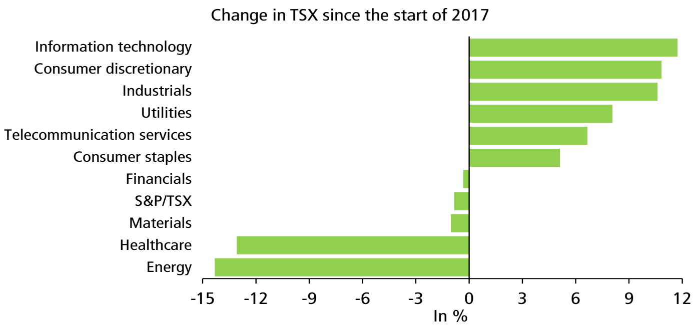
After a remarkable first half of the year, smaller gains are expected of foreign stock markets between now and the end of 2017, as we expect a rebound of the U.S. dollar. However, there is little reason to anticipate a sustained slump for stock indexes in general until clear signs that the end of the expansion cycle become apparent.

The Canadian Stock Market Lags

While most asset classes have exceeded our expectations since the start of the year, the Canadian stock market's performance has been far less stellar. At the middle of June, the S&P/TSX posted a total return of just 0.4%. While this result fell well below most other indexes, we must remember the index's spectacular gain of 21% last year.

Upon closer examination, the difficulties of the Canadian stock market appear to be primarily due to the retreat of the important sectors related to commodity, especially energy, and of the financial sector (graph 5 on page 3). Most of the other sectors posted significant gains, with the exception of healthcare, which continues to face difficulties, but without a notable impact on the total index.

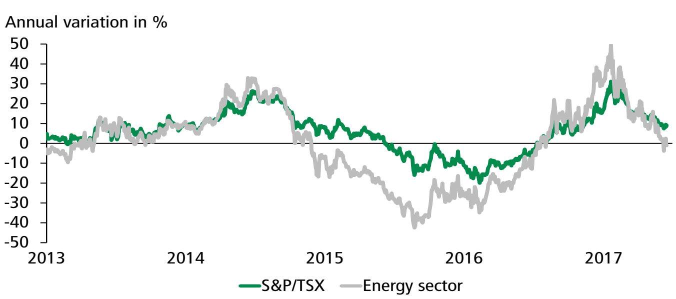
GRAPH 5
Energy is a big part of the problems facing the TSX



Sources: Datastream and Desjardins, Economic Studies

With regard to the energy sector, we must remember that 2016 was marked by a surge of this sector, as the drop in oil prices gave way to an upswing in the spring (graph 6). As a result, the energy component of the S&P/TSX jumped 31% last year, which contributed to the index's excellent performance. Since the start of 2017, we have seen the fallout of this surge as profit-taking and concerns over future moves in oil prices have brought this component down by nearly 15%. This pullback has not only affected Canadian companies; the energy component of the S&P 500 has posted a similar drop since the start of 2017. Given the higher weighting of this component in the Canadian index, i.e. about 20% for the S&P/TSX versus 6% for the S&P 500, the difficulties facing this sector have however a much more negative impact on the Canadian stock market.

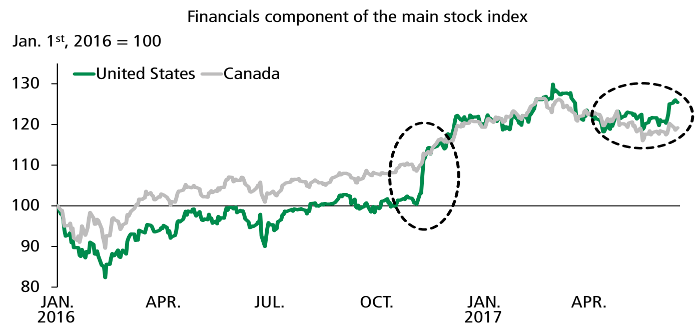
GRAPH 6
The significant volatility of the energy sector is a determining factor in the performance of the Canadian stock market



Sources: Datastream and Desjardins, Economic Studies

The decline in the financial sector represents a similar situation. A surge of optimism at the end of 2016 led to a rise for the sector in North America. However, the last few months have been more difficult as difficulties for the Trump administration have led to concerns that the promised reforms and deregulation will not be achieved. The return to a downward trend for bond yields also put the financial sector at a disadvantage. After a strong start to the year, the S&P 500 financials component dropped at the beginning of June close to its level of the end of 2016. The Canadian financial sector fared even worse, posting a decline of approximately 3% (graph 7). The difficulties facing Home Capital and new signs of excess in the real estate market, which led Moody's to lower its credit rating for several banks, fuelled concerns over the Canadian financial sector.

GRAPH 7
Donald Trump's election and renewed concerns about Canada led to an underperformance by the Canadian financial sector



Sources: Datastream and Desjardins, Economic Studies

Since the problems facing Home Capital do not seem to be spreading and oil prices could rise to around US$55, we expect the Canadian stock market to compensate for some of its losses in the next few months and post a total return of approximately 6.5% for the year, as a whole.

A Tougher Second Half of the Year for the Bond Market

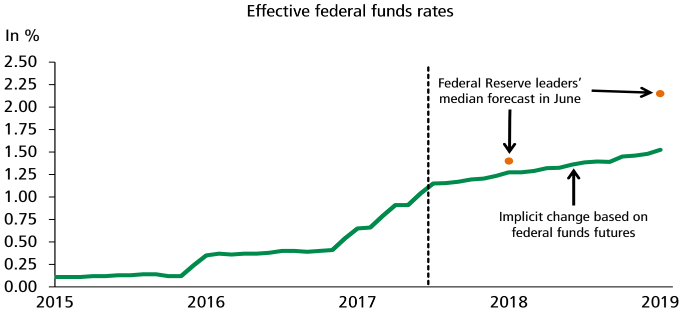
While the stock markets have performed more or less according to our positive medium-term forecast for this asset class, the Canadian bond market's over 3% gain is surprising, particularly in a climate in which the Fed picked up the pace of monetary firming by raising its key rates for the third consecutive quarter in June. All Canadian bonds benefited from a downward trend in yields, but provincial securities set themselves apart with a return of 4.6%.

The downward trend of North American bond yields since the start of 2017 appears to be due to the difficulties of the Trump administration in implementing tax cuts that could have strongly stimulated inflation. As a result, inflation expectations dropped, putting downward pressure on bond yield. A certain amount of pullback is also understandable after the sharp rise in the last months of 2016.

However, maintaining 10-year bond yields at close to 2% is incompatible with further monetary firming in the United States.

If the Fed continues to raise its key rates by 0.25% per quarter, they could exceed the current 10-year yield in just a year. However, the bond market seems to be counting on the Fed not raising its rates much higher in the current cycle (graph 8). If we are correct in our assumption that the Fed will continue to gradually raise its key rates in the next few quarters, bond yields should soon resume their upward trend, which would limit bond market returns. As we are now forecasting that the Bank of Canada will begin monetary firming in October, the next few months could be particularly difficult for the Canadian bond market.

GRAPH 8
The markets anticipate little further monetary firming in the United States



Sources: Datastream, Bloomberg and Desjardins, Economic Studies

Mathieu D'Anjou, CFA, Senior Economist