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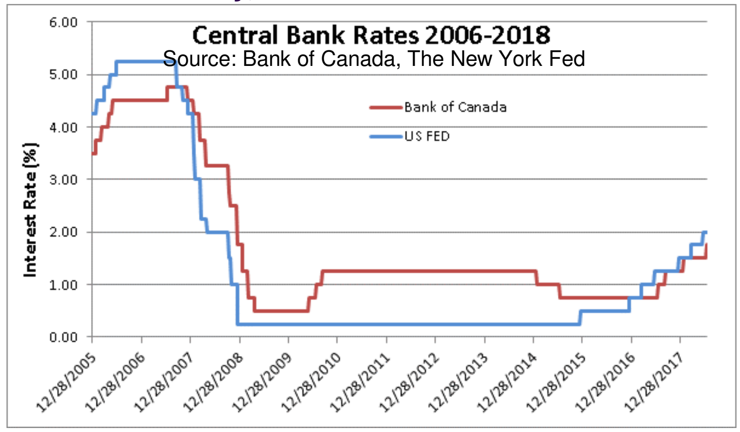
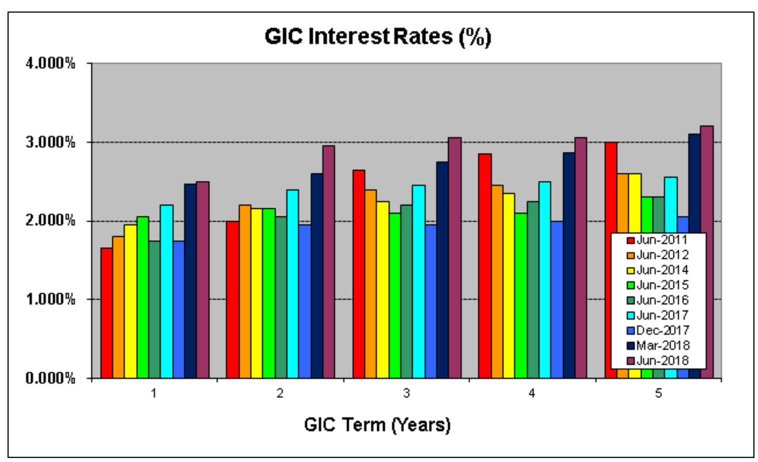
Interest Rate Outlook



With low unemployment, and inflation inching higher, the Bank of Canada was widely expected to hike its benchmark interest rate a second time this year before the quarter was over (it actually happened July 11th). This follows the lead of the US Federal Reserve, which made its second hike of this year in June, on the heels of three increases in 2017. All increases have been of ¼%. It is widely expected that the Fed will hike once or twice more in 2018, and the Bank of Canada should follow suit as long as the economy continues humming along.

These short term overnight rates are still low compared to historical averages, and a few more increases would be needed to get back to a 'neutral' range. Note that these overnight rates do not directly determine longer-term rates, which are more dependent on trading in the bond markets.

Bond yields for 10-year terms have not moved much this quarter, with the US generic 10-year government bond yield briefly breaking through 3% in May, then retreating again by the end of June.

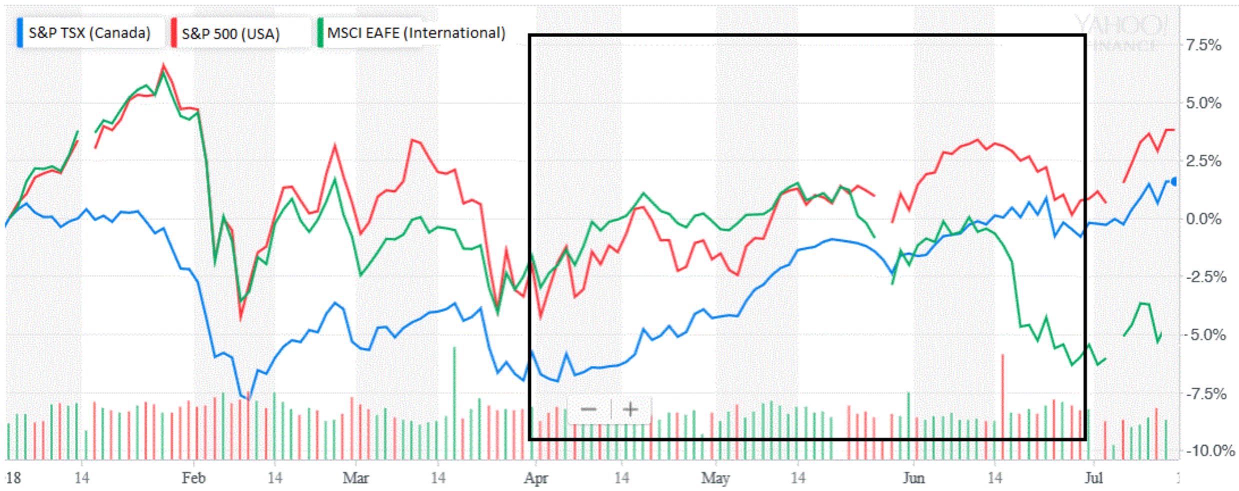


Many market watchers fear that short term rates may actually get to be higher than the longer bond rates: an 'inverted yield curve', as this condition often precedes a recession. Some economists doubt how much of an effect such an inversion could have with longer bond yields still so low. We do expect long bond yields to continue to increase gently as higher inflation persists, allowing more room for central bank hiking before the curve would be inverted.

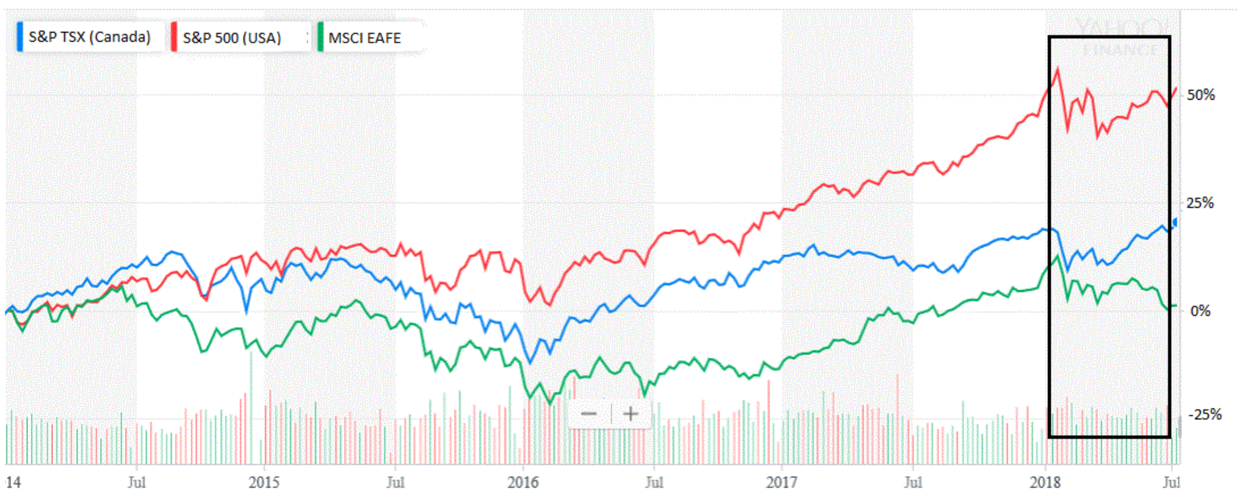
Top GIC rates came up slightly since the end of March, with the spread between 1 and 5-year terms widening very slightly, but with 2 - 4 year rates increasing more sharply. Our yield curve has certainly become flatter from 2-5 years (Source: Cannex Information Exchanges).

Investment Market Commentary

Canadian and US stock markets recovered somewhat in the second quarter of 2018, after a volatile money-losing start to the year. Continued growth in oil prices and employment in both countries helped the recovery, along with decent US corporate earnings growth. After a strong start to the quarter, both markets sold off somewhat in the second half of June as global trade tensions mounted, and ended the quarter about where they started the year. International equities declined for the second quarter in a row, now off about 5% year-to-date in US dollar terms. The graphs below show price values of three benchmark indices, with a box around the second quarter (source: Yahoo Finance).



For perspective, we also show the same series since January 2014, with a box around the current year.



Corporate earnings continue to grow to support market valuations in the US, though some economists are now calling for increasing odds of a US recession beginning late 2019 based on employment and other capacity constraints.

Both Canada and the US have been posting record low unemployment levels for some time. In Canada, May's unemployment rate of 5.8% may seem high, but is the lowest measure in over 40 years of keeping track. This includes oil patch impacts from the recent drop in crude oil prices from which we should now be recovering. In the US, a shortage of skilled labour is already having impacts on wages and capacity.

Global trade tensions also factor as a risk to continued growth, though some economists note that impacts should be quite limited in the short term, risking continued growth only if they deepen and linger for several quarters..

Any trade actions by the US should logically target China and Mexico, whose trade surpluses with the US are significant. But early actions are hitting Canada as well. Trump no doubt wanted a quick win with NAFTA changes that would benefit the US, but the partners are not rolling over. Canada's most recent retaliation was a drywall dumping allegation against the US which it submitted to the World Trade Organization in June. The US has a complaint there against Canadian softwood lumber since November 2017, a push it has lost there on 4 prior occasions. Canada has the Trans-Pacific Partnership and the new Europe trade deal, so there are areas to grow if the US becomes a challenge, but the costs of realigning supply chains currently integrated so closely with the US would be significant, and preferably avoided.

Other US trading partners are also hitting back, with China and Europe retaliating with reasonably equivalent measures. The pain for China so far is not great, since it exports to the US only 2-3% of its GDP. Trump says 'in this war we have way more bullets', noting that US imports from China are more than 4 times their exports there, so any disruption would hit China that much harder. He shouldn't forget that China also has a secret weapon – its holdings of over $1.2trillion of USD treasury bonds which it could dump into the market to sink the US bond market and stoke an interest rate shock.

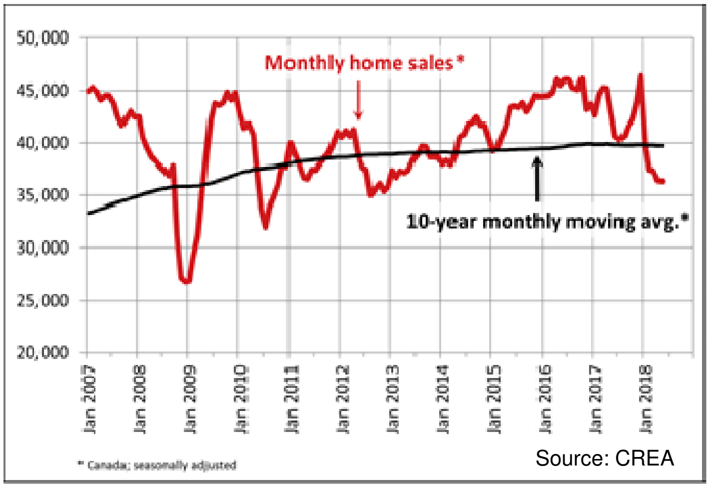
However, it is commonly accepted that the global economic pie is larger when there are fewer trade barriers, and many believe that the Trade war will end in time, and the result will likely look not much different from NAFTA and other global trade frameworks, with some symbolic victories for the US. In this view, Trump's tariff volleys are merely part of his negotiating strategy. It looks like the market is shrugging off the risk for now, though it seems that negative trade news is followed by off days in the market. With mid-term elections looming in the US this fall, Trump has a strong incentive to get these trade issues resolved sooner rather than later. Let's hope he takes that course.

Table: Index Total Returns in Canadian Dollars for Selected Periods ending 30 Jun 2018 (Guardian Capital).

Canadian Dollar ($US/$CA)	*-1.67%*	*-2.09%*	*-4.73%*	*-1.45%*	*-0.61%*	*-1.79%*	*-5.11%*	*-4.41%*	*-2.53%*	*0.19%*	*0.56%*
Index	1M	3M	YTD	12M	2Y	3Y	4Y	5Y	10Y	15Y	20Y
Canada											
Fixed Income											
91-day T-Bills	0.12%	0.30%	0.61%	0.97%	0.71%	0.64%	0.69%	0.75%	0.89%	-	-
FTSE TMX Short Term Bond	0.23%	0.31%	0.53%	0.36%	0.28%	0.71%	1.38%	1.74%	2.92%	-	-
FTSE TMX Universe Bond	0.57%	0.51%	0.61%	0.76%	0.39%	1.97%	3.03%	3.48%	4.50%	-	-
FTSE TMX High Yield Bond	0.18%	1.33%	2.82%	7.71%	11.29%	6.93%	5.17%	6.22%	7.36%	-	-
Equities											
S&P/TSX Composite	1.69%	6.77%	1.95%	10.41%	10.73%	6.96%	4.87%	9.24%	4.24%	8.69%	6.59%
S&P/TSX SmallCap	-0.30%	6.58%	-1.66%	5.39%	4.57%	6.28%	0.09%	6.45%	2.26%	5.18%	-
S&P/TSX Equity Income	2.22%	4.73%	-1.97%	4.01%	8.72%	5.98%	2.11%	6.31%	6.32%	-	-
S&P/TSX Sectors											
Cdn. Energy	2.52%	16.94%	8.23%	22.77%	6.76%	2.70%	-8.83%	-0.49%	-4.63%	5.65%	-
Cdn. Materials	1.82%	7.88%	3.26%	11.95%	1.54%	7.15%	0.88%	4.35%	-3.79%	6.94%	5.21%
Cdn. Industrials	-0.40%	8.75%	7.10%	16.77%	22.29%	14.63%	10.65%	14.91%	11.05%	11.76%	8.03%
Cdn. Consumer Discretionary	0.65%	6.59%	3.53%	13.27%	18.55%	8.73%	13.18%	15.92%	12.42%	9.97%	7.38%
Cdn. Consumer Staples	2.99%	4.16%	-1.08%	1.83%	5.41%	8.00%	14.85%	15.60%	14.23%	10.08%	12.02%
Cdn. Health Care	7.39%	15.85%	2.45%	41.47%	9.82%	-8.88%	3.76%	6.56%	13.72%	4.92%	3.81%
Cdn. Financials	0.07%	2.07%	-1.48%	8.87%	15.21%	10.90%	8.72%	12.72%	9.59%	10.43%	-
U.S.											
S&P 500 (LargeCap)	2.32%	5.64%	7.74%	16.06%	16.83%	13.97%	16.75%	18.65%	13.03%	9.09%	5.87%
Russell 2000	2.43%	10.05%	13.01%	19.30%	21.77%	12.99%	15.74%	17.64%	13.48%	10.28%	7.43%
International & Other											
MSCI World (Net)	1.65%	3.90%	5.42%	12.73%	15.29%	10.46%	12.42%	15.01%	9.02%	7.93%	4.64%
MSCI EAFE (Net)	0.46%	0.87%	2.08%	8.42%	14.05%	6.81%	8.06%	11.35%	5.52%	7.05%	3.75%
EM (Emerging Markets)	-2.46%	-5.89%	-1.86%	10.19%	16.83%	7.91%	8.74%	10.25%	5.27%	10.85%	8.26%

Canadian Real Estate

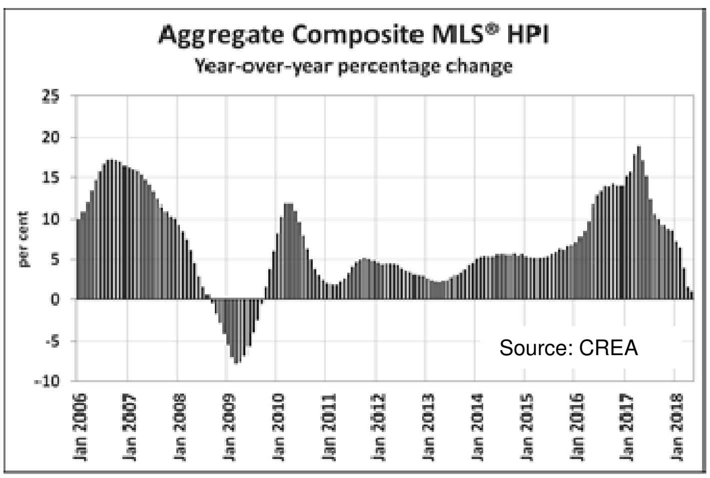
Canada's residential real estate market has been hot for a few years now, especially in the Greater Toronto and Vancouver areas, which are some of the most cosmopolitan cities in the world and therefore attractive to foreign capital. Toronto's most expensive condo - a 3 level penthouse on a downtown tower - sold in late June for $27 million to a business tycoon. The most expensive cities in the world to buy a home include Shanghai, Moscow, Paris, Sydney, Hong Kong, and New York, but Toronto this year is #14 on Money Inc.'s list of most expensive cities to buy a home.



Some wonder whether these market values are sustainable. Bidding wars were seen again in Toronto in May, but total sales in June were down over 10% from a year ago, and 7% below the 10-year average for June according to the Canadian Real Estate Association (CREA).

A new stress test for homebuyers introduced in January of this year may be contributing to the softer sales. Now, all borrowers now must have their total debt service ratio under 44% of gross income, and total housing costs under 32% of income, including mortgage payments based on the higher of their own interest rate plus 2%, or the average 5 year mortgage rate. The tighter criteria were expected to take some demand out of the hot real estate market, and may be having an impact.

Also, Toronto and Vancouver have both implemented foreign buyers' taxes aimed to reduce the excess demand from offshore buyers, once estimated at about 5% of GTA residential sales, but more recently under 2%.



Home prices in Toronto seem to have plunged year-over-year, but only in relation to the spring spike in 2017 (Mar-May). GTA prices may be down -5.40% since a year ago, but up 39.54% over 3 years, second only to the Vancouver area (+11.50% and 58.19% respectively) and Barrie at -6.30% since a year ago, but up 43.79% since 3 yrs ago!). CREA's national average price index still grew 0.9% from a year earlier, but it was the 14th consecutive month of slowing growth, and the lowest growth figure since 2009.

Should we expect price growth to resume? The Millennial generation is buying, but the boomers aren't selling enough of their housing stock to meet the demand. As long as that imbalance persists, it should support prices. But if rising rates remove enough potential buyers, or a surge in supply or listings materializes, the market could turn backward.

With interest rates expected to drift higher in the next year, the high average consumer debt levels in Canada could become a drag on future growth.

Feedback

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