Market update | Q2 2015

Opinions as of July 2, 2015

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HIGHLIGHTS

- Greek debt crisis reclaims headlines
- Global equity markets lose steam as quarter ends
- Oil stabilizes near US$60/barrel
- North American bond yields finally start to rise

All eyes on Greece

The debt crisis in Greece has entered a new phase. And while it's clear the country is facing serious economic, political and social turmoil because of its crippling financial obligations, it's important that investors keep the big picture in mind and stay focused on their long-term goals.

Sun Life Global Investments' retail mutual fund platform has what we would consider to be immaterial exposure to Greece. As of the end of June, Sun Life Schroder Emerging Markets Fund had direct exposure of just one quarter of one percent. Four of our flagship Sun Life Granite Managed Portfolios invest in that fund, but none has direct exposure of even two one-hundredths of one percent.

We don't know how it's all going to end, or when, or what tomorrow's market reaction will be. But we're confident in our strategic view and we're standing by to take advantage of any tactical opportunities that we judge to be worth the risk.

[Editor's note: Opinions in this document reflect our knowledge and interpretation of events surrounding the Greek debt crisis as of July 2. The situation is unfolding at a furious pace. Contact your financial advisor or visit www.sunlifeglobalinvestments.com for any additional commentaries specific to Greece.]

We did see new highs in some equity markets, including the U.S., but gains faded toward the end of the quarter.

The U.S. Federal Reserve has not raised interest rates but liftoff looks to be coming sooner rather than later, with our expectation being either September or December. Early indications show decent economic data, which should translate to moderate growth for the quarter.

After a strong first quarter in Canadian stocks, weaker economic data started to take its toll on the equity market. The final numbers from Q1 showed the economy contracted 0.6%, which meets our definition and expectation of a terrible quarter. Oil-related markets (primarily Alberta, Saskatchewan and Newfoundland and Labrador) are showing the biggest signs of weakness as oil prices remain low. The S&P/TSX Capped Composite fell 1.6% in Q2, dragging the year-to-date gain down to just 0.9%.

With the situation in Greece intensifying, international developed markets pulled back significantly from Q1. The MSCI EAFE Index ended the period with a gain of 0.8% in US$ terms, thanks entirely to Japan. The Euro STOXX 50 Index sank 5.3% in local currency.

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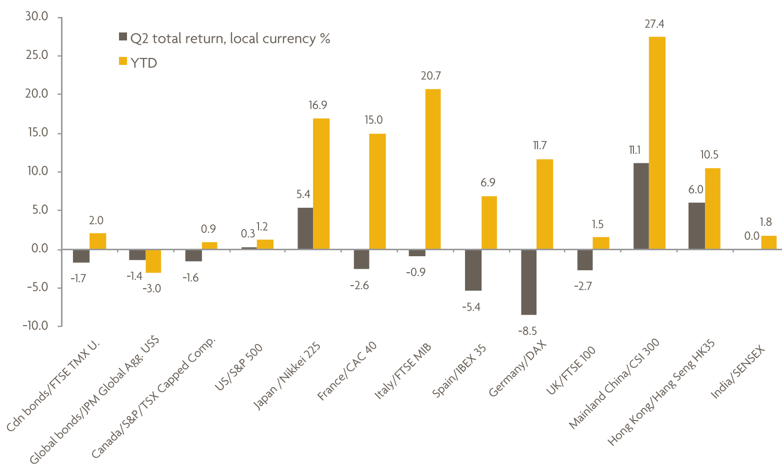
The MSCI Emerging Markets Index also climbed 0.8% in US$ terms. In local currency terms, Chinese mainland stocks rose 11.1% with some significant volatility along the way.

Rising bond yields in North America led to negative quarterly returns for the first time since the middle of 2013. The FTSE TMX Canada Universe Bond Index fell 1.7%, wiping out almost half the extraordinary gains of the first quarter. Global bonds also fell.

As the year progresses, we continue to feel less and less bullish about both the equity and bond markets.

Chart 1: Mixed markets in Q2



Source: Bloomberg

Canadian bond yields rise at healthy clip

Though the increase in U.S. yields was largely in line with our outlook, the jump in domestic yields was faster than we'd anticipated – particularly given the economic data has been mixed at best.

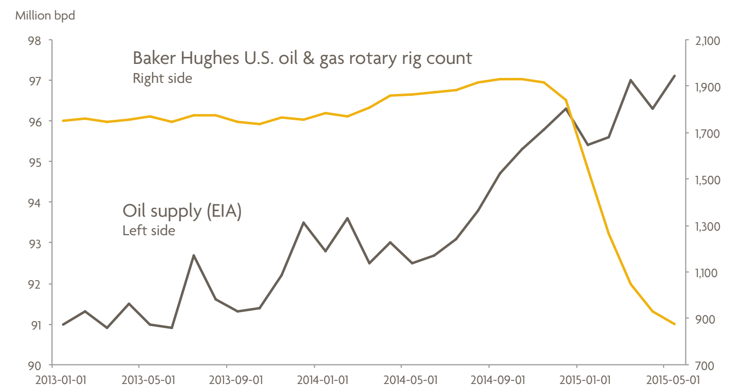
With the Fed likely to raise rates next quarter, we should continue to see rising U.S. bond yields, though Greece may slow things down. Canadian bond yields on the other hand may not appreciate as fast given we see no rate hike on the horizon and a rate cut remains a possibility. The result is likely negative bond returns for the rest of the year.

U.S. 10-year Treasury yields rose from 1.92% to 2.35% in the period, while Canada's 10-year government bond yields rose from 1.36% to 1.68%.

Canadian equities likely to remain in the red

The economic impact of low oil prices continues to be the story in Canada. West Texas Intermediate crude continues to struggle to hold above US$60 per barrel, and with supply still high (see Chart 2), we could see another test of the $50 level. Not surprisingly, the energy sector had another negative return for the period (see Chart 3). We are "patiently bullish" on this sector.

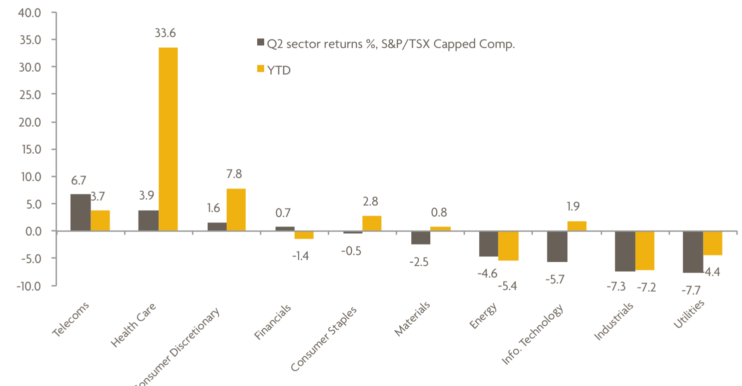
Chart 2: Oil supply still rising



Source: Bloomberg. Data as at May 31, 2015

Alberta, Saskatchewan, and Newfoundland and Labrador have been hit the hardest and could be heading toward a recession this year. Real estate values in those markets are also falling given demand has deteriorated as new homes come up for sale. We still feel there's more pain to come as the impact of low oil continues to make its way through the economy. We remain bearish on the Canadian equity market.

Chart 3: Resource sectors continue to show weakness



Source: Bloomberg

(continued)

The U.S.: expectations getting too high?

We are starting to feel that too many investors have climbed on the U.S. bull bandwagon and that expectations may be lofty. We still believe that economic data will be healthy, but perhaps not as strong as some appear to expect.

However, as long as the U.S. produces jobs at a pace of over 200,000 per month give or take, we feel the economy is on solid footing.

With mortgage rates still low the housing market has been stronger than we'd expected, and as long as supply remains low it should continue to support the economy.

We continue to expect a positive year for the U.S. equity market but record highs are likely behind us for now and risks are increasing.

Eurozone in better shape (Greece notwithstanding)

The eurozone economy looks much better this quarter than in the previous one, but with Greece in meltdown mode it may be difficult for some to get past the headlines. Unemployment is slowly improving, as are exports and consumer spending. Quantitatve easing from the ECB has had the desired effect in the early goings and should continue to benefit the economy over the longer term.

The euro has started to fall again, which we consider to be one of the more positive results of the ongoing turmoil.

Emerging markets eke out gain

After a strong Q1, emerging markets pushed higher again in Q2 - albeit by much less. Results were mixed within the overall region with India doing well and China suffering significant volatility.

Russia, though up from its lows, still faces significant issues from lower oil prices, as do other oil exporters within the region. We still feel that emerging markets will move higher over the long term, but in the short term we could see more downside pressure as the U.S. dollar continues to strengthen. This remains a market where macroeconomic factors play quite an important role.

Outlook: higher anxiety, higher volatility

There is no sign the volatility we saw in Q2 will dissipate any time soon. The market waits for the situation in Greece to play out and it will be hard for equities to find direction until the situation is resolved – one way or another.

We still feel good about the U.S. economy but we see the risk/reward ratio tilting more toward "risk." The jobs picture still looks promising and consumers continue to show strength. We remain bullish, but less so than in past quarters.

We believe that quantitative easing in Europe and a lower euro will help the region get back on track, but we expect to remain very cautious until there's more certainty around Greece.

On the home front we still feel bearish on the economy and equity markets. We feel that the negative effects of low oil prices are likely to persist through the year. We expect further job losses and lower confidence to cause ongoing declines in the equity market. While we do expect oil prices to move lower in the short term, we're monitoring the market closely for opportunities to position ourselves for long-term gains.

The dollar ended the quarter at just around US$0.80. If the Fed raises rates and the Bank of Canada cuts, then $0.75 could be in the cards, otherwise somewhere between the two is likely where we see the loonie for most of the year.

We expect bond yields to continue their upward trajectory once Greece is resolved, causing negative returns.

Overall, we feel that higher volatility is here to stay and further upside in most equity and bond markets may be limited.

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