Sun Life GLOBAL Investments

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MARKET UPDATE

Q4 2016

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Opinions as of December 31, 2016

HIGHLIGHTS

- President-elect Donald Trump surprises by winning the U.S. election
- U.S. Federal Reserve raised interest rates – more hikes are likely
- North American bond yields moved sharply higher
- Oil prices climbed to US$54 a barrel after OPEC, and some non-OPEC countries, agreed to cut production
- Canadian dollar dropped sharply to US$0.74

TRUMP VICTORY SENDS MARKETS SHARPLY HIGHER IN Q4

Given President-elect Donald Trump's often controversial opinions, and what pundits describe as his unpredictable nature, not surprisingly markets were jittery in the run-up to the U.S. election. But following his conciliatory acceptance speech, the focus shifted to two key elements of his campaign platform that could boost the U.S. economy – tax cuts and a proposal to spend $1-trillion building new infrastructure. As a result, U.S. markets (and those potentially benefiting from stronger U.S. growth) rallied higher.

Emerging-market indexes, which did not spike higher following Trump's win, were among the rare exceptions. This is because a more robust U.S. economy could lead to a stronger dollar, which increases the cost of U.S.-denominated debt that is often carried by countries in the developing world. Many of these same countries also import oil, and were hurt by the recent rebound in the price of crude.

As well, international markets were flat following Trump's election, but moved slightly higher after shrugging off the immediate risk from the Italian referendum that saw the Prime Minister resign, adding to the uncertainty over the country's future in the European Union. In the end, 2016 proved once again that markets do not like uncertainty – but change is not always perceived as bad. And that is probably just as well, because there will likely be more political uncertainty in 2017 with elections in Germany and the Netherlands.

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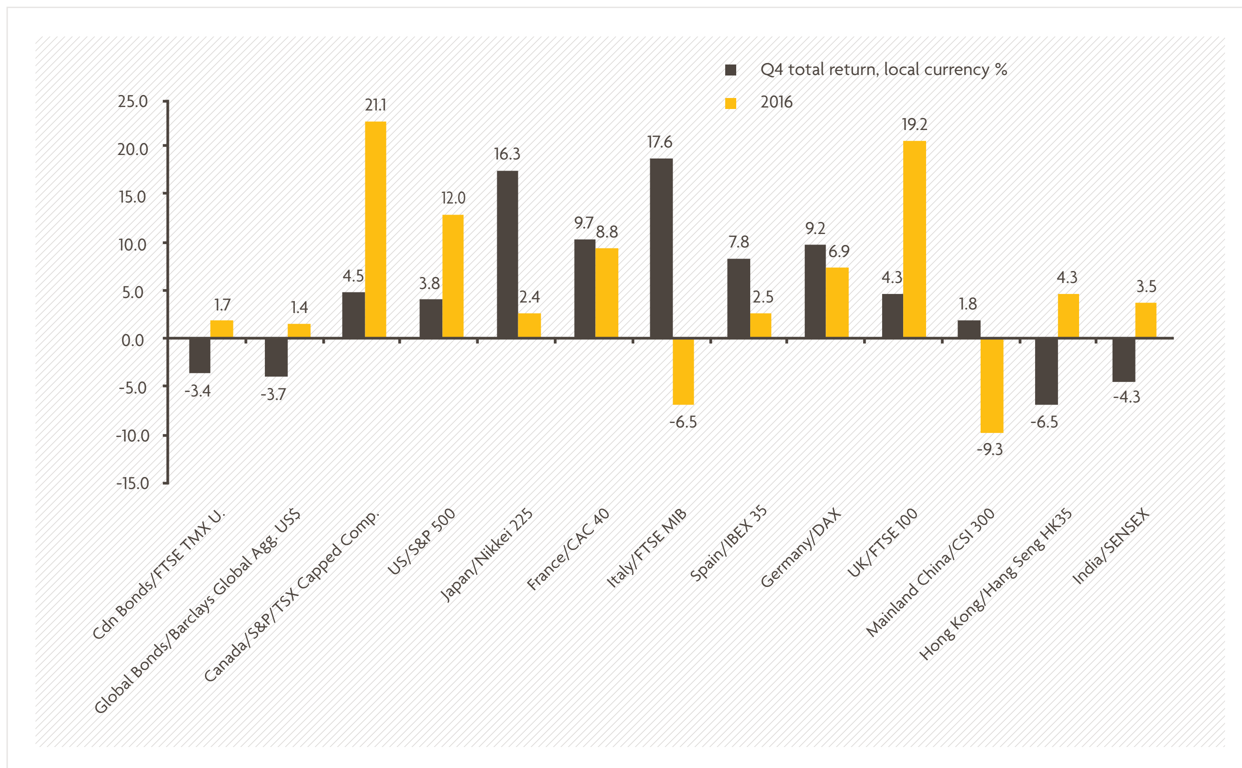
CANADIAN ECONOMY: SLUGGISH GROWTH WILL CONTINUE

While there is still plenty to debate about the health of Canada's economy, its performance in Q4 hinted at potential growth to come. Certainly, if stronger U.S. growth materializes it would be good for Canada. And our struggling energy sector could be helped by the agreement reached by OPEC, and some non-OPEC countries, to cut oil production, which could further increase or at least stabilize crude prices.

However, stronger growth in the U.S. could cause bond yields to rise (as we witnessed following Trump's election) and this will likely result in higher borrowing costs in Canada, including on mortgages. If interest rates head higher, given the record levels of Canadian consumer debt and soaring real estate prices in some parts of the country, it could potentially hurt our economy – possibly sooner rather than later.

Despite Canada's sluggish economic growth, the S&P/TSX Composite Index was one of the best performers among developed equity markets in 2016, finishing up 21.1 % on a total return basis (Chart 1). And while materials took a hit in the fourth quarter, that sector was one of the top performers for the year, along with energy, which surged in Q4 (Chart 2).

CANADA LEADS THE WAY IN 2016



Source: Bloomberg

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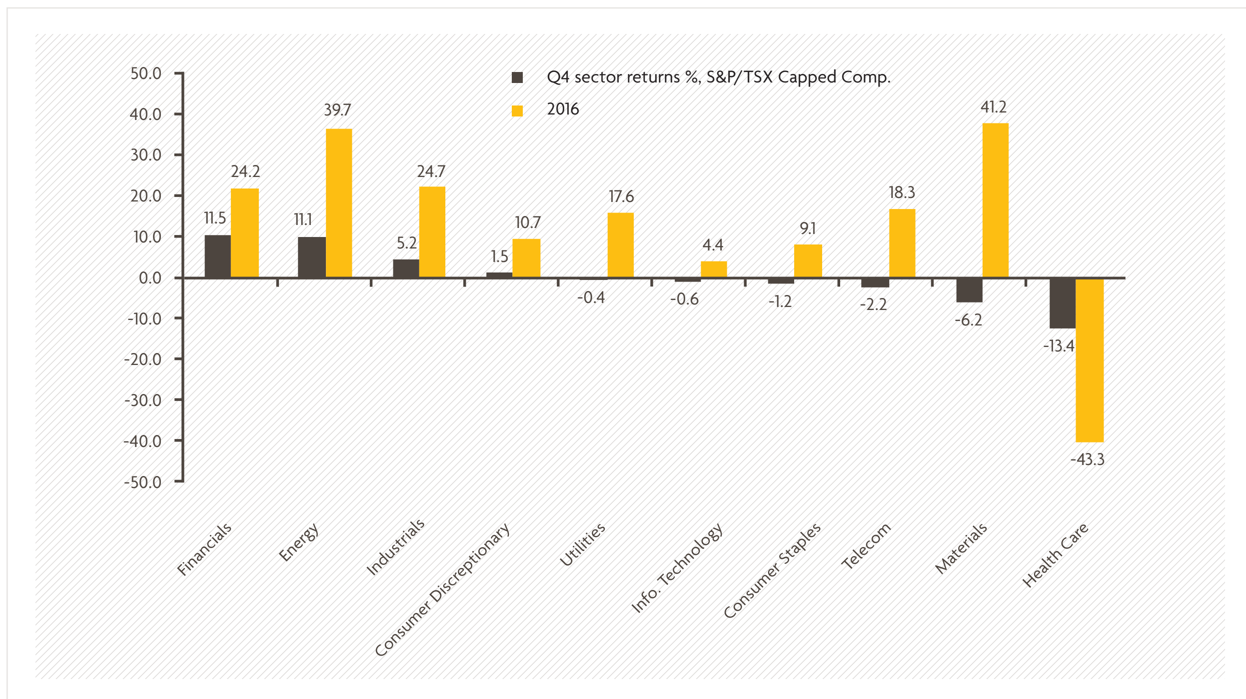
CANADIAN BOND YIELDS HEAD SIGNIFICANTLY HIGHER

Canadian bond yields finally took off, with the yield on Canadian 10-year bonds starting the quarter at 0.91% and ending at 1.72%. Similarly, U.S. 10-year Treasury yields moved higher from 1.59% to 2.44%. There is little doubt that it was Trump's pro-growth plan, and the Fed's decision to increase interest rates by a quarter of a percent to 0.50%, that led to the spike in the yields. And we expect both Canadian and U.S. yields to move steadily higher if the Fed continues to raise rates in the coming years.

ENERGY SECTOR SURGES, MATERIALS DECLINE IN Q4



Source: Bloomberg

U.S. ECONOMY HAS A STRONG TAILWIND

Trump's election and economic-stimulus proposals boosted investor confidence. But the American economy was already in good shape with a healthy job market, strong consumer balance sheets, rising housing prices and good corporate earnings. However, with Trump at the helm the U.S. economy may get an additional lift from tax cuts and increased government spending, particularly around his proposed US$1-trillion infrastructure program.

The markets could still take a hit if Trump's campaign promises don't come to fruition, but this is not our base-case scenario. We are closely watching the Fed, because the stronger the economy gets, the more likely it is that it will try to contain inflation by raising interest rates to hold growth to the 2% to 3% range. For now, our short-term outlook is positive on the U.S. Longer term, we will have to wait to see how Trump deals with immigration and trade issues, which could impact future growth.

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EUROPEAN UNION /U.K. DIVORCE COULD BECOME A REALITY

Britain's decision to leave the EU could be finalized in 2017 if the U.K. exercises its option to opt out. If it does, it would formally start the divorce process and highlight the growing political risks facing Europe with a number of national elections occuring in 2017. In addition to the ongoing debate over the EU's future, we think its economic growth will slow in 2017 and market volatility will pick up. As such, there are good reasons to remain cautious.

EMERGING MARKETS: ATTRACTIVE VALUATIONS, BUT RISKS REMAIN

Emerging-market economies remain the strongest growth area in the global economy, but they face headwinds from a strengthening U.S. dollar and potential trade wars with the U.S. – particularly involving China and Mexico. That said, Russia had a very strong year as oil prices moved higher and Brazil's economy may be starting to turn the corner, while India's growth remains strong.

Overall, equity valuations in emerging markets are still attractive, but the question remains: What is the catalyst that will move these stocks higher in 2017? And until we have a clear answer, we think that being neutral on emerging markets is the right position to take at this time, with significant market pullbacks producing good buying opportunities.

OUTLOOK: EQUITY MARKETS HAVE ROOM TO MOVE HIGHER

Heading into the U.S. election a Trump victory was supposed to be bad news for the U.S. economy and markets. But as we've noted, the prospect of lower taxes and increased government spending has boosted investor confidence and we are now positive on U.S. equities.

At the same time, we are taking a cautious stance on international markets, with political uncertainty, including that surrounding the U.K./EU divorce, taking its toll and restricting growth in the region.

In Canada we still have longer-term economic issues that need to be solved, but our outlook is improving. In part, this is because we think a stronger U.S. economy could help increase exports, and potentially higher oil prices could aid the energy sector. There is also a slight chance of a Bank of Canada rate cut, which would spur growth as well.

Exaggerated real estate values in some parts of the country, and the drag high personal debt levels may have on consumer spending, still worry us. But we think positive economic factors will more than offset the negatives in 2017.

We finally have some stability in oil prices with OPEC and some non-OPEC countries on the same page. But while the price of crude could potentially head higher in 2017, as we have seen numerous times in the past, even a small increase in surplus oil can cause prices to fall.

The value of the Canadian dollar is closely correlated to the price of oil, but it still dropped by almost three cents in 2016, even as crude prices climbed. And what happens to the Canadian dollar in 2017 will also depend on whether the Fed actually follows through with further rate hikes and whether the U.S. economy grows as strongly as many people expect. Neither of these factors are certainties, but we expect the Canadian dollar to be somewhere between US$0.73 and US$0.78 for most of the year.

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Canadian and U.S. bond yields should continue to move higher in 2017, which could result in negative total returns for bonds. However, we don't expect yields to move up by as much as we saw in 2016. And while we are neutral in specific areas, overall we are slightly bullish on equity markets – but we will pay very close attention to how the U.S. economy performs under the new leadership in the White House.

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