

DM Portfolio commentary

1st QUARTER 2017

Gradual improvements don't make great headlines

Geopolitically speaking, the year's opening quarter brought more of the same: North Korea lobbed some missiles into the Sea of Japan, Russia continued to stir up trouble, and, back on our shores, one could be forgiven for mistaking actual White House press briefings for their subsequent Saturday Night Live parodies. Against this disconcerting backdrop, however, stocks behaved as if the outside world had somehow stumbled into a rare state of tranquility. In fact, on March 22nd, the S&P 500 suffered its first 1% drop in 109 days, marking the longest such streak in more than 20

years. As one of the earliest market sages said in the 1920s, "The stock market is not obvious. It is designed to fool

most of the people, most of the time." And so, while the media and strategists alike obsessed over all things Trump, stocks remained on their upward path, defying what would have seemed like obvious catalysts for retreat.

Rather than taking their cue from jarring headlines, it is likely that markets were responding to a gradual but persistent improvement in global

economic conditions. This progress is reflected in the accompanying table, which shows Purchasing Manager Index (PMI) figures for major economies over the past year. The PMI is based on surveys of tens of thousands of business managers to gauge their assessment of prevailing industry conditions and is one of the most important indicators of economic direction used by analysts and academics worldwide. Of note, PMI is a "diffusion" index, meaning that readings below 50 indicate economic contraction, while measures above 50 denote expansion. As you can see,

underlying economic conditions have been on an upward path over the past 12 months, with the globe's most important regions having moved well

into expansionary positions.

In Canada, progress was corroborated in late March when the release of January GDP figures showed an unexpected surge in activity, leading several analysts to posit that the country is finally moving past the slowdown brought on by the steep drop in energy prices. Importantly, the boost to growth came from a broad sweep of

| | <u>Feb-16</u> | <u>Aug-16</u> | <u>Jan-17</u> | <u>Feb-17</u> |
|------------------|---------------|---------------|---------------|---------------|
| Global | 50.0 | 50.7 | 52.7 | 52.9 |
| US | 49.7 | 49.4 | 56.0 | 57.7 |
| Canada | 49.4 | 51.1 | 53.5 | 54.7 |
| Japan | 50.1 | 49.5 | 52.7 | 53.3 |
| Euro Area | 51.2 | 51.7 | 55.2 | 55.4 |

Source: Bloomberg

sectors, with manufacturing, resources, wholesale goods, and retail all posting material advances, and 15 of 20 major industries recording gains. Said Douglas Porter, chief economist at BMO, “We have liftoff. We would point out that we now see Canadian GDP growth outpacing that of the US in 2017, quite a dramatic turnabout from the past two years.”

Not surprisingly, the brighter backdrop has also been reflected in the yield curve and in the actions of the US Federal Reserve. From the lows of last summer, yields on both Canadian and US 10-year government bonds have leapt by more than half, correctly foreshadowing a 25 basis point rate hike implemented by the Fed in March. Based on recent and expected growth, several observers now believe that at least two more policy rate increases will be put in place south of the border before year-end and, if we see follow through on *our* latest GDP report, perhaps the Bank of Canada won't be on hold for as long as some might think.

As it happens, the considerations that have us feeling good about the economy and the outlook for stocks also see us trading more carefully in bond allocations. To dampen the negative effect

of rising rates on bond performance, we've pushed duration (or average maturity) well below that of the broad fixed income benchmark and have overweighted maturity areas that we feel offer excess relative value. At the same time, we've been reducing credit risk – or corporate and provincial bond exposure – within allocations, under the belief that such “spread product” has been bid to unattractively expensive levels as investors chase what little yield they can find.

Looking out to the balance of 2017, we'll maintain the pro-growth stance we established in equity allocations last year and will endeavor to keep portfolios as invested as possible to take fullest advantage of the improving economic landscape. Though a pause or pullback in the market's trajectory is certainly possible in the near term, we don't see conditions in place to fuel a prolonged downturn. On the fixed income side of mandates, durations will likely be kept shorter than benchmark for some time, though we will look for opportunities to redeploy capital into the corporate segment should spreads expand back to levels we deem appealing from a risk/reward perspective.