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CANADA WAKES UP

Two thousand and fifteen. Those were dark days. The West Texas oil price plunged 30% (on top of a 46% drop in 2014) sending our nation into recession, wildfires raged in Fort McMurray, unemployment jumped and the new Liberal government was being viewed by investors with considerable uncertainty. Unsurprisingly, the Canadian market fell 11% in 2015, amongst the world's worst performing.

However, we've slowly started to clamber out of the mud. Aided by a 45% increase in the oil price last year, the ongoing surge in the US economy (our largest trading partner) and an accommodative interest rate policy from the Bank of Canada (two interest rate cuts in 2015), the Canadian economy has not only pulled out of its 2015 recession, but it may now rival the US for economic growth this year. And the S&P/TSX Composite has followed along, advancing 21% since the beginning of 2016, outstripping the 16% gain of the S&P 500.

For the reasons we detail below, we think that our market's positive momentum can continue over the coming year.

Canada Y-o-Y GDP Growth (%): The Recovery Builds

Source: Bloomberg

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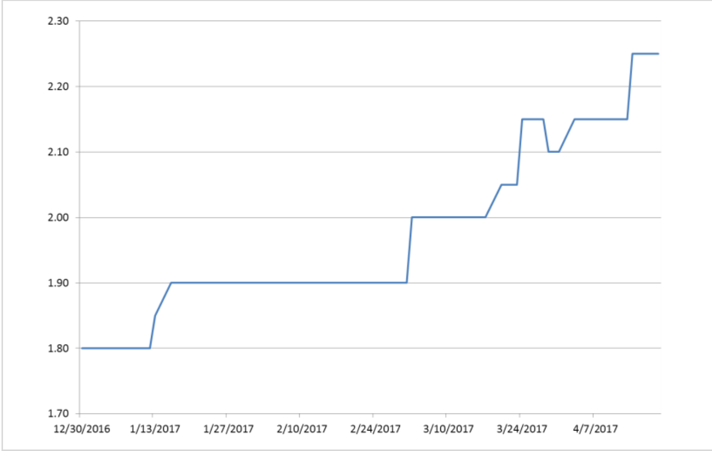
Estimates Raised

The Bank of Canada has become more optimistic on our economy recently raising its 2017 GDP growth estimate to 2.6% from 2.1% previously. The economic growth rate in Canada has continued to ramp up from its 2015 lows (see chart above) and consensus now expects GDP growth this year of 2.3% with these estimates also steadily being revised higher throughout the year (see adjacent chart). Odds of a rate hike at the Bank of Canada's September meeting now sit at a reasonably high 29%, up from only a 17% chance a month ago. Last year, there was no discussion of a rate increase, now at least the possibility is on the table. The Bank of Canada, of course, would only consider a rate increase if economic conditions supported it.

Consensus 2017 GDP Growth Estimates (%) Have Been Rising All Year



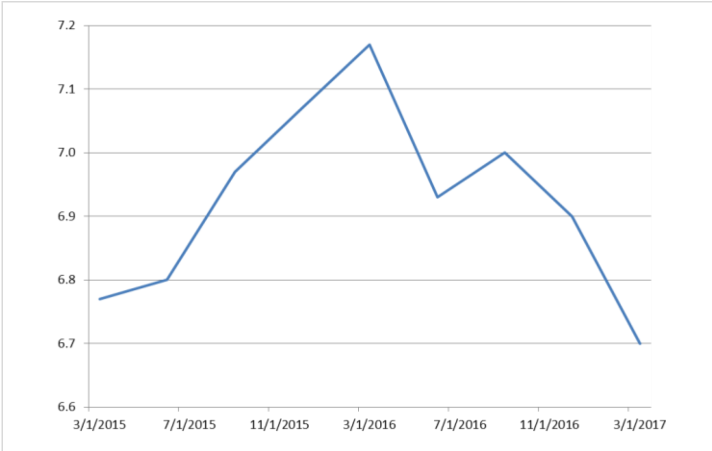
Source: Bloomberg

The improvement in our economy has not gone unnoticed. The OECD also recently raised its estimates for Canadian GDP growth for this year to 2.4%, up from 2.1% previously, putting Canada ahead of most other G7 countries including Germany, France and the UK. Our own domestic economists are also becoming more bullish. For example, CIBC recently stated that "the Canadian economy seems to be firing on almost all of its cylinders."

Stimulus Spending

A potential positive for our economy has been the commitment of the Liberal government to engage in stimulus spending including a proposal to spend tens of billions over the coming decade on infrastructure programs. While this spending has been criticized on many fronts, including the slow pace of recent project approvals, and the increase in the deficit could have negative longer term implications, we believe that the short- to medium-term impact will be positive. Forecasted federal infrastructure spending, for example, will increase from roughly $5 billion annually from 2011–2015 to more than double this amount annually from 2017–2021, according to Aecon Group, one of Canada's largest infrastructure companies. The unemployment rate

Canadian Unemployment Rate (%) Recovering From 2015–2016 Highs



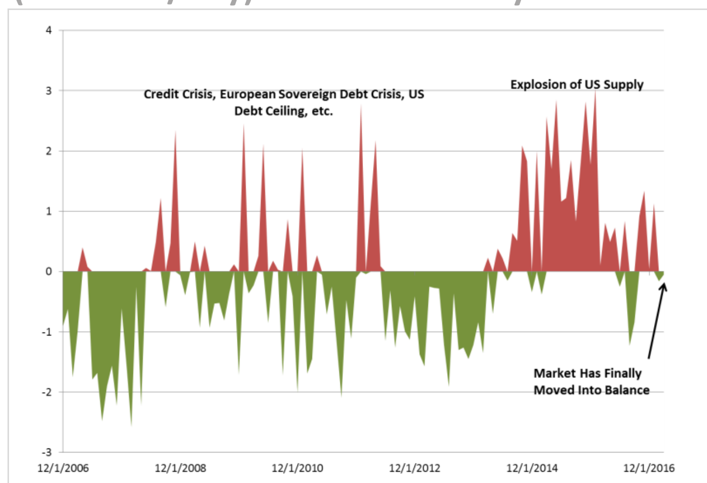
Source: Bloomberg

varies for a variety of reasons, but the initial effects of the Liberal spending, which began to ramp up in 2016, appear to be having the desired effect as our unemployment rate (see chart above) has steadily declined from its highs following the 2015 recession.

Energy Sector Improving

After refusing to cut supply for years in order to drive down the oil price and slow the pace of new US production, OPEC finally agreed in November 2016 to cut output. OPEC plans to curb production by 1.2 million barrels a day in the first half of 2017 in an effort to reduce global oversupply and support oil prices. Non-OPEC producers, including Russia, also committed last year to reducing supply. These announcements, combined with several years of depressed oil prices, have finally allowed the global oil market to move into supply-demand balance. Naturally, the removal of excess supply has been beneficial to our equity market (energy still comprises 21% of the S&P/TSX Composite) and has assisted our economic recovery.

Global Crude Oil Supply Minus Demand (Mlns BBL/Day): A Market Finally In Balance



Source: Bloomberg. Red = Oversupply.

We recognize the fragility of this balance as many OPEC nations, including Iraq, continue to pump oil freely and US shale producers can now much more easily ramp up production than in previous years due to better extraction technologies; however, a balanced oil market is still beneficial for Canada and we remain cautiously optimistic regarding OPEC's actions and the current state of the energy sector.

Canadian Banks Remain Highly Profitable

Canadian banks form the largest component of our equity market and, because they are so widely held, greatly support the health of our economy. Fortunately, Canadian banks have been doing well. Trailing 12-month earnings for the Big Six banks has, combined, come in at a mind-boggling $39 billion and consensus expects profits to reach $42 billion next fiscal year. Reflecting the strength of their earnings, Canadian banks have been consistently raising their dividends. Royal Bank, for instance, has raised dividends *seven* times since 2014 and the average Big Six bank has raised its dividend 7% annually over the past three years. Diversified business lines and geographic exposure in addition to still-strong domestic retail banking operations have supported their performance. Canadian banks have returned 12% annually over the past three years, including dividends, and they remained highly profitable throughout the 2015 energy sector downturn.

Relative Strength Breakout

Relative strength analysis forms an important part of our investment strategy decisions. Relative strength is a fairly simple concept: It's one equity market divided by another. This ratio can then be plotted out over time to indicate which market is outperforming or underperforming. One of the key principles of relative strength analysis is that outperformance and underperformance tend to persist over time. Typically, once a relative strength shift occurs, it lasts—at least for a few years. This is one reason why Canada outperformed the US for roughly the entire decade during the commodity boom of the 2000s and underperformed from 2010 to 2015 as the energy sector weakened.

S&P 500 Versus S&P/TSX Composite: A Relative Strength Breakout

Source: Bloomberg

Currently, there is a break of the relative strength trendline between the US and Canadian markets—an inflection point—which indicates Canada could be poised to outperform longer term (see chart). Ideally, we'd prefer a cleaner and more extended 'break', but it is, nonetheless, a break. Yet another favourable signal for Canada.

NOT PERFECT, BUT IT'S BETTER

We're not out of the woods yet. The Liberal government is taking on substantial debt to stimulate our economy, which it may have to manage with higher taxes. The energy sector has fundamentally changed over the past 15 years and new drilling techniques mean that supply can accelerate much more quickly than in the past. Canadians also have very high personal debt levels, which has inflated housing prices in many of our major cities. The Vancouver and Toronto housing markets, for instance, are still dangerously hot. And there's always Donald Trump and his protectionist trade policies. However, no market or economy is ever perfect and we believe the positives currently outweigh the risks. While returns have been mediocre (but still positive) for the Canadian equity market this year, we remain positive on Canada and expect this performance to improve throughout the year. Our market's been asleep for a while, but it's finally waking up.

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