REVIEW AND COMMENTARY
2nd QUARTER - 2016

Political Discord

Stability returned in the second quarter of 2016- at least to the Canadian equity markets. Oil was trading below $40USF per barrel at the start of the quarter yet spent a considerable period of time over $50USF per barrel before retracing to sub $50USF levels recently. The Oil and Gas sector has significant weighting in the TSX/SP index so it should be no surprise that the Canadian index provided a better return than any other major exchange over the quarter. Year to date, the Canadian index improved by just under 10% outpacing most other major countries indexes. Canadian equities were well overdue for relative and absolute out-performance and finally got it. While oil markets appear to be closer to a more balanced supply and demand level, expected modest growth in North America and uncertainty in Europe and Asia may slow the ascent of oil prices in the foreseeable future. The Financial index showed improvement, moreover the banking index, adding nicely to a strong performance in the first quarter. The Materials index increased significantly, led by the Gold shares, other commodity related gains were more a reaction to share prices being severely oversold rather than a significant rally in the underlying commodities. Given the political and economic uncertainty around the globe, Canada should continue to attract investors and investments. While the U.S. has always been considered a safe haven, increasing civil unrest and election rhetoric are creating a much higher level of uncertainty- something investors fear most.

Uncertainty is increasing internationally as well. Beyond the U.S. Presidential election and evidence that a significant number of Americans are supportive of building walls rather than bridges, Asian economies appear unable to gain traction. The recent BREXIT vote (for Britain to leave the EU) raises many more concerns both economic and political. It is inevitable that BREXIT will lead to some economic dislocation but there are too many moving parts at the moment to be able to accurately determine the extent to which Britain and the rest of the EU will be affected. Even prior to BREXIT several struggling economies remained unable to gain any economic traction even after their Central Banks employed negative interest rates (where the borrower pays back the lender less than what was lent). So with the uncertainly surrounding the BREXIT vote, major Asian and European economies continuing to struggle, it would appear that global interest rates will not be rising anytime soon. This should be supportive of equities. Investor fear is leading interest rates even lower in the U.S. The US Treasury 10 year, at the time of writing is yielding less than 1.4%. To put that in perspective, the majority of stocks in the SP 500 presently yield more than the 10 year treasury- possibly the first time this has ever happened. This is what they call the ‘fear on’ trade – where investors seek a safe haven to allay their fears. Just imagine what might happen to North American equites (and bonds for that matter) if the ‘fear off’ trade prevails?

The BREXIT referendum vote may be one of the most significant events in recent history. Marine Le Pen, leader of France's National Front (who espouses similar sentiments to the BREXITers) stated after the vote that it was "by far the most important historic event known by our continent since the fall of the Berlin Wall." Comparing Britain's decision to leave the EU to the falling of the Berlin Wall is oddly ironic given that the vote to leave was a vote, in some respects, against the heightened levels of immigration, the equivalent to putting a wall back up. One of the BREXITers rallying cries was to "take our country back" which they certainly did by deciding to leave. British Prime Minister Cameron has resigned as did the two leading proponents of BREXIT, Boris Johnson and Nigel Farage. Imagine getting the country "back" and the most vocal and visible members of movement leave. The level of irony is equally compelling. This leaves some of us to wonder whether they, leaders and leavers both, ever really thought much past the rhetoric. Will BREXITers get everything Farage and Johnson promised? Or will they get what they were so upset with prior to the vote- political leaders that promised well more than they ever delivered? Bets are on the latter.

While the equity markets have regained most of what was lost after the results from the vote, there is enough to worry about for BREXITers. With the English Pound falling precipitously to a 30 year low since the vote, inflation will start to surface. And it could be painful. Employers have already become more cautious by freezing hiring and carefully reviewing whether to re-locate employees or re- direct capital investments to other countries. Inevitably it will take some time; Britain needs a new Prime Minister upon whose shoulders will rest the extremely difficult task of negotiating an exit plan. And if a plan were to materialize that was satisfactory to BREXITers, the vote still remains with all the remaining EU members as to whether it will be approved. There are different paths to take in these negotiations- a possible model would be something similar to Norway's arrangement that allows access to the EU markets in return for free movement from EU countries and a contribution to the EU budget. But the immigration issue is something that rallied the BREXITers and the leaders promised that much of the existing payments to the EU would be re-routed back into Britain if they quit. The latter will not likely happen and little support presently would be for allowing increased immigration. Thus the matter could take even more than the two years required once Article 50 of the Lisbon Treaty is invoked- tactically, Britain may stall invoking Article 50 for as long as possible.

More importantly is the unintended consequences of BREXIT. Some European Banks, particularly Italian Banks, have greatly weakened. Foreign exchange volatility, an economic downturn and the effect BREXIT many have on many company's balance sheets could make them more vulnerable. In turn, this would have a knock on effect to the rest of the EU. The EU has to be concerned that if the deal Britain is able to negotiate is determined to be favourable, then other countries may follow Britain's lead. Thus, it is in the EU's best interest to make the terms of separation as punitive as possible. This too may cause more economic pain in the short term. If the process is drawn out and little progress made, Britain's new Prime Minister may call an election and some possible compromise or reversal of the decision may result. Regardless, it would appear that Britain and Europe will be under some duress for the next while. And along with the uncertainty surrounding the upcoming US election, Canada may be considered a relatively good choice for the next few years. If nothing else, Canada is due.