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REVIEW AND COMMENTARY- 2016

2016 was a good year for Canadian equity investors. The TSX Composite Total Return increased by over 21% providing one of the strongest returns among major developed countries equity indexes. In comparison, in the U.S. the SP 500 Total Return Index increased by 12% (USD) or 8.8% if measured in Canadian dollars. Comparable indices in France, United Kingdom, China and Japan were all negative save Japan which returned 0.3% on the year. German broad indexes posted an annual gain of 0.6%. Canadian equities, as we had expected, had a good year in absolute and relative terms.

While there were many events in 2016 few will be any more memorable than the BREXIT vote in the UK and the U.S. Presidential election. Initial reactions to the outcomes were extremely negative. The UK market took a few days to head higher. Considerably less time was required in the U.S. Prior to the President Elect's acceptance speech U.S. equities futures were significantly lower and after an unexpected conciliatory tone during his speech the markets turned dramatically in a positive direction. U.S. (and other major world) equity indices responded positively posting healthy gains in the 4th quarter.

Canada's relative outperformance over the year can be attributed, in most part, to the rally in commodities and cyclicals. Oil was a significant contributor. While it took a considerable amount of negotiations OPEC was able to agree on production cuts in the last quarter of the year. This added to an already steady performance of the Energy index (sub-index of the TSX SP Composite Index) throughout the year, posting an annual gain of 35%. The Materials sub index was even stronger posting an annual gain of just over 41%, however, it posted a weak 4th quarter performance. The Financial sub-index posted a strong annual return of just over 24% for the year, just under half of that coming in the fourth quarter.

With all this in mind let's look back on our predictions for the past year. Last year our predictions were;

Geo-political tensions will continue to increase pushing oil prices lower short term but oil prices will bottom in 2016 and improve from current levels (35US/bbl) by the end of 2016.

Bonds will not perform as well as equities in Canada or the US.

Interest rates in the US will not be raised by the Federal Reserve as much as presently expected (four times in 2016).

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Oil did bottom in 2016. There was an inflection point in February when the uptrend took hold among news of financial strain among junior producers and continued drill reductions on marginal wells. ISIS continued to disrupt the Middle East and Iran was ramping up their production after years of prohibitive sanctions. While discussions among OPEC producers were ongoing, few could agree and holdouts such as Iran did little to infuse any confidence short term that a production cut could be not only negotiated but adhered to. Finally, in the 4th quarter 2016, OPEC and non OPEC producers came to a formal production cut agreement. While it is still early to tell, indications are that production is being capped. Oil ended the year at $53.72 US/bbl. up nicely from the start of the year.

Bonds in Canada and the US underperformed equities by a substantial amount. In fact, after the US Presidential Election, US bond prices fell significantly. The President Elect's many promises of lower taxes, infrastructure spending and trade agreement re-negotiations were in some part stimulative, other parts inflationary (something bond investors are not too keen on). The US Long bond posted a loss of almost 14% in the last quarter of 2016, most of the damage coming after the election in November. This is something quite new to many new bond investors and sent for the first time in a long time an important message that all asset classes have risks. The Federal Reserve finally raised interest rates in December, for only the second time in 2016, validating our last prediction of 2016. US Treasury bond returns (30 Year, 10 Year and 5 Year) were all positive for the year but only nominally. Canadian Government Bond returns with similar maturities were all negative for the year.

What does give us pause is the level of optimism in the equity markets surrounding the President Elect and the various promises made. The US equity market reaction to- date is a combination of various things, the most prevalent is the promise of lower corporate tax rates which will make US companies immediately more profitable (in the majority of cases) and thus more attractive. As well, he has promised or inferred that regulatory reform, spending on infrastructure, and revisions to, or cancellations of, health care and trade agreements will be a high priority. Trade wars can cut both ways and diplomacy will be required to navigate potentially turbulent waters with major powers such as China and Russia. A rather ambitious agenda for even the most seasoned public servant.

Our predictions for 2017 are;

1) The TSX SP Composite will hit new all-time highs in 2017.
2) Equities will again outperform medium and long term bonds.
3) Pullbacks in the equity market will be an opportunity for those under- invested in equities to increase their exposure.

Thank you for your continued confidence and all our best in 2017!