HIGHLIGHTS

Economic Review

- While economic momentum has moved meaningfully lower, largely driven by weakness in China, the Canadian economy has surprised markets to the upside.
- Equity markets maintained a generally positive tone over the quarter as ongoing concerns regarding global trade were offset by dovish monetary policies.
- Bond markets posted strong returns in the second quarter of 2019 in response to evidence of weakness in the global economy and anticipation of central bank interest rate cuts.

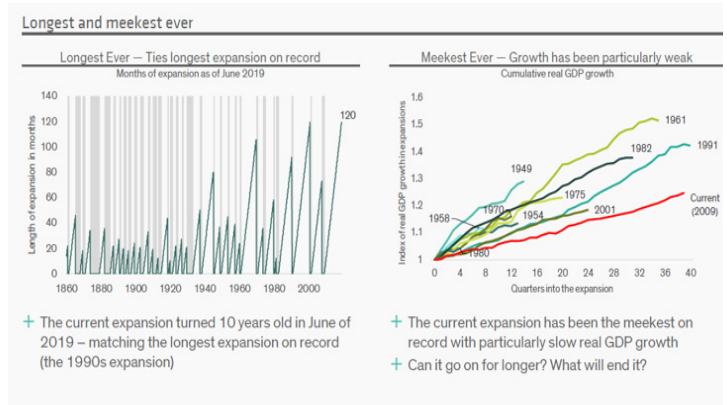
Investment Outlook

- As the global economic and inflation outlook continues to deteriorate, central banks will prepare financial markets for possible forthcoming interest rate cuts.
- There has clearly been a ratcheting up of policy stimulus in this business cycle.
- Longer term, quality companies with superior pricing power and competitive moats should hold up better in an environment where coordinated government and central bank policies leads to higher long-term inflation.

ECONOMIC REVIEW

Global economic growth momentum had slowed early in the quarter and confidence took another downturn as the trade dispute between China and the United States escalated. Despite the weaker economic outlook, stock markets added to their strong gains from the first quarter, reversing most of 2018's declines. The stock market gains can be attributed to the decline in yields and anticipated interest rate cuts, as this benefits market valuations and also makes debt-financed stock buybacks more attractive. With the deterioration in the global economic and inflation outlook, central bankers have become more uniformly dovish. The US Federal Reserve (Fed) prepared financial markets for interest rate cuts, and European Central Bank (ECB) Governor Mario Draghi again pronounced the intention to use all available policy tools should inflation prospects deteriorate.

The current economic slowdown, which began last summer, has been the third within the continuing U.S. economic expansion—which is now the longest in history. Part of the reason for longer business expansions in developed markets is the fact that the economic mix has shifted from manufacturing to predominantly services, essentially reducing the impact of inventory cycles. In addition, the globalization of the supply chain has diffused the inherent volatility of the production process. Policymakers have also been more willing to use stimulus to grow debt when household income growth wanes. Well-anchored inflation expectations have given central banks the room to aggressively use monetary policy tools, and policy makers are seemingly more willing to use fiscal stimulus such as tax cuts, even during the expansion phase of the cycle.



Source: NBER, BLS, and Bernstein U.S. Economics analysis

BOND MARKETS

The bond market posted strong returns in the second quarter as yields continued to decline, in response to evidence of weakness in the global economy and anticipation of central bank interest rate cuts. Within the central banks' data dependency framework we are not surprised that the Fed has shifted relatively quickly from a tightening to an easing bias. Economic momentum has moved meaningfully lower, driven by weakness in China, although the Canadian economy has generally surprised to the upside. The pressure to lower interest rates is not as obvious in Canada when looking at inflation and growth prospects for the economy, and it is a dubious proposition that households require more incentives for debt fueled spending.

Corporate bonds outperformed government bonds in the second quarter as the rally continued. As with the first quarter, the driving force was central bankers' shift to a more dovish policy stance, improving the pricing of all financial assets and, in particular, the more credit sensitive ones in the bond market. The yield curve further inverted as the 3-month Treasury bill yield was unchanged at 1.66% while the 10-year Government of Canada bond yield declined 14bps to 1.47%. Some of the inversion was a result of central bank intervention, however, this could still be seen as a signal of weaker economic growth to come.

EQUITY MARKETS

Equity markets maintained a broadly positive tone in the second quarter, with ongoing rhetoric around global trade being more than offset by dovish monetary policy from key central banks. Regionally there were relative distinctions, as those areas more exposed to trade tended to underperform broader global indexes. In particular, Asia's key markets such as China, Korea and Japan all lagged.

Canada was a relatively strong market (+2.6%), with gains fueled by strength in technology and materials—gold being a notable contributor. Offsetting this was weaker performance in the energy sector, which has been a laggard in most markets as demand concerns were prevalent in the face of economic uncertainty.

U.S. markets also outperformed (+4.3% in USD), with technology stocks continuing to provide strong returns. Financial stocks recovered some ground as relief came from the Federal Reserve's dovish tilt. Conversely, Health Care was a relative laggard, with ongoing pre-election posturing creating some uncertainty.

International markets showed mixed results. The UK exhibited ongoing weakness as a result of the continued wrangling regarding Brexit. Most core European markets posted generally good returns with the Swiss index as a notable outperformer. Emerging markets were relatively weaker with disparate returns, a derivative of China's underperformance.

Central banks once again came to the rescue in providing continuing monetary accommodation. This injection of liquidity served to calm markets; however, aside from some reasonable gains we have not seen any materially-improved economic results or earnings expectations. Even with the market uncertainties, valuation measures have generally remained stable through the quarter, which may require some caution in the short term.

Market Returns (as at June 30, 2019)

(%)	3 M	1 Yr	5 Yrs	10 Yrs	15 Yrs
S&P/TSX	2.6	3.9	4.7	7.8	7.4
S&P 500 (C$)	2.0	9.8	15.3	16.1	8.6
S&P 500 (US$)	4.3	10.4	10.7	14.7	8.8
Russell 2000 (US$)	2.1	-3.3	7.1	13.5	8.2
DJIA (C$)	0.4	9.0	14.2	13.5	6.3
DJIA (US$)	2.6	9.6	9.6	12.2	6.4
MSCI EAFE Net (C$)	1.4	0.4	6.5	8.2	5.2
MSCI EAFE Net (US$)	3.7	1.1	2.3	6.9	5.4
MSCI Emerging Mkts (US$)	0.6	1.2	2.5	5.8	8.7
FTSE Canada Universe Bond	2.5	7.4	3.9	4.5	5.0
FTSE Canada 91 Day T-Bills	0.4	1.6	0.9	0.9	1.6
C$/US$	2.2	0.7	-4.0	-1.2	0.2

Converted to CAD using London 4pm rates. Returns are annualized for periods greater than one year.

INVESTMENT OUTLOOK

Although global growth has decelerated during recent quarters, there is a notable difference between the recession risk for the US and the rest of the world. Europe faces structural weaknesses in its financial sector and fiscal policy pressures that are not prevalent in the US or Canada. For its part, China is attempting to reduce the pace of debt growth. In contrast, the US has both a relatively unencumbered financial system as well as the political will to use fiscal levers aggressively. In the past, global (ex-US) recessions have dragged the US into recession in about half the instances, however, the defining factor will be the strength of the US economy going into a wide-spread downturn. The current global slowdown started almost one year ago as the US economy was still growing at an above-trend pace, so in this case, a near-term recession in the US is unlikely. Typically, recessions occur when imbalances in the economy or financial markets correct. At this time, the imbalances in developed markets are not obvious. China presents the most risk given its extraordinary debt growth in recent years.

Source: BIS, CEIC, Haver Analytics, IMF, national sources, Morgan Stanley Research estimates; Global includes Morgan Stanley coverage excluding Kazakhstan, New Zealand, Norway, Peru, Sweden, Switzerland, Ukraine and Venezuela. Note that 1Q19 numbers are estimates.

There has clearly been a ratcheting up of policy stimulus in this business cycle. It is unusual to see aggressive fiscal policy stimulus during an expansion, which the US instigated in 2018, and now the Fed is preparing to further stimulate an economy that is already enjoying accommodative financial conditions by historical standards. Trade negotiations between China and the US could drag on for years, which makes a policy move with such a responsive instrument as interest rates questionable. At a certain point, should we question the effectiveness of the central banks' stimulus efforts? Since 2009, there have been 715 interest rate cuts globally, US$12.4 trillion of asset purchases by the five largest central banks alone, $5.4 trillion of US stock buybacks, and yet growth and inflation are still below trend while the MSCI global equity index ex-US is 25% below its 2007 high. Maybe there is some truth to the view that the lowest rates in 5,000 years are working counter to the central banks' goals of boosting inflation and growth. After all, low interest rates help keep afloat uncompetitive corporations that maintain supply above demand.

The reality is that policymakers are unlikely to change their playbooks. In fact, political winds seem to suggest that they will be doubling down on their efforts. More recently, however, political pressures to address inequality have the potential to change the long term-inflation outlook. If fiscal policy is coordinated with monetary policy so that government deficits do not lead to rising interest rates, and fiscal policy is targeted at using up excess economic resources, then we could see long-term trend inflation shift higher. Higher inflation would be an extremely disruptive force for both the economy and asset markets which are heavily invested in a declining inflation trend. Quality companies with superior pricing power will be the clear winners in this environment.

All returns are expressed in Canadian dollars unless otherwise indicated.
Sources: TD Securities, S&P and Bloomberg. This document is prepared for general circulation to clients of Jarislowsky, Fraser Limited (JFL) and is provided for information purposes only, it is not intended to convey investment, legal, tax or individually tailored investment advice. All opinions and estimates contained in this report constitute JFL's judgment as of the time of writing and are provided in good faith. All data, facts and opinions presented in this document may change without notification. This is not a solicitation for business. Past performance is not a guide to future performance. Future returns are not guaranteed. No use of the Jarislowsky, Fraser Limited name or any information contained in this report may be copied or redistributed without the prior written approval of JFL.