

Market Matters

Q2 2016 Highlights

- The UK's vote (June 23rd) to exit the European Union (EU) shocked capital markets and was a defining moment for the second quarter of 2016.
- Markets whip-sawed; from a pre-Brexit referendum rally in anticipation of a result that would see Britain remain within the EU, to a sharp fall when the opposite result came in, followed by an impressive recovery attempt in the final days of the quarter.
- For the most part, risk assets (like equity markets and commodities) avoided significant quarterly losses, while gold and fixed income assets remained elevated by a demand for their safe-haven qualities amidst the market and economic uncertainty.
- North American economic data ended the quarter on a positive note (e.g. strong US consumer and housing results, good Canadian GDP results) after a disappointing US payroll data release in May.
- Trading sessions remained tumultuous, particularly in the second half of June, with expectations for more capital market volatility to come as the Britain/EU divorce proceedings unfold.

What an interesting quarter it turned out to be: it began with a strong 'risk-on' tone in April (commodity prices, economic data and investor sentiment all improved) and culminated with what can only be described as one of the most shocking results ever to impact the British Isles... Iceland's 2-1 victory over England in an elimination game at the Euro cup.

While that loss didn't have an impact on markets, the other piece of major news out of Britain certainly did.

GOBSMACKED

When UK citizens voted to leave the European Union (EU) market watchers around the world did a double-take in disbelief. In the days prior to the June 23rd referendum vote global markets had rallied strongly on the expectation that Britain would vote to remain in the EU. Subsequently, markets fell hard when expectations were proven wrong and the Brexit reality hit. Amid the sudden uncertainty for the political and economic future of Britain and the EU, here's how the flight to safety trade unfolded:

- Global markets plunged.
 - Shedding \$2 trillion USD in a day, amounting to the worst one-day loss ever for global markets.
- Government bonds rallied as yields dropped.
 - Record low yields in British and German sovereign bonds.

Table 1
Summary of major market developments

Market returns*	June	Q2 2016	YTD
S&P/TSX Composite	0.0%	4.2%	8.1%
S&P 500	0.1%	1.9%	2.7%
- in Canadian dollars	-0.8%	1.9%	-3.6%
MSCI EAFE	-4.0%	-1.9	-9.0%
- in Canadian dollars	-4.4%	-2.6%	-12.0%
MSCI Emerging Markets	0.9%	-0.3%	2.1%
FTSE TMX Canada Universe Bond Index**	1.8%	2.6%	4.0%
FTSE TMX Canada all corporate bond index **	1.3%	2.5%	4.0%

*Local currency (unless specified); price only
 **Total return, Canadian bonds

Table 2
Other price levels/change

	Level	June	Q2 2016	YTD
U.S. dollar per Canadian dollar	\$0.774	1.3%	0.6%	7.1%
Oil (West Texas)*	\$48.33	-1.6%	26.1%	30.5%
Gold*	\$1,322	8.8%	7.2%	24.6%
Reuters/Jefferies CRB Index*	\$192.57	3.4%	12.9%	9.3%

*U.S. dollars

Table 3
Sector level results for the Canadian market

S&P/TSX sector returns*	June	Q2 2016	YTD
S&P/TSX Composite	0.0%	4.2%	8.1%
Energy	1.4%	8.6%	17.2%
Materials	12.8%	26.4%	50.8%
Industrials	-1.3%	0.8%	4.3%
Consumer discretionary	-4.7%	-3.4%	-1.1%
Consumer staples	-3.2%	-4.3%	2.1%
Health care	-21.3%	-15.5%	-72.4%
Financials	-2.8%	0.2%	2.9%
Information technology	-7.1%	-6.1%	-6.1%
Telecom services	1.5%	1.9%	12.3%
Utilities	3.9%	5.9%	14.7%

*price only
 Source: Bloomberg, MSCI Barra, NB Financial, FTSE TMX Global Debt Capital Markets Inc.

- Germany's 10-year bunds traded at a negative rate for the first time in its history, joining Japan and Switzerland in negative territory.
- In Canada, 10-year bond interest rates fell from 1.23% at the start of the quarter to 1.06% at the end of June (down from 1.39% at the start of the year, and significantly down from a 2016 year-to-date peak of 1.55% at the end of April).

- In the US, interest rates fell even more from 1.77% to 1.47% (down from 2.27% at the start of the year).
- Gold prices soared.
 - Bullion prices rose 4.7% on June 24th (the day after the Brexit vote) and augmented the strong year-to-date result of 24.6%.
- The British pound was shunned by investors.
 - British pound sterling dropped 7.3% for the quarter against the US dollar, and recorded a record one-day drop post-Brexit of -8.1%.
- Oil prices gave back recent gains.
 - Oil price's impressive rise over the past quarter would have been even better if not for the Brexit-related pull back. After having recovered to above \$50/barrel USD, West Texas oil prices dropped back down to \$48.33/barrel USD by the end of June.

LONDON FOG

In the last remaining days of the quarter markets managed to shore themselves up, even while a great London fog hung over the future prospects of Britain's economy. Not that all the volatility was done. Rather, soon after the big news broke capital market reaction swung from an initial emotional sell-off toward a more technical appraisal of what the impact on global growth might be.

Aiding North American equity investors' view that the world will move on (or at least that we are insulated to some extent) was a host of encouraging data:

- The best results ever for US banks in the Federal Reserve's stress test. All 33 banks passed, a prerequisite for releasing capital to pay dividends, make acquisitions or repurchase shares.
- US consumer data came in solid (in particular US consumer spending was up).
- Canadian GDP rose 1.5% on a year-over-year basis.
- Oil received a boost at the end of the quarter from a larger-than-expected drawdown in US crude oil inventories and further declines in US production.

The world's financial system is in better shape than it was in 2008, and Britain's unique situation (i.e. having a separate currency and central bank) may provide some insulation from a greater global economic impact. The

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Bank of England and European Central Bank were both quick to provide reassurances by suggesting that stimulus and/or interest rate cuts would be considered and made available where necessary. The possibility of further delays to rising rates for the US are now back on the debate table as well.

Perhaps most surprisingly, UK's broad equity market (the FTSE 100) finished the month and quarter in positive territory. The FTSE 100's significant weight in UK multinational and exporting companies (deriving two-thirds of the index's total revenues from outside of Britain) was helped in no small part by the collapse in the value of the pound sterling. About a 5% weight in precious metal related stocks also boosted the FTSE 100's return.

On this side of the pond, the rise in gold prices helped the S&P/TSX Composite stay flat for the volatile month of June, and both the Energy and Materials sectors can be credited for the strong quarterly performance of the benchmark. The Canadian market, with half the year in the record books, is at the top of the leaders' board among its developed market peers. With minds momentarily distracted from US politics, the S&P500 managed to stay positive for the month and quarter. At the end of June the S&P500 sat only 1.5% away from its May 21, 2015 closing high.

Having said all that, divergence among sector results is high with dramatic winners and losers. Summer has begun with a series of tumultuous trading sessions. It's capital market stability and breadth in sector gains that will help to support investor confidence going forward.

KEEP CALM AND CARRY ON

We don't know how the complex process of the British/EU divorce will unfold, though we anticipate it will take months and years to do so. Each move forward will be judged by market watchers and economists alike, and there will be further market responses (i.e. volatility) as negotiations unfold. But each step forward will also add clarity to the situation. As uncertainty diminishes, realistic fundamentals will get considered again. In the meantime, as currencies, commodities and capital markets re-position themselves and remain on the move, diversification (globally and across sectors) remains a good friend to long-term investors hoping to smooth the ride to their long-term goals.