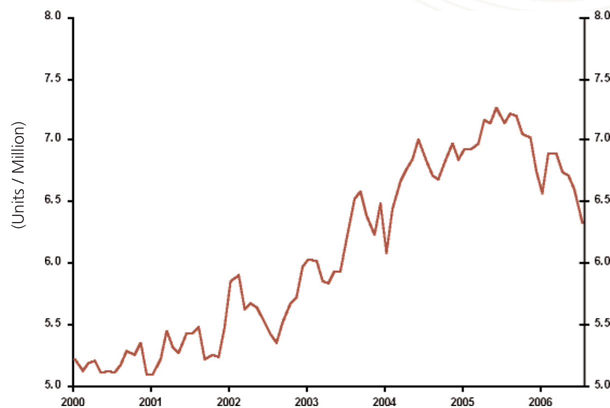
Review and Outlook

MID-CYCLE CORRECTION – SOFT LANDING?

North American economic growth is starting to slow. Second quarter U.S. GDP slowed to 2.9% YOY from 5.6% YOY the prior quarter. This slowdown is being led by the residential housing market.

Economic cycles are normal and inevitable; periods of above trend growth are eventually followed by below trend and occasionally even negative growth. It is the role of central bankers to adjust the cost of short term money to help moderate and sustain economic cycles so as to contain inflationary expectations, encourage long term price stability, and maintain the conditions for sustainable, real growth.

U.S. Housing Sales



U.S. Federal Reserve Pauses

On August 8th, the U.S. Federal Reserve paused in their steady ascent of short term interest rates at 5.25%. The weight of evidence suggested that the economy was beginning to slow, moderating future inflationary pressures. As monetary policy acts with a lag, it requires some degree of anticipation to avoid causing a severe slowdown, or recession. It is this lead-lag response which can cause anxiety for investors as policy errors can create unfavorable investment conditions. Year over year, to the end of August, U.S. inflation, as measured by the CPI, was 3.9% and 2.9% ex food and energy. Both numbers are above the Federal Reserve comfort range of 1-2%. The latest unit labor costs rose 5.0% YOY, which will undoubtedly cause some concern about whether inflation expectations have been contained. The Federal Reserve's actions continue to be data dependent, making the prospect of further rate increases still possible.

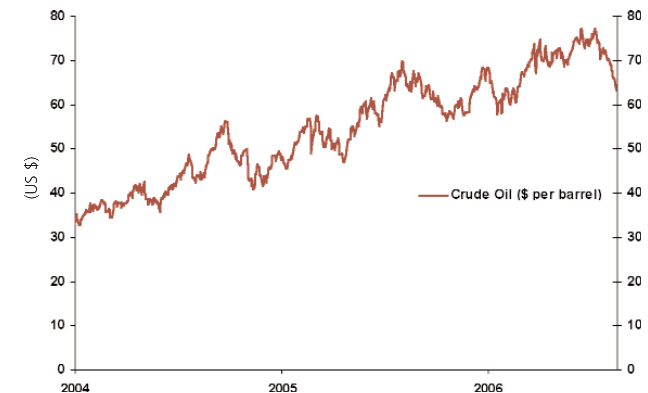
Geopolitics and Markets

It is impossible to escape the daily onslaught of news about wars, conflict and chaos around the world. Some of this news has been used to explain the high prices of oil and gas. Geopolitical events can raise risk premiums resulting in a "flight to quality", typically U.S. treasuries. In the long run, the fundamentals of supply, demand and equilibrium pricing determine where asset prices and markets will be set. We, therefore, do not try to predict or anticipate geopolitics, but rather seek to assess the degree to which geopolitics might result in "external shocks" disrupting normal market forces. An example might be the withdrawal of oil supplies by producing countries for political purposes.

Oil Prices Softening

Oil prices, which have been rising steadily for three years, have declined more than $14/bl from the highs as global growth slows, inventories build and "supply risks" from

Oil Prices



unstable nations become less of a concern. This is important for the inflation outlook as the high energy prices have been increasingly driving up costs for many industries as well as reducing consumer disposable income. It is encouraging that oil prices are beginning to decline since the high prices act as a tax on the economy.

Market Outlook

Capital markets have begun to discount slower growth as evidenced by declining bond yields. Equity markets have been holding up reasonably well, as earnings growth has generally met expectations and valuations are reasonable relative to history. Earnings forecasts by corporations have tended to be cautious reflecting less confidence in revenue and earnings growth and the already very high level of profit margins. Corporate balance sheets are strong, which has in part prompted merger and acquisition activity and supported some stock prices at elevated levels.

Our near term outlook for equity markets is cautious as earnings growth may fall short of expectations going into the year end. We are neutral on Canadian bonds and expect U.S. bonds to outperform based on the current higher relative interest rates. It is our view that we are experiencing a mid-cycle economic slowdown and that easier monetary policy and lower oil prices should over time help to maintain economic growth and profitability.

Conclusions

We are positioned defensively for clients at this time, with higher cash and bonds, and lower equity weights than the benchmarks. We are also somewhat defensively positioned with respect to sector allocations within our equity selection, lowering the risk of the overall portfolios. It is our intent to remain defensive until there is more evidence that the economic slowdown has been priced into capital markets. We view this economic slow down and the market impact as a mid cycle correction. On either a market price or time correction we would be prepared to reduce our cash and increase our equity market exposure.

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