TERRA NOVA
ASSET MANAGEMENT

U.S. Financial Markets
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Stock Market Development

Although the fundamentals of the economy remain intact and momentum is ongoing, the medium term U.S. economic outlook is somewhat muted as it reflects the reduced odds that any of the Trumponomics pro-growth agenda will be enacted. Despite the lack of progress in Washington which is likely to continue through 2018 due to pressure from mid-term elections that, even in the absence of Trumponomics, the economy is showing momentum. Most importantly, the prospect of sustained economic expansion remains intact, and the probability of the eight-year economic cycle extending at least by another two years, remains favorable. We, therefore, expect the stock market to continue to run its bullish course. In our opinion, near term major corrections are unlikely as corporate profits have not peaked. Despite short term corrections in overvalued sectors, the S&P 500 Index ended the quarter up 9.3% YTD, just 1.2% below its record close on June 19th.

Fixed Income Market Development

Short-term debt maturities are acting as if the economy is very strong and inflation is already at target. Longer-term maturities are trading within a range as if inflation may not reach the Federal Reserve's 2 percent target anytime in the next years. So far, the Federal Reserve Bank has gradually increased interest rates, and short-term yields follow as if the economy were very strong. Long term yields, however, do not react much because inflation is under control. This conundrum is driven by efforts to make the financial system safer. U.S. money-market reforms, the Basel Committee on Banking Supervision's global bank capital adequacy and liquidity ratio requirements, and central bank bond purchases have contributed to excessive demand for safe assets such as treasuries, which keeps yields low. The byproduct of this is that despite higher short-term rates, the economy is still being stimulated. Even as the Fed continues to raise the fed funds rate and begins to reduce its $4.48 trillion bond holdings, demand for safe Treasuries, bills and notes is likely to remain high and thus continue to keep yields low. So far, bond and equity markets are comfortable with this scenario, as long as the dollar remains weak and inflation controlled.

Economy

Despite persistent weakness of consumer spending in May, income gains and weak price pressures were sufficient to keep the economy on track for a rebound in the second quarter. An appreciation of a total of $ 4.3 trillion in household net-worth as a result of stock market gains and a 10% jump in annual home prices in 2017 should lead to a rebound in consumer spending in Q 2. The consumer is likely to dominate 75% of this year's GDP growth of 2.4%. Business investment could add 0.5% to GDP if corporate profits continue to rise and as long as the prospect of deregulation and tax-reform agenda continues to bolster optimism.

Federal Reserve Bank Policy Outlook

Although the recent slowdown in inflation was mainly due to the price wars in the wireless-industry which led to a price decline of 10% this year, deducting 0.30% off of core inflation (1.4%), there are also pockets of inflation weakness evident in other labor cost sensitive service sectors like household operations, medical care, transportation, education and personal care. The Fed, which is mainly concerned with financial stability, expects inflation to increase more broadly in 2018 in line with the strengthening labor market, and is likely to keep its neutral level on monetary policy until core inflation reaches its target of 2%. Furthermore, the Fed will carefully monitor whether the start of the unwinding of its balance sheet in Q 4 is likely to have tightening effects on its monetary policy. Current conditions would allow the Fed to continue to raise the federal funds rate to its long-term target of 3 percent from its current range of 1% to 1.25% without causing disruption or volatility in the markets. As the Fed is communicating very well and anticipates reductions to be gradual and predictable, we do not expect major ripple effects in the fixed-income markets.

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Corporate Earnings

Q1 2017 earnings growth was boosted by very favorable comparisons to Q1 2016. Therefore, some moderation in Q2 growth is to be expected. However, Q 2 should mark the second consecutive quarter of double digit earnings growth since 2011. Across sectors, growth is estimated to average 10%. Financials (from 18% in Q1 to 13% in Q 2) and Technology (17% to 12%) are likely to have the strongest growth, albeit a deceleration; Industrials (5% to 9%), Staples (6% to 9%) and Materials (3% to 7%) an acceleration.

TN-Outlook

The combined weight of the 10 largest stocks in the S&P 500 is 19%, below the long-term average of 20% but more importantly way below 27% in 1999 and, therefore, does not represent an overconcentration. On an equally-weighted basis, Health Care has been the best performing sector in 2017 – beating Technology by nearly 200 basis points. Energy has given back all of its 2016 outperformance and is now at new relative lows vs. the S&P 500. The extremes, where valuation and prospective earnings growth point in the same direction remain our strategic sector weightings. We expect the best risk/reward in favour of higher interest rates to be in in Financials. Technology remains attractive, as it is likely to continue to be supported by earnings and low long-term interest rates. As valuations in this sector are stretched, we continue to take partial profits. Earnings estimates in energy are likely to be further downgraded, as we do not believe in a strong rebound in oil prices and, therefore, expect performance to be flat to lower. Industrials remain attractive as a rebound in capex and synchronized global growth should continue to drive earnings upgrades. Health Care remains undervalued with negative earnings momentum in big pharma, and ongoing political risk. We find attractive value in specialty mid-cap Health Care stocks and continue to regard this sector as the most attractive one this year. We remain neutral on the classic defensive stocks like telecom despite attractive dividend yields and low valuations as earnings momentum remains negative.

We remain defensive in the fixed income markets and prefer short term maturities and/or longer term hybrid investments like perpetual fixed/floating rate investment grade bonds.

Your Terra Nova Team will continue to carefully monitor the development of your investments in your accounts.

Best wishes for a happy summer!

Your Terra Nova Team!

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