

# AWF Fall Economic Update

## What to Expect in 2016: Forecast for BC Businesses and Outlook for the Global Economy

Sponsored by:



**RBC Wealth Management**



Jock Finlayson



Christine Hughes



Jim Allworth

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## **Jock Finlayson - Executive Vice President Business Council of British Columbia**

- Jock Finlayson is Executive Vice President and Chief Policy Officer at the Business Council of British Columbia. In this capacity he directs the Council's work on economic, fiscal, tax, environmental and human capital policy issues of interest to the province's business community.
- Mr. Finlayson previously served as Vice President of Research at Canadian Council of Chief Executives, a leading national business association in Ottawa.
- Prior to that he worked in the market research field and gained experience at two Canadian management consulting firms.
- From 2007 to 2013 Jock was a member of the Board of Directors of the Bank of Canada.
- Mr. Finlayson holds a doctorate from Royal Roads University, BA and MA degrees from UBC, and an MBA from Yale University.

## **Christine Hughes - President & Chief Investment Strategist, OtterWood Capital Management**

- Christine Hughes founded OtterWood Capital Management in 2012. Prior to starting her own firm Christine spent 10 years with AGF Management where she managed the Lipper Award winning AGF Canadian Balanced Fund.
- Christine started her career at Cassels Blaikie (now Scotia Cassels) where she took the unusual route of directly working, one on one, with ultra-high-net-worth clients. Spending seven years managing these discretionary portfolios allowed her to pinpoint the exact needs of her clients. She firsthand understands that while appreciation of capital is important, preservation of capital is paramount.
- Christine received her Bachelor of Economics degree from University of Toronto, has earned the CFA designation and is a registered portfolio manager.

## **Jim Allworth - Investment Strategist & Co-Chair RBC Dominion Securities' Global Portfolio Advisory Committee**

- Jim Allworth has been in the investment business since 1968, both as research analyst and as portfolio strategist.
- He is vice-chair of the RBC Capital Markets Investment Strategy Committee, which provides direction on the outlook for financial markets to the rest of the firm and to clients.
- Through nearly four decades at RBC Dominion Securities, Jim has played a key role in developing investment policy for the firm and translating that work into solutions for individual clients.
- He is the RBC Dominion Securities investment strategist and Co-Chair of the Global Portfolio Advisory Committee.



Business Council *of*  
British Columbia

# **Our Economic Prospects in a 'Slow Growth World'**

presentation to  
**Association of Women in Finance  
Vancouver, BC**

**November 17, 2015**

**Jock Finlayson**  
Executive Vice President  
[Jock.Finlayson@bccbc.com](mailto:Jock.Finlayson@bccbc.com)



# What Do Business Leaders Think of Economists?

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“Any company  
that has an economist  
on staff certainly has  
one employee too many”

Warren Buffett

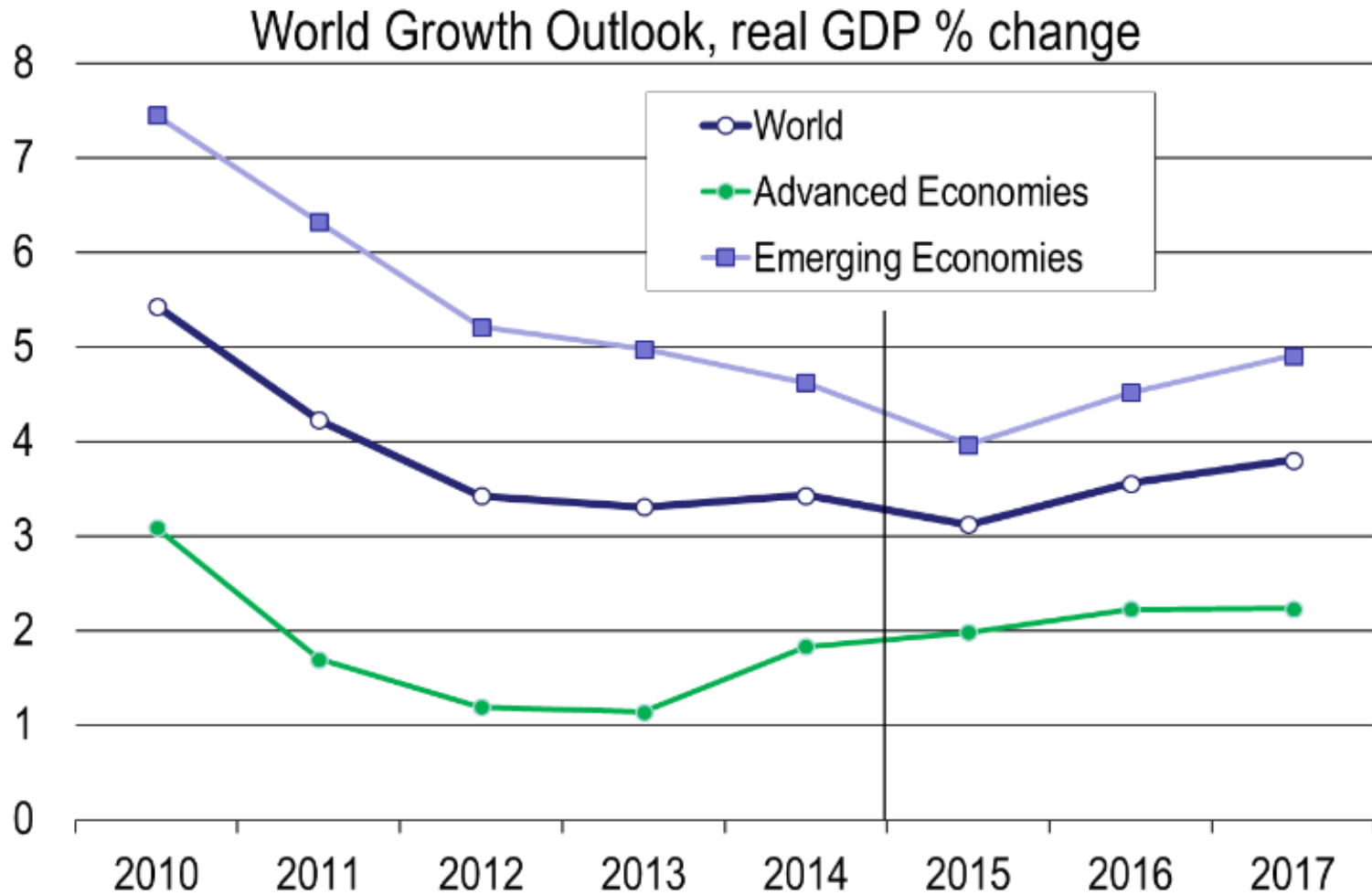
# Today's 'Unforgiving' Global Economy\*

- Disappointing overall growth
- Unusually low interest rates (and low inflation) across the OECD
- Depressed business investment
- China is decelerating -- and moving to a different growth model
- Plus...diminishing economic growth, rising capital outflows, and currency turbulence in many emerging markets
- Commodity prices have plunged
- Lack of coordination and cohesion among G20 economic policy-makers
- Geopolitical tension and conflict

\*"Policymakers will be tested in current 'unforgiving' environment, the Bank of England's Governor has warned," Telegraph, October 8, 2015.



# Economic Growth Loses Momentum Post-2010





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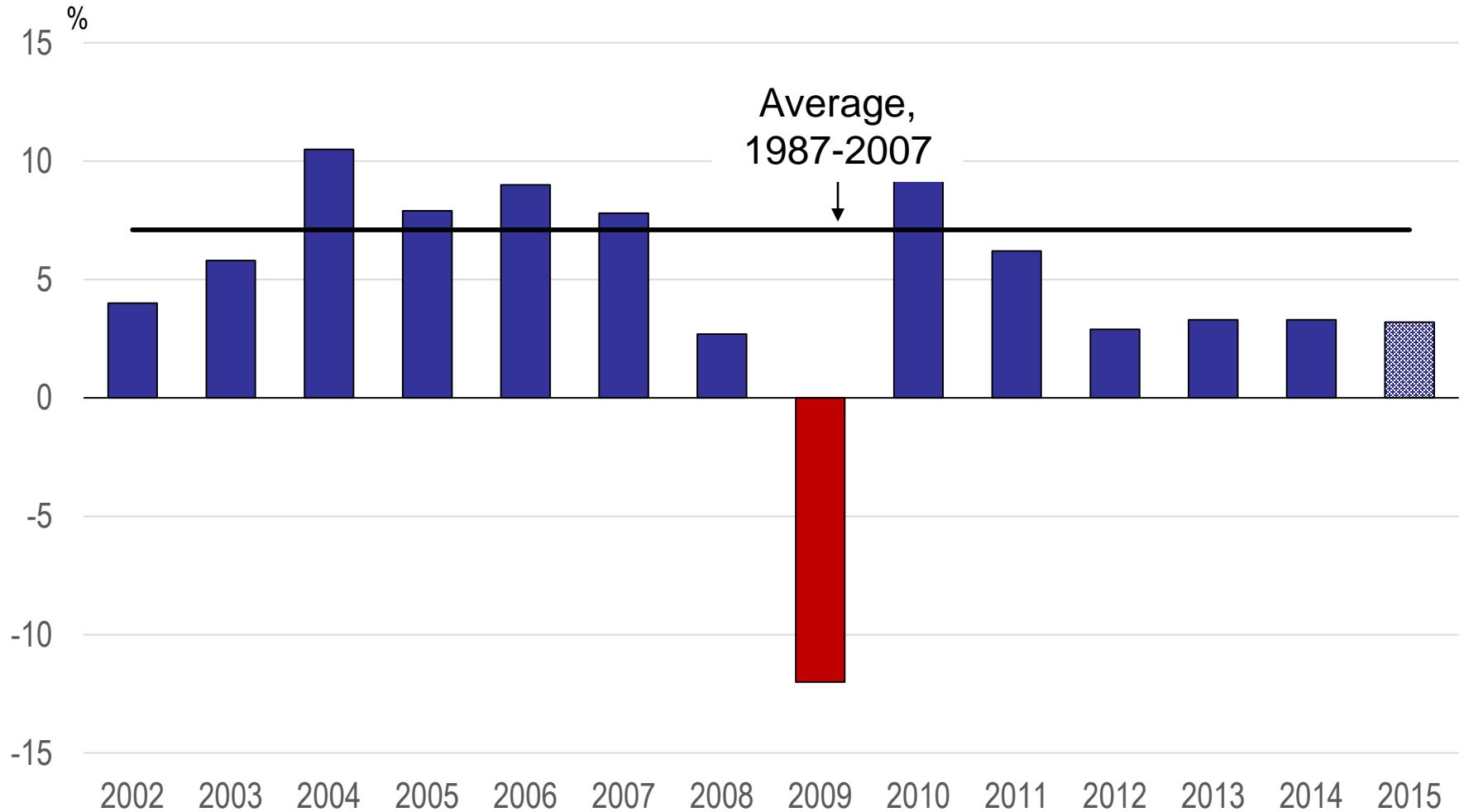
# **Global economic slowdown in real danger of persisting**

*Reuters, October 15, 2015*

## **Why commodities are back in the 1990s**

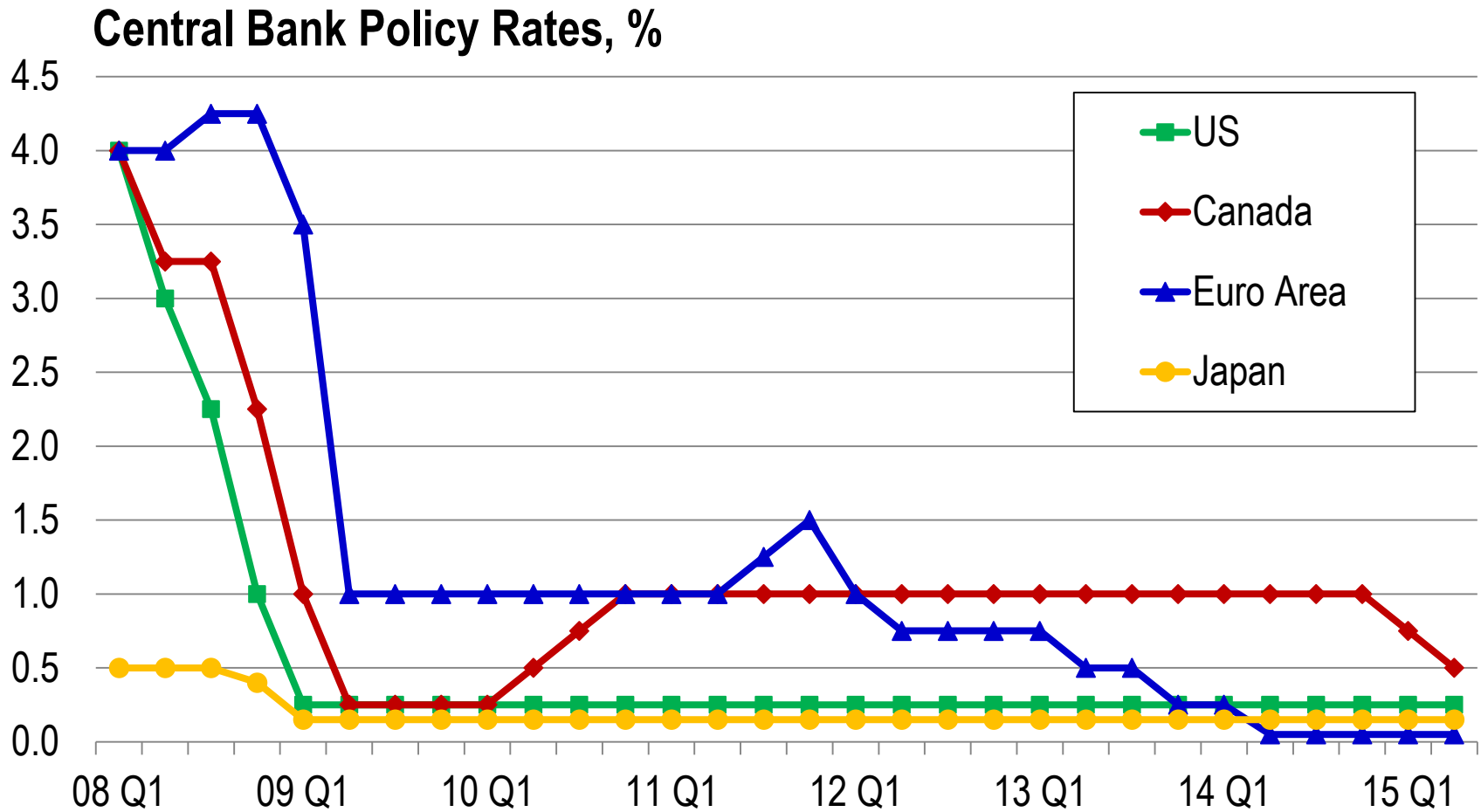
*Bloomberg View, Oct 1, 2015.*

# Faltering Growth in the Volume of World Exports



# Six-Plus Years of Record Low Central Bank Interest Rates

12





# Risks Stemming from Prolonged Period of Very Low Interest Rates

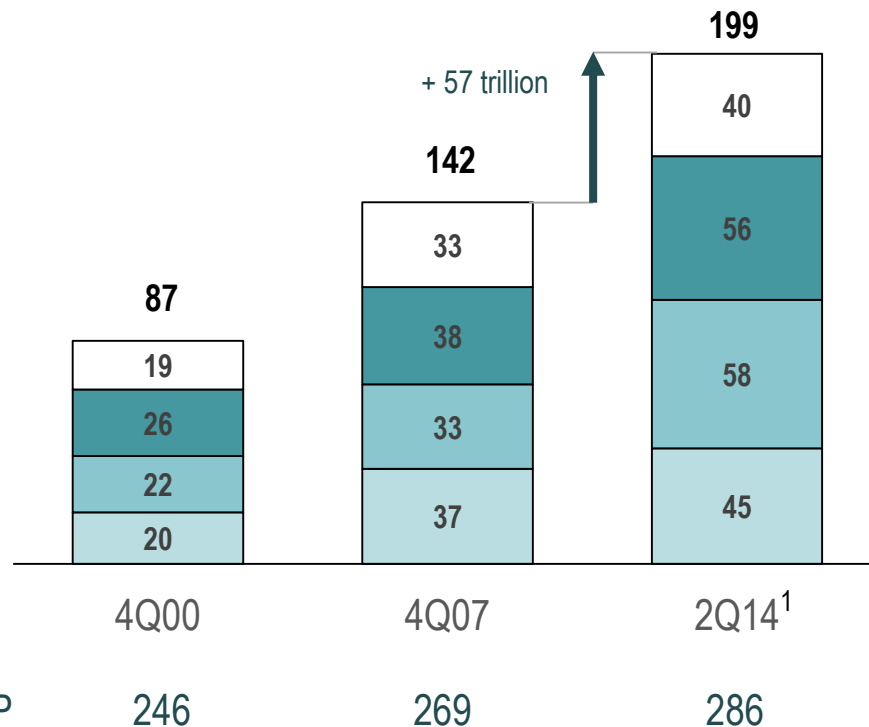
- ▶ “Globally, interest rates have been extraordinarily low for an exceptionally long time, in nominal and inflation-adjusted terms, against any [known] benchmark...”
- ▶ “[S]uch low rates are a symptom of a broader malaise in the global economy...which has proved exceedingly difficult to understand.”
- ▶ Problematic impacts include...ongoing debt accumulation, inflated asset values, misallocation of capital, punitive treatment of savers, malfunctioning banking/financial systems (in some countries), & difficulties facing the pension and insurance industries



# Global Debt Has Increased by \$57 Trillion since 2007, Outpacing World GDP Growth

14

Global stock of debt outstanding by type<sup>1</sup>  
\$ trillion, constant 2013 exchange rates



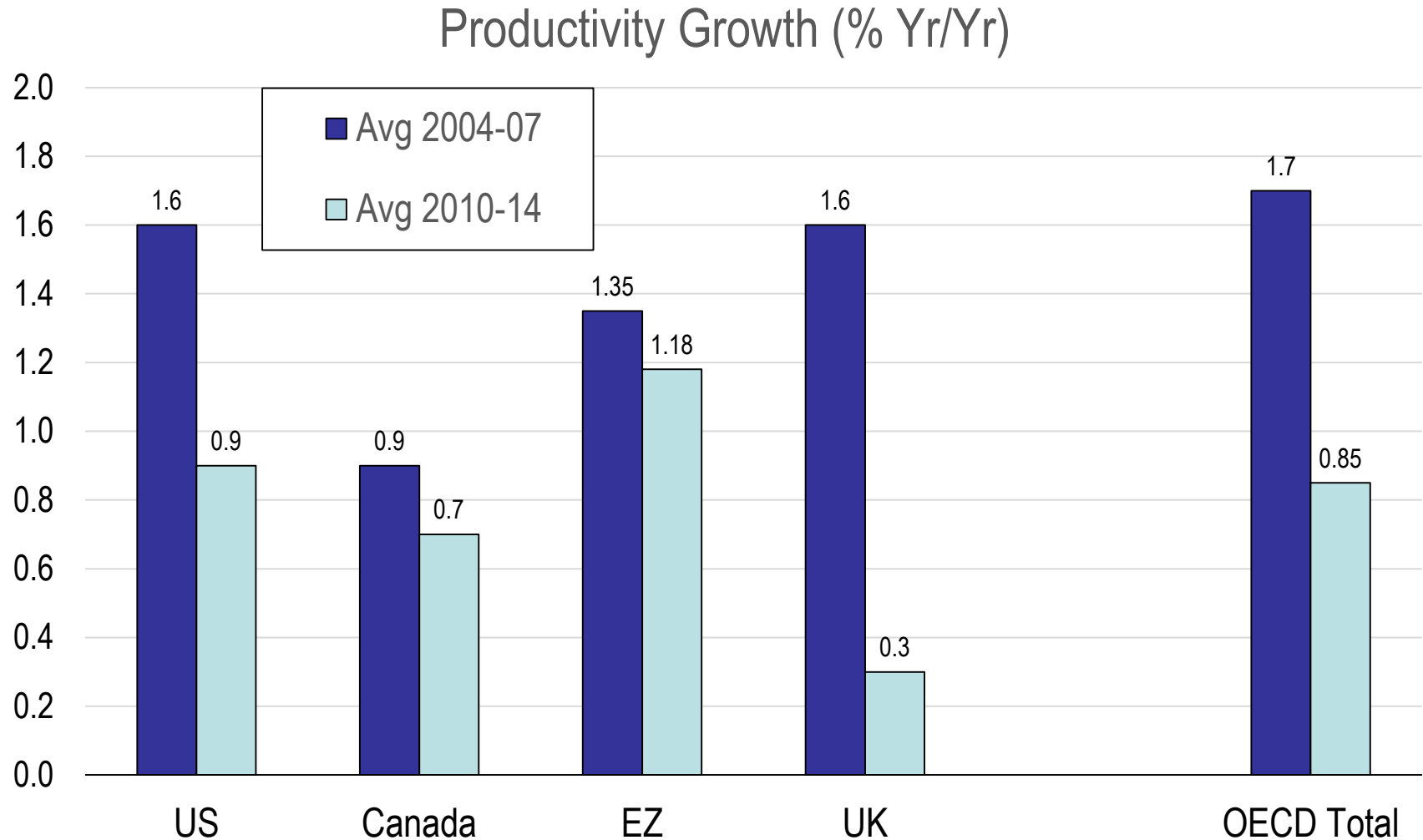
Compound annual  
growth rate (%)

	2000-07	2007-14 <sup>1</sup>
	7.3	5.3
Household	8.5	2.8
Corporate	5.7	5.9
Government	5.8	9.3
Financial	9.4	2.9

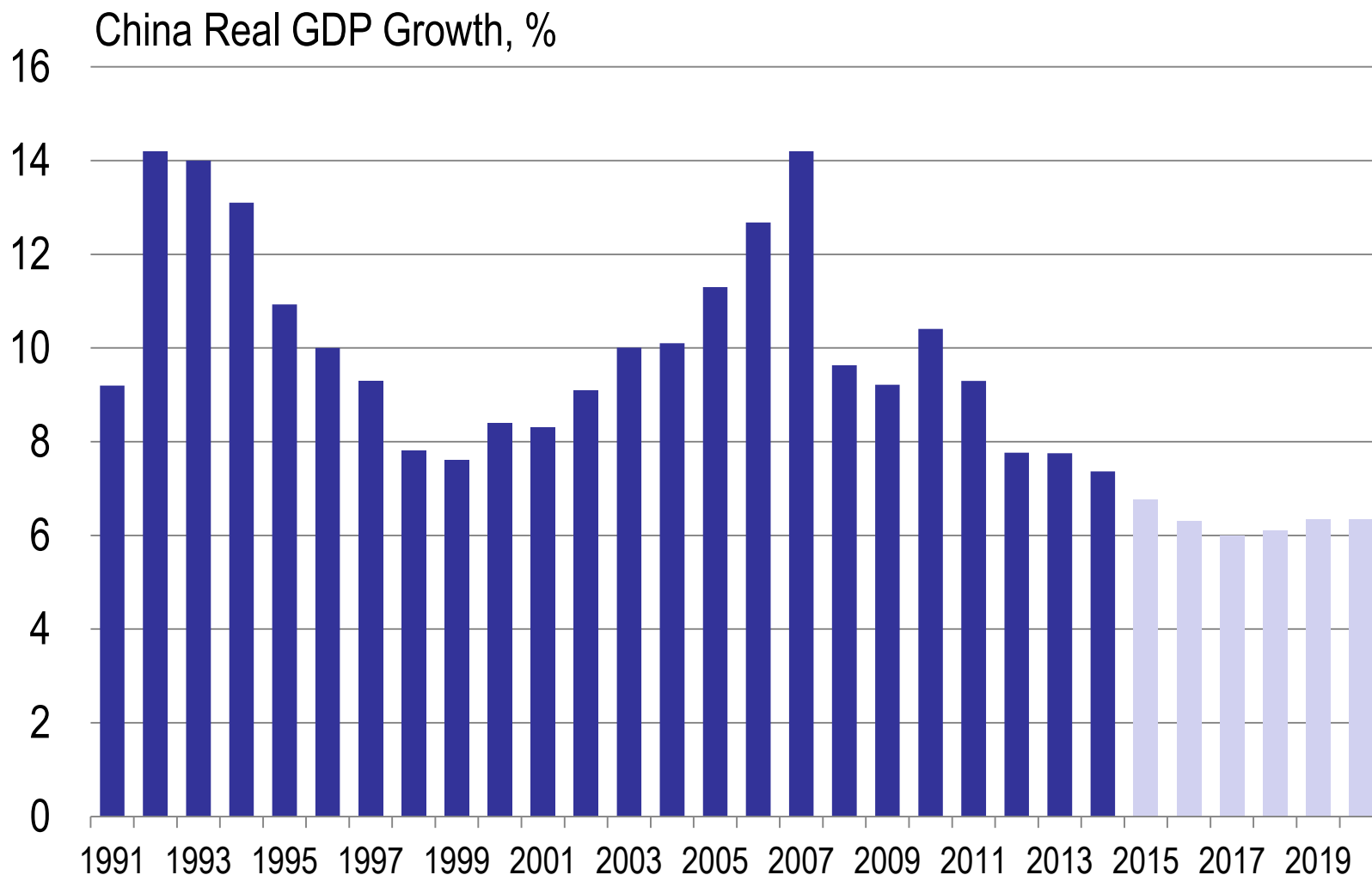
<sup>1</sup> 2Q14 data for advanced economies and China; 4Q13 data for other developing economies.

NOTE: Numbers may not sum due to rounding.

# Deceleration in OECD Trend Productivity Growth



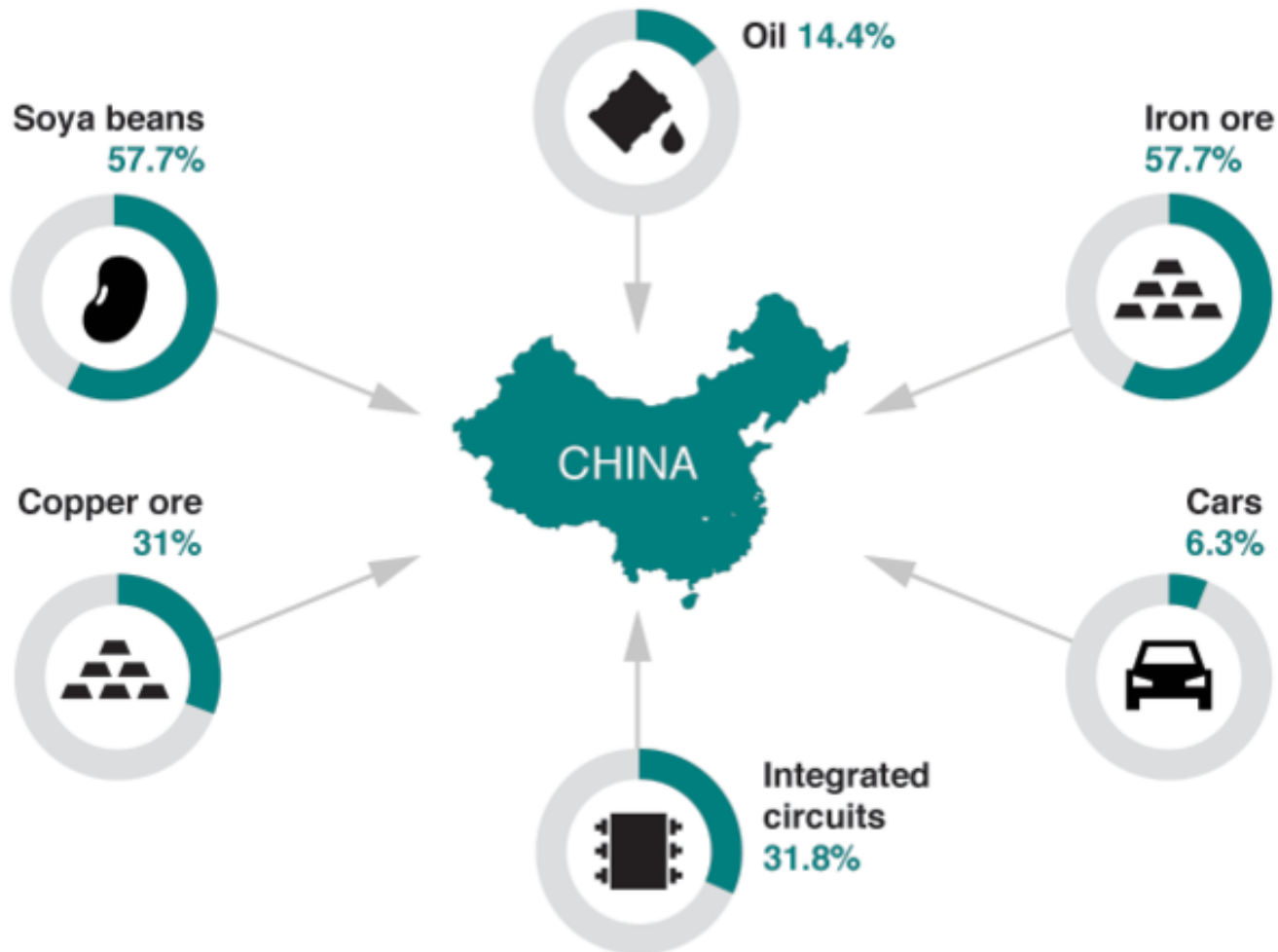
# China Moving to 5~6% Growth Scenario...





# China's Central Role in World Trade

■ China's imports as a percentage of world total





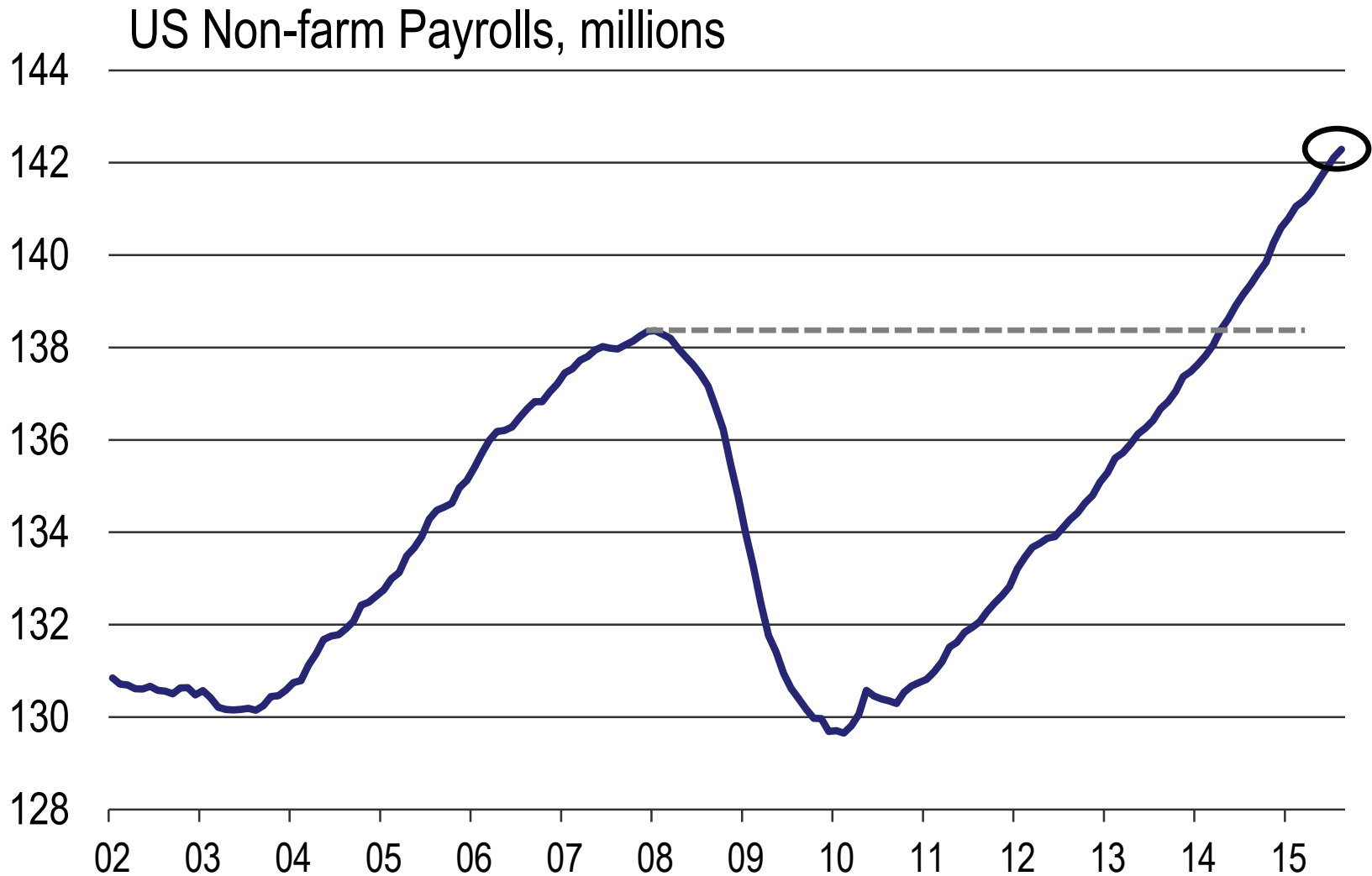
# America's Expansion Chugs Along

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- Economy grew almost 4% (annualized real GDP) in Q2, but momentum has flagged amid softer global economy, higher US dollar, and mounting trade and current account deficits
  - » 66 consecutive months of job gains
  - » consumption trending higher, with bumps along the way
  - » significant household balance sheet repair
  - » housing starts gradually climbing, ~1.1 million this year
  - » lower oil prices are a (net) plus for the US economy
- US Federal Reserve's interest rate is expected to edge up (from zero) over 2016-17...but monetary policy 'normalization' is still a long way off

# US Job Market Has Revived

19



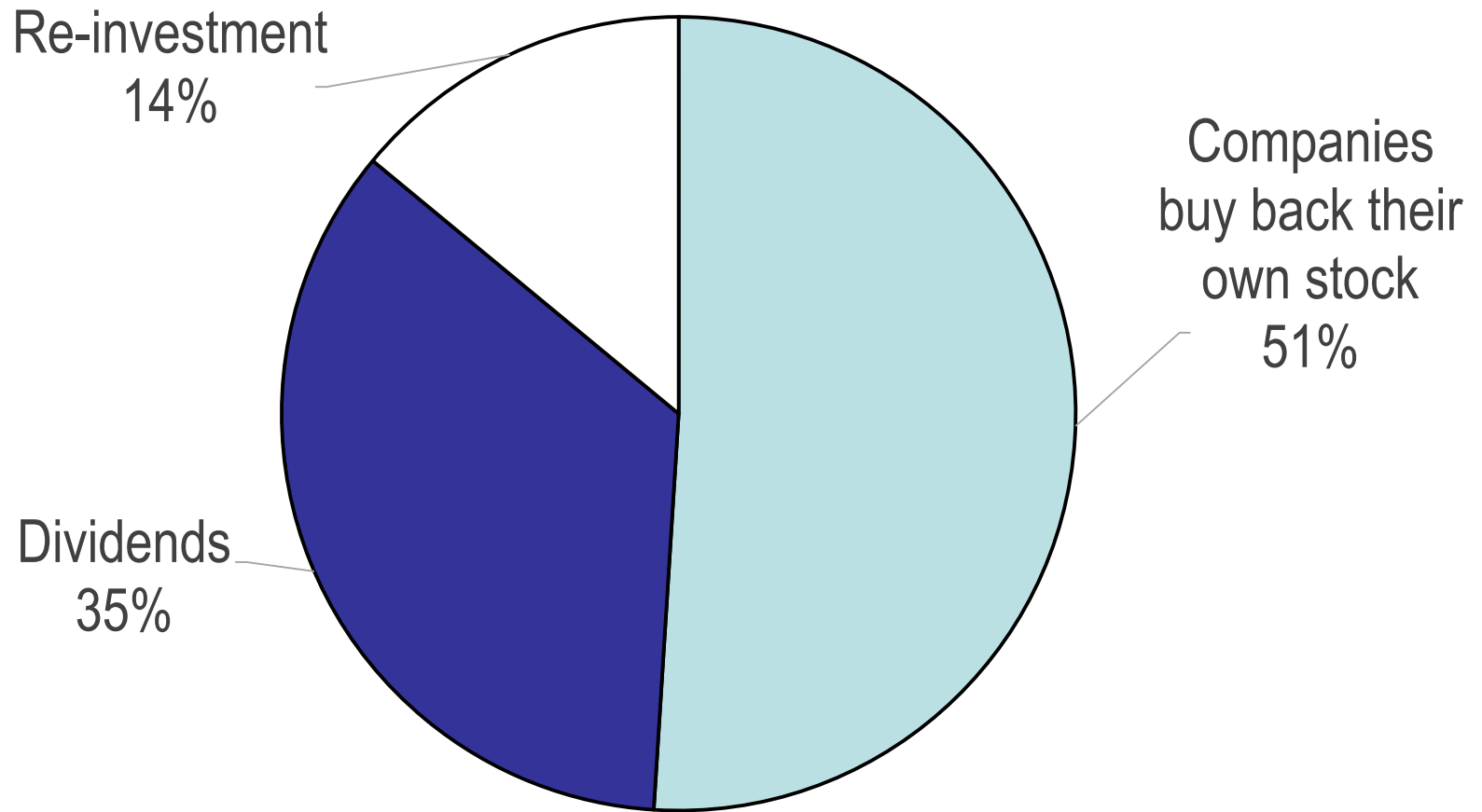


# ...As Housing Starts Continue to Grind Higher





# Disposition of the Cumulative Profits of US S&P<sup>21</sup> Companies\*, 2004-2013





# Updated US Economic Forecast

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(annual % change unless otherwise noted)

	2013	2014	2015	2016
Real GDP	1.5%	2.4%	<b>2.4%</b>	<b>2.5%</b>
CPI inflation (all-items)	1.5%	1.6%	<b>0.1%</b>	<b>1.8%</b>
Industrial production	1.9%	3.7%	<b>1.4%</b>	<b>2.1%</b>
Unemployment (rate)	7.4%	6.2%	<b>5.3%</b>	<b>4.7%</b>
Housing starts (millions)	0.92	1.00	<b>1.13</b>	<b>1.25</b>
10 year US gov't bond yield*	2.35%	2.17%	<b>2.20%</b>	<b>2.51%</b>

# America's Huge Economy Still Matters!

- Estimated US\$18 trillion of GDP this year; equals 22% of global output (market exchange rates)
- US consumer spending = 17-18% of world GDP
- Consider the size of these US metro areas, in terms of annual output/GDP:

Metro New York > Australia

LA/Long Beach/Anaheim > Netherlands

Metro Chicago > Nigeria

Greater Houston\* > Taiwan

Dallas-Fort Worth > Norway

Washington/Arlington > Austria

San Francisco/Oakland > Ireland

Boston/Cambridge > Colombia

Greater Atlanta > Malaysia

Seattle/Tacoma/Bellevue > Singapore

Miami/Fort Lauderdale > Israel

Greater Detroit > Greece

Metro Minneapolis > Portugal

Denver/Aurora > Vietnam

Portland/Vancouver WA > Hungary

(\* Also 2.5x bigger than the BC economy!)

# Canadian Economic Setting

- ▶ Canada recovered quickly from the 2008-09 global downturn and posted solid economic and employment growth ***until early 2015***
- ▶ Under the pressure of falling oil and other commodity prices, ***the Canadian economy stalled*** over the first half of 2015
- ▶ For 2016-17, **a return to modest GDP and job growth** is expected, driven by the US expansion and some gains in non-energy exports
- ▶ **BC and Ontario** should lead the provinces in GDP and job growth over the next two years
- ▶ But Canada as a whole faces significant **economic headwinds**

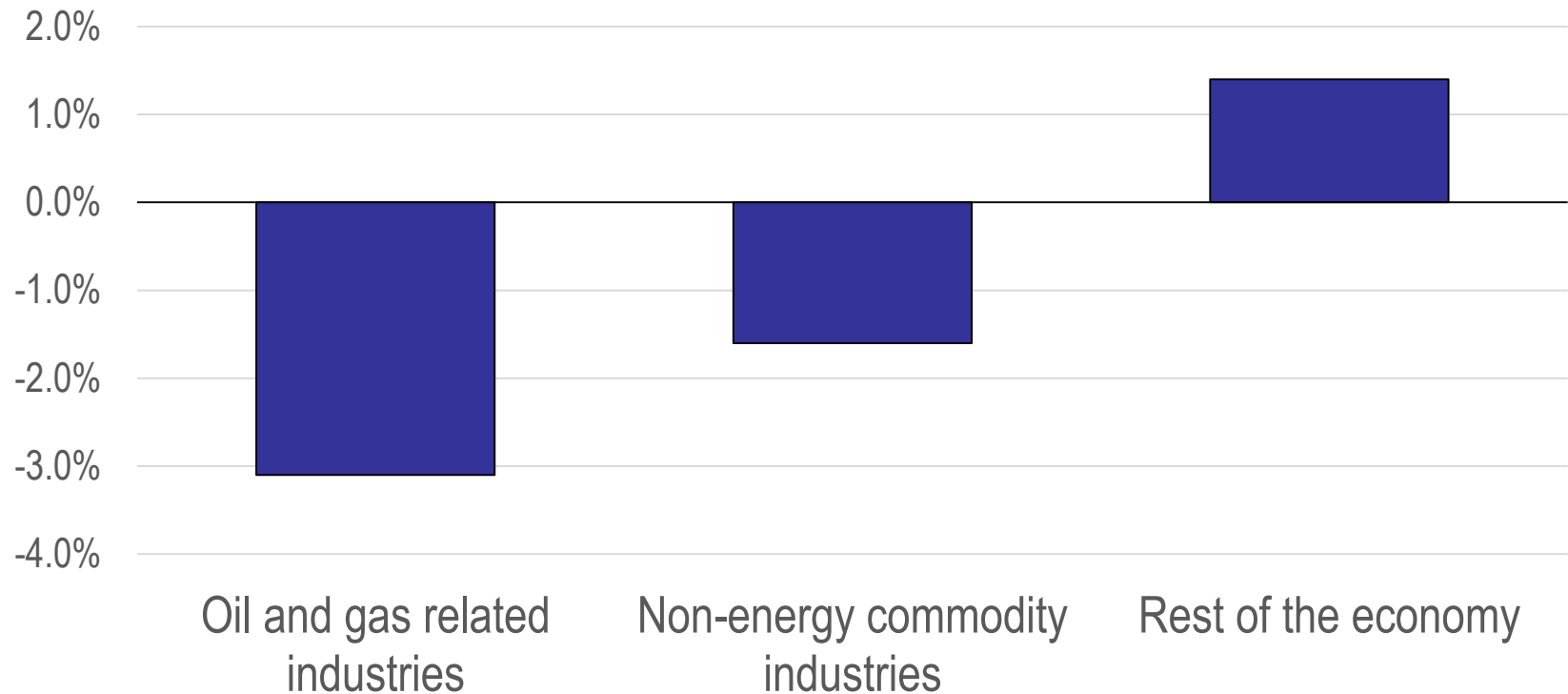




# Canadian Output by Broad Sector in 2015

(y/y % change from 2014)

25



- Resource-related industries, representing ~20% of Canadian GDP, account for most of the weakness seen in the economy over the past year



# Factors Influencing Canadian Economic Growth in 2016 - 2017

26

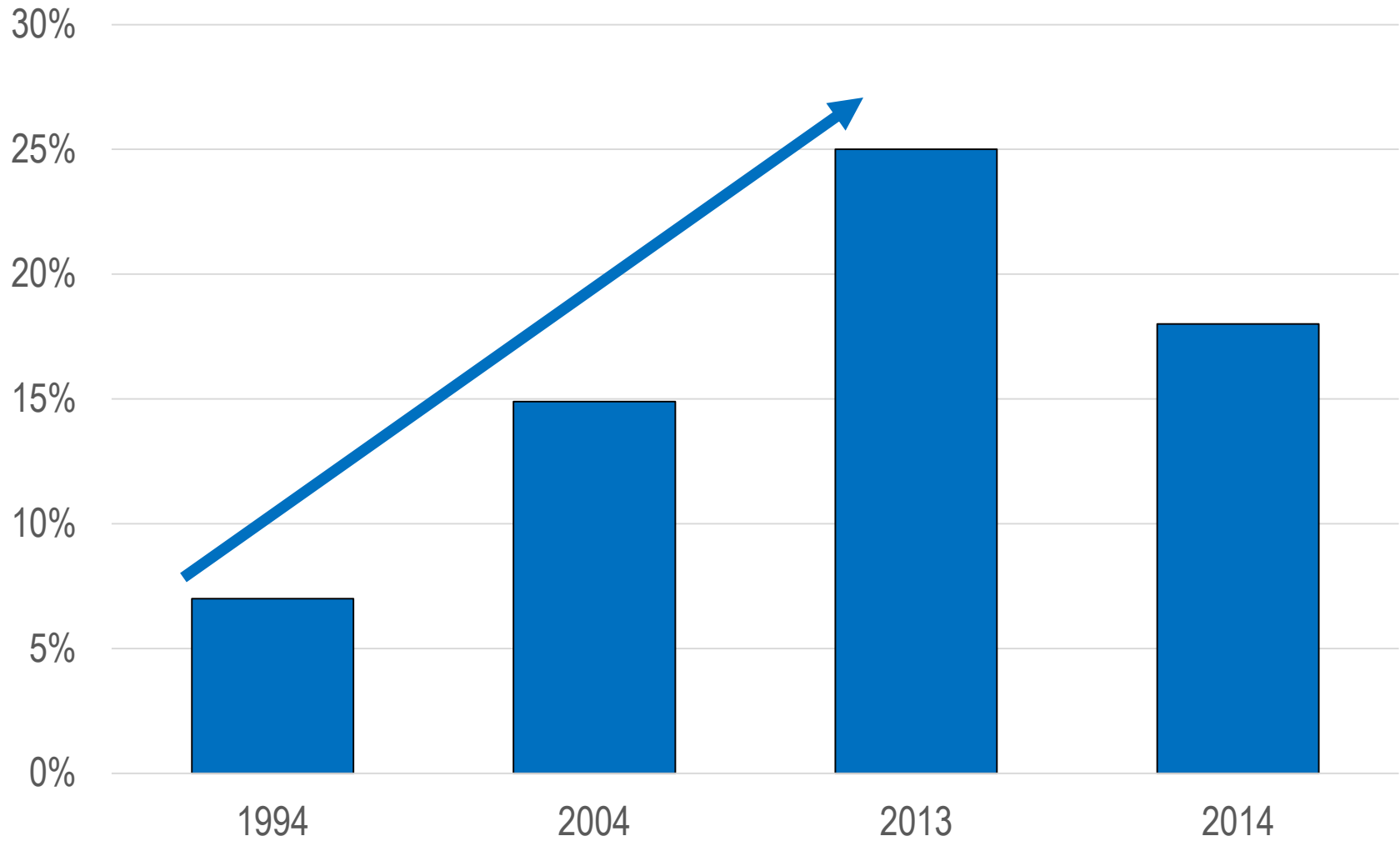
## Negative impact

- Largely tapped out domestic consumers – pointing to weaker growth in consumer spending going forward
- Expected slowdown in housing-related investment
- Declining overall business investment
- Sluggish global commodity markets

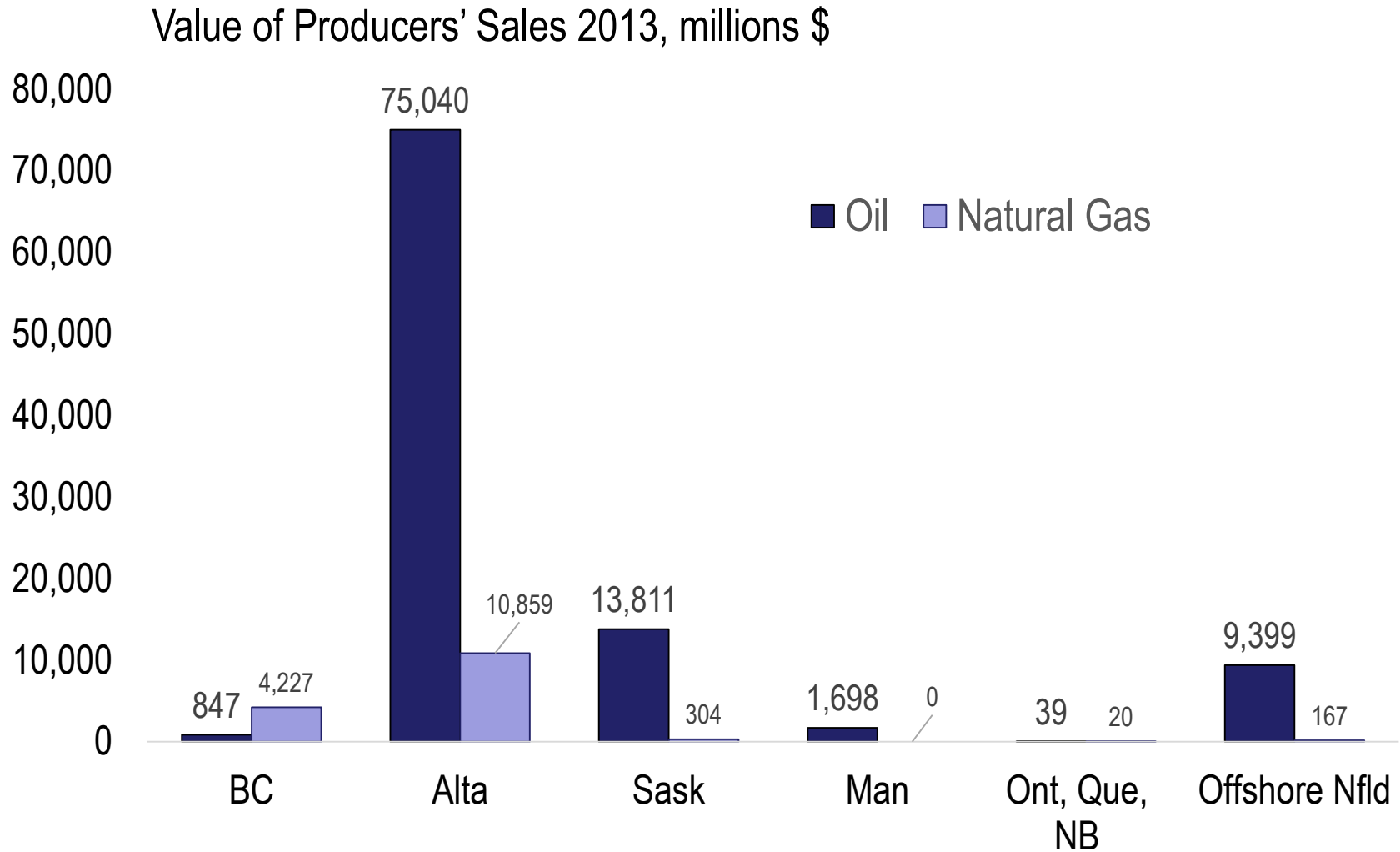
## Positive impact

- Federal government economic stimulus
- US economic expansion
- Gains in Canadian non-energy exports
- Continued low interest rates and low(er?) dollar

# Energy's Place in Canada's Export Mix\*



# Oil and Gas Production Across the Provinces



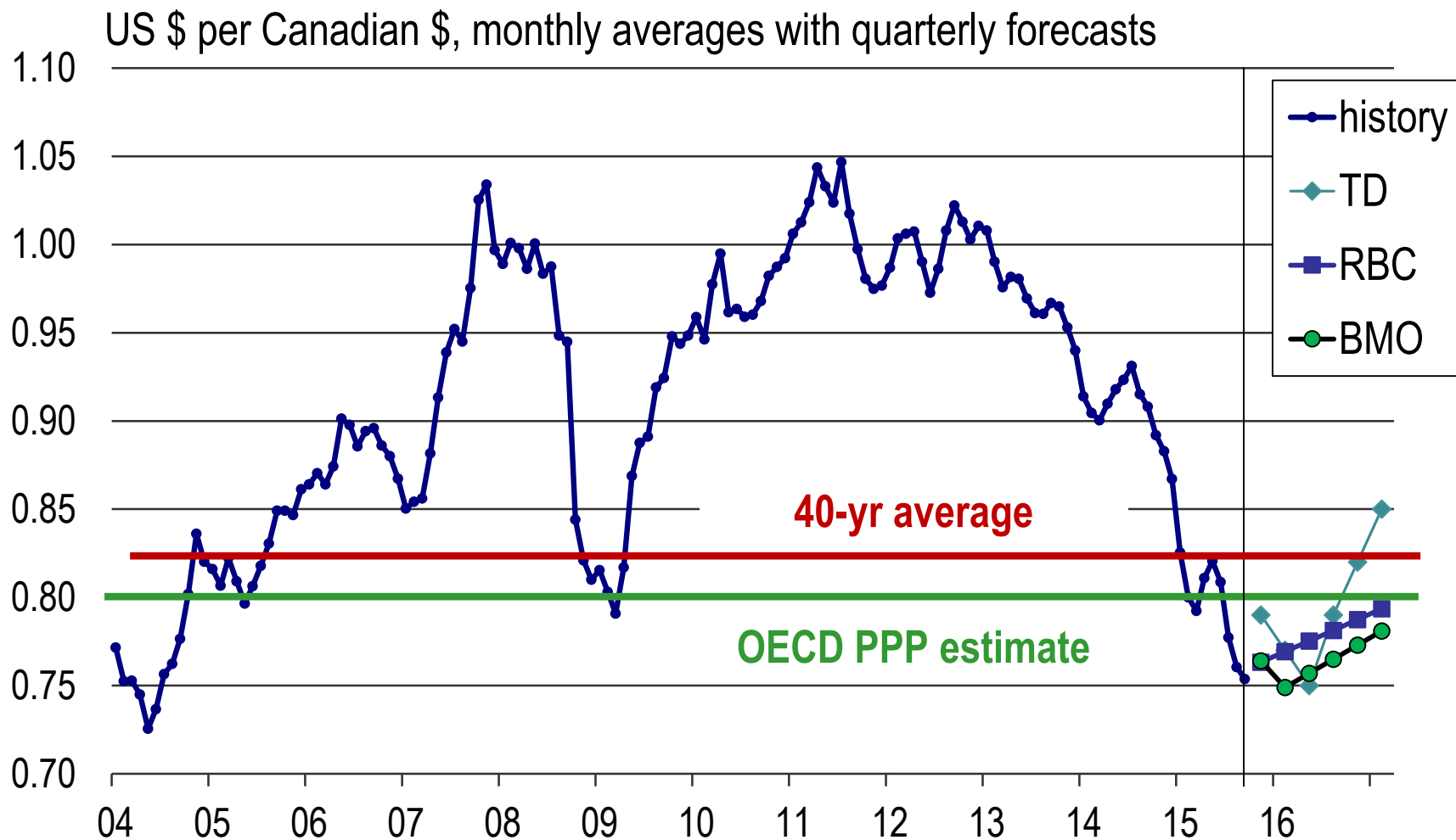
# Canadian Household Finances (Q3, 2015)

Household debt as % of disposable income	163%
Mortgage debt as % of disposable income	96%
Consumer credit/loans as % of disposable income	52%

Assets as % of disposable income	844%
Residential real estate as % of household assets	38%
Net worth as share of disposable income	681%

House price to income ratio, 2000	4.5
House price to income ratio, 2015	7.6
BC house price to income ratio, 2015	11.6

# Exchange Rate Down Sharply



# Winners and Losers from the Loonie's Slide

## ***Winners...***

- ▶ Exporters (especially firms with high domestic value-added per dollar of export sales)
- ▶ Tourism industry
- ▶ Other Canadian-based service providers capable of generating export business
- ▶ Retailers in communities vulnerable to cross-border shopping
- ▶ Inward Canadian investment (real estate, other assets). Canadians channeling more investment into domestic assets; foreigners see falling loonie as a buying opportunity

## ***Losers...***

- ▶ Households generally (a dollar of Canadian income now buys less on a global basis; many imports cost more; more expensive to travel to or buy property in the US)
- ▶ Businesses with a high proportion of US value-added inputs per dollar of sales
- ▶ Canadian companies looking to expand in the US or purchase American assets
- ▶ Firms that have issued debt in US dollars
- ▶ Professional sports teams involved in North American leagues

# Canadian Economic Forecast

	2014	2015	2016
Real GDP (% change)	2.4%	1.1%	2.0%
Real gross domestic income (% change)	2.0%	-1.2%	1.2%
Memo items: Contributions to real GDP growth (in percentage points)			
Consumption	1.5	1.2	1.1
Housing	0.2	0.3	0.0
Business fixed investment	0.0	-0.9	-0.2
Exports	1.7	0.9	1.7
Imports	-0.5	-0.3	-0.6





# The Business Council's BC Economic Forecast

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(annual per cent change unless otherwise indicated)

	2013	2014	2015f	2016f
Real GDP	2.0	2.3	2.4	2.6
Employment	0.1	0.6	1.1	1.0
Unemploy. rate (%)	6.6	6.1	6.0	5.9
Housing starts – all areas (units)	27,100	28,400	30,400	31,000
Retail sales	1.6	5.5	6.0	4.0
All-items CPI	0.0	1.2	0.8	1.5

# Economic Implications of Federal Election

- Majority government should be positive for business confidence and market stability...compared to the alternative
- Liberal infrastructure promises and broader fiscal plan are expected to augment real GDP growth by perhaps ~0.2% per year
- Stronger focus on spurring business innovation, technology diffusion, and the growth of manufacturing may produce economic dividends over time
- Higher personal income tax bracket will dull entrepreneurial activity, boost incentives for individuals to receive income through business structures, affect locational choices by some HQP, and make it harder for Canadian employers to recruit and retain top talent



# Impact of Liberal Government's Policy Agenda By Industry: Initial Assessment

35

Construction	positive
Engineering	positive
Manufacturing	likely positive
Clean energy/clean tech	definitely positive
Retail and consumer	slightly positive (middle income tax cut, Canada Child Benefit)
Oil/gas/pipelines	negative
Other natural resource industries	negative
Technology	negative (higher PIT bracket, change in tax treatment of options)
Financial services	negative (roll back TFSAs, expand CPP)

# Recap

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- ▶ Subdued and choppy global economic environment will continue into 2016...and perhaps beyond
- ▶ There is increasing concern about the consequences of many years of record-low interest rates and unconventional monetary policy
- ▶ Muted economic outlook for Canada, with hopes largely riding on the US. Interest rates and inflation will stay low over 2016-2017
- ▶ Canada faces substantial headwinds that will weigh on economic performance over the next few years
- ▶ British Columbia should be at or near the top of the provincial growth charts in 2016-17



NEI

# MARKET PERSPECTIVE

Staying one step ahead of market movements

November 17, 2015

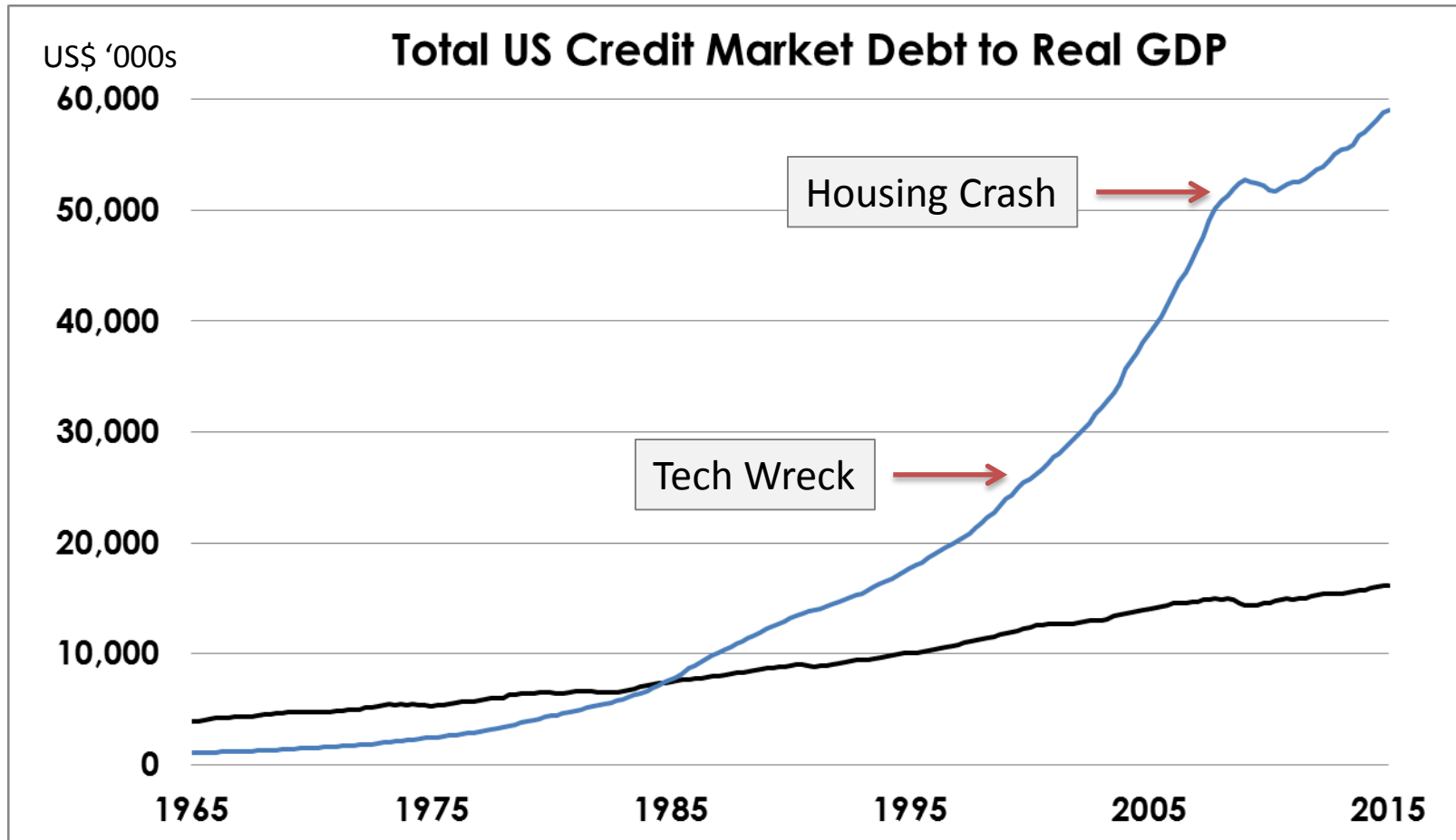
**Christine Hughes, CFA**

OtterWood Capital Management- President and Chief Investment Strategist

INVESTMENTS DONE DIFFERENTLY

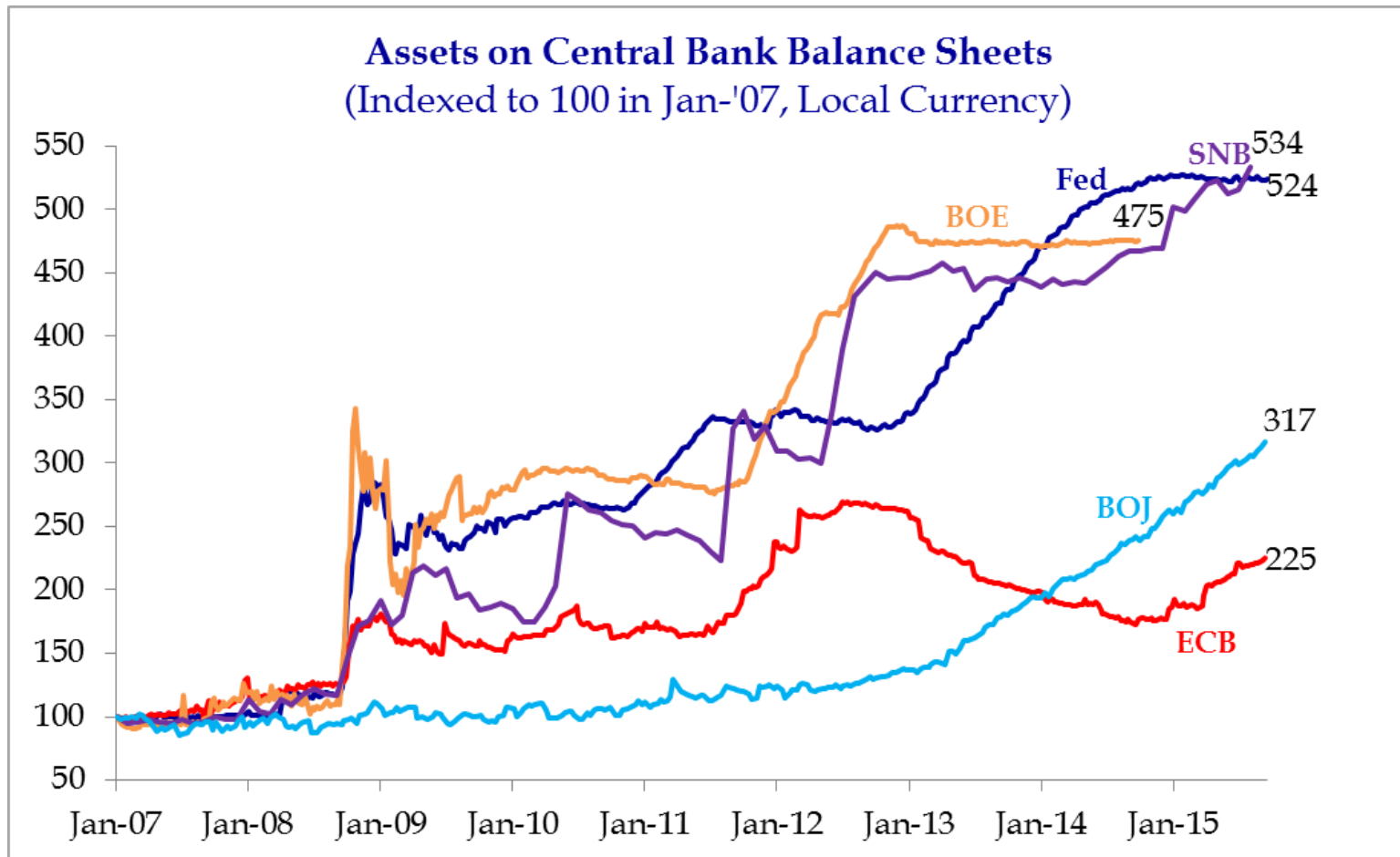
OtterWood  
CAPITAL MANAGEMENT

# System Leverage At Record Highs



Source: Federal Reserve Bank of St. Louis

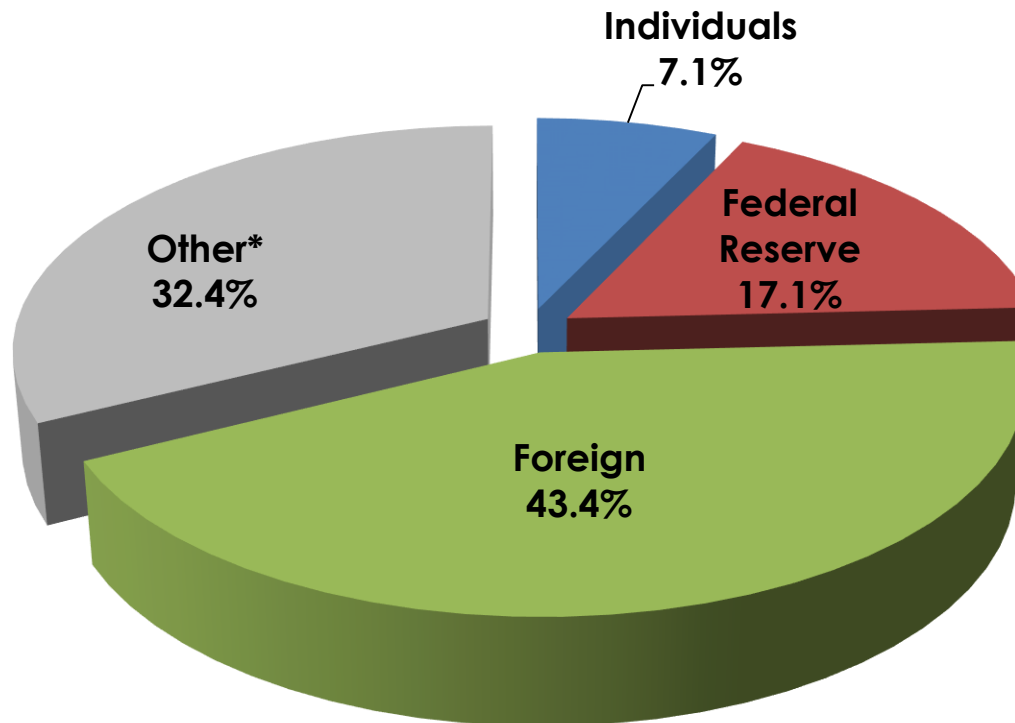
# The Printing Presses



Source: Strategas Research Partners

# Who Owns US Government Debt

## Holder of U.S. Treasury Securities

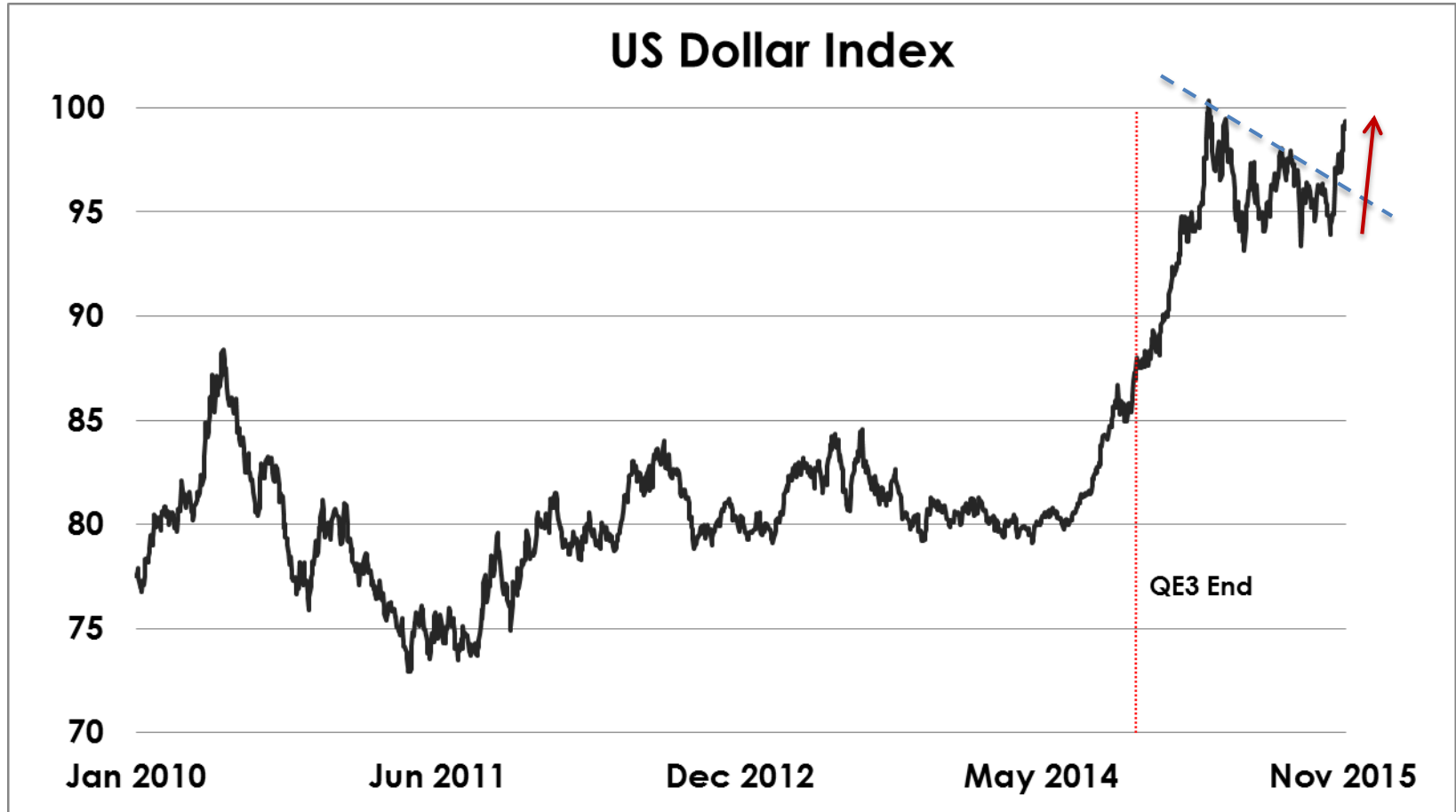


Source: Securities Industry and Financial Markets Association (SIFMA)

\*Other includes Mutual funds, Banking Institutions, Insurance Companies, Pension Funds and State & Local Governments

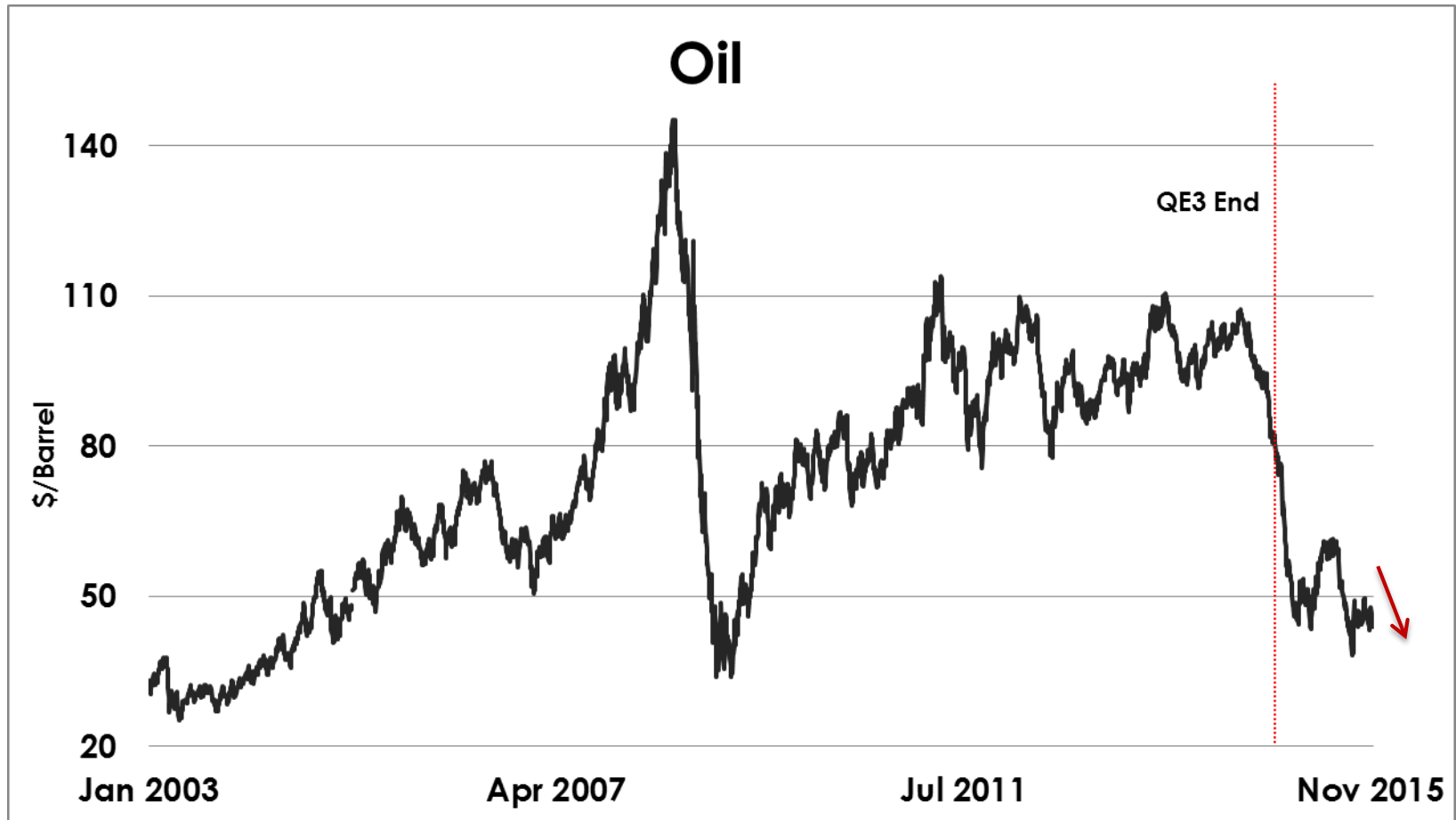


# USD Has Strengthened Since End of QE3



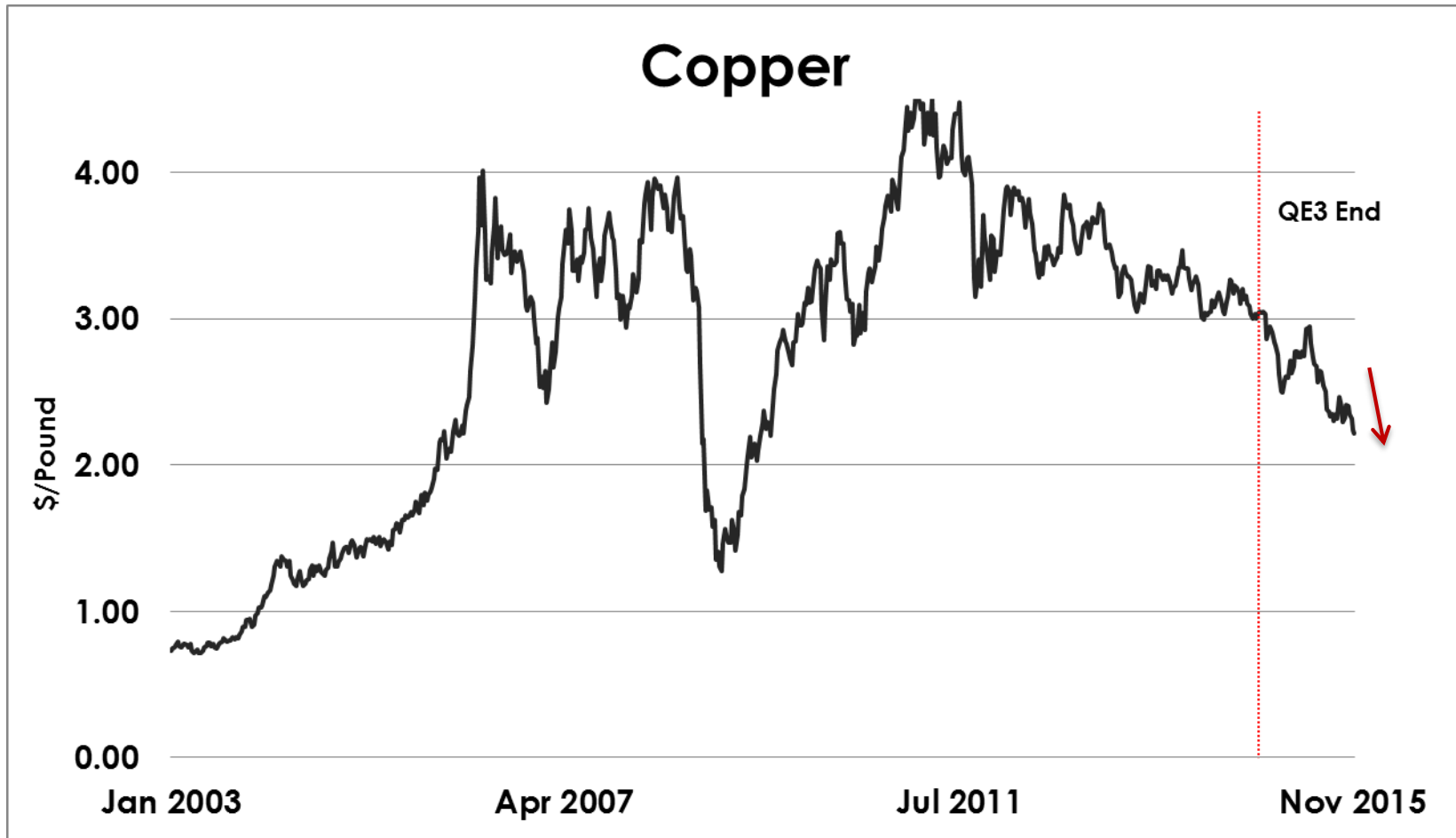
Source: Bloomberg

# Commodities Feeling The Pressure



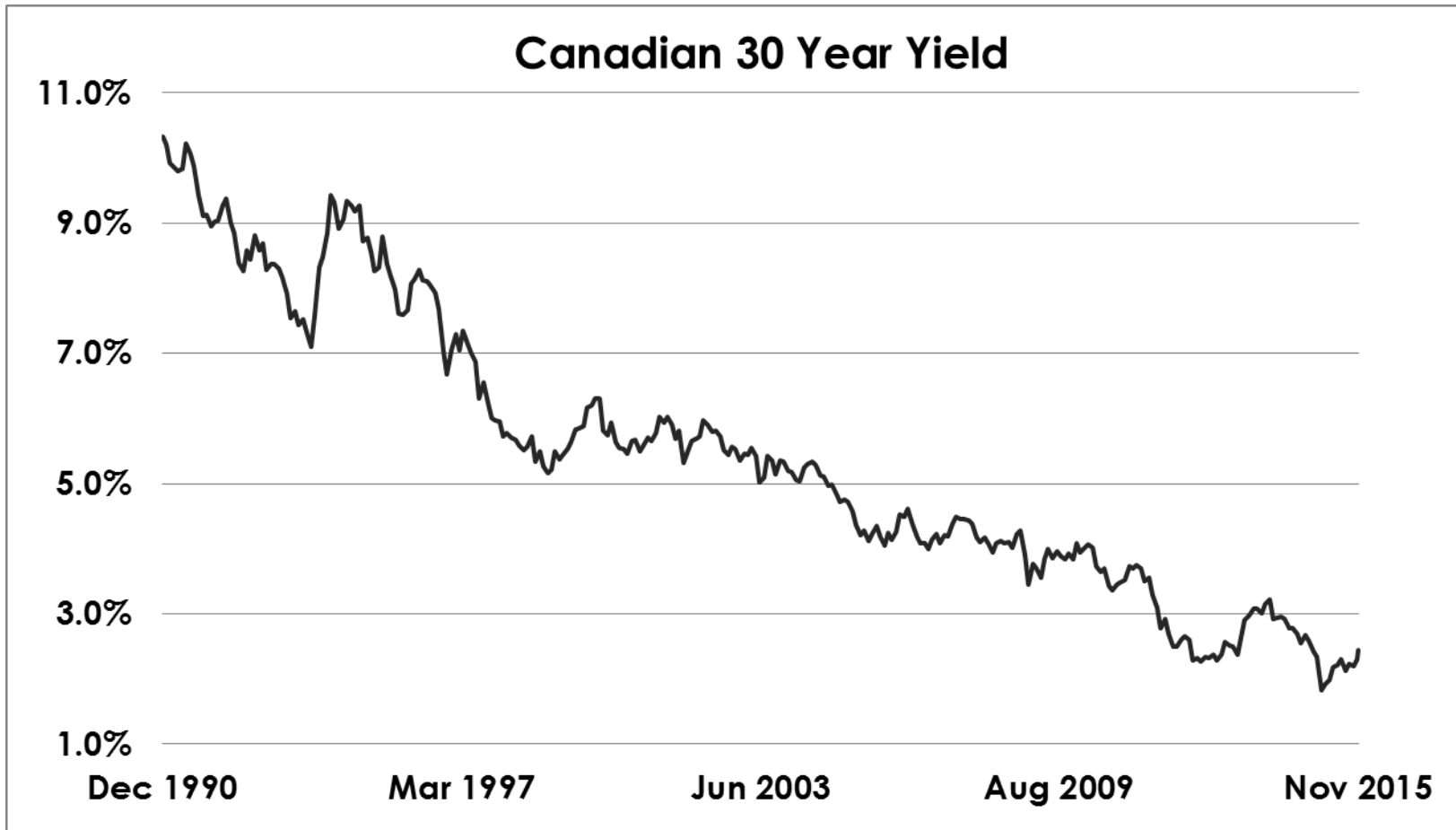
Source: Bloomberg

# Commodities Feeling The Pressure



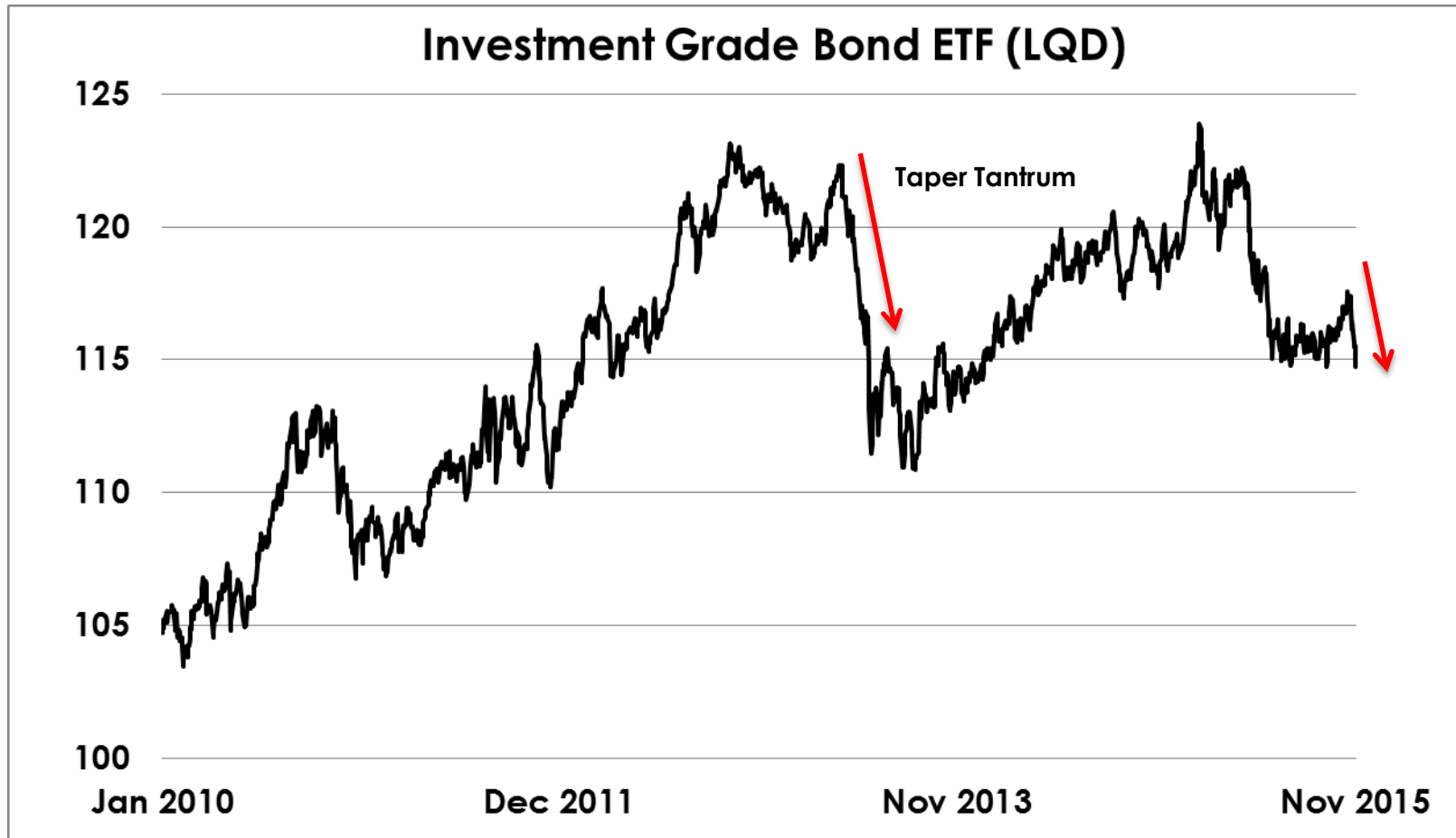
Source: Bloomberg

# Yields Close To Historic Lows



Source: Bloomberg

# Investment Grade Bonds At Pivotal Juncture



Source: Bloomberg

# Stock Market Rally Has Been Narrow

## Investors Are Hiding Out In Mega-Caps

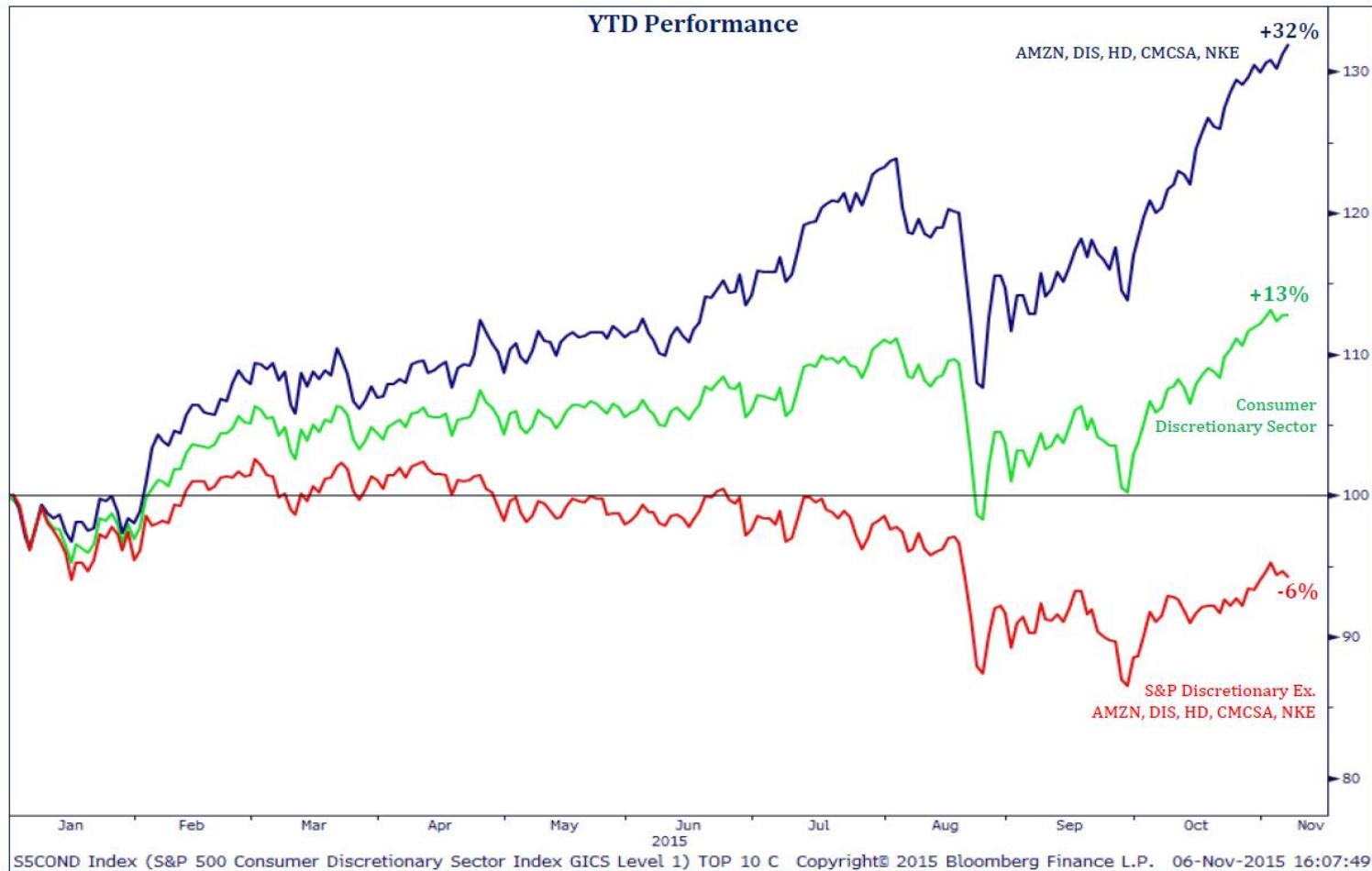
<u>2015, YTD</u>	
Point Contribution of 10 Largest S&P Stocks	
AAPL	7.1
GOOGL	7.5
MSFT	7.6
XOM	-3.8
BRK/B	-2.8
AMZN	15.1
FB	7.1
GE	5.3
WFC	0.5
JNJ	-0.8
<i>Largest 10 Total</i>	42.9
<i>S&amp;P 500 Point Gain</i>	40.3
<i>Largest 10 % of Total</i>	106.4%

<u>2014</u>	
Point Contribution of 10 Largest S&P Stocks	
AAPL	20.7
XOM	-4.2
MSFT	7.5
BRK/B	6.4
GOOGL	-0.8
JNJ	4.1
WFC	5.0
WMT	1.3
GE	-3.1
PG	2.9
<i>Largest 10 Total</i>	39.9
<i>S&amp;P 500 Point Gain</i>	210.5
<i>Largest 10 % of Total</i>	19.0%

<u>2013</u>	
Point Contribution of 10 Largest S&P Stocks	
AAPL	2.7
XOM	7.3
GOOGL	12.6
MSFT	9.1
BRK/B	5.9
GE	8.1
JNJ	6.7
WMT	1.9
CVX	3.7
WFC	6.1
<i>Largest 10 Total</i>	64.2
<i>S&amp;P 500 Point Gain</i>	422.2
<i>Largest 10 % of Total</i>	15.2%

Source: Strategas Research Partners

# Five Names Dominating Discretionary



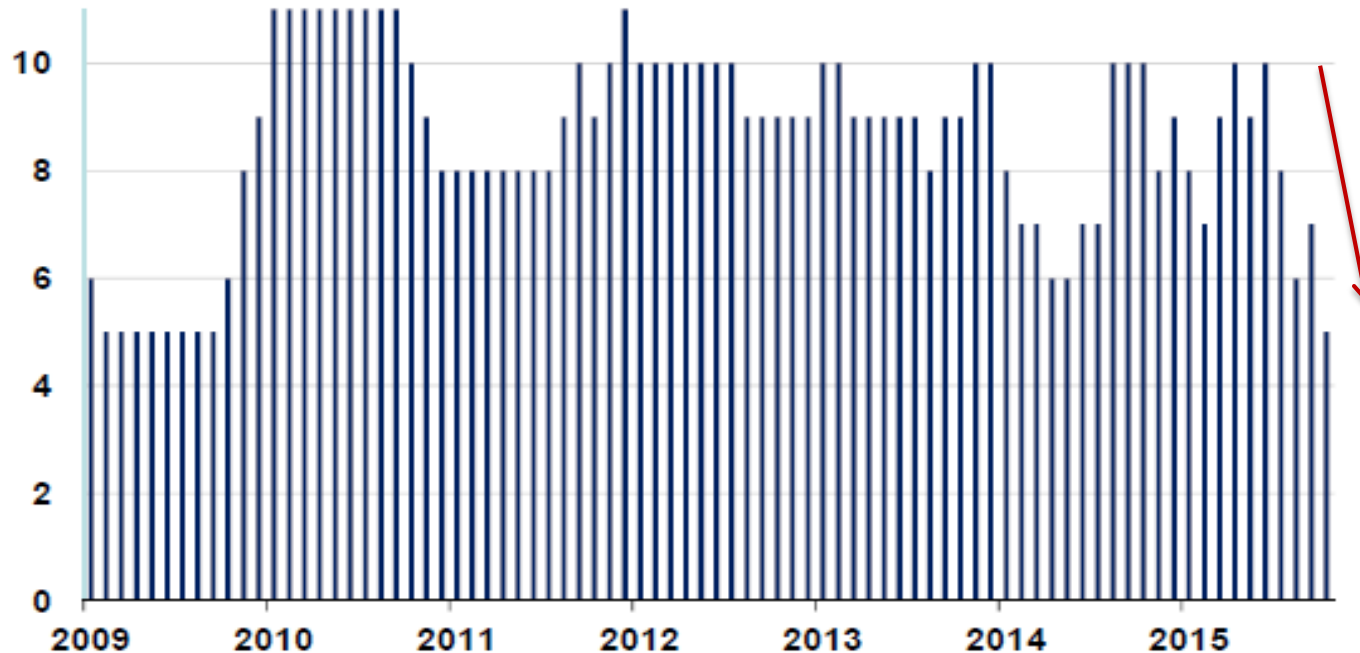
Source: Strategas Research Partners

# Canadian Housing Market Rolling Over?

## Lowest breadth in 12-month price increase in 6 years

*Number of regions with 12-month price gain*

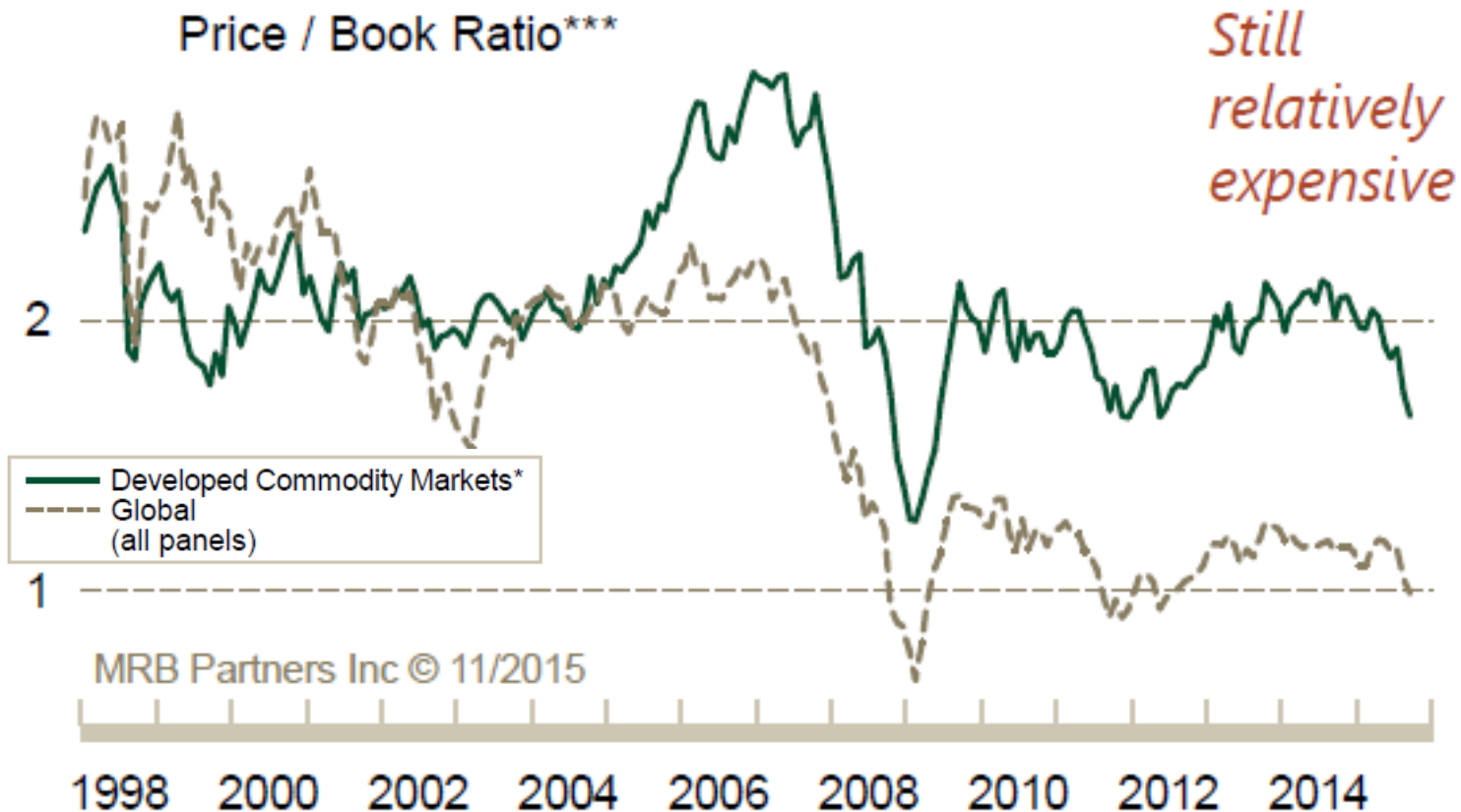
Number of regions



*NBF Economics and Strategy, Teranet-National Bank House Price Index.*



# Commodity Related Bank Stocks Are Vulnerable



\* Market-cap weighted aggregate of Australia, Canada and Norway  
\*\* U.S. dollars; rebased at pre-Great Recession peak; source: MSCI  
\*\*\* Source: MSCI

Source: MRB Partners

- Liquidity will continue to drain out of the system in 2016; expect volatility until US QE4 is announced.
- Currently conservative portfolio positioning expected to last through the first quarter. Assets expected to perform well in this environment include:
  - Canada Government Bonds
  - Consumer Staples Stocks
  - Canadian Telecom
  - Special situations (McDonalds, etc.)
  - Protective Strategies (hedging to reduce volatility)

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# Thinking About What's Next

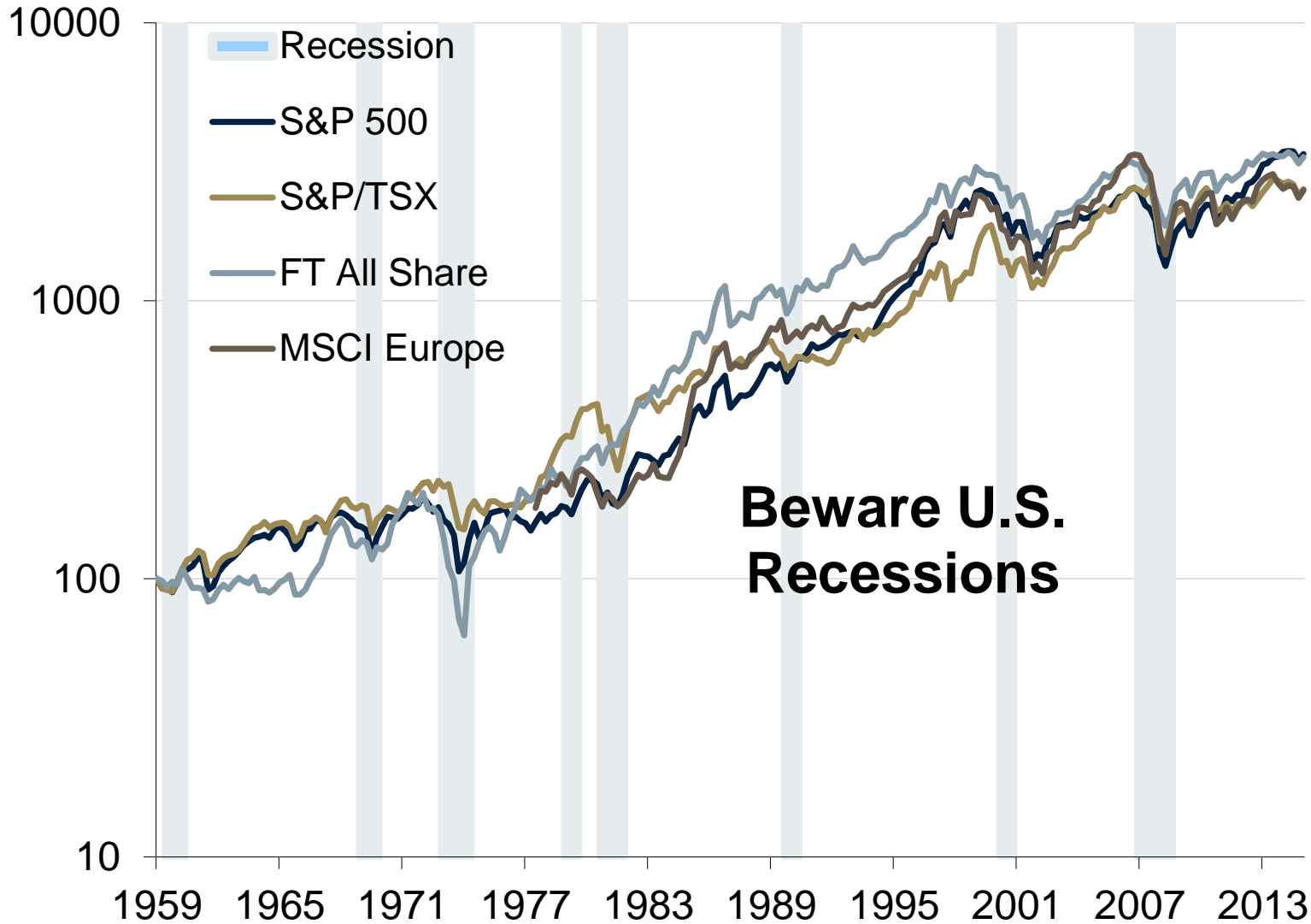
## AWF November 2015

Jim Allworth



RBC Wealth Management

Bull markets die of recession, not old age.



Every bear market has been associated with a U.S. recession.

“No boom, no bust”

Bank Credit Analyst

# Over the next three years...

- ❑ Global growth trundles along led by the U.S., most developed economies, and a handful of better positioned emerging economies – India, Taiwan, Indonesia, Mexico, Poland
- ❑ China continues to slow. Some added fiscal stimulus and monetary easing allow it to avoid a hard landing.
- ❑ Commodities and commodity economies eventually stabilize as inventories and production levels are right-sized.
- ❑ Inflation moderate/muted – weak for goods, stronger for services.
- ❑ The (very) gradual wind-down of extraordinary monetary policies produces an upward bias to rates over the next 12 months, more measurable increases thereafter.
- ❑ Stocks deliver all-in returns of 8%-10% per annum over the full three years. No major downturn in developed economies or equity markets arrives until after credit conditions have become restrictive, which we don't expect before 2018 at the earliest.

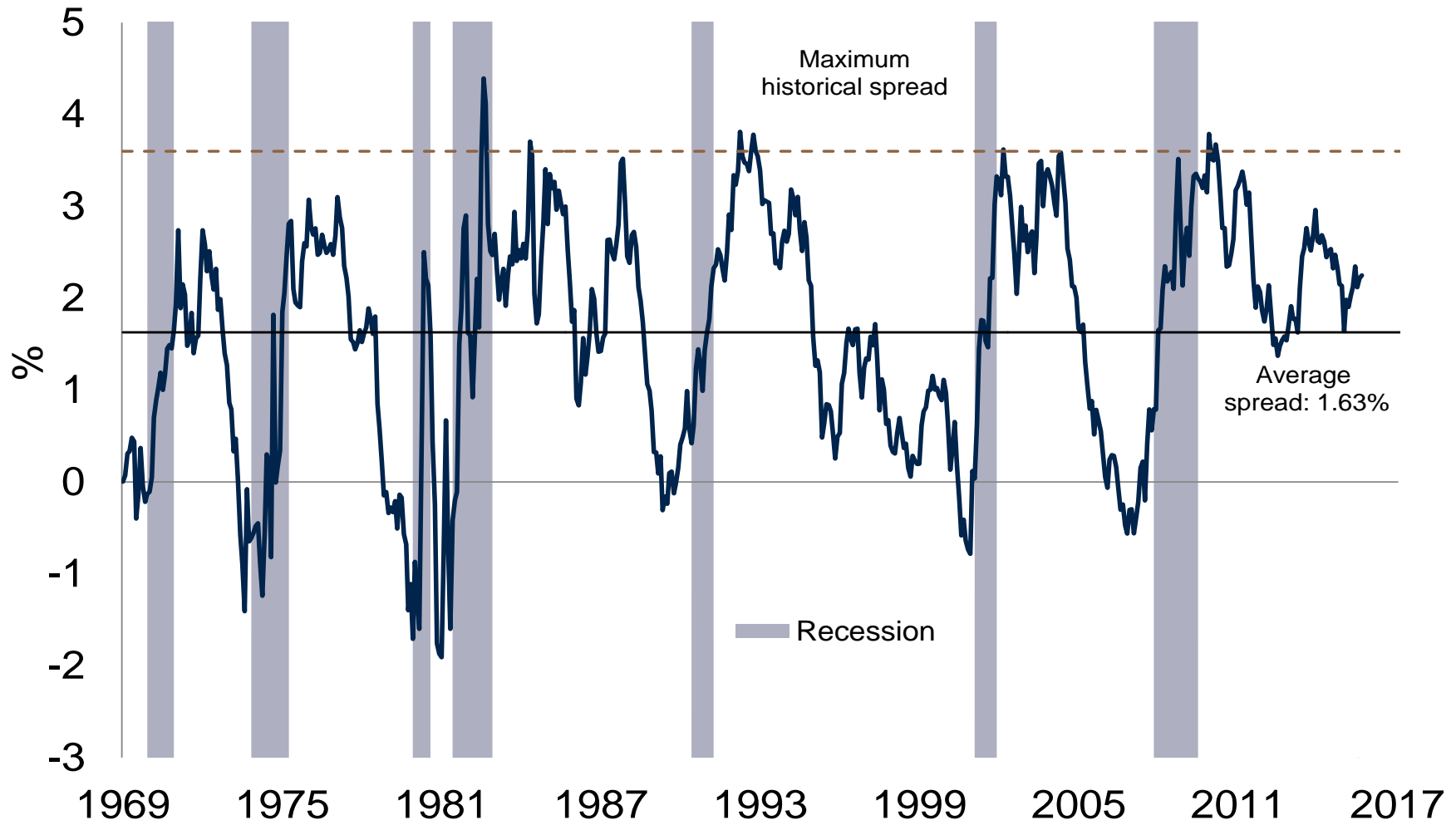
# The U.S recession call is paramount.

- There is no U.S. recession anywhere on the horizon.
- The economy is growing at an above-potential rate and has a great deal of forward momentum.
- The pre-conditions of recession are nowhere in sight.
- Most importantly, the credit cycle remains very constructive. It would take a long period of rate hiking to produce a sustained economic downturn.



# U.S. Treasury yield curve

Spread between yield on 10-year and 3-month maturities



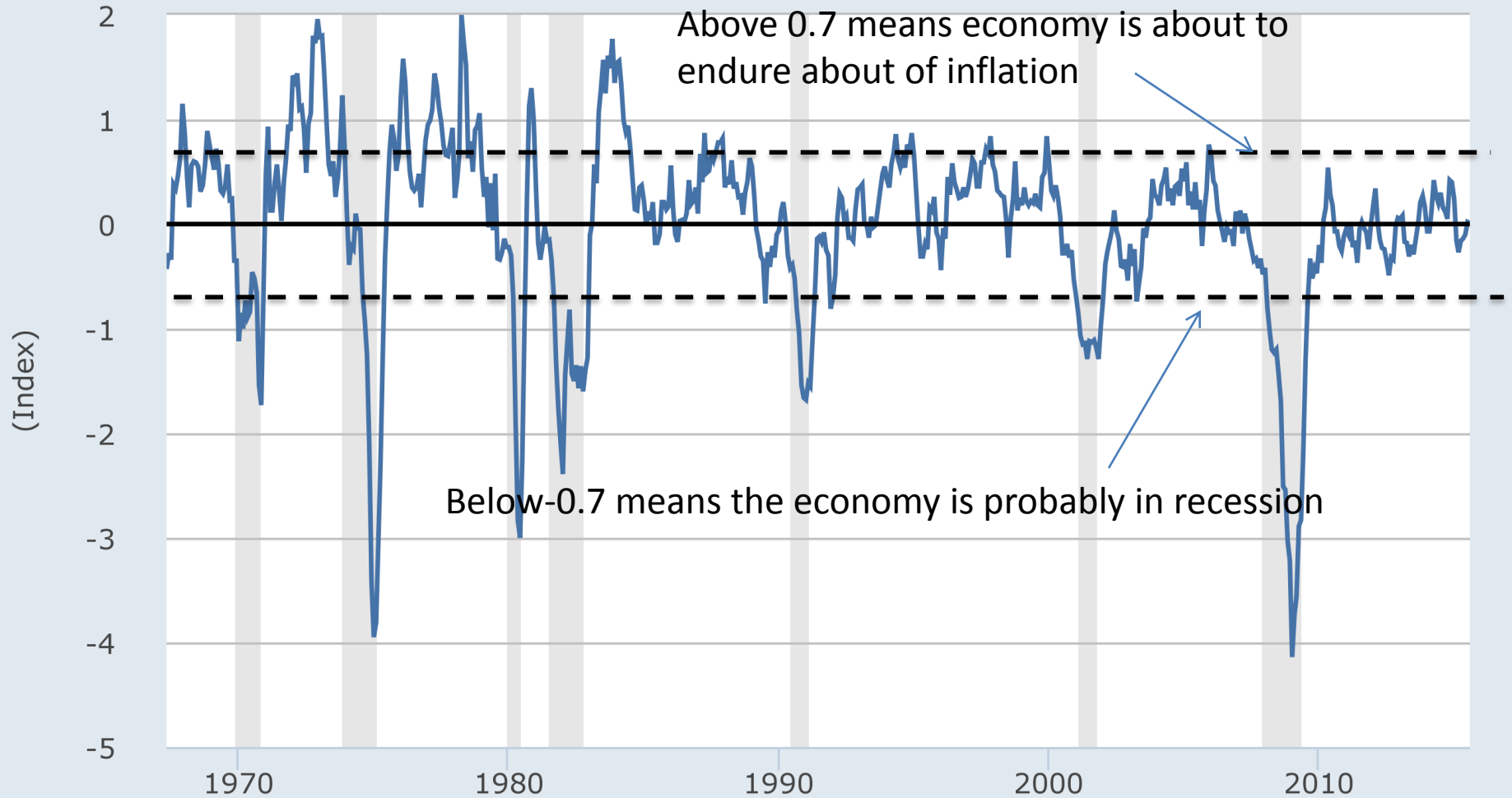
Source: Bloomberg, RBC GAM

There's never been a U.S. recession without the difference between the 10-year yield and the 3-month yield narrowing to less than 50 basis points ahead of time (usually a year or more).

Reading of “zero” indicates the U.S. economy is growing at it’s long-term trend rate.



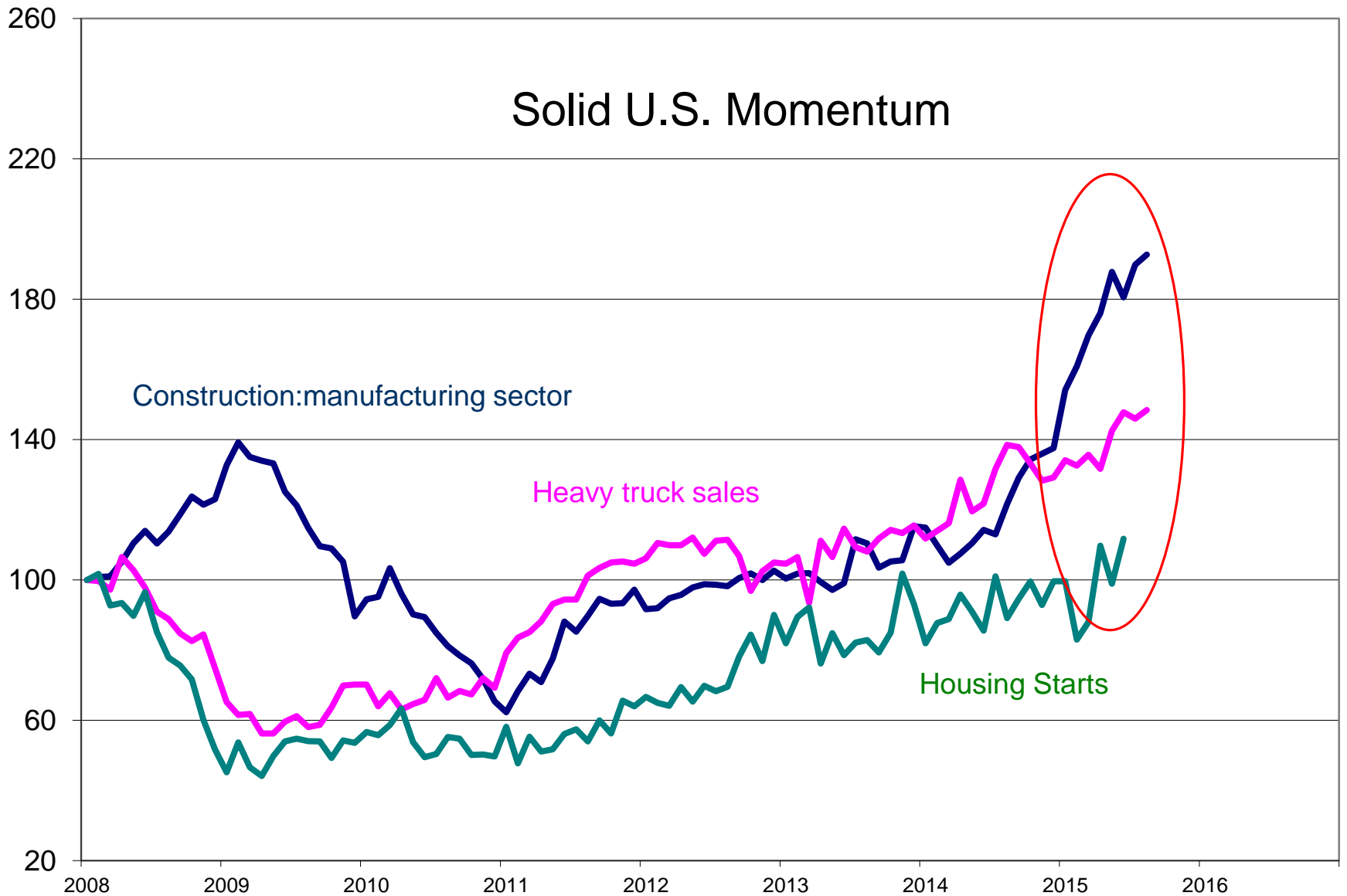
— Chicago Fed National Activity Index: Three Month Moving Average



Source: Federal Reserve Bank of Chicago

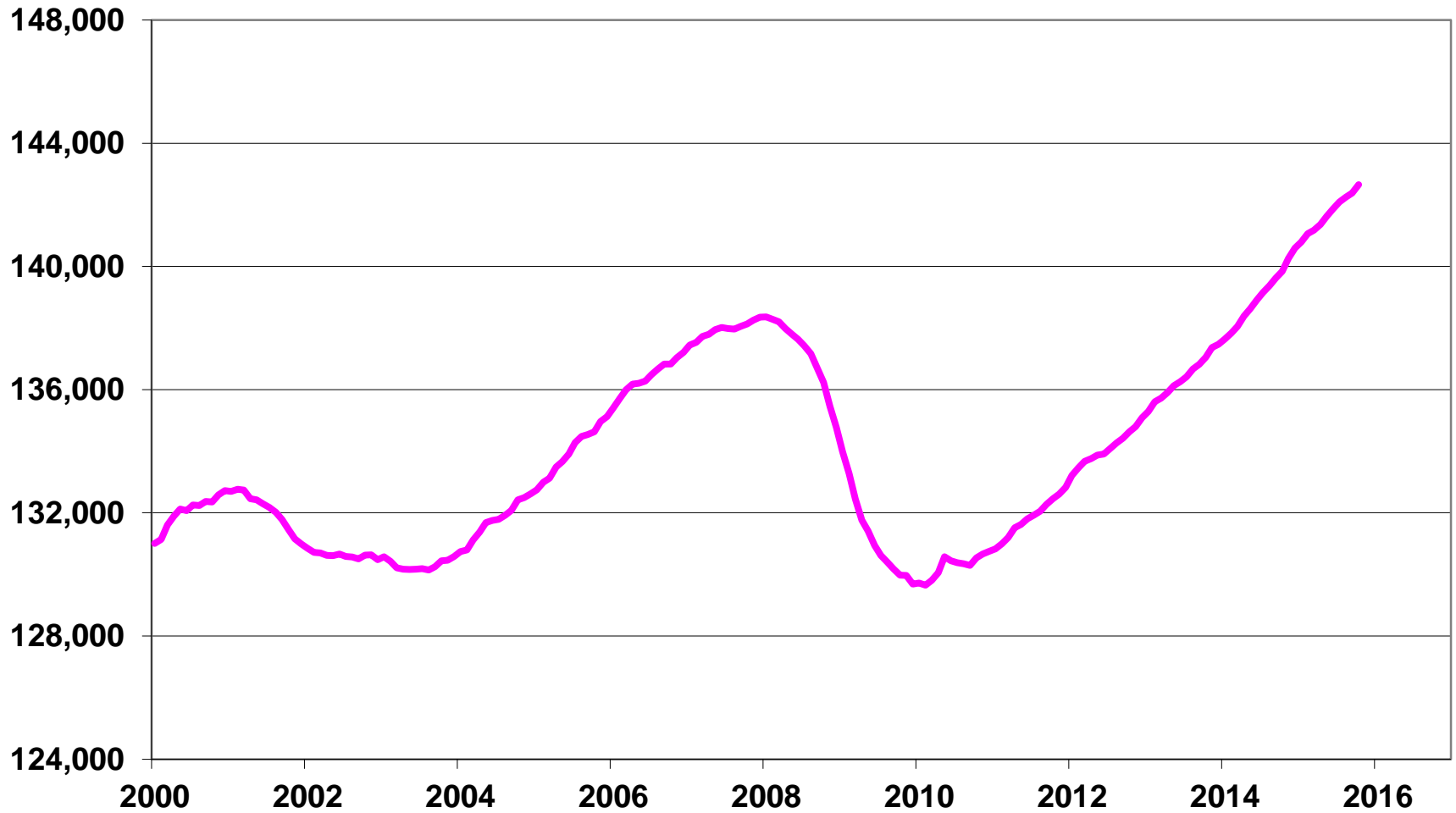
Shaded areas indicate US recessions - 2015 research.stlouisfed.org

# Solid U.S. Momentum

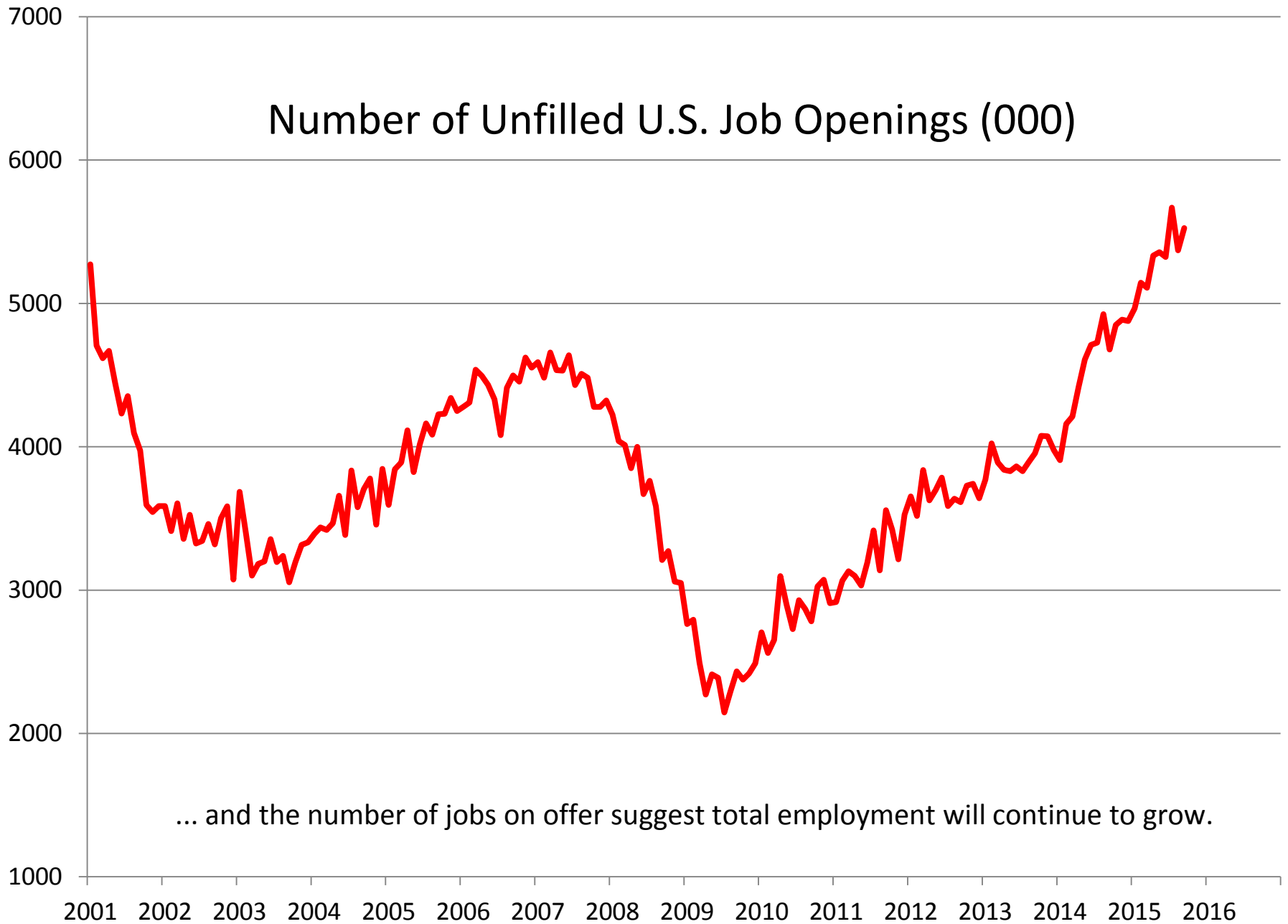


# U.S. Non-Farm Employment

Source: Bureau of Labor Statistics

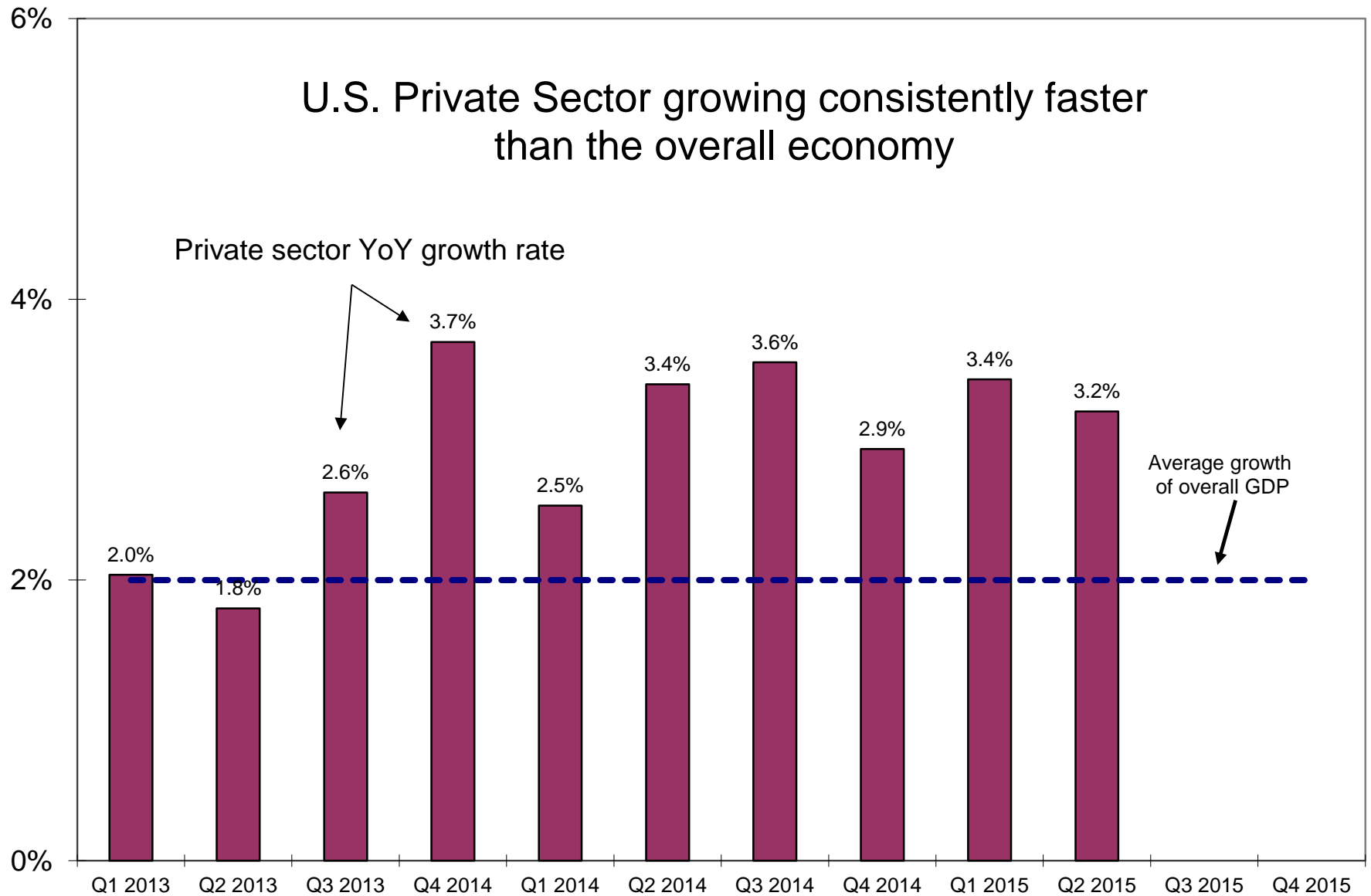


## Number of Unfilled U.S. Job Openings (000)



... and the number of jobs on offer suggest total employment will continue to grow.

# U.S. Private Sector Real GDP Growth



## Recessionary Indicator Scorecard

Start of Recession	Yield Curve	ISM Mfg.	Inf. Trends	Capacity Utilization	Housing Starts	Avg. Wkly Hours
Dec-69	×	×	×	×	×	×
Nov-73	×	×	×	×	×	×
Jan-80	×	×	×	×	×	×
Jul-81	×	×	✓	✓	×	✓
Jul-90	×	×	×	×	×	×
Mar-01	×	×	×	×	--	×
Dec-07	×	×	×	×	×	--
Present	✓	✓	✓	--	✓	--

**Key:** × Recessionary Territory

✓ Expansionary Territory

-- Neutral

Source: S&P, NBER, Federal Reserve, BLS, ISM, Census Bureau, Haver, and RBC Capital Markets

# Markets have been worrying about China's economy

China's slowdown mostly centered in manufacturing

- Over-capacity
- Bloated inventories of unsold goods
- Weak offshore demand from EMs and until recently from Europe.

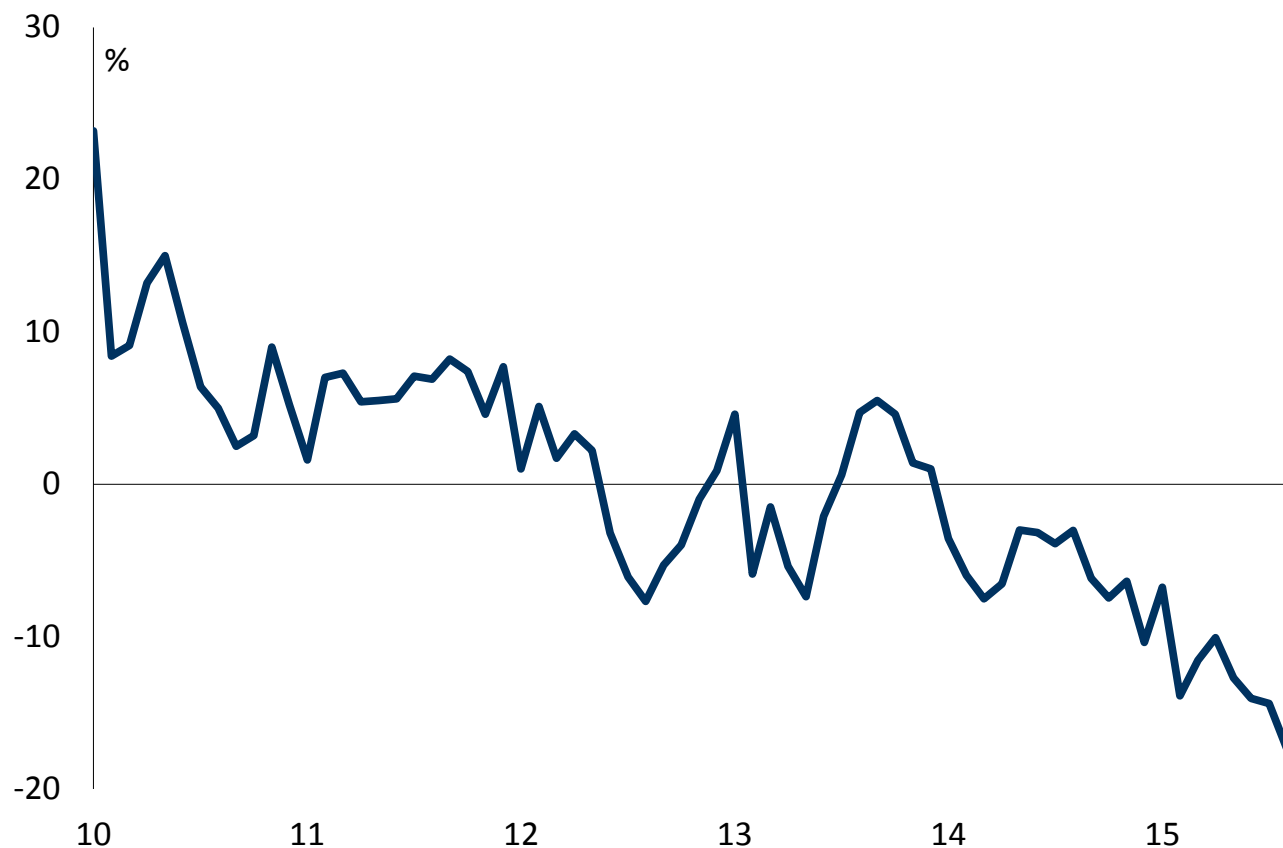
Sector outlook should improve

- Currency devaluation/weaker US dollar
- Stronger demand from U.S. and Europe
- Production slowdown will help clear inventory overhang
- Within China, lower interest rates, rising home prices, and growing wages will stimulate demand.



China's manufacturing sector is suffering under the weight of over-capacity and weak global demand.

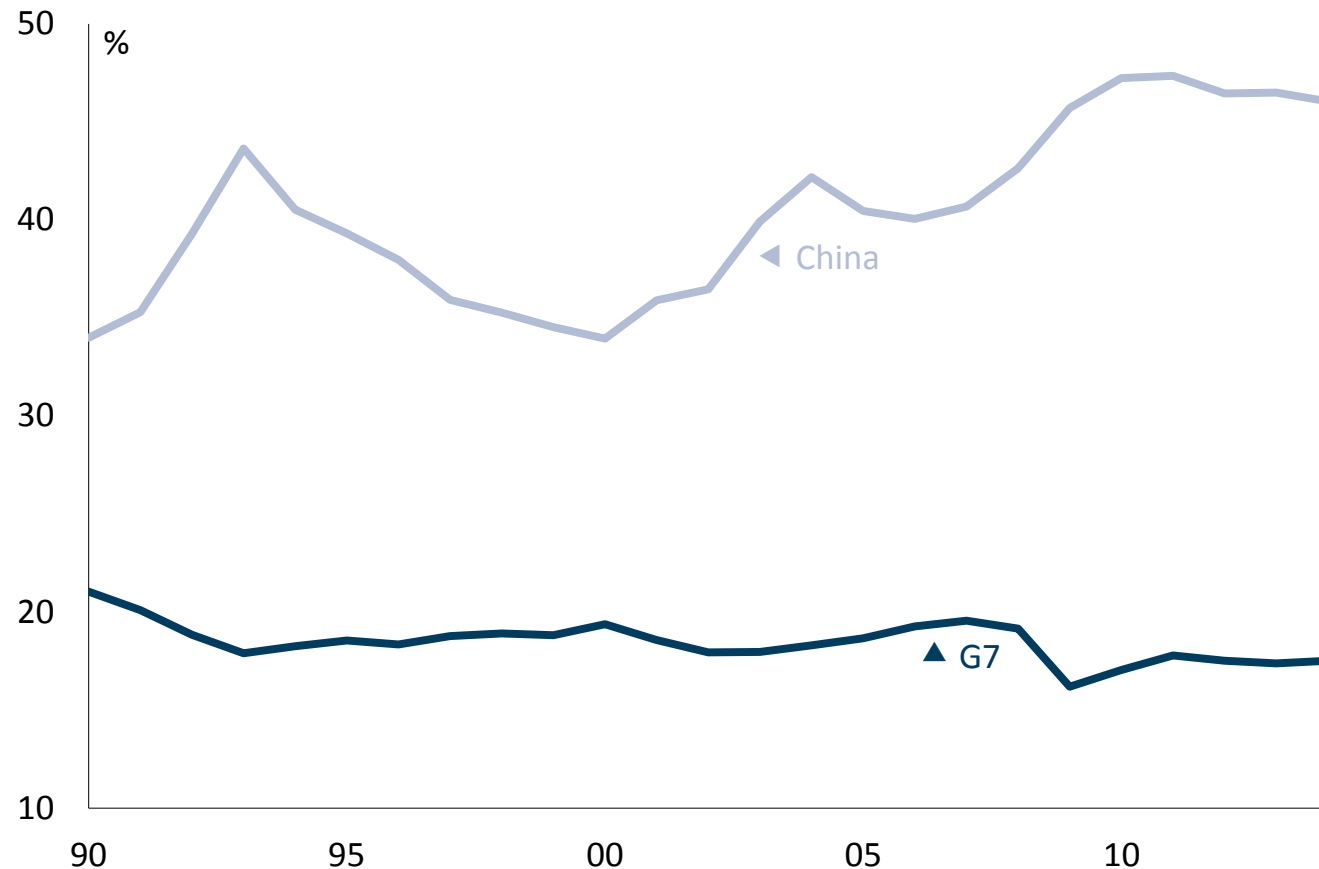
China Freight Traffic (YoY)



Source: National Bureau of Statistics China, Bloomberg, and RBC Capital Markets

Chinese GDP still heavily dominated by fixed asset investment. Rebalancing will take decades. But won't necessarily entail an absolute decline in spending.

Investment as a Percentage of GDP – China vs. G7



Some things are starting to improve.

Electricity production turning up...

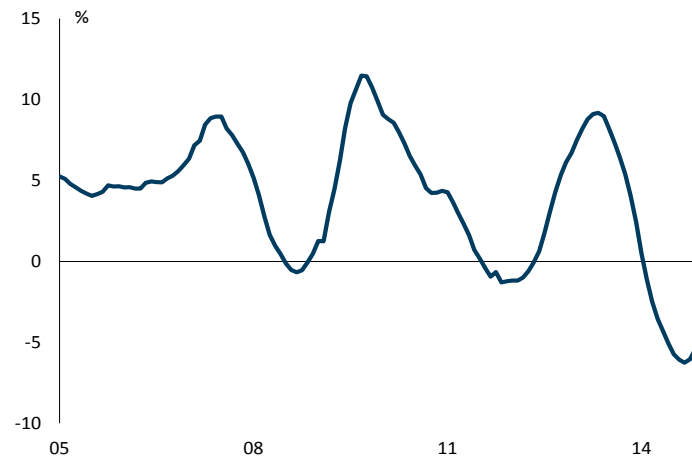
China Electricity Consumption (YoY)



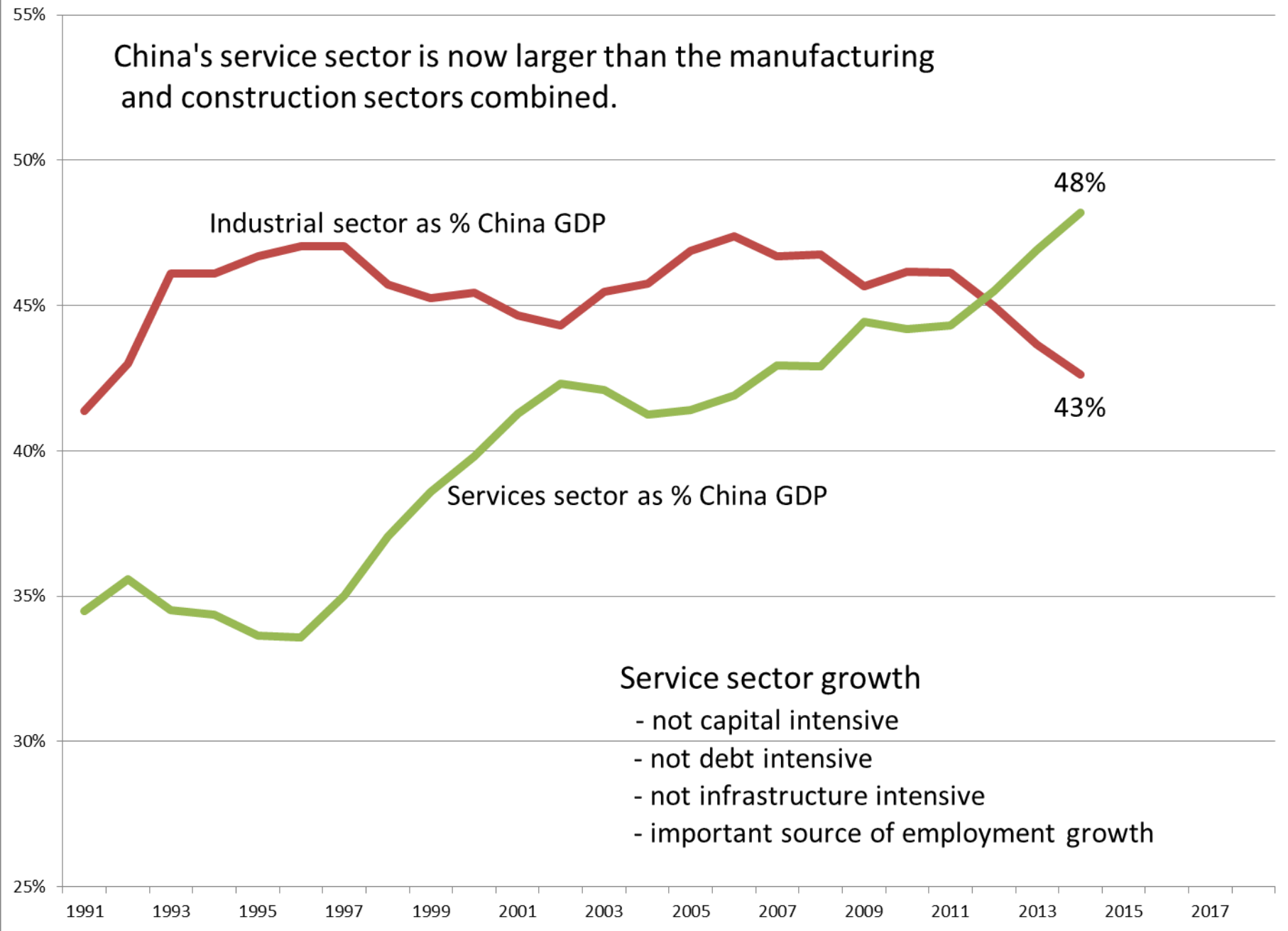
Source: China National Energy Administration, Bloomberg, and RBC Capital Markets

...as are house prices.

China Newly Built Home Prices YoY – 70 City Average

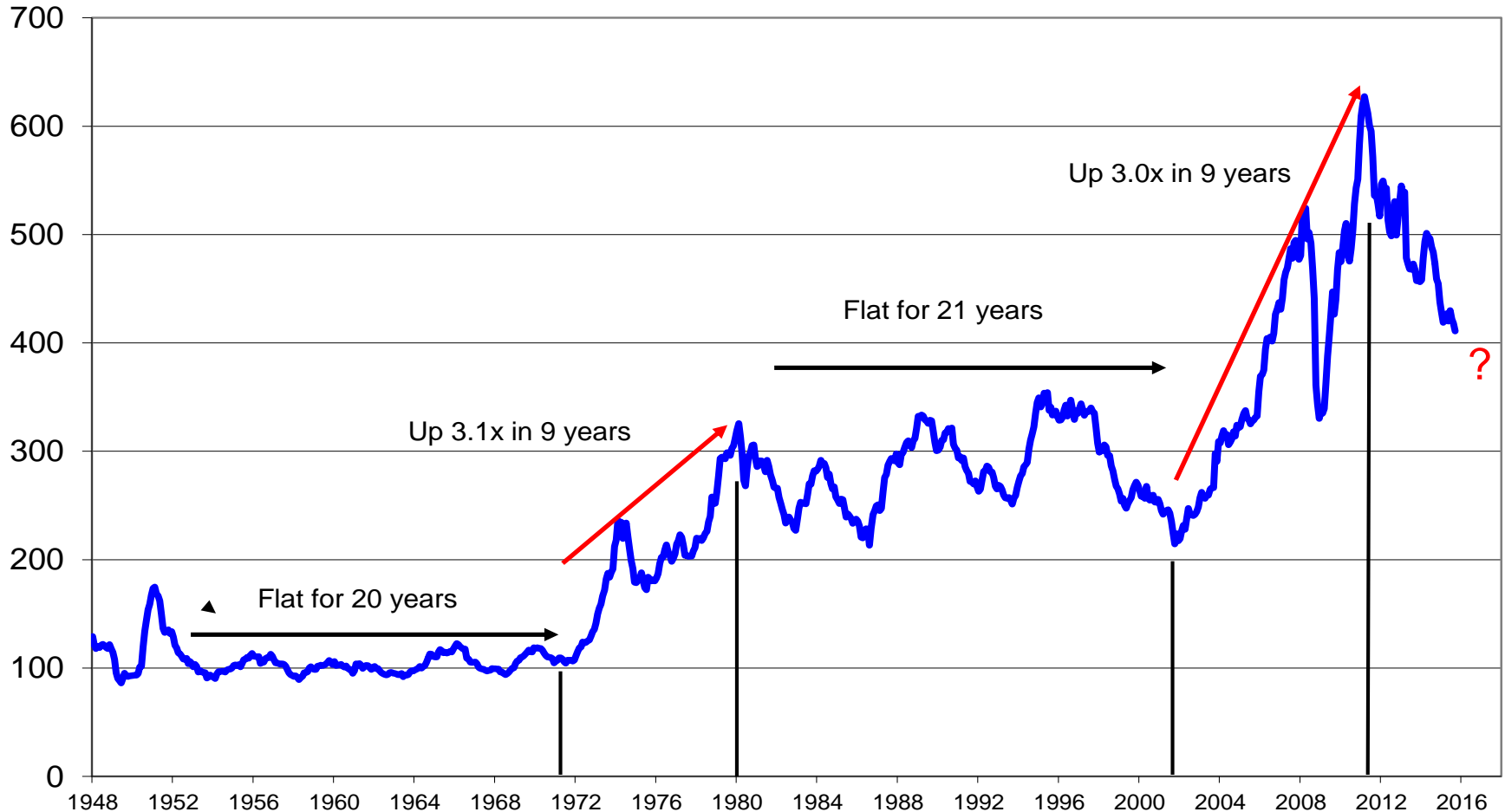


China's service sector is now larger than the manufacturing and construction sectors combined.

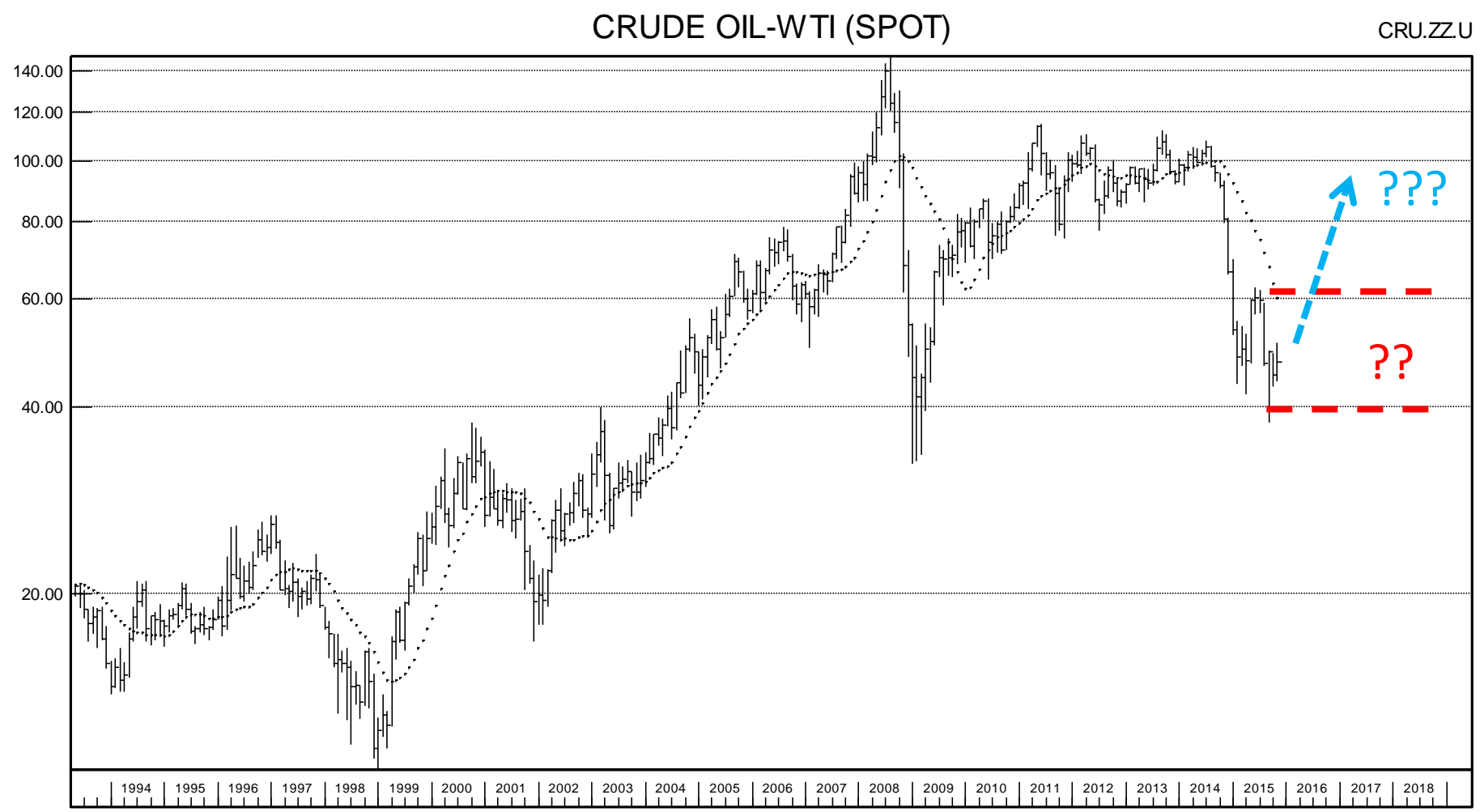


The biggest impact of slower Chinese growth has been on commodity prices.

## CRB Raw Industrial Commodities

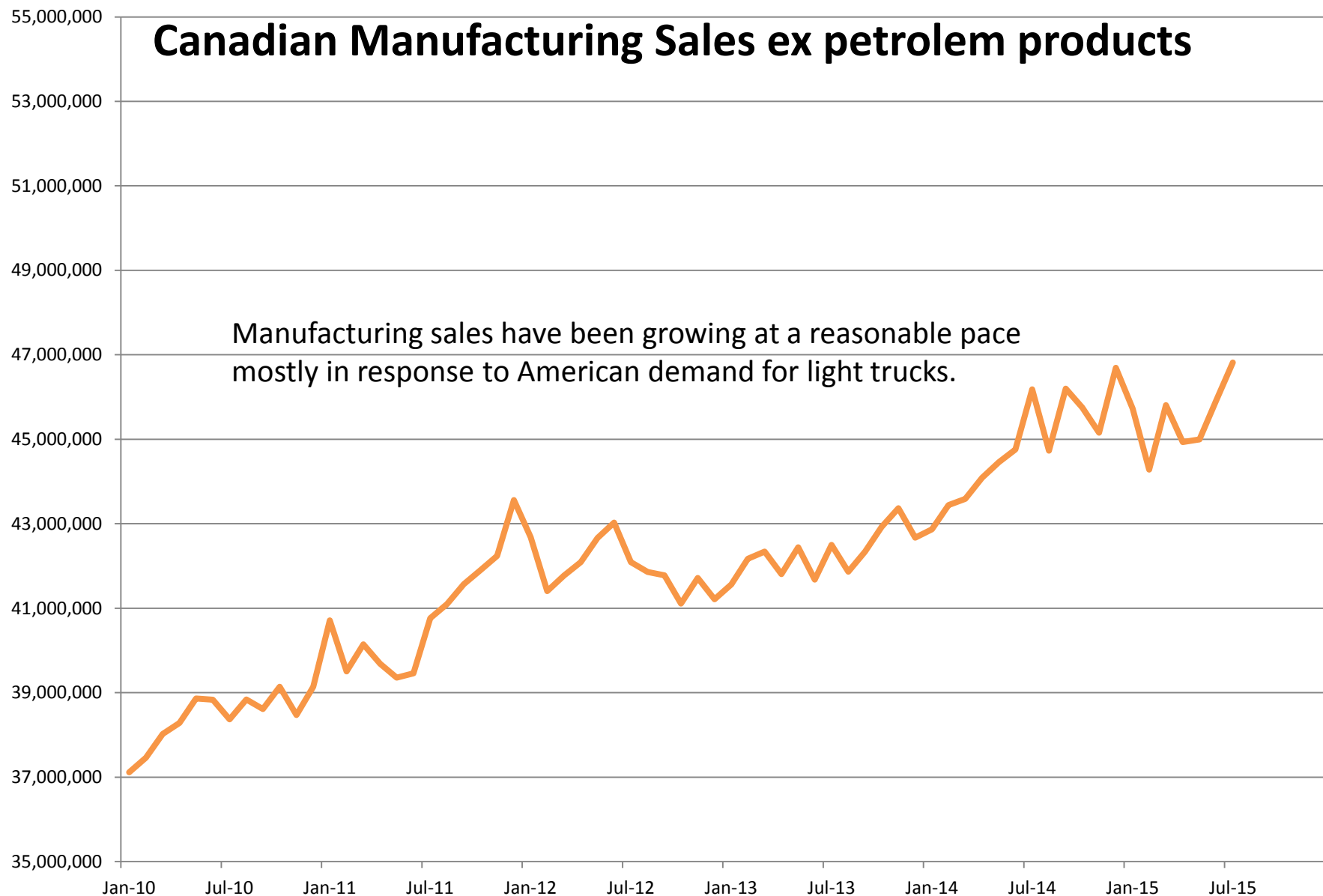


# Crude Oil – Ready to rebound or carving out a new equilibrium range ?



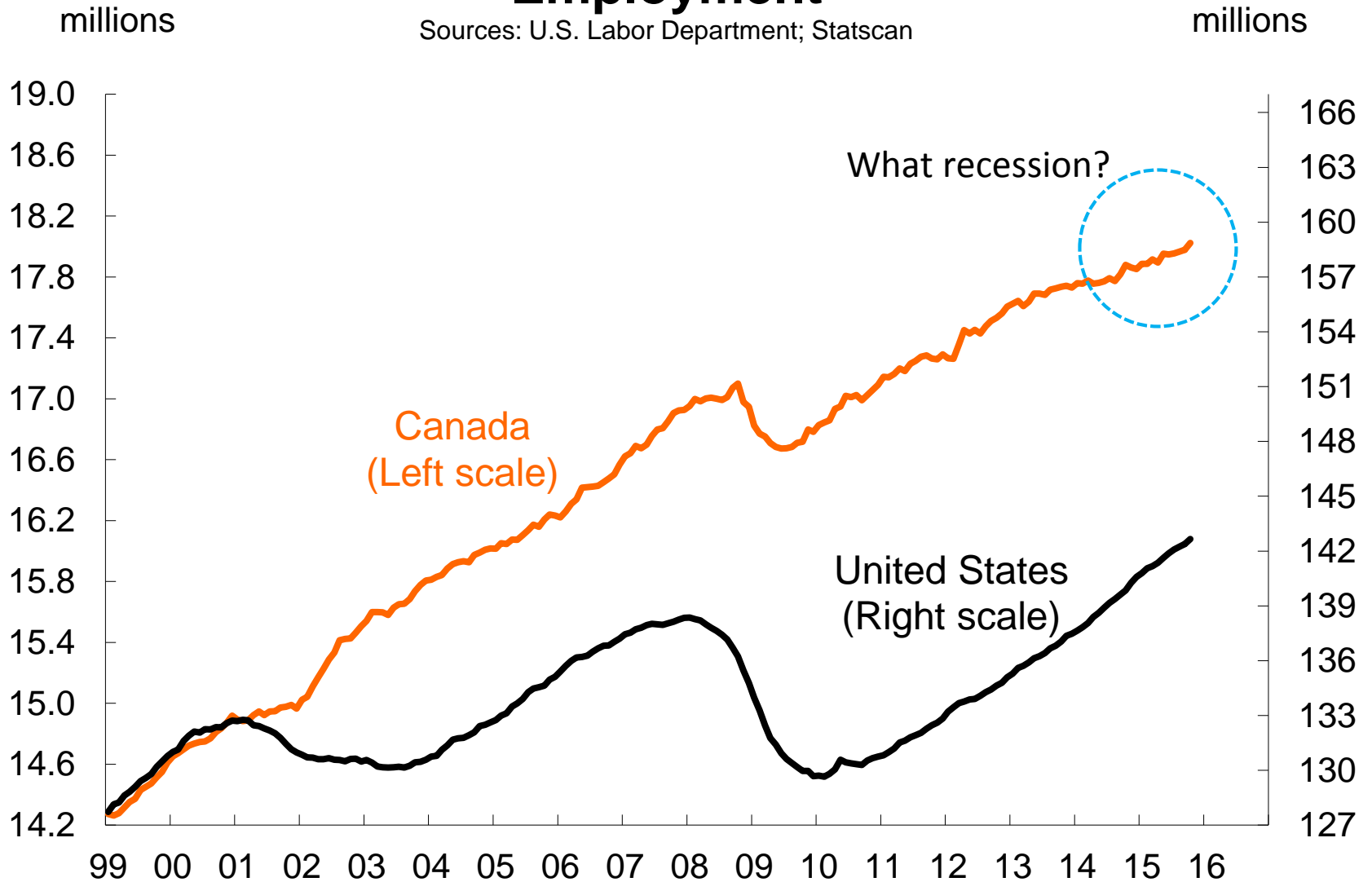
# Canadian Manufacturing Sales ex petroleum products

Manufacturing sales have been growing at a reasonable pace mostly in response to American demand for light trucks.



# Employment

Sources: U.S. Labor Department; Statscan





# S&P500 relative to TSX (currency adjusted)

source: RBC CM

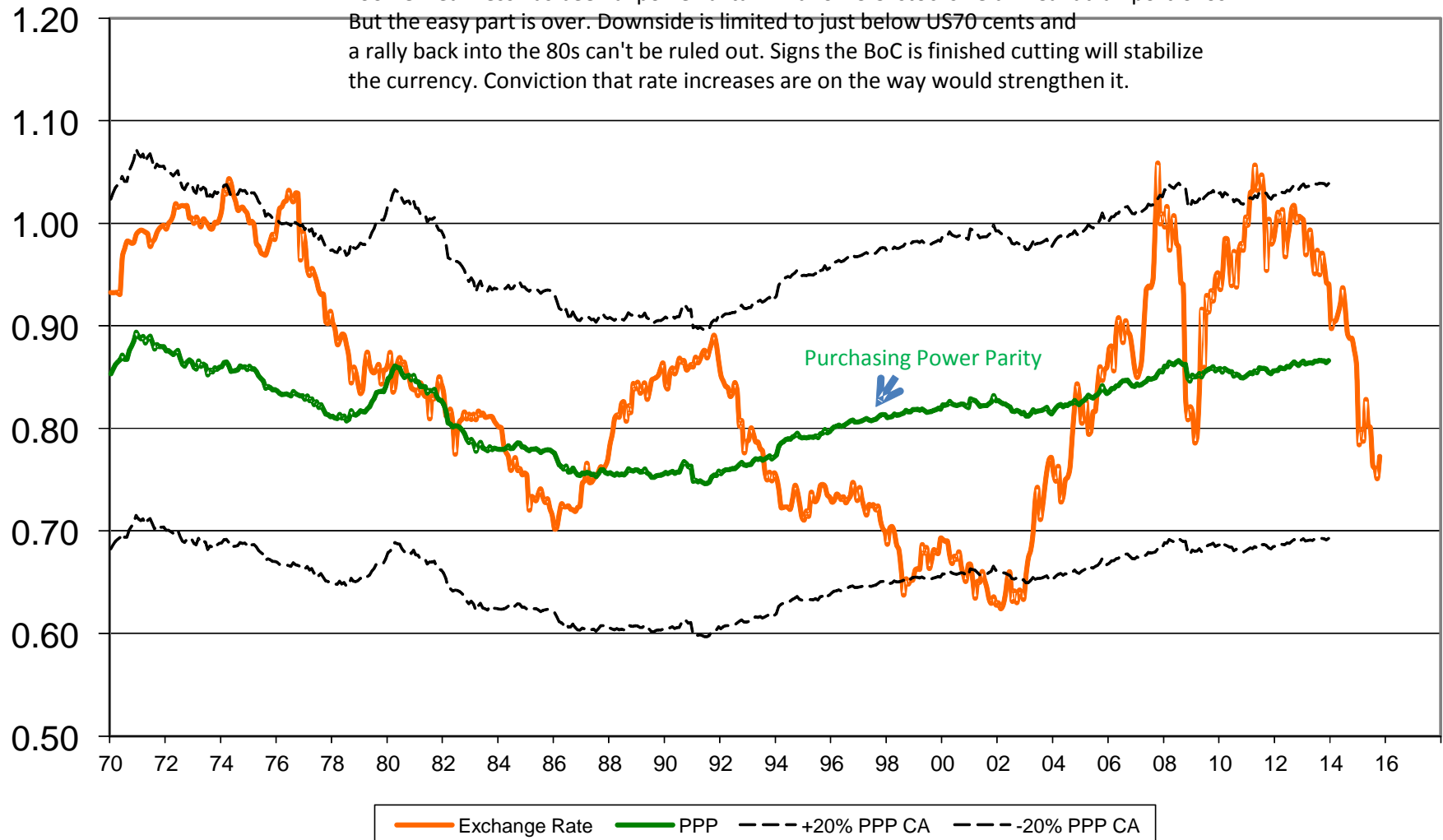


# Looking for a real Canadian portfolio?

Name	1 Month	3 Months	6 Months	1 Year	2 Years	3 Years	5 Years	10 Years
Canadian Focus List	5.11	-2.06	-1.40	5.38	11.04	11.56	7.59	6.74
S&P/TSX Composite	1.96	-5.76	-9.78	-4.62	3.61	6.01	4.29	5.61

# Canadian Dollar & Purchasing Power Parity

Loonie weakness has been a powerful tailwind for U.S. stocks held in Canadian portfolios. But the easy part is over. Downside is limited to just below US70 cents and a rally back into the 80s can't be ruled out. Signs the BoC is finished cutting will stabilize the currency. Conviction that rate increases are on the way would strengthen it.

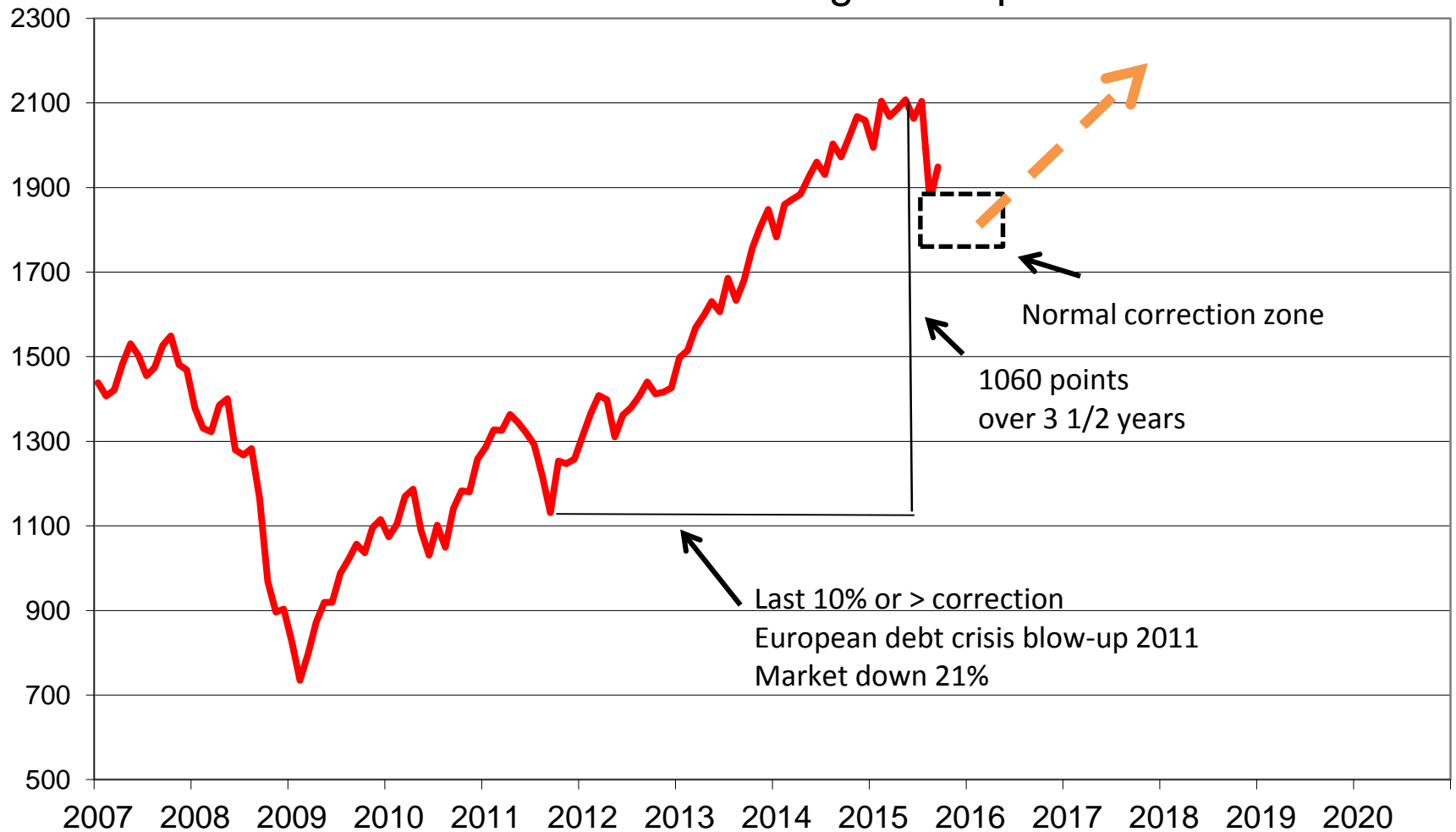


# 2016

- ❑ The U.S. should grow by 2.5%-3.0% in “real” terms, 4.0%-4.5% nominal. Canadian growth should be somewhat slower - ~2%.
- ❑ S&P 500 sales should grow somewhat faster – 5.0%-5.5% - more like the nominal growth rate of the private sector.
- ❑ Earnings should grow faster than sales as the hard-hit energy and materials sectors face easier year-over-year comparisons.
- ❑ P/E multiples could move from slightly below average to modestly above as conviction grows about the sustainability of the U.S. economic expansion.
- ❑ For 2016 we expect the broad market in both the U.S. and Canada should be able to deliver all-in returns including dividends in the low-double digits.
- ❑ We expect the year to be back-end loaded with the first half prone to more correction/consolidation and the long-term uptrend re-asserting itself in the second half.

# S&P 500

## Correction within a long-term uptren



## P/E Ranges & Subsequent 12 Month Returns (since 1940)

<8x: Average 18.6%

Median 18.8%

8x to 10x: Average 8.8%

Median 6.7%

10x to 12x: Average 9.7%

Median 9.6%

12x to 14x: Average 10.5%

Median 10.5%

14x to 16x: Average 13.7%

Median 17.0%

16x to 18x: Average 5.1%

Median 8.5%

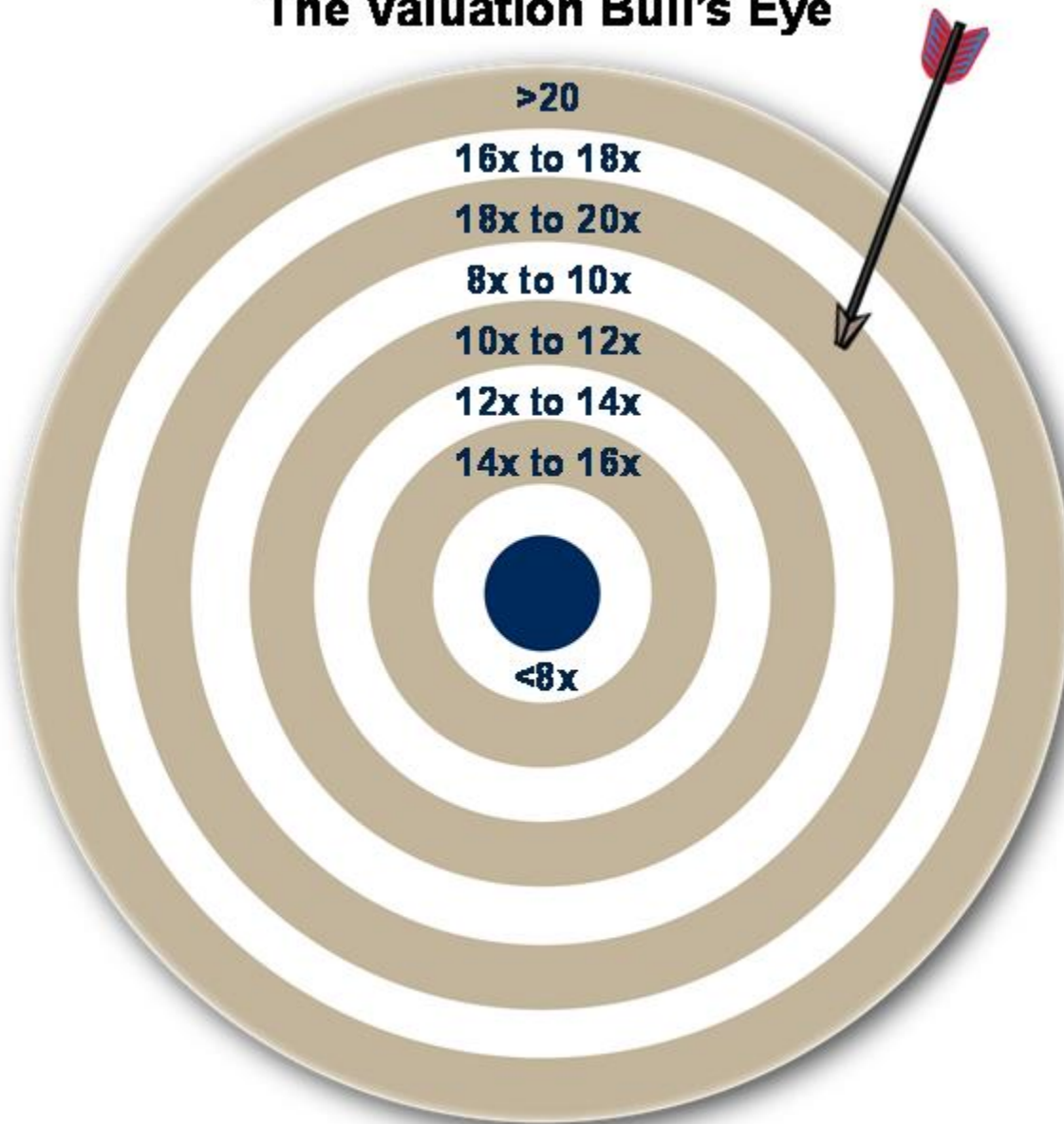
18x to 20x: Average 5.7%

Median 6.3%

>20x: Average -0.8%

Median -0.6%

## The Valuation Bull's Eye



# What will it take? Conviction.

Breaking out to the upside will require investor conviction on several fronts:

- **Stability in energy markets:** Some sustainable balance is more important than price level. Only then can the future earning power of this important market segment be recalibrated with confidence.
- **Some re-acceleration in global growth:** This mostly depends on China. The market needs indications that inventories have been right-sized and that exports are growing once again. Signs that monetary easing is working would be welcome as would new fiscal initiatives.
- **Sustained expansion in developed economies:** This requires conviction that the credit cycle remains in a constructive phase. In Europe there seems little doubt. While both the Fed and the Bank of England are headed toward first rate hikes, this is seen as “normalizing” policy, not tightening. We think it will require quite a number of hikes, probably over more than one year, to move rates to a level that would make an economic downturn probable.

# AWF 2015 Fall Economic Update

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## Questions & Answers



# Save the date ...



## ***Fireside Chat Series***

- *January 28, 2015*
- *February 18, 2015*

# Hold the date for:



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**peakawards**  
HONOURING WOMEN IN FINANCE

## 2016 AWF PEAK AWARDS: May 10





2016 PEAK Nominations information:

**Calle Johnson**

**calle.johnson@ca.pwc.com or call 604.806.7774**

2016 PEAK Nominations Deadline:

Friday, December 18, 2015 at 5:00 p.m.



Thank you for joining us today...

