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## Uncertainty Amplified

Humans have a natural tendency to want to know what the future will hold. It's what makes the proverbial crystal ball so appealing. Yet we have become accustomed to living with a degree of uncertainty, as we really have no choice in the matter. For investors, the magnitude of unknowns that we've had to withstand has been increasing since the 2008/2009 financial crisis. Just when it seemed that there was enough to worry about, the Brexit outcome shocked the world and brought future uncertainty to a whole new level. Up until June 23rd, the day of the Brexit vote, the 2nd quarter was looking reasonable for investors with many global stock and bond markets edging higher. Amplified uncertainty, though, can be intolerable. This was evident by the dramatic sell-off in global stock markets and risk assets and a flight to the safety of government bonds, the US dollar and gold.

### The Potential Domino Effect of Brexit

We believe the vote by Britain to leave the European Union is a material event, not to be shrugged off by investors. It has geo-political implications which we must certainly consider in setting forth our investment strategy. We assume we will see a number of other countries hold their own referendums as this wave of anti-globalization and anti-establishment spreads. We anticipate a significant amount of concern and attention to be focused on the mechanics of Brexit over the next number of months. Brexit itself, though, is not the major risk to global markets. We see three potential knock-on effects from Brexit which would provide further headwinds for investors if they were to become amplified:

Interest rates – The sovereign debt of major developed economies is yielding close to or less than zero. With the Brexit vote, investors fled to the safety of sovereign bonds, pushing yields down considerably further into negative territory. This has major negative implications for the profitability and soundness of financial companies, including banks and insurance businesses, as well as for pension plans globally. A stable and healthy banking system is critical to global economic growth.

Confidence – Prior to the Brexit vote, the global economy was challenged to regain historic growth rates, even with significant central bank stimulus. Stagnating economies struggling to generate significant global growth now have yet another challenge to deal with. For investors and corporate executives, confidence has been shaken. Confidence is critical to a well-functioning economy as it encourages consumers to spend and corporations to invest, in turn accelerating growth and prosperity. As in past instances, we believe central bankers and politicians will do their best to restore the market's confidence. The real risk comes if investors lose confidence in the bankers and politicians themselves.

Foreign exchange – A significantly stronger U.S. dollar as a result of its safe haven status has a potentially negative effect on the U.S. economy, emerging market economies and currencies, and commodity prices. Just as recently as this January, a strengthening U.S. dollar sent the equity markets into a tailspin as investors panicked on the back of fears the Chinese would further devalue their Yuan, triggering a widespread global currency war.

As real as Brexit risks are, we believe the parties are incentivized to deal with the transition and put in place trade agreements which will minimize the economic fallout. Europe has potentially as much to lose, if not more, from Brexit than Britain. While this event will be a cloud over the global economy and stock markets for some time, we must remember that 22 European countries reside outside the European Union. There is a solution. We will continue to allocate future investment dollars to this area of the world if good businesses offer compelling value. The fear that has gripped global markets also improves the value investors pay for businesses globally. Alternatively, bond market valuations are more stretched today than they ever have been.

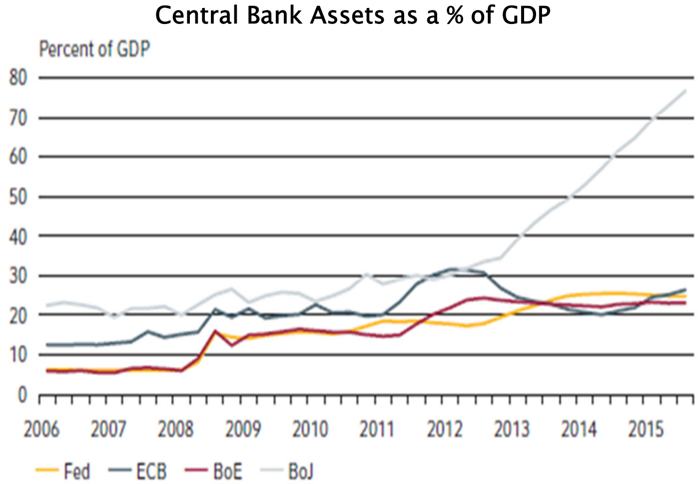
## Central Bank Policy

Putting Brexit aside for the moment, global monetary policy remains more extreme today than immediately after the financial crisis. Back then, policies were considered "emergency" measures, but now they are the norm and are more broadly exploited. If markets didn't like the uncertainty of Brexit, we cringe to think how they would react to any fallout from this unprecedented use of non-traditional monetary policy.

During the quarter and even before the Brexit event, global bond yields fell further into negative territory. The Bank of Japan (BoJ) and the European Central Bank (ECB) are executing massive quantitative easing programs. The BoJ now buys almost all of the Japanese government bonds issued every year. For all their effort, the benefits to their economies have been muted. The longer term distortions they are creating may cause greater challenges than what they bargained for.

The chart below shows that the Federal Reserve, ECB, and the Bank of England (BoE) are currently running with balance sheet assets equivalent to around 25% of GDP, compared to little more than 5% prior to 2008. The BoJ asset commitments are extremely elevated at nearly 75% of GDP. Despite this, their economy continues to struggle. Central bank policy risk continues to grow.

**Central Bank Assets as a % of GDP**




Source: Commerzbank Research

## What's Next

It remains our belief that we are stuck in a world with slower growth. This is the price we pay for decades of debt buildup, which inflated global growth at the time but has longer-term consequences. We are now living through the consequences. As investors, we anticipate this means lower returns for the foreseeable future given low interest rates and high stock valuations. We also expect the present volatility in markets and economies to continue. While this is a challenging environment, it does create opportunity. Investors often focus on the negative without considering where positive developments are occurring.

For all the negative headlines Brexit attracted late in the quarter, no one seemed to talk much about the fact that all 33 big banks in the U.S. passed the Federal Reserve's recent stress tests. These tests are aimed at ensuring the banks have enough capital to withstand a severe economic shock. While we remain concerned with the state of the banks in Europe, the balance sheets of U.S. banks are very sound and these businesses provide attractive investment opportunities. As far as the Canadian financials are concerned, their resiliency to low oil prices continues to play out well as the cycle progresses.

## Strategy Review

Fueled by a rapid rebound in resources, the Canadian equity markets continued to outperform the majority of their global peers during the quarter. With less resource exposure, our large cap and small cap strategies underperformed the index returns, but still posted healthy positive absolute results. Our global strategy held steady with its index, with both posting modest gains. Fixed income provided a buffer in our balanced strategy, increasing 1.6%, and our Canadian balanced strategy as a whole gained 1.8% during the period. We remain committed to building portfolios consisting of quality franchises which will survive a world full of uncertainties. We depend on the sustainability of the businesses and the care of capable management teams to steer us through the ups and downs.