SPROTT FOCUSED STRATEGY

Global Market Update

2016 Global Review

Equity markets in 2016 have largely been driven by macroeconomic events and central bank activity. The start of the year was exceptionally ugly as the Federal Reserve ("Fed") began the process of interest rate normalization with a 25bps hike in the Federal Funds rate in December. However, it was the Fed's forecast of four rate hikes in 2016 that clashed with the market's belief that only two were required that contributed to the risk-off slide. US Producer Manufacturing Indexes ("PMI") were sub 50.0 from December through February, adding to the weak growth narrative and making the Fed seem even more out of touch. A growing "oil glut" thesis began to take hold as investors extrapolated Iran production ramping up after the nuclear deal was signed. Initially, falling oil prices were looked at as a boon for global economic growth, but as the slide continued and oil fell below breakevens for a number of oil-exporting nation's budgets, the negative effects of low oil prices (huge government deficits and material curtailment of business investment) began to weigh on risky asset prices. China's surprise devaluation in August of 2015 was revisited as Chinese citizens and global investors continued to pull large amounts of capital out of the country, impacting Chinese reserves. The fear of another surprise devaluation and a potential crisis in China added to the negative sentiment around equities. Finally, in March, as rate hikes failed to materialize and oil prices stabilized, markets began to recover. Momentum was added by European Central Bank ("ECB") and Bank of Japan ("BOJ") monetary stimulus and markets began to pare their losses. Then came Brexit.

Much has been made of the United Kingdom's decision to withdraw from the European Union. Leaving aside the arguments for or against European Union membership, global equity markets fell sharply for two days in response. Much of the immediate reaction was repositioning portfolios to reflect the leave vote and initial fear, driven by the dire forecasts of stay campaigners leading up to the vote. However, global equities rallied aggressively off these lows, led by the FTSE 100 and its heavy weighting in large, multi-national corporations.

The Bank of England ("BOE") and Conservative government can take some credit for this rally as they both moved very quickly to dispel uncertainty. The government appointed a new Prime Minister within a month and Theresa May made it quite clear that she would be pursuing Brexit (as opposed to ignoring the results). The BOE surpassed the market's expectations, delivering an expansion of its quantitative easing program in addition to the anticipated rate cut. The end result was an initial 11% decline in the British pound versus the US dollar and Euro, as the impact of Brexit was manifested in the weakening of the currency. Economic activity in the UK, as measured by PMIs, stalled badly in July but rebounded sharply in August, prompting many to argue that Brexit was a "non-event". However, to us it is clear that in the future there will be less capital formation, less job creation and less wealth accumulation in the UK. All that is in question is the delta and magnitude of the losses.

Dennis Mitchell
Senior Vice-President,
Senior Portfolio Manager

> "Post-Brexit, it is clear that there will be less capital formation, less job creation and less wealth accumulation in the UK."

Since Brexit, global equity markets have lacked sustained momentum and direction. Lack of conviction on the part of investors has been manifest in the shorter cycles of bullishness and bearishness in all markets (equity, fixed income, currency) in reaction to economic data, central bank activity and company reporting. We enjoyed a period of very low volatility in the month of August but that was quickly followed by elevated volatility in the month of September. Going forward, most analysts expect corporate earnings to increase year-over-year in Q3 and accelerate higher in Q4. However, volatility is likely to remain elevated through the end of the year as investors begin to position for a 25bps rate hike from the Fed in December.

A freeze in OPEC oil production has the potential to elevate global growth. OPEC nations need WTI to move higher to help alleviate their budget deficits. Given Saudi Arabia is running budget deficits of 10% of GDP (down from 13% in 2015 and even higher in 2014), we think it is highly possible that November sees OPEC and Russia agree to freeze production, with the option of a cut to get oil prices comfortably into a higher range. This would certainly benefit the upcoming Saudi Arabian bond issue and the pricing of their spin out of Saudi Aramco. Higher WTI pricing could also boost North American production and overall business investment. Combined with continued strength in the US labour market and the resulting impact on consumer confidence and spending, we feel that 2017 is set up much better than 2016. Any market weakness on the back of the Fed raising rates should be a buying opportunity.

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Global GDP Growth

Both the IMF and the OECD have recently updated their forecasts for global GDP growth. Both institutions have expressed concern that the world is stuck in a low-growth trap. The OECD in particular, has called for co-ordinated global monetary, fiscal and structural policies to move to a higher growth path and ensure that promises are kept to both younger and older generations.

IMF GLOBAL GDP FORECASTS			
Country/Region	2015	2016	2017
World	**3.2%**	**3.1%**	**3.4%**
United States	2.6%	1.6%	2.2%
Canada	1.1%	1.2%	1.9%
Euro Area	2.0%	1.7%	1.5%
United Kingdom	2.2%	1.8%	1.1%
Japan	0.5%	0.5%	0.6%
China	6.9%	6.6%	6.2%
India	7.6%	7.6%	7.6%
Brazil	-3.8%	-3.3%	0.5%

Source: IMF, October 2016

OECD GLOBAL GDP FORECASTS			
Country/Region	2015	2016	2017
World	**3.1%**	**2.9%**	**3.2%**
United States	2.6%	1.4%	2.1%
Canada	1.1%	1.2%	2.1%
Euro Area	1.9%	1.5%	1.4%
United Kingdom	2.2%	1.8%	1.0%
Japan	0.5%	0.6%	0.7%
China	6.9%	6.5%	6.2%
India	7.6%	7.4%	7.5%
Brazil	-3.9%	-3.3%	-0.3%

Source: OECD, September 2016

The state of political gridlock in the US makes it difficult to see how tax reform and infrastructure spending initiatives will be agreed upon. Barring a sweep of the Presidency, Senate and House by any one political party, a "grand bargain" between Democrats and Republicans would be required. For reference, in 2011 President Obama and Speaker Boehner negotiated a grand bargain to rewrite the tax code, cut entitlement spending and reduce budget deficits. It failed at the 11th hour, likely because neither man could get his party purists to swallow the necessary concessions. It is harder to see how President Clinton & Speaker Ryan or President Trump & Majority Leader Durbin (?) will negotiate anything as far reaching or conciliatory. The current Congress can't even agree on a funding bill to combat the Zika virus. Some may point to the Budget Control Act of 2011 or the American Taxpayer Relief Act of 2012 as recent examples of bi-partisan fiscal compromise. However, both were in response to an impending US fiscal crisis (fiscal cliff, government shut down) that helped galvanize action. Absent that motivational factor we fear US fiscal policy will remain on indefinite hold.

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In the Eurozone, Germany continues to fight non-existent inflation as they are on pace to rack up their third consecutive federal budget surplus. Germany has delivered these surpluses despite ramping up expenditures to settle over one million refugees. The Bundesbank continues to call on the ECB to end loose monetary policy and has been one of the main reasons the ECB has been behind the curve in terms of easing monetary policy. Given that German federal elections will take place sometime between August and October of 2017, we anticipate this dynamic continuing into the future.

Theresa May has recently stated that the UK will trigger Article 50 and begin the Brexit process by March of 2017. So while the UK is forecast to be the fastest growing G7 economy in 2016, Brexit fears will drag that rate of growth down in 2017 and likely into 2018, as the negotiations play out. Expect the BOE to continue to support the economy with accommodative monetary policy and the Conservative government will likely roll out additional fiscal stimulus measures. The British Pound will likely continue to weaken and the FTSE 100 should continue to outperform, despite weakening economic data and results from the domestic economy.

China continues to restructure its economy and manage its growth rate down. The recently-completed merger of the two largest state-owned shipping companies in China (Cosco and China Shipping Group) takes additional capacity out of a large, capital intensive industry and continues the repositioning of the Chinese economy. China is likely to implement more controlled devaluations of the Yuan, but nothing dramatic that would jeopardize their recent inclusion in the IMF Special Drawing Rights. Given the questionable quality of the data coming out of China and the declining accuracy of the Keqiang Index, we see China as a potential source of excess market volatility in 2017.

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Purchasing Manager Index Composite

The Global Composite PMI has declined from 52.9 in December to 51.0 in September. This is in line with the slowdown in the pace of global growth and reflected in the lowered growth expectations of the OECD and IMF. The Global Manufacturing PMI is flat at 51.0, which is actually very resilient performance. Global trade remains below trend and China's restructuring would have been expected to reduce this number. However, performance at the country level showed clear winners (US, India, Russia, UK) and losers (Japan, France, Italy, Ireland). The Global Services PMI has declined from 53.1 to 51.5 as the UK, Germany, Japan and Italy all experienced material declines. This is a troubling development as services are generally produced and consumed within a nation. With global trade weak, if domestic consumption begins to wane, global growth could weaken further.

The US and the UK show robust PMIs with the US showing particularly strong Services PMI while the UK Manufacturing PMI is strong. It should be no surprise then that these two equity markets have lead the way with the best local market returns (9.0% and 16.1% respectively). Eurozone PMIs have weakened slightly but the ECB's accommodative monetary policy has kept the region in expansion territory.

Italy is also troubling because of the weakness of its banks and the impending referendum this fall. Italian banks continue to work through non-performing loans that were underwritten during and since the Great Recession. However, evidence exists that Italian banks continue to experience growth in non-performing loans, indicating either continued business weakness or truly poor underwriting. Given that trend in Italian PMIs we believe it is skewed towards business weakness. The referendum in the fall is about stabilizing the Italian government, which has been led by five different Prime Ministers since 2006. A loss here would usher in a sixth Prime Minister and more turmoil.

Japanese PMIs remain in or near contraction territory, despite unprecedented monetary stimulus. Some fiscal support has been delivered but has not resulted in sustained inflation and/or productive output. Japan is the fourth largest economic region/country in the world and its stagnation will put further downward pressure on global GDP growth.

Brazil remains in terrible shape but its equity markets have rebounded sharply with the broadening of the corruption investigation. It should be noted that the rally in Brazilian equities now makes them flat over two years and still leaves them 12.2% below their March 2012 peak.

Overall, weak European and Japanese PMIs are fueling the argument that central banks have run out of ammunition to spur global growth. The perceived desperation of negative rates and the obvious effects on savers and financial institutions has advanced the narrative that monetary policy and low rates are now doing more harm than good. However, the alternative, raising rates before the global recovery has reached escape velocity, would likely do an even greater amount of harm than good. Cutting off the recovery when global growth is 3% and inflation is non-existent would be a self-fulfilling prophecy, creating a recessionary environment at a time when central banks lacked conventional ammunition to combat it. Central bankers now find themselves in the difficult position of trying to determine the course of action that will do the least amount of harm to global growth.

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GLOBAL DECEMBER PURCHASING MANAGER INDICES					
Market	Manufacturing	Services	Market	Manufacturing	Services
Global	**51.0**	**51.5**	Eurozone	52.6	52.2
United States	51.5	57.1	United Kingdom	55.4	52.6
Japan	50.4	48.2	Germany	54.3	50.9
China	50.4	53.7	France	49.7	53.3
Brazil	46.0	45.3	Italy	51.0	50.7
India	52.1	52.0	Spain	52.3	54.7
Russia	51.1	53.0	Ireland	51.3	56.2

Source: Trend Macrolytics, Markit Economic Research

We believe that corporate profits troughed in Q2 and will show accelerating growth into Q3 and Q4. We expect the Fed to raise rates by 25bps in December and outline a more dovish rate path than a year ago. Oil prices should begin to reflect a more balanced, if not under-supplied picture later this year and support current if not higher prices. Finally, wage gains driven by increases in minimum wages and a tighter labour market will put a floor in inflation expectations and boost consumer and business confidence. We still expect global growth to remain below trend and the political calendar (Italian referendum, French and German elections) is filled with potential landmines that could impact sentiment and output. However, our base case remains, low growth, low inflation and low rates for an extended period of time.

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Global Equity Valuations

At the start of the year, we felt that global equities were priced to deliver total returns in the low teens. As the year began and equities fell, we felt comfortable with our forecast given the expectation that oil prices would eventually rebound and the UK would reject Brexit. Since Brexit, volatility has been elevated with only a brief respite in the month of August. We still feel that global equities are priced to deliver low double digit returns in 2016, however, we underestimated the amount of currency volatility that would appear. In our defense, we expected Brexit to fail and Hilary Clinton to campaign better.

GLOBAL EQUITY MARKET FUNDAMENTALS						
	Forward P/E Multiple Estimate			Earnings Growth	Dividend Yield	10 Year Bond Yield
Market	Current	3 Year Avg	5 Year Avg			
MSCI World	**15.4x**	**14.1x**	**12.9x**	**10.0%**	**2.6%**	**0.6%**
S&P 500	16.1x	14.6x	13.4x	10.4%	2.1%	1.8%
FTSE 100	15.0x	12.8x	11.5x	16.3%	4.0%	1.0%
Shanghai	11.9x	9.8x	9.6x	6.8%	3.4%	2.7%
Nikkei 225	15.7x	16.3x	14.7x	5.3%	1.8%	-0.1%
S&P/TSX	15.9x	14.1x	13.3x	6.0%	2.9%	1.2%
EuroStoxx 50	12.9x	12.4x	11.0x	12.1%	4.0%	0.1%

Source: Bloomberg, October 7, 2016
Note: Global bond yield is the Global Developed Sovereign Bond Index, Eurozone bond yield is EFSF yield

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At 16.1x 2017 EPS estimates, the S&P 500 is trading above its long term averages but, given the low level of interest rates and inflation, this is not surprising. The Fed is on track to raise the Fed Rate by 25bps at their December meeting and they will likely lower the future forecast of interest rates to reflect two hikes in 2017 and 2018. Continued low global growth and the Fed's interest rate policy should combine to keep the US dollar strong versus most other currencies. This will impact the earnings of US multinationals but unless the US Congress implements another tax holiday, the impact will be largely translational and not operational. Overall, the S&P 500 is poised to deliver returns in-line with that of the global equity market as a whole, with upside should the US recovery gather steam or US equities receive a safe haven bid.

At 12.9x 2017 EPS estimates, the EuroStoxx 50 Index is trading slightly above its long term average. However, given the monetary policy being employed by the European Central Bank, Bank of England and Swiss National Bank this is not surprising. The ECB and BOE in particular, stand ready to add additional stimulus to what is already a very accommodative monetary policy environment.

The FTSE 100 Index is trading at 15.0x 2017 EPS estimates, which puts it at risk for multiple contractions above that of the global equity market as a whole. The rate of earnings growth forecast in the market is significantly more that of the global equity markets, buoyed by further anticipated British Pound devaluation on future Bank of England easing. With a 4.0% dividend yield the FTSE 100 offers compelling total return potential above that of the global equity market but Brexit-driven volatility is likely to emerge when the UK officially triggers Article 50 and commences the process of exiting the European Union.

The introduction of negative interest rates by the BOJ in January has not been embraced by the markets. Regardless, Prime Minister Shinzo Abe's coalition government won a larger majority in July and he has a clear mandate to drive Abenomics forward. Sustained growth and inflation have been elusive for the Japanese economy and Yen appreciation and Nikkei declines have ensued. The Nikkei currently trades at 15.7x 2017 EPS estimates, making it cheap on a historical basis however, it is likely that earnings forecasts will come down if the Yen continues to appreciate. The 1.8% dividend yield is attractive and the BOJ continues to put a floor in the Nikkei through its purchases of equities (and everything else). The BOJ's shift to interest rate targeting should alleviate some of the pressure on Japanese banks and the Yen has moved lower in response.

Portfolio Positioning

Our portfolios remain invested in companies domiciled in the US and Europe but the allocation to the US has increased as the expense of the allocation to Europe. In addition, these markets are home to the greatest number of high quality franchises, making it easier to deploy our strategy as outlined in the white paper published in December 2015. Our cash weightings and trading activity have increased, reflecting higher market volatility. We favour companies that are able to drive volume AND pricing gains in this low growth environment (and really always). The level of risk aversion and uncertainty in the market will likely yield sharply negative moves for companies that disappoint or guide to mediocre performance.

Earnings estimates growth rates are above long term averages, largely due to anticipated cyclical recoveries (energy and financials) and lapping currency impacts. The FTSE 100 tracks the 100 largest companies domiciled in the UK and these companies tend to be multinationals. The dramatic devaluation of the British Pound after the Brexit vote has boosted the earnings expectations for these companies disproportionately. We continue to be overweight the UK and have hedged away all of the currency impact. The EuroStoxx 50 tracks the 50 largest companies domiciled in the Eurozone and continues to demonstrate that Eurozone equities are cheap on an absolute and relative basis. However, the index's biggest weights are financials from a sector standpoint and France from a country standpoint (20.9% and 38.1% respectively), which lowers the overall index valuation. Still, material upside exists in European equities and we continue to be allocated there.

Japanese equities scan as cheap but the low earnings growth is a huge red flag. The earnings are impacted by the Yen strength versus very low domestic growth and inflation. For a country that is monetizing virtually all of its debt issuance to still have its currency appreciate versus the US dollar is a repudiation of Abenomics. Unless the BOJ can engineer Yen weakness Japanese equities will continue to demonstrate low earnings growth and experience little in the way of multiple expansion.

Thanks and Stay Focused,

Dennis Mitchell
Senior Vice-President,
Senior Portfolio Manager
Sprott Asset Management

"With a 4.0% dividend yield the FTSE 100 offers compelling total return potential above that of the global equity market, but Brexit-driven volatility is likely to emerge when the UK officially triggers Article 50 and commences the process of exiting the European Union."

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