Q2|Q3
2018

GLOBAL ECONOMIC & MARKET UPDATE

Waiting for the Lift

ONTARIO TEACHERS' PENSION PLAN

The global economy is at an important inflection point, with positive (though weaker more recently) cyclical forces bumping up against an unfavourable secular growth backdrop. Viewing these cross-currents through the lens of the Ontario Teachers' Global Macroeconomic Framework leads us to believe that the cyclical component will prevail, helping the global economy shake off its recent soft patch and putting it on track for a stronger performance through the remainder of this year. Consistent with this constructive cyclical growth view, we continue to see further modest upside for risk assets and are mildly bearish on global fixed income. We have no strong conviction on the direction for the USD over the medium term, though we see the risks as now tilted in favour of a modest cyclical bounce in the near term. Our expectation for a shift away from the abnormally low volatility regime of last year is unchanged, while our outlook for commodities remains positive.

Our relatively constructive global medium-term outlook is not without risks. In fact, while the level of conviction associated with our base-case view is high, we see elevated (and rising) risks over the medium term from increasing global trade tensions, the sharp rise in energy prices, potential central bank missteps and intensifying geopolitical tensions in the Middle East.

Millan Mulraine, Chief Economist

CYCLICAL GROWTH BOUNCE EXPECTED

Underpinning our constructive growth view is a recognition that the global business cycle remains on the upswing—buttressed by robust trade and capex activity, with additional help from fiscal policy and still supportive global financial conditions.

HIGHER VOLATILITY REGIME TO PREVAIL

Financial markets have stabilized since the February panic that resulted in the VIX spiking, even though recent anxiety around rising US-China trade tensions has kept volatility from dropping more aggressively. While the VIX remains well below the February high watermark, we do not expect the index to fall back to the abnormally low levels seen prior to the February spike.

INFLATION MOMENTUM TO DRIFT HIGHER

Alongside a pick-up in growth momentum, we see further scope for underlying global inflation pressures to rise as the pace of economic slack absorption accelerates. Importantly, the upshift in inflation momentum should remain gradual, providing considerable latitude for central banks to remain patient.

BALANCE OF RISK LOWERED

On net, the upbeat macro assessment is unchanged relative to our expectations at the start of the year. However, we now see the risks to our base-case growth view as being finely balanced (representing a downgrade from an upside bias earlier).

GLOBAL ECONOMIC & MARKET UPDATE

Q2|Q3 2018

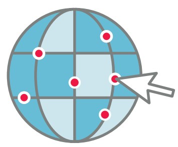
Eyes on the World

PHILOSOPHY

Our competitive edge stems from our unique access to key global decision-makers and a diverse platform of portfolio companies. This unique information gateway informs our view of the world, and provides a benchmark against which our global outlook (and associated risks) for growth, inflation and the discount rate (interest rates) can be judged. The underlying views are forged by an analysis of the interconnections between three key pillars of the economic infrastructure (namely the structural trends, cyclical dynamics and global adjusting forces) that shape the medium-term outlook for the global economy and financial market performance.

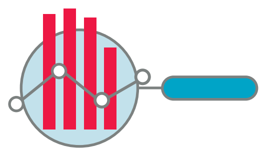
ONTARIO TEACHERS' GLOBAL MACROECONOMIC FRAMEWORK

Unique Information Gateway



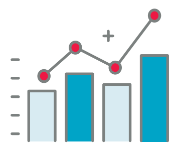
The Competitive Edge
- Portfolio Companies
- Hedge Fund Partners
- Research Community

The Analytical Framework



The Teachers' Tri-Cycle
- Structural Trends
- Cyclical Dynamics
- Global Adjusting Forces

Market Assessment and Outlook



The Investment Outlook
- Financial Market Outlook
- Global Macro Risk Monitor
- Global Scorecard

THE TEACHERS' TRI-CYCLE

1 **Structural Trends**
The long-term trends or secular regimes that define the investment environment, and influence the decision-making process of firms, households and non-market actors at both the individual and aggregate level.

2 **Cyclical Dynamics**
Forces related to fluctuations in the economy, policy and credit regimes that are driving forces behind economic and asset market performance.

3 **Global Adjusting Forces**
These forces define the avenues for spillovers across economies and regions. In particular, they form the mechanism through which developed and emerging economies and financial markets become integrated through trade and capital investment flow.

Global Macroeconomic Outlook

DEVELOPED MARKETS:

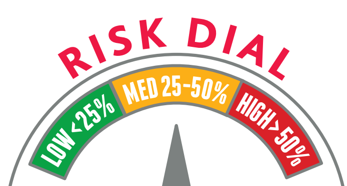
Constructive Growth Narrative Intact: Although the economic data flow has been somewhat disappointing so far this year, we do not see this weakness as being sufficiently entrenched to disrupt the self-sustaining growth narrative. The biggest negative data surprises have been concentrated in the Eurozone and Japan, where the market's growth expectations were unjustifiably high in our view. We expect global GDP growth to re-accelerate.

Inflation Risk Drifting Higher: We see further scope for underlying global inflation pressures to drift higher as the pace of economic slack absorption accelerates. The upshift in global core inflation momentum should remain gradual, providing considerable latitude for central banks to remain patient. The supportive monetary policy backdrop will be a key ingredient in sustaining positive global growth momentum.

Gradually Shifting From QE to QT: After a decade of emergency monetary policy settings across DMs, underpinned by unconventional policies, the dial is slowly shifting towards synchronized tightening. This pivot continues to be gradual and led by the economies with more mature business cycles – namely, the US, the UK and Canada. However, over the course of the next year, we expect the ECB and BoJ to join the fray.

EMERGING MARKETS:
EM Prospects Challenged, but not Derailed

Our constructive medium-term view on EMs is being stress-tested as we move through 2018, with EM assets seeing a broad re-pricing lower and EM FX volatility picking up. However, we continue to believe that the recent weakening of EM asset prices is a transitory correction of perhaps excessively euphoric expectations around the outlook at the turn of the year.



KEY GLOBAL MACRO RISK MONITOR	RISK LEVEL
1 U.S. encounters an economic recession over the next 12 months	
2 The Canadian economy enters a recession in the next 12 months	
3 Global geopolitical tensions rise owing to competitive devaluation and protectionism	
4 DM central banks make a policy error by tightening too aggressively NEW	

Financial Market Outlook

EQUITIES: Risk Appetite to Rebound

Global equities are mostly flat on the year, after briefly dropping into correction territory in February. We expect risk appetite to enjoy a modest rebound into the remainder of the year, underpinned by supportive cyclical economic growth and the continued delivery of earnings relative to (admittedly demanding) expectations.

OUTLOOK: Bullish

FIXED INCOME: Upside Bias to Yields

The rise in yields so far this year has been broadly consistent with our expectations. Less expected, however, has been the pace of the adjustment, which has been much faster than anticipated. And while we do not expect a repeat of the sharp selloff, we believe that the dynamics behind the back-up in yields will persist.

OUTLOOK: Cyclically Bearish

U.S. DOLLAR: Cyclical Bounce

Over the medium term we see no clear direction for the dollar, as the tug-of-war between negative structural and favourable cyclical forces plays out. However, with near-term economic growth and interest rate differentials likely to favour the greenback, we see some modest upside dollar risks over the next few quarters.

OUTLOOK: Cyclically Bullish

CREDIT: Spread Widening Bias

With benchmark rates drifting higher at a time when the global business cycle is entering a more mature phase, credit markets' resiliency is likely to be tested in the face of rising financing costs. Against this backdrop, we expect credit spreads to grind gradually higher.

OUTLOOK: Mildly Bearish

COMMODITIES: Firming Demand to Support Prices

The backdrop for energy is favourable, with the oil market now closer to balance. Any supply disruptions resulting from the re-imposition of Iran sanctions will boost prices. Even though we expect some of the resulting shortfall to be taken up by increased production elsewhere, we see the potential for demand growth to support prices.

OUTLOOK: Bullish

ON OUR RISK RADAR

HIGHER OIL PRICES

Crude oil prices have risen sharply since the start of the year, weighing on the otherwise constructive backdrop for consumers globally. Although the impact appears to have been only mildly negative so far, the calculus would likely change if crude oil prices continue climbing to above US $100/barrel.

RISING TRADE TENSIONS

We have become more concerned about the potential for the US and China to engage in a potentially damaging tit-for-tat trade war, risking a disruption to one of the key pillars of the constructive global growth story. Although recent conciliatory moves are encouraging, a quick fix to these underlying issues is difficult and the risk of miscalculation is high.

CENTRAL BANK POLICY ERROR

We see higher risk of a DM central bank policy error. This risk may not be imminent, nor is such an error part of our base-case view. However, with monetary policy tightening across DMs, uncertainty has increased relative to an environment in which zero interest rates policy had been the prevailing bias for many years.

GEOPOLITICAL RISKS ELEVATED

The geopolitical climate has improved in some regions and worsened dramatically in others. On the Korean Peninsula, tensions have eased. In contrast, the prognosis in the Middle East has worsened, and an unravelling in this region will have implications for crude oil prices and the global outlook more generally.

Global
Medium-term Scorecard

The scorecard reviews the directional impact of economic indicators ranging from structural trends like geopolitics and the regulatory backdrop to cyclical dynamics and global adjusting forces on the three key primitives – growth, inflation and interest rates. This is compared to our assessment of what the market is pricing in for these factors.

GLOBAL

		Growth	Inflation	Discount Rate
Structural Trends	Geo-Political Trends	–	+	+
	Regulatory Backdrop	–	+/–	+
	Secular Growth Drivers	+/–	+	–
Cyclical Dynamics	Credit Cycle	+	+	+
	Business Cycle	+	+	+
	Policy Cycle	+	+	+
Global Adjusting Forces	Investment Cycle	+	+/–	+/–
	Trade Cycle	+/–	+	+
	Capital Flow Cycles	+	+	+/–
Ontario Teachers' Bias		+/–	+	+
Relative to Market		+/–	+	+

CANADA

		Growth	Inflation	Discount Rate
Structural Trends	Geo-Political Trends	–	+	+
	Regulatory Backdrop	–	+/–	+
	Secular Growth Drivers	+/–	–	–
Cyclical Dynamics	Credit Cycle	+/–	+	+
	Business Cycle	+	+	+
	Policy Cycle	+/–	+/–	+
Global Adjusting Forces	Investment Cycle	+	+/–	+/–
	Trade Cycle	+/–	+	+
	Capital Flow Cycles	+	+	–
Ontario Teachers' Bias		+	+	+
Relative to Market		+/–	+	+

\+ = Upward – = Downward +/– = Outcome uncertain

ONTARIO TEACHERS' PENSION PLAN

For questions and comments on this report, please contact:

Millan Mulraine
Chief Economist
millan_mulraine@otpp.com
1 (416) 730-6192

Published June 12, 2018