LANDRY INVESTMENT MANAGEMENT

Market Review
Fourth quarter 2013

Stock markets advanced quite strongly in 2013, and yields on bonds maturing in two to 30 years also rose. This situation indicates that the extremely expansionary monetary policies of recent years are starting to have an effect and that economic activity is firming.

In March 2014, we will complete the fifth year of an equity bull market. The returns for one and five years are given in the following table.

Performance in Canadian currency

	1 year	5 years
Canadian equities	13.0%	11.9%
U.S. equities	41.4%	14.8%
Europe and Pacific equities	31.2%	9.4%
Emerging market equities	4.0%	11.7%
Bonds	-1.0%	4.7%
Real estate investment trusts	-5.3%	19.7%

Source: Bloomberg

Real estate investment trusts continue to lead, even though they declined last year. As for the stock market, U.S. equities had the best performance with a return of 100%. At 15% a year, capital doubles in less than five years. As a result of such large increases, equities in general may appear to be expensive. But, if we take the S&P 500 equity index, we see that it is currently trading at 1,800, or barely 20% higher than it was 14 years ago in 2000. The price-earnings ratio based on 2014 forward earnings is 15 times, which is lower than the average of the past 50 years, if the inflationary years from 1973 to 1980 are excluded. But, if the ratio is based on the average earnings of the past 10 years, as was done by Robert J. Shiller of Yale University, the multiple is a high 25 times.

For an equity investment, the initial value is very important, even with a 10-year horizon, because dividend yields are low. An approach that has served us well in recent years is to calculate the return on equities over the previous 10 years and to compare it to all combinations of 10-year returns for the past century. The idea behind this approach is that equities are expensive if they have risen significantly for 10 years and vice versa. We concluded then that the probability of a negative return over 10 years is almost nil when the return for the previous 10 years is negative, as was the case between 2009 and 2012 for U.S. equities. This analysis prompted us to invest in equities with confidence during that period.

Where do we stand today? From 2003 to 2013, equities returned 7.4% a year, which is slightly below the 9.6% annual long-term return on U.S. equities. This leads us to the following conclusion: U.S. equities are not too expensive but they can no longer be bought at a discount.

U.S. ECONOMY

The U.S. economy grew by 1.8% in 2013 even though the government imposed the largest fiscal drag in the country's history last year. This shows the underlying strength of the U.S. economy. Consumer spending and business investment were up, while the trade deficit fell to its lowest level in four years at the end of the year. Governments stopped reducing their spending toward year-end, which will enable the private sector to strengthen in 2014. The U.S. economy is still a long way from full employment, and growth may continue for several more years.

WORLD ECONOMY

The U.S. Federal Reserve was the first central bank to respond with determination to the financial crisis, and the United States was the first country to emerge from it, but other countries are following suit. Japan recorded very acceptable growth in 2013, and the economic indicators for Europe suggest that a good portion of it has emerged from recession. In 2014, we will therefore see synchronized economic growth in the developed countries, which will support exports from developing countries.

QUANTITATIVE EASING

In addition to keeping short-term interest rates at 0.25%, a level far below inflation, the Federal Reserve opted to purchase $85 billion of bonds a month to keep long-term interest rates as low as possible. As the economy improves, investors expect the Fed will stop its purchases at some point in 2014, and everyone expects interest rates will rise when that happens. Even so, the opposite did not occur: interest rates did not really go down when the Fed was making its purchases because the level of long-term interest rates is based on expectations of the economy's health in the years to come. If the Fed purchases bonds, investors can be sure that it will continue to do so as long as the economy has not improved, which guarantees that interest rates will rise.

INTEREST RATES

All commentators expected interest rates to rise last year, including us, and that is what happened: rates went from 1.8% at the start of the year to 3.0% at the end. The market is still expecting interest rates to rise in 2014 but this outcome seems far less obvious to us for several reasons. First, it is quite likely that short-term interest rates will rise in 2014 but the 10-year bond market has already priced in an increase: the two-year rate is only 0.4%, which leaves an enormous differential of 2.6% between the two maturities. Second, a 3.0% nominal rate is a real rate of 1.5% (in an environment of 1.5% inflation), which is the average real rate of 10-year bonds in the long run. Third, the risk of deflation is still present, which places a premium on quality bonds.

INFLATION OR DEFLATION?

As a result of the unbridled monetary expansion of recent years, rampant inflation could have been expected by now in the United States, which is not the case. In fact, the opposite has occurred, because it appears to be very difficult to reach the Fed's objective of 2.0% inflation. At present, core inflation is falling in all the developed countries, except Japan.

We do not know exactly why inflation has been so low for 10 years but technological progress and the greying of the population have no doubt played a role. For the United States, we must add the significant decrease in the cost of energy as a result of development of the shale gas industry. These factors are not about to disappear and will continue to put downward pressure on inflation.

A central bank is completely powerless when confronted with deflation because the main instrument it uses to affect the market, namely interest rates, cannot be negative. For that reason, the Fed ensures that the inflation rate does not approach zero for long.

SHALE GAS

The development of shale gas in the United States is the most important energy-sector innovation of the past century. In a few years, the United States will become the world's largest oil producer, surpassing Saudi Arabia and Russia. This development will have significant geopolitical impacts but has already begun to transform the industrial sector in the United States.

Energy is a vital input in the production process and, because this industry is highly capital-intensive, a change in the price of energy has a long-term impact on a country's overall production capacity. It will be recalled that the 1973 oil price increase caused an inflationary spiral and a drop in productivity, and that it took the United States almost 10 years to recover.

Today, we are seeing the reverse phenomenon: the United States is becoming increasingly competitive thanks to shale gas, and this advantage may be sustainable because very few countries have begun to use this innovation.

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DASHBOARD

		December 31, 2013
Canada		
	Canadian dollar vs. U.S. dollar	-
	Corporate bonds	+
	Long-term government bonds	=
	S&P/TSX 60	=
	Small caps	=
	REITs	-
United States		
	U.S. dollar vs. euro	=
	Long-term Treasury bonds	=
	S&P 500	+
	Nasdaq	+
Europe		
	Euro vs. U.S. dollar	=
	MSCI Europe	++
Asia		
	Yen vs. U.S. dollar	=
	MSCI Japan Index	+
Emerging markets		
	MSCI Emerging Markets	-

=: neutral +: overweighted –: underweighted