Market Review
First quarter 2014

The stock markets continued to advance in the first quarter, with the U.S. market reaching a new peak. On the bond market, interest rates were down slightly, and financing conditions were fairly easy. In the United States, the market is partial to BBB-rated securities and credit spreads are tight. All this generally indicates there is ample liquidity to finance economic expansion in the years to come.

The immediate impacts of the 2008-2009 crisis have now been mitigated, and we can turn to the medium-term outlook for the global economy. In the developed countries, it is becoming increasingly clear that economic growth will be slow, and forecasters are even concerned about the possibility of deflation in Europe. In this context, emerging countries will have to adjust their policies because their exports to the developed countries will rise far more slowly. China especially will have to make the transition from an economy based mainly on infrastructure construction to one based on consumption.

We can therefore expect interest rates to remain abnormally low for several more years. As for the stock market, valuations show that U.S. equities are trading at ratios comparable to or higher than their long-term average. In fact, the U.S. stock market is expensive when considered in absolute-value terms but inexpensive in relation to interest rates. The other stock markets are less costly.

Performance in Canadian currency

	3 months	1 year
Canadian equities	6.1%	15.7%
U.S. equities	5.7%	32.1%
Europe and Pacific equities	4.7%	28.2%
Emerging market equities	3.3%	7.2%
Bonds	2.7%	0.9%
Real estate investment trusts	5.4%	-1.8%

Source: Bloomberg, March 31, 2014

We have concluded that the returns we can generally expect from equities for the next three to five years will be equivalent to their long-term return, namely 6% to 8% a year. Valuations on the European bourses are lower than on the U.S. stock market and offer better short-term potential, provided that economic activity in Europe firms, as we expect it to.

Contrast between the U.S. and Europe

The employment rate in the United States recently surpassed the previous peak of 2007-2008 and its recent progress has been vigorous. This has led economists to forecast 2.75% growth in 2014 with a high level of confidence. Most of the imbalances created by the crisis have abated or are in the process of doing so, including the residential housing market, bank capitalization, government budget deficits and even the persistent balance-of-payments deficit.

In Europe, the unemployment rate is stuck at 12%, and most countries are still hesitant to reform their labour markets to allow a generalized increase in employment. Even so, according to the short-term economic indicators, a recovery is getting under way. What is even more important for the long term, the financing rates for the peripheral countries have been constantly falling for 18 months and have returned to normal: the yields on Spanish and Italian 10-year bonds are now about 3%, which is not much higher than the yield on U.S. Treasury bonds. Moreover, in several of these countries, the balance-of-payment deficits are starting to improve.

If the European Central Bank adopts a more expansionary monetary policy, somewhat like the U.S. Federal Reserve's policy of recent years, it could provide further support for the incipient economic recovery.

Quantitative easing in the U.S.

When the Federal Reserve announced last year that it would gradually taper its quantitative easing program, yields on U.S. bonds immediately began to rise, to the point where some commentators became concerned about an economic slowdown. The impact of the announcement of this policy change even caused emerging markets to fall. The Federal Reserve then clarified its intentions, and the bond market stabilized. Even so, the level of real interest rates is 1% higher than previously, which indicates a more balanced market. At 2.7% for 10-year bonds, interest rates are below their long-term average, but the Fed has stated that they will continue to be below-average for several more years.

Canadian dollar

The Canadian dollar was down 8% over the past 15 months, mainly because of weak commodity prices but also because Canada is having difficulty finding ways to ship its crude oil to markets outside the country. The decline was encouraged by the Bank of Canada because an excessively strong Canadian dollar tends to have negative impact for Canadian exports. It is unlikely that prices for natural resources will rise sharply in the short term, so we expect the Canadian dollar to trade at about US$0.90 for quite some time.

Emerging markets

Emerging markets were down in recent months because a number of them are facing political and structural challenges. The years of rapid growth which enabled them to postpone the necessary adjustments are now over, and difficult political decisions have to be made. In several countries people have taken to the streets to demand a change of government. Given these factors and emerging markets' dependence on commodity prices, it is still too soon to increase emerging market investments.

REITs

Last year, the risk that unit prices of real estate investment trusts (REITs) would decline seemed high because interest rates looked as if they were about to rise. The prices of REITs did indeed fall but recently recovered as the market became convinced that interest rate hikes were not imminent. Canadian REITs are inexpensive in comparison with their U.S. counterparts, considering their yields and stable cash flows. We have concluded that they currently represent a sound investment.

Corporate era

The 1970s were considered the union era. In the same way, we can say that we are now living in the corporate era, especially the era of transnational corporations. Such corporations have adapted to technological change (unlike governments, which have barely begun to do so) and therefore have constantly increased their profit margins over the past 10 years. The profit margins of U.S. companies are now at an all-time high, with no indication they will revert to the mean in the next few years. Companies also have far more solid balance sheets, with low levels of debt and record liquidity ratios.

In fact, if we compare the balance sheets of the three main sectors of society, we generally find that governments are highly indebted, consumers are reducing their debt (except in Canada, where consumer debt is still at a record level) and corporations are awash in cash.

Dashbord

	March 31, 2014
Canada	
Canadian dollar vs. U.S. dollar	=
Corporate bonds	+
Long-term government bonds	=
S&P/TSX60	=
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