LANDRY INVESTMENT MANAGEMENT

Market Review
Second quarter 2014

In the second quarter of 2014, the U.S. stock market considerably exceeded its previous peak, and the Canadian stock market is in the process of doing so. Several other stock markets have not yet surpassed their latest peak but the MSCI World Index is now at an unprecedented level.

The United States is entering its sixth year of expansion, its economy is near full employment and corporate earnings are at record levels, not only in terms of absolute value but also as a percentage of GDP.

Performance in Canadian currency

	3 months	**6 months**
Canadian equities	6.4%	12.9%
U.S. equities	1.7%	7.5%
Europe and Pacific equities	0.8%	5.6%
Emerging market equities	3.1%	6.5%
Bonds	2.2%	4.9%
Real estate investment trusts	4.0%	9.7%

Source: Bloomberg, June 30, 2014

No one doubts that the unprecedented injection of liquidity into the markets by the central banks in the United States, Europe and Japan has played a role in this phenomenon. If we look at the performances of the main stock markets over the past two years, we see the following returns:

	2 years (annualized)
United States	22.5%
Canada	17.8%
Great Britain	14.4%
Germany	23.8%
France	21.7%
Japan	32.1%

The figures are fairly similar, leading us to conclude that there is a single reason for the strength: liquidity.

As a result, complacency has settled over financial markets. The equity volatility indexes are at their lowest levels in a decade and price-earnings ratios are up on most stock markets. On the bond markets, yield spreads have narrowed considerably in a low interest rate environment.

Do all these factors point to the end of the bull market? Not necessarily. A great deal of unused capacity remains and the world economy can continue to expand for several years.

U.S. STOCK MARKET AND EARNINGS

The U.S. stock market is trading at a record 15 times earnings. This valuation is not worrisome, however, for two reasons: the ratio of 15 times is only slightly higher than the historic average; and the earnings of U.S. companies are high because they are making a great deal of profit on their foreign sales and at the same time paying far less income tax on their foreign earnings.

For their U.S. operations only, profit margins have been higher before. This suggests that the after-tax earnings of U.S. companies can rise further.

OTHER STOCK MARKETS

The Canadian stock market's multiple is about the same as that of the U.S. stock market, even though it is usually lower because there are fewer growth securities and more cyclical securities on the Canadian stock market. The Canadian market has outperformed the U.S. market by 6% since the start of the year but the longer-term trend is another story: over one year it has underperformed by 16%. Unless commodity prices rally significantly, the trend of recent years should continue.

The European stock market is less costly at 14 times, because earnings have been hampered by a sluggish economy. The recovery is slow to arrive and the authorities are dithering over the best way to stimulate growth. It is possible that the European Central Bank will launch a massive bond-purchase operation to encourage banks to resume lending to businesses.

The Japanese stock market, at 14 times earnings, represents the largest discount in relation to its historic average valuation. The Japanese government has already introduced substantial measures to stimulate the economy and to stabilize public finances. It is now tackling structural changes involving business governance and the labour market. Similar reforms have been tried unsuccessfully in the past but the public may be prepared to accept such changes after a decade of deflation.

The least expensive stock markets in the world are emerging markets at 11 times earnings. This ratio is lower than their historic average of 13 times but many emerging markets face significant challenges, especially China.

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CANADIAN DOLLAR

The Canadian dollar was slowly making its way toward purchasing power parity with the U.S. dollar (namely about US$0.87) last year but suddenly went back up from US$0.90 in February to US$0.94 recently. The increase in the price of crude oil as a result of new disruptions in the Middle East seems to be the main reason for its strength. It is impossible to predict what will happen in that region but, over the medium term, the Canadian dollar is slightly overvalued, given that the permits required to build the pipelines needed to increase crude oil exports are constantly being delayed.

INTEREST RATES

Yields on 10-year U.S. Treasury bonds ranged from 2.5% to 3.0% over the past year even though the Federal Reserve tapered its quantitative easing program during the period. We argued that a reduction in its purchases would not cause interest rates to rise, and that is what happened. At their current level, U.S. Treasury bonds represent good value in comparison with German bonds at 1.2% or Spanish bonds at 2.7%.

The risk that interest rates will rise is not imminent but it is increasing as the U.S. economy approaches full employment over the next year. Already, the two-year Treasury bond yield is 0.5%, its highest level in three years.

BOND SPREADS

The yield spread between high-yield bonds and U.S. Treasury bonds has returned to the narrowest point seen from 2004 to 2007. It will be recalled that this episode ended in a financial crisis. Many analysts say this situation indicates that investors are willing to assume a great deal of risk in their search for yield. The least we can say is that there is no lack of liquidity in the market. But a trend reversal does not look imminent, nor does a crisis appear inevitable. It is quite possible that the excess liquidity will be absorbed gradually by economic activity and a less-expansionary Fed policy without necessarily disrupting the corporate bond market. Even so, we should not expect a strong performance from high-yield bonds.

HOUSE PRICES

House prices have risen almost everywhere in the developed world in the past two years. Some countries saw decreases of 30% to 50% during the financial crisis, and the recent increases represent a catching-up. That is not the case for Canada, however. House prices in Canada dropped only a little during the crisis in the United States and have continued to rise in recent years, mainly because Canada followed in the footsteps of the U.S. with a policy of very low interest rates.

According to the International Monetary Fund, Canada, along with Hong Kong, has the world's highest housing prices relative to average income and rents. The federal government has imposed several restrictive measures on mortgages to curb demand but with little success. We can conclude two things: owners of houses and condos should at best expect stable prices in the years to come; and the risk that house prices will fall by about 10% to 20% has increased.

DASHBOARD

	June 30,2014
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