Market Review
Fourth quarter 2014

Even though the U.S. stock market continued to rise in the fourth quarter of 2014, the world's other stock markets did not follow suit. In addition, the U.S. dollar strenghtened. It must be noted that the U.S. economy has been the global leader for several years. It has on many occasions demonstrated its outstanding ability to adapt, it remains the uncontested leader in terms of innovation and more recently it has been taking advantage of an abundant new supply of energy in the form of shale oil and gas. As a result, the United States is gradually approaching full employment, whereas Europe is on the verge of a recession and Japan has failed to kickstart its economy.

Performance in Canadian currency

	3 months	1 year	3 years (annualized)
Canadian equities	-1.5%	10.6%	10.2%
U.S. equities	8.7%	24.2%	25.8%
Europe and Pacific equities	0.1%	4.7%	16.8%
Emerging markets equities	-1.1%	7.0%	9.0%
Bonds	2.7%	8.6%	3.5%
Real estate investment trusts	1.2%	10.0%	6.7%
Canadian/U.S. dollar	-3.7%	-8.6%	-4.2%

Source: Bloomberg, December 31, 2014

The most important economic event of 2014 was without a doubt the 50% collapse in the price of oil toward the end of the year. In contrast to 2008-09, the drop was caused by factors inherent to the oil market. Demand has slowed, but the determining factor was excess supply from various countries, including Russia, the United States and several Middle Eastern countries.

It is impossible to forecast the oil price over the short term, but over the medium term we expect it to go back up to between US$65 and $80 a barrel, a range that covers the marginal costs of many operators, including some shale oil producers in the United States and the first oil sands facilities in Canada. The Middle Eastern countries have much lower production costs, but they rely on oil revenues to fund government programs designed to maintain political stability.

From the macroeconomic standpoint, the lower oil price represents an immense transfer of purchasing power from producers to consumers. It can be regarded as a tax cut that will stimulate global demand. This context is not really advantageous for Canada, because it is both a producer and a consumer. Even so, Québec and Ontario will benefit from lower prices at the pump and even more from the devaluation of the Canadian dollar in relation to the greenback.

An oil price of $100 a barrel kept the loonie at a level that created a drag on Canadian exports. It is generally estimated that purchasing power parity between Canada and the United States is US$0.85, and we do not expect the Canadian dollar to exceed this level in the first six months of 2015, which will boost exports from Québec and Ontario.

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The drop in the price of oil ensures that inflation will fall, at least in the first half of the year. Central banks will continue their expansionary policies, and interest rates will stay lower for longer.

From a longer-term perspective, this decline shows that the downward phase of the commodity-price supercycle, which began in 2011, continues unabated. As stated in several previous reports, this major trend is both economic and geopolitical and it could last 25 years.

STOCK MARKETS

The U.S. stock market maintained its leadership in 2014, advancing 11%. In terms of U.S. currency, most of the world's stock markets significantly underperformed the U.S. market and in many cases recorded negative returns. Expressed in local currency, the returns on most stock markets, including the U.S. stock market, were lower than the return on long-term bonds last year.

The S&P 500 Index is currently trading at 16.5 times 2015 forecast earnings, which is far from being a ratio that indicates speculation. The world's other stock markets are less expensive than the U.S. market but their prospects are less appealing.

An investment in the U.S. market has outperformed an investment in the Canadian stock market by 30% over the past two years. This trend will probably continue in 2015, because low oil prices could reduce the earnings of the companies in the S&P/TSX Index by 10%. Over the longer term, the outlook is no better; recent events are indicating once again that the deflationary trend in the natural resources sector is continuing.

The European bourses are quite inexpensive, but Europe's economy is slowing and only a major intervention by the European Central Bank will stimulate investment. This may occur in the months to come, because Europe's consumer price index was down 0.5% in December on a year-over-year basis, providing the first official indication of deflation in Europe.

INTEREST RATES

Long-term interest rates continued to fall in the fourth quarter of 2014. During the year, 10-year U.S. Treasury bond yields went from 3% to 2%. In Europe, German bonds are yielding 0.5%. These decreases are clearly pointing to a substantial revision of inflationary expectations, because yields on U.S. real return bonds fell only slightly in 2014.

Over the very long term, bonds provide a real return of 3%. Current bond yields therefore reflect a risk of deflation in the developed countries. Moreover, it is interesting to note that in Germany and Japan, the two countries that are aging the most rapidly, interest rates currently range from 0.3% to 0.5%.

For the United States, the risk of deflation is far lower. The main economic indicators are showing that the economy is reaching its best growth rate of the past 10 years, and two-year bond yields have already begun rising. We expect interest rates to rise slightly in 2015. Our range for 10-year U.S. Treasury bonds continues to be 1.8% to 3.0%.

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HOUSE PRICES

House prices in the United States have attracted a great deal of attention in recent years, but the crisis in that sector is over. Instead, Canada's house prices could attract attention in 2015. *The Economist* publishes a quarterly guide to the world's housing markets, and for several years Canada has found itself at the top of the list, with houses that are among the world's most expensive. Deutsche Bank also recently published a study on this matter. The two analyses use the same method: they compare median house prices in various urban areas to median income and median rent for the same areas.

Of the six countries that have recorded the largest increase in house prices since 2007, four have markets that are among the most overvalued in the world: Canada, Australia, Norway and Sweden. Three of these four countries rely heavily on commodities. Canada's house prices are estimated to be overvalued by 35% against income and 90% against rent.

With a lower oil price and the prospect of an increase in short-term interest rates in the United States, the outlook for the residential real estate market is not positive, especially because the supply of new condos in Vancouver, Toronto and Montréal recently reached a historical peak.

DASHBORD

	December 31, 2014
Canada	
Canadian dollar versus U.S. dollar	-
Corporate bonds	+
Long-term government bonds	-
S&P/TSX 60	=
Small caps	-
REITs	+
United States	
U.S. dollar versus euro	+
Long-term Treasury bonds	-
S&P 500	+
Nasdaq	+
Europe	
Euro versus U.S. dollar	-
MSCI Europe	+
Asia	
Yen versus U.S. dollar	=
MSCI Japan Index	+
Emerging markets	
MSCI Emerging Markets	-

= : neutral   + : overweighted   – : underweighted