Market Review
First quarter 2015

The stock markets were up from 2% to 4% in Canadian currency in the first quarter, but the return on the investment portfolios comes mainly from the Canadian dollar's weakness against the U.S. dollar and higher bond prices.

Performance in Canadian currency			
	3 months	**1 year**	**3 years (annualized)**
Canadian equities	2.6%	6.9%	9.6%
U.S. equities	10.2%	29.5%	25.7%
Europe and Pacific equities	14.7%	14.5%	18.8%
Emerging markets equities	11.6%	15.7%	9.0%
Bonds	4.3%	10.3%	5.2%
REITs	7.9%	12.6%	7.6%
Canadian/U.S. dollar	-8.4%	-12.9%	-7.7%

Source: Bloomberg, March 31, 2015

The deflationary trend that began on the financial markets in the second half of 2014 intensified in the first quarter of 2015. Long-term interest rates continued to fall, reaching unprecedented lows. Germany's 10-year bond was yielding only 0.2%. Nestlé's 2.625% 2018 bond denominated in Swiss francs recently traded with a negative yield. The currencies of commodity producers fell. The Canadian dollar lost 8% against the U.S. dollar while the Australian dollar was down 7%. The central banks therefore continued their expansionary monetary policies, and the European Central Bank even adopted a quantitative easing program in March, following in the footsteps of the U.S. Federal Reserve and the Bank of Japan. The European bourses responded well, rising 19% during the quarter, while the euro was down 11% against the U.S. dollar.

THE STOCK MARKETS

March 2015 marks the six anniversary of the U.S. bull market and its spillover effects on the world's other stock markets. Not only is the U.S. market trading at an unprecedented level but the MSCI World Index also reached a new peak recently in local currency. After rising 194% since the spring of 2009, the U.S. market is fully valued in comparison with its historical ratios but continues to be inexpensive in relation to bonds. The return expected from this market over the next two or three years is therefore 6% to 8% a year, or the equivalent of its long-term performance.

The outlook for the other stock markets, especially those in Europe and Japan, is far more appealing because they are less expensive and the monetary policies in both regions will remain decidedly expansionary for longer than in the United States. Stock markets that are strongly influenced by commodity prices, such as Canada's, may underperform in the years to come even though they look oversold on a short-term basis.

THE GLOBAL ECONOMY

The years of 5% global economic growth are clearly a thing of the past. This long-term slowing of the economy is due to three factors: the aging population in the developed countries, the need for debt reduction in many regions and the slower growth rate in China.

But these factors do not mean we are condemned to stagnation. The United States, for example, has succeeded in getting its unemployment rate down to a level approaching full employment as a result of aggressive economic policies, and the other countries are drawing inspiration from it.

Moreover, the more than 50% decrease in the price of oil provides major stimulus for two reasons. First, it causes disposable income to rise significantly, just as if it were an income tax cut. In the United States, it is estimated that the lower energy price represents the equivalent of a tax cut equivalent to 0.5% of GDP, or $86 billion.

Second, the lower oil price is accompanied by an equally significant decrease in the price of natural gas and the cost of generating electricity in non-regulated markets. Generating and transmission facilities that were unprofitable when a barrel of oil cost $100 are becoming profitable now that oil is down to $50. This situation represents a substantial increase in the global economy's output with minimal investment.

Whenever the price of oil has fallen more than 50% in the past 30 years, the global economy has responded with a V-shaped recovery.

INTEREST RATES IN CANADA

The Bank of Canada took everyone by surprise in January when it lowered its key rate. This move caused the Canadian dollar to fall and long-bond yields to decrease significantly. As a result, the 10-year Government of Canada bond yield fell to 1.4%, or 0.5% less than U.S. Treasury Bonds. Are Canada's interest rates heading in the same direction as Germany's? This scenario is unlikely because the economic conditions are very different in the two countries. Canadian interest rates are much more aligned with U.S. rates, which will probably go up later this year, when the Federal Reserve increases its key rate.

INTEREST RATES IN EUROPE

In September 2014, the European Central Bank introduced a negative interest rate of 0.2% on deposits that it receives from banks. Such a measure is rarely adopted by central banks and its purpose is usually to discourage inflows of foreign capital onto the local market. The Swiss, for example, have used this measure fairly often to slow the appreciation of the franc. In this case, the purpose of the negative rate is also to encourage European banks to lend. The results were as follows: the euro fell 22% from its 2014 peak against the U.S. dollar and business loans rose modestly but, above all, government bond yields were driven down to unprecedented lows.

Will the new quantitative easing policy push interest rates even lower? Judging by the U.S. experience, the opposite is likely to occur. Long-term interest rates went up in the United States during the Fed's three rounds of quantitative easing.

THE OIL PRICE

For the Canadian economy and therefore the Canadian stock market, the price of oil is the most closely watched statistic. Canada's balance of payments clearly shows how important it is: for several years Canada had a $6-billion surplus from hydrocarbons, offset by a $6-billion deficit for all other goods. As for the stock market, the oil and gas sector accounts for 21% of the index.

For now, the price of oil seems to have stabilized between $50 and $60 a barrel, which represents the marginal cost for U.S. shale oil producers. The balance is highly unstable, however, because even though the number of new wells has dropped, output continues to increase and inventories are very high.

Even so, we are entering a period that is more favourable to the oil price, as refineries increase their output in anticipation of the summer driving season. It will take several months for the price to stabilize.

THE CANADIAN DOLLAR

The Canadian dollar is currently trading at purchasing power parity with the U.S. dollar. The currencies may, however, deviate a great deal from parity, possibly for several years, if very different economic conditions develop in the two countries. In short, the level of the Canadian dollar will be determined by the price of oil in the months to come.

DASHBOARD

	March 31, 2015
Canada	
Canadian dollar vs. U.S. dollar	=
Corporate bonds	0
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	+
Emerging markets	
MSCI Emerging Markets	=

= : neutral   + : overweight   – : underweight