Market Review
Second quarter 2015

Bond yields rose in the second quarter, right after a fourth major central bank, the European Central Bank, began a quantitative easing program. In this case, the program involves gradually purchasing European bonds totalling an immense €1.1 trillion.

The irony here is that Germany's bonds fell the most. The yield on the 10-year Bund went from 0.2% in March to almost 1% in June.

The three most important central banks in the developed world have therefore used all the instruments available to them to bring inflation up to the desired rate. (The People's Bank of China currently has an expansionary policy but has not engaged in quantitative easing.) They will most likely succeed in combating deflation at least for a while; but if prices begin to fall, the central banks will have nothing left in their toolboxes.

The stock markets faltered slightly in the second quarter but were still up on a year-to-date basis. We continue to think that equities will give better returns than bonds in the years to come, and that foreign equities are more appealing than Canadian equities at this time.

Performance in Canadian currency			
	6 months	**1 year**	**3 years (annualized)**
Canadian equities	0.9%	-1.2%	11.1%
U.S. equities	8.8%	25.7%	25.5%
Europe and Pacific equities	13.4%	12.1%	19.8%
Emerging markets equities	10.6%	11.0%	11.0%
Bonds	2.2%	5.8%	3.6%
REITs	2.2%	2.5%	3.8%
Canadian/U.S. dollar	-7.0%	-14.6%	-6.6%

Source: Bloomberg, June 30, 2015

OIL PRICE

The price of oil fell from $100 a barrel last summer to approximately $ 40 a barrel in January 2015 to subsequently rise back up to $60 a barrel at the end of April. We have identified a range of $40 to $70 for the years to come on the basis of the marginal cost of shale oil production in the United States. The price of $60 per barrel from last April represents the best scenario because it is high enough to enable intermediate producers to survive but low enough to stimulate the global economy.

As for the longer term, there are two opposing theories. The more widespread theory is that shale oil is sufficiently abundant to keep prices at the current level for a very long time. The other theory suggests that we have experienced a temporary increase in supply and that demand will continue to grow over the long term. According to this theory, the oil price will resume rising. We have no way of knowing which is correct, so we will have to wait several months to get clearer signals from the market.

CANADA'S ECONOMY

Canada's economy has been on the verge of recession since the start of the year. The lower oil price had an immediate impact on employment, but the devaluation of the Canadian dollar has still not boosted exports. It is likely that economic activity will improve in the second half of the year. Even so, we must not expect strong growth, because Canadian households are highly indebted.

INTEREST RATES IN THE UNITED STATES

The U.S. Federal Reserve has not yet raised its key rate. It is aiming for a 2% rate of inflation, but the rate is still at only about 1%. In contrast, the labour market is tightening, with average increases of 200,000 jobs a month, and earnings appear to be starting to rise. For those reasons, the Fed is expected to raise its key rate in the fall. Long-term interest rates have already gone from 1.8% at the start of the year to 2.4% recently. It is likely that the secular low in interest rates is finally behind us, and a return to normal rates should take U.S. rates closer to 3% than to 2%.

INTEREST RATES IN CANADA

The Canadian economy has been much weaker than the U.S. economy since the start of the year, and this has had an impact on Canada's bond market. Ten-year Canadian bond yields started the year at a level slightly above their U.S. counterparts, but ended the second quarter almost 0.7% below comparable U.S. yields. We have not seen such a large difference between the two countries in a long time.

The current difference reflects the situation of recent months, because the Canadian economy has been on the verge of recession since the start of the year. Even so, the 20% decrease in the Canadian dollar will start to have a positive impact on economic activity during the second half of the year, and it is always possible that the oil price will go back up. This situation leads us to believe that Canadian bonds are riskier than U.S. bonds at this time.

REITs

The price of REITs is affected by economic activity and bond yields. Weak economic activity is not favourable to REITs but if economic activity picks up, interest rates will probably rise in Canada. The outlook for REITs is therefore less appealing at this time.

Greece

"It's not over until it's over." The Greek financial crisis has been going on for several months and is far from resolved. The Greek voters recently rejected Europe's financing proposal. This does not mean that Greece will be automatically excluded from the euro zone, but that outcome is possible.

There have been hundreds of sovereign debt defaults and restructurings, but not all of them have been successful. According to Kenneth Rogoff, a former chief economist of the International Monetary Fund and the author of a bestseller on all the sovereign debt crises of the past 100 years, there are two essential conditions for a successful sovereign debt refinancing: a portion of the debt has to be written off by the lenders because the GDP-to-debt ratio is usually too high for the debt to be repaid; and the government of the excessively indebted country must have the population's support for the reforms needed to turn around public finances. This involves stringent austerity programs and above all taking away the privileges of some very powerful interest groups.

From the economic standpoint, writing off a portion of Greece's debt is not a problem, because the debt is equivalent to 3% of Europe's GDP. Writing it off represents a serious political problem, however, because Angela Merkel and François Hollande would have to explain why they encouraged Europe's public authorities to finance Greece while it repaid its private-sector creditors. Nationalization of Greece's debt could cost the European countries billions, and that is why politicians are insisting that the Greek people make sacrifices, even though they are already experiencing depression-like economic conditions.

As for the Greek government, it is clear that the population is still not ready to accept the reforms required by Europe.

The most ironic aspect of this situation is that the Germans have experienced economic difficulties twice in the past century. After the First World War, the Allies, mainly at the urging of the French, required astronomic war reparations of Germany. The Germans were unable to service their debt, which led to an economic depression that drove Germany toward Nazism. After the Second World War, however, the United States helped Germany get back on its feet, and Western Europe experienced a period of prosperity referred to as the 30 glorious years.

The situation is currently a stalemate, and it will take many more months to resolve the conflict. That being said, as time goes by, the risk of a financial crisis affecting all of Europe will decrease, because the economic agents will have time to prepare.

ASSET ALLOCATION MODEL

A year ago, we developed a momentum-based asset allocation model to select the best-performing assets on the basis of moving averages so as to limit downside risk. The model may invest in 16 asset classes selected to achieve maximum diversification.

Specifically, we identified those asset classes whose behaviour differs the most from one another. Some asset classes even have inverse trends: when the one goes up, the other goes down, and vice versa.

Each month the model selects the seven asset classes with the most momentum. Each asset class is allocated the same percentage of the portfolio, namely about 15%. A momentum asset class will not be purchased, however, if the asset price is trading above its 200-day moving average. In such a case, the percentage allocated to that class is invested in treasury bills.

The simulated return on a portfolio managed according to this model is 10.7% a year over the period from 1994 to 2014. The portfolio's largest decrease over this 20-year period would have been only 8%.

This performance compares favourably with the 5.5% annual return on a portfolio invested on a 50-50 basis in Canadian equities and international equities over the same period, with a maximum decrease of 50%.

We believe this model can be useful for portfolio management. Each quarter, our Market Review will therefore include the model's selection along with our dashboard on financial assets.

At the end of June 2015, the model was invested above all in U.S., European and Japanese equities. It also selected Canadian bonds but recently moved out of U.S. bonds.

DASHBOARD

	June 30, 2015
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	+
Emerging markets	
MSCI Emerging Markets	=

= : neutral + : overweighted – : underweighted

ASSET ALLOCATION MODEL

Cash
Government of Canada bonds
U.S. equities
U.S. equities, small caps
NASDAQ equities
European equities
Japanese equities