# Market Review
# Third quarter 2015

From the financial standpoint, the third quarter was characterized by the Chinese stock market's 28% loss and soft commodity prices. The stock markets of countries that rely on commodities were down about 15%, while the other stock markets corrected by about 10%. The Canadian dollar declined 6% against the U.S. dollar, which is favourable to Canadian investors with international investments. The asset class that fell the most during the quarter, and has retreated the most since the start of the year, was preferred shares, particularly preferred shares with a dividend yield that is reset every five years. These shares are down by an average of 20% to 25% on a year-to-date basis.

**Performance in Canadian currency**

| | 6 months | 1 year | 3 years (annualized) |
|---|---|---|---|
| Canadian equities | -7.9% | -7.0% | 5.7% |
| U.S. equities | 0.4% | 9.3% | 24.5% |
| Europe and Pacific equities | -3.7% | 9.3% | 17.1% |
| Emerging market equities | -11.9% | -2.5% | 5.0% |
| Bonds | 0.4% | 2.5% | 3.4% |
| REITs | -3.2% | -1.1% | 1.3% |
| Canadian dollar/U.S. dollar | -6.1% | -12.7% | -9.6% |

***Source: Bloomberg, September 30, 2015***

## COMMODITY PRICES

Commodity prices have fallen 40% since March 2014 and are down a total of 60% since they peaked just before the 2008 crisis. For several years, the consensus was that China would continue to be a major consumer of commodities for decades to come, putting constant upward pressure on demand. It can now be seen that, over the long term, both supply and demand govern prices.

Over the long run, the real price of commodities is falling as a result of technological advances that enable us to use them more efficiently. Commodity prices follow long cycles lasting from 10 to 25 years. The last upward cycle lasted less than 10 years. The current downward cycle began seven years ago and is likely to continue for several more years.

## CANADIAN STOCK MARKET

The Canadian stock market reached its latest peak in August 2014. Since then, it has fallen 18%, of which 15% is attributable to weakness in the oil and commodities sector.

This situation seems to indicate that investors think the Canadian dollar's decline to US$0.93 in 2014, to US$0.80 in the first six months of 2015 and to US$0.75 recently will allow Canadian exports, other than crude oil, to increase enough to prevent a recession in Canada. Even so, the risk remains high because the foreign trade balance has scarcely improved over the past year: our average monthly deficit has gone from $7 billion to $6 billion. The trade balance will contribute to Canada's GDP growth in the second half of 2015, but it is far from certain that the contribution will be enough to benefit the majority of the country's businesses.

## U.S. STOCK MARKET

Is the U.S. stock market too expensive? To answer that question, we must ask it in the following way: too expensive in relation to what? If we compare current equity prices in the United States with past valuations, the U.S. stock market is expensive according to the great majority of the valuation techniques used. But if we compare the expected return on U.S. equities with the level of interest rates, equities are not expensive. Given that interest rates are very low, this implies that the expected return on U.S. equities over fairly long periods of five to ten years is below the real long-term return on equities, which is about 6% to 7% a year.

That is not surprising, given that central banks have injected unprecedented amounts of liquidity to boost the markets and that slow growth will characterize the developed countries in the years to come.

That is fine over the long term but what will happen over the next two or three years? A scenario approach is more appropriate here. On the pessimistic side, the possibility of a bear market does not appear to be imminent because the risks of a recession are low. The possibility of another financial crisis can also be ruled out because they never occur twice within a short period. On the optimistic side, we can foresee a speculative bubble that would push equity prices to far higher levels in the years to come. Given the abundant liquidity on the markets, this last scenario is the most likely.

## PREFERRED SHARES

The prices of preferred shares have fallen almost 25% since the start of the year. This occurrence is unusual in the absence of a financial crisis or rising interest rates. The correction is due to low interest rates, because it is concentrated mainly in shares whose rate is reset every five years at a spread over the prevailing five-year Canada bond yield. It appears that investors are convinced that interest rates will remain very low for several years to come.

The consequence of this decrease in the price of reset-rate preferred shares is the assurance that their yield will remain attractive even if interest rates do not go up. If the five-year bond yield remains at 0.7%, which it is currently, the yield on BCE's preferred shares, for example, will be 5% for the following five years when it resets in 2017.

Given the risk of holding preferred shares, they should be selected carefully. We are being very cautious about the banks' preferred shares, especially because banks are allowed by law to force the conversion of some preferred shares into common shares.

## Crude Oil Price

Even though the price of crude oil seemed to be stabilizing at about $60 in the spring, it fell to $40 in August, only to come back up to $50 recently. During that time, global oil consumption has continued to increase: it went from 92 million barrels a day early in 2014 to more than 95 million barrels a day recently. We must conclude that a price of $40 to $60 seems to encourage consumption, which will continue to increase by at least 3 million barrels a day.

The possibilities of increasing the oil supply are very limited. In the United States, production reached a plateau of 9.5 million barrels a day and has begun to fall. This trend will continue because the number of new wells drilled over the past year has plummeted. As for OPEC, it appears that Saudi Arabia is operating at full capacity and that Iran's output will not increase for two years. We can therefore expect the price of oil to rise over the next year.

## Asset Allocation Model

Our asset allocation model selects the seven markets with the most momentum from among 16 global financial markets. Currently, the model has selected only four markets; as a result, the portfolio's largest position is in cash.

| | |
|---|---|
| Cash | 40% |
| Govt. of Canada bonds | 15% |
| U.S. equities | 15% |
| NASDAQ equities | 15% |
| European equities | 15% |

## Dashboard

| | September 30, 2015 |
|---|---|
| **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 | + |
| **Emerging markets** | |
| MSCI Emerging Markets | - |

= : neutral  + : overweighted  – : underweighted