Market Review
First quarter 2016

The price of crude oil had a major impact on the portfolios of Canadian investors in the first quarter. It fell below $30 a barrel in January, only to go back up to $38 at the end of the quarter. This increase caused the Canadian dollar to appreciate by more than 10% in two months. Moreover, during the first quarter the Canadian stock market outperformed the U.S. stock market for the first time in years.

The higher oil price is not related to negotiations between some producing countries to freeze their output because most of them are already producing at full capacity. Instead, the increase is due to the fact that oil consumption has risen in recent months, which usually happens when the price of a product goes down a great deal. The oil price will probably continue to firm in the next year, which will be favourable not only to Canada's economy, but also to its stock market and its currency.

Performance in Canadian currency

	Q1 2016	1 year	3 years (annualized)
Bonds	1.3%	0.6%	3.8%
Canadian equities	4.5%	-6.6%	5.0%
U.S. equities	-4.9%	4.2%	21.2%
Europe and Pacific equities	-8.9%	-5.5%	11.5%
Emerging markets equities	-0.8%	-9.5%	4.0%
REITs	10.5%	-2.2%	2.7%
Canadian/U.S. dollar	6.0%	-2.5%	-7.9%

Source: Bloomberg, March 31, 2016

Oil price

Shale oil produced by the United States is the only additional short-term source of oil in the world but at the current price the number of new wells being drilled in the United States is in freefall and production has begun to decline. Production will not rise until the price of oil goes above $50. It appears that global oil inventories stopped increasing in January and February 2016, indicating that consumption has caught up to supply. The price of oil should therefore firm between now and year-end.

Canadian stock market

The Canadian stock market has long performance cycles in relation to the U.S. stock market, (the world's largest stock market), and the cycles are usually related to natural resource cycles. From 2001 to 2011, the Canadian stock market outperformed the U.S. stock market by 125% in Canadian currency. From 2011 to 2015, the U.S. stock market outperformed the Canadian stock market by 137%. Thus far in 2016, the Canadian market has outperformed the U.S. market by 9%. If the oil price firms, the Canadian stock market will continue to outperform.

Preferred shares

The yield on preferred shares usually goes up and down along with bond yields, but that is not what has been happening since last summer: while the 10-year Government of Canada bond yield went from 1.5% to 1.2%, the preferred share yield went from 5.0% to 5.7%. Such an increase in the market rate causes the price of a perpetual preferred share to fall by 12%.

The decline of this market was caused by an adjustment to the price of preferred shares whose rate is reset on the basis of the five-year Government of Canada bond yield. When interest rates on five-year Canada bonds were 2%, investors were satisfied with a rate-reset preferred share with a spread of, say, 2% for a yield of 4% a year over five years. When the five-year Government of Canada bond yield dropped to 0.7% last year, investors began looking for a larger spread in relation to such bonds. This caused the price of rate-reset preferred shares to decline by 25%. It therefore appears that investors are now convinced that Canadian interest rates will remain very low for many years.

Preferred shares are currently trading at a yield of 5%, which is very attractive because it represents an unprecedented spread in relation to bonds. A narrowing of the spread could generate a total yield of 10% a year on these securities over the next two years.

REITs

Canadian REITs are again becoming attractive for several reasons. First, the price of U.S. REITs recently went up. Second, with the decline of bond yields, the relative return on REITs has again become appealing. Third, the recent increase in the price of oil implies that the risk of a recession in Canada has abated significantly.

The REIT yield follows the yield on preferred shares fairly closely, and the performance outlook is the same as it is for preferred shares over the next two years.

A new paradigm

About one-third of government bonds in the developed countries are currently trading at a negative yield. According to most analysts, this situation is the result of ultra-expansionary policies by the U.S. Federal Reserve, the European Central Bank and the Bank of Japan. These banks purchase large quantities of government bonds, which pushes their price upward to the point where their yield becomes negative. The purpose of such purchases is to inject liquidity into the economy in order to stimulate it. These policies have been used for years but have produced little in the way of results: economic growth has been well below expectations since 2008.

There may be another explanation for this phenomenon: the lack of safe financial assets. According to this theory, there are not enough safe financial assets available in the world and investors are reducing their expenditures in order to acquire them. This would explain both the negative yield on quality bonds and the anemic economic growth of recent years. For example, we see that large international corporations are flush with cash, which they invest in liquid securities rather than in production equipment.

Low for long

Several factors will keep interest rates very low for a long time. The most important is the slowing of the world's population growth, combined with the aging population in developed countries. Next comes technological change, which constantly lowers production costs. Moreover, many countries need to lower their debt levels, and the limitations on banks' ability to lend have been far more restrictive since the last financial crisis. Lastly, income inequality is concentrating capital in the hands of fewer people.

Asset allocation model

Our model selects the seven financial markets that have the most momentum from 16 global markets. The fund began 2016 with a large proportion of equities. European and Japanese equities were eliminated during the quarter, as were NASDAQ equities.

The model continues to emphasize long-term bonds even though interest rates are very low, and it has even selected Canadian and U.S. REITs.

Cash	0%
Bonds	45%
Equities	30%
REITs	15%
Gold	10%

DASHBOARD

	March 31, 2016
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