Market Review
Second quarter 2016

The Canadian stock market was one of the best-performing markets in the developed countries in the first half of the year, rising almost 10%. Commodity prices are the main reason for the increase, especially gold, up 24%, and crude oil, up 33%. As for the U.S. stock market, it advanced 2%, while Europe declined by 15% and Japan by almost 20%.

You might think that the most important event of the second quarter was the Brexit referendum in the United Kingdom; even so, for long-term investors the reaction of the global bond markets after the event, especially U.S. Treasury bonds, is more thought-provoking. Ten-year U.S. Treasury bond yields were down 1.4% after the referendum, falling to their lowest level in 70 years. This development is significant because the decline in interest rates in the United States is not related to internal economic conditions. The economy is expanding, wages are rising and the inflation rate has risen to 1%. Lastly, monetary conditions are less expansionary than they were previously.

Even so, interest rates have continued to fall this year, indicating that the scenario of secular stagnation has become increasingly likely.

Performances in Canadian currency

	6 months	1 year	3 years (annualized)
Bonds	4.0%	5.4%	5.6%
Canadian equities	9.8%	-0.2%	8.3%
U.S. equities	-2.5%	8.1%	19.7%
Europe and Pacific equities	-9.9%	-6.0%	10.1%
Emerging market equities	-0.1%	-8.2%	5.9%
REITs	20.9%	12.9%	8.4%
Canadian/U.S. dollar	7.1%	-3.3%	-6.6%

Source: Bloomberg, June 30, 2016

U.S. ECONOMY

Along with the decline in long-term yields in the United States, the yield curve flattened; in other words, the difference between long-term and short-term yields decreased. Economists consider a flattening yield curve to indicate a possible recession.

And yet the U.S. economy is doing well, in fact very well. It is operating at almost full employment, consumer confidence indicators are strong, business order indicators are positive and the leading economic index is up sharply. Moreover, experience shows that there has never been a recession in the United States when residential construction is rising strongly, as has been the case since the start of the year.

Real interest rates

It is possible that the yield curve is indicating not a recession in the United States but instead the fact that the country's growth potential is rather limited and inflation will remain tame for a long time.

Real-return bond yields have been indicating this for several years.

The yield has ranged from -1.0% to +0.5% since 2011 and is currently close to 0%. If investors are prepared to invest capital for 10 years without any return, it is because they believe economic growth will be anemic and could even be negative in the years to come.

Inflationary expectations

We can determine the inflation rate that investors are expecting over the next 10 years by comparing the yield of inflation-indexed bonds with nominal bonds. We know that the U.S. Federal Reserve is targeting 2% long-term inflation, and the bond market inflation indicator referred to above stayed between 2.0% and 2.5% from 2003 to 2013. Since 2013, however, this indicator has been showing that inflationary expectations are constantly falling. They recently fell again, to 1.4%.

Brexit and Europe

The citizens of the United Kingdom have voted to leave the European Union. This decision could cause a short recession in England, and most economists agree that it will take about half a percentage point off the country's growth rate for several years. U.K. citizens will feel the effects of this decision fairly quickly, because the 10% devaluation of the pound sterling will cause the prices of imported goods to rise.

On the financial markets, we can undoubtedly expect a decrease in the price of London real estate, but not necessarily a significant decline on the English stock market because the substantial devaluation of the currency will be beneficial to exporters. In fact, currency devaluation is favourable to businesses and the wealthy but unfavourable to the middle class. On the European bourses, bank stocks have already fallen a great deal because very low interest rates are negative for banks. The stock markets rarely advance when banks are experiencing difficulty.

CANADIAN DOLLAR

The price of crude oil is up 33% since the start of the year and the Canadian dollar has risen 7%. According to our estimates, the dollar is still undervalued by about 6% but this discount is due to several factors.

First, more than a year after the currency devaluation, Canadian exports of products other than oil have still not rebounded. Then, at less than $50 a barrel, the oil price is still not high enough to contribute an economic upturn in Canada. A price of $60 to $65 will probably be required for investment to resume. We forecast that this level will be reached by the end of the year because global oil inventories began to fall in the second quarter of the year.

ASSET ALLOCATION MODEL

Our model selects the seven financial markets with the most momentum from the 16 main world markets. Simulations of the model indicate that it can generate a return of 8% to 10% a year with limited downside risk. The model began the year with a strong proportion of equities, which were gradually reduced until it held only Canadian equities. Long-term government bonds were also sold. Recently, the model added REITs and commodities.

Cash	15%
Corporate bonds	15%
Equities	15%
REITs	30%
Commodities	15%
Gold	10%

DASHBOARD

	June 30, 2016
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