Market Review
Third quarter 2016

Stock markets continued to rise in the third quarter, with the Canadian market outperforming once again. Interest rates were down slightly in Canada and remained stable in the United States and elsewhere in the world. During the summer, investors expected the U.S. Federal Reserve to raise its key rate but it opted to stand pat. We expect an increase in the key rate after the U.S. presidential election, probably in December. The U.S. economy is operating at full capacity with an unemployment rate of only 5.0%, and initial jobless claims (a leading indicator of employment) are at their lowest level in 10 years. The U.S. economy no longer needs monetary stimulus.

The situation is quite different in Canada where the outlook depends mainly on the price of oil. Fortunately, the prospects in this regard continue to improve. Global oil inventories stopped rising several months ago. It has become increasingly clear that OPEC cannot increase its output and that U.S. production is in decline. Thus it is only a matter of time until demand drives the price up. We expect the oil price to increase by year-end or at the latest during the coming winter. As a result, the Canadian stock market and the loonie will both rise.

Performance in Canadian currency

	9 months	**3 years (annualized)**
Bonds	5.1%	6.0%
Canadian equities	15.8%	8.0%
U.S. equities	2.3%	20.5%
Europe and Pacific equities	-3.5%	8.9%
Emerging market equities	10.1%	7.8%
REITs	16.6%	8.2%
Canadian/U.S. dollar	5.4%	-7.7%

Source: Bloomberg, September 30, 2016

LONG-TERM RETURNS

Bank of Canada Governor Stephen Poloz recently gave an important talk, titled “Living with Lower for Longer,” to financial analysts in Québec. In it, he twice repeated the Bank’s forecast that Canada’s potential long-term economic growth is 1.0% to 2.0% a year. It should be noted that these figures represent the economy’s potential, and that there is no guarantee it will be reached.

In comparison, the economy's growth potential was 4.0% a year in the 1960s. The main reasons for slower growth are the aging of the population and weak business investment. In this context, Mr. Poloz forecasts that interest rates will remain low for a long time and that people of retirement age will have to cope with the situation by working longer.

Business investment weakness

Business investment has not recovered since the Great Recession of 2008-09 even though interest rates are at their lowest levels in 50 years. Long-term investment is not related to interest rates alone; above all, it is related to risk. Today, technological change is so powerful that it can destroy an entire industry and, moreover, can attack any industry. Companies are therefore holding onto record amounts of cash, buying back their shares and paying out dividends, but are investing very little. Over the long term, these practices reduce the economy's growth potential.

U.S. interest rates

Ten-year U.S. Treasury bond yields reached a low of 1.5% during the summer. It was the second time they had done so. The first time was in 2012. Back then, we pointed out that the 1.5% level probably represented a secular low in U.S. interest rates and that in the years to come rates would range from 1.5% to 3.0%.

We are still of this opinion.

Canadian interest rates

Canadian interest rates are lower than U.S. rates because weak oil and gas prices are putting deflationary pressure on the Canadian economy. The pressure will abate if the price of a barrel of oil goes back up to a range of $60 to $70. A higher price is not really necessary for a recovery in the oil industry because production costs have fallen by 15.0% to 20.0% over the past five years.

Negative interest rates

Around the world, $10 trillion of bonds is trading with a negative yield. This is no temporary phenomenon and it indicates that a transformation is occurring in financial markets. These bonds are issued by governments but recently companies have issued bonds with maturities of 50 years or more at very low rates. For example, Mitsubishi Corporation recently issued a 60-year bond with a 0.85% coupon rate.

Evidently, investors are not concerned about inflation. But why are they prepared to lend capital when they are certain to lose some of it? This situation shows clearly that there is a lack of risk-free assets on global markets and central banks are for the most part responsible for the shortage.

What is the alternative for investors? The only equivalent in terms of safety and liquidity is cash kept in a safe. The Bank of Canada's research department estimates that it costs about 0.5% a year to keep and insure cash and that is why it believes negative rates will not generally exceed this level.

Even so, the fact that investors are prepared to commit themselves to very low rates for long periods indicates not only that they do not expect inflation but also that they want to protect themselves from deflation.

U.S. STOCK MARKET

The U.S. stock market has been rising for more than seven years and is trading at 16 times forward earnings. This ratio is neither very high nor very low in absolute terms but it is very attractive in comparison with the bond yields currently available on the market. Moreover, even if equities are individually riskier, as a group they are less risky than in previous years because corporate balance sheets are far more solid. Lastly, and this is probably the most important factor, companies are very profitable and will continue in that vein. We are living in an era favourable to corporations: interest rates are very low and technology is constantly driving production costs down.

CANADIAN STOCK MARKET

Generally speaking, Canadian companies are underperforming their U.S. counterparts but that will not prevent the Canadian stock market from outperforming the U.S. stock market over the next 12 months if the price of oil goes back up to a range of $60 to $70, as we expect.

CANADIAN HOUSE PRICES

The federal government recently announced new rules to restrict mortgage lending in Canada. One of them is designed to slow the rise in house prices, especially in the Vancouver and Toronto markets, but it will affect all Canadian markets. Essentially, the income test to obtain a mortgage will be more difficult to pass if buyers have a down payment of less than 20%. This measure will exclude a large number of first-time buyers from the market. It is not the first time that the government has tried to slow the upward trajectory of house prices. If this measure is not sufficient, the government will take further action until the two hottest markets cool off. The problem with this approach is that it could cause a decline, rather than a slowdown, in the other cities.

ASSET ALLOCATION MODEL

Our model selects the seven global financial markets with the most momentum. Our simulations show that this approach can generate a return of 8.0% to 10.0% a year with limited downside risk. The model began the quarter with a portfolio that held Canadian equities, bonds, commodities and gold. As the fourth quarter gets under way, it is invested mainly in equities, which represent 60.0% of the portfolio.

	September 30, 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