GESTION DE PORTEFEUILLE LANDRY

Market Review
Fourth quarter 2016

For Canadian investors, the most important development of 2016 was by far the firming of commodity prices, especially crude oil, which went from US$26 a barrel at the start of the year to US$50 at the end. Canada was therefore able to avoid a serious slowdown and perhaps even a recession, and its stock market recorded one of the best performances in the world in 2016, advancing 21%.

The second-most-important development for investors was the increase in interest rates toward year-end, because it probably marked the end of a downward trend that lasted 36 years. Even so, we must not conclude that rates will rise sharply: rather, we have entered a period when 10-year Government of Canada bond yields will fluctuate from 1.5% to 3.0%.

The year 2016 also marked an important turning point in politics, with the Brexit vote in England and the election of Donald Trump. We do not know exactly what is happening but something has changed in the political realm. A vital factor has to be taken into account: with the widespread use of social media, voters are obtaining their information from different sources and have developed a great deal of mistrust toward traditional leaders, including the media.

Moreover, they are dissatisfied with the status quo and, because they want change, they voted for a candidate precisely because he had no political experience. They are therefore willing to assume great risk. The work of Daniel Kahneman, a Nobel laureate in economics, can help us understand this phenomenon. Kahneman has observed that people tend to take on more risk when they have to choose between two disagreeable outcomes. We must therefore expect surprising political choices in the years to come, particularly in 2017, when the elections in France and Germany could disrupt the markets.

We customarily do an assessment of the outlook for the stock markets at the end of the fourth quarter. Are we still in a bull market? The answer is the same as in recent years: the bull market will continue. After eight years of gains, we can qualify it as a secular bull market. The three secular bull markets of the past 100 years took place in 1921-29, 1948-65 and 1982-2000. They therefore lasted from eight to 18 years.

Performance in Canadian currency			
	2016	**3 years** (Annualized)	**5 years** (Annualized)
Bonds	1.6%	4.5%	3.1%
Canadian equities	21.1%	7.1%	8.2%
U.S. equities	8.9%	17.8%	21.2%
Europe and Pacific equities	-1.8%	6.4%	12.7%
Emerging markets equities	8.1%	5.4%	7.1%
REITs	17.1%	7.3%	6.3%
Canadian/U.S. dollar	3.0%	-7.5%	-5.3%

Source: Bloomberg, December 31, 2016.

OIL PRICE

In December OPEC announced an agreement to cut production in order to “stabilize” the oil price. It is interesting to note that the agreement came about after global oil inventories began to fall in the third quarter. It appears that they continued dropping in the fourth quarter. It will therefore be fairly easy for the cartel to push the oil price up because global consumption now exceeds supply, even without the supply cuts that came into effect in January 2017.

The oil price is now above US$50, and some analysts think it cannot continue to rise because the current price will boost output in the United States. For the next six months, however, the price has a good chance of continuing to firm because U.S. output cannot be ramped up instantaneously and also because we are entering the period of the year that is most favourable to the oil price: over the past 15 years, it has risen 80% of the time from February to May.

ECONOMIC ACTIVITY

The events of recent years show that very strong economic activity is not necessary for a rising stock market. Since the end of the Great Recession seven years ago, economic growth has averaged only 1.5% to 2%, yet the stock market has more than doubled during that period. But some growth is required for corporate earnings to go up.

The leading indicators for the global economy are rather favourable at the moment. For the United States, growth of slightly more than 2% is forecast, after an increase of 1.6% in 2016. U.S. consumers are unusually optimistic, and the drastic income tax cuts planned by President-elect Trump should stimulate investment.

The reversal was most spectacular in Canada. Even though the country seemed to be heading straight for a recession early in 2016, the indicators began to rise in the second half of the year. Job creation was especially vigorous.

INFLATION

With an unemployment rate of 4.6% the U.S. economy is now operating at full capacity. In such conditions, the inflation rate should increase during the year. Wages are already rising at an annual rate of 2.5%. The rate of inflation for personal consumption expenditures (the rate used by the Federal Reserve) is currently 1.7% and should exceed 2% during the year. The rate has fluctuated from 1.5% to 2.5% since 1995.

In contrast, Canada is far from operating at full capacity and its inflation rate should be stable at about 1.5%. Europe has almost no inflation, and Japan continues to grapple with slight deflation.

INTEREST RATES

In the fourth quarter, interest rates saw one of the most important increases of recent years. The 10-year U.S. Treasury bond yield went from a low of 1.60% in September to 2.40% at year-end. The low of 1.60% had already been touched once before, in 2012. Since then, the yield has fluctuated from 1.60% to 3.00%, and we expect it to be about 3.00% this year.

CANADIAN DOLLAR

A model that takes into account purchasing power parity between Canada and the United States, the interest rate differential between the two countries and the oil price explains most of the fluctuation of the loonie against the greenback. At US$0.75, the Canadian dollar is trading at a discount in relation to its purchasing power parity because Canadian interest rates are lower than U.S. rates and because the oil price has recently been weak. The latter factors are changing because the Canadian economy is strengthening and the oil price may well continue to rise. The loonie should trade at US$0.80 in the first half of 2017.

GOVERNMENT DEBT

In recent years, analysts have become increasingly concerned about ratios of public debt to GDP. In some countries, public debt has risen a great deal. For instance, in Japan it stands at 250% of GDP. In the United States and Canada, it is 104% and 91%, respectively. Such high debt ratios are not dangerous for a country that has its own currency, because the central bank can buy unlimited amounts of government bonds in the event of a crisis. Obviously, such a situation could cause a currency devaluation but a crisis would be avoided. The situation is different for a country that does not have its own currency, such as the members of the euro zone, where the purchase of one government's bonds by the central bank subsidizes that country at the expense of all the others. The Greek crisis shows just how difficult such a situation can be.

EURO

The world has three major currencies: the U.S. dollar, the yen and the euro. (China's yuan will become a major currency once capital restrictions are lifted but that will take several years.) Of the three currencies, the euro has been the weakest. It has gone from US$1.60 to US$1.05 for good reason. Europe's economic problems should not be underestimated but, in addition, political support for a common currency is weakening in Europe. This year's elections in France and Germany could play a determining role in this regard.

DASHBOARD

	December 31, 2016
Canada	
Canadian dollar vs. U.S. dollar	+
Corporate bonds	+
Long-term government bonds	=
S&P/TSX 60	+
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