GESTION DE PORTEFEUILLE LANDRY

Market Review
Second quarter 2017

In the second quarter, the world's stock markets continued to advance while interest rates fell slightly in the United States. But the Canadian stock market was the exception to this trend because of the weak oil price. The best-performing markets were the European bourses and emerging markets; in U.S. currency, they recorded year-to-date advances of 16% and 18%, respectively. Meanwhile, the Canadian dollar was up almost 4% during the quarter.

Our basic scenario is unchanged. The current cycle will be very long. It will be characterized by global economic growth that is slower than it was in recent years but sustained enough to bring unemployment rates down. Inflation will continue to be fairly tame, even though many countries are approaching full employment owing to rapid technological advances, expanding world trade and lower energy costs.

This context will not prevent corporate earnings from continuing to rise, but they will increasingly be concentrated in those industries that take advantage of technology. Conversely, some sectors of the economy will see their sales fall precisely because of technology, as has been the case for brick-and-mortar retailers as a result of Amazon's spectacular expansion.

Interest rates have reached a secular low and will rise gradually as central banks withdraw the excess liquidity injected into the monetary system since 2009, however the rate hikes will be moderate. The bull market in equities is therefore not over, but its leadership will change. In this cycle, the U.S. stock market has been the best performer, but we have to expect the other stock markets to catch up, especially the European bourses and emerging markets, as has been the case so far this year.

Canadian Dollar

The Canadian dollar and the oil price are strongly correlated, but this relationship broke down recently, with the Canadian dollar rising to US$0.77 even though oil prices fell below $50. This temporary disconnection is due to an important speech by Bank of Canada Governor Stephen Poloz, who announced a shift to a less expansionary monetary policy. He explained that the Canadian economy's adjustment to the lower oil price was complete, implying that it's no longer necessary to keep Canadian interest rates lower than U.S. rates.

We think the long-term equilibrium level between the Canadian dollar and the U.S. dollar is determined by the relative rate of inflation between the two countries and the oil price. This relationship indicates an equilibrium level of US$0.80 to $0.82 for the Canadian dollar. Given that Canada's economy is functioning practically at full employment, the Bank of Canada no longer needs to keep the Canadian dollar at a discount in relation to its equilibrium value in order to stimulate the economy.

Performances in Canadian currency

	First half	1 year	3 years (annualized)	5 years (annualized)
Bonds	2.2%	-0.2%	3.5%	3.0%
Canadian equities	0.7%	11.0%	3.1%	8.7%
U.S. equities	5.6%	18.0%	17.0%	20.3%
European and Pacific equities	9.9%	20.4%	8.0%	14.1%
Emerging market equities	14.4%	23.9%	7.9%	9.1%
REITs	3.7%	0.6%	5.2%	4.9%
Canadian/U.S. dollar	3.7%	-0.3%	-6.3%	-7.7%

Source: Bloomberg, June 30, 2017

Canadian Economy

A good portion of Canada's economy has now reached full employment. The Canadian unemployment rate is currently 6.7%. The lowest level reached in decades is 6%. If we take into account the fact that the unemployment rate in Alberta is 2% higher than its historical average, we can conclude that the rest of Canada has already reached full employment. In Québec, for example, the unemployment rate is at a historical low of 6%.

Moreover, all economic statistics are showing that the Canadian economy is faring very well, even when Alberta is taken into account. Retail sales are strong, house prices are high, consumers are increasing their debt levels and new orders are rising. Everything is going well from a short-term perspective, but the fact remains that over the longer term Canada's economy is not very competitive on the international market, as shown by the fact that its exports have not increased in years, apart from oil.

Oil Price

We forecast an increase in the oil price because global consumption continued to rise and the OPEC countries cut back their production. Global oil inventories did begin to fall in mid-2016, but U.S. shale-oil production started rising in 2017 as soon as the oil price went back up to US$50 a barrel. This situation caused inventories to increase temporarily in the

United States and prices to fall. The additional output from shale-oil wells is caused, but at present it is impossible to assess how much more the industry can increase its production. The world consumes slightly less than 100 million barrels of oil a day, and demand is increasing by one to two million barrels a year. The United States produces nine million barrels a day. Can it increase its output by more than a million barrels a day? It's hard to say.

We must therefore wait and see how things play out in the U.S. industry in the months to come. We can say with some certainty, however, that there is a limit on any increases in the oil price, which should range from US$50 to US$70 a barrel.

Why Donald Trump is wrong

The United States has run a trade deficit with the rest of the world for years, and Donald Trump is convinced that it is due to unfair trade tactics on the part of some countries. As a result, he wants to put tariffs on certain products to reduce imports.

Such a policy will not correct the trade balance because the fundamental cause of the U.S. trade deficit is the country's financial surplus. A country's balance of payments has two components – the current account and the capital account – and both accounts have to constantly add up to a net figure of zero. If the one is in surplus, then the other has to be in deficit. This is an accounting equation.

The United States has the world's most sophisticated financial system and produces a constant financial surplus because foreigners increasingly want to hold U.S. dollars. This surplus is not about to disappear. The U.S. dollar will not be replaced by the euro, the yen or the yuan any time soon. Accordingly, if Mr. Trump decides to curtail U.S. imports with tariffs, the U.S. dollar will rise against other currencies. Its strength will then stimulate imports further and reduce U.S. exports to the point where the U.S. trade deficit will offset the financial surplus.

Inflation

If we compare the yield on 10-year real-return U.S. Treasury bonds to that of fixed-coupon bonds with the same maturity, we obtain the long-term inflation rate forecast by investors. From 2003 to 2013, the expected inflation rate stayed between 2% and 2.5%. During that period, the inflation rate targeted by central banks was 2% but it remained below that target throughout the period. In recent years, the expected rate has dropped to 1.5%, as inflation rates in the developed countries converge toward that level.

Speculative bubble?

Are technology stocks in a speculative bubble? Many analysts think so and have therefore concluded that a stock market crash is inevitable. The five most popular stocks on the U.S. market are nicknamed the FANG stocks, namely Facebook, Apple, Amazon, Netflix, Google (now Alphabet). These securities have performed strongly for several years and are up 30% so far this year. Today's situation is different from that which prevailed in 1999 and 2000, when a spate of tech stocks were rising even though the companies had yet to generate profits or even earnings. Today, most of the large technology stocks have profit margins that are far above average and, moreover, are constantly rising.

It is true that the proportion of tech stocks in the S&P 500 Index exceeded 20% this year, which is the largest weighting since 2000. In comparison, the technology sector represented 10% of the index in 1995. We live in a world that is changing rapidly because of technology, and that is what technology stock valuations are telling us.

Dashboard

June 30, 2017	
Canada	
Canadian dollar vs. U.S. dollar	+
Corporate bonds	=
Long-term government bonds	-
S&P/TSX 60	+
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