Market Review
Third Quarter 2017

The stock markets' rise in the third quarter was not especially strong but it was widespread and it included Canada. The performance data takes into account the appreciation of the Canadian dollar, which reduced foreign returns, as shown in the adjacent table. For example, in U.S. dollars the MSCI World Index was up 16.0% on a year-to-date basis. In other words, most of the stock markets were up in local currency, some of them significantly.

After global economic activity paused in 2015-16, the leading indicators are pointing to an upturn in business activity in all the major regions of the world. Interest rates have begun to rise in Canada and the United States. We are far from a period of credit restriction, but we must expect central banks to allow interest rates to increase from time to time in the years to come.

Economic cycle

The economies of Canada, the United States and the United Kingdom are now operating at full employment. Europe is not there yet, but its employment has been rising for at least three years. In fact, the entire world is approaching its full production capacity. If a normal cycle plays out, we must expect wages and commodity prices to rise in the years to come, causing inflation to accelerate and central banks to eventually adopt restrictive policies, which will cause a recession.

It is likely that the economic cycle will follow its traditional trajectory, but the increase in inflation should be far more gradual than in the past.

Performance in Canadian dollars

	3 months	9 months	3 years (annualized)	5 years (annualized)
Bonds	-1.8%	0.4%	2.4%	2.2%
Canadian equities	3.7%	4.4%	4.5%	8.0%
U.S. equities	0.4%	6.0%	14.9%	19.8%
Europe and Pacific equities	1.3%	11.3%	8.9%	13.7%
Emerging market equities	3.7%	18.6%	8.7%	9.1%
REITs	0.2%	3.9%	5.6%	4.1%
Canadian/U.S. dollar	4.0%	7.7%	-3.5%	-4.6%

Source: Bloomberg, September 30, 2017

Wages

The U.S. economy was the first to emerge from the Great Recession and has been expanding for eight years – one of the longest cycles of the past century. The unemployment rate is indicating full employment, and yet workers' average wages do not seem to be increasing. Does this situation mean that the relationship between wages and the employment rate has broken down? It appears that this is not the case. Studies show baby boomers are being massively replaced by younger workers who are highly qualified but earn less than their elders. This replacement of people who are retiring by young people who earn less is preventing average income from rising. Even so, we see increases in earnings for people who are already employed. Once this replacement is complete, wages will start to go up, but the transition will slow this process for several years.

Commodity prices

Global commodity prices follow a long cycle, which is not necessarily synchronized with the global economic cycle. The downward cycle, which lasted about 10 years, probably ended last year, and a consolidation phase that could last up to 20 years recently began. This situation indicates that commodities will not cause inflation for quite a few years to come.

Inflation

The global inflation rate has been less than 2.0% since the start of the 2000s. Whereas analysts constantly underestimated the inflation rate in the 1970s, over the past 10 years they have constantly feared a resurgence of inflation, which has not yet materialized. Almost all countries have experienced an abnormal decline in their inflation rate for a year or two. The many causes of this phenomenon are not well understood. Fed Chair Janet Yellen recently admitted that she was being cautious about reversing her monetary policy, precisely because she was not sure that this problem had been well defined.

The main deflationary factor in the years to come will be technology. Not only does it simplify many production and marketing processes, but it allows better use of existing capital – a phenomenon called "capital deepening." In other words, more can be done with the same capital, which increases the supply of goods and services and keeps downward pressure on prices.

Interest rates

Bond yields for maturities of up to five years recently increased, but the yields of longer-term bonds have been fairly steady, showing that investors do not think inflation will accelerate. We continue to forecast that 10-year interest rates will range from 1.5% to 3.0% over the next few years.

CANADIAN DOLLAR

The Canadian dollar recently surged to more than US$0.80. It was one of the loonie's most significant rises of recent years. Its appreciation was caused by the fact that short-term interest rates have recently gone up more in Canada than they have in the United States.

The Canadian dollar is currently trading at its purchasing-power-parity level, and we expect to see more stability in the exchange rate in the months to come, unless the price of oil rises significantly.

DASHBOARD

September 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