Market Review
Second quarter 2013

The most significant financial development of the second quarter was the U.S. Federal Reserve's announcement that it would begin to taper the pace of its quantitative easing program in the foreseeable future. U.S. government bond yields immediately began to climb, and the yields of lower-quality bonds increased even more.

This development confirms that we have reached the end of an era. It began early in the 1980s when the Federal Reserve raised interest rates to an extraordinarily high level to rein in runaway inflation, at the same time giving investors the opportunity to buy bonds offering an unprecedented and almost risk-free yield because they knew the central bank was on their side. Interest rates then fell for 30 years.

U.S. interest rates bottomed at 2.5% in the summer of 2012. Since then even quantitative easing has not kept them from rising to 3.5%. It is unlikely we will see 2.5% again in the next decade because the central bank is not on the side of bond holders. Long-term interest rates averaged 4.7% over the past century.

Performance in Canadian currency

	Second quarter 2013	6 months 2013
Canadian equities	-4.1%	-0.9%
U.S. equities	6.6%	20.4%
Europe and Pacific equities	2.5%	10.2%
Emerging markets	-5.0%	-4.3%
Bonds	-2.6%	-2.0%
REITs	-7.1%	-5.6%

Source: Bloomberg

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Bonds

In May 2013, we experienced the first spike in long-term interest rates in a very long time. Long-term U.S. Treasury bond yields surged from 2.8% to 3.5% in only a few weeks, pushing down bond prices by about 10%. As a result, bond yields rose throughout the world, with even larger increases for riskier borrowers. In other words, not only have yields risen but risk premiums are also up.

Even so, the Federal Reserve made no reference to a more restrictive policy; it simply announced that it would begin to taper the most expansionary monetary policy of the century. Looking at the evolution of the Federal Reserve's balance sheet, we can see that there has been no precedent for such a policy since the Fed was created. The Fed will not only have to stop purchasing bonds but it will also have to constantly sell them for years to come. We therefore conclude that we have just seen the secular bottom in interest rates.

Real estate income trusts (REITs)

Canadian REITs were affected significantly by the increase in long-term interest rates. They were down 10% from their peak, whereas the Canadian market fell 6%. We consider this decline excessive in the current context because the yields on REITs are comfortably higher than bond yields, and we have already seen REITs trade at a yield equal to that of bonds.

Now that the favourable interest rate cycle is over, we will have to scale back our positions in REITs as soon as their price is more favourable relative to bonds.

Canadian dollar

The Canadian dollar was down 3% in the second quarter. At US$0.95, the loonie is approaching its equilibrium value, which we estimate to be US$0.90 to $0.92 in a context of continuing weak commodity prices. For the time being, this scenario is most likely to prevail because global economic growth is not strong enough to drive prices up. This is especially true in China, where the government is trying to slow the rate of investment.

China

The growth of Chinese exports slowed recently but the pace of investment continued and even accelerated. China is at the point where investment accounts for almost 50% of GDP. Obviously the Chinese can have a high rate of investment because their savings rate is also extraordinarily high.

Recently, however, the authorities have realized that banks are financing projects that are increasingly less serious, and the People's Bank of China has decided to restrict credit in order to send the market a clear warning. The transition from an economy based on exports and investment to a consumer-driven economy is challenging, and we will therefore wait before adding to our investments in China even though the Shanghai stock exchange is down 17% on a year-to-date basis.

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SHALE GAS

In recent years, we have stated several times that the development of new shale gas extraction techniques was one of the cornerstones of economic recovery in the United States. The country's reserves are enormous and it will become a hydrocarbon exporter in the near future. The price of natural gas is currently $3.50 a unit versus an average of $8.00 just before this technological revolution. Moreover, it is still $10 in Europe. Energy prices will therefore remain low for several years to come and will sustain economic growth.

The availability of low-cost natural gas could have a positive impact on other countries once they decide to adopt the new techniques, because immense gas reserves are found almost everywhere in the world.

The falling natural gas price also has many other impacts. For example, it would be easy to demonstrate to Quebecers that the long-term value of Hydro-Québec, their government's largest asset, has been cut in half over the past four years because hydroelectricity is far less competitive than it was previously.

U.S. ECONOMY

The United States caused the financial crisis of 2007-08, emerged from it first and continues to be the country offering the best growth outlook for the years to come.

Consumers have reduced their debt, home prices and housing starts are up and, over the past three years, companies have been accumulating enormous amounts of cash because of historically high profit margins. The most interesting short-term indicator published recently is the consumer confidence index, which reached its highest level in four years.

But the most impressive aspect of the U.S. economy's recent progress is that it has occurred despite the drag created by the spectacular decrease in the federal government's budget deficit, which fell from 10% of GDP to 4% recently. It is forecast to decline to 2% in 2015 without any income tax increases.

CANADIAN ECONOMY

Economic growth in Canada and the U.S. has been roughly equal since 2010 but the outlook for the next two years is less positive in Canada.

Canadian consumers are still coping with the heaviest debt burden in their history. Canada's housing prices are among the highest in the world in relation to income according to *The Economist*, and the new condominiums set to flood the market in Montréal, Toronto and Vancouver over the next 12 months have created concerns about a speculative bubble. During this period, corporate earnings will be rather low, mainly because of weak commodity prices, and net exports will be flat even though our main trading partner is in recovery. In this context, the Bank of Canada is expected to let the Canadian dollar slide.

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Source: Robert J. Shiller, www.irrationalexuberance.com

DASHBORD

	June 30, 2013
Canada	
Canadian dollar vs. U.S. dollar	–
Corporate bonds	0
Long-term government bonds	–
S&P/TSX 60	0
Small caps	0
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	0
MSCI Japan Index	0
Emerging markets	
MSCI Emerging Markets	–

0: neutral +: overweighted –: underweighted