Market Review
First quarter 2013

The stock markets continued to rise in the first quarter of 2013. The U.S. market has been advancing for the past four years and the S&P 500 Index has doubled. Despite investor skepticism, we have maintained for several years that we are in a bull market. The consensus several years ago was that economic growth would be slow as we emerged from the financial crisis of 2007-08 and that the stock market would suffer. Even so, it had already been shown that there is no correlation between the economic growth rate over three to five years and the stock market's performance. Economic growth has indeed been very slow since 2008 but we have seen one of the market's strongest rallies during that period.

This four-year bull market may seem long in the tooth, and many will be tempted to sell, especially because U.S. equities have returned to their historic peak. Even so, a careful study of rising markets over almost a century shows that rallies on the U.S. stock market have usually lasted more than four years. Of the 11 bull markets that have taken place since early in the 1930s, three lasted two years and all the others lasted more than four years.

Wisdom has it that a bull market doesn't die of old age. In fact, two types of events cause markets to decline: (1) an imminent recession or (2) a tightening of credit. Neither is expected at present. The most likely scenario is that the U.S. stock market should tread water for several months as the economy continues to strengthen. We must keep in mind that we are now entering what could be the last portion of the bull market and that the tail end of such cycles has always seen strong advances.

Performance in Canadian currency

	First quarter 2013	1 year as at March 31, 2013	4 years as at March 31, 2013*
Canadian equities	3.3%	6.1%	13.2%
U.S. equities	13.0%	16.0%	14.6%
Europe and Pacific equities	7.5%	13.3%	9.6%
Emerging market equities	0.6%	3.9%	12.6%
Bonds	0.7%	4.4%	6.0%
Real estate investment trusts	1.5%	12.7%	31.3%

***Annualized**

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FINANCIAL REPRESSION

Financial repression is the term used to describe the behaviour of central banks in response to an explosion of government debt during a crisis. A substantial increase in government debt would normally cause interest rates to rise but in fact the opposite has occurred because central banks have flooded the financial markets with liquidity. This phenomenon is known as repression because investors have practically no choice but to buy government bonds even though their yields are inadequate. For several years, short-term rates have been kept at levels that are lower than the rate of inflation. Investors are therefore gradually losing their purchasing power. The same thing occurs if investors purchase long-dated bonds.

At present, the most extreme example is Germany's two-year bonds, which have a negative yield. Why don't investors put their money in the bank rather than accept a negative return over two years? Because they don't want to risk leaving their money in a bank for fear of losing it if the bank encounters financial difficulties or if bank deposits are taxed, as in the case of Cyprus. Many investors have concluded that it is better to line up on the side of the government and buy sovereign debt.

Even though this strategy appears advisable at this time, it comes with risks because it leads to a long-term decrease in purchasing power. A more appropriate way of avoiding such repression is to invest in the shares of solid companies.

U.S. ECONOMY

We can now state that the financial crisis has ended for the United States. Banks have been recapitalized, household debt has been reduced considerably, companies have substantial cash reserves and, what is most important, house prices have begun to rise on an active market. It will therefore be much easier to lower the unemployment rate in the years to come. The sole legacy of the financial crisis is the very weak state of public finances. It will take the U.S. federal government several years to return to a balanced budget but this problem is not insurmountable, provided that politicians manage to avoid gridlock.

EUROPEAN ECONOMY

Europe is still in a recession and the unemployment rate continues to rise. The situation in Great Britain is almost as gloomy. In both cases, the authorities have adopted highly restrictive fiscal policies based on income tax increases and spending cuts. This approach has weakened the economy without eliminating the deficits. In Europe, the financial crisis of 2007-08 has not ended and it will continue to have an impact as long as fiscal policy remains restrictive and the labour market is not thoroughly reformed.

CANADIAN ECONOMY

Canada's economy is slowing and this year's growth is expected to be only 1.5%. The economy is slowing for three reasons: (1) commodity prices are weak, especially the price of Canadian crude oil; (2) the Canadian dollar is a little too strong; and (3) the governments' fiscal policies are somewhat restrictive. None of these factors is significant enough to cause a recession but there is no new stimulus. Canada will have to count on a global recovery to drive its growth.

U.S. STOCK MARKET

Given the economic outlook, it is not surprising that the U.S. stock market has recorded the best performance so far this year. Despite the rally, U.S. stocks are not very expensive, with a price-earnings ratio slightly below the long-term average. It is true that earnings are at a level that is historically very high, but this situation can probably continue for several years.

CANADIAN STOCK MARKET

The Canadian stock market has offered rather mixed results over the past year. In fact, it has underperformed the U.S. market since March 2011. A Canadian investor who bought the U.S. market two years ago has obtained a return that is 34% higher than the return on Canadian equities.

The fluctuations of the Canadian dollar have not had much impact on this divergent performance. The main reason is weak commodity prices and slowing internal demand. The commodity sector (especially oil and gold) and the banks account for 70% of the Canadian index.

Is it too late to switch from Canadian equities to U.S. equities? An analysis of the relative performances of the Canadian and U.S. stock markets shows that most cycles last more than two years and far exceed 34%. Out of 12 relative-performance trends since 1971, only two have lasted less than 24 months and only three have generated relative performances of less than 34%.

It seems therefore that it may not be too late to replace Canadian equities with U.S. equities.

CANADIAN DOLLAR

At slightly more than US $0.98, the Canadian dollar is about 2% above its two year average. of the past two years. That difference is not much, given that Canada's balance of payments is still showing a deficit, that the country is having a great deal of difficulty exporting its crude oil and that domestic demand is weak. We expect the loonie to continue to slide against the greenback.

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DASHBORD

	March 31, 2013
Canada	
Canadian dollar vs. U.S. dollar	–
Corporate bonds	0
Long-term government bonds	–
S&P/TSX 60	0
Small caps	0
REITs	0
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 Index	+
Emerging markets	
MSCI Emerging Markets	+

0: neutral +: overweighted –: underweighted