May 2013

Market Commentary

April markets 'stirred, not shaken'

The 1964 movie *Goldfinger*, the third to star Sean Connery as Bond, featured a villain obsessed with gold. Auric Goldfinger's Rolls Royce was made from an impressive two tons of 18-carat gold that could be smuggled across international borders to a country with a higher gold price, then melted down and converted into ingots. He was engaging in arbitrage, which involves taking advantage of price differentials in different markets, buying low in one market and selling at a profit in another.

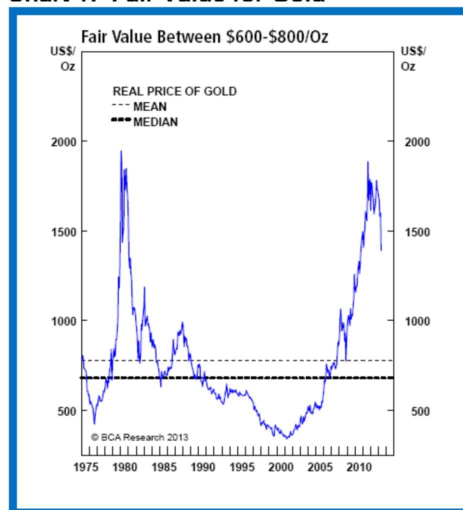
Let's imagine we owned that golden Rolls in April and take a look at how its spot price (the cash price) would have varied. On April 2, gold closed at $1,583.50 (US$) an ounce, making the gold in the car worth $113, 505,280. The lowest close for gold in the month occurred on April 16 at $1,380.00 (a two-year low), reducing the car's value to $98,918,400 – a 13% drop. April closed with gold bouncing back to $1,469.00 (US$), making that Rolls worth $105,297,920 at month end.

What made the price of gold fluctuate and why did it end lower for the month? Gold prices are one indication of the global economy's health. High gold prices typically indicate that investors are expecting inflation and are therefore seeking a safe haven to protect their assets. If that's true, then logic tells us that gold prices should have risen in April as a hedge against inflation, which seemed a real possibility given that central banks around the globe continue to printing money. By the end of April, investors had returned to buying the precious metal, yet, the fear of renewed deflationary pressure was signaled.

The recent drop in gold prices is part of the general weakness in commodity prices we've seen since the beginning of the year. Base metals will likely fare well when economic growth in China is in the 8% range (the current rate is slightly below that figure). Ongoing concerns that growth is slowing in the Chinese economy go a long way toward explaining why base metal prices have softened. Energy demand is a different kettle of fish. Demand for non-OPEC oil has risen by 60% since the millennium. Further development in emerging market economies almost guarantees that there will be strong and growing demand for energy. It's more likely that gold is overvalued at current prices, which would explain why gold sold off more than the base metal or energy sectors in April. Some analysts pointed to events in Europe as the cause of the price drop and Cyprus's plan to sell off its gold reserves. But Cyprus is far too small a player to have any impact on gold prices.

In fact, gold may just be returning to a more realistic price level. While the U.S. dollar has fundamentally replaced gold as the primary reserve currency for central bankers around the world, both gold and the greenback are important to investors as stores of value (you can put them away for a period of time and they remain valuable).There is a caveat, however: investors should be wary of purchasing gold above its long-term, inflation-adjusted price. That would place its value in the range of $600 to $800 per ounce. Inflation would need to run at about 8% in the U.S. over the next decade to justify today's gold price.

Chart 1: Fair Value for Gold



Source: BCA Research

U.S. Growth Plods Forward

Equity markets in the U.S. continued their upward progress in April, adding to impressive gains in the first four months of the year. U.S. stocks advanced 1.93% (US$) bringing the year-to-date return of the S&P 500 to 12.74% (US$). In April, markets reacted to economic data that was modestly less upbeat: the U.S. March job numbers were weak; the Institute for Supply Management Index of new orders rose – but only slightly; and the economy overall was not as positive due to fears about the impact of sequestration and government spending cuts.

In Canada, markets slumped by 2.07% (C$), bringing the overall return for the year to a lacklustre 1.2% (C$). Most of the Canadian underperformance is directly attributable to the Materials sector. The outlook for commodities is inextricably bound to economic growth in China, where the Purchasing Managers Index indicated only marginal expansion for the month. It came in at 50.6, down from 50.9 in March and below the expectation of economists. (A number above 50 signals an expanding economy.)

The MSCI EAFE (Europe, Australasia, Far East) reported a total return of 5.33% (US$) for April, bringing that index's return for 2013 to 10.84% (US$).

Fixed Income Performance

In the month of April, bond returns were driven more by term exposure (the length of time to their maturity) rather than by the type of credit (Canada bonds versus corporate bonds). During April, the overall DEX Canadian Universe Bond Index increased 1.14%, the Short Term Bond Index (1-5 years) increased by 0.37%, the Mid Term Bond Index (5-10 years) returned 1.25%, and the Long Term Bond Index (10+ years) lost 2.22%. (Our long term strategic view avoids the long end of the market.) There was not much divergence in the returns within the various terms (short, mid and long), meaning that for a similar duration sector there was little difference in returns from Canada bonds vs. provincials vs. corporate bonds.

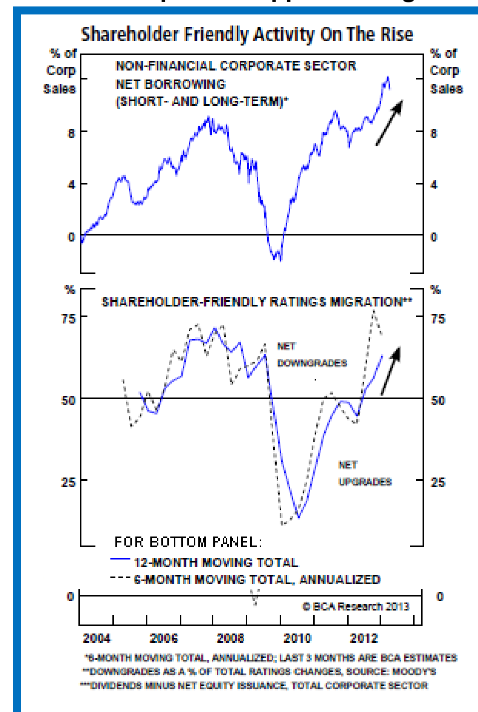
The 10-year U.S. Treasury bond, a good proxy for the overall U.S. bond market, peaked at a yield of 2.04% on March 11 and slowly shifted down to close the month at 1.85%. This rally of 19 basis points has been attributed to a combination of renewed fears about Europe and recognition that U.S. economic growth may be cooling somewhat. Deflationary fears are resurfacing.

Our Strategy

We remain modestly overweight equities versus fixed income and continue to believe this is the right allocation for client portfolios. Geographically, we have emphasized U.S. and Canadian equities over those of EAFE.

During the past few months, we have been gradually adding high-yield corporate bonds to our holdings. In April, we purchased the last of five tranches. Yield generation is a key objective for our income-oriented portfolios; this exposure to high-yield corporate bonds enhances that. The performance of high-yield bonds is primarily driven by two factors: monetary policy and the underlying health of the corporate sector. Both conditions are favourable. Monetary policy is very easy, meaning the U.S. Federal Reserve is keeping interest rates low, and will likely continue to do so. The Bank of Canada will no doubt follow suit. The Fed is waiting for unemployment to drop to 6.5% as one key signal that it could be time to increase interest rates. A strengthening U.S. economy supports corporate health and high-yield bonds.

Chart 2: Corporate Support for High Yield



Source: BCA Research

The Last Word

For the last two to three years, broad trends have driven commodities to perform as a homogeneous group. The subsectors – precious metals, base metals, agriculture and energy – are now decoupling, which has important implications for Canada's economic outlook. We believe that Canada's economy is likely to lag that of our southern neighbour by about a half percentage point over the next year or so. If he were around today, Auric Goldfinger would probably shift out of gold arbitrage, given the ho-hum price outlook for commodities and precious metals.

Information contained in this publication are based on sources such as issuer reports, statistical services and industry communications, which we believe are reliable but are not represented as accurate or complete. Opinions expressed in this publication are current opinions only and are subject to change.

® "BMO (M-bar roundel symbol) Harris Private Banking" is a registered trademark of Bank of Montreal, used under licence. Investment Management Services are offered through BMO Harris Investment Management Inc., an indirect subsidiary of Bank of Montreal.