January 2014

Market Commentary

Should old acquaintance be forgotten…

Like most revelers on December 31, you probably belted out the refrain to Auld Lang Syne. If you've ever wondered why we celebrate with that particular song, well there's a Canadian connection – Guy Lombardo and his Royal Canadians performed the tune each New Year's Eve for over 30 years in their live broadcasts from the Roosevelt Hotel in New York City thereby making it a traditional part of year-end festivities. The song is a gentle urging to revisit the past kindly and so it's with that spirit that we review 2013.

The year was most noteworthy for a steady continuation of global economic and capital market recovery – a recovery that has been in place for the last five or more years since the global financial crisis. Policy makers and central bankers around the globe continued to take and reinforce the measures necessary to ensure that a recovery would be sustained. The persistent threat of deflation was tackled head on by deliberately low interest rates – easy money dominated central bank policy throughout Western developed countries. By design, those low interest rates guided, some might say coerced, investors into risk assets that helped to fuel the outsized returns in some equity markets.

There are quite a number of positives to tally this year. Central bankers have, for the most part, continued to play a very constructive role in supporting the recovery. They certainly got it right in 2013. While the U.S. unemployment figures have remained stubbornly high, there was encouraging improvement reported in those numbers during the last quarter, a key indicator in gauging the strength of this recovery. Abenomics in Japan, particularly the aggressive monetary policy component of that plan, appeared to have that economy set on a much better path. Europe avoided slumping back broadly into recession and continued its recovery through a somewhat more tempered approach to austerity, importantly acknowledging the need to balance job creation and economic growth. China also enjoyed success in engineering a soft landing for its economy although some concern still lingers for its credit markets.

The U.S. – Leading the Way

Equity markets returns are often a leading indicator of economic performance. If the economic outcome could be based on that premise alone, then the U.S. economy would be in for one heck of a year given that the total return of the S&P 500 index was just over 30.3% for 2013. Perspective is important here. Valuations are high but not too far above historical averages. It is clear that liquidity and momentum have played a role in driving those returns. What will be important for sustaining equity market performance in 2014 will be growth in corporate revenues and earnings – so far they've been trailing stock price movement. Historically, equity markets have delivered some pretty decent returns in the year following strong market gains; however, it's also the case that one year's return is a fairly poor predictor of next year's markets.

2013 witnessed the U.S. making solid progress in trimming its on-going budget deficit, slashing $400 billion from the previous figure. And, a somewhat surprisingly cooperative Congress reached an agreement late in the year on a budgetary path forward. Removing that uncertainly is good news for business and consumer alike.

In an important move towards normalizing interest rates, the U.S. Federal Reserve announced the beginning of its plan to withdraw from open market bond purchases, trimming $10 billion from its previous monthly target of $85 billion. The bond market naturally responded by moving yields higher and ended the year with the 10-year U.S. Treasury Note hovering around 3.0%. It's only the third time that this asset class has finished with negative returns in the last 34 years. Despite those negative returns, this action by the Federal Reserve should be viewed positively given that the Fed's action was predicated on a view that the economy is now showing signs of a more resilient recovery heading into 2014.

China – A Year of Transition?

The key theme for China in 2014 will be similar to that of 2013 – economic restructuring. It's crucial that China continue to move forward on these initiatives it began in 2013. Among the more important of those undertakings is moving away from credit expansion as a lever for stimulating economic growth. Large infrastructure projects also need to be appropriate capital investments. Encouragingly, economic growth in China seems to be on track to hit the targets prescribed by central planners. While economic reform is likely to disappoint those who believe that there will be a speedy reacceleration, that reform is essential longer term, particularly in the banking sector.

Continued strong growth in China is one of the essential ingredients to a more robust global recovery and China watchers are encouraged by upticks in both business and consumer sentiment surveys there. Sweeping tax reform will also effectively lower income tax for businesses in 2014.

Europe still struggling

Headline attention in Europe diminished materially by year-end. That comment sounds a bit like 'damning with faint praise', however, it's a sincere testament to policy makers in the euro zone that they were successful in stabilizing most economies and restoring confidence in the ability of the euro zone to remain intact and to work its way out of its financial crisis. The job is not finished and we continue to monitor the events in Europe closely.

Canada

Canada did a lot of things right over the last number of years that have positioned this country well. It enjoys sound fiscal, monetary and industrial policies that serve as a solid foundation for economic growth. While Canadian equity markets lagged its developed country counterparts somewhat in 2013, further strength in the U.S. economy, growth in China and a rebound in Europe all bode well. Softness in commodity prices held back better returns from Canadian equities. Some weakness in the Canadian dollar in the later part of the year should prove to be a solid tailwind for Canadian exports.

Our Strategy

Our strategy in 2013 was built on a couple of fundamental beliefs. First, we believed that equity markets would perform better than bonds and our overweight to equities was rewarded.

Second, we believed that an increase in interest rates was imminent and that it was important that bond portfolios be prepared for that. To protect the capital invested in fixed income, we shortened the average maturities of our bond holdings and increased the coupons through allocations to both high yield bonds and preferred equity where appropriate. That too proved to be opportune.

We will further both of those strategies into the New Year.

The Last Word

As we raise a glass to toast the New Year and bid adieu to 2013, it's important to appreciate just how far global economies and capital markets have recovered since the events of 2007-2008. We enter 2014 on much better footing than we did a year ago. While it may be too early to worry, one prudent answer to the query posed in the lyrics of Auld Lang Syne is surely that investors and policy makers not forget the tough lessons of recent years.