Market Commentary

Sidetracked

Many of us make plans, but discover good intentions are not enough to persuade us to follow through. “Sidetracked,” a new book by Harvard Business School Professor Francesca Gino, explores the unexpected forces that derail plans and block people from reaching their goals.

Her research found that we tend to ignore the advice of experts – even when it’s based on more accurate knowledge than our own – because we consider the opinions of others less compelling and convincing than our own beliefs. “Sidetracked” could be the theme for February as we examine what’s happened over the last month across at least part of the global economy.

Emotion seemed to override measured progress toward financial and economic recovery in a variety of geographies. In Europe, unease returned in the wake of the anti-austerity Italian election results, Britain’s loss of its cherished triple-A credit rating and a variety of troubling events in Spain. In the U.S., Republicans and Democrats were unable to forge a deal that would avert the sequester, which authorized the U.S. Treasury to withhold, or sequester, $85-billion in funds needed to run federal agencies. Most senior economists predict the cuts will significantly slow economic growth and damage confidence in the U.S. economy. In Canada, the pace of business investment by miners and construction firms – key drivers of the economy – stalled as companies in these sectors grew reluctant to spend. It’s no wonder the markets began to stutter once again as uncertainty rattled investors.

U.S. – preoccupied with politics

At the start of the year, when a bipartisan agreement on tax hikes saved the U.S. from falling off the fiscal cliff, it was clear party leaders were far apart on how to cut the deficit. With no deal on the table, on March 1 automatic spending cuts legislated in the 2011 Budget Control Act took effect. Differences in ideology continue to sidetrack U.S. politicians, preventing them from reaching a well-reasoned compromise on the deficit. At a grass-roots level, some Americans welcome sequestration because it will lead to a leaner government. Despite the political posturing, behind the scenes both sides are working toward a grand bargain, which will likely emerge over the next three to six months.
Sequester aside, the pace of growth in the U.S. continues to slowly improve. January saw decent employment growth (157,000 new jobs) and strong numbers for both manufacturing and non-manufacturing business activity as measured by the Institute for Supply Management Index.

Turmoil Returns to the Eurozone

When the dust settled from the Italian elections, the losers were international markets. Political stalemate was the outcome after voters rejected the economic reform and austerity measures that caretaker Prime Minister Mario Monti had promised to eurozone partners.

The Five Star Movement, led by outspoken comedian Beppe Grillo, tapped into Italian outrage over tax increases and pension cuts. Italy’s former prime minister – the “bunga bunga” convicted tax fraudster Silvio Berlusconi – compounded the chaos when his People of Freedom party came within a whisker of forming the government. The Democratic Party under Pier Luigi Bersani holds a tenuous grip on power. Markets dislike uncertainty, which will continue at least until a workable coalition forms or a new election takes place. Contagion is also a risk: will public rejection of austerity in Italy, the most indebted and third-largest economy in the eurozone, spread to Spain and other peripheral countries? Mr. Grillo’s call for a referendum on eurozone membership added to the instability, mirroring British Prime Minister David Cameron’s referendum approach that effectively sidetracks leadership responsibility on the EU question.

Meanwhile, France has fallen well behind Germany in competitiveness during the 10-month leadership of Francois Hollande, even though he rode to power on an anti-austerity platform. France may, in fact, lag some of the peripheral eurozone countries as they make solid economic gains. The high cost of labour and weaker productivity have eroded the competitiveness of French exporters; France’s share of world exports has fallen even farther than Italy’s. Holland seems to be slipping as well, giving us concerns about the northern economies in Europe.

China Under New Management

In something of a surprise move, the People's Bank of China tightened credit in an effort to cool that country's hot housing sector.

The sleeper story in China is how new president Xi Jinping will make his mark on the country and its economy. He is certainly one of China's most assertive leaders to come along in years. Reform is his mandate and agenda. He has been vocal about tackling obstacles like corruption (particularly with rural-to-commercial land conversion) and growing income disparity. As the Middle Kingdom's economy downshifts, Mr. Xi must revive stalled economic initiatives. Growing nationalism needs to be curbed, or at least focused, to avoid friction with China's neighbours. When he takes over this month, the new president will be empowered to make the changes he envisions as the leader of the party, the state and the military. Let's see how that plays out over 2013.

Canada Chugs Along

Is Canada's recovery sidetracked or getting stronger? Canada's export sector relies heavily on a robust economy in both the U.S. and China, which neither is currently enjoying. The S&P/TSX equity index delivered respectable (1.08% CAD) returns for February (compared to 2.02% CAD in January). The Materials sector dragged down performance – an indication that a full export recovery is still in the early stages.
Finance Minister Jim Flaherty continues to sternly warn Canadian banks not to stimulate the housing market with a "rush to the bottom" on mortgage rates. Nevertheless, on the first weekend of March, Bank of Montreal cut the price of a five-year, fixed-rate mortgage to 2.99%. This is the lowest rate offered by a big Canadian bank, but will likely be matched by the others fairly quickly. Lower mortgage rates could spur demand in the cooling housing market, giving the economy a boost.

Our Outlook and Strategy

Global capital markets delivered reasonably good returns in February (1.11% U.S. for the S&P500), although they didn't match the torrid pace of January (5.04% U.S.). These results continue to support our strategy of being broadly overweight equities across most client portfolios. For portfolios where a more assertive asset exposure is appropriate, we took profits on part of our overweight position in Canada and redeployed the funds into emerging market equities, which tend to respond better than Canadian equities in a recovering risk environment. GDP forecasts for developing economies are projected to come in at 4.5% versus below 2.0% for developed economies. Public-sector debt in emerging markets is significantly lower than that of their developed counterparts – and forecasted to fall even lower. Public debt for emerging market countries is set to decline to 30% of GDP, while it will remain above 100% for developed markets (in aggregate).

We remain underweight bonds in most portfolios. We continue to add high-yield bonds, encouraged by better-than-consensus economic data and solid first-quarter earnings. As we reported last time, more than 65% of companies reporting earnings came in above estimates. The month saw positive performance as spreads tightened further. Prices have remained firm even in the face of some ETF (exchange traded funds) rotating out of the sector. We continue to opportunistically add to this asset class.

The Last Word

Behavioural scientist Francesca Gino's research found that people get sidetracked by three different kinds of forces: those that come from within us; our relationships; and the world around us. In reviewing February's events, we can identify emotions, relationships and external forces at play on a national and global economic scale. We'll be closely watching events over the coming weeks. If governments in the U.S. and Europe are willing to heed logical advice and focus on measures that will reduce debt and bolster growth, the global economic recovery could begin to move from sidetracked to back on track.