

AS AT DECEMBER 31, 2013

Towards a synchronized world recovery in 2014?

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As per tradition at the end of each year, it is time for an annual review. The buoyant optimism we expressed at the start of the year for the U.S. economy finally proved to be well founded, even if it took until the second half of the year for the upturn to be felt. It was mostly the advanced economies that headed the pack in 2013, led by the United States, Canada and Japan (Graph 1). Germany also played a large role by helping to pull Europe out of its recession even as France flirted dangerously with a relapse. In the United Kingdom, after having inflicted a difficult period of austerity in the middle of a world economic crisis, the political class was relieved to see domestic demand regain full steam, fueled by a surge in confidence.

On the stock markets, the S&P 500 delivered an exceptional performance, climbing more than 30%, following a gain of close to 14% in 2012. In fact, 2013 will go down as one of

the Top 10 years of the last century! In Canada, the S&P/TSX under-performed the U.S. stock market for a second year in a row by more than 10% (nearly 20% if we include the currency impact) because of the hefty weight held by the resources sector.

The Fed dominated the news and influenced the markets throughout the year, even though the change in monetary policy direction was not officially announced until the end of the year. At the same time, the bond market experienced a very difficult year as it continually feared a reduction in the quantitative easing (QE), pushing U.S. 10-year bond rates up close to 160 points since early May.

2014 should be the year of synchronization within the advanced economies. The U.S.

Graph 1

Economic Surprise Index

Citigroup index, advanced and emerging economies



Source: IA

cisive actions of the new Japanese government should enable Japan to shake off deflation, but the emerging markets will probably endure a rough start to the year, given the end of QE. As for the Canadian economy, it may unfortunately disappoint in 2014, with debt-ridden consumers who will not be able to keep up the pace forever and an external sector that is still suffering from an overvalued loonie.

World

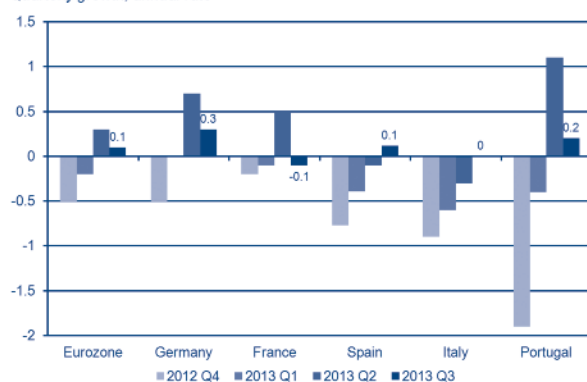
Last quarter we spoke of the synchronization of growth in the advanced economies. This theme continued in the fourth quarter, but now it is the synchronized slowing of inflation that is holding attention, having forced some central banks, such as the Bank of Canada, to take the approach of an even more accommodating monetary policy.

Indeed, despite all the new money printed in the last few years, inflation is gradually receding in the leading world economies. It is difficult to see where the next source of inflation could come from, especially in the current situation where output gaps (the difference between real production and the

Graph 2

Euro zone: Back to fragile growth

Quarterly growth, annual rate



Source: IA

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production capacity of an economy during full employment) remain high or have widened during the year. Perhaps the depreciation of certain currencies will bring localized inflation in 2014, but the downward trend could take time to reverse.

In Japan, the Abe government's plan can be summed up as follows: so far, so good! Signs that the plan is working are undeniable: inflation has reached 1.5%, the Yen lost 15% of its value in 2013 (25% since September 2012), the Nikkei surged 50% (more than 70% since September 2012) and business confidence is at its highest in six years. The governor of the Bank of Japan judges that although they are half way there, the real tests will take place in 2014. The increase in the sales tax, which will go from 5 to 8% in April, will likely create volatility as consumers and businesses move up many of their purchases to the first quarter (in fact, we are expecting strong GDP growth in the first quarter and a sharp decline in the second, given this displacement effect of demand). The key to the Japanese economy's return to prosperity still lies in the structural reforms; the most important ones aim to improve

productivity by increasing women's participation in the workforce and by delaying the age of retirement. In short, the first "arrows" of the Abe plan have hit their mark but now we are moving into the critical phase.

In China, growth finally took an upturn after three quarters of slowing. The Chinese economy is currently growing at an annual pace of 7.8%, slightly above the target set by the administration in 2013. Industrial production and retail sales are also progressing according to expectations, reflecting the government's implementation of a mini fiscal stimulus during the year, composed of railway spending and tax cuts. After being a source of concern at the start of the year, China returned to the forefront of the world economy just as the world was positioning itself for the end of QE in the United States (and even, for a few weeks, for the possibility of a default on the U.S. debt). Like Japan, China is in the process of implementing major structural reforms, and their success will dictate the country's trajectory for the coming years.

Chart 1 – Returns of the Canadian Bond Market as at December 31, 2013

| Index | Returns (%) | |
|---------------------------|-------------|-------|
| | 3 months | YTD |
| DEX Universe Bond Index | 0.4 | (1.2) |
| DEX Short Term Bond Index | 0.8 | 1.7 |
| DEX Mid Term Bond Index | 0.4 | (0.6) |
| DEX Long Term Bond Index | (0.2) | (6.2) |
| DEX Canada | 0.0 | (1.5) |
| DEX Provincial | 0.4 | (2.7) |
| DEX Municipal | 0.6 | (0.8) |
| DEX Corporate | 0.9 | 0.8 |

Source: Scotia Capital Debt Market Indices

True, the Fed is not the only central bank printing money (the Bank of Japan is even about to eclipse the Fed's mark by a large margin), but the withdrawal of its QE policy will no doubt weigh heavily on the inflows of capital in these countries.

The year 2014 should therefore be one of adjustment for the emerging countries where the financing of investments may become more difficult. For the moment, we find it unsettling that a company such as Cisco, an excellent barometer of world investment conditions, reported that the end of the third quarter was a major turning point in the emerging countries. The demand for investment plummeted suddenly and the environment is reminiscent of that of 2009, with the drop in demand among the most rapid recorded.

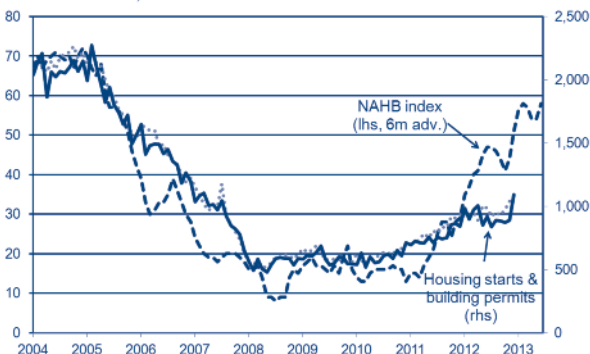
Finally, in Europe, the most recent data confirm the degree to which the exit from recession will be slow, uneven and fragile. Although Germany (1st European economy) remains at the forefront with its strong domestic demand and healthy external sector, the situation elsewhere is not as rosy. France (2nd) is heading straight back into recession while Italy (3rd) still hasn't come out of it (Graph 2). And that's not even counting the southern countries (Greece, Spain and Portugal) which are still suffering the effects of the bursting of the credit bubble

The other emerging economies, however, do not enjoy such an advantageous position. The year 2013 showed us just how vulnerable they are to the drying up of liquidity in the advanced economies. The emerging countries run mainly on foreign investment and need the injections of foreign capital to support their growth.

Graph 3

U.S.: Housing sector closing the year on a high note

Index & thousands, annualized



Source: IA

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and of not controlling their own monetary policy. Adjustments must therefore be made through the real economy: marked increase in default rates, sustained decline in salaries and housing prices, etc., not to mention the unemployment rate which remains at a record high of 12.2% across the continent. All these pressures on demand have weighed on the inflation rate, its downward trajectory forcing the European Central Bank (ECB) to lower its key rate and revise its forecasts for GDP growth and inflation to 1.1% each in 2014.

United States

The U.S. economy ended the year on a very positive note. GDP growth in the third quarter was revised upward, the real estate market is back on track after a slight pause in October, the unemployment rate finally dropped to 7%, the Senate and the House of Representatives agreed for the first time since 2011 on a budget plan, and the Fed finally deemed that the conditions on the job market are ripe to begin the “infamous” tapering process.

As to the spectacular 4.1% growth in GDP recorded in the third quarter, nearly one third came from a jump in inventory, suggesting at first glance that part of this growth was

borrowed from the fourth quarter. Digging a bit deeper, however, we realize that these fears may be unfounded, as the large majority of this rise in inventory was concentrated in the automobile sector, where sales are growing rapidly and approaching pre-crisis levels. In addition, December’s ISM report (a survey of more than 300 major U.S. companies) indicates that just 17% of respondents believe their inventory is excessive, down from 28% in previous months. As well, 83% of companies surveyed reported an increase in demand for their products, compared to just 33% at this time last year. All this suggests that the inventory accumulation is not caused by a weakness in demand but rather by a surge in confidence as businesses get ready for an improvement in the coming quarters. The conditions are therefore coming together for increased hiring and investment in 2014.

Despite the government shutdown in October (which lasted just over two weeks and is expected to have cost \$300 million per day in GDP in the fourth quarter, which can be put into perspective by considering that annual GDP in the U.S. is \$15.7 trillion, or \$15.7 million million), consumer and business confidence were only temporarily affected.

Car sales are moving at an annual rate that is close to the pre-crisis period, the NAHB Builder Confidence index is at its highest in seven years (Graph 3), construction starts are at their highest in five years, and the most recent household surveys showed a surprising jump in confidence in November.

Retail sales are headed in

the same direction, suggesting that 2014 will start out with the momentum of confidence. We should not forget that from a macroeconomic standpoint, the spending of one is the income of another, and that it is confidence that makes households consume and businesses invest. Confidence is none other than the secret ingredient to economic vitality!

Canada

The Canadian economy is more difficult to characterize than the U.S. economy. The level of economic activity is greatly superior to its pre-crisis level, in this respect outranking the other G-7 partners (Graph 4). Despite this exploit, attributable to a cautious management of public finances in the years prior to the crisis and to a conservative and well-capitalized banking system, growth continues to be fueled primarily by household consumption, and the debt levels of these households are reaching ever-higher records.

What does 2014 have in store for us? It is hard to say. The real estate sector continues to raise concerns, as the weekly magazine *The Economist* reminds us each quarter (Graph 5), but it seems that a large part of this high assessment can be attributed to the growth of the population aged 20 to 44, fostered by a significant immigration contribution. All in all, while there is no imminent collapse on our radar, the Canadian real estate market is expensive and vulnerable to an eventual rise in interest rates and to a lull in migratory flows.

Chart 2 – Market Returns as at December 31, 2013

| Index | Returns (%) | |
|-------------------------------|-------------|-------|
| | 3 months | YTD |
| DEX 91 day Tbill Index | 0.2 | 1.0 |
| DEX Universe Bond Index | 0.4 | (1.2) |
| S&P/TSX Composite Index | 7.3 | 13.0 |
| S&P 500 (Can. \$) | 14.3 | 41.5 |
| MSCI - EAFE (Can. \$) | 9.3 | 31.3 |
| MSCI - World (Can. \$) | 11.7 | 35.4 |
| Exchange Rate (Can. \$/US \$) | 3.4 | 6.9 |

Chart 3 – Market Returns as at December 31, 2013

| Index | Returns (%) | |
|-----------------------------------|-------------|--------|
| | 3 months | YTD |
| S&P/TSX Sector Returns | | |
| Energy | 5.7 | 13.6 |
| Materials | (2.0) | (29.1) |
| Industrials | 16.3 | 37.5 |
| Consumer Discretionary | 8.0 | 43.0 |
| Consumer Staples | 4.1 | 23.6 |
| Health Care | 13.8 | 72.1 |
| Financials | 10.0 | 23.7 |
| Information Technology | 7.3 | 37.3 |
| Telecommunication Services | 6.9 | 13.1 |
| Utilities | 3.1 | (4.1) |
| S&P/TSX Composite Index | 7.3 | 13.0 |

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The real determinant of the Canadian economic growth rate in 2014 will be the behaviour of the external sector. One thing that seems clear is that even when U.S. imports finally resume, the external sector will not support growth like it did in the 1990s. First, although we often cultivate the idea that Canada is an export economy, the external sector has hardly contributed to economic growth since 2000 (Graph 6). Second, the rise of the loonie over the last decade has eroded the Canadian economy's competitiveness and turned the current account to red. The result: Canada's market shares in the U.S. and in the rest of the world are in freefall (Graph 7). Finally, this lack of competitiveness has led several export industries, such as the automobile industry, to leave the country and set up shop elsewhere, including south of the border.

In short, although the Bank of Canada is not specifically targeting the value of the Canadian dollar, authorities are no doubt delighted with its recent depreciation, as it gives Canadian industries back a dose of competitiveness and increases the external sector's potential contribution to GDP growth in the coming years.

Financial markets

It has finally happened: "tapering" was announced at the end of the December 18 meeting of the Federal Open Market Committee (FOMC). The first step will be to reduce the monthly purchases of treasury bonds and mortgage-backed securities by \$5

Chart 4 – Asset mix: Diversified Fund (FU040)

| | Min. | Neutral | Max. | Actual Weight | Over Weight (+)/ Under Weight (-) | Change in quarter |
|---------------------------------|-----------|------------|-----------|---------------|--------------------------------------|----------------------|
| Money Market | 0 | 5 | 25 | 7.5% | +2.5% | -0.5% |
| Canadian Bonds | 20 | 45 | 70 | 25.0% | -20.0% | 0.0% |
| International Bonds | 0 | 0 | 15 | 0.0% | 0.0% | 0.0% |
| Total – Bonds | 20 | 45 | 70 | 25.0% | -20.0% | 0.0% |
| Canadian Equities | 5 | 25 | 45 | 35.5% | +10.5% | -1.5% |
| U.S. Equities | 5 | 12.5 | 45 | 18.0% | +5.5% | -1.5% |
| International Equities | 5 | 12.5 | 45 | 14.0% | +1.5% | +3.5% |
| Total – Foreign Equities | 10 | 25 | 45 | 32.0% | +7.0% | +2.0% |
| Total – Portfolio | | 100 | | 100.0% | | |

billion each, slowing the monthly purchasing program from \$85 billion to \$75 billion. Subsequent revisions will depend on the quality of monthly data; any additional decreases will be decided and announced at the next FOMC meetings.

The Fed believes that the job market is showing sufficient improvement and that the time has come to reduce the pace of monetary stimulation, but insists that the recovery is still not sufficiently viable to walk without crutches.

The decision was more or less anticipated by the bond market, which had positioned itself for the possibility of such an announcement in December rather than in 2014. Rates for 10-year U.S. bonds had already gone from 2.5% to 2.8% between October and December based on the quality of the economic data and therefore barely reacted to the announcement. Meanwhile, world stock markets cheered the news, and the

Canadian dollar seems to be positioning itself to continue the decline begun earlier in 2013.

Now that tapering of the Fed's purchasing program is underway, we expect 10-year rates to gradually exceed the bar of 3.0% and to trade within a new range of 3.25% to 3.50% by next summer. The short part of the curve should be less sensitive since the Fed seems to have managed to anchor expectations that it will not raise its key rate before inflation accelerates considerably (above 2.5%) and before the unemployment rate drops below the 6.5% threshold.

The Canadian bond market reached the end of 2013 on a positive note, with the DEX Universe Bond Index offering a gain of 0.4% in the fourth quarter. Short-term bonds were up 0.8%, and long-term bonds were down -0.2%. Corporate BBB bonds emerged as the winners, up 1.1% in the last quarter of the year. For the year, only corporate bonds (+1.2%) and short-term bonds (+1.7%) posted gains, while the DEX Universe was down -1.2% and long-term bonds -6.2%. The big losers of the year were real return bonds, which declined -13.1%.

The U.S. stock market ended one of the best years in its history with a flourish, going from one high to the next since the end of October, with a total quarterly return of 10.5%

Chart 5 – Estimated Gross Returns for the Next 12 Months Starting on December 31, 2013

| Market indicators | Interest or dividend | + | Capital gains | = | Total estimated gross return |
|---|----------------------|---|---------------|---|------------------------------|
| DEX 91 day Tbill Index | 1.00% | + | 0.00% | = | 1.00% |
| DEX Universe Bond Index | 3.60% | + | (6.60%) | = | (3.00%) |
| Canadian stocks (S&P/TSX Composite Index) including dividends |▶ | | | | 6% to 8% |

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(14.3% in Canadian dollars) for the S&P 500 and 32.4% for the year (41.5% in Canadian dollars). Cyclical sectors were the driving force of 2013 (Graph 8), led by consumer discretionary (+43.1%), health care (+41.5%), and industrials (+40.7%).

The S&P/TSX posted a second positive quarter in a row with a total quarterly return of 7.3%, allowing it to post a gain of 13.0% in 2013. Sectors that performed best during the year were health care (+72.1%), consumer discretionary (+43.0%) and information technology (+37.3%). Only two sectors were down in 2013: materials (-29.1%), which unfortunately represent about 12.0% of the Canadian index, and utilities (-4.1%).

Stock markets in Europe, Asia and the emerging markets also ended the year on a positive note. The European market, represented by the MSCI Europe Index, bounced back with a total return of 7.9% in the fourth quarter (11.6% in Canadian dollars). The MSCI EAFE Index was up 5.7% (9.3% in Canadian dollars), the MSCI World Index was up 8.0% (11.7% in Canadian dollars), and the MSCI Emerging Markets Index ended the year on a second positive quarter with a gain of 1.9% (5.3% in Canadian dollars).

Asset allocation

The fourth quarter of the year progressed in keeping with our expectations: our diversified funds benefited from their high exposure to the stock market and to the U.S. dollar. Being underweight in bonds was also "profitable" given the reduction in prices that accompanied the sustained increase in interest rates since October.

More weight was granted to the EAFE market (European and Asian market) during the quarter in order to position the portfolio for

an expansion of markets in Europe and Japan in 2014. We believe the valuation of the European market in terms of the potential price/earnings ratio is certainly attractive, but that it will take a significant improvement in business earnings before market projections are realized, hence our caution.

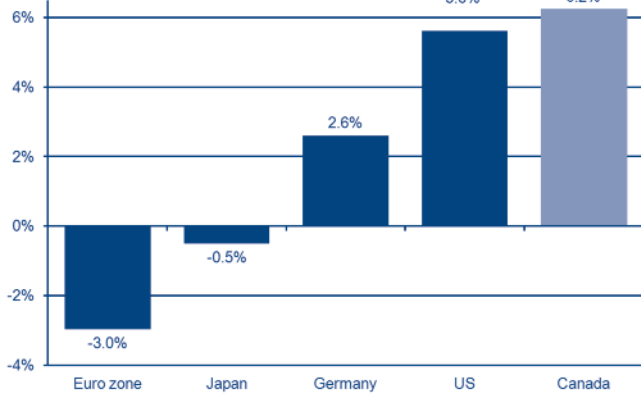
The emerging markets are also drawing our attention, but there too, we remain cautious. As discussed above, we must first gauge their reaction to the Fed's withdrawal of liquidity on the markets (and also assess the impact of the QE wave emanating from Japan). We are advocating a targeted regional approach, looking first to Latin America, which should profit from the U.S. recovery. It should be said that 2013 was not a very positive year for the emerging markets, and our diffusion index, which measures how many of these countries currently have a market index exceeding the 100-day moving average, deteriorated considerably in December, barely exceeding 50% at the year's end (Graph 9).

The year 2013 has shown the importance of making the right choices when it comes to asset allocation. The bond market ended the year with negative returns, as did the emerging markets, while the U.S. stock market enjoyed one of its best years of the last century. The year 2014 may not be as positive on the stock market, and will no doubt require going off the beaten track to generate additional returns. In our opinion, although more volatile and by definition more risky, the asset classes meriting greater attention in 2014 are corporate bonds in the fixed-income sector and, on the equities market, the stocks of small- and mid-cap Canadian companies.

ECONOMIC AND FINANCIAL ENVIRONMENT (CONTINUED)

Graph 4

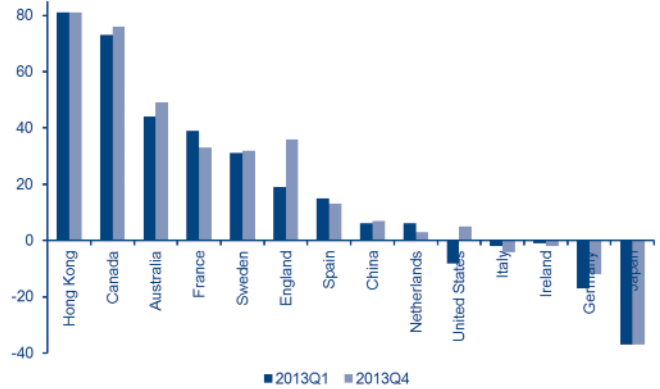
Q3 2013 Real GDP compared to pre-recession peak



Source: IA

Graph 5

Real estate: Canada among the most overvalued
% Under(-)/Over(+) valued against long-run average of price-to-rents ratio

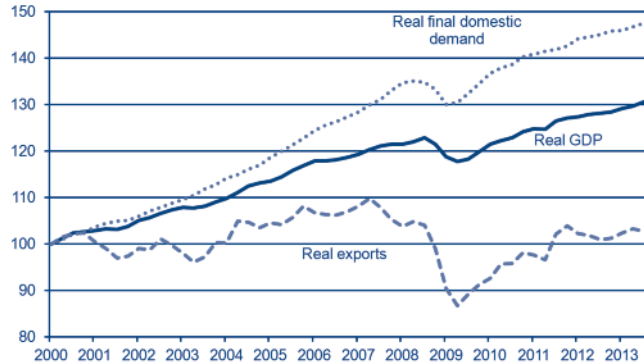


Source: IA

Graph 6

Canada: Exports will eventually have to take over

Real final domestic demand, GDP and exports
Index, 2000=100



Source: IA

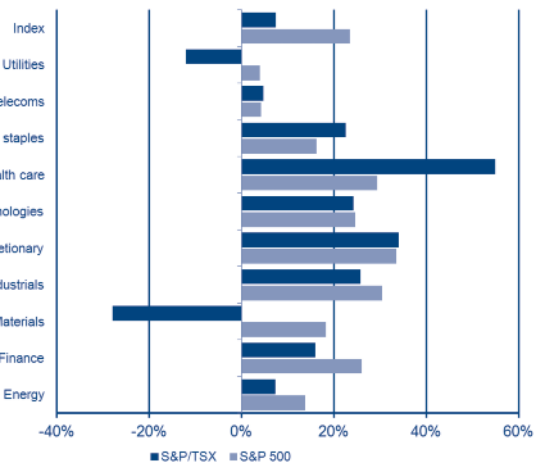
Graph 7

Canada has lost market shares in the last 10 years
% of imports coming from Canada, 12-month M.A.



Source: IA

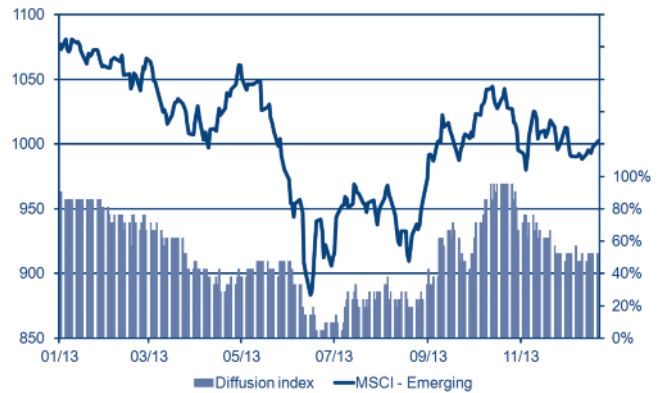
Graph 8



Source: IA

Graph 9

Emerging markets: Price and diffusion indices
% of countries where the price is higher than the 100-day moving average



Source: IA