AS AT MARCH 31, 2014

Polar vortex and geopolitical tension

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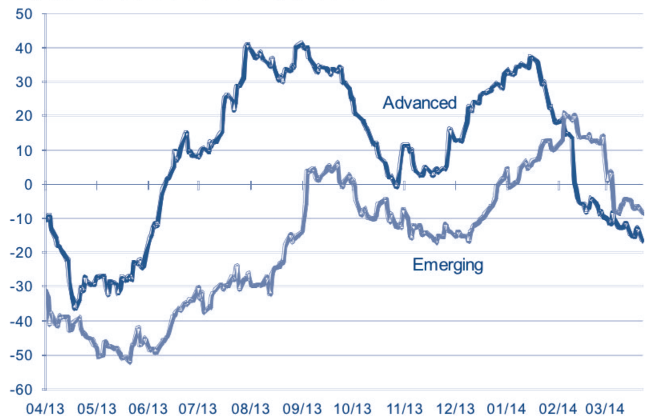
Canadians are not the only ones who experienced the harsh reality of winter this year. While last year it was the U.S. Congress holding back U.S. economic expansion, this time it was Mother Nature's turn. The loss in momentum of key U.S. indicators has created confusion in the markets since the start of 2014, with people wondering whether other underlying factors are not the cause. However, our in-depth analysis suggests that the U.S. private sector recovery has not broken down, and the apparent rebound of these same indicators at the end of the quarter seems to confirm this.

Extreme cold and precipitation affecting even the southern U.S. were not the only events to make headlines. There was also the tense situation in Ukraine, a country whose population's allegiance is shared between Europe and Russia, and which saw one of its strategic territories withdrawn in the results of a referendum that is still not recognized by the international community. Considering that Europe imports 30% of its natural gas from Russia, most of it passing through Ukraine, the situation is obviously disconcerting. Germany, which gets more than one third of its oil and gas from Russia, is pushing for a diplomatic resolution.

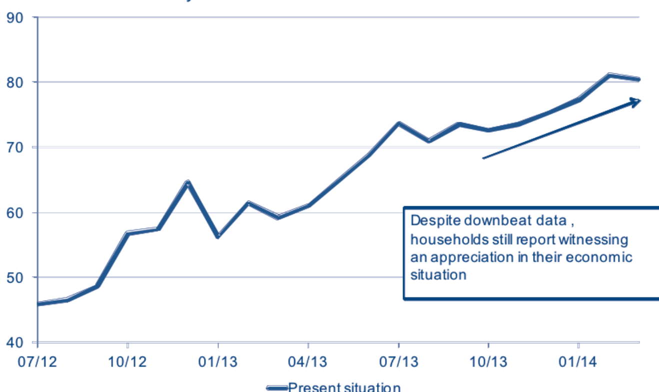
Graph 1



Source: IA

China is also giving the markets headaches, as it is believed to be exposed to a contagion effect within its financial system. China has taken a lot on its shoulders for the year 2014 and could disappoint economically, as the financial and structural reforms set in motion could generate uncertainty. At least, given the strong grasp the government keeps on its banking sector, China has all the tools necessary to manage turbulence within its financial system.

Graph 2



Source: IA

World

The major advanced economies are continuing their synchronized growth, despite the weather in North America and the situation in Ukraine. For the moment, it seems unlikely that the geopolitical turbulence created by Russia's annexation of Crimea will have any significant impact on the world economy, even though Europe is heavily dependent on Russian oil and gas.

Rather, the main source of economic concern on a world scale is China, which had the slowest start to the year in 10 years in terms of industrial production, retail sales and investments. It is becoming increasingly difficult to get a clear reading of the Chinese economic situation (we expressed concerns at the start of 2013, optimism at the end of the year, and now we are concerned once again!).

The Chinese administration has in fact set itself three aggressive objectives that could prove difficult, perhaps even impossible, to achieve. First, it wants to significantly reduce pollution, which will be no easy task for a manufacturing-based economy. Second, it is implementing deep structural reforms to its financial system. One should not forget that the Chinese economy is still largely controlled by the government, and that the banking system is no exception. Some Chinese businesses do not have access to credit through traditional banking channels and have to turn to non-bank credit (where

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interest rates are higher) for their financing, which has led to an explosion in the number of loans and, incidentally, in the potential risk of loan defaults. It is the spectre of a wave of defaults throughout the Chinese financial system that scares the emerging markets, even though the Chinese government recognizes the gravity of the situation and has stated that defaults will be kept under control. Third, the administration is maintaining a "flexible" yet aggressive growth target of 7.5%. In light of these objectives, it is reasonable to suspect that at least one of them may not be achieved!

In Japan, the positive momentum that was getting underway at the end of 2013 seems to have run out of steam. For the moment, the Abe plan has succeeded in pushing inflation into positive territory, a major victory for the Japanese administration. The turbulence within the emerging markets, however, seems to have turned Japan into a safe haven, as shown by the yen's appreciation since the start of the year. Moreover, increased energy imports in the post-Fukushima era have given Japan a negative trade balance, while one of the core objectives of the plan is to boost the economy through foreign trade, by taking advantage of a relatively inexpensive currency. The much-anticipated sales tax hike expected in April remains an element of concern for observers, especially considering that the anticipated effect of consumers moving up their purchases to the first quarter in no way appears in the data. In short, we will have to wait a few more quarters before seeing any tangible confirmation of the Abe plan's success.

Chart 1 – Returns of the Canadian Bond Market as at March 31, 2014

Index	Returns (%) 3 months	Returns (%) 1 year
FTSE TMX Canada Universe Bond Index	2.8	0.8
FTSE TMX Canada Short Term Bond Index	1.1	1.9
FTSE TMX Canada Mid Term Bond Index	3.2	1.2
FTSE TMX Canada Long Term Bond Index	5.1	(1.1)
FTSE TMX Canada Federal	2.1	0.1
FTSE TMX Canada Provincial	3.4	0.4
FTSE TMX Canada Municipal	3.2	1.6
FTSE TMX Canada Corporate	3.0	2.3

Source: Scotia Capital Debt Market Indices

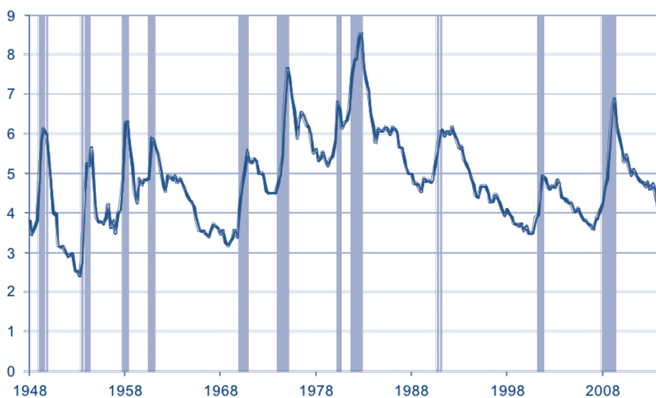
As mentioned above, emerging countries are experiencing some turmoil, although for the moment it is limited to the financial markets. It is true that the massive sums of capital invested in these countries were not always used to increase business productivity, but in the short-term, the dip in the financial markets does not seem to be supported by economic fundamentals. In our opinion, the emerging markets have mostly fallen victim to a repatriation of assets toward the developed countries, since the economic surprises were even rather positive at the start of the year (graph 1).

Europe remains nearly the only place where the economic news is generally positive (with the exception, of course, of the conflict in Ukraine). Household and business confidence continues to climb, economic growth has spread to most regions, and the rise in unemployment seems to have stopped at 12%. On the other hand, the spectre of deflation still hovers over the continent, with the euro trading near $1.40 and the continued contraction of credit. The European Central Bank (ECB) seems to have traced a line in the sand by putting the blame on the currency and now considers, among other options, implementing a quantitative easing program based on buying bank loans, in order to restart the credit cycle. A major risk factor in 2014 is still the heavy dependence of several European countries on Russian oil and gas, exposing them to a deterioration of the conflict in Ukraine, should Russia decide to take action against international sanctions.

Graph 3

U.S.: Short-term unemployment near historical lows

% of labour force unemployed since less than 27 weeks



Source: IA

United States

There has never been as much talk of the weather as in the first quarter of 2014. As evidence, the U.S. Federal Reserve's Beige Book, which summarizes comments collected by the Fed's district offices from businesses on economic conditions in their sectors of activity, contains no less than 119 mentions of the word "weather," compared to an average of about 15 since 1996 and a previous record of 40 in 2010. This unusual winter, characterized by record cold and precipitation (with snowstorms even in the south), had a major impact on economic activity. The sudden and brutal weakness of the economic indicators on the heels of a largely positive autumn pushed many to question the solidity of the current recovery.

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Despite the weakness of key indicators, such as employment, retail sales, construction starts and industrial output, we remain of the opinion that the weather explains almost all of the U.S. economy's apparent shortness of breath.

In such periods of upheaval, the approach we advocate is to study the fundamental factors that dictate the evolution of economic activity: consumer and business confidence, their readings of the current situation, and their intentions for durable goods purchases and investment. On the consumer front, the stability of the confidence indices and the improvement in the perception of the current situation are in no way compatible with an abrupt slowdown in retail sales or a sudden halt to job creation (graph 2). On the business front, same observation: the Institute for Supply Management (ISM) survey reports that business managers saw their activities hindered by weather conditions while their order books continued to swell. In short, if consumers are losing steam and companies have lost so much confidence as to put a sudden end to hiring, someone forgot to tell them.

The story is slightly different in the real estate market. After a hectic autumn with respect to construction starts and skyrocketing confidence indices, the market was probably due for a pause. Construction permits did not plummet as far as construction starts and are slowly increasing again, suggesting a moderate return to growth.

In short, following a forced pause in economic activity in the first quarter, accumulated pent-up demand should unfurl between now and the summer. The true test, however, will be the strength of the data in the second quarter.

Meanwhile, a number of factors are starting to convince us that inflation could emerge sooner than previously expected south of the border.

We believe the job market is currently much tighter than the overall 6.7% unemployment rate would suggest. People who have been unemployed for more than 27 weeks now represent only 4.2% of the active population (graph 3), indicating that the newly unemployed do not remain jobless for very long. In previous cycles, this "cleansing" of qualified unemployed workers came much later, at a time when inflation was already rising. At the same time, the portion of unemployed remaining jobless for more than 27 weeks is still much bigger than what we've seen over the last 50 years and does not seem to be progressing (graph 4). It seems, therefore, that there are two categories of workers: those whose skills are in demand and those who, unfortunately, have seen their human capital depreciate as a result of being unemployed too long and who have become less attractive to employers. The pool of workers is therefore more limited than headlines would suggest, implying that wage pressures could heat up sooner than anticipated, as competition intensifies to attract qualified resources. Signs of wage pressures are slowly appearing in the data and could build during the year.

Chart 2 – Market Returns as at March 31, 2014

Index	Returns (%) 3 months	1 year
FTSE TMX Canada 91 Day T-Bill Index	0.2	1.0
FTSE TMX Canada Universe Bond Index	2.8	0.8
S&P/TSX Composite Index	6.1	16.0
S&P 500 (Can. $)	5.8	32.6
MSCI - EAFE (Can. $)	4.6	27.9
MSCI - World (Can. $)	5.2	29.6
Exchange Rate (Can. $ / US $)	3.9	8.8

Canada

The depreciation of the Canadian dollar begun in the second half of 2013 continues. It should be said that the Bank of Canada seems to be doing everything possible (without resorting to its traditional tools) to keep the loonie close to the 90-cent threshold. The benefits of a weaker currency are clear: increased competitiveness of Canadian companies on the international market and inflationary pressures resulting from an increase in the cost of imported goods and services. The entire western world is trying to avoid deflation at all costs, and Canada may have found its antidote.

In the column of positive points, the recovery that is expected to accelerate in the United States in the coming quarters will necessarily be beneficial for the Canadian economy, which will also have gained in competitiveness in relation to its main competitors on the export market. The effect of a weakened currency does not usually become apparent immediately in company balance sheets, or even in national accounting. According to the literature, it

Chart 3 – Market Returns as at March 31, 2014

Index	Returns (%) 3 months	1 year
S&P/TSX Sector Returns		
Energy	9.6	19.5
Materials	9.7	(13.3)
Industrials	2.3	23.1
Consumer Discretionary	4.3	32.5
Consumer Staples	7.3	25.6
Health Care	12.6	57.8
Financials	3.0	22.2
Information Technology	5.8	23.7
Telecommunication Services	4.2	5.5
Utilities	8.7	3.7
S&P/TSX Composite Index	6.1	16.0

takes four to eight quarters before the stimulating effect can be seen, which brings us to the second half of 2014 at the earliest.

In February, the federal government presented its latest budget, which it projects should be balanced by 2015. That would make Canada the first G-7 country to rebalance its budget since the financial crisis. Canada remains a member of the select club of countries enjoying an AAA rating, and its sound management of public finances should enable it to continue enjoying some of the lowest borrowing rates in the world. Despite everything, however, Canadian bonds seem to have been losing their appeal for foreign investors since mid-2013 (graph 5), as medium-term Canadian interest rates have closed the gap relative to U.S. rates, primarily in reaction to the Bank of Canada's statement that it is not excluding a rate cut should inflation decline.

In the column of negative points, some of our concerns are growing. First, the real estate market, which we already consider expensive, quickened the pace in 2013, up 3.8% compared to 3.1% in 2012. One worrisome fact, in February 2014, prices continued to climb, but only in 7 of the 11 markets surveyed by the Teranet–National Bank index. Victoria, Quebec City, Halifax and Ottawa-Gatineau all saw their prices drop on a year-over-year basis, indicating that holes are starting to appear in a market that has been defying gravity for the past several years (graph 6).

Chart 4 – Asset mix: Diversified Fund (FU040)

	Min.	Neutral	Max.	Actual Weight	Over Weight (+)/ Under Weight (-)	Change in quarter
Money Market	**0**	**5**	**25**	**4.0%**	**-1.0%**	**-3.5%**
Canadian Bonds	20	45	70	30.0%	-15.0%	+5.0%
International Bonds	0	0	15	6.0%	6.0%	+6.0%
Total – Bonds	**20**	**45**	**70**	**36.0%**	**-9.0%**	**+11.0%**
Canadian Equities	**5**	**25**	**45**	**34.0%**	**9.0%**	**-1.5%**
U.S. Equities	5	12.5	45	18.0%	+5.5%	0.0%
International Equities	5	12.5	45	8.0%	-4.5%	-6.0%
Total – Foreign Equities	**10**	**25**	**45**	**26.0%**	**1.0%**	**-6.0%**
Total – Portfolio		**100**		**100.0%**		

Second, business investment intentions are slowing. In total, firms are planning on increasing their capital spending by only 1.4%, which would be the lowest increase since the financial crisis. A survey by the Bank of Canada also reveals that planned capital spending is intended primarily for the upkeep of equipment and machinery, and not to increase productive capital. Many would like to see economic growth depend less on consumption and more on investment, but that does not seem to be the direction we are headed in this year.

Despite these concerns, the Canadian economy expanded 2.0% in 2013, ahead of the U.S., where growth was 1.9%. Canada therefore continues to rank first within the G-7 in terms of growth since the pre-crisis peak. Growth rates for the first two quarters of 2013 were both revised upward by 0.6%, while a growth rate of 2.9% was recorded for the fourth quarter. One important reservation, however, is that the accumulation of inventory explains half of the last quarter's growth, suggesting that a portion may have been borrowed from the start of 2014.

Financial markets

The change of guard took place at the U.S. Federal Reserve, and Janet Yellen is now at the helm. At her first press conference at the end of March, the new chair surprised some by going as far as to provide a provisional timetable for the changes to U.S. monetary policy. In short, tapering should continue at a rate of $10 billion per meeting, which means the bond purchases should logically end in the fall. After that, short-term rates should remain low for a "considerable time," which Ms. Yellen estimates to be about six months. This would imply a first rate hike in the spring of 2015. Moreover, forecasts by FOMC members, published at the same time, indicate that most of them foresee a policy rate of at least 1% at the end of 2015. Our reading matches this scenario, especially considering that the effects of the weather will likely cause growth in the second quarter to be more vigorous than expected, which could prompt the Fed to launch its exit strategy sooner.

The negative tone of the economic data has been casting doubt over the bond market since the start of the year. The raising of

Chart 5 – Estimated Gross Returns for the Next 12 Months Starting on March 31, 2014

Market indicators	Interest or dividend	+	Capital gains	=	Total estimated gross return
FTSE TMX Canada 91 Day T-Bill Index	1.00%	+	0.00%	=	1.00%
FTSE TMX Canada Universe Bond Index	3.50%	+	(3.90%)	=	(0.40%)
Canadian stocks (S&P/TSX Composite Index) including dividends			→		11% to 13%

interest rates begun last summer came to an abrupt halt in January, pushing 10-year U.S. rates up to 3.0%, before bringing them back in the range of 2.6% to 2.8%. We are still expecting them to climb into the range of 3.25% to 3.50% sometime this year.

The Canadian dollar also had a rough quarter, sliding from $0.94 at the beginning of January to less than $0.89 in March — its lowest in five years. Although historically the price of natural resources has played a dominant role in the loonie's evolution, it is now governed by the divergent expectations toward Canadian and U.S. monetary policies (graph 7). The negative tone of the BoC, which continues to repeat that a lowering of interest rates is not to be excluded, and the less and less conciliatory tone of the Fed are causing the spread between Canadian and U.S. 5-year bond rates to hover around zero, which in turn is lessening interest in Canadian securities. Judging from the BoC's determination, we should not see the dollar climb back up in the coming quarters.

The Canadian bond market began the year on a positive note, with the FTSE TMX Canada Universe Bond Index up 2.8% in the first quarter. Short-term bonds were up 1.1%, while long-term bonds benefited from the drop in rates to register a gain of 5.1%. Meanwhile, BBB-rated corporate bonds posted a gain of 3.0%. Since the start of the year, exposure to duration has been the main source of return on the bond market, as can be seen by real bonds advancing 6.1%.

After one of the best years in its history, the U.S. stock exchange was ripe for a pause. The beginning of the year was rather positive, down in January but back up in February and reaching a new historic peak in March. The S&P 500 therefore posted a total quarterly return of 1.8% (5.8% in Canadian dollars), led by utilities (+9.0%), health care (+5.4%) and materials (+2.3%).

On the Canadian stock market, the S&P/TSX benefited from renewed interest in natural resources and gold stocks, posting a total quarterly return of 6.1%. The sectors offering the best performances for the quarter were health care (+12.6%), materials (+9.2%) and energy (+8.7%). Meanwhile, the S&P/TSX Small Cap Index started the year with an appreciable performance of 7.9%.

Stock markets in Europe, Asia and the emerging markets were off to a more lukewarm start, in reaction to concerns over a slowdown in China and the tense situation in Ukraine. The European market, represented by the MSCI - Europe Index, gained 1.2% in the first quarter (5.5% in Canadian dollars); the MSCI - EAFE Index lost 0.9% (+4.6% in Canadian dollars); and the MSCI - World Index was up 0.5% (5.2% in Canadian dollars). Finally, the MSCI - Emerging Markets Index was down 0.9% (+3.5% in Canadian dollars).

Asset allocation

After a record year on the stock markets, a slowing of pace was to be expected. Last year, the current price/earnings ratio of the U.S. market went from 14.1 to 17.0, pushing the valuation above the historic average, but to levels that are still reasonable if we consider the weakness of inflation. Historically, when inflation has been between 1% and 3%, as is currently the case, the S&P 500's price/earnings ratio has averaged 18.0, which implies that there is still room for expansion (graph 8). Moreover, if we look at the 10 years that delivered the highest returns in the history of the S&P 500 (the year 2013 now ranks sixth), we notice that the average return of the following year is about 14% and that, with only one exception, the return is always positive (graph 9). Weak economic data and geopolitical events may have slowed stock market enthusiasm at the start of the year, but we maintain a positive bias toward the U.S. stock market.

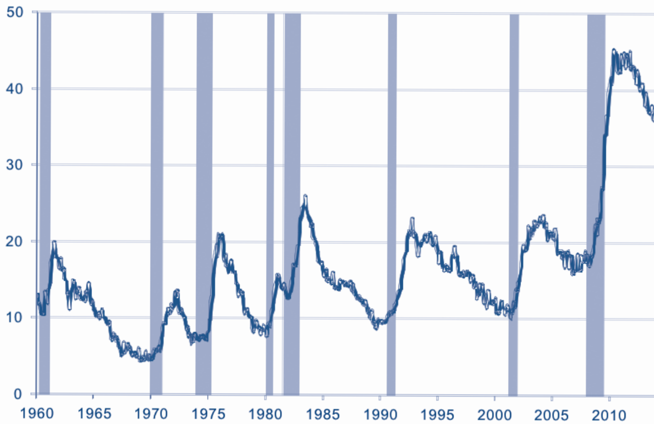
Our exposure to the EAFE stock market (European and Asian market) was corrected downward in the first quarter, for two reasons. First, our main diversified fund is in the "Canadian balanced funds" category, and to this end, it has to respect certain constraints in terms of its exposure to the various asset classes. With a view to adhering to a rule that imposes, on a moving average of 36 months, a maximum exposure of 30% to foreign assets and 60% to equities, we reduced our exposure to international equities from 14% to 8%, and opted to keep our exposure to the U.S. market to close to 20%. Second, in light of the accumulation of troubling factors affecting Eurasia (conflict in Ukraine) and China, our concerns over profit growth in Europe remain real.

Exposure to Canadian equities was also reduced to 34% given the adjustment that needed to be made to the weight of equities. During the quarter, we made room for small-cap stocks within Canadian equities, because we are confident that small Canadian exporting companies will benefit directly from the U.S. recovery and, especially, from the sustained depreciation of the loonie.

The diversified portfolios under our responsibility contain no exposure to the emerging markets, despite some signs suggesting a trough may have been reached in February. For the moment, we are keeping our eyes on a few key markets where we have a positive outlook for the economic situation in the medium term, but patience is required.

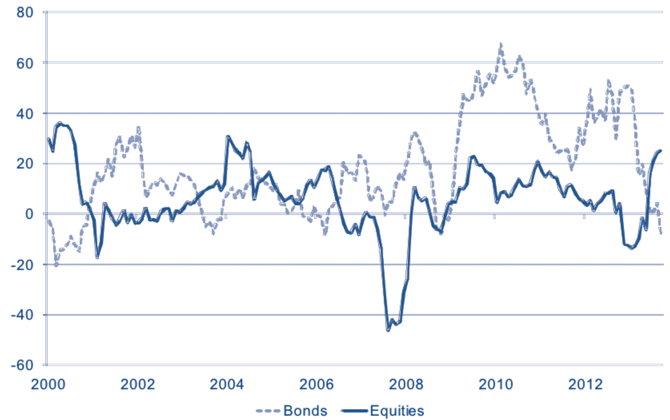
We are convinced that interest rates are getting ready to begin a steady ascent in the coming quarters. In addition to underweighting fixed-income securities overall, we deem it appropriate to reduce the duration of our portfolio by increasing the weight of the monetary market and by making place, within bonds, for shorter-term securities.

Graph 4



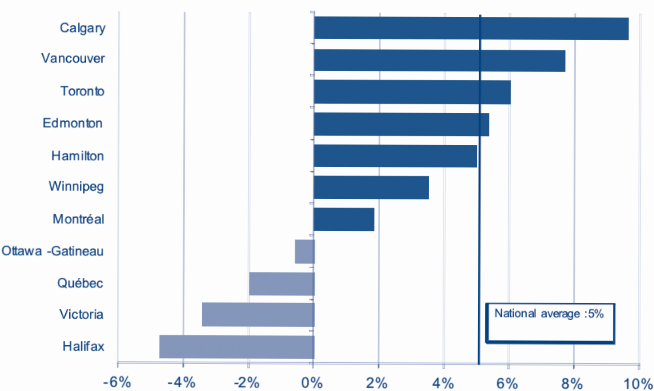
Source: IA

Graph 5



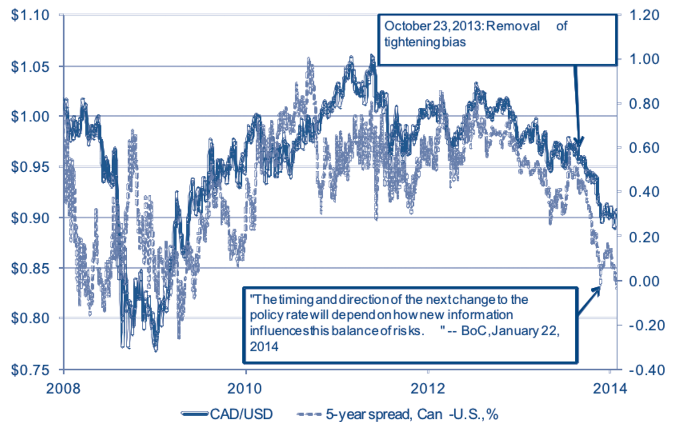
Source: IA

Graph 6



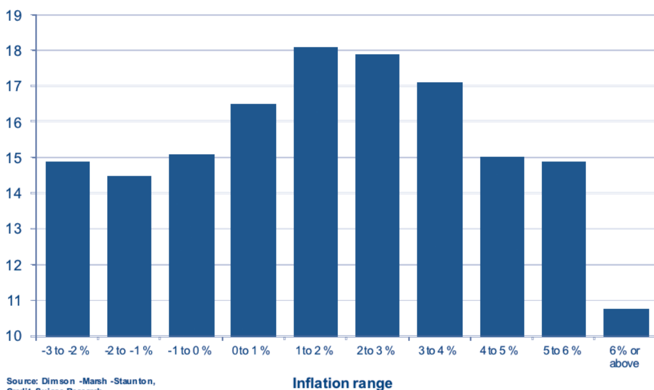
Source: IA

Graph 7



Source: IA

Graph 8



Source: IA

Graph 9

The best years in the history of the S&P 500

Year	Return	Following year
1954	45.0%	26.4%
1958	38.1%	8.5%
1995	34.1%	20.3%
1975	31.5%	19.1%
1997	31.0%	26.7%
2013	29.6%	??
1989	27.3%	-6.6%
1998	26.7%	19.5%
1955	26.4%	2.6%
2003	26.4%	9.0%
Average	31.8%	13.9%

Source: IA