Special

MARKET OUTLOOK

Continued U.S. economic resurgence bodes well for market returns

Clément Gignac, chief economist at Industrial Alliance, is part of a team that manages close to $3-billion in balanced fund assets. A keen market observer for more than four decades, he shares his uniquely informed views on the questions that investors are asking.

In your view, should the impressive performance of the U.S. stock market be a reason for concern for Canadian investors?
When you take a breath and look back, it's impressive to see the S&P 500 close to 2,000, depending on the day. The U.S. market has recovered nicely from the trough. During 2009, it was thought that this recovery would be long – a U or L shape – and people made parallels with Japan.

Today we see a 200 per cent recovery, more or less.

The S&P 500 now trades at about 16 times forward earnings, which is acceptable when you have a 10-year U.S. bond yield of 2.5 per cent. Earnings have been strong since the beginning of the year, and it is interesting to see the resilience of the U.S. economy as well as the performance of the stock market.

Make no mistake: we are vulnerable to a reality check and correction at any time, as we haven't seen a correction, defined as a decline of more than 10 per cent, in the last two years. But I don't see a bear market occurring – a 20 per cent or greater correction – because bear markets are associated with a recession or with a disequilibrium related to inflation. The U.S. stock market is still overweight in our portfolio. With the Canadian dollar trending lower, the currency adds additional performance.

The TSX has performed better than the S&P 500 in local currency so far this year, but looking ahead, I still believe that the U.S. market offers greater value on a risk-reward basis. It provides much better market breadth and diversification, with exposure to technology.

What is your view on the bond market?
We maintain a short duration portfolio, and it was definitely the right strategy last year. For the first eight months of this year, however, it was painful because rates have been moving lower.

Bonds are less risky than stocks at first glance, but it depends how you measure and define risk.

I'm reluctant to recommend financing the Canadian government at the current rate for the next 10 years. Yes, the Government of Canada will not file for bankruptcy, but 2.2 per cent, the current 10-year bond yield, is not an appropriate price. With a two per cent inflation target, the 10-year bond yield is normally closer to 3.5 per cent.

When the Federal Reserve completes its exit strategy from quantitative easing (QE) and normalizes its lending rate next year, it is likely we'll then see 10-year Canadian bond yields closer to 3.5 per cent.

We can't predict the future, of course. But if we're right, and there is a 100-basis-point increase on the 10-year bond yield over the next two years, there is a high probability of experiencing negative returns in bond portfolios, just as in 2013 and 1994.

While it is essential to have exposure to the bond market for diversification, I recommend choosing short duration provincial bonds or corporate bonds, which provide additional yield.

With the decline of natural gas prices, companies have become much more competitive, and we're now seeing a renaissance of the U.S. manufacturing sector.

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What is your view on the U.S. economy looking forward?
If we look back, again, to 2008 and 2009, there was a great deal of pessimism about a U.S. economic recovery. But you have a huge game changer, starting in 2008 and accelerating after, in the energy revolution. Nobody really talked about shale oil and shale gas before then, because fracking was a new technology.

When you analyze the situation now, corporate America has cleaned its balance sheets and begun to invest again. Consumer confidence and housing prices have rebounded; job creation is accelerating, with the private sector creating more full-time jobs. The unemployment rate is about six per cent compared to 10 per cent five years ago.

The U.S. energy revolution contributes about 2.5 per cent to the country's annual economy growth. For the past three decades, the U.S. had become increasingly dependent on imported oil, particularly from the Middle East. Suddenly, in just the past five or six years, the production of energy in the U.S. has returned to a level not seen since the beginning of the 1970s. That means that the trade deficit has improved, with money being spent in the U.S. rather than sending cheques to the Middle East or other countries. With the decline of natural gas prices, companies have become much more competitive, and we're now seeing a renaissance of the U.S. manufacturing sector.

All in all, we are back in a sustainable recovery, and QE will be over by next month. The question is when the interest rate normalization will start – as the inflation rate is currently around 1.5 per cent or two per cent, the Federal Reserve could take its time to start the normalization process, which is good for the stock market.

It's always a mistake to underestimate the ability of Uncle Sam's economy to make a comeback.

The U.S. energy revolution contributes about 2.5 per cent to the country's annual economy growth. ISTOCKPHOTO.COM

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