AS AT MARCH 31, 2015

Oil dominates the headlines

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The oil market has been at the forefront of financial news since the beginning of the year, even beating out analysts' obsession with trying to decode the U.S. Federal Reserve's intentions.

The price war that OPEC has been waging against "new producers," which is to say, Canada and the U.S., is in full swing and shows no sign of letting up. All eyes are on two indicators that investors had largely ignored until now: the number of active drilling rigs and the number of barrels extracted from the ground and stored somewhere in the United States.

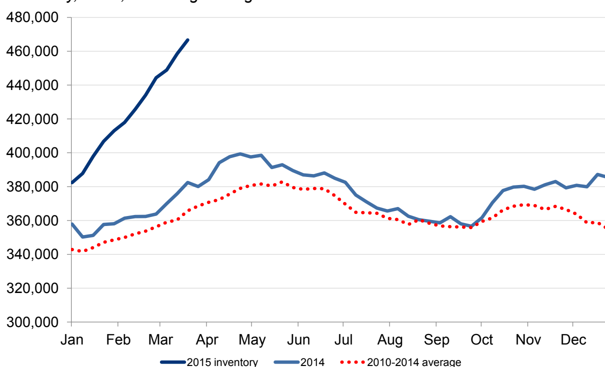
Despite the sharp drop in the number of active drilling rigs (Graph 1), total production continues to increase and should even show positive annual growth in 2015, according to the International Energy Agency. As for the amount stored, we're seeing a veritable race against the clock, as the maximum storage capacity on American soil could be reached by mid-year (Graph 2). Current market dynamics are such that it is more profitable for producers to sell their production forward, that is, to enter into a sales contract with delivery at a later date (such as in 12 or 24 months) and to temporarily stockpile production. Should the storage capacity become saturated, as some specialists are predicting, producers would then be forced to sell their production on the "spot market" (with immediate delivery), which would add to the massive downward pressure on world prices. The reason is that a shale-oil well must be exploited quickly once drilling has begun; one can't simply close the valves and wait for market conditions to improve.

Graph 1

Source: IA

We are keeping a keen eye on non-commercial positions, which have nothing to do with the physical supply and demand for oil but rather the speculation engaged on the financial markets over what will happen with oil prices. After having peaked in mid-2014, the level of net speculative positions remains very high, indicating that speculators are expecting a quick rebound in prices (Graph 3). We view this as a sign that there is still some complacency among investors and, before adopting a positive discourse toward this market's outlook, we expect to see signs of capitulation and significant damage to the North American industry. For the moment, we do not see any.

Graph 2



Source: IA

World: India outpaces China

The slowdown in China continues, as the country faces a credit bubble that threatens the stability of its financial system. Overbuilding and recourse to non-traditional credit sources have injected a dose of fear into the markets and have been hampering the launch of new investment projects, pushing the Chinese administration to intensify its stimulus plans and the central bank to relax its monetary conditions. These measures have had limited effects so far given the reluctance of businesses to borrow, as they prefer instead to purge any excess credit from their balance sheets.

For the first time since a brief period in the late 1990s, Indian economic growth surpassed that of China in 2014. According to the World Bank and the International Monetary Fund, in one or two years, this will become the norm. India is in fact a precious gem within the emerging countries, with a new government advocating growth and implementing a clear and complete program of reforms, generating a strong appetite for foreign investment. Contrary to a good number of emerging countries, including Brazil, Russia and South Africa, the decline in oil prices has had a stimulating effect on India, which imports 80% of the oil it consumes. In terms of its contribution to world growth, however, it should be noted that India is 2.5 times smaller than China, and that its contribution to world GDP, even with stronger growth, is therefore much smaller (Graph 4).

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Meanwhile, Japan seems to have broken free from deflation for the first time in 15 years (Graph 5), with the exception of a brief period in 2009. The Abe plan continues to show signs of success, although the progress is not as rapid as initially hoped. Prime Minister Shinzo Abe now seems to have convinced major automobile and electronics manufacturers to significantly raise wages in order to generate inflation while supporting household purchasing power. Investors seem to believe in the plan's chances for success, making the Nikkei one of the stock markets with the best returns since the start of the year.

Europe: source of good news

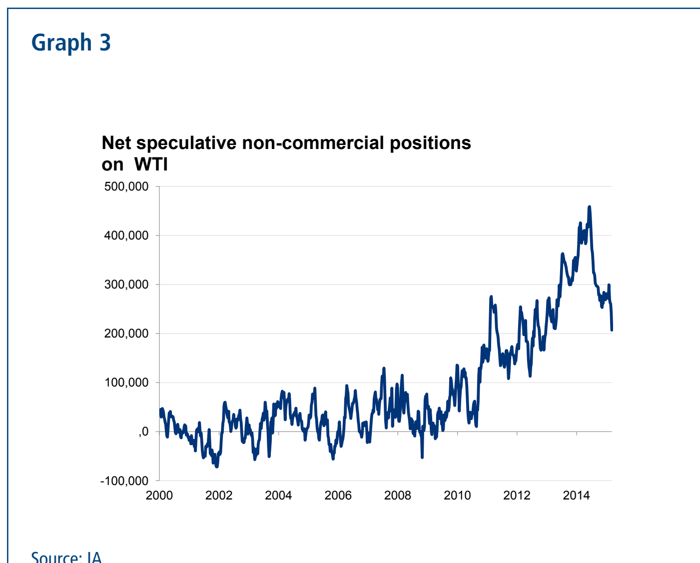
Signs of a solid recovery are appearing in Europe, with most of the economic data coming in surprisingly positive (Graph 6). Expectations were naturally very low, after several years of disappointment and new starts in the Euro zone, but it is clear that some momentum is finally taking hold, at a time when Chinese and U.S. indicators have been repeatedly disappointing.

The event of the quarter was no doubt the start of the European quantitative easing program, which should continue at least until September 2016. This program consists in buying securities on the secondary market, including sovereign bonds, in proportions dictated by the relative size of each of the euro zone economies.

Among our preferred indicators, the primary and most important is no doubt the credit cycle, which is about the return to positive territory this year (Graph 7). The European economy has a very distinct characteristic when it comes to the importance of banks as the economy's transmission belt. Unlike in the North American market, businesses are financed primarily through banks. This is even truer for SMEs, which alone account for 90% of job creation in the euro zone, and which are even more dependent on the banking sector. The resulting equation is simple: to create jobs, you have to get banks to lend money.

One of the measures put in place in 2014 by the European Central Bank sought precisely to encourage banks to lend money to companies, by providing them

Graph 3



Source: IA

Chart 1
Returns of the Canadian Bond Market as at March 31, 2015

Index	Returns (%)	
	3 months	1 year
FTSE TMX Canada Universe Bond Index	4.2	10.3
FTSE TMX Canada Short Term Bond Index	1.9	3.9
FTSE TMX Canada Mid Term Bond Index	4.3	10.3
FTSE TMX Canada Long Term Bond Index	7.1	19.7
FTSE TMX Canada Federal	3.3	8.2
FTSE TMX Canada Provincial	5.7	14.6
FTSE TMX Canada Municipal	4.7	13.0
FTSE TMX Canada Corporate	3.6	8.2

Source: Scotia Capital Debt Market Indices

cash at very low interest on the condition that the banks show growth in their loan portfolio. After two failures at the end of the year, a third wave of liquidity offered in March was met with twice the demand anticipated, bolstered by an additional decrease in the cost of these liquidities for banks in January. Given the favourable movement of the credit cycle that began even before the start of the quantitative easing program, there is a slight chance that the ECB will not need to carry out its full program.

United States: another rough start

While economic data are exceeding expectations in the Euro zone, the situation is quite the opposite in the United States. In a way that is rather similar to the start of last year, the U.S. economy seemed to be dragging its feet in the first quarter, a phenomenon that took us a bit by surprise after the second half of 2014, when the job market was breaking records.

The main sources of this disappointment are related to U.S. consumers, who alone account for 70% of the size of the first world's economy.

First, retails sales slowed considerably, when sharp gains in employment should have led to an increase in household consumption. On this front, it is important to remember that retail sales account for only one third of household consumption, with services making up the major part of spending. Despite this, there has been a clear change in the behaviour of consumers, who are saving more than previous generations. The ageing of the population is also a major factor, resulting in a growing number of retirees whose spending habits are more highly concentrated in services than durable goods.

Second, although we are still expecting wage pressures to materialize, given the strong growth in jobs and the economy in 2014, this has not happened yet. While it is difficult to reduce the analysis to a single cause, the surplus in labour—those who had been on the sidelines since the end of the recession—is definitely a major factor. In short, workers probably do not yet have enough negotiating room with their employers to demand wage increases (for example,

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Chart 2
Market Returns as at March 31, 2015

Index	Returns (%)	
	3 months	1 year
FTSE TMX Canada 91 day T-bill Index	0.2	0.9
FTSE TMX Canada Universe Bond Index	4.2	10.3
S&P/TSX Composite Index	2.6	6.9
S&P 500 (Can. $)	10.4	29.4
MSCI - EAFE (Can. $)	14.7	13.7
MSCI - World (Can. $)	11.9	21.7
Exchange Rate (Can. $/US $)	9.3	14.7

Chart 3
Market Returns as at March 31, 2015

Index	Returns (%)	
	3 months	1 year
S&P/TSX Sector Returns		
Energy	(1.1)	(14.1)
Materials	3.3	(8.2)
Industrials	1.6	21.0
Consumer Discretionary	6.1	31.3
Consumer Staples	3.4	43.6
Health Care	45.1	67.9
Financials	(0.2)	10.3
Information Technology	8.7	38.8
Telecommunication Services	0.2	11.1
Utilities	3.5	10.5
S&P/TSX Composite Index	2.6	6.9

in January alone, more than one million Americans decided to return to the job market, eliminating any scarcity in workers that had come from the 3 million jobs added in 2014). Generally speaking, history shows that wage pressures appear when the unemployment rate dips below its long-term equilibrium level (commonly known as the "natural rate of unemployment"), estimated between 5.2 and 5.5%, which will likely be reached in 2015.

A lot of ink is being spilled over the lack of wage increases, and some analysts explain the weakness in retail sales or the sudden slowdown in the housing sector by the fact that the average hourly wage of workers is growing more slowly than in the past. On this topic, we believe that the most important variable for explaining the aggregate changes in consumer demand is not the average wage, but rather the growth in the global wage bill (Graph 8). A quick look at the data shows not only that the total wage bill is expanding nicely, bolstered by the historic surge in employment since the start of 2014, but that the consolidated purchasing power of U.S. consumers has grown at a pace similar to the peaks of previous cycles. In short, although household consumption may have stagnated at the beginning of the year (as compared to a pace of 4.4% in the fourth quarter of 2014, an eight-year high), it is certainly not due to a lack of growth in the average hourly wage but rather, as mentioned earlier, to a sharp renewal in the propensity to save.

Canada: a difficult first half of 2015 expected

The Bank of Canada caused quite a surprise in January when it cut its key rate to 0.75 per cent, just one month after having talked about broadening the foundations of the recovery and its intention to turn its attention again to the overvaluation of the housing sector and the high levels of household debt.

This softening of monetary policy is, according to BoC Governor Stephen Poloz, a form of "insurance" against the negative effects of the rapid drop in oil prices since last summer. This decision had an immediate and pronounced effect on the loonie, which quickly fell below the threshold of 80 cents against the U.S. dollar. The Bank's message is clear and pessimistic: Canadian data will no doubt be poor in the first half of the year because the negative effects of a lower price for our primary export will be felt immediately, whereas the positive effects (weaker loonie, lower prices at the pump, etc.) will be felt much more gradually.

One of the most telling indicators of the negative effects of the drop in the price of crude is no doubt the real estate market. In Alberta, since the end of 2014, the number of home sales concluded has fallen drastically while the number of newly listed homes has jumped, reflecting the fact that owners are becoming distinctly more nervous about the long-term value of their homes and creating a sudden imbalance in the market. The Alberta market quickly turned into a buyer's market, while the Canadian market outside of Alberta remains balanced.

A troubling conclusion can also be drawn from the distribution of employment growth in the country in 2014, since more than 80% of jobs created were located in the western part of the country, precisely where the price collapse will hit the hardest in 2015 (Graph 9). The Canadian economy will therefore need new regional leadership over the coming quarters, and hopes have turned toward Quebec and Ontario, which stand to benefit the most from the weaker loonie. Indeed, data published over the first two months of the year show that job creation has migrated toward the centre of the country (Graph 10) but, unfortunately, this migration is not sector-based.

In the first two months of the year, although the natural resources sector shed about 25,000 jobs, the manufacturing sector did not take up the slack but also saw a decline in employment, although to a lesser degree, by about 9,000 jobs. Moreover, all the jobs created in Quebec as well as a large portion of those created in Ontario were part-time, indicating that the hoped-for transition to other sectors is not taking place and that the change in leadership has not been consolidated.

We are therefore of the opinion that the Canadian economy will show weakness in 2015 and that, in an environment where oil prices are likely to

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Chart 4
Asset mix: Diversified Fund (040)

	Min.	Neutral	Max.	Actual Weight	Over Weight (+)/ Under Weight (-)	Change in quarter
Money Market	**0**	**5**	**25**	**10.5%**	**+5.5%**	**+1.5%**
Canadian Bonds	20	45	70	28.0%	-17.0%	-6.0%
International Bonds	0	0	15	0.0%	0.0%	0.0%
Total – Bonds	**20**	**45**	**70**	**28.0%**	**-17.0%**	**-6.0%**
Canadian Equities	**5**	**25**	**45**	**32.0%**	**+7.0%**	**+5.5%**
U.S. Equities	5	12.5	45	11.0%	-1.5%	-3.5%
International Equities	5	12.5	45	15.5%	+3.0%	-0.5%
Emerging Markets	0	0	45	3.0%	+3.0%	+3.0%
Total – Foreign Equities	**10**	**25**	**45**	**29.5%**	**+4.5%**	**-1.0%**
Total – Portfolio		**100**		**100.0%**		

remain under pressure, we can expect its underperformance in relation to the U.S. economy to persist. The depreciation of the loonie combined with an acceleration of the U.S. economy could, however, bring a positive surprise in the manufacturing sector during the year.

Financial markets: central banks dominate

For better or for worse, it was once again the central banks that set the tone on the financial markets at the start of the year.

In order of importance for Canadian investors, the Bank of Canada decided to lower its key rate in January, dragging the loonie down from 86 cents to a low of 78 cents in March. Thanks to this depreciation, returns in Canadian dollars for foreign investments were boosted by about 10%, giving investors with a world outlook a very strong return for the beginning of the year.

South of the border, the U.S. Federal Reserve has markets holding their breath with the choice of words used in its statements. Generally, the consensus expects the Fed to raise its key rate this year, for this first time since 2006, sometime between June and September. The weakness in U.S. data at the beginning of the year tempered expectations somewhat, although the sustained vigour of the job market argues in favour of a necessary normalization of monetary policy. As they wait for that fateful moment, markets are hanging on every word of the members of the decision-making Federal Open Market Committee (FOMC). Up until March, emphasis was on the word "patient," but that has been removed from the press releases. The latest release states that it is "unlikely" that the Fed will raise rates in April and goes to great lengths to explain that the absence of "patience" does not imply that the Fed has become impatient.

The handling of monetary policy now depends on the quality of the data published; we can therefore expect more and more volatility as summer approaches. We can also expect negative economic news to once again be perceived as positive by the stock market (as an indication that the accommodating monetary policy will continue) and that good economic news will have a negative impact on the markets.

Finally, it is now the European Central Bank and the Bank of Japan who are printing colossal amounts of money to stimulate their respective economies through the credit cycle. It is important to remember that, together, these two banks are injecting more cash each month than the Fed was injecting at the height of its quantitative easing program. Since cash inevitably finds its way into the financial markets, a number of trends are highly probable: 1) world interest rates (including North American rates) should remain under pressure for the coming quarters; 2) the U.S. dollar should be sustained by the incessant demand for U.S. bonds offering superior returns than those possible in Europe or in Japan; and 3) the European and Japanese stock markets offer attractive growth potential in light of the overall improvement in economic data and the easy access to liquidity.

Meanwhile, the U.S. stock market could start to lose steam in 2015, after two years of strong returns. Growth expectations for business earnings are very low for the coming year, pushed downward by the energy sector. Gains on the U.S market this year may come entirely from an expansion of multiples, which are already high in historical terms. The rapid decline of the loonie in January allowed Canadian investors to reap some attractive returns, but we believe the currency's contribution is likely to be lower, or even nonexistent, in the coming quarters.

On the Canadian stock market, given the importance of the natural resources, energy, and banking sectors, it is difficult to formulate clear expectations for the year's returns. We are still of the opinion that the fundamentals will keep oil prices low, but the constant possibility of a geopolitical event in the Middle East, for example, makes a rapid rebound in the price of our primary export product likely to materialize sooner than anticipated. As for banks, following warning messages from the Bank of Canada last December, we are being cautious in formulating our expectations given the impact that a warning message from Governor Poloz would have on this major segment of our stock market. We are therefore watching the Canadian market carefully and remain poised to step up our investments should favourable conditions return.

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Chart 5
Estimated Gross Returns for the Next 12 Months Starting on March 31, 2015

Market indicators	Interest or dividend	+	Capital gains	=	Total estimated gross return
FTSE TMX Canada 91 Day T-Bill Index	0.45%	+	0.00%	=	0.45%
FTSE TMX Canada Universe Bond Index	3.20%	+	(5.60%)	=	(2.40%)
Canadian stocks (S&P/TSX Composite Index) including dividends					10% to 12%

The bond market remains a source of concern since it would take a total increase in interest rates of just 40 to 60 basis points in 2015 for investors to obtain negative yields in their bond portfolios. There has also been a sharp increase in volatility. However, the Canadian market continues to show expectations of a second rate cut by the Bank of Canada this year, despite a decreasing level of conviction since January, which could keep Canadian bond market prices at high levels.

The Canadian bond market began the year in the green, thanks to the Bank of Canada. The FTSE TMX Universe Bond Index gained 4.2% in the first three months of the year. Short-term bonds were up 1.9%, and long-term bonds climbed 7.1%. Corporate BBB bonds were up 3.6%.

The S&P 500 was flat, despite a strong February, ending the quarter with a total quarterly return of 1.0% (10.4% in Canadian dollars). The Canadian stock market also lacked conviction, weighed down by the energy sector. The S&P/TSX posted a total return of 2.6% in the first quarter. Meanwhile, the S&P/TSX Small Cap Index posted a slight gain of 0.3% .

Stock markets in Europe, Asia and the emerging markets were off to a strong start, shored up by Europe’s quantitative easing program. The European market, represented by the MSCI - Europe Index, was up 18.9% (15.3% in Canadian dollars), the MSCI - EAFE Index climbed 10.8% (14.7% in Canadian dollars) and the MSCI - World Index gained 4.9% (11.9% in Canadian dollars). Finally, the MSCI - Emerging Markets Index was up 4.9% (11.8% in Canadian dollars).

Asset allocation: international shift

In the first quarter, we maintained an international position in equities within our diversified funds, primarily in Europe and Japan, as we see rising potential in these regions, where 1) valuations are attractive on a relative (vis-à-vis North American markets) and a historic basis, and 2) the injection of liquidity by the central banks should stimulate both corporate earnings and investors’ appetite for risk. The weight of this position remains similar to the previous quarter, at 15.5%.

In light of a high valuation and a mixed outlook for earnings growth, we have continued to reduce our weighting of U.S. equities. Their weight therefore went from 14.5% to 11.0% during the quarter.

The weighting of large cap Canadian equities also remains below the target, given our lack of optimism for the 2015 market outlook. However, we did increase the weight of Canadian small-cap equities within our main diversified fund, given the signs of a transition to the east and to the manufacturing export market as the motor for Canadian economic growth. The weight of small-caps was therefore increased to 10.0%, bringing the total weight of Canadian equities up to 32.0%.

We have also initiated positions within the emerging markets, which are concentrated for the moment in Mexico and India, totalling 3% of the portfolio. We chose these regions on the basis of economic criteria, primarily for the major economic and social reform programs being implemented in these regions which we believe will encourage long-term growth. In addition, we deem that the slowdown in China will favour India within Asia and that the importance of Mexico’s manufacturing exports to the U.S. will result in worthwhile returns on the stock market.

We reduced the weight of bonds by 6%, from 34 to 28%, in light of the additional interest rate cut since the start of the year. Given the significant risks present on the bond market, a market that we deem to be overvalued, we prefer to exercise caution and to hold cash. During the quarter, most of this cash was held in the U.S. money market, so as to take advantage of the anticipated appreciation of the greenback against the loonie, and this position was liquidated before the end of the quarter.

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Chart 6
Economic and financial scenarios

Economic scenario

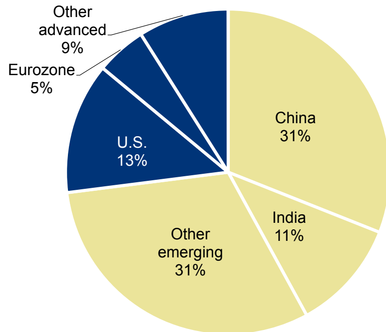
							Change since December 31, 2014	
		2013	2014	2015	2016	2017	2015	2016
United States	Real GDP	2.2%	2.4%	3.3%	2.9%	2.8%	-0.2%	+0.2%
	Inflation rate	1.5%	1.6%	0.5%	1.7%	2.0%	-1.0%	---
	Unemployment rate	7.4%	6.2%	5.4%	5.0%	4.9%	-0.4%	-0.4%
Canada	Real GDP	2.0%	2.5%	1.2%	1.9%	2.2%	-0.8%	0.2%
	Inflation rate	0.9%	1.9%	0.6%	1.5%	1.8%	-1.1%	-0.3%
	Unemployment rate	7.1%	6.9%	6.7%	6.5%	6.4%	+0.2%	+0.1%

Financial scenario*

			Targets			Change since December 31, 2014	
		Actual	June 2015	Dec. 2015	June 2016	June 2015	Dec. 2015
Interest rate							
	U.S. 10-year rates	1.94%	2.20%	2.60%	2.90%	-0.05%	-0.15%
	Canada 10-year rates	1.36%	1.60%	1.95%	2.30%	-0.40%	-0.30%
Exchange rates							
	$US/$CAD	0.79	0.75	0.80	0.82	-$0.07	-$0.01
	$US/Euro	1.07	1.05	1.05	1.05	-$0.15	-$0.10
	Oil price (WTI), $US	47.59	45	50	55	---	---
	S&P 500	2,068	2,125	2,200	2,280	---	---
	S&P/TSX	14,902	15,200	15,800	16,300	+450	+825

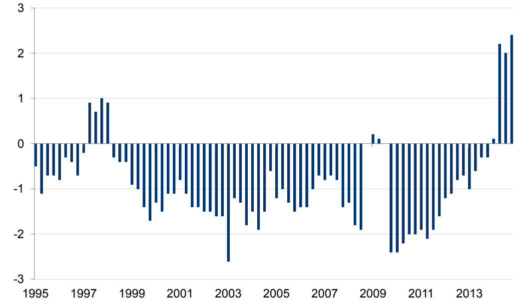
* end of period

Graph 4



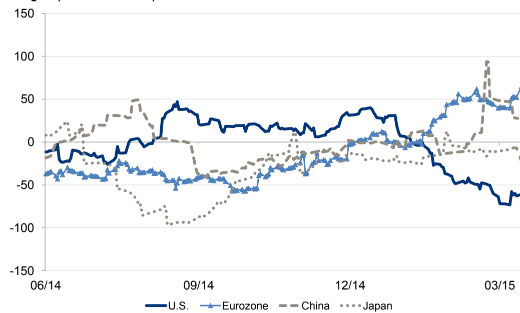
Source : IA

Graph 5



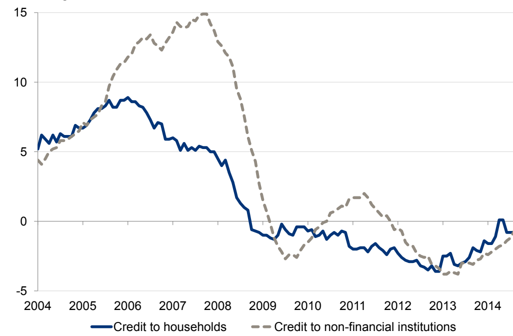
Source : IA

Graph 6



Source : IA

Graph 7



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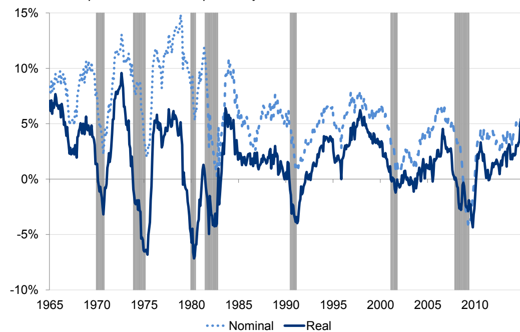
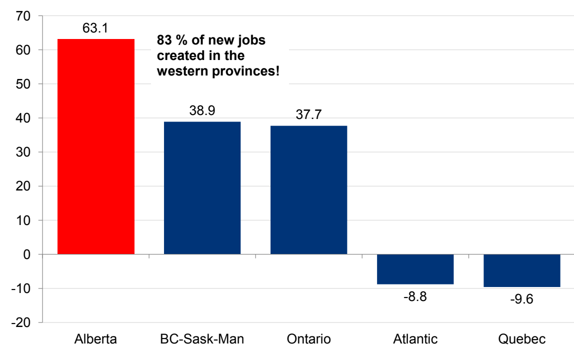
Graph 8



Source : IA

Graph 9



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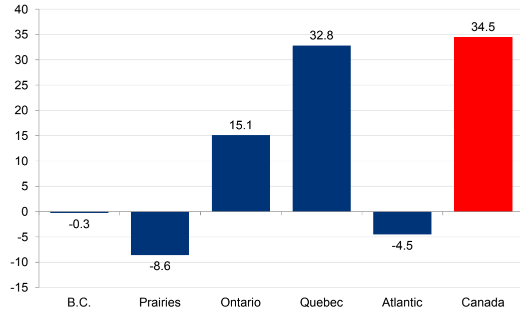
Graph 10



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