AS AT JUNE 30, 2015

Re-evaluating risks

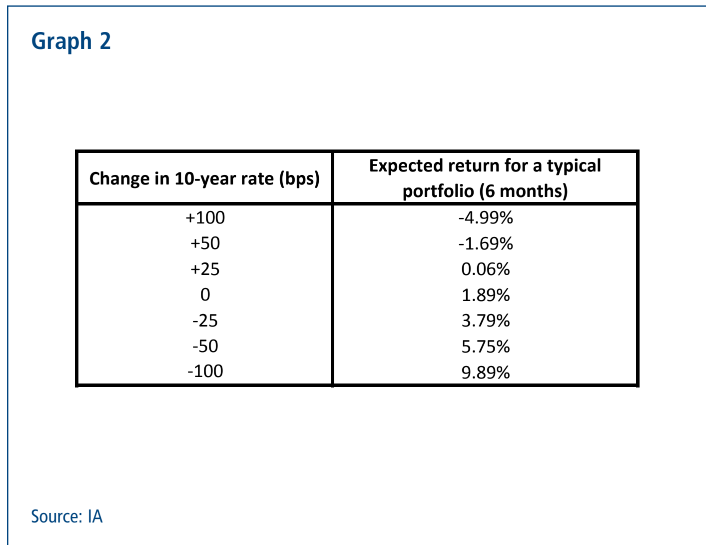
By Sébastien Mc Mahon, M.E.Sc., PRM, CFA
Economist
Industrial Alliance Insurance and Financial Services Inc.

The revision of inflation expectations in Europe played a significant role on the international bond markets in the second quarter. Positive surprises with respect to growth, particularly on the periphery, as well as a turnaround in the core inflation rate forced a re-evaluation of risks on the European bond market, bringing German rates from nearly 0% to almost 1% in just a few weeks. It only took this reversal to generate an increase in interest rates in the developed countries, and Canada was no exception, with 10-year rates going up 33 basis points during the quarter (Graph 1). In terms of the impact on investors, it was enough to bring the FTSE TMX Canada Universe Bond Index's return for the year-to-date from a peak of nearly 4.5% in early April to just 1.7% at the end of the quarter. As we come to the end of the second quarter of 2015, we estimate that a simple average increase of 25 bps in Canadian interest rates by the end of the year would result in a return close to zero for a typical bond portfolio over the next six months, while an increase of 50 bps would be sufficient to push the total return into negative territory (Graph 2). As we approach an imminent tightening of U.S. monetary policy, the probability of seeing a general increase in North American rates in the second half of the year cannot be ignored, which prompts us to exercise caution toward the bond market in the coming months.

World: China's softening of monetary policy not producing results

It seems that we come back to it every quarter: China's economy is slowing. Despite efforts to stimulate demand by households, which are being counted on as the future drivers of economic growth instead of businesses and foreign investors, demand for credit reached a historic low in the second quarter of 2015. Same story for companies, where investments have slowed to their slowest pace of growth in 15 years. And given the low rates of return being offered, international investors are pulling out of the country, resulting in a net exit of capital and a further tightening of monetary conditions.

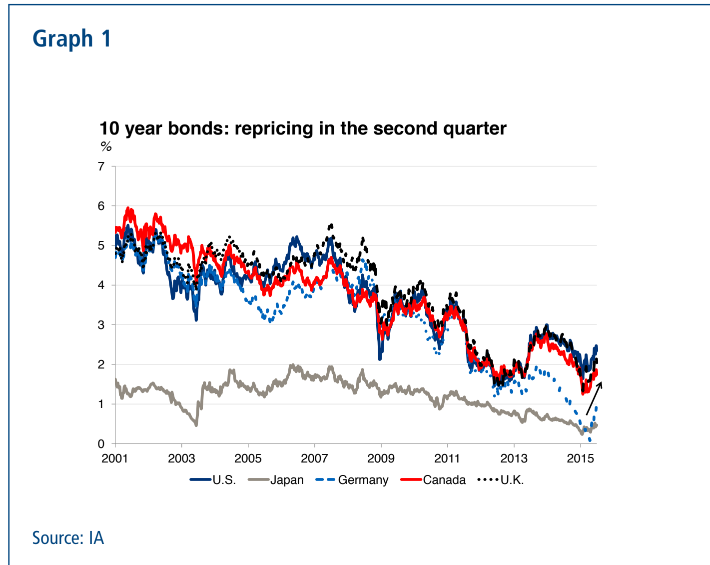
Graph 2



Change in 10-year rate (bps)	Expected return for a typical portfolio (6 months)
+100	-4.99%
+50	-1.69%
+25	0.06%
0	1.89%
-25	3.79%
-50	5.75%
-100	9.89%

Source: IA

Graph 1



Source: IA

Of even greater concern at the moment is the Chinese stock market, which skyrocketed more than 150% in the twelve months leading up to mid-June 2015 and which is showing clear signs of fragility. One eloquent sign is the explosion, at a rate of 463% over 12 months, of margin loans, which allow investors to speculate using money they don't actually have. The Chinese government was forced to announce restrictions on margin loan offers in order to prevent the bubble from inflating even more, propelling the Chinese market into a "bear market," that is, a drop of more than 20% in relation to its June peak. Household confidence is already fragile and a bursting of the stock market bubble would certainly not help the world's second largest economy regain its momentum.

Europe: Despite Greek saga, economic data convey positive tone

All eyes are on Greece and its Prime Minister, Alexis Tsipras. As the second quarter drew to a close, everyone was waiting for the results of the referendum, which will ultimately decide whether or not the Greek people wish to remain in the euro zone.

Apart from the Greek political situation, the tone of economic data has been rather encouraging since the start of the year. Economic growth has spread to the peripheral countries (Graph 3), mainly Spain and Portugal where spending restraints appear to be bearing fruit.

The most significant change nonetheless lies in the lifting of the fear of deflation that had been hanging over Europe for the last few years. The core inflation rate has finally halted its decline begun in 2012 and seems to have stopped at a 0.6% low in April, before climbing to 0.9% in May (Graph 4). Total inflation, which is more directly exposed to the collapse of oil prices, shows an ascending profile, after having reached -0.6% in January. This observation was a major factor in European interest rate movements, as well as North American rates, as the upward revision of inflation expectations reduced the pressure that had been weighing on bond rates (for example, 10-year German bond rates went from 0.075% in April to nearly 1.0% in June).

Finally, all these factors combined have created volatility for the European currency, which hovered between 1.06 and 1.14 U.S. dollars during the quarter. The strength of the euro in May weighed on the U.S. dollar, which seems to have halted its strong appreciation begun last year and, at the same time, its supplementary pressure on oil prices. Variations in the euro during the second half of the year will be at the centre of our radar screen given the potential collateral effects on the value of the U.S. dollar and, by extension, the Canadian exchange rate.

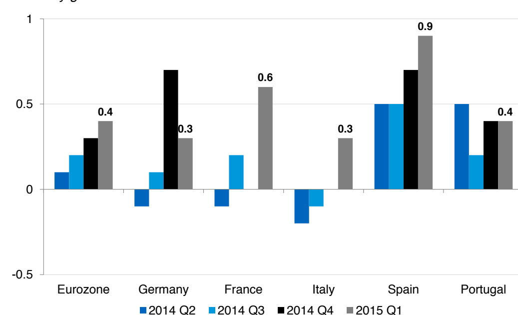
United States: Strong rebound anticipated despite disappointing Q1

First-quarter weakness has been confirmed, with a 0.2% drop in U.S. gross domestic product (GDP) resulting from the weakness in energy sector investments and the decline in international trade, affected by port strikes on the west coast and the dollar's strength. However, this result masks the vigour of household consumption, a sign that the elements weighing on growth in the first quarter were of a temporary nature. Second-quarter growth is looking positive, buoyed by the rebound in exports, gains on the labour market, and the acceleration in the housing sector.

As in the first quarter, we are counting on U.S. consumers to be the drivers of world growth for the coming quarters. On this front, retail sales south of the border are showing promising signs, having rebounded substantially since March (Graph 5), while total household spending grew in May at its fastest pace since 2012.

In the first quarter, many were asking where all the savings put away by consumers were going, given the drop in prices at the pumps, job market gains, the surging stock market, and the overall appreciation of real estate. The answer is in three parts. First, U.S. households have upped their savings rate, which went from 4.5% of disposable income in November 2014 to 5.6% in April 2015, a sign of heightened caution in household behaviour. Second, the changing behaviour of "new" U.S. consumers translates into a heavier demand for services, which now account for two-thirds of total consumer spending,

Graph 3



Source: IA

Chart 1
Returns of the Canadian Bond Market as at June 30, 2015

Index	Returns (%)	
	3 months	YTD
FTSE TMX Canada Universe Bond Index	(1.7)	2.4
FTSE TMX Canada Short Term Bond Index	0.2	2.1
FTSE TMX Canada Mid Term Bond Index	(1.2)	3.0
FTSE TMX Canada Long Term Bond Index	(4.6)	2.3
FTSE TMX Canada Federal	(1.2)	2.1
FTSE TMX Canada Provincial	(2.7)	2.8
FTSE TMX Canada Municipal	(2.2)	2.5
FTSE TMX Canada Corporate	(1.3)	2.2

Source: Scotia Capital Debt Market Indices

compared to one third for retail sales. Finally, it seems that a large portion of household monetary earnings have been directed toward the housing market, which continues to be stimulated by low borrowing costs.

Building starts leapt forward in the second quarter, reaching a level not seen since 2007, while building permit requests, new home sales and existing home sales all showed a rebound in activity as well (Graphs 6 and 7).

Given the cascading effect that results from the purchase of a new home, such as purchases of furniture and appliances, we are expecting a positive effect on GDP growth that should extend over the next few quarters. The increase recently observed in household formation (Graph 8) could also sustain housing demand over the coming quarters.

Canada: Beginning of an "atrocious" year?

At the beginning of the second quarter, Bank of Canada Governor Stephen Poloz warned observers that the start to the year would be "atrocious" for Canada on the economic front, in light of the crash in oil prices. The first quarter did indeed prove to be negative (without being atrocious, to be honest) with a 0.6% decline in GDP. Forecasts for the second quarter remain sluggish and the probability of a technical correction is admittedly not zero.

The Canadian economy being what it is, the impact of the collapse in oil prices does not affect all citizens and Canadian businesses in the same way. The oil-producing provinces (Alberta, Saskatchewan and Newfoundland) are suffering from a significant decrease in export revenues, while the other provinces are benefitting from discounts at the pump. For Ontario and Quebec, where the manufacturing sector is of key importance, the weaker Canadian dollar adds another positive effect by stimulating demand for exports.

This phenomenon is clearly evident in the geographic distribution of job creation: roughly 94,400 of the 102,300 jobs created in the country in the first five months of the year were located in Quebec and Ontario (Graph 9).

Chart 2
Market Returns as at June 30, 2015

Index	Returns (%)	
	3 months	YTD
FTSE TMX Canada 91 day T-bill Index	0.2	0.4
FTSE TMX Canada Universe Bond Index	(1.7)	2.4
S&P/TSX Composite Index	(1.6)	0.9
S&P 500 (Can. $)	(1.4)	8.8
MSCI - EAFE (Can. $)	(1.0)	13.5
MSCI - World (Can. $)	(1.3)	10.4
Exchange Rate (Can. $/US $)	(1.6)	7.5

Chart 3
Market Returns as at June 30, 2015

Index	Returns (%)	
	3 months	YTD
S&P/TSX Sector Returns		
Energy	(4.3)	(5.4)
Materials	(2.5)	0.8
Industrials	(9.5)	(8.1)
Consumer Discretionary	1.6	7.8
Consumer Staples	(0.1)	3.2
Health Care	9.1	58.3
Financials	(0.1)	(0.3)
Information Technology	(6.3)	1.8
Telecommunication Services	2.4	2.6
Utilities	(7.7)	(4.5)
S&P/TSX Composite Index	(1.6)	0.9

However, the fact remains that there has been a net loss of 14,000 jobs in the Canadian manufacturing sector since the start of the year, despite a significant addition of more than 20,000 jobs in May alone. In short, regional leadership in job creation shifted to central Canada in 2015, but the manufacturing sector is not yet leading the way. In fact, there have never been as few workers in the country's manufacturing sector as in 2015.

The disparity in impacts is also evident on the real estate front, with the Calgary market being the hardest hit. From May 2014 to May 2015, the price of Canadian homes rose 4.6% across the country as a whole, led by above-average gains in Toronto, Hamilton, Vancouver, Victoria and even Edmonton, while the major cities in eastern Canada showed slight gains. In Calgary, however, prices on an annual basis fell for the first time since July 2011. In May 2015 alone, Alberta's largest market plunged a record 3.3%, primarily in the single-family house segment (excluding condominiums).

Meanwhile, the Canadian dollar fluctuated between 78 and 84 cents during the quarter, carried by the price of oil, which seems to have stabilized around US$60. The clear relationship that has existed for more than 15 years between the loonie and the price of oil continues to hold, but the loonie's relationship to the interest-rate gap between Canada and the U.S. provides a more convincing explanation for the last few quarters. A simple reading of the differential in 5-year rates between the two countries can in fact explain very precisely the movements of the Canadian exchange rate (Graph 10), a sign that in the currency market too, it is the central banks who dictate the tone, by means of the expectations they generate with respect to monetary policy outlooks.

Financial markets: Waiting for the Fed and spotlight on Greece

Two themes dominated the financial markets in the second quarter of 2015: will Greece exit the euro zone, and when will the U.S. Federal Reserve raise its benchmark rate?

To judge by the daily movements of the European markets, there is a certain detachment compared to the 2010 episode. The main reason is that, contrary to that period, it is now taxpayers and the International Monetary Fund (IMF) that are exposed to a potential default by Greece, and not private investors. As the quarter comes to a close, resolution of the situation is still very uncertain and the risk premium surrounding European rates is still present.

As for the Fed, uncertainty remains but the signals are getting clearer. The Federal Open Market Committee (FOMC), responsible for setting monetary policy, meets eight times a year, and every two meetings it publishes the results of the forecasting exercise of its 17 members. Within these results are the members' projections for the level of the key rate at the end of the current year, and for the next two years. For the year 2015, the median projection of committee members indicated expectations of two increases to the key policy rate before the end of the year (15 of the 17 members anticipate at least one increase, and 10 members expect two increases or more). Since the meetings of September and December are the only two dates remaining when Janet Yellen, chair of the decision-making committee, will hold a press briefing following the issuing of the press release, these two dates are the two most likely times for the Fed to act. Ms. Yellen repeated that the trajectory of rate increases is likely to remain slow and will be dictated by the data, not by a pre-established calendar.

The U.S. bond market, meanwhile, remains skeptical and is anticipating only one increase before the end of the year, probably in December. This reaction is not atypical of the bond market, which tends to under-estimate the movements of the Fed in times of monetary policy change and has historically had to later review its anticipations to the movements of the key rate (for example, during the last upward cycle begun in 2004, the market systematically anticipated a slower pace than what proved to be the case, even after several consecutive hikes by the Fed (Graph 11).

It therefore seems reasonable to expect history to repeat itself and for the Fed to move more quickly than what is implicitly set in the market's expectations.

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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**	**23.0%**	**+18.0%**	**+12.5%**
Canadian Bonds	20	45	70	25.0%	-20.0%	-3.0%
International Bonds	0	0	15	0.0%	0.0%	0.0%
Total – Bonds	**20**	**45**	**70**	**25.0%**	**-20.0%**	**-3.0%**
Canadian Equities	**5**	**25**	**45**	**28.0%**	**+3.0%**	**-4.0%**
U.S. Equities	5	12.5	45	11.0%	-1.5%	0.0%
International Equities	5	12.5	45	10.0%	-2.5%	-5.5%
Emerging Markets	0	0	45	3.0%	+3.0%	0.0%
Total – Foreign Equities	**10**	**25**	**45**	**24.0%**	**-1.0%**	**-5.5%**
Total – Portfolio		**100**		**100.0%**		

Should this be the case, the bond market could be weakened by a rapid adjustment in expectations, which could lead to sudden increases in U.S. interest rates and, indirectly, Canadian rates.

It is important to remember that the current U.S. monetary policy can be qualified as "ultra" accommodating, with a key rate at practically zero, and that the first increases will merely constitute a normalization of the situation (to a policy that is simply accommodating). We remain of the opinion that the strength of the U.S. economy justifies setting the normalization process into motion, cautiously of course, and that the impacts on expansion of the U.S. economy will be slight. However, a potential injection of volatility into a bond market characterized for the past several years by a low level of liquidity increases the probability of a quick and disorganized rise in interest rates.

Because the bond and stock markets are closely intertwined, we must remember that even if the economic data turn out to be positive between now and the first rate hike, we cannot exclude the possibility that the stock markets will also react suddenly and erratically.

Another concern that we have about the stock market is tied to the historically high level of profit margins of U.S. companies. In analyzing the two episodes preceding a rate hike by the Fed, begun in 1994 and 2004, we see that corporate profit margins started low and grew during the cycle, pushing the rate of earnings growth upward (Graph 12). The reason is that the Fed began its monetary policy tightening in reaction to an inflationary acceleration of the U.S. economy, an environment conducive to the expansion of company earnings margins. Thus, as the Fed increased its key policy rate and, in so doing, weighed on the price/earnings ratio of the stock markets, the earnings growth profile of companies remained favourable and supported the market, which posted positive returns despite the tightening monetary policy.

In 2015, however, the situation is different, because the Fed won't be starting the upward cycle in reaction to a strong expansion of the economy, but rather with the goal of normalizing its monetary policy. Profit margins are already near 60-year highs and emerging signs of wage inflation point to pressure on these margins, which could mean a return to the long-term average, weighing on the growth rates of company earnings. The factor that sustained the market during the last two upward cycles could therefore play an inverse role in this cycle, and weaken the bull market that has persisted since 2009 and which has not seen a correction of more than 10% since 2011.

However the stock market behaves between now and the end of the year, one will recall that historically, it is recessions that put an end to rising markets, and that we do not foresee one in the coming year. Should there be a correction but no change in our economic outlook, it will likely represent an opportunity to be seized.

The Canadian bond market erased some of its gains from the first quarter as markets began to anticipate a first increase in rates in the United States. In fact, the FTSE TMX Universe Bond Index lost 1.7% in the second quarter of the year. Short-term bonds stagnated while long-term securities posted a loss of 4.6%. Corporate BBB bonds were down 1.3%.

The S&P 500 has been flat for the last few months and ended the quarter with a total return of 0.3%. The decline of the U.S. dollar against the loonie was detrimental for Canadian investors, pushing the total return for the Canadian index to -1.4% in Canadian dollars. The Canadian stock market began in the red, pulled down mainly by the industrial sector. The S&P/TSX Composite Index posted a total return of -1.6% in the second quarter. The Canadian S&P/TSX Small Cap Index was up slightly by 1.3%.

Stock markets in Europe, Asia and the emerging markets experienced a negative quarter. The European market, represented by the MSCI - Europe Index, fell 1.0% in Canadian dollars, the MSCI - EAFE shed 1.8% (-1.0% in Canadian dollars) and the MSCI - World lost 0.7% (-1.3% in Canadian dollars). Finally, the MSCI - Emerging Markets Index was up 0.8% (-0.8% in Canadian dollars).

Chart 5
Estimated Gross Returns for the Next 12 Months Starting on June 30, 2015

Market indicators	Interest or dividend	+	Capital gains	=	Total estimated gross return
FTSE TMX Canada 91 Day T-Bill Index	0.70%	+	0.00%	=	0.70%
FTSE TMX Canada Universe Bond Index	3.20%	+	(3.45%)	=	(0.25%)
Canadian stocks (S&P/TSX Composite Index) including dividends					8% to 10%

Strategy: Neutral in equities

For the first time since our arrival as managers of the diversified funds at the end of 2012, our strategy is to remain neutral in equities. The reason is simple: with no convincing evidence pointing to the future direction of the stock markets, which seem fully valued, we prefer to increase our holdings in cash and protect the portfolio while positioning it advantageously should a market opportunity present itself. Meanwhile, stock picking becomes even more important as a means of adding value to the fund.

Our strategy aims primarily to protect the portfolio; we believe that by limiting the potential for losses, while acting in an opportunist manner when occasions arise, we will be able to offer a better return than our peers. Therefore, in the absence of a strong conviction, prudence is the best avenue. We are still of the opinion that it is impossible to accurately predict the moment a market will decline, but our more defensive strategy is influenced by anticipations of a widespread return to volatility in the coming quarters.

The bond market therefore seems expensive to us and we deem that a decline in the market is more likely than an increase, which leads us to stay underweight in bonds within the portfolios.

Like last year, it is in the currency market that we are currently adding value to the solutions we manage. Changes in oil prices, monetary policy expectations and developments in the situation in Greece are making waves on the exchange market, and we are able to profit from them through various investment tools. The decline of the Canadian dollar since the beginning of the year, the weakness of the euro and the overall vigour of the U.S. dollar have been three attractive lines where we've been able to add a few basis points to the annual returns of our funds, primarily in the diversified funds where we use a wider and more varied range of tools.

The neutrality of our exposure to equities is maintained approximately according to geographic regions. Canadian equities now make up 28% of the Diversified Fund, slightly more than the 25% target, of which 10% are invested in small-cap stocks. Foreign equities now represent less than 24% of the assets, including a 3% exposure to emerging markets by means of a position in an exchange-traded fund (ETF) reproducing the MSCI - Mexico Index.

The weight of bonds remains well below the target, at 25% compared to a target of 45%, for the reasons explained in the last few quarters as well as those described above.

Finally, at its peak the cash balance represented more than 22% of the funds' assets during the quarter, with more than half exposed directly to the U.S. dollar. We have maintained our strategy of holding U.S. treasury bonds directly and made use of the strategy employed in 2014 consisting of holding a position in an ETF that replicates the performance of the U.S. dollar in relation to a basket of the world's major currencies, composed predominantly of the euro and the yen.

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Chart 6
Economic and financial scenarios

Economic scenario

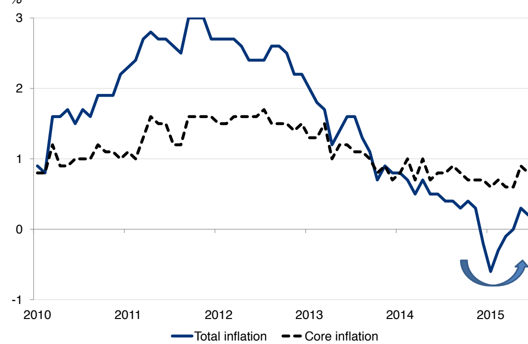
							Change since March 31, 2015	
		2013	2014	2015	2016	2017	2015	2016
United States	Real GDP	2.2%	2.4%	3.3%	2.9%	2.8%	---	---
	Inflation rate	1.5%	1.6%	0.5%	1.7%	2.0%	---	---
	Unemployment rate	7.4%	6.2%	5.4%	5.0%	4.9%	---	---
Canada	Real GDP	2.0%	2.5%	1.2%	1.9%	2.1%	---	-0.1%
	Inflation rate	0.9%	1.9%	0.6%	1.5%	1.8%	---	---
	Unemployment rate	7.1%	6.9%	6.7%	6.5%	6.4%	---	---

Financial scenario*

			Targets			Change since March 31, 2015	
		Actual	Dec. 2015	June 2016	Dec. 2016	Dec. 2015	June 2016
Interest rate							
	U.S. 10-year rates	2.35%	2.55%	2.90%	3.20%	+0.35%	+0.30%
	Canada 10-year rates	1.68%	1.90%	2.30%	2.40%	+0.30%	+0.35%
Exchange rates							
	$US/$CAD	0.80	0.75	0.78	0.80	---	-0.02$
	$US/Euro	1.11	1.05	1.05	1.05	---	---
	Oil price (WTI). $US	59.47	50	55	55	+5	+5
	S&P 500	2,063	2,125	2,200	2,400	---	+120
	S&P/TSX	14,553	15,000	15,300	15,900	-200	-500

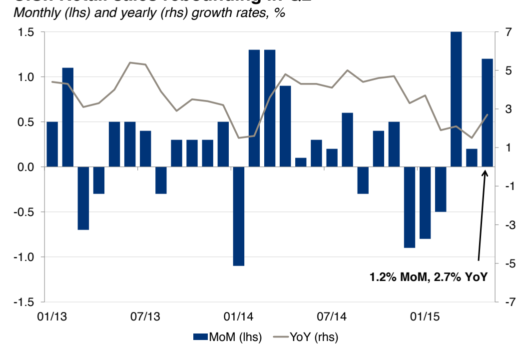
* end of period

Graph 4



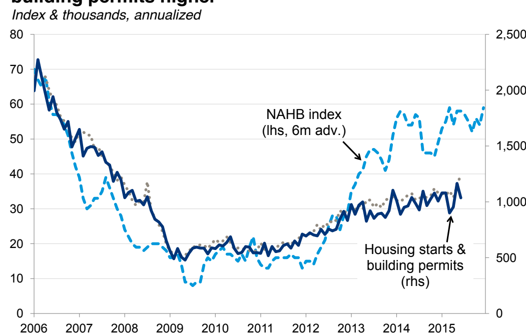
Source : IA

Graph 5



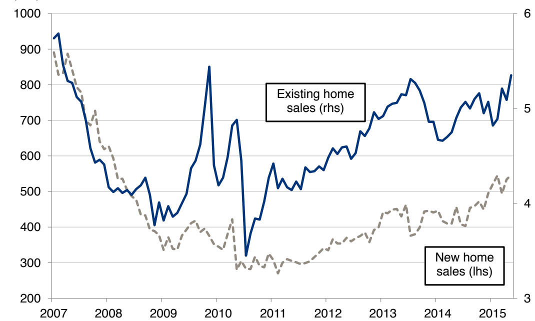
Source : IA

Graph 6



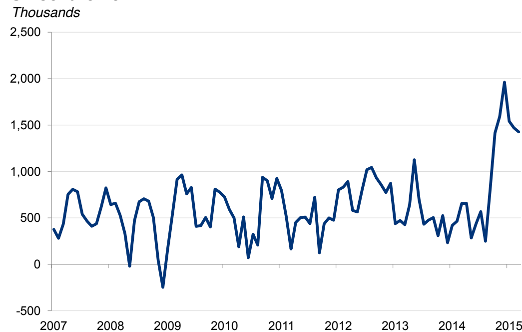
Source : IA

Graph 7



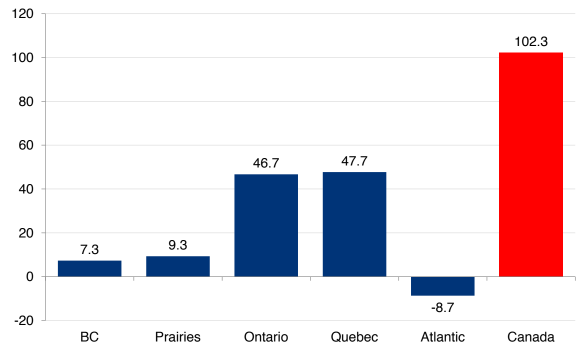
Source : IA

Graph 8



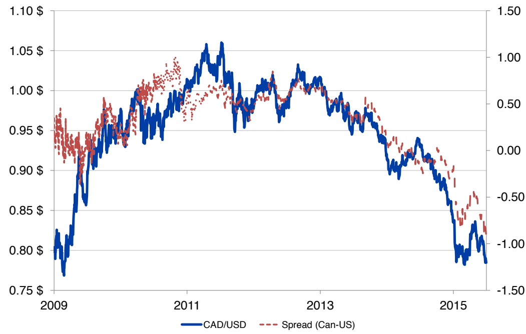
Source : IA

Graph 9



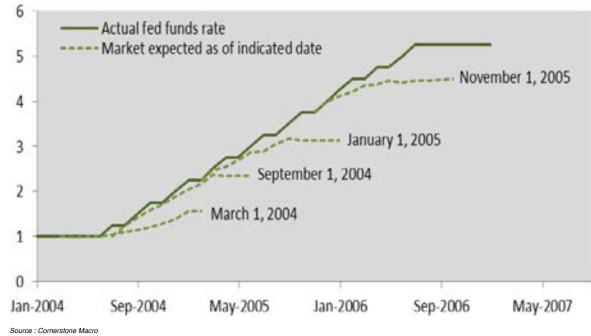
Source : IA

Graph 10



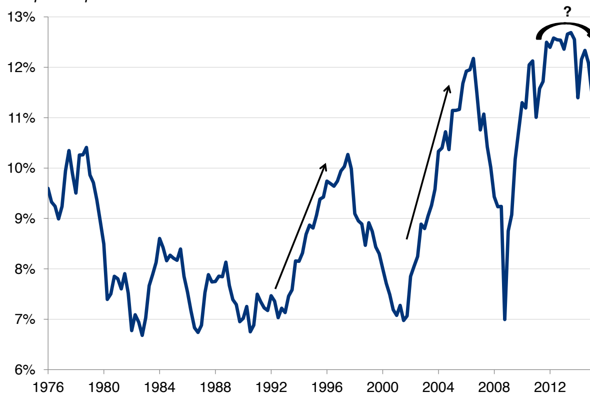
Source: IA

Graph 11



Source : Cornerstone Macro

Graph 12



Source : IA