Economic and Financial Environment

As at March 31, 2021

Group Savings and Retirement

Has economic news become too positive?

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The first quarter of 2021 marks the first anniversary of the COVID-19 pandemic. Looking back, the past 12 months have been nothing short of historic.

In quick succession in the months of March and April 2020, the market experienced its worst monthly declines in its history, along with the loss of nearly three million jobs in Canada and more than 22 million south of the border. Canada's GDP shrank at an annualized rate of almost 40% in the second quarter of 2020, before rebounding by nearly 40% in the third quarter. In spite of it all, stock exchanges reached new peaks during the course of the year.

As we look ahead, it may seem as if economic news is becoming "too positive." The pace of the worldwide vaccination campaign is picking up week after week, exceeding all expectations we might have had in 2020. Budget support from governments all over the world has been, and remains, massive. In fact, it's even on the rise in the United States, which may lead to an absolutely wild year for consumer spending once the lockdown measures have been eased. In short, investors have gone from worrying that the world economy would grow too slowly to worrying that it will grow too quickly, thereby triggering an inevitable inflationary spiral.

In recent months, this investor anxiety has prompted a rapid rise in long-term interest rates as the market continues to struggle to make sense of the messages put forward by central banks. The U.S. Federal Reserve has repeatedly stated that at this stage it does not intend to raise its policy rate in the course of the next two years, even if the economy begins to overheat.

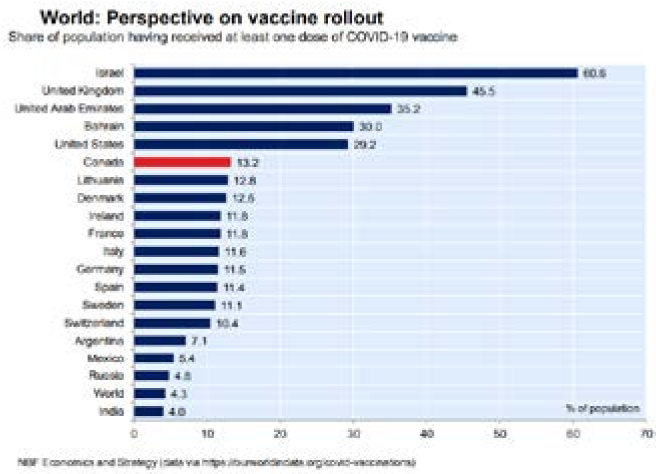
Under these circumstances, even with the markets' historic positive performance of the past 12 months, we continue to recommend that investors strongly favour equities over bonds. History suggests that stock markets are able to resist interest-rate rises as long as borrowing costs do not increase to such a point where a recession is triggered. With all of the fiscal and financial support in place, and given the accelerating pace of the vaccination campaign, we believe that the current risk of a return to recession to be very low.

Around the world: a strong start to the vaccination campaign

Week after week, the news about the pandemic gets better, with the mass vaccination campaign continuing to gain momentum.

The country with the most noteworthy progress in this regard is Israel, where more than 60% of the population has now received at least one dose of the vaccine (see Graph 1). Herd immunity has almost been achieved in Israel, where businesses are reopening, images of public gatherings have become headline news, and the number of COVID-related hospitalizations among seniors is in sharp decline.

Graph 1



Vaccine rollouts in the United Kingdom and the United States have also outpaced those of other Western nations; as a result, both countries are in a good position to attain herd immunity by the end of the summer. Continental Europe made a slow start on vaccination, which prompted political pressure. Also, while the saga surrounding the decision to suspend the use of the AstraZeneca vaccine did not help, by the end of the quarter things seemed to be righting themselves. Canada also suffered from a slow start since no vaccine is produced domestically; however, by the end of March, the data showed a definite speeding-up in the rollout of the vaccine.

As we stated at the end of 2020 and believe even more strongly now, vaccine rollout will be the most decisive factor for the economic outlook of 2021 and 2022.

As far as traditional economic indicators are concerned, data coming China and other emerging economies are very impressive.

Chinese macroeconomic figures published in February and March show considerable strength that significantly outpaces expectations.

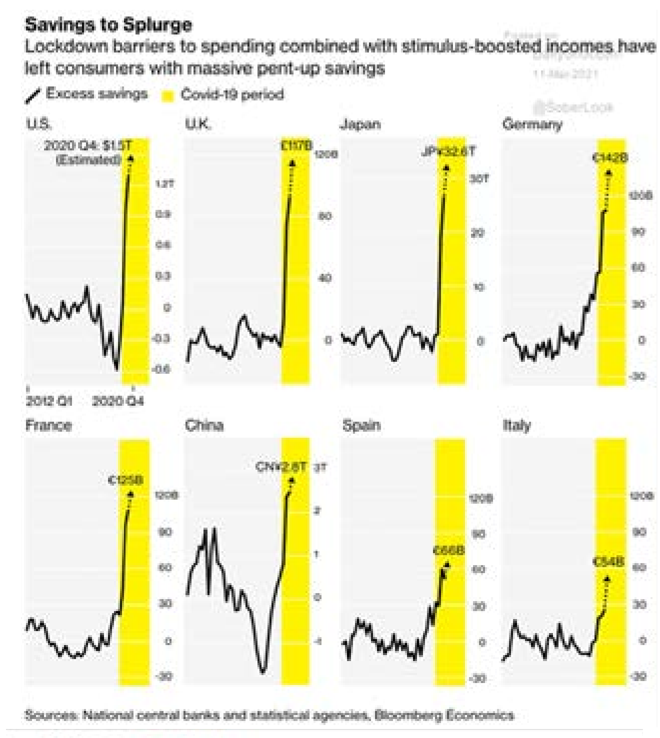
Effects related to the basis for comparison between the present day and the same period in 2020, when we were experiencing the worst economic downturn resulting from the pandemic, will likely remain present throughout the first quarter of the year, thereby creating a challenge for decision-makers and investors attempting to detect genuine trends.

Two dependable macroeconomic indicators are providing positive signals with respect to China's economic vitality: (1) exports from South Korea – a country that supplies Chinese domestic production with multiple electronic components – have surged sharply; and (2) the price of copper has jumped much higher in recent quarters and is slowly approaching its all-time peak, which occurred in 2010 (see Graph 2). This metal is often referred to as Doctor Copper as a result of its importance in the vast global manufacturing chain in which China plays such a central role, and current forecasts are positive as China's economy is unquestionably expanding.

Graph 2

Another noteworthy economic development has to do with consumer behaviour. In both China and developed economies, household savings rates have leapt to historic highs (see Graph 3). The reasons for this are simple: the increase in government transfers and the lockdown have made it impossible for households to spend as much as previously.

Graph 3



This increase in household savings must be considered a positive development. As the vaccination campaign progressively enables the lifting of the lockdown, households can return to their routines and spend what they have saved in the past year. This will act as a tailwind for the global economy and generate sustained growth for several quarters (or even years), thereby directly reducing the need for future government economic stimulus.

In fact, in March[1] the Organisation for Economic Co-operation and Development (OECD) published an update to its economic outlook for 2021 and 2022. It has raised its expectation for 2021 revising the global GDP growth rate to 5.6%, which is an increase of more than 1.0% from its stated expectation of December 2020. The OECD also expects the volume of the global economy to return to its pre-COVID scope in mid-2021 with the caveat that all will depend on the outcome of the race between the rollout of the vaccine and the spread of the virus variants.

Beyond its economic forecasts, the OECD has emphasized some key points we need to keep in mind as we move ahead.

First, economic recovery will be uneven across different sectors and different countries (and their workforce's varying average levels of education). Consequently, even if the global situation is becoming clearer, output and incomes may remain below pre-COVID levels until late 2022 in many countries.

Second, the magnitude of the United States' fiscal response (more below in the section devoted to the U.S.) means that the world's leading economy will play a major role in the global recovery. The U.S. economy – driven by its sizable stimulus packages – is expected to grow by 6.5% in 2021, which should create considerable benefits for its main trade partners.

Third, also in connection with the U.S. economy, the OECD believes that there is a real risk that U.S. economic growth will be so strong in comparison with that of other developed countries that it will act as a sort of magnet for capital on a global scale. This outlook for stronger growth and inflation in the United States may push interest rates in the U.S. higher than in other developed countries, thereby attracting foreign capital. The result would be a rising American dollar, which would further stimulate the flow of capital toward the U.S. and act as a brake on the recovery elsewhere around the world.

We agree that an over-performing U.S. economy may slow down the greenback's downward movement in the months ahead; however, we're not ready to relinquish our view that the U.S. dollar is in secular decline.

We expect the vaccine rollout in Europe and Canada to gain momentum soon. We also expect growth forecasts in other developed economies to be reviewed upwards later this year. We should keep in mind that the expiry of various stimulus measures in the U.S. will also have a dampening effect on the country's economic growth outlook. In addition, the Fed's reluctance to signal a tightening of its monetary policy will prevent two-year real U.S. interest rates (already quite low in comparison with other developed markets) from acting as a tailwind for the greenback.

In our view, the long-term impacts of the pandemic are beginning to take shape. We will return to these issues in the months ahead, but for the time being let us look at three matters that deserve our attention.

First, governments' perceptions regarding safety threats will probably change. Major public safety issues are not necessarily tied to the actions of rival foreign nations; alternatively, they may be viral in origin or linked to climate change.

Second, public health crises will more likely be treated on a "community" basis, that is, they will involve all levels of government, thereby expanding the government's footprint in society.

[1] https://www.oecd.org/economic-outlook/

Third and last, the quicker-than-forecast growing preference for online transactions will result in a permanent reduction in the number of physical commercial outlets.

Europe: a slow start for the vaccine rollout

Europe is experiencing a more challenging start to the year than anticipated, and its slow vaccine rollout is inhibiting the outlook for 2021. According to the OECD, the Euro Zone should post growth rates of about 3.9% in 2021 and 3.8% in 2022, slowly offsetting the 6.8% contraction that occurred in 2020 (as against a decline of 3.5% in the United States in 2020).

While the vaccine rollout has surged in the U.S., logistical difficulties in Europe has prompted sharp criticism from the media directed at the political class. Then came the saga surrounding the AstraZeneca vaccine, whose use was temporarily blocked due to concerns regarding potentially serious side effects – despite the more reassuring view put forward by the World Health Organization.

The gap between Europe and the United States regarding vaccine rollout is striking: Europe is a long way behind its objective of vaccinating 70% of its adult population by September, while President Joe Biden has stated that all adults in U.S. will be eligible for vaccination by May 1, 2021. Moreover, in March, some studies suggested that European countries would have to boost their daily-dose delivery by a factor ranging from 2.5 to 3.5 to attain herd immunity by yearend 2021.

On the economic front, unlike North America, Europe closed out the year 2020 on a negative note with its GDP contracting by nearly 3.0% in the fourth quarter. This poor performance was the result of a combination of stringent lockdown measures and, above all, less in the way of fiscal stimulus at the close of the year.

In contrast with the U.S. economy, that of the Euro Zone should return to its pre-COVID size in the course of 2022 – probably 12 months after the U.S. To get an idea of the gap between the E.U. and the U.S., consider that the United States' fiscal response for 2021 alone will, according to some studies, affect 11 to 12% of its GDP, which is three times as much as the output gap (defined as the difference between the current GDP and potential GDP at production capacity) as against 6% for Europe, that is, 70% of its output gap. Naturally, it is easier politically to implement support programs in the United States than in Europe, where the decentralization of power ensures that such ambitious measures are costly in political capital. It is therefore unlikely to see more support measures enacted in the short term in Europe, which places a greater onus on European officials to achieve a successful vaccination campaign.

In this context, the European Central Bank (ECB) is attempting everything in its power to support growth and even announced in March that it would "significantly" increase its purchase of market securities so as to limit the rise of interest rates in the Euro Zone.

ECB President Christine Lagarde has insisted that this is not designed to control the yield curve, a measure used in Japan in recent years and by the U.S. Federal Reserve during the Second World War. While we believe her, the fact remains that economic and financial dependency on central banks will continue to be high in the years ahead and that everyone is forced to listen when their representatives speak.

The United States: a case of excessive economic growth?

On January 20, 2021, Joe Biden was sworn in as the new President of the United States, officially putting an end to the Trump era. As promised, the new President got his fiscal stimulus package through Congress. At 1.9 trillion dollars, the value of this package is equivalent to nearly 10% of the country's GDP.

With 2021 just under way, we may wonder if economic growth south of the border will be too strong! This may seem an unusual statement to read (and to make) in the year following a worldwide lockdown during which we wondered if we were about to embark on a long period of economic difficulties.

First, some may wonder if such a thing as excessive growth is even possible. Can things "go too well" in the economy? Without doubt, the answer is yes. In fact, that is why central banks were created: to control economic cycles and prevent history from being merely a sequence of rapid expansions and recessions in accordance with human nature.

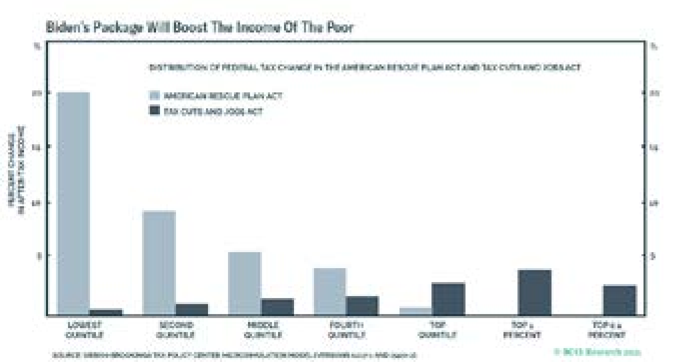
In 2021, however, reasons other than human nature are fuelling worry. It is the magnitude of the fiscal and monetary stimulus initiatives that is causing observers, and investors, to speculate if the authorities have done too much in the noble goal of supporting the post-COVID economic recovery.

According to recent data, the extent of the fiscal and monetary stimulus packages implemented by governments and central banks around the world in response to the COVID-19 pandemic is now approaching 30 trillion U.S. dollars, which is 1.5 times the GDP of the United States and 15 times that of Canada. Japan has deployed the boldest stimulus measures equal to nearly 27.0% of its GDP, with the United States ranking second in this regard. And there is more to this situation than prompting economic recovery. Politicians are already preparing economic recovery plans with a particular emphasis on infrastructure! In fact, the United States are developing a ten-year, three-trillion-dollar infrastructure plan, equivalent to roughly 1.5% of GDP annually.

Another argument in favour of restricting the number of new recovery programs is tied to current savings rates. As is the case elsewhere in the world, the combination of transfers to households and lockdown measures in the U.S. has pushed savings rates to historically high levels (with households receiving sums they could not readily spend). It is estimated that U.S. households have saved an extra 1.7 billion dollars from the start of the pandemic to the month of January 2021; these sums have either been invested or used to pay down debt. Some studies estimate that one-third of household savings comes from increased government transfers and two-thirds from a reduction in spending.

If we take into consideration the fact that President Biden's latest support program mainly targets less-well-off households, which have a greater marginal propensity to consume than wealthy households, we can expect it to have a great impact quickly (see Graph 4).

Graph 4



As U.S. households gradually emerge from lockdown, they will progressively spend this cash cushion, thereby creating a lasting tailwind that will support economic growth in the years ahead.

At this stage, we can ask two questions: (1) have governments done too much? and (2) how do we finance all this?

In response to the first question, we would be inclined to say yes – at least to the extent to which it was probably not necessary to spend so much to offset the many impacts that COVID has had on the U.S. economy.

The definitive answer, however, lies in gauging the output gap, that is, the gap between the current level of economic activity and what would be the case if the economy were operating at full capacity.

The output gap can be measured in more than one way.

The first and more classical method focuses on measuring GDP. In early 2020, we were aware that the U.S. economy was performing just below capacity according to experts. The COVID-fuelled recession then triggered a drop in GDP of about two trillion dollars between February and June 2020. The GDP has since rebounded by nearly 1.5 trillion dollars. As a result, the GDP was at about 5% below what it would be under a full-capacity economy. Consequently, by using this method and recognizing that we are not taking into account the impacts of President Biden's most recent stimulus package (which, let us recall, is equivalent to roughly 10% of GDP), we can quickly conclude that the output gap will probably close by the end of 2021 and that, subsequently, the economy may be overheated.

The second method, which is just as valid and, apparently, a favourite among politicians, is to focus on the labour market. By tallying the number of lost and unrecovered jobs, we estimate that there is a shortfall of nearly 12 million employment positions (that is, by counting also those who are forced to work on a part-time basis for financial reasons), which is equivalent to between 8 and 10% of full-capacity employment. By using this method, the extent of the Biden plan seems more cogent given the magnitude of the employment shortfall.

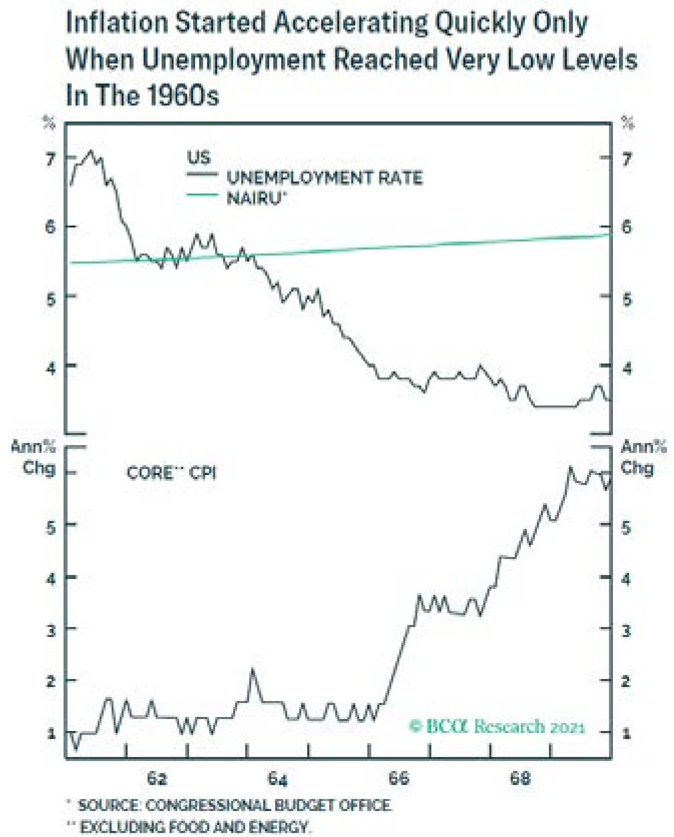
The situation, however, remains complex. The extraordinary support programs implemented in the past year include very generous unemployment benefits; as a result, about 40% of unemployed workers will receive greater compensation by staying at home than by returning to work. While these unemployment benefits are temporary and due to expire in the autumn, they will certainly contribute to reducing labour supply for much of 2021 and artificially amplifying the labour market shortfall. Since businesses will actively seek to hire personnel as the economy re-opens, these measures will also have the perverse effect of adding to inflationary pressure (companies will have to be more generous to attract workers and pass on the extra expense to their customers).

As you can see, the situation is significantly more complex than it appears to be, but we all believe that inflationary pressure will begin to emerge in the next 12 to 18 months. While we would be surprised to see inflation exceed 3.0% and stubbornly remain above this threshold, the markets are probably right: we should see an average inflation rate above 2.5% over the course of the next five years. This is a situation that is expected even though it did not occur in the previous cycle.

History also suggests that even if all economic signals point toward an upswing in inflation, it generally takes time for inflationary pressure to spread extensively throughout the economy. Certainly, we have already seen increases in price for food products, homes, and construction materials, but this phenomenon may remain in check until such time as wages – a main driver in this regard – begin to foster the spread of inflation to all goods and services.

In the 1960s, for example, the unemployment rate had settled below what was considered the full-employment level for a period of two years before inflation finally made an impact on the broad price index. On the flip side of the coin, however, as our 1960s example also shows, once it is triggered, inflation can begin to spiral and become difficult to rein in. As can be seen in Graph 5, CPI inflation doubled in the space of nine months in 1966, then pursued its upward trend until it reached 6% in 1969. It is in situations like these that we can fully appreciate the importance of the central banks' credibility and proactive approach.

Graph 5



As to the second question (how do we finance all this?), it is still too early to provide a definitive answer but certain possibilities are beginning to emerge.

The first tool to be used will likely be market borrowings. Despite their recent increase, U.S. interest rates remain close to historic lows, and it is only natural that the U.S. government – as in the case of the majority of governments around the world – would seek to take advantage of this situation by issuing long-term bonds at attractive rates. The strong economic performance that is expected in the years ahead, along with rising inflation will naturally drive up government revenue and facilitate debt-servicing.

The option of raising taxes also resurfaced in mid-March as some details from the Biden administration tax reform plan began to emerge. Let us recall that the Trump administration had passed its own tax reform plan aiming to reduce tax rates for businesses and high-income households. The Biden administration plan would rewind some aspects of the Trump plan by raising the average tax rate for businesses to 28% (from its current level of 21%) and by raising both the income-tax rate and capital gains tax rate applied to high-income individuals. The idea of a wealth tax is also being discussed – but this is hardly a universally popular option among politicians.

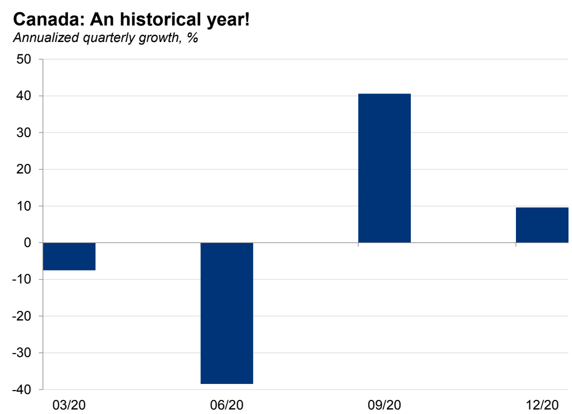
The objective of this tax reform would be to collect additional revenue on the order of two to four trillion dollars over the course of the next decade, which would be enough to refund a great part of the cost of recent aid programs.

Canada: raised expectations

Against all odds, Canada's economy is experiencing a boost in early 2021.

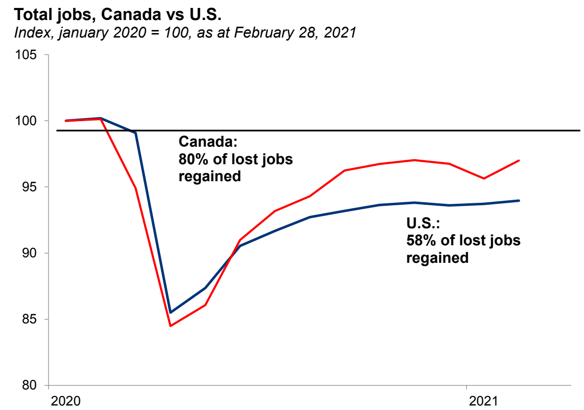
Let us review the sequence of events: in 2020, quarterly growth of Canada's GDP at an annualized rate was, in chronological order, -7.5%, -38.5%, +40.6% and, finally, +9.6% in the fourth quarter (see Graph 6). This last figure was a pleasant surprise as expectations had pegged the growth rate lower at 7.3%. While, as was the case in Europe, Canada's economy was subjected to a partial lockdown in late 2020, its economic recovery managed to maintain a head of steam and even elicit surprise among expert forecasters. In fact, in December 2020, the OECD raised its growth expectations for Canada's economy in 2021 from 3.5% to 4.7%.

Graph 6



The labour market provides a favourable picture of the underlying strength of Canada's economy. As at February 28, 2021, Canada had already recovered 80% of jobs lost since February 2020, as compared with 58% for our neighbours south of the border (see Graph 7). It is worth repeating once more that the federal government's policy of subsidizing wages rather than sending cheques to Canadians seems to have been the right call.

Graph 7



As was the case for central banks in other developed nations, the Bank of Canada remained on the sidelines in the first quarter of the year. When it published its monetary policy report in January, the Bank of Canada forecast a growth rate of 4.0% for 2021, down from its autumn 2020 4.2% projection. It is worth noting that the Bank of Canada was expecting a difficult start to the New Year as a result of new lockdown measures enacted across the country. While the Bank of Canada had forecast a contraction of 2.5% in the first quarter, signs at the end of the March point to an upswing of 2.5% to 3.5%.

Consequently, we should expect the Bank of Canada to raise its own expectations for the economy when it announces its next forecast in April. It remains to be seen if the revised expectation coincides with the beginning of a tightening in the monetary policy. While we would be surprised to see the Bank of Canada raise its policy rate before 2023, it is quite likely that it will quickly slow the pace of its quantitative easing program, which is curiously much more generous than that of the U.S. Federal Reserve, despite Canada's positive economic data.

As we look ahead, we believe that the outlook for Canada's economy is rather favourable. Following a slow start, the vaccination campaign picked up the pace at the end of the quarter. There is no doubt that the absence of vaccine-production facilities in Canada complicated supply management in the first months of the year. This serves to remind us that even if the Canadian government had signed agreements with suppliers, borders still matter! After all, a government decree is all that is needed to close and open borders.

Faced with lingering uncertainty, the federal government has opted for a late budget this year, pushing its release to April 19. Clearly, this opens a window of opportunity for calling an election in the spring (the minority Liberal government is already laying the foundations for it): however, the argument that a later budget date provides more time to establish a clearer picture of public finances is valid.

The two main measures we expect to find in the budget are the creation of a national daycare system, inspired by the Quebec example, and an economic recovery plan worth 70 to 100 billion dollars over three years that aims to establish a greener and more inclusive economy. We can debate about the necessity to implement such an economic recovery plan, but its scope seems appropriate to us.

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You may wonder when the time will come to pay for these spending programs. Probably not before next year. Will the Government of Canada draw inspiration from the Biden administration and tax companies and the wealthy or will it make use of its advantageous fiscal position within the G7 to allow rising inflation gradually to reduce the debt burden? Probably a bit of both, but the time to answer this question has not come yet.

Markets: the bull market enters its second year

Year 2 of the bull market got under way on March 23, 2021. On this date last year, the U.S. Federal Reserve took action to support the credit market, thereby putting an end to the quickest bear market decline in history.

Historically, the first year of a bull market is a vintage period with an average annual return of 42.2% since 1957, much greater than the return in a typical year. The performance of the S&P 500 Index from March 23, 2020 to March 23, 2021 exceeded 75.0%, shattering all records (see Graph 8).

Graph 8

S&P Performance 1st & 2nd Year Following Bear Market Low

Bear Market Low	1st Year Off Low	2nd Year off Low	2nd Year Max Drawdown
10-22-1957	31.0%	9.7%	-9.2%
06-26-1962	32.7%	17.4%	-6.5%
10-07-1966	32.9%	6.6%	-10.0%
05-26-1966	43.7%	11.1%	-11.0%
10-03-1974	38.0%	21.2%	-5.1%
08-12-1982	58.3%	2.0%	-14.7%
12-04-1987	21.4%	29.3%	-9.2%
10-11-1990	29.1%	5.6%	-6.8%
10-09-2002	33.7%	8.0%	-8.8%
03-09-2009	68.6%	15.7%	-17.1%
03-23-2020	74.8%		
Average	42.2%	12.7%	-9.8%

As for the second year of a bull market, it is also generally positive with an average return of 12.7%. But unlike the initial year of a bull market, the second year tends to be rather volatile.

Since 1957, the worst intra-year declines observed in the second year of a bull market have averaged -9.8%. More specifically, when drawing comparisons with the 2009-2010 and 1982-1983 occurrences (these being the two instances that share the most similarities with market behaviour in 2020, see Graph 9), we note that the beginning of the second year may be characterized by a pause to consolidate the impressive gains realized in the first year, before embarking upon another rise after a few months. It is always difficult to forecast short-term market movements, but a few months of volatility along the way should come as no surprise.

Despite it all, we remain optimistic and vigilant. Over the course of the year, we intend to use any market downturn to add risk to our portfolios.

The year 2021 began as the year 2020 ended, with both stock markets and interest rates on the rise. Truth be told, the economic outlook for the years ahead are constantly being revised upwards, and the combination of real global GDP growth at a rate exceeding 5.0% and more vigorous, yet controlled inflation creates an environment that is favourable to risky assets.

The most decisive factor in the first quarter, however, has undoubtedly been the rapid rise in long-term interest rates, which has resulted in a sharp steepening of the yield curve.

Graph 9

Let us review what has happened more closely. The U.S. Federal Reserve, the Bank of Canada, and the European Central Bank have all been using the same messaging, that is, they intend to maintain their policy rate near the bottom for several more years so as to help the labour market recover. These central banks also believe that the expected inflationary pressures will only be temporary and that there is no reason to review their monetary policies at this time. The markets interpret this message, in combination with strong economic data, as a signal that future inflation will probably exceed the central banks' target of 2.0%, thereby making it less interesting for investors to hold bonds in their portfolio. As a result, long-term bonds are sold, pushing their price down and long-term interest rates up.

But there is another dimension that is new and that markets are having a difficult time handling. Things were simple enough when 2.0% inflation targets were set in the early 1990s: if total inflation as forecast exceeded the target, markets would expect central banks to tighten their monetary policies; however, if expectations pointed in the other direction, we could expect more accommodative monetary policies. Central banks (with the U.S. Federal Reserve leading the way) have revised their messaging in the course of the past year and now target average inflation of 2.0%. That is to say, they are ready to tolerate inflation above the target down the line if it is held below the target for a few years.

There is more: while the U.S. Federal Reserve has an official mandate to favour full employment, it now claims to foster inclusive labour market recovery, that is, inclusive of all levels of education, all genders, and all racial and ethnic backgrounds. How monetary policy can achieve this goal is unclear, and markets have a great deal of difficulty expressing their expectations for what is to come.

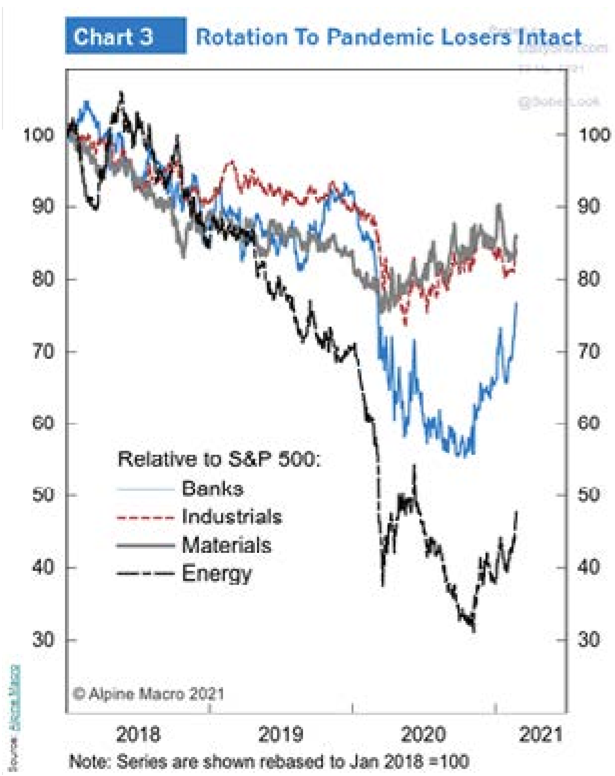
As a result, the yield curve (measured on the basis of the gap between 10-year and two-year interest rates) has quickly steepened in the first quarter, and we should expect this movement to continue, probably at a slower pace, until the end of the year.

Over the course of the quarter, this long-term interest-rate increase was a decisive factor in stock-market movements. Keep in mind that growth-oriented stocks, for instance, technology stocks, have performed extremely well since the market low of March 2020. The upward revision with respect to economic outlook, inflation, and, incidentally, interest rates has acted as a brake on this market momentum and ushered in a sector rotation toward "value stocks" that strongly reflect cyclical sectors that are more sensitive to the swings in the economy and to interest rates.

The connection between technology-stock performance and interest-rate movements is probably not clear to all investors. Transactions involving technology stocks are usually based on strong income-growth expectations in future years and generally do not pay out dividends. Through the practice of discounting cash flows, a rise in interest rates directly reduces the current value of long-term growth and, therefore, puts downward pressure on the fair value of these stocks. The logic behind all this is quite simple: low interest rates favour "growth stocks," while higher interest rates foster "value stocks."

That is the conclusion we come to when we look at stock markets' sector-based performance in early 2021. As we can see in Graph 10, various "value sectors," including banks, industrials, materials, and energy, have rebounded in the markets since the beginning of the upward movement in interest rates, while the NASDAQ Technology Sector Index is having trouble keeping up.

Graph 10



In the first quarter, the Canadian bond market, gauged by the FTSE TMX Canada Universe Bond Index, posted a return of -5.0%. As for the FTSE TMX Canada Short Term Bond Index, it returned -0.6%. Finally, the FTSE TMX Canada Long Term Bond Index showed a return of -10.7%.

U.S. stocks listed on the S&P 500 provided an overall return of 6.2% in the first quarter (4.7% in Canadian dollars). Canadian stocks listed in the S&P/TSX Index rose by 8.8%.

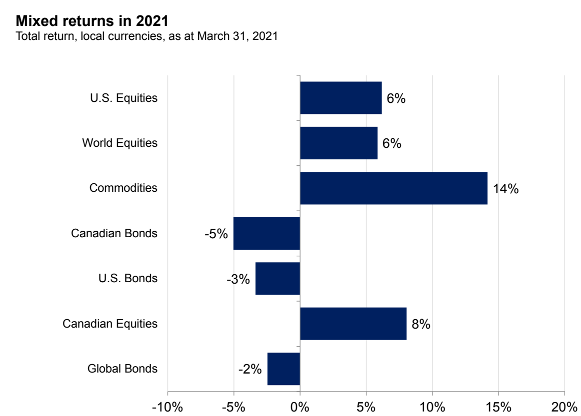
The European market, represented by the MSCI Europe Index posted a return of 7.8% in the first quarter (2.8% in Canadian dollars). The MSCI EAFE Index rose by 7.6% during the quarter (2.1% in Canadian dollars). The MSCI World Index returned 6.1% during the quarter (3.5% in Canadian dollars). Emerging markets, as gauged by the MSCI Emerging Markets Index, posted a return of 4.0% for the quarter (1.0% in Canadian dollars).

Strategy: a post-COVID roadmap

As mentioned in the previous section above, the second year of a bull market has just got under way, and we have already had a foretaste of what may come next.

While almost all asset classes provided positive returns in 2020, the current year shows signs of being more volatile. Stock markets are on the rise, but leadership change is clear both in terms of geography and sectors. The Canadian Stock Market Index and the Europe, Asia and Far East Index have recorded the best start to the year in 2021, driven by the rebound in sectors sensitive to economic growth. Contrary to our expectations, the U.S. dollar finally experienced a rebound in the first quarter, thereby limiting gains in the Emerging Markets Index (see Graph 11).

Graph 11



The rise in interest rates will remain the leading issue this year, and all indications are that this upward movement may continue for some years. The central banks have kept interest rates at historically low levels over the past decade, and the volume of fiscal stimulus injected into the global economy in the past 12 months should create favourable conditions for pursuing a correction in the price of bonds.

Keep in mind, however, that since it is positive economic news that is pushing interest rates up, it is reasonable to suppose that stock markets will withstand the revaluation in the bond market.

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Graph 12

Performance In The 12-Months Following Periods of Rising Interest Rates

Index	11-30-1994 11-30-1995	08-31-1996 08-31-1997	01-31-2000 01-31-2001	06-30-2006 06-30-2007	12-31-2009 12-31-2010	12-31-2013 12-31-2014	12-31-2018 12-31-2019	Average
Financials	54.2%	55.3%	29.5%	14.7%	12.1%	15.2%	11.7%	27.5%
Technology	50.5%	80.7%	-24.5%	25.9%	10.2%	20.1%	22.6%	26.5%
Health Care	51.4%	39.8%	18.8%	18.6%	2.9%	25.3%	8.6%	23.6%
Industrials	42.0%	36.9%	15.3%	17.4%	26.7%	9.8%	14.9%	23.3%
Real Estate				11.7%	28.0%	26.1%	26.7%	23.1%
Staples	39.9%	32.2%	17.6%	14.8%	14.1%	16.0%	14.0%	21.2%
Utilities	26.2%	9.9%	28.1%	26.1%	5.5%	29.0%	23.7%	21.2%
S&P 500	**37.0%**	**40.6%**	**-0.9%**	**20.6%**	**15.1%**	**13.7%**	**14.3%**	**20.1%**
Materials	25.4%	26.4%	-6.9%	29.1%	22.2%	6.9%	13.5%	16.7%
Discretionary	19.1%	26.2%	-0.9%	19.1%	27.7%	9.7%	15.8%	16.7%
Communications	37.9%	22.7%	-27.3%	38.8%	19.0%	3.0%	15.5%	15.7%
Energy	21.6%	42.7%	14.0%	28.0%	20.4%	-7.8%	-11.0%	15.4%

Graph 13

Sector Breakdown By MSCI Country Index

Country	CD	COMM	HC	TECH	CS	ENE	IND	FIN	MAT	RE	UTL	Value / Growth Bias
U.S.	12.1%	11.3%	13.3%	28.4%	5.7%	2.6%	8.2%	10.8%	2.6%	2.5%	2.5%	Growth
China	35.1%	20.8%	6.4%	5.8%	4.3%	1.2%	4.4%	13.9%	2.3%	3.9%	1.9%	Growth
Japan	18.5%	10.2%	10.0%	13.6%	7.1%	0.7%	21.1%	8.9%	5.1%	3.6%	1.2%	None
Germany	20.0%	5.1%	11.1%	13.7%	2.5%	0.0%	16.1%	14.5%	8.9%	3.7%	4.5%	None
Italy	17.9%	2.7%	3.9%	2.0%	1.7%	8.7%	8.2%	30.0%	0.0%	0.0%	24.9%	Value
U.K.	7.0%	4.5%	10.2%	1.1%	19.3%	10.4%	10.2%	19.6%	13.2%	3.3%	1.2%	Value
Mexico	1.5%	20.7%	0.7%	0.0%	30.9%	0.0%	10.4%	14.1%	13.6%	6.5%	1.4%	Value
Canada	4.0%	2.6%	1.1%	12.1%	3.7%	13.3%	10.8%	36.3%	11.6%	0.7%	4.0%	Value

As we can see in Graph 12, all occurrences of sharp interest-rate hikes since 1994 have been followed by good stock market performance with the exception of the years 2000 and 2001 when the technology bubble burst. The average return for the S&P 500 Index in a year following long-term interest-rate hikes approaches 20.0%, and in such cases, it is no surprise that the financial sector benefits the most. Interestingly, the tech sector ranks second in this regard, despite the negative correlation that exists between interest rates and the sector's valuation. Given the NASDAQ Index's astronomic returns in 2020, we believe the sector may display poor performance in 2021.

Since the impact of the movement in interest rates on stock markets should be seen in the interplay between "value" and "growth," we continue to recommend overweighting Canadian and European equities. As illustrated in Graph 13, the Canadian Index has one of the most favourable "value" compositions among the major stock indices; moreover, it offers a historically high discount in relation to the U.S. stock market on the basis of expected price/earnings ratio (see Graph 14).

Clearly, the road ahead in 2021 is not straight, and we should not exclude the presence of volatility. Interest rates will likely continue to rise, causing some episodes of volatility in stock markets. Despite it all, we maintain our expectations, namely, that: (1) equities will provide better returns than bonds; (2) "value stocks" will perform better than "growth stocks"; and (3) Canadian, European, and emerging markets will have a good year and recover some of the losses accrued in relation U.S. markets.

Graph 14

Finally, we remain optimistic regarding the outlook for the Canadian dollar in 2021. A well-entrenched global economic recovery and a rise in the price of raw materials should support the Loonie, which may return to its fair value of 85 U.S. cents by mid-2022.

Economic and Financial Environment (continued)

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Chart 1
Returns of the Canadian Bond Market as at March 31, 2021

Index	Returns (%)	
	3 months	1 year
FTSE Canada Universe Bond Index	(5.0)	1.6
FTSE Canada Short Term Bond Index	(0.6)	2.8
FTSE Canada Mid Term Bond Index	(4.5)	1.7
FTSE Canada Long Term Bond Index	(10.7)	(0.2)
FTSE Canada Federal	(3.7)	(1.8)
FTSE Canada Provincial	(7.2)	0.6
FTSE Canada Municipal	(6.0)	2.3
FTSE Canada Corporate	(3.5)	7.6

Chart 2
Market Returns as at March 31, 2021

Index	Returns (%)	
	3 months	1 year
FTSE Canada 91 Day T-Bill Index	0.0	0.2
FTSE Canada Universe Bond Index	(5.0)	1.6
S&P/TSX Composite Index	8.1	44.2
S&P 500 (Can. $)	4.7	38.1
MSCI - EAFE (Can. $)	2.1	27.7
MSCI - World (Can. $)	3.5	36.0
Exchange Rate (Can. $ / US $)	(1.4)	(11.7)

Chart 3
Market Returns as at March 31, 2021

Index	Returns (%)	
	3 months	1 year
S&P/TSX Sector returns		
Energy	20.3	40.6
Materials	(6.9)	39.0
Industrials	6.6	46.9
Consumer Discretionary	12.5	96.0
Consumer Staples	2.5	17.9
Health Care	38.0	69.1
Financials	13.9	46.7
Information Technology	(1.1)	85.7
Communication Services	7.1	12.2
Utilities	3.4	25.9
Real Estate	10.0	40.3
S&P/TSX Composite Index	8.1	44.2

Chart 4

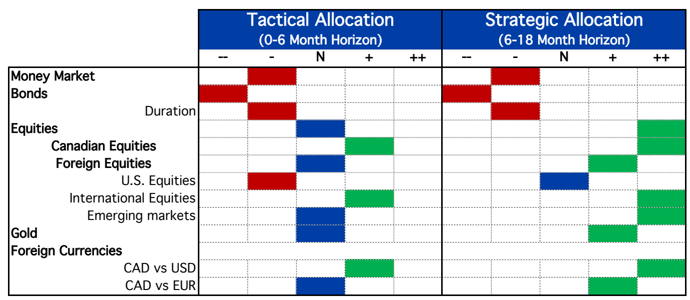

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Chart 5
Economic and financial scenarios

Economic scenario

							Change since December 31, 2020	
		2019	2020	2021	2022	2023	2021	2022
U.S.	Real GDP	2.2%	-3.5%	6.6%	5.8%	2.4%	+2.1%	+2.7%
	Inflation rate	1.8%	1.2%	2.3%	2.5%	2.8%	+0.3%	+0.3%
	Unemployment rate	3.7%	8.1%	5.6%	4.4%	4.0%	-0.4%	-0.6%
Canada	Real GDP	1.9%	-5.4%	5.8%	4.5%	2.6%	+1.8%	+1.0%
	Inflation rate	1.9%	0.7%	2.1%	2.3%	2.5%	+0.1%	--
	Unemployment rate	5.7%	9.6%	7.9%	6.3%	6.0%	--	--

Financial scenario*

			Targets			Change since December 31, 2020	
		Actual	June 2021	Dec. 2021	June 2022	June 2021	Dec. 2021
Interest rate	Canada 10 years rates	0.68%	1.85%	2.15%	2.50%	+0.90%	+1.00%
	U.S. 10 years rates	0.91%	1.95%	2.25%	2.60%	+0.70%	+0.80%
Exchange rate	US $/Can. $	0.79	0.82	0.84	0.85	+0.02	+0.03
	US $/Eur	1.22	1.23	1.24	1.25	--	--
	Oil price (WTI). US $	49	61	62	65	+9	+7
	S&P 500	3,756	4,000	4,100	4,350	+100	+65
	S&P/TSX	17,433	19,450	20,450	21,450	+950	+950

* end of period