TRIASIMA

Economic and Financial Markets Commentary

August 2014

Thawing the Winter Frost

Overall, the past few quarters have been uneventful on the economic front. The global backdrop remained that of an expanding global economy, although world economic growth decelerated somewhat in the opening months of 2014.

As such, early on in the current year, Japan witnessed an unexpected acceleration but this was more than offset by disappointing gross domestic product readings in the United States, the Eurozone and the emerging economies. In the case of the United States, the low growth could partially be ascribed to tough winter weather.

As at the close of the second quarter, early indications point to an economic reacceleration in the United States. This insures this country stays on its self-sustaining growth path and continues to act as the primary worldwide growth engine. Meanwhile, the Eurozone recovery is still weak with large differences amongst its constituent countries, France being a noteworthy laggard and with Germany slowing down of late. The emerging countries slowdown is showing signs of stabilizing, especially in Latin America.

Just like the United States, the Canadian economy weakened in the first quarter of 2014 and also appears to have reaccelerated in the second quarter. We have repeatedly used the word "lukewarm" to describe the situation in Canada over the last two years due to very weak internal demand growth and poor export demand from the emerging countries and the United States. This is still an appropriate qualifier.

This weak internal demand growth is caused by provincial and federal government fiscal austerity, high household indebtedness and slow job growth.

Overall, we maintain our "average worldwide growth scenario", which was raised in December 2013 from "below average growth".

A New Country Called Kurdistan ?

On the political front, Russia's recent annexation of Crimea, a part of Ukraine since the breakdown of the Soviet Union, has led to instability in that country and a hardening of politics against Russia by some advanced countries, including Canada and the United States.

More importantly in the second quarter, a fundamentalist pro-Islamic and anti-Western insurgency has risen in northern Iraq, cleaving the country over the course of a few short weeks along Sunni and Shiites lines. This is adding to instability in the Middle East. A side effect has been to detach northern Iraq's Kurd population from the much diminished Bagdad based central administration.

This now make it possible for the nation of Kurdistan to be eventually established. Raising the odds this may happen is Turkey's complete reversal on the desirability of having a Kurdish state south of its border.

Turkey used to see this eventuality as a destabilizing influence as long as Iraq was united and pro-Western. But Turkey now believes a self-sustained and relatively wealthy (due to its oil riches) Kurdish state would act as a buffer between itself and a fundamentalist Islamic state occupying parts of Iraq and, possibly, eastern Syria.

Risk Appetite on the Rise for Bonds

A weak Canadian economy pushed interest rates down over the opening months of 2014, with the yield-to-maturity of the FTSE TMX Canadian Universe Bond Index falling from 2.75% to 2.53%. Rates subsequently stabilized however over the second quarter alongside a rebound in economic activity, with the yield for the index settling at 2.44% at June 2014.

This 2.44% average interest rate for all outstanding Canadian bonds is not that far above the recent all-time low of 2.23%, set 15 months ago in March 2013.

Contrary to the broad consensus of prognosticators who believe interest rates are currently much too low and are bound to move up substantially soon, we think interest rates around 2.5% are almost appropriate given the prevailing low inflation level and substandard growth for the Canadian economy. Almost but not quite since we also believe a better long term equilibrium level would be about 2.8%. The main justification for the low inflation expectations is the excess capacity situation in the capital and labor markets.

Given that rates stand below our preferred equilibrium level, but that we also do not fear a huge rise in rates, we continue to keep bond portfolio duration at a high level on an absolute basis, at about 6 years, but nonetheless below the elevated duration index value of 7.1 years.

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The TMX bond index returned 2.0% over the quarter and is up 4.8% after six months in 2014. These are good returns made possible by the weak economy in the opening months of the year.

Interest rates also fell elsewhere over recent months, in the United States and Europe. The view that central banks will cover nearly any risk has led to a substantial fall in risk premia, explaining why government bond yields have dropped recently in Italy, Spain and Portugal.

Also contributing to the strong performance of the Canadian bonds has been the significant narrowing of credit spreads over the first half of the year. The Provincial to Federal difference fell from 129 basis points to 110 while the Corporate BBB to AAA/AA spread dropped from 153 to 120 basis points. Bond investors have plainly become more comfortable with risk in 2014.

Natural Resources Outperformance

The Canadian equity market had a great second quarter. It posted a jump of 6.4%, propelled by the strong showing by the natural resources sectors: Energy and Materials. This repeated precisely what had happened in the first quarter when these two sectors began rebounding from depressed valuations and also had strong gains. Six months into 2014, they are up 21% and 17% respectively.

The Industrials sector, also cyclical, performed well too with a 9% jump over the past quarter. A weaker Canadian dollar, firmer commodity prices and recent acceleration in the growth of the global Gross Domestic Product are all reasons for the improved performance by these cyclical sectors.

The Canadian equity market has thus jumped 13% over the first half of the year, helped along thus by the economically sensitive areas of the stock market. This is a strong performance. Highlighting the leadership difference, the four defensive sectors (Consumer staples, Health care, Telecommunications and Utilities) are trailing badly over the first six months. They are up 8% on average, a commendable outcome but nonetheless far below the returns of the cyclical sectors.

The Bull Market Soldiers On in the United States

The tale from the American equity market tells a somewhat different story, especially since the Energy and Materials sectors are much less important in that market. These two sectors account for 14% of the American index while they represent a much larger 39% of the Canadian index.

The S&P 500 index is up 5% (in US $) over the second quarter, helped along by the Energy sector which climbed 12%. The price of oil was firm due to renewed Middle-East instability and a reacceleration in world Gross Domestic Product growth.

The next best sector in terms of performance was Utilities. This defensive and interest sensitive sector was supported by the decline in American interest rates over the first six months of 2014.

On a year-to-date basis, the two best performing sectors are Energy, +13%, and Utilities, +19%. The overall S&P 500 Index is up 7%, an above average outcome. At 8%, the performance is similar when measured in the Canadian currency; the Canadian dollar having been weak in the first quarter but with a smart recovery in the second.

Emerging Economies Troughing

In the international arena, after a pedestrian 1.3% return in the first quarter, the MSCI Word Equity Index surged ahead in the second quarter, posting a 4.9% advance. However, this outcome drops to only 1.3% in Canadian dollars due to the sudden second quarter rebound of the currency.

The better second quarter showing by world equities was caused by a reacceleration in the American and Japanese economies and by the absence of bad news from Europe and the emerging countries.

Japan, Emerging markets and Latin America were all up 7% while the Eurozone countries lagged with a 3% return. Investors came to realize more acutely recently that the recovery would be long and shallow in Europe. To wit, over the recent months, German industrial production disappointed while economic news from France are, basically, uniformly bad. These are the two largest economies of the Eurozone which needs all the help it can get from the European Central Bank. Eurozone growth is low, the overall unemployment rate is near record, deflationary forces are prevalent and credit growth is negative. It will take a while for this part of the world to renew with economic dynamism.

In contrast, and despite both regions having their share of issues, China has been posting better trade statistics of late and Latin America growth is generally solid, with stabilizing inflation and interest rates. However, China

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still faces serious headwinds from its real estate market and immature banking system. Fortunately, the Chinese government has huge monetary and fiscal resources at its disposal to deal with further deterioration on both these fronts.

Conclusion

The economic expansion carries on. The current phase of the cycle is now in its sixth year, having begun in the second quarter of 2009. However, this is actually not a very long period given the deep cleansing effected by the Great Recession. This process of resetting the bar at a lower level improves the odds that a long span of time will go by before major economic imbalances build anew or before the arrival of the next bubble, either of triggering the next recession.

The Great Recession also coincided with the second worst plunge in equity markets in history, which also paved the way for a long protracted rise, which we are currently benefiting from.

As a note of caution, however, regarding the longevity of the current bull phase of the market, we believe strong and sustained outperformance by the Energy and Materials sectors of the Canadian equity market is a sign the bull market is entering the speculative phase that is a hallmark of the last part of the economic and stock market cycles. This bears watching (no pun intended) as these two sectors have indeed outperformed in the first half of 2014.

Notwithstanding, we remain positively disposed towards equities and continue to foresee positive returns into the second half of 2015.

We recently changed in December 2013 our reference scenario to ‘average worldwide growth’ from ‘below average worldwide growth’, which had been previously adopted in August 2011.

If, with the passage of time, either Europe or emerging countries grow stronger, probably the latter, we will change the reference scenario to ‘above average worldwide growth’.

As for bonds, we are optimistic that a debacle caused by rising interest rates will not occur. The absence of inflation, the presence of excess labor capital and very low velocity of money conspire to diminish the probabilities of future abrupt and large increases in rates. This remains so despite an ongoing American Federal Reserve tapering.

Short term, over the remainder of 2014, the strong first half performance by the bond asset class probably borrows from the 2014’s second half performance.

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