Market Matters

FEBRUARY HIGHLIGHTS

- By and large the bull market for equities remains intact – particularly for developed countries – as investors rotate from fixed income into equity assets.
- An indecisive election in Italy, ponderings over the eventual unwinding of U.S. quantitative easing programs, and the latest self-imposed U.S. fiscal deadline gave investors pause, but little more.
- Positive economic momentum in the U.S. is outshining more muted expectations for Canada.
- Weaker than expected manufacturing data out of China (still the economic bellwether country for emerging markets) created headwinds for many emerging country stock markets, including those in China, Brazil and India.
- Bond markets benefited from increased market volatility as January's price drop reversed in February.

A GROWING NUMBER OF BULL-IEVERS

Improving economic conditions, particularly out of the U.S., are trumping worries of impending budgetary cuts and political unease. Growing investor confidence is supporting equity markets as investors rotate out of cash and fixed income investments (their comfort-zone since the crisis) into equities (see Table 1). Investors seem more willing than they've been in years to take on market risk and once again consider the benefits of being owners (equity shareholders) rather than loaners (bond investors).

THE HEAVY WEIGHT OF GOLD

Eight out of 10 S&P/TSX Composite sectors had a positive return in February (see Table 3), and year-to-date results are strong. In spite of this, the strong bull market in the U.S. continues to outrun our Canadian market, and a weakening Loonie further exacerbates the difference in returns once U.S. investments are converted back into Canadian dollars.

In contrast to the strength seen in most sectors, within the Canadian Materials[1] sector sentiment towards gold companies is poor. These companies have yet to convince investors that they've made meaningful

Table 1
Summary of major market developments

Market returns*	February	YTD
S&P/TSX Composite	1.1%	3.1%
S&P 500	1.1%	6.2%
- in Canadian dollars	***4.4%***	***9.9%***
MSCI EAFE	1.6%	7.5%
- in Canadian dollars	***2.0%***	***7.6%***
MSCI Emerging Markets	-1.1%	0.2%
DEX Universe Bond Index**	1.0%	0.3%
BBB Corporate Index**	1.4%	1.3%

*local currency (unless specified); price only
**total return, Canadian bonds

Table 2
Other price levels/change

	Level	February	YTD
U.S. dollar per Canadian dollar	$0.972	-3.1%	-3.4%
Oil (West Texas)*	$92.03	-5.8%	0.2%
Gold*	$1,583	-4.9%	-4.8%
Reuters/Jefferies CRB Index*	$292.95	-3.6%	-0.7%

*U.S. dollars

Table 3
Sector level results for the Canadian market

S&P/TSX Composite sector returns*	February	YTD
S&P/TSX Composite	1.1%	3.1%
Energy	0.5%	2.9%
Materials	-5.6%	-9.0%
Industrials	6.3%	14.2%
Consumer discretionary	2.2%	6.4%
Consumer staples	4.9%	4.0%
Health care	5.8%	17.2%
Financials	2.8%	5.6%
Information technology	3.8%	13.8%
Telecommunication services	4.8%	8.3%
Utilities	-2.2%	1.7%

*price only
Source: Bloomberg, MSCI Barra, NB Financial, PC Bond, RBC Capital Markets

improvements to their operating cost structures, and on top of this the traditional attraction of the bullion as a safe-haven trade during times of economic turmoil has lost its luster as investors gain confidence in the global economic recovery.

The Canadian Energy sector* has held up well on a year-to-date basis helped by China's effective maneuvering of a soft economic landing, and improved optimism toward the outlook for global economic growth. One factor that continues to weigh on Canadian energy companies is the significant pricing gap between West Texas Intermediate (WTI)[2] and Western Canadian Select (WCS)[2]. Simply put, a barrel of oil from the oil sands trades at a discount to oil from other regions in part because it's considered 'heavy' and requires more refining. That discount is well above its historic norms and at the end of February stood at $26.40 less per barrel. Why? There is not enough 'take-away capacity' to move the oil from the oil sands to its refineries, as well as the increased oil production within the U.S. weighing on the outlook for demand for Canadian oil.

[1]*Weight in S&P/TSX Composite as of February 28, 2013 for the Materials sector was 17% of which 8% is in the gold mining sub-sector, and 25% for the Energy sector.*
[2]*WTI reflects the trading price of oil for the broad North American market. WCS reflects the trading price of oil for the Canadian oil sands producers.*

AUSTERITY MEASURES? NO GRAZIE!

Troubling election results in Italy, with no clear winner determined, created concern for the stability of the Eurozone resulting in market volatility and a pull back in results for some European stock markets (such as France's CAC 40, Germany's DAX, and Italy's FTSE MIB). If you are struggling to understand the political popularity of a scandal-besieged ex-Prime Minister and the rise in support of an anti-establishment party led by a comedian and convicted felon – perhaps the answer lies more in who the Italian people did not vote for - the pro-austerity politicians. Negotiations to form a coalition government will likely add to some market volatility, but the European Central Bank's (ECB) ability to initiate the Outright Monetary Transaction (OMT) program is giving investors confidence that there would be a credible lender of last resort to support the Euro if need be.

U.S. SEQUESTER

If U.S. politicians were trying to confuse their constituents as they go about their work in Washington they would:

- impose self-manufactured, detrimental fiscal deadlines,
- wait until deadlines have passed to begin discussions,
- use media and public forums to discuss the lack of shared ideology between political sides, instead of actual ideas on how to resolve the problem, and
- describe relatively simple concepts, like 'spending cuts', using little known and rarely-used terms like 'sequestration'.

Without political agreement the full impact would mean about $85 Billion (USD) of spending cuts would occur over the course of the year, which is estimated to create a drag on economic growth of around half a percent or slightly more. To put that in perspective, the full effect of the fiscal cliff (which included these spending cuts plus tax hikes) would have been closer to two percent, effectively putting the U.S. into a recession. With U.S. economic data, such as jobs and housing, improving and a fair dose of 'fiscal crisis fatigue', market reaction to the March 1st sequester deadline was very muted when compared to the days leading up to the fiscal cliff deadline.

KNOW YOUR LIMITS

Given the magnitude of demand for fixed income that followed the financial crisis, some rotation back into equities is likely healthy for many investors – but the key is to know your limits. Exposure to equities is important for capital growth opportunities, but so are the principles of diversification and staying within your personal risk tolerances.