Market Matters

2013 Highlights

- Equity markets roared ahead and the U.S. market led the way. In 2013 the S&P500:
  - Saw 40+ new closing highs;
  - Had its best year since 1997;
  - Showed remarkable breadth with 455/500 members advancing;
  - Gained more than 10% in every sector.
- Canadian equities fared well, but lagged behind their developed market peers. Weak commodity prices (e.g. gold, copper, potash) contributed to a precipitous decline in stock prices in the Canadian materials sector.
- International market results varied.
  - Eurozone emerged from its longest recession in history and equities experienced solid gains across the region.
  - Japan's Abenomics (a series of policy measures aimed at reenergizing the Japanese economy) helped to boost the Nikkei 225 to a remarkable 57% gain.
  - Emerging bond and equity markets were laggards. Key reasons included significant capital outflows and slowing economic growth.
- Rising longer-term interest rates posed a headwind for bonds. Bond investors faced their first negative return year since 1999.
- Corporate bonds fared 2.4% better than their government counterparts. The DEX Corporate Bond index managed a modest positive return for 2013.
- The Canadian loonie declined in value relative to the U.S. dollar (boosting Canadians' investment results abroad). Several factors weighed on the Canadian dollar, including weaker commodity prices, stronger U.S. economic data, a slowdown in foreign funds seeking the relative safety of Canadian government bonds, and the Bank of Canada's dovish low-rate policy.

Table 1
Summary of major market developments

Market returns*	December	Q4 2013	2013
S&P/TSX Composite	1.7%	6.5%	9.6%
S&P500	2.4%	9.9%	29.6%
- in Canadian dollars	**2.4%**	**13.5%**	**38.4%**
MSCI EAFE	1.3%	6.0%	23.5%
- in Canadian dollars	**1.4%**	**8.8%**	**27.6%**
MSCI Emerging Markets	-1.1%	2.7%	0.9%
DEX Universe Bond**	-0.4%	0.4%	-1.2%
BBB Corporate Index**	-0.4%	1.1%	1.2%

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

Table 2
Other price levels/change

	Level	December	2013
U.S. dollar per Canadian dollar	$0.941	-0.1%	-6.6%
Oil (West Texas)*	$98.42	6.2%	7.2%
Gold*	$1,205	-3.7%	-28.1%
Reuters/Jefferies CRB Index*	$280.17	1.9%	-5.0%

*U.S. dollars

Table 3
Sector level results for the Canadian market

S&P/TSX sector returns*	December	Q4 2013	2013
S&P/TSX Composite	1.7%	6.5%	9.6%
Energy	2.8%	4.9%	9.9%
Materials	1.9%	-2.6%	-30.6%
Industrials	1.0%	15.8%	34.9%
Consumer discretionary	2.5%	7.4%	39.5%
Consumer staples	0.3%	3.6%	21.4%
Health care	7.9%	13.8%	71.7%
Financials	1.0%	9.1%	19.1%
Information technology	3.0%	7.0%	36.2%
Telecom services	-1.3%	5.7%	8.1%
Utilities	-0.4%	1.8%	-8.6%

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

LOOKING FOR MATERIAL GAINS?

The significant weighting of the Canadian materials sector meant that sluggish global growth, including a declining growth rate in China, weighed on most commodities. Gold bullion prices were down 28% and Canadian gold companies (down 45%) struggled to manage operating and capital costs. Owning gold stocks in 2013 was akin to banging your head against a cement wall (painful and going nowhere fast). Copper slid 8% and took the stock prices of diversified metals producers down 21%. Further wounding the sector, Russian potash producer Urakali opted out of its selling cartel that controlled 40% of the global potash market and drove the commodity price, and Potash Corp's stock, down sharply.

It wasn't all bad news in Canada. Ex-materials, the Canadian stock market actually performed quite well, albeit still lagging the strength south of the border (see Table 3). Areas of strength included the health care, consumer discretionary, information technology and industrials sectors. The heavily weighted financials sector also gained a respectable 19%.

CLIMBING A WALL OF WORRY – TO NEW HEIGHTS!

U.S. equity markets climbed a wall of worry in 2013, including: overcoming the sequester; worries over when and how the U.S. Federal Reserve would cut back on their quantitative easing program; fears of a military strike on Syria; and a government shut down and concerns over the debt ceiling. No small feat and they did it with spectacular equity market results (see Table 1). Corporate earnings results were strong. Profit margins were helped by the absence of significant wage pressure and corporate buybacks. Strong equity markets and encouraging economic data boosted investor confidence. While it hasn't been an easy or smooth road forward, Americans have seen improvements in their employment, manufacturing, retail sales, and housing data.

FIXED INCOME FALTERS

The brooding rights for 2013 go to bond holders. Yields on 10-year Government of Canada bonds increased about 100 basis points since late April. Bond values declined faster and more significantly than the income they generate could compensate for. The Canadian DEX Universe Bond index saw its first annual negative return in 13 years. The significant jump in long-term yields occurred when the U.S. Federal Reserve (Fed) first made mention of the eventual reduction in their asset-purchasing plan. The so-called 'taper talks' and speculation persisted throughout the summer and fall, creating significant volatility. The Fed finally announced a $10 billion dollar monthly reduction in their asset-purchasing plan beginning in January 2014.

LOOKING FORWARD

Given improving global economic conditions against a backdrop of accommodative monetary policy, we anticipate that equity returns should outpace bonds again in 2014.

While it is unlikely that U.S. equities will repeat the stellar returns of 2013, economic conditions are improving which should help drive better revenue growth in the year ahead. As a result, expectations of another positive year in equities seem reasonable. Having said that, we acknowledge the strong gains already achieved since the financial crisis may need to consolidate (i.e. a modest correction would be healthy) before the next step forward.

With fewer headwinds for the materials sector on the horizon and a weaker Canadian dollar (which will help boost exports and manufacturing), the Canadian equity markets are poised to perform more in line with their developed market peers in 2014.

Overall we believe developed markets continue to offer a better risk/reward backdrop than emerging markets. For instance, although China's economy is showing signs of stabilizing, it still faces some immediate challenges. Within developed markets, we favour the outlook for North American equities over European equities given the underlying risks that remain within the eurozone.

Bond investors should temper their return expectations in 2014. Our base case is for a gradual increase in longer-term interest rates over the course of 2014, with the Fed providing forward guidance that an overnight rate hike will be pushed off until at least late 2015. Over time this will allow for interest rates to normalize and should balance supply and demand conditions, which have been artificially manipulated through quantitative easing measures. Within appropriate risk tolerances, it is appropriate to consider a bias toward shorter-duration fixed-income products that are less sensitive to rising rate headwinds, as well as exposure to corporate bonds where there is the opportunity for higher yields.

QUITE A YEAR!

Isn't it amazing what we can learn in just one year? For example, in 2013 we learned that we can actually buy stuff with bitcoins, and then withdraw some more at a bitcoin ATM - right here in Canada! We learned that a government deadline is really just the starting line for political gamesmanship, and the term 'crackberry' can lend itself to stories about Canadian mayors and beleaguered tech-companies alike. We even learned that the Leafs can make it to the playoffs – who would have thought! The bottom line is that each year brings about a new set of surprises (economic, political or otherwise) and lessons to be learned – and 2014 will be no different. With that we wish our readers much success as we navigate together whatever surprises 2014 has to hold.