



# MILESTONE COMMENTARY

October 28, 2013

## Rising Equity Tides with a Fixed Income Undertow

### **Bottom Line:**

The third quarter of 2013 saw a solid advance in world equity markets, however, fixed income remains in an intermediate-term bear market. The downturn in fixed income markets that began in May continued throughout the summer with a bit of a bounce at the end of September. Government and investment-grade corporate bonds in Canada experienced price declines of approximately five to ten percent which is very significant. The US, Japan and parts of Europe have been the best equity performers this year, whereas commodity-based equity markets like Canada continue to lag behind.

Economic data out of the US continues to slowly improve but growth is still not at a pace that would alleviate some longer-term investment concerns. There has been some volatility surrounding the Federal Reserve tapering and the US debt ceiling; however those concerns have once again been pushed into the future.

### **Economic Overview:**

Although there have broadly been sunny skies across developed country markets this year there has been a stealth undertow in the fixed income markets since the beginning of May. June was by far the worst month with long-term bond yields snapping up by approximately 1% (see chart next page). Bond yields and prices move in opposite directions. By the end of September, the US Government 7-10 year Treasury index and the Canadian Government Bond index were both sucked down roughly 4% year-to-date. For Government bonds, that is a pretty big move to the downside. Consequently, this has led to a selloff in other interest rate sensitive instruments such as corporate bonds and preferred shares. Even some equities that are looked upon as income-generating investments, such as REITs, pipelines and utilities have declined as well.



Source: [www.tradingeconomics.com](http://www.tradingeconomics.com) | Treasury Board of Canada

There are a few reasons that have contributed to this. First off, and most importantly, the US Federal Reserve (the central bank of the US) has started to signal that its Quantitative Easing (money printing) program will need to slow down and eventually stop. Currently they are printing \$85B each month and using that cash to buy Federal Treasuries and Mortgage-Backed Securities (MBSs). By creating artificial buying pressure, they have been successful in keeping the prices for these assets higher than they otherwise would have been.

Two recent events have led bond prices to recover somewhat, albeit not close to the levels earlier this year. Firstly, in September's Fed Meeting, Ben Bernanke announced that the Fed has chosen not to taper back its money printing yet. This took the markets by surprise and gave the bond market some reprieve. Buying pressure came back into Government bonds and they were able to recoup some of their losses. Secondly, in October, the US Government experienced a shutdown due to the Democrats and Republicans not being able to come to an agreement on the budget. More worrisome was that by around October 17th, the Government was at risk of running out of money and hitting their self-imposed debt ceiling. However, in the end, cooler heads prevailed and a deal was reached. That again allowed the bond markets to chart towards safer waters and bond prices were able to recover a bit more.

A second reason for the downturn in bonds in 2013 is due in part to a better mood towards the US economy. It has been a long road to recovery from the Great Recession in 2008-09, but there is some recent evidence that the US economy may be finally reaching exit velocity. We suggest that the US might actually be seeing some real growth above the 1.5% - 2.0% range that the economy has been trending at the past few years. This is still only very recent and the last action by the Federal Reserve to refrain from tapering their purchases shows a lack of confidence that this short term growth can lead to the same longer-term growth required. However, as a result of this more positive outlook and increased optimism, money has been flowing increasingly from bonds to stocks. This of course is good for equity prices, but a difficult current to navigate for bond valuations.

## The Markets & Our Strategy:

Below is the price performance summary of global equity and North American bond markets up to September 27<sup>th</sup>, 2013:

Equity Markets				
<b>Canada</b>				
	Level	Wkly Chg (%)	YTD	YTD C\$
S&P/TSX Composite	12844	0.3%	3.3%	3.3%
S&P/TSX 60	737	0.3%	3.2%	3.2%
S&P/TSX Small Cap	577	-0.3%	-1.4%	-1.4%
<b>US</b>				
	Level	Wkly Chg (%)	YTD	YTD C\$
Dow Jones	15258	-1.2%	16.4%	21.0%
S&P 500	1892	-1.1%	18.6%	23.2%
Nasdaq	3782	0.2%	25.2%	30.1%
Russell 2000	1074	0.1%	26.5%	31.4%
<b>International</b>				
	Level	Wkly Chg (%)	YTD	YTD C\$
DAX	8862	-0.2%	13.8%	21.1%
FTSE 100	6513	-1.3%	10.4%	13.9%
Nikkei	14760	0.1%	42.0%	29.1%
MSCI EAFE	1836	0.0%	14.5%	18.9%
MSCI World	1555	-0.5%	16.2%	20.7%
MSCI EM	1000	-1.3%	-5.2%	-1.6%

  

Fixed Income			
<b>Indices / Rates</b>			
	Level	Wkly Chg (%)	YTD
DEX Universe Bond	879	0.9%	-1.7%
DEX Real Return Bond	477	1.8%	-11.8%
Mer Lynch US High Yield Master II	989	-0.3%	3.9%
LIBOR 3-month	0.2484%	-0.5%	-18.8%
<b>Government Bond Yields</b>			
	3-mo T-bill	10-yr Bond	30-yr Bond
Canada	0.97	2.557	3.082
US	0	2.625	3.687
Spread	0.97	-0.068	-0.605

Source: TD Asset Management

There has been a stark contrast between US and Canadian equity market performance this year with the US market ahead by roughly 20%. The Japanese equity market has also had a very strong year. In addition, there has been a nice recovery for many countries in Europe. It is no secret that the US and Japan are large benefactors of the printing press. With the US equity market rising far more than earnings growth the past few quarters, it is difficult to gauge fair value in these unprecedented times of monetary stimulus. It is our belief that equity markets are primarily being driven by sentiment. As long as monetary easing measures are kept in place, we are likely to see a continued rise in these equity markets. Canada's resource based equity market has not been able to keep pace, however we continue to believe we are well positioned from a fiscal and monetary standpoint going forward with a relatively strong economy.

Our portfolios have had to navigate this undertow with higher fixed income weightings. We had very good reasons for being conservative with regards to the US and foreign equity markets as we've discussed in prior commentaries, but despite that, equities have outperformed. With accommodative measures still in place and mostly positive economic data coming out of the US lately, we now feel confident in slowly increasing our equity weightings to target over the next couple quarters and using any short-term rebounds in fixed income to do so. This is providing an investor's situation allows for it (risk tolerance, age and investment objectives). Slowly gravitating more towards a larger weighting in equities and a somewhat smaller weighting in fixed income will allow our portfolios to participate more in the upside potential of the stock market if we are truly in a new expansionary phase to the economy.

Our overall 'SIRP' investment strategy (a term coined by economist David Rosenberg which

stands for 'safety and income at a reasonable price') has not changed; however, as long as we see current monetary conditions in place we will be gradually increasing our global equity exposure. We have put a lot of due diligence into finding equity strategies that we feel comfortable with in terms of risk-adjusted return potential and feel this will benefit our portfolios going forward.

Our investment decisions are based on a full market cycle. We continue to maintain our focus on capital preservation and risk-adjusted returns, while maintaining a solid income yield for our clients.

With recent agreements in place in Washington, the US has likely bought more time to sort out their longer-term issues. We are hopeful they will be able to navigate their way through to provide the balance markets need to flourish. We continue to monitor economic data as it arrives, primarily leading indicators, in addition to sentiment and market internals. We are continually mapping out different scenarios for global economies and striving to maintain a diversified portfolio that can endure and thrive.

We would like to thank our clients for their continued trust in us.

Respectfully,

- **Your Milestone Team**

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