# MILESTONE COMMENTARY

July 18, 2014

## *Tranquility*

*"The more tranquil a person becomes, the greater is their success, their influence, their power for good. Calmness of mind is one of the beautiful jewels of wisdom."*
*- James Allen*

***Bottom Line:***

The first half of 2014 saw a calm come over the markets. It was a very rare case where generally speaking, stock, bond and commodity markets were up – maybe not all dramatically so, but up nonetheless. In fact, this is the first time since 1993 where world stock, bond and commodities markets were all positive for the first half of the year. With uneven economic growth out of the U.S. as well as political turmoil in Ukraine and the Middle East, markets have been remarkably resilient.

Although economic growth has been uneven in the U.S. with a large part of its Q1 GDP decline being weather related, we have seen resurgence in their economy in the second quarter to the point where we might finally say it is fairly healthy. If one could pinpoint one major driver to the positive gains in all asset classes this year, the drop in the U.S. 10-Year Treasury Notes yield from approximately 3% to 2.5% could be it. Low government yields are continuing to push individual and institutional investors into bonds, commodities and equities in search of higher returns.

The key feature to equity markets the first half of this year has been extremely low levels of volatility. The market volatility index, known as the VIX, has recently been hovering at a level last seen in 2006 and 2007. There are many who argue that when volatility is this low, investors are far too complacent and take on too much risk for the reward. They also posit that markets are likely due for a correction. This remains to be seen, but one should point out that the last time the VIX declined into recent equivalent low levels (2005) the markets continued their upward push for another two and a half years.

With low levels of volatility, low interest rates, unprecedented central bank stimulus, strong corporate profit growth and a gradually improving economic backdrop (particularly the U.S.), we are inclined to be positive and will continue to view markets through a healthy lens.

## ***Economic Overview:***

*The Loonie is in the News again*

The first quarter saw a definite weakening trend for the Canadian dollar. Starting the year at $0.941 to the U.S. dollar, it bottomed out briefly below $0.89 before rebounding to end the first quarter at $0.905. Throughout the second quarter, however, the Canadian dollar strengthened slowly to finish at $0.937. So by mid-year, our dollar was only down slightly (less than half a percent).

There are always multiple factors that go into currency pricing, however certainly a major reason for the changes so far in 2014 is the comparative economies. Coming into 2014, the general consensus by economists and the markets was that the US economy was finally breaking out of its mediocre growth, leaving Canada still stuck in that range of 1.5% - 2.0% annual real GDP growth. For the first part of the year, the markets in general believed that the U.S. would outperform Canada, pushing down the value of the Canadian dollar relative to the U.S. dollar.

Once the first quarter was behind us, the estimates for Q1 GDP started to look surprisingly weak for the U.S. (mostly due to the extreme weather in the eastern U.S.). The first estimate of U.S. GDP was for flat growth, then the second estimate was for a -1.0% GDP, and when the final number came out, it was in fact -2.9% (annualized). This was clearly a very disappointing number and will make it difficult for the U.S. to pull off a 2014 GDP growth rate north of 2% (once again). Based on this information, the Canadian dollar was able to gradually gain back some ground on its counterpart. This is of course in the rear view mirror and estimates for a sharp snapback in second quarter growth (which seems to be continuing this quarter) could lead to the strengthening again of the U.S. dollar.

*Oh Canada! (or shall we say Oh Alberta?)*

Looking at the Canadian economy, status quo seems to be in order for 2014. For a few years now, since the end of the Great Recession, the Canadian economy has been running at a 1.5% - 2.0% annual real GDP growth rate. And that looks to be the pace once again this year. As always, there are bright and not so bright spots. Certainly Alberta has been a real bright spot lately and that looks to continue. With Alberta estimated to come in at around 3.7% growth for 2014, we are clearly outpacing the country as a whole by a wide margin. With solid growth and a continued relatively low unemployment rate, in-migration to Alberta continues to drive other parts of the economy such as consumer spending and housing. Our provincial government is benefiting as well which may translate into a *true* balanced budget this year (as opposed to the 'operating surplus' they reported for last year).

As Calgarians, it is easy to see this steady growth just by looking at the pace of activity downtown with cranes at every turn. Although Canada's real estate market growth has been mediocre of late, Calgary's has been very strong leading the way nationally with average sale prices reaching an all-time high in June. In fact, Calgary's annual price growth in resale housing was the best in Canada in May, more than doubling the national average. As a senior economist with BMO Capital Markets recently said, Calgary and Alberta more broadly, "is on an island by itself" when referring to our housing market.

This carries over into employment as well, where Calgary and Alberta went against the national trend in job creation in June. With overall employment surprisingly dipping across Canada during the month, Alberta's monthly and annual employment growth is far above the national rate. Richard Tuscott, Alberta director for Canadian Federation of Independent Business, said "there's no doubt Alberta's job market is operating in a different realm from the rest of the country."

*Bond Markets*

Bond markets in North America are up this year with strong back-to-back quarters. There are several reasons for this, but we focus on three major ones. First, as mentioned above, the economy has been somewhat weaker than expected in 2014, alleviating some concerns that inflation may kick in at some point in the near future.

Second, interest rates in Europe have been dropping (quite significantly in some countries). So the global competition for yield makes North American bonds look like a pretty good investment compared to government bonds in European countries. According to Bloomberg, the German 10-year yield was 1.24% at mid-year while the U.S. 10-yield was 2.52%. Even economically struggling France has a 10-year yield sitting at 1.69%. When there is increased demand for bonds, the price gets driven higher and yields lower.

And third, as expected, the U.S. Federal Reserve has been tapering back their Quantitative Easing program. However, this hasn't had a detrimental impact on the bond market yet. This time last year, the U.S. Fed was printing $85 Billion per month – roughly half of that going into U.S. Treasuries and the other half going into mortgage-backed securities. Currently, they have incrementally scaled that back to only $35 Billion per month.

Bond market participants panicked last spring/summer on just the thought that without this massive bond buyer in the marketplace, bonds would surely sell off. However, that hasn't materialized in 2014 so far. A big reason is that the U.S. government's fiscal position is looking much better this year, leading them to require less and less borrowing. After the Great Recession, the U.S. government was running an annual budget deficit in excess of $1 Trillion, but this year is projected to be about half that amount. So even though the U.S. Fed is 'printing' less money, they are still acting to stimulate the economy and support the bond market because the U.S. government's new bond issuance has gone down in tandem.

## ***The Markets & Our Strategy:***

Below is the 2014 performance summary of global equity and North American bond markets to June 27th, 2014:

| Equity Markets | | | | |
|---|---|---|---|---|
| **Canada** | | | | |
| | Level | Wkly Chg (%) | YTD | YTD C$ |
| S&P/TSX Composite | 15094 | -0.1% | 10.8% | 10.8% |
| S&P/TSX 60 | 864 | 0.1% | 10.3% | 10.3% |
| S&P/TSX Small Cap | 704 | -1.4% | 15.3% | 15.3% |
| **US** | | | | |
| | Level | Wkly Chg (%) | YTD | YTD C$ |
| Dow Jones | 16852 | -0.6% | 1.7% | 2.1% |
| S&P 500 | 1961 | -0.1% | 6.1% | 6.5% |
| Nasdaq | 4398 | 0.7% | 5.3% | 5.7% |
| Russell 2000 | 1190 | 0.1% | 2.2% | 2.6% |
| **International** | | | | |
| | Level | Wkly Chg (%) | YTD | YTD C$ |
| DAX | 9815 | -1.7% | 2.8% | 2.5% |
| FTSE 100 | 6758 | -1.0% | 0.1% | 3.4% |
| Nikkei | 15095 | -1.7% | -7.3% | -3.6% |
| MSCI EAFE | 1966 | -0.9% | 2.6% | 3.1% |
| MSCI World | 1741 | -0.4% | 4.8% | 5.2% |
| MSCI EM | 1046 | 0.2% | 4.3% | 4.8% |

| Fixed Income | | | |
|---|---|---|---|
| **Indices / Rates** | | | |
| | Level | Wkly Chg (%) | YTD |
| DEX Universe Bond | 924 | 0.3% | 4.6% |
| DEX Real Return Bond | 518 | 0.7% | 10.4% |
| Mer Lynch US High Yield Master II | 1080 | 0.0% | 5.6% |
| LIBOR 3-month | 0.2346% | 1.7% | -4.7% |
| **Government Bond Yields** | | | |
| | 3-mo T-bill | 10-yr Bond | 30-yr Bond |
| Canada | 0.95 | 2.25 | 2.801 |
| US | 0.02 | 2.535 | 3.367 |
| Spread | 0.93 | -0.285 | -0.566 |

*Source: TD Asset Management*

After a flat first quarter, the MSCI World (local currency) is now up 4.8% at mid-year. One shining star is our TSX Composite which continues to be one of the strongest performing markets globally this year. The main reason for this is the resurgence of the energy and materials sectors up 22.3% and 15.5% respectively.

In bond markets, the Canadian bond index is up a very strong 4.6%. Perhaps this partially a snap back from last year's poor performance, but nonetheless is no longer a headwind for balanced portfolios.

Commodity markets have also been favorable, with Gold rallying 8.7% and commodity prices overall up 8.1% to mid-year.

Our repositioning to full weight in our equity allocations within a balanced mandate in the fall has proved successful for the last three quarters. We continue to have a positive view of markets, although we may likely see some higher volatility or perhaps a correction later this summer which is not seasonally strong for equities. There appears to be many managers who have raised cash in the second quarter, and thus any expected correction could likely be short lived. In addition, most mid-year outlooks we have read from other managers are fairly positive.

How equity markets will react to the end of Quantitative Easing remains one major unknown factor. However, we are hopeful that the recent resurgence in U.S. economic growth, coupled with strong corporate earnings profiles and balance sheet strength, can transition the market smoothly away from Central Bank intervention to a more traditional scene whereby investors focus more on earnings and fundamental drivers.

We continue to monitor economic data as it arrives, primarily leading indicators, in addition to sentiment and market internals. Our investment decisions are based on a full market cycle and we continue to maintain globally diversified and balanced portfolios with a focus on capital preservation and risk-adjusted returns, while maintaining a solid income yield for our clients.

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

Respectfully,

- **Your Milestone Team**

*"Peace begins with a smile."*
- *Mother Teresa*

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