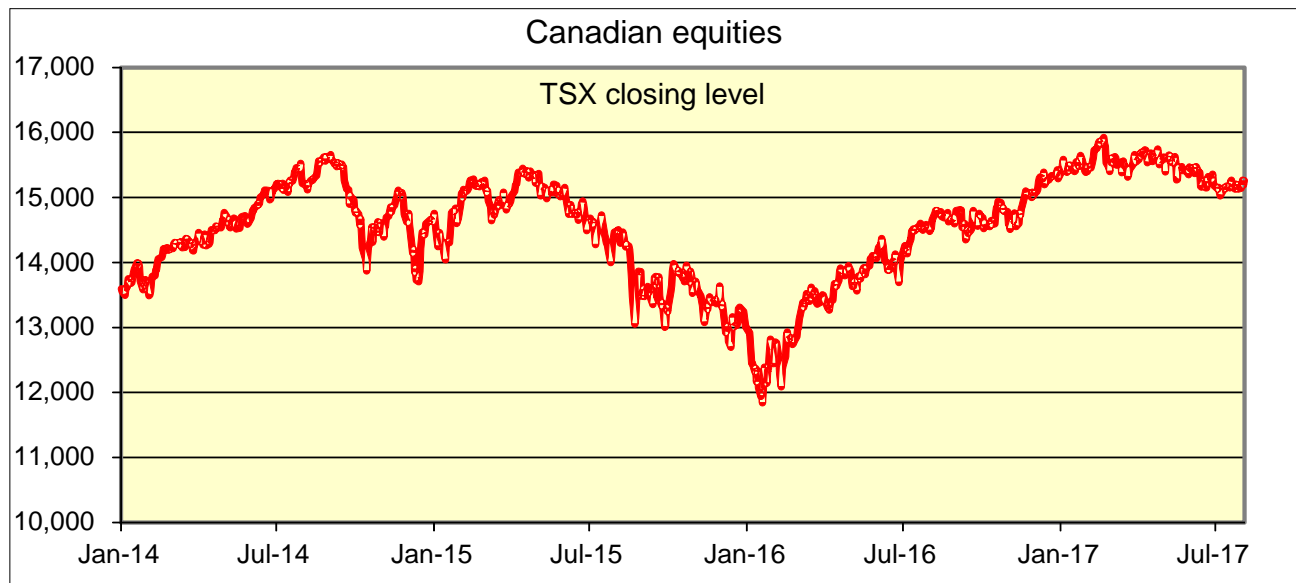


The lagging Canadian market

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These days Canadians may be feeling a bit jealous of their U.S. neighbours, but not necessarily for their political environment. It is far more likely that this envy would be a result of their recent stock market performance. Stateside, the equity market has seen a remarkable string of success in the years that have followed the global financial crisis. Since the North American markets bottomed out on March 9, 2009, the main U.S. index (S&P 500) had gained more than 267% by early August. Over the same period, the domestic market claimed less than half of that advance (101%). Naturally, the path for both markets was far from a straight line, but over that 8+ year period, reversals in the U.S. market were limited to only three material corrections. There are no set rules, but a decline of between 10% and 19.9% in a market index is widely considered to be a correction. An outright bear market is generally declared once a sustained 20% decline has been recorded. Unlike the U.S. experience, the broader Canadian equity market (the S&P/TSX Composite Index) has had a bumpier ride. Over the same period, while we experienced only one correction, we did see two bear markets. Investors may feel anxiety during periods of underperformance and a desire to chase markets where returns have been better. However, these episodes are part of normal market adjustments. Accessing professional advice and having a well-developed financial plan can go a long way to easing these anxieties and ensuring that an investment portfolio is well diversified.

Figure 1

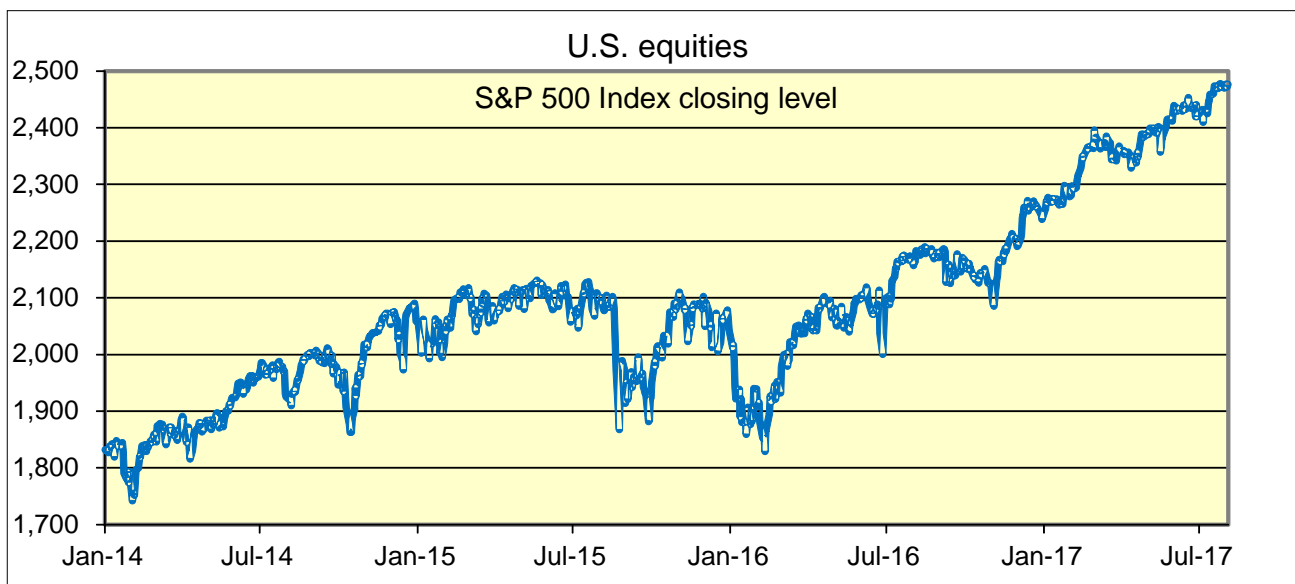


Source: Bloomberg

As the preceding chart illustrates, the Canadian equity market appears to have been unable to make any clear headway since 2014. After posting a new all-time high, closing at 15,658 on September 3, 2014, the domestic market began an extended period of weakness, culminating in a 24.4% decline by the end of trading on January 20, 2016. This was the end of the second previously mentioned bear markets¹. The subsequent recovery did not come about until February 10, 2017, representing a 29-month stretch between highs. The most recent high was recorded just a few sessions later, on February 21, 2017.

U.S. markets

Figure 2



Source: Bloomberg

In the U.S., a far different pattern emerged. Even though its market did go through a correction², which was in some ways similar to the second Canadian bear market, it lasted for a far briefer period. It took less than 14 months from the high established on May 21, 2015 before a new high eventually emerged on July 11, 2016. Perhaps more importantly, the U.S. market was successful in extending these gains. New highs were hit in August, November and December of 2016. In addition, thus far into 2017, April has been the only calendar month where a new high was *not* recorded. One of the underpinning differences actually does have to do with politics. U.S. President Trump's proposed changes in corporate tax rates have raised the possibility that companies could begin to repatriate significant profits back to the United States. As the market price of equities attempts to predict the influence of these changes, without any expectations for a similar move in corporate taxes here in Canada, the relative price gain has gone to the United States.

¹ The first bear market ended when the index had fallen 21.7% (on October 4, 2011) from the relative high of 14,271 recorded on April 5, 2011.

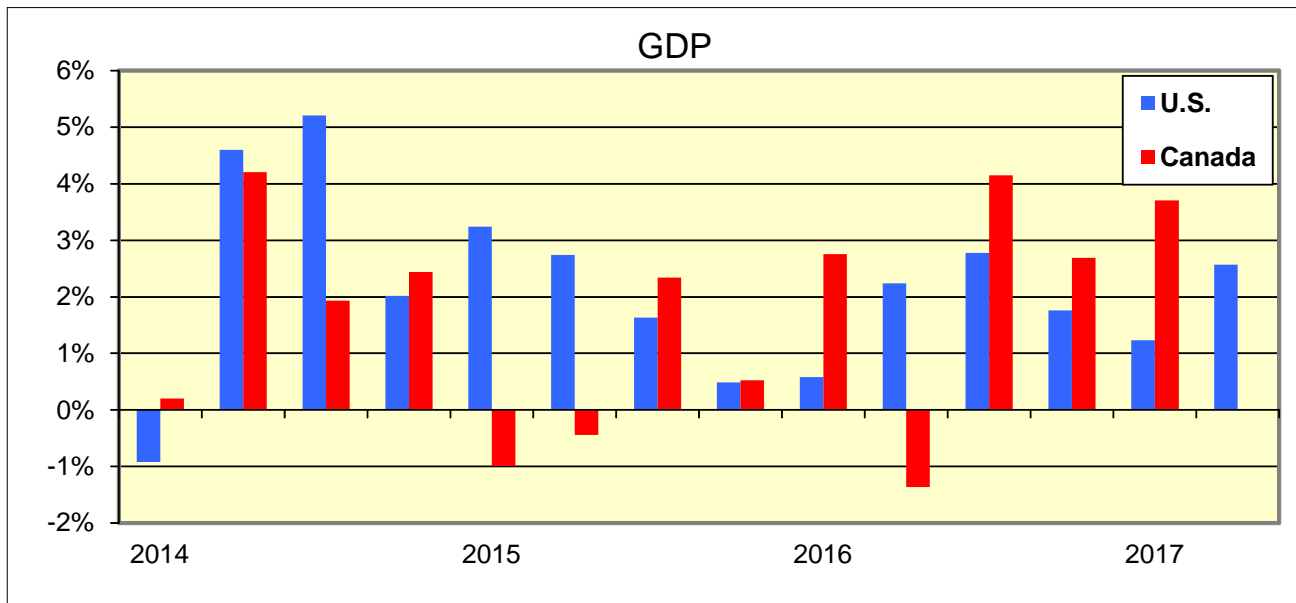
² The correction ended when the index had fallen 14.2% (on February 11, 2016) from the high of 2,131 recorded on May, 21, 2015.

Investors in U.S. equities have bid up the share prices of the companies most likely to benefit. This has fostered part of the U.S. market’s relative outperformance.

Economic performance

The North American economies have recorded some considerable fluctuations in overall GDP growth during the past few years. Stateside, growth has been in positive territory since the first quarter of 2014, averaging an annualized 2.4%. However, as can be seen in the following graph, quarterly GDP has ranged from 0.5% to 5.2% (on the same basis). Meanwhile, over virtually the same period³, the Canadian economy actually experienced a brief “technical” recession⁴ and a total of three negative-growth quarters. Average GDP growth was a less robust 1.8%. In addition, even with the fluctuations in economic growth, the U.S. has steadier growth in its labour market with 82 consecutive gains in non-farm payrolls and a commensurate decline in its unemployment rate. Canada has seen a firmer job market of late, but this has been a far more recent occurrence. This gives the advantage to the U.S. with respect to stable consumer spending.

Figure 3



Source: Statistics Canada; U.S. Bureau of Economic Analysis

Interest rates

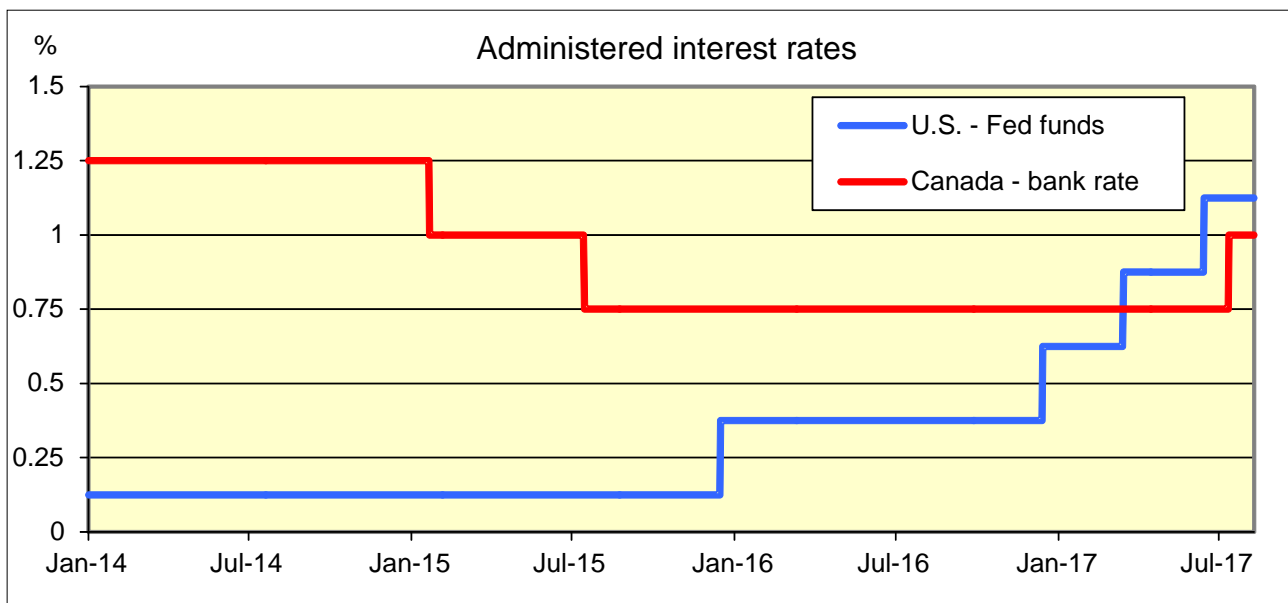
Not surprisingly, stronger economic growth and a firmer job market produced a divergence in monetary policy between Canada and the U.S. As can be seen in Figure 4, the first tightening move by the U.S.

³ Data for Canadian GDP for the second quarter of 2017 were not available as of this writing.

⁴ Economists, generally, view a recession as two consecutive quarters of negative growth.

Federal Reserve took place on December 16, 2015, while the Bank of Canada was still publicly discussing the notion of further rate *cuts*. The bank’s first rate hike was not until July 12, 2017. This less aggressive stance had been one of the reasons why the Canadian dollar underperformed the greenback for most of the past few years. However, the effects of the recent policy move have actually been reflected in the currency. Traders viewed the rate hike as marking the end of the policy divergence. More directly, however, investors holding bonds have seen their value decline. Prices of fixed-income instruments (bonds and Treasury bills) move inversely to interest rates, so that when interest rates rise, the value of these investments falls.

Figure 4



Source: Bank of Canada; U.S. Federal Reserve

Canadian dollar and oil

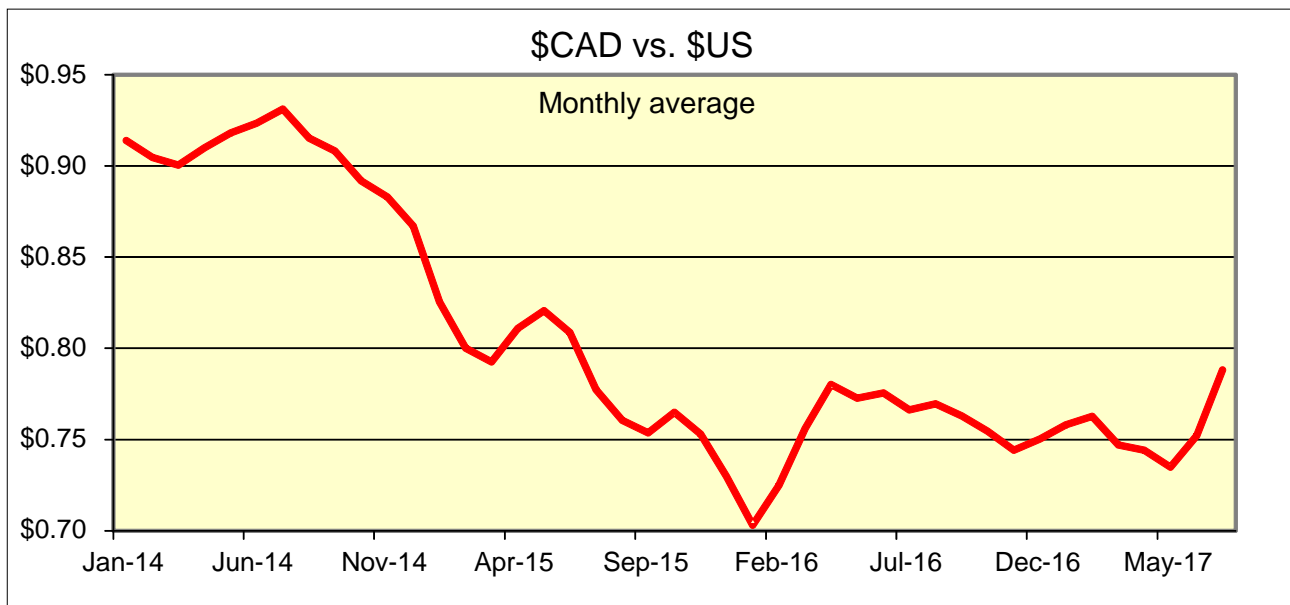
When looking at the loonie, Canadians have become accustomed to some measure of volatility, and the recent gyrations are nothing new. During much of the past two decades, the linkage between world oil prices and the Canadian dollar has been apparent. The run-up in oil prices eventually produced an all-time high for the spot price⁵ for West Texas Intermediate (WTI) of US\$147.27 on July 11, 2008. At these elevated levels, unconventional reserves, including Canada’s oilsands, were pushed well into economically viable territory. As Canada ranks third behind only Venezuela and Saudi Arabia in terms of proven oil reserves⁶, the Canadian dollar had been tagged with a “petro currency” label. As can be seen in the following graphs, over the past few years the Canadian dollar has exhibited movements in its price (essentially in U.S. dollars) that do, generally, correspond to movements in oil prices, which are also quoted in U.S. dollars. World oil prices actually fell below the lows seen during the financial crisis, hitting

⁵ The “spot” price is the current market price at which an asset is bought or sold for immediate payment and delivery.

⁶ U.S. Energy Information Administration, International Energy Statistics, 2015.

US\$26.19 per barrel on February 11, 2016, the lowest level since May 6, 2003. By September 2016, U.S. crude oil inventories had reached their highest levels in more than 80 years⁷. Even though a recovery in prices followed OPEC announcements of supply controls, a skeptical market has limited these price gains. While the linkage between the currency and oil prices remains, the most recent observations included in the graph clearly reflect the greater influence of the Bank of Canada's change in policy. The 25 basis point hike in the bank rate pushed the currency back higher through US\$0.80 (a basis point is 1/100th of one percent). Interestingly, this move raised another issue for investors. The returns provided by the relative strength of U.S. equity investments have been diminished by the recent move higher in the Canadian dollar.

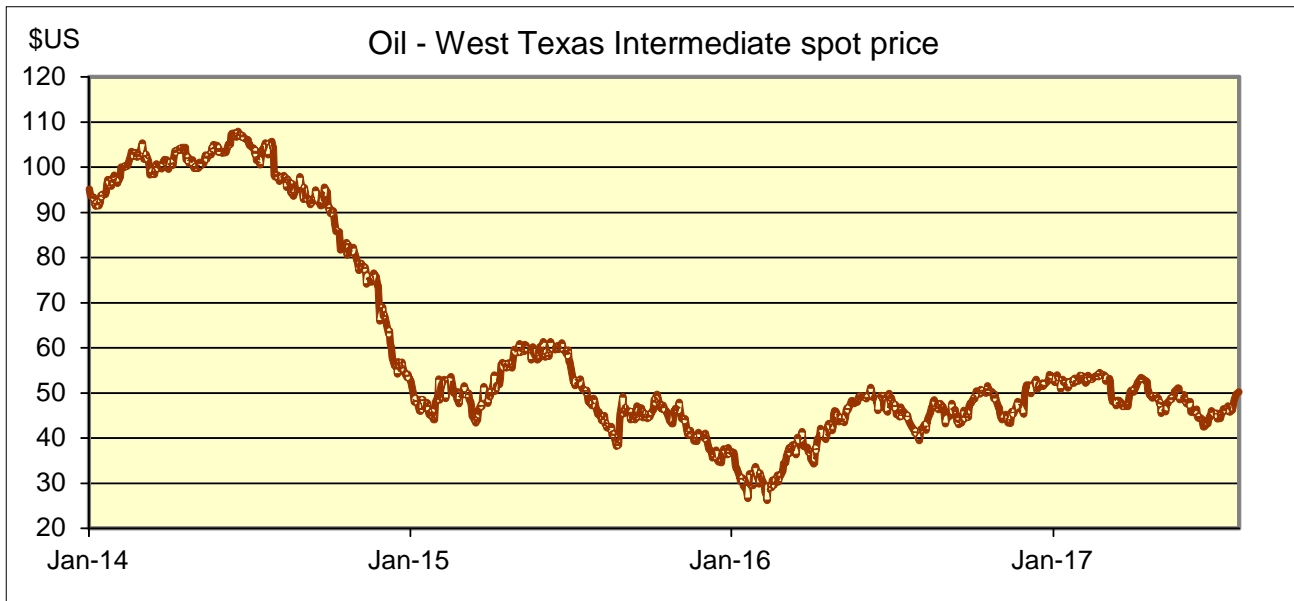
Figure 5



Source: Bank of Canada

⁷ U.S. Energy Information Administration, Weekly Report, September 9, 2016.

Figure 6

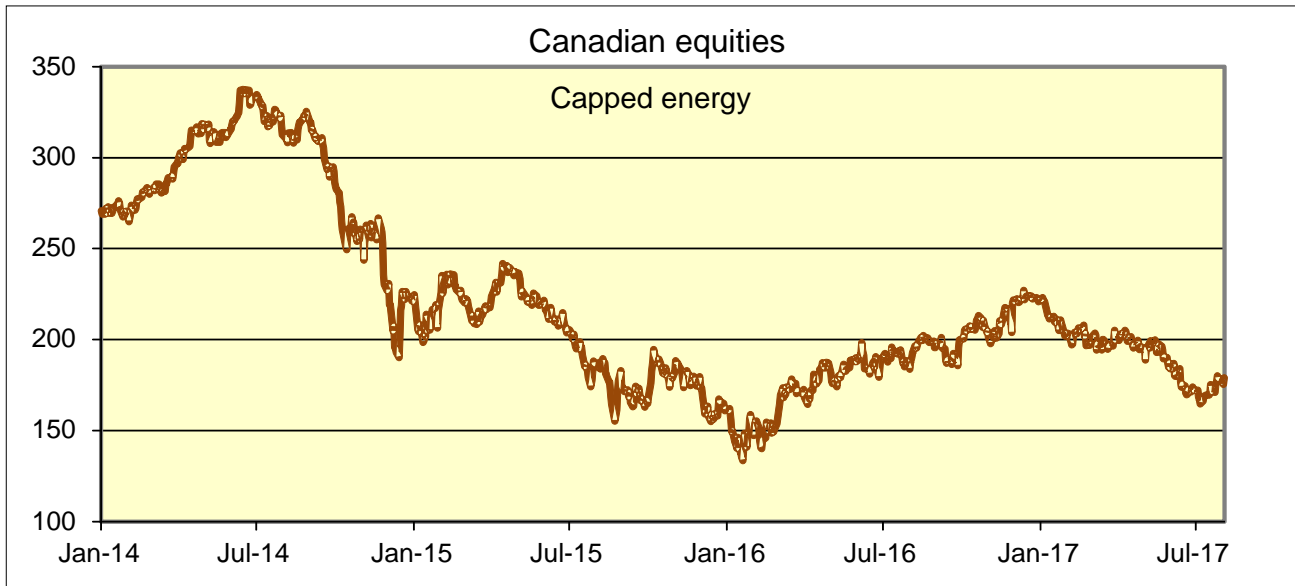


Source: U.S. Energy Information Administration

Sector influences

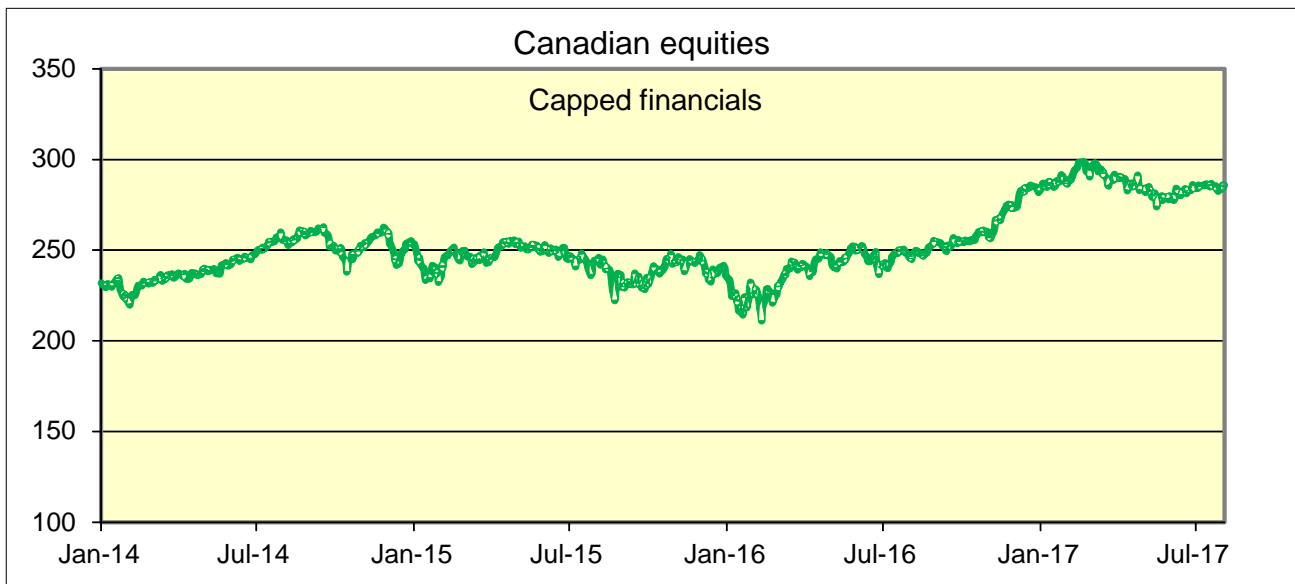
Not surprisingly, the Canadian equity market has also been weighed down by energy prices. The energy sector comprises almost 20% of the total equity market capitalization in Canada, making it the second-largest sector. As can be seen in Figure 7, the range-bound pattern in oil prices in place since April 2016 is clearly reflected in the limited movement in the related market sub-index. This important sector's inability to make headway represents another component in the domestic equity market's underperformance. As a sector, financials represent an even greater proportion of the total market capitalization and is actually the largest (approximately 37%). Pricing of a number of the underlying constituent companies was adversely affected by the fallout from the press surrounding mortgage lender Home Capital. This spring, the Ontario Securities Commission accused Home Capital of making misleading statements to investors about its mortgage underwriting business. By mid-June, the lender and three former executives had agreed to pay a total of \$12 million to settle these allegations, but the drag on financial stocks was considerable. So with the two largest sectors experiencing headwinds, the underperformance of the overall market is hardly surprising.

Figure 7



Source: Standard & Poor's

Figure 8



Source: Standard & Poor's

Conclusions

- The prospect for a material reduction in corporate taxation has been one of the drivers in the outperformance of U.S. equities. There appears to be very little chance that the Canadian government would contemplate making a similar move.
- Canada's underlying economic performance has been disappointing compared to that in the U.S. However, some of the more recent data have suggested enough of an improvement for the Bank of Canada to raise interest rates, narrowing the difference in monetary policy.
- Investors can be forgiven for feeling that there has been nowhere to hide. Higher interest rates have hurt the performance of fixed-income instruments at the same time as domestic equities have been struggling with some sector-specific issues. Meanwhile, the recent gains in the Canadian dollar have eaten into the returns that would have otherwise come from U.S. or other international investments.
- Having a financial advisor and a specific investment plan can help to alleviate the anxiety that accompanies these market episodes. Having a well-diversified portfolio ensures that an investor does not feel like they are missing out when the performance of their domestic investments lags behind.