Market Matters

MAY 2014 HIGHLIGHTS

- China's manufacturing activity grew at its fastest pace in five months in May, strengthening views that its economy is regaining traction. The strong China PMI reading drove emerging market currencies and stocks higher, and led to gains in developed world stock markets. Oil prices rose due mainly to the prospective pickup in demand by the world's top energy consumer.
- Weak inflation data out of Germany and slower-than-expected manufacturing growth in the euro zone increased pressure on the European Central Bank to cut rates and introduce other policy measures to support the economy when it meets in early June.
- The S&P/TSX composite index declined from the previous month, largely due to sliding mining stocks. With risk appetite strong, safe-haven gold lost favour with investors, closing just above a four-month low hit on May 30, driving down the materials sector.
- The S&P 500 index wrapped up four straight months of gains when it posted its latest record closing high at the end of May despite mixed U.S. economic data and a continued decline in bond yields.
- Canada's bond market posted its second-strongest month this year as investors continued to flock to bond funds. It is generally believed the bond rally reflects concerns over global economic growth prospects, low inflation and declining net bond issuance.

Table 1
Summary of major market developments

Market returns*	May	YTD
S&P/TSX Composite	-0.3%	7.2%
S&P 500	2.1%	4.1%
- in Canadian dollars	*1.2%*	*6.3%*
MSCI EAFE	1.8%	1.3%
- in Canadian dollars	*0.1%*	*4.3%*
MSCI Emerging Markets	2.6%	2.1%
FTSE TMX Canada Universe Bond Index**	1.2%	4.6%
FTSE TMX Canada Corporate BBB Bond Index***	1.2%	5.7%

*Local currency (unless specified); price only
**Total return, Canadian bonds, previously known as DEX Universe Bond Index
***Total return, Canadian bonds, previously known as DEX Corporate BBB Bond Index

Table 2
Other price levels/change

	Level	May	YTD
CAD per USD exchange rate	$0.922	1.1%	-2.1%
Oil (West Texas)*	$102.71	3.0%	4.4%
Gold*	$1,246	-3.7%	3.4%
Reuters/Jefferies CRB Index*	$305.48	-1.3%	9.0%

*U.S. dollars

Table 3
Sector level results for the Canadian market

S&P/TSX Composite sector returns*	May	YTD
S&P/TSX Composite	-0.3%	7.2%
Energy	-0.9%	13.5%
Materials	-4.2%	5.0%
Industrials	1.7%	6.2%
Consumer discretionary	0.8%	6.4%
Consumer staples	-2.9%	6.7%
Health care	0.0%	10.0%
Financials	0.8%	4.1%
Information technology	-3.6%	4.4%
Telecommunication services	3.2%	5.6%
Utilities	-1.5%	6.6%

*Price only
Source: Bloomberg, MSCI Barra, NB Financial, FTSE TMX Global Debt Capital Markets Inc.

A NEW WAY TO GROW

Stock and bond markets are dependent on global economic and industry trends. The drivers of economic growth the world over are approaching a crossroads.

U.S. Real GDP (gross domestic product) declined 1% on an annualized basis in the first quarter due mainly to lower inventories and a disruption in construction and exports caused by severe winter weather. Economic indicators are pointing to growth in the second quarter approaching 4% and remaining relatively strong through the rest of the year. Consumer spending and business non-residential investment are expected to make important contributions to U.S. Real GDP growth. The U.S. job market is steadily improving and should support new home sales and construction starts, transitioning the housing recovery from a market driven by investors to one driven by first-time home buyers.

In contrast to the U.S., Canada's economy is relying too much on two traditional pillars of economic growth—consumer spending and housing construction. Real GDP grew at a 1.2% annualized rate in the first quarter, but final domestic demand (spending by consumers, businesses and governments) actually weakened, while new home construction has declined for the last two quarters. Canada's positive first quarter GDP performance was due mainly to two factors—net exports resulting from a sharp drop in imports and a winter chill that held back spending across most sectors.

It is widely believed that in order for Canada's economy to grow, it needs business and government investment rather than reliance on consumer spending and housing. And it needs the U.S. economy to continue to normalize.

According to a discussion paper released by the Bank of Canada in April, about half of the non-energy export subcategories are expected to lead Canada's recovery, "including those likely to benefit from robust growth in U.S. construction, U.S. investment in machinery and equipment, and/or the recent depreciation of the Canadian dollar."[1] (The U.S. accounts for more than 70% of Canadian exports.) The Bank says that "three categories (motor vehicle assembly; food, beverage and tobacco products; and farm and fishing) that outperformed over the past decade are not likely to be key drivers of growth."[2]

While manufacturing activity in China appears to have stabilized in May, China's growth rate is slowing as its economy transitions from emphasis on exports and fixed investment to domestic consumption.

Europe is out of recession, but growth is weak. It is anticipated the European Central Bank will introduce measures to boost the economy at its June 5th meeting, including cutting to below zero the interest rate it pays on money banks deposit with it. The goal is to push banks to lend that money to companies and consumers to get the economy moving.

Britain and Italy are now including illegal business activity—narcotics sales and prostitution—in GDP. The reason for the change is to harmonize economic reporting across the European Union. Prostitution and some drugs are legal in the Netherlands and the Dutch include them in official government statistics. Estonia, Austria, Slovenia, Finland, Sweden and Norway also measure illegal business activity. Even the U.S. Bureau of Economic Analysis (BEA) measures prostitution as a part of Nevada's state GDP and more recently, the BEA records marijuana industries in Washington and Colorado.

The world has traveled a long road from the 2008 financial crisis to the present. This year's strong performance by stock and bond markets confirms that investors believe the changes underpinning global economies are the way to grow.

AN OLD WORLD CELEBRATES

On July 1, 1867, with passage of the British North America Act, the Dominion of Canada was officially established as a self-governing entity within the British Empire. In just three years from now Canada will celebrate its Sesquicentennial. Canada has undergone many changes over the last 150 years, from the way we communicate with each other to the way we travel, live and shop. Even the venerable Hudson's Bay Company, operating in the fur trade two centuries before Confederation, has positioned itself for the greater movement of sales online.

On November 15, 1867, the first stock ticker was unveiled in New York City. The advent of the ticker revolutionized the stock market by making up-to-the-minute prices available to investors around North America. Today we have the Bloomberg terminal, one of the largest sources of electronic information—providing news, stock quotes, information on our portfolio holdings and instant messaging with the online brokerage community.

Bob Harvey, a Royal Air Force Veteran who flew with Canadians in the Second World War, recently said, "I've always liked Canadians. They're forthright and down-to-earth."

That's what makes us a great nation—the people…and the earth beneath our feet.

[1, 2] Binette, André, de Munnik, Daniel, Gouin-Bonenfant, Émilien. *Canadian Non-Energy Exports: Past Performance and Future Prospects*. Bank of Canada Discussion Paper 2014-1, April 2014.