Market Matters

Q1 2011 HIGHLIGHTS

- In the face of significant geopolitical unrest in North Africa and the Middle East, European sovereign debt concerns, and the Japanese earthquake and nuclear concerns, capital markets remained resilient and investor confidence was resolute.
  - Risk assets, like equities and commodities, were favoured over safe-haven assets such as government bonds.
  - Oil prices surged to north of $106/barrel (WTI), strengthening the Canadian dollar with it.
  - U.S. S&P500 posted the best first quarter result since 1998.
- The Bank of Canada, U.S. Federal Reserve and the European Central Bank (ECB) all held their rates steady during the quarter, though the ECB raised rates modestly in the early days of April.
- Global economic growth/recovery has continued to show strength and self-sustaining resilience
  - The Organization for Economic Co-operation and Development's (OECD) GDP forecast for the G7 (excl. Japan) was upgraded to 3% for the first half of 2011.
  - Global export volumes rose above pre-recession highs, helped by a 35% increase in import demand from China.
  - North American labour markets signaled a revival in job-creation.
  - Corporate earnings growth among developed countries was strong.
  - Canadian Q4 GDP rose 3.3% yr/yr.
  - U.S. Q4 GDP rose 3.2% yr/yr.

Table 1
Summary of major market developments

Market Returns*	March	YTD
S&P/TSX Composite	-0.1%	5.0%
S&P 500	-0.1%	5.4%
- in C$	*-0.5%*	*2.8%*
MSCI EAFE	-3.3%	0.3%
- in C$	*-2.7%*	*-0.2%*
MSCI Emerging Markets	4.1%	0.3%
DEX Universe Bond Index**	-0.1%	-0.3%
BBB Corporate Index**	-0.4%	0.0%

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

Table 2
Other price levels/change

	Price	March	YTD
USD per CAD	$1.0312	0.4%	2.5%
Oil (West Texas)*	$106.73	10.0%	16.9%
Gold*	$1,437	1.6%	1.4%
CRB Industrials*	$842.42	0.5%	16.4%

*U.S. dollars

Table 3
Sector level results for the Canadian market

S&P/TSX sector returns*	March	YTD
S&P/TSX	-0.1%	5.0%
Energy	-2.1%	8.1%
Materials	-0.4%	-1.6%
Industrials	2.8%	8.2%
Consumer Discretionary	-0.5%	-2.5%
Consumer Staples	0.2%	2.2%
Health Care	18.3%	51.0%
Financials	1.5%	8.2%
Information Technology	-9.7%	0.9%
Telecommunication Services	0.3%	2.8%
Utilities	1.4%	0.0%

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

TEFLON MARKETS

Global equity markets displayed remarkable 'non-stick' Teflon qualities during the first quarter of 2011. Having managed to weather an onslaught of significant global and geopolitical events, equity markets extended the winning streak that started in March 2009 (see Table 1).

Having said that, the first quarter results belie the volatility that investors experienced. The S&P/TSX posted a strong positive return in the first quarter of 2011, though experienced significant volatility, particularly throughout the month of March (see Table 3). Notably during March, the S&P/TSX fell over 7% from its high on March 7th before rallying to close just 2% shy of this earlier level by month's end.

Sector leadership witnessed so far this year has been narrowing, with the majority of cyclical sectors outperforming defensive sectors. For the first quarter, the small Health Care sector led all sectors in light of a stunning run in that sectors only major stock – Valeant, which traded higher on the back of very well received merger and acquisition news. However the most significant drivers of the S&P/TSX in the first quarter were the Financials and Energy sectors. Canadian banks in particular have shown healthy earnings growth and their stock prices have been rewarded. Oil prices (surging almost 17% in the first quarter) boosted the Energy sector, while weaker gold and diversified metals companies lagged and were a drag on the results of the Materials sector.

The Canadian bond market saw muted results as low interest rates and an improving economic backdrop caused investors to shift funds away from bonds into equities and hard assets, like commodities. While expectations for bond markets remain muted, over the longer-term the shift to equities is expected to be somewhat offset by the rapidly growing demographic demand for income products.

HUMBLED EXPECTATIONS

Anyone who expected a calm and uneventful start to 2011 was swiftly disappointed. Within the first three months of the year we experienced:

- Political upheaval in the Middle East and North Africa.
- European sovereign debt concerns resurfacing (particularly in Ireland and Portugal).
- Rising energy and food prices, and growing inflationary pressures in China and India.
- A tragic natural disaster with ongoing concerns over nuclear plant damage and consequences in Japan.

If these facts could have been predicted going into the quarter, the prudent reaction would have been to move out of equities and into fixed income. This would have been wrong. Market pundits and economic forecasters were humbled by the unexpected in the first quarter of 2011.

It will be some time to come before the world can fully assess the tragic human toll of the Japanese disaster. Likewise the full economic impact on the world's third largest economy cannot be immediately known either. We do not expect the economic impact to be significant enough to derail the overall global economic recovery. In the near term the key negative economic impact will be felt in Japan. Further down the road we expect that to reverse as rebuilding efforts in Japan should provide somewhat of an economic boost. Outside of Japan, the key impact is being felt in very specific sectors and industries (such as the auto industry) as a 'supply shock' (the disruption of Japanese exports) hits factories and businesses around the world.

As the winds of political change blow through North Africa and the Middle East, there has been an increase in uncertainty around the prospect of oil supply disruptions from the region. This has pushed oil prices significantly higher, affecting energy costs around the world. To date, these concerns have been relatively contained (note that oil prices remain well below their $147/barrel highs of three years ago), though the situation remains uncertain and can spark further market volatility.

Markets in the face of these events have continued to be strong because of good market fundamentals (strong corporate earnings growth; relatively reasonable stock prices; healthy corporate balance sheets) and strong economic data (improving unemployment, strong global trade numbers; healthy GDP results). These factors continue to support a positive outlook for equity markets overall. However, each of the before-mentioned risks remain significant and very real concerns for the short-term outlook of capital markets, and further volatility is expected.

TO WANT IT ALL

It can be human nature to want it all. We want the seat at the front of the bus when opportunity comes; we seek the middle of the road when disagreements occur; and we prefer the back of the room when the situation is unknown. Rarely do we get to have it all.

For investors, perhaps the closest you can come is to ensure you have:

- a professionally managed portfolio (to benefit from the expertise of professional money managers when opportunities come)
- a well-diversified portfolio (to mitigate the market's volatility when global, geopolitical or macro-economic conflicts occur)
- a portfolio adjusted to your risk tolerance (to give you comfort to stay focused on the long-term, when the short-term is unknown).