Market Matters

FEBRUARY 2011 HIGHLIGHTS

- February saw an escalation of geopolitical worries, but this proved only to be a modest headwind as market sentiment remained bullish overall (see Table 1).
  - The S&P/TSX closed February at its highest level since July 3, 2008.
  - The S&P 500 had its best February since 1998.
- Commodity prices showed a lot of heart in February.
  - Gold prices (and gold-related companies) dazzled for investors looking to hedge against the possibility of rising inflation.
  - Oil supply concerns (stemming from the unrest in the Middle East and North Africa) fuelled rising oil prices.
- Canada's GDP growth results came in better than expected for Q4.
  - Exports rose to their highest level in six years
  - Consumer spending hit a three-year high.
- The Bank of Canada held the central bank rate steady, but talk of rising inflation concerns and the need to moderate economic growth are gaining momentum and are increasing the likelihood of future rate increases—albeit they are expected to be modest in nature.

Table 1
Summary of major market developments

Market Returns*	February	YTD
S&P/TSX Composite	4.3%	5.2%
S&P 500	3.2%	5.5%
- in C$	*0.2%*	*3.3%*
MSCI EAFE	2.1%	3.7%
- in C$	*0.0%*	*2.7%*
MSCI Emerging Markets	-1.5%	-3.7%
DEX Universe Bond Index**	0.2%	-0.2%
BBB Corporate Index**	0.4%	0.4%

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

Other price levels/change

	Price	February	YTD
USD per CAD	$1.0275	4.0%	2.2%
Oil (West Texas)*	$97.00	5.3%	6.2%
Gold*	$1,415	6.2%	-0.2%
CRB Industrials*	$838.15	7.8%	15.8%

*U.S. dollars

Table 2
Sector level results for the Canadian market

S&P/TSX sector returns*	February	YTD
S&P/TSX	4.3%	5.2%
Energy	5.6%	10.4%
Materials	4.4%	-1.2%
Industrials	1.7%	5.2%
Consumer Discretionary	-4.2%	-1.9%
Consumer Staples	2.5%	2.0%
Health Care	4.4%	27.6%
Financials	5.9%	6.6%
Information Technology	8.6%	11.8%
Telecommunication Services	-1.6%	2.4%
Utilities	-2.0%	-1.3%

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

FEBRUARY'S UPRISING

Despite uncertainty created by the rapidly developing situation in the Middle East and North Africa, most major global equity markets finished higher in February (see Table 1).

Geopolitical concerns did hamper the results of emerging market equities. However, within the developed markets, this unease caused only a slight stumble for equity markets mid-month, and then they quickly regained their traction. Investors responded more to improving global economic fundamentals such as: strong economic growth in Asia; recovering North American GDP and employment figures; and solid U.S. consumer spending numbers. With the world's economic bellwether (the U.S.) still ringing, equity markets have enjoyed a rally that is now well into its sixth month—but it has also raised the potential for a modest 'breather' in stock prices as they begin to appear more and more overbought.

Even bond markets were not particularly impacted either way by rising commodity prices, more optimistic central bank views or the turmoil in Libya. Bond prices dropped as investors gained comfort with riskier assets such as equities and commodities, but the DEX Universe Bond Index managed to remain in the black on the merits of the income generated by bonds.

OIL, TOIL AND TROUBLE

Canada's S&P/TSX composite was one of the best performing indices among global markets in February, thanks to strong results in our Energy and Materials sectors (see Table 2). However, political unrest in Libya raised concerns over a potential disruption of the global oil supply. While Libya is responsible for only a small portion of the world's oil, the proximity of public protests to other significant oil-producing countries has elevated the "international boiling point". The result has been sharply rising oil prices and a corresponding increase in the value of oil-oriented energy stocks.

As anyone who has filled up at the pumps knows, there is a downside to higher oil prices. Increased energy costs have renewed inflation concerns for both developed and emerging countries. While the Bank of Canada has the power to combat inflation worries with higher interest rates, Governor Carney finds himself in the middle of the proverbial "rock and a hard place". On the one side, he is charged with addressing inflation concerns (in which raising interest rates would help by moderating economic growth) while on the other side, he must consider the impact raising interest rates would have on an already strong Canadian dollar (which has created quite the headwind for the country's manufacturing and exporting industries). Current market expectations are for the Bank of Canada to begin modest interest rate hikes mid-year, erring on the side of addressing inflation concerns and moderating economic growth.

Gold has traditionally been viewed as a hedge against inflation, and investors took interest in February. Gold prices rose and gold-levered stocks rose alongside, helping our Canadian Materials sector (heavily weighted in gold stocks) deliver a strong monthly performance.

In Canada, only the interest-sensitive sectors (those more likely to be negatively effected by the potential for rising interest rates) such as Consumer Discretionary, Utilities and Telecommunications were down for the month.

THE 'YIELD TOURIST'

Two years after the equity market depths of the global financial crisis, we see the effect events have had on investor behaviour since March 2009. Rocked by equity market volatility and the realities of a demographic shift, Canadian investors flocked toward fixed-income securities for their low volatility and income/yield-generating characteristics. But for some, the pendulum may have swung too far. The irony of the shift toward bonds is that it came at a time when equity markets were beginning their rebound (the S&P/TSX is up almost 90% since March 9, 2009), and the need to stimulate the economy forced bond yields to be pushed down to historic lows, frustrating investors looking for the steady and strong bond returns of yesteryear.

Recently, the term 'yield tourist' was used to describe investors whose search for achieving higher yields has led them to move from asset classes such as government bonds and investment grade corporate debt into junk bond territory—all in the hunt for yield. Investors' desire for reward has become their overwhelming focus, rather than a more objective look at the classical trade-off between risk and reward.

Economist John Kenneth Galbraith once observed, "We have two classes of forecasters: Those who don't know—and those who don't know they don't know." We agree. We do not believe it is possible to predict the future. As professional money managers we manage our portfolios as we suggest you do:

- make disciplined decisions based on what you do know, not what you don't;
- consider both the risks and rewards of all your investment decisions; and
- maintain a longer term perspective.

The need for income-generating investments for those approaching retirement is real, but so is the need to balance the risks required to achieve those goals. Your long-term investment plan should have both in mind.