REVIEW & COMMENTARY
1ST QUARTER 2013

A tale of two indices

Given the inundation from US financial news services, it is hard to imagine any investor who hasn't been aware of the major US indices hitting new highs toward the end of the most recent quarter. In the shadow of these new highs, the major Canadian exchange, the Toronto Stock Exchange (TSE) was positive but not close to all-time highs. From here, we would need close to 11% or roughly 1600 points to hit new highs. Will we ever get there?

The answer is easy, at least, in part. We will get there. The difficulty is trying to figure out exactly when. There are a few reasons why the US indices are doing better. First is the sheer size of the markets. The New York Stock exchange is about 7 times the size of the TSE (trade volume) and when the enormous flow of international capital looks for a place to invest, it often goes to the largest markets first. NASDAQ, Tokyo, London, Shanghai and Hong Kong stock exchanges are all larger than the TSE. With the US economy improving so has the US currency, giving US exchanges and US companies an advantage. Another reason for the US success is that the US exchanges are more industrial based as opposed to the TSE which has more of a resource weighting. While this migration to equities is something we have talked about for a while, there is only modest evidence that it is happening. The good news is that when it starts in earnest, the amount of money to be invested will be enormous given that there are a lot of investors who vacated the equity markets 4 years ago who remain on the sidelines.

The economic recovery in the US remains on track, though modest. A big factor in the recovery is the house pricing which continues to show improvements in most locations. For most investors, this is their biggest asset and any time higher values prevail, home owners gain a little more confidence. This wealth affect certainly is positive and has some spillover effect on equity prices. To balance this positive, negative political overtones in the U.S. remain; sequestration, a dysfunctional Congress, and a US government that continues to promise and spend without being able to fortify its treasury with enough income to pay down debt. Accommodative monetary policy from the U.S. Federal Reserve and various other Central Banks, including most recently Japan, keeps the globe flush with liquidity which in turn, at least partially, is helping equity markets given many blue chip companies offer higher yields than 10 year Government bonds. Industrials seems to be leading the U.S. markets higher which accounts for the Dow Jones Industrial Average- only 30 stocks- hitting new highs before the other major indices.

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The Toronto Stock Exchange in the past quarter was up 2.5% compared to double digit returns in the U.S. Thankfully, Canadians weren't exposed to the same banking issues or the steep decline in real estate prices that happened in the U.S. five years ago. Further, our central bank, while accommodative hasn't been as aggressive as many others in increasing liquidity. The TSE and Canada is more resourced based which has hurt the performance of the index. Oddly, energy prices have done well in the first quarter, crude posted a gain of roughly 6% while the energy index of the TSE posted a gain of just under 2%. The hardest hit components of the TSE where Materials, Metals & Mining and Gold sector all down in the double digits for the quarter. But is China going to be as weak as trending commodity prices indicate?

China still appears to be a compelling story, at least in our minds. Not only is there a new administration that wants to do all the right things such as increase jobs, manage the urban migration to cities but they also want to cool real estate speculation and rein in corruption. In March of this year, China's service industry expanded at a faster pace than in February and the non- manufacturing Purchasing Managers index rose as well, at least demonstrating that the economy is showing some signs of resilience. Credit Agricole CIB, from Hong Kong has stated that the Chinese "…economy is on track to meet or beat the government's (China) target." It is important to note that government officials in China are aiming at 7.5% growth in 2013, trying to match 2012's increase. If China's first quarter GDP is as positive a surprise as the fourth quarter of 2012's 7.9% appreciation, then the TSE may gain traction.

As of 2013, China has become the largest importer of crude oil in the world, a title held by the U.S. for the past 40 years. While it may be argued that this is not an indication that they will continue to grow at a pace significant to resurrect commodity prices, it is worth remembering that China will soon become the largest economy in the world. Reports that they are stock piling, iron ore, copper and various other commodities have hurt commodity prices recently as short term demand is weak. However, it would appear totally plausible that the new administration has significant plans to use these raw materials and continue to build and industrialize a country that had 18 million babies born there last year. It would seem that the consensus is that China will slow but it really becomes an issue of whether they will manage the slowdown properly. And 7.5% for the second largest economy in the world will be a pretty decent stimulant for rest of the world.

Certainly, sentiment amongst institutional investors remains cautious- something not typical of market tops. So unless the pull-back is related to a specific event or incident, we wouldn't be overly concerned. The one thing we have learned is that the more an expected outcome is expected, the less likely it will.

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