2013 Year End Review

Stock Bulls and Bond Bears

Equity markets in 2013 enjoyed a banner year as the global economy continued to improve and central banks generally maintained their bias for low interest rates – possibly into 2016. With the U.S. economy starting to gain real traction, the Federal Reserve (the Fed) finally announced its intention to reduce its bond-buying program late last year. In the Eurozone, the ECB (European Central Bank) surprised investors by lowering interest rates in November. Unprecedented monetary stimulus in Japan resulted in a surging stock market with the Nikkei index rising over 50% last year. The U.S. S&P500 index rose over 40% in Canadian-dollar terms. Overall, most equity markets finished the year in double-digit territory. The laggard was emerging markets which rose only 2%.

In Canada, we experienced a bit of a mixed bag in 2013. Financial stocks once again posted excellent returns, rising almost 25%. However, this was offset by continued weakness in commodity stocks. **The price of gold fell for the first time in 13 years**, declining 28%, and other precious metals were also weak. Real estate investment trusts (REITs) were a drag on the broad Canadian market as well, declining over 5%. These companies have posted exceptionally strong returns over the past ten years but were hampered last year by rising bond yields. All of these factors resulted in the Canadian stock market rising 13% last year, placing it at the lower end of the global ranking, but a very respectable number nonetheless.

As stocks enjoyed very strong gains, **2013 proved to be more challenging for fixed-income investors**. As we have discussed in previous notes, bond yields will probably remain low by historical standards for some time. Nevertheless, the trend is for yields to gradually rise and this puts downward pressure on bond prices. This started to happen last year, and while it is a positive development going forward, there is a period of adjustment when bond returns turn negative, as some did in 2013. When discussing “interest rates” it is important to distinguish between those controlled by central banks (short-term rates) as opposed to the yields in the bond market, which central banks influence but do not control. For example, although the Fed left short-term interest rates unchanged last year, the yield on ten-year treasury bonds rose from a low of 1.6% to the current level of 3%. The irrefutable rule is: as bond yields increase, bond prices decline.

In summary, **short-term bonds and GICs outperformed long-term bonds**, which declined over 6%. Similarly, real-return bonds fell last year because of rising bond yields as well as very subdued inflation numbers. After many years of good returns, real-return bonds declined by over 13% and preferred shares were also weak, falling almost 3%.

Following are the returns for major indices for the period ended December 31, 2013:

	4^{th} quarter actual	1 year actual	3 year annualized	5 year annualized	10 year annualized
Canadian Short Term (DEX 30-Day T Bill)	0.2	1.0	0.9	0.7	1.9
Canadian Bonds (DEX Short Term Bond)	0.8	1.7	2.8	3.3	4.0
Canadian Stocks (S&P/TSX Comp.)	7.3	13.0	3.4	11.9	8.0
U.S. Stocks (S&P 500)	14.3	41.5	18.8	14.7	5.3
Non-North American Dev. Stocks (EAFE)	9.3	31.3	10.6	9.3	4.9
Emerging Markets Stocks (FTSE / MSCI Emerging)*	5.0	2.1	0.2	11.6	9.0

* Last quarter and 1 year returns are FTSE Emerging. Other periods are MSCI Emerging. All returns in Canadian dollars. Source: SS&C Technologies and PalTrak

It's a relief to say that **our investment outlook for 2014 is not being dominated by political considerations**, as has been the case in recent years. This year economists and market watchers alike are focused mainly on traditional fundamentals with the hope that politics will play only a small role. This is thanks to some political progress in 2013: Germany's election had a market-friendly result in September, the U.S. managed to pass a budget agreement last month, and the risk of military action in Syria and/or Iran is perceived to have diminished. All good news for investors, who now may once again assess market valuations in their proper context of underlying economic conditions, interest rates and corporate profitability.

To that end, let's begin with the United States which is expected to lead future growth. Its economy grew about 2% last year, even in the face of governments (at all levels) imposing higher taxes, cutting about a million jobs and allowing numerous stimulus measures to expire. The U.S. Congressional Budget Office estimates that without this "fiscal drag", growth would have been about 1.5% higher. With no new austerity measures on the horizon, **many analysts expect a material improvement in U.S. economic activity in 2014**. Several factors are bolstering these economic prospects overall: households have repaired their balance sheets, banks have rebuilt capital, and the supply of vacant homes is now low enough that the housing market should continue its recovery. In addition, strong stock market gains have had a positive "wealth effect" on Americans, who are now well-positioned to increase purchases this year. This would translate into a long-overdue uptick in corporate revenues.

Of course, Wall Street cannot ignore Washington completely. While it is hoped that the recent budget agreement has eliminated any chance for a repeat government shutdown this year and also improved the odds of a deal on the debt ceiling in February, **there is still the question of how monetary policy may affect markets in 2014**. Last month, when the Fed announced the plan to reduce its Quantitative Easing (QE) program by $10 billion per month, the news caused a surge in stock prices. Some were surprised because, by its nature, a more restrictive monetary policy dampens growth; however, the prevailing view is that the private sector is now robust enough to more than make up for it. Certainly, almost everyone agrees QE must be tapered back – after all it was intended as a "temporary" emergency measure. Also, QE is a completely unconventional tool which has taken the Fed into uncharted territory, and that carries its own risks. Investors may take comfort in their commitment to move slowly and only as economic data supports the taper. Once QE is eliminated down the road, we should expect the Fed to follow with interest rate increases but that is not likely until late 2015 or beyond.

Here at home, **the Canadian economy is expected to lag the U.S. because of sustained weakness in commodity prices**, caused in part by lower demand from emerging markets and, with respect to oil in particular, an oversupply in the U.S. Further clouding our domestic outlook is an overinflated housing market, particularly in the major centers. In addition, unsustainably high household debt may finally crimp Canadian consumer spending this year. These concerns should be offset to some degree by stronger exports, facilitated by a pickup in U.S. and European demand. Exports are also helped by a weaker Canadian dollar which many economists have forecast to settle between 90 cents and 93 cents U.S. In this relatively fragile growth scenario, the Bank of Canada should have ample room to delay any hike in interest rates.

Europe remained relatively quiet in 2013 but will be forging ahead with its banking reforms this year. The ECBs goal is to first review the solvency of its member banks and then to provide them with the tools to facilitate a more open flow of much-needed capital to businesses and consumers. **Europe's central bank is also committed to providing additional stimulus if required**, including a tax on bank deposits. Other progress in the Eurozone includes Ireland's imminent exit from the bail-out program and Latvia's adoption of the euro, making it the eighteenth member. Ongoing problematic situations include Greece, which may experience its seventh consecutive year of recession, and Portugal and

Cyprus, both of which will likely need additional financial assistance in 2014. Even so, the overall Eurozone is expected to grow about 1% in the year ahead. Britain is in a much more favourable position: it will surpass its all-time high GDP set in 2008. However, Britain will need to start dealing with its bloated debt (second largest behind Japan in the G20) before elections in 2015.

Japan will be a most interesting country to watch during 2014. Prime Minister Shinzo Abe, who was elected in 2012 to rescue Japan from its multi-decade deflationary funk, has been using a multi-pronged approach (called Abenomics) that includes deregulation through structural reforms, devaluation of the yen to revive exports, various new taxes to improve the government's balance sheet and higher consumer prices. This spring an increase in their value-added tax (similar to our HST) is in the works, from 5% to 8% which may prove to be his biggest challenge yet as it could threaten Japan's nascent recovery. As the year unfolds, stock and bond prices will be the best indicator of Abe's success.

Probably the biggest disappointment in 2014's otherwise optimistic global outlook is found in emerging markets. These economies, which maintained growth after the developed-markets debacle of 2008, are now lagging behind. As *The Economist* has recently noted, **this year the G4 (U.S., Japan, EU and Britain) is poised to contribute more to world growth than the BRICs (Brazil, Russia, India and China)**. This can be explained in part by the U.S. shift to less monetary stimulus (which hinders the BRICs access to capital), lower exports to places like Europe and some tightening of financial conditions in China in its attempt to keep inflation in check. On the bright side, we would expect to see some positive spillover effects as renewed demand from the U.S. translates into higher exports.

Overall, it seems that many of the risks investors have faced since the 2008/2009 meltdown are now in our rear-view mirror. Although global economic growth for 2014 remains somewhat constrained in the 1% to 3% range for the western world and in the 5% to 7% range for emerging-markets countries, the chance of a serious shock to the downside is materially lower. **Corporate profitability and balance-sheet strength are near record levels**. Some long-overdue growth in sales is likely even in a modestly growing economic environment and that may allow some profit margin expansion in 2014. Each passing month of growing employment (on average 200,000 new jobs monthly in the U.S.) results in an increase in the aggregate buying power of the labour force and the pricing power of the corporation. The list of worries is still present: a real estate sell-off in Canada, higher-than-expected bond rates or some calamity in the Middle East, for example; but it is growing shorter and this should give investors some reassurance.

Investment Strategy

Investors are starting 2014 with apparently fewer things to worry about than they have experienced in several years. However, **since equity markets enjoyed such resounding growth in 2013, some wonder if further upside potential is now more limited**. Only time will tell, but we think equities continue to have attractive prospects. The global economy is gaining some "legs". Corporate profitability is robust. And valuations, although not as attractive as 12 months ago, are not as overstretched as one might think. In fact, when compared to alternatives such as bonds, stocks win out. One way to gauge value is through the so-called Price/Earnings ratio. On that basis, U.S. stocks are currently trading at 16.5 times earnings. As a refresher, this P/E ratio means that for every $16.50 invested in the stock market at today's levels, the investor gets ownership of $1 of annual corporate profits. This is slightly above long-term averages – not cheap, but not expensive either. Schroders, a large global asset management company, recently conducted a historical study which looked at subsequent 12-month returns for U.S. stocks given various P/E ratios. They put together this chart:

Forward P/E	<10x	10-12	12-14	14-16	16-18	18-20	20-22	>22x
Average Return	15.0%	14.7%	12.6%	12.5%	9.9%	8.8%	5.4%	3.5%

This evidence suggests that if history is any guide (and it isn't always), attractive, even double-digit, returns in some stock markets may still be ahead of us.

Emerging markets, where economic growth is still decelerating, are the cheapest. Their P/E ratios are particularly depressed – now in the single digits. Higher P/E ratios are found in the developed markets whose higher prices are based on robust expectations, especially in the U.S. The others, including Europe, Japan and Canada, fall somewhere in between. P/E ratios are not static, but ever-changing as investors seek price equilibrium. Therefore we know it is rational (though not always easy) to trim back positions in the best-performing markets and redeploy those funds in markets where P/Es indicate better value is indicated. For example, **adding to emerging markets now should prove to be rewarding over time**.

With respect to fixed income investments in 2014, **we should expect further price adjustment as the interest rate cycle bottoms around the world**. The U.S. Fed is leading the shift to tighter monetary policy, first by scaling back its QE program and eventually through higher interest rates. For this reason, we also believe that the outperformance of dividend-paying stocks such as banks, utilities, pipelines and REITs seen in the past ten years is largely behind us. These stocks will continue to offer attractive payouts in the form of dividends and distributions that are well above bond coupons, but their total returns will likely fall short of stock market averages. Given this reality, we will assess future purchases and existing positions against specific client portfolio objectives.

For similar reasons, bonds will likely continue to disappoint on a total return basis. Although central banks in western countries do not plan to increase rates until perhaps 2016, thereby keeping short-term interest rates very low, bond markets are already anticipating the effects of less stimulus and higher rates down the road. The yields on mid- and longer-term bonds are expected to continue adjusting upwards in 2014. By definition, higher yields will result in somewhat lower prices for short- and mid-term issues, while longer-term issues experience even greater price declines. Offsetting this is the fact that we will be able to use cash and proceeds from maturities to extend term at better rates. Our approach at Milestone is to maintain a laddered maturity schedule of bonds and GICs between one and five years, and to reinvest in longer positions in that ladder as issues come due. **This now provides us with the opportunity to obtain higher rates offered on the three- to five-year issues** while keeping the overall average term of this component of the portfolio in the two- to three-year range. In 2014, we expect to replace some GIC maturities with bonds as the spread between them shifts in favour of bonds. The DFA Global Bond Fund will continue to provide us with opportunities to gain higher rates outside of Canada while being fully hedged to changes in the Canadian dollar. Its return over the past 12 months has been flat but its three-year annualized return has been 3.5%, which is respectable for a very low-risk position. Preferred shares continue to play a tertiary role in our fixed-income portfolio and, although they are more sensitive to changes in interest rates, preferred shares offer yields in excess of 4% as well as tax advantages for taxable accounts through the use of the dividend tax credit. Lastly, we are watching for opportunities to add to real-return bonds in the year ahead.

In summary, investors can take some comfort that five years on, many of the serious risks that arose in the aftermath of the 2008/2009 meltdown have subsided. That said, the world is still in a slower-than-normal growth environment and therefore **our expectations for overall returns in 2014 are somewhat modest** – in the mid- to high-single-digit range for equities. After the roller coaster ride they've experienced over the past fifteen years, many investors would be just fine with that outcome.