

July 2013: The first half of 2013 in review

“We can always count on the Americans to do the right thing, after they have exhausted all the other possibilities.” Winston Churchill

With the first half of 2013 behind us, I’m writing to summarize market developments since the start of the year and to share my thoughts on positioning portfolios for the period ahead. First though, a quick recap of the first half of 2013.

In late May, the U.S. stock and bond markets reached all-time highs; from the start of the year U.S. and global markets were up in high double digits. Then at a press conference on May 22, Federal Reserve Board Chair Ben Bernanke made a low-key suggestion that a stronger outlook for U.S. economic growth would lead to a gradual reduction in bond purchases that has helped keep interest rates low. The prospect of an end to the record-low interest rates shocked markets, leading to declines in the next six weeks of 4% in the U.S. and 8% in global stock markets excluding the U.S. Here’s what performance looked like before and after Bernanke’s announcement.

2013 performance	Canada	U.S.	Europe	Emerging Markets	World Markets ex U.S.
Jan 1 to May 21	4%	18%	16%	3%	19%
May 22 to June 30	-4%	-4%	-8%	-7%	-8%
First half of 2013	-1%	14%	7%	-4%	10%

Source: MSCI, returns include dividends, all returns in local currency

Some things worth noting about performance in the first half of 2013:

1. Even with the declines after Ben Bernanke’s announcement, for the first half of the year the U.S. is still up 14% for the year and global markets outside the United States are up 10%.
2. The strength in the U.S. is a continuation of the trend of the past three and a half years. Since the beginning of 2010, the U.S. market is up 32%, compared to 14% for global markets outside the United States.
3. In spite of continuing headlines about Cyprus, Greece and Portugal, European stock markets had solid gains in the first half of 2013, as some of the worst case scenarios built into stock prices failed to materialize. While smaller countries got the headlines, the large bulk of Europe’s economic performance will continue to be driven by the larger economies.

4. Canada continues to under-perform not just the United States but virtually every major developed economy. Canada is down 4% since the beginning of 2011 at a time when most developed markets have shown solid gains.

Will America pick up the global growth baton?

With Europe's economies facing continuing challenges and slowing growth in China and other emerging market, the United States is once again being looked to as the driver of global growth. That's why it's important to step back and look critically at prospects for the American economy.

Like every other country today, the United States faces serious issues. A Wall Street Journal article by Harvard economist Niall Ferguson made the bear case for the United States, focusing on political dysfunction, burdensome regulation and slipping competitiveness.

On the other hand, a recent Globe and Mail article titled *The Star Spangled Recovery* pointed to a laundry list of positives for the U.S., among them:

- Improvement of the budget situation
- Growth in housing and auto sales
- Stronger job growth, fuelled in part by the return of manufacturing from overseas
- The positive impact of small and mid-sized businesses and America's hyper-competitive culture, positioning it for success in global trade.

Another positive perspective comes from The Economist Magazine; published in London. (The Economist is broadly respected for its objective analysis of global trends.) In April, The Economist published a special report on American competitiveness. The Economist's take wasn't entirely positive, as it drew a distinction between political dysfunction in Washington and what's happening in the rest of the country.

Here's an excerpt from their comments about political leadership in Washington:

This is the America that China's leaders laugh at and the rest of the democratic world despairs of. Its debt is rising, its population is ageing in a budget-threatening way, its schools are mediocre by international standards, its infrastructure rickety, its regulations dense, its tax code byzantine, its immigration system hare-brained—and it has fallen from first position in the World Economic Forum's competitiveness rankings to seventh in just four years.

Offsetting those issues, The Economist urges readers to look outside of Washington to the progress being made across the country:

- The shale oil and gas revolution is changing the dynamics of the energy industry and provides America with the prospect of energy self-sufficiency.

- Sweeping reforms are taking place at the state and municipal level to create accountability and greater focus on results in the public education system
- America's innovation engine is once more operating at full speed – research and development as a percent of the economy has set the previous record set during the space race
- In a world where technology is playing a growing role, the United States is home to 27 out of the world's top 30 universities for scientific research

Earlier this year, Warren Buffett addressed the uncertainty that preoccupies many members of the media and which has dampened the willingness of American business to invest. He points out that uncertainty has been a constant in the United States since 1776; the only variable is whether people ignore the uncertainty (which typically happens in boom times) or fixate on it. Buffett continues to express confidence in the resiliency of American business, just as he did in his famous New York Times article in the fall of 2008 titled “*Buy American, I Am*” that appeared close to stock market bottoms during the uncertainty in the aftermath of the global financial crisis.

None of this is to say that the United States doesn't face issues around regulation, infrastructure, education and entitlement spending. But as we look forward, there is a strong case that the United States recovery will help fuel economic growth around the world – and with the growth we'll see the prospect of solid performance by stock markets.

What this means for your portfolio

Two of my roles as your investment advisor include being your emotional anchor during uncertain times and your financial coach; keeping you in the game and on plan. Here are some guiding principles in my approach to building client portfolios.

1. Time to re-balance: Adhering to your plan

In light of stock valuations and the risk in bonds, over the past year I have been recommending that clients increase US equity exposure. That has worked out well and I continue to advise clients to hold their maximum US equity weight.

Strong performance in US stocks has also meant that some clients now exceed the recommended US equity allocation. In those cases, I have been recommended trimming US equities to bring portfolios back within their guidelines. Regardless of what happens to markets in the short term, barring a significant change in your circumstances, it is important to stay within your investment parameters.

2. Diversifying portfolios

When building equity portfolios, I've always advocated geographic diversification. This helped clients through most of the 1990s, hurt them in the decade after 2000 and has helped them again in the past three years.

Going forward, I have no idea whether the Canadian market will do better or worse than global markets, but I do know that Canada represents fewer than 5% of investing opportunities around the world. In addition, because of our resource focus, Canada's market will tend to be more volatile over time than that of the U.S. and yes, even Europe. For those reasons, I continue to recommend geographic diversification of stock portfolios.

3. *Focus on dividends and cash flow*

The final principle relates to the role of cash flow from investments. Amid the uncertainty surrounding economic growth and equity returns, I continue to place priority on the cash yield from investments. While the headlines talked about US markets hitting new highs in May, investors who reinvested their dividends have seen their account values exceed the 2007 peak significantly.

Dividends on stocks in selective sectors continue to make these stocks attractive. When it comes to equities, we do have to be increasingly discerning, however; as some traditional high-dividend sectors stocks that pay steady income are expensive by historical standards and show signs of stretched valuations.

I hope you find this overview helpful. Should you have questions about anything in this note or about any other issue, please feel free to give me or Sarah Dennis a call. And as always, thank you for the opportunity to serve as your financial advisor.

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