



# After a Stellar Year, What's Next?

## May 2014



RBC Wealth Management

# World we've been in since 2008

- Dominated by financial and fiscal crises
- Low economic growth
- Low inflation
- Ultra-low interest rates
- Low price-earnings ratios
- Policy uncertainty

# World we're transitioning to

- Crisis ebbs unevenly between the US, Europe, China and Emerging Markets as a whole
- Growth expected to enter a catch-up phase
- Inflation comes back on the radar
- Monetary policy and interest rates start to normalize (tapering of QE in the US)
- Price-earnings ratios expand
- Policy uncertainty fades

# Goodbye 2013, hello 2014

Regardless of the market's shorter-term ebbs and flows, the underlying fundamentals will determine the long-term direction of asset markets.

History tells us that performance for equity markets the year after a spectacular year is typically "good".

While 2013 was a good year for the TSX, it was spectacular for the S&P 500 and developed world equity indices.

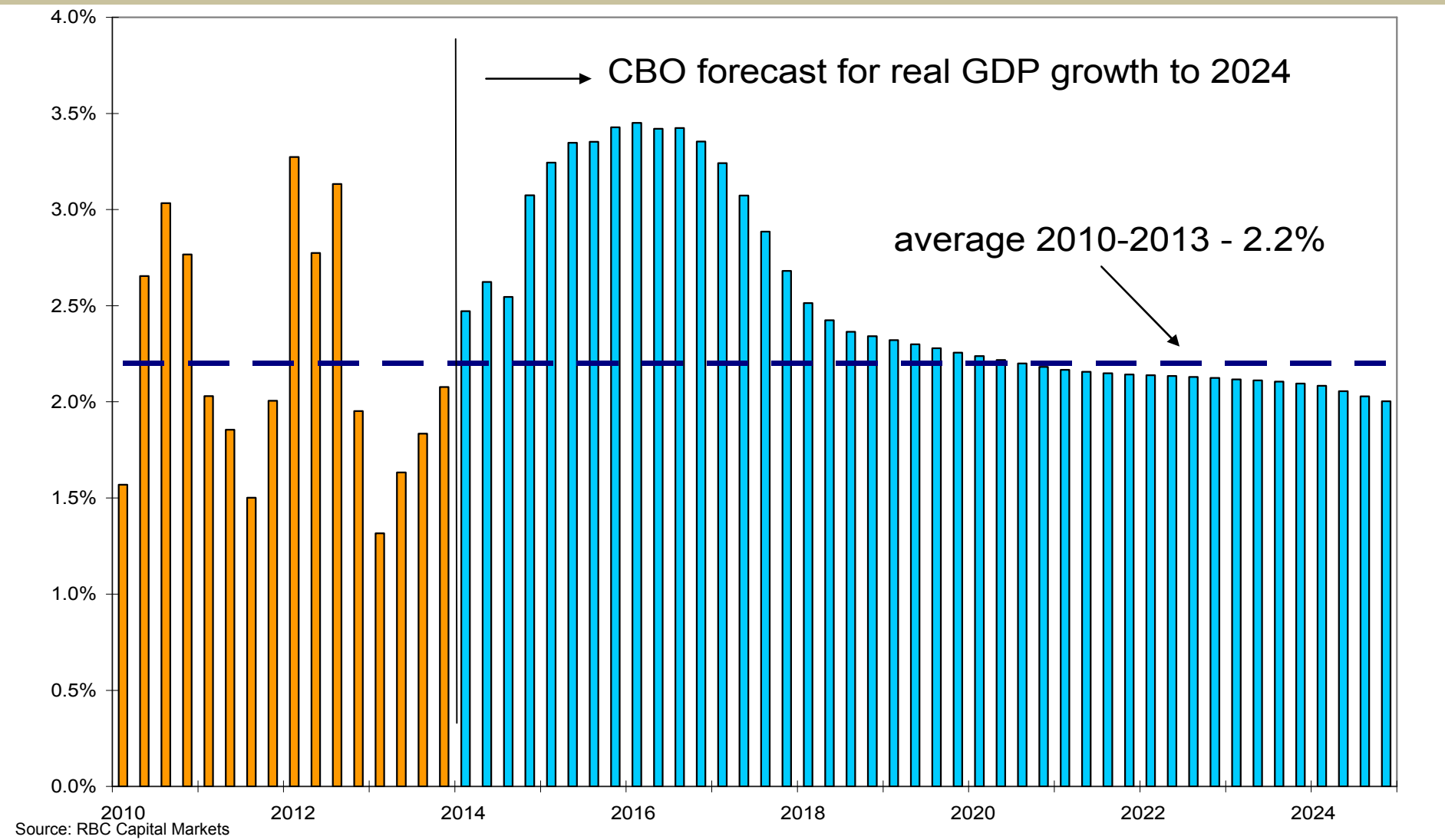
**TSX**                      **9.3%**

**S&P 500\***              **30.2**

**MSCI EAFE\***        **19.4**

(Returns measured in US\$. Source: RBC Capital Markets)

# Congressional Budget Office (CBO) Forecast for US Economy



Source: RBC Capital Markets

## Developments in the US that weren't on anyone's radar two years ago

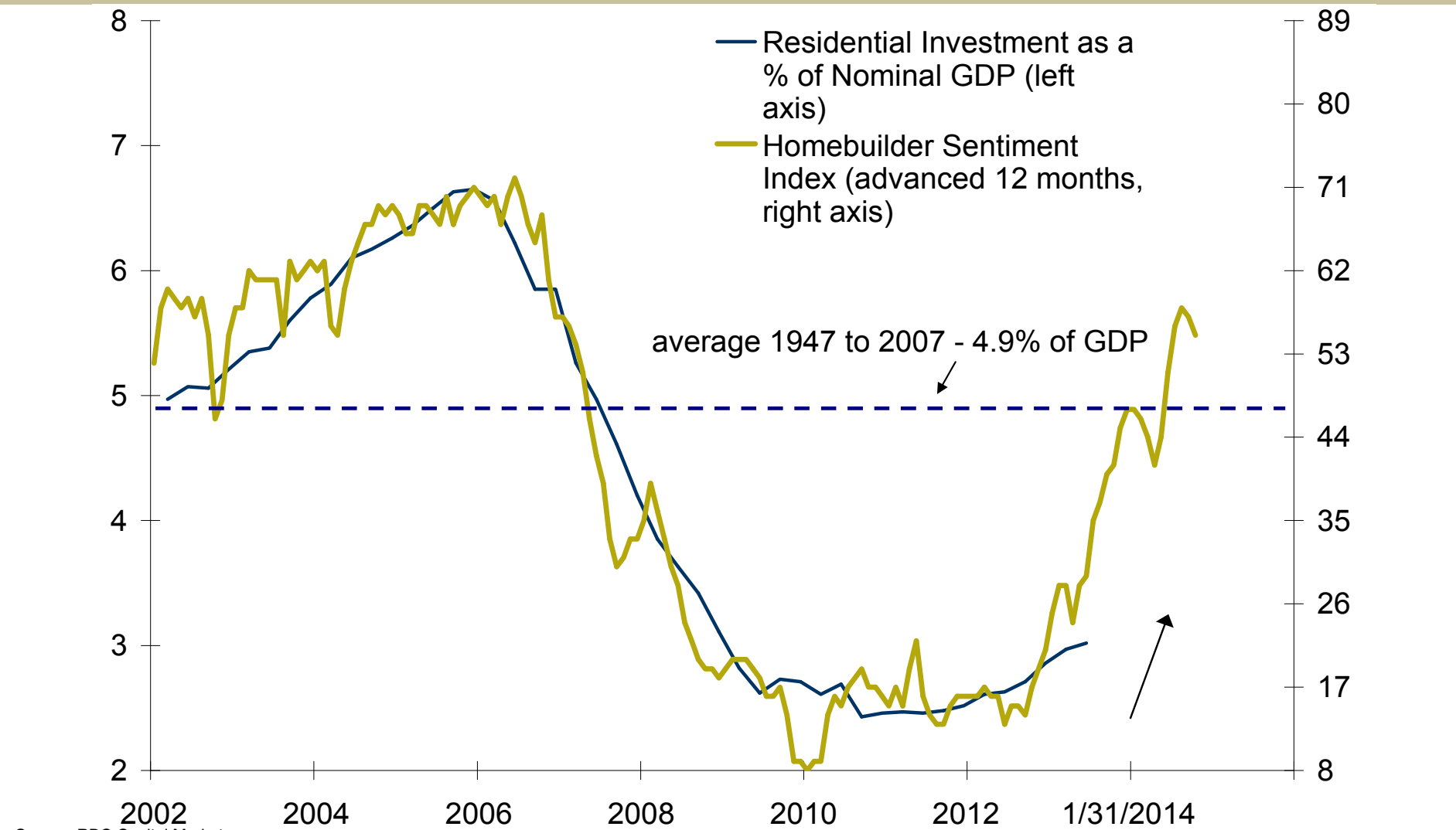
- Housing recovery
- Domestic energy development
- Manufacturing resurgence

Some positive developments that are beginning to influence economic activity to our south.

The importance of the housing market to a national economy should not be underestimated:

- Allows the banks to continue lending to business and consumers
- Contributes to the wealth effect that is such an important factor influencing consumer behaviour
- New household formation is a powerful force in any economy

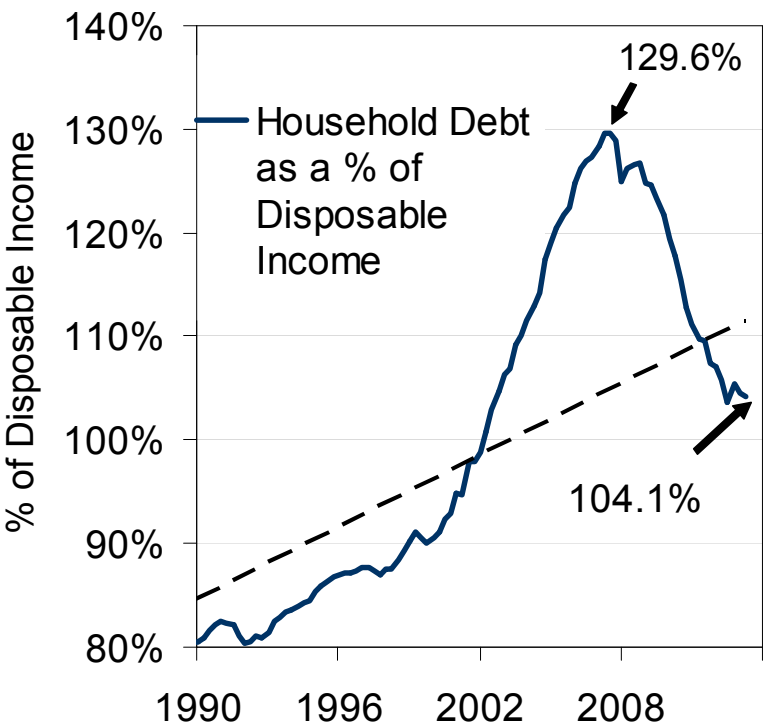
# U.S. Housing: Even a partial recovery is a big deal



Source: RBC Capital Markets

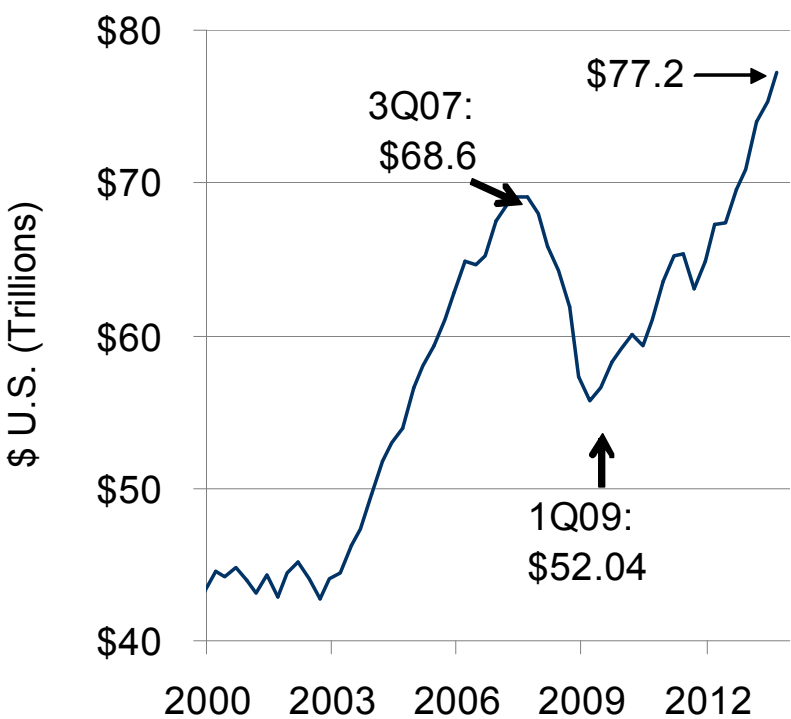
# The US Consumer is Getting Back into Shape

Household Debt



Source: Bloomberg, quarterly series, data through September 2013

Household Net Worth



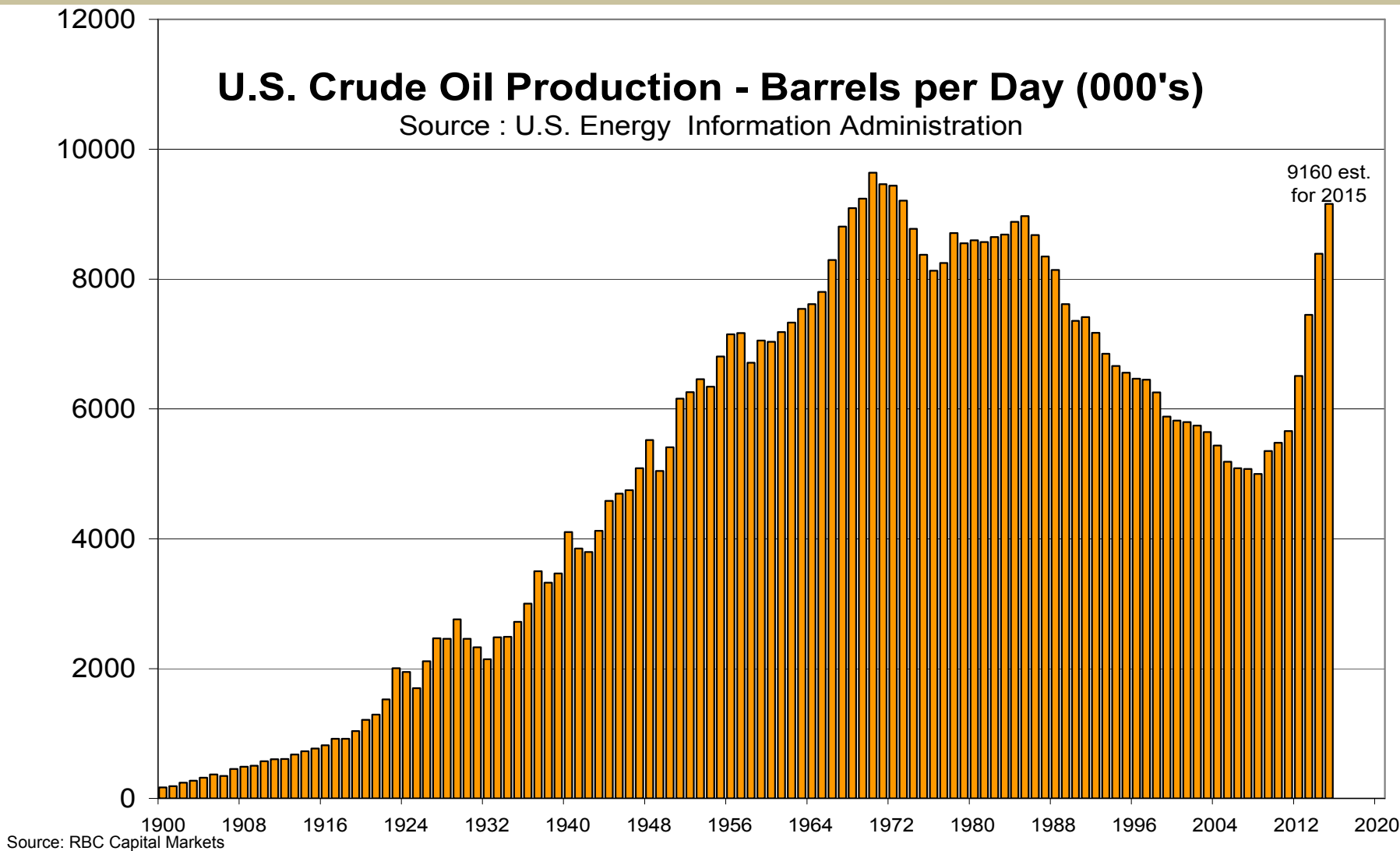
Source: Bloomberg, quarterly series, data through September 2013



# US is ramping up domestic energy production

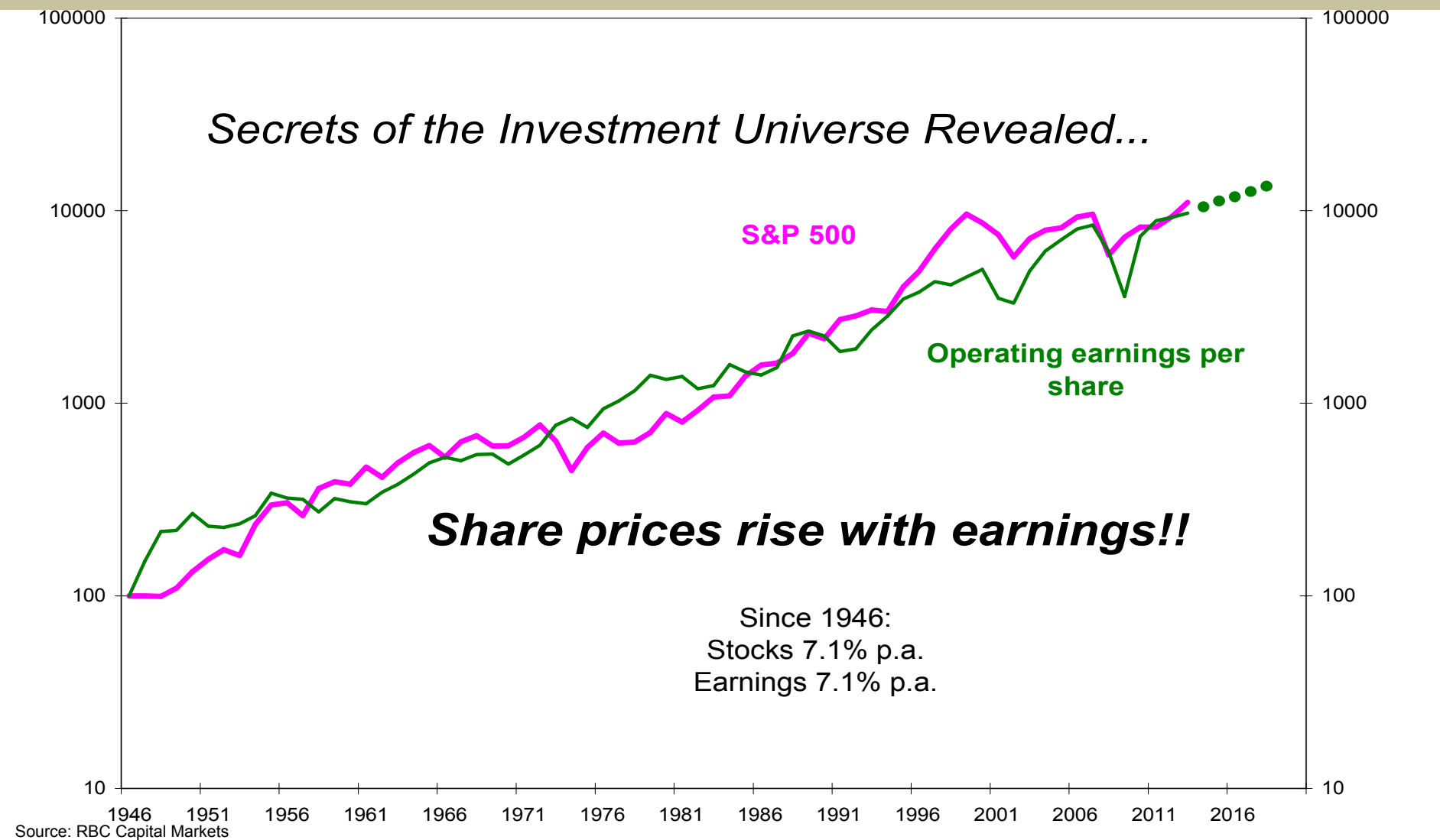
- Cheap and secure energy is fuel to the US economy
  - Provides an important competitive advantage for manufacturing
  - Leaves the consumer with funds for discretionary spending
  
- Represents a significant change for global politics as the US shifts away from reliance for supply from the Middle East

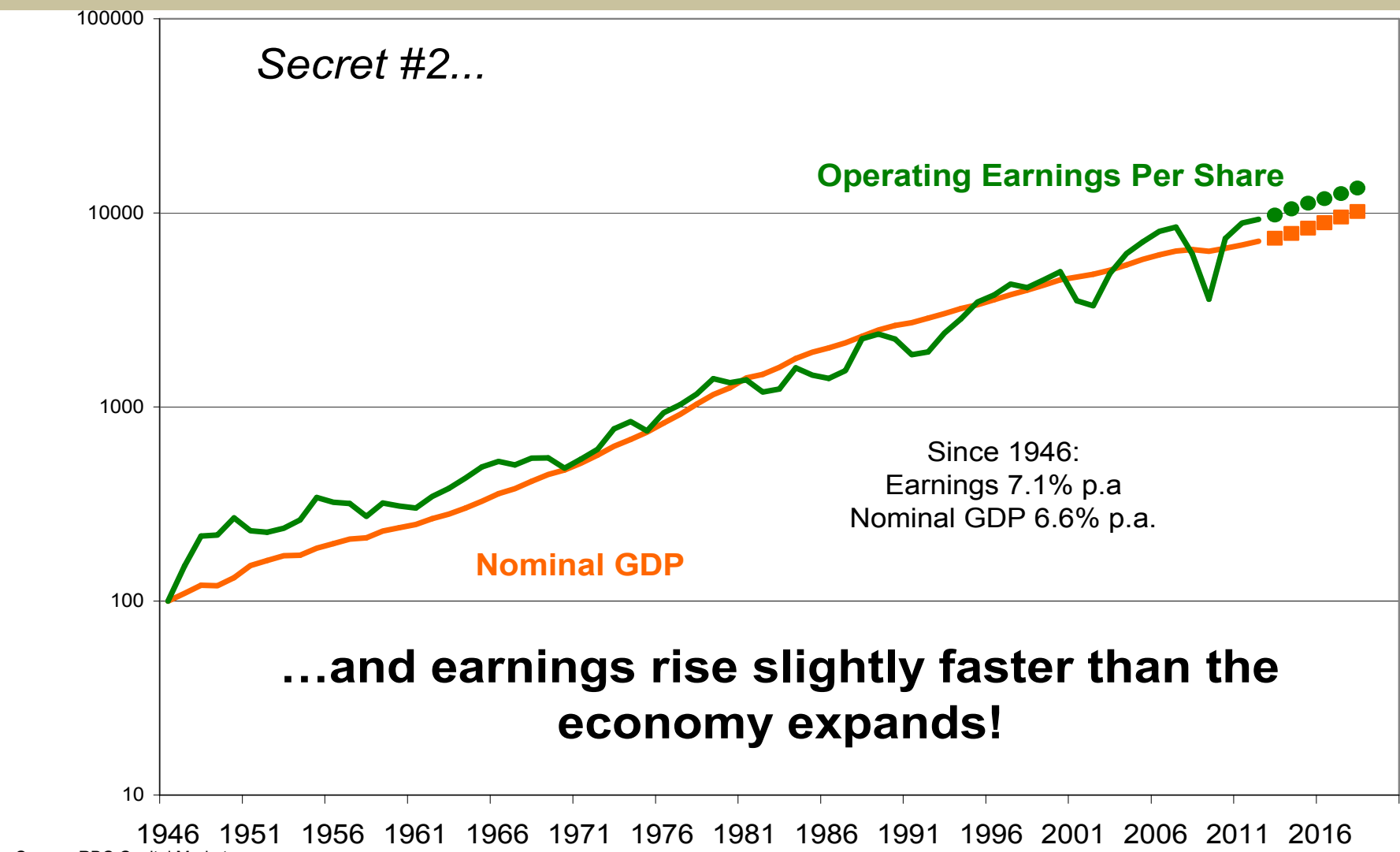
# U.S. Crude Oil Production



# One of Life's Great Mysteries:

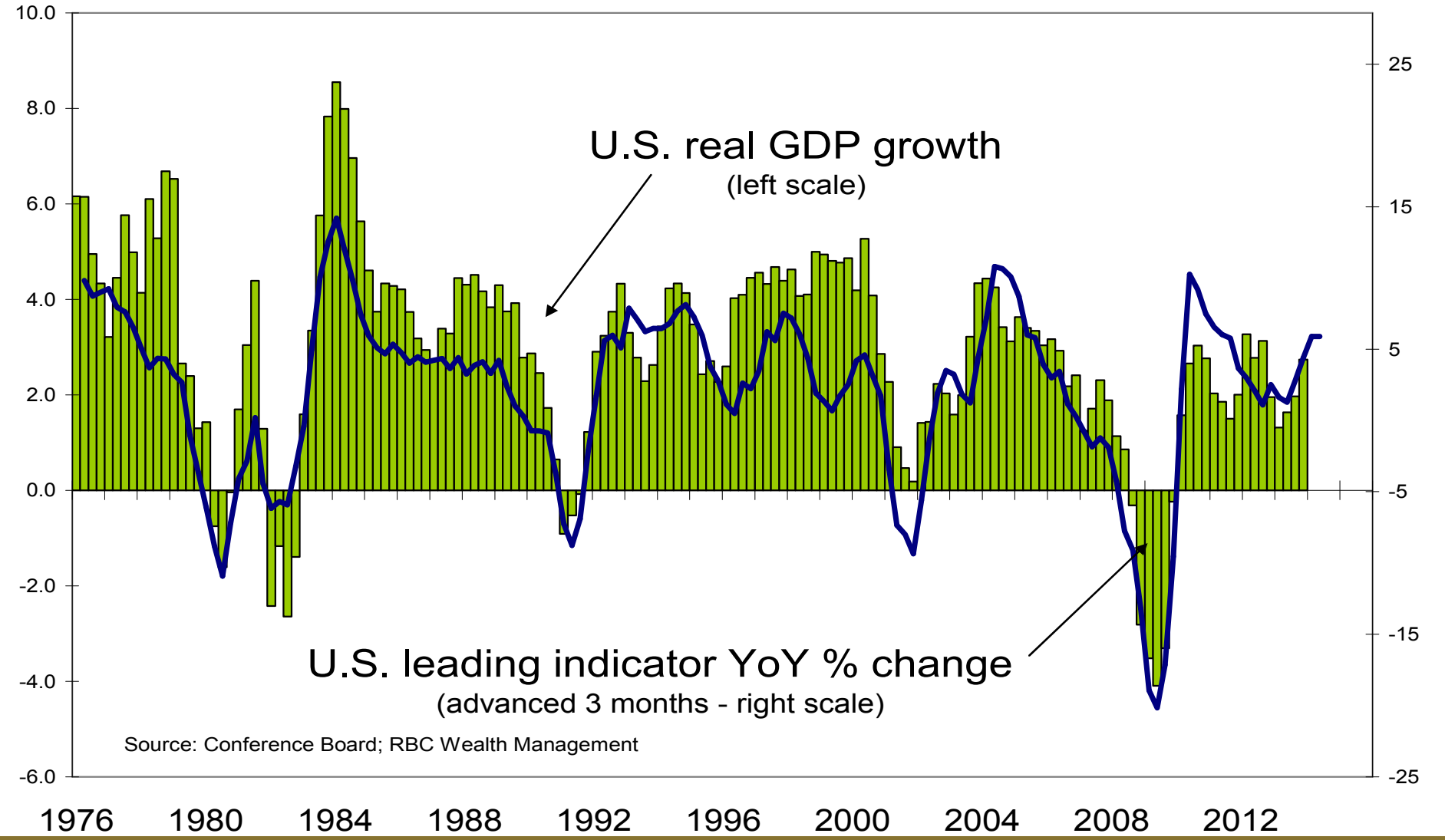
- What Makes the Stock Market Go Up?
- See the next two slides for some clues ...



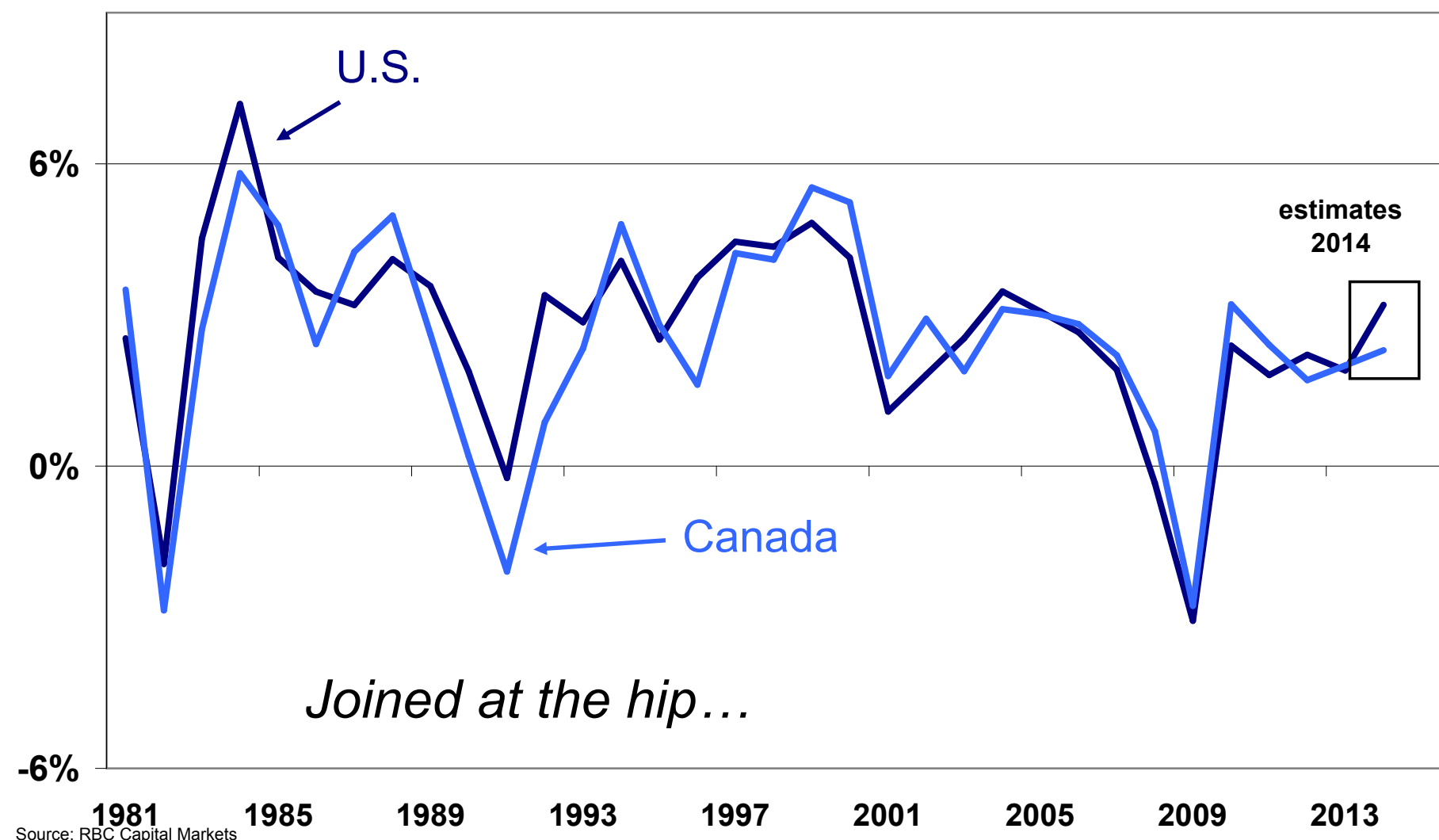


Source: RBC Capital Markets

# If the Leading Economic Indicator is to be Believed, US Economic Growth Continues to Look Up!



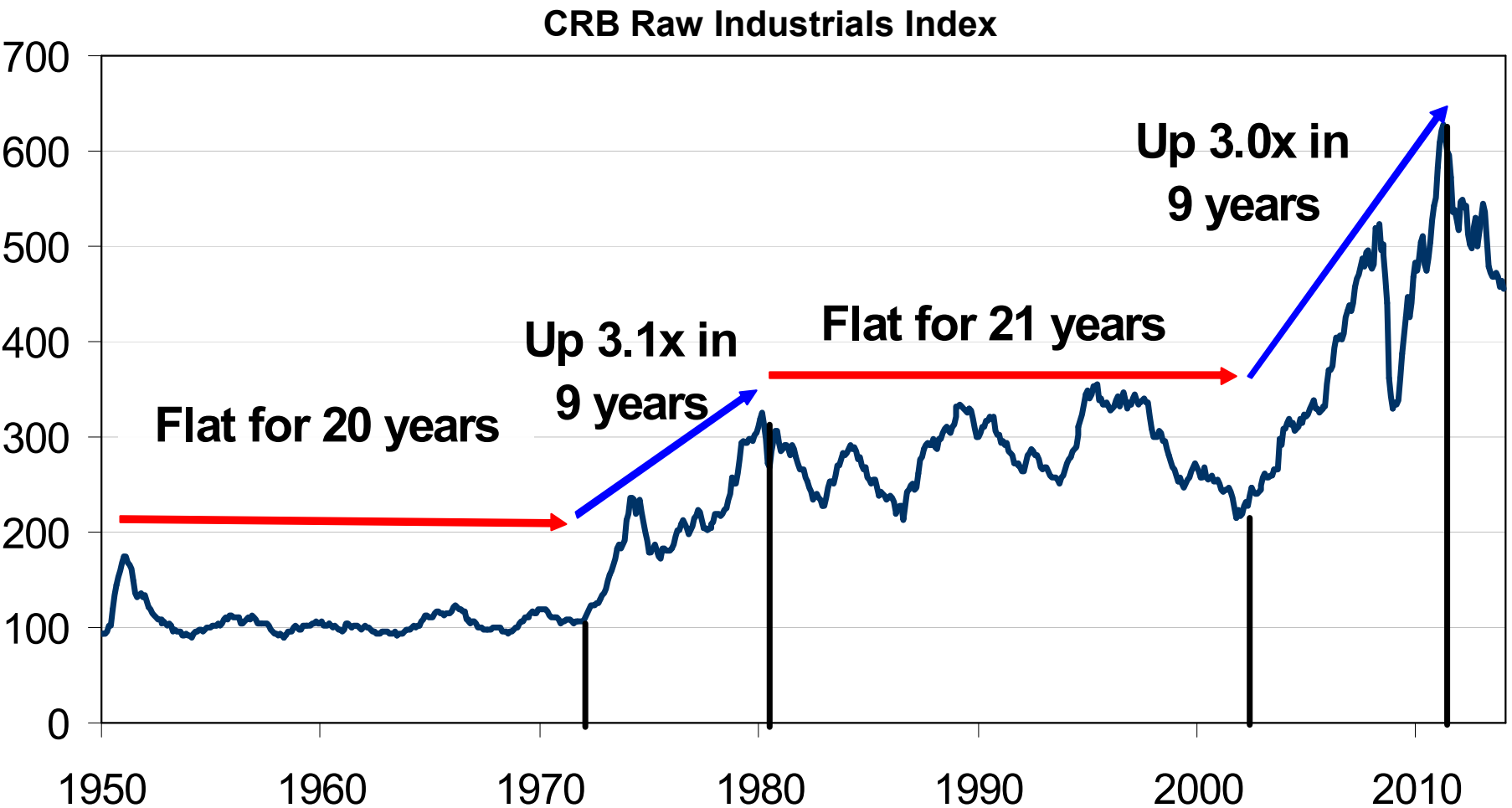
# Real GDP Growth – U.S. and Canada



Source: RBC Capital Markets



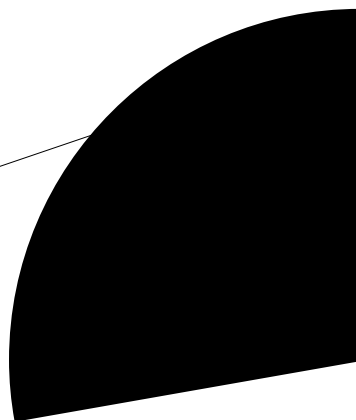
# Just like Everything Else, Commodity Prices Run in Cycles



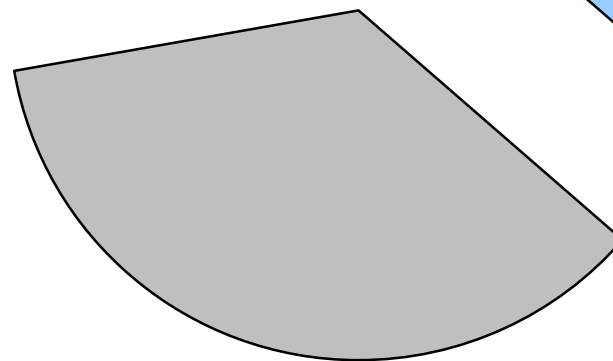
Source: Bloomberg. monthly series, data through December 2013

# TSX Sector Weights: lacking in breadth

**Industrials,  
Consumer,  
Telecom,  
Utilities,  
Healthcare,  
Technology**  
**27.8%**



**Resource  
(Energy &  
Materials)**  
**36.5%**

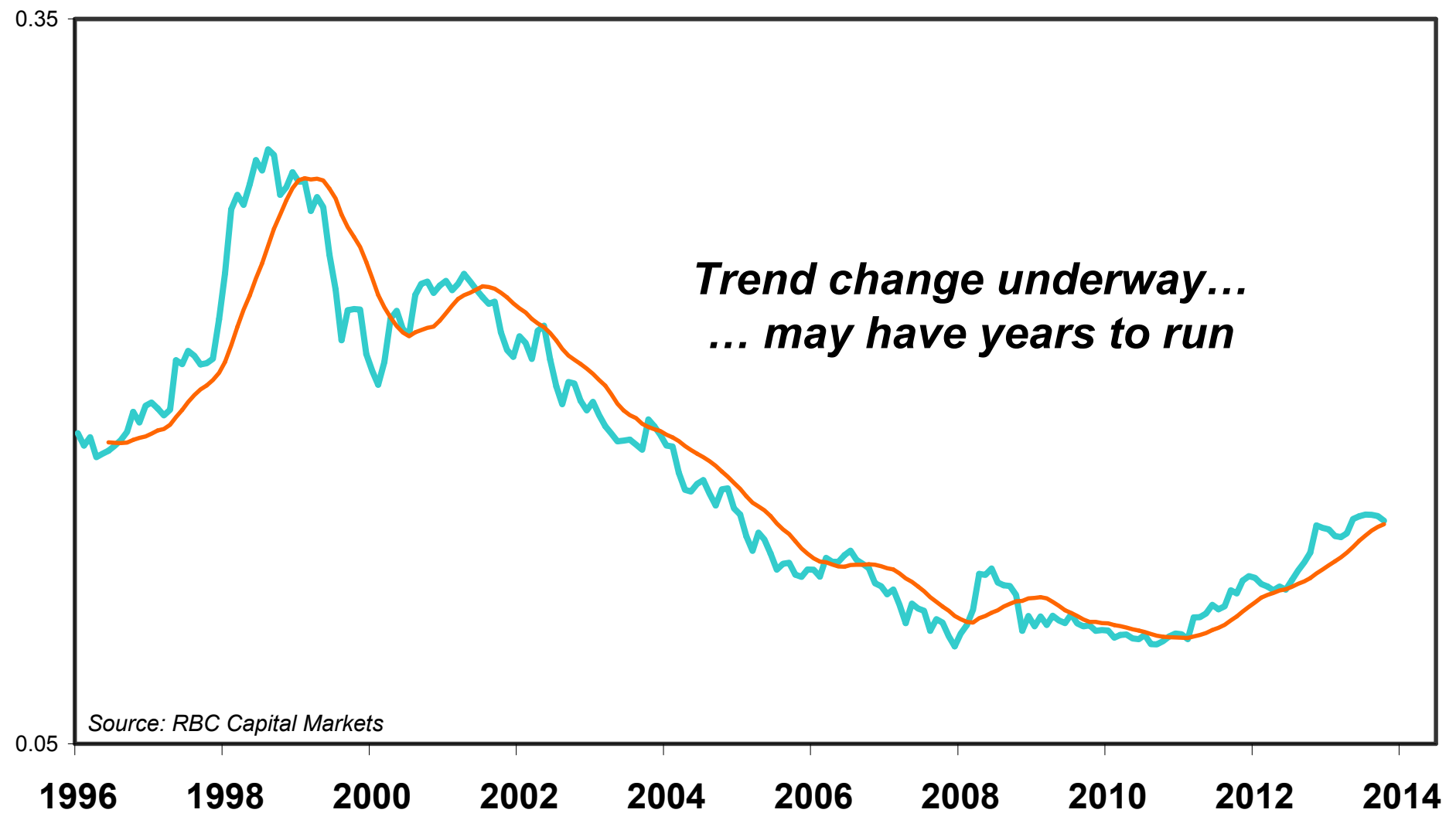


**Financials**  
**35.7%**

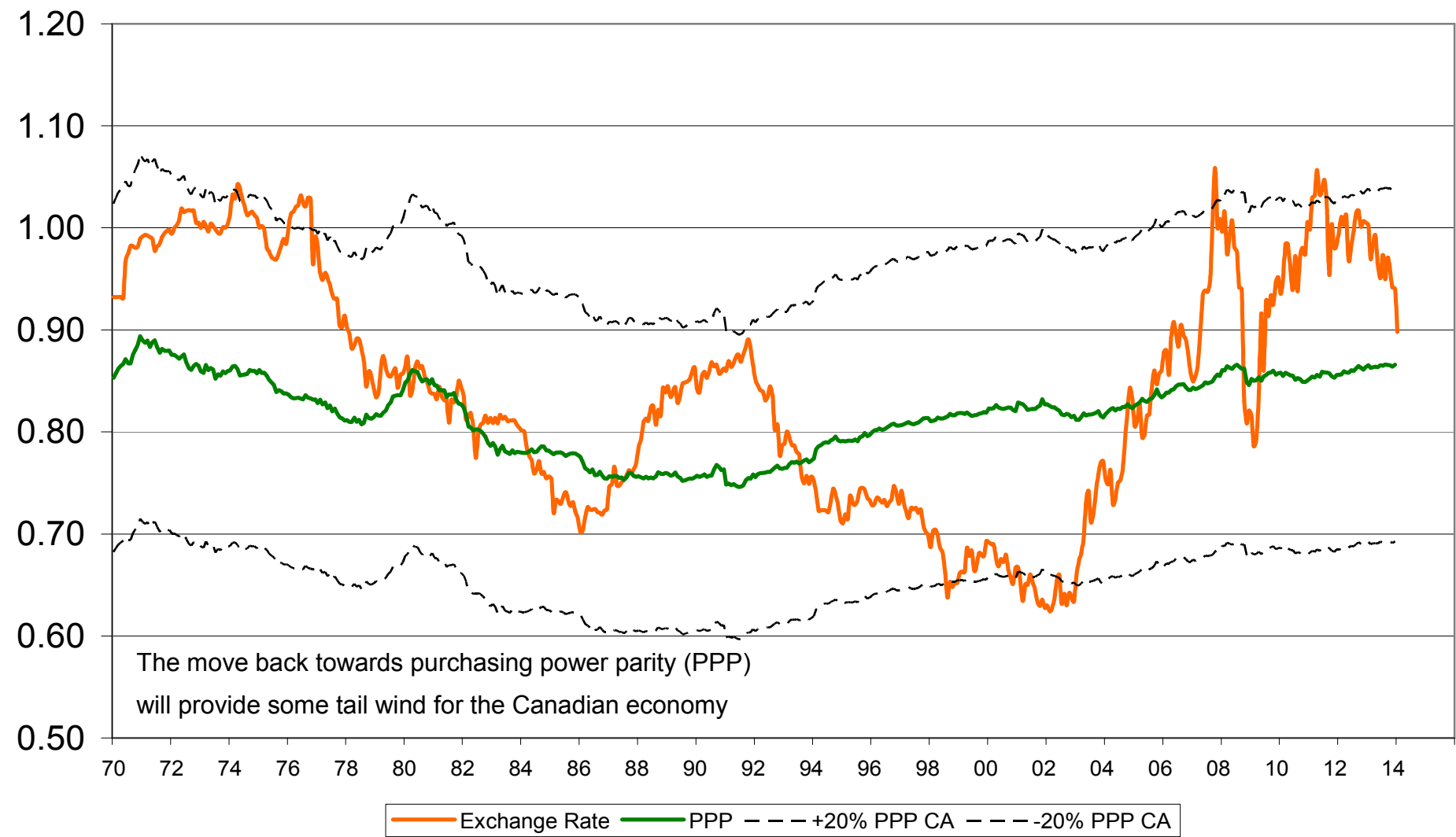
When you look at Canadian equities as a whole, you realize that only two sectors make up over 70% of the Canadian market.

Source: TSX, RBC Capital Markets Research

# S&P 500 Relative to TSX (Currency Adjusted)



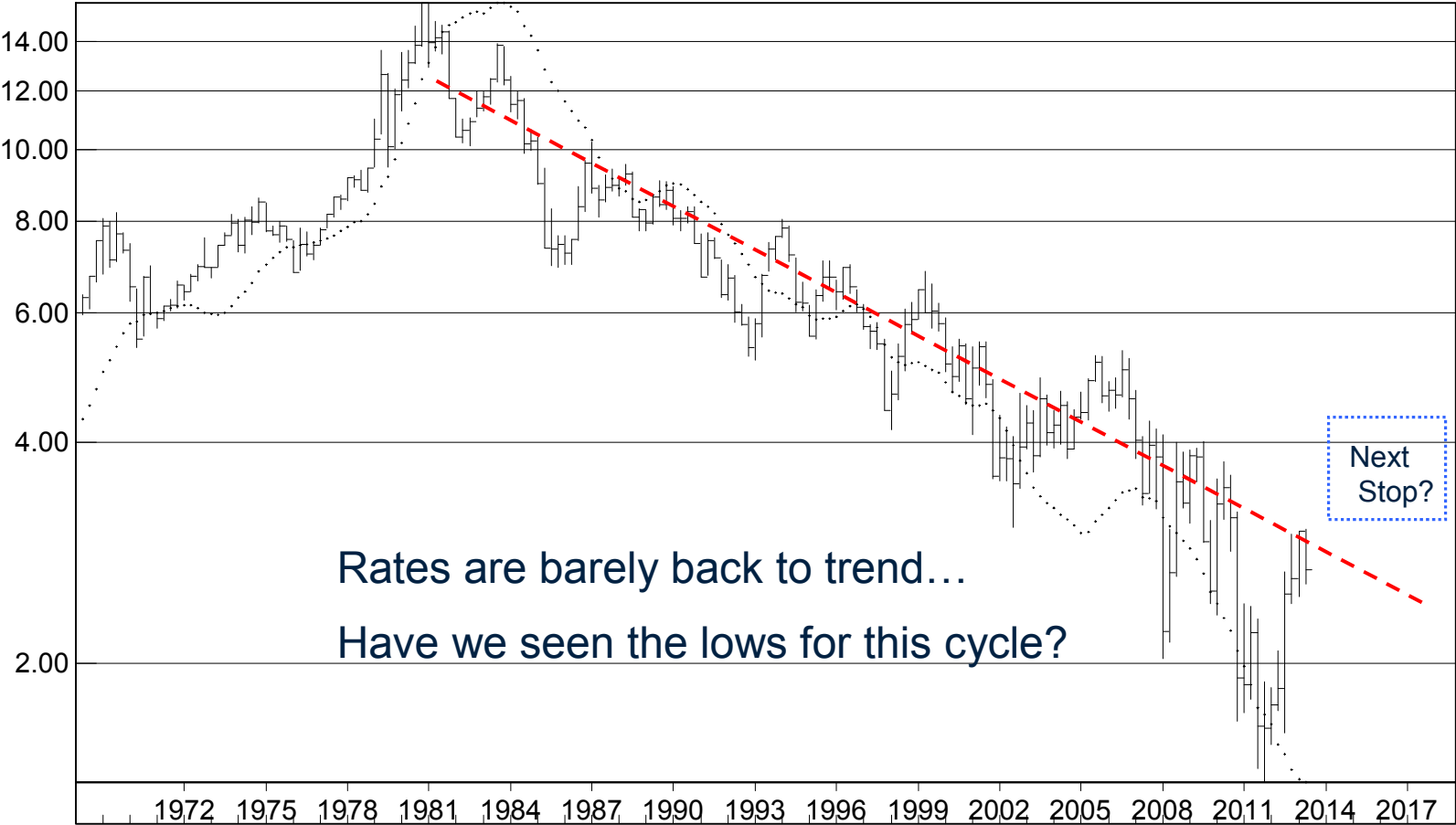
# Canadian Dollar & Purchasing Power Parity



# Are interest rates really that important... ?

- Determine the affordability of debt for business and consumers
  - Are a direct determinant of the health of the real estate market, among other asset markets
  - Serve as a critical benchmark for decision-making by stock and bond investors
- ... darn right they are!

# US 10 – Year Treasury Bond Yield



Source: RBC Dominion Securities Trend & Cycle



# When The Interest Rate Trend Reverses ...

In some quarters, there is concern that interest rates have been so low for so long that consumers and investors are beginning naively to believe they will remain low for a long time yet. (Our tendency to believe that tomorrow will be just like yesterday.)

## Potential for trouble:

- *In real estate markets* owners may find they can't afford the cost of financing their properties at higher rates (lack of affordability among new home buyers / potential for forced sales of existing homes).
- *In fixed income markets* where investors have become increasingly aggressive in their search for higher yields, higher rates will put downward pressure on bond prices.

# Thinking in advance about what's to come

- In the short term, expect greater volatility in asset prices than we've experienced over the past two years; the equity markets appear to be in a consolidation phase that could include a correction as a way of working off some of the speculative excesses, before continuing on an upward trend supported by good fundamentals.
- A few years of faster than expected growth from developed countries starting with the U.S.
- An end to unconventional monetary policies (quantitative easing to be specific)
- Inflation back on the scene, which will lead to ...
- A normalizing of interest rates and potential for pain in the bond market as a result
- Reallocation back to equities
- A phase of growth that favours the U.S. market over the Canadian.

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