

Towers Watson Q1 2010 – The Market in Review

The first quarter of 2010 seems to have marked a change in direction in many ways. An increasing discrepancy in the financial recovery is emerging in different parts of the global economy. The emerging markets are leading the rebound, with growth sufficiently strong that significant concerns about inflation are arising in economies such as China, Brazil and India. In the U.S. and Canada, the recovery seems to be gathering steam, as evidenced by the rapidly improving employment numbers and GDP growth. At the other end of the spectrum, the Eurozone continues to struggle with anemic growth, as private domestic demand continues to contract and sovereign credit stress in southern Europe (particularly Greece) creates downward pressure on the currency and on the economies of the stronger countries. The U.K. economy also continues to struggle under the spectre of heavy government and consumer debt loads and an inability to provide strong fiscal stimulus (due to the amount of money dedicated to rescuing its financial services industry).

For the U.S. economy, there is an interesting series of cross currents that create considerable uncertainty about the prospects for the next decade. The public sector debt load is rapidly escalating, as government deficits continue at previously unforeseen levels – only strong economic growth will likely permit this to be brought under control, as the economic effects of increasing taxes or significantly cutting spending could choke off the recovery. The longer term problem for the government is the pending impact of demographics on budget deficits – the retirement of the baby boom generation results in the gradual transfer of the “unrecognized” balance sheet deficits for social security and Medicare being gradually expensed through the annual income statement. Meanwhile, the household sector has noticeably begun to repay their debts (mortgage and credit card), but still has a long way to go before total debt loads are back at levels that can reasonably be sustained by current income levels. Overall employment and wage levels continue to be constrained – total employee compensation as a percentage of GDP has fallen more than 7% since 2000 (from 40% of GDP) and is now at its lowest level since the early 1950s. Sharp cost cutting by corporations has permitted them to quickly recover profit levels, even though revenues are down significantly – most of these profits have been building up as cash on corporate balance sheets and are available to be deployed in a variety of productive ways once corporations are convinced that the climate is advantageous. The combination of private sector deleveraging and the withdrawal of government stimulus could make it difficult for the economy to generate robust growth. Similarly, as long as the consumer remains a reluctant borrower, the vast funds deployed by the Fed to prop up bank balance sheets are unlikely to find their way into the real economy – this suggests that inflationary pressures should remain muted.

Government of Canada bond yields were relatively stable over the quarter, except at the shorter end of the curve where the bond market has begun to price in an expectation that the Bank of Canada will soon begin to move its lending rate up from its current historical low (0.25%). Spreads (over Canada bonds) for both provincial and Canadian corporate bonds narrowed slightly over the quarter, although they continue to be somewhat wider than the normal level. In the U.S. and U.K., the yields on investment grade corporate bonds continued to fall more rapidly than on comparable Canadian bonds, but continue to display spreads over local government bonds that are wider than observed in Canada. The DEX Universe Bond Index posted a return of 1.3% over the quarter, with the best returns coming from the corporate portion and the worst return from federal government bonds. For the current plan year (July 1 to March 31), the DEX Universe Bond Index has posted a return of 3.8%.

Equity markets had another positive quarter, despite the sharp correction experienced during the mid-January to mid-February period. The market rotation favouring companies with strong fundamentals continued to progress, particularly in Europe and Asia. Currency played a large role in market returns as the Canadian dollar continued to strengthen against most major currencies (including the U.S. dollar) and the European currencies weakened sharply against other currencies due to concerns over the Greek sovereign debt crisis. The Canadian market was up 3.1% for the quarter and 18.5% for the current plan year. The MSCI World Index was up 4.7% for the quarter and 25.6% for the plan year (in local currency terms), but currency impacts reduced the return for the last quarter -0.1% for the Canadian investor. In Canada, market performance over the quarter was led by the Financial stocks and the economically sensitive sectors (Industrials and Consumer Discretionary); Energy was the only sector to post a negative result. In the global markets, the strongest performance also came from the Consumer Discretionary and Industrial sectors, with Energy and the defensive sectors lagging. The weakest performance (from a regional perspective) came from the European markets that are most exposed to the sovereign debt issues (Portugal, Italy, Greece and Spain) and the strongest performance came from the U.S. and Japan (due to its heavy exposure to China).