

Towers Watson Q2 2010 – The Market in Review

The second quarter is best characterized as a period dominated by uncertainty, translating ultimately into fear on the part of investors:

- Concerns over sovereign debt default in southern Europe (particularly Greece) caused a flight to safety (largely U.S. Treasuries), as European equity markets plummeted and the Euro devalued sharply against most currencies. The \$1 trillion bailout package coordinated by the European Union, the IMF and the European Central Bank removed the threat of default and hopefully bought enough time for fiscal conditions to stabilize.
- Mixed economic data on the U.S. economy, particularly in short-term data, caused violent market movements in the U.S. and global markets. In particular, persistently high unemployment and disappointing housing data caused market skittishness, as people continue to worry about the potential for a “double-dip”.
- Efforts by the Chinese government to slow its red hot housing market gave rise to fears that GDP growth could also slow. As context, the national Chinese housing market is more over-levered than either the U.S. or U.K. housing markets at the height of the recent property bubble (ratio of home price to income exceeds 8x) and it is worse in major industrial centres such as Shanghai.
- The Gulf oil spill, while truly a phenomenon related to one industry and a small group of companies, added disproportionately to global fear.
- Concern that the economic recovery in most of the developed world will be slower and weaker than previously hoped, as economic commentators revise their expectations for 2010/11 downward.

Against this backdrop, we are seeing continued improvement in GDP for Canada and the U.S. Unlike other recessions (when the consumer has led the economy out of recession), the U.S. economic recovery is being fueled by export activity primarily related to the emerging economies – the recession in the emerging economies was not as deep and they recovered much more quickly than the developed economies. As the consumer eventually begins to spend, this will provide additional fuel for the economic growth. Despite this, there should continue to be caution around the future strength of the recovery, as governments will ultimately need to commence the process of addressing their fiscal deficits (as Canada and the U.K. have) and bringing the growth of their debt back under control. This deleveraging must also occur for household debt in much of the developed world. Corporate earnings continue to improve, exceeding expectations by wide margins. Corporate balance sheets are in excellent condition, as corporations have paid down debt and are holding near record levels of cash (ready to finance new business spending growth). Although it has occurred to some degree in the U.S., inventory restocking on a global basis is still at a very early stage.

The Bank of Canada raised its target overnight rate for the first time since the recession began (25 bps in June), becoming the second developed economy (after Australia) to begin the long process of tightening credit. The BOC has indicated that it will move rates upward cautiously in order to ensure that it does not choke off the economic recovery. In both the U.S. and Canada, yields on medium and long-term government bonds fell sharply over the quarter as a direct result of the flight to safety mentioned earlier – due to our performance during the recent financial crisis and the perceived strength of our banking system, the Canadian dollar (long with the Australian dollar) has taken on something approaching secondary reserve currency status. This caused the risk premiums (i.e., corporate spreads) to again widen, although corporate bond yields themselves changed very little. As a result, Canada bonds and provincial bonds both outperformed corporate bonds over the quarter. The DEX Universe Bond Index posted a return of 2.9% over the quarter and the DEX Long Bond Index (bonds with 10 year term or longer) posted a return of 5.1% for the quarter. The overall yield curve, while still much steeper than normal, is significantly flatter than at the beginning of the calendar year.

In response to the build-up of fear amongst investors, equity markets had a very poor quarter on a global basis. Currency also continued to be a significant factor for Canadian investors, as the Canadian dollar depreciated sharply against the U.S. dollar and Yen, while appreciating sharply against the Euro. The Canadian market posted a loss of 5.5% for the quarter, with the strength of gold and consumer stocks helping buffer the market from worse losses. The U.S. market (S&P500) was down sharply in May/June, posting a loss (in USD) of 11.4% for the quarter – for the Canadian investor, this loss was moderated to 7.2% due to the strengthening of the U.S. dollar. Losses in the U.S. market were widespread, with virtually all economically sensitive sectors posting double digit losses for the quarter. The U.S. energy sector did not escape the BP oil spill unscathed, as cessation of production in the Gulf of Mexico and the linkage of some of the U.S. oil service companies (e.g., Transocean) to the BP disaster weighed on the sector. In the rest of the world, performance was also poor, with the MSCI EAFE Index (developed markets excluding U.S.) posting a loss of 11.2% for the quarter (in local currency terms). While not as much of a factor, currency did provide a small tailwind for Canadian investors, moderating the loss to 9.9% for the quarter. The negative performance was dominated by the southern European markets (in particular Greece), the U.K. market (due largely to BP's 50% decline) and Japan (strengthening Yen was a drag on the exporters). The Energy (led by BP) and Materials (due to weakening prices on industrial metals due to concerns about the Chinese economy) sectors were the worst performing sectors over the quarter. Emerging markets stocks were also hurt by the weakness in commodity prices.