Standard Life Investments

Investment Newsletter (Third Quarter 2013)

Equity Markets

Global equity markets were volatile during the third quarter, moving in reaction to speculation surrounding the tapering of quantitative easing in the US. Nevertheless, equity markets responded positively to stronger signs of global economic growth.

Cyclical sectors took the lead, as the biggest market driver was the improvement in global economic growth led by Europe, Asia ex-Japan and Canada, all of which are more cyclically geared markets while China showed signs of stabilization. This drove the equity market and sector rotation. The perceived change in Fed policy reinforced this trend, with funds flowing out of bonds, the US dollar, and from more yield oriented or “steady growth” sectors into cyclically oriented sectors, reflecting a broader shift toward risk-taking.

Canadian Equities

The S&P/TSX Composite Index returned 6.25% in the third quarter. As the market took on a more pro-cyclical stance, performance was driven by in part by a rebound in commodities, as stocks in the metals, gold, integrated oil, and lumber sectors outperformed; consumer discretionary and banks also did well. The weakest sectors were those that suffered from a rise in bond yields, such as REITs, pipelines, etc. The utilities sector, which is often considered as having a bond-like component in the stock valuations due to their attractive yield, was the worst performing sector generating negative returns. The S&P/TSX SmallCap Index outperformed the Composite Index since it has a higher exposure to commodity stocks.

Other sectors such as financials (other than banks), energy and information technology rose in line with the general market index. The telecommunication services sector recovered from weakness in the second quarter on news that Verizon would not pursue its entry into Canada.

US Equities

During the quarter, the S&P500 Index returned 5.24% in US dollars, although when converted to Canadian dollars, the return was 2.97%. Drivers of early-quarter performance included a favourable global economic growth environment, stabilizing data out of China, acceptable earnings and recovery from early volatility related to concerns over tapering by the Federal Reserve. The recent market weakness toward the end of the quarter appears to have been due to the gridlock in Washington over the government shutdown and debt ceiling.

As in other major global markets, cyclical sectors took the lead. Sectors such as materials and industrials – both driven by improved macro data, especially from China – as well as the consumer discretionary – driven by stronger housing and labour market – and the information technology sectors outperformed. As was the case for the Canadian equity market, the weakest sectors were the higher dividend defensive stocks. Consumer staples, telecommunication services and utilities were the worst performing sectors, again reflecting the broader shift toward risk-taking within the market.

International Equities

The MSCI EAFE Index posted a return of 9.33% in the third quarter. European equities performed well as the Euro zone emerged from recession, outperforming other major indices. Whilst Germany and the UK were the main drivers of economic growth, early signs that the peripheral countries were starting to stabilize were beginning to multiply. Unemployment also showed signs of improvement and the European Central Bank maintained interest rates at 0.5%. Market reaction to the German elections and further political turmoil in Italy was muted. Emerging markets in Central and Eastern Europe have been performing better than other emerging markets according to MSCI.

UK equities delivered solid returns, with the majority of the market's gains coming early in the quarter. The market rebounded in July following losses in June, as the US Federal Reserve moved to calm fears of a reduction in its asset purchase programme. However, concerns over events in Syria and the US government's inability to pass its budget subsequently hit sentiment. UK economic data continued to improve steadily, with the leading PMI indices at robust levels.

Japanese equities also recorded gains during the quarter, due in part to fiscal and monetary stimulus. The effect of quantitative easing and an increase in capital expenditure resulted in second quarter GDP coming in at 3.8%. Corporate earnings showed signs of improvement and a more competitive currency was beneficial for the economy overall. Similarly, Pacific Basin equities were positive over the period. In China, economic data improved as the quarter progressed, with exports growing marginally faster than imports, industrial production beating expectations and consumer price inflation drifting down slightly.

Bonds

The quarter was marked by a bond sell-off in response to concerns over the Federal Reserve "tapering" its purchases of US bonds. These concerns adversely affected most bond markets, with rising longer-term yields causing a steepening of yield curves, which resulted in capital outflows from many emerging markets and redemptions in almost all categories of bonds. Yield spreads on provincial and corporate bonds over federal bonds widened during the sell-off, yet these bonds still outperformed their federal peers. Against this backdrop, the DEX Universe Bond Index returned 0.11% for the quarter, with short term bonds providing the best performance while the Long Term Bond Index posted the poorest performance (-1.12%). The DEX Real Return Bond Index also posted a negative return (-0.5%) during the quarter.

Government "safe haven" bonds came under a lot of strain. The 10-year term was under major pressure from bonds sellers. With the notable exceptions of Japan and peripheral Europe, bond yields reached year-to-date highs during the quarter, but declined slightly in September when, contrary to market expectations, the Federal Reserve did not indicate an imminent tapering of its bond purchasing program. The fiscal/debt limit issues in the US also created uncertainty and contributed to market volatility. The Federal Reserve tapering program seems to be fully priced into markets, and bonds may not sell off materially beyond their recent highs in yields.