Global Securities
CORPORATION

Equity Research
1 (800) 455-5778
www.globalsec.com

Market Bulletin

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The Market Bulletin will not be released next week.
The next Bulletin will be issued in the first week of April.

Commentary – Yellen's "around six months" remark suggests equity rally may have another year or two to run

TSX reached our 14,400 target today, S&P 500 hit record high intra-day

Elvis Picardo, CFA

Federal Reserve chair Janet Yellen's first FOMC press conference on March 19 will probably be remembered in the years to come for the wrong reasons. Market participants have long had a tendency to parse every word uttered (or not) by Federal Reserve officials, especially in this era of more Fed transparency and communication that was ushered in by Yellen's predecessor Bernanke. But the degree to which comments by a Fed official can roil the markets was driven home by the consternation that greeted Yellen's casual "around six months" response to a reporter's question about how long interest rates would stay low after the Fed's asset purchases end.

Yellen's remark was interpreted to mean that the Federal Reserve would probably tighten monetary policy faster than expected. The Fed reduced its monthly pace of bond purchases by $10 billion to $55 billion, having done so by a similar amount in December and January. This puts the Fed on course to complete its unprecedented asset purchase program by end-2014, although it has reiterated that asset purchases are not on a preset course. Six months from that point would place the Fed's first rate hike at mid-2015, which is a slightly more aggressive timeframe than the consensus expectation of market participants.

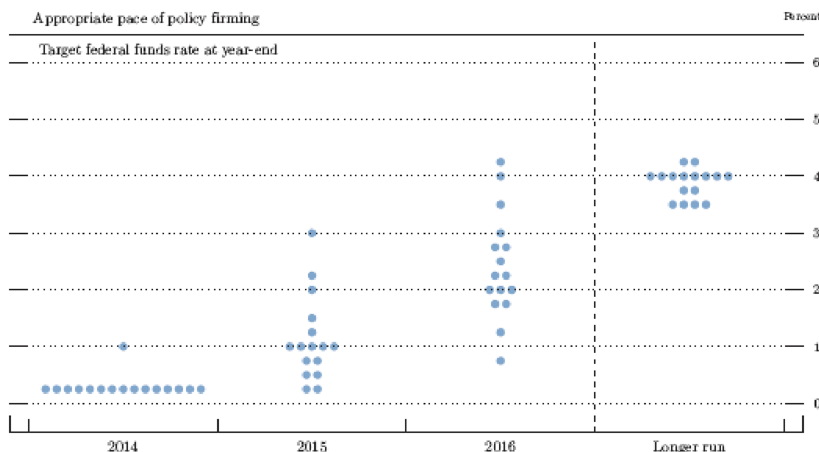
The Fed's "dot plot" (Exhibit 1) also suggests that rates could be going up sooner than expected. More Fed officials are now forecasting that the federal funds rate will rise to at least 1% by end-2015 and 2.25% by end-2016, compared with the median projection of 0.75% and 1.75% respectively in December 2013.

Initial market reaction to Yellen's remark was unequivocally negative, similar to the reaction that greeted Bernanke's "tapering" talk when he first broached the subject on May 22, 2013. The nervousness lasted for all of one month in that instance, with the S&P 500 declining 5.8% over that period, and emerging market assets and currencies in particular subjected to a ferocious sell-off. But things settled down rather quickly after that initial downdraft. Just as investors have now become conditioned to the Fed's scaling back of its bond purchases, they will take the Fed's inevitable monetary policy tightening moves in stride. But with the beginning of the rising interest-rate cycle still more than a year away, the question is at what point equities will begin reacting adversely to higher short-term rates.

Let's look at the Fed's previous rate hike cycle to get some insight into this issue. The Fed started raising rates in May 2004, when the federal funds rate was 1.00%, and steadily ratcheted it up to 5.25% by June 2006. The S&P 500 had already advanced 42% from its March 2003 low by May 2004; it then traded essentially sideways for the next two years, gaining only 14% by June 2006. With the Fed holding the federal funds rate steady at 5.25% over the following year, the S&P 500 gained an additional 24% to its October 2007 peak. Overall, the index gained 100% from its March 2003 intra-day low to its October 2007 record high.

The difference this time is that the S&P 500 is already up **182%** from its March 2009 low, with the Fed still a year away from raising the federal funds rate. We believe that there is a possibility that when the Fed does start tightening, it does so at an even faster pace than this week's revised expectations. But given that the tightening cycle will start from a near-zero base, we believe rising short-term rates may not affect investor sentiment until the fed funds rate rises above 1%, which only seems likely in 2016. **Barring any unforeseen shocks, our view is that the global equity rally could last through 2015, although the pace of the advance is likely to be markedly slower than that of the last five years and accompanied by rising volatility. In our opinion, the TSX Composite, which today reached our end-2014 target of 14,400 well ahead of schedule, could breach its record high of 15,154 before this rally is over.**

Exhibit 1: FOMC participants' (16) forecasts on target federal funds rate



Currencies and Markets

Canadian dollar may extend weakness as bearish factors mount

Currency weakness may provide tailwind for Canadian corporate earnings, boost TSX

The Canadian dollar lost a cent against the greenback this week, but given the spate of bearish factors that are besetting the currency, it wasn't a bad performance by the loonie. A number of developments weighed down the loonie this week, the most important of which was a growing consensus that monetary policy in Canada and the US are moving in divergent directions. Bank of Canada Governor Poloz said on March 18 that he would not rule out an interest-rate cut if the economy worsens, in stark contrast to expectations that the Federal Reserve may embark on tighter policy sooner than estimated. Increasing concern about the spectre of Quebec separatism is also weighing down the loonie. The currency traded at a 4½-year low of 88.66 US cents yesterday, before staging a modest recovery today after reports showed that Canadian inflation and retails sales rose faster than expected.

Loonie weakness may be contributing to the recent strength of the TSX, however (Exhibit 2). A weaker Canadian dollar would provide a much-needed boost to earnings of industrial companies and commodity producers. The positive correlation between the TSX and the loonie has broken down since mid-2013, with the equity index up 22% since June 24, 2013, and the Canadian dollar down 6.5% vs. the US dollar over this period. While the Canadian dollar looks set to break down below strong support at the 89-90 US cents level, further currency weakness could propel the TSX higher and enable it to add to its recent gains.

Exhibit 2: TSX and S&P 500 vs. C$ – Five year performance **Source: Bloomberg**

Market Snapshot

At close on Friday, March 21, 2014

S&P TSX	14335.76	-26.07	**Commodities**			**Yields (%)**	**Can.**	**US**
TSX Venture	1034.76	-0.50	Canadian $ (US cents)	89.10	+0.15	90 Day T-Bill	0.87	0.05
DJIA	16302.77	-28.28	Gold (Spot)-US$	1334.70	+6.82	2-Year Bond	1.07	0.42
S&P 500	1866.52	-5.49	Oil (WTI-May)	99.46	+0.56	10-Yr.Bond	2.48	2.74
NASDAQ	4276.79	-42.50	CRB Index	299.40	-0.10	30-Yr. Bond	2.95	3.61

Thought for the Day

"Since I have become a central banker, I have learned to mumble with great incoherence. If I seem unduly clear to you, you must have misunderstood what I said." – Alan Greenspan

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