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The Bigger Picture

A weekly snapshot of the markets

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Commentary – TSX at record high, traded above 15,500 on Friday

Index gains are accelerating but that could be a disconcerting sign

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On Friday, July 25, the TSX Composite briefly traded above 15,500 for the first time in its history, before paring its gains to close at a new record of 15,455.04. The index has added about 2.3% since June 23, when we had written that more gains were likely after the benchmark index had closed at new highs in the preceding week.

The TSX continues its recent streak of outperforming the S&P 500. On Friday, for instance, it gained 0.4% even as the S&P 500 and DJIA declined 0.5% and 0.7% respectively. Table 1 shows the divergence in performance between the two indices for various periods.

Table 1: Performance differential – TSX vs. S&P 500

	Change			
	1-week	1-month	YTD	1-year
TSX Comp.	1.23%	3.21%	13.46%	21.99%
S&P 500	0.01%	0.96%	7.03%	17.04%
Difference	**1.22%**	**2.25%**	**6.43%**	**4.95%**

The outperformance of the TSX year-to-date and over the past year represents a big change from the situation a year ago. In mid-August 2013, the Canadian benchmark was underperforming the S&P 500 by 13.6% YTD and 11.1% over the previous 12 months. TSX gains of 13.5% this year are being driven by the Energy sector (+19.1%), Materials (+18.4%) and Industrials (+16.4%). All 10 groups are in positive territory YTD, with the cyclical groups dominating the index at present, and the defensive sectors – Telecoms, Health Care and Utilities – the biggest laggards.

Overall, the TSX Composite has doubled since this global rally commenced on March 9, 2009, while the S&P 500 has almost tripled (104.2% for the TSX vs. 192.4% for the S&P 500). Of the four biggest groups on the TSX, Industrials and Financials have outperformed the index over the past five years, while Energy and Materials have underperformed (Figure 1).

Even accounting for the fundamental differences between the Canadian and U.S. markets, the performance differential for similar sectors on the TSX and S&P 500 over the past five years is quite startling. For example, the TSX Materials sector has only gained 15.1% since March 2009, while the S&P 500 Materials sector has surged 190.7%. The TSX Energy sector is up 82.9% since March 2009, while the S&P 500 Energy sector has gained 134.1%.

This sector performance differential can be explained by factors unique to their respective markets. For instance, the best performers on the S&P 500 Materials sectors over the past five years are chemical and paint companies, which are not a major component of the TSX Materials sector. The latter has also been weighed down by its large number of precious metal producers, the worst performers over the past five years. As for energy, Canadian producers were hindered by the lack of pipeline capacity, which resulted in Canadian crude oil trading at huge discounts to international oil prices; thankfully, those discounts have shrunk appreciably.

The fact that the TSX has a much larger cyclical component than the S&P 500 benefits it when global growth has upward momentum, as seems to be the case presently. But it should be noted that in the two previous bull markets that terminated in 2000 and 2007, the TSX only peaked months after U.S. indices had hit their highs. So while it is gratifying to see the TSX finally make up for its relative underperformance from 2011 to 2013, if the index continues to reach new highs even as the S&P 500 retreats, this may be a disconcerting sign.

Figure 1: TSX Group Performance – March 9, 2009 to July 25, 2014

Source: Bloomberg

Figure 2: S&P 500 Group Performance – March 9, 2009 to July 25, 2014

Source: Bloomberg

Economic Analysis

Don't assume that U.S. equity markets will keep rising even as Fed tightens

The interplay between U.S. monetary policy and equity markets is very different this time

Notwithstanding Janet Yellen's recent reassurances that interest rates are likely to stay low for a considerable period, market participants are bracing themselves for the Federal Reserve to commence tightening monetary policy by raising the federal funds rate either in Q1 or Q2 of 2015. This would mark the first such tightening measures since 2006, and would also move the federal funds rate from the 0%-0.25% range where it has been stuck since 2009.

We had cited fund manager Stanley Druckenmiller's recent comments about the Fed's interest-rate policy in last week's Bulletin, and we think those comments are worth repeating. Druckenmiller said at a conference earlier this month that the Fed's policy of keeping interest rates near zero for so long was risky and as "baffling" as it was in late-2003.

In that year, the Fed had said that its target rate would stay at 1% for a "considerable period" even as growth was picking up. The Fed subsequently embarked on a tightening cycle from 2004 onwards that pushed the federal funds rate to 5.25% by 2006. But those rate hikes were taken in stride by investors, as the S&P 500 continued to advance over that period, only peaking in late-2007. The same theme also played out from 1999 to 2000 (Figure 3).

But the situation is very different this time, to use a well-worn cliché. The S&P 500 has rocketed to new highs this year for a number of reasons, but a primary one is that U.S. monetary policy has been so accommodative. In our opinion, it would be dangerous to assume that the S&P 500 can continue to post robust gains once the Fed commences its tightening cycle.

Figure 3: Federal funds rate vs. S&P 500 – 1994 to 2014

Source: Bloomberg

Chart of the Day

Spread between DJIA and TSX could shrink in months ahead

(DJIA – TSX) spread has ranged from +4,000 to -3,000 over past 30 years

The point differential between the Dow Jones Industrial Average (DJIA) and the TSX Composite (DJIA *minus* TSX) provides a good visual comparison of the relative attractiveness of U.S. and Canadian equities. As can be seen in Figure 4, the difference between the DJIA and TSX is presently around 1,500 points. That differential is half of the 3,000-point difference between the two indices less than a year ago, and as recently as end-2013.

Over the past 30 years, the differential has ranged from a maximum of 4,000 in 1999, when U.S. indices were flying high on the dot-com boom, to a low of about -3,000 in June 2008, when the TSX was peaking while the DJIA was sliding.

The TSX is outperforming the DJIA by more than 11 percentage points YTD. If the performance of the two indices continues to diverge, that spread could narrow significantly in the months ahead.

Figure 4: Dow Jones Industrial Average *minus* TSX – 1984 to 2014 (weekly)

Source: Bloomberg

The Week Ahead

Economy Watch

This week will provide a key read on U.S. economic growth, with the GDP report out on **July 30** and employment report due for release on **August 1**. The U.S. economy is forecast to have expanded at a 3.0% annualized pace in Q2, after shrinking by 2.9% in Q1 due to the unusually harsh winter. The economic rebound is expected to have been spurred by corporate investment in equipment, faster inventory building and home construction. The payrolls report is expected to show job growth of 230,000 this month, with the unemployment rate forecast to stay unchanged at 6.1%.

Stocks to Watch

Earnings season continues in full flow this week as well, with a number of bellwether companies reporting quarterly results –

- **July 29:** Pfizer, Talisman Energy, Corning,
- **July 30:** TransAlta, Barrick Gold Corp, Kinross Gold Corp, Suncor Energy, Cenovus Energy, Kraft Foods
- **July 31:** Cameco Corp, Goldcorp, Exxon Mobil, Canadian Oil Sands, Bombardier, PPL
- **August 1:** Procter & Gamble, Fortis, Berkshire Hathaway

Market Snapshot

At close on Friday, July 25, 2014

S&P TSX	15455.04	+60.59	Commodities			Yields (%)	Can.	US
TSX Venture	1017.44	+5.79	Canadian $ (US cents)	92.46	-0.61	90 Day T-Bill	0.93	0.03
DJIA	16960.57	-123.23	Gold (Spot)-US$	1307.15	+13.42	2-Year Bond	1.08	0.49
S&P 500	1978.34	-9.64	Oil (WTI-Sept.)	102.09	+0.02	10-Yr.Bond	2.11	2.47
NASDAQ	4449.56	-22.54	CRB Index	298.34	+0.15	30-Yr. Bond	2.66	3.24

Thought for the Day

"Get someone else to blow your horn and the sound will carry twice as far."– Will Rogers

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