

Towers Watson July 1, 2010 to June 30, 2011 – The Market in Review

A fiscal year that began with significant optimism about the Canadian and U.S. economies and concerns about Europe and some of the emerging economies ended with concern about the global economy. Many of the global issues that were present at the beginning of the year continue to be a concern, including:

- Concerns over sovereign debt default in southern Europe (particularly Greece). Various bailout approaches have been underwritten by the European community (particularly Germany and France), with the focus increasingly turning towards concerns over the solvency of some of the European banks as a result of their exposure to sovereign debt. The sovereign debt concerns have also broadened to include some of the more important economies, with Italy and Spain both having their debt downgraded. With continuing riots in the streets of Greece over opposition to the spending restraints and tax initiatives being initiated by the government in order to qualify for continued support from the IMF and European community, it may only be a matter of time until Greece defaults.
- Anemic U.S. economic growth, continued high unemployment (with few permanent jobs being created) and significant concerns over the federal government debt ceiling. In addition, the phase out of QE2 (without its replacement with another vehicle) is causing concerns about both the economy and capital markets in the U.S.
- Continuing efforts by the Chinese government to keep control of inflation have begun to slow the Chinese economy, which has ramifications for commodity prices and other things. The Chinese government has also stopped buying U.S. Treasuries and is diversifying their holdings of foreign currency reserves.

Just like last year (with the Gulf oil spill), the global economy has suffered from the effects of a major non-economic event. The earthquake and subsequent tsunami in northeastern Japan significantly disrupted global supply chains. The nuclear accident at Fukushima caused power disruptions that harmed production at a large number of the Japanese exporters. Lack of access to shipping facilities also disrupted supply chains. Even Apple was forced to slow some of its production due to the inability to import a key part (that is only produced by a Japanese company).

Canada began the year with the Bank of Canada raising the target overnight rate twice (July and September) to ensure the economy did not overheat. Since then, the Bank of Canada has held the rate at 1% with no guidance as to when they might resume increases in the overnight rate. The implementation of the HST in Ontario and sharp increases in food and energy prices caused a sharp increase in headline inflation as the year progressed. Over the year, the Canadian dollar strengthened sharply against the U.S. dollar. The Bank of Canada continues to walk a delicate tightrope, as further increases in the overnight rate could well result in strengthening of the Canadian dollar and slow Canadian manufacturing (particularly that intended for export). Weakness in the U.S. economy continues to have an impact on our exports. In addition, the Governor of the Bank of Canada continues to emphasize the need for Canadian consumers to reduce the debt loads to more manageable levels, to protect against the impact of the eventual increase in interest rates. Corporate earnings continue to improve, exceeding expectations by wide margins for many companies. Corporate balance sheets continue to be in excellent condition, as corporations have paid down debt and are holding near record levels of cash (ready to finance new business spending growth).

Over the year, the government of Canada yield curve has flattened slightly, with the short end of the curve increasing in response to the Bank of Canada's actions on the overnight rate and the long end of the curve decreasing somewhat. Corporate spreads (relative to Canada bonds) have remained relatively stable from beginning to end of year. The spread on provincial bonds (relative to Canada's) narrowed significantly over the year. Yields have also become increasingly volatile as concerns about the situation in southern Europe play into the bond market as a whole. Canada has increasingly come to be viewed as a safe haven by global investors, with significant buying of Canadian government bonds whenever the concerns about southern Europe spike (an increasingly frequent occurrence as the last quarter of the year unfolded). As a result, provincial bonds have been the best performing sector of the bond market over the fiscal year. Bond returns over the year have been solid (if unspectacular), the DEX Universe Bond Index posting a return of 4.7% over the year.

Equity markets globally performed strongly during the fiscal year, with the S&P/TSX Index posting a 20.9% return and the MSCI World Index posting an 18.5% return. Just as in the previous year, the final quarter of the year was a difficult one for equities, with negative returns in many countries' stock markets, as the combined impact of the concerns about southern Europe, U.S. economic growth and the impact of the Japanese tsunami weighed on investor sentiment. While the economically sensitive sectors (Energy, Materials, Industrial and Consumer Discretionary) led global markets upward in the first nine months of the fiscal year, they became the main drag on performance during the last quarter. Financials were one of the weakest sectors, as the concerns over bank exposures to potential sovereign debt default weighed on investors. Gold and precious metals stocks (now 14% of the Canadian Index) helped buoy the Canadian market, as precious metals prices continued to rise through much of the fiscal year. Over the fiscal year, the U.S. market has been the strongest of the major developed markets, with returns in the 30% range.