

# MONTHLY INSIGHT

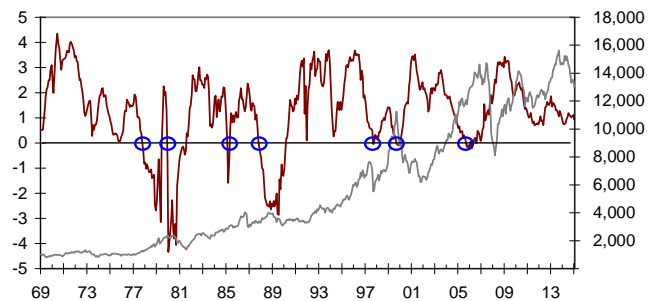
*“The yield curve has an excellent record of predicting stock market peaks over the past 45 years and it is not signaling a bear market now.”*

## RATE HIKES DO NOT MEAN DOOM

In theory rising interest rates spell trouble for stocks but history confirms that equity market returns have varied significantly following an initial central bank rate hike. This is because not all interest rate hikes are equal. An increase is more meaningful if the starting point is 0.5% as opposed to 5.0%. When 10 year bonds yield 5%, then bond yields are viewed as potential replacements for stock returns, but since 10 year Government of Canada bonds are currently yielding 1.4% the worry is less.

Equity bull markets do not usually end at the first rate hike. Stocks tend to peak much later as can be seen in the table to the left. For the eight Canadian stock market recoveries since 1970, stocks continue to gain 25.2% on average for 12 months. This is split into two distinct periods: 1970 to 1989, when stocks gain 8.2% on average before peaking 5 months after the first hike; and 1990 to 2008, when stocks gain 42.2% on average before peaking 20 months after the first hike.

Twitchy investors should look beyond rate hikes and focus on the yield curve. The yield curve is one of the most reliable economic indicators and one that savvy market watchers keep on their radar. Most other economic data is backwards looking, so it is no wonder that the track record of forecasters using other signals is abysmal. The yield curve has an excellent record of predicting stock market peaks over the past 45 years and it is not signaling a bear market now. A yield curve inversion usually takes place about 12 months before the start of a recession, but the lead time ranges from about 5 to 16 months. The peak in the stock market usually occurs near the time of the yield curve inversion and just ahead of a recession.



*The percentage spread between 3 month T-bills and 10 year bonds (left side values) is superimposed over the level of the S&P/TSX stock index (right side values) shown here in grey over the last 45 years and confirms that the spread is turning negative, as indicated by blue circles, and precedes a period of weak equity performance.*

The yield curve describes the difference between short term Canadian cash yields and long term bond yields. Typically short term interest rates are lower than long term rates so the yield curve slopes upwards, reflecting higher yields for longer term investments. This is referred to as a normal yield curve. When short rates move above long term rates and the curve becomes inverted, this is a clear sign that a slowdown is likely. It is no wonder that an inverted yield curve often incites fear in equity markets.

The yield spread between 3 month T bills and 10 year Canada bonds is shown in the chart above for the past 45 years. It also shows when the differential has turned negative, as indicated by the blue circles, and also shows the S&P/TSX stock index for ease of comparison. The yield curve has been flattening over the last three years but the good news is that the curve is still steep and certainly a long ways from inverting. If the Bank of Canada aggressively hikes its key policy rate and short term yields rise swiftly, the central bank would have to increase yields by 0.93% (assuming bond yields stay the same) before the yield curve becomes inverted.

An inverted yield curve is the best indicator of pending stock market trouble. Rates are usually increased to cool an overheating economy but in the current situation an increase would simply be the normal process of raising rates from the low levels they have been at following the financial crisis. Based upon what the yield curve is currently telling investors, this bull market has more room to run because a bear market will not come until the yield curve says so.

Period of Canadian Rallies	% Return after Hike
Jun '70 - Oct '73	11.9%
Dec '74 - Nov '80	8.3%
Jun '82 - Dec '83	4.3%
Jul '84 - Jul '87	8.4%
Oct '90 - Jan '94	38.1%
Jan '95 - Apr '98	11.4%
Aug '98 - Aug '00	49.5%
Sep '02 - May '08	69.8%

*This chart shows eight Canadian stock market recoveries since 1970 and the amount stocks rose after an initial rate increase by the Bank of Canada. The average gain was 25.2% but the numbers are skewed by the four most recent recoveries between 1990 and 2008 when the average gain was 42.2% versus an 8.2% gain for the four periods between 1970 and 1989.*

# MARKET DATA

## 31 DECEMBER 2015

### Index Total Returns (%) (C\$)

	1 Month	1 Year	5 Years
S&P TSX	-3.1	-8.3	2.3
S&P TSX High Dividend	-4.7	-14.6	3.3
S&P TSX Small Cap	-1.6	-13.3	-5.7
S&P TSX Preferred Shares	2.3	-14.9	-0.3
S&P 500	2.2	21.8	20.9
Russell 2000 (US Small Cap)	-1.4	13.3	15.9
MSCI EAFE	2.5	19.5	12.1
MSCI World	2.1	19.8	16.4
MSCI Europe	1.2	13.8	8.8
MSCI Asia	2.5	17.3	5.4
MSCI Emerging Markets	1.4	0.4	0.3

Currencies:	US\$		
(%) (C\$)	EURO	6.6	7.1
	GBP	1.8	13.2
	YEN	5.8	15.8

### Bond Total Returns (%) - DEX Indices

	1 Month	1 Year	5 Years	Yield
Universe	1.1	3.5	4.8	2.01
Short Bonds	0.5	2.6	2.8	1.19
Mid Bonds	1.2	4.9	5.7	2.00
Long Bonds	2.0	3.8	7.3	3.14
Federal Bonds	1.0	3.7	3.9	1.15
Provincial Bonds	1.7	4.1	5.9	2.34
Corporate Bonds	0.6	2.7	5.1	2.69
Real Return Bonds	1.6	2.8	4.2	0.45
91 Day T-Bills	0.0	0.5	0.9	0.52

Barclays Aggregate Bond (US\$)	-0.3	0.5	3.2
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Commodities:	Index		
(%) (US\$)	Oil	-11.1	-30.5
	Gold	-0.5	-10.4
	Wheat	9.8	-26.9

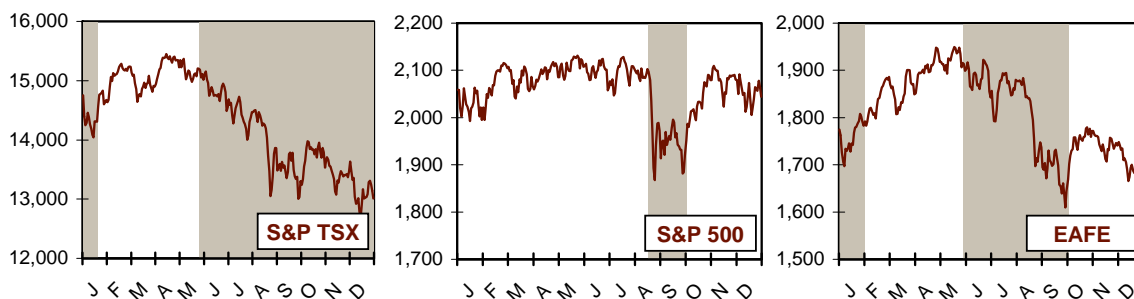
### Sector Returns (%)

	S&P TSX (C\$)				S&P 500 (US\$)				MSCI EAFE (US\$)			
	1 Month	1 Year	5 Years	Weight	1 Month	1 Year	5 Years	Weight	1 Month	1 Year	5 Years	Weight
Consumer Discretionary	-5.7	-3.5	10.7	6.3	-3.0	8.4	16.0	12.3	-1.4	-0.2	4.8	13.2
Consumer Staples	-0.3	10.0	19.7	2.4	2.5	3.8	11.3	9.2	-1.0	6.3	5.8	11.0
Energy	-8.7	-26.8	-12.9	21.6	-10.0	-23.6	-2.4	7.9	-8.2	-22.1	-9.3	5.6
Financial Services	-3.6	-6.8	5.1	36.1	-2.4	-4.9	8.4	15.8	-0.6	-5.8	0.2	25.7
Health Care	-0.6	22.5	20.6	6.0	1.6	5.2	18.0	15.9	1.1	5.7	9.8	11.7
Industrials	-5.0	-14.5	8.4	8.3	-2.2	-4.7	9.0	10.5	-2.5	-1.6	0.5	12.6
Information Technology	1.2	13.5	12.1	2.3	-2.3	4.3	12.3	20.1	-1.0	3.1	1.5	4.9
Materials	-2.4	-22.8	-17.9	10.5	-4.4	-10.4	2.7	2.6	-3.6	-19.2	-10.0	7.5
Telecommunication	-6.4	2.2	8.0	4.5	1.7	-1.7	3.1	2.5	-1.7	0.4	2.5	4.5
Utilities	1.8	-7.8	-1.2	2.0	1.8	-8.4	6.7	3.2	0.8	-8.2	-5.0	3.3
Growth Index	-2.7	-4.2	1.5		-1.7	2.5	12.0		-0.9	2.1	2.4	
Value Index	-4.9	-13.0	-0.1		-1.9	-6.6	8.2		-2.0	-8.6	-1.1	

### Index Charts

12 Months ending December 2015

Grey shaded areas indicate periods of stock index decline.



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