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CANADA

Diminishing risk aversion makes provincial bonds interesting

In a recent *Economic Viewpoint*,[1] we argued that fears of entry into bear market for the S&P 500 were exaggerated and that the stock market rather provided an interesting opportunity from a fundamental point of view. This finding is not necessarily limited to U.S. equities. Given the fact that the U.S. stock market cycle generally affects a wide range of assets, it is useful to examine the performance of different asset classes in the context of a rebound in U.S. stocks. Here we limit the analysis to the past 25 years, and to S&P 500 corrections without an entry into bear market. Since 1990, there were six such corrections.

Unsurprisingly, stocks outperform three months after the trough of the S&P 500. The European MSCI index comes first, while the S&P 500 and the MSCI Emerging Markets both show average increases of similar magnitude. Bonds generally offer less spectacular returns in this kind of environment, but they were still able to generate positive total return, on average. This is surprising at first glance, since a resurgence of risk assets is normally perceived as synonymous with underperformance in safe havens. But it should be noted that bonds usually start to struggle the most when there is a monetary tightening. Historically, in the months after the trough of a correction, the Federal Reserve has rarely been in tightening mode. The opposite has rather tended to be true.

By analyzing the fixed income asset classes, we see that in both episodes of recovery from a correction that occurred after the Great Recession of 2008–2009, provincial bonds outperformed federal government bonds. This was reflected in a narrowing of provincial yield spreads relative to those of the federal government. But even further, we observe that in these two episodes provincial bonds were among the fixed-income classes generating the best returns over a 3-month period.

[1] Desjardins, Economic Studies, *Economic Viewpoint*, "Would an entry in bear market territory be justified for the U.S. equity market?", February 23, 2016, www.desjardins.com/ressources/pdf/pv160223-e.pdf?resVer=1456229868000.

3-month asset class total return when the S&P 500 recovers from correction* (in %)

S&P 500 bottom of…	*Benchmark*	*Jan. 1990*	*Oct. 1990*	*Aug. 1998*	*Oct. 1999*	*July 2010*	*Oct. 2011*	*Average*
European equities**	MSCI Europe index	n/a	n/a	n/a	18.3	5.7	6.8	**10.3**
Emerging market equities	MSCI Emerging market index	-9.3	-4.2	3.9	27.2	15.6	5.2	**6.4**
U.S. equities	S&P 500	-0.6	6.0	6.7	9.8	8.8	7.5	**6.4**
Global sovereign bonds	Barclays Index	-12.4	25.9	12.5	-2.6	9.3	-0.8	**5.3**
Canadian equities	S&P /TSX	-9.7	3.3	0.6	20.4	8.8	3.4	**4.5**
Canadian corporate bonds	FTSE TMX Canada Bond Universe	7.1	1.0	-0.5	3.5	2.6	2.5	**2.7**
U.S. Treasury bonds	Barclays Index	-1.7	6.9	3.5	-0.2	2.9	1.5	**2.2**
Provincial bonds	FTSE TMX Canada Bond Universe	-5.3	6.1	2.1	-1.3	5.1	4.0	**1.8**
Canadian federal bonds	FTSE TMX Canada Bond Universe	-4.8	6.9	3.3	-0.9	2.8	1.9	**1.5**
Commodities	S&P GSCI	-4.0	-19.2	2.1	8.3	11.8	5.5	**0.8**
U.S. dollar	DXY index	0.4	0.1	-6.2	3.5	-6.8	4.1	**-0.8**

n/a: not available; * Bear markets excluded; ** Data since the euro zone creation.
Sources: Datastream and Desjardins, Economic Studies

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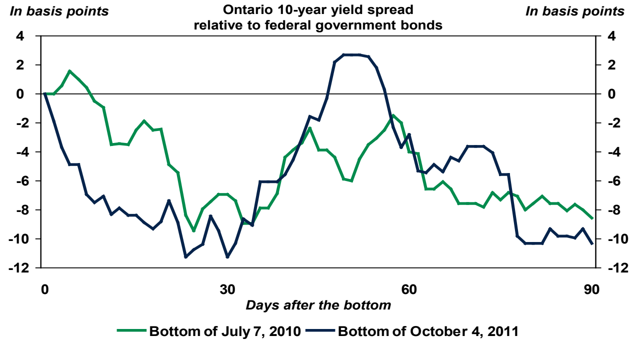
The behaviour of the Ontario spread has been similar in the two most recent equity market recoveries



Sources: Desjardins, Capital Markets and Desjardins, Economic Studies

Implications: Provincial spreads have widened considerably in recent months, in tandem with a rise in risk aversion. However, stock markets seem to have settled and the improvement could carry further, especially if U.S. economic data continue to improve. Our relative value models indicate that provincial bonds are very cheap, and it may be appropriate for fixed-income investors to increase their allocations to this asset class.

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