THE ECONOMIC PULSE

September 3, 2008

Economic Indicators

Canada

	Dec. 2007	July 2008	
GDP[1]	2.7	0.6[2]	↘
CPI[1]	2.4	3.4	↗
Unemployment	5.9	6.1	↗

United States

	Dec. 2007	June 2008	
GDP[1]	2.2	1.8[3]	↘
CPI[1]	4.1	5.6	↗
Unemployment	5.0	5.7	↗

(1) Year-over-year % variation
(2) May 2008 (3) June 2008

Sources: Statistics Canada, U.S. Dept. of Commerce, U.S. Dept. of Labor Statistics.

Equity Indices

% Change	2008 in local currency	2008 in C$	
S&P/TSX	-3.9	-3.9	↘
S&P 500	-13.0	-6.2	↘
Russell 2000	-3.6	3.8	↗
Nikkei	-17.6	-8.7	↘
S&P 350 Europe	-20.8	-15.1	↘

THE ANATOMY OF SAVING AND INVESTING – PART 2

Last month, we reviewed how decisions about portfolio risk and saving are intertwined. The equation is straightforward: the riskier the portfolio, the higher is its expected return, and therefore, the lower the percentage of income that must be funneled into savings to ensure a decent retirement. Moreover, retirees are not exempt from this principle, since many of them will have to shoulder some level of risk in order to make their capital produce the lifetime income that they need. This month, we'll start to discuss the pleasant part of investing: the expected return on capital.

A key element of any investment strategy is figuring out what kind of return can be expected from various asset classes. The expected return on high-quality bonds is readily apparent: it is their yield to maturity. For example, 30-year Government of Canada bonds presently yield 4%.

Estimating the expected return for equities is a lot trickier because common stocks don't bear a contractual interest rate. The financial-services industry typically bases its projections on returns from the last 10 or 20 years, which can be misleading. But by building on some key lessons learned from the bond market, we can set up a framework to estimate the expected returns on equities. These lessons are as follows:

1. **Even the least volatile of securities, government T-Bills, will likely pay a return that exceeds inflation.** Therefore, the expected rate of inflation acts as a lower boundary for the expected returns on all asset classes;
2. **The riskier the bond, the higher its yield.** For example, high-quality U.S. corporate bonds ("investment-grade" bonds) offer an average yield premium of more than 3% over the yields of U.S. Treasury bonds. Speculative-grade bonds (also known as "junk bonds") offer a yield premium that exceeds 8%. Therefore, the expected return of an asset class can be estimated by piling up the premiums associated with each additional risk increment.
3. **Expected returns are not certain.** They are only a best estimate of future returns. For example, even if today's expected return on a 30-year Government of Canada bond (based on its yield to maturity) is 4%, there is a high probability that its ex-post realized return will be different if the investor sells this bond before its maturity, resulting in a capital gain or loss.

Estimating the expected returns of asset classes is difficult but necessary. In part 3 of this series, we will use what we have learned from the bond market to estimate the expected returns on equities.

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