Market Matters

AUGUST 2015 HIGHLIGHTS

It was a wild ride for global equity markets in August.

- A market sell-off that began in Asia moved in a wave through Europe and North America, fuelled by concerns over Chinese-driven economic growth.
  - At the lows, fears of worse-than-expected global growth pushed developed markets down anywhere between 12% to 18% from their highs reached earlier in the year.
  - At one point the S&P/TSX Composite was off 19% from its September 2014 highs as the aforementioned fears continued to hit the commodity complex and oil prices particularly hard.
  - US 10 year Treasury yields hit an intraday low of 1.9%, while Canadian 10 year yields touched 1.19 % in the midst of the mid-month market sell-off.
- An impressive rally was staged in the second half of the month. Cooler heads prevailed as some market action appeared to be overdone and some reassurance from better-than-feared US economic data emerged.
  - Bond yields moved back up.
  - Oil gained 29% from its lows in August.
  - North American markets moved up and out of official correction territory for the month, though still significantly down.

UPDATED MARKET ADAGE

The old market adage ‘when the US gets a cold, the rest of the world comes down with pneumonia’ needs an update. Perhaps something like “When China catches a cold, the US sneezes, emerging markets run a fever, Europe stays in bed with the chills, and commodities cough up a lung.” We recognize that isn’t your everyday market summary, but it sums it up quite nicely for August 2015!

FROM GREEK FIRE-PIT TO CHINESE HOT-POT

After months of holding the unenviable position of front-page financial news, there was nary a headline about Greece in August. Under different circumstances, the upcoming Greek elections (Sept. 20) would have been a worthy distraction. But August was anything but boring, with China being the bigger economic dragon to fret about. More specifically, anxiety peaked with a mid-month sell-off in Asian equity markets that extended in a wave through Europe and over to North America.

Table 1
Summary of major market developments

Market returns*	August	YTD
S&P/TSX Composite	-4.2%	-5.3%
S&P 500	-6.3%	-4.2%
- in Canadian dollars	***-5.0%***	***9.0%***
MSCI EAFE	-7.9%	2.0%
- in Canadian dollars	***-6.3%***	***11.3%***
MSCI Emerging Markets	-6.6%	-7.2%
FTSE TMX Canada Universe Bond Index**	-1.0%	2.8%
FTSE TMX Canada all corporate bond index **	-1.0%	2.1%

*Local currency (unless specified); price only
**Total return, Canadian bonds

Table 2
Other price levels/change

	Level	August	YTD
CAD per USD exchange rate	$0.761	-0.4%	-11.6%
Oil (West Texas)*	$49.20	4.4%	-7.6%
Gold*	$1,134	3.6%	-4.6%
Reuters/Jefferies CRB Index*	$202.09	-0.2%	-12.1%

*US dollars

Table 3
Sector level results for the Canadian market

S&P/TSX Composite sector returns*	August	YTD
S&P/TSX Composite	-4.2%	-5.3%
Energy	-3.3%	-16.0%
Materials	-2.4%	-17.0%
Industrials	-8.1%	-12.0%
Consumer discretionary	-7.0%	2.1%
Consumer staples	-2.3%	7.7%
Health care	-8.9%	70.8%
Financials	-3.7%	-5.7%
Information technology	-2.3%	7.1%
Telecommunication services	-2.1%	0.7%
Utilities	-1.8%	-5.7%

*Price only
Source: Bloomberg, MSCI Barra, NB Financial, FTSE TMX Global Debt Capital Markets Inc.

YUAN FOR THE MONEY, TWO FOR THE SHOW

A number of global economic and geopolitical factors have contributed to financial markets being on edge, but the epicenter of issues sparking August's market sell-off was the bursting of the Chinese stock market bubble and growing concerns over the Chinese government's ability to sustain Chinese economic growth. China's stock market had been declining since mid-June, with concern being largely contained within Asian markets. That is until mid-August, when Chinese officials made a surprising policy move to devalue the yuan. The word from Chinese officials was that the decision was made to seek a more market-driven rate. However, in the court of public opinion it was seen as a convenient way to add more economic stimulus (i.e. boost the attractiveness of their exports), sparking fears that the Chinese government saw greater signs of economic weakness than they had been letting on to the global investment community - and with that, the bursting of the Chinese stock market bubble ensued with fervour.

The risk-off sentiment was pervasive, as equities and commodity values shrank, while a flight-to-safety trade pushed bond prices up amidst lower yields. Whether officially in a correction or bear market territory, by mid-month many stock markets watched early 2015 gains evaporate.

As the month wore on, bouts of volatility (both up and down) made for a dramatic show of large intra-day swings and skittish investors. In fact, most global equity markets and commodities staged an impressive rally from the lows during the month. Bond yields moved back up and oil gained 29% from its lows in August, actually ending the month up over 4%. The move in bond yields is something we watch closely. In August we were somewhat comforted that bond yields began to recover up within the very early days after the dramatic equity market sell-off – an indication that fears for the global economy and the resulting market sell-off had been, at least somewhat, overdone.

THE LONG AND SHORT OF IT

It is far from new news that the Chinese economic growth rate is slowing, but in spite of this, the Shanghai Composite stock market continued its dramatic rise into 2015. The long and short of it is that the Chinese stock market rose much more than economic realities warranted. We long held the view that it was not sustainable - it was a market bubble, and a correction was overdue. We remain cautious on Chinese equities as we continue to see extremes in volatility and market speculation.

What is more relevant to Canadian investors is what recent events and the current market factors mean for global economic growth going forward. The US remains the world's largest economy and as our closest neighbour, we are intricately tied to their economic well-being. Fortunately, the US economy remains significantly healthier today than prior to the 2008/2009 financial crisis. Banks and US households both have much stronger balance sheets than they have had in years. Continued market volatility around the timing of a US Federal Reserve interest rate lift-off is all but a certainty, but we do not foresee the US economic recovery being derailed.

All things commodity related (including Canada's economy) have been hit hard by the prospect of slower global economic growth. The significant re-pricing of commodity-related assets has been going on for some time with companies and investors re-adjusting their expectations for future earnings along the way. Resource stock prices have been severely punished. While we see a lot of bad news already been priced in, a catalyst is still needed for sustained recovery.

At this point, even with some further slowdown in Chinese economic growth (slower than their current officially stated growth rate of 7%), we continue to expect to see global economic growth, perhaps slower growth, but growth none the less.

BUILD FOR THIS

Market corrections and gyrations like we experienced in August (with some more likely to come in the weeks and months ahead) can cleanse the waters for portfolio managers to add to or pick up high-quality companies with strong prospects for price appreciation. In fact, active portfolio management and disciplined investment processes were built for this - finding attractive opportunities amidst, and in spite of, market noise and volatility.