Market Matters

AUGUST HIGHLIGHTS

- While not all economic data was negative, worries about the American and global economy grew.
- Stock markets were rocked in August as investor confidence sank and severe market volatility ensued.
- Gold prices soared to record highs and bond markets strengthened as investors shunned risk.
- Strong corporate earnings and healthy corporate balance sheets were not enough improve investors' glum sentiment in August.
- A band-aid solution to the U.S. debt ceiling crisis early in the month didn't keep debt-rating agency, Standard & Poor's, from downgrading a segment of U.S. debt a notch from AAA to AA+.
- The U.S. Federal Reserve declared that short-term interest rates would stay low until the middle of 2013. The Bank of Canada also kept their bank rate unchanged this summer.

SHAKEN AND STIRRED

Felt unsettled in August? You might have felt the earthquake in central Virginia. Or maybe you just watched the equity markets. In August, equity market volatility measures (i.e. the VIX index) hit levels not seen since March 9, 2009 (of note, that is the date the recent bear market hit its low).

Stock markets were downright ugly in August (with emphasis on 'down'). Developed markets and emerging markets alike were struck by a battering to investor confidence. (see Table 1)

RECIPE FOR MARKET VOLATILITY WITH A SIDE OF WHIPPED CONFIDENCE

- Take one part political wrangling (à la U.S. debt crisis debacle).
- Take one part unfolding European debt crisis (leaving investors concerned that bailouts would prove increasingly politically challenging and leave banks smarting from bad sovereign debt)
- Throw in Standard & Poor's U.S. debt downgrade
- Layer with summer's typical low trading volumes, which amplify market volatility
- Garnish with a smattering of weak economic signals (causing a shift in focus toward a potentially weakening global economy, particularly concerning for the U.S.)

…Et voila! You've got equity markets the likes of which we've been experiencing lately.

Table 1
Summary of major market developments

Market Returns*	August	YTD
S&P/TSX Composite	-1.4%	-5.0%
S&P500	-5.7%	-3.1%
- in C$	*-3.6%*	*-4.8%*
MSCI EAFE	-9.0%	-13.7%
- in C$	*-7.1%*	*-9.9%*
MSCI Emerging Markets	-7.6%	-11.8%
DEX Bond Universe**	1.2%	5.5%
BBB Corporate Index**	0.5%	5.6%

*local currency (unless specified); price only
**total return, Canadian bonds

Table 2
Other price levels/change

	Level	August	YTD
USD per CAD	$1.0236	-2.1%	1.8%
Oil (West Texas)*	$88.91	-7.3%	-2.6%
Gold*	$1,826	12.5%	28.8%
Reuters/Jefferies CRB Index*	$342.57	0.1%	2.9%

*U.S. dollars

Table 3
Sector level results for the Canadian market

S&P/TSX sector returns*	August	YTD
S&P/TSX	-1.4%	-5.0%
Energy	-6.3%	-9.6%
Materials	5.1%	-4.0%
Industrials	-4.5%	-2.1%
Consumer discretionary	-7.3%	-15.4%
Consumer staples	-2.6%	1.0%
Health care	-15.0%	38.3%
Financials	-1.3%	-2.9%
Information technology	10.9%	-30.1%
Telecom services	5.1%	12.5%
Utilities	2.4%	1.6%

*price only
Source: Bloomberg, MSCI Barra, NB Financial, PC Bond, RBC Capital Markets

Now, to be fair, markets did rally later in the month from their earlier lows, but investor confidence remains about as fragile as a soufflé in the oven during a thunderstorm.

A review of Table 1 is a little easier if you held a measure of fixed-income holdings in your portfolio this month. Much as you would expect, as uncertainty rose so did the tide of investors moving into fixed income – pushing yields down from already historically low levels.

This helped provide a pretty sweet capital gain boost to fixed-income returns in August.

We caution those banking on a continuation of strong fixed income returns, as low yields translate into low income, and while corporate bonds can offer an increased yield over government bonds, that higher income is your proportionate compensation for taking on greater risk. This makes it important for investors to know what they can expect from their fixed-income investments over the long term, and at this point, muted long-term returns remain the prevailing wisdom.

Fixed income securities do offer the measure of stability to a balanced portfolio when equity market volatility prevails – and this past month certainly highlighted that. However, in the long-term, an all-or-nothing approach to either equities or fixed-income is unlikely to grant you the ability to have your cake and eat it too. There is no free lunch in the world of investing.

THE DISH ON MATERIALS

Turning to Table 3, generally speaking you'll find the defensive sectors performed better than the cyclical sectors – typical during times of investor uncertainty. But with more than a moments glance, you'll also note that the Materials sector (considered a more cyclical sector) bucked the trend and was one of the best performing sectors in the Canadian S&P/TSX Composite. This is a direct result of the astronomical rise of gold bullion prices and the resulting boost to Canadian gold companies. Investors flocked to the precious metal like bees to honey; causing gold prices to rise 12.5% in August for yet another record-setting month (see Table 2). At this point, gold is benefiting from two, seemingly opposing, groups of investors: 1/ nervous investors making the traditional flight to safety trade, and 2/ risk-tolerant investors willing to speculate that demand and price will continue to rise. Time will tell if the record high prices will hold – but it is still a good time for that sage reminder to not have all your eggs in one basket…even if they are golden eggs.

THE RIGHT INGREDIENTS

Bulls and bears are in a tug of war right now and this fight will centre on whether the slowdown in global economic growth is just a slow patch or if it is a signal for another recession. At this point we still believe the most likely scenario is the former – that is, we anticipate sluggish, sub-par growth, but not a full blown recession. We believe that the challenges in Europe remain a key risk, so we will be keeping a close eye on that.

Corporate earnings have continued to be strong and, post-financial crisis; corporations have been forced to make tough but healthy choices. Debt levels are more manageable now than in past. Companies have large cash holdings that can help them make it through a short-term financing or liquidity issue. And many large corporations have managed to control costs and add to their bottom line. They may not be hiring loads of people and sales may not be soaring, but they are still making money. Add stock valuations which are below historical averages, and equity markets continue to show longer-term appeal. We expect that significant market volatility will continue for some time, but we also know that historically, investors who stay invested and dollar cost average into assets at lower prices tend to be more successful over the long run than those who make wholesale changes based on emotion when volatility and investor anxiety run high. As professional money managers, we continue to see attractive opportunities emerge throughout these market conditions.

We understand it is challenging for investors to remain focused on their long-term investment strategies while market gyrations hit headlines and even start to invade the talk around the kitchen table. We think it can be made a bit easier with a tried and true recipe for long-term investment portfolios: Take a diversified mix of investments (often a balance of equity and fixed income holdings), paired to your tolerance for risk and time horizon. And then try not to mess with a good recipe.