October 16, 2014

Portfolio Strategy

Reiterating Our Optimism on the Economy and Equity Markets

Portfolio, Action & Research Team

The stock market has made investors more anxious as of late. Broad measures of Canadian and U.S. stock price performance are down significantly from their summer highs.[1] While no one can predict with certainty when this latest period of volatility will end, history has shown that markets eventually recover and that long-term investors are rewarded.

The recent correction appears to have been triggered by a number of factors including concerns regarding: i) the spread of Ebola; ii) the conflict in Ukraine; and iii) slowing economic growth in Europe and Asia. These same factors have driven interest rates to near record low levels as investors seek safer investments. While these are reasonable concerns, their impact has far outweighed their true importance.

Within the context of a multi-year bull market, pullbacks are a naturally-occurring (albeit sometimes unnerving) phenomenon. The uptrend from the mid-2013 low was relentless with more than a year elapsing since the last 5% correction. In many respects, we were overdue.

Corrections can be short-term in nature, lasting about 2-4 weeks in length and resulting in stocks and indexes coming back to their rising 50-day moving averages.[2] More pronounced/prolonged medium-term corrections—such as the one we are currently experiencing—can last 2-4 months and will bring stocks and indexes back to, and sometimes underneath, their rising 200-day moving averages. Historically, these tests of the 200-day are generally the best point at which to buy stocks in long-term uptrends. With most of the major indices now at, or slightly below their 200-day moving averages the downside is likely limited from here.

Corporate and sovereign credit markets remain well behaved; as such, a repeat of the Credit Crisis (2008-09) or the European Sovereign Debt Crisis (2011-12) is highly unlikely at this juncture. Regarding the last point, we note that Italian and Spanish 10-year bond yields are well below 3% as compared to rates of above 6% experienced during 2011-12.

Although economic growth in Europe and China appears to be decelerating, North American growth should remain reasonably robust, particularly in the U.S. A stronger U.S. dollar and weaker demand in Europe and China will likely weigh on U.S. exports, but the drop in oil prices will provide a boost to the U.S. consumer, offsetting any losses from trade. In Canada, the decline in oil prices is expected to trim growth modestly in the year ahead. However, the combination of lower oil, a weaker loonie and still-sturdy U.S. demand is a clear positive to non-resources sectors and will provide a helpful counterbalance.

At a minimum, given this economic outlook and the decline in stock prices already experienced, we believe it would be unwise for investors to unwind their exposure to equities. More appropriately, we believe the market has presented investors with an opportunity to buy many North American-focused, non-commodity related equities at attractive valuations, including railroads, pipelines and banks. We firmly believe that the current bull market has years to run.

As always, it's important to be reminded that while the recent turmoil may be unnerving, remaining focused on long-term goals and the market's ability to adapt over the long-run is the best course of action. This strategy proved itself in previous corrections and we believe that it will be the most prudent course of action for the current situation.

1 In domestic currency terms, The S&P/TSX Composite Index and the S&P 500 are down 11.6% and 7.8% respectively from their highs as of October 15, 2014.

2 A moving average is the average price of an index or stock over a given period. It is called a 'moving' average because it is continually recalculated as new data becomes available with older data dropping out of the calculation. Moving averages help to illustrate the general trend of a security or index.

All figures in C$ unless otherwise noted

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