Market Matters

Q3 2014 Highlights

- By the end of the quarter, geopolitical issues decreased in number, but increased in uncertainty.
- Global equity markets showed good resilience for much of the third quarter of 2014, up until mid-September when market imbalances tipped the scales and stock prices fell.
- Commodity prices weakened as fears of slowing demand from Europe and China increased; the US dollar strengthened, and supply/demand fundamentals turned over.
- Central banks in Canada and the US maintained their low overnight rates, while the European Central Bank (ECB) dropped their rates even lower and announced a new asset purchasing plan to revive their faltering economy.
- Recent US and Canadian economic data has been mostly positive. Strong corporate balance sheets are supporting healthy merger and acquisition activity, an increase in overall business capital spending, and corporate earnings growth.
- In spite of a moderate reversal in September, bond markets managed to stay positive for the quarter with longer term bonds performing best. Yields on 10-year Government of Canada bonds fell for a third straight quarter.

Table 1
Summary of major market developments

Market returns*	September	Q3 2014	YTD
S&P/TSX Composite	-4.3%	-1.2%	9.8%
S&P 500	-1.6%	0.6%	6.7%
- in Canadian dollars	***1.6%***	***5.7%***	***12.5%***
MSCI EAFE	-0.1%	0.4%	1.7%
- in Canadian dollars	***-1.0%***	***-1.6%***	***1.6%***
MSCI Emerging Markets	-4.4%	-0.3%	2.9%
FTSE TMX Canada Universe Bond Index**	-0.6%	1.1%	5.9%
FTSE TMX Canada Corporate BBB Bond Index**	-0.7%	0.7%	6.8%

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

Table 2
Other price levels/change

	Level	September	YTD
U.S. dollar per Canadian dollar	$0.893	-2.8%	-5.1%
Oil (West Texas)*	$91.16	-5.0%	-7.4%
Gold*	$1209	-6.1%	0.3%
Reuters/Jefferies CRB Index*	$278.55	-4.9%	-0.6%

*U.S. dollars

Table 3
Sector level results for the Canadian market

S&P/TSX sector returns*	September	Q3 2014	YTD
S&P/TSX Composite	-4.3%	-1.2%	9.8%
Energy	-8.0%	-7.3%	10.5%
Materials	-11.5%	-10.5%	3.4%
Industrials	1.1%	9.0%	21.0%
Consumer discretionary	-4.1%	3.3%	11.4%
Consumer staples	3.2%	12.0%	22.6%
Health care	10.3%	7.4%	12.9%
Financials	-2.5%	1.9%	8.7%
Information technology	0.5%	3.7%	16.2%
Telecom services	-3.2%	-1.8%	0.8%
Utilities	-0.9%	-0.6%	7.0%

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

BENEATH THE MASK

Both the Canadian and American stock markets hit new all-time highs in the quarter, but this surface strength was masking an underlying sector rotation that had begun earlier in the year – foreshadowing market volatility. Market breadth (a measure of the number of issues actually participating in the market advance) had begun to decline, as had the performance of the average stock versus the broad market index.

The market imbalances revealed themselves as additional concerns grew, including geopolitical issues pertaining to the US-ISIS situation, the Hong Kong protests, shaky European economic data and a weakening outlook for global commodity demand. Each, to varying degrees, soured investors' views and contributed to the decline in equity values in September (see Table 1).

COMMODITIES GET SPOOKED

The resource sectors suffered a ghastly decline in September (see Table 3). The strong US dollar took a bite out of all commodities priced in US dollars, like oil and gold (see Table 2). The steady oil production continuing out of Canada and the OPEC countries, along with increased production of US shale oil meant that supply levels were ample to meet demand. But it was the weakening expectations for demand from China and Europe that put a real fright into investors. Both European and Chinese economies have slowed, with their forecasted demand for oil and other commodities declining in tandem.

LIKE CANDY – STILL LOTS OF DEMAND

The supply of high-quality North American bonds is challenged and keeping downward pressure on rates. As of September 30, 2014 the yield on the 10-year government of Canada bonds fell to 2.15%, from 2.24% at June 30, 2014. The bag full of diverse reasons for the strong demand includes:

- Increased global demand due to geopolitical risk and the ensuing flight to quality;
- Global relative value (particularly versus european and emerging market countries)
- Aging populations;
- Increased demand among pension funds as they de-risk their portfolios and currency reserves;
- Governments are issuing fewer bonds as their budget deficits improve.

In addition, demand for corporate bonds remains high as the additional yield helps to soften the negative impact of rising interest rates.

With this in mind, we expect interest rates to remain below historical averages for some time to come and we anticipate fixed income markets will trade in a range over the short term with a longer-term bias to higher interest rates as economic data strengthens.

EXPECT CHAIN RATTLING

Over the past quarter central banks in Canada, US, and Europe have continued to support slow but steady growth and emphasized ‘lower for longer’ policies. The ECB expects to launch their asset purchasing program in the fourth quarter, coincidently within the same time frame that the Federal Reserve plans to wind down their asset purchase program. The start and end of these monetary easing programs highlights the tale of two very distinct economic worlds: North America having reasonable economic growth and benign inflation conditions, and Europe having slow economic growth and deflationary fears.

Economic data out the US and Canada was mostly positive during the quarter, bringing with it renewed emphasis on the US Federal Reserve’s ability to walk the tightrope of managing expectations for when higher central bank rates will come. In addition, expect that political noise will ramp up (and volatility with it) as debates over military engagement in the Middle East unfold and US midterm elections approach.

B.O.O. (BUYING OPPORTUNITY IN OCTOBER)

While never pleasant, it’s important to note that modest market corrections are effective at re-setting stock valuations from sentiment-driven results back to levels justified by more fundamental data, such as stock prices supported by strong corporate earnings results (the hard ‘dollars and cents’ evidence of an improving economy). At GLC we recognize market corrections can be attractive buying opportunities in which stock valuations come down to levels that optimize their upside potential. It’s an opportunity to refine (not abandon) long-term risk/return strategies, and we stand ready for such opportunities as part of our everyday practiced and disciplined investment processes (not just in October as the title of this section may have led you to believe).

What is important for investors to remember is that market volatility (whether it gives you fun or fright) is no time to get tricked into abandoning your long-term investment approach. Like any trick-or-treater with an upset tummy can tell you, moderation is the trick to making the treats last longer! Have a safe and happy Halloween!