By **Daniel Theriault**, CFA, MBA,
Chief Investment Strategist

Market Commentary

Expect a Rough Ride on Volatility

"Only the desert has a fascination – to ride alone – in the sun in the forever unpossessed country – away from man. That is a great temptation..."
D.H. Lawrence, ***The Letters of D.H. Lawrence, Volume IV (1921-1924)***

"...never ride faster than your guardian angel can fly."
A.H. Rosenberg, ***The First Ride: A Misadventure in Central America***

The Mojave Desert in the southwestern United States is one of the most popular tourist destinations in North America. Although Las Vegas casinos have their appeal, beyond the slot machines and gaming tables lies a spectacularly diverse geography splashed in a rich palette of muted reds and tans. Mountain ranges ringing the desert help create an arid climate and temperature extremes. Death Valley is both the lowest and hottest point in North America, with shimmering summer heat blasting past 49 degrees Celsius. Despite the hostile conditions, more than 1,800 varieties of plant life thrive in this desert home. Public lands in the Mojave, which are administered by the U.S. Bureau of Land Management, include one of the world's largest open-use areas for off-road vehicles. Dirt bikers are drawn to the smorgasbord of terrain and riding conditions. Deep sand, gravel washes, loose rock and the hard pack of dry lake bottoms challenge a biker's skill. The trick to enjoying the ride is twofold: respect a fragile ecosystem and test your limits – but not so much that you need a lift home by air ambulance.

A test for markets in 2016 will likely be a continued rough ride on the back of volatility that we saw in the second half of 2015.

U.S. – Ready to Rise

One of the more notable features of U.S. economics in 2015 is that interest rates did not rise as quickly as most observers expected. In 2016, we could see just the opposite occur. A rebound in inflation will force the U.S. Federal Reserve to abandon its pledge of a gradual tightening cycle. Here are the likely catalysts for that to occur. The two most prominent deflationary pressures in the U.S. over 2015 were the strong dollar and falling commodity prices. Any further appreciation in the greenback will probably be modest at best. Even if commodity prices continue to fall in the short term, industrial and energy commodity prices will likely end 2016 higher than they are today. Meanwhile, we are seeing domestic price pressure starting to build, with unit-labour cost growth and core service inflation both jumping to about 3.0%.

GDP growth in the U.S. doesn't have to exceed a moderate 2.5% for inflation to hit the Fed's target rate of 2% – likely by mid-year. The back half of the year would then see inflation move above the target band; this would prompt additional rate hikes. The Fed overnight rate could reach 2% by year end. This is consistent with the Fed's projections as well. The implication is this: if inflation and interest rates are both moving up in tandem, then real interest rates remain below zero.

Of course, 2016 will provide plenty of surprises for central banks and capital markets alike. Given decent data out of the eurozone, China and Japan, we could get a surprise to the upside. A milder-than-normal winter courtesy of the El Nino effect should provide a nice, albeit temporary, boost to GDP.

Europe – Not Quite Out of the Desert

Recent numbers strongly suggest that eurozone peripheral countries continued to improve their fiscal budgets through the last months of 2015. Government data out of Brussels showed that all of the peripheral countries ran smaller deficits in the first 11 months of 2015 compared to the same period a year earlier. On the other hand, recent general elections in both Spain and Portugal have again raised concerns that fiscal slippage could blight the year ahead. Ireland actually ran a budget surplus – its first in eight years – on the back of much higher tax revenue. Both sales tax (VAT) and corporate tax revenues were higher due to strong economic growth. Ireland was successful in curtailing expenses as well, which likely means it will beat the deficit target of 2.7% of GDP.

Among peripheral countries, Greece alone did not see a year-over-year rise in cumulative revenue. Yet the country did make progress, reducing its headline deficit from 1.0% to 0.7% by cutting expenditures to offset the fall in revenues. The Greek government faces the difficult challenge of revamping the country's pension system while trying to satisfy its creditors and left-leaning parliament.

Running against the frugality trend is Italy, where government spending has spiked up by almost 9.0% over the last 12 months. Italian budgets for 2016 don't offer much room for optimism either, as there are no signs that salary bonuses and cultural handouts will be curtailed. A further €3.5 billion in tax revenue was lost when Italy removed the tax on principal residences. With a public debt ratio over 130%, expect some tussles between Rome and the European Commission.

China – Slowing to Rebalance

The growth slowdown in China and the lurching unpredictability of Chinese policy are nothing new. Yet, markets continue to react to events out of China with surprise. Growth has been slowing markedly since early 2014; equity market volatility was broadly expected given the enormous difficulty of enacting financial market reform.

Events in China are prone to global influence. The higher volatility of Chinese equity markets is consistent with what has been described as the global "FANG" phenomenon. (FANG is an acronym for four tech companies: Facebook, Amazon, Netflix and Google. These companies are noteworthy for their 2015 market performance, lack of dividend, high volatility and outsized price-to-earnings ratios. In short, they're not stocks for the faint of heart.) Chinese equity performance has also become narrowly driven by just a handful of so-called new economy stocks. China has two major stock exchanges. The Shenzhen index is dominated by technology companies and trades at a P/E of approximately 50 times – not cheap. For context, the U.S. NASDAQ index currently trades at about 31 times trailing earnings. The other major exchange, the Shanghai index, trades at a more normal 17.5 times earnings, which is consistent with the U.S. S&P 500 index. Higher stock valuations such as those found on the Shenzhen index are historically associated with much higher levels of volatility. We can reasonably expect more of a rough ride in Chinese equities in 2016.

Slower economic activity in China has the potential to finally pull the global economy out of its post-crisis malaise. Weaker growth in China, coupled with financial liberalization, has the potential to rebalance the global economy – which is just what policymakers and investors the world over have been seeking. This can't happen unless the yuan moves to a lower exchange rate against a number of currencies, not just the U.S. dollar. The yuan appreciated by more than 3% last year against a trade-weighted basket of currencies. Not surprisingly, the People's Bank of China recently announced that it will target an exchange rate against that same basket of currencies. Yuan weakness should be viewed by investors as a favourable outcome (in that the global economy is adjusting appropriately) and not as further evidence of weakening Chinese growth. It would be more concerning if this exchange rate adjustment were to be stopped. What could trigger that? In a U.S. election year, China-bashing is tempting for candidates gunning for the top American job.

Canada – Ruts in the Road

It's becoming increasing difficult to share the Bank of Canada's optimism that the non-energy sectors of the economy are offsetting the impact of the oil shock. October GDP was flat – and that was on top of a disappointing September. In fact, the three-month annualized growth rate was a lacklustre 0.7%. Industrial production is down by 1.0% from a year ago. Even utility output fell, most likely because of the unusually mild fall weather.

Retail sales were a bit of a bright spot on a value basis, although sales volumes were off somewhat. Annualized growth rose to 3.4% for the three months ending in October versus 3.0% for the previous three months. Preliminary data for vehicle sales suggests a softening in that sector; the torrid sales pace was bound to decelerate at some point.

Residential construction continues to be a strong sector for the Canadian economy. At the same time, the chorus of concern over excessive household borrowing grows ever louder.

The sustained decline in business investment across most sectors is troubling. Non-residential construction is down by more than 10.0% compared to this time last year. The Canadian dollar was supposed to provide a tailwind for exporters, but that benefit has yet to materialize in a meaningful way. Canada's trade with the U.S. actually shrank in October, down for a third consecutive month. One ray of sunshine came from increased exports to the European Union and the U.K. So far, the biggest impact of a lower loonie is a higher price tag for capital equipment. It's no surprise that real imports of machinery and equipment have tailed off.

Industrial capacity utilization was up in the third quarter, although weak domestic demand has kept inventories on the high side.

Our Strategy

Volatility in capital markets persisted unabated throughout December. The broad weakness in equity markets of November continued in December, with most major indices turning in negative performance. Canada’s S&P/TSX Composite index, along with the German DAX 30, led the retreat. Even the U.S. S&P 500 edged lower in December, but it did manage to finish the year with a modest 1.38% total return (USD). Weakness in the loonie again supported investment returns on non-Canadian equities.

Yields on fixed income investments moved in different directions in December. Canadian yields dropped lower across most maturities, while U.S. yields once more edged upward, although modestly. Our positioning remains defensive within fixed income; we continue to shop for yield improvements where we can safely find them. We are monitoring opportunities in both the high yield and preferred equity asset classes.

Despite some recent softness in equity markets, we continue to emphasize equities over fixed income. Interest rates remain stubbornly low and central banks are highly accommodative, which provides substantial support for risk assets.

The Last Word

There's a trick to ensuring a safe dirt-biking experience in unfamiliar and potentially dangerous environments like the Mojave Desert. You must manage the risk: hire a competent guide, set a course within your abilities, ensure the motorcycles are in good running order and wear appropriate safety gear. The parallel for investors is pretty straightforward. Work with expert advisors who know you well and can help set appropriate goals bounded by a risk profile that lets you sleep at night. For longer-term investing success, it's critical to employ a disciplined, diversified approach to portfolio management, devoid of emotional – and perhaps extreme – responses to market events. That will keep you rolling in the right direction.