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Market Commentary

In Pursuit of Perspective

"Our perception of space is dominated by perspective, in the sense of a reduction of the projected size of objects with distance. One of the key jobs of the visual brain is to decode this size diminution as distance in the third dimension, or egocentric distance. If the eye were a pinhole cameras [sic], the projection of the world onto the back plane would be in perfect linear perspective (and in perfect focus)."

WebExhibits

Science and Art of Perspective, Christopher Tyler and Michael Kubovy

Institute for Dynamic Educational Advancement

The world of art underwent a massive transformation in the Renaissance. Central to that transformation was solving the problem of how to make objects appear the same as they do in real life. The answer lay in mathematics, specifically geometry. One of the earliest known treatises tackling the subject was written in 1435 by Leon Battista Alberti. He described how linear perspective could be achieved in two-dimensional drawings. It came down to this – parallel lines converge at a single vanishing point and objects decrease in size as they get farther from the viewer. Renaissance mastery of perspective reached its peak in the luminous works of Raphael.

Perspective is clearly important in the world of economics and investment as well. Over the last two to three months, dramatically different and changing perspectives have driven volatility significantly higher across global equity exchanges. A number of events in China are the prime cause.

U.S. – We See More Employed People

August's equity market volatility seemed to ignore the U.S. economy's dogged improvement. While the gain of 173,000 in the non-farm payroll number might seem a bit soft, it was accompanied by big upward revisions to numbers from prior months. An increase of nearly three million jobs in the last year is impressive. Other labour stats were good across the board: number of hours working was up 2.7% and wage increases rose nicely as well. Those wage gains will likely translate into real disposable income growth of roughly 3.0%, which should fire up consumer spending. Unemployment inched down to 5.1% and underemployment also dropped.

The good news didn't end there. August vehicle sales touched a 10-year monthly high at 17.8 million units. Mortgage applications were up. Construction spending saw a month-over-month rise of

0.7% in July. GDP in the second quarter was revised upward to 3.7% annualized growth, which is a pretty significant adjustment from the 2.3% previously calculated.

The revisions were made broadly across the economy and form a solid base for the balance of the year. Still, the U.S. Federal Reserve remains cautious about the timing of an interest-rate hike. Unsettled financial markets, lower-than-target inflation and fear of slowing the economy's momentum are real reasons for heel dragging.

The health of the U.S. economy is significant beyond its own borders – global recessions don't usually occur unless the U.S. leads the way down. U.S. recessions rarely come when oil prices are falling and interest rates are low or falling, as they are now. The typical catalysts for recessions are rising energy costs and interest rates, which are most damaging together.

Europe Looking Up

Headlines in Europe have quite naturally shifted to the huge influx of refugees fleeing the conflicts in the Middle East and sub-Saharan Africa. This humanitarian crisis has recently evoked much-needed offers of asylum from many larger European countries.

Flying somewhat under the radar is continued and welcome, albeit slow, improvement in Europe's economy. GDP growth is now forecast at 1.2% for 2015, bolstered by solid upward revisions for both the first and second quarters by 0.5% and 0.4%, respectively. Both household and government spending were up; investment spending lagged.

Considerable slack remains in the eurozone economy thanks to sluggish private fixed investment and stubbornly high unemployment. The jobless rate did improve to 10.9% in July, however, dipping below 11.0% for the first time in three years. This slack likely means that the European Central Bank will extend its quantitative easing program beyond the scheduled end-date of September 2016. ECB President Mario Draghi strongly signaled this possibility in his latest address. The ECB did raise limits on how much it can buy of each instrument under the program. It looks increasingly likely that the pace of purchases will also be increased. Evidence is mounting that QE is working as composite PMIs (which indicate the manufacturing sector's health) are broadly in expansion territory. France is a notable exception.

Liquidity is flowing in the eurozone. Money supply increased by 5.3% in July; wages popped up by 2.3% on a year-over-year basis in the first quarter; and, encouragingly, inflation bounced back to 0.9% in August on a year-over-year comparison.

The key to a more robust expansion is resurgence in investment spending. Low energy prices and further accommodation from the ECB are certainly supportive of that.

China's Point of View

China sparked the recent market turmoil. Global investor sentiment first soured in response to the Chinese yuan devaluation. In fact, the move was relatively small and the currency has been fairly stable since the initial two-day drop. A collapse in Chinese equity markets, plus disappointing manufacturing numbers and trade data, added to the concern. For some, the concurrent weakness in oil and commodity prices provided conclusive evidence that global economic activity was either slipping or on the verge. Worse, many feared another deflation scare. The issues are a bit more nuanced than that.

First, let's take a look at trade. China's total import bill fell about 13.8% year-over-year in August – and that's on top of an 8.1% decline in July. A couple of factors are at play here that explain these numbers: they are being compared to a very high base, given that imports were exceptionally strong a year ago and commodity prices are substantially lower now versus last August. Volumes of industrial metals have held up much better than the drop in the value data might suggest. In addition, oil imports are higher than they were at this time last year. Coal imports are still falling.

The likely and logical reason behind the recent currency devaluation is China's ongoing policy shift aimed at liberalizing its capital markets. It's probably not a ploy to engage in a currency war with other emerging market countries. China's greater aspiration is to have its currency included in the International Monetary Fund's SDRs. (Special Drawing Rights, or SDRs, are the IMF's fiduciary currency for central banks.) While China's export trade is certainly large enough to meet the IMF's criterion on that dimension, it falls short on the liberalization of financial markets and exchange rates. The People's Bank of China made a few other policy moves in parallel with the currency devaluation. It lowered the reserve requirement ratio (RRR) for banks and removed the cap on bank deposit rates. Both moves are consistent with previous IMF recommendations.

Canada – Reasons for an Optimistic Outlook

Despite two consecutive quarters of negative GDP growth (which is one technical but incomplete definition of a recession), August brought positive news for the Canadian economy. June GDP figures were encouraging: ahead of forecast, up 0.5%. There is some justification for optimism that the second half of the year will be better. It won't be robust unless oil prices rebound, but positive results are likely nevertheless.

The employment statistics were better than expected, with a gain of 12,000 jobs reported in August. This was largely the result of a hiring spree in the public sector. Diving a little deeper, new full-time jobs increased about 54,400, while part-time jobs fell by 42,400. The net result is a strong bounce in the number of hours worked. It's a likely indicator that wages and salary growth improved after the second quarter slowdown. The jobless rate rose to 7.0% from 6.8%; however, this is the result of an increase in the labour force participation rate, mainly in the 55-and-older age group.

The trade deficit also narrowed in July, another sign that the economy began the third quarter on a solid basis. The explanation for this is encouraging: bilateral trade with a number of countries other than the U.S. improved, most notably with the United Kingdom. Back-to-back gains in export volume over the last couple of months are a hopeful sign that non-energy exporters are finally ramping up. We should note that this activity is consistent with the Bank of Canada's forecast. It was probably a material factor in the BoC's decision to stand pat on interest rates.

Canadian equity markets remain volatile. For many, pessimism may have obscured the fact that the price of oil was actually a couple of dollars higher at the end of August than it was at the start of the month. With a steadier price for oil, at least for now, the trading range for the loonie relative to the U.S. greenback has been a bit tighter.

Our Strategy

Market volatility grabs headlines and quite naturally worries investors. It's especially important to maintain the right perspective under these circumstances. Volatile markets are the domain of traders and speculators who thrive or perish on the short-term swings. Prudent investors remain on the sidelines, comfortable in the knowledge that they own productive, quality assets. They do not sell into market weakness or corrections; they shop for opportunities.

Little has really changed in terms of the big events we have seen unfold. China continues to repurpose its economy to a somewhat more domestic, consumer orientation. The U.S. Federal Reserve is agonizing about when to start the process of normalizing interest rates. Oil and other commodities are still experiencing downward price pressure. All the while, global economic recovery chugs along slowly and consistently. Our strategy continues to favour equities over bonds. Within both of those major asset classes we maintain a slightly defensive posture. Our relative overweight to U.S. equities is based on the belief that the U.S. will continue to lead the way in this economic expansion.

The Last Word

The Renaissance was a glorious period for painting, sculpture and the decorative arts. The scientific study of light and colour, as well as the new geometric perspective, propelled the quantum leap toward realistic art. Raphael, da Vinci and Michelangelo wanted to express the experience of the individual. Perspective shifted to the people looking at the painting.

As noted in the Christopher Tyler and Michael Kubovy quote at the top of this article, it would be nice if our eyes could give us the undistorted perspective of a pinhole camera. It would be nicer still if we had a pinhole camera designed to give us the perfect economic perspective and investment focus. Unfortunately, we don't have one to help with investing decisions.

But we do have other resources. In periods of high market volatility like this one, we can rely on two advantages: a carefully crafted wealth plan, paired with a disciplined, risk-aware investment management approach. Experience has shown that this perspective works well.