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Market Commentary
Market Volatility

Volatility, as broadly predicted, continues to be a dominant feature of capital markets globally – certainly a tough start for investors in 2016. The reversals are not immaterial – the bellwether S&P 500 is down almost 5% in the first four trading sessions of the year; other exchanges, particularly those of emerging markets, are down substantially more.

What's driving volatility? Part of it is, no doubt, attributable to human emotion. Market participants are still nursing a hangover from the Great Financial Crisis and that means there's a tendency to overreact to potential threats or concerns. Let's investigate two of the major concerns from the Canadian investor's perspective. That means, first and foremost, oil.

Oil

The price of oil has slipped below US$35 in recent days. Lower prices for oil means a lower Canadian dollar and slower domestic economic activity. All of this puts downward pressure on domestic equity markets.

Lower oil prices are not the result of reduced consumption. In fact, estimated demand growth over the last three years is running right at its longer-term growth rate of 1.4% per year. China's demand for energy is not the problem either given that its demand is growing at a pace greater than 9%. It's a supply issue. At the back end of the U.S. shale oil boom, lower oil prices drove down mining and exploration by 50%. However, energy companies with debt on their balance sheets furiously pumped out oil to get as much cash flow as possible to service that debt. The result – inventories experienced a massive surge and that too has contributed to lower prices. Then there's OPEC. Today's OPEC is not the OPEC of yesterday. It lacks cohesion and a unified view. The decision not to cut production in the face of lower prices is odd at best. Not cutting production is perhaps best understood as an unintended, unattractive outcome of a high-stakes regional struggle between Saudi Arabia and Iran. These two protagonists seem bent on damaging the other even at their own expense and are engaged in a number of proxy fights throughout the Middle East. Events of the weekend are further evidence of this enmity. OPEC's refusal to curtail production has resulted in a flood of oil coming to market.

Predicting the future price of oil is obviously challenging, however, with oil at levels below the cost of shale oil production, prices should eventually begin to drift upward. Here's the bottom line – low oil prices are not the result of a plunge in global demand or a retraction of the global economy. It continues to be about too much supply.

China

The second big issue troubling markets is events in China. The list of hotspots within that economy is long: overall economic growth is slowing rapidly, there's a lack of reliable data, the currency is too high, they've overbuilt housing, there's a burgeoning debt problem, capital outflows are accelerating and then there's the policymakers. We had a preview of this current market tempest with 'all things China' last August when a small devaluation in the Chinese renminbi caused markets to roil. The recent low reading on the Chinese PMI number is taking part of the blame for the volatile market response though that seems unlikely given that manufacturing is not that weak and, in fact, recent stimulative action by the People's Bank of China will likely boost production over the coming months.

One of BPIC's primary concerns regarding what could go wrong for 2016 and the next few years is the behaviour of policymakers. The intervention of Chinese policymakers in equity markets is one example of just how wrong they can get it. Circuit breakers are a normal feature of most equity markets, however, the design of the circuit breakers for the Chinese equity markets seemed flawed from the outset. Those breakers trip at very tight thresholds. Once tripped, they fuelled fear in inexperienced Chinese investors that they would not be able to get liquidity when needed and that in turn triggered panic. Expensive, volatile markets plunged quickly as a result.

To top it off, fears of a significant devaluation of China's currency added gas to the fire. The renminbi moved down about 1% against the U.S. dollar over the past week. This is an extension of the bi-lateral exchange rate movement which began in mid-2014. Perspective here is important. A depreciating renminbi against a strengthening U.S. dollar does not mean that the Chinese are engaged in devaluing their currency. In fact, the renminbi has been relatively stable in trade-weighted terms over the last year and is actually up about 8% compared to where it was a couple of years ago. Chinese policymakers, despite their somewhat mangled efforts at communicating their intentions, seem pretty clear at aiming to keep the currency stable in trade-weighted terms and it seems unlikely at this stage that they plan to engineer a broad devaluation. There's little upside for China economically in doing that and substantial cost politically. There's some comfort, in that, as a command-driven economy, China can fix its exchange rate and its equity markets as it deems necessary. A final thought on China – its industrial economy will likely slow steadily as expected avoiding that feared hard landing.

Market activity this week does not alter our strategy. BPIC remains overweight equity relative to fixed income. Duration remains defensively short of benchmark for fixed income with a heavy overweight to shorter maturity, investment-grade corporate credit. Within the equity asset class, we maintain our overweight to the U.S.

One final thought – an investor's true risk tolerance is most appropriately determined during periods of high market volatility or adverse market moves. Unless the client's circumstances change, that risk profile is stable. It does not 'float up' when times are good to justify a more assertive asset allocation. This presumes that there will be some clear signal to adjust back down when times are not. While volatility is clearly uncomfortable, it's a great catalyst for investors to review their overall wealth plans.

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