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Market Commentary

Why Anxiety?

"Anxiety's like a rocking chair. It gives you something to do, but it doesn't get you very far".
***Sing You Home*, Jodi Picoult**

*"I know what came over you. High Anxiety, you've still got it… These things do not let go.
High Anxiety can be a dangerous enemy."*
Professor Lilloman, *High Anxiety*, Mel Brooks (1977)

High Anxiety was Mel Brook's initial foray into producing movies and also his first role as a lead in a speaking part. The 1977 movie received critical acclaim and garnered two Golden Globe nominations. Mel plays Dr. Richard Harpo Thorndyke, a distinguished Harvard professor of psychiatry about to take over as the new head of The Psycho-Neurotic Institute for the Very, Very Nervous. The movie is filled with parodies of famous scenes and characters from Alfred Hitchcock's suspense films. In the end, Dr. Thorndyke conquers his own neurosis in order to rescue his future father-in-law.

Last month, many investors suffered from that same feeling of "high anxiety." Markets were exceptionally volatile, fueled by fears about China, commodities, the sustainability of global growth, U.S. interest rates and corporate earnings.

U.S. – Retail Therapy

One of the more serious concerns of investors is the U.S. economy's direction and pace of growth. If it stumbles, global economic growth would be vulnerable. Despite strong performance in a number of key measures such as employment and housing, weak results in the manufacturing sector made investors uneasy in January. The strong U.S. dollar was most frequently cited as having an adverse impact on that sector.

A deeper look at corporate earnings is warranted. In the S&P 500, 40% of the companies reported on earnings by the end of January; the results are less dire than feared. A healthy 72% reported earnings above the mean estimate. Roughly 50% indicated that sales also exceeded consensus estimates. At first blush, this seems reassuring; however, many companies had guided earnings estimates lower going into the quarter. That pattern continues. To date, forward guidance for the first quarter of 2016 is trending downward as well. The offsetting forces of falling energy prices and a stronger greenback are largely to blame.

The latest adjusted consumer spending reports were calming. Consumer spending in 2015 was the strongest in a decade, rising more than 3.1% on a year-over-year basis. The underlying data showed mixed results. Retail sales at stores were weak; however, other sales such as autos and experiences (for example, eating in restaurants and travel) made up the difference. Online spending continues to chip away at market share. Forecasts for 2016 and beyond show that the pace of spending is likely to continue, despite some modest weakening in consumer net worth (down about 5%). Two factors could dampen spending: a return of inflation, or a material increase in the savings rate. Since inflation currently seems benign, anything that might encourage greater savings – such as a significant jump in interest rates – is worth watching.

Meanwhile, guidance from the U.S. Federal Reserve seems pretty consistent about further rate hikes this year and next. At the end of January, the Fed Open Market Committee said that it expects economic conditions to “evolve in a manner that will warrant only gradual increases in the federal funds rate.” At this stage, though, it seems unlikely that we will see a rate hike in March.

Europe – Keep the Worry Beads Handy

Eurozone consumers have been enthusiastic about spending their energy windfall. Lower oil prices and negligible inflation triggered consumer behaviour that will probably have a greater-than-expected positive impact on the overall economy.

This comes as a bit of a surprise. Eurozone consumers tend to be known for their caution and propensity to save rather than spend. Analysts were concerned that traditional behaviour from consumers would exacerbate the downward inflationary expectations created by the energy-driven price contraction. The eurozone does not need a Japanese-style deflationary spiral. The question remains: what happens when the energy savings fade? Will policy makers need to substitute another incentive to keep the recovery moving forward?

Political events have captured attention in recent weeks. Spain’s Socialist Party leader, Pedro Sanchez, continues to seek an arrangement with other political parties to try to form a government seven weeks after an inconclusive election. This will be an uphill battle, given the philosophical chasm among the parties, particularly on the issue of austerity. There is a mechanism in place to force another election within a couple of months should Mr. Sanchez’s efforts fail. So far, neither the Spanish economy nor bond market seems hurt by the confusion. The failure to reach a quick resolution increases the risk, however.

Ireland is also holding elections in February; early opinion polls suggest no party is the odds-on favourite. An unclear result, like the recent one in Spain, could prove problematic. But, at this juncture, Ireland's anti-austerity parties don't seem to have enough support to win. The recent improved strength of the Irish economy offers a cushion in case a period of uncertainty follows the election.

To no one's surprise, Greece failed to meet its 2015 targets for budget deficit reduction. This was going to be tough even under the most optimistic scenario. The goal sailed completely out of reach after revenue was hampered when the ECB and eurozone national central bank suspended the return of profits made on their holdings of Greek bonds.

China – Due for a Shrink

Going into 2016, three overarching factors about China continued to worry investors.

First, the actual economic data – despite being reasonably stable of late – does not inspire confidence. Markets doubt the integrity of the numbers and are assuming, rightly or wrongly, that the slowdown is much greater than reported. The advent of the Lunar New Year's week-long holiday typically worsens that problem. Much of the data goes silent for a rather lengthy period of time.

Second, there is a fear that a major devaluation is looming: market participants are uncertain of policy direction. The recent Chinese intervention in currency markets did little to calm nerves.

The third major area of concern is whether policy makers are skilled enough to make the right decisions. China faces a number of very substantial challenges simultaneously. Frankly, the risk of a policy error is high. Markets see China as being a key source of global growth; the potential for a destabilizing event is concerning.

Are investor worries justified? Well, it's true, China's growth is slowing; however, it's been doing that noticeably for at least the last three years. A lower growth rate on a much bigger economic base still generates fairly healthy demand. A contrarian perspective being floated in economic circles argues that a slowdown in China is actually positive for the global economy, given that the world still lacks adequate consumer demand. The resulting decline in commodity prices acts as a wealth transfer from producers to consumers. If consumers get spooked by investor fretting and the ensuing market turmoil, then they are likely to pocket the savings rather than spend it. Thus the "prophesy" of the market self-fulfills.

Also important to note, China is the only major economy that has an overvalued currency and has not resorted to competitive devaluation. An appreciation of the U.S. dollar shouldn't be interpreted as a Chinese devaluation. Markets must adjust to the fact that the People's Bank of China is targeting the yuan's value against a trade-weighted basket of currencies versus the greenback alone. That's reasonable and prudent.

Canada – Feeling Down

If it wasn't clear before, it's glaringly obvious now: Canada's economic outlook is overwhelmingly tied to commodities. The precipitous drop in oil prices triggered an equally sharp plunge in the Canadian dollar. That is quickly translating into job losses. January alone saw an additional 5,700 workers erased from the payroll, pushing the unemployment rate up to 7.2%. Alberta bore the brunt of the retrenchment. All the chatter about fiscal stimulus through much-needed infrastructure investment hasn't yet translated into practical, shovel-ready projects. Policy makers appear to be underequipped to stabilize the economy using conventional stimulus measures.

Real exports should get a boost from the loonie at these levels. Canadians are still waiting for sufficient momentum in non-energy exports to make a real difference. The year is starting from a relatively weak position. Annual growth will likely be modest for 2016, perhaps clocking in around 3%. Look for 2017 to be better; export growth will likely accelerate to 5%.

Construction output has been flat, reflecting a slowing of both residential and non-residential activity. The little positive news came from the energy-related engineering sector. That will likely be short-lived, given the dearth of major oil projects in the works. A sustained energy drought will inevitably lead to further slowdowns in related construction.

Our Strategy

The correction in equity markets continued into January, with some relief coming in the last few trading sessions. Canada's S&P/TSX Composite Index was down 1.17% after dividends for the month. Even so, that was enough to place it among the better-performing exchanges, given that U.S., European and Asian markets backed off by more substantial amounts. The loonie closed more than three quarters of a cent lower, giving back some of December's gains.

Although corrections are discomforting, they are a normal part of the investment process. Market volatility has not altered our view that equities still represent good investment opportunity; we maintain our overweight posture. Continued support from central bankers globally helps put a floor under risk assets. It's a collateral benefit of their collective efforts to stimulate economic growth. It's also a not-so-subtle nudge to encourage re-deployment of savings into investments.

The continued softness in the high-yield and preferred-equity asset classes has made us hesitant to add to our current underweight positions. On the other hand, we do view those yields as attractive and will continue to look for the right opportunity to add to those positions.

The Last Word

The more extreme movements in capital markets last month may have tempted some investors to consider checking into Brooks' 'Institute for the Very, Very Nervous'. The feeling is completely understandable because market volatility is unsettling. Some of the discomfort may come from expectations that it's possible – perhaps even necessary – to make substantial adjustments to portfolio risk exposures during periods of high market volatility. However, investors are rarely rewarded financially for panicking. It's much wiser to ensure that portfolio risk is set at levels that allow investors to keep calm and carry on until valuations once again drive asset prices.

Patience is key. Warren Buffett once said "the stock market is a device for transferring money from the impatient to the patient." That transfer often happens during periods of market gyrations. It's usually best to stand pat. If action is required, then careful shopping for opportunity is the recommended prescription.

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