Volatile Markets – Stick to your long term strategy

Over the past month, volatility in global financial markets has increased substantially. Although this is a difficult time, this is not unprecedented. Based on long fundamentals and market action, investors should not panic or pull-out at this time based solely on views over near term direction – staying with a disciplined strategy is the right move over the long run.

The recent volatility has primarily been driven by the following factors:

- Concerns in the credit/lending market, initiated by rising sub-prime mortgage defaults
- Renewed evidence of US economic softness
- Tighter global monetary policy with central banks around the world raising rates (outside of the US)
- Persistently high oil prices and overall inflation
- Rising US-China currency-related friction
- The ease and willingness of investors to take profits and stay on the sidelines

In response, risk aversion has risen, and credit conditions have tightened. This has resulted in equity markets retreating from their highs, government bonds rallying, and credit spreads (the differential between corporate and government yields) rising substantially.

In addition, we have also witnessed the sudden appreciation of the Japanese yen, as the carry trade is unwound. The carry trade is the borrowing of yen at prevailing low Japanese interest rates, and investing these borrowings in higher yielding assets and currencies. When the yen appreciates, however, investment returns fall, and therefore they may be compelled to liquidate.

Finally, liquidity has dried up in debt and debt derivative markets, putting a number of leveraged buyout plans in question, and forcing managers to either wind up or disallow redemptions in a number of hedge funds.

Amidst this volatility, we highlight the following key points.

- The equity market does not go straight up forever, and inevitably does suffer declines and increased volatility. Bond markets similarly do suffer through times of volatility. This is why you have built a balanced portfolio that can weather this pullback.

- Fear should not drive the investment decision – the key is to focus on fundamentals and not get swept up in market sentiment. However, now is a critical time to revisit your long term plan, and ensure your portfolio is built to meet your investment objectives, while keeping risk within a level you are comfortable with.

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- Year-to-date equity portfolio performance remains positive. As of August 9th, the S&P/TSX Composite index has provided a total return of 5.9% year-to-date, the S&P 500 has provided a total return of 3.6%, and the MSCI EAFE index has provided a total return of 8.4%.

- Bond performance has been essentially flat, as interest income generated from coupon payments and accruals has been offset by declining bond prices. The decline in bond prices is the result of yields rising in response to strong growth, persistent inflation, and rate hikes from the Bank of Canada. Year-to-date, the Universe Bond Index is down -0.55%.

- Although risk premiums have widened significantly, corporate bonds have not underperformed dramatically – year to date, the Universe Government Bond index is down -0.4%, while the Universe Corporate Bonds Index is down -0.9%.

- Cash has outperformed bonds this year – the 91-day T-Bill index has provided a total return of 2.6% year to date.

However, we continue to hold a constructive view towards financial market returns going forward:

- The economic outlook continues to be positive. Global growth is expected average 2.0% - 3.0% in developed markets, while emerging markets will continue to grow at more than double that pace. Emerging markets have driven demand for resources, which in turn has been a key driver to the performance of the S&P/TSX Composite.

- Inflation is also expected to remain at the high end of central banks comfort zones, over 2.0% in North America and the United Kingdom, but more contained in Europe and Japan.

- Corporate fundamentals remain solid. The second quarter earnings season is once again on track to deliver stronger-than-expected growth, and although slowing, year-over-year earnings growth remains in double-digit territory. We also note high corporate cash positions, leading to dividend increases, share buybacks, and recapitalization.

- Although focus has been on financial institutions exposure to sub-prime lending and the difficult liquidity situation, we note that globally the industry is in one of their strongest positions ever, being over capitalized and with greater diversification across product lines and geographies, and with record earnings that are the first line of defence against write-downs and charges.

- This is not the tech bubble. Balance sheets are far stronger and valuations are reasonable given the level of interest rates and earnings growth. The S&P/TSX Composite is trading at 18 times earnings, and the S&P 500 is trading at 17 times trailing earnings, well below the average of almost 30 times trailing earnings both traded at through the tech bubble.

- These factors are supportive for equity market performance and counters fears of rising corporate defaults. Scotia Capital Strategist Vincent Delisle continues to forecast a target of 14,200 for the S&P/TSX Composite Index and 1625 for the S&P 500.

- Scotia Economics continues to forecast the Bank of Canada to lift its overnight rate another 0.25% on September 5th to 4.75%, as growth remains solid, inflation has been higher than expected. In contrast, Scotia Economics expects the Federal Reserve will reduce its funds rate 0.25% to 5.0% in response to weakness in U.S. housing and consumer spending.

- Against this backdrop, the Canadian dollar should continue to appreciate, with Scotia Economics forecasting a range of US$0.95-1.00 over the next twelve months. However, the primary direction of bond yields remains higher, reflective of increased inflation risks. Therefore we remain negative on longer maturity debt instruments.

Therefore, we recommend investors keep their discipline – stay with a long term plan, and maintain exposure to a diversified portfolio.

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