TD Wealth

What's ailing the market?

Monthly Perspectives | Portfolio Advice & Investment Research

February 2016

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Martha Hill, CFA

The tone of uncertainty and heightened sensitivity that we experienced toward the end of last year carried over to 2016. In an already low-growth, low-return environment, renewed concerns over global economic growth and an escalation in geopolitical tensions triggered steep and widespread declines in global equity markets, placing a number of indices into bear market territory. For Canadian investors, the headlines have been unnerving: oil plunging to 13-year lows, a weak Canadian dollar and equity market declines.

In this edition of Monthly Perspectives, we examine what has been ailing the markets and remind investors that we are in a period of slow growth, low returns and heightened volatility. Although we are unable to predict the future, we do know that volatility is part of investing and one of the keys to successful investing is to develop a plan that includes a strategic asset allocation suited to your investment goal(s) and your ability to tolerate risk. When the noise in the marketplace becomes too loud, referring back to your plan can reassure you that you are following the right course of action and help prevent you from making emotional investment decisions that could lead you down the wrong investment path.

This document is for distribution to Canadian clients only. Please refer to Appendix A of this report for important disclosure information.

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Fixed Income

Re-pricing risk

Sheldon Dong, CFA

What do a head of cauliflower that currently sells for around $8.00 in Toronto, a litre of gasoline in Calgary that has dropped to 66.9 cents (lowest since 2008), lifting of international trade sanctions against Iran, defusing of real estate speculation in China and strong Canadian retail sales have in common? They are all interconnected and reflected in credit market movements. Zhu Min, the International Monetary Fund's deputy director, warned at the recent World Economic Forum in Davos that his worry is that policy-makers still do not understand the complex interactions in the global financial system. Keeping the bond market awake at night currently are concerns about the repricing of risk and contagion.

The reasons for the high-priced cauliflower start with the currency. As prices for commodities have dropped, the value of the Canadian dollar has fallen (from approximately US$0.93 a year ago to US$0.73 on February 4, 2016), which is a direct link to an economy that is dependent on oil and other resources. Adding to the higher import price shock is tighter supply due to a drought in California, where Canadians get most of their vegetables from in the winter season.

The 8-year-low gasoline price in Calgary is mainly due to the precipitous drop in the price of crude oil used in its manufacture. From a peak of approximately US$147/barrel in July 2008, crude oil reached a 13-year low near US$27/barrel in mid January 2016. As oil prices climbed, more energy projects became economically viable; with low interest rates (the U.S. Federal Reserve (Fed) moved to a zero interest rate policy in December 2008) helping fuel a surge in capital spending, which led to increased supply, particularly in U.S. shale. That shifted the demand/supply balance, resulting in a downward adjustment of prices. Exacerbating the price correction has been the slower-than-expected pace of global economic growth and an expected ramp up in exports from Iran, as its trade sanctions are lifted.

China's housing market is one of the most important parts of its economy as residential real estate together with construction accounts for more than 10% of gross domestic product. The Communist party allowed most workers to buy their government housing at a steep discount to market value, resulting in home ownership in China now among the highest in the world: 89% compared to about 64% in the U.S. For years, the investment of choice in China was property and infrastructure, with anticipation of ever-growing prosperity leading to overvaluation and overbuilding. The construction boom resulted in China accounting for as much as 40% to 50% of global commodity demand, which led to a similar supply/demand rebalancing as crude oil. The general outlook for the global metals and mining market remains subdued due to the combination of slower global economic growth, particularly in emerging markets, and signs of oversupply of several commodities, most notably iron ore and coal. China's import iron ore prices have plunged from US$154/ton in early 2013 to about US$40/ton by the end of January 2016.

Canadian retail sales rose 1.7% month-over-month in November 2015, well above market expectations calling for a modest gain of 0.2%. With the exception of gasoline stations (-0.6%),all subsectors recorded sales increases, representing 90% of retail trade. Sales were buoyed by the low Canadian dollar, which is helping keep more spending within Canada. In November 2015 alone, 775,000 fewer Canadians visited the United States compared to year-ago levels, 70% of those being daily visits associated with shopping. At the same time, an additional 130,000 Americans took the trip up north—a benefit particularly for retailers closest to the border. The lower Canadian dollar has set in motion complex adjustments to the economy with a reorientation towards non-resource activity.

Bond markets are at the epicentre for pricing risk

Years of ultra-low interest rates from central banks around the world flooded financial markets with excess liquidity, suppressed the pricing of risk and encouraged overvaluation of riskier assets. The financial repression caused by miniscule, or even negative, sovereign bond yields encouraged investors to take on more risk in exchange for higher returns so that capital could be made more readily available within the financial system to promote economic growth.

Since the Fed first telegraphed its intention to normalize its monetary policy, a rebalancing in the pricing of risk has been underway. The anticipation of diverging monetary policies has already seen sharp adjustments in currency markets, particularly U.S. dollar appreciation. A tightening in financial market conditions is reflected by higher credit costs, which are illustrated by widening credit spreads. So how are the items mentioned above connected to the bond market? First, the price of the cauliflower from a weak Canadian dollar reflects risk to Canadian economic growth from the downturn in energy and mining such that the Bank of Canada (BoC) may need to cut interest rates further. However, the weaker dollar is expected to help other sectors of the economy, such as retail sales, which gives the BoC more time to make a policy response. Second, the decline in oil and commodity prices show up in widening credit spreads and higher cost of financing of companies in those sectors, as weaker cash flows increase debt servicing risks. Higher default risks in those sectors raise contagion concerns in other sectors such as banks, generally resulting in higher repricing of corporate bond spreads over government securities. The Fed's first rate hike since 2006 in December has accelerated the risk rebalancing process. For financial markets that have become addicted to zero interest rate policy support, the withdrawal must be done carefully.

Equities

Worried minds move markets

Chris Blake, CFA

"Two super-contagious diseases, fear and greed, will forever occur in the investment community. The timing of these epidemics will be unpredictable...we simply attempt to be fearful when others are greedy and to be greedy only when others are fearful."

-Warren Buffett

What ails the equity market indeed. So far this year, some days have felt like this question would be better phrased by asking what doesn't ail the equity market?

While we ended 2015 on a lackluster note, we don't think many market participants were prepared for the relentlessly negative tone present during the first three weeks of January. We opened the year with a 9.0% loss on the S&P 500 Index (S&P 500) in 13 trading days. In Canada, the S&P/TSX Index (S&P/TSX) was also down 9.0%, and the Dow Jones Industrials Average lost 9.5%, the worst of the lot. Clearly, fear had overtaken greed in the market at the beginning of 2016.

Slowing growth in China

During the night on January 3, 2016, before trading in North America began for the new year, the Caixin Manufacturing Purchasing Managers Index (PMI) was released in China. Reported at 48.2, and compared to an expectation for 49.0 and a 48.6 November reading, the report was weak and marked the tenth consecutive month of readings below the important 50 level, which indicates the dividing line between contraction and expansion. That reading sent the widely watched Shanghai Composite Index down 6.9% after it opened the day essentially flat ahead of the news, setting the tone for trading around the world. European and North American markets traded down that day. While concerns about growth in China have been around for some time, they were given greater gravitas when (two days later) the Caixin Services PMI was released at a 50.2 level, down from a 51.2 reading in November.

Since China is one of the last bastions of real growth in the world, signs of a slowdown there caused fears for the outlook of global growth. More specifically, Chinese GDP growth accounts for nearly 40% of the total world growth. So, if China's growth slows from 12% to 8%, then global growth will be meaningfully impacted.

Economic transition in China

Embedded in the fears about the PMI data are concerns about the impact of China's ongoing economic transition on the global economy. China has been heavily reliant on growth in trade of manufactured goods and fixed asset investments. As any economy matures, it needs to transition to a higher percentage of services driving overall growth. The statistics measuring this transition are still developing in China and are therefore met with some skepticism and caution. One data set we can have some confidence in, auto sales, showed a marked slowdown last summer and has only been re-invigorated with the help of some stimulus plans in October as the government reduced taxes on certain vehicle models. However, auto sales, which grew a strong 10% year over year (Y/Y) in October and followed up with a very strong 24% Y/Y growth in November softened to just 18% Y/Y growth in December, giving the market another reason to focus on softness. A guided economic transition, such as this, over a short time frame, such as this, has not been seen before and as a result, it was met with caution, and perhaps fear, by the markets.

Commodity price weakness

The spillover effect was felt most heavily in the commodity markets where China has been a major source of demand and is said to account for as much as 60% of global demand of some industrial metals. These markets are concerned about both ebbing demand and increased supply. The price action in commodities began to stoke fears of a global recession: spot nickel prices dropped nearly 22% in the first week of the year; copper futures tumbled a little over 9% mirroring equity markets; and oil fared worst of all with WTI crude oil dropping 25.6% from the December 31st close to its intraday low on January 19, 2016. The price of Brent crude oil was similarly crushed, losing 27.3% in the same time frame to its intraday low.

According to a recent article in the Economist, at a benchmark price of lower than US$40/barrel of Brent crude oil, only 561 billion (B) of the world's 1739B barrels of oil reserves are economically viable. At US$60/barrel, the economically viable reserves rise to 859B barrels; 1065B at US$80/barrel; and 1282B at US$100/barrel. There are a lot of available resources; the question is one of cost. If the cash costs of production aren't covered, production will fall as producers will not continue to invest capital in uneconomic production. It will take time to work through the inventories that have accumulated during the period of overproduction and overcapitalization of the commodity sectors. We should not necessarily see the commodity prices as an indicator of economic weakness but rather as an indicator that too much capital flowed into these sectors when prices were high, resulting in excess supply. Commodities will likely continue to be plagued by volatility until inventories stabilize and prices recover.

Does the market weakness presage a recession?

Paul Samuelson, a famous economist, said in the 1980s that the stock market had predicted nine of the last five recessions—a number that has recently been updated to 27 of the last 11 recessions by the economist and strategist David Rosenberg.

Equities

Worried minds move markets (cont'd)

Chris Blake, CFA

While the comment was delivered somewhat in jest, the point remains that the stock market is a poor predictor of recessions and has a lower than 50% batting average in these predictions. However, in this case, several markets seem to indicate something similar and the U.S. Federal Reserve (Fed) has embarked on a path of tightening, a path that invariably does choke off economic growth and sometimes can push the economy into recession. So, the question of whether or not we are heading toward the development of a recession in the United States and/or Europe would seem reasonable.

And yet, recent economic data in the United States have been encouraging and not indicative of a recession. Some figures might be indicating a cycle peak but certainly not an impending recession. Auto sales in 2015 hit a record high in the United States, housing data shows continued increases in building intentions with recent permit data running ahead of expectations and the National Association of Home Builders indicated that its members are talking of a building labour shortage. Wages are growing reasonably without signs of pronounced increases that generally indicate overheating and core inflation is hovering around the Fed's goal of 2%. With the talk of rate increases, the U.S. dollar has strengthened and that is its own brake on the economy as American goods and services become less competitive in foreign markets. All considering, we do not expect the Fed to be aggressive with rate increases and put at risk the economic recovery in the U.S.

Valuations

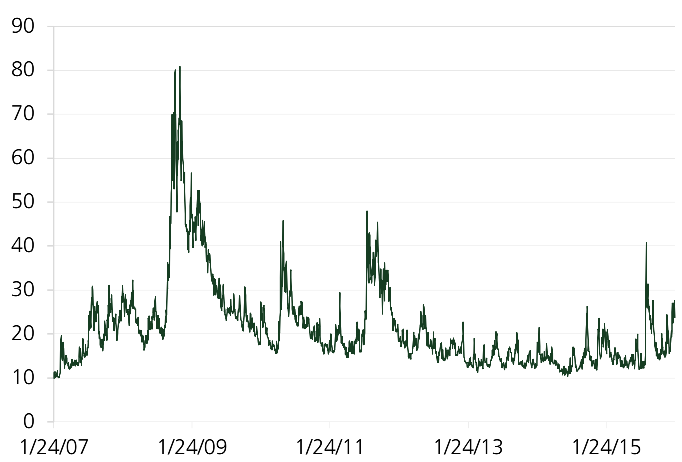
The S&P 500 did not look particularly expensive coming into the year. At the end of December 2015, S&P Capital IQ had an expectation of US$116.87 in earnings for this index in 2015 and US$125.66 for 2016, which means that the market was trading at 17.5x the 2015 estimate and 16.3x the 2016 estimate. The dividends paid in 2015 amounted to US$44.03 (equal to about a 2.15% dividend yield) were essentially in-line with the 10-year Treasury, and the dividends are expected to grow by about 7% according to consensus (in-line with earnings) to US$47.07 in 2016, so the forward looking yield was about 2.30%. While valuations can be described as being at the rich side of a normal valuation range, an investment in bonds appears to be more expensive with government yields near all-time lows.

As if these concerns of a global slowdown, a Chinese economic transition and weak commodity prices were not enough, we also had news that: Britain decided to hold a referendum on its continued participation in the European union, North Korea has been engaged in sabre-rattling again, and that Iran may flood an already oversupplied oil market with even more oil. Add in a dash of fear that petro-driven economies, including our own, are falling into deficit due to low oil prices and we have all the fear we could possibly need to affect equity markets. However, there is an old saying that equities climb a wall of worry, and many seasoned investors suggest that the best time to buy assets is when one feels queasy at the thought of putting money in the market.

Volatility in perspective

Market participants generally get uneasy—even queasy—at times of heightened volatility. There are two reasons for this: first, heightened volatility is nearly always associated with downward adjustments to asset valuations (and it is just hard to watch as apparent wealth goes down, even temporarily); and second, the uncertainty that is the natural fallout of rapid price changes. Market bottoms are the points of capitulation for the largest number of investors who may sell at a loss to simply stop the pain of watching asset values go down. Volatility as measured by the VIX index has been trending up for several months, and while elevated, has not yet reached the crescendo levels that generally indicate the presence of panic in the markets.

Figure 2: Volatility Index (Chicago Board Options Exchange)



Source: Bloomberg Finance L.P. As at January 22, 2016.

It is worth keeping in mind that volatility is not the same as risk. Volatility describes the magnitude of ups and downs in the market; risk can be thought of as not being able to meet your goals, or the likelihood of sustaining a permanent impairment in capital.

Look for opportunity

Maintaining a long-term view and a sensible asset allocation will help mitigate the fear of volatility, and may even enable investors to not only accept market volatility, but to see it as a potential opportunity rather than a threat. As Warren Buffet once said, "Whether we're talking about socks or stocks, I like buying quality merchandise when it is marked down."

The Last Word

Then and now

Scott Booth, CFA; Christopher Lo, CFA

Some investors have expressed concerns that financial markets are heading back into a crisis reminiscent of the one experienced in 2008. On the positive side, even though the markets have been erratic recently, significant advances have been made since the sub-prime instigated credit crisis, with equity markets having advanced strongly since 2008. It is widely understood that the consumer is the backbone of the U.S. economy and strong auto sales are a sign of consumer confidence. Banks are better capitalized and credit conditions are not near crisis levels. Global economic growth, while far from robust, is still a reality. There are challenges out there as well. Despite improvements in credit conditions, leverage remains a concern. The U.S. consumer has de-levered but Canadian debt loads have increased relative to incomes. The relentless advance in Canadian housing prices combined with low interest rates have encouraged consumers to take on more debt. While not all wine and roses, as we take stock of conditions and weigh the various factors influencing markets and the economy, we don't see crisis on the horizon. Below is a list of selected data points comparing then (2008) to now (2016).

Potential Economic Impact

Positive | Negative | Mixed

	Impact	2008	2016	
S&P/TSX Composite Index Closing Level		8,988	12,593	The Canadian index has recovered substantially since the credit crisis.
S&P 500 Index Closing Level		903	1,913	The S&P 500 has more than doubled since the credit crisis.
Canada MLS HPI Aggregate (Composite Benchmark)	Mixed	$365,800	$509,500	Canadian home prices have risen substantially since 2008.
U.S. Existing Home Sales Average Price (NSA)	Positive	US$217,600	US$266,800	U.S. home prices have advanced at a modest pace.
Debt to Disposable Income Canada	Negative	149%	166%	Canadian debt levels continue to rise relative to incomes; likely a result of low borrowing costs.
Debt to Disposable Income U.S.	Positive	128%	104%	U.S. consumers have been de-levering since the global financial crisis.
Canada GDP Growth	Positive	-1.40%	0.20%	Although improving, Canadian GDP growth has been challenged by a weak commodity price environment.
U.S. GDP Growth	Positive	-2.80%	1.80%	U.S. GDP growth is still showing modest expansion.
U.S. ISM Manufacturing PMI	Positive	33.1	48.2	A reading above 50 indicates expansion in the manufacturing sector and a reading below 50 indicates contraction.
U.S. Auto Sales	Positive	10.2 M	17.2 M	Auto sales have been very strong, tracking near record high annual levels.
Central Banks* Balance Sheet (Billions)	Mixed	US$1,352	US$3,187	Central bank balance sheets have ballooned as quantitative easing has become the policy tool of choice.
Canadian Banks TIER 1 Capital Ratio	Positive	9.76%	11.98%	Canadian banks are much better capitalized than they were back in 2008.
USD/CAD Exchange Rate	Mixed	US$0.821	US$0.73	The Canadian dollar experienced a roller coaster ride since the credit crisis, finishing lower. Helping exporters and making importing more expensive.
Oil price (WTI) per barrel	Mixed	US$44.60	US$32.70	Oil price continues to slide on an imbalance of supply and demand. This is positive for oil consumers but negative for producers.
Canada 10-Year Bond Yields	Mixed	2.68%	1.15%	Muted growth expectations and central bank policies continued to restrain bond yields.
U.S. 10-Year Bond Yields	Mixed	2.21%	1.88%	Although less dramatic than Canadian bond yields, U.S. bond yields have also pulled back.
U.S. Investment Grade Credit Spreads	Positive	540 bps	269 bps	Narrowing credit spreads indicate improving creditworthiness of corporate borrowers.
U.S. Unemployment Rate	Positive	7.20%	5.00%	A return to the workforce is a positive indicator of a sustainable recovery.

*U.S. Federal Reserve, European Central Bank, Bank of Japan, Bank of England and Swiss Central Bank. Source: Bloomberg Finance L.P. As at February 4, 2016.

Performance Monitor

Monthly market review

		(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)
Canadian Indices ($CA) Return	Index Level	1 Month	3 Months	YTD	1 Year	3 Years	5 Years	10 Years	20 Years
S&P/TSX Composite (TR)	40,404	-1.17	-4.42	-1.17	-9.88	3.44	1.86	3.65	7.28
S&P/TSX Composite (PR)	12,822	-1.44	-5.23	-1.44	-12.62	0.36	-1.10	0.71	4.85
S&P/TSX 60 (TR)	1,922	-0.99	-4.20	-0.99	-9.20	4.35	2.38	3.95	7.84
S&P/TSX SmallCap (TR)	698	-4.09	-7.17	-4.09	-17.26	-5.22	-6.39	-1.07	-
U.S. Indices ($US) Return	Index Level	1 Month	3 Months	YTD	1 Year	3 Years	5 Years	10 Years	20 Years
S&P 500 (TR)	3,632	-4.96	-6.18	-4.96	-0.67	11.30	10.91	6.48	7.73
S&P 500 (PR)	1,940	-5.07	-6.69	-5.07	-2.74	9.00	8.57	4.25	5.74
Dow Jones Industrial (PR)	16,466	-5.50	-6.78	-5.50	-4.07	5.91	6.73	4.25	5.74
NASDAQ Composite (PR)	4,614	-7.86	-8.70	-7.86	-0.46	13.66	11.31	7.18	7.63
Russell 2000 (TR)	4,954	-8.79	-10.56	-8.79	-9.92	6.11	7.25	4.92	7.54
U.S. Indices ($CA) Return	Index Level	1 Month	3 Months	YTD	1 Year	3 Years	5 Years	10 Years	20 Years
S&P 500 (TR)	5,114	-3.32	0.98	-3.32	9.98	24.78	18.71	8.72	7.87
S&P 500 (PR)	2,732	-3.43	0.43	-3.43	7.68	22.21	16.21	6.44	5.87
Dow Jones Industrial (PR)	23,185	-3.87	0.34	-3.87	6.21	18.74	14.24	6.43	5.87
NASDAQ Composite (PR)	6,497	-6.26	-1.73	-6.26	10.21	27.43	19.14	9.43	7.77
Russell 2000 (TR)	6,976	-7.21	-3.73	-7.21	-0.27	18.96	14.80	7.12	7.67
MSCI Indices ($US) Total Return	Index Level	1 Month	3 Months	YTD	1 Year	3 Years	5 Years	10 Years	20 Years
World	5,982	-5.96	-7.99	-5.96	-4.55	6.21	6.39	4.46	6.09
EAFE (Europe, Australasia, Far East)	5,919	-7.22	-9.87	-7.22	-8.04	1.11	2.04	2.12	4.42
EM (Emerging Markets)	1,534	-6.48	-12.08	-6.48	-20.62	-8.91	-5.23	2.16	4.74
MSCI Indices ($CA) Total Return	Index Level	1 Month	3 Months	YTD	1 Year	3 Years	5 Years	10 Years	20 Years
World	8,423	-4.33	-0.97	-4.33	5.68	19.08	13.88	6.65	6.22
EAFE (Europe, Australasia, Far East)	8,334	-5.62	-2.99	-5.62	1.81	13.36	9.22	4.26	4.55
EM (Emerging Markets)	2,160	-4.86	-5.37	-4.86	-12.11	2.12	1.44	4.31	4.87
Currency	Level	1 Month	3 Months	YTD	1 Year	3 Years	5 Years	10 Years	20 Years
Canadian Dollar ($US/$CA)	71.02	-1.70	-7.09	-1.70	-9.68	-10.80	-6.57	-2.06	-0.12
Regional Indices (Native Currency) Price Return	Index Level	1 Month	3 Months	YTD	1 Year	3 Years	5 Years	10 Years	20 Years
London FTSE 100 (UK)	6,084	-2.54	-4.36	-2.54	-9.86	-1.04	0.74	0.55	2.44
Hang Seng (Hong Kong)	19,683	-10.18	-13.06	-10.18	-19.68	-6.04	-3.44	2.25	2.79
Nikkei 225 (Japan)	17,518	-7.96	-8.20	-7.96	-0.88	16.29	11.34	0.51	-0.86
Bond Yields		3 Months		5 Years		10 Years		30 Years	
Government of Canada Yields		0.45		0.68		1.22		2.03	
U.S. Treasury Yields		0.32		1.33		1.92		2.74	

Canadian Bond Indices ($CA) Total Return	Index Level	1 Month	3 Month	YTD	1 Year	3 Year	5 Year	10 Year
FTSE TMX Canada Universe Bond Index	998.72	0.39	1.63	0.39	-0.67	4.02	4.98	5.14
FTSE TMX Canadian Short Term Bond Index (1-5 Years)	690.99	0.22	0.72	0.22	0.87	2.54	2.80	3.87
FTSE TMX Canadian Mid Term Bond Index (5-10)	1098.00	0.59	1.72	0.59	0.74	4.80	5.90	5.94
FTSE TMX Long Term Bond Index (10+ Years)	1560.70	0.47	2.84	0.47	-3.60	5.48	7.80	6.69

Sources: TD Securities Inc., Bloomberg Finance L.P. TR: total return, PR: price return. As at January 31, 2016.

Appendix A

Important information

The information has been drawn from sources believed to be reliable. Where such statements are based in whole or in part on information provided by third parties, they are not guaranteed to be accurate or complete. Graphs and charts are used for illustrative purposes only and do not reflect future values or future performance of any investment. The information does not provide financial, legal, tax or investment advice. Particular investment, trading, or tax strategies should be evaluated relative to each individual's objectives and risk tolerance. TD Wealth, The Toronto-Dominion Bank and its affiliates and related entities are not liable for any errors or omissions in the information or for any loss or damage suffered.

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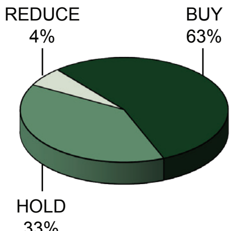

Percentage of subject companies under each rating category—BUY (covering Action List BUY, BUY and Spec. BUY ratings), HOLD and REDUCE (covering TENDER and REDUCE ratings).
As at February 1, 2016.

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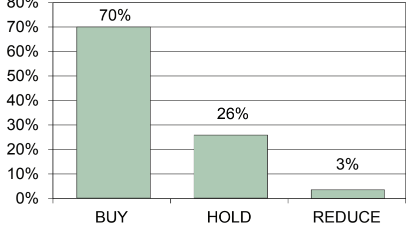

Percentage of subject companies within each of the three categories (BUY, HOLD and REDUCE) for which TD Securities Inc. has provided investment banking services within the last 12 months.
As at February 1, 2016.

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