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Gestion de portefeuilles / Portfolio management

La voie des Alizés

Navigating the Trade Winds

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In this edition:

- ***An emotionally-filled volatile quarter for the stock markets;***
- ***The impacts of the Chinese slowdown and the Fed's inaction;***
- ***A healthy correction within a bull market.***

Dear clients,

It goes without saying that investors experienced the spectrum of emotions during the 3rd quarter, with the Canadian stock market down 8.6%. South of the border, the S&P 500 registered a loss of 6.9% while overseas markets recorded a drop of 9.5%. The highlight of the quarter is without doubt the return of volatility and the general market's deepening angst. Yet the question remains what are the factors behind this new environment? It is our opinion that the market's difficulty in ascertaining the Federal Reserve's intention is the predominant factor. Notwithstanding, we also contend that this general retreat represents a correction that is part of the regular transition process inherent to a bull market. It is normal to observe a spike in volatility before the passage to the second phase in the cycle.

		Closing	Change	
		30-Sep-15	Quarter	YTD
Stock Indices		**30-Sep-15**	**Quarter**	**YTD**
S&P/TSX		13,307	-8.6%	-9.1%
S&P 500		1,920	-6.9%	-6.7%
MSCI EAFE*		956	-9.5%	-3.1%
Currencies				
CAN$ (US$ / C$)		0.7510	-6.2%	-12.7%
Euro (US$ / EUR)		1.1177	0.4%	-7.6%
Commodities				
Oil (WTI)	$	45.06	-24.2%	-15.7%
Gold	$	1,113	-4.7%	-6.1%
Volatility index				
VIX		24.50	30.0%	1.3%

** MSCI Europe, Australiasia and Far East*

Going back into time we can reach interesting conclusions on similar episodes. The history of the S&P 500 since 1928 indicates that two thirds of market corrections beyond 10% stop before the 20% level – the start of a bear market. The average correction is 14%, which is a level similar to the actual 12% correction from peak to trough. An interesting fact is that from the experiences from 1998 to 2011 the market had corrected severely on the 3rd quarter only to rebound in the final stretch of the year. We don't exclude this possibility for the 4th quarter, a quarter that is historically more favorable to stock markets than the 3rd.

What makes our current situation particular is that the U.S. economy is having its best growth in almost a decade. Let's now examine two factors which contributed to market anxiety: China and the Federal Reserve.

On China
Although slowdown of the Chinese economy and the ham-fisted policy from the authorities remain major concerns for the globe, we also believe that the underlying economic situation doesn't look nearly as bad as markets appear to assume when looking at the fundamentals of the second largest economy. While questioning themselves on the slowdown, investors aren't giving sufficient importance to what advanced economic indicators are suggesting – that the Chinese economy is transitioning to a stabilization phase wherein spending and imports play more important roles. Recall that China has accumulated massive reserves over the years, of over $300 billion. With that large a piggy bank, it is safe to presume that Chinese authorities have enough fuel to stimulate the economy if need be.

On the Fed
It is routine that a monetary tightening cycle is accompanied by heightened volatility. Three weeks after the Fed's decision not to increase the overnight rate it seems clear that the no-move and dovish stance have backfired. Far from soothing markets, the inaction has generated additional uncertainty over the policy path. We believe that it's been a few months since a rate hike is already baked-into market expectations. However, by signaling an increase in the interest rate it seems that the Fed has painted itself into a corner. In order to retain its credibility we believe that we will see a first rate hike later this year. Once the hike is announced we should see a dissipation of uncertainty in the context that the Fed's message is clear concerning its future intentions.

Canadian monetary policy
The situation on the Canadian side is completely different since we have just gone through two consecutive rate cuts this year alone. While Canada might be in a technical recession there is plenty of evidence that the drop in activity is almost exclusively in the oil-producing regions. Moreover, in the last two months we have seen a strong improvement in growth numbers. In other words, we don't believe that Governor Poloz will feel the need to cut the overnight rate to stimulate the economy. Our bond portfolio is invested accordingly.

Conclusions and perspectives
Despite recent volatility in the financial markets we continue to believe that we are going through a healthy correction inherent to a bull market. Market valuations are far from excessive and allow a continuation to the current upwards cycle. Thus, our base case scenario allows us to believe that stocks will make interesting gains in the next 12 to 18 months. However, more heightened volatility episodes could surge in the short term. For this reason we continue to privilege diversification in quality stocks and we avoid speculative stocks such as biotech and tech stocks that have not reached their breakeven point.

Truly yours,

The Alizé Capital Team