August 2016

Dog days of summer

Markets over the month were characterized by tight trading ranges and low volumes, conditions indicative of a general lack of conviction. The S&P/TSX Composite Index was the top performing developed market (+0.7%), not surprising given oil's performance (+3.0%). The S&P 500 followed behind Canada's main market (+0.1%) but barely registered gains ahead of broader international equities (-0.1%). Emerging markets delivered strong performance (+2.9%) over the month and remain at the top of the performance list on a year-to-date basis. While US markets hang at all-time highs, prevailing winds do not give the sense we're in a bull market. The combination of weak fundamentals and expensive valuations co-existing with a probable interest rate hike in 2016 has left investors wondering if markets can continue to march higher.

While the majority of investors remain unconvinced about this rally, August's decent performance (normally the weakest month of the year with average returns of -1.3% over the past 20 years) could be taken as a sign of good things to come. Those in the bull camp remain steadfast in their belief that corporate profits have bottomed and will begin re-acceleration in the coming quarters. And after 5 consecutive quarters of negative revenue and EPS growth, we may very well be at the bottom. Analysts that cover individual stocks collectively forecast year-over-year EPS growth of 24% in the first 6 months of 2017. This seems like a high hurdle rate however and represents a potential disappointment for the market. Still, should companies deliver on these expectations, the 'E' in the price-to-earnings ratio will rise, offering a nice discount to stocks giving markets a new sense of direction.

In terms of the bear camp, key concerns include uncertainty surrounding the US election, unknown effects of the Brexit vote and impacts from a potential rate hike in the US. Adding to the uncertainty, equity strategist's price targets (normally a bullish lot) for the S&P 500 remain below current levels. And we've only seen bearish estimates from strategist Wall St. handful of times over the past 10 years so it makes us wonder do they know something we don't? Interesting to note however, these bearish views over the past decade have only proven to be good buying opportunities, so any bearish sentiment from the analyst community should be taken with a grain of salt. And while valuations remain expensive versus historical levels, the current 18.5x price-to-earnings ratio may not be as expensive as it appears when compared to corporate bonds.

While we recognize markets are not without their risks, trying to time turning points in the market can prove to be a near impossible task. Instead we prefer to wait for a confirming trend to take hold, a trend that we have yet to detect. Based on this, our equity and bond exposures in the Active Balanced Portfolios remain in neutral position relative to our long term strategic targets. In terms of our equity exposure, we maintain a relative underweight in Canada offset by a relative overweight in the S&P 500. As well, we are currently utilizing low volatility ETF's to help protect to the downside should markets shift into risk-off mode.