Quarterly Insights

INDEX WEALTH MANAGEMENT

Economic & Investment Outlook

September 30, 2015

Moderate Global Growth

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While China Seeks Balance

The global economy continues to advance at an uneven pace. While some developed economies are attempting to normalise monetary policy, China is attempting to rebalance its economy to increase domestic consumption. These divergent economic policies are increasing volatility across all financial asset classes.

Canada experienced two quarters of negative growth in the first half of the year to confirm a "technical" recession. A swift drop in oil prices weakened business spending to overwhelm an otherwise stable economy. However, recent indicators confirm that the worst appears to be over for the Canadian economy.

Canada's June export growth surged by a record 6.3%, which offset all the declines from the first five months of the year. Retail sales rose 0.5% in July, which marked the third consecutive monthly gain. Manufacturing began the third quarter on a strong note, rising by 1.7% in July.

Our economy added jobs in both July and August, confirming a continued increase in hiring. Despite the slowdown in the first half of the year, the total number of jobs created so far in 2015 is over 100,000.

We expect continued growth for the remainder of the year, as exports and consumer spending continue to advance.

The Eurozone economy grew in the second quarter more than initially reported. Driven by increased exports and consumer spending, gross domestic product rose 0.4% in the second quarter after expanding by a revised 0.5% in the first quarter.

The Eurozone jobless rate is receding, as it fell to 10.9% in July. This is the first decline below 11% in more than three years.

The US economy grew by a faster than expected 3.9% pace in the second quarter, gaining momentum after a moderate start to the year. Economic indicators also remain strong leading into the third quarter.

US construction spending in July climbed to its highest level in more than seven years, boosted by the increased building of houses, factories and power plants. In August new auto sales accelerated to a decade-high annualized rate of 17.8 million units, while consumer spending rose for the sixth consecutive month. Purchases of new homes also jumped in August to a seven-year high, as Americans took advantage of historically low mortgage rates.

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Economic & Investment Outlook cont'd.

Companies are continuing to hire new workers. US payrolls have expanded by nearly 3 million positions in the past year. The jobless rate has now fallen to a 7½-year low of 5.1%.

The US Federal Reserve has stated that it will likely be appropriate to raise the target range for the federal funds rate sometime later this year. This rate has remained near zero since December 2008 and it has been more than nine years since the last rate hike.

To place greater perspective on how unusual the current level of interest rates are, the last time the US jobless rate was 5.1% (May 2005), the Federal Reserve was a year into a tightening cycle and the federal funds rate was three percentage points above where it stands today.

With current inflation at a historically low level, the effectiveness of extremely low interest rates as a tool to stimulate demand has diminished.

In fact, such rates may actually now pose a risk to economic stability by distorting investment decisions and encouraging the accumulation of larger debt loads.

Financial Markets

Despite improving economic performance in North America and Europe, global financial markets were very weak in August and September, recording the worst quarterly performance since 2011. Third quarter returns in local currency terms for world equity markets were:

Country	Index	2015 Q3 Returns
Canada	S&P/TSX	-8.56%
United States	S&P 500	-6.94%
United States	NASDAQ	-7.35%
United Kingdom	FTSE 100	-7.04%
Japan	Nikkei	-14.07%
France	CAC 40	-6.99%
Germany	DAX	-11.74%
Hong Kong	Hang Seng	-20.59%

Financial Markets cont.

Financial markets have a long history of underreacting for extended periods to new developments, only then to abruptly change course and overreact. The performance of the Dow Jones Industrial Average on August 24th is a prime example.

In the first 90 minutes of trading, the index travelled more than 3,000 points in a downward and upward move. At the close of trading, the index had traversed 4,900 points making it the largest intraday point swing on record.

What was the cause of such a dramatic reaction in financial markets? The majority of the financial media simplistically linked the recent poor performance of Chinese equities as the catalyst for the declines experienced in other major markets. However, we believe that it was a mix of interrelated factors: an unexpected devaluation in the Chinese currency in early August heightened concerns about a slowdown in the Chinese economy, commodity prices reached multi-year lows and increased expectations about the probability of the first rate rise by the U.S. Federal Reserve since 2006.

Financial markets are complicated environments. They are driven by the combined sentiments and opinions of all investors. Optimism precipitously changes to pessimism, only to reverse suddenly once again. There is rarely a single cause that can change the behaviour of all market participants.

However, history has shown that the outlook eventually improves. Reviewing the six other times the Dow Jones Industrial Average declined by 10% in four days like it did in August, in each of those periods the market reached higher price levels within a year.

The Bottom Line

The global economy is undergoing a period of more turbulent cross currents while producing modest economic growth.

Recent equity volatility has been extreme, and it was preceded by similar volatility in currency, commodity and fixed income markets over the past eight months. Divergence in global monetary policies and the unintended consequences of previous quantitative easing programs are having unprecedented effects.

However, we expect that once the normalization of US monetary policy begins, it will remove some of the uncertainty influencing equity markets and lead to an unwinding of pricing anomalies that have occurred in fixed income markets over the past six months.

Most global equity markets have now experienced two consecutive quarters of negative returns. The decline in prices has improved valuations. We will continue to use market volatility and analysis of relative valuations to benefit client portfolios for the longer term.

The Curious Case of Chinese Equities

The Chinese economy is the second largest in the world, behind only that of the US. It is the leading consumer of energy and industrial metals, and last year it represented 38% of total global economic growth. Without a doubt, Chinese economic developments are important to the global economy.

Although there are legitimate concerns about the effects that a slowing Chinese economy may have on the outlook for world economic growth, using the performance of a Chinese stock market index as either a leading indicator of domestic economic growth, or as a primary explanation for volatility occurring in other major financial markets, is fraught with error.

The largest equity exchange in China is the Shanghai Stock Exchange. This exchange is not entirely open to foreign investors due to capital controls that limit trading to a certain class of shares and in a restricted amount.

The Shanghai Composite Index is viewed as a proxy for the performance of Chinese equities. The index grew 150% from June 12, 2014 to June 12, 2015. Since then it has declined over 40%, including two single day declines of more than 8%, on July 27th and August 24th.

This volatility prompted numerous government efforts to stabilize prices including: cutting benchmark interest rates, reducing bank reserve requirements, further loosening margin restrictions, implementing trading halts and even direct government purchases of stocks. Once it became clear that these efforts had done little to change investor behaviour, the securities regulator announced it would begin to investigate certain individuals they identified as being “responsible” for the market decline because of manipulation.

This unpredictable performance of the Shanghai Composite Index was also routinely attributed by our financial media as the cause for much of the volatility that occurred in global equity markets in August. But is the performance of the Shanghai Composite Index actually that influential for other global financial markets?

Goldman Sachs estimates that 80% of the trading volume on this exchange is derived from individual Chinese investors and government sponsored entities that pay little attention to corporate fundamentals. Additionally, these investors are highly leveraged. By Goldman Sachs’ estimate, a 30% loss in the Shanghai index should translate into a 60% loss to the average Chinese investor. Therefore, as market prices drop, investors are forced to sell shares to cover loans which cause additional selling. This type of broad-based, highly leveraged investing is not common among individual investors in developed markets.

Although the recent price volatility is large, it is far from being unprecedented. Since the index began trading in 1990, its history has been marked by extreme swings. There was a 500% gain between mid-July 2005 and a peak in October 2007. This was followed by a decline of 72% through to November 2008. The index then advanced 100% in less than a year from the 2008 low, only to drift downward more than 40% over the next five years.

Historically, the Shanghai Composite index has not had a directional link with major global equity markets. According to data from Bloomberg, the average 120-day correlation between the Shanghai Composite and the US S&P 500 index over the past five years is less than 0.1, which implies no relationship at all.

When Chinese share prices almost tripled over the past year, they no more reflected a marked improvement in China’s economy than their recent decline reflects a sudden deterioration. Previous market advances have done little to boost consumption by Chinese consumers and we expect that the recent decline should have a similarly muted effect on spending.

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