Market Insights

Portfolio Advice & Investment Research

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Equity Market Correction At Hand

Equity markets have been under pressure in recent weeks and volatility has increased as worries about the outlook for global economic growth, geopolitical tensions, the looming end of quantitative easing (QE3) and the uncertainty over the timing of rate hikes from the U.S. Federal Reserve (Fed) weigh on investor sentiment. From tensions in the Ukraine and military intervention in the Middle East, to the expansion of the Ebola outbreak and fears of European recession and slowing growth in China, investors are confronted with a deluge of issues and concerns that have been sufficient to stem the market's upward momentum.

After continually defying expectations and reaching new all-time highs in early September the S&P/TSX Composite Index (S&P/TSX) is now down 11.4% from its high, while the S&P 500 Index (S&P 500) is down 7.4% from its high in native currency terms. Despite their recent declines, both the S&P/TSX and the S&P 500 are in positive territory for the year.

Table 1: S&P/TSX Composite and S&P 500 Sector Returns

S&P/TSX Composite Sector	Percentage Change from Peak (09/03/2014)	Percentage Change YTD	S&P 500 Sector	Percentage Change from Peak (09/18/2014)	Percentage Change YTD
S&P/TSX ENERGY INDEX	-19.40	-3.89	S&P 500 ENERGY INDEX	-13.64	-9.25
S&P/TSX MATERIALS INDEX	-13.57	-0.93	S&P 500 MATERIALS INDEX	-10.01	-1.64
S&P/TSX INDUSTRIALS IDX	-6.05	11.74	S&P 500 INDUSTRIALS IDX	-8.09	5.29
S&P/TSX CONS DISCRET IDX	-8.48	6.93	S&P 500 INFO TECH INDEX	-7.78	-5.52
S&P/TSX FINANCIALS INDEX	-10.24	9.11	S&P 500 CONS DISCRET IDX	-8.11	-4.55
S&P/TSX INFO TECH INDEX	-3.44	0.55	S&P 500 HEALTH CARE IDX	-6.74	9.01
S&P/TSX TELECOM SERV IDX	-1.67	19.92	S&P 500 FINANCIALS INDEX	-2.06	3.51
S&P/TSX UTILITIES INDEX	-4.13	3.70	S&P 500 TELECOM SERV IDX	1.28	12.43
S&P/TSX HEALTH CARE IDX	-5.22	-0.63	S&P 500 CONS STAPLES IDX	-3.89	-0.78
S&P/TSX CONS STAPLES IDX	-8.28	2.97	S&P 500 UTILITIES INDEX	-7.27	0.70
S&P/TSX COMPOSITE INDEX	-11.42	1.82	S&P 500 INDEX	-7.40	0.76

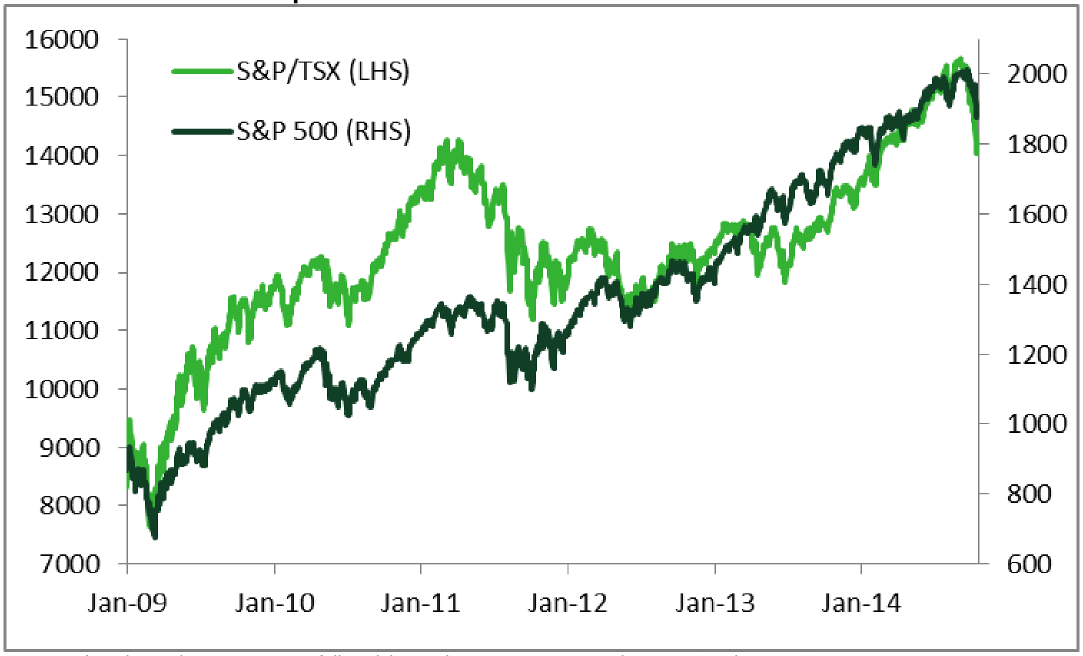
Source: Bloomberg Finance L.P., Portfolio Advice and Investment Research. As at October 15, 2014

The S&P/TSX has experienced a more severe decline from its recent peak due to its higher weight in the energy and materials sectors. Commodity prices, in particular oil, have been under significant pressure. U.S. dollar strength has been a key catalyst for the decline, as commodity prices tend to exhibit a strong negative correlation with the U.S. dollar. When the dollar strengthens against other major currencies, the prices of commodities often drop.

Over the past few years volatility has been extremely low as markets moved steadily higher. The changing of the season has brought on a bout of volatility, with the VIX Index recently spiking up to levels last seen in December 2011.

Investors should not lose sight of the fact that equity markets were steadily climbing higher and had not experienced any meaningful pullback since December 2011 and October 2013, respectively. For perspective, the S&P/TSX is up roughly 11% since the beginning of 2013 and up more than 82% from the March 2009 lows. The S&P 500 has risen more than 29% since the beginning of 2013 and is up over 172% from its global-financial-crisis lows.

Chart 1: S&P/TSX Composite and S&P 500 Index Levels



Source: Bloomberg Finance L.P., Portfolio Advice and Investment Research. As at October 15, 2014

While we are unable to predict the future, we would not be surprised to see equity markets continue to come under pressure and the recent volatility to persist in the near term. However, at this stage we do not believe it will mark the beginning of a bear market.

There are positives out there. North American growth, while moderate, remains supportive for equity markets. Recent earnings releases and guidance from major U.S. firms have on balance been positive. Earnings expectations for the U.S. and Canada are constructive with consensus growth estimates of roughly 10 percent for the S&P 500 and 13 percent for the S&P/TSX over the next 12 months. Equity market valuations are not unreasonable. At 14.0x forward earnings estimates, the S&P 500 is trading below its long-term average of 15.5x. The S&P/TSX is trading at 13.3x forward earnings, compared to its long-term average of 15.1x.

The interest rate environment remains supportive. Government bonds have performed very well of late, with U.S. Treasury and Government of Canada bond yields testing new 2014 lows. Government bond prices, which move in the opposite direction to yields, have been pushed higher by the flight to quality bid. 10-year U.S. Treasury prices have risen almost five percent over the past month. The increase in bond prices has helped to offset some of the declines in equity prices in balanced portfolios, illustrating the importance of constructing well-diversified portfolios with a combination of equities, fixed income and cash.

Although the U.S. Federal Reserve (Fed) is systematically unwinding its QE, monetary policy remains accommodative. It is important to remember that the Fed's decision to end QE and expectations for an increase in the Fed Funds rate (which is not expected until later in 2015) are positives in that it suggests that the U.S. economy is healthy enough to grow without excessive monetary policy stimulus.

During these periods of volatility, investors should focus on their long-term investment plan rather than the short-term market movements and noise in the marketplace. It is difficult to predict the duration and magnitude of a market correction, but a well-constructed diversified portfolio with a combination of equities, fixed income and cash that reflects their long-term investment goals and risk tolerance can help investors sleep at night when these events occur.

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