Market Comment

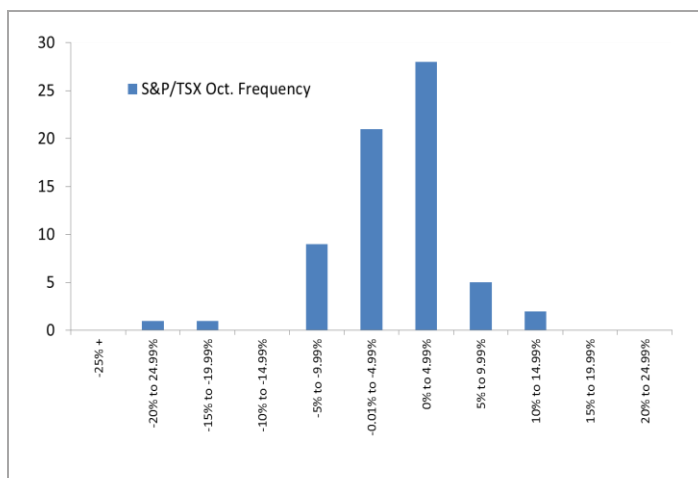
PRIVATE CLIENT SOLUTIONS

November 1, 2018

Nightmare on Bay Street

Equity markets are off to a rough start in Q4, following a challenging Q3 (excluding the US markets). The MSCI World Index as of October 30th was down 8.4% and has wiped out US$4.5 trillion in market value in just one month of trading. We expected an increase in market volatility this year as monetary liquidity conditions continued to tighten; however the selloff this October has been more dramatic than anticipated. That said, October does have a reputation of being a difficult month for equity market returns, experiencing some of the largest single daily moves in history. Of course, October returns are skewed as both the S&P/TSX and S&P 500 have experienced two 15%+ corrections over the past 6 decades. Additionally, October has tended to be particularly more difficult for the S&P/TSX compared to the S&P 500. Considering data since 1951, the S&P/TSX has experienced a negative return 48% of the time, while the S&P 500 has experienced a negative return 40% of the time. Putting this month's performance into perspective, the correction experienced thus far falls between a 1- to 2-standard deviation move, so it's unusual, but not an extreme reading.

S&P/TSX Historical October Returns



Source: Bloomberg, Raymond James Ltd.

This round of volatility can be attributed to a couple factors: weaker economic growth in China and concern surrounding emerging markets, trade protectionism impact on investor sentiment, US longer yields rising too fast over a very short period of time and the uncertainty surrounding the US mid-term elections.

China & Emerging Markets

Ironically, the strength of the US economy has created difficulties for emerging markets. As the US Federal Reserve continues on its path of normalizing interest rates, the US dollar has strengthened creating headwinds for countries that have dollar-denominated debt. Over US$200bln of USD-denominated bonds and loans, issued by emerging market governments and companies, will come due during the remainder of 2018, and about US$500bln will come due in 2019. The stronger dollar makes it harder to service the debt and puts additional strain on government finances.

Additionally, upward pressure on US interest rates has forced other central banks around the world to follow the Fed. This tightening cycle is occurring at a time when the world's second largest economy, China, is experiencing an economic slowdown. One can see this deceleration by looking at China's GDP which grew at its slowest pace since 2009.

China GDP +6.5%; Slowest Pace Since 2009

Source: Bloomberg, Raymond James Ltd.

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The US trade measures have put additional strain on the Chinese economy. This year the Trump administration has imposed tariffs on US$250 bln in trade with China (the tariff rate that took effect in September is also due to increase on January 1, 2019). In addition, Trump has threatened to impose tariffs on the remaining goods imported from China, which last year were worth US$505 bln, if talks between Trump and Chinese President Xi next month fail to make any breakthroughs.

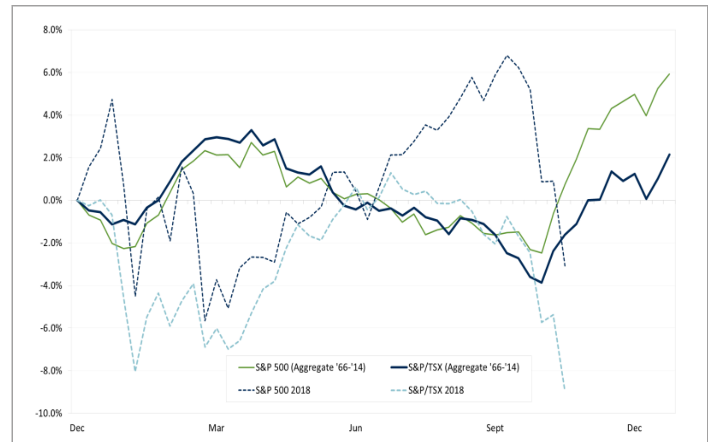
In response, Chinese officials have offered limited stimulus to their economy by lowering the reserve requirement ratio, weakening the currency, infrastructure spending and more recently a proposed tax cut to revive the flagging automotive market (China made a similar car-purchase tax cut in September 2015, the last time the Chinese economy experienced a material slowdown). Following a weaker-than-expected PMI print this week, the government signalled that further stimulus measures are planned to address the situation. We anticipate Chinese officials will announce these additional steps to spur economic growth in December at the Annual Economic Work Conference.

Mid-term election

Markets dislike uncertainty and this year's US mid-term elections are certainly adding to market anxiety. It appears there is a high potential for the House to flip from Republican to Democrat, while the Republicans will retain the Senate. Earlier in the year, there had been speculation that the Republicans would lose control of both, which they have held since 2015. Despite needing to gain only two more seats for a majority, current polling show the chances of a Democratic Senate appear remote.

From a market perspective, regardless of the party in power, the general trading pattern during mid-term years has been a choppy one, followed by a year-end rally to new highs. However, mid-term election years have a reputation for being the worst of the four-year presidential election cycle. Since 1872, the average return for the S&P 500 during the mid-term years is +4.1%, below the average for the remaining three years of the presidential cycle. One contributing factor to the recent bout of market volatility is the potential for the House of Representatives to flip (Republican to Democrat), which historically has not been a good outcome for the markets. The combination of a Republican President, Democrat controlled House and Republican Senate has produced below average market returns, but there have been very few instances of this combination occurring.

Mid-term



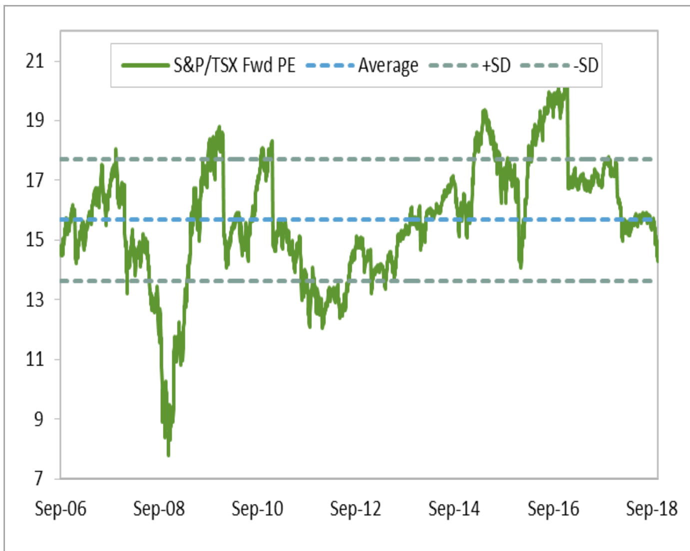
Source: Bloomberg, Raymond James Ltd.

Reasons for Optimism

From our perspective, we remain constructive on equities and believe there is the potential for a powerful relief rally to occur over the next 3-6 months. The global economy remains on a firm footing even though growth has slowed from elevated levels and there is limited evidence to suggest the US is heading towards a recession over the next 12 months. As we look forward, we point to a few reasons to remain constructive:

- US corporate buybacks are set to resume this week after earnings-related blackout periods begin to expire. According to Factset, corporate America will be freed up to buyback an estimated ~US$110 bln in stock this week and rise to US$145 bln next week. Given the US market is off ~10% this month and valuation levels look particularly more attractive, we anticipate healthy demand from buybacks in the coming weeks.
- Valuation levels are more attractive. The recent rout in equities has improved overall valuation levels for a number of markets. We believe the correction is nearing a bottom as investors will refocus on the strength in corporate earnings. S&P 500 12 month forward earnings estimates have held up well over the past 4-weeks, slipping just 0.3%, indicative that the selling has more to do with sentiment and positioning rather than an actual deterioration in the fundamental outlook. We do contend the path forward will not be as easy as in the past since the rate of earnings growth has likely peaked, but earnings remain strong.

S&P/TSX Valuation More Compelling



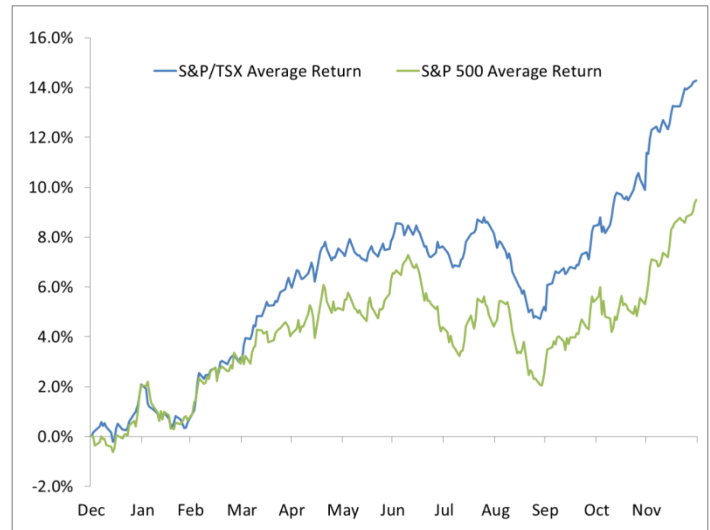
Source: Bloomberg, Raymond James Ltd.

- Investor sentiment is near lows seen before the 2016 US election, which from a contrarian perspective is positive for the markets. Investors Intelligence reported bulls fell to 44.3% in week-ended October 30th from 50.5% a week ago and 61.8% at the end of September.
- Conclusion to the midterm elections next week will provide certainty for the markets. Historically, markets have tended to outperform through year-end following the conclusion of the election.
- Expectations for a US-China trade deal are very low, so any breakthroughs could deliver an upside surprise.

Canada

- Fall fiscal update. We anticipate Finance Minister Bill Morneau will announce business-friendly policies, such as allowing businesses to deduct capital investments in order to address competitiveness challenges faced by corporate Canada due to US tax reform.
- Hot and cold. Should the US market finish the year in positive territory and the Canadian market closes in the red, then history suggests Canada should perform well in 2019. Considering historical returns since 1930, the S&P/TSX has finished negative six times when the S&P 500 finished positive or flat. During these years, the average returns for the S&P 500 and S&P/TSX were +7% and -5%, respectively. In the following year, the S&P/TSX gained an average of 14.5%, while the S&P 500 gained 9.4%

Mixed Markets: S&P/TSX Setting Up For a Good Year



Source: Bloomberg, Raymond James Ltd.

- Oil differentials. We anticipate the WCS/WTI differential to ease over the coming months as US refiners come back on line (~1.3 mln barrels a day of US Midwest refining capacity will resume in the coming weeks) and Canadian railway increase oil-by-rail capacity. We also highlight differentials tends to experience "v-shaped" recoveries after reaching extreme levels. Looking a few quarters out, Enbridge Line 3 replacement will increase capacity to the US in late 2019 and TransCanada Keystone XL construction should also begin in 2019.

WCS/WTI Differential V-Shape Recovery

Source: Bloomberg, Raymond James Ltd.

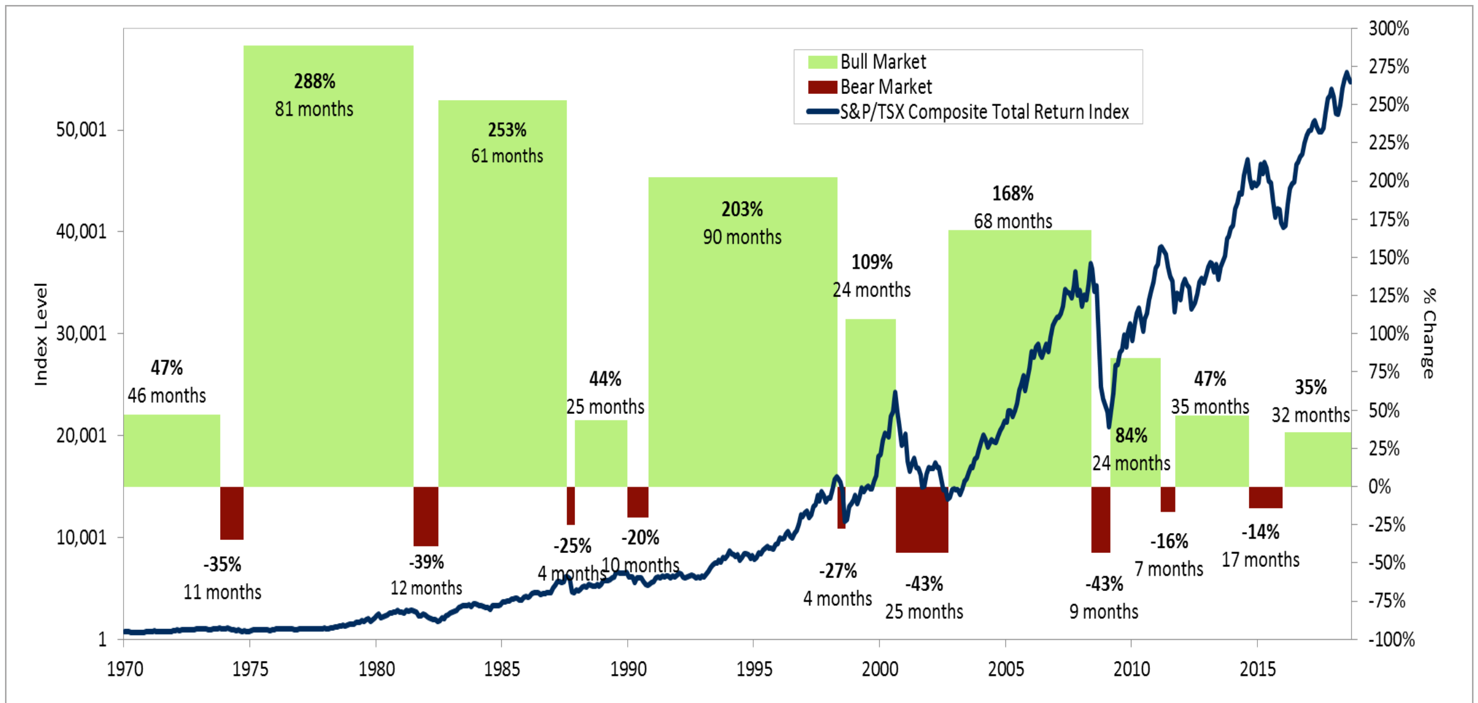
Taking a Step Back

During periods of volatility, it's important to take a step back and look at the bigger picture. Equity markets are prone to corrections and can even temporarily slip into bear markets within the context of a secular bull market. What is key to remember is that:

1) bear markets tend to be shorter in duration and magnitude than bull markets;
2) bull markets always follow bear markets, with equity prices recovering from previous downturns; and
3) over the long run, equities provide investors with solid returns, enabling then to achieve their financial goals.

These points are illustrated in the chart below. Note how the bear markets (in red) are shallow in duration and magnitude relative to bull markets (in green), and note the long-term upward trend of the S&P/TSX. While the S&P/TSX goes through these up and down cycles, over the long run, it has returned roughly 10% on average, including dividends, per year.

Canadian Bull and Bear Markets



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