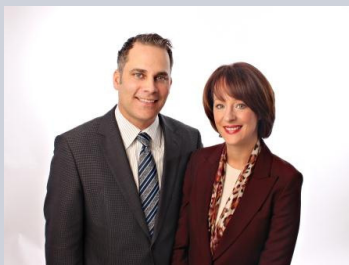


# Johnston Journal



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for the clients and friends of

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## Falling Financial Markets



World wide stock markets have been giving investors a volatile ride this month. As of today's date, the US S&P 500 is now in "correction" territory, down 11% and Canadian equity markets have declined further still, down 15%.

### Why are markets down?

There are several reasons markets have reacted strongly.

#### Chinese growth

- On Friday, China posted the weakest manufacturing data since 2009.
- The Chinese economy normally generates about 30% of global growth.
- The Chinese economy is also quite geared to commodity prices including the price of oil. China is in a multi-year transformation. This will take time.

#### Chinese stock market

- Chinese equities have been extraordinarily volatile for several months and this may be spooking investors.

Until today, markets were disappointed we hadn't seen enough of a response from Chinese policy makers. Today, the People's Bank of China has made two policy moves to shore up financial markets. China announced it will cut the amount banks must hold in reserve by 50 bps for all commercial banks and rural banks will get another 50 bps cut. This is the third reserve cut this year and it will probably be effective at supporting both liquidity and growth by liberating additional bank funds for other purposes.

China also cut lending rates by 25 bps to 4.6%, it's fifth interest rate cut since China's easing cycle began.



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# Falling Financial Markets (con't)

## Technical factors

- The S&P500 was long overdue for a 10% correction.
- Market internals have been poor for quite some time with low market participation.
- Historically, in the year preceding the US presidential election, equities have experienced a median correction of 11% since the 1940's, with the past four cycles seeing a drawdown in the range of -10% to -19%.

## Is this a bear market or a temporary dip?

There are arguments to be made for both sides and it remains to be seen if the glass is half empty or half full.

### Bear Scenario: markets decline substantially further

- The US Federal Reserve move to raise rates in September would hurt markets in this fragile state.
- Chinese growth is worse than it looks with big credit/equity market problems.
- The pain from low commodity prices may be worse than conventional economic models argue.

### Base Case Scenario: markets rebound

- Stocks are now attractively valued
- Sentiment readings are at rock-bottom levels. This is usually a sign that markets are oversold.
- It appears unlikely the US Federal Reserve will raise rates in September and will proceed carefully later in the year
- Chinese growth is slowing. The policy decisions implemented this week will stimulate growth later this year and into 2016.
- Growth is ok in Europe and will continue to expand at a familiar pace relative to this year.

### Bottom Line

Markets appear more likely to rise than fall from here, but timing bottoms is never easy and there are still multiple vying scenarios. At current valuations, it is a reasonable time to start allocating a portion of portfolio cash.



## Why are Preferred Shares Getting Hit Hard?

The preferred shares market has been in decline ever since the view on Canadian interest rates changed. The majority of preferred shares issued since 2008 have been rate reset series. With interest rates falling, this makes the future interest rate lower on the preferred's reset date. Preferred shares are an illiquid market which is out of favour right now. When there is selling with few buyers, prices plummet. Also not helping the preferred share market has been new issuance of shares which feature superior reset levels. We believe sometime later this year or early next year, preferred shares will be very attractive to investors since we can pick up yields of 5.50% in this ultra-low yield environment. We do expect preferred shares will be candidates for tax loss selling in November/December so we recommend investors be patient and tactical in adding new preferred shares to their portfolios.

## Feeling Concerned About the Drop in Portfolio Value?

Investors will be receiving the August 31st statements shortly and after this summer's market correction, it is important for each investor to realize that it's normal for the stock market to sell off sharply and severely from time to time and it's also common for it to rally for long periods of time. The magnitude of these moves often defies expectation.

We have not experienced a bear market (-20% drop) in North American stocks since March 2009. During that timeframe investors indexed to the S&P 500 saw the value of their investments more than triple. Up until this past week, there had been only one period of double-digit losses in that timeframe – four years ago. The problematic aspect of this recent period of consistently high returns with few drawdowns is that it appears to have impacted our expectations and made us feel accustomed to consistent gains.

This week served as a reminder that it's normal for the market to sell-off from time to time, sometimes severely. Up until the 1980s it was common to experience a double-digit drawdown in the market every couple of years or so. Since then, drawdowns have been less frequent, but losses have tended to be more severe.



Common stocks have an excellent track record of building long-term wealth, and have provided average annualized 30-year returns of 11%/year. However, investing in stocks and achieving these gains in the past has meant exposing oneself to the probability of suffering period severe losses and the feelings of regret that go along with them.

Losses can be painful, but with stocks, time bails you out. The problem is we're not programmed to think about it in such rational terms when we're in the thick of it.

If you have an 8-10 year time horizon, a major market drawdown should be viewed positively as they offer the opportunity to buy assets at lower prices. However, if you have less time, or a temperament where you can't accept large losses, you have to allocate something less than all your assets to the stock market. Since 1926, bonds have averaged a much lower 5.4% compound annualized return, but they never performed worse than -5% in any one calendar year. They also tend to perform pretty well when the stock market is doing poorly. The other advantage of bonds is they can be used to rebalance back into your target mix after an equity drop.

Now is a good time to consider whether you feel your stock market exposure is a fit for this time of your life and whether any rebalancing is necessary.

We always appreciate the confidence and trust you have in us to manage your portfolios. Please don't hesitate to call us or send us an email. We will always get back to you promptly to listen to any concerns you may have.

# How to Participate in Choppy Markets?



2% GIC doesn't have appeal and want to take advantage of the drop in markets without losing your shirt, consider one of these investment options.

(1) "Low Volatility" ETFs or mutual funds. Typically, an investor would only experience,  $\frac{1}{2}$  to  $\frac{1}{3}$  of the level of decline of broad market.

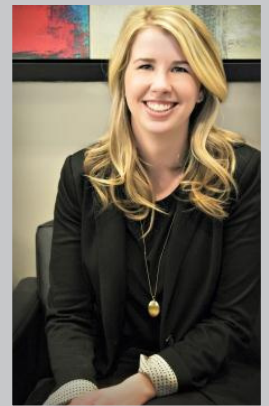
(2) Principal Protected Notes – RBC and other banks issue notes which have exposure to stocks markets and provide a full or partial guaranteed return of your capital. Typically the notes have hold periods of 3-10 years.

(3) Dollar-cost average into mutual funds. Investing on a weekly basis is a great way to benefit from volatile markets. There are a couple funds companies which provide the alternative for investors

## Team News

We are excited to announce Kim Balas, our assistant and her husband Jay are expecting their first baby in late November. We wish them both well at this exciting time.

To help us out with administrative duties while Kim is away on maternity leave, we are welcoming Nicole Killen to the team. Nicole is an experience assistant and we are happy she will be joining us on September 1st.



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