AUGUST 2015

Stormy Weather

A special report by the Portfolio Advisory Group

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RBC Wealth Management

Stormy Weather

Secular Bull Market Likely to Be in a Corrective Phase for Some Months, but We Still Like Long-term Set Up

Over the past several weeks, market volatility has increased meaningfully and many global equity markets have begun corrections of varying degrees. This has been accompanied by (and in some cases caused by) increasingly negative headlines from China and other emerging markets (EMs) and a sharp sell-off in commodities.

While we believe that this corrective phase could have more weeks to run, we also remain of the view that the secular bull market in stocks that began in 2009 still has significant room to run.

What Is Causing the Sell-off?

It would be folly to blame recent volatility on any one thing, as we believe there are several related issues weighing on investor sentiment:

- **Fed Tightening**: These tightening cycles have not historically been bad for stocks and, in fact, because they tend to speak to the strengthening of the U.S. economy, Fed tightening is often accompanied by continued equity market strength. However, periods of volatility are not uncommon as the market repositions for higher rates.
- **China Weakness**: China has undertaken a shift in its economy from one overly dependent on investment to one more balanced between investment and consumption. This shift has led to an expected slowing of the Chinese economy; however, markets have become concerned that Chinese growth has slowed too much and the economy is in danger of stalling. While this risk exists, we believe that the multiple levers China has at its disposal to stimulate its economy mitigate those risks and that China will continue to grow, albeit at a more-muted pace than recent years.
- **Commodity Sell-off**: The sharp decline in crude and most other commodities has spooked investors as it is viewed as an indicator that global growth and especially Chinese growth is dangerously low. While Chinese demand growth has slowed to be sure, we believe the bigger concern for most commodities is simply too much supply, which was built up over many years to position for a China growing at 10%+. Chinese growth is now about one-half that level, which has left a large supply overhang, which has trumped demand increases that we have started to see in the U.S. and even Europe.
- **Emerging Market (EM) Risk**: An EM typically struggles to adjust to changes in Fed policy. Add to this the sell-off in commodities and a slowing China and you have a potential toxic mix for an EM.

The U.S. Economy Remains on Firm Ground

While the above issues are near-term headwinds, we would continue to point to strong underlying fundamentals within the world's largest economy.

The U.S. continues to generate more than 200,000 jobs per month on average and has created nearly 12 million jobs over the past four years. Wage growth, which was elusive for much of the recovery, has also begun to underpin the jobs market, while the manufacturing sector continues to add jobs and grow at a steady pace.

Consumer balance sheets are in good shape with a rising savings rate. Furthermore, while interest rates may be poised to rise, they remain near historically low levels, and the cost of servicing debts remains very low. Add to this the sharp decline in gasoline prices, and consumers have a significant amount of dry powder.

The housing market continues to improve with Starts recently hitting six year highs. Stronger consumer balance sheets coupled with banks that are in good shape and increasingly willing to lend could provide a further tailwind for the economy—a tailwind that has been largely absent for much of the past decade.

Emerging Markets Bear Watching

As mentioned above, EMs are under a significant amount of pressure with some pointing to the current situation as a replay of the Asian Financial Crisis that took place in 1997 and 1998.

While it is beyond the scope of this piece, suffice it to say that a combination of persistent U.S. dollar strength, which has raised concerns that many EMs will have difficulty funding their external debts, and the collapse in commodities, which are central to the economies of many EMs, have placed significant pressure on EM economies, currencies, and markets.

The U.S. economy is very insulated and weakness in EMs is unlikely to derail the U.S. economy. However, negative headlines out of EMs may continue to weigh on markets globally.

Until such time that commodity prices find a bottom (many are trading at or below cash costs, which has often served as a floor in the past) and/or the U.S. dollar stabilizes, EMs are likely to continue to face significant pressure.

Canada: Some Signs of Recovery

The marked slowdown in the Canadian economy may be winding down as recent data suggests that a weaker Canadian dollar coupled with continued strength in the U.S. is beginning to stabilize the economy. That said, the Canadian economy has become reliant on oil and oil investment over the past 15 years, and the adjustment process to a marked downshift in oil-related investment will not be without bumps.

The U.S. Stock Market May Be Overdue

The S&P 500 has gone more than 1,400 days without a 10% price correction. While this is not unprecedented (there have been runs of more than 2,000 days), it is more usual for the market to experience a 10%–20% correction roughly every one to two years. These corrections often present good long-term buying opportunities as good businesses sell-off with the broader market.

Corrections of greater than 20% (i.e., bear markets) are almost always associated with U.S. recessions. We currently see U.S. recession risks as very low and thus believe that any corrective phase is likely to be just that—a correction, not a bear market.

Patience Is Called For

Historically, the stock market volatility around the first Fed rate hike lasts for two to three months in both the U.S. and Canada. That would suggest the market may spend much of the next few months correcting further or consolidating.

This year, we believe tax-loss selling will also figure into the mix. Some stocks, notably in the energy and commodity sectors, are down substantially from their peaks. There are also quite a number of stocks in other sectors that have retreated by a significant amount from highs posted earlier this year or last year. Many investors paid capital gains tax on profits realized last year or will have to pay next year. Similarly, mutual funds and hedged funds that have realized gains earlier in the tax year will be looking to offset those by realizing some losses.

Now that the correction is here, we expect it will eventually present opportunities to buy outstanding businesses at very attractive prices. However, the selling pressures that are providing that opportunity may not fully abate for some weeks or months yet.

Outlook

We believe the long-term secular bull market that began at the financial crisis lows of 2009 has further to run. This is the first correction of consequence for the S&P 500 since the 21% pullback in the teeth of 2011's European debt crisis. From the lows of that correction to the peak this May, the S&P 500 added approximately 1060 points or almost 100% over four years. In a correction, it would not be unusual to give back some of that advance while remaining inside the confines of a long-term uptrend that would eventually take the market to new all-time highs. We think we are in that correction phase.

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