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# STILL NOT OUT OF THE WOODS

A special report by the Portfolio Advisory Group

There's Wealth in Our Approach.™

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**RBC Wealth Management**

# STILL NOT OUT OF THE WOODS

The correction that began last summer may have been in hibernation for a while, but once again appears to be rearing its ugly head. We continue to believe that while this bumpy road may have some months left to run, the secular bull market that began in 2009 remains in place.

Back in August, equity markets worldwide came under intense pressure driven by collective fears over weakness in China, a continued decline in oil and other commodities, and an impending Fed rate hiking cycle. Soon after, markets appeared to find their footing. But in recent days, we once again appear to be in the midst of a sharp worldwide correction.

In August, we felt that the corrective phase was likely to drag on for some weeks or even months, but that the equity secular bull market that began in 2009 still had significant room to run.

We reiterate this view now.

## WHAT'S CAUSING THE SELLOFF?

Many of the same issues that plagued the market in August are continuing to act as an overhang::

- **China Weakness:** China has undertaken a shift in its economy from one overly dependent on investment to one more balanced between investment and consumption. While a subsequent slowing of the Chinese economy was expected, markets have become concerned that Chinese growth has slowed too much and policy has become unpredictable.

Ironically, we have seen some economic stabilization out of China since August with manufacturing and growth metrics no longer falling. However, the somewhat disjointed approach China has taken to weakening the renminbi and continued government intervention in domestic equity markets have become new areas of concern. While China has multiple levers at its disposal to stimulate its economy, we acknowledge that China's approach thus far has been uneven and authorities need to do more to stabilize both the economy and investor confidence in their approach to policy tools.

- **Fed Tightening:** Historically, Fed rate hiking cycles have not been bad for stocks. In fact, because it tends to speak to the strengthening of the U.S. economy, Fed tightening is often accompanied by continued equity market strength. However, bouts of volatility are not uncommon as the market repositions for higher rates. Back in August, we thought the first Fed rate hike would likely come in September and that there would be a period of volatility in the wake of this. Rather, the first Fed rate hike did not come until December, which may have delayed this period of volatility to the present time.
- **Commodity Sell-off:** The ongoing decline in crude oil prices has spooked investors as it is viewed as an indicator that global growth is slowing. We continue to believe that the larger problem for oil is too much supply (most measures of demand, especially those in developed economies, have been rising smartly) and is not indicative of a sharper global slowdown. In the near term, the return of Iranian barrels to the market is likely to act as an overhang. However, we believe as the year unfolds, supplies, which have already begun to decline in the U.S., are likely to peak and help to stabilize oil prices.



## 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. Further, 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 willing to lend could provide a further tailwind for the economy—one that has been largely absent for much of the past decade.

## EMERGING MARKETS BEAR WATCHING

Emerging markets (EMs) are feeling a significant amount of pressure with some pointing to the current situation as a replay of the Asian Financial Crisis of 1997–98.

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 several EM economies, currencies, and markets.

The U.S. economy is very insulated and EM weakness is unlikely to derail it, in our view. 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 remain under pressure.

## CANADA: CONTINUES ON AN UNEVEN PATH

The Canadian economy became overly 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. While we have seen some signs of stabilization in the Canadian economy, the recovery from the oil rout remains uneven and we expect continued bouts of low growth through the first half of 2016. Eventually, we think the benefits of a weaker Canadian dollar on trade and proposed fiscal stimulus from the newly elected government should help lift the economy onto a more stable path.

## OUTLOOK

Market volatility is not uncommon against a backdrop of uneven global economic fundamentals, (U.S.) national politics that are heavily influenced by anti-establishment movements, and a number of geopolitical threats. Add Fed rate hikes to the mix, which often leads to market accidents, and we believe this current episode of share price weakness may have some room left to run.

Often in such periods, the market will eventually reach a point where investors throw out the good with the bad. In our view, such a juncture is rapidly approaching. We would use this opportunity, not only to ensure that portfolios own the right businesses—those that have reliable and well-established management teams, high returns on invested capital, and a strong and defensible business—but also to gradually allocate capital to these businesses as they do not tend to go “on sale” that often.

Repeatedly over the past four years we have heard from investors that “if only the market pulled back, I would add some exposure.” But when these opportunities do come, investors are often scared off by the intense volatility that accompanies these pullbacks.

Back during the August/September selloff, this is what we said:

“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% pull-back in the teeth of the European debt crisis in 2011. 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 about a quarter of that advance while remaining inside the confines of a long-term up-trend that would eventually take the market to new all-time highs. That is where we think we are.”

We still do.

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