Volatility

QAM Perspectives – July 2015

Quadrant's regular newsletter that highlights topics we believe will affect markets or are important in understanding them.

"Forecasts may tell you a great deal about the forecaster; they tell you nothing about the future." - Warren Buffet

Quadrant Asset Management
Suite 720, One Lombard Pl
Winnipeg, MB
Ph: (204) 944-8124
email: inquiries@quadasset.com
web:www.quadasset.com

Q2 2015 in Review

The return of volatility was the name of the game for the second quarter of 2015.

The S&P/TSX Composite Index in Canada dropped by 1.6% over the quarter, with Technology, Industrial, and Utility companies posting the largest negative returns. The S&P 500 finished marginally higher in USD total return terms, but after the CAD currency conversion it translates into a loss of about 1.3%. The story is similar outside of North America, with both the MSCI EAFE and the MSCI Emerging Markets indices posting negative returns in CAD currency terms.

Uncertainty over the situation in Greece, the Chinese stock bubble and seemingly closer Fed policy rate hike were the main factors contributing to the risk-off attitude this past quarter. The Canadian dollar gained slightly relative to the US dollar in Q2, which also contributed to lower returns after adjusting for currency conversion.

Volatility in global bond markets was mainly driven by European bonds.

U.S. and Canadian bond yields rose over the quarter amidst speculation that U.S. interest rates may rise this year. Rising yields mean that prices declined, resulting in bonds across the maturity spectrum posting negative total returns for the first quarter in a long time. Positioned with a shorter duration relative to the Canada Bond Universe index, Quadrant portfolios managed to suffer less downside pressure on the Fixed Income side, but were still negative in absolute terms.

As we write this, economists are debating whether Canada is technically in a recession. While the official definition of a recession is two quarters of negative growth, most analysts now believe we're in a recession (or "mild contraction") caused mainly by the dramatic drop in the price of oil with few signs of the positive effects of a weaker currency and cheaper fuel on the industrial output and exports. Production of crude oil represents just 3% of Canada's GDP but makes up 14% of its exports.

Crude oil ended the second quarter up around 37% from the bottom in mid-March, but volatility remained high.

Markets at a glance:

Equity Market Total Returns (in CAD dollars)	Q2 - 2015	YTD	1 Yr
Canada (S&P/TSX Composite)	-1.61%	0.91%	-1.16%
S&P/TSX Capped REIT Index	-4.94%	2.57%	2.84%
U.S. Large Caps (S&P 500)	-1.27%	8.80%	25.71%
U.S. Small Caps (Russell 2000)	-1.13%	12.58%	24.63%
MSCI EAFE	-0.74%	13.85%	12.83%
Germany (DAX)	-6.37%	10.16%	6.13%
MSCI Emerging Markets	-0.73%	10.75%	11.40%

Fixed Income Total Returns (in CAD dollars)	Q2 - 2015	YTD	1 Yr
Canada Universe Bond Index	-2.10%	2.04%	5.51%
Canada Real Return Bond Index	-3.93%	2.44%	5.07%
US Investment Grade Index	-3.33%	7.11%	19.16%
US High Yield Bond Index	-2.12%	9.54%	14.07%
US Treasury Inflation Protected Index	-2.86%	7.37%	15.07%

Source: Bloomberg

Greece, China and the interconnected world we live in

China, now the world's number one economy in terms of size and number one importer of copper, aluminum, and cotton, is the largest marginal consumer of most commodities. If Chinese growth were to slow, the entire world economy would feel it but commodity prices are likely to suffer the most. According to some analyst's estimates, China accounted for 38% of global growth last year, up from 23% in 2010. These numbers are important for economic activity and corporate profits around the globe.

Greece, on the other hand, is actually quite small and does not have a significant effect on global economic activity. It only represents about 2% of the Eurozone GDP.

Yet the possibility of a "Grexit" from the Eurozone has been dominating financial news headlines over the quarter as Greece first postponed and then failed to make its required debt payments to the International Monetary Fund.

After a referendum and long and complicated negotiations, Greece was forced to strike a deal with its creditors. As we write this, negotiations with Greece's creditors continue with discussions starting on a third multi-billion euro bailout deal.

It is QAM's opinion that the whole Greece situation is overblown, particularly by some members of the media, and is unlikely to have any drastic effect on the world economy or Canadian portfolios in the long run. However, nobody can see with certainty what kind of effects a "Grexit" would have, particularly on the political front. And the political waters always affect the markets in the short-term.

This year in the stock market, growth oriented companies seem to be in style and commodity-related stocks seem to be the laggards. Value style managers continue to lag as well. Odds are that this pattern will continue for the near future unless something abruptly positively affects the world economy (e.g. Chinese government efforts to reaccelerate the economy and capital markets) in which case the most unpopular asset class out there today, namely commodities, could show some reinvigorated strength.

Even as the outlook for equities remains generally positive, after a six-year bull market that has seen the S&P 500 rise more than 200%, some analysts question whether investors may have grown too complacent about the risk associated with higher short-term volatility. Equities still appear attractive, particularly on a relative basis, compared to extremely low Treasury yields, but valuations are stretched making them vulnerable to external shocks and the ever-present threat of the Fed increasing interest rates to more historically normal levels.

Companies with strong balance sheets, competitive advantages, sound economics and reasonable valuations are inherently of higher quality and outperform the general market in more challenging times. We expect companies selected by our Managers to hold value and outperform the Index in the long run.

For this reason, we recommend investors remain committed to their long-term asset mix and be cognizant of liquidity issues that may affect their ability to ride out volatile markets without jeopardizing their long-term results.

Higher volatility seems more likely. We remain firm in our belief that inflation protected growth in the long-run comes from holding high quality stocks, while liquidity requirements and stability has to be provided by a cautiously selected Fixed Income position in the portfolio.