Quadrant
ASSET MANAGEMENT

What Just Happened?

QAM Perspectives - October 2014

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

"In investing, what is comfortable is rarely profitable."
Rob Arnott,
CEO - Research Affiliates

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Stock markets in both the U.S. and Canada hit record highs over the summer, but are we now suffering a hangover from a two year long party? The onset of Fall has brought with it a spike in volatility, a steep decline in energy and commodities, a jump in high yield bond rates and a retraction in stock prices. In short – a lot has been going on.

While markets pulled back hard in September and October, some asset classes continue to be in positive territory year to date. North American large cap stocks have fared relatively better than North American small caps and international equities. REITs, investment grade bonds and Real Return bonds have performed well given their income component and the fall in long term bond yields. Many strategists (including ourselves) thought interest sensitive asset classes would underperform this year, but in fact they're outperforming equities. This just further strengthens our belief that a balanced portfolio, which includes fixed income, is vitally important (see our last QAM Perspectives piece called Why Bother with Bonds?).

Equity Market Total Returns

(in CAD dollars)	Q3 - 2014	YTD
Canada (S&P/TSX Composite)	-0.58%	5.29%
S&P/TSX Capped REIT Index	-0.91%	9.36%
U.S. Large Caps (S&P 500)	6.25%	3.40%
U.S. Small Caps (Russell 2000)	-2.65%	-7.78%
MSCI EAFE	-0.96%	-5.64%
Germany (DAX)	-6.60%	-7.61%
MSCI Emerging Markets	1.55%	1.19%

Fixed Income Total Returns

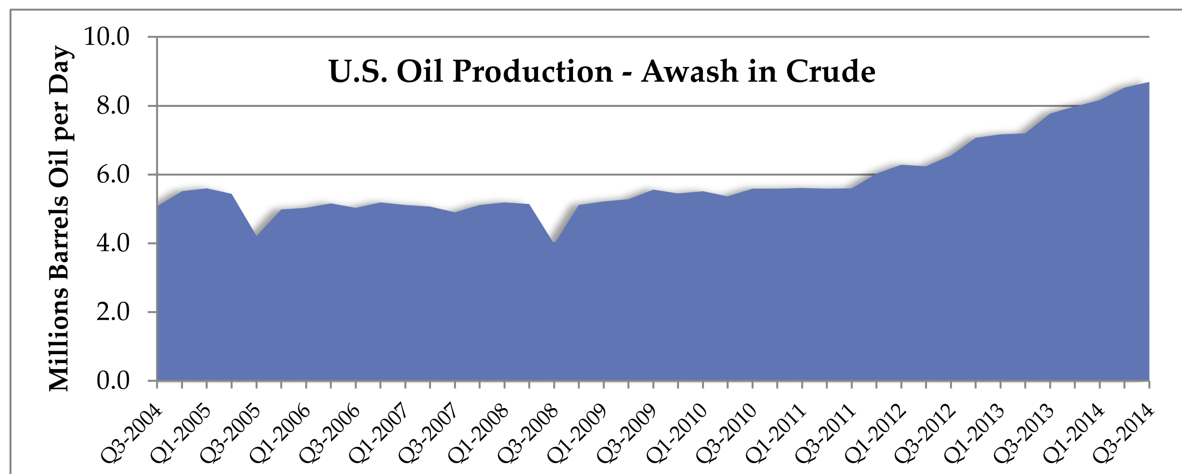
(in CAD dollars)	Q3 - 2014	YTD
Canada Universe Bond Index	0.74%	6.90%
Canada Real Return Bond Index	1.01%	12.82%
US Investment Grade Index	5.35%	5.58%
US High Yield Bond Index	2.57%	1.48%
US Treasury Inflation Protected Index	2.90%	6.13%

**Source: Bloomberg, as of Oct 15th, 2014*

Fears of a glut in oil and natural gas supplies, as well as downward revisions to global GDP and energy demand, have pushed energy prices down. This is more of an issue for Canadian equity

markets than in the U.S., since energy makes up approximately 22% of the Canadian market and 9% in the U.S.

To understand the dynamics of supply and demand in the energy market one only needs to look as far as the boom in U.S. oil production and the steadily declining growth estimates for global GDP. The boom in supply from the shale regions has resulted in the U.S. now producing almost 9 million barrels of oil per day versus approximately 5 million just three years ago. The impact of which is that the United States is now approaching energy independence.

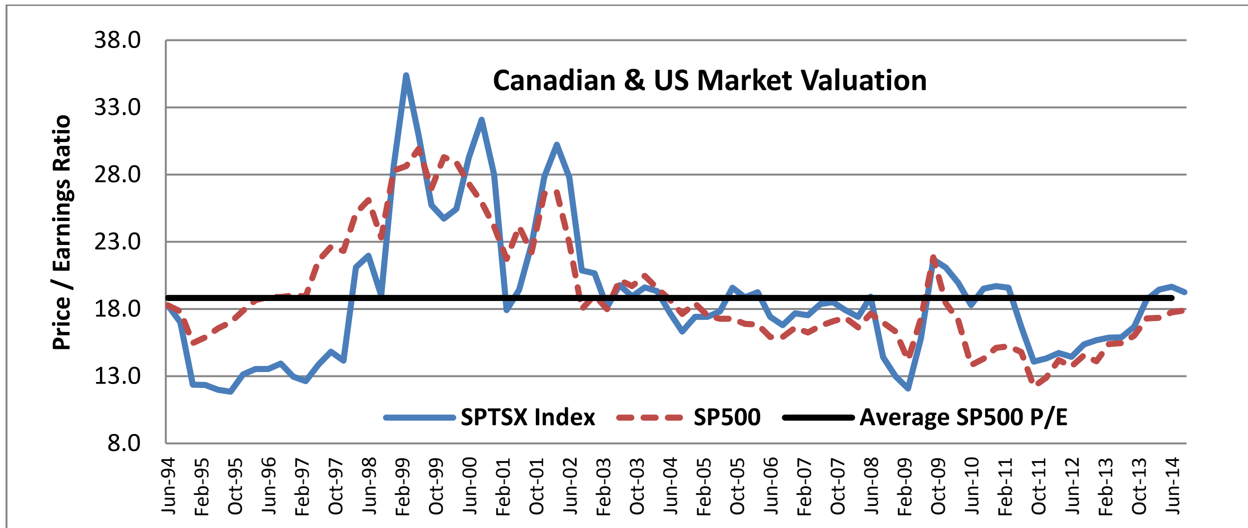


In other commodity markets, slowing demand from China is driving metals prices down. Across the spectrum, almost all major metals and agricultural commodities were down in Q3. Especially hard hit were corn and wheat. Stocks in these industries have also been hard hit, as weak commodity prices affect margins and revenues.

Futures Markets Returns

	Q3 - 2014	YTD *(As of Oct 15th)*
Metals		
Gold	-8.6%	0.68%
Copper	-5.6%	-11.45%
Nickel	-12.5%	17.40%
Energy		
Crude Oil	-13.4%	-7.38%
Natural Gas	-7.7%	-2.58%
Agricultural		
Corn	-24.4%	-23.99%
Wheat	-15.4%	-21.07%

While materials and energy have certainly been the most volatile sectors this year, the broader market has fared relatively better. This is due in part to earnings growth combined with reasonable valuation levels. Large cap stocks, which by definition will be a larger part of stock indices, are trading at approximately the average price to earnings ratio of the past twenty years.



Given the positive economic growth trend for Canada and the U.S., we feel that equity markets are fairly valued and pullbacks will likely be good buying opportunities. This is our top down view of the market. However, there are sectors where assessing value is difficult. For example, despite the recent dramatic decline in materials related stocks, it's unclear whether there are any good value opportunities. This is where our sub-advisors play an important role. They dig through the piles of financial data to assess value. Our equity managers have been fairly defensive for much of the year, fearing that the market was getting overly optimistic. As a result they have been holding more cash than usual and selling stocks where valuation levels were high and they had large gains. This selloff should provide them with a much larger list of buying opportunities. Also, as part of our regular rebalancing process, we will continue to monitor client portfolios and rebalance from fixed income to equities in order to meet asset mix targets.

We do have some concerns however. Many economies around the world are witnessing a slowdown in growth and this could have an impact on the North American economy. This effect is already happening in the energy space, which will affect the earnings of oil and gas companies. If the down draft is real and persistent, then this could adversely affect corporate earnings across many sectors.

There is a saying amongst traders that "markets move escalator up and elevator down", meaning that bull markets move up slowly, while down markets tend to move faster and with greater volatility. It's human nature to gradually move money into upward trending markets, but then to rush for the exits and panic when markets start to go down. This has happened many times before. It's normal and has historically provided patient investors with buying opportunities. We continue to actively monitor our portfolios and don't see this selloff as the start of a bear market since economic fundamentals in North America are solid, markets are not trading at egregious levels and much of the gains over the past two years were driven by earnings growth.

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