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Global Pacific Financial Services Ltd.

Manulife Asset Management - Week in Perspective Ending September 11th, 2015 - Time to Run for the Hills?

Submitted by Dan Thorburn on September 16, 2015 - 10:21pm

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Week in Perspective

Time to Run for the Hills?..

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Week in Perspective

Time to Run for the Hills?..

Macan Nia

Director, Capital Markets & Strategy

?I should have stayed on vacation?, is what I thought to myself sitting in an airport waiting to come home while watching CNBC Europe. Over the past couple of weeks investors have witnessed major equity markets selling off with daily drops in excess of 4%. These were swings in the markets that we had not seen since 2008. Is this volatility consistent of typical corrections of years past, or is it indicative of something more problematic to come? Back at my desk in Toronto, after being shielded from the markets and economic data for two weeks, I turned back to the chart we rely on when assessing past performance and market volatility.

The chart below highlights the S&P 500 returns over the various components (dividends, earnings growth and contribution from valuation). There is a lot in this chart, but I focus on the red horizontal lines for each year which represent the index?s total return. Approximately three quarters of the time, the S&P 500 has a positive return on a calendar year basis. Years that experience negative returns in most cases coincide with a recession. Recessions can be caused by a number of conditions: a contraction in consumer spending, business investment, housing or a contraction in credit which we saw in 2008. These conditions often lead to a valuation contraction, earnings contraction or both, taking the markets lower. As we have discussed in recent weeks then, it is imperative to understand whether the current market volatility is a function of deterioration in fundamentals, or merely a sentiment driven market correction.

S&P 500 Total Returns ? Break of Returns by Contribution (PE Expansion/Contraction, Earnings Growth & Dividend Yield)

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Source: Bloomberg. As of December 31st, 2014

Earnings, earnings and more earnings

S&P 500 earnings have been flat in the most recent quarter with 1.5% growth from a year over year perspective. Energy was the largest detractor with a decline of approximately 35% in yearly earnings. When you strip out the impact of energy, S&P 500 earnings were up approximately 8.9%. We believe Energy earnings are likely to remain weak over the next couple of quarters as the drop in oil prices is fully absorbed however, the worst on a year-over-year basis may be behind us. Oil prices may have reached a bottom, or at the very least have much less downside and better upside from today?s impact going forward.

As a result, we believe S&P 500 earnings growth is likely to improve given the August US Institute for Supply Management Manufacturing Purchasing Managers Index (PMI) of 51.1. The chart below illustrates that S&P 500 forward earnings have correlated well with the PMI. As of the most recent reading of 51.1, it is expected that earnings in the next 6 months will grow near 5% on a year-over-year basis. Historically, pubic earnings growing at 5% have not correlated with recessions.

Manufacturing PMI vs. S&P 500 ? Trailing 12 Month EPS growth (lagged 6 months)

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Source: Institute for Supply Management. Bloomberg. As of August 31st, 2015

If you want to know what is happening in the equity markets asked someone in fixed income

Historically, the spread between the 10 year government bond yield and 3 month government bond yield contracts / as the chart below highlights. In fact, there has never been a recession that didn?t follow an inverted yield managers tend to be focused on the upside whereas fixed income managers are more focused on the downside. As of right now, with a spread of 220 basis points, the term structure in the United States is not indicating a recession.

U.S and Canada Term Structure Spread between 10 year and 3 month government bonds (in basis points)

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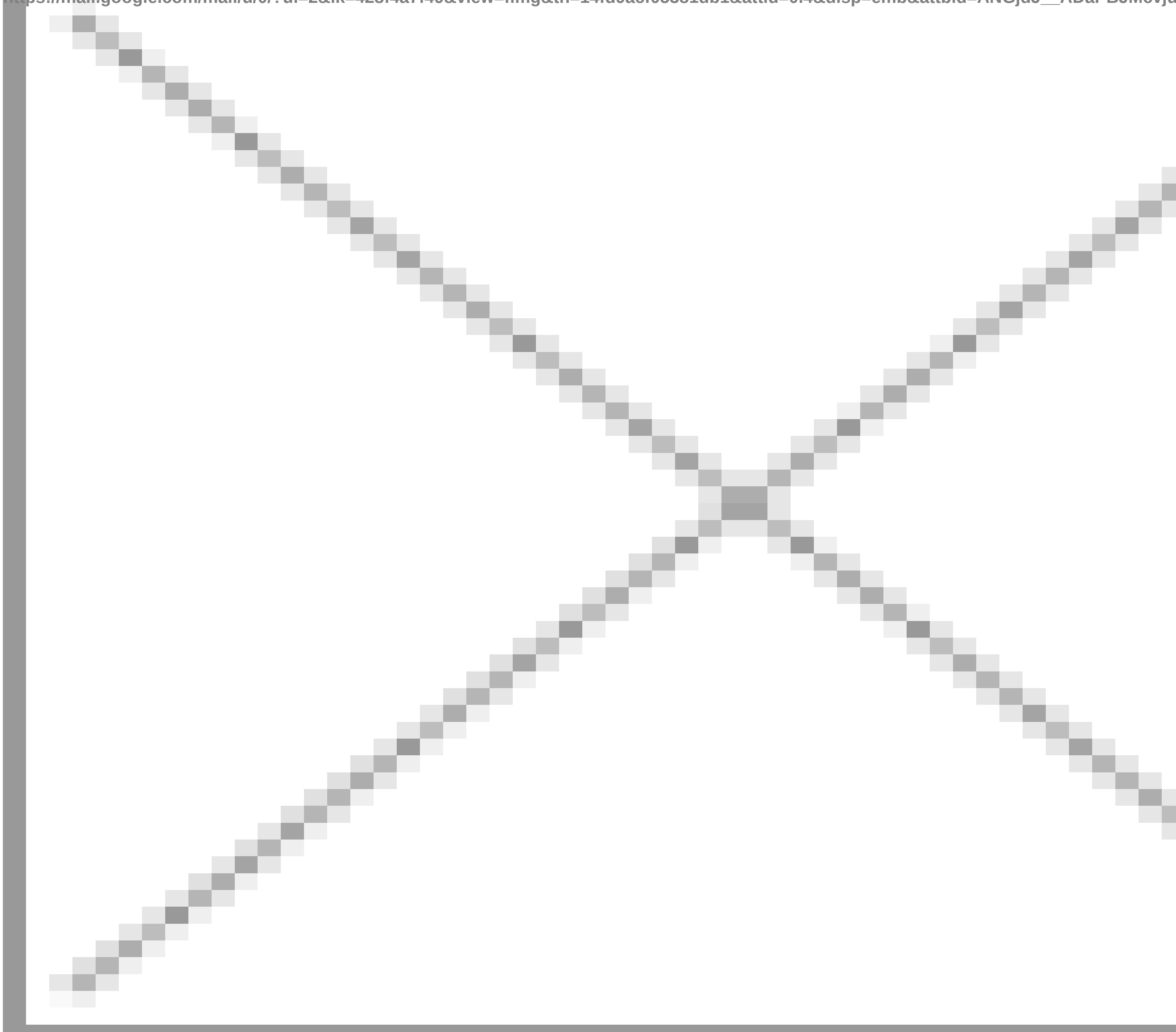

Source: Institute for Supply Management. Bloomberg. As of August 31st, 2015 strongest economy in the world measured by private companies. The most recent revision of 3.7% for Q2 GDP coupled with average monthly private sector job growth of approximately 200,000 over the past six month highlight the US economy?s strength. Regardless of when the FED begins raising rates, it will be a slow rate hike cycle and a gradual increase in interest rates is unlikely to slow the domestic US economy. Historical low interest rates coupled with low energy costs will provide further fuel for US economic expansion.

We observe that the economic health of Europe has improved dramatically over the past couple of years, albeit it is growing from a smaller base. Nevertheless, Europe in aggregate is the world?s second largest economy and positive growth is unlikely to trigger a recession in the Eurozone. European banks continue to expand credit; this coupled with lower energy prices will help Europe.

The weakness in global economic activity clearly lies with Asia. In Asia, the centre of the storm has been China and fears of its slowdown and impact on the region?s economy.

Global Purchasing Manager?s Index Survey (PMI)

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Source: Markit. Bloomberg. As of August 31st, 2015

During the past decade, to fuel its infrastructure boom, China consumed about half the world?s aluminum, nick, steel and copper production. Countries and companies that are tied to resources (Canada, Australia and Brazil) are likely to benefit less going forward, while companies focused on consumer goods are likely to benefit from China?s new growth model. For example, Tim Cook, CEO of Apple recently highlighted that he has seen little slowdown in sales, and expects the region to be the primary driver of Apple iPhone demand over the next decade as hundreds of millions of individuals enter the middle class. Toyota, for example said that sales are up in mid teen?s year over year, and anticipates stronger sales as consumers? trade up their automobiles.

In light of the recent weakness, we expect the Chinese government to continue its reforms and stimulate the economy through both monetary and fiscal policy. China has by far the world?s largest foreign exchange reserves at US$3.557 trillion to combat the recent outflow of capital. August?s biggest monthly fall on record of US$93.9 billion is relatively small, and we expect the government to utilize its reserves to stabilize the yuan and the financial markets.

In addition, China is likely to implement further expansive policy with its lending rates still at 4.6% and required reserves ratio for the banks of 18%. Recent retail sales and income growth figures continue to point to a scenario that the service sector will continue to grow at a healthy pace. Unless we see a sharp leg downward in housing prices and income growth, we believe that China will avoid a hard landing scenario that would have otherwise materially impacted the global economy.

Rational thought

The chart below is one of my favorites; it illustrates the year over year percent change for the S&P 500. Sell offs can be characterized into two types, those driven by economic recession and those driven by sentiment. The severe drawdowns of 1991, 2001 and 2008 corresponded with economic recessions. Other periods of market sentiment driven (Mexico, Asia and the downgrade of US government debt respectively). We believe the current drawdown falls in the latter. Public company earnings, economic growth and the term structure do not indicate a recessionary environment.

S&P 500 Year over Year Price Movements and Corresponding Headline Event

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Source: Bloomberg. As of August 31st, 2015

Our thesis for 2015 was that global markets would generate mid to high single-digit returns charted along a volatile path. We continue to see no reason to change our viewpoint. Volatility is likely to continue given the Federal Reserve?s eventual change in monetary policy, continued uncertainty around China?s economy and the sustainability of European growth. With the recent correction equity valuations are not expensive, and bonds, leading us to believe that the current secular bull market is not on its last legs. However, we need to adjust our expectations for the near future.

Key Statistics (week-over-week)

Ending August 14, 2015

	Weekly Change	YTD
MSCI World Index (USD)	2.0%	-4.8%
S&P 500 Index (USD)	2.1%	-4.8%
S&P/TSX Composite Index	-0.1%	-8.0%
MSCI Europe Index (EUR)	0.7%	2.8%
MSCI Emerging Market Index (USD)	1.8%	-16.1%
Hang Seng (HKD)	3.2%	-8.9%
Topix Index (JPY)	2.5%	5.2%
	Current Week	**Previous Week**
CAD/USD	$0.7540	$0.7530
EUR/USD	$1.1338	$1.1149
USD/JPY	¥120.59	¥118.99
10-Year US Treasury Yield	2.19%	2.12%

10-Year GoC Yield	1.47%	1.44%
Gold USD/oz.	$1,107.78	$1,123.45
Oil USD/bbl.	$44.63	$46.05