CIBC Wood Gundy

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Risk Makes a Comeback
(and Rick too)

The enclosed CIBC Wood Gundy report (The Return of Volatility) provides some background to the recent correction in the equity markets.

Markets are digesting a greater than average number of negative political events in the world combined with European growth numbers that have underperformed market expectations. In terms of 'what is going on out there,' here are brief comments on most of today's headlines:

Ebola: A serious issue that needs to be dealt with but having managed money throughout SARS, Avian Flu and H1N1 (all of which could be transmitted by air, not just fluids as is the case with Ebola). I don't believe the market will focus on this issue in the medium-term.

ISIS: Previously, this was just the name of my children's cat (true story). And the cat never did anything to hurt the stock market. Now ISIS means something else to most people. The new 'ISIS' has between 20,000 to 30,000 soldiers and no airpower versus the Iraqi army of 200,000 (albeit dysfunctional) which has total air superiority compliments of the U.S. and other coalition partners. ISIS is a very nasty group causing lots of problems… but as far as making any medium-term market impact, not likely. As far as calling the cat in at night however, 'here kitty kitty' has had to replace 'here ISIS ISIS'.

Syria, Libya, and Egypt: Well, at least Tunisia got some benefits out of their 'Arab spring,' but for the others, it will probably take another five years plus for these situations to potentially work themselves out. Though in Iraq and Afghanistan, and we have a region that unfortunately remains in perpetual turmoil. I believe stock market impact though will continue to be minimal.

Ukraine: With Russian military and nuclear capability, this situation could only result in what we have already seen … 'Name calling and trade sanctions' vis-à-vis the West and the Kremlin. Still, this remains an unresolved issue with a tenuous ceasefire that is not yet working (and of course this negatively affects the European and Russian economies); but the media now has more topical things to cover at the moment (see other stories above).

Long-term clients know we do not react to situations like the aforementioned. Personally, my main concern has been and still is 'oversized levels of government debt,' with a lesser but secondary concern about a possible bubble situation in China's economy. These risks dwarf regional conflict issues and viruses, and while I am not concerned about them being near-term risks, they will be tracked closely.

Regarding European debt levels, fortunately, long-term interest rates in Spain, Italy and Portugal have fallen dramatically, which significantly decreases European sovereign bond risk – a situation that could have ‘gotten ugly’ about a year and half back.

There is one benefit to excessive levels of government debt though and that is ‘secular low interest rates’. This is a big plus for the economy and effectively means debt servicing costs remain quite reasonable for governments, corporations, and consumers. Always two sides to every coin, eh?

As we have been saying for a while now, markets have been unusually calm for the past five and a half years; with the last time we experienced any material pullback being the summer of 2013. In terms of ‘mathematical volatility,’ markets have experienced about half the normal level of volatility we normally see – from a long-term historical standpoint (since markets bottomed in March 2009). At the moment, risk is indeed making a comeback and I would not be at all surprised to see a return to normal and at times ‘higher than normal’ volatility.

With many clients now frequently checking account values ‘online’ (rather than having to wait for monthly statements to arrive), some may feel a heightened level of sensitivity to day-to-day market fluctuations, when they occur on the downside. As said, markets normally fluctuate with twice the level of volatility than has been experienced in recent years, so please try and keep that in mind when we experience these inevitable swings. Historically, stock markets experience a pullback of ten percent or more at least once a year so what we are experiencing now is quite normal.

In terms of where we go from here, of course anything can happen in the short-term, but given the after-tax payment investors receive in risk-free fixed income investments continues to be below inflation, we think this low interest rate environment provides us a good degree of protection from a major sell off in equity markets. In the ongoing competition for capital, ownership in companies (through the equity market) continues to look better than bonds–from any long-term standpoint.

The other reason we do not see reason for a major pullback is simply that equity markets in Canada are still lower than the previous 2008 peak, while globally they are only a bit higher than the previous peak a long seven years back. Stocks are certainly not ‘cheap’ but they are also not trading at expensive levels.

A typical account we manage experienced a down month in September, and October started out very weak but has improved a bit of late. As we have been saying and writing for a while now, we have (and are) continuing to prepare as best as we can for downturns by ensuring good quality in terms of fixed income issuers we use, appropriate levels of fixed income, and good quality and diversification in terms of the equity component of client accounts.

Are there bargains out there?

Markets are not down enough to create real ‘bargains’ but there are certainly some reasonably priced investments out there at the moment.

Canadian resource stocks have been in the ‘dog house’ for many years now and are starting to look cheap. Small cap stocks and emerging markets are also down worse than the stock market in general, but these areas of the equity market have higher risk and our inclination is still to ‘decrease’ rather than ‘increase’ risk at this stage of the equity market cycle. In terms of some near term adjustments to our ‘Index and Stock Strategy,’ we are looking to pair a slight increase in our currently low ‘resource stock weighting’ with a few stock changes that will add a bit more ‘defense’ to the portfolio.

We continue to add good quality preferred shares to certain accounts (on a new issue basis to save clients the buy commission). Real Estate Investments Trusts (REITs) also look fine at current prices. REITs pay healthy rental income distributions (averaging about 6.5%), and typically trade five to ten percent below the value of their buildings.

We are starting to pare back high-yield bond funds (that invest in below investment grade bonds) in favor of a safer ‘monthly income fund’ with asset- and mortgage-backed securities. We also continue to use investment grade bonds with unexciting but safe yields of 3.5% or so and maintain our position in commercial mortgages through ACM Commercial Mortgage fund (which has performed well and is largely unaffected by day-to-day swings in equity and bond markets).

What’s happening on the team front?

This is our first letter since our pal, colleague (and now client) John Doyle retired. He is enjoying himself, having just come back from a camping/photography trip to Iceland where he got ‘up close and personal with live volcanoes’–you know John, he loves that stuff.

Rick is settling in well, although he recognizes the challenge of (re)acquainting himself with over 600 households. For those clients that John brought in to our team, it may take a bit of time for you to get know Rick and I better, and vice versa. Slowly but surely we are making good progress. Rick and I are typically doing joint meetings with those clients, and by the end of each meeting, we think we are making a good start to what we hope will be continued satisfaction with our services.

A big welcome to the new households who have joined us from Rick’s former firm! It’s a pleasure and honour to have you join our group.

Rick's wife Pav just gave birth to their son Kyan on October 13th, the day after their daughter Karis' 2nd birthday. Mom and baby are doing very well and Rick is slowly recovering from his key hospital role as Ice Chip Provider and Heart Monitor Watcher.

We want to thank all clients who took the time to answer our firm's (very long) client survey, which is sent out every two years to most of our clients. It takes a while to get the information summary back, so we just went through this a little while ago. We were very pleased and humbled by the results, but we always learn some valuable information that we use to try and improve. Two areas that we wish to work on are more frequent updates of financial plans, plus initiating financial plans for any of our clients who do not have same.

As always, please call us anytime you have questions or any concern whatsoever.

Cheers,
CIBC Wood Gundy

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