Foresights from Foresters Asset Management Inc.

Recent Volatility

February 2018

Why Markets Corrected: A Short-Term Explanation

While we think there are also long-term issues at play (see below), we would make the following observations about the recent volatility:

- The current correction has been very sharp and widespread, with many asset allocation strategies unlikely to perform as well as expected as most asset classes are weaker: bonds, equities and energy correcting. The only traditional "safe havens" performing as expected were the U.S. dollar and Japanese yen.
- Many securities and sectors have not declined in line with their betas – a sign that this is a technical correction, not caused by recession fears, an inverted yield curve or any specific fundamental issue. This may partly be explained by a shift away from interest rate sensitive securities but much of the reason is the dominance of ETFs and index trading contributing to the lack of discrimination in security declines -- and creating opportunities for active managers!
- The well-publicized short-volatility trade and the leverage associated with it, is real and has exacerbated the move down. We expect volatility to stabilize at a new higher level.
- Equity valuations at the high end of their historic range are not the cause of the recent decline but they intensify the magnitude of any decline. Importantly, however, valuations are no longer stretched: the S&P 500 has gone from approximately 20x to 17.2x 2018 estimated earnings, while the TSX has contracted from 18x to 15x.

Context is Key (And We Remain Bullish)

It was the best of times and then suddenly it seemed like the worst of times. We're referring, of course, to the recent burst of volatility in the stock market. After successive record highs to start the year, benchmark U.S. equity indices plunged, taking other markets with them. The rout started as a strong jobs report triggered inflation fears in the bond market. The corresponding jump in yields hit equity valuations with the equity selloff snowballing the next week. The Dow Jones plummeted nearly 3,000 points in a week. For investors, its been an unpleasant reminder that stocks can in fact decline, and sometimes at a rapid pace.

On the one hand, it's important not to be overly dramatic about what just happened. While the Dow suffered its worst point decline ever, in percentage terms the fall was far from the worst ever seen. That said, there is no doubt that volatility has been awakened from its prolonged slumber, and many investors are rattled. With this in mind, we thought it might be helpful to put all the market drama in some context. Long story short, we're not overly concerned and we don't think our clients should be either. A lot has changed in market prices, but not market fundamentals. We are focused on the latter.

As we see it, synchronized global growth remains intact and corporate earnings are accelerating. Combined with declining share counts as a result of buybacks, these elements keep us bullish in spite of the recent sea of red. As always, if the facts change, we will reassess our position. Key risks to our outlook include rates rising faster than anticipated and corporate earnings disappointing.

Why Markets Corrected: A Longer-Term View

To understand why the markets fell out of bed, we would argue that factors related to the global financial crisis need to be considered. In 2008, a liquidity crunch hit major financial institutions as a result of the U.S. mortgage market meltdown. This necessitated governments and central banks taking decisive actions, both fiscal and monetary, to prevent the situation from worsening. Even though the panic of those years has long since abated, the U.S. economy and financial system have spent the last decade or so removing the dangerous excesses of the bubble years. Slowly but surely, the required healing has taken place. U.S. household debt levels have come down, for instance. And

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banks, forced by government regulations, have rebuilt their capital positions so as to protect them from future crises. Policy actions have also reduced systemic leverage and curtailed ratings agency practises that played a role in worsening the U.S. mortgage bubble.

While badly needed, the measures aimed at removing excesses have put a lid on economic growth. Banks, for one thing, have been reluctant to lend while they have been busy repairing their balance sheets. To counteract this, central banks stepped in to provide massive amounts of stimulus in the form of low interest rates and quantitative easing. But central banks were shovelling large amounts of money into a financial system that was limiting lending into the real economy so, much of the central bank-generated liquidity flowed into asset prices. For several years central banks were "pushing on a string". During those years markets were more worried about deflation than inflation.

This fear started to abate in 2016 for a few reasons. First, the world finally started to experience synchronized growth. Second, U.S. unemployment, which peaked at over 10% during the recession, trended steadily lower to its current level of just over 4%, at or very close to full employment. Talk of deflation disappeared.

Now the U.S. economy is firmly on the upswing, and fiscal and regulatory policy is set to throw gas on the fire. Whereas financial regulations were tightened after the crisis, deregulation is the song of the day, which would encourage lending. U.S. tax reform is set to provide significant stimulus to the U.S. economy. Add to this the fact that corporate earnings growth has been incredibly strong and it's easy to see why investors became so exuberant.

The problem was that in their exuberance, investors ignored signs of rising inflation and what that meant for the bond market and monetary policy. Until last week, that is. In short order, markets became spooked as yields marched upward, the yield curve steepened, and the prospect for a reasonably hawkish Federal Reserve became clearer.

It's Not the End of the Bull Market (Just a Change in Leadership)

We don't believe the heightened volatility is a sign that the bull market is over. Rather, we think it signals a transition for equities. Big moves like the one we just saw usually herald a change in market leadership and this time should be no different. The days when investors could buy stocks without much regard for valuation are likely behind us. Now investors will have to reckon with which sectors are best positioned to benefit from a rising rate and inflation environment.

One implication of this regime change is that value should start outperforming growth, after a year in which growth trumped value by one of the largest differentials in recent memory. We'll illustrate this by pointing to the relative merits of Netflix vs. Sun Life: Netflix trades at an astronomical 88 times earnings, whereas Sun Life trades at 11.3 times. Another way to think of a price to earnings multiple is, if earnings stay flat, that is the number of years of earnings that would need to be generated to justify the stock price. Both companies are growing earnings, and certainly Netflix is growing much faster than Sun Life so it shouldn't really take anything close to 11 and 88 years, but in a rising interest rate environment future earnings growth is not worth as much as earnings that will be generated in the near term. We're not saying

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that Netflix is a short here, but in an environment where value beats growth, we prefer to hold Sun Life.

Speaking of relative valuations, Canadian equities are now attractively priced compared to international indices. While we are cautious of specific risks associated with NAFTA and high household debt levels, the Canadian market valuation levels and leverage to global synchronized growth is compelling. At 15x this year's (estimated) earnings, the TSX is right in the middle of its 10-year valuation range. In the U.S., the S&P 500, at 17.2x, is much closer to the high end of its range over the past decade. And amidst all the bullishness over European equities, it's worth mentioning that European blue chips are also trading closer to the high end of their 10-year range.

One final note: in a classic economic cycle, higher interest rates ultimately bring the expansion and bull market to an end. The great recession, crucially, was not a classic cycle. It occurred because of systemic insolvency and illiquidity. We believe that we are now in a classic cycle, and we don't believe it's over yet. Growth is still very good, and indeed we think the U.S. tax reform will make the American economy accelerate even more by 2019. This is very positive for corporate earnings. There's lingering concern over valuations, but valuations do not typically end bull markets. As in prior classic cycles, we believe the bull run will be over when the impact of interest rate increases surpasses the positive impact of rising corporate earnings. We don't believe we're close to that point yet.