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ASSET MANAGEMENT GROUP

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A message from Ron Hanson, Chief Investment Officer, GLC Asset Management Group Ltd.

With the S&P/TSX Composite Index crossing 'correction' territory, down more than 10% from its highs, stock market headlines have been increasing in number and drama. Understandably, investors watching the news may be feeling concerned or uneasy.

Since the depth of the financial crisis in March 2009, equity markets have enjoyed very strong returns. As we have cautioned several times over the past few months, equity markets were susceptible to a correction as valuations had pushed above historical averages and market internals were weakening. For example, as the S&P500 and S&P/TSX Composite reached new highs in July and September, market breadth failed to confirm. Specifically advance/decline ratios did not reach new highs. As a result, the recent market decline is not altogether surprising (nor unwelcome). What has been more concerning is the sharp drop in bond yields. Yields on US 10 year Treasuries have fallen to 2.14% as of October 15th from recent highs of 2.62% on September 17th, raising questions of whether we are in the midst of a healthy consolidation period, or a more significant turning point.

What's happened?
Stock markets around the globe have dropped significantly since mid-September. The S&P/TSX Composite is off by 11.4% since its closing highs on September 3rd to market close on October 15, 2014, while the S&P500 is down 7.4% from its September 18th closing high. More troubling is the move in bond yields, as bonds have traditionally served as the barometer for the health of the economy. Bond yields have been moving downward over the past few weeks, but this trend was accentuated by an intra-day 30 basis point move in 10 -year US Treasury yields on October 15th. This is one of the most significant intra-day moves in recent history, and has certainly caught our attention.

The main source of current angst appears to be fears of slowing global growth – with deflation concerns including the significant drop in oil prices and geopolitical risks also weighing on investor confidence. The list of worries includes:

- Although the European recovery has been teetering for several months now, Germany's larger-than-expected drop in industrial production, a decline in exports, and a sharp drop in consumer confidence, sparked fears that Europe's only island of strength may be buckling under the weight of having shouldered the European economic recovery.
- China has all but settled in to a new growth target of 7% - 8% (still strong, but well below the growth rate of recent years).
- The U.S. Federal Reserve has expressed growing concerns that slowing global economic growth and the negative effect of the strong greenback on U.S. exports could hamper the US recovery.
- Despite the record levels of monetary and fiscal stimulus since the financial crisis, the risk of deflation continues to overhang the global economy with the eurozone at the epicenter of these fears. But keep in mind that inflation in the US is still running below the Fed's 2% target..
- Ongoing geopolitical risks weighing on sentiment include sanctions resulting from conflict in Ukraine, the escalation in the fight against ISIS and the growing Ebola crisis.
- U.S. economic data has been generally positive, but a larger than expected drop in September retail sales spooked an already nervous market.

Keeping perspective

Clearly there is no shortage of things to worry about and investor sentiment has been bruised. The change in sentiment has been dramatic this month, more so than the shift in economic conditions. Uneven and subpar global growth have been hallmarks of this recovery, and, while we recognize that the European recovery is stalling and risks tipping back into recession territory, we don't yet see evidence of a reversal in the positive and improving momentum in the US economy.

The recent drop in US and Canadian bond yields does have us concerned. But in reality the underlying growth outlook has not changed materially, particularly in North America. The recent employment reports in Canada and the US point to continued recovery. As well, third quarter earnings season has been on balance positive so far, providing some underlying support for equities. Having said that it is still early into earnings season and guidance on future earnings will be critical to the outlook for equity markets. The global sell off in equities has done some technical damage but as prices drop, and, if earnings continue to hold, valuations will become more attractive.

When equity markets correct it never feels particularly good, but we have experienced a significant period of time since the last 10% correction in Canadian equities. Markets do not move up in a straight line and corrections do happen and can be healthy. We will look to Q3 earnings and guidance along with the action in the bond market to gauge market direction. We do believe that US Treasury yields need to dig in and start to move higher before we can see equities move materially higher. We will continue to watch for signs of a significant deterioration in global growth outlook but caution against a knee-jerk reaction.

Given our view that economic growth in North America, led by the US, continues to improve, albeit with some grey clouds around the globe; we continue to believe that this is a correction in an ongoing bull market.

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