

Recent market volatility

Markets took it on the chin this week as investors shunned assets they considered risky – equities, commodities, etc. – and markets are reflecting this bias. Looking at the big picture, there hasn't necessarily been any major 'new' news since mid-summer. The most recent market volatility has stemmed from more of the same issues; European debt and fears about weakening global growth. Much of the current market sell-off can be attributed to a lack of consumer and business confidence, which have been further exacerbated by less-than-hoped-for policy responses to financial problems in the Eurozone.

As we've stated over the past couple of months, our outlook is that higher than normal volatility will persist as these two issues are not ones that can be fixed quickly or easily. That's clearly what we are experiencing and we expect more of the same.

WHERE WE ARE TODAY

The risk of a recession in the U.S. has risen; however, we continue to feel that the U.S. will avoid a full-blown or severe recession. In support of our view, we point out we are not in the same economic conditions we were in during the financial crisis. Recent releases of some major economic indicators put them well above early 2009 levels, granted, coming off of higher levels in the past year. There remains a significant improvement in economic conditions since the bear market lows of March 2009 (see table below).

Economic Indicator	March 2009	August 2011	
US ISM	36.6	50.6	} Greater than 50 denotes expansion
US ISM Non-Manufacturing	41.2	53.3	
Eurozone ISM	33.9	49.0	
Eurozone ISM services	40.9	53.7*	
U.S. LEI (year over year)	-4.9	6.5	
U.S. household debt (% of GDP)	13.4	11.1*	

*as of June 2011. Source: Bloomberg

Furthermore, the week of Sept. 19, we've seen U.S. leading economic indicators coming out better than expected. U.S. Institute of Supply Management (ISM) results continue to be above 50, signaling economic expansion. Both factors are in contrast to the economic conditions we saw in 2008/2009. Both businesses and consumers are stronger than they were two years ago with the former holding high cash levels and the latter having deleveraged significantly since the credit crisis. Shifting our focus overseas, it is important to note that not all European countries are in the same boat as Greece. Despite having been one of the poster-children of the European sovereign debt problems, Ireland recently reported better than expected gross domestic product (GDP) growth after its government imposed tough, but necessary, austerity measures to see them through to stronger economic health. And finally, policymakers have not turned a blind eye. While not having acted with the conviction we would like to see, they are taking some steps to get financial matters in order.

Dave Gill, Senior Vice-President, Equities (London Capital), stresses that when markets capitulate, it tends to be a sentiment-driven reaction in which investors overshoot to the downside and the proverbial baby gets thrown out with the bathwater. That's when you see great buying opportunities emerge. That said, he cautions that attractive valuations (prices) on their own are not enough. Dave emphasizes, "You have to do your homework and that has to be part of your daily process, not just on the big volatility days. We start everyday knowing the companies we want to watch, so when opportunities present themselves, our homework is done, our research is up to the minute, and we're ready to act."

GOING FORWARD

As Patricia Nesbitt, Senior Vice-President, Equities (GWLIM) describes it, "The fallout from equity market losses is going to have to put the policymakers feet to the fire before investors believe the economy is ready to turn around, and that hasn't quite happened yet." We believe both consumer and business confidence will need to gain traction before we see a turnaround in investor sentiment and thus a turnaround in market performance. We'll be watching that carefully as this remains the linchpin to economic recovery.

We realize many investors will have questions and may be tempted to move from equities to the sidelines for a few months to avoid market volatility. We caution against this kind of market timing. Markets are forward-looking and have already priced in a significant drop in future corporate earnings. Estimates currently suggest a 20 to 25 per cent drop in U.S. corporate earnings has already been priced-in. It's the forward-looking nature of equity markets that makes market bottoms difficult to predict. Your best chance to take advantage of the markets when they turn around is to stay in the markets.

Market volatility is never easy to stomach, but cooler heads prevail. GLC's professional portfolio managers don't abandon a well-thought-out investment strategy on short-term market volatility; rather part of the investment strategy is to have well-defined processes that allow us to capitalize on market volatility. For investors, we also stress the importance of not abandoning long-term investment strategies which, for most investors, will include a diversified combination of equity (domestic and foreign) and fixed income investments.

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