August 8, 2011

Here's What We're Thinking

The Investment Committee of the Portfolio Advisory Group meets weekly to formally discuss markets, sector allocation and investment recommendations. Below is a brief synopsis of our current market view.

Outlook in the aftermath of the S&P downgrade of U.S. debt

- The current decline in stock prices represents a buying opportunity for equity investors.
- Markets are adjusting to the wake-up call for governments around the world, lower confidence levels, and the heightened risk of a sustained period of lower global economic growth.
- On Friday evening, well after the market closed for the week, credit rating agency Standard and Poor's (S&P) announced their decision to downgrade the rating on U.S. debt from AAA to AA+ in response to concerns that spending cuts agreed to in Washington to conclude the debt ceiling debate were insufficient in addressing record government deficits.
- Perhaps worse than the actual downgrade is that S&P has kept the outlook on the U.S. rating "negative" indicating there could be a further downgrade over the next two years.
- As reported by Bloomberg: "the S&P move went further than Moody's Investors Service and Fitch Ratings, which affirmed their AAA credit ratings for the U.S. on Aug. 2, the day U.S. President Barack Obama signed a bill that ended the debt-ceiling impasse that had pushed the country to the edge of default. Moody's and Fitch both said that downgrades were possible if lawmakers fail to enact debt reduction measures and the economy weakens.
- Scotia Capital Economist Derek Holt wrote "this is the first downgrade experiment affecting a nation's debt securities that play such a dominant role in the world financial order. We are therefore in uncharted waters."
- In an article written in late July contemplating a potential downgrade, Scotia Economics said the reaction by Treasuries would likely "be insulated in part by concerns over the risk trade as the US plays a safe haven role during times of market duress."
- A statement from G-7 leaders who held emergency conference calls over the weekend in response to the downgrade said the G-7 would take every action necessary to stabilize financial markets by agreeing to inject liquidity and intervene in currency markets to thwart any disorderly moves in exchange rates if necessary.
- The European Central Bank (ECB) indicated it would buy Italian and Spanish bonds to support European bond markets. Bloomberg reported "The bank [ECB] also called on all euro-area governments to follow through on the measures agreed in July, including allowing the European Financial Stability Facility to buy bonds on the secondary market. "It is on the basis of the above assessments that the ECB will actively implement its Securities Markets Program," the central bank said. After a series of calls involving German Chancellor Angela Merkel, French President Nicolas Sarkozy, Spanish Prime Minister Jose Luis Rodriguez Zapatero and Italian Prime Minister Silvio Berlusconi, European leaders pledged to push implementation of last month's deal on the European Financial Stability Facility. Berlusconi announced measures to speed austerity and target a balanced budget in 2013, a year ahead of schedule".
- Also a concern is the potential impact the U.S. downgrade might have on China's economic and investment policy as it relates to the United States as they are a major creditor to the U.S.
- Asian and European equity markets are down 1%-3% overnight but have bounced off their lows of the day; uncertainty and therefore volatility are likely to remain a constant for the foreseeable future. North American equities are down a comparable amount at the open of trading today.
- The lack of clarity and decline in stock prices however creates unique buying opportunities; In spite of these serious very macro-economic concerns, our intermediate and longer term bias still favours equities over all other asset classes.
- For fixed income exposure, the current low rate environment offers little value in the mid to long end of the curve and we recommend investors remain short duration at this time. From a sector weighting perspective, investors should be underweight Canada's and overweight provincials, municipals and corporates. With the Canadian dollar expected to outperform most major currencies over the coming year, we recommend Canadian investors remain in Canadian dollars for their fixed income holdings.
- Investors should maintain exposure to gold or at least gold equities in their portfolio as another level of portfolio diversification as gold is viewed as the currency of last resort and a hedge against inflation.

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- Most of the positive factors which supported equity prices during the rally between August, 2010 and this past April are still relevant, if not more relevant today as evidenced by another solid quarterly earnings season.
- Equities appear attractively priced in the context of still increasing profitability, albeit growth expectations are somewhat tempered in this environment. Low interest rates, cash-rich corporate balance sheets, growing dividends, and continued emerging market strength sustaining demand for commodities are all supportive for equities.
- Stocks have been trading within a range-bound market over the past two years, and with the recent sell-off, we believe we are near the bottom end of that range; while equities are likely to remain volatile in the near term, the so-called "risk-off" trade appears to be extended.
- **Although return expectations should be modest in the context of a slow growth economic environment, we believe potential equity market returns are beginning to modestly outweigh the risks at current levels.**
- Current weakening global economic conditions and geopolitical circumstances suggest interest rates will remain lower for an extended period of time.
- Although share prices may remain rangebound for several months, investors in diversified portfolios should be looking to selectively add equity exposure. In addition to commodity cyclicals that are trading at a steep discount, investors should focus on adding defensive, dividend paying stocks to counter ongoing equity volatility and enhance total returns.

For more information on how these ideas pertain to your investment portfolio, please contact your ScotiaMcLeod advisor.

Summarized by Stephen Uzielli - *Director, Portfolio Advisory Group*