Market Matters

Q3 2011 HIGHLIGHTS

- Investor confidence sank over the course of the quarter, and with it all major equity markets suffered significant market value losses, while the bond markets rallied.
- American and European lawmakers stretched investors' patience with a 'too little too late' approach to policy action addressing the growing fears of a U.S. and Eurozone recession.
- Strong corporate earnings and some economic data supporting continued growth (albeit rather sluggish growth) did little to soothe investors' concerns during the quarter.
- In a textbook safety trade, money exited risk assets such as cyclical equities, commodities and corporate bonds, while money piled into government bonds, more defensive income-yielding equities and the U.S. dollar (which made impressive gains against major global currencies).
- The Canadian dollar weakened significantly, hit by a double whammy of U.S. dollar strength and falling commodity values.
- The quick ascent of gold bullion prices reversed sharply in September, influenced in part by the strengthening U.S. dollar.

Table 1
Summary of major market developments

Market returns*	Sept.	Q3 2011	YTD
S&P/TSX Composite	-9.0%	-12.6%	-13.5%
S&P500	-7.2%	-14.3%	-10.0%
- in C$	*-1.2%*	*-7.6%*	*-5.9%*
MSCI EAFE	-4.7%	-16.4%	-17.8%
- in C$	*-3.2%*	*-12.3%*	*-12.8%*
MSCI Emerging Markets	-7.6%	-15.7%	-18.5%
DEX Bond Universe**	1.8%	5.1%	7.4%
BBB Corporate Index**	0.7%	3.8%	6.4%

*local currency (unless specified); price only
**total return, Canadian bonds

Table 2
Other price levels/change

	Level	Sept.	YTD
USD per CAD	$0.96	-6.0%	-4.4%
Oil (West Texas)*	$79.08	-11.1%	-13.4%
Gold*	$1,618	-11.4%	14.1%
Reuters/Jefferies CRB Index*	$298.15	-13.0%	-10.4%

*U.S. dollars

Table 3
Sector level results for the Canadian market

S&P/TSX sector returns*	Sept.	Q3 2011	YTD
S&P/TSX	-9.0%	-12.6%	-13.5%
Energy	-12.3%	-19.2%	-20.7%
Materials	-14.7%	-9.0%	-18.1%
Industrials	-9.0%	-18.8%	-10.9%
Consumer discretionary	-2.7%	-15.7%	-17.7%
Consumer staples	1.4%	-1.4%	2.4%
Health care	-5.7%	-16.4%	30.3%
Financials	-3.9%	-10.5%	-6.7%
Information technology	-19.7%	-18.8%	-43.8%
Telecom services	-2.6%	-0.9%	9.6%
Utilities	0.3%	2.3%	1.8%

*price only
Source: Bloomberg, MSCI Barra, NB Financial, PC Bond, RBC Capital Markets

WICKED REPUTATION

September lived up to its wicked reputation as the worst month of the year for stocks. Right down to the last day, it was a sour ending to a sour month and quarter for equity markets (see Table 1).

Capital markets suffered a virtual vacuum of investor confidence in the third quarter of 2011. Fear and risk aversion dominated investors' decision making. A take-no-prisoners sell-off of risk assets accelerated into the final days of the quarter (and into the early days of October as well). Coinciding with this, investors made a headlong rush into the safe liquidity of U.S. dollars and fixed-income markets, where investors showed their willingness to accept historically low yields in exchange for stability.

THE BLOOM IS OFF THE LOON...AND OTHER SIGNS OF FALL

All major commodities fell in value over the month and quarter. Even gold could not hang on to its safe-haven appeal (see Table 2). Gold bullion values waivered as some momentum investors swiftly reversed their bet as values slipped when the U.S. dollar appreciated (gold bullion is priced in U.S. dollars and therefore has an inverse effect on its price).

With a strengthening U.S. dollar and sliding oil prices, needless to say, the bloom came off the loon, and the Canadian dollar experienced an eight cent drop in value versus its U.S. peer during the quarter.

Not surprisingly the Canadian S&P/TSX Composite index was particularly negatively affected by the lower oil and metal prices (see the Energy and Materials sector returns in Table 3). The Information Technology sector continued to be weighed down by the weakness of its most prominent stock (Research In Motion). But Table 3 also highlights a modest bright spot in the Canadian equity landscape as a couple of defensive, income-yielding sectors managed to stay in the black in September (the Utilities sector remained in the black for the quarter as well).

A SCORECARD

Inflamed by heightened (and primarily negative) media attention and book-ended by the political wrangling over the U.S. debt ceiling and the lack of consensus on how to solve the European sovereign debt problems - it's no wonder financial market tensions flared this quarter. Taking a step back from the media and market noise, we note some significant economic factors influencing the current economic landscape (certainly not an exhaustive list, but some worth noting).

- **Positive:** Global business health (except perhaps for European banks at the moment) continue to be a bright spot, posting strong earnings results and high cash levels to support them through slow economic patches.
- **Positive:** Government policies continue to be supportive of economic growth. Central banks in Canada and the U.S. announced intentions to keep interest rates low for prolonged periods, and the U.S. introduced operation twist - the plan to sell short-term government bonds for the purchase of long-term government bonds - with the intent to lower long-term borrowing rates.
- **Neutral-positive:** U.S. consumers have done a lot to deleverage themselves and improve their household balance sheets. Decent retail spending reports seem to be backing this up. (This may be more of a neutral economic signal rather than a positive one, but with investor sentiment so low, neutral is the new positive in today's environment.)
- **Neutral:** Developing countries' economic growth continues to be strong, but inflation concerns are emerging.
- **Negative:** European sovereign debt problems (and contagion risks) are posing a significant concern to Europe's short-term and long-term economic health.
- **Negative:** U.S. employment needs to improve sooner rather than later so more Americans can get back on their financial feet and to provide a boost to consumer confidence.

Overall, we continue to see economic support for continued global economic growth – albeit sluggish growth. But perhaps more importantly, we have yet to see evidence of the 'slam on the brakes and come to a screeching halt' no-growth scenario that investors fear and capital markets appear to be pricing in.

A CRISIS OF CONFIDENCE

Market volatility can test resolve and even the most level-headed among us can find ourselves wishing for a metaphorical Chinook wind to blow through the markets and warm them up a bit. Yet we believe that fundamentally, the recent market turmoil has come down to a crisis of confidence: consumer confidence, business confidence or investor confidence. Each has relapsed lately after the initial recovery days in 2010 and earlier 2011. We believe a coordinated response from global policymakers will go a long way towards improving the certainty around economic conditions going forward and will be a strong confidence booster for investors, consumers and businesses alike.

While we fully expect capital markets to remain on tenterhooks in the near term, we caution against making short-term emotion-based decisions that can derail you from your long term investment plans. If your investment plan was built on a solid foundation of diversification, appropriate risk tolerances and personal time horizons, then maintaining your confidence in that plan – even during times of market volatility - sounds like the best plan of all.