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Gestion de portefeuilles / Portfolio management

La voie des Alizés

Navigating the Trade Winds

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Dear friends,

If the old trading adage "Sell in May and go away" is a well-known one, it is also recognized that the strategy does not always work. This saying assumes that stocks tend to underperform from May to October compared with November to April. But it seems that, up to now this year, the market has been on a break since the end of May. All the same, thanks to a good start, the S&P 500 ended the quarter up 2.6% (but at -0.1% in Canadian dollars because of the loonie's strength). In Toronto, the S&P/TSX finished the second quarter down 2.4% (-0.7% for the year) due to weakness in resource stocks. An indicator that we are watching is the VIX volatility index, which remains low.

	Closing	Change	
	30-Jun-17	Quarter	2017
Stock Indices			
S&P/TSX	15,182	-2.4%	-0.7%
S&P 500	2,423	2.6%	8.2%
MSCI EAFE*	1,096	1.7%	5.7%
Currencies			
CAN$ (US$/C$)	0.7713	2.7%	3.6%
Euro (US$/EUR)	1.1426	7.3%	8.7%
Commodities			
Oil (WTI)	$ 46.02	-8.9%	-14.4%
Gold	$ 1,243	-0.3%	7.4%
Volatility Index			
VIX	11.18	-9.6%	-20.4%

** MSCI Europe, Australasia and Far East*

If the trajectory of the VIX has tended to flatten out in recent years, its behaviour remains all the same central to our analysis. Once again in Q2, the few usual upheavals that we have become accustomed to ended in a return below its past 6-year average. During the 1990s, the VIX, sometimes called "the fear index," rose above the 20-point mark in 55% of the months. In the 2000s, it reached this same mark 2 months out of 3. But since 2012, it has reached 20 points only 30% of the time. The peaks are now shorter and more noticeable, which signifies heightened nervousness when these spikes occur. In short, there is no real capitulation, so to speak, by pessimistic speculators who sell short. In our opinion, a drop in the VIX to new historic lows (i.e. around 9) would be a red flag for stocks. In December 2006, the complete and utter capitulation of the VIX foreshadowed an eventual market high that, in fact, materialized later in 2007.

On the international markets side, the Q1 momentum continued into Q2. The MSCI EAFE index of developed countries posted +1.7%, while the index of emerging markets recorded a 5.8% gain. The encouraging trend for the year is now 5.7% and 13.7%, respectively. We reiterate our recommendation for international equities, including those of emerging countries. We believe that the valuation for international shares is cheaper and that these markets provide a higher risk-return ratio. At this point in the market cycle, an asset reallocation toward these markets would be appropriate.

Clear skies for the world's economy

On a global level, one should scan the horizon carefully for menacing clouds in the short term. No economic forecasting model is perfect, of course, but it is sufficient to say that, notwithstanding some softening in recent U.S. numbers, everything seems to point to a stronger synchronized recovery in the second half of 2017. The world GDP should grow by 3.5% for 2017 and 2018. Nevertheless, worldwide expansion, which overall remains one of the most synchronized since 1992, will not last forever and grey skies will eventually appear on the horizon. In China, the authorities are sending clear signals that seem to suggest the central bank will be less accommodating in its continued desire to contain the system's debt level. This is not the first time that experts have predicted action from the Middle Kingdom that will be a game changer. This time, the possibility seems more probable. We believe that a credit tightening in China would probably force the hand of the Federal Reserve in the U.S. and accelerate the normalization of interest rates. In this regard, we should mention that the attitude of the Fed since recent meetings clearly has been to telegraph a sustained increase in interest rates. We think that the risk is not in the intent but rather in the execution. Janet Yellen, however, has already given herself enough latitude to counter the hypothetical overheating of the U.S. economy. As a result, risk factors are more in terms of China and Europe.

The presidency of surprises

On the political side, the biggest question mark remains the erratic behaviour of President Trump. We could never claim that understanding the president's intentions would be easy. We believe that he is capable of the best and the worst. Capital markets are counting a great deal on a cut in corporate tax rates and a reduced regulatory framework; this is what drove the markets and created the "Trump rally" in the wake of his election. But disappointment on these two fronts could prove risky for stock market indices that are already at their fair value. The same is true for a too rapid normalization of rates. The capital market has already assimilated a gradual increase in world rates but not a rapid rise. Yet if the scenario of a sustained generalized increase is not already on the specialists' radar, this outcome will be seen in a negative light. An upward spiral from China or elsewhere could unleash a storm on stock markets because there are no expectations of this happening.

Conclusions and perspectives

In our opinion, if world rates are gradually normalized, as we expect they will be, stock markets should finish the year by posting positive returns, thanks to clear economic skies. While the summer break may continue, there is a strong probability that markets will re-establish their uptrend after the vacation period, in keeping with tradition. We still believe, however, that stock prices will continue to rise only if earnings remain strong. As we wrote in our previous issue, Q1 results were a determining factor for 2017. And they did not disappoint with an annual growth rate of 15.3% for the S&P 500, far exceeding expectations. While current growth forecasts for 2017 continue to be strong with a rate of 11% for the S&P 500, they are even stronger for the S&P/TSX with a rate of 22%. This is encouraging for the rest of the year, especially at this point in the market cycle when indices are priced at their fair value.