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Market Insights SPECIAL EDITION

Market Volatility – February 6, 2018

Over the past few days we have seen a significant increase in the volatility of the markets, which has been sparked by concern over inflationary pressure that could force central banks to raise interest rates at a pace faster than the market had anticipated.

Economic growth has been relatively strong in both the U.S. and around the world of late, and last week the U.S. employment report showed stronger numbers than anticipated. January's U.S. nonfarm payrolls (i.e. jobs) increased by 200,000, above expectations for 180,000. More importantly, the report also showed the average hourly earnings had increased by 2.9% annualized - the strongest wage increase since 2009. The wage inflation, along with late stage fiscal stimulus, caused 10-year U.S. bond yields (See Chart 1) to jump to 2.86% on expectations the U.S. Fed would need to increase interest rates at a faster pace than anticipated by the market.

Easy monetary policy (i.e. ultra-low interest rates and bond buying) has been a significant driver of the stock market since the financial crisis and the tightening of monetary conditions results in a higher cost of borrowing, potentially slowing economic growth and corporate profits.

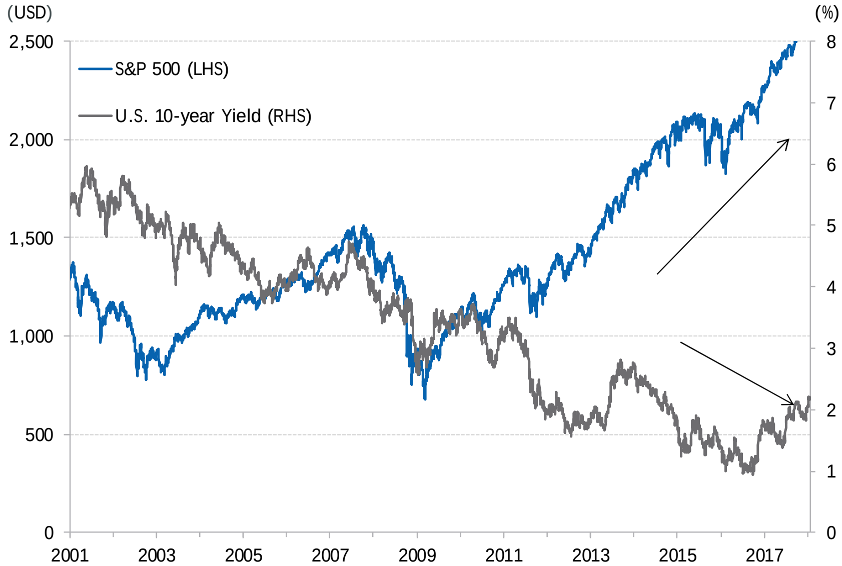
We believe this is a normal, healthy market correction and not the beginning of a recession or bear market based on the following:

- Extended periods of low volatility, like we have seen in the past 2 years, can result in more pronounced short term drops when volatility re-emerges. Markets had shown increased complacency to risk with many speculative investments showing excess (such as cryptocurrencies, cannabis etc.).
- Corrections are an important part of the stock market. They allow excesses to be removed, and create healthier fundamentals to be able to move markets higher. Historically, corrections of 5% or more on the U.S. stock market have occurred every 6-8 months. The S&P500 had gone over 19 months since the last 5% decrease, and almost two years since the last 10% correction.
- The declines of the past few days, while sharp, are minor in the scope of the bull market that began in 2009 (See Chart 2). U.S. and global markets went through a dramatic increase in January and hit an all-time high of over 26,616 on the Dow at the end of January.
- The wage growth showed tightening in the labour market, but only for a period of one month. We will need to see sustained higher than anticipated inflation levels for the Federal Reserve to hike rates at a faster pace. The current Federal Reserve rate of 1.5% remains very low by historical standards, and still has room to increase without significant economic impact.
- The world is undergoing a cyclical change from monetary easing to monetary tightening, and there will be volatility as markets adjust to the changing dynamic. However, global economic growth and corporate profits continue to grow and set a strong backdrop for continued expansion.

Key Messages for Clients

- Have a sound, asset allocation strategy. Times like this highlight why staying within your overall risk tolerance is crucial, and rebalancing is valuable.
- Stock market investing is a marathon and not a sprint.
- Volatility creates opportunities to buy high quality companies at a discount.
- During this correction, the U.S. dollar has been strengthening relative to the Canadian dollar, and helped pare Canadian investor losses of U.S. investments.

Chart 1: U.S. 10-year Yield vs S&P 500



Source: Addenda Capital Inc.

Chart 2: S&P500

Source: Bloomberg as of 2/5/18. Price return in USD

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