Market Update – Opportunity beyond the volatility

October 23, 2018

October has ushered in a roller coaster for riders of North American and global stock markets just as we saw in January and February. Over the last year we have repeatedly forecast higher volatility as this bull market ages. This current pullback or correction may lead to discomfort particularly given the higher volatility, but we do not see this as the end of the bull cycle.

We expect the current economic expansion and market growth to continue into 2019. The indicators that precede recessions are simply not there; the economy is still strong, and should continue to be so for some time. Stock markets worldwide (Canada, Europe, Japan, China and other emerging markets) are now negative in 2018, many even before this October correction. In the U.S. the Dow Jones Industrial Average (30 of America's largest industrial companies) and the S&P500 index (500 of the largest U.S. businesses) are now at or near zero return for the year. The technology heavy NASDAQ index (which includes the FANGMA stocks we wrote about in our quarterly and in "October musings" on October 8) is still in positive territory for 2018.

Investor sentiment is negative. Headlines have shaken confidence. Indeed, there have been many reasons to "worry": Trump rhetoric, trade war with China, slowing China growth, Italian economic weakness, BREXIT, mid-term elections and most importantly, rate hikes by the Federal Reserve in the U.S. It is easy to forget that corporate earnings have been very strong, as has been the outlook for earnings going forward, and perhaps most importantly, the stock market is actually now well priced. The U.S. market is at a valuation level on par with its twenty year average, and this is in an economic environment that is arguably as strong as any period in these past twenty years. Canadian and international stocks are even cheaper. The nervousness is exacerbated by financial TV's talking heads who are more focused on what's going to happen tomorrow, or next week versus what's more important down the road.

We believe that markets are in a bottoming process as we write. Although uncomfortable, this is an opportunity. Whereas we've previously been critical of the parabolic rise in some of the FANGMA (Facebook Amazon Netflix Google Microsoft Apple) stocks, which for much of this year had been the sole reason propelling the U.S. index higher, the recent correction in these stocks presents an entry opportunity. Similar to the market, many of them now are at compelling prices, particularly when we look at the earnings growth outlook and the fact that most of these stocks should not be impacted by the ongoing trade war between the U.S. and China - likely one of the reasons why they became too pricey before this correction. Most of these companies are cash rich businesses, and higher corporate borrowing costs have little impact on them since most don't carry much or any debt. This group of stocks is likely to be the same leadership group to lead the market out of this correction.

After 35 years of falling interest rates, investors are not prepared to see rates rising across the yield curve and have little understanding of how much higher they can go or how low they currently are in support of economic growth. Markets can go higher over the coming year, climbing the wall of worry.

At Worth Allaye-Chan Investment Counsel we are neutral in our asset allocation, (stocks vs bonds and cash) invested in the regions we favour, and hold the stocks and bonds we want to own. Correct positioning now will enable investors to benefit in the late stages of the cycle, and equity market returns during these late stages are likely to be very rewarding.

Investors should remain focused on the longer term.

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