

Volatility: it's back

By Richard J. Wylie, CFA
Vice-President, Investment Strategy, Assante Wealth Management

Investors are no doubt scratching their heads, yet again, and asking, “Aren’t we done yet?” Anyone who witnessed the unprecedented volatility during the financial crisis of 2008-2009 is experiencing déjà vu, as significant volatility has returned. Not surprisingly, this renewed market turmoil has raised concerns of a possible repeat of the market meltdown. While these fears are understandable, circumstances have changed in the past three years. It appears that elevated levels of volatility can be expected in the financial markets for some time to come. However, despite, or in some cases because of, the heightened volatility, opportunities for investors will also appear. Making use of professional advice should pay dividends for investors who can stick with their financial plan and take advantage of these opportunities as the markets work their way back toward a more stable state.

Measuring volatility

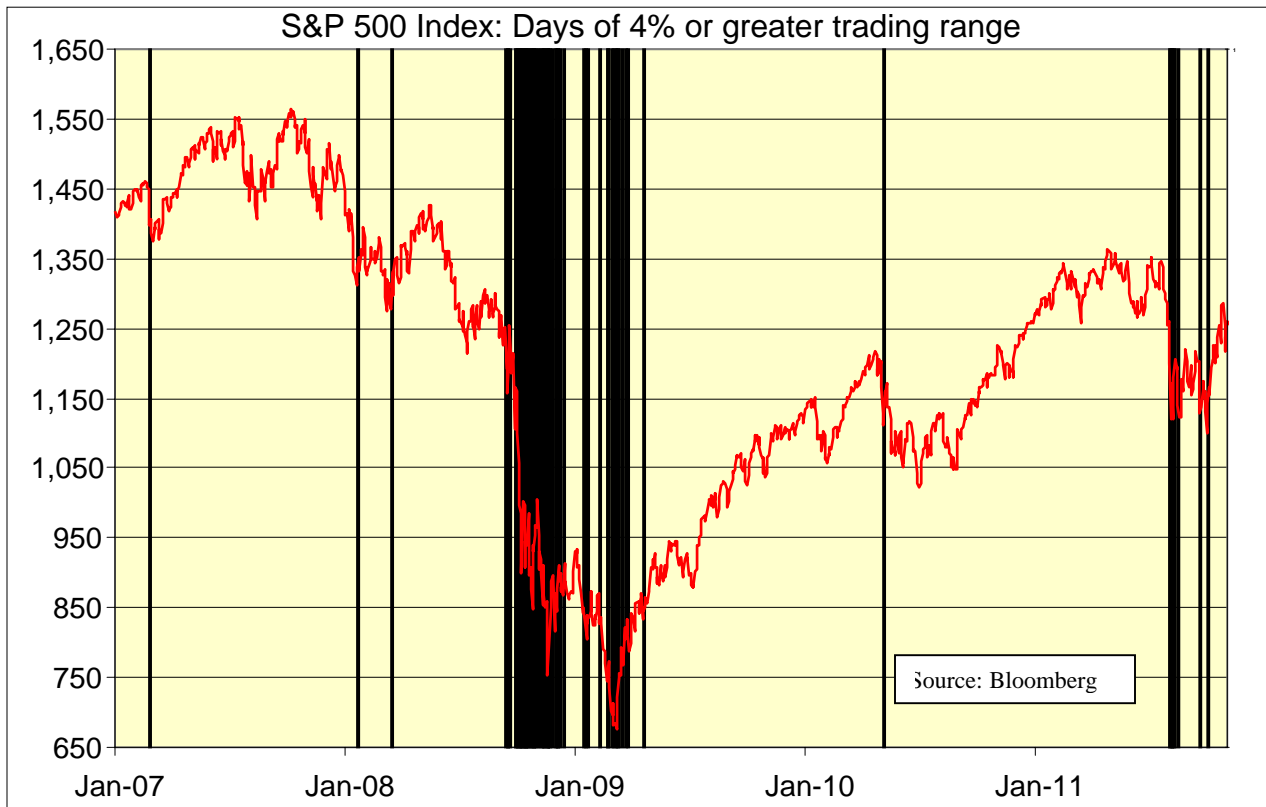
There are a number of ways to assess volatility. One measurement that has become more popular recently is the “VIX,” which is often referred to as the “investor fear gauge.” VIX is simply the ticker symbol for the Chicago Board Options Exchange (CBOE) Volatility Index. The index is constructed using the prices of a wide range of options (puts and calls) on the S&P 500 Index. The pricing of these options allows a calculation of an implied volatility, producing what is viewed as traders’ expectations of 30-day volatility for the market.



The index itself is relatively new. First introduced in 1993, the index was modified to its current form in 2003. As can be seen in the graph on the previous page, the index hit its highs in September-October 2008, at the height of the financial crisis.

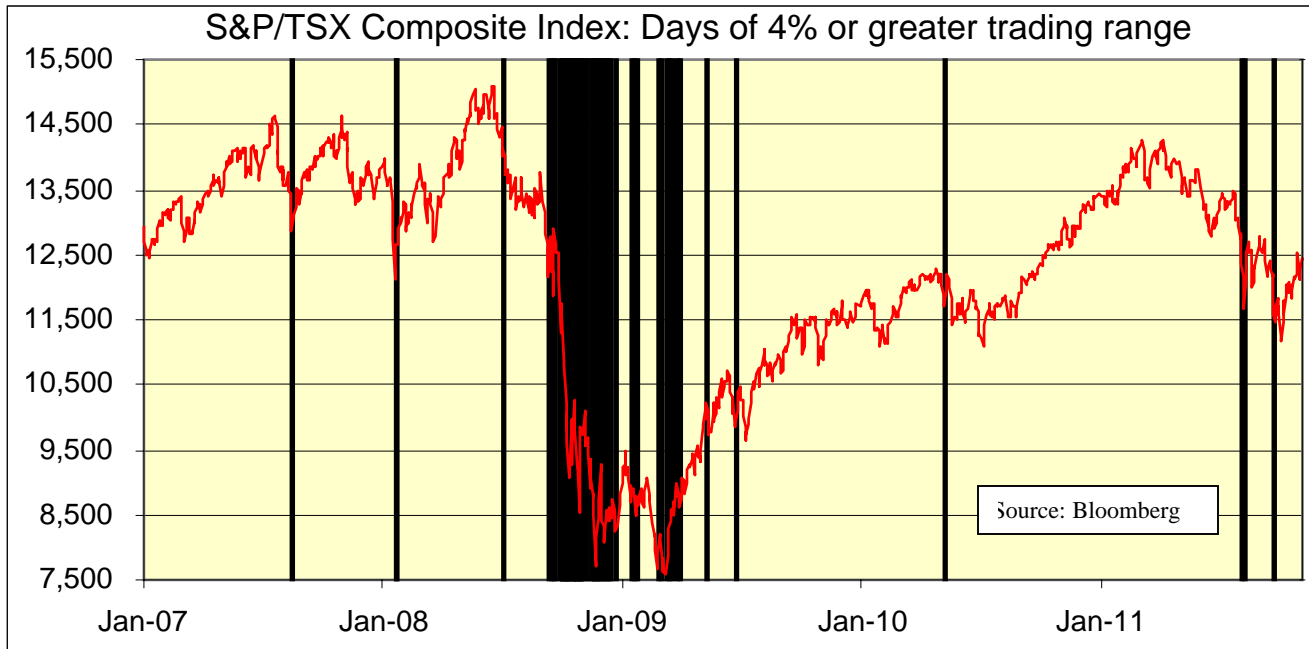
Equity markets

Another way to assess volatility is by observing the markets directly. The graph below shows the U.S. S&P 500 Index (red line) and days when the index experienced a 4.0% (or more) trading range¹ (marked in solid black). Over a long history for the S&P 500 the market would, on average, experience one session with a 4.0% trading range for every 100 trading days or once every five months. Between September 15 and December 15, 2008, during the height of the financial crisis, the market experienced a 4.0% trading range on 43 of the 65 trading days.



Similarly, the Canadian market had, historically, experienced one of these volatile trading days for every 69 trading sessions. That ratio rose to the same 43:65 as the U.S. market between September 15 and December 15, 2008. More recently, between August 4 and October 4, 2011, the Canadian index was somewhat less volatile than that of our southern neighbour, recording three sessions with a 4.0% trading range compared to nine for the S&P 500.

¹ A trading range is calculated by taking the difference between the “high” and “low” quote for the day and dividing it by the value of the previous day’s closing level.



Sovereign debt

While the market had gone through a period earlier this year in which volatility eased, one issue that had not gone away since the height of the financial crisis is Europe's sovereign debt problem. Under the common currency, some of the economically weaker nations were able to borrow at lower interest rates by being a part of a much larger economic bloc. Instead of using the opportunity to restructure their existing debt, these nations simply raised both their debt and spending levels at a lower cost. Specifically, Greece's debt stood at US\$136 billion in 2001. By 2006, it had increased to US\$281 billion and it has subsequently climbed to US\$430 billion², more than 140% of the country's GDP. Typically, a country finding itself in a position of untenable debt would have a number of options and would usually end up with a blend of tax hikes, spending cuts and higher inflation (to devalue the currency and make it easier to pay back the debt). In many ways, Canada's own experience during the 1990s followed this path, though the starting point was nowhere near as dire. However, Greece today has fewer options than Canada did in the 1990s. The Mediterranean nation does not have its own currency or method of establishing its own interest rate policy. The economic interconnectivity of the Eurozone raises the risks for all member states if one of them is allowed to fail or default. In addition, with many credit default swaps outstanding, a Greek default would mean that these contracts would be triggered. Some pundits question whether there is sufficient capital behind these contracts.

With debt issues still outstanding in Greece, Portugal, Italy, Ireland, and Spain, Europe faces a long road to sustained recovery. Complicating matters, weaker economic growth in the region will hamper efforts being

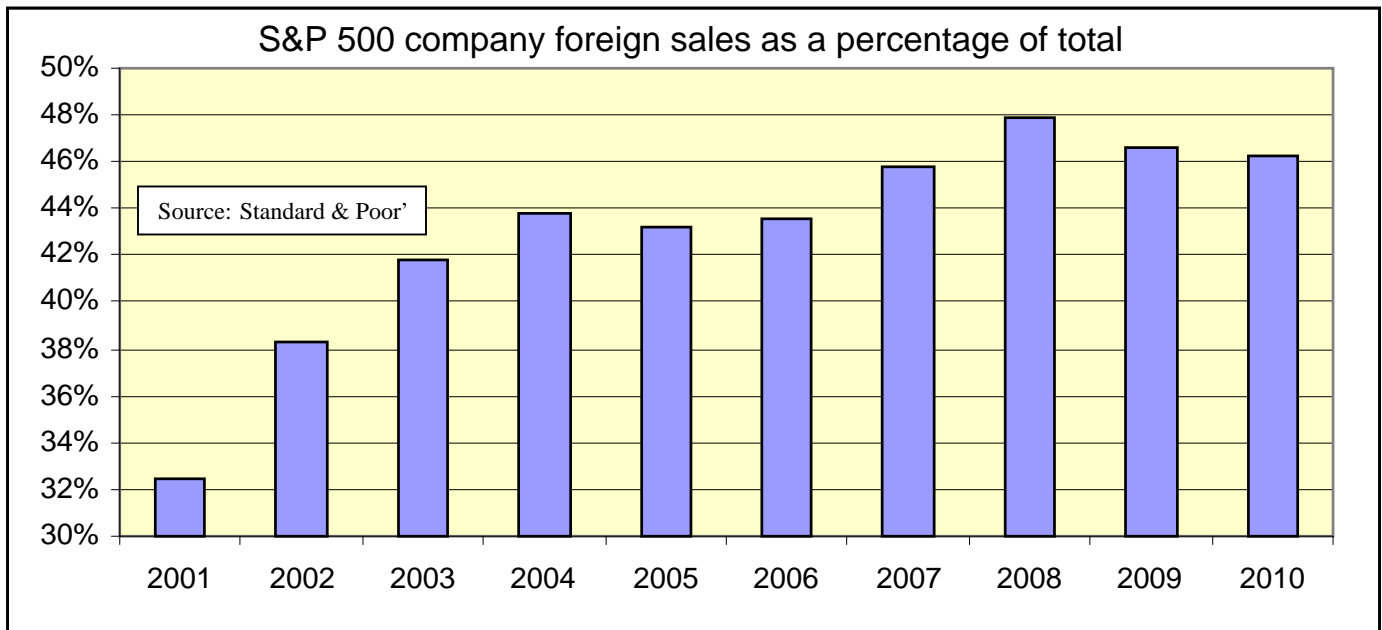
² Source: International Monetary Fund.

made even by the stronger members of the currency union. In the past, European debt problems had been dealt with and markets were able to adjust. However, those adjustments occurred in a less challenging period in which the U.S. enjoyed a stable debt environment.

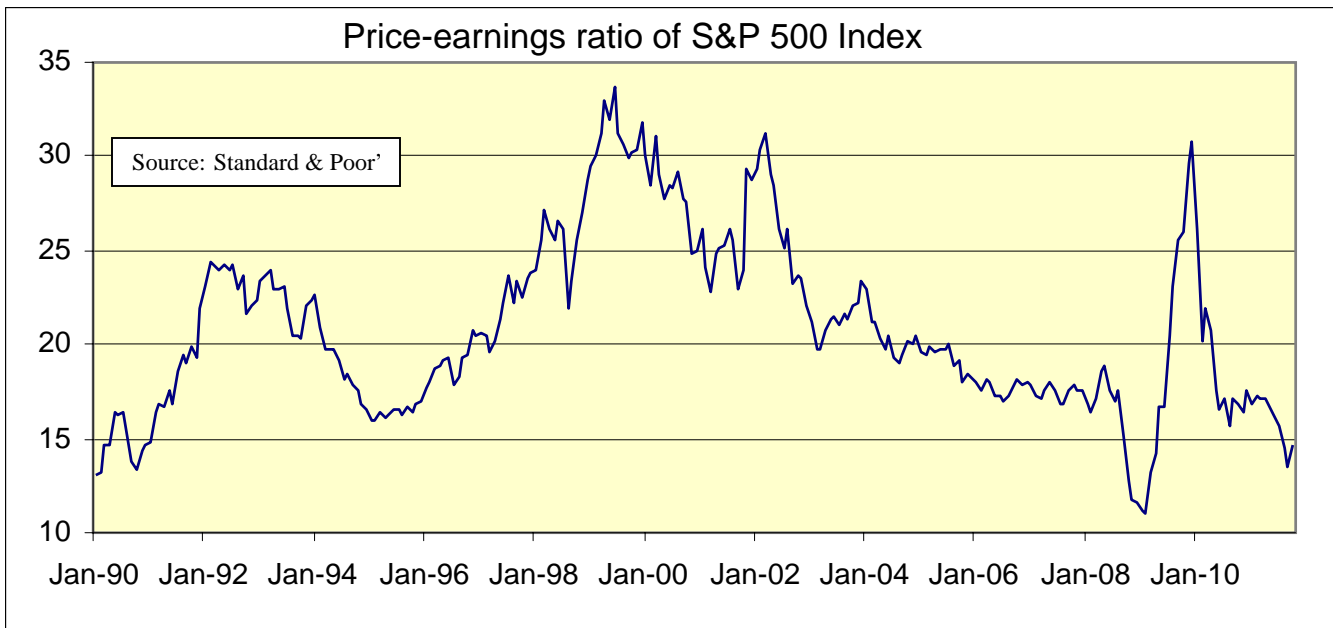
The end of the period of diminished volatility was punctured in early August of this year when Standard & Poor’s announced that it had cut the United States’ credit rating to AA+. This was the first time since the U.S. achieved AAA status in 1917 that its credit rating had been reduced. The returning volatility underscored the depth of the sovereign debt problem and the fact that the U.S. was not in a position to provide much help.

Silver lining

Amid the market gyrations that have reflected the sense of uncertainty over governments and their debt loads, businesses have been active in improving their profitability. By reducing their outstanding debt and shoring up their balance sheets with substantial cash positions, a large number of corporations have improved their risk profile. A key trend that has emerged over the past decade has been the increase in U.S. companies’ exposure to foreign markets. This diversification of sales has helped these corporations significantly during the recent period, which has been characterized by slower economic growth in developed markets and more rapid economic expansion in developing markets. And even though there has been some slippage in this trend recently, as the graph below shows, the overall trend is positive for U.S. companies. The developing economies of China, India and Brazil have large populations that aspire to a standard of living that more closely mirrors that of the developed western countries. Recognized, brand-name products from many of these multinational U.S.-based corporations have found a significant toehold in these emerging markets.



Interestingly, investors appear to remain reluctant to move away from government bonds as they feel that they remain a safe haven. Proof of this was the paradoxical rally in U.S. Treasury bonds on the very day in August of this year that they were downgraded for the first time. In fact, the first Treasury bond auction following the downgrade announcement saw the U.S. borrow at record low interest rates. Three-year notes worth US\$32 billion were auctioned off at 0.50%. Similarly, \$24 billion of 10-year notes were auctioned off at 2.14%. Meanwhile, cash fled the equity markets. The latest round of corporate quarterly announcements saw two-thirds of U.S. companies beat analysts' profit expectations, reinforcing the notion that the business part of the world is doing better than the government part of the world. Company earnings are a key driver of stock prices over the long term. Today's share prices of S&P 500 companies do not appear to reflect the significant shift to foreign sales that these companies now enjoy, and therefore may understate their full earnings power. As seen in the chart below, the price-earnings ratio of the S&P 500 remains near a 20-year low, providing an opportunity for stock investors to take advantage of attractive valuations at a time when governments continue to push low-yielding bonds into the market.

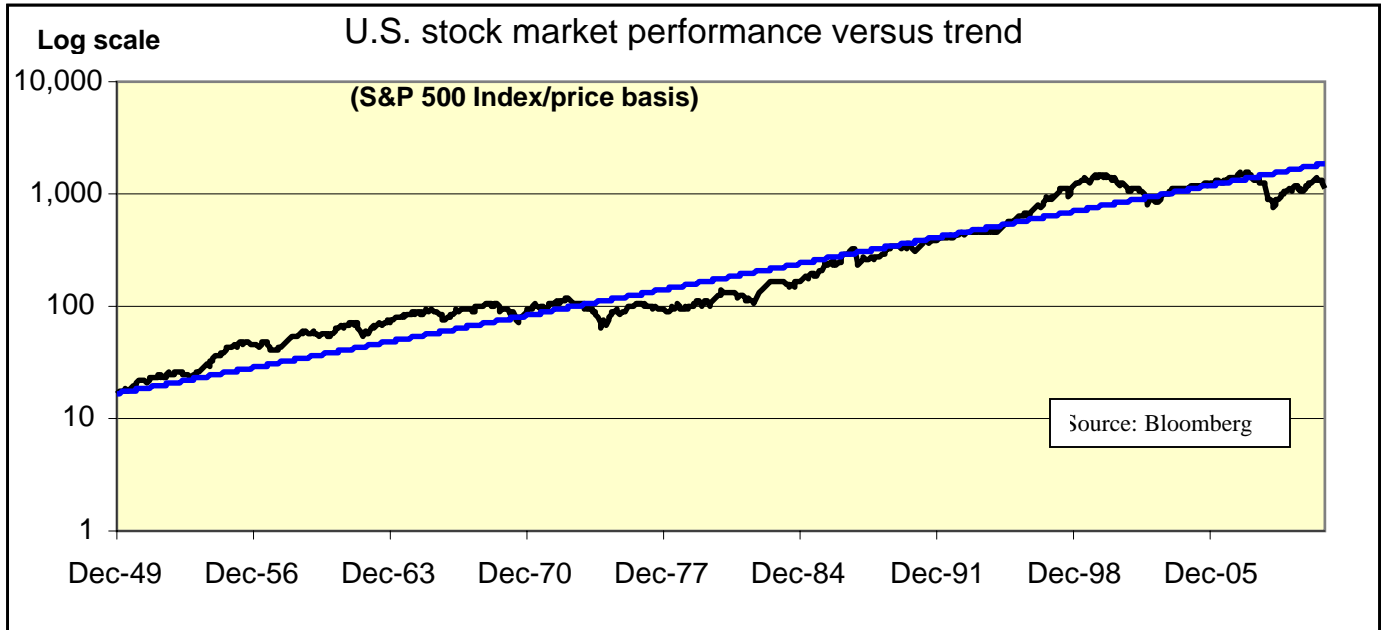


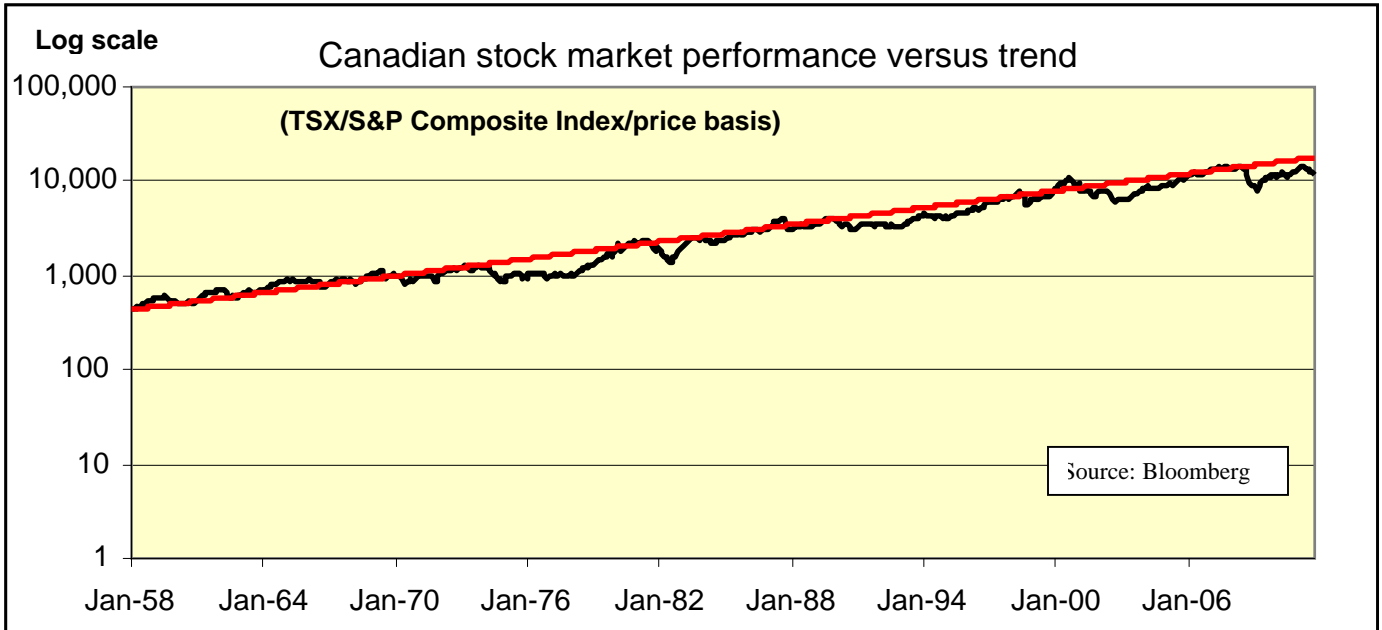
Longer term

Historically, equity investing has provided the best opportunity to offset the erosion to buying power caused by inflation. Over very long periods of time, the U.S. market has been shown to rise at 7.2%³ on a price basis. As can be seen by the graph on the next page, periods of outperformance are followed by periods of below-trend performance and vice versa. The Canadian market has shown a similar but lower long-term

³ The S&P 500 Index averaged a 7.2% annual gain in the 60 years between the end of 1949 and the end of 2009. Source: Standard & Poor's.

trend (a 6.6% average annual return from the end of 1957 to the end of 2009), with the same pattern of periods of below-average returns being followed by above-average growth. History shows us that markets have eventually shaken off some of the prevailing fear and stock prices have come to reflect the fundamental values of the companies that issued them.





Conclusions

- The road to settling the world's sovereign debt problems will be long and will inevitably produce episodes of heightened market volatility. Investor resolve will be tested as the process continues.
- Episodes of elevated volatility can easily mask positive investment developments. Opportunities will be missed by investors who stick to the sidelines during these times.
- Establishing a financial plan and sticking to it will help ensure a disciplined approach to investing. Taking advantage of professional advice will simplify the process.

The information contained herein consists of general economic information and/or information as to the historical performance of securities, is provided solely for informational and educational purposes and is not to be construed as advice in respect of securities or as to the investing in or the buying or selling of securities, whether expressed or implied. Neither Assante Wealth Management (Canada) Ltd. nor its affiliates, or their respective officers, directors, employees or advisors are responsible in any way for any damages or losses of any kind whatsoever in respect of the use of this report or the material herein. This report may not be reproduced, in whole or in part, in any manner whatsoever, without the prior written permission of Assante. Copyright © 2011 Assante Wealth Management (Canada) Ltd. All rights reserved.