Update on the recent market volatility

Global markets experienced a widespread sell-off on Monday, extending last week's losses and raising new fears over how far markets will drop. In North America, the biggest drop was the Dow Jones which fell by more than 6% at its open, but reversed some of the earlier losses to close 3.6% lower. Similarly, the S&P 500 fell 3.9% on the day entering into correction territory, defined as a decline of 10% from a recent peak. In Canada, the S&P/TSX closed 3.1% lower while European equities were down 5%-6% as stocks suffered their worst day since 2008.

While the volatility was significant, it was not the worst we have seen. Looking at the Volatility Index (VIX), which tracks the volatility of the S&P 500 index, volatility was markedly higher in October 2008 and September 2011 (see Figure 1). In fact, this was more of a correction – and one that many had been anticipating.

Figure 1: S&P 500 Volatility Index over the last 10 years

Source: Bloomberg, August 24, 2015

The retreat in equities was on the back of a broader sell-off in China, after the Shanghai Composite had the largest one-day plunge in almost eight years of 8.5%. We believe that the broader sell-off was driven by two main factors: 1) fears that China's growth is slowing, which would in turn weigh on global growth, and 2) anticipation of a U.S. federal interest rate hike.

China has been a large contributor to global growth, which is why a series of disappointing economic data is having an impact. On Friday last week, China reported disappointing numbers with a preliminary Caixin/Markit China Manufacturing Managers' Index (PMI) reading of 47.1 for August, below economists' expectations and the worst reading since March 2009. At the same time, July retail sales reported mid-August were slightly shy of expectations. Additionally, the Chinese central bank's devaluation of the yuan earlier this month, while its goal was stabilization, added to concerns that the country needed to boost its exports in order to reach its 7% growth target.

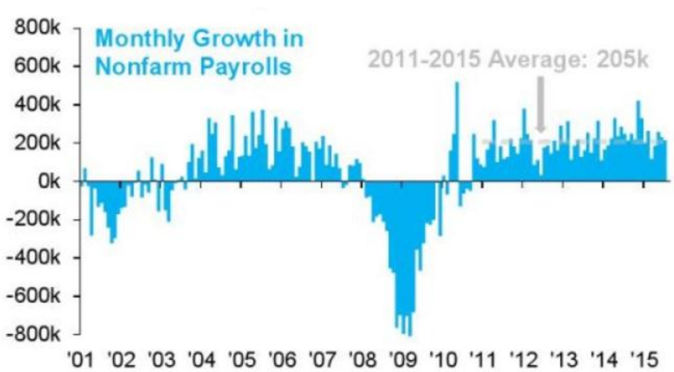
Yesterday, following the global rout, China announced a reduction in its benchmark bank lending rate by 25 basis points (bps) to 4.6% and also reduced its one-year benchmark deposit rate by 25 bps to 1.75%. Additionally, the People's Bank of China (PBoC) lowered its interest rate market and reserve requirement ratio by 50 bps to 18.00% for most big banks, effective September 6. Global equities responded positively reversing some of the earlier losses, except in China where the Shanghai Composite extended losses for a second day.

AGF INVESTMENTS VIEW

The question is now whether the volatility is behind us and how investors should position themselves going forward. The AGF Asset Allocation Committee (AAC) believed the risk of a correction was heightened and now suggests that, to the extent that investors are underrepresented in equities, the retreat presents an opportunity to accumulate positions. In the long term, the AAC is positive on equities relative to fixed income, particularly as fundamentals remain unchanged, although we could see some more volatility in the near term. Central bank policies also remain accommodative, which should also be supportive of equities going forward. We outline some reasons to stay invested below:

- **U.S. economy remains resilient:** Recent economic data out of the United States has generally been positive. U.S. home sales climbed 5.4% in the biggest gain this year to a 507,000 annualized pace from a 481,000 gain in the prior month[1]. Similarly, job growth remains strong with employers adding 215,000 jobs in July and the employment rate is at a seven-year low of 5.3%.

Figure 2: Slow but steady U.S. job gains

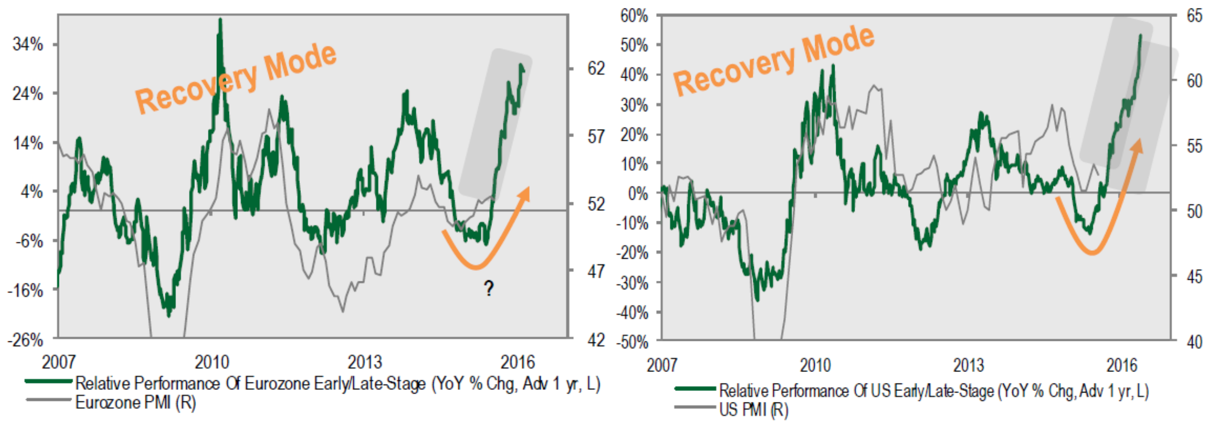


Source: Business Insider

- **Global economy seems poised to grow:** In looking at leading indicators for the Eurozone and the United States, early cyclicals point to the fact that developed markets are now in recovery mode (see Figure 3). Purchasing Managers' Indexes (PMIs) are already off their lows in Europe as well as in the U.S. and some leading indicators of the business cycle suggest that the PMIs are going to continue to rise.

[1] Bloomberg

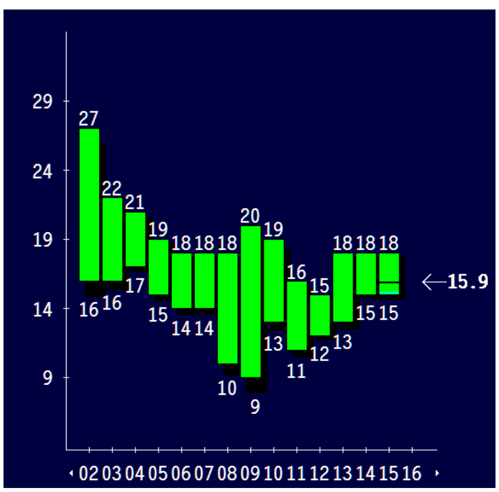
Figure 3: Recovery in the Eurozone and U.S. is likely just in the early innings



Source: Cornerstone Macro

- **Corporate profitability remains strong:** Corporate profitability remains strong, which is a good indicator of the overall health of the economy. In the second quarter, earnings per share (EPS) was estimated to rise by approximately 6% year over year, which should be supportive of equities.[2]
- **Valuations remain attractive:** At the current 2015 trailing price to earnings multiple of approximately 16.0x, (see Figure 4), we do not see valuations as particularly demanding especially as they are well below historic peaks. In light of forecasted growth in earnings, we see further upside to equities from the current levels.

Figure 4: Historical trailing price to earnings multiple

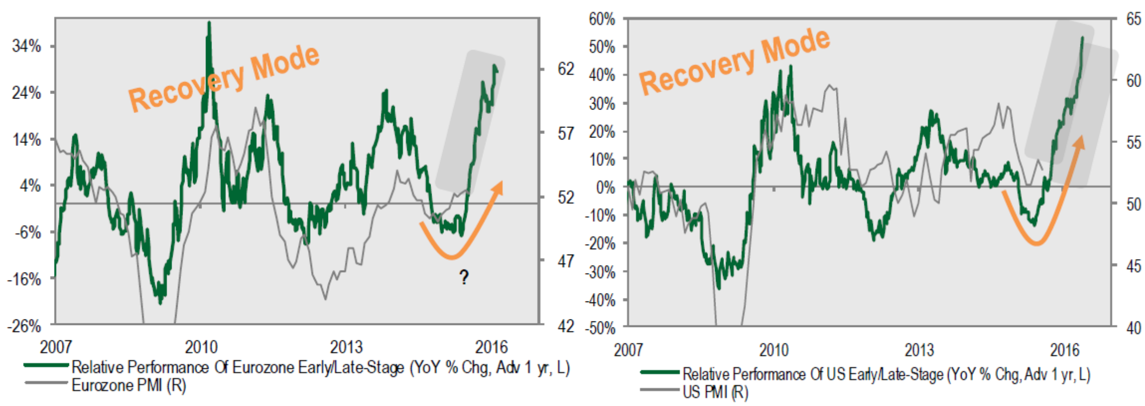


Source: Thomson Reuters Baseline.

[2] Fact Set, BofA Merrill Lynch U.S. Equity & Quant Strategy.

- **Central Bank policy remains accommodative:** We expect that capital markets will also be supported by excess liquidity going forward, particularly as the quantitative-easing (QE) programs in Japan and the Eurozone are in the early innings. The European Central Bank (ECB) continues to buy US$65 billion worth of bonds a month and ECB President Draghi has explicitly stated that he will do whatever it takes to support the economy, suggesting the potential for more QE if the economy does not improve.

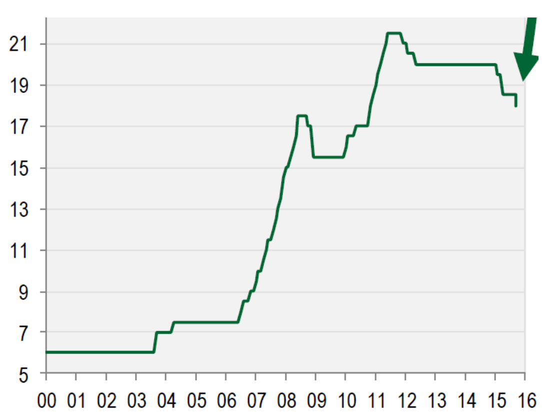
Figure 5: The Eurozone and U.S. recovery



Source: Cornerstone Macro.

- **China can still drive reform:** As evidenced by China's policy actions following yesterday's broad sell-off, China still has a number of policy options at its disposal that it can use to bolster growth including further interest-rate cuts and reductions in its reserve ratio (the PBoC reserve ratios are approximately 18% compared to the U.S. Federal Reserve Board's 0.25%) (see Figure 6). We would also not be surprised to see fiscal stimulus measures being employed.

Figure 6: China's required reserve ratio Sep 6: 18.0% e



Source: Cornerstone Macro.

- **Currencies are expected to trade in line with growth:** Whereas the sell-off in China created noise for currencies, going forward we expect currencies to trade in line with the underlying economic fundamentals of their countries. Essentially countries that post strong economic growth should see their currencies appreciate and countries with imbalances are likely to see a deterioration in their currency.

To reiterate, the AGF Asset Allocation Committee remains positive on equities given fundamentals remain intact as the economy continues to expand and corporate earnings continue to grow. Valuations are also relatively attractive compared to prior periods, which coupled with growth is supportive of equities.

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