Market Snapshot – August 2016

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A Recent Lesson on Market Moving Events

By Joe Zawawi

It has been nearly seven weeks since the U.K.'s June 23rd referendum, or Brexit, vote. The shocking result, in which Brits elected to leave the European Union, roiled global financial markets. Major European equity indices tumbled the following day, with some plummeting over 10%. The British pound dropped to levels not seen in over three decades and government bond yields around the globe slammed through the floor as investors scrambled for safety.

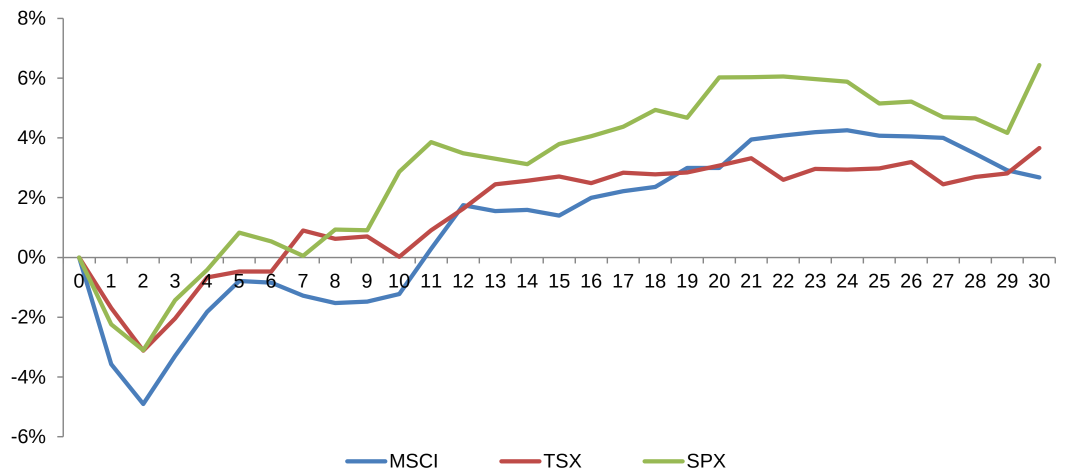
In the days following the Brexit vote, the MSCI World, TSX and S&P 500 indices were off by 7.4%, 3.7% and 5.8%, respectively, at their lowest (measured in Canadian dollars). Scathing reports from news outlets and many market pundits were constantly front and centre, painting varying pictures of what doom potentially lay ahead.

Now that we are over a month removed from the initial reaction, the dust has seemingly settled and the apocalyptic-style headlines have begun to subside, we thought it would be a good time to revisit this event and investigate the market reaction to other shocks that have occurred over the past few decades. The lessons of the past may allow us to be better prepared to deal with the fallout of the next large-scale event that creates market chaos.

Where We Are Now

In the aftermath of the initial post-Brexit market turmoil, most major equity indices have not only regained the ground lost, but they have trekked higher. In the case of the S&P 500, fresh all-time highs have been reached. As chart I illustrates, markets around the globe sold off sharply in the days following the referendum and recouped losses in as few as seven days.

Chart I: Daily Cumulative Market Performance 30 Days Out from U.K. Referendum (in $CAD)



Source: Bloomberg, HollisWealth

What History Tells Us

It should not come as too much of a surprise that markets have rebounded strongly, post-referendum, for anyone who is a student of the history of financial markets because dramatic market reactions to perceived shocks are, for the most part, the norm. There has been no shortage of world-changing geopolitical events, natural disasters or endogenous financial calamities over time and the subsequent stock market reaction following these events follows a similar pattern: there is a sharp sell-off immediately following the event and the market generally recovers to its pre-event level within a few days or weeks. Most of the time.

S&P Capital IQ compiled a list (Table I) of some of the most significant market shocks since the beginning of World War II and analyzed the resulting impact on global stocks, measured by the MSCI World Index. As the findings in Table I show, the bottom for the market was reached within six days of the initiation of the shock, on average, and recovery was achieved within 14 days, on average.

Table I: Global Stock Performance Post Major Geopolitical Events (MSCI World)

Market Shock	Closing Levels			Bottoms			Days to Recover
	Prior Day	Next Day	% Chg.	Level	Days	% Chg.	
Japanese Tsunami (3/11/11)	1304.28	1296.39	(0.6)	1256.88	3	(3.6)	6
Flash Crash (5/6/10)	1165.87	1128.15	(3.2)	1110.88	1	(4.7)	4
Lehman Bankruptcy (9/15/08)	1251.7	1192.7	(4.7)	676.53	121	(46.0)	285
Madrid Bombing (3/10/04)	1140.58	1123.89	(1.5)	1093.95	10	(4.1)	18
9/11 Attacks (9/11/01)	1092.54	1038.77	(4.9)	965.8	5	(11.6)	19
Collapse of LTCM (9/23/98)	1066.09	1042.72	(2.2)	959.44	11	(10.0)	9
Iraq's Invasion of Kuwait (8/2/90)	355.52	351.48	(1.1)	334.43	2	(5.9)	30
Program Trading (10/19/87)	282.7	224.84	(20.5)	223.92	33	(20.8)	223
Reagan Shooting (3/30/81)	136.3	134.7	(1.2)	134.7	1	(1.2)	4
Nixon Resignation (8/8/74)	82.65	81.57	(1.3)	62.28	39	(24.6)	143
OPEC Oil Embargo (10/17/73)	111.3	110.05	(1.1)	109.16	6	(1.9)	10
Kennedy Assassination (11/22/63)	71.62	69.61	(2.8)	69.61	1	(2.8)	2
Cuban Missile Crisis (10/22/62)	54.96	53.49	(2.7)	53.49	1	(2.7)	5
Pearl Harbor Attack (12/7/41)	9.38	8.97	(4.4)	8.37	18	(10.8)	257
Medians			**(2.4)**		**6**	**(5.3)**	**14**

Source: S&P Capital IQ

There are, of course, periods when stocks don't recover as quickly. Downdrafts that are related to, or occur in times of more deeply rooted systemic issues in the financial system tend to have much longer recovery times.

The Lehman bankruptcy in 2008, for instance, took place at the cusp of what was to become a global financial crisis. Although the market selloff was of a grand scale, the bottom was reached within four months and recovered in about a year after that (285 business days) even then.

Similarly, the market crash of 1987 took 223 days to recover from a low that was reached in just 33 days. Again, this crash, which followed "Black Monday", was associated with outstanding systemic issues within the financial system related to program trading for portfolio insurance strategies at the time. But the point is that markets *did* recover in all cases.

Events that fall into the category of terrorist attacks, natural disasters or armed conflict – or exogenous shocks - are generally less impactful on the markets as they generally don't have a material impact on economic or financial system fundamentals and recovery periods following selloffs that are induced by any of these events are often swift.

What Type of Event is Brexit?

So far, the impact on the market as a result of the Brexit vote has been limited. Although most economists predict dark days ahead for the economy of the U.K., the effects on the global economy resulting from a U.K. exit alone are estimated to be rather muted. The vote itself was known about for months in advance, and although the outcome was surprising, advanced polls were close enough to compel many investors and businesses to position themselves appropriately for a Brexit. In addition, the British government has reshuffled its leaders quickly and the ultimate date of exit could be as far as two years away or more; two factors which have instilled a sense of calm in market participants.

Future developments, of course, could change all of this. It is well known that populist parties are gaining traction on many other countries within the EU such as France, Italy and the Netherlands. These parties share the same level of discontent with the EU as those who supported a Brexit. The fear in all of this is the prospect of an eventual collapse of the trading bloc, which includes a common currency and monetary system. The ramifications of an EU collapse could extend globally and to every asset class.

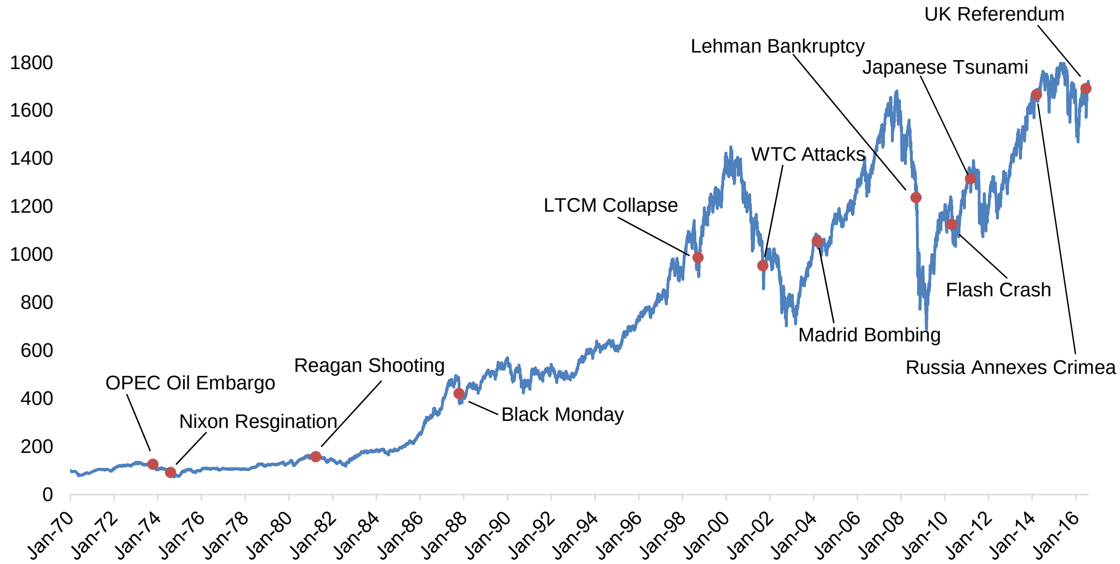
The Brexit decision would likely have limited repercussions for global stocks moving forward if it remains as an isolated event. However, if the U.K. is in fact just the first domino in a series of similar referendums which would bring the entire European Union's existence into question, the outlook for the market would likely be incredibly murky.

Keep This in Mind

There is no doubt that large-scale market shocks make investors nervous and generally lead to heightened volatility. History, however, has shown that the impact from such occurrences has been relatively muted in the medium to long term.

The best hedge against the impact of market shocks is a long term investment plan. With talks of a potential Frexit, Abortgual, Quitaly, Retireland and Nexit – along with the risk of exogenous shocks always looming - it is important for one to take a step back to look at the market more broadly and gauge its behaviour over time. It is clear that no matter the number or magnitude of external factors or problems that lie ahead for the financial system, patience pays off.

Chart II: Global Stocks through Major Geopolitical Events (MSCI World)

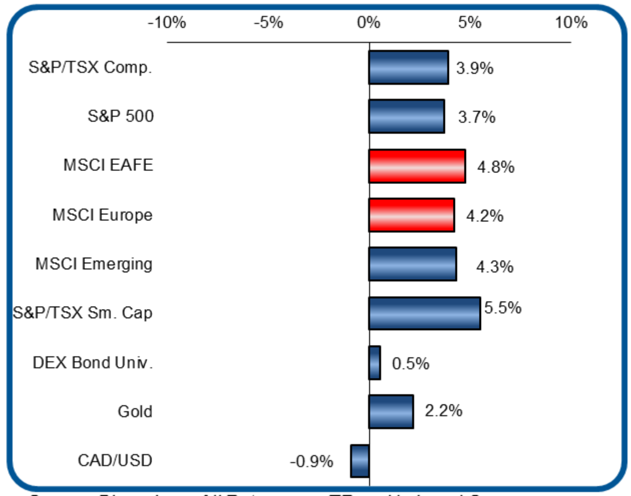


Source: Bloomberg, HollisWealth

MONTHLY OVERVIEW

Global equities were mostly in the green during July. The S&P/TSX Composite finished the month up 3.9%, pushing the index's year-to-date to 14.1%. The infotech was the best performing sector during the month, jumping 9.2% as CGI Group Inc. (GIB.A) climbed 14.9% following a large post-Brexit selloff. The Canadian energy sector was the only loser for the month, shedding just 0.4% as crude prices pulled back. In the U.S., the S&P 500 traded up 4.4% for the month, putting its year-to-date performance firmly in the green at 1.7%. Gains were also chalked up in Europe, with the Stoxx Europe 600 Index ending the month 5.2% higher. In Asia, the MSCI Asia Pacific Index added 6.7%. (All returns are in $CAD)

1 MONTH RETURNS



Source: Bloomberg, All Returns are TR and in Local Currency

As widely expected, the effects of the wildfires in Northern Alberta which knocked out one million barrels per day of crude oil production were reflected in the national GDP reading, which showed that Canada's economy contracted by 0.6% for the month of May. The silver lining in the reading was that StatsCan stated that there was "little evidence" that the wildfires affected any other industries. The number of people filing for unemployment claims in Alberta also rose during the month as a result of the slowdown in oil sands output. Unemployment claims rose by approximately 70%; the largest increase ever recorded for any province.

After a paltry nonfarm payroll increase of 11,000 in May, the U.S. jobs data for June exceeded even the highest estimate by adding 287,000 positions for the month. This compares with the average estimate by economists that called for an increase of 180,000. The employment report also showed that average hourly earnings rose by 2.6% in June from a year earlier. Wage growth has averaged 2.5% so far in 2015, which compares to 2.3% and 2.1% in 2015 and 2014 respectively. The combination of slower monthly job additions on average this year and stronger wage pressures may be an indication that the labour market is moving towards its natural level. These wage pressures in turn appear to be rubbing off positively on retail sales, which rose at a robust pace of 0.6% in June, far surpassing the expected gain of 0.1%.

The fly in the ointment of U.S. economic data was second quarter GDP growth which rose at a disappointing 1.2% annual rate, versus economists' expectations that called for 2.6% growth. Furthermore, Q1 GDP was revised downward to 0.8%, from the initial reported figure of 1.1%.

Although much has yet to unfold in the U.K. post-Brexit, recent economic releases have shed some light on the situation. Manufacturing PMI – a gauge for manufacturing activity - plunged from 52.4 in June to 48.2 in July (figures below 50 indicate contraction). The average over the prior 12 months was 51.3. This decline may be attributed to businesses slowing their production as they wait to see what lies ahead. Inflation also ticked up in June to 0.5% year-over-year; up from 0.3% in May. The recent significant drop in sterling should work to further bolster the consumer price index in future readings. The European Commission has lowered its growth forecasts, stating that economic growth would be 0.2% - 0.5% lower for the EU and 1% - 2.5% lower for the U.K. in 2017 as a result of the potential Brexit.

MARKET OUTLOOK

Although both the S&P500 and TSX Composite have had solid run-ups this year, lofty valuations, further risks from Brexit, the contentious presidential election, increased skepticism surrounding the effectiveness of monetary policy efforts, and other potential geopolitical happenings will likely add to volatility and uncertainty through the rest of the year.

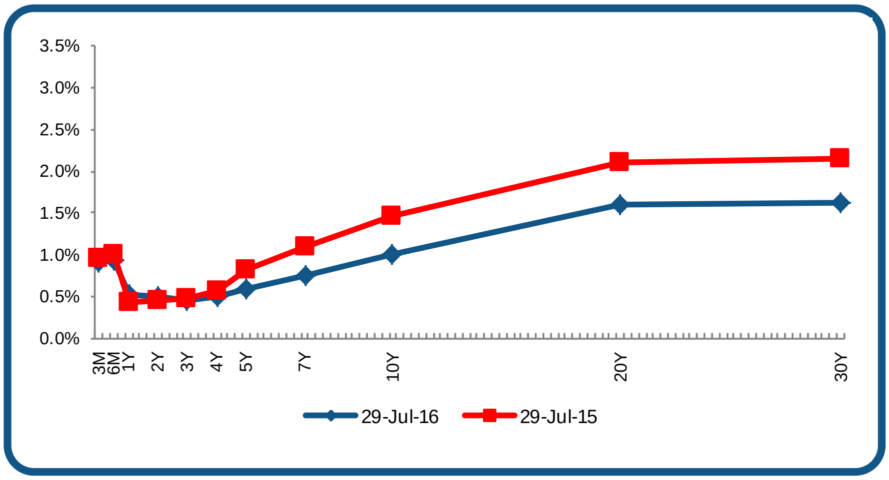
The IMF has cut its global economic growth projection to incorporate the ramifications of the U.K.'s exit from the EU will have. 2016 overall growth is now expected to be 3.1%, down a tenth of a percent, and 3.4% in 2017.

Monthly Market Statistics: July 2016

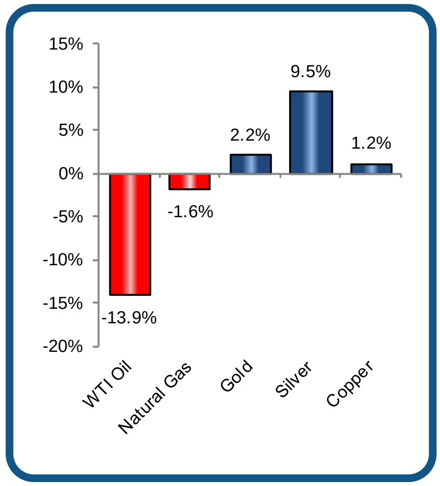
Total Return Index Returns (Annualized After One Year)

	Local Currency Returns							Canadian Dollar Returns						
	1M	3M	6M	YTD	1YR	3YR	5YR	1M	3M	6M	YTD	1YR	3YR	5YR
TSX Composite	3.9%	5.3%	15.5%	14.1%	4.0%	8.5%	5.5%	3.9%	5.3%	15.5%	14.1%	4.0%	8.5%	5.5%
S&P 500	3.7%	5.8%	13.3%	7.7%	5.6%	112%	13.4%	4.4%	10.1%	5.5%	18%	5.9%	20.4%	20.7%
MSCI EAFE	4.8%	2.9%	3.6%	-2.4%	-8.7%	6.4%	8.5%	5.8%	4.9%	12%	-4.7%	-6.9%	110%	10.2%
MSCI World	4.1%	4.7%	9.7%	3.8%	-0.5%	9.1%	10.9%	5.0%	8.0%	4.3%	-0.5%	0.4%	16.1%	15.5%
MSCI Pacific	6.1%	0.9%	-0.4%	-7.8%	-14.1%	6.1%	9.4%	7.4%	8.0%	5.4%	-2.0%	-15%	12.7%	10.8%
MSCI Emerging	4.3%	5.2%	14.0%	8.1%	10%	5.0%	3.4%	5.8%	9.6%	116%	5.9%	-0.1%	8.4%	3.9%
TSX Small Cap	5.5%	10.7%	40.8%	35.0%	23.8%	8.3%	0.9%	5.5%	10.7%	40.8%	35.0%	23.8%	8.3%	0.9%
Global Small Cap	5.4%	5.6%	14.3%	6.1%	1.1%	9.4%	112%	6.3%	9.2%	9.3%	2.3%	2.7%	16.7%	16.0%
CDA Bond Uni.	0.9%	3.6%	4.9%	4.9%	4.6%	5.8%	4.9%	0.9%	3.6%	4.9%	4.9%	4.6%	5.8%	4.9%
CDA 1-5 Yr Bond	0.1%	0.9%	12%	12%	13%	2.6%	2.5%	0.1%	0.9%	12%	12%	13%	2.6%	2.5%

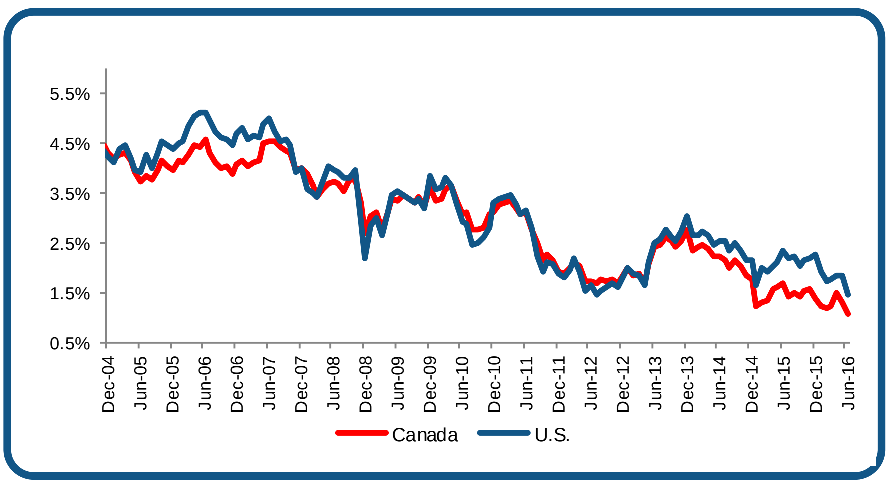
Canadian Yield Curve



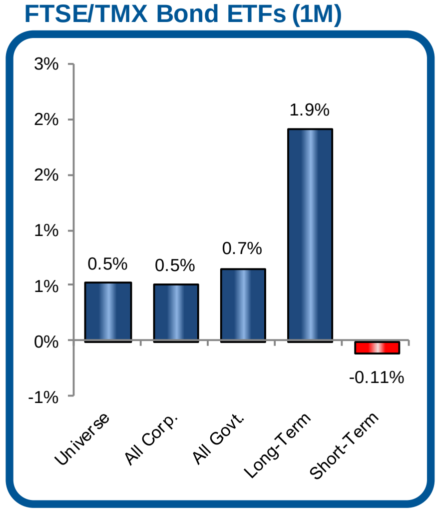
Commodities Performance (1M)



10YR Government Bond Yields



FTSE/TMX Bond ETFs (1M)



Source: Bloomberg, iShares.ca

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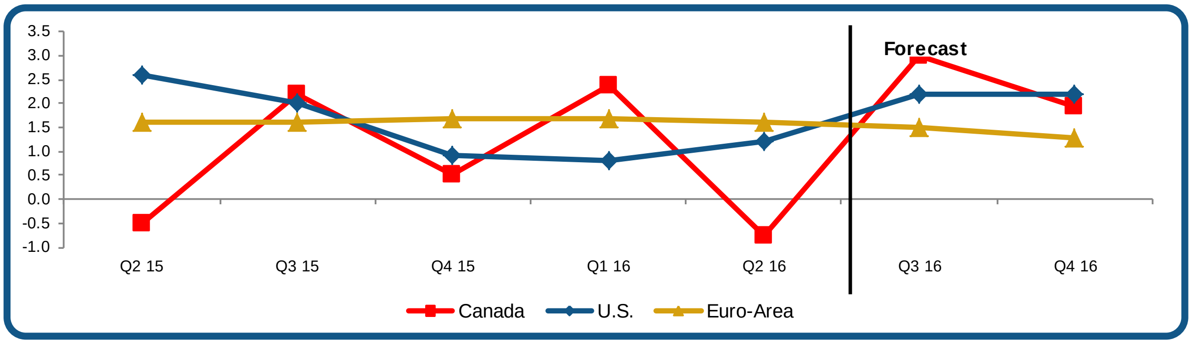
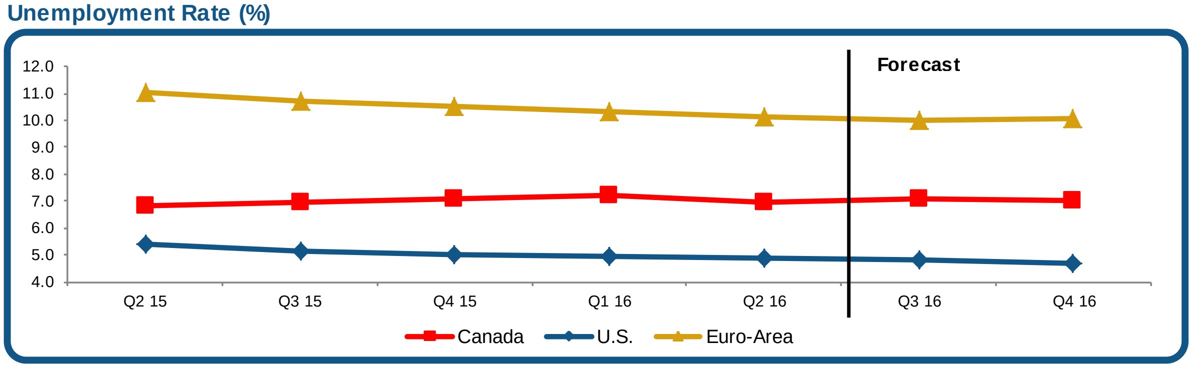
Economic Statistics

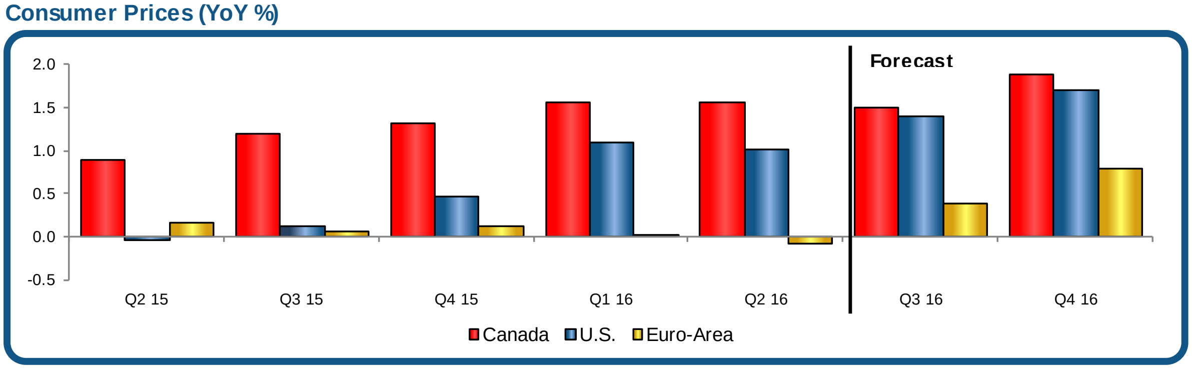
Real GDP (%)



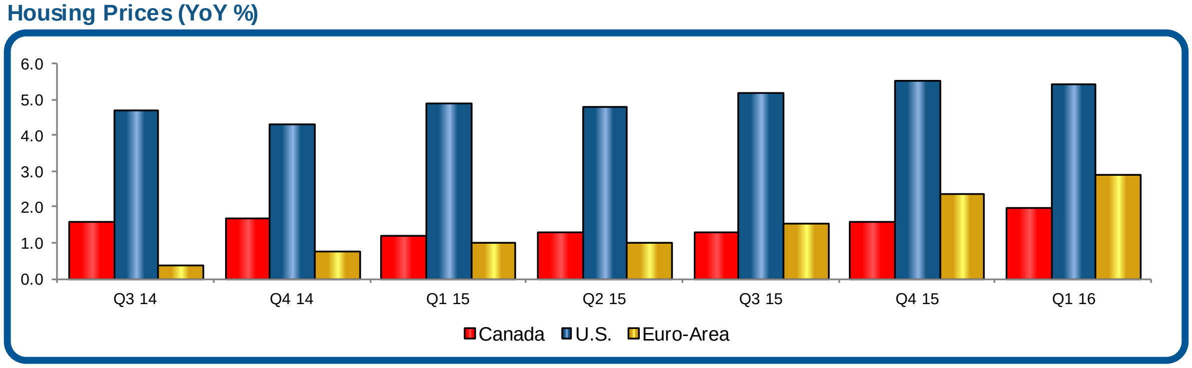
Unemployment Rate (%)



Consumer Prices (YoY %)



Housing Prices (YoY %)



Source: Bloomberg

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