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Pre-election nerves

An uneasy tone has permeated markets south of the border, as investor's nerves remain frayed on the potential outcome of the US election. Adding to investor angst is a potential interest rate hike this December, which theoretically would boost the US dollar and slow US overseas profit growth. As a result, the S&P 500 turned negative over the month (-1.8%) on a total return basis. The S&P/TSX 60 Composite Index (+1.4%) offered more encouraging performance, due in part to the big five Canadian banks (+3.3) surpassing quarterly earnings estimates. International stocks (+1.1%) appear to be prospering despite continued challenges in the EU banking system, and uncertainty surrounding the impacts of the BREXIT vote. Emerging markets were slightly negative (-0.2%) and Canadian bonds fell over the month (-1.0%).

While markets sold off in the US, corporate fundamentals continue to strengthen. As at the time of writing this commentary, the S&P 500 (+70% of companies have reported results) has delivered earnings results better than that expected by Wall Street analysts. And what has thus far been largely ignored by markets, is that in aggregate revenue growth has potentially entered into positive territory for the first time since fourth quarter of 2014 (1.5% y/y). And earnings per share growth has undergone a similar transformation with expectations of positive growth for the first time since the first quarter 2015 (0.9% y/y). Based on the positive results thus far, an additional $10 billion in additional capital has been generated by US corporations ($3 billion of which has come from the financial sector)*. The significance of this aggregate performance to investors is potential resumption of growth after a protracted period of slowing profit growth.

While corporate fundamentals have improved, valuations admittedly remain elevated due to a clear lack of investment alternatives. The S&P/TSX Composite Index P/E ratio trades more expensively relative to the S&P 500 at 19.5 times forward earnings (a 15 year record in terms of absolute level). The premium relative to the US equity market is indicative of investors again trying to time the bottom in oil, much like we saw in 2015 before oil fell to $26/barrel. Based on this and the resiliency in the supply of oil, we believe sector related risks continue to plague Canadian markets. While S&P/TSX Composite valuation continues to defy gravity, we have seen some reprieve in the S&P 500 valuation as investors stockpile cash ahead of the US election and the potential US rate hike. In terms of the possible election outcomes, the polls currently indicate a Hilary victory. Important to keep in mind however, polls are just opinion based and therefore don't offer any guarantee of the predicted outcome (case in point; the Brexit vote). And given that both candidates generally remain disliked by the populous, a Trump victory may not be totally out of the cards yet. Perhaps this explains the hefty cash positions across retail mutual funds which have reached approximately 8% of total assets.

Despite the perceived vulnerability of equity markets, Equitable Life Active Balanced portfolios remain fully invested across the broader market. Should markets maintain stability post the US election, corporate fundamentals could provide marginal upside opportunity for equities. Still, we remain cautious and avoid an overweight equity position until we see corporate fundamental momentum continue into 2017. From a regional equity perspective, we are overweight the US with an offsetting underweight to Canada and neutral position in international equities. Our neutral bond positioning, as usual, remains invested in investment grade bonds with zero exposure to junk bonds.

*Source: Factset Insight