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Market correction = an opportunity to buy the best companies at bargain prices

Summary: As long-term investors, we have learnt that it pays to stick to your investment plan and not get swayed by market volatility or negative headlines. Recall that earlier this year, the S&P 500 and TSX Composite overcame declines of 12% and 10% respectively to reach new record highs. We remain positive on equities as the NAFTA renegotiation has eliminated a major overhang for the Canadian economy, while the negative impact of higher interest rates and a U.S.-China trade conflict may be absorbed by investors in due course. We intend on increasing U.S. equity exposure based on its economic momentum, while continuing to avoid the overpriced FAANG stocks.

With Halloween around the corner, October is living up to its reputation – yet again – as a scary month for investors.

As of October 11, 2018, the S&P 500 was down 6.4% for the month, while the Dow Jones Industrial Average had fallen 5.3%. The technology-heavy Nasdaq Composite had tumbled 8.9%, bringing its decline from the record high it reached on August 30, 2018, to 9.9% (data source: FactSet).

But this selloff is by no means restricted to U.S. markets. In Canada, the TSX Composite was down 4.7% as of October 11 and was off 7.7% from its July peak of 16,586. Equity indexes in Europe and Asia have also sold off sharply, with Chinese equities among the worst performers. The Shanghai A share index, for example, had plunged 8.4% as of October 11, for a year-to-date decline of 21.9%. As is often the case during market turbulence, there are few places to hide.

There are two main drivers for the current sell-off. The first is investor concern about the impact of higher interest rates / bond yields on the U.S. economy. The Federal Reserve hiked the federal funds rate by 25 basis points on September 26 and has signaled its intention to raise rates again in December and three more times in 2019. The yield on the 10-year U.S. Treasury, which is closely watched by traders and investors, recently rose to a seven-year high of 3.23%.

The second driver is apprehension about a protracted trade war between the U.S. and China, the two biggest economies in the world. To quote an African proverb, "When elephants fight, it is the grass that suffers." Investors have been complacent for months about the risks to the global economy arising from a deteriorating outlook for international trade, but as tariffs begin to bite, this complacency is dissipating. In its recent "World Economic Outlook," the IMF – which lowered its 2018-19 global growth forecast to

3.7%, down 0.2 percentage point from its April 2018 projection – cited escalating trade tensions and the potential shift away from a multilateral trading system as key threats to its forecast.

As long-term investors who have encountered market turbulence on numerous occasions before, the one lesson we have learnt is to stick to one's long-term asset allocation plan and not get swayed by market volatility or negative headlines. In keeping with this philosophy, we view market corrections as an opportunity to buy the best companies in the world at bargain prices.

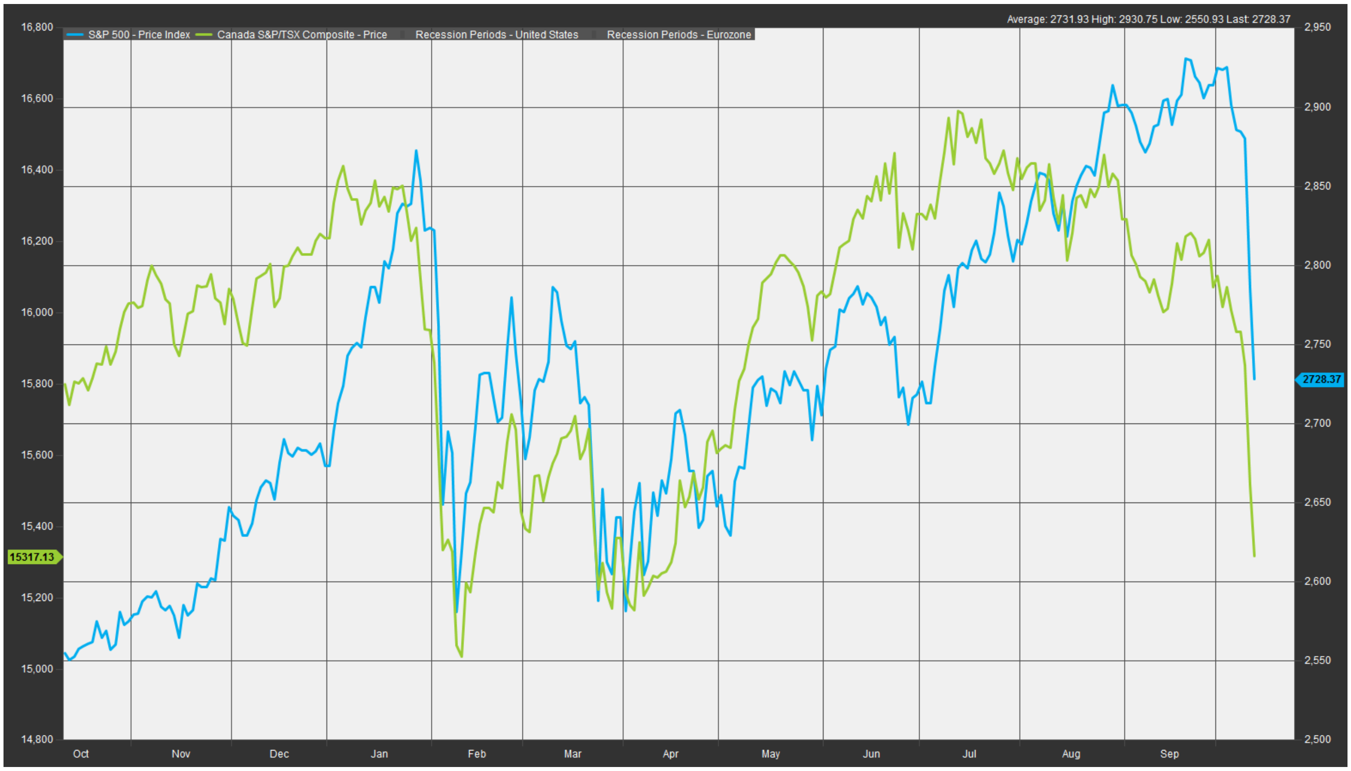
We should also point out that we remain positive on equities over the medium to long term for two reasons – one, the renegotiation of NAFTA (now called USMCA) has eliminated a major overhang for the Canadian economy; and two, the negative effect of higher interest rates and a trade conflict may be absorbed by market participants in due course, given that the global economy is still expanding nicely.

If equity markets continue to tumble, it is quite possible that the Federal Reserve may ease up on its rate-hike agenda. In addition, we support the view of many market participants that U.S. trade rhetoric regarding China is being used as a bargaining chip and is unlikely to lead to the worst-case scenario of a full-blown trade war.

We have been actively rebalancing client portfolios and have recently added to positions in stocks that have been disproportionately sold off, such as insurance giant **Manulife**, auto-parts maker **Magna**, and engineering major **SNC-Lavalin**. We have used recent weakness in these three blue-chips to add to positions, based on their positive long-term outlook, attractive valuations, and financial strength.

We had rebalanced client portfolios from October 1, based on positive news for the Canadian economy – the successful NAFTA renegotiation, approval of the $40-billion LNG project in northern BC by its five main partners, and Husky Energy's bid for MEG Energy. We intend to rebalance portfolios again if the TSX Composite declines below the key technical level of 15,000 and / or if the S&P 500 falls below the support level of 2,600, which had held during the downdraft earlier this year (see Figure 1). We also intend increasing our U.S. exposure based on its economic momentum, although we will continue to steer clear of the overpriced FAANG companies (Facebook, Apple, Amazon, Netflix, Google) which are bearing the brunt of this selloff and are down by an average of 19% from their peaks earlier this year.

Figure 1: TSX Composite vs. S&P 500 – October 2017 to Present (Source: FactSet)



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