

TAKING STOCK OF THE MARKETS

August 2011

The last few weeks have been a rollercoaster ride for investors. For instance, on August 6, the Dow Jones had plunged 653 points following the US credit downgrade. Nevertheless, the major stock indices ended the week on a positive note. During the same period, bond prices rose and the price of gold reached record highs.

What should you make of this volatility? What are its causes, and most importantly, what should you expect in the coming weeks? Let's try to shed some light on the situation.

► Causes

Investors were already concerned about the debt ceiling crisis south of the border when Standard & Poor's (S&P) announced that it was downgrading the US sovereign credit rating, a first in 70 years.

Investor reaction was swift: investors demanded a higher risk premium on international stock markets the day after the announcement (Saturday) and over the days that followed. The market responded not only to the S&P downgrade but also, and perhaps most likely, to the downward revision of economic growth prospects and the increased risk of recession in the United States.

There are also very real concerns about the situation in Europe. The crisis in the old continent's economy is deepening and the official response continues to disappoint. We are seeing real signs of contagion and growing fears of a banking crisis. The decline in stock prices over the past few days is probably due in large part to fears of a global economic slowdown and a new financial crisis in Europe.

What about the bond market? The prices of U.S. Treasury bonds have risen. Faced with extreme volatility, investors have opted for the relative safety of bonds, which continue to serve as a safe haven in the storm. In short, the media hysteria surrounding the downgrade of U.S. government bonds may have mostly been a reaction to the political wrangling unfolding in the U.S.

► What now?

Professionals at Natcan Investment Management believe the recent market downturn is part of a normal market correction, stemming from the economic and political events of the past few weeks. It is not a new financial crisis like the one we experienced in 2008. A slowdown in economic recovery seems certain for the short term. However, portfolio managers still believe that the likelihood of a new recession looming over the horizon is low.

To mitigate these risks, the Fed has committed to keeping its key interest rate exceptionally low "at least until the middle of 2013." In this context, Natcan's portfolio managers reaffirm their position – already established several months ago – that the Bank of Canada could keep its key interest rate unchanged until the end of the year. The Fed will be meeting in late August and markets expect the announcement of new measures to reinvigorate the economy – an announcement they would welcome.

In this environment, Natcan's portfolio managers believe that equities are currently trading at attractive prices and that they should not be liquidated in times of turbulence. In their view, the value of central government bonds is particularly high. They favour bonds issued by certain Canadian provinces and by large corporations.