

What's Driving The Markets

By: Sam Wiseman

Exclusive Online Article

used with permission from

BENEFITS AND PENSIONS
MONITOR

www.bpmmagazine.com

Investment
What's Driving The Markets
By: Sam Wiseman

This note does not attempt to join the revived fad of picking a market bottom; we do not believe we are wise enough to do so, nor can we be. History has demonstrated conclusively that no one can make money timing the markets, except on a lucky occasion. You need to be correct more than 70 per cent of the time to do so, and no one ever has.

Yet, throughout this recent 'Great Recession,' some managers fled to vast sums of cash and, as the market rose, this strategy was a drag on performance.

Driving Performance

Some managers waded into very defensive stocks. Again this is a drag on performance on the way back up. According to the history of markets, there will be a recovery. I write this at the beginning of April, and in traditional value style measures, price-to-book, a key indicator, has been a notable factor driving performance.

Are pension plan sponsors confused now more than ever with markets? They thought global diversification was the way to go and most searches in recent years were for overseas managers. Yet, Canada turned out to be the place to be. Again, this is true year-to-date in Canada. Hedge funds based on equities perform just like equities (see my article warning sponsors in *Defined Benefit Monitor*, April 2008). By asset class, equities fell beyond expectations and will likely recover beyond expectations. The worst performing stocks and drivers will become the best.

Meanwhile, with committee meetings taking place, bonds will suffer next as inflation rises and interest rates are raised to fight it. This may happen very soon. The following shares our window on reality, along with some regression results, all significant at a 95 per cent confidence level.

The U.S. stock market has literally ruled the world. Since the beginning of 2007, the ex-USA stock market returns have been 97 per cent correlated to the S&P 500. They have been influenced minute by minute by the S&P 500. During the night, futures kept up the drumbeat. For Canada, this has been somewhat less, as commodities have been a strong secondary driver (See *Chart 1*).

Coefficients 2007-2009(24 months ending February)			
Index	S&P500	RICI	Gold
World ex. USA	0.97	0.17	0.10
TSX	0.51	0.36	-0.07

Is gold a hedge to troubles? Well, gold has been, on average, a small driver of ex-U.S. markets, not a hedge, since the beginning of 2007. In the Canadian market, it has been acting as a hedge. But only by a little bit, and only during the last two years. If we take a long historical period, gold does act as a hedge against global markets falling, but only by a bit.

Not merely oil, but a broader measure of commodities has driven the Canadian market. This is measured using RICI (Rogers International Commodities Index). Energy is about 40 per cent of RICI, with all other commodities accounting for the rest of this benchmark that we have been following for many years. This broader commodity significance has been true both in the bear market and the bull market over several years. Oil has received undue attention in Canada. Over successive two-year periods, it sometimes is positively correlated to the Canadian market, sometimes not. As expected, it has less impact on the rest of world.

Surprising to many, oil has not driven the Canadian dollar (See Chart 2).

Coefficients Sep 2006 – March 2009		
	Oil	RICI
Exchange Rate	0.027	0.212

Even when viewed alone, oil does not explain changes in the Canadian dollar. If the price of oil rises from its bottom 100 per cent as it should, this will only explain a three per cent rise in the Canadian dollar (as measured against the U.S. dollar). A 100 per cent increase in the broader commodity base, a very possible event, will explain 21 per cent of the same in the Canadian dollar, or 16 cents from its current level.

Perhaps you would think that oil drives the dollar that day because energy now comprises about 30 per cent of the TSX (with all of the income trusts now thrown into the composite). The evidence does not support it, short term or long term.

Fearlessly Peering Ahead

The time horizon of pension funds is very long. Equities will preserve value over years of moderate inflation, say four per cent or less, as these public companies can readily pass on price increases. Or pension funds can jump into real assets, largely real estate. However, real estate has high transaction costs and very great specific investment risk. You can hold a few properties, but you do not know the price until it closes. Your area might become the worst place to have a property 15 or 30 years down the road. Undoubtedly, the investment banks will create some new investment products.

Based on compelling valuations, regardless of traditional measures, as banking and the economy recovers, we should see substantial merger and acquisition activity and a rush back into the markets and into all sectors. And why not? There is a tidal wave of earnings increases to come by 2010 and 2011. Sovereign country wealth funds will be active in taking over our companies and individual companies will use up their excessive cash.

Which markets are up over 10 years, only the commodity rich countries of Canada and Australia. Who will be one of the top performing markets over the next 10 years? The Canadian market – with the majority of its index in cyclicals, energy, and the commodities the world needs and led by a pro-business government. Oh, and Australia.

Sam Wiseman is chief investment officer of Wise Capital Management.