PERSPECTIVE

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RISK-FILLED ENVIRONMENT AUGURS FOR CONTINUED VOLATILITY

Anyone with investments in equities over the past few months has needed a strong stomach to endure the gut-wrenching volatility on global stock markets. Unfortunately investors will likely need to keep their seatbelts fastened, as the risks that produced recent turbulence in markets will not be going away any time soon. That said, we do see an environment of modest growth for the global economy as a whole in 2012, and equities should still prove relatively attractive, as interest rates, and hence returns on cash and bonds, are expected to remain lower for longer.

All of the recent volatility is the result of markets facing a crisis of confidence on three fronts; (1) worries about European government's ability to deal with the current fiscal crisis, (2) concerns over the ability of the U.S. to deal with its own fiscal situation, and (3) the sustainability of the economic recovery in advanced economies. Unfortunately, none of these fears can be easily allayed in the short term. The fiscal problems in the U.S. and Europe are likely to continue over the medium term, and it will be a few months before the hard economic data shows how the advanced economies, and most importantly the U.S., are holding up in the wake of the crisis of confidence that hit markets beginning in August.

The first crisis of confidence centers on whether European leaders can manage the insolvency and inevitable default of Greece, without sparking contagion to other countries and a region-wide banking crisis. In our interconnected global financial system the consequences would be severe. American banks, for example, had an estimate $1.4 trillion in exposure to European debt as of March 2011. The bottom line is that the European sovereign debt crisis will not be solved in the near term, and in the meantime the crisis is weighing on growth. We expect the euro zone to slip into a technical recession in the third and fourth quarters of this year, and for real GDP growth to be held to less than 1% in 2012. This disappointing growth should lead the European Central Bank to reverse the interest rate hikes made earlier this year.

The situation in Europe has dominated the headlines more recently, but it is only a matter of time before the second crisis of confidence – the U.S. fiscal situation – is back in the spotlight. As part of the eleventh-hour debt ceiling agreement reached this summer, a Joint Select Committee is required to find $1.5 trillion in fiscal savings over the next 10 years by November 23rd, or trigger automatic spending cuts that would threaten the economic recovery. With politicians already gearing up for the next election, the odds of compromise seem unlikely, and the risk of further market uncertainty driven by politicking in Washington is high. The ability of America to meet its debt service obligations is not in question, and the current low level of bond yields indicates markets are giving the U.S. a pass for the time being. But investors in Treasuries will not wait indefinitely for a medium-term plan for debt stabilization.

Worries about the sustainability of the current recovery, particularly with growth in North America weaker than previously thought, are the backdrop for interest rates to remain lower for longer in both the U.S. and Canada. The U.S. Federal Reserve has made a conditional commitment to keep the policy rate unchanged until at least mid-2013, and has since taken action to sell shorter-term government securities and buy longer-term securities in an effort to keep long-term interest rates low. With the Fed on hold, we don't expect the Bank of Canada to raise interest rates until at least the beginning of 2013. Lowered expectations for economic growth have also led bond yields to fall, pricing in a deep economic downturn. If as time passes, these fears are not realized, bond yields would be expected to back up, but not too far.

What does all of this mean for equities? The extreme volatility seems to reflect a tug of war between pessimists who see a deep downturn coming, in line with what the bond market has priced in, and value investors who see buying opportunities as prices move lower. In the near term, we could see equities sell off further, particularly if any of the fears of a renewed economic contraction are realized. However, if, as we expect, an environment of low interest rates and slow growth in the advanced economies persists, that is not bad news for stocks, which would still see moderate earnings growth even in a modest growth environment.

Moreover, highly accommodative monetary policy means that cash will deliver a return below inflation, and bond yields would garner a return only slightly above inflation. That makes equities relatively more desirable. And, high-dividend yielding stocks look very attractive in the current environment.

As for commodities, while prices are off their recent highs this spring, they should remain supported by growth in emerging markets. That is good news for commodity-endowed economies like Canada. Emerging markets have cooled relative to their pace earlier in the economic recovery, but are still the global economy's growth engine. Asia will remain the main driver to global growth in 2012.

Also key for investors in Canada's small, open economy is the fate of the Canadian dollar. The recent flight-to-safety moves in currency markets in the face of all the economic uncertainty have seen the loonie depreciate sharply. But, if the markets worst fears are not realized, we could see the Canadian dollar once again return above parity next year. That is a reality investors also need to be mindful of when considering investments abroad.

In 2012, TD Economics expects a modest macroeconomic growth environment, and low interest rates, which will provide support for stocks, particularly high dividend yielding issues. But equity investors will need to buckle up for a bumpy ride, since the current environment is exceptionally fraught with risks. Markets will be on tenterhooks as Europe struggles to manage its ongoing sovereign debt crisis over the next year. The U.S. fiscal situation also has the potential to rattle markets as deep political divisions re-emerge on any medium-term plan for fiscal rebalancing. Markets are also anxiously waiting to see whether the crisis of confidence in financial markets that began over the summer will tip the economy back into recession. That will become clearer as the economic data for the fourth quarter are released over the coming months, adding to the potential volatility. Unfortunately, the risk-filled environment is unlikely to be resolved in the near term, prolonging the current turbulence for equity markets into 2012.

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