CHOO'S FINANCIAL INSIGHTS

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HollisWealth

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3RD QUARTER VOLATILITY

I hope you had a wonderful summer. Overall it was a very warm summer with very little precipitation.

The markets were volatile through the summer and now into the fall. Initially, we had the Greek crisis. This Greek crisis will not be resolved as long as Greece refuses to make the drastic economic changes that are necessary and required.

Following the Greek crisis, presently, we have the China crisis.
The short answer here is that a bubble in the Chinese stock market - with share prices rising 150 per cent in the year to mid-July - has now burst in spectacular style.

The Chinese Government has been desperately intervening to prop share prices up, directly buying at least $485bn of shares and banning trading in some company shares. This has not worked; effectively, speculators don't believe that the government will be able to stop the bubble bursting.

The bubble was created, alongside a much bigger bubble in property, after the 2008 crash. The Chinese Government response to the crisis then was to let borrowing rip, creating money on a huge scale and allowing all sorts of financial institutions, including local governments, the opportunity to borrow on a huge scale.

As a result, total Chinese debt (government and private sector) has risen from $7tr in 2007, to $28tr today, or about 282 per cent of GDP.

In the midst of this month's global stock market sell-off, the U.S. provided investors with some relief last week with a revised gross domestic product number that showed the world's largest economy grew more than previously thought in the April-June period. For now, the country's second-quarter economic activity has eased fears that a China led global economic slowdown could spread to the U.S.

To be sure, there is nervousness in the U.S., too. The current recovery has been the weakest in the country's history, and some economists fear the U.S. isn't strong enough to withstand a global slowdown. Last week, when the S&P 500 was in the midst of its first correction since late 2011, it triggered talk of recession.

Even so, most economists say the U.S. economy is not at severe risk of recession -- not yet, anyway. The Conference Board's most recent monthly Leading Economic Index (LEI), released last week, suggests the risk of recession in the next 12 months is low at just 4 percent. The LEI measures 10 economic factors, including employment, income and housing values, and has been largely effective at forecasting recessions in the last half century. The Conference Board's report did note, however, that the odds of a recession increase to 9 percent when looking out 18 months and 11 percent within a 2-year period.

The real threats to U.S. expansion lie elsewhere, experts say.

1. <u>The ever-strengthening dollar:</u>

One of the main risks of a U.S. recession has to do with the Federal Reserve's decision on interest rates. The concern is whether the U.S. central bank will raise interest rates this year.

"A rate hike", says Robert Godby, a professor of economics and finance at the University of Wyoming, "could really drive us into a recession because that would lead to currency appreciation and would hurt our entire trade sector."

Economists also fear the U.S. dollar, which has gained more than 16 percent in the last 12 months, could appreciate even further if the U.S. central bank hikes interest rates. As the Fed aims to begin tightening its monetary policy, other major economies around the world, including China, Japan and Europe, are stimulating their economies to boost growth. Those moves have depreciated other world currencies against the greenback.

"Even a small move in interest rates from the Fed could have a disproportionate impact on the U.S. dollar, driving it higher," says Sal Guatieri, a Senior Economist at BMO Capital Markets.

The U.S. economy doesn't rely heavily on exports to China. Only 7 percent of U.S. exports go to China. However, an appreciating dollar makes it more difficult for U.S. companies to sell to Americans when they are competing against foreign companies.

2. <u>Plunging U.S. stocks:</u>

If U.S. stocks continue to fall sharply, the plummet would undercut household wealth and overall consumption.

When consumers have smaller balances in their retirement accounts, they end up spending less.

But, stock market downturns don't always imply recession, but what's important now is how things change in the near term.

Economists see a low likelihood of global recession. Global interest rates are currently at historic lows, and economists expect consumer-driven economies like the U.S., Europe and Japan to benefit from the drop in oil prices because it will lead to cheaper fuel.

Canada's economy:

1)The Canadian economy shrank at an annualized rate of 0.5% in the second quarter, following a decline of 0.8% in the first quarter. The decline in the second quarter was less than expected.

2) Growth in 2015 to average around 1.0% and close to 1.8% in 2016.

3) The unemployment rate has been flat at 6.8% for the last six months.

4) Despite the lower Canadian dollar, manufacturing shipments have been disappointingly soft.

5) Retail sales have lost steam in recent months.

6) Without seasonal adjustment the vehicle sales numbers are very volatile. But the trend has been strong with May setting a multi-year peak.

7) Housing starts have seen unexpected strength lately and will be helped by the recent interest rate cut.

8) Core inflation remains above the 2% target but the Bank of Canada considers this to be the transitory result of the Canadian dollar's decline. The headline rate has been under 1% because of low gasoline prices (which may fall again in the autumn).

9) Toronto continues to post the largest house price increase; we expect Calgary house prices to turn negative in coming months.

10) The Canadian dollar is suffering from the decline in commodity prices.

11) The probability of another rate cut is well above 50%; our forecast has a rate cut in January 2016 but it could come sooner.

12) Canadian long-term rates are now significantly below US rates.

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SUMMARY & RECOMMENDATIONS:

1) We are seeing extreme investor capitulation. The historic record points to a high likelihood of rewarding share price returns over the next 3-6 months.
2) On a longer-term basis, we believe the bull market has taken a breather. It's not over just yet! Sustained earnings contractions are typically associated with the end of a market cycle and we're not there yet. As far as we are concerned, the odds of a recession is unlikely in the next 6-9 months.
3) We continue to advocate an overweight position in equities versus bonds. The ride will be bumpy at best over the next several weeks, however, it's our believe that an overweight in equities will prove rewarding on a 12 month horizon.

I hope you find this overview of the current state of affairs enlightening.

If you have any questions or concerns, please don't hesitate to contact me.

Till the next time...stay safe and healthy!

Warmest regards,

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