MARKET RESEARCH PRIVATE CLIENT RESEARCH

Market Snapshot – September 2015

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Election Cycle Theory

Intro by Joseph Zawawi

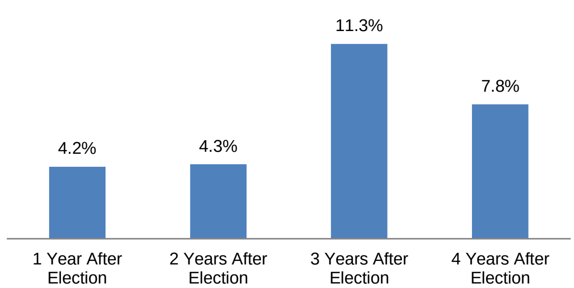
With the federal election set to take place on October 19^{th}, a thought on the minds of many investors across the country is, "what does the election mean for my personal finances and investments?"

In the U.S., presidential election cycle theory is widely followed and suggests that the market's performance follows certain patterns based on the years leading up to, during, and following the election year. The theory holds that stock market returns are typically sub-par in the early years of a new presidential term and strengthen later on.

What is the Rationale Behind this Theory?

A key assumption behind the theory is that a newly elected president will attempt to push tougher legislation through in the earlier years of his or her term in the hopes that it will be forgotten before the next election. In the later years of the term, the expectation is that more stimulative measures, such as tax cuts and spending programs, will be implemented. These are, in part, designed to improve the mood of the voting public. In the U.S., this has resulted in the strongest average market performance occurring in the third year of a presidential term. Average performance in the fourth year has also been quite strong.

Chart I: Annual Average S&P 500 Performance Through Presidential Terms Since 1900

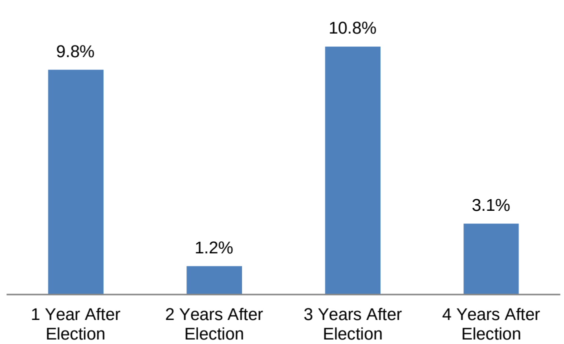


Source: Business Insider

How Does It All Play Out in Canada?

We thought it would be interesting to find out if similar election cycle-related patterns exist in Canada, so we analyzed returns for the S&P/TSX Composite back to 1922 and spanning 27 elections. As illustrated in Chart II, the best performing year for the Canadian market historically has also been the third year after an election, followed by the first year post election.

Chart II: Annual Average S&P/TSX Performance Through Prime Ministerial Terms Since 1922



Source: TMX Group and the Parliament of Canada

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Digging into the data deeper and looking at the frequency of positive annual returns, the third year of a term saw positive market performance 85% of the time, while in the fourth year there was a roughly even distribution of positive and negative returns.

Table I: Positive versus Negative TSX Returns During a Term

	# of Negative Years	Frequency	# of Positive Years	Frequency
1 Year After Election	9	32%	19	68%
2 Years After Election	9	38%	15	63%
3 Years After Election	3	15%	17	85%
4 Years After Election	8	47%	9	53%

Source: TMX Group and the Parliament of Canada

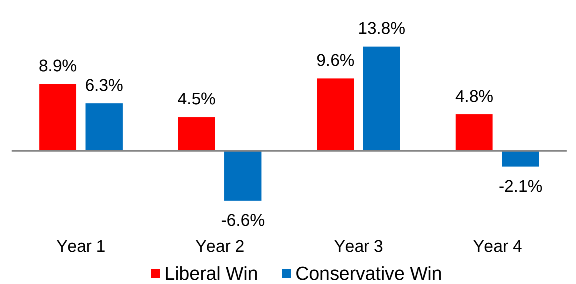
The S&P/TSX Composite returned an average of 6.3% during election years. Compare that to the average calendar year return for the 93 year period we considered of 7.3%. Through August 31, 2015, the Canadian index was off over 6% on a YTD basis, a stark contrast relative to the average return seen during an election year, however, election theory may have yet to play out this year as candidates continue to announce stimulus measures as a part of their platforms.

We have seen from our analysis that the S&P 500 has historically performed extremely well in the last two years of a term, whereas the TSX has historically seen its best years during the first and third years of a term. Based on the theory, 2015 and 2016 should result in a higher likelihood of positive returns by year end for the S&P 500. In Canada, 2016, being the first year of a new term, should have a higher likelihood of being a positive year for the S&P/TSX Composite.

Tories Versus Grits

We also wanted to investigate whether there were any discernable Canadian market trends based on the party in power. Aside from a brief stint by the Unionist Party in the early 1920's, the federal landscape in Canada has been a horserace between the Liberal Party and the Conservative Party. Our data paint an interesting picture of the performance of the stock market given the party in power.

Chart III: Average S&P/TSX Composite Performance During a PM's Term (Liberal vs. Conservative Governments)



Source: TMX Group and the Parliament of Canada

Chart III shows that the performance of the TSX during the first, second and fourth years of a Liberal government trump the performance during the comparable years of a Conservative government historically.

Conclusion

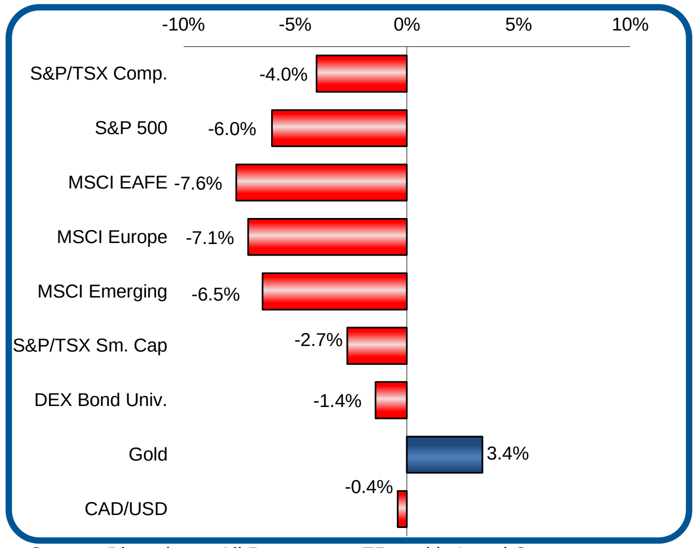
So is election cycle theory a predictive indicator, or is it just fun trivia? Even if one can apply a logical explanation as to why the theory makes sense, we haven't been able to identify any hard and fast empirical evidence indicating that it has predictive merit. And it is very clear that the theory doesn't always hold water. The most obvious and recent case would be 2008, which was an election year in the U.S. Based on the theory, investors should have been bathing in positive returns, however, the S&P 500 was slapped with a 38% loss during the year. This event is one of many throughout the course of history showing that there are plenty of other factors that are much more important drivers of market performance than the leadership cycle.

In the end, there are many theories that attempt to predict market performance based on historical patterns, however, in the longer term, economic and corporate fundamentals are still the primary drivers of stock returns.

MONTHLY OVERVIEW

Global financial markets were very volatile during August, as China's currency devaluation on August 11th, along with increased concerns regarding global growth amid weaker economic data out of China triggered selling. The S&P 500 and S&P/TSX Composite declined 6% and 4%, respectively, over the month. In Europe, the Stoxx Europe 600 Index slid over 8%, while in Asia, major indices also posted losses, with the Shanghai Composite shedding 12.5%, and the MSCI Asia Pacific Index dropping 8.2%. (All returns in local currency terms).

1 MONTH RETURNS



Source: Bloomberg, All Returns are TR and in Local Currency

The U.S. economy grew at a faster rate in the second quarter than originally estimated. GDP Growth for Q2 expanded 3.7%, beating forecasts of a 3.2%. The labour market also remained strong, with the unemployment rate holding at 5.3%, the lowest level since April 2008. Going into August, the market broadly assumed the Fed would begin the path to normalize interest rates at its next meeting in September; however, sentiment seemed to have changed given benign inflation and wage growth. Personal Consumption Expenditure (PCE), the Fed's preferred inflation gauge, rose by 0.3% in July from a year earlier – weaker than the 0.4% expected, and far below the Fed's 2% target. Core PCE (less food and energy) was 1.2%, down from 1.3% in June. In contrast, CPI and Core CPI climbed 0.2% and 1.8%, respectively, from a year earlier. Wage growth has also been slow. Average hourly earnings rose by 0.2% in July from June and increased by 2.1% from a year earlier, implying very little real growth relative to core inflation gauges.

Here at home, the prolonged period of volatility in commodity prices has continued to impact both the stock market and the economy. Fears of slowing economic growth in China, along with U.S. dollar strength, and OPEC's unwillingness to cut oil production have continued to put pressure on commodity prices. Throw in two interest rate cuts from the BoC this year and the loonie was down over 11% versus the greenback on a YTD basis through August 31. As widely expected, the Canadian economy shrank in the second quarter at a 0.5% annualized rate. By definition, this officially puts Canada in recession territory, although on an optimistic note, the aforementioned decline was well above the 1% drop forecasted by economists. The June GDP print indicated that the economy actually expanded by 0.5%, perhaps setting the tone for further expansion as we near the end of the year The Canadian economy created 6,600 jobs July compared to economists' expectations of a gain of 5,000, and the unemployment rate remained at 6.8% for the sixth consecutive month.

The major story for global markets during the month was China and its continued attempts to prop up its financial markets. The Shanghai Composite gave back 37% from its June 12th high through the end of August. Earlier in August, China devalued the yuan by 1.9%. The weaker currency may be advantageous for Chinese exporters, although could possibly ignite or further advance currency wars. Furthermore, this sudden move heightened fears that China's economy may be in even worse shape than thought previously, and with the Chinese economy accounting for about 15% of global GDP, the ramifications for global growth are substantial. Other actions rolled out by the PBOC to stave off a hard-landing included reducing minimum reserves required to be held by banks to 0.5%, as well as another 0.25% cut in interest rates – the fifth rate cut in nine months. With the current one year rate on loans still standing at 4.6% and 1.75% for deposits, the PBOC still has a good amount of wiggle room in terms of further monetary easing if needed.

MARKET OUTLOOK

For the remainder of the year, the weakness in the Canadian dollar could act as a stimulative tailwind for exports and may bode well for growth prospects. In the U.S., a highly anticipated Fed meeting is taking place on September 17th. The Fed has been hinting at a September rate hike for some time, and failure to carry out with a rate move may suggest that the U.S. economy may not be growing as strongly as originally thought and may reflect poorly on the credibility of the Fed.

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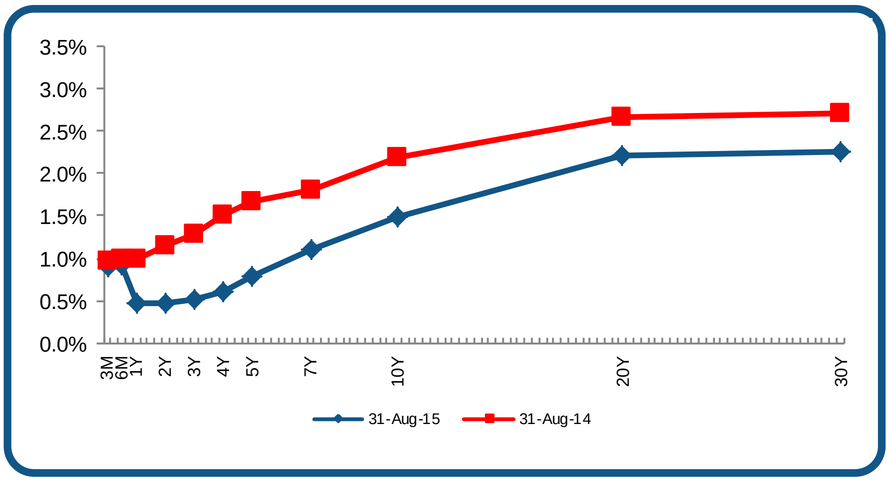
Monthly Market Statistics: August 2015

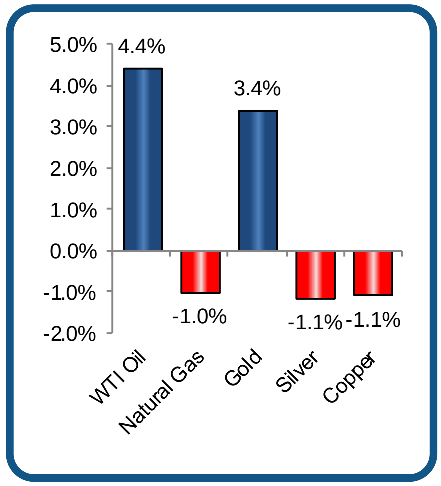
Total Return Index Returns (Annualized After One Year)

	Local Currency Returns							Canadian Dollar Returns						
	1M	3M	6M	YTD	1YR	3YR	5YR	1M	3M	6M	YTD	1YR	3YR	5YR
TSX Composite	-4.0%	-7.0%	-7.7%	-3.5%	-8.7%	8.3%	6.1%	-4.0%	-7.0%	-7.7%	-3.5%	-8.7%	8.3%	6.1%
S&P 500	-6.0%	-5.9%	-5.3%	-2.9%	0.5%	14.3%	15.9%	-4.8%	-0.3%	0.0%	10.5%	22.2%	26.0%	20.9%
MSCI EAFE	-7.6%	-8.6%	-4.6%	4.4%	6.5%	15.6%	10.4%	-6.1%	-2.6%	-0.7%	13.9%	13.0%	20.2%	12.2%
MSCI World	-6.6%	-7.0%	-5.1%	0.0%	2.4%	14.7%	12.9%	-5.3%	-1.5%	-0.5%	11.4%	17.2%	23.0%	16.6%
MSCI Pacific	-8.4%	-10.0%	-3.4%	4.4%	10.9%	21.6%	12.3%	-6.6%	-4.7%	-1.0%	14.2%	14.8%	19.2%	11.1%
MSCI Emerging	-6.5%	-12.4%	-9.6%	-5.3%	-9.2%	4.5%	4.0%	-7.8%	-12.4%	-11.0%	-0.6%	-6.0%	8.0%	3.8%
TSX Small Cap	-2.7%	-12.1%	-11.3%	-8.0%	-23.8%	-0.8%	-0.2%	-2.7%	-12.1%	-11.3%	-8.0%	-23.8%	-0.8%	-0.2%
Global Small Cap	-5.3%	-6.5%	-3.1%	2.2%	3.1%	16.9%	14.8%	-4.0%	-0.9%	1.5%	14.0%	18.3%	25.2%	18.4%
CDA Bond Uni.	-1.0%	-0.1%	-1.6%	2.8%	4.9%	3.7%	4.6%	-1.0%	-0.1%	-1.6%	2.8%	4.9%	3.7%	4.6%
CDA 1-5 Yr Bond	-0.2%	8.0%	0.4%	2.3%	3.2%	2.6%	2.7%	-0.2%	8.0%	0.4%	2.3%	3.2%	2.6%	2.7%

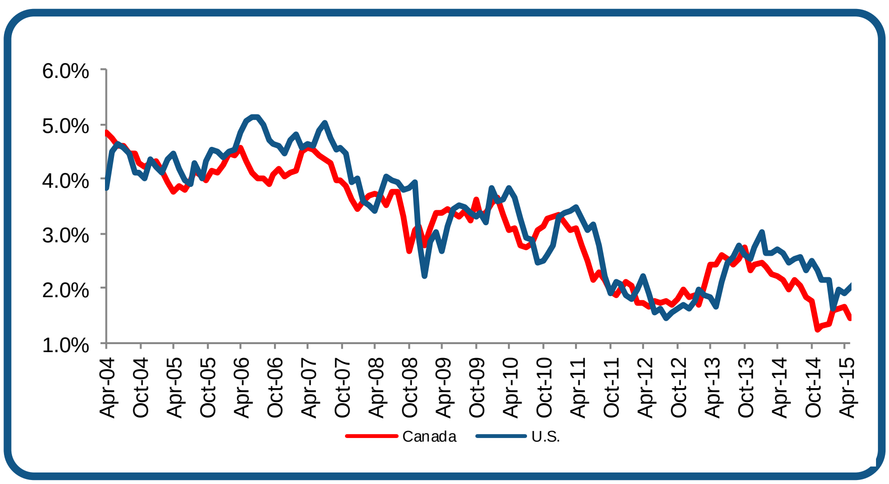
Canadian Yield Curve



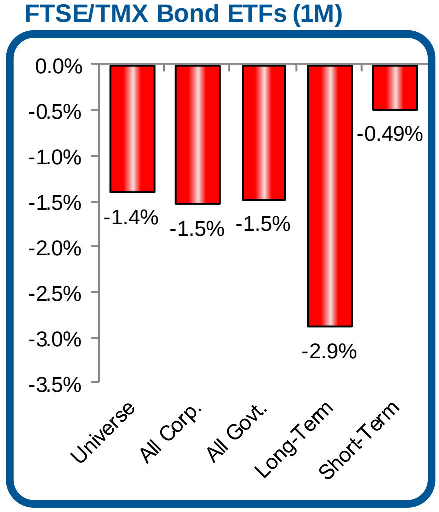
Commodities Performance (1M)



10YR Government Bond Yields



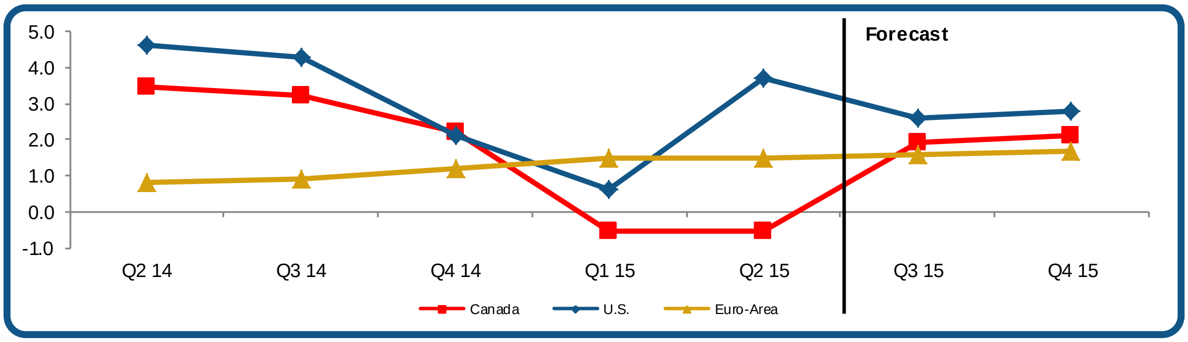
FTSE/TMX Bond ETFs (1M)



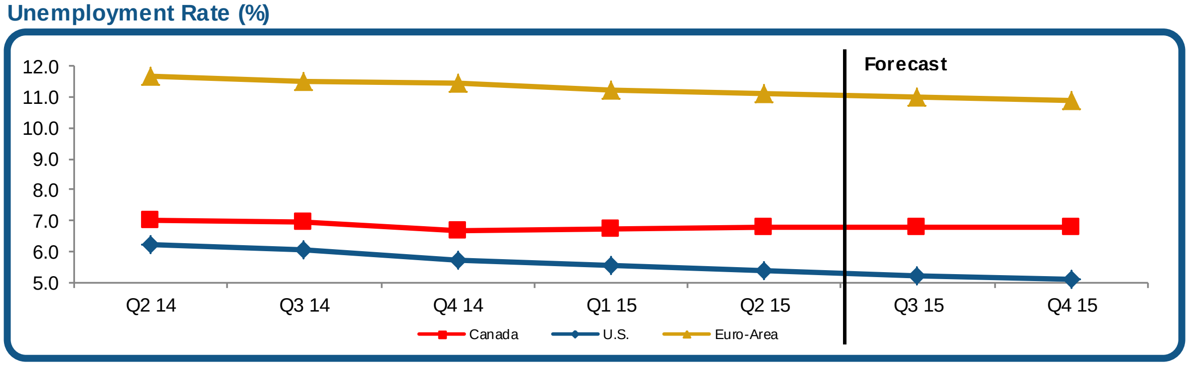
Source: Bloomberg, iShares.ca

Economic Statistics

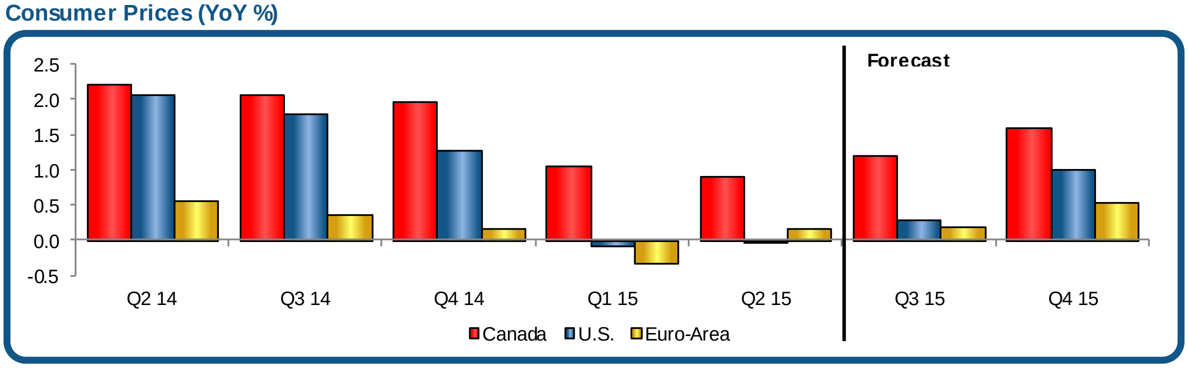
Real GDP (%)



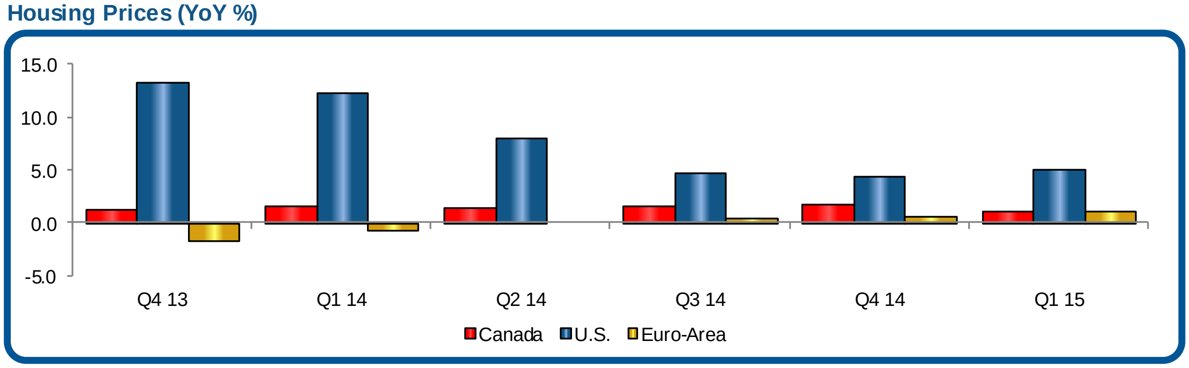
Unemployment Rate (%)



Consumer Prices (YoY %)



Housing Prices (YoY %)



Source: Bloomberg

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