

Shaky markets

By Frédéric Gamache, MBA, CFA

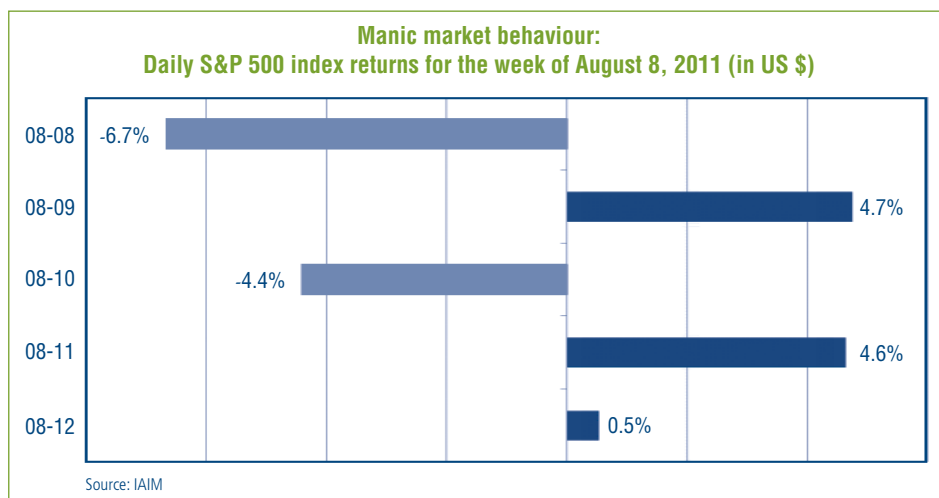
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A simple look at the month-end performances posted by the Canadian financial markets does not do justice to the turmoil that took place during the month of August. Indeed, -1.2% for the Canadian equities market (S&P/TSX index) and 1.2% for the Canadian bond market (DEX Universe index) are nothing to write home about. However, the full picture becomes clearer when we look at the returns of the foreign markets: -5.7% for the S&P 500 (U.S. market) and -9.0% for the MSCI - EAFE (international market), expressed in local currencies. The main explanation for this difference between the Canadian and foreign markets is, of course, the Canadian market's heavy proportion of gold stocks (13.52% of the S&P/TSX index at August 31, 2011). These stocks profited from a climate of deep uncertainty and the strength of gold, a safe haven currency, resulting in the Canadian stock market outperforming others in August.

Let us now look at the weekly movements of the U.S. S&P 500 index during the month of August in order to better understand the emotional climate suffered by investors. For the first five days of the month, i.e. the week ending August 5, this index's return was -7.2% (still in local currency); the following week, ending August 12, it was -1.7%; for the week ending August 19, it was -4.7%; and for the week ending August 26, the return was +4.7%. The last few days of the month of August were also positive (+3.6%), resulting in the cumulative monthly return of -5.7%, as stated earlier. The least we can say is that this type of rollercoaster ride is nerve-racking for investors! There are two avenues of analysis to explain these market movements: the "fundamentals" avenue, based on the state of the economy, and the "emotional" avenue, which looks at the increasingly visible phenomenon of investors' crowd behaviour, or what some call "risk on/risk off."

First, there is the economic situation. The media made a great fuss over the downgrading of the U.S. debt by the credit rating agency Standard & Poor's to explain the storm that hit stock markets in August. This reduction in the credit rating from AAA to AA+ took place on August 5, after the S&P 500 index had already dropped 7.2%. Without minimizing the significance of this event, it appears that this downgrade did not change much in investors' risk assessments, despite all the media space devoted to the news. It is more likely that the market succumbed to its own mounting concerns over the

The market's manic behaviour, illustrated by the "risk on, risk off" catchphrase, is amplifying the downward market movement, caused by the lack of vigour of the U.S. economy and Europe's sovereign debt problems.



strength of the U.S. economic recovery and the sovereign debt problems in Europe.

Here assiduous readers will recognize two themes that recur regularly in our reflections on the markets and the state of the economy. Europe's sovereign debt problems have been making headlines since February 2010, and the lack of vigour in the U.S. economy—the unemployment rate does not seem able to go below 9%—has been a nagging concern since the recovery began.

Since the start of 2010, investors have been seeking signs to support their ingrained conviction that, like the eternal cycle of the seasons, after a great recession, economic activity will naturally resume, and the employment situation will naturally improve. However, the deterioration in U.S. economic data (GDP growth slowing since the third quarter of 2010, decline in the Philly Fed Leading Index, and disappointing employment figures yet again) is back at the forefront of the worries which, until now, investors had managed to push aside. This wake-up call is one of the main causes of the bearish trend seen in August.

Amplifying this "fundamental" movement is the trend increasingly observed in markets with mob behaviour, which can be likened to a manic attitude. As mentioned earlier, this phenomenon is often called "risk on/risk off." Picture the market as a relatively homogeneous whole that moves its holdings quickly and without other distinction than between "risky" or "less risky" assets. When the context is favourable to economic expansion and profit growth, the market launches into buying risky assets, i.e. the risk switch is "on". When the economic environment begins to cool, the market starts selling off its

risky assets and buying safer ones, abandoning the equities market and the more cyclical stocks to take refuge in bonds, the U.S. dollar and gold.

This phenomenon is behind the large swings seen in August. As proof, the correlation of returns among the various stock market sectors became very pronounced in August, showing in a quantitative way that the market was alternating between "sell" mode and "buy" mode on the stock market, without much distinction as to sector or the specific stocks it was buying or selling.

This being said, the question that investors must now ask themselves is: are we heading into another recession, or is this simply a "bad patch" in economic growth? And, in echo to this fundamental question, should we be selling our risky assets, or buying more of them?

Let's place this alongside what we know at this moment about the U.S. economic situation. The most recent data on job creation in the U.S. (September 2) shows no new jobs; the September 1 reading of the ISM manufacturing index (leading indicator) is just above 50, suggesting a slowdown but not a recession; retail and car sales are good. Therefore, there are a certain number of positive indicators, or at least indicators that are not negative, with the exception of employment. How can the confidence of consumers and company managers be restored, and how can the economy be restarted?

Recently, U.S. Federal Reserve Chairman Ben Bernanke, in addition to announcing his intention to keep the U.S. key rate exceptionally low, as it has been for several years already, until 2013 (but without announcing a third round of quantitative easing), called on the U.S. government to take up the baton and play its part in stimulating the economy, by adding its own political and fiscal measures to the monetary measures the Fed has been taking for some time.

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Table of net returns as at August 31, 2011

	Unit value \$	Net assets ¹ in millions \$	Simple returns ²			Compound annual returns				MER ³ %	GSB Fund Fee Rate ⁴ %	Investment Advisor
			1 month %	3 months %	YTD ¹ %	1 year %	3 years %	5 years %	10 years %			
FOCUS FUNDS												ECOFLEXTRA
Focus Prudent	14.13	145.7	(0.4)	(0.5)	0.9	3.2	2.9	2.7*	3.7*	2.60	0.50	Various Managers
Focus Moderate	14.35	226.7	(1.2)	(2.3)	(1.0)	3.3	2.0	2.1*	3.5*	2.68	0.60	Various Managers
Focus Balanced	14.50	387.0	(2.0)	(4.1)	(2.8)	3.4	1.0	1.5*	3.2*	2.80	0.60	Various Managers
Focus Growth	14.61	132.2	(2.7)	(5.8)	(4.6)	3.5	0.0	0.9*	2.9*	2.84	0.75	Various Managers
Focus Aggressive	14.69	65.4	(3.5)	(7.5)	(6.3)	3.6	(1.1)	0.3*	2.6*	2.85	1.00	Various Managers
INCOME FUNDS												ECOFLEXTRA
Money Market	16.92	259.5	0.0	0.0	0.1	0.2	0.2	1.3*	1.4*	1.49	0.50	Industrial Alliance
Short Term Bonds	15.24	199.7	0.6	1.5	2.3	1.4	2.8	2.7*	2.8*	2.16	0.50	Industrial Alliance
Bonds	25.88	1,642.8	0.9	2.7	4.4	3.2	4.7	3.8*	4.4*	2.13	0.50	Industrial Alliance
Bonds - series 2	17.13	655.1	0.8	2.5	3.9	3.2	4.5	3.7*	4.2*	2.14	0.50	Industrial Alliance
DIVERSIFIED FUNDS												ECOFLEXTRA
Diversified Security	17.36	301.5	(0.1)	(0.9)	0.7	3.8	3.2	2.9*	4.3*	2.65	0.50	Industrial Alliance
Diversified	31.01	1,686.7	(1.0)	(3.5)	(1.7)	4.8	1.6	2.0*	4.3*	2.65	0.60	Industrial Alliance
Diversified Opportunity	19.28	217.7	(1.5)	(5.4)	(3.6)	5.4	0.7	1.7*	4.6*	2.74	0.75	Industrial Alliance
Fidelity Canadian Asset Allocation	15.78	497.7	(0.8)	(3.4)	(3.0)	6.1	1.1	3.3*	5.1*	3.03	0.75	Fidelity
Canadian Balanced (QV)	10.92	41.8	(0.7)	(3.8)	(0.1)	4.9	1.8*	2.0*	2.8*	3.00	0.75	QV Investors Inc.
SRI Balanced (Inhance)	10.45	3.8	(1.4)	(3.6)	(2.0)	3.0	-	-	-	2.96	0.75	Vancity
Diversified Income	18.98	182.8	(1.9)	(6.2)	(3.9)	7.5	2.0	3.4*	-	2.61	0.75	Industrial Alliance
Global Diversified (Aston Hill)	9.77	31.5	(4.5)	(6.2)	(2.8)	6.3	0.5	-	-	3.02	0.75	Aston Hill
Tactical Income (Aston Hill)	14.37	143.4	(3.5)	(5.3)	(2.2)	5.6	2.8*	-	-	3.04	0.75	Aston Hill
CANADIAN EQUITY FUNDS												ECOFLEXTRA
Dividend Income	10.43	142.3	(3.5)	(9.2)	(5.9)	(0.1)	(2.6)	(1.8)*	4.8*	2.38	1.00	IA Clarington
Dividend Growth	13.17	713.6	(0.7)	(7.0)	(2.4)	6.2	0.9	2.7*	8.1*	2.63	1.00	Industrial Alliance
Canadian Equity (Leon Frazer)	15.54	178.9	0.4	(5.0)	1.7	11.1	2.6	2.7*	-	2.98	1.00	Leon Frazer
Canadian Equity Index	17.44	147.5	(0.9)	(7.9)	(5.6)	4.4	(3.6)	1.3*	4.6*	2.74	1.25	Industrial Alliance
Select Canadian ⁶	24.78	50.7	(0.7)	(7.0)	(5.5)	8.0	(0.7)	2.0*	6.4*	2.67	1.25	Industrial Alliance
Canadian Equity Value	36.56	395.5	(1.6)	(7.7)	(6.5)	5.4	(2.8)	(0.5)*	4.5*	2.75	1.25	Industrial Alliance
Canadian Equity (Dynamic)	17.36	590.5	(6.2)	(9.6)	(12.6)	0.1	(2.4)	1.9*	9.2*	3.10	1.25	Dynamic
Canadian Equity (Jarislowsky)	13.03	102.8	(2.6)	(9.0)	(6.7)	2.3	(3.2)*	0.5*	6.1*	3.05	1.25	Jarislowsky
Canadian Leaders	12.93	10.5	(2.2)	(10.0)	(10.0)	(1.8)	(4.3)*	3.6*	-	2.74	1.25	Industrial Alliance
Fidelity True North [®]	23.13	357.6	(1.2)	(6.3)	(4.9)	6.6	(3.4)	1.9*	5.7*	3.18	1.25	Fidelity
Canadian Equity Growth	21.28	233.3	(2.7)	(8.6)	(7.6)	5.8	0.2	4.4*	-	2.71	1.25	Industrial Alliance
Fidelity Canadian Opportunities	27.38	205.6	0.7	(7.4)	(4.9)	13.9	8.7	7.6*	8.2*	3.15	1.25	Fidelity
Canadian Equity (Small Cap.) (QV)	14.99	26.5	(5.4)	(7.1)	(3.3)	8.0	0.3*	0.6*	11.7*	3.13	1.25	QV Investors Inc.

Table of net returns as at August 31, 2011 (continued)

	Unit value \$	Net assets ¹ in millions \$	Simple returns ²			Compound annual returns				MER ³ %	GSB Fund Fee Rate ⁴ %	Investment Advisor
			1 month %	3 months %	YTD %	1 year %	3 years %	5 years %	10 years %			
U.S. & INTERNATIONAL EQUITY FUNDS												ECOFLXTRA
Global Dividend (Dynamic)	9.60	56.2	(5.7)	(8.8)	(4.5)	7.0	(0.7)	0.0*	-	3.08	1.25	Dynamic
Global Dividend (BNP Paribas)	12.79	9.7	(6.4)	(10.1)	(6.9)	4.1	(4.7)*	(4.9)*	-	3.04	1.25	BNP Paribas Inv Partners
Global Equity	10.72	72.7	(6.3)	(11.2)	(9.0)	2.1	-	-	-	3.03	1.25	Industrial Alliance
Global Equity (Templeton)	8.91	185.6	(7.0)	(13.3)	(8.2)	0.0	(6.8)	(5.7)*	(2.5)*	3.19	1.25	Templeton
Global Equity (Mackenzie Cundill)	11.82	12.1	(7.8)	(11.5)	(8.7)	5.8	(2.4)*	(3.2)*	1.8*	3.34	1.25	Mackenzie Cundill
Global Equity (Oppenheimer)	8.92	8.5	(5.9)	(12.4)	(7.7)	3.0	(3.1)	(3.5)*	(1.4)*	3.03	1.25	Oppenheimer
Fidelity NorthStar®	9.52	36.0	(4.3)	(8.3)	(7.3)	4.8	(2.9)	(2.1)*	-	3.19	1.25	Fidelity
Global Equity Small Cap. (DB Advisors)	8.69	80.2	(6.1)	(10.2)	(8.0)	6.5	(2.5)	-	-	3.19	1.25	DB Advisors
International Equity Index	6.11	12.4	(7.0)	(11.4)	(9.0)	(1.6)	(7.2)	(6.0)*	(2.4)*	2.66	1.25	BlackRock
International Equity	11.75	206.4	(7.2)	(12.3)	(7.5)	1.7	-	-	-	2.84	1.25	Industrial Alliance
International Equity (Templeton)	11.05	60.9	(8.1)	(13.8)	(10.0)	(3.3)	(8.0)	(6.2)*	(2.7)*	3.13	1.25	Templeton
International Equity (McLean Budden)	8.57	6.4	(7.1)	(11.5)	(8.6)	(3.5)	(5.2)	(5.3)*	(2.6)*	3.04	1.25	McLean Budden
Fidelity European Equity	7.79	57.5	(8.7)	(14.9)	(11.6)	(0.9)	(10.5)	(2.3)*	(0.3)*	3.17	1.25	Fidelity
U.S. Equity Index	6.96	28.0	(3.3)	(8.7)	(5.2)	5.4	(5.2)	(4.7)*	(4.9)*	2.70	1.25	SSgA (State Street)
U.S. Equity	7.70	234.2	(4.9)	(9.9)	(9.0)	4.9	(5.3)*	-	-	2.96	1.25	Industrial Alliance
U.S. Equity (McLean Budden)	8.28	30.3	(4.6)	(10.3)	(8.8)	1.4	(7.0)	(4.5)*	(3.1)*	2.98	1.25	McLean Budden
U.S. Equity (Sarbit)	12.58	15.3	(7.1)	(10.9)	(7.4)	13.1	-	-	-	3.10	1.25	Sarbit
DISTINCTION FUNDS**												ECOFLXTRA
Distinction Prudent	11.99	3.4	(1.5)	(3.3)	(1.0)	3.3	1.4*	1.6*	-	2.81	0.60	Industrial Alliance
Distinction Conservative	12.48	6.3	(1.8)	(4.0)	(1.9)	3.5	1.5*	1.5*	-	2.84	0.60	Industrial Alliance
Distinction Balanced	12.88	23.4	(2.4)	(4.9)	(2.3)	4.2	0.7*	1.1*	-	2.86	0.75	Industrial Alliance
Distinction Monthly Income	12.80	4.4	(2.4)	(5.2)	(2.0)	3.9	0.2*	(1.2)*	-	2.69	0.75	Industrial Alliance
Distinction Growth	13.02	15.5	(3.4)	(6.8)	(4.9)	3.6	(1.2)*	(0.8)*	-	3.01	0.75	Industrial Alliance
Distinction Bold	13.23	2.7	(4.1)	(8.1)	(5.8)	3.7	(1.7)*	(1.0)*	-	3.12	1.00	Industrial Alliance

Returns after deduction of MER (Management expense ratio). Past performance is not a guarantee of future returns.

The EcoStrategist in Brief | Ecoflextra economic and financial bulletin, produced monthly, and its more exhaustive quarterly version, are available on the Company's website under *Investment Vehicles and Publications*.

¹ Total net assets of the fund including individual and group contracts.

² The rates for the period are non-annualized.

³ Management expense ratio (GST and HST included).

⁴ The GSB fund fee rate (guaranteed surrender balance) is used to determine the GSB Fee based on the year-end GSB. The GSB fund fee rate applies to the Guaranteed Surrender series only.

⁵ Indexes presented in this document are total return index.

⁶ Not offered in registered contracts and TFSAs.

* Simulation of past returns as if the fund had been in effect for these periods.

Index funds: Simulation of past returns from the return of the index that the fund aims to reproduce.

** Distinction Funds are only offered in the Guaranteed Surrender Series.

Reference indexes⁵ - Returns as at August 31, 2011

	Simple returns ²			Compound annual returns			
	1 month %	3 months %	YTD %	1 year %	3 years %	5 years %	10 years %
INDEXES RELATED TO INCOME FUNDS							
DEX 91 day Tbill Index	0.1	0.2	0.7	0.9	1.0	2.2	2.5
DEX Short Term Bond Index	0.7	1.9	3.5	3.3	5.1	5.1	5.0
DEX Universe Bond Index	1.2	3.3	5.5	5.4	6.8	5.9	6.4
S&P/TSX Capped Income Trusts (Total Return)	0.0	(0.8)	14.6	32.9	7.8	7.5	15.6
SB - World Government Bonds (Can. \$)	4.7	5.7	6.8	0.4	5.1	5.3	2.9
INDEXES RELATED TO CANADIAN EQUITY FUNDS							
S&P/TSX 60	(0.5)	(7.1)	(3.8)	7.6	(1.2)	3.9	7.8
S&P/TSX Completion Index	(2.9)	(6.3)	(2.9)	17.1	6.3	4.9	9.9
S&P/TSX Composite Index	(1.2)	(6.9)	(3.5)	9.9	0.4	4.0	8.1
S&P/TSX Capped Composite Index	(1.2)	(6.9)	(3.5)	9.9	0.4	4.0	8.1
BMO Nesbitt Burns Small Cap	(4.6)	(9.6)	(7.9)	18.8	9.8	5.0	11.2
INDEXES RELATED TO U.S. & INTERNATIONAL EQUITY FUNDS							
S&P 500 (Can. \$)	(3.0)	(8.0)	(3.4)	9.0	(2.2)	(1.7)	(1.9)
S&P 500 (Can. \$) (Reuters)	(3.1)	(8.1)	(3.3)	8.7	(2.1)	(1.7)	(1.9)
MSCI - World (Can. \$)	(4.6)	(9.3)	(5.5)	5.3	(4.0)	(2.6)	(1.0)
MSCI - World Small Cap. (Can. \$)	(5.9)	(11.4)	(6.7)	11.3	1.4	0.0	4.1
S&P Citigroup High Income Equity Index (Can. \$)	(4.7)	(9.5)	(4.4)	5.7	(1.4)	(3.8)	-
MSCI - EAFE (Can. \$)	(6.7)	(10.7)	(7.6)	1.2	(5.6)	(3.9)	0.2
MSCI - EAFE (Can. \$) (Reuters)	(6.8)	(10.8)	(7.5)	0.9	(5.5)	(3.9)	0.2
MSCI - Europe (Can. \$)	(7.7)	(13.8)	(6.2)	1.7	(6.3)	(3.5)	0.7
EXCHANGE RATE (Can. \$ / US \$)							
As at August 31, 2011: 0.9784	2.6	1.0	(1.6)	(8.0)	(2.7)	(2.4)	(4.5)
EXCHANGE RATE (US \$ / Can. \$)							
As at August 31, 2011: 1.0221	(2.5)	(1.0)	1.7	8.7	2.8	2.5	4.7

Continued from first page

One potential avenue of intervention that is being invoked more and more would aim to make mortgage refinancing easier for individuals by forcing the hand of lending institutions. U.S. consumers could save tens of billions of dollars in interest if they refinanced their mortgages at the current market rate, but the refinancing process is made rather complicated (deliberately?) by banks. In addition to putting

money back in consumers' pockets (which could lead to a renewal in spending), this approach could solidify the current stabilization of home prices and, through the principle of the virtuous circle, breathe new life into the very anaemic construction sector. To be continued in the U.S. political arena... ■