Market Update
January 2016

Update on market volatility
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Royal Bank of Scotland recently issued a note to its clients calling on them to "sell everything except high-quality bonds." Given the extreme nature of this statement, it quickly became a hot item highlighted by the media. We think it is somewhat irresponsible to advise anyone to sell everything without knowing their objectives and what they actually own. Meanwhile, Goldman Sachs called the recent plunge in the U.S. stock market an "emotional response," as it sees upside of 11% in the S&P 500 Index. We recognize that successful investing requires planning, patience and discipline, and does not involve being too extreme.

The stock and currency markets were volatile in 2015 and that trend continued into 2016. The broad U.S. stock market, as represented by the S&P 500 Index, has lost 7% in the last eight business days. During the last couple of years, the markets have generally been trading within a fair valuation range. While long-term fundamentals of most companies are solid and valuations are fair, the changing dynamics at the macro level have been shaking investor confidence. We highlight those issues below.

Fed Policy

As was widely anticipated, the U.S. Federal Reserve raised interest rates by 25 basis points last December. There is growing concern that the Fed may raise rates as many as four times in 2016 for a total increase of 100 basis points. The implications are: 1) a higher borrowing cost for government, companies and individuals, and 2) continued strength in the U.S. dollar versus other currencies, which will reduce the U.S. economy's competitiveness and also depress the commodity prices that are priced in U.S. dollars.

We think this concern is overstated. The Fed has repeatedly said its interest rate policy will be flexible and adjusted according to economic conditions and inflation. This means that if the economy slows down because of external or internal factors, rate hikes will be halted. It is not unprecedented for a central bank to change course. For example, the Bank of Canada began raising rates in June 2010. Over the course of four and a half years, rates rose only by 75 basis points and the central bank actually changed course in 2015 by cutting rates. Also note that declining commodity prices are putting a lid on global inflation which reduces the need for rate hikes.

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Fluctuation in oil price

The price of oil has failed to stay at a level that is profitable to oil producers, except Saudi Arabia, which has the world's lowest marginal cost. We have mentioned before that it is unusual for the oil supply to be maintained at the current level, supporting lower, not higher, oil prices. OPEC has repeatedly reaffirmed its intention to maintain market share; in other words, somebody else has to give. We are starting to see a decline in supply as it is no longer profitable for many at this level. Lower oil prices have already been reflected in valuations of oil companies globally.

We expect the price of oil to remain volatile. OPEC effectively has the ability to drive the price higher or lower with its production policy and the decision will ultimately impact the profitability of oil companies, the currencies of the oil exporting countries and global inflation. We generally think that at US$30 per barrel, we are not too far from the bottom. However, the supply is adjusting at a pace that is likely too slow and allows speculators to profit. In the meantime, the U.S. dollar and government bonds are great investments to hedge against declining oil prices.

Devaluation of Chinese currency

The perception that the Chinese economy will be growing at a slower pace has caused capital to flow out of China, causing its currency to depreciate. A lower yuan will bring lower inflation to countries that import goods from China and also hurt their economies due to stronger competition. We believe the expectation of a lower yuan is likely overblown. Even if the Chinese economy grows at a "lower rate" of 6%, it is effectively doubling or tripling the growth rate of major developed economies. We see continued demand for Chinese products and its currency.

Over the course of the last 12 months, we have reduced the equity exposure and simultaneously increased the government bond exposure of all of our portfolios, including programs such as Portfolio Series and Portfolio Select Series. The change is more apparent in the conservative portfolios, which are generally for investors who do not have a long investment horizon to weather the storm. The recent volatility has caused downside in the equity portion, but bonds and foreign currencies have done extremely well for the same reason. We expect a recession would cause limited damage to conservative portfolios, as they have a large exposure to bonds, which have continued to perform. Investors who invest for the long term should not focus on short-term volatility and should not make short-term changes that may derail their long-term goals. Short-term downside can actually allow an enhancement to long-term results. For example, U.S. stock markets were very volatile from 2008-2010 and we took advantage by adding U.S. stocks and the U.S. dollar

at unusually low valuation levels. The result was an enhancement to our investors' long-term performance.

We believe we are better prepared for continued volatility than those who simply advise clients to sell everything.

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