Market Bulletin

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Commentary – Positioning portfolios against rising secession risk

Crimea is the near-term flashpoint; Quebec and Scotland are on the horizon

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Merriam-Webster defines secession as "the act of separating from a nation or state and becoming independent." The rising risk of secession has been a nasty surprise this year. While the referendum in Crimea this weekend is the near-term flashpoint, the spectre of Quebec separatism has again raised its head, and Scotland holds its own referendum on September 18.

But investors do not seem unduly concerned by the potential downside risk posed by these events, especially the worst stand-off between the West and Russia in a quarter-century. The euro presently trades at a 2½-year high, approaching 1.40 versus the US dollar, with the S&P 500 and Dow Jones Industrial Average only 2% to 3% away from their record highs.

Note that because secession is such a wildcard event, even a credible threat of it actually occurring can inflict significant damage on market sentiment. In our opinion, the current complacency that reigns with regard to secession risk presents a great opportunity to position portfolios against this risk. Even investors who believe secession poses only a remote threat to financial markets should consider taking steps to hedge downside risk, since the warning signs seem to be mounting at the five-year mark of this bull market, as noted in last week's Bulletin. We present below some ideas on portfolio positioning and hedging as we head into a period of greater uncertainty:

- **Currencies** – Secession or separation would trigger a selloff in the domestic currency. The euro appears vulnerable in this regard, as it may retrace recent gains if there is marked deterioration in the situation between Russia and Ukraine after the Crimean referendum. The Canadian dollar could also trade sideways to lower over the next month, given that Quebec goes to the polls on April 7. Given that the near-term risks to the loonie appear skewed to the downside, consider adding US stocks in defensive sectors to investment portfolios.

- **Equities** – While the TSX is within striking distance of our end-2014 target of 14,400, renewed concerns about global growth may hinder its performance in the near term.

Recent economic data has cast substantial doubt about the Chinese economy, and Russia may slow down if economic sanctions are imposed against it. The TSX is outperforming the S&P 500 by almost five percentage points YTD, but we feel that margin of outperformance may narrow in the weeks ahead. At the present time, we recommend getting into defensive sectors like utilities (**Fortis, FTS, $31.28**), US telecoms (**AT&T, T, US$32.49**) and consumer staples (**Kraft Foods, KRFT, $55.47**), while taking profits in hot sectors like biotech and alternative energy.

- **Gold** – Gold seems to have come back in favour as a safe haven, with the precious metal up 15% YTD, while gold equities have outperformed with an advance of 36%. Buying gold in euro terms might be a way for experienced traders to hedge downside if geopolitical risk continues to rise.

- **Option strategies** – Writing calls and buying protective puts should be considered in this environment. The cost of hedging using at-the-money calls on the TSX-60 ETF units (XIU, $20.57) would involve the following expense – 19.3% (one month), 11.3% (three months), and 8.3% (six months). Hedging using at-the-money calls on the S&P 500 ETF (SPDR, $184.65) would involve the following costs – 22.6% (one month), 13.3% (three months), and 9.7% (six months). Those are sizeable costs, but then insurance is never cheap.

Market Snapshot

At close on Friday, March 14, 2014

S&P TSX	14227.66	-17.48	**Commodities**			**Yields (%)**	**Can.**	**US**
TSX Venture	1033.64	+1.53	Canadian $ (US cents)	90.06	-0.24	90 Day T-Bill	0.82	0.05
DJIA	16065.67	-43.22	Gold (Spot)-US$	1383.05	+12.91	2-Year Bond	1.00	0.34
S&P 500	1841.13	-5.21	Oil (WTI-April)	98.89	+0.69	10-Yr.Bond	2.39	2.65
NASDAQ	4245.40	-15.02	CRB Index	302.88	+0.24	30-Yr. Bond	2.92	3.60

Thought for the Day

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