QUARTERLY COMMENTARY

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June Swoon

It's no secret that 2022 has been challenging for markets, after all it's the worst start to an investing year since 1970. The second quarter performance in the markets was dismal – the TSE dropped 13.8% and the S&P500 was down 16.1%.With both bonds and equities declining in the first half of the year, there has been no place to hide – markets even breached the traditional bear market threshold of -20%. However, dislocations have always led to opportunities and believe it or not, I'm just now starting to get a little excited about the prospects of investing at lower prices soon. It's why I almost always have some investible cash on hand – to take advantage of opportunities.

Central banks, including the Bank of Canada (BoC), are facing tough trade-offs when trying to rein in inflation driven by production constraints: live with higher inflation or choke growth by raising interest rates too much. So far, the BoC is focusing on the latter – and the last move, a whopping 1% increase in rates, beat even the most bearish of forecasters. But as I've said in the past, they are having to play catchup since they left rates way too low for way too long. The risk facing inflation-fighting policymakers is that tighter monetary policy leads to higher unemployment. That outcome, combined with increased mortgage costs, could rapidly cool Canada's housing market. That's already happening even without the effect on employment which is sure to come. With a rate hike of 100 basis points, Macklem said his message to Canadians is that high inflation is "not here to stay," but he cautioned that

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"It is going to take some time to get inflation all the way back down to our two-per-cent target … this is not going to be without some pain." There is no way that target is a reasonable one. I think the BoC will be eventually happy with a result closer to 3-4%. Central banks around the world will undoubtedly become more accepting of a higher rate than their current official targets. Otherwise, a major and much longer recession will be in the cards. The stock market is already pricing in a recession and it soon will also further discount lower corporate earnings.

So as we round out the second half of an already tumultuous 2022, we're bracing for more volatility and higher inflation. The volatility of the markets is partly a result of sectoral corrections. For instance, energy was the only positive sector in Q2 but now it's probably the worst performing sector so far this month, correcting quite strongly due to lower oil prices. Many commodities including energy have moved down since the beginning of the month primarily because of strength in the US dollar which usually benefits when there is fear and uncertainty. Regarding oil, strategists are all over the map with their prognostications – Citibank last week announced they expect oil to crash down to $65/barrel while many other firms predict the possibility of $140 – 160/barrel oil. This huge disparity in opinions is a result of different assumptions on how an economic slowdown will affect oil prices and how much supply can be increased. On the one hand there is a supply constraint and on the other hand an economic downturn lowers demand and prices drop. I think that even if President Biden was successful in asking the Saudis to increase their production, it won't be enough to lower prices meaningfully. After all, the International Energy Agency recently warned that "global oil supply may struggle to keep pace with demand next year" even with a slowdown. Over the past year, the White House has sold almost 115 million barrels from its Strategic Energy Reserves. The US is selling more barrels from its reserve than the production of most medium-sized OPEC countries, such as Algeria or Angola. If Washington sticks to its current pace, the reserve will shrink to a 40-year low of 358 million barrels by the end of October, when the releases are due to stop. Recession fears and a higher USD are temporarily weighing on commodity prices but even so, in the medium term structurally higher commodity prices will support the earnings and free cash flow of Canada's energy and materials sectors for years to come. The energy shock in Europe is even greater than ours of course. As a result of the war, Europe has borne the brunt of the energy and agricultural commodity surge. The risk of recession as the energy crunch hits is even higher there but necessity is the mother of invention, right? Europe has the opportunity now to create a more sustainable and more resilient version of itself – replacing high dependencies on Russian energy and shedding the image of an "old" economy by accelerating the green transition for instance. It will take time but Europe will end up more economically diverse and stronger than ever.

Going forward, the key to successful investing will be dividend and interest income – just like the good old days. Investors will no longer be able to rely on high returns by overweighting their portfolios in high tech. Fundamentals such as a company's revenue growth, profit margins, valuations and debt levels will be meaningful once again. Also now many fixed income investments are now yielding 4% or more for the first time in more than a decade. Even though in the short-term the real return is low (with inflation eroding it) guaranteed investments will provide a bit of a cushion to the volatility of the markets.

Other than the quick and dirty 20% drop and then bounce in 2020, it's been a while since a true bear market has occurred. Investors forget what they can be like – we need to recognize that bear markets and their far more troubling cousins, recessions, are not that rare even if the relative calm of the last decade has deceived us into thinking so. Bull markets are overwhelmingly the predominant experience of people who started investing after March 9, 2009. That was the day the S&P

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500 hit bottom after a 57 per cent bear market decline during the financial crisis that started in 2007. The Fed intervened, cutting interest rates to nearly zero and buying bonds to start the bull market in stocks that lasted nearly 11 years.

In the past, after big declines, the stock market has always come back. Over 10 year periods, if you had put money into the entire S&P 500 you would have lost money only 6 percent of the time and never over a 20 year period. In reality the stock market is in a bear market almost 25% of the time – historically it's not that rare an event. Recessions are quite common as well. Turmoil is a constant recurrence in the markets and economy – that's just the way it is, but rough times don't last – the economy grows over the long term and financial markets produce handsome returns for patient, diversified investors. Long term investors learn to live with them much as you do with bad weather.

Thank you for your continued trust and confidence. Should you have any questions or concerns at any time or if you would like to have a detailed discussion of your personal portfolio, please do not hesitate to let me know.

Sincerely,

Richard