QUARTERLY COMMENTARY

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Changing Colours

Inflation has been the clear focus of investors for much of the past year, but the growing fear of a recession is starting to compete for their attention and shake up financial markets in the process. Yes, inflation has probably peaked, but it's going to take a while to get the proverbial "genie back in the bottle". The Fed and the Bank of Canada have been telling markets that it still needs to raise rates aggressively to get inflation back to where they want, which is somewhere closer to 2%. It's expected that there will be another .75% rate increase next week from the bank. If inflation does persist and rates do keep going up, there is a good chance that markets remain choppy like they have. In fact, the last time interest rates went up in the United States, back before the pandemic, the S&P 500 Index was extremely volatile with very big moves to the upside as well as the downside, but effectively traded sideways and gained almost no ground between the start of 2018 and the third quarter 2019. And that is why I expect income from dividends and interest is going to be a much larger part of investor's returns over the next number of years.

Over the past few months though it's not just inflation that investors are worried about. In fact, we may be at a turning point in the current cycle, and fears of an economic slowdown have emerged as the potentially bigger concern. This, in turn, may be setting up a potential shift in markets that will create new winners and losers going forward.

For all the talk of recession though, the North American economies still seem to be doing just fine based on several metrics, including labour statistics such as the very high employment rates. As a result, the consumer, is significantly more resilient to rising rates than he or she has been in the past, so as much as the market fears recession and is predicting eventual rate cuts, at least for now the economic environment may be more stable than many investors believe. The CPI is basically how much it costs for the 40% of the lower income population to live - the top 60% is unbelievably different. People who have money are travelling, spending money on airfare, cruises, etc…

Undoubtedly though with higher rates there eventually will be some destruction of demand and of course corporate earnings will decline for the most part. And that is what the markets ultimately focus on – earnings. We still need to be cautious until equities appear even cheaper. By many measures, equities still look overpriced. The CAPE (Cyclically adjusted PE) is above 26, which is 31% above its historical average and the market capitalization to GDP (Warren Buffet's favorite valuation measurement) is 150% above its historic trend. This "Buffett Indicator," depending on which measure of the market you use, is either still above the Dot Com Bubble peak or very near it. That's right, despite all the air that has come out of the bubble over the past couple of years, the broad market has only fallen back to where it was at arguably its most "bubblicious" point in history (at least by this one measure).

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Still, there are a few things that give me some comfort: 1) There is plenty cash on the sidelines; 2) Investor sentiment is too bearish; 3) The Fed and Bank of Canada are likely to become less hawkish in 2023; 4) The U.S. dollar is likely in the process of peaking so there will be less pressure on the earnings of multinational companies. Regarding this last point, in the last year the USD has been incredibly strong. When the dollar rises against, say, the euro, as it has done in the last year, then a company's euro-denominated sales are worth less once they're exchanged into dollars. That means a rising dollar is likely to have a noticeable impact on these companies' revenues, earnings, and stock prices.

For investors, the third quarter began with a relief rally but ended back in the doldrums. It was an especially dour quarter for the already-bloodied bond market, where many bond mutual funds posted their worst losses ever. In the third quarter, the performance of a diversified 60/40 portfolio would have been worse than one just invested broadly in stocks, an extremely unusual turn of events. No one knows what is going to happen over the next week, month, year, decade, etc. That is why I focus so much on the rather boring concept of risk vs reward because I feel that is truly the best way to find long-term success in the markets. I am prepared to adjust my thinking and positioning if conditions appear to be improving, but at the moment I think, at best, the overall risk vs reward is pretty balanced. That is why right now, I prefer fixed income over equities. For the most part investors have enough equity exposure already – enough so that when the markets recover, they will participate with increasing returns. But if interest rates come down over the next year or two due to an economic slowdown, anything paying over 5% right now is going to look pretty darn good.

One can actually draw a parallel for this market to another period in history – the bear market years after WWll. While the circumstances of today are very different from the 1940s, in many ways there are similarities too. Back in 1946, after the war ended and the veterans came home, the economy had to transition from wartime to peacetime. This created supply-chain bottlenecks and very high inflation. Sound familiar? The S&P 500 suffered a 26% decline, entirely driven by falling price-earnings ratios (rather than by a recession and falling earnings). Earnings never missed a beat, at least in nominal terms. Interestingly, since the U.S. market hit a new low of about 3,500 just last week, it would equate to a drawdown of about 27%—almost exactly in line with the 1946 post-WWII analog.

Regarding near-term market moves though I believe we will see a sustained move back up once there is a change in sentiment and that will happen when we see compelling evidence that inflation is receding and corporate earnings steady after a possible mild recession. So some short term pain is necessary to lead to a long term gain.

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