July 2022

RICHARDSON Wealth

Investor Strategy

The latest market insights from Richardson Wealth

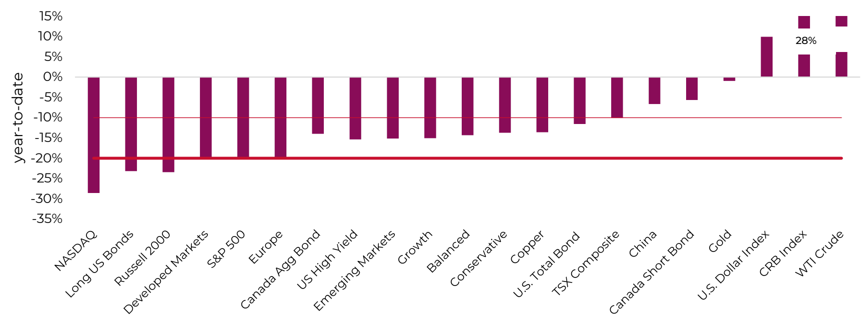
Our halftime report: a recap and playbook

Executive summary

1. June market recap
2. Halftime report – anatomy of a bear
3. Market cycle: rewards and risks
4. Portfolio positioning

If this investing year were a football game, the coach would be having a hard talk with the team at this halftime. Markets are beaten down, investors are generally having a very difficult time of it, and there has been no place to hide. In traditional allocation terms, what was supposed to protect us – sector diversification, different asset classes, global diversity – has mostly failed to protect so far this year.

Let's dig in with a recap and try to figure out what the best plays for the back half of the year will be to try and steal victory from the jaws of defeat.



Source: Bloomberg, Conservative/Balanced/Growth are ETF models from a large asset manager

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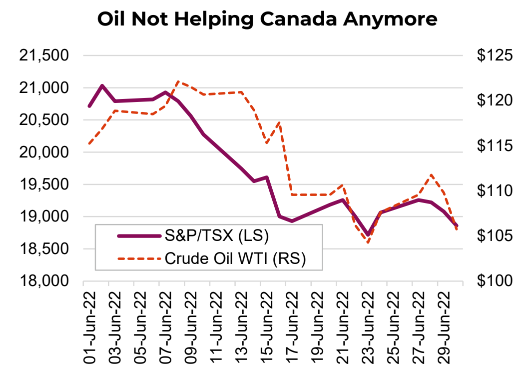
June recap – ouch!

June did not provide much reprieve to what has been a tough first half. Aggressive central-bank tightening and concerns around inflation continued to push both equity and bond markets down. North American equities, which saw all-time highs only a few months ago, have been experiencing the longest losing streak in decades. Geopolitical tensions continued to add to the concerns on the global outlook, leaving many investors on the sidelines.

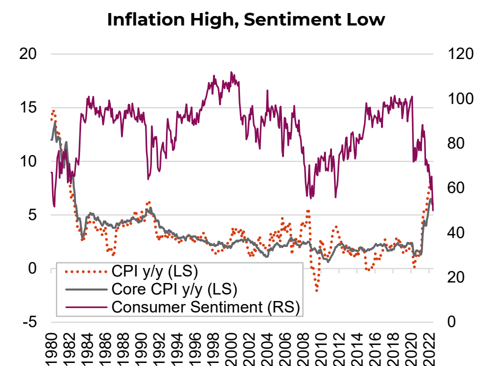
	Jun-2022	Q2-2022	YTD
S&P/TSX TR	-8.7%	-13.2%	-9.9%
S&P 500 TR	-8.3%	-16.1%	-20.0%
Nasdaq	-8.7%	-22.4%	-29.5%
Europe	-8.8%	-11.5%	-19.6%
Japan	-3.3%	-5.1%	-8.3%
China	6.7%	4.5%	-6.6%
Canadian Bonds	-2.2%	-5.6%	-12.2%
U.S. Bonds	-1.6%	-4.7%	-10.3%

June capped off the worst first half for the **S&P 500** since 1970, down 8.25% for the month and 19.96% YTD. In Canadian dollar terms, performance was a bit better at 18.56% YTD and 6.52% as the loonie weakened. Growth-style investments continued to lag as bond yields rose, with the technology, communication services and consumer discretionary sectors all down. This can be seen most notably in the **Nasdaq** which lost 8.65% for the month and 29.22% YTD.

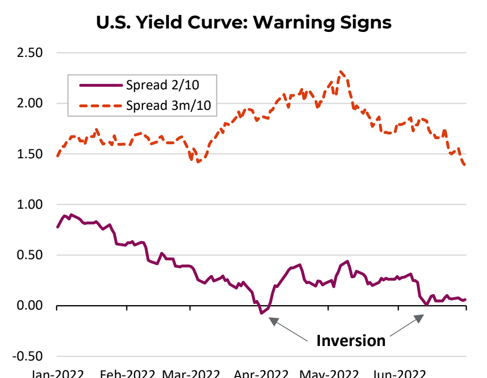


Oil prices, which are on have been a net positive for Canada so far this year, suffered their first monthly loss since November, which helped push the **S&P/TSX Composite** lower, falling 8.71% in June and 9.87% YTD. Risk-averse investors were also feeling the squeeze as bonds failed to provide their typical diversification benefit yet again. Central banks remain hawkish with the Bank of Canada (BoC) hiking interest rates by 50 bps earlier this month bringing the overnight rate to 1.50%. The Fed shocked the market in June, hiking rates by 75bps, the biggest increase since 1994, bringing the overnight rate in the U.S. to 1.58%. With rising rates, the **Canadian Aggregate Bond Index** was down 2.05% in June, and the **U.S. Aggregate Bond Index** posted a June loss of 1.57%.

Economic data released this month showed US Q1 GDP falling by 1.6%, marking the first contraction since the pandemic. More worrisome than the headline number is that personal consumption was revised sharply lower to +1.8% from +3.1% as consumer spending slows. To wrap up the tough data releases this month, U.S. inflation hasn't stopped and consumer sentiment is at its lowest reading since inception of the index in 1978. All this negativity and we saw the U.S. bond market flash its second 2/10 yield curve inversion (albeit it was intraday). At home, Canada's inflation rate hit 7.7% in May, its highest level since January 1983 amid a surge in energy prices. A tight labour market and wage pressures have many believing inflation is unlikely to fall anytime soon. Rising rates have also impacted the housing market in Canada, with volumes and prices slowing as borrowing costs rise.



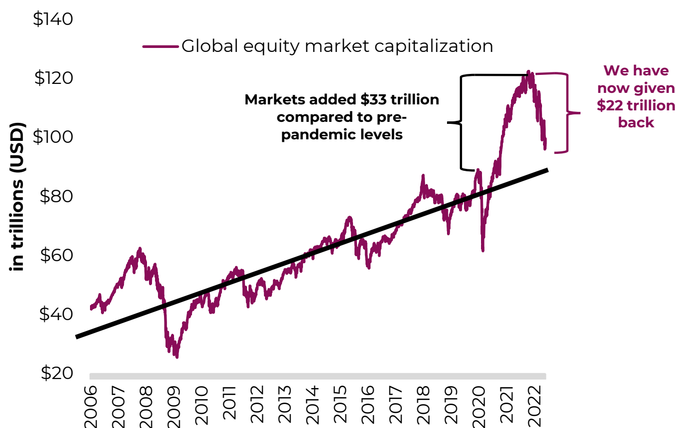
Even Europe, where rates have not risen since 2011, is preparing to hike rates. The ECB said it would raise its key interest rates by 0.25% in July, with further increases planned for later in the year. The bank also intends to end its bond-buying stimulus program after inflation hit 8.6% in June, well above the ECB's target.



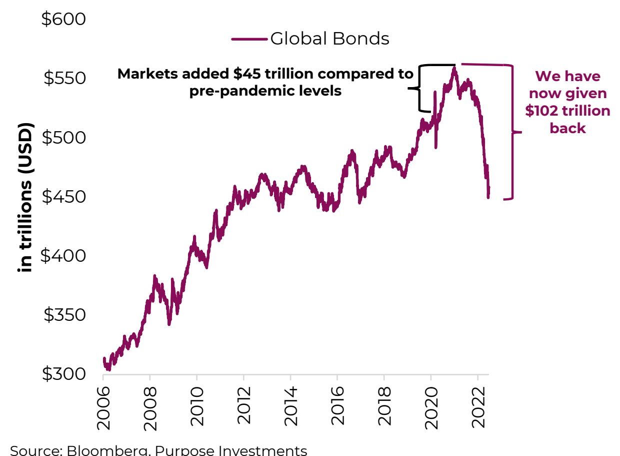
So that was June. But since it is halftime, let's recap where we are for the year.

Halftime report: looking back

The magnitude of the wealth evaporated cannot be overstated. After adding $33 trillion to pre-pandemic levels, equities have given most of this back. The scope of the rally in less than two years was historically unheard of. There were markets that rose faster in value; the NASDAQ in 1999/2000, for example, had a similar run to the S&P 500 from March 23, 2020 to the end of 2021. However, the market cap added globally was a new one. Everything with a price participated. Markets took over a decade to add that amount of value from the recession in 2008 till 2020. Incredibly, equities have given back two thirds of it in a mere six months. Even more incredible is the drawdown in debt. Global bond markets are much bigger than equities. The global bond market rose in value to $550 trillion. But with yields rising, and now credit spreads widening as well, this amount has fallen by $102 trillion. Add them up, and global wealth has been reduced by $140 trillion this year.



Source: Bloomberg, Purpose Investments



Source: Bloomberg, Purpose Investments

Why is this happening?

There are plenty of reasons. Central banks and government spending has pivoted from being supportive of markets to restrictive. Pandemic support was no longer needed, so the focus turned to combatting the high global inflation levels. Looking back, it is increasingly obvious that the "policy error" was made on the easing side: too much stimulus and spending for too long when it was no longer needed.

Globally, people moved from spending more on goods to services. These kind of sea changes really mess with the economy and add uncertainty, as we have noted repeatedly in previous publications. Add the war in Ukraine to the mix. In addition, we now have slowing global economic growth and rising recession risk – all weighing on assets.

But let us not forget asset prices, from stocks, bonds to real estate, were very elevated at the start of the year. Many of those factors have reversed direction, creating a great re-pricing of assets. Global equities were trading at about 20x earnings on January 1, considerably higher than the long-term average of about 15x. Meanwhile global bonds carried a yield of 1.3%, an historically low yield with billions worth in negative-yield territory. Fast forward six months, global equities are down 18% and global bonds are down 14%. Valuations for both are at or below historical averages. Equity valuations have fallen to 15.7x and bond yields have climbed to 3.0%.

What we predicted

Let's go back to our January 2022 Investor Strategy and hold ourselves accountable for the calls we made.

2021 Year-end Portfolio Tilts						
Equities				■		
Fixed Income		■				
Cash				■		
Canada				■		
U.S.		■				
International				■		
Value to Growth Tilt		■				
Small to Large Tilt		■				
Overall		■				
Duration		■				
Credit				■		-
CAD Short Term (3m)				■		-
CAD Longer Term (1yr)				■		-
Overall Allocation				■		
Growth		■				
Diversifiers				■		
Alternative Credit				■		
Real Assets					■	

While we all knew this would be a challenging year given the potential for simple mean-reversion after the incredible 2021 results, the magnitude of the drawdown in asset prices – all in unison - is a surprise. Our outlook for 2022 surmised that the economic cycle was still healthy, but valuations were rich all around. We focused on value, short duration, but having got these tilts "right" still feels hollow. Absolute losses still hurt, even when we got it right on a relative basis.

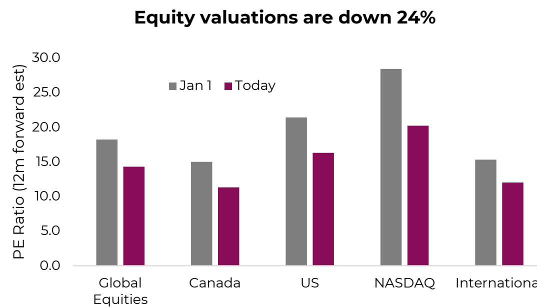
We'll now draw your attention to the reality of the bear market that we are now in and look at how it may play out.

The 3 stages of a bear market

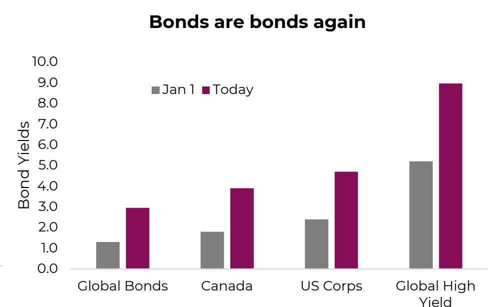
Yes, we said it. The bear market is here. Whether you want to stick with the literal definition of a close below 20% or are satisfied with the fact that most of the world's equity markets are selling off and resetting their multiples to levels that are more commensurate with higher interest rates. We are happy that Canada is outperforming, but after June we can no longer claim "in-the-green" superiority like we had earlier this year. Since we are in the bear, it is important we look at the anatomy of a drawdown like this to inform us of how to position ourselves going forward.

Stage 1 – Valuation reset

Valuations of any asset are based on its forecasted future cash flow or earnings, discounted into today's dollars. The discount rate depends on the risk-free rate and a premium for the future uncertainty of those flows. For bonds this premium tends to be smaller but does rise if default risk escalates. For equities, which enjoy upside of earnings surprises, the premium is much higher as the future uncertainty is greater. If a recession looms, the discount rate goes way up, affecting both.



Source: Bloomberg, Purpose Investments



Source: Bloomberg, Purpose Investments

In today's world, the risk-free rate is rapidly changing as central banks embark on a tightening program to combat inflation. Should we use 1.5%, 2.5% or 4%? Ultimately, it will depend on the path of inflation. But there is a rising recession risk ... should we now reduce our estimates of risk free? It's hard to know. Simply put, the discount rate has gone up faster than we have seen in generations given the quick onset of inflation and the high level of uncertainty over the coming quarters.

Why have valuations reset materially? On average the price-to-earnings ratio globally has fallen about a quarter. That's meaningful and brings the S&P 500, for example, into a range that a Shiller CAPE disciple would even start to get interested in. We won't call it a screaming buy, especially if you view the 'earnings' to be at risk of revisions (see next stage). Our view is that valuations have reset for two main reasons: interest rates, and expectations for downward earnings revisions. At least the froth is now out of the equity market. But will valuations stop here, or over-correct and become even cheaper?

A valuation reset for bonds too

Yields were ridiculously low during the pandemic uncertainly. However, yields started to rise way back in 2020 after the major economic shock. They just accelerated in 2022, so the bond market has been in decline for two years now. Yields are no longer ridiculously low, they are not even low, they are normal again or … dare we say juicy?

From a valuation reset, the bond market may be the more relatively attractive asset class. But this really comes down to defining the more imminent and longer recurring threat: **inflation or recession?** If inflation continues, bonds are still at risk. But if a recession is developing, bonds should outperform equities. The good news is that with today as a starting point, valuations in both asset classes are much improved, bettering the future expected returns even in an uncertain world.

We believe the valuation reset is largely done … but revisions are up next.

Stage 2 - Revisions

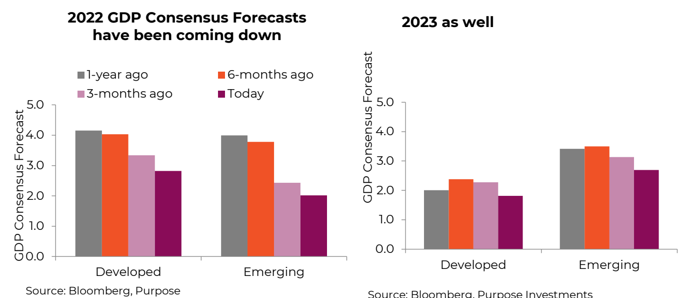
Whether it was a natural cycle, or the tightening of financial conditions, consumer behaviour is reverting to pre-pandemic patterns. Consumer confidence is in the dumps due to the market drop and inflation, and high energy prices are not helping.

We see several signs of slowing global economic activity. Copper has been falling quickly. Housing activity in Canada and the U.S. has started to slow materially, largely due to higher mortgage costs. This is now starting to show up in prices, and the Homebuilders index is off 34% year-to-date.

> From Credit Suisse June monthly survey of real estate agents – *'The adjustment to higher rates appears to be happening more rapidly than in prior cycles as the change in traffic was more abrupt and we're now already seeing a reaction on pricing.'*

Manufacturing activity, based on PMI surveys, is slowing after running really hot to catch up and alleviate many backlogs or shortages. Meanwhile leading indicators are declining. The data has been softening. Let's not forget the U.S. economy contracted in Q1 and based on the Atlanta Fed's GDP Now (a measure that attempts to capture how the economy is doing in almost real time), Q2 is negative as well. If Q2 comes in below zero as GDP Now is suggesting, that would be a technical recession for the U.S. economy: two consecutive quarters of negative GDP growth. While the economy is slowing, however, it is too early to say it is heading into a contraction.

Make no mistake, GDP forecasts are being revised lower. Consensus expectations for 2022 growth has been trending lower, more so in emerging economies given the events in Easter Europe. These trends will likely continue to come down as we move through the second half of 2022.



Source: Bloomberg, Purpose

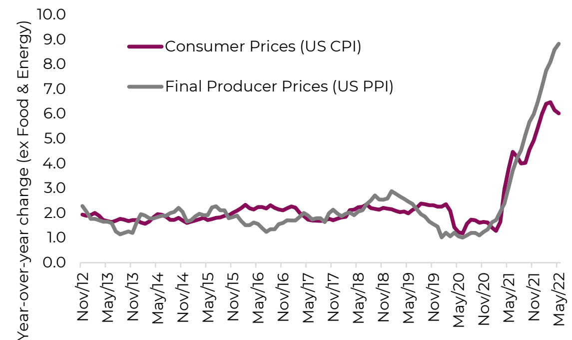
Source: Bloomberg, Purpose Investments

The good news is few market participants observe economic forecasts, perhaps due to a patchy success rate at forecasting the turning points. Investors focus on company earnings, and they may be set to see downward revisions as well.

Margins keep rising

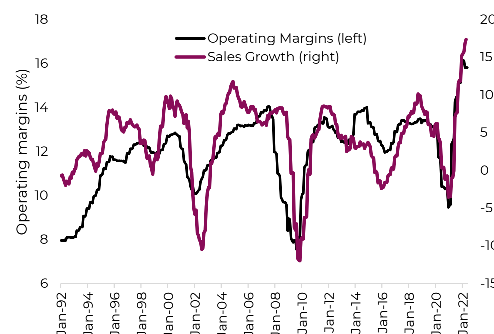
Let's start with margins, which we did get wrong. We thought cost pressures would crimp margins near the end of 2021. There is no denying that corporate costs are on the rise: shipping costs, wages due to a tight labour market, commodity prices, the list goes on. However, we underestimated the ability of companies to pass this on very quickly into higher prices, which most of us consumer have become keenly aware ... but able to pay. Everyone's got their inflation story from restaurants to vacations.

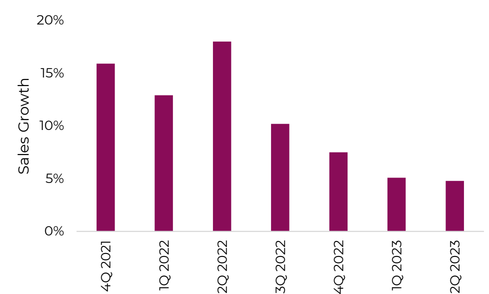
While the pace of increases in consumer prices (CPI) have abated, producer prices (PPI) are still rising. CPI is starting to come down as the efforts to combat inflation are working. Demand is softening. Costs, using our proxy of PPI finished goods, will come down too but it is a lagging indicator. And during this lag, margins are at risk. It does get a bit more concerning since margins are sitting at all-time highs (as far back as our data goes). The lifeblood of margins is sales growth. Now this can come in the form of greater output in units or rising prices, or simultaneously as has been the norm over the past few years. The risk now is even based on current consensus analyst estimates, sales growth is poised to decelerate in the second half of 2022 and into 2023.



Source: Bloomberg, Purpose Investments

Slowing economic growth, begets slowing sales growth which leads to margin compression. What does this mean for earnings forecasts? Perhaps they may be too optimistic. Current forecasts have S&P 500 operating earnings growing on average 12.5% across the second half of 2022 and first half of 2023. **We believe earnings forecasts will come under pressure in the months ahead, even as early as this coming earnings season. Expectations are simply too high and downward revisions are likely.**





Source: Bloomberg, Purpose Investments

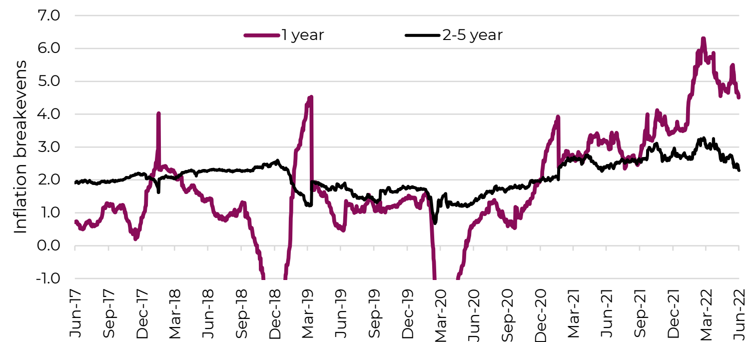
Stage 3 – Recovery

Stage 1 and Stage 2 paint a pretty bleak picture, but don't forget how far markets have already fallen. Has much of this been priced in? Probably a good amount, but we don't think all. Remember, much of this is by design. Markets went too far, inflation got too hot, and now the central banks of the world are tightening to slow economic growth and tame inflation. What we are experiencing – recession talk, markets reacting negatively – is precisely what is supposed to happen.

As the economic data cools, it will increasingly show up in the inflation data. The bond market is keenly aware of this and break-evens, as the market's measure of inflation, have started to come down. The amount of inflation priced into the bond market in the 2–5-year range is now back down to early 2021 levels.

We are not saying that inflation risk is gone; the future path of rents and wages remain very uncertain and could accelerate. Even if inflation retreats, it will likely not get all the way back down to pre-pandemic norms that the markets had become so accustomed. The inflation risk is starting to decline, though, and that is good news.

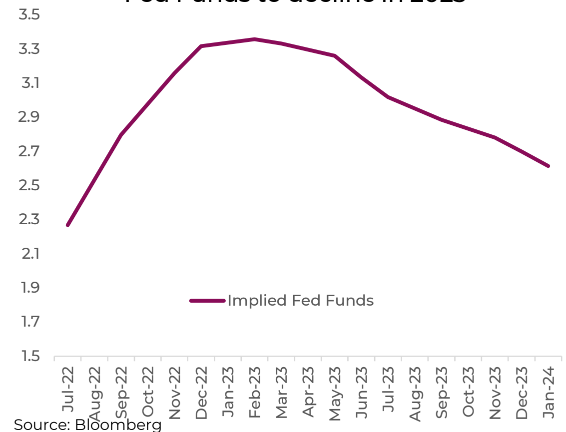
Longer term inflation break evens are trending lower, rather quickly



Source: Bloomberg, Purpose Investments

If inflation begins its long retreat in the second half of 2022, that will be in part because economic growth is cooling. This will open the door for central banks to slow or cease their rate hiking paths. This has already shown up in the Fed Funds futures market. Futures have the U.S. Federal Reserve moving their rate from the current 1.5% to 3.5% in Q1 of 2023, but then cutting rates back down to 2.75% by the end of 2023.

Whatever the path, as soon as inflation pressures ease, financial conditions should begin to ease as well. Whether we can avoid a recession during this adjustment will be the conversation in the second half.



Source: Bloomberg

Market cycle: rewards and risks

While we do believe the second half of 2022 will provide relief from the first, it is likely to remain volatile. Here are three key aspects that could surprise the market:

- **Summer of discontent** – Food and energy prices are very high. They are even higher if your currency is not US dollars. As the summer drags on, this could lead to increased political unrest in developing countries, where food and energy make up a big portion of the consumer basket.
- **Wages & rents** – The path over the coming quarters is very sensitive to the path of inflation. Wages, which impacts the services categories of CPI, have been rising. While there are signs employment is cooling, wage pressures and rent remain a risk. The CPI rent component often trails housing prices by a year or so. Given home prices had been going up until a few months back, this CPI component may have further to run, lifting headline CPI.
- **Recession** – No doubt this is the BIGGIE. Markets continue to struggle with what to worry about more: inflation or recession. We believe as the second half drags on, recession talk will grow louder and louder. Let's dive into this one.

Bumpy landing or recession?

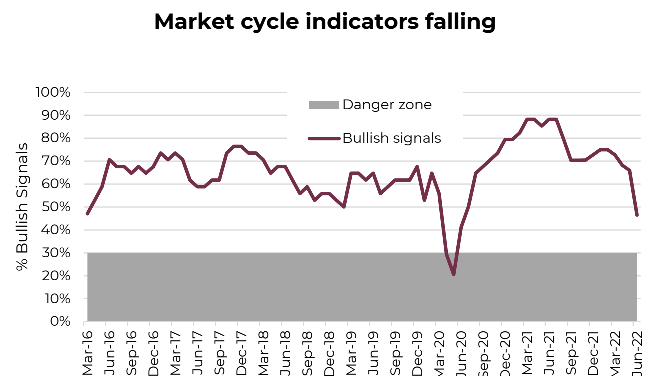
Central bankers have a poor track record of using monetary policy to successfully pull off an economic "soft landing" at the best of times – and these are hardly the best of times. The global economy grew by 5.8% in 2021, well above trend. Inflation became a significant problem, as did the supply chain and labour shortage issues. The runway is a mile off and we are still at 10,000 feet with a strong crosswind. At best we are looking at a bumpy landing, at worst there is a recession pending.

The timing of the next recession remains very uncertain. The old adage is: a recession is when your neighbour loses their job, a depression is when you lose yours. At the moment, just about everyone has a job and we just are complaining about high gas prices. Job postings remain elevated and the bargaining power still sits firmly with the worker. That said, we are starting to hear more about layoffs than hiring sprees.

Beyond employment, the economic momentum is clearly softening. The Market Cycle indicators, which capture rates, economic, sentiment and fundamental forward-looking indicators, have been falling fast. They are still above the danger zone, but not by too much.

That said, the U.S. consumer, which makes up about 20% of the world's economy is in very good shape. China and other parts of Asia, which had been on stricter COVID lockdowns due to less effective vaccines and higher population density, are now coming out of lockdown. When this happened in North America and Europe, we enjoyed one of the strongest economic bounces in years.

Market cycle indicators falling



Source: Purpose Investments, Bloomberg

Portfolio construction

With so much movement in asset prices from stocks to bonds, changes in economic trajectory and sentiment, it should come as no surprise that Richardson Wealth has made a number of changes for positioning into the second half. In the 'Portfolio Tilts' table below, a solid square represents our tilt for the second half while a shaded box denotes the previous positioning.

Overall asset allocation

Overweight equities has clearly been the wrong tilt year-to-date, but given valuations and how far the market has come down we feel more comfortable going forward. As bond yields have risen considerably this year, we have upgraded bonds to market weight. Yields in government and investment grade have risen to much more attractive levels. Inflation remains a risk but given rising recession fears, a more neutral bond allocation is prudent today. The overweight in alternatives, which has helped shield value year-to-date, is being downgraded. It has become easier to find yield from traditional sources and given the market decline, the need for diversifiers has diminished.

Portfolio Tilts 2nd Half

Overall Asset Allocation	-				+
Equity				■	
Bonds		▨	■		
Alternatives		■		▨	
Equities	**-**				**+**
Canada			■	▨	
U.S.		▨	■		
International				■	
Developed vs EM					■
Value to Growth Tilt		■			
Small to Large Tilt		▨	■		
Active vs Passive				■	
Bonds	**-**				**+**
Cash		■		▨	
Duration		▨	■		
Credit			■	▨	
Alternatives	**-**				**+**
Growth			■		
Diversifiers				■	
Alternative Credit		■			
Real Assets				■	▨
Currencies	**-**				**+**
CAD Short Term (3m)				■	
CAD Longer Term (1yr)				■	

Equities

There are several changes to our recommended equity tilts. Reducing Canada, which has been a relative winner this year, as recession risk rises. Upgrading U.S. equities on the -20% drop in prices year-to-date provides a better risk/return balance. International equities, remain overweight given an improved view on Asia and elevated relative value of the Canadian dollar to yen and euro. We continue to strongly favour developed markets and shy away from emerging markets. Financial conditions are tightening and we have some fears of political instability and social unrest in developing economies given high energy and food prices.

Below are a few deeper dives into equity categories.

Cooling on Canada – It's been a good run for Canada, but with recessionary winds blowing, our fear is that the Canadian economy is more vulnerable to an economic slowdown and higher yields compared to the United States.

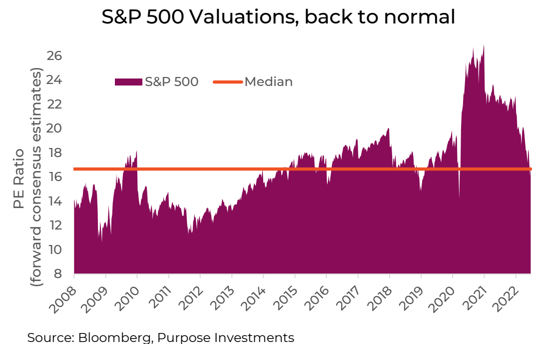
Excessive leverage within the financial system is the main reason. The Canadian economy is far more rate sensitive than the U.S., given the frothy housing market and high household debt. With debt levels so high, there is a distinct possibility that the next Canadian recession is more severe than the one in the United States, just as it was the opposite in 2008.

We are mixed on energy – a dearth of capital investment for the past decade as well as some terrible energy policy globally gives us reason to believe that energy companies could do well, despite a global slowdown. However, the sector is the definition of cyclical and this would be an anomaly should recession fears continue to grow. Volatility remains high, and we'd note that the sector already fell 20% from its peak in May. The best time to buy commodities was when inflation was not on anyone's radar, not when it's making multi-decade highs. If we extend this logic to Canada as a whole, this is not the ideal time to be overweighting an index with heavy commodity and housing exposure.

Given these risks, our overweight Canada allocation has been reduced to neutral. The positives for Canada are being uniquely positioned with both energy and food security, as well as relative political stability. This explains how the Canadian dollar has been so strong so far this year against everything but the US$. The TSX is also still trading at attractive valuations with the blended 12m forward P/E ratio at just 11.5. Balancing out these elements, a neutral weighting is warranted.

Tipping back to Market Weight U.S. - While our conviction is not extreme, due to various reasons such as heightened recession risk and challenges ahead for the Fed to orchestrate a soft landing, there are cases to be made that allow for a modest change of our American weight in our view.

The S&P 500 just crossed below the 15-year median of 17x price-to-earnings making equities in the US more attractive. While it doesn't look 'cheap', it has returned to from the stratosphere. This valuation compression was large and swift, as one would expect when yields on the US 10-year go from 0.6% to 3.2% in two years. Margins will be challenged by inflation, but hey, we never said investing comes without risk. This calls for a modest shift to market weight, though we would likely need to see a larger compression to warrant a move to overweight.



Source: Bloomberg, Purpose Investments

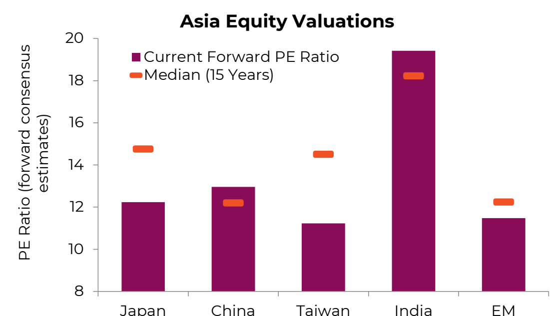
From a currency standpoint, after the recent run of the U.S. dollar the best way to implement a US market trade would be to hedge the USD. The safe-haven currency has been propped up by the risk-off trade. Laying out the scenario that if we get a rise in US equities, the risk-off trade will subside, and the dollar may fall alongside it. Canada has their own currency challenges ahead due to our housing market and debt ratios, but this strategy is weighed more heavily on a pullback in the US dollar.

Overall, the long cash-flow duration of the US market has been punished during this rising rate environment. US growth is down -26% year to date while value has only pulled back -10%. Future recession aside, if inflation begins to subside and we begin to see a change in investor sentiment, the growth in the US is set up for a larger bounce back than other global indexes.

International, gut check time for Japan - Asian markets are becoming increasingly interesting. Emerging market equities appear extra risky given recession risk, geopolitical risk with high food & energy price, and tightening global financial conditions. Usually, they are no place to be if we are going into a recession. While China still holds the title of the largest economy (developed and developing) in the region, Japan remains a major player on a global scale and may be the solution when looking internationally. The Asia-Pacific region will certainly benefit from the reopening tailwinds of China. However, China does continue to carry significant risk due to political actions towards public companies. As China re-opens, the market reaction may be more swift than other members in the region, but a less volatile and longer-term play may just be Japan.

While most global economies are enacting a hawkish policy, Japan remains on the dovish side of things, which has come with a cost: the historic fall of the Yen against global currencies. The Bank of Japan (BOJ) has maintained its target short-term rate of -0.1% and defends the 10-year yield around 0%; much different than our North American economies that continue to raise rates. Thus, the obvious weakness in the Yen stems from widening interest rate differentials between Japan and other economies. We aren't talking about small moves in the currency. From January 2021, the Yen has fallen 30%+ against both the US Dollar and the Loonie. There is a strong belief that the BOJ will have to abandon its 0.25% cap on benchmark bond yields and let them rise to relieve the Yen. If this does happen, it sets up a strong scenario for international investors to benefit. However, the longer Japan stays accommodative and if inflation continues to pick up, the Yen could break these levels. From our view, a rapid move like this warrants a deeper look at the potential for portfolios.

The Japanese equity market, the year-to-date performance of the Nikkei has seen an identical drop to the S&P 500 of -20% in US dollar terms. However, a large percentage of it is due to currency. The Nikkei in Japanese Yen has held up relatively well. At the same time, Japan is still experiencing growing profitability due to the advent



Source: Bloomberg, Purpose Investments

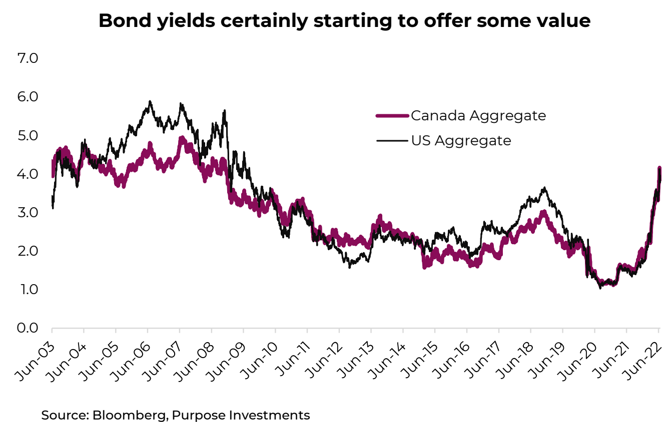
of Abenomics; a set of policies laid out by former prime minister Shinzo Abe through increasing money supply and government spending to make the Japanese economy more competitive. After sustaining some compelling earnings growth, the valuations are signaling a convincing buying opportunity. Not to mention, Japanese exports are increasingly competitive given the weak yen. Looking across other regions in Asia, the gap between current forward P/E and the 15-year median is persuasive, especially since we outlined that we want to be underweight emerging markets at the risk of a recession.

Another plus for Japan is the makeup of their index. Some of the most exciting future global trends such as robotics, electric vehicles, semiconductors, and many other innovation opportunities are being built. Prime Minister Kishida is a supporter of innovation and wants to see Japan thrive in the long term. While the weakness in the Yen due to accommodative policy is a setback, it helps their exports. Any slight tightening in the future may help tame inflation and reverse the fall of the Yen. On the other side, perhaps they simply ride out inflation and wait for a global recession and rate-cutting elsewhere without having to change their dovish attitude. Regardless, the recent economic and market activity in Japan has opened the door for investors to consider a place for it in their portfolios.

Bonds

With the worst sell-off in decades, the one positive is that yields currently available in the market are attractive. And you don't need to go down the credit spectrum to find yield. Add in the uncertainty of a potential recession, and it is time to go market weight bonds once again.

Within bonds, the need to remain low duration is also fading. It was an easy call when 10-year yields were below 1% to stick with low duration and lean on credit for cash flow. Today, with 10-year yields over 3%, they look attractive on their own, and will perform better than credit should a recession come faster or deeper than expected. Corporate balance sheets are strong, and this is good news for credit. However, there are many high yield companies that have increased financial leverage significantly trying to get through the pandemic. With the market awash in yield across different risk levels, is the extra yield worth it? At the very least, go active to try and avoid some of the potential defaults.



Alternatives

Alternatives certainly helped in the first half of the year. Leaning on diversifiers and real assets were the places to be. For the second half, given bonds are bonds again and we believe equities will enjoy a rebound on fading inflation, we find less need to be overweight alternatives.

The only change among alternative strategy buckets is a cooling of our strong overweight in real assets down to overweight. The strong overweight tilt was before inflation and commodity prices spiked. As inflation cools, real assets will likely follow. We remain overweight as the longer-term prospects remain very compelling.

Real Assets – still constructive, but relatively less attractive. One area of strength in markets this year has been in Real Assets. Energy has been the group that has experienced the strongest returns and continues to show promise going forward. Over the last few years as ESG investing has gained popularity, there has been a lack of capital deployed towards the resource sectors. The lasting impact of this shift is that there are no readily available sources of new supply to come on in both energy and materials.

Everyone wants to move to a more sustainable and greener future, but it's not that easy and will take time. Investors should consider the theme of energy transition for the next few years, and this transition will require natural gas, nuclear,

and renewables. Energy companies that survived the years of $20 WTI have become incredibly profitable in an environment of over $100 prices. What is different in this cycle versus others, is that this free cash flow is being returned to shareholders instead of wasted on acquisitions or risky growth projects. Energy stocks should continue to act well and selloffs in which they participate with the broader market should be looked at as buying opportunities.

The one commodity that has frustrated investors for the past two years is gold. In many textbooks you can see model portfolios that would show a 5% weight in precious metals to have an asset that is uncorrelated and will protect against inflation. Well, we are in an environment where all these themes are occurring, but gold isn't really working as expected.

Maybe last year some of the demand for gold was diverted to new areas such as cryptocurrency, but that should have reversed this year. What may be the main culprit for the lack of performance is the strength of the US$. In a risk off world, global investors tend to turn to US Treasury bonds to protect value; this increases the price of the US$ and has weighed on the price of gold in US$ terms. Investors in Asia and Europe are having a very different experience with their gold holdings, as in local currencies it has acted very well.

There is still time for gold to work in this cycle and by the end of the year it may turn out to be one of the top-performing asset classes. But for this to happen we need to see the US$ peak vs other currencies. If inflation levels off in the 5% range and the FOMC becomes more balanced, we may see the US$ pause and gold move higher.

Conclusion

2022 has started off as a bear and inflation and recession risks remain. While we are not uber bullish, given the declines and valuations, the second half certainly looks like it should be better than the first half.

Source: Charts are sourced to Bloomberg L.P., Purpose Investments Inc., and Richardson Wealth unless otherwise noted.

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