August 2022

Investor Strategy

The latest market insights from Richardson Wealth

A collaboration between **Richardson Wealth** and **Purpose Investments***

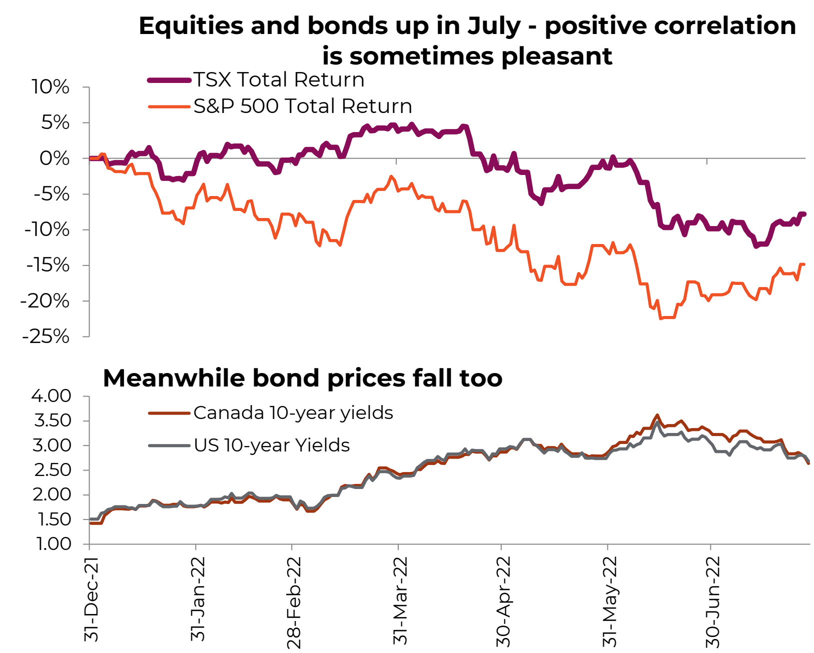
RICHARDSON Wealth

Second half off to a good start

Executive Summary

1. No summer doldrums in July
2. Two charts that explain just about everything
3. Dividend stocks ready for their moment
4. Market Cycle still softening
5. Portfolio construction

One would think with CPI rising, Fed going 75 bps, Bank of Canada raising by 100 bps and U.S. GDP posting a second consecutive quarter of negative growth that the recession chorus is growing louder and things sound dire. Yet markets have rallied this month, reinforcing the fact that the market's starting point matters just as much as the news flow. After a terrible June, the S&P/TSX advanced 4.7%, S&P 500 9.2% and Nasdaq by 12.3% in July. Meanwhile, bond yields have dropped on recession fears. While many have complained of the positive correlation between equities and bonds this year, temporarily reducing the efficacy of portfolio construction, positive correlation is nice when everything goes up.



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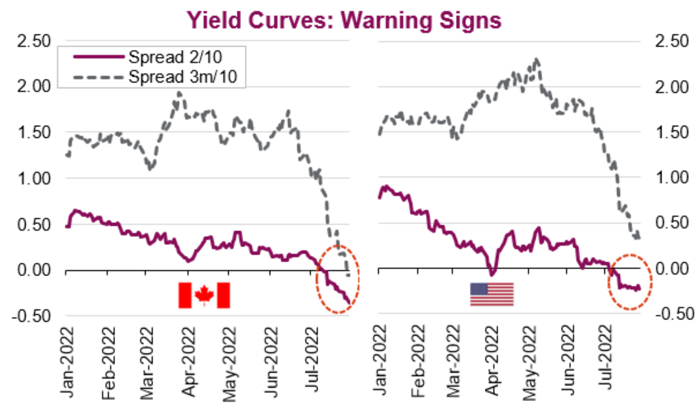
No summer doldrums in July

Investors did not enter July with much optimism. Instead, worries of disappointing corporate earnings and their potentially worrisome outlooks along with the barrage of central banks' inflation-quelling interest rates hikes weighed on investors' minds. One would think that this sentiment would have continued throughout the month, given the negative yield curve spreads (a historically good forecaster of past recessions) in Canada and the U.S. and news of the second consecutive negative quarter of U.S. GDP print. However, this was not the case.



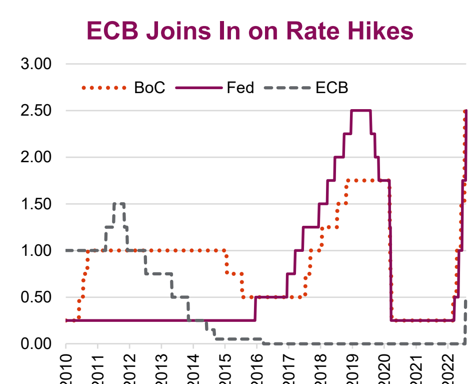
The change to optimism this month was notable in corporate earnings, where many companies are beating estimates despite warnings in previous quarters. Consumer spending remains elevated and the job market remains strong. Major averages in the U.S. had their best month of the year in July, with the S&P 500 finishing up 9.2% while the Nasdaq was 12.3% higher, cementing their biggest monthly gain since November 2020 and April 2020 respectively. The resource-heavy TSX hit its lowest point in over a year mid-July due to a pullback in oil, gold and metal prices. However, the back half of the month was a different story, helped by a rally in crude prices, strong earnings and a recovery in many industrial and technology stocks. The TSX snapped its three-month slump and finished up 4.7% in July. Outside of North America, there was positive sentiment with the MSCI World index closing the month up 8.0% (its best month since November 2020) buoyed by broad gains across European markets, as the STOXX Europe 600 index was up 7.7%.

Nice bounce in July

S&P/TSX TR	4.7%	-5.7%
S&P 500 TR	9.2%	-12.6%
Nasdaq	12.3%	-20.8%
Europe	7.3%	-13.7%
Japan	5.3%	-3.4%
China	-4.3%	-10.6%
Canadian Bonds	3.9%	-8.8%
U.S. Bonds	2.4%	-8.2%

On the economic front, it was all about GDP and interest rate hikes. Canadian GDP figures were flat month-over-month while U.S. figures showed the second straight quarterly contraction, with GDP falling at a 0.9% annualized rate in Q2 after a 1.6% decline Q1. Although the fall in U.S. GDP brought the economy in line with a "technical" definition of a recession, we will not know if they have officially entered a recession until the National Bureau of Economic Research (NBER) declares it and they tend to be tardy. Before they released the GDP numbers, the Fed raised rates by 75 bps as they look to rein in inflation, which takes the upper target range to 2.50% and the highest level since 2008. Interest rate futures markets now predict that U.S. interest rates will peak by December this year (rather than June 2023) and the Fed will cut interest rates by nearly 50 bps next year to support slowing growth. The Bank of Canada took a page out of the Fed's playbook and increased rates by 100 bps in July.

In Europe, who has been late to the rate hike party, Eurozone inflation hit a record high with CPI jumping 8.9% from a year earlier in July and up from 8.6% last month. This came after the central bank surprised markets by pushing its benchmark rate up for the first time since March 2011 by 50 bps, surpassing estimates of a 25 bps hike. With inflation remaining elevated, bets have increased on more jumbo hikes. The euro's weakness has become a problem for the ECB, with the recent parity to the U.S. dollar, deteriorating confidence in the Eurozone. Criticism of the central bank's easy monetary policy has grown and the risk of Russia cutting off energy supplies has contributed to an exodus of investors from the currency. The ongoing natural gas situation in Europe and whether Russia will restore its distribution will be



closely monitored in the coming months. At least wheat/grain shipments have started to make their way out of the Black Sea Ports.

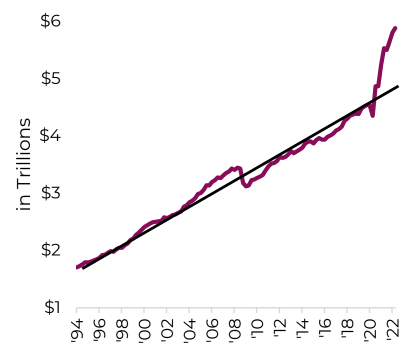
Global bonds had their biggest monthly gain since November 2020, as markets brace for a slowdown in the global economy. The U.S. 10-year yield fell to the lowest level since April on the final trading day of July in a volatile session. The Barclay's U.S. Aggregate Bond TR Index was up 2.4% and the FTSE Canada Universe Bond TR Index was up 3.9% for the month.

There looks to be no summer doldrums this time in the markets with inflation, recession and the war in Ukraine continuing to add volatility. However, as inflation surges and central banks scramble to raise rates without stifling growth, risky assets have started to react positively to any perceived softening in sentiment on the part of policymakers. It appears that many investors believe that much of the bad news has already been baked into market returns, as equities have rallied after the GDP releases and interest rate hikes this month. We believe the back half of 2022 will remain a challenging year with recession risks building, but the second may be better than the first half for both equities and bonds, and particularly for dividend stocks.

Two charts that explain just about everything

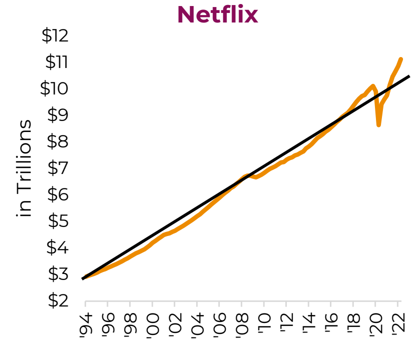
So if a butterfly flaps its wings in Africa, it can cause rain on the other side of the world. Yes, we are misquoting a common misquote about chaos theory. But the lesson is that a small change (the butterfly) in a dynamic complex system (weather) can result in huge differences in outcomes over time. Let's say the butterfly is the pandemic (though perhaps Mothra or a meteor would be a better analogy). And instead of weather, we are watching the impact reverberate through the economy, our behaviours and the markets. This was an exogeneous shock to the entire system, it changed behaviours, moods, economic relationships, etc. Now things will return to normal, but the impacts will continue to reverberate through the system for years, likely with a diminishing magnitude. Okay, maybe a pebble in a pond may have been a better analogy.

Spending on Goods - cars, ipads, TVs, furniture, stuff



We think the two charts (on the side) can help explain just about everything. How the pandemic changed behaviours in one direction then another which has caused everything from a +25% year and -20% half year; global growth and now slowdown; inflation and central bank policies … even why you can't fly with your luggage or get a reasonable reservation at a fancy restaurant.

Spending on Services - travel, food, recreation, Netflix



We are referencing U.S. consumer data in these charts, but the pattern is similar in many developed economies. Starting with the first chart, this is U.S. consumer spending on goods or simply "stuff". Cars, iPads, renovating our homes to make them more comfortable, etc. The pandemic hits and many work remote, travel and go out to dinner less: this was the initial behaviour response. All that income saved from not going to Six Flags or le Bernardin (services), was instead piled into stuff (goods). Goods spending has a bigger impact on the overall economic activity and on corporate earnings.

Goods spending generally follows a steady growth path, with a dip down in recessions. You can see this in the top chart with the step down 2008 and as the economy recovers the line resumes its upward path. Then came the pandemic and with most consumers tilting even a bit towards more goods spending, this line went parabolic. That is an extra trillion dollars being spent by consumers on stuff. Even if supply chains were not impeded by pandemic issues, the economy has a hard time adjusting to such an abnormal shift in demand.

So corporate profits soar and so does the economy: this was a worldwide impulse. Companies clamour to expand capacity to meet demand and hire many people quickly. Probably too quickly, as the passage of time will likely tell. We are not downplaying the contribution of stimulus, but changing behaviour is bigger. Put all this into the mix and markets rock higher.

Now the wave of behaviour has started to change direction. We don't need a new RV, the one in the driveway is only a year old. Instead, we want to go out and do things again, demanding more services (the second lower). And we are willing to pay for it because after sitting around the same town for two years, the travel itch is strong (revenge travel). Yet this sudden demand for travel and services is running into capacity issues. Different from manufacturing bottlenecks and more due to soft demand for many services for a couple years led to less capacity. Now with demand back, capacity takes time to adjust.

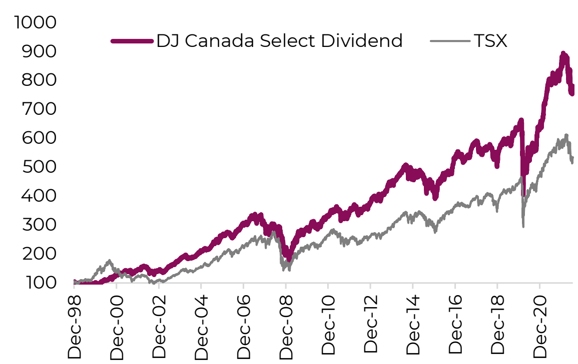
Add all this up and we have inflation, wage pressure and not enough baggage handlers. Capacity in services will rise to meet demand but it takes time. Same as manufacturing is steadily catching up with the sudden rise in demand for goods. These are big waves that are moving through the system, economy and market, all caused by the exogenous shock of the pandemic in 2020. The waves cause imbalances and distortions, turning historical norms upside down. In fact, if service spending continues while goods spending rolls over, we could very well have a recession or earnings recession with employment still rising.

We are not downplaying central bank policy as a big driver but would say central bankers are reacting to these waves just like the rest of us. To live in interesting times.

Dividend stocks ready for their moment

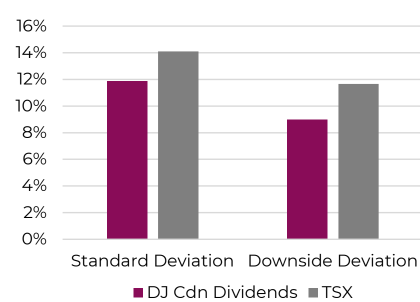
It's been a difficult year for investors so far, with central bankers battling inflation and recession fears dominating news flow. Not to mention typical diversifiers not providing the type of protection investors have come to expect. Forty years of declining bond yields, particularly during times of volatility, tend to entrench certain expectations. This is the way stocks and bonds are 'supposed' to work together … and then there is the 2022 way.

Dividend stocks have outperformed over the long term



When it comes to portfolio construction, the stock to bond asset mix tends to dominate the asset allocation discussions. Within equities geographic and factor diversification gets a lot of attention as well. The average investor has a much better understanding of value, growth and momentum compared to a decade ago. Dividend stocks tend to lean more towards value compared to the growth factor, but there is a full spectrum from those that are more growth sensitive (cyclical yield) to traditional safe havens (utilities and staples). The group as a whole has offered investors attractive relative returns while offering a larger degree of inflation protection and added much needed portfolio stability.

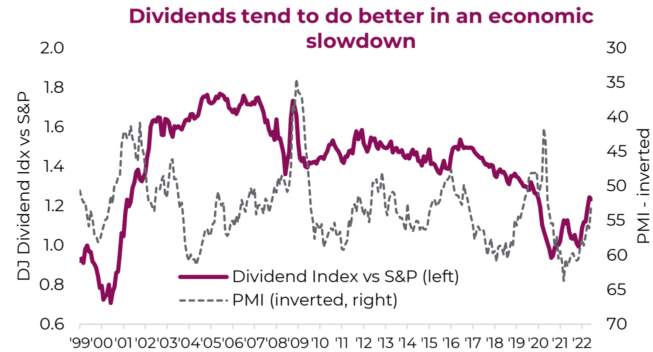
Dividend stocks offer added portfolio stability



Dividend-paying stocks help meet a wide variety of investment objectives, chiefly the search for yield. Though they are not as glamourous as disruptive tech, over the long-term when reinvested, dividend income offers attractive compounding effects. Specifically, over the past thirty years the annualized price return for the S&P/TSX Composite was 5.9%, compared to 8.4% in total return including dividends. Over the even longer term, dividends account for well over half of the market's total return.

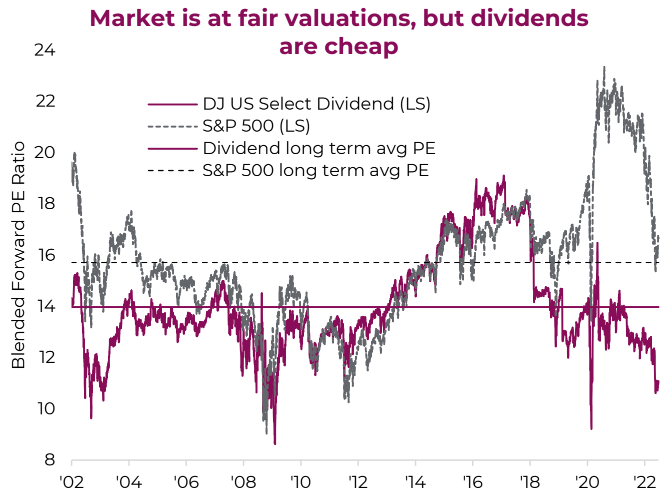
Increases portfolio stability without sacrificing returns

Volatility has been at the forefront of the markets so far this year. The VIX has been above 20 for all but a handful of days in 2022. Dividend stocks have historically performed well in choppy markets, but also do well as a standalone portion of a portfolio. Since 1998, the DJ CDN Dividends index has not only outperformed the TSX, but it has done so with a lower standard deviation and lower downside deviation.



Source: Bloomberg, Purpose Investments

Regardless of whether a recession manifests, divided stocks tend to be more stable during periods of weakening economic growth. The chart below plots the ratio of DJ US Select Dividend Index to the S&P 500 along with the ISM Manufacturing PMI data inverted. When the economy is slowing, there is plenty of anxiety and dividend stocks can be like a Xanax for your portfolio. They can smooth out the highs and lows and add further portfolio resiliency. In bear markets, a resilient portfolio is exactly what most investors should strive for.



Source: Bloomberg, Purpose Investments

Attractive valuations

Despite a solid start to the year, valuations are still attractive for dividend-paying stocks, especially in the U.S. They still trade at a solid discount based on price-to-earnings. Despite the bear market, the broader U.S. market is only now just trading in line with its longer-term average valuations, while dividend stocks are trading closer to prior troughs.

Added diversification – especially with an active touch

Depending on the market environment, certain sectors outperform, while others struggle. It's just how the normal market cycle tends to work. So far this year, the difference between the best and worst sectors in Canada is about 85%. Sector disparity is massive and as such, proper diversification is essential. This is where it gets a little problematic. The Canadian market is rather poorly constructed: it has big weights in Financials and Energy. The U.S. is a better but has an outsized allocation to Technology. Dividend-focused indexes help fix some allocations but tend to worsen others.

Adding an active touch to the portfolio management process is a great way to increase diversification. Compared to many other static ETFs, active portfolio managers can tactically shift sector weights to position portfolios for different market environments. Also, unlike many other rules-driven funds, they are not narrowly confined to just high-dividend payers long-term growers like certain ETFs. High yields are not always an indicator of financial health. Sustainability is important and a company that is paying out too much may inhibit its longer-term financial health. Likewise, only focusing on dividend growers with a long history of growth would tend to eliminate new entrants into the dividend universe and focus too much on older mature companies.

Market Cycle still softening

There is no denying, the economic data continues to worsen. Just look at the U.S. Q2 GDP print! We can blame foreign trade in Q1 or inventories in both Q1 & Q2 for triggering two back-to-back negative GDP readings. But make no mistake, things are slowing down across the board, including consumer and business spending. Yes, the employment market remains strong, but remember: employment is a LAGGING INDICATOR. Companies cut back on incidental spending first, then investment and then labour. Good people are hard to find and even bad employees are expensive to fire. This normal order was flipped around in 2020 due to the abrupt shutdown of many services which created a 'recession' that had employment as a coincidental or leading the broader weakness. That was an anomaly and this pattern is more normal.

Slowing economic growth isn't great, but a normal pattern is welcome after two years of abnormal. Tighter financial conditions are hitting the interest rate sensitive industries which is spreading. And this slower growth continues to soften fears of inflation.

Is the U.S. economy in a recession? Two back-to-back quarters of negative GDP does fit the rule of thumb for a recession, but the odd gyrations still washing through the economy have made many rules of thumb less useful over the past few years. We could wait for the official word on recession from the NBER, but we would likely be left waiting until the recession is over. They do tend to be tardy.

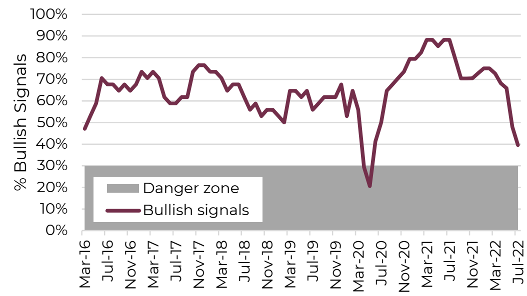
We don't think the U.S. is in a recession now, but the odds continue to rise. Plus, the data is only going to continue to soften in the months ahead, so the recession talk will continue to grow louder. This deterioration continues to be evident in our Market Cycle indicators which dropped significantly in June and continued to soften a bit in July.

The bad news or soft spots have remained. This includes the global economy, with 6/7 signals in the bearish camp. The U.S. economy remains on a stronger footing but that is softening as well, with notable weakness in housing and now manufacturing. Fundamentals have also started to show weakness as earnings revisions are increasing negative.

It is even a bit worse than the chart above portrays. In addition to whether a signal is bullish or bearish, we track the direction of the indicator: is it getting better or worse, improving or deteriorating? There are a lot more signals that continue to get worse vs better, as we would expect given the overall tide of data. While maybe it's a bit early to celebrate, the global economic data has a number of indicators starting to improve.

Aggregate demand is slowing which is alleviating inflationary pressures. This is literally what is needed to keep inflation

Market Cycle indicators falling



Source: Purpose Investments, Bloomberg

Market Cycle indicators

Grouping	Metric			Better/ Worse
Rates				**0 / 2**
	Net Cuts		✓	
	Yield Curve	✓		-
	Yield Curve 3m		✓	-
US Economy				**3 / 16**
	Leading Ind (3m)		✓	-
	Leading Ind (6m)		✓	-
	Phili Fed Coincident	✓		-
	Credit (3m)	✓		-
	Recession Prob (NY Fed)	✓		-
	Recession Prob (Clev Fed)	✓		-
	Citi Eco Surprise		✓	+
	GPD Now (Atlanta Fed)		✓	-
	US Unemployment	✓		
	Consumer Sentiment (3m		✓	-
	PMI	✓		-
	PMI New Orders		✓	-
	Energy Demand (YoY)		✓	+
	Truck Demand (YoY)		✓	-
	Rail (YoY)		✓	+
	Starts (6m)		✓	-
	Months Supply (6m)	✓		-
	Home Sales		✓	-
	New Home Sales		✓	-
	NAHB Mkt Activity		✓	-
Global Economy				**4 / 4**
	Global PMI	✓		+
	Copper (6m)		✓	-
	DRAM (3m)		✓	-
	Oil (3m)		✓	-
	Commodities (3m)		✓	-
	Baltic Freight (3m)		✓	+
	Kospi (3m)		✓	+
	EM (3m)		✓	+
Fundamentals				**1 / 11**
	US: PE	✓		-
	US: EPS Growth	✓		-
	US: EPS 2FY v 1FY	✓		-
	US: 3m EPS Revision	✓		-
	Canada: PE	✓		-
	Canada: EPS Growth	✓		-
	Canada: EPS 2FY v 1FY		✓	-
	Canada: 3m EPS Revision	✓		-
	International: PE	✓		-
	Int: EPS Growth		✓	-
	Int: EPS 2FY v 1FY		✓	-
	Int: 3m EPS Revision		✓	+

Source: Purpose Investments

expectations from becoming entrenched which would be a bigger, longer-term issue. Will the slowing economy lead to a recession? Maybe. But it's worth noting that this is still more adjustment-oriented following the pandemic waves. There are few pockets of excess in the economy, which is good. Banks are well capitalized, so it's not a 2008 kind of thing. Valuations have been knocked down already, so maybe not even a 2001 kind of market. It may be more akin to 1994, rapid tightening of financial conditions led to equity and bond market weakness, plus softening of the economy. This re-pricing did set the stages for better times ahead.

Portfolio construction

There are no changes to our portfolio positioning since last month. Our move to neutral bond allocations has worked out well as recession risk rises. And while it may seem counter intuitive to remain overweight in equities, given the market drop this year a lot of bad news is priced in. And if inflation fears do continue to recede, there could be an extended reprieve.

Among equities we have become more positive on markets that have normally weathered traditional economic slowdowns better, including the U.S. and Japan.

The second half of 2022 will not be smooth sailing as changing behaviours will continue to reverberate through the economy and the markets. However, given more reasonable bond yields and prices in the equity market, our return expectations for the balance of 2022 are positive.

Portfolio Tilts

Overall Asset Allocation	-				+
Equity				■	
Bonds			■		
Cash		■			
Alternatives		■			
Equities	**-**				**+**
Canada			■		
U.S.			■		
International				■	
Developed vs EM					■
Value to Growth Tilt		■			
Small to Large Tilt			■		
Active vs Passive				■	
Bonds	**-**				**+**
Duration			■		
Credit			■		
Alternatives	**-**				**+**
Growth			■		
Diversifiers				■	
Alternative Credit		■			
Real Assets				■	

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

*Authors:
Purpose Investments: Craig Basinger, Chief Market Strategist; Derek Benedet, Portfolio Manager
Richardson Wealth: Andrew Innis, Analyst; Phil Kwon, Head of Portfolio Analytics; Mark Letchumanan, Research; An Nguyen, VP Investment Services