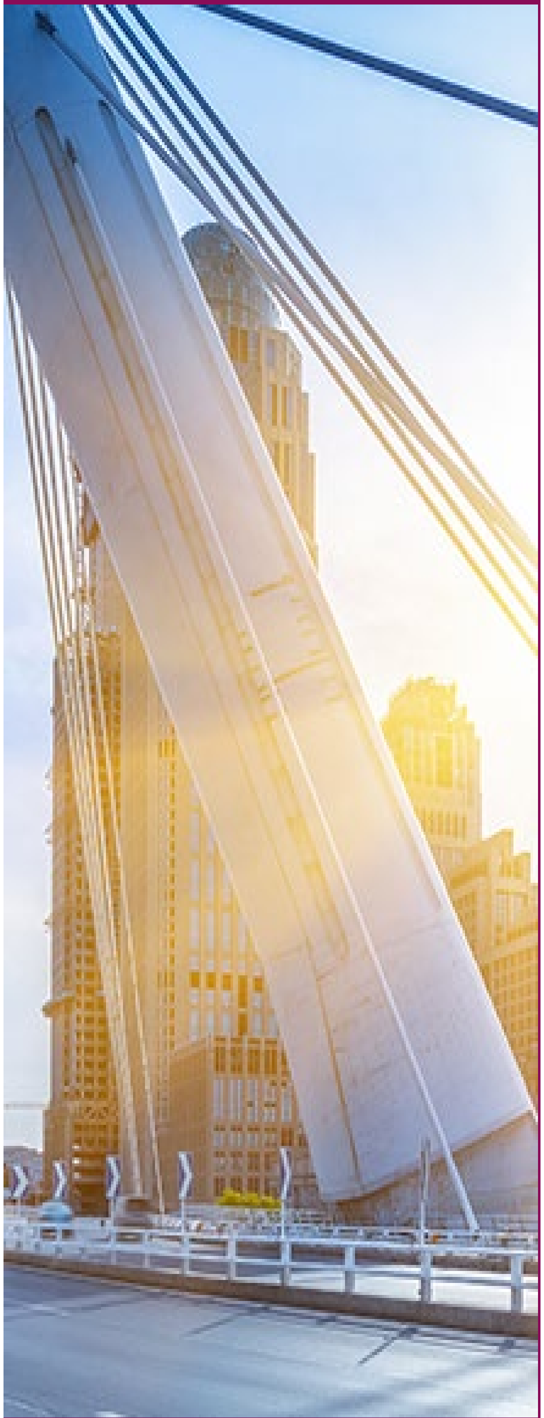
September 2022

Investor Strategy

The latest market insights from Richardson Wealth



A collaboration between Richardson Wealth and Purpose Investments*

RICHARDSON Wealth

Summer Sizzle Fizzle

Executive Summary

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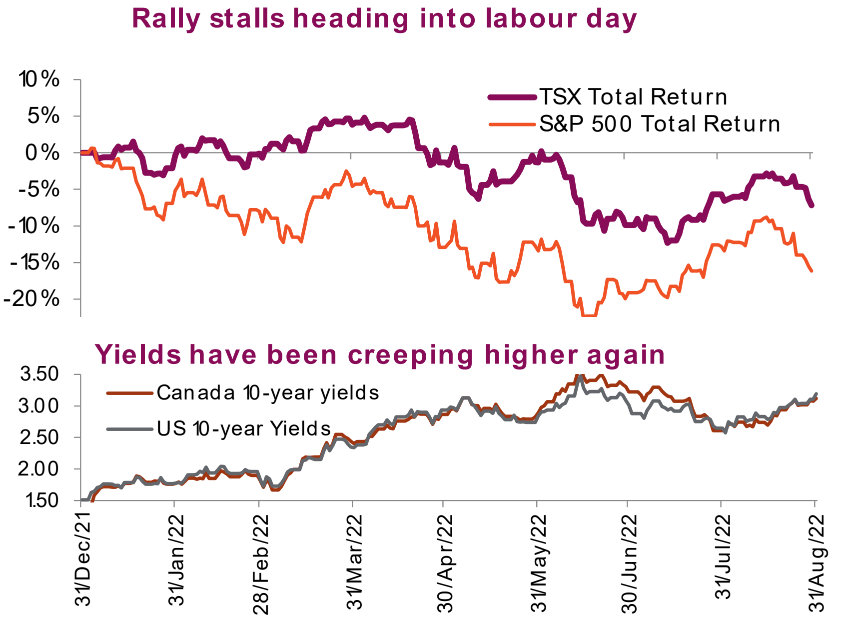
It seems as though the left side of the porridge (inflation) was too hot and the right side (the economy) too cool but mixing them together made things just right for a rally. Markets bounced hard off the June bottom, during summer trading that typically has less liquidity. Unfortunately, around mid-August the market appeared to be limping across the line. Seems the porridge isn't cooling fast enough for the Fed, which reiterated an aggressive hiking path to tackle inflation. We're now heading into a time of year that is historically challenging for markets.



Source: Bloomberg, Purpose Investments

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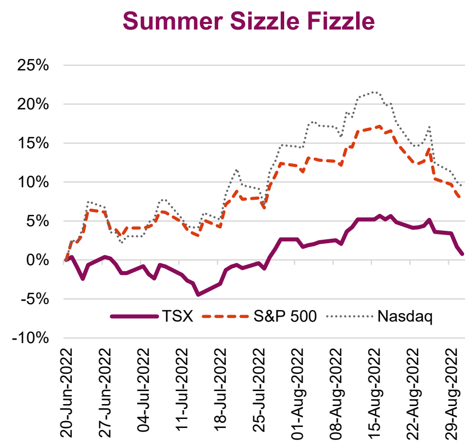
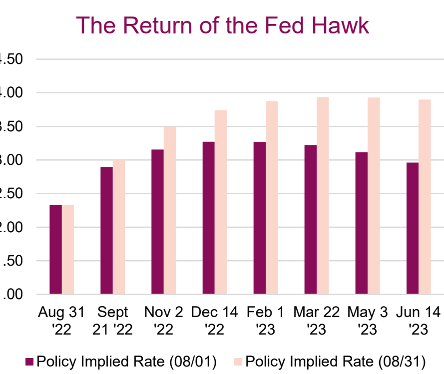
August ends with a hawkish hangover

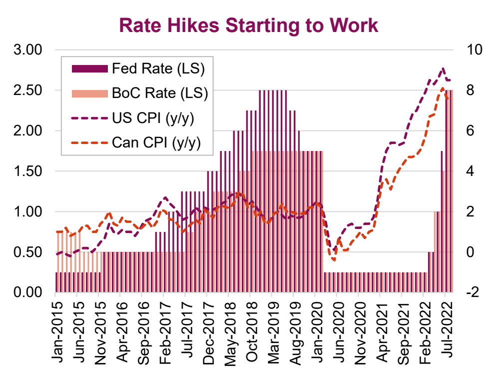
The summer rally lost steam in August, with equity and bond markets seeing a sharp decline in response to hawkish commentary from central banks. North American equities sealed their worst month since June, reflecting fears of slowing economic growth alongside restrictive monetary policy to curb inflation. Canadian equities fared better than their U.S. counterparts with the TSX ending the month down -1.55% compared to the S&P 500 and Nasdaq falling -4.08% and -4.53% respectively. Hampered by the likelihood of slower global growth, oil had its third monthly drop in August, the longest losing run in more than two years.



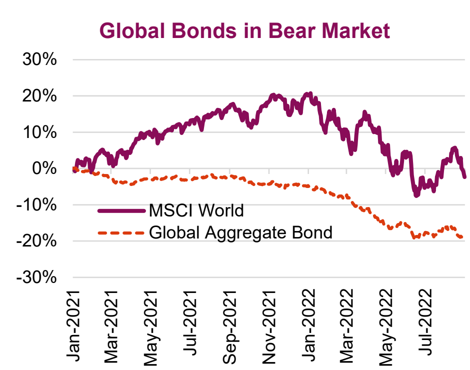
There seemed to be glimmers of hope in early summer, after investor sentiment improved, pushing equities from year-to-date lows and even breathing new life into meme stocks. However, a stern reminder from central bankers brought markets back to reality. At the Jackson Hole symposium, Jerome Powell signaled the Fed Reserve (Fed) would continue to be aggressive with its monetary policy tightening as it remains focused on lowering inflation and restoring price stability. The Fed and Bank of Canada are likely to increase rates by another 75bps at their next meetings in September, which seems to have spooked the market, despite messages remaining consistent with past statements. Meanwhile, euro-area inflation accelerated to another all-time high, strengthening the case for the European Central Bank (ECB) to consider a jumbo interest-rate hike when it meets next on September 8.



Inflation numbers are starting to roll over in North America, however, a few declines in inflation readings are unlikely to materially slow down the pace of the central banks' interest rate hikes. Data released this month showed economic output in Canada rose by 4.7% annualized ending Q2, slower than the +4.9% survey and nearly 1/6th below May's pace. While the quarter as a whole saw a 3.3% expansion, Stats Canada's advance reading is calling for a -0.1% contraction in July to follow the +0.1% read in June and flat print in May. Pundits have already forecast our nation's GDP to shrink by -1.5% in the back half of 2022. The recent comments from central banks and clouded macroeconomic outlook seems to be too much for the market, leading to a decline in investor sentiment.



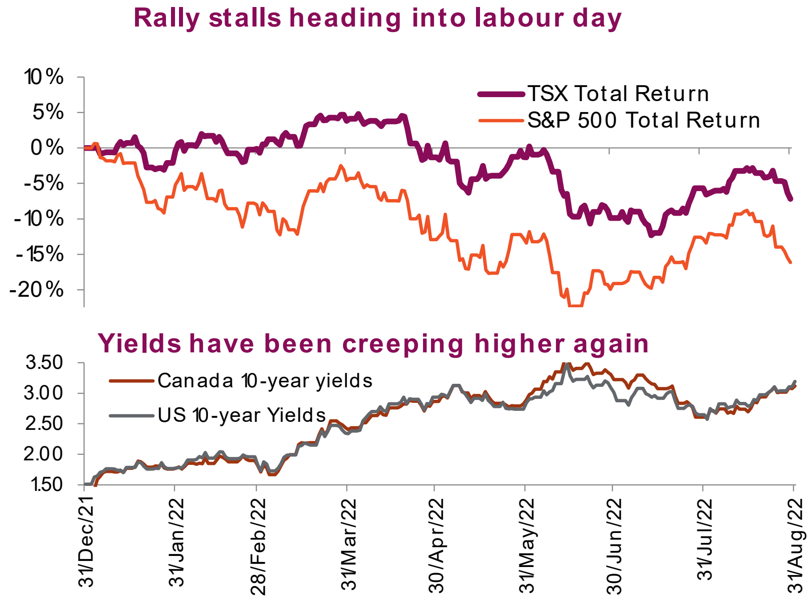
China has been one of the biggest wildcards this summer, causing angst in the global economy. As the country's property crisis, power shortages, and persistent Covid outbreaks cloud the outlook, investors remain pessimistic on China. Deflation and the continuation of weaker-than-expected economic growth are the country's main economic risks. Both core and services CPI are below 1% while property prices are also in decline. In addition to rate cuts by the People's Bank of China, a series of growth supportive measures have also been announced. These fiscal measures could potientally help offset the sharp contraction in government revenue and support infrastructure investment growth in coming months.



With losses across major asset classes in August, stock markets are entering a month that has historically been more volatile. This poses more risks to an already fizzling bounce in global shares from June lows as central banks push back against expectations of tempered rate hikes. Even bonds, which are historically negatively correlated to equities, are under pressure as global bonds (measured by the Bloomberg Global Aggregate TR Index) head into its first bear market in decades. There has definitely been no summer doldrums and the remainder of the year is shaping up to be a bumpy one in the markets.

Tough time of year

Yes, the summer rally really went from oversold levels in mid-June to getting a tailwind from several contributors. Valuations in June had become much more appealing, and second quarter earnings did not erode as many had expected from rising costs. Meanwhile recession fears were tapped lower thanks to improving economic data while inflation pressures started to roll over a bit. **Seems that the left side of the porridge (inflation) was too hot and the right side (the economy) too cool but mixing them together made things just right for a rally.** Markets bounced hard off the June bottom, during summer trading that typically has less liquidity.



Source: Bloomberg, Purpose Investments

Unfortunately, around mid-August the market appeared to be limping across the line. Seems the porridge isn't cooling fast enough for the Fed, which reiterated an aggressive hiking path to tackle inflation. Meanwhile, the improving economic data appears to be fleeting, especially when you look globally. We're now heading into a time of year that is historically challenging for markets.

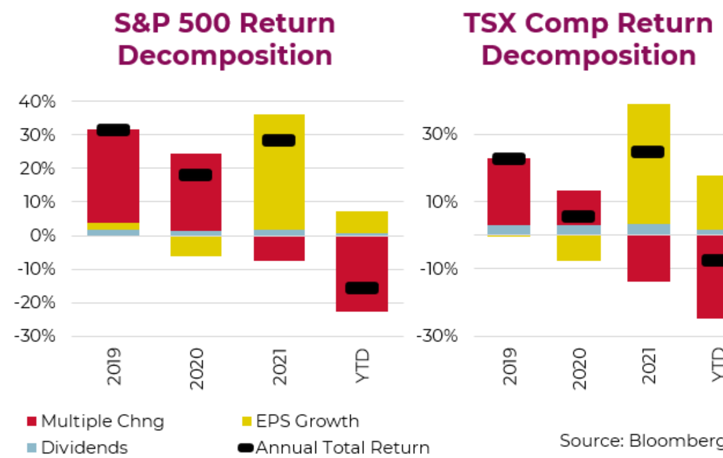
As we move into the final quarter of 2022, the outlook remains challenging. Inflation may be starting to come down, but the pace remains a big question; service-related inflation is building while goods prices are becoming disinflationary. The one certainty is that short-term interest rates will continue to move higher this year. This is already being felt materially in housing markets given the high sensitivity to financing costs. Meanwhile manufacturing, which has been playing catch-up due to previous shortages, is beginning to weaken. On the positive side, **the U.S. consumer remains healthy, but this remains one of the few bright spots globally.**

The final third of 2022 is likely to continue to see heightened volatility. Seasonality, midterm elections, inflation, slowing economic growth, negative earnings revisions, and tightening policy are all headwinds. The winds may strengthen or dissipate at times, which will likely see bigger than normal swings in the market in both directions. As we pointed out in our second half outlook, we believe the market should finish higher than end of June levels, but by no means will it be a smooth line.

Was June the bottom? We don't think so

In mid-June, both global equities and the S&P 500 reached a trough level that was down about 23% compared with the highs about six months ago. **The TSX, benefitting from commodity supply disruptions and comprising more value stocks, peaked at the end of March and bottomed in July—a month after the broader market.** This is notable as the TSX is more sensitive to global recession fears and less sensitive to inflation fears. This is why the TSX was one of the best markets earlier in the year, before fears started migrating from inflation to recession.

June, or July for the TSX, could have been the bottom. Bear market bottoms are always doubted after the rally begins, often for months. There is no textbook or normal recovery path; some bears end with a violent upswing or a V-shaped bottom, while others are much more gradual and grind out for months with only limited gains. Sometimes company earnings bottom before the market bottoms, sometimes after, and sometimes earnings don't contract at all.



So far this market decline has been one of a valuation reset. Breaking down the return of the S&P and TSX, dividends and positive earnings growth have been evident, which means the market drop has been all about falling valuations or the market multiple (red bars in the chart). With the S&P now trading at 17x and the TSX way down at 12x, these are much more reasonable or even attractive valuations. And one thing is certain, lower valuations often translate into better future price returns. But the concern now is earnings, which are a function of economic growth.

A one-legged stool, albeit a strong leg

Let's simplify the global economy into three pieces – Asia, Europe and North America.

Asia

Asia has some positives, including the fact that some countries are increasingly opening after Covid-related restrictions which provides a good economic boost. However, China remains the biggest driver of economic growth and their lockdowns have been more persistent. Plus, the real estate industry is still troubled. **Put that all together, and Asia is likely more of a headwind for the global economy than a tailwind.**

Europe

Europe, well do we really have to say anything? With inflation, potential energy rationing, consumer budgets increasingly consumed by electricity costs, and a war in the region … could all this be priced into the euro and the markets? It's very hard to say. Nonetheless, **Europe is likely a detractor from global growth.**

Market cycle indicators

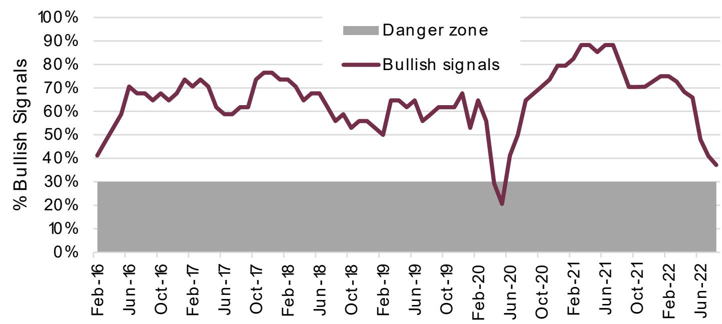
Grouping	Metric	Bull	Bear	Better/ Worse
Rates				1 / 1
	Net Cuts		✓	
	Yield Curve	✓		-
	Yield Curve 3m		✓	+
US Economy				8 / 11
	Leading Ind (3m)		✓	+
	Leading Ind (6m)		✓	+
	Phili Fed Coincident	✓		
	Credit (3m)	✓		-
	Recession Prob (NY Fed)		✓	-
	Recession Prob (Clev Fed)		✓	-
	Citi Eco Surprise		✓	+
	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				2 / 6
	Global PMI	✓		-
	Copper (6m)		✓	-
	DRAM (3m)		✓	-
	Oil (3m)		✓	-
	Commodities (3m)		✓	-
	Baltic Freight (3m)		✓	-
	Kospi (3m)		✓	+
	EM (3m)		✓	+
Fundamentals				5 / 7
	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: Bloomberg, Purpose Investments

North America

North America is largely about the U.S. and the U.S. consumer, which comprises about 20% of the global economy. This is the good news. With employment and wage gains and not being overly leveraged, the U.S. consumer is likely to remain a positive contributor even with higher interest rates and elevated food and energy costs. **But it's hard to envision spending accelerating, and when it comes to economics, rate of change is often the more important factor.**

Market cycle indicators falling

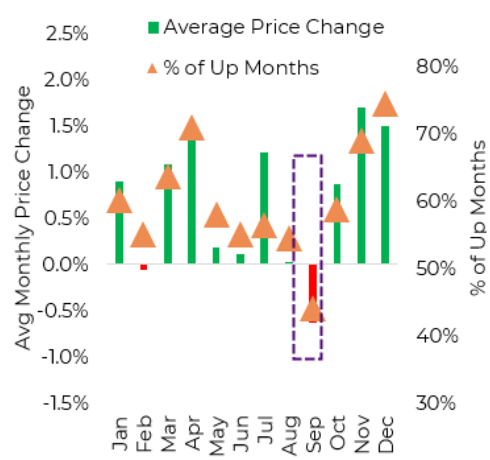


Source: Purpose Investments, Bloomberg

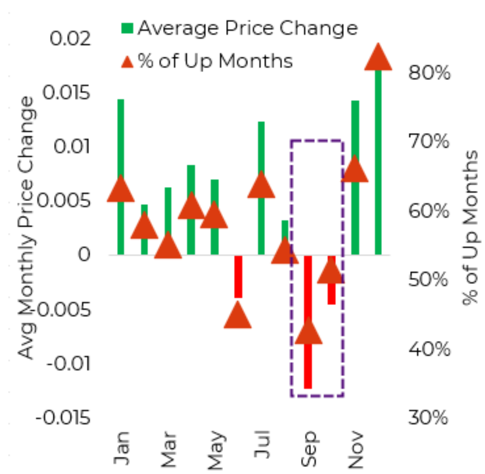
So, there we have it: the global economy is sitting on a one-legged stool. **A recession isn't a certainty in the coming quarters, but the risk continues to rise.** This has been picked up in our Market Cycle framework, which continues to inch closer to the historical *danger zone*.

Rising interest rates have been one negative for much of this year. On the global economy, most signals are bearish, which isn't too surprising since the stool is missing those two legs. **U.S. economic data has held up better but has started to soften—notably in the housing data, which is more sensitive to interest rates.** But even manufacturing data is weakening after remaining resilient as companies wrestled to catch up. More recently, fundamentals have started to erode, mainly in future earnings revisions.

S&P 500 often doesn't enjoy September



...neither does the TSX



Source: Bloomberg, Purpose Investments, 1951 to 2022

Portfolio construction

Yes, headwinds for the markets remain. The global economy is slowing, which is starting to be reflected in earnings expectations. On a positive note, inflation appears to be rolling over, which is good news. But as we head into the seasonally difficult September and October months alongside the U.S. midterms elections, markets will continue to be challenging. **During August, we reduced market exposure primarily through reducing U.S. equity weights and raised cash, outlined in our portfolio tilts.**

Below we outline our likely paths for equities and bonds in the coming months. We stress "likely" as our path for portfolio construction is not just predicated on our expectations for the economy but also how the markets react.

Equities – caution with our finger on the trigger

For many, flipping the calendar over to September is about when the kids will be heading back to school; but for investors, it's also a good reminder to look at your portfolio and make sure you are positioned for some volatility. Looking at seasonality for the last 50+ years, the period of September through October is one of the worst for equity markets (refer to the chart).

Many of the most dramatic events in stock market history have occurred in this time (think 2008 and 1987), and while we aren't forecasting anything of that magnitude this year, it is never a bad idea to make sure you are prepared. So far 2022 has been a year many investors would rather forget as both bonds and stocks have lost money at the same time, which is not often the case. The main reason for this, of course, has been the dramatic moves from global central banks that are removing pandemic stimulus programs to control inflation.

The battle against inflation was never going to be easy but add onto that the impact on commodities from Russia's invasion of Ukraine and continued tension with China, and the factors weighing on markets during the first half of the year persist. Investors in July were able to breathe a sigh of relief upon seeing the Q2 earnings reports as companies did an admiral job of controlling expenses to maintain earnings growth. However, as many companies get ready to meet investors again for "conference season" the updates we get in the next few weeks may be less optimistic. Another event that will be front and centre for American markets is the U.S. mid-term elections in November. U.S. politics have become very polarizing and as polls swing, this may add to volatility. **It's not a huge sample size but September and October markets during midterm elections usually have an even worse track record.**

Portfolio Tilts

Overall Asset Allocation	**-**				**+**
Equity			■	▨	
Bonds			■		
Cash		▨		■	
Alternatives		■			
Equities	**-**				**+**
Canada			■		
U.S.		■	▨		
International				■	
Emerging Markets	■				
Bonds	**-**				**+**
Government		■			
Investment Grade					■
High Yield		■			
Preferred Shares		■			
Alternatives	**-**				**+**
Volatility Reduction Strategies			■		
Volatility Enhancement Strategies				■	
Structured Product / Yield		■			
Real Assets				■	
Portfolio Tilts					
Value		■			
Small				■	
Active		■			
Low Duration			■		
Low Credit Exposure			■		

For us, this adds up to the view that it's not the time to be a hero and take undue risk in your portfolio. For those who have weathered the storm so far this year, consider becoming a little more defensive until some of these events pass or markets become more comfortable with the direction. That will give you the option to reassess in a few months heading into year end, which is normally a stronger time for equity markets.

To become more defensive, we suggest a few alternatives:

First, cash is nice. We increased cash in August and the good thing is that post rate hikes, cash has become an investible asset class once again.

Second, look at options strategies. Volatility elevated funds that generate yield through call or put writing can generate income and potentially provide downside protection as well. On the fixed income side, while yields may still climb, recession risks are mounting. Adding duration is not as scary now as it was in years past.

As always, we would point to being tactical and seeking active investment strategies. As we head through earnings season, not every company will handle these changes as well as others, and similarly not every asset class will do as well as others.

We are entering one of the most difficult periods of the year for markets, which appears to be coming early based on the soft finish to August. Will we see another pullback in markets to new lows because of the many headwinds (inflation, recession, earnings, seasonality)? With dry powder, we intend to be opportunistic.

Bonds – moving in tranches

At the start of 2022, we were underweight in bonds with portfolio positioning tilted to much lower duration and more credit. As yields rose, we moved in steps, adding duration and dialing back on the credit overweight to our current neutral stance: neutral from an overall allocation to bonds and neutral from a duration/credit exposure.

Our strategy, which remains true, was to increase duration and bond weights as yields rose. While we currently cannot envision getting to market weight duration, which sits at about 7, if 10-year yields were to climb up to around 4%, we would take that opportunity to add more duration and likely trimming credit as well.

Duration has been the bane of bond allocations this year as yields have moved higher. But remember, if a recession comes to fruition in 2023, duration will once again likely be a portfolio stabilizer. And with each tick higher in yields, the future expected return rises as well. But we simply don't know how high yields will go, which is why moving in steps is our preferred strategy.

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

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