February 2022

Investor Strategy

The latest market insights from Richardson Wealth

Trend reversals

Executive summary

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This month we are looking at the global markets and economy with an eye on some long-terms trends that may be on the verge of reversing. Whether equities, interest rates, economic trends or political leanings, we analyze whether or not we are witnessing some Titanic-like shifts that will certainly require some re-positioning and rebalancing of our portfolios.

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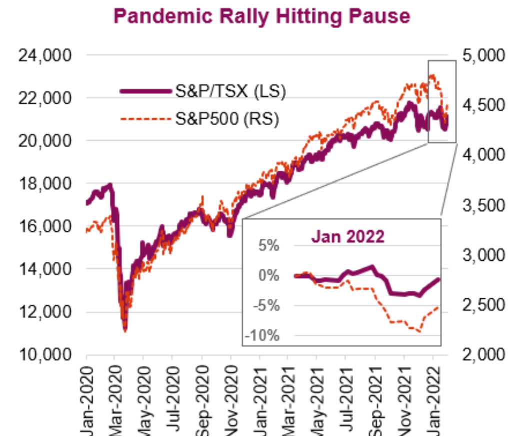
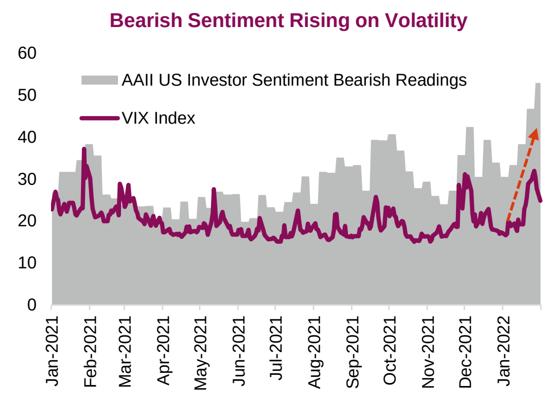
Non-January effect: up by escalator, down by elevator



2021 was a wild year for the markets, but investors were able to look past many concerns, leading to a solid performance for equities as a global vaccination effort contributed to re-opening economies around the world. December 2021 ended on a positive note despite Omicron becoming the dominant variant and threatening to shut down global economies once again. After a formidable run since March 2020, with the S&P 500 nearly doubling and the TSX up over 80%, markets finally answered the volatility door in January that had been knocking repeatedly. News, headlines and data that could have derailed equities throughout 2021 were finally heard, leading to massive selloffs in many markets and sectors in the month.



Last year's speculative fervor appears to have cooled, shifting the dynamics within the market. Throughout 2021, the Fed kept interest rates near zero and continued pumping billions of dollars into markets each month. This encouraged investors to seek out higher-risk assets and contributed to higher inflation. Investors were aware that the Fed's support would inevitably end, and when the Fed confirmed their plans and guided towards a schedule of such, the selling began. As the Fed eases its support, investors will once again need to focus more on whether fundamentals can support further gains. Closer to home, the Bank of Canada head faked and delivered one of the most hawkish non-hikes at their January 26 meeting. With rate hikes on the horizon and central bank support dwindling, bearish sentiment indicators were on the rise alongside volatility. Yields have been rising and the benchmark U.S. 10-year treasury is again trading at cycle highs. With Treasury yields moving higher and the Fed viewed as moving aggressively amid persistent inflation, investors are heading for the exits from the largest Treasury Inflation Protected Securities ETF. Outflows last week reversed sharply from strong inflows over the course of 2020 and 2021.

Jan 2022 Returns: What Your Made of Matters

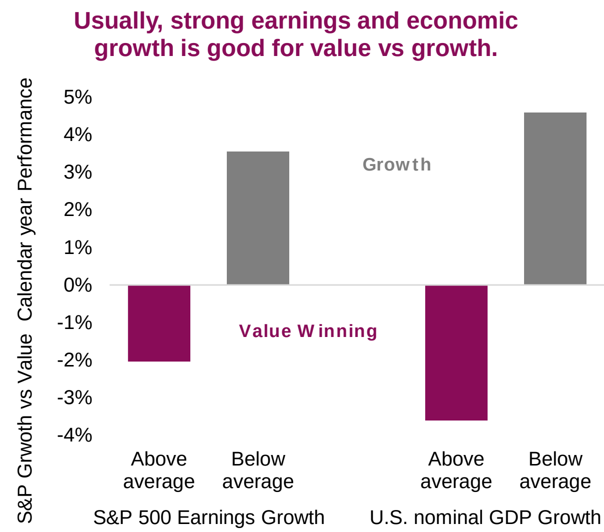
	S&P/TSX		S&P 500	
Sector	**Return**	**Weight**	**Return**	**Weight**
Energy	12.49%	14.8%	18.97%	3.4%
Financials	3.56%	33.5%	-0.08%	11.3%
Cons Staples	-2.69%	3.6%	-1.52%	6.1%
Utilities	-2.32%	4.5%	-3.31%	2.5%
Industrials	-2.86%	11.7%	-4.76%	7.8%
Comm Services	1.60%	4.8%	-6.38%	10.0%
Materials	-3.39%	11.2%	-6.86%	2.5%
Health Care	-9.17%	0.7%	-6.90%	13.1%
Info Tech	-20.36%	8.6%	-6.92%	28.7%
Real Estate	-5.96%	2.9%	-8.54%	2.7%
Cons Disc	-2.06%	3.6%	-9.70%	12.0%
Index	-0.59%	100.0%	-5.26%	100.0%

Despite some broad downtrends, there were pockets of positivity in January. Energy and financials, the two biggest sectors of the TSX, overcame lossses in the other nine equity sectors to push the TSX to a win for January. Energy in particular has doubled over the last year and keeps moving higher. South of the border, it was a different story, with such a big weight to Info Tech, the U.S. took it particularly hard and was one of the worst performing among major global exchanges. Information technology, which was the darling of the pandemic, reversed course very quickly and pressured equity markets.

If the reversals in January were tough to stomach, it may be time to revisit your risk profile. Make no mistake, with bonds and equities down, even well-balanced portfolios suffered in January. Correlations in international markets have been high as well. That said, with the long running trends that have been in place, giving rise to big sector concentration in the US index, it is easy for a portfolio to have become concentrated. Looking around the world, from growth to value and amongst industry sectors, there have been plenty of pockets of relief. We will be watching the "January Effect" to see if this is one of those years.

Growth or value, or just not growth

The last few years have been anything but typical. In a normal world [whatever that is], growth tends to outperform value when earnings growth and/or economic growth is weak. Lower overall earnings growth causes those companies that can still manage at an above-average pace to become more valuable. Think of it like a scarcity premium for growth. When earnings growth is plentiful, most companies are growing nicely, so you can find it just about anywhere. That is one of the core reason growth dominated value during the 2010-2019 period. Economies were sluggish coming out of the credit-driven recession. Earnings growth during the period was about 9% on average, compared to 14% and 17% in the previous two cycles.



Calendar year periods 1975-2021

You can also see this relationship looking at the average performance of growth versus value in years when overall market earnings or economic growth is above or below trend. When growth is abundant, value tends to win. When growth is scarce, the growth investment style wins.

This certainly does not explain 2021 which had very strong earnings and economic growth, yet the growth style outperformed value. The pandemic-induced behavioural changes had all of us spending more time at home, consuming more home media, upgrading our personal networks (Wi-Fi, not circle of friends), less in person shopping, improving our homes and buying more gadgets. This disproportionately supercharged the growth investment style given the largest companies in the S&P 500 Growth index are Apple, Microsoft, Amazon, Alphabet, Meta, Tesla, Nvidia and Home Depot. Yes, Home Depot is #7.

There are three reasons why 2022 and beyond will make it extra challenging for this growth outperformance trend to continue. First, the overall economy is opening up, more in some countries than others. Society's desire to become more mobile again appears to be outweighing pandemic fears. End result: spending will likely start to migrate away from pandemic-focused goods to more normal consumption. We are done spending more money on wifi and streaming services. If you purchased a car, RV, iPad, you likely won't be buying another one in 2022 or 2023. Even if spending patterns don't rush back to normal patterns, the growth trajectory of pandemic spending has already, or will likely crest in 2022.

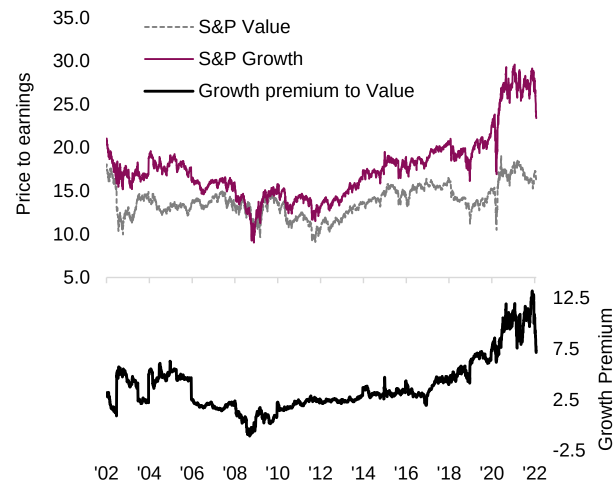
At the same time, economic growth and earnings growth are expected to remain above average (those are the second and third reasons). True, they are both starting to decelerate, but the economic pace of growth is still going to be healthy in 2022. Add inflation, which values a dollar of earnings today higher than one in the future helping value more than growth, and things are stacking up pretty good for this overall trend of the past decade to reverse.

Focus on value or not focus on growth – This is a bit more of a philosophical question. Value and growth is a standard approach to break the market down into two large groups based on earnings or valuation metrics or factors. But there are other ways to slice up the market: quality, low volatility, momentum, size, etc. So, is this the time for value or is it simply just a tough time for growth?

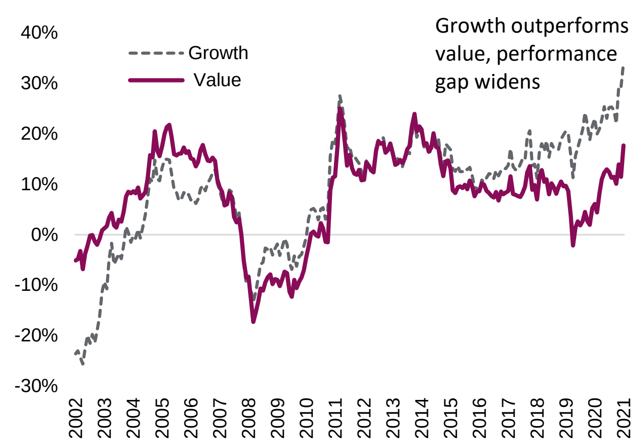
We are less confident answering this question. It could very well be the time for quality, or small caps which have lagged considerably in the past year. It is an easier assertion that growth is more at risk with stretched valuations (chart), index concentration, and given the previous points above. Value remains reasonably priced after a decade of underperformance, so there seems to be a decent margin of safety, at least relatively.

Portfolio implications – There will likely continue to be a battle for market leadership as this year progresses. After a decade of outperformance and such a high concentration of growth companies in many indices, especially the U.S., don't expect growth to go quietly into the night. If there is a longer-term rotation out of growth and into value, it will have a very negative impact on some markets and a positive impact on others. Canada and Europe, relatively, have much greater tilts towards value and less growth than many other markets. Go Canada!! Obviously, the U.S. S&P is a growth market, and we can see what happens when one of the big growth names stumbles after Meta (aka Facebook) missed expectations and sent the market tumbling. Within the U.S., tilting more towards dividend-paying companies reduces the growth exposure. Even using an equal-weighted ETF has helped to reduce the impact of the growth names that have grown to be giants over the past decade of outperformance.

Relative valuations still stretched



Growth vs. Value (2000 to Today)



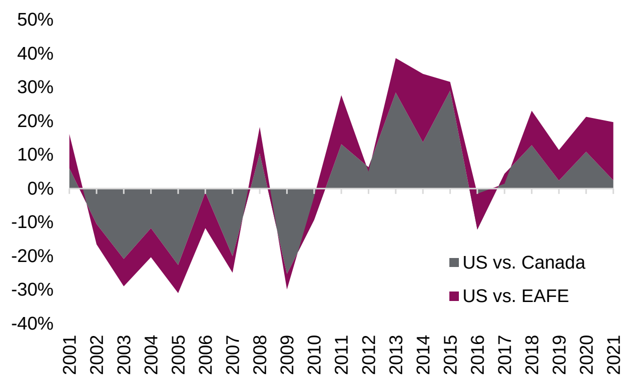
Rolling 3-year return: Russell 1000 Growth and Russell 1000 Value, calculated monthly.

The U.S. versus the world

A bifurcated start to the twenty-first century

The first decade of the twenty-first century was marked by U.S. equity underperformance which was bookended by the aftermath of the tech bubble and the great financial crisis – a painful period for investors. The second decade saw a record bull market run that would take markets to new highs and specifically send U.S. equities soaring. As the chart shows, relative to Canadian and international developed markets, the U.S. outperformed mightily in the 2010s. Between January 2010 to December 2020, the S&P 500 index returned 16.0% on annualized basis (C$), while the S&P/TSX Composite and MSCI EAFE returned 6.7% and 7.5% respectively. This in comparison to the 2000s when the S&P500 index declined -4.0% in C$ (-1.0% in US$).

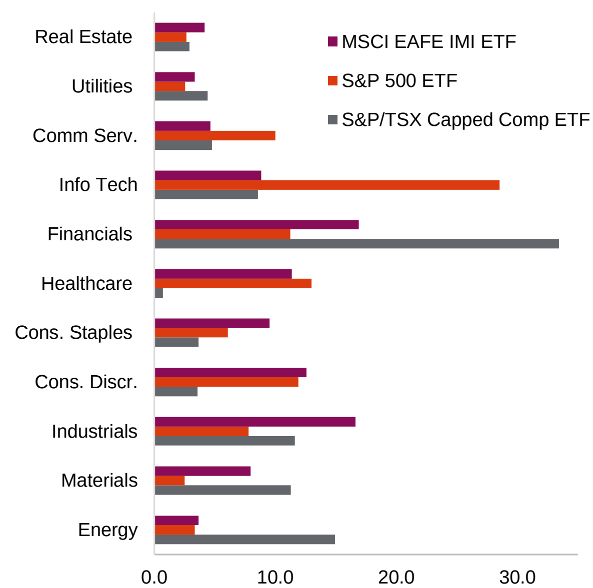
U.S vs. the World Over the Last Two Decades



US vs. Canada: Performance difference of the S&P 500 ETF and S&P/TSX ETF
US vs. EAFE: Performance difference of the S&P 500 ETF and MSCI EAFE ETF

As discussed above, the performance between growth and value styles also diverged, with growth lagging in the 2000s, then regaining the lead through the end of 2020/21. The shared performance path between U.S. equity and growth style should not come as a surprise given the strong technology sector relative to their global peers. In contrast, Canadian and International equity markets have higher exposure to more cyclically sensitive sectors such as financials, energy, materials, and industrials, which tend to be the stomping grounds for value-oriented investors (lower P/E, PB, higher distributions, etc.). As the chart shows, Canada's concentration in cyclically sensitive sectors is stark, with over one-third of its equity market allocated to financials alone, followed by 15% to energy. Today, U.S. technology constitutes nearly 30% of the S&P 500, compared to just under 9% in both the Canadian and International (EAFE) indices. The significant overweight will therefore drive the over/underperformance of the U.S. market relative to Canada and International; hence **as goes growth, so goes the U.S. equities.**

Sector Exposure by Market



What comes next?

If we've learned anything over last two years, it is that the future is unpredictable. Although that doesn't mean we throw our hands up in the air either and hope for the best. Even before the pandemic, there were signs we were in the very late stages of the bull market, including lofty equity valuations, the length of the run, an inverted yield curve and credit spreads near historical lows.

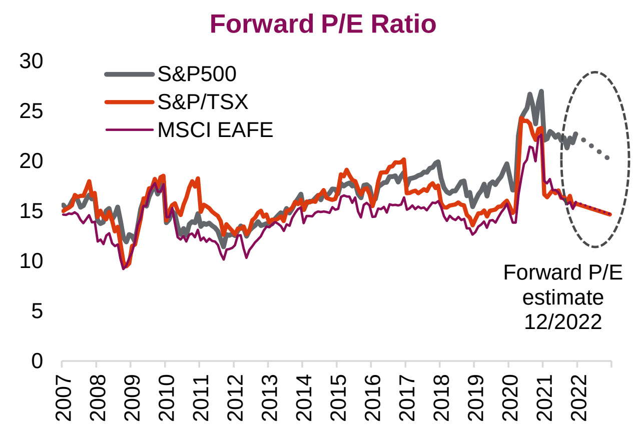
At the time, we remained cautious and reduced our credit exposure (specifically high yield) and trimmed our market-cap-weighted exposure in favour of equal-weight. Admittedly, these "calls" seemed premature if it wasn't for the pandemic-induced correction that ensued. We can't say we knew all along, but we did assess the potential implications of the aforementioned "risks" and acted accordingly.

We don't have a crystal ball for this year or the next, whether for the path of COVID or the markets. However, we can look at the current "risks" in the market (or opportunities, depending on your vantage point) and thoughtfully adjust the portfolio to prepare for the potential outcome.

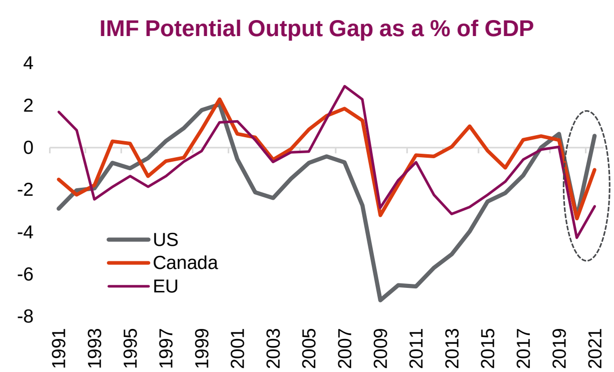
Lofty valuations, rising yields, and the "catch-up" trade

We think several factors may make global ex-US equity investments compelling including high U.S. equity valuations, rising rates and a global output gap that is still below potential, thereby giving global economies the opportunity to catch-up.

Valuation and rising interest rates. U.S. stocks, led by technology, have been propelled by factors such as the pandemic recovery, solid corporate earnings, a favourable low yield environment and 'animal spirits' for growth. As a result, the valuation spread between the U.S. and Global equity markets have widened. However, 2022 estimates have the gap narrowing as these favourable tailwinds begin to wane, or in some cases reverse. This should help pave the path for more cyclically sensitive regions to perform well. This is already playing out in January as technology stumbled while energy soared, leading Canadian equities to a positive January while peers lost. While one month does not spell the demise of the U.S., headwinds have rattled the market. Valuation concerns, rising rate, and waning investor exuberance are not anomalous factors, but ones that will ebb and flow throughout the year as Central Banks look to manage inflation concerns with tighter monetary policies. Meanwhile, higher inflation should bode well for the energy sector, while higher interest rates should benefit financials due to higher lending margins. As Canadian and International equity markets have more exposure to these cyclical sectors they should benefit in this environment.



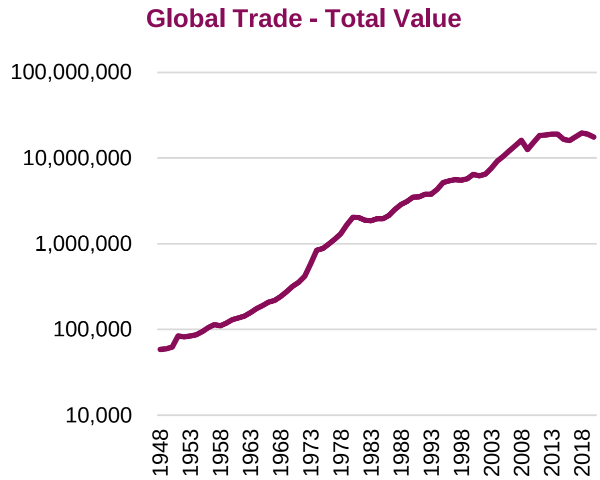
Catch-up trade. The U.S.-led recovery from the pandemic-induced recession was nothing short of remarkable. After falling sharply in 2020, the IMF estimates the U.S. closed its output gap in 2021. In contrast, Canada and the European Union are still operating below their potential, leaving room for both economies to catch up, good news for their equity markets.



Admittedly, near-term risks that could derail economic growth in Canada and the EU remain, including more pandemic restrictions and ongoing geopolitical tensions which have the potential to exacerbate Europe's already precarious position as they grapple with skyrocketing natural gas prices and shortages. However, the factors that have the potential to weigh heavily on U.S. equities including higher valuations, and higher rates will not disappear nor correct overnight. This may be an opportune time to pare back U.S. equity overweight on strength and redeploy to more cyclically sensitive regions on weakness.

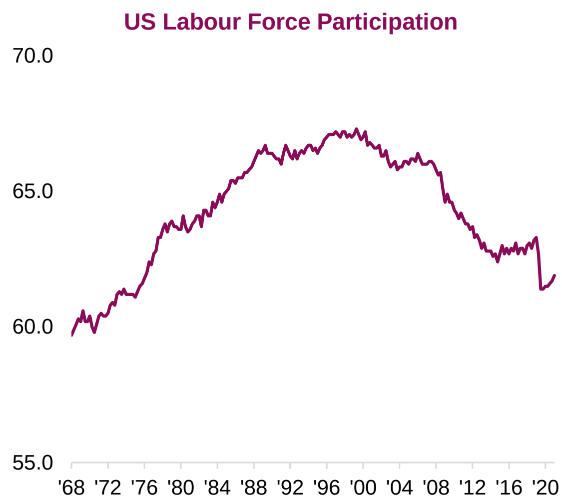
Disinflation versus inflation

We have spilled a lot of pixels over the past year in our Market Ethos and other publications about the potential transition from a disinflationary environment to a more inflationary one.



The bulk of the debate is around whether the true trend has changed, or if we are just experiencing a short-term spike in inflation, largely amongst parts of the economy that have been strained by the changing spending preferences because of the COVID pandemic. The shift in spending from services to goods has put enormous stress on supply chains, housing, and goods. Of course, prices rose. We are quite confident that good shortages will be followed by gluts. That's generally the way capitalism works. Life will return to normal, and people will start spending on services as well as supply-constrained goods.

However, what if globalism had already peaked, or was in process of peaking? The less expensive areas of the world exporting their deflation may have been coming to an end anyway.



What if the demographic push of the huge millennial cohort finally entering the family building years, with associated spending, is changing the winds of inflation?

This is before we even get into the labour force participation. Presumably, supply and demand of labour will have similar dynamics as the supply and demand of goods do, so what should we make of the decline in the participation rate? Will this push wages higher, creating a re-enforcing loop of inflation? Was the 20-year trend in participation decline reversing before COVID, and the government subsidies that resulted sent everyone home?

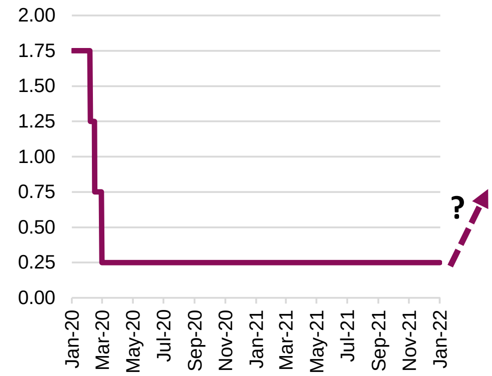
We get into the labour argument below (capital versus labour), but we do see the potential for wage inflation to resume, given different political leanings and a groundswell of populism throughout the world.

Taking away the punch bowl

After almost two years of extraordinary monetary easing, central banks around the globe have embarked on a tightening cycle.

Although not the first to move (the Bank of England and the Reserve Bank of New Zealand have already raised rates), the Bank of Canada (BoC) is a step ahead of the U.S. Federal Reserve. The BoC specifically announced at its January meeting that it has decided to end its commitment to hold the policy rate at the lower bound, and that looking ahead, it expects rates will need to increase. As Table 1 shows, the market now expects the BoC to raise rates as many as six quarter points from the current 0.25% by year end.

BoC Target for the Overnight Rate

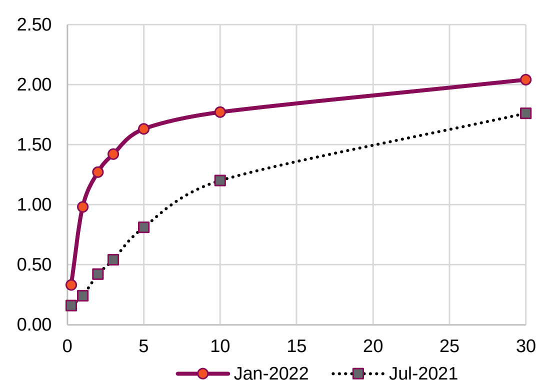


Additionally, although the BoC ended its outright purchase program in October, it has continued to purchase approximately $5 billion of bonds each month, reinvesting to maintain the overall level of its holdings. This is also about to reverse. In last week's statement, the BoC noted "it will keep its holdings of Government of Canada bonds on its balance sheet roughly constant at least until it begins to raise the policy interest rate. At that time, the Governing Council will consider exiting the reinvestment phase and reducing the size of its balance sheet by allowing roll-off of maturing Government of Canada bonds." With a rate hike coming soon, it is expected the balance sheet will start to shrink as well. Meanwhile, the Government of Canada continues to run significant, debt-funded deficits.

Canada Overnight Index Swaps - Rate Hike Probability

Meeting Date	Implied Rate	Change	# of 0.25% Hikes
02-Mar-2022	0.50%	0.31%	1.3
13-Apr-2022	0.76%	0.57%	2.3
01-Jun-2022	0.97%	0.78%	3.1
13-Jul-2022	1.23%	1.05%	4.2
01-Sep-2022	1.29%	1.11%	4.4
26-Oct-2022	1.55%	1.37%	5.5
07-Dec-2022	1.78%	1.59%	6.4

Canada Yield Curve



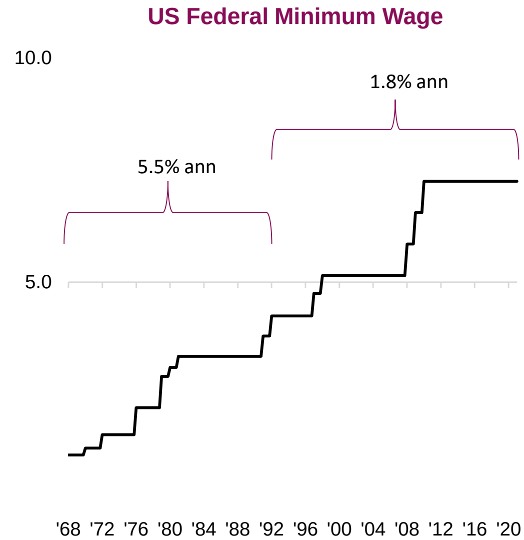
For fixed-income investors, higher interest rates and excess bond supply sounds like a scary proposition. It is worth pointing out however that the Canadian bond market has already priced much of this in. As Chart 2 highlights, rates have already moved higher, led by the short end, leading to a flatter yield curve. This is what has led to a -4.8% loss for the FTSE/TMX Universe Bond Index over the past year. Further, if we look at the past six rate hike cycles in Canada, 10-year bond yields ended lower in four of them. 30-year bond yields ended lower 5 of those periods. Finally, even the BoC has noted that the effect of the bond-buying program on yields was estimated to be modest and transitory. While ending QE will help to push rates higher, this is part of the overall shift in rates, and is not expected to be overly significant.

We are starting to see some decent value in bond markets again. Investment grade bonds over five years have yields over 3%, long provincial bonds are approaching that level, while long corporate bonds are even higher. This is providing decent real returns, given long-term inflation expectations still below 2.0%.

Therefore, it is time for investors to consider looking at fixed income again, especially longer duration bonds. The returns from the asset class will likely remain shy of what equity markets may return, but they should exceed the returns on cash. This argues strongly for an allocation out of the curve.

Capital versus labour

Perhaps one of the most important trends to watch is one of the longest-lasting ones, and probably the hardest to measure.



The Reagan/Thatcher era began in 1980 ushering in policies that, in general, favoured capital over labour. Unions and collective bargaining were on the decline, and workers were less likely to spend careers at one employer. Wage growth for workers started to slow. Consider the U.S. minimum wage, for example, which, between 1968 and 1992 grew at an annualized rate of 5.5%, but in the 30 years since has only grown at a 1.8% annualized pace. Have regional minimum wages become a more important measure? Yes, but as we said … hard to measure.

The tax code also continuously evolved to favour income from investment as opposed to income from labour. Consider that capital gains are taxed at half the rate of ordinary income, and in the U.S. there are considerable loopholes, such as property "1031 rollover" which allows investors to sell a building and not pay gains if the proceeds are re-invested into another building. Meanwhile, personal income taxes (measured in the U.S.) have dropped considerably since 1980 for the top tax bracket but have risen for the lowest marginal rate.

Have we started to see the tide turn here? Many regions have started raising their minimum wages and the long-stagnated wage growth numbers have started to pick up. While anecdotal, we have also been noticing more union settlements like that of Deere's recently, which awarded immediate 10% increase in pay, more pension benefits, and 5% annual wage hikes, not to mention higher productivity bonuses.

We will not discuss concepts like Modern Monetary Theory or Universal Basic Income at length in this strategy, but these views seem to be gaining more and more traction among economic and political circles. We will note that the narrative seems to be shifting towards those populist lines of thinking, especially while data like the Gini coefficient, measuring the gap between rich and poor, seems to be gaining increased traction.

The reason we bring this trend up, is that when labour is gaining the advantage, generally capital is giving it up. This will have implications for inflation overall and will hit industries and companies that are dependent on labour more than those that are not. Fixed revenue streams should be avoided in favour of inflation-adjusted ones. Portfolio construction and capital allocation will have to be adjusted accordingly if this trend proves to be a meaningful reversal of the last 40 years.

Portfolio implications

While some of the shifts we discussed are cyclical – like the bond markets and rate cycles or shifts in earnings expectations and growth premiums – some are also secular and could shape the way that the capital markets behave for decades to come.

There are a generation of investors now who have never been rewarded for diversification. Sure, bonds have had a positive 3% 10-year return, and it is reasonably hard to find an asset class with a negative 10-year return (Gold and South American equities, however…), but why bother when the NASDAQ is so easy? Just buy the dip, right?

Well, the time when it is hardest to argue to do something different is often the time to *at least* re-assess the situation.

The NASDAQ has more than doubled the century-plus average annual returns for equities of about 10%, the broader S&P500 has done 50% better than that measure. Will that continue? Perhaps, but we hope that this report has highlighted some of the potential trend changes on the horizon and will prompt a review of your diversification in case the trends are indeed changing.

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

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