April 2022

RICHARDSON Wealth

Investor Strategy

The latest market insights from Richardson Wealth

Volatility in the house

Executive summary

1. March market recap
2. Correction, complete?
3. Cycle watch
4. Portfolio implications

In this month's issue we take a pause from our portfolio construction theme but will return to it next month.

There has been too much action in the markets to ignore. It is worth taking stock of where March has left us and what could be in store as we begin Q2 2022. With so much action in the geopolitical arena, piled on top of what was already an interesting confluence of inflation, shifting monetary policy, and a potential renewed wave of COVID, it really is time to make sure we understand our portfolio exposures.

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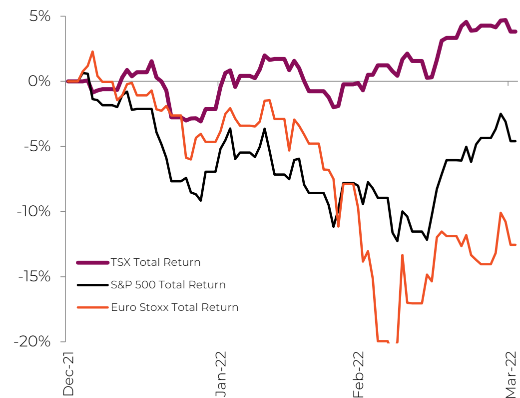
March & Q1 recap: the good, the bad, the inversion

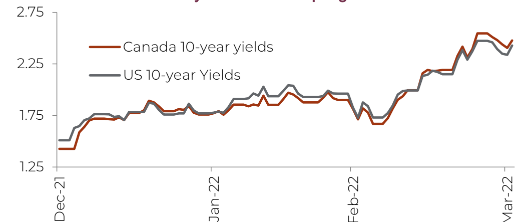
This year, ‘March Madness’ might be better used to describe markets than a basketball tournament. With its tradition of bracket-breaking upsets and Cinderella stories, we can certainly draw some similarities when looking at the capital market performance for the first quarter.

Markets had to absorb a lot of big macro news from the war in Ukraine and associated sanctions on Russia, Covid flare ups and troubling property crisis in China, sprinkle on high inflation and central bank pivots. This pushed many equity markets into their first corrections (drop of 10% or more) since the pandemic-induced bear of Q1 2020. However, in what may end up being a classic case of markets ‘climbing a wall of worry’, equity markets rose in March to offset much of the early damage.

Correction for S&P & EuroStoxx while TSX shines



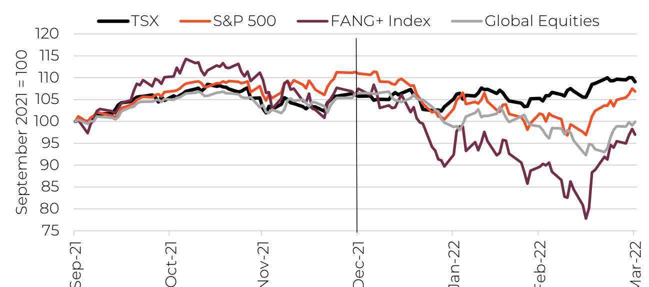
Bond yields take a step higher



Thanks again to a heavy weighting in resources (energy and materials), the TSX has outperformed its global peers and finished the month and quarter with a total return of 4.2%. South of the border, beaten down technology and growth names roared back to erase half of the quarter’s losses in March, but still turned in a loser for Q1. Across the pond, sentiment was similar with European equities back to levels before Russia invaded Ukraine, having initially fallen more than 9% in the two weeks following the invasion. Asia Pacific equity markets, led by Japan, traded broadly higher during the month. U.S.-listed Chinese stocks have regained almost all their recent losses after shares sold off in the first half of March as the U.S. SEC moved towards delisting Chinese companies. The Nasdaq Golden Dragon China Index is up more than 50% since its March 15 low (its lowest level since 2013). The sharp correction in the earlier part of the month prompted Beijing to announce its intention to keep the stock market stable, ease the regulatory crackdown, and support property and technology companies.

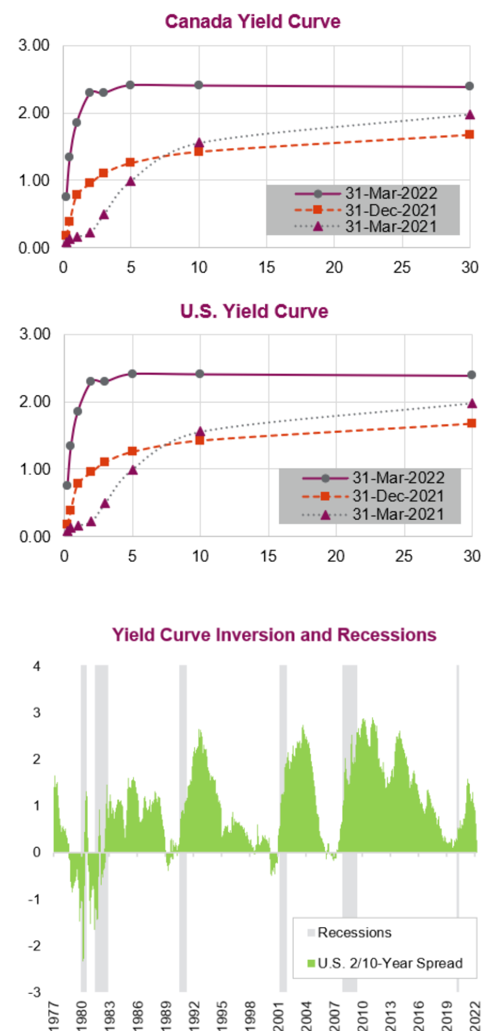
Unlike most periods of equity market weakness, this one has also been accompanied by bond weakness as well. This has certainly muted the benefits of the bond / equity portfolio mix, supporting evidence for diversifying beyond traditional asset classes. The short duration stance of most portfolios limited the drag from bonds but still, this is the first time in years that investors are losing money in bonds for such a long period of time – this bear is now 20 months old.

Impressive turnaround
FANG+ up over 25% and S&P 500 up over 10% from lows



Central banks around the world are now in the midst of the balancing act of tightening monetary policy to tame inflation without killing growth. The tightening has begun, and markets are pricing in up to eight quarter-point hikes in the six remaining Bank of Canada meetings this year. With stimulus drying up as asset purchases wind down and ‘hike-mageddon’ on the horizon, bond markets have been under significant pressure – Canadian and U.S. bond markets were down -3.0% and -2.8% respectively for March 2020.

Now to the elephant in the room: curve inversion. By classic definition, the steepness of a yield curve is determined by the spread between the 2 and 10-year yield, and when this spread becomes negative it has been a good predicter of recession. These days however, there have been other measures, such as the 3-month/10yr, or the 2/30yr, used to determine inversion. There are only two Fed meetings inside of three months, so the bills are only reflecting the rates during that time. Looking out to the end of the year sees much higher rates, and therefore a much flatter – even inverted – curve. How much is being distorted by the Fed's huge holdings of Treasury bonds? Maybe the curve would be much steeper without that intervention. Only time will tell.



The move during the month for the commodities is also notable. Energy, and oil in particular, had a great move to the upside which justifies the gains in Canadian equities. The world is just now coming to terms with the realization that the transition to clean energy will not happen overnight. Add to this the lack of capital provided to this sector over the past few years and sanctioning one of the largest commodity producing countries, and you have grounds for the rip higher in gas and oil. This all helped the TSX manage this tough quarter in stellar fashion.

Will gold be next? 2021 disappointed, but this may be the year to get AU back on track. One of the most dramatic sanctions enacted on Russia by the world was the 'voiding' of overseas central bank reserves. After years of central banks treating US treasury bills as the world's safest assets, will this come into question? Maybe just for those countries with plans to invade their neighbour. Still, the events of 2022 are causing many countries to re-think their reserves diversification, whether that be in energy sources, food sources, supply chains or even central bank reserve assets.

As the quarter ends it will take time to fully understand what has taken place. Headlines that would normally dominate the narrative for a year are occurring on a weekly basis. Investors and markets are reeling from the volatility and may have used the month end move to reset positions. But don't be fooled, the volatility is far from over. You don't get moves like we saw in fixed income and commodities and not find out there was collateral damage that won't come out till later. 2022 is likely going to remain a bumpy year.

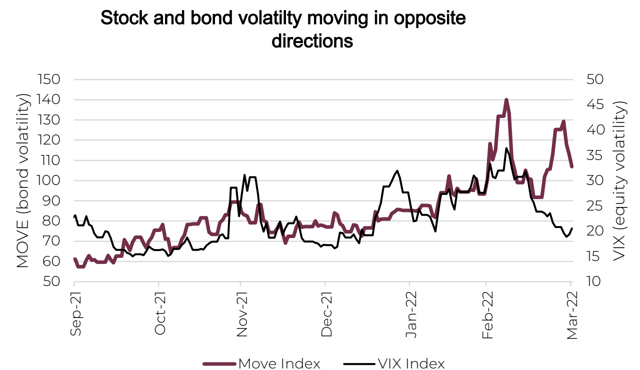
Russia's invasion of Ukraine started the month as the focus for investors. Despite pessimism regarding a speedy resolution to the crisis, the conflict has faded as an immediate issue for investors, and the outlook for the world economy remains positive. The pandemic recovery continues with economies continuing to loosen up. U.S. and Canadian economies remain strong despite inflation concerns, with economic data showing strong labour markets and consumer spending. However, the pace of monetary tightening for other consumer-restrictive realities like the price of energy continue to be of utmost importance. It has been a long time since we have seen an environment with monetary tightening, high energy prices and high inflation all at once. Much less when there's still a war going on. The recession is over the horizon as the bond market is telling us; how fast we are moving towards it is the question.

Correction, complete?

Despite the ongoing conflict in Ukraine and expectations of aggressive monetary tightening, markets have had an impressive bounce. The S&P 500 has gained over 10%. Growth has revived with the FANG+ index rallying by more than 25% since the low on March 14. Is it a bear-market rally? Perhaps for the Nasdaq, but the S&P did not get to bear market territory. Though it may be premature to declare the end of the correction at this point, the worst appears to be over. It's very rare to see a rebound occur at a faster pace than the initial drawdown. The S&P 500 took over two months to hit the March 14 low yet has already made back nearly 2/3 of what was lost in just a couple of weeks.

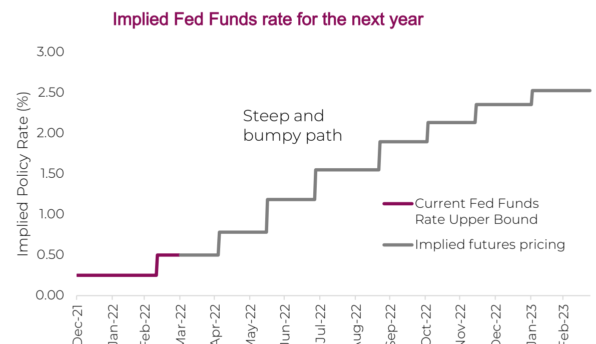
The volatility of volatility

Outside of the initial pandemic months in 2020, the past quarter has been the most volatile period for investors in years. Cross asset volatility continued to rise over the first quarter led by the bond, commodity and currency markets and while equity volatility spiked, the VIX is now back below 20. This divergence in cross asset volatility is certainly strange, and rather rare. The last time we saw this market behaviour to this magnitude was back in the taper tantrum of 2013. The chart below plots the spread between the Move Index (bond volatility) and the VIX Index. After reaching a high a few weeks ago the VIX Index started a smooth descent. Volatility itself is typically volatile, and this orderly retreat is abnormal, particularly as bond yields are surging. Aspects of the market appear broken – normal relationships are not behaving as we would expect.



Steep and bumpy path

As we welcome a new quarter, markets appear confident that the worst of 2022 is in the rear-view mirror. However, we are still very cautious regarding the outlook for risk-markets over the course of the next 12 months. Recession talk aside, the path higher for bond yields and central bank rate hikes is disquieting.



Central banks are under pressure to quickly normalize rates to tackle inflation. We don't know exactly where "neutral" rates sit but the long-term overnight rate going back to 1960 is around 4.8%. BCA research estimates neutral to be in the 3.5% range. The market is discounting more quarter-point rate hikes than there are Fed meetings this year. It's aggressive, and some strategists doubt they will be able to pull it off. The one thing that could tame the hawkishness is sustained weakness within financial markets. The central bank playbook to tackle inflation is to dampen economic growth. Stock expectations just don't seem to be reflecting this.

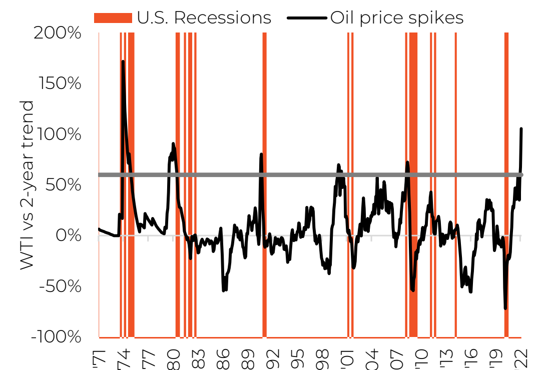
Coping with a path of financial tightening is sure to induce some stress pockets. How the market deals with potentially multiple 50bps moves remains to be seen. It's been 22 years since these have happened and one could argue the market is more sensitive to these moves today given asset prices and debt levels. Besides rate hikes there are numerous other reasons to remain cautious including a U.S. mid-term election, China slowdown, energy prices, potential global food shortages and of course a prolonged war in Ukraine with no lasting resolution in sight.

We don't doubt this relief rally could keep going or even make new highs. But 2022 is the year of volatility and we believe another correction looms. Earnings expectations are high, and it's our belief that, given the difficult macro backdrop, equity fundamentals face downside risk. In the fall we wrote about how monetary stimulus being pulled back is in effect draining the punch bowl. Over the rest of the year, we'll see how markets handle the punch bowl punching back. We doubt they will be as cool and collected as Chris Rock was during the Oscars.

Reports of my death are greatly exaggerated

Don't worry, we are aware this is a Mark Twain misquote, but with all the talk of a recession it seems apropos. The current economic expansion is slowing or will begin to slow very soon for a number of reasons. The war in the Ukraine, with its associated sanctions and impact on energy and food prices, is a clear headwind. This will be most apparent for the European economy given the proximity of the conflict, reliance on imported energy and greater sensitivity to global trade (relative to the U.S.). Beyond Europe, higher energy and food prices are the equivalent of a tax on the global consumer, disproportionately impacting lower-income households.
Inflation was raising prices before the war erupted and accelerated since. Adding to this, most central banks are raising their respective overnight rates and longer-term bond yields are rising. For now, let's call these headwinds a Beaufort wind force 4, Moderate Breeze.

Any oil spike of this degree has historically been followed by a recession

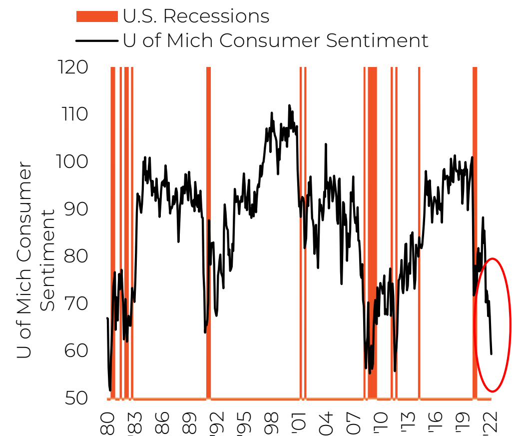


Source: Bloomberg, FRED, Purpose Investments

Grabbing additional headlines are a few common rules of thumb that are flashing recessionary warning signals. The rapid rise in oil prices is one such culprit. Historically, spikes in energy of this magnitude have preceded recessions in the U.S. and often material global slowdowns. The world consumes about 90 million barrels of oil per day, so the $40 increase this year would be an annual $1.3 trillion tax on the consumer. Just to play some more with big numbers, the world economy is about $95 trillion. While this may make the $1.3 sound small, if that spending comes at the expense of other spending on goods and services, the economic drain over a year would be a big hit to overall growth.

Then there is consumer sentiment which recovered following the pandemic recession but has been degrading for a year now (right chart below). Even before inflation and the war, the consumer was not happy even though job gains were strong and wages rising. Maybe Covid makes people complain or maybe it's the inflationary data. Whatever the reason, sentiment this low has coincided or preceded recessions.

Consumer sentiment is also flashing a warning

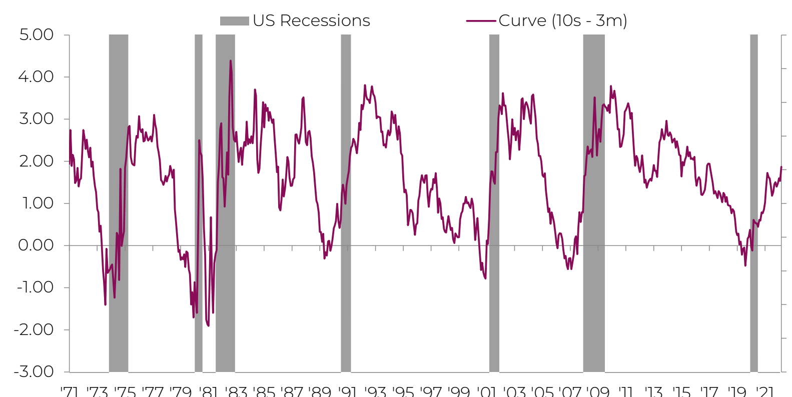


Source: Bloomberg, Purpose Investments

And then there is the yield curve. An inverted yield curve is perhaps the most popular recessionary canary these days and for good reason. The U.S. yield curve inverted before the 1974, 1980, 1982, 1990, 2001, 2008 and even the 2020 recessions. Respect. The 2s-10s inverted to close out the quarter.

So, is it time to batten down hatches and prepare for a recession? Not so fast. These warning signs are as serious as red skies in the morning but let's visit them individually for a moment. As the global economy has evolved, it has become less oil intensive. Plus, the all-important U.S. consumer used to spend 7-9% of total consumption on energy in the 1970s and 1980s. This has been on a long declining trend thanks to higher incomes and energy efficiency. Currently, about 4% of consumption is spent on energy, so not as biting as it used to be in the past. Add in elevated savings over the past year, and perhaps the consumer is better positioned to weather higher energy prices.

10s vs 2s inverted, 10s vs 3month is not



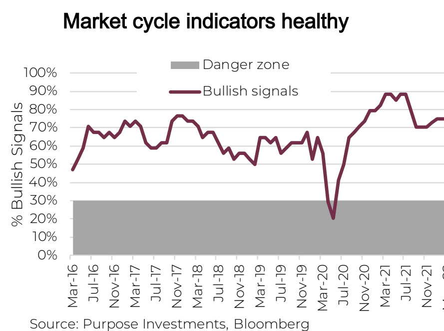
As noted earlier the consumer sentiment data has been at odds with improving employment trends for a while now. We would also highlight it has been at odds with actual spending patterns, which has been solid over the past year. Survey data is what is called soft economic data. Literally, people are contacted and asked about their spending intentions. This information can provide more timely insights into the future than hard economic data, such as GDP or consumer spending, but it also tends to be influenced by other factors. Perhaps consumers have been in a negative mindset due to the pandemic, inflation and now war. Actual spending remains solid, and sometimes actions speak louder than words.

Now for the yield curve's apparent perfect record of forecasting recessions. The 2s vs 10s inversion is less timely and less accurate than the 10s vs 3-month yields. The 2s & 10s inverted in 2005, about two years before the actual recession, and also in 1998, two and a half years early. The 2-year yields are also very influenced by the supply-driven inflation environment we are wrestling with, creating a rather unique scenario. If you look at other countries' yield curves, the inversion signal has been much more hit and miss. We certainly will take note when the 2s vs 10s inverts but will hold off sounding the R alarm given the 3-month vs 10s remains plenty steep for now.

Yes, these signals are concerning, and we are certainly heading into a slowing economic growth world. But calling for a recession does appear very premature. Looking at the other side of the ledger, inventories are very low and manufacturing activities are very robust. Unemployment continues to fall, while leading indicators are still rising. Earnings growth remains positive. Many of these are equally accurate at predicting recessions. And the data today does not support the recession talk. Could the data change in the coming quarters? Could inflation and energy prices accelerate the lag between yield curve inversion and recession? Most certainly they could. For now, it's a slowing of growth.

Market cycle

There are always many moving parts to the markets and the economy. This is why we use a broader-based market cycle approach, that includes all the aforementioned indicators, plus many more. The good news is with 75% still bullish, our recession/bear market alarm bells remain quiet.



Source: Purpose Investments, Bloomberg

Market cycle indicators

Grouping	Metric			Better/ Worse
Rates				2 / 1
	Net Cuts		✓	-
	Yield Curve	✓		+
	Yield Curve 3m	✓		+
US Economy				10 / 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	✓		+
	Chemical Activity (3m)		✓	-
	Energy Demand (YoY)	✓		+
	Truck Demand (YoY)		✓	-
	Rail (YoY)		✓	-
	Starts (6m)	✓		+
	Months Supply (6m)	✓		+
	Home Sales	✓		-
	New Home Sales	✓		+
	NAHB Mkt Activity		✓	-
Global Economy				5 / 3
	Global PMI	✓		+
	Copper (6m)	✓		+
	DRAM (3m)	✓		-
	Oil (3m)	✓		+
	Commodities (3m)	✓		+
	Baltic Freight (3m)	✓		+
	Kospi (3m)		✓	-
	EM (3m)		✓	-

Given the heightened concern over the economy, we have shared the breakdown of which indicators are bullish and which are bearish. We have also included whether the measure is improving or deteriorating. Given we use the 3-month / 10-year yield curve, this remains bullish. The U.S. economy also stacks up well with many more bullish checkmarks versus bearish. We would note the data points are roughly even split with 10 improving and 10 deteriorating versus last month. The global economy remains decent as well.

This has us in the camp of economy slowing yes, stopping no. Slowing economic growth could actually be a positive development over the coming months. It would help alleviate some of the inflationary pressures and could open the door for the market to forecast a less hawkish path for central banks, given how far the pendulum has swung in the hawkish direction of late. This is going to be a bumpy ride for the data and the markets; expect overreactions in both directions at times.

Portfolio implications

In fixed income, our stance has been to be well short of a “benchmark” duration. While we still think there is more room for bond yields to move higher, it is worth starting a slow movement towards normalizing our duration stance. Similarly, the recent weakness has made corporate bonds more attractive, and so we are interested in some corporate credit.

On the equity side, we still favour value over growth. While tactically our belief is that there may be more volatility in this correction, we are staying with the view that there is still room in this cycle for equity performance. Favouring value over growth has worked well for the past six months, save for the strong bounce over the past two weeks. Not coincidentally, this has been the period where the move up in bond yields has really accelerated. This favours Canada over the U.S. and we remain with this bias, though some large drops in the growth sector has certain piqued our interest of late.

This tilt to Canada has worked for equities, but not for the currency itself. The underperformance of the loonie against the greenback is perplexing, given the strength in oil and similar interest rate outlooks between the two countries. Sure, loonies have been good bets versus Stirling and Euros, but our main measure is the greenback which continues to hang in.

Managing volatility will be key, for those who aren’t comfortable seeing it in their portfolios. This transition to a tightening monetary environment has been bumpy, and will continue to be, so buckle up!

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

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