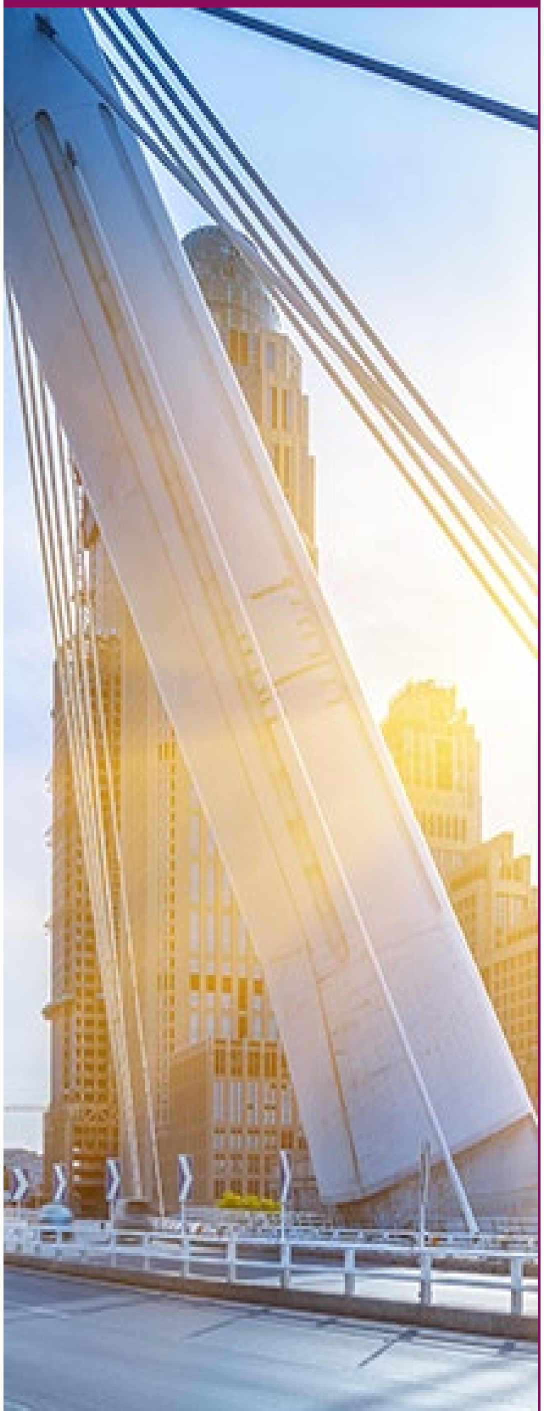
October 2022

Investor Strategy

The latest market insights from Richardson Wealth



RICHARDSON Wealth

When does the bear market end?

Executive Summary

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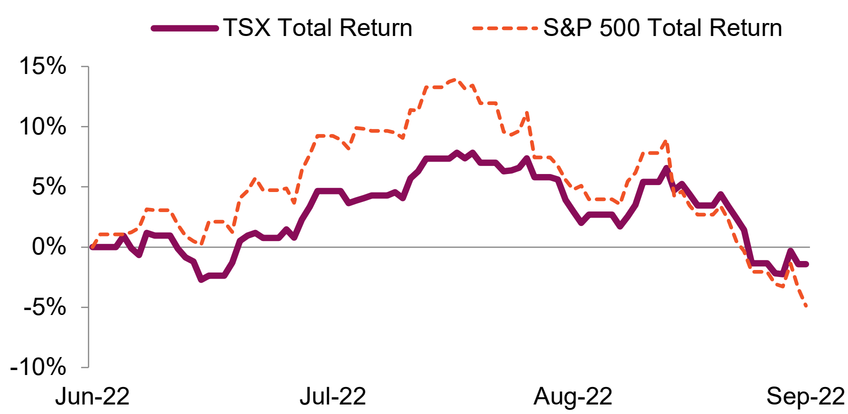
Even after the strong mid-summer rally, markets were left in a slightly negative position to end the quarter. In Canada, the S&P/TSX finished down -1.4% and the S&P 500 finished slightly worse down -4.9% (USD). Market drawdowns in the US were not drastically in favour of growth or value, in fact, value surprisingly finished marginally worse than growth over the quarter by about 2.0%. That is not something you would expect in a rising rate environment but is something you would expect in the final stage of a bear market that sees more indiscriminate selling. With Q3 coming to a close, the question is, when does the bear market end?

Summer rally runs out of steam



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Wake me up when September ends

For the first half of the quarter, it looked hopeful that the markets were through the worst of it. By the midpoint of the quarter in August, both the S&P/TSX & S&P 500 were both chugging along nicely, up +7.8% and +13.9% (USD) respectively. However, at that midpoint, due to stubborn inflation and hawkish central banks, the bounce off the mid-June lows ran out of steam. North American equities continued their decline in September, falling as investors digested tightening financial conditions and aggressive rate hikes. After the roller coaster ride, major averages ended the month at lows for the year with the **S&P/TSX** down -4.3%, the **S&P 500** down -9.2% and the **Nasdaq** falling -10.5% for the month.

Central banks were again in focus for September as inflation continued to remain untamed. In particular, the Bank of England (BOE) was forced to intervene and pledged to buy 65 billion pounds of long-dated gilts and delayed its program to sell down 838 billion pounds of government bond holdings to stem a market rout. This was in reaction to newly appointed UK Prime Minister Liz Truss unveiling a budget that was heavy on tax cuts and household subsidies, which set off a wave of selling in the British pound and Gilts. Closer to home, the Bank of Canada (BoC) stuck with their plan and hiked their key interest rate by 75 bps as expected, moving it to 3.25%. South of the border, the Fed kept with a 75 bps move higher on their policy rate, not the 100 bps some were forecasting, and decided to use commentary to keep up their hawkish rhetoric. Volatility in bond markets increased substantially this month, particularly after the BOE intervention and a newly released Fed Dot Plot showed that interest rates in the U.S. may be higher for longer. With hawks still circling, North American bond markets were negative for September, and are down double digits year-to-date.

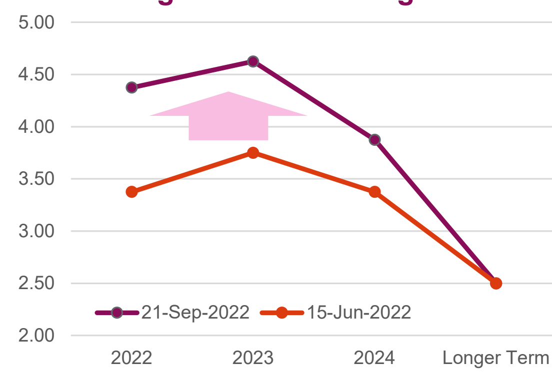
One area of the market managed to stay positive – the greenback. The **U.S. Dollar Currency Index** (DXY) rose 3.15% for the month and is up over 17% year-to-date. The Canadian dollar has declined by roughly 8% against its U.S. counterpart so far this year, nevertheless, it is worth noting that the loonie has held up better than many other major currencies thanks in part to Canada's relatively strong economy and the BoC largely matching the Fed in the pace and scale of rate hikes. The yen, pound, and euro have depreciated between 14% and 25% relative to the USD year-to-date.

Oil prices rebounded from recent losses towards the end of the month. The rally came after the European Union announced a new round of sanctions against Russia after three ruptured pipelines in the Baltic Sea were suspected to be the result of sabotage. Adding to this, Chinese demand showed signs of rebounding and declining U.S. inventories raised the prospect of supplies tightening in the

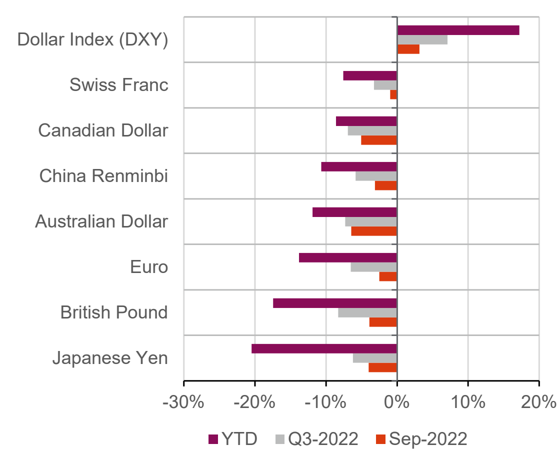
Summer Sizzle Fizzle

	Sep-2022	Q3-2022	YTD
S&P/TSX TR	-4.3%	-1.4%	-11.1%
S&P 500 TR	-9.2%	-4.9%	-23.9%
Nasdaq	-10.5%	-4.1%	-32.4%
Europe	-5.7%	-4.0%	-22.8%
Japan	-7.7%	-1.7%	-9.9%
China	-5.6%	-11.0%	-16.9%
Canadian Bonds	-0.5%	0.5%	-11.8%
U.S. Bonds	-4.3%	-4.8%	-14.6%

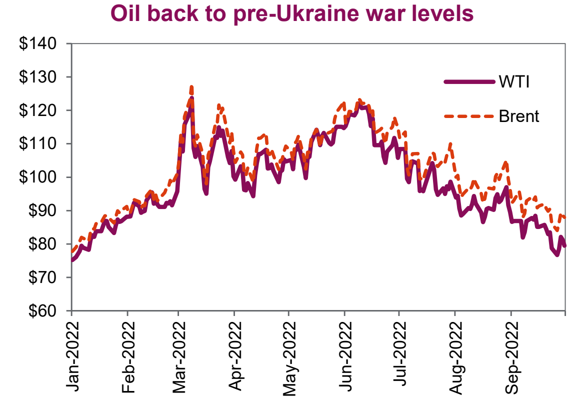
FOMC median dot plots signals higher rates for longer



Currency Matters

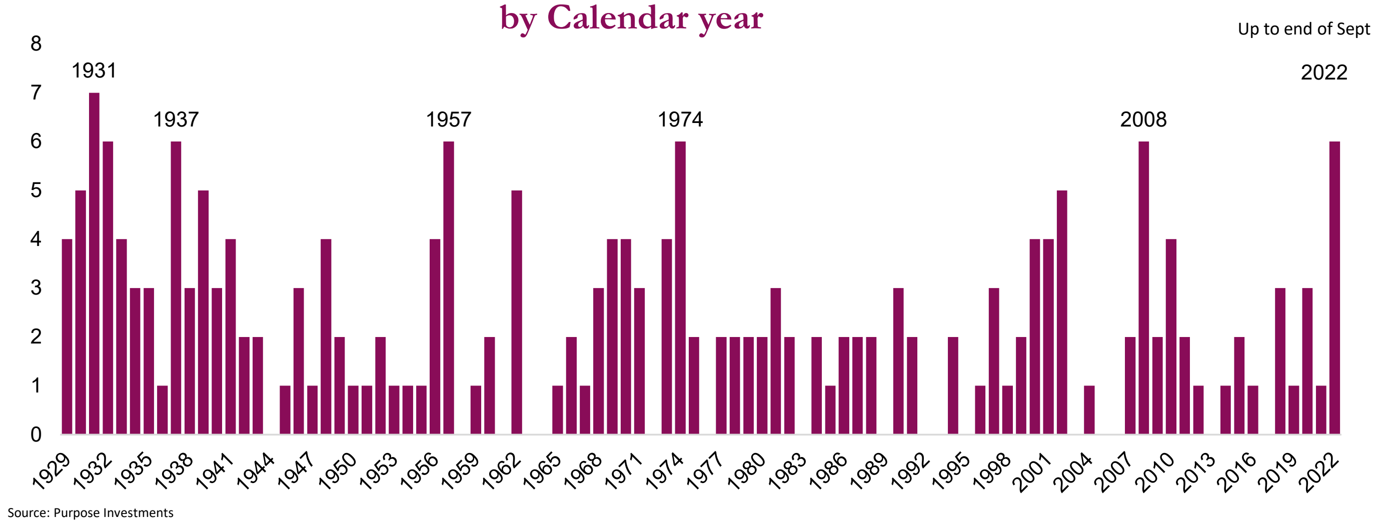


Oil back to pre-Ukraine war levels



near term. However, this short-term rally was not able to recoup the massive losses for oil in the third quarter with benchmarks down nearly -25% and posting their first negative quarter since 2020. Gold, viewed by many as a safe-haven asset class, and other precious metals continued their decline, down -3.2% in September and down -8% over the quarter. Gold spot has fallen around -19% since the 1-year peak in March, continuing to be pinned at levels not seen since April 2020. Keep in mind that oil, and pretty much every other commodity, due to being priced in U.S. dollars, has become more expensive and has been under volatile demand pressure. China for example, continues to stand by its zero-Covid policy despite that policy dragging down domestic growth and impeding global economic recovery. Investors remain uncertain about China as it appears that production zones such as Shanghai can be shut down at a moment's notice.

S&P 500: Number of -3% Down Months by Calendar year

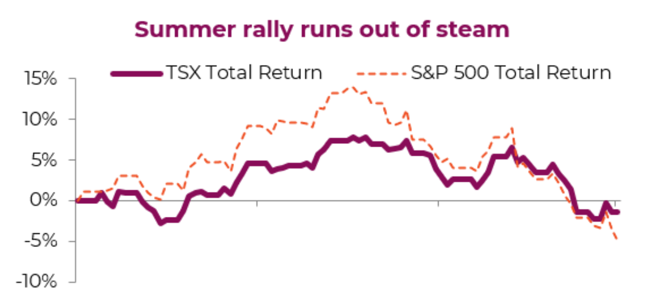


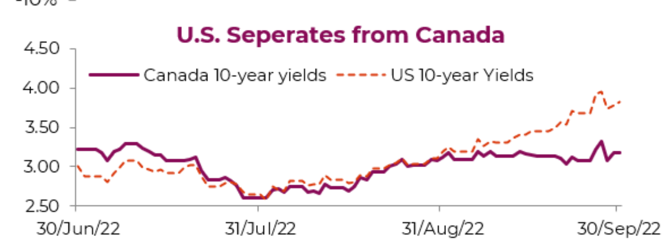
Source: Purpose Investments

Unfortunately, this September lived up to its historical reputation of increased weakness and volatility, posting the worst September since 2011. For the S&P 500, the number of months that posted a return of -3.0% or worse in a year is close to reaching all-time levels. In fact, with three months remaining in the year, if two of those three months post weaker drawdowns than -3.0% we will have achieved the most in history. Not sure if that counts as an achievement, but impressive feats can happen on both ends of the spectrum. Let's not forget, in 2021 the S&P 500 was up +29%.

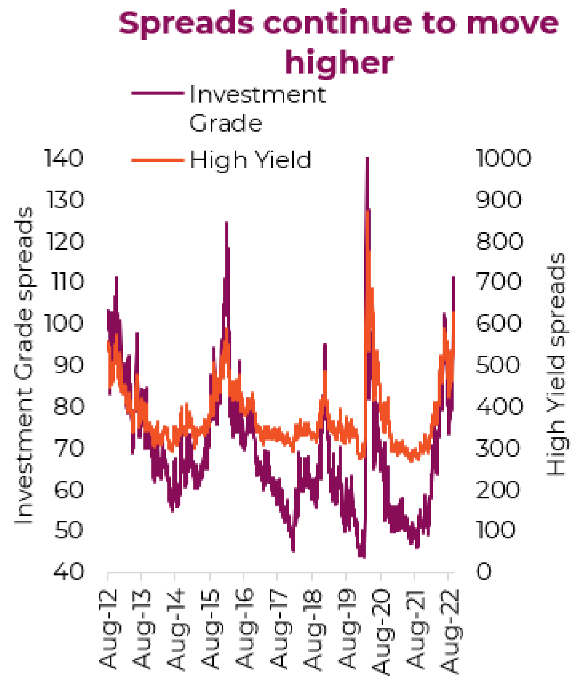
Q3 comes to a close – when does the bear market end?

For the last month and a half, the challenges of being an investor have ramped up. Everything was down, including a continued downtrend in the bond market, albeit showing more stability compared to earlier in 2022. The all important U.S. 10-year yield started the quarter at 3%, went down to 2.55%, then rose to near 4%. Nothing short of breathtaking. Unfortunately, it's not the type of shortness of breath you experience when you witness a stunning landscape, but rather the type you feel when you get punched in the gut unexpectedly. Credit spreads have been rising at a steady pace, but if inflation persists and slower growth avails, balance sheets and cash flows will grow in importance. If we are going to go into a recession, credit spreads likely still have much more room to run.





A couple of consecutive negative GDP prints bring concerns about slowing growth to the end of the year. Q3 Earnings are right around the corner in October, where expectations have been declining and still have a strong chance to be worse than expected. While there is some hope that inflation has peaked, the stubborn readings can still damage the bottom line. Supply chain problems persist in the economy as well, causing companies to struggle with meeting demand. While the outlook for economic conditions and markets remains grim, staying invested and managing risk along the way is always the preferred long-term game plan.



Even after that strong rally mid-summer, we are left in a slightly negative position to close out the quarter. In Canada, the TSX finished down -1.4% and the S&P 500 finished slightly worse down -4.9%. With both indexes touching or brushing up against fresh lows for this bear market, there could surely be more selling to come. Market drawdowns in the US were not drastically in favour of growth or value either, in fact, value surprisingly finished marginally worse than growth over the quarter by about 2.0%. That is not something you would expect in a rising rate environment but is something you would expect in the final stage of a bear market that sees more indiscriminate selling. **With Q3 coming to a close, the question is, when does the bear market end?**

The obvious answer to this rather important question is, it ends when the next bull market begins. And unfortunately, there is no simple or consistent metric given that each bear market is different. Some bear markets see markets drop a breathtaking 40-50%, or even more. Not great news consider the S&P is down 25% and TSX off by 17%. Fortunately, some are much shallower (there is always hope). Some last several years, while others last a couple of months.

There is no valuation metric or sentiment score that marks the bottom. The last four bear markets troughed at S&P 500 price-to-earnings multiples of 10x, 14x, 9x and 14x, with the market currently sitting at 15.5x. Worse yet, trough valuations did not always coincide with the market price bottom as earnings are a moving component of the PE ratio. Sentiment is very bearish right now, which is bullish. Not lost on us is that the last time the AAII investor survey showed over 60% bearish, it was a few days before the bottom in March of 2009. However, it was also over 60% bearish in October of 2008, with five long months and another 25% of pain to go before the bottom.

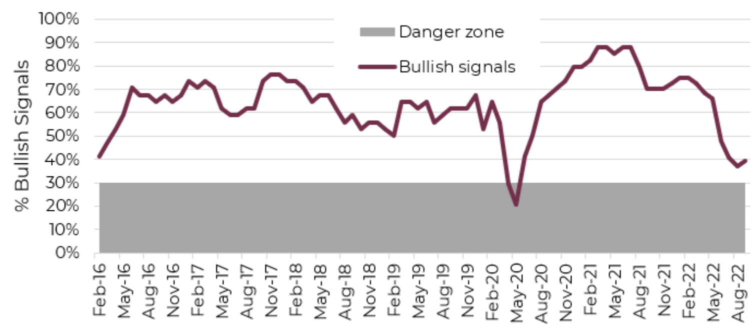
Even after the market bottom has been put in, it is rarely believed. The market rallies all the while most investors and market pundits fret it is simply another bear market rally. Doom and gloom remains the persistent narrative. Bear markets are similar to recessions, you don’t know they are over until well after the fact.

Take heart, not all is lost. One common occurrence of a bear market bottom is that the root cause of whatever triggered the bear market begins to show signs of improvement. Now we could debate the cause of this bear market, but most would likely agree it is that inflation got out of control. Central banks are not raising rates and reversing stimulus because they don’t like investors or are trying to wreck your home’s value, it is in response to inflation.

When (not if) inflation begins to come back down, we think the ensuing equity and bond market rally will be strong. This may very well mark the end of the bear market, even if a recession or earnings recession looms on the horizon. Stock market bottoms rarely coincide with the trough in economic activity. In most cases the market bottoms well before the economy, often by months or quarters. This bear was caused by inflation; an improvement of this root cause should not be underestimated.

Of course, there is a 'but' to this. Inflation has not started to improve, and one monthly print may not solidify a new trend. So, even if improving inflation has the potential to mark the bottom of the bear, it may be at a minimum a few months from now or potentially longer. In the meantime, the economic data and earnings data will likely continue to show downward trends. At a time that market stresses are elevated due to wild currency swings, big moves in yields and of course lower markets. To put it more plainly, we do not think today is the bottom, but it is getting closer.

Market cycle indicators falling



Market cycle

We have some encouraging news but first, a quick recap of what our market cycle indicators are trying to provide. If you wait for the IMF or consensus economists to let you know a recession is coming, this is too late from an investment perspective as the markets have likely already moved or turned. Our market cycle indicators are a vast array of economic, sentiment, fundamental, interest rate data points.

However, most of the signals, either bullish or bearish, are rates of change. In other words, the momentum in the forward-looking indicator is getting better or getting worse. For instance, if US employment rises by 0.5% that indicator turns bearish. We could very well still be at low unemployment levels, but it's the rate of change that matters. The economy is like dominos, when one starts to roll over, it crashes into another. Housing sales activity weakens first, then prices, then building activities and employment loss. Feedback loops and knock-on effects are what tend to move the economy in one direction or another.

Back to our good news – the indicators have stabilized just above what has historically been the danger zone for a pending recession, but there's no denying the downward trend has been fast (chart). The global economic indicators have been bearish for quarters, and the US has started to weaken as well of late. Still a mixed bag on the U.S. side with housing weak, manufacturing still holding in, but the trend is slower activity. The improvement came from market fundamentals, valuations have come down while earnings revisions have been holding, for now.

Being this close to the danger zone is not good. And given the news flow we believe more indicators will turn negative than positive in the coming weeks. The impacts of tighter financial conditions are increasingly being felt in the economy and it is starting to manifest in company earnings or comments.

Still, this is a unique cycle and a unique environment given the emergence from the pandemic. There's no denying this bear market remains more about inflation than a recession. This focus will likely change in the coming months as recession risks are likely to continue to rise. With markets

Market cycle indicators

Groupin	Metric			Better/ Worse
Rates				**2 / 0**
	Net Cuts		✓	
	Yield Curve	✓		+
	Yield Curve 3m		✓	+
US Economy				**7 / 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				**5 / 3**
	Global PMI		✓	-
	Copper (6m)		✓	+
	DRAM (3m)		✓	-
	Oil (3m)		✓	+
	Commodities (3m)		✓	+
	Baltic Freight (3m)		✓	+
	Kospi (3m)		✓	+
	EM (3m)		✓	-
Fundamentals				**7 / 5**
	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		✓	-

already down on inflation and higher yields, which lifted the discount rate for all assets, causing asset price declines across all asset classes. The question is, should we fear a recession? We would say not as much as in a normal cycle. A lower or depressed starting point, the current market levels, does reduce the market reaction to recessions. Recession, or recession risk, is never good news but a good portion of this is already priced in.

There is also part of us that believes a mild recession would be cathartic. It would reduce inflation pressures and help yields drop lower from current levels. It would also address the tight labour situation and a, shall we say, elevated sense of entitlement.

Portfolio construction

Headwinds remain firmly in place, though with sentiment at extremes and markets oversold we could be nearing an inflection point where the markets have overshot, pricing in a more dire scenario than what may unfold. Symmetrical moves in the market are commonplace, and like a compressed spring, a market that has been pushed too far can suddenly release its energy. You know, like a spring.

After reducing equity exposure in August, our overall portfolio tilt remains neutral, with an overweight in cash. The global economy is slowing, but a recession has yet to manifest. Earnings estimates are still not reflecting a recession scenario. The benefit is that cash, or short-term money market securities now provide a decent yield, the highest in over a decade, but more importantly it provides liquidity and optionality.

Yes, our cash is liquid, not locked into a multiyear GIC which appears to be the talk of the town among many investors frustrated with the performance this year, especially bond performance. The uptick in yield from locking in is not worth it, in our view. If yields rise further, liquid cash will follow the higher yield which GICs won't. And if inflation starts to cool, we have a daily liquidity to adjust our asset mix.

Portfolio Tilts

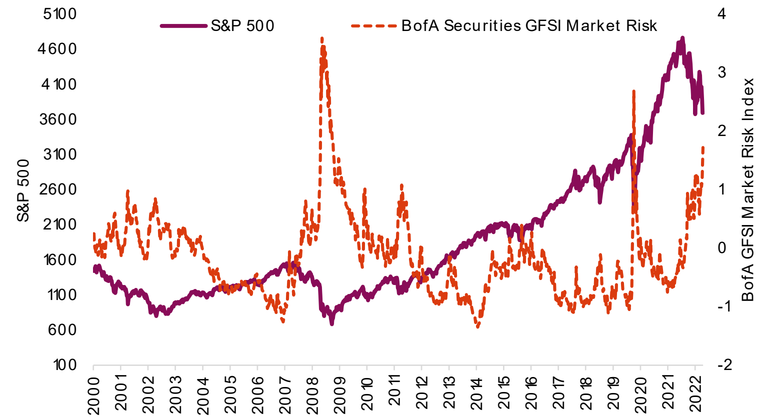
Overall Asset Allocation	-				+	
Equity			X			
Bonds			X			
Cash				X		
Alternatives		X				
Equities	-				+	
Canada			X			
U.S.		X				
International				X		
Emerging Markets	X					
Bonds	-				+	
Government		X				
Investment Grade					X	
High Yield		X				
Preferred Shares		X				
Alternatives	-				+	
Volatility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

Our allocations are historically far from static, they have not changed materially from last month. We remain cautious; however, we are fully aware that when sentiment is at an extreme, the winds can change at a moment's notice. This could be a better-than-expected inflation print, or perhaps an unexpected tonal shift from a central banker [which would likely be the result of the data]. For now, markets are fully comfortable being uncomfortable. Not knowing how far rates will have to rise, where the terminal rate is and how long the recent tightening will take to show up in the economic data.

Equities

Uncertainty breeds volatility, and volatility is now as prolific as talking about House of Dragons on a Monday morning zoom call. Volatility across equity markets is reflected by the risk of future price swings, which recently reached the highest level since the beginning of the pandemic, as shown in the chart by a Bank of America index. These volatility spikes are typically short lived and often coincide with market bottoms. For now, we remain cautious, with a neutral equity weighting. There could be an opportunity for another tactical bounce in growth similar to what occurred in the summer, however, we're comfortable letting the markets make the first move. From this point forward, equities are really going to take their cues from the bond market and the inflation data. So, if you see bond yields move lower, that is a good sign for equities.

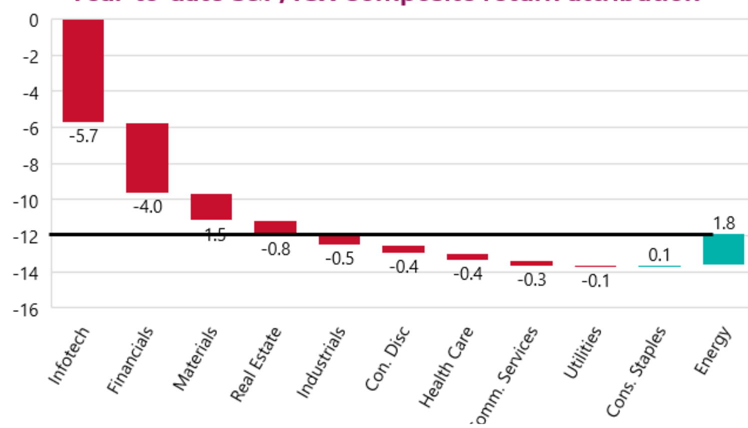
Options market is pricing in large anticipated moves in equities



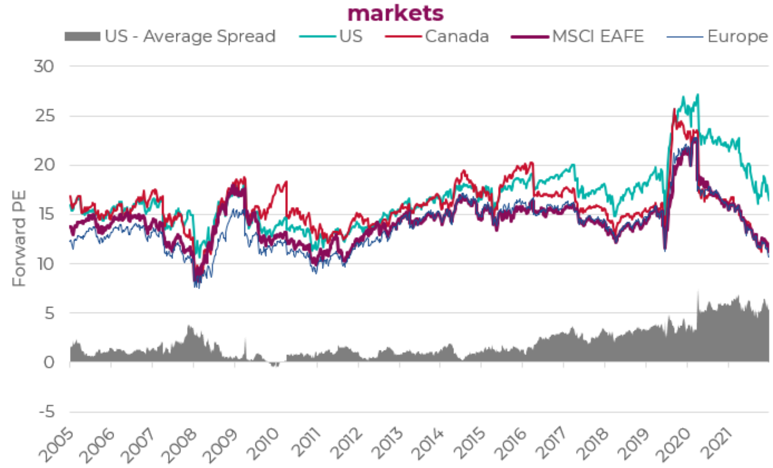
Canada

While the safety trade of the US dollar could persist for more months or quarters, even in Canadian dollar terms, Canadian markets have been a better refuge for investors than many other international markets. Year-to-date the S&P/TSX Composite is down just 11% and has thus far evaded a bear market. We remain neutral on Canada, but any reversal in the risk-off trade could become a strong tailwind for Canadian stocks. The relative strength of Canada is largely an Energy question. The sector carries a 17% weight and besides Consumer Staples has been the lone pillar of positive contribution.

Year-to-date S&P/TSX Composite return attribution



Valuations in the U.S. remain far higher than other markets



Oil has sold off 20% in just two months, however, it's at or approaching a level where we can see a path higher from here. Given U.S. SPR releases are set to end in a month, there has been little headway on an Iran agreement and sanctions on Russia will continue to dampen supply. A drop in the U.S. dollar would also be a welcome tailwind.

We remain concerned over recession risks in Canada and the impact a slowing housing market will have on the economy as well as the banks. However, valuations are quite depressed and do provide a margin of safety.

U.S.

In August we reduced our allocation to U.S. equities, after growing wary of the strong advance particularly in the tech heavy NASDAQ. With looming mid-term elections and a hawkish Fed, we expect volatility to linger. From a seasonality standpoint, the months preceding mid-term elections have a rather poor track record, but this reverses after the election.

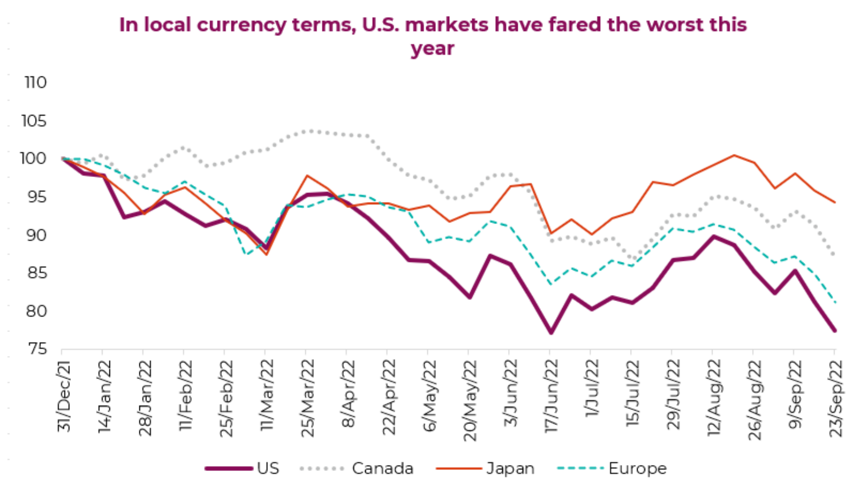
The spread in global valuations also has us wary that value investors may see better opportunities abroad given an expensive U.S. dollar and U.S. valuations still sitting at levels far from what we would consider cycle lows. The current PE for the S&P 500 is 16.5x forward earnings compared to 11.4x for the TSX and 11.2x for the MSCI EAFE Index. The elevated spread has been in place for the past couple of years, and leaves U.S. equites still expensive on a relative basis. The Fed remains aggressively hawkish, which is an additional factor to consider.

International

Some pre-conditions for a market bottom are beginning to fall into place, especially in international markets. Outside of the U.S., stocks are increasingly looking cheap and approaching value territory. Positioning and sentiment is extremely depressed as seen in the above valuation chart.

Europe remains structurally challenged amid an energy crisis, war on its border and currency woes that have brought the Euro and British Pound to near parity with the U.S. dollar. Currency moves have been a large component of negative returns this year. Year-to-date the MSCI EAFE Index is down 27%, Europe is down 21% and Japan is down -8%. Excluding currency weakness, all of these markets are actually outperforming the U.S.

Given the structural challenges present in Europe, we continue to favour Japan. The Yen is undervalued as the BoJ is thus far not following the footsteps of other central banks. The Nikkei has been rather strong this year, outperforming even the commodity heavy TSX and is down just 6.6% in local terms. This compares to -25% YTD in U.S. dollars. The underlying industry exposure Japan is heavy on Autos, Pharmaceuticals, Banks, Industrials as well as Telecom companies. A nice blend of domestic defensives and export-oriented companies that suddenly find their products more price competitive on a global market given the Yen's decline.



Our base case remains that the Yen weakness will first slow, then subside with a BoJ policy shift. The current tension between the BoJ and the Ministry of Finance highlights that the Yen weakness has become a political problem. Last week Japan had to intervene to prop up the Yen for the first time since 1998. Of course, it's hard to time such shifts, but we expect the economy to remain resilient which should increase inflation pressure that will precede a policy adjustment or, at the very least, a softening of the dovish stance.

It's important to caution being overly bearish on nearly every currency besides the U.S. dollar. Though the balance of risks is still giving the U.S. dollar a bid, the trade is increasingly becoming very crowded. At a moment's notice, international markets could see a material higher upside, bolstered by cheap valuations and even cheaper currencies.

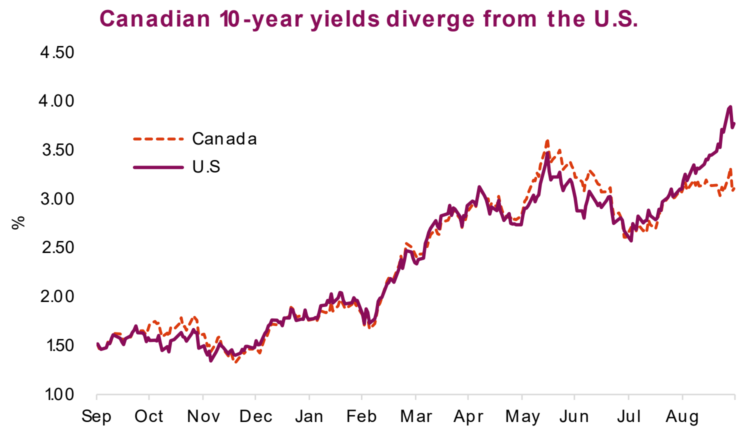
Emerging Markets

We remain significantly underweight, near no weight, emerging markets. U.S. dollar strength is a real problem for many developing markets as is a Chinese slowdown. Not to mention the additional political/social risks that arise with food shortages, high inflation and elevated commodity prices. Though emerging markets are now trading below pre-Covid levels, it's hard to envision a scenario where the lead to the upside amid a global economic slowdown. When green shoots emerge, emerging markets could be a great investment, however we continue to believe that now is not the time.

Fixed income

Rather than being a diversifier, bonds this year have been a driver of lower returns. Rising rates over the year caused a tremendous amount of turmoil in the bond market. Looking ahead, uncertainty about the economy, inflation as well as future central bank policy are all big question marks. Within our models, we remain tilted with lower duration and an overweight in credit.

Our current duration of 5 years is shorter than the FTSE TMX Universe duration of 7.5 years. We continue to have an eye to increase duration as yields rise. In August we mentioned that if rates got up to 4%, we would take the opportunity to increase duration to the 6 range. Though U.S. 10-year yields briefly hit 4%, it quickly retraced over 20bps in a matter of hours.



The divergence between Canada and U.S. 10-year bond yields has also caught our attention. Canadian yields are materially lower than they were in June, and nowhere close to our 4% target. The spread currently stands at -67 bps, a decline of 100bps from the beginning of the quarter. In the US, the latest Fed meeting came with a significant upward revision to the 'dots' and markets now expect a terminal rate of 4.5% by early 2023 vs. 4.25% previously. Though the BoC has had its own monster rate hikes, the terminal rate has not changed as much and is around 4.0% in early 2023. We continue to plan on increasing duration in tranches as our upper targets are hit, taking a more measured approach. Should a recession materialize in 2023 we expect longer duration fixed income positions to perform better than shorter duration bonds.

Credit

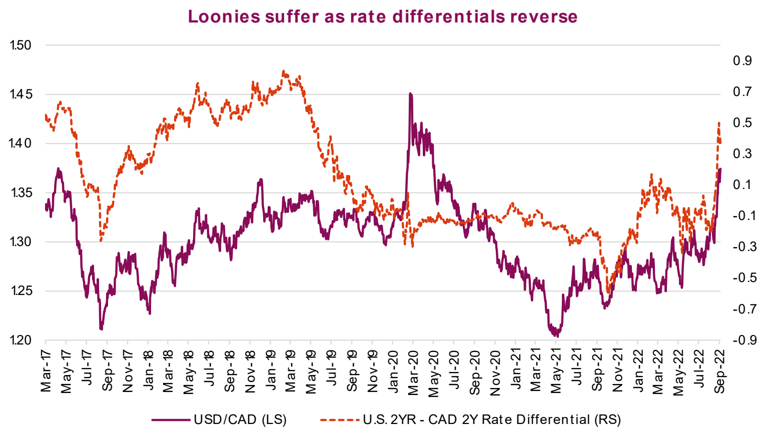
We remain overweight credit within the portfolio, with a preference to higher quality investment grade exposure. Defaults remain low, and rising credit spreads have increased the yield. Popular high yield ETFs are yielding close to 6%, though we don't believe the added level of risk heading into a potential recession is worth it. A slowing economy will put pressure on earnings, and default risk. A lot of damage has already occurred in credit markets, we're focusing on quality preferring investment grade exposure to high yield at this point. Though near-term risks remain, over a full cycle the outlook for high quality credit given current spreads is appealing despite the perceived risks.

With Japan and the U.K. as early examples, the tension between central banks and governments will undoubtedly increase in coming quarters. Fighting inflation is impossible without causing economic harm. For all the credit that central banks receive in moving markets, it's important to remember that central banks may decide when to raise rates, but markets decide when to lower them. This shift can occur suddenly, and without warning.

Currency matters

The U.S. dollar continues to steamroll every other currency. The pain has been most acute just this past week and is beginning to cause issues for economies around the world. A "reverse currency war" is breaking out amongst central banks as they struggle to keep pace with the surging greenback. So far, the strong dollar seems not to be a problem for the U.S. administration and the nearly historic central-bank fueled move is unlikely to abate anytime soon. By some measures, such as purchasing power parity the U.S. dollar is overvalued, but the situation is summed up nicely by this 50-year quote by the then U.S. Treasury Secretary John Connally, "the dollar is our currency, but it's your problem."

The pain of a rising dollar is typically most acute in emerging markets, but with both the Yen and British Pound both down over 20% YTD, developed markets have been far from immune. The Canadian dollar remains stronger than most other major currencies year-to-date. The loonie has fallen -4.75% in September, almost double the fall in the Euro and nearly keeping pace with the pound. The swift move coincides with a sudden reversal in rate differentials. The spread between U.S. and Canadian 2-year government bonds has reversed from -16bps to nearly 40bps just this month. The vanishing yield premium for Canadian paper has punished the loonie the past few weeks. The dramatic fall brought the loonie below $0.73 USD and brings about an important question for investors: to hedge or not to hedge?



We've long preferred to leave our U.S. dollar exposure unhedged, believing that the U.S. dollar provides strong diversification benefits to Canadian investors. 2022 has been a great case study of the U.S. dollar safe haven status, but it's hard to deny that the U.S. dollar is looking overbought. The one-year rate of change for the U.S. dollar Index is nearly 20%, a level that historically implies a top or at least a period of consolidation. Should the loonie weaken a few more cents or even now, it may be the time to consider hedging U.S. dollar exposure.

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

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