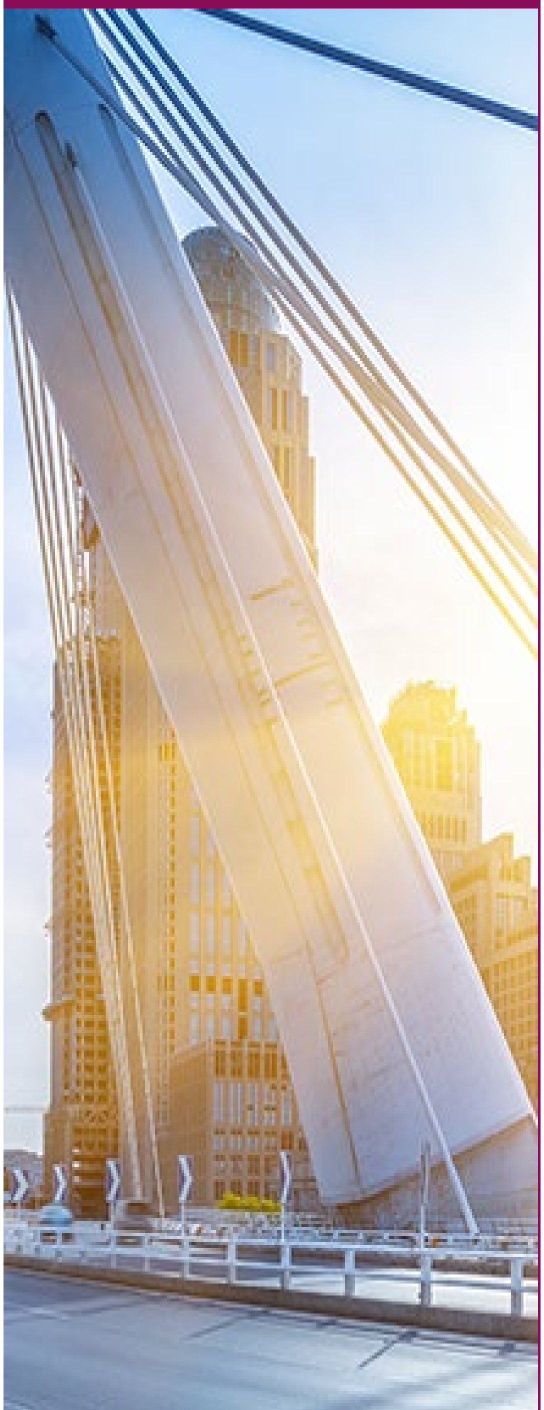
November 2022

Investor Strategy

The latest market insights from Richardson Wealth



RICHARDSON Wealth

Road not taken

Executive Summary

1. A not so scary October
2. Two different roads
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The next few quarters will likely remain volatile in both directions. Fortunately, entry points today in either equities or bonds do offer a compelling 12-month outlook. In a year, inflation will likely have subsided to a degree. If a recession arises in North America, it should be largely played out by that point. There might be better entry points ahead, but one-year return expectations are the best we have seen in many years, given current yields and valuation. Based on this view we remain comfortable with being market-weight equities and bonds. Should either market sell off more, it would be more enticing to go overweight at that time.

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A not so scary October

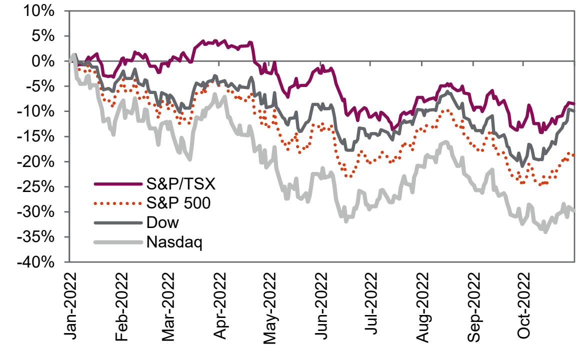
Following a period of poor performance for markets, equity investors got some relief in October despite continued headwinds and a looming recession. Rate hikes continued to consume the market's attention, however, investors also looked to the latest round of corporate earnings to determine the economy's strength. Nearly 87% of S&P500 companies reported earnings, with 70% posting a positive earnings surprise (albeit on lowered expectations), helping the S&P 500 finish the month up 8.1%. The clear outperformer for the month was the Dow which had its largest monthly percentage gain since 1976, finishing 14% higher for the month (and registering its best October since 1900). Poor tech earnings led investors to rotate out of the sector, however, the Nasdaq was still able to finish the month up 3.94%, its first positive month since July.

The Bank of Canada surprised markets this month by raising its key interest rate by 50 bps and not the expected 75bps. Despite making a smaller-than-expected move, the BoC reiterated that additional hikes would be needed. The pace of additional hikes is now becoming less certain as central banks opt for less forward guidance. Economic data showed Canadian retail sales increasing 0.7% in August compared to the previous month, well ahead of the 0.2% consensus expectations, however, the surge in spending only partially reverses the declines experienced in July. Higher interest rates are likely to continue to weigh on consumer spending in the coming months but with the BoC easing off the pedal and the renewed strength in the energy sector, the S&P/TSX closed 5.57% higher for the month.

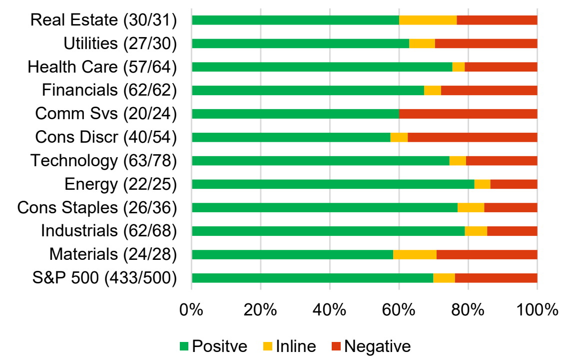
This year has certainly been an anomaly for fixed income, with the market not seeing the negative correlation between stocks and bonds we have grown accustomed to. Bonds have not been able to provide their typical buffer when equities started to fall this year, instead becoming positively correlated with equities. That is, until equities rose during the month while bonds continued their downward trend leading Canadian Bonds to fall -0.93% and U.S. bonds to fall -1.3% in October.

Europe continued to face challenges in October, however, unseasonably warm temperatures helped natural gas prices retreat, providing some inflation relief. Still, the outlook for the region looks cloudy with geopolitical tensions continuing and economic indicators suggesting the region may already be in a recession. It was with all this in mind that the European Central Bank (ECB) announced a 75 bps increase in interest rates and indicated further increases. The one bright spot for the region was the appointment of Rishi Sunak as the UK's newest prime minister which was greeted with relief in financial markets. Gilt yields on 10- and 30-year sovereign bonds fell back close to the levels they held just before Liz Truss' budget was announced, suggesting that the market has more faith in the current government's economic strategy.

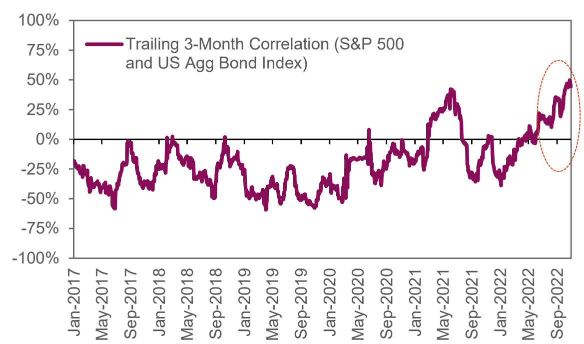
October Bounce



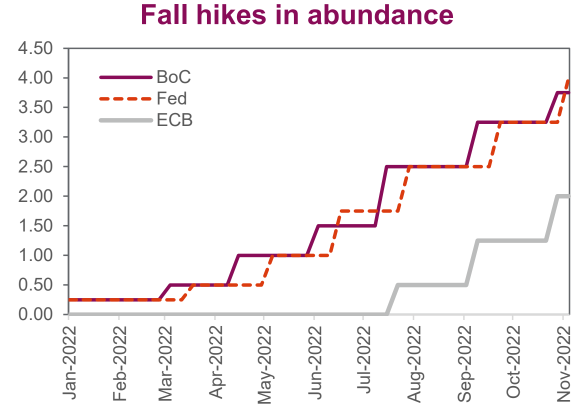
S&P 500 Q3 Earnings



Equites and bonds moving together lately

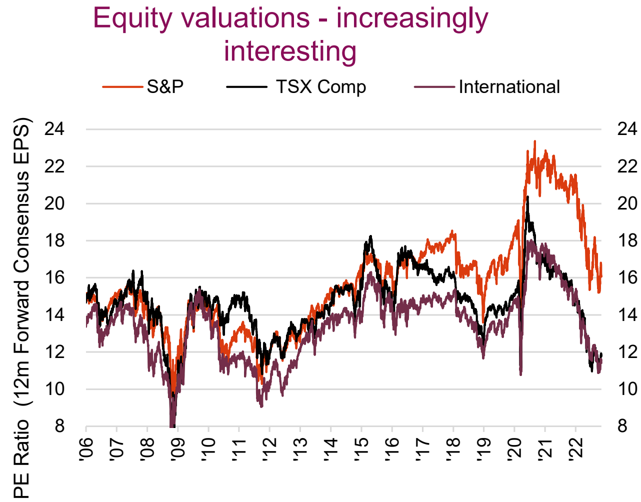


Fall hikes in abundance

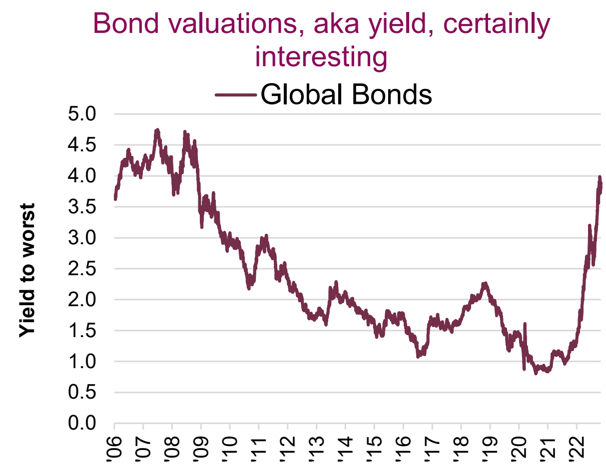


Two different roads

The bear market in global equities is now in its 11th month — not necessarily long for a bear market but indeed approaching the average duration. Then again, global bonds are in their 23rd month of a bear market. It's noteworthy that each asset class peaked in January: equities in January of this year, and bonds in January 2021. Naturally, and with 20/20 hindsight, when global bonds yielded 0.82% in January of '21, the risk vs reward was certainly tilted heavily towards risk. Now that the value of global bonds has contracted by a mind-blowing $130 trillion (USD) and yielding 3.8%, the risk/reward does appear tilted the other way. Equities (aka the stock market) are a bit more complicated. **At their peak in January of this year, global equities had risen about $30 trillion from BEFORE the pandemic**. That has all been given back, and now the market is trading at a more reasonable 14x. But we're not sure the equity risk/reward probabilities are tilted in either direction.



Source: Bloomberg, Purpose



Source: Bloomberg, Purpose

Gauging the risk/reward tradeoff: it's all about probabilities and magnitude

Let's talk bonds first. There is a probability or chance that six months or a year from now, inflation will remain a problem and bonds have had to yield more to compensate investors (i.e. prices go down further). Perhaps wages spiral, or there is a policy mistake, or the economy takes off. But more likely, in our opinion, is that inflation begins its long road back downward as behaviours are returning to normal, supply issues are being resolved, and the global economy is slowing. Include to that list the stimulus (fiscal cheques, near 0% central bank rates & quantitative easing) that was all turned on full bore in 2020-21, and this has a lagged impact on inflation which was clearly felt in 2022. This year, we're seeing no more cheques, a rapid rise in central bank rates, and quantitative tightening. If the lagged impact works both ways, inflation will come down.

With that inflation view, the bond outlook is tilted more towards reward than risk. Having the probabilities in your favour is important, but so is magnitude. How much can you expect to gain if you are right, and conversely, how much could you lose if wrong? For this, the current price becomes very important, and obviously, where the price could go. **If yields rise by another full 1%, the global bond market will drop about 6.7% based on its current duration. But with a yield of 3.8%, a good chunk of this decline would be offset** (of course, depending on the speed, given the yield is an annual number). Note that this offset was seriously missing when yields were below 1%. The longer this bond bear market goes on, the less potential downside it has left.

On the positive side, if inflation comes down as the global economy flirts with a recession, bond prices should rise. And that current yield will still be a positive boost. A double-digit return in bonds may be in the cards, with the timing of the start very uncertain.

Equities: two roads

There is always uncertainty about the future path of markets, and today the paths forward for equities remain very divergent. The good news is with the global equity bear market in its 11th month and down -25%, this bear is getting up there in both drop and duration. Bears don't die of old age, but this is no cub. We believe there are two most likely paths forward from here:

- **The good road:** Often, when the root cause of a bear market begins to improve, the bear market ends. That means inflation must start improving, which may be getting close. The October data (out Nov 10) for the U.S. has several base effects that should bring down the headline number … or not. Inflation is clearly stickier than most thought, including ourselves. When it does begin to improve, this could mark the end of the bear even without a capitulation event and with a potential recession on the horizon. Depending on the tenor of the economic slowdown, this would alleviate inflation pressures – so one negative (recession) and one positive (less inflation), which is bigger, is the tough question. **A rollover in U.S. inflation coinciding with a seasonally strong period for markets, given everyone is bearish, makes a Santa Claus rally a distinct possibility.**
- **The bad road:** Something could break in the meantime. There are a lot of stressors in the market due to the rapid rise in rates and yields. Add to this high food and energy prices while the U.S. dollar rose materially and quickly. This is putting pressure on many economies and many financial mechanisms. There have been some cracks, but markets have absorbed all these big changes so far. Are there emerging markets near the breaking point due to dollar strength and food/energy costs? So far, markets remain orderly; lower, yes, but orderly. Should these stressors trigger an event, it would likely be the missing capitulation this bear has thus far avoided – and likely the bottom.

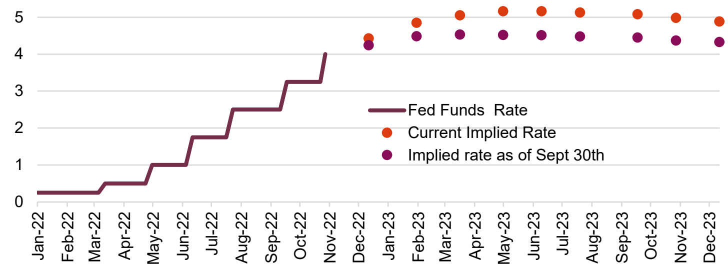
From a probability perspective, we do believe either of these roads is very plausible. We are a bit more inclined towards the 'good road' but not convincingly so. Plus, there are obviously other potential roads. **The only thing we can say with greater certainty is volatility is not going away anytime soon**. There is simply too much going on.

This brings up magnitude, which must incorporate price or where markets are today. On an encouraging note, high inflation, central bank hawkish responses, recession risk with slowing economic growth and the need for earnings estimates to come down are all well-known by the market, and at least partially priced in.

The next few quarters will likely remain volatile in both directions. Fortunately, entry points today in either equities or bonds do offer a compelling 12-month outlook. In a year, inflation will likely have subsided to a degree. If a recession arises in North America, it should be largely played out by that point. There might be better entry points ahead, but one-year return expectations are the best we have seen in many years, given current yields and valuation. Based on this view, we remain comfortable with being market-weight equities and bonds. Should either market sell off more, it would be more enticing to go overweight at that time.

Leaning into the yield factor

Terminal Rate
Investors have lifted their forecast of how high the Fed will hike rates next year



The future direction of inflation and global bond yields is one of the largest factors in determining when the bear markets in bonds and equities will end. With U.S. 10-year yields above 4%, and the Fed issuing yet another super-size rate hike, bond market volatility has begun to fall from the highs of early October. Perhaps we're nearing peak hawkishness for central banks. Globally, dovish central bank surprises have recently outnumbered hawkish ones. By no means does this mean that short-term rates have peaked, but the path of hiking is beginning to slow. For example, the recent dovish surprise from the Bank of Canada and Australia are hints of this shift. These two countries are more sensitive to slowing global economic growth. The Fed is the elephant in the room of course, yet even Jerome Powell hinted at a change in cadence at future meetings. A pivot to slower rate hikes would require inflation to cooperate, but we're seeing some signs of this as well. It's still too early to see if this will result in a lower terminal rate.

After the quickest pace of monetary tightening since 1981, the chart above shows market expectations for the federal funds rate over 2023. The current terminal rate is 5.17%, about **63bps** higher and a couple of months later than the market was expecting at the end of the third quarter. The uptick in bond yields and hike expectations has been a common occurrence over the course of 2022, but what should stand out is how quickly the ramp-up in rates will flatline. If this were an Avengers movie, we might not be in the *Endgame* yet, but more like *Infinity War*, the beginning of the end … hopefully without the blip.

Fixed income – taking one more step up in duration

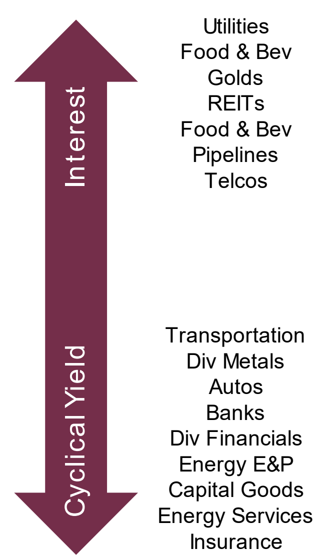
As rates move higher, it has been our strategy to slowly shift away from short-duration bonds while incrementally adding duration in stages, as we are never going to be able to market time-peak rates. Across our multi-asset portfolios, we've increased duration back to approximately 5.0. Still shorter than the Canadian market duration of 7.3 years but closer to neutral. As noted in the previous section, the increase in yields has provided a larger buffer for fixed-income investors against interest rate risk. In investing, how much you pay for an asset is a key factor to the potential downside risk. Bonds have been beaten down, and what you are currently paying means the magnitude to the downside is just less. Thanks to the cushion, higher coupon payments provide. Any hint of a real recession or a sniff of anything mildly dovish in nature from the Fed, and we could witness an abrupt turnaround into a rally in bonds.

Equities – rate sensitives look appealing

Increasing duration isn't the only portfolio move we've initiated recently. The belief that we're nearing peak yields has us focusing much more on the yield factor within dividend-paying equities. This tilt prioritizes companies that pay higher dividends but also incorporates dividend sustainability and quality. As a bonus, it's a defensive factor meaning that it tends to benefit during periods of economic contraction. With a recession potentially on the horizon, we are wary of having too much cyclical exposure.

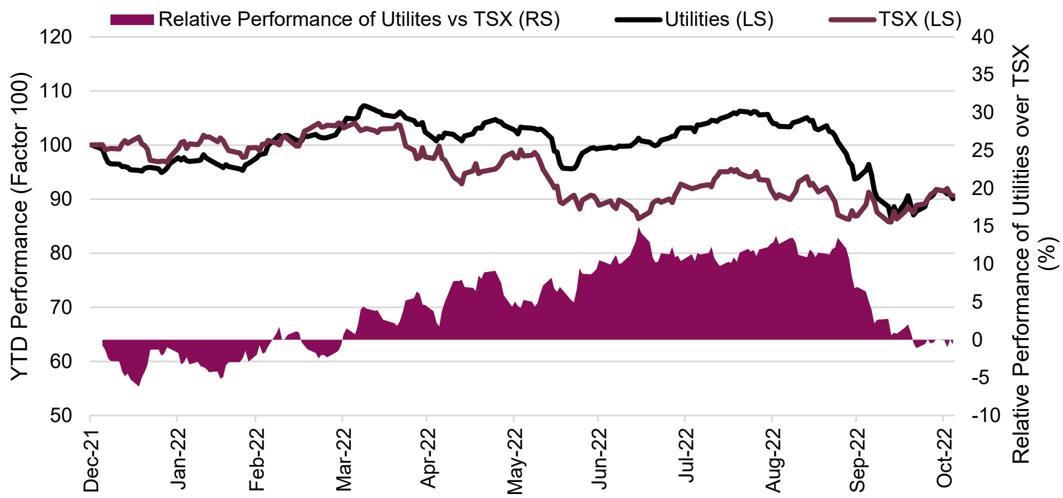
We've written previously about the spectrum of dividends, which you can see on the chart to the right. Given our view that we're nearing peak hawkishness, this sizeable headwind should subside, benefiting rate-sensitive sectors. One of the most rate-sensitive sectors is Utilities. Historically low beta, mature companies with durable demand that can weather difficult economic environments. Regulated Utilities also have a decent amount of pricing power to handle high inflation environment by passing along cost increases. Valuations have improved recently as the sector sold off significantly over the past few months, making valuations and the dividend yield even more attractive.

Dividend Spectrum



Utility stocks are historically one of the more rate-sensitive sectors and are significantly impacted by changes in interest rates for two main reasons. They are highly levered and are often viewed as bond proxies meaning that they are often viewed as a close equity substitute to bonds. **The Canadian Utilities sector yields 4.5%, with many companies yielding north of 5%**. Recent selling intensified in September and October on the latest uptick in bond yields. The sector is now barely outperforming the broader market in 2022, having lost nearly 15% relative to the TSX over the past few months as seen in the chart below.

Pullback in Utilities has erased all relative gains this year

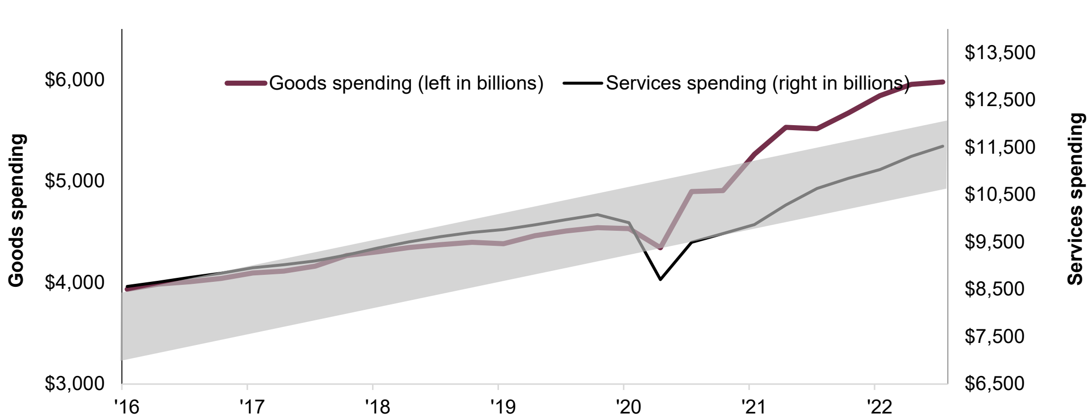


Much like our strategy to increase duration, tilting towards the yield factor is a process. Within the Purpose Core Equity Income fund, we have recently moved to market-weight Utilities after a long period of being materially underweight. The timing is right, with a disinflationary phase on the horizon. At present, we are still concerned that a challenging macro backdrop will continue to pressure more cyclical sectors. With bond yields likely to be capped near-term, the outlook for more rate-sensitive securities with a high yield factor looks promising, and we have been buyers.

Market cycle – stable for now

The global economy is slowing, with evidence supporting this view rather pervasive. Honestly, though, this has to be the most talked about recession ever. Usually, they surprise at least a few market participants. And while a recession or economic slowdown is not a good thing, below we have outlined why it may not be all that bad:

Service spending back to trend, hyper goods spending starting to roll over



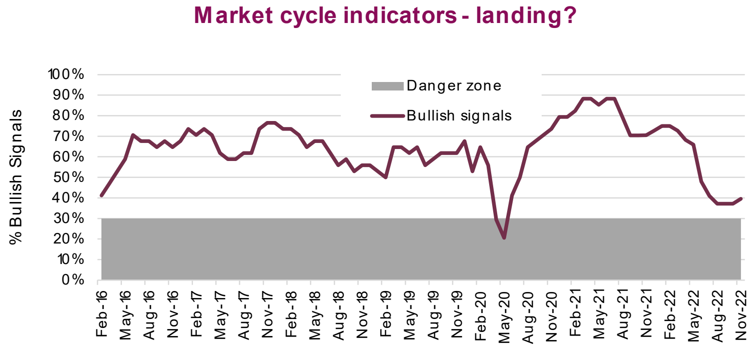
Source: Bureau of Economic Analysis, Purpose Investments

- **Inflation concerns remain a bigger angst for the markets** and have been the primary reason that equity and bond markets are down in bear market territory. Slowing economic growth or even a recession would alleviate much of the inflation pressures – not all of it, given a few lingering supply issues and the war, but much of the pressure. The market lift from falling inflation concerns may even be bigger than the headwind of a recession, especially given markets are already down a hefty amount.
- There is also the **desynchronized nature of the economic slowing**. The recession in 2008/09 was terrible, and what made it worse was the fact that pretty much all economies around the world went into recession at the same time. We all went over the falls simultaneously. Today, we have a material slowdown in China and Europe. Canada is doing well but slowing fast. America is doing a bit better than well and just starting to show signs of slowing. By the time a slowdown or recession hits North America, China or Europe may be already coming out the other side. If/when China alleviates their zero-Covid policy, there will be a good amount of pent-up activity. This desynchronized nature should mute the market impact of a slowdown. Of course, there is the risk of things synching up. Time will tell.
- **The consumer is healthy**. Maybe not as much in Canada with our household financial leverage, but the U.S. and European consumers are in good shape, and they matter much more. This has the potential to soften the impact of slowing economic growth.
- **Goods-to-service spending was going to trigger a slowdown**. If you spend a dollar on goods, it has a bigger impact on the economy and corporate earnings compared with a dollar spent on services. Societies pivoted to more goods spending during the pandemic, supercharging the economy and corporate earnings. Now that we are pivoting back to more normal service spending, the normalization of spending habits was always going to manifest as a slowdown of economic growth. Not sure that is the worst thing in the world.

Market cycle indicators

Grouping	Metric			Better/ Worse
Rates				**1 / 1**
	Net Cuts		✓	
	Yield Curve	✓		-
	Yield Curve 3m		✓	+
US Economy				**11 / 8**
	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				**3 / 5**
	Global PMI		✓	+
	Copper (6m)		✓	+
	DRAM (3m)		✓	-
	Oil (3m)	✓		+
	Commodities (3m)		✓	-
	Baltic Freight (3m)		✓	-
	Kospi (3m)		✓	-
	EM (3m)		✓	-
Fundamentals				**1 / 11**
	US: PE	✓		-
	US: EPS Growth	✓		-
	US: EPS 2FY v 1FY	✓		-
	US: 3m EPS Revision		✓	-
	Canada: PE	✓		-
	Canada: EPS Growth	✓		-
	Canada: EPS 2FY v 1FY		✓	+
	Canada: 3m EPS Revision		✓	-
	International: PE	✓		-
	Int: EPS Growth		✓	-
	Int: EPS 2FY v 1FY		✓	-
	Int: 3m EPS Revision		✓	-

Naturally, the future is uncertain, and things could slow more, become synchronized, or on the optimistic side, perhaps not much of a global slowdown at all. No denying our more forward-looking Market Cycle indicators are indicating a slowing environment. As evidence the slowing of economic activity is desynchronized, there remain a number of positive indicators in North America, while the global indicators are largely negative. We have seen some improvement on the global side but it is still early. Meanwhile, the fundamental data, which incorporates valuations (good) and earnings revisions (bad), have softened.



Source: Purpose Investments, Bloomberg

We do believe this bear market will manifest into the end of a market cycle that began way back in 2009. Given inflation is high, central banks have pivoted, and some sort of global recession/slowdown is in the cards as markets are resetting. Resetting isn't enjoyable, but it does set the stage for the next bull cycle, which hopefully starts sooner rather than later.

Portfolio construction

No big changes to portfolio positioning this month. We remain market-weight equities given our split view that we could see a material market bounce just as much as we could see further weakness. Bonds remain a good allocation in this market, given higher yields, even if there is a bit more pain. The only minor change was our improving outlook for smaller-cap over larger-cap (from our last Ethos).

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		■				Growth
Small		■		■		Large
Active		■				Passive
Low Duration			■			High
Low Credit Exposure			■			High

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

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