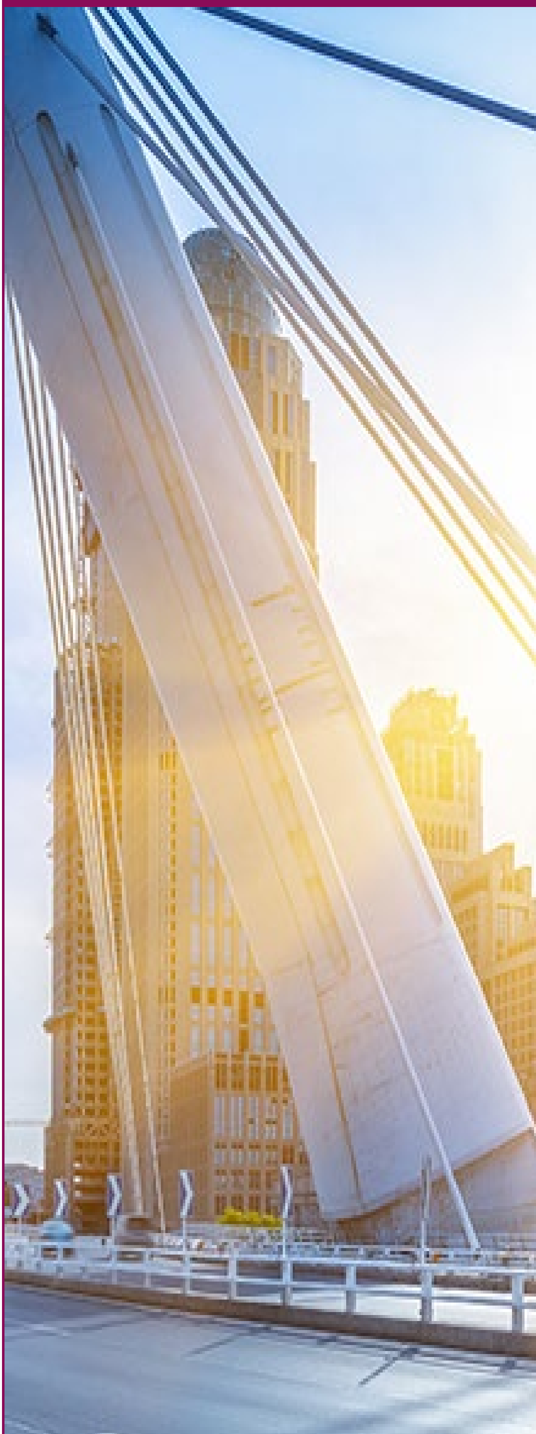
December 2022

Special Report

The latest market insights from Richardson Wealth



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RICHARDSON Wealth

Preparing for the next bull

Executive Summary

All good things must come to an end, even bear markets. Of course, nobody knows when this bear market ends; we want to believe we are much closer to the end than the beginning, but this remains unknown. Some past bear markets have lasted a few months, some a few years. Maybe this one could end when inflation begins to improve, or after the economic data worsens, or when stock prices are so cheap that investors can't resist. Or it will simply end, and many months afterwards, the 'consensus' will slap a reason or narrative why it ended when it did. Hell, maybe the bottom was mid-October – the markets have certainly managed to rally of late.

Last bull cycle (2009-21)	Next bull cycle (202?-??)
Quantitative easing	Quantitative tightening
Disinflation	Inflation
Low yields	Normal yields
Office	Hybrid
Growth	Value
Globalization	Onshoring
Peace	Less peace
Large Cap	Small cap
Monetary excess	Fiscal excess
Borrowers	Lenders

Source: Purpose Investments

When this bear does end, it will birth the next bull cycle, which will not look much like the last bull cycle, given how much has changed. The last bull cycle, which was great and kind to investors, had a lot of help. Disinflation and low yields enabled central banks to stimulate whenever the economy or markets wobbled. Until near the end, geopolitical risks were low. Globalization trends remained strong, with steady gains in supply chain logistics encouraging outsourcing.

We would not dare say it will be different this time, but the list of changes in the economy, market, politics, and behaviours is significant. Looking at the last decade and the next – quantitative easing to quantitative tightening, globalization to isolationism, disinflation to inflation, office to hybrid, growth to value, large to small, monetary excess to fiscal excess, borrows to lenders, low yields to 'normal' yields …

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All these changes will impact portfolio construction. Strategies that worked best in a low-yield disinflationary environment may not work in the next bull market if inflation and growth become more volatile. Some strategies that didn't work well in the last bull may be better designed for the next. This isn't a complete portfolio overhaul, but if you agree that the next cycle will be very different, some changes seem prudent.

The timing of those changes remains a challenge. We do not believe this bear market is over and many of the ideas and conclusions of this content are for the next bull. Unfortunately, nobody will know when the bear is over until well after the fact. We are probably closer to the bottom than the top, so gradually starting to position or line things up for the next bull does seem timely.

Preparing for the next bull: Dives into cycles, why we think the last cycle is ending and thoughts on positioning for the next cycle. This introductory primer will see additions and updates as the markets wind their way through this bear and inevitably start the next bull.

Summary

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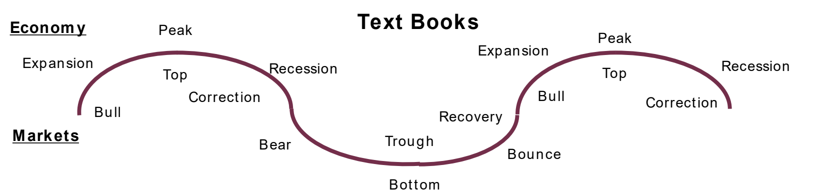
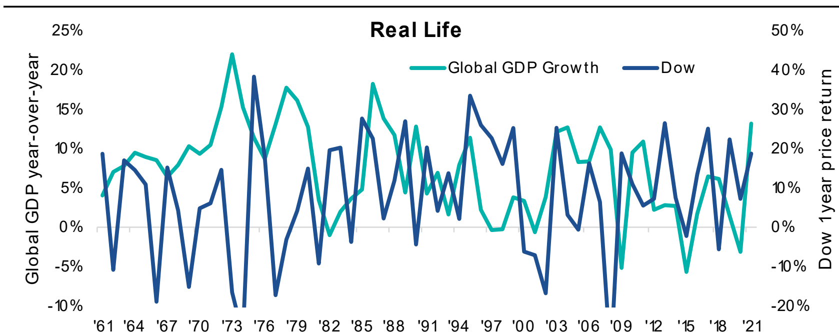
I. Cycles

a. Every cycle is both different and the same

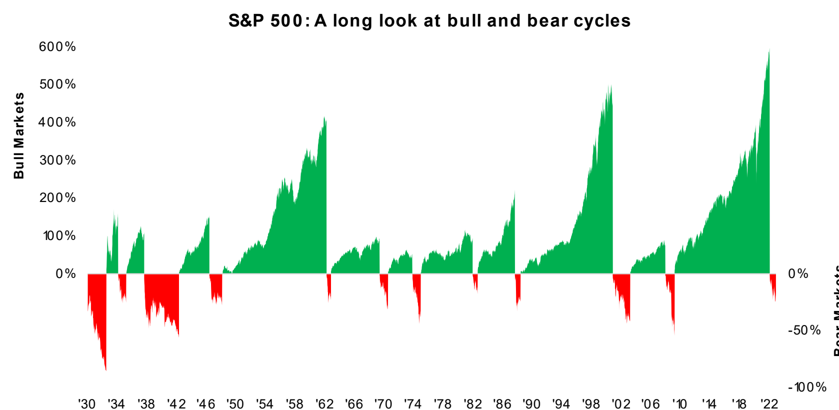
The economy moves in cycles, from expansion to peak to recession to trough to recovery and then back to expansion again. For anyone who remembers Economics 101 textbooks, the graphic representing these various stages was a nice wavy line that was both elegant and made the world seem so simple. Equity markets, too, pass from bull to top to correction to bear to bottom and then a bounce back into a bull.





Source: Bloomberg, Purpose Investments

Unfortunately, the world is not that simple and rarely fits neatly into an academic construct. Different stages can last much longer than anyone expects or be much shorter. The economic growth line can be steeper, flatter, or erratic. During each stage, there are false turning points when it appears the path has changed, but it doesn't. Then it does change, often surprising most. And this all masks the fact that each cycle has parts of the economy that are growing or contracting at various speeds, which tend to be different each cycle.



Source: Bloomberg, Purpose Investments

The markets also work in cycles related to the economic cycle, but it is a loose relationship. It may be easier to view the markets as tethered to the economy, with that tether changing length at times. The economy drives corporate earnings, which does drive the stock market. Yet, at times, the valuation multiples change for various reasons. In the real world, the dynamics in the stock and bond market cycles are even more erratic than the economy, with changing leadership, internal dynamics and many more false pivots.

There is a lot of noise in the economy and the markets, but if you take a step back, there are very evident cycles. And there are clear turning points, which unfortunately only become visible well after the fact. Nonetheless, understanding which stage we are likely in now, and which is likely next, has dramatic investment implications from asset allocation to portfolio construction.

Investing is not a science – Trig, physics, and chemistry are what we would call hard sciences. The foundation of these disciplines is built on a number of proofs or laws that are constant. Investing has no hard rules, mainly because markets are the aggregate behaviour of those people willing to enter a transaction on a given day. Same with the economy – it is our behaviour. Just look at what we did to the economy when an increased percentage of us sat at home, ordered stuff on Amazon, and watched Netflix instead of drinking Aperol Spritz at Villa del Balbianello.

It is human behaviour that causes both economic and market cycles. Good ideas become great ideas that attract more people or capital, and then it goes too far (we go too far). As the great idea collapses, depending on its size in the economy or market, it can also drag the rest down. Then we have a reset of expectations, and it starts all over again.

Similarities from one cycle to the next	Differences from one cycle to the next
Bull markets tend to be more gradual and last longer. Bear markets are shorter and more abrupt	The market and economy relationship can be tight or very loose. Some bears coincide with recessions; some don't.
Great ideas or a high-growth industry leads to excesses late in the bull cycle as less discriminant capital joins. Excesses pop due to a shock or just on their own.	The best industries in one cycle are often those that were starved of capital in the previous
Leaders fall the most becoming laggards	The leaders of one bull are VERY RARELY the leaders in the next.
Resetting or the painful reallocation of capital sows the seeds for a new cycle	Starting points matter

Since behaviours drive the economy and markets, this makes each cycle the same as previous cycles in some ways and different in others. Therefore, understanding what will likely be the same and what will likely be different is critical.

	1990s Bull	2000s Bull	2010s Bull
Top 3 performing sectors	Info Tech	Energy	Info Tech
	Financial	Materials	Cons Discretionary
	Health Care	Utilities	Health Care
Bottom 3 performing sectors	Cons Staples	Cons Discretionary	Cons Staples
	Utilities	Financials	Telco
	Materials	Health Care	Energy

Source: Purpose Investments, S&P 500 Sectors

We cannot stress enough that the **leaders in one bull cycle are VERY RARELY the leaders in the next**. This is a risk as the past leaders feel comfortable as household names. Sometimes a sector may repeat as the leader, but the composition usually has changed materially from one cycle to the next. This table shows the top three and bottom three sectors in each of the past three bull cycles.

Notice how often a sector in the bottom moves to the top in the next cycle or vice versa. Two factors really contribute to this pattern – capital and starting points. A strong performing sector attracts more capital, chasing returns. This often leads to a lack of discipline and poor decisions, which takes longer than a short bear market to sort out. And starting points, the poor performers are often beaten down and become very capital responsible (out of necessity), and only the best ideas survive. This sets the stage for a higher probability of outperformance in the next cycle.

In every cycle, some things are the same, and some things are different.

b) Is this cycle ending?

Before we jump into what we think the next cycle will look like and discuss thoughts on portfolio construction implications, a critical question needs answering: is this cycle really ending? As we have highlighted, the turning points only become evident well after the fact; even then, there can be a debate.

The pandemic bear of 2020 – This was a bear market in equities and a recession, which does check a lot of the boxes for the end of a cycle. And it could have been if not for the monetary response to backstop markets and then the fiscal response to backstop the economy. Without those responses, the shutdowns and changed behaviours would likely have led to a severe recession that would have ended the cycle that started in March of 2009. But the stimulus prolonged the cycle, leadership didn't change, and previous areas of excess actually accelerated.

Today – Clearly, we have a bear market, but an accompanying recession is still to be seen. So why are we confident the 13-year-old cycle is ending? Well, leadership does appear to have already changed during the bear market, as the previous leaders are being taken out. Plus, areas of excess are really starting to reverse. This is evident in everything from profitless tech and venture capital to digital assets.

It is possible the uncorking of inflation, with the accompanying rise in yields, ended this cycle. The dynamics in the market have changed. And while inflation will come back down from these levels, it does not appear that we are heading back into a super low yield disinflationary environment anytime soon.

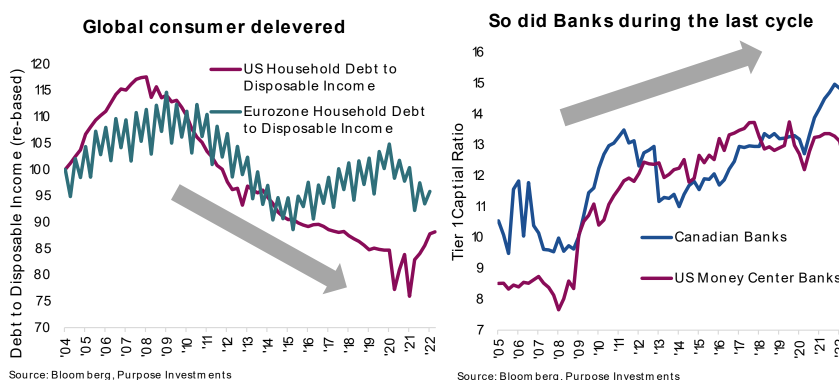
Besides, some sort of a recession or slowing of economic activity is clearly coming. Hopefully mild, but only time will tell. Nonetheless, we think this will be enough to wash out many past excesses and start a new cycle … once the bear is over.

II. Thoughts on the next cycle

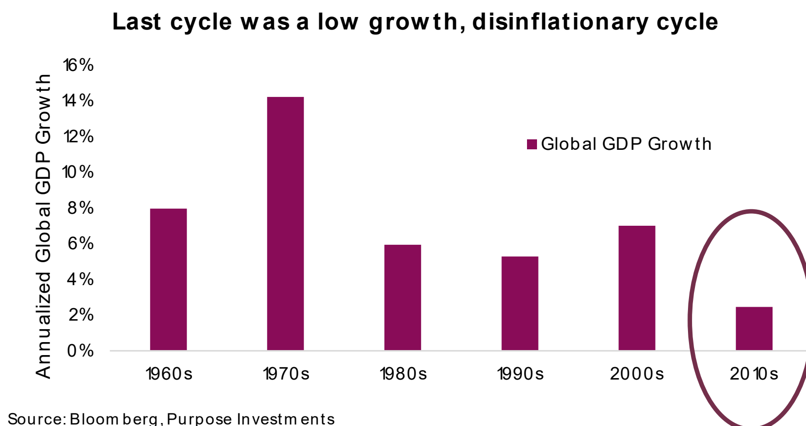
So how will the next bull cycle look? There are many unknowns, including what it looks like in the early and later stages. But we do know **every bull market cycle DOES NOT look like the previous bull**. So, with this mindset, let's start by looking at the last bull, so we know with some confidence what the next bull ain't.

a. Last bull

It was born out of a credit-driven recession (global financial crisis in 2008/09). Credit-driven recessions historically lead to deleveraging, which was evident at the consumer level, more so at financial institutions. Perhaps less so for the Canadian consumer but the big ones, namely U.S. and European consumers, have significantly lowered debt to disposable income during the past bull cycle.



Banks too. During the 00s bull cycle for banks, it was all about earnings growth and return on equity. After the global financial crisis and during the 10s bull cycle, all investors wanted to hear about was safer balance sheets. And they sure did deliver, backing away from many business lines to hold less leverage on the bank balance sheet. This opened the door for alternative lenders to fill part of the gap; more on that later.



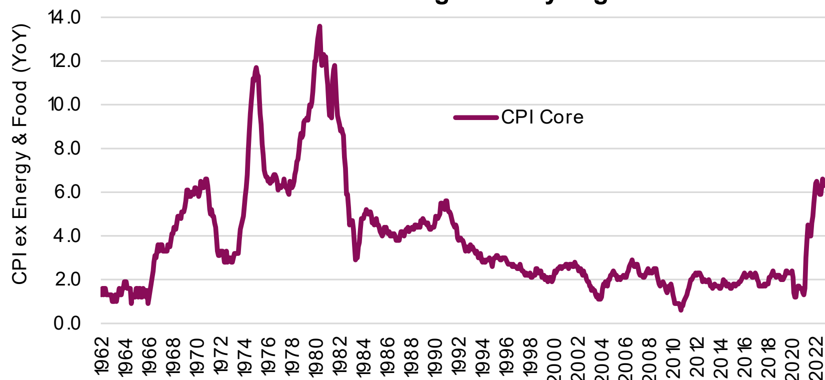
Following credit-driven recessions, there has historically been sub-par economic growth and long-lasting disinflationary pressures. All were very evident during the last cycle as yields remained very low, while economic growth/inflation was hard to come by for many years until very late in the cycle. With prevailing disinflationary forces, central banks had a blank cheque to implement policy to attempt to foster growth (or support asset prices), and they sure did use that chequebook. This led to a bull market that was more driven by asset price inflation than economic growth. Low yields and low central bank rates allowed the discount rate to remain very low. Monetary stimulus with low yields = asset price inflation. Very friendly for stocks, bonds, and real estate.

b. Next bull – Thoughts on the economy, inflation, and central banks

While we remain unconvinced the next bull market has started, it will begin at some point. So how do we think it may look? There are several good aspects for the next cycle and some more challenging. We believe nominal global economic growth, which had been suppressed for much of the last cycle due to deleveraging, is likely to return to a healthier pace in aggregate.

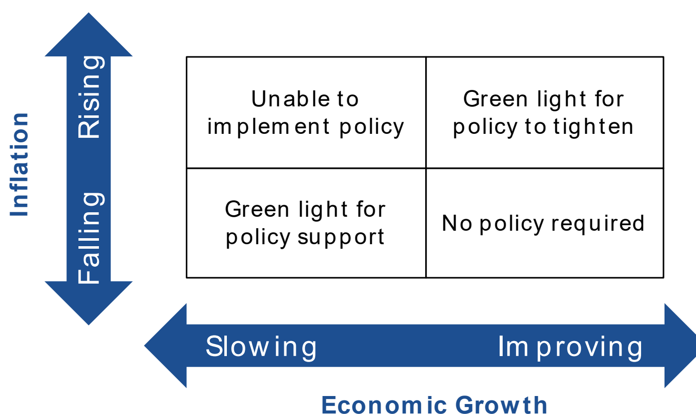
This growth will not be smooth, either over time or across regions. The last cycle's economic growth was low but relatively stable, given that central banks could intervene without any inflation repercussions. That is clearly not the case anymore, which will lead to greater variability of economic growth. Expect larger economic swings and faster, shorter cycles. Economic growth will also be less synchronized across economies. While we do not believe the trend in global trade is reversing, the map is being redrawn somewhat. Following the pandemic and war, diversifying supply chains of many inputs and, notably, energy will likely remain a gradual trend. The cost will remain the dominant driver in decisions (it always is) but no longer the only driver of supply chain structures. All are contributing to more variance across economies relative to before.

It was the lack of inflation that was the problem during the past cycle, up until near the end. Remember those charts of all the negative-yielding debt, which peaked at $18 trillion globally? Today, the tally is less than $2 trillion, and those bonds are just in a couple of countries now. Or recall when deflation was the big fear? That has certainly changed today.



Source: Bureau of Labor Statistics

Inflation won't remain at the current high single-digit pace (or low double digits in some countries) and may have already started to come back down from pandemic imbalances. It may even come down faster than many expect as goods inflation turns disinflationary and the economy slows. But the next cycle will see higher average inflation, and it will likely be more volatile, similar to economic growth.



A higher average level and more volatile inflation will likely have several contributors. The disinflationary cover from the deleveraging is gone. The slowing trend in globalization is another factor. Increased focus on diversifying supply chains, notably in energy, is another. Plus, labour appears to have a strong bargaining power that could keep wage pressures higher than before. Still, demographics remain disinflationary, as does technology.

Higher average inflation begets higher yields in the coming cycle compared with the last. And it will limit the freedom central bankers have enjoyed in implementing policy. The punch bowl isn't gone, but the days of 'all you can drink' are over. Policy response to a slowing economy will depend on the inflation at that time.

This brings up the issue of tenors. Markets, the economy, and inflation all have different tenors. The market, given daily pricing, is pretty fast – news or changes are reflected quickly. Sometimes wrong, but certainly fast. Parts of the economy, while slower than the market, react more slowly to changes. For instance, housing sales activity does react pretty quickly to changes in interest rates or employment. Home pricing reacts as well but slower, and construction even slower. Overall, employment is a slow or lagging measure, given companies will hold on to people, even if business is slowing, until they can't. Inflation and overall pricing is even slower.

Due to these different tenors, countries will likely see periods when economic growth is improving and slowing, combined with inflation that is either rising or falling. Depending on the combination, there will be periods when central banks can implement support policy and periods when their hands are tied. This will lead to larger swings in the economy and likely markets.

Compared with the last cycle, which enjoyed an all-you-can-drink punch bowl, we are now moving to a cycle that will have a couple of drink tickets or worse – at times, it will be mocktails. All leading to more cyclicality in inflation, the economy, earnings growth and likely the markets.

c. Next bull – Yields and the cost of capital

The cost of capital during the past cycle was abnormally low (yields), mainly due to deleveraging triggering disinflation pressures. Whether you attribute this to deleveraging or central bank quantitative interventions, it doesn't really matter because that is over (or will be greatly reduced). This will raise the cost of capital which is a headwind for growth. However, those low yields led to misallocations of capital into less or non-economic endeavours.

Higher yields and higher spreads – We are not convinced a multi-year bear market in bonds has begun but are confident yields are unlikely to get back down to or remain in the uber-low range from the last cycle. We also believe the last cycle enjoyed artificially low credit spreads as too much global liquidity continually put downward pressure on spreads.

Source: Bloomberg, Purpose Investments

In the last cycle, capital was plentiful and cheap. If you had a heartbeat, you could raise money in the debt market. This encouraged leverage, opened the door wide for earnings engineering (issue bonds, buyback stock), and fuelled growth through acquisition, etc. These are unlikely to be strategies that work nearly as well in the next cycle compared with the past.

The low cost of capital also meant that simply owning assets in the last cycle worked well. Going forward, not so much, and it will be operating companies that are growing that should be able to manage the higher costs and inflation swings.

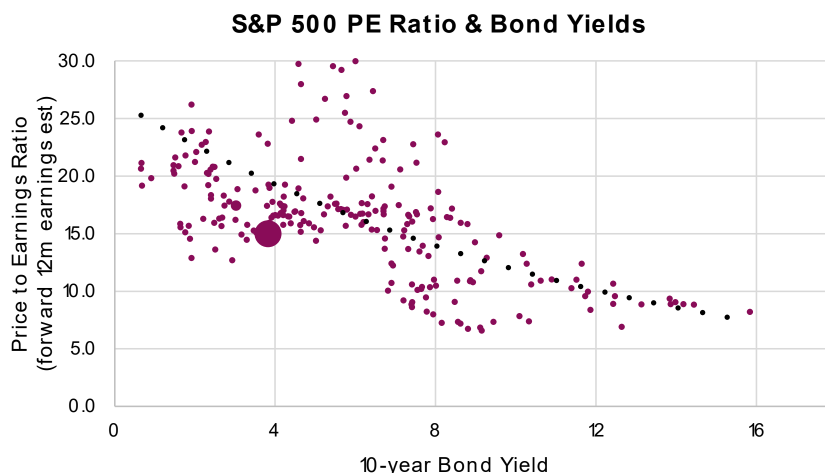
d. Next bull – Equities

Equity investors have had little to complain about over the past decade, apart from the current bear market, of course. Even with this pullback, global equities have annualized a little over 8%, clearly delivering. This is a bit below the VERY long-term annualized pace of 9.7% (back to 1950), decent nonetheless, given the endpoint is in a bear market phase.

We do continue to believe equities will do well in the next bull cycle. Literally, that is what defines a bull cycle. However, the drivers of performance may be materially different, which is worth considering.

Valuation tailwind may prove challenging – There was a lot of multiple expansion during the past cycle, which was mostly given back during the bear phase. That is pretty normal. The U.S. is still slightly elevated, while global equity markets – including Canada – are cheap. We do not know the starting valuation point for the next cycle as we don't believe it has begun. In the next cycle, if inflation remains a recurring issue/flareup and bond yields average out at a

higher level compared with the last cycle, valuation expansion will likely be somewhat muted. There is a strong historical relationship between bond yields and the valuation multiple in the equity markets.



Source: Bloomberg, Purpose Investments, S&P, 1962-2022

Earnings growth – There is good news and bad news. The good news is if inflation is more elevated as we expect in the next cycle, this does help top-line growth. On the flip side, cost inflation will likely be higher, notably if wages enjoy strong gains. The winners and losers in this environment will be a function of those that can better contain costs relative to top-line benefits. Labour intensity will become a more impactful input to earnings growth and margins.

A potential headwind is the cost of capital. The last cycle was filled with companies enjoying falling interest expenses thanks to lower yields, even with the level of indebtedness rising. This tailwind to earnings is likely over and may become a headwind in the next cycle. Plus, how many companies issued debt to buy back shares to enhance earnings per share growth? Well, that is over. A report from BNP estimated 20% of earnings growth for Europe in the last decade came from the above combination. Likely similar in other jurisdictions, earnings growth can't be manufactured as it was in the last cycle. Companies must grow their business more to see earnings growth.

Overall, we would expect earnings growth to be somewhat lower than the last cycle. Combine that with potentially less valuation expansion, and the next cycle may be a tougher slog for equities. But equities are not homogeneous, and we believe a greater focus on the balance sheet, growth strategy, and impact of variable inflation (labour intensity, ability to raise prices) will be essential.

The last cycle benefited the growth factor and mega-caps, a combination that really favoured passive beta-heavy market exposure. Given the changing dynamics, this is unlikely to repeat. The next cycle will more likely favour tilts more towards the value/dividend factor (less duration) and less of a mega-cap bias.

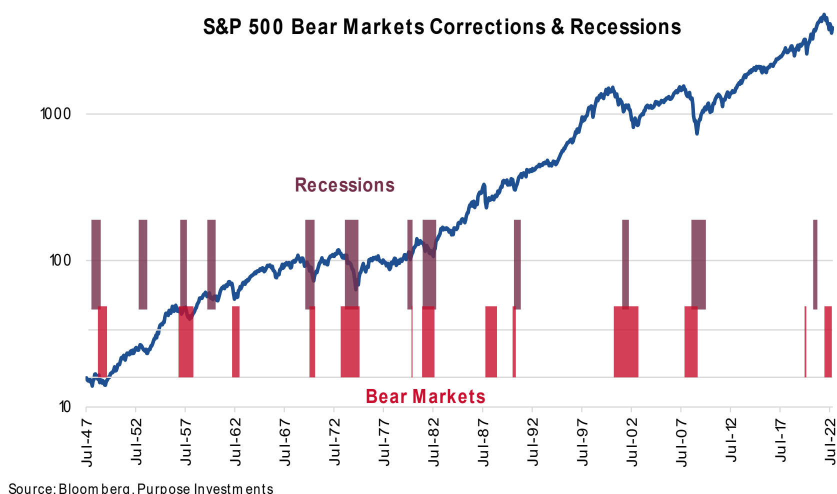
III. Portfolio construction implications for the next cycle

We do not believe that the bear market is over or that the bottom is in yet. But we do believe this is a cycle-ending bear market given inflation, central banks, speculative excesses being removed and slowing economic growth. And at some point, a new bull cycle will begin. In this section, we narrow our views down from the macro cycle thoughts to potential portfolio construction considerations for this new cycle.

a. Standard cycle playbook – Starting points matter

There are some standard cycle characteristics that are worth considering. On average, equities enjoy some of their stronger returns in the early stage of the bull and the very late stage. The initial recovery is often predicated on hope more than anything else, and the fundamentals catch up later. Leadership often changes, with the new leaders not becoming apparent until well into the cycle. At first, all we know is the previous leaders are at risk. This can be a headwind for cap-weighted indices depending on how concentrated the index has become in previous winners.

Bonds may not follow their normal playbook. Typically, bonds are bid up in a bear as a risk-off destination for capital and give up some of those gains as the new bull cycle begins. Given this was an inflation-induced bear market, moving yields higher, pretty sure nobody has been running to bonds as a safe haven risk-off move so far this cycle. That may change if economic growth slows more than most are expecting.

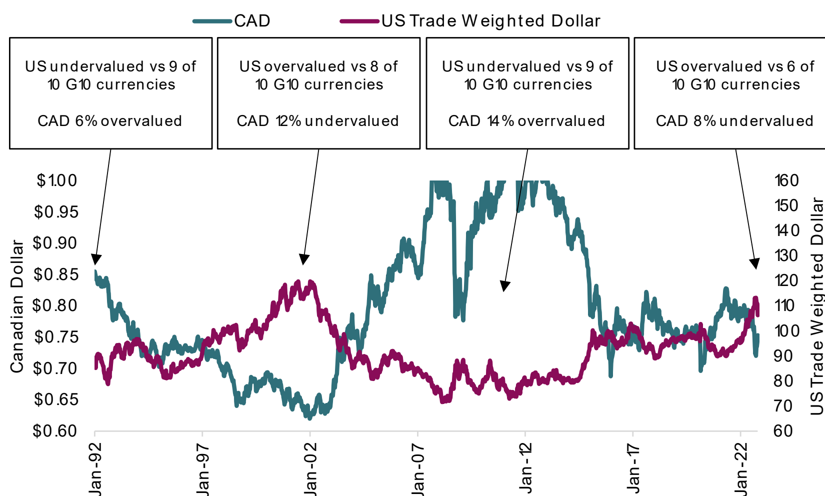


Usually, there is a recession associated with a bear market. Historically (the 1940s-1980s), the recession has taken hold before the bear sets in, but in more recent decades (1990s+), the market has started to be the early mover. Maybe better economists' forecasts? Or, given the consumers increased wealth exposure to markets over time, maybe the wealth effect of the bear market now causes the recession. The crux is there will likely be some sort of recession ahead. Maybe not in every country, and maybe it has already started in Europe. While markets now tend to fall ahead of recessions, they have also bottomed well before the economic pain intensifies. This is good news, considering the economy in North America is not near a recession yet.

Starting points matter – Since we are not sure this bear is over, we also don't know the starting points. If that were the bottom of the S&P 500 in October at 3,500, valued at 15.2x, we would be surprised. But if it were, that would not bode well for U.S. equities considering European equities dropped more and touched a 10.5x valuation, or the TSX at 11x. Equity starting points for the next bull are still uncertain, but there are some starting points that are clearer.

Bond yields are not high by longer-term historical standards, but they are very healthy. This does appear to be an attractive starting point for bond yields going into the next cycle. Of course, lots could happen in the near term, but the risk/return balance is decent.

The starting point for currencies favours the loonie, or more accurately, disfavours the U.S. dollar (USD). Developed market currencies are often a zero-sum game in the VERY LONG TERM. If one country's currency becomes too overvalued, they become less competitive, their assets cost too much, and money flows out. If a currency becomes too weak, say the pound or yen at the moment, the opposite happens. The economy becomes more competitive on the global stage, and opportunistic buyers come in. Anecdotally, Americans have been increasingly active in buying U.K. real estate of late and friends in Japan have never been able to get such quality sushi for a reasonable price (converting back to USD, of course).



The U.S. dollar may not be extremely overvalued, but it is up there. And the CAD may not be bargain-basement, but it is on the ground floor. The chart above highlights how the U.S. dollar stacks up against other G10 currencies and vs CAD based on purchasing power at the start of all past bull cycles.

Asset classes or categories that are relatively undervalued enjoy a better risk/return probability as we head into a new cycle.

What has worked for a decade may not work anymore - In the long run, when talking full cycles, many things revert to the mean or average. If we are close to the start of the next bull and based on relative returns in the last cycle, this does have many portfolio construction implications. The CAD or international currencies relative to the USD, Canadian and international equities relative to the U.S. market that was the darling last cycle. Value over growth, small over large cap, the list goes on.

b. Getting specific

In the following section, we dive into several narrower themes or ideas that we believe investors should consider within their portfolio construction process in the coming bull cycle. And remember, we are not convinced the next bull cycle has started just yet.

i. Asset Allocation – Wider IPS, flatter & more volatile returns – be tactical

What should you do if you could hop in a time machine for your portfolio and go back to the start of the last bull cycle in 2009? The answer is simple: forget asset allocation, including bonds and alternatives, pass on all the fancy investment strategies, embrace the full volatility of the market, and simply buy equities – ideally U.S. equities in the form of the S&P 500. Then turn off your monitor or access to updates/quotes, set it and forget it for a decade or so. Or if you *really* wanted to trade, **BUY THE DIP**. Anytime the market weakened, buy some more.

Unfortunately, time machines don't exist, and you can build a portfolio based on 20/20 hindsight anytime. And this looking-back investment approach arguably does the most damage to investor portfolios. So without the benefit of hindsight, what led to this nice upward and relatively smooth ride starting at the end of 2009?

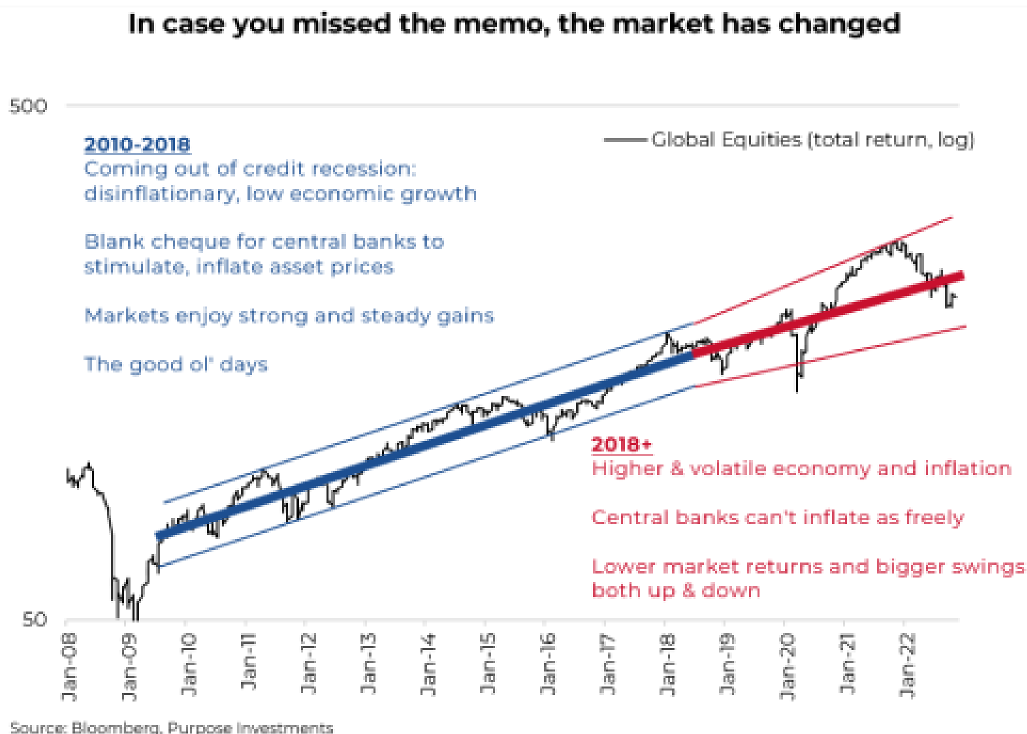
Starting point – The global financial crisis-induced bear market in 2008/09 was not fun, but it did effectuate a complete reset of valuations and decimated investor expectations about the future. That is a good setup for healthy returns going forward.

Yields – The resulting deleveraging of the global consumer and global banking system created a disinflationary environment. This caused lower-than-normal economic growth (bad) but continued to put downward pressure on yields (good). Low yields became one of the engines for equities, whether in financial engineering or simply because there was no alternative to equities.

Fed put – In a disinflationary environment, central banks can do as they please as their actions won't result in inflation or imbalances as easily. This disinflationary cover enabled central banks to really expand their playbook and come to the rescue anytime the market or economy faltered. Aka, the Fed put – if the market drops 10%, the Fed or other central banks will jump in with more stimulus.

Added up, and markets enjoy strong returns with limited volatility – a pleasant world denoted in the blue section below.

In fact, on anyone's Bloomberg, you can call up a list of some of the most popular technical trading strategies and see how they all fared over a certain period. These include things like Bollinger Bands, Relative Strength, MACD, Moving Average strategies, Rate of Change, and the list goes on, totaling a little over 20. From the end of 2009 until mid-2018 for the S&P 500, the dominant strategy was buy-and-hold. And when we say dominant, it destroyed all other strategies from a profitability perspective.



Source: Bloomberg, Purpose Investments

Regression to the mean – The only way to add a bit of value during this 2009-18 run was to reduce a little market exposure when the market charged well ahead of its trendline. And if it falls decently below, buy some more equity. This was the 'buy-the-dip' trading strategy employed by many, predicated on the markets' regression back to its longer-term trend line.

But this market does appear to have changed in mid-2018, and if not, things have certainly changed in 2022. We are currently in a bear market which does add a lot to the swings in the market (bear = much more down, clearly). And it is common for the market gyrations to become very high late in a bull cycle, as was the case in mid-2018 onwards.

Big market swings are much less friendly for a buy-and-hold approach and for those faithful 'buy the dip' folks. During the bull, investors that did some buying whenever the market dropped 7% or more did well. Investors who bought the market when it went down 7% in 2020, or 7% in 2022, did not do well. **The market dynamics appear to have changed**.

We would certainly not view the last year or even back to 2020 as normal. The question is when the bear market ends and the next bull begins, what kind of bull market will it be? We could hope for another bull cycle with healthy returns and low, smooth volatility, but that is probably not the case. The disinflationary cover of the last cycle is clearly gone. This will likely lead to higher and more volatile inflation and the same for economic growth.

Reflexive markets – In this less controlled market environment, the regression to the mean may give way to a more reflexive market. Whether you prefer George Soro's definition of reflexivity or synonyms for reflexive, including spontaneous, unintentional or uncontrolled, the implications are the same. A market that feeds upon itself, resulting in bigger swings both up and down. Weakness begets more weakness; strength begets more strength.

Add to these bigger swings potentially a market with a flatter or lower return trajectory. If inflation and yields remain higher than the last cycle, multiple expansions will be harder to come by. Plus, a chunk of earnings growth last cycle was driven by share buybacks fueled by issuing low-cost debt. Companies are going to have to grow the old fashion way in the coming cycle.

This market may have already changed. From mid-2018 until now, many different momentum-based trading strategies have outperformed the static buy-and-hold. And this is during a period that the market has annualized over 10% returns. **It does appear something has changed**.

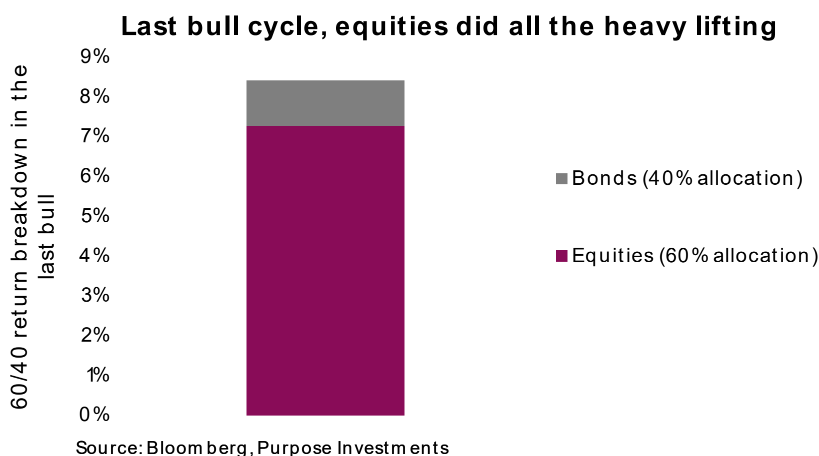
Portfolio considerations - If you agree that equity returns will be marginally flatter in the next cycle and there will be increased gyrations, both up and down, this does have portfolio construction considerations, namely being more tactical.

1) **Wider IPS limits** – From an Investment Policy Statement perspective, you may want greater latitude within each asset class. If (when) equities go on a strong bull run, you may want to allow it to run further before rebalancing. And vice versa on a downswing.
2) **Momentum** – In this kind of environment, momentum as a factor should perform better. The bigger swings help, as does the flatter general return trajectory, as this reduces the lost performance when out of the market.

ii. Simplify

This bear market may not be over yet, and yields could tick higher, equities lower, earnings could fall, and maybe even a recession. But already, there has been a massive reset of valuations and expectations. The speculative fever that was evident late in the last cycle is clearly gone; just ask any venture capitalist trying to raise money. Today, you can buy the TSX with a dividend yield of 3.1% and trading at a valuation of 12.4x. The Canadian bond universe now yields 4.1%, while the corporate subset yields 5.3%. Most bonds now trade below par, and cash has a decent return.

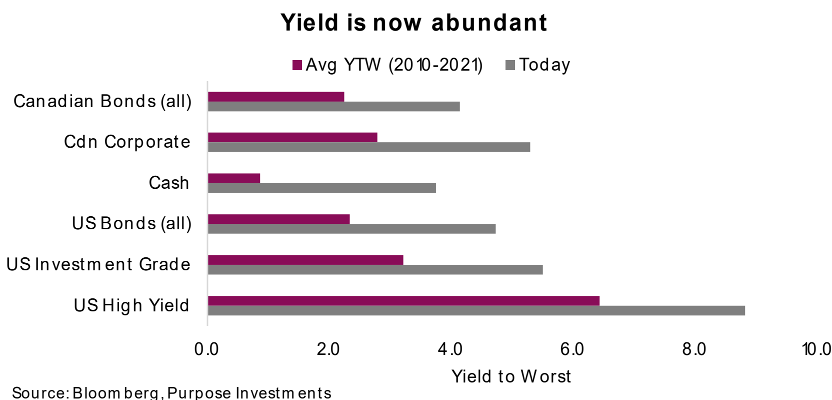
We are not contending that any of these measures are cheap; that will depend on their valuation or yield a few years down the road. But we can say after the painful reset in the first half of 2022, when everything simply fell in value, the market is much more balanced or fair today. This should better balance out returns in the next cycle. There is no denying returns in the last bull came mainly from the equity side of the portfolio. The chart on the right is the return attribution for a 60/40 portfolio from the end of 2009 to the end of 2021 (before this bear). With total performance a little over 8% annualized, almost all the performance came from equities.



Source: Bloomberg, Purpose Investments

As we near the start of the next bull, yield is now plentiful, and available in equities, bonds and cash. Given the biggest contributor to bonds, returns are the yield at the time of purchase, and these higher bond yields should better balance the performance contribution for portfolios. This bond and equity bear of 2022 may have actually reset returns in favour of the old boring 60/40. It's been a painful journey to get here, but it's a much more balanced investment landscape.

Simplify your income – In the last cycle, with yields so low and generally trending lower during the cycle, the stretch to find yield really had to get creative to meet investor demand. Very successful strategies were created to find yield in faraway locations, create yield with more exotic trading strategies, or gain access to yielding assets previously unavailable. Many proved very successful and certainly helped fill a demand caused by this low-yield environment.



With today's abundant yield, does your portfolio need to be as creative? Many of the strategies developed and used today carry other risks, perhaps geographic or execution or some nuanced risk that few investors are aware of. They may still have their place in a portfolio, but with plain vanilla yield now readily available, simplifying a portfolio's yield component may prove prudent.

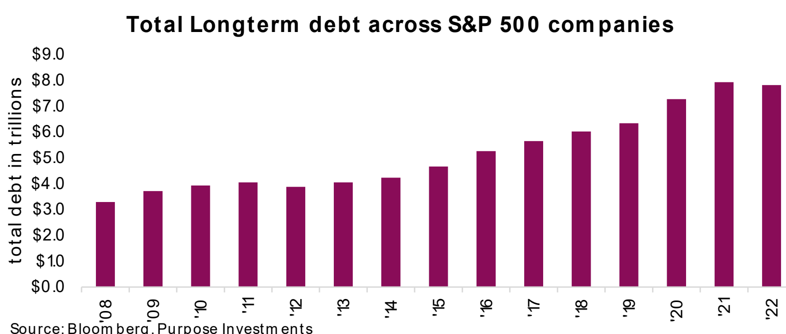
iii. Equities – What's a balance sheet again?

In a world where anyone with a heartbeat can issue a bond with light covenants and a low coupon, it's not surprising companies jumped on this attractive source of capital. Tap the bond market for money, go buy a competitor, integrate the business lines, pay down some of the debt, rinse and repeat. Or just use the bond proceeds to buy back stock, engineering some added earnings per share growth. In a low yield/rate environment with tons of capital available, neither are surprising strategies. S&P 500 constituents now carry about $8 trillion in long-term debt. But corporate strategies will have to adjust as the debt market becomes less borrower-friendly, with stronger covenants and higher costs.

Debt isn't the only thing becoming more expensive for companies. Wages have moved higher, raising the cost of labour. Employee engagement and participation changed during and following the pandemic. It may revert to normal someday. However, at the moment, labour appears to have a stronger bargaining position, which could become a larger issue in the coming cycle.

Supply chains are being at least partially reformed. The desire for greater diversification in the supply of inputs is a trend that is slowly building. Companies are already starting to invest in more supply closer to home, even if the expense is higher.

Next cycle equity leadership – We don't know who will lead in the next cycle from an equity performance perspective, although we wish we did. But a disinflationary, low, stable economic growth with consistent central bank stimulus seems very unlikely. The winners in the next cycle may be those companies that either benefit from the changing landscape or can best manage it. At the equity level, we believe investors should place increased emphasis on:

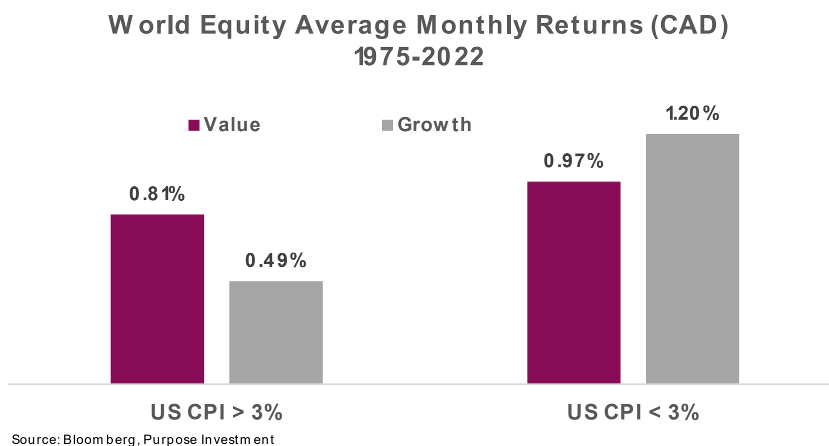


- **Balance sheet** – The amount, term, fixed or variable are all becoming more important going forward. We are already starting to see this factor come up more often, and remember, the economy has barely slowed. If we have more volatile inflation and economic growth, leverage does become more dangerous.
- **Output and input inflation** – Cost inflation, from such things as higher wages, debt service costs or diversifying supply to a high-cost source, is not an issue as long as the company can pass on those costs. It is the relative mix of output and input inflation that separates the winners and losers. And this mix will determine whose margins stay healthy or get crushed.
- **Adapters** – If labour costs do become an issue, which companies are providing solutions to increase productivity to offset the cost? If companies decide to bring production closer to home, which companies benefit or enable that activity? Business intelligence has made large advances over the past decade, and companies are leveraging this potential advantage to increase productivity.

We don't think the next cycle will be a set-it-and-forget-it bull run. The diversity of returns will likely be greater, and it won't necessarily be the mega-caps of today that win. Dare we suggest fundamental analysis may be coming back into vogue?

iv. Value over growth

For the past decade, Investors have been dancing on the grave of value stocks, wondering when a shift over to value stocks may occur. Amidst a low inflationary environment, growth was certainly the winner. If you managed a Canadian Equity portfolio that didn't own Shopify, you likely underperformed the market on the upside or outperformed on the downside. In the U.S., if you didn't own a ton of Amazon and Microsoft, you couldn't keep up. The tide has certainly turned during this bear market, with value outperforming growth by 23% (S&P 500 Value vs Growth Indices).



This reversal in favour of value is really driven by how much growth led in the last bull and how extended it became. In a cycle-ending bear market, the previous leaders tend to suffer the most. So when the next bull begins, will it be value or growth? We believe value will be the stronger performing factor in the next bull for a few reasons:

Shorter duration – given our view that economic growth will be higher and more variable this coming cycle, value should do better. Higher economic growth tends to be better for value as the companies are more economically sensitive. Plus, growth benefited from stable and falling yields based on their longer duration earnings stream. Since we believe that will change, shorter duration value stocks should fare better.

Higher inflation – While the current inflation level will come back down, our view is that it will continue to flare up and remain more volatile and average at a higher level than the last cycle. This is better for the value factor. Looking back over the last 47 years, there was approximately the same number of months where inflation was greater than 3% as there was inflation below 3% (US CPI). Separating those two periods, value stocks outperformed on an average monthly basis by +32 bps in periods where inflation was greater than 3%. As you can expect, in periods where inflation was less than 3%, growth beat value by approximately +23 bps. Low inflation and quantitative easing throughout the prior decade brought returns out of growth equities that investors grew comfortable with, an asset class upon which could be relied. However, what is familiar and comfortable is not likely what will transpire in the next cycle.

Dividends – A large subset that is predominantly found in the value universe includes companies that pay above-average dividends. Of course, dividend investing is a core for almost every Canadian's portfolio. Market composition and attractive tax treatment have always enticed investors to lean into dividends.

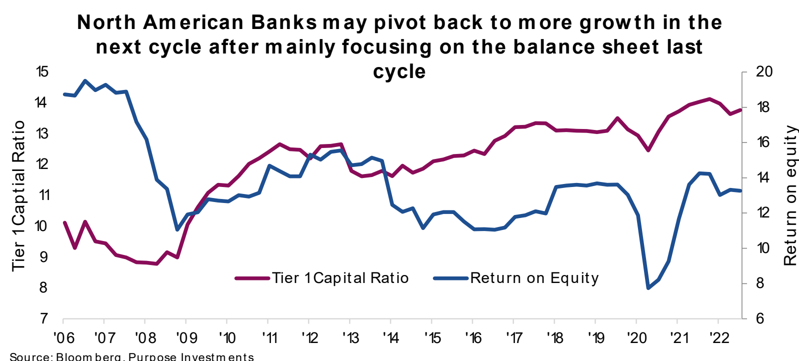
For the same reasons we like value in the next cycle, this does translate to dividend investing. During periods of volatile economic growth and higher inflation, dividends play a role in reducing the volatility of a portfolio. And while bonds have certainly become a stronger competing asset class given the rise in yields, if inflation does remain elevated in the coming cycle, equities have a better chance of navigating that kind of environment – especially those with some pricing power and not over-indebted.

Among dividend payers, keep an eye on leverage. Companies with higher debt are unlikely to raise their dividends in a higher-rate environment. Paying down debt will become a higher priority for these companies, which can present a long-term challenge. If inflation protection is not what you seek, keep in mind the simple fact that these companies paying a dividend means that they have free cash flow and are profitable, resulting in less standard and downside deviation in volatile times.

Moving forward through the next cycle, having a portfolio tilted towards value with a focus on lower-leverage dividends may contribute to outperformance in portfolios. A focus on shorter-duration equities with less leverage will help portfolios in an environment of higher rates and inflation. Even with the outperformance of value over the last couple of years, the price reset provides an opportunity to allocate to value as they are very much discounted to their growth counterparts.

v. Banks and lenders

Banks in Canada, and even more so globally, have so many various divisions and moving parts in their business that it is very challenging to group them together. A little easier in Canada, but even among our big six, some have more or less real estate exposure, commercial and industrial (C&I) loans, fixed income, currency and commodities (FICC,) investment banking, wealth and international operations. We could devote many more pages to the topic. However, there are some general long-term trends that should be positive for banks in the next bull cycle.

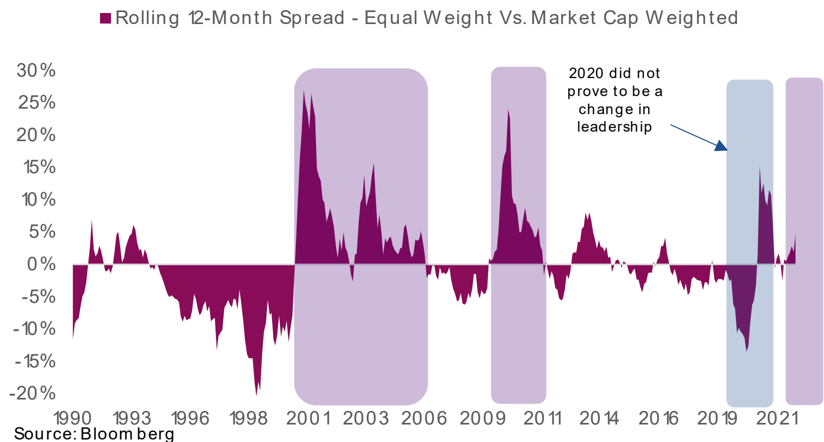


In the early 2000s, if you listened to a bank's quarterly conference call, you would have heard a lot about return on equity, growth, and maybe acquisitions. After the 2008/09 financial crisis bear market, the messaging certainly changed during those calls. It was then all about the balance sheet, how much tier 1 capital, tighter on lending, and less risk. Beyond investor demands for this change, two things contributed to the pivot: 1) the near-death experience for some banks during the financial crisis and 2) lending simply became less profitable.

The last bull cycle experienced low and falling yields, reducing financing costs for many people and companies. But this cost is revenue to the lender, and with yields so low, banks dialed back lending. Plus, there was tons of capital chasing any yield. Lots of willing lenders at low prices is not ideal for profitability. So, banks stepped back from traditional lending to focus on other business lines. This opened the door for many alternative lenders to fill the void. Oh, and lending less did help improve the banks' balance sheets as well.

The next bull cycle will likely be different. For one, capital will be less abundant and cost more (remember, cost is revenue for the lender). The quest for yield, when yields were low, provided a near-endless amount of capital for any

lender that could pay back just a little more to investors. But now, cash yields a decent amount, and government bonds yield much more, as do many traditional sources of yield. The quest for yield may be quenched as yield is everywhere now.



Less abundant capital and higher cost of credit has the advantage passing from the borrower to the lender. And the lenders in the best position are those with a diversified basket of deposits or capital. Banks have many sources of capital, but many other lenders do not. We believe banks may retake market share in the next cycle, helping their profitability.

BUT, there is likely no rush as there is a near-term speed bump for banks in the form of a potential recession/slowdown and/or housing risk. Yes, there is a current lift from things such as net interest margin, with the uncertainty of loan loss provisions. After the bump, we believe banks could be a strong performer for the next cycle.

vi. Factor – Smaller/equal weight

The S&P 500 remains very overweight, the winners from the last cycle. This will likely prove to be a headwind during the bear and into the next bull if leadership is changing. What works in the previous decade is likely not what will work in the next decade. A change of leadership is very common when the cycle shifts. The companies that outperformed in the 2010s (Mega–Cap) have already shown signs of underperformance, dragging the market-weighted indexes down along with them. This has opened the door for equal-weight indexes to outperform.

Looking back over the last 30 years, the best times to shift the portfolio to equal weight have been at the end of a cycle. The challenging part is determining, of course, when that actually is. We are not proponents of market timing; however, in the argument of equal weight vs. market weight, there are benefits to timing the allocation change. Over the long term, since 1990, it really does not matter whether or not you were equal or market-cap weighted. The S&P 500 equal weight returned an annualized percent of 9.7%, while the market-weighted counterpart returned 9.9%. Not much of a difference, but within that long-term chart, there are a few pockets where equal weight outperformed.

In the Dot-Com bubble of 2000, equal weight massively outperformed due to the concentration of the index in technology. The market shifted and discovered new leaders as energy, materials, and utilities became the top-performing sectors of the index. The timing to shift to equal weight in this scenario was at the peak of the bull, but adding equal weight throughout the correction would have served just as well. There was not as much of a concentration risk correction in 2008 as it was in 2000. However, coming out of the bottom in 2008, we still witnessed outperformance of equal weight until 2011. So that leads us to today and the years ahead. We have already seen outperformance of equal weight off the peak at the beginning of 2022.

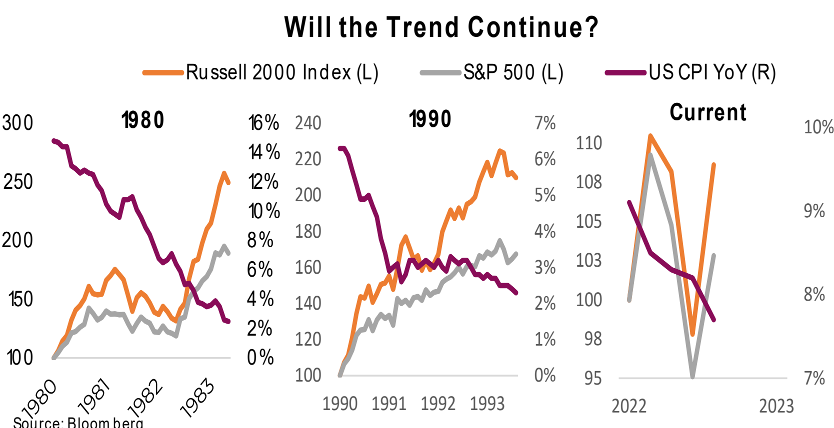
Making a comparison to the concentration risk that was faced in 2000, the market could be set up for another multitude of years of equal weight outperformance. If that outperformance repeats 2000-2006, the implications could have a major impact on portfolios. There has been less of a market cap outperformance leading up to this bear compared with 2000, but it was a long compounding run throughout the 2010s. The case for equal weight remains strong and removing the bias of mega-cap names allows for a more balanced exposure for the investor, which should pay off during future periods of market stress.

Small-cap – Keeping with the same thought of not knowing who the winners of the next cycle will be, tilting towards small-cap for the early period of the bull cycle historically has proven more profitable for portfolios. There appear to be more potential tailwinds for small caps than headwinds whenever this next bull market begins. But the timing is very impactful.

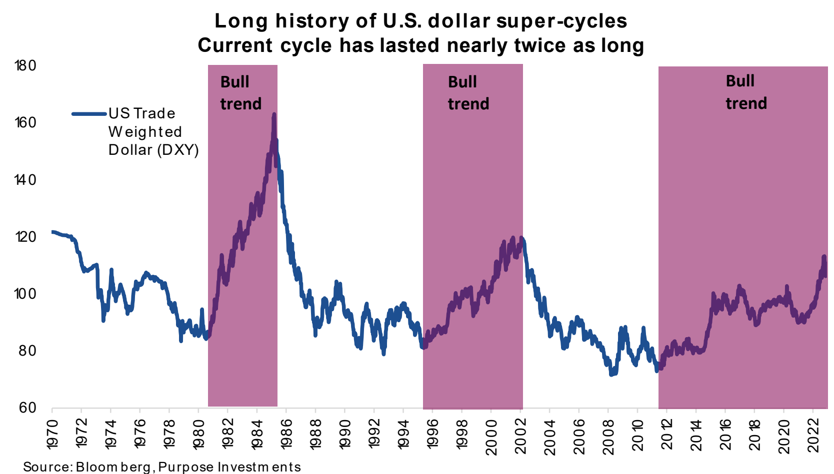
Big drops & big pops – One of the reasons small-cap tends to outperform early in a bull cycle is it often does so terribly during the bear. This has not yet been the case for this bear, as inflation has driven it. If a recession develops, small-cap will likely suffer more, so timing any small-cap tilt is challenging at this point.

Concentration – Similar to the equal weight thesis, if you don't know who the next leaders will be, simply less exposure to previous leaders is the best strategy. Given it was mega-caps that led, by definition, those companies are not in the small-cap world.

Inflation – There is a history of small-cap outperforming as inflation begins to come back down. Looking back at periods of inflation in the 1980s and 1990s, there have been two periods where inflation spiked higher than 6% and subsequently came back down. During these two periods of slowing inflation, the U.S. small-cap outperformed the large-cap by a significant margin.



We do not have enough data yet to determine where we are at in the current inflation cycle specifically. However, we have seen inflation come off slightly from its peak a few months ago, and in that time, the Russell 2000 has outperformed the S&P 500. We caution again: this is a very small sample size. Now the easy part, determine if that was the final peak inflation reading or if we still have more to go.



It is not all sunshine and rainbows. If we enter a recession in 2023, or even if earnings growth simply continues to decelerate, this is a negative for small cap historically. And the historical pattern of underperformance of small caps during the bear market has not been evident so far. Will they pop as much if they don't drop?

Currently, we are most comfortable with our equal weight call and, let's say, slowly warming up to small cap. When we have more confidence the bottom is in and a new cycle has begun, we expect to become stronger fans of small cap.

vii. Currency – Not the USD

Being on the right side of long-term cycles in currency markets can be very profitable. Like any other market, foreign exchange markets have their own unique cycles, of which super-cycles can last for extended periods of time. The last two super-cycles averaged around six years; however, the current cycle is now in its eleventh year – quite the run. The broad-based U.S. dollar Index (DXY) bottomed in 2008, consolidated for a few years, and has risen 57% since 2011. It

went through several smaller cycles but consistently made higher highs and higher lows – the definition of a strong, trending market.

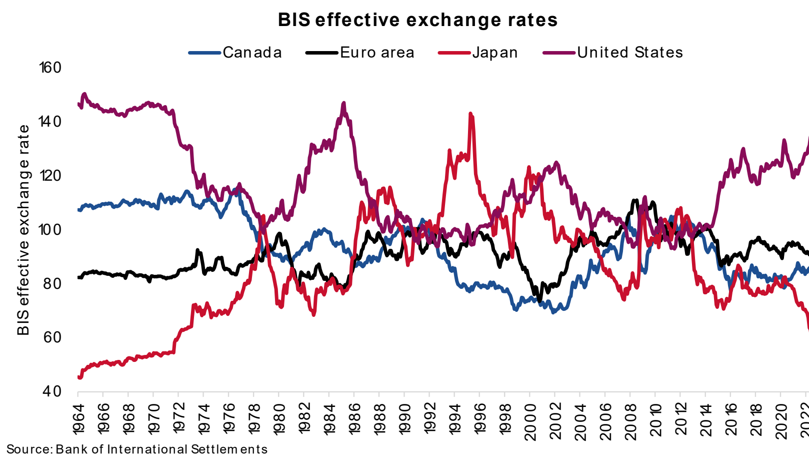
These currency tailwinds boosted returns for an already outperforming stock market and like we said, being on the right side of the currency can add to performance. For example, if a Canadian investor had purchased an unhedged S&P 500 ETF ten years ago, they would be up 362%, while a hedged version would only be up 243%. That's a meaningful difference and reinforces why currency is also an important consideration for equity investors.

Drivers of bull and bear trends

Characteristics of dollar bear trends	Characteristics of dollar bull trends
- Decline in USDs relative interest rate advantage	- Increase in USDs relative interest rate advantage
- Higher growth in the rest of the world	- Stronger domestic growth versus the rest of the world
- Low market volatility	- Geopolitical risks on the rise
- Money being put to work in the rest of the world	- High market volatility giving rise to the 'safety trade'

The shift is on – After a strong rise this year, we have our doubts that the current currency cycle will endure through the next bull market. The current bull trend in the U.S. dollar has gone on far longer than previous cycles, though it's simplistic to state that we're overdue. In the framework below, we've tried to simplify the conditions that merit cyclical bull and bear trends for the U.S. dollar. Over the past few years especially, nearly all of the dollar bull conditions have been met; however, looking ahead into the next bull market, this will not always be the case.

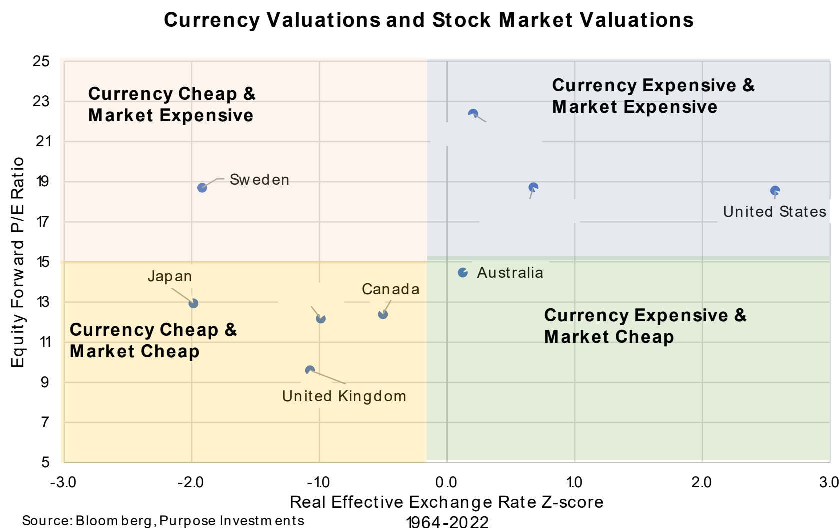
Starting points matter – There are several ways to measure if a currency is over or under-valued. Purchasing power parity is a common one, but current inflation and the energy crisis in Europe have made that model more volatile, especially for the Euro. You can use the Big Mac Index, but that doesn't exactly carry a lot of weight outside fast-food enthusiasts. The Bank of International Settlements has a great model that measures currency relative valuations back to the 60s. According to the Bank of International Settlements Real Effective Exchange Rate model, **the U.S. dollar is now more expensive than in all but two periods in the last 51 years.** Driven by safe-haven demands and a strong carry trade, the dollar is now just 5% away from the level where it peaked in 1985, as seen in the chart above.



Why this matters – With the U.S. dollar historically stretched, it's worth considering what's cheap. Countries with substantially overvalued currencies can see their equity markets underperform sharply, and countries with cheap currencies historically tend to outperform. Having a cheap currency is great for domestic companies whose costs are based in that country but export their goods to the rest of the world. These results don't materialize overnight and can take quarters or perhaps years to impact a region's growth trajectory, but it does happen.

The chart below outlines that investors have two ways to win and lose. The box with the most intriguing longer-term opportunities are countries that have a cheap currency as well as cheap equity markets. The U.S. dollar is overvalued, whereas Europe, Japan, and even Canada, to some degree, appear attractively positioned with an undervalued currency and undervalued equity markets in relation to the U.S.

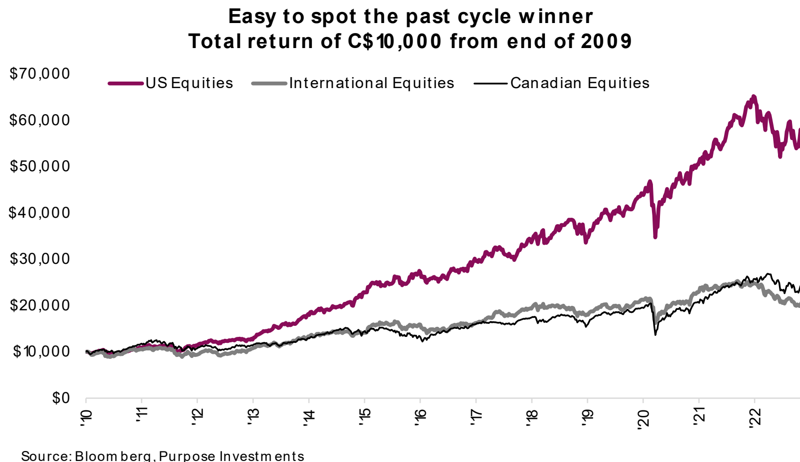
The speed and ultimate extent of a U.S. dollar decline will depend on many factors, including how quickly inflation falls, if the U.S. enters a recession, how fast global economies recover, as well as evolving policy from central banks. We're still in a bear market, and the U.S. dollar is behaving as it usually does: a solid safe-haven asset. However, with the current conditions, it looks increasingly likely that the U.S. dollar is beginning a peaking process. Ultimately the U.S. dollar will remain strong so long as there remains lots of uncertainty and a strong carry trade. This won't change overnight and centers on inflation cooling and a return of a healthy risk appetite.



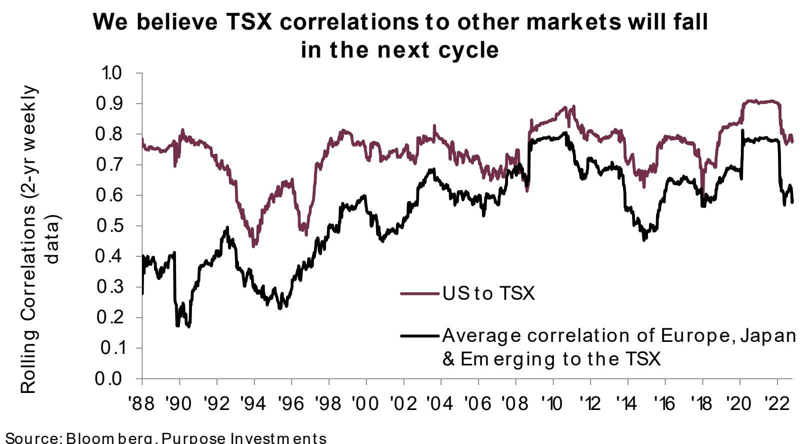
viii. Geographic – Diversification is back in vogue

It isn't this simple, but it just might be. In the '80s, the U.S. sucked, as did the U.S. dollar (USD); meanwhile, international markets rocked. In the '90s, the U.S. rocked, as did the USD, while all other markets trailed. In the aughts, the U.S. lagged, plus a weak USD, while TSX and emerging markets (E.M.) crushed it. In the most recent bull, the '10s, the U.S. was the star again, plus a strong USD, while others lagged. If this simple long-term pattern follows, the '20s should be international/E.M. with weak U.S. and USD.

Geographic diversification has always been a core tenant of portfolio construction. Unfortunately, it's been more like geographic 'diworsification' over the past cycle. A simple overweight U.S. equities has been the no-brainer portfolio allocation move. U.S. mega-cap tech has been the global cycle leader driving U.S. returns over the past cycle to outperform Canadian and international allocations significantly.



Besides the outright dominance of U.S. markets, the past cycle has been characterized by a sustained period of synchronized global growth, which has caused global correlations to rise, decreasing the benefits of international diversification. Higher correlations reduced the benefits of diversifying, but as the chart shows, correlations have dropped from historically elevated levels. Correlations always get lower during bear markets, but it's worth noting that international markets are still far less correlated to the TSX than the S&P 500. And if global growth is going to become less synchronized and more variable, the benefits of international diversification should continue to rise.



Investors looking for value have a whole world to choose from

	US	International	Canada
Enterprise Value	2.7	1.6	2.8
Price to Cash Flow	13.5	6.8	8.4
Price to Book Value	4.1	1.6	1.9
Price to Earnings	18.3	12.2	12.9

Source: Bloomberg, Purpose Investments

No single country can outperform all of the time. The global economy continues to evolve, and while we cannot predict the outcome of wars or policy decisions of foreign governments, we can quantify relative value. Global markets are considerably undervalued relative to U.S. equities across multiple measures. Given the depressed valuations, the likelihood of some degree of 'catch-up' during the next bull should suggest that international exposure can help investors experience a quicker recovery compared with less diversified portfolios.

Looking ahead through the next cycle, we expect to see a period of desynchronized global growth, which should only enhance the benefits of geographic diversification. Persistent pockets of inflation will likely decrease the degree of coordinated accommodative monetary policy around the globe leading to potentially large differences in country performance.

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

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