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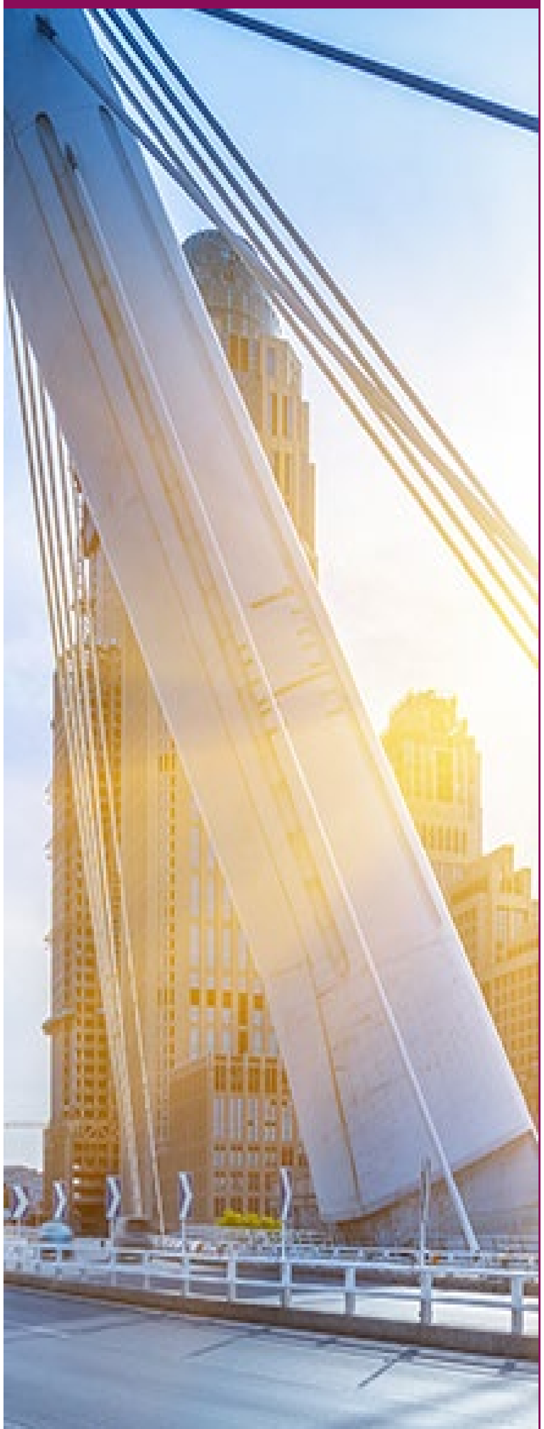
Market Ethos

The latest market insights from Richardson Wealth



Craig Basinger

RICHARDSON Wealth

Walking a tightrope

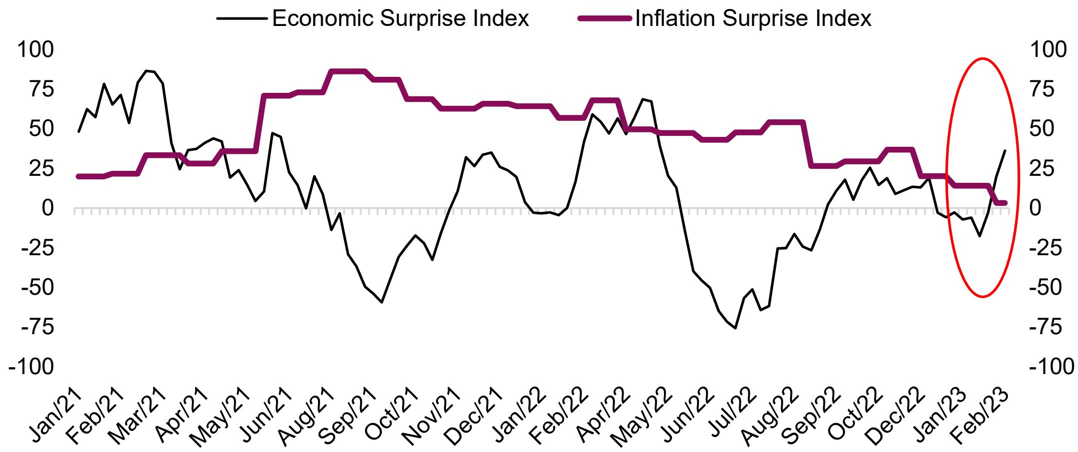
Sometimes good economic news is bad (when inflation is the most significant risk), and sometimes bad is bad (when a recession is the risk). Today, this market appears to be walking a tightrope where either good or bad economic news could elicit a bad market reaction. If the economy is doing well, this reignites inflation fears. If the economy shows signs of slowing, the inflation fear decreases, but recession or slowing growth fears rise. Lean too far in either direction, and the markets could tumble off the wire. Especially given valuations have quickly jumped higher given the strong price gains to start 2023 while earnings growth forecasts have continued to moderate.

The strong market advance so far this year appears to be largely driven by improving news on the inflation front. That has helped the S&P and TSX rise in the 6-7% range. But so far in February, this advance appears to have stalled, and the likely reason is the economic data has been surprisingly strong. While this may reduce recession fears, it appears to be reigniting inflation fears. **U.S. 10-year yields, which fell from 3.8% to 3.4% during January as equity markets rose, have risen in February back up to 3.8%.** Canadian yields have followed a similar pattern.

The trends in the data are well captured by the CitiGroup economic and inflation surprise indices. The inflation index is monthly, so the last reading is from the end of January. With both U.S. Consumer Prices and Producer Prices coming in a bit hotter than expected, this will likely turn up a bit. Meanwhile, the economic surprise index has been suddenly rising. These are surprise indices, meaning they measure how the economic data come in relative to consensus economist forecasts. It appears the forecasts for inflation coming down may have gotten ahead of themselves, as did the forecasts for a slowing economy.

The path lower for inflation in 2023 was never going to be a straight, smooth line. Just as its movement higher in the second half of 2021 and 2022 was not a straight line up. We may be in a reversal period at the moment. The duration is hard to say but given the gradual loss of momentum in many of the more cyclical parts of the North American economy (housing, manufacturing), we continue to believe inflation fears will fade this year and gradually be replaced by recession or pace of economic growth fears.

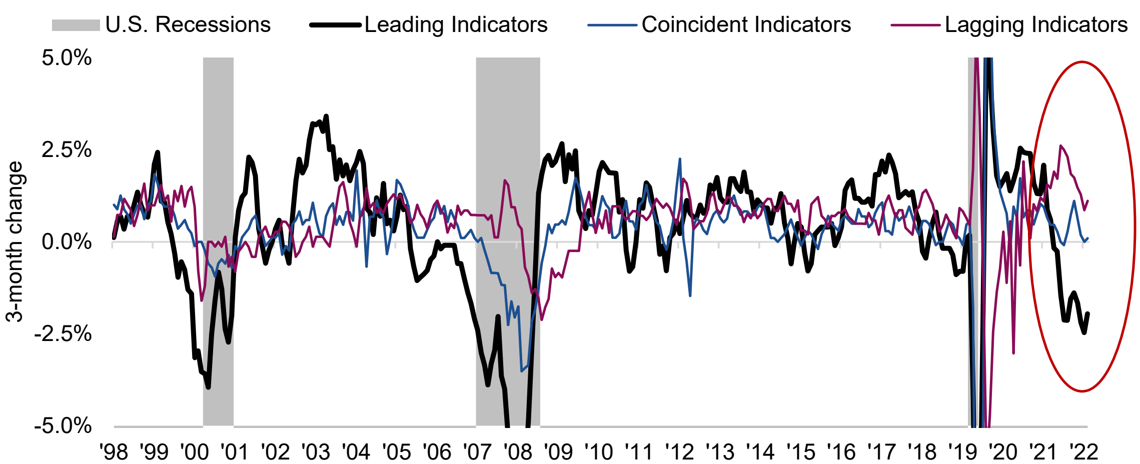
Inflation data has been improving, but wonder how long that will last with economic data heating up



Source: Bloomberg, CitiGroup, Purpose Investments

It isn't the most original analysis on our part, but there is no denying the U.S. Conference Board's leading, coincident and lagging indicators are all following a familiar pattern. The leading index is comprised of 10 pieces of economic or market data that have a history of turning ahead of the overall economy. Jobless claims, manufacturing new orders, building permits, and credit are a few of them. As is the stock market. The coincident index includes employment, business sales, personal income and industrial production. Lagging includes duration of unemployment, inventory/sales ratio, prime rate and services CPI, to name a few. Please note that services CPI is literally in the lagging economic indicators index. **Inflation is very lagging**.

Leading indicators down, coincidental indicators about to turn down and lagging indicators, well lagging naturally



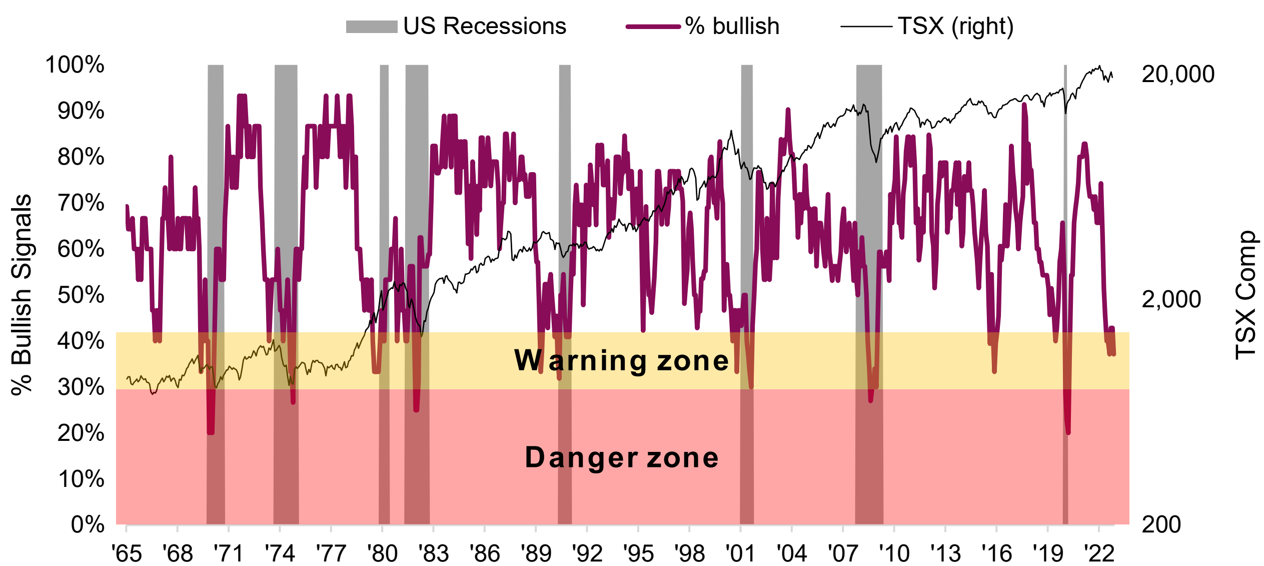
Source: Bloomberg, Purpose Investments

Leading indicators were trending down in 2022. Maybe this is skewed because economic activity was so elevated in 2021 as the North American economy opened more, and we were still catching up on supply shortages. So, part of this downward move could be just 'normalizing', or the economy is about to slow down. It's likely a combination of both; the world has never been simple or binary. Interesting that the coincident indicators tend to cross over to negative territory at the same time a recession starts. We should add that the onset of a recession (grey shaded bars) is not known in real-time; this crucial turning point is determined many months after the fact by the National Bureau of Economic Research.

Moving to more of our in-house analysis, we have been using our Market Cycle framework for many years. This was developed to provide insight into the risk of an economic cycle coming to an end. Instead of just U.S. economic data, as is used in the Conference Board leading indicators, we incorporate many other data points – economic, yields, central banks, global economic activity, commodities, fundamentals, etc. All told, it tells a similar story. In our publication two weeks ago, we included the Market Cycle bullish indicators and all the specific inputs (*Rent This Rally, Don't Buy It*).

Below we share these indicators and framework looking back about half a century. Nothing is ever perfect, and how the economy works changes over time. But it provides insight into the economic cycle's health beyond just U.S. data. With the signals hovering in that danger zone, things are rather precarious.

Market cycle bullish signals are in the warning zone



Source: Bloomberg, Purpose Investments

Add to this a market that really isn't down all that much anymore … was it even a bear market? The S&P 500 is down 12.6% since the beginning of 2022, but **take out those mega-cap tech giants, and it's down a mere 5%**. Slicing and dicing an index like this isn't fair, but if a bear market largely punishes a few trillion-dollar mega-cap tech giants, that is not that painful. FYI – **the TSX is down a mere 7% from its high, and Europe is down 2% from its all-time high**.

Portfolio considerations

The market, outside a handful of giant tech companies, is not down that much after this rally of the past few weeks. Goodbye, valuation safety buffer. Meanwhile, inflation remains a risk, and so does an economic slowdown/recession. Given our Market Cycle and the Conference Board indices, we believe inflation fears will diminish as recession fears grow, even if inflation fear may be experiencing a little tick higher of late. This has lifted bond yields higher, 10-year at 3.85% in the U.S. and 3.30% in Canada, yet our fear of duration is incrementally lower. Dialing back market risk in return for duration risk seems reasonable.

On the left, you have inflation, on the right, recession. And given market levels, this tightrope is more than a few feet off the ground.

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

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*Authors:
Purpose Investments: Craig Basinger, Chief Market Strategist; Derek Benedet, Portfolio Manager
Richardson Wealth: Andrew Innis, Analyst; Phil Kwon, Head of Portfolio Analytics; Mark Letchumanan, Research; An Nguyen, VP Investment Services