



Quarterly Market Commentary

July 2022

The high and persistent level of inflation in most parts of the world has wreaked havoc on both the bond and stock markets in 2022. In fact, we need to look back 50 years to see this same level of carnage in the first six months of a year. Not surprisingly, back in the early 70s, it was also inflation that was the culprit of the decline in both markets.

The question is – are we through the worst, or is there more still in front of us?

The Bond Market

Bonds have suffered massive losses as central bankers attempt to rein in inflation. In my opinion, they face two main challenges:

1. They are late to the party. Central bankers relied on their belief that inflation was transitory for too long before acting. Now, not only are inflation numbers high and harder to bring down, but inflation expectations are elevated. Inflation expectations are what people (individuals and corporations) expect inflation to be a year from now. They matter because actual inflation depends partly on what we think inflation will be. If companies feel that inflation will be 5%, they may move their prices up by 5%, ultimately impacting the inflation numbers a year from now. According to the New York Fed, the one-year inflation expectation in April 2021 was 3.1% and in April 2022 it was 6.1%. Central bankers need to increase rates not only to impact the current inflation numbers, but also the expectations.
2. There is delayed impact. Rising interest rates tend to impact bond and stock prices almost immediately, but the actual impact on the economy can take upwards of a year. If you are running a business and the rate goes up today, this change won't necessarily impact your profits or decisions today. However, as interest costs mount over time, you may behave differently with respect to hiring practices or expansion plans. Your customers may also feel the impact which could alter their decisions. Central bankers are raising rates today to bring inflation under control, but there is a risk that these aggressive rate increases will drive the economy into a recession next year.

When it comes to bonds, the worst may be behind us. Current bond prices typically reflect rate increases that are expected to happen. It's very possible that we will see the impact of higher rates on the economy much sooner than 12 months from now. I can't recall a time when rates were rising while food and energy prices were soaring. This scenario of higher rates with higher food and energy prices could cause the economy to

stall and shift into a recession. If the economy does slow as I expect, the rate increases that are currently being priced into the bonds may not happen. This means that buying bonds today might prove to be a good investment a year from now.

The Stock Market

Stocks have also suffered this year. Even though the market has dropped by 20%, this does not equate to the market being cheaper. Our perception may be that as share prices drop, the value of a company is less, or the value of the market is less. However, this one measure doesn't tell the whole story – the relationship between the expected earnings of a company and its stock price is a better gauge of how expensive or inexpensive the company is. Given that we have had significant global change since the last earnings reports including the war in Ukraine, higher oil prices and higher food prices, there is a possibility that earnings announcements in July may come in lower than expected. This would mean that the market isn't as cheap as it may appear to be.

My suspicion is that even if companies meet their earnings guidance for July, the uncertainty of higher rates and prices hitting consumers, coupled with ongoing supply chain disruptions, may cause companies to be cautious when providing expectations for future earnings. The risk of a further 5-10% decline for the market is a possibility.

Before becoming too bearish, we must keep a few things in mind.

1. Not every company is going to be impacted the same way. It would make sense that companies selling discretionary items may be impacted more than utilities, telecom, and consumer staples. As share prices decline on many of the companies that have a track record of paying dividends, it may be a good time to acquire quality names.
2. Companies with strong balance sheets will likely be less impacted by higher interest rates and may be able to gain market share from weaker competitors.
3. Resource companies will likely be impacted if there is a fear of a recession. However, there is often a long-term fundamental supply/demand imbalance when it comes to resources. Increasingly, they are in demand not only to support our existing technology companies, but even more so as we try to move to a green economy. The supply of most resources is in deficit.

4. I believe that we have seen a peak in globalization and as more companies build factories to secure their supply of key items, industrial companies that help build and automate will be in a strong position.

It's next to impossible to pick the very bottom in any market. However, history has shown that selectively adding to equities when the markets are down 20% proves to be a successful investment over the next three to five years.

We are using this decline in the markets to better position our portfolio to capture the opportunities we see and add to key companies and industries that are expected to thrive in the coming decade.

Fixed income market dynamics			
U.S. Treasuries	Yield		Return (USD)
	6/30/2022	12/31/2012	2022 YTD
2-Year	2.92%	0.73%	-3.05%
5-Year	3.01%	1.26%	-7.15%
TIPS	0.65%	-1.04%	-8.92%
10-Year	2.98%	1.52%	-11.71%
30-Year	3.14%	1.90%	-23.57%

Global equity markets		
Returns	2022 YTD	
Regions	Local	USD
U.S. (S&P 500)	-	-20.0
MSCI ACWI ex-U.S.	-11.6	-18.2
MSCI EAFE	-10.9	-19.3
MCSI Europe ex-UK	-17.3	-23.6
MSCI Emerging Markets	-13.5	-17.5
Canada (S&P/TSX Composite)	-9.87	-

Ashit Dattani

Portfolio Manager and Investment Advisor
 Tel: 604-482-8336
 ashit.dattani@td.com

Borzo Salehi

Associate Investment Advisor
 Tel: 604-659-8136
 borzo.salehi@td.com

Kristen Vilbrunt

Client Service Associate
 Tel: 604-482-8446
 kristen.vilbrunt@td.com

Kim Dadgar

Client Service Associate
 Tel: 604-482-8488
 kim.dadgar@td.com



Source:

<https://www.brookings.edu/blog/up-front/2020/11/30/what-are-inflation-expectations-why-do-they-matter/>

Charts: JPM Q3 2022 Guide to the Markets. Page 36 & 45

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