



Quarterly Market Commentary

October 2022

Performance Returns YTD

S&P/TSX	-11.14%
DJIA	-20.95%
S&P 500	-24.77%
NCOMP	-32.40%
CAD Bonds	-11.85%
US Bonds	-14.65%

Returns as of Sep 30, 2022 – Morningstar Research

Central bankers across the globe have one focus right now and that is to bring down inflation. That singular focus has caused havoc in bond and stock markets around the world. This challenge didn't start with the rise of inflation however, it started with the COVID-19 global pandemic.

Looking back to 2020, central bankers worked to avoid a global depression by supporting the bond market through Quantitative Easing (QE) or aggressively buying the bond market, by dramatically dropping interest rates, and by creating tremendous liquidity into the market. Although these actions did indeed contribute to avoiding a depression, when combined with government spending and supply chain issues, they have led to an inflation storm that we have not witnessed in decades. We are now all paying for that miscalculation.

Currently faced with the challenge of bringing inflation under control, central bankers recognize that although they cannot control supply chains or geopolitical events, they can impact demand. To do so, they are removing the liquidity they created in 2020 by raising rates and by embarking on Quantitative Tightening (QT) or selling of the bond market. As the bonds they bought in the pandemic continue to mature, they are not reinvesting in other bonds. This is an important point because the proceeds from the sale of these bonds pay the Federal Reserve instead of being reinvested in the market which literally removes money from the economy. In June, they let \$47.5 billion worth of bonds mature without reinvesting, effectively removing \$47.5 billion worth of liquidity from the market. In September, that amount doubled.

By raising rates and simultaneously removing liquidity, consumers and businesses are negatively impacted – a recession is likely. It seems counter-intuitive that a quasi-government body would knowingly harm their own consumers, however they see a greater good in bringing inflation under control. Here are some of my thoughts on what this means for us.

1. Bonds – As interest rates have risen, bond prices have fallen, and year-to-date returns have recorded the worst losses in the history of the bond market. As central bankers keep raising rates, bond prices will continue to fall. Despite the risk of a further decline in prices, I think bonds are starting to look very attractive. If the objective of the central bankers is to destroy demand and create a recession, that means that at some point inflation will be lower than today and so will interest rates. Worst case, you could earn 4-5% on your bonds over the next few years and there's a possibility that if the economy goes into a deep recession, interest rates will come down even faster and bond prices will rise. Unlike a year ago when I didn't think bonds provided diversification and a reasonable return, they do today.

2. Stocks – Stock prices have come down substantially this year in reflection of the higher interest rates. At this point, I don't think these prices reflect the possibility that earnings can be lower and lower earnings could mean further stock market declines. Recently, I was on a conference call by Argus Research, an independent US based research firm. By their estimates, most analysts still see corporate earnings growing by 3% in the upcoming quarter. I'm finding it hard to believe that corporate earnings will be positive when many companies face the headwinds of higher interest rates, higher wages and consumers that have less money to spend. I recognize that not all companies will face the same pressures, consumers will continue to spend on necessities while spending less on discretionary items. With higher interest rates and increased food and energy prices, consumers just have less money to spend.

We do not own consumer discretionary companies and instead have a greater weighting in utilities, healthcare, and telecom. I still like energy and resources however, I prefer to add to those if we do in fact enter a recession given, historically, that those names tend to underperform in a recession. High growth technology companies are also unattractive in this environment. Many technology companies require access to capital to grow their business. During times like this, many companies begin laying

off staff which impacts growth. We have started to notice many large well capitalized technology companies announcing layoffs. At times of inflation, investors want earnings today and not some point in the future.

3. Cash – Cash is an asset class where we hold a combination of short term GICs and money market instruments. Although it is currently an attractive asset class, that might not be the case over the next year. Beyond clients that require it for their lifestyle requirements, cash instruments give us the opportunity to earn a positive rate of return as we look for better entry points into bonds and stocks. Long term, cash yields a negative rate of return when compared to inflation. There are times like now however, where it is a viable asset class. I suspect cash levels will go down in the coming year as we deploy into more attractive alternatives.

These are very challenging markets and although we have managed to navigate and avoid the losses that the overall indices have suffered, I recognize that any losses are difficult. We were worried about inflation a year ago and tried to position the portfolio away from those companies that would be most impacted. Our exposure to bonds was minimal and we had started to reduce our technology exposure last year. Although we don't know what the future holds, we are buying bonds that have 4-5% returns and buying high quality stocks that have a history of paying a dividend yield over 4%. Having cash to deploy and minimizing our losses gives us an opportunity to achieve good returns over the next five years.



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