



# Times Like These, Indeed

Market Insights

September 14, 2022

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Wealth Investment Office | TD Wealth

We know that days like yesterday are difficult, particularly after the reprieve markets had through the summer, following a very weak first half of 2022. For reference, yesterday's market reaction to the higher-than-expected August inflation data amounted to a 99th-percentile daily move on the S&P 500. In fact, there were only 41 days (out of 13,462 since 1971) when the S&P 500 logged a worse daily return.

## Inflation

"Times Like These" is what we titled our latest edition of *Portfolio Strategy Quarterly* (July 28, 2022). In that publication, we highlighted the No. 1 signpost we were using to inform our investment strategy: inflation. Indeed, that was the catalyst for yesterday's weakness. The U.S. consumer price index for August saw an acceleration after showing signs of easing in July, which was disappointing. We expect that inflation will remain a key driver of investment strategy and market performance through the next few months.

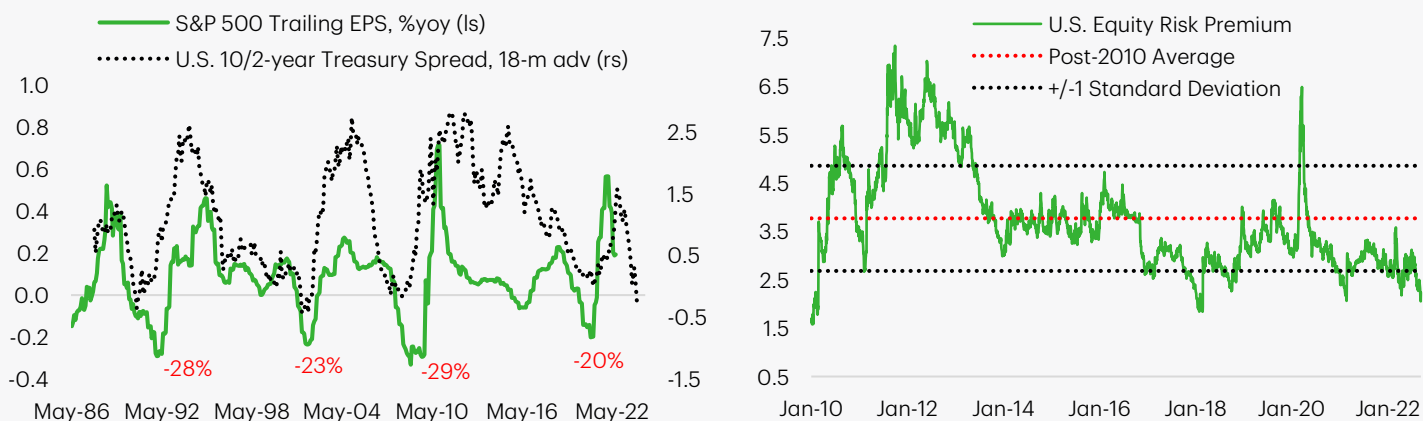
The word "inflation" appeared in our latest *Portfolio Strategy Quarterly* 254 times. We're not sure if that's a record, but at minimum, it deserves honourable mention. It goes without saying, inflation is a big concern right now, which puts investment markets on edge. Yesterday's higher-than-expected data intensified the debate about the likelihood of a soft landing, given that the Fed may now feel it has to increase rates more aggressively in order to tame inflation. The Fed will announce its next rate hike on September 21. Prior to the CPI data yesterday, the markets had expected a 50- to 75-bp hike. Following the CPI release, expectations increased to a range of 75 to 100 bps. We will not speculate; a lot can change in five days, especially in times like these.

At the same time, September is often a challenging month for markets. We come back from the haze of summer holidays, begin to focus on year end, look forward to the next year and often find that reality does not look quite so good as it did during the lull of summer. Would markets have declined as much yesterday if they had not rallied so much through July and August? Probably not.

## Premium Valuation

Monetary conditions have tightened dramatically, and likely have further to go given the persistent inflation. The August CPI number highlights the persistence of several component of inflation, such as food, shelter and new vehicles, even as oil and gasoline prices continue to decline. On the bright side, the U.S. economy is still expected to grow (albeit at a slow pace), and the labour market is strong, which provides downside support (see page 42 of our latest PSQ). However, a more aggressive monetary-tightening cycle does increase the likelihood of a hard landing, which is a potential headwind for equities. Valuations have risen to elevated levels, with the U.S. equity risk premium — the spread between the S&P 500 earnings yield and the 10-year Treasury yield — at 2.24% on Tuesday, close to a record low. The forward earnings multiple for the S&P 500 is above its historical average, even as bond yields have risen dramatically.

Figure 1: The Challenges for Equities



Source: Bloomberg Finance L.P as of September 13, 2022

**Remain defensive**

We expect global equity markets to remain noisy as persistent pressures from rising interest rates (to combat high inflation), geopolitical risks and macro headwinds create an environment of uncertainty. As a result, financial conditions could continue to be constrained, and contribute to decelerating economic conditions and thus earnings growth in future quarters. Therefore, we remain focused on companies that can generate consistent free cash flows, maintain strong balance sheets, and possess management teams that have a proven track record of allocating cash effectively. We believe these companies will provide the best breadth of opportunity amid the uncertain macroeconomic backdrop.

Until we see inflation decisively roll over and hear a tone shift from the central banks, we will stay cautious and prepare to move to offence from defense. At that time, we will tilt away from sectors that are viewed as defensive (for example, staples and utilities) and move to sectors with higher leverage to the economic cycle, such as industrials, discretionary and materials. But that time is not yet.

Instead of trying to forecast unpredictable events such as market bottoms, or the market's reaction to economic data releases, investors should remain calm and focus on things they can control. It's a good time to have a closer look at current investments to ensure a well-diversified portfolio is still in place and is properly aligned to achieve your long-term goals. Leave market timing to the speculators and let time be your friend. Stay invested to improve your chances to reap the benefits of market recoveries. □

## Wealth Investment Office, TD Wealth

### Head of Wealth Investment Office

Brad Simpson | Chief Wealth Strategist

### North American Equities:

Chris Blake | Senior Portfolio Manager

Chadi Richa | Manager, North American Equities

David Beasley | Senior Portfolio Manager, Global Equities

Kevin Yulianto | Quant Equity Portfolio Manager, Global Equities

### Managed Investments:

Christopher Lo | Head of Managed Investments

Aurav Ghai | Senior Fixed Income Analyst

Kenneth Sue | Senior Alternative Investments Analyst

Mansi Desai | Senior Equity Analyst

### Investment Consulting:

Brian Galley | Head of Investment Consulting

Shanu Kapoor | Senior Portfolio Consultant

Richard Nguyen | Senior Portfolio Consultant

Shaun Arnold | Senior Portfolio Consultant

Greg McQueen | Senior Portfolio Consultant

Duncan Morton | Senior Portfolio Consultant

Remek Debski | Senior Portfolio Consultant

Jesse Kaufman | Senior Portfolio Consultant

Ivy Leung | Senior Portfolio Consultant

Anita Linyu Li | Portfolio Consultant

Shaiara Hossain | Portfolio Consultant

Taimur Malik | Portfolio Consultant

Hai Ho | Portfolio Consultant

Joseph Abinaked | Portfolio Consultant

Jack Zhang | Analyst

Jason Fernandez | Analyst

Dan Iosipchuck | Analyst

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