TD Wealth

Real Time

Monthly Perspectives
November 2022

15 minutes

Real Time

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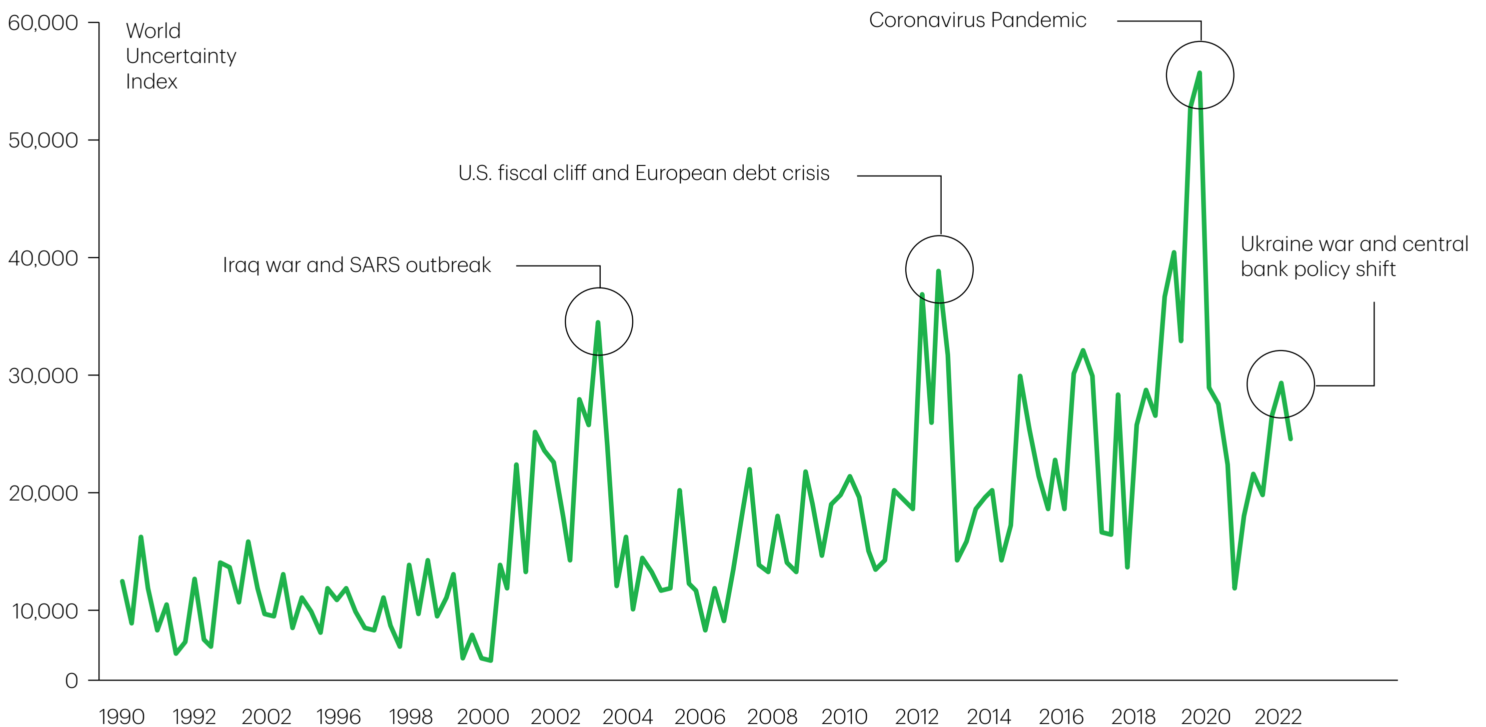
Falling equity and bond markets, rising interest rates, high inflation and the war in Ukraine have many of us wondering, *"What is going to happen next?"*. We go through a lot of ink on these pages writing about what we believe is around the corner, with the goal of parsing out the noise in financial markets. As the old saying goes, knowing is half the battle.

Our current *Portfolio Strategy Quarterly* bears the title "White Whales," which we defined as any large macro event that policymakers pursue in the attempt to control risk at any cost. The current environment is the epitome of a white whale, where central banks, in the spirit of being cautious and keeping us "safe," have kept interest rates too low, for too long, overstimulating growth and stoking inflation.

The bottom line is, financial assets have been riding a wave of stimulus for decades. On top of that, we're in the midst of a generational shift, where economic, policy and geopolitical uncertainty abound. Figure 1, highlights the World Uncertainty Index, which tracks the frequency of the word "uncertainty" in the 143 country reports of the Economist Intelligence Unit. It should come as no surprise the current lofty level of this measure has only been exceeded a few times in the past, most of which has been during the Covid-19 pandemic. The outcome of these longer-term trends is an unknown, but as they are playing out, our job is to make decisions to grow and protect capital in real time. Real time is what this issue is all about. While the future is unknowable, we can determine our current environment and make decisions based on where we're at.

The following pages outline our most current thinking to help investors gain a better understanding as we move towards the end of 2022 and into 2023. The point is not to make predictions about the coming year, but rather to break down the trends and themes that are likely to play an important role in the shifting economic landscape.

Figure 1: Uncertainty abounds



Source: FactSet as of November 18, 2022. Note: A higher number means higher uncertainty and vice versa. The Index is constructed by counting the frequency of the word "uncertain" (or its variant) in Economist Intelligence Unit country reports. The Index is then normalized by total number of words and rescaled by multiplying by 1,000.

Repricing of Risk

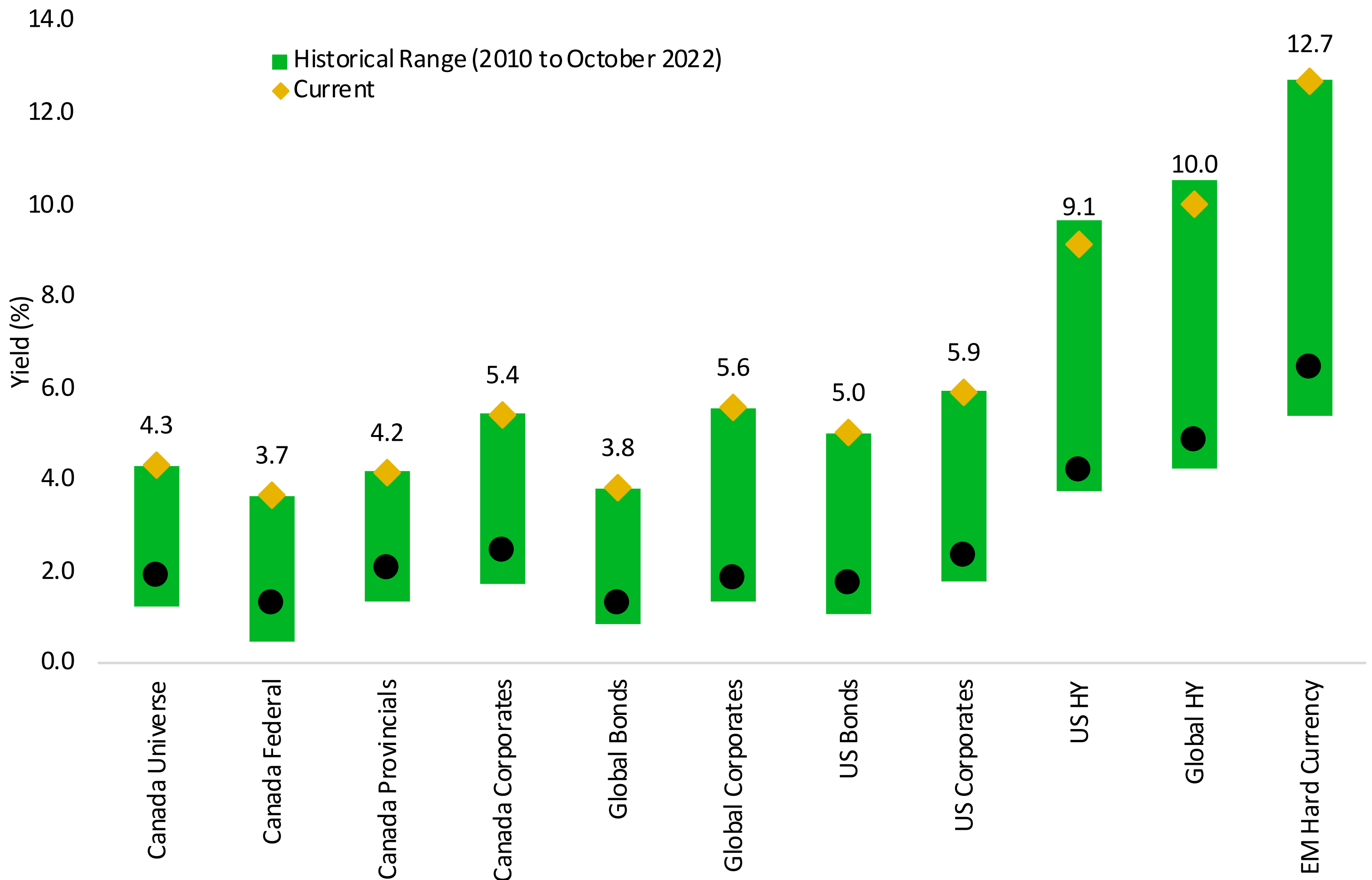
Figure 2: Risk has been repriced with end of easy money

Source: Bloomberg, as of November 18, 2022

Low rates and high liquidity have characterized the economic landscape for about a decade — an era of easy money that started after the 2008 global financial crisis with rounds of quantitative easing. But that chapter seems to be ending, with risk-free bond yields increasing from as low as 0.5% 30 months ago to 4% currently — an eight-fold increase. Higher rates affect the valuations for all assets. We have seen a significant repricing in fixed income and public equity markets, and real estate valuations have started to cool. Private assets are also likely to see some additional downward adjustment, although private assets tend to adjust more slowly and by less than what is seen in public markets because they are marked to model, which is done on a quarterly basis. As the cost of capital rises, fewer projects will be funded given a higher hurdle rate. This will likely have a major effect for start-ups, which may face a drought in funding as the era of easy money ends.

Attractive Bond Prices

Figure 3: Yields, the most crucial valuation metric for fixed income instruments, reset to 12yr highs



Source: Bloomberg Finance L.P., TD Wealth as of October 31, 2022

At current yields, we believe Treasury bonds have become very attractive going into the next year.

Today's starting yields offer attractive entry points for those able to look beyond near-term volatility. Yields across fixed income sectors are well above the lows of the past decade and offer real potential for future returns.

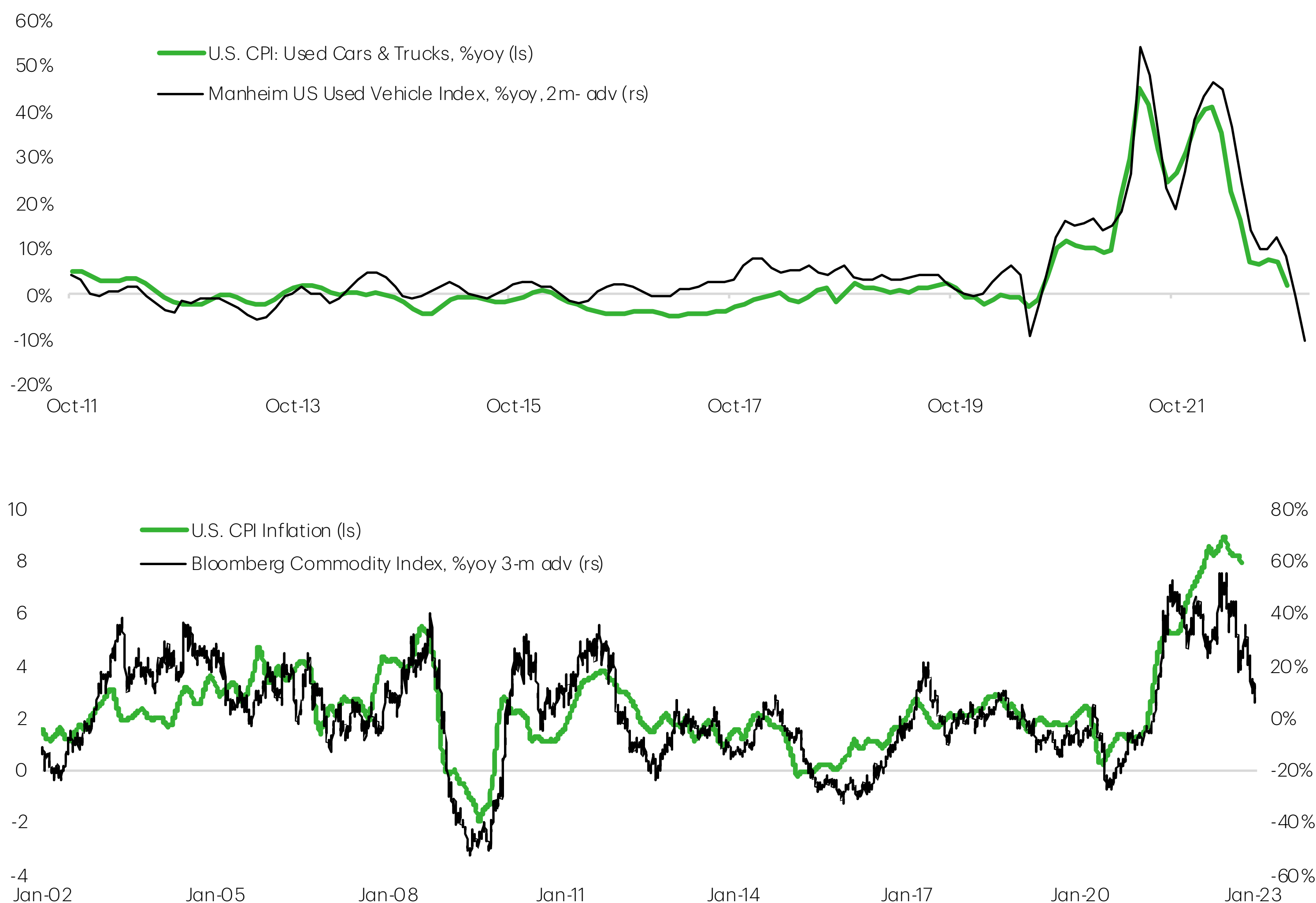
Instead of dwelling on the losses we've incurred, let's look ahead to the segments of the fixed income market that offer attractive opportunities. We believe yields will become even more appealing investment opportunities as implied volatility subsides or central banks change course and focus on underpinning economic growth rather than controlling inflation.

Higher Yields: A Blessing In Disguise?

Historical data suggests that higher yield levels translate into higher total returns in the future. This means that investors could benefit from holding bonds across fixed income asset classes—including government bonds, IG and HY credit, and even emerging markets bonds—because increased income tends to bolster total returns over time, even if prices remain volatile in the short term. In fact, a greater portion of income needs for investors can now be met with traditional fixed income than would have been the case in recent years. Bonds tend to perform well during recessionary periods meaning the backdrop for fixed-income investments could be even stronger when Fed actions start to clip inflation. Remember, higher potential income and improved diversification are two of the bedrock reasons for owning bonds.

Declining Inflation

Figure 4: Inflation begins to tick lower



Source: Bloomberg Finance L.P. as of October 30, 2022

Inflation has remained uncomfortably high this year even as the Fed delivers sizeable rate hikes. Central bankers are becoming increasingly concerned that we've already entered into a "wage-inflation spiral" — a kind of self-fulfilling prophecy where workers demand higher wages to compensate for inflation expectations, which in turn forces companies to raise prices, which further contributes to inflation. If higher wages are being demanded, that could complicate the Fed's job in bringing inflation closer to its 2% target. That being said, recent high inflation has been driven by the increased costs of shelter, food and, more recently, medical services. Meanwhile, prices for some categories of goods, such as used cars, have declined significantly. Shelter inflation, which accounts for 30% of the CPI basket, will also likely cool by the middle of next year, as indicated by the recent drop in rental prices (tracked by Zillow). More importantly, the lagged impact of monetary tightening to the real economy has yet to be felt. With commodity prices tumbling (oil, copper, iron ore, etc.) on a year-over-year basis, headline CPI inflation should also turn lower in 2023.

Heightened Geopolitical Risk

Figure 5: Ukraine scenario probabilities

	Description	Probability	Latest change
Russia Holds the Line	Further Ukrainian gains lead to only limited changes to the front line; asymmetric Russian actions against NATO and Ukraine; US and EU add marginal to moderate additional sanctions	50%	Down from 60% on October 10, 2022 ▼
Russia Lashes Out	Ukraine makes major territorial gains; Russia intensifies attacks in Ukraine and asymmetric retaliation against NATO/EU states; WMD risk increases; significant new Western sanctions	45%	Up from 35% on October 10, 2022 ▲
Pause	Ukraine and Russia pause offensive actions and regroup; no substantial diplomacy; new sanctions are limited to enforcement actions	5%	No change

Source: Eurasia Group as of November 14, 2022

Geopolitical risk is hard to quantify, and its impact is usually short-lived. However, it appears the tide towards a more peaceful world may be shifting with heightened geopolitical risks globally. The great "peace dividend" that saw governments divert defence spending in favour of social welfare spending may face headwinds from here on out. An example of this shift came earlier this year when Germany — the fourth largest economy in the world — announced that it would ramp up defence spending in order to counter an increasingly aggressive Russia.

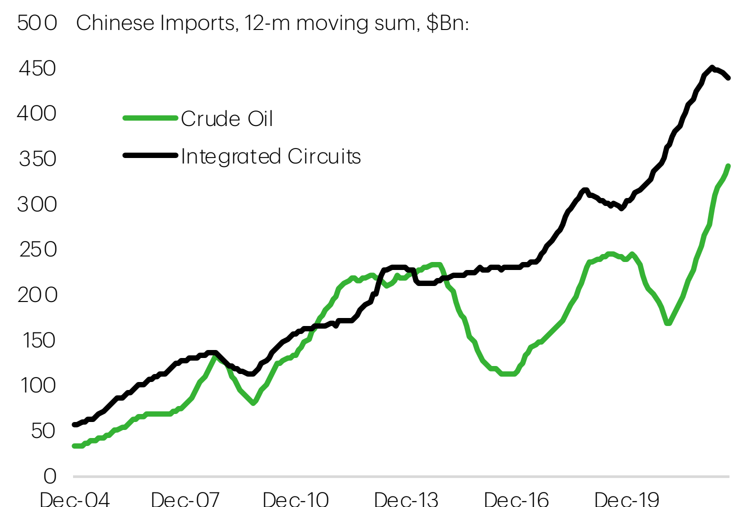
The shift towards heightened geopolitical risk began increasing with the rise in populism globally, then was exacerbated by the pandemic, and topped off by Russia's invasion of Ukraine in February of this year. This conflict is the largest and likely most dangerous military act since World War II and holds a constant risk of escalation between NATO and Russia.

To put this all into perspective, and get some sense of what the future may hold, let's look at the Eurasia Group's estimated probability of various scenarios. According to their estimates, the probability that the Russian military will be able to stand their ground against superior conventional armament supplied by Ukraine's Western allies has fallen from 60% to 50%, indicating erosion of Russian military capability. The likelihood that Russia will lash out by targeting civilians or using weapons of mass destruction, however, has risen from 35% to 45%. Unfortunately, Eurasia Group offers only a 5% chance that a ceasefire is issued, which is a view shared by many political commentators. The full impact of this war remains unknown, but there are strong indications that it has the potential to be large and protracted. We saw the immediate impacts of heightened market volatility; unprecedented financial sanctions; price spikes in energy, metals and grains; plus added strain on supply chains that were still stressed by two years of pandemic. Longer-term impacts may include the reversal of the historical trend toward peace; as well as the reversal of the trend towards globalization (which we think will be one of the biggest themes going forward).

Sino-U.S. Relations

Microchips permeate all aspects of our life — from powering our smartphones, TVs and laptops, to guiding ballistic missiles. War is no longer decided by which side has more tanks, fighter planes or infantry. Drones and smart missiles that lock in and target with high precision are increasingly changing the balance of power in the battlefield. This has made access to advanced chips a matter of national security that both the West and China can no longer take for granted. In October, the U.S. announced a new export control that prohibits the sale of advanced chips to China, while also effectively banning U.S. citizens and residents from helping China develop its own semiconductor industry and catch up to the West. This matters greatly to China, which is still highly reliant on imports for the advanced technology that powers its industry, despite efforts to push for home-grown innovation. Given that a single company in Taiwan (TSMC) produces 92% of world's most advanced chips, the geopolitical stakes could not be higher.

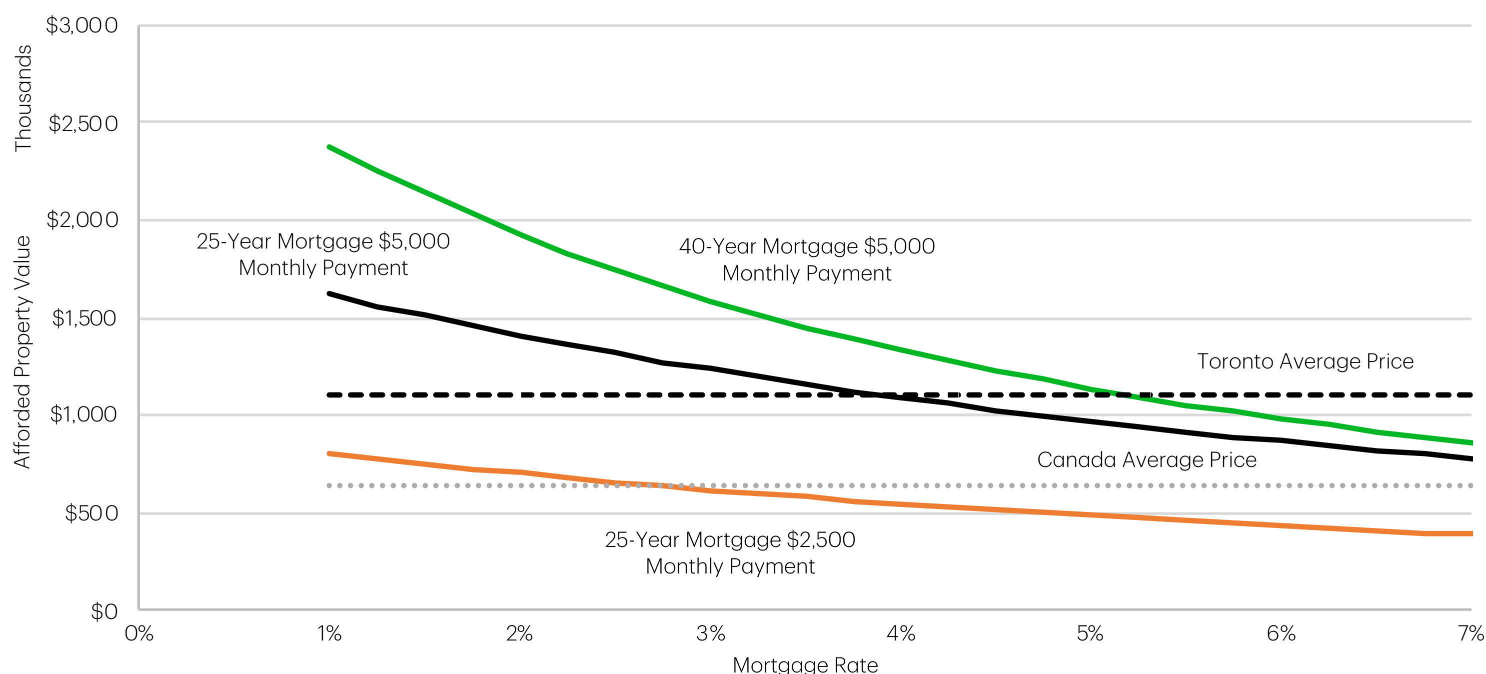
Figure 6: China's growing appetite for microchips



Source: Bloomberg Finance L.P. as of October 30, 2022

Housing Market Challenged

Figure 7: Housing Affordability Based on Income & Interest Rate



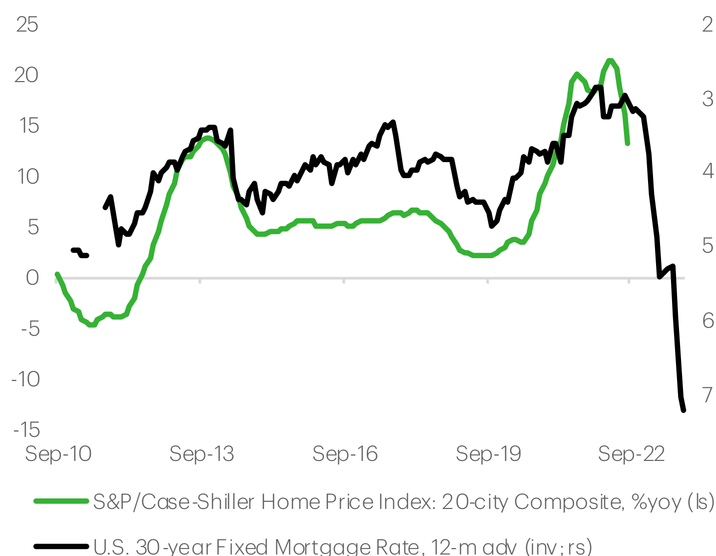
Source: TD Wealth, CREA as of September 30, 2022

The debate about the housing market comes down to two camps: the optimist would argue that the structural tailwind of Canada's immigration policy and the inflow of wealth combined with a dearth of inventory will support the Canadian real estate market whereas the cautious points to the fact that housing affordability has gone from worse to the worst.

Following the real estate boom during the pandemic, when monetary stimulus brought mortgage rates down to record lows, housing activity has cooled rapidly. This year, the 30-year fixed mortgage rate (in the U.S.) rose from 3% to above 7.3%. Without a doubt, interest rates are the single most important factor for housing affordability. For example, for a 25-year mortgage with a $5,000 monthly payment, the afforded house value drops from $1.4 million to around $870,000 as the rate goes up from 2% to 6%. However, an important nuance is that when the mortgage rate surpasses 6%, affordability is much less sensitive to rate change or term of the loan. Given how fast rates have increased in Canada, it is likely most of the damage on affordability has been done and it is possible we have not yet completely felt it.

High-frequency indicators are pointing to a slump in housing starts, sales and prices in the coming quarters. As consumers wage a battle against inflated prices for all their daily necessities, especially as income fails to catch up with inflation, their capacity to spend on housing will be significantly curtailed. Fundamental indicators all argue against higher house prices, amid elevated price-to-income and price-to-rent ratios in developed countries. Limited income and rent growth mean that housing prices will need to adjust for the ratios to revert to historical averages.

Figure 8: Higher mortgage rates to cool housing prices



Source: Bloomberg Finance L.P. as of October 30, 2022

Cooling Labour Market

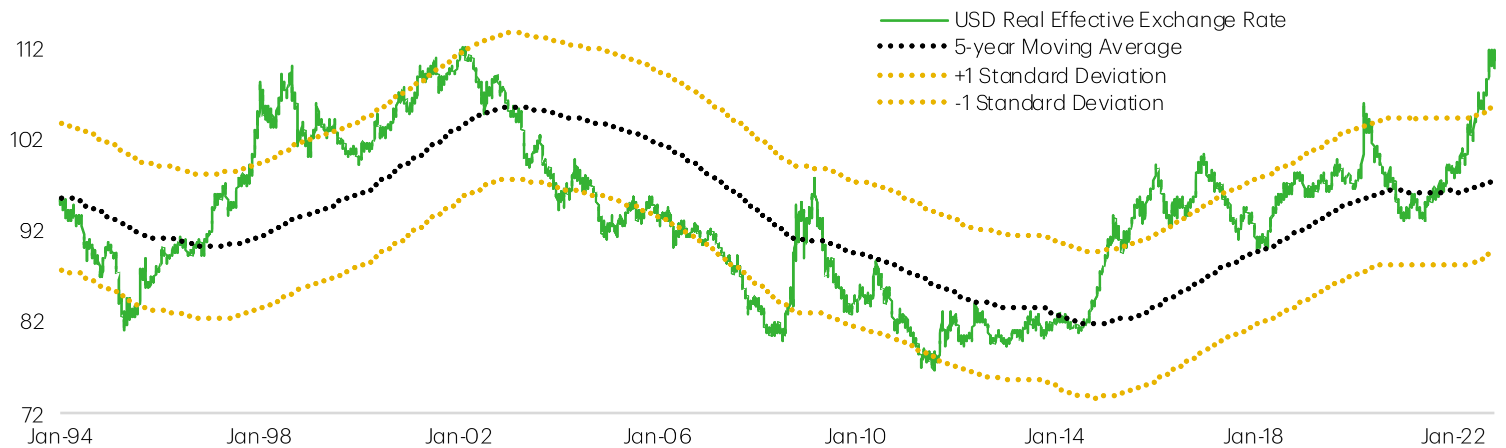
Figure 9: High energy, USD to rein in labour market

Source: FactSet as of October 30, 2022

Strong U.S. economic growth and a weak recovery in the labour-force-participation rate have widened the imbalance between supply and demand for labour this year, with data from the U.S. Bureau of Labor Statistics showing that there were 1.6 job openings for every unemployed person as recently as September. However, as the risk of a deep recession in the U.S. rises, labour demand is likely to cool. Already, we are seeing companies in cycle-sensitive sectors announce layoffs. On the supply side, we expect more people to join the labour force as the cost-of-living crisis remains a challenge and pandemic fears ease. Our growth tax indicator continues to point to a higher unemployment rate in the 18 months ahead.

Dollar Deflation

Figure 10: USD trading well over its 5-year moving range

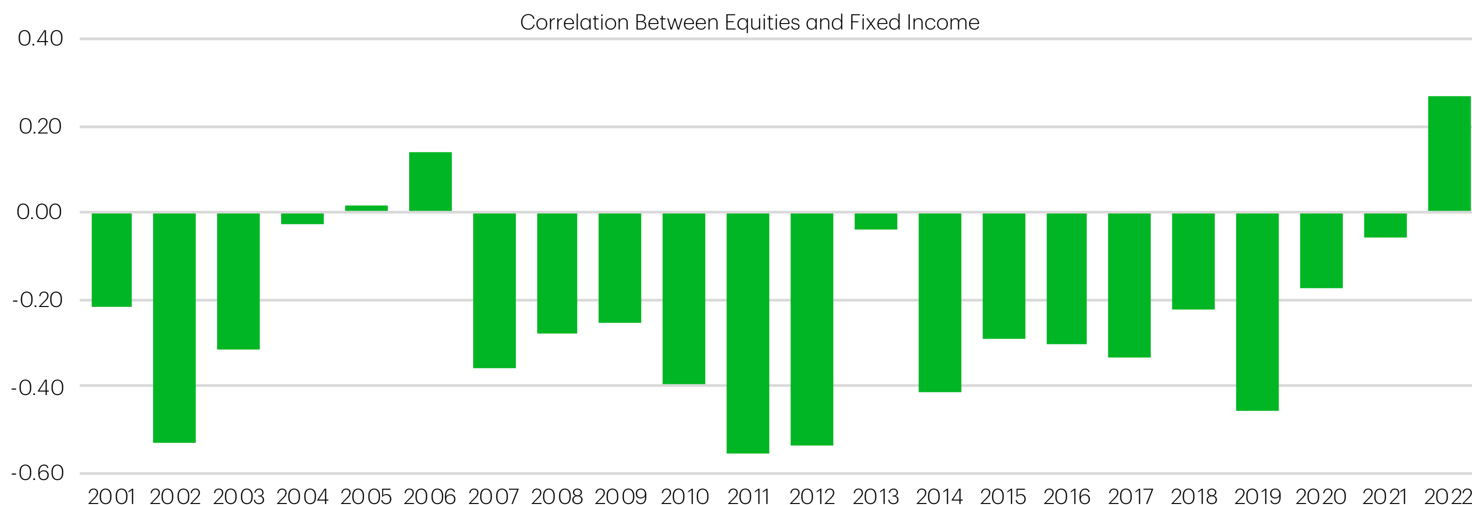


Source: Bloomberg Finance L.P. as of October 30, 2022

The greenback has advanced more than 15% over the past year relative to the currencies of its trade partners. A more aggressive Fed, capital flows into U.S. assets and a weak growth outlook across Europe and China have all exacerbated the strength in the dollar. There are two primary factors that could reverse this trend. First, the market is increasingly pricing in a “Fed pivot” as the whole yield curve becomes inverted, signalling a recession within the year. A narrowing of yield differential between the U.S. and other central banks should make the U.S. dollar less attractive and foreign assets more so. Second, growth outside the U.S. could start to pick up in 2023. The Chinese credit impulse index, a measure of credit growth in China,has been picking up momentum, and Europe seems to have been able to avoid the worst-case scenario related to the energy crisis. Weaker U.S. growth relative to other regions historically coincides with periods of dollar weakening.

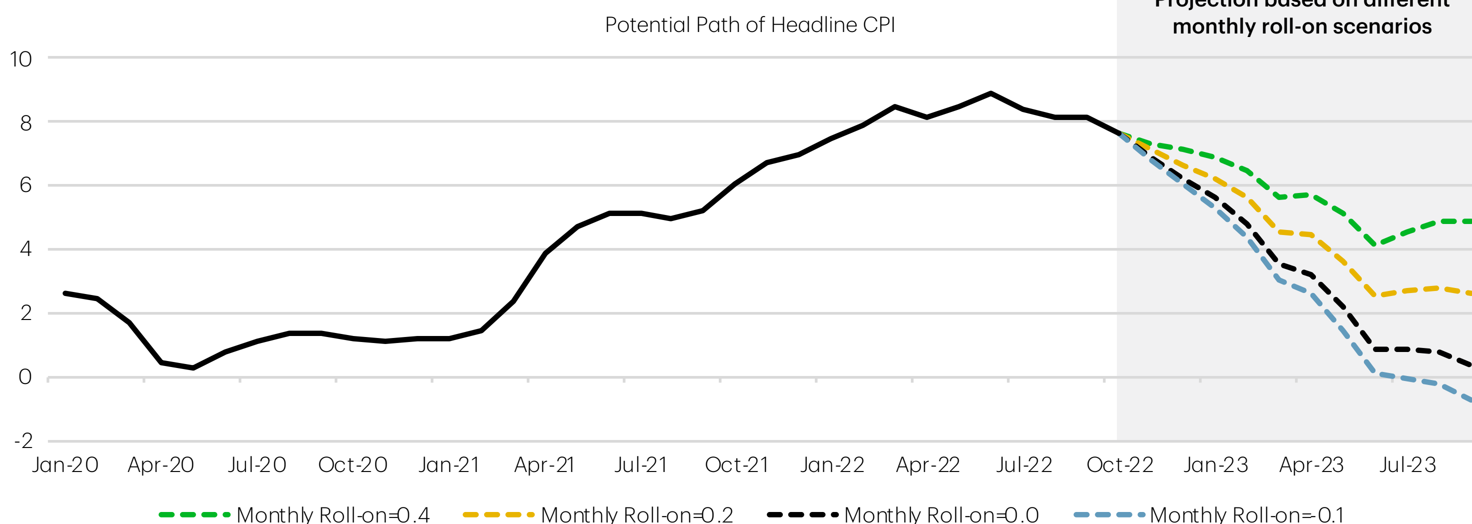
Stock/Bond Correlations

Figure 11: Negative correlation may reestablish



Source: Bloomberg Finance L.P. as of October 31, 2022

Figure 12: Inflation expected to normalize

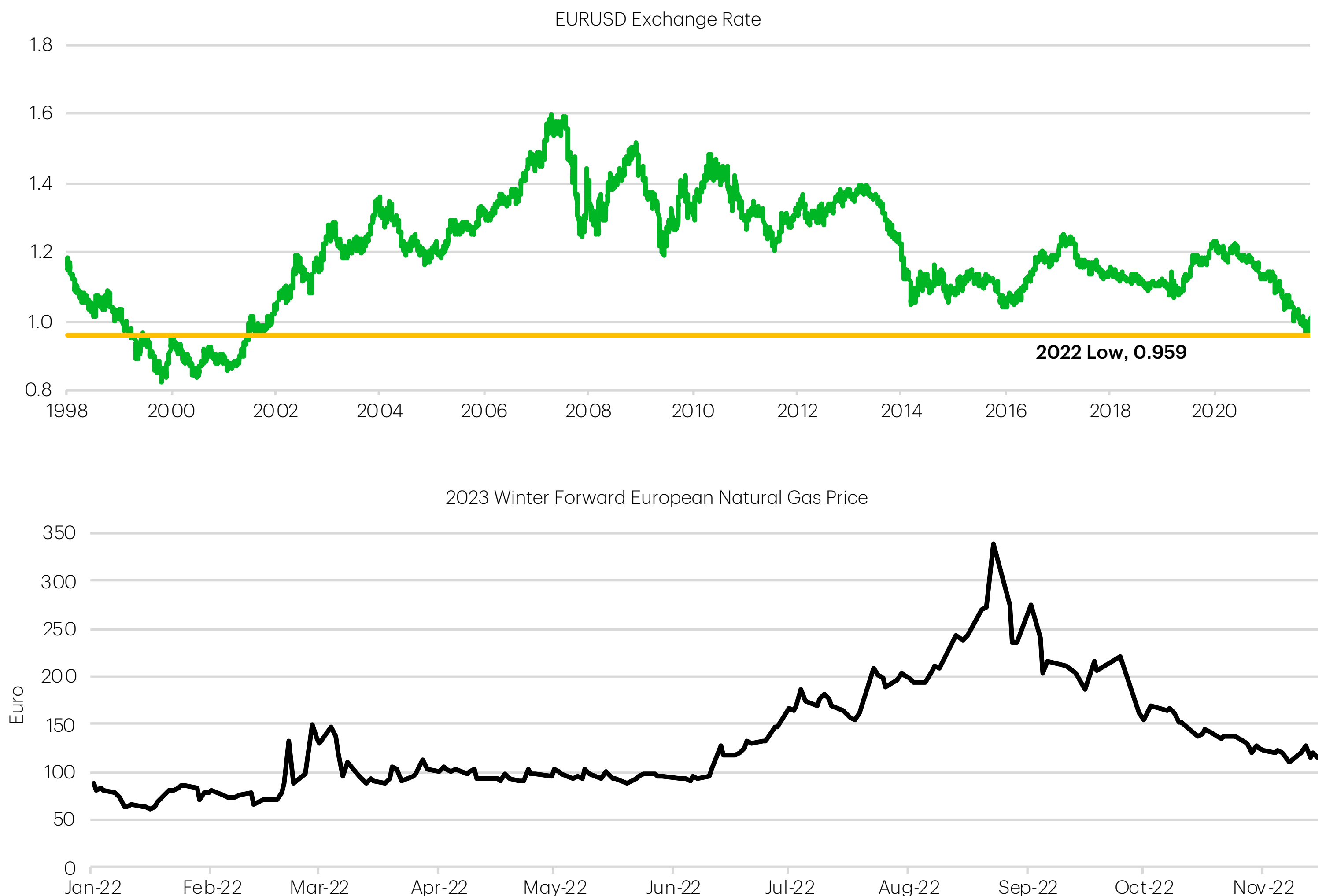


Source: Bloomberg Finance L.P. as of October 31, 2022

In 2022, the correlation between stocks and bonds hit a new high with a balanced portfolio delivering some of the weakest performance seen in decades. In this environment, the typical balanced portfolio failed to show any diversification benefit. While the 60/40 portfolio has worked well for more than 10 years, we saw a similar correlation breakdown in 2008. Cash has once again become the top diversifier, according to the Bank of America Fund Manager Survey, which recorded the highest cash level since 2001 in October 2022. Going forward, a couple things could nudge the correlation back to its historical negative relationship. First, long-term yields could fall. At their current level, government bond yields are attractive again, in both nominal and real terms. This provides positive real carry and plenty of room for the yield to drop in a bear market. Second, inflation could normalize, which is expected in the first half of 2023, due to base effects and the recent easing of energy, used car, and transportation prices. Against this backdrop, we are unlikely to see persistent hawkish surprises from the Fed, which has been a constant headwind for stocks and bonds.

International Sentiment Reversal

Figure 13: European markets could bounce back alongside improved sentiment



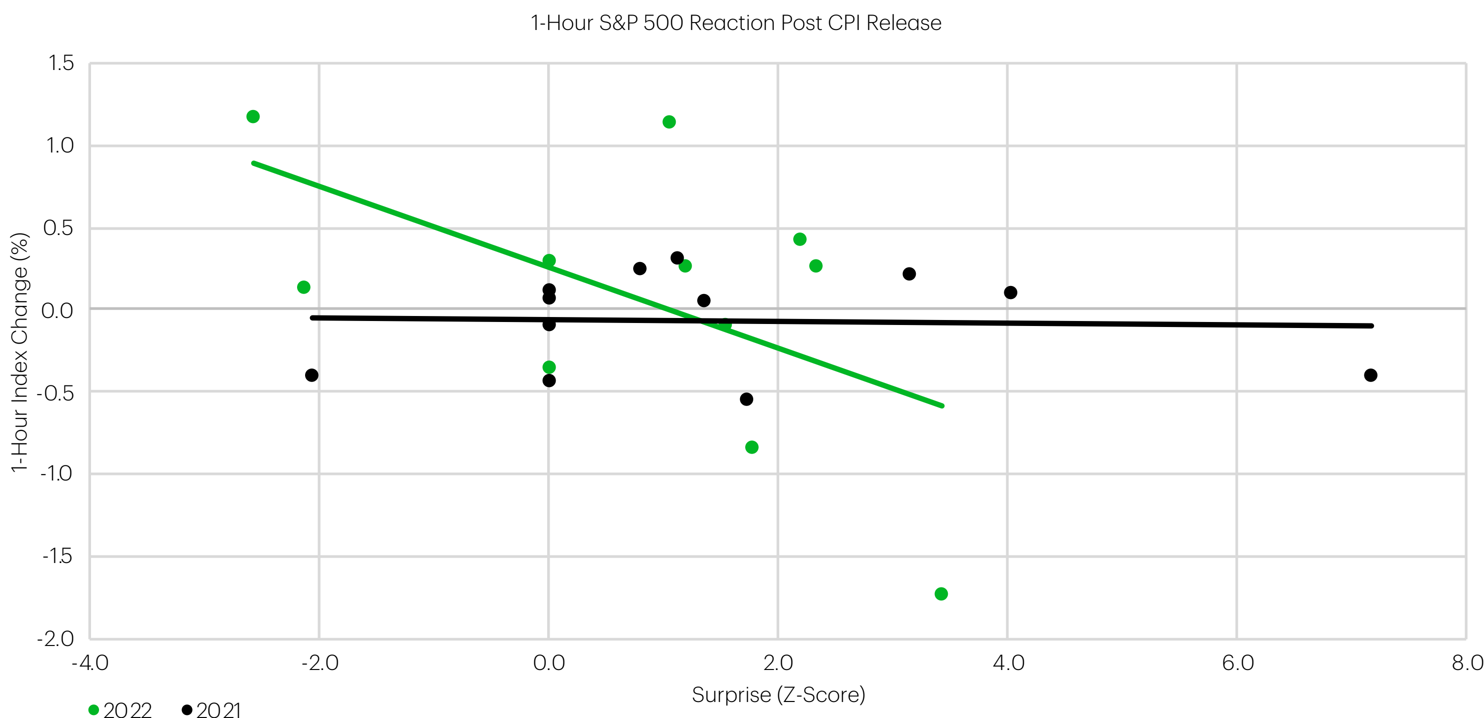
Source: Bloomberg Finance L.P. as of October 31, 2022

While inflationary pressures and geopolitical risks continue to cloud the outlook for global equities, we see some opportunity within international (Europe) and Chinese equity markets as they appear inexpensive on a forward price-to-earnings basis relative to their history and to U.S.equities.

In China, the lead-up to the National Congress meeting in spring of 2023 could see a sentiment reversal in China triggered by the government's possible easing of certain detrimental policies. These include the zero-Covid policy, the property-market crackdown, anti-trust campaigns over the tech sector, investigations of overseas corporations, and geopolitical tension with the U.S. and Taiwan. These issues will continue to create challenges for Chinese equities, as speculating on political decisions is fraught with error. However, expectations are that with the party congress behind it, China's government will begin to provide support to the ailing economy. As a result, beaten-down Chinese equities and high-yield bonds could enjoy a strong rebound. The other obvious region where we could see a reversal is Europe, which has been weighed down by geopolitical tensions, elevated inflationary pressures, monetary tightening and an energy crisis. In September, the euro hit a level not seen since the early 2000s. Although the war in Ukraine has not come to an end, fears over a natural gas shortage over the winter months have dwindled as unseasonably warm weather and high inventory levels ease the risk for the next winter. European equity markets are in the same camp as Chinese equities. With a 9% earnings yield, over 4% dividend yield and a potential reversal of the euro, the risk is to the upside in 2023.

Investor Behaviour

Figure 14: Market reaction to inflation news intensifies



Source: Bloomberg, as of October 31, 2022

This year the markets have been driven by macroeconomic events, a fact that is particularly evident in the hedge fund arena. Global macro and commodity-trading advisor (CTA) funds have been the best performing strategies this year. Both strategies thrive in high macro uncertainty and market volatility. Economic releases are closely watched and being speculated on. In the accompanying scatterplot, we compare the one-hour post-release market reaction to monthly CPI figures in 2021 and 2022. In 2021, there were bigger CPI surprises, but they did not meaningfully move the market. In 2022, meanwhile, the release of inflation figures has prompted furious trading. For long-term investors, the implication is that investment decisions next year could be subject to heightened and little understood volatility. Underinvesting, holding cash or hedging (thus high CFTC hedge positions) are natural coping mechanisms in this noisy market, but as the uncertainty around future inflation, the economic outlook and monetary policy gradually recedes, short traders will likely retreat to make room for stock pickers, leading to higher risk sentiment and investment flows.

Conclusion: Stick to Your Principles

The days of relying on monetary policy to drive portfolio returns have likely come to an end. Correspondingly, reliance on what worked the past few years may not work as well going forward. In a world that is open and complex, the only thing you can be certain of is that uncertain things will occur. Long-term, high inflation along with significantly higher interest rates, while unlikely, are possible. Credit can restrict and spreads can widen when you least expect it. Companies will fail, countries will wage wars, and volatility in financial markets will be the result. We must embrace human nature and, in doing so, challenge our blind spots.

As we move forward, our approach will be to follow our principles, which are based on the conviction that markets are adaptive. Financial markets are always evolving as its participants learn, adapt and innovate. The process of natural selection takes its toll on individuals, institutions and markets. Times like these are the natural order of things, and while recessions can be painful, they are the natural mechanism for clearing out excesses in advance of the next period of growth. This evolutionary process is what determines financial-market dynamics, risk and returns.

Market Performance

Canadian Indices ($CA) Return	Index	(%) 1 Month	(%) 3 Months	(%) YTD	(%) 1 Year	(%) 3 Years	(%) 5 Years	(%) 10 Years	(%) 20 Years
S&P/TSX Composite (TR)	74,921	5.57	-0.55	-6.19	-4.89	8.84	7.12	7.76	8.78
S&P/TSX Composite (PR)	19,426	5.32	-1.35	-8.47	-7.66	5.63	3.92	4.57	5.84
S&P/TSX 60 (TR)	3,696	5.65	-0.08	-6.16	-4.04	9.47	7.80	8.46	9.17
S&P/TSX SmallCap (TR)	1,157	3.72	-6.08	-13.18	-15.29	8.46	2.84	3.60	0.05
U.S. Indices ($US) Return									
S&P 500 (TR)	8,219	8.10	-5.86	-17.70	-14.61	10.22	10.44	12.79	9.81
S&P 500 (PR)	3,872	7.99	-6.25	-18.76	-15.92	8.43	8.50	10.61	7.65
Dow Jones Industrial (PR)	32,733	13.95	-0.34	-9.92	-8.62	6.57	6.96	9.59	7.04
NASDAQ Composite (PR)	10,988	3.90	-11.32	-29.77	-29.10	9.84	10.31	13.95	11.14
Russell 2000 (TR)	9,663	11.01	-1.68	-16.86	-18.54	7.05	5.56	9.93	9.76
U.S. Indices ($CA) Return									
S&P 500 (TR)	11,217	7.64	0.19	-11.40	-5.89	11.56	11.71	16.35	9.07
S&P 500 (PR)	5,285	7.53	-0.23	-12.54	-7.34	9.75	9.74	14.11	6.94
Dow Jones Industrial (PR)	44,674	13.47	6.06	-3.02	0.71	7.87	8.19	13.06	6.33
NASDAQ Composite (PR)	14,997	3.46	-5.62	-24.39	-21.86	11.18	11.57	17.55	10.40
Russell 2000 (TR)	13,188	10.54	4.64	-10.49	-10.22	8.36	6.77	13.41	9.03
MSCI Indices ($US) Total Return									
World	11,416	7.21	-6.74	-19.74	-18.09	6.62	6.92	9.52	8.64
EAFE (Europe, Australasia, Far East)	8,076	5.39	-8.95	-22.81	-22.62	-0.82	0.39	4.61	6.40
EM (Emerging Markets)	2,114	-3.09	-14.01	-29.15	-30.73	-4.07	-2.73	1.16	8.59
MSCI Indices ($CA) Total Return									
World	15,580	6.75	-0.75	-13.59	-9.73	7.92	8.14	12.99	7.92
EAFE (Europe, Australasia, Far East)	11,022	4.94	-3.10	-16.90	-14.72	0.40	1.54	7.92	5.69
EM (Emerging Markets)	2,885	-3.50	-8.49	-23.73	-23.66	-2.89	-1.62	4.36	7.86
Currency									
Canadian Dollar ($US/$CA)	73.27	0.42	-6.04	-7.11	-9.26	-1.21	-1.13	-3.07	0.67
Regional Indices (Native Currency, PR)									
London FTSE 100 (UK)	7,095	2.91	-4.43	-3.93	-1.98	-0.71	-1.09	2.07	2.86
Hang Seng (Hong Kong)	14,687	-14.72	-27.14	-37.23	-42.13	-18.27	-12.26	-3.80	2.23
Nikkei 225 (Japan)	27,587	6.36	-0.77	-4.18	-4.52	6.36	4.62	11.94	5.98

Benchmark Bond Yields	3 Months	5 Yrs	10 Yrs	30 Yrs
Government of Canada Yields	3.87	3.41	3.25	3.29
U.S. Treasury Yields	4.09	4.23	4.05	4.17

Canadian Bond Indices ($CA) Total Return	Index	1 Mo (%)	3 Mo (%)	YTD (%)	1 Yr (%)	3 Yrs (%)	5 Yrs (%)	10 Yrs (%)
FTSE TMX Canada Universe Bond Index	1,040	-1.00	-4.23	-12.66	-10.43	-2.78	0.13	1.57
FTSE TMX Canadian Short Term Bond Index (1-5 Years)	728	-0.06	-1.56	-4.74	-4.17	-0.24	0.80	1.30
FTSE TMX Canadian Mid Term Bond Index (5-10)	1,151	-0.40	-4.00	-10.96	-9.09	-1.88	0.50	1.88
FTSE TMX Long Term Bond Index (10+ Years)	1,581	-2.83	-8.04	-23.19	-19.14	-6.77	-1.13	1.63
HFRI Indices ($US) Total Return								
HFRI Fund Weighted Composite Index	17,414	2.00	-0.02	-4.45	-5.28	6.62	4.69	4.84
HFRI Fund of Funds Composite Index	7,106	1.47	0.48	-5.42	-6.49	4.53	3.17	3.65
HFRI Event-Driven (Total) Index	19,951	3.70	1.27	-4.31	-4.57	6.39	4.64	5.21
HFRI Equity Hedge Index	26,223	2.93	-1.64	-11.28	-12.21	6.77	4.75	5.65
HFRI Equity Market Neutral Index	5,988	-1.03	-0.10	-0.61	-0.13	2.25	1.68	2.88
HFRI Macro (Total) Index	19,349	0.95	3.59	11.51	9.85	8.50	5.36	3.41
HFRI Relative Value (Total) Index	13,759	-0.34	-1.17	-2.45	-2.71	3.34	3.21	4.03
HFRI Indices ($CA) Total Return								
HFRI Fund Weighted Composite Index	23,751	0.91	6.44	3.03	4.21	7.89	5.86	8.15
HFRI Fund of Funds Composite Index	9,692	0.40	6.96	1.98	2.89	5.77	4.33	6.93
HFRI Event-Driven (Total) Index	27,211	2.60	7.81	3.18	5.00	7.66	5.82	8.53
HFRI Equity Hedge Index	35,766	1.84	4.71	-4.34	-3.41	8.05	5.93	8.99
HFRI Equity Market Neutral Index	8,167	-2.08	6.34	7.17	9.88	3.47	2.82	6.13
HFRI Macro (Total) Index	26,391	-0.12	10.27	20.24	20.86	9.80	6.55	6.68
HFRI Relative Value (Total) Index	18,766	-1.40	5.20	5.18	7.04	4.58	4.37	7.31

Sources: TD Securities Inc., Bloomberg Finance L.P. TR: total return, PR: price return. As of October 31, 2022.

Wealth Investment Office, TD Wealth

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Richard Nguyen | Senior Portfolio Consultant
Shaun Arnold | Senior Portfolio Consultant
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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
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