Monthly Newsletter
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Wise Investor – July 2022

Executive Summary

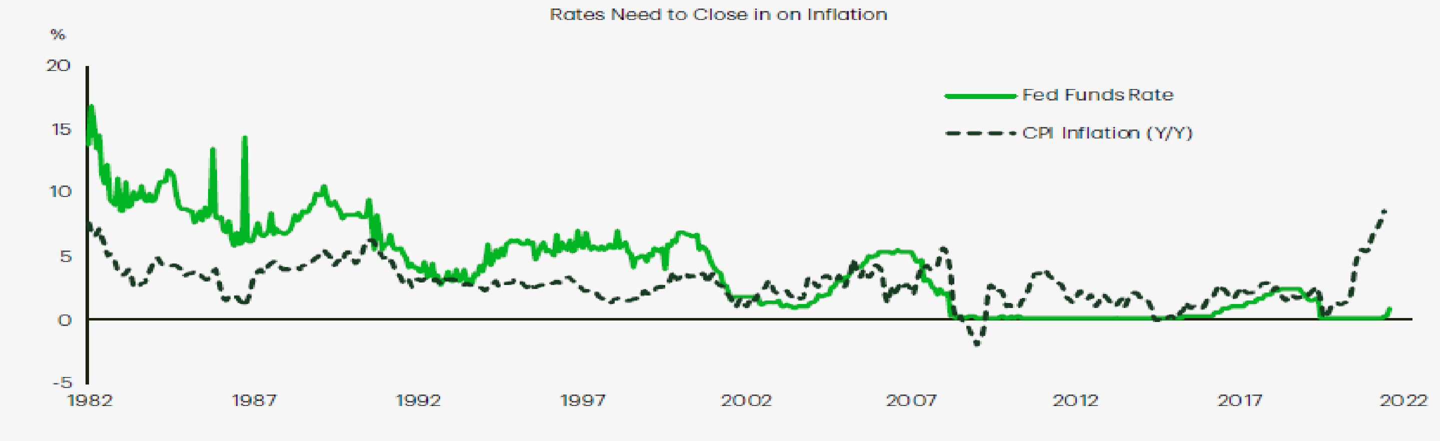
When I was a child, one of my aunts used to give me Canadian Savings Bonds as a Christmas gift each year. At first, I was taken aback and much preferred the new pair of sneakers or baseball cap to a small piece of paper that ended up locked away in our safety deposit box for years. My opinion quickly changed when those years had passed, and the piece of paper could be exchanged for real money in a much larger sum than the original number suggested. I quickly learned how fast money compounded at 10% risk free. I can still remember as a 11-year-old how irate my mother was when we went into the local bank to renew one of my maturing savings bonds and the rate had fallen from over 10% to 7.5%. I was far too young to understand that the rate had fallen drastically as I was experiencing my first recession and that rates had only gotten so high over the previous decade to fight out of control inflation. I sure wish there would have been an option to lock-in that Canada savings bond at 10% for the next 30 years but at the time, I probably wouldn’t have anyways. I don't blame my ignorant 11-year-old self but sometimes it's important to take a step back and think about where we have come and what the future holds before we make too drastic of a conclusion about where we are.

It was only a few years ago when the pandemic hit, the economy shut down, panic ensued, and we thought we were on the edge of a deep depression. How quickly that changed, and the stock market marched ahead after dropping over 30% in a month! Although we are facing a completely different shock at the moment, there will come a time that we look back on this as brief period of decline and likely even a great opportunity to buy high quality companies at cheap prices. Although I believe we still have some volatility in the near term, I think the worst of the pain is in the rearview.

In this month's article I will touch on a lot of the topics discussed at our Mid-Year Market Update Webinar, most specifically:

- **What we're seeing in the latest inflation data**
- **The drastic changes in interest expectations and their influence on investments**
- **What we expect we need to see before a sustained recovery**
- **How to think about positioning a portfolio for the road ahead**

Figure 1: Interest Rates Follow Inflation



Source: Bureau of Labour and Statistics, Federal Reserve Board, TD Economics as of April 2022.

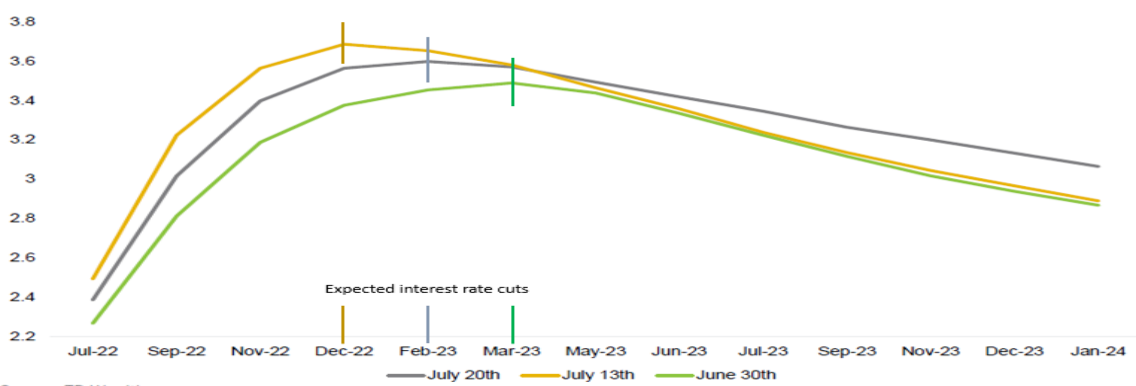
What's Happened Lately

Until 2022, inflation was never a dinner-table conversation in my household but it's hard to do anything these days without the topic of higher prices coming up. With inflation running at 40-year highs, Canadian and US central banks are currently down a path of aggressive interest rate policy which has resulted in negative stock and bond performance. In fact, the first quarter of this year was the first in 35 years that both stocks and bonds lost money simultaneously. I'm sure we've all heard enough about the things that have contributed to the high inflation, but I would say the three most important include stimulus cheques and excess savings flooding the market when lockdowns ended, followed by supply chain constraints, then a war. Now the governments have to play catch up in an attempt to slow spending demand, which is the only of the three they have some control over when fighting inflation.

In my last publication I wrote a lot about how interest rates and, more importantly, interest rate expectations are influencing the investment world and the inverse relationship rates have with both stocks and bonds. On top of all that, June brought with it increased fears of a recession which finally took the legs out of the last positively performing sector for 2022, energy. As we do every month, we compiled all the latest data into our **Recessionary Indicators Dashboard** and found that the risks of a recession in the next 6 to 12 months have certainly increased. Unfortunately, I believe our destiny is largely in the hands of central bankers and not being helped by Russia or China which I will elaborate on next. I believe the most important thing to fix is inflation as we've seen in the urgency from central bankers but that must be balanced against what the economy can bear as we continue down the path of one of the most rapid interest rate adjustment periods in history. Over stimulating in the pandemic led to an error early in this cycle of having waited too long to raise rates which can now quickly turn into an even worse mistake by overcorrecting. There is little margin for error.

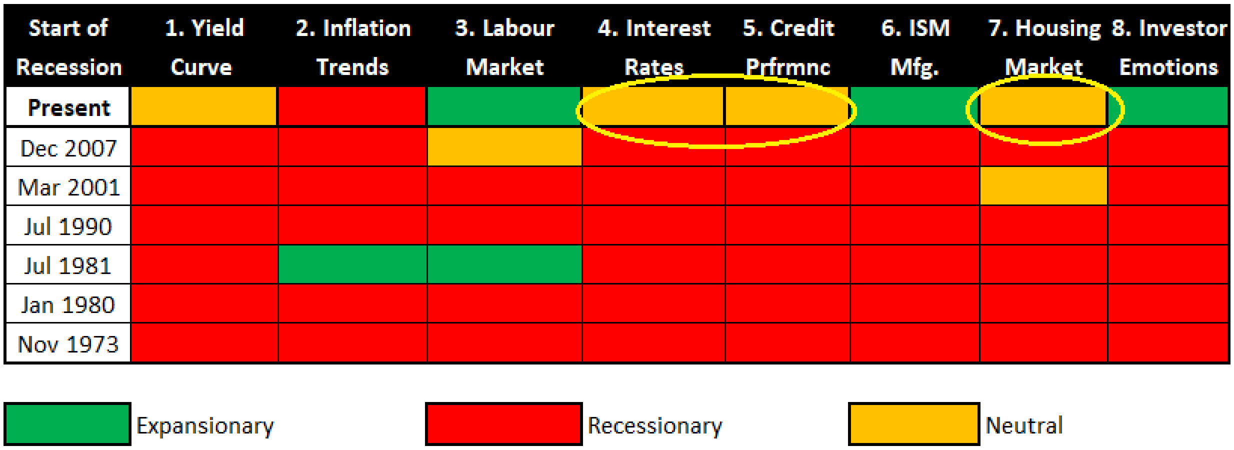
July has been met with a bit of a market recovery. I would equate this to a reversal of interest rate expectations. In fact, as of July 22nd 2022 the bond market is calling for the first interest rate cut in February 2023. Much like the drastic changes in interest rate increase expectations we witnessed through the first half of the year, this too has been a moving target as the expectation only 1 month ago was for the first cut to take place in June 2023 (see chart 1). This can be looked at in 2 ways. On the positive hand, expectations of a rate cut, also known as the "Fed put" in financial talk, will likely drive stock prices up. On the negative, this means that the bond market is expecting a significant economic slowdown which could be accompanied by a recession, albeit I would expect a mild one.

Chart 1: Interest Rate Expectations



Source: TD Wealth

Figure 2: Recessionary Indicators Dashboard



source: Marley Snow, as at July 25, 2022

Why Should We Care

With recession warnings exploding across headlines, I wanted to take a moment to explain what a recession is and what that might mean for investments. An official recession can only be determined by the National Bureau of Economic Research (NBER) who decide when a recession starts and ends. You may hear or read that the definition of a recession is two consecutive quarters of negative GDP growth although that is not the only way NBER can determine a recession has occurred. I make this point because the US had negative GDP growth in Q1, but not because the economy was shrinking but because inventories were building abnormally high due to supply chain constraints and those impact GDP, despite the strong Q1 economic performance. The most recent preliminary data would suggest we may get an actual economic slowdown with a negative print for Q2 GDP which would surely sound the recession alarm bells in the media. An important takeaway here is that most recessions have been defined long after the real slowdown has ended, and the recovery is already underway. If the Fed does pivot on the back of inflation falling, one could argue the market has already bottomed and is on the road to recovery, but I think it may be early to suggest that. If we take a moment to look at my Recessionary Indicators Dashboard, I find it hard to believe that we are currently in a recession although some areas have deteriorated over the last few months.

If we look at the yield curve we find that the most important comparison, 10-year bond yields vs 3-month bond yields, is not yet inverted which is a harbinger for a recession. With that said, the 10-year/2-year is now inverted and if rate increases go the path they're expected to, the 10-year/3-mo will likely invert by year end, likely even month end. This indicator again suggests the bond market sees a significant economic slowdown on the horizon and the 10/2 inversion typically has preceded a recession by on average of 11 months over the last 7 recessions. One caveat to that is that on average, the US S&P 500 Index was up 14.6% over those months which suggests, even if a recession is coming, there should be gains to be had and time to adjust ahead of it. Employment remains the largest driver of why I do not believe a recession is imminent as you typically see jobless claims rise solidly above 300k towards 400k and a much higher unemployment rate, currently at multi-year lows. Remember, the consumer is nearly 70% of economic growth in North America. Interest rates have moved into the caution zone mainly because Q1 GDP was negative and a significantly negative Q2 GDP number at the end of July could push annualized GDP below the Federal Reserve rate signaling economic contraction. ISM Manufacturing (PMI) is above 50 which is the line in the sand of growth vs contraction but again, the trend has been negative, so it needs to be monitored. Lastly, housing which has a huge impact on the consumer, has turned cautionary. With mortgage rates more than doubling, demand has started to slow as shown in an increase in housing supply and a slowing of new building permits. Nothing synonymous with a recession yet but again, interest policy will likely have a huge influence and where housing goes from here. Then there's the basic things we would expect to see in our everyday life during a recession like boarded up shops, the silencing of hammers on construction sites, bargains on real estate, large job losses and unpaid credit card debts.

We're not there yet and if employment can stay strong, and rates can stabilize or come back down, there is a path to a soft landing. In a worst case scenario, I believe it would be a mild recession and everyone would feel it differently. For those scraping by or over-leveraged in a variable rate mortgage, or anyone who's employment is tied to the real estate sector, it may be a challenge. I don’t think we would see the spike in unemployment of recessions past therefore most would be able to weather the storm and GDP wouldn’t be as poor based on the strength of the consumer. We would expect the consumer will continue to spend but those spending habits would obviously change, and our investment thesis would need to follow.

	Upside Risk		Current Positioning	Downside Risk
Macro Indicator	Early Stage (22%)	Mid Stage (42%)	Late Stage (22%)	Recession (13%)
Economic Growth	High	Moderate	Low	Negative
Inflation	Low	Moderate	High	Low to Negative
Monetary Policy	Loose	Neutral	Tight	Loose
Term Premium	High	Moderate	Low	Low to Negative
Credit Conditions	Loose	Loose but Tightening	Tight	Enter: Tight; Exit: Loose
Equity Portfolio Considerations	Early Stage	Mid Stage	Late Stage	Recession
Style	Growth	Growth	Value	Value & Income
Business Cycle Positioning	Cyclical	Cyclical	Defensive	Defensive
Sectors	Financials, Technology, Discretionary	Technology, Comm. Services, Industrials, Discretionary	Energy, Materials, Staples, Health Care, Utilities	Health Care, Utilities, Real Estate

Source: TD Wealth

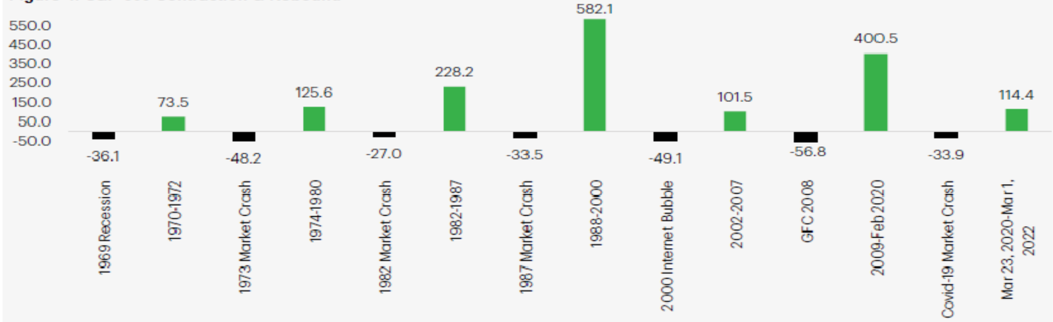
What should we do: Investment Strategy

At this point in the cycle, we need to keep a close eye on the economic data. As stocks fall, there is temptation to sell-out and hold safer investments like cash, GICs or bonds. One thing we know for certain is that inflation is high and likely remains higher than normal for a while. Therefore, from an inflation-adjusted perspective, safer investments may guarantee money-loss over time. Tactically adjusting portfolios through a contraction can help better position for the rebound but completely selling out to time re-investment is very hard. By doing so, investors may miss out on some of the best days of the recovery and having the confidence to reinvest when the news and outlook is the worst is virtually impossible. As you can see in Figures 3 & 4, North American stock markets have suffered through several significant market downturns which were dwarfed by the strong rebounds afterwards.

Ultimately, we never recommend attempting to predict market bottoms, but a volatile environment is a time where we ensure we continue to have well-diversified portfolios that are aligned with each of our clients' individual longer-term goals. When we think about repositioning, I believe the most important thing to focus on at this juncture is corporate earnings. The markets are currently suggesting strong earnings over the next year and any sort of economic slowdown paired with high inflation will likely have to take expectations and stock prices lower. As such, we want to make sure we have some exposure to those sectors and companies that have more reliability in their earnings. For instance, companies that don't rely on energy or commodities for inputs will likely be better positioned or those that can pass along wage increases to end customers. I believe that large tech companies that have been beaten down and discount retailers, utilities or healthcare are preferred sectors in this environment. There's also probably a trade in energy and commodity companies that should show outsized earnings if commodity prices stay elevated. Needless to say, it's a challenging environment with most areas struggling at the moment. But like every contraction in the past a rebound will likely follow, and we believe the environment will favour some areas of the market more than others therefore a focused approach makes more sense now than ever.

Figure 3: TSX Contraction & Rebound

Figure 4: S&P 500 Contraction & Rebound



Source: Bloomberg Finance L.P. and TD Wealth as of May 12, 2022.

Personal Note

It was a slow start to summer as I can probably count the number of sunny days in June on 1 hand. We soaked up the beautiful Canada day weekend at our uncle's house on a small lake on the island. Although a touch too cold for a real swim, taking some quiet time on the dock to admire the fish was very enjoyable and a much-needed recharge in the midst of the chaotic world. Kingston had his first lesson in fishing but was having no part of taking the bass off the line when we had some success. I've never seen anyone quite so scared of a 1 lb fish but then so demanding when we couldn't catch another.

It didn't take long for me to realize how impactful inflation is when I started my backyard shed project. After months of speaking to contractors and trying to convince them to actually show up to provide a realistic quote, I decided to do the build myself. Given the lack of available workers out there I had to put my son to work. Jokes aside, I concluded that North America might actually benefit from slightly higher unemployment. That may sound counterintuitive and suggest I want people to lose their jobs, but I believe if there wasn't 2 job openings for every 1 unemployment, we would probably end up with more productivity as the right people would be in the right jobs. I equate this to a recent paint department visit where it was like pulling teeth to get the cashier to get off her phone and an absolute disaster trying to get a stain matched.

We'll be taking our vacation this year in August with the first time on an international flight in over 3 years. Friends of ours are finally getting married after 2 years of cancellations and decided to commemorate the long delay with a wedding in Italy the 1st week of August. Originally, we were going to make the long journey there and back over the week but in a resent surprise we have learned my wife's parents will be joining us after the wedding. This is unique as it will be my mother-in-law's first time to Europe ever and my father-in-law's 1st time back to where he was born in over 30 years. We decided to extend our trip for the once-in-a-lifetime experience of visiting his tiny hometown outside of Naples to experience authentic Italy with an 'almost' local. Given a few prescheduled work necessities, I will be back fully online through market hours as of August 9th and of course Chris will be available any time that I am not.

I'm hoping that you all find some time for some R&R through the most beautiful season to be in B.C. and look forward to catching up soon. Of course, if you have any questions or comments on anything in this months Wise Investor don't hesitate to reach out. And, f you have any friends or family that might benefit from our perspective, don't hesitate to pass this newsletter along, I appreciate the share.

Best regards,

Marley

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“Wealth is not his that has, but his that enjoys it.”

Benjamin Franklin

We will take as much time as needed to get to know what matters most to you while establishing a strong working and personal relationship. We have every confidence that this relationship can benefit you greatly. We have proven our value time and time again by helping a small niche of high-net-worth Vancouverites realize their lifelong goals.

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