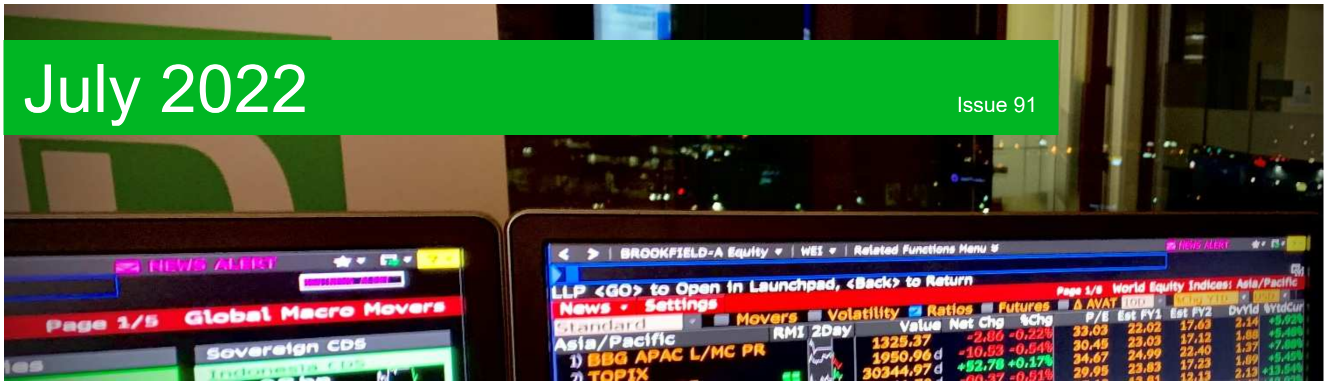
The Charter Group Monthly Letter

July 2022

Issue 91



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Economic & Market Update

Half & Half

The first half of this year was the worst for the various primary asset classes in the last 50 years. It is more common to see many asset classes, like bonds and stocks, move in opposite directions over a stretch of time. And, if they move down together, there are fewer places to hide from the resulting volatility.

The first half of 2022 was historic in terms of both the bond and stock markets falling simultaneously and significantly.

Negative years in the bond markets are relatively rare. Even if bond prices fall, most of these securities generate income. When this is added back, it can produce a positive overall result despite lower bond prices (assuming the decline in bond prices is not too severe and the income yield on the bonds is relatively robust).

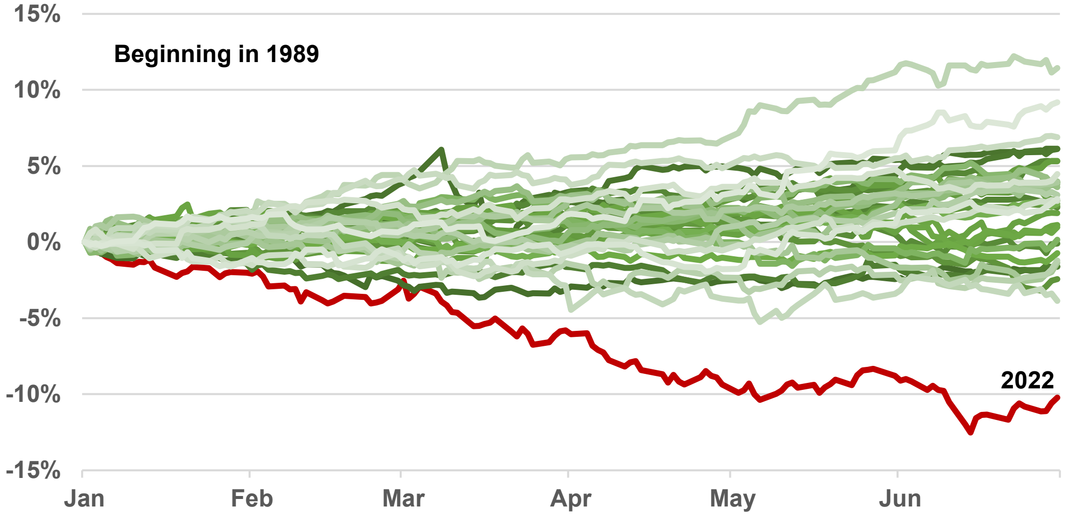
This year, the price declines on bonds have been too great so far to be offset by the interest income (which is still low by historical standards).

Since 1980, there have only been four years where the main U.S. bond market index has been negative. And, in the worst of those years, 1994, it was down -2.92%.[1] 1994 was also the last time U.S. stocks and bonds were both down together during a calendar year. In contrast, the subsequent three negative years for bonds over the next 27 years were accompanied by big stock market gains. During the first half of this year, the main U.S. bond market index was down -10.43% (**Chart 1**), while U.S. stocks as measured by the S&P 500 Index were down -20.58% over the same period, the worst since 1970 (**Chart 2**).

It was the worst first half for stocks since 1970 and, by some estimates, the worst ever for bonds.

Chart 1:

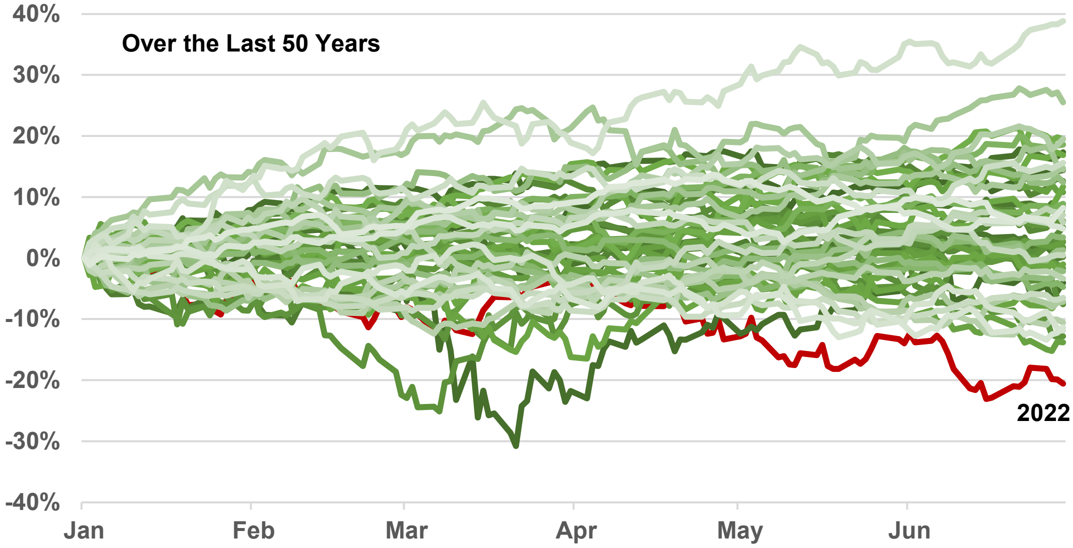
First Half Performance - Bloomberg U.S. Aggregate Bond Index



Source: Bloomberg Finance L.P. as of 7/7/2022

Chart 2:

First Half Performance - S&P 500 Index (U.S. Large Stocks)



Source: Bloomberg Finance L.P. as of 7/7/2022

[1] Source: Bloomberg Finance L.P. as of 7/7/2022. The Bloomberg U.S. Aggregate Bond Index. The negative years since 1980 include 1994, 1999, 2013 & 2021.

You might have noticed that your portfolios with us are not down as much as the stock markets *and* bond markets in general (it is very rare for quality bonds to do worse than multi-asset portfolio as they normally represent a relative safe harbour). Part of this is due to holding investments that have better immunity to inflation (for example, companies that can pass on price increases without suffering a decline in sales).

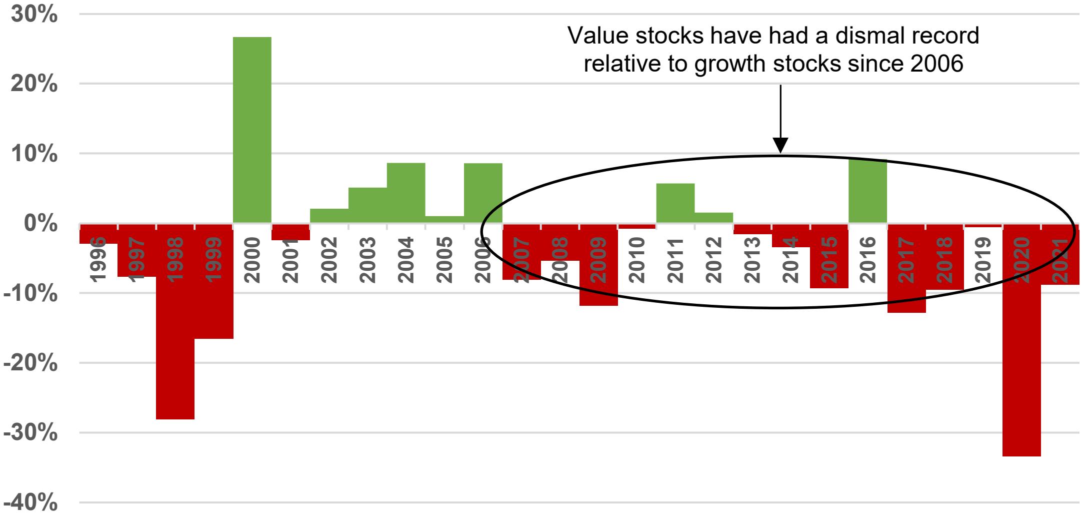
Another reason for this is that more investors are migrating to companies with stronger balance sheets (better positioned to weather uncertainty), more cash (less need to borrow at higher interest rates), and with higher dividends (increasingly investors want some cash returned earlier rather than waiting a decade for a growth company to live up to promises). "Value stocks" is the general term for these kinds of companies, and value stocks are having one of these best runs versus growth stocks in years (**Chart 3**). Both value and growth were down over the first six months, but the decline in growth stocks has been much more dramatic (**Chart 4**).

However, within the markets and within asset classes, not everything was down by the same amount.

There was some relative shelter in value stocks and the stocks of companies that are able to pass along price increases without hurting sales.

Chart 3:

US Large Value Stocks vs US Large Growth Stocks
Relative Difference in Calendar Year Performance

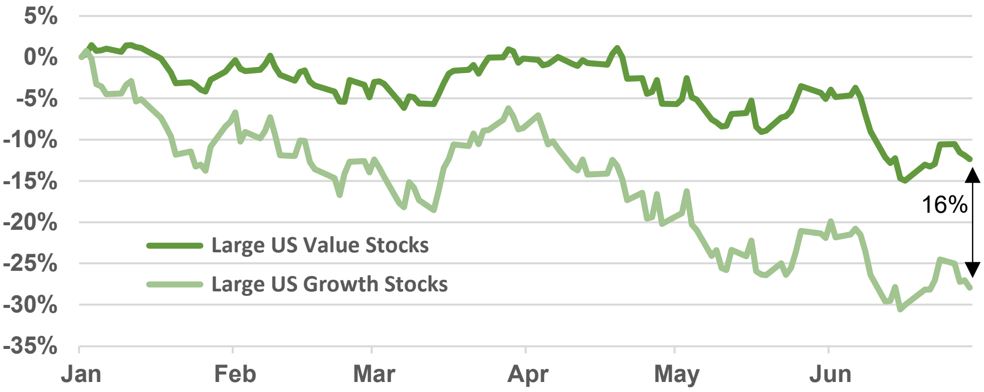


Source: Bloomberg Finance L.P. as of 7/7/2022

Over the last decade, there has been some published academic research which has argued that the low inflation / low interest rate era had been bad for value stocks. Investors may feel that they don't need the extra safety provided by value stocks in such an environment. However, from a valuation perspective, low inflation / low interest rates magnify the good news that is far off into the future, and that is what growth stocks offer. The first significant dose of inflation in 40 years and the higher interest rates needed to combat rising prices have appear to change the landscape for value versus growth.

Chart 4:

Value versus Growth: First Half of 2022



Source: Bloomberg Finance L.P. as of 7/7/2022. The proxy for Large US Value Stocks is the S&P 500 Value Index, and the proxy for Large US Growth Stocks is the S&P 500 Growth Index.

Value stocks lost notably less than growth stocks since January 1st.

It was also helpful that our portfolios limit the bond exposure to shorter maturities. Long-term bonds represent a vast commitment which can be put under severe stress if inflation creates uncertainty with respect to the purchasing power of the money that the bondholder will eventually receive back. As a result, long-term bonds decline in popularity *and* price when inflation and interest rates rise.

After a historical first half of the year with the significant simultaneous declines in stock and bonds, what is the prognosis for the second half?

I mentioned above that this year was the worst first half for stocks since 1970. That year, stocks made a stunning comeback to finish the year higher! So, anything can happen. But that example from 1970 is likely a very low probability result.

There could be some reprieve if investors believe policymakers and central bankers have a solution for inflation.

But, if it appears that they don't, both the bond and stock markets could be vulnerable again.

Inflation, in my opinion, is the most prominent issue. There is talk of a recession, but recessions tend to be short compared to inflationary periods, and they are focused on the near-term, not years of difficultly that get discounted in the present value of an investment. A recession would be a negative, but perhaps not as troubling as sustained inflation.

Over the next few months, expect policymakers to dream up various solutions for inflation. Investors could be eager to give policymakers the benefit of the doubt by bidding up growth companies again, resulting in a better second half of 2022. However, inflation has been brewing for years and was only amplified recently by the pandemic and Russia. Investors that are hoping for easy and simple solutions may have to reassess their portfolio strategies if inflation turns out to be as complex as it was fifty years ago.

Model Portfolio Update[2]

The Charter Group Balanced Portfolio
(A Pension-Style Portfolio)

	Target Allocation %	Change
Equities:		
Canadian Equities	12.0	None
U.S. Equities	38.0	None
International Equities	8.0	None
Fixed Income:		
Canadian Bonds	22.0	None
U.S. Bonds	6.0	None
Alternative Investments:		
Gold	8.0	None
Silver	1.0	None
Commodities & Agriculture	3.0	None
Cash	2.0	None

There were no changes to the asset allocations or the individual securities in the model portfolios during June. The proceeds from the March bond maturity are still in cash which has helped to add defensiveness to the model portfolios during the recent volatility.

No portfolio changes during June.

All of the primary asset classes that we use in the model portfolios were down for the month. Stocks were down regardless of geography: -6.65% in the U.S., -9.31% internationally, and -9.83% in Canada.[3] It was the same thing with bonds: -2.55% in the U.S., -2.90% in Canada, and -3.87% internationally.[4]

None of the asset classes used in the model portfolios were positive during the month.

Inflation, and the hiking of interest rates to fight inflation were the main culprits.

[2] The asset allocation represents the current *target* asset allocation of the Balanced Model Portfolio as of 7/7/2022. The asset allocations of individual clients invested in this Portfolio may differ because of the relative performance of the asset classes since the last rebalancing and because of differences in the timing of deposits and withdrawals. The Balanced Model Portfolio is part of a sequence of five portfolios ranging from conservative to aggressive: Conservative, Balanced Income, Balanced, Balanced Growth, and Growth.

[3] Source: Bloomberg Finance L.P. as of 7/7/2022. The S&P/TSX Composite Index for Canada, the S&P 500 for the U.S., and the MSCI EAFE Index for international stocks.

[4] Source: Bloomberg Finance L.P. as of 7/7/2022. The Bloomberg US Aggregate Bond Index for the U.S., the Bloomberg Global Aggregate Index for international bonds, and the Core Canadian Universe Bond index for Canada.

As we got into the first week of July, there was some chatter in the financial media that the probability of a recession was increasing leading to speculation that this would put a lid on inflation by reducing the demand for goods and services.

Talk of recession is increasing.

With recession, there is a hope of "demand destruction" which could lessen price pressures.

As I mentioned in the last couple of months, statistically, the rate of inflation growth would likely crest because of the base effect. This time last year, inflation was already getting elevated which makes it statistically more difficult to grow at a rate as fast as the initial increase.

As inflation has been the major issue this year, investors might view this as a silver lining.

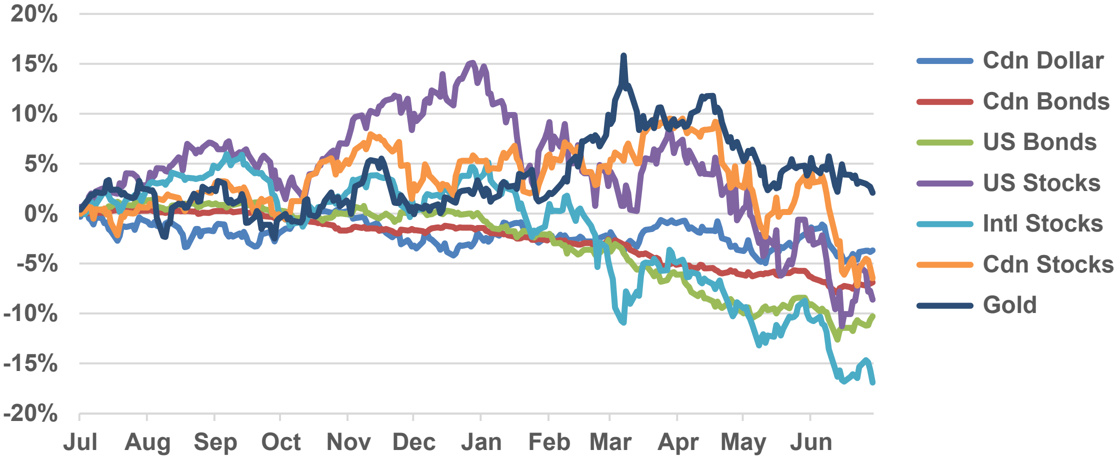
However, if inflation remains persistent, some of this optimism might be re-assessed.

There is a good possibility that investors will interpret this as a positive (from an investor perspective, not a consumer/worker perspective) and lift stock prices as a result. There might even be some policymaker temptation to stimulate the economy before the U.S. midterm elections in November which could have the side effect of fueling stocks even more. However, as I mentioned in the first section, inflation often has more resiliency and is more complex than policymakers might assume (it's their first inflation-rodeo!). We might get a reprieve only to be hit with the reality of lingering inflation heading into 2023.

Below is the 12-month performance of the asset classes that we have used in the construction of The Charter Group's model portfolios. (**Chart 5**).[5]

Chart 5:

12-Month Performance of the Asset Classes (in Canadian dollars)



Source: Bloomberg Finance L.P. for the interval from 7/1/2021 to 6/30/2022

[5] Source: Bloomberg Finance L.P. – The Canadian dollar rate is the CAD/USD cross rate which is the amount of Canadian dollars per one U.S. dollar; Canadian bonds are represented by the current 3-year Government of Canada Bond; US bonds are represented by Barclays US Aggregate Bond Index; U.S. stocks are represented by the S&P 500 Index; International stocks are represented by the MSCI EAFE Index; Canadian stocks are represented by the S&P/TSX 60 Composite Index; Gold is represented by the Gold to US Dollar spot price.

Top Investment Issues[6]

Issue	Importance	Potential Impact
1. Global Geopolitics	Significant	Negative
2. Canadian Dollar Decline	Moderate	Positive
3. Canadian Federal Economic Policy	Moderate	Negative
4. China's Economic Growth	Medium	Negative
5. Inflation (Portfolio Impact)	Medium	Positive
6. U.S. Fiscal Spending Stimulus	Medium	Positive
7. Short-term U.S. Interest Rates	Medium	Negative
8. Global Trade Wars	Medium	Negative
9. Long-term U.S. Interest Rates	Medium	Negative
10. Canada's Economic Growth (Oil)	Light	Positive

[6] This is a list of the issues that we currently deem to be the ten most important with respect to the potential impact on our model portfolios over the next 12 months. This is only a ranking of importance and potential impact and *not* an explicit forecast. The list is to illustrate where our attention is focused at the present time. If you would like an in-depth discussion as to the potential magnitude and direction of the issues potentially affecting the model portfolios, I encourage you to email me at mark.jasayko@td.com or call me directly on my mobile at 778-995-8872.

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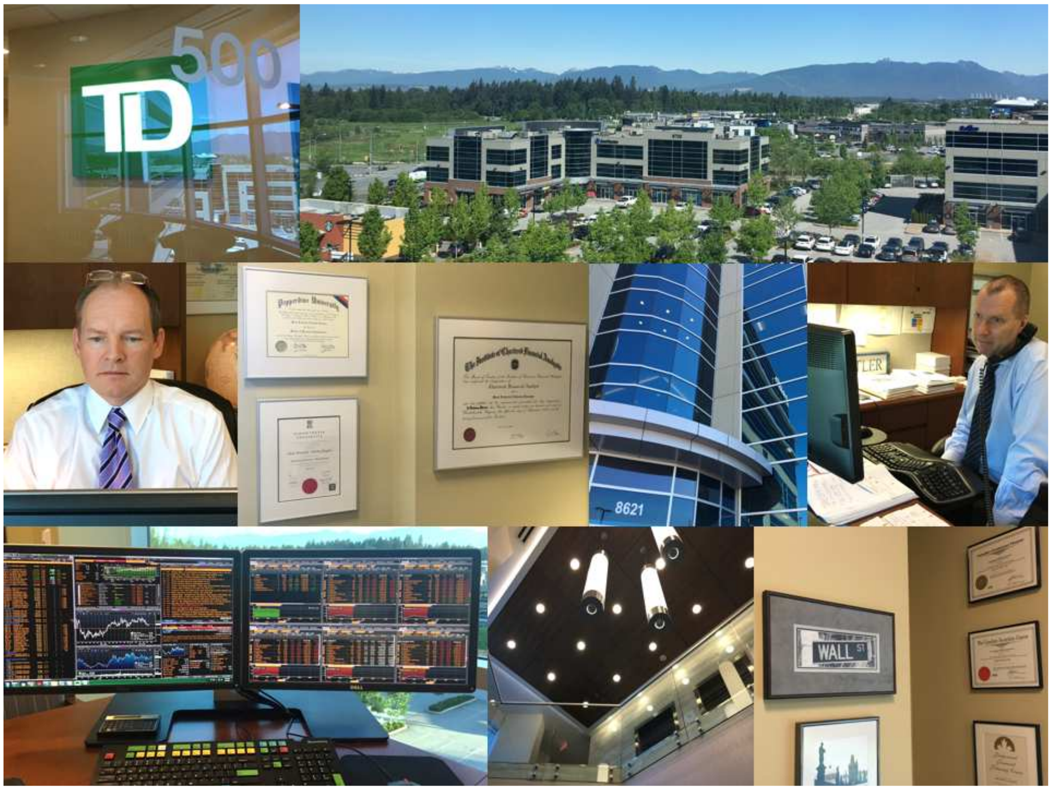
The Charter Group is a wealth management team that specializes in discretionary investment management. For an annual fee, we manage model portfolios for private clients and institutions. All investment and asset allocation decisions for our model portfolios are made in our Langley, B.C. office. We do not outsource any of the decision-making for our model portfolios – there are no outside actively-managed products or funds. We strive to bring the best practices and the calibre of investment management normally seen in global financial centres directly to the Fraser Valley and are accountable for the results.

Accountability is further enhanced by the fact that we commit our own investable wealth to the same model portfolios in which our clients are invested.



The information contained herein is current as of July 7, 2022.

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