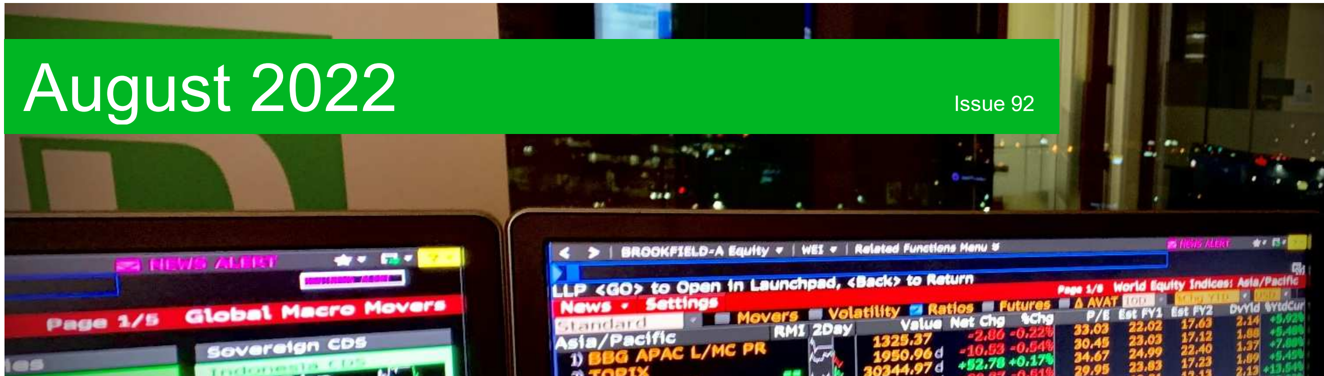
The Charter Group Monthly Letter



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Economic & Market Update

More Than Just a Summer Rally?

As I wrote in the last issue of *The Charter Group Monthly Letter*, the first half of 2022 was the worst in half a century for stocks and the worst ever for bonds.[1]

Then boom! Most of the asset classes shot upwards during July.

My interpretation of this recovery would be as follows: A consensus of investors believe that the U.S. Federal Reserve (the Fed) will solve the inflation problem without causing much of a recession and that we are quickly heading back to halcyon days of the pre-pandemic investment markets.

That might be a combination of wishful thinking (it is common to wish that good times will return) and some summertime seasonal investor psychology.

The stock and bond markets suddenly turned around after a tumultuous first half of 2022.

Are economic and corporate fundamentals really improving? Or are investors wrong? Or are investors merely in a better mood because it's summertime?

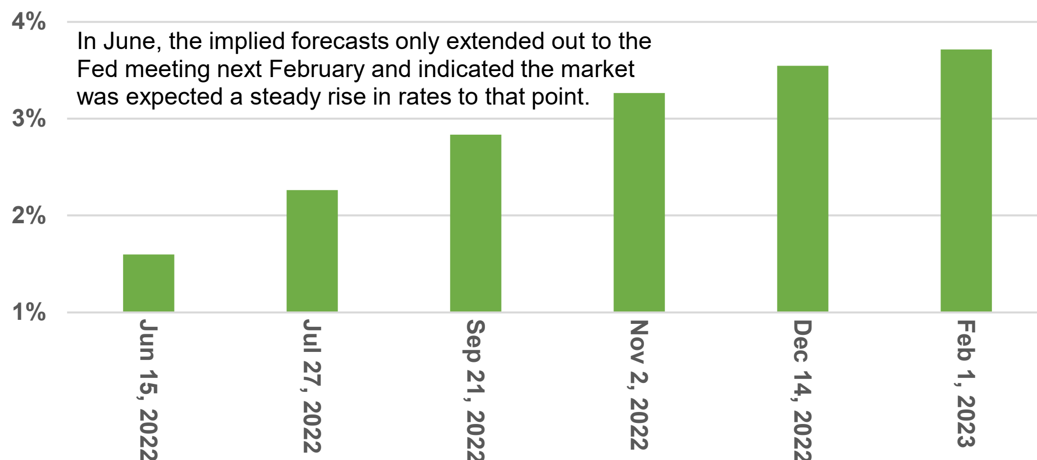
[1] Using the S&P 500 Index for stocks and the Bloomberg US Aggregate Bonds Index of bonds as proxies.

The hopeful mood emerged around a flurry of headlines indicating that the markets expected the Fed to begin cutting rates again early next year. In June, the Interest Rate Probability Page on my Bloomberg Terminal showed increasing Fed Funds Rates[2] through to February 2023, but the forecasts ended there (**Chart 1**). Then in July, the Page added implied rate forecasts out to January 2024 and indicated that the market expected steady rate cuts from beginning in March 2023 to January 2024 (**Chart 2**).[3]

A consensus of investors at the beginning of July appeared to think that the U.S. Federal Reserve will have inflation under control soon and will be able to cut rates next year.

Chart 1:

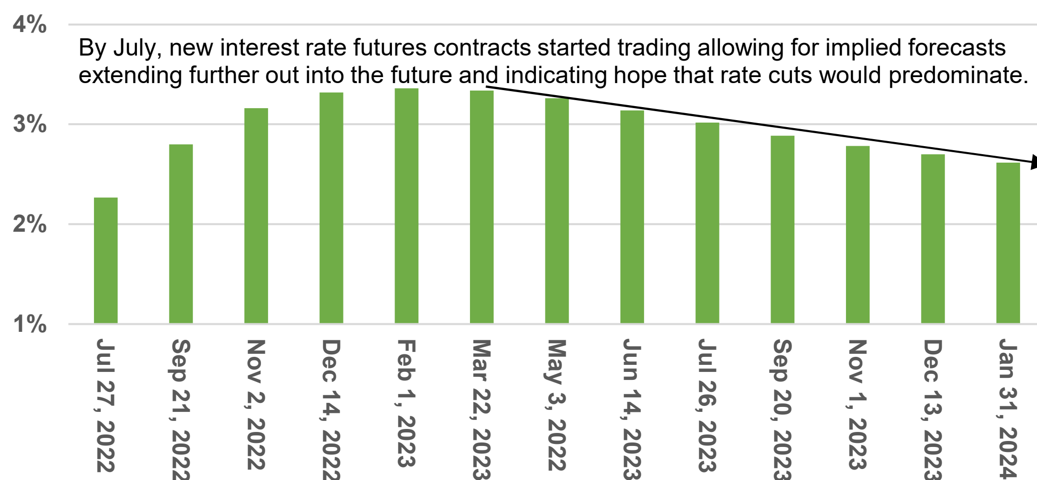
Implied Federal Funds Rate as of June 15, 2022



Source: Bloomberg Finance L.P. as of 8/8/2022. Forecast dates are the scheduled Federal Open Market Committee meetings at the U.S. Federal Reserve Board.

Chart 2:

Implied Federal Funds Rate as of July 1, 2022



Source: Bloomberg Finance L.P. as of 8/8/2022. Forecast dates are the scheduled Federal Open Market Committee meetings at the U.S. Federal Reserve Board.

[2] The Fed Funds Rate is a rate suggested by the U.S. Federal Reserve Board for overnight lending between major U.S. banks.

[3] The implied interest rate forecasts use the current pricing of interest rate futures contracts.

On one hand, rate cuts might be a response to a recession. Alternatively, they might be a response to fading levels of inflation. While a recession is not good news, officials from the Fed as well as the U.S. Treasury Department were unanimous that any downturn would be shallow (I couldn't find any officials forecasting anything worse). Investors appeared to indicate that they were willing to look past a mild recession and bid up shares. And, there was a notable amount of discussion that inflation would recede by the end of the year, with officials (such as Minnesota Fed Bank President Neel Kashkari) emphasizing that the Fed was aiming to get U.S. inflation back to a desired level of 2% (from a current level of 9.1%!!).

Investors and policymakers may be downplaying the severity of any recession resulting from this year's interest rate increases.

This market reaction brings us back to the "transitory" debate regarding inflation. Perhaps a generation of low inflation rates is making it difficult for policymakers and prognosticators to give up on the notion that inflation is a simple economic phenomenon driven by a couple of factors: deal with those factors and, *voilà*, inflation will be solved.

The markets were willing to give policymakers the benefit of the doubt last year regarding inflation, but suffered volatility when forecasts turned out to be wrong.

Are we going through a similar pattern this year?

About this time last year, many central bankers, economists and commentators were working so hard in an attempt to persuade investors and consumers that the appearance on inflation would be short-lived that they earned the moniker "Team Transitory" (which included the aforementioned Neel Kashkari). Judging by the market's performance over last summer, investors looked like they were accepting the message. Investment prices drifted upwards and remained in tight channel with limited volatility. When it became evident that Team Transitory was wrong, markets became very volatile.

Rather than discussing the dozens of factors that can impact inflation (some of them correlated, and others independent of each other, and many of which have been examined in previous issues of *The Charter Group Monthly Letter*), the discourse has been heavily focused on the supply chain problems emanating from pandemic-related disruptions. The consensus conclusion was that once the supply chain problems had been ironed out, inflation would fall back to the 2% U.S. Federal Reserve target.

Then we got the Omicron variant, more Covid-lockdowns (especially in the People's Republic of China) rising energy prices, rising wages, and Russia's invasion of Ukraine (which accelerated food and energy prices). A number of prominent members of Team Transitory surprisingly admitted their erroneous inflation forecasts from last year. However, following those *mea cuplas*, Team Transitory never really disbanded. The message has generally evolved into "It's transitory, starting now."

Perhaps investors are giving the Fed the benefit of the doubt, much like they did last year. This sentiment may be reinforced if annual inflation growth descends. However, as I talked about in previous issues, that might happen merely because of the high-base effect where last year's already high inflation numbers make it statistically more difficult to maintain a high growth rate, and not because central bankers are winning the battle.

Also, the market appears to be ignoring some very inflationary elements. Monetary conditions are still significantly accommodative. Real interest rates (which is the inflation rate minus the nominal interest rates that we see) are notably negative. Jerome Powell, chairman of the Federal Reserve Board, as suggested that the current Fed Funds Rate is at "neutral" – where it is neither accommodative or restrictive. One might argue that monetary policy remains historically easy and that it would be very difficult to frame this as a serious fight against inflation. Adding to the inflationary fuel is the Inflation Reduction Act just passed by the U.S. Senate. The Act strives to reduce inflation by increasing spending to help Americans dealing with rising costs of living. Good luck with that.

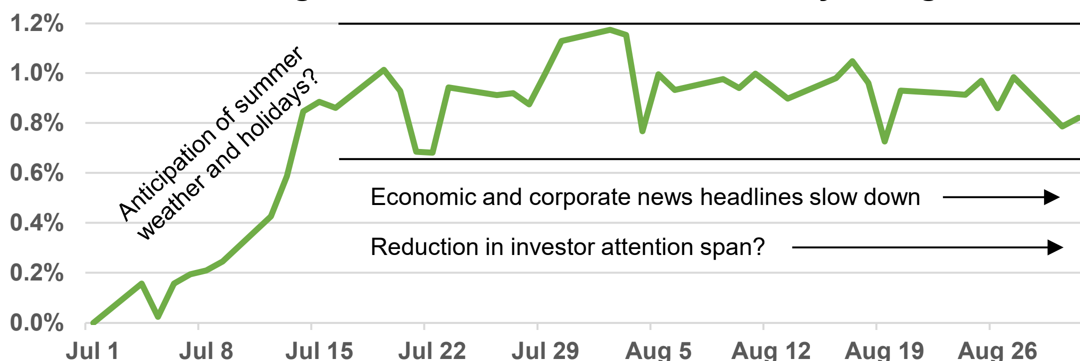
It is difficult to reconcile some very inflationary factors that are persisting with the ebullient mood among investors in July.

However, there could be another separate circumstance contributing to good market performance this summer: the traditional "summer rally." Investors are in a better seasonal mood, enjoying better weather and looking forward to holidays. As a result, it is harder to upset them with negative headlines. The news needs to be especially severe to get a reaction similar to other times of the year. Often there is a slow drift higher during July followed by a rather sleepy market. A summer slowdown in the pace of corporate and economic news might also contribute to sedating investors (**Chart 3**).

Perhaps investors are not digging too deep into the economic fundamentals and are, instead, enjoying the summer and the positive psychology that often accompanies the season.

Chart 3:

The 50-Year Average of S&P 500 Performance for July & August



Source: Bloomberg Financial L.P. as of 8/5/2022. From the years 1972-2021.

So, this might be nothing more than just a summer rally. We might as well enjoy it while it lasts!

Model Portfolio Update[4]

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

No portfolio changes during July.

There were no changes to the asset allocations or the individual securities in the model portfolios during July. The proceeds from the March bond maturity continues to remain in cash which has been a benefit during bond market volatility.

Stocks were the main contributor to the model portfolio results as investors' hopes (or complacency) got discounted into share prices.

As mentioned in the first section of this *Monthly Letter*, July was a good month for stocks with the S&P 500 Index (U.S. stocks) up 8.60%, the MSCI EAFE Index (international stocks) up 4.44%, and the TSX/S&P Composite Index (Canadian stocks) up 4.41% (all measured in Canadian dollars).[5]

The main detractor from the model portfolio results was a 2.29% decrease in the value of gold bullion (measured in Canadian dollars).[6] Perhaps this is another sign that investors are complacent about inflation, thinking that central banks will have it under control.

[4] The asset allocation represents the current *target* asset allocation of the Balanced Model Portfolio as of 8/8/2022. 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.
[5] Source: Bloomberg Finance L.P. as of 8/8/2022.
[6] Source: Bloomberg Finance L.P. as of 8/8/2022.

The next headline U.S. inflation release will likely show a slight decline from last month. Without a Federal Reserve meeting this month, a slight variation in annual inflation may not be enough to wake up a rather sleepy summer market. The central banker meeting in Jackson Hole at the end of August may not yield much in terms of shifting monetary policy as most of the policy reaction to inflation has already been communicated. The Fed has indicated that it wants to become more "data dependent" as opposed to providing future guidance, but it's doubtful that there will be a significant change in the data before then.

Gold was the main detractor from results. Who needs an inflation hedge if inflation is expected to evaporate soon?!?

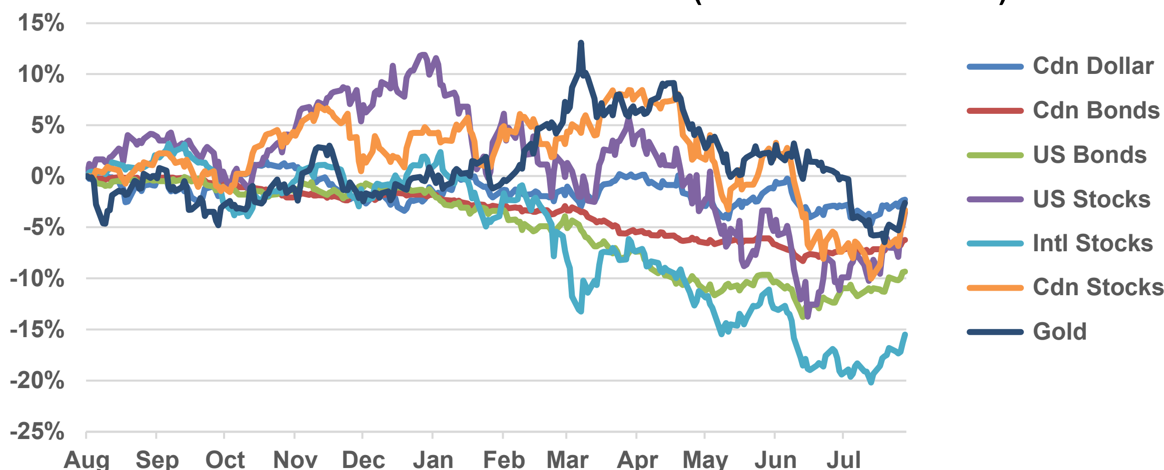
Beyond August's central banker meeting, the focus will be on the U.S. midterm elections in November and the probability of a recession over the next year. I would be inclined to think that the Fed might want to ease off on the rate increases to minimize the economic impact on the elections (an economy suffering under the burden of higher rates may spell trouble for the incumbents). And, with the Fed erring on the accommodative side, signs of a recession may be delayed. Apart from some traditional seasonal choppiness during the autumn, there doesn't appear to be any other catalyst factors (other than those we already know about), potentially impacting markets. Concerns that I would have regarding an increase in volatility would focus on some time after the U.S. midterm elections.

Likely no new data that would change current accommodative policies. This could push any implementation of tough economic medicine into next year.

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 4**).[7]

Chart 4:

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



Source: Bloomberg Finance L.P. for the interval from 8/1/2021 to 7/31/2022

[7] 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[8]

Issue	Importance	Potential Impact
1. Global Geopolitics	Significant	Negative
2. Canadian Federal Economic Policy	Moderate	Negative
3. China's Economic Growth	Medium	Negative
4. Canadian Dollar Decline	Moderate	Positive
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. Canada's Economic Growth (Oil)	Light	Positive
10. Long-term U.S. Interest Rates	Medium	Negative

[8] 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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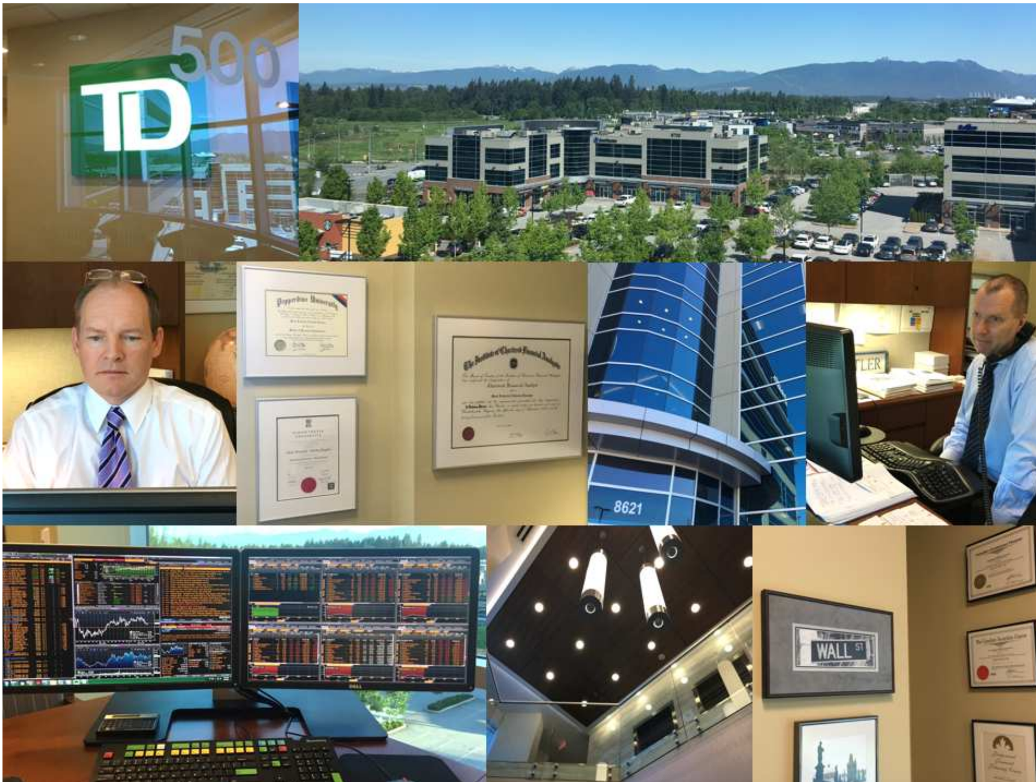
The Charter Group is a wealth management team that specializes in discretionary investment management. For an annual fee, we manage model portfolios for private clients and institutions. All investment and asset allocation decisions for our model portfolios are made in our Langley, B.C. office. We do 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 August 8, 2022.

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