Investor Insights

Bubble Or Not Here We Come

At the end of week ending Feb 25th, the S&P/TSX Composite Index was at 21,106 – only down about 3% of its recent all time high last November while the S&P500 Index was at 4,385 down about 9% from its January high. YTD in the S&P/TSX the biggest sector down is in the Tech area with the Health sector not far behind. Meanwhile the negative performance in the S&P500 are distributed more evenly across the various sectors of Tech, Communications Services, Consumer Discretionary and Real Estate. The commodity areas like Energy and Gold as well as the Financial sectors continue to show their strength YTD. Financial sector has been benefiting from sharp rise in long-term rates while energy has responded positively to the rise in oil and gas prices. News in the geo-political arena has added on to the market volatility with Russia's invasion into Ukraine, oil prices surged and Gold climbed as investors concerns heightened. The swings in energy and gold prices, market declines and same day reversals clearly contribute to the markets uncertainty on how to deal with the constant barrage of headline news.

The S&P500 Growth Index is down close to 13% while the S&P500 Value Index is down only about 3%. The strength in the areas which respond well to rising inflation and interest rates and the corresponding weakness experienced in the other areas is comprehendible given the current trend on both higher inflation

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and anticipated rate increases thus far in 2022. Central bankers have clearly poised themselves to deal with inflationary pressures through monetary tightening. The U.S. intends to pursue reduction/elimination of their Quantitative Easing and both Canada and U.S. have signalled interest rate hikes to begin in March. The central banks here in North America and in Europe have been wrong in the sustainability of inflation, forecasting its path will not be any easier for them. Of the observers we most respect, their views stated that inflation in North America would likely decline as 2022 progressed and with it long-term interest rates. But what does this all mean for the Markets?

Equity Market Risk Are Rising

Navigating cycles is helpful to understanding periods of heightened risk in equity markets. My predecessor and mentor continues to be a dedicated subscriber to Notley's Trends & Cycle Reports which I too am a student of Cycles and carry on the same views. They have unrivalled set of data on global and equity markets and individual stocks going back for many decades. They also try to define what are short-term, medium-term and long-term as well as secular cycles. In their latest work, they conclude that the first three; short-, medium- and long-term cycles are approaching a termination point, but the secular cycle is still positive in North American markets.

The long-term cycle they note lasts about four years and this one started in Christmas of 2018 – the last time the Fed tightened as it is about to do now. That resulted in a 20% decline over three short-term down cycles from September 2018 to December 2018 at which point the cyclic bear terminated. Then, in Q1 2020, the market had a blow off resulting the in the April 2020 30% decline. Which reinstated the longer-term bull condition which has existed ever since and is in line with the secular bull market. However, that 4-yr cyclical bull market is near its end although the secular bull trend remains. The strength of the cyclical bull since 2018 attests to the fact that we are still, however, operating within a secular bull market. Historically, over the last 125 years, these have lasted anywhere from 8 to 30 years and has a wide range of gains.

Dow Jones 30 Industrials Secular Uptrend Appreciation Lows to Peaks

Date	Duration	% Gain
1896 – 1909	13 years	211%
1920 – 1929	9 years	317%
1942 – 1972	30 years	788%
1982 – 2000	18 years	1,393%
2009 - ?	13 years	621%

Source January 4/22 Notley's Notes Weekly Update Volume 36 Number 1

We suggest the secular bull market is yet incomplete but the long-term cyclical picture is not encouraging

at this juncture and suggests caution. Volatility Index (VIX) the measure of volatility and risk has shown an increase over the past couple months. During a time where central banks decisions to remove or create liquidity increases volatility and risk. The discussions of the various cycles although referred to the U.S. and their markets any correction in the U.S. will undoubtedly be accompanied by a similar correction in the S&P/TSX. Although Canadian markets should have less of a downside as seen in the Shiller Cyclically-Adjusted- Price-Earnings (CAPE) Ratio which indicates the heavily weighted S&P/TSX index in the energy and financial sectors are trading below their 10-yr averages unlike the S&P500 which is the second most expensive in history.

The market has been displaying bubble type conditions however, it is impossible to predict when a bubble might pop. Indeed, the best student of bubbles in recent times is Jeremy Grantham, one of the of the founders of GMO, a well known money manager in the U.S. Last year, in his January 2021 he issued a warning about the size of the equity market bubble. Further to that in his January 2022, he issued another report suggesting we were in a super bubble. Historically over the last 100 years, he believes that a super bubble of this magnitude has only been matched by the U.S. 1929 and 2000 equity markets and Japanese equity and real estate bubble of 1989.

Conclusion

There is very little doubt that the central banks in North America will require to press on with their monetary tightening. Rates will increase and quantitative easing will come to an end and the resulting withdrawal of liquidity that has helped bolstered the markets to new record levels will need to unfold. Could this be a policy misstep that could spur a downturn or will the ongoing geopolitical tensions create hesitation for central bankers that could lead to a detrimental outcome of inaction. We believe that caution and significant risk reduction is therefore prudent at this state of the market cycle in a period of heightened risk. A plan to execute a reduction of equities has already begun. Trimming back in areas of the financials, telecoms and REITS and an increase to shorter-duration fixed income in our defensive portfolio as well as a modest increase in gold and precious metals in our Canadian portfolio that carries exposure to the commodity sectors.

Sincerely,

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