Investor Insights

The Volatility Continues

At the beginning of this year, we took the view that inflation was going to prove much more than transitory and that Central Banks would have to prove their inflation fighting credentials by increasing interest rates more than market participants had anticipated. 11 out of the last 12 tightening cycles had resulted in overkill by the monetary authorities in the United States resulting in recession. We therefore concluded that a bear market was more than likely and adjusted our strategy accordingly.

We became very defensive in our client portfolios such that an on a consolidated household view, an average asset allocation mix included about 45% in cash and fixed income of mostly shorter-term bonds. Early in the first quarter, we maintained and added a decent exposure to cyclical stocks in the energy, agricultural and precious metals sectors. We lightened our exposure to the financial sectors and trimmed back but maintained a defensive exposure to our utilities, pipeline and telco holdings. We maintained diversification through roughly an average exposure of about 20% to our US/International portfolio, which like other growth areas of the market (such as technology stocks) has shown sharp losses year-to-date.

Our Canadian portfolios versus the market compared and measured against the TSX60 Total Return Index and S&P500 Index have

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outperformed them thus far. The month of June and the recent market weakness has been the result of continuing high inflation numbers being printed in the U.S. and investor fears and reaction to the 75-basis point hike in the over-night rate, which has not seen a jump of equivalent magnitude since 1994.

We still believe that the risk of a North American recession is, if anything, greater than we thought at the beginning of the year. With further market weakness dominating this month, the S&P500 Index entered into bear market territory – being down more than 20% from its peak. Since the Fed's move to combat inflation with rate hikes to slow down the demand side of the economy is still in its early stages, we believe the bear market still has a way to run although it hasn't arrived in Canada. Thus, we will roughly maintain our current portfolio mix for clients. We think it unlikely we will see it fit to change that mix significantly to take advantage of a new cyclical bull market until the first quarter or even the first have of 2023.

Longer-term implications of higher inflation on Canadian equites

The subdued declines the Canadian markets have experienced compared to the U.S. market, with the TSX60 TR Index down in the high single digits while the S&P500 is down closer to 20% as of June 29th close. This is partially because of the cheapness of stocks in our financial sector but more importantly because the strong performance of our cyclical stocks particularly in the oil and gas, agricultural and mining sectors. We have recently been doing our normal process of reviewing each individual company within our universe. Among those recently reviewed have been Cameco, Canfor, West Fraser, Methanex, Teck, Ovintiv, Equinox, Wheaton Precious Metals and Finning. Most of these stocks have had excellent moves upwards in the last year or two as have our holdings of Canadian Natural Resources, Cenovus, Tourmaline and Nutrien. In the face of global slowdown and a likely North American recession, all of these stocks will see some reduction of demand expectations for their commodities over the next few quarters, which could well see pullbacks for these stocks in the ensuing quarters. However, in reviewing the 3-5 year fundamentals of each commodity, we are extremely optimistic about the longer term prospect for their commodity price.

This applies to the lumber sector, the outlook for lumber and engineered wood is very positive. Demographics are favourable with the millennials being the largest age group in the early 2020's buying houses. Demand for lumber and lumber products is expected to increase into the next decade. Canfor and West Fraser Timber – two of the world's largest lumber producers – look very attractive on a 3-5 year basis. Similar comments can be made about Cameco, the world's largest uranium producer. While Europe is reversing their plans to phase out nuclear, the U.S. congress has authorized a multi-billion dollar program to develop nuclear.

Clearly, the price of energy and food has been boosted by the Russian invasion of Ukraine and the subsequent realization that the war would not be over quickly and that the supply of a number of these commodities would be impacted for longer and by more than most observers had predicted. But that only came on top of the fact that the supply/demand prospects for each of these segments was already strong over the next few years.

Finally, it is important to note that the U.S. 10-year Treasuries recently broke a 40-year secular downtrend as they briefly touched 3.5% down from 14% in the early 1980's. While a recession in the next while would see long-term bond prices rally somewhat, we believe that the long-term bond yields will thereafter be rising on secular basis over the next few years. Historically, 60% of bond yield changes is explained by inflation and we believe that inflation will stay relatively elevated over the next number of years. How determined the Federal Reserve Board will prove to be in slowing down the demand side of the economy through rate increases will govern how successful they are in suppressing inflation. But our bet is that Powell and the Fed will do what they did Q4 2019. In other words, panic in the face of market declines and guarantee that – down the line – higher inflation levels will prevail.

Looking ahead to the end of the year or the first half of next year, we intend to significantly reduce our cash holdings and increase our exposure to the mentioned cyclical sectors in the belief that a long-term secular bull market in commodities such as existed between 2001 and 2008 will be ahead of us.

Sincerely,

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