Investor Insights

Bear Market and Recessions

As volatility and extreme swings remain the major theme, we saw the month of April post negative returns in both the Canadian and U.S. Markets. The S&P/TSX Index was down 5.2% in April, while the S&P500 was down 8.8%. In May, the first few weeks of the month showed negative returns, for the week ending May 20th the S&P/TSX was down close to 3% and the U.S. counterpart down to 5.6%. The daily volatility moves as witnessed in the S&P500 after the Federal Reserve Chair, Jay Powell, raised the overnight rate by 50 basis points as everyone expected but his comments on May 4th sparked a sharp rally. The S&P rallied 3% after his remarks that the Fed was not considering raising rate by 75 basis points. The general tenor of the press conference was much less hawkish than markets had feared. After rallying that 3% on the Wednesday, it fell 3.6% the next day more than reversing the recovery. To close out the month of May, the last week or so we saw a rebound and recovery of previous weeks' negative returns to finish the month flat, S&P/TSX -0.2% and S&P500 0.0%.

The impetus of this volatility is in large part due to inflation concerns. Supply chain bottlenecks, frictions in re-opening the economy from the pandemic shutdowns and spikes in food and energy prices due to geo-political strife, the forces that have driven inflation to its current levels could potentially be coming to a leveling but uncertainty nonetheless is

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prevalent. Although the driving forces that steer inflation seem pretty apparent one could ask, what is the key cause of the current inflation. We think it is reasonable to conclude the role of monetary policy as measured by the massive expansion of the money supply over the past two years is that key cause. The advocates of money supply theory have studied the inflation and recession risks since the outbreak of the pandemic, monitoring the flood of money into the global economy and correctly predicting the current inflation explosion – and warning of an almost inevitable recession to follow. In any instance the cause of inflation or key drivers of inflation is moot point at this juncture, as we feel the price increases at the gas pumps, in food costs, in housing prices, in building materials, in car prices and we sit idly as the central banks tinker with monetary policies.

The federal funds rates has done a decent job as a leading indicator of U.S. recessions. It has risen ahead of every recession since it first became the Fed policy tool in the 1950s. There have, however been soft landings where the central bank raised rates and then cut it without precipitating a business downturn. There's enough data series that are pointing to and anticipating a U.S recession to start sooner rather than later. Which in turn would also mean the same for the Canadian markets.

The U.S. central bank plans to not only raise its policy rates but also to reduce its huge portfolio of Treasurys and mortgage-backed securities. The central bank flooded financial markets with liquidity to bail out financial institutions in response to the 2008 financial crisis and Fed assets jumped from about $1 trillion to $2.3 trillion. Then again, the central bank reacted to the pandemic by adding about $5 trillion, bringing the total to $8.9 trillion. The Fed plans to shrink its portfolio starting in June by not replacing maturing securities instead of actively selling them. Still, the switch from buying $140 billion per month to declining assets is shock to financial markets and the economy that became accustomed to predictable and steady additions to central bank created liquidity. The Fed's hope for a soft landing seems like a low probability but there's always hope.

The World Bank recently cut its forecast for global economic growth this year to 3.2%, down from its 4.1% outlook in January. The International Monetary Fund (IMF) slashed its 2022 GDP forecast from 4.9% last October to 3.6% just recently. It also reduced its 2023 outlook from 3.8% to 3.6%. The IMF projects U.S. economic growth to fall from 5.7% in 2021 to 3.7% this year and 2.3% next year. That international body also worries about strengthening prices pressures in coming months that could prompt more aggressive financial tightening from policy makers, further denting economic growth. Economic growth numbers are trending down from past forecasts and tightening monetary policies into those environments could be enough to tip the scales into a recession.

As the Fed tightens credit, shorter-term Treasury rates rise faster than those further out on the yield curve, and inversions occur as short rates top long-term Treasury yields. This inverted yield curve, which can be measured by the difference between 2-year and 10-year Treasury note yields, always occurs before recessions, as it briefly did last month. Generally speaking, the lead time to the inverted yield curve and recession is a wide range and can be anywhere from 12-months to 24-months.

Bear markets in stocks are another very consistent forerunner of recessions. So far this year at the end of May, the Dow Jones Industrial Average is down 9%, the S&P500 is off about 13% and tech-heavy Nasdaq is down 23%. As investors anticipate Fed credit-tightening and the resulting recession depresses corporate earnings, they dump equities. Bear markets defined as 20% decline or more below the previous high seems to be on the horizon for the S&P500, while the Nasdaq is down 32% from its peak in November last year to its recent low in May. Although comparatively the Canadian markets, S&P/TSX is down about 2% and seems to have performed well relative to the US to which the energy sector has been the main contributor to their relative outperformance. We do believe as mentioned in our previous notes that we are in an intermediate cyclical bear market and perhaps could be halfway through it and do continue to believe that there are considerable downside risks still pending. A bear market doesn't necessarily indicate an economic recession. There have been 26 bear markets since 1929, but only 15 recessions during that time. Bear markets often go hand in hand with a slowing economy, but a declining market doesn't necessarily mean a recession is looming.

With many data points signaling towards a recession, our stance continues to be defensive with decent cash positions on hand. There are no imminent signs of immediate recession but we do believe all the makings of one are on deck and we continue to monitor and stand ready. With price targets locked into our radar we are ready to deploy into the gold sector and other selected quality names. We continue to monitor our energy prices and may consider opportunities in crystallizing the immense gains experienced in that area so far this year.

Sincerely,

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