Investor Insights

The "R-word" Are We There Yet

Market Summary

The current bear market cycle has been evident as we continue to experience the volatility and downward pressure in the stock market. The Canadian Market Index measured by the S&P/TSX saw a significant rally in July, with the index posting a 4.4% monthly return retracing back close to half of June's losses. The first half of August continued with July's rally trend but ended the month down about 2%. Several weeks into September as further declines continue, year-to-date (YTD) at the end of week September 23rd the index was down close to nearly 13% (ThomsonOne, 2022). In the precious metals area, the Gold subsector index has again returned negative returns for several months, opposite of its performance in the early months of this year. YTD, the energy sector is up mid-double digit returns but has come down substantially since May's 40% returns (ThomsonOne, 2022). Our relative outperformance compared to the U.S. main index S&P500, which is down in bear market territory in the low 20's, has been due to the heavy influence of the energy sector of the Canadian Markets. While their largest sector influence is marked by the Technology sector which down more than close to 30%.

The word "recession" brings about differing definitions and associations. Wall Street, always looking for a short cut to the bottom line, says it's two consecutive quarters of declining GDP, as occurred in the first two

Rana Lee, CIM

Wealth Advisor & Portfolio Manager

Tel: 604.623.6791
Cell: 778.986.8210
rana.lee@nbc.ca
www.ternionwealth.com

September 28, 2022
Vol. 1, No. 6

quarters of this year. But by that definition, not all previous historical recessions would be true, for example, in the 2001 recession, GDP didn't contract for two consecutive quarters and in the mid-70's recession, the economy fell in the first quarter of 1974, but then grew slightly in the second. Other government institutions don't like using the "R-word", they lower their economic forecasts bit by bit until they can no longer deny a business downturn. The International Money Fund (IMF) now sees the world economic growth dropping to 3.2% this year after repeatedly cutting its forecast from 4.9% last October, 4.4% in January and 3.6% in April. For 2023, it forecasts 2.9%, much lower than its April forecast of 3.6% (Shilling, 2022).

The notion of a recession isn't a statistic but rather a process. Defined as a pronounced, pervasive, and persistent decline in broad measures of output, employment, income, and sales. The National Bureau of Economic Research (NBER) states, "a recession is a significant decline in economic activity spread across the economy, normally visible in production, employment and other indicator." The NBER business-cycle dating committee looks at an array of economic and financial indicators, including output, income, manufacturing activity, business sales and employment, before setting a recession's date.

One might ask, when do we know if we are in a recession, especially when some believe that a recession is under way when they are laid off or their portfolio suffers a big loss. The data NBER uses to date recessions are reported with timing lags and data revisions. As a result, the NBER's dating of business cycles are often too late to be of immediate use to investors.

We follow several economic experts where much work is done looking at economic leading indicators that help forecast business cycles and inflation cycles. Lakshman Achuthan one of the co-founders the Economic Cycle Research Institute (ECRI) believes there's no ambiguity in the leading indexes he uses to predict business cycle downturns, all indicators are showing a pronounced, pervasive and persistent decline and clearly shows a recession is coming.

Gary Shilling, a well-respected financial analyst and commentator, lists out the leading indicators of recessions as we are currently experiencing. The declines in stock prices almost always lead the NBER's onset of recessions, and stocks have been falling since January. Fed credit tightening – by raising overnight federal funds policy rate, a recession follows with few exceptions, a process that clearly commenced in the spring. Inverting yield curve – every time the central bank's actions push up shorter-term Treasury note yields to exceed longer-term yields and inverting the yield curve, a recession follows. The Conference Board's index of leading economic indicators has also turned down. The 10 components of that index are average weekly hours in manufacturing, average weekly initial jobless claims, manufacturers' new orders

for consumer goods and materials, ISM index of new orders, manufacturers' new orders for nondefense capital, S&P 500 index, Leading Credit Index, interest rate spread (10-yr Treasury minus fed funds rate) and average consumer expectations for business conditions.

We continue to believe that the risk of not only a North American but potentially a global recession is greater than most observers would predict. Not only do we agree with the above observations of our respected peers. It is evident a sharp rise in global oil prices has preceded every North American recession since the 1970's except for the 2020 recession caused by the Covid pandemic. In 2022, the West Texas Intermediate (WTI) oil price rose sharply to a peak contract high of $130.50 just after the Russian invasion of Ukraine on March 7, 2022. Simon Ward, a monetary economist whose work has proven valid over the years, says "Central bankers have ignored the lessons of their 2021-21 policy blunder and deserve the opprobrium they are likely to attract as an economic debacle continues to play out over coming quarters… The monetary evidence, therefore, is that policy settings had already reached overkill territory by mid-year, suggesting a severe recession with rising medium-term deflation risk".

We ask ourselves, how do we interpret the above in terms of investment strategy going forward. Despite a moderate bounce in North American markets around mid-year, along with a retracement of that rally, we are convinced that currently the risk of normal market exposure outweighs any potential rewards. If the risks of North American and global recession are as high as we continue to believe they are, then this bear market is not at its end. Our best guess is that the depth of the current/coming recession will be evident to investors over the next several quarters. In essence, we conclude that the bear market will play itself out over the coming months ahead. Bear markets tend to bottom before the end of ultimately turns out to be the evaluation by the authorities that the recession is over but we strongly sense we are not there yet. Thus we don't intend to change our defensive posture or commit any or all the substantial cash reserves in our portfolios at the present time.

Sincerely,

Rana Lee, CIM

Wealth Advisor & Portfolio Manager

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