Newsletter

Back to the Future, From Russia with Love, or Airplane?

Unable to decide which of these titles would best fit this newsletter, I kept all three of them.

Back to the Future

The recent rulings by the U.S. Supreme Court leave us puzzled, to say the least. Taking away abortion rights and authorizing the carrying of concealed weapons bring us back to the 50's, if not to the Far West. Is the Supreme Court about to move its seat to Salem? Talk of a divided country...!

From Russia with Love

In 2022, how can a single man's murderous megalomania imperil the security of humanity? Nuclear weapons were meant as a deterrent against an attack. Now, in the hands of Vladimir Putin, they have become a licence for aggression and blackmail against the planet.

Airplane! (Is there a pilot onboard?)

Inflation is on everyone's mind these days and has become public enemy #1. Ironically, while everybody is lamenting that groceries, rents and gas prices keep going up, airports, restaurants, hotels, camping grounds and dealers of (always bigger and more expensive) cars are thriving. The less well-off are suffering whereas most people seem to be awash with dollars. To lower inflation, it will be necessary to reduce demand; let's hope the message gets across, and soon.

This period of inflation can be attributed to a series of accidents and questionable decisions.

1- COVID-19: The pandemic impacted production and distribution channels, leading to product scarcity.

2- Excessively generous and pandering government programs: The steep increase of the national debt and excess liquidity (as noted in the paragraph above) boosted demand and probably created a disincentive to work.

2- Lagging central banks: Central banks are supposed to smooth out inflation. But in 2021, their inaction, and even their efforts to stimulate an economy that was already rallying, contributed to the current inflationary spike. The central banks are behind the curve and are taking erratic actions to offset their past complacency, thus hurting market confidence.

3- Opportunism: Some strategic suppliers/workers are taking advantage of their position to indulge in profiteering or unduly improve their long-term conditions at the expense of society.

4- War: The war in Ukraine has disrupted the energy and food supply chains, adding an extra layer of inflation. Most countries are supporting Ukraine in its valiant fight against Russian aggression. Our thoughts are with them.

This combination of bad decisions, greed, pandering and megalomania has brought about the current correction.

Although we are not yet out of this slump, several positive indicators point toward an improving outlook. We know how to fight inflation, but the current rate hikes will take some time to play out. The correction started several months ago, and the markets have already discounted the incoming data.

Let's have a look at what the markets are telling us.

Connect with us

Claude Desrochers
Senior Investment Advisor and Portfolio Manager
514-282-5957
claude.desrochers@nbpcd.com

Arthur Martinot
Associate Investment Advisor
514-282-5854
arthur.martinot@nbpcd.com

Alexandra Lepore
Administrative Assistant
514-282-5893
alexandra.lepore@nbpcd.com

1501 McGill College Avenue
Suite 3200
Montréal, QC H3A 3M8

www.leporegosselindesrochers.com

Recap of the first half of 2022

To start, the first half of 2022 was difficult. The combination of COVID-19, war and inflation led to a wave of concern and pessimism among investors.

In these challenging times, the aim is to maintain maximum capital preservation in order to restart from a higher base when the markets recover.

On this front, we did an excellent job over the last months. We invite you to compare the performance you achieved with us vs. the markets. We are confident that you will be satisfied.

Our January forecasts were generally right on the mark. The invasion of Ukraine led to a further disruption of distribution channels and higher inflation. China re-imposed COVID-19 lockdowns on entire regions. Many employees do not want to return to work in person. Rates have risen by 1.5% so far, and oil prices reached $130/barrel at some point.

2.1 Fixed Income

Holders of market-tracking bond ETFs were up for a brutal wake-up call, with losses of over 12% since January. Their return is 0% over 5 years and only 1.7% over 10 years. The message is for all those who do not believe in the value of advice...

For our part, we preferred short maturities, floating rate securities, and a few similar investments. This was the most appropriate strategy for the current environment and you were protected.

2.2 Currencies

The Canadian dollar fell slightly relative to the US dollar (-1.6%). However, the loonie did well in comparison with the euro and the yen. In uncertain times, the greenback remains the safe haven currency.

2.3 Real Estate

I rarely comment on this sector, but a word of caution is in order. For the last 40 years, interest rates trended almost constantly downward. With easy access to credit and ultralow rates, real estate values strongly increased. Most mortgage holders never experienced periods of rising rates.

Therefore, we should expect declining real estate values and a transition from a seller's market to a buyer's market in the next few years. The pendulum is swinging back.

2.4 Equities

The first half of 2022 was brutal for equities, particularly in June when the central banks' rate hikes and aggressive stance raised the possibility of a recession.

You may refer to the returns of various market indices and fund managers in Section 2.5 below.

The Canadian market posted the best performance, retreating almost -10% (-8.7% in June), while the NASDAQ was the worst performing index, down about -28%. The transition from growth to value continued.

2.4.1. Canada

Our sector positioning acted as a positive tailwind in the first part of the year. Our overweight positions in Energy, Telecommunications and Utilities enabled us to beat the market. The Financials sector was hurt. We were also underweight in the Information Technology and Health Care sectors. Too bad for the holders of Shopify that was down almost 80%. Remember our early 2021 warning: even if a company has a great product, it is the price paid for its stock that really matters. Our stock selection within the sectors was also very good, as most holdings outperformed their respective sub-indices.

2.4.2. United States

Over the past 2 years, the U.S. market lagged Canada as it was overweight technology and growth stocks. The so-called FAANG (Facebook, Apple, Amazon, Netflix, Google) are down significantly, while they represented more than 35% of the S&P 500 until recently.

That being said, with our overweight positions in the Energy and Health Care sectors and regular profit-taking, we once again outperformed the indices in the first half of the year. Our best hits: Valero and Chevron. Our less profitable takes: Netflix and GM.

2.4.3. International

As you know, we prefer North America to the rest of the world. We believe that the additional return potential of emerging markets is not high enough to offset the increased volatility related to geopolitical risks in the region, and that Europe has serious structural problems. Only a few world-class companies such as Rio Tinto are included in our coverage universe.

2.5 Returns of main indices and mutual fund mandates

Mutual fund returns net of fees as of June 30, 2022 (CAD)

	Returns				
Mandate	YTD	1 year	3 years	5 years	10 years
Canadian Equities	-8.75%	-2.42%	6.88%	6.26%	7.82%
Canadian Balanced	-10.78%	-6.70%	2.91%	3.34%	5.05%
US Equities	-18.23%	-9.59%	7.09%	8.37%	12.39%
Global Equities	-20.84%	-17.16%	4.67%	5.24%	6.53%
International Equities	-18.07%	-15.58%	0.61%	1.81%	6.87%
Global Balanced	-13.91%	-11.59%	1.72%	2.87%	5.22%
Canadian Bonds	-12.13%	-11.59%	-2.50%	-0.25%	1.17%

Source: Morningstar

Total returns of the major indices as of June 30, 2022 (CAD)

	Returns				
Index	YTD	1 year	3 years	5 years	10 years
S&P TSX	-9.87%	-3.87%	7.97%	7.62%	8.18%
S&P 500	-18.65%	-7.07%	10.03%	11.15%	15.65%
NASDAQ	-28.35%	-20.94%	10.69%	12.27%	16.88%
MSCI World	-18.98%	-10.52%	6.96%	8.07%	12.73%
MSCI EAEO	-17.93%	-14.05%	1.02%	2.55%	8.41%
Canadian Bond	-12.23%	-11.39%	-2.30%	0.18%	1.72%
US Bond	-7.65%	-5.27%	-1.39%	0.60%	3.31%
CAD / USD	-1.61%	-3.92%	0.52%	0.14%	-2.33%
Preferred Shares	-11.97%	-7.54%	6.05%	2.60%	1.91%

Sources: Bloomberg, Banque du Canada, Barclays Capital, BMO Capital Markets, Standard & Poor's

2.6 2022 (year to date) returns of S&P 500 and S&P/TSX sectors

Canada	Relative Weight (31/12/2021)	2022 Return by Sector	2022 Relative Return
Financials	32.2%	-12.7%	-4.1%
Real Estate	3.1%	-22.9%	-0.7%
Energy	13.1%	23.5%	3.1%
Materials	11.5%	-9.0%	-1.0%
Industrials	12.0%	-9.9%	-1.2%
Consumer Discretionary	3.6%	-18.0%	-0.7%
Communication Services	4.7%	-2.9%	-0.1%
Consumer Staples	3.7%	-1.7%	-0.1%
Information Technology	10.7%	-55.3%	-5.9%
Utilities	4.6%	-0.6%	0.0%
Health Care	0.8%	-54.2%	-0.4%
		S&P/TSX return	-11.1%
		S&P/TSX return - ex. materials	-10.1%
		S&P/TSX return - ex. materials and energy	-13.2%

United States	Relative Weight (31/12/2021)	2022 Return by Sector	2022 Relative Return
Financials	10.7%	-19.5%	-2.1%
Real Estate	2.8%	-21.2%	-0.6%
Energy	2.7%	29.2%	0.8%
Materials	2.6%	-18.7%	-0.5%
Industrials	7.8%	-17.5%	-1.4%
Consumer Discretionary	12.5%	-33.1%	-4.2%
Communication Services	10.2%	-30.5%	-3.1%
Consumer Staples	5.9%	-6.8%	-0.4%
Information Technology	29.2%	-27.2%	-7.9%
Utilities	2.5%	-2.0%	0.0%
Health Care	13.3%	-9.1%	-1.2%
		S&P 500 return	-20.6%
		S&P 500 return - ex. tech.	-12.6%
		S&P 500 return - ex. tech. & cons. disc.	-8.5%

Second half forecasts

In this environment where everything looks disrupted, a well-thought-out strategy is essential. Planning matters the most in tougher times!

First, we believe there is a 50% chance of recession in the next 12 months, as we are paying for the errors and excesses of the past.

There is no need to panic, though. The bulk of the correction is already reflected in the markets; companies are healthy, we are back to full employment, inflation is starting to lose momentum, etc.

So, it is now time to think ahead to the next 12 to 18 months, and take a cue from the bond market (considered smarter than the stock market by many) to begin positioning ourselves.

Here are some predictions:

1. The U.S. Senate and House of Representatives will switch to the Republicans, despite widespread disapproval of the Supreme Court rulings.
2. With the economic damage caused by dramatic rate increases, interest rates will stabilize toward the end of the year and likely start declining in 2023.
3. As inflation is measured based on price comparisons over time, it will start receding.
4. Since the conflict in Ukraine is totally irrational, it is hard to predict when it will end. Regardless of the outcome, Russia will come out losing in the long run.
5. Production reshoring will continue in North America, but labour and housing shortages will need to be addressed if it is to be successful. A functional U.S. Congress would also help. These factors will slow down the process.
6. After a sharp price correction, many high-quality stocks are now reasonably valued. We think here of Google, Facebook, Amazon, etc. But beware of buying just about anything, as some stocks will not recover.
7. A recession means a new business cycle and sector repositioning. It is always difficult to get everything in sync, but now is the time to start thinking about this.
8. Energy will stay more expensive for longer. Several countries will want to reduce their dependence on Russia, the economy will reaccelerate, there will be a need to rebuild after the war, the last years' underinvestment in exploration and development will lead to a fragile supply-demand balance, etc.
9. Will Trump be the Republican candidate in 2024? We think it will be DeSantis from Florida.
10. If Pierre Poilievre becomes leader of the Conservative Party, expect a new Liberal victory at the next federal election.

3.1 Asset Allocation

Allocation recommended by BMO Capital Markets strategists based on your investor profile.

	Income		Balance		Growth		Aggressive Growth	
	Recommended Asset Mix	Benchmark Weights	Recommended Asset Mix	Benchmark Weights	Recommended Asset Mix	Benchmark Weights	Recommended Asset Mix	Benchmark Weights
Cash	10	5	10	5	10	5	5	5
Fixed Income	65	70	35	45	15	25	0	0
Equity	25	25	55	50	75	70	95	95
Canadian Equity	20	15	30	25	40	35	45	40
US Equity	5	5	20	15	20	20	30	30
EAFE Equity*	0	5	0	5	5	10	10	15
Emerging Equity	0	0	5	5	10	5	10	10

* Within EAFE, we specifically recommend Continental European equity.
Source: BMO Private Client Strategy

3.2 Currencies

As long as uncertainty persists, the U.S. dollar will remain strong. However, high energy prices are helping the Canadian dollar, that should gain some ground against the greenback.

3.3 Fixed Income

Interest rates will rise a bit further and then stabilize. Conservative investors should invest in bonds with an average maturity of 2 years (1-3 years) as they are finally earning something (4%). For those who can tolerate somewhat higher volatility, it seems appropriate to start buying longer-term bonds (7-10 years). Keep your preferred shares.

3.4 Equities

A defensive positioning will be warranted in the near term. Just as in the aftermath of the 2001 tech bubble burst and the 2008 financial crisis, investors will need to be highly selective when buying stocks that corrected sharply recently.

Short-term sector overweight recommendations:

Canada

- Consumer Discretionary
- Financials
- Resources

United States

- Telecommunication Services
- Financials
- Health Care

Conclusion

Although the current environment is disturbing, we must stay calm and look further down the road.

It is likely that we will experience a short recession, as a result of the rate hikes required to fight inflation. This is already discounted by the markets, and the bond market is starting to reposition itself toward a potential rate decline.

A recession also means a future economic recovery, for which we must gradually begin to reposition ourselves.

Together, we have done a good job in preserving your capital in the last months. We took advantage of the rotation from growth to value, and we acted prudently on the fixed income side.

We look forward to markets recovering, and we wish you a beautiful rest of summer!

Private Wealth

LEPORE | GOSSELIN | DESROCHERS
Wealth Management

BMO Nesbitt Burns

BMO Private Wealth is a brand name for a business group consisting of Bank of Montreal and certain of its affiliates in providing private wealth management products and services. Not all products and services are offered by all legal entities within BMO Private Wealth. Banking services are offered through Bank of Montreal. Investment management, wealth planning, tax planning, philanthropy planning services are offered through BMO Nesbitt Burns Inc. BMO Bank of Montreal are Members of CDIC. ® Registered trademark of Bank of Montreal, used under license.
BMO Private Wealth provides this publication for informational purposes only and it is not and should not be construed as professional advice to any individual. The calculation of performance data set forth herein has been prepared by the author as of the date hereof and is subject to change without notice. The author makes every effort to ensure that the contents have been compiled or derived from sources believed to be reliable and contain information and opinions, which are accurate and complete. The information contained in this publication is based on material believed to be reliable at the time of publication, but BMO Private Wealth cannot guarantee the information is accurate or complete. Individuals should contact their BMO representative for professional advice regarding their personal circumstances and/or financial position. Please note that past performance is not necessarily an indicator of future performance. The indicated rates of return are gross of fees or commissions. Individual results of clients' portfolios may differ from that of the model portfolio as fees may differ, and performance of specific accounts is based on specific account investiture. The noted model portfolio may not be appropriate for all investors. All rights are reserved. No part of this publication may be reproduced in any form, or referred to in any other publication, without the express written permission of BMO Private Wealth.
BMO Nesbitt Burns Inc. is a wholly owned subsidiary of Bank of Montreal. If you are already a client of BMO Nesbitt Burns Inc., please contact your Investment Advisor for more information.

PCD15982