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BMO Private Wealth

BROCK Wealth Management

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Philip's Comments

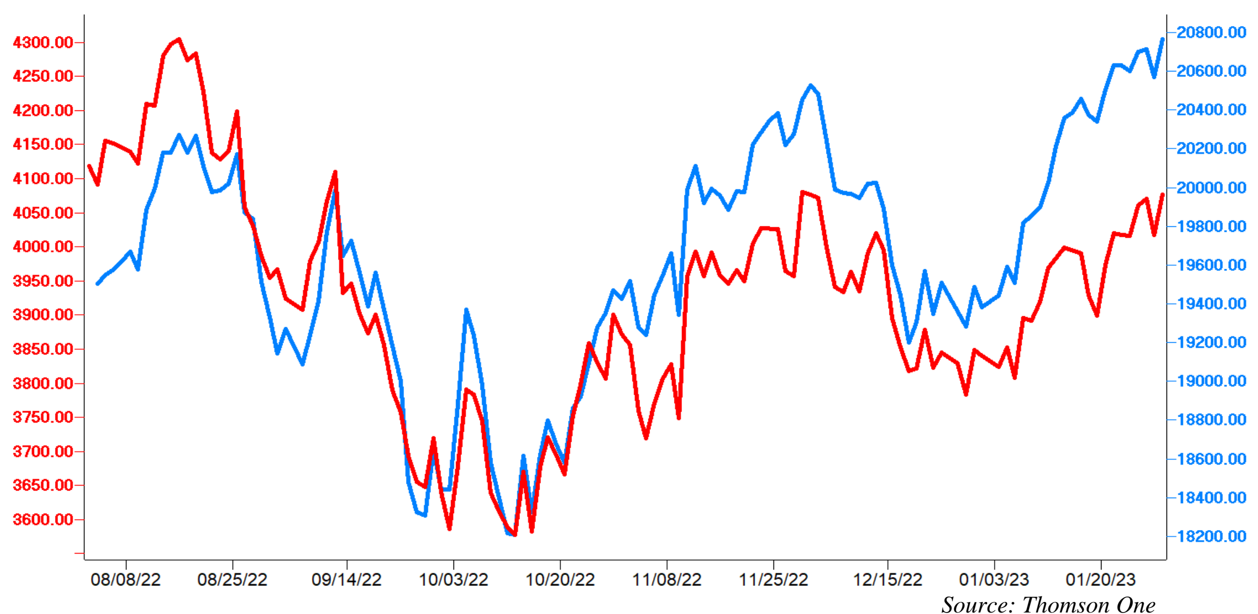
Special Notice:

Before providing you with our Winter 2023 commentary, I wish to take a moment to welcome a new addition to our team's personnel! I am happy to announce that **Elyse Gauntsmith, CPA** has joined Brock Wealth Management and that, upon completion of her training and licensing, she will fulfill the role of **Investment Associate**. A graduate of St. Francis Xavier University and the University of Toronto, Elyse adds a fresh perspective and new skillset to our team, having worked as a manager in a major accounting firm, specialising in audit and corporate tax, both in Canada and in France. I am very much looking forward to introducing Elyse to our clients, and I am confident that you will find her to be a valuable addition to our team.

***

Investors would be forgiven for hoping that with the start of a new year would come a calmer phase for financial markets, as the latter part of 2022 delivered little but volatility for both equity and fixed income securities. While Canadian markets posted firmer results than US markets over the last six months (with the S&P/TSX Composite Index advancing almost 1,200 points, or 6.1%, and the S&P 500 contracting by 36 points, or slightly less than 1%)[1], what really characterized markets on both sides of the border was jarring volatility, with investors experiencing painful lows in October, a substantial rally in November, another step back in December, and further recovery in January (see Figure 1). Truly dizzying.

*Figure 1: **S&P 500** & **S&P/TSX Composite Index** (August 1 2022 – January 31 2023)*

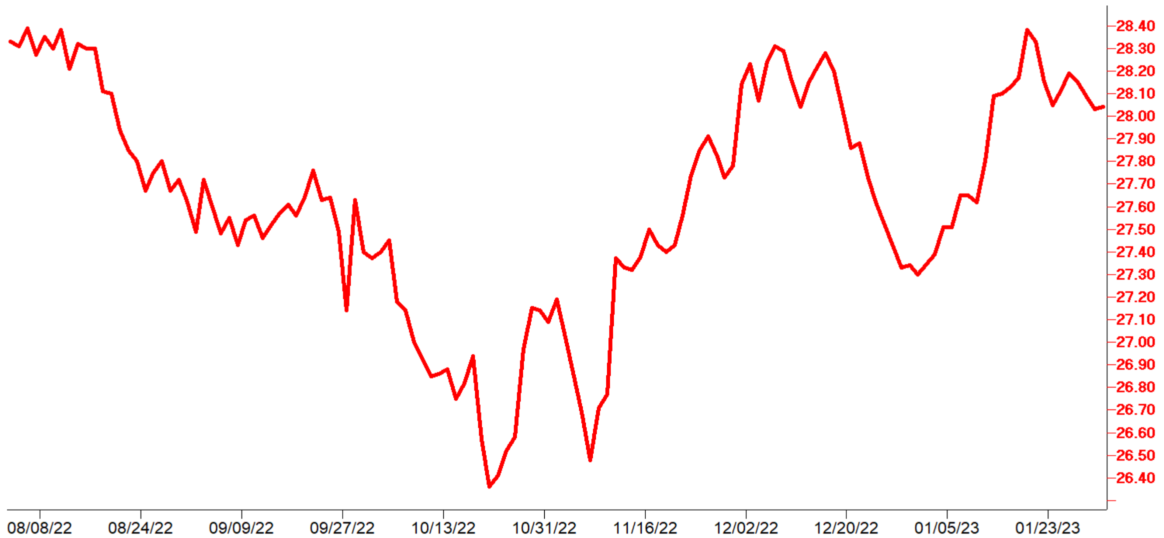


Source: Thomson One

Fixed income investors continued to face volatility in the second half of 2022, though less damage was done to bond values in the latter part of the year than what was

witnessed in the first half. Still, volatility prevailed, and just like with equity markets, the month of October marked a recent low for Canadian bonds[2] (see Figure 2).

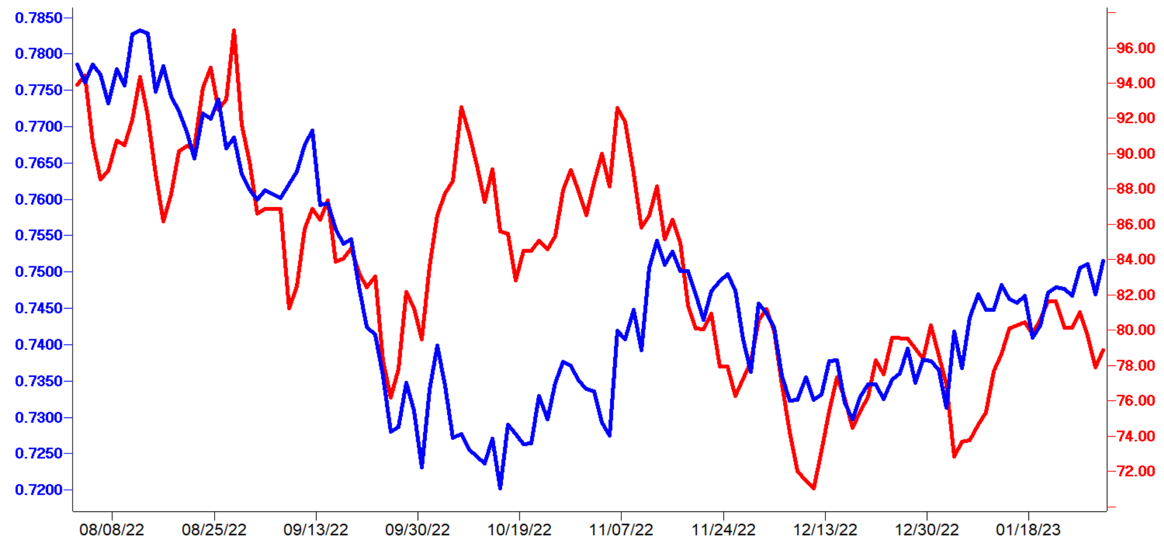
*Figure 2: **iShares Core Canadian Universe Bond ETF (XBB)** (August 1 2022 – January 31 2023)*



Source: Thomson One

Our Loonie – which had been performing admirably through much of 2022 as compared to the Greenback – was little changed over this period, losing a little ground to the US Dollar, in close correlation with Oil, which also weakened slightly[3] (see Figure 3). Our Foreign Exchange Strategists expect the Loonie to fare somewhat better in 2023[4], in particular if the Canadian economy strengthens along with commodity prices.

*Figure 3: **Oil (Light Crude)** & **Canadian Dollar (CAD/USD)** (August 1 2022 – January 31 2023)*



Source: Thomson One

The October lows in both bonds and stocks may yet prove to mark the low-point of this particular cycle (let's hope so) but regardless as to whether or not markets re-test those levels in the year to come, it is our belief that there is a significant transition at work in

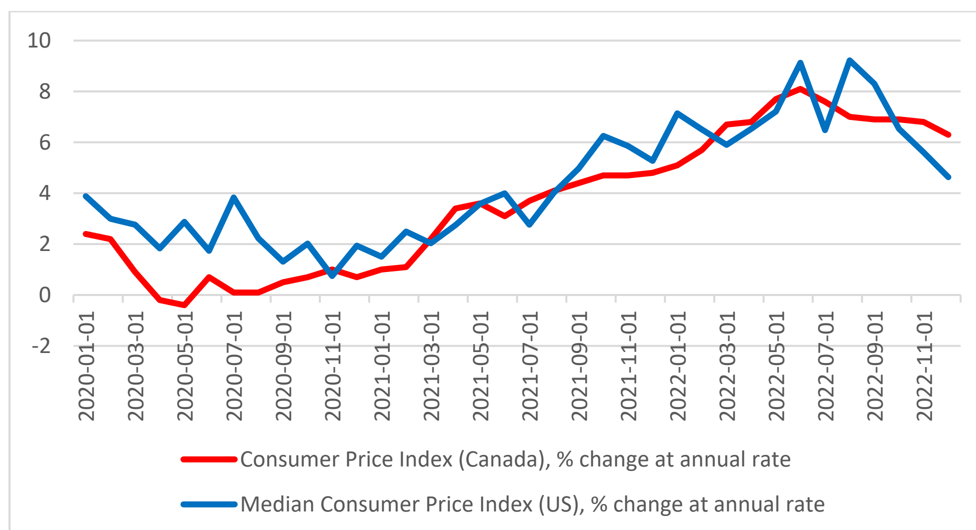
financial markets – that with the help of disciplined efforts by central banks around the world, markets may be in a good position to *Turn the Page*, and move into a new regimen of normalcy – characterized by higher prevailing interest rates, the return of an inverse correlation between equity and bond values and an end of "good-news-is-bad-news" dynamics, as well as a renewed enthusiasm for investing in lower-multiple "value" assets. In this newsletter (our 20th!), we will touch on these elements as well as discuss the strategic shifts we continue to implement in client accounts.

Inflation: the main plot line

On January 25th, the Bank of Canada announced a 25 basis point increase in its benchmark rate, and also indicated that there would be no further interest rate increases for the time being, while it monitors the "impact of cumulative interest rate increases"[5]. South of the border, the US Federal Reserve followed our central bank's lead, raising interest rates by 25 basis points, a step down from the 50 and 75 basis point increases that had characterized recent Fed meetings. While the Fed has essentially stated that it would keep its options open, it is widely expected that after this most recent interest rate increase, only one or two more would likely be considered before it too would consider a pause[6].

These efforts are bearing fruit, and a downward trajectory for inflation seems to be setting in on both sides of the border (see Figure 4).

*Figure 4: **Consumer Price Index (Canada)** & **Median Consumer Price Index (US)** (January 2020 – December 2022)*



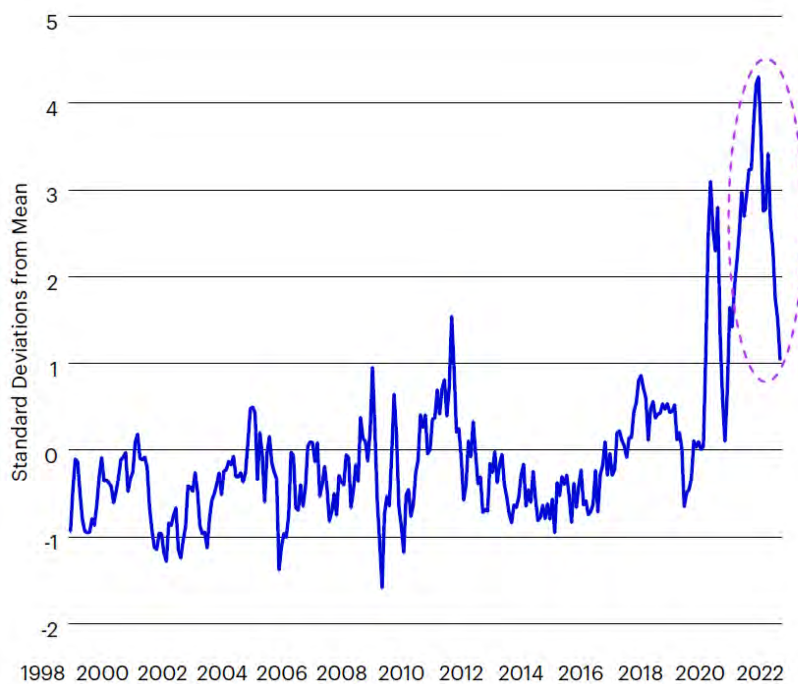
Source: Federal Reserve Bank of St. Louis, Statistics Canada

Central bank discipline has begun to produce effects, but higher borrowing costs tend to only show their full impact later – as consumers' mortgages, for example, are gradually reset to higher rates, changing consumers' behavior over time.

The inception of current inflationary pressures was the sudden shock to the global supply chain caused by the pandemic, which led Federal Reserve Chair Jerome Powell to famously use the term "transitory" in refence to the perceived temporary nature of rising

costs. The prevalent belief was that global trade would adapt, and inflation would ease. This theory was quickly set aside as inflationary pressures lingered and accelerated, and global supply chains were further strained by Russia's invasion of Ukraine last year. It also became apparent that government financial assistance during the pandemic (fiscal policy), as well as consistently low interest rates since the end of the 2008-2009 financial crisis (monetary policy) were serious contributing factors to the inflation problem[7]. Governments around the world are moving past the fiscal supports tied to the most restrictive phase of the pandemic, and central banks are turning off the tap of easy money by tightening monetary policy. Beyond this, while geopolitical challenges such as COVID or the war in Ukraine have yet to resolve themselves, the global supply chain has begun to adapt[8] just like the proponents of the "transitory" nature of inflation believed (see Figure 5)… only far later than initially expected.

Figure 5: Global supply chain pressure index (1998 –2022)

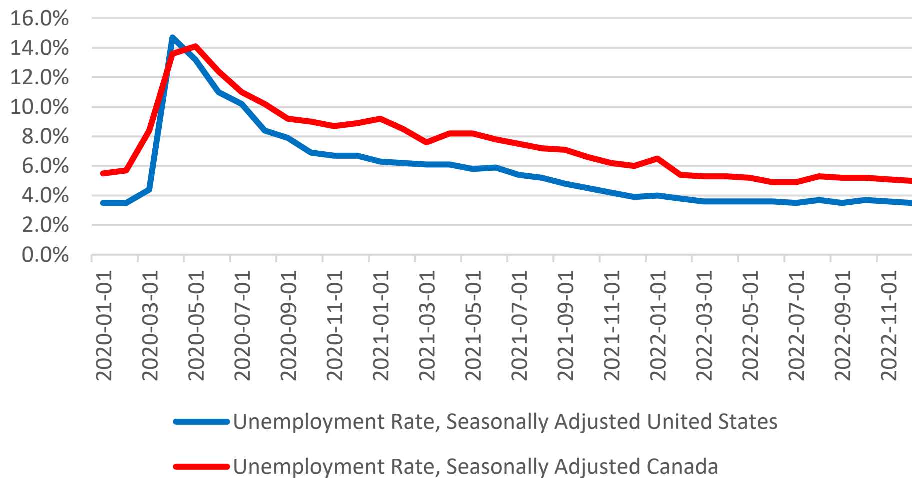


Sources: Invesco, Bloomberg L.P., S&P Global, and the Federal Reserve Bank of New York, as of 2022-09-30

With the above-mentioned factors (monetary policy, fiscal policy, supply chain effects) steering inflation lower, it stands to reason that the Consumer Price Index (CPI) results from last summer may represent high-water marks, and that we should expect inflation to continue to ease this year. If this expectation were to become reality, this would be good news for both stocks and bonds, as financial assets in general do not perform well in periods of high inflation[9]. Central banks on both sides of the border, and on both sides of the Atlantic have set their targets for inflation at 2% - still a long way lower than where we find ourselves now. It may be that inflation does moderate but gets "stuck" at higher levels than the central bankers would like. Their reaction to a 3% inflation world, for example, is hard to know, especially since most central banks also carry a second mandate – the achievement of full employment – and that further monetary tightening to "unstick" inflation could lead to economic hardship.

One year ago, in the Winter 2022 edition of our newsletter titled "*Soft Landing?*" we discussed the task ahead for central bankers: the engineering of a soft landing, or a deliberate slowdown of economic activity, in order to ease inflation while avoiding recession and the high unemployment rates that come with it. It is too early to tell if these efforts will be entirely successful, but early indications are that the landing is softer than it could have been. We (probably) have seen inflation peak, and we have seen it begin to moderate, all the while, unemployment rates on both sides of the border have continued to fall (Figure 6). Gross Domestic Product (GDP) numbers on both sides of the border also pointed to economic growth (though slowing) rather than contraction – with US GDP numbers annualizing at 2.9%[10] for Q4 2022, and Canadian GDP numbers posting at 1.6%[11] for the same period.

Figure 6: Unemployment Rate, Seasonally Adjusted, in ***Canada*** *& the* ***US*** *(January 2020 – December 2022)*



Source: Federal Reserve Bank of St. Louis, Statistics Canada

These GDP numbers do point to a deceleration of economic growth, and it would not be surprising to see both Canada and the US experience a period of contraction (negative growth) often associated with a recession at some point this year[12]. It is also true that GDP and employment data are lagging indicators – and are not very helpful in forecasting future trends. Furthermore, *leading* indicators such as the currently inverted shape of the yield curve point to further challenges ahead. However, six months ago we were facing much higher rates of inflation than we are today, and the possibility existed that the remedy of rising interest rates would have triggered a major economic adjustment that would have caused unemployment to spike.

Every narrative about markets is filled with subplots and distractions, but in our view the throughline is clear: markets find themselves on a stronger footing today than six months ago, and that bodes well for the year to come.

Plot holes ahead…

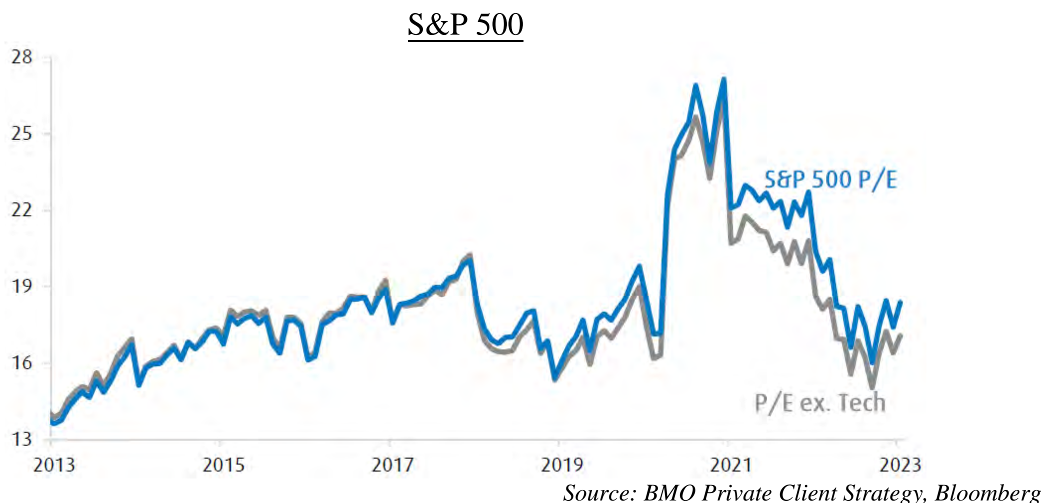
While it is true that we look forward with some measure of optimism, we recognize that any major shift in market dynamics like what we believe is occurring at this time will not take place without the occasional setback and periods of meaningful market volatility.

We continue to see significant risk on the horizon from evolving geopolitics, with the war in Ukraine far from over – though its economic impacts have eased a little with Europe experiencing a far warmer winter than usual[13], and therefore not relying nearly as much on Russian-sourced natural gas – and US tensions with China ballooning[14] – though China's recent push towards pandemic re-opening[15] should continue to ease pressure on the global supply chain.

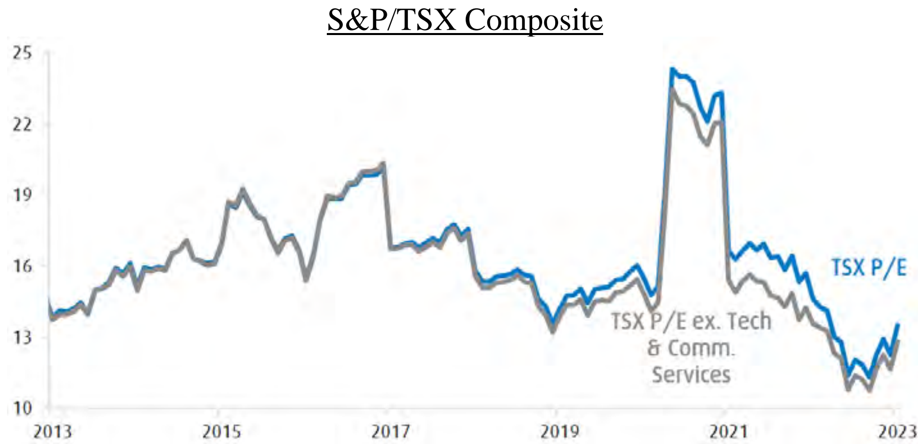
Before pen is put to paper on next summer's Newsletter, we will also navigate yet another round of America's perennial debt-ceiling fiasco, and this time with a new Speaker of the House, Kevin McCarthy, who's difficult election to the role effectively granted his congressional colleges a veto over his speakership[16], no doubt complicating future debt-ceiling negotiations. Nevertheless, the United States of America has never defaulted on its debt, and we feel that it would be a bad bet to assume that this time it will, though if negotiations fail to make progress we could see a circumstance not unlike the summer of 2011[17], when America's credit rating was downgraded, which caused financial markets to gap lower before eventually recovering.

We will continue to use moments of market volatility like those that may be caused by the factors above as opportunities to rebalance our clients' portfolio exposures, keeping in mind that, geopolitics notwithstanding, the most important consideration in investing is the price we pay for assets, and that if we can build an equity position at a good value (without over-paying) over the long term we can navigate all kinds of risks, both foreseen and unforeseen alike. Thankfully, the year has brought about a moderation in the valuation of equity markets[18] on both sides of the border, in particular when excluding the more expensive technology and communication services sectors (see Figure 7).

Figure 7: P/E Ratio and P/E Ratio ex. Tech (2013 – 2023)



Source: BMO Private Client Strategy, Bloomberg



Source: BMO Private Client Strategy, Bloomberg

These more modest equity valuations should help us move forward with confidence as we navigate the year to come.

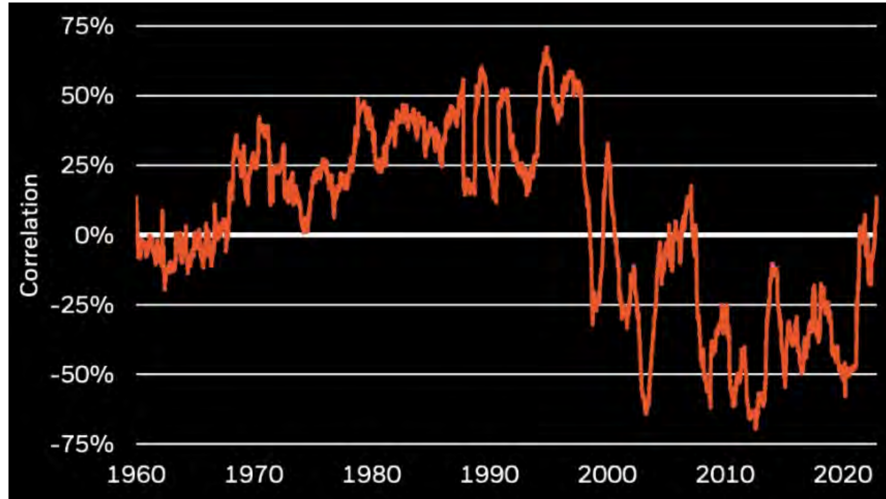
Writing the sequel

This last point of valuation vs. risk is a good place to broaden out our discussion and to outline the sequel to this story by plotting our next steps.

If the initial pages of this market commentary seemed focused on macro-economics, it is because that has been the obsession of markets in recent memory – to the point where good economic news such as strong employment numbers have caused downside volatility in equities and bonds alike as the market was more focused on the reaction of the central bank to any such positive datapoint, as increasing the likelihood or expected pace of interest rate increases. As inflation normalizes, and central banks openly advertise "wait-and-see" approaches or outright pauses, we would expect this "good-news-is-bad-news" phenomenon to end – and that would be good news indeed.

With this should also come a re-emergence of the negative correlation between stocks and bonds – which is caused by capital flowing from conservative assets such as bonds into equities when investors feel optimistic, and back into bonds when investors feel fearful. Since the pandemic, equity markets and bond markets have been moving in tandem, which was most apparent in 2022 – a year where the stock market posted negative returns, and fixed income investors also faced particularly painful outcomes. That said, there have also been prior periods in history (see Figure 8) when correlations between both asset classes have been high and positive – with inflation and growth dynamics dictating which correlation regime we find ourselves in.

Figure 8: Correlations of U.S. equity and government bond returns



Source: Blackrock, Investing.com

This has further reinforced our conviction in our recent decision to prioritize ladders of Guaranteed Investment Certificates (GICs) for client accounts. We have also increasingly been introducing discount (less-than-par-value) bonds with lower coupons in non-registered client accounts in particular, in order to achieve comparably laddered structures with more tax efficiency.

We expect the world we face to be one of slightly higher (than what we were used to pre-pandemic) inflation and decidedly higher interest rates, and this is an environment where we will look with increasing suspicion at high-multiple, interest-sensitive "growth" assets such as technology and certain consumer discretionary and communication services securities. It is with this in mind that we have incorporated a recent change in our client holdings in passive securities, with the most significant change being the elimination of many market-weight S&P 500 exchange-traded funds, in favor of equal-weighted alternatives, thereby decreasing client exposure to the above-mentioned industrial sectors. Further changes of this type may be contemplated.

A higher interest-rate regime also caused us to select model portfolio holdings with lower levels of leverage, which was the rationale at the source of our recent elimination of Chartwell Retirement Residences (CSH.UN) in favor of CT REIT (CRT.UN) – not to mention Chartwell's continued struggles at raising its occupancy rates in an industry forever changed by COVID.

It is our expectation that 2023 may bring about an investment environment that feels more classically familiar – where equity valuations matter and where good news is good news again: in large part because financial markets have closed the book on low interest rates.

Conclusion

Volatility was the watchword for markets in the second half of 2022, with equity and bond markets finding fresh lows in October. Since then, we have seen asset values recover somewhat, with central banks making progress in their fight against inflation.

- Rising interest rates, less accommodating fiscal policies, and easing pressures on global supply chains have caused an apparent peak in inflation and a subsequent moderation of inflationary pressures, though it is still too early for central banks to claim victory, with inflation still substantially higher than their targets.

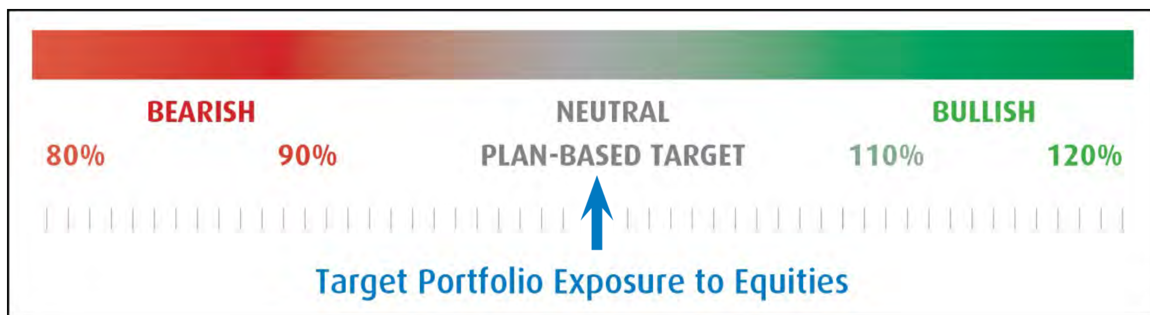
- Various risks remain on the horizon for financial markets – including the possibility that inflation heats up again, as well as various geopolitical concerns, but more modest equity valuations could provide markets with a certain measure of resistance to these potential obstacles.

- If inflation continues to moderate without the onset of a major recession, we may be left with an investment environment characterized by the return of inverse correlations between stocks and bonds, a renewed role for fixed income securities in contributing to investors' total return, and an environment for equities where valuations matter once again – all of which we would see as positive developments.

Asset Allocation

Every investor's asset allocation target should be determined through a financial planning process. The portfolio's equity allocation should be in line with this target when our view on the markets is "neutral". At times, financial markets will present us with possibilities for greater growth or greater risks. Modifying the asset allocation of the portfolio to account for these factors is appropriate, so long as the investor's actual asset allocation does not deviate too severely from their plan and remains within their investor profile and risk tolerance boundaries.

At this time our view is that portfolios should be tilted as follows (deviations are a percentage of equity exposure, not a percentage of the total portfolio):



For example, a portfolio with a long-term strategic target of 60% equity should currently be targeting an equity weight fully in line (100%) with this target.

Please note that our Model Portfolio is meant to be a guide as to the equity portion of our clients' portfolios – not their entire portfolio. Clients who have *Balanced* or *Income* investor profiles will require significant assets in fixed income securities in addition to the equities they hold.

Model Portfolio Metrics

	Model Portfolio	MSCI World Index[19]
Yield*	2.64%	2.21%
Portfolio Beta*	0.90	1.00
Number of Holdings	30	1508
Sector Allocation (Core Portfolio)		
Financial Services	25.0%	14.3%
Real Estate	2.5%	2.7%
Communication Services	7.5%	6.4%
Utilities	8.3%	3.2%
Consumer Staples	14.5%	7.9%
Consumer Discretionary	10.0%	10.0%
Healthcare	6.0%	14.6%
Information Tech.	6.0%	20.2%
Industrials	11.0%	10.7%
Energy	4.3%	5.7%
Materials	5.0%	4.5%

*As at 2023-01-31; source: Thomson ONE

Meet Our Team

Philip Brock, CFA, CFP, F.Pl., B.Com
Portfolio Manager and Financial Planner
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Philip made his entry in the financial industry almost two decades ago, in 2004, and joined BMO Nesbitt Burns as an Investment Advisor in March of 2006. Since then, Philip has advised many families on retirement and estate planning, personal credit, and investment management. In addition to his work with clients, Philip served as Assistant Branch Manager for the Ottawa Dalhousie/Lansdowne branch of BMO Nesbitt Burns between 2014 and 2019. Philip holds a B.Com. from the University of Ottawa with options in finance and international management and holds the Chartered Financial Analyst (CFA) designation. In addition, he has been practicing financial planning as a CFP® certificant since 2007 and has held the *Institut Québécois de planification financière*'s F.Pl. designation since 2015. Philip is happy to offer his services in English and French.

Born in Montreal, Philip has lived in the National Capital Region since 1987. He calls Orléans home along with his wife Kathleen and their young sons, David, Jonathan and Nicolas. When he's not providing financial advice to his clients, he and his family can usually be found on the ski hill, camping, cottaging, or travelling.

Patricia Butler, DEC, B.A.
Senior Investment Associate
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Patricia has worked in the financial services industry for over 35 years and is well known to our clients, having joined BMO Nesbitt Burns in 2004, after having worked in various positions in banking, lending, and investments at other financial institutions. She completed her Diplome d'études collégiales (DEC) at Vanier College in Montreal in 1983, completing a program in special care counselling. She then received a BA from Concordia University in 1987 and has completed the Canadian Securities Course (CSC), Conduct and Practices Handbook course (CPH), Professional Financial Planning Course (PFPC) and the Derivatives Fundamentals and Options Licensing (DFOL) course. As a Senior Investment Associate, Patricia engages with our clients around issues of financial planning and portfolio maintenance and is happy to assist clients in either English or French.

A Montreal native, Patricia enjoys golf, boating, reading and spending time with her husband, two children, and three grandchildren.

Elyse Gauntsmith, CPA, BBA
Client Service Assistant
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Elyse joined the financial services industry in 2017 following her undergraduate and graduate studies at St. Francis Xavier University and the University of Toronto. A Certified Public Accountant (CPA), Elyse was a Dean's List graduate receiving her BBA in Accounting, and subsequently received a Graduate Diploma in Accounting. More recently, she has completed Chartered Financial Analyst (CFA) Level 1 as well as the Canadian Securities and Canadian Professional Handbook courses. Prior to joining BMO Nesbitt Burns in January 2023, Elyse was a manager at Ernst & Young where she participated in a variety of financial statement audits and the preparation of corporate tax returns. During 2022, Elyse pursued an international transfer to the EY Paris office to further her professional development, including her proficiency in French.

Outside of work, Elyse is most passionate about staying active, traveling and reading. Elyse will always find time to prioritize a workout and participates in a bi-weekly book club. She strives to visit at least one new country a year.

Clara Augustine, BBA
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Clara has nearly two decades of experience in Business Administration and Sales Management. She received her BBA from the University of New Brunswick, subsequently beginning her career in the financial services industry. Clara worked with several BMO Bank of Montreal branches in a management capacity, joining BMO Nesbitt Burns in 2018, when she completed her Canadian Securities Course and Conduct and Practices Handbook course. She works closely with each member of our team to ensure your administrative needs are met seamlessly in the pursuit of your investment goals, and is pleased to offer her assistance in either English or French.

Clara was raised on the East Coast, where she lives with her husband and their young children. She is passionate about fitness, cooking, and spending time near the ocean with her family.

Megan Labelle, DEC, BBA
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Megan entered the financial services industry in 2016, completing her Canadian Securities Course and Conduct and Practices Handbook course to become a licensed investment representative. Megan earned her DEC from Heritage College in 2013 and was a Dean's List graduate of St. Francis Xavier University's BBA degree with a focus on leadership in management. Before BMO Nesbitt Burns, Megan's career was in hospitality with five years of experience in front office operations at hotels of varying size. She is dedicated to fostering strong client relationships and trust, as well as careful attention to detail, and loves keeping the team organized. She is pleased to offer assistance in English and French.

Megan was born and raised in Aylmer, and is now settled in Ottawa. In her spare time, she enjoys cooking, spoiling her chihuahua Flash, listening to audiobooks, traveling the world with her partner, and has a passion for advocating equality and LGBTQ+ rights.

[1, 2, 3] Thomson One

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[19] MSCI World Index, MSCI Inc, www.msci.com

[20]

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