BMO Nesbitt Burns

ISSUE #106: FALL 2022

The Fundamental Investor

A QUARTERLY INVESTMENT NEWSLETTER

# PARADIGM SHIFT?

Good asset managers are constantly asking themselves if anything fundamental has changed with respect to their basic assumptions about the economy and financial markets. While truly profound changes to the market environment are few and far between, they do happen: changes profound enough to force most asset managers to make important modifications to their general approach.

I am convinced that we are undergoing exactly such a shift: a fundamental change in the investment environment that will have serious implications for all investors for years to come. Specifically, I am referring to the resurgence of inflation. A pernicious force we haven't had to deal with in almost four decades.

**The Myopia of Nominal Returns**

I can't blame the average investor for thinking in nominal returns, after all it's pretty much what's posted and reported everywhere we look. Furthermore, we all tend to suffer from recency bias and with inflation having been subdued for so long, investors can be forgiven for thinking of inflation as zero and equating nominal returns to real returns. But when inflation picks ups dramatically and looks to be sticky, failing to make asset allocation adjustments can lead to a rapid erosion of purchasing power. There's a big difference between earning a 7% return and ignoring a benign 1-2% inflation rate and earning 7% in a 5% inflation environment!

**The Destructive Period of 1966-82**

This is exactly what happened to investors in the late 1960s. Not only did inflation start to move, but it would also prove to be sticky at structurally higher levels. Furthermore, year-to-year levels of inflation began to fluctuate wildly: ramping up to 5.7% in 1970 from a fairly consistent 1-2% during the previous decade; plunging to 3.2% in 1972; jumping to 11% in 1974 during the Arab oil embargo; falling back to 5.8% in 1976; leaping to 7.6% in 1978; before finally peaking at 13.5% in 1980.

While many still talk about The Crash of '29 as the ultimate bear market, I would highlight that because consumer prices fell quite dramatically during the early depressionary years that followed, that the 1966-82 period was actually worse for investors in real terms. Those that had cash savings, held government bonds and still had income from a job, actually saw their purchasing power increase by as much as 30%. During the 1966-82 period bond investors where eviscerated in real terms and if you didn't own the 'right kind of stocks' things weren't much better, as the Dow Jones Index meandered sideways between 700 and 1000 for 15 years. Those that failed to see the paradigm shift getting under way in the late '60s and failed to reposition their portfolios for higher inflation, got eaten alive.

*continued on back page*

**Al Rizk**, BBA, CIM
Portfolio Manager
Tel: 514-286-7242
al.rizk@nbpcd.com

**Mark A. Stairs**, B.Eng., CFA
Portfolio Manager
Tel: 514-286-7334
mark.stairs@nbpcd.com

**RS Wealth Management**
**BMO Nesbitt Burns**
3200 - 1501 McGill College Ave.
Montreal, Quebec, H3A 3M8

# FIXED INCOME: Good-bye TINA, Hello TARA

For the better part of the past decade investors looking for income had no choice but to buy equities. Hence, market participants used the acronym TINA (There Is No Alternative) to stocks to describe the landscape.

The current monetary tightening cycle driven by inflation has finally given savers a chance to put money into safe, guaranteed investments that offer a reasonable return. We had been warning of the dangers of bonds and have had a hard time finding suitable fixed income holdings for portfolios. This forced us to overweight cash and dividend paying equities, however the situation has changed substantially over the past few months. Our overweight cash position has saved our clients some pain this year, as bond prices have been trashed by rising interest rates. Today, there is a new acronym: TARA (There Are Reasonable Alternatives)!

**There's A Limit**
While no one can know the exact trajectory of interest rates, we suspect that there is a limit to how much central banks can raise them. We have already witnessed the tremendous damage done to many emerging economies and currencies by the relentless rise of the U.S. dollar. As the Americans aggressively raised their interest rates to combat inflation, the dollar rose against other currencies.

Since many commodities and most world trade is done in dollars, a strong dollar has exacerbated the inflation problem for the rest of the world. This has caused a lot of pain for the world's emerging economies who spend a disproportionate amount of their resources on sustenance.

Even in developed economies, the rise in interest rates and the dollar is starting to put very serious pressure on their financial systems. At some point, sooner rather than later, the Federal Reserve is going to be forced to scale back its rhetoric and begin to cut rates.

Even if the Federal Reserve decided to ignore concerns outside its borders, at some point the monetary tightening is going to cause a recession at home. We have already seen housing roll over and economic activity begin to slow. Hence, it will be very difficult to continue the super hawkish stance with American families struggling and the economy in decline.

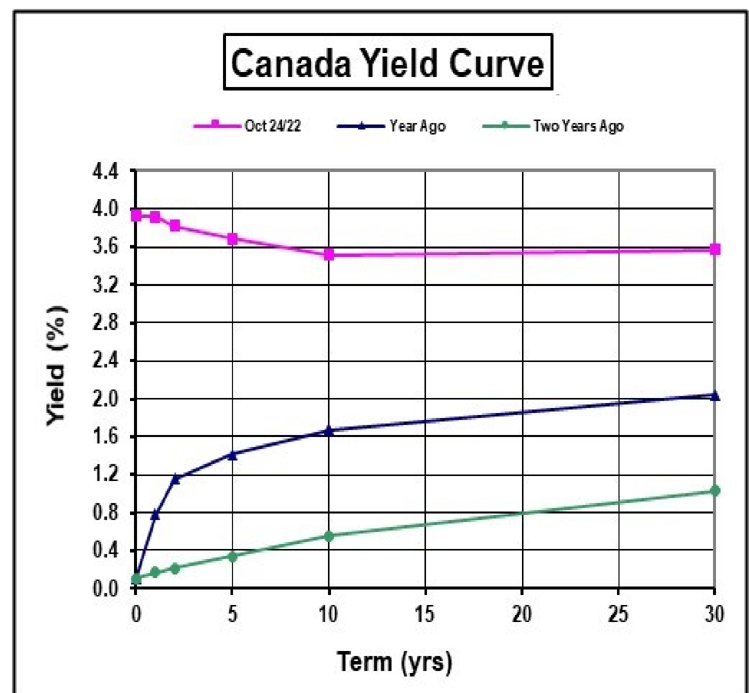
The Bank of Canada has also been tightening and no doubt we are also approaching the limits of what the economy can handle. The amount of debt held by Canadian households leaves them unable to withstand much higher borrowing costs.

The market believes central bankers will be able to bring inflation under control. I'm not sure if we will return to their long-term stated goal of 2%, but certainly much less than what we have recently lived through. As I have written in past issues, I believe that the world has changed post pandemic and several secular forces now favor a higher for longer inflation rate.

**Opportunity**
As investors, I believe this has created opportunity: Investors can now comfortably allocate some funds to fixed income. GICs (Guaranteed Investment Certificates) are currently offering better yields than equivalent maturities for government bonds. A year ago these instruments were paying 1-2%, now we can get between 4-5%.

If in fact, central banks will eventually be forced to moderate or even reverse course due to the reasons I highlighted above, perhaps we will look back at these rates a few years from now with nostalgia. Either way, even if rates continue to move a bit higher from these levels, at least investors now have an alternative to the stomach churning volatility in the stock market.  They can now at least put a portion of their hard earned money in safe, secure guaranteed investments and earn a reasonable return.

*Always to be careful out there.  Sincerely, Al.*



# PORTFOLIO MANAGER: No Pain, No Gain

Investors have had quite the year so far in 2022. Many individual stocks are down 60, 70 and even 80%, while the broader indices are off by as much as 25%. Thankfully, we haven't suffered anywhere near those levels of decline in portfolios under our management. However, persistent elevated volatility and negative headlines have made this a difficult year.

As portfolio managers and fiduciaries we try our best to protect our clients' money. It is tempting to try to "add value" by selling out of positions while markets are in a general decline. I sincerely believe that in most cases this would actually be doing our clients more harm than good. This is because timing the market is almost impossible. First, you need to be right about when to get out and then you need to be right again about when to get back in. Furthermore, in non-registered accounts, the disposition of low cost, long held names would prematurely trigger taxable capital gains. I am well aware of the data that shows returns made by most investors are far lower than market returns. While there are several factors at play, the biggest one is that most investors make the wrong decisions at extremes: selling when conditions appear gloomy and markets are down while often over paying when the environment is optimistic and markets are buoyant.

Mark and I focus on making sure we buy quality companies at reasonable prices. This combination does not prevent portfolio values from declining, as Bear Markets generally pressure most sectors and companies. However, such names decline less and more importantly, they recover when conditions improve.

The current volatility in markets is truly head spinning. Intraday moves of 1000 Dow points have occurred a number of times. Reversals from up to down and vice versa happen within minutes. I believe this is more evidence that investors need to be in for the long term. Those who follow the market closely on a daily basis recognize that movements are based on unforeseen events and unknown incoming data.

| Wilshire 5000 - Worst 9 Months Periods & Forward Returns (1971 - 2022) | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| Worst 9 Month Periods | | | | Forward Total Returns | | | | | |
| Rank | Total Return | Start Month | End Month | 3-Month | 6-Month | 1-Year | 3-Year | 5-Year | 10-Year |
| 1 | -46.7% | Jun-08 | Feb-09 | 26% | 42% | 56% | 102% | 189% | 372% |
| 2 | -39.3% | May-08 | Jan-09 | 8% | 23% | 35% | 73% | 147% | 309% |
| 3 | -37.0% | Jul-08 | Mar-09 | 17% | 36% | 52% | 91% | 167% | 341% |
| 4 | -34.5% | Jan-74 | Sep-74 | 9% | 36% | 41% | 84% | 153% | 392% |
| 5 | -32.3% | Mar-08 | Nov-08 | -16% | 6% | 27% | 53% | 132% | 288% |
| 6 | -30.6% | Apr-08 | Dec-08 | -11% | 4% | 28% | 52% | 134% | 246% |
| 7 | -29.7% | Aug-08 | Apr-09 | 14% | 20% | 41% | 72% | 142% | 315% |
| 8 | -28.6% | Feb-08 | Oct-08 | -14% | -7% | 11% | 41% | 108% | 250% |
| 9 | -28.1% | Nov-73 | Jul-74 | -5% | 1% | 21% | 50% | 90% | 255% |
| 10 | -27.2% | Mar-74 | Nov-74 | 19% | 35% | 36% | 65% | 123% | 334% |
| 11 | -27.2% | Sep-08 | May-09 | 12% | 20% | 23% | 53% | 135% | 268% |
| 12 | -27.0% | Apr-74 | Dec-74 | 25% | 46% | 38% | 70% | 135% | 356% |
| 13 | -26.6% | Jan-02 | Sep-02 | 8% | 4% | 26% | 66% | 115% | 129% |
| 14 | -25.9% | Jan-22 | Sep-22 | | | | | | |
| 15 | -25.0% | Dec-73 | Aug-74 | -1% | 18% | 29% | 62% | 121% | 333% |
| 16 | -23.7% | Feb-74 | Oct-74 | 7% | 22% | 26% | 51% | 100% | 318% |
| 17 | -22.0% | Oct-73 | Jun-74 | -25% | -18% | 19% | 41% | 75% | 236% |
| 18 | -21.8% | Feb-01 | Oct-01 | 8% | 5% | -13% | 18% | 53% | 58% |
| 19 | -21.6% | Apr-02 | Dec-02 | -3% | 13% | 32% | 58% | 93% | 113% |
| 20 | -21.2% | Jul-00 | Mar-01 | 7% | -10% | 3% | 9% | 33% | 55% |
| Average Worst Periods | | | | 4% | 16% | 28% | 59% | 118% | 262% |
| Average All Periods | | | | 3% | 6% | 12% | 41% | 79% | 218% |
| Differential | | | | 2% | 10% | 16% | 18% | 40% | 44% |
| COMPOUND | | Data as of 9/30/22 | | | | @CharlieBilello | | | |

**Data Dependent**

As I wrote in the last edition of this publication, markets are currently hyper-focused on incoming data relating to inflation and hence the future path of interest rates. Every piece of inflation related information that is hotter than expected, results in a surge in the U.S. dollar, an increase in bond yields and a decline in equity prices.

From time to time the market seems to believe that the next data point will be softer, will therefore lead to a slowdown in the pace of interest rate increases and the stock market subsequently rallies. It is impossible to predict weather or not the next report will be hotter or cooler than expected. In addition, markets discount the released information very quickly, so any attempt to make portfolio moves post-release are effectively too late. Our clients' goals are measured in years, not the short-term focus of financial markets and algorithmic traders. Even for clients who are withdrawing funds for retirement, the money is intended to be there for the rest of their lives and in most cases beyond.

**The Song Remains The Same**

This is not the first time markets have declined. Over the past few years, we have seen some difficult periods. The reasons for the declines are not always the same, in fact, they are almost always different. However, problems get resolved, markets recover and investors who stay the course, get rewarded in the end.

The recent decline in prices has brought valuations down substantially, setting the stage for interesting future returns. Benjamin Graham, father of value investing and mentor to Warren Buffett is famous for saying: *"In the short-term the stock market is a voting machine, but in the long-term it's a weighing machine".* In other words, the market is currently looking at the next few quarters and is concerned with economic slowdown, recession, inflation and is therefore pricing on this shorter time horizon. However, as the economy normalizes and we emerge from the slowdown, the true earning potential for many quality names is far greater than is currently being priced in.

In investing, it's not always the most intelligent or most clever who succeed, sometimes it is simply the ability to endure some discomfort and have conviction and patience. Nobody likes to see the value of their portfolio decline (myself included), unfortunately that is the only true and tested way to achieve long term investment success.

*I never said it was going to be easy. Sincerely, Al.*

*continued from front page*

**Peak Inflation, Are We There Yet?**
Even if inflation settles back down from its recent post-pandemic highs, I feel confident, based solely on the lack of investment (i.e. exploration & development) by commodity producers especially energy companies, that it will be nearly impossible for inflation to come back down to pre-pandemic levels of 1-2% and stay there for years. Add-in other factors such as deglobalization, rising labour costs (China cheap labour all used up), aging demographics in most parts of the world, reshoring of fragile supply chains and inflation over the coming decade is likely to average 3-5%: a paradigm shift indeed! Such a structural change will require a downward repricing of all asset classes. I believe this repricing began with the money losing bubble stocks in spring of 2021 and has now moved to the broader stock and bond markets in 2022. The real estate markets have also come to a grinding halt with the doubling of mortgage rates this year. This will eventually be followed by downward price adjustments.

**Forget the Fed Put, Central Bankers Are Trapped**
As central bankers continue to raise rates and talk tough about shrinking their massive balance sheets, asset classes are cracking one by one. So far the repricing has been quite orderly in my view. Real Bear Markets, not just quick & dirty corrections, tend to be grinding multi-year affairs. There is simply too much debt at every level, sovereign, corporate and consumer, for central bankers to actually raise rates high enough to kill inflation. Once market participants and consumers start to realize that the emperor has no clothes and that all central banks will be forced to pivot back to lower rates and Quantitative Easing (QE: printing of money to buy bonds in order to support government spending), then the jig is up.

**Bank of England (BoE) First to Pivot**
Following the appointment of Elizabeth Truss as the new British PM, her conservative government promptly announced an 80B pound energy subsidy for British households and a broad based tax cut. The conflicting polices of stimulative government subsidies and tax cuts while the BoE was attempting to tighten, clearly made no sense. Investors revolted en-mass, dumping both UK bonds and the pound. The yield on British long bonds rose precipitously, while the pound probed multi-decade lows vs the dollar. Investors looked at the new government's fiscal numbers and they just didn't add up and thus they decided to vote with their feet. This precipitated a crisis in the UK pension fund sector, forcing the BoE to abandon its scheduled Quantitative Tightening plans, pivot 180 degrees and begin QE (print pounds to by government bonds) again to halt the vicious decline in bond prices. A price decline which threatened to render a majority of UK defined benefit plans insolvent! Rest assured that while the BoE may have been the first to pivot, they won't be the last.

**Go Macro or Go Home**
I started my career in 1993 during the early years of a new regime of central bank (and fiscal) market interference, guided by then Fed Chair Alan Greenspan. Despite this growing market interference—(think 1998 Long Term Capital Management crisis, 1999 Y2K panic, 1% interest rates post dot.com bubble burst, etc.) company specific fundamentals still mattered and remained the dominant force in the market place. As a bottoms-up fundamental value investor myself, this time tested approach proved very profitable for the first half of my career. I recall Louis Rukeyser, host of PBS's very popular *Wall Street Week*, asking his guest, the great Peter Lynch, how much time he spent studying macro variables and what influence they had on his asset management. To which Lynch answered, *"I think last year I spent a total of 10 minutes thinking about macro economic variables and that was probably 10 minutes too much."*

No doubt, Lynch would find today's world very different. Post the popping of the real estate bubble of 2008, the financial markets would come to be dominated by radical and unproven central bank policies, not the least of which included, zero interest rates and QE. All investors must now be macro economists!

**Don't Get Caught by the Shifting Sands**
Unfortunately there are very few financial advisors practicing today that have any experience managing money in an inflationary environment. Most have been lulled into complacency by the past decades of low and stable inflation accompanied by central bank largess. Furthermore, their now well embedded recency bias prevents most from even considering the possibility of regime change. Thus few are properly positioned for the paradigm shift that is happening right under their feet. The near death experience of UK pensions should be seen as clear evidence of this.

*Central Bankers are not our friends. Given the chance they will inflate away our life savings. Stay vigilante, Mark.*

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, and philanthropy planning services are offered through BMO Nesbitt Burns Inc. and BMO Private Investment Counsel Inc. Estate, trust, and custodial services are offered through BMO Trust Company. BMO Private Wealth legal entities do not offer tax advice. BMO Trust Company and 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.

**Member-Canadian Investor Protection Fund and Industry Regulatory Organization of Canada (IIROC)**