BMO Nesbitt Burns

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CARNAGE IN BONDLAND

While I have warned about extreme asset valuations for some years, as a decade plus of extreme monetary policy from CBs around the globe fueled this fire, I have consistently maintained that bonds were the most overvalued asset class and by a wide margin. Indeed, in 2018 I called the end of the 40 year bond bull market following technical indicators suggesting that the low yield for the 10 yr US treasury bond (1.6%) was made during the summer of 2016. Of course, nobody could have predicted the COVID pandemic, which conveniently gave governments (central banks) an excuse to rapidly cut rates back to zero and flood the system with trillions of dollars through bond buying programs, colloquially known as Quantitative Easing.

These actions gave the bond bull one last gasp at making new price highs (yield lows), as 10 yr US treasury bonds probed the 0.5% range. Those extreme bond valuations lead me to write new TFI articles such as:

> *As we wait for things to unfold, I am forced to acknowledge that this asset class no longer serves any real purpose for investors. Hijacked – TFI Fall 2020*

> *…..even a modest move to normalize rates would produce massive losses for longer term bond investors rivaling that of any stock market bear. A Truly Broken Asset Class –TFI Winter 2021*

The Bond Vigilantes are Back!
I've been amazed at just how complacent the bond market has been for so many years, tolerating negative real rates and deeply so after factoring in portfolio expenses and taxes. Even as inflation rapidly ramped up during 2021, the bond market was slow to respond in any meaningful way, preferring to adhere to the false central bank narrative of *'transitory'*. Of course now we know, that by anyone's reasonable definition of transitory, that our current bout of inflation is anything but and the bond vigilantes seemed to have woken up from their long slumber with a vengeance.

The damage done to bonds YTD has been epic. I'll maintain that I expect bonds to produce a negative nominal return over the coming decade and a deeply negative real return, even if inflation tempers itself a bit in the coming months and years. Consider for a moment that 10 yr bond rates have only risen to roughly 3% on both sides of the border and that inflation is running at 6%+ in Canada and better than 8% in the USA. Hence, I would say that the bond vigilantes still have lots of work to do, which means more suffering to come for bond investors.

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FTSE Canada Bond Indices	2021 Total Return	2022 Total Return YTD to April 30th
Short term (1-5 yrs)	-0.9%	-3.9%
Med term (6-10 yrs)	-2.7%	-9.6%
Long term (11+ yrs)	-4.5%	-18.1%
Universe	-2.5%	-10.2%

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FIXED INCOME: Better Late Than Never

After reducing interest rates to zero, accelerating Quantitative Easing (QE) and bloating their balance sheet during the pandemic, central bankers around the globe are in the midst of a 180 degree turn.

While it's easy to second guess, I believe the Federal Reserve had no choice but to signal to the market that it was ready to backstop the system in those dark early days of the pandemic. Without that support I shudder to imagine what would have happened to financial markets and the real economy.

In hindsight there is no doubt that Chairman Powel waited too long before beginning to raise interest rates and end QE. Once the economy began to recover following the initial shock from the pandemic, it would have been appropriate to ease off the monetary stimulus. However, this did not occur and now they find themselves behind the curve. In addition, they are forced to raise rates into a somewhat slowing economy. To be clear, the economy is still strong and the labour market is healthy. However, as always, the fear is the rate hikes will eventually tip the economy into recession. The Fed has made it clear that in each of the next two Federal Open Market Committee meetings it will raise its benchmark rate by 50 basis points.

The Big Question

There is much debate among market participants about whether the U.S. is in fact headed for recession or if a soft landing, growth slowing enough to reduce inflation but not triggering a recession, can be achieved. The yield curve recently inverted (the yield on the 2 year treasury was higher than the yield on the 10 year), this has occurred before every recession during the post WW2 period. Nonetheless, the yield curve sometimes inverts without a recession following. At the same time consumers and businesses are in good financial shape and likely able to withstand some tightening of financial conditions: Just how much is anyone's guess.

To be fair, a lot of the inflationary pressure we are seeing today would have been difficult to forecast a short time ago. For example, the Covid related supply chain backlogs which are causing shortages of products, leading to higher prices were difficult to foresee. The massive shift in consumer spending away from services towards goods took everyone by surprise. In addition, prior to February 24th most of the world believed Vladimir Putin wasn't really going to invade Ukraine, leading to a jump in energy and food prices. Much of what is creating this white hot inflation can be reversed. For example, an end to the war would take some pressure off of grain and fertilizer prices. Furthermore, an elimination of China's Zero Covid policy lockdowns, which has exacerbated supply chain bottlenecks, would be helpful.

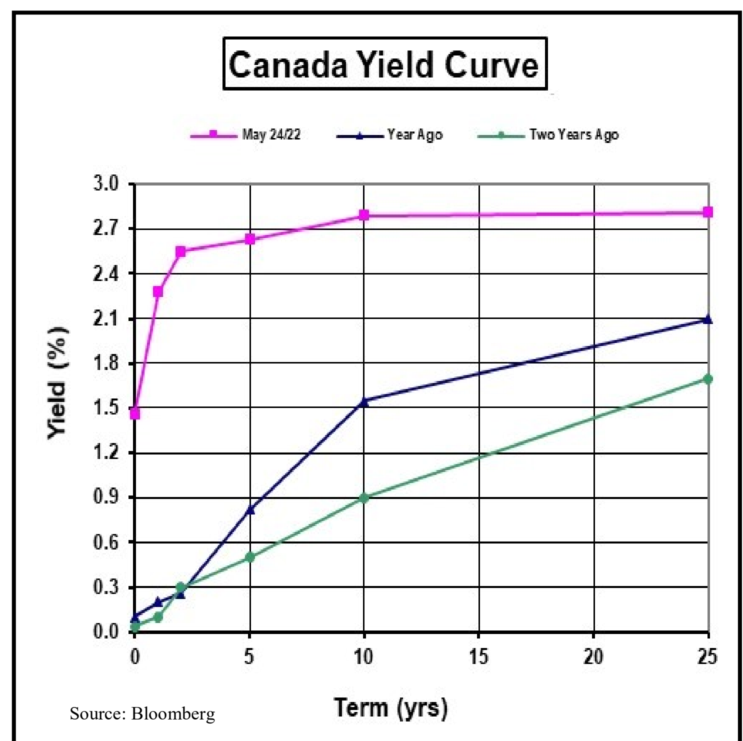
It is difficult to see how raising interest rates and reversing QE will bring inflation down, if the inflation itself is a product of supply constraints and not just demand. Hence, blaming Chairman Powell for today's inflation problem is a little harsh in my view.

Here at Home

In the Great White North, Governor Tiff Macklem has signalled the Bank of Canada's intention to return its benchmark rate to the "neutral" range. While the Canadian economy is enjoying some tailwinds from higher energy and commodity prices, it is the housing market that has the central bank's attention. The BoC expects the Canadian economy to grow 4.2% this year and 3.2% in 2023, however, Canadian home prices are now among the most expensive in the world: home price to income ratios appear unsustainable.

The BoC will now embark on Quantitative Tightening as they will not be replacing maturing bonds. The recent 50 basis point rate increase was the largest hike in 20 years. By raising rates aggressively and shrinking its balance sheet, Dr. Macklem hopes the market will get the message that the game has changed.

Stay tuned...Al



PORTFOLIO MANAGER: Brave New World

It is clear to me that the world has changed dramatically as we emerge from the pandemic. Russia's invasion of Ukraine, its rapprochement with China as well as the forces of de-globalization have changed the game. Prior to COVID, the world had been on a trajectory of low inflation, globalization and mostly regional conflicts. Pre-pandemic open trade policies and global supply chains acted to suppress inflation. China and other emerging economies became manufacturing hubs for the global economy, providing the world with an abundance of relatively cheap labour. Technological advances drove prices lower as efficiencies garnered through innovation helped suppress costs . Fiscal stimulus which was accelerated greatly during the pandemic, helped put cash into consumer's bank accounts encouraging them to spend thus supporting economic growth. Furthermore, rock bottom interest rates since the Great Financial Crisis of 2008-09, have encouraged governments and consumers to pile on debt, knowing that paltry interest rates would make repayment manageable.

Protectionism (a policy of protecting domestic industries against foreign competition by introducing tariffs or subsidies) is on the rise. Protectionist policies have been implemented in the past, usually during times of conflict or economic downturns. These policies can lead to greater self sufficiency for nations, however, they're usually ultimately inefficient and are likely to cause higher levels of inflation for consumers. Instead of outsourcing manufacturing, reducing barriers to trade and lowering tariffs, the conversation has shifted to energy security, bringing jobs back home, global supply chain disruptions and protecting intellectual property. These are not new ideas, it's just that they are more mainstream today than they were just a few years ago.

It is difficult to pinpoint the precise inflection point. Was it really the pandemic or was it Donald Trump's shift on China ? Trump changed the optics on the Middle Kingdom to adversary first and trading partner second. Since then, opposing views of the world order, democracy, human rights and fair trade has the west, led by America and China on a far more confrontational path.

From an investment perspective, I believe these shifts have important consequences. In my opinion the confrontation between the western alliance on one side versus Russia and China on the other justifies increased defence spending. Very few politicians hoping to be re-elected will advocate to spend less on defence after what we have seen in Eastern Europe. In addition, China's ambitions with respect to the South China Sea and Taiwan has come to the forefront. Hence, I think it makes sense to maintain some defence industry holdings as part of a well balanced, diversified portfolio.

It is incredible to witness the shift in the conversation regarding energy over the last two years. I will never forget during the early days of the pandemic when I stared at my television screen in disbelief watching the price of oil turn negative. While pundits and so called experts in the media claimed that oil was "un-investable", we would all be driving electric cars shortly and only dinosaurs and fools would put their money into oil stocks. Instead, we should be buying something with a future like Zoom and Peloton they proclaimed. In fact at the height of the madness, Zoom was worth more than Exxon, currently it's worth one tenth!

Reality Check

Today, the importance of energy and energy security is paramount. To see how Europe is held hostage by its dependence on Russian oil and gas is truly game changing. One does not need to be a historian to know that a lot of blood has been spilt in pursuit of energy resources. The strategic importance of energy supplies to economic development and advancement cannot be understated.

As Canadians, we are fortunate to have ample supplies of oil and gas. I believe investors and politicians are beginning to recognize the value and potential of these assets, in addition to the pipelines which move them!

In a world where inflation will likely remain elevated due to these massive shifts, it will be important to hold some hard assets. Commodities have historically been a good hedge against rising prices. While I have always been weary of the cyclicality of commodity prices and their producers, I do think that in this new world a more important portion of portfolios should be allocated to them.

Despite the recent decline in quoted prices for the mega-cap technology names I still believe they belong in portfolios. While their earnings and revenue growth trajectories will likely slow, their dominance and relevance will remain for years to come in my view. In a sense portfolios are currently constructed with a barbell strategy. On one side of the barbell are the mega-cap technology names which grew and flourished over the past few decades, balanced on the other side of the barbell with the beneficiaries of the new world order: energy, materials, defence.

I sincerely hope for a quick resolution to the humanitarian crisis in Ukraine and I suspect a slowdown in inflationary pressures will occur in the near future. While the shock to the global economy created by the pandemic and the war will likely wane in the coming months, I believe the changes to the mind set of business and political leaders will have a lasting impact.

Be super careful out there, Al.

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Speculative Chickens Coming Home to Roost
Higher rates began to affect the most speculative long duration assets in 2021. It is important to understand that the rate on the 10 year US treasury bond is the global benchmark risk-free rate used to determine the present value of any asset by discounting its anticipated future cash flows. Thus long duration assets, especially money losing concept stocks that pay no dividend and whose profitability is years into the future, are particularly susceptible to repricing in this environment. I've also cautioned people about the excessive valuations in many of the stock market darlings of the past few years and that staying away was the best course of action. Those boasting about all the money they made over the last few years at 'the club' or more likely on social media, have largely fallen silent now, as the horrific figures in the table below highlight. (figures which have only gotten worse in early May as I write!).

Rising Rates to Pressure Corporate Profit Margins
The average term to maturity for corporate borrowing is roughly five years. Good CFOs will typically try to balance their company's borrowing by spreading out maturities in a laddered fashion from 2-10 years. For the better part of 40 years corporations have been able to refinance their maturing debts at ever lower rates, helping to expand corporate profit margins. Many companies that must rollover debt maturities coming due in the next few years will face substantially higher financing costs. This, along with rising labour costs, commodity input costs and shipping expense will also add to the pressure on margins. Unless corporations are able to fully pass on these higher costs through price increases, margins and profits will suffer. I suspect that in the near future analysts will need to reduce their S&P500 earnings estimates for 2022: never a good thing for stock prices.

Company	COVID High	Price Apr 29	% Decline	Investor Losses
Money Losing IPOs & Meme Stocks				
Peloton	$167 (Dec/20)	$18	-89%	-51B
Games Stop	$483 (Jan/21)	$125	-74%	-26B
AMC	$73 (Jun/21)	$15	-79%	-33B
Door Dash	$250 (Nov/21)	$81	-68%	-60B
Tele-Doc	$308 (Feb/21)	$34	-89%	-48B
Twilio	$441 (Feb/21)	$112	-75%	-63B
DocuSign	$315 (Sep/21)	$81	-74%	-49B
Virgin Galactic	$63 (Feb/21)	$7	-89%	-16B
Wayfair	$348 (Mar/21)	$77	-78%	-32B
Air BnB	$220 (Feb/21)	$153	-30%	-44B
Uber	$64 (Feb/21)	$31	-52%	-63B
Snowflake	$405 (Nov/21)	$171	-58%	-77B
Beyond Meat	$198 (Oct/20)	$37	-81%	-11B
Robinhood	$85 (Aug/21)	$10	-88%	-68B
Richly Valued Companies with Profits				
Rocket Co.	$30 (Aug/20)	$9	-70%	-41B
Shopify	$1,690 (Nov/21)	$427	-75%	-165B
Zoom Video	$588 (Oct/20)	$99	-83%	-154B
Coinbase	$369 (Nov/21)	$113	-69%	-61B
Roku	$491 (Jul 27/21)	$93	-81%	-60B
Expensive Dominant Mega-Cap Stocks				
Face Book	$384 (Sep/21)	$200	-48%	-526B
Netflix	$701 (Nov/21)	$190	-73%	-239B
Tesla	$1,244 (Nov/21)	$870	-30%	-401B
Nvidia	$334 (Nov/21)	$185	-45%	-397B
Amazon	$3,760 (Jul/21)	$2,486	-34%	-651B
Microsoft	$345 (Nov/21)	$278	-19%	-502B
Google	$3,032 (Nov/21)	$2,299	-24%	-488B
Apple	$183 (Jan/22)	$158	-14%	-414B

How Determined are Central Banks to Fight Inflation?
There's been a lot of tough talk of late from central banks around the globe. But the idea that central bankers can solve a 6% plus inflation problem by raising rates to 2-3% over the course of the next 12 months seems dubious at best. Of course, given the extreme levels of debt we've pilled up as a percentage of GDP, even 2-3% rates might be enough to tip the economy into recession, in which case aggregate demand will fall, likely brining down inflation with it. So the question a the moment is, can central banks raise rates enough to tame the inflation beast without tipping us into recession? History says this is very unlikely. Typically central bankers raise rates until something breaks and a recession soon follows.

Powell Pivot 2.0
Despite all the tough talk about inflation fighting, I suspect a soft pivot is coming. With such a move the Fed likely believes it would be able maintain what little credibility is has left. Well before the inflation dragon is actually slain, as rates approach 3% and the economy begins to wobble, I expect the Fed will declare victory and pause its rate hiking efforts. Of course, 3% bond yields and 5% inflation still leaves investors with highly unattractive negative real yields. Will this be enough to satisfy the recently awoken bond vigilantes? Or will they try to force greater discipline on central bankers to continue their fight against inflation? An important moment may come if inflation bottoms out at 4-5% and starts moving up again. Will central banks be willing to resume hiking rates in the middle of a recession?

This seems unlikely, and thus investors faced with persistent negative real rates may continue seeking higher returns in risk assets such as real estate and stocks, possibly putting a floor under any stock market correction.

Central banks are not your friend. Sincerely, Mark.

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