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A QUARTERLY INVESTMENT NEWSLETTER

BMO Nesbitt Burns

CLOUDY WITH SUNNY BREAKS

For the majority of 2022, market participants were convinced that the global economy was headed for disaster. A nasty cocktail of rising interest rates globally, a war in Europe and endless lockdowns in China would surely lead to economic doom. As we begin the new year, it seems at least for the moment, that the most dire scenarios have been averted. This has encouraged investors to look towards better days ahead.

The relentless rise in interest rates over the past year had most experts convinced that the U.S. economy was headed for recession. After all, history would suggest that a soft landing (a slowing economy but not a technical recession: two consecutive quarters of negative GDP growth) is very difficult to achieve. In fact, the last time the Fed achieved this was in 1994 under then Chairman, Alan Greenspan.

Never the Same

However, no two scenarios are ever the same, this time around the world is emerging from a pandemic, which caused many disruptions to supply chains as well as labour shortages. In addition, we have been living through an extended period of easy monetary policy and the fear is/was that either the Fed would overshoot on the tightening, chocking the economy into a recession and/or that inflation would be so persistent that central banks would need to take rates much higher, causing a sustained and deep recession.

It would appear today that the probability of a soft landing has increased. Of course, we will not know for sure until the government releases the data many months from now, but the market is a forward looking instrument and it is increasingly starting to believe the worst can be avoided.

Crack a Smile

There are reasons for this optimism. First, the end to the hiking cycle is now in view, whether it's another 25 basis point hike in March, then a pause or an additional 25 point hike in May, market participants can see the end game. Since markets are forward looking, this has begun to reverse the relentless rise in the U.S. dollar. For much of last year the Greenback's strength was a thorn in the side of investors as just about every other asset class was hammered against the all mighty dollar. The dollar's decline, if it continues, will become a tailwind instead of a headwind. Secondly, inflation is clearly trending downwards, at the same time corporate earnings have been better than feared. Furthermore, supply chains have begun to unblock, reducing shortages and downtime.

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It would appear that a good chunk of the inflationary pressures were related to the pandemic and its after effects. Goods inflation is rapidly declining as the situation normalizes.

Services inflation is still elevated but is likely to subside. In addition, the job market has proven far more resilient than during other rate hiking cycles, the consumer remains relatively confident and corporate balance sheets are generally healthy. Of course, the full effects of the rate rises have yet to be fully felt. But at least for now, it would appear that economic activity has slowed but not collapsed. Some may view the strength in the job market as a glass half empty scenario, as it implies that a still strong jobs market will lead to competition for workers thus higher wages, hence stickier inflation, thus forcing the hand of Mr. Powell to raise rates even further. One could also take a more positive view, noting that wage inflation is declining and it is a good sign that the economy is far from contracting.

The Russian invasion of Ukraine convinced many investors (myself included) that Europe, due to its high dependence on Russia for energy, would be in for a disastrous economic period. In addition, Mr. Putin's sabre rattling and weaponizing of energy appeared to have Europe at his mercy. How would they cope? How could the economy survive if people are freezing in their homes? Alas, a combination of good fortune and market forces helped to avoid the worst. Europe has avoided recession thus far and European markets are performing quite nicely.

Germany's targeted 20% natural gas consumption reduction, coupled with abnormally warm winter has helped tremendously. While the warm weather might be disappointing for winter sports enthusiasts and Alp resort operators, it has removed a lot of pressure on the continent. This will allow more time to secure resources before next winter. Furthermore, the market has adapted, liquified natural gas from the U.S. has been moving east to fill the void. Indeed, European prices for natural gas have declined precipitously from the initial spike immediately following Russia's invasion last February. This rearranging of gas supplies to Europe will take years to work itself out, however, for now it would appear things will be ok, alleviating the worst fears of market participants.

China's Zero- Covid policy brought havoc and disruption to its economy and much of the global supply chain. Most western observers and no doubt many Chinese citizens felt this was an ill-advised way to handle the pandemic and its after effects. The opening of borders, ending the quarantine requirement for incoming travellers, mass lockdowns and removing curbs on movement will surely help to re-energize its economy. The reversal of this policy has been welcomed by investors around the world as the normalization of trade, manufacturing and travel in China will undoubtedly be a positive for the global economy.
For much of 2022, these issues plagued financial markets. While a lot can still go wrong, it seems that one-by-one these issues are being resolved and that finally there is light at the end of the tunnel. Nonetheless, I still suspect it'll be a bumpy ride. As I mentioned, the economic data is suggesting a soft landing, however, a recession is still a possible outcome . In that case, equity prices would fall as markets are not currently pricing-in a recession into stock prices in my opinion. However, even if equity prices do fall, there will be a recovery on the other side as economic growth returns.

Ultimately nobody knows with any certainty what the future holds, all our economic models and forecasts are simply best guesses. For this reason, I believe a diversified portfolio of sound businesses with reasonable valuations paying sustainable dividends and competent management teams, held for the long term is the best way to maintain and create wealth. Let's keep our focus on the long term, not trying to get too cute and avoid shooting ourselves in the foot.

Be real careful out there…...Al.

FIXED INCOME: What If I'm Wrong?

Ray Says Cash Is Now Trash
Ray Dalio, founder and retired Chief Investment Officer of Bridgewater & Associates, the world's largest hedge fund (160B assets under management), characterized cash as trash in a recent interview . I can't say I disagree with his assessment given his simple argument that 90 day T-bill rates, despite their recent rise, remain well below the rate of inflation. Furthermore, he made cautionary statements about longer dated bonds, which have also risen in yield, yet remain below current inflation as well. Despite his cautionary words about bonds, he's calling for a near term rally in bond prices as fears of recession mount. How can Ray's seemingly contradictory statements co-exist? Simply put, bond market participants appear to whole heatedly believe the Federal Reserve's rhetoric about returning inflation back to its 2% target level.

A Recession Would Help the Fed's Cause
Many believe the Fed will need to induce a recession to get inflation back down to its target of 1-2%. They believe that once inflationary pressures have subsided, this will allow the Fed to immediately pivot to lowering rates to help a sinking economy. There is historical evidence to support their case. Indeed, the last time inflation was elevated, albeit at much lower levels, was back in mid-2008 when US CPI got to 5.5% before falling precipitously into negative territory (–1%), just nine months later. Of course, it took a near collapse of the global banking system to correct a 5% inflation problem. What will it take to correct an 9% inflation problem this time? Inflationary pressures appear to have peaked in June 2022 at 9.1% in the USA and 8.1% in Canada and currently stand at 6.5% and 6.3% respectively. While recent CPI data is certainly moving in the right direction, will it settle anywhere near the Fed's 2% target? Is it falling fast enough to prevent consumers and bond holders from being eaten-alive for a third year in a row? Bond market participants certainly believe so, although I'm not so sure consumers are quite as optimistic.

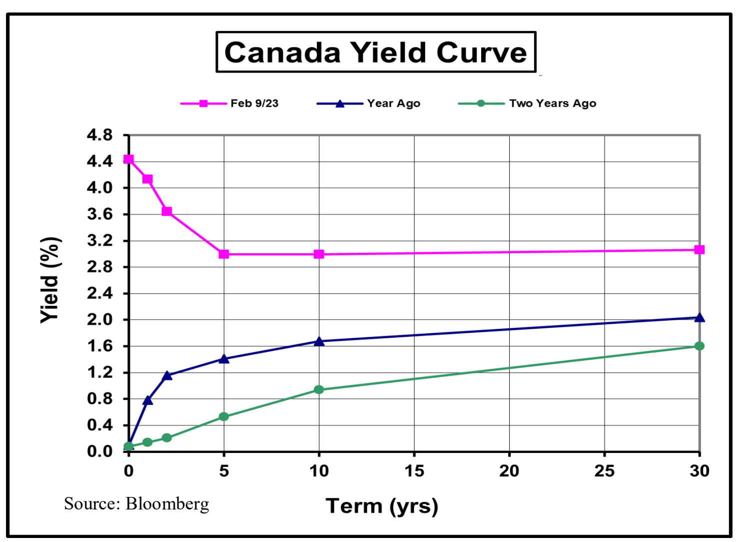
Still an Inflationista, But Willing to Hedge My Bets
Personally I am still leaning towards more persistent inflation that averages a higher rate in the current decade versus the 2% average rate we enjoyed for the previous two decades (*see Paradigm Shift, TFI Fall'22*).

However, as fiduciaries, it would be inappropriate of us at the RS Group to position (bet) the entirety of our client portfolios on this inflation thesis. Good money managers must always ask themselves: What if I'm wrong and what would be the magnitude of the impact on client portfolios? Positioning ones portfolio 100% for a much higher inflationary environment could be disastrous should a persistent deflationary/dis-inflationary environment evolve.

Because I don't truly believe that policy makers would allow a deflationary bust to occur, I remain convinced that the path of least resistance for them remains an inflationary one. That is, the printing of money to fund government deficits through central bank bond buying. This avoids the embarrassment of default, politically unpopular austerity measures and tax hikes.

Placing Your Bets
No doubt, if you are buying fixed income products today, you are betting on lower inflation, as no (quality) product currently pays a rate that exceeds inflation. Nonetheless, given the rapid rise in rates in 2022, a falling inflation rate and the possibility of even steeper declines should we enter recession, investors should be making a reasonable bet on bonds in anticipation of lower inflation. Depending on your personal risk profile, tax bracket, the availability to shelter interest bearing products in registered accounts, etc., allocating between 10-30% of your capital to fixed income on the shorter end of the yield curve(1-5 years) is a reasonable strategy at this juncture. If inflation moderates, yet proves sticky in the 3-5% range, then you'll simply preserve purchasing power on products yielding 4-5%. While, if it falls back below the Fed's 2% target, or even goes negative for a period in the event of a deflationary bust, then those gov. guaranteed 4-5% yields will look great. But until fixed income products actually offer investors a real yield (i.e. a rate that exceeds the inflation rate) I would not be inclined to make an allocation much beyond 25-30%. Should real rates of 1-2% materialize in the coming quarters, then investors can get more aggressive with respect to fixed income. Of course, this would take inflation moderating substantially from here and longer term bond yields of 5-7%, something we haven seen in decades. Furthermore, this would be a great opportunity for older, retired investors to shift back to a more balanced mix (40/60) after being forced into the uncomfortable position of being growth investors for many years during a record low interest rate environment.

Central bankers are not your friend. Sincerely, Mark.



PORTFOLIO MANAGER: 40/60 R.I.P

Born 1990—Died 2022
The now widely adopted 40%-10yr US treasury bond and 60%-S&P500 portfolio just capped-off its third worst year ever, plunging a rather painful 18% in 2022. You have to go back to the depression era of the early 20th century to find worse results: 1931(-27.2%) and 1937(-20.6%).

So What Happened?....It Was All About the Bonds
No doubt it was a rough year for US equity investors with the S&P500 down 19.4%. However, from a historical perspective this decline was not particularly notable, in fact it's been down more nine times over the past century.

The standout was the concurrent negative returns on the bond component of this standard model. Ten year treasury bonds fell a horrific 17.8%! Indeed, the bond damage was global in nature, with the Bloomberg Global Fixed Income Aggregate Index off 16.2% (in USD).

Intergenerational Recency Bias & Dogma
The 40/60 bond/stock portfolio wasn't always the gold standard, this evolution really only began in the late 80s. During the 40 year period following WW2 portfolio construction was quite different, for example, conventional wisdom in 1970s and 80s was that all investors should have a 5-10% allocation to precious metals.

So what happened in 2022? Why did so many professional money managers get hammered so badly? I think there are several important factors which led to this result; most importantly a very long declining trend in both rates and bond market volatility from their peak in 1982, complacency resulting from recency bias and the rise of passive investing starting in the early 2000s.

Prior to 1980 the volatility in bonds was higher and the variability of their correlation with stocks was also greater, sometimes positively correlated and sometimes negatively so, with few persistent long-term trends. This required managers to be more vigilant, on their guard and to shift their portfolio structure more frequently. But the 40 year decline in rates accompanied by lower volatility and a persistently trending negative correlation with stocks had most managers convinced these trends would be with us forever. It did last a very long time, so recency bias eventually became dogma. The only portfolio investors needed was a US centric 40/60 bond/stock portfolio. No requirement for precious metals anymore, no use for international diversification, this was *the portfolio*. Afterall, due to its persistent negative correlation with stocks during market sell-offs, managers came to believe they had found the Holy Grail of portfolio hedging, an asset with zero hedging costs that went up in value during periods when the riskier stock side of their portfolio was declining.

But because stocks are generally more volatile than bonds, when stocks fell 15%, the less volatile, smaller bond allocation might only go up 5%. So smart guys like Ray Dalio, founder of Bridgewater & Associates, realized as early as the 1990s that they could lever-up the bond side of the portfolio 3-5x in a volatility-size-matching exercise and structure their portfolio in such a way that when stocks fell 15%, their bonds would go up on a proportionate dollar-for-dollar basis, offsetting all of their equity losses. Furthermore, because they could borrow short at rock bottom rates and invest in longer dated bonds, they could earn a positive carry on this portfolio structure. Levered institutional portfolios, what could possibly go wrong!?

Throw-in a constant bid from the growing trillions of price indiscriminate passive money flows driving prices higher, coupled with a dearth of money managers who have nary a recollection of elevated bond volatility and positive bond-stock correlations and you get a complacent, multi-generational group of money managers that were destined to take the shellacking they did in 2022.

A Bullet-Proof Portfolio for a New Era
Ironically enough, this group of money manages still seems ill positioned, despite the wake-up call that was 2022. So engrained is the recency bias, that most are still positioned as they have been for the past two decades, overweight long duration assets such as non-dividend paying tech stocks and long dated US treasury bonds, expecting the halcyon days to return soon: the days of central bank QE, zero interest rates, 2% inflation, low volatility and the limitless expansion of tech stock valuations. Indeed, Cathy Wood's Ark Innovation Fund, the poster child for this cycle's excesses, saw positive inflows in 2022! This despite the fact that her collection of grossly overvalued, unprofitable, non-dividend paying stocks is down 70% from its peak. The bear market won't be over until these investors have thrown-in the towel.

While I believe a paradigm shift to a more volatile, higher inflation decade is underway, I am willing to acknowledge that I could be wrong about this and thus investors should include a deflationary hedge in the form of a short-term bond allocation. In my opinion, the new bullet-proof portfolio for the coming decade looks more like 30% 1-5yr gov. guaranteed fixed income products, 25% commodity inflation hedges (copper, uranium, oil, nickel, gas, fertilizers, lithium, chemicals), 10% precious metal (disaster insurance), 35% defensive dividend payers(telcos, cable, pharma, tobacco, pipelines, power producers, grocery).

Prepare yourself psychologically now, for the rodeo that lies a head. In investing, mental toughness counts. Sincerely, Mark.