Putting the Pieces Together

Price "War"

Before we begin with this quarter's newsletter, we just want to take a moment to reiterate that our thoughts are with all people affected by this war in Ukraine.

In this quarter's newsletter, we are just going to focus on the obvious which is the impact of this war, inflation, and the continuous effects of the pandemic. In our last couple of newsletters, we highlighted that we have allocated more of a weighting or importance on companies that can demonstrate predictable earnings growth rather than other financial ratios and we continue to work within that framework. The reason is quite simple, in a rising interest rate environment it is harder for companies to make money hence margins are very important. Even though, the short-term movements in the indices are driven by headlines (mostly negative), we are not losing sight of the fact that positively trending margins outperform the indices. Consequently, as we review our clients' portfolios, we have been outperforming the indices. However, the year-to-date returns are negative albeit not by much and far less than the indices.

Furthermore, in our previous newsletters we estimated that inflation would peak in the second quarter of this year (reasons were stated in last couple of newsletters) and this might still be the case, but the inflation number is higher than previously estimated because of the war. Moreover, in our first newsletter of this year, we stated that the market was already pricing in 5 rate hikes and that it was starting to consolidate. Plus, we had some concerns leading into the second half of the year about slower growth and an inverting yield curve. The latter two concerns have materialized already and have been the narrative since the beginning of the war. Currently the market is pricing in 7 to 10 rate hikes in which one of those rate hikes might be of 50bps instead of the usual 25bps as per the statement by the chairman of the FED, and an inverted yield curve. These latter topics will be touched on below but suffice to say that volatility will persist for a bit longer. That said, all these negative headlines are priced into the market and even though performance is lacklustre, the equity markets have been quite resilient but not for equities that have very high earnings multiples (which we have avoided for quite some time now). We want to remind our readers that corrections do occur via a price drop or time. Hence, we do expect a consolidation period for indices.

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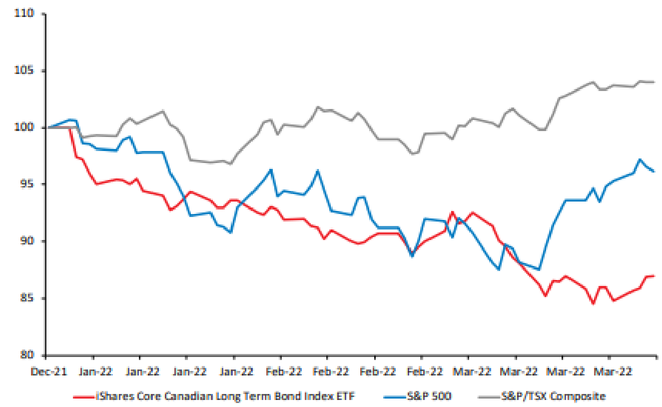
The war in Ukraine adds yet another layer of uncertainty onto an already highly complex economic and financial outlook. While the situation is extremely fluid, the main takeaway is that it further heightens intense inflation risks and puts new downside risks on growth. BMO Economics have cut their global growth outlook for this year by half a point to 4.0%, on an expected dive in Russia's economy, the hit to Europe, and slightly softer activity elsewhere. Plus, they have also further lifted their inflation forecasts broadly due to the run-up in oil to well above $100, alongside big gains in a variety of other key commodities. This backdrop of softer growth and additional upside inflation risk complicates the task for central banks.

As a result, we are taking a more cautious stance and reducing our equity exposure slightly. Hence, we are overweight cash and increasing the defensiveness of portfolios given the risks posed by higher inflation and interest rates and a looming economic growth slowdown. We still believe that equities as an asset class have a better risk reward profile than other asset classes at this moment. We are already witnessing inventory build ups which tells us that at a certain point prices for goods will come down, but it also tells us that consumer confidence is low because people are not willing to spend. If not for the war which made consumers more cautious on what they spend their money on (because oil and food prices have gotten expensive), we would have probably seen those inventories subside. Hence, the yield curve and sentiment indicators will prove essential in the coming months.

To be clear, the risks of a recession in the next year have risen but are still only around 20% so we are not hitting the panic button just yet. As for bonds, they are off to a very rocky start this year given the interest rate increases we have seen (bond prices move inversely with interest rates). Value is being created in the fixed income market, but we think it is still too early to increase our recommendation there. The bottom line is that we still think equities are a better bet than bonds at this point. At a more micro level, we continue to emphasize quality companies with sufficient growth and pricing power to offset the toxic impact of inflation.

Canadian Long Bonds vs U.S. and Cdn Stocks



Source: FactSet

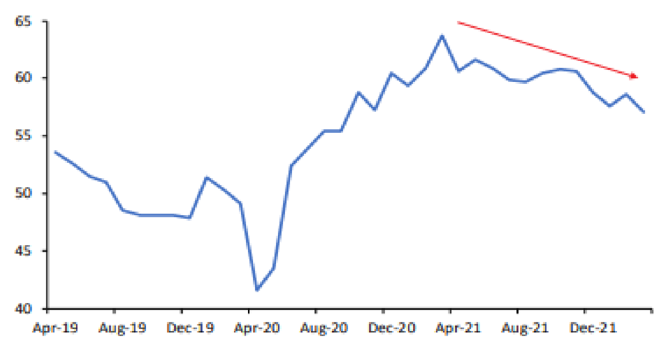
Of course, all eyes continue to be on the war in Ukraine. We never advocate profiting from human suffering but must also address the investment implications of this. We continue to firmly believe that this shocking event has not created new trends but rather, has accelerated pre-existing ones such as higher inflation rates, and a move away from globalization and toward higher defense spending. Given Russia's enormous production of energy and basic materials, it is not surprising that prices continue to rise. The same goes for base metal and grain prices which were already on strong uptrends.

The silver lining for Canada and the TSX more specifically is that our country happens to be very well positioned for higher inflation and the current geopolitical crisis. In our view, the impact on energy markets will be more substantial and longer lasting than many realize and should encourage Europe to look to North America to secure a safer supply of oil, natural gas (through further LNG investments for instance), metals and grains. The Great White North just happens to produce all these things (and much more) in abundance. For example, YTD performance for the TSX is 3.2% but when you take out the energy sector the YTD performance is -2.7%.

Slower Growth

Looking at the just released and all-important U.S. ISM (Institute for Supply Management), along with comparable international indices, it is becoming clearer that economic momentum has peaked. Economic activity is still robust but the best days of the post-COVID rebound are behind us. BMO Economics notes that the U.S. ISM manufacturing PMI stepped down in March, falling 1.5 pts to 57.1. That marks the fourth drop in the past five months with the gauge now sitting at the lowest level since September 2020. Global supply chain disruptions continued to cap activity, this time resulting from the war in Ukraine and lockdown measures in key Chinese cities. Production slumped 4.0 pts while new orders nosedived 7.9 pts, the biggest drop since April 2020. Meantime, prices paid for materials accelerated further, up 11.5 pts to 87.1 as inflation continues to run at multi-decade highs.

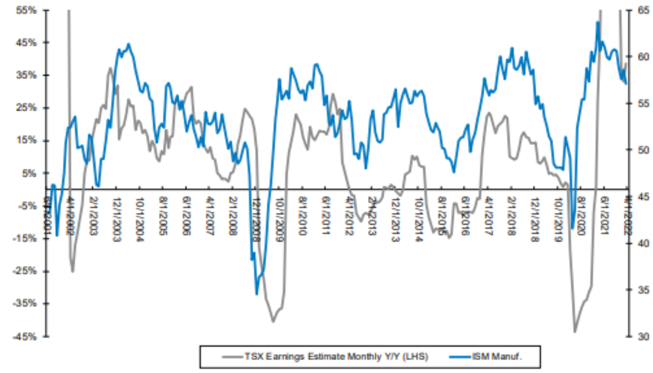
U.S. ISM New Orders



Source: Bloomberg

BMO Capital Market's (BMOCM) analysis clearly shows that the direction of the ISM/PMI surveys leads corporate profitability by several months (this is true both for the TSX and S&P 500) and therefore has a massive impact on the performance of sectors.

TSX Composite EPS vs ISM Manufacturing Index



Source: Bloomberg

Hence earnings visibility is very important in this type of economic environment, that is why defensive sectors outperform.

Our research partner's at Piper Sandler outline that this current tightening cycle is beginning later in the earnings cycle than usual. History says that Fed tightening cycles see strong market returns on the back of improving earnings – that's because most tightening cycles began during an upswing in the global economy, not at the top of an earnings cycle like where we are today. Going forward, revisions to earnings expectations will become the dominant driver of equities as the global slowdown unfolds over the next year and a half. For market positioning, the market earnings cycle matters more than the Fed's tightening cycle at this point. As such, Investors should embrace stable, profitable growthstocks. This thesis reinforces our investment discipline which was outlined at the beginning of the newsletter.

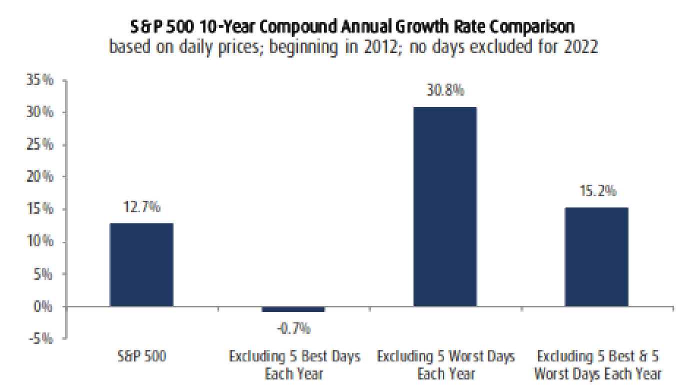
Basically, the latter is the biggest worry for market partipants. That the FED started too late to increase rates because they should have been increasing rates while growth was still robust. As opposed to now, whereby they are increasing rates while growth indicators are trending lower. The reality is, if not for the war, oil and other commodity prices would have not spiked suddenly (they were trending higher before the war began).

Timing the market

Despite the damage in the US equity market so far this year, we would advise investors to avoid the impulse of completely rotating out of US stocks or trying to time the market at every turn, as these actions could be very costly. For instance, when looking at the worst S&P 500 daily price declines over the past 50 years, BMOCM found that the index logged an average gain of 11.4% in the subsequent six months with losses occurring in only five instances all of which came in 2008. In the 12 months following these sharp declines, the S&P 500 recorded a 25.5% average gain with losses present in only three periods.

Since the start of 2012, the S&P 500 has delivered a 12.7% annualized price return. Excluding the five best performance days each year through 2021 would bring that return down to -0.7%, while excluding the five worst days would lift the return to 30.8%. Obviously, missing the worst days would be ideal, but history has shown that most of these days tend to occur unexpectedly, making them nearly impossible to predict. More importantly, BMOCM's work shows that some of the best performance days for the market occurred soon after some of the worst market days. Even if an investor times the market in a way to avoid both the five best and worst days, the annualized return would still only be 247bps higher than staying invested throughout the period. As such, we continue to believe it is more beneficial for investors to maintain investment discipline instead of trying to time the market.

Significant Performance Impact



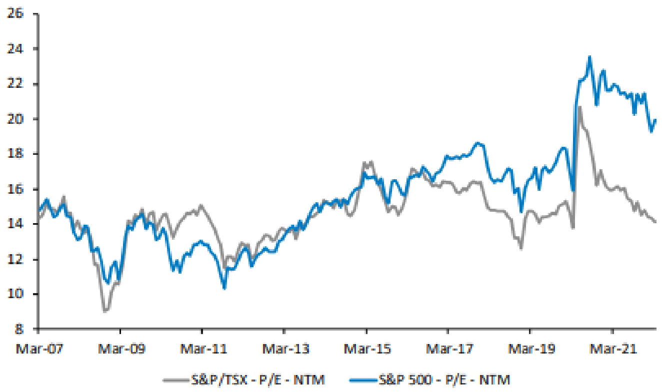
Source: BMO Investment Strategy Group, FactSet.

As we have often stated, looking at valuations for stocks or other asset classes for that matter- is a terrible timing tool. However, financial history has proven time and time again that being disciplined about the price paid for assets (having a "margin of safety" as Warren Buffet famously put it) is the best way to ensure an appropriate return for long term investors. This principle applies as much to real estate as if does for financial assets such as bonds and stocks. The principal reason for this is that the stock market is inherently mean reverting meaning that excesses to the upside or downside tend to be corrected with opposite reactions. We are simply reiterating that investors need to be selective in their choices. In an inflationary environment, and especially when growth momentum is slowing, companies with pricing power (i.e. the ability to pass on price increases to their customers) will be better able to protect their profit margins, thereby offering a measure of protection to their share price.

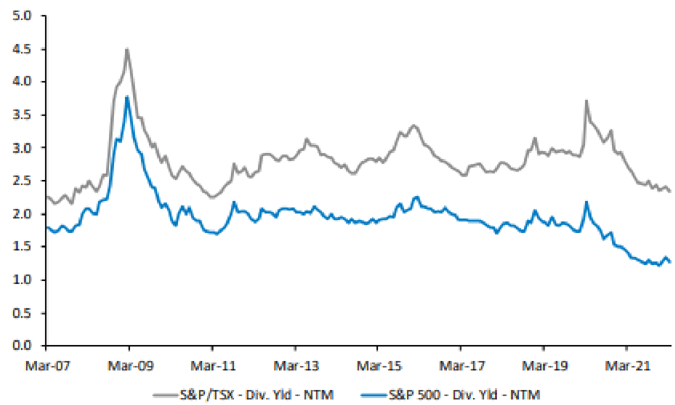
We again turn to the relative value advantage of Canadian stocks vs. U.S. stocks. Canada has already outperformed the U.S. by over 7% YTD (Year-to-Date) but we still consider the current discount to be excessive relative not only to history but also to the profit growth potential for several natural resource industries. While Energy is not a defensive sector, we want to reiterate our view that oil and natural gas stocks remain too cheap given their huge cash flow generation and ability to buy back shares and increase dividends.

Looking at the commodities, BMOCM thinks oil and natural gas prices will continue to be well supported by increased demand as lockdowns ease while supply constraints should be exacerbated by the chronic lack of investment in production growth over the last five years.

P/E multiples for TSX vs S&P500



Dividend yield for TSX vs S&P500



Source: BMO Private Client Strategy, FactSet

Inflation

All the recent economic and related commodity price strength has led to fears of inflation staying higher for longer. This focus on rising prices is well-founded since inflation trends are among the most important determinants of market returns.

Since inflation erodes the value of paper currency (since it will take more money to buy the same coffee during inflationary periods) and fixed income investments, bond investors demand compensation in the form of higher interest rates to protect the real value of their holdings. The impact on equities is more complicated since mild inflation can be positive as it provides additional pricing power to well-positioned companies and confirms the risk of a deflationary trap are now firmly behind us.

BMOCM's data analysis work going back to the 1960s clearly shows that stocks generally do better when inflation is declining. This makes intuitive sense since the value of future corporate cash flows is worth more in today's dollars when inflation and interest rates are low. This being said, it is still possible to make money when inflation is rising, but one does have to be more selective. Our historical rule of thumb has been that stocks suffer real multiple compression when inflation rises sustainably above 3%. In Canada, however, the performance has been better when inflation was rising, no doubt because of our market's very high exposure to basic materials and energy which offer good inflation protection. In order to get an even longer term understanding of the impact of inflation on market and sector returns, we turned to our partners at NDR research who have one the best databases in the business. They ran numbers going back to 1926 for the U.S. market. The results are below, and the key conclusions are that the stock market clearly does better with low inflation but that some sectors can still generate decent returns when inflation is higher than 3%. As we noted above, it all depends on pricing power. The historical data shows that 7 of the top 10 sectors are "Defensive" when inflation is >3% and have long had reasonably strong pricing power (pharma, medical equipment, tobacco etc.). This is the current environment and fits well with our more defensive recommendation and our preference for quality healthcare, consumer staples, utility, and REIT companies.

Sector Returns in Descending Order when Inflation is >3%

(December 1926 - December 2020)	% Gain/Annum		% Gain/Annum	
U.S. CPI Inflation (%)	>1%	<1%	>3%	<3%
Industry				
Tobacco Products	6.97	4.81	8.42	4.58
Pharmaceutical	8.40	8.10	8.15	8.54
Defense	6.00	2.05	7.60	2.72
Medical Equipment	9.50	4.93	6.92	10.35
Measuring & Control Equipment	9.96	6.12	6.86	11.70
Insurance Industry	7.40	2.85	6.46	6.50
Food Products	6.93	5.48	6.44	6.85
Health Care	5.07	1.72	6.44	2.28
Beer & Liquor	7.93	7.57	6.31	9.52
Business Services	8.37	4.03	5.90	9.20
Restaurants, Hotels, Motels	8.39	3.51	5.81	9.11

Source: BMO Private Client Strategy

The central bank's job is definitively getting more complex with a geo-political conflict adding to an already very challenging first quarter environment. Perceptions were that they were already late in starting to remove the stimulus and the persistent price pressures only confirmed the Bank of Canada (BoC) and the U.S. Federal Reserve (Fed) are behind the inflation curve and much work is needed. **This realization led to an astonishing policy shift; expectations of a gradual but periodic tightening cycle drastically shifted to a need of an aggressive response to deal with prices accelerating at the fastest pace in decades with no sign yet of it having peaked. Pricing of four to five 25 basis points (bps) hikes in 2022 have now given way to expectations of a minimum of 2 consecutive 50 bps and more than 200 bps in increases for the year. Interestingly though, while the pace of expected tightening has significantly increased, the expected terminal policy rate has not with the consensus anchored around the Fed/BOC targeting a neutral rate ranging between 2.25 to 2.75%. We are just going to get there faster, much faster than initially expected.**

Markets responded swiftly to the sentiment change, with short-term rates adding on average 85 to 90 bps (for some perspective, U.S. 2-year yields have risen 170 bps in Q1, closing in on 2.50% the highest level since early 2019).

The violence of the move contributed further to an already weak quarter for bond investors, delivering the worst start of the year for Canadian and U.S. indices on record, even surpassing 1994 which was considered until now the worst year for bond markets. Like 1994, rising government bond yields in anticipation of strong policy responses was the main culprit. However, credit spreads, normally providing a cushion during higher volatility and rising rates, also significantly widened contributing to perfect storm conditions in markets; not only did the conflict-driven safe haven support fail to calm inflation fears, but policy expectations led many to shed term exposure including from all credit sectors.

The return to normalcy is not over, and so your team will remain alert to emerging trends. Hope to talk to you soon.

Team Roux & Associates

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