Putting the Pieces Together

Are we in a Recession or not?

The title above really has dominated the financial news rhetoric in the last month. So have the terms soft or hard landing which describes the unintended consequences of the Federal Reserve's sudden strong stance on inflation and its commitment to reigning it down by raising interest as quick as possible. However, we must remain patient to get any such confirmation on if inflation has peaked or if we are or will be in a recession because the economic data is backward looking. We will not attempt to forecast the latter because that will be backward looking, but what we know to be true is that the market has already priced in a recession.

With that in mind, in our previous quarterly newsletter, we touched on inflation and the impact it has on equity markets. In this newsletter, we will take a closer look into recession fears, the Canadian currency, we will also look at technical analysis and lastly, we will comment on the financial sector which holds a big weight in many investors portfolios.

Before we begin, we would like to outline what the equity markets and credit markets are telling us regarding inflation and recession. In his last testimony to the Congress, Fed Chairman Powell repeatedly stated that he wants to see consumer demand decrease. Hence, instead of looking at the CPI number which dominates the headlines, we are focused on the PCE (Personal Consumption Expenditure) index which measures the prices that people in the United States are buying and paying for goods and services. In the last couple of months in has plateaued at 6.3%. We would have to wait to see if the trend has broken but it seems that at the very least the trend has flattened. Our assumption is that the price for goods is starting to decrease because in the first quarter, companies started reporting that they will be forced to discount items, something we hadn't seen since the beginning of the pandemic. Reason being, is because the pandemic brought upon us two major themes (amongst others), work from home and onshoring. The latter two were discussed in our previous newsletter as inflation drivers. That said, people's consumption patterns changed because their needs were different.

Let's connect

Roux & Associates
Wealth Management Group
BMO Nesbitt Burns

1501 McGill College Ave.
Suite 3200
Montréal, QC
H3A 3M8

www.christian-roux.com

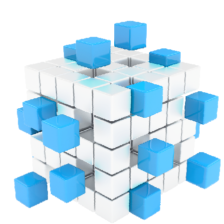
Christian Roux
(514)871-7026
Christian.roux@nbpcd.com

Nektarios Pouliezos
(514)282-5929
Nektarios.pouliezos@nbpcd.com

Catherine Lach
(514)282-5832
catherine.lach@nbpcd.com

Nancy Belanger
(514)871-7076
Nancy.belanger@nbpcd.com

Elizabeth Le Comte
(514)282-5808
Elizabeth.lecomte@nbpcd.com



Further, last week President Biden announced the lifting of some the Chinese tariffs and consequently China changed its covid policy and suddenly, the ports started to ship out more goods. Hopefully, they don't revert to their old covid policy.

Moving on to oil… in the last couple of weeks we've seen the price of oil go from $122 a barrel to $87. There is a lot of geopolitics involved in the price of oil and in what we stated earlier regarding the Chinese supply chains, but for this newsletter we won't go into that. Basically, this is telling us that their will be a slowdown which translates in a decrease in demand. However, the fundamentals for oil are still strong because we did have a shortage of oil production before the war in Ukraine started. The latter just compounded those shortages. The reason being for the oil production shortages were geopolitical because many countries put quotas on production for environmental concerns.

As for services, the demand for services is high currently. The covid mandates have been lifted and many people are travelling hence the issues airports and airliners are having. However, we suspect that demand to decrease because logically people are travelling now but they won't take a second and third vacation in September and October.

Furthermore, **the credit markets are telling us that they are looking past the inflation fears and onto slower economic growth, because the long-term yields have come down substantially from their highs.** Which is along the lines of what we had written in our last three newsletters whereby inflation should abate in the second half of 2022. Obviously, the war didn't help in terms of the steepness of the increase in inflation.

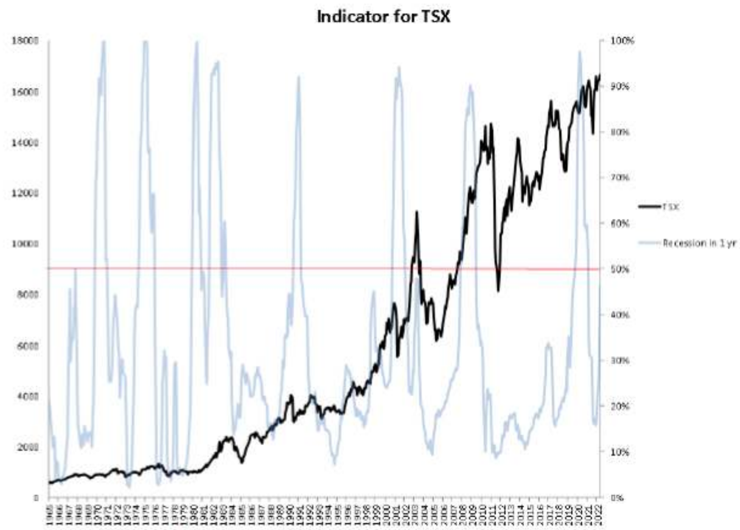
In summary, short-term rates are going higher in the coming months and equity markets have priced in a recession and credit markets have also signaled slower growth. And for the second time this year, the yield curve has also inverted by a few basis points again in the last few days, with the 2 Year Treasuries higher than the 10-year maturity. The FED has also stated that after this increase in rates, they will bring them back down 2%. Hence, they are signaling to us that they will be accommodative after all this. The question remains when will the equity markets start pricing in this reality. Plus, we know that equity markets are on average a six-month leading indicator.

Our major concern at this point is how credit markets are going to react when the overnight rate goes to 3.5%. Basically, it could trigger liquidity issues and margin calls especially for those who are overexposed in high value multiple sectors. We saw this happen in June when the price of Bitcoin dropped suddenly. Thus, we might just have another sell-off in equity markets which would be driven by liquidity. That said, if the latter were to occur, we would see this as a buying opportunity. The reasons for this will be outlined in the technical analysis commentary below. Moreover, the second quarter earnings season starts shortly, and this too shall give us more clarity on corporate earnings.

Recession fears

While a North American recession is not a sure thing the odds of this outcome are not trivial either. To try to quantify the odds, BMO's Recession Probability Model which is a seven-variable model, is now showing a 45% chance of a U.S. recession in the next 12 months (which is a good proxy for Canada as well), so basically a coin flip. This happens to triangulate precisely with the odds of our BMO Economics Team has for a North American recession. It previously was at around 30% just a few months back so the trend has clearly deteriorated given the much more hawkish stance from Central Banks and the growth slowdown which is becoming clearer based on real world manufacturing survey data. Keep in mind that apart from housing and autos which react quickly to higher interest rates, the impact on most of the real economy has a 12-month lag or even longer so it will take time to determine the effectiveness of tighter monetary policy on inflation with which most economies are currently wrestling.

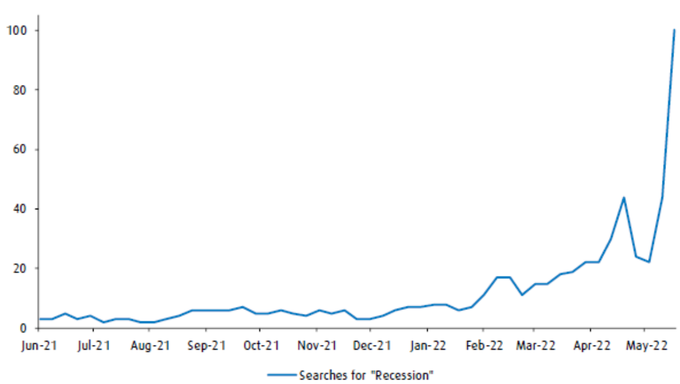
Recession Odds for next 12 Months (in Blue) vs. TSX (in Black)

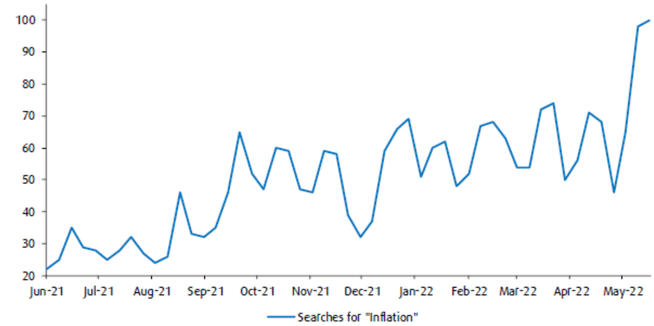


Sources: BMO Wealth Strategy, Bloomberg, Factset

From a contrarian perspective, the silver lining is that inflation and recession have becoming pervasive themes, not only among finance professionals but also among the public at large as shown by Google keyword searches in Canada:

Google Keyword Search Trends for "Recession" and "Inflation" in Canada





Source: Google

As BMO Chief Economist Doug Porter recently wrote "It seems that almost no one now believes that the economy can achieve a soft landing in the face of the current inflation battle—not Chair Powell, nor the majority of Canadians. Each has opined in their own unique communications style in recent days that the expansion is at serious risk in coming months. In his testimony to Congress this week, Powell suggested that the path to a soft landing is becoming "*more and more challenging*", and that bringing down inflation without driving up joblessness will be "*significantly more challenging*".
In turn, financial markets are building in those rising risks and thus we've witnessed yields and cyclical commodity prices retreat meaningfully as stated above.

Amid mounting recession concerns, markets have had a serious rethink on central bank pricing and have moved off the most extreme levels from a little more than a week ago. For example, after pushing up close to 3.5% on two occasions last week, Treasury yields have since tumbled across the board, with 2-year rates even temporarily dipping below 3% at one point. While another 75-bps hike appears almost locked in for the late July meeting, it gets fuzzier thereafter. The latest dot plot had a median expectation that rates will rise by a cumulative 175 bps through the second half of this year and then another 50 bps in 2023. After initially pricing in even more than the Fed median call, markets have since moved back in the direction of our view, presumably in the belief that the economy just can't handle much more than that degree of tightening..."

However, market history has proven time and time again that when everybody becomes fearful, we could be getting close to an interesting buy point. The caveat of course is that getting the timing wrong can be very costly in a declining market, particularly since the final phase of liquidation can see asset prices "gap down" quickly. From our perspective, a lot of risk is already priced in, but we still advise caution and to focus on high quality stocks that have great upside potential when the next upturn unavoidably happens; it is just a matter of time.

Canadian Dollar Should Get Stronger (Eventually)

Our Foreign Exchange Team just published some interesting comments on the strength in the U.S. Dollar and their view that the Canadian Dollar is well positioned. In essence, it is not that the C$ has been weak, its that the U.S.$ has been so strong relative to all major currencies.

Risk-off sentiment has become the dominant theme in financial markets over the past few months. Financial volatility, both implied and realized, has spiked. The U.S. dollar has also spiked. The Fed's broad nominal USD index is up about 10% over the past 12 months, including 5% in Q2.

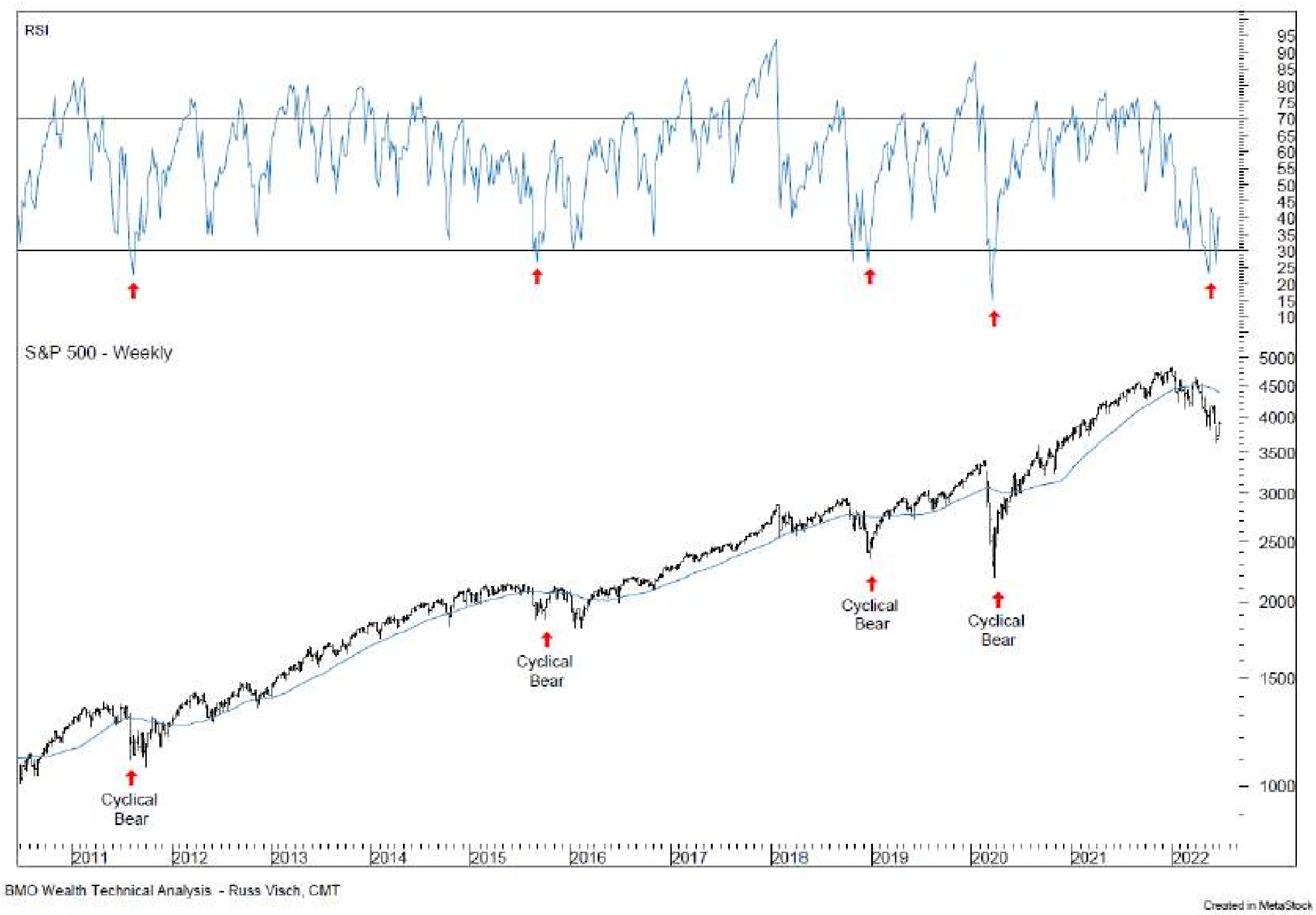
Further our Foreign Exchange Team states; "that this year's USD rally began as a reasonably gentle Fed-on rally, but it has transitioned into more of a risk-off spike on the back of global recession fears. Those fears are unlikely to dissipate this summer, so our base case projection is another 3% spike higher in the USD before it peaks out some time around September. However, if/when the USD peaks out on risk-off sentiment, we do not think it will resume the Fed-on rally because Fed rate hikes now seem a bit overpriced. We look for the Fed to deliver its last rate hikes in Q4 and that will restore confidence in global markets, thereby allowing the USD to drift lower in 2023. We admit to being unusually uncertain on that view, though. It is certainly possible that the USD spike extends to the point that global authorities find themselves scrambling to dust off the Plaza Accord playbook by year's end'.

CAD: They view the loonie's combination of economic growth, monetary policy, fiscal policy, political stability, and external balance fundamentals as the best in the G10. However, when the broad USD stops rallying, they believe USDCAD will reverse relatively sharply, and the loonie's gains on crosses will increase.

The Technical Picture

Over the past 80 years, cyclical bear markets in the S&P 500 within bigger secular bulls have lasted six months on average with a decline of just under 22%. As we start the third quarter the S&P 500 is nearly six months past, and 23% below its early 2022 peak as measured to the mid-June low, so we are certainly in the "zone" where a major low could occur at any time now. More importantly, all the indicators in our medium-term timing indicator are now essentially 100% of the way towards where they get to at the end of bear markets. For example, weekly momentum gauges for all the major averages are now deeply oversold. In fact, some of them are now more oversold than they were in March of 2020.

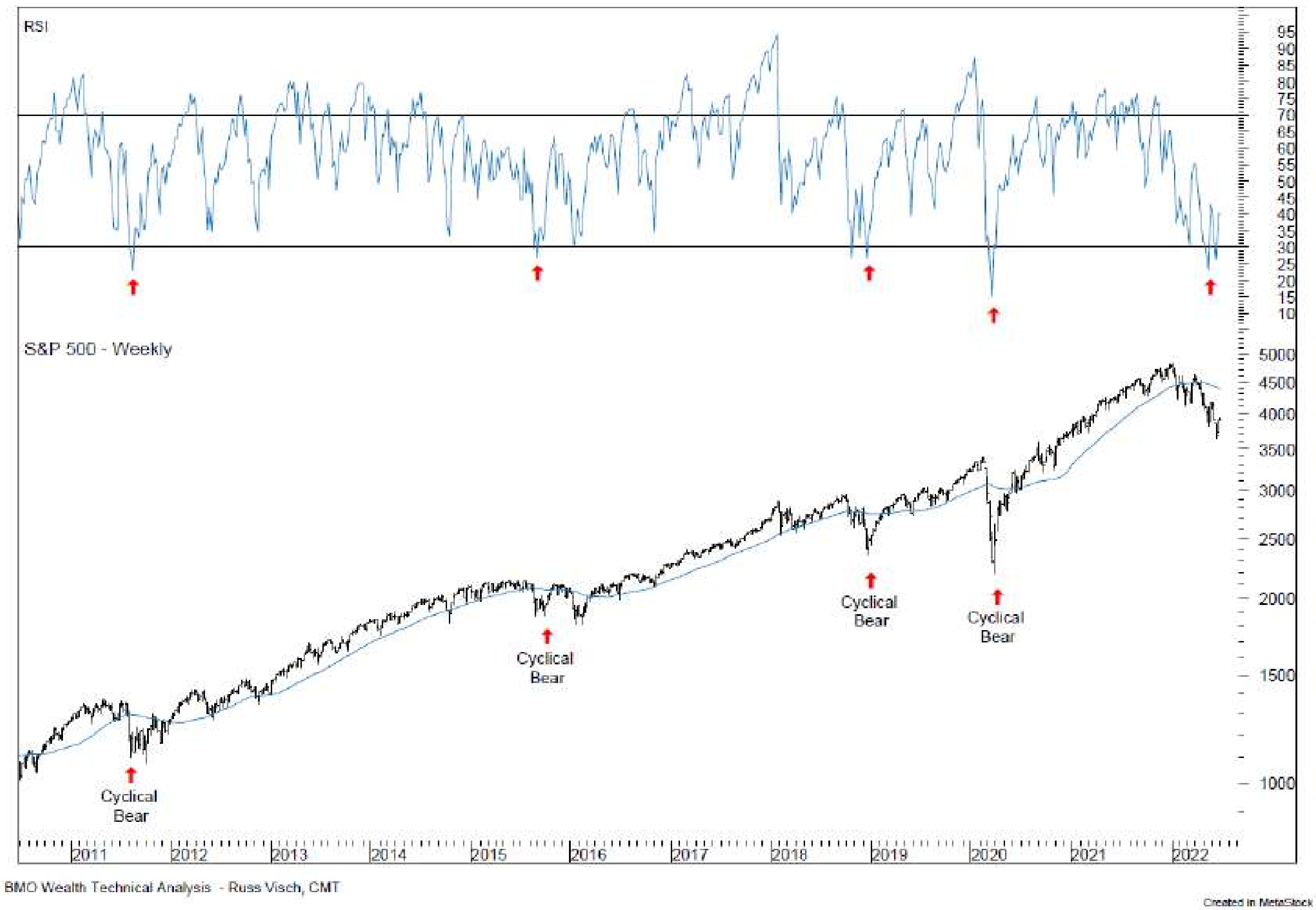
S&P 500 Medium-Term Momentum



Source: BMO Nesbitt Burns Technical Analysis

Recall that the sell-off in the S&P 500 during the pandemic was the worst since the early 1940's and we are now more oversold than that. The same is true for breadth oscillators such as the percentage of stocks in the S&P 500 trading above their 50 and 200-day moving averages.

Percentage of S&P 500 Stocks Above Moving Averages

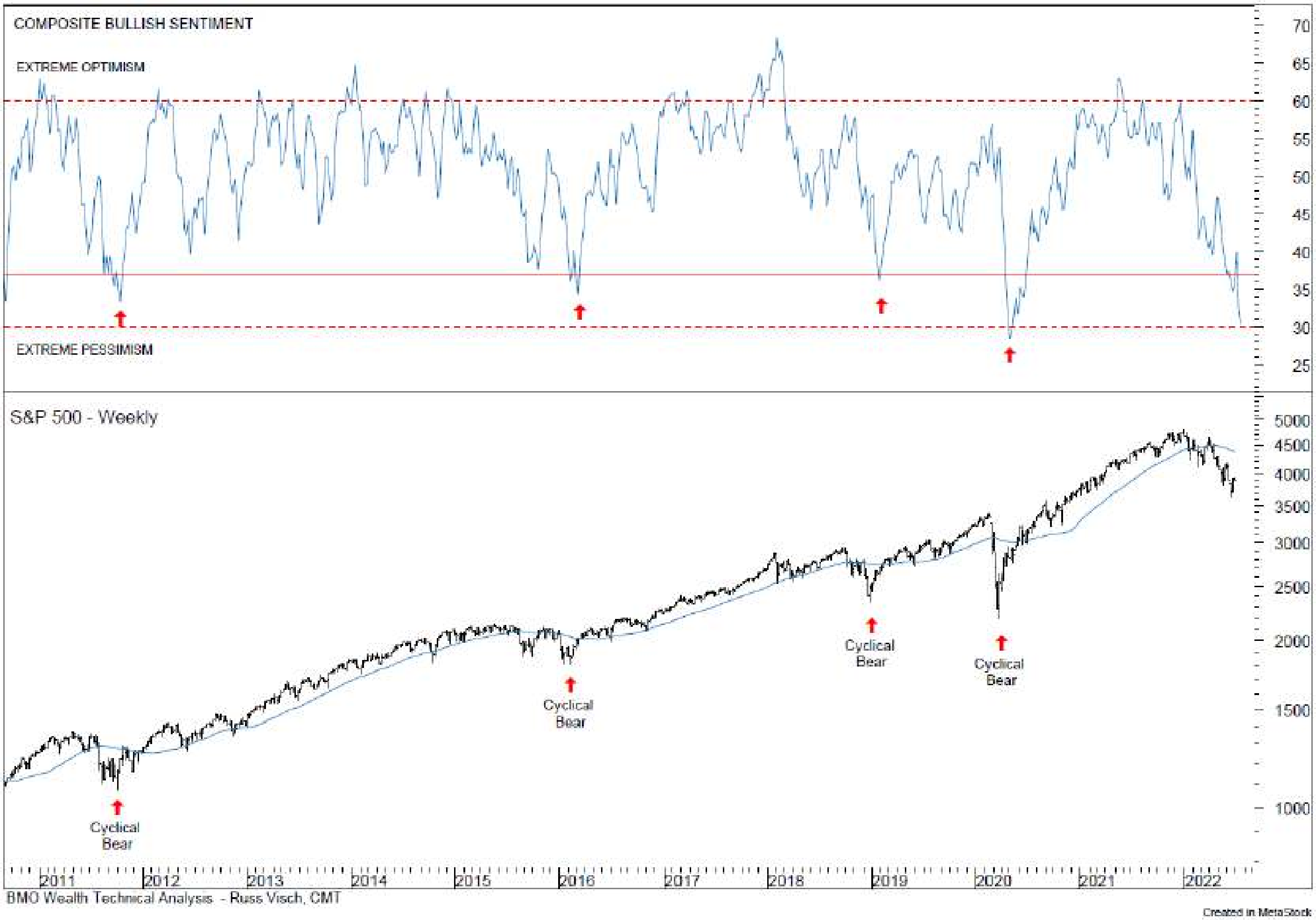


Source: BMO Nesbitt Burns Technical Analysis

Just last week those gauges matched the deep oversold levels that they got to in March of 2020. As of the middle of June there were only 10 stocks in the S&P 500 trading above their 50-day moving average. Finally, sentiment is also rampantly pessimistic. Our Composite Sentiment Indicator is an aggregation of several different sentiment surveys which poll different segments of the market asking them if they are bullish or bearish. It is now just 2 points away from the bearish extremes that developed at the pandemic low.

In fact, it is only been this negative three times in the past 15 years: at the end of the early 2020 pandemic sell-off, and at the March 2009 low following the 18-month, 58% decline in the S&P 500. This just begs the question – who has not sold everything they have wanted to sell yet? Given the state of these indicators our expectation is that this bear market ends at some point early in the third quarter, possibly even as early as this month. As such, investors should soon be shifting their focus from being defensive to taking on more risk.

Composite Sentiment



Source: BMO Nesbitt Burns Technical Analysis

Financial Sector

While the Financials sector moved deep into correction territory in June, our conviction on the sector has not changed. Yes, earnings growth is set to slow on tough comparables, rising rates will put pressure on debt servicing and household loan growth, and normalizing loan loss provisioning is now a headwind for earnings growth. However, these are all largely expected and very manageable risks. Overall, despite these modest headwinds we believe the sector remains one of the strongest relative value plays in Canada, not to mention within most global markets. Moreover, the sector's perpetual strong income and dividend growth characteristics broadly position Canadian Financials as an attractive destination for value and income investors. As such, we steadfastly maintain our holdings within this highest-conviction Canadian sector and continue to prefer those companies with strong US platforms – especially within the banks (commercial banking + wealth management). Furthermore, Canadian-centric investors concerned about rising and elevated interest rates could tilt their Financials exposure towards insurance providers which offer similar value and income characteristics, but also tend to outperform banks during extended periods of rising rates.

Furthermore, very little optimism was priced into the sector, even as foreign investors flooded into Canadian equities in 2021. As such, we believe the sector is less susceptible to downside risk, even if the economy enters a recession.

- Banks' price-to-book ratio is well below what is implied by the strong overall profitability of the sector. In fact, a basic regression of price to book versus ROE implies price to book should be almost 24% higher than current levels.

- Furthermore, banks are typically the proxy trade for Canada and often benefit when foreign flows are increasing. However, this was not the case in 2021 as the bank industry NTM PE remained largely stable throughout the year.

- Financials, including both the banks and insurance industries, have dividend yields firmly above the overall market and long-term Government of Canada yields.

- Distribution rates, including dividend and buybacks, have only started to rebound from trough levels set in late 2020.

- Overall dividend growth has continued to trend higher over recent quarters and is likely to hit double digits as we move through 2022.

On cue, the Financials sector bears roll out their 2008 playbook on any slight increase in housing or credit risk. Yes, credit spreads have nudged higher from trough levels, mortgage debt servicing has risen, and mortgage loan growth has started to slow from the highest levels since 2007. Despite this, these risks are well telegraphed and remain very manageable in our opinion. Even with the slight increase in credit spreads, a sharp rise in loan loss provisioning seems unlikely. Instead, provisioning is likely to continue to normalize over the coming quarters from the extreme lows seen in 2021. While mortgage growth reached elevated levels in 2021 and is likely to drop in 2022,
non-mortgage loan growth continues to rebound from the sharp decline seen during the pandemic. Overall, we agree earnings momentum is set to slow as comparables get tougher, provisioning normalizes, and total loan growth slows – however, these are normal course risks for the sector and very manageable in our opinion.

The effects of the pandemic are still being felt in our daily lives and in the stock markets, however your team will remain alert to developing trends and remain active to keep your short- and long-term plans on track.

Hope to talk to you soon.

Team Roux & Associates