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October Newsletter: Baked In or Not?

Market Update: We thought this an opportune time to give you all an update on the markets, as difficult as the last 10 months have been, there may be some signs that we are close to putting a 'bottom' into this beastly bear that has ravaged the equity and bond markets this last year.

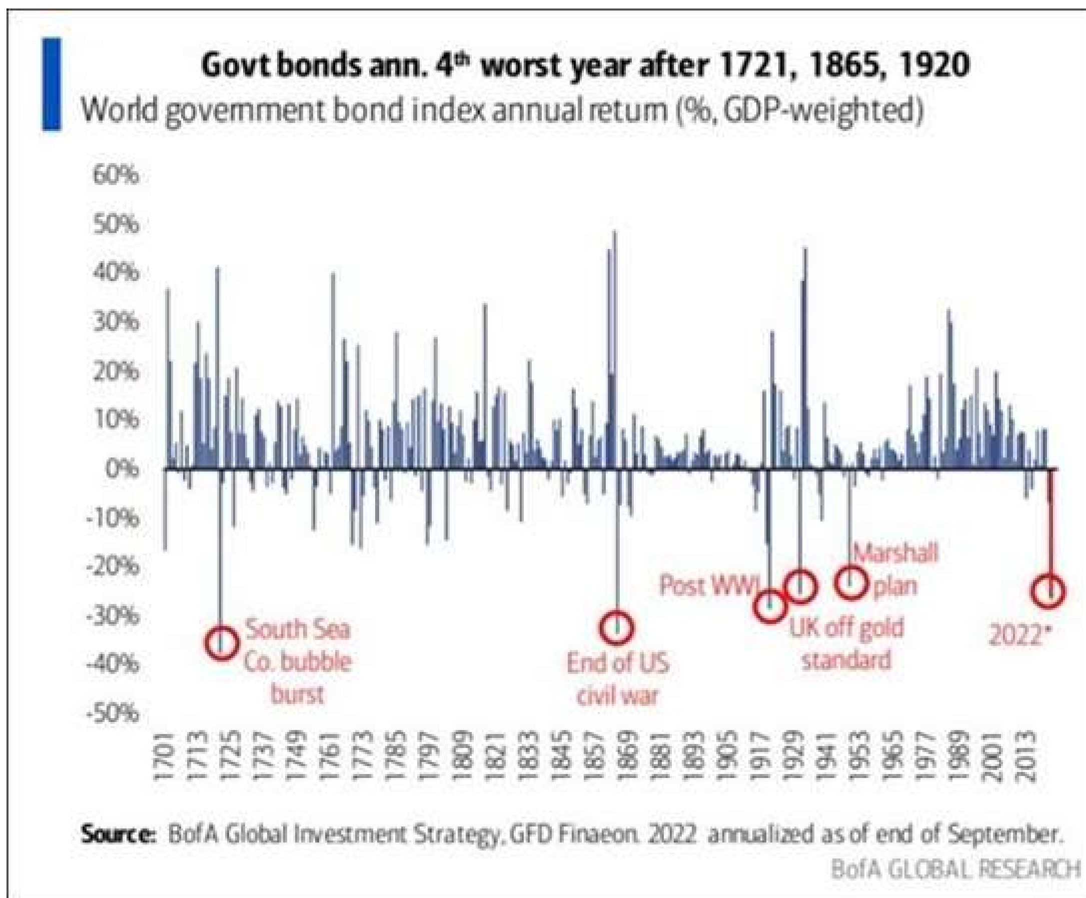
To recap, not a lot has changed since our last newsletter, in that the global stock and bond markets have struggled to deal with the rise in global inflation and the action of the Central Banks in raising interest rates in an effort to squash inflation. Inflation has been more persistent than the Central Banks expected and consequently they have raised interest rates higher and faster than the market expected.

The uncertainty in the markets around inflation and interest rates has led to some of the highest volatility that we have experienced in over 25 years. The daily swings have been huge and to put it into perspective here is a rough timeline of just the last 2 weeks in the markets. Basically from October 2nd the market rallied +6% in 2 days and then over the next 3 days declined -5.5%. Then on October 13 when the CPI numbers came out the market declined -2.5% as the market opened and then during the course over a couple of hours turned around and closed +2.5%. In a single day we saw some stocks that were negative -5% on the open close up +5%. So that was Thursday and then Friday the market traded back down -2.5%. Monday 17th however the market traded back up over +2%. Last month we saw FedEx lose -23% of its value in a single day on an earnings announcement. These wild swings have been a theme over the last 10 months. 'Rational' is not a term that we would apply to these gyrations. There has been no 'safe havens' in this volatility as even the CDN Banks like Royal are roughly -22% from their high, give or take a day or week.

The markets in the month of October hit new lows with the S&P 500 being down -25% and the Nasdaq down -36% on the year. These sorts of numbers do not occur very often as we have pointed out before. What people also forget is that the Bond market which normally provides some stability in times of volatility has feared as badly as the stock markets of this world. This is the 4th Worst Year in the history of the US Bond market since 1721, 1865 and 1920 with returns pushing north of -20%. So even defensive Balanced Portfolios holding 'Blue Chip Dividend Stocks' and Government Bonds were staring at losses of greater than -20%. Case in point the US Aggregate Bond Index was -17.1% and the US Long Bond Index -34.8% at its low point.

I do not tell you these numbers in order to scare you, but in order to provide context on where we have come from and where we are going. These are the market cycles which tend to repeat themselves and in turn how the markets 'heal' themselves going forward. Irrational behaviour leads to these crazy gyrations and volatility and then at some point rationality returns, valuations matter, balance sheets matter dividends matter, strong management matters and that is when you have market bottoms put in and recoveries from these bottoms.

595 Burrard Street, 9th Floor Vancouver BC V7X 1L7 · T: 604- 665-7500 (Greg Vos) 604-221-2853 (Jed Brezer) · F: 604 665-7461



Through this volatility we have also had some sharp rallies as the S&P has had 7 'Bear Market Rally's' this last year. The sharpest was following the **'June Low'** where the market rallied 19% from the low point. This was a very sharp and strong rally with all stocks and sectors participating and many believed that this was the end of the Bear Market, as the belief was that inflation had peaked. Unfortunately, the following month the inflation numbers came in slightly higher and led to the market once again to roll back over.

This is the 'Bear Trap' of which we have spoken of before and which has occurred 7 times this last year. You can see from the chart below how rapid both the rallies and retracements have been this last year and a key reason why trading in this market has been so incredibly difficult, given the large daily and weekly swings. Even Consumer Staples (think toilet paper, detergent, food) which is considered a very defensive sector has not been spared the volatility and something that we paid the price for earlier this year, when the entire sector traded down -8% over 2 days. Lesson learned.

Bottoming Sequence
This **'June Low'** or now **'October Low'** is an important data point as at that time the S&P 500 traded back to roughly 3600 points in June.
Through the rally and the subsequent pullback over the last 2 months we saw the S&P trade just below the 'June Low'. Our Technical Analyst Russ Visch said that this was the, 'line in the sand', in that it was very important that the S&P hold here at this point. From a Technical Perspective what Russ Visch has been looking for, is the 're-test' of the June low. Why it was crucial for him, is that in technical analysis one needs to see the low point 're-tested' before a market 'bottom' can be put in place.

Comments from Russ Visch: We'd like to see some more follow through on the upside over the next few days but at this point it's looking like the recent price action, while more volatile than we would have liked to see, represents a successful test of the June low as part of the "low, rally, re-test" bottoming sequence that's common to see at the end of bear markets. It's too early to suggest a new cyclical bull market has taken hold just yet since that would only occur on a close above the August peaks. (TSX: 20,323, SPX: 4325, Nasdaq: 13,181) However, we are becoming increasingly confident that all of the price damage for this cyclical bear is now "baked in."

The 'Bottoming' process is incredibly important, as this will set up the platform from which this market will rally over the coming days, weeks, months and years. By **NO MEANS** is this going to be a straight line back up like what occurred after the Covid lows. There will be stutters, up & down, some sideways action and some volatility around the normal US Federal reserve comments on interest rates (The next one on Nov.2) and what the CPI or inflation numbers come in at each month. The market needs to see CPI decreasing if it is to rally meaningfully from these low points in the market. Other Technical Metrics that Russ follows, have also shown readings that have not been seen in some cases since 1987, which has given him increasing confidence that the market is very oversold and on his call of a market bottom.

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Market bottoms are very difficult to call and we have to be weary of the 'Bear Traps', that we have seen 7 times already this year. By no means are we stepping in and using our cash to buy new positions just yet, as we need to see more confirmation from both the market and the economy that 1. Inflation has peaked. 2. That the rate of increase in interest rates has slowed. 3. That the consumer is still healthy. 4. Stability in housing prices. 5. That US and global unemployment does not suddenly start to spike. Some increase in unemployment would actually be welcomed by the market as it would indicate a lessening of wage pressure in the inflation matrix.

Over the last 2 weeks we have seen a strong rally off the low in the S&P 500. Giving a lot more support to the bottoming process. We are also in the midst of earnings season and are seeing many companies beating earnings estimates with their shares trading higher and starting to indicate a change of trend from downtrend to uptrend. Currently the S&P 500 sits at 3807 so nearly 200 points above Russ' 'line in the sand'.

Baked In?
How much of the inflation threat and growth slowdown is embedded in stock prices? Quite a bit of it after a very difficult stretch for the market. That is our short answer to what has become the most important question for investors. Inflation remains a key concern – however, BMO Economics stands by their call that it has likely peaked in North America. That being said, it will not be a straight line down from here.

On October 27 the Bank of Canada raised interest rates by 0.50 bps, which was less than expected due to the fact that they were starting to see slowing economic activity. The market took this as a strong positive that the rate of interest rate hikes is slowing and the desired affect is starting to be seen on inflation.

This includes lower energy/commodity prices, median rents, shipping (and more specifically trucking freight rates), manufacturing and services PMI prices, and core import prices. All signaling pressures are abating. Even the average hourly earnings and used car price increases are slowing and home prices have started falling, a sign the effects of monetary policy decisions that normally come with a 6- to 12-month lag are starting to have an impact. (BMO Economics, Nov 18)

It may still be early to change the narrative on inflation but some Fed members have recently offered some caution to the risk of moving too fast, providing a slight variation to what was perceived as a unanimous committee. Inflation may be the focus, but for central banks the financial stability is equally if not more important. Deteriorating financial conditions, weakening market liquidity conditions and rising credit risk can have a lasting impact. The Bank of England (BoE) response to an ill-advised U.K. government fiscal policy is a recent example on how rapidly rising interest rates can de-stabilize financial markets. UK PM Liz Truss resigned after 3 weeks on the job, a casualty of misguided economic policy.

We will know more after Nov 2nd once the US Federal Reserve meets and announces their interest rate projections.

So where does this leave the markets?
Many feel that given the declines that we have already seen in global equity markets that the worst is already baked in, as per some comments from Bank of America.

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> Bank of America Corp. said sentiment on stocks and global growth among fund managers it surveyed shows full capitulation, opening the way to an equities rally in 2023. The bank's monthly global fund manager survey "screams macro capitulation, investor capitulation, start of policy capitulation," strategists led by Michael Hartnett wrote in a note on Tuesday. They expect stocks to bottom in the first half of next year after the Federal Reserve finally pivots away from raising interest rates.

Source: Quote from the Bank of America analyst Michael Hartnett. Published in Bloomberg, Thursday, October 13th.

This aligns with what Russ Visch is saying above, so we are starting to get both Technical and Fundamental Analysts pointing to a bottom in the market. On the earnings front we are also seeing companies report better earnings than forecast and provide positive guidance. One more sign that this market is starting to turn.

When we look at many stock prices and their balance sheets, we see valuations and dividend yields that we have not seen for many years and in some cases over a decade. This makes us excited, in that we know at some point in the very near future that the market will once again take notice of these valuations and start to reward those companies with higher share prices. Something we are already starting to see.

By focusing more on the dividend side of the market, we also build an income stream in the portfolio which is higher than normal, due to the fact that the stock prices are so low, so the dividends as a % are a lot higher. When we do our analysis, we see companies that have a strong ability to continue to pay dividends and a history of increasing the dividends yearly, along with good earnings growth. These are the companies that we are buying and want to own going forward.

We also realize that though the volatility is unsettling, it is something that we have to live with to a greater or larger extent. Even these great dividend paying stocks have gone through sharp corrections over this last year, however with us buying them at these levels, we feel we are setting up the portfolios for strong returns in the coming years, supported by the strong dividend yield.

We also realise that we cannot be 100% out of the markets, as then we will not participate in any recovery in the markets. We have allocated a percentage of every portfolio into a strategic cash holding, which we will hold alongside of our equity exposure. The stocks that we continue to hold, we have a high conviction on and we will use our cash allocation to buy more of these stocks as we see the recovery unfolding.

For example, Royal Bank in a strong market may be 4% to 5% of a portfolio yet currently is only 2% to 3%. Same with Telus, Bell Canada, Microsoft, Target to name just a few. Many of the Canadian names are looking especially attractive.

The Technology sector is also the most beaten down this year and so consequently when this market does turn is likely to produce the largest returns, yet not without a higher degree of volatility. We are currently underweight Tech in every portfolio and so would look to add to those ‘Tech Names’ when we feel the timing is right and look once again for dividends in this sector. Once again, we are trying to be more defensive in our approach where there is heightened volatility.

Currently we are also in the start of earnings season which often leads to increased volatility both in the up and the down. For example, Netflix was down -60% this year and reported decent earnings this quarter giving the stock a +13% boost to the upside. This is a clear example of where the market had ‘baked in’ a far worse outcome for the company than was the current reality and we are starting to see more and more examples of this from Caterpillar, Deere and other industrial names.

We do maintain that we are closer to the end of this Bear Market than the beginning and that the Central Banks and most importantly the US Federal Reserve, will start to scale back their interest rate hikes and possibly stop rate hikes in 2023. We think that any meaningful recovery is likely to be more of a 2023 story as inflation starts it’s descent.

What we have learned and changed.

Over the decades, we have used a ‘stop loss’ strategy in the management of the portfolios which has proven to be quite affective. To recap when a stock falls below a certain price threshold the position was sold from the portfolio. During this last year this strategy has worked somewhat against us due to the heightened volatility and these massive rallies and the subsequent pullbacks.

What ended up happening was that we ended up getting ‘stopped out’, on positions that we would have preferred to hold on to. In many cases we ended up buying back the security at a lower price only to see the volatility take hold again and for us to get stopped out for a 2nd time. No matter how good a company, strong a balance sheet and dividend or how defensive in nature, there was no shelter as prices cascaded lower. This ended up in heightened trading activity in portfolios and in some cases us having bought and sold the same position in very quick succession to prevent further loss.

As a result, we have changed our stop loss strategy and moved it from an individual stock level to a portfolio level. As discussed, there are Core Names that we know we want to own and hold through the volatility and into the recovery. There are these great dividend paying stocks trading at multi year lows that we are excited to own. However, we also need to reduce some of the impact of the volatility and the overall risk that exists in the market. This we have done by holding a percentage of Cash in every portfolio. Cash is our defense and will remain so until we have a high conviction on the state of the recovery.

Strength of the US $ Dollar.

The US $ has been the strongest currency over the last year versus basically every other global currency. At one point we even saw the US $ at parity with the Euro, something not seen in a very long time. How this works is that in times of uncertainty people buy US $ for safety. Ironically when the US economy is doing very well the US $ weakens relative to other currencies.

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The CDN $ despite of the strength of Oil prices over the last year, has also weakened relative to the US $. The strength of the US $ has also a lot to do with the US Federal Reserve raising interest rates higher and fast than most other Central Banks. If we are to assume that at some point in the near future that the US Fed pauses on rate hikes, then we are likely to see the US $ start to weaken in 2023.

On a Portfolio basis we would like to capture some of the strength in the US $ that we hold in portfolios and so shift some of our US $ holdings back into CDN $. As mentioned above we see some very good stock buying opportunities in the CDN market which we would like to take advantage of.

US $ holdings will continue to be a strong part of the portfolio but just not as big of a percentage going forward.

All the best from our team members.

Greg, Jed, Dave, Marion, Lili, Samantha, Kenzy, Mahad, Ling, Tracy, Kelly, Sarah and Jennifer

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