April Newsletter:

Threading the Eye of the Needle.

Introduction: I apologize ahead of time if I rehash many of the topics that we have discussed previously and or some topics that occur in the daily media. I do however think it is important, as it is the confluence of all these different factors that has bought us to the place that we are currently in. Sometimes we read an article, yet we do not necessarily see how it might relate to something else and how all the various factors in confluence can end up in a certain result.

The stock market is arguably a confluence of all of these factors combined and as is also a forward-looking entity, as it tries to peer into the future of what the economy and market might look like 6 to 8 months or so in the future. What the market currently sees coming down the pipe has it somewhat rattled and decidedly undecided on what the outcome might look like.

So to explain:
Inflation: Something we have discussed in previous newsletter and no doubt you have all read about in the media as it has become daily headline news and no longer something just discussed by economists. Inflation is ripping higher and suddenly it is a big concern of not just economists and Central Banks, as it starts to hit the consumer squarely in their pocketbook.

As our Chief Economist Doug Porter stated:
But even we have been blown away by how far inflation has risen in that year. Remarkably, Canada's outsized 6.7% y/y headline inflation rate is below the median pace in the industrialized world, with the U.S. at 8.5%, the Euro Area at 7.4%, Britain at 7.0%, and New Zealand at 6.9%. A wide range of developing economies are even higher. Even Japan is reporting 1.2% headline inflation, the highest in more than three years (hey, you have to walk before you run). Canadian producer prices also surged 4% m/m in March (and a towering 18.4% y/y), the largest monthly advance in the 66-year history of the series—that's a lot of history.

On-the-ground intel finds that conversations among relatives and friends (non-economists; yes, we have a few), have suddenly morphed from swapping stories about how much house X down the street sold for *("Can you believe it? Ridiculous!")* to how much product Y has risen since the last purchase *("Can you believe it? Outrageous!").* Not surprisingly, consumer inflation expectations are gradually climbing. Accordingly, the messaging from central banks is continuing to ratchet higher. Chair Powell said on Thursday that the Fed will move *"expeditiously"* to get rates back to neutral (or about 200 bps north of where we stand today).

In some ways, furniture captures all the aspects of the pandemic economy—a raging housing market, soaring demand for goods, rising tariffs, and a snarled supply chain. And, as a result, furniture prices have jumped more than 20% since February 2020, after essentially lying flat for 25 years, like a giant beast awoken from a lengthy slumber. Let's hope this is not emblematic of inflation as a whole. (Doug Porter: BMO Taking Points. April 22, 2022)

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So lets dissect these comments above from Doug. What has happened is the massive spike in inflation has caught the Central Banks of this world flat footed and made them all realize that they should have been raising interest rates last year; however that may not have made them very popular with politicians trying to get re-elected on promises of more liquidity and cash for everyone.

Now the Central Banks of this world are trying to play 'catch-up' in an effort to hike interest rates along with the historical belief that the higher rates will bring down inflation. **But what if it does not, what if they are too late??**

Inflation historically moves up when the economy is booming and Central Banks would hike interest rates to try and cool an 'overheated' economy. However this time it could be argued that this is not the case. The cause for high prices has a lot to do with Covid related supply issues and fueled further by the ongoing war in Ukraine. What we are currently seeing is actually the **opposite**, in that the economy is already cooling rapidly and is a long way from overheating. In terms of the Business Cycle the top of the cycle was arguably late 2021 and the business cycle is already in the late contraction phase.

Think of it from your personal perspective, how likely are you to go by another Peloton Bike, do 'MORE' Zoom Calls, shop any MORE On-line, upgrade your RV or buy another computer, because you probably upgraded last year. For many companies 'peak' earnings was probably last year and they are already seeing orders and growth slow to more normalized levels.

This is a very different scenario than anything that we have seen before. The Central Banks are scheduled to raise interest rates by as much as 2% over this coming year to fight and try and slay the Inflation Dragon, but at what cost? The higher rates are already starting to have an affect on Global Manufacturing or 'PMI' numbers, which historically have always declined in a rising interest rate environment. Higher rates are also an increase cost on business, as the cost of servicing debt is increased and the cost of taking on any new debt to fund expansion is now much higher.

As Doug Porter points out the family conversation has shifted from the housing market to the cost of goods. How likely is the average family to load the kids in the RV and drive down to Disneyland this summer with gas at over $6 per gallon? And oh, by the way, RV sales and car sales in the US are falling rapidly month by month as the consumer continues to pull back on high-ticket items.

Switching to the housing market: BMO raised their mortgage rates x4 this last month and moved the Prime Rate to 3.2%, as did all the other CDN Banks. Think about what this does to the cost of mortgaging a house. In Canada over 55% of homeowners have a 'variable rate mortgage' which is tied to the Prime Rate. With most of these types of mortgage being Prime + 0.5% or +1%. So if Prime is 3.2% and the Bank of Canada hikes another 2%, theoretically Prime could move somewhere close to 5% and then you add 0.5% or 1% to that and you could be staring at a mortgage of 6%...(Last year people were getting fixed rate mortgages in the 1.8% range). I just finished writing this and received an email from BMO saying they had increased the posted rate on a '5 year Fixed Closed' to 4.99%.

So basically rates are more than double already what they were last year. Think about the impact that this could have on the housing market. If you could not afford real estate when mortgages were at sub 2% how affordable is it likely to be with mortgages at 5% or 6%? Surely this is likely to put the brakes on the housing markets around the world and not just in Canada?

Housing is also a massive store of wealth and when prices decline it really impacts consumer sentiment and what is known as the; 'Wealth Affect'. Bottom line people do not feel like spending money when the value of their home declines. We are already starting to see new home start permits and mortgage applications in the US decline. Home prices are likely to follow in the coming months.

Stock and Bond Markets.

Stock markets around the world are now looking at all of these data points and starting to worry. The worry of course is that the economy is facing long term inflationary pressure and that higher interest rates are likely to do little to alleviate these pressures. The markets worry that the peak in the business cycle and corporate profitability was last year and that the Central Bank will be racing interest rates while the consumer and the business cycle is already slowing rapidly. The worry is that higher interest rates are just likely to make the slow down worse, add in falling home prices, declining stock prices and the, 'Recession' word starts to maybe become a reality.

The Bond markets are normally seen as the more sane and rational side of the Stock markets, where normally, there is very little volatility and movements in Bond prices are quite small and orderly. Well these last couple of months we have seen the worst rout in the bond market in 40 years. To put it in perspective, the US Long Bond price Index (TLT) is down -35.13% as of April 22nd. This is somewhat unprecedented, as the Bond market is trying desperately to calculate where interest rates go and how fast they end up getting there.

What we have also seen is the Bond Yield Curve flatten and invert. Basically this means that short-term interest rates are higher than long-term interest rates. Why so much attention is placed on inversions, is that have historically been good indicators of a recession with recessions normally following an inversion in around 8 to 12 months or so after an inversion.

The stock market of course sees the huge movements in the Bond market, which only serves to feed in more uncertainty and volatility. So what the stock markets are saying, is that they do not know or maybe believe, that in the current environment the Central Banks of the world, can raise interest rates to fight inflation without destroying the economy and causing the next recession. History seems to favour this view.

The reality is, Central Banks are in a tough place as they have to fight inflation and they also have to get interest rates off of the Zero mark. Unfortunately, it is all about timing and their timing might just be too late. The question then still remains; as to whether they can thread the eye of the needle and raise rates enough to combat inflation without causing a recession?

The impact to the stock markets of this world has been quite severe and I am not sure if many people realize how much many stocks prices are already down this year. Just to give you a brief snapshot: Netflix is -71%, Sony -30%, Google -17%, General Motors -30.5%, JP Morgan -17%, Microsoft -16%. The list goes on and some of the losses are quite staggering especially in some of the 'Covid Darlings' like Zoom, Peleton and others. Don't be fooled by the indices of this world, as you start to realize that in some cases 20% of an index can be the result of just 2 stocks, in the Nasdaq; Apple and Microsoft represent just over 20% of that one index and Apple is/was 7.1% of the S&P 500. So when Apple is only down -6% on the year it can sway the perception of how the indices are actually doing until you look under the covers. If Apple shares break on their earnings report April 28th things could look a little different.

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Likely Outcomes:
Basically there are a couple of likely outcomes.1. Being a Recession. 2. Period of Stagnation or Stagflation or 3. A sharp recovery following Peak Inflation.

Recessions always have a way resetting the bar, removing the excess speculation from all markets and in some ways are not that bad, as the recovery out of them can be quite spectacular. Look at 2008 and where we are today. Yes they can be painful to go through however they also present a massive amount of opportunity on the recovery. Given my example above of some of the damage to stock prices one could argue that the stock markets have already priced in a full-blown recession to some degree and that there is not much downside left in the markets. There will be some incredible buying opportunities in the days to come and it was interesting to see Warren Buffet make a huge acquisition recently of Hewlett Packard stock.

In managing the portfolios we are primed for a recessionary environment as we now have well over 24% of portfolios in Consumer Staples. Think of things that the consumer buys in both good and bad times. Food, toilet paper, pet food etc. This is one of the defensive sectors that weather the storm generally very well along with Utilities and Telco's.

We have also raised cash in all portfolios and will be looking to take advantage of the opportunities that present themselves in the days and months to come. In staying active, we have also raised our sell prices on all of our stock positions and so should the market move the other way then we will sell our position and raise our cash position.

Volatility is never fun, however it is the name of the game and something that we are going to have to deal with for the rest of this year, or at least until this market has a better idea of where interest rates will land. Recessions when they occur, are also pretty short in terms of time and generally last between 6 to 8 months. The market prices in a recession before it happens and also prices in the recovery in the economy before most people are even aware of it. As always, the market is forward looking and we look for the opportunity that exists at these turning points from negative to positive trends.

If we do go into a recession, then the Central Banks will be forced to stop raising interest rates and may even have to start cutting them again. (The Bond market is already starting to price in this scenario for 2023.) Lower interest rates and you start the whole process over again, housing stabilises, markets rally and so you get the inevitable recovery off the bottom and the push to new highs in the market.
In many ways a recession might not be too bad a thing as a way to 're-set' things, but as always careful what you wish for..a bit like politicians pushing for lower housing prices..

2. **Stagnation or Stagflation**.
This is the 2nd possible outcome: in spite of higher interest rates inflation stays stubbornly high. The Central Banks continue to raise interest rates and the economy slows but does not go into a recession. There is little Growth, as consumers remain under pressure and so do not have a lot of disposable income to purchase more goods. Companies cannot raise their prices of their goods, consumer demand remains flat, corporate profits remain subdued and so there is little incentive to invest more capital in new factories or facilities. This is somewhat the situation that Japan has found itself for the last couple of decades. Unemployment levels stay the same and we muddle along in this Stagflationary environment.

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In this type of situation, it really affects lower income earners more than the wealthy, as the rich are less impacted by the higher cost of goods and inflation in general. A situation like this would only serve to widen the income disparity even further in society, which is something that has become more and more noticeable in the last decade.

I personally do not see Stagflation as a real threat, as markets and commodity prices have a way of mean reverting. What I mean by that is I think it is much more likely that high prices will start to self correct as demand dries up and that inflation basically takes care of itself by pricing itself out of the market. Which leads me to the next point and possibly the most likely outcome.

3. **Peak Inflation has Passed**.

There is also the distinct possibility that Peak Inflation occurred last month. The moment that it became headline news, was when it was probably at it's peak. As we have written before; The cure for high commodity prices, is high prices'. So oil peaked out $130 a barrel for WTI, Gold peaked out at over $2050 an ounce, Copper at $5.03 a pound, Lumber at $1700. **All** of these commodities are already a lot lower in price. We have heard so many stories of the Semiconductor Chip shortage, yet I see analyst reports already of the price of some chips starting to fall. If the consumer is under pressure and new car purchases are falling well then the demand and hence pricing of 'Chips' will fall.

If we see a further reduction in the cost of all goods in the coming months, we are very likely to see prices start to fall further and hence a reduction in inflationary pressure. If we see a consistent reduction in inflation, then this will reduce the pressure on the consumer and also reduce the need of the Central Banks to jack up interest rates. If the Central Banks can proceed at a much slower pace, then this will allow the economy and markets time to adjust to the 'slightly' vs 'markedly' higher rates.

Employment has also been incredibly strong through this period and if we can continue to see strong employment in the coming months then any pullback is likely to be pretty muted. As long as people are fully employed it makes a huge difference to 'Consumer Confidence'. Think of it this way; you have a good job; the price of gas and groceries starts to come back down; your mortgage rates do not go up too much and the value of your house is stable, then people start to feel pretty good.

If this occurs in North America, then we are likely to see the stock markets of this world start to rebound quite quickly. Many stock prices have already fallen into recessionary levels and any sign of good news, could lead to a very strong rebound in equity markets. I think this is highly probably given that the current sentiment is so strongly negative out there. This is the opportunity that we are waiting for and looking for, to put any cash that we have to work and pivot out of the defensive names and take advantage of the growth that will come.

I always describe the market like a pendulum, that swings too far in one direction and then too far in the other way only to come to rest back in the middle. I think we are close to that reversal point and the next couple of months will reveal all. Even if we do fall into a recession it is likely to be pretty mild and fairly short in nature as long as employment stays strong through the period. Once again setting the stage for the inevitable recovery and so the cycle continues.

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House Keeping:
Account Documentation: Please note that due to Regulatory Changes we are now required to update your account information every year. The good news is that we can deliver the documents to you to sign or update electronically. If there are any changes in your **personal situation or financial needs**, please let us know during the update process when you speak to one of our Team members.

On our end we have a designated one partner as, **'Signing Officer'** for all accounts which is, David Mandell. David is Co-lead Portfolio Manager and as such will sign off for our entire Team, in order to make the process as streamlined and painless as possible for all of our clients and our Admin Team. Thanks in advance for your understanding.

All the best from our team members.

Greg, Marion, Kenzy, Jed, Lili, Samantha, Dave, Tracy, Kelly, Sarah and Eddie

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