This Too Shall Pass

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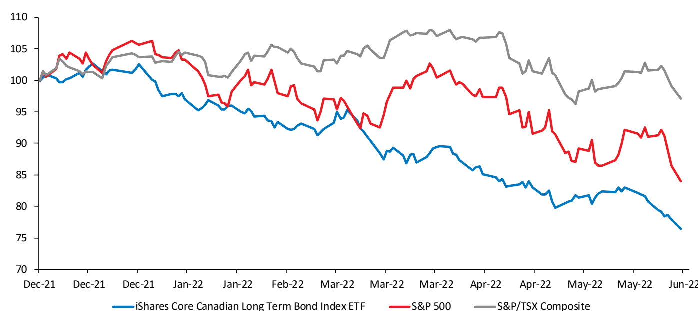
The S&P 500 falling into a bear market (down over 20%) has generated a number of worrisome headlines in the media. The proximate causes for stock weakness remain the same and will not surprise our readers: stubbornly high inflation, rising interest rates and fears of a sharp economic slowdown. It is worth emphasizing that the S&P/TSX has held up far better this year, and we expect this outperformance to continue given our market's high exposure to Basic Materials and Energy which are traditional inflation hedges. Canadian stocks' far more attractive valuation has also helped cushion the blow.

Bonds vs. S&P 500 vs. S&P/TSX – Advantage Canadian Stocks



Source: FactSet

While the fear of losing more money is an understandably strong emotion – and far more powerful than greed in our view – market history unequivocally tells us that liquidating after a substantial pullback is detrimental to long-term portfolio returns. Just to underline the point one more time, selling out of quality, dividend paying stocks after they have already declined substantially is the wrong thing to do. In fact, going back to the 1950s, the U.S. market has usually rebounded strongly after falling into bear market territory (up 15% on average one year later). This also holds true for fixed income securities; selling today means foregoing the expected future capital recovery. Despite the price depreciation as yields rise, there has not been any permanent capital impairment and investors holding good quality securities until their maturities should be made whole.

It is also worth reminding ourselves that with over more than a century of economic history, no matter the severity of the economic or financial problems faced, the stock market has **always** managed to recover and exceed previous highs, although much patience was required in certain instances (the 1930s, and the period following the financial crisis of 2008, for example).

So, what will it take for equities to stabilize and start moving up again? More confidence that inflation has peaked and that the trend is improving is probably the biggest potential catalyst in our view. We are not there yet, but at least North American Central Banks are now taking the issue seriously and raising rates to contain the damage. Even after seeing both the U.S. Federal Reserve ("the Fed") and Bank of Canada ("BoC") raise short-term rates, markets still expect multiple rate hikes before the year end.

The other potential catalyst would be more confidence in the U.S. and Canadian economies' ability to avoid a recession in the near future. While the odds of recession are not trivial, it is not our base case scenario either at this point. Helping from this perspective, BMO Economics believes there are two main reasons why the economy can continue to churn forward in the year ahead. First, business spending looks to remain solid as firms expand capacity to catch up with demand and amid flush finances. Second, consumer spending is expected to hang tough, supported by both pent-up demand for some hard-to-source goods (mostly vehicles), but also by still-hefty excess savings. The head of the Bank of Canada Tiff Macklem, adds that, "There is excess demand for labour. What that means is you can slow demand, you can reduce that demand for labour, and that reduces those unfilled jobs without actually putting someone out of work."

So, can the Fed and BoC engineer a so-called "soft landing" which lowers inflation while avoiding an outright recession? It has been a very tricky thing to pull off historically, but the Fed did manage to do it in 1965, 1984 and 1994. And, as noted by BMO Chief Economist Doug Porter, "Since the BoC tends to largely follow the Fed, and Canada's economy largely follows the U.S., we have very similar patterns of rate hikes and "soft-ish" landings." Probably the most dramatic example in Canada was also in the mid-1990s; rates went up by ~400 bps in about a year in 1994/95, and the economy avoided an outright downturn. We also had a similar episode to the U.S. in 1984/85. The bottom line is that it is not unheard of.

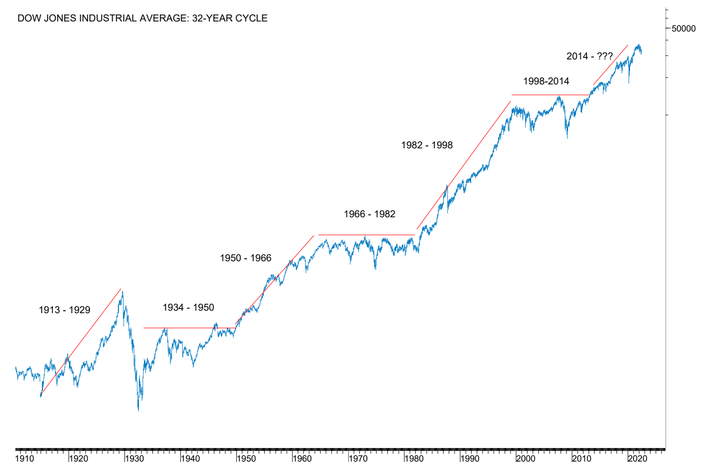
Being Selective

The silver lining is that over a long period, stocks have always been, and will remain the asset class of choice to help investment portfolios withstand the ravages of inflation. However, being selective in geographic, sector and company allocation is critical. In this environment we continue to emphasize quality companies with large competitive advantages which provide enough pricing power to offset their own cost increases and protect their profit margins. We strongly encourage investors to be especially sensitive to valuations (i.e., do not overpay for stocks) as there are still many technology/communications stocks which we consider overvalued despite significant declines.

Market Technicals

BMO Private Wealth Technical Analyst Russ Visch, notes that equity markets have come under a great deal of pressure in the past few weeks, and as negative as the price action has been, he believes we are finally seeing indications in our medium-term timing model that this cyclical bear market is very near to being over. As an example, weekly price momentum gauges for all of the major averages are now stretched into the deep oversold readings that only occur at major bear market lows. The same is also true for sentiment gauges, which now reflect deep pessimism across all segments of the market – also something that only occurs at the end of cyclical bear markets.

It's also important to note that the weak start to 2022 has had no material impact on the secular bull market we've been in for the past 8+ years, either. A long-term chart of the Dow Jones Industrial Average shows a very clear 32-year cycle (16 years of stagnation followed by 16 years of strong ascent) that's been playing out for more than 100 years in the Index. If this cycle continues to hold then the bias for equities should be firmly to the upside through the remainder of this decade (i.e., this cyclical bear market will prove to be the best buying opportunity since the pandemic low in March 2020).



Source: BMO Private Wealth Technical Analysis

While the environment could remain volatile for some time and more downside is possible, the key is to stay disciplined about the price paid for any assets and to maintain a well-diversified portfolio including cash, bonds, and high-quality stocks.

Please contact your BMO financial professional if you would like to discuss your investment portfolio.

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