Points in Time: Q2 2022

"Central banks are tripping over themselves to assure the market that they'll do whatever needs to be done to bring inflation in line, even if it means increasing interest rates to levels that will push economies into a recession."

What's next?

The first half of 2022 was one that most investors would like to forget. Oil, natural gas and some agricultural products were up over the period while almost everything else produced negative returns.

Nowhere to hide

Most investors have a mix of stocks and bonds in their portfolios. The diversification typically helps to ease the pain when one asset class turns in a negative performance. This year, so far, both stocks and bonds are down. This is incredibly rare.

In the last 94 years, the U.S. stock market (S&P 500) has only produced a negative return in any given calendar year 25 times. In all but two of those instances, U.S. investment-grade bonds posted positive returns. In other words, when stocks are down bonds are almost always up. Just not this year.

Where do we go from here?

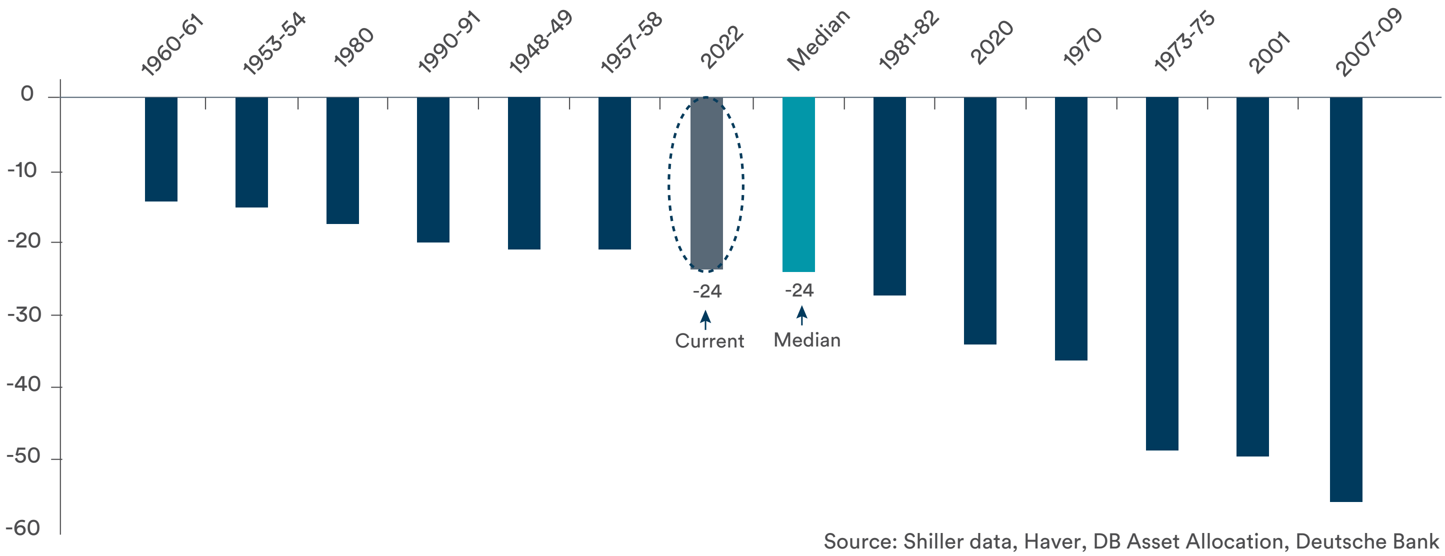
In our last quarterly commentary, we discussed how the outlook for 2022 was becoming increasingly hazy. The picture is clearing but not necessarily in a good way.

Central banks are tripping over themselves to assure the market that they'll do whatever needs to be done to bring inflation in line, even if it means increasing interest rates to levels that will push economies into a recession. Although not a foregone conclusion, many economists believe a recession is likely this year or next.

If economies tip into a recession, we will almost certainly see corporate earnings fall which is an additional negative for stocks. Also, the longer it takes for inflation to be reined in, the higher rates will likely go and the longer they will stay high. This would imply a longer recession.

The economists' view is increasingly becoming the common view. Of course, it's not easy to predict the future and

Figure 1: S&P 500 returns in post-war recessions (%)



Source: Shiller data, Haver, DB Asset Allocation, Deutsche Bank

forecasting what might happen since the pandemic has been a humbling experience. So, what conditions need to be present for the economy not to fall into a recession? It all comes down to inflation. The quicker we get inflation under control, the better chance rates won't rise to levels that will totally choke off economic growth. That could help ensure a soft landing.

There are many signs that the economy is cooling which should lower inflation. Consumer confidence is very low which should impact spending. Many commodity prices have come down from recent highs. For instance, lumber prices are down over 50% since March. It's a sign that rates are impacting housing demand which has been a big inflationary factor. Demand for many goods, which were inflation drivers last year, like motor vehicles, have also fallen dramatically.

What's priced in?

It looks like there's a case to be made that a potential recession could be relatively mild with the employment situation being a big pocket of strength. Currently, Canada's unemployment-to-job-vacancy ratio is 1.3 which means there are almost enough jobs for every Canadian looking for one. This is the most favourable number on record.

If we do have a recession, jobs will be lost but we've never entered a recession with an employment situation as good as the one we're in now. People with jobs generally pay their mortgages and spend money, which helps to keep the economy going.

In any case, a recession seems to be already priced into the market (figure 1 shows S&P 500 returns in each recession since WWII). At its worst point in the first half of this year, the S&P 500 was down 24% from its high which is fully in line with a typical recession.

Of course, things are changing rapidly and it will likely take until at least the end of next year for the economy, and perhaps society, to be somewhat back to normal versus pandemic times. Buying in a bear market (down 20%) has historically been a great investment over the long term, but it's not always the best in the short term. We'll only know that in hindsight.

Sources: FactSet, Fidelity, Bloomberg

CWB Wealth Management
Investment Team

Fixed Income

WATCHING

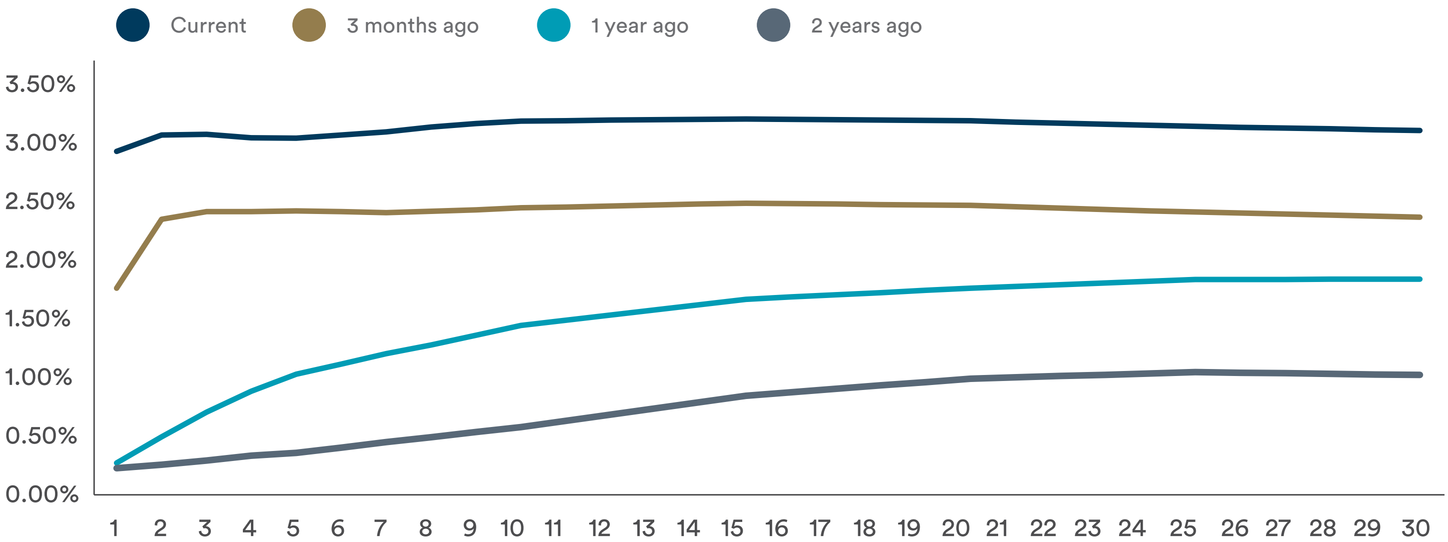
The first half of 2020 was tough for fixed income markets. Usually, bonds are a reliable port in a storm when equities fall, but not so far this year. The Canadian Bond universe was down over 5% on the quarter and over 12% year to date. Although it was expected that interest rates would rise this year, the speed and magnitude of the increase was not foreseen by most observers. For bond investors, it was a period to forget.

The inflationary effects of COVID-19 stimulus, supply chain disruptions and the Russia-Ukraine war continue. While it's uncertain how long the influence of these disruptions will last, central banks have made it clear that taming inflation is the priority. To do so, they're willing to sacrifice economic growth and employment. We expect central banks will continue to raise rates until there's real, lasting progress in bringing inflation down. If it's persistent, this could mean rate increases for the remainder of this year and even into next.

Investment-grade spreads have increased slightly over the quarter while non-investment-grade spreads increased more substantially. A potential recession would likely have a disproportionate effect on weaker companies as their cost of borrowing rises.

The yield curve has significantly flattened and is inverted at certain points. A flat yield curve is a signal of a slowing economy, while an inverted curve means we could see a recession (see figure 2).

Figure 2: Canada Curves – June 2022



Source: Bloomberg

"We expect central banks will continue to raise rates until there's real, lasting progress in bringing inflation down. If it's persistent, this could mean rate increases for the remainder of this year and even into next."

THINKING

The market is forecasting that the Bank of Canada overnight rate will end the year somewhere between 3% and 3.5%. That's a huge increase in a short period, given the rate was 0.25% at the beginning of the year. The 10-year bond yield is somewhere between 3% and 3.5%. The market believes inflation will be brought under control and that yield curve movement from here should be muted. If this is the case, bonds should be able to earn their coupons going forward.

Credit spreads have increased substantially year to date from unusually low levels. This indicates that markets seem to have already discounted a lot of potential bad news.

DOING

Although it's a struggle to find good value in federal bonds, they still have a purpose for risk control, so we're maintaining exposure in short-dated Canada bonds. We don't see a significant recession happening in the near term, and we're comfortable holding an overweight position in credit bonds.
Given our belief that most of the potential movement in the yield curve is already complete, we're maintaining a slightly underweight exposure to duration.

Sources: FactSet, Bloomberg

Malcolm Jones, MBA, CFA
Senior Portfolio Manager, Fixed Income

Canada

WATCHING

The more aggressive stance in rate hikes recently adopted by central banks has led to fears of a recession in the coming months, and investors have been selling stocks as a result. The Canadian equity market, as measured by the S&P TSX Index, was down 13.2% in the second quarter. Our portfolio was a relative outperformer in the quarter. The classically-defensive sectors, consumer staples and utilities, were relatively strong performers in the quarter. This shows concern about possible slowing growth going forward and investors moving towards these more earnings-stable areas.

On the energy front, we continue to see oil in excess of $100 per barrel. We've mentioned in the past that there's a supply issue side story, and we've yet to see significant investment in oil production from industry. Equilibrium at a lower price level will require significant demand reduction, which may be brought on by persistent high prices, combined with the effect of higher interest rates on consumer consumption. Recent weakness in energy stocks was a reflection of this concern, though they appear to be rebounding somewhat. The energy group was the strongest performer in Canada in the second quarter, being down only 1.9%.

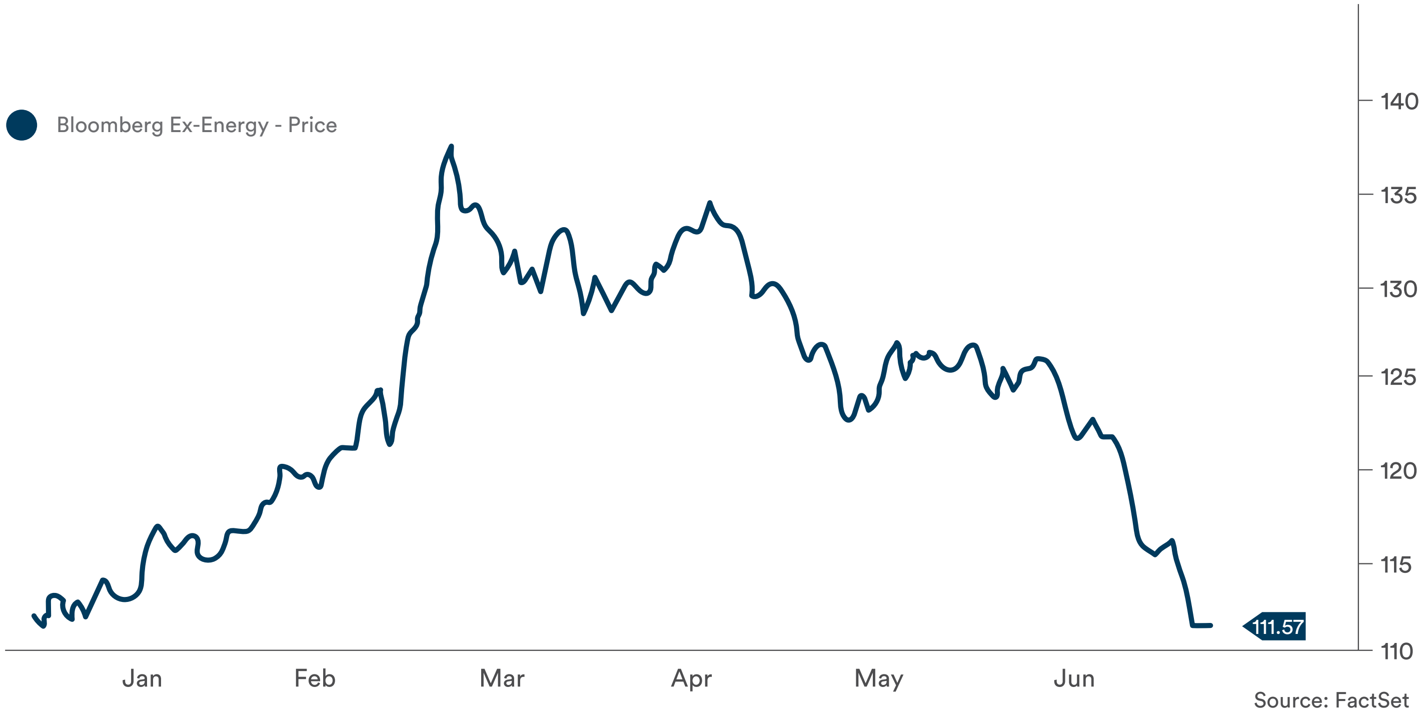
Most commodities outside of food and energy have pulled back recently, consistent with an overall slowing in the economy, or anticipation thereof. This is shown in Bloomberg's commodities index chart (see figure 3).

Information technology and health care were the weakest sectors, down 30.7% and 49.6% respectively. We avoided the worst of that, having no health care stocks in the portfolio, and holding Open Text within the technology space, which was down 7.7% in the quarter. Open Text is one of the few dividend-paying Canadian technology stocks, and we continue to like it long term.

THINKING

The mood within the equity space has changed considerably since last quarter. We're mindful of two things. The first is sentiment, which is driving the trading activity in the equity market at the moment. Market sentiment turned decidedly negative in June on the back of a surprisingly high inflation number. This happened very quickly. It's entirely possible that sentiment will reverse just as quickly, as a response to an unexpected positive data point or event. These reversals of sentiment are not forecastable, and it's important to be in the market when they happen.

Figure 3: Commodities index chart Year to Date



We must also bear in mind that, by nature, the data describing economic growth refers to what has already taken place. The equity market is forward looking and often looks beyond the latest data to where things will be in six months. It wouldn't be unusual for the equity market to begin rallying as weak economic numbers come out, especially if the weakness was expected.

DOING

We had a fairly quiet quarter with respect to portfolio trading activity in Q2. We remain cautious when markets are not trading on fundamentals. We saw several dividend increases in the quarter. The portfolio now has seen 20 of its 31 stocks increase their dividend this year. We're very happy with that and while the market may be correcting, we're being paid to patiently wait it out.

Sources: FactSet, Bloomberg

Gil Lamothe, CFA
Senior Portfolio Manager,
Canadian Equities

"It wouldn't be unusual for the equity market to begin rallying if weak economic numbers come out, especially if the weakness was expected."

U.S.

WATCHING

The current economic environment reminds us of Aesop's fable, *The Boy Who Cried Wolf*. Just as the wolf in the fable showed up eventually, so did inflation, surprising economic and market participants. Over the past 6 to 12 months, we saw the inflation narrative shifting from "transitory" to "higher for longer" to now "we need to tame it at any cost". It showed up when it was least expected, led by a confluence of factors. While many of these were unpredictable, one wonders how a decade-long underinvestment in resources and global supply chains went unnoticed.

Given all this uncertainty, it would be fair to characterize the first half of 2022 with the word "fear". We saw fear across asset classes and markets. The first half of 2022 marks one of the worst performances for the S&P 500 since 1970, with markets yielding negative 20% total returns for the period. Within equities, defensive sectors such as utilities, staples and healthcare have been the best performing sectors. The laurels for the worst performance were shared by consumer discretionary, communication services and the information technology sector. The economically-sensitive energy sector remains an outlier with about 32% returns on a YTD basis, while bonds, commodities and even crypto all ended in negative territory.

THINKING

In an environment where consensus is calling for a recession due to higher interest rates resulting from persistence of inflation, the odds of predicting any economic outcome with a degree of certainty are low. Our job, as stewards of capital for our clients, is to make decisions where odds are favourable and to act deliberately when the world around us seems to be falling apart. Our edge is in analyzing businesses thoroughly and taking advantage of prevalent fear by buying at lucrative valuations.

We're fully focused on how long-term economic prospects of businesses are impacted by the current environment. Figure 1 shows the earnings revision trajectory for the S&P 500. It's clear from the exhibit that more companies are starting to feel earnings pressure in the current environment, and the market seems to catching up to it. Averages, while great in certain aspects, can be deceiving, creating opportunities for investors like us. We don't believe that earnings for all businesses will be impacted equally and it's our job to find ones that will overcome the current environment and where the price is already discounting significantly.

DOING

During the quarter and first half of the year, our U.S. portfolio showcased resilience versus the S&P 500 leading to relative outperformance despite having no exposure in the energy sector. We give little importance to short-term performance and focus on investing to enhance the portfolio for the long run.

Taking advantage of the ongoing fear, we initiated a position in Aramark, one

Figure 4: S&P 500 Earnings Revisions Breadth

Source: FactSet, Morgan Stanley Research

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of the leading catering companies in the world, with a mid single-digit structural growth profile and operational turnaround potential. We exited our position in P&G and Republic Services as we deemed risk/reward to be more lucrative in other opportunities, and redeployed the capital in Costco, Nvidia and Microsoft. Overall, we continue to stay disciplined and focused on the long term by investing in high-quality companies at lucrative valuations which we believe will lead to superior returns for the portfolio.

Sources: FactSet, Bloomberg, Morgan Stanley Research

Liliana Tzvetkova, CFA
Portfolio Manager, U.S. Equities

Saket Mundra, CFA, MBA
Portfolio Manager, U.S. Equities

Q2 2022 Dividend Performance Summary

Canadian Dividend Portfolio

Number of companies in the equity portfolio	31
Number of companies that declared an increased dividend	20
% of companies that declared an increased dividend	64.5%
Weighted average of dividend increase	5.7%
Consumer Price Index Increase (YoY*)	7.7%
Equity portfolio dividend yield**	3.9%
S&P/TSX dividend yield	3.2%

Top 10 Dividend Growers

CANADIAN NATURAL RESOURCES LIMITED	27.7%
CANADIAN TIRE (NON VTG A)	25.0%
CANADIAN NATIONAL RAILWAY	19.1%
METHANEX CORP	16.0%
AGNICO EAGLE MINES LTD	14.3%
SUNCOR ENERGY INC	11.9%
INTACT FINANCIAL CORP	9.9%
BROOKFIELD ASSET MANAGEMENT CL A	7.7%
ROYAL BANK OF CANADA	6.7%
BROOKFIELD RENEWABLE CORP	5.3%

* Estimate from Statistics Canada May 31 2022
** The dividend yield is based on the Leon Frazer Canadian Dividend Fund using the target weight for cash

Source: Leon Frazer & Associates, June 30, 2022

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