THOUGHTS FROM HOME

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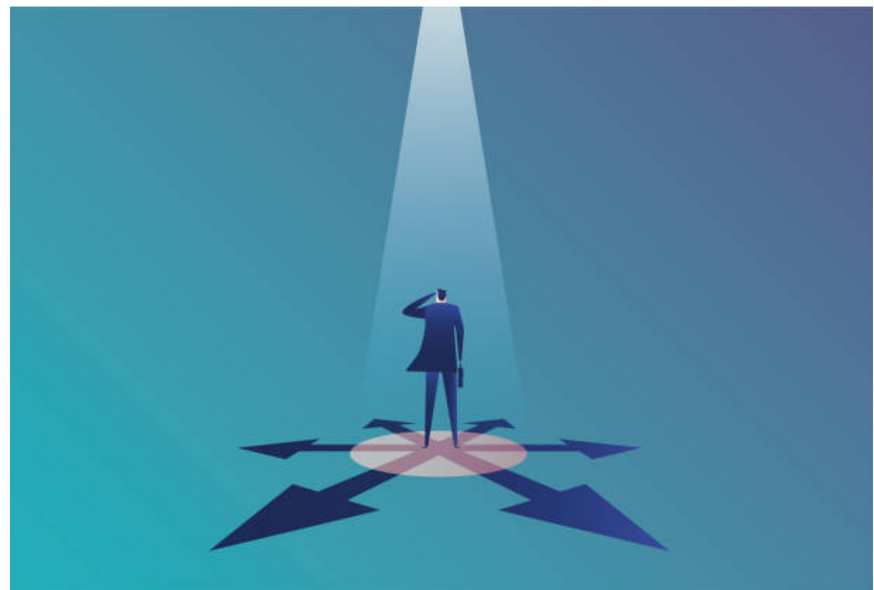

The Value of Uncertainty

"The future is never clear and you pay a very high price for a cheery consensus. Uncertainty actually is the friend of the buyer of long term values."
- Warren Buffett, Chairman, Berkshire Hathaway

Uncertainty in any aspect of our lives leads to doubt and worry, often leaving one frozen in a state of mental paralysis until a path forward becomes clear. As an investor, this paralysis can lead to missed opportunities. Warren Buffett

made a lucrative career out of taking advantage of uncertainty in the market, highlighted by extraordinary gains in the wake of the 2008 financial crisis. This month, we explore of the current uncertainty in financial markets to help us determine what challenges and opportunities lie ahead.

The greatest source of market worry over this past year has been the U.S. Federal Reserve's (Fed) efforts to curb inflation by raising interest rates. The market was unprepared for the size and velocity of the Fed's rate hikes. The uncertainty level was too high earlier this year as inflation was still rising. However, at the recent Fed meeting, Chairman Powell acknowledged that inflation was coming down and they were inclined towards a smaller 50 basis point rate hike for December. Why is this a positive? It means that while the inflation fight is not over, the Fed is closer to the end of its rate increase cycle. The Fed doesn't want to create a recession as this would be trading one problem for another.

The bond market's reaction was particularly interesting this month as traders became more certain of the Fed's intentions. Last month, the 2 Yr U.S. Treasury bond yield was 4.7% and the 10 Yr was 4.15%. The 2 Yr is now at 4.41% and the 10 Yr is down to 3.57%. From these figures, we can derive a number of positive conclusions for the market. With the Fed announcing another rate increase for December, we would have expected these yields to be higher not lower. This leads to two conclusions: 1) the market believes the Fed is almost done raising interest rates and 2) rates will begin moving lower sooner rather than later. The market is also sending a warning message to the Fed by steepening the inversion of the yield curve. In plain language, last month the 2 Yr yield was 55 basis points higher than the 10 Yr and now the difference is 74 basis points. Normally, the longer a bond is from maturity, a higher yield is expected. When this is not the case, as we stand currently, it is the bond market predicting a recession. By raising the 2-10 Yr yield spread, the market is telling the Fed that they believe the chances of a recession are increasing.

Inflation is beginning to ease as the supply and demand for goods and services comes back into balance. For October, the U.S. Consumer Price Index increased 7.7%. This was the smallest 12 month increase since the period ending January 2022. Food and housing remain the major concerns with the demand for travel and dining out still elevated and higher interest rates keeping housing costs up. The high point of this recent bout of inflation was 9.1%, so the trend lower is positive. The World Container Index, which tracks the cost of shipping globally, also continued to decline to $2,404 U.S. from $3,149 U.S. last month, down 75% from the March high. Even more promising was the Core Personal Consumption Expenditure Index, the Fed's preferred gauge of inflation, declined to 5%.

Despite the bond market's warning, it is difficult to imagine a recession in a country with record Black Friday holiday spending and an economy that added 269,000 new jobs last

month. There are layoffs in certain sectors of the economy, notably technology, but overall jobs are widely available.

Markets do not wait for conditions to be perfect. Over the last two months, we have seen the equity markets rally substantially. In November, the Dow was up 5.5%, the Nasdaq up 6.7% and the TSX up 4.8%. While U.S. markets are still down for the year, the momentum of the recovery is promising. While some headline technology names have remained weak, the broader market has generally performed better.

As we near the end of 2022, portfolio rebalancing could offset the effects of tax-loss selling as many institutional investors are underweight equities and hold too much cash. Analysts' will also soon give their earnings forecasts for 2023. Given this year's results and recession concerns, we expect downward revisions for most companies. This uncertainty surrounding earnings is actually a good opportunity for investors because if a recession fails to occur, next year's earnings could easily surprise on the upside and give the market another boost.

The Canadian market had a good month with banks, insurance and materials leading the way. Our portfolio holdings in Royal Bank, TD, Sun Life and Labrador Iron were all up over 5% for the month. Most notably, Royal Bank raised the dividend to $1.32 per share and announced its intention to purchase HSBC for $13.5 billion. Canadian bond yields also declined as the Bank of Canada raised interest rates by 50 basis points last month and seemed more likely to stop further increases sooner than the U.S. We have not seen the preferred share market rally in a meaningful way yet but we expect this to happen as interest rates begin to fall.

Uncertainty definitely benefits the U.S. dollar as the world's reserve currency. The good news is that the U.S. Dollar Index which is the measure of the dollar against a basket of major international currencies, was down over 5% last month suggesting global investors are growing more confident. We don't want the U.S. dollar to fall too quickly versus the Canadian dollar as this hurts our returns on U.S. stocks, but with the Canadian government raising interest rates at a slower pace than the U.S., our currency should stay in a fairly narrow trading range.

Another change to the portfolio was made as we sold out of TradeDesk for capital loss purposes and added Halliburton in its place, which is a leading global oil field services company. With global demand for oil and gas expected remain steady for the next few years, Halliburton's, combination of dividend income and option value are expected to generate the positive cash flow we are looking for in the coming year.

Uncertainty in the market with unexpected events such as the Ukrainian invasion and Covid, place unexpected stress on our investments. However, by sticking to our investment plan, we can overcome these challenges with patience and discipline. As one year ends and another begins, we will continue our pursuit of long-term value opportunities as Mr. Buffett advised.

On behalf of the Cooper Wealth Management team, we wish you, your family and friends good health and all the best of the holiday season.

As always, questions, comments, concerns and feedback are always welcome.

Yours truly,
Trevor, Walter and the Cooper Wealth Management team

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