Market volatility and the path forward

Mark Bayko:

Hello and welcome to an audio recording for RBC Wealth Management. Today is Monday, October the 17th, 2022. My name's Mark Bayko, and I'm head of the Portfolio Advisory Group in Canada. We are now more than three quarters of the way through what is turning out to be a challenging year to say the least. To help us think through the current situation and the outlook ahead, I'm joined today by Jim Allworth, co-chair of our firm's Global Portfolio Advisory Committee. Jim, thanks for joining us today and let's get right into it.

When thinking about the global economy, there seems to be mounting evidence things are slowing down, and in many ways, that's something investors and policymakers have wanted to see in order to get inflation under control. And so the talk of a potential recession continues to grow to the point where it now seems to almost be the consensus view. And I'm just wondering, is it really that simple, and is this really a foregone conclusion at this point in your view?

Jim Allworth:

Sure, Mark. Well, I guess I'd say it probably is my view, and I would just, at the risk of putting people to sleep, I would just say our approach has been the same for a long time. We watch for recessions, especially U.S. recessions. We like to see them coming ahead of time. We do have some things that have done a good job of telling us ahead of time a recession is coming. Two of the most reliable of those have flipped in the last few months and are saying now that a recession is on the way. They both have outstanding track records. In other words, they're not very often wrong, if ever, and they usually give you some long lead time.

The two of them, just so you know, are the yield curve. That's the relationship of short rates to long rates, and the normal situation is for short-term interest rates to be lower than long-term interest rates. When they rise above long-term interest rates, that's abnormal, and it indicates credit conditions are tightening or are about to tighten, and that happened back in July this year. That's called inversion of the yield curve, when short-term rates move above long rates. Inversion happened in July.

The second one is the leading indicator of The Conference Board in the United States, which looks at 10 different things and uses them to compute a leading indicator of the U.S. economy. And when it goes negative, in other words, when it falls below where it was a year ago, a recession has always been on the way, and it went negative in September. And both of them would point to a recession arriving somewhere between the second quarter and third quarter of next year if they kind of followed their normal path. But that normal path is an average in each case. In other words, we look at all the examples of yield curve inversion and look at how long from there till the point that the recession arrived, and the average time is 11 to 12 months. And for The Conference Board leading indicator, the average time is two to three quarters.

But averages mean that there's some instances that things happen faster than that, and some instances where things happen slower than that. You're not going to know till you're through all this which pertains. But the fact that they lead is interesting because something happens, and let's put it... The inversion of the yield curve happens. People talk about it, there's a lot of discussion about it, people worry about it, and usually for quite a number of months afterwards, the economy keeps doing okay. And then the question arises, well, was the yield curve wrong this time? It seems like the economy's okay. And then kind of somewhere out there you get your head handed to you because suddenly the economy weakens under the burden of the tight credit conditions that the inversion of the yield curve was telling you were coming. And by tight credit conditions, I mean, one, high interest rates, which we've already got and are getting more of, and two, banks becoming unwilling to lend or more choosy about who they lend money to, and there's a lot of discussion about that out there too.

So tight credit conditions eventually turn the economy over and put it into some period of contraction or recession, and I have no reason to expect that this time is going to be different. The question is when, and as I said, the averages point to the middle of next year. So I guess one has to acknowledge there can always be a first time where those things that have signaled recession in fact turn out to be wrong and the recession doesn't arrive, and I'm certainly open to that. But so far, there's nothing in what's going on that somehow really suggests that.

Now, the one thing I would say is that of course part and parcel of all this is tightening by the Federal Reserve and the Bank of Canada, and other central banks around the world, and it's almost always the intention of central banks to tighten enough to take away inflationary pressures and reduce inflation, which they have deemed to be too high, that's why they're raising rates in the first place, but not to raise rates far enough to create a recession. And in fact, the Fed has been able to do that more often than not. I think when we looked at it, there were 17 Fed tightening cycles since the early 1950s and nine of them produced soft landings, no recession, and eight of them produced a recession. So it's possible, the Fed has a track record that says one shouldn't rule out the possibility they may be able to stop tightening soon enough and maybe introduce cuts soon enough to avoid a recession outright and get a soft landing. But the yield curve experience, which is somewhat different, says that that's very unlikely because yield curve inversion has always preceded a recession.

Mark Bayko:

Great. Thanks. Thanks for that, Jim. If we switch to the markets and focus a little bit on a few asset classes, it certainly looks like equity markets are behaving as if a recession is on the horizon with markets really around the world having been under pressure this year. Bond markets on the other hand, have been even more interesting in my view, and are giving off somewhat conflicting signals with spreads widening, but also bond yields being quite elevated despite the fact that equity markets have been under the pressure they've been under. So I'm just wondering, what do you make of the recent behavior we've seen between equity markets on the one hand and bond yields on the other hand?

Jim Allworth:

Well, I think people give too much credit to the market as a predictor of future things. So people are convinced that the stock market has come down because it sees a recession coming. I'm not sure that's correct. There are a few things that don't jive in all this with how the market would normally behave if what it was doing was predicting a recession. I'll mention just two of them.

One of them is that there was no disconnect between breadth of the market and market performance. And by that I mean we had a market that moved up all through last year, right up till December, January of this year, into January of this year. And measures of breadth, in other words, are most of the stocks in the index doing what the index is doing, in this case going up? Or is some significant fraction of the index doing worse than that, and it's just a few maybe heavyweight large capitalization stocks that are driving the index higher and the bulk of stocks are not participating?

Well, the answer to that is that breadth was marching in lockstep with the market. The market was going up and most stocks were going up. It wasn't just a few stocks carrying the market higher, it was the majority of stocks were participating and going higher. That's usually not what happens if the next peak in the market is the peak before a bear market starts. Usually, before a bear market starts, breadth gives up the ghost, and more and more stocks are in down trends even though the index is going up, and indeed the index is being carried higher, usually by just a handful of heavyweight stocks that are big enough to drive the index higher, while the majority of stocks have already turned into down trends. Well, that didn't happen this time. They were in lockstep together till the final day, if you like. Usually breadth gives up the ghost four to six months ahead of time, and there was no sign of that happening.

The second thing is that the peak in the stock market usually comes after the yield curve inverts, usually three to six months after the yield curve inverts. The yield curve inverted in July of this year. That would suggest there should have been a peak in the market, a new high in the market somewhere between September and December of this year or maybe even January. Well, in other words, the decline we'd been in and the peak we saw back in the first of the year wasn't the peak for the cycle. That still lies ahead. And I have some sympathy for that view because if you just stand back from the stock market here for a while and look at what happened, it's a stretch to call what we've been in a bear market.

From the bottom of the pandemic panic to the top of the market at the end of last year, the beginning of this year, the S&P 500 rose 120% in value. That was 21 months. In the stretch of 21 months, it more than doubled. It went up 120%. The TSX over the same period of time went up 100%, no slouch. The TSX did very well. In the nine months since, the S&P 500 has given back about half of the points it gained. Not quite, actually. Not quite half of all the points it gained in that period. The TSX has given back not quite a third of all the points it gained in that period. If you just looked at that kind of pattern up for 21 months, down for nine months, giving back somewhere between a third and a half of what was gained, that sounds an awful lot like, first, a strong bull leg in the market, followed by a pretty ordinary correction or consolidation when you kind of digest those gains for a while. It's a stretch to call it a bear market.

And so I would say that at least one has to at least leave on the table the possibility that over the next few months we might see a rally in the market that gets us back close to the old highs, maybe even beyond the old highs. And one of the things that I think fits in that is that there's a tremendous amount of pessimism in the market. What's really happened in the nine months is attitudes have changed. We've gone from people being complacent and imagining that things were going to continue the way they had, and that this is the way markets normally behaved and not to worry about it, to one of where great concern is out there.

There's huge negative sentiment both among investors and among the observers of the market. Both of them are hugely negative at the moment compared to what they'd normally be. And usually that kind of unanimity of pessimism just doesn't sustain itself for very long. And so it's not out of the question to imagine that given a reason or two to turn, that the market could easily turn on us here and give us quite a strong move back up towards those old highs. But I would still leave in place, whether that happens or not, I would still leave in place the idea that if a recession is coming, and we think it is, that at least through the first part of a recession, the market struggles. And so, volatility out through into the middle of next year and maybe right through next year can't be ruled out.

As for the bond market, well, we are usually in the position of recommending to our clients a balanced approach to investing. And balance usually is a balance between equities and fixed income. And the fixed income is kind of there for two reasons. One, because as fixed would imply, maybe it's the wrong adjective in this case, but it gives some ballast to the portfolio, it takes some volatility out. The fixed income investments are usually not as volatile in price as equity investments, and they give a portfolio some staying power to own equities and own them for the long-term knowing that there's some part of their portfolio that isn't going to be subjected to the strong ups and downs that equity markets very often are.

The second thing that fixed income provides is income. And very often, it's the income from the fixed income portion that satisfies a lot of the income needs of an investor or a client. Well, what we know is that we went through a period where the income part was pretty skinny. Central banks had driven short-term interest rates down to the floor. They'd introduced quantitative easing to buy bonds in large amounts that drove long-term interest rates down. It was like holding a beach ball under underwater. And during that period when the Federal Reserve and the Bank of Canada, everyone else was keeping interest rates extremely low, there was very little income being generated by certainly new investments on the fixed income side.

Well, that's changed, and we've seen bond yields move up, and now it's possible to have bonds in a portfolio and actually have some decent income from them, and that's quite a change. And I think it reintroduces the idea of fixed income as a worthwhile component of the portfolio. They're not only going to provide you with less volatility in all likelihood for this juncture, but also better income than you've seen in a number of years. So I think fixed income is worth looking at, especially when I see an environment where economic difficulties are not likely to be over for a while.

Mark Bayko:

Thanks for that. And maybe we could finish along similar lines. Just it feels like every year that goes by, the world, and investors for that matter, seem to get very increasingly short-term focused, which is understandable, but investing should require a timeframe beyond the next year or two. So how would you encourage investors to look past what's happened this year, to look past the recession talk and think about their investment timeframe and the prospects for returns over time?

Jim Allworth:

Sure. Well, I think you've really described it in a way, and let's take your view off the short-term and look at the long-term. The discussion almost always becomes one of the short-term. Our discussion in this call up until now has been almost completely, really, the short-term. Last year, this year, maybe next year, but that's the short-term. And everyone feels obliged to talk about it, and I guess I do too, and it almost makes it sound like I know what I'm talking about. But I can assure you, the reliability of my view of the short run is not something you would want to bet the farm on, and certainly I wouldn't. And I don't think I'm the exception of the rule here. I listen to other people talk about the short-term, and in my view, their views are questionable.

The long-term lays itself out for us very nicely and we can go back and look at it. It's just that for whatever reason, it doesn't inspire the same sort of attention from people, but here is what it really looks like. Over a long period of time, the economy grows, and it grows remarkably consistently over time. And even allowing for the fact that occasionally there's recessions when you go through a period of one or two or three quarters when the economy actually shrinks, when you stand back a little bit from that, those periods barely show up in the long-term progress of the economy. And as the economy grows, so grow corporate earnings. They grow at a very similar pace.

And corporate earnings are the determining factor for what a company is worth. And so in the large scale, what the market is worth. The market just being a collection of businesses and the most important businesses for the most part. And their earnings, quite understandably, grow in line with the economy, and their values grow in line with their earnings. So you have this long period where the value of the stock market driven by those things I just talked about has moved higher steadily, certainly since the end of World War II, and you can go back further than that if you choose to.

Well, when you look at that, when you look at anything that's climbing over time, what you find is that it spends more time going up than it spends going down. And you could kind of eyeball the market here and you could say the market looks like it advances for three or four or five years usually, and then it gets interrupted by a recession or a slowdown in the economy and slowdown in earnings and slowdown in investor confidence, and it checks back for a year or so, usually not much longer than that, before it gets going again for another three, four, or five year run on the upside.

So one observation would be probably you want to spend as much time in the market as you can, and one of the reasons you want to is that businesses that are good enough to make it into the S&P 500 or the TSX 300 tend to have very high internal rates of return. They're strong businesses, they've been around a while. They usually have some sort of a franchise in the broader sense that they operate in that it's hard for other people to compete with them, and as a result, they're able to grow their values at high internal rates of return that otherwise would not be available to people.

The return on equity of the average company of the S&P 500 is somewhere between 11 and 13%. And the TSX, the average return on equity is somewhere between 10 and 12%. And as the owner of those businesses, the internal intrinsic value of that business is sort of compounding at that kind of a rate for you, and that's a wonderful investment, especially when you see that compound and continue over time. So I saying that that world hasn't changed, we can have a debate about how fast the economy's going to grow over the next decade or so and how fast earnings are going to grow and hence what the returns are likely to be, and that debate is worth having. But it seems to us highly likely that the growth rate is going to be a positive one, and that the best way to capture the growth in the economy is going to be by owning businesses for as long as possible.

So I feel it's a good idea to alert people when the things that we look at tell us that the economy's going to go through a rough patch. Forewarned is forearmed. And it may be that that requires some adjustments to portfolios be made for a whole variety of reasons. But generally speaking, whatever the problems of the economy and the market in the coming year, we would expect that we'll be past them in that period, and the market, which by the way, usually turns around before the economy does, will be moving higher once again. So I'm certainly optimistic about the future described that way, but I'm also pretty convinced that the economy still has some troubling moments ahead of it between now and the end of next year.

Mark Bayko:

Great. Look, why don't we end on that note just in the interest of time. Jim, thank you for sharing your thoughts, and I look forward to doing it again in the not too distant future. And thank you to everyone for taking some time to listen to us today. If you have any questions or feedback, please reach out to your advisor at RBC Wealth Management. Thank you and have a great rest of your day.

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